The e-grocery challenge: Moving toward profitable growth

Winning online was a priority for growth in grocery retail even before the onset of the pandemic. Now, with the increased customer penetration and intent to stick to buying online, e-commerce acceleration and profitability have turned into top priorities for many European grocers.

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+ Interview with Per Strömberg on page 74

Gaining market share in grocery retail in the past few years has increasingly been linked to winning online. Before the onset of the pandemic, online business models were the primary growth driver within grocery retail. In the United Kingdom, for example, between 2015 and 2020, online accounted for more than one-third of the industry's growth. Now, with the changes brought about by COVID-19—high online grocery penetration levels and customers' stated intent to continue to do their shopping online—e-grocery is the new imperative. The results of our grocery retail CEO survey (see chapter 2) underscore this: respondents see the scaling of their online businesses as a top priority for 2021 and beyond. Many retailers are currently investing in their online business to gain a larger share of customers' wallets and stomachs. In this game, they are up against pure online competition, as well as against alternative business models, such as meal-kit providers and meal-delivery platforms—business models that are often much more highly valued by investors due to their high growth expectations.

At the onset of the COVID-19 crisis, customer demand grew rapidly within just a few months. Some grocers, such as Tesco in the United Kingdom, were able to quickly react and meet the demand, and thus their online share of sales expanded by up to 15 to 20 percent. Many other retailers, however, faced capacity and execution constraints in trying to fulfill the rising demand, often causing a poor customer experience. While consumer research indicates that the recent change in demand is likely to persist at least in part, stickiness unsurprisingly is highest among customers with a satisfactory experience. Grocers acting decisively now to offer satisfactory propositions and experiences aimed at gaining share and creating loyal customers will likely reap the rewards.

As the online channel has matured, grocers have diversified their online value propositions to cater to or shape customer expectations. Offerings now extend beyond the classic home delivery of families' weekly groceries to address different customer segments, needs, or shopping occasions through instant grocery delivery, fresh ready-to-cook, meal delivery, and the like. Just as in the offline world, a differentiated online value proposition is crucial—especially given that in more mature online grocery markets, winners tend to capture a large share. Incumbent grocers that are not in a position to feasibly invest in their own winning online business are increasingly opting for partnerships with ecosystems or for M&A with pure players and start-ups (for example, Monoprix, DIA, and others partnering with Amazon; Morrisons and others partnering with Ocado; Reitan partnering with Kolonial.no; Carrefour investing in ecosystem expansion with the acquisition of stakes in Dejbox and Quitoque; and so on). Strategic moves like these allow grocers to test new propositions, accelerate time-to-market, and benefit from their partners' capabilities in the online game.

Reaching profitability in online grocery, even only at basket level before central cost, has always been a challenge for retailers. Compared with store-based business, which mostly proves profitable also after depreciation and interest, even leading e-grocery players have struggled to be profitable, particularly while generally chasing expansion. To increase capacity and stay competitive, grocers need to continue to invest in operational infrastructure, technology, and so on. This ongoing investment makes it difficult to improve profitability, even over time. Key value drivers that grocers can optimize include average order value and frequency through their commercial offer (for example, assortment, price, personalization, and delivery fees). Media monetization can be an additional source of income. Beyond that, grocers need to optimize operational and delivery costs (Exhibit 1). Given the current market dynamics in which grocers are reaching substantial online shares, cracking online profitability over time is essential.

With increasing scale and retailers more systematically addressing optimization levers, more profitable online grocery models have started to emerge—at least for ramped-up businesses. According to Tesco CEO Ken Murphy, the company is aiming to move closer to parity in terms of operating contribution from online and offline, which he defined as a realistic possibility in the "foreseeable future" in a recent analyst call. Partnership approaches also often aim to improve economics—for example, through generating sourcing advantages or benefiting from better drop density in crowdsourced last-mile operations for instant delivery models. Finding a way to win share online while building a profitable business model is going to be one of the key challenges for many grocers going forward.

Three pathways to profitability

With the current online outlook characterized by high customer penetration and likely sticky demand, players are pursuing different strategies to try to achieve both growth and higher profitability or even profit parity. At the same time, common themes keep resurfacing—such as differentiating customer value propositions; optimizing and automating the "operations system"; and implementing cutting-edge digital, analytics, and tech tools and capabilities, often enabled through ecosystem partnerships. Overall, there are three key types of players that are currently dominating online grocery:

1. Online pure players

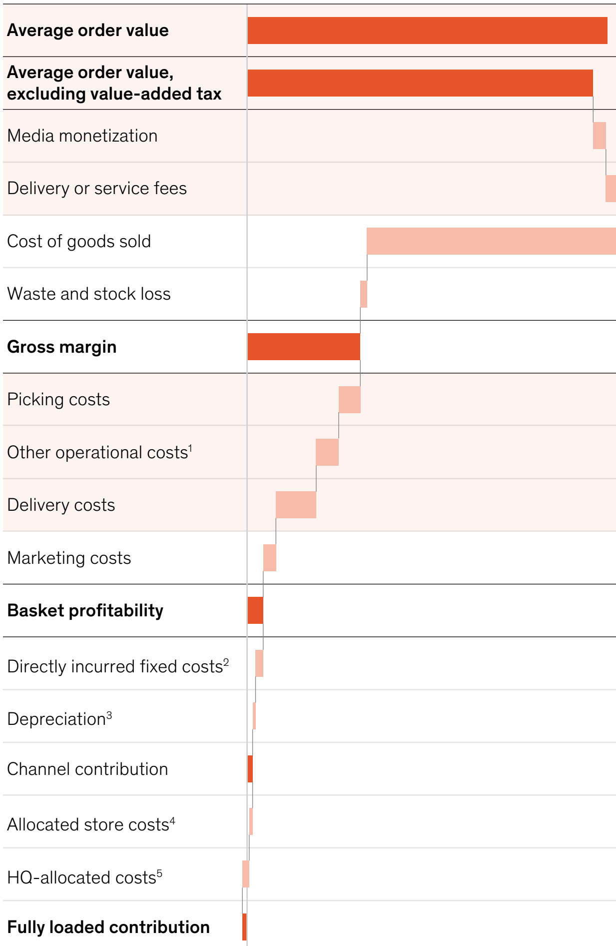
Online pure players often provide highly tailored customer value propositions, such as value-focused assortments and service levels, fresh meal kits, or farm-to-table concepts. They do not face the same limitations as offline retailers, which are often bound by the need to maintain certain levels of consistency in pricing, promotions, and assortment across channels—or by the need to deal with legacy systems and infrastructure. Leveraging digital and analytical approaches, tools, and capabilities in their workforce, pure players typically put a focus on differentiating and personalizing their customer experience to achieve higher conversion rates, larger basket sizes, longer-term loyalty, and—ultimately—greater customer lifetime value. Leading pure players often deploy modern technology throughout their supply chains to optimize fulfillment and delivery costs (for example, through microfulfillment centers or optimized last-mile vehicle deployment). While staying light in assets and overhead compared with store-based competitors, pure online players seek out purchasing and logistics partnerships to benefit from scale effects.

An example of a leading pure player is Picnic, a Dutch no-frills online grocer that provides its customers with a user-friendly app combined with competitive prices, a low minimum order value, and no delivery fees. Drawing on advanced analytics and a fit-for-purpose technology stack developed entirely in-house, Picnic optimizes order preparation and last-mile logistics. The retailer increases efficiency through a targeted assortment, warehouse automation, and a milkman-run logic where electric delivery vehicles only visit a given area once or twice a day to increase the density of deliveries in the last mile. A new partnership

Exhibit 1

Online grocers can leverage key drivers, such as operational and delivery costs, to create value.

Structure of basket economics, excludes sales cannibalization of other channels



Key value drivers, typical cost as % of sales in stock-up proposition

Average order value
Key to cover fixed cost per delivery; under pressure through more frequent purchases, lower delivery fees, subscription models, etc; can be pushed with dedicated measures—from assortment, pricing, and promotions over minimum order value and fees to personalization and enhanced user experience

Media monetization, >3–5%
Additional source of income that flows directly through to bottom line; includes supplier bonuses for online, as well as monetization of data and advertisements

Delivery or service fees (or subscription income), ~2–4% for fees
Flows directly through to bottom line and can boost size of basket if linked to order value; in many markets, decreasing due to subscription offerings and competition for low-fee delivery players

Picking and other operational costs,[1] ~11–14% (store picking, excluding inbound)
Major cost item; can be optimized by choosing optimal fulfillment model for local demand level (eg, automated fulfillment centers), as well as operational excellence in all processes and system support; operational cost lower in automated models at expense of higher capital expenditures

Delivery costs, ~10–13%
Major cost item; can be optimized by operational excellence in loading and unloading processes, route optimization, and vehicle design, as well as by smoothing and increasing density of demand (eg, through dynamic slot pricing or a milkman-run model)

[1]Includes credit card commissions, contact centers, replenishment, inbound supply chain, and consumables.
[2]Includes directly incurred store costs, IT, and e-commerce teams.
[3]Depreciation includes depreciated capital expenditures for online-related investments, such as website build costs and equipment.
[4]Includes utilities, back-room use, and other costs that would be incurred with or without the online business but are allocated to online.
[5]Includes items such as central office costs, central IT costs, and pension funds.
Source: McKinsey analysis

Incumbents can learn from ecosystems to take an omnichannel approach to customer-lifetime value creation—driving customer loyalty across channels and ensuring services and products that matter.

with German supermarket leader Edeka has been signed with the goal of optimizing product-sourcing costs.

Incumbent players can learn from pure players both to focus on differentiation toward customers and to align operations with their value propositions (for example, by reducing the number of delivery windows if the proposition is not focused on convenience of delivery). Moreover, incumbents could consider entering partnerships with pure players to de-risk their business models, reduce investments, leverage external capabilities, or scale. These include partnerships with crowdsourced or gig-economy delivery platforms (such as Deliveroo or Uber) for instant-delivery or meal-delivery propositions—such as those recently set up by several UK grocers, including Morrisons, Co-op, and M&S, and also by discounters including ALDI. The platforms aggregate demand across retailers, and via crowdsourced drivers, they operate at costs that retailers are not likely to attain on their own.

2. Ecosystems

Many online giants have added grocery to their ecosystems and are using customer data from across their offerings—such as nonfood, payments, and social media—for optimization purposes. For these players, their grocery divisions do not necessarily need to be profitable as stand-alone businesses; instead, the grocery operation supports the overall profitability of the ecosystem by securing daily traffic and engagement on the platform, thereby boosting loyalty and customer lifetime value and allowing for different, new revenue models, such as media monetization.

The Chinese ecosystem Alibaba has been focusing on convenience for customers across channels as it offers instant omnichannel shopping across categories. Through its Hema retail-store format—part tech-enabled supermarket, part distribution center—customers can order groceries on their smartphones and either pick up their purchases or have them delivered within 30 to 60 minutes, depending on location. Alibaba's logistics arm and payment solutions enable this service. In fall 2020, Alibaba acquired from Auchan the majority stake in Sun Art, with approximately 500 hypermarkets in China, to further strengthen the group's offline presence. Across its many companies, offerings, and channels, Alibaba is thus optimizing customers' total lifetime spending on the company's products and services.

Amazon also took its grocery offering to the next level through its acquisition of Whole Foods in the United States. The deal not only expanded Amazon's sourcing capabilities but also allowed it to more deeply understand the customer food journey and provide customers with omnichannel offerings through Whole Foods' physical stores. The company also continues to expand in Europe—most recently with the introduction of Amazon Fresh in Spain and a deeper partnership with local player DIA. In all geographies, the Amazon Prime loyalty program connects grocery and nongrocery platforms, while Amazon's data, analytics, and e-commerce capabilities are being applied to improve the food journey. Amazon is also experimenting with tech-enabled offline formats, such as Amazon Go (physical stores with entirely automated checkouts) and the recently opened physical Amazon Fresh stores in the United States.

Incumbents can learn from ecosystems to take an omnichannel approach to customer lifetime value creation—driving customer loyalty across channels and ensuring, likely with partners, the addition of services and products that matter to them (for instance, seamless checkout and payment). To capitalize on loyalty, cutting-edge digital and analytics capabilities are prerequisites. Several incumbents have chosen to enter partnerships with leading ecosystems to create an online route to market or provide a specific proposition. The partnerships bring scale, infrastructure, and capabilities that the retailer would otherwise likely take years to build. However, fully owning customer data or ensuring the extension of loyalty to stationary stores can turn out to be challenging in these partnerships.

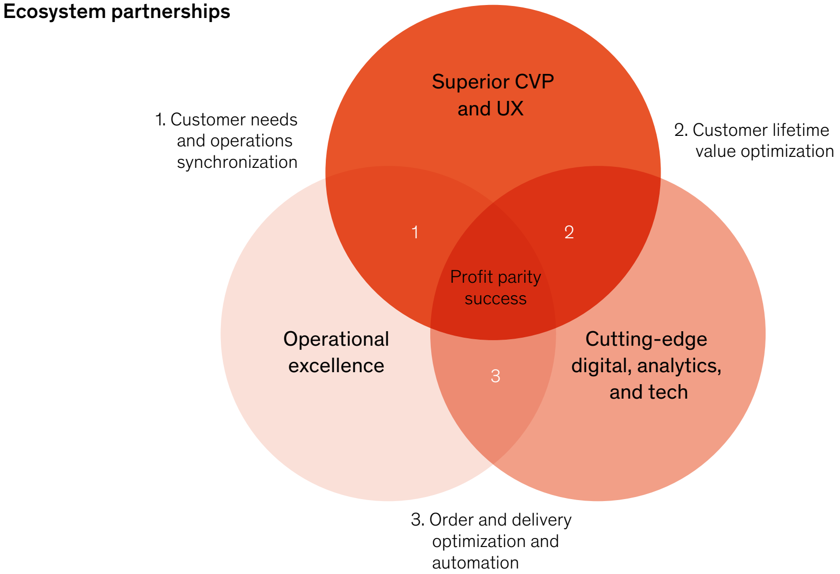
3. Own play by traditional retailers

Incumbent retailers with their own online offerings are striving to accelerate their e-commerce businesses and reach profit parity. They are currently transforming their businesses across many areas and making multiyear investments to improve and increasingly automate their operating systems and technology. Those that want to play an active role in the online game often start by rethinking the value propositions that they bring to customers. We have seen grocers optimize their online assortments in terms of size, private-label penetration, and (ultra-)fresh quality. We have also seen them increasingly decouple pricing and promotions from online and the store-based business, given the direct impact on profitability—while at the same time trying to leverage offline assets for services like click and collect. Many grocers are doubling down on customer experience, for example through basket-size personalization or by rewarding loyalty via subscriptions or specific programs. In addition, they generate further income from online supplier bonuses or from monetization of digital assets to advertisements.

Traditional retailers are also reimagining their operating systems—in particular by optimizing their networks, order preparation models, and last-mile mix—given the importance of those systems as cost drivers. To ensure future capacity and maximize profitability, grocers must set up an operational network that fulfills the forecasted demand and service-level mix in a region at the lowest total operating cost. The right level of automation can make a large difference. For example, grocers can elevate picking productivity from an average

Exhibit 2

For profit parity to materialize, several drivers across three domains need to come together.



Customer value proposition (CVP)
- Mix of propositions
- Basket size push (eg, price, promo, and assortment)
- Frequency push (eg, delivery fees, minimum order value, loyalty, and subscriptions)

User experience (UX)
- Mobile first
- Personalization

Fulfillment
- Excellence in warehouse operations (processes and advanced analytics)
- Automation (eg, robotics and microfulfillment)

Delivery and last mile
- Excellence in delivery operations
- Fleet and contract optimization
- Dynamic routing optimization

Network optimization

Other costs
- Overhead and organizational efficiency
- Direct and indirect procurement

Media and data monetization
- Digital assets
- Vendor allowances, bonuses, etc
- Advertising

Digital and analytics
- Omnichannel vision and incentives
- Prioritized use-case road map
- Digital and analytics talent and data platform
- Agile, product-led ways of working

Marketing
- Spend mix on customer acquisition vs retention
- Spend mix across media

Technology
- Stable and flexible backbone
- Omnichannel architecture

Source: McKinsey Analysis

of 100 to 150 picks per hour (for picking in-store) to up to 500 to 800 picks per hour at automated stations in microfulfillment centers. If volume and utilization are high enough, this can improve operating cost by two to five percentage points of earnings before interest and taxes (EBIT) margin or more, depending on the starting level. For the last mile, grocers are optimizing vehicles, processes, and routing systems and are also actively steering delivery slots to shape demand to gain efficiency—often together with partners. Leading grocers across the world are piloting solutions and making investment decisions now, given the long timelines for implementation.

Managing the online transformation effectively

To win the growth and profitability challenge in online grocery, retailers need to commit to a deliberate and transformative approach that ensures differentiation and optimization of customer lifetime value as well as cost. As discussed, three domains need to be successfully addressed for an effective online transformation (Exhibit 2):

Superior value proposition and user experience. Grocers need to define the right mix of customer value proposition(s) and create a superior user experience that drives customer lifetime value across channels.

Operational excellence. Players need to ensure the most productive fulfillment and delivery of customer demand in an optimal network that is adapted to (future) demand density and service levels. Decisions on partnerships need to be made sooner rather than later, as the race for capacity and partnerships is on.

Digital and analytical capabilities and operating model. Retailers must deploy cutting-edge technology and analytics to differentiate their value propositions and ensure maximum automation of their operating systems, which requires ongoing investment over the coming years. Grocers also need to build native digital and analytics capabilities in their workforces and introduce agile, product-led organizations that work cross-functionally. The monetization of core (data) assets or technology adds new income streams.

Online grocery is an exciting, high-growth business field in which incumbents and disruptors are currently moving head-to-head in the race to cater to increasing customer demand. To establish profitable business models, they will need to adapt their operating systems end to end, and they need to be ready to invest. Further transformation, technological innovation, and new partnerships are highly likely to emerge, as these will be drivers of profitable growth going forward.