AlixPartners

HONEY, I SHRUNK MY MARGINS

HOW TO AVOID FINANCIAL RISK FROM INCREASING ONLINE GROCERY SHOPPING

Ongoing social distancing measures made necessary by the COVID-19 pandemic have dramatically altered consumer behavior. While most grocery stores remain open, many customers are preferring to stay home and take advantage of home delivery and curbside pickup in unprecedented numbers. During the crisis period, grocers have seen their digital sales more than double across click-and-collect and delivery channels. This makes a deep dent in operating income, the extent of which we analyze below.

Based on history, we expect a significant portion of digital growth to stick and become permanent once the restrictions are lifted. During the 2008-09 downturn, many shoppers were driven to discounters and a large portion never fully returned to traditional grocers. The current crisis is similarly forcing customers to try something new. Many will like it and will not snap back into past behaviors.

More than 40% of those who have bought groceries online in this period are new to this channel. Those who aren't new expect to increase their frequency of online purchases, according to the AlixPartners Surge Demand Consumer Survey[1], with 39% indicating they were shopping online for groceries more than they previously had.

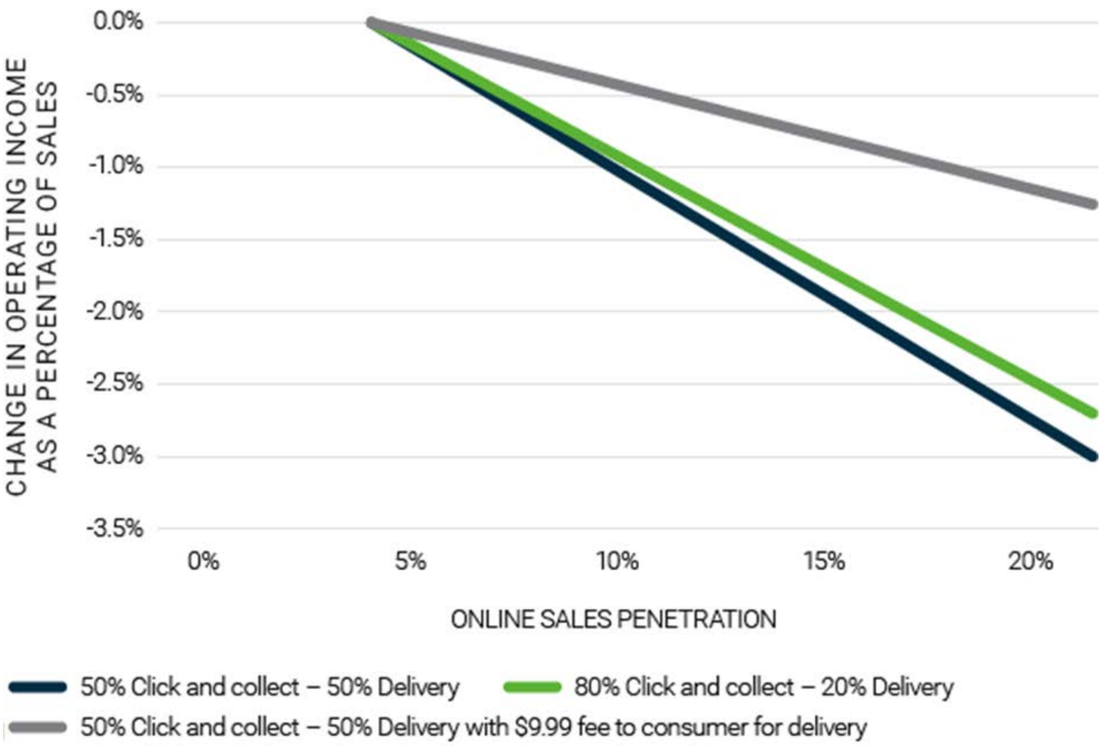
Two myths about online grocery are being disproven by the current situation. First, there is now clear evidence that grocery delivery is not simply a niche offering for dense, urban areas. Even before COVID-19, some of the country's largest operators were making rapid ecommerce progress in their core suburban markets. Second, grocers must change their belief that low ecommerce margins are acceptable because this is incremental business. Rather, grocers are fighting to keep their existing share as customers' expectations change and baskets shift from traditional in-store trips to online.

Another long-held theory – that customers are unwilling to pay more for delivery and click-and-collect options – will be tested in the medium term. Many customers have been willing to pay extra for services they view as necessary from a safety standpoint in this time of crisis. However, this willingness may decrease over time and even potentially disappear. Additionally, if even a handful of grocers start offering these options for free to gain a competitive advantage, pricing power for everyone could evaporate quickly. Irrespective of whether consumers are willing to pay extra, grocers urgently need to figure out how to get more operationally efficient at digital channels and operations.

Over the next few months, the possible implications for the industry may include increased consolidation and changes in pricing structures. Currently, grocery delivery is margin-neutral or even negative in some cases, while click-and-collect options hold only slightly higher margins. This is, of course, because of these channels' implicit higher cost structure, which includes additional labor, third-party service fees, and capital expenses that come with creating new warehouses and processes to cater to these options.

How big is the issue? All other factors being equal, our analysis suggests that a permanent overall online penetration of between 7.5% and 20% would result in an individual retailer's current operating income being reduced by approximately 0.75 to 2.75 points if the retailer is unable to charge the customer extra fee for the service. Pushing customers to click-and-collect options can deliver significantly better operating income than a more delivery-heavy mix (Figure 1). This is the magnitude of the change grocers are going to have to deal with.

FIGURE 1: ONLINE GROCERY PENETRATION ECONOMIC SCENARIOS



Note: Analysis averages P&L of a representation of national and regional grocers in the US.
Data assumes additional costs for online orders such as labor and service fees, while addressing impacts like lower margin product mix, returns, and leave-behinds.
Source: AlixPartners analysis

Grocers need to take these immediate actions now to stay viable and avoid the margin impact depicted in Figure 1 as the market evolves into its new normal:

> Make bold capability decisions: Because circumstances have forced rapid ecommerce scaling, it is imperative that digital capabilities be at full throttle now. Understandably, grocery retailers have been busy weathering the current demand storm. But going forward, they must evaluate the how to manage a longer-term shift. Does it make sense to use a third-party provider or build your own platform? Consider the pros and cons of each and ensure that whichever option you choose still allows you complete understanding of your customer. Outsourcing ecommerce is an easy solution and can be a huge advantage when executive time and focus is in short supply. The right white-label provider may offer both the right capabilities as well as control of the customer relationships and trade funding. If your balance sheet allows for it, assess acquiring ecommerce capabilities. In any case, evolving labor models to new shopping patterns will be essential.
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> Codify learnings from the current crush: While the last few weeks have been a true test rather than a test run, there are valuable lessons to unpack. Track how the shift to digital channels affected profit and loss while isolating the effects of the demand bump. As comparables return to normal, model out financial and operational scenarios with a sustained, elevated level of ecommerce. Determine what is incremental to your business and what has simply shifted online to the detriment of in-store shopping.

Choose customer incentives carefully: Pay attention to how your channel mix and profitability evolves as you settle into the new normal. Do not incentivize customers into actions unprofitable for the business. If click-and-collect purchases structurally deliver higher profitability than delivery, make them efficient and attractive for customers. This may require tactics such as offering pickup-only assortments or increasing the availability and flexibility of pickup slots. Consider focusing promotions on traditional shops to incentivize higher-margin and larger basket in-store purchases. Feature private brands in digital channels and actively promote them using substitution logic when branded products are out of stock.

Experiment with store real estate: Evaluate how your current real estate footprint can increase your ability to fulfill delivery orders and use store space you already have to facilitate ecommerce logistics. In locations where stores are too large, experiment with creating a mini-dark store by separating an area for dedicated picking and packing. Identify lower-cost locations in your area and snap them up to operate dark stores.

Partner with wholesalers: Wholesalers have a once-in-a-generation opportunity to help their independent and regional customers by offering turnkey ecommerce solutions. They have the required capital, balance sheet, and scale to make this work. The potential upside for wholesalers, as they find success, is that they will help their smaller customers survive and may become more relevant to larger multi-region grocers.

The current spike in home delivery and click-and-collect options will likely come to rest significantly higher than where it was prior to COVID-19. This dynamic is forcing grocery retailers to accelerate their digital channel development timeline by three to five years. Those that act now and evolve their thinking and operations to scale digital channels quickly will be able to capitalize on this momentum. Lessons from the last several weeks of shifting buying behaviors will help grocers adapt faster and more effectively – delivering a better customer experience, mitigating the risk of operating income losses, and taking share from competitors that don't evolve as quickly.

FOR A DEEPER DISCUSSION ABOUT THIS TOPIC, CONTACT:

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.

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[1] Survey conducted from March 27 to 31, 2020 across 1,006 representative US households.