6. THE RISE OF ONLINE RETAIL

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The online share of grocery retail is still relatively small in most regions of the world. Within that industry, the share of ultra-fresh categories – including fresh fruit and vegetables – accounts for an even smaller portion. Yet, despite these small beginnings, we expect the online channel to assume much greater importance over the coming years. This deep dive looks at what that could mean for the business in the coming decade. We then look at the example of Amazon Fresh.

It should first be noted that there are already exceptions to the general pattern. In Asia, in particular, online has a much higher-than-average market share. That is true in certain urban centres in the Western Hemisphere too. Online grocery in London, for instance, already accounts for 20 per cent of the market.

If, at present, it would be somewhat foolish to neglect the online grocery market entirely, by 2030, to do so could prove fatal. All the indications are that online's share of the fruit and vegetable market will grow significantly over the next 10-15 years, reaching around 7 per cent globally by 2030. This growth is expected to be driven by a number of factors, including increased consumer familiarity with online purchasing, especially with the rise of the digital generation, an accompanied increase in convenient delivery options (especially frequent deliveries of small quantities), reduced hurdles to supply, and an increasingly broad online offer – one that cannot be equalled by big-box retail.

The many varieties of online grocery

E-commerce grocery comes in many forms, each presenting a distinct form of disruptiveness for the industry, and each requiring its own distinct set of capabilities. At one end of the spectrum – the more familiar one – are the retail-driven, multi-channel approaches. These include bricks-and-mortar players that also offer home delivery or click-and-collect services. The good news for these retailers is that we expect the larger share of online activity in fruit and vegetables to happen in this space. The opportunity for such players is to leverage their existing cold chains and capabilities.

At the other end of the spectrum are direct-to-consumer approaches that seek to eliminate the traditional middleman in the supply chain. This model requires significant investment in new capabilities and is burdened with high operating costs due to costly last-mile delivery. As a result, we expect to see less activity here when it comes to fruit and vegetables.

Expectations regarding online grocery seem to be underlined by recent activity among the e-commerce giants. A number of these companies have started to extend their highly efficient distribution models into this area, the most notable move being Amazon's acquisition of Whole Foods, which brings the company into even more direct competition with the likes of Walmart. Likewise, Alibaba's investment in physical retail chains suggests similar developments in China.

Implications for bricks-and-mortar retail—the threat to profitability

Online grocery poses a threat to established grocers everywhere, but the exact nature of the threat varies from one market to another. In some, online-only home delivery options may capture a large part of the market; in others, bricks-and-mortar grocers may move to establish a mix of click-and-collect and home delivery models. Either way, bricks-and-mortar grocers will feel a significant financial impact from online, as their slender margins make them sensitive to even a small loss in market share. For a traditional grocer with 2 per cent EBIT and a 20 per cent volume variable margin, a 10 per cent loss in share to online would destroy all its profit. Even a 5 per cent share would be severely disruptive. A point to note is that online grocery already has a 6 per cent share in the UK.

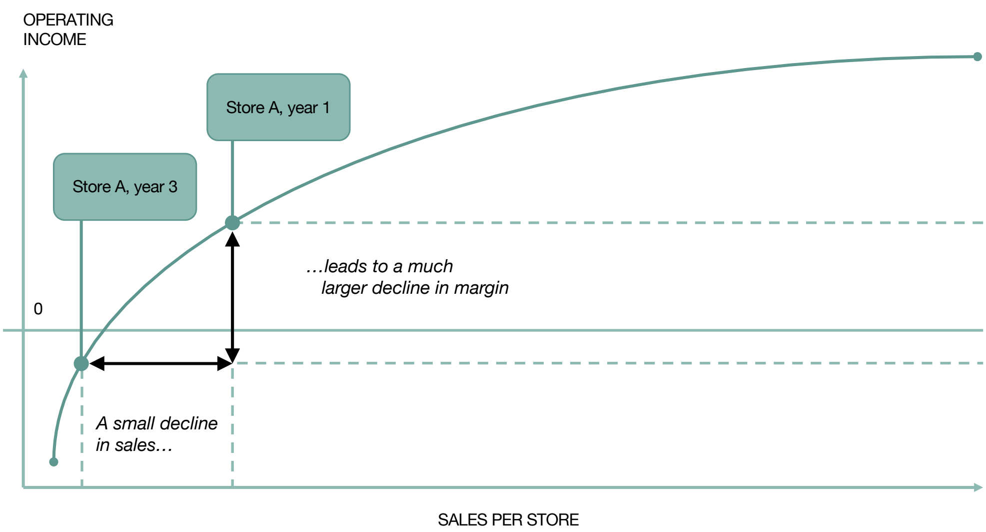
The advance of online does not spell the end for bricks-and-mortar stores, however – far from it. In fact, the stores that do survive are likely to be more profitable than the average today. Somewhat counterintuitively, becoming one of the survivors is not about beating online formats, as such – although that can help, of course. It is about each store winning its local competitive battles in order to become the 'last store standing' in that given area. In other words, you do not have to outrun the bear – you just have to outrun the person standing next to you.

Whether online grocery is already taking hold in your market (as is the case in the UK and France) or is in the early stages of growth (as in the US and Germany), the first step for bricks-and-mortar retailers is to recognise that this will inevitably mean a net loss of sales through their traditional bricks-and-mortar grocery channel. High operational gearing means that as stores lose sales, income will decrease by a much higher proportion than indicated by the percentage loss of sales. The implication is that some – perhaps many – individual stores will actually become unprofitable. *Figure 7* illustrates the effect of declining sales per store on operating income.

FIGURE 7.

THE IMPACT OF FALLING SALES ON A COMPANY'S OPERATING INCOME

Source: Oliver Wyman



In short, bricks-and-mortar retailers will need to close their unprofitable stores. Some of the sales lost through those closures can be clawed back through the remaining bricks-and-mortar estate, making the stores that survive more profitable and better able to weather the channel shift. However, it needs to be borne in mind that many of these sales will end up with other formats or in other channels.

The exact impact of this channel shift depends on the manner in which the individual retailer responds. If the retailer tries to maximize its cash profit, the impact could be very dramatic. If, instead, it merely tries to stay profitable at a similar rate as today, it could keep most of its stores open. In the midway scenario, the most stable one, we expect that an online market share of about 8 per cent would mean that up to 30 per cent of bricks-and-mortar square footage would ultimately close in most of the geographies we have modelled. We think two key patterns will emerge as a result: increasing disparity between the best and the worst sites; and an increasing challenge for those seeking to win customers using a traditional, full-assortment, grocery proposition.

Traditional middle-of-the-road grocers have always been fighting a battle on two fronts, since they face competition from both sides of the customer value proposition. The price leaders beat them with lower everyday prices underpinned by lower-cost formats, while the quality leaders beat them with premium products and services that are too costly for the traditional grocer to deliver. This 'collapse of the middle' is a constant struggle for those traditional grocers trying to balance both pricing and quality (by which we mean all aspects of choice, service and freshness) in order to win customers in their local area.

Fighting this collapse, on the one hand, is about reducing the share of your customers you lose to online and, on the other, is about beating the other competitors in your format.

Price leaders
Price leaders should protect their leadership position, cutting costs and ploughing savings into better value for their customers. The more aggressive they are about ruthlessly lowering costs, the more protected they will be against a play by Amazon or Google.

Quality leaders
These should focus on the things that differentiate their offer from both online and traditional grocers. This means assortment innovation, leading on fresh, and adding or growing services that drive traffic.

Traditional grocers
The old guard's priority should be the battle for customers, to beat all other traditional grocers in their market. This requires holding a price position that is in touch with the leaders, and a shopping experience that is differentiated from lower-cost options. In turn, this means constantly finding ways to make savings that can be invested to deepen customer relationships, bring down prices, sharpen promotions, raise quality and improve service – wherever returns are highest.

Implications for incumbent grocery retailers—an opportunity to compete online

As well as the threat posed by online grocery for the bricks-and-mortar grocer, the format also offers an opportunity to reach new customers and grow sales. What's more, the grocer's current assets and knowhow can provide it with an advantage. Those businesses not already running an online channel should think seriously about doing so, while those that are already active ought to be thinking about how their offer will evolve. That evolution will be crucial in defending against any future disruption instigated by the internet giants.

Of course, going online is not without its challenges. For bricks-and-mortar stores, it is absolutely the case that taking their grocery business online will cannibalise some of their more profitable sales. This does not make *not doing so* an option, however, since it is fair to assume that someone will soon be serving those same markets in the foreseeable future, even if it is not the established grocer. Choosing to delay will make entry even more difficult, risky and expensive, as late movers in France and the UK are finding to their cost.

Fruit and vegetables retail will play a distinctive and decisive role in the larger fight for grocery customers in the coming years. There is no doubt that fruit and vegetables will remain the single most-important grocery category in driving frequency and basket size. While this will hold true for bricks-and-mortar sales, we can also expect fruit and vegetables to be increasingly relevant to online sales as well. As a consequence, online models are likely to play a critical role for all grocers, whether the main emphasis is on a differentiating bricks-and-mortar model or on reinventing themselves in the online space.

Implications for producers and suppliers —coming to terms with new standards

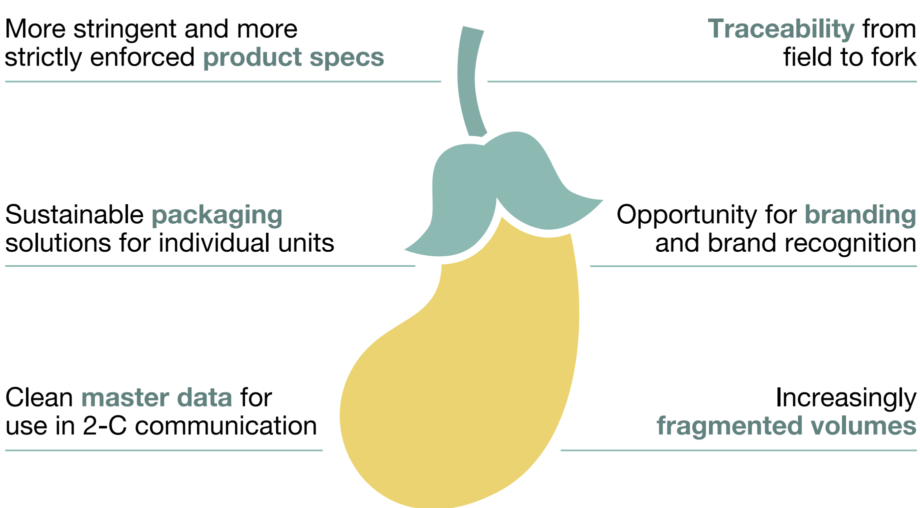
While the fight between online and bricks-and-mortar sales is one that predominantly involves retailers, parties that are not in front-row seats – including growers and suppliers – will also have to come to terms with the new channel. This is due not merely to the growth of online fruit and vegetables sales but to the requirement for 'new minimum standards'. We expect these new standards to be driven by online and multi-channel players: they will force these standards upstream on other participants in the fruit and vegetable supply chain.

Figure 8 illustrates the various dimensions of these new minimum standards. While some will play an increasingly important role for bricks-and-mortar retail as well, the online channel is likely to be the catalyst. Each of these dimensions is examined in more detail below.

FIGURE 8.

THE NEW MINIMUM STANDARDS CATALYSED BY ONLINE RETAIL

Source: Oliver Wyman



More stringent and more strictly enforced product specifications

Until now, the categories that have been the most successful in online channels are those that have a high level of standardisation. This enables consumers to know exactly what they will get from the online purchase without having to physically see or touch the product. We expect the fruit and vegetable business will have to move in this direction if it is to secure the trust of online customers. Growers are becoming increasingly aware of this. For example, one interviewed producer reported only a quarter of his oranges qualified to be sold via online channels.

Standardisation will be achieved by online retailers that enforce strictly regulated and well-controlled specifications for fresh produce. Although, today, most pure online retailers lack the experience and/or scale to achieve this, we expect that many will acquire these capabilities within the next ten years. In order to meet their expectations, growers and suppliers will need to establish the same level of strictly enforced, zero-tolerance dispatch control. However, this does not mean higher levels of food waste, as there is likely to be a market for each quality level of fruit and vegetables, each quality being strictly defined by tight specifications.

If consumers' emerging expectations with regard to quality and origin are to be met, standardisation will need to encompass varieties of produce that today are not commonly available in the marketplace, including many products delivered in smaller volumes by recipe-box home delivery services.

Sustainable packaging for individual units

Driven by home delivery, the average size of deliveries will decrease significantly over the coming decade. This requires producers to start thinking in terms of a 'unit of one'. Even though some online retailers aim to deliver loose produce without individual packaging, at a more general level we expect to see increased packaging of individual units. Doing so enables the online channel to ensure that space is used efficiently in transportation, thereby reducing the overall shipping cost.

Packaging needs to be not only leak-proof (for convenience and hygiene reasons), and include machine-readable labels, but also should protect against contamination (so that the fresh produce can withstand being transported with FMCGS in the same consignment). In this context, fresh fruit and vegetable packaging will also increasingly be expected to contribute to sustainability: for example, extending shelf-life and making increased use of ecologically friendly materials.

Growers will either need to extend their own packaging capabilities and processes, or partner with service providers. We already see the packaging industry moving its production capacity towards the producers – a trend likely to continue as online sales increase.

Clean master data for use in 2-C communication

We expect the growth of online sales to lead to ever-increasing demand for information on all activities along the supply chain, an expectation that will ultimately be driven by consumers who will require transparency with regard to the produce they consume. In turn, retailers will pass on this requirement, expecting growers and suppliers to provide clean product master data. While keeping master data accurate and up to date in itself will prove a challenge for many vendors, applying new data structures can be even more demanding. The need to link produce from various sources (ironing out seasonal availability) into a single, uniform output, for example, will become ever more inevitable since the online channel is geared towards year-round continuity.

In a second step, real-time data – such as seasonal quality deviations – will be requested from growers in order that the information can be provided to customers. While such expectations will not be confined to the online world, we expect online players to be the trailblazers in leveraging their data and analytics capabilities in this manner.

In this context, we also expect to see the creation of clearer standards designed to support well-orchestrated sales activities and increased transparency across all the various online channels and platforms. This will, among other things, allow customers to filter their targeted assortment more efficiently than in bricks-and-mortar outlets – imagine being able to filter your fruit and vegetable selection according to the fertilisers that have been applied during production.

Traceability from field to fork

The demand from customers in the online channel for information transparency will give rise to additional requirements with regard to the traceability of fresh produce. In responding to this pull effect, fresh fruit and vegetable businesses can use the availability of this information both in customer education and as a way to differentiate their offer. This is likely to provide only a short-term advantage, however: Traceability back to the individual field is likely to become commoditised in due course and could even end up supported by regulation.

Branding and brand recognition

Fruit and vegetables have traditionally been a private label business in bricks-and-mortar retail. In the rather anonymous world of online grocery, consumers will be looking for new sources of trust, while growers and suppliers will be seeking new ways to differentiate themselves from each other. Industry experts say that high-quality sustainable packaging and branding will play an increasingly important role when it comes to online sales of fruit and vegetables.

Creating and establishing such brands comes with some risk attached, however, as the quality of the fresh produce will need to be consistently in line with the brand promise. Those that do succeed in building their brands will gain a distinct advantage in customer perception and may realise superior profitability.

As the large online platforms further develop their direct sourcing models in fruit and vegetables, the producers themselves will need to find ways to position their produce in the marketplace. This will include developing and enhancing their own marketing and brand management capacities.

Increasingly fragmented volumes

As already indicated, the average unit size of produce is likely to become smaller over the coming decade. This will be driven, in part, by the nature of online business and, in part, by the inevitable fragmentation of volumes as the number of channels grows. Additionally, volumes in the online channel tend to be more volatile than in bricks-and-mortar retail due to the dynamics of product rankings, increased price transparency, and the short-term nature of promotion planning and execution. These developments will increase the complexity of volume planning in each channel. If not managed properly, this will lead to inefficiencies in warehouse operations and transportation.

At the same time, service levels demanded of producers and suppliers in the online channel tend to be even stricter than for bricks-and-mortar retailers. This is because e-commerce customers tend to be even less forgiving with regard to stock-outs than their offline counterparts. For suppliers, this necessitates building up their skills in order to fully master advanced predictive analytics. On the one hand, this will act as a means of standardising and improving their supplies. On the other, it will enable them to respond to the online channels' desire to steer demand actively and more dynamically (using dynamic pricing, short-term promotions and so on).

The online imperative

While retailers already find themselves in a struggle to reinvent their offer in order to remain relevant to the modern consumer – and over the next years this struggle is likely to intensify – fruit and vegetable producers will also need to develop their capabilities to keep up with the new requirements being ushered in by the online channel. The online game will always be a long shot, and many investments will not pay off. Yet there is no easy answer – those that fail to take the right measures today to future-proof their business could well face a rude awakening tomorrow.

WHAT IF AMAZONFRESH GAINS SIGNIFICANT MARKET SHARE IN FRESH PRODUCE?

Supposing the sword of Damocles fell... What would it mean for the fruit and vegetable business if AmazonFresh secured more than just a toehold in groceries in general, and fresh produce in particular? Supposing Amazon invested significantly in a specific part of the world and so managed to grow its share to 10 per cent of the total market – what then?

First of all, Amazon's uncompromising focus on customer satisfaction has been key in paving the way to market leadership in other categories – plus, of course, it is something that is driving its ongoing AmazonFresh initiatives. Its ambition is huge: 'unlimited' choice, maximum availability, seamless shopping 'by recipe', flawless quality, reduced click-to-delivery, shorter delivery windows, convenient delivery choices... you name it. While some of these can be addressed by AmazonFresh itself, others will have distinct implications for upstream supply chain participants.

Here, we look at the implications for the fruit and vegetable business along three dimensions: sourcing, produce and service level requirements, and product range and assortment. We then conclude by examining how the business might respond.

Sourcing

This is the obvious one. Amazon will come to market with size and purchasing power, and with this comes price pressure on growers and suppliers. AmazonFresh already sources the majority of its produce from established suppliers, with distributors or wholesalers used only to fill in the gaps.

As AmazonFresh gains market share, we can expect it to move to a direct sourcing model, taking out intermediaries. This process has obviously been accelerated in the US by Amazon's acquisition of Whole Foods. We may well expect similar moves in other regions. Alternatively, or in addition, we might see the bundling of volumes in the form of centralised physical distribution hubs. This would enable AmazonFresh to reach critical mass and thereby increase its negotiating power.

Less obvious – and less certain – is whether Amazon will capitalise on its analytical capabilities in order to complement traditional sourcing with a secondary market approach; that is, will it use analytics to match surplus production and consumer demand better (using a bid-ask system)? If adopted, this could produce a win-win-situation: higher utilisation and value capture for suppliers, increased sales potential for Amazon, and reduced levels of food waste leading to improved sustainability.

Produce and service level requirements

As argued previously, ensuring consistency in operations and in the quality of produce is key in fruit and vegetable retailing online. AmazonFresh's selection of preferred suppliers already focuses on criteria that validate the supplier's ability to deliver just that, through mechanisms such as ensuring the highest possible adherence to agreed product specifications, small-size unit packaging, machine-readable labelling, data maintenance, and agreed service levels. The idea is to remove as much burden and complexity as possible from Amazon's own operations, with the vendor taking care of this – the argument for this being that, since they are more experienced, they are better placed to do so.

Keeping in mind Amazon's customer-centric approach, it is easy to see why such criteria can outweigh buying prices when it comes to supplier selection. Amazon will surely not change this approach in the foreseeable future.

What will change, though, are the requirements it places on growers and suppliers as new best practices emerge. Once established, these best practices will quickly become the benchmark that differentiates preferred vendors from those disregarded by AmazonFresh. As an example, while maintaining clean product master data may today be sufficient for growers and suppliers to qualify as potential suppliers (from a data integrity perspective), tomorrow the requirement may shift to the real-time exchange of a broad range of transaction data, including attributes that allow for full traceability.

Similarly, AmazonFresh is likely to want to build on its own analytical strengths in order to avoid stock-outs. This will set service levels at a high standard and, in turn, require growers and suppliers to develop new capabilities. Much will be expected of them, especially in terms of advanced demand and volume planning.

Range and assortment

Amazon's brand promises an unprecedented breadth of assortment. The AmazonFresh range already includes a couple of hundred thousand SKUs. Since Amazon aims to leave no customer demand untapped, expect this figure to grow as AmazonFresh gains market share (surely two mutually dependent forces).

How can Amazon identify unmet demand? It will do so in a very structured way: constantly monitoring product searches, and recording those that fail to produce a result. This will give it a good understanding of not only the products that might sell but also what quantities. For example, it could identify types of fruit or vegetable that are most sought-after as organic produce but not yet available. This information will gain even greater validity once Amazon's market share increases and the number of searches are multiplied. In essence, Amazon is going to carry out valuable R&D by taking advantage of its data and analytics DNA.

Simultaneously, AmazonFresh will drastically reduce the time it takes to go to market as it improves its 'early-warning system'. It will look specifically for partners that are flexible, fast and able to support its ambition to speed up its go-to-market approach, enabling it to react to any unsatisfied demand in a timely manner. Again, those abilities will inform its selection of growers and suppliers.

The implication for fruit and vegetable growers is that you will need to choose. Are you satisfied with being the nth supplier of a standard and undifferentiated product? If so, you need to be prepared to offer this product at a very competitive price and quality. If not, can you contribute to AmazonFresh's increasingly broad range by offering a truly different product?

There are various ways to differentiate. There is the opportunity to supply niche products that few others supply, and in this respect AmazonFresh can also be an attractive outlet for small producers that might otherwise find it difficult to sell their niche fruit and vegetables through bricks-and-mortar retailers that have limited – and expensive – shelf space, no matter how large their stores may be.

Another route is to become better and bigger in the fresh-cut business, which remains largely underdeveloped in most markets. Establishing a recognised fruit and vegetable brand may be another way to go. As one illustration of the potential importance of branding when it comes to selling through AmazonFresh, think about your online order via Amazon's ever-evolving voice assistant Alexa: which apple will Alexa find more easily – the one identified by a unique brand name, or the ordinary variety? Branding will increase the chances of offering a product of choice.

The fruit and veg industry's response

So how can fruit and vegetable suppliers respond to these challenges? The short answer is by being prepared. There is no time like the present to start positioning the fresh produce business for such an outcome. AmazonFresh will increasingly seek to work with sophisticated suppliers. Data analytics in farming is likely to become more the norm than the exception. Consequently, there are steps that individual businesses can take in the near term to ensure they are well prepared.

The main task is to ensure growers and suppliers have the required analytics capabilities to provide what AmazonFresh will demand, along with the accompanying technology and processes. In turn, this means hiring the right talent. Another key area is to decide what products to supply, which requires the business to develop a product strategy.

Smaller growers are likely to be most excited by the prospects AmazonFresh provides. For them, unlike many of the bigger suppliers, this new platform can provide their products with much better placement than seen in the bricks-and-mortar retail environment.

Lastly, what will it take to thrive as a fruit and vegetable partner of AmazonFresh? Ultimately, this will require thinking like Amazon – that is, putting the customer at the heart of all your decision making.