

# Online Grocery Shopping—Time for a Stock-Taking

*Some online grocery retailers had a rocky start to 2000 as Wall Street skepticism deepened*

Until now, ICSC has focused much of its Internet research on consumer goods categories that have either already achieved significant online sales or have good prospects of doing so in the near future. Despite continuing uncertainty about the viability of online grocery shopping, this is a topic of vital concern to operators and tenants of neighborhood shopping centers. Although some investors in the first quarter of 2000 seemed to have made up their minds already and withdrawn a good deal of money from online grocers' stocks, ICSC decided to do some stock-taking of its own and evaluate the current status of this segment. We provide in this article a brief overview of current data, prospects and players in the online grocery business. This will be followed by a similar survey of online drug, health and beauty products (drug/HBA) retailing in the summer *Research Quarterly*.

## DAUNTING OBSTACLES

Of all the categories of goods that companies have attempted to sell over the Internet, few have been trickier than groceries. There are three main problems:

- The first, and most obvious, problem is that consumers generally like to touch and see grocery items—especially fruit and vegetables—an activity that is precluded by having someone else do the “picking and packing.”
- Second, groceries are high-bulk, perishable goods that must be delivered to individual households quickly, usually while the customer is at home to take receipt of the order.
- Third is the pricing issue: Groceries are everyday necessities for which most consumers are loathe to pay a premium; for the traditional grocer, margins are thin and profits are generated by selling in large volumes. Online operators have already attempted—without overwhelming

success—to persuade consumers that paying a home-delivery premium is worthwhile. Some have now abandoned that approach in favor of absorbing the delivery cost and seeking significant operating efficiencies by building their own distribution infrastructures.

Thus, the online grocer starts out with a seemingly intractable set of distribution challenges, no brand recognition, powerful bricks-and-mortar competitors and very substantial operating capital requirements. Despite these obstacles, new companies persist in trying to crack the market because groceries were a \$437 billion dollar business in 1999; even a modest share of that market would represent huge revenues.

Also, market research makes it seem plausible that time-strapped consumers may be interested in online grocery shopping: according to A.C. Nielsen, the average American household makes 94 trips a year to supermarkets and 9 to warehouse clubs. Andersen Consulting reports that the average supermarket “stocking-up” trip lasts 47 minutes. If these figures are to be believed, it comes to just over three days per year that consumers spend in supermarkets, plus travel time to and from the supermarket and shorter trips to convenience stores.<sup>1</sup>

Yet, so far, online grocery sales have been a small niche market for high-income individuals. Probably the earliest of the online grocery companies—Peapod, Inc.—needed 11 years from its initial launch in 1989 to build a modest customer base of 100,000 people in eight cities. It was never profitable and lost \$28.5 million in 1999 on revenues of \$73.1 million. By the end of the first quarter of 2000, Peapod's investors had jumped ship and the company was virtually insolvent. At the last moment, it was rescued by Royal Ahold, which bought it for \$73 million — the same

<sup>1</sup> Internetretailer.com “Online Grocers Are Hungry for Action,” May 5, 1999



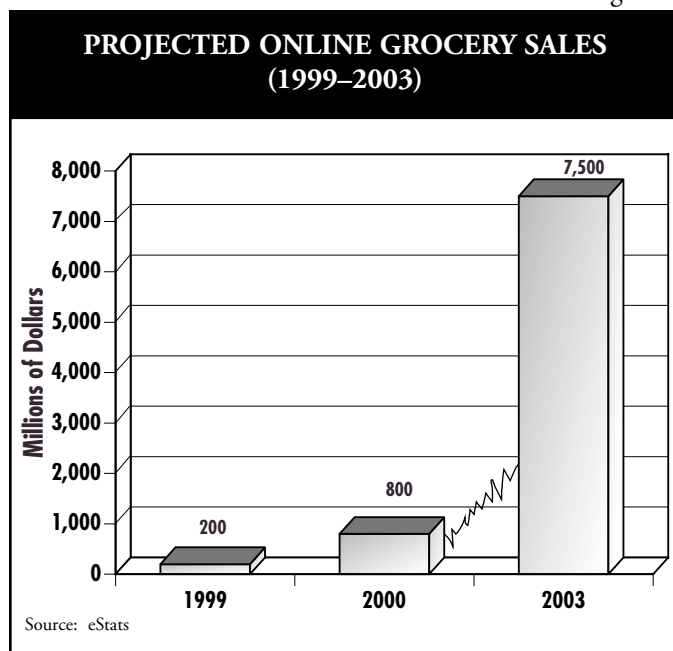
amount as its 1999 revenues. Yet, Peapod's problems have not deterred other Internet start-ups from setting up shop in the grocery business, although none have so far succeeded in turning anything like a profit.

### REVENUE PROJECTIONS

Internet industry research and consulting firms, which have been virtual cheerleaders for online sales growth in many retail and service segments, have been conspicuously lukewarm about online grocery sales, at least in the near term.

Figure 1 shows online sales projections by Jupiter Communications. Last year, according to Jupiter, sales were a mere \$200 million, or 0.04% of the \$437.4 billion grocery business. That was unexpectedly low, since Jupiter had earlier predicted 1999 online grocery sales of \$350 million. By 2003, Jupiter expects online grocery sales to reach \$7.5 billion, which would still be barely greater than 1% of total sales in that year.

Figure 1



However, these revenue projections are little short of guesswork and even if the structural problems with online grocery retailing were solved, other significant problems cloud the forecasts. One issue not addressed by the forecasters is that grocery delivery services are likely to be very susceptible to economic cycles—in a recession or

downturn, people are more likely to dispense with non-essential services if it means saving a few dollars than they are during good economic times. To the extent that online grocers demand premiums for their services, they will suffer sharply declining sales when the downturns come. This, in turn, will cause price-cutting to maintain the customer base, with adverse effects on profitability. Also, the timing of any economic downturn will have a profound effect on the growth path for online sales in this segment—if it comes early, it may decimate most of the retailers and set the segment back for a long time to come. If it comes later, after online sales have had a chance to gain some momentum and after the inevitable consolidation has weeded out weaker players, the adverse impact of recession may not be so devastating.

### THE LEADING COMPANIES

Table 1 lists seven of the leading online grocery companies as of the first quarter 2000, with some basic financial and other information.

Four of the seven companies—Webvan, Streamline.com, Peapod and Homegrocer.com—are public companies that in 1999 collectively suffered net losses of \$277 million on net sales of \$124 million. Excluding Webvan, which wasn't open for business in 1998 and has no comparable figures, the other three companies increased their sales by 44% from 1998 to 1999, but net losses widened by 169%.

Nevertheless, these companies believe that the key to their survival is to expand quickly into as many major metropolitan markets as possible, with Webvan, Streamline.com and Homegrocer.com leading the charge. (See Table 1.) Required are enormous sums of capital for the construction of warehouses, the installation of delivery systems and the implementation of other essential infrastructure. For example, Webvan has an agreement with Bechtel to build 26 distribution centers over the next three years at a cost of between \$25 million and \$35 million per center. Webvan must also staff the centers, hire its own delivery personnel, and lease or buy its delivery trucks. At the same time, in order to ensure



Table 1

LEADING ONLINE GROCERY COMPANIES AS OF FIRST QUARTER 2000							
Company	Location	Markets Served	Sales 1998	Loss 1998	Sales 1999	Loss 1999	IPO
WebVan	Foster City, CA	San Francisco (first distribution center in Oakland)	N/A	N/A	\$13.3m	\$144.6m	Nov. 10, 1999 raised \$405m
<p><b>Comments:</b> Launched June 1999. Signed leases for distribution centers in Boston, Denver, North NJ, Philadelphia, Dallas, Chicago, Seattle, Washington, DC. Plans to open distribution centers in 2000 in Atlanta, Chicago and Seattle, and in 15 markets by end of 2001. Agreement with Bechtel to construct 26 centers over 3 years. Distribution centers cost \$25-35m. Ave. order size \$81.31 in the fourth quarter of '99, up from \$72.53 in the third quarter. 47,000 active customer accounts in the fourth quarter compared with 22,000 in the third. Expects to incur significant operating losses in foreseeable future due to need to invest in marketing, distribution facilities &amp; equipment, technology &amp; personnel. Anticipate current cash reserves sufficient for next 1-2 years. Aims to pick, pack and deliver goods in 30 min., claims a 90% on-time rate. Webvan estimates that if centers operate to capacity (8,000 orders per day, 7 days per week) and order size increases to \$103, it can achieve operating margin of 1.2%, compared with 4% for conventional supermarket. Currently operating on a delivery schedule of 6 days per week, 7am to 10pm. Offers free delivery for orders above \$50 and charges \$4.95 for smaller orders.</p>							
Streamline.com	Westwood, MA	Boston, Washington, Chicago	\$7.0m	\$11.4m	\$15.4m	\$19.5m	June 17, 1999 raised \$40.3m
<p><b>Comments:</b> Plans to expand to be in 20 markets by year-end 2004. Uses freezer/refrigerator unit (provided free to customer) placed in garage, or special temperature-controlled bins that are placed outside house. Delivery made at same time each week. Ordering can occur up until 11pm the night before delivery. There is a \$30 per month flat fee for the service plus cost of groceries and "services." Average order size was \$102.36 in fourth quarter '99, down from \$108.51 in fourth quarter '98.</p>							
Homeruns.com	Burlington, MA	Boston	N/A	N/A	N/A	N/A	Private
<p><b>Comments:</b> Received \$100 million investment from private group in February to fund planned three-year expansion into 20 markets. Currently has one 136,000 square foot fulfillment center. Delivery available Monday-Saturday from 8am to 10pm. Delivery charge of \$10 on orders of less than \$60; orders over \$60 are delivered free. No monthly fee.</p>							
Peapod, Inc.	Skokie, IL	Boston, Chicago, Columbus, Ohio, Dallas, Houston, Austin, Long Island, San Francisco	\$69.3m	\$21.60	\$73.1m	\$28.5m	June 16, 1997 raised \$58.4m
<p><b>Comments:</b> Lost chief executive and \$120 million investment funding on March 16. Future as an independent company was in serious doubt until purchased by Ahold in April 2000. Founded in 1989 and has customer base of 100,000 people in 8 U.S. cities. Had shifted business model to building warehouses. Fees are per order and per month, and depend on the city: e.g., Chicago \$9.95 per order and no monthly fee, or, \$5 per order and \$4.95 per month, or unlimited deliveries for \$19.95 per month provided minimum of \$60 per order (orders less than \$60 are charged \$5).</p>							
Netgrocer.com	N. Brunswick, NJ	National	Est. \$5.0m	N/A	N/A	N/A	Private
<p><b>Comments:</b> Dry groceries only, delivered by Federal Express. Graduated delivery rates, beginning at \$5.99 for orders under \$60. Guarantees delivery by third business day after shipment. March 20, 2000, Italian dairy products group Parmalat took a 22% stake in Netgrocer for \$30m.</p>							
Homegrocer.com	Kirkland, WA	Seattle, Portland OR, Southern California	\$1.1m	\$7.9m	\$22m	\$84m	March 10, 2000
<p><b>Comments:</b> Signed with America Online (AOL) February 22; paid \$60m over 5 years for favorable positioning at AOL. Plans to launch this year in Dallas, Southern Connecticut, San Diego, Atlanta, Washington, DC, San Francisco Bay Area. Orders above \$75 have no delivery fee. Customers can order until 11pm the night before delivery and choose 90-minute delivery window. Average order size in the Seattle market was \$99 in the 39 weeks ended October 2, 1999, compared to \$89 for the 18 weeks ended October 3, 1998.</p>							
GroceryWorks.com	Carrollton, TX	Dallas, Houston	N/A	N/A	N/A	N/A	Private
<p><b>Comments:</b> Began home delivery in Dallas in November '99; planned delivering in Houston in May 2000 and rollout in other metropolitan areas. Plans to open more than 20 warehouses over next two years. Minimum order \$75. Delivery free and available same day if order placed before 10:30am. In April 2000, Safeway invested \$30 million to make GroceryWorks its online channel.</p>							



profitability, Webvan must continue to invest heavily in marketing to build brand awareness and quickly boost its customer base and average order amount.

Each of the major online grocers operates slightly differently, although in certain respects there was some convergence in 1999. The original model—Peapod’s—was basically as follows: Peapod partnered in each of its markets with a large food retailer, with its employees taking a customer’s order to the nearest partnering store, choosing the items and making the delivery. This was ultimately unsuccessful for several reasons, including high prices to the consumer and delivery bottlenecks. The latter occurred because the company had no independent fulfillment capability: if online customers ordered groceries at the same time as in-store shoppers, the company’s personnel had to shop the aisles of the local supermarket and wait in the same long lines as would in-store customers to fill the orders.

Most of the prominent online grocers are now building their own automated warehouses, which take the middleman out of their operations but create the need for staggering investments in real estate, technology, software, staff (although not as many employees as an average supermarket) and delivery systems. By the end of 1999, Peapod itself had its own centralized distribution warehouse in four of the eight markets it served. The transition from the earlier model to the independent warehouse model is partly to blame for the increasing losses suffered by the company in recent quarters.

Most of the online grocery companies either charge a delivery fee or have a minimum order requirement. Some require that the customer be home while others are experimenting with other options—e.g., Streamline.com provides its customers with a complimentary refrigerator/freezer that goes in the garage—the delivery person accesses the garage with a keypad system at the same time every week, regardless of whether or not the customer is home. Netgrocer delivers via Federal Express to anywhere in the United States; for obvious reasons, it offers only non-perishable items.

## CONCLUSION

Online grocers have yet to come up with a sufficiently convincing operating model for analysts to believe that they could take significant market share from traditional grocers and still be profitable. Recently, the stock prices of public online grocers have fallen as the financial community becomes increasingly skeptical about the long-term viability of some of these companies.

As if credibility and lack of profits were not enough, another major problem now lurks on the horizon for the online companies—the bricks-and-mortar grocery chains are fighting back with their substantial resources and infrastructure and making online sales themselves. (This has a double edge — Safeway recently took a \$30 million stake in GroceryWorks to make the latter its online grocery arm.) They are also dabbling in some innovative marketing and discounting programs using the Internet. (See the accompanying article in this issue, “Web of Alliances,” page one.)

In these circumstances, it is difficult to escape the conclusion that the grocery-anchored neighborhood shopping center is in little danger from the Internet. If anything, the Internet will provide some interesting opportunities for traditional grocery stores to rejuvenate themselves.

ICSC will continue to monitor developments in the grocery segment and report to the membership in this publication and elsewhere.

This article was written by Michael Baker. For further information, please contact him at ICSC:  
(703) 549-7404.