HOME DELIVERY FULFILMENT IN UK GROCERY

OPPORTUNITIES AND THREATS FROM MARKET GROWTH

ALVAREZ & MARSAL


poivron rouge
plus il est mûr, plus il est rouge
choisissez-le ferme, lisse avec la peau
brillante et bien tendue
origine : ESPAGNE
le kg
5,95
POIVRON
ORANGE

HOME DELIVERY FULFILMENT IN UK GROCERY: OPPORTUNITIES AND THREATS FROM MARKET GROWTH

EXECUTIVE SUMMARY

- The growth in home delivery adoption in the UK will be a threat to profits at all supermarkets
- By 2018, only half of the large six home delivery market players will still be profitable unless they change their methods or increase prices
- Encouraging 'click & collect' only, will help, but doesn't solve the underlying economics
- The race to capture market share with models that are unsustainable will speed the decline in profits

The UK grocery home shopping market is predicted to grow to more than £14billion by 2018 from £6.5billion in 2013.[1]

This tremendous growth presents both opportunities and threats to businesses attempting to balance innovation, customer service, quality and cost.

Early adopters of online ordering and home delivery have found that, unlike traditional store growth, growing volumes do not always present economies of scale. Some early adopters claim to be profitably operating home delivery across the UK, although serious doubts exist as to whether this claim is based on fair cost allocation.

If we step back to traditional bricks and mortar UK grocery retailing, the drive to lowest prices has meant very low operating margins for grocers, and while customers came to the store using their own time, fuel and walked the shelves picking their own products, it's largely been a successful formula. Gaining overall market share and opening more real estate brought higher revenues and while operating margin percentages were small the sheer numbers of stores and customers brought material profits.

[1] Source: IGD

The rate of adoption and popularity of online grocery shopping has caught some large grocers napping. All major UK grocers now have some form of online capability, most have a blend of home delivery, click & collect as well as hybrid combinations. Having some form of online offering with fulfilment capability is seen as essential by shoppers and shareholders alike. Some of the largest grocers have been dragged kicking and screaming into the online world unsure of direction, strategy and shape of offer. The greater the push from external pressure, the less prepared they appear, and therefore the cost of entry to the online market has been greater.

In a simple economic model of the largest players in the market (Tesco, Asda, Sainsbury's, Morrison's, Waitrose and Ocado) it's possible to predict which will survive the growth predictions using current models. The economic model output does not read well for any of the above, with half of them not making any margin much beyond 2016 if they operate as they do today.

THE SHOPPER EXPERIENCE

While grocers have been marketing, designing, trialling and testing different ways for us to shop, the experience for customers in store has suffered.

Stores are now more difficult than ever to navigate whether due to aisles full of home shopping / click & collect order picking by staff or store entrances blocked by click & collect orders being collected by shoppers. Range and shelf size planning is being miscalculated due to online demand being mixed with conventional store volumes. As a result store staff have to fill shelves during peak periods to keep up with demand, meaning that roll cages, totes, and residual cardboard packaging also congest aisles.

> "There are no proven, profitable home delivery models in the UK grocery market at present."

It's no wonder then that four in five (79%) online grocery shoppers describe their last order as a 'main' grocery shopping trip, and half these (39%) referred to it as a 'big' main trip involving extra stocking up or immediately following payday.[2] The poor in-store experience will only likely increase this trend.

If the large grocers continue to operate in this way they will drive even more people online and away from the large traditional store shopping format. More shoppers will adopt a mixture of large weekly / monthly online ordering topped up by selective purchasing at convenience stores when required. Those retailers who lack a convenience format will probably lose business as a result.

For those able to offer this mix of online and convenience presence this may not be such a bad thing, providing the fulfilment model is economically sustainable. It does though beg the question as to what they will use their large store formats for in future. Some are already looking actively at how to arrest the erosion of gross margin return on space as their larger stores return less and less each month.

[2] Shopper Vista / IGD

THE FULFILMENT MODEL

There are no proven, profitable home delivery models in the UK grocery market at present.

Some offer an attractive click & collect service; some have a reasonable home delivery model but none have a scalable reliable comprehensive model capable of taking them to 2018 and beyond in a profitable way. Indeed, if most continue to operate as they have been doing they will struggle to meet expected demand much beyond 2016. Volumes will rise and the stores will become so congested with pickers that nobody will be able to move.

Why is this so difficult?

One of the reasons for this may be the gradual growth nature of online – the popularity of e-commerce and home shopping has generally mimicked the growth of Broadband availability and maturity of internet shopping and general usage. Even so, early practitioners have not commercialised their models to scale in a cost effective way.

Another reason may be because Retailers are famously insular and reluctant to adopt best practices from outside retail, they feel that retail issues are unique and often recruit and promote either from within or from other retailers, perpetuating older practices.

Most retailers are not yet organised to optimise a multi-channel business model that embraces on-line and different store formats. Simply hiring an e-commerce Director and leaving everything else the same really isn't enough to drive the right operational response to the rapid changes in consumer behaviour all are facing. Very few Retailers have Senior Management with responsibility for end-to-end product availability, i.e. from shelf edge back to farm / source. This division of responsibilities may be one reason why so many still struggle with on-shelf product availability and supply scares. When no-one has end-to-end responsibility it's easy to lay blame elsewhere.

Another part of the reason for the poor economic performance of home delivery operations is that the cost drivers and logistics are very different to those of the traditional store based model.

Where larger and larger cube vehicles drove economies of scale in the traditional model, it's now all about 3.5T vans with multi drop routines. Where it was about pushing millions of cases a day in a general direction towards Regional Distribution Centres (RDCs) and on to large stores it's now about picking individual apples and single tins of beans into a shopping basket for a single address. The blunt instrument of old has to be sharpened.

The need for accuracy and finesse as well as new customer service skills has never been greater, as the delivery driver is now becoming the face of the grocer's Brand. Taking a skilled multi-drop driver and turning them into the polite, courteous and well-dressed face of your organisation is tough. Training and equipping them to deal with order problems, credits and substitutions, damage claims etc. just adds to the challenge and typically pushes up the hourly pay rate for the best operators.

Taking an end-to-end view of the model is essential if it's to be a success.

FORMAT ATTRIBUTES

	RANGE	PRODUCT HANDLING	LOGISTICS	PICKING	CONSUMER TOUCH POINT	COST PER ORDER	COMPLEXITY
STORE	Full	Cases / Cages	Full Truck	Cases / Cages	In Store	Low	Low
HOME DELIVERY	Selective	Singles	3.5T Van	Singles	Delivery Driver	High	High
CLICK & COLLECT	Full	Singles	N/A	Singles	In Store	Medium	Medium

It's no surprise then that many large grocers are pushing consumers towards click & collect as it offers some of the benefit of online shopping (avoidance of the in-store experience) with smaller margin erosion to the retailer. There's also the benefit of shoppers collecting their order, parking and then shopping in store!

However, three in five online grocery shoppers cite ease or convenience as their main reason for using the online channel[3], so there's a risk of lost customers for those grocers who push this format alone.

Several hybrids have also emerged such as inner city collection points such as Underground Tube station. This new trend is popular with commuters but is likely to attract a lower basket size, (people collecting are either walking home from the Tube or walking to their cars in nearby car parks) and therefore a lower margin.

For those customers who still want a home delivery, getting the logistics operation right is balanced on a knife edge of innovation, service, quality and cost. To develop a model that is flexible, accurate, and scalable takes careful planning and a sound understanding of the cost drivers involved.

[3] Shopper Vista / IGD

EXISTING MODELS

Here are a few examples of current practices along with observations on strength and weakness:

A. TRADITIONAL – (USERS INCLUDE ALL MARKET PLAYERS EXCEPT OCADO)

Strengths:

- Low investment and quick to establish — suitable for retailers waiting to see if online will be popular

Weaknesses:

- Highly inefficient pick rate — typically between 5 – 10 orders per shift per person
- Congestion of aisles in-store with order pickers
- Range dilution / confusion in store and blurring of store performance
- Returns are typically written off as they cannot be returned to store shelf position

B. DARK STORE – (IN USE BY TESCO, WAITROSE, ASDA, SAINSBURY'S)

Strengths:

- Congested aisles in the existing stores are reduced
- Dark stores are arranged internally to copy store layout making familiar picking operation for staff
- Easier returns process as stock may be put back onto shelves (where permissible)

Weaknesses:

- Dark stores are arranged internally to copy store layout making them inefficient pick operations
- Current dark stores are only adjacent to densely populated areas — others revert to model A
- Staff are 'walking the store' with shopping tote trolleys and may travel miles per day per person
- Replenishment occurs as for a traditional store making picking difficult and potentially requiring additional shifts

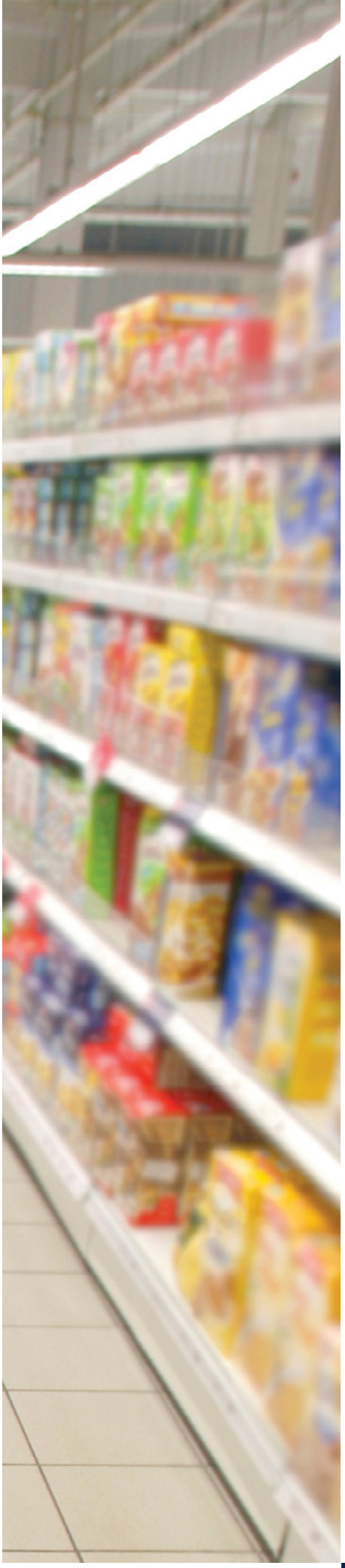
C. CENTRALISED MODEL – (OCADO MODEL)

Strengths:

- Low picking cost per order due to high level of automation

Weaknesses:

- Centralised picking in a geography as large as the UK pushes up delivery cost
- Stem mileages to and from the centralised depots are large making delivery very expensive
- Cross docking food orders (where practiced) to maximise volume in primary transport is expensive
- Multiple handling of picked orders is expensive
- Sophisticated automation is expensive to implement, maintain and replicate with market growth
- Returns impossible to manage in a cost effective and food safety conscious way




. . . the cost drivers and logistics are very different
to those of the traditional store based model . . .
5
4
3

The economics and scalability of each model are also varied. The relative cost per order can vary depending on the following fixed and variable costs across the models:

	TRADITIONAL	DARK STORE	CENTRALISED
FIXED COSTS			
RENT AND RATES	Low (existing)	Medium	Medium
UTILITIES	Low (existing)	Medium	Very High
DEPRECIATION	Low (existing)	Medium	Very High
VEHICLE LEASING	Medium	Medium	High
EQUIPMENT CAPITAL	Low	Medium	Very High
VARIABLE COSTS			
LABOUR COSTS			
- PICKING	High	High	Low
- DRIVERS	High	High	Very High
FUEL COST	Medium	Medium	High
MILES PER ORDER	Medium	Medium	Very High
TRAINING	Low	Low	High
MAINTENANCE	Low	Low	Very High
OVERALL COST INDICATOR	Medium to High	Medium to High	High to Very High
SCALABILITY	Very Poor	Poor	Good but Expensive

Each current model has its drawbacks, whether highly automated centralised or dark store, each has its sub-optimal characteristic and none scale very well or are very expensive.

Using IGD's growth projections for grocery home shopping to 2018 and a few cost / performance assumptions, we are able to model the number of orders / picks per day, and illustrate the operational challenge ahead:

ANNUAL DATA	2014	2015	2016	2017	2018
Home delivery revenue / year (forecast)	£7,300,000,000	£8,400,000,000	£10,100,000,000	£12,500,000,000	£14,500,000,000
Total number of orders / year	95,000,000	109,000,000	131,000,000	162,000,000	188,000,000
Total number of orders / day	269,000	310,000	373,000	461,000	535,000
Total number of item picks / day	13,000,000	15,000,000	18,000,000	22,000,000	26,000,000
Percentage change in number of orders		15%	20%	24%	16%

Whilst the average basket size (order value) may rise, the challenge the industry faces to fulfil more than **half a million online orders per day and pick more than 26 million line items (accurately) per day** by 2018 is enormous. An additional consideration, and vital to future planning, is the assumption of the split between home delivery and click & collect orders. Whilst the order has to be picked regardless of final delivery method, the onward home delivery by the grocer is an expensive cost element.

DESIGNING THE MOST EFFECTIVE MODEL

When considering any model design it's usually good to firstly understand the objective.

Surely, providing excellent service combined with a quality product at a competitive price is the objective for all grocery retailers. Some compete on everyday low pricing, some on the perception of higher quality products; all need to offer excellent service or risk losing customers.

An ideal on-line fulfilment model should be characterised by:

- Excellent service potential to the consumer in delivery windows / times throughout the day
- Geographic spread and inclusion for the target customer group
- Scalability to take advantage of market growth
- Lowest or optimum cost point
- Flexibility to allow for both seasonality in demand and operational efficiency whilst growing
- The right use of technology to both save cost and offer differentiated service levels to customers
- Leveraging the legacy network where the optimum operational performance is maintained
- Local, Regional and National model overlaps — something that works well in central London may not work in Cornwall — one size doesn't fit all
- An understanding of your customer profile in your market including regional variations

Clearly, there is a minimum scale to entry, especially at Regional or National level, however the smaller regional player shouldn't be put off domination of the online home delivery market in their respective geography.

A POSSIBLE SOLUTION

When considering the cost drivers it's clear what needs to be improved and what shape the successful model takes.

For a delivered order, more than 55% of the current cost lies in picking (under current methods)[4] due to in-store or dark store methodology. This would suggest a more dynamic picking operation is called for whether the order is delivered or collected. The balance (45%) of the cost lies in the physical delivery to the address / pickup point.

To maintain the lowest delivery costs it would seem reasonable to keep mileage of the final delivery vehicle as low as possible and to maximise the number of drops in a given geographic area.

To minimise overall transport cost it would seem reasonable to move product to the geographic area in the largest vehicle possible (as current operations to the traditional stores). This process along with RDCs is well established and offers the lowest case rate.

In summary:

- Move product to the geographic region using existing primary transport as if going to the existing stores (indeed it should be the same vehicle)
- Keep stem mileages down by running the delivery van out of localised facilities, multiple delivery trips within a day may be possible depending on density of demand
- Establish a high frequency picking operation away from the traditional store (but in the same geography) and combine with a click & collect offer similar to a trade counter (Argos / ScrewFix)
- Use modern pick methodologies and appropriate technology to maximise pick rates
- Customers may either collect their order from the front desk or get it delivered by small van from the back of the facility — they may purchase additional products from the front desk if required using either a web terminal / iPad or similar device

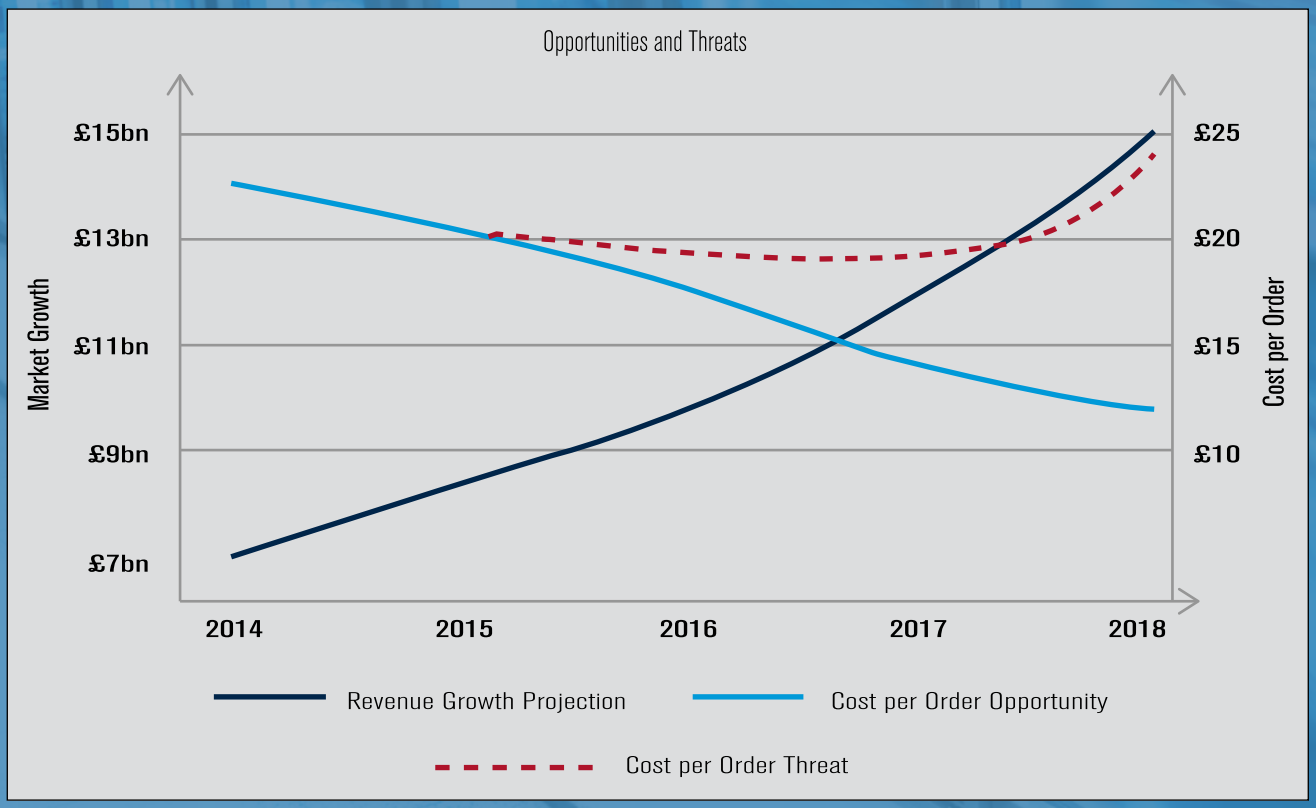
[4] Excludes Ocado model

THE TIPPING POINT IN ONLINE FULFILMENT

If current methods and models remain unchanged the projected growth in the market will not be achieved as fulfilment, whether home delivery or click & collect will grind to a halt.

Picking operations (whether in traditional store or dark store) cannot maintain the sorts of pick output levels required to satisfy the demand with current thinking, their efficiency and scalability is poor compared to the output needed.

Home delivery vehicle capacity and delivery window availability maxes out at around of 25 drops per day per vehicle, resulting in more and more home delivery vans delivering to more and more addresses. Drivers capable of representing a grocer's Brand will become a rare human resource and hourly rates will climb. Fuel costs are unlikely to reduce over the period to 2018.



IN CONCLUSION

The graph opposite illustrates the opportunity and threat of getting the model right for growth, those who prepare well will see a reduced fulfilment cost per order to a level where the customer is probably prepared to pay for delivery thus protecting margin; those who don't will either grind to a halt or be forced into spending margin on fulfilment. The tipping point will vary by grocer, many already struggle to fulfil orders — it will not improve without an end-to-end strategy.

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