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Online Food Shopping: Peapod Finds a Path

> "Mike, the evidence is clear: Nearly every single technical innovation—from PCs to digital music and mobile phones—has struggled at first with low sales for a long period of time before reaching an inflection point, then rising exponentially. E-commerce is following that principle. We are on the cusp of rapid acceleration."

Andrew Parkinson, founder and president of Peapod, the online grocery company, did not have to convince Mike Brennan, Peapod's Chief Operating Officer, that Peapod was poised for growth. Grocery was the biggest category in retailing but had proved the most resistant to the advance of online shopping. Nevertheless, Parkinson and Brennan had worked side by side for 18 years to keep Peapod, the nation's oldest online grocer, in the fore of technological innovation and consumer relevance. They had watched with a certain fascination as many hopeful online food startups had been launched to great fanfare, only soon to fail. If not always profitable in its early years, Peapod had stood the test of time. But despite the hefty investments made and industry-leading status, a new brand of competition was entering the online marketplace and the rules of the game were shifting rapidly.

Peapod's parent company, Royal Dutch Ahold, was one of the world's largest supermarket companies with 2014 sales of $43.5 billion and more than 3,500 stores.[1] Yet most of these stores were conventionally positioned and, in both its European home market and in the US, its historic market shares were being eroded by new competition. In the US, discounters such as Aldi, Lidl (soon to come to the US), tens of thousands of Dollar Stores and, from the other side, upscale formats, such as Whole Foods, Wegmans and even Trader Joe's were attracting some of the most profitable customers of Peapod. Ahold was betting that e-commerce would further differentiate its operations from discounters and allow them to deliver greater value to contemporary shoppers looking for convenient ways to simplify busy lives. But Ahold and Peapod were hardly alone in recognizing the new competitive landscape. Virtually every player in the global food industry, traditionally a bastion of brick and mortar retail and torchbearers of the "in-store experience," had considered whether to enter the online grocery business, and how. But the stakes were now immeasurably higher. Recently, two of the best-capitalized and most technologically sophisticated companies in the world had ventured into the online grocery space: Amazon.com and Google. Worse, the goal of both companies was driving traffic

1 Ahold Annual Report 2014

This case study was prepared by Edward McLaughlin, Robert G. Tobin professor of marketing at Cornell University, as a basis for class discussion and represents the views of the author, not the university.

to their websites. Neither needed to make a profit delivering groceries.

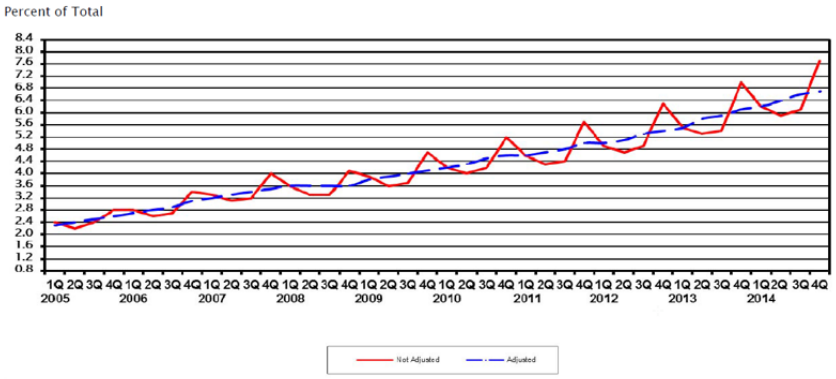

Exhibit 1: Quarterly U.S. Retail E-commerce Sales as a Percent of Total Quarterly Sales: 1st Qtr. 2005-4th Qtr. 2014

Several years earlier Ahold's supervisory board had approved aggressive investments in online retailing to position itself for the new future and differentiate its banners from other, generally more conservative, mainstream competition. But as they observed the new developments in online grocery sales, they realized they needed to remain increasingly vigilant and increasingly innovative just to keep pace. The board turned to Peapod to deliver an aggressive growth plan before the end of the next quarter.

Online Retailing: The Background

Retailers had offered home delivery services for as long as mom and pop corner stores existed. In the early 1800s shop owners knew the names of most of the customers in their neighborhoods, selected products from the shelves and bins in the days long before the concept of self-service was introduced, and even delivered the goods to the customer home—perhaps by horse and wagon. Two hundred years later, technologies have revolutionized the ordering component of this business model, but the physical fulfillment component is still complex, costly and perhaps the biggest remaining opportunity for home delivery.

While there were many early experiments in the 1980s with interactive Videotext in the UK and Minitel in France, the real takeoff for business application of electronic purchasing was created between 1989 and 1991 when Tim Berners-Lee wrote the first web browser, WWW. This made way for an entirely new commercial channel and forever changed how markets would be conceived. Retailing was no longer about just physical stores. The old adage of the three most important things in retailing: location, location, location, suddenly was as folksy as the horse and wagon.

Although Netscape did not release its first browser, Navigator, until 1994 and Amazon did not begin taking orders online until 1995, several innovators had attempted home delivery of a limited line of grocery products in the late 1980s: Harvest America (1986), JC Penny's Telaction Express (1988) and the Sears, Roebuck-IBM partnership, Prodigy (1988). They relied on telephone, fax, cable TV and the first phone modems for home computers. From the beginning of these first online initiatives, industry prognosticators enthused about the possibilities and forecast wildly optimistic growth rates for online commerce. In 1996, McKinsey forecast that electronic commerce would grow 30 percent annually for the next ten years[2]. In 1998,

2 McKinsey & Company (1996) The Battle for Growth

US Retail Ecommerce Sales, by Product Category, 2012-2018
billions

	2012	2013	2014	2015	2016	2017	2018
Computer & consumer electronics	$49.0	$57.4	$66.4	$76.1	$86.1	$96.9	$108.4
Apparel & accessories	$38.0	$44.7	$52.0	$59.7	$67.9	$76.6	$86.0
Auto & parts	$23.3	$27.3	$31.6	$36.2	$41.1	$46.2	$51.6
Books/music/video	$19.6	$23.2	$27.2	$31.5	$36.0	$41.0	$46.2
Furniture & home furnishings	$15.2	$17.7	$20.3	$23.1	$26.0	$29.1	$32.3
Health & personal care	$12.9	$15.0	$17.3	$19.6	$22.1	$24.7	$27.4
Toys & hobby	$8.9	$10.5	$12.1	$13.8	$15.6	$17.5	$19.5
Office equipment & supplies	$6.3	$7.3	$8.3	$9.3	$10.4	$11.4	$12.6
Food & beverage	$5.3	$6.1	$7.0	$7.9	$8.8	$9.7	$10.9
Other	$46.7	$54.1	$62.0	$70.1	$78.5	$87.3	$96.6
Total	**$225.3**	**$263.3**	**$304.1**	**$347.3**	**$392.5**	**$440.4**	**$491.5**

Note: includes products or services ordered using the internet, regardless of the method of payment or fulfillment; excludes travel and event tickets
Source: eMarketer, April 2014
171460 www.eMarketer.com

US Retail Ecommerce Sales Growth, by Product Category, 2012-2018
% change

	2012	2013	2014	2015	2016	2017	2018
Books/music/video	17.8%	18.5%	17.0%	15.7%	14.5%	13.6%	12.8%
Apparel & accessories	16.9%	17.6%	16.2%	14.9%	13.7%	12.9%	12.2%
Auto & parts	16.6%	17.3%	15.9%	14.6%	13.4%	12.6%	11.6%
Computer & consumer electronics	16.5%	17.1%	15.8%	14.5%	13.3%	12.5%	11.9%
Toys & hobby	16.2%	16.9%	15.5%	14.2%	13.0%	12.2%	11.6%
Furniture & home furnishings	15.7%	16.4%	15.0%	13.7%	12.6%	11.8%	11.3%
Health & personal care	15.6%	16.3%	14.9%	13.6%	12.4%	11.6%	11.2%
Food & beverage	14.6%	15.2%	13.9%	12.6%	11.4%	10.5%	12.1%
Office equipment & supplies	14.5%	15.1%	13.8%	12.4%	11.2%	10.4%	9.9%
Other	15.2%	15.9%	14.5%	13.2%	12.0%	11.2%	10.6%
Total	**16.2%**	**16.9%**	**15.5%**	**14.2%**	**13.0%**	**12.2%**	**11.6%**

Note: includes products or services ordered using the internet, regardless of the method of payment or fulfillment; excludes travel and event tickets
Source: eMarketer, April 2014
171463 www.eMarketer.com

Exhibit 2: US Retail Ecommerce Sales, by Product Category, 2012-2018 (in billions)

Computer World forecast $294 billion of sales would be generated by 2002[3]. In 1995, Management Horizons reported that electronic commerce would capture 10 percent of food sales by 2005[4]. The reality has been much less dramatic. Even by the end of 2014, e-commerce sales accounted for only $304 billion, or 6.5 percent of total retail sales, and less than 2 percent of grocery sales. While 6.5 percent was regarded as a tiny market share in most commercial settings, retailing was the largest component of the US economy and, as such, the $304 billion dollars generated by e-commerce sales represented a powerful market opportunity (Exhibit 1).

The US Census Bureau estimated that e-commerce sales grew 15.4 percent in 2014 compared to only 3.8 percent for retail sales in general. Furthermore, such double-digit growth rates are forecast for online retailing at least through 2020. Of course, certain product categories benefit from online sales much more than others, including shipping-friendly items, hardware, and products with tightly described specifications have generally led the way in sales. Digital marketing research firm eMarketer estimates that computer and consumer electronics led all e-commerce sales in 2014 at $66.4 billion, with apparel and accessories next at $52 billion (Exhibit 2). Product categories with the opposite profile, that is, non-standard, perishable items, have lagged. Despite being the largest sub-category in all retailing, food and beverage has been the smallest revenue generator among major categories.

Changing Consumers

Whereas new technology has enabled online retailing, it is consumer change that has driven the growth. A great deal of research has explored the benefits and limitations perceived by consumers regarding online shopping. These can be summarized as follows:

3 Deck, S. Study sees growth in online shopping. Computerworld (May 21, 1998)

4 Management Horizons (1995), PWC, Retailing 2005.

Pros	Cons
Don't have to wait in line (60%)	Shipping costs (59%)
Can order when it's convenient for me (53%)	Can't touch / feel products (54%)
Avoid bad weather (51%)	Waiting for delivery (49%)
Don't have to load groceries into car (49%)	More expensive (42%)
Don't have to get in and out of car (44%)	Can't use coupons (37%)

Exhibit 3: Advantages and Drawbacks of Online Grocery Shopping: Peapod Shoppers

Advantages

Convenience. Online stores are available 24 hours a day, and with more than 80 percent of American consumers now having internet access at work or home, online shopping eliminated the need to travel to a conventional store during what might be restrictive business hours. Peapod's own research reinforced that nearly all of the principle reasons among those who prefer online grocery shopping were related to convenience (Exhibit 3). Moreover, the demographics of aging baby boomers who not only need convenient delivery but understand technology, should continue to reinforce the convenience attribute.

Information and reviews. Although direct inspection of physical products was not possible, online stores describe products with text, photos, and multimedia files and many link to supplemental information, such as instructions, safety procedures, demonstrations, or manufacturer specifications. Specifications such as ingredients or nutritional information could be easily filtered or sorted to enhance the customer's decision making process around, say, healthy choices. What's more, increasingly, online stores allowed customers to comment or rate items or link to dedicated review sites and blogs that host user reviews for different products.

Price and selection. One major advantage consumers pointed to for shopping online was being able to quickly seek out deals for a wide array of products or services provided by many different vendors. The inventory of many online covers nearly every imaginable form of a particular product. A physical retailer such as Best Buy distributes its supply of digital cameras, for example, across all of its stores, hoping to guess roughly what the best sellers will be, where, and how big. Supply and demand only meet in the store aisles. But, despite today's sophisticated forecasting algorithms, retailers guess wrong. The reality of limited inventory in physical stores results in misallocation of resources, unsatisfied consumers and system-wide inefficiencies.

The inventory of online retailers is generally not so physically constrained. Even the big-box superstores can only carry a fraction of the choices available. Walmart carries around 4,500 unique music CDs, while Amazon carries 800,000. Barnes & Noble carries about 100,000 book titles compared with Amazon's 5 million. Blockbuster carries 3,000 DVD movies, while Netflix carries 90,000. [5]This has become known as the "long tail" of e-marketing.

5 Anderson, Chris, The Long Tail," (2008, October), Hyperion.

Online price-comparison services and discovery-shopping engines can be used to look up sellers of a particular product or service and, often, locate a lower price than in a local store. Of course, shipping costs generally reduce any price advantage of online merchandise, though depending on the jurisdiction, a lack of sales tax might compensate for this.

Disadvantages

Improper order. E-commerce has not been embraced by all shoppers. In the event of problems, such as a product not being what the consumer ordered, otherwise unsatisfactory or arriving late, consumers reported difficulty in returning an item for either the correct product or a refund. They complained about the huge hassle to contact the retailer, visit the post office, pay return shipping, and then wait for a replacement or refund. Some online companies had generous return policies to make up for the traditional advantage of physical stores. Some examples include providing labels for free return shipping or not charging a restocking fee.

Security. Security and information privacy were concerns for many consumers. Given the inability to inspect merchandise before purchase, consumers are at higher risk of fraud than face-to-face transactions, and had to trust the merchant (and employees) not to use credit card information improperly. Even with food, many consumers did not wish to reveal the nature of the products they buy. In response, most online merchants today, like their brick and mortar brethren, promised not to disseminate consumer information. But some consumers remained skeptical.

Cost. Although lower product prices could sometimes be an advantage for certain product categories, distribution expenses incurred for any home delivery by brick and mortar stores were incremental. Whereas consumers do much of the labor in-store, online retailers had to charge more, either for groceries or for delivery fees, to cover the greater costs. Most consumers resented paying an extra 15 percent for something that came free when done in-store.

Online Grocery Industry Landscape

In the 1990s and 2000s scores of firms experimented with ways to take advantage of the many new technologies rapidly enabling online retailing. Nearly every sector of the economy was impacted, and several of them were revolutionized. Traditional music soon became dominated by online players, such as Napster, then Spotify, Kazaa and iTunes. Books were revolutionized by Barnes and Noble and Amazon, shoes by ASOS and Zappos, movies by Netflix, travel services by Orbitz and Kayak (83 percent of leisure flights were booked on line in 2014[6]), and more. The combination of extreme variety and low-cost inventory and distribution was too compelling to ignore. The theme could be summarized succinctly: "What can move to the Internet will move to the Internet."

6 Progressive Grocer, April 2015, p60.

While clothing, books and mobile devices were the products most often purchased online, other categories were showing promise. But neither the mainstream grocery industry nor consumers were ready to acknowledge that food shopping might move to this format. They were not prepared to imagine how fresh crusty bread and succulent summer melons could move to electronic channels. Nevertheless, many intrepid firms tried. Northern New England retailer Hannaford Brothers set up a home shopping subsidiary, Homeruns, in Boston as early as 1996. Although the chain had no stores in Boston, the idea was to distribute groceries to storage boxes on consumers' front porches in densely populated neighborhoods from a single distribution center. But volumes never built to the point of covering high logistics and transportation costs and the business folded four years later. Many other conventional retailers, including Safeway, Meijer, Kroger, Publix, attempted to tap the same market white space that had attracted Hannaford, but exited soon thereafter as losses were deeper than expected and could not be sustained.

Not all companies who entered the online grocery fray were brick and mortar retailers. Many so-called pure-plays, or companies whose primary business was not brick and mortar retail, smelled opportunity in online grocery. The most famous of these was Webvan. Founded in the midst of the dot-com bubble, Webvan was high-profile excess in every way. It attracted venture capitalists, such as Goldman Sachs and Sequoia Capital, and many top executives, including its CEO George Shaheen, legendary former head of Anderson Consulting (Accenture). Webvan also signed a $1 billion Bechtel contract to build robotic distribution infrastructure.[7] At its 1999 IPO, it was valued at $4.8 billion. Webvan delivered to 10 US markets at its peak, but ultimately crumbled under its own weight.Its high-flying executives, none of whom had any experience in the supermarket industry, made unrealistic promises from the outset—deliveries within 30 minutes of ordering and opening in new markets before proving concept in the initial markets. The company burned through more than $1 billion in venture funding and 19 months later the IPO declared bankruptcy.[8]

Peapod: A Pioneer

In 1989 Andrew Parkinson and his brother Thomas founded the first electronic shopping service with a full selection of groceries for home delivery. They called it "Peapod" after a similarly named venture the two brothers launched as college undergraduates at Wesleyan University. They believed the name was reminiscent of two things going well together—two peas in a pod—and besides, it had a nice, fresh ring. Thomas said, "I thought it was a friendly name and I wanted children to like it."

Although orders in the early 90s were sometimes received by telephone, the majority of Peapod's orders were received by computer, even in the early years. Consumers had a choice of more than 18,000 different products that could be sorted in a myriad of ways novel at the time: category, price, brand, or calorie count. Sales promotions and coupon redemption were

7 http:// techcrunch.com/2013/09/27/why-webvan-failed-and-how-home-delivery-2-0-is-addressing-the-problems/

8 http:// yourstory.com/2014/09/webvan-e-tailer/

Exhibit 4: Evolution of Peapod Format with DC capacity and customer density

popular with the early adopters. In the formative years, the distribution of the goods was achieved through partnerships with other brick and mortar retailers: Safeway in San Francisco, Kroger in Columbus and Jewel Stores in Peapod's home market, Chicago. Initially, Peapod served roughly 15,000 households in the three cities, pulling products from about 65 different stores.

As volumes grew over the course of the 1990s, the business model of shopping from individual stores became infeasible. In 1997, Peapod opened its first "wareroom" in an empty backroom of a Stop and Shop supermarket in Boston. Warerooms, roughly 8,000-10,000 square feet, presented only an abbreviated inventory of all products in a typical store but allowed greater picking efficiency than the congested store environment, and could be built with relatively low capital requirements. What's more, warerooms lowered transportation costs relative to a larger distribution center, since the warerooms, like the stores to which they were adjacent, were closer to customers.

The turn of the 21st century marked an important turning point for Peapod in two ways: Peapod opened its first distribution center outside of Chicago, and Royal Dutch Ahold acquired a majority share of the company in 2000 before acquiring full ownership in 2001. Despite the repeated failures of online start-ups, most analysts were enthusiastic about Peapod's prospects with Ahold. Morningstar's David Kathman noted that online grocery requires an extensive infrastructure to store and transport goods, so a partnership between an online venture and a traditional retailer might be more successful in the long run. He said at the time, "E-tailing, in general, is hard to do as a pure online retailer. The wave of the future is bricks-and-clicks."[9]

Over the course of the next decade Peapod rolled out a unique spectrum of distribution formats, each engineered to meet the volume demands of specific markets—from assembling orders in an individual store when volumes were low to fully automated distribution centers when volumes were high. One example is the state-of-the art distribution facility in Jersey City opened in 2014 and located strategically adjacent to New York City. The evolution and range of Peapod distribution formats is illustrated in Exhibit 4.

Drivers in the Contemporary Online Grocery Marketplace

If operators can agree that the major driver of the online grocery business is convenience,

9 http://www.chicagobusiness.com/article/20010716/NEWS/20002843/peapod-sells-out-to-royal-ahold

they cannot agree on how to provide it. Making ordering easy, and perhaps even fun, has been successfully addressed by many companies. That is, after all, what computers are good at. But success at crafting the fulfillment piece of the business model has proved elusive in the US. Retailers have wrestled with concepts of local home delivery, shipping from afar, pick-up models, etc.

	DETAILS	WHO TYPICALLY DOES THIS
Picking: In store, by retailer	• Retail employees pick orders directly from the shelves • Orders typically picked from a store near delivery address	• Bricks-and-mortar retailers, especially at launch, e.g., Tesco UK at launch
Picking: In store, by third party	• Individuals contracted through a third party pick orders directly from the shelves, just as an in-store customer would	• Technology based start-ups, e.g., Instacart
Picking: From warehouse or dark stores	• Orders picked from purpose build warehouses or dark stores • Dark stores are essentially warehouses that are laid out more like stores, complete with shelf replenishment processes • Automation is generally higher in warehouses, although the two are converging	• Online-only retailers, e.g., FreshDirect • Many bricks-and-mortar retailers add dark stores to in-store picking as online business grows, e.g., Tesco UK • Some bricks-and-mortar stores use third-party warehouses from the beginning to minimize upfront investment yet take advantage of picking efficiencies, e.g., Morrisons
Delivery: Click-and-collect	• Customer collects pre-picked order from a collection point • Collection point may or may not be attached to a store • Increasing range of collection points (e.g., refrigerated lockers at an airport in the UK)	• Bricks-and-mortar retailers, especially in France and the UK, e.g., Auchan
Delivery: By retailer	• Retailer has own fleet of vans and delivery drivers • Order is driven to the customer	• Bricks-and-mortar retailers and online-only retailers, e.g., AmazonFresh
Delivery: By third party	• Third party may be a traditional logistics company, a dedicated grocery delivery service, or contracted individuals	• Mostly when picking is also done by (the same) third party, e.g., Instacart • Retailers focused on ambient groceries (e.g., Amazon, not AmazonFresh) may send via traditional courier services

Exhibit 5: Selected Models for Online Grocery Retail

Globally, consumers had spoken. They wanted to be able to shop whenever and wherever they want. Because online shopping had greater penetration elsewhere in the world including Japan, Europe and urban markets worldwide, many American companies looked outside the US for guidance. Tesco.com, launched in the U.K. in 2000, delivers groceries hand-picked from selected stores. As early as 2006, Tesco was reported to be the only retailer in the world to make online shopping profitable.[10] By 2015, Tesco offered both a home-delivery option for a £1 delivery fee and a click-and-collect (at the store) option for free. As the shift to online shopping accelerated, Tesco CEO Phil Clarke said "...Our priority of establishing multichannel leadership has never been stronger. We are moving from bricks and mortar to a seamless blend of bricks and clicks."[11] In 2014, Tesco.com offered one-hour delivery in 98% of the U.K., made "Click & Collect" available in 260 locations and generated £2.5 billion in sales.

Several other European countries have seen success with "pick-up point" models. In The Netherlands, the Albert Heijn supermarket has created two pick-up point options: adjacent to existing stores and at free-standing depots near primary intersections of national highways. Both options are growing in popularity. French retailer Auchan, similarly, launched its "Drive" online model in 2000 which allows shoppers to pick up their orders on the same day at 12-lane, stand-alone, low-cost picking centers. Some US retailers have begun to experiment with these European distribution models. By 2015, Harris Teeter, owned by Kroger, offered in-store pick-up at a few locations and Walmart.com was testing Auchan's "Drive" model in several

10 Walker, Gaelle (11 November 2006). "Online failing to deliver". The Grocer (William Reed Publications). p. 6

11 Tesco Annual Report 2014

places. The management consultancy, Oliver Wyman, summarized the principal online grocery models in 2014 (Exhibit 5).

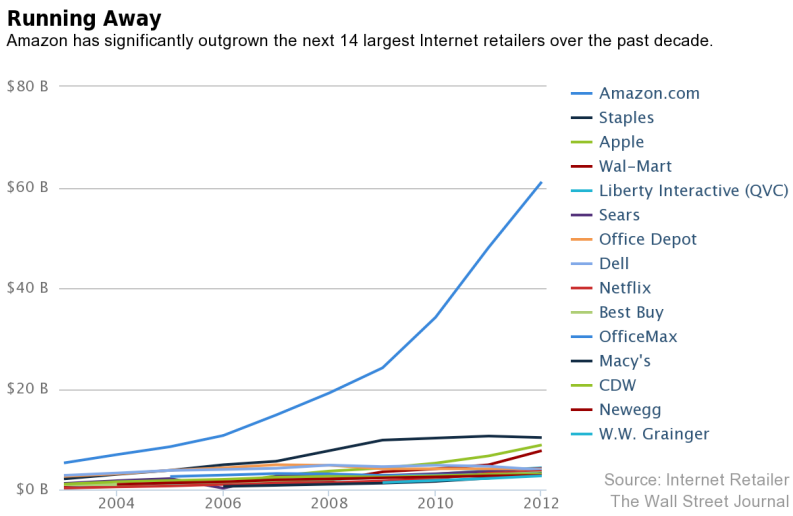

Exhibit 6: Growth of 14 Largest Internet Retailers, 2013

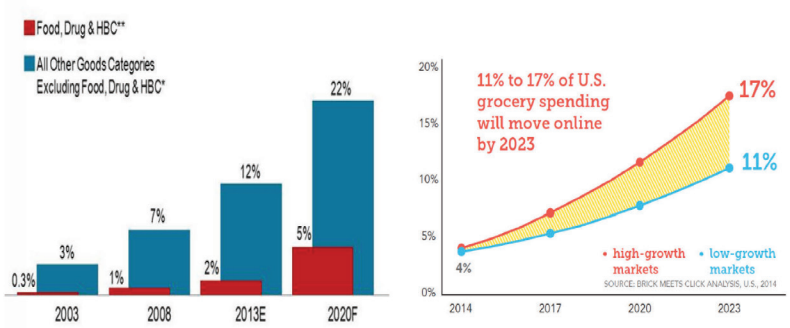

Exhibit 7: Forecasts of Online Grocery Sales

The US grocery distribution system appeared to lag online developments in other countries for a number of reasons. First, many fast-growing grocery delivery services in developing countries had emerged due to the lack of contemporary brick and mortar stores. Second, in many countries, population density was high enough to justify the tight delivery schedules needed to optimize the economics of transportation models. US supermarkets generally offered larger, more convenient and more pleasant shopping environments in physical stores—even in sparsely populated rural areas—than most other countries. Thus, many US consumers did not yet perceive the need for online shopping. Exhibit 6 presents the growth of the top US Internet retailers.

The excitement about online grocery shopping had been reinforced by projections from respected marketing research firms. Kantar Retail estimated that 5 percent of US food and drug sales will be via e-commerce by 2020, Bloomberg Businessweek estimated 11 percent by 2023[12] and Brick Meets Click forecast that 11-17 percent of grocery spending would move online by 2023 (Exhibit 7). AC Nielsen produced a 2014 report with McKinsey that projected online grocery to grow to four times the overall rate of the grocery industry and a 2015

12 Progressive Grocer, April 2015. p60.

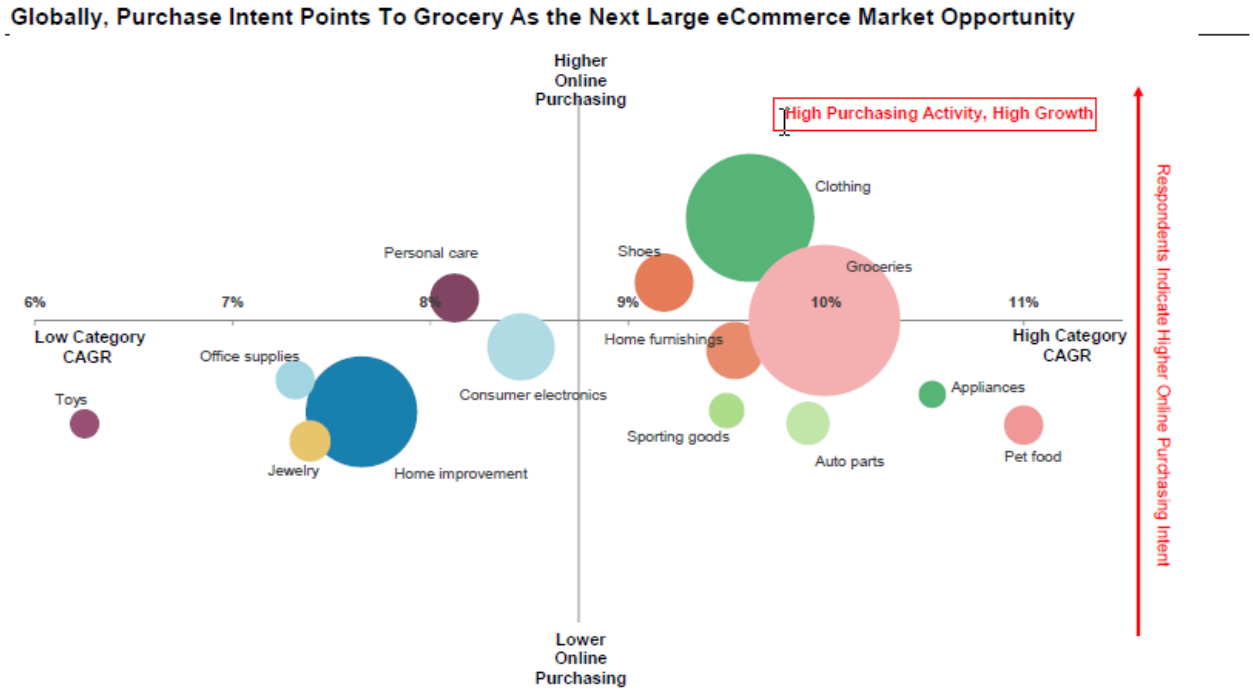

Exhibit 8: Consumer Purchase Intent Points to Grocery as Largest Potential

Morgan Stanley report estimated that fresh grocery would be the next largest opportunity for e-commerce markets globally[13] (Exhibit 8).

Disruptive Competitors and Logistics

With the novelty of online grocery shopping in the early 1990s, early adopting consumers appeared satisfied by a truncated version of the much larger set of products offered in physical stores. Many even seemed to find charging a fee for next-day delivery to be reasonable since the costs for additional services have to be covered somehow. But over the course of the 2000's, customer expectations changed dramatically. With the advent of increasingly sophisticated ordering and logistical systems in other sectors of the economy, consumers began to demand same day delivery and exhibited decreasing tolerance for additional fees.

New startups were disrupting conventional thinking about home delivery. Uber was a California-based company that operated a mobile app-based transportation network allowing consumers to submit a trip request, say for a grocery delivery, which was routed to crowd-sourced taxi drivers who might make delivery in a few hours. In 2014, UberEssentials offered a service in Washington, D.C. whereby it promised to deliver "everyday grocery items you need in 10 minutes or less." This experiment was quietly discontinued in early 2015, but Uber had put consumers on the alert that same day delivery was not a fantasy. By 2015, Uber was available in 55 countries and had raised nearly $3 billion in venture funds.

Instacart, a San Francisco-based startup operating in a dozen cities in 2015, also dispatched crowd-sourced "personal shoppers" to as many retail stores as were on the consumer's list.

13 Morgan Stanley, January 2015, "Global eCommerce." Alphawise.

One shopper might buy dog food at Costco (the consumer did not need a membership) while selecting the fine wine and organic melons at Whole Foods. The consumer chose the delivery options. Under an hour? No problem, but it would cost $14.99. The price dropped to $3.99 for a two-hour window. "Instacart Express" provided free delivery for all orders over $35 for a $99 annual fee. Instacart's strategy was not to displace existing retailers but to extend their range to more digitally oriented consumers. Founder Apoorva Mehta put it this way: "Rather than trying to disintermediate local stores as some delivery services have done, our strategy is to partner with retailers to help them expand their geographic reach and overall revenue."[14] In early 2015, Whole Foods passed the $1 million sales mark in weekly Instacart-delivered goods.

Many analysts believed that the new area of online food delivery growth would not be retail groceries, but home-delivered meals. Most such services—Blue Apron, Plated, HelloFresh, Grubhub, Munchery—worked similarly to eliminate grocery shopping. Chefs prepared balanced, healthy recipes and delivered everything needed to cook the meals at home to most US zip codes, with packaging to keep ingredients fresh for up to 24 hours. Most of these services did not come cheap. A 2-person plan at Blue Apron for three meals per week was $59 in 2015, while a similar plan at HelloFresh was $69. GrubHub, a business valued at $3 billion and available in more than 700 US cities[15], connected consumers to local restaurants. In 2014, Grubhub served more than 4.19 million unique dinners and sent more than $1 billion of food sales to local restaurants. The restaurant makes the delivery.[16] Munchery, operating in San Francisco and New York, delivered locally sourced, precooked meals, from high-end chefs—lobster rolls, Cambodian pork burgers, for example—for $10 to $13 a dish.[17]

Next, but most disruptive, was Amazon.com and Google. Both seemed intent on entering every type of on-demand delivery space. Amazon, the Seattle-based Internet giant, began home delivery of groceries and fresh food in Seattle in 2007 under the name AmazonFresh. Since that time, moving from a niche offering to something with demonstrably more staying power, it had expanded to Los Angeles, San Francisco, San Diego, New York and Philadelphia, with plans to extend its coverage to 41 major US cities by 2016. AmazonFresh offered same-day delivery on groceries, fresh food and nearly its entire inventory of more than 20 million non-food items from electronics to apparel and books. One of AmazonFresh's unique features was connecting consumers with iconic local restaurants and specialty stores, saving consumers long trips across town. Beginning in June 2015, an annual membership ($299) was required (called Amazon Prime Fresh) to use AmazonFresh. The membership included free same-day delivery of any item, unlimited access to stream movies, TV and Kindle book inventory.[18] The customers of Amazon Fresh were reported to spend 90 percent more money online than the average Internet user.[19] Some analysts believed that Amazon was better positioned than other retailers since others would have to spend meaningful capital to build similar distribution scale (more

14 http://www.forbes.com/sites/erikamorphy/2015/02/16/instacart-is-retails-new-best-friend-just-ask-whole-foods/3

15 http://www.reuters.com/article/2015/02/05/grubhub-results-idUSL4N0VF5YF20150205

16 http://en.wikipedia.org/wiki/GrubHub_Seamless

17 https://munchery.com/

18 http://www.amazon.com/gp/help/customer/display.html?nodeId=201338210

19 Research Farm "US Online Grocery Report 2015." http://researchfarm.co.uk.

than 60 fulfillment centers in 2015 in the US alone). Moreover, Amazon's real objective was driving customers to the general website, not making a profit on food. Amazon had repeatedly demonstrated to the financial community that it was willing to forego short-run earnings by "investing in market share." In 2014, like the majority of preceding fiscal years and despite a staggering $90 billion in revenue, Amazon actually lost money (-$.22 billion in net income[20]). Analysts again questioned how its newest service, Amazon Prime Now, launched mid-2015 and promising free two-hour delivery, could possibly be profitable.[21]

Google, the other internet behemoth ($67 billion in 2014 revenue), in a clear attempt to challenge Amazon Prime and protect its search business, entered the delivery business in 2012. Although product delivery might have seemed like a stretch for Google, its chairman, Eric Schmidt, recently acknowledged that Amazon was its biggest search competitor. "Google Express," available in 6 major US cities in 2015, promised same-day or overnight delivery from local stores at prices identical to store prices for a fixed monthly fee of $10. Google Express reached 7 million people across the US with same-day delivery in 2015 while aligning with many big-brand brick and mortar stores also impacted by Amazon, including Costco, Target, Staples, Office Depot and Barnes and Noble.[22] No company in any sector had more consumer data and insights on their shopping behavior than Google, including knowledge of a huge range of consumer price elasticities. Further escalating competition with Amazon, Google announced the addition of "buy buttons" to their paid search results in mid-2015[23].

Conventional Retailer Responses

These disruptions in the online grocery landscape had not been lost on conventional retailers. Generous estimates of the amount of online grocery business were only 2 percent of total sales. This was a national average, though many markets, particularly in urban areas, were already much higher. Yet, even limited market penetration leads to the threat of what was sometimes known in retailing as the "5 percent rule." No company likes to lose 5 percent of its business to a new competitor, but in the supermarket industry the margins are so low that when top-line volume is reduced by 5-10 percent, earnings in many stores of a chain can be virtually wiped out. A conventional retailer with a 2 percent EBIT and a 20 percent contribution margin would lose much of its profits with a 5 percent loss in sales and virtually all its profits with a 10 percent loss. Stores would start closing. This is an important part of why mainstream retailers were paying such close attention to the erosion of their sales to online, and why they were responding.

By 2015, online shopping topped the strategic agendas of brick and mortar grocers, even many who earlier had observed the frenzy of online activity from the sidelines. Safeway, Kroger and Meijer were examples of major brick and mortar retailers who had dipped a toe into the online waters a decade ago and decided that the temperature was not right, but had since re-entered

20 http://en.wikipedia.org/wiki/Amazon.com

21 Forbes April 2, 2015, Five Reasons Why Prime Now Will Drive Real Profits To Amazon

22 http://techcrunch.com/2014/10/14/google-shopping-express-expands-to-more-cities-rebrands-as-google-express/

23 USA Today May 16 2015; http://www.usatoday.com/story/tech/2015/05/15/google-buy-buttons/27408239/

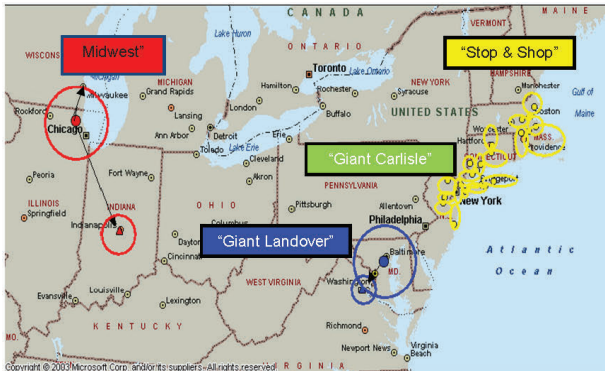

Exhibit 9: Peapod Network 2015: 29 fulfillment locations in dense urban markets

the online pool with impressive offerings. Costco's online grocery sales grew to $3 billion in FY 2014 with a higher margin on the 8,000 SKUs carried than in-store purchases. In the US, Walmart.com, launched in 2000, offered more than 5 million products online by 2015[24]. They offered both home-delivery and pick-up-at-store options, with the latter format conferring a formidable distribution advantage given that two-thirds of the US population lives within 5 miles of Walmart's 4,100 stores.[25] Finally, Walmart was focused on the future of e-commerce perhaps more than any other retailer. In fiscal year 2016, its investments in e-commerce are expected to range between $1.2 and $1.5 billion[26]—a level virtually unattainable by other retailers. Very few of Walmart's technology investments had failed.

Top 500 rank	2013 web sales	2013 total sales	2013 % of total sales	2012 % of total sales
60 J. Crew Group Inc.	$590,000,000[1]	$2,428,000,000	24.3%	23.0%
61 Peapod LLC	$585,000,000[1]	$585,000,000	100.0%	100.0%
62 Bluestem Brands Inc.	$560,000,000	$839,000,000	66.7%	64.0%
63 Ancestry.com Inc.	$540,400,000	$540,400,000	100.0%	100.0%
64 Nike Inc.	$540,000,000	$25,310,000,000	2.1%	2.0%
65 1-800-Flowers.com Inc.	$538,500,000	$735,500,000	73.2%	72.0%
66 American Eagle Outfitters	$527,900,000[1]	$3,310,000,000	15.9%	13.0%
67 The Estee Lauder Cos. Inc.	$525,000,000[1]	$10,181,700,000	5.2%	5.0%
68 Weight Watchers International	$522,200,000	$1,724,100,000	30.3%	27.0%
69 Recreational Equipment Inc.	$510,000,000[1]	$2,017,476,000	25.3%	22.0%
70 Adobe Systems Inc.	$500,100,000[1]	$4,055,240,000	12.3%	10.9%
71 Restoration Hardware Inc.	$500,000,000[1]	$1,580,000,000	31.6%	31.0%
72 Dick's Sporting Goods Inc.	$480,000,000[1]	$6,210,000,000	7.7%	5.0%
73 PCM Inc.	$480,000,000[1]	$1,424,199,000	33.7%	33.0%
74 Hulu LLC	$479,400,000[1]	$479,400,000	100.0%	100.0%
75 Deluxe Corp.	$475,000,000[1]	$1,584,800,000	30.0%	29.0%
76 Follett Higher Education Group	$470,000,000[1]	$2,300,000,000	20.4%	19.0%
77 Crate and Barrel	$460,000,000	$1,382,869,140	33.3%	33.3%
78 Blue Nile Inc.	$450,008,000	$450,008,000	100.0%	100.0%
79 Build.com Inc.	$450,000,000	$450,000,000	100.0%	100.0%
80 FreshDirect LLC	$450,000,000[1]	$450,000,000	100.0%	100.0%
81 RueLaLa.com	$440,000,000[1]	$440,000,000	100.0%	100.0%

Exhibit 10: Largest Online Retailers 2013: 60-81

Peapod's Position Challenged

As he pondered the new landscape of online grocery shopping, Andrew Parkinson and his team had good reason to take pride in what they had accomplished. They had steered Peapod over more than 25 years through countless phases of technological innovation and competitive disruption to hold two distinctions: the number one position and oldest online grocery service in the US. What's more, its recent performance and positioning were strong. Between its original distribution network around Chicago and the more recently added capacity in dense urban markets on the East Coast (Exhibit 9), Peapod reached 50 million people, about 17 percent of the

24 http://www.corporatereport.com/walmart/2014/ar/globalEcommerce.html

25 http://techcrunch.com/2014/01/28/walmart-to-go-denver-grocery-test/

26 http://news.walmart.com/news-archive/2014/10/15/walmart-will-accelerate-investments-in-e-commerce-and-moderate-global-square-footage-growth

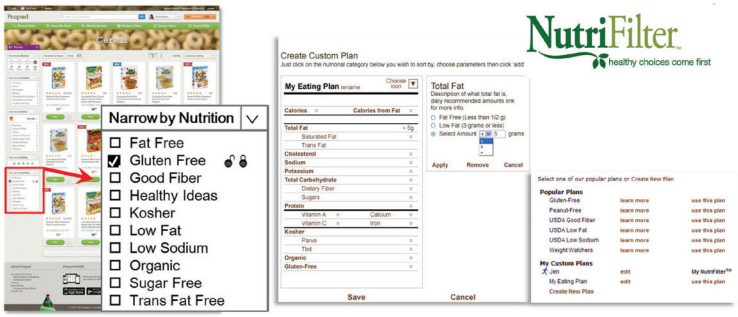

Exhibit 11: Peapod Website 2015

US population, and ranked 61 in the Internet Top 500 (Exhibit 10), ahead of national retailers like Nike and Dick's Sporting Goods.

Peapod's business model had tapped a financially attractive consumer segment and, according to its own marketing research, had kept them satisfied. While carrying only 18,000 SKUs, about half of a typical supermarket,[27] Peapod averaged an astonishing $160 per order—roughly eight times the average supermarket basket. Peapod's own analysis showed that 80 percent of these sales were incremental to Ahold's in-store sales.[28] Moreover, in Peapod's established markets, 75 percent of consumers were aware of the brand and 84 percent of users would likely recommend the service to others. When Peapod's research revealed that consumers wanted online shopping to be simple and healthy, Peapod responded with easy and inspirational website features (Exhibit 11). Parkinson understood a simple retailing truism: consumer satisfaction leads to loyalty, and loyalty to market share and profits.

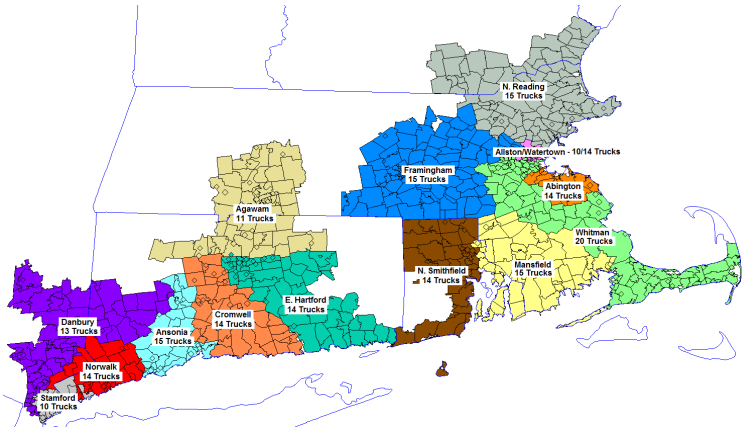

Exhibit 12: Peapod New England Markets: home delivery

By the end 2014, Peapod's sales had reached $590 million and, in the mature New England home-delivery market (Exhibit 12), it had achieved an EBITDA of more than 3 percent.[29] Those achievements aside, Parkinson was mindful of the aggressive targets that parent Ahold had set for Peapod at its 2014 shareholders' meeting—$1.5 billion in sales by 2018.

He needed a plan for growth in an online world radically different than the one he started in.

A Quest for Growth

Parkinson summoned Mike Brennan, an 18-year Ahold veteran and current Peapod chief operating officer, to assist in developing the pathways to growth that Ahold's Supervisory Board had called for. The Peapod base was solid but Parkinson and Brennan both

27 http://www.fmi.org/research-resources/supermarket-facts

28 Peapod documents

29 Royal Dutch Ahold Annual Report 2014

Source: Internal Peapod documents, 2015.

Exhibit 13: Peapod Positioning 2015

understood that the base was the past. How would they meet the board's mandate to nearly triple Peapod's size in only four years' time?

They agreed on the three overarching advantages that their business model had over all competitors. First, Peapod was a specialist in the food business. It did business only in that vertical slice of the online industry, not the much broader marketplace. Unlike generalists, Peapod did not sell books, music, electronics or apparel (Exhibit 13). Its established expertise was food. Second, as an early entrant targeting the most attractive markets, Peapod had made it much harder for those wishing to enter the online business later. In France and the UK, where online models had taken off, late brick and mortar entrants were finding it difficult to get traction. Third, Peapod represented one component of the overall Ahold omni-channel strategy to reach consumers however and whenever they were ready to shop. Unlike pure-play challengers, Ahold and Peapod offered the same high-quality brands and private-label products, fresh and organic foods, and loyalty cards in physical stores as they did online. They also offered distribution options for home delivery and pick-up points (209 PUPs in early 2015). They did all of this through a unique customer-identification profile. Consumers could have access anyhow, anywhere and anytime. The consumer feedback that Ahold and Peapod had already gleaned from their omni-channel strategy allowed a more complete understanding of how the new generation of consumers wanted to shop. These were attributes, the two executives believed, that would keep them in the lead.

The Plan

A series of senior management meetings and a weekend retreat led by Parkinson and Brennan produced a plan, in coordination with their colleagues at Ahold, with three distinct directions of growth: **more customers, more places,** and **more choices.** The three separate initiatives were simple to state, but Parkinson and Brennan knew that producing results following them would not be.

More customers. The key to all retail businesses was volume, but online retailing with home delivery was particularly dependent on customer counts and the need for dense urban locations to minimize transportation costs. Peapod management believed that acquisition of more customers was critical to allowing Peapod to further spread its rising fixed costs. They realized that a strategic goal for "more customers" would be difficult to argue against, but the tactics to actually produce these new customers was lofty and still vague.

They had high expectations that new mobile apps and the ability to shop from anywhere would bring in more customers. Plans were already underway to expand the "virtual stores" that allowed consumers to order from train stations and subway platforms while they waited.

More places. Peapod already enjoyed a distribution footprint in two of the most attractive areas of the US—second-city Chicago and the most densely populated corridor of the United States: Boston-NYC-Washington, DC. Such density allowed optimization of delivery into some of the highest per-capita income areas of the US. But Peapod had only recently entered the New York City market and its new automated distribution facility in Jersey City was operating at less than half of its capacity. Building market share in this high-potential market should be, the executive team decided, of the utmost priority. Deliveries per route was a key business driver that must be optimized. Moreover, the competition for this prize was already intense with Fresh Direct, an entrenched New York City online icon, consistently producing some of the highest customer satisfaction ratings in the industry.

Furthermore, despite high distribution costs, there remained vast rural areas between the major markets that had yet to be tapped and similarly, areas just outside the current distribution that promised new business. Parkinson and Brennan believed that Peapod's multi-format online model(s), whereby business could be scaled up gradually as volume in a new market grew, permitted Peapod to win in these smaller markets in ways that others with top-heavy fixed costs could not. Peapod had watched while others had attempted and failed to operate from the same business platform everywhere. Peapod had a format for every market size.

More choices. Peapod believed that its current inventory—less than half of an average supermarket—needed to be expanded and customized to meet new customer needs, particularly for millennials. That included more food that was fresh, healthy and local; boutique signature products; organic offerings; and even an increase in ready-to-eat and ready-to-prepare meals. However, further penetration into fresh foods would have its challenges. The in-store environment was expected to remain dominant for many fresh foods, such as produce,

seafood and deli products, where consumers wanted to gauge quality themselves through physical contact.

Many analysts believed that online retailers would be expected to exceed the product assortment of physical store competitors to create loyalty, perhaps even offering high-end specialties to appeal to less price-sensitive consumers. Parkinson was not, however, convinced by this argument. He believed more SKUs inventoried in Peapod's warehouses would only complicate the otherwise smoothly functioning model. But adding new SKUs by partnering with key suppliers could present a genuine opportunity.

In this regard, Peapod believed it had not adequately pursued collaborative opportunities with suppliers in order to deliver higher value and more choices to consumers. Brennan pointed out that many major brick and mortar retailers were putting pressure on suppliers to share the pain of Amazon-induced sales and profit declines. Suppliers were seeking partnership in new channels. Many suppliers had approached Peapod to develop previously under-explored alliances in the online world. Suppliers understood that online shopping behavior was profoundly different from in-store and Peapod, after all, had 26 years of data on online shopping behavior.

Peapod's Future

Parkinson and Brennan were convinced the plan's directions were the right ones. Would the Ahold Board agree? Which of the strategic options was the most critical for success and, given limited resources, which had the highest likely return on investment—and the quickest? Finally, with the technological and competitive landscape shifting so quickly in the nascent online world, they wondered what forces the Board would think they had missed.

Discussion Questions

1. In 2015, more than 95 percent of retail food purchases take place in a physical store. Will consumer behavior change to the extent that online food purchase accounts for a significant portion of a family's annual food budget? Otherwise stated, is online sales a real opportunity, or only a real flash in the pan?

2. Royal Ahold is an international retailer whose entire century-long history has been based on the operation of physical stores—more than 3,500 in 2015. Ahold's associates understand warehouse logistics, visual merchandising, in-store production and face-to-face customer service. Can it be successful in navigating the new waters of digital commerce?

3. Because most mainstream bricks and mortar retailers were slow to enter the ecommerce "omni-channel," Ahold enjoyed a premium position for many years as leader of the pack with its Peapod operating company. By 2015, however, traditional retailers, such as Safeway, Kroger and especially Walmart, were beginning to enter the fray. Do their relatively larger size, more substantial resource base and greater time to prepare put them into a position to leap frog Peapod?

4. Since 1989, Peapod has held off nearly all incursions from the so-called e-commerce "pure plays"—that is, online start-ups with little or no experience in bricks and mortar retail. By 2015, however, Google and Amazon, two of the world's most technologically sophisticated and best-capitalized companies, had entered the online grocery space. Both have world-leading online capabilities, consumer name recognition and trust. Worse, both want food as a new category to drive traffic to their general merchandise sites. Neither needs to make a nickel in online groceries.

5. In response to direction from the Ahold Supervisory Board, Peapod had identified a number of primary growth strategies. Time to respond to marketplace changes is short. Which strategy should Peapod follow? Are there strategies they have overlooked?

6. Peapod actively competes with many large, traditional supermarket retailers and is expecting suppliers to help with its efforts. Is it risky for Peapod suppliers to assist in making Peapod successful? What are the tradeoffs?