Going on offense

BUILDING YOUR OWN CLICK & COLLECT OFFERING

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KEY TAKEAWAYS

Many food retailers are struggling with the day-to-day challenges of driving same-store sales growth, building new stores, and driving efficient operations. With all of those challenges, it is tempting to ignore big challenges like launching an online business.

However, driving sustainable growth will require food retailers to make a number of different growth investments. Acting quickly with investments in "click & collect" can allow food retailers to capture substantial first-mover benefits; initial forays into this technology have been well-received by customers, while capturing business from competitors.

Successful click & collect implementation hinges on three key principles:

- **Customer proposition.** In order to be attractive to customers, retailers must tailor pricing strategies and product options to their audience. Historically, we've seen younger and larger households as a highly receptive demographic.
- **Operational model.** Implementation should foster profitability by facilitating and encouraging bigger baskets, generating margin from other sources, and increasing the cost efficiency of fulfillment operations.
- **Technical execution.** Retailers must ensure that the technical experience delivers on the customer proposition and executes against the operational model, with a focus on details and functionality in their features.

WHY CLICK & COLLECT? WHY NOW?

When talking about options for moving online in grocery, much of the debate has been about click & collect vs. home delivery. As we have watched both formats evolve in Europe, click & collect has demonstrated the greatest growth potential in markets with moderate population density, like most of the larger US cities. For brick and mortar retailers, it also takes advantage of fixed assets making it a low capex way to get started online. Both home delivery and click & collect will play a role in the future of online grocery, but most US brick-and-mortar grocers are better off focusing on click & collect for now.

Being a first adopter gives a substantial advantage. Experience abroad has shown that those who move first in this arena reap significant competitive benefits above those who are slower to adopt. In the UK, 48 percent of online traffic at Tesco.com, a first mover, consisted of customers cannibalized from competitors, while traffic at second and third movers reached cannibalization rates of only 26 percent and 18 percent, respectively.

Market leaders have recognized this fact and are already moving quickly, as shown below in Exhibit 1, with initial positive feedback from customers and the press.

HOW TO DELIVER CLICK & COLLECT SUCCESSFULLY

A successful implementation relies on the interaction between the strategy's customer proposition, operating model, and technical execution. With thoughtful design, each of these levers can serve to reinforce the success of its counterparts and contribute to the overall success of the strategy.

1. Customer proposition

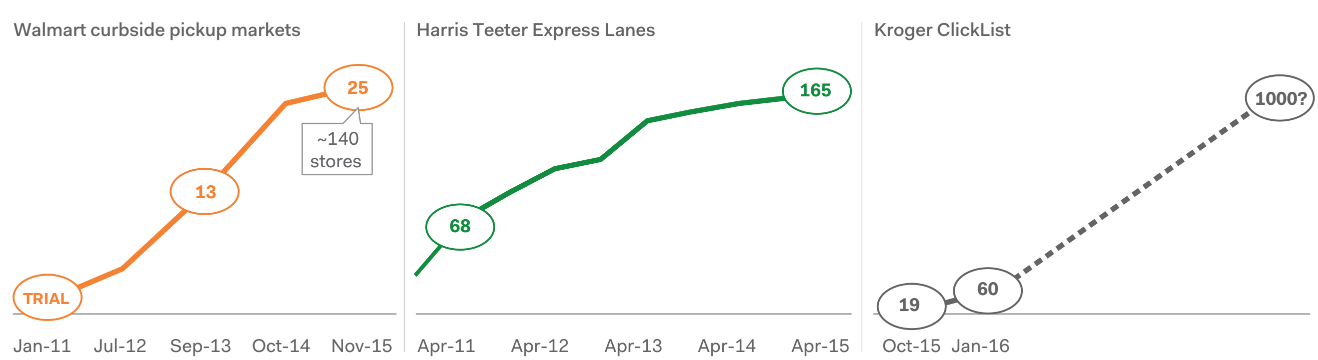
The customer proposition must make the channel attractive to customers by tailoring the experience to those who are most likely to use this service. In order to capture this customer base, the initial strategy must consider how to appropriately value the channel as well as what components of the offer will drive uptake.

The current trend in North America shows that customers today are willing to pay an incremental fee for click & collect service, although experience in Europe indicates that in the long term, customers will eventually expect the service free of charge. Retailers in the UK and France offer click & collect for no additional service fee, offering prices and promotions comparable to those seen in-store. These retailers subsidize the service as a means of remaining competitive. With the benefit of knowledge from the European market, savvy US retailers should look to ensure that the channel will be sustainable in the long run, even as incremental fees are driven down.

Different methods for collecting these fees are available, each of which will affect the consumer's value perceptions. One option is to increase the mark-up on products offered through click & collect; however, for brick-and-mortar stores, experience has shown that this approach erodes customer trust and is likely not sustainable. Fee-for-use pricing is more transparent to customers, although this visibility means that it is also the most susceptible to downward competitive pressure over time. Potentially the most appealing pricing option is through annual subscriptions, especially if retailers can expand the range of services included in the membership such that customers are willing to pay more upfront to lock-in "free" services, such as click & collect, throughout the year.

In addition to pricing, retailers introducing an online channel must consider the demand side of the equation, ensuring the offer will be appealing to its customers. Our research shows that, in the United States, click & collect is most attractive to younger, larger households, as shown in Exhibit 2. All aspects of the value proposition must be designed with this

Exhibit 1: Click & collect locations by company



Q&A WITH CHRIS BAKER AND MARTIN MUMFORD

Is vendor funding for placement or prioritization purely incremental to existing promotional dollars or does it cannibalize from traditional allowances?

You would generally expect this to be incremental to the funding from in-store promotions, as you would be offering a wider range of options that the vendor would pay more for. Increasingly, vendors are putting a lot of pressure on traditional forms of funding, and the online approach may also help to mitigate this type of pressure.

Is there a point of diminishing returns for total or department SKUs offered?

Absolutely. Robust store data about how customers switch between SKUs can give a sense of which SKUs people are loyal to and which items sales are most likely to flow towards if a particular item is discontinued or not offered. This data can be combined with an understanding of the demographic most interested in an online offering to calibrate your selection to include the most important products, while eliminating those that don't add incremental value. You can continue to refine this process over time to develop a carefully curated selection.

Importantly, this does not necessarily mean eliminating relatively worse-selling SKUs; some particular items can drive customer loyalty more than their higher-selling counterparts. As an example, based on sales, a retailer may consider not offering sugar-free orange juice in addition to the top-selling sugared versions, but there is an entire customer set who will only buy orange juice via click & collect if it is sugar-free. Thus, this item may drive more incremental value than other another higher-selling sugared substitute.

It is important to note that, while discontinuing SKUs in your stores will almost always have some negative impact that needs to be offset with a corresponding investment, starting a new format like click & collect with a more limited assortment creates less downside risk.

Is there a particularly good time to think about adopting and executing click & collect in my stores? If I am late to the game, how I can differentiate my offering versus those who have already gained first-mover advantage?

To answer the first question, the time to adopt is now. It matters a little bit what geography you're talking about, but if you look at the new cities Walmart is rolling this service out into, it's not exclusively large metropolitan areas; there are a number of smaller cities and towns as well. Almost no matter where you are, unless you're very rural, the time to adopt is now. One exception may be if you're in massive growth and expansion mode, with operationally stretched stores across the country and a small footprint, it may be beneficial to focus on core growth.

For the second question, customers will switch to an offer for the same reasons that they're willing to switch to your stores. If you have new and different products, meaningfully better value, or an improved service experience, these are all things that can differentiate you online just like in a brick-and-mortar store. However, the barrier to switching is reasonably high. Customers are relatively sticky, given that placing the first order is time consuming and re-order makes subsequent orders much easier.

How have the international retailers been able to deliver click & collect free of charge? What are the implications of the U.S. adopting a charge-based model?

For the first question, the answer is that the offer has been dilutive to margin. They have been able to manage the extent to which it reduces margins through some of the levers we've discussed, such as promoting private brands and generating vendor funding. Those that have been able to drive incremental profit from click & collect overall have done so by capturing market share; their online sales are less profitable than their in-store sales because they can't cover all of their variable costs with the margin-boosting tactics mentioned, but more of those online sales are incremental than at their competitors. Most of those that have succeeded have been the first-movers.

For the second question, the level of charge that we're currently seeing in the US is roughly what we estimate the variable costs of delivery to be, which means that as long as customers are willing to pay this incremental fee, the offer can have comparable margin rates to your in-store business. This would allow retailers to make value-added services part of the offerings and have a broader assortment. It's possible the US could end up with a charge model that has a higher-service, higher-assortment offering than in Europe, while other retailers might have a no-charge, lower-service, curated offer. However, looking at the trends in Europe, as well as in the US in non-food services, it seems likely that there will be pressure on the charge model over time, so there is a real risk that the charge won't be sustainable.

demographic in mind, from assortment to pricing to operations.

Consider the design of the pickup experience. Not having to get out of the car is a critical differentiator for this customer segment. In fact, this format only began to gain market share in France once this feature was introduced. Other key aspects of the proposition like speed of service must also meet the needs of this demographic.

Targeting this demographic with selective assortment can also lead to cost savings. The available assortment of items doesn't need to be especially broad (in France, click & collect selections include about 30 percent of the items available in store). However, the assortment should be deepest in key, over-indexed categories for these customers, such as diapers, baby food, and baby formula. Further, the assortment should be diverse enough to ensure that basic grocery needs are covered; the offer won't appeal to customers if they must still shop in-store for some essentials. Finally, the items offered must have a very high in-stock rate – something enabled by limiting the assortment.

2. Operational model

The operational model must deliver this value proposition in a way that's profitable to the retailer. The key is to make the operational model as incremental as possible to in-store offerings, while ensuring maximum cost-efficiency.

Though online shopping can reduce impulse buys, the online experience has some advantages in driving larger baskets. In particular, online formats have shown that prompting re-order in routine purchase categories can drive up basket size by reducing the "missed items" that might otherwise be picked up in a convenience store or at a mass retailer. Additionally, techniques to drive impulse buys have improved. These techniques include using customer history to recommend new products to try and incorporating recipe features into the shopping experience.

Online channels can also take other steps to incentivize consumers to make choices that are more profitable for the retailer. For example, search pages can promote higher-margin private brands, emphasizing the savings relative to other products. Further, the selection of items available online can disproportionately weight private brands, nudging the customer toward more profitable choices for the retailer. The same can be done to nudge consumers toward more profitable branded goods, and that positioning can be auctioned off to suppliers in the same way shelf placement is sold today.

Beyond auctioning off search placement, online can extract funding from vendors in other new ways. Much of this funding will be incremental to what retailers receive today, while some pieces will simply protect retailers from further downward pressure on funding. Suppliers will pay for inclusion in the curated online assortment, targeted ads, one-to-one marketing, and preferential placement in features like recipes.

The final component of a successful operating model is cost efficiency. Initially, most European examples have started with lower capital intensive implementations, often with staff collecting baskets without any additional aid. This approach can be an appropriate short-term entry into click & collect offerings, but is less cost efficient. In the long run, higher capital expenditures, moving from investments in in-store picking technology to dedicated in-store pick areas to separate picking facilities, will drive down operational expenses and promote lasting profitability.

Limiting the number of items offered can also ensure cost efficiency by simplifying the picking process and reducing out- of-stocks, which cost sales. Combined with careful curation to promote private brands, as described above, a reduced selection can work in multiple ways to support a more successful implementation.

3. Technical execution

Technical execution is critical to effectively delivering your customer proposition while executing against your operational model. A good technical execution can seamlessly support the rest of a retailer's concept, but a poor one can significantly hinder it; the convenience of the platform is a big factor in the perception of the overall service proposition and will influence the number of abandoned baskets and, subsequently, lost revenues.

One of the most important decisions for a retailer's technical execution is whether to utilize a third-party solution or to develop an in-house system. A third-party solution is appealing because of its low cost and speed to implement, and thus can be an easier way to begin executing a click & collect strategy. However, by developing a homegrown system, a retailer will have more control

Exhibit 2: Likelihood to Use Click & Collect by Demographic

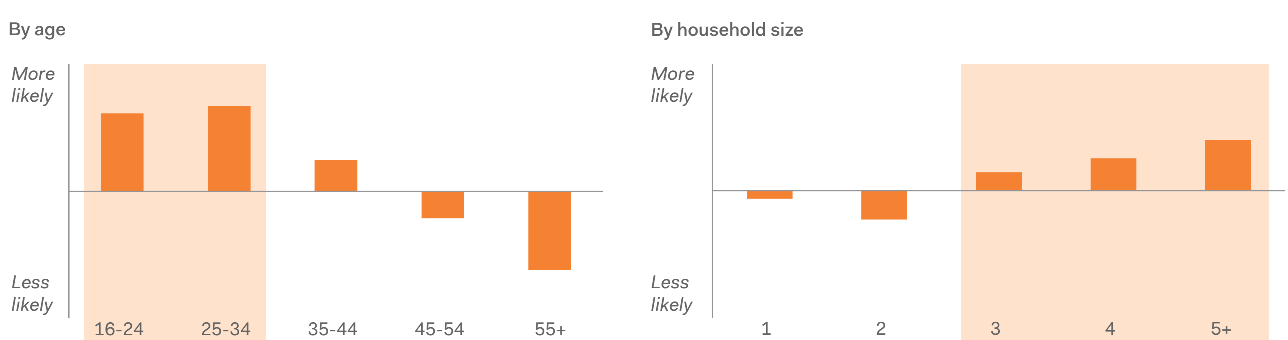


Exhibit 3: Customer satisfaction

and customization, which can, if done effectively, create an ongoing advantage over competitors.

The interface is incredibly important to customers, and small effects can have large impacts on the customer experience. As one case study, AmazonFresh has replicated the app features of FreshDirect and Peapod, but in doing so failed to execute on small details which have led to customer dissatisfaction. (See Exhibit 3.)

Contrary to popular belief, shiny features are not the most important interface elements, since they can be easily replicated across organizations. Instead, the technical delivery of each feature is key – the delivery should promote convenience and ease of purchase. Examples of important functionalities include an effective search engine that displays relevant results and the ability to purchase items in useful increments (e.g. searching for chicken breast and getting results for raw chicken as opposed to chicken broth; ability to purchase garlic by the clove rather than the pound).

CONCLUSION

The time to invest in click & collect offerings is now, as the race to gain market share has already begun in a number of geographies. Retailers should learn from the lessons in Europe to develop an implementation that will attract customers. The best way to do so is to ensure that the customer proposition, operational model, and technical execution work in lockstep to create an offer that saves consumers time and effort, while creating value for the retailer.

90%

OF CUSTOMERS WHO ARE REPEAT USERS, FOR AN EARLY ADOPTER IN THE US

48%

OF ONLINE TRAFFIC FROM COMPETITORS' CUSTOMERS, FOR A FIRST MOVER IN THE UK