Chapter 9

E-Commerce: Digital Markets, Digital Goods

LEARNING TRACK 2: E-COMMERCE CHALLENGES: THE STORY OF ONLINE GROCERIES

When Webvan.com flamed out in July 2001 after having spent almost $1 billion trying to build the Web's largest online grocery store based on huge distribution warehouses in seven U.S. cities, most pundits and investors thought the entire online grocery business model was either a failure or a fraud. Facing the costs of building an entirely new distribution system of warehouses and truck fleets to compete with existing grocery businesses, not to mention the expense of marketing, Webvan compounded its problems by offering below-market prices and free delivery of even small orders at just about any time of the day or night in urban areas often clogged with traffic. But the pundits did not count on Manhattan's FreshDirect-or the ability of traditional grocery chains to move into the ashes of the online grocery business to create solid, profitable businesses. Online groceries garnered sales of $2.4 billion in 2004, and by 2008, sales are expected to grow to $6.5 billion, an annual growth rate of 42%. FreshDirect and other traditional firms are learning how to exploit this potential market with profitable business models.

In 2005, traditional firms such as California's huge Safeway Stores, Royal Ahold (Dutch owner of the U.S. Stop & Shop and Giant stores, among others, and the Internet firm Peapod.com, which handles Internet shopping for Stop & Shop and Giant), and Albertson's (a West Coast chain), are following the lead of the successful British grocer Tesco. Tesco is the largest chain of supermarkets in Britain and opened an online division in 1990. It differed from Webvan's effort because Tesco used its current warehouse infrastructure and existing stores to put together the baskets of food for consumers. Customers could either pick up their baskets or have them delivered within a chosen time window for a fee that recouped most of the delivery costs. In 2002, Safeway began offering online ordering and delivery in Portland, Oregon, and then extended service to San Francisco and Sacramento. Customers register online, entering their personal information, including their frequent shopper cards. They are shown lists of recently purchased items to speed selection. The prices of goods are the same as those in the stores. Safeway has so-called "pickers" roam the aisles of nearby stores using a computerized picklist that directs them through the store in an efficient pattern, and even specifies the order of packing goods into bags. The orders are put into a van and delivered to the customer within a two-hour window for a fee of $10. According to Safeway.com head Mitch Rhodes, "Our business has doubled in the last two years, and we expect it to double again this year." Although Safeway doesn't disclose how much it sells online, Rhodes says that he believes Safeway's Internet sales could be up to $1 billion within a couple of years. For these traditional supermarket chains, the value being offered to customers is convenience and time savings at prices only marginally higher than self-shopping.

FreshDirect has a more revolutionary, but also successful approach. In September, 2002, Joe Fedele and Jason Ackerman founded FreshDirect as a new kind of high-quality and high-tech food preparation and delivery service in Manhattan, and raised $120 million in venture funding. Operating out of a 300,000-square-foot plant in Queens-just across the river from Manhattan-FreshDirect trucks deliver groceries to densely populated Manhattan, Brooklyn, and Queens at prices 25% below what most New York grocers charge. It charges a $3.95-$4.95 delivery fee, depending on location, and requires a minimum order of $40. The value proposition to consumers is convenience and time savings, but also higher quality at lower prices.

How can FreshDirect succeed at these prices? One answer is that FreshDirect concentrates on very fresh perishable foods and stays away from low-margin dry goods. For instance, the FreshDirect Web site features around 5,000 perishables and 3,000 packaged goods compared to the typical 25,000 packaged goods and 2,200 perishable items that a typical grocery store offers. To do so, FreshDirect created the most modern automated perishable food processing plant in the United States. While most of the factory is kept at 36 degrees to ensure freshness and quality control, dedicated areas vary from a low of minus 25 degrees for frozen foods to a high of 62 degrees in one of its specially designed fruit and vegetable rooms. At the factory, FreshDirect butchers meat from whole carcasses, makes its own sausage, cuts up its own fish, grinds coffee, bakes bread and pastries, and cooks entire prepared meals. FreshDirect co-founder Jason Ackerman likens FreshDirect to Dell Inc. in this regard: FreshDirect employs the same "make-to-order," manufacturer-direct philosophy as does Dell. Cleanliness is an obsession-the factory was built to exceed U.S. Department of Agriculture standards. The firm uses SAP software (an enterprise resource planning system) to track inventory, compile financial reports, tag products to fulfill customers' orders, and precisely control production down to the level of telling bakers how many bagels to cook each day and what temperature to use! It uses automated carousels and conveyors to bring orders to food-prep workers and packers. The FreshDirect Web site is powered by BEA Systems' Weblogic platform, which can track customer preferences, such as the level of fruit ripeness desired, or the preferred weight of a cut of meat. FreshDirect also uses NetTracker, Web site traffic and online behavior analysis software, to help it better understand and market to its online customers. At peak times, the Web site has handled up to 18,000 simultaneous shopping sessions. The final piece in the formula for profit is a supply chain that includes dealing directly with manufacturers and growers, thus cutting out the costs of middle-level distributors and the huge chains themselves. FreshDirect does not accept slotting fees-payments made by manufacturers for shelf space. Instead, it asks suppliers to help it direct market to consumers and to lower prices. To further encourage lower prices from suppliers, FreshDirect pays them in four business days after delivery-down from the industry pattern of 35 days.

As of December 2005, FreshDirect delivers to around 120 zip codes in Manhattan, Brooklyn, Queens, the Bronx, Westchester, and the Hamptons, a summer resort area located at the eastern end of Long Island, as well as Jersey City and Hoboken in New Jersey. It has fulfilled close to 3 million orders since opening for business, has annual revenue of around $150 million, and is reportedly profitable. Typical order size has grown from $79 to over $100 dollars, with an average of 30 items; the number of orders per day has increased from 2,500 to 4,000; and the company has about 200,000 active customers. In June 2005, Richard S. Braddock, formerly chairman and CEO of Priceline.com, increased his investment in FreshDirect, and was named the company's Chairman of the Board. According to Braddock, an initial public offering is "one of the options" the company is evaluating as part of its financial strategy. But despite all this success, FreshDirect intends to remain cautious. According to Jason Ackerman, what FreshDirect learned from Webvan's demise was that: "This is a very complex business, and the customer demands perfection every time we fill an order. Webvan's rapid expansion was unmanageable … no matter how good the executive team." Once FreshDirect achieves $500 million in annual revenues from its current facility, it hopes to open three or four additional processing facilities in the New York metropolitan area, and ultimately reach $2 billion in sales and a 5% market share within five years.

SOURCES: "FreshDirect-Help-FAQs," FreshDirect.com, December 30, 2005; "Internet Grocer Names Chairman," by Saul Hansell, New York Times, June 2, 2005; "A Fresh Approach to Technology," by Darrell Dunn, Information Week, January 24, 2005; "Web Grocer Hits Refresh," by Jennifer Harsany, PC Magazine, May 18, 2004; "Internet Groceries Continue to Expand," by Jason Straziuso, Associated Press, May 17, 2004; "FreshDirect: Ready to Deliver," by Larry Dignan, Baseline, February 17, 2004; "NetTracker Web Analytics Software Delivers Online Marketing Analysis to FreshDirect," NetTracker Press Release, July 1, 2003;" What FreshDirect Learned from Dell," by Tim Laseter, Barrie Berg, and Martha Turner, Stategy+ Business, Spring 2003.