case 8 Peapod, Inc., and the Online Grocery Business

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Peapod, Inc., cofounded by brothers Andrew B. Parkinson and Thomas L. Parkinson in 1989, was a $68 million online grocery service that used both its own central warehouses and the retail stores of supermarket partners to fill customers' grocery orders. Peapod was a pioneer of the online grocery industry, getting its start on the Internet well before the Internet became a global phenomenon and well before such competitors as HomeGrocer.com, Webvan, and NetGrocer.com were even organized. However, the company had grown more slowly than first anticipated, revising its trial-and-error strategy several times to find a formula that would attract more customers and make the company profitable. In September 1999, Andrew Parkinson relinquished the position of CEO and turned the reins over to a new president and CEO, Bill Malloy, who had been recruited from AT&T Wireless to fine-tune and execute Peapod's latest order fulfillment strategy and capitalize on what the cofounders believed was a blossoming opportunity in online grocery sales. Andrew Parkinson stayed on as chairman of Peapod's board of directors.

Malloy faced three daunting challenges at Peapod. He had to prove that the company's newly revised business model was viable; that the company could be made profitable after six years of mounting losses; and that it could withstand competition from HomeGrocer.com, which had recently allied itself with Amazon.com, and from newly formed Webvan, which raised over $350 million in its initial public offering of common stock in the second half of 1999.

COMPANY BACKGROUND

As noted above, Peapod was an early pioneer in e-commerce, inventing an online home-shopping service for grocery items years ahead of the commercial emergence of the Internet. With its tagline "Smart Shopping for Busy People," the company began

providing home shopping in the early 1990s, going so far as to install modems in consumers' homes to provide an online connection. Until 1998, the company's business model involved filling customer orders by forming alliances with traditional grocery retailers. The company chose a retail partner in each geographic area where it operated and used the partner's local network of retail stores to pick and pack orders for delivery to customers. Peapod personnel would cruise the aisles of a partner's stores to select the items each customer ordered, pack and load them into Peapod vehicles, and then deliver them at times chosen by customers. Peapod charged customers a fee for its service and also collected fees from its retail supply partners for using their products in its online service. In its first years, Peapod built delivery capabilities in eight market areas:

Chicago, Illinois
Columbus, Ohio
Houston, Texas
Boston, Massachusetts
San Francisco/San Jose, California
Dallas, Texas
Austin, Texas
Long Island, New York

The company steadily built a base of about 90,000 to 100,000 customers across all eight markets; it filled over 700,000 orders in 1999. Peapod's revenues rose from $8.0 million in 1994 to $73.1 million in 1999 (see Exhibit 1). Meanwhile, the company made improvements in its Web site (www.peapod.com) and invested in proprietary software technologies to facilitate efficient order fulfillment and delivery routes, accumulate data on customer buying patterns, and better integrate pricing, merchandising, and product promotion. The company went public in June 1997, offering shares at $16. During 1999 and early 2000, Peapod's stock (listed on the NASDAQ National Market under the symbol "PPOD") traded mostly in the $8 to $12 range.

In 1997, faced with mounting losses despite growing revenues, Peapod management determined that its original, partner-based business model entailed too high a cost structure for the company to achieve profitable growth. The cofounders opted to shift to a new order fulfillment business model using a local company-owned, company-operated central distribution warehouse to store, pick, and pack customer orders for delivery. By mid-1999 the company had opened new distribution centers in three of the eight markets it served (Chicago, Long Island, and Boston); a fourth distribution center was under construction in San Francisco. Peapod stocked its distribution centers with products purchased at wholesale from a variety of food and household products companies, including Kellogg's, Kraft, Colgate-Palmolive, Frito-Lay, Coca-Cola, Clorox, Kimberly-Clark, Procter & Gamble, Nabisco, Ralston Purina, Nestlé, Walgreens, and in some cases, traditional retailers. Peapod management had announced plans to use the centralized distribution model in all eight markets over time and in all new areas it entered. The company was reportedly losing money in five of the markets it served in mid-1999.

PEAPOD IN EARLY 2000

Going into the new millennium, Peapod was the largest Internet supermarket, with over 90,000 customers (based on a count of customers who had placed an order within the past 12 months). It had a 30 percent share of the estimated $235 million market for

exhibit 1 Six-Year Summary of Peapod's Financial Performance, 1994–99 ($000s)

Date	Sales	Net Income	Earnings per Share
1999	$73,134	($28,450)	($1.62)
1998	69,265	(21,565)	(1.27)
1997	56,943	(12,979)	(0.87)
1996	27,642	(9,566)	(0.82)
1995	15,209	(6,592)	(0.79)
1994	8,005	(4,437)	(0.75)

grocery products sold online.[1] The eight market areas where the company presently operated had an estimated 6.6 million households, representing approximately 7 percent of total U.S. households. Delivery operations in these areas were conducted out of 22 order fulfillment locations. Exhibit 2 shows the company's eight metropolitan markets, the number of households represented in each market, and the company's local retail supermarket partners. Peapod processed an average of 2,000 orders daily; the average order size was $110–$115 but ran a bit lower in areas where the company used central distribution warehouses—Peapod stocked fewer items at its warehouses than its supermarket partners stocked at their stores. Management believed that Peapod's average order size was about five times the in-store average of supermarkets and convenience stores.

Management's vision for the company was expressed in three statements:

- *Our Dream*—To fundamentally improve people's lives by bringing interactive shopping to a broad consumer market.
- *Our Mission*—To be the world's leading and preferred provider of interactive grocery shopping services.
- *Our Passion*—To amaze and delight each one of our customers.

Peapod's recent income statements and balance sheets are shown in Exhibits 3 and 4.

Peapod's Customers

Peapod's target market was a middle- and upper-income household with PC-savvy adults who were stressed for time and didn't particularly enjoy grocery shopping. This was the basis for its tag line, "Smart Shopping for Busy People." The company's market research indicated that its typical customers were women between the ages of 30 and 54 who lived in dual-income households and had children. The incomes of customers covered a wide range, with a median annual income exceeding $60,000.

Peapod's Strategy

Peapod's strategy was to provide customers with a convenient, user-friendly, personalized way of shopping for grocery items online 24 hours a day, seven days a week. Its product offerings consisted of fresh meat, produce, deli and bakery goods, name-brand

[1]Peapod, Inc., Investor's Overview, www.peapod.com.

exhibit 2 Peapod's Metropolitan Markets, Household Exposure, and Retail Partners, February 2000

Metropolitan Market Area Served	Estimated Number of Area Households, 1998	Retail Partners	Peapod Distribution Center
Chicago, Illinois	1,732,000	Jewel Food Stores	Yes
Columbus, Ohio	398,000	Kroger	
Houston, Texas	939,000	Randalls Food and Drug	
Boston, Massachusetts	1,242,000	Stop and Shop	Yes
San Francisco and San Jose, California	840,000	Certified Grocers of California, Andronico's, and Walgreens	Yes
Dallas, Texas	995,000	Tom Thumb	
Austin, Texas	257,000	Randalls Food and Drug	
Long Island, New York	226,000	Giant/Edwards Super Foods Stores	Yes

exhibit 3 Peapod's Statements of Income, 1996–99 ($000, Except Per Share Data)

	1999	1998	1997	1996
Revenues				
Net product sales		$57,305	$43,487	$22,015
Member and retailer		9,650	11,234	4,558
Interactive marketing		1,460	2,222	1,069
Licensing		850		
Total revenues	$73,154	$69,265	$56,943	$27,642
Costs and expenses				
Cost of goods sold	$55,585	$53,903	$40,823	$20,485
Fulfillment operations	24,478	17,196	14,469	6,889
General and administrative	9,788	8,029	5,935	3,785
Marketing and selling	7,168	7,545	7,726	4,739
System development and maintenance	3,543	3,386	1,696	1,124
Depreciation and amortization	2,222	3,264	1,234	651
Total costs and expenses	$102,784	$93,323	$71,883	$37,673
Operating loss	($29,650)	($24,058)	($14,940)	($10,031)
Other income (expense)				
Interest income	$1,384	$2,683	$2,044	$537
Interest expense	(187)	(190)	(83)	(72)
Net loss	($28,453)	($21,565)	($12,979)	($9,566)
Net loss per share	($1.62)	($1.27)	($0.87)	($0.82)
Average shares outstanding	17,542,990	16,964,439	14,915,734	11,664,956

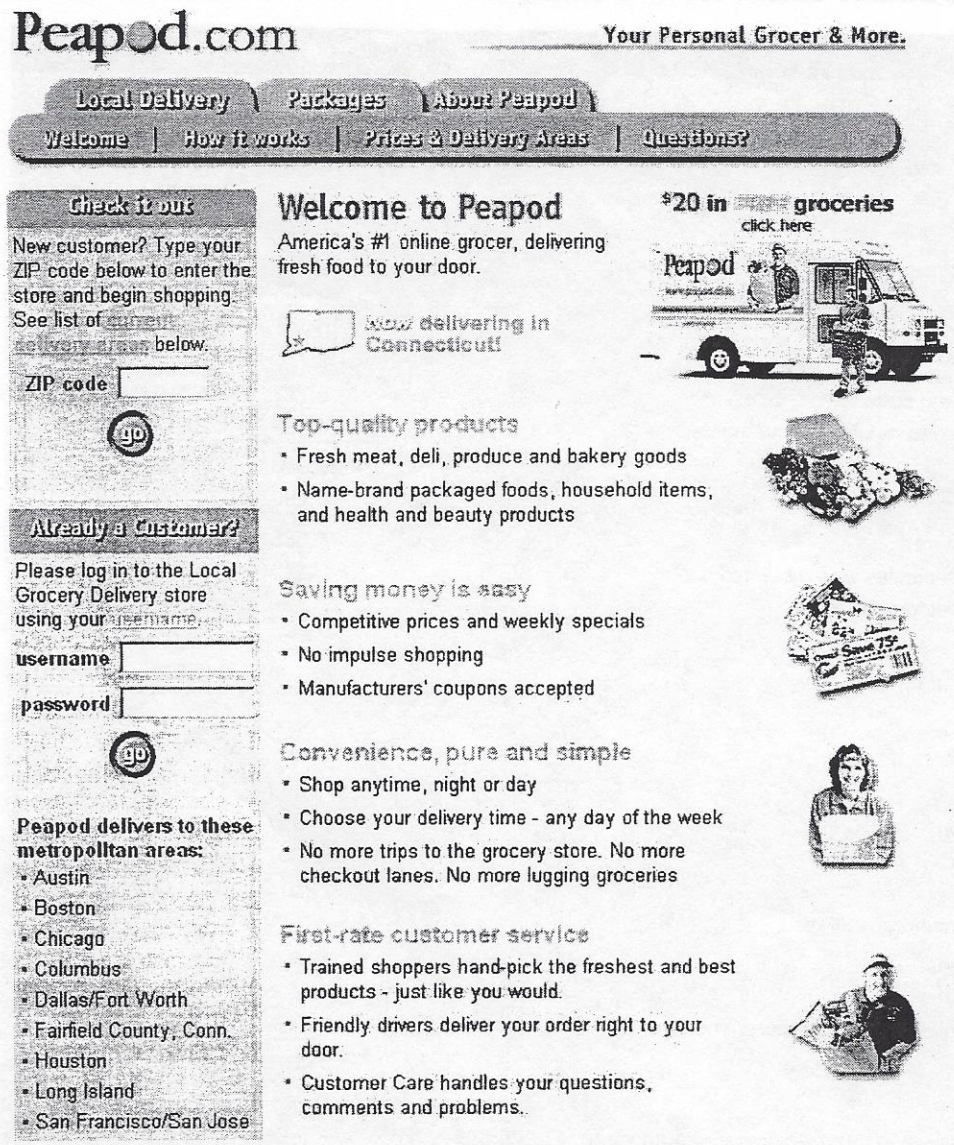
Source: Company 10-K and 10-Q filings.

exhibit 4 Peapod's Balance Sheets, 1997–99 ($000)

	1999	1998	1997
Assets			
Current assets			
Cash and cash equivalents	$ 3,343	$ 4,341	$54,079
Marketable securities	4,704	15,836	8,798
Receivables	1,498	2,516	1,195
Prepaid expenses	473	186	444
Other current assets	993	974	228
Total current assets	10,991	23,853	64,744
Property and equipment			
Computer equipment and software	6,737	4,010	4,499
Service equipment and leasehold improvements	4,189	2,147	1,053
Property and equipment, at cost	10,926	6,157	5,552
Accumulated depreciation	4,290	(2,252)	(2,301)
Net property and equipment	6,636	3,905	3,251
Noncurrent marketable securities and restricted cash	3,143	15,213	
Capitalized software development costs	—	—	998
Goodwill	—	—	117
Total assets	$20,780	$42,971	$69,110
Liabilities and stockholders' equity			
Current liabilities			
Accounts payable	$ 6,147	$ 3,442	$ 7,514
Accrued compensation	497	802	1,258
Other accrued liabilities	1,897	2,688	926
Deferred revenue	615	1,000	1,969
Current obligations under capital lease	690	590	727
Total current liabilities	9,846	8,522	12,394
Deferred revenue	95	448	1,212
Obligations under capital lease, less current portion	1,129	395	701
Total liabilities	11,070	9,365	14,307
Stockholders' equity			
Common stock ($.01 par value, 50 million shares authorized; 17,245,828 and 16,852,557 shares issued in 1998 and 1997)	$ 183	$ 172	$ 169
Additional paid-in capital	71,698	64,319	63,148
Note receivable from officer	(2,369)		
Unrealized gain on available-for-sale securities	(118)	83	—
Accumulated deficit	(58,513)	(30,060)	(8,495)
Treasury stock	(1,171)	(908)	(19)
Total stockholders' equity	9,710	33,606	54,803
Total liabilities and stockholders' equity	$20,780	$42,971	$69,110

Source: Company 10-K and 10-Q filings.

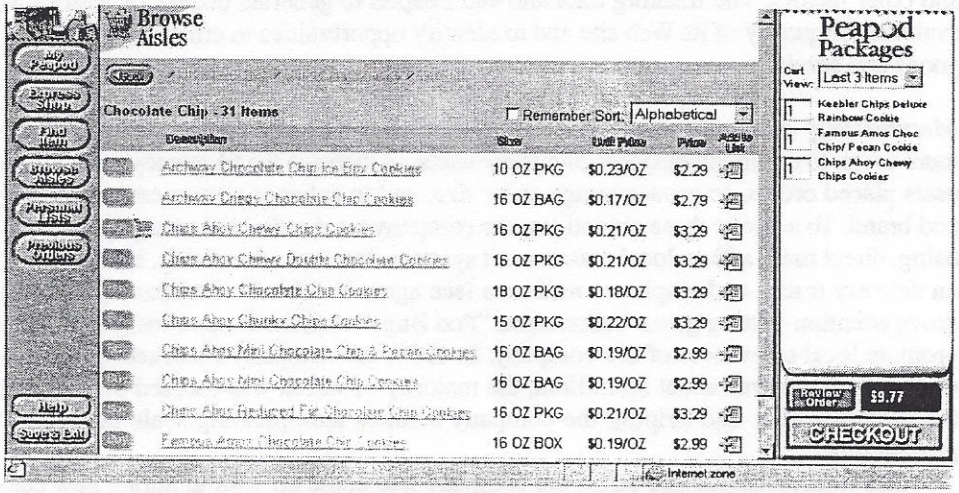
exhibit 5 Peapod's Welcome Page at www.peapod.com



canned and packaged goods, household items, and health and beauty products—essentially the same perishable and nonperishable name-brand products typically found in local supermarkets or drugstores. Peapod's prices were competitive, and it had weekly specials; manufacturer's coupons were accepted. Delivery was available seven days a week and could be scheduled for the same day or next day at a time chosen by the customer. Peapod charged a fee for its online order and delivery service that varied by market area. In most markets customers had the option of paying a service charge per order (about $10 per delivery) or a flat rate for unlimited monthly deliveries.

The company's Welcome Page at its Web site is shown in Exhibit 5. The site was accessible to anyone using a Web browser, via personal computers, Web-enabled televisions, high-speed cable services, and wireless devices.

exhibit 6 Ordering Page at Peapod's Web Site



Peapod's Multifeatured, Highly Functional Web Site Technology

Peapod's easy-to-navigate Web site had variety of highly functional features that, management believed, helped encourage repeat purchases and differentiated Peapod from other e-tailers and direct competitors. Customers could shop for items in several ways. One was to browse aisles, moving logically from general product categories to individual items (see Exhibit 6). Another was to conduct product searches by brand name or category, which was particularly useful for redeeming coupons or purchasing recipe ingredients. Shoppers could also sort items in any product category alphabetically or by price, nutritional content (such as fat, calories, cholesterol, and sodium), sale items, and kosher status. Another feature stored a customer's last three grocery orders, eliminating the need to start a shopping list of frequently purchased items from scratch again. Other features included:

- An extensive library of product pictures, nutrition information, and product ingredients.
- An "Express Shop" that helped first-time shoppers build their order without having to browse through the aisles or search for items one at a time. For existing customers, Express Shop, in conjunction with the Previous Orders feature, allowed customers to easily add items to their order.
- A "SmartCart" that displayed a list of the items selected for purchase, as well as a running dollar total of the bill.
- The capability to generate Web pages based on a customer's shopping preferences, buying profile, and other variables so as to provide users with a customized shopping experience.
- A "Buddy E-Mail" function that delivered order confirmations to two different e-mail addresses—something that was useful in households where shopping duties were shared among members.

Gomez Advisors, a leading provider of Internet research and analysis, in September 1999 rated Peapod's Web site first in terms of ease of use among all online grocers.

The company's Web site technology was designed to capture behavioral information from users—mouse clicks, time spent viewing each page, coupon redemptions, and other factors. The tracking data allowed Peapod to generate dozens of metrics to evaluate the quality of its Web site and to identify opportunities to cross-sell additional goods and services.

Marketing and Advertising Peapod's marketing objectives were to attract more users, to retain the business of current users, to increase the frequency with which users placed orders, to grow average order size, and to enhance awareness of the Peapod brand. To achieve these objectives, the company used radio and newspaper advertising, direct mail, ads on local mass transit systems, Internet advertising, and branding on delivery trucks and employee uniforms (see again Exhibit 5). Company personnel drove attention-getting green Volkswagen "Pod Bugs" with the Peapod insignia to help promote local awareness of the company. In 1999, the company's marketing and advertising budget was about $6 million, the majority of which was focused on growing the customer base and helping the company achieve the operating scale needed for profitability.

One Internet marketing effort the company had come up with to attract new customers was the Peapod Affiliate Program. Peapod started the program in April 1999 as a way of compensating other Web sites for promoting Peapod and providing links to Peapod from their site. Affiliates could earn a $15 commission for each referred visitor who placed an order with Peapod plus an additional $15 for a customer's third order.

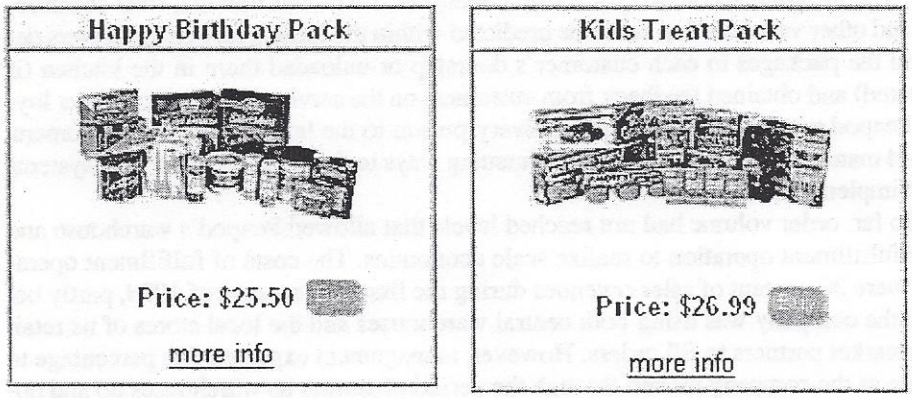
To further promote consumer awareness of Peapod, the company had entered into an agreement with Hearst's HomeArts Network, a premier lifestyle site for women on the Web, whereby Peapod would be the exclusive Internet grocery service promoted on the HomeArts Network. The network provided online programming, as well as features from Hearst's 11 women's magazines, including *Redbook, Good Housekeeping, Cosmopolitan,* and *Country Living*. The HomeArts Network had a user base that strongly matched the target Peapod customer. Peapod had also formed a marketing alliance with Excite, Inc., that made Peapod the exclusive online grocer on Excite's Web site. The agreement with Excite gave Peapod exposure to an estimated 35 percent of all Internet users.[2]

Peapod Packages To help build national presence and awareness of the Peapod brand, the company had begun promoting its "Peapod Packages" for shipment to any location (see Exhibit 7). The company had put together preselected themed product assortments targeting such niche occasions as the Super Bowl, Christmas, Thanksgiving, the arrival of a new baby, or a birthday. There were also care packages for college students and recipe/meal solutions in a box. Shoppers could create their own Peapod Package. Peapod planned to expand the Peapod Package line to include specialty and gourmet foods and gifts.

Distribution Center Operations and Order Fulfillment Peapod's new $2 million distribution centers each stocked over 12,000 dry grocery, frozen, and dairy products, along with perishable products such as produce, meat, and prepared foods. Items were replenished on a just-in-time basis to optimize space utilization and ensure

[2]"Peapod Signs Multi-Year Internet Marketing Deal with Excite," www.peapod.com/v5/Html/Press/press045.html.

exhibit 7 Examples of Peapod Packages



freshness.[3] While Peapod was opening distribution centers in each of its eight markets, it stated its intention to continue its partnerships with its present retail supermarket allies, albeit on a reduced basis. Until its new central warehousing model was perfected, Peapod was temporarily relying on these partners to stock its central warehouse with perishables, health and beauty aids, and other items it did not currently stock and to fill orders for delivery to those addresses not convenient to its warehouse. Moreover, such alliances gave Peapod an advertising channel for promoting its website at its partners' brick-and-mortar locations.

A major component of Peapod's strategy was to optimize its order fulfillment process from a cost standpoint. As the company began shifting from supermarket partnerships to centralized warehousing, it reengineered its product distribution and order fulfillment practices to reduce costs, minimize stockouts, improve the accuracy of order picking at warehouses, make it economical to accommodate higher order volumes, and ensure that orders were delivered within the scheduled time frame. New warehousing, order picking, and delivery routing software and systems had been designed and put in place.

Order fulfillment was managed by a handheld scanning device that contained pick data for a given metropolitan market area and controlled the order selection process in a manner calculated to minimize the labor time for picking and packing orders. The list of items for a particular order was sorted according to the location of each item in the warehouse, thereby requiring only one pass through the warehouse. The handheld unit displayed each item to be picked and provided a variety of features for assuring accuracy and allowing flexibility for handling exceptions. As individual items appeared on the screen, the picker confirmed the proper item by scanning the item's uniform product code, and was alerted if the wrong item had been scanned. If an item was out of stock, the device noted the out-of-stock status and, if requested by the customer, automatically directed the picker to the customer-designated substitution. A list of out-of-stock items was automatically transmitted to the manager to generate replacement orders.

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[3]"Peapod Opens Centralized Operations Center in Chicago," Peapod Press Release January 25, 1999.

Delivery logistics were managed by a sophisticated computer program that provided time management information and point-to-point directions throughout the delivery route. The program accounted for traffic conditions, rush-hour volume, road construction, and other variables that could be predicted within the local area. Peapod drivers delivered the packages to each customer's doorstep or unloaded them in the kitchen (if requested) and obtained feedback from customers on the service. To build customer loyalty, Peapod tried to send the same delivery person to the homes of repeat customers. Peapod management was aggressively pursuing ways to fine-tune all of the new systems it had implemented.

So far, order volume had not reached levels that allowed Peapod's warehouse and order fulfillment operation to realize scale economies. The costs of fulfillment operations were 30 percent of sales revenues during the first nine months of 1999, partly because the company was using both central warehouses and the local stores of its retail supermarket partners to fill orders. However, management expected this percentage to decline as the company moved through the period of getting its warehouses up and operating, as experience with the new systems accumulated, and as order volume increased. For the company to become profitable, order fulfillment costs had to drop to a much smaller percentage of revenues.

Nonetheless, Peapod believed that its business model would give it a significant competitive advantage over traditional grocery retailers. By using the Internet to receive orders and central warehouse and distribution facilities to process them, Peapod eliminated the expenses associated with maintaining multiple retail locations in a metropolitan area. Moreover, its use of centralized inventory warehouses and just-in-time deliveries from suppliers led to high inventory turns and reduced stockouts, while at the same time lowering waste and spoilage of perishable goods and reducing the shrinkage associated with store personnel and customer handling of in-store products. Peapod management expected that the efficiencies of its business model would permit competitive pricing and, further, that its sophisticated Web technologies would result in being able to increase sales of high-margin products (private-label goods). Thus, the company expected that, over time, it ought to have higher gross margins and better bottom-line profitability than traditional grocery retailers.

Research and Data Partnerships with Suppliers Peapod was leveraging the database it was accumulating from tracking user behavior and shopping patterns on its Web site. The company provided advertisers on its Web site with feedback on the effectiveness of marketing programs, and it provided a forum for consumer goods companies to conduct targeted advertising, test electronic couponing, and gather data on online purchasing behavior. The company had created research panels of users at costs that management believed were well below the costs of consumer panels used by Internet research firms. Peapod linked users from its eight markets to form a national online network of panelists and users, enabling the company to collect information on user attitudes, purchasing behavior, and demographics.

Peapod's database and membership profiles permitted it to deliver highly targeted ads and electronic coupons to users, as well as to count the number of Web-page exposures, click-throughs, coupon redemptions, and sales—the data were captured in a manner that allowed the company to measure the impact of a marketing program. Peapod had agreements to provide fee-based online marketing data and research services to a number of national consumer goods companies, resulting in annual revenues of

$1.0 to $1.5 million. Management believed that as Peapod's customer base grew, consumer goods companies would increasingly view Peapod as a powerful advertising venue as well as a valuable research tool, thereby generating additional revenues for Peapod. Participating subscribers included Kellogg's, Kraft, Colgate-Palmolive, Frito-Lay, Coca-Cola, Clorox, Kimberly-Clark, Ralston Purina, and Nestlé U.S.A.

Growth Strategies Aside from its efforts to build order volume and add new customers in the eight markets where it already operated, Peapod's strategy to grow its business consisted of two major initiatives: (1) expanding into additional market areas and (2) moving beyond groceries and adding altogether new products and services to its lineup. Peapod management planned to use its central warehouse business model and new systems capabilities as the basis for expanding its service into a total of 40 metropolitan areas with 400,000-plus households. The company planned to keep its investment costs down by building economical $2 million distribution centers. Moreover, by establishing a local order fulfillment network with recurring grocery purchases as a foundation, Peapod management believed it would have a pipeline into customer households through which it could provide an increasingly wide range of goods and services at little incremental cost. Peapod management believed that its "last-mile" delivery network for groceries gave it an unparalleled opportunity to build the Peapod brand and to establish personal relationships with individual customers through regular deliveries. Management planned to transform Peapod into a one-stop online shopping site offering home delivery of a host of different products and services, thereby dramatically improving profitability.

As one of the first steps in expanding its product offerings, the company had recently formed a strategic product alliance with Walgreens. Under this agreement, Peapod would begin offering health and beauty products, household hardware and small appliances, electrical supplies, audio- and videotapes, stationery and art supplies, and seasonal items supplied by Walgreens.[4]

The major impediment to Peapod's growth strategies was a potential shortage of capital. The company had nearly $13 million in cash and marketable securities going into the fall of 1999, but the size of the company's losses was creating negative cash flows from operations. The company was depleting its cash reserves to cover the negative cash flow from current operations. Peapod management anticipated that its existing cash and marketable securities would be insufficient to fund the company's operations and capital requirements in 2000 and was therefore currently evaluating financing opportunities. Exhibit 7 shows recent trends in the company's stock price. Analysts following the company forecast that Peapod's losses would amount to $17–$20 million in 2000, equal to a negative $1.10 per share.

Management Changes

Peapod's top management team underwent significant change in 1999. Bill Malloy, brought in as president, chief executive officer, and a member of the board of directors, had established an impressive record of successfully launching new operations and new services while managing rapid growth at AT&T Wireless, and had been one of the key architects of AT&T's Digital One Rate strategy. Cofounder Andrew Parkinson, who stayed on as chairman of the board, began devoting his efforts full-time to Peapod's long-term strategy and business development. Malloy made several top-management

[4]"Peapod and Walgreen Co. Announce Product Alliance," Peapod Press Release, March 10, 1999.

changes in the months following his appointment. Michael Brennan was promoted to senior vice president of marketing and product management, George F. Douaire was made senior vice president of Peapod Interactive, and Robert P. Ziegler joined Peapod as director of Chicago operations. The top five officers under Malloy collectively had 36 years of experience in the online grocery business, and several officers had previous experience in packaged foods and consumer products at such companies as Kraft Foods and Procter & Gamble. Peapod employed approximately 475 full-time and 370 part-time employees in early 2000.

THE RETAIL GROCERY INDUSTRY

The U.S. retail grocery industry was a $430 billion business.[5] Sales of health and beauty aids amounted to an additional $200 to $225 billion. Forrester Research estimated that the total sales of grocery and household items, health and beauty items, and beverages in all types of retail outlets amounted to a $720 billion U.S. market.

The top five supermarket chains in 1999 were Kroger, with $43.2 billion in sales; Albertson's, with $35.9 billion; Wal-Mart, with $27 billion from its grocery operations; Safeway, with $26.5 billion; and Ahold, with $20 billion.[6] Slow growth and intense competition were driving supermarket industry consolidation. No supermarket chain had an industry market share much above 10 percent; the top five chains had a combined share under 30 percent. Supermarket sales had grown at an average of just 3.4 percent over the past 10 years, partly because more consumers were shifting some of their purchases to drug chain, wholesale club, and discount chain "supercenter" formats. Traditional grocers' share of total U.S. food sales had dropped from 42 to 40 percent over the last ten years.[7]

Typical supermarkets carried an average of 30,000 items, ranged in size from 20,000 to 40,000 square feet, and averaged $12 million in sales annually. Consumers tended to be price-conscious, and the industry was characterized by fierce price competition.

The supermarket business was a notoriously low-margin business with net profits of only 1 to 2 percent of revenues. Store profits depended heavily on creating a high volume of customer traffic and rapid inventory turnover, especially for perishables such as produce and fresh meat. Competitors had to operate efficiently to make money, and tight control of labor costs and product spoilage was essential. Because capital investment costs were modest, involving mainly the construction of distribution centers and stores, it was not unusual for supermarket chains to realize 15 to 20 percent returns on invested capital.

Supermarket Chains as Potential Competitors in the Online Grocery Segment Most supermarket chains were following developments in the online grocery industry carefully. While some observers believed that existing supermarket chains would be slow to enter into online sales for fear of cannibalizing their existing sales and undermining their brick-and-mortar investments, other industry observers expected supermarket chains to enter the online grocery segment, especially if

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[5]Ronette King, "Grocery Mergers Are Part of the Growing U.S. Trend," *Times-Picayune,* October 13, 1999, p. A4.

[6]Joan Bergmann, "Food for Thought: Going into the Grocery Industry," *Discount Merchandiser,* May 1999, p. 36.

[7]Nora Aufretier and Tim McGuire, "Walking Down the Aisles," *Ivey Business Journal,* March–April 1999, p. 49.

online grocery sales took off. However, other supermarket industry analysts believed some existing supermarket chains would definitely not stand by idly and let online grocery companies steal market share without a fight. These analysts saw existing supermarket chains as potentially formidable competitors in the online segment because they had well-established supply chains, bought in volumes that gave them bargaining power with food and household product suppliers, had well-known brand names, knew local markets, and could use their distribution centers and neighborhood stores as bases from which to make home deliveries. As many as one-third of U.S. grocery chains were said to have experimented with some type of delivery service.[8]

Albertson's had recently begun testing the market by offering online shopping to customers in the Dallas/Fort Worth, Texas, area. Albertson's was well established in the Dallas/Fort Worth area, with numerous stores and a sizable share of the supermarket business. Management indicated that if its online venture in the Dallas/Fort Worth area was deemed successful, it would expand its online grocery service to other areas.

Clark's Supermarkets, a small, family-owned Colorado chain, announced plans in early 2000 to experiment with online grocery sales at its stores. Clark's intended to put the items stocked in its stores online, allowing customers to log on to its Web site and select the items they wanted. The company had designed a special cart that allowed store personnel to cruise store aisles and pick five orders simultaneously. Clark's strategy was to run the items through its checkout counters, pack them, and have them ready for customer pickup at a time chosen by customers. For the time being, Clark's did not plan to deliver orders to customers' homes. Clark's store in Steamboat Springs was selected to be the pilot for the online experiment; if the service proved popular and successful, Clark's intended to make it available at other Colorado store locations. Clark's saw online ordering as a time-saving service to customers; management did not expect the service to add substantially to the company's profitability.

THE ONLINE GROCERY SEGMENT

The online grocery shopping business was in its infancy in 2000. Analysts believed that online grocery sales amounted to about $235 million in 1999, less than 0.25 percent of total supermarket industry sales. There were 45 companies in the online market, and none were profitable yet.[9] So far, online grocery shopping had been slow to catch on, and industry newcomers had encountered high start-up and operating costs. Sales volumes were too small to permit profitability. The problem, according to industry analysts, was that consumers had been largely disappointed in the service, selection, and prices that they had so far gotten from industry members.

However, some analysts expected online grocery sales to grow at a rapid pace as companies improved their service and selection, PC penetration of households rose, and consumers became more accustomed to making purchases online.[10] Forrester Research forecast that online grocery sales could reach $3 billion by 2003 and as much as $85 billion by 2007. A two-year study by Consumer Direct Cooperative (CDC) concluded that online, consumer-direct grocery sales would account for between 8 and 12 percent of the total grocery market share by 2010.[11] CDC had also done a study of the types of online shoppers (see Exhibit 8). Most online grocery customers were believed to be either starved for time or averse to grocery store visits.

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[8]Laurent Belise, "A Mouse in the Bakery Aisle," *Christian Science Monitor,* September 8, 1998, p. 11.

[9]Sharon Machlis, "Filling Up Grocery Carts Online," *Computerworld,* July 27, 1998, p. 4.

[10]Ibid.

[11]Terry Hennessy, "Sense of Sell," *Progressive Grocer,* August 1998, pp. 107–10.

exhibit 8 Types of Online Shoppers

Types of Online Shoppers	Comments
Shopping avoiders	Dislike going to the grocery; prime candidate for online grocery shopping
Necessity users	Have limited ability to go to the grocery store; strong candidate for using online grocery shopping as a substitute for in-store shopping
New technologists	Young and comfortable with technology; certain to experiment with buying products online; amenable to online grocery shopping if it is a pleasant and satisfying experience
Time-starved shoppers	Insensitive to price; don't mind paying extra to save time
Responsibles	Have available time; get an enhanced sense of self-worth from grocery shopping
Traditional shoppers	Older; may want to avoid technology and buying products online; very likely to prefer "touch and inspect" shopping in a grocery store

Source: A study by Consumer Direct Cooperative cited in Michael McGovern, "One Stop Shopping," *Transportation & Distribution* 39 (May 1998).

A MARC Group study concluded that "consumers who buy groceries online are likely to be more loyal to their electronic supermarkets, spend more per store 'visit,' and take greater advantage of coupons and premiums than traditional customers."[12] Another study found higher demand for produce online. Edward McLaughlin, head of the Food Industry Management Program at Cornell University, found that 12 to 16 percent of grocery expenditures through Peapod were for fresh produce, compared to the supermarket average of about 10 percent.[13] He reasoned that this outcome was because "decisions made through a computer are more rational, and choices are for healthier foods."

One of the problems with online grocery shopping was that consumers were extremely price-sensitive when it came to buying groceries. The prices of many online grocers were above those of supermarkets, and shoppers in many cases were unwilling to pay extra for the convenience of home delivery. Consumer price sensitivity meant that online grocers had to achieve a cost structure that would allow them to (1) price competitively, (2) cover the costs of picking and delivering individual grocery orders, and (3) have sufficient margins to earn attractive profits and returns on investment. Some analysts estimated that online grocers had to do 10 times the volume of a traditional grocer in order to be successful.[14] However, other analysts and several online grocers believed that the value chain of online grocers was more cost-effective than that of traditional supermarkets (see Exhibit 9).

Gomez Advisor's Ratings of Online Grocers

Gomez Advisors provided user-oriented ratings of numerous types of online companies, ranging from banks to auction sites to travel agents to sellers of sporting goods.

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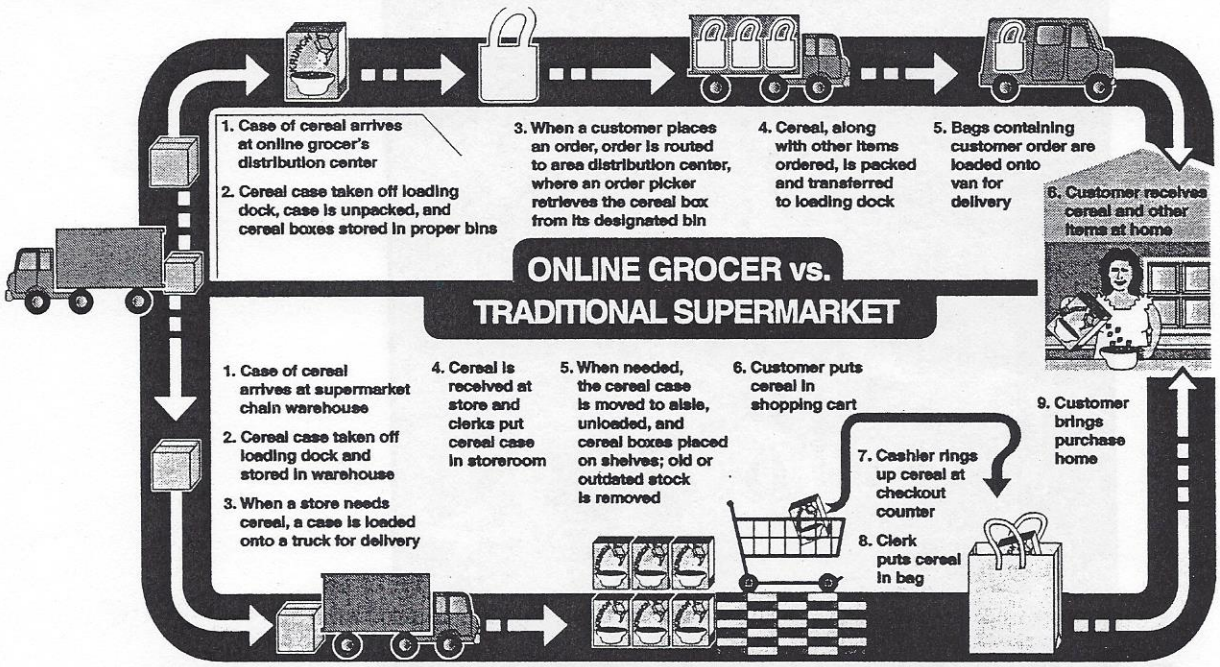
[12]Bob Woods, "America Online Goes Grocery Shopping for E-Commerce Bargains," *Computer News,* August 10, 1998, p. 42.

[13]"Net Profits: Making the Internet Work for You and Your Business," *Fortune,* Summer 1999, pp. 240–43.

[14]Lawrence M. Fisher, "On-Line Grocer Is Setting Up Delivery System for $1 Billion," *New York Times,* July 10, 1999, p. 1.

exhibit 9 Comparative Logistics for Traditional Supermarket versus Online Grocer



Source: Adopted and revised from E.81Z section of *Business Week,* July 26, 1999, p. EB46.

Many online shoppers were using the Gomez ratings to help them select which Internet providers to do business with. Gomez evaluated online grocers on five aspects:

- *Ease of use*—whether the Web site had well-integrated features that minimized order time and that gave shoppers product comparison capabilities.
- *Onsite resources*—the breadth of product selection and the quality of information resources provided to users.
- *Relationship services*—whether the grocer provided such "extras" as in-home visits with first-time customers, account representatives to answer questions, and willingness to fill unique orders.
- *Overall cost*—product costs (based on nonpromoted prices of a market basket of commonly purchased items), delivery charges, length and frequency of price promotions, and membership fees (including whether there were free trial periods for new members).
- *Customer confidence*—financial stability, reliability of customer service, and guarantees for what was sold.

Gomez also determined on the basis of its ratings which online grocers were most suitable for selective shoppers, bargain-hunting shoppers, time-constrained shoppers, and meal solution shoppers. Exhibit 10 reports the fall 1999 Gomez ratings of the top 10 online grocers.

PROFILES OF SELECTED PEAPOD COMPETITORS

Peapod management anticipated that the company would experience increasing competitive pressures in the online grocery segment. Competition was expected to come

exhibit 10 Gomez Ratings of the Top 10 Online Grocers, Fall 1999

Company	Ease of Use	Overall Cost	Customer Confidence	Onsite Resources	Relationship Services	Overall Score	Comments
Peapod	9.07	7.96	5.41	7.90	3.75	6.97	Rated third (score of 6.17) for time-short shoppers looking for the best deal with the least hassle
HomeGrocer.com	7.33	7.41	4.82	7.74	5.00	6.67	Rated second best (score of 7.02) for selective shoppers wanting *the* best products and delivery service; also rated second best (score of 6.80) for shoppers looking for specific meal solutions (recipes, seasonal foods, and prepared foods)
Webvan	8.22	7.16	2.63	7.32	5.00	6.36	Rated best (score of 7.23) for selective shoppers and best (score of 7.14) for shoppers looking for specific meal solutions
Streamline	4.62	5.93	5.16	7.47	7.50	6.31	Rated best (score of 6.92) for time-short shoppers
ShopLink	6.36	6.98	5.33	5.93	6.25	6.26	Rated second best for time-short shoppers (score of 6.70)
HomeRuns	5.56	8.75	4.97	3.41	2.50	5.18	Ranked best (score of 8.68) for bargain shoppers who love to browse and the thrill of shopping for the best deal
NetGrocer.com	8.22	3.33	2.97	5.49	3.75	4.70	
Albertson's	4.67	8.16	3.99	0.90	2.50	4.13	Ranked second (score of 7.54) for bargain shoppers
Grocer Online	5.42	3.46	6.64	0.36	2.50	3.73	
Your Grocer	4.53	3.84	5.91	2.70	5.00	3.68	

Source: www.gomez.com, February 6, 2000.

exhibit 11 Comparative Prices of Selected Online Grocers, February 2000

Grocery Item	Peapod's Price	Webvan's Price	HomeGrocer.com's Price	NetGrocer.com's Price
Lea & Perrin's Worcestershire sauce (10 oz.)	$2.19	$2.47	$2.25	$2.39
Campbell's Chunky Classic chicken noodle soup (19 oz.)	$2.45	$2.44	$2.19	$2.29
Bunch of green onions (scallions)	$0.50	$0.50	$0.49	Fresh produce not available
French's mustard squeeze (8 oz.)	$0.97	$0.97	$0.95	$0.99
Maxwell House Instant Crystals (8 oz.)	$4.89	$4.92	$5.49	$5.49
Kraft Macaroni and Cheese Deluxe (14 oz.)	$2.39	$2.47	$2.29	$2.49

Source: Company Web sites.

from (1) supermarket chains adopting "click-and-mortar" strategies and pursuing online sales as a new distribution channel to complement their traditional chain of retail outlets and (2) the aggressive market expansion efforts of the 45 companies already in the online segment. This section provides a brief look at three of Peapod's competitors in the online grocery business. Exhibit 11 provides a comparison of Peapod's prices for six selected items with those of Webvan, HomeGrocer.com, and NetGrocer.com.

Webvan Group, Inc.

Webvan's strategic intent was to become the market leader in the full-service online grocery and drugstore business. Louis H. Borders, a founder of the Borders Group who left the bookstore chain in 1992 to form his own investment firm, launched Webvan in Foster City, California, in June 1999 as one of the most ambitious e-commerce enterprises to date. Before going public, Webvan had attracted $122 million in investment capital from CBS, Yahoo!, Softbank, Sequoia Capital, Benchmark Capital, and Knight-Ridder and had recruited the head of Andersen Consulting, George Shaheen, to be its president and CEO.[15] Webvan completed an initial public offering of its stock in November 1999, raising $375 million in capital by selling 9 percent of its shares. The shares, initially priced by Goldman Sachs at $13 to $15 a share, rose to as high as $34 per share before ending the first day's trading at $24.875. The company's prospectus forecast that Webvan would post $11.9 million in revenues in 1999, $120 million in 2000, and $518.2 million in 2001. The prospectus also stated that company expectations were for a $73.8 million loss in 1999, a $154.3 million loss in 2000, and $302 million in losses in 2001.[16] The company shares traded in the $15 to $20 range in early 2000.

Webvan attracted about 10,000 customers in its first six weeks of operation in the San Francisco Bay area. The company had recruited several executives from Federal Express and was using FedEx's hub-and-spoke delivery system as a model for its own distribution system and delivery service. Webvan was using Wal-Mart as its example of

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[15]Linda Himelstein, "Louis H. Borders," *Business Week,* September 27, 1999, p. 28.

[16]"Webvan Group Files Amended Prospectus for Initial Offering," *The Wall Street Journal,* October 13, 1999, p. A8.

breadth of product selection, Yahoo! as its model for speed, Amazon.com as its model for designing the kind of online shopping experience it wanted to provide, and eBay as its model for "warm-and-fuzzy" feel.[17] It had hired 80 software programmers to create proprietary systems that linked every aspect of its business processes and had recruited managers with expertise in logistics, grocery and drug retailing, and customer service.

Webvan's Strategy and Business Plan To begin operations, Webvan had constructed a 330,000-square-foot prototype in Oakland, California, to service an area of 40 miles in any direction.[18] The $25 million facility included 4.5 miles of conveyor belts and temperature-controlled rooms to store wine, cigars, produce, meat, and frozen foods. It was designed to serve as many households as 20 to 25 supermarkets. The company planned to eventually stock 50,000 items, including an array of drugstore items, 300 varieties of fresh fruits and vegetables, 750 kinds of cheese, 500 types of cereal, 700 cuts of fresh meat and fish, 700 different wine labels, and chef-prepared meals that could be reheated in the microwave or oven. In the San Francisco market area, Webvan had formed alliances with leading local vendors to provide the freshest produce available; it planned to use such alliances in other markets as well. Webvan claimed that its prices were up to 5 percent less than those of local grocery stores. See Exhibit 12 for Webvan's home page.

Webvan had entered into an agreement with Bechtel Group, one of the world's largest engineering and construction firms, to build Webvan's distribution centers and delivery systems in 26 markets over the next two years. Webvan's projected investment costs for its distribution centers and delivery systems amounted to $1 billion. The company's second distribution center had recently been built in Atlanta.

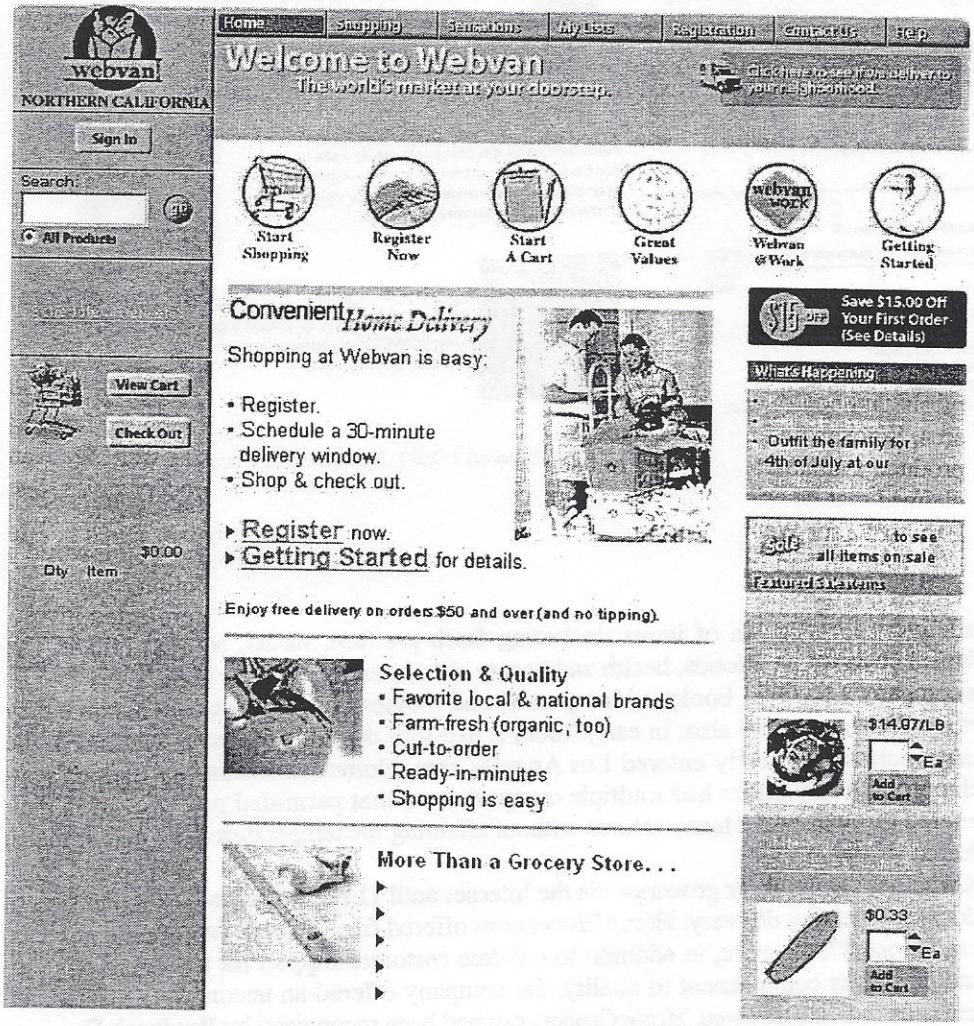
Webvan's tracking systems monitored customer orders starting with the time they were placed on the company's Web site. Orders were directed from the Web site to the appropriate distribution center. Workers were located at order-picking stations scattered throughout each distribution center; their job was to pick items stocked in their area of the warehouse and put them in color-coded plastic tote bags that signaled whether the items were frozen, refrigerated, or dry. Pickers did not travel up and down aisles but instead moved no more than 20 feet in any direction to reach 8,000 bins of goods that were brought to the picker on rotating carousels. Once pickers completed their portion of a customer's order, the tote was transported on conveyors to other areas of the distribution center where pickers for the remaining items were located. After orders had made the necessary rounds through the warehouse, they were loaded onto trucks refrigerated at 35°F and taken to staging areas located throughout the metropolitan market area. From there, the totes were loaded onto one of the company's 60-plus vans for delivery to customers' homes. Staging areas were located so that Webvan's couriers did not have to travel more than 10 miles in any direction from the staging area to reach a customer's home. The couriers were trained to be courteous and friendly, and to act as customer service professionals and ambassadors for Webvan's service; they were not permitted to accept tips or gratuities. All of the logistics—how many items a tote bag should hold, how far pickers should travel to rotating carousels, how far trucks should travel from staging areas to make deliveries—had been carefully plotted to maximize efficiency.

Webvan management expected that each distribution center would be able to handle 8,000 orders a day (involving more than 225,000 items) and bring in $300 million

[17]Linda Himelstein, "Can You Sell Groceries like Books?" *Business Week,* July 26, 1999, p. EB-44.

[18]Ibid., p. EB-45.

exhibit 12 Webvan's Welcome Page at www.webvan.com



in annual revenues.[19] Louis Borders predicted that Webvan's business model would be so successful and efficient that the company would be able to charge lower prices than both traditional supermarkets and rival online grocers.

Webvan offered free delivery on orders over $50, whereas most other online grocers waived delivery fees only on orders over $75. And the company did not charge a membership fee. Orders were delivered within a 30-minute window selected by the customer. Webvan's Web site offered customers recipes and use of a weekly menu planner.

HomeGrocer.com

Founded in 1997, HomeGrocer.com provided online grocery ordering and delivery service to customers in Seattle, Washington; Portland, Oregon; Orange County, California; and portions of Los Angeles and San Bernardino County. HomeGrocer.com

[19]Ibid., p. EB-46.

exhibit 13 HomeGrocer.com's Welcome Page at www.homegrocer.com

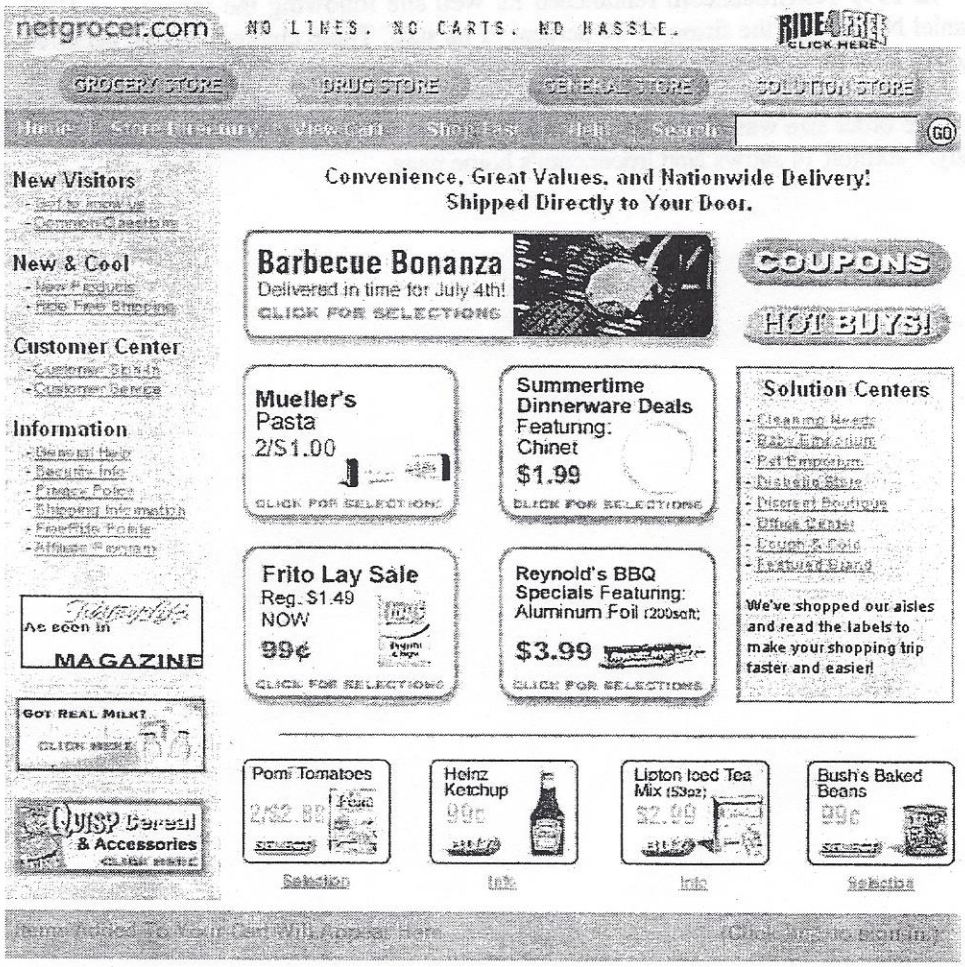
offered a broad selection of items, including fresh produce, meats, seafood, dairy products, local specialty foods, health and beauty aids, household items, fresh flowers, pet supplies, best-selling books, video games, and movies. HomeGrocer.com used a distribution center model also; in early 2000, it had four distribution centers and was adding others in the newly entered Los Angeles area. HomeGrocer.com's signature peach-logo delivery trucks had multiple compartments that permitted products to be stored at their appropriate temperatures without affecting the temperatures of the other products.

Customers could order groceries via the Internet until 11 PM and select a 90-minute window for next-day delivery. HomeGrocer.com offered free delivery for all first orders and those $75 or more, in addition to toll-free customer support for its members. To underscore its commitment to quality, the company offered an unconditional 100 percent satisfaction guarantee. HomeGrocer.com had been recognized by Feedback Direct, a leading online customer service authority, as one of the top 50 North American companies to consistently demonstrate superior customer service. Exhibit 13 shows Homegrocer.com's home page.

Although HomeGrocer.com was a fairly small business, with fewer than 25,000 customers, it had ambitious plans to expand into 20 other markets in the near future, aided by a $42.5 million investment from Amazon.com.[20] Amazon's investment gave it a 35 percent stake in the company. Amazon had also recently invested in drugstore.com and Pets.com, and there had been speculation that Amazon might start to use HomeGrocer.com's vans to deliver CDs, books, and prescription drugs to customers' homes. Homegrocer.com had also received funding from the Barksdale Group, an investment firm run by James Barksdale, founder of Netscape, Martha Stewart Living

[20]Andrew Marlatt, "Amazon Diversifies Further with $42M Stake in Grocer," *Internet World*, May 24, 1999.

exhibit 14 NetGrocer.com's Welcome Page at www.netgrocer.com



Omnimedia Inc., Hummer Winblad Venture Partners, and Kleiner Perkins Caufield & Byers.[21] The company had filed plans with the Securities and Exchange Commission to issue shares of its common stock to the public in the first half of 2000.

NetGrocer.com

NetGrocer.com began operations in 1995 and offered nationwide distribution through a large central warehouse located in New Jersey. NetGrocer.com's product line included canned and packaged grocery items, paper products, cleaning products, organic and natural foods, international food items, dog and cat foods, laundry items, health and beauty products, dietary supplements, pain relief products, fragrances, baby products, a variety of electronics items (cameras, film, calculators, data organizers, audio accessories, batteries, and video games), CDs, and gifts. It generally offered prices of 10 to 20 percent

[21]Rachel Beck, "Online Grocers Work to Build a Market," *Houston Chronicle,* May 30, 1999, p. 7.

less than supermarkets and free delivery for orders over $75. NetGrocer.com's orders were delivered by FedEx on the third business day after the order was received.

In 1999 NetGrocer.com relaunched its Web site following the removal of CEO Daniel Nissan and the firing of 80 percent of its staff. These changes, which occurred shortly after the company shelved its $38 million initial public offering, were attributed to market conditions and expense cuts. Since the launch of the new site, NetGrocer.com's average order size was up 40 percent and time spent on the site had increased dramatically.[22] Exhibit 14 shows NetGrocer.com's home page.

[22]Barry Janoff, "Point, Click, Shop," *Progressive Grocer,* June 1999, p. 31.