THE U.S. GROCERY INDUSTRY IN THE 2020S: WHO WILL COME OUT ON TOP?

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ABSTRACT

The world of grocery retail is constantly shifting. Competition continues to intensify driven by two main players: Amazon and Walmart. The two American giants are dominating the brick-and-mortar and online realms. However, they are being challenged by a German underdog, Aldi. Aldi's business model is built around slashing cost without compromising quality. A typical Aldi store is 12,000 square feet, and carries a limited selection of mostly inexpensive private brands (1,000 SKUs). Merchandise is often stacked in the aisles and sold straight from the cardboard box it was shipped in. Basically, Aldi is a grocery store that's the size of a convenience store. Consequently, the deep-discount grocer has been able to appeal to a growing price-sensitive segment and continues to win over American consumers. Aldi U.S. has grown from one store in 1976 to almost 2,000 stores in 36 states in 2019, and has plans to expand to 2,500 stores by the end of 2022. There is no doubt the nimble "underdog" has disrupted the $700 billion grocery industry, and giants like Amazon, Kroger, and Walmart have no choice but to up their game. The retail behemoths are aggressively lowering prices and continuously refining online ordering and home delivery programs to respond to the threat Aldi poses. Selling groceries in America has never been harder. Can U.S. grocery retailers effectively stand up to the German hard discounter? Who will come out on top?

INTRODUCTION

Retailing includes the business activities involved in selling goods and services to consumers for personal, family, or household use. Retailing does not have to involve a store. Mail and phone orders, direct selling to consumers in their homes and offices, Web transactions, and vending machines are part of retailing. This definition includes products bought at stores, through catalogues, and over the Internet, as well as services like fast-food restaurants, airlines, and hotels. The retail trade sector encompasses twelve different subsectors of the US economy, from food and beverage stores to car dealerships. Retailers purchase merchandise from suppliers that is then sold through both brick-and-mortar establishments and non-store outlets. Retailing sits at the end of the channel of distribution where marketing meets the consumer. A marketing channel is made up of firms, such as manufacturers, wholesalers, and retailers, all (hopefully) working together to bring products and services to customers. Each of these firms forms a link in what is generally referred to as a value chain or the chain of activities that add value to a product on its way from manufacturing to an end user (Brown, 2004). Total retail sales in the United States amounted to approximately $6 trillion in 2017. Table 1 identifies the largest retailers around the world based on publicly available data for fiscal year 2017.

Table 1: Top Ten Retailers (FY2017)[i]

Rank	Retailer	Country of Origin	Revenue ($Billion)	Countries of Operation
1	Walmart	United States	500.3	29
2	Costco	United States	129	12
3	Kroger	United States	119	1
4	Amazon	United States	118.6	14
5	Schwarz	Germany	111.8	30
6	Home Depot	United States	101	4
7	Walgreens	United States	99.1	10
8	Aldi	Germany	98.3	18
9	CVS	United States	79.4	3
10	Tesco	United Kingdom	74	8

Source: Deloitte Touche Tohmatsu Limited. Global Powers of Retailing 2019

THE GROCERY INDUSTRY

The food retail sector comprises a decent share in the industry with $700 billion or about 12 percent. In 2017, average food at-home expenditure of U.S. households was almost $4,400. Retail grocers carry a broad line of fresh, frozen, canned, and other prepackaged foodstuffs. Many of these stores also sell a variety of nonfood items such as health and beauty products, paper goods, and cleaning supplies. However, food items constitute the majority of their product lines and sales volumes. On average, groceries are purchased five times per month. Traditionally, this meant visiting a brick-and-mortar store. However, a new trend that the market cannot overlook is that consumers are growing more comfortable ordering groceries online. During the five-year period leading up to 2019, industry revenue has grown at an annual rate of 16.5% to $33.4 billion. The online grocery industry consists of companies that are based online and those that have both a physical presence and also sell food products on the internet. Major players include Amazon, Kroger, and Walmart. The online grocery sales industry has grown rapidly as online shopping has increased and industry services has improved considerably. Revenues are expected to grow by 6% in 2020, meaning the industry is still in the growth stage. Steady employment rates will keep leisure time for consumers at a minimum, making online food shopping more convenient and desirable. Besides, per capita disposable income is anticipated to continue growing, further stimulating industry demand by making online grocery shopping more affordable. However, larger competitors, such as Amazon's AmazonFresh service, will drive down prices in an attempt to crowd out the competition, hampering industry profit growth.

In an attempt to save both time and money, consumers are progressively choosing to shop online rather than visiting physical locations, prioritizing convenience over actually examining their items prior to buying them. Gen X consumers (those born between 1965 and 1978) are driving growth as they represent nearly 50% of the market. Meanwhile, sensing heightened demand for internet-based delivery services, major companies like Amazon and Walmart are scaling up their industry-relevant operations. In addition, a new group of highly focused online grocers, like Relay Foods, FreshDirect, Instacart, and Door-to-Door Organics, are targeting niche markets across the country by selling organic and other niche groceries online. The two companies dominating the online grocery industry are Amazon and Walmart.

Amazon.com, Inc., doing business as Amazon, is a multinational technology company focusing in e-commerce. The company was founded by Jeff Bezos in 1994 to sell books online but turned into the largest e-commerce marketplace and cloud computing platform in the world as measured by revenue and market capitalization. The trillion-dollar company has declared its adherence to four principles: customer obsession rather than competitor focus, passion for invention, commitment to operational excellence, and long-term thinking. These principles represent sources of Amazon’s competitive advantage. To capitalize on this trend and continue to compete effectively, many companies that traditionally operated through physical locations now also operate websites that enable their customers to shop online. For example, the sector’s largest operator, Walmart Inc., generated $318.5 billion through its Walmart US segment in fiscal 2017 (year-end January). $11.5 billion of this revenue stemmed from online sales, representing an increase of 44.0% from the year prior. The Sams Club segment operates membership-only warehouse clubs, offering two types of membership options: Plus and Club. These facilities consist of space ranging between 94,000 sq. ft. and 168,000 sq. ft. It provides specialty services such as travel, auto buying, pharmacy, optical, hearing aid centers, and tire and battery centers. The segment offers products under five categories - grocery and consumables; fuel and other; home and apparel; technology, office and entertainment; and health and wellness.

Walmart’s dominance has been predicated on its reputation for low prices and its excellent distribution network to stores. That is, Walmart’s famed logistics capabilities have allowed it to get products from distribution centers onto store shelves more efficiently than virtually any other retailer (Artz & Stone 2006). However, it lacks the skills and logistics ability to move those products from stores to customers’ homes. Furthermore, its low price reputation is being challenged by Amazon too. Unscientific experiments show that the two retailers vary in which one offers the lowest price on any particular product (Huddleston; et al 2009). Amazon also changes its prices constantly, which makes a direct price comparison difficult. However, the overall notion that Walmart has long tried to develop—namely, that it would always be the place where consumers could find the lowest prices—no longer holds for many shoppers. Consumers might be able to find the lowest price at Walmart, but the substantial price transparency of the Internet means that they can always click around to see if they might find a better deal elsewhere—like Amazon.

Competition between the two titans is fierce due to the limited level of product differentiation and consumers' insignificant switching costs, combined with a challenging and volatile market environment. A lack of switching costs and the limitations in product differentiation lead to buyer mobility, which forces larger retailers to maintain attractive pricing schemes. There is a rising pressure laid on players to adapt to fast changing consumer needs and the market leaders should be able to position the desirable product at a price suitable for customers and manufacturers. Whilst specialist, luxury or organic retailers do not feel the same price sensitivity, they are not able to secure a large volume of customers, and may have no choice but to commit to long term supplier contracts in order to secure a steady supply, quality, or specifically prepared products. The food & grocery retail market in the US is dominated by Walmart, which accounted for over a quarter of the US food & grocery market value in 2017 (Banker, 2019). Other large market players include Kroger, Target, Costco, and Ahold among others. These companies are large-scale, established retailers, with operating businesses that benefit significantly from economies of scale and the ability to employ aggressive pricing schemes that cannot be matched by smaller retailers, thus enjoying a significant advantage. Strong branding exercises and fast paced expansion deepens this market control.

Nevertheless, large retailers are not invulnerable to the threat of new entrants. Potential entrants may be encouraged by the relatively low entry and exit costs. There has been a rapid growth of health consciousness, plus an increasing number of consumers opting for a more ethical or organic range of goods. This forms attractive avenues for new entrants seeking to move into a niche area that offers inbuilt protection from pricing pressures and mainstream marketing (Goic; et al 2015).

ALDI

Aldi operates nearly 2,000 stores in 36 states and is on track to become America's third largest supermarket chain behind Walmart and Kroger, with 2,500 stores by the end of 2022. However, the "Aldi way" is not for everyone. Many customers are not that heavily price-conscious to accept the low frills store. Others are loyal to their national brands and are not eager to switch. Shoppers who are not willing to do the extra work of bringing bags and returning carts won't find Aldi attractive. Some shoppers may dislike the experience of shopping at an Aldi, which expects its customers to tolerate a number of inconveniences not typical at other American grocery stores. For instance, shoppers need a quarter to rent a shopping cart. Plastic and paper bags are available only for a fee. And at checkout, cashiers rush shoppers away, urging them to bag their own groceries in a separate location away from the cash register. Aldi will also struggle in metropolitan cities that expect prompt and sophisticated online delivery systems. Physical stores remain Aldi's competitive advantage, and the company has a lot of work to do in the online and home delivery realm. When Amazon and Walmart catch up to Aldi on the cost-effectiveness front, the company will have a big e-commerce problem on its hands.

How Aldi manages to keep its prices so low is no secret. The German discount grocer strips down the shopping experience in a blatantly efficient way. Specific reasons the company can keep its prices at rock bottom include:

- Relying on private (store) brands. Ninety percent of the merchandise sold at Aldi is exclusive to the store.
- Limited assortment of quality products. This translates into purchasing a higher volume of items. Because Aldi focuses on less SKUs, they are able to buy more of each SKU.

- Stores are small and energy efficient, with minimal decoration, and have reduced hours.
- Food items are displayed in the cardboard boxes in which they were shipped to the store, and stacked on wooden pallets (rather than neatly organized on shelves). This means employees need less time to restock shelves.
- Fewer workers (3-5 employees at any given time).
- Customers bring their own bags and bag their own groceries.
- A smart shopping cart rental system. Shoppers are expected to return their shopping carts saving employee costs.
- Relying on social media and word of mouth for advertising rather than expensive TV ads.

NATIONAL VS. PRIVATE BRANDS

National brands, also known as manufacturer's brands, are products designed, produced, and marketed by a supplier and sold to various retailers. The manufacturer is responsible for developing the merchandise, producing it with consistent quality, and undertaking a marketing program to establish a compelling brand image. Store brands (also called private-label brands, or house brands) on the other hand, are products developed by retailers. In many cases, retailers develop the design and specifications for their store-brand products and then contract with manufacturers to produce those products. In other cases, national-brand suppliers work with a retailer to develop a special version of its standard merchandise offering to be sold exclusively by the retailer. In recent years, as the size of retail firms has increased through growth and consolidation, more retailers have the economies of scale to develop store-brand merchandise and to use this merchandise to establish a distinctive identity. Also, manufacturers and national-brand suppliers are more willing to accommodate the needs of retailers and develop exclusive private labels for them.

Grocery retailers rank store brands as the most important factor that differentiates them from their competitors. Retailer competition should have a stronger impact on the more substitutable national brands than the more differentiated store brands. Grocery retailer store brands are imperfect cheap substitutes to national brands. According to Private Label Manufacturers Association (PLMA) data, total sales of store brands in U.S. supermarkets were $67.5 billion in 2018 (Larson, 2018).

When determining the mix between national versus store brands, retailers consider the effect on their overall assortment, profitability, and flexibility. Retailers examine their assortments to make sure they are providing what their customers want. They may introduce an innovative new store-branded product that isn't being offered by their national-brand vendors or a product that can be offered at a better value—or both. Stocking national brands is a double-edged sword for retailers. Many customers have developed loyalty to specific national brands. If a retailer does not offer the national brands, customers might view its assortment as lower in quality, with a resulting loss of profits. On the other hand, the consistency of national brands means that it is easy to compare the retailer's prices for national brands. National brands can limit a retailer's flexibility. Vendors of strong brands can dictate how their products are displayed, advertised, and priced.

Offering store brands has several advantages: (1) exclusivity boosts store loyalty, (2) well known, highly desirable store brands enhance the retailer's image and draws in customers, (3) relatively lower prices for consumers, (4) fewer restrictions on merchandise display, promotion, or pricing, and (5) potentially greater gross margin opportunities. However, there are drawbacks to store private brands. For example, retailers must make significant investments to design merchandise, manage manufacturers, create customer awareness, and develop a favorable image for the brand. In addition, if the store branded merchandise doesn't sell well, the merchandise cannot be returned to the supplier or sold at an off-price retailer.

WHO WILL COME OUT ON TOP?

Aldi's limited assortment of SKUs is a key competitive advantage. Today's shoppers are realizing that having 100,000 SKUs in a Walmart supercenter or even 50,000 SKUs in a traditional supermarket is too confusing and difficult to shop. Because Aldi's product selection is limited, stores are smaller, layouts are consistent from store to store, and it can be faster to find everything on a shopping list. Aldi has asserted its advantages over the warehouse-style stores by offering shoppers a less crowded and fast experience. A shopper can shop an entire Aldi store in 15-20 minutes. Aldi is also known for performing constant quality checks and frequent taste tests, so that even when the prices are ludicrously low, the quality of the products is enough to attract shoppers. About 90 percent of Aldi's products are private-label, which enables greater quality control and pricing flexibility for the supermarket chain. Consumers with less disposable income like Aldi because they can get what they need at a low price. And people with more income still shop there as well, because they can get exclusive brands not available elsewhere. Meanwhile, Aldi's "Twice as Nice Guarantee" policy is designed to ensure that customers are completely satisfied with their purchases. For example, if a customer buys a box of store-brand ketchup and ends up hating it compared to their usual national brand ketchup, they can simply return the product to receive a full refund AND a replacement item.

Aldi is a year into its five-year, $5 billion U.S. growth plan, which includes building approximately 800 new stores, remodeling older locations, and upgrading and expanding its product assortment. Aldi, however, has some vulnerabilities that will need to be shored up. Aldi's strengths lie in the brick-and-mortar area, while its online offering needs to be overhauled. Even though the company does have vulnerabilities, it has also proven itself to be a shrewd operator capable of moving quickly to close competitive gaps.

Amazon presents a significant threat to many other operators in the retail sector. Primarily, due to the width of Amazon's product lines, most products sold by other retailers can be purchased on the company's website, making the need to visit multiple brick-and-mortar establishments to complete one's shopping list obsolete. Additionally, Amazon offers its consumers quick shipping options, including the guaranteed two-day shipping offered through its Amazon Prime subscription service. Amazon Prime members pay a yearly fee to receive free two-day shipping on millions of products on Amazon.com, as well as access to video and music streaming and other membership benefits. This entices consumes to spend more on Amazon's website and has raised customers' expectations.

In 2017, Amazon acquired Whole Foods Market, one of the largest operators in the supermarkets and grocery stores industry, for $13.7 billion. The acquisition included 460 stores in the United States and an additional seven international locations. In summer 2019, Amazon's Whole Foods started offering grocery pickup within 30 minutes of placing an online order. This not only marked the company's first step into the food and beverage stores subsector, but also its first presence in the brick-and-mortar side of the retail landscape.

Walmart's dominance has been predicated on its reputation for low prices and its excellent distribution network to stores. That is, Walmart's famed logistics capabilities have allowed it to obtain products from distribution centers onto store shelves more efficiently than virtually any other retailer. However, it lacks the skills and logistics ability to move those products from stores to customers' homes. Walmart has a goal of reaching 40 percent of the country's population with its grocery delivery program by the end of 2019.

Furthermore, Walmart's low price reputation is being challenged by Aldi and Amazon. The notion that Walmart has long tried to develop—namely, that it would always be the place where consumers could find the lowest prices—no longer holds for many shoppers. Consumers might be able to find the lowest price at Walmart, but the substantial price transparency of the Internet means that they can always click around to see if they might find a better deal elsewhere—like Amazon. About 15 years ago, Walmart committed itself to Internet retailing. Back then, Amazon was just a small bookselling blip on the public's radar. Today however, Amazon has dominated the digital marketplace and has overtaken Walmart in terms of its stock market value. However, Walmart continues to seek a firm foothold in the online domain. Walmart certainly is not alone in struggling to compete with Amazon in cyberspace, but it is the largest and most prominent example of how Amazon has transformed the retail landscape. In addition to its long-standing advantages—low overhead, achieved because it does not need to invest in physical stores; vast inventory, unlimited by any reliance on square footage in stores; and a unique recommendation algorithm—Amazon continues to invest heavily in its fulfillment capabilities. By achieving the ability to offer same- and next-day delivery regularly, Amazon has become a primary source that consumers rely on to meet their immediate consumption needs.

Although Walmart has retained its throne for twenty-plus years, it cannot ignore the threat posed by Amazon. In 2001, Amazon was the 157th largest retailer. Today, it's closing in on Walmart. As shown in Teaching Note Table 2, Walmart is still in the lead with more revenues, assets, and profits. Amazon, however, is the third most valuable brand in the world. Amazon's brand equity grew by 56% in one year to hit $100 billion! Aldi and Walmart did not even make the top 100 (Interbrand, 2018).

Table 2: Rank, Revenues, and Employees (2018)

RETAILER	RANK	REVENUES ($M)	PROFITS ($M)	ASSETS ($M)	EMPLOYEES
Walmart	1	500,343	9,862	204,522	2,300,000
Amazon	4	177,866	3,033	131,310	566,000
Aldi	8	98,000	-	-	25,000

Source: Companies' Websites (Since Aldi is a privately held company, it is not obligated to share financial records).

The competition between Aldi, Amazon, and Walmart is evident and obvious. However, the platforms they use are different. Walmart is the world's leader in brick-and-mortar grocery sales with more than 3,500 supercenters in the United States. Amazon is undoubtedly the number one e-commerce marketplace. Amazon and Walmart lead in the grocery industry due to their exceptional fulfillment capabilities and massive marketing across platforms. Aldi is contending their leadership with its brutally efficient no-frills business model and is presenting an insurmountable challenge. Ultimately, the retailer which responds proactively to changing customer preferences and serves them in the best possible way will survive and thrive. Right now, it seems that the three firms have an equal shot of dominating America's groceries. Future research may look into how the underdog, Aldi, fares in this new cut-throat competitive landscape. Looking into motives of why millennials prefer smaller grocery stores compared to big box retailers could be a useful route as well.

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