Industry Analysis
Retail Grocery Industry Analysis,
Value Creation & Best Practices

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9/30/2010
Retail grocery in the U.S. is a massive, $1.3 trillion a year industry\(^1\).

Competition at the top is fierce: over half of 2009’s revenues—approximately $606 billion—were generated by just ten retailers and wholesalers in 2009\(^2\), with Walmart in the lead earning $262 billion. As a superstore, Walmart is uniquely positioned as the sole member of a strategic group unto itself (because the barriers for entry are so incredibly high). Although highly-fragmented, the rest of the industry can be categorized by primary strategic groups: grocery chains, non-traditional grocery sellers (e.g. Costco and “dollar” stores) and hyper-local, artisanal markets. Walmart’s greatest competitor, grocery companies such as Kroger and Costco Wholesale own the next largest slice of annual revenues, earning $76 billion and $71.4 billion in 2009, respectively\(^2\).

The strategies in the retail grocery industry are as diverse as its players. Three companies that exemplify different but successful strategies are Walmart, Whole Foods and Trader Joe’s. Walmart wins the cost leadership game due to its immense bargaining power with suppliers, and adds value by allowing customers to also shop for clothing, electronics, etc. in any one of thousands of conveniently-located superstores. Whole Foods pursues an “enhanced” differentiation strategy that has redefined the experience of grocery shopping for consumers willing to trade price with unique service. Finally, Trader Joe’s focuses its product line in order to achieve exceptionally high turnover on a small number of items. This in turn allows them to buy in volume and at steep discount from their suppliers.

While these companies pursue an array of distinct strategies, all seek to strengthen existing structures and create new value such as convenience, low cost, and quality, and create better methods to capture value. The design of these strategies are outlined below as a way of relating service design and profits, and assessing the industry over the next 3-5 years.

**Walmart** Cost Leadership

With $260 billion in sales and 20% market share in 2009\(^3\), Walmart is the uncontested leader of the retail grocery industry. Due to the sheer volume of product orders placed, Walmart can negotiate extremely low prices from their suppliers. This intrinsic negotiating power allows Walmart to compete almost exclusively on price, thereby ensuring a dominant cost leadership position. Walmart maintains a vast in-house distribution network enabling them to quickly ship goods anywhere within the country\(^4\). It also carries a line of private-label products, sold at prices even less than their discounted merchandise. The private-label offering is a prime example of the vertical integration utilized by the company to further lower prices for both itself and their customers\(^5\).

Aside from low prices, Walmart creates and captures value by: 1) selling a wide-variety of products, 2) offering the convenience of online grocery shopping, and 3) providing the accessibility of thousands of stores throughout all fifty states. Walmart’s decision to enter the retail grocery business was the main focus of their diversification strategy that allowed customers shopping for clothing or electronics the opportunity to easily purchase groceries in a one-stop shopping environment. Walmart’s integration of pricing, geographic coverage, product range and vertical integration have created steep mobility barriers to their competition to overcome, many of whom simply cannot afford to compete on price or even location alone.
Whole Foods Differentiation
The grocery industry is highly fragmented—so much so, that it is difficult for firms pursue a generic differentiation strategy. However, Whole Foods—the all-natural grocery chain—has achieved success in the form of a hyper-customer focused, “enhanced differentiation” strategy that works to differentiate them from their competitors while simultaneously differentiating their product line.

To differentiate themselves from their competitors, Whole Foods has maximized the value they add as a company to the sale of products by providing exceptional service in the form of creating customer experiences. Some argue, Whole Foods has elevated service to spectacle. It has been likened to “shopping as showtime,” and a “better-for-you food bazaar on organic steroids.” Although the cost of servicing the typical Whole Foods customer is invariably higher than other companies competing in the same strategic group, Whole Foods customers unique in that they are willing to trade price against the service that they receive.

A firm with a highly differentiated product line is able to sell to “good” customers whom are unavailable to many of its competitors. In response to trends placing a premium on all-natural and organic food, Whole Foods has differentiated their product line by only offering products that are “free of artificial preservatives, colors, flavors, sweeteners or hydrogenated fats” and are of exceptional quality. This strategic dimension grants Whole Foods access to customers who demand a high-value product and are willing to pay for it—the holy grail of not only companies within Whole Food's strategic group, but of all competitors in the industry.

Pursuing an “enhanced differentiation” strategy allows Whole Foods to sell to large numbers of less- or non-price sensitive buyers whom are unavailable to their competitors. By doing so, they have fed two birds with one seed: they’ve insulated themselves from the bargaining power of their customers and preserved higher profit margins that could not otherwise be achieved. However, Whole Foods must take care as they continue to grow: customers who are less- or non-price sensitive can rapidly become so as the grocery industry matures or other companies begin to adopt their practices. In the meantime, “enhanced differentiation” provides a strong, defensible position to protect Whole Foods against the five competitive forces in a highly fragmented industry.

Trader Joe’s Focus
The $8 billion of estimated revenue Trader Joe’s earned in 2009 was nearly indistinguishable from Whole Foods’ of the same year. However, if you look to a different metric—sales per square foot—Trader Joe’s was the industry leader, earning more than double the sales per square foot of Whole Foods. Trader Joe’s wants to be “your unique neighborhood grocery store,” providing customers quality food at a fair price, while exposing Americans to new food experiences from around the world. Trader Joe’s keeps their prices low by: 1) sizing their locations 1/4 the size of average supermarkets, 2) keeping private-label product packaging and the store design simple as a cost-saving measure, and 3) carrying a smaller variety of products.

Trader Joe's strategy is focused: considering the fact that they do not stock many of the items you might expect at a national chain—like toothpicks or baby food—Trader Joe’s isn’t for everyone. Of the products you do get, you will not get much choice between brands. With great turnover
on a smaller number of items, Trader Joe’s can buy large volumes, secure deep discounts, making logistic systems, like transport and shelving, much simpler and more efficient. In fact, 80% of Trader Joe’s products are sold under their private-label, enabling them to “skip the middle man”—buying directly from the vendors and gaining more control over their supply-chain.

On one hand, Trader Joe’s maintains an image of being the quirky shop around the corner that sources its products from small scale vendors like local farms; on the other, their business strategy is not actually in sync with the image they convey. Many of Trader Joe’s suppliers are actually big, well-known companies, however, Trader Joe’s and its suppliers strive to keep their collusion a secret. In general, Trader Joe’s strategy is very hush-hush. Whether or not they manage to keep the image of a mom-and-pop neighborhood store while trying to grow, remains to be seen. In the meantime, their deliberate “scale-down” strategy of only opening five more stores a year, may just be the strategy required to keep their credibility intact.

**Analysis & Projections**

Design quality will be informed by some apparent trends in the market during the next 3-5 years and beyond. These trends include 1) healthier eating habits, and a more sustainable lifestyle, 2) an increased passion for food due to growing media attention (e.g. Top Chef, Hell’s Kitchen), and 3) a shift from grocery shopping as a necessity towards grocery shopping as an user experience. These trends will lead to customers searching for new food experiences—demanding variety and more exotic goods in the product line, as well as focusing on organic and locally produced food. A larger segment of the market might also be willing to pay extra for enhanced customer experience in terms of service and shopping atmosphere.

On a small scale, these values are captured very well by artisanal, hyper-local markets. The larger entities such as Trader Joe’s and Whole Foods will look to these competitors as a model for best capturing value, while at the same time taking advantage of their larger size—being able to buy in large quantities and bargaining better prices. The opportunity for growth is still there for these companies, and the clever model Trader Joe’s has set up is definitely a threat to some of the smaller food markets. Although people are in search of a great food experience, a good price will always be an important factor. Walmart knows very well what low prices are all about, and as we have seen through our analysis, they definitely make the most money. However, the U.S. market for mega-stores has matured and leaves little room for growth; they look to new markets abroad for expansion.

From our analysis, Trader Joe’s has the best designed service. It captures value by blending the best parts of Walmart’s and Whole Foods’ strategies. By combining low cost products with a passion for gourmet quality food, Trader Joe’s couples service design and profitability better than any competitor in the retail grocery industry.
Footnotes

1. Based on the fact that Walmart's grocery sales is 262 billion according to Supermarket News, and that Walmart has 20% of the market share according to this article: http://www.wikinvest.com/concept/Supermarket_Consolidation).


4. Street Authority: http://web.streetauthority.com/terms/industry/grocery.asp


6. A hyper focus on identifying and selling to what Porter refers to "good" customers. By his definition, a "good" customer is one who has high growth potential (among other attributes).


Profitability Estimates

The numbers below are estimates of Trader Joe’s cost of revenue, operational costs, and net profitability drawing from Whole Foods operational costs and revenue in merchandise per sq. foot.

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<thead>
<tr>
<th></th>
<th>Whole Foods</th>
<th>Trader Joes</th>
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<tbody>
<tr>
<td>Total Revenue</td>
<td>$8 billion</td>
<td>$7.2 billion</td>
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<tr>
<td>Cost of Revenue</td>
<td>$5.3 billion</td>
<td>$3.64 billion</td>
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<tr>
<td>Operational Costs</td>
<td>$2.55 billion</td>
<td>$3.2 billion</td>
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<tr>
<td>Number of Stores</td>
<td>273</td>
<td>344</td>
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<tr>
<td>Operational Cost Per Store</td>
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<td>$9.3 million</td>
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<td>Revenue in merchandise per sq. foot*</td>
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<td>$1,750</td>
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<tr>
<td>Net Income†</td>
<td>$146 million</td>
<td>$292 million</td>
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<tr>
<td>Net Profitability‡</td>
<td>1.84%</td>
<td>4.05%</td>
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</tbody>
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* Kowitt, Beth, “Inside the secret world of Trader Joe’s” Fortune. August 23, 2010. Whole Foods estimate based on claim Trader Joe’s “stores sell an estimated $1,750 in merchandise per square foot, more than double Whole Foods.”
† Based on revenue in merchandise per sq. foot.
‡ Trader Joe’s estimate based on: estimated net income / total revenue