Sequoia Spotlight

Ocado: a slow motion

Often referred to as the Marmite of grocery retailers (customers love it, retail analysts hate it), rarely does a company elicit such strongly opposing opinions as Ocado.

At Sequoia, we like to back our opinion up with as much numerical analysis as possible, so we recently ran an internal project to model Ocado's current & future supply chain costs in detail – with some startling conclusions.

Numerical analysis

Our modelled costs of Ocado's future supply chain indicate that their expansion plans should deliver a £6 saving per customer order. If Ocado were able to maintain their gross margin, we estimate this saving would give them a higher operating margin than any of the major supermarkets - quite a turnaround for a company once dismissed by Sir Terry Leahy as a 'charity'.

Economies of scale

The key to achieving this turnaround (& Ocado's business model) is securing the economies of scale required to hit their operational sweet spot. Half of the £6 saving comes from increased capacity at the Customer Fulfilment Centres (CFCs) coupled with an assumed rise in picking efficiency. The remaining half comes from reduced trunking distances and greater drop density from increased deliveries.

If the future operational model appears sound, why is Ocado so unloved by retail analysts? The lack of profit after 10 years is understandably a key issue. Our analysis, however, indicates that Ocado is a slow-motion equivalent of Amazon, which endured 7 years of losses before making a profit. During the loss making years, many analysts questioned their lack of profitability. Today though, 8 years after Amazon turned the profit corner, few would question Amazon's business model.

Ocado's lack of size is another issue - as a relative minnow, they risk being caught in the crossfire as the supermarkets slug it out on price. With online sales representing a relatively small part of their business, supermarkets can afford to subsidise their online operation. Waitrose, for example, are offering free delivery on orders over £50 – unsustainable in the longterm, but such short-term tactics to grab market share put pressure on Ocado's margins.

Finally there is the inherent risk involved in being the first company to develop highly automated picking for grocery orders and consequently, an unproven business model.

Efficiency is key for online orders

In the online channel however, the added costs of picking & delivering orders mean in the long run, the most efficient supply chain will prevail. Once established, Ocado's unique approach to picking customers' orders would make them an attractive acquisition target. Faced with either following Ocado down the same painful development path or acquiring existing expertise, a future buyer is likely to decide on the latter.

The list of potential suitors could include more than the usual line-up of supermarkets, too. Brand owners have an uneasy relationship with the supermarkets, who historically have been the gatekeepers to consumers. The internet, however, opens the door to anyone with a website. If competing brand-owners could find a way to collaborate, they could take the opportunity to increase their share of the value chain. After all, you don't need to have a supermarket to sell online.

To view a YouTube presentation of our Ocado analysis, please visit:

http://www.sequoia-uk.com/Insights/OcadoVideo