

# Analysis of franchising strategy



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FreshDirect is the leading online grocer, who serves more than 300 zip codes in Manhattan, Queens, Brooklyn, Nassua County, Riverdale, Westchester, Staten Island, New Jersey, and some areas of Connecticut, and they are providing a new way to shop for food. They are based in a 300, 000-square-foot production building in Long Island City and they are the largest employers in the city.

Joseph Fedele and Jason Ackerman cofounded FreshDirect in July 2001. Before FreshDirect was established, most other online grocery businesses had failed. Even with the demise of online grocery businesses for the previous decade, cofounders strongly believed that they would succeed in their business as their efficient operating strategy was built to provide high quality at lower prices. At first, however, FreshDirect was blamed for the limited service area until it expanded its area slowly. The company started to become popular by providing high quality products, such as locally grown fresh products and organic food at lower prices to local residents and offices. Then a few years later, people could see many refrigerated trucks of FreshDirect all over the Manhattan streets. FreshDirect has proven their efficient operating strategies, and it led to success in the online grocery industry.

Since FreshDirect made profits, there has been a movement toward this online grocery industry, and they are facing a few challenges. Today, FreshDirect is facing fierce competition from traditional retail grocery, local restaurants, and other online grocers with delivery services. People have consistently questioned how fresh the products delivered by FreshDirect are because they have a limitation for seeing and feeling the products as an

online grocer. According to one article, FreshDirect spent \$600, 000 for parking tickets as part of their operating expenses (Moskin, 2005). In addition to that, in 2007, the New York City government required a congestion charge for FreshDirect because FreshDirect has contributed to traffic jam, and the increasing gas prices are adding to their delivery expenses.

One major challenge for FreshDirect is environmental issues. People complain about their idling delivery trucks which are contributing to additional exhaust fumes and taking parking spaces. Another environmental issue is using too many cardboard boxes. Their choice of which neighborhoods to deliver to is related to accused discrimination, and they have faced union related problems for unfair wages.

## **Analysis**

### **SWOT Analysis**

One analytical framework that can be used for the internal and external environment of FreshDirect is SWOT analysis. The analysis of the FreshDirect issues will be broken down into “ strengths, weaknesses, opportunities, and threats” (Dess, Lumpkin, Eisner & McNamara, 2012).

#### Strengths

- Their wide choices of products with high-quality information on the foods that were sold
- Low operating expenses due to not renting expensive retail space.
- FreshDirect’s efficient supply chain with no middleman.
- Low-cost marketing approach

- Cost-effective operating strategy of FreshDirect for their production facility.
- Extremely high standards for safety, health, and cleanliness in all areas.
- Strong partnerships with well-known chefs and restaurants in Manhattan

Overall, FreshDirect has lots of strengths that are superior to competitors. They have provided various products to select with high quality at low cost on their well-designed website with high-quality information on the foods which are sold. With no retail location, they have lower operating expenses, resulting in more net revenues relative to traditional retail grocery businesses. Rather than having the middleman, they order all fresh products from individual suppliers and deliver directly to their customers. The less intermediaries between the distribution channel, the less the product costs. This allows FreshDirect to provide their high-quality goods at lower costs. They have adopted a low-cost marketing approach by using a recommendation-based campaign from actual customers, which increases the credibility among new and existing customers. Their production facility is located close to their Manhattan customer base with 12 separate temperature zones and an SAP manufacturing software system, which have kept the best condition of their products at the optimal temperature. High standard for cleanliness leads to high quality products. Strong partnership have enhanced the quality and taste of the four-minute meal.

#### Weaknesses

- Limited selection of dry goods and packaged goods

- High dependence on the sales of perishables
- Constant change in senior management with short terms
- Extremely price sensitivity of consumers
- Using too many non-eco-friendly cardboard boxes with no returning system for recycling.
- Serving only selected areas around New York with no further market expansion strategy.

FreshDirect has many weaknesses where they might be inferior to competitors. FreshDirect has few brands and kinds of dry goods and packaged goods relative to other competitors. For instance, Amazon.com has focused on dry goods and is increasing its market share due to its existing customer base and better customer service. FreshDirect highly depends on the sales of perishables, which leads to high delivery costs and the other operating expenses related to keeping perishables in good condition. Constant change in Senior Management can result in decreasing the firm's values because it increases the firm's risks. Different CEOs pursued different operating strategies. It will cause investors and customers to fall into confusion for their existing customers. One weakness with FreshDirect is that customers are highly price sensitive when they purchase their products because customers tend to pay no additional fees for online grocers and home delivery services. The more price sensitive their customers are, the more FreshDirect will lose their customers. FreshDirect will have less net revenues as they decided to continue doing their business because they need to cut their prices below to have price competitiveness. As people become more concerned about the environment, the cardboard

boxes of FreshDirect become one main weakness. The non-eco-friendly boxes for one-time delivering are too wasteful and there is no return system in FreshDirect for recycling. FreshDirect serves only limited areas with no further market expansion strategy. Other competitors, especially NetGrocer, cover more areas with the same delivery services as FreshDirect provides.

### Opportunities

- Market expansion by using their reputable name and image domestically and internationally, such as the firm, Ford and eBay of the previous cases.
- Diversifying their products into un-perishable products.
- Developing eco-friendly and safe delivery and packaging ways, or open a return center for the cardboard boxes for recycling.
- Aggressive merge and acquisition with other global grocery retailers, like eBay did with other top global auction websites.

FreshDirect has many opportunities to overcome their weaknesses. Even with bad market conditions when they started doing their business, they succeeded in this industry, and have earned a good reputation and image among their customers and in New York City. By using their reputation and image, they can expand their operation domestically and internationally. European and Asian markets are so broad that they can expand into the market and make more revenues. FreshDirect can compete with their rivals more efficiently if they diversify their delivery products into more un-perishable products. With the increasing environmental concerns, FreshDirect needs to develop eco-friendly delivery methods, or open a return center for the cardboard boxes for recycling. At first, they will be required to

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spend more, but as they operate further, they would make better image than competitors and finally it would lead to more profits. FreshDirect can consider aggressive mergers and acquisition with other leading global grocery retailers. It would allow FreshDirect to expand and increase their market share in the online grocery industry.

### Threats

- Fierce competition in the online grocery industry.
- Increased cost parking tickets as part of operating expenses, rising cost of fuel, and a congestion charge proposed by New York City government.
- Labor challenges such as truck drivers joining workers unions due to unfair wages, working overtime, and investigation of immigration status.

Today, FreshDirect face threats in the market. Since FreshDirect succeeded in this industry, many rivals came to the market and competed fiercely with each other. For instance, Whole Foods has threatened their market shares in Manhattan with the same focus, organic health food. YourGrocer. com is the most geographical rival in the New York City with a bulk-buying strategy which makes home delivery services. Increased cost parking tickets, rising cost of fuel, and a congestion charge proposed by New York City government all has currently threatened FreshDirect. As mentioned above, FreshDirect spent \$600, 000 for the parking tickets and additionally, in 2007, New York City government required a congestion charge for FreshDirect, and the increasing gas prices are adding to their delivery expenses. All these condition would not allow them to reach their target profits and market

shares. The increasing gas costs are adding to orders and they will lose their price competitiveness with other competitors, and also probably could not keep their promise, higher quality at lower prices. Lower wages, high-cost health benefit premiums, and investigation of immigration status led to joining workers union and it has threatened FreshDirect. Further, it had the negative effects on their image and might result in losing the existing customers to other competitors and making less revenues.

### **Porter's Five-Forces Model Analysis**

This analytical model that will be examined for the external environment of FreshDirect is Porter's Five-Forces Model of Industry Competition. This analysis of the FreshDirect competitive environment and issues will be broken down into "the threat of new entrants, the bargaining power of buyers, the bargaining power of suppliers, the threat of substitute products and services, and the intensity of rivalry among competitors in an industry" (Dess, Lumpkin, Eisner & McNamara, 2012).

#### The threat of new entrants

In this FreshDirect case, the threat of new entry is very low. The online grocery industry continues to mature. Maturity stage is characterized by very few prospects and new entrants. One major source of entry barriers, capital requirement, makes it difficult for new entrants to enter this industry. High start-up costs, operating expenses, large financial investment for a state-of-the-art production facility, and an efficient manufacturing software system are required in the online grocery retail industry. This overall low entrant threat has positively affected FreshDirect's sales.



### The bargaining power of buyers

The bargaining power of buyers is important in analyzing the FreshDirect case. This case states that buyers are very price sensitive, and the prices for most online grocery products are above local market prices. Buyers tend not to pay more costs for home delivery service. A buyer group is powerful in this case because the buyers have few switching costs. For example, if the customer of FreshDirect thinks the price of products offered by them is expensive, the customer can switch to other competitors such as YourGrocer, Peopod, or NetGrocer very easily with no other costs. Therefore, buyers have a powerful ability to force the prices down. This condition has negatively affected the net margins of FreshDirect.

### The bargaining power of suppliers

The bargaining power of suppliers is also crucial in evaluating the FreshDirect case. The key for success to FreshDirect in this industry is providing high quality products at lower costs. They are operating under a unique operating strategy in the industry by offering the premium choices and the standardized cuts made by their customers. They eliminated the middleman between suppliers and FreshDirect. All high quality products ordered by their customers are shipped to FreshDirect directly, and this system allows FreshDirect to force down the prices from their suppliers. In this case, the bargaining power of suppliers for FreshDirect is not powerful because their supplier's quality products is important to their business, but there are various of substitutes to switch to with no costs. Therefore, they

can provide such high quality items at lower costs, and this has positively affected the net revenues of FreshDirect.

#### The threat of substitute products and services

All firms in the same industry have the risk for the threat of substitute products and services. However, the threat of substitute products and services for FreshDirect is so low relative to other industries. FreshDirect have a comparative advantage, offering high quality at lower costs by eliminating the middleman. They provided about 5, 000 perishable and organic products from local suppliers. With 12 separate temperature zones and an SAP manufacturing software system, all products are under the best condition. There are no substitutes in the market to offer high-quality of perishable goods with the same level of efficient management system that FreshDirect has used. Customers could not find a substitute for FreshDirect that meets their needs, and could not switch to other products. They have earned good reputation and loyalty from local areas. This limited threat of substitute products and services has affected the earning powers of FreshDirect positively.

#### The intensity of rivalry among competitors in an industry

FreshDirect is faced with relatively low intense rivalry among competitors in the industry. Some interacting factors prove this. The online grocery industry makes profits quickly, and Braddock expected that “ the online grocery sales will increase up to more than 20 percent of total grocery sales within next 10 years” (Dess, Lumpkin, Eisner & McNamara, 2012). This leads to advantages over competitors in the industry. Low exit barriers also show low intense

rivalry. The firms with insufficient margins will leave the markets, and it will result in more revenues for the other firms in the markets. This low intense rivalry among competitors in the industry has a positive effect for FreshDirect with more profits.

## **Porter's Value-chain analysis**

This analytical model that will be used for the value-creating activities of FreshDirect is Porter's Value Chain Analysis. This analysis will be divided into two different activities, " five primary activities and support activities" (Dess, Lumpkin, Eisner & McNamara, 2012).

### Five primary activities

**Inbound logistics** FreshDirect has the unique and good relationships with their suppliers. The production facility controls efficiently and keeps the high-quality of products in the best conditions.

**Operations** FreshDirect offers about 5, 000 perishable items with high quality at lower costs. Their efficient operating system and an SAP manufacturing software system reduce their operating expenses with greater efficiency and no middleman.

**Outbound logistics** FreshDirect deliver their products daily to their customer's home or office by FreshDirect trucks.

**Marketing and sales** FreshDirect's customers are highly satisfied with their high-quality products with lower costs. Their market strategy for the delivery allows their customers to save their time and shop for better items

conveniently. They also employed a low-cost advertising method, which is the testimonial-based campaign from existing customers.

Services FreshDirect send their refrigerated trucks to serve suburban customers, and offer delivery service for picnic needs. They provide pick-up service for orders made by their customers from the processing center. They also offer office delivery service to business customers in Manhattan.

#### Support activities

**Procurement** Due to the unique and good relationships with suppliers by employing a make-to-order philosophy, FreshDirect has the ability to reduce the purchase prices and to increase the quality.

**Technology development** FreshDirect have focused on technology development to continue their success and increase their market shares with greater efficiency. They spend lots of money for developing new software and upgrading their website. Their employees are highly recommended to learn the technology operating system.

**Human resource management** FreshDirect have recruited, trained, developed, and compensated their employees well. For instance, they built a state-of-the-art production center with expert personnel.

**General administration** FreshDirect has the superior ability to manage the quality of their products which is a competitive advantage over other competitors. With the expert employees, they are making large profits by taking the competitive advantage. For example, FreshDirect have teamed up with the best restaurants and chefs for the four-minute meal. They also take

a competitive advantage of \$100 million in financial investment from private investors and the State of New York.

## **Alternatives**

### **Alternative 1: Joint ventures**

FreshDirect has many options to expand into their market which will result in more profits, and market expansion is required when they want to grow further. One of the options is joint ventures with leading online retailers.

FreshDirect serves only limited areas, such as Manhattan, Queens, Brooklyn, Nassua County, Riverdale, Westchester, Staten Island, New Jersey, and some areas of Connecticut. Doing a business in small and limited areas can have a comparative advantage that allows FreshDirect to respond the needs of their customers quickly and offer higher quality and better a customer service.

However, serving only the limited number of customers also has a side effect. There might be the ceiling where FreshDirect can make profits. Joint ventures can solve this problem. For instance, if FreshDirect forms a joint venture with Amazon, they can make synergy effects to increase their market shares in an online retail industry. Amazon has a number of its existing loyal customer base, and provides only the selection of nonperishables. FreshDirect has an efficient production facility and software programs, and provides the selection of perishables mostly. A joint venture might enable these two companies to pool their own advantages in order to reduce costs and increase their market shares. The synergy will result in more earnings, and economies of scales will be achieved.

## **Alternative 2: Franchising**

Another option to expand the profit base of FreshDirect is franchising.

Franchising gives many opportunities such as increasing the revenue base, limiting the risk exposure that a franchisee can have in the domestic and international markets, and generating royalty income to FreshDirect.

FreshDirect can invest the additional income received by a franchisee in developing efficient software programs and production facilities in order to provide higher-quality of products at lower costs. The advantage of franchising over licensing is monitoring a franchisee's operation. FreshDirect can control effectively a franchisee so that they can make better reputation and image in the industry.

## **Alternative 3: Implementing differentiation strategy**

To compete with other online grocers efficiently, another alternative to FreshDirect is implementing differentiation strategy, which focuses on providing difference in FreshDirect's products by making unique products and valued by their existing and prospective customers.

FreshDirect has applied the overall cost leadership strategy, which is the strategy using competitive advantages by providing low cost products in an industry through FreshDirect's value chain. With no middleman between suppliers and FreshDirect, they provide high quality perishables at lower costs to their customers. As people become more concerned about their health and healthy food, people tend to pay more for the organic and safe foods. With the needs of customers, who want unique items, FreshDirect needs to implement differentiation strategy in order to satisfy their customers. The senior managers of FreshDirect should carefully analyze

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what their customers want to purchase even with higher prices. If

FreshDirect brings something unique to the industry, it will increase sales volume of FreshDirect and enhance their reputation and image.

## **Recommendation**

After considering all three alternatives, the second alternative, Franchising is recommended. Franchising will be more appropriate to increase

FreshDirect's values and market shares with relatively limited risk. The most important business principle is to maximize profits with limited sources.

Franchising can reduce the risk to penetrate the new overseas markets.

Today, FreshDirect face many challenges and issues. One main disadvantage of FreshDirect is only serving the limited areas. This places a ceiling of which FreshDirect can make profits as well as limiting their potentials to grow.

However, FreshDirect can expand their markets with efficiently monitoring and controlling the quality based on their mission statement, " High quality and lower price". Also, an investment in developing technology and efficient operating facility can be financed by the additional income from the loyalty fees. FreshDirect has done an incredible business so far and will continue to set the standard in the online grocery industry.