CHANGING THE RULES

VIABLE MODELS FOR E-COMMERCE

With shopping moving online and store sales stagnating, many established retailers see their internet business as their primary source of growth. But although most now have a significant online presence, profit remains elusive: e-commerce has been great for customers but has done little for retailers' earnings. It's clearly difficult to come up with a viable model for an online business, but, as this article explains, it's not impossible.

E-commerce has changed the rules of retail in two fundamental ways: firstly by shifting it to a winner-takes-all environment; and secondly by transforming the economics.

RETAIL IS NOW A WINNER-TAKES-ALL INDUSTRY

Markets are no longer local but national or, in many cases, international. When distance mattered, every store had a built-in advantage with customers living or working nearby. Comparing retailers wasn't easy, and switching between them wasn't effortless, so each store effectively competed with a small number of local rivals. If a store was in a convenient location, it could attract trade without offering the lowest prices, the best products, or the most helpful service – it didn't have to be the best at anything, as long as it was "good enough" and near to its customers.

Online, all this has changed. In most retail sectors, location is irrelevant and price comparison straightforward. Customers can easily shop around in search of the best deal. The implication is clear: competing online is about being the most attractive to customers, full stop. Customers must see you as the best choice or else they won't consider shopping with you. You don't have to be the best at everything – but you do have to be the best at something.

E-COMMERCE HAS TRANSFORMED THE ECONOMICS OF RETAIL

The new economics of an online world make it much harder for retailers to earn a profit. Greater competition has increased price elasticity and depressed margins, while on the other hand, e-commerce requires less investment and usually involves lower fixed costs than bricks-and-mortar retail. But the decisive difference is that many e-commerce operators have low expectations about their current financial performance: as businesses, they are valued based on profits they might make in the future, not profits they make today. Some online retailers are effectively running their entire operation as a loss

leader, in the hope of buying a customer base that will confer a lucrative position years down the road. And in a winner-takes-all market, competitors who expect low (or no) earnings depress profitability for the entire sector.

SUCCEEDING ONLINE

Together, these two changes explain why it's so difficult to come up with a viable online business: you need to identify areas where you can be the best choice for customers yet still earn a profit. Just as only a few types of bricks-and-mortar concepts proved successful – the category killer, the one-stop-shop, the discounter, and so on – only a handful of online models can offer defensible long-term value creation.

No online business achieves more than one of these and, in contrast to the bricks-and-mortar world, there's no room for a generalist "jack of all trades" retailer that does a pretty good job across all dimensions. To succeed online, you need to be first choice for a particular set of customers on a particular set of purchase occasions. The rest of this article discusses what this means in practice, and explains how each of the four models can provide the template for a successful business.

Viable online businesses fall into one of four categories:

1 The absolute cheapest prices in the market

2 The best range and service

3 The first place customers look

4 A fantastic end-to-end shopping experience

MODEL 1 | The price leader
"The cheapest"

The price leader is the most straightforward online business model; see Exhibit 1 for two examples. If you can offer the lowest prices, the price transparency of the internet is a huge advantage. You don't need expensive facilities, lots of staff, or even a brand (beyond being seen as reasonably trustworthy) provided you have an advantaged source of supply, or extremely low operating costs, or both. For products that are usually bought on their own and that have straightforward purchase dynamics, being the lowest price in the search engine is often enough.

Three types of company compete in this space:

1. The multi-category internet giants who have the logistics networks and scale to be cost advantaged

2. The off-price merchants selling grey market, diverted, and over-supplied branded goods (particularly in clothing, jewellery, and other low-volume-per-SKU, "fashion" categories)

3. The sole traders who feature so heavily on eBay and Amazon's marketplace

This is a tough model to pursue if you aim to build a defensible large-scale business, because it requires either massive scale or an advantaged source of supply. Without one or the other (ideally both), systematically offering the lowest prices is financially ruinous – especially for bricks-and-mortar retailers where online prices tend to drag down in-store prices and make it impossible to cover fixed costs.

✓ **Where it works:**
Searched categories, one-off purchases, and simple purchase dynamics

✓ **How it wins customers:**
By winning the price battle, search by search

✓ **How it earns a profit:**
Advantaged sources of supply and low cost structures

Exhibit 1: Examples of retailers that have established themselves as price leaders

	ESTABLISHED: VENTE-PRIVÉE	UP AND COMING: MADE.COM
What it is	• High-end discount fashion	• Designer furniture made to order
Successes so far	• €1.1BN turnover in 2011; €1.3BN turnover in 2012. 2.5MM unique visitors per day with 18MM members in Europe • Ten years old and still growing • Expanding into other countries • Lots of copycat sites	• Young, growing business established in 2010 • Sales £10MM+ • On the UK government's Future Fifty list • Hired 100 FTE in 2012 • Also expanded into France and Italy
Customer proposition	• Online "flash sales" of a limited period (3–5 days), with 24 hours' notice	• Designer furniture 70% cheaper than the high street • Customers vote for their favourite designs and only the most popular get made
Profit model	• Privileged supply from designer brands looking to clear excess stock • Secret sales mean they aren't listed on price-comparison sites so branded suppliers are less worried about devaluing their brands or cannibalisation	• Re-engineers the value chain – from made.com to manufacturer to consumer • Pieces only commissioned after orders are placed, allowing low stock levels and negative working capital

MODEL 2 ⧄ The category expert
"The best range and service"

Just as category killers won for many years by creating a dominant customer proposition within their categories, there is a role for category experts online. Most online purchases satisfy a single easy-to-define consumer need – "I want a new TV" or "I need a car seat" – and the search-led way that most consumers shop works well for that type of purchase.

But the consumer experience most websites deliver is hopeless for more complex purchases. When needs are less well-defined – "I need some new shoes" or "I'm looking for a new sound system" – the search-based approach doesn't work well and the endless aisle that is so powerful in other situations just becomes clutter and confusion. While some search-based sites tackle this problem by using consumer reviews, retailers that really understand the purchase occasion and provide an experience that is optimised for it can create a real advantage. In categories where consumers repeat purchase, that superior experience can be translated into long-term loyalty.

Not all categories are suited to the category expert model: the categories that were the basis for the most successful bricks-and-mortar category killers may not necessarily be the same as those used by successful online category experts. Nonetheless, there remain purchase occasions with particular (and in many cases, particularly demanding) service requirements, which can best be served by businesses that have been specifically designed around them (see Exhibit 2).

✓ **Where it works:**
Complex purchase occasions, medium frequency purchase cycles, many-to-many product dependencies, discrete sets of categories not bought together with others

✓ **How it wins customers:**
Customers know it's where they can find the products that best meet their needs

✓ **How it earns a profit:**
Natural margin is raised by differentiation and long-term loyalty, based on hard-to-replicate expertise

Exhibit 2: Examples of retailers that have established themselves as category experts

	ESTABLISHED: ZAPPOS.COM	UP AND COMING: WIGGLE.COM
What it is	• Mass market shoes and clothing retailer • World's largest online shoe store	• Specialist sporting goods retailer • Owned by private equity firm Bridgepoint Capital since acquired for £180MM in 2011
Successes so far	• Acquired by Amazon in 2009	• Revenues up from £86.3MM in 2011 to £140.8MM in 2013
Customer proposition	• Range authority: – 50,000+ types of shoe – Large speciality range – Out-of-stocks can be pre-ordered • Strong focus on customer service: – Call centres open 24/7, no scripts, staff build brand "legend" by going the extra mile	• Range authority: – Full range of cycling, running, and swimming gear – Shop by brand or category • Expert advice: – Buying guides for each category – Live webchats with an advisor available • Low risk: – 12-month returns policy – 30-day test ride on bikes
Profit model	• Driven by repeat custom	• Driven by a differentiated, expert proposition

The default destination
"The first place you look"

The default destination is the online equivalent of the one-stop-shop where a consumer knows they can always get what they want at a fair price – essentially, it's what convenience has come to mean in the online world. Such retailers offer all the product range a customer is likely to need, a solid website, a no-hassle shopping experience, and prices that are reliably competitive (if not always the absolute cheapest). Their aim is to build a customer base that sees them as the default option for all of their needs.

This has been the approach Amazon has taken (see Exhibit 3). As the categories it sells broaden, it meets more and more of a typical household's needs and the logic for just going to Amazon without checking anywhere else becomes stronger and stronger. Meanwhile, an AmazonPrime subscription creates long-term lock-in. Today, Amazon's lead in customer consideration, category breadth and range, and favourable price perception, all make it hard to see how anything other than an intricately configured consortium of other retailers could compete on a level playing field.

But there are other customer segments – small businesses, schools, young families, silver surfers, and so on – around which similar models could still be built.

The challenge is to define your target and be relentless about serving their needs better and better over time. Half-hearted won't work. For example, to target small businesses, an office supplies retailer needs to provide everything they need, not just some of it. The aim is to become the default destination for an office manager, and leave them with no reason to shop around. Achieving this means tailoring shipping and invoicing arrangements and offering services as well as physical goods. This is a fundamentally different business approach for retailers who have traditionally defined themselves in terms of the products they sell.

✓ **Where it works:**
Customer segments with wide-ranging but identifiable needs

✓ **How it wins customers:**
By conveniently meeting all their needs at reliably low prices

✓ **How it earns a profit:**
By building default shopping behaviour

Exhibit 3: Examples of retailers that have established themselves as the default destination

	AMAZON	STAPLES
Initial proposition	• Started as a category expert book retailer, selling its first book in 1995 • Able to carry many times the number of titles as the incumbent bricks-and-mortar players	• Established in 1986 as an office supply superstore and for a long time was a category killer
Development	• Established itself as a broad price leader, offering products below RRP on nearly all lines, either through its own fulfilment or its marketplace • Rapidly expanded into other categories and became focused on owning the last mile • Deeply customer-focused, with membership and subscription services increasing customer retention • Developed into default destination for many households	• Branched out into related categories (like break-room supplies and office furniture) and services to become the default destination for B2B office supplies • Focused on improving customer engagement, for example by acquiring Runa, an e-commerce personalisation company • Currently redesigning strategy around fewer stores and more online business

MODEL 4 The customer experience captain
"A fantastic end-to-end shopping experience"

For many of today's biggest bricks-and-mortar retailers, this may be the most interesting model, since by its nature it's a multichannel concept that leverages physical store assets. It's also the most difficult to explain, because no retailers have fully delivered it.

In the past, apart from advertising and perhaps some direct mail, customers' only contact with retailers took place in the store at the point of purchase. However, now the shopping experience begins long before a customer sets foot in a store, continues long after they leave it, and can be helped along by today's technology at many touchpoints along the way.

By using technology to seize more chances to interact with customers, and linking this seamlessly into relevant in-store experience that adds value, a traditional

retailer should be able to build a compelling customer experience that differentiates them from online – and bricks-and-mortar – competitors.

To take advantage of this opportunity, a retailer needs to understand the often subtle or implicit choices that customers make at each stage of the shopping experience. As shown in Exhibit 4, these will vary from one product category and purchase occasion to another but, at the most basic level, customers move through four identifiable, sometimes overlapping or iterative, steps. The starting point for a retailer is to identify opportunities to engage with the customer at each step and to ask themselves some existential questions about what customers are looking for, how to deliver it, and using which channel (see Exhibit 5).

Exhibit 4: Questions to be answered and acted upon at each stage of the shopping experience to enable a retailer to fully engage with a customer

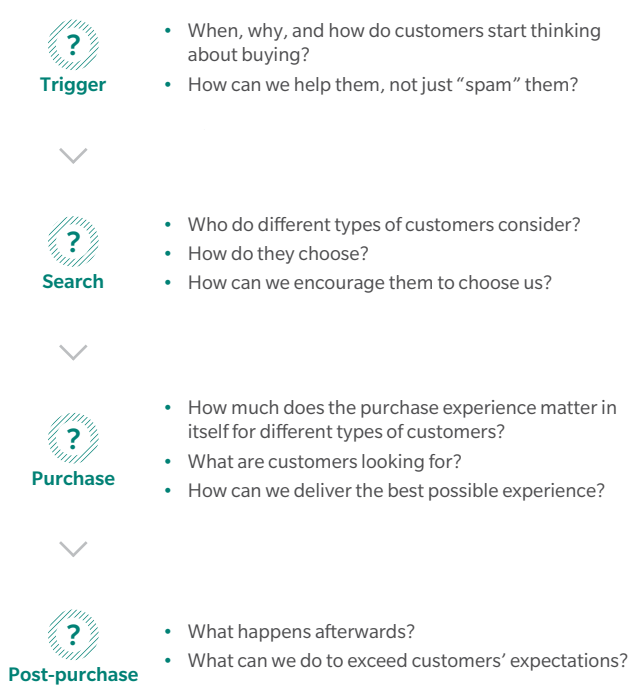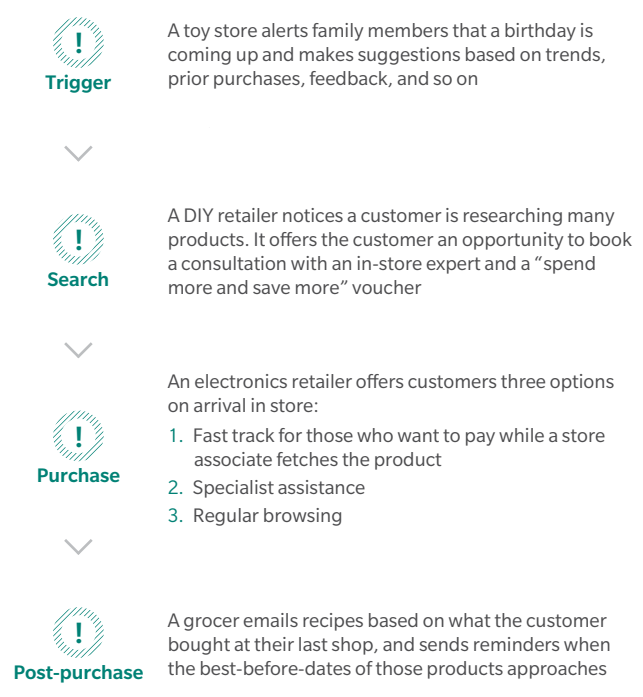**Trigger**
- When, why, and how do customers start thinking about buying?
- How can we help them, not just "spam" them?

Search
- Who do different types of customers consider?
- How do they choose?
- How can we encourage them to choose us?

Purchase
- How much does the purchase experience matter in itself for different types of customers?
- What are customers looking for?
- How can we deliver the best possible experience?

Post-purchase
- What happens afterwards?
- What can we do to exceed customers' expectations?

Exhibit 5: Examples of how some retailers could innovatively engage with customers at each stage of the shopping experience

Trigger
A toy store alerts family members that a birthday is coming up and makes suggestions based on trends, prior purchases, feedback, and so on

Search
A DIY retailer notices a customer is researching many products. It offers the customer an opportunity to book a consultation with an in-store expert and a "spend more and save more" voucher

Purchase
An electronics retailer offers customers three options on arrival in store:
1. Fast track for those who want to pay while a store associate fetches the product
2. Specialist assistance
3. Regular browsing

Post-purchase
A grocer emails recipes based on what the customer bought at their last shop, and sends reminders when the best-before-dates of those products approaches

Clearly these are strategic, conceptual questions, far removed from the day-to-day reality of running a retailer. But answering them is a key first step in building a true multi-channel retailer.

What might a true multichannel retailer look like? Aligning pricing across channels, integrating logistics networks, being able to sell products through different channels, delivering well-designed apps and websites, and offering reviews, recommendations, and advice are all necessary but they aren't enough on their own.

To make this model work, a retailer will need to mine customer data to understand choices and shopping behaviour better than ever before. This goes beyond in-store experience to the end-to-end shopping experience. This approach will require identifying purchase occasions that didn't exist in the past and aren't yet well served. It will require mastering the use of social media and other channels to help the retailer become customers' first choice. It also requires recognition that different customers shop in different ways, and a successful retailer must provide the right level of service and assistance to each of them, without seeming pushy.

In this model, the online and offline worlds should enhance the experience in each other.

To date, this is something that has been developed further in the services industry than in retail. For example, airlines now use real-time mobile survey data to pick up customer frustrations in the airport and smooth things over when the customer reaches the lounge or aircraft. In addition, hotel chains can predict where a customer might like to go next and when. In the end, a bricks-and-mortar store may play a reduced role compared to today, but will still be a crucial element of delivering the best possible end-to-end experience.

The end-to-end shopping experience needs to become just that: a genuine proposition with value-adding customer interaction at all stages. While many retailers are addressing some aspects of this today, none are covering all in a powerful and compelling way.

Perhaps most challenging of all, a retailer will need to do all these things in a way that makes customers' lives better, easier, and nicer, to help them rather than just sell things to them. Of course, no retailer has yet achieved all this, but the examples in Exhibit 6 give some indication of the opportunities that are opening up and of the ways retailers can capitalise on them.

✓ **Where it works:**
Potentially anywhere, with the most obvious being complex purchase occasions where neither store-only nor online-only provides the best experience possible, and categories where choices have strong subjective elements (for example, fashion, furniture, luxuries, and gifts)

✓ **How it wins customers:**
By making their lives easier and better

✓ **How it earns a profit:**
By becoming a fundamentally new breed of retailer, achieving differentiation through a unique customer proposition at the same time as right-sizing bricks-and-mortar assets

Exhibit 6: Examples of retailers that have established themselves as the customer experience captain

	ESTABLISHED: JOHN LEWIS	UP-AND-COMING: SEPHORA
What it is	• UK department store	• Perfume and cosmetics
Successes so far	• One of the only major high-street retailers to see consistent growth through recent downturn	• Owned by LVMH • $4BN revenue in 2013 • Expanding aggressively into China

Customer proposition	• Stores offer:
	  – Ability to see and touch the full range, notably big-ticket categories like furniture and electronics
	  – Cooperative approach, owned by staff, resulting in high-quality service in store
	  – Wide range of services such as home fittings and installation, personal style advice, and so on
	• Website is fully integrated to enhance stores:
	  – In-store booths allow customers to browse, check stock, and order online
	  – Free click-and-collect, using sister supermarket Waitrose to gain nationwide reach
	  – Gift lists selected and held in store, but can be accessed and purchased online
		• In-store experience is essential for trial, events, and classes
		• Online experience gives access to reviews and ratings and the full range of products
		• Effectively integrated the two channels, allowing customers to:
		  – Book store classes and events through an app
		  – Scan in-store products with their phone to see ratings and reviews
		  – Access music, magazine, and book downloads through the Sephora Shares app, boosting adoption of the technology

Profit model	• Online is driving growth: during Christmas 2013, online represented a third of sales, having grown 22% over previous year and compared to a 1.2% growth in store sales • New smaller stores are being developed with an edited range complemented by terminals to order online	• Reinforces underlying category expertise model benefits of differentiation and loyalty

CONCLUDING REMARKS

A high-level review like this inevitably simplifies some of the issues involved, but it can also help identify where the opportunities for long-term value creation lie. E-commerce is a particularly challenging part of the retail world, and one common theme that emerges across all four models, summarised in Exhibit 7, is the need for radical innovation, not just incremental improvement. With technological change accelerating and competition becoming ever more intense, building a successful retailer based on any of the four models takes genuine creativity and bold, decisive action: a cautious approach won't build the deep moats to protect profits in the long run.

Exhibit 7: Summary of viable online business models

	MODEL 1: THE PRICE LEADER	MODEL 2: THE CATEGORY EXPERT	MODEL 3: THE DEFAULT DESTINATION	MODEL 4: THE CUSTOMER EXPERIENCE CAPTAIN
Where it works	Searched categories, one-off purchases, and simple purchase dynamics	Complex purchase occasions, medium frequency purchase cycles, many-to-many product dependencies, discrete sets of categories not bought together with others	Customer segments with wide-ranging but identifiable needs	Complex purchase occasions where neither store-only nor online-only provides the best experience possible, and categories where choices have strong subjective elements
How it wins customers	By winning the price battle, search by search	They know it's where they can find the products that best meet their needs	By conveniently meeting all their needs at reliably low prices	By making their lives easier and better
How it earns a profit	Advantaged sources of supply and low cost structures	Natural margin is raised by differentiation and long-term loyalty, based on hard-to-replicate expertise	By building default shopping behaviour	By becoming a fundamentally new breed of retailer, achieving differentiation through a unique customer proposition at the same time as right-sizing bricks-and-mortar assets

Online only

POSITIONING

Strong bricks-and-mortar presence

○ Today   ◯ +5 years