The Impact of the Internet on Retailing

The most talked-about subject in retailing, and indeed, the entire business world, as we enter the new millennium is the potential impact of the Internet. There continues to be tremendous speculation on the impact it will have on retail sales. E-commerce, e-retailing, and e-tailings have all become commonly used buzz words. In some circles, traditional "brick and mortar" retailers are considered dinosaurs as Wall Street and venture capitalists place huge valuations on promising Internet start-ups while penalizing those companies without a strong E-commerce presence.

Estimating Internet sales has also become a cottage industry for research and consulting organizations. Historically, the estimates for potential sales have been so outlandish that they are laughable—

continued on next page

By **Neil Z. Stern**

Neil Z. Stern, partner in the Chicago-based retail consulting firm McMillan|Doolittle, specializes in retail strategy development. Since joining the firm in 1986, he has completed projects with many clients, including McDonald's Corporation, Publix Supermarkets, Sears, Roebuck and Co., and Vons Supermarkets. He is editor of McMillan|Doolittle's publication, *Retail Watch.*

greatly overestimating the rate of growth and potential size of the market. Still, the combination of the press and the hype has put considerable fear into the minds of most retailers about what their appropriate strategy should be.

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Make no mistake, the Internet will have a tremendous and everlasting impact on a retailer's relationship with the consumer. The Internet is already having a measurable impact on the way in which customers receive information about products and services. It will also, in many categories, have a considerable impact on retail sales.

The key in analyzing the Internet is to separate fact from fiction and keep a level-headed, rational view—a difficult stance when irrational projections rule. This article seeks to look beyond the short-term hysteria and build a solid, sustainable case concerning the real trends underlying the phenomenon of the Internet. It concludes with some suggestions on how to approach the critical issues that a retailer must face in developing an Internet strategy.

The Compressed Retail Life Cycle

The Internet, at its most basic, represents another channel in which to market and sell goods and services. It brings compression of the overall retail life cycle to a new level. From an historical context, the pace of retail change is continuing to accelerate. Peddlers and "mom and pop" retailers controlled retail trade for hundreds of years. Then, the big department stores and mass merchants dominated retail for nearly 50 years, with the growth of regional malls and huge retail concerns like Sears, JC Penney and Kmart.

Progressively, we are now seeing brick and mortar retail concepts get created and mature at faster rates. Office supply superstores, as an example, reached maturity in around 12 years. With the advent of advanced technology, access to huge capital resources, and with lower barriers to entry, the Internet promises to compress the retail life cycle faster than anyone could have previously imagined. It is conceivable that this industry will go through growth, maturation, consolidation, and shake-out in little more than five years. This gives huge advantages to (and puts considerable pressure on) first-mover sites. It also suggests that the window of opportunity to set the appropriate Internet strategy is a narrow one.

> "It is conceivable that this industry will go through growth, maturation, consolidation, and shake-out in little more than five years."

Just how big is the Internet opportunity? Not so long ago, many analysts predicted that direct mail would displace retailing as we know it. And, while growth was initially impressive, catalog sales have stabilized at around 7 percent of total retail sales (excluding food and auto). Core catalog users (those who make two or more purchases a year) still represent only 35 percent of the population.

> "The very fundamentals of the business, not technology, will ultimately determine the success of the Internet as a retail channel."

Why do we reference catalogs? Lost amidst the hype of projecting huge e-retail sales are some fundamental structural issues that surround any retail business—telling customers about your brand, the mechanics of selling the product, physically getting the product into the customer's hand, and making sure that the customer is satisfied with the purchase. As wonderful as this new technology promises to be, one can't overlook the "basics" that drive the retail business. The very fundamentals of the business, not technology, will ultimately determine the success of the Internet as a retail channel.

The Numbers As They Exist Today

The years 1998 and 1999 promise to be watersheds for E-commerce. The business is gaining momentum, as new E-commerce players continue to emerge and they record real and substantive sales increases. For the purposes of this article, we will focus on the business-to-consumer (e-retailing) segment of the business. This ignores the huge business-to-business market, which is already experiencing massive change.

Business-to-consumer Internet sales (e-retailing sales) were estimated at around $8 billion in 1998, according to Jupiter Communications. Impressive, but still less than 1 percent of the over $1.2 trillion retail business (excluding food and auto) and less than 10 percent of the $85 billion direct marketing (catalog) business. Considering how much has already been written about the business, these sales levels are surprisingly small. However, even conservative projections have e-retailing sales exploding over the next five years. The real question is how high can these sales go?

There is considerable evidence from a consumer standpoint that supports rapid growth. As consumers become more comfortable with technology while continuing to be time constrained, commerce on the Internet presents a compelling option. Consider the following:

- **The number of homes with computers reached 50 percent in early 1999.** This is up from 37 percent just over two years ago, as tracked by a number of reporting firms. And, these numbers will continue to grow as computers cost less. Indeed, we expect to see computers given away free in the near future in exchange for online service agreements or other similar incentives. Many more consumers have access to a computer at work. More significantly, the need for a computer to access the Internet will probably be a minor point in the future as TV, cable, phone, and other easier access options become more readily available.

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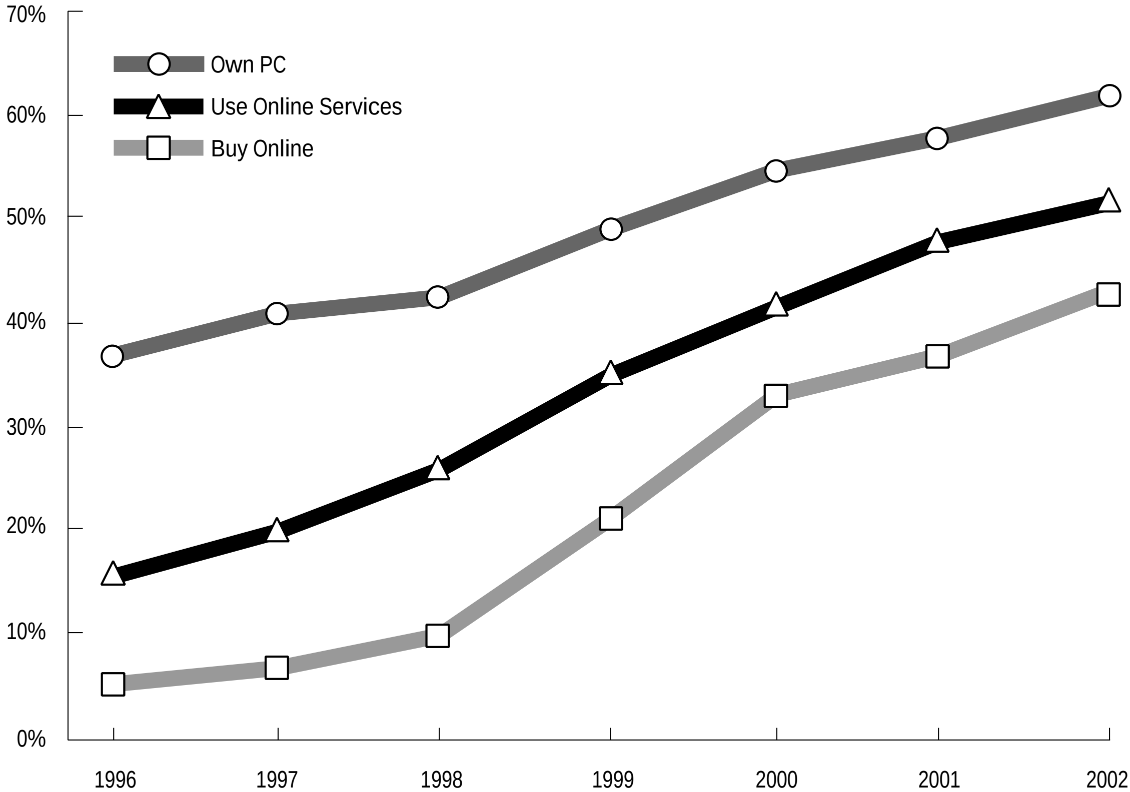
- **More users of online services.** Nearly 33 percent of the U.S. population (and growing fast) has access to the Internet at home, and again, more can reach the Net at the office. This number is particularly significant, as it has grown even faster than computer ownership (17 percent of customers had access to the Net in January of 1997). America On Line (AOL), the largest online provider, has grown to well over 18 million users, up from 5.5 million users in 1996. The quality of online access continues to improve, and we expect to experience quantum leaps in both the quality and speed of access.
- **Less than 15 percent of all households have purchased online.** While this is up dramatically from just 3.5 percent two years ago, it still represents a fairly small number of total consumers. Consumers cite considerable barriers as reasons not to use the Internet. These barriers include security concerns, high shipping costs, poorly designed Websites, and frustrations over the ordering process. Most of these concerns are rapidly disappearing as better sites, better technology, and better security measures emerge.

Consumer and Technological Convergence

We believe that society is approaching a major convergence point between consumer behavior and technological capabilities. It is this critical inflection point between computer ownership,

Chart 1: Growth of Internet Usage, 1996-2002



Source: Jupiter Communications

online usage, and commerce capability that is driving much of the optimism behind Internet projections. In the next five years, as illustrated above, we expect over 40 percent of American consumers to have purchased online, three times today's number. We expect these users to purchase more items from more sites as their comfort level in using this medium increases. The real question then becomes, how much will they buy?

A Comparison to Catalogs— A Starting Point

To answer the question of how big the market can be, the catalog industry provides a relevant comparison point from which to judge Internet sales potential. The two channels share many similarities and some important differences. Both mediums work to make customers comfortable with the remote shopping and buying process, dealing with the challenges of selling products without a customer's ability to physically touch them. Both communicate with customers on a one-on-one versus mass basis. Both share similar logistics—the shipping and handling of individual orders. Both face the same challenges of customer acquisition, order fulfillment, handling returns, and remote customer service.

> "The direct marketing business did grow faster than traditional retail during the 1980s, fueled by the advent of toll-free 800 telephone numbers, express shipping services, and the explosion of credit cards."

As we mentioned, catalogs have grown impressively, reaching over $85 billion in sales. The direct marketing business did grow faster than traditional retail during the 1980s, fueled by the advent of toll-free 800 telephone numbers, express shipping services, and the explosion of credit cards. Through the 1990s, however, growth rates have been comparable to retail stores, and catalogs did not fulfill the promise of overtaking the bricks and mortar model. While catalogs have gained a solid foothold, we did not see the anticipated impact on the traditional retail model.

We do believe that Internet sales will exceed those of catalogs and will do so over the next five years. Specific advantages for E-commerce include:

- **Lower barriers to entry.** Producing a catalog is an expensive undertaking, and the cost of publishing and mailing is significant. While sophisticated Internet sites are becoming very costly, it is still relatively easy and inexpensive to start a business. Lower barriers to entry yield more competition.
- **Getting products to market faster.** The Internet allows for shorter lead times than catalog production schedules. This will allow Internet retailers to get products to customers faster—and get in and out of trends much faster than conventional retailers.

> "Catalogs and retail stores are limited in assortment by practicality and efficiency. Internet retailers can theoretically carry anything."

- **Ability to carry broader assortments.** It would be impossible (as Amazon.com likes to point out) to physically enter millions of books into a catalog. Catalogs and retail stores are limited in assortment by practicality and efficiency. Internet retailers can theoretically carry anything. They are not constrained by the physical limitations of catalog pages or the size of a retail store. Amazon, the most prominent Internet retailer, has grown its business by seamlessly, and relatively inexpensively, increasing the number of categories it sells. From its roots as a bookseller, Amazon has added videos, music, toys, electronics, and an auction service—all on the same site.

eBay, the Internet's premier auction site, has more than a million products for sale.

- **Ability to reach small markets and create new markets.** The Internet serves niche markets very efficiently. While much is made of the giant commerce sites, tens of thousands of sites have sprung up marketing niche merchandise. These are merchandise categories that are not large enough to support a retail store or catalog but can thrive on the Internet. eBay, the Internet's premier auction site, is an outstanding example of both serving and creating niche markets. eBay currently has more than a million products for sale, many of which fall in the category of niche collectibles. By linking together both buyer and seller, auction sites actually create a huge secondary market for products. The Internet is a wonderful medium for selling a one-of-a-kind product and for the disposition of surplus and clearance products.
- **Ability to touch customers often.** Once a customer visits an Internet site, the e-retailer is able to communicate with its customers

cheaply and efficiently. E-commerce players who specialize in music, for example, can contact customers when an artist they have already bought releases a new album. Drug retailers can inform customers when a prescription is ready to run out, etc. These messages, specifically tailored to consumer needs, are a lot less expensive than sending out a general catalog.

- **Ability to quickly reach a mass audience.** Drugstore.com, an Internet start-up, registered an incredible seven million hits on its first day of business. Public relations, links to other prominent sites, and the general ability of the Internet to create news lead to a medium that has an incredible ability to reach masses of consumers more effectively than any "brick and mortar" or catalog format.
- **Worldwide potential.** Geographic barriers are also more easily reduced. The worldwide commerce potential is staggering, as more countries are likely to follow the North American pattern of dramatic increases in Internet usage.
- **Tapping into a virtual community.** While harder to quantify, there is considerable benefit in the ability to tap into expanded information content and the sense of a virtual community. Live chats with authors, the ability to read customer reviews, recipe sharing, tapping into consumer guide ratings, previewing music online, are all examples of the intangible benefits of shopping online. The richness of information content is a powerful driver of consumers onto commerce sites. It stands to reason that these sites will ultimately be able to turn researchers into buyers.

As creative marketers continue to exploit the uses of the Internet, we will undoubtedly discover more new benefits of the channel. Technology advances, while impressive to date, will increase exponentially, eliminating slow download times, page loads, and other nuisances that hamper current commerce efforts today.

The Internet Won't Replace Bricks and Mortar—Here's Why

While it's easy to become euphoric over the Internet's potential and join the crowds who predict the quick demise of traditional forms of retailing, many disadvantages to e-retailing have not received enough attention. Some of these issues are category specific; others will remain as universal problems.

> "While the potential of these sites is obvious, the long-term financial model is not. There are few, if any, publicly traded Internet retailers that can demonstrate a long-term profit model."

Before we kill off retail stores, here are some issues to consider concerning Internet retailing:

- **Unproven financial model.** The valuations given to E-commerce companies have become the stuff of legends. Amazon.com, which continues to rack up huge losses, has a valuation based on recent stock prices of over $25 billion on sales just now approaching $1 billion. Compare that to Sears, Roebuck and Co., a $40 billion retail company that made $1.5 billion in profits last year—but has a valuation today of around $12 billion. eToys, a wonderful Internet start-up, had a market capitalization of nearly $4 billion when it had its initial public offering—on only $30 million of recorded sales. While the potential of these sites is obvious, the long-term financial model is not. There are few, if any, publicly traded Internet retailers that can demonstrate a long-term profit model. Ultimately, the catalog did not prove to be a more efficient distribution model than retail. The money saved by not having stores was more than made up for by higher marketing costs (this includes production, publishing, mailing, and customer acquisition costs). The Internet has some major financial hurdles to overcome before the model can be perfected.

eToys had a market capitalization of nearly $4 billion on sales of $30 million.

This includes:

— **High customer acquisition costs.** Current acquisition costs are enormously high for Internet retailers. These costs include exclusive marketing arrangements with the major portals, including sites like Yahoo, AOL and Excite. It also includes a tremendous amount of traditional advertising, including billboards, TV and radio messages, etc. The stakes are extremely high for gaining and keeping customers—and this has meant enormous marketing costs. It remains to be seen whether these costs can be reduced over time.

— **High site development costs.** The costs for developing and maintaining Websites are also enormous, as companies struggle to keep up with the enormous technological advances being made as well as addressing all of the necessary compatibility issues. The maintenance of sites also requires a substantial human resource commitment.

- **High merchandise return rates.** As with catalogs, high merchandise return rates could be the bane of Internet retailers. Returns in the catalog business average at least 15 percent and jump even higher (up to 40 percent) on size and style sensitive items. Returns are a source of intense customer dissatisfaction and inconvenience and represent significant, profit-draining handling costs for retailers. This will be a prime reason why some product categories will be much more difficult to sell online than others—the less commodity oriented the item, the higher the return rate. While early Internet categories like books and music are relatively straightforward, more complex categories will face a unique set of issues.

"Returns are a source of intense customer dissatisfaction and inconvenience and represent significant, profit-draining handling costs for retailers."

- **Consumer Trust.** This is a major issue today, usually related to credit card security and privacy concerns. We expect this issue to rapidly diminish over time. Putting your credit card on the Net should be no less safe than handing it to a waiter in a restaurant. Secure transaction sites are becoming the norm. Many Internet retailers are also overtly stating their privacy policies to address privacy concerns. Longer term, issues such as trusting the company you're buying from are more critical; there are too many "fly by night.com" sites out there that are not reliable. Branded sites (whether they are run by customer-focused virtual companies like Amazon or traditional retailers like The Gap going online) will have an advantage, particularly as the Internet penetrates a larger base of consumers. In addition, Internet retailers must come clean about the nagging issue of hidden charges, such as shipping and handling. Variability of shipping charges is a major determinant of a consumer's total product cost. On many sites, the charges are hidden until the last moment; on others, inflated shipping charges negate any savings over retail alternatives.

> "While we have seen major technological advances in picking product and in shipping methods, this central problem remains for many Internet retailers."

- **Taxation**. Internet sites, for the time being, have the added advantage of not charging consumers local sales tax. This difference helps equalize the costs of shipping and handling today. As the category grows in attention and importance, there is no guarantee that these sites will remain tax-free.
- **The economics of distribution.** Major retail stores originated with a simple premise—it is cheaper to deliver goods en masse to a central place than it is to deliver directly to a home. While we have seen major technological advances in picking product and in shipping methods, this central problem remains for many Internet retailers. Books and music are small, flat, uniform size objects that are relatively cheap to ship via conventional methods. By contrast, furniture is bulky, heavy, easily damaged, expensive to ship, expensive to get into a customer's home, expensive to set up, and deadly expensive if returned. Grocery products, as another example, have a high degree of perishability. Many products have been designed to sell in a retail environment, not be direct shipped one at a time (e.g., shampoo or ketchup bottles that are not safety sealed). So, while the Internet is definitely an efficient place to order items, it may never become an efficient place to deliver products into a customer's home. The variations by product category are substantial and should have profound implications on what categories will work and won't work on the Internet. The economics of distribution—the cost effectiveness and efficiency of direct to the home—is a very real, though not often discussed, barrier.
- **Bounded Rationality.** As good as computers have become (and as good as they promise to be in the future), they will never match the human mind as a decision-processing tool. While searches are getting better (eToys has the best search functions we've seen), they will never replace the power of the mind. Consumers literally make thousands of decisions per second as they wander down the aisle of a supermarket, drug store, discount store, or department store. They can decide what item they are looking for based on a complex series of choices regarding brand, price, size, color, function, packaging, sales offers, etc., without even being consciously aware of the thought process. But, it is this ability that lets customers choose from the tens of thousands of choices that retailers give them. We laughed when we first saw the impressive, four-page list of toothpaste available at Drugstore.com. In this instance, and in countless others on the Internet, huge selections actually increase the difficulty of making a purchase.

> "If there is too much information to process, we simply ignore it. Good retailers help customers make purchasing decisions."

What is "bounded rationality"? It refers to the limitations we put on ourselves to make decisions. If there is too much information to process, we simply ignore it. Good retailers help customers make purchasing decisions. True merchants narrow the selection down to just the products that consumers want. We anxiously await the arrival of virtual shopping experiences, intelligent shopping agents, and other advances that will aid the Internet buying process. However, we have real doubts if they'll ever replicate the power of the human brain.

- **Planned versus impulse purchasing. Fun versus routine.** Internet retailers do a credible job today of fulfilling a planned purchase. If you know exactly what you want, going to get it is efficient. On the other hand, it's difficult to browse, difficult to get ideas, difficult to impulse shop, and difficult for retailers to sell highly profitable add-on items. It is also difficult to get inspired by new ideas, as you would by window shopping or browsing the pages of a catalog, and difficult to find a total solution. If you want John Grisham's new best-seller, you're in luck. Looking for some light summertime reading? A much more difficult proposition. This carries over to other categories as well. It's a lot easier to buy a pre-sized polo shirt from The Gap than it is to find an evening dress for a formal event. The implication: many products and categories won't translate easily to E-commerce.

What Role Will the Internet Have?

The litany of concerns above should force retailers and manufacturers to take a hard look at the pros and cons of selling their products on the Internet. While there is clearly a future for E-commerce, the fundamental issues addressed in this article won't go away. And, they make a compelling case for the continued dominance of a physical store setting as the primary source of retail sales for the foreseeable future.

In the next breath, we are continually amazed at the ingenuity of entrepreneurs to develop new uses and benefits of the Internet. Great Internet applications that are already revolutionizing business include:

- **Auctions.** Sites like eBay and uBid have added a new dynamic to selling new and used products. Auction sites allow consumers to sell to one another directly in a highly efficient manner. The used market is huge (and difficult to track), estimated at well over $100 billion. eBay lets customers set their own prices and allows for the sale of thousands of unique items. uBid allows for the highly efficient selling of refurbished, overstocked, or old models in areas like home office and electronics. Traditional retailers like Sharper Image are turning to auction techniques to move products and create excitement, and traditional auction houses like Sotheby's are moving onto the Internet.

uBid allows efficient selling of refurbished, overstocked, or old models in areas like home office and electronics.

- **Name your price models.** Priceline.com is a revolutionary idea that allows customers to name their own price for items like airline tickets and hotel rooms. This allows companies to use surplus inventory while also allowing consumers to save money. While this began as a service to sell virtual items, it is expanding to big ticket purchases like cars.

- **Direct content download.** Huge strides are being made in the ability to directly download content (music) to the consumer. This technology (MP3 is the leading provider) eliminates the physical barrier of having to deliver an item to a home. Obviously, non-physical transaction areas—airline tickets, hotel reservations, banking services, financial services like stock trading—will continue to experience tremendous growth.
- **Group Buying.** Buying consortiums are emerging that allow individual customers to sign up and buy products on a volume discount principle. The more buyers—the lower the cost. Accompany, for example, is a start-up buying service. It negotiates bulk sales with a manufacturer in advance and then is able to bring down costs, as more and more consumers agree to buy the product.
- **Shopbots**. Shopping robots like MySimon are virtual shopping agents for a consumer. Enter a product or category, and this service will search the Web looking for the best price. An efficient way to price compare could place significant downward pressure on margins on the Web.

"Shopping robots like MySimon are virtual shopping agents for a consumer. Enter a product or category, and this service will search the Web looking for the best price."

- **Kids' malls.** Innovative ideas like kids' malls are emerging. Parents can credit kids with "money" at the mall, with kids free to spend this money at approved stores. The money can also be accrued for kids to save up funds. These sites are targeted towards Generation Y Internet users, who will ultimately represent the real test of the staying power of E-commerce.
- **Emergency gifts—gift reminders.** 1-800 Gifts and other services are trying to fill two voids. They provide automatic gift reminders for forgetful consumers and convenient, often last minute, shopping help.
- **Registry sites.** Major efforts are under way to develop Bridal Registry sites. Sites like Della & James act as middlemen for many well-known specialty shops like Crate & Barrel and The Pottery Barn. The Wedding Channel has support from bridal magazines and retailers like Federated—owner of department store chains Macy's and Bloomingdale's. The Knot is a virtual shopping site without retail partners.

"There will be no shortage of entrepreneurs who continue to push the envelope of where and how consumers will shop."

Some of these ideas will work; others (probably the majority) won't. The point is to demonstrate the incredible flexibility and diversity the Internet offers. There will be no shortage of entrepreneurs who continue to push the envelope of where and how consumers will shop.

Projections for E-Retailing Growth

We have broken down projections for e-retailing growth over the next five years by major shopping category. For each section, we have grouped segments together by high impact (10 percent or more of sales); moderate impact (4-5 percent of sales) and limited impact (less than 3 percent) by 2003. We also have a category that will have a high non-transactional impact. It is important to note that some categories may have a limited impact but represent huge potential sales volume—grocery stores and drug stores, for example.

The estimates of total category sales are based upon segment breakdowns, as reported by the U.S. government. In some cases, figures are reported by segment (e.g., toy retailers); in others, we present a reported breakdown by general segment (discount stores) that sell a multitude of items. These figures also take into account estimated sales from direct marketing.

Chart 2: Projected E-Retailing Sales by Segment, 2003

High Impact Segments	Sales (billions)	% of Total Category Sales
Book and music stores	$6.0	20%
Office product stores	$11.8	12%
Toys	$3.5	15%
Electronics/Computers	$13.5	10%
Moderate Impact		
Auto supply stores	$2.4	5%
Sporting goods	$2.0	5%
Drug stores	$7.9	5%
Apparel	$8.5	5%
Department stores	$2.5	4%
Warehouse clubs	$2.8	4%
Home furnishings	$3.3	3%
Discount stores	$8.0	3%
Limited Impact		
Home improvement	$4.8	2%
Grocery	$11.5	2%
Shoe stores	$0.8	2%
Furniture	$1.3	2%
Convenience stores	$0.1	–%
Total	**$90.7**	
Non-Transactional Impact		
Automotive	-	-

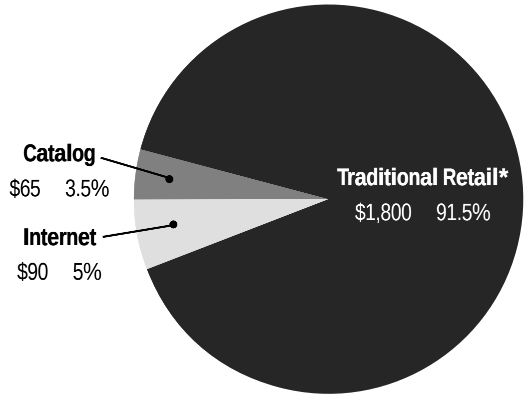
Source: McMillan|Doolittle projections

Total Projected Retail Impact—2003

Adding up the numbers, we expect that e-retailing sales will total about $90 billion and account for 5 percent of total retail volume (these numbers exclude business-to-business sales and used merchandise). This represents phenomenal growth from the $8 billion recorded in 1998 but may be less than some have predicted. Still, we expect traditional “brick and mortar” retail stores to account for an incredible $1.8 trillion in sales, a fact that many observers overlook.

We expect catalog sales to decline from an $85 billion high, as many of those sales move to the Internet. We will briefly examine the thinking behind the classification of the segments.

Figure 3: 2003 Retail Sales ($ billions)



**Excludes restaurant and auto sales*
Source: McMillan|Doolittle projections

High Impact Segment

The high impact segment (10 percent or more of sales) is characterized by a few major points:

- **Commodity-oriented product.** Overall, these categories sell branded commodity products that are easily shipped and have relatively low merchandise return rates.
- **Established e-retail providers.** While books and music are not the largest retail categories, they were the ones to experience the earliest online usage from pioneering companies like CD Now and Amazon. Computer sales benefitted from a tight match between consumers and the products being sold. Dell Computers pioneered a different way to sell its product—to a user base that was comfortable with technology.

> “Others can easily sell this product, which could lead to extreme margin pressures. High sales volume may not necessarily translate to huge profits.”

The drawback to the high impact segment is the very commodity nature of the product. Others can easily sell this product, which could lead to extreme margin pressures. High sales volume may not necessarily translate to huge profits.

High Impact Example—eToys

eToys benefits from a commodity-driven, branded category that has also seen the traditional industry leader faltering. eToys is one of the better designed e-retailing sites to date—easy to use with terrific information availability and search capabilities. With Toys 'R' Us slow to respond and hampered by problems at its "brick and mortar" outlets, eToys also took advantage of the ability to launch its site without major competition. However, Amazon now sells toys, and others are trying to get into the business.

Moderate Impact Segment Analysis

The moderate impact segment (3-5 percent of total retail sales) is characterized by the following:

- **Ambiguous merchandise offerings.** While warehouse clubs and discount stores are huge retail segments, their strategy is to not dominate specific categories. While Wal-Mart and Target are spectacular "brick and mortar" retailers, it isn't certain that these strengths will easily translate to a virtual setting. Can a generalist win in the virtual world?

> "While Wal-Mart and Target are spectacular 'brick and mortar' retailers, it isn't certain that these strengths will easily translate to a virtual setting."

- **Sizing and selection issues.** Apparel and department stores sell a lot of products that are size and style sensitive. We have talked about the difficulties of selling fashion-driven product online. The Gap, on the other hand, sells basics-driven merchandise which is not as fit sensitive. They should be very successful on the Web.
- **Few established online efforts.** While certain categories may hold considerable promise (auto supply, sporting goods), we have yet to see a really powerful online effort. It will take time to build a brand and sales, which leads to more conservative projections.

Drugstore.com had seven million hits on its Website the first day of business.

Moderate Impact Example—Drugstore.com

Drugstore.com has established a great deal of momentum in a short time, thanks in part to its close association with Amazon and a successful initial public offering. Drugstore.com also has connections with vitamin giant GNC and drug chain giant Rite Aid. Other notable start-ups include Planet RX and Soma.com.

While Drugstore.com is a well-done site with marketing muscle behind it, we are not sure that this will be as big a category as many believe. Issues with the site include:

- **Prescription drug dynamics.** The maintenance drug business is huge and offers much promise for Internet providers. However, the complicated network of HMO's, insurance companies, and other third-party providers creates many more complications than simply selling a book online.

- **“Need it now” convenience.** A lot of what’s sold is convenience sensitive and not planned purchasing. Can customers wait three days when they run out of toothpaste or have a cold or headache?

“**C**an you make money shipping tubes of toothpaste or bottles of aspirin?”

- **Commodity driven.** Many products are branded and commodity driven. Can you make money shipping tubes of toothpaste or bottles of aspirin?

Limited Impact Segment Analysis

Some of the largest retail categories fall into what we consider to be a limited impact segment (less than 3 percent of total category sales). Still, they do represent huge potential volume and have attracted considerable attention. We’ve dismissed, in our projections, the potential of shoes due to huge fit and return issues. Nevertheless, Nordstrom, a terrific retailer, has announced it intends to create a site that will offer over one million pairs of shoes. While home improvement stores have a major convenience component and often deal with complex do-it-yourself projects, Home Depot intends to be a major E-commerce force. No category has attracted as much attention as grocery, however, thanks to the more than $400 billion in business and the consumer’s stated aversion to grocery shopping.

Limited Impact Example—Webvan

Webvan is an extremely well capitalized start-up with big ambition: It has already announced an IPO and a $1 billion warehouse expansion to be in over 26 major cities. Webvan’s intention, along with competitor HomeGrocer, is to dominate the at-home grocery delivery business. And all of this without any track record on how the service will work.

Webvan’s site is straightforward and functional.

Many other efforts are under way, all working on variations of the same issue—how do you profitably deliver commodity and perishable products to consumers’ homes on a timely basis. Peapod, the industry pioneer, began by picking products out of local stores, but this has obvious cost disadvantages. Streamline, another start-up, builds lock-boxes in the consumer’s home and fulfills out of a warehouse. An interesting model, but it is rigid in usage and still expensive.

Webvan also picks out of an automated warehouse but promises delivery to a consumer’s home in an agreed-upon 30-minute window. If Webvan can fulfill this delivery promise, it would probably eliminate the need for a lock box. Its pricing claim is to be lower than supermarket shelf prices. While Webvan so far seems to meet this claim, it is not competitive with supermarket sale prices and doesn’t currently offer lower priced private label alternatives. Interestingly, Webvan claims to have superior perishables merchandise because of reduced handling requirements. Its site isn't fancy but straightforward and functional.

If a virtual supplier can deliver quality products, on a timely basis, with competitive prices to a consumer's home profitably, this will be a very big segment. That's a big IF, however. These are low-margin goods without much room for error.

Non-Transactional Impact

The Internet will transform the way a consumer **shops** for any item. Using the Internet for information is already the number one reason consumers state for being online in the first place. Internet-savvy consumers will have, at their fingertips, more information about the product or service they are looking for than ever before. The more informed the consumer, the bigger the change in the dynamic of the shopping process.

"One category that figures to have enormous non-transactional impact in the next five years will be in the big ticket area of car shopping."

One category that figures to have enormous non-transactional impact in the next five years will be in the big ticket area of car shopping. Car shopping provides a dramatic example of the impact of information. With sites like CarPoint, AutoWeb, and AutoByTel as examples, consumers now have a tremendous wealth of information at their fingertips. These sites give all of the facts about a particular car, comparisons across competitive models, invoice pricing, and considerable information about warranties and financing.

While these sites have linkages to dealerships, and many sites are beginning to also offer full transactional capability, we believe that car selling will still require brick and mortar outlets for the foreseeable future. For such a big purchase, most customers will still want to see, feel, and test drive a car; colors and option packages are numerous; cars still need to be prepped; title transfer and documentation are complex; financing is complicated; service is an integral component; and trade-ins may be an issue. For all of this complexity, the need for physical dealerships will still exist for large numbers of customers. However, the way in which dealerships operate will forever change. The amount of information available to customers significantly impacts the relationship and should affect the way in which cars are sold. It remains to be seen how quickly traditional dealers can change to meet these needs.

How Should Retailers Respond? The Ultimate Dilemma

This article has explored the incredible impact and complexity of the Internet as a commerce mechanism. While there is little doubt that every aspect of the customer-retailer relationship will change, a retailer needs to carefully assess the right strategy for the business. Determining the appropriate Internet strategy could well be the critical factor for success, or failure, for retailers moving into the next century. The stakes are that high.

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Here's a brief list of issues that must be considered at all retail companies:

- **Determine the appropriate Internet strategy.** First and foremost, the response to E-commerce must be a strategic issue tackled by the top management of a company. It cannot be passed off to the Marketing or MIS departments. The potential investment and business impact is simply too great. A rigorous strategic planning process should guide a company through industry critical issues: What impact will the Internet have on your category? Where are the threats coming from? What are our competitors doing, and why? How prepared are we to respond? What will the impact on capital be? Do we have the right resources? These are examples of the big, strategic issues that have to be faced.

- **Be a World-Class Communicator.** Whether E-commerce is ultimately the goal, every retailer should be communicating with customers, associates, and their supplier community via the Internet. It is a powerful information tool that can help in virtually every aspect of the business. There will also be tremendous negative repercussions for companies that don't have a strong Internet presence. A strong information-oriented site will be a "greens fee" for companies in the future.

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For companies seriously considering e-retailing, here is some more detail on critical issues:

- **Understand the company culture.** Some companies are simply not suited for e-retailing. They haven't settled the issues of how this business will fit into, or alter, the traditional business. Many senior managers are threatened by the Internet and see it as the enemy. In these cases, culture change is needed or the company must determine an alternate structure (partnerships, joint ventures, spin-off business) to succeed.

- **Do we have the talent?** Can we get it? The demand for top Internet experts is intense. Many talented people are being lured to start-up chains with the promise (and, in dozens of instances, the reality) of getting rich on stock options. It may be very difficult to attract talent in traditional brick and mortar corporations. Tracking stock, joint ventures, corporate spin-offs may be a necessity in attracting talent and breaking through the cultural issues.

"For low impact segments, selling via the Internet may not be as critical as running the existing business better."

- **What is our category's potential?** How are we positioned? Companies must take a very close look at their industry to determine whether E-commerce is truly viable. For companies in the high impact segments, Internet selling is a key to survival. In moderate impact segments, we believe that companies need to look seriously at E-commerce. For low impact segments, selling via the Internet may not be as critical as running the existing business better. Once they have assessed the category, companies need to look at their place within it. Market leaders must react to keep their dominance. Niche players may have a completely different strategy.

- **Can our company afford the Internet?** The Internet is turning into a much more expensive proposition than most companies originally anticipated. The costs for developing and maintaining a commerce-based Website are rising exponentially as customer expectations of site capabilities rise. The payroll costs are skyrocketing, as are consulting fees. Marketing costs have proven to be far more expensive than most companies anticipate: Once you build a site, how do you tell customers about it? This capital commitment could significantly impact the bottom lines of a company. The ultimate dilemma facing retailers today: Can we afford to launch a major Internet effort because of these costs? Can we afford not to, based on consumer trends, Wall Street's view, and the potential business impact?

- **Back-end integration.** Most retailers do not have the capability of getting a product directly to a consumer's home. They built their entire distribution system upon the principle of large shipments moving to stores.

The systems, warehousing, and logistics needed to impact this change are also considerable. Catalog companies have a considerable head start here—even traditional retailers like Wal-Mart (creator of the most sophisticated retail distribution system in the world) are looking to outside partners like Fingerhut to assist in their E-commerce distribution efforts.

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- **Marketing alliances.** Many Internet start-up companies are bartering stock for advertising. Huge alliance deals are made every day to gain access to Yahoo's or AOL's customer base. Co-linkages between retailer and manufacturer are growing. Advertising dollars are shifting toward Website activities. However, the right marketing formula for the Internet is still an unknown. Real creativity is needed to properly position a company in this realm.
- **Assess manufacturer relationships.** Understanding what your key suppliers and manufacturers are doing is also critical. Many big manufacturers are taking steps to sell to consumers directly, which could have an enormous impact on future business models. Others may be key partners in the funding, marketing, or distribution side of the business. Developing alliances with key manufacturers will be essential.
- **Create a channel integration plan—The "click and mortar" model.** In the future, the retailer who has all channels working seamlessly together will likely be the big winner. With 90 percent of sales still coming from the retail channel, the need for seamless integration between Internet and brick and mortar will be absolutely essential. Yet, surprisingly, integration efforts today are generally poor or even non-existent. Marketing the Website at the store, signing up customers for the Internet site, easily handling merchandise returns, offering pick-up on Internet orders, Internet kiosks at the store, are just a few examples of integration. Look to The Gap and Lands' End as role model companies who understand integration needs.
- **Re-think store-based assets.** Perhaps the most critical success factor in the future will be appropriately tailoring the in-store experience in the age of E-commerce. This will affect everything from how big the stores are to merchandise mix, commission structures, training of store personnel, marketing communications, pickups, and returns. The physical store of tomorrow is liable to look a lot different from today's stores, thanks to the impact of the Internet.

2003 and Beyond—What Does the Future Hold?

Projecting Internet sales is admittedly a difficult and almost meaningless task. There are so many variables, and the rate of technological change makes it difficult to predict future consumer behavior. But, as this article demonstrates, there are very real barriers that stand in the way of e-retailing ever completely dominating the landscape.

> "This means that we expect fast, substantial growth for perhaps ten years. This will lead to continued sales increases—$200 billion by 2008—but at a slower rate of growth than the first five years."

We believe that the Internet will follow an extremely compressed retail life cycle, hitting maturity much faster than any retail format that has come before it. This means that we expect fast, substantial growth for perhaps ten years. This will lead to continued sales increases—$200 billion by 2008—but at a slower rate of growth than the first five years. As the industry matures, Internet retailers will have to develop new ways to continue to interest customers. How effective they can be at doing this will be the ultimate determiner of growth.

Summary

Jack Welch, Chairman of General Electric, calls the Internet “the most significant business event in his lifetime.” Bill Gates turned Microsoft’s total company efforts around practically overnight when he realized that he made a major strategic error in underestimating the impact of the Internet. The Internet has already made billionaires of E-commerce entrepreneurs like Michael Dell of Dell Computer and Jeff Bezos of Amazon. And the impact of the Internet as a communications tool is being demonstrated every day in practically every field.

While we believe that the Internet will make a significant impact on the way in which goods and services are sold, we also express a final cautionary note to all retailers: With an unproven business model and significant costs for entry, your company’s Internet strategy should be very carefully thought out.