Winning in E-Commerce and Digitalization

By

Jean Berg and Frédéric Milgrom

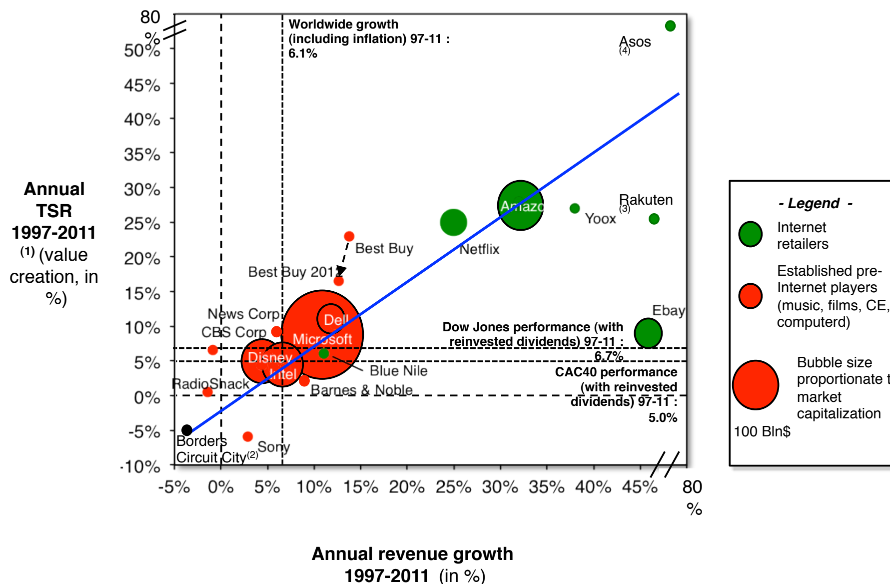
Senior Vice-President and Vice President, Estin & Co.

Selling and advertising on the Internet is now a must for brands and for retailers. They cannot ignore a sales channel that has enjoyed double-digit growth for nearly 20 years and a medium that is used several hours each day[1]. However, this growth in sales and exposure has not led to a significant and fairly distributed sales growth and value creation. Of the leaders that existed before the Internet emerged, none of the top music or film distribution companies, of the largest consumer electronics or computers manufacturers and of the associated retailers have managed to grow significantly and to create value (see Chart 1). As for the new leaders, ie the Internet "pure players", their growth has indeed been strong, but value creation has not been consistent. For example, the combined enterprise values of Netflix, Asos and Rakuten, three major Internet success stories, account for only 25% of that of Amazon.

- Chart 1 -

Established players have not grown and Amazon has captured most of the Internet pure players value creation

Growth in revenues and value creation - 1997-2011



Notes: (1) Annual shareholder return on investment (including capital gains, dividends, distribution of bonus shares, etc.), from 1997 or the year of the IPO if the stock was listed on the stock exchange after 1997; CAGR of revenue for CBS Corp and News Corp from 2004-2011; (2) Borders and Circuit City declared bankrupt in 2011; (3) CGAR 54%, TSR 26%; (4) CGAR 73%, TSR 54%

Sources : Bloomberg, analyses and estimates by Estin & Co

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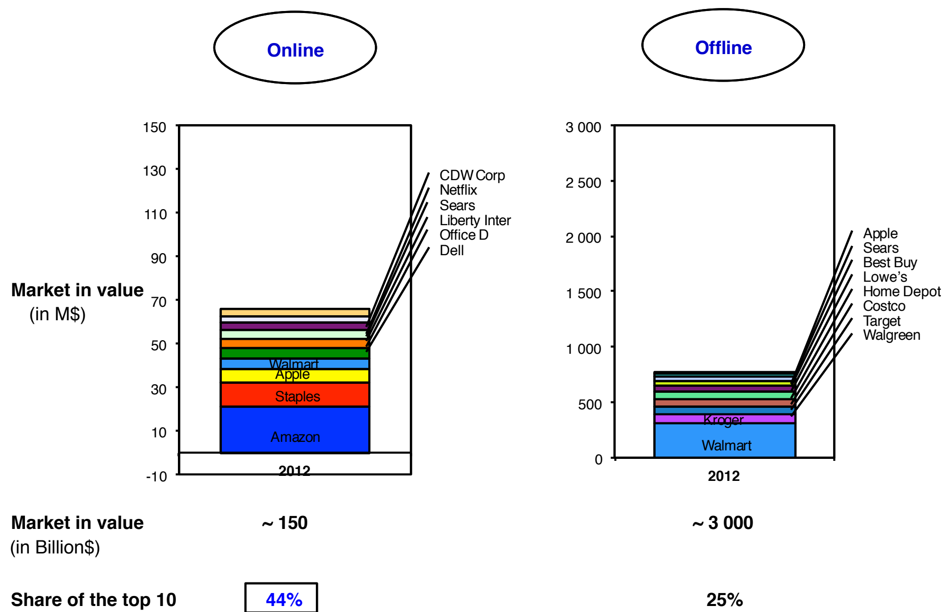
[1] 3h45 in the USA in 2011, of which 2h45 on fixed Internet and 1h on mobile Internet ; close to 2 hours in the UK and in Germany

- Chart 2 -

The online market is more concentrated than the offline market

USA example, 2012

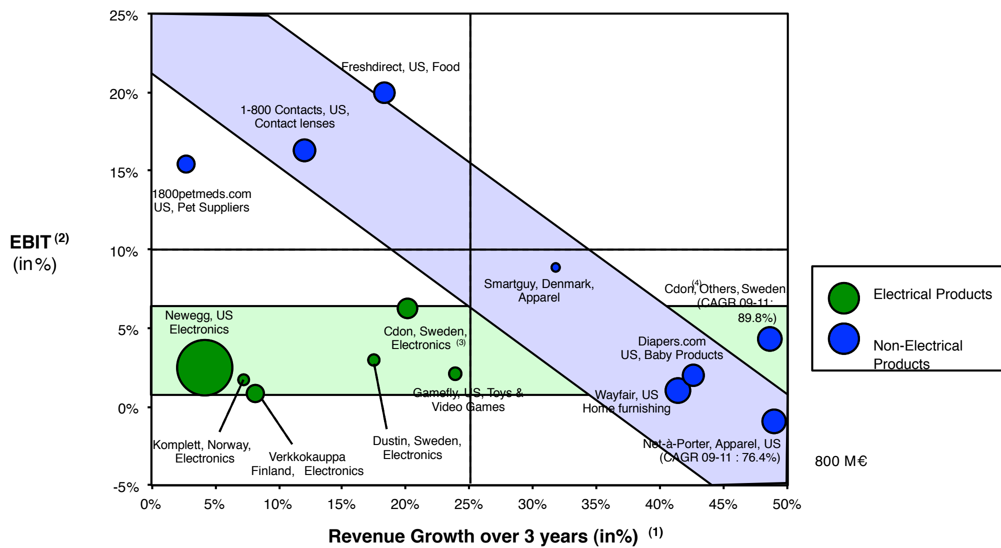


Source : Internet retailer, US Federal Statistical Office, Estin & Co analyses and estimates

- Chart 3 -

The combined performance in growth and profitability is better in the Home/ Textiles/Healthcare categories than in the Multimedia and Electrical Goods categories

USA and Scandinavia, 2007-2011



Note : (1) CAGR of revenues from 2009-2011; (2) Average EBIT from 2009-2011; (3) Cdon's electrical segment; (4) Fashion, sports, health and gardening segment;

Source : Annual reports, Amadeus, Estin & Co analysis and estimates

Only a handful of companies have become highly profitable leaders, which shows that the Internet follows a logic whereby "many are called but few are chosen". Therefore, Digitalization is not only a commercial and technical question ("how do we deploy on the Internet?") but also a strategic and financial one: how do deploy on the Internet to win? The potential answers are different for retailers and brands.

Retailers: invest significantly more where it is possible to make a difference

Revenue and value creation are more concentrated in e-commerce than in the physical world: the ten largest US retailers on the Internet account for nearly 45% of Internet sales, while their "offline" counterparts capture only 25% of "offline" retail sales (see Chart 2).

Indeed, the value to local or national leadership, which is a strategic given in retail, is higher on the Internet. While powerful offline concepts (such as Walmart, Zara or Kaufland) achieve their roll-out of stores in a country in two to three decades, the Internet allows for a much more immediate coverage rate. This accelerated "colonization" enables companies to increase sales'volumes more quickly, capture savings in COGS and logistics faster, reinvest these savings at a higher pace in an improved price/range proposal, and eventually stifle the weakest competitors. The development and concentration process is therefore accelerated twice over. Amazon took only eight years to achieve revenues of $5 billion (compared to 27 years for the Gap retail clothing chain) and established itself outside the USA after three years of existence (compared to 12 years for Gap). Ventes Privées, the French leading flash sales company, exceeded €1 billion in sales in less than ten years while the French leader in hardlines sales, CDiscount, took 12 years, even though both these companies are mostly selling in a single one country.

A successful growth strategy on the Internet therefore requires sharper "angles of attack" and more focused investments than one in the offline world in terms of:

- *Product categories selection.* Not all categories are equally attractive. In most countries, "historical" Internet categories, electrical and multimedia goods, are significantly less profitable than more niche categories such as clothing, health and furniture (see Chart 3). In the latter three categories, price transparency and price comparison are more difficult, and greater differentiation in terms of products, customer experience (online and multichannel) and service can be achieved (as evidenced by the parallel successes in the online UK clothing market of Asos, Next and John Lewis, which are three very different business models). Furthermore, the current smaller sizes of these markets make them more accessible;

- *Choice of business model*, in particular:

    - Choice of a purely Internet or multichannel approach. For instance, Wayfair, the American leading Internet pure player in niche furniture, opted not to sell top end products online but rather to channel sales' leads to selected specialized physical retailers; it recognized the value in the high-end market to the test and touch of the products and the limits of a purely Web-based approach; in a totally different field, click and collect options in hardline goods have been very popular, thanks to the associated reduced shipping costs;

- Degree of product differentiation, as a key tool to avoid commoditization and to respond to opportunistic "showrooming" behaviors. For instance, Target (in the USA) recently enhanced its exclusive offers (Missoni clothing collections, Up & Up health beauty and care products, own label food products, etc.) and managed, unlike Best Buy and Sears, to significantly limit the impact of price comparisons with Walmart and Amazon. The growth in own label and exclusive products within the ranges of the largest French home-improvement stores (Leroy Merlin, Adeo Group and Castorama, Kingfisher Group) further illustrates this quest for differentiation.

- *Selection of countries* where a complete Internet approach should be implemented and costly logistical infrastructure for fast product delivery set up. Not all countries are the same: the sizes and degrees of development remain heterogeneous, some countries have already experienced strong "US-style" concentration, while others suffer from a surplus of products which destabilizes retailers' margins through the high presence of discount and secondhand sites. Such is the case for large domestic appliances in France; the existing overcapacity largely explains, in our view, Amazon decision to withdraw from this category in France.

- *Choice of a combination of categories/business models/countries* compatible with the sizes of the various segments, the market share thresholds to be reached and consistent with the company's financial resources. Much like the development in a large emerging market, success on the Internet requires to build up a strong position and to continue to invest in order to concentrate the market. Although 10% growth per year may appear attractive, in most cases it leads to marginal and relatively uncompetitive positions in the long term. The growth target must be more than 30% per year, i.e. a rate that is double the market growth rate. This will require extremely rapid, sizeable and resilient investments and may lead to have to deprioritize other potential developments (in new geographical areas, in new or existing offline concepts, etc.).

Brands: disinvest selectively from offline to invest in online, including in one own commercial site

The Internet offers brands and marketers a new way of interacting with their customers with greater frequency, in more detail and without intermediaries. However, at least in mature countries, the guarantee that the Internet will provide additional revenues and margin is limited to markets in which increasing media pressure generates additional demand (as in the case of mobile telephones 15 years ago or smartphones today) and to certain industry leaders that will be able to capture a higher share of voice and market share. Most companies run the risk of incurring additional digital advertising and marketing investment costs for a total revenue that will be at best unchanged and therefore for a lower profitability.

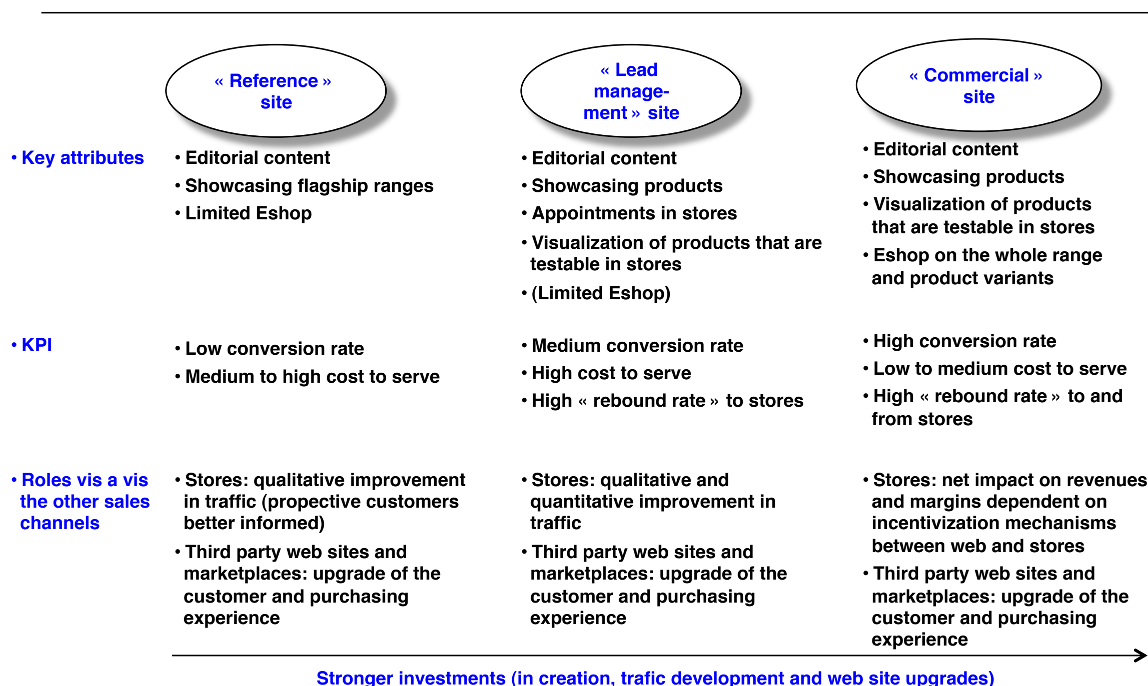
In order to invest more in digital expenditures, one must disinvest from other media, channels, retailers and promotional mechanisms, the ones which reach the weakest revenue and incremental profitability. Some non-food brands have already done this by sharing and outsourcing the commercialization of their products to hypermarkets and supermarkets, when the latters have become marginal channels. For instance in France, Michelin automotive accessories are sold to supermarkets by a category captain; Henkel uses a large wholesaler/rack jobber of an adjacent section for some of its product referencing in small stores, and large fishing gear brands (Rapalla, Mitchell) do not deal directly anymore with

hypermarkets and supermarkets. This disinvestment process can be undertaken gradually to minimize the risk and the impact on revenue. However, it is essential to start now by the least profitable lines. Tools for measuring the efficiency of online and offline marketing and promotional expenses will have to be refined (to take into account the lengths of purchasing cycles, lag effects and transversal effects).

The funds freed up will be invested in digital presence, including the brand's own site. In addition to their presence on selected marketplaces, brands must sell directly on the Internet[2]. The role given to the brand's own website will vary depending on the case (see Chart 4). It can be primarily a reference site that "drives" the other sales channels to improve and enhance the customer experience; it can be a lead management site that channels qualified traffic toward partnering physical networks; or it can be mainly a commercial site that is designed to generate significant revenue at a competitive cost to sell. Choices could be different within emerging countries, where a commercial brand web site can be the right way to kick start sales and to incentivize the development of third party retailers, versus in mature countries, where the web site will play a key role in playing « judo » with the pressure from established third party retailers. The choice of this role (and the corresponding business case) will dictate the amount of investment to be allocated.

- **Chart 4 –**

Role and economic contribution of a website for a consumer goods brand



[2] See Estin & Co's article " Why brands should now be investing in retail", September 2011

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The path to accretive growth on and via the Internet exists for most retailers and brands… but it is narrow and hazardous. It requires difficult choices and highly focused, resilient and rapid efforts and investments. It requires that Digitalization be placed in its proper context: a fundamental question for which the adoption of the "best technical practices" can not be the only answer and for which the amount of potential investments to be made requires a stringent evaluation.

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Estin & Co is an international strategic consultancy firm based in Paris, London, Zürich and Shanghai. The firm assists the boards of major European, North American and Asian groups in their growth strategies, and private equity funds in analyzing and improving the value of their investments.

ESTIN & CO

PARIS - LONDRES - ZURICH - SHANGHAI

43 avenue de Friedland 75008 Paris
Tél. : 33 1 56 59 87 87 - Fax : 33 1 56 59 87 88 - E-Mail : Estin@estin.com