OLIVER WYMAN

ONLINE RETAIL REPORT

THE GAME IS CHANGING

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MARSH & McLENNAN COMPANIES

EDITORIAL

For customers, online shopping means unprecedented choice, value, and convenience. For established retailers, it means tough strategic choices and, in many cases, a difficult long-term outlook. This selection of articles focuses on how e-commerce is changing the rules of the retail game and suggests ways an incumbent retailer can emerge as one of the winners.

Online shopping has already completely transformed some retail markets, and is set to disrupt many others. As our first article explains, this represents an opportunity as well as a threat for bricks-and-mortar retailers. Since most established retailers are building an online operation of their own, our second article discusses which business models look most promising, particularly in combination with an existing bricks-and-mortar operation. Next, we acknowledge how e-commerce has shifted the balance of power to the customer and use the German market as a case study to examine what makes an online retailer a customer favourite.

Grocery is the subject of our fourth article and, taking the US market as an example, we ask how online grocery can grow, under what conditions, and what this will mean for the existing bricks-and-mortar players. Online shopping relies on efficient last-mile distribution, and our fifth article discusses innovations in delivery logistics and suggests ways multichannel retailers can keep pace with the online giants. In the final article, we discuss ways in which e-commerce is blurring the boundaries between retail and business-to-business distribution.

I hope you find these articles interesting and that they can prompt discussion and debate within your organisation.

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HOW TO THRIVE IN AN ONLINE WORLD

Today, e-commerce matters in every retail market. In some – such as books, entertainment, and electronics – it has already brought massive upheaval and traditional players have been driven out of business. In others – such as grocery and DIY – its impact has so far been limited but this is set to change.

While e-commerce will affect all retailers, it will not affect them all equally. Modest differences in competitiveness and financial health will be amplified and, as weaker stores are forced to close, those that remain may actually gain volume. This disrupted, dynamic environment does not just present new threats for retailers; it also offers new opportunities.

THE THREAT

All sectors are vulnerable and some are more vulnerable than they seem

It's no surprise that e-commerce has grown fastest where products are high value, highly comparable, and easy to send through the post. Although perishable, bulky, or hard-to-deliver products are less well suited to online shopping (see Exhibit 2 in the article *Beware Amazon and Google: Staying Ahead in Wholesale Distribution*), the bricks-and-mortar retailers who sell them still face a serious threat. In many cases, their economics are already on a knife edge: earnings and demand growth are low and there is too much selling space in

the market. Even a modest loss in volume to online channels will prompt store closures, and some retailers will ultimately go out of business.

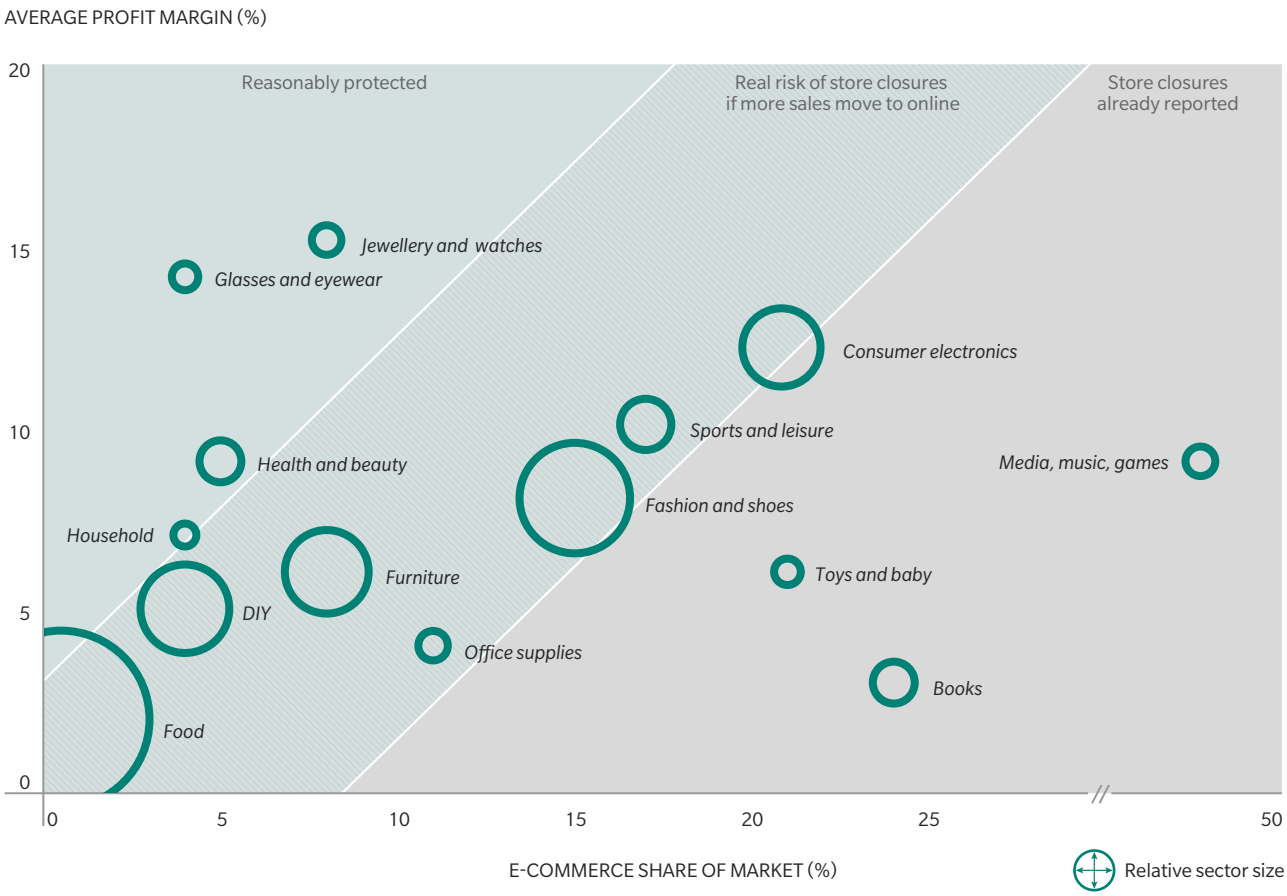
Because retail is characterised by high fixed costs and modest operating profits, small volume losses can quickly wipe out a retailer's profitability, and sectors with thin margins are more sensitive than others. The vulnerability of the US grocery market is examined in the article *Online Grocery: Where Can it Work and What is the Threat?* Compared with a grocer, a typical DIY retailer makes slightly higher operating profits, but since they also have higher contribution margin (in the region of 30–40%) a 10% loss of sales to online retailers would erase all operating profit. So this sector is highly sensitive to online disruption even though many of the products involved are not necessarily well suited to e-commerce.

On the other hand, sectors with healthier operating profits are more resilient, for example health and beauty, eyewear, and jewellery. From an individual retailer's point of view, this may be more important than the fact that these markets are easier to serve online.

Exhibit 1 illustrates these points using the example of the German retail market. High margin and easy-to-ship products are an obvious vulnerability, but this also highlights the risk to low margin sectors, such as grocery and DIY, which have the lowest structural profitability and as such are the most sensitive to any volume loss, however small.

Overall, we think that although the growth of e-commerce will be uneven across sectors, it is likely to drive market consolidation almost everywhere.

Exhibit 1: Vulnerability of retail sectors in Germany to e-commerce



Source: Industry reports and Oliver Wyman analysis

THE OPPORTUNITY

Within each sector, different retailers will fare differently

As well as variability across the retail industry as a whole, within any given retail sector – be it clothing, grocery, or home furnishings – not all retailers are equally vulnerable to e-commerce. Some businesses are better insulated from online competition than others and those with higher operating profits are likely to prove more resilient. It is important to realise that the relationship between financial health and future prospects is much stronger within each sector (for example, grocery versus grocery) than between sectors (for example, grocery versus clothing).

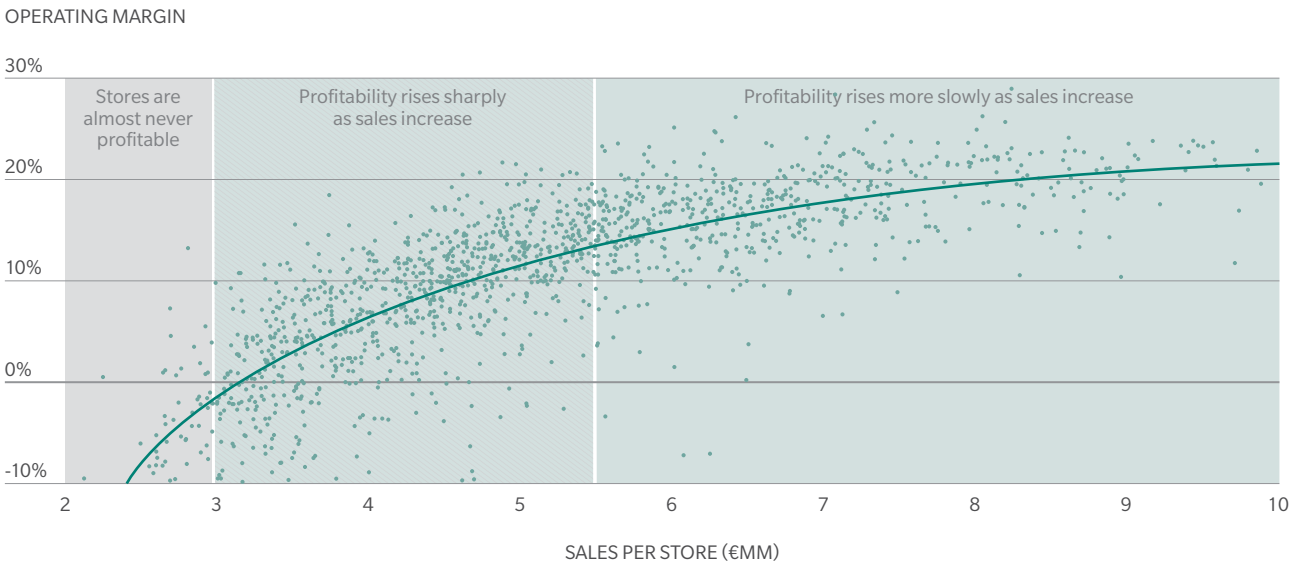
This is because relatively small differences in profitability can mask big differences in the proportion of stores that are barely viable today – which can be very significant in cases where there is an across-the-board drop in sales. High-level comparisons of financial performance therefore tend to understate the differences in the prospects for individual retailers.

In the example shown in Exhibit 2, online retail has already captured 15% of the market and sales losses are being compounded by a move from physical to digital products. We expect average store sales to decline by between 3% and 6% every year over the next three years. Across the industry, this is likely to prompt the closure of around 30% of stores but, as Exhibit 3 shows, this could play out very differently for the competitors in the same sector.

Overall, Retailer A is slightly more profitable than Retailer B, but it has significantly fewer stores that are only just above breakeven today. As a result, it is better placed to cope with volume losses: whereas around 20% of its stores are projected to become unprofitable, the figure for Retailer B is 45%. Without a major improvement in performance, many of these unprofitable stores will be forced to close.

In a disrupted market, a slight difference in profitability today translates into a huge difference in prospects for the future. Second order effects will compound Retailer A's advantage: because the two retailers compete head-to-head in many locations, store closures by either one will significantly benefit the other. Over the medium term, closing significant numbers of stores hurts buying power and supply chain efficiency. Depending on the exact nature of a retailer's fixed costs (some are fixed more firmly and over longer time frames than others), there may be a domino effect in which one round of store closures leads to another.

Exhibit 2: The correlation between store sales and profitability in a non-food sector



Source: Oliver Wyman analysis

All of this will serve to Retailer A's advantage to the point where, when the dust settles, the overall impact of e-commerce could actually be favourable: in a sector where ~20% of sales end up online, the other 80% become easier for the most successful bricks-and-mortar retailer to capture.

SURVIVING AND PROSPERING

Strategies for incumbents

As discussed, most bricks-and-mortar retailers are highly sensitive to modest losses in volume. E-commerce can therefore have a big impact even without capturing a large share of the market, and the disruption this brings will amplify differences in competitiveness between incumbent retailers. The implications are clear: no retailer can afford to ignore e-commerce, and those who can develop even a small advantage now will be much better placed to cope with the challenge it poses.

In almost all cases, developing a viable online channel of your own will be part of the answer. Even though it may mean cannibalising your own store sales to some degree, consumers will switch to online sooner or later and it would be worse if competitors picked up this online volume. Furthermore, an established bricks-and-mortar retailer has existing advantages that an online-only upstart cannot easily match, for example a comprehensive logistics network. The article *Changing the Rules: Viable Models for E-Commerce* discusses the strategic challenges of building an online channel in more detail.

As far as the brick-and-mortar business is concerned, there are three things retailers can do to maximise their chances of emerging as one of the winners:

1. Throw everything you have at building competitive advantage

The winner-takes-all nature of competition when volumes are declining makes this more important than ever. Higher stakes should provide the impetus to make even tougher decisions on cost or to redouble your efforts to manage retail levers such as supplier negotiations, range, pricing and promotions, and category management more tightly. Small differences will be amplified over time; get ahead now, and it's likely that you will be able to stay ahead.

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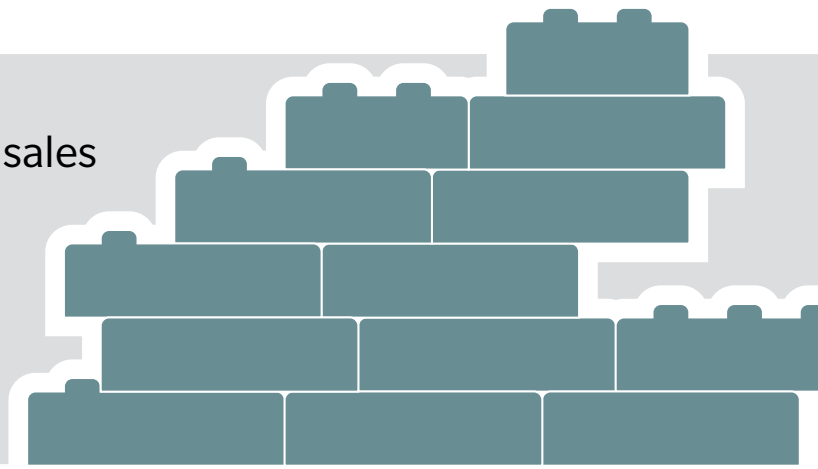


Exhibit 3: Compared to the competition, small profitability advantages can reduce the impact of online disruption

2. Develop a proactive "weakest stores" strategy

Even a modest drop in sales will make it hard for the weakest stores in the estate to survive. This makes it vital to identify these stores in advance and develop a better understanding of their true prospects. Some will be impossible to save in the face of declining volumes, while others will remain viable if you can improve their performance even slightly. If you can develop a thorough understanding of the local markets around each of the weaker stores in the estate, you can make significant gains by focusing marketing efforts and store investment on sites where you compete head-to-head with rivals facing the same struggle for survival.

3. Get to work on transforming the fixed asset base

Part of the strategy to defend the business must be to squeeze fixed costs to maximise the proportion of stores that will remain viable in the face of small volume losses. However successful these efforts are, the hard truth is that few retailers will be able to avoid closing at least some of their stores, with all the pain that rationalising the store network brings. Divesting sites, trying to get out of rental contracts, and reorganising the supply chain to preserve efficiency is never going to be easy – but, if left until profits start to decline, it gets even harder.

CONCLUDING REMARKS

Putting these strategies into practice is a real challenge. They require placing the long-term health of the business ahead of short-term financial performance, even though results might already be weak. In addition, organisational change is always difficult for large, long-established retailers. There are significant obstacles to overcome but developing a slight edge over traditional competitors is likely to already make a big difference. Of course, realising ambitious growth plans in the long run may require the business to actively participate in the macro market shift to online, which we explore more in our next article.

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

MODEL 3 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

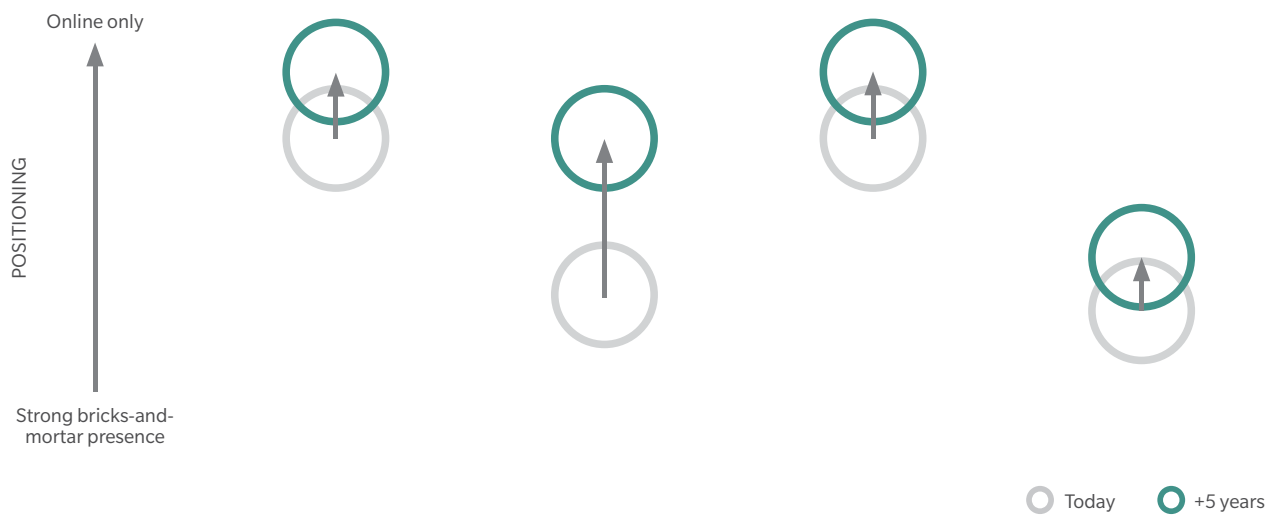
	ESTABLISHED: JOHN LEWIS	UP-AND-COMING: SEPHORA
What it is	• UK department store	• Perfume and cosmetics
Successes so far	• One of the only major high-street retailers to see consistent growth through recent downturn	• Owned by LVMH • $4BN revenue in 2013 • Expanding aggressively into China
Customer proposition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



WINNING CUSTOMERS

LESSONS FROM GERMAN RETAIL

In online retail, winning is everything. Fixed costs may be low but fierce price competition means thin margins which require massive volumes to deliver a profit. With customers able to easily shop around online to find the best deals on the products they want, there's little value in being their second choice.

So who are the winners today and how can you ensure your business is one of the front-runners in the future? How satisfied are customers with what you and your competitors offer? And, in customers' eyes, how do multichannel retailers compare with those who operate purely online?

This article shows how the Oliver Wyman Customer Perception Mapping tool can identify winners and losers and how a Customer Perception Map can be used to inform a winning customer proposition for the online business.

UNDERSTAND WHAT CUSTOMERS REALLY THINK

Simply asking customers how satisfied they are does not tell you why they shop where they do. In addition, because each customer is more familiar with some retailers than others, it does not allow meaningful comparisons between all competitors.

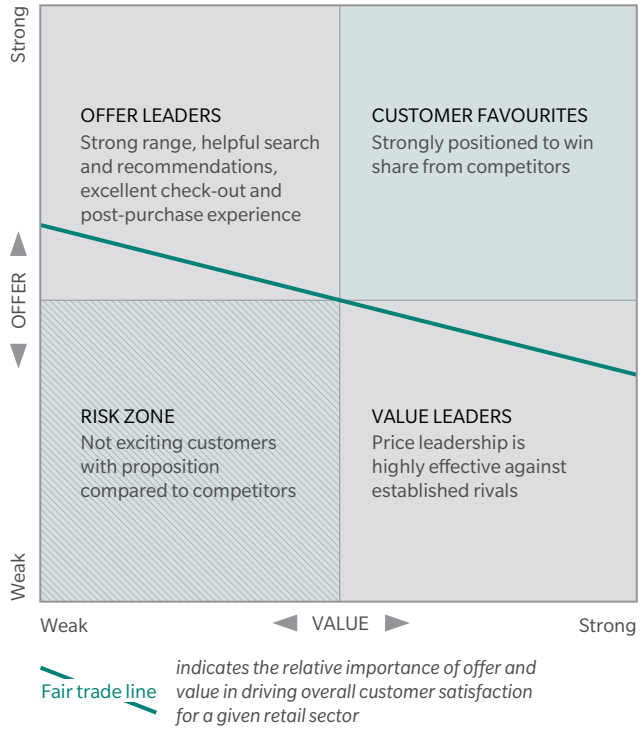
To address this, we have developed a methodology called Customer Perception Mapping.

We ask thousands of customers to make direct, detailed comparisons between different retailers across dozens of shopping attributes. The survey is constructed in a way that allows us to match what consumers say about different retailers with their actual choices about where to shop – to generate fair measurements of how well each retailer is doing in customers' eyes.

Customer Perception Mapping distils customer satisfaction into two fundamental, independent aspects: offer and value. Effectively, it summarises the retail proposition down to "what customers get" and "what it costs them". For any given retail market, these two measures can be presented in a single Customer Perception Map that shows how customers view each of the players in each market (see Exhibit 1).

Over the past decade, we've applied this approach across many different bricks-and-mortar retail markets in different geographies, and have found the results it generates to be a good leading indicator of financial performance.

Exhibit 1: Interpreting a Customer Perception Map



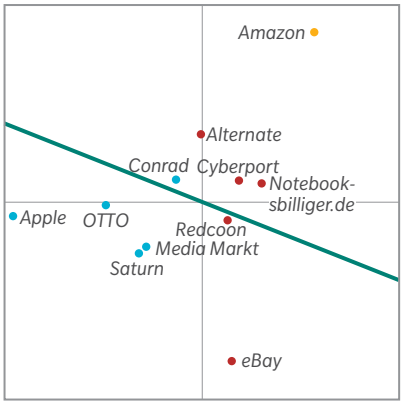
USE CUSTOMER PERCEPTION MAPPING TO CREATE A COMPETITIVE ADVANTAGE

The Customer Perception Maps shown in Exhibit 2 paint a high-level picture of online retail in Germany. They identify those who have a winning customer proposition and those who are vulnerable to losing market share. By looking more closely at the detailed customer responses from this dataset, we can suggest three common strategic learnings that apply across geographies.

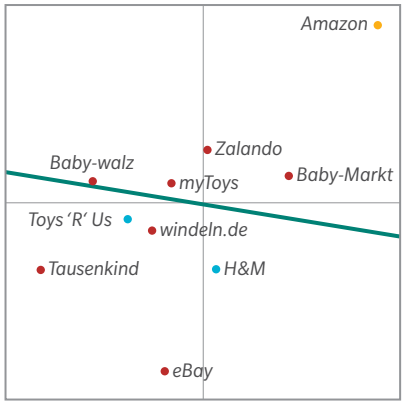
1. Amazon does have areas where other retailers could gain a customer advantage.
2. Move the battle to the shopping experience.
3. Bricks-and-mortar category leaders must upgrade their online proposition.

Exhibit 2: Customer Perception Maps for the different retail sectors in Germany

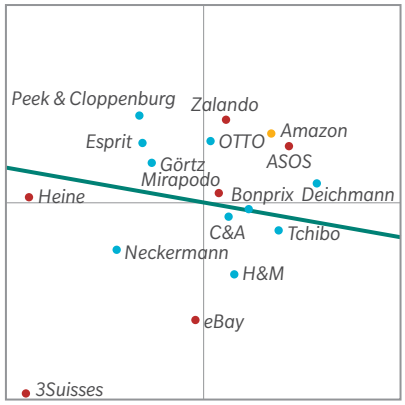
ELECTRONICS



BABY AND CHILDREN



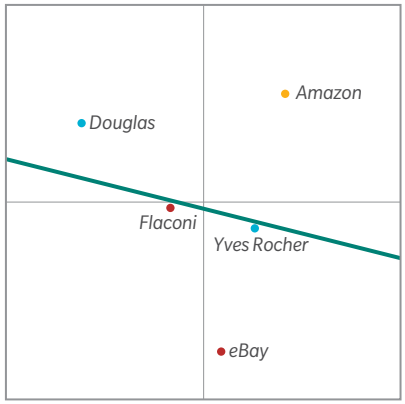
APPAREL AND FOOTWEAR



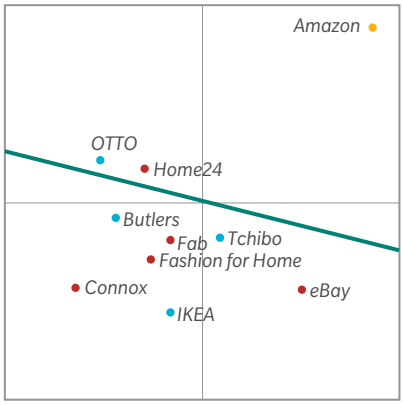
GENERAL RETAIL AND MARKETPLACES

GROCERY

HEALTH AND BEAUTY

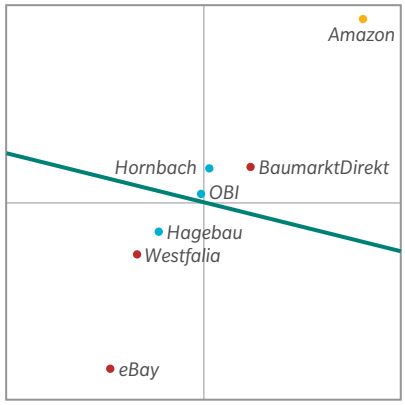


FURNITURE AND HOME DECORATION



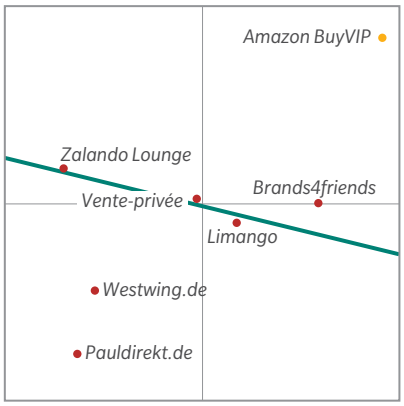
PET FOOD

DO-IT-YOURSELF

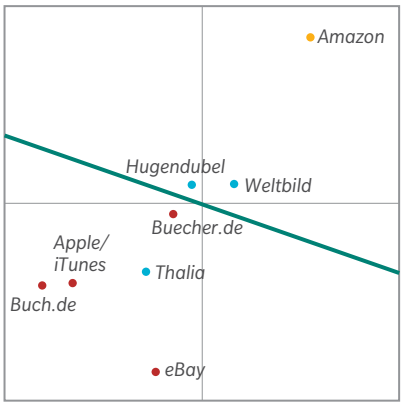


Online-only retailer Multichannel retailer Amazon

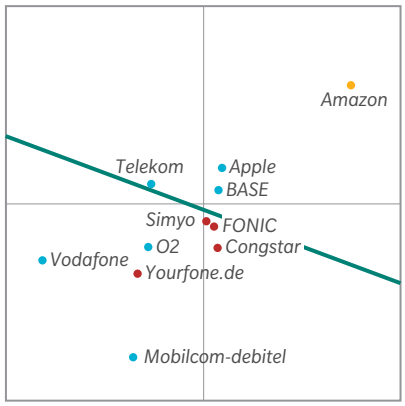
SHOPPING CLUBS



BOOKS



MOBILE



LESSON 1 Amazon does have areas where other retailers could gain a customer advantage

In every sector shown in Exhibit 2, Amazon scores highly out of the 12 sectors investigated and it was the clear customer favourite in ten. Clothing and shoes and pet food are the only exceptions: here, Amazon trails the category leader overall and ranks no higher than third in the market for either value or offer.

In addition, although Amazon's proposition is strong overall, there are four specific areas where it displays some vulnerability, shown in Exhibit 3.

Exhibit 3: Four areas where other online retailers could win the customer battle against Amazon

1 VALUE

Amazon's weakest area is the low number of promotions it runs, which reflects their decreased aggression around price and discounting. Amazon scores relatively poorly on this dimension across all sectors, even those where its rating for other aspects of value is high. There seems little doubt that customers have noticed this change, but it remains to be seen whether it will ultimately be enough to cause any significant damage.

2 PRODUCT DISCOVERY AND SELECTION

Product specialists often seem to beat Amazon on certain dimensions: expert advice, product filters, and the usefulness of pictures and videos provided. This is particularly true in categories where shopping is more emotional or subjective – clothes and shoes, furniture and home decoration, baby and children, and, to a lesser degree, beauty and pet food. This might be an area in which Amazon's broad scope turns out to be a disadvantage, and sectors where searching is complicated may be better served by a specialised online shop.

3 RANGE

Range is generally Amazon's greatest strength, but it is sometimes beaten by at least one competitor that offers a better range of premium products. The perceived gap is, admittedly, small – but as with product discovery and selection, a category killer's focused, tailored proposition could create an advantage.

4 PURCHASE AND POST-PURCHASE EXPERIENCE

This tends to be one of Amazon's strengths, as would be expected given its Prime service and strong focus on logistics excellence. Even so, it shows some weaknesses on ease of collection and returns, as well as on customer service.

LESSON 2 Move the battle to the shopping experience

Online, location is irrelevant, price transparency is all but perfect, and retailers can offer a broad range of products. Such characteristics of a retail proposition might have been of marginal significance in the bricks-and-mortar world, but they now give the advantage to online players. Similarly, each of the three following areas plays a much stronger role in customer satisfaction with online shopping than with retail:

- Ease of use
- Product recommendations
- Checkout experience.

Clicking through an app or web page is not the same as browsing products on a shelf in front of you, and customers are often looking for more guidance. It means that winning in online retail is not all about offering lower prices or a broader product range – you probably will not be able to. Instead, retailers – and particularly multichannel retailers – must leverage these other sources of competitive advantage, as explained in the article *Changing the Rules: Viable Models for E-Commerce*.

LESSON 3 Bricks-and-mortar category leaders must upgrade their online proposition

In general, customers see traditional bricks-and-mortar category leaders trail as inferior to their newer online competitors. The specific gaps vary across sectors and across retailers but, in general, poor competitiveness falls into three categories:

1. Lack of scale
   Typically affects product range, product reviews, and technology-enabled recommendations
2. Lack of commercial aggressiveness
   Exhibited in the delivery charges, returns policy, and pricing
3. Lack of excellence
   Where a company is behind the curve in the development of digital products such as product display, shop usability, and filter options.

Traditional retailers need to upgrade their offer attractiveness quickly: they risk being squeezed out by sector leaders who have scale advantages that not only reduce costs but also allow them to deliver superior offer quality. Scale advantages in online retail take many forms – compounding the winner-takes-all nature of the market:

- It becomes more economical to invest in a superior digital experience
- Big data plays an essential role in supporting customers in product discovery and selection
- Network effects in product ratings, reviews, and recommendations come into play.

CONCLUDING REMARKS

In terms of customers' perceptions, it's clear that, in Germany, Amazon has a big lead over almost all other retailers in almost all markets, and this is likely to be the case in many other countries as well. Their only obvious weakness is in situations where the purchase decision is particularly complex, purchase occasions where a tailored shopping experience and a more comprehensive high-end range can allow a specialist retailer to deliver a more attractive proposition. In fact, the importance of recommendations, ease of use, and service as competitive weapons is likely to drive increasing specialisation in both pure online and multichannel retail over the next few years – perhaps offering some significant growth opportunities.

Beyond this, how customers view different online retailers has strong implications for established bricks-and-mortar players. Today, they are rated poorly compared to newer, pure e-commerce operators; to compete successfully online, they will need to raise their game significantly. And this means more than just competing more aggressively on the "traditional" retail levers of price and range – ease of use and the shopping experience also have an important influence on where online customers choose to shop.

Some of the traditional retailers' weaknesses are the result of deliberate decisions not to invest: to protect margins and live with the competitiveness gap that results. This is understandably tempting from a short-term perspective – and indeed, in some cases it might be unaffordable to do anything else. But in the longer term, it may fatally undermine their ability to compete online.

While Amazon is a customer favourite in 80%+ online categories, there are vulnerabilities for the savvy retailer to exploit.

ONLINE GROCERY

WHERE CAN IT WORK AND WHAT IS THE THREAT?

Pure-play online grocers are nothing new: companies have been experimenting with the concept since Peapod and HomeGrocer.com launched in the late 90s. But while in the past many pure-play online grocers failed, recently more and more are experiencing sustained growth, suggesting they're here to stay.

The momentum that AmazonFresh has built up is particularly interesting: in the US, Amazon has announced plans to roll out AmazonFresh to 30+ markets by the end of the year, and they already made clear their intentions to enter Germany as well. Exhibit 1 shows some of the most prominent examples of pure-play online grocers around the world.

But despite their recent success, questions remain regarding the profitability of online grocers – so their long-term growth potential is unclear. In the US, many still limit their operations to a small number of major metropolitan areas. Is it possible to run a profitable home delivery business that isn't supported by sharing fixed costs with physical stores? It's reported that players such as Ocado and FreshDirect are already profitable – but is this just because they operate in densely populated areas?

Exhibit 1: A few of the pure-play online grocers around the world

	OCADO	FRESHDIRECT	AMAZONFRESH	YIHAODIAN
Current markets	UK – urban areas	US – select metropolitan areas on the East Coast	US – California and Seattle area Germany – coming soon	China – many areas
Delivery	Free with Ocado SmartPass membership (£70+ per year), or pay per delivery (price depends on demand and order value)	Pay per delivery (price depends on location)	In most markets, free with annual Prime Fresh membership ($99 per year)	Pay per delivery (price depends on weight and location)
Good to know	Also provides technology for Morrisons' (UK top 4 grocer) online offer	Fresh products a much higher share of baskets than at typical grocers	Constantly innovating to try and capture larger share of wallet (e.g., Dash)	Currently majority owned by Walmart 1,000 virtual stores

Online grocery involves a set of complex financial relationships, many of which are still evolving. Distribution costs are, of course, highly significant and are strongly affected by scale. Fulfilment costs are similarly important: they are heavily influenced by the picking technology and processes that are used, as well as by basket size and product mix, and they scale in discrete steps as new distribution centres are required. How much different customers will pay for delivery and how precisely timed and reliable the delivery needs to be all affect distribution costs – and are changing month by month as attitudes towards online shopping change.

The economics of online grocery retail are therefore complex and rapidly evolving, and vary significantly from one business to another. But there is a common theme: the importance of scale. To be viable in the long term, every online grocer needs to achieve profitable scale – and this means that the reach of pure-play online grocers will ultimately depend on some basic economics. At the simplest level, there are three key drivers of the viability of online grocery in a given market:

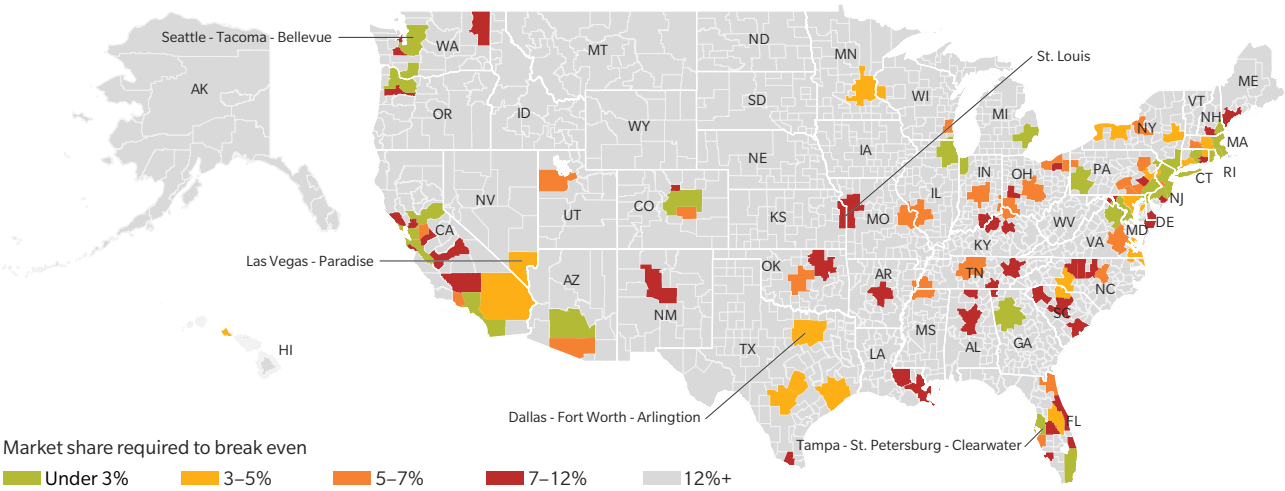
- Population density: a key factor in the economics of the last mile of delivery
- Total population and grocery spend: drives efficiency of both delivery and fulfilment by fully utilising fixed assets
- Market price levels: drives gross margin achievable by an online grocer.

To understand where pure online grocers are most likely to be viable, we have developed a profitability model based on the financial reports of a set of current online-only grocers and on our own industry experience, and fed in data for each of the three key drivers for each market. By way of an example, the rest of this article discusses our findings for the US.

WHICH US MARKETS CAN BE PROFITABLE?

By looking at how population density, total population, grocery spend, and market price levels are likely to affect profitability in different markets across the US, we can predict what market share levels would be required in each area for a home delivery grocer to break even, assuming operating efficiencies remain as they are today. Our results imply there are 40 markets, together covering 50% of the US population, where an online grocer could break even with less than 5% market share. These markets are shown in green (like Seattle) and yellow (like Dallas) in Exhibit 2. As a point of comparison, in more developed online grocery markets such as the UK, online grocers are already at about 5% market share and still growing strongly.

Exhibit 2: Market share required to break even for a pure-play grocer by US market



There are another 26 markets (shown in red, like St. Louis, above) that are only marginally more challenging for an online player, and where a 7% market share would be enough for them to break even.

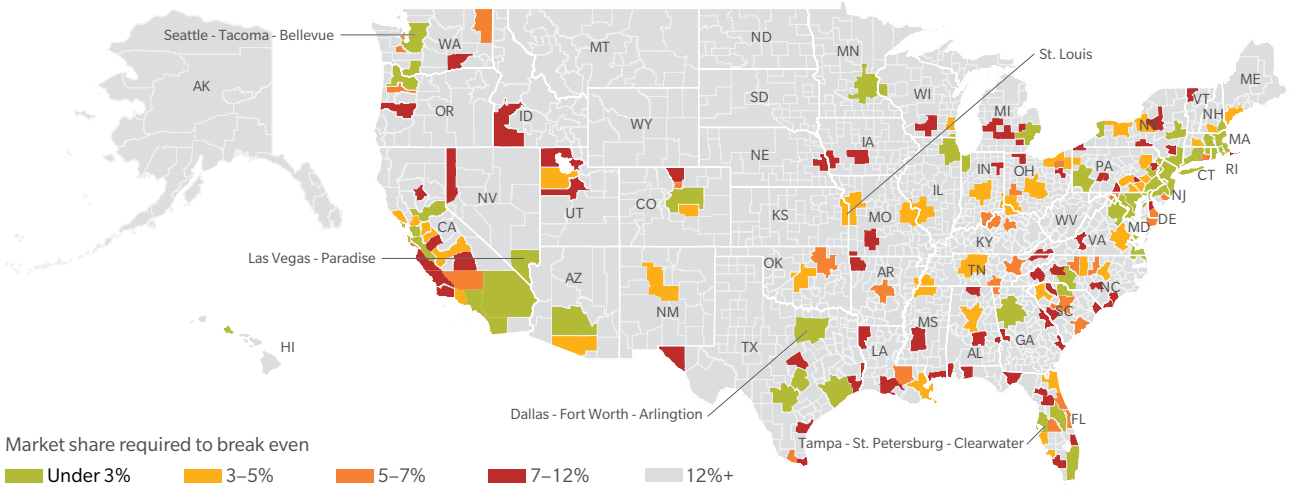
Exhibit 3 shows three example Metropolitan Statistical Areas, to illustrate trade-offs at work. Both Tampa and St. Louis have large populations and relatively low market price levels, but St. Louis has much lower population density and a small market price disadvantage. So while there are superficial similarities, the market share needed to break even varies considerably. Las Vegas has a smaller population and slightly lower population density than St. Louis, but a high market price level means a lower market share is needed to break even.

Over the coming years, we anticipate that the economics of home delivery grocers will evolve as operators come up the learning curve and find new ways to bring down their costs. Additionally, as they start to scale to multiple markets, there will be brand and fixed-cost leverage advantages. This will open up new markets and mean that markets that are already attractive may be able to profitably support more than one pure-play online competitor. For example, if online players get 10% more efficient, the number of markets where the breakeven market share is 5% or less would increase to 80, to include places such as St. Louis. The total number of markets where a 7% share is enough to break even would rise to 108, and at this point pure-play online grocers would be able to cover up to 70% of the US population – and therefore become a real threat for almost all conventional grocery store operators. Exhibit 4 shows the detailed picture for the whole country.

Exhibit 3: Comparing three market areas with different characteristics

MARKET	POPULATION	POPULATION DENSITY	MARKET PRICE LEVEL	RESULTING MARKET SHARE REQUIRED TO BREAK EVEN
Tampa - St. Petersburg - Clearwater	2.7MM	High	Low	Under 3%
Las Vegas - Paradise	1.9MM	Medium	High	3–5%
St. Louis	2.7MM	Medium	Very low	5–7%

Exhibit 4: Market share required to break even after 10% efficiency improvement

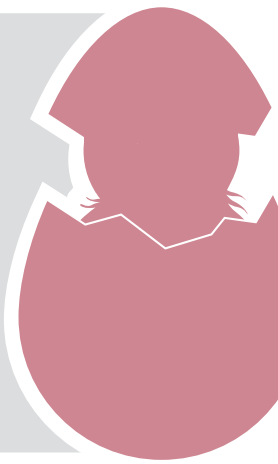


CONCLUDING REMARKS

It is clear that online grocery poses a real threat to traditional grocers in the US; in other rich countries that have higher population density, the threat is greater still. While the market share losses to online grocery might sound small, a relatively small drop in volume can mean a massive fall in profit. When a typical grocer has 2% EBIT and 20% volume variable margin, online grocers capturing 10% of market share would erase all of the profitability of the traditional grocery store sector – and even taking only 5% would cause significant changes.

Of course, this also means there are opportunities for those that take the initiative to go after the online market themselves. In many markets, only a couple of players will be able to achieve the scale needed to break even. Being the first mover fundamentally changes the economics for whoever follows, including Amazon. Perhaps most importantly of all, established grocers have fixed assets (stores, warehouses, trucks, customer data, a brand) that mean they are particularly well placed to move quickly and shape the market.

50% of the US population could today be served by an online grocer requiring less than 5% market share to break even.



DISRUPTIVE LOGISTICS

THE NEW FRONTIER FOR E-COMMERCE

Delivery logistics, once a relatively staid business, continues to be pushed in new directions by e-commerce. Online retailers of all sizes are looking to "disruptive logistics" – a combination of delivery speed and innovation – as a way to add value, separate themselves from the pack, and keep the customer under their banner throughout the entire shopping process. Formerly well-defined borders between online retail and logistics are dissolving, shifting the entire e-commerce ecosystem in new ways that will impact on all businesses in the space. Some of the largest names in e-commerce are leading this change.

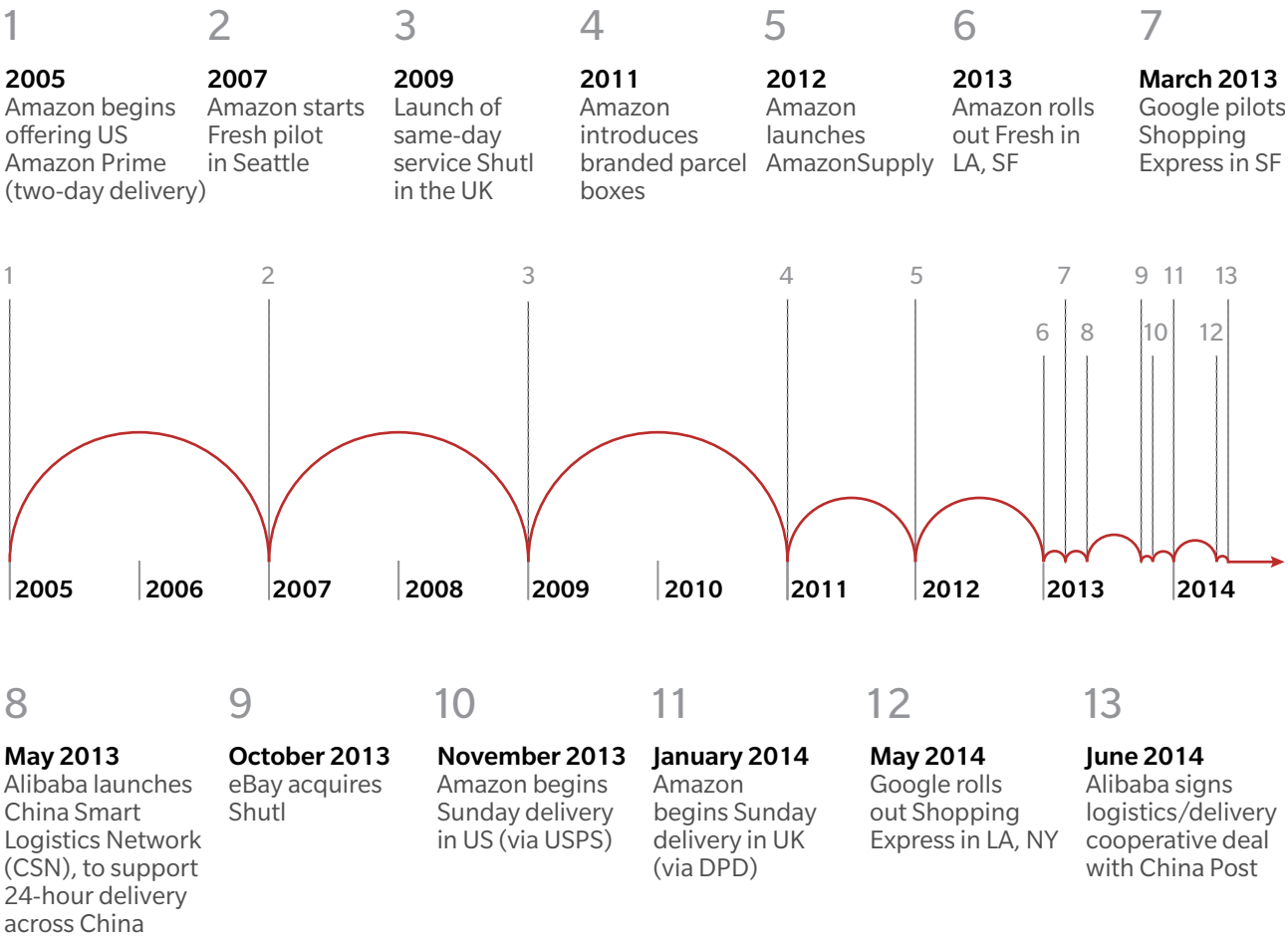
- Amazon is offering fresh products, moving into wholesale, and adding Sunday service (via the Postal Service in the US and DPD in the UK).
- Chinese e-commerce firms are increasingly using Amazon Marketplace and eBay as sales channels. Amazon's warehouse and fulfilment capabilities, for example, ensure low-cost goods are customs cleared and ready to be shipped quickly.
- Google is taking on Amazon for same-day delivery: only days after Amazon announced it was expanding same-day shipping to more cities, Google launched

its Shopping Express service in Los Angeles and New York, which provides same-day service for selected retailers.

- eBay is expanding same-day delivery: UK start-up Shutl uses the capacity of local courier firms to deliver local goods based on customer preference in one- to two-hour slots. eBay acquired Shutl in late 2013 and plans to expand its same-day "eBay Now" service using Shutl's infrastructure and IT.

Exhibit 1 outlines these and other enhancements that have occurred in the logistics e-commerce space over the past ten years. This push for logistics innovation by large online companies is sure to benefit customers in terms of more convenience, more service, more options, and faster delivery. But can the giants keep up the pace? What can smaller online retailers do to ensure they aren't left behind? And how can third-party logistics regain its role as a driving force in the e-commerce market?

Exhibit 1: The quickening pace of e-commerce logistics development

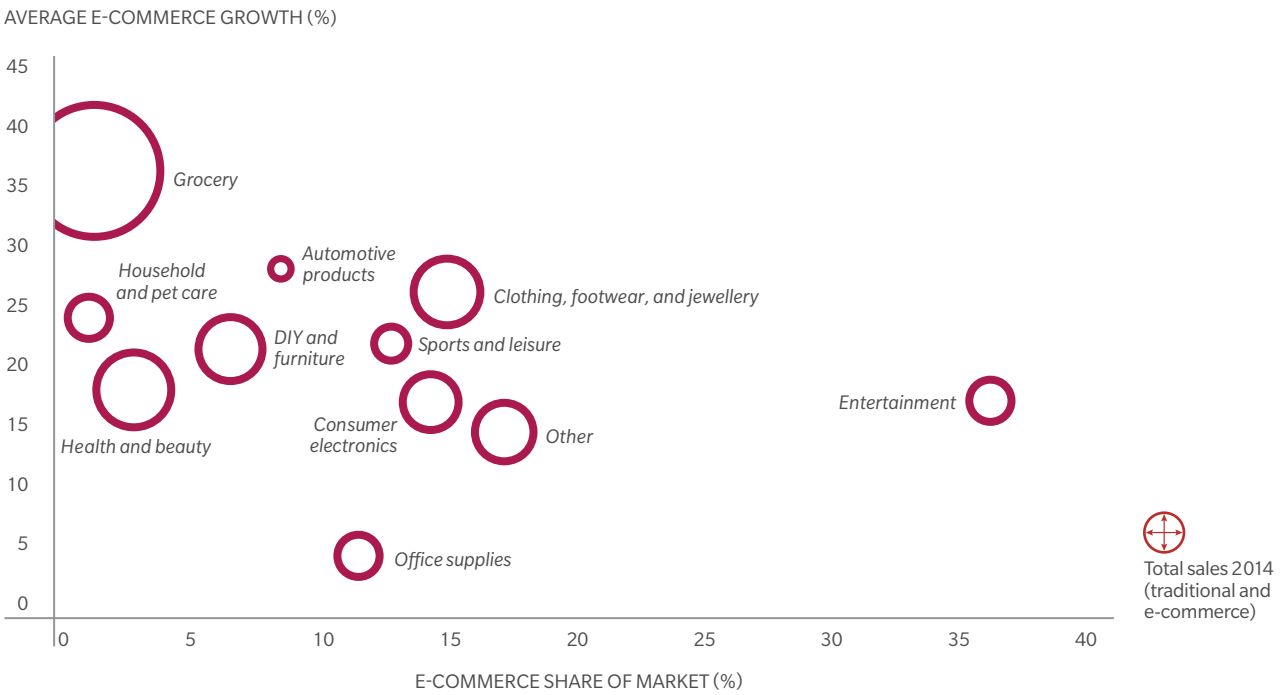


THE GIANTS: RISING SERVICE PRESSURES

The sheer size of companies such as Amazon, Google and Alibaba, allows them to dictate their needs to the logistics firms with which they partner. Continuous double-digit growth rates (see Exhibit 2) are becoming a problem, however: Amazon saw a big drop in performance during peak retail season in 2014 in the US; some European delivery logistics markets also were down to borderline capacity. As well, in most countries, there are only one to three firms that can operate delivery networks at scale. In some large European countries, Amazon accounts for 30% of the value of goods moving on the top logistics operator's network. Doing a better job on peak volume and resolving growth bottlenecks more generally will therefore be critical issues for e-commerce giants in the future. Some of the relevant issues and options include:

- E-commerce giants will need to ensure that they spread volume out and nurture a variety of logistics companies in each region, to increase market competitiveness and better leverage their buying power. Careful choices around long-term contracts and yields will be crucial.
- Increasing the number and size of fulfilment centres and warehouses raises operational complexity in order fulfilment. Diligent inventory management and supply chain process optimisation is required to manage inventory and operations cost. Line-haul logistics now happens before the purchase – not as part of distribution.
- Labour conflicts and strikes pose a significant risk to growth. In Germany, for example, recent strikes at Amazon warehouses may be a reason that more warehouses are being planned in Eastern European countries. Hence risk management, both on the operational and on the branding side, is required.
- Most importantly, online giants need to continue developing their own delivery logistics solutions as a powerful means of differentiation. With Google introducing Shopping Express, eBay acquiring same-day delivery provider Shutl, and Amazon testing its own delivery services in major US cities, the game has just begun.

Exhibit 2: E-commerce market maturity (US, Germany, France, UK)



Source: Planet Retail, Oliver Wyman analysis

SMEs: HOLDING ON TO CUSTOMERS

Small and medium-sized enterprises (SMEs) in the online retail still need logistics companies to provide them with innovative and customer-friendly solutions that can help them narrow the gap with the giants.

When it comes to innovative logistics solutions, pure-play SMEs may find introducing a physical means of differentiation such as same-day delivery tough to implement, as most have only one or a few centralized warehouses and thus cannot offer broad same-day delivery. Once same-day takes off (and customers demand it), solutions could include developing more decentralized distribution centers or teaming up with other niche SMEs to set up local same-day warehouses for critical stock. Enabling IT won't be trivial, but Oliver Wyman analysis shows that such warehouses could be highly efficient.

Sending items toward a destination area even before the customer places the order (anticipatory shipping) could be a viable solution for fast-moving items in dense areas as well. Such anticipatory shipments can be triggered if ordering likelihood, based on big data analysis, rises above certain thresholds. (It's worth noting that Amazon has filed for a patent in the US for "a method and system for anticipatory package shipping.")

THIRD-PARTY LOGISTICS: DELIVERING INNOVATION

To serve the e-commerce market, parcel/postal logistics firms will need to pay more attention than ever to demands for speed and innovation.

New delivery solutions

In terms of new delivery solutions, logistics firms will need to be faster, more predictable, more focused on the last mile, and innovative in the areas of Sunday and grocery delivery.

- Speed: third-party logistics providers (3PLs) will need to offer faster delivery options, such as same-day, at scale. Integrating same-day into normal delivery options will be key to keep costs down sufficiently to meet customers' shipping price points.
- Predictability: while one-hour delivery time windows will be the new standard, what customers really want is to determine when and where they get their packages. Such self-selected delivery windows will offer new "pay per slot" revenue opportunities (for example in Germany, €5 extra for Saturday 8–10 am and €2.50 extra for any day 5–8 pm).
- Last-mile touch points: parcel lockers, to-the-door options, and parcel shops will continue to expand, with innovation around convenience, such as finding the best locations for parcel lockers, parcel shops with 24/7 access, and delivery later in the day when people are at home.
- Sunday delivery: Amazon is setting a new standard for Sunday delivery – one the rest of the pack will be forced to follow. We expect to see Sunday delivery expand beyond the US and UK, although the speed of adoption will depend to a large extent on legal restrictions.
- Fresh solutions: fresh goods will be the next big thing in e-commerce, meaning that logistics companies must start building scalable, cost-efficient solutions now. Major 3PLs are already testing options for delivery using normal trucks and cooled vehicles.

Customer interfaces and data integration

Data management and integration will play an expanding role in logistics. Customers will want (and get) full end-to-end control of the delivery process, allowing them, for example, to change destinations in real time. This shift will require logistics providers and e-commerce platforms to be fully integrated along the whole value chain, with a constant, real-time interface for the customer. Who owns the customer could be up for grabs as a result: while online businesses seek to control all customer communication (and contact), end-to-end logistics players can take advantage of their

physical customer touch points. By generating insights into customers' behaviour patterns and preferences, 3PLs can improve their own services, such as preferred delivery time windows.

Anticipatory shipping

As noted above, logistics companies can help SMEs develop anticipatory shipping, which requires faster delivery speeds and a proactive supply chain. Completing the final destination address while the product is in shipment, for example, requires seamless data integration between the retailer and its 3PL. Logistics firms will also need to implement intelligent shipment steering processes to manage physical delivery efficiently and prepare their IT and operations for a world in which nothing other than a barcode identifies a parcel.

Pricing products

E-commerce volume giants in particular can be expected to play 3PLs and postal services against one another to extract maximum service at a minimum price. What is new is that they are choosing service providers more selectively for certain areas or lanes – rather than for a country as whole. Lane-based/area-based pricing thus will be important to get right. Logistics firms must ensure they have full transparency on their costs per customer and lane, as well as on their service quality, to offer competitive products. This could also involve benchmarking rates, closing operational performance gaps, and preparing for sudden moves, such as Amazon Fresh (which could potentially cut high-density volumes and use third parties only for rural parcels).

Cost focus

Cost-down initiatives remain important and the old network economics rules for 3PL and postal still apply: Efficient standardised processes and an optimal but flexible network topology are key to superior network economics, with a growth imperative to profit from density-driven cost advantages. A mis-planned peak season today can easily eat a big chunk of a full year's earnings. UPS for example lost nearly $180MM in operating profit due to unexpected peak-season demand patterns. Hence, a new level of cost and flexibility management is required.

BRINGING IT ALL TOGETHER

E-commerce logistics innovation today is being driven by the online retail giants, with logistics firms pushed out of the driver's seat and SMEs scrambling to keep up. While we observe many companies still in shock and overwhelmed by the speed of e-logistics innovation, we also see companies that are getting a handle on market evolution and moving in the right direction:

- European electronics company Conrad Electronics is effectively blending online and offline businesses, including same-day delivery
- Express parcel carrier DPD is driving the market with one-hour time windows
- REWE in Europe is innovating in the grocery space, including online ordering and one-hour delivery
- Deutsche Post DHL has made bold moves toward becoming an online retailer itself (meinpaket.de, allyouneed.com) and is piloting a same-day solution on a wide scale
- Walmart is testing same-day delivery in San Francisco, California, and planning to expand testing to Denver, Colorado
- Car service Uber is testing same-day delivery in Washington, DC– customers can order "corner store" products for immediate delivery by a private driver, via the Uber app.

CASE STUDY

The CEO of eBay's new same-day delivery platform, Shutl, says the rise of same-day service will be inevitable. He argues that consumers measure expectations against past experience, and since the biggest names in retail and e-commerce are making same-day delivery a priority, market demand will rise quickly.

And indeed, more and more retailers are going this route, choosing one of three existing operating models, as shown by the example of same-day service development in Germany (see Exhibit 3).

Exhibit 3: Timeline of online retailers introducing same-day delivery in Germany

MARKET	COMPANY	DATE STARTED SAME-DAY	OPERATING MODEL
Clothing/Fashion	Luxodo	December 2012	Courier network
	Lodenfrey	December 2012 (pilot), March 2013	
	MyTheresa	2013	
Consumer Electronics	Conrad	December 2012	
	Cyberport	March 2013	
	Media Markt	August 2013 (pilot), February 2014	
	Saturn	February 2014	
Office Supplies	Notebooksbilliger	October 2012	
	HQ Patronen	2013	
Jewellery	Uhrzeit		
Entertainment	Hugendubel	December 2012	
	Thalia	December 2012 (pilot), July 2013	
	Amazon	2009	Postal provider
Health & Beauty	Aponeo	September 2013	
Food Service	myTime	November 2012 (pilot), May 2013	
	Gourmondo	May 2012 (pilot)	
Grocery	Allyouneed	December 2012	
	REWE		Own delivery vans
	Bringmeister (Kaiser's Tengelmann)	2012	

MODEL PROs AND CONs

The courier network model

The most common operating model, used by courier brokers Shutl and Tiramizoo, for example. The business model is based on local fulfilment and superior dispatch software fully integrated into retailers' existing technology. Retailers can dispatch from point-of-sale through a fleet of local couriers, which usually deliver within two hours, or within a specified one-hour window scheduled by the customer. This model provides the opportunity for all retail stores in a given urban area to become meaningful same-day market players; it is also quick to implement (as long as there is an IT link to the broker). Drawbacks of this model include the need for a real-time overview of inventories across all stores and warehouses (still a hurdle for many online players), and it is not all that scalable for lower-cost delivery options.

The build-your-own model

Large grocery retailers in particular tend to invest in their own delivery fleets, since 3PLs may not have the type of vehicles needed, such as refrigerated trucks. Benefits include end-to-end control of processes (quality, branding, and so on) and the flexibility to adjust to changing customer requirements. Disadvantages are that it's an expensive model, requiring substantial volume to keep down costs, and may be a complex activity to take on outside of a retailer's core competence.

The postal provider model

Several parcel carriers are piloting same-day solutions, with the goal of making delivery more cost efficient vis-à-vis courier services, which bundle pick-up and delivery and provide integrated routing. DHL, for example, is offering an evening delivery wave in several German cities where customers can choose a two-hour time slot in the evening for delivery (6–8 pm or 8–10 pm). While currently volumes are small, we expect this model to win mid-term over the courier-based model due to its scalability, cost advantages, and synergy with the existing asset base (delivery vans). This model does require moving beyond a classic hub-and-spoke network and more flexibility in pick-up and delivery management.

CONCLUDING REMARKS

With same-day poised to become a de facto standard for retailers of any stripe that want to serve metro areas, careful consideration will be needed as to which delivery model to pursue, and in what time frame. Smaller multichannel retailers can get a head start by setting up a courier-based solution right now. This option is particularly attractive if the retailer has a broad network of stores and IT that enables integration with one of the major courier brokers. For most companies, couriers can serve as a bridge until parcel/postal carriers roll out same-day offers. When demand rises, we expect parcel/postal will scale best, while a model involving a retailer's own delivery fleet will only continue to make sense for very large online retailers, such as Amazon.

Where scenarios reveal the potential for market share loss, own delivery logistics strategies will be necessary. These could be developed in partnership with logistics carriers that enable both partners to benefit from a differentiating service offer.

BEWARE AMAZON AND GOOGLE

STAYING AHEAD IN WHOLESALE DISTRIBUTION

Over the past 15 years, the internet has transformed the way consumers buy everything from books to music to insurance to travel. Giants such as Amazon and Google promise a future filled with instant-access information, interactive eyewear, and drone delivery of our groceries.

But another change is afoot that threatens wholesale distribution business models as more procurement professionals log on to AmazonSupply and Google Shopping. Worth about $7.2 trillion a year, the business-to-business (B2B) market is a target that Amazon and Google can no longer ignore.

The question is not whether Amazon and Google will be a threat in B2B, but rather which customers, purchase occasions, and categories will be attacked first.

In our view, AmazonSupply, Google Shopping, and most likely one or two more "new" entrants, will have a profound effect on many wholesale and distribution sectors over the next five years. In fact, we are already seeing the early stages of a wave of innovation as the most forward-thinking wholesale and distribution businesses invest significant time and resources into becoming potent multichannel competitors.

B2B BUYING: THE NEXT GENERATION

The growth of general online purchasing is driven by one simple fact: customers rule, and most procurement executives increasingly value quick, simple, effective ways of interacting to get the products and services they need, as well as new value-added services unavailable previously. As one chief executive officer recently shared with us: "Our customers have already been trained by Amazon on what 'good' looks like. That's what we have to compete with."

Online B2B purchasing already has a greater following among younger professionals. Ninety per cent of procurement buyers between the ages of 18 and 35 in the US make B2B purchases online, versus only 45% of purchasers between the ages of 46 and 60 (see Exhibit 1).

As more of the purchasing workforce becomes internet-savvy, the threat from online competition in wholesale distribution will only grow. Forty per cent of corporate buyers spend at least half of their procurement budget online. Elsewhere in the supply chain, some manufacturers are using the Web to reach customers directly and to reduce their reliance on channel partners and intermediaries. Google AdWords supports this strategy by allowing suppliers and manufacturers to pay to appear in Google search results.

Next up could be meta-search businesses, already established in insurance, general retail, and travel, which allow B2B purchasers to compare products and prices before going direct to the manufacturer, cutting out the wholesale distributor altogether.

AMAZONSUPPLY IS CHANGING THE RULES

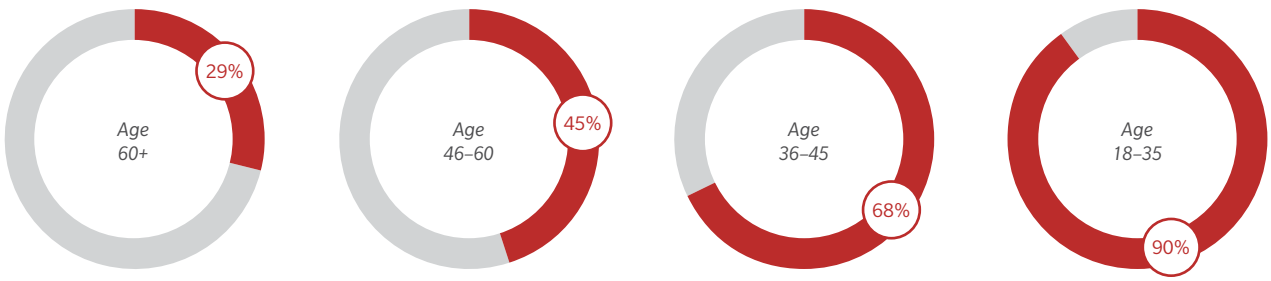
In our view, there are three reasons why AmazonSupply's offering is about to change the rules for wholesale distribution. We examine each, in turn.

RULE 1 Choice of stock

In retail, Amazon already has a comparable or broader range of offerings than club stores or cash-and-carry formats. Additional services such as Subscribe & Save allow Amazon to automatically deliver frequently purchased, high-margin items – such as razor blades and nappies – every month. The impact on the club stores is twofold: firstly, Amazon is "hollowing out" shoppers' baskets since fewer items are needed, and those that are bought have a narrower margin; secondly, customers are making fewer trips to the store, decreasing the amount that they spend on additional purchases, impulse or otherwise.

Exhibit 1: Younger procurement buyers – the future of the B2B customer base – are far more likely to use online platforms than their older counterparts

RESPONDENTS BY AGE MAKING B2B PURCHASES ONLINE



Source: The Acquity Group *2013 State of B2B Procurement Study*

Exhibit 2: Example analysis of which categories are more immediately prone to a new online threat

		INDUSTRIAL CHEMICALS	INDUSTRIAL PARTS
PRODUCT DRIVEN	**Intrinsic "shipability"**	Much lower-value, heavy, bulky product – requiring local supply chain density	Typically high-value, light, smaller product – easy to ship via common carrier
	Handling requirements	Often requires specialist equipment/ handling/certification	Straightforward
CUSTOMER DRIVEN	**Technical guidance**	Numerous products require technical guidance and support	Many products easily "bought to specification"
	Product selection	Typical customer buys a small number of predictable products – enabling local SKU counts of 100s or 1,000s only	Customers can buy across many 1,000s of SKUs
	Value-added services	Diluting, blending, cleaning, etc. are widespread and require physical presence	Real-time availability, tracking, inventory management, etc. can often be executed remotely
		Not an obvious category for an online-only business to attack	**Online platform and remote DCs well suited to meet many customer needs**

Items that are small, high value, low weight, and easy to handle and ship are especially amenable to Amazon's offering. It is no coincidence, then, that AmazonSupply launched with an industrial parts offer – a category that meets all of the above criteria – rather than, say, industrial chemicals, which fail most of the above tests (see Exhibit 2).

RULE 2 Product range and price

AmazonSupply's low prices are underpinned by a business model that permits it to run on operating margins that are a fraction of traditional suppliers' operating margins. Amazon's scale and lack of local operations and field sales give it a 20% sales and administration cost advantage. As a result, its operating margins are less than 2%.

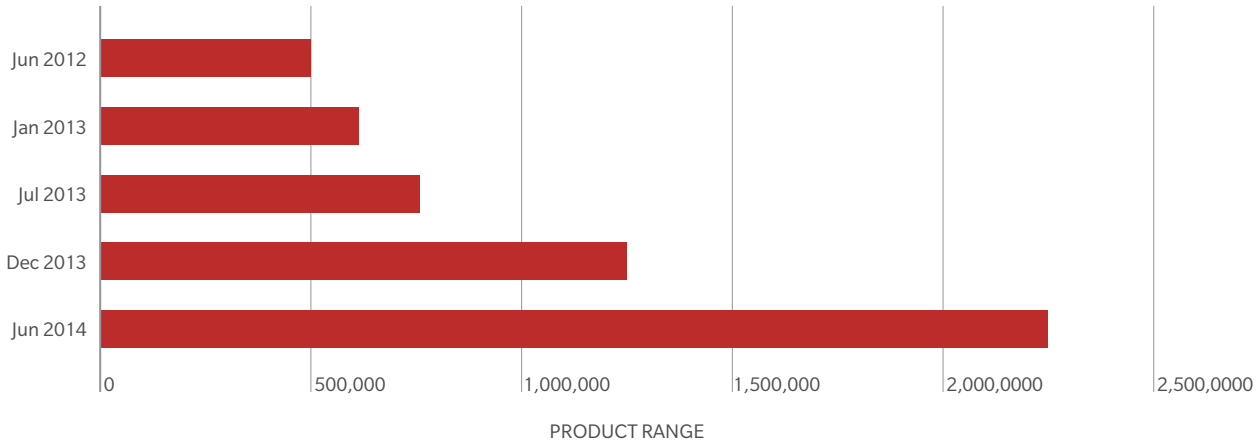
The range of products available to users of AmazonSupply is another key advantage. Between June 2012 and June 2014, its product range grew from 500,000 to 2.25MM items (see Exhibit 3).

Amazon has also made substantial investments in distribution centres (DCs), allowing it to offer same-day delivery within 19 cities in North America and Europe. This reach will only grow, and rapidly. We estimate that as many as 20 additional satellite depots are potentially being considered.

RULE 3 Brand awareness

Amazon has also already won an important battle: its brand is almost universally recognised and associated with the idea of a one-stop-shop for anything and everything at a competitive price. This means that it is often the first and only place that consumers and professional buyers go when thinking about making a purchase. Strong reliability, a "no quibble" returns policy, and aggressive pricing add to its appeal. As a result, many customers now never check prices or range anywhere else.

Exhibit 3: Building a compelling range – AmazonSupply has been aggressively growing its product selection, doubling its breadth in just over a year



Source: Oliver Wyman analysis

What is the threat from **Amazon**?

In April 2012, Amazon launched a website for purchasing products for businesses, labs, workshops, and factories in the US. AmazonSupply is specially tailored for B2B purchases in several ways. Firstly, orders can be placed by telephone and fax as well as online. Secondly, a telephone customer service and helpline is available seven days a week. Thirdly, suppliers can obtain credit through the service.

What is the threat from **Google**?

From January 2013 to June 2014, Google ran Google Shopping for Suppliers as a test service targeted at B2B companies. Many of the learnings will be transferred to the main Google Shopping and Google AdWords businesses. Google Shopping for Suppliers was essentially an online catalogue in three test categories, with detailed structured technical data comparable across products and suppliers. The customer concept was to develop a truly comprehensive, fully up-to-date product catalogue that is as easy to search as Google.

CONCLUDING REMARKS

Until recently, wholesale distribution was an industry ruled by traditional distributors that had local presence and fulfilment, field sales, expert knowledge, and established relationships. These traditional tenets for success are now being disrupted by online distributors with more centralised operations and fulfilment, and no pretence of technical knowledge or field sales.

The online invasion has given rise to a well-executed multichannel model, where a number of CEOs are already working hard to take their businesses in the next two to three years. This approach enables customers to get the information and products they need via the Web, phone, mobile devices, and in person in a seamlessly integrated way, and with competitive economics.

History suggests that those companies that act quickly to strengthen a differentiated, high-quality, and good-value customer proposition will see their businesses flourish. Those that do not will struggle.

If your business does not yet have a credible plan to survive and thrive in the new ecosystem, there may be less time than you think.

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ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialised expertise in strategy, operations, risk management, and organisation transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

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