

Multi-Channels: The Real Winners in the B2C Internet Wars

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This article presents evidence that multi-channel retailers are out-performing online-only (“pure-play”) retailers, and that their success is reflected in their market value. Multi-channel retailers are most successful when they define distinct roles for each channel, use the Web creatively as a customer acquisition tool, and work hard at converting browsers to buyers. To help get this last part right, the authors isolate key defection points – critical moments when retailers are apt to lose customers. They conclude that, for retailers, the key to making the most of the Internet is to correctly determine its strategic role in relation to other channels and invest to play that role excellently.

Little more than a year ago, some pundits were predicting the downfall of shopping as we know it. One pseudo-revolution later, few of us have changed where we shop; we’ve just found more ways to get there. Indeed, as pure-plays – companies doing business only over the Internet – struggle to find a profitable business model, multi-channel companies

have quietly adapted their own. They have fashioned the Internet into a tool that can help them expand customer roles, build revenues, cut costs, and improve profits. They have achieved this “quiet victory” by leveraging their existing assets, brands, and customer bases through their online channel; by cleverly exploiting the synergies between online and offline operations; and by finding creative ways to convert the highest possible percentage of website visitors into loyal customers.

The market is paying attention to these success stories. A Bain & Company analysis shows that even as Internet pure-play and technology stock valuations have plummeted, multi-channel companies that have embraced the Internet are enjoying premiums on their market multiples proportionate to the percentage of business they move online. In other words, multi-channels that invest in and harness the power of the Internet – rather than half-heartedly dabbling in it – are achieving measurable results and strategic advantage over their competitors, and the market is rewarding them.

Multi-Channels: Finding Success in the Wake of the Pure-Plays

Internet pure-plays, once heralded as the leaders of an economic revolution, have lately had a tough go of it. Of the 142 companies with top-ranked websites between 1996 and 1998, 88% were pure-plays. Just one year later, 61% had merged or formed

alliances with other pure-plays, a handful had joined forces with bricks-and-mortar companies, and 10% had gone bankrupt. This may be just the tip of the iceberg. Of 300 publicly-traded B2C pure-play companies, less than 5% are profitable today, and many are in dire straits.

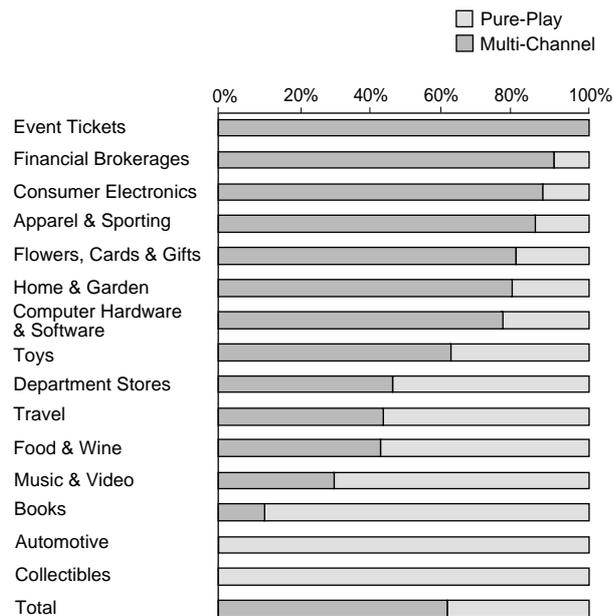
But this doesn't mean that B2C Internet commerce has been a flop. On the contrary, multi-channels have learned from the successes and failures of the dotcoms and from their own online efforts. Now they are using the Internet to gain customers, build revenues, and enhance profits.

The Quiet Victory: The Internet as Revenue Enhancer...

Despite the attention the pure-play dotcoms have gained, it is multi-channels that own the majority of online B2C commerce. Multi-channels' share of the US online market has increased significantly, reaching about 60% overall (for all retail categories) in 2000 (Figure 1). In categories such as event tickets, financial brokerage, electronics, apparel and sporting, flowers, cards and gifts, and home and garden, multi-channels have captured more than 80% of the online business.

The online channel still generates a relatively small percentage of total sales for most product and service categories – in the low single figures for most sectors

Figure 1
Percent of Total Online Market



Source: Shop.org December 1999

and little more than 10% in the top sectors, software and banking. But for certain individual companies, online commerce has become an important part of their business. At discount brokerage Charles Schwab, the Internet brings in more than 50% of total sales, and has provided the bulk of its recent growth. For department store J.C. Penney, the Internet represents only a tiny sliver of its \$19bn sales, but it has become the fastest-growing channel and is expected to account for most of its growth in 2001. And at consumer electronics retailer Sharper Image, where online sales somewhat cannibalized catalog orders for 2000, sales growth from the Internet that year equaled the revenue effect of opening 30 new stores.

...and Profit Lever

These are visible examples of top-line success driven through the online channel. But behind the scenes, there is strong evidence that the Internet is becoming a pervasive and powerful cost-cutting tool at a broad range of companies. The result is increased profitability for many multi-channels.

Again, Charles Schwab is a good example. Although revenues initially fell as Schwab moved customers online (substituting \$80 offline trades for much cheaper online trades in the process), new customer growth and lower operating costs have more than offset this decline. As online penetration has increased over time, Schwab's operating margins have increased from 20% in 1995 to 27% in 2000.

Other financial services companies have moved aggressively to take advantage of the Internet in non-retail categories, often with startling success. Goldman Sachs now conducts 75% of its treasury trades for institutional customers online. Deutsche Bank reports a similar number – 70% – of its treasury trades online, with Merrill Lynch not far behind. In what is almost certainly not a coincidence, Goldman and Merrill have recently announced lay-offs from their government sales desks, suggesting that online penetration is already translating into cost reductions.

Further integration at financial services companies between customers and back office functions (such as order entry, portfolio tracking, and account management) should result in even more cost reductions. Credit Suisse First Boston estimates that we can expect to see transaction costs lowered by 15% per year for several years as Internet-based technology

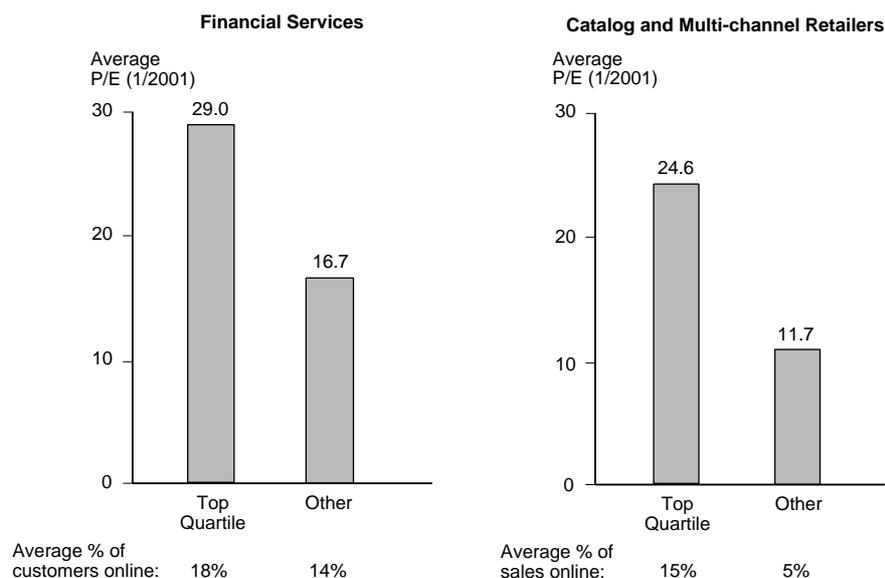
allows automation of many pieces of the transaction process. In the near term, we anticipate significant cost reduction announcements from the major brokerage houses as more functions and trades are moved online. Likely targets for headcount reduction include staff in foreign exchange, corporate bonds, and asset-backed securities. In the short term, these cost cuts will probably result in higher profitability. In the longer term, falling costs will set the stage for falling prices. How this will affect industry-wide profitability remains to be seen, but one thing is certain: financial services companies that do not embrace the Internet and quickly harness it to reduce costs will be at a significant disadvantage.

The Internet has also affected non-financial service companies. Since Sharper Image introduced its website in 1995, building and occupancy costs have fallen from 6% of sales to 4%. And Cisco eliminated \$360m in operating costs in 1998 and more than twice that in 1999 through web-enabled initiatives in supply chain management, customer care, workforce optimization, and commerce. For instance, 83% of customer service enquiries are now serviced on Cisco's website, and 90% of software upgrades are downloaded over the Internet, saving the company \$250m. Cisco has also firmly established the Internet as a critical sales channel in its portfolio: 82% of orders are now placed online.

The Internet can also play a valuable role in customer acquisition. Although online customer acquisition methods can actually be more costly on average than offline methods (1999 research by Shop.org showed that, for a sample of companies, banner ads cost about \$128 per acquired customer, email \$114, sponsorships \$67, and direct mail \$66), best-in-class companies like the online auction site eBay have found that through viral marketing (and word of mouth) they can acquire customers for as little as \$10 each, far less than offline methods.

Even for companies that do pay more for online customer acquisition, the Internet is still a valuable resource: it helps them reach customers they would not have found otherwise. Making those customers profitable depends on a host of factors. One of the most important is customer retention. A recent Bain & Company study found that apparel customers who return to a given site spend 80% more on their tenth visit than first-time customers, and that in many categories, online retailers make money *only* on repeat customers (Reichheld *et al* 2000). The lesson for multi-channels is that the Internet can be an important resource for gaining customers, growing profits, and even lowering customer acquisition costs, but only if it is treated as part of an integrated approach to customer acquisition. Multi-channels need to target the *right* customers, be clever in the methods they use to reach them, and then work hard to retain them and build them into profitable customers.

Figure 2
Price/Earnings Multiples



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Reaping the Rewards

The market's response to the revenues and profits of multi-channels is striking. We analyzed companies in two sectors – financial services and multi-channel retailers – and found a similar pattern (Figure 2): the larger the online portion of a firm's business, the higher its market multiples. For the financial services sector in the first quarter of 2001, a regression shows that more than 21% of companies' price/earnings (P/E) ratios could be explained by the success of their online strategy. When ranked by the percentage of customers

they were able to get online, the top quartile of financial services companies had an average P/E ratio of 29.0, while all other financial services firms had an average P/E of 16.7. For catalog and multi-channel retailers, the top quartile in online penetration had an average P/E of 24.6; all others averaged a P/E of 11.7. A regression of these retail players shows that 14% of their P/Es could be attributed to online performance (R squared for financial services regression was 0.73, compared to 0.65 for retail).

Online Best Practices

Effectively employed, the Internet can be a powerful tool for increasing revenues, profits, and market capitalization for multi-channels. So how can companies best leverage their online business?

We analyzed the most successful multi-channel players and pure-plays to identify best practices that other firms might apply. Here are the lessons from the online winners:

- Define distinct roles for each channel.
- Exploit offline and online synergies.

- Use the Web creatively as a customer acquisition tool.
- Convert browsers into buyers.

Define distinct roles for each channel

Companies that excel at executing a multi-channel strategy use different channels – wholesale, store, catalog, and the Internet – for different purposes, capitalizing on the capabilities of each. The outdoor retailer REI, for example, moved its close-out sales from retail stores to a separate online outlet. (Figure 3). The result? Unlimited space online for discounted merchandise, more space in the stores for regular merchandise, an expanded customer base, and less cannibalization of regular-price sales.

Exploit offline and online synergies

Companies that are reaping the benefits of a multi-channel strategy use their online and offline channels to reinforce each other. They integrate traditional customer-acquisition tactics – such as direct mail – with new ones that bring offline customers online, where they can be served more profitably. Visitors to Gap, Sears, REI and Borders, for example, can use in-

Figure 3
REI



REI Outlet Experience

- Open since 1998
- Fewer space constraints
- Larger customer base than traditional outlet store
- Cannibalization not experienced

store kiosks to shop online for a larger and more diverse inventory than even a superstore can carry. When offline and online operations are fully integrated, customers can shop seamlessly back and forth across channels, taking advantage of in-store pickups and returns for online orders, integrated inventory systems, online store locators, and cross-channel promotions.

Use the Web creatively as a customer acquisition tool

On average, pure-plays pay \$82 to acquire a new customer, while multi-channel retailers pay only \$12 (Morgan Stanley Dean Witter 2001). This may change in the future, but for now it is incumbent on multi-channel companies to craft an integrated approach to customer acquisition that makes the most of both online and offline methods, and to be creative and clever in finding the most economical and effective ways to reach customers online.

The best solution may not be the most obvious: when a maker of patches to help people stop smoking first tried to reach its target audience – 25-45-year old men – it invested in search engines, using the keywords “stop smoking” to drive visitors to its website. But after studying its targets’ online habits, the company found a less expensive option. The company learned that visitors to gaming and gambling websites tended to include a high percentage of smokers. Advertising the smoking patches on these sites lowered online customer-acquisition costs by 40%.

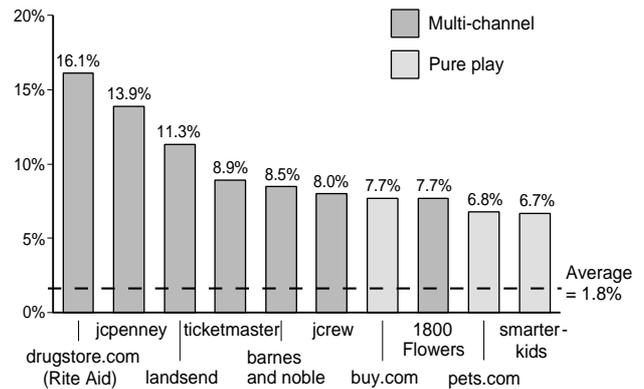
Another example of cost-effective online customer acquisition is viral marketing, the multiplier effect achieved when visitors to your website provide contact information not only for themselves but also for others who may be interested in a product or service, or when they pass on your site’s information to others. Visitors to 1-800-flowers.com, for example, can choose from an assortment of flowers and vases to create and send a virtual bouquet – for free. In exchange, the company gets email addresses for two potential customers – the flowers’ sender and their recipient – to whom they can then market the real thing.

Convert browsers to buyers

Attracting visitors to your company’s website is a big step, but it’s only the first. Turning them into buyers is a bigger challenge, one at which many online sellers fail: the average sales conversion ratio across online B2C merchants is just 1.8%.

But a handful of companies outperform the rest. Seven of the ten best conversion ratios – and all of the top six – last year were achieved by multi-channel retailers, as shown in Figure 4. These companies are doing five to eight times better than the online average.

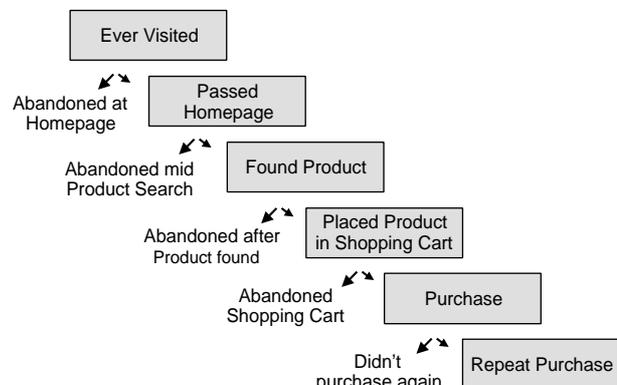
Figure 4
Sales Conversion Ratios
July 2000



Source: Nielson Netratings, July 2000

Yet even these firms are missing more customers than they should. Companies lose potential customers at five points in the purchasing process. Together this chain of vulnerable spots makes up the online “revenue sieve” (Figure 5). Using the best online performer at each defection point, we constructed a best-case scenario to see how high the potential conversion rate could be. The result is striking: a firm that matched the best performance (that is, the lowest defection rate) for the first three defection points could, in theory, achieve a best-practice conversion rate of 40% (Figure 6).

Figure 5
The Performance Sieve

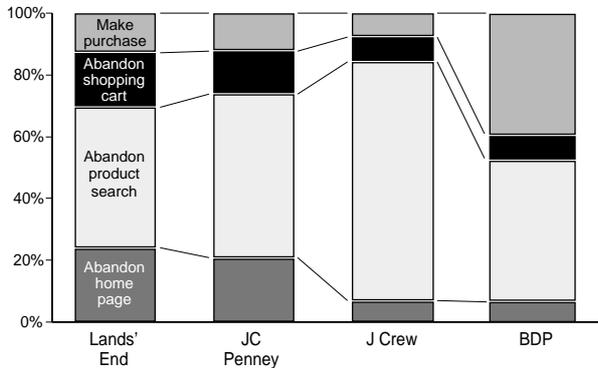


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Figure 6

Best Practice Conversion Rates

Percent of Total Unique Visitors to Web Site



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What Makes Customers Lose Interest?

Such flawless execution may exceed any one firm's grasp. Yet multi-channel companies must continue honing their online tactics at each of the defection points. The stages at which customers lose interest can be summarized under the following headings:

- Home page;
- Product search;

- After product found;
- Shopping cart; and
- Failure to repeat purchase.

A reason for defection which applies throughout each of these stages is:

- Unacceptable download times.

Abandoned home page

There are many reasons why a visitor may take one look at your home page and decide to leave. Errant advertising is a leading cause. TheStreet.com launched a banner ad that flashed the following sequence of phrases: "Prostate exam. Root canal. TheStreet.com. Ignore us at your own risk". While the message attracted a hefty number of visitors, many left once they had realized the site focused on investments, rather than cancer or dental work.

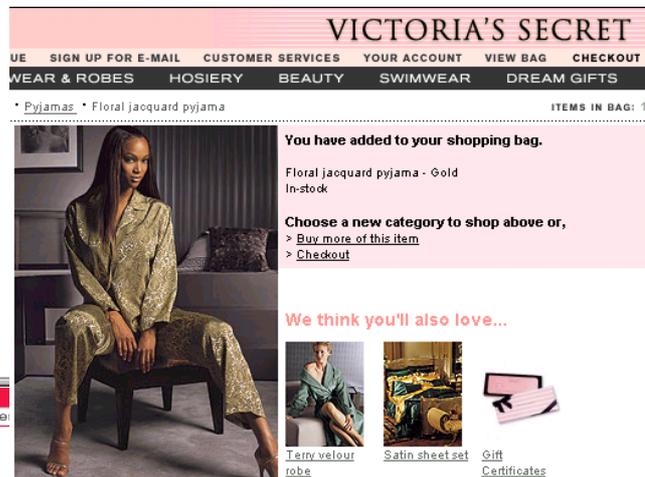
Established clicks-and-mortar companies have an advantage over pure-plays in attracting visitors. People know from experience what the company sells. But even well-established brands can lose a significant percentage of their homepage visitors. Often, it is poor

Figure 7

Victoria's Secret

Idea Generation Tools

- Wish Lists / Gift Registries
- Gift Finder / Personalized Suggestions
- Gift Reminders
- Cross-Selling
- Electronic Gift Certificates
- Product Displays



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design features such as slow download time or confusing navigation that drive them away.

Abandoned product search

Customers who bail out while they're still perusing merchandise typically do so when they can't find what they're looking for. Perhaps the selection's too limited, or the shopper has run out of gift ideas. Best-practice merchants such as Victoria's Secret overcome such problems by feeding the visitor suggestions ("We think you'll also love..."), directing them to the recipient's wish list, or promoting online gift certificates (Figure 7).

Abandoned after product found

Even after online customers find what they're looking for, many stop short of making a purchase. There are many reasons: last year, 85% of net shoppers who decided not to purchase holiday gifts online wanted to actually see the physical product before buying it, according to Pew Internet and American Life Project. Tiny pictures and incomplete product information keep many browsers from buying online. Out-of-stock items and high prices are also deterrents. To stem the tide of customer defections at this stage of the buying process, best practice merchants such as Lands End offer a live chat feature so shoppers can get their questions answered on the spot.

Abandoned shopping cart

According to a recent study, the foremost reason customers abort an online shopping trip is a cumbersome checkout process (Creative Good 2000). Other reasons include excessive shipping costs and concerns about credit-card security or making returns. In this final moment of reckoning, multi-channel companies whose offline business has already established a strong brand and loyal customers are less likely to lose out on the sale. Retailers must have an efficient checkout process that minimizes the amount of information shoppers have to enter and closes the sale as quickly as possible.

Failure to repeat purchase

What's better than a new customer? A repeat customer, since repeat shoppers tend to spend more. One major electronics site calculated that returning customers spend an average of \$251 versus \$127 for first-time customers.

One of the main reasons customers don't return is delivery problems. Since about half of all e-tailers make

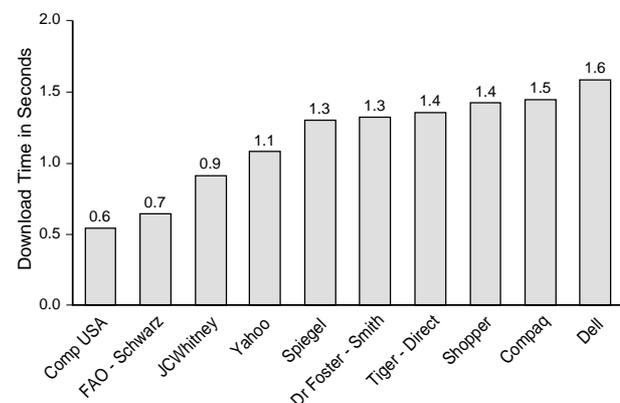
on time deliveries at least 97% of the time, the industry standard is extremely high. According to a recent survey by Binary Compass Enterprises, only 60% of customers who received their order late said they were likely to shop again at a site, compared to 96% of those whose order arrived on time.

To plug this hole in the online revenue sieve, multi-channels must make or buy a back-end system that will meet or exceed customer needs. Managing customer expectations is also important. In the case of stockouts or backorders, it is better to give shoppers the bad news *before* they submit an order than to send a follow-up e-mail, as some e-tailers do. While the result may be a lost sale, preserving the customer relationship is more profitable in the long run.

Unacceptable download times

Another factor in customer abandonment that is relevant at *all* points in the transaction chain is slow download and server response times. Eight seconds is considered the current "breaking point" for page downloads, above which customers will go elsewhere. Even this number would seem to be on the high side – the top ten online retailers all had download times under two seconds (Figure 8). Meanwhile, consumer expectations are continually rising. Companies that decline to make the necessary investments to keep their websites fast may see declines in sales and retention. But, companies should be careful how they invest in their sites; fancy graphics and interactivity features designed to simplify the purchase process can actually slow down transaction times, especially since many

Figure 8
Top Download Time Performers



Top 10 Performance Scores Among Top 120 Retail Websites

Source: Nielsen Netratings, July 2000

potential customers do not have high bandwidth. Even if *your* servers are adequate, a data-rich website (such as one with lots of images, flash capabilities, or sound) may render your site maddeningly slow and impractical for a large percentage of your potential customers. The key for retailers is to find the balance between the site's marketing impact, its functionality, and the ability of company and consumer infrastructure to handle the content.

Making the Most of the Internet

The Internet has turbo-charged the growth of multi-channel companies, enabling them to leverage their existing assets, brands, and customer bases for revenue and profit growth. Key to this leverage is correctly determining the strategic role of the online channel in combination with all other channels. But, beyond the strategic questions, much of the potential leverage of the Internet still relies on a very unsexy word: execution. Mastering the five junctures of the revenue sieve may seem very tactical, but it is the difference between average customer conversion rates of less than 2%, and industry-best conversion rates of 7%, 10%, and even 16%. Here are a few important ideas on how multi-channels (and pure-plays for that matter) can build competitive advantage:

- *Define the Internet's role in your channel and operational portfolios.* The Internet means different things for different companies: a new channel, a place to unload slow-moving inventory, a customer service resource, a cost reduction tool, a customer acquisition channel, or all of the above. Identifying where the Internet can help your business and where investments will pay off the most is the first step in extracting value from this fungible tool. Next you need to integrate the offline and online functions, both to cut costs and to raise service levels for customers. Only then can the natural advantages of multi-channels over both online pure-plays and bricks-and-mortar companies be translated into profits.
- *Identify and cater to your most profitable customer segments.* Whether you plan to make a large investment in the Internet or simply place "a check in the box", you need to understand which groups of customers are providing the bulk of your profits, and how the Internet can best improve your offering for those customers. You can also learn to avoid unwanted customers: the best website on the Internet won't do you any good if you are attracting unprofitable or fickle customers. Once you understand your best customers, you can execute a marketing plan to attract and retain new ones, and better serve existing ones. At heart, this is a decision about which customers you want to court in *all* media, and how. The Internet represents just one important facet of this plan.
- *Invest in execution.* As we have seen, the companies that best execute on their Internet sales sites enjoy customer conversion rates up to eight times the industry average. Retention rates for online companies vary widely too. Differences in performance are achieved by being world-class in a small number of key areas: targeted, accurate, and cost-efficient marketing; an intuitive, fast and easy-to-use site; sufficient product information available on the site, with non-Internet back-up options for customers; timely and accurate shipping; and a quick and simple transaction process. The companies that execute on these factors have seen significant improvements in their online performance; these improvements translate into profits that can be reinvested in their online presence.
- *Take risks, but remain flexible.* The multi-channels have the pure-play dotcoms (and the venture capitalists who funded them) to thank for many early lessons and forward steps that we now take for granted: the dotcoms educated consumers, created awareness of the Internet, demanded and paid for infrastructure development, and dragged the bricks-and-mortar companies into the online arena far faster and further than they would have come otherwise. They also bore the brunt of some costly mistakes: it is dotcoms, for instance, that have most felt the disappointments of online advertising. Partly as a result, the pure-plays are now on the wane, and the mantle of online leadership has passed to the multi-channels. It won't be as easy for multi-channels to sit back and watch any more, and then invest in the safer bets. So managers of multi-channel retailers will have to adjust their approach to investing in the Internet. They will have to become the risk-takers, and like the pure-plays before them, they will have to place a number of bets, carefully monitor them to see which are panning out, and redirect spending as their learning progresses.

The Internet continues to be a perplexing new tool. Intuitively useful, versatile, and in some ways transformational, it has nonetheless been hugely disappointing to many business people and investors, as the last 12 months of stock price slides have shown. But the Internet has also exceeded expectations in some important areas. Huge bricks-and-mortar companies – the engine of the world economy – are figuring out how to make the Internet work for them as a source of revenues *and* a lever for cutting costs. A few are even beginning to harness it to turn non-balance-sheet assets – like information – into new services.

GE, for example is using the Internet to provide information on operating its engineering products, such as turbines and engines. GE's customers can now buy the ability to make real-time comparisons between the performance of their machines and all the similar ones around the world. Not only does this service generate a profit for GE, it also improves the

company's competitive position. Only by sourcing equipment from GE do customers get access to such a wealth of information to help them make their purchase decision.

Those companies that make the most of the many possibilities the Internet presents have an opportunity not only to lengthen their lead over pure-play Internet companies, but also to set new standards for their industry peers, multi-channels and bricks-and-mortars alike.

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