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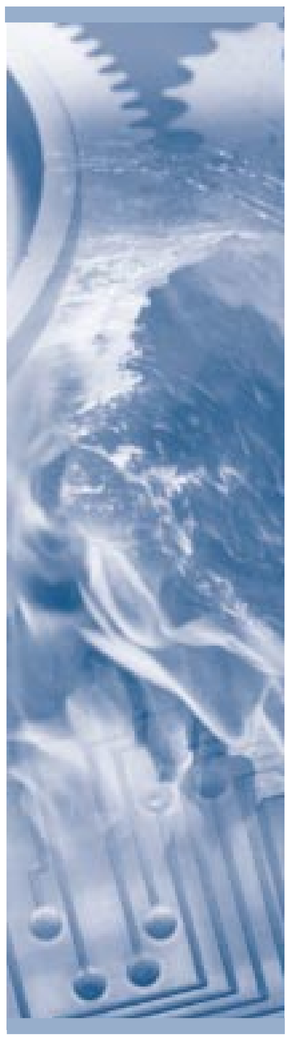


Fighting Fire with Water—

From Channel Conflict to Confluence

eStrategy Brief

Fighting Fire With Water—From Channel Conflict to Confluence

By Darrell Rigby and Michael O'Sullivan of Bain & Company; Randall Hancock of Mainspring

In '96, the young owner of a small watch company seized an opportunity to serve customer needs better through a new, more efficient distribution channel. He made his play with a broadened product selection, a promise of superior service, and a wake-up call to competitors for making "unreasonable profits" and failing to attend properly to customers. Success came rapidly—within two years the business was processing up to twenty thousand orders per day and sales were growing exponentially. Sound like a dot-com? This year was 1896 and, the revolution was the advent of low-cost package delivery across the country. The entrepreneur was one Richard Warren Sears, launching his first general merchandising mail-order catalog.

Some retailers are paralyzed into inaction by fear of cannibalizing their existing business; others have been tempted by potential market valuations into creating a spin-off without a coherent channel strategy; and most have been mesmerized by pure plays into thinking there is only one way to compete—on price.

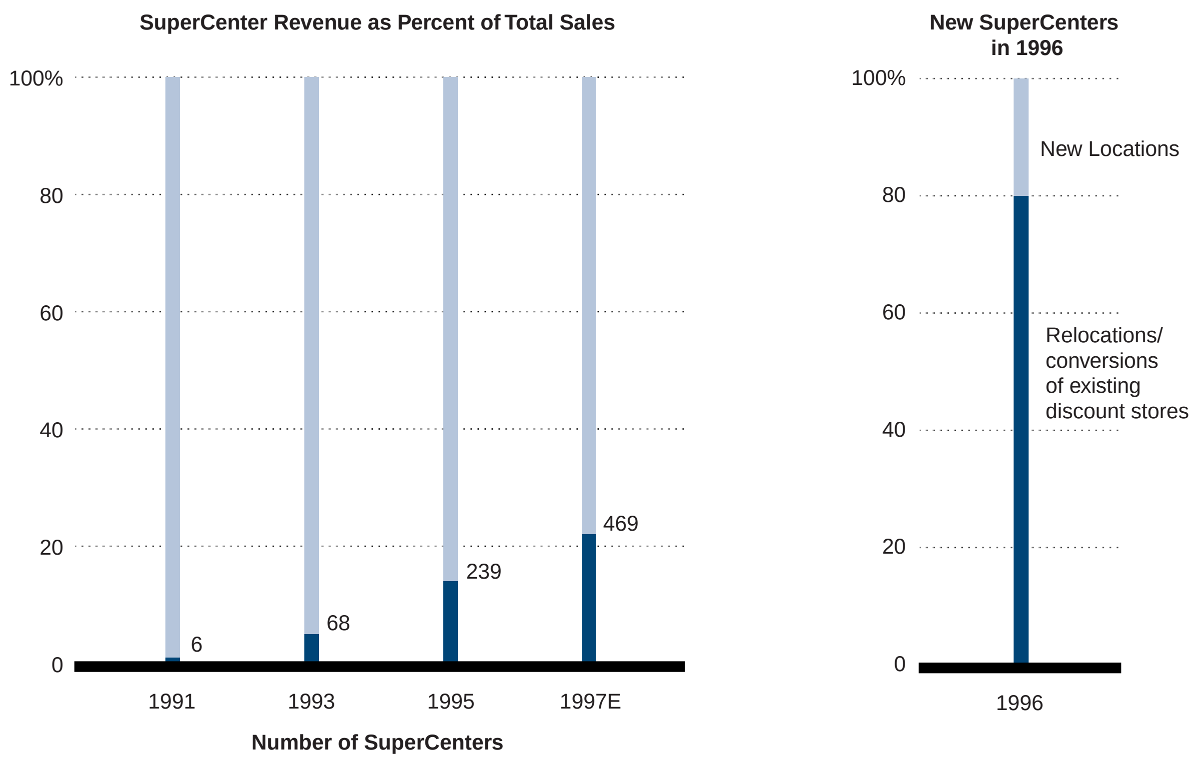
The Internet has taken hold much faster than direct mail. It took Sears thirty years to become a household name. It took Amazon about three. Today, Amazon's market valuation is more than 10 times that of competitors Barnes & Noble or Borders, which struggle to adjust. Bricks-and-mortar retailers should take heart. In 1896, Sears sounded the death knell for traveling peddlers—its chief competitors for rural dollars—whose only assets were tough shoes and a friend in each village. By contrast, today's traditional retailers have a host of potential advantages over pure plays—brand equity, physical stores and distribution systems, customer knowledge and purchasing power—that can help them compete successfully across all the channels—physical and electronic—at their disposal.

So if established retailers have all of these valuable assets—why are so few getting their channel strategy right? There are at least three reasons.

1. Some retailers are paralyzed into inaction by fear of cannibalizing their existing business;
2. Others have been tempted by potential market valuations into creating a spin-off without a coherent channel strategy;
3. And most have been mesmerized by pure plays into thinking there is only one way to compete—on price.

Bricks-and-mortar retailers need to force pure plays to fight on the established player's turf. For many, this means using their assets to build a strong multi-channel organization that is well placed to deliver a seamless offering and build loyal customer relationships. They may need to start by overcoming their fears.

Figure 1: **Wal-Mart SuperCenter cannibalization**



Source: Bain Analysis, Annual Reports

Overcome the fear of cannibalization

Seeing confluence where others see only cannibalization has long been a boon to retailers like Wal-Mart. The discount retailer's intrepid foray into superstores and discount clubs gained the company share overall and squeezed slower moving competitors like K-Mart out of the running. ***(Figure 1)*** Today, the spoils go to online retailers who see similar opportunity. Gap grasped this early. To target profitable segments—the convenience shoppers who buy in high volumes across multiple categories—it crafted its Internet play as part of a seamless offer across channels. Innovatively, it makes the Internet a sales support feature: if an item is out of stock, customers can order it from an in-store kiosk. Today, Gap is strengthening relationships with existing customers and winning market share from less responsive competitors. Its web site was one of the 20 most heavily visited during the 1999 holiday season[1].

[1] *Source: Nielsen/NetRatings*

But other retailers remain paralyzed by fear. Take, for example, UK grocers, where added convenience attracts customers to shop online. The Internet offers limited opportunity for revenue growth—the market is already consolidated and, if anything, consumers buy less online. Margins in the US grocery business, which is more fragmented, can be razor thin to start; there's little room to discount and little space to come in with a new business model and retain any prospect of profits. What's worse, on either continent, delivery of groceries to people's homes is much more expensive than offering them in-store, especially if that store base is already in place. That means if grocers sell through the Internet, they cannibalize their stores and their economics deteriorate; but if they don't, they may lose market share. Either way the economics are likely to worsen. It's a gloomy prospect, but inaction is the wrong reaction. Gauge your online competition carefully—if it's economically viable, don't let fear of cannibalization prevent you from exploiting a channel that your customers want to use. Instead, you should bet that you will lose those customers to competitors who want to cannibalize your business for you. Don't mourn the loss of store traffic; rather, focus on ways to grow revenues across all your channels. For example, can grocers expand to non-grocery products?

Make the most of off-line assets

Spin-offs often don't make sense. Don't lessen your ability to gain synergies across channels by rushing to create separate online operations. Instead, examine how you can use your assets to create a seamless offer that pure plays can't touch. Consider the tactical trade-offs ***(Figure 2)***. First, leverage your brand. In an online world where five percent of sites receive 75 percent of hits, brand is a major factor in attracting customers. Be sure your site carries the right brand message. For example, Nordstrom took online its reputation for no-quibble returns, a strong brand asset, and provides a postage-paid envelope to expedite them.

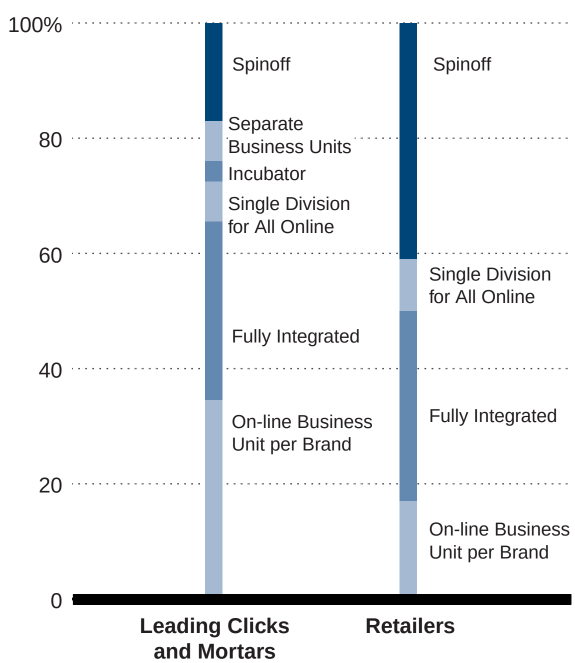
***Figure 2*:** **Tactical tradeoffs**

	Favors Integration	Favors Separation
Management Talent	Available	Problematic
Timescale to Launch	12-36 Months Acceptable	3-6 Months Essential
Need to Appear Separate from Progenitor	Irrelevant	Critical
Need for Investment Capital	Low priority	High priority

Source: Chris Zook, Bain & Company, "Profit from the Core" study

Over 80 percent of leading clicks-and-mortar firms have enabled channel confluence by keeping online operations in house, at least for now. ***(Figure 3)*** Broker Charles Schwab kept Schwab.com, its electronic service arm, within the larger organization. As online customer numbers grew, Schwab saw that the whole sector of electronic trading was destined to move onto the Web. Schwab built on its traditional brand and integrated its operations so the electronic arm became central to the larger organization. The nature of Schwab's business has altered substantially. Despite this, it has emerged as the market leader with a seamless offer that pure plays can't beat—the majority of online customers actually open their accounts in Schwab's street-level offices.

***Figure 3*: Organization of online operations**



Source: Bain Analysis

Next, consider your most precious asset—your customers. You can strengthen your relationship with them using cross-channel promotions and loyalty schemes. And you can hone customer understanding by feeding the details you glean online back to your off-line stores through integrated customer databases. For example, grocers who track online shopping baskets have perfect data to help them improve store layout or pick special offers. With that feedback loop in place, you can reinforce the virtuous circle of cooperation by using in-store kiosks or web site advertising at bricks-and-mortar stores to strengthen online customer relationships. In addition, you can use the fulfillment loop of online orders to build off-line traffic by allowing in-store returns.

Finally, get the most from your workforce. Clicks-and-mortar successes like Schwab are finding you don't need entirely new personnel to go online; established employees building a career are less likely to leave at the first sign of failure than the 'get rich quick' brigade attracted to pure plays. Reward employees with a share in the company's success and they will reward you with their loyalty. Take Sun Microsystems, which faced resistance to online sales from commission-based sales reps; now it credits those reps with online sales. Similarly, Ethan Allen appeases the bricks-and-mortar store managers who are vital to its success. Whenever feasible, the stores fill orders placed online, receiving 25 percent of the sales price. If orders are shipped directly from the factory, the store nearest the customer receives 10 percent of the price.

Ease spin-off tensions

Spin–offs make sense in some cases, but this will depend on your situation and the strategy you intend to pursue. If your off-line model is becoming obsolete—or your target customers online belong to your current channel partners– you may need to distance your Internet offerings from your existing business. A separate operation under a different brand will allow you to pursue new customers unfettered by historical patterns and alliances. Sabre, the airline ticketing system that serves airline and travel agents spun off Travelocity to sell online directly to travelers. Another situation where a spin–off can make sense is where your Internet business is only loosely related to your traditional one. UK electrical retailer Dixons struck gold by using its strong distribution to high street stores as a springboard to create a completely new business. The result: Freeserve, a free Internet service provider, that generates income from the vendors it links, brought 1.25 million British homes online in eight months. At its initial public offering, Freeserve was valued at $2.4 billion, creating substantial value for its progenitor.

Many of the spin–offs that have been launched inappropriately face tricky issues—for example, how to share control of the brand.

These spin–offs are appropriate. Why? They rely on some aspect of the core business, but are only loosely related to it. Furthermore, the businesses are ready to compete as stand–alone public companies. If a spin–off makes sense for you, you need to think through how it will gain access to and leverage that core asset. In some cases this is simple. For example, Freeserve pays Dixons a straight distribution fee for each new customer acquired. In cases where there is some sharing of systems or capabilities the relationship will be more complicated. Many of the spin–offs that have been launched inappropriately face trickier issues—for example, how to share control of the brand.

Fight fire with water

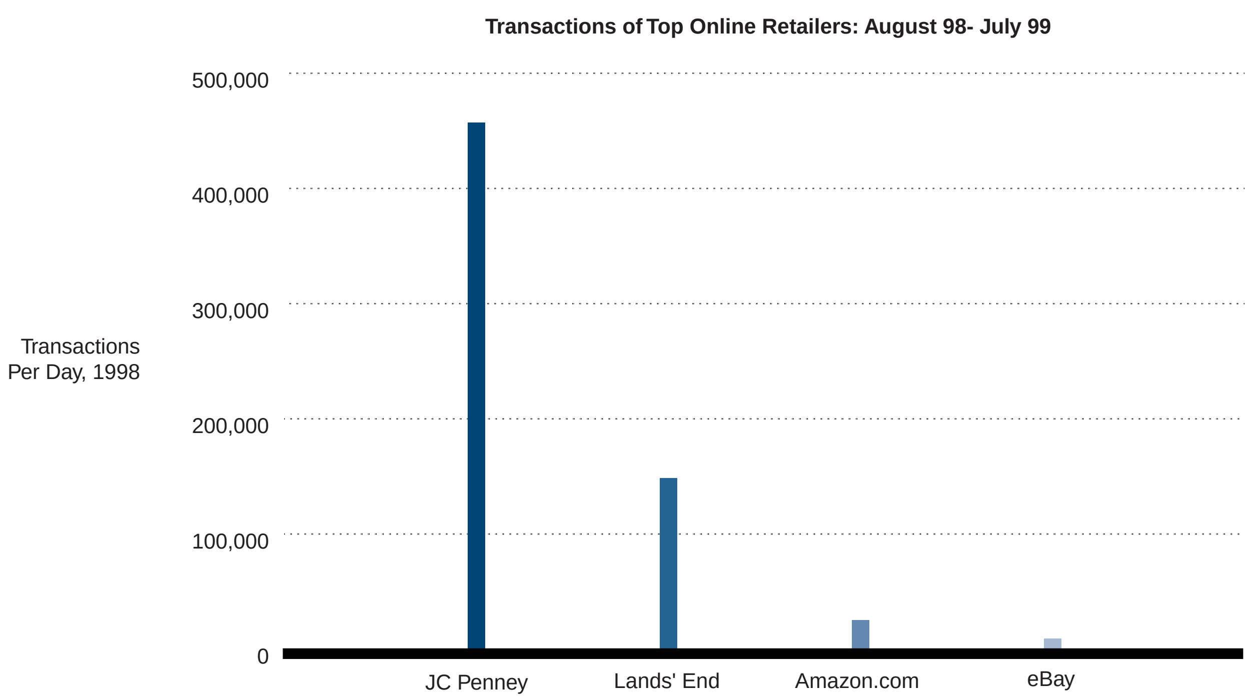
Bricks–and–mortar retailers' third mistake is to fight fire with fire. The Internet offers the chance for innovative new approaches to meeting customer needs. Many retailers have taken that to mean they should launch copycat offers, competing head to head with pure plays. That's wrong minded. Dot–coms spend millions on acquiring customers because they start from a customer base of zero. And they price low because they have no other source of differentiation. Traditional companies like OshKoshB'Gosh, suppliers of distinctive, premium–priced children's clothing, have swallowed the lie that the only way to compete online is on price. OshKosh scrambled to place plain photos of current stock on its web site, emphasizing discounted items and special offers. The result: a site like any other that weakens rather than strengthens its brand[2].

[2]*For further insights on pricing strategy see 'Assuring the price is right online' March 2000, www.bain.com*

Even more misguided is the stream of UK banks that saw the success of Prudential's online bank, Egg, and rushed to create their own under new brands like Cahoot, IF and Smile. All these companies are missing the point. The Internet is not a magic money machine that delivers dollars if you plug in the right formula. Rather, it is a tool to deliver value to customers. Don't copy the pure plays, and don't follow the latest fad. Fight fire with water—to deliver superior value to customers in the long term, decide how you can use assets your competitors *don't* have. ***(Figure 4)***

For example, retailers should challenge themselves on how to use the Internet to redefine their offers. Are there specific categories that can be extended or spun–out? Can the off–line offer be enhanced? Leading UK pharmacist Boots launched handbag.com, a magazine–style site that sells cosmetics. In doing so, it's leveraging its unique assets—beauty products purchasing power and customer knowledge—to stimulate magazine–inspired purchases.

Figure 4**: Catalog retailers' scale advantage over pure plays**



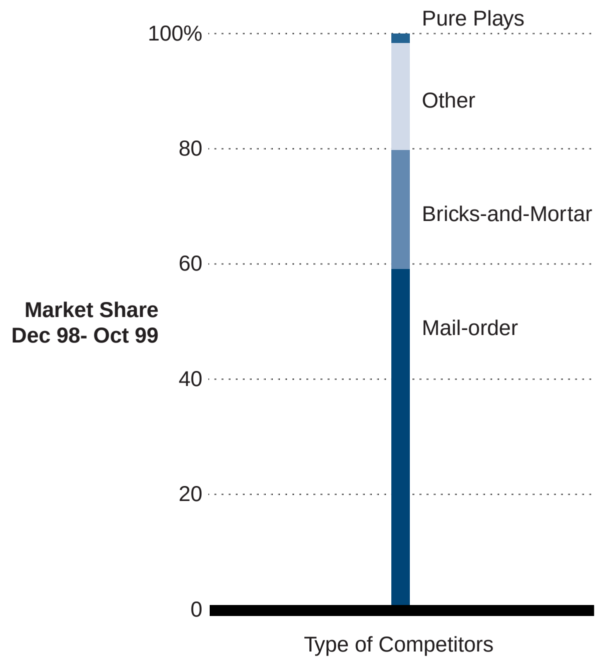
Source: Annual reports/ Stores Magazine, Sept. 1999

Note: JCP sales are for catalog division only; average transaction value= $35 from Land's End Annual Report

And lastly, as you plan for the future, don't get blind-sided by the limitations of today's technology. If you are currently creating a strategy for a dial-up channel, you're too late. Broadband and wireless technologies are already removing channel barriers, and TV-based Internet access will revolutionize the Internet channel once again. Ask what these innovations could do for your customers and plan ahead.

Some of the Internet's most successful sellers are modern day mail-order companies like Lands' End. ***(Figure 5)*** It has brought a strong brand and a thorough understanding of home shopping to the Internet and used the technology to enhance and complement its catalog offerings. Lands' End provides online customers with style advice and personalized models on which to try out clothes. Browsers can link up with friends online to 'shop with a friend' ™ and, if they need help, click to request assistance from a "live" online sales representative. The results are impressive—Lands' End has become the biggest seller of apparel online and rates ahead of pure play sites on customer service[3]. Building on this success, its next target for reinvention is the way it serves its corporate customers. Historically, Lands' End has sold custom-monographed apparel to businesses through catalogs. Now it plans to offer these online and to provide custom online stores and procurement aggregation services for large corporate customers.

***Figure 5*: Online apparel retailers**



Source: Bain/Mainspring Customer Survey

Like Lands' End, many retailers will find that embracing the Internet leads to sweeping changes in their products and services and the way they do business. Those that recognize this as good news, those who are not frozen by fear of channel conflict, but who take the lead in designing new offerings and business models, will win this revolution and survive to fight the next.

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[3] *Gomez rated Lands' End second best online apparel retailer overall for Spring 2000, behind Eddie Bauer*

Bain & Company: Strategy for sustainable results

Bain is one of the world's leading global business consulting firms. Its 2,500 professionals serve major multinationals and other organizations through an integrated network of 26 offices in 18 countries. Its fact-based, "outside-in" approach is unique, and its immense experience base, developed over 27 years, covers a complete range of critical business issues in every economic sector. Bain's entire approach is based on two guiding principles:

1) working in true collaboration with clients to craft and implement customized strategies that yield significant, measurable, and sustainable results, and
2) developing processes that strengthen a client's organization and create lasting competitive advantage. The firm gauges its success solely by its clients' achievements.

Bain & Company's global e-commerce practice helps businesses achieve outstanding results in the new economy. We work with traditional companies to launch and manage online operations, and with pre-IPO clients to hone business models and accelerate to market. We also work with entrepreneurs to incubate new ideas into viable businesses, in some cases taking equity stakes through our bainlab subsidiary. Our e-commerce practice professionals work around the globe in every major industry.

Mainspring eStrategy Consulting

Mainspring is the leading eStrategy consulting firm that focuses exclusively on developing actionable Internet strategies. It enables Fortune 1000 companies to protect, evolve, and transform their business for sustained competitive advantage by offering an integrated process of business, customer, and technology strategy planning. Its proprietary process hinges on the following activities to help guide clients effectively through eStrategy development:

- Building the Business Model
- Creating the Customer Experience
- Defining the Solution Architecture
- Commercializing the Business Plan

Working with Mainspring, companies identify, define, and formulate a portfolio of strategic Internet initiatives that are customized for their business and designed to create sustainable competitive advantage.

Mainspring's core services include eStrategy Consulting, eStrategy Direct, and the eStrategy Executive Council. These services are provided to companies in the financial services; retail and consumer goods; technology, communications, and media; and manufacturing industries. Mainspring was founded in 1996 and has offices in Cambridge, Massachusetts and New York City.

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