APPENDIX 5

RETAIL OF TANGIBLE GOODS: ANALYSIS AND CASE STUDIES

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FIGURES

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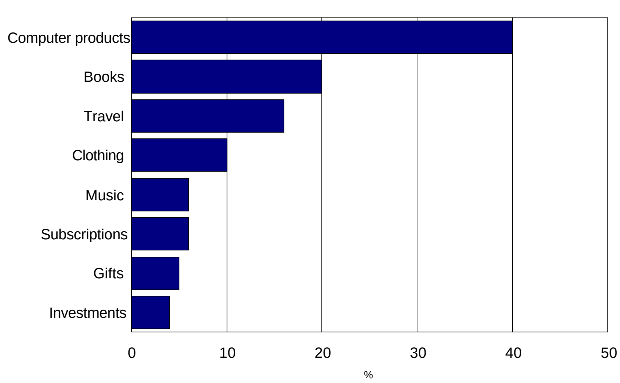
In 1994 and 1995, very few retailers were present on the Internet. Large information technology companies including IBM, MCI, and media giant Time Warner, established "cybermalls" early on and attempted to rent virtual space to interested retailers. Start-ups like Amazon.com, CDNow and N2K, Peapod, and Virtual Vineyards saw an opportunity to become the first Internet retailers in their specialty market segments of books, music, groceries and wine. These new Internet-only businesses had a head start of one to two years during which they invested heavily to build a brand image and gain market share before super retailers like Walmart, Barnes and Noble, the Gap, and J.C. Penney equipped their Web sites with a sales capability.

Today, even though Internet retail still represents but a small fraction of total retail, Internet consumers have a wide variety of shopping alternatives and products from which to choose. They can access sites that specialize in books, computer goods, groceries, music, magazines, hosiery, sporting goods, candles, flowers, and a range of other products. These sites may be sponsored by well-known store-based retailers, manufacturers, media companies, or wholesalers; they may be hosted by information technology companies present only on the Internet or via a toll-free telephone number.

Figure 1. What Do People Buy on the Net?



Source: Forrester Research

With sales topping $850 million in 1997, PC hardware and software is the largest specialty retailing area on the Internet.[1] Consumers can shop for desktop computers, notebooks, software and accessories direct from the manufacturer, via a reseller, well-known retailers with large store networks and new retailers with a presence limited to the Internet. Egghead.com, a $361 million computer reseller,[2] began offering hardware and software products from its Web site in February 1996; nine months later, consumers could directly download selected software products to their PCs. In January 1998, Egghead announced that it would close its network of retail stores and stake its future on Internet commerce.

Books and music are other large categories of Internet commerce (Figure 1). Amazon.com closed 1997 with sales of $148 million. Barnes and Noble reports that its Web-based business, launched in mid-May 1997, generated about $14 million during its first nine months of business. The company expects its 1998 sales to exceed $100 million.[3]

N2K and CDNow, two of the largest music sites, posted $6.5 million and $9.5 million in net revenues respectively for the first nine months of 1997. N2K's full-year 1996 revenues were just under $1.7 million; CDNow's were $6.3 million.[4]

Gifts and flowers are other important Internet retail categories. 1-800-FLOWERS had online sales of $30 million during 1997, for 10 percent of the company's total revenues. Garden Escape, a Web site selling plants, gardening supplies, tools and equipment, reports that its sales have been growing 30-40 percent every month since its fall 1995 launch.

Hallmark, the world's leading creator and marketer of greeting cards and personal expression products, recently launched its site in December 1997, offering more than 1,100 cards and 100 multimedia/animated greeting cards, gifts, and other services.

Super retailers like Walmart and direct marketer, Cendant Corporation (formerly CUC International), present consumers with one-stop shopping under one roof. Both companies' Web sites offer a vast selection of products across different product categories. As in its stores, shopping at Walmart.com is free of charge, and consumers can choose to make single or bulk purchases. Shoppers at Cendant's netMarket pay a $69 annual membership fee in order to purchase from their selection of over 1 million products.[5]

Not only have specialty and mass-market retailers established Web presences; businesses that do not traditionally compete for consumer retail spending have also established consumer-oriented Web sites.

Online service providers like America Online (AOL) and Earthlink Network, search engines like Yahoo! and Excite, and content businesses like Time Warner's Pathfinder bring together leading retailers for one-stop shopping, commonly organized by product type (books, computers, consumer electronics, furniture, etc.) and type of retailer (department store, mass merchandiser). In order to participate, retailers pay these companies some combination of rent, transaction and advertising fees.

For instance, tenants that qualify as "anchors" (a concept akin to department stores in shopping malls) on AOL's Shopping Channel pay for prominent placement in the Shopping Channel and advertising rotations to AOL's more than 11 million members. AOL also has exclusive advertising partnerships with retailers such as Barnes & Noble and the Cendant Corporation. For tens of millions of dollars over a multiyear period, AOL reserves the shopping space in particular product categories for these partners, advertises and markets their products on AOL's online service and/or aol.com, and participates with them in joint technical development and research.

Excite and Yahoo! hope to make the shopping experience more convenient for the consumer by providing intelligent software agents that scan the product databases of participating retailers and present only those that carry a particular product. The agent saves the consumer the time and effort he otherwise would have spent "visiting" each Web site in search of the product. The agent also presents price and delivery information that allows the consumer to comparison shop, weighing price, brand and availability when making the decision to purchase.

Internet consumers can participate in virtual auctions at sites like Onsale and First Auction. These sites combine entertainment and shopping, with real-time auctions that take place 24 hours a day, each one lasting for a few hours. Bidders compete with each other for a limited number of products, bidding the price up at set increments. In the past, the products offered at auction sites were limited to computer products and consumer electronics; today, bidders can also take home golf clubs, jewelry, clothing and a variety of other products.

Even buying a car—more of an investment than a typical retail purchase—is possible through a number of auto marketplaces, online classified sites, and manufacturers' own sites. Web shoppers can view pictures of different car models and read extensive information on the car's features, performance and reviews. Financing and insurance options are also available online. The existing distribution system and franchising laws require that a licensed dealer closes the transaction, so today's Internet-based businesses have direct links to dealership sites or send leads to dealerships who follow up with interested customers.

JD Power & Associates estimates that about 10 percent of all new car and truck buyers used the Internet as part of their shopping process in 1996. By 2000, at least 21 percent of all new car and truck buyers will use the Internet.[6]

The National Automobile Dealers Association (NADA), which represents more than 20,000 car dealers nationwide, reports that more than half of new-car dealerships have a Web site. Forty percent of the remainder plan to launch one within six months. Dealers with Web sites sell five cars a month on average over the Internet—double the number a year ago. Consumers use the sites to access vehicle inventory information, schedule sales appointments, order new and used cars, and apply for financing (Figure 2).[7]

Figure 2. What Consumers Can Do at Auto Dealers' Web Sites*

Access vehicle inventory	>50%
Schedule sales appointment	28%
Order new and used cars	22%
Apply for financing	26%

*Chart represents percent of dealer sites offering a given feature.
Source: National Automobile Dealers Association, October 1997

The largest volume of car sales is being driven by car marketplaces, like Auto-by-Tel, AutoVantage, AutoWeb and CarPoint. These services charge participating dealerships fees for listing their cars on the service.

Auto-By-Tel works with 2,700 dealers nationwide and refers more than 100,000 purchase requests to them each month. The company currently generates over $500 million in vehicle sales per month, or $6 billion on an annualized basis.

AutoVantage, owned by the Cendant Corporation, reports that it works with 1,000 dealerships nationwide and refers 30,000 customers to them each month.[8]

AutoWeb, a service based in Santa Clara, CA, has a network of 1,200 dealers in the U.S. and Canada and refers 110,000 purchase requests per month, up from 15,000 per month a year ago. In November 1997, the company announced its one millionth purchase request.[9]

Analysts estimate Internet retail at between $1.3 - $4 billion for 1997, a fraction of the $2.5 trillion consumer retail market. By the year 2000, U.S. online consumer retail could be as little as $7 billion or as high $37 billion.[10] If mail order sales are used as an indication of the potential for Internet retailing, as some suggest, the figure could reach $115 billion in five to eight years.[11] Some who offer this comparison to mail order believe that the Internet has three advantages over that channel. It offers consumers a more complete assortment, better and more complete information, and over the long term, better prices.

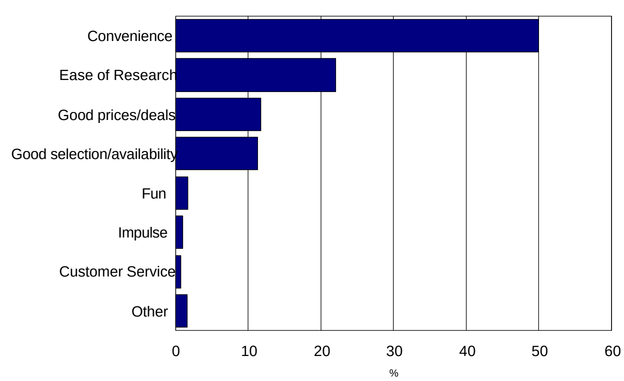
The growth of online consumer retail is being driven by cost savings, the ability to customize marketing, and increased consumer demand.

Consumer Demand

According to a Fall 1997 survey conducted by CommerceNet and Nielsen, 10 million people in the U.S. and Canada have used the Internet to make a purchase. This represents almost a doubling from their survey conducted six months earlier, when they found 5.6 million purchasers among the Internet users in North America.[12]

A larger number of people use the Internet to shop before making a purchase offline. A recent study by Ernst & Young shows that 64 percent of Internet users research products online and then buy them at stores or by telephone.[13]

Figure 3. Reasons Why People Shop Online



Source: Forrester Research

AOL reports that 79 percent of its members have window-shopped for products and services online. Forty-two percent have made purchases online at some point.[14]

When asked why they use the Internet to make a purchase, Internet users cite convenience. (In fact, 40 percent of the transactions made with retailers on AOL are made during hours when traditional malls are closed.[15]) Ease of research and good prices rank a distant second and third in the order of reasons given (Figure 3).[16]

Lower Operating Costs

Virtual stores report lower operating costs than their physical counterparts. They typically limit their operations to advertising and marketing, site content, establishing relationships with manufacturers or distributors, accounting functions and customer service. Rent and depreciation, store personnel, utilities and other expenses of a physical store infrastructure are almost entirely avoided. Internet-only stores may not even take possession of the goods, leaving fulfillment activities—warehousing and distribution functions—to third parties. More than one-fourth of Web sellers currently outsource these functions.[17]

NECX Direct, an online computer products store, is linked electronically to two distributors, Ingram and Merisel, which ship orders directly from their warehouses. Ordering, payment, invoicing and inventory management are handled electronically. It cost NECX Direct about $1 million to establish its Web site. The online division operates with a staff of 40 employees, including a Webmaster and developers, networking staff, graphics designers, telephone sales and support personnel, merchandisers, buyers and management. The company reports that its online operating model is cheaper than traditional mediums because fewer people are involved in each transaction.[18]

Comparing Amazon.com to a large traditional bookseller illustrates some key differences in an Internet-versus-physical-store business model. During the fall of 1997, Amazon's gross margin (retail sales minus cost of goods sold) was 19.5 percent of retail sales compared to this retailer's 36.7 percent.[19] The traditional retailer purchases its books from publishers and benefits from discounts due to its large sales volume. Up until very recently, Amazon purchased its books almost exclusively from wholesalers, paying markups the traditional retailer largely avoids. Aggressive price discounting online further erodes the gross margin of the online retailer. Amazon has recently begun to purchase more titles directly from publishers to reduce its purchasing cost.

As a virtual retailer, Amazon has no physical store infrastructure. Rent and depreciation represent less than 4 percent of Amazon's sales compared to 13 percent for the traditional retailer, and its labor costs are lower as a percentage of sales. Amazon has less capital tied up in inventory: its books turn 20-40 times per year versus two to two-and-a-half times per year for the traditional retailer. On the other hand, Amazon's advertising and marketing costs have been high relative to its sales volume. In a new and rapidly growing market, it is not unusual for companies to invest heavily to build a brand and capture market share. Over time, as sales volumes increase, advertising and marketing expenses decline as a percent of sales.

Distribution requirements differ greatly for traditional store retailers and companies selling through the Internet. Large store retailers purchase large quantities of a single item and deliver them in pallet (large) quantities to a warehouse or directly to a store. Rarely do they deliver goods one-by-one to a customer's home or office. Internet retailers, on the other hand, require a distribution system that moves goods from a manufacturer or a warehouse to a customer's home, typically within a week or less.

Just as in mail order purchases, the Internet customer typically pays the full charge for the home delivery service. Depending on the method of shipment, home delivery can add significantly to the price of the product.[20] The high cost of delivery will likely have an influence on the way customers shop: rather than purchasing one item at a time, they will bundle several items in a single purchase to save on delivery charges. Over time, delivery charges will decrease as the volume of Internet retail increases. Like their larger store-based counterparts, Internet businesses will benefit from the economies of shipping larger quantities to a given geographic area and then distributing them locally, and likely pass these savings on to their consumers.

Direct marketers that sell via the Internet report lower operating costs versus their telephone and catalog sales operations. The Cendant Corporation reports that it loses $9 per new member in its telesales operation during the first year of membership when it factors in the sales and marketing expenses to acquire that new member. Because of its lower sales and marketing costs to acquire new Internet members, Cendant makes a profit of $10 for each new member in the first year. By the second year of membership, Cendant makes $30 per member in telesales and $40 per Internet member.

One-to-one Marketing

A shopkeeper in a small store may remember the purchases of his regular customers. A salesperson in a large store with customer traffic that changes daily has a very difficult time keeping track of a customer's purchases to be able to make individual recommendations.

Though not yet widely in practice, the Internet offers the opportunity to profitably market directly to narrow bands of customers, and even to market to customers one-by-one. Software programs detect when an individual customer enters a Web site, greeting the customer by name, much as a neighborhood shopkeeper might recognize a regular customer. Querying one or more databases reveals that the customer has recently purchased a pair of blue jeans and an Extra-large sweater or books on the topic of travel in Italy. On the Internet, the store might prompt the customer to purchase another sweater in a similar style or a shirt to go underneath the sweater. It might notify the customer when new travel books have been published, or suggest books on Renaissance art.

Researchers are working to develop software agents that learn the behaviors and preferences of individuals. As these technologies become more sophisticated, Internet businesses are likely to employ them to assist in one-to-one marketing.

If Web users become convinced that businesses will protect their privacy at the same time they make targeted offers, one-to-one marketing will become commonplace.

The Future

The retail sale of tangible goods on the Internet is likely to grow more slowly than business-to-business Internet commerce or commerce of goods and services that can be delivered digitally. How quickly it evolves will depend on consumers' trust of the medium, the sophistication and efficiency of distribution, and the speed at which the Internet becomes a mass market.

The most frequent complaint from online shoppers is that finding and buying things on the Internet is slow and complex. Some of that is due to delays in accessing information because of slow modems. Some of it is due to sites that are poorly organized, making it difficult to find things.[21] As bandwidth to the home increases, delays should be minimized. Search and categorization tools currently being developed should make navigating the Internet easier and more intuitive for users.

The tools are not yet in place to authenticate Internet businesses or to safeguard privacy. Leading Internet retailers worry that bad actors may lead to a backlash against the industry. Without authentication tools, a site can claim to be a retailer, but not be legitimate. A site may abuse a customer's privacy by collecting and sharing information without the individual's knowledge or consent. Or, a retailer might sell a customer a product but provide inadequate customer service.

As digital signature and certification authorities become widespread, and as privacy guidelines are more widely adopted, consumers will have better information and more control over where they shop. Industry groups like shop.org, launched in 1996 by leading Internet retailers, and others, have been formed to establish and promote good business practices for Internet retailers to ensure consumers have a problem-free online shopping experience.

Some consumers still fear giving their credit card online. Ernst & Young discovered that 68 percent of consumers who have yet to make a Web purchase say they are uncomfortable sending their credit-card numbers across the Internet. To address these concerns, a new industry in security services has been developing. Ernst & Young estimates that the market for firewalls and encryption was approximately $1 billion in 1996 and is projected to grow to $5 billion by 2000.[22]

Industry efforts to improve security through encryption like Secure Sockets Layer (SSL) and the newer Secure Electronic Transaction (SET) appear to be making an impact. 1-800-Flowers reports that fewer than one-third of its customers worry about credit card security, compared to almost 75 percent last year.[23]

The growth of Internet retail will also depend on how quickly retailers and manufacturers establish a presence on the Web. Most of them have a Web presence, but it tends to be limited to information about the company and store locations. Only 12 percent of retailers and 9 percent of manufacturers currently sell via the Internet.[24] Few have the experience or the infrastructure to deliver orders directly to end customers. In addition, selling online is likely to have an impact on their existing store sales and, in the case of manufacturers, their relationships with wholesalers and retailers.

Web sites marketing cars describe the uncertainty of the legal and regulatory environment as another potential inhibitor to the growth of Internet commerce. If a state interprets the business model of an online auto marketplace as functioning like a brokerage, the marketplace will have to become licensed in every state and modify its business practices, or shut down in that state. If, on the other hand, a state interprets the business as an advertiser or marketer, the licensing requirements would not apply. How and whether an auto site can offer financing and insurance also centers around how states interpret their role.

Online auction sites raise other regulatory questions. Many states have statutes governing offline auctions, requiring professional licensing of auctioneers and registration of the auction with local authorities. In many states, municipalities are also authorized to regulate and/or license auctions. Online auctions differ from physical auctions in that bids placed in an online auction may come in from many different states, not just a single location. In addition, the frequency of online auctions (sites operate 24 hours a day and new auctions begin as frequently as every few minutes), for example, would prohibit the business from registering each auction with local authorities.

Most of these concerns are expected to be addressed as the market develops. Some will be addressed by technological advances; others by competitive dynamics and government action.

AMAZON.COM

From little more than a concept two and a half years ago, Amazon.com has grown to a $148 million business with customers in more than 150 countries, attracting them with a choice of 2.5 million titles, discounts of up to 40 percent, and search tools and book reviews that Amazon hopes make buying a book that much easier. By the end of 1997, over 1.5 million customers had shopped at Amazon.

Amazon is not a traditional bookseller. It has no physical stores, so it does not support the cost of the space and the labor to staff the stores. Moreover, because it is not constrained by physical space, Amazon offers a selection of books much greater than any single traditional bookstore. Amazon tries to find its customers any book a customer might request, whether in print or out of print, promising to get the book for them within a couple of days (for those in print) or as quickly as they can find it (for those out of print).

At the same time, Amazon shares typical retailers' goals of attracting and keeping customers. As a young company, Amazon spends heavily on advertising and marketing to build its brand name. It draws visitors to the store through advertising, both on the Web and off. But getting someone into the store is only part of the battle. Amazon believes that making the shopping experience as intuitive and enjoyable as possible is what turns the visitor into a customer. Amazon's sophisticated online search tools let the visitor quickly navigate the vast selection of books to find a specific author and title; they also let visitors take their time to browse through subject areas. Brief descriptions and book reviews give additional information a potential buyer might need to make a purchase. These tools, combined with a very simple and quick check-out process, help convert window shoppers into customers. Amazon recorded its millionth customer in October, 1997 then attracted another 500,000 by the time the year drew to a close. And customers appear to be satisfied with the experience: 58 percent of Amazon's orders come from repeat customers.

Because a customer does not walk into the store, pick up the book and carry it home, Amazon has more work to do once the sale is made to get the book to the customer's home or office. In its early days, Amazon relied almost exclusively on large book wholesalers like Ingram and Baker and Taylor for its inventory. Amazon's Seattle warehouse stocked only a couple thousand titles. As the company has grown larger, its strategy for order fulfillment is changing. To drive down cost and to meet its corporate goal of shipping 95 percent of its orders the same day, Amazon has begun to increase the inventory it keeps on hand. Rather than pay the additional markups that the wholesalers charge, Amazon now purchases some of its titles directly from publishers and stocks them in an expanded Seattle warehouse and a second warehouse in Delaware. At the close of 1997, Amazon's warehouses stocked more than 700,000 books, including partially filled orders.

Amazon believes that it has an inherent cost advantage versus traditional book sellers.
Because Amazon does not support a physical store infrastructure, it benefits from lower rent and depreciation and lower labor costs relative to traditional booksellers. For instance, rent and depreciation represent less than 4 percent of Amazon's sales and 13 percent of the sales of a large

store-based retailer.[25] Amazon quotes sales/operating employee of over $300,000 versus $100,000 for the traditional retailer.

Amazon has less capital tied up in inventory. Its books currently turn between 20-40 times per year versus two to two-and-one-half times for the traditional bookseller.[26] As Amazon continues to stock more titles in its own warehouses, its inventory turns are likely to fall, but the company believes they will still be far higher than those of store-based retailers.

When it does not stock a book, Amazon receives payment for its goods before it has to pay its vendors. Rather than paying interest on money tied up in inventory, Amazon earns interest on its own sales. Other booksellers have money tied up for the books that stock their stores and warehouses and do not receive payment until the books are sold. Then, they receive payment from customers once the books are sold.

At this early stage of its operating history, Amazon has not yet made a profit.

Through 1997, it purchased most of its books through wholesalers, paying markups that traditional booksellers avoid by buying direct from the publisher. At the same time, online booksellers have been engaged in aggressive price discounting. These two factors contribute to a gross margin that is lower than that of its larger competitors.[27] And, in order to build its brand name, Amazon's expenses in advertising and marketing are a high share of its total cost structure.

Amazon has been taking steps to buy more of its books directly from publishers in order to improve its gross margins. As volumes increase, Amazon expects its advertising and marketing expenses to decline as a percentage of sales.

AUTO-BY-TEL

Auto-by-Tel launched its Web site in March 1995. During its first nine months of operation, the company processed a total of 43,000 purchase requests, and 70 percent of these requests resulted in sales at participating dealerships. In 1996, Auto-by-Tel received 345,000 purchase requests, for more than $1.8 billion in auto sales.[28] As of the end of November 1997, the Web site is generating $500 million a month in auto sales (or $6 billion on an annualized basis) and processes over 100,000 purchase requests each month. Over 1.3 million car buyers have shopped at Auto-by-Tel.

Auto-by-Tel shoppers can access model and pricing information, including dealer invoice pricing and manufacturer rebate information on all new and used cars from 2,700 dealers it has accredited across the country. Along with a picture of the car and brief descriptions, the customer can access new-car and used-car pricing from third party sources like AutoSite, Edmund's, CarCenter and Kelley Blue Book.

After deciding which car to buy, the customer enters the zip code where he or she lives and the make and model of the car desired. A screen pops up requesting which color exterior and interior is preferred, the type of transmission, how many cylinders, and if it is available in both door model options, to choose between a 2-door or 4-door model. Then, the customer completes a new car purchase request, selecting the manufacturer options to include on the car: radio, power windows, anti-lock brakes, sunroof, etc. With these selections and some contact information for the customer, the request goes to the Auto-by-Tel dealer closest to the customer's home. Within 24 hours, the dealer contacts the customer with a no haggle price.

For customers wishing to obtain financing, Auto-by-Tel provides rate information compiled by Bank Rate Monitor on different financing rates available in the city where the customer lives. Options are explained by the dealer and all the paperwork is prepared before the customer arrives to complete the transaction and pick up the car. Auto insurance quotes from AIG are also available online or by calling an AIG representative. The customer is also asked whether or not he wishes to acquire service agreements or after-market products available from their dealer. If interested, the customer can compare retail list prices and special Auto-by-Tel prices for each.

Auto-by-Tel charges the dealer a sign-up fee and flat monthly fee, ranging from $995 to $2,500, regardless of how many customers it sends to the dealer. For the fee, dealers are connected to Auto-by-Tel's proprietary server-based dealer communication network. In addition, Auto-by-Tel provides dealers with training for servicing Internet customers. The company has found that Internet customers expect a higher degree of professionalism and knowledge from the sales representative than a customer walking in to the showroom.

The National Automotive Dealers Association estimates that it costs the average dealer $101,500 to sell 100 cars, or about $1000 per car. With Auto-by-Tel, a dealer can sell 100 cars for $20,000, for a savings of $800 per car. Because Internet customers have access to both manufacturers' suggested retail price and the dealers' cost, the company expects that the gross margins for Auto-by-Tel sales at participating dealers are likely to be lower than for their showroom sales. But, because their costs are so much lower, they can afford to pass some of these savings to customers in the form of lower prices.

Auto-by-Tel just expanded its site to include a used car service. Customers can search a database of 20,000 certified used cars, and see the condition of the car through digital photographs available online. The site was launched in June 1997. In January 1998, Auto-by-Tel received 600,000 inquiries against the database for that month alone.

CENDANT CORPORATION - NETMARKET

Cendant Corporation is a $5.3 billion consumer goods and business services company with more than 66.5 million members worldwide. It is a membership-based company which allows its members to shop by computer, bypassing retail stores.

After a couple of false starts in the early 1970s and 1980s trying to create a market for online retail before there were PCs in the home, Cendant's (formerly CUC International) business started to take off with phone and catalog sales.[29] The concept was simple: Cendant planned to link manufacturers with their end consumers, skipping the steps in-between. Cendant would work both ends, getting enough manufacturers to work with them to build an attractive product selection and signing up enough customers so that they could negotiate the best prices with the manufacturers. Cendant would do the advertising and marketing, take the orders and pass them through to their suppliers. Customers would get the product at wholesale and pay shipping charges to get it delivered to their home. Revenues to Cendant would come in the form of membership fees. By 1993, the concept had blossomed into a $2 billion business.[30]

Cendant experimented with America Online (AOL) initially, then launched its own site called Shoppers Advantage in the fall of 1995. Without doing major promotions of its online presence, it sold $400 million worth of products in 1996. More recently, Cendant has partnered with AOL and now offers numerous co-branded sites to AOL members. Cendant also launched its own site, netMarket, in July of 1997.

For $1.00, visitors to netMarket can become trial members for a three-month period and have access to over 1 million products and services with a 2-year extended warranty. Products cover approximately 20 percent of an average family's shopping needs, from cars to electronics and cameras, books, appliances, luggage, perfume, flowers and gifts, computer hardware and software, video games, and a variety of other goods and services. After the trial period expires, the annual interactive membership fee of $69 applies.

Cendant projects it will have facilitated the sale of more than $1.2 billion over the Internet during 1997. Each month, it adds 100,000 new interactive members.

Cendant's business model relies almost entirely on membership fees. The company reports that because it does not make its money on transactions, it sells products to retail customers at, or near, wholesale prices. If customers feel they are getting a value, Cendant figures they will buy a membership. And, once customers have paid their annual fee, they have a reason to check out what Cendant has to offer. The cycle continues.

Before the decade comes to a close, Cendant plans to offer a product selection to cover 95 percent of the products a typical household would buy.

Benefits of the Internet

As Cendant already operates without the confines of physical stores, it has the ability to offer a huge array of products, even through its telesales and catalog business. The Internet takes that to a next step. The benefits the Internet provides beyond that are:

- *Lower operating costs*: As a direct marketing company, Cendant does not incur many of the costs of a traditional retailer. The company reports that its margins are therefore 8 to 10 times higher. The Internet only improves the situation. In its telesales operation, Cendant loses $9 per new member during the first year of their membership. On the Internet, they make $10. By the second year, Cendant makes money either way: $30 per member in telesales, $40 over the Internet.

- *Higher average purchase*: Because it is easier to sell something visually than it is to do verbally, Cendant's online customers tend to buy up to three times as much as its telesale customers.

INTERNET SHOPPING NETWORK/FIRST AUCTION

A wholly-owned subsidiary of the Home Shopping Network, the Internet Shopping Network (ISN) presents two different retail models to Web users: the Computer Superstore—a virtual superstore selling 40,000 computer-related products and First Auction—a site that conducts real-time auctions of computer, consumer electronics and general merchandise. Both sites operate 24 hours a day, 7 days a week.

Combined, the two sites had sales of $15 million in 1997. Based on the pace that sales increased through the year, ISN anticipates that 1998 sales could reach $38 million.

Computer Superstore

To fit the online marketplace in its infancy—early Web "surfers" were high-tech, higher-income and predominantly male—ISN launched a business selling computer hardware and software. Computer products appealed to the early Web audience and had a track record with telephone and catalog sales that demonstrated that people would buy them on specification—sight unseen.

Marketing and technology drive this Internet-only business. Customers are attracted to the site by well-placed advertising, an extensive product mix and low prices. Computers behind the scenes receive customer orders from the Web site, process them and pass them along to a distributor. The distributor picks the item from its inventory, packages it, and FedEx ships it directly to the customer's home.

The Computer Superstore reports having a lower cost structure than traditional retailers because it doesn't support the costs of operating a physical store infrastructure, with the corresponding rent, labor, utilities and inventory costs. Nor does it incur the costs of warehousing and shipping. Reduced costs flow to lower prices to the customer.

The company provides the following example of the retail price and margins of three different selling vehicles for a well-known hand-held electronic personal organizer:

ISN Sells for Less Than Traditional Retailers

	ISN	Mail order	Store
Retail price	$260	$275	$292
Cost	$234	$234	$234
Margin	$26 (10%)	$41 (15%)	$58 (20%)

At the close of 1997, The Computer Superstore site had 175,000 members and attracted 25,000 visitors every day.

First Auction

ISN thinks the auction model will sweep the Web, appealing to Internet users who are adventurous, looking to be entertained, and seeking a bargain. Auctions take advantage of the interactive nature of the Web, allowing people from all over the country to bid against each other in real-time. They “transform a traditional shopping experience into an entertainment experience.” First Auction plays to the entertainment element, starting many of its bids at $1.00, well below a product’s cost. Bidders respond, competing with each other to take possession of whatever items First Auction is offering at the moment—whether golf clubs, CD players, television sets, jewelry or something else that’s caught the bidder’s eye.

The site auctions off over 5,000 items a week. Products, along with their picture, specifications and starting price, appear at the top of the First Auction home page. To place a bid, visitors must register with the site—providing name, address, email, phone number and credit card information (which is encrypted to ensure security). The Bid page shows how many units are up for bid, the starting bid, bid increments, the top bids so far, and the start and end time for the auction. The new bidder enters a bid, upping the price by the preset increment. This bid is posted on the Bid page under an alias. At the close of the auction, the bidders with the highest bids “win.” (In almost all cases, more than one unit of a product is offered for bid.)

First Auction changes its auction items based on its inventory. It buys end of life, close-out merchandise at large discounts from distributors with inventories they cannot move through traditional channels. By getting the product at a low price, First Auction can offer a very low starting bid (often below cost). The difference between this model and the virtual superstore model is that First Auction takes possession of the merchandise, warehouses it and is responsible for getting it to the customer. Still, with the discounts they get and the volume of traffic they anticipate, ISN believes that First Auction can make money and customers can get bargains.

Launched in July 1997, First Auction’s membership roster approached 100,000 people by the end of 1997, and 30,000 people visited the site each day.

1-800-FLOWERS INTERACTIVE SERVICES DIVISION

1-800-FLOWERS goes to market in three ways: through its own flower shops and partners in major cities across the country, by telephone order, and online sales through America Online, Microsoft Network and the Web. In total, 1-800-FLOWERS fulfills about 9 million purchases per year through these three channels.

The company started a telephone order center ten years ago before it was common for consumers to purchase goods over the phone. It has continued that tradition with its online business, starting an online service on CompuServe back in 1992. The company supplemented this arrangement with partnerships with Bloomberg Financial Services, AOL, Microsoft, AT&T WorldNet, Earth Link Network, Switchboard and two dozen other companies, as well as launching its own Web site.

By 1996, 1-800-FLOWERS' stand-alone Web site was its fastest growing business sector.[31] In 1997, the online business contributed 10 percent of the company's $300 million in revenues.

The company sees the following benefits in its online business:

- *New sales opportunities*: 1-800-FLOWERS' Web site reaches an international group of customers it had not reached in the past. About 15-20 percent of the online business comes from outside the U.S., much of it from Americans working overseas who send flowers to their friends or family back home.[32]

- *Lower operating costs*: Although its online business generates just 10 percent of 1-800-FLOWERS' total revenues, it contributed nearly as much profit to the overall business as the company's store-based operation, which generated twice as much revenues.[33] 1-800-FLOWERS passes on some of these savings to its online customers who pay service fees 35 percent lower than the service fees charged for phone orders.

- *Targeted marketing*: 1-800-FLOWERS offers incentives for customers to share personal information that will help them better target offers. Customers that register with the company's Web site benefit from a service that reminds them of special occasions such as birthdays and anniversaries. The company also plans to offer local neighborhood specials based upon the zip code in customers' billing addresses.

ENDNOTES

1. Delhagen, Kate. “Retail Revs Up.” Forrester Research. October 1997.

2. 10-K filing. SEC. June 27, 1997.

3. “Barnes & Noble Post $100 M in Online Sales.” *CRW Business Desk*. January 16, 1998. http://www.techweb.cmp.com/crw/news98/b&n0116.lhtml

4. Company filings with SEC.

5. Visitors to netMarket can get a trial membership for $1 for the first three months. After that, the $69 annual fee applies.

6. December 1997 phone interview with John Osborn, JD Power and Associates.

7. “Half of New-car Dealerships Market Sales, Services on Internet.” National Association of Automobile Dealers. October 1997. http://www.nadanet.com/news/internet.htm

8. Richtel, Matt. “Net-Savvy Shoppers Driving Off with Bargains.” CyberTimes. The New York Times on the Web. November 8, 1997.

9. AutoWeb press releases: “Autoweb.com Announces Automotive Industry and Electronic Commerce Milestone.” November 12, 1997 and “Dealerships nationwide profit by “revving-up” alternative channel.” February 1, 1997. http://www.autoweb.com/press/nov12-97.htm and http://www.autoweb.com/press/feb1-97.htm

10. INTERNET RETAIL PROJECTIONS, 1997-2002*

	1997E	1998E	1999E	2000E	2001E	2002E
Forrester Research	$1.8 B	$3.3 B	$6.1 B	$7.3 B	$9.9 B	
RobertsonStephens	$1.3 B	$2.7 B	$5.1 B	$7.4 B		
IDC	$4.3 B			$37 B		$60.2 B

*This table reflects U.S. consumer retail, excluding auto and travel except where noted.

Forrester’s figure includes PC hardware/software, entertainment, books and music, gifts/flowers/greetings, apparel/footwear, food and beverages, jewelry, consumer electronics, sporting goods, toys and hobbies, health/beauty/drugs, tools and gardening, home furnishings, other. Forrester normally includes travel in its overall retail spending estimates. See: Delhagen, Kate et al, "Retail Revs Up." Forrester Research, Vol. 4, No. 6, October 1997.

Robertson Stephens includes computer hardware/software, other sales, gifts/flowers, books, apparel, music, e-services, food/drink. RobertsonStephens normally includes travel and auto in its overall retail spending estimates. See: Benjamin, Keith E. et al. "Digital Media Overview." Robertson Stephens & Company. August 26, 1997.

IDC's figures include include **all** goods and services purchased by U.S. consumers, excluding funds transfers and stock trades. This estimate includes a much larger array of products and services than the Forrester and Robertson Stephens estimates. Source: IDC phone conversation, February 1998.

11. Meeker, Mary and Pearson, Sharon. *Morgan Stanley U.S. Investment Research: Internet Retail.* Morgan Stanley. May 28, 1997. pp.4-2+. The report estimates that mail order spending in the U.S. ranged from $71 - $155 B in 1996, for an average of $113 billion for the year. It posits that Internet retailing's growth may occur three to five times faster than mail order did, given the growth in the number of Internet users and the ease and efficiency of ordering from the Internet. Based on these assumptions, Morgan Stanley estimates that Internet retailing could reach $115 billion in five to eight years.

12. CommerceNet/Nielsen Spring and Fall 1997 Surveys. Spring survey polled 6600 representative households in the U.S. and Canada between December 1996/January 1997. Fall survey polled 9,000 representative households in the U.S. and Canada. http://www.commerce.net/news/press/121197.html and http://www.commerce.net/neilsen/press_97.html

13. "Internet Shopping." Ernst & Young, LLP. January 1998. Ernst & Young surveyed over 850 consumers and 150 companies about their present and future plans for the Web.

14. America Online.

15. America Online.

16. Delhagen, Kate et al. "Retail Revs Up." Forrester Research. Vol. 4, No. 6. October 1997. Forrester surveyed 300 consumers who had made an online purchase in the last 12 months. When asked to rank what they liked best about online purchasing, 50 percent of the respondents cited convenience, 22 percent cited ease of research and 11.7 percent cited good prices/deals.

    Ernst & Young's survey of 850 consumers revealed similar patterns. Fifty-three percent of current Web purchasers cited convenience, 46 percent cited choice/variety and 45 percent said to save money.

17. “Internet Shopping.” Ernst & Young, LLP. January 1998.

18. Goff, Leslie. “Online computer store forecasts growth.” *Interactive Age Digital*. 1997. http://techweb.cmp.com/ia/iad_web/networth/ccstudy/necx.html

19. SEC filings.

20. At CDNow, a consumer purchasing a CD that costs $12.58 pays an additional $2.99 for standard delivery, raising the price to $15.57, or an additional 24 percent. In this example, delivery is within 3-8 business days. CDNow has a maximum delivery charge of $4.97.

Amazon.com charges $3.00 per shipment and $0.95 per book for standard delivery (within 3-7 business days). For a book with a retail price of $16.77, delivery of $3.95 raises the total price to $20.72, or an additional 24 percent. Overnight delivery costs a premium: $8.00 per shipment and $2.95 per book. That $16.77 book would cost $27.72, or an additional 65 percent. Given the high delivery charges per single unit, it’s likely that consumers will combine purchases.

21. Hansell, Saul. “Money Starts to Show in Internet Shopping.” New York Times on the Web. December 1, 1997.

22. “Internet Shopping.” Ernst & Young, LLP. January 1998.

23. “1-800-FLOWERS announces key findings in on-line purchase habits...” 1-800-FLOWERS press release. December 23, 1997.

24. “Internet Shopping.” Ernst & Young, LLP. January 1998.

25. Comparison of SEC 10-Q filings.

26. Discussions with Amazon management.

27. Amazon points out that pricing at traditional bookstores is significantly higher than for all online bookstores. Thus, gross margin is on the order of 1,000 basis points lower for booksellers’ online operations versus their store operations.

28. Silverman, Robert. “Web ads pay off for autos: Auto-By-Tel signs ad pact with AOL, search engines...” *Inside Media*. Vol. 8, No.11. p. 28. May 29, 1996. Note: the actual quote from the article was: “Auto-by-Tel’s 1,400 member car dealer network estimates that nearly 300,000 new car buyers will tender purchase requests via the service this year, resulting in a potential of $1.8 billion in sales.” In fact, according to documents filed with the SEC and Auto-By-Tel’s own press releases, Auto-By-Tel generated 345,000 purchase requests for 1996.

29. Schwartz, Evan. “It’s!Not!Retail!” *Wired*. November 1997.

30. Ibid.

31. Tadjer, Rivka. “Many Ways to Go Online - - Can a service provider be your quick ticket to online brand-name recognition?” *CommunicationsWeek*. July 28, 1997. http://www.techweb.com/se/directlink.cgi?CWK1997072850065

32. Goth, Nikki C. “Sweet Smell of Success.” H!TS supplement, Red Herring online. Spring 1997. http://www.herring/com/hits/03/800.html

33. Ibid.

For more information, contact:

Secretariat for Electronic Commerce
U.S. Department of Commerce
Washington, D.C. 20230
202-482-8369