A perfect market

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E-commerce is coming of age, says Paul Markillie, but not in the way predicted in the bubble years

WHEN the technology bubble burst in 2000, the crazy valuations for online companies vanished with it, and many businesses folded. The survivors plugged on as best they could, encouraged by the growing number of internet users. Now valuations are rising again and some of the dotcoms are making real profits, but the business world has become much more cautious about the internet's potential. The funny thing is that the wild predictions made at the height of the boom—namely, that vast chunks of the world economy would move into cyberspace—are, in one way or another, coming true.

The raw numbers tell only part of the story. According to America's Department of Commerce, online retail sales in the world's biggest market last year rose by 26%, to $55 billion. That sounds a lot of money, but it amounts to only 1.6% of total retail sales. The vast majority of people still buy most things in the good old "bricks-and-mortar" world.

But the commerce department's figures deal with only part of the retail industry. For instance, they exclude online travel services, one of the most successful and fastest-growing sectors of e-commerce. InterActiveCorp (IAC), the owner of expedia.com and hotels.com, alone sold $10 billion-worth of travel last year—and it has plenty of competition, not least from airlines, hotels and car-rental companies, all of which increasingly sell online.

Nor do the figures take in things like financial services, ticket-sales agencies, pornography (a $2 billion business in America last year, according to *Adult Video News*, a trade magazine), online dating and a host of other activities, from tracing ancestors to gambling (worth perhaps $6 billion worldwide). They also leave out purchases in grey markets, such as the online pharmacies that are thought to be responsible for a good proportion of the $700m that Americans spent last year on buying cut-price prescription drugs from across the border in Canada.

Tip of the iceberg

And there is more. The commerce department's figures include the fees earned by internet auction sites, but not the value of goods that are sold: an astonishing $24 billion-worth of trade was done last year on eBay, the biggest online auctioneer. Nor, by definition, do they include the billions of dollars-worth of goods bought and sold by businesses connecting to each other over the internet. Some of these B2B services are proprietary; for example, Wal-Mart tells its suppliers that they must use its own system if they want to be part of its ▸▸

annual turnover of $250 billion.

So e-commerce is already very big, and it is going to get much bigger. But the actual value of transactions currently concluded online is dwarfed by the extraordinary influence the internet is exerting over purchases carried out in the offline world. That influence is becoming an integral part of e-commerce.

To start with, the internet is profoundly changing consumer behaviour. One in five customers walking into a Sears department store in America to buy an electrical appliance will have researched their purchase online—and most will know down to a dime what they intend to pay. More surprisingly, three out of four Americans start shopping for new cars online, even though most end up buying them from traditional dealers. The difference is that these customers come to the showroom armed with information about the car and the best available deals. Sometimes they even have computer print-outs identifying the particular vehicle from the dealer's stock that they want to buy.

Half of the 60m consumers in Europe who have an internet connection bought products offline after having investigated prices and details online, according to a study by Forrester, a research consultancy (see chart 1). Different countries have different habits. In Italy and Spain, for instance, people are twice as likely to buy offline as online after researching on the internet. But in Britain and Germany, the two most developed internet markets, the numbers are evenly split. Forrester says that people begin to shop online for simple, predictable products, such as DVDS, and then graduate to more complex items. Used-car sales are now one of the biggest online growth areas in America.

People seem to enjoy shopping on the internet, if high customer-satisfaction scores are any guide. Websites are doing ever more and cleverer things to serve and entertain their customers, and seem set to take a much bigger share of people's overall spending in the future.

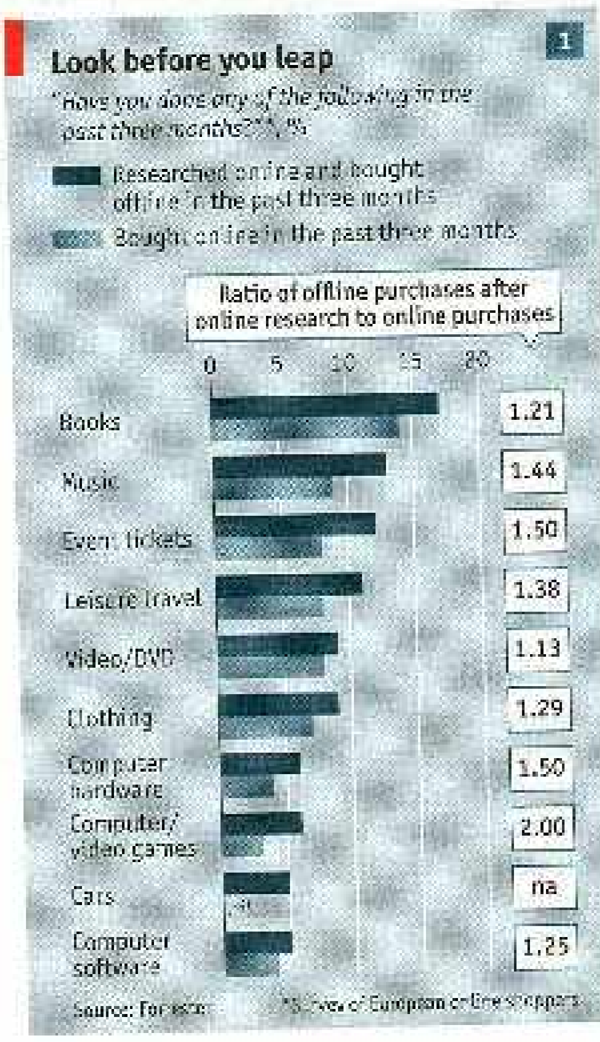
Why websites matter

This has enormous implications for business. A company that neglects its website may be committing commercial suicide. A website is increasingly becoming the gateway to a company's brand, products and services—even if the firm does not sell online. A useless website suggests a useless company, and a rival is only a mouse-click away. But even the coolest website will be lost in cyberspace if people cannot find it, so companies have to ensure that they appear high up in internet search results.

For many users, a search site is now their point of entry to the internet. The best-known search engine has already entered the lexicon: people say they have "Googled" a company, a product or their plumber. The search business has also developed one of the most effective forms of advertising on the internet. And it is already the best way to reach some consumers: teenagers and young men spend more time online than watching television. All this means that search is turning into the internet's next big battleground as Google defends itself against challenges from Yahoo! and Microsoft.

The other way to get noticed online is to offer goods and services through one of the big sites that already get a lot of traffic. Ebay, Yahoo! and Amazon are becoming huge trading platforms for other companies. But to take part, a company's products have to stand up to intense price competition. People check online prices, compare them with those in their local high street and may well take a peek at what customers in other countries are paying. Even if websites are prevented from shipping their goods abroad, there are plenty of web-based entrepreneurs ready to oblige.

What is going on here is arbitrage between different sales channels, says Mohanbir Sawhney, professor of technology at the Kellogg School of Management in Chicago. For instance, someone might use the internet to research digital cameras, but visit a photographic shop for a hands-on demonstration. "I'll think about it," they will tell the sales assistant. Back home, they will use a search engine to find the lowest price and buy online. In this way, consumers are "deconstructing the purchasing process", says Professor Sawhney. They are unbundling product information from the transaction itself.



All about me

It is not only price transparency that makes internet consumers so powerful; it is also the way the net makes it easy for them to be fickle. If they do not like a website, they swiftly move on. "The web is the most selfish environment in the world," says Daniel Rosensweig, chief operating officer of Yahoo! "People want to use the internet whenever they want, how they want and for whatever they want."

Yahoo! is not alone in defining its strategy as working out what its customers (260m unique users every month) are looking for, and then trying to give it to them. The first thing they want is to become better informed about products and prices. "We operate our business on that belief," says Jeff Bezos, Amazon's chief executive. Amazon became famous for books, but long ago branched out into selling lots of other things too; among its latest ventures are health products, jewellery and gourmet food. Apart from cheap and bulky items such as garden rakes, Mr Bezos thinks he can sell most things. And so do the millions of people who use eBay.

And yet nobody thinks real shops are finished, especially those operating in niche markets. Many bricks-and-mortar bookshops still make a good living, as do flea markets. But many record shops and travel agents could be in for a tougher time. Erik Blachford, the head of IAC's travel side and boss of Expedia, the biggest internet travel agent, thinks online travel bookings in America could quickly move from 20% of the market to more than half. Mr Bezos reckons online retailers might capture 10-15% of retail sales over the next decade. That would represent a massive shift in spending.

How will traditional shops respond? Michael Dell, the founder of Dell, which leads the personal-computer market by selling direct to the customer, has long thought many shops will turn into showrooms. There are already signs of change on the high street. The latest Apple and Sony stores are designed to display products, in the full expectation that many people will buy online. To some extent, the online and offline worlds may merge. Multi-channel selling could involve a combination of traditional shops, a printed catalogue, a home-shopping channel on TV, a phone-in order service and an e-commerce-enabled website. But often it is likely to be the website where customers will be encouraged to place their orders.

One of the biggest commercial advantages of the internet is a lowering of transaction costs, which usually translates directly into lower prices for the consumer. So, if the lowest prices can be found on the internet and people like the service they get, why would they buy anywhere else?

One reason may be convenience; another, concern about fraud, which poses the biggest threat to online trade. But as long as the internet continues to deliver price and product information quickly, cheaply and securely, e-commerce will continue to grow. Increasingly, companies will have to assume that customers will know exactly where to look for the best buy. This market has the potential to become as perfect as it gets. ■

Santa's helpers

Retailers are the top performers online

FOR retailers, the two months before Christmas are the busiest time of the year. The same is true for e-tailers, who enjoyed an exceptionally good holiday season last year. Lots of records were broken: Amazon, for example, took more than 2m orders worldwide in a single day. What is intriguing, however, is not so much that the online traders increased their share of spending (the dotcom community still takes rapid growth in its stride) but that consumers are changing their behaviour.

In November and December 2003, Americans spent $18.5 billion online (excluding travel), 35% more than they did in the same two months in 2002, according to a joint survey carried out by Goldman Sachs, Harris Interactive and Nielsen//NetRatings. The popular perception is that online retail sales rely heavily on gadgets, mostly bought by young men. Not so. Over the holiday period, the most popular category was clothing, up by 40% to $3.7 billion, followed by toys, video games and consumer electronics, which grew little in value because of falling prices (see chart 2).

The overall growth, says the report, was fuelled by the rising number of high-speed broadband links, which now connect 50m American homes to the web. This makes online shopping faster and more convenient. It was a similar story in those countries in Europe and Asia where internet connections are becoming quicker.

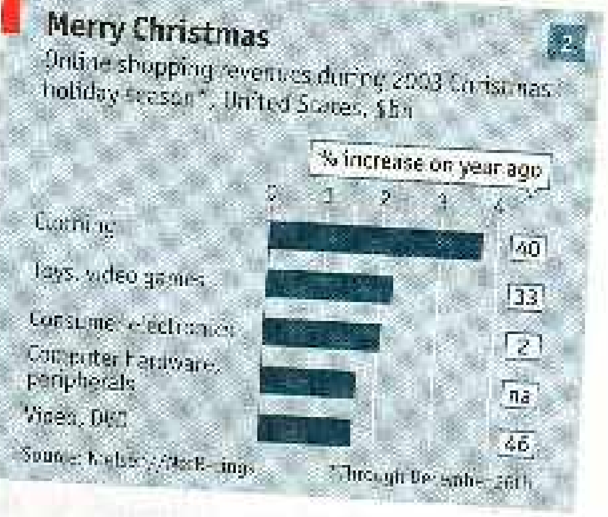
Spending patterns on the internet are also getting closer to those on the high street. For instance, in Britain last year women spent more online than men: £495 ($809) against £470 per person. The growth in spending by female online shoppers was 71%, six times faster than that for men, according to Verdict, a retail consultancy. This helped to boost Britain's total online market by 36% to almost £5 billion last year, which meant it grew nearly ten times faster than total retail spending.

Older people, too, are using the internet more to shop. "The over-55s have flooded online over the past year, and they are spending more than any other age group, at £527 per head," says Verdict. Groceries, electrical goods and home-improvement products are particularly popular with the older set. But for all age groups, convenience seems to have overtaken price as the main reason for shopping online.

Much of the online shopping is heavily concentrated on a few sites. In January 2004, 83.5m Americans, or just over half of the country's internet users, visited either eBay or Amazon, making these sites among the most frequently visited retail outlets in the country, both online and offline, according to comScore Networks, a technology consultancy. Search engines have also generated sales on a huge scale. Sites such as Google, Yahoo!, MSN and AOL are used increasingly to find and buy products. Search sites now compare prices from rival retailers for many products.

Sell it cheap

How does Seattle-based Amazon, the leading online retailer, cope with such price transparency? The first part of the answer is simple, says Mr Bezos: "The approach we take is actually to have low prices." The second is to accept that there is transparency. So if one of the big retailers who now also sell through Amazon, such as Circuit City or J&R, manages to clinch a better deal with one of their suppliers and offer a lower price, Amazon has to reduce its own price, lose sales or keep its fingers crossed that it will win the order for reasons other than price.



Pricing on the internet may well become totally transparent, says Kellogg's Mohanbir Sawhney; but the notion of value remains opaque, and this is where online merchants can compete—even with different prices. The "value proposition" offered by a merchant can mean different things. People might simply like one trader better than another and so be prepared to pay a little more; they might be placing multiple orders and can save money by taking advantage of a free-shipping deal; the site could have recommended something to them based on their previous buying or browsing habits; or they stumbled on something they did not know about and found irresistible.

Amazon's business model is built on five fundamentals which it thinks will not change: low prices; a big selection; availability; convenience; and good information about products. "We are not going to wake up ten years from now and find people saying: 'This is all well and good, but I wish the prices were a little higher'," says Mr Bezos.

In its efforts to become "Earth's most customer-centric company", Amazon is ▸▸