Executive Insights

Future of Retail: Navigating Delivery Dynamics to Improve Ecommerce Margins

Ecommerce is now an inescapable feature of the retail landscape. It offers consumers wide choice, low prices and the convenience of home delivery, and provides businesses with the opportunity to extend their reach beyond their local catchment areas.

But ecommerce also increases competitive pressure for retailers by making the fulfilment of online orders a key contributor to the overall customer experience. Speed and convenience are two features highly prized by shoppers, and the need to compete on both is challenging retailer economics.

In this *Executive Insights*, L.E.K. Consulting examines the delivery dynamics of online sales and outlines the steps businesses can take to develop a profitable ecommerce proposition.

Online challenges

About 1 in 5 retail transactions in the U.K. are completed online, and 4 out of 5 consumers have bought something online during the past year (see Figure 1). Ecommerce penetration continues to grow across retail categories, from groceries to household goods and electricals to clothing (see Figure 2).

Consequently, the basis of competition amongst retailers and brand owners has shifted. Consumers now have unparalleled access to product choice online and are readily able to switch from one retailer to another in search of the best offer. Retailers are therefore increasingly under pressure to compete in terms of the quality of online merchandising, convenience of rapid delivery to customers' homes or to other suitable locations, and flexibility of product returns.

Figure 1

U.K. ecommerce statistics

Channel penetration

- 20% of transactions are completed online
- 80% of consumers have completed an online product purchase in the past 12 months
- 40% of online retail transactions are on mobile devices

Main reasons for shopping online

- More than 50% of consumers indicate price comparison, product choice and convenience as the top reasons for shopping online

Delivery expectations

- 90% of consumers are influenced by the availability of free shipping and the retailer's online delivery rating
- More than 45% expect free delivery with no minimum order size
- 40% do not complete an online order because of delivery charges

Influence of returns policy

- More than 30% of products purchased online are returned compared to less than 10% of products purchased in-store
- 80% of consumers expect returns to be free
- More than 65% of consumers read the returns policy before making a purchase

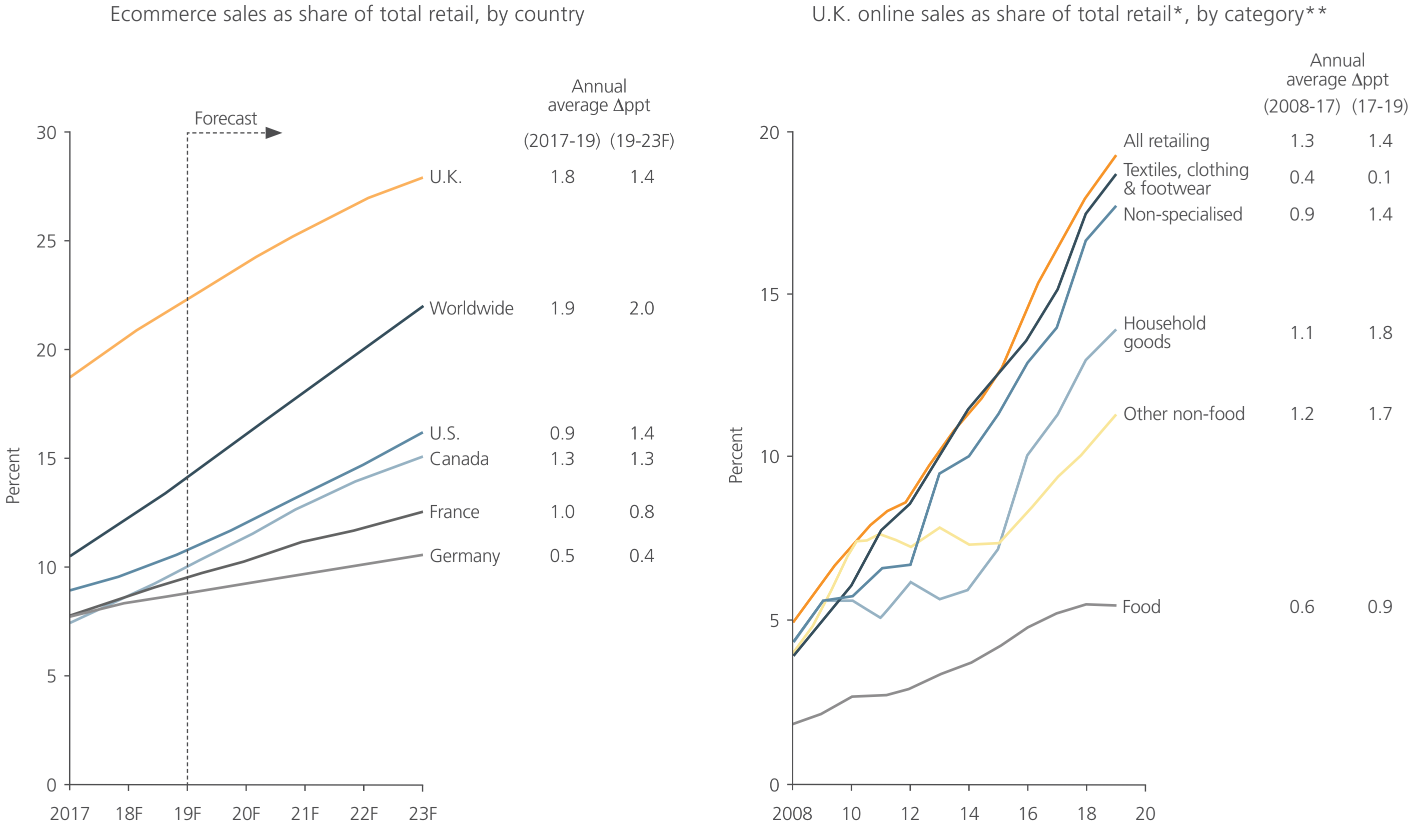
Note: all figures are approximations. Source: Nasdaq, Royal Mail, eMarketer, Retail Gazette

Future of Retail: Navigating Delivery Dynamics to Improve Ecommerce Margins was written by **Vassilis Economides** and **Mark Boyd-Boland** Partners at L.E.K. Consulting. Vassilis and Mark are based in London.

For more information, please contact consumerproducts@lek.com.

L.E.K.

Figure 2
Growth in ecommerce



Note: *excludes expenditure on services such as holidays, air fares and train tickets, insurance, and banking; **non-store retailing not shown
Source: eMarketer, ONS, US Census Bureau, L.E.K. analysis

From a delivery perspective, this has led to the emergence of a number of new propositions. Options include within-the-hour (e.g., Sainsbury's Chop Chop, Amazon Prime Now, Ocado Zoom), same-day (Sainsbury's, Argos) and timed next-day delivery (Currys, AO).

Just as important is optimising the experience of product returns, such as by allowing customers to try before they buy (e.g., Amazon Wardrobe), effortless home pickup and extended returns — Hawes & Curtis and Boden, for example, offer a three-month returns policy as standard.

Although penetration of online sales originally grew primarily in 'low touch' household commodity products (such as books), it is now also increasing rapidly in 'high touch' products (such as homewares and fashion) that are more experiential in nature — as consumers are overcoming natural barriers to online purchasing.

For low-touch products, a lower average order value often creates challenging economics for home delivery. Deliveroo exemplifies the challenge of many well-known consumer businesses that are still struggling to generate profits from online orders and home delivery, despite explosive revenue growth.

For high-touch products, offers like try-before-you-buy have helped increase sales but can be unprofitable, especially among consumers who deliberately over-order and then return most or all of the items.

As a result of these challenges, some high-street retailers, particularly those operating on narrower margins (such as Primark, Lidl and Aldi), are choosing to stay out of ecommerce. Yet for the majority of retailers, being limited to bricks-and-mortar retail is not tenable — ecommerce is unavoidable, and the key question should not be 'if' but rather 'how' to develop a profitable ecommerce proposition.

Order economics

To build a profitable ecommerce business, retailers must actively measure and manage the economics of their online activities. This means examining profitability by customer, product category, and ordering or fulfilment channel. The analysis will reveal the profitability of each product or service, and the locations or regions in which the ecommerce business is performing best.

Once retailers have a grasp of order economics, they can use four levers to develop and maintain a sustainable and profitable ecommerce business:

1. Implement variable delivery charges
2. Drive increase of average basket value
3. Reduce cost per delivery
4. Manage product returns

Implement variable delivery charges

Consumers increasingly expect their orders to be delivered free. To balance the cost and profit impact, retailers often apply a minimum order threshold so that free shipping is limited to orders with positive profit contribution. John Lewis and Debenhams, for example, offer free standard delivery on orders above £50; smaller orders incur a delivery charge.

A minimum order threshold can have significant indirect benefits for retailers. Research by HBS has confirmed that free shipping thresholds motivate consumers to increase their total expenditure. In doing so, consumers may not make optimal choices to reach the minimum threshold, often leading to order values well above the minimum[1].

Variable delivery charges based on the speed of delivery and delivery subscription models are also being used to recognise the value consumers attach to rapid or convenient delivery. Asos has a menu of delivery options that include standard delivery (free above a threshold), next-day delivery, precise delivery (next-day delivery with a designated one-hour slot) and Asos Instant (same-day delivery in specified high density locations). It also offers unlimited premium delivery options for a fixed annual fee.

Third-party business models are emerging to enhance retailers' delivery propositions. Buymie in Ireland varies its delivery fee based on the required speed of delivery, and City Sprint's On the dot in the U.K. focuses on flexible timeslot deliveries.

Drive increase of average basket value

The economics of home delivery are underpinned by the relationship between average transaction value (and more specifically cash margin) and the delivery cost per order. This equation explains why some retailers have been slower to embrace ecommerce or have struggled to derive sustainable profitability from web sales. For example, prior to its partnership with Ocado, Marks & Spencer struggled to compete in the home delivery market with a lower average basket value than its competitors, driven by the convenience-led shopping mission of M&S customers and a narrower product range.

As a result, strategies that increase average basket value can fundamentally transform home delivery economics. At a basic level, basket values can be influenced by setting minimum order levels, charging for delivery on sub-scale orders and offering incentives for larger basket sizes — e.g., promotions and discounts based on order size.

At a more sophisticated level, retailers can promote cross-sales, increasingly assisted by artificial intelligence shopper profiling to create advanced, personalised product recommendations. Sports Direct's online checkout page features a small number of complementary 'impulse' add-on purchases, as well as higher-value 'recommendations for you'.

[1] Chaoqun Chen and Donald Ngwe, "Shipping Fees and Product Assortment in Online Retail", Harvard Business School.

Another strategy entails developing ancillary propositions or partnerships that enrich the core offer. Ocado, for example, has embedded relationships with partners such as Fetch (the online pet store) and Fabled (the online beauty store now owned by Next) into its main booking platform.

Reduce cost per delivery

Cost per delivery is inversely related to the number of orders and delivery density in each catchment area that a business serves.

The absence of these preconditions in a specific area raises fundamental questions around the appropriate fulfilment model. In those cases, partnering with a third party may be a prerequisite for profitable home delivery, or alternatively may render a click-and-collect model as the only viable fulfilment option. There is no one-size-fits-all model, and the proposition often needs to be tailored to local market conditions and order density.

Net cost per drop — cost per drop minus any delivery charges — is key to a sustainable fulfilment proposition. The cost can be reduced by using planning algorithms to increase deliveries per hour through route efficiencies and more drops per route. This needs to be balanced against the overall capacity of delivery assets, especially at the point where incremental growth is possible only with the addition of extra capacity at significant additional cost.

Techniques to manage delivery yield can further support delivery economics by influencing customer choice about how and when items are delivered. For example, some grocery providers use differential pricing to incentivise customers to choose delivery windows that help consolidate deliveries and increase drop density. Ocado, for example, sets delivery charges by taking into account the attractiveness of certain delivery slots and the likely capacity constraints.

Manage product returns

For high-touch products, returns can blight the profitability of an online business. Carefully managing frequency and cost of returns pre-purchase and post-purchase, without jeopardising the customer proposition, can make the difference between an ecommerce business making losses or profits.

At a pre-purchase level, return management starts with product selection and quality control. Improving how products are presented to customers — high quality photos, detailed descriptions, and accurate information on product sizing, fit and other attributes — can dramatically improve product alignment with customer requirements. Uniqlo, for example, has introduced a 'Find your perfect fit' function that helps shoppers identify the correct size based on their height and weight.

Technology continues to transform how products are presented to online customers. Virtual trial rooms show how retailers are looking to provide an enhanced customer experience and cut the costs of returns. Emerging services include virtual dressing rooms such as Metail, and personalised fit recommendations such as True Fit and Virtusize.

Terms and conditions also influence the frequency and financial cost of returns. Examples include unsubscribing customers who abuse the right to return, limiting the number of returns per customer or per order and requiring customers to drop off items to specified collection points.

Amazon has a comprehensive approach to managing the economics of returns while limiting negative impact on customer convenience and, ultimately, satisfaction. It requires customers to drop off unwanted products at a broad range of designated locations, and adds return charges depending on the reason for return.

The future

Over time, autonomous vehicle technologies and business models will transform both the consumer experience and the economics of 'last mile' delivery, creating opportunities and challenges for existing retailers.

Early adopters will have the opportunity to build the capabilities and scale to provide a differentiated proposition while potentially generating both increased throughput and superior economics by acting as logistics service providers to third parties. Retailers such as supermarkets, which have large physical networks and excess in-store warehousing capacity, may be able to turn their current impediment into an advantage, by providing local aggregation and fulfilment services that support last-mile delivery.

On the other hand, retailers that are slow to adapt may find their proprietary customer fulfilment displaced by — and the bargaining power shifting towards — third-party, last-mile service providers such as Uber, Deliveroo and Amazon. Such companies have the technological capabilities and investments to deploy, at scale, autonomous vehicles on the ground or in the air.

Retailers may also find themselves disintermediated by consumer brand owners that find new economical paths to access and serve consumers directly, disrupting the economics of the traditional ecommerce value chain.

All retailers need to act decisively now, to both capture the near-term opportunities of ecommerce and to anticipate disruption. This requires a clear focus on order economics, and a willingness to embrace new service propositions and technologies.

Businesses that lead the move to autonomous delivery stand to transform their expensive and declining store networks into critical assets to win in the last-mile delivery wars that are on the horizon.

About the Authors

Vassilis Economides is a Partner and head of L.E.K.'s London office. He is a member of L.E.K.'s global Consumer practice and has extensive experience advising major organisations in Europe, the U.S. and the Middle East. His specific areas of interest are go-to-market strategy and capabilities, operating model transformation, organisational design, cost management, performance improvement, and sales and marketing effectiveness. Vassilis holds an MBA with distinction from INSEAD.

Mark Boyd-Boland is a Partner in L.E.K. Consulting's London office and a member of our global Consumer practice. He has extensive experience advising clients across the retail, consumer products and travel & leisure sectors, having worked on a broad range of strategic engagements, including growth strategy, digital strategy, proposition development, customer segmentation, loyalty & customer experience and market entry. Mark holds an MBA with distinction from INSEAD.

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