L.E.K.

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Reaching for Value: Net Shareholder Value

Today, if you took a poll of individual stock market investors about prospects for shareholder value creation from the Internet, you'd probably wind up with some pretty gloomy responses.

With the notable exception of a few big winners such as Amazon, eBay and Google, there have been far more high-profile losers than winners over the last ten years. While many venture capitalists and bankers got rich in the early Internet euphoria, millions of individual investors saw real wealth destroyed.

Would a poll of business leaders in retail and B2B companies lead to substantially different responses? Based on my work with a wide range of companies in the U.S. and abroad, I'm not sure. Many business people seem to think that the transformational potential of Internet-based commerce was oversold during the Internet bubble, and it is sufficient now to have created an e-commerce group with a web site and a VP – a group with a contribution to make, but a sideline to the traditional business where the real money is made. They seem to think that Amazon is the rare exception: a company that succeeded by using the Internet to fundamentally redefine the way business is done.

If they think that, they're wrong. Amazon *is* exceptional but it is far from the only winner on the Web. There remains huge untapped potential to create what might be called "Net Shareholder Value," especially for companies that already have a loyal base of customers whom they are serving through traditional channels, such as retail stores or direct sales organizations.

Let's revisit those glowing assumptions that dominated the thinking about the Internet in the late 1990s, and led to those massive (and in many cases, outlandish) valuations. People assumed that:

- the Internet presented a much lower cost structure than traditional channels
- the Internet would render obsolete and irrelevant companies with established brick-and-mortar infrastructure
- power and economic rent would shift away from suppliers with traditional channels in favor of "pure" Internet companies that "owned the clickstream"

As it turned out, the first of these three assumptions has proven only partly true. The other two have proven mostly false.

Obviously, a web site-and-distribution-warehouse combination has lower overhead costs when compared to a network of stores all over the country – stores with sales staffs, security systems, merchandise displays, local inventory, and so on. But e-commerce businesses require substantial fixed-cost investments, including product sourcing, warehousing, and logistics. Webvan, for example, signed a billion dollar contract with engineering giant Bechtel to create the automated warehouses that sat at the heart of its business model.

Reaching for Value: 'Net Shareholder Value was written by **Stuart Jackson**, Vice President of L.E.K. Consulting and author of *Where Value Hides: A New Way to Uncover Profitable Growth for Your Business* (Wiley 2007). This article is © Emerald Group Publishing Limited and first appeared in the Journal of Business Strategy.

As for the impending irrelevance of brick-and-mortar businesses, it has become clear that "pure play" Internet companies have substantially underestimated the cost of customer acquisition. Building a base of repeat customers through advertising or click-through referral fees is still the highest single cost for emerging Internet businesses - and is the main reason why so many continue to lose money years after their launch. Webvan's high-tech warehouses worked well, but there were never enough customers to sustain them.

In fact, far from becoming obsolete, brick-and-mortar businesses have proven an almost indispensable part of 'Net Shareholder Value. Some of the greatest Internet successes have been racked up by retailers with established infrastructure exploiting the Internet to achieve the best of both worlds. While most of the largest e-commerce sites are linked to brick-and-mortar retailers (Staples, Office Depot, and Sears are all top ten e-commerce retailers), relatively few are stand-alone Internet companies. A number of major retailers are currently experiencing double digit sales growth at their shopping web sites, even while in-store sales are flat or declining. For example, Victoria's Secret had an eight percent decline in same store sales for the first quarter of 2008, but an eleven percent increase in catalogue and on-line sales. Most research shows that these results are not the result of cannibalization between channels. Rather, it illustrates that Internet sales represent added revenues from customers who like the brand and product selection, but don't have the time or inclination to visit the physical stores.

So, have power and economic rent shifted away from traditional suppliers and channels? No. For the most part, the Internet has made product and content suppliers stronger, rather than weaker. Three of the top ten e-commerce companies (Dell, HP, and Apple) are product businesses that use the Internet to bypass traditional channels and go direct to their customers. Dell led the way in developing low-cost, Internet-based sales to consumers and businesses, with HP and Apple quickly following. Today, Apple sets the standard for integrated e-commerce and highly productive retail stores.

Going further outside the retail industry, airlines have saved hundreds of millions of dollars by effectively disintermediating travel agents and selling direct to consumers and businesses.

As for content providers, the availability of broadband digital communication has substantially expanded the routes-to-market options for sports franchises, and has increased their pricing power vis-à-vis TV stations and cable operators. Some teams have gone so far as to launch their own channels.

So, what are the lessons from e-commerce successes and failures over the past ten years, and how should companies position themselves to capture "Net Shareholder Value" over the next ten years? The most important insight is to stop thinking about the Internet as a separate business from other channels to market. E-commerce and off-line businesses selling the same products are competing in the same strategic market segment. Competitive advantage will go to those who can achieve overall scale benefits superior to the competition (taking into account customer acquisition costs as well as physical infrastructure and operating overhead costs). In most situations, the best way to achieve this will be through an integrated offering, leveraging multiple channels. There are a number of specific strategies involved in making this work:

1. Create benefits to customers from multiple channels. If your combination of physical and virtual channels offers an array of services to your customers that neither alone can match, then you have created a major competitive advantage against purely on-line or traditional competitors. Look at it from a customer's point of view: Can they graze an on-line catalogue, make a purchase, and go pick it up at the closest store in your chain? Or, going in the other direction, can they visit your mall store, actually sit down in the particular chair that's caught their eye, then go home, order it on-line, and have it shipped to their home? Can they return an item purchased on-line to one of your brick-and-mortar stores, if that's more convenient for them?

2. Use the Internet to strengthen your brick-and-mortar business, and vice versa. When established retailers or product businesses venture into e-commerce, they can leverage their existing product sourcing infrastructure. They can reduce customer acquisition costs (a big piece of Webvan's downfall) by leveraging their existing brand awareness and customer contacts. Apple, for example, sends receipts for in-store sales by e-mail to capture e-mail addresses for its e-commerce channel.

3. Unshackle your e-commerce business from off-line constraints. Your established off-line business may be constrained by all sorts of limitations that don't apply to on-line sales. Avoid the trap of simply replicating your off-line business in on-line form. For example, on-line stores can carry a much broader selection of sizes and colors than would be practical in a physical store. Grainger, the industrial supplies company, added 44,000 products in the last year alone, taking advantage of its centralized warehousing and shipping systems. Companies with multiple store formats can allow customers to place their product in a single on-line shopping basket with a standard shipping charge, as was recently announced by Gap Inc. for its Old Navy, Banana Republic, Piperlime, and Gap stores. To keep in touch with on-line customers, email allows frequent, customized and virtually free communication that would be impractical through direct mail or other tools.

4. Break down organizational barriers. A recent episode of the TV show *The Office* showed the head salesman desperately trying to persuade a customer to continue ordering office supplies through him rather than going through the new Web site. A humorous fictional example, but one that has been played out in thousands of real-life organizations selling everything from office products to medical supplies. A company spanning both on-line and off-line routes to market can only reach its full potential if people on both sides of the organization are working together, and if the on-line group has sufficient CEO-level visibility to avoid being crushed by the scale of the established off-line business. Overcoming this requires appropriate organizational design, and a degree of shared incentives. It also requires that off-line leaders recognize the potential contribution of e-commerce while on-line groups likewise recognize how much they depend on the brands and product offerings already developed by the organization.

In 2007, retail e-commerce amounted to $136 billion – under 5 percent of retail sales. On the B2B side, there are some early adopter categories, such as office products and industrial MRO supplies, where e-commerce penetration approaches 15 percent. However, there are many more categories in which it is closer to zero. The untapped potential for e-commerce far exceeds what has been achieved to-date. For companies able to achieve this potential faster than the competition, there are still billions of dollars of "'Net Shareholder Value" to be realized.

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