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PEAPOD.COM: INTERNET GROCER STRATEGIES

Teaching Note

Case Synopsis

Peapod.com describes the birth and evolution of one of the first egrocers. The different operational strategies that Peapod adopted over time are documented: in-store picking, centralized fulfillment centers, and its brick&clicks partnership with Ahold. A short description of its nemesis, Webvan, is also provided, together with some operating data (that will be very useful to do a valuation of Peapod).

The case takes as its starting point the drop in Peapod's share price, which stabilized around $1. The exponential decline in Webvan's share price is even more spectacular. While Webvan, one of the prime examples of the Internet bubble of the late 1990s is no more, the case asks whether the egrocer business process "makes sense" and, if so, to identify a path to profitability for Peapod.

Case Purpose and Use

The case provides a rich context within which to examine:

1. Service & Operations strategies that home-delivery grocers can choose from. [mainly qualitative discussion]
2. Detailed description of various fulfillment processes. [mainly qualitative]
3. Valuation of financial performance using operational "process thinking":
   - Identification of key operational drivers via activity analysis,
   - Estimation of key productivity numbers,
   - Valuation of financial performance.

   Yes, this is the meat of the case: the outcome is a true income statements with hard dollar numbers! The financial emphasis of the case makes it of interest to a wide audience.

   [qualitative & quantitative]
4. Identification of "shortest path to profitability" and larger strategic discussions [qualitative & quantitative]
5. The case can also be used as an example of the framework to think about the Internet channel, as discussed in "Which e-Business is Right for Your Supply Chain?" by Chopra and Van Mieghem, *Supply Chain Management Review,* July/August 2000. [qualitative]

Assignment Questions

Professor Jan A. Van Mieghem prepared this teaching note for the sole purpose of aiding classroom instructors in the use of his case Peapod: Internet Grocer Strategies. *It provides analysis and questions that are intended to present alternative approaches and to energize classroom discussion.*

The following assignment questions can be distributed to students prior to their preparation for class discussion:

1. What are the pro's and con's of the different Internet strategies?
2. What drives profit performance in this business? Identify key drivers.
3. What is the "shortest path" to profitability, if one exists? Which key metrics would you watch and benchmark?

Teaching Plan

The attached document (or file: Harley Teaching Note2) outlines my detailed preparation of teaching the case. (I have taught the case four times this Fall 2001: three times in MBA electives and once in an executive program. General reception was really good and, at least equally important, I really enjoyed teaching this case.

I believe this case draws its strength from the inherent familiarity of the service (everyone knows about grocery shopping and most have heard and have strong feelings about Internet approaches), and from the realism of the problem and analysis: combining traditional process activity analysis to finally come up with a financial income statement estimate that comes very close to the actual one. It is my best example of how to "marry" operational thinking with financial analysis.

My general plan will be to follow the sequence of assignment questions above, discussion first the broad, qualitative strategic issues and focusing in on the specific activity and financial analysis later. End with improvement plan and discussion of larger strategic questions (time permitting). My timing has consistently been:

1 hour: introduction, description of different strategies and processes, qualitative pro and con.

1 hour: deriving the "key business hypothesis" of the egrocer, the components in the costs differential with a traditional supermarket, and finally the estimation of productivity numbers and the income statement.

20 mins: improvement plan and broader strategic questions.

(Opening questions are in italics: See next)

1. Peapod Introduction

1. My Intro

- Peapod has been in business for more than 10 years
  - Started by Northwestern Univ computer science undergrads. They developed software that first ran on an NU mainframe.
  - Nice story: from initial startup based on a new idea to national business in an extremely competitive industry. It shows how Peapod changed/adapted its operational strategies.
- Show Exhibit 1: however, after the Internet bubble burst, the question now becomes whether Internet grocers can ever be profitable and, if so, what is the shortest path to profitability? (You may have heard that Webvan went bankrupt in July 2001.) We'll follow this outline:
  - Understand the business & processes
  - Adopt the Strategy-Operations-Profit Flows framework to distill key drivers of performance
  - Financial evaluation of the operations
  - Suggestions for shortest path to improvement

2. *Who's used an Internet grocer? What's your experience?*

- Ask them how it works: set-up the discussion for the process
  - » Good reference article (summarized below is Mike Langberg).
- *What's so great about it?*
  - From the customer perspective, many great things:
    - » deliveries are on time,
    - » produce and meats are first rate,
    - » prices are comparable to conventional supermarkets
    - » and ordering from the Web site is easy.
  - In short, e-grocers did it 'right' but:
    - » The price for this excellence has been high for warehouses, delivery trucks, automated ordering and fulfillment systems ($1B for Webvan)
    - » Despite all of this, it still hasn't caught on that much
- *What are some of the problems you encountered?*
  - Procrastination: Mike Langberg's "banana story"
    - I have a banana for breakfast every morning, and that banana is choking Webvan.

- ``I've been converted from skeptic to big fan," I wrote last year. ``I'm going to be ordering regularly from Peapod and Webvan." Not true. To my surprise, I never became a regular customer of either online supermarket.
- That banana is perhaps the biggest reason: I regularly find myself eating the last one in the house and realizing I won't have a banana the next morning unless I stop at the supermarket on the way home from work.
- So I'm still in the express check-out lane at Safeway or Albertson's at least once a week buying a bunch of bananas and a few other things my family needs.

» For egrocers, you have to anticipate your needs at least 24 hours in advance. Most of us simply aren't that organized. And if you're going to the supermarket anyway for last-minute needs, you'll probably do most of your grocery shopping there.

– Forced one-place shopping: “Toilet paper effect”

- One may prefer to buy certain items at different stores; egrocers’ delivery fees induce people to place big orders at one store.

– New product learning

- Typically, by strolling through a supermarket we see new product introductions at no effort. On a website one must go through new clicks etc.

– Attended delivery is typically required

- Streamline, also bankrupt now, used to place outside storage + refrigerators at customer homes. Clearly, too expensive
- Peapod now allows unattended delivery, which can work in suburban sites.

◆ These problems may explain the major problem of egrocers: why don’t customers return after the first experience?

– See later: customer acquisition process

– This shows the limitations of the Internet as a new technology

» Recall Jack Welsh’s quote: “there is no new economy, only new technology”

» This case really is about the application of new Internet technology and analyzing its fit/appropriateness in the grocery business.

2. Understand the business: Key Processes

1. Customer order process

◆ Walk through the Powerpoint slides and retell the story laid out in the case

◆ Compile the main activities in Internet shopping:

– Go to website = direct contact to the company

– View information + prices

– Place & Track order

– Fulfillment

- Payment

2. Fullfillment Process

- This is a good point to discuss some of the logistical details:
  - How pick & pack works
  - The storeage lane and van loading process (in FILO order)
  - The IT software used:
    - » Website
    - » Palms: picking decomposition and routing
    - » Delivery routes

3. Customer Acquisition Process

- Obviously, a major determinant of success, especially for a startup. While this is more a marketing concern, some basics:
  - Marc van Gelder told me (Aug, 2001): out of all people entering address and name on website, only 17% actually buy. They consider the following steps in **customer acquisition** process: transform
    - » 1. web site visitor into customer
    - » 2. a first-order customer into a third-order customer
    - » 3. once a customer has placed 3 orders, Peapod's experience is that that customer has become a loyal customer.
- Customer acquisition costs:
  - Webvan: $195
  - Streamline: up to $1000! (I believe that may reflect the cost of the storage fridges.)
  - Peapod: $75

3. Different eGrocer Fulfillment Strategies: Qualitative Pro & Con

1. Existing store picking (early Peapod & Tesco model)

- Pro's:
  - Think of the store as a warehouse: it is close to where people live, it is simple to pick from because the layout is designed for customers to navigate, infrastructure is there and it is already part of a supply chain.
  - Excellent start-up model. (Actually, Mr. Higginson, Tesco's finance director, believes that the stores can comfortably handle 1.5billion pounds a year in online sales before Tesco needs to build its own dedicated warehouses.)

- Accounting gimmicks: every operation must charge direct expenses, such as vans and pickers, against its online revenues. But the pure play dotcom rivals also have to shoulder the running costs and depreciation charges of their warehouses, whereas the cost of Tesco's stores, including depreciation and lighting, is booked against its offline sales. (Tesco also charges 5 pounds per delivery.)

◆ Con's:

- More decentralized (although supermarkets already have the scale)
- Risk of "crowding out shoppers"
- Stock outs at the local grocery store.
- Grocery store price variation and margins.
- Limited by the SKU's in the local store, which may not be consistent across all stores.
- Scalability.
- Difficult to build strong brand image and deep customer relationships if the person involved in a handshake does not portray a consistent image and behavior.
- Peapod early: This model relied on using temporary workers and their vehicle for the delivery. Since the carriers were using their personal cars, the capacity was limited by trunk size and thus limiting the scale both from product variety as well as area served as the carrier needed to get back to the stores often. There was an overall lack of consistency that created variations in the customer experience and did not help with brand building.

2. Centralized DCs

◆ Big scale

◆ Fast-pick = adjacent to regular store

- Boston has 4 fast-pick centers:
  - » Better for transportation, startup
  - » Worse for real-estate, management, lower productivities, coordination

3. Bricks & Clicks Hybrid strategy (current Peapod): four advantages

◆ 1. procure through Ahold's immense purchasing power (5-7% advantage over pure-play—see below)

◆ 2. co-branding in marketing

- this affects the customer acquisition process greatly (see below)
- advertise on trucks and in stores both the Peapod brand and the Stop & Shop brand
- do in-store promotion for Peapod
- integrate "bonus points" lists (similar to an airline consortium)

◆ 3. use of existing infrastructure:

- real estate
- storage
- existing supply chain

- 4. corporate services:
  - HR (401K; health etc.), legal, and financial reporting

4. Top-Level Key Performance Drivers

1. Basic hypothesis of eGrocers:

- P.3: "The centralized distribution model is predicated on the assumption that its costs are lower than those of operating several stores."
- Let us test this hypothesis! Current NPV of company is negative, what does it take to be profitable?
  - Obvious answer is: have more customers, but sometimes they don't come as fast, frequently, or quickly as needed (as Webvan found out!)
  - Thus, we'll do a conservative analysis: assume constant or small increase in customer base and check whether there is a road to profitability under this slow growth scenario.

2. Compare processes at egrocer with those at supermarket

- Show animated Powerpoint slide.
  - Egrocers can get closer to ideal pull system than supermarkets
- Use my Strategy-Operations-Performance framework
  - How can Egrocer improve profit flows?
  - Work on productivity -> we should look at
    - » the marginal costs of
      - supplier mgt (purchasing mainly here)
      - processing (DC ops)
      - customer mgt (delivery ops + customer care)
    - » utilization of fixed assets (Property, Plant & Equipment)
  - Work on growing revenues -> we should look at
    - » Increasing value proposition
    - » What does this require of our ops?
- ΔC = Cost differential between egrocer and supermarket =
  - plus sourcing (purchasing of goods) cost differential
  - plus DC ops = pick, pack, load

- plus delivery ops = "the last mile"
- minus cost of operating several stores

◆ ΔV = Value differential between egrocer and supermarket =

- how much more valuable is the egrocer service to consumers? (see next)
- clearly, the price differential between egrocers and supermarkets cannot be larger than ΔV

3. Key Profitability Condition: $\Delta V > \Delta p > \Delta C$

◆ Let's now analyze these two terms

5. The Value differential ΔV: Revenue opportunities of egrocer

1. *What are the typical opportunities for revenue growth when using the Internet channel?*

◆ Build up the slide in general

2. *What can be exploited by an egrocer?*

◆ Again do slide

◆ Notice that there is negligible opportunities for inventory pooling savings etc. because a typical supermarket chain already has a rather large scale.

- That may be different for a national specialty store (say, Belgian chocolates and beers) or a store that plays on assortment, but that's not the case with peapod (in fact, their # of SKUs is quite a bit smaller than that of a regular supermarket (around 50,000 now!)

3. Conservative:

◆ Most of the Internet hype was based on the assumption of huge , which is hard to value. We will use a conservative approach and consider only the value of home-delivery. Then we get an upper bound on the price differential that an egrocer can charge: $\Delta p < \Delta V\_home\ delivery$

6. The Value differential ΔC: Cost opportunities of egrocer

1. *What are the typical opportunities for cost reduction when using the Internet channel?*

◆ Build up the slide in general

2. *What can be exploited by an egrocer?*

◆ Again do slide

3. Cost of operating several stores

- *What are the savings from not operating several stores?*
  - The key question is how many stores are "replaced" by one DC
- It would be very interesting to see Louis Borders' first business plan and how he justified the huge investment in automated DCs. Most likely he did an analysis similar to ours. However, a big part must have been his overly optimistic estimate of the savings from not operating stores.
  - Borders' estimated that at capacity one of his DCs would be equivalent to 25 traditional grocery stores.
  - If you then run the numbers on real estate (FC) and variable labor and energy savings, you probably can make this look good.
- But in actuality, one Peapod DC is equivalent to how many stores?
  - FY 2000: $92M sales (Exh 4A) = $92/52 = $1.8M/week
  - Allocate to DCs
    - » Lower bound: This is over 11 fullfillment centers (Exh 4A)
      - = $1.8M / 11 < $180k/week, center
    - » Upper bound: Assume most business comes from 2 DCs (Chicago and Washington DC)
      - = $1.8M / 2 = $900k/week, center
  - compare to typical supermarket (Exh 2):
    - » Lower bound 180/374 = ½ typical supermarket
    - » Upper bound 900/374 < 2.3 typical supermarkets
- Conclusion:
  - In the best case, one DC is equivalent to 2.3 supermarkets.
  - Given that one DC (70-100,000 square feet) is roughly double the size of a typical 44,600 square feet supermarket, the savings will be marginal at best.

4. Sourcing cost differential

- The typical top-10 supermarket chain has sales of $10-50B/yr, compared to Peapod's $92M. Hence, they are 1000 times larger!! Clearly, their purchasing power is much greater.
- *Where is this reflected in the financials?*
  - In the COGS, which is 73.6% for a supermarket, leaving a gross margin of 26.4%.
  - For Peapod, it was 53,903/68,786 = 80% (FY 98); 55,585/72,696 = 76.5% (FY 99); 71,646/92,844 = 77%.
    - » Their purchasing prices are 3 to 6% higher than supermarkets; a killer in a one percent margin industry!

- Notice: in Q1, 2001: 16,963/24,937 = 68%, a huge jump in purchasing economies and gross margins to 32%, reflecting:
  - No longer sourcing via Kroger, which charged a 4% fee; without that Peapod margin would have been also around 26%.
  - Sourcing directly through Ahold's immense procurement system
  - PLUS: this also reflects the added/increased delivery fee (which directly increases gross margin)!!

5. DC processing cost differential

- To avoid accounting gimmicks, let's do a simple financial analysis *per order*.
- *What are key performance drivers of pick & pack & load?*
  - Aha, this is pure detailed activity analysis. This is what industrial engineers are specialists in:
    - » 1. optimize storage of items throughout warehouse
    - » 2. optimize picking routes & picking activities
    - » 3. optimize packing in totes
    - » 4. optimize in-lane storage & combining of total order
    - » 5. optimize truck loading
  - The key performance measures here are as in our core ops class: time of all activities, inventory in process, and capacity per worker.
  - The simple key aggregate driver is: P&PPH = pick&pack productivity in terms of orders picked & packed per hour per worker
  - *What's a good estimate of P&PPH?*
    - » We know we need 3 picks per order, and you know how long it takes you to run through a supermarket to compile one order (say 15minutes if you're fast and know where to go)
      - Thus: 45min/order => P&PPH = 4/3 = 1.33
    - » The case provides an upper bound estimate: Webvan's peak capacity was 800orders/700employees = 11.4 orders/worker/day = 1.425 P&PPH.
    - » Assume P&PPH = 1.3
  - The second key driver is the labor rate ($14.50/hr) + a charge for supervisor time (say 1 supervisor/10workers)
- Total: P&P cost per order: C_{PP} = DL / P&PPH = $14.50 x 1.1 / 1.3 = $12.27

6. Delivery cost differential

- *What are key performance drivers?*
  - SPH
    - » Webvan's upper bound: 20 deliveries/day = 2.5 SPH

» The case states that we didn't get there. Assume SPH = 2 (I know from my discussions that it's even lower)

– DL cost: as before, assume $14.5/hr x 1.1

– Trucking costs

» Depreciation: $100/day = 100/8 /hr = $12.50/hr

- Say truck costs $50K, depreciate over 4 years = $12.5K/yr, over 250 days = $50/day
- Our $100/day is probably a bit high, but it should also include maintenance, insurance, etc…

» Gas: say a full filling of $30 per day = $3.75/hr

7. Total: Delivery cost per order: C_{del} = (DL+Truck) / SPH = ($14.50 x 1.1 + $12.50 + $3.75) / 2 = $16.10

1. Summary of ΔC

◆ To build up income statement, include a fixed cost allocation per order:

– Facilities: $150k/yr * 8 facilities / 203k orders/yr= $6 (Peapod actually told me they figure $8 total fixed cost)

– We also should include other overhead

	BEFORE Ahold		AFTER Ahold	
Net sales	$ 115.00	100%	$ 115.00	100%
Cost of sales	$ 88.55	77%	$ 78.20	68%
Gross profit	$ 26.45	23%	$ 36.80	32%
Operating expenses:				
Fulfillment operations: P&P	$ 12.27	11%	$ 12.27	11%
Fulfillment operations: delivery	$ 16.10	14%	$ 16.10	14%
Variable Costs (lower estimate)	$ 28.37	25%	$ 28.37	25%
Unit Contribution Margin (loss)	$ (1.92)	-2%	$ 8.43	7%
General and administrative				
Marketing and selling				
System development and maintenance				
Depreciation and amortization	$ 8.00	7%	$ 8.00	7%
Pre-opening costs				
Non-recurring expenses				
Total operating expenses	$ 8.00	7%	$ 8.00	7%
Operating profit (loss)	$ (9.92)	-9%	$ 0.43	0%

– How realistic are our estimates?

» Actual fulfillment cost can be calculated from income statement: Q1 2001: $12,443K/205K orders = about $60/order!!!

» Note: Peapod told me that Fullfilment and delivery in 2000 *in Chicago area* was $41 per order, and in March 2001 it was $31 ($18 transport, $13 receiving and fullfilment). Notice that we didn't include receiving given that we were comparing with regular supermarket.

◆ Bottom-line:

- no brake-even now
- this also shows why Webvan went under: they focused on revenue growth, but at a negative unit contribution (as a pure-play their gross profit was also low 20%) this just magnifies losses

8. Path to Profitability?

1. We must first get unit contribution positive!
2. Actions:

- Increase gross margin:
  - 1. Must work on sourcing: given very small 1% margins, a pure play cannot survive alone.
  - 2. Try to increase average order size (but we already are rather high at $115)
    - » target large families, no single guys
  - 3. Add delivery fee
    - » Without delivery fee and pure-play (Webvan), you're dead
    - » Peapod charged no fee for orders above $75; in Aug. 2001, they changed the policy to induce larger orders:
      - $9.95 for orders <
      - $4.45 for orders < $75
      - $2.25 for larger orders
- Increase fulfillment productivity
  - 1. DC operations to increase P&PPH
  - 2. Delivery ops: must increase SPH
    - » increase delivery density (customers/square mile)
    - » decrease the time spent at each house
    - » better pre-schedule by allowing for unattended delivery so that we have more deliver window flexibility to compile dense routes

3. "Milkrun" or home-delivery SPH improvement

- The last mile delivery system has a high fixed cost – warehouse, trucks, information infrastructure, insurance etc. among others. Therefore, the efficacy of the system depends largely on improving the asset and resource utilization. Ideally, Peapod would like to deliver large quantities of high value and low bulk items to the consumers that are living in high population density areas.

- However, Peapod is not there yet: the milkman model has fallen short on one of the key metric – orders delivered per hour (stops per hour – SPH). In 2000, Peapod was achieving SPH of 1.27 and its target is to achieve SPH of 2.5 for effective truck and other resource utilization.
- There are several factors that affect the SPH for the Peapod delivery system. Some of them are the following:
  - Market Penetration
  - Distance from warehouse
  - Variation of demand per time slot
  - Variability in driving speed
  - Traffic, weather
  - Routing efficiency
  - Number of warehouses
  - Driver training and incentives
  - Problems with directions
- Hence, some actions for SPH improvement:
  - Increase penetration in areas with potentially high customer/order density.
  - Achieve uniform high demand across the area served.
  - Achieve uniform demand across the time window offered.
  - Reduce the delivery window from current 2 hours down to 1 hour or less.
  - Establish strong relationships with the customers to become their primary home delivery source for variety of goods.

9. Some larger questions:

1. Should Peapod remain a separate entity?

- Note that in August 2001, Ahold bought up Peapod completely but will keep it as a separate subsidiary
- According to van Gelder: yes, because the emphasis is different than from the regular supermarket business: one needs capabilities in:
  - » Logistics a la UPS
  - » Assortment and purchasing a la typical supermarket
  - » Entrepreneurship to grow this 'new' business

2. Why did Webvan go under?

- As we saw: stressed growth of negative unit contributions
- Overbuild in fixed assets

- Promised free transport in ½ hr window
  - » This attracts low, small orders; just the ones you don't want!

3. What's the outlook for the future?

- Now < 1% of grocery industry is supplied by egrocers
- Future: likely higher because:
  - » Younger generation brought up with the Internet
  - » Faster Internet home connections + PC in the kitchen
    - This too depends on the customer's own life-cycle!

4. Why did Ahold buy Peapod?

- Growth in supermarkets is less than inflation. Hence, growth comes through consolidation + cut cost on back-end
- Supermarkets loose from convenience stores and restaurants
  - » Peapod is an excellent tool for Ahold to get some of this business back
    - There is little cannibalization to existing stores by adding the egrocer
    - Egrocer builds/increases customer loyalty

◆ What about competitive advantage? Van Gelder says that barriers to entry are extremely high because an egrocer needs many capabilities:

- Transactional website
  - » Much harder than Amazon website: here an order must be able to handle 55 products vs. typically 1 book for Amazon (I have to admit that I personally don't see the big deal here, but I'm sure there's something to it.)
- Merchandising marketing
- Fulfillment: pick & pack
- On-demand routing

5. Updates on Peapod

◆ Peapod is re-configuring its second warehouse in Chicago area (in Lake Zurich). While farther from downtown, it serves the Northshore +

- Has a better labor base
  - » This warehouse is expected to have automated material handling systems (Niles is completely manual). I'll visit it later this year.
- Enjoys sales tax rebate

◆ Automation?

- Is hard to justify given cheap labor in US, according to van Gelder

- This is different in Europe, whose supermarkets are way ahead of the US in terms of operational sophistication, mainly because space and labor is at a premium in Europe. For example: inventory turns
  - » 3-4 days in Europe + pull-based
  - » 2 weeks in US + push-based
  - » Also, consolidation is basically finished in Europe, whereas here it is still happening.

6. Clicks vs. Bricks: On-line vs. "real" stores

"Online grocers serve half of the 30 largest cities in the US currently. And coverage is mixed within those cities, targeting the most wealthy suburbs where they can reach the most attractive consumers," said Nick Karris, analyst at e-commerce research firm Gomez Advisors in Lincoln, Mass. "They're looking for dual income families with kids, where mom and dad are strapped for time and have income to spend on services like this."

◆ Advantages of local stores:

A Jupiter Consumer Survey conducted in November 1999 found that there are distinct advantages that a local store (whether it is an independent mom-and-pop or a part of a large chain) can offer that a Web-only merchant cannot. The fundamental advantages that merchants with physical locations have are all related to proximity:

- 83 percent of consumers surveyed said that they must see, touch, and/or try on products before they will buy them.
- 65 percent said that sometimes they *need* to have a product immediately. The need for instant gratification is particularly strong among younger users, women, and those that spend a lot of time online.
- 57 percent of respondents like to have the ability to return merchandise to a local store. Women and those of lesser means (annual household income below $35,000) are more likely to cite local returns as a top concern.
- 37 percent said that they prefer to pay cash for goods and services rather than with a credit card. Cash substitutes have yet to present a strong alternative online, which forces consumers to pay with credit cards.

◆ Advantages of on-line store

A need or desire for human contact appears to have little to do with online users' preference of sales channel. Online consumers surveyed indicated that the four least compelling assets of a local store involved staff or other shoppers.

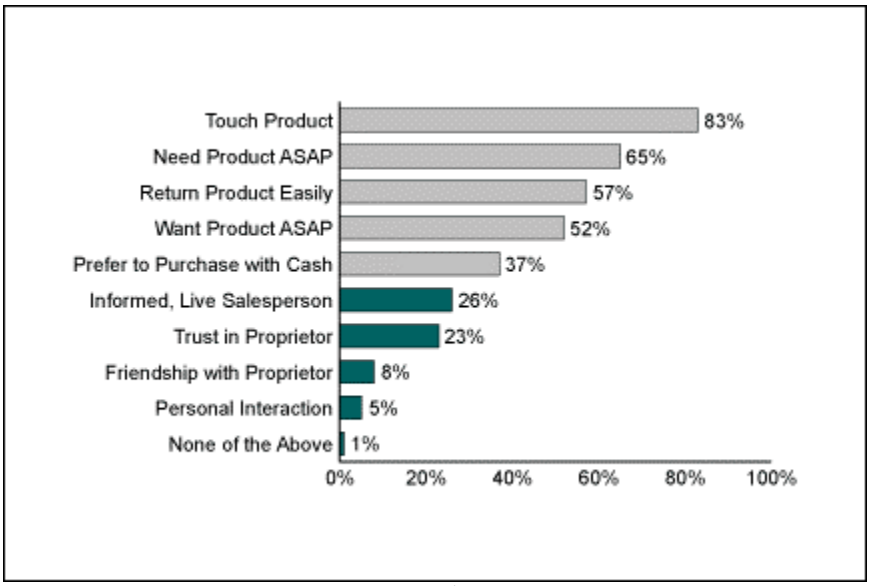
- 26 percent of respondents said that they appreciate the advice that knowledgeable store employees can give them. Men are far more likely to value such advice, surprisingly enough.
- 23 percent trust local stores more than mail order or Internet stores.
- Eight percent indicated that they like the people that run their local store.
- Five percent said that they enjoy interacting with store employees and other customers.

◆ Two fundamental lessons can be derived from the preceding data:

- First, brick-and-mortar merchants enjoy a valuable advantage over Internet-only merchants because of their proximity to customers.
- Second, the people that staff brick-and-mortar stores, who collectively account for one of the largest single expense lines on an income statement, do not provide compelling value to customers.

Figure: Advantages of Local Merchants

Traditional stores will never go away because of the following needs:



SOURCE: JUPITER/NFO; N = 1,781

PUB. 12/99

◆ **Internet Economics Expected to Prove Superior to Those of Brick-and-Mortar Retailers**

Despite the early challenges that online merchants have had generating profits, there are significant opportunities for Internet merchants to shave costs inherent in the brick-and-mortar model.

– Three of the biggest lines on a typical store-based retailer's income statement include:

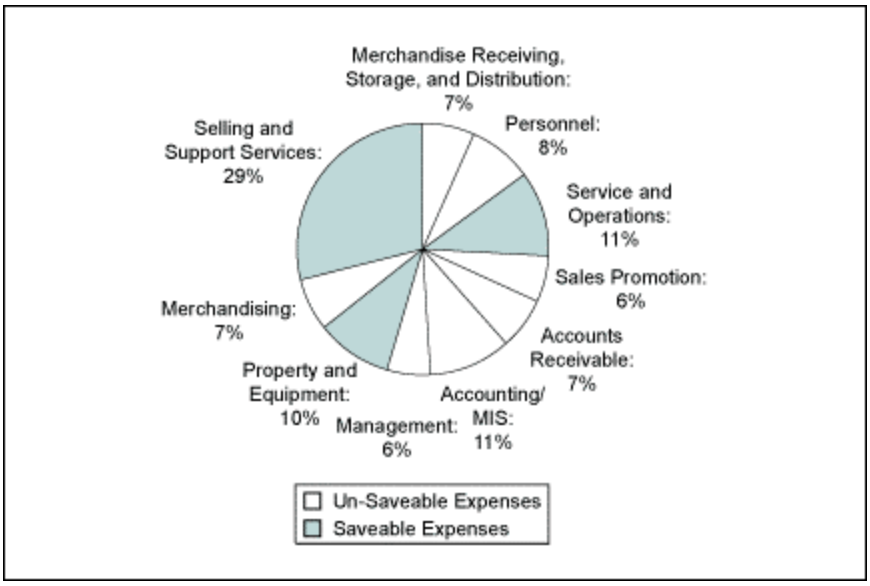
» selling and support (29 percent of expenses),

» property and equipment (10 percent of expenses),

» and service and operations (11 percent of expenses).

• These expenses, which total 50 percent of total expenses, offer significant cost savings opportunities for the Internet-only retailer.

Figure: The Cost Structure of a Brick-and-Mortar Retailer



SOURCE: NATIONAL RETAIL FEDERATION

PUB. 12/99

– In summary, the core strength of an Internet pure-play is clearly in its depth of inventory. By contrast, the strengths of brick-and-mortar merchants are based on their proximity to customers.