# THE IMPACT OF THE INTERNET ON THE VALUE OF RETAILERS

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The Internet is becoming an ever increasing force in retailing. Over the next five years, till 2003, it is expected that half of the total increase in US retail sales will be channelled through it. The rise of this new shopping medium is having an impact on the value of every store in the country.

Some categories such as books, CDs, videos, software and toys, which are the same everywhere, have already become dominated by the web, which can offer a far greater selection than even the biggest stores. For the time being, clothing is still bought hands-on in the malls, and we want to squeeze and smell the groceries in the supermarkets, but this may not last forever; in a recent survey 11% of Internet users say they intend to make an apparel purchase on the web during the 1999 holiday season. This is a matter of price, but even more so, of time.

These new developments will affect the value of all retailers; every valuation will have to take into account your client's relationship with the Internet. Some of them may have been there for some time, with more or less success, but many are likely to be at the stage where they are pondering what to do.

In either case, the first thing to remember is that there is a lot of competition in this new medium, much of it by "big guys" who can afford to lose a buck or two. In order to properly value your client's business, you must include his existing website, or his plans for the Internet; you must be aware of what is involved in his throwing his hat into the ring, as P.T. Barnum would say. It might even enable you to advise your client of the pros and cons, which I have found is well received, as valuators are generally regarded as disinterested, objective parties - and who minds a Brownie point or two?

Begin by investigating the existing on-line competition, and try to determine what their websites bring to their organizations. Is it: greater visibility? a simple extension of existing shops or catalogues? or does it truly contribute to their image, adding to sales and profits? This will lead to questions your client may never have asked himself: is his product wanted at the far end of the country? overseas? how many others offer it already? with what degree of success? should he enter the fray alone? or in partnership? if so, under what conditions? does he merely want to show that he exists and can outwit the other guy, no matter what the cost? etc.

Cost is the magic word: extending a retail store to the Internet can be very expensive requiring significant additional capital and operating costs. These include: establishing a website, maintaining and constantly updating it, setting up fulfilment arrangements, and, very importantly, devising appropriate marketing. On the Internet, there is no walk-in trade; you must attract browsers by clever means - which usually involves expensive talent. These substantial costs are part of the reasons, to date. Very few Internet companies make a profit.

For a "stand and fight" strategy several approaches have been successful; "edutaining" customers, personalized service, or private labels. Whichever direction is chosen, the impact and costs must be carefully analyzed to verify expected sales increases.

Forrester Research, a well-regarded Boston high tech market research firm, projects that retail sales on the Internet will rise at around 65% a year until 2003; in this period, they are expected to increase from an estimated $8 billion in 1998 to $108 billion in 2003. During the period, sales of traditional merchants are anticipated to grow slowly, from $1,600 billion in 1998 to $1,700 billion in 2003. There are exceptions, of course, such as Wal-Mart, which will likely continue to grow by more than 10% a year, leaving many stores with static or declining volumes.

As Internet retailing becomes more visible, most merchants will find it hard to maintain their current profit levels. Goods on the Internet are very often discounted to sell in volume and price comparisons are easy; therefore, a decline in margins is likely for nearly everybody.

Finally, traditional Capitalization and Discount Rates should be reduced, not only to reflect lower margins, extra costs and slower growth, but also the changes that are taking place in investor attitudes, as shown by guideline retail companies traded on the stock market.

**Attitude of Major Retailers**

Thanks to the Internet, retailers are finding that competition is coming not only from a similar store three blocks away, but also from national "etailers", such as: Amazon.com books, eToy for toys, CDNow for music, BestBuy for consumer electronics, Bluefly Inc. for designer clothing etc., in addition to the Internet and mall outlets of national and regional chains. On-line retailing is a growing, and obviously very glamorous field as far as investors are concerned.

Until recently, many traditional merchants believed that publicly traded Internet retailers, such as Amazon.com, were grossly overvalued and their stocks likely to crash to earth, as they didn't appear to know how to make a profit. This is typical of the Internet where "market share" is everything and, to my knowledge, very few companies have yet achieved any significant earnings. As a result, managers of "real" companies thought they had little to fear from such firms which obviously had no idea what business was all about. At the same time, some Internet "upstarts" believed that they would be able to sweep away their "bricks and mortar" competitors. It seemed like a re-enactment of Kipling's "East is East and West is West and ne'er the twain shall meet..."

 

Attitudes are now changing; most large retailers acknowledge that on-line competition is a threat; they also realize that the Internet can provide them with an opportunity to protect their market position and extend their geographical reach. Therefore a number of progressive traditional merchants are devoting considerable efforts and funds on establishing in-house Internet operations.

Some of them do not expect having to spend large amounts on their on-line extensions. Their managers argue that they already have the merchandise, supply systems, brands, customers, employees, distribution centers and advertising campaigns in place. They expect to achieve profits relatively quickly, well before the on-line only firms, as they are merely offering the consumer another means of buying: "Macys.com", rather than the store on Herald Square, New York, or "Macy's by Mail".

Other traditional merchants hesitate, as they are not sure they have the skills and corporate culture needed to succeed on-line; such firms lean towards an acquisition, or a partnership. This works both ways: as some well-known retailers such as The Gap are "going virtual" by adding an Internet extension, a number of Internet businesses, like the profitable on-line auctioneer, eBay, are "going physical" by purchasing well regarded, complementary "real-world" operations.

Both sides recognize the importance of an established infrastructure; this is as essential for a store as it is to e-commerce. Customers want the same speedy, accurate, and reliable delivery of the goods as the Internet gives them in placing orders, while everybody needs the ability to easily return merchandise. In all this, we take for granted that satisfactory means have been adopted by your clients to relieve one of on-line buyers’ greatest fears, the misuse of their credit cards.

Examples of partnerships between traditional and Internet retailers are found in the drugstore field. In 1998 and 1999, three Internet based pharmacy operations were launched: Drugstore.com, PlanetRx and Soma.com. Once they were "up and running", major chains joined up with them: Rite Aid (3,853 stores) acquired, 25% of Drugstore.com (No. 1 on the Internet), while CVS (4,090 stores) purchased Soma.com (No. 3). The intent is to combine speed of service with local delivery in a "clicks-and-mortar" hybrid concept.

### Costs of an Internet Operation

For an existing retailer to expand to the internet is more than a matter of buying the appropriate technology. It also involves hiring suitable, skilled staff and creating an appropriate corporate culture that will not be worried about "cannibalizing" customers from the parent's other stores. The website is the first stage: an entry level position can be established for around $20,000, but a respectable presence runs up to $100,000, and an eye-catching location, with multi-media and the ability for visitors to "try on" garments, will leave little change from $1,000,000. This has to be taken into account in your valuation, and it might be a good idea to give yourself a contingent of at least 20%.

 

Operating a website is not very expensive, but the upkeep is; it must be continuously improved, and that requires well paid talent. Until it is integrated with the firm's other systems, so that orders arrive when promised and the customer can track their progress over the Internet, a website may really not be much more than a glorified brochure. Such integration, and appropriate fulfilment arrangements, will likely involve significant capital and operating costs.

After fulfilment comes marketing, a major and on-going expense. Visitors first have to be attracted to the website by advertising, then encouraged to stay a while through irresistible, easily readable design, and finally, they must be enticed to buy. The Internet is more competitive than a local shopping center and much more so than Main Street, as you can get out of one website and into a competitor's without leaving your chair. Marketing, promotion and advertising costs for an on-line retailer currently run around 20% of revenue, and may amount to 40% for a new site when sales are low.

The differences in the cost structures of the two types of business are shown in the following summarized comparison of a traditional merchant and an Internet retailer.

| | Traditional Merchant | Internet Retailer |
|---|---|---|
| **Revenue** | | |
| Merchandise Sales | 200 | 200 |
| Add-on Sales & Services | 10 | 20 |
| Advertising | - | 5 |
| User Fees | - | 10 |
| | 210 | 235 |
| **Direct Costs** | | |
| Goods | 153 | 160 |
| Fulfilment | - | 25 |
| Payout Charges | 2 | 1 |
| | 155 | 186 |
| **Gross Profit** | 55 | 49 |
| Margin | 26.2% | 20.9% |
| **Overhead** | | |
| Administration | 16 | 10 |
| Marketing | 20 | 47 |
| R&D | - | 15 |
| Customer Service | 2 | 7 |
| | 38 | 79 |
| *Pre-Tax Profit (loss)* | 17 | (30) |
| Margin | 8.1% | -12.8% |

 

Over time, the gross margins will tend to converge, and the on-line businesses will become profitable as their marketing and R&D will not have to be increased in line with sales.

The majority of consumers is not yet convinced that online purchases, or even catalogue shopping, offer greater convenience and lower prices than a mall; most of them may never buy anything through the Internet, as they want to see and feel what they are getting. In spite of this, the stock market rates on-line retailers much more highly than traditional merchants, which are being downgraded due to the growing fear of Internet competition.

### Action of Valuators

As mentioned previously, some of the important steps in valuing a retailer must be to find out:

1. What effect Internet competitors are likely to have on your client's company?
2. Who is already established?
3. What action does the firm intend to take?

Managers who do not expect any impact from the Internet on their firms are unlikely to stay in business. If the strategy is to join the Internet, it is essential to make sure that the appropriate skills and infrastructure are put in place, and that all future costs relating to the on-line operation are taken into account. Cost estimates by management must be verified by comparison with those of publicly reporting on-line retailers.

If the approach is to "stand and fight", namely to resist the electronic siren, it is essential to consider the costs of any contemplated changes and improvements.

In either case, we must closely watch the factors influencing retailers' sales: the local economy, the strength of the brand, the level of service and the product mix. Financial Projections used for a valuation should not assume any growth in revenues without very strong evidence of its source and sustainability. As discussed, they should reflect lower margins, due to the discount pricing of most Internet competitors, and the costs of strengthening customer service.

 