



Costs



Online Shopping Isn't as Profitable as You Think

by Darrell Rigby

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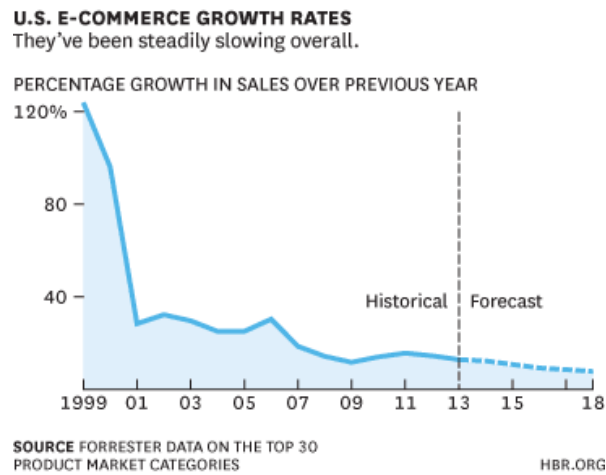
by Darrell Rigby

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When I argue that e-commerce isn't likely to destroy innovative omnichannel retailers, I typically receive passionate responses. Am I really suggesting that the growth of e-commerce will slow before it annihilates most physical retailing? And how could I possibly argue that the economics of omnichannel retailers are as favorable as those of pure-play e-tailers?

Growth rates first. Several organizations track e-commerce sales, including the U.S. Census Bureau, ComScore, eMarketer, and Forrester. All show similar trends. For example, Forrester's data on the top 30 product categories (which account for 97% of total e-commerce sales) indicates that e-commerce growth fluctuates with economic conditions but is clearly slowing overall:



This is a familiar growth pattern: E-commerce as a percentage of total retail sales seems to be following a classic S-shaped logistic curve. If historical trends continue, e-commerce's share of retail will rise from 11% today to about 18% in 2030, albeit with big variations by category.

Of course, that pesky “if historical trends continue” phrase generates ferocious debates. What if e-commerce creates such enormous economic advantages that physical retailers simply can't compete?

E-commerce companies, like physical retailers, have wide-ranging cost structures and financial results. In general, however, e-commerce operations aren't as cheap to run as most people think. Their economics greatly resemble those of mail order catalogs—in fact, many e-commerce businesses continue to use catalogs in their marketing mix—and they aren't all favorable. Amazon, whose results are similar to those of other e-commerce companies and divisions, has averaged only 1.3% in operating margins over the past three years. Operating margins for department, discount and specialty stores typically run 6% to 10%. Lower margins can come only from lower prices or higher costs.

“Ah,” you might say, “Amazon does have lower prices, and its costs are higher only because it is investing so heavily in growth.” But how much of the difference do these reasons explain?

Price comparisons are always tricky: they are complicated by the basket of items selected, how promotions and coupons are treated, the handling of loyalty program rebates, and many other variables. But Amazon's prices aren't uniformly lower than competitors'. One recent Kantar Retail study of 59 items found that prices at Walmart's Supercenter stores were 16% below Amazon's. Another study, by William Blair & Company, found that prices at several physical retailers are about 10% below Amazon's on items costing less than \$25. In cases where store-based retailers do charge higher prices, several I have spoken with calculate that closing price gaps with Amazon would cost them between 1 and 3 percentage points of operating margin. That would still leave them with 2 to 8 points of margin advantage.

But what about the economics of e-commerce orders? Even there, creative omnichannel retailers aren't necessarily at a disadvantage. E-commerce companies ship to customers from large, expensive, highly productive fulfillment centers. (A state-of-the-art center can cost \$250 million or more to build, or about 10 times as much as a big box store.) Fewer fulfillment centers mean lower capital expenses but higher shipping costs and slower deliveries. Meanwhile, omnichannel retailers already have hundreds or thousands of distribution centers called “stores.” It costs only about a dollar more to pick an order from store shelves than from automated warehouses, and the proximity to customers saves at least as much in shipping costs—especially for in-store pickups, rapid deliveries, and returns.

It's true that rapidly growing e-commerce companies like Amazon have been investing heavily in their future. Still, market maturation often

forces sustained expenditures just to hold ground. For example, as Amazon builds fulfillment centers in more states, those states are now forcing it to collect sales taxes—an effective price increase of about 7% on average—and researchers at Ohio State University say that reduces spending on Amazon by about 10%. Substantial investments in price or differentiation may be required to offset such effects. Several public e-commerce companies are already experiencing reduced growth and margins as competition intensifies.

A common argument is that rapidly evolving digital technologies will increase e-commerce's advantages. But retailers who fuse the best of digital and physical technologies—we examined these “digical” innovations in an [article](#) in the September issue of HBR—can capitalize on digital advantages both online and in stores. Digital technologies will [improve in-store visual merchandising](#), help customers choose the type of service they prefer, speed checkout times, customize offers, and provide virtual connections to global experts or trusted friends. Radio frequency identification (RFID) tags will improve in-store fulfillment speeds. Automated backrooms in supermarkets will pick and pack commodities while customers hand-select their favorite produce and meats.

I'm not underestimating the magnitude of the changes physical retailers must implement. But digical strategies combining the best of both worlds will be more attractive to a broader range of customers while enabling superior economics. Perhaps this is why even Jeff Bezos has said that if Amazon can find the right idea, “We would love to open physical stores.”



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