

E-TAILING'S TROJAN HORSE



■ Satish Jindel

EVERYWHERE YOU TURN, people are bullish on the future of online retailers. It's reflected in Amazon's stock price, which has grown rapidly thanks to ... free shipping.

What's surprising is that the frenzy of blind investing in Amazon's stock ignores time-tested stock valuation measures and fails to recognize that there is no such thing as free shipping. Analysts and research firms may be blinded by the rapid growth of online sales, but none has undertaken the task of forecasting the future of e-commerce without free shipping.

Ordering merchandise for delivery to homes isn't a new concept. It started more than 100 years ago when Sears was a mail order retailer before opening its first store in Chicago. Sears didn't offer free shipping.

Similarly, UPS started delivering parcels to homes of Nordstrom customers in 1907. The retailer didn't provide free shipping nor did UPS absorb the cost of such deliveries, yet the mail order business grew because consumers valued the convenience.

Mail order retail evolved into phone order retail and then online retail, which allowed product information, order placement and payment to be done via personal computers.

Internet-driven sales, however, still require products to be transported. The only difference between the evolution of online retail and mail or phone order is that companies offered free shipping to help them achieve rapid growth in a dash to go public at irrational valuations as the market overlooked profitability for revenue growth during the dot-com boom.

With shipping and handling charges representing 10 percent or more of the value of goods, it's no surprise online retailers are struggling to generate profits. Revenue growth based on pricing below cost may be easy to accomplish but isn't sustainable. As other industries have learned, once customers get used to

something for free, it's hard to wean them off (see: checked baggage).

To grasp the impact of free shipping, look at Amazon. In 2013, the company received \$3.1 billion in shipping charges from its customers, yet spent \$6.6 billion on transportation services. This result is contributing to a decline in its margins each year since 2009.

Amazon, however, isn't alone in failing to generate profits despite double-digit revenue growth. Even the online divisions of some brick-and-mortar retailers generate losses as they are driven by free shipping and frantic attempts to copy Amazon's model.

For fast-moving consumer goods such as toilet paper and diapers that Amazon seeks to supply its Prime members on a weekly basis, free shipping will become a lot more expensive in January with new dimensional pricing announced by FedEx Ground and United Parcel Service. The U.S. Postal Service and other carriers are likely to follow suit because they are all impacted by the cost of delivering lightweight but large cube parcels.

Surveys show that online shoppers want free shipping even if it comes with slow delivery — 92 percent of online shoppers are willing to wait four-plus days for free shipping and only 2 percent are interested in faster shipping at a premium charge.

In addition, those declaring that same-day delivery will replace slower transit times are showing their ignorance about the industry because same-day service is the most expensive delivery to provide, and consumers aren't willing to pay for it.

For validation of same-day delivery being a Trojan Horse and free shipping being the most successful model for online retailers, consider Zulily and Amazon. Zulily customers receive their merchandise two to three weeks after an order is placed, yet it's growing at a much faster rate than Amazon.

Monoprice, another online

retailer, charges for shipping but then passes on cost savings from not having stores by offering prices considerably lower than its brick-and-mortar competitors. Although small, Monoprice also is growing at a faster rate than Amazon.

The free shipping model overlooks the fact that it subsidizes some customers at the expense of others. An Amazon Prime customer receiving five deliveries a year at \$20 per delivery is subsidizing a Prime customer receiving one delivery a week and only paying \$2 per delivery.

Although online retailers are leveraging the Internet to generate sales with free shipping, they're forgetting that they're no different than brick-and-mortar retailers in one respect: Investors require them to generate profits. The moment investors change their valuations, online retailers will have to impose shipping charges, e-commerce growth rates will slow dramatically, and consumers will return to buying products from brick-and-mortar stores.

The same-day delivery model already has suffered a major blow. EBay Now is being curtailed because it was draining too many resources, and the USPS's Metropost test for same-day delivery in San Francisco resulted in delivery of only 95 packages over five months, yielding per-parcel results of only \$8 in revenue and \$108 in cost — for a net loss of \$100. Furthermore, the two best-operated parcel carriers, UPS and FedEx, have avoided investing in same-day service.

Just as there is no free lunch, e-commerce based on free shipping isn't sustainable, and the day of reckoning is not far off. When that bubble bursts, it will bring down the broader stock market and not just the stock price of online retailers. For brick-and-mortar retailers, that day can't come fast enough. **joc**

~~~~~  
Satish Jindel is president of SJ Consulting Group, with offices in Pittsburgh, Pennsylvania, and India.