Bulletin of the *Transilvania* University of Braşov
Series V: Economic Sciences • Vol. 8 (57) No. 1 - 2015

# Cost reduction analysis in the online retail as compared to the classic retail

Mirela Camelia BABA[1]

**Abstract:** *The industry of retail has been segmented by new technologies, but the financial performance of every segment is far from explaining the market share. An exploratory study is necessary in order to explain the appeal for entrepreneurs. A comparison between two new forms of retail is used to understand the business models in this industry. Due to the fact that the maturity of the new segment of retail is different in various countries, the study cases focused on some leading firms from USA, China and Romania ) are important to design a probable trend for the online commerce. General theoretical benchmarks, validated by current practice are used in case studies, as well as innovative approaches and well-known examples of successful retail companies.*

**Key-words:** *e-commerce, performance, strategy, cost leadership.*

## 1. Introduction

Retail industry can be divided into several segments in order to facilitate the study of one component. Laudon and Traver (2014) discussed the seven segments (durable goods, general merchandise, food and beverage, specialty stores, gasoline and fuel, mail order/telephone order (MOTO), and online retail firms); as seen, the list includes the online retail, which held in 2012 in the US (according to the US Census Bureau) only 6% of the total retail. Each segment uses new technologies in its own way, and this is rapidly changing under the pressure of innovation. Alongside, it is to be noted that the quality of the human capital is crucial for any company, enabling it to maintain a competitive advantage in this knowledge economy era, away along with technology and innovation (Drumea, 2012).

Online retail is closely related to another segment, the mail order/telephone order (MOTO), which is actually a predecessor of e-commerce. The companies in this segment have created the experience of rapid delivery of small orders, and some have developed their own business online. In line of this "legacy" there are now "pure" online retailers, which do not own any “physical” store, as well as so-called “multichannel” retailers that combine the online approach with the classic retail through their own stores.

[1] Transilvania University of Braşov, mirela.baba@unitbv.ro

Essentially, an online retailer is a seller who exhibits his products through internet images, which facilitates consumer's information and the whole ordering procedure and payment is then made using again the internet's specific tools. This is how the transfer of information is made, in order to facilitate the buying decision, covering an unlimited area (actually limited by the existence of communication networks), despite of the "physical" way between consumer and provider. For many of the standardized products, such as books, this type of information is sufficient to trigger the buying decision.

## 2. Costs and associated elements in online and classic retail

The issue of the "physical" transfer of the product to the consumer is retained. It requires intermediaries such as postal service providers, as well as the existence of logistic facilities for the online retailer or the intermediaries. The chain of maneuvers involving human input is intact, but the consumers can possibly save some time in the buying process. For maneuvers performed by a "professional" instead, the consumer pays.

The organization naturally seeks ways to become more competitive in its sector, exploiting all possible sources of competitive advantage (Drumea, 2014). It may be inferred that every potential consumer will compare the costs incurred by the act of buying from a classic retailer with those from an online retailer. The consumer will also compare other associated elements, such as satisfaction in choosing and buying or the confidence in the seller. In this context, the online retailer will have no choice but to implement a strategy that responds to the consumer's aspirations, namely to render technical and economic conditionality that ties out. The economic conditionality would translate into the assertion by the retailer of a "fair price", which objectively leans on low costs. It is why the transport costs, on top of the retailer's price list, can become exasperating to the extent of not being able to offset the other facilities offered by this online system.

A minimum of maneuvers rendered by the consumer defines the online retailer as being "pure" (in the sense depicted above), meaning that he eliminates the physical facilities of exposing the products. Larger maneuvers define the so-called brick-and-mortar retailers, who keep stores in the classical format but perform the physical transfer of merchandise in specific combinations, but not to the consumer's place.

## 3. Findings in the world of online retail leaders

Emblematic for the pure online retail is the American company Amazon. The study of its evolution suggests the main clouts used for the survival, expansion and dominance of American retail industry. Aside this giant, thousands of pure online retailers were created and disappeared, leaving behind a list of interesting successes and spectacular failures. Online retail repeats thus the evolution of other industries such as the automobile or computers at the beginning and the end of the twentieth century, respectively.

Jeff Bezos, founder of Amazon said that his company is set to "offer the Earth's biggest selection and to be Earth's most customer-centric company where customers can find and discover anything they may want to buy” (Laudon and Traver, 2014). Beyond this strategic vision, there are three directional elements: the lowest/exclusive prices, the best selection, and convenience (which translates into feature-rich content, user-generated reviews of books and products, fast and reliable fulfilment, and ease of use). It means there is a huge supply of goods readily available for the consumer, at a low (sometimes lowest) price. Aside the asking price, another trigger of the buying decision is offering short-term or even deliveries at a specified time.

For Amazon the service is called „Prime now” and it has just being released in the week before Christmas 2014; it promises "delivery in 1 hour", which can be misleading in the sense that delivery will not necessarily occur in one-hour time from the clicking order, but it guarantees a certain time (i.e. a point in time) delivery, but certainly the same day. The services is only available in US, provided underwriting an annual subscription - Amazon Prime for $ 99. But the competition is fierce: for same-day service, users of Google Express must pay $ 95 per year. The idea which led to the creation of Prime now is not the original, as it has been previously implemented by eBay, who dropped the "now” service in 2014 while Amazon plans to expand it in 2015 for all major cities in US. The tangible result of this initiative was, as Jeff Bezos announced that "customers ordered more than 10 times as many items with company’s same day delivery over the same period in 2013" (according to www.cnet.com). For Western Europe, the same service now only promises "free two-day shipping" for the same value of the subscription.

An analysis of the evolution of the Amazon stock shows that the low price does not reflect a reduced cost basis, but, contrary to the Porterian theory, is a strategic goal in itself. The stocks fluctuated from $106 in 1999 to merely $6 in 2001, then between $ 50 and $ 90 in 2003-2009, so that it reached in 2013 a peak of $ 312. Although revenues increased from $ 600 million in 1998, to $ 61 billion in 2012, reflecting an aggressive growth strategy, the profitability got forfeited. From $ 1.1 billion profit in 2010, Amazon reports a loss of $ 31 million in 2012, given that the increase of the turnover between 2010 and 2012 doubled the operating expenses - from $ 33 billion to $ 60 billion. We conclude then that shares’ price reflects the market confidence in the company's growth strategy, rather than the immediate satisfaction of shareholders for the dividends cashed in.

So Amazon is forcing the turnover increase and enlargement of its market share by reducing prices and by product portfolio diversification, while compromising the idea of reducing costs. The mentioned diversification and the sophistication of the IT platform linked to internet, as well as reducing prices appear to rather be an industry benchmark of differentiation more than a cost leadership strategy in the sense given by Porter (1980). In the future, a cost reduction is probably expected due to the economies of scale and economies of scope, associated to the impressive size of the firm's operations system. A partial conclusion is that in this case there is no reason to consider e-tail as associated to a cost leadership strategy.

Amazon case must be studied simultaneously with other large online retail companies in China, such as its homologue Alibaba, as well as with other US click-and-mortar companies as Walmart, Sears or Home Depot.

Since its creation in 1999, Alibaba has enjoyed the advantage of a huge national market, as well as local suppliers with competitive labour costs and extreme versatility. Local suppliers obtain economies of scale by increasing their volume of production, part of which is subsidized by the State for export. The subsequent result for a large retailer is that he can have low entry prices that allow him to impose selling prices below those of competitors.

Chinese online retail development is stimulated by the explosive development of national communications infrastructure, so Alibaba operates on a huge market, and in a dominant position, thus enjoying benefits from both sides. Its position counts for 80 % of the national online retail, with a record of daily sales of $ 9.3 billion in November 11, 2014 (according to CCTV), and it is the result of a first mover strategy rather than a cost leadership strategy.

Large US companies like Walmart, Sears or Home Depot have developed alongside traditional retail, an online retail business segment. This segment has enjoyed several types of advantages: on one hand the advantages of scale related to the initial businesses, as well as network benefit of brick-and-mortar stores and the huge products portfolio in order to achieve cost advantages. On the other hand a more important advantage was conferred by the image of their respective companies, which generated the consumer's aplomb to try the click-and-mortar version.

Prior US statistics show that there is a tendency of accelerated growth of the new retail, probably as a response to the pressure of new technologies and the expansion of IT devices. Statistics on Asian countries, especially China, India and South Korea, show that this trend is reflected in this geographic area as well. What is significant for the research direction addressed in this study is that the number of mobile phone users is triple as compared to the PC holders and that out of the 1.4 billion mobile phones, about a third are smartphones (Laudon and Traver, 2014). Hence it seems that a light internet will be installed to boost all forms of e-commerce.

It should also be noted that US and Chinese companies, as well as the Japanese or South Korean enjoy outstanding communication infrastructures that facilitate payments, but particularly the physical transfer of the product, thus giving to the consumer the requested trust in the online retail. Even so, shipping costs are significant and seem unreasonable for many products. As US Post is somewhat "legendary" for its services and the use of rapid post as UPS or FedEx induces even higher costs, then the delivery problem becomes interesting (Frischmann, Skiera and Hinz, 2012). This becomes even more significant when the shipping cost influences the final price to the consumer.

## 4. Romanian online retail

In Romania the online retailing is quite at the beginning, but there are optimistic opinions expressed by Euromonitor (www.euromonitor.com). So far there are still collateral issues, notably the quality of transport infrastructure and Post services, as well as deliveries by courier.

The most important online retailer is eMag (turnover of 260 million euros in 2014), owned by a South African company, which covers a third of the market. In order to obtain economies of scale eMag expanded to the neighbours in Bulgaria and Hungary. The main source of cost advantages is reducing the staff thus cutting payroll costs, but the company still holds brick-and-mortar stores that are intended to strengthen consumers' trust in the company's name and the online brand. According to the local market specificity the payment is made on delivery, cash or by card, after checking the product. It should also be noted that the eMag executives consider that the Romanian market is not attractive for Amazon, (although the latter has already created a "bridgehead" for future business) or for eBay, given the local difficulties related to infrastructure and consumers behavior.

In Romania, we find several possibilities to obtain a low cost advantage in an online activity, which would induce a differentiation based on prices (Băcanu, 2008).

A comparative study of the products prices for books for example, shows that the use of low prices in order to win customers is a practice, even if it is obvious that profits are compressed to the maximum. The inference is based on knowledge of input prices, especially in the case of some "certified partners" of the eMag.

It can be concluded that eMag is pursuing a growth strategy in the area, by taking advantage of the early stage of development of online retail in Romania. It is evident that attractive prices are a tool to win out customers, but this is the result of a massive initial investment without being clear that a management focused on reducing costs is put in place. There are a number of other "ingredients" put in place to support attractive prices and aggressive promotions. So eMag tries to combine a price leadership advantage with some features that provide a differentiation, as described by Băcanu (2010).

## 5. Conclusions

The common denominator of the three leader companies in the online retail in the US, China and Romania, is represented by an aggressive growth strategy based on a combination of differentiation elements with supporting low prices, even if profitability is affected. Differentiation is reflected in the product portfolio extension to a superior rate as compared to direct competitors, simultaneously with building up the confidence into the corporate brand. There is nothing consistent to be reported about actions that would trigger cost reductions in order to define the implementation of a cost leadership strategy. This would rather create a differentiation approach in strategy, although constituting elements might suggest the use of cost leadership.

## 6. References

Băcanu, Bogdan 2010. "Differentiation vs. low cost strategies in Romania." *Management & Marketing* 5(2): 135-142.

Băcanu, Bogdan. 2008. "Using strategic management study cases in Romania." *Annals of Faculty of Economics* 4.1: 61-65.

Brynjolfsson, Erik and Micael D. Smith. 2000. "Frictionless commerce? A comparison of Internet and conventional retailers." *Management Science* 46(4): 563-585.

Drumea, Cristina. 2012. "An Analysis of the Human Capital Management Effectiveness, as Key-factor of the Organization's Performance." *Ovidius University Annals, Economic Sciences Series* 12.2: 1085-1089.

Drumea, Cristina. 2014. "Staff performance evaluation in public organizations", *Bulletin of the Transilvania University of Brasov. Series V: Economic Sciences* 7(2): 133-138.

Frischmann, Tanja, Oliver, Hinz and Bernd Skiera. 2012. "Retailers' use of shipping cost strategies: Free shipping or partitioned prices?." *International Journal of Electronic Commerce* 16(3): 65-87.

Hambrick, Donald C. 1983. "An empirical typology of mature industrial-product environments." *Academy of Management Journal* 26(2): 213-230.

Laudon, Kenneth C. and Carol GuercioTraver. 2014. *E-commerce*, 10th ed. Upper Saddle River, NJ: Pearson Education.

Porter, Michael E. 1980. *Competitive strategy: Techniques for analyzing industries and companies.* New York: Free Press.

Porter, Michael E. 1985. *Competitive advantage: Creating and sustaining superior performance.* New York: Free Press.