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Small Business Survival In Competition With Large Multi-Unit Retail Firms

Part 1
Market Analysis of the Retail Book Industry

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EXECUTIVE SUMMARY

The expansion of book superstores has put substantial pressure on small booksellers. Significant economies of scale exist in book retailing and the largest retail chains have been able to capture these and expand their market share.

Independent bookstores have nonetheless managed to survive by competing in markets that are not dominated by retail chains. Many independent booksellers have maintained their existing businesses by exploiting prime geographic locations, specialization and niche markets.

Hundreds of independent bookstores have established on-line stores. Barriers to entry on-line are low, but these markets are more concentrated than traditional land based markets. A high percentage of sales have been captured by the largest on-line retailers. In traditional retail markets, geographical location can provide a competitive advantage to smaller retailers who may not be able to compete with larger retailers on such factors as price or the number of titles stocked. Customers often choose to shop at smaller stores because they are conveniently located to their home or workplace. The on-line retail environment is less hospitable to small retailers because they are largely unable to use geographic location as a competitive advantage.

The impact of on-line commerce has varied across different segments of the market. Many small antiquarian booksellers have benefitted from the emergence of auction sites and rare book search engines. Those independents engaged in mail order sales have found on-line retailers to be formidable competitors. On-line independent stores selling a wide selection of books have had difficulty competing with the richer content and lower prices available on the sites of the major on-line retailers. The academic textbook market may be more suited to smaller retail operations because the needs of student customers are determined locally by the specific course offerings at particular schools.

There are many aspects of Internet markets that are favorable to small businesses. Internet commerce service providers have substantially reduced the technical difficulty associated with setting up a database driven web site capable of handling commercial transactions. There are important synergies

between traditional retail operations and web based electronic commerce. Many independent booksellers have found that an on-line presence can serve as a useful mechanism for promoting traditional retail activity. Traditional retail operations may also serve to reduce marketing costs for on-line sites.

Affiliate marketing can provide on-line small businesses with some of the advantages that location provides off-line retailers. Large Internet retailers often derive as much as 30% of their revenue from affiliate relationships with other sites. A number of small retailers are using affiliate marketing, although there is currently little data to evaluate the effectiveness of these programs.

Internet commerce enhances the market for niche players. Access to large markets via the Internet may make possible the emergence of specialized "gnatagory killer" retail sites, if such sites can differentiate themselves based on content and service. Stores serving very specialized consumer markets might not be able to attract enough customers in a particular geographic region. The Internet makes it easier to serve very tightly defined customer groups by aggregating thin demand across a broader customer base.

While the cost of getting on the web is low, there are other barriers to effective competition by small businesses. The expense involved in marketing a web site can be a significant barrier to entry for small businesses. Economies of scale in advertising, branding and cross-selling provide competitive advantages to large on-line retail operations.

1. INTRODUCTION

The retail book market has undergone significant concentration in recent years. The four largest booksellers control approximately half of retail book sales. An American Booksellers Association study found that the sales of independent book stores declined by 9.4% between 1996 and 1997, while sales at the four largest bookstores (Barnes &Noble, Borders, Crown and Books-A-Million) increased. The rapid growth of Amazon.com in the last two years suggests that electronic commerce may lead to further market concentration.

The increasing concentration of the industry has been a concern of many small booksellers. They have argued that the co-operative advertising polices of some publishers have given the big box retailers an unfair competitive advantage. The aggressive expansion of the book superstore chains have challenged many independent booksellers who have struggled to adapt their retail formats. On-line competitors such as Amazon.com and BN.com have also emerged over the last two years as significant competitors. Several hundred independent booksellers have gone on-line and a number of independent on-line stores have found that they can compete on-line.

This reports describes the state of competition in the retail book industry, both on-line and off-line. The report relies on secondary data as well as anecdotal information gathered from interviews and industry publications. The purpose of this effort is to highlight those aspects of the competitive environment that impact the ability of small businesses to compete in this market.

2. INDUSTRY OVERVIEW

The retail book industry is currently in the midst of major restructuring. Between 1994 and 1997 the market share of the four largest retail chains grew from 34.2% to 45.2%.[1] More recently, technological changes in the publishing industry and the emergence of the Internet as a sales channel hold the potential to spark even more fundamental changes in this market.

Publishers, wholesalers and retailers each play somewhat different roles in bringing books to market. Publishers purchase content from authors and package and promote this content to bookstores. While the Internet has allowed some authors a channel to promote their own books, most authors aren't established enough to fully exploit this. Many believe that the Internet holds great promise for publishers. They are the owners of content and the Internet will allow them to distribute and market this content more efficiently.

Book retailers can order books directly from publishers or from wholesalers. Wholesalers provide one source for a range of titles. Additionally, wholesalers are able to fulfill orders faster. Publishers typically take five to ten days to fulfill orders while book wholesalers can ship orders the same day they are received.[2]

Libraries and bookstores also turn to wholesalers to save time and money on the ordering process. A book order might consist of a number of titles from different publishers. By ordering from a single source, retailers can save time on order processing, shipping and invoicing. Wholesalers also provide title databases that allow purchasers to easily check on the availability of back list and forthcoming

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[1]American Booksellers Association, http://www.bookweb.org/home/research/stats/389.html

[2]Mutter, John. "Wholesale Change at Baker & Taylor". PublishersWeeklyOnline, May 31, 1999

titles. Other value added services, such as electronic ordering, prepublication announcement information and catalogues are also provided by wholesalers.

Retailers are the last leg of the distribution process. Traditional retailers provide a physical store and display the books in an appealing format. Small traditional independent bookstores offer personalized service. Staff can often make recommendations based on their personal knowledge of the customer. Small independent bookstores have faced three waves of retail competition.

In the 1980's, retail chains challenged independent bookstores. Retail chains, such as B. Dalton, Waldenbooks, Hudson Pickwick and Booksmith, typically built stores with 2,000 to 3,000 square feet of space. These stores tended to be located in shopping malls and were focused on the best sellers. They offered information systems capable of locating books according to a number of different references. Those books not in stock could be electronically ordered.

In the 1990's, book superstores emerged as an even more formidable retail competitor. Crown, Borders and Barnes & Noble built stores with approximately 12,000 to 36,000 square feet. These stores stocked more than 275,000 books and had 160,000 titles available in their database from approximately 7,000 publishers.[3]

Online retailing is presenting independent bookstores with a third wave of competition. This competition has extended the traditional forms of competition further. Online retailers have offered greater selection and more aggressive discounting.

The suggested retail price (SRP) of books provides retailers with a 30% to 40% margin above the wholesale price. Best sellers are typically marked down by as much as 30%. The book superstores

[3] "Fireside Booksellers: Distribution on the Internet". Case Research Department, International Graduate School of Management, University of Navarra, 1996

have the capability to buy in bulk from distributors at lower cost and thus these stores are able to offer discounts from 5% to 30% on all books. In March of 1998, the American Booksellers Association and a number of independent bookstores sued Barnes & Nobles and Borders, arguing that "the two stores engaged in a pattern and practice of soliciting, inducing and receiving secret, discriminatory, and illegal terms from publishers and distributors." The suit further contended that the chains' "market saturation strategies are fueled in significant part by secret and illegal terms and that much of this expansion can only be profitable if the chains receive illegal deals and existing independent booksellers are driven out of the marketplace." This issue is still in litigation.

The issue of discriminatory pricing by publishers has been litigated a number of times in recent history. Under the provisions of the Robinson-Patman Act, discriminatory pricing is illegal unless it is necessary to meet the competition or can be justified by differences in the cost of selling to different types of customers.

Pricing practices of online booksellers such as Amazon.com have further intensified discounting in the book retail market. Amazon.com recently discounted all books on the New York Times Best Seller List by 50%. Industry sources believe that online booksellers do not currently receive any purchasing discounts beyond those offered other traditional retailers[4], but the lower book returns experienced by such sales may justify discounts in the future. It thus seems likely that price competition may intensify further.

A number of technological and market changes are occurring in the publishing industry which have important implications for the retail book market. These are described in more detail below.

[4] "Advertising & Publishing: Challenging Transition Ahead" Merrill Lynch, Global Securities Research & Economics Group, April 8, 1999

2.1 MARKET DEVELOPMENTS IN PUBLISHING

The publishing industry has recently been characterized by slower growth. Book publishing industry net sales for 1998 were approximately $23 billion. Total net sales grew at a rate of 6% between 1987 and 1998. In recent years growth has been somewhat slower, averaging 5.3% annually between 1992-1998.

Internet commerce has spread sales over a greater number of titles by aggregating thin demand and generating orders for older or less popular titles that may not have typically been stocked in traditional book stores. Key word searching of online databases has tended to bring a different set of books to consumers' attention than those offered consumers in stores. Key word searching by subject, instead of year of publication, has increased sales from publishers' back lists. Small publishers also have a greater capability to market themselves online. This has further increased the number of titles available.

Publishers have traditionally sought to increase profits by practicing title list management. By reducing the number of titles carried and the inventory of books required to service these, they have attempted to reduce inventory carrying costs. The spread of Internet book sales across more titles may render this strategy untenable.

Internet sales may increase the profitability of publishers in other ways. Sales through Internet channels experience rates of returns which are much lower than sales to traditional retailers. For instance the Penguin Group experiences return rates between and 1% and 7% for online sales compared to 30%-40% through traditional retail stores.[5]

[5]"Advertising & Publishing: Challenging Transition Ahead" Merrill Lynch, Global Securities Research & Economics Group, April 8, 1999

2.2 TECHNOLOGICAL DEVELOPMENTS IN PUBLISHING

Two important technological developments for book publishing are on-demand printing and electronic books.

On-Demand Printing - There are currently two models of on-demand printing. Wholesalers offer on demand printing services from their warehouses, but new printing technologies are making in-store on-demand printing economically feasible.

One example of wholesaler on-demand printing is Ingram Lightning Print Inc. (LPI). LPI provides a service for publishers which allows books to be printed as they are ordered. Publishers submit titles for which they want LPI services. Retailers order these books from Ingram in the same way they order other books. Books are printed as they are ordered and can be shipped within 48 hours. LPI books are of equivalent quality to traditionally published books, with the exception of half tone images, which may be of lower quality. This service allows publishers to keep more titles in print and to bring back titles which were formerly out of print. The service also allows publishers to test market titles for lower cost.

In the future, publishers may choose to use on-demand printing to forestall the reversion of book rights to authors. Tax rules penalize publishers for holding on to slow moving inventory, thus giving them an incentive to take titles out of print and allow the rights to revert to the author. On-demand printing removes the requirement to maintain inventory to keep a book in print. For a small investment, publishers can bring a title back into print and have it “in stock” at Ingram and every Internet retailer that orders from Ingram. Baker & Taylor’s Replica Books offers a similar on-demand printing service.

The equipment used by wholesalers and publishers to perform on-demand printing is expensive, costing over half a million dollars. Several products coming to market in the near future will reduce the cost of on-demand printing, rendering it possible for individual stores to purchase this equipment.

Companies such as On Demand Machine Company (ODMC) and InstaBook Maker offer a "print-in-store" model. These companies plan to sell equipment which allows for in-store printing of a set of digitized titles. ODMC's book machine is still under development, but company officials expect to demonstrate the "Book Machine" at Denver's Tattered Cover bookstore in late 1999. The Book Machine will cost approximately $70,000.

The InstaBook Maker is currently available for $29,000 and is being installed in a number of publisher offices. A two hundred page book can be completed in five minutes, including downloading time. The machine requires minimal training to operate and is approximately 4' by 3' by 2.5', and thus could reasonably be located in a small bookstore. Currently there are only 2,000 titles available for printing with InstaBook, but the company is expanding this title base. It is quite possible that the number of digital titles available for on-demand printing could exceed 100,000 in the near future.[6]

In-store printing of books could offer land-based booksellers a competitive advantage over online retailers by allowing them to make a greater number of titles available in their stores. The president of InstaBook claims that a bookseller would need to sell only two to three books a day to break even on the cost of their $29,000 machine. The commercial viability of this model is not yet certain and depends to a great extent on the number of titles made available for on-demand printing.

Electronic Books - The emergence of electronic books is another technological development which could have important implications for the book retail industry. A number of companies are

[6]Scott, Richard. "Is On-Demand Printing Ready for Prime Time?". Industry Newsroom, American Booksellers Association, http://www.bookweb.org/home/news/btw/2064.html

developing electronic book readers. These include NuvoMedia's Rocket eBook, Softbook, Librius.com's Millennium E-Reader, Glass Book and Everybook. SoftBook and Rocket eBook are the only two products which are currently available.

There are a wide range of features and prices for the electronic book readers under development. Librius.com's Millennium Reader is the smallest and cheapest product being developed. It will be 12" x 8" and sell for about $200. The $1,500 Everybook will consist of a two page, hinged notebook screen, which will allow for the display of material in a "book like" format. The target markets for this product are legal and medical professionals.

In order to preserve copyright protection, electronic books incorporate several features. Electronic books are sold for use by a particular user. Licenses do not allow multiple users to read content from one electronic book reader. Text is downloaded in encrypted format from the Internet and is displayed in either HTML or portable document format (PDF).

There is also a market for electronic books distributed on PC's and hand-held computers. For instance, OverDrive Systems' BookWorks software provides a platform to publish searchable books for PCS. A number of corporations are distributing books to be read on Palm Pilots.[7]

Display technology and the number of titles available are barriers to the acceptance of electronic books. Rocket eBook, the most advanced electronic book reader available, has only several hundred titles available for distribution. The conventional wisdom is that readers prefer books in a paper format. Electronic screens cannot currently provide resolution of equivalent quality to a printed book.

[7]Hilts, Paul. "It's A Wrap! BEA 99: Selling to an Audience of One". PublishersWeeklyOnline. May 24, 1999

The initial market for electronic books will most likely be institutionally driven. Some corporations already prefer to distribute certain kinds of content electronically to reduce costs. Colleges and universities may also prove to be an important market. Sales of electronic book readers to students would allow publishers to amortize hardware costs across a number of titles.

One important consequence of institutional use of electronic books will be to distribute the hardware for the consumption of electronic books to a large audience. These users may choose to use this hardware for personal use as well. As display technology improves and electronic book readers penetrate the market, electronic books will become an increasingly viable option for publishing books. Some industry watchers believe that electronic books will be widespread by 2005.[8]

The emergence of electronic books will give online book retailers an additional advantage over their land-based rivals. It will provide them with an inexpensive way to distribute books and might also provide a means for users to browse content online. B&BN.com recently announced a partnership with Microsoft to distribute electronic books from its web site. The Microsoft Reader will be available as a free download from the site. There is no reason why independent booksellers cannot also sell to this emerging market. Powell's Books, based in Portland Oregon, was the first independent bookstore to sell electronic books.

2.3 MARKET DEVELOPMENTS IN WHOLESALE

A number of market developments in the book wholesale industry have important implications for the book retail market. The industry has been significantly affected by the shift to electronic commerce. Book wholesalers have introduced new service offerings to facilitate the use of electronic commerce.

[8]Ibid.

There are only two book wholesalers with a national reach. Ingram Book Group is the largest book wholesaler in the U.S. It annually ships more than 115 million books, audiotapes and CD-ROMs. It handles about two thirds of the books that go to US retailers via wholesalers. It is more efficient and has more distribution centers than the number two wholesaler, Baker & Taylor.

Ingram has a unique relationship with the retailers it serves. Many small retailers buy 100% of their books from Ingram. Ingram licenses the database used by a number of web based electronic commerce sites. It also manages the operating system used by many stores to collect point-of-sale information and provides the software which allows bookstores to access the Books-in-Print database. Ingram has agreements with many of its customers that allow it to obtain sensitive sales information from store computers on a regular basis. As a precondition for providing credit to booksellers, it has required many small retailers to provide detailed financial data on store performance.[9]

Barnes & Noble recently attempted to purchase Ingram Book Group. This effort was driven, in part, by the desire to obtain additional distribution centers to speed delivery of books ordered on the BN.com web site. The decision of the FTC to deny the merger was premised on Ingram's unique role as an information intermediary.

Ingram's status as a takeover target caused many booksellers to give other wholesalers more of their businesses. Baker & Taylor (B&T), the second largest book wholesaler, has experienced significant sales growth as a result of this. Recently B&T announced plans to increase its warehouse capacity by 90%. The expansion of facilities will allow B&T to offer a greater selection of titles and faster shipping.

[9] Petrocelli, William. "Books on the Brink". Industry Newsroom. Bookweb.org, January 9, 1999

B&T offers a number of services which cater to Internet retailers. For the last year, B&T has offered drop shipping from its warehouses. This service works in the following way. An online retailer or bookseller transmits a customer address, book title and price to B&T. The book is then shipped directly to the customer with a shipping label and invoice which has only the retailer's name on it. A bookseller wishing to participate in this program pays a setup fee of $250 which is refunded when a certain sales volume is reached. The company charges 95 cents per book and attaches a drop shipment fee to the order. Varsitybooks.com is one online retailer that has taken advantage of this service. A number of independent booksellers use this service as well. B&T also serves as the fulfillment company for BookSense.com, ABA's online sales program for independent booksellers.

B&T recently added the capability to bundle different types of products (books, CDS, video) into the same package. This service is of particular value to online retailers.

Other wholesalers, such as Ingram and Koen, also offer drop shipping services. Large wholesalers can often perform these shipping functions more efficiently since they have lines set up to pack orders and have frequent pickups scheduled with parcel delivery services.

The emergence of Internet technologies has had important impacts on book wholesaling. While some industry analysts had initially predicted that wholesalers would be disintermediated by Internet technologies, the opposite seems to be the case in the book wholesale market. The explosion of active titles has made the job of the wholesaler more difficult, but it has also increased the value of the wholesaler as an intermediary. Electronic retailing has provided opportunities for wholesalers to offer new services and has allowed them to obtain better data on the markets they serve. Online fulfillment services enable wholesalers to obtain valuable data (customer identity, retail prices) which they did not previously have access to.

2.4 TECHNOLOGICAL DEVELOPMENTS IN BOOK RETAILING

A number of technological developments have made Internet retailing possible. The widespread adoption of PCS, the increasing bandwidth available for communication, the emergence of Internet protocols for network communication and the development of new software products have all been important building blocks of the electronic marketplace. In book retailing, the most important technological developments have been computerized title databases and the software products to make these databases available over the Internet. Ingram Book Group developed the first computerized title database in the late 1980's. Internet merchant software has been available since 1995. The cost of installing and using these types of software packages has fallen dramatically since.

Amazon.com used Netscape's Internet Commerce Server and customized search engine technology to set up its original site. Their current site uses Oracle database technology. Cost estimates for setting up a full featured Internet commerce site range between $50,000 to $2,000,000 depending on the types of features which are provided.

Retailers who have waited to go online now have access to Internet commerce service providers who can make these capabilities available remotely for a monthly fee. A number of sites offer back end databases and ordering software that can be linked to a bookseller's web page. Nautilus's Booksite.com and the ABA's BookSense.com are two examples of this technology. Booksite.com currently serves a number of Independent booksellers, while BookSense.com is a forthcoming ABA initiative, which is scheduled to begin operation sometime in the year 2000. Also significant for the small bookseller is the movement of electronic ordering software to the Internet. Each of these is described in more detail below.

Nautilus's Electronic Commerce Solutions

Nautilus provides database and site hosting services to enable bookstores to establish an online presence cost effectively. The company has several different services. Its Echieve.com service allows businesses to rent an Internet commerce database, that offers a shopping cart, secure online ordering and web page hosting features for $50 per month. This service does not provide database content. The labor involved in providing this content might include securing promotional material from publishers, obtaining the rights to reproduce book covers and scanning this material into digital form.

Echieve.com is a generic Internet commerce provider service. Its database can contain any merchandise that a retailer might want to sell. This service is similar to that provided by the Yahoo! Store and numerous other vendors.

Nautilus also offers a more advanced service called Booksite.com. It gives booksellers database content and electronic ordering through Nautilus's OrderDemon.com service. This service also provides a means for retailers to efficiently place orders with publishers. The cost of this service has fallen dramatically from $2,500 in 1996 to $110 per month today. Nautilus currently has approximately 150 bookstore customers.

OrderDemon.com has a database of 1.2 million titles, 500,000 which can be ordered electronically. It utilizes both Baker & Taylor and Ingram's title Database. The OrderDemon.com can be linked to a web site and used as the back end for an Internet bookstore, or it can be used by traditional retailers as a substitute for phone or EDI orders from publishers. Order Demon is an extranet based ordering system that charges a fee to publishers for each transaction. The system primarily serves those publishers and wholesalers not served by the industry's major EDI vendor, PUBNET.

Booksite.com uses Texis database software. The shopping cart ordering system is proprietary add on software designed by Nautilus programmers.

Other services are planned for the near future. Card Demon will allow integrated Internet and in-store credit card processing. Drop Demon will simplify the process of using wholesaler drop shipment services by automating submission of the forms necessary to employ these services. Register Demon will provide Internet based product listing for stores without in-store computerized inventory management systems.

PUBNET

Regardless of whether a book store chooses to receive orders from customers electronically, electronic ordering from publishers has become common in recent years. The cost to set up and use the industry standard ordering system has also fallen significantly. PUBNET is the most widely used electronic ordering system, with over 3,000 bookstores participating. PUBNET is an EDI system that allows booksellers to order books electronically from publishers. In 1998 it was upgraded to a hybrid EDI/Internet system called PUBNET 2000. A number of customers still use the older system.

The costs of using PUBNET 2000 are lower than the previous EDI system. Setup costs for booksellers have fallen from $300 to $75. The need for proprietary software and the use of specific computer hardware has been eliminated. Additionally, bookstores no longer need to dial in, but can access the system over the Internet. The system is free for booksellers, but charges publishers a transaction fee of 75 cents for each order.

About 75% of bookstores use point of sale systems, most of which can be tied in to PUBNET to enable automatic re-stocking. Point of sale software typically only allows automated re-stocking through a few major wholesalers and publishers (as well as PUBNET).

The replacement of EDI systems with Internet based or hybrid ordering systems is a development which is beneficial for small businesses. Internet based procurement systems do not require expensive proprietary technology. This allows a greater number of small publishers and small retailers to take advantage of electronic ordering.

BookSense.com

The American Booksellers Association is currently deploying a web site that will allow participants in the Book Sense marketing campaign to establish an on-line presence. The site will use the 1.6 million title Muze database, which includes blurbs, reviews and full color jackets. The pricing information in Baker and Taylor's 300,000 title database will supplement the Muze database information. The site will include a search engine and real-time credit card processing. Fulfillment will be handled by Baker & Taylor and eventually by individual stores as well.

Phase I of BookSense.com was scheduled to launch in September of 1999, but has been delayed until sometime early next year. Phase I of BookSense.com will provide basic ordering capabilities with fulfillment being handled by Baker & Taylor. In phase II the ABA plans to bring the inventory of individual stores on-line and allow them to fulfill orders. While phase I of BookSense.com will let stores discount according to B&T's discount codes, phase II will give stores the flexibility to discount titles individually. Phase III of the program will occur later in the year 2000 and will include an associates program, store charge accounts and frequent buyer clubs.

The ABA estimates the site will cost $2 million. The system utilizes Oracle database software and customized search engine technology.

Booksellers who participate in the program will design their own sites and maintain their own identity. BookSense.com will provide stores with tools that allow non-programmers to set up their own web sites. Stores will pay a $500 setup fee and a $200 monthly membership fee. BookSense.com will also collect 4.5% of the value of each sale.

Stores that participate in BookSense.com are required to co-brand their sites with the Book Sense logo. They are also required to show at least one of the featured Book Sense titles.

The profitability of book sales through BookSense.com will depend on the types of discounts provided, and the number of books ordered. Assuming a customer orders three books at once, a typical $10 trade book that carries a 40% markup from B&T would yield a 30.5% gross profit for the bookstore. From the sale, 2% would be paid to Muze, 4.5% to BookSense.com, 2% to the credit card processing company and 1% to the bank for online transaction processing.[10] The actual margin that a bookstore might expect from such a purchase would undoubtedly be less due to robust competition on-line.

BookSense.com, Booksite.com and PUBNET 2000 each promise to reduce the economies of scale in on-line commerce and bookstore administration. Small booksellers can have access to a set of database and Internet tools with a reduced requirement for investment in hardware, software and their attendant complexities. These services reduce the technical hurdles and the barriers to entry for booksellers into electronic commerce.

[10] BookSense.com FAQ, Bookweb.org

Competition between the ABA’s BookSense.com and Nautilus’s Booksite.com has implications for who will eventually control electronic ordering in the industry. The ABA‘s BookSense.com is a more full featured system, but it is also more expensive and has yet to be deployed. Booksite.com doesn’t have fully automated transactions, and thus a person must review each order before it is submitted. Booksite.com is an established technology though, and has benefitted from its early introduction into the market. Competition between these two services will be good for small booksellers, who will have a choice of service providers and receive a competitive price.

Important technological developments are also occurring in the college textbook and rare book markets. The National Association of College Stores has introduced Courseweb.org to help college stores get on-line. Several rare book search engines have become an important part of the rare book market. These developments are described in separate sections below.

Courseweb.org

Since the launch of Varsitybooks.com in August 1998, the on-line college textbook market has seen the entry of numerous players. Bigwords.com, Efollet and Textbooks.com(B&N) have all opened shop on-line. In the spring of 1999, the National Association of College Stores (NACS) rolled out Courseweb.org, a service that provides college stores a way to get on-line with minimal in-store technology. Courseweb.org, currently has ten stores on-line, with approximately 100 stores planning to participate.

Courseweb.org provides web site hosting and database services for participating stores. The site includes web development tools that minimize the technical knowledge required to set up store web pages. Vendor databases from Ingram, Baker & Taylor, NACS Inc. and others are also provided. Some of these databases are made available at the Courseweb site, while others are located at other vendor sites and can be searched remotely.

The NACS has partnered with Collegestudent.com to host the Courseweb.org sites. Links to participating stores have been placed on Collegestudent.com's web site. Web sites established through Courseweb.org will benefit from Collegestudent.com's marketing program, which will spend $8 million to market their site over the next year. NACS's relationship with Collegestudent.com is a strategic one that does not currently cost the Association any money.

Each Courseweb site is customized to fit the needs of the local store. Courseweb.org provides the capability to upload data from a number of textbook management systems. Stores can thus upload information on the required texts for courses offered at their specific college or university. Individual stores may use their own promotional material, or incorporate turnkey promotions and merchandising content provided by Courseweb.org. Unlike BookSense.com, Courseweb sites are not required to reveal that their site is part of a cooperative network of college stores.

College stores can use their existing credit card accounts or take advantage of rates negotiated by the NACS with Bank One or Penn Security. The credit cards of customers are not charged until orders are reviewed through Courseweb's order management system, which is accessible over the Internet.

The cost to participate in the program varies by the volume of commerce transacted through the site. Courseweb.org charges a $1,000 one-time activation fee, a 5% transaction fee and a variable monthly fee that depends on the volume of store sales. Stores selling under $1 million annually pay $100 per month while those with sales between $1 million and $5 million pay $150. Stores selling more than $5 million are charged $200 per month.

The college market is divided between contract managed stores, university affiliated stores and independent stores. Only the independent college text book stores would be considered small businesses.

The NACS represents approximately 3,500 stores, 1,100 of which are contract managed stores. Follet manages 600 of these stores and Barnes & Noble manages 300 others. Most of these stores are going on-line through Efollet or Textbook.com.

University affiliated and independent stores are the likely users of Courseweb.org. There are approximately 1,750 university affiliated stores and 650 independent stores. Many of the independent stores are located off campus and compete with a campus store.

Larry Daniels, Associate Executive Director at the National Association of College Stores was interviewed for this report. He believes that traditional stores can compete on-line with the national players as long as there are not imbalances which lead to unfair competition. Dual pricing and sales tax exemptions are two issues that may tilt the playing field against local stores.

The dual pricing policies of some publishers have been a source of concern for many traditional retailers. Books sold for educational use are often discounted less than those that are destined for the general market. On-line retailers, who purchase books that are not "short discounted", can obtain a price advantage over traditional college stores who don't receive these discounts.

Some on-line retailers have also been treated by publishers as distributors and thus have been able to purchase books at a discounted rate. While publishers are allowed to price their products differentially, the Robinson Patman Act requires that such prices must be justified by differences in the cost of selling to different customers. Publishers argue that the higher marketing costs associated with academic sales and the no-returns policy used for distributors justify these cost differences.

Varsitybooks, based in Washington DC, was the first on-line textbook retailer. The company achieved $5 million in sales in the first half of 1999 and recently won a first round of venture capital funding. Industry analysts have attributed the success of Varsitybooks.com to an aggressive marketing program that has targeted professors and used Freedom of Information Act (FOIA) requests to obtain course lists. Varsitybooks.com has built relationships with publishers and existing stores to promote on-line sales. As the "first mover" in the on-line college textbook market, Varsitybooks.com has also been the beneficiary of the free advertising provided by media attention.

The college textbook market is substantially different than the trade book market. Textbook shoppers are predominantly precision shoppers. They have a list of books that they need, and they go to a store to buy these. The convenience of on-line shopping is thus well suited to serve these customers.

A number of factors may enable small businesses to effectively compete in this market. Localized marketing is needed to reach the college student textbook shopper. The particular needs of these consumers differ across schools, determined by the courses offered.

National retailers have relied on marketing expenditures to build on-line brands. Smaller rivals have often found that they lack the resources to invest in building a brand on-line. Building an on-line brand using search engine advertising and affiliate marketing may be less effective for college students. The population of these consumers has a rapid turnover, and it is unclear what the value of branding in this market will be.

A number of local factors may also influence competition. Some college dormitories don't allow small package deliveries, reducing the relative convenience of the national on-line textbook sellers. The local presence of college stores enables them to more effectively purchase used books or provide books for immediate pickup.

The content that national on-line retailers provide on their sites is a major scale advantage that they enjoy over their smaller rivals. For instance, Courseweb.org does not provide extensive book reviews and site content that the larger sites can afford. Content advantages may be less significant in the college market, since students typically already know what they need to purchase and may be less interested in obtaining additional information on specific titles.

The major on-line textbook retailers have used a number of marketing innovations to overcome their lack of local presence. They have developed affiliate relationships with professors. These provide monetary incentives for professors to steer their students to a particular on-line retailer.

Varsitybooks uses student representatives, some of whom have stock options in the company, to provide local marketing services. Such services might include putting up posters or handing out flyers.

As colleges out-source their Internet services to private businesses, campus email systems and web sites may provide another channel for national retailers to reach local college consumers. A number of companies, such as Pipeline.com, have begun to provide email and web hosting to colleges for free, or at very reduced rates. In exchange for these services, they place advertisements in college email and on hosted web sites. The spread of these services is likely to alter the competitive landscape. They will provide national retailers with another channel to market themselves to students.

Antiquarian/Rare Book Search Engines

The impact of Internet selling is perhaps most advanced in the rare/antiquarian book markets. The launch of several major book search services in 1996 initiated rare and antiquarian booksellers to Internet selling. Since then, the emergence of Internet auctions has further facilitated trade in rare and antiquarian books.

Publishers Weekly interviewed a number of rare book dealers in April of 1999 and found that most dealers reported the Internet contributes at least 8% to 10% of their sales. About 70% of the members of the Antiquarian Booksellers Association, who comprise the high end of the used and rare book trade, reported doing business on-line.

Rare book dealers can sell on-line by listing their inventory on one of the major search engines. These include the Advanced Book Exchange (www.abebooks.com), Bibliofind (www.bibliofind.com) and Bibliocity (www.bibliocity.com). Another book search engine, launched more recently, is the Netherlands based Antiqubook (www.antiqbook.com). To list inventory, booksellers pay a flat fee between $10 and $40 per month. The Advanced Book Exchange and Bibliofind were the largest dealer networks in April 1999, having over 4,000 booksellers listing at each site.

The Bookfinder.com site serves as a “meta search engine”. Customers searching for a particular book may launch a search on the Bookfinder.com site and search all the book search engines simultaneously. Bookfinder also searches the inventories of on-line retailers, such as Amazon.com and Powell’s Books.

Alibris (www.alibris.com/cgi-bin/texis/bookstore), another site listing rare books, operates on a slightly different model. Customers purchasing books from the site purchase from Alibris directly, although often the books listed on the site are physically located on the premises of other dealers. When a purchase is made, Alibris has dealers forward books to its facilities for inspection prior to fulfilling the customer order. Alibris also holds a substantial inventory and makes its money by marking up each book sold through the site. Alibris’s customers are mostly large institutions such as Amazon.com, libraries and large retailers.

A number of booksellers have also taken advantage of eBay to sell books on-line. The emergence of the Internet market has reduced the barriers to entry into the rare book markets. This has resulted in a substantial expansion of the number of dealers trading books and a disruption of the traditional food chain in the industry. Previously, book scouts would sell to dealers, who would sell to high end dealers, who would sell to collectors. Now it is common for scouts and dealers to market their own books.

The Internet has facilitated bringing buyers and sellers together, and many dealers have reported a substantial increase in sales volume. Another impact has been a downward pressure on prices as consumers have access to data on what others are paying for specific types of books.[11] Individuals entering the market on a part time basis have also driven down prices. With no overhead, these hobbyists can make a profit with a lower markup.

Independent bookstores have done well in the rare/antiquarian book market. Powell's Books, a Portland, Oregon-based independent bookseller with nine stores, sells approximately 10% of its books over the Internet. Approximately 83% of on-line revenue comes from used books.[12] Many booksellers report that Internet revenues from used/rare books are not enough to support their stores, but provide a substantial source of revenue.

In general, used books in the $10-$100 range sell best on-line. Shipping costs often exceed the value of books falling under $10, providing a substantial disincentive to buyers. Rare items over $100 often require the customer to see the book and evaluate its quality in person.

[11] Raugust, Karen. "Used and Rare Books Go Online". Publishers Weekly, April 12, 1999

[12] Ibid.

2.5 MARKET DEVELOPMENTS IN BOOK RETAILING

Changes in consumer tastes and the emergence of new marketing techniques are two important developments in the book retail market. A number of factors determine the retail environment in which consumers choose to purchase books. The most critical factors are enjoyment of the retail experience, convenience and price. Book buyers can be divided into two basic types, those searching for a particular title, and those who are browsing. The increasing size of chain stores and superstores cater to both of these types of customers. The increasing number of titles offered in the largest stores provides both a better browsing experience and a higher likelihood that a customer searching for a particular title will find it.

Internet retailers have provided a retail environment that caters more to the customer searching for a particular title. Although some Internet retailers provide on-line content, such as interviews with authors and reviews of books, they can not duplicate the book buying experience of browsing in a traditional book store.

A customer browsing for a certain type of book may wish to ask for advice. Small booksellers are more likely to have staff that can provide book recommendations to particular customers based on their knowledge of both the customer and the books available. On-line services do provide customized recommendations based on computer matches by subject and books purchased by similar customers. Although database recommendations are often of interest, they are less likely to point a reader in fundamentally new directions. Personal interaction is an aspect of the small booksellers retail environment that can not be duplicated on-line.

Traditional stores thus have a competitive advantage when it comes to serving the “browser”, but browsers may not be the most profitable customers. They may choose to browse in a bookstore and then buy on-line. Paco Underhill has suggested that chain book stores have been relocating out of malls because the high rents in these retail spaces were not justified by the volume of sales the stores were able to generate. Many of the customers browsing in these stores were waiting for family members who were shopping in other stores. These browsers tended not to buy many books.[13]

In the Experience Economy, Pine and Gilmore argue that retailing of the future may become more focused on providing an "experience" than on the sale of goods[14]. The extent to which this could be a viable model for small booksellers seems questionable. Unfortunately for the small bookseller, customers can consume the experience of a bookstore without buying anything.

Bookstore cafes are one mechanism that many small bookstores have found effective to charge for some of the experience aspects of the bookstore environment. While some stores have found these useful in increasing sales, others have found that the skills needed to manage these cafes are significantly different from those used in running their existing bookstores.[15]

Convenience is another important factor that affects the competitiveness of small booksellers. Many independent bookstores are located in the central business districts of towns and cities. The decline of retailing in these downtown locations has made them less convenient to consumers who are shopping in malls or at big box retailers.

There is some evidence that customers have recently begun to place a higher value on their time. The amount of time devoted to leisure has fallen since the early 1980's and consumers may be more willing to accept higher prices in return for enhanced convenience and time savings. Precision shopping is

[13]Underhill, Paco. Why We Buy, The Science of Shopping. Simon & Shuster, New York, 1999, p. 229

[14]Pine, Joseph; Gilmore James. Welcome to the Experience Economy. Harvard Business School Press, April 1999

[15]Kate Whouley. Manual On Book Selling: Practical Advice for the Bookstore Professional. American Booksellers Association, 1996

becoming more common. For instance, consumers are visiting fewer stores when they shop at malls.[16]

On-line retailing has offered consumers the convenience of shopping from their homes. It is interesting to note that catalogue mail order was a dominant mode of retailing until the 1920's when improved transportation and urbanization made in-store retailing profitable. Congestion in some areas may be reducing the convenience of visiting traditional stores.

On-line retailing is convenient to the customer in a number of ways. The search engine technology offered by the major on-line retailers allows customers searching for a particular book to locate it with ease. Affiliate marketing programs and search engine advertisement also offer the consumer the option to purchase books in the specific contexts in which they are searching for information. For instance, a Yahoo! search on a particular model of car will bring up an icon for Amazon.com offering to sell Chiltons manuals and other books for the car. Home delivery of on-line books is convenient for customers who don't mind waiting a few days for their books.

Independents who can put their inventory on-line may be able to provide convenience to those customers seeking to obtain books immediately. Some retail consultants have argued that Independent book stores who don't have merchandise on hand can often order books and have the item delivered to customers faster than the major on-line retailers.[17] Thus an important component of the convenience on-line retailers offer seems to be generated by marketing expenditures that place links to their stores in the contexts where consumers are searching for information.

[16]"Note on the Retailing Industry". Harvard Business School, Case 9-598-148, May 13, 1998

[17]Whouley, Kate. "Racing the Cyber Stores to Success".www.bookweb.org/news/btw/1803.html. March 18, 1999

Pricing is another important component that determines the retail venue in which consumers purchase products. Currently the large superstores and online retailers have tended to discount books more deeply than independent book stores. For on-line retailers, some discounting has been made possible by the attractive economics of the Internet business model. Both the superstores and the large on-line retailers also enjoy economies of scale that provide them with structural advantages over small booksellers.

Some discounting has been driven by the desire to purchase market share. Amazon.com's move to become an Internet retail hub has involved using its book discounting policy to build brand awareness to make possible the sale of other products. In the long run, the economic viability of the small bookseller depends on the existence and magnitude of the structural advantages book superstores and on-line retailers enjoy relative to small booksellers.

Dick Harte, the President of Nautilus and the owner of Rutherfords Book Shop in Delaware, Ohio, was interviewed for this study. He believes that the Internet holds great promise for small retailers. According to his analysis of small bookstore finances, Internet retailers enjoy a 15% to 20% advantage in reduced operating costs from not having a traditional storefront. Shipping costs largely negate these saving, averaging about 15%. Additionally, Internet retailers need to spend funds to market their site. The storefront of a traditional retailer can be considered a marketing expense to draw in foot traffic. Internet retailers have no foot traffic, and thus must invest more in marketing.

Booksellers who have a web site in addition to their land based store can enjoy certain cost advantages that are not available to on-line only retailers. If customers choose to pick up goods ordered electronically, then a 15% savings on shipping costs can be achieved. This might be considered the Service Merchandise model of retail. If Internet orders can be processed with existing store personnel, then small booksellers may acquire an additional 10% cost advantage.

Traditional booksellers who also have an on-line presence can take advantage of name recognition in their community to sell to local customers. Web technologies can be an effective means for booksellers to expand and extend existing customer relationships. Store newsletters, book reviews, staff picks and notices of store events can all be disseminated cheaply using web page and email technology. They are also an effective way to direct customers to a store's web site.

Some booksellers have also been effective at using the media to promote their web site. For example, Politics & Prose in Washington DC has managed to increase hits to their web site from 2,000 in January 1999 to 40,000 in June 1999. This Internet traffic has been driven by articles in Publishers Weekly and the Wall Street Journal. Appearances by store owners on CNN have also helped. While Politics and Prose doesn't sell a significant share of books on their web site (about two per day), it is an important way to communicate with their customers. They have a weekly email newsletter and an email notification of store events that reaches 2,000 people.

Internet marketing efforts have focused on constructing affiliate networks and building strong brands. Each of these is discussed separately in the following sections.

Affiliate Marketing

Affiliate marketing is an important component of the on-line retailers' advantage over traditional stores. Affiliate marketing links the particular contexts in which people learn about books or topics of interest with an on-line retail location. This "contextual marketing" is convenient for the consumer and encourages impulse buying.

Under affiliate marketing plans, web sites register with a merchant and place a link on their site to the merchants store. Usually web sites sell items that are related to the interests of their users. For instance, a web site devoted to skiing might advertise books on skiing and provide affiliate links to

Amazon.com. Software at Amazon records how many users clicked through from a particular site and if they purchased anything. Amazon offers affiliates from 5% to 15% of the sale price of books. Barnes & Noble and Borders have similar affiliate programs, although these offer commissions between 5% and 7% of the sale price, depending on the total volume of sales generated from the site.

Media based affiliate relationships have been the subject of much controversy recently. The New York Times Best Seller List's affiliate relationship with BN.com has upset some independent booksellers, who provide sales data to the list. Salon magazine is another example of a media based affiliate relationship. All book reviews in the on-line magazine contain links to the BN.com site.

BN.com recently introduced email affiliate marketing. The program allows people to embed BN.com affiliate links in their email and obtain 5% of revenues generated from these links. These commissions can be donated to a favorite charity or collected for personal use.

On-line retailers typically derive 25%-35% of their revenue from click through purchases at affiliate sites. Retailers like affiliate marketing because they are paying for results. Unlike banner advertisements, affiliate marketing only costs money when a sale occurs. Amazon.com has over 300,000 affiliates, and BN.com claims an affiliate network of 160,000 sites.

Some small businesses, such as Positively-You.com, are also using affiliate marketing. This on-line bookstore was started by the director of the University of Iowa's Small Business Development Center. The store provides non-profits with 10% of every sale generated through affiliate links. Private sites can earn 5% commissions for affiliate sales. In addition to this, Positively-You donates 10% of every sale to a non-profit of the customers choice. The store is a Booksite.com customer and uses the affiliate marketing software built into that site.

Affiliate marketing seeks to achieve two primary goals. It builds brand awareness by displaying graphic or textual images that advertise an on-line merchant. Affiliate marketing also provides an important mechanism to reach users who otherwise wouldn't frequent a site. Affiliate marketer beFree.com argues the following on their web site,

"Affiliate sales channels evolved when merchants began applying lessons they had learned in the brick-and-mortar world to the online marketplace, but not before they had made a few mistakes. When merchants first established an online presence, they tended to forget the old retail adage that there are three secrets to successful selling: location, location, location. The merchant established a single, monolithic store and assumed that people would flock to it. When this failed, they tried to advertise their way out of trouble. Unfortunately, advertising can't overcome the location issue any better on-line than it does in the real world."

Studies by Forrester, Jupiter, and Nielsen show that by the time a user has been online six months, they have largely stopped using portals and have established regular traffic patterns on their favorite sites. In essence, they have created a virtual neighborhood for themselves consisting of sites that relate to their interests. In the real world, if a store is located 50 miles from your home, no amount of advertising will make you a regular customer of that store. Interestingly, just as in the real world, it is very difficult to shift online users outside their regular traffic patterns. The challenge to merchants is therefore to find a way to sell goods on the hundreds of thousands of sites that their online customers visit."

Many larger on-line merchants use service providers, such as beFree or Linkshare, to manage their affiliate marketing channels. These services provide several benefits. They are an independent clearinghouse to manage affiliate payments. They also leverage relationships with a number of Internet service providers to make it simple for web sites to become affiliates. For instance, beFree has a partnership with the web hosting service Geocities. Geocities has agreed to provide tools to their users to facilitate the creation of affiliate links to beFree's clients.

There may be some economies of scale associated with affiliate marketing technologies. Larger on-line retailers who can afford affiliate marketing service providers may have access to the superior technology and strategic relationships developed by these companies. Small businesses can employ affiliate marketing through such services as Booksite.com, or in the future, BookSense.com.

One advantage that large businesses enjoy in both the off-line and on-line markets is possession of a strong brand. The ABA's Book Sense program seeks to extend the advantages of branding to independent bookstores.

Book Sense Marketing and Branding Program

Large corporations have the ability to invest significant resources in building brand recognition. Branding allows a retailer to differentiate itself in the market and compete on factors other than price. In the on-line world, where consumers are deprived of other contextual clues about a product or service, the power of a strong brand can become dominant. Consumers are more likely to entrust their credit card information to a branded Internet merchant than they are to an unknown upstart. Web sites may be more willing to become affiliates with a branded retailer who has a reputation for providing quality service to its customers.

The American Booksellers Association has initiated an integrated marketing and branding program called Book Sense to build awareness of independent bookstores. The campaign is composed of several elements. Participating stores display the Book Sense logo, honor Book Sense gift certificates, conduct grass roots marketing and focus on hand selling a list of 76 books. There are over 1,000 bookstores signed up to participate in this program.

Book Sense was a concept that emerged from the Northern California Independent Booksellers Association and was adopted by the ABA. Book Sense seeks to build a national identity for independent bookstores while celebrating the unique virtues of each store. The campaign identifies four characteristics that independent bookstores share. These are personality, a passion for and knowledge of books, a commitment to community and a distinct character. The program seeks to stress the role of independent booksellers in offering and selling a diverse range of books. The motto of the program is independent bookstores for independent minds.

The gift certificate program seeks to raise consumer awareness of independent book stores by issuing certificates redeemable at any participating Book Sense store. This will encourage consumers to locate independent bookstores in their community.

The Book Sense program includes national advertising and grass roots public relations. The ABA is placing advertisements on National Public Radio and in weekly newspapers around the country. The campaign will rely heavily on the coordinated promotional efforts of local stores as well. Booksellers are provided with sample press releases and encouraged to inform local papers about the launch of the program. Book Sense logos will be placed on bags, in stores, store newsletters, stationary and store advertisements.

Book Sense stores will make nominations each month for the Book Sense 76 List. Participating bookstores will promote and hand sell books from this list. Not only does the list reflect the distinct literary taste of the independent bookseller, but also provides publishers with a measure of the combined selling power of independent bookstores.

There are economies of scale in building a brand. Significant investments in advertising and promotion must be made over a duration of time before a brand comes to the attention of consumers. By conducting the Book Sense program on a nationwide basis through a cooperative network of stores, the ABA hopes to achieve this scale. The Book Sense "brand" is focused on traditional land based retail operations. It is unclear how this brand addresses the important aspects of on-line competition.

The previous sections have dealt with a number of new technological and market developments in bookselling. These new technologies have not changed the fundamental economics of book retailing. The economics of independent bookstore retailing are thus described below using 1997 data.

3. ECONOMICS OF BOOK RETAILING

Profit maximizing retail activity seeks to increase sales while minimizing the cost of sales. Cost of sales includes the cost of goods (price paid to publishers and wholesalers for inventory), as well as the expenses required to operate a store. These operating expenses include payroll, rent and advertising. The difference between the price charged customers and the price of books purchased from suppliers is the gross margin. To obtain operating profits, a bookseller must have a gross margin that is larger than its operating expenses. The difference between the gross margin and operating expenses, plus any other income, minus other expenses, is the net income before tax. Table 1 shows the profit and loss statement of independent booksellers as derived from the "Abacus" survey data.

The ABA's ABACUS survey provides an annual snap shot of the financial health of independent booksellers. The ABA has collected detailed financial information from a sample of its members since 1989. The most recent data available is from the 1999 ABACUS survey, which reports financial information for the 1997 fiscal year. Approximately 3,000 questionnaires were mailed to the ABA's bookstore members throughout North America. From this universe, 237 responses were received, of which 227 were usable.

One bias of the survey is that it excludes those stores who are unable to generate the required financial information. The purpose of ABA's survey is to provide a means for independent bookstores to benchmark their performance against the average for their industry.

To effectively compare the performance of different stores, financial ratios need to be employed that compare store expenses and profit as a percent of sales. Table 1 shows profit and loss statement data as a percent of sales. Stores were divided into three profitability groupings. Unprofitable bookstores had 0% or less net income before taxes as a percent of sales. Low profitability stores

Table 1: Profit and Loss Statement for Independent Booksellers by Profitability Grouping

	All Independents (average)	Unprofitable (average)	Low Profitability (average)	High Profitability (average)
Total Sales	100.00%	100.00%	100.00%	100.00%
Less: Cost of Goods Sold	61.55%	62.81%	61.81%	59.38%
Gross Margin	38.45%	37.19%	38.19%	40.62%
Less Expenses: *				
Payroll Expense (Total)	18.49%	19.48%	19.41%	15.67%
Owners Compensations	5.60%	5.72%	6.37%	4.23%
Wages: Employees	12.08%	12.94%	12.15%	10.78%
Employee Benefits	0.76%	0.76%	0.84%	0.63%
Data Processing--Payroll	0.04%	0.05%	0.04%	0.03%
Occupancy Expense	7.39%	8.62%	6.74%	6.67%
Advertising	2.20%	2.53%	2.08%	1.93%
Telephone/Communications	0.72%	0.82%	0.68%	0.65%
Professional Services	0.61%	0.68%	0.51%	0.65%
Stationary and Supplies	1.04%	1.20%	0.96%	0.92%
Data Processing Exclusive of Payroll	0.23%	0.24%	0.23%	0.20%
Depreciation	1.07%	1.46%	0.82%	0.90%
Travel and Entertainment	0.41%	0.45%	0.38%	0.41%
Insurance	0.56%	0.76%	0.47%	0.40%
Credit Card Service Charges	0.95%	0.99%	0.97%	0.85%
Dues and Subscriptions	0.34%	0.41%	0.31%	0.28%
Miscellaneous Office Expense and Postage	1.06%	1.39%	0.95%	0.75%
Taxes	0.36%	0.42%	0.39%	0.25%
All Other Operating Expense	1.83%	2.18%	1.46%	1.92%
Total Operating Expense	37.25%	41.63%	36.38%	32.46%
Operating Income	1.20%	-4.44%	1.81%	8.16%
Other Income	0.71%	0.43%	1.27%	0.23%
Other Expense	0.76%	0.64%	1.22%	0.22%
Net Income Before Tax	1.14%	-4.65%	1.85%	8.17%

were classified as those with net income before taxes between .01% and 4.24% of sales. Those stores with net income before taxes greater than 4.24% of sales were classified in the high profitability group.

The key difference between profitable and unprofitable independent booksellers is control of payroll costs. Unprofitable booksellers had payroll expenses of 19.48% of sales while profitable booksellers had payroll costs of only 15.67% of sales. Profitable booksellers had lower relative costs across all payroll categories, including owners compensation, wages, employee benefits and payroll data processing.

Control of payroll costs can stem from a number of different business practices. For instance, lower payroll costs as a percent of sales may result from a bookseller achieving a large scale of operation, creating a greater volume of sales per employee. It may also reflect the business philosophy of the owner to pay lower wages to employees or to reduce his own payroll compensation and take some of this income as business profits.

Other factors may also affect the profitability of a bookseller. For instance, the data show that depreciation costs and advertising costs are lower as a percent of sales for highly profitable booksellers than for unprofitable booksellers. This can result from the larger scale of store operations for profitable booksellers, that allow these stores to spread advertising and equipment costs across a greater volume of sales, or it might also indicate that recently opened stores might incur expenses that more established and profitable booksellers do not have.

Another important factor affecting advertising costs are co-op payments from publishers. Co-op payments are distributed by publishers to promote particular titles. These monies can be obtained by stores to set up window displays, promote author readings or advertise books in the local media. The co-op policies of many publishers are elaborate and complicated. Larger stores may often have an entire employee dedicated to obtaining the co-op monies that are available. To the extent that a store is able to obtain co-op monies to advertise, it may be able to reduce its own expenditures for advertising. There are economies of scale for obtaining co-op monies, driven primarily by the complexity of the rules governing these payments.

The ABA is currently suing Barnes & Noble and Borders for soliciting more favorable terms for co-op payments than are publicly available to other stores. Under the Robinson-Patman Act, marketing payments, such as co-op money, are required to be made available to all retailers on equal terms unless there are cost differences in distributing these funds to different types of customers.

Co-op payments have, so far, had less significance for on-line retailers. The policies of many publishers haven't been fully updated to facilitate the use of co-op payments for Internet advertising. On-line retailers are still working with publishers on how their co-op policies apply to the Internet. Regardless of the outcome of the ABA case, the ability to obtain co-op monies is likely to remain an important economy of scale that allows larger booksellers to reduce their own advertising expenditures as a percent of sales.

Table 1 also shows that as the cost of goods sold decrease, profitability increases. Cost of sales comprised an average of 61.55% of sales for those booksellers in the unprofitable group, but only 59.38% of sales for those booksellers in the profitable group. Cost of sales is influenced by a number of different order management and purchasing practices. Stores that anticipate demand for certain titles can purchase books directly from publishers and avoid higher wholesale prices. Stores that attain sufficient volume may also order in bulk from publishers and obtain discounts.

The Abacus data allows a number of measures of retail productivity to be constructed. Productivity is generally defined as output produced given a particular input. The productivity of retail activity can thus be measured for a number of different inputs, including advertising expenditures, operating costs, square feet of retail space, number of employees and investment in inventory. Table 2 shows data on the ratio of sales to a number of these variables. The data is broken out by store size and shows that for a number of variables productivity increases as the size of the retail operation increases.

Advertising expenditures as a percentage of sales fall from 3.0% for stores with $125,000 in sales to 1.2% for those stores with greater than $4 million in sales. These results reflect advantages that large stores have in obtaining co-op money as well as other factors.

Operating expenses as a percent of sales are generally lower for those stores falling into larger sales categories, although this is not uniformly true. Stores falling into the second largest sales category achieved the best ratio of operating expenses to sales.

Net income as a percentage of sales was not uniformly higher for larger stores, although those stores falling into the two smallest sales categories were the least profitable. Stores falling into the second largest sales category achieved the highest profitability, with net income comprising 4.2% of sales. In general, independent book stores operate with very slim profit margins. On average independent bookstores achieved net income of 1.1% of sales.

Table 2 also shows that average sales per selling square foot are generally higher for stores with greater sales. Sales per selling square foot average only $86 per square foot for those stores in the smallest size category, while those stores falling into the $4 million or greater size category average $577 per square foot. Average sales per employee tend to increase for stores in larger sales categories, although the greatest sales per employee were achieved by those stores in the $2 to $4 million annual sales category.

Tables 2: ABACUS Survey Financial Ratios by Store Sales Volume

Sales Category	Stores	Advertising % Sales	Total Operating Expense % sales	Net Income % Sales	Sales per Selling Square Foot	Average Sales Per FTE Employee	Inventory Turns	Gross Margin	Gross Margin Return on Inventory Investment
$125,000 or less	14	3.0%	47.5%	-7.1%	$86	$52,951	1.5	39.6	1.08
$125,001 to $250,000	38	2.5%	39.3%	0.5%	$132	$94,431	2.2	38.8	1.46
$250,001 to $500,000	42	2.7%	35.8%	1.9%	$160	$107,642	2.8	38.3	1.64
$500,001 to $750,000	25	2.2%	36.2%	2.0%	$253	$127,653	2.7	38.4	1.64
$750,001 to $1,000,000	15	2.6%	37.7%	1.2%	$318	$127,708	3.3	39.8	2.09
$1,000,001 to $2,000,000	15	1.6%	35.1%	2.8%	$307	$119,833	3.2	37.9	2.25
$2,000,001 to $4,000,000	9	1.8%	33.8%	4.2%	$373	$159,448	3.6	38.3	1.94
$4,000,001 or greater	9	1.2%	37.1%	1.3%	$577	$139,928	4.4	38.6	2.77
Multiple Independents	125	1.2%	35.4%	1.5%	$374	$135,087	2.6	37.3	1.68
All Single Independents	167	2.4%	37.5%	1.1%	$317	$111,284	2.9	38.6	1.73
All Independents	292	2.2%	37.3%	1.1%	$350	$114,117	2.8	38.5	1.71

Table 3: Key Financial Variables for Booksellers
Independents, Superstores and Amazon.com

Financial Variables *	Independents	Barnes & Noble	Borders	Amazon.com
Occupancy Costs (% of sales)	7.4%	12%	12%	< 4%
Sales Per Operating Employee	$111,284	$124,000	NA	$239,413
Inventory Turns	2.9	2-3 est	2-3 est	50
Sales Per Gross Square Foot	$271	$263	$261	$1,670
Rent Per Square Foot	$13	$20	$20	$8
Advertising	2.2%	NA	NA	7.0%
Gross Margin **	45.9%	27.8%	27.9%	23.5%
Net Income (% of sales)	1.1%	3.5%	5.8%	NA
Operating Costs (% of sales)	29.9%	22.5%	21.4%	35.3%

* See text for detailed description of which data these variables where drawn from
** Gross margin is calculated as the difference between sales and the costs of goods and occupancy costs

An important measure of retail performance is the productivity of the investment made in inventory. One way to measure this is by calculating how many times a store turns its inventory per year. Inventory turns reflect how much merchandise a store can sell a year for a given average monthly investment in inventory. Table 2 shows the number of inventory turns per year by sales category. Inventory turns are calculated as the cost of goods sold divided by average monthly inventory. The number of inventory turns generally increases as sales increase. Stores in the smallest sales category turn their inventory 1.5 times per year. Those in the largest sales group turn their inventory 4.4 times.

Examining only inventory turns sheds no light on the profitability of the goods sold. It is both the gross margin and the volume of the goods sold that determines the profitability of retail activity. The last column in Table 2 thus shows a combined measure of these two variables. The gross margin return on inventory investment (GMROI) is calculated as the total value of the gross margin of goods sold, divided by the value of the average monthly inventory. It shows the dollar amount in gross margin generated for every dollar investment in inventory. GMROI can be increased by either turning inventory more quickly or increasing the gross margin on the goods sold. In general, GMROI tends to increase with store size class. Those stores in the largest size class achieved the greatest GMROI, 2.77. While all the other statistics shown in the table are averages, the figures shown for GMROI are medians.

Table 3 compares key financial variables for booksellers. The data is drawn from a number of different sources, including 10-K forms from Amazon, Borders and Barnes & Noble. Estimates on the number of sales per employee, inventory turns and rent per square foot for Borders and Barnes & Noble are taken from the Harvard Business School Case study "Amazon.com - Going Public". Data on independent booksellers are drawn from the Abacus survey data. All figures are representative of the 1997 fiscal year.[18]

[18]Fiscal year beginning and ending dates vary between companies

The data show that independent bookstores use space more efficiently than the book superstores. Independents have average sales of $271 per gross square foot compared to $263 and $261 per gross square foot for Barnes & Noble and Borders respectively. Independent bookstores also have lower average rent per square foot than the major chains, who tend to locate superstores on more expensive real estate near high traffic areas. Amazon.com's retail model is the most efficient user of space, achieving sales of $1,670 per square foot[19]. Since location of its retail facilities is irrelevant to its ability to sell on-line, Amazon.com's rent per square foot is also lower than either the book superstores or the independents.

Independent booksellers mark up their merchandise more than either the book superstores or Amazon.com. The independents maintain average gross margins of 45.9%.[20] The gross margins for Barnes & Noble and Borders are 27.8% and 27.9% respectively. Amazon.com's marks up its merchandise the least, maintaining a gross margin of only 23.5%.

Net income as a percent of sales (pre-tax profit margins) are slim for independents, averaging only 1.1% of sales. Borders is the most profitable of the major chains, maintaining profits of 5.8% of sales. Amazon.com has yet to turn a profit. Its continued investment and aggressive expansion strategy have inflated its operating costs as a percent of sales (35.3%). Both Barnes & Noble and Borders have been able to maintain higher profits and lower gross margins by achieving very low operating costs as a percent of sales, 22.5% and 21.4% respectively.[21] Independent books stores have struggled with high operating costs (29.9% of sales), in part, because of higher labor costs. Sales per

[19]Square footage includes the sales office, but excludes distribution facilities

[20]Gross margins shown include cost of goods as well as occupancy costs. They are reported in this format because the Borders and Barnes & Noble 10-K's report the data in this fashion. Note that the gross margin for independents in Table 1 differ from those reported here by the percent occupancy costs.

[21]The difference between gross margins and operating costs do not equal profits since pre-opening expenses and amortization of goodwill associated with acquisitions is not included in operating costs

operating employee averaged $111,284 at independent bookstores compared to $124,000 per employee at Barnes & Noble.[22]

Amazon.com dominates in the retail labor productivity category, with sales per operating employee of $239,413. Amazon.com also shows superior inventory investment performance, turning its inventory 50 times per year compared to 2-3 times for typical land based retailers. Since on-line retailers can choose not to hold any inventory, they can theoretically achieve infinite inventory turns. In reality, on-line retailers have typically chosen to hold some inventory to improve customer service and reduce delivery times. Ordering from publishers and holding inventory can also improve gross margins by eliminating wholesaler markup. Since 1997 Amazon.com has chosen to expand its own inventory and reduce the percentage of merchandise ordered from wholesalers.

While many have touted the advantages of on-line commerce in eliminating the expense of a retail store front, the data suggest that this may not currently be a major advantage of this retail model. One can consider occupancy costs as a marketing expense required to attract foot traffic to a land based store. On-line commerce operators don't have these expenses, but they do have to invest significant resources in advertising and marketing to drive traffic to their sites. The combined occupancy costs and advertising expense of independent bookstores are 9.6% of sales. Amazon.com's combined occupancy and advertising costs are higher at 11%.

There is significant debate over the extent to which on-line advertising costs will decline over time. Advertising costs incurred currently could be viewed as investments to establish the Amazon brand and raise consumer awareness of the on-line retailer. Many analysts have suggested that advertising costs as a percent of sales are likely to decline over time as Amazon is able to take advantage of repeat customers and word of mouth advertising. It is not currently clear whether on-line retail

[22]Sales per employee were calculated on an full time equivalent basis. Barnes & Noble part time employees were assumed to be half time.

advertising expenditures are an investment or a cost of doing business. The answer to this question will determine the degree of success of the online retail model.

An analysis of Amazon.com's operating expenses over time show that the on-line retailer is achieving economies of scale. Figure 1 shows that total operating expenses have declined as a percent of sales through the end of 1998. The data shows an increase in these expenses in the first two quarters of 1999. This reflects a major expansion of Amazon's distribution facilities, the opening of a number of new on-line stores and a number of acquisitions. Each of the subcategories of operating expenses also reflect this general pattern.

3.1 ECONOMICS OF E-TAILING

The attractiveness of on-line book retailing is premised on a number of factors. These factors include cash flow advantages and low barriers to entry into markets.

E-tailing is highly efficient from a cash flow perspective. The retail book industry enjoys generous terms from its suppliers. Publishers typically require payment 90 days after ordering. A land based store that turns its inventory 2.5 times per year will thus sell an average book in about 146 days.[23] As a result, a store will carry a typical book 56 days in inventory after paying the publisher. During this time the store will incur interest costs on the book. These costs are one component of the "float" costs of the store.

The cash flow position of Amazon.com, which turned its inventory an estimated 50 times in 1997, actually incurs negative float costs. An average book remains in inventory only 7 days. Since Amazon.com can charge a customer and receive payment before it is required to pay its suppliers

[23]"Amazon.com — Going Public". Harvard Business School, Case 9-899-003, November 18, 1998

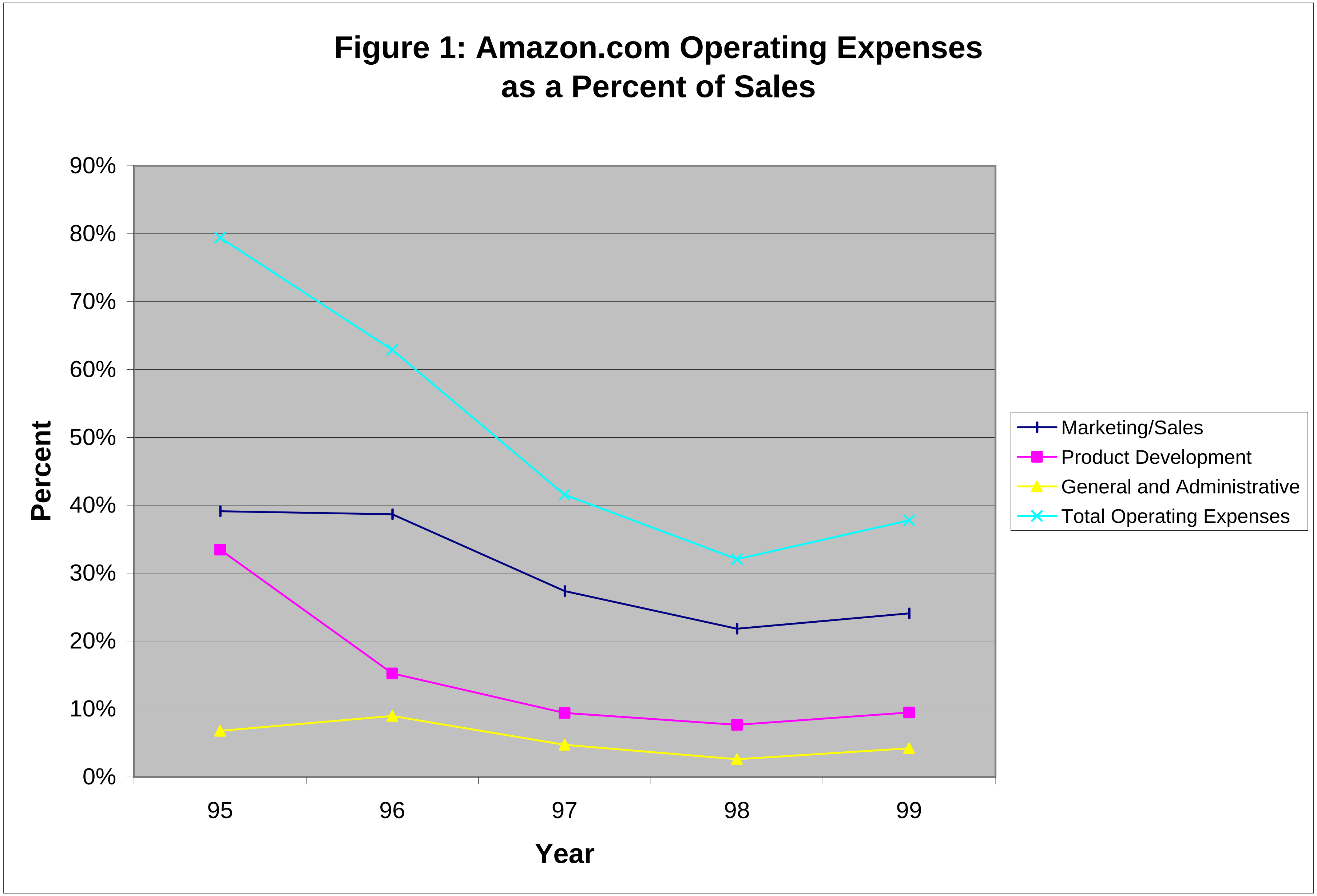


Figure 1: Amazon.com Operating Expenses
as a Percent of Sales
Percent
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
95
96
97
98
99
Year
Marketing/Sales
Product Development
General and Administrative
Total Operating Expenses

(in 90 days), its sales generate cash that can earn interest for 82 days before payment to publishers is required.

Another advantage that on-line retailing enjoys is low barriers to entry into the global market. Establishing an electronic storefront enables a retailer to sell to every consumer with access to the Internet. While land based retailers are required to negotiate leases and build out store space to reach new markets, an electronic retailer can simultaneously open shop in every single market.

The ease of entry into the electronic market highlights a third component of electronic retail competition. Consumers have many choices available and can easily choose the services of a competitor with a click of the mouse. Indeed there are hundreds of online book retailers, many offering a wide selection of titles at low prices.

The ease of selecting between competing retail establishments also suggests that consumers will choose those organizations with superior prices, products and services. Some analysts have described this as the "winner take all" market. They believe that this type of retail market will encourage the concentration of market share among a few top retailers who are the best at serving consumers. For instance, a recent report from Forrester Research argues that the Internet will radically restructure the relationship between national chains and local stores. They claim, "The Internet will nationalize local commerce. By 2003, advantages in scale, technology, and brand will bring 94% of on-line consumer sales to national retailers. This shift will siphon ad dollars from local media and recast local merchants as service providers."[24] The report noted that off-line small and medium sized businesses have a 50% share of retail sales, but only 9% of retail sales on-line.

[24]Forrester Research. "Local Commerce Goes National". June 1999

Merrill Lynch has made a similar argument about the impact of Internet commerce on small businesses. They note, "E-commerce ... could produce not just more efficient markets, but nearly perfect markets by eliminating transaction costs when electronic billing and payment reduces administrative and float costs to almost zero. In such a market, size shouldn't matter and small companies should be equally competitive with big ones. But where will the small companies come from? In a less than perfect world, inefficiencies in pricing and cost structures in effect create an umbrella which encourages new competition to enter. But without that umbrella, new entrants may only be those with a revolutionary idea (which we presume is, if not rare, at least uncommon). Lack of new entrants could slow growth, lead to monopolies and, taken to the extreme, undo the democratization that e-commerce wrought in the first place."[25]

Small booksellers have reacted to this market by differentiating their services from the major players. For instance, Cody's bookstore in Berkeley California offers same day delivery of books available in its store via bicycle messenger. They believe that their prices are lower and delivery is faster than Amazon.com.

The on-line book retailer 1bookstreet.com has been competing with Amazon.com on price and marketing a relatively specialized collection of romance, mystery, cooking and remainder titles. They have skimped on marketing costs and instead used price comparison services, such as PriceScan.com, to attract customers. PriceScan.com receives price information from vendors as well as using software to conduct real time searches of commerce sites. PriceScan does not charge for listing prices nor does it display the pricing information of some vendors more prominently than others. Customers search for products and those vendors with the cheapest prices (including shipping costs) rise to the top of the list. The site makes its money from selling advertising that is separately displayed from its price listings.

[25]"E-Commerce: Virtually Here". Merrill Lynch, April 1999

The on-line bookstore Frontlist.com has chosen to specialize in the “best new books for the scholarly avant-garde and other theoretically-minded readers”. The store offers a selection of books recently published, on a range of topics not commonly covered in book superstores. Their marketing strategy emphasizes discounting, but also their unique identity as a small on-line business. They claim on their web site, “you'll get a discount of 10 to 20 percent off list price and the satisfaction of keeping your greenbacks away from The Man at Amazon.com."[26]

While on-line competition is more intense than traditional retail competition, on-line retailers are counting on building “sticky” customer relationships.[27] For instance Amazon’s site remembers customer credit card numbers and shipping addresses and offers recommendations based on prior ordering history. Even in the fluid world of on-line commerce, customer loyalty plays a crucial role in determining the purchasing patterns of consumers. Amazon.com has already been able to raise its prices above other on-line competitors, in part, because its brand, customer service and customer loyalty have kept consumers coming back.

In a friction free market, consumers would be expected to purchase products from those sellers with the lowest prices. Friction free markets should thus result in one market clearing price. Recent research has shown that there are substantial price differences among Internet retailers for identical goods. A study conducted by the Sloan School of Management collected a database of 8,500 price observations over a period of 15 months from 41 Internet and conventional retailers.[28] The study

[26]http://www.frontlist.com/

[27]One example of the “stickiness” of on-line relationships is the value of the default setting of the start page in Internet browsers. Netscape and Microsoft were able to propel their web pages into the top ranks of Internet sites, in part, because users rarely changed the default setting for the first page their browser pulled up. Netscape’s Internet portal Netcenter.com has derived tens of millions of dollars in revenue from these traffic patterns. This fact seems to suggest that the characterization of Internet commerce as “friction free” may be an overstatement.

[28]Brynjolfsson, Erik; Smith, Michael. “Frictionless Commerce? A Comparison of Internet and Conventional Retailers”. Http://ecommerce.mit.edu/papers/friction, August 1999

found that prices among Internet retailers differed by as much as 33% for books and 25% for CDS. When the data is weighted for market shares, the dispersion of book prices is lower on-line than in land based stores, but still substantial. The study found numerous examples of on-line book sellers undercutting Amazon's prices. The study also found examples of independent book stores, such as Powells.com, that were able to maintain substantial sales volume charging higher prices than Amazon.com. The existence of widely differing prices suggest that the Internet is not yet a "friction free" marketplace.

With respect to price adjustments, Internet commerce had substantially reduced friction in price changes. Internet retailers price adjustments were up to 100 times smaller than conventional retailers price adjustments, reflecting lower menu costs in re-pricing products. The study found that Internet retailers were 9-16% lower in price than conventional stores for books and CDS, even after accounting for shipping costs.

A number of factors explain "friction" in the Internet marketplace. While shopbots and other price search tools often enable the consumer to identify and locate cheaper prices, these may be time consuming. For instance, Amazon.com provides customer reviews and other content to enable a consumer to evaluate books and other products. It is often possible for consumers to use these informational aids, and then purchase from a lower cost seller. Nonetheless, many on-line consumers value their time highly enough that they do not bother to search for a lower cost seller.

Consumers have shown a willingness to pay a premium to do business with a branded Internet retailer. Shopbot operators have indicated that many consumers who use search engines to identify low cost sellers still choose to purchase higher priced products from branded Internet retailers such as Amazon.com.[29]

[29]Smith, Michael; Baily, Joseph; Brynjolfsson, Erik; "Understanding Digital Markets: Review and Assessment" July 1999, http://ecommerce.mit.edu/papers/ude

Many sites incorporate features that allow them to differentiate between cost conscious shoppers and those who value convenience. These sites segment the market and sell to both types of customers. For instance, Amazon.com's zSHOPS and auctions include products that compete with those offered through its stores. There are booksellers who are using zSHOPS to sell books in competition with Amazon. Customers who value convenience will thus purchase from Amazon.com's book store. Those that prefer to get the lowest price by expending time bidding in the auctions or searching through the zSHOPS can also be served by Amazon's site.

3.2 ECONOMIES OF SCALE

Critical to the evaluation of the prospects of small businesses in on-line bookselling is the role of economies of scale in Internet book retailing. Many analysts have argued that there are substantial economies of scale in on-line commerce that will favor large retail operations. Economies of scale derive from both real and pecuniary factors. Real economies of scale refer to those elements of scale that allow a firm to operate more efficiently and achieve greater outputs per unit of input. Pecuniary economies of scale refer to the ability of large retailers to obtain preferential prices through the exercise of market power. Non-cost justified differential prices are illegal in book retailing, and a number of law suits are currently pending on these issues.

Specialization and division of labor is one important efficiency that a large scale of operation allows. For instance, many small booksellers may not have staff on hand who possess the technical skills necessary to maintain a web site. The specific knowledge and skills to market and promote an on-line store are also different than those required to run a traditional store. Small booksellers who have access to technical staff may become too dependent on them, subject to the "tyranny of the techie".

Internet commerce service providers, such as booksite.com, reduce the economies of scale associated with some of the more technically challenging aspects of setting up a database driven, electronic commerce site. Nonetheless, many booksellers find that they lack the skilled personnel to perform even basic web site maintenance.

There are significant economies of scale enjoyed by large on-line retail operators related to specialization. Maintenance of in-house technical staff and web servers provide on-line booksellers, such as Amazon.com, with the ability to customize their web site, providing such features as one click ordering, customer recommendations, purchase circles and other capabilities that are not available on the sites of smaller on-line operators.

Small booksellers venturing on-line often find that separate facilities are required to efficiently pick and pack orders. The complexity of co-operative advertising funding is another area where larger scale operations enable specialized personnel to be more efficiently employed.

Another source of economies of scale is indivisibilities of marketing. These result from two sources, indivisibilities of advertising and cross selling. In the on-line market, advertising plays a critical role in drawing customers to a site. Scale economies exist in advertising because a certain level of advertising expenditures is required to get the attention of the consumer. Once a substantial amount has been invested in advertising, the expenditures necessary to maintain recognition of a product or brand is substantially less than that required to obtain this recognition initially. In the on-line world, attracting the attention of consumers is one of the greatest barriers new entrants face.

The importance of brand in the on-line world is also significant because consumers are often unwilling to do business with a retailer who they do not trust. Spatial and temporal separation between buyers and sellers removes contextual clues that consumers might otherwise use to assess the quality of a merchant. Trust is particularly important in an on-line transaction since the buyer must provide a credit card payment first and trust the store to send the merchandise later. A number of analysts have noted that there are network externalities associated with building consumer trust in a brand. “More customers create a stronger signal of trust and strong signals of trust may lead to more customers"[30] Amazon.com has been willing to expend large sums of money on acquiring customers, in part, because they believe this will lower the cost of acquiring new customers in the future.

Cross selling is another important economy of scale enjoyed by larger on-line operators. Once an on-line store has established a compelling retail format and promoted the site to draw in customers, the incremental cost of selling additional merchandise on the site is a fraction of the costs initially incurred in marketing and selling the first products. In a land based retail format, there is a scale of operations that can become too large and daunting for a consumer to navigate. On-line, there are no physical limitations to the number of products that can be merchandised. Electronic search tools can allow a consumer to more effectively navigate through large volumes of products. The Internet retail format is information rich, and can intelligently recommend products related to the ones a consumer is searching for. Thus consumers searching for books on Amazon's site are also shown related items in the auction area.

Amazon.com has also discovered a number of new ways to leverage its investments in marketing and advertising. Its zSHOPS forum allows other Internet retailers to use Amazon's one click ordering system and customer information database to sell their own products. Amazon collects fees from merchants selling goods through zSHOPS.

Amazon's shopping search tools allow consumers to search across a variety of Internet retailers by product and price. Amazon charges a fee to list retailers in this search engine.

Amazon's move into retailing CDS, videos, toys, games, electronics, software, home improvement goods and gifts reflects their belief that they will be able to effectively cross sell a variety of products.

[30]Brynkolfsson, Erik; Smith, Michael. "Frictionless Commerce? A Comparison of Internet and Conventional Retailers". August 1999

Barnes & Noble also sells a basket of products from its web site. BN.com currently sells books, music, ecards, prints, posters, software and magazines. Booksamillion.com sells coffee in addition to a number of other items. College booksellers, such as Ecampus.com, have diversified into apparel, furniture and other items.

Amazon has also made investments in Internet retailers such as Pets.com, Drugstore.com, Homegrocer.com and Gear.com. Amazon has provided links to a number of these sites from its site to facilitate cross selling products in these categories as well. With respect to these companies, Amazon.com has been acting more like a venture capitalist, paying cash for a share of these companies and installing its managers on their boards of directors. Amazon is able to provide these companies technical assistance through access to its technology. For instance, Drugstore.com uses Amazon's proprietary one-click ordering technology.

Another important economy of scale is related to the ability of large companies to raise capital more easily than small businesses. If the costs of investigating a loan rise at a slower rate than the size of the loan, economies of scale are said to exist in finance. Additionally, if a large business is able to spread risks over a number of operations, scale may reduce risk and allow for funding to be secured on more favorable terms.

The Internet economy has somewhat reversed the privileged position of large corporations in capital markets. It is a much noted fact that pure Internet companies have been able to raise money at more favorable terms than existing retailers who want to augment a traditional retail operation with a web presence. This has favored smaller startups against their larger rivals. For the largest retailers, many analysts have described a "valuation paradox". Land based retailers who have ventured on-line have found that the initial operating losses involved with launching a web store reduced their profits and their stock price. Pure Internet companies have often found that investors are willing to value their profitless operations very highly. Barnes & Noble and many other Internet retailers have thus found that financing a web retail operation is best achieved through a spin-off company. BN.com is thus considered to be a separate corporate entity from its parent corporation. Its May 1999 IPO raised $421 million.

The financial markets long term focus on providing capital to Internet companies has allowed Internet retailers to sustain substantial operating losses. This privileged position in securing capital has given Internet companies a temporary advantage over their land based rivals.

Another important economy of scale in on-line retail is associated with holding inventory. Larger on-line operations can reduce the risk of holding inventory. For a small retail operation, the number of titles it can hold in inventory is often limited to the best sellers and other commonly ordered titles. As the volume of sales grow, it becomes easier to predict how frequently specific titles will be ordered and to hold the necessary inventory for immediate shipment. The ability to hold a larger inventory allows for both greater retail margins through ordering from publishers as well as faster shipment and improved customer service. One investment report estimated that a scale of approximately $150 million in annual sales was necessary to achieve substantial economies of scale in inventory risk.

Learning by doing is an economy of scale that is typically associated with high tech industries. Learning by doing refers not just to the scale of an operation at any given time, but to the total volume of output over time. Learning by doing suggests that the price of a product will fall as a business produces a greater volume of this product over time. In on-line commerce there is a substantial element of learning by doing. New entrants into the field discover the best methods of operation through a process of experimentation. Those following in their footsteps may incur higher costs. For instance, Amazon has patented its one click ordering system. They are currently engaged in a law suit to require Barnesandnoble.com to pay royalty fees for their use of one click ordering on their site. Amazon.com has invested substantial resources into its site technologies. It is quite possible that its costs will fall over time as a result of these.

The general theory of economies of scale suggests that larger, more efficient businesses should dominate their smaller rivals. Small retailers are often able to identify new markets, innovate into new lines of business and serve niche markets. The following sections describes the major retail chains and discusses briefly how independent booksellers have reacted to their market expansion.

4. MAJOR RETAIL CHAINS DESCRIBED

For booksellers, the 1990's has been defined by the emergence of book superstores. The book superstore concept was initially pioneered by independent bookstores such as the Tattered Cover and Powell's Bookstore. As the viability of this retail model became apparent, a number of retail chains emerged. Since 1991 these chains have aggressively expanded into most major markets across the country. Since 1997, three of the four chains have also gone on-line. The major bookstore chains are each described below.

Barnes & Noble

The large scale roll out of book superstores began in the early 1990's when Barnes & Noble, a well established New York bookseller, purchased Bookstop, a regional chain of large discount book stores. Barnes & Noble also acquired the mall based chain B. Dalton and became the largest book retailer in the country. Barnes & Noble began an aggressive expansion strategy that has continued to this day.

At the end of 1998, Barnes & Noble operated 1,009 bookstores. Of these, 520 operate under the Barnes & Noble Booksellers, Bookstop and Bookstar trade names. Another 489 stores operate under the B. Dalton Booksellers, Doubleday, Book Shops and Scribners trade names. The company also has its own imprint that publishes books exclusively available through its retail stores, mail order catalogues and web site.

Barnes & Noble stores range between 10,000 and 60,000 square feet of space. The company opened 1.3 million square feet of new retail space in 1998, bringing total square footage to 11.9 million square feet. The company opened approximately 50 new Barnes & Noble superstores in 1999. New stores have averaged 26,000 square feet in size.

Weaker overall sales in the B. Dalton stores have led the company to pursue a program of closing stores. Declining mall traffic and superstore competition have made these store less profitable in recent years. Total sales for Barnes & Noble in 1998 were just over $3 billion, $2.5 billion of these sales derived from Barnes & Nobles superstores.

Barnesandnoble.com (also BN.com) was launched in 1997. In 1998, a separate corporation was formed, owned 50% by Bertelsmann and 50% by Barnes & Noble. In May 1999 Barnesandnoble.com went public, raising $421 million. The on-line store has pursued an aggressive marketing campaign for the site. Barnesandnoble.com is the exclusive bookseller on America Online. Through affiliation with the New York Times, they became the exclusive bookseller for the New York Times Best Seller List. Readers of the online edition can click through to the BarnesandNoble.com site to purchase books.

At the end of 1998, Barnesandnoble.com was ranked as the fourth largest electronic commerce site by Media Metrix. Sales growth has been strong in 1999. Net sales for the quarter ending September grew to $49 million, up 215% from the third quarter of 1998. Marketing and sales cost fell to 53.6% of sales, down from 94.4% in the third quarter of 1998.[31] Barnesandnoble.com is following in the path of many other electronic commerce sites, spending heavily on marketing and incurring up front losses in hopes of achieving market share.

Barnesandnoble.com has benefitted from the extensive distribution system of its parent corporation. The company has access to the largest standing inventory of any on-line retailer, with more than 750,000 titles available for immediate delivery.[32] The company is currently experimenting with

[31]SEC 10-Q filing, November 12, 1999

[32]SRC 10-K filing, April 30, 1999

providing delivery from its stores as well. This could theoretically provide the capability to provide same day delivery service to a large number of markets.

Borders Group

Borders grew from one store opened in Ann Arbor in 1971. This initial store featured a broad selection of titles for the serious reader. The chain expanded to fourteen stores in 1992 and was acquired by Kmart Corporation for $100 million. Kmart purchased WaldenBooks to create a second book retail power house. Borders purchased its stock back from Kmart in 1997 and became a separate, publically traded corporation. Also in 1997, Borders Group launched its on-line subsidiary, Borders Online, Inc. Borders.com's approach to on-line commerce is based on a "clicks and mortar" strategy that seeks to integrate its on-line store with Borders Group's off-line stores. The company plans to install in-store kiosks that will allow customers to order books on-line that are unavailable in the store. Borders.com achieved only $4.6 million in annual sales in 1998.

In 1998, Borders Group Inc. had approximately $2.59 billion in sales. Of these $1.56 billion were derived from its superstores. Waldenbooks stores had sales of $941 million for the year.

Borders Group opened 47 superstores and 16 WaldenBooks mall-based stores in 1998. Borders Group plans to continue its aggressive expansion strategy in coming years using retained earnings to finance its growth. As of January 1999, Borders Group operated 250 superstores, including 3 in the United Kindom, 1 in Singapore and one in Australia. Borders Group also operated 900 mall based bookstores, most being under the Waldenbooks name. In the United Kingdom the company operated 26 mall based stores under the Books etc. name.

Crown Books

In the Washington DC and Los Angeles, Crown books emerged as a major discount retail chain. The chain, which is privately held, grew to become one of the top four book retailers in the 90's. Suffering from financial difficulties, the firm declared bankruptcy in 1997. The chain closed a number of unprofitable stores and recently emerged from bankruptcy. Crown has yet to set up a web site.

Books-A-Million (BAM)

BAM is a regional discount bookseller based in the southeast and headquartered is in Birmingham Alabama. The company operates 175 stores in 17 states. These stores are in four distinct formats. Large superstores, the first of which was opened in 1988, are operated under the names Books-A-Million and Books and Co.. The company currently operates 124 superstores. Traditional bookstores and combination book and greeting card stores are both operating under the name Bookland. Newsstands are operated under the Joe Muggs Newstands name. In 1998 the company had net sales of $347 million and a net income before taxes of 2.1%.

BAM owns a wholesale operation that serves as the fulfillment agent for Wal-Mart’s on-line book retail sales. BAM has also launched a web site to sell books at Booksamillion.com.

Figure 2 shows quarterly revenues of the major publically traded booksellers. Bookselling is a seasonal business. Annual revenues and profits are substantially determined by fourth quarter performance. For instance, Borders Group earns most of it operating profit in the fourth quarter.

Figure 2 shows the rapid rise of Amazon.com into the ranks of major booksellers. The company became the third largest publicly traded bookseller in the first quarter of 1998, surpassing Books a Million. Overall, the data show a steady growth for Borders Group and Barnes & Noble.

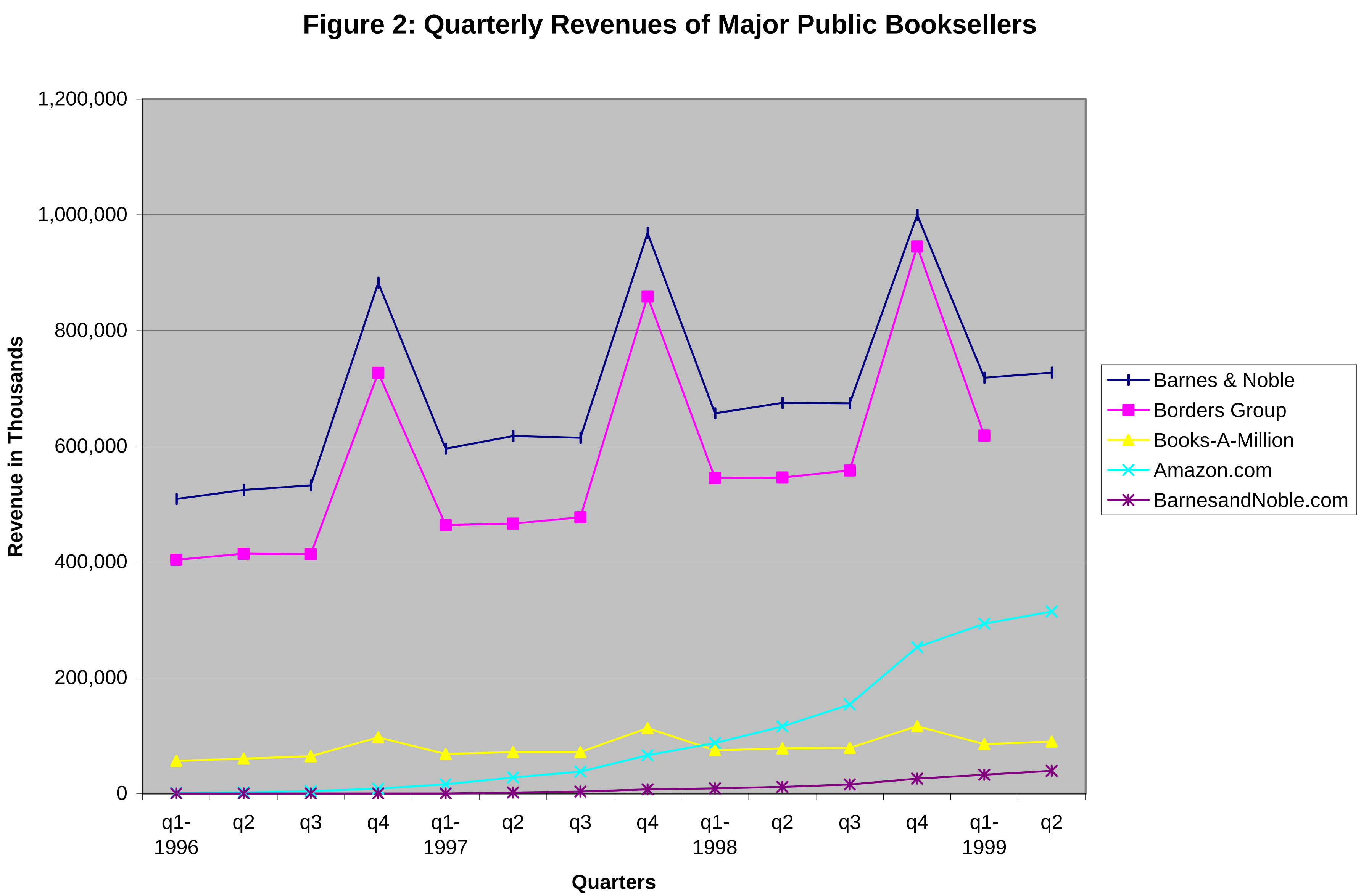


Figure 2: Quarterly Revenues of Major Public Booksellers
1,200,000
1,000,000
800,000
600,000
400,000
200,000
0
Revenue in Thousands
q1-1996
q2
q3
q4
q1-1997
q2
q3
q4
q1-1998
q2
q3
q4
q1-1999
q2
Quarters
Barnes & Noble
Borders Group
Books-A-Million
Amazon.com
BarnesandNoble.com

4.1 IMPACT OF SUPERSTORE ROLLOUT ON BOOKSELLERS

The impact of the roll out of book superstores has substantially reduced the market share of independent booksellers. Between 1994 and 1997 the market share of the four largest retail chains grew from 34.2% to 45.2%. The number of stores belonging to the American Booksellers Association fell from 5,200 in 1991 to less than 3,500 today.

Figure 3 shows Dun & Bradstreet estimates of the total number of bookstore failures. Book store failures rose from 61 per year in 1988 to a high of 152 in 1996. Business failure statistics include those businesses that ceased operation following assignment, bankruptcy, foreclosures, receivership or other court proceeding and voluntary agreements that result in losses to creditors . These statistics do not include businesses that discontinue operations due to loss of capital, inadequate profits, ill health or retirement if creditors are paid in full.

Since total businesses failures are influenced by a number of factors, such as the size of the economy and business cycles, Figure 4 compares bookstore failure rates per 10,000 with business failure rates of the entire retail sector and the economy as a whole. The data show that retail book stores have historically had lower business failure rates than the U.S. economy and the retail sector. In 1995 the rate of bookstore failures exceeded the rate of failures for the retail sector as whole. In 1996, failure rates exceeded the failure rates for all businesses in the economy.

The expansion of book superstores has created an intensely competitive environment for booksellers. Many independent booksellers have identified niche markets and concentrated on serving these markets instead of competing head to head with the chain stores. For instance, Barbara's Bookstores, a Chicago based independent with nine stores, is opening its tenth store in a hospital. The store will allow patients to dial "book" from their rooms and receive immediate delivery of books. Don

Figure 3: Total Bookstore Failures 1988-1997

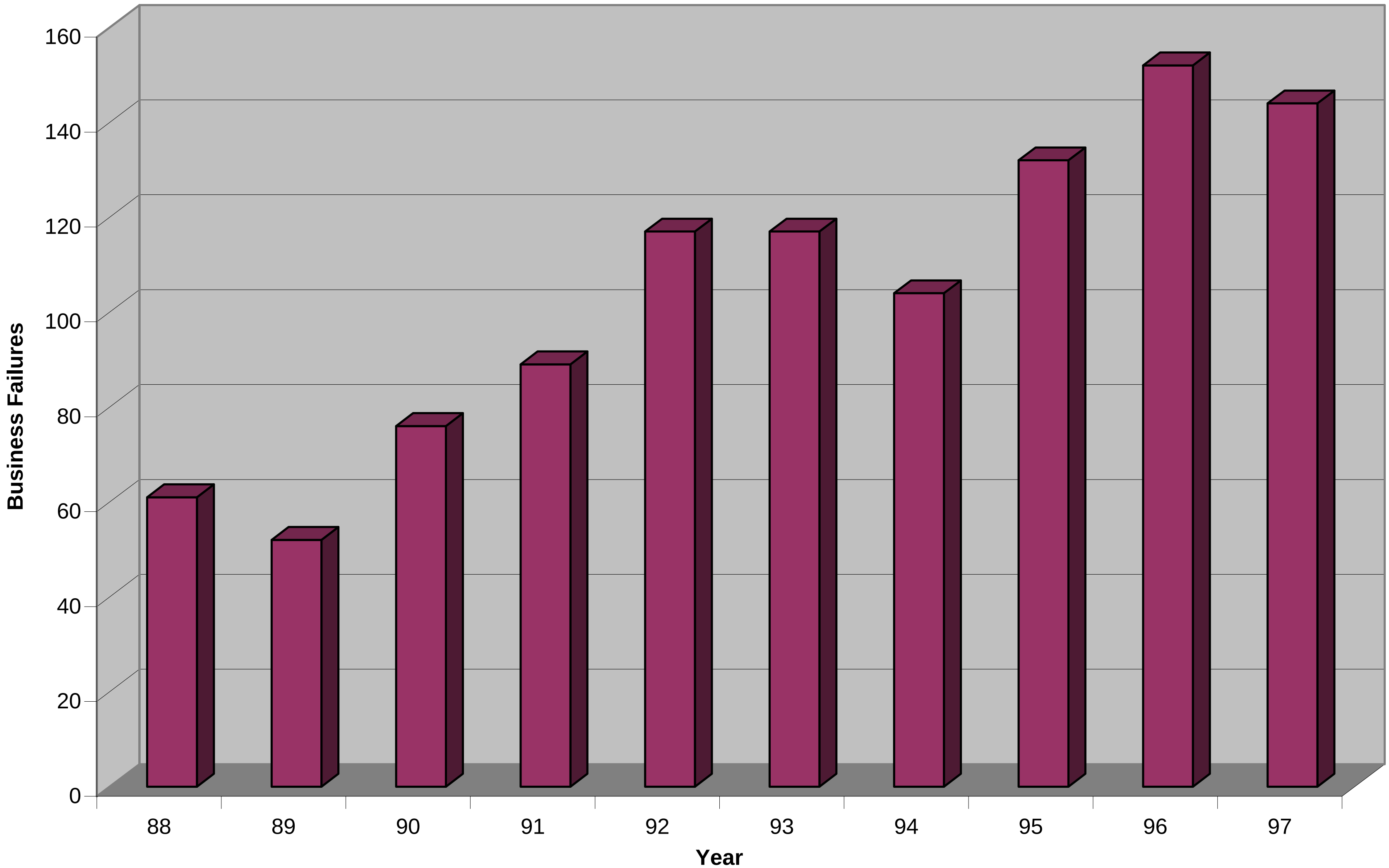
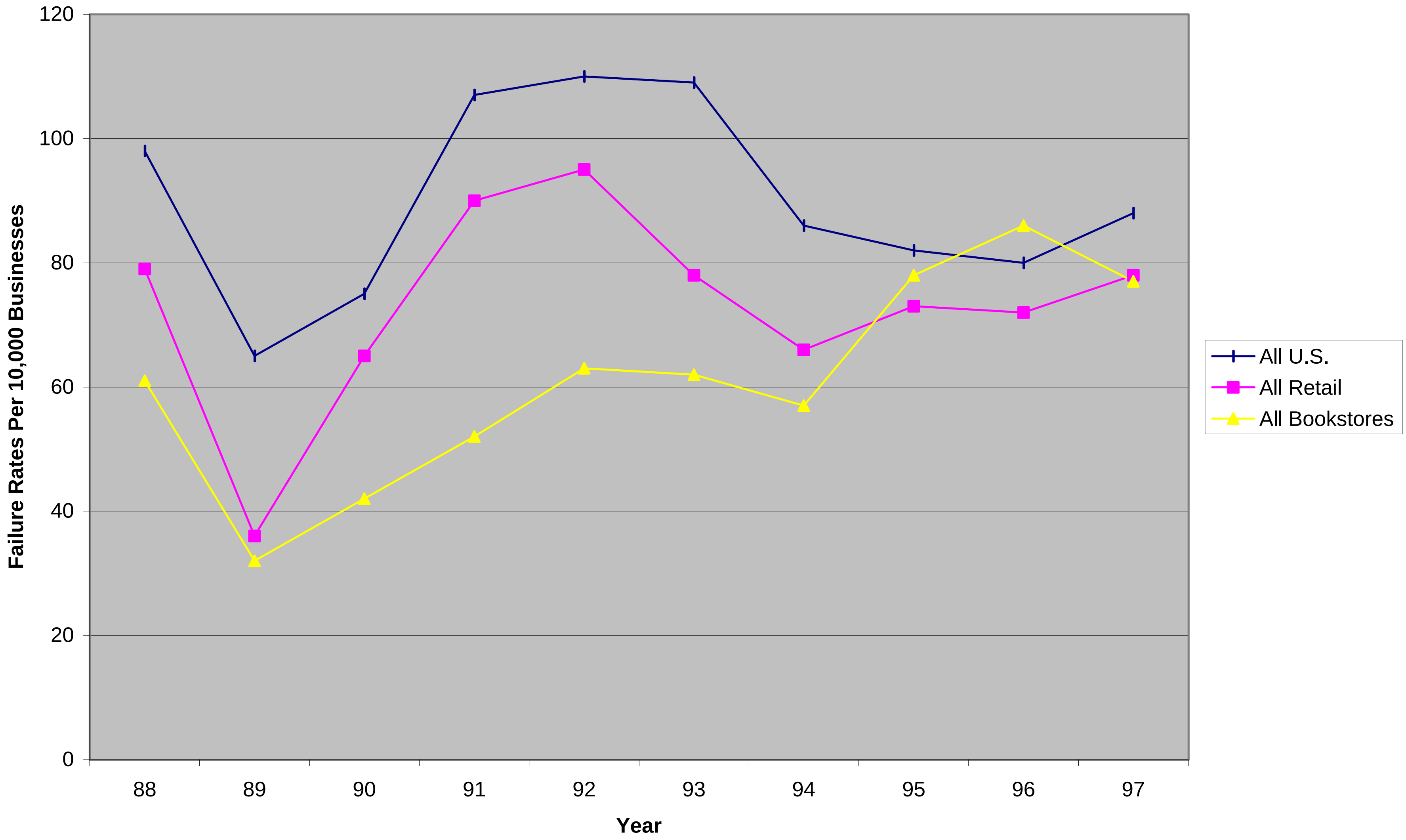


Figure 4: Comparative Business Failure Rates



Barliant, owner of Barbara's noted, "Competing in this market requires a constant search for niche locations--by that I mean locations where Borders can open up next door and we could care less. We've built successful stores in airports and train stations. In October we're also opening a small Shakespeare specialty bookstore at the new Chicago Shakespeare Theater at Navy Pier".[33]

4.2 EMERGENCE OF INTERNET RETAILERS

The emergence of Internet retailers has put pressure on some specialty bookstores while at the same time creating a number of new niches for small businesses. Internet retailing has been a fierce competitor to mail order booksellers. Some traditional land based retailers who operate mail order businesses have been particularly hard hit. One example of this is the Traveller's Bookstore, which was located in the Times-Warner Building on West 52nd Street in New York. The store specialized in travel books and served an upscale clientele. The store had built a mail order list of 65,000 people. Approximately 20%-30% of the stores sales volume was derived from mail order business. The owner noted, "We survived 12 Barnes & Noble superstores coming to Manhattan — and two Borders. We were hit pretty hard, but we survived. But a year ago we really began feeling the impact of the on-line discounters. They were the last straw."[34] Traveller's Bookstore announced its intention to close in January 1999.

Some independent stores have been able to adapt to on-line competition by selling to niche on-line markets. A number of stores have become suppliers to the major on-line retailers. One example of this is Wonder Book & Video, a three store independent bookseller specializing in used and rare books. The opening of a Borders Books and Music superstore three miles from Wonder Book &

[33] "Hospital Location Spells Good Health for Independent Bookstore". Http://www.bookweb.org/news/btw/2152.html, July 1, 1999

[34] "Manhattan Bookstore to Close After 16 Years". Http://www.bookweb.org, January 29, 1999

Video's Frederick Maryland store captured some of the store customers. The store put 40,000 titles of its inventory on-line and began to sell rare books on-line. Barnes & Noble Booksellers has become the store's biggest on-line customer, purchasing about 30 books per week. The second largest on-line customer is Amazon.com.

The store's owner, Chuck Roberts, noted, "Best sellers used to be the bread and butter for the independents, and selling popular books made them able to carry books that were less popular. But the thing independents have had to do is innovate and find niches that the big guys can't or won't carry and beat you up on."[35]

Identifying niches has often occurred through a process of experimentation. For instance, in the early days of Internet book retailing (1996) a store known as "The Internet Bookstore" attempted to compete with Amazon by offering text only versions of books for immediate download. A customer could purchase a book and download it on-line in 30 seconds. The service required the customer to have a custom hardware encryption device that plugged into the printer port of the computer. Without this device, the text was unreadable, providing some copyright protection. This business model proved too cumbersome and the "Internet Bookstore" is no longer in business.[36]

A recent innovator, Dial-A-Book, is currently marketing first chapters of books to sites such as Amazon.com, the New York Times, the Washington Post, CNN, C-Span and Book-of-the-Month. Dial-A-Book obtains permission from publishers and authors, coverts the text into HTML and prepares the files for mounting on particular sites. When it was founded in 1993, the initial mission of Dial-A-Book was to offer full length books for download. When this idea proved ahead of its time, the company began providing first chapters to assist with the marketing of traditional books.

[35]Glanz, William. "Rare finds turning up on line". Washington Times

[36]"Fireside Booksellers: Distribution on the Internet". International Graduate School of Management, University of Navarra, March 1996

Recently, Dial-A-Book made its services available to Independent booksellers with an on-line presence.

Dial-a-Book is not a traditional retail bookseller, but the company is an example of how small businesses are often able to innovate, find market niches and operate at lower cost. In February 1999, the company had 4.5 employees, all of whom telecommuted to its “virtual office”.[37]

The changes in the retail book industry caused by the expansion of the retail chains and on-line booksellers are also reflected in a number of more generic sources of industry information. Some of these data sources are described in the following section.

[37]Mutter, John. “Last Chapter for Dial-A-Book: Excerpts for Indies, Too”. Publishers Weekly Online, Feb. 8, 1999

5. OTHER SECONDARY DATA SOURCES

A number of other data sources are available to describe the retail book market. These characterize both the producers (retail book stores) and consumers (book buyers) in this market. The Department of Commerce makes estimates of monthly retail sales, by four digit SIC code. The Association of American Publishers provides estimates of publishing industry annual sales, by type of book. The "Consumer Research Study on Book Purchasing" describe samples of book consumers and their purchasing behavior. Each of these data sources is described in more detail below.

5.1 BUREAU OF CENSUS: RETAIL SALES ESTIMATES

The Bureau of Census publishes monthly estimates of retail sales by four digit SIC code. Booksellers fall into several different industry classifications. Firms engaged primarily in the retail sale of new books are classified under SIC code 5942 (book stores). Used book stores are classified under SIC code 5932 (used merchandise). This SIC grouping includes other retail establishments, such as antique stores and pawnshops. A substantial fraction of books are sold through mail order catalogues. These establishments are classified under SIC code 5961 (catalog and mail order houses). Booksellers also face competition from SIC 5311 (department stores) and SIC 5994 (news stands).

Our analysis focuses on SIC 5942 (new book sales) since there is no practical way to dissaggregate book sales in the other relevant SIC codes. Any retail establishment with sales consisting of more than 50 percent new books and periodicals is classified into SIC 5942. Sales estimates include all products sold in these stores.[38] Census estimates are based on sales reported by a scientifically selected group of bookstores and are projected to the composite total of all U.S. bookstores with payrolls. Regional sales trends may differ from those of the total sample.

[38]Sales figures are revised as of May 1998

Overall sales for 1998 showed a modest increase of 2.6 %, although January and November new book sales were lower than the previous year. Total book sales were $13.02 billion, up from sales of $12.69 billion in 1997. All retail sales for the year 1998 were up 5.4%.

Table 4 shows sales of all types of participating bookstores, including trade, college, religious, chain stores (including their superstores), and others. Table 5 compares the market share of the four largest bookstores compared to all other bookstores.

5.2 ASSOCIATION OF AMERICAN PUBLISHERS

The Association of American Publishers (AAP) estimated U.S. book sales to be $23.03 billion in 1998, a 6.4% increase over 1997. Overall trade sales ($6.15 billion) were up 6.5%, with adult and juvenile paper bound books showing double digit growth (10.2% and 13.8% respectively). The education market showed continued vigor: elementary and secondary (elhi) sales ($3.3 billion) rose 10.3%; higher education sales were up 8.2%, to $2.9 billion.

Other sectors showing healthy growth were: professional/stm - $4.4 billion (up 6.3%); mass market paperbacks - 1.5 billion (up 5.6%); university presses - $391.8 million (up 6.5%); standardized tests - $204.6 million (up 6.9%); and subscription reference - $767.4 million (up 4.2%). The only sector showing a significant downturn was mail order sales (down 9.7% to $470.5 million), continuing the slide that began last year.

Table 6 shows sales figures prepared by the Statistical Service Center. The figures are based on year-to-date data from the AAP December Monthly Sales Report, along with other information

Table 4: Retail Sales For Bookstores 1993-1998

Period	1993 Final (Millions of Dollars)	1994 Final (Millions of Dollars)	1995 Final (Millions of Dollars)	1996 Final (Millions of Dollars)	1997 Final (Millions of Dollars)	1998 Final (Millions of Dollars)	% Increase 1994 Over 1993	% Increase 1995 Over 1994	% Increase 1996 Over 1995	% Increase 1997 Over 1996	% Increase 1998 Over 1997
January	992	1,072	1,336	1,429	1,595	1,462	8.1	24.6	7	11.6	-9.5
February	569	646	735	792	831	921	13.5	13.8	7.8	4.9	9.4
March	604	646	712	777	815	881	7	10.2	9.1	4.9	6.7
April	586	621	705	784	806	851	6	13.5	11.2	2.8	4.3
May	617	697	806	893	890	916	13	15.6	10.8	-0.3	1.7
June	624	738	829	876	870	935	18.3	12.3	5.7	-0.7	6.1
July	615	691	804	821	822	876	12.4	16.4	2.1	0.1	5.2
August	996	1,178	1,283	1,419	1,287	1,375	18.3	8.9	10.6	-9.3	5.5
September	916	1,042	1,136	1,081	1,143	1,235	13.8	9	-4.8	5.7	6.6
October	679	747	773	930	910	940	10	3.5	20.3	-2.2	2
November	704	788	882	935	979	972	11.9	11.9	6	4.7	-1.9
December	1,297	1,440	1,523	1,644	1,740	1,815	11	5.8	7.9	5.8	3
Total Bookstore Sales	9,199	10,306	11,524	12,381	12,688	13,179	12	11.8	7.4	2.5	3.9
Total Retail Sales	2,073,839	2,229,878	2,329,310	2,461,196	2,566,209	2,694,519	7.5	4.5	5.7	4.3	5

Sources: Bureau of the Census, Current Retail Trade Branch; Report prepared by the ABA Research Department

Table 5: Comparative Bookstore Sales (Loss) and Market Share for 1994-1997

	FY1997		FY1996		FY1995		FY1994		PERCENT CHANGE			
	Sales Millions $	%	Sales Millions $	%	Sales Millions $	%	Sales Millions $	%	1997 VS 1996	1996 VS 1995	1995 VS 1994	1997 VS 1994
Total All Bookstores*	12536.0	100.0	12547.0	100.0	11617.0	100.0	10570.0	100.0	-0.1	8.0	9.9	18.6
Four Largest Chains**	5670.6	45.2	4973.2	39.6	4239.2	36.5	3611.5	34.2	14.0	17.3	17.4	57.0
Barnes & Noble	2782.3	22.2	2448.1	19.5	1976.9	17.0	1622.7	15.4	13.7	23.8	21.8	71.5
Borders Group	2266.0	18.1	1958.8	15.6	1749.0	15.1	1511.0	14.3	15.7	12.0	15.8	50.0
Crown Books	297.5	2.4	287.7	2.3	283.5	2.4	305.4	2.9	3.4	1.5	-7.2	-2.6
Books-A-Million	324.8	2.6	278.6	2.2	229.8	2.0	172.4	1.6	16.6	21.2	33.3	88.4
All Other Book Stores	6865.4	54.8	7573.8	60.4	7377.8	63.5	6958.5	65.8	-9.4	2.7	6.0	-2.3

Sources: Bureau of the Census, Current Retail Trade Branch; Report prepared by the ABA Research Department

*Based on Current Retail Census estimates for twelve month periods ending 1/31/95, 1/31/96, 1/31/97 and 1/31/98, respectively, all as revised May 1, 1998

**Fourth quarter endings:

B&N 1/31/98, 2/1/97, 1/27/96, 1/28/95; excludes barnesandnoble.com figures

Borders 1/25/98, 2/1/97, 1/28/96, 1/25/95

Crown 1/31/98, 2/1/97, 2/3/96, 1/28/95

B-A-M 1/31/98, 2/1/97, 2/3/96, 1/28/95

Table 6: Preliminary Estimated Book Publishing Industry Net Sales

	MILLIONS OF DOLLARS									
	1987	1992	1996	PCT CHG FROM 95	1997	PCT CHG FROM 96	1998	PCT CHG FROM 97	% CMPD GROWTH	% CMPD GROWTH
	$	$	$		$		$		1987-1998	1992-1998
TRADE (TOTAL)	2712.8	4661.6	5643	1.5	5453.2	-3.4	6148.9	6.5	7.7	4.7
ADULT HARDBOUND	1350.6	2222.5	2586	-2.3	2663.6	3	2751.5	3.3	6.7	3.6
ADULT PAPERBOUND	727.1	1261.7	1609.4	1.4	1731.7	7.6	1908.3	10.2	9.2	7.1
JUVENILE HARDBOUND	478.5	850.8	867.7	3.7	908.5	4.7	953.9	5	6.5	1.9
JUVENILE PAPERBOUND	156.6	326.6	579.9	18.3	470.3	-18.9	535.2	13.8	11.8	8.6
RELIGIOUS (TOTAL)	638.8	907.1	1093.4	5.4	1132.7	3.6	1178	4	5.7	4.5
BIBLES, TESTAMENTS, HYMNALS & PRAYER- BOOKS	177.6	260.1	294.8	0.6	285.4	-3.2	296	3.7	4.8	2.2
OTHER RELIGIOUS	461.2	647	798.6	7.4	847.3	6.1	882	4.1	6.1	5.3
PROFESSIONAL (TOTAL)	2207.3	3106.7	3985	3	4156.4	4.3	4418.7	6.3	6.5	6
BUSINESS	388.8	490.3	721.4	16.8	768.1	6.5	*	*	*	*
LAW	780	1128.1	1429.8	2.1	1502.7	5.1	*	*	*	*
MEDICAL	406.5	622.7	815.8	0.8	856.5	5	*	*	*	*
TECHNICAL, SCIENTIFIC & OTHER PROF'L	632	865.6	1018	-2.3	1029.1	1.1	*	*	*	*
BOOK CLUBS	678.7	742.3	1091.8	11.9	1143.1	4.7	1209.4	5.8	5.4	8.5
MAIL ORDER PUBLICATIONS	657.6	630.2	579.5	3.6	521	-10.1	470.5	-9.7	-3	-4.8
MASS MARKET PAPERBACK RACK-SIZED	913.7	1263.8	1555.1	3.7	1433.8	-7.8	1514.1	5.6	4.7	3.1
UNIVERSITY PRESSES	170.9	280.1	349.3	2.8	367.8	5.3	391.8	6.5	7.8	5.8
ELHI (K-12 EDUCATION)	1695.6	2080.9	2618	6.2	3005.4	14.8	3315	10.3	6.3	8.1
HIGHER EDUCATION	1549.5	2084.1	2485.8	6.9	2669.7	7.4	2888.6	8.2	5.8	5.6
STANDARDIZED TESTS	104	140.4	178.7	6.8	191.4	7.1	204.6	6.9	6.3	6.5
SUBSCRIPTION REFERENCE	437.6	572.3	706.1	5.3	736.5	4.3	767.4	4.2	5.2	5
OTHER SALES (INCL. AV)	423.8	449	493.2	3.6	510	3.4	526.3	3.2	2	2.7
TOTAL	**12190.3**	**16918.5**	**20780**	**4.2**	**21641.9**	**4.2**	**23033.3**	**6.4**	**6**	**5.3**

gathered during the year. The data is not strictly comparable to Census reports. SIC 2731 (Book Publishing) does not include data on many university presses, other institutionally sponsored and not-for-profit publishing activities and audiovisual and other media material sales. AAP estimates also exclude Sunday school materials, and certain pamphlets which are incorporated in the Census data.

5.3 CONSUMER RESEARCH STUDY ON BOOK PURCHASING

The Consumer Research Study on Book Purchasing has been conducted for each of the last eight years by the NPD Group. It is funded by the ABA and the Book Industry Study Group (BISG). The study utilizes data compiled from diaries filled out by a panel of consumers in 16,000 households concerning their purchases each month. The panel is designed to be representative of the US national population in terms of size of household, geographic location and other factors.

Recent year studies (1996-1998) have found the consumer market for books to be weak. Adult books purchased by US households grew just 0.6% from 1996 to 1997. Purchases (excluding juvenile titles) totaled 1.06 billion units in 1996 and 1.07 billion in 1997. During the same period, the U.S. population grew approximately 1%, suggesting that actual per household purchases were down in 1997. The preliminary results of the 1998 survey show that book sales fell from 1.07 billion in 1997 to 1.04 billion in 1998, a decline of 3%. The 1998 results were the first time in the survey's eight year history that a decline in book sales occurred.[39]

The 3% decline in demand for adult books contrasts dramatically with the Association of American Publishers' reported 6% increase in publisher dollar sales for 1998. It also is not consistent with the Census Bureau's reported 2.6 % increase in bookstore dollar sales. There are a number of possible

[39] "Book Industry Study Group Figures Are Disappointing". American Booksellers Association. May 14, 1999

explanations for this inconsistency. It is possible that inventory in the pipeline may result in heavy returns in the future for publishers. Many of the purchases may be by buyers other than households, such as professional, business, educational, institutional, and government. The NPD estimates also reflect only adult consumer book purchases.

Over the years the survey has documented the decline of the independent bookseller. The independent bookseller market share was 32.5% in 1991, the first year the study was conducted. By 1997 this share had declined to 17.2%. Total sales also declined. Between the years 1993 - 1997, independent book store sales fell 23%.

The percentage of adults in 1997 who purchased one or more books within the 30 days prior to being interviewed decreased from 48% in 1994 to 44% in 1997. Of those 1997 buyers, 20% bought a book from a local, privately owned, independent bookseller. This percentage was the same as it was three years earlier. Buyers who made a recent purchase at a chain superstore, however, increased by more than six percentage points to 15%. In total, 45 of every 100 recent book buyers patronized a chain bookstore in 1997.

Preliminary data from the 1998 survey show purchases made online account for 1.9% of total book sales. This figure was somewhat lower than industry analysts expected and may reflect the fact that children's books, textbooks, other online sales to college students and international online sales were not included in the estimate.

6. CONCLUSIONS

In both traditional and on-line retailing, independent booksellers have come under substantial competitive pressure from retail giants. Booksellers have met this challenge by repositioning themselves as niche players or serving markets not saturated by the chain stores. On-line, Internet service providers have rolled out a number of products that enable independents who wish to sell on the web to do so at reasonable cost.

While Internet commerce currently represents only a small fraction of the book retail market, it seems likely that this share will grow significantly in the next few years. Competition in the Internet marketplace has led to a high level of market concentration for large retailers. Amazon.com alone is estimated to possess 85% of the on-line book market.

The future shape of on-line markets is uncertain. There are significant scale economies related to marketing in on-line commerce. At the same time, Internet markets are far from “frictionless” and thus independent booksellers will likely capture a share of this market.

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Small Business Survival In Competition With Large Multi-Unit Retail Firms

Part 2
On-line Retail Market Dynamics

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Executive Summary

The birth of Internet retailing initially favored small startup companies. On-line retail markets are likely to be more concentrated than traditional retail markets in the future. The low barriers to entry into Internet markets suggest that those retail operations that can achieve economies of scale quickly may capture a large share of the market. Information is the primary component of customer service in on-line markets. Site content is an asset that can easily be scaled to serve a greater number of customers.

The size of future Internet retail markets can be estimated through comparisons with mail order retailing. Many analysts expect Internet retailing to be larger than mail order retailing, which currently comprises approximately 3% of total retail sales and 6-7% of many retail categories.

Internet commerce service providers have emerged in many retail categories to assist small businesses establish commerce enabled web sites. These firms significantly reduce the technical burden of building web sites with extensive product databases and secure credit card transaction processing capability.

Many Internet retailers are engaged in multi-channel marketing efforts to promote their web sites. On-line commerce is likely to become more integrated with catalog and storefront retail operations in the future. Small traditional retailers who go on-line have important resources that can be used to reduce web site marketing costs.

Introduction

Internet retailing has exploded in the last two years. Both traditional retailers and Internet startups have launched web sites in almost every retail category. Ernst & Young estimates that Internet retail sales for 1999 will be between $25 and $30 billion. This task seeks to identify those aspects of Internet retailing that may affect small business competitiveness.

This report consists of four sections. Section 1 discusses concentration in the on-line marketplace. Section 2 describes the potential size of Internet commerce and includes a brief description of six different retail sectors. Section 3 addresses the most important elements of this marketplace as they relate to small businesses. Section 4 draws some conclusions from the previous sections.

1 On-line Retail May Encourage Industry Concentration

Internet retailing has a number of characteristics that are favorable toward small businesses. These include low barriers to entry and low cost access to large markets. Counterbalancing these are economies of scale and advantages associated with branding that tend to favor large businesses. To date, Internet markets have displayed a higher degree of concentration than land based retail markets. A number of industry analysts believe that on-line retail leaders will ultimately capture 50% or more of their respective markets.[1] Store based retailers have rarely captured more than 20%-25% of their markets. Goldman Sachs estimates that the top five apparel sites have captured 65% of Internet sales. Amazon.com may have as much as 85% of the on-line market for books.

On-line retail leaders can leverage a number of assets to dominate their respective categories. They are not limited by the demand of customers in a tight geographical market, but can offer a deep selection of items. The infrastructure to serve customers is easily scalable, consisting primarily of database content and the computer hardware to serve this information via the Internet. Store based retailers are often limited by the size of the inventory they can stock or the physical capacity of their store to serve more customers. Even mail order retailers are limited by the cost of adding and distributing additional catalogue pages.

Greater site traffic can actually be an asset to an on-line retailer, producing valuable information such as customer reviews. Increased site traffic allows for the collection of customer purchase information that can be used to produce best seller lists or collaborative filtering recommendations. Sites, such as Buy.com, have even sought to sell merchandise at cost and make money through advertising.

[1] Internet Retailing. Goldman Sachs Investment Research. June 1, 1999

Customer service in the on-line world consists primarily of site content and product information. These information assets are highly scalable. Rich content can be used to attract greater numbers of customers. The cost of this content can then be spread across greater sales, thus producing declining customer service costs as scale increases.

Low barriers to entry may also encourage market concentration. Local retailers have typically enjoyed a qualified monopoly in particular geographical regions. Since on-line stores can sell to customers anywhere and it is easy to locate competing retail sites on-line, consumers are likely to gravitate towards those merchants with the lowest prices, the best service or the most well known brands. This competitive market may tend to favor a few dominant retailers.

2 Estimating the Size of the Internet Retail Market

Internet retailing is most similar to mail order direct marketing. Comparisons to mail order are thus one means by which the potential market for Internet retailing can be assessed. Catalogue sales currently comprise 7%-8% of retail sales in many merchandise categories, and 3.52% of total 1998 retail sales.[2]

Internet retailing is a more flexible medium than catalog retailing, allowing for the merchandising of a greater number of products, the display of more value added information and the collection of more detailed marketing information. As a result of this, Internet sales are likely to eventually exceed the value of catalogue sales. Some analysts have estimated that Internet retailing could eventually capture 15% to 20% of total retail sales.[3] These forecasts are premised on bullish estimates of rapid growth. In 1998, Internet sales comprised approximately 1% of total retail sales. If current forecasts for this year are correct, total Internet sales as a percentage of all retail sales might increase to almost 1.5% in 1999.[4]

Those merchandise categories best suited for on-line retail are also those that have been well developed by catalogue retailers. Table 1 shows the sales of the top 100 catalogue mail order companies by merchandise category. Computers are the most popular mail order category, comprising approximately 49% of catalogue sales. The success of apparel, office supplies, general

[2]Retail sales exclude automotive dealers.

[3]Internet Retailing. Goldman Sachs Investment Research, June 1, 1999, p. 1

[4]It is interesting to note that early forecasts of the market penetration rate of mail order were wildly optimistic. Some analysts foresaw consumers purchasing 50% of merchandise through catalogues. A history of this is described in The Internet Retailing Report. Morgan Stanley. May 28, 1997.

Table 1: Major Catalogue Sales Merchandise Categories

Merchandise Category	1997 Sales ($ millions)	% of Sales
Computers	29,363	49%
General Merchandise	9,501	16%
Apparel	7,734	13%
Office Supplies	3,028	5%
Medical, Dental & Vet Supplies	2,431	4%
Industrial Supplies	2,221	4%
Miscellaneous	1,554	3%
Electronics	1,372	2%
Home	1,015	2%
Sporting Goods	977	2%
Educational Supplies	672	1%
Food	316	1%
Total Catalog Sales	60,184	100%

* Source: Goldman Sachs Investment Research

Table 2: Percentage of On-line Shoppers Purchasing in Each Category

Merchandise Category	1998	1997
Computer-Related Products	39%	40%
Books	39%	20%
Clothing	21%	10%
Recorded Music	21%	6%
Gifts	20%	5%
Consumer Electronics	19%	NA
Travel	14%	16%
Movies and Videos	14%	NA
Subscriptions to Online Publications	11%	6%

* Source: Ernst & Young Internet Shopping Study

merchandise, electronics, sporting goods and other categories in mail order suggest that Internet retailers will also be able to succeed in these product categories.

Since 1997, Ernst & Young has conducted an annual shopping survey of Internet users. Table 2 shows data from this survey on the percentage of on-line shoppers reporting retail purchases in different merchandise categories. Similar to mail order, purchase of computer related products were the most common for on-line shoppers. Books, music and video were relatively more well developed Internet retail categories. These categories have benefitted from the pioneering efforts of such companies as Amazon.com, CDnow and Reel.com. Due to the large number of items typically available in these categories, land based stores and catalogue retailers are unable to carry every item currently available. Internet retailers have been able to stock virtual stores listing every product available. This has been made possible by well developed wholesale distribution networks in these categories that have allowed Internet retailers to offload inventory risk onto suppliers.

Privately held Internet retailers have typically chosen not to disclose quarterly and annual sales estimates. One way to gauge the relative success of Internet retailers is to estimate the fraction of the Internet audience that they reach. Media Metrix has installed software on the computers of a sample of 50,000 Internet users to collect information on the specific sites and web pages viewed. The set of URLs associated with each site are aggregated and used to estimate a variety of statistics, such as number of page views, average viewing time per page and number of unique viewers at each site. Using this sample, Media Metrix estimates the fraction of total Internet users a site reached in a given time period. Table 3 shows the reach and number of visitors at the top twenty five traditional retailing sites in April 1999. The data show that approximately 15.5% of Internet users visited Amazon.com's site in the month of April. Barnesandnoble.com had the second greatest reach, with approximately 6.5% of Internet users visiting this site.

Table 3: Top 25 Traditional Retailing Sites, April 1999

Rank	Site	Category	Reach	Visitors
1	Amazon.com	Books, Music, Video, Gifts	15.5%	9,497
2	Barnesandnoble.com	Books	6.5%	3,954
3	Cdnow.com	Music	3.8%	2,348
4	Bmgmusicservice.com	Music	3.8%	2,314
5	Beyond.com	PC Hardware & Software	3.5%	2,141
6	Columbiahouse.com	Music	3.5%	2,131
7	Egghead sites	PC Hardware & Software	3.3%	2,003
8	Dell.com	PC Hardware	2.9%	1,795
9	Musicblvd.com	Music	2.9%	1,783
10	Gateway.com	PC Hardware	2.3%	1,423
11	Compaq.com	PC Hardware	2.3%	1,412
12	Buy.com	General Merchandise	2.3%	1,410
13	Cnet Commerce Services	PC Hardware & Software	2.3%	1,402
14	Garden.com	Gardening Equipment & Nursery	2.0%	1,249
15	Etoys.com	Toys, Software, Video Games, Music	1.7%	1,024
16	Landsend.com	Apparel	1.6%	984
17	Shoptlc.com	Toys & Gifts	1.6%	979
18	Spree.com	Books & Music	1.5%	936
19	Cdw.com	PC Hardware & Software	1.5%	930
20	Fingerhut.com	General Merchandise	1.5%	905
21	Qvc.com	General Merchandise	1.4%	858
22	Netmarket.com	General Merchandise	1.4%	841
23	Victoriassecret.com	Apparel	1.3%	795
24	Reel.com	Video	1.3%	785
25	Shopnow.com	General Merchandise	1.2%	740

* Source: Media Metrix

Media Metrix recently calculated the number of visitors at the top ten e-commerce sites for comparable November weeks in 1999 and 1998. Site traffic to the top ten e-commerce sites increased by 28%. Table 4 shows that Amazon.com has retained its position as the top electronic commerce site. Toy retailers have raised their profile in the 1999 holiday season. Toysrus.com overtook Etoys.com as the most prominent toy web site. Launching early this year, Vitaminshoppe.com has managed to catapult into the upper ranks of commonly visited web sites. These data are not sufficient to estimate sales volume, but do show a highly volatile market.

It should be noted that the definition of a "commerce site" differs between Table 3 and Table 4. Ebay, Expedia and Shopping.Yahoo.com are not considered traditional retailing sites since they serve as intermediaries between buyers and sellers. These sites are thus not included in Table 3.

Estimates of site traffic for short durations of time are more heavily influenced by particular advertising campaigns and media buys. Web traffic has been found to be particularly sensitive to advertising and marketing campaigns. For instance, Toysrus.com was recently inundated with traffic after a major marketing campaign offered free shipping, free toys and discounts to 62 million customers. Toy R Us was forced to turn away customers from its web site after traffic increased by 1000%. Computer World notes, "When a brick-and-mortar store sends out a promotional flyer, retail models predict how much traffic is likely to result. But online, they don't realize there's so few barriers to people clicking to a site....foot traffic may build over a week's time in dozens of stores, but millions of online shoppers can hit one web site in a day."[5]

While a number of traditional land based stores have applied significant marketing muscle to enter Internet markets, catalogue retailers and pure Internet companies have had more impact in other

[5]Collett, Stacy. "The Glitch that Stole Christmas?" Computer World. November 14, 1999

Table 4: Top 10 E-Commerce Sites
Unique* Visitors (in thousands)

Site	Week ending 11/28/99	Week ending 11/29/98	% change
Amazon.com	4,163	2,941	42%
Ebay.com	3,499	2,172	61%
Toysrus.com	1,591	350	355%
Etoys.com	1,386	909	52%
Cdnow.com	1,246	1,159	8%
Vitaminshoppe.com	1,191	NA	NA
Barnesandnoble.com	1,169	1,151	2%
Buy.com	1,106	265	317%
Expedia	962	712	35%
Shopping.Yahoo.com	929	525	77%

* Repeat visitors are counted once each
Source: Media Metrix

markets. The potential utility of Internet commerce differs across retail sectors. A number of different sectors are examined briefly below.

Toys - Like most electronic retailing sectors, Internet toy sales currently represent only a fraction of the toy market. The total U.S. toy market is expected to reach $28 billion in sales in 1999, according to the Council of Toy Industries. Gomez Advisors has estimated that Internet retailers will capture 0.9% of this market in 1999, or approximately $248.7 million. Gomez Advisors forecasts that by 2003, Internet purchases will comprise more than 5% of the Toy market.

Apparel - Catalogue mail order companies have found initial success selling on the Internet. In 1998, Lands End racked up $61 million in sales, or 4.4% of its total sales on the Internet. Approximately 3.6% of L.L. Bean's sales were transacted through its web site. A number of apparel retailers plan to offer complete size selections through their Internet sites. As in other retail categories, Internet retailers have the potential to offer a greater variety of merchandise than might be available in stores.

In 1998 Internet sales of apparel comprised 0.2% of the retail market. Jupiter Research has forecast that Internet apparel sales will comprise 1.1% of the total market by 2003. This assumes a 52.8% compounded annual growth rate. Forrester research has made more optimistic forecasts of this market, estimating that apparel sales will grow at a 111.7% compounded annual rate and comprise 5.2% of the market by 2003. Since mail order currently comprises 7% of the apparel market, it seems likely that at least this much of the market is well suited to Internet retailing.[6]

Home Furnishings - Furniture is a good that consumers prefer to test out before purchase. Thus many have questioned how important the Internet will be to this retail sector. A number of Internet

[6] Internet Retailing. Goldman Sachs. June 1, 1999

retailers are pursuing this market, including Furniture.com, Furnitureonline.com and Behome.com. These retailers believe there are a variety of factors that make this sector appealing.

Furniture is a planned purchase, thus consumers can typically wait for the product to be delivered. Even store bought merchandise is often delivered, so in many cases shipping costs will not provide a competitive disadvantage to Internet retailers. Slow moving inventory is a problem for traditional land based retailers and is an area were Internet retailing could improve the economics of the business.

Catalogue retailers, such as the Pottery Barn, have proved that consumers are willing to purchase furniture via catalogue. Approximately 15% of the Pottery Barn's $200 million in annual sales is comprised of furniture.

Many analysts have speculated that a hybrid Internet-land based model might be more appropriate for this category. The electronic commerce service provider HomePoint.com is one means a traditional store can use to add electronic commerce to its traditional retail facilities. The company is working with 200 furniture makers and dealers to implement an extranet based ordering system. Traditional retailers install a Home Point kiosk in their stores. If customers can't find what they need in the store, they use the kiosk to browse a broader range of products. Retailers make a profit from sales made through these kiosks, and give a commission to Home Point. Manufacturers also like this system because it provides them access to a broad range of customers. Unlike some distributors in the furniture business, Home Point lists products from multiple manufacturers.

The fragmented nature of the furniture retail market and the availability of electronic commerce service providers suggest that small businesses may fare better in this sector. E-commerce service providers reduce the technical barriers to entry for small retailers to engage in electronic commerce.

The integration of electronic ordering with traditional retail operations seems likely to represent more of an evolutionary rather than revolutionary change for existing retailers.

Electronics - A number of businesses are currently engaged in retailing electronics over the Internet. The largest of these include Cendant's Netmarket.com, Crutchfield.com, Jandr.com, 800.com, Value America, Electronics.net, Buy.com, Best Buy, Circuit City and Amazon.com. Electronics are big ticket items and thus consumers tend to be more price sensitive toward these products. Price competition on-line has thus been fierce as sites have sought to acquire customers first and make profits later. Most of the major sites have sustained large losses in the process of customer acquisition. Access to capital and the ability to sustain losses have become necessary conditions of survival in this market.

Some analysts have suggested that price will ultimately be neutralized as a factor of competition in the same way that Best Buy and Circuit City maintain relatively similar pricing in their land based stores. Site content and customer service are expected to be the factors that differentiate the successful sites from those that will not succeed. The emphasis on pricing, site content and the ability to sustain losses (at least for the immediate future) imply a rather poor environment for underfunded, smaller businesses who do not aspire to become large scale enterprises in short order.
Barriers to entry into this market are low. Retailers, such as Buy.com, operate without holding any inventory by relying on wholesalers to secure goods in a timely fashion. Their strategy of attempting to sell goods at 0% margins and make money via site advertisement has nonetheless been capital intensive. Buy.com has incurred $80 million in losses for the first nine months of 1999.

Office Supplies - The office supply market, which includes such goods as business machines, computers, furniture, some services as well as typical office supplies, has been estimated to approximate $100 billion. These products are sold through a variety of retail outlets, including office superstores, warehouse clubs, discount stores, consumer electronics retailers, computer superstores, supermarkets and drugstores. In addition to this, approximately $60-$70 billion of office products are sold for delivery by contract stationers, office supply mail order firms, catalog operators and specialty distributors. Contract stationers already sell to large customers electronically through electronic data interchange systems, suggesting that electronic ordering is something that is valued by customers.

A number of features of Internet commerce are particularly well suited for the office supply market. The primary customers in this market tend to have access to the Internet. These customers order from a basket of goods, and thus customization can provide menus of items that have been ordered in the past and allow for a more efficient shopping experience.

Office supplies are a commodity, and thus customers are likely to choose the most efficient means of obtaining them. The ability of the Internet to provide product information is less of a benefit in this market, where the characteristics of such items as paper or pens are well known and require little evaluation for the typical customer.

Pure Internet retailers were the first to enter this market. Onlineofficesupplies.com and Atyouroffice.com were launched by entrepreneurs in the summer of 1998. Since that time, the major office supply chains have entered the market and spent heavily to market their sites. By 1999, the top four office supply sites were owned by the major office superstores. According to Media Metrix, OfficeMax.com was the most popular site, with a reach of 1.1%. ValueAmerica.com and OfficeDepot.com both have a reach of 0.8%. Staples.com has a reach of 0.7%.

Small businesses have reacted to this market in a variety of ways. Atyouroffice.com has relied on guerrilla marketing techniques, such as giving away free products in exchange for customer registration data. Onlineofficesupplies.com has become a technology service provider by licensing its technology to other businesses who want to sell on-line. The company forged a partnership with

United Stationers to help build commerce sites for its customers. Onlineofficesupplies.com helps mom-and-pop stationery stores go on-line by providing the database software necessary to implement a functional electronic commerce site. Each of these small businesses have been able to obtain significant private and venture capital funding to compete against their larger rivals.

Drugs/Pharmaceuticals - Since October of 1998, eight major Internet drug retailers have launched. The major retailers in this category are Rx.com, YourPharmacy.com, WholeFoods.com, PlanetRx.com, Drugstore.com, Soma.com, WildOats.com, Mybasics.com, GreenTree.com and Drugemporium.com. The entire drugstore retail market is approximately $205 billion. Mail order has enjoyed some success, particularly in the pharmaceuticals category, where it is estimated 10% of the prescriptions are filled via mail order.

On-line sale of drugstore merchandise are limited by a number of factors. Acute prescriptions can not be served by on-line operators since customers demand the product immediately. Additionally, older customers comprise a disproportionate share of this market. These customers are less likely to have Internet access or want to purchase goods on-line. Convenience items, many of which are small impulse purchases, will not likely be suitable products for on-line merchants. As a result of these factors, Goldman Sachs believes that Internet drugstores won't capture more than 1.4% of the market by 2002.

One trend in drugstore retailing over the Internet has been for web sites to join forces with land based stores to gain access to customers through a trusted retail outlet. CVS purchased Soma.com earlier this year, while Drugstore.com has partnered with Rite Aid to allow customers who order on-line to pickup in stores.

Higher margin products, such as vitamins, have been considered by a number of analysts to be candidates for more robust Internet sales. The higher markup on these products in stores provide

Internet retailers the capability to slash prices beneath those offered by their land based rivals. In the Vitamin product market, clicks and mortar retailing has also made inroads. For instance, Vitamins.com recently merged with the Vitamin Superstore, a retail chain located in the Washington, DC, area. The land based stores will have kiosks installed that allow customers to browse the Vitamins.com web site. The firm also purchased the catalogue retailer L&H Vitamin and plans to use catalogue marketing to promote its web site.

The multichannel marketing strategies currently being employed in the drugstore Internet retailing market suggest that existing stores have assets that can be leveraged on-line. At the same time, the importance of content and trust in this on-line market implies that on-line drug retailing may be more favorable to large operators. For instance, Vitamins.com provides detailed health information and is planning to make experts accessible on-line. These types of services may not be affordable for smaller operators, who can not spread these costs across a large sales volume.

3 Factors Affecting Small Business Competitiveness

The Internet is a double edged sword for small businesses. The Internet lowers barriers to entry into markets, but it also increases the importance of branding and allows large businesses to more easily leverage economies of scale.

The Internet provides access to vast markets. It allows the aggregation of thin demand, creating numerous markets for niche players. Small businesses have taken advantage of these opportunities. Indeed, on the Internet, the innovativeness and flexibility of small business startup companies have been highly valued. Larger rivals have often been willing to pay premium prices for small startup companies who are first to market with a concept. Public markets have also valued these firms highly, exhibiting great demand for the shares of companies in initial public offerings (IPOs).

Those companies first to market with an idea have often found that the unique communications properties of the Internet allowed them to attain a level of recognition that would have been impossible in a traditional media environment without an expensive marketing campaign. One example of this is Bluemountainarts.com. Bluemountainarts.com is a web site that allows users to send an electronic greeting card for free. It was ranked as the tenth most visited digital media property by Media Metrix. The site attracted an estimated 10.96 million unique visitors in October 1999 and makes money through the sale of advertisement and other items.

The first mover advantage on the Internet is particularly powerful. Those businesses that are first into a particular market benefit from free advertising created by media attention. Further, these businesses often generate significant word of mouth advertising as their customers refer other people to them. They are likely to acquire customers with less expense than later entrants because those most interested in the service they provide will be the first customers who sign up. Later entrants into the market are often forced to spend more heavily on advertising and promotion than first movers. As a particular market becomes saturated with advertising, marketing campaigns by new entrant may have less impact. How many dot-com companies can the average consumer remember?

The Internet economy has been favorable to small business startup companies who have shown a greater ability to innovate in this new market. As the Internet economy matures, it is unclear whether this favorable environment for small businesses will continue. The business strategy of many startups suggests that they believe that first movers will enjoy a sustainable advantage over later entrants. The willingness of investors to sustain losses implies that they believe that the path to success in Internet retail is to get there first and get big quickly.

There are a number of features of the Internet economy that have lowered barriers to engaging in e-commerce. Internet startup companies have access to specialized service providers to assist them in building their businesses. Retail businesses can hire logistics or fulfillment firms to handle the processing of orders and returns. Retail sectors such as books and computer products have well developed wholesale distribution networks that allow Internet retailers to offload inventory and shipping onto a third party. Many wholesalers have the capability to ship individual orders directly to the consumer. These types of services can allow a small business to focus on building a web site and selling product.

There are also a variety of Internet commerce service providers who offer web site and database hosting services. In books, office supplies, furniture and other categories, these service providers give small businesses access to the technology to set up product databases and take credit card orders via the Internet.

While much of the focus in the past two years has been on Internet startup companies, recent trends in Internet marketing suggest that brick and mortar stores are not obsolete. Many on-line stores without a presence are acquiring one. For instance Gerald Stevens Inc., the owner of three on-line flower stores, has recently been on a buying spree, purchasing traditional flower shops to complement its on-line businesses. Gerald Stevens Inc.'s CIO noted, "What we're trying to do on a simple basis is meet the customer wherever the customer wants to shop".[7] Vitamins.com is another store that is pursuing this strategy.

Traditional land based retailers are using their stores to promote their web site. Borders is pursuing a "clicks and mortar strategy" that involves locating kiosks in their stores to allow ordering from the Borders.com web site.

Web businesses have also found that catalogues can serve as a lower cost way to drive traffic to a site. Garden.com is planning to promote sales through its store via catalogues. Amazon.com recently purchased a number of catalogue retailers, presumably because it intends to pursue a similar strategy.

Overall, the trend in Internet marketing is toward multi-channel marketing. This strategy uses traditional store front and catalogue assets to promote on-line sales. Some on-line retailers have found that customer acquisition costs can be reduced by leveraging traditional marketing tools. This suggests that small traditional retailers do have some unique advantages on-line because they have existing customer bases that they can market to at lower cost. Of course these advantages also accrue to larger multi-unit retail firms who wish to go on-line.

Large chains enjoy numerous mechanisms through which they can promote their on-line stores. For instance, Wal-Mart has recently agreed to market AOL's services in exchange for prominently positioned links in AOL's marketplace .

[7]King, Julia. "On-line stores add offline outlets". Computer World. August 9, 1999

4 <u>Conclusions</u>

Current estimates of the Internet retail market fall between 1% and 2% of total retail sales for 1999. The size of existing mail order markets and the superior efficiencies associated with Internet retailing suggests that this market will grow significantly in the future.

Traditional retailers do have some advantages over their on-line rivals. Current trends in marketing imply that Internet retailing in the future will become more integrated with catalog and storefront retailing. Traditional retailers have significant assets that can be leveraged on-line.

Small businesses, particularly startup companies, were the initial beneficiaries of the Internet economy. The Internet has opened up a range of opportunities that were more easily exploited by new entrants with fresh ideas. In the future, on-line markets are likely to be more concentrated than land based retail markets. Small, less efficient retailers have traditionally competed with their larger rivals by operating from convenient locations. In the on-line world, the physical location of a retailer has become unimportant. Consumers are likely to shop at those sites that have the best service, price or most prominent brand, since the ability to use these sites is independent of their location. Those retailers who can achieve economies of scale and provide the best service will capture a large share of on-line sales.