The UK is one of the fastest growing and most competitive online retailing markets in Europe. 1999 saw the market triple as retailers and consumers got online. Online sales as a proportion of total sales is higher in the UK than any other European country except Sweden. But 1999 was also just the start. 2000 will see more entrants, enhancements to existing sites, new access channels, and increased competition.

This report – The State of Online Retailing in the UK: Getting Started – is part of The Boston Consulting Group’s ongoing programme of research into the evolving world of e-commerce. It covers the UK results of a comprehensive interview-based survey involving 546 European retailers.

For the UK online market this report covers
- Overall size and shape
- Development by category
- Market concentration
- Position of US players
- Share by business model
- Marketing
- Outsourcing
- Future prospects

This report is intended to complement our pan-European study – The Race for Online Riches: E-Retailing in Europe. In addition to these publicly available reports, a further volume covering detailed performance benchmarks is available to retailers who participated in the study.

We would like to thank the many retailers who participated in this study by providing us with their data and experience. Special thanks also goes to the project team members from BCG, Huw van Steenis, Jonathan Fahey and Nick Gardiner.

We hope you find this report a valuable guide to the state of online retailing.

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February 2000

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The Boston Consulting Group
Summary of Key Findings

Online Retail spending took-off in the UK growing 280% in 1999 to €976m (£625m)(1).

- Online sales represented 0.4% of the total retail market for the categories researched
- Market penetration exceeded 1% in the computer, book, travel and brokerage categories
- The volume of online orders grew by 470%, as users bought more frequently

Market was concentrated within a few categories and companies

- Computer, travel, book and food & wine categories represented 83% of the online market
- The top 10 online retailers accounted for 65% of the online market

US companies dominated the leading categories

- US companies captured over half of online sales in the computer, brokerage, books, and music & video categories
- US companies accounted for 41% of total online sales in the UK

Pureplay(2) and direct retailers(3) have been the most successful in building sales, often providing financial incentives to shop online

- 72% of revenue of the top 25 online retailers was attributable to non store-based retailers
- Almost all pureplay and direct retailers offered a financial incentive to shop online, in contrast, less than a third of store-based retailers did the same

Most store-based retailers have yet to embrace the online channel as aggressively as pureplays

- Store-based retailers spent about half as much on marketing as a percentage of revenue as pureplays (28% versus 54%)
- 36% of store-based retailers had no marketing expenditure directly attributable to online operations

Most online retailers are failing to leverage the customer information available through the Web

- Only 44% of retailers collected basic customer demographics such as gender and age profile
- Of those retailers that collected traffic and customer metrics, less than 40% were actively analysing these metrics and incorporating the analysis into operations planning and management

Future prospects

- The market will become increasingly competitive as the battle for market share continues. Entry costs for new players will continue to rise
- Interactive digital TV (iDTV) providers will attempt to move online retailing from the study / bedroom into the living room. Mobile operators will also seek to enter the market
- The winners and losers will start to emerge. We believe the winners will be those retailers who master the total customer experience, from initial proposition to ongoing relationship management

(1) Exchange rate used in this report is €1=£0.64
(2) Web-only retailers
(3) Web and offline direct retailers
The UK Online Market

OVERALL SIZE AND SHAPE

The online market came of age in 1999 with companies and consumers scrambling to get online. The UK online retail market grew by 280% to €976m. Within this overall growth a number of trends can be discerned. First, growth has varied across categories with less well penetrated categories such as brokerage, food & wine and apparel growing much faster than highly penetrated categories such as books and computers. Second, penetration by category differs significantly from the pattern seen in the US. Some categories such as consumer electronics lag well behind the US, the book category is comparably penetrated, while food & wine is more penetrated in the UK than the US. Third, the growth in the UK market is being driven primarily by attracting more consumers online, rather than increases in the average sales per consumer.

Figure 1: Online Retail Market, UK 1999

Note: Brokerage and Automotive include agency fees only
DEVELOPMENT BY CATEGORY

- The computer category (hardware and software) grew solidly in 1999 as direct retailers increasingly pushed the Internet channel, with momentum picking up towards the end of the year.
- The travel market grew very rapidly in 1999. Discount airlines have driven the growth of this category, quickly taking advantage of the Internet as a low cost direct channel and offering incentives to attract customers online.
- In common with continental Europe, price-based competition characterised the online book market last year. By Internet standards the book category saw relatively low growth.

Easyjet: Online Incentives
Change Customer Behaviour

Easyjet, founded in 1994, offers low airfares on European routes. It is part of a group of companies with entrepreneurial management, a single “Easy” brand, and strategies of low-cost service provision. Easyjet sells exclusively direct to keep fares low. The Internet is its preferred revenue and marketing channel: online bookings with e-ticketing are more than 50% cheaper than telesales to process.

Easyjet deliberately encourages migration of customers online by pioneering Internet-only promotions and other incentives. Starting with a £1 discount for any online booking, exclusive Internet deals have become standard. New seasonal schedules are available for Internet reservations several weeks before they open to telesales customers. Promotion of the Easyjet URL in regular offline advertising and through sister companies' activities keeps the brand profile high at low marginal cost. Consequently Easyjet has rapidly attained the highest proportion of sales online of any European airline, rising from 25% in March 1999 to roughly 40% by December. For recent promotional offers this has risen to 70%.

The aspiration is to move 60% of all sales online by the end of 2000 – a target more ambitious than low-fare competitors and several years in advance of the major global carriers. Total revenue was projected to double in 1999.

- The UK food & wine category saw particularly strong growth, due to aggressive supply side investments by a number of major supermarket chains. The UK now leads the US in terms of penetration, with just under 0.1% of all retail food & wine sales online.
- The apparel and consumer electronics categories saw high growth from a very small base during 1999. The low penetration in these categories is explained by the absence of aggressive competitors.
• There was an explosion in the numbers of players seeking to profit from online financial brokerage in 1999. New entrants sought to grow share aggressively through heavy discounting which grew the market dramatically. However, the overall size of the category is still relatively small and well behind US penetration levels.

• One interesting feature of the UK market has been the relative under-performance of local players in the music & video category. Around 55% of all sales in this category are imports, in part due to significantly higher prices in the UK and relatively poor offerings by local online retailers.

**Figure 2: Online Retailing Growth 1998-1999**

<table>
<thead>
<tr>
<th>Categories</th>
<th>1998 online sales (m)</th>
<th>1999 online sales (m)</th>
<th>Growth (%pa)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Computer</td>
<td>105.1</td>
<td>300.0</td>
<td>185</td>
</tr>
<tr>
<td>Travel</td>
<td>44.3</td>
<td>272.2</td>
<td>515</td>
</tr>
<tr>
<td>Books</td>
<td>62.4</td>
<td>137.0</td>
<td>120</td>
</tr>
<tr>
<td>Food &amp; wine</td>
<td>12.3</td>
<td>102.4</td>
<td>733</td>
</tr>
<tr>
<td>Auction</td>
<td>7.3</td>
<td>23.5</td>
<td>247</td>
</tr>
<tr>
<td>Brokerage</td>
<td>1.3</td>
<td>24.1</td>
<td>1,754</td>
</tr>
<tr>
<td>Music &amp; video</td>
<td>6.7</td>
<td>23.0</td>
<td>243</td>
</tr>
<tr>
<td>Apparel</td>
<td>2.6</td>
<td>21.1</td>
<td>712</td>
</tr>
<tr>
<td>Tickets</td>
<td>4.0</td>
<td>20.8</td>
<td>420</td>
</tr>
<tr>
<td>Consumer electronics</td>
<td>2.1</td>
<td>12.8</td>
<td>510</td>
</tr>
<tr>
<td>Home &amp; garden</td>
<td>2.0</td>
<td>12.7</td>
<td>535</td>
</tr>
<tr>
<td>Automotive</td>
<td>2.1</td>
<td>10.8</td>
<td>414</td>
</tr>
<tr>
<td>Flower, cards &amp; gifts</td>
<td>3.5</td>
<td>9.1</td>
<td>160</td>
</tr>
<tr>
<td>Toys</td>
<td>1.5</td>
<td>5.0</td>
<td>233</td>
</tr>
</tbody>
</table>

(1) Defined as how long it would take to reach current US penetration at today's growth rates

Note: Penetration rates defined as online sales (ie domestic reported sales plus estimated imports) as a percentage of total (online and offline) consumer spending

Source: BCG Retail Study; BCG/Shop.org; The State of Online Retailing 2.0, US
MARKET CONCENTRATION

Figure 4: Concentration

<table>
<thead>
<tr>
<th>%</th>
<th>Top 10</th>
<th>Top 11-25</th>
<th>All remaining</th>
<th>Total industry</th>
</tr>
</thead>
<tbody>
<tr>
<td>65%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>17%</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: BCG Retail Study

The UK online retail market is relatively concentrated with the top ten companies generating 65% of total revenue, compared to 43% for the US. Major traditional retailers have been slow to move online, while well funded US pureplays are swiftly expanding their offering to the UK. Eight out of the top 25 UK retail sites are US owned, and these eight retailers account for 38% of the UK online market.

POSITION OF US PLAYERS

By leveraging their experience and capabilities US companies have achieved leading positions in several categories. US companies account for over half of sales in the two largest categories, computers (70%) and books (90%), and the fastest growing category, brokerage (70%).

The strength of US companies in the UK can be explained by American retailers’ tendency to use the UK as their point of entry into Europe. Shared language and similarities in cultural and managerial styles encourage this. A consequence of this strong US presence is that the UK will likely become the most competitive European online market. Local retailers will need to out perform the best of the US to succeed.

SHARE BY BUSINESS MODEL

The relative success of different types of retailer varies enormously by category. Direct and pureplay retailers have reached leading positions through aggressive early movement online, and have priced for market share. Store-based retailers dominate only in food & wine and financial brokerage, where incumbents have moved early and most aggressively.

Our research suggests that many store-based retailers are suffering from corporate inertia, often treating the Internet simply as another sales channel, rather than a new business model. Many store-based retailers manage their online operations with the same decision making processes, speed and metrics that they use in their offline operations. They make little effort to promote or differentiate their online offering. For example, 36% of store-based retailers do not undertake dedicated marketing for their online operations beyond using the URL on existing promotional material. Even
in price-competitive markets, store-based retailers have shown a reluctance to substitute offline sales or price aggressively online. A number of store-based retailers stated their intention is to compete on customer service, while at the same time citing customer service as one of their biggest issues.

The performance of online retailers varies enormously. This survey revealed conversion rates (orders/unique visitors) ranging from less than 0.1% to over 10%. The performance of the retailers also varied significantly within categories. We believe this is a sign of the immaturity of the market and offerings.

MARKETING

Dissatisfaction with online advertising is widespread. A significant majority of the companies surveyed expressed disappointment with the quality and rapidly increasing expense of online advertising. Most leading companies use multiple marketing channels, heavily biased towards the offline world. They make extensive use of traditional media for advertising and complement this with a growing use of public relations. These leading companies are also more strategic in their approach to online marketing. First, through an increasing use of performance-based ‘tenancy’ agreements and second, through being more selective in which sites they choose to market themselves on, with community interest sites becoming more important. Banner advertising is used mainly for specific activities such as short-term promotions.

Figure 5: Share of Retail category by Retailer Type

OUTSOURCING

Pureplays have mostly adopted a ‘virtual’ operating model, with a greater tendency to outsource than multichannel retailers, particularly for fulfilment. In contrast, multichannel retailers are more likely to outsource website design and traffic analysis – new skills for these retailers. Few store-based retailers have chosen to outsource inventory management or logistics. However, we note that 62% of store-based retailers report fulfilment as a problematic area.
FUTURE PROSPECTS

Competitive pressure will intensify, even as cost of entry increases
The competitive environment will intensify as currently absent store-based retailers come online, US Internet retailers continue to set up UK operations, and further local start-ups launch. All retailers will be seeking to achieve a critical mass of customers and establish brand awareness. Individual retailers will invest heavily along a number of dimensions: marketing (on- and offline), price point and promotions, customer service, range, site functionality, and customer relationship management. Deep-pocketed competitors will be playing the long game in 2000, investing for position and share, rather than near term earnings. The UK is quite likely to be the most competitive online market in Europe.

Interactive digital TV challenges the PC
The UK will be a unique market for online retailing. By the end of 2000, the combined efforts of BSkyB, Telewest, ONdigital and NTL may result in there being more online TVs than online (home) PCs. All the iDTV platform operators are developing partnerships with online retailers. From the consumer perspective, the iDTV proposition will be quite different to online PC. iDTV promises to be: in the living room (not the bedroom), always on, linked to TV adverts, simple to use, and offer a select (restricted) set of retailers. A key unknown today is the extent to which iDTV will encourage the mass market to go online. By the end of 2000, the UK market will have given us some clear pointers as to how consumers want to shop online.

A complementary role for mobiles
The next phase of development in the mobile phone market is going to be the introduction of interactive data services. The next generation of phones, compliant with standards such as WAP, will enable e-commerce functionality. Mobile devices are unlikely to be attractive for many retail categories until screen size and bandwidth increase significantly, however we can expect them to play an important role in certain niches during 2000. For example, financial brokerage sites will add mobile messaging / alert functionality, and travel sites will support remote timetables and electronic ticket purchasing.

Competitors will focus on managing the total customer experience
Today’s experience online frequently leaves a lot to be desired. Successful companies will focus on improving and mastering the total experience. This will require continued investment in: website speed and usability, inventory and fulfilment systems, order handling and customer service, delivery, and customer relationship management. Customer expectations will rise (in line with the best they have experienced). There is much to be learned and no online retailer will be allowed to stand still.
The Internet is an unmapped world of infinite possibilities and challenges for retailers, both multi-channel and pureplays. We hope that all retailers in the UK will benefit from the research, analysis and insights presented in this study.

The Boston Consulting Group will continue monitoring and analysing the development of the online retail market in the UK, and we will publish further research in the near future. Please contact us if you are interested in participating in future studies on the online market.

Since our objective is to create a broad ongoing dialogue about e-commerce in the UK, we are very interested in your reactions and would welcome your comments.

Please feel free to contact Henry Elkington or Neil Monnery at The Boston Consulting Group in London at:

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