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E-COMMERCE BUSINESS MODEL STRATEGY OPPORTUNITIES AND CHALLENGES IN BRAZIL

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ABSTRACT

This article presents and discusses the different business models adopted by e-commerce firms. It addresses the issue of the business model, concerning the revenue-generating model, marketing-related costs, logistical problems, risk of fraud and the demand for investment in technology. Some of the models are profitable and most are not. The world is experiencing a sharp increase in this sale channel, but many operations are still losing a lot of money.

Key words: *e-commerce, business strategy, Brazil, business model, internet price strategy, value perception, internet safety.*

1. INTRODUCTION

E-commerce is a relatively new way of doing business. This concept entered the business vocabulary in the 1970s; however, it began to gain prominence at the end of the 20^{Th} century with the development of a digital world. The widespread use of personal computers, the proliferation of the internet, as well as the development of on-line payment security systems have been the main drivers for e-commerce development.

In today’s world, e-commerce has become an important alternative sales channel for virtually all retailers. However, it can mean different things to different people. Zwass (1996), for example, defines e-commerce as “the sharing of business information, maintaining business relationships and conducting business transactions by means of telecommunications networks”. Others (Applegate, 1999, Fellenstein and Wood, 2000) also support this view and consider e-commerce to include various processes inside and outside organizations in addition to buying and selling activities.

In this article, e-commerce is considered in its most common and popularized use known as B-to-C (business to consumer). According to Molla & Licker: E-Commerce Systems Success (2001) in this type of e-commerce, organizations offer their products and services and generate revenue from the actual sale of those products and services to their customers.

The internet and e-commerce are impacting distribution management strategies and consumer behavior in new ways which need to be examined more closely. Small enterprises can now reach niche markets which, until the advent of the internet, were not cost effective to serve. The impact of internet-based distribution on the demand curve has implications for both consumers and strategists (Day, Ward, Choi and Zhao, 2011).

Along with this expansion, discussion of which e-commerce business model is more profitable is very common. Does the model vary according to the product assortment or need to be adapted based on the target market and the region where it is located?

The world witnessed the US$ 21.8 billion Alibaba IPO, a record for the U.S., reaching values higher than Facebook Inc. and Amazon.com Inc.

On the other hand, investors have been discussing for how long this kind of business will be able to generate profit consistently. Its revenue comes from advertising and commissions on sales. Alibaba’s CEO, Mr. Jack Ma, classified the business not as an e-commerce, but as a virtual shopping center. In fact, it does not sell its own

products. This business model has provided Alibaba with a higher operating margin (43.4%) than eBay Inc. (18%), Google Inc., (27%) and Amazon which registered a negative operating margin of 0.1% over the same period.

Alibaba's business model is an interesting case for discussion. Its operation alters the traditional value chain model to attend customers and provide service as no physical product moves through their logistics.

Its sales in 2013 reached US$ 300 billion. The company has a broad range of digital businesses including activities similar to Amazon, eBay and Paypal. Its unique way of doing business, while maintaining synergy among its different investments to leverage the operation, also includes a "Cloud Computing and Internet Infrastructure" business line.

In China approximately 80 percent of all mobile retail volume comes from the Alibaba site and the company utilizes 14 delivery partners employing 950,000 delivery personnel and dominates mobile commerce in that country.

In its vertical business model, Alibaba is a partial owner of Alipay, which processed 78.6 per cent of its transactions last year. Alibaba has a massive scale and an enormous market share, which has allowed it to experience continuous profit growth.

In Brazil, Privalia is an example of an e-commerce company following the same business model as Alibaba. It carries no inventory and works as an outlet for well-known fashion brands for men, women and children offering discounts of up to 70%. More than one thousand brands are available in its store. This online purchase club has been operating in Brazil since 2008 and has more than 6 million associates in Brazil and 15 million around the world, including Germany, Italy, Spain and Mexico.

Globally, 28% of its sales are made on mobile devices (smartphones and tablets). Its Privalia Mobile app is available for OS and Android platforms to make the purchase experience easier and 1.8 million copies of this software have already been downloaded.

One of its differentiations is its virtual store on Facebook known as Fan Shop with 2.6 million fans. Using this social network, the firm has a direct contact with its associates, offering exclusive promotions, purchase privileges and sharing suggestions and opinions. Part of its huge success can be attributed to its intensive and well disseminated promotions, including between five and seven new campaigns launched every day for new offerings and the design and performance of its site.

Those firms have guaranteed huge sales using a non-traditional business model where virtual retailers manage their own inventory, delivery processes and payments. Are the Alibaba and Privalia business models the best business mode in a virtual environment?

2. THE BUSINESS MODEL

In the last twenty years, the internet has completely reshaped how people shop all over the world. It is common sense to actively surf the web to compare prices, research potential purchases on multiple websites, consult social networks and blogs for product reviews, and use different sources of information purchase wherever is most convenient for them.

But not all e-commerce experiences are successful. Walmart's online volume for example, represents only 2% of its total global sales of US$ 473 billion. Amazon has annual sales revenues of US$ 75 billion, almost eight times more than Walmart. Theoretically Walmart stores should be able to leverage the online business. They could work as storage and collection points for those customers who do not want to receive the purchase at home. Today 19% of its physical store customers also buy on its site. The problem is that 53% of them also buy on Amazon.

As the world's largest retailer, Walmart is investing in technology, to promote the intersection between its physical and digital business.

Neil Ashe, Walmart's global e-commerce president and chief executive officer states: "*There isn't a store customer or an online customer or a mobile customer. There's just one customer, and we're all committed to delivering one Walmart and one Sam's Club to that one customer,"* (MMR/March 31, 2014)

As two-thirds of the U.S. population live within five miles of a Walmart store, the company can use the stores as a delivery option for same-day shipping or in-store pickup.

Besides that, one quarter of Walmart customers have no credit cards or bank accounts. As such they would be excluded from e-commerce if they did not have the chance to order online and pay with cash at a store.

Walmart is laying the logistical groundwork for the convergence between its brick-and-mortar stores and digital platform. That can give the firm a differentiation offering the customers what no one else can do.

A recent study by Hahn and Kim (2009) found that consumers' trust in an off-line store was a significant predictor of both their confidence in shopping at the company's online store and their intention to search product information online using the company website. Consumers' trust in a retail brand significantly influences their intention to shop at the retailer's website.

Zentes et al (2007) state that retailer's stores brand can be considered to be their 'products'. It identifies a retailer's goods and services and differentiates them from those of competitors. A brand has its own characteristics or traits and they can be translated into a personality like a unique human being. There is a potential influence of brand personality on store loyalty (Zentes et al,2008) because brands can convey symbolic associations.

Following the same line of thought, Angela Ahrendt, who used to be Burberry CEO, was invited by Apple to develop a better link between the virtual stores and the showrooms. In her opinion, in the next five years, there will be seven billion smartphones in the world willing to become potential customers. The internet page will be the store window and it must be developed to leverage sales.

Brand trust is the relationship between the confident expectations of the consumer and the resulting responsibility of the brand or retailer (Lau and Lee, 1999; Chaudhuri and Holbrook, 2001). If a customer has a positive behavior regarding an off-line retail brand, he or she is likely to be comfortable about shopping at the retailer's website. If the brand has a strong and positive reputation it will lead to brand repurchase, brand satisfaction and brand loyalty. Trust in a retailer is significantly related to intention to shop at the retailer's website (Loiacono, 2000; Liao and Cheung, 2001; Gommans et al., 2001).

Many analyses have been made on the conversion rate from search to sales and may suggest a product and brand assortment problem. Website design may also be improved to induce a cross selling practice, influencing buyers to increase their total purchase amount.

The best business model is clearly associated to company size. An e-commerce business model demands scale in processing capability and an e-business model, focusing on customer needs, working intensively on marketing and communication.

The development of electronic commerce not only reduces shopping time, but also brings new possibilities of information technology in-house. Increasing customer requirements for product demand, giving rise to new products, which significantly contribute to rapid return on investment (Němcová and Dvořák, 2011).

3. THE EXPERIENCE OF E-COMMERCE IN BRAZIL

Due to the sales success of independent on-line websites, Brazilian brands have discovered that they must use the e-commerce channel in their strategy of multi-channel option to increase sales, complementing their market capillarity.

The strategy makes sense in a country like Brazil that represents today a consumer market of 203 million people. It is bigger than the combined population of Spain and France.

On the other hand, today, 89% of the country's cities have less than fifty thousand inhabitants and, as the average national income is low, especially in those smaller cities many types of stores would not reach their breakeven point making the e-commerce the only way to serve consumers in these cities.

E-commerce increased greatly in Brazil in the last two years due to the increase in income, intense availability of internet infrastructure connections and increased sales of computers, smartphones, and tablets. Approximately eighty million Brazilians have bought on the internet at least once. Sales are expected to reach US$ 16 billion by the end of 2014. Fashion and accessories lead the sales ranking representing 18% of total volume followed by perfume and cosmetics (16%) and appliances (11%).

Nike opened its online store in Brazil in 2014 and has already become its second largest online store in the world. Overall, e-commerce in Brazil tripled in the last four years and grew at a rate higher than the principal countries of Europe, the United States and Mexico. It has received investments from private equity firms of more than R$

2.3 billion (US$ 1 billion) but most of the fifty largest retailers on line are not making money and specialists say that some of them never will.

Although there is a strong demand for this sale channel, firms have not been able to balance sales revenue and operational costs. It is important to analyze what the best strategy of e-commerce in Brazil should be concerning business model, product assortment, logistics, advertising expenses, and payment terms.

Dafiti is a website which sells over 75 000 apparel items. It obtained over US$300 million in capital from Rocket, a German private equity, and has more than US$ 500 million in sales revenue. But the problem is that, the more it sells, the more money it loses. It has never been profitable in its four-year existence and specialists estimate a monthly loss of US$ 10 million.

The website recently merged its operation with four other online retailers to create the e-commerce company Global Fashion - GFG. The merger was announced by the controlling investors: AB Kinnevikt of Sweden and Rocket Internet from Germany. This group consists of sites specialized in fashion from India (Jabong) Russia (Lamoda), Middle East (Namshi) and South East Asia and Australia (Zalora).

The intention is to develop a larger scale operation, to negotiate a larger budget with the internet media and obtain better conditions.

This operation seems to confirm the concept that e-commerce is a large scale operation which demands huge investments in technology, customer assistance, advertising and logistics. Creating synergy among these companies could lower costs and promote operating efficiency.

Is a large-scale business needed here, offering no room for small and medium size companies?

In the last years Brazilian market has witnessed the emergence of many variable retail stores on line. Some of them were: the furniture store Mobly, baby stores, pet shops and the wine store ”Wine.com.br” which became the second largest in world. Some other entrepreneurs have invested in cosmetics, fashion apparel and real estate. The most recent movement has been in the stock brokerage business.

Most of them are losing money, but nonetheless, some are worth a lot of money. Potential investors count on the long run to make money, or wait until someone bigger would feel bothered by the competition and take over the competitor or go for an IPO.

The strong growth of e-commerce is being leveraged by international investors like JP Morgan Bank and Skype co-founder Niklas Zennström.

The idea is to replicate here the history of two American online retailers like Diapers.com, sold to Amazon for US$ 500 million in 2010 who also bought Zappos, a shoe store, by US$ 900 million in 2009. None of them had ever made a profit but became large enough to attract Amazon.

But this strategy is difficult to follow in Brazil since the leaders in each niche face their own profitability problems. As there are many companies selling the same products on line, sellers must compete on price and offer free freight and payment in as many as twelve installments.

Those companies able to sell more and more with no profit will last longer. As the stock market has been undergoing a difficult period over the last three years, the IPO alternative has become a distant dream for most companies. Comprafacil.com was founded in 2003 and became the third largest electronic on line store before it went bankrupt in 2014.

Pressed by the risks and increasing debt, many of the firms tried to reduce their advertisement expenses, but sales dropped immediately.

One alternative is to create a “fidelity club” where customers pay a fixed amount each month and can choose products on a regular basis. Wine.com.br adopted that strategy in 2013 and was able to make some profit for the first time. The firm has fifty thousand subscribers. This club sells over 150,000 bottles a month.

A business model able to generate recurring revenue seems to be a way to guarantee enough funds to cover fixed costs and give longevity to the operation.

Those stores able to produce their own products or sell exclusive items can work with higher margin, which means an advantage over competitors.

The main reasons presented for losses are low sales prices due to competition and the ease of comparison to other websites, high delivery costs, heavy investment in advertising, and financial cost of consumers purchase on credit and high level of fraud.

Netshoes, the largest online sporting goods store was founded in 2000 and through 2014 has been unable to make profit even with sales over US$ 500 million. New investments have become necessary to keep the wheel turning. Morgan Stanley investment bank was engaged to find an investor interested in buying the business, but were unsuccessful.

The combination of loss and poor cash flow can lead to conflict between entrepreneurs and investors.

4. INTERNET PRICE STRATEGY

Online retailers must take price splitting decisions regarding shipping and handling fees. Some of them present customers with a price split between product price and a separate delivery surcharge and others prefer to offer free shipping using a single-price format where the product price already includes shipping (Mehmet Gumus, Wonseok and Saibal, 2013).

Two considerations must be made here: the first refers to the customer's perception of product cost and the other is that e-commerce related shipping and handling costs can account for more than 30% of the total cost in a number of sectors such as groceries and toys (Barsh et al. 2000 apud Mehmet Gumus, Wonseok and Saibal, 2013). In Brazil, as only 20% of the roads are paved, thus this cost can be an important issue.

Online retailers must carefully trade off the negative impact of delivery-related expenses on their total costs against the positive effect of not charging customers for delivery expenses. It is not very easy to decide on the optimal pricing strategy based on the characteristics of the products being sold by the retailer.

Better supply chain network design and inventory management can certainly reduce shipping and handling costs for online retailers.

5. INTERNET SAFETY

E-commerce not only has tremendous potential for growth but also poses unique challenges for both current players and new entrants. According to Saini and Johnson (2005) some capabilities act as drivers of firm performance in e-commerce: information technology capability, strategic flexibility, and trust-building capability. Concerning trust building Kwon and Lee (2003) found empirical evidence of an inverse relationship between security concerns and Internet purchases. They also found that providing alternative off-line payment methods reduces security concerns and therefore promotes on-line purchases.

Security is still a significant issue for today's Internet shoppers despite the introduction of e-cash, encryption and decryption technologies. It is critical for Internet retailers to dispel consumers' negative attitudes about the safety of using credit cards on-line.

The Internet retail industry has introduced various methods such as encryption technologies attempting to prevent fraud such as stolen credit card numbers and identity theft, one of the main costs for on-line retailers on line. Security issues and consumer protection has been extensively discussed by specialists in Brazil since the payment using mobile phones represents today eight percent of total sales, but specialists foresee a participation of 15% in the next five years. New technologies such as Chip&Pin and NFC (Near Field Communication) are being introduced in order to increase consumer protection needs when using their credit cards. The reluctance to use credit cards for on-line purchases is one of the primary obstacles to the future growth of Internet shopping.

Lack of trust is one of the most frequently cited reasons for consumers not purchasing from Internet vendors due to anonymity, lack of control and possible opportunism (Grabner-Krauter and Kaluschab, 2003). Sensitive personal information must be supplied such as mailing address, telephone number and credit card number, making risk and trust crucial elements of electronic commerce.

Internet Retail companies must necessarily focus on measures and policies to build and maintain consumer trust. According to Shim et al. (2001), transaction service such as payment security, privacy, safety, product guarantees, and minimal cost/time for returns affected consumers' intentions to use the Internet for purchasing.

Analyzing from the retailers point of view, Brazil has a high rate of fraud and, according to CyberSource Brasil, seven percent of total sales online are rejected by the sellers in Brazil due to suspected fraud equivalent to US$ 110 million. In United States this represents 2.7% of total sales. Local legislation says that, when a purchase is made online, retailers assume responsibility for any loss. If the purchase is made in an onsite store the credit card administrator should assume that loss.

This kind of threat brings an extra cost to the operation. The huge online sites have teams dedicated to making manual reviews to ensure that transactions are not fraudulent in 31% of the cases. Nonetheless, 1.08% of total sales are identified as fraudulent after the transaction has been completed. Considering that 104 million transactions will be made in 2014 that means tremendous operational costs for companies. That risk may increase with the adoption of mobile devices by the population.

6. VALUE PERCEPTION IN INTERNET SHOPPING

Many studies have covered the possible variables related to value perception in an e-commerce environment. Some of them, in addition to security on the Internet (already discussed) are: Influences of Friends and Advertisements, Convenience of the Internet, Brand admiration, Better price offering, Ease in Ordering and Delivery process, Return Policy and Quality of information online.

A previous study reported a strong relationship between a website's information quality and customer usage of interactive features on impulsive e-shopping purchase behavior (Lin and Chuan, 2013). According to them, information quality has a direct influence on impulsive purchase on internet, but perceived trust and use of interactive feature were not supported.

As many consumers use the Internet as a source of information this affects the intention to purchase through this channel (Shim et al.2000). When consumers are satisfied with the information provided by the retailer on-line, they are more likely to make a purchase. For web retailers it is easier to provide customers with specific and up-to-date information about the product on a 24hour/7day base (Silverman, 1998). Other advantages offered by technology are the facility to improve online product displays and real-time customer service, which apparently lead to more sales (Paderni et al., 2005).

From the shopping process, people derive several different outcomes such as products, information, and pleasure (Lee and Johnson, 2002). Shopping includes both information searching behavior and purchasing behavior.

Many sites have as their main business to offer the customers the ease of viewing the vast amount of information available and comparing products and prices on-line.

The interactive nature of the Internet is a crucial element in online consumer decision making (Shim et al., 2001). When a consumer has enough information about a product's price, size, color, function, it is easier to make a decision and Shim et al. (2001) proposed that intention to search for information online is a predictor of an intention to buy online.

Customer perceived value has a subjective nature with a number of components that contribute to an evaluative judgment. There is a relationship between store perceived value and customer attitude, which is an important determinant of customer loyalty. A study by Ruiz-Molina and Gil-Saura (2008) concluded that store perceived value has a strong influence on both customer attitude and, consequently, store loyalty.

Brakus et al (2009) had related the brand experience to store loyalty. The shopping and service experience includes not only utilitarian attributes but also hedonic dimensions, such as feelings and pleasure and can be affected by marketing communication. Brand connection can lead to involvement related to values, interests and needs.

Innovativeness is part of consumers' shopping behavior. To understand that it is important to help online retailers learn how to convert browsers into purchasers to capture revenues (Ha and Stoel, 2004).

Innovativeness includes the adoption of new products and Goldsmith et al.'s study (1987) showed that women are more likely to more innovative than men. The basic proposal of fashion apparel is to be innovative every season and shopping on Internet is a new sales channel for most consumers in Brazil.

Due to security reasons or difficulty in trying on apparel products, consumers may choose to search for information online as a more convenient way, but still prefer to visit stores for shopping. The in-store experience cannot be replicated on Internet, but other benefits may be added to this new channel like the use of avatars to help consumers to see how clothes will fit on.

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Brand involvement may give the consumer the perception of innovativeness and Michaelidou and Dibb (2008) considered the potential influence on involvement with the choice of a shopping channel for the purchase of particular products. Even on the Internet, sensorial experience is important to consumers.

Customer satisfaction leads to perceived service quality and, consequently, service value. Perceived service quality is defined as the customer's assessment of the service’s overall excellence or superiority (Zeitham, 1988). Bolton and Drew (1991) say that customer assessments of service value are positively related to their evaluations of service quality. Perceptions of performance exert a direct influence on customer satisfaction and customers’ expectation will depend on their tastes, characteristics, personal needs and word-of-mouth past experiences. The gap between expectations and perceptions leads to satisfaction or dissatisfaction.

Customer satisfaction can be related to a specific transaction or to an overall evaluation of a particular service’s quality. When considering consumer behavior, the higher the level of satisfaction, the higher the chance to generate purchase intentions and behavior.

Another variable considered by shoppers in their service evaluation is delivery-time–related information, which is directed related to stock availability and shipping/handling cycle (Park and Kim, 2007). Reduction of waiting time for Internet products is considered important to consumers and contributes to their value perception.

7. PRODUCT ASSORTMENT ON THE INTERNET

Concerning product assortment, it is important for developing a successful e-commerce strategy to focus on the experience of the current and potential customers. For that, it is necessary to consider which advice is being used to access the site. According Faisal Masud, vice president of global e-commerce at Staples, as smartphones or tablets became a moving store in customers’ hands, good product selection, low price, quick delivery and clear return policy became the main issues for business success (Lundquist, 2014).

Walmart, for example, included grocery delivery business in 2012 and food contributed more than half of the retailer's annual sales.

The decision on width and depth of product assortment on the internet is another consideration to be made. While “bricks and mortar” retail establishments live with the physical constraints of carrying large inventory and limited space available to display products that constraint does not exist in a virtual environment. For most retailers, the Pareto rule or, more simply, the “80/20” rule is suitable. That means in practice that businesses will focus on the 20 percent of products that produce 80 percent of all revenue. Firms could reasonably ignore products that were not “popular” as they represented a relatively small proportion of the total sales. Besides that, due to a store’s limited ability to service a specific regional market, there is no demand for almost all products.

In the internet business, where theoretically there is no physical restraint on inventory width and depth, the “long tail“concept may be applied. This term was coined by Anderson (2004) to describe his observations of the impact of the internet on the demand curve for products sold electronically.

This theory defends the idea that the typical demand curve is characterized by high demand for a few items (the short head) and reduced demand for a larger variety of products (the long tail).

The “short head” and “long tail” describe the statistical distribution of sales in which a few items occur frequently (the short head) and a large number of items occur less frequently.

On the internet this concept may work in a different way. As on the internet, transaction costs are low, inventory can be unconstrained and market reach extensive, online retailers could take advantage of the “long tail” demand curve. The internet has shown that, under certain circumstances, the “long tail” has become longer, thicker, and more profitable than previously understood. Offering products on the internet that are not easily found on traditional retailers can offer a competitive advantage to online businesses to ensure better profit margins.

The combination of high turnover items that have the power to attract customers with exclusive and high margin items could be a good way of making money.

This strategy could settle or at least mitigate the “unprofitable game” that most e-commerce businesses in Brazil have been playing. The concentration of product assortment on high sales items can compromise companies’ profitability. (Day Ward, Choi and Zhao, 2011) while the 80 percent on the products can always contribute to higher revenue for the online market (Anderson, 2006).

According to Anderson (2006), three forces reinforce the long tail concept:
1-In the internet environment it is easier to use tools that enable companies to establish a web presence and present their products; 2-Consumers can access products in an easy and inexpensive way; 3-Sites are able to introduce customers to newly available but scarce goods, driving demand to the tail. Google and Trip Advisor are examples of services that have the potential to stimulate niche demand, the basic characteristic of a long tail strategy.

8. FINAL CONSIDERATIONS

E-commerce demands a large massive scale and costly operations. Some virtual retailers have been successful in the process of mitigating risk and controlling operational costs. Due to the ease of price comparison firms must offer competitive prices preventing them from making higher profits. On the other side, differentiation by product assortment applying the "long tail" concept" and using other companies' inventories to offer exclusive products with better profit margin , could be a good option to conciliate the offer of a broader assortment without increasing inventory cost. The business model creating recurring revenue on the development of "fidelity club" could also minimize the business risk.

Due to intense competition, the business demands intensive communication and the use of social media perhaps would be the lowest cost alternative.

Customers' value perception is also related to information quality, ease of ordering, return policy, short delivery time and payment security. All those attributes demand investment in technology and operational structure. In order to minimize this investment, outsourcing those services, especially payment security and financing operation, providing a long term installment and delivery process including reverse logistic cost, could be a good alternative as long as the synergy among these elements is preserved. Alibaba has already promoted that business model, keeping those activities concentrated in specialized firms, but holding equity ownership in those companies.

Another important consideration in the business model strategy is the merging between the "bricks and mortar" store and the e-commerce operation. The joint operation can be used to leverage sales, reduce inventory volume and shipping and handling cycle.

So far, the e-commerce business model that has shown itself to be profitable, has been based on the cost reduction strategy, acting as an intermediary who promote and sells merchandise from some other firm's inventory. Logistics, customer financing cost, and risk of fraud cost have been outsourced. Product exclusivity has had to be focused in order to increase profit margin.

For further study it would be useful to investigate how large the market has to be to allow e-commerce firms to earn money on the basis of operating scale. As mentioned previously, some companies in US were sold to larger firms after many years of loss because they got large enough to disturb the business of important market players. In Brazil, although this has already taken place in the "bricks and mortar" retail business, it is unlikely to happen in the internet environment. Profitable and huge virtual businesses are still in operation.

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