TARGETING HIGH-VALUE CUSTOMERS

The Key to Profitability in Multichannel Retailing

THE OPPORTUNITY IN MULTICHANNEL RETAILING

Today more and more consumers are shopping and purchasing across channels, and they are doing so with increasing frequency. In developed categories—such as travel, computer hardware and software, and books—consumers transact more than 10 percent of their purchases on the Internet. Furthermore, because consumers frequently browse online before purchasing offline, the Internet is having a huge impact on brand perception, product positioning, and in-store sales. Yet few store-based retailers have figured out how to profit from this opportunity. Accustomed to traditional business models that rely on generating traffic and expanding the shopping basket, retailers are struggling to apply old rules to a new game. In fact, the multichannel phenomenon calls for a different approach.

The Boston Consulting Group gained a rich understanding of multichannel retailing over the past few years as its clients sought to understand the new phenomenon. Our experience has convinced us that the best way to benefit from this ripe opportunity is to capture the spending of the most profitable customers and then work to increase it. Of course, that's not a bad strategy for any retailer. But we believe that this strategy is essential in a multichannel environment for these three reasons:

- In most categories, the top 20 percent of customers generate from 50 to 80 percent of the revenues and an even greater proportion of profits
- Because today's big spenders are more likely to be multichannel shoppers and purchasers, it pays for retailers to give their best customers a consistent, customized experience that carries over from one channel to another
- If retailers succeed in deepening and extending their relationships with customers, particularly with those who are high-value consumers, the additional cost of operating through multiple channels can be justified

Such an approach will allow retailers to gain a higher share of wallet from their existing customer base, as well as win new profitable consumers from competitors that are unable to satisfy multichannel needs. Therefore, rather than thinking of the Internet as an independent channel or a standalone business, retailers should be treating it as an integral component in a new business model whose goal is to attract the most profitable customers and build deeper relationships with them.

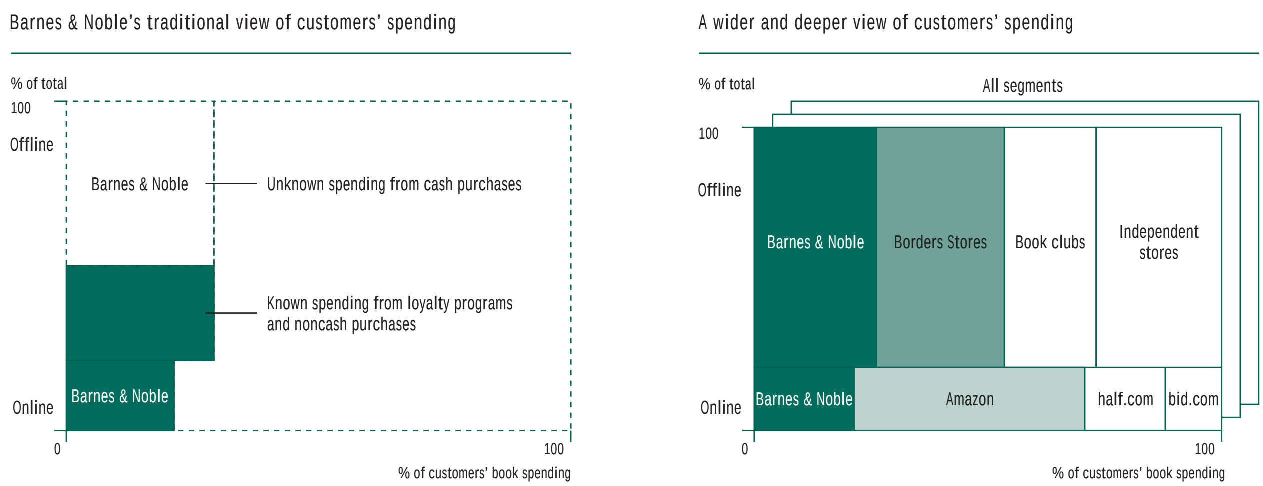
TARGETING THE BEST CONSUMERS

To identify the most valuable consumers, multichannel retailers must broaden their understanding of how consumers shop. That will require their looking beyond traditional sources of information, such as loyalty clubs and credit card data, and researching how consumers behave in various categories and across retailers and channels. It's a daunting prospect for most retailers, which don't even track their own customers across channels, let alone the customers of their competitors. (See Exhibit 1.) However, the idea of segmenting consumers according to their value and activity is not a new concept. Taking our cue from mail-order retailers, we base our approach on a straightforward, data-driven formula called RFM (recency, frequency, monetary value). With RFM data, retailers can focus on their most recent customers, their most frequent purchasers, and their biggest spenders.

To appreciate the value of tracking consumers' spending across channels and competitors, we considered the book category, one of the most mature of the multichannel categories. We identified five segments of book consumers on the basis of how recently those consumers had purchased books, how frequently over the past year, and how much they had spent. Exhibit 2 clearly shows that segments 4 and 5, the top two segments, drive the category. Although they account for only 35 percent of the book category's consumers, segments

EXHIBIT 1

EXPAND YOUR INSIGHT INTO CUSTOMERS' SPENDING



Source: BCG analysis.

EXHIBIT 2

RETAILERS CAN TRACK THE RECENCY, FREQUENCY, AND MONETARY VALUE OF BOOK PURCHASES

	Recency of transaction (Number of weeks since last transaction)		Book transactions (Number per consumer)			Category spending ($ per consumer)		
	Online	Offline	Total	Online	Offline	Total	Online	Offline
Segment 1	13	12	3	1	2	31	8	23
Segment 2	10	8	4	1	3	88	31	57
Segment 3	9	7	7	2	5	164	41	123
Segment 4	8	5	12	3	9	255	75	180
Segment 5	6	3	20	7	13	526	195	331

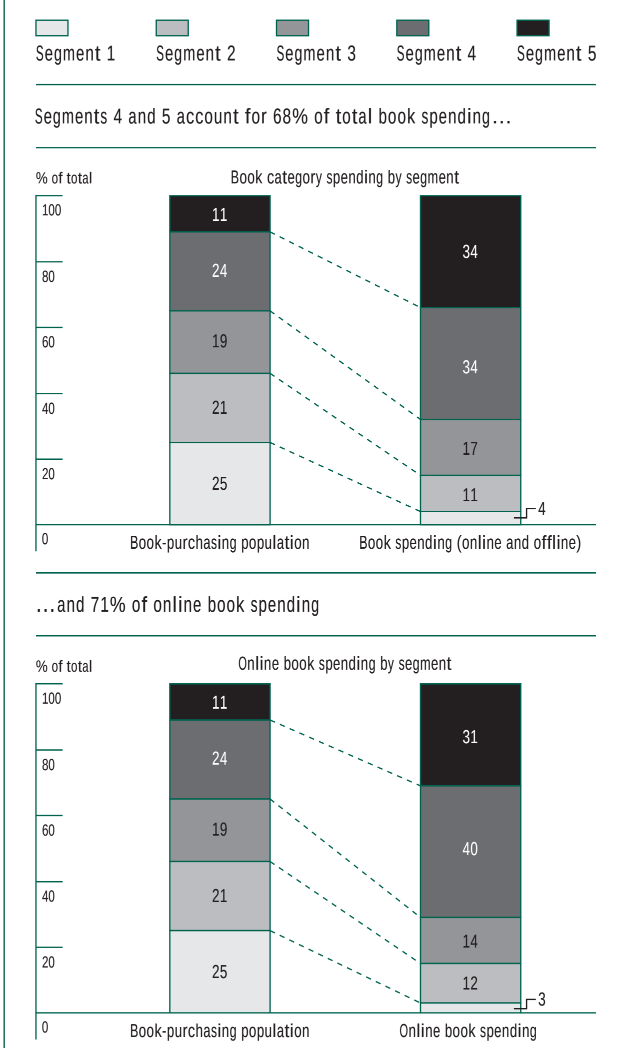
Source: *BCG/Harris Interactive Customer Value Monitor Survey.*

Note: Segment 1, N = 758; segment 2, N = 655; segment 3, N = 582; segment 4, N = 719; segment 5, N = 351.

4 and 5 represent a full 68 percent of total category spending and 71 percent of online category spending. (See Exhibit 3.)

If that isn't reason enough to focus on these segments, retailers should consider behavioral, demographic, and cybergraphic data. They indicate, for example, that consumers in the most valuable segment spend twice as much on books every year as those that comprise the next most valuable segment and 17 times more than those in the least valuable segment. Furthermore, high-value consumers purchase more frequently, averaging 20 transactions a year. They are the most affluent, the best educated, and the most Internet savvy of all book consumers. More than 25 percent of consumers in this segment earn at least $100,000 per year; 52 percent hold bachelor's or graduate degrees; and 62 percent have been online for more than five years.

EXHIBIT 3
THE MOST VALUABLE SEGMENTS ACCOUNT FOR THE MAJORITY OF SPENDING



SOURCE: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

BRINGING INSIGHT TO THE OFFERING

The retailer's goal should be to design a multichannel offering that will increase its share of wallet of high-value customers. To achieve this, the retailer will need to understand consumers' attitudes about shopping and how those attitudes shape their behavior. For instance, nearly one-third of the top purchasers of books visit a bookstore at least once a week, shopping for an average of 45 minutes—about 20 percent longer than consumers in the other segments. It's not surprising that consumers in segment 5 are not likely to be book club members, preferring instead to select their own books. By capitalizing on this information, retailers can tailor their brand positioning, promotions, merchandising, and in-store experience to satisfy and entice their best customers.

Retailers can gain important insights from data on channel preference and usage as well. For example, an overwhelming 70 percent of book consumers from the top segments are multichannel purchasers, spending a full 37 percent of their category dollars online. However, their purchasing behavior online doesn't always match their behavior offline.

For instance, book lovers cite superior product availability and selection as their main reason for shopping online. Indeed, they often make online purchases following a store visit, and they use the online channel to locate hard-to-find titles. (Store retailers should take this opportunity to direct customers to their Web sites whenever their stores can't immediately fulfill requests.) Customers also say that a price discount influences them less online than it does in a store environment. Understanding these factors will help online retailers develop the right marketing programs for their best customers.

Retailers may not be aware of how much influence they have over the contents of the shopping baskets of their top customers. Of the highest-value book customers who actually made purchases in online sessions, 41 percent reported that when they logged on, they had no specific title in mind; 61 percent said they weren't looking for a specific author; and 65 percent weren't looking for a specific genre. In fact, 14 percent said that they had purchased on impulse. Such behavior presents a tremendous opportunity for retailers to make recommendations on the basis of past purchases, provide value-added information such as reviews, and bundle products in attractive ways. Information about how consumers use available channels can provide important insights, especially for multichannel retailers.

EXHIBIT 4
CONSUMERS BLAME THE SITE, NOT THE CHANNEL, FOR FAILURES

Consumers' responses to functional failures	% of consumers who have experienced failures 1999	2000
I stopped shopping online.	6	2
I stopped purchasing online.	10	2
I stopped shopping at that particular Web site.	28	41
I stopped purchasing at that particular Web site.	23	30
I stopped purchasing from the offline stores of that particular company.	6	9

Sources: *BCG Q4 2000 Online Purchaser Survey* (N = 948); *BCG Q4 1999 Proprietary Consumer Database* (N = 376).

MANAGING THE CROSS-CHANNEL EXPERIENCE

Gone are the days when every retail channel could be operated independently. Consumers, who move from one channel to another without even thinking about it, are creating a growing need for a consistent, satisfying experience that extends across channels. For example, whether an Old Navy customer shops in an Old Navy store or logs onto Oldnavy.com, he or she experiences the same environment. Furthermore, customers can return products purchased online at any Old Navy store. However, the risks of not delivering a seamless experience are high: dissatisfactions in one channel can damage the overall relationship. Many consumers who become frustrated with an online site, for instance, blame the retailer, not the Internet. (See Exhibit 4.)

It is important to know how consumers use and expect to use all the shopping channels available to them, but that doesn't mean that every channel should try to be all things to all people. Instead, retailers should determine which functions they want to provide through each channel, making sure that the costs are aligned with consumers' requirements. For instance, the function of a Web site may range from simply building the brand and providing information to full-fledged retailing of a range of products. No matter what level of functionality retailers offer, they must present a seamless interface across channels. For instance, by providing online information about the availability of products in its stores, a retailer can reduce the likelihood that a consumer who has researched products on its Web site will go to a competitor to make his or her purchases.

Finally, to succeed in the new multichannel arena, retailers need to integrate branding, product assortment and positioning, promotions, inventory forecasting, and product returns. To do so, retailers must mount organizationwide efforts to learn to work with new metrics, reporting relationships, incentives, and personnel. Shifting an organization from a *profit-and-loss focus on channels* to a *cross-channel focus on customers* is not an easy task, but the competitive advantage that shift confers in profitable customer relationships is worth it.

* * *

More and more high-value shoppers are becoming multichannel consumers. They want to be able to use the Internet in conjunction with offline channels to select products, conduct transactions, and obtain after-sales support. Consequently, now is not the time for retailers to stop building the Internet channel. Rather, they should be using investment dollars strategically to increase the spending of their most profitable customers in all channels.

QUANTIFYING THE OPPORTUNITY FOR BOOK RETAILERS

Barnes & Noble: Challenges and Opportunities

Together Barnes & Noble and Borders Stores are the top book retailers in the offline channel. What's more, they account for almost half—48 percent—of total spending in the highest-value segment. But it's a different story online, where Amazon, clearly the dominant player, controls a significant share of all consumer segments. (See the exhibit "Incumbents Are Losing a Significant Share to Amazon in the Online Channel.")

Like many other incumbents, Barnes & Noble has struggled to become successful across retail channels. Its current customer base is a valuable asset; and in the offline world, the retailer has a disproportionately large share of the most valuable purchasers of books.

However, Barnes & Noble has not yet been able to transfer this advantage to the online environment. Compared with the offline channel, barnesandnoble.com has not been successful at attracting the high-value segments of offline consumers; and consequently, it has captured a lower proportion of their spending. In fact, Barnes & Noble's best customers typically spend less and transact less often online than the average consumer in high-value segments. (See the exhibit "Barnes & Noble Is Not Leveraging Its Customer Base Online," page 6.)

In addition, those customers Barnes & Noble does attract report having a shopping experience that falls short of the experience Amazon provides. Barnes & Noble's satisfaction scores trail Amazon's: Barnes & Noble's customers from the critical high-value segments report the least satisfaction on several important dimensions. (See the exhibit "Amazon Satisfies High-Value Customers," page 8.)

In the course of its struggle to leverage its offline customer base, Barnes & Noble lost significant online market share to Amazon. Even the most loyal of Barnes & Noble's offline customers shifted their online spending to other online retailers. Consumers who had been making more than 90 percent of their offline book purchases at Barnes & Noble were devoting only 24 percent of their online spending to barnesandnoble.com, while Amazon was receiving 57 percent of their spending.

INCUMBENTS ARE LOSING A SIGNIFICANT SHARE TO AMAZON IN THE ONLINE CHANNEL

Source: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

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QUANTIFYING THE OPPORTUNITY FOR BOOK RETAILERS

Barnes & Noble is working hard to create a more consistent and integrated experience for its customers across channels and hopes to become the best bookstore in all channels. For instance, Barnes & Noble has created a Readers Advantage Loyalty Program to better manage its customers as they shop online and offline. The company's objective is to build a database of customers that will help it identify, profile, and target the highest-value customers. Most in-store purchases are cash transactions and therefore difficult to track, so this program is a significant step forward.

To better serve its growing number of multichannel customers, Barnes & Noble is also planning to accept in-store returns of products purchased online. And it plans to install Internet service counters or Web kiosks so that customers can order products not available in the store and specify delivery preferences. These steps, combined with a focus on "getting it right" with high-value customers, could have a significant impact on the company's bottom line.

But Barnes & Noble could do even more to deepen its relationships with its customers and raise profits. For example, the bookseller could try to increase its share of its high-value customers' wallets by 10 percent. That increase could generate an estimated $61 million in incremental profits. Barnes & Noble could also take action to capitalize on the thousands of customers who buy books on its Web site but don't visit its stores. If the retailer could persuade the most valuable of those online customers to shop in its offline stores as well, it could effectively increase its base of high-value offline customers. By enticing its online customers to spend as much in Barnes & Noble stores as other high-value customers do, the company could generate up to $14 million in profits. (See the exhibit "Barnes & Noble Can Take Two Key Actions," page 7.)

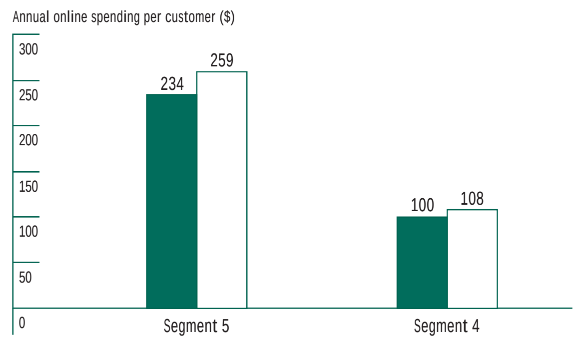
BARNES & NOBLE IS NOT LEVERAGING ITS CUSTOMER BASE ONLINE

High-value segments are overrepresented in Barnes & Noble's customer base

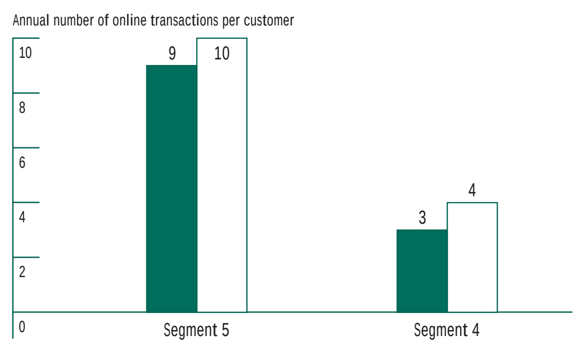
	Barnes & Noble customers (% of total)	Ratio of Barnes & Noble customers to the total population of book purchasers
Segment 5	18	1.6
Segment 4	28	1.2
Segment 3	22	1.2
Segment 2	17	0.8
Segment 1	15	0.6

Barnes & Noble   Other online book retailers

However, its customers spend less in the online channel…

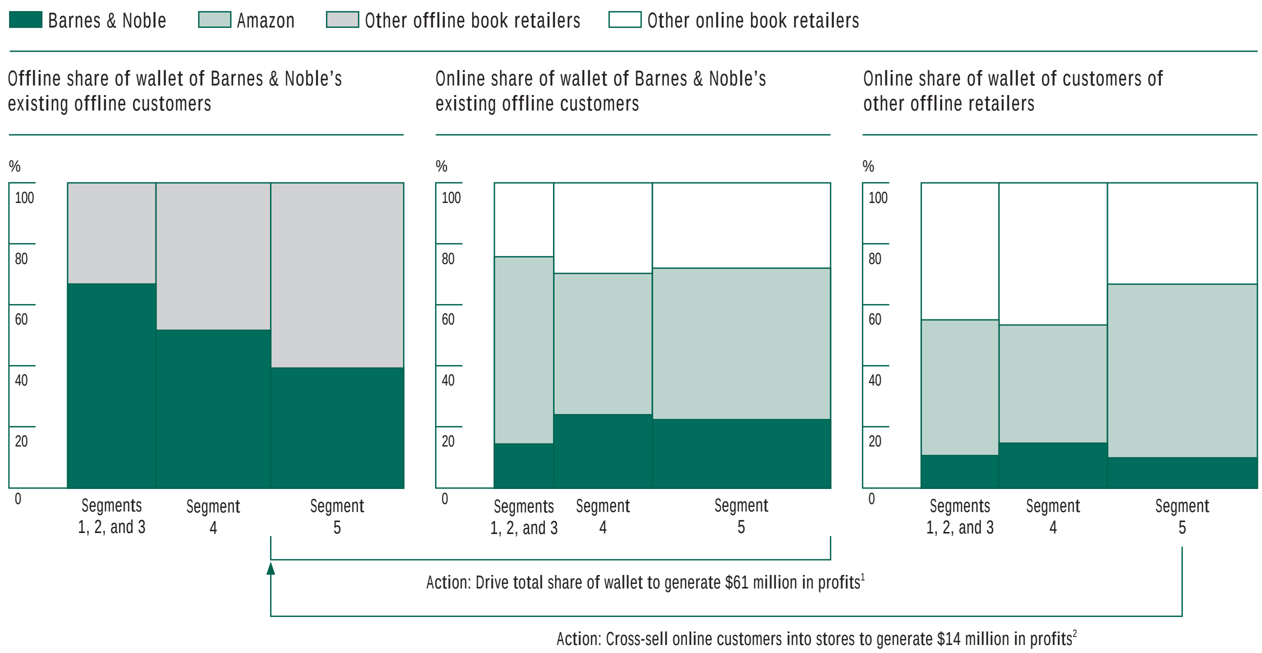


… and transact less often



Source: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

BARNES & NOBLE CAN TAKE TWO KEY ACTIONS



SOURCE: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

[1]This projection assumes an increase of ten percentage points in offline share of wallet of existing offline customers and an increase of ten percentage points in online share of wallet of offline customers.

[2]This projection assumes Barnes & Noble achieves its fair share—about 40 percent—of the segment.

Amazon: Serving High-Value Segments

Amazon, perhaps the best-known online retailer, has recently shifted its focus from customer acquisition to customer profitability. The company cites several initiatives that are under way to deepen relationships with their best customers, enhance profitability, and increase its share of customers' wallets.

By focusing on the shopping experience, Amazon already has achieved relatively strong satisfaction and loyalty among its high-value customers. Amazon achieves higher satisfaction scores overall than Barnes & Noble, and Amazon's customers in the high-value segments are more satisfied with product selection, prices, and site navigation than customers in the lower-value segments. Amazon's customers in the top segments are also more likely to be loyal, reporting the highest expectation to purchase again. (See the exhibit "Amazon Converts and Retains High-Value Customers," page 9.)

Lacking an offline presence, Amazon realizes that it must create alliances with bricks-and-mortar retailers in order to capture the highly valuable multichannel shopper. Therefore, it is building a network with offline retailers, such as Borders Group in the book category and Toys "R" Us for toys and games. Amazon aims to leverage their assets to help serve the multichannel needs of its customers. (See the exhibit "Amazon Has Built an Extensive Network of Alliances," page 9.)

Amazon's success will hinge on its ability to win in the high-value segment. If, for instance, the company can increase its share of spending from those customers to the level that it achieves with lower-value segments, profits from its book business could increase by as much as

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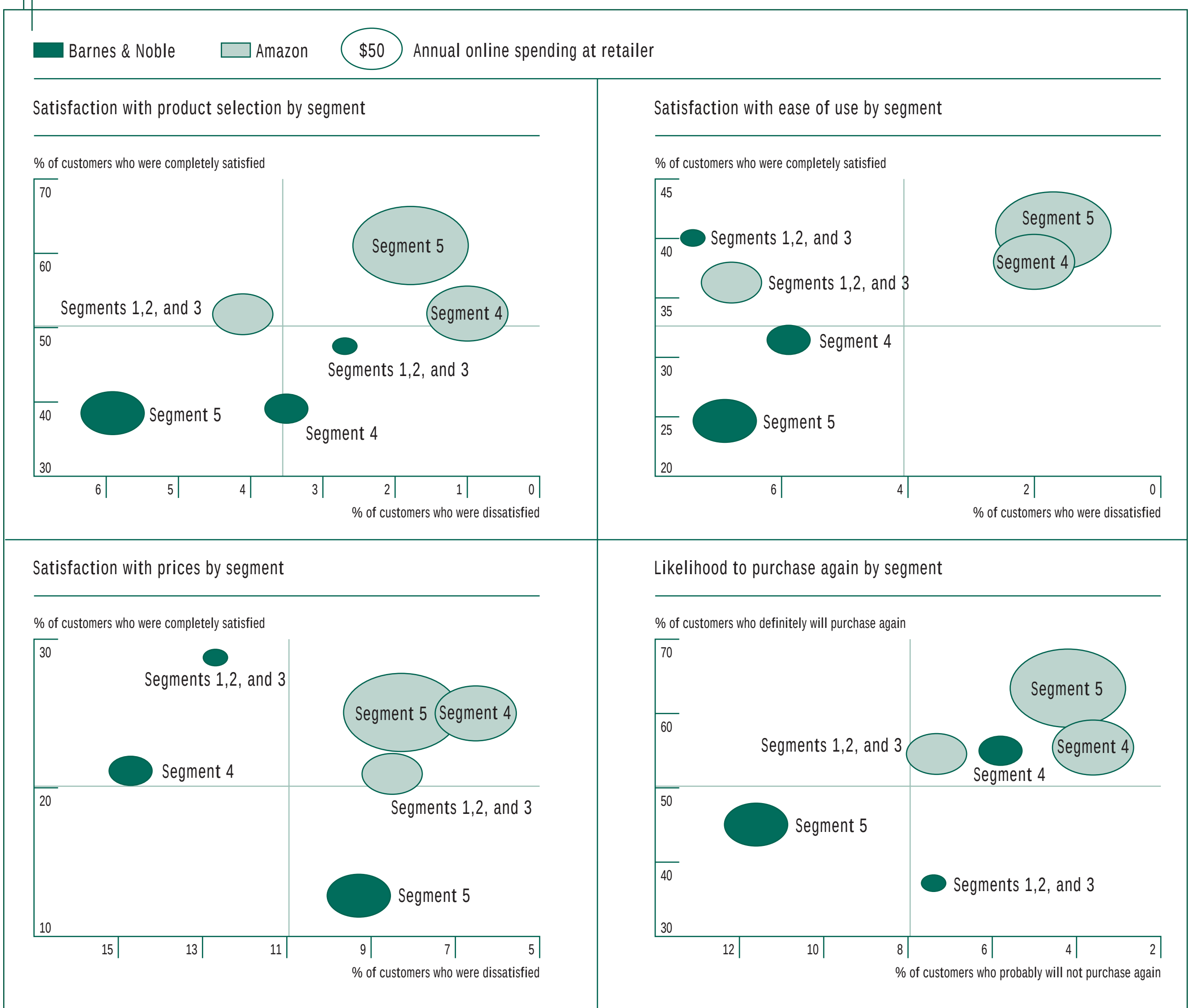
$41 million a year. If it can raise the number of its high-value customers by 20 percent, the incremental impact on profits from its book business could be as high as $34 million a year. (See the exhibit "Amazon Can Take Action to Increase Profitability," page 10.)

However, if Amazon were to spread its marketing efforts equally across all consumer segments instead of focusing on the higher-value segments, the impact on profitability would be marginal or even negative. The incremental revenues would be unlikely to cover the marketing costs.

AMAZON SATISFIES HIGH-VALUE CUSTOMERS

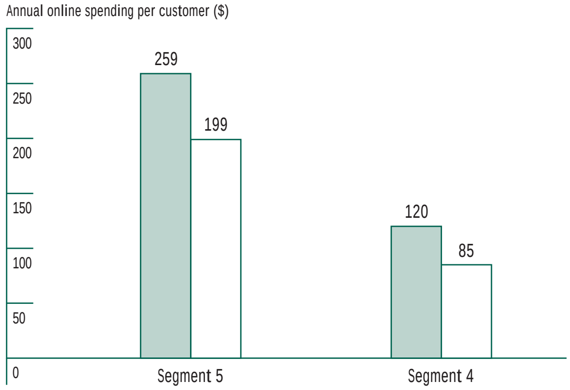


Sources: *Harris Interactive/Net Ratings eCommercePulse Q1 2001 Database; BCG/Harris Interactive Customer Value Monitor Survey* (N = 3, 945).

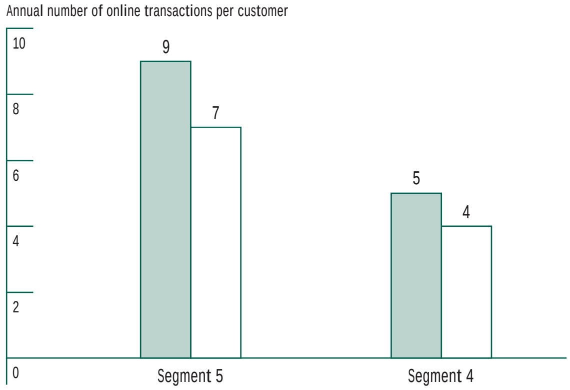
AMAZON CONVERTS AND RETAINS HIGH-VALUE CUSTOMERS

Amazon | Other online book retailers

Amazon's segment 5 customers spend more in the online channel...



... and purchase more frequently



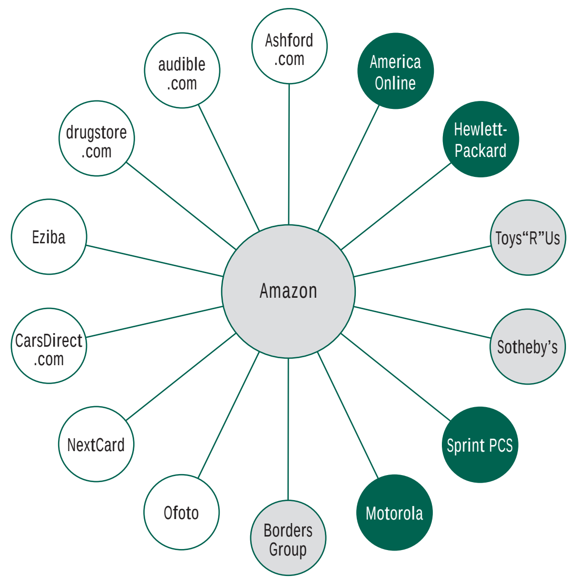
Source: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

AMAZON HAS BUILT AN EXTENSIVE NETWORK OF ALLIANCES

Investment or strategic alliance with start-up

Strategic alliance with incumbent

Marketing or vendor alliance with incumbent



Sources: Amazon investor relations and company reports; interviews with market analysts.

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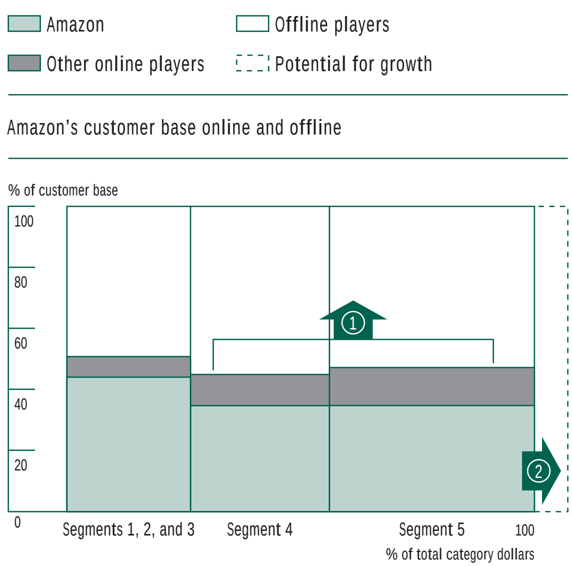
QUANTIFYING THE OPPORTUNITY FOR BOOK RETAILERS

AMAZON CAN TAKE ACTION TO INCREASE PROFITABILITY

Amazon's customer base online and offline



	Actions	Estimated impact on: Revenues ($millions)	Estimated impact on: Earnings before interest and taxes ($millions)
1	Grow share of wallet of high-value customers by increasing it nine percentage points to the level of segments 1, 2, and 3	226	41
2	Grow customer base of high-value consumers by increasing the number of customers in segments 4 and 5 by 20%	176	34

Source: *BCG/Harris Interactive Customer Value Monitor Survey* (N = 3,945).

The research and findings on the book category draw on quantitative research jointly conducted by BCG and Harris Interactive during the second quarter of 2001. The research examined the U.S. online population in terms of consumers' online and offline book purchases.

The research was conducted as a custom survey for which predefined respondents were contacted for additional research. Consumers who had previously participated in the *Harris Interactive/NetRatings eCommercePulse* were contacted again and asked detailed questions about their book purchasing and their attitudes toward buying books online and offline. Data from 3,945 consumers are included in the analysis. The sample was weighted to accurately reflect the Internet population as it currently exists.

Overall, the accuracy is ±1.6 percent, 95 times out of 100. To provide additional information, we supplemented the results of the custom survey with selected elements from the *Harris Interactive/Net Ratings eCommercePulse*, which examines consumers' online shopping and purchasing behavior. The case studies and best-practice examples were taken from BCG research, publicly available reports, and company press releases.

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