TRUST: A KEY SUCCESS FACTOR IN
THE ONLINE RETAIL INDUSTRY

by

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ABSTRACT

This paper examines the role of consumer trust in the North American online retail industry. Consumers perceive risks associated with online shopping and are concerned about loss of personal privacy, as well as the possibility of financial loss. Using literature reviews, the role of trust is examined as a key success factor for online retailers, focusing on the quasi-commodity market segment (books, music, and video). An external analysis reveals that the market is highly concentrated and can be described as a ‘tight’ oligopoly or duopoly in the growth phase of the industry life cycle. Amazon.com, an exemplary firm in the online retail industry, is strategically analysed to understand the reasons for its success and to determine how consumer trust may impact future earnings. The analysis suggests that its success is attributed to a first mover advantage in the industry, a passion for innovation, and leadership in service differentiation. A scenario evaluation predicts that a loss of consumer trust would have a devastating impact on Amazon’s future earnings, while an increase in trust would contribute to a stronger and more favourable business reputation and increased profits. Finally, nine recommendations are presented to help online retailers improve consumer perceived trustworthiness, with the goal of ensuring long-term sustainable rents. Overall conclusions confirm that trust plays a vitally important role in contributing to business success in the online retail industry.
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1 INTRODUCTION

Governments and business recognize that trust is fundamental to the success of Internet-based business enterprises, and that public concerns regarding individual privacy and the perception of risk, relating to Internet use, could compromise future growth. Information databases have become a powerful yet problematic tool that can put businesses in conflict with the interests and concerns of consumers whose information is collected. The rise in incidents of identity theft, coupled with loose regulations and rules on usage of personal information, has raised public concern. Unless this concern can be ameliorated, there is risk that Internet ‘online’ businesses may not reach their full potential.

Governments have begun to enact privacy legislation impacting data mining and electronic business (e-business). Businesses must confront privacy issues with regulators and those individuals whose information is collected. Europe, the United States and Canada each take a different approach in the protection of an individual’s personal data. The European government has been most rigorous in its enactment and application of legislation treating privacy as a right. North America has been slower to respond with the United States, in particular, less willing to act because of constitutional restrictions. Canada has recently enacted legislation to protect personal data in both the public and private sectors. Significant issues are expected to arise with respect to trans-border data flow; these issues are most prominent in data exchange between the United States and the European Union.

The future success of e-business is significantly dependent on the level of trust the public is willing to place in it. It is reasonable to conclude that the more at ease the public is in the security of personal data, the more willing they will be to engage in e-business activities. Online
Businesses face a dilemma: they must collect sufficient personal information to serve their customers effectively, but limit the quantity and type of information collected, while restricting its use and distribution in order to respect privacy.

This paper will focus on the importance of customer trust as a key success factor for firms engaged in online, electronic retail business activities. There are many factors that influence trust. Consumers are concerned about issues relating to personal risk, privacy and security. Their level of trust is also influenced by attributes of a business and the outward image it projects. Fundamental to developing trust is the consumers' perception that personal information and data, in the online retailer's possession, will be respected and protected.

1.1 Background – The Foundation for E-business

1.1.1 The Internet

Most people in the developed world are now familiar with the Internet, if only by the term. Government and academia have always had historical ties to the early Internet but now it has gained wider acceptance as business and consumers access its global reach in ever increasing numbers. It has, by no exaggeration, transformed our culture and way of life.

The Internet grew from the concept of open architecture networking, whereby multiple independent networks communicate with each other. This concept has revolutionized the computer and communications world like nothing before. The Internet has global reach; it is a

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1 (Leiner et al., 2003)
medium for information dissemination, and it facilitates collaboration and interaction between individuals and their computers.

The idea of an Internet arose through discussions about the possibilities of a "Gallactic Network" that were initiated at MIT in 1962. At that time, researchers envisioned "a globally interconnected set of computers through which everyone could quickly access data and programs from any site," in much the same way, as we know the Internet today. Although this Gallactic Network was not acted upon then, in 1967, a proposal for ARPANET (Advanced Research Projects Agency Network) was submitted to the U.S. Department of Defence. ARPANET is considered to be the progenitor of the global Internet, but at that time was "intended for, and largely restricted to closed communities of scholars. UCLA was selected as the first node on the ARPANET, followed one month later, by Stanford. By the end of 1969, four universities were interconnected; the first host-to-host messages were sent, and the concept of the Internet became a reality.

Packet switching concepts evolved through the early sixties to become the foundation technology in transport protocol that ultimately made the Internet possible. In 1973, R. Kahn and V. Cerf developed TCP/IP (transport control and internet protocol), a packet switching protocol which today controls how data is transmitted between two computers across the Internet. The TCP/IP structure also gives the Internet its flexibility in adapting to new applications.

As the numbers of personal computers, workstations and local area networks (LANs) grew throughout the 1980's, so did the complexity and scale of the Internet. This necessitated upgrades to underlying technologies and changes to the hierarchal structure (e.g. router upgrades and the addition of classes). Although the Internet was becoming well established, its primary use
was to support a broad community of researchers and developers. Many competing technologies for interconnectivity were also being developed by the commercial sector (e.g. XNS, DECnet, and SNA.) In 1985, the National Science Foundation (NSF) began development of NSFNET using TCP/IP as the underlying protocol. NSFNET eventually superseded ARPANET, which in 1990 was decommissioned. The Internet backbone was now established on robust commercial hardware equipment. Because of its limited reach and non-commercial application, prior to 1990, issues of privacy involving early Internet usage did not arise.

1.1.2 The Emergence of the World Wide Web

The World Wide Web (WWW) was created by Tim Berners-Lee in 1990, in conjunction with CERN (European Organization for Nuclear Research), and implemented to improve information access to the members of the international high-energy physics community. The goal was to provide a means whereby anyone, anywhere within the distributed organization, could access needed information from all relevant sources. It was proposed that a solution be formulated based on a distributed hypertext system. Hypertext, a term coined in the 1950's and defined as “human-readable information linked together in an unconstrained way”, allows a user to move easily from within one section of text to another without having to leave the document. By the end of 1990, the first text only browser / editor was demonstrated by CERN. CERN released the WWW system in 1992. The last impediment to commercial use of the Internet was removed when the NSF lifted its restriction on commercial activity. The stage was set for the development of electronic business (e-business).

\[2\text{ (History of the WWW, 1998)}\]
In 1993, a working version of the graphic browser “Mosaic for X”, developed by Marc Andreessen at the University of Illinois, was released for public use. Although there were only 200 HTTP (hypertext transport protocol) servers connected to the Web at that time, the number of accessible Internet sites ballooned exponentially thereafter, making the notion of an Internet more attractive to mainstream users because of the number of useful and interesting sites that could be accessed. The last hurdle to wide acceptance was overcome when Mosaic was revised and released in 1994 as Netscape, a freely available, easily downloadable browser for the masses. This action spawned network externalities that would eventually generate the infrastructure to support e-business. By 1995, NSFNET had reverted back to a research project, leaving the Web in commercial hands. Privacy concerns began to emerge as e-business flourished.

1.2 E-Business

The term e-business is used in place of the more common term e-commerce as the latter denotes trade whereas e-business reflects a diversity of commercial activities including operations and logistics (Jones et al., 2000, p. 82). E-business can be defined as any form of business activity that is at least partially completed via the Internet (e.g. ordering, payment, delivery). There are many types of on-line interactive sites and e-business can assume many forms: B2B, B2C, C2C, G2B, and G2C. The two most common are: 1) those that engage in direct business to business transactions, or B2B (business transactions conducted between corporations), and 2) those businesses that target consumers, or B2C (business-to-consumer: business transactions conducted between corporations and individual consumers and referred to as “online retail”). The most

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salient difference between B2B and B2C sites is that consumers browse more at B2C sites. It follows that the site presentation and selection options must offer a "stickiness" to hold the consumer's interest. B2B clients have specific business information and transactional needs for site access, and are therefore motivated differently. This paper will focus on B2C (business to consumer) exchanges in the retail sector, and will be referred to as online retail.

Online retail covers a broad spectrum of business activities; a few examples are: banking, retailing, entertainment, information portals, and auction houses. In most instances, exchanges occur between an on-line retailer and an online consumer. In the case of auction sites, such as eBay, exchanges may occur between individual bidders with the business site acting as an intermediary. Online retailing differs from traditional direct marketing channels in three ways: 1) there is more data creation and collection, 2) information and communications are global in scope, and 3) centralized control mechanisms are absent (Brown & Muchira, 2004, p. 63).

1.2.1 Opportunities and Benefits of Online Retailing

This section examines the opportunities and benefits that online retailing offers both the retailer and the consumer:

1.2.1.1 Opportunities and Benefits for the On-line Retailer

The Internet has expanded the possibilities for retail businesses to reach consumers globally. With the emergence of enabling-technologies, online retailers have tools at their disposal to efficiently collect, store, and exchange consumer data in support of their marketing strategies. Data mining, data warehousing, the secondary use of information, and the ability to
follow online behaviour and link to a single identifiable person, expands a business’s reach (Hoffman et al., 1999. p. 82). These tools assist retailers in creating customer profiles by retrieving and linking personal data and then using these profiles to match a sales pitch to specific customer segments. Some firms also sell their customer profiles to other businesses. Tools allow retailers to track consumers’ movements online making it possible to monitor their behaviours and preferences.

Using customer profile information, online retailers may use “personalization” or “customization” to tailor products and purchasing experiences to the tastes of individual consumers. Personalization strategies can increase customer loyalty and also act as a deterrent to switching (Chellappa & Sin, n.d., p. 3).

1.2.1.2 Benefits for the Consumer

The consumer can realize several benefits from shopping online. The experience of shopping on the Internet can be very positive and compelling and most reputable retailers provide fast service and delivery to the door. Once they are initiated, consumers find the online shopping experience offers many advantages such as: a large product assortment; availability 24/7; no sales pressure; time saving because of no travel; and no need to contend with parking problems or crowds. Consumers also find that it is easier to check competitor prices online and reach shopping sites around the globe, as the Internet does not erect geographical barriers.

Retailers who personalize or customize a product or service to the tastes of individual consumers can instil loyalty in frequent online shoppers. These services, which are rarely charged to the consumer, may include anniversary or birthday reminders with suggestions for specific
products as gifts based on the customer's buying history and personal information (Hoffman et al., 1999, p. 83; Chellappa & Sin, n.d., p. 3).

1.2.1.3 Conflicting Issues for the Consumer and Online Retailer

Many consumers perceive the Internet as a complex and abstract environment strongly characterized by risk (Olivero & Lunt, 2003, p. 15). There are system security issues that consumers feel put them at risk. Although most consumers are not technically savvy, most do hear of breaches of security through media reports. These breaches involve third party fraudulent behaviour such as unauthorized access to personal or credit card information and systems security intrusions by hackers. For the online retailer, system security adds additional cost to business operations. Sales transactions, conducted over the Internet, expose retailers to an increased the risk of payment fraud (Udo, 2001, p. 166).

Although online customers derive benefits from personalization and customization, consumers in general are uncomfortable sharing personal data with online retailers or marketers and are concerned about protecting their privacy. Studies have found that “80% of consumers do not want Web sites to sell their personal information and yet 72% would be willing to give demographic information as long as they were made aware of how it would be used” (Rose, 2000, p. 20). “The loss of control over personal information is a major concern” for all consumers; for those who shop online, “it becomes a greater concern as users gain online proficiency” (Rose, 2000, p. 20). This aversion to personal information disclosure can prompt some consumers to “opt out entirely or choose to provide erroneous data ... in order to gain access to information or in exchange for goods offered at the site” (Rose, 2000, p. 20). This reluctance to share personal data has been observed in studies where “95% of consumers indicate they have declined to
provide data and 40% have provided false data.” This evasive action opposes the goals of Internet marketers and retailers who seek to benefit from the use of the data; at worse, it misleads the marketer or retailer and wastes resources. Consumers responded differently however, when data collection was “perceived as a benefit. Participants reported higher willingness to disclose information to companies that were well known (and/or well established off line) and with whom they had already established a relationship. Even under these circumstances, guarantees of control over the use of the information were perceived as an important incentive if not a necessary condition” (Olivero & Lunt, 2003, p. 16).

“[We] do not have an environment of trust where consumer concerns about privacy can be balanced with the needs of business to collect information” (Rose, 2000, p. 20). Personalization is possible only if consumers are willing to share information and use the services, and if vendors have the capability to acquire and to process information in a manner that wins consumers’ trust (Chellappa & Sin, n.d., p.3). Because privacy protection has become an issue, the benefits that the consumer can realize through personalization are being undermined.

Another concern relating to breccles of personal privacy is that individual customer profiles may be sold to third parties, for purposes unknown to the customer. Recent studies reveal “86% of businesses do not provide consumers with any information on how their personal data is used” (Rose, 2000, p. 21). But as Rose (2000) points out, the benefits promised by the emerging market e-business is not fully realized and that “one can argue that the internet marketer adds value to the (consumer) data by processing it.... to create a new information product” (p. 23). Surveys suggest that most consumers are not comfortable with this argument.

Marketing strategists and online retailers want to gather sufficient information to build customer profiles in order to increase profits and improve customer service. The customer wants
to retain control and provide only information that is necessary to complete the sales transaction. The consumer perceives that there are privacy infringements that online retailers frequently make, among these: sharing or selling personal information to other companies, tracking a customer’s shopping habits and purchases, placing of cookies\(^4\) on a consumer’s computer, and contacting consumers by telephone, e-mail, or otherwise) without consent. There is a heightened concern of receiving unsolicited e-mail (junk e-mail or “spam”), unsolicited advertisements, and pop-up ads. Consumers may also worry about non-delivery of goods or difficulty exchanging goods, as well as misrepresentation or fraud (Miyazaki & Fernandez, 2001, p. 35).

Consumers face two significant risks when they shop online: loss of privacy, and loss of money (Friedman, et al., 2000, p. 37). “Although the acquisition of consumer information may yield short term advantages, perceived breaches in privacy and security likely will hinder online retailing in the long run” (Miyazaki & Fernandez, 2001, p. 39). If the environment is such that trust between online retailers and customers can develop, the outcome will lead to repeat purchases, to development of strong brand loyalty, and will encourage word-of-mouth recommendations, especially when there is frequent interaction with the same seller.

Presently, online consumer spending accounts for only 1.7% of overall retail sales, both on and off line. The online retail industry is expected to grow significantly. Forrester Research projects that 63 million, or two-thirds, of U.S. households will shop online in 2007, spending an estimated $217.8 billion (Van Slyke, 2004, p. 2). Results of a study conducted by Miyazaki et al.

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\(^4\) Cookies are small information files, sent from Web site servers, and written directly onto the user’s hard drive. The files contain user-specific information and are used by the Web sites to assist the user on subsequent visits. Cookies are generally stored and accessed without the user’s knowledge or consent. Although users can block cookies, Web sites can require that users allow cookie storage before they are permitted access to the site. Unscrupulous sites use cookies to surreptitiously collect information about consumers’ online activities and combine it with other personal data for target marketing purposes.
(2001) suggest that "higher internet experience and the use of remote purchasing methods are related to lower levels of perceived risk toward online shopping, which in turn results in higher online purchase rates" (p. 38). That projected future growth, however, could be adversely impacted if issues surrounding consumer trust are not adequately addressed (Belanger et al., 2002, p. 268).

Trust issues, within the online retail environment, will now be explored.
TRUST

There is, as yet, “no universally accepted scholarly definition of trust” (Rousseau et al., 1998, p. 394). Bailey et al., (2000) define trust as “the perception of the degree to which an exchange partner will fulfill their transactional obligations in situations characterized by risk and uncertainty” (p. 2). Olivero et al., (2003) describe trust as being based on predictability, dependability and faith (p. 17). Another opinion, expressed by Rousseau et al., suggests that:

Trust is a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behaviour of another under conditions of risk and interdependence. (1998, p. 395)

Trust in business relationships is essential. Trust is also “recognized as key for the continued growth of e-business” and, to a significant extent, online retail transactions. “Business and governments in most advanced countries have attributed the slow adoption of e-commerce to a severe lack of trust by consumers and small-business in corporations and government” (Clarke, 1999, p. 61). Rose (2000) goes further in describing a source of tension in e-business, which arises from “the balancing of economic efficiency with social and political concerns” (p. 21). According to Doney et al., (1997) trust aids in building long-term relationships, enhances competition and reduces transaction costs (p. 35). “The development of trust relies on the formation of a trustor’s expectations about the motives and behaviours of a trustee.”

Trust is a function of shared value, perceived security, and communication (Banphoth et al., 2004, p 68). However, it is not unreasonable to expect that given the uncertain nature of e-business, companies may behave in an opportunistic manner making their behaviour unpredictable; ergo, trust in e-business transactions is extremely important (Shankar et al., 2002,
It is generally conceded that where we cannot directly control our environment there is risk; we must therefore operate on the basis of trust (Rutter, n.d., p. 3).

There is great uncertainty about the buying process in that much of it is invisible to the consumer; unlike the shopping experience one has in a physical store, the consumer is unsure of what is taking place online. Entering into the transaction in a committed manner becomes difficult and fraught with risk as much depends on trust. Those who are new to the on-line shopping experience will be looking for some aspect of familiarity within the transaction process, however they will find it absent (Rutter, n.d., p. 5).

It has been argued that trust is something one individual offers to another. It is not a trust in mediating technologies, for consumers do not trust their PC or the network, and “trust does not reside in integrated circuits or fibre optic cables, but rather consumers trust people and firms with whom they do business” (Rutter, n.d., p. 4); essentially, “people trust people not technologies” (Friedman, et al., 2000, p. 36). Therefore it is incumbent upon on-line retailers to ensure that the technology deployed supports a trusting retail business environment.

Giving the consumer control over their personal information also engenders trust (Olivero & Lunt, 2003, p. 2). “The trade of information reinforces the perception of risk, stimulating a need for protection that may imply lack of trust and be incompatible with the development of trust” (Olivero & Lunt, 2003, p. 17). One way that retailers can return control to the consumer is by offering an opt-in choice for personal information use. When consumers choose to opt-in, the online firm is granted permission to collect personal data; if a consumer does not wish to have personal data collected, they can opt-out. “Culnan and Armstrong find support for the argument that an increase in trust through procedural fairness alleviates concerns an
individual has about being profiled through information collection” (cited in Cazier et al., 2003, p. 618).

Online trust has evolved over time, beginning with the issue of whether a consumer felt safe giving credit card information over the Internet to direct privacy issues relating to how comfortable consumers were sharing personal information with online retailers or marketers. Trust extends to data networks used by the firms as well as to multiple stakeholders (customers, employees, distributors, stockholders and regulators). It is said that, “understanding how online trust is created and maintained can lead to improved Web sites, sales revenues, profitability, and ultimate shareholder value” (Shankar, et al., 2002, p. 326).

Online trust is more fragile than offline trust and can be more easily destroyed. For the online consumer there are no geographical, temporal, tactile or social experiences of shopping (Rutter, n.d., p. 5). There are no “face-to-face interactions, which evoke higher levels of trust” (Belanger et al., 2002, p. 253). Consumers must “draw on cues from their environment to ascertain the nature of their own vulnerabilities and the good will of others (Friedman, et al., 2000, p. 37). Bailey et al. summarize the benefits of fostering a trusting environment:

Trust creates more favourable attitudes towards suppliers as well as source loyalties, and helps partners project their exchange relationships into the future”…”Trust enhances competitiveness, reduces transaction costs, and mitigates opportunism in uncertain contexts. In fact, trust is required for all willing transactions; and without it no market could function. (2000, p.1)

Studies suggest that privacy, security, credibility, reliability and emotional comfort are important underlying constructs supporting trust while other studies attribute ability, integrity, and benevolence to the creation and maintenance of trust (Belanger et al., 2002, p. 251; Shankar,
et al., 2002, p. 325). These constructs will be explored collectively under the headings: privacy and security.

2.1 Privacy

There is a tug-and-pull between governments and business over the regulation of privacy; attempts by governments to enact legislation are met by protests from businesses that claim such controls would impede market activity (Brown & Muchira, 2004, p. 64). In consumer surveys, “80% felt they had lost control over how their personal information was collected and used by companies, and 72% of U.S. respondents were worried about the collection of information over the Internet. Further, 86% believe that businesses should ask before collecting information about them,” providing them with the option of participating (opt-in). “In a 2001 survey, respondents ranked personal privacy above health care, education, crime, and taxes as concerns.” Amongst the top “most feared privacy violations is the misuse of personal information, financial theft, and identity theft” (Belanger et al., 2002, p. 248).

Consumer privacy has been described as “the right to be left alone” (Wang et al., 1998, p. 64). However, there is a “social balance” between an individual’s right to keep information private and the societal benefit derive from sharing information” (Rosenberg, 1998, p. 138). Consumers have a keen interest in both privacy and security issues, and in particular relating to the use of personal and financial information (Miyazaki & Fernandez, 2001, p. 38). “Consumers ...must realize that in any non-cash transaction, a certain degree of privacy is traded for the convenience of an efficient marketing exchange” (Miyazaki & Fernandez, 2001, p. 40).
“Many marketers believe that experience gained through simple usage of the Internet for non-purchase purposes such as information gathering and non-commercial communication will lead consumers to discover that privacy and security risks are often exaggerated” (Miyazaki & Fernandez, 2001, p. 30). “Concern over cookies – pieces of information that a Web site stores on a consumer’s computer that are used to identify repeat visitors and personalize the online shopping experience – could dissipate as consumers learn that cookies typically cannot access data other than that already provided to the web site by the consumer (FTC 2000)” (Miyazaki & Fernandez, 2001, p. 30). However, other studies have found that “privacy was actually a greater concern for consumers with longer periods of experience, suggesting that the accumulation of such experience may lead to higher concerns regarding privacy issues” Miyazaki & Fernandez, 2001, p. 38).

In 1998 surveys, it was observed that 87% of female Internet users and 76% of male users were “very concerned about threats to their personal privacy” Ackerman et al., 1999, p.3). A majority of respondents (79%) were highly reluctant to share their information with other companies or organizations. Most Internet users do not want to receive unsolicited communications that are prompted by an exchange of information at e-business Web sites. This includes unsolicited marketing, e-mail messages, direct mail or phone calls. “Most do not want tools that transfer information about them to Websites automatically” (Ackerman et al., 1999, p.6). In a 1998 GUV survey, 78% of respondents said privacy was more important to them than convenience” (Ackerman et al., 1999, p.6).

Most reputable online retailers post privacy policies on their Web sites. Privacy policies are understood to provide fair warning and gain implied consent from consumers accessing the retail site. In some instances, however, their form, location and legal context often render them
“unusable as decision making aids for a user concerned about privacy” (Jensen & Potts, 2004, p. 477). Businesses that use customer information without fully disclosing intent or are “concerned about revealing what consumers may find to be questionable practices,” must be aware that “failure to disclose such privacy policies may lead to a violation of the implied social contract that is made when consumers exchange information with an online retailer” (Miyazaki & Fernandez, 2001, p. 40).

2.1.1 The Role of Governments - North America (US and Canada) and Europe

The global nature of the Internet and differing governing political philosophies make enforcement of the protection of privacy rights difficult (Rose, 2000, p. 20). When it comes to safeguarding individual privacy in the marketplace, it can be generally stated that privacy experts want government intervention while business wants self-regulation (Udo, 2001, p. 166). It is useful to examine how governments have responded and how this may impact business.

The U.S. has chosen industry self-regulation. Rose argues that “self-regulation is problematic from the consumer’s perspective in that there is no cost effective way to police violations, and the legal stance is uncertain given the global nature of the Internet.” Overall, “privacy protection legislation is difficult to enforce without international collaboration and treaties” (Rose, 2000, p. 20). The U.S. consumer is on his/her own when it comes to protecting personal data, whether the consumer is technologically sophisticated or not.

The U.S. has no explicit constitutional protection for privacy. Rights relate only to protection from the government, not individuals or companies, and individuals rarely win lawsuits against private parties for privacy violations. U.S. courts have generally ruled that
whoever goes to the expense and effort to collect and store information owns it. The U.S. constitution prohibits the government from placing individual privacy ahead of the right of free expression. As a result, the government is inhibited from enacting legislation that would protect individual privacy and prevent others from collecting and disseminating information. (Caloyannides, 2003, pp. 100-101) U.S. online businesses are self-regulating and as such have considerable leeway to conduct interactive marketing and personalization by gathering large volumes of data on individual consumers.

Governments of Western Europe legislate strong legal protection for individual privacy and explicitly protect an individual’s personal data and information. Governments prohibit the exchange of information with non-member countries that do not provide an adequate level of privacy protection (Caloyannides, 2003, p. 100). The E.U. (European Union) regards privacy as a fundamental human right, and as a result, the “Safe Harbour Principles” were evoked by the E.U. to control cross-border data flow from Europe to the U.S. in order to safeguard individual privacy (Frosch-Wilke, 2001, p. 193). “Companies which conduct business with E.U. countries must also state that they abide by the ‘safe harbour’ principles in their published privacy policy statement” (Jones et al., 2000, p. 5). Unlike the U.S. and Canada, E.U. legislation ensures that “private information on Europeans is protected everywhere in the world” (Rosenberg, 1998, p. 138).

Canada formally recognized the protection of privacy in 1995 when the Canadian Standards Association (CSA) accepted a “Model Code for the Protection of Personal Privacy” as a national standard for Canada (Rosenberg, 1998, p. 140). In 2001, the Personal Information Protection and Electronics Documents Act (PIPEDA) took effect for federally regulated companies; and in January 2004 the Act was extended to all businesses operating in Canada. The
act recognizes the rights of individuals with respect to the collection, use, disclosure and retention of their personal information. Businesses are obligated under law to protect personal information.

2.1.2 Consumer Attitudes towards Privacy in E-business

Hoffman et al. (1999) claim, "87% of Web users think that they should have complete control over the demographic information Web sites capture, and over 71% feel there should be new laws to protect their privacy online." A further 69% of Web users do not provide data to Web sites because the sites provide no information on how data will be used (pp. 81-82). Consumers want "a social contract executed in the context of a cooperative relationship built on trust" (Hoffman et al., 1999, p. 82). There is a sense that control of personal information is being lost.

Data, concerning consumers' online browsing habits, collected by Internet marketers innocuously on the Web, can be combined with voluntarily disclosed information to create data warehouses. The data is mined using technology tools to create detailed customer profiles that many regard as a violation of an individual's privacy. If data - used to create the consumer profile - is taken out of its original context, there is risk that the consumer may be denied services, or access to products. This issue may be amplified as e-business becomes more data-centric and there is a shift to a more customer relationship management (CRM) focus (Rose, 2000, p. 20).

To the average online consumer, having personal control and the ability to manage information about oneself is important in asserting one’s privacy rights. Olivero & Lunt, (2003) claim, in their study, that consumers who were aware of being targets for consumer profiling were also aware of the potential value of their personal information, termed "commodification of
information.” These individuals were prepared to take control over the right of use and ask for rewards against disclosure (p. 15).

2.2 Security

From a consumer perspective, we can define security as the protection of personal data, where release of such data may result in a breach of privacy or a possible financial loss. It is also defined as the protection from threats to personal data. From an online retailer perspective, we can define security as the protection from data loss, interruption, interception, modification and fabrication (Chellappa & Pavlou, 2002, p. 360). This implies that technological resources, supporting the retail site, as well as the external network, must be secure. The online retailer must ensure that the technological infrastructure has built in security features and processes such as encryption and authentication\(^5\) to minimize the risk of security breaches.

When we address the issue of security, it is to minimize the impact of security threats. Security threats can be defined as: “a circumstance, condition, or event with the potential to cause economic hardship to data or network resources in the form of 1) destruction, 2) disclosure, 3) modification of data, 4) denial of service, 5) fraud, 6) waste, and 7) abuse.” Security is the protection against these threats (Belanger et al., 2002, p. 249). From the point of view of the online consumer, any loss of privacy, theft of credit information or financial loss, would be

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\(^5\) Encryption translates information from a recognizable and usable form to an encoded incomprehensible form using complex mathematical algorithms and keys. Authentication is a process which establishes and confirms the identity of a network user. The common method of authenticating a user, such as a consumer, is by use of a password. The identity of an online retailer is usually confirmed through use of digital certificates, or by independent third parties such as VeriSign.
perceived as a breakdown in security and the credibility of site in question, and consumer trust, would be compromised (Belanger et al., 2002, p. 248).

The Internet was conceived as an information-sharing medium and was not intended to support business transactions; thus, security mechanisms were not implicitly included (Chellappa & Pavlou, 2002, p. 359). This has raised new technological challenges in keeping one step ahead of hackers and cyber criminals who adept at finding security weaknesses in the network, protocols, hardware and software. The technical competence or ability of the online retailer to conduct e-business transactions without error is the measure of a safe site in the mind of the consumer (Belanger et al., 2002, p. 248). Any hint of “questionable security is a major deterrent to online shopping” (Hoffman et al., 1999, p. 82).

2.3 Trust - a Key Success Factor

Key success factors determine a firm’s ability to survive and prosper. In order to survive and prosper firms must supply what customers want to buy, and must also survive the onslaught of competition (Grant, 1998, p. 76). Trust is important as a key success factor because the online retail business is so competitive and because information availability can be instantaneous. Firms that recognize, develop and entrench trust supportive practices are better positioned to prosper and earn sustainable rents over the long term. Trust-focused practices aid in understanding how online trust is created and maintained and can lead to improved sales revenues, profitability, and ultimately shareholder value (Shankar, et, al., 2002, p. 326).
This paper has explored trust in terms of the consumer’s perception of privacy and security; but there are other drivers that influence trust and reinforce it as a key success factor: business size, reputation, brand recognition, expertise, and personal experience.

**Business size:** The larger the firm, the more perceived trustworthiness the consumer places in that firm. If the business has grown to a large size, relative to the competition, the conclusion is drawn that the firm must have treated its customers fairly and is therefore worthy of trust. “Through its size and market share”, a firm “produces a sense of reliability and good intentions” (Bailey et al., 2000, Section 4.2.2).

**Brand identity:** “The willingness to engage in electronic transactions seems to be largely dependent on the brand image of the organization”(Olivero & Lunt, 2003, p. 17). The recognition of a familiar brand, associated with an online firm, can be a substitute for the face-to-face relationship that develops trust between consumer and retailer in a land-based store. “Brands convey a specific image in terms of expertness, localness, and reliability”, which reinforce feelings of trustworthiness (Bailey, 2000, Section 4.1). Strong “brands can signal quality in the reliability of delivery, security of personal information, dependability of the return policy and customer service in general.” which translates into increased trust (de Figueiredo, 2000, p. 7).

**Reputation:** Reputation enhances the credibility of the online retailer, reduces the consumer’s perception of risk, and creates a willingness to disclose to companies that are well known and who have an image to maintain. Studies have shown that reputation is a “factor that leads companies to act more responsibly primarily with the intention of avoiding unfavourable

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6 A traditional retailer, sometimes referred to as “bricks-and-mortar” or B&M retailers.
publicity” (Olivero & Lunt, 2003, p. 17). Reputation, as well as trust, is also strengthened through “community relationships” (Rutter, n.d., p. 7) and through brand image. Trust is enhanced when consumers know a retailer has a reputation for quality (products or services) and reliability.

**Expertise:** Expertise is judged by the firm’s ability to deliver what is promised without inconveniencing, or distressing the consumer. Attributes of expertness may include the ability to process orders promptly and accurately, to deliver merchandise in good condition and within the time frame promised, and to handle warranties or service disruptions in a manner that preserves business relationships.

**Personal experience:** Rutter (n.d.) suggests that “personal experiences and personal narratives have profound importance in the creation of trust,” and that “trust deepens or retreats based on experience” (p. 9). Online communities serve to deepen trust through the exchange of beneficial information. Customers, who share their personal experiences in doing business with an online retailer, contribute to the development of trust within their ‘online community.’ A direct benefit of increased personal experience is the tolerance towards a retailer’s variability of service (Rutter, n.d., p. 10).

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7 Online communities can generate a core of dedicated customers who become committed promoters of the online site. These communities arise through participants’ expression of common interests and are facilitated through customer reviews, critiques, and the participation in chat forums. Online retailers who promote “communities” are seen as trusted members and not just institutions.
3 ANALYSIS OF THE NORTH AMERICAN ONLINE RETAIL INDUSTRY

3.1 History of the Industry

The online retail industry emerged in the mid nineties when several online booksellers opened for business. Early entrants were Booksite.com, which considers itself a pioneer in online bookselling, and Amazon.com in 1995. Fatbrain.com and Buy.com followed these early entrants in 1996. Barnes & Noble, and Borders, the two largest traditional land-based retailers, entered the online market in 1997 and 1998 respectively. The third largest bookseller in the US, Books-A-Million, launched its online retail site in 1999; its sales growth has flattened and is no longer considered a significant player in the online market as of this date (Books-a-Million Annual Report, 2003).

After Borders established a partnering agreement with Amazon in 2000, Barnes & Noble, and Amazon were left to dominate the online book market (Latcovich & Smith, 2001, p. 219). The remaining market entrants did not establish a significant customer base; some competitors absorbed new entrants, while those remaining have had only a small presence in the industry. Amazon gained an early first-mover advantage and a commanding lead over its rivals by recognizing growth opportunities and by taking advantage of the inefficiencies within the publishing industry’s distribution networks (Laseter et al., 2000).

The industry began to grow and diversify towards the end of the nineties but was still crowded and fragmented, with few companies having significant market share (Global Online Retailing, 2001, p. 13). Gradually more land-based retailers have established online channels to complement their store based operations, among these: Wal-Mart, Home Depot, Lowe’s, and Marshall Fields. Amazon gradually expanded beyond books to include music and video; by 1999
it had added tools, home products, apparel and other merchandize product lines. It also opened an online marketplace for third parties to sell and auction their own items, with Amazon taking a commission on all sales.

Since its inception in the mid 1990's, the online retail industry has experienced steady growth. Online retail sales were up 21 percent in 2001 to $51.3 billion, and 48 percent in 2002 to $72.1 billion, comprising 3.6% of total U.S. retail sales (Van Slyke et al., 2004, Introduction and Objectives, para. 2). For 2003, 26 percent growth is expected to push sales to $96 billion, which will represent 4.5% of total sales (The State of Retailing Online 6.0, 2003). Over the next five years, online sales in the U.S. are expected to grow at a 19 percent compound annual rate, reaching $230 billion by 2008, making it 10 percent of total retail sales (Johnson, 2003, ¶ 1). In the Canadian market, Forester Research estimates that by 2006, seven million households will purchase $24 billion online (Online Retail in Canada., 2001, ¶ 1).

The industry follows traditional retail seasonality with higher revenues earned during the late fall (fourth calendar quarter), and declining revenues during the summer months.

3.2 Current Industry Situation

There are many established land-based retailers that now have an online presence. The product categories that are offered are extensive and continuously emerging. Online retail product offerings from 1995 through to the year 2000 were primarily quasi-commodities, with books, music (CD), and video (tape and DVD) being the most common categories. Since 2000, the number of online competitors has grown as well as the number product categories, which now include electronics, software and games, toys, tools, home and garden products, and apparel. Table 1 is an industry product customer matrix (PCM) covering the most prominent product and
service categories currently offered in the North American online retail market. It is interesting to note that Amazon.com is present in each category.

In this following analysis, life cycle, market concentration and government regulation will be explored and discussed.
<table>
<thead>
<tr>
<th>Products</th>
<th>Services</th>
<th>Customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Books</td>
<td>AM, BN, BY, BM, CH(Cdn), WM</td>
<td>BN, CH(Cdn), WM</td>
</tr>
<tr>
<td>Music</td>
<td>AM, BN, BY, WM, CC</td>
<td>CC, VG, WM</td>
</tr>
<tr>
<td>DVD / Video</td>
<td>AM, BN, BY, UB, CC, WM</td>
<td>CC, WM</td>
</tr>
<tr>
<td>Software</td>
<td>AM, CC</td>
<td>CC</td>
</tr>
<tr>
<td>Games</td>
<td>AM, BN, BY, UB, WM</td>
<td>CC, FS(Cdn), WM</td>
</tr>
<tr>
<td>Electronics</td>
<td>AM, CC, UB, FS(Cdn), WM, TG, QV</td>
<td>CC, FS(Cdn), WM, TG, QV</td>
</tr>
<tr>
<td>Home/Garden</td>
<td>AM, WM, QV, TG, MR, LW, HD</td>
<td>WM, TG, HD, MF, QV, LW</td>
</tr>
<tr>
<td>Tools/Hardware</td>
<td>AM, HD, LW</td>
<td>HD, LW</td>
</tr>
<tr>
<td>Toys</td>
<td>AM, BY, WM, QV</td>
<td>WM, QV</td>
</tr>
<tr>
<td>Apparel Accessories</td>
<td>AM, TG, MF, QV</td>
<td>WM, TG, MF, QV</td>
</tr>
<tr>
<td>Online Marketplace</td>
<td>AM</td>
<td>AM</td>
</tr>
<tr>
<td>Auctions</td>
<td>EB, AM, UB, PL</td>
<td>EB, AM</td>
</tr>
<tr>
<td>Online payments</td>
<td>AM, BP</td>
<td>AM, BP</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>AM - Amazon</th>
<th>BP - BidPay</th>
<th>BM - BooksAmillion</th>
<th>BN - Barnes &amp; Noble</th>
<th>BY - Buy.com</th>
</tr>
</thead>
<tbody>
<tr>
<td>CC - Circuit City</td>
<td>CH(Cdn) - Chapters</td>
<td>EB - Ebay</td>
<td>FS(Cdn) - Future Shop</td>
<td>HD - Home Depot</td>
</tr>
<tr>
<td>VG - Virgin</td>
<td>WM - WalMart</td>
<td>PL - Priceline.com</td>
<td>RS - RadioShack.com</td>
<td></td>
</tr>
</tbody>
</table>

Table 1: Industry Product Customer Matrix (2004)
3.2.1 Life Cycle

Online retailing is currently in the growth phase of the industry life cycle as “the number of consumers using the Internet to purchase products continues to ramp-up” (Global Online Retailing, 2001, p.13). “Roughly 5 million new U.S. households will shop online in each of the next 5 years, creating a total of 63 million U.S. online shopping households in 2008” (Johnson, 2003, ¶3). This increasing online shopping activity is reaching a level where it is beginning to effect land-based store sales. “More than half of all shoppers say they visit the store less often because they shop online“ (Global Online Retailing, 2001, p.6).

It might seem that the online retail industry, with its dependency on the Internet, would encourage a free flow of information (transparency), impose few barriers to entry and exit, and create a market in which there are many buyers and sellers – in other words, perfect competition and an efficient market. Evidence suggests that this is not necessarily true. Although the efficiency of consumer searches and availability of information on the Internet would ensure consumers were well informed on price and product value, product searches may not always be efficient or complete as the consumer must often commit time and effort to conduct adequate searches. Latcovitch and Smith (2001) point to high industry concentration and suggest that there might be collusion amongst market leaders as price changes over time according to demand (p. 232). Studies have shown that leaders are not pricing at marginal cost – more evidence that this is not a market in perfect competition – these are profit takers. There are also barriers to entry, one example is the large expenditures in advertising required to establish branding, reputation, quality in the mind of the consumer, consumer confidence, and trust. These expenditures, which are sunk endogenous fixed costs, develop distortions in the competitive landscape to the advantage of the market leaders, but erode the possibility of earning rents in the near term. Rather than perfect competition, the industry is more accurately described as an oligopoly or duopoly with two
dominant leaders and several smaller online retailers vying for market share (Latcovich & Smith, 2001, p. 232).

### 3.2.2 Market Concentration

There are two market leaders in this industry, Amazon.com and Barnesandnoble.com—a joint venture between Barnes and Noble (the land-based retailer) and Bertlesmann AG (Latcovich & Smith, 2001, pp. 218-219). For both organizations, the mainstay revenue generator has been the “books, music, and video” market segment. The segment’s concentration ratio (CR₂) for 2001 (see Table 2) is approximately 68 percent, which would classify this industry as a “tight oligopoly” (Samuelson & Marks, 1999, p. 389).

<table>
<thead>
<tr>
<th>Year</th>
<th>Amazon (millions $US)</th>
<th>Bn (millions $US)</th>
<th>US Census (millions $US)</th>
<th>CR₂</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>1,698</td>
<td>320</td>
<td>3,019</td>
<td>67%</td>
</tr>
<tr>
<td>2001</td>
<td>1,688</td>
<td>404</td>
<td>3,066</td>
<td>68%</td>
</tr>
</tbody>
</table>

Table 2: Market Concentration

### 3.2.3 Government Regulation

There are few laws or regulations relating specifically to online retailing at this time. It is reasonable to expect that consumer protection laws and/or regulations may be enacted in the future and that such a move may impede growth of the industry (Amazon Annual Report, 2002).

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8 Data Sources: Amazon.com - Annual Reports '00/'01; Barnes and Noble.com - Annual Reports '00/'01; U.S. Census Bureau – 2001 Annual Retail Trade Survey.
Most recently, privacy legislation has been enacted in both Canada and the U.S. governing all forms of business enterprise and is intended to specifically protect consumer privacy.

The growing threat of software viruses and the shear volume of unsolicited e-mails (spam) will require government intervention in the form of legislation at some future point. Laws to curb spam have already been enacted in the U.S.; Canada has yet to follow. Because virus attacks are a problem that is global in nature, it is difficult for any national government to act unilaterally, and will likely require international cooperation.

3.3 Competitive Analysis of the Online Retail Market

An analysis of the North American online retail market will be conducted to examine the dynamics and interrelationships of the various market forces. The analysis will focus on Porter’s Five Forces (Figure I): competitor rivalry, supplier power, buyer power, substitutes, threat of entrants, and a sixth force: government (Boardman & Vining, 1999). The Five Forces analysis can be useful in determining attractiveness of the industry, forecasting industry profitability, and formulating strategic alternatives. In this paper, the analysis will assist in understanding the industry dynamics and the role of key success factors.
3.3.1 Nature of Rivalry in the North American Online Retail Industry

The industry has already been defined as being in the growth phase of its life cycle, characterized by increasing revenues over time. The industry leader, Amazon.com, reported a positive net operating income, for the first time, in all of 2003. This is a significant milestone as the learning curve, branding, and infrastructure investment for this industry is substantial and has been a burden in realizing economic profits (rents).
There are basically three industry segments: 1) books, music, video; 2) electronics, home improvement / tools, toys, apparel and accessories, other retail products; 3) services (auctions, affiliates, and third party retail channels.) Competition in the first segment is primarily between Amazon and Barnes & Noble.com (B&N). Figure 2 depicts the rapid growth in Amazon’s net Sales over B&N. Since Borders entered into a partnering agreement with Amazon, it is no longer viewed as a direct competitor. The second segment began to emerge in 2000 and is in the early growth stage in the life cycle. There are no clear rivals emerging at this time, although Wal-Mart can be expected to pose the greatest potential competitive threat. It has a secure position in the market, has consistently been earning rents, has a well-established land-based presence, and has a very highly efficient and a well developed supply chain system. The third segment, services, is also emerging with eBay.com in a dominant position in online auctions, while Amazon is effectively leveraging its infrastructure in a leadership position to support third-party sellers.
With the development of technological infrastructures to support customer browsing, interaction, ordering, payment and fulfillment processes, companies such as Amazon have streamlined processes and achieved significant economies of scale. These economies have been achieved more easily because of the ease with which digitized information can be stored, processed, retrieved and searched. Having created an efficient technology platform, the next logical step is to replicate its use in selling different products and services, yielding increasing economies of scope (Graham, 2001, p. 149). This has been Amazon’s blueprint for success; few rivals have been able to duplicate this model on the same scale. As was noted earlier, Wal-Mart is best positioned to emerge as a direct rival to Amazon’s current leadership. Like many land-based retailers who establish an online channel, Wal-Mart struggled in 2001 to overcome operational problems with its online unit, Walmart.com. At that time, it entered into negotiations but did not conclude an agreement to use Amazon’s technology services in support of its online operations.

The learning curve for new rivals can be formidable. There is much more to online retailing than simply creating an attractive Web page. Much investment in time, capital and learning is required to put into operation a technology base that will support the various processes necessary to conduct online business in this increasingly competitive industry. As well, there is brand and reputation development, and most importantly consumer trust.

Large land-based retailers have the resources and revenue stream from their land based operations to sustain them through any downturn in the online retailing industry. In effect they have ‘staying-power’ whereas companies, such as Amazon, may be vulnerable as an online only business. Much depends on a firm’s ability to maintain a technological and business lead over its online rivals. It must also overwhelmingly convince consumers of the benefits that shopping online offers in comparison to the land-based retail store experience. There are vulnerabilities.
Should problems arise in safely conducting online retail sales transactions or should personal information be compromised online, the trust of the consuming public may be lost. This situation might arise if governments are slow to enact laws that would deter those who create viruses and other means to disrupt the Internet. If such malicious activities are not curbed, slow response time of the Internet and the occurrence of possible outages will erode public trust. Further, there is future risk posed by those who engage in the theft of personal identities. These activities collectively erode public confidence and trust in online retail – problems that are not as severe for land-based retailers. With face-to-face contact, opportunities for product touch-and-feel and product try-before-you-buy, and in-person financial transactions, consumer trust is more easily developed and sustained by land-based businesses. This is why online retailers must commit so many resources to branding and development of trust. So long as there are distinct advantages and benefits, the consuming public will use online retail services in ever increasing numbers.

The challenge for firms in this industry is maintaining a leadership position as an online retail interface to the Web, with a stellar reputation, solid branding, and the trust of the consuming public. Provided Amazon’s ‘passion’ for innovation continues to compliment sound business decisions, it will be successful in differentiating itself from its rivals and innovation will bolster its ability to earn sustainable rents. There are no clear competitor strategies that are directed towards undermining or overtaking a leader such as Amazon; its rivals are challenged sufficiently just getting online. Amazon has gained such a formidable lead over its rivals that it has been able to strike partnering agreements with some to use its highly developed technology infrastructure, realizing economies of scope in the process. These rivals (Borders, Toys-R-Us, and Target) have been neutralized as competitive threats to Amazon in the online retail market. There are however possible opportunities for competitors to capitalize on regional variances in delivery and service, which exist in areas remote from urban centres.
3.3.2 **Buyer Bargaining Power**

The nature of Internet retailing has empowered the online consumer, but not to the degree that may have been anticipated; that is one of several reasons why the online retail industry does not resemble a perfectly competitive environment, but rather operates as an oligopoly. Although not perfect, transparency has improved buyer bargaining power through online availability of good buyer information through reviews, newsgroups, and other instantly available information. In the offline marketplace, a consumer would have to comparison shop at physical land-based retail stores or gather information randomly through media advertising. Notwithstanding, buyers must still make an effort to conduct online searches. The sites to search are not easily identified and the ease of locating these sites is dependent on the level of advertising online retailers engage in. Buyers can compare prices online more easily than by physically traveling to different land-based retail stores.

Price sensitivity to buyers is moderate, there are substitutes and switching is easy, however, there are compelling benefits to shopping online: breadth and depth of product assortment, convenience, time savings, no travel, no parking, and no crowds. Buyers are highly sensitive to shipping costs and sales can be lost when the customer reaches checkout. Amazon and other online retailers have initiated aggressive shipping cost reduction strategies geared to cost of goods ordered.

Buyers in online transactions are limited only by their access to the Internet and a suitable computer interface, there are no geographical or national boundaries hence buyers are global. Limitations on shipments to foreign countries, imposed either by government or the seller, are the
only restriction to buyer access of goods. Some countries with restricted freedoms may limit access to its citizens. This industry is considered an oligopoly with a limited number of sellers.

In order for the online retail industry to be successful, merchants must offer customers unique incentives to buy such as: offering a large product choice, availability 24/7, fast service and delivery, and a convenient and enjoyable online shopping experience. Neither buyer nor seller is a price taker. The largest product categories on line are quasi-commodities (books, music, video) and buyers have a choice of finding a substitute either online or off line at a land-based retailer. The service offered by online retailers is the differentiator and its appeal undermines buyer power by creating a “stickiness” that encourages return visits to trusted sites. Because of service differentiation, sellers can adjust prices. These price adjustments are dynamic owing to the ease with which competitor pricing information can be obtained – simply by clicking on a competitor site. This is dramatically different from the land-based model, where traditional retailers physically post pricing information and require time for customers to research competitors’ pricing strategies by phoning or traveling to different stores.

Buyers can also conduct searches using the best available online tools at a particular web site to find the best price, and then place an order at a competing site that offers a lower cost.

3.3.3 Supplier Bargaining Power

In the first years of operation, Amazon – an example of a large volume purchaser – had relied primarily on two large distributors, Ingram Book Group and Baker & Taylor. This past year, its purchases of inventory have been reduced to less than 10 percent from any individual supplier, lowering supplier bargaining power. There is little threat of supplier forward integration.
Considering the order volumes, which are delivered directly to large regional warehouses, it follows that supply chain economies can be realized that are a direct benefit to the suppliers, but undermine their bargaining position. Supplier bargaining power has been further eroded since the industry has begun to diversify beyond quasi-commodities to other product categories, sourcing inventory from a broader base of suppliers. Firms that are serious about having an online presence maintain substantial warehouse space (Amazon has over 3.2 million square feet) to support an extremely high inventory turnover rate. Amazon, as an example, does not have any long-term contracts or arrangements with its suppliers, payment terms or extension of credit limits (Amazon Annual Report, 2002).

3.3.4 Threat of Entry

In the mid-90’s, it was assumed that setting up an online retail site presented few barriers, especially for established land-based retailers, aided by open standards and interoperability of equipment, and the ease of connecting with people globally (Graham, 2001, p. 149). There was much excitement about the novelty and potential of the Internet, seed capital was readily available and new ventures that went public quickly achieved high market capitalization. Market entry posed no formidable challenges beyond creating an attractive web site and establishing a link to the Internet. The belief was that there would be many new entrants, and with near perfect information, the industry would be characterized as a perfectly competitive market environment.

This notion has been refuted by the history of the last decade. Amazon’s experience demonstrates that set-up costs increase beyond a basic web page development to include the administrative and technology infrastructure necessary to process and ship order requests, track and manage inventory through distribution warehouses, and create an online customer experience.
which offers a basic level of appeal. This represents only one component of fixed costs that new entrants must expend to launch a basic online retail channel. The second component is an ongoing endogenous fixed cost that aids in differentiating the site from those of competitors. This second component is a sunk cost and includes investment to increase processing speeds, to improve security of transactions, to enhance the customer experience, to advertise, to establish branding, and to protect proprietary processes (patents). Above all, the objective is to increase the number of customer visits, turn browsers into buyers, and create a “stickiness” that encourages buyers to make repeat visits (Latcovich & Smith, 2001, p. 220).

This investment in sunk costs, in particular, has protected Amazon from the threat of new entrants, which can be considered as low to medium. Over the long term, the greatest threat may be from large, well-established and financially strong land-based retailers such as Wal-Mart, who have moved into online retail. These firms have the resources and a well established brand; what they lack is know-how, and like all newcomers face a steep learning curve. Toys-R-Us and Target avoided the learning curve and sunk costs by entering into partnering agreements with Amazon to leverage Amazon’s well-established online service infrastructure. Wal-Mart came close to striking a partnering arrangement with Amazon in 2001 as it faced mounting problems with the operation of its online channel, walmart.com (Olsen, 2001). Amazon’s continued success in discouraging new rivals from entering the industry will depend on it maintaining a solid lead by continuously innovating, safeguarding new ways of doing things through patent protection, adhering to a customer-centric focus, and building customer trust.

3.3.5 Competition from Substitutes

The threat from substitutes is medium. Successful firms, such as Amazon, have invested heavily in advertising and have established a credible brand – Amazon, for example, is associated
with a convenient and pleasurable online shopping experience. Online firms must create switching costs for the consumer by offering personalized service such as buy recommendations based on past history, convenient order placement such as Amazon’s “1-Click” shopping, free shipping above a purchase threshold, and most importantly, trust in terms of consistent service, security of transaction and customer satisfaction. Customers will remain with the online retailer they know and trust and return for future purchases. Land-based retailers are credible substitutes; they offer ambience (coffee bars and comfortable seating), face-to-face service, and hands-on browsing. Other online retailers are also substitutes, however they must overcome the “stickiness” of successful online retailers in order to draw customers to their sites. To accomplish this, they must offer a more compelling site “stickiness” by creating virtual communities, customer loyalty and rewards programs, and a more trustworthy process; they must also instil confidence in customers that they can complete the transaction with a feeling of satisfaction (de Figueiredo, 2000, p. 7). This is a tall order when one considers the lead Amazon has already achieved through its customer-centric philosophy.

It should be noted that switching costs are lower for online substitutes in comparison with land-based retailers. Online buyers do not have to travel to a distant store, find parking, contend with crowds, and sacrifice more personal time in the process. It would be fair to conclude that Amazon has blunted competition and lessened substitutability by increasing service differentiation, thereby reducing cross-price elasticity of demand (Samuelson & Marks, 1999, p. 411).
3.3.6 Government: The ‘Sixth Force’

There is little indication, in early 2004, of any government regulation or legislation that specifically targets online retail. At this time there is an open and free market on the Internet. There may be potential impacts as a result of government inaction to curb and eradicate the threat to online business posed by software viruses, worms, and ‘spam’, which place a heavy financial burden on e-business enterprises. Any reluctance on the part of legislators and the courts to take identity theft and other privacy issues seriously could undermine public trust in online retail and e-business in general. So far government has maintained a “hands-off” approach to Internet services in terms of regulation and legislation.

Amazon has made significant progress in establishing a leadership position because of its ability to innovate and to preserve proprietary innovations through patent protection. It is assumed that government policy will continue to support protection of online processes in the future. There is always a risk of government intervention in the marketplace through taxes or other encumbrances that may adversely affect the online retailing industry.

3.4 Macro-Environment Analysis (PEST)

3.4.1 Political Factors:

North American governments are supportive of a free market economy and may be less prone to regulate online retail than in other areas of the world. Outside of North America, the political environment and its motivations are more difficult to predict. In order for the industry to evolve and optimize efficiency in delivering goods and services, governments and the courts must
continue to support and promote innovation and the protection of proprietary technology and processes. There is always risk that the industry may become so concentrated as to favour a single dominant firm; in which case, government will likely attempt to level the playing field through intervention in the marketplace.

3.4.2 Economic Factors:

Tax rates and structures must continue to encourage the growth of the online retail industry; governments must resist prematurely milking a potential cash cow. Dominant firms such as Amazon have invested heavily in non-recoverable (sunk) costs in advertising and branding of unique service offerings. Amazon is just now in a position to begin earning rents. It has successfully weathered downturns in the economy over the past several years and has continued to prosper. This resiliency bodes well for its ability to survive in tougher economic times. The effects of world terrorism are an uncertainty, the outcomes of any catastrophic events are difficult to predict or prepare for. Economic globalization will have a direct impact on the industry; firms that follow Amazon’s lead in becoming international in scope, should be well positioned to benefit from the evolving and expanding world economy.

3.4.3 Social Factors:

Surveys have shown that the demographic that is attracted to online retail is shifting. Whereas, historically, the “typical online shopper has been male, well-educated, more affluent than most, and technologically savvy,” the online shopper now seems to resemble “the typical middle class retail consumer”(Global Online Retailing, 2001, p. 11). This would suggest an expanding appeal for online shopping. There is continued growth in the number of home
computer users with a greater acceptance of conducting online transactions from the home (online banking, bill payment, news gathering, information searches) and consequently a growing potential customer base.

Countering this shift to a greater consumer confidence in online retail shopping, are moves by land-based retailers to attract customers. In the book retail sector, stores now offer coffee bars, comfortable couches, improved ambience and a more refined social setting. In the short period of time that e-business and online retailing has emerged, it is difficult to suppress natural social urges to meet people face-to-face and read the trust level in any given situation. This is a key advantage that land-based retailers hold over the online retail industry.

3.4.4 Technological Factors:

The online retail industry is dependent on the Internet for its existence. A company has control of the computing infrastructure that it owns and operates; it is the external link to the customer via the Internet that it does not control. Congestion may arise if technical improvements and upgrades to the Internet do not keep pace with the growth in online retail. Slow response times may frustrate customers and weaken online retail demand.

The Internet is vulnerable to cyber-criminals who unleash viruses, worms and denial of service (DOS) attacks. To most Internet users, they have become a significant nuisance; to most businesses online, they have become a serious threat. Should the frequency and severity of these events increase, there will most likely be a detrimental impact on the online retail industry.
3.5 Overall Assessment of External Environment

The external online retail environment, as it is at the present time, can be summarized in the following six points:

1. The industry is expanding and growing and is in the early growth phase of its life cycle. The industry has been continuously evolving and can be described as an oligopoly with two dominant firms, Amazon and Barnes & Noble, in the books, music, and video segment. The online shopper demographic has shifted from one who is educated, affluent, and technology savvy to the average middle class consumer.

2. As a first mover in the industry, Amazon developed a commanding lead over its rivals. As with all online only businesses, Amazon has faced a greater challenge than land-based retailers in developing customer confidence and trust. To achieve a leadership position, it has invested heavily in infrastructure development and advertising, expanded its product and service offerings, developed a strong brand, and has been a leading innovator. With this investment, it has realized significant economies of scale and scope. In this strong position, it has entered into partnering agreements with several large land-based retailers, effectively neutralizing potential competition.

3. Many land-based retailers have begun to establish an online channel to complement their network of physical stores and outlets. Some have considerable resources and highly efficient supply chain networks. These retailers may, in the future, become serious rivals to leaders such as Amazon. Because the customer can relate to a well-known brand – the land-based store – where there are face-to-face transactions with sales personnel, it is easier for land-based retailers to build customer confidence and trust in their online channels, by using brand-extension.
4. Online shoppers are most influenced by convenience, a pleasurable online shopping experience, an opportunity to save time, low product price (including shipping costs), and reputation of the firm, which fosters confidence and trust.

5. Online retail is dependent on the Internet as its only sales channel. The Internet may impose exogenous shocks that would be detrimental to the industry. Such shocks may include: congestion - resulting in slow response times; virus, worm and DOS (denial of service) attacks; and security breaches that may compromise personal information. These shocks may undermine consumer confidence and trust.

6. Only those firms that make customer trust a priority, that adapt easily to change, that innovate, and that continuously ensure their products and services are adequately differentiated, will be best positioned to earn sustainable rents in this evolving industry.
4 STRATEGIC ANALYSIS OF A SUCCESSFUL ONLINE RETAILER – AMAZON.COM

4.1 Overview

Amazon.com is an example of a successful online retail business. A strategic analysis will be conducted with two objectives: first to assess its degree of success, that is, whether there is sustainable competitive advantage and thus an ability to generate economic profits or rents over the long term; and second, to examine the role of trust as a key success factor in contributing to the company’s current and future success.

4.1.1 Historical Introduction to Amazon.com

After completing degrees in electrical engineering and computer science at Princeton, company founder, Jeff Bezos, spent part of his career on Wall Street, which included a five year stint working for the D.E. Shaw an investment bank where at twenty-eight he rose to a position of senior vice president. While with Shaw, he became intrigued with the Internet and its potential as a sales medium. Bezos recalled:

Web usage, as measured in number of bytes flying across the Internet in Web format, was growing at 2300 percent a year, and things just rarely grow that fast. So I set about trying to find a business plan that might make sense in the context of that growth, and I made a list of 20 different products looking for the first best product to sell online (Mendelson, H., & Meza, P., 2001).

After researching what could be sold on-line, he chose books. His goal was to give customers the largest selection possible without the time, expense, and hassle of opening stores. Seattle was chosen as the base of operations because of the availability of software designers in the region and the close proximity to the largest book distribution warehouse in the country. “Starting the company in his suburban Bellevue, Washington garage, Bezos interviewed suppliers
and prospective employees at, ironically, a nearby cafe inside a Barnes & Noble superstore” (Hof, 1998).

“Surviving the online retail industry’s incubator phase would be a challenge and could only be achieved by gaining enough market share to become a sustainable entity” (Laseter et al. 2000). The online retail model had significant advantages over land-based book retail stores. “Brick and mortar book retailers must make significant investments in inventory, real estate, and personnel for each retail location. This capital and real estate intensive business model, among other things, limits the amount of inventory that can be economically carried in any location.” In addition, Amazon also cited the collection of customer data as a key advantage in its business model: “publishers and traditional book retailers cannot easily obtain demographic and behavioral data about customers, limiting opportunities for direct marketing and personalized services” (Mendelson, H., & Meza, P., 2001, p. 4).

Amazon.com commenced business on the World Wide Web in July 1995, and quickly differentiated itself by focusing on massive selection, service quality, simplicity, efficiency, and pricing. An initial public offering was completed in May 1997 with common stock listed on the NASDAQ exchange (Vogelstein, Fred, 2003). Amazon was establishing itself as a leader in the online retailing industry.

The Amazon.com business model, as described in Amazon’s prospectus, called for a minimum of ‘bricks’: The company “carried minimal inventory and relied on rapid fulfillment from major distributors and wholesalers.” In the words of the company’s founder, “we seek to offer Earth’s Biggest Selection and to be Earth’s most customer-centric company, where customers can find and discover anything they might want to buy online” (Amazon Annual
The trend at Amazon.com has been diversification. The company was launched as an online bookseller in 1995; by 1998, Amazon added music, videos, and DVDs, rounding up its core “BMV” (Books, Music and Video) business. In 1999, Amazon expanded its retail categories to include toys, video games, and electronics products and tools, and built a network of distribution centres to support its expanded product categories.

In July 1995, only a month after it opened for business, Amazon exported merchandise from Seattle, Washington to customers in forty-five countries. In October 1998, it launched Web sites in the United Kingdom and Germany, (www.amazon.co.uk and www.amazon.de). It added a Web site in France (www.amazon.fr) at the end of August 2000 and launched another in Japan (www.amazon.co.jp) in November 2000 (Mendelson, H., & Meza, P., 2001, p. 5). “In just a few years, Amazon had grown from a tiny warehouse in Seattle to the world’s pre-eminent Internet retailer with facilities across the United States, Europe and Japan. Beginning largely as an Internet order-taker for books, the company grew into an online mega mall supported by a network of distribution centres” (Mendelson, H., & Meza, P., 2001, p. 18).

In order to survive the tumultuous dot.com boom-bust era, Amazon required a solid strategy to secure the ongoing commitment of its investors and to weather the uncertainty of that period. “It trained its focus on supply chain management. If Amazon was to show a profit, it
would have to compete with world-class retailers like Wal-Mart on mundane but crucial areas such as inventory minimization and order shipment consolidation – in a word, fulfillment” (Mendelson, H., & Meza, P., 2001, p. 5). The company built an e-business technology platform to streamline and automate services offered. Through a process of continuous innovation, which the company is passionate about, it enhanced, streamlined and differentiated the platform’s capabilities, further reinforcing its branding while achieving economies of scale. The next step was to leverage that specialized technology by offering services to further spread infrastructure costs over a wider area of operations and thus achieve economies of scope. On March 30, 1999 Amazon.com announced that it was introducing Amazon.com Auctions, a bold move on the part of Amazon to compete directly with the large Internet auction house- eBay (Krishnamurthy, 2002, p. 15). Amazon further diversified its business by offering an ‘affiliates (associates) program’ which it patented in 2000. The program accepts referrals to Amazon from other websites for a fee. By the end of the first quarter 2001, there were 600,000 affiliates onboard (Mendelson, H., & Meza, P., 2001, p. 5). Amazon also added zShops, and Amazon Payments to its services segment, acting as ‘a virtual middleman’ or agent, facilitating transactions and taking a fee (Mendelson, H., & Meza, P., 2001, p. 14). In a strategic move to neutralize potential competition online, Amazon leveraged its technology and storefront by teaming with land-based retailers, such as Toys-R-Us and Target, to provide them with an online presence for a fee. Realizing that it had missed first-mover advantage, Borders closed its online channel and established a partnership with Amazon in 2001. Amazon successfully out-smarted other retailers by teaming, rather than fighting with direct competitors such as Borders.

There is little doubt that Amazon, as a significant first-mover in the online book business, has established a solid foothold in online retailing. Sales grew from $15.7 million in 1996 to $2.7 billion in 2000. Having successfully weathered the “dot.com” downturn, the company continued
to grow, achieving profitability for the first time in 2003 with net income of $35.3 million on $5.3 billion sales.

4.1.1.1 *Description of Amazon.com*

Amazon launched its business selling books and eventually branched into music (CD) and video (tape and DVD). These products are considered quasi-commodities and are excellent for selling on line as they are easily delivered, are small in size (less warehouse space), and are appealing the mass market (these are not specialized or esoteric items). In fact the biggest increase in online retail has occurred in quasi-commodity products (de Figueiredo, 2000). Amazon’s business model required that it develop a technology platform that would streamline its operations, from product searches and selection, through order taking and fulfillment, concluding with delivery to the customer’s door. As the platform evolved, more enhancements were added. When Amazon adds additional products and services, it is able to leverage the capabilities built into its platform, since identical processes are used. Significant economies of scope are realized over the many product groups introduced. As each group becomes established, the platform resources are easily extended to provide support at minimal additional cost.
Figure 3: Amazon Operations Flow Diagram

Figure 3 illustrates a typical flow of goods/services through Amazon's operations structure. Sellers, buyers, and browsers converge through the company's Web interface directly or through other channels via strategic alliance partners (e.g., Yahoo and AOL). Amazon Associates also channel customers from their Web sites to Amazon's site.
Amazon offers its customers a wide range of products that can be purchased online. The customer selects the desired items, checks-out, and makes payment online. At that point in the transaction, Amazon initiates fulfillment processing: retrieving the goods from warehouse inventory, packaging and shipping the items to the customer. Users of Amazon’s site can provide feedback to others by submitting product reviews that are posted on the Web site and associated with the particular item.

Amazon also offers a variety of services such as Amazon Marketplace, zShops, Auctions, and Amazon Payments. These services support third-party sellers who can offer their products (new or used) for sale through Amazon’s Web site. Amazon provides online buyer search tools, payment processing, and optionally, fulfillment if the seller so desires. In instances where a seller does not wish to have Amazon provide fulfillment services, Amazon will provide notification to the seller once payment has been received from a buyer. The seller is then responsible for shipping the product directly to the buyer.

Figure 4 lists products and services within the four primary segments, and associates each segment with specific Web sites in North America (Amazon.com, Amazon.ca) and Internationally (Amazon.co.jp, Amazon.fr, Amazon.co.uk, Amazon.de). Syndicated stores also link, as shown, to specific sites. Figure 5 visually depicts the segment and aggregate net sales for Amazon’s four segments. It is instructive to note that media (books, music and video), Amazon’s original business segment, continues to provide the bulk of revenue, followed closely by its international operations. Net sales growth in the merchandize segment has been more gradual while services net sales actually fell slightly during the year 2002.
Figure 4: Amazon Market Segments

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<tr>
<th>BMVD</th>
<th>ETK</th>
<th>Services</th>
<th>International</th>
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<td>Merchant.com</td>
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<td>Music</td>
<td>Tools / Hdw / Toys</td>
<td>Merchants@program</td>
<td>Music</td>
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<td>Video</td>
<td>Kitchen / Housewares</td>
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<td>Home Improvement</td>
<td>zShops</td>
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<td>Software</td>
<td>Garden</td>
<td>Amazon Payments</td>
<td>Electronics / Photo</td>
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<td>Computer / Games</td>
<td>Mail-order catalog</td>
<td>Marketing / Promos</td>
<td>Software / Games</td>
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<tr>
<td>Gifts</td>
<td>Apparel &amp; Access</td>
<td>Amazon Commerce Net</td>
<td>Kitchen and Home</td>
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<td>Amazon Marketplace</td>
<td>Health / Personal Care</td>
<td>(ACN) Portal</td>
<td>Toys / Kids</td>
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**Syndicated Stores**
- Amazon.ca
  - www.virginmega.com
  - www.borders.com
  - www.waldenbooks.com
  - www.cdnow.com

- Amazon.com
  - www.virginmega.co.jp

- Amazon.co.uk
  - www.amazon.co.uk
  - Syndicated Stores: www.waterstones.co.uk

- Amazon.co.jp
  - www.amazon.co.jp

- Amazon.fr
  - www.amazon.fr

- Amazon.de
  - www.amazon.de
4.2 Internal Characteristics of Amazon.com

Amazon’s existing sources of rents are its sales of retail products and services to customers via the Internet. There are two significant potential impediments to earning future rents. First, the threat posed by large land-based retailers that are emerging with their own online retail channels; and second the stability of the Internet as a secure and trustworthy medium. Will Internet capacity keep up with rising consumer online transactional demand and will governments and the industry mitigate the potential detrimental effects of viruses, worms and similar disruptive tactics of cyber-criminals? Amazon’s ability to earn sustainable rents will depend on the level of consumer trust that it can achieve, the innovation and creativity that it brings to service delivery, and the extent to which it can continue to differentiate its products and services. Because its success in earning rents is dependent on its customer’s willingness to engage in online purchase
transactions and to execute payment over the Internet, Amazon must continue to build and reinforce its customer's confidence and trust.

The company's strength is its expertise and ability to create a unique and compelling interactive experience for its online customers, to deliver the products and services to its customers in a very short time, and to provide a high level of post-sale customer satisfaction. Its core capability and competitive advantage is its highly efficient integrated online customer interface and order process system that is supported by a highly effective technology platform and support infrastructure. These systems have helped it achieve the economies of scale and scope that make it an industry leader. The support infrastructures and technology are imitable and, over time, competitors can be expected to make gains in narrowing this lead. Amazon will need to continually innovate and evolve while protecting its unique processes through patent and trade secret protection if it is going to achieve sustainable rents.

4.2.1 SWOT Analysis of Amazon.com

4.2.1.1 Strengths

From a business perspective, Amazon has been a first-mover in the industry and as such has had a distinct advantage over its competitors. It has an advanced technology service platform that supports various customer interactions, searches, purchase transactions, fulfillment, and customer information gathering and processing. Its site offers a "stickiness" that holds the interest of browsers and buyers. It has a strong brand name and is a leader in the industry. It has achieved enviable economies of scale and scope and has applied these strengths to synergistic partnering agreements with potential rivals such as Toys-R-Us and Target.
From a customer perspective, Amazon has developed a reputation for quality of service, convenience, and offers a pleasant and trustworthy interactive shopping experience.

4.2.1.2 Weaknesses:

Amazon is an online only retail business; its future is therefore dependent on continued consumer acceptance and willingness to engage in purchasing goods and services online. It is at a disadvantage with respect to land-based retailers since it cannot communicate quality or look-touch-and-feel of products directly and in person, to the consumer, nor can it offer a face-to-face sales experience, with its higher degree of trust. It is primarily reliant on the reputation of the “Amazon” brand and therefore dependent, to a greater degree, on consumer confidence and trust.

4.2.1.3 Opportunities:

Amazon has effectively used its technological leadership and its propensity for innovation to shape the future of online retail. It has developed and patented unique online sales and customer interactive processes, created barriers to entry, and thereby preserved its competitive advantage. Building on its creativity, Amazon may, in future, be able to communicate product quality over its online interface directly to the customer. Exploiting imaging and spatial orientation capabilities of advanced and emerging technologies, Amazon could become the leader in online sales of “high-touch” products by communicating more directly with buyer senses.

4.2.1.4 Risks:

Amazon is solely dependent on the Internet as a link to the consumer and is therefore exposed to potential exogenous shocks such as: congestion - resulting in slow customer response
times; virus, worm and DOS (denial of service) attacks; and security breaches that may compromise personal information and result in identity theft. These shocks may undermine consumer confidence and trust. Amazon is a customer-centric business – it risks losing more if trust is lost. Amazon would likely find it more difficult to recover from a loss of brand power as its customers do not have the same face-to-face and social interactive relationship that land-based retailers have in developing trust. As a further risk, Amazon is at a disadvantage to land-based retailers, as it has no other source of revenue but through its online channel.

### 4.2.2 Corporate Level Strategy

At the corporate level, the scope of the firm can best be described as combinational. Amazon is to some extent vertically integrated in that it adds value while channelling product from the distributor to the consumer’s residence. It is to some degree horizontally integrated in that it has the infrastructure to offer a wide range of products and services and can do so on a global scale. Although it successfully engages in online retail in a number of product categories, its technology platform and infrastructure is really the core of its business. Amazon has leveraged this core by providing a service to land-based retailers who wish to establish an online channel without making fixed cost investments.

### 4.2.3 Business Level Strategy

#### 4.2.3.1 Strategic Stance

Amazon’s business strategy has been both to push its demand curve outwards, by differentiating the services it provides its customers, and to push its cost curve downwards so that it is able to achieve lower marginal costs on new orders. Marginal costs are lower than what could
be achieved by land-based (B&M) retailers, because of Amazon’s highly automated customer order placement process. Amazon increases demand by offering the best online retail shopping experience for its customers, the widest selection of products available online, and one of the most reliable delivery and service records in the industry. Having achieved first mover advantage, it ramped up its technological infrastructure to gain enviable economies of scale. It has leveraged these economies in infrastructure by entering into partnering agreements with potential competitors, creating a win-win association by exploiting synergistic relationships and neutralizing competitive threats. As a customer-centric firm, Amazon has sought to add value for the consumer by offering personalization services that remind customers of important dates such as birthdays and anniversaries, and making purchase recommendations. Amazon can then offer a product choice that matches the customer’s tastes quickly and precisely, based on individual customer purchase histories. Amazon strives to offer unparalleled warranties and return policies and continues to build a stellar reputation for quality and reliability. Coupled with its differentiated service offering, Amazon is able to build strong brand awareness and brand equity.

4.2.3.2 Value Chain Strategy

Amazon performs all functions of its operation internally and has a vertically integrated value chain. Figure 6 identifies elements of Amazon’s core competencies, which are highlighted in bold font and are discussed here. The firm’s entrepreneurial spirit has facilitated the leveraging of its established technology infrastructure to achieve economies of scope and scale on a global level. Advertising and brand development contribute significantly to profit. The “1-Click” patented order processing, its high quality fulfillment logistics, and its personalization services all contribute, synergistically, to the development of strong brand equity. The value chain is highly automated and, as a consequence, employment levels and labour costs have declined over the years as the technology base has expanded. The customer appeal of Amazon’s Web site creates a
"stickiness" that holds attention and keeps shoppers browsing. The size of Amazon’s online operations, the positive reputation that it has gained, and its strong brand awareness together contribute to a perceived trustworthiness and comprehensiveness in the minds of consumers. Examining the elements of Amazon’s core competencies in this manner is instructive to other firms attempting to establish competitive advantage in the North American online retail industry.

Figure 6: Amazon's Value Chain

4.2.3.3 Financial Performance Analysis

An examination of Amazon’s financial statements reveals that the company was in a stronger financial position in the early years of the “dot.com boom”, between 1996 and 1999. In 1999, the company restructured and in 2000, it absorbed losses that it had incurred in equity investments, such as it made in Pets.com. These losses were reflected in its financial reports for 2000. Although Figure 7 reveals that from 2000 onwards Amazon has been technically insolvent, its strong recovery over the past year and its achievement of a net operating profit bodes well for the future.
As Figure 8 shows, operating expenses rose steadily in the early years of operations as expected, peaking significantly in 2000, and then falling to slightly above 1999 levels for the past two years. Administration, Marketing and Sales were steady at just above 1999 levels. What is significant is the reduction in the “Other” category between 2000 and 2003. This category relates to costs associated with restructuring and losses attributed to business acquisitions in 1999 as well as asset impairment, which peaked in 2000, and contributed to loss of shareholder equity.

![Shareholder Equity (Deficit)](image_url)

Data Source: Amazon.com Inc. Annual Reports.

Figure 7: Shareholder Equity
Figure 8: Operating Expenses

Table 3: Financial Ratios

Table 3 provides a summary of several important financial ratios that describe Amazon’s difficult time period from 1999 to 2002. Amazon’s liquidity decreased sharply in 1999 as a result of increased liabilities required to offset rapidly rising operating expenses. The steady drop in operating expenses since 2000, coupled with increasing revenues has resulted in a net profit for 2003 for the first time in its history, as shown in Figure 9. The cost of goods sold relative to sales
has more or less remained steady. There appears to be an improving trend in Asset Turnover. As an online retailer, Amazon requires a large technological infrastructure relative to its size of operations that puts downward pressure on its asset turnover ratio. The rise in recent years suggest that it will be better able to cope with lower profit margins if and when competition becomes a significant issue. The firm’s current debt equity ratio is currently negative, reflecting the significant financial losses of 2000.

![Financial Performance graph]

Data Source: Amazon.com Inc. Annual Reports.

Figure 9: Financial Performance

Although faced with high fixed costs during its start-up phase, Amazon has reduced marginal cost on new business resulting in declining average cost as sales increase. This favourable state, of declining average costs, has helped it achieve economies of scale. If Amazon can limit the growth in its operating expenses, while continuing to increase its revenue base, it will be in a position to realize positive returns and strengthen its position in the equity markets.
4.3 Fulcrum Analysis

Currently, the quasi-commodity segment of the North American online retail business is attractive. Amazon is the dominant player in this segment and is challenged only by Barnes & Noble. Amazon reached this dominant position by exploiting a first mover advantage in an industry that was in the early growth phase of its life cycle when Amazon was founded. It has developed a commanding lead over its competition. It has expanded its technology infrastructure, realizing economies of scale and scope, and entered into partnering agreements with other online retailers, neutralizing potential competitors. It is totally dependent on the Internet as its only sales channel. Although Amazon has recently achieved profitability, consumers continue to perceive risk in shopping online. Hence the establishment of consumer trust is imperative to Amazon and others entering the online retail industry.

Key success factors in this industry are: differentiation, adaptability, innovation, creation of Web site “stickiness”, and trust. Of the five factors, trust is the most vulnerable. Consumer trust in Amazon as an online retailer is crucial to success, but so is trust in Amazon’s only sales channel, the Internet. It is subject to exogenous shocks, beyond Amazon’s control, and there is no back-up channel on which the retailer can rely. Notwithstanding, Amazon is in a very favourable position relative to its competition in online retail.

When considering future strategy for Amazon, consumer trust will have the greatest impact on its future profitability. There are two possible scenarios to consider: first (Scenario A) if consumer trust diminishes in Amazon or online retail in general; and second (Scenario B) if consumer-trust deepens and expands. The potential outcomes are depicted in Figure 10.
4.3.1 **Scenario A: Less Consumer Trust**

A reduction in consumer trust, directed towards either Amazon the firm, or towards use of the Internet as a communications and transactional medium, would be devastating. Less frequent customer visits would translate into reduced revenues and loss of confidence in the company’s ability to earn rents or even survive. Because of high fixed costs (hardware, software and marketing activities) and low marginal costs (information commodities), unrealized customer orders would significantly impact the firm (Frosch-Wilke, 2001, p. 194). The financial markets would react with a devaluation of company stock that would weaken the company’s capital position. Although Amazon has seen stellar growth in terms of reputation, branding and infrastructure, loss of trust would severely cripple that advantage and damage the company’s image. Shankar et al. (2002) point out that “the value of a loss of trust is larger than that of a value of a gain of trust…. trust is difficult to earn, but easy to lose…. While the process of building online trust is gradual, the process of losing online trust can be steep” (p. 338).
4.3.2 Scenario B: More Consumer Trust

A further increase in consumer trust and acceptance of online shopping as a low risk alternative to land-based retail establishments, would significantly improve Amazon's business outlook. There are several attributes that create, in the minds of consumers, a perceived trustworthiness in an online retailer: business size, reputation, brand recognition, expertise, and personal experience. Trust is also built when policies and procedures, that protect personal privacy and ensure that personal data is secure, are used to collect personal information.

Increased consumer trust will translate to a stronger favourable business reputation resulting in a lower perception of risk associated with shopping online. Other resulting spin-offs may develop, such as: more testimonials or 'word-of-mouth' advertising, increased customer loyalty, and more customer-visits resulting higher revenues. Another direct benefit arising from an increase in trust is the distinct competitive advantage that Amazon will have acquired.

4.4 Amazon Strategic Analysis – Recommendations and Conclusions

Amazon launched its business with a first mover advantage in an industry that is in the early growth phase of its life cycle and has developed a commanding lead. It is renowned for its convenience, selection and service, and boasts a lower cost structure than land-based stores. To maintain a leadership position, it must continue to innovate, as it has successfully done in the past, and discover new ways to differentiate its service from competitors. Its operating costs must be managed effectively to reduce the risk of incurring losses, as in 1999 and 2000, which would further weaken its capital position.
Unlike land-based retailers, Amazon has faced a formidable challenge building consumer confidence and trust. The nature of the Internet as an unknown entity to many consumers, the new and “unnatural” shopping environment, and media reports of security breaches and malicious activities perpetrated by hackers and criminals, have created the perception of risk in the minds of consumers. Consumer trust, not only in Amazon as a company, but trust in the security of the Internet, is fundamental to Amazon’s survival. That trust is fragile and if lost would take considerable effort and resources to re-establish. Amazon has invested much in advertising, in building brand equity and in developing a good reputation. These investments are sunk and not recoverable. Amazon must take great care and attention to strengthen and deepen perceived trustworthiness in its business, its processes and in e-security. It must retain its customer-centric philosophy and commit itself to building and nurturing long-term customer relationships. It has the opportunity to further differentiate itself from its competitors in this regard. Having successfully developed personalization and customization services for individual customers, it can further enrich these services, meanwhile strengthening the ongoing customer relationship, enhancing customer loyalty and building more trust. These efforts can be synergistic and if managed correctly, could maintain a high level of trust and a sustained customer following.
5 BUILDING E-BUSINESS TRUST – RECOMMENDATIONS

5.1 Developing a Trust Based Online Business in the New Economy

The following section describes steps online retailers can take to improve customer perceived trustworthiness.

Given the uncertainty expressed by consumers, regarding security of online shopping as well as reliability of businesses on the Web, online retailers must take steps to build and sustain consumer trust. By creating trust and perceived trustworthiness online, retailers reduce the level of risk to which consumers feel exposed and build positive attitudes towards shopping online. There are several steps online retailers can take to increase online trust, thereby making it a key success factor in producing sustainable rents.

5.1.1 Give Consumers Control

Studies have repeatedly confirmed that consumers want control over access to personal information; it has also been revealed that the level of control influences trust perceptions. (Olivero & Lunt, 2003, p. 17). Astute retailers will provide consumers a choice to opt-in or opt-out regarding data collection and more aggressive approaches to selling. Distributing cookies, using Web-bugs, or displaying pop-up or banner ads without consumer opt-in undermines consumers’ sense of control and renders a site untrustworthy. There is a key differentiator between aggressive marketing tactics, which may rely on capturing personal data surreptitiously, and customer relationship building, and that differentiator is trust. Aggressive and clandestine tactics may yield short-term profits but the most enduring sustainable rents are those generated within a trusting consumer-retailer relationship. As Hoffman et al. (1999) claim, “Trust is best
achieved by allowing the balance of power to shift toward a more cooperative interaction between an online business and its consumers...recognizing consumers' rights to data ownership on the Internet in an important first step” (p. 85).

5.1.2 *Provide Full Disclosure*

It is in a firm’s best interest that information posted on the Web site be complete and accurate. This applies to: price, delivery time, cost, taxes, fees, return policy and guarantees. As well, online firms will need to make frequent updates to keep information, concerning products, prices and product availability, current. Firms must provide meaningful descriptions for their products and, when beneficial to consumers, unbiased information about competing products. It is also in a firm’s best interest to recommend a competing product if the one offered cannot properly serve the customer’s needs (Urban et al., 2000, p. 45).

5.1.3 *Provide Exemplary Service*

Online retailers must have in place the necessary technology, authentication processes, and procedures to ensure that credit card purchases are secure and risk free for the consumer. Procedures must be streamlined to ensure that merchandise can be returned quickly, and without hassles. Promises must be made for on-time delivery; and when those promises are not met, the online retailer must offer the consumer a discount. As Urban et al. (2000) correctly state, “the most important element of trust is fulfillment.... trust is earned by meeting expectations” (p. 42).
5.1.4 Create Customer Communities

Create an environment that encourages the formation of customer communities where product reviews, hints, tips, buying advice, and user feedback can be posted and exchanged. This openness and sharing of similar experiences with others reduces the perception of risk, promotes site “stickiness” and fosters trust. Both Amazon and eBay have created beneficial online communities. Amazon provides a forum for book reviews that serves to enhance consumer confidence in making purchase decisions, while eBay posts customer evaluations of the online auction process. There is always the possibility that reviews or evaluations may be purposefully slanted or biased, however the community environment, the sharing of information and the exchange of experiences can foster a perception of trust in the minds of consumers (Urban et al., 2000, p. 41). The spin off for online retailers is that members “feel part of the community and begin to align themselves with the community and, by extension, the community host” (Rutter, n.d., p. 7).

5.1.5 Implement a Privacy Policy

Display a clear privacy policy that is sensitive to consumer concerns and that, for the average user, is easy to locate and read. It must explain “if, when, why, and under what circumstances customer’s personal information, such as e-mail address, home address, or credit card number, will be used, stored, or traded to third parties,” and how it will be protected (Bailey et al., 2000, p.6). A clear policy that resonates with customers can help to differentiate an online retailer from its competitors. To build customer confidence and trust, policies must be enforceable and verifiable through third party assurance services such as TRUSTe and BBBOnline. According to Ackerman et al (1999), “much of the discomfort with the Web today results from
not knowing, or not trusting the information practices of a site. If we wish to raise the comfort level, we must ensure users are informed and can trust whatever policies are disclosed" (p.7).

5.1.6 Provide Third Party Assurances

Assurance services for e-business have emerged to facilitate the development of trust between consumers and online retailers. Online retailers must agree to meet the third party certification standards, after which, they are permitted to display the certifier’s assurance seal. Three of the most prominent and best-recognized seals are those of TRUSTe, BBBOnline, and Verisign. TRUSTe and BBBOnline provide stringent privacy disclosure requirements assuring that the online retailer will disclose and comply with stated privacy policies and will comply with certifier audits. Verisign provides assurance that its encryption and authentication service technologies, deployed by the retailer, will enable a secure and reliable transfer of data in completing online order and payment transactions.

The presence of an assurance seal conveys information about the retailers past behaviours, intentions and capabilities to a consumer. It reinforces a positive perception of the retailer’s values enabling the consumer to forecast future behaviour with greater confidence. Third party assurances lead to greater confidence in outcomes and higher levels of trust (Kimery & McCord, 2002, p. 67). According to Belanger et al.,

when consumers notice privacy seals they consider them important, and are more willing to provide personal information to the site because of third party verification…. 91% of consumers would feel more comfortable using sites participating in a third party verification program. (2002, p. 250)
5.1.7 Demonstrate Technical Competence

To be successful in the Internet marketplace, online retailers must demonstrate Web site professionalism. The site must be designed for ease of navigation and location of crucial information. It must also convey and contribute to a pleasurable experience for the consumer.

Technical competence is also measured by the retailer’s ability to conduct online purchase transactions correctly. Although the details may be transparent to most online consumers, the retailer must implement the required infrastructure: hardware, software and processes (encryption, authentication and verification) that ensure security of all personal data exchange and financial transactions. Technical competence contributes to long-term relationship building and sustained trust.

5.1.8 Build Long-term Relationships

Consumer trust is further developed and enhanced through the nurturing of long-term customer-retailer relationships. The spin-off for the online retailer is a solid reputation in the eyes of the consumer, which is one of the hallmarks of long-term growth and sustainable rents. Successful retailers are customer-centric and aware of the needs of the customer. There are many benefits to be derived from long-term relationships, and one of the salient benefits is tolerance reserved by the consumer for a variability of service. If the retailer has had an unforeseeable hardship that compromises service, consumers are more apt to overlook the transgression (Rutter, n.d., p. 9).
5.1.9 Build Brand Equity

Build or transfer brand equity. A strong brand name “can provide an important trust cue connoting a Web site’s credibility.” Companies, such as Barnes and Noble, have attempted to capitalize on their reputation as quality land-based retailers by transferring an established brand to the company’s Web site (Urban et al., 2000, p. 41). Amazon has been highly successful in developing and building an online brand associated with a unique and satisfying online customer experience, prompt and reliable service, information transparency, and customer satisfaction.
CONCLUSIONS

This paper is intended to provide readers with an understanding of the value of trust in the online retail industry, focusing on the North American market. Governments and business recognize that privacy and security of personal information is of concern to most consumers and those concerns, if not ameliorated, will have a detrimental impact on the success of online retail. The paper includes an overview and evolutionary history of the Internet, a discussion of the benefits and issues surrounding online retail, a review of the foundations of trust, a strategy analysis of a successful online retailer, and recommendations for businesses in the online retail industry.

Benefits of online retail, for both the retailer and the online shopper, were explored. There are many benefits that consumers can realize by shopping online, among these: convenience, selection and service. Online retailers benefit from the personal information collected from customers. This information can be used to more accurately target products and services to better meet individual interests and needs, and lead to increased sales. To optimize the benefits derived from this information, detailed customer profiles are often created which may lead to abuse if exploited by aggressive marketers who do not respect and protect an individual's privacy. Media reports of abuses and online criminal activity have raised fears in the minds of consumers, who sense a risk of financial loss or loss of privacy in shopping online.

A review of academic literature was undertaken to explore the foundations, definitions, and impact of trust as it applies to the online retail industry in North America. Numerous studies point to consumers' perception of risk and concerns about privacy and security as critical issues that lend support to the premise that trust is an important factor in the success of the online retail
industry. The literature suggests that specific attributes of online firms also serve to increase a consumer’s perception of trust, specifically: business size, reputation, brand recognition, expertise, and personal experience. The research also suggests that customer relationship building can contribute to longer-term trust maintenance and business success.

An analysis of the North American online retail industry—focusing on quasi-commodities—revealed a highly concentrated market with an oligopoly or duopoly structure; two dominant leaders and several smaller online retailers vie for market share. Amazon.com, as the dominant leader, has established a commanding lead over its rival Barnesandnoble.com. Online retail is in the growth phase of the industry life cycle and significant growth in this industry is expected to occur over the next five years.

A strategic analysis of Amazon.com was conducted to gain insight into the role of trust as a key success factor. A competitive analysis of Amazon and the online retail market, using Porter's Five Forces as an analysis tool, examined the dynamics and interrelationships of buyers, suppliers, potential entrants and substitutes, as well as government. SWOT, PEST and financial analyses were also conducted. A value chain of Amazon’s key functional activities and operations was created and five core capabilities were identified: site “stickiness”, “1-click” order capture, fulfillment, brand equity, and personalization. Two scenarios were examined to determine the potential impact on Amazon’s success as an online retailer: (Scenario A) a decrease in consumer trust, and (Scenario B) an increase in consumer trust. The results of the strategic analysis suggest that although Amazon is currently in a strong position, it must continue to build on its key success factors, especially trust, to shield it from competition and vulnerabilities to Internet exogenous shocks.
Finally, nine recommendations were presented to help online retailers improve customer perceived trustworthiness. These recommendations include: consumer control, disclosure, service, communities, privacy policies, assurances, competence, relationships, and brand equity. The objective is to reduce customers’ perceived risks associated with online shopping, minimize concerns regarding loss of personal privacy or potential financial loss, maximize perceived trustworthiness and contribute to the goal of earning longer term sustainable rents.
7 BIBLIOGRAPHY


