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RESEARCH NOTE

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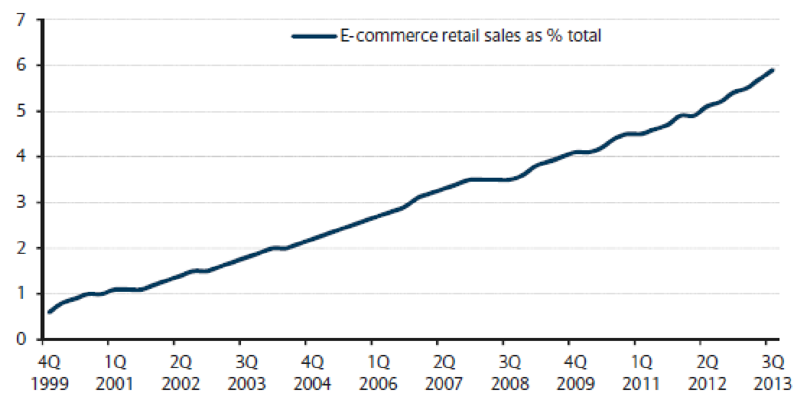
SUBJECT: **Commerce Research Note**

MARKET OVERVIEW

eCommerce refers to the buying and selling of products and services by businesses and consumers through an electronic medium; however, our research note will focus more broadly on "commerce" as the environment for business expands beyond in-store or online given the prevalence of omni-channel retail strategies (outlined on page 2). Commerce activity can be categorized in three ways: (i) business to business ("B2B") (e.g., Cisco), (ii) business to consumer ("B2C") (e.g., Amazon), and (iii) consumer to consumer ("C2C") (e.g., eBay). The scope of this research note will include B2B models (commerce enablement software platforms, retail analytics) and B2C models (social, marketplaces, eRetail).

MARKET OPPORTUNITY

- B2B
  - Gartner estimates the US eCommerce software market to be $3 billion in 2013
  - The global predictive analytics market was valued at $2.1 billion in 2012 and is forecast to grow at a 17.8% CAGR from 2013-2019 (Transparency Market Research)
    - End-use sectors such as banking and financial services, insurance, government, pharmaceuticals, telecom and IT, and retail, are seen as key demand drivers
    - Retail and manufacturing are expected to be the fastest growing segments
- B2C
  - Euromonitor estimates the value of global online retail sales to be $521 billion in 2012, implying a five-year CAGR of 17%
  - The US market accounted for greater than 40% of total global online retail sales in 2012
  - LTM Q3 2013 US online retail sales of $253 billion; forecasted to grow near the global average of ~15% annually (Barclays' Demandware initiating coverage report)
  - US online retail sales account for 6.0% of total retail sales, increasing consistently and non-cyclically over time (US Census Bureau)



Source: US Census Bureau

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MARKET TRENDS

We organized the market trends first by category (B2B and B2C) and then by business model to align with the commerce market map.

A key theme across all business models is the emphasis on omni-channel retail (a seamless approach to the consumer experience through all available shopping channels, including online (via computer, tablet and mobile), brick-and-mortar, kiosks, television, radio, direct mail and catalog)

- Omni-channel capabilities include buy online/ship from store, buy online/pick up in store, see store inventory online, reserve online/pick up & pay in store, cross-channel returns/exchanges, associate in-store ordering/endless aisle (e.g., buy in store, item ships from web), home delivery for out-of-stock inventory and reserve in-store inventory online
- While 80% of consumers now research products online, 75% still prefer to buy them at a physical retail location
    - Consumers are browsing online using mobile devices, finding what they want, identifying the nearest store where they can buy it and going to that store to purchase
- The Amazon Effect: Amazon is redefining consumer expectations of **ALL** retail channels
    - Excluding in-store pickup of online purchases, shoppers are traveling to brick-and-mortar stores less and less, favoring online retail channels that require no travel time and offer rapidly evolving fulfillment options including two-day, next-day and ultimately same-day delivery
- By 2017, 50% of all US retail sales will be omni-channel (i.e., initiated in one channel and completed in another)

B2B Trends

Commerce Enablement Software Platforms

- Companies spend an average of 4.6% of online revenue on eCommerce technology infrastructure (inclusive of app licenses, fees and resources)
- One-third of retailers have already implemented omni-channel fulfillment capabilities
- A major re-platforming cycle is underway for systems built in 2003-2010, with 25% of systems expected to re-platform in the next 2 years and 54% in the next 4 years; omni-channel capabilities will be a key focus of this cycle
    - To support cross-channel scenarios, retailers are revisiting their existing paradigm for order management and enabling their entire universe of inventory across all channels
    - Requires complex consolidation of disparate inventory data that typically lives in legacy point of sale (POS), warehouse management, ERP and mainframe systems
- The following B2B commerce features are key criteria for companies selecting B2B vendors:
    - **Premium customer experience online and on mobile** – Front-office content, community and commerce features that meet customer expectations for 24/7/365 ordering, real-time customer service and expedited shipping
    - **Robust back-office functionality** – Streamlined intra- and inter-system connections, complex order orchestration and fulfillment workflows; integration capabilities to interface with real-time pricing and inventory information
    - **Mobile compatibility** – Online, tablet, and mobile strategies implemented in parallel, with responsive design capabilities and multiplatform smartphone/tablet support
        - One-third of activity on Cyber Monday came through mobile devices, up from just 4% three years ago (IBM)
        - Global commerce sales via mobile devices are expected to top $638 billion in 2018, with tablets, not smartphones, as the primary drivers of growth (Goldman Sachs)

    - <u>Location targeting technology used to tailor promotions</u> to those who are nearby or already in store (i.e., retailer uses consumer's purchasing history to push coupons or other offers to the device using GPS or Wi-Fi)
  - **Support transformative nature of enablement offerings with qualitative and quantitative business case that drives sustained investment** – ROI case studies enable B2B companies to demonstrate the transformative value of their software/services

<u>**Retail Analytics**</u>

- <u>Increase in available customer data</u> (e.g., basic demographic information, purchase history, call center interaction, mobile/social interaction, supply chain data) due to growing cross-channel volume
  - <u>Focus on customer behavior data</u> (e.g., transaction data, foot traffic, in-store checkout wait times) to understand how customers are researching and buying products
  - Retailers have introduced in-store kiosks, free Wi-Fi and mobile devices for sales staff that allow them to better serve customers in-store
- <u>Improving personalization</u> as "big data" enables retailers to adapt communication and sales techniques to life events and preferences
  - <u>Personalization can deliver five to eight times the ROI on marketing investment and boost sales 10%</u> (Harvard Business Review blog)
  - Facebook and Twitter allow retailers to target specific subsets of customers based on their online habits
- <u>Segment and prioritize the most valuable customers</u>
  - Top 1% of customers spend as much as the bottom 50% combined (RJ Metrics)
  - The LTV for a company's top 1% of customers is worth 30 times more than its average customers (RJ Metrics)

B2C Trends

<u>**Social (B2C and B2B2C)**</u>

- <u>Emphasis on interactive technologies that allow two-way communication</u> between the merchant and the consumer
- <u>Rise of mobile further enables shoppers to price-compare and solicit advice from friends</u>
  - Facebook and Pinterest combine for over 56% of social generated eCommerce
- Visual websites (e.g., Tumblr, Pinterest, Instagram, Wanelo) becoming user-generated catalogs with shopping ideas, fashion tips and wish lists
  - 63% of online shoppers said they plan to use online catalogs; 35% said they plan to use Pinterest to make purchases
- Broadening social commerce demographics from mobile-savvy consumers in their teens and early twenties to include females between the ages of 30 and 49
- <u>Power of social recommendations</u>
  - Consumer reviews are nearly 12 times more trusted than descriptions that come from manufacturers
  - Across the Bazaarvoice client network, mobile shoppers who view customer content (e.g., reviews) show 133% higher conversion rate
  - <u>The number of reviews and average rating on a product correlate closely with conversion to purchase</u> (e.g., in the Beauty product category, when the number of reviews increases from 1 to 15, orders increase 56%)

<u>Marketplaces (B2C and B2B2C)</u>

- Marketplaces display sellers' wares, collect orders and payments, forward orders to the seller, track delivery and release payment to seller after deducting a fee
  - Unlike conventional commerce websites, marketplaces transfer the responsibility of maintaining inventories, logistics, images, product descriptions and pricing to the seller
- The marketplace model provides a valuable online go-to-market channel for many "smaller" retailers while offering consumers depth of product choice across a centralized platform
- Key differences from traditional commerce models include:
  - <u>Low capital intensity</u>
  - <u>No inventory risks</u>
  - <u>Greater and faster operational scalability</u>, particularly into new geographies
  - <u>Powerful network effects</u>

<u>eRetail</u>

- <u>Consumer adoption of omni-channel merchandising</u>
  - Omni-channel customers shop more and purchase more often (e.g., in a department store, omni-channel customers purchase nearly 30% more than their single-channel counterparts due to the net effect of being present in a curated retail environment)
- <u>Continued success of business models that disrupt traditional retail channels</u> (e.g., Warby Parker in eyewear, Dollar Shave Club in razors, Blue Apron in groceries, Rent the Runway in fashion)
  - Creating new channels and models (e.g., subscriptions in the cases of Dollar Shave Club and Blue Apron) for procuring non-discretionary and discretionary goods (similar to Quidsi in diapers)

KEY OPERATING METRICS

- B2B
  - Revenue model (software subscription, variable transaction-based fees (often a % of gross merchandise value, or "GMV"), professional services, etc.)
  - Mix of software and services revenue
  - Gross margin
  - Average revenue per customer
  - Customer acquisition cost
  - Churn
  - Customer lifetime value / payback period
- B2C
  - Gross margin, contribution margin
  - Average order value
  - Number of items per order
  - Annual order frequency
  - Customer acquisition cost
  - Customer lifetime value / payback period (according to <u>Lightspeed Venture Partners</u>, the target payback period is less than one year)
  - Operating expenses / leverage

INVESTMENT THEMES

- ***Platforms*** – We are interested in commerce enablement software platforms because they are similar to the SaaS models with which we are familiar yet still provide exposure to the rapidly growing omni-channel commerce market. It is common for platform companies (e.g., Demandware, Brightpearl) to charge a minimum subscription fee as well as a variable transaction-based fee based on the percentage of gross revenue processed through the platform, which allows platforms to benefit from their customers' growth. This hybrid revenue model is attractive as it provides the stability of recurring subscription revenue and the upside of transaction-based fees.

- ***Marketplaces –*** We are interested in the marketplace model due to the high operating leverage and powerful network effects. Unlike the "hit-driven" model of most B2C commerce businesses, marketplaces provide a platform that brings together both buyers and sellers with low capital intensity and no inventory risk. B2B2C marketplaces (e.g., Miinto, Shoptiques) are particularly interesting as they generate both platform fees from businesses participating in the marketplace and transaction fees from consumer purchases. As such, B2B2C marketplaces yield higher margins than B2C marketplaces due to the recurring platform revenue.

- ***Differentiated Merchandise eRetail*** – We are interested in eRetailers that are able to carve out a sustainable market niche by providing a unique product assortment (e.g., The Clymb, Pet360) and/or proprietary merchandise (e.g., Bonobos, BaubleBar). Such eRetailers attract a highly engaged audience and build a community around their differentiated products and experience, which yields loyal followers and repeat customers. Additionally, differentiated eRetailers generate higher gross margins and are less prone to commoditization and competition from Amazon, which, due to its scale and competitive pricing, would otherwise win.