DISINTERMEDIATION: AN EXPLORATORY STUDY OF CHANGING CHANNEL STRUCTURE IN E-COMMERCE B TO C MARKETS

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ABSTRACT

This paper examines the use of a distribution channel disintermediation strategy in selected firms by industry type. Multiple cases reported in the literature and financial media were examined to develop a set of theoretical constructs that could serve to guide future research. Fundamental issues in disintermediation were identified from cases and relate to strategic customer or market focus, innovativeness of corporate culture, and product characteristics.

Keywords: E-Commerce, Value Chain, disintermediation, e-business

INTRODUCTION

The Internet may be viewed as a new channel of distribution—a way of getting products, services, and information to consumers. As such, the Internet and its increasing, widespread use has created the potential opportunity for firms to more efficiently bring products or services to consumers because of the direct link between the manufacturer and the individual consumer any where in the world. With this direct link available, producing firms may be able to eliminate previously required partners or links in the channel of distribution—known as disintermediation, thus eliminating concomitant costs. A number of firms have seized this potential opportunity to market and sell directly to consumers, yet the effects are just now becoming known.

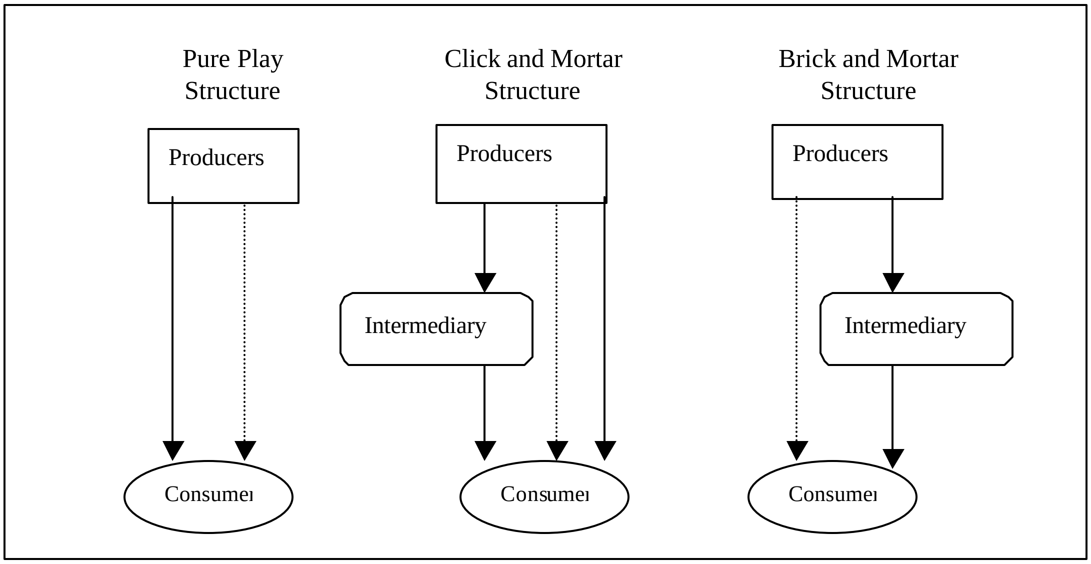
The purpose of this paper is to examine disintermediation of channel partners as firms move part or all of their distribution channel to the Internet. Since this study is in its very early stages and given the lack of empirically grounded theory on the topic, the primary focus will be on theory building. Case histories and trends of manufacturers, services, and retailers that have disintermediated channel partners are examined. Factors contributing to and effects of disintermediation will be examined in an effort to identify significant issues that will serve as a theoretical basis for future research as recommended in the literature(1, 2, and 3).

INTERNET CHANNEL STRUCTURES

The potential connectivity of manufacturers and sellers with consumers provided for by the proliferation of the Internet has dramatically affected the channel of distribution for many firms. Most notably, the need for middlemen has been eliminated or reduced, a process generally referred to as disintermediation. Although the term *middleman* or intermediary can cover a wide range of channel participants, disintermediation is primarily focused on distribution channels and the development of direct sales channels between the company and its customers. It is this distribution channel focused definition of disintermediation that is the focus of this paper.

Three basic structures exist for firms who employ the Internet in their channel strategy, as shown in Figure 1. Though all firm structures shown use the Internet to communicate directly with consumers, only two structures allow selling directly to consumers. First, firms, known as pure play or *dot.coms*, communicate with and distribute directly to their consumers over the Internet and have no other form of communications or distribution. Examples of such firms include Amazon.com and Seattle Film Works. In the second structure, hybrid or *click and mortar* firms (firms that have traditionally had a physical presence but now use the Internet to both communicate with and sell directly to consumers) bypass distribution intermediaries, selling directly to the consumer online, as well as in a physical location. Examples of click and mortar firms include Barnes and Noble, Levi Strauss, J. C. Penney and Compaq. The last structure is the *brick and mortar* structure where the Internet is used strictly to communicate with potential consumers and to refer them to the geographically appropriate brick and mortar intermediary. Examples are automobile manufacturers, such as Ford Motor Company and General Motors, where franchise agreements prohibit the sales of cars over the Internet (4).

Figure 1. Structures Using the Internet for Communications and Sales/distribution*



* Dotted lines refer to Internet communications lines and straight lines indicate Internet sales/distribution

The Click and Mortar structure has posed the greatest threat to channel partners since these partners may be completely bypassed at some point. Moreover, adoption of this structure type may limit or restrict a producer firm in its options for reaching consumers even though distribution costs are reduced. In the next sections, several case histories are examined in an effort to identify factors that may influence the propensity to disintermediate and critical success factors for pursuing this strategy.

DISINTERMEDIATION CASE HISTORIES

Disintermediation: Retailers to Consumers

By the end of 2001, online spending on apparel should reach $2.4 billion (5) with 60 percent of Internet users reporting that they shop for clothing online, and 41 percent shop for apparel monthly (6). Online sites of traditional stores or catalogs were the benefactors of online shopping with 80% of consumers who shopped online in the past six months shopping there. Moreover, about one-third of online shoppers report apparel shopping at familiar brand name manufacturers operated sites (6). One financial analyst predicts apparel sales to increase 12 percent over the decade while expecting sales at stores and catalogs to remain flat (5). These findings strongly suggest that apparel retailers establish and maintain a selling presence on the Internet and the experiences of several firms, J. C. Penney, Bluefly.com, and Boo.com, provide some lessons for implementation.

Bluefly.com and Boo.com are both pure play firms, selling clothing directly to consumers only online, but each with different results. According to its firms May 10, 2001 press release, Bluefly.com, began in 1998 as a discount Internet retailer of designer fashions. The year 2001 first quarter sales were $4,646,000, a 24 percent increase over the previous quarter, with a gross profit of $1,283,000 (up 92 percent). Like many dot.coms, the firm continually sustains net losses, with a net loss of $3,909,000 reported in the quarter ending March 2001. The firm also reports acquisition costs of new customers of $41, an average order size of $129, and a percentage of total sales attributable to repeat customers of 56 percent. As a result of cost cutting measures already implemented and increasing sales, losses are decreasing at an increasing rate and the firm hopes to become profitable by the end of 2002. A loyal customer base, (10 percent of the customers visit daily, 50 percent weekly and 75 percent monthly) (7) and increasingly smaller losses resulting in the promise of future profits indicate the likely success of Bluefly. The reasons may be attributable to its promises to consumers, that keep them coming back: deep discounts, tremendous selections, world-class service, and convenience.

Pure play firm, Boo.com, failed to achieve the 'success' recorded by Bluefly. Begun in 1999, the firm lasted only about a year in its original form. According to reports, the firm was touted to be the 'golden child of fashion e-commerce' but overspent (in excess of $125 million) in every area including marketing, had 400 employees, and had five launches with glitches that meant a virtually inoperable site (8). The reasons for the failure of the firm are likely summarized in this quote: "It was a classic tale of over-everything—over-promise, over-expansion, over-spending, over-hiring and over-ambition—followed by disastrous underachievement" (9, p. 37).

Traditional apparel retailers have also ventured to the Web, potentially disintermediating their own retail outlets. Most notable for its successful efforts is J. C. Penney, cited as the most popular apparel site on the Internet with year 2000 sales at $294 million and projections of $1 billion by 2003 (10, 11) despite flat sales in their brick and mortar and catalog divisions. As of an April 12, 2001 press release, the firm had Internet sales of $88 million in March and April compared with $54 million during the same time period in the previous year.

J. C. Penney's key to success is developing the "Internet sites around specific customer needs and lifestyles" (12, p. 5) such as providing a "3-D cyber model", which allows customers to see themselves in different apparel. Also, contributing to success is the infrastructure that successfully fulfills orders on a timely basis, 68 million orders in 1999 at a rate of 1,000 orders a minute, and 14 telemarketing centers, 200,000 items online, and connectivity (returnability) to local brick and mortar local sites (11). The importance of efficient and timely fulfillment centers is paramount considering that one survey found that two-thirds of respondents had noted online transaction problems and that 66 percent felt they would receive better service in stores than online (13). Added to these advantages is the previous experience J.C. Penney had in the direct marketing arena, where the principles seems to transfer well to the Internet marketplace.

Disintermediation: Manufacturers to Consumers

Development of direct to the customer relationships is not limited to traditional sales outlets. During the 1990's, a number of manufacturers attempted to disintermediate some or all of their distribution channel partners. This form of click and mortar arrangement is particularly problematic in that these companies become competitors to their customers, raising legal and ethical issues.

Jeans manufacturer, Levi Strauss launched a Web presence in 1995 and later began efforts to sell clothing directly to its teen and young adult consumers at the site. Though the strategy seemed fail proof, considering that 80 percent of Web users visit manufacturers' Web sites (14), Internet sales were halted in 2000. Internet sales were insufficient to cover costs. For Levi's, customers are "going into the store and buying and touching the goods. The Internet is not going to substitute for bricks-and-mortar shopping," according to CEO and president of the company, Philip Marineau (15). Levi's has now begun efforts to reintegrate channel partners by working with its intermediary retailers to build sales in their stores and at their Internet sites. The company's Internet presence is used to build brand image that serves to boost sales along all distribution channels.

The sale of personal computers to consumers has traditionally occurred through a series of sales intermediaries. These sales intermediaries include retail outlets (i.e., Radio Shack and CompUSA) and specific authorized dealerships (e.g., Apple Computer, and NEC) where these contractual relationships presented a barrier to entry in the personal computer industry. However, in the late 1980's and early 1990's companies, such as Gateway 2000 and Dell Computer, introduced a direct sales model into the personal computer industry, eliminating the retailer middleman. This model focused on selling to highly knowledgeable computer users in both the consumer and business areas of the pc market. With the increased popularity and functionality of the World Wide Web (WWW), these direct sales firms developed Internet-based channels to market and sell products.

Though lagging behind its competitors, Compaq Computers finally began to redesign its sales channels, incorporating direct sales to consumers using an Internet-based catalog and ordering system (consumers could also place orders via the phone) along with its retail establishments and dealers, in an effort to overcome declining market share. Reaction to Compaq's direct sales effort was very negative. Compaq's entry to direct sales was considered to be too little too late (16) and with the fear that direct sales would only cannibalize the company's traditional dealer-based sales channel, dealers expressed concerns over their ability to obtain favorable pricing and delivery terms with Compaq. As of a July 10, 2001 company news release, Compaq is restructuring and aggressively cutting its supply chain costs to combat its decline in revenue.

Disintermediation: Financial Services Industry

The financial services industry, which includes banks, brokerage firms, insurance companies, and like industries, has disintermediated channel members to some degree for quite some time with dramatic effects. For example, disintermediation has forced a change in the relationship of the branch bank with the consumer where the use of branch bank services has declined from a high of 70 percent usage in the 80's to a 40 percent usage level today (17). Even more, banks worldwide have progressed through three levels of disintermediation according to Azzam:

- "the first involved the growth of mutual funds at the expense of bank deposits;
- the second saw the bond market taking on some of the banks' traditional role of providing credit; and
- the current third disintermediation is in the distribution of banking products over the Internet." (17)

There is little question that the Internet has changed the delivery system in the banking industry, so that increasingly, consumers seems to prefer direct delivery channels for conducting their banking business. This means that the future of banking may require a focus on selling services, even more than making loans. In fact, some mortgage bankers think that mortgage banks face the prospect of being cut out of the mortgage process altogether because of the advances that have been made in technology through the Internet (18).

In the past, bank customers were limited to the product offerings selected for them by their local bank. Now, however, online banking has given the consumer the ability to choose products from expansive, worldwide offerings. This is a critical shift in the banking process. In response to this threat, banks may, however, use the Internet to EXPAND their banking operations. A number of the larger banks, for instance Wells Fargo, have spent considerable time, effort, and money on Internet technology to expand their opportunities (19). Online since 1989 and offering online banking services for customers since 1995, Wells Fargo bills itself as the "#1 Internet bank." This commitment to direct-to-consumer Internet and technology delivery at Wells Fargo is evident from the company's press releases in the past year, which show a pattern of continuous new Internet offerings. Examples include an online full-service brokerage, Commercial Electronic Office (CEO), which offers a one-point portal to all banking and financial services needs for commercial customers; and, uniquely a satellite-enabled bus with 16 Internet terminals created to span the country educating customers on Wells Fargo offerings.

Consumers also seem to be seeking other direct delivery channels for banking related services. Banks, Internet companies, and software development firms are forming consortiums that are offering even more choices for banking and brokerage services to consumers. These consortia are developing innovations such as open standards that allow for Open Financial Exchange (OFX) where there is an easy exchange of information between customers, financial institutions, and the Internet (20). Microsoft, Intuit, and CheckFree and many Internet vendors have signed up for the OFX. Charles Schwab & Co. has also joined the consortium with many other brokerages and banking firms to follow. This technology and service offering means that consumers now have the capability of doing considerable research and transaction activity on their own. This capability threatens brokerage firms in many ways but primarily by the potential to eliminate the middleman and the old brokerage/customer relationship. As Wiesul stated,

"Some brokerages call these practices 'customer disintermediation': but it is the brokerage . . . that's in danger of being left out of the loop" (20).
Another recent innovation that further threatens the banking industry is MSFDC (WWW.MSFDC.COM), which offers some interesting services to consumers and customers in monthly or periodic billing. This Internet service allows companies to bill consumers online and for the consumer to pay these bills online. The companies save 35 to 50 cents for each bill and the consumer saves the cost of postage and other factors. This service may not only disintermediate banks, but also the postal services, U. S. and others.

FACTORS INVOLVED IN MOVING TO THE INTERNET

There are a number of factors described in the literature and learned from these case histories that serve to drive industry incumbents to pursue Internet-based sales channels. Chief among them is heightened competition. The ability to be in the market on a continuous basis and react quickly to consumer needs is now a competitive necessity rather than a competitive advantage (21 22). For the most part, in the cases discussed above, the chief justification for moving to the Internet was to retain the competitiveness of the company through cost reductions and preservation of market share. This represents a traditional internal focus for action rather than an externally oriented customer focus though much of the e-commerce strategy literature encourages organizations to adopt a customer-oriented focus (21, 22, 23, 24). This difference in strategic orientation of the Internet initiatives by incumbents versus pure-play challengers represents a potential theoretical difference across the three distribution channel models described in Figure 1.

Also at issue in the cases examined, is the reaction of incumbents to the entry of pure-play firms and other innovative competitors into their respective industries. In the case of Compaq, its early lead in the personal computer industry and large sales channel was not able to save the company from slipping behind the more innovative Dell Computers. This inability to hold market leadership despite established distribution channels and an established technical brand demonstrates the fleeting value of both barriers to entry (25) and technological leadership (26). In a study of barriers to entry, Han, et al. (2001) found that barriers based on capital requirements, switching costs, and distribution channel access were highly susceptible to innovative new market entrants. These new entrants (e.g., Wells Fargo, Bluefly.com, Amazon.com, Dell) tend to be technologically innovative and proactive in approaching markets (27). Companies like Compaq and Barnes and Noble find themselves reacting to market encroachments by these innovative organizations. The second theoretical difference between channel models, then, is that of innovative/proactive corporate cultures versus reactive (those who wait for an innovation to achieve a critical mass) cultures.

The final issue highlighted by the cases presented in this paper is that of product type and value of selling that product via an electronic channel. A major criticism of online selling is that the medium is most suited for sales of digital products (i.e., software, information, airline tickets). Companies selling more tangible items like furniture and apparel have found success much more difficult. In the case of Levi Strauss, the activity of purchasing custom blue jeans did not lend itself to the web and was rejected by consumers. Characteristics of the product may impact an organization's ability to establish direct sales channels, and more specifically use the Internet to facilitate distribution.

Aside from the issues of market focus, innovativeness of the firm, and the product, the cases examined suggest other factors that may affect disintermediation and online, direct-to-consumer success. They include:

- Familiarity of brands and offerings
- Sales generation costs versus costs of being online
- The value added by channel partners
- Excellence or deficiencies in fulfillment and customer service
- Convenience and ease in shopping, trialability and returnability
- Glitches in the site
- Value provided to consumers at the site, such as convenience, timeliness, and information
- Linkage of direct marketing practices with the Internet presence
- The ability to build and sustain customer relationships

CONCLUSIONS AND FUTURE DIRECTIONS

This paper represents the first theory building steps in a program of research to examine the way that companies use the Internet to reconfigure the distribution channel as a competitive strategy. Published cases and information from the financial media on both retailing and manufacturing firms were examined using a multi-case study approach to theory building (1).

From the information gathered from these case descriptions, three fundamental issues were identified that may impact the success and feasibility of conducting electronic commerce. The first dimension observed is the strategic market focus of the organization. Many of the cases examined found an internal orientation to disintermediation, focusing on market share rather than a customer orientation that focuses on establishing customer relationships. The second dimension observed is the level of innovativeness present in the corporate culture. Understanding the tendency of the organization to lead or follow technological trends may be insightful in examining how companies form value chain relationships. Finally, the nature of the product moving through the distribution channel exerts an influence on the decision to disintermediate and the configuration of the channel.

The next phase of this research is to expand upon these three constructs. A subsequent round of case study analysis is planned to expand and develop these initial three constructs. Additionally, other forms of disintermediation, beyond distribution channels, will be examined. The majority of case and anecdotal evidence on disintermediation focuses on the establishment of distribution channels that directly connect the company to end consumers. Given the rising use of Internet-based systems to manage the back-office and production processes, additional research is required to understand the issues surrounding these systems.

[Reference Available Upon Request]