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Small Business Survival in Competition with Large Multi-Unit Retail Firms

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Purpose

The Small Business Administration's Office of Advocacy regularly tracks changes in the market conditions in which small businesses, including retailers, compete. "Main Street" independent retailers have faced competition in the past from large chains and others opening stores in suburban malls. More recently, so-called "category killer" or "big box" stores have added further competition. Now the Internet is adding a third level of competition for large national chain stores and independent retailers alike.

To learn more about how this third wave of competition is affecting the competitive balance in the retail sector, and about possible policy implications of such changes, the Office of Advocacy contracted with Jack Faucett Associates for this two-part study. Part 1, "Market Analysis of the Retail Book Industry," is a case study that examines the impact of the Internet and other technological developments on independent, multi-unit, and Internet-based book-sellers. Part 2, "On-line Retail Market Dynamics" provides an overview of competitive considerations in several consumer segments.

Scope and Methodology

The researchers used a variety of sources for their report. Part 1 makes use of data from the American Booksellers Association, the Association of American Publishers, NPD Group's Consumer

Research Study on Book Purchasing, and the Bureau of the Census. The firm became the first Advocacy contractor to gather information by posting questions on a bulletin board on its Web site. The researchers also conducted interviews and digested academic, online, and trade publications.

For Part 2 the firm turned to surveys and analyses by investment advisors and market measurement firms. The researchers present snapshots of current and potential market penetration by on-line retailers in toys, apparel, home furnishings, drugs/pharmaceuticals, office supplies, and electronics, along with brief discussions of factors that enhance or limit the potential for electronic retailers in each segment. The report concludes with an assessment of factors affecting small business competitiveness.

Highlights

Highlights of the researchers' findings in Part 1 of the report, "Market Analysis of the Retail Book Industry," include:

- Significant economies of scale exist in book retailing, enabling the largest retail chains to expand their market share. Nonetheless, independent book-sellers have managed to survive by competing in markets that chains do not dominate, such as by exploiting prime geographic locations, specialization, and niche markets.
- Hundreds of independent bookstores have established online stores. Barriers to entry on-line are low,

but these markets are more concentrated than traditional bricks-and-mortar markets because the small retailers no longer have the advantage of convenient location.

- The impact of online commerce varies by segment of the market. Many small rare-book sellers have benefited from the emergence of auction sites and rare-book search engines. Independents that engage in mail-order sales have found online sellers to be formidable competitors. The academic textbook market may be more suited to smaller retail operations because the needs of student customers are determined locally by the specific course offerings at particular schools.

- Many aspects of Internet markets are favorable to small vendors. Internet commerce service providers have substantially reduced the technical difficulty associated with setting up a database-driven web site capable of handling commercial transactions. Many independent booksellers have found that an online presence can serve as a useful mechanism for promoting traditional retail activity. Traditional retail operations may also serve to reduce marketing costs for online sites.

- Affiliate marketing can provide on-line small businesses with some of the advantages that location provides off-line retailers. Large Internet retailers often derive as much as 2 percent of their revenue from tie-ins to other sites. A number of small retailers are using such affiliate marketing, though there is currently little data to evaluate the effectiveness of these programs.

- Internet commerce enhances the market for niche players. Access to large markets via the Internet makes possible the emergence of specialized “gnatagory killer” retail sites if such sites can differentiate themselves based on content and services.

- While the cost of getting on the Internet is low, there are other barriers to effective competition by small firms. The expense involved in marketing a web site can be a significant barrier to entry for small businesses. The researchers’ analysis of book sellers’ financial data shows that combined occupancy costs and advertising expenses for Amazon.com are 11 percent of sales, higher than the 9.6 percent reported by a sample of independent off-line bookstores. Economies of scale in advertising, branding, and cross-selling provide competitive advantages to large online retail operations.

- Other technological developments may also shape the market. The falling cost of on-demand

printing may make it possible for small land-based retailers to compete better with online businesses by providing on-site production of publications. Conversely, the emergence of electronic books may give online retailers an advantage by allowing customers to download books without entering a store or waiting for a package to be shipped.

Highlights of the researchers’ findings in Part 2 of the report, “On-line Retail Market Dynamics,” include:

- Although the Internet initially favored small startup firms, online retail markets are likely to be more concentrated than traditional retail markets in the future. The low barriers to entry into Internet markets suggest that those retailers that can achieve economies of scale quickly may capture a large market share. Information is the main component of customer service in on-line markets. Site content is an asset that can easily be scaled to serve a greater number of customers.

- The potential utility of Internet commerce differs across retail sectors. Many analysts expect Internet retailing to be larger than mail-order retailing, which currently accounts for approximately 3 percent of total retail sales and 6 to 7 percent of many retail categories.

- Internet commerce service providers have emerged in many retail categories to help small firms establish commerce-enabled Web sites. These firms significantly reduce the technical burden of building Web sites with extensive product data bases and secure credit card transaction-processing capability.

- Online commerce is likely to become more integrated with catalog and store-front retail operations in the future. Small traditional retailers who go online have important resources that can be used to reduce Web site marketing costs.

Conclusions

The Internet is a double-edged sword for small businesses. The Internet lowers barriers to entry into markets, but it also increases the importance of branding and allows large businesses to more easily leverage economies of scale.

The Internet economy has been favorable to small business startup companies, which have shown a greater ability to innovate in this new market. As the Internet economy matures, it is unclear whether this favorable environment for small businesses will continue.

Ordering Information

The full text of this report, along with summaries of other studies performed under contract to the U.S. Small Business Administration's Office of Advocacy, is available at www.sba.gov/advo/research.

Printed copies are available from:

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The National Technical Information Service's complete data base of federally funded business research is available on the Internet at www.ntis.gov.

Some studies related to this report include the 1999 Office of Advocacy staff report *E-Commerce: Small Businesses Venture Online* and a 1996 contract study, *Lilliputian Strategies: Small Business Responses to Big Business Entry*, by Reginald Litz (see *Research Summary* no. 172, December 1996).