

The E-commerce (R)evolution: New Business Models and Investing Opportunities

Unlocking the potential of e-commerce

The proliferation of e-commerce business models around the globe this past decade has been remarkable to watch from an investment perspective. Yet, despite the massive surge in online spending since the start of the pandemic in 2020, e-commerce as a percentage of all retail sales remains below 20% across several major markets, including the U.S., Continental Europe, and Latin America.¹

Therefore, we believe that many of the world's leading e-commerce platforms have ample runway to become much larger in scale and breadth of services. The heat map in Figure 1 shows the largest e-commerce companies in terms of sales and some of the attributes of their business models.² As investors, it's intriguing to watch the evolution of these different platforms and the approach they utilize to compete in their respective markets and define their value proposition to customers.

Figure 1: E-commerce business model heatmap



Source: Polen Capital, Bloomberg (as of September 2021).

1 E-marketer. As of May 2021.

2 Within a universe of publicly traded companies that generate at least \$100 million in absolute e-commerce sales and where e-commerce sales are at least 1/3rd of total revenues. Excludes vertical-specific e-commerce companies that only sell to one type of end market.

The importance of inventory management

As seen in the heat map, most of the largest e-commerce companies utilize both first-party (1P) and third-party (3P) inventory offerings. Some platforms, such as Amazon, began as 1P businesses and added a 3P marketplace a few years later. Others, like MercadoLibre, have pursued the opposite strategy, starting as a 3P marketplace and then adding their 1P inventory later.

The 3P strategy, initially pioneered by eBay, is a model that positions the e-commerce business essentially as a middleman for sellers and buyers. In this system, the marketplace typically takes a percentage of each transaction performed by the seller, plus add-on charges for other services. Even within the 3P model, there can be variations. For example, while eBay's third-party sellers are typically responsible for storing their own inventory and shipping it to the buyer, Taiwan's Momo.com holds their merchant partners' inventory at their warehouses on consignment before it ships.

Given the less capital-intensive nature of their operations, 3P platforms are generally easier to scale and tend to have higher profit margins than 1P platforms. This has enabled them to grow at a fast pace in many regions beset by economic, social, and other structural challenges. Despite this advantage, several companies have also integrated a 1P offering to meet new consumer demands. 1P typically provides the business more control over the pricing and selection of their products, which can be a valuable tool for retaining customers.

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Still, other more inventory-specific platforms such as Etsy—which focuses on handcrafted and vintage items—make far more sense as a 3P marketplace to us, given its smaller scale, less complex seller base and its products' unique, custom nature. Etsy's niche-oriented 3P model has helped the company thrive by selling large numbers of specialized long-tail products, rather than more generic, mass-marketed items.

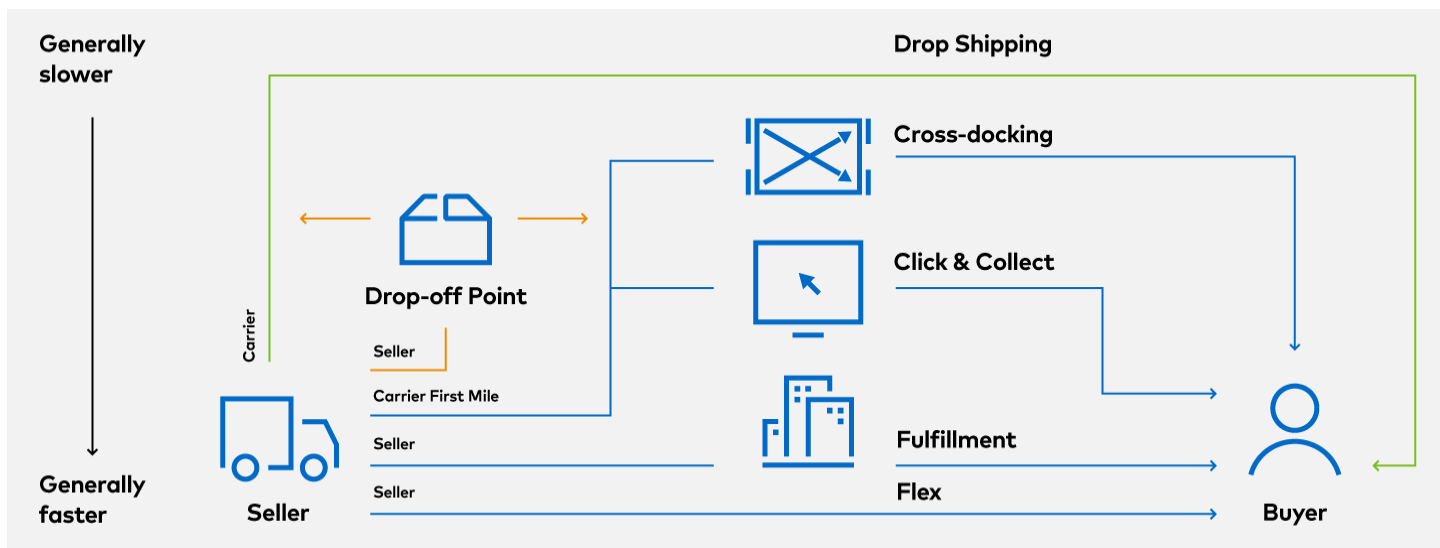
While most platforms in the heat map have adopted 1P and 3P strategies, there is no one-size-fits-all approach to e-commerce. Factors including competitive dynamics, customer preferences, investment capabilities, and geography can all affect a company's strategic choice. Over time, it is also not uncommon for different e-commerce models to converge in terms of their breadth of offerings, as competition drives businesses to implement new features to rival their peers.

Logistics as a competitive advantage

Another increasingly prominent feature of e-commerce platforms is in-house logistics capabilities, which allow businesses to fulfill orders for their customers directly. Once again, as seen in the heat map, companies have taken different, sometimes multi-pronged approaches to how they prefer to handle the fulfillment and delivery of their merchandise. Logistics models can become quite complex, as Figure 2 shows, with many options available depending on the region.

Dropshipping, whereby a third-party provider handles the entire logistics process, enables retailers to focus on sales by outsourcing the fulfillment process. Dropshipping can lower overhead costs since it doesn't require the seller to keep inventory in stock. Instead, the business sells the product and passes the order to the

Figure 2: Logistics models



Source: MercadoLibre (as of October 2021).

third-party, which handles the picking, packaging, and shipping. However, the system does come with some limitations. For one, since products are sent directly from vendors to customers, there is little opportunity for quality control (e.g., order tracking) and customization along the way.

Several e-commerce businesses are also integrating the Click & Collect model, which enables shoppers making purchases online with the ability to pick their order at a designated site rather than have it delivered to them. The pickup location is usually centralized, such as at a physical store, kiosk, or purpose-built locker. Click & Collect is generally a more cost-effective alternative to the traditional fulfillment model, where the marketplace ships the order directly to the customer from its warehouse.

Several e-commerce businesses are also integrating the Click & Collect model to allow pick-ups at a designated site.

Meanwhile, the emergence of the “gig economy” has given way to the “flex” model, which connects sellers that have products to ship with independent contractors who get paid to deliver packages using their vehicles. The “flex” model—most common in highly dense, urban areas—offers a solution to the challenges of “last mile” deliveries, usually considered one of the most complex and costly aspects of fulfillment. It is worth noting that not all companies need to become logistic powerhouses to be competitive. For example, Singapore’s Sea Limited favors a less capital-intensive system and relies primarily on dropshipping from third-party logistics partners.

In comparison, Amazon has invested billions of dollars into its logistics infrastructure (composed of fulfillment centers, trucks, drones, planes, etc.) to deliver the products on its platform and position itself as a vital service provider for its 3P merchants. Though initially capital intensive and margin dilutive, logistic investments can help optimize the customer experience (thanks to quicker deliveries and fewer lost orders) while also reducing shipping costs.

Monetizing through e-commerce

In recent years, e-commerce businesses have found new ways to expand their monetization strategies, unlocking new sources of revenue. While some of them maintain their focus on traditional online retail, others have also developed subscription-fee models. One option is to charge sellers a monthly or yearly fee to have

access to the marketplace. Another is to collect a recurring fee from customers who want to subscribe to products and services on an ongoing basis.

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In turn, many tech-driven e-commerce platforms have been able to capitalize on their software tools by offering third-party sellers additional services, including designing, setting up, and managing their own online stores. Still, almost all platforms tend to charge at least a transaction fee for every order processed, while several longer tail platforms—which generate most of their revenue by selling relatively smaller quantities of many different niche items—also add listing fees for each product the seller posts online, regardless of whether the product sells.

Navigating the e-commerce investing landscape

While investors may raise the question of which models make the best investments, we believe that the answer depends on various factors, including the company’s size, target audience, product offerings, and growth outlook. Ultimately, it is our view that the best business models are those which provide a superior value proposition to their customers and key stakeholders. Looking forward, we expect e-commerce platforms to take advantage of new technologies like 5G, blockchain, internet-of-things (IoT), automated robotics, virtual reality, and artificial intelligence, illuminating new investing opportunities along the way.



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