

RETAILING IN AN ERA WITHOUT ONLINE/OFFLINE BOUNDARIES – JAPAN'S PATH TO OMO –

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SUMMARY

- A merging of the online and offline spaces is attracting attention in the retail industry, and the food market is one of the stages on which this process is unfolding.
- In the operations of early online supermarkets and convenience stores, a number of problems came to the fore, including a discrepancy in the targeted user demographics, the profitability of delivery services, and inventory management, and a spate of retailers withdrew or shrunk the scale of their online services. After these experiences, EC companies and brick-and-mortar retailers have now started to pursue collaboration.
- While collaboration is expected to be effective in improving business efficiency and capturing customers to a certain extent, the key to realizing profitability will be the marketing mechanisms that combine sophisticated data acquired from online spaces and offline outlets, and the establishment of an infrastructure to that end.

INTRODUCTION

A new trend known as OMO (Online Merges with Offline) has recently been attracting attention in the retail industry. OMO refers to a marketing strategy designed to improve customer experience by providing an integrated service that transcends the boundary between the online and offline worlds. One reason for the heightened attention toward OMO recently is that companies that originated in the online world are also venturing into the offline (brick-and-mortar) realm, and they are becoming increasingly active. In China and the US, Alibaba and Amazon, both of whose roots are e-commerce (EC), have invested large sums of money in brick-and-mortar stores and logistics to obtain more customers with new services characterized by a fusion of the internet and the real world, and they are posing a threat to some physical store-based retailers.

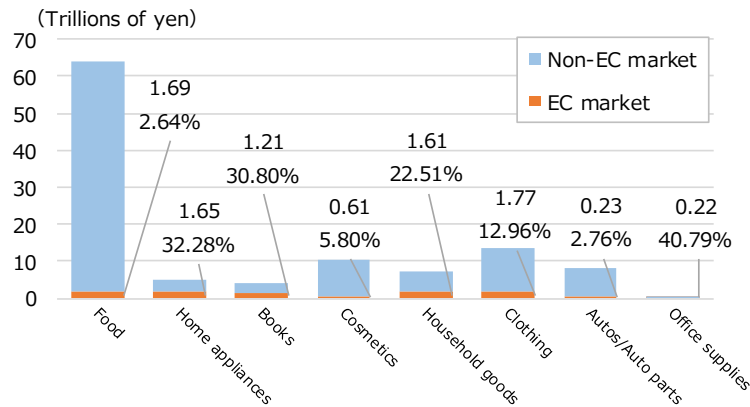
The strategy of these companies are to improve business efficiency and enhance customer experience and thereby to increase their customer base and revenue by taking advantage of the benefits and data that can only be acquired from operating both in online and offline realms. This is indeed the embodiment of OMO. While it is not as noticeable as in China and the US, a movement in line with the OMO trend is also emerging in Japan. This report reviews the trends to date in online supermarkets in Japan, centering on the food market where EC companies are particularly aggressive, and considers the possibilities and directions for future development as well as the issues involved.

1. OVERVIEW OF EC IN JAPAN

1-1 Low EC ratio of food products despite the large market scale

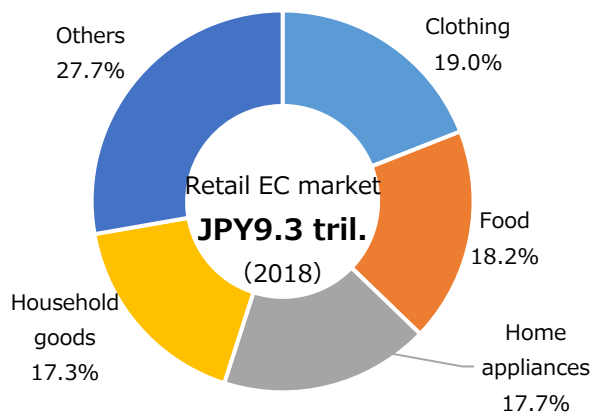
In 2018, the scale of the retail EC (B2C) market in Japan was JPY9.3 trillion, representing an EC ratio of 6.22%¹. Viewed by category, clothing and apparel items accounted for the largest share (JPY1.77 trillion), followed by food, drink, and alcoholic beverages (JPY1.69 trillion), home appliances, AV equipment, PCs and peripherals (JPY1.65 trillion), and household goods, furniture, and interior items (JPY1.61 trillion). In particular, the EC ratio of food products stands out as remarkably low at 2.64% (Fig. 1). However, since the food market itself is huge (approximately JPY64 trillion), food products still account for 18.2% of the retail EC market overall, despite having an EC ratio that low (Fig. 2).

Fig. 1 Market scale & EC ratio in the retail sector by category



Note 1: The figures in the chart show the EC market scale and EC ratio by category.
 Note 2: "Other categories" amounting to JPY308.3 billion have been omitted.
 Source: Prepared by MGSSI based on data from the "E-Commerce Market Survey" by the Ministry of Economy, Trade and Industry.

Fig. 2 Percentage share of the retail EC market by category



Source: Prepared by MGSSI based on data from the "E-Commerce Market Survey" by the Ministry of Economy, Trade and Industry

¹ To be classed as EC, orders need to be placed over a computer network system. Accordingly, transactions in which only quotations are issued via a computer network system and actual orders are placed and received by an individual verbally, in writing, or by telephone, fax, or any similar means, are not classed as EC ("E-Commerce Market Survey," Ministry of Economy Trade and Industry).

1-2 EC companies tapping into latent needs

A low EC ratio for food products is not unique to Japan, but rather a common trend in markets worldwide. There are a number of possible reasons for this. First of all, food has a shorter shelf life than other products, and some items require the temperature to be controlled, making them unsuitable for long-term storage and transportation. Also, EC does not allow consumers to confirm actual products that are of varying quality and shape before purchasing. For these reasons, food has been regarded as a sector that is rather incompatible with EC.

However, this is not to say that there is no EC need for food products. There are many people who cannot make frequent visits to retail stores for a variety of reasons. For example, elderly people who have difficulty driving or walking and people requiring nursing care are unable to go out easily, and working parents with children have the need to reduce the time and effort spent on shopping.

In other words, as it deals with products that are closely related to consumers' daily lives, the food market has huge potential for EC companies. Against this backdrop, companies such as the US's Amazon and China's Alibaba and JD.com have been focusing on exploring this area in recent years. A similar trend has started to appear in Japan as well, such as Amazon's launch of its "Amazon Fresh" EC brand specializing in food products.

2. DEVELOPMENT OF FOOD EC IN JAPAN

2-1 The uphill battle of online supermarkets

The history of food EC in Japan dates back to around 2000. When online supermarkets and convenience stores were launched back then, the idea was to add an online aspect at their offline locations. In other words, online business was introduced to supplement the core business of brick-and-mortar stores. With the use of a mechanism whereby goods were picked up from a physical store's inventory or a distribution center and delivered to the customer's home, consumers were basically able to purchase the same products that could be bought in physical stores, depending on their convenience. According to the people concerned, however, after the launch of services, a number of unexpected developments unfolded.

Firstly, while it had originally been assumed that senior citizens and other people with poor shopping access use the services, once the service started, it turned out that younger generation usage was more considerable than expected. Responding to orders from a generation that places a high priority on specific delivery times and immediacy complicated delivery operations, delivery time slots filled up quickly, and it became difficult to meet the demand for specific time or same-day deliveries. Moreover, the delivery charges of several hundred yen were not paid for themselves, and the more orders were received, the more deficits increased. As such, online supermarkets and convenience stores have come to be recognized as non-profitable business models that hardly any company could turn a profit on a stand-alone basis.

What's more, the large number of online orders made inventory management difficult. When the unexpected volume of online orders came flooding in, some products went out of stock at physical stores to cover the online orders, resulting in a counterproductive situation for physical outlets. Because of these operational difficulties, many companies withdrew or shrunk their online services one after another.

2-2 Collaboration trend between EC companies and brick-and-mortar retailers

These experiences, in turn, revealed that there surely is a demand for EC in the food sector, which is also growing. A new approach has now emerged to capture this demand and tackle the operational difficulties that became apparent with the online supermarkets at their early stage. The approach features business development through collaboration between EC companies and brick-and-mortar retailers. For example, the Seiyu supermarket chain has integrated its existing "Seiyu.com" service into the "Rakuten Seiyu Netsuper," an online grocery delivery service, newly launched in collaboration with Japan's EC giant Rakuten. In addition, the Life supermarket chain has begun selling fresh food and ready-made meals handled at its physical stores via the Prime Now service for Amazon Prime members. The Lawson convenience store chain has also started a

pilot program in collaboration with the food delivery company Uber Eats (Fig. 3).

Fig. 3 Examples of collaboration between EC companies and brick-and-mortar retailers

	Seiyu/Rakuten (Rakuten Seiyu Netsuper)	Life/Amazon	Lawson/Uber Eats	Ito-Yokado/Askul (IY Fresh)
Characteristics	Uses both brick-and-mortar stores and dedicated distribution centers	Uses stores as Prime Now logistics bases	Trial operation using the Uber Eats' UI	Tie-up with Askul's Lohaco service
Delivery	Delivery in 2-hour time slots, shortest delivery time 4 hours	Shortest delivery time 2 hours	Immediate delivery	Next-day delivery in 1 hour time slots
Launch	Oct. 2018	Sep. 2019	Aug. 2019	Nov. 2017 (scheduled to end Nov 30, 2019)
Service area	17 prefectures	7 Tokyo wards	13 Tokyo stores	Shinjuku and Bunkyo Wards, Tokyo

Note: As of October 2019

Source: Prepared by MGSSI based on information from each company's website and other sources

3. JAPAN'S PATH TO OMO

3-1 Merging Japan's online and offline spaces through collaboration

This Japanese approach somewhat differs from those in China and the US. In China, EC companies are developing their own brick-and-mortar stores, such as Alibaba's FreshHippo (Hema Fresh) and JD's 7Fresh. In the US, Amazon laid out US\$13.7 billion to purchase Whole Foods, which operates hundreds of stores across the country. Amazon is using those store outlets as distribution centers for its Prime Now same-day delivery service. Both are cases of vertical integration led by EC companies. On the other hand, developments in Japan have so far centered on collaboration between EC companies and brick-and-mortar retailers, as shown in Fig. 3.

This collaboration benefits both the EC companies and the brick-and-mortar retailers. Firstly, new investment can be minimized by utilizing the existing capabilities and assets of both parties. For brick-and-mortar retailers, the issues around logistics and inventory management can be addressed through efficiency improvements by leaving the delivery work to EC companies that possess the logistics infrastructure and delivery know-how, and by sharing inventories to handle the orders of both physical stores and EC. By the same token, the EC companies do not need to establish their own networks of brick-and-mortar stores as points of physical contact with customers. Rakuten Seiyu Netsuper mutually share Seiyu's brick-and-mortar stores as well as Rakuten's dedicated distribution centers. In this way, physical contact points are being provided to customers, while at the same time, delivery operations are made more efficient by optimizing the shipping location in accordance with its delivery destination and the content of orders.

The greatest merit of this approach is that it leads to the development of new markets for both parties. In the process of developing online supermarkets, brick-and-mortar retailers realized that an online demand exists for the products offered in their stores by certain customers. This customer segment prioritizes convenience and timesaving, and appears to accept higher prices and additional costs to some extent. In addition, by utilizing an EC interface, it becomes possible to attract new customers who usually shop at convenience stores or other stores in easily accessible locations. Providing its products to customers via Amazon's Prime Now service enables the Life supermarket chain to approach a customer segment that has not regularly shopped at Life before; in the words of Life's President Iwasaki, "This is a new opportunity for people who have not used our stores before to experience the appeal of Life."

Conversely, from the perspective of EC companies, they could gain the customer trust of allied brick-and-mortar retailers. In Japan, where consumers are highly demanding in terms of food quality and safety, the biggest challenge in developing the food EC market is winning the consumers' trust. While it is difficult for EC companies to gain that trust on their own, partnering with brick-and-mortar retailers, who have already earned the trust of customers through their daily shopping, is likely to be a bridgehead to that market.

3-2 Utilization of customer data: remaining issues and a key to success

However, it is highly unlikely that profitability can be guaranteed solely through improvements in efficiency, cost reductions, and the sharing of customer bases through collaboration. It is not clear whether the companies listed in Fig. 3 share the same issues, but some industry insiders say that at the current low product prices, set at the same levels as those offered at physical stores, and the current range of delivery charges, it is not possible to cover the cost of randomly generated demand. The IY Fresh service, which was launched jointly in November 2017 by Ito Yokado and Askul ahead of the launch of Rakuten Seiyu Netsuper, was set to be terminated at the end of November 2019, assumedly because of the profitability problem.

The key to tackling the issue of profitability seems to obtain a more detailed and personalized understanding of customer needs, and employ more sophisticated marketing, such as fine-tuned product recommendations, to appeal to those needs. Traditionally, marketing approaches of brick-and-mortar stores have been based on the changes of product lineup or their display on the shelves in accordance with the season, day of the week, or time of day, and using flyers to advertise special sale days. However, such methods represent that customers are regarded en masse, and that the arrangement of products and price settings are optimized based solely on the inclination of customers as a single group according to the retailer's experience.

On the other hand, in the online realm, such techniques that the purchasing behavior of each customer is predicted and specific products are recommended, by gleaning their needs and preferences from their purchase histories, are in wide use. For example, information such as a customer's preferences, health consciousness, and family anniversaries are identified, and in combination with weather and event information, suitable premium products are recommended to the customer through targeted advertising. As it seems that a certain number of the target customers for food EC, such as people in busy, dual-income households, are not overly concerned about price, provided that the service is more convenient and meets their needs, it is possible to pass the costs on to customers to some extent.

CONCLUSION

In the POS-oriented offline world, it was virtually impossible to obtain information linked to individual consumers. While this has been becoming possible through the advent of technologies such as payment apps, low-cost sensors, and facial recognition systems, collaborative services in Japan, including those described in Fig. 3, have only recently begun to take shape, and none of those operations have yet to achieve a significant growth in their customer bases or revenue through the use of personal data from both the online and offline realms. According to an industry representative from a major retailer, although they recognize the need for sales promotions targeting individuals, they cannot even consider taking on this kind of new initiative, being tied up in cutting costs to streamline their operations.

Nevertheless, given that improving the average spending per customer, which affects the sustainability of their business, will remain a challenge for many brick-and-mortar retailers, we can expect to see the data utilization know-how possessed by the EC companies increasingly crossing over into the physical realm. Since business collaboration requires data to be shared between different companies, it could take longer to develop than with the vertically integrated models seen in other countries. That said, realizing a highly sophisticated use of data is likely to be the key in looking ahead into the future of the Japanese retail industry as well.

In addition to POS analysis, the food wholesalers Mitsubishi Shokuhin and Itochu Shokuhin have begun to play leading roles in the analysis of ID-POS, which includes data on individual consumers. In Japan, companies' initiatives towards the true realization of OMO, while also involving peripheral businesses, is still in its infancy, but we can surely catch the stirrings of such momentum.