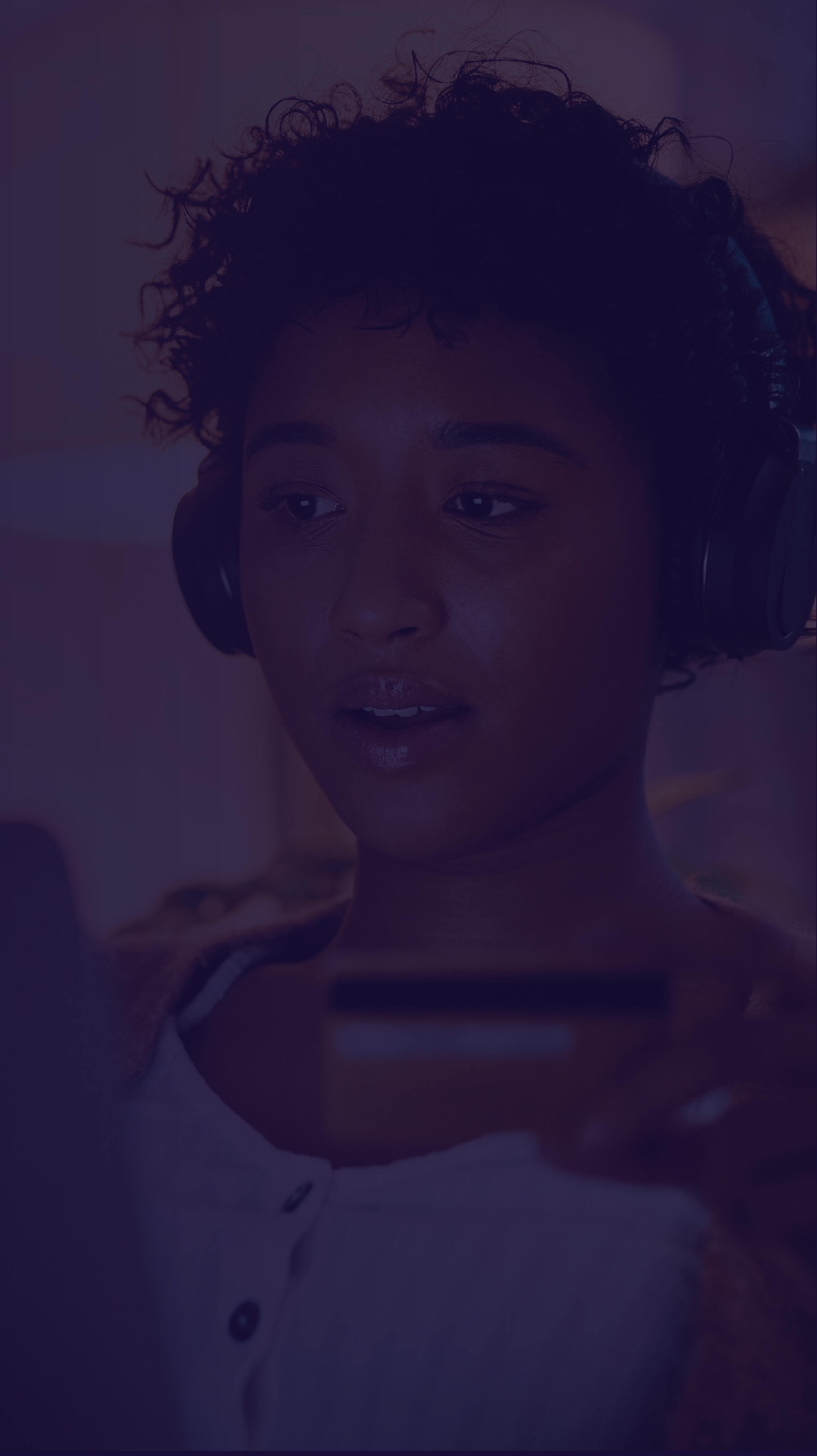
REPORT

Executive Insights: the Primary Drivers of Ecommerce Profitability Across the Digital Shelf



DIGITAL SHELF INSTITUTE

bobsled MARKETING

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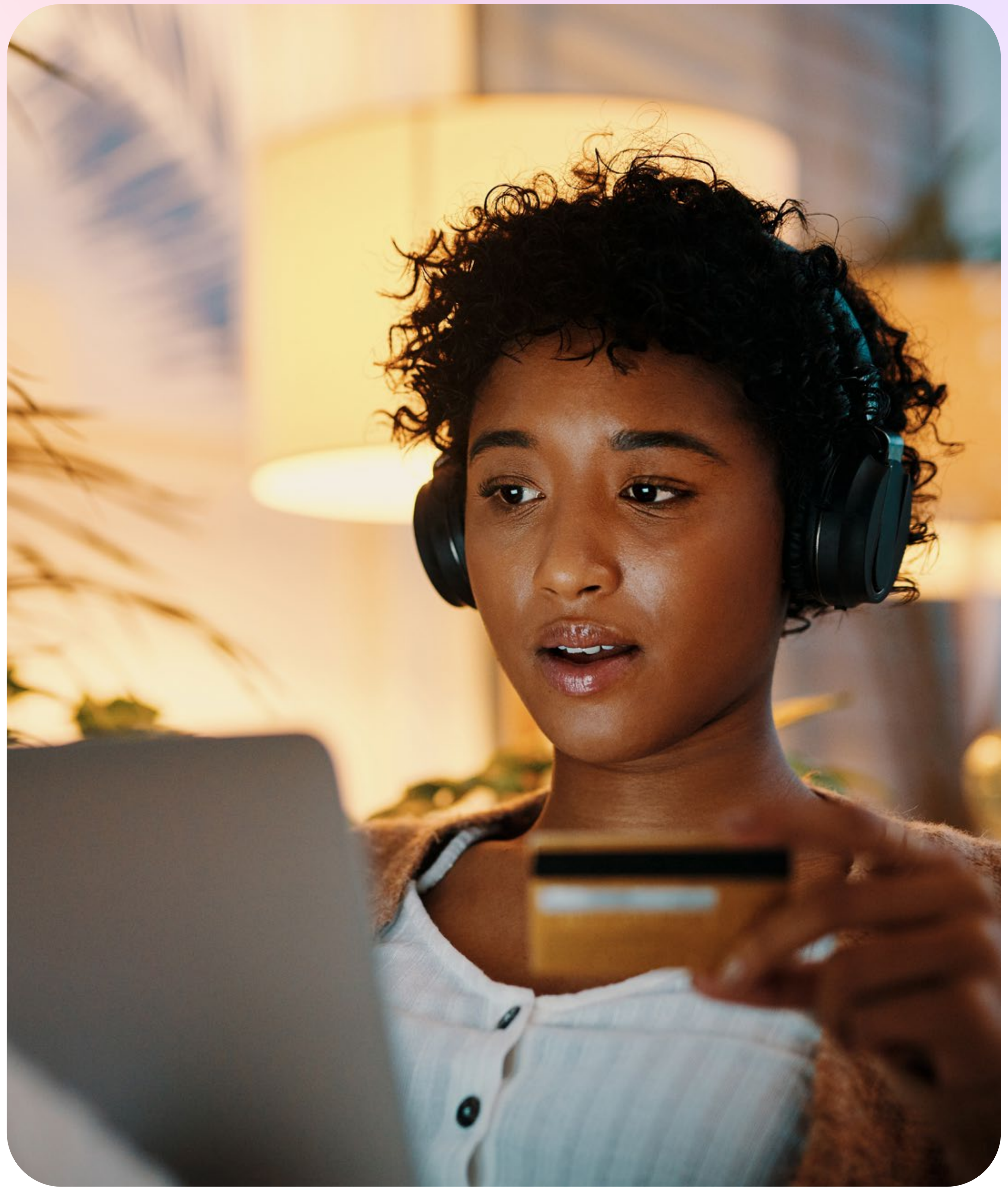
The Future of Retail

As shopping shifts from an activity conducted purely in retail stores to one that usually includes at least one online touchpoint, consumer brands are reckoning with the unique financial profiles of their various sales channels. For most brands, their ecommerce sales were already steadily increasing well before the rocket fuel of COVID-19 in 2020.

In the old world, where ecommerce often comprised less than **15% of a company's sales,** the requirement to improve the profitability of online channels was easily punted down the road. But as companies see the proportion of ecommerce sales increase dramatically, the urgency has arrived.



Ecommerce is no longer considered an edge case — it's the future of retail. This renewed focus has led many executive teams to ask their digital leaders: What drives profitability in ecommerce — and how can we improve it?

What we have found in this initial report is that many companies state profitability as an objective but are often not investing meaningfully in efforts to address profitability.

Respondents cited internal silos, inconsistent targets, and conflict around resources and budget allocation as critical issues. All this at a time when many consumer products companies are cutting funding to traditional brick-and-mortar channels and expecting digital channels to prop up the organization.

As one report respondent remarked: "Every company I've worked for in an ecomm kind of capacity typically looks at ecommerce through a lens of challenge … [with statements like] 'Ooh, this profitability looks a little squeezed. Please go fix it.'"

This report aims to bolster collective intelligence among large consumer product manufacturers: identifying the primary drivers of ecommerce profitability, as well as some solutions that have proven to be successful. We hope that this research will help power the cross-functional conversations and alignment needed for transformation to a digital-first, omnichannel organization.

Meet the Experts

The author of this report interviewed 10 leaders at large multinational brands with annual revenues over $250 million, sourced from the Digital Shelf Executive Forum. These leaders hold executive-level digital and ecommerce positions within these companies. Industry verticals included health and beauty, electronics, grocery, and home.

The qualitative interviews were designed to uncover trends across categories, company sizes, and channels. This report summarizes all drivers and fixes to provide the most comprehensive view of the industry — recognizing that great ideas and frameworks can come from anywhere.

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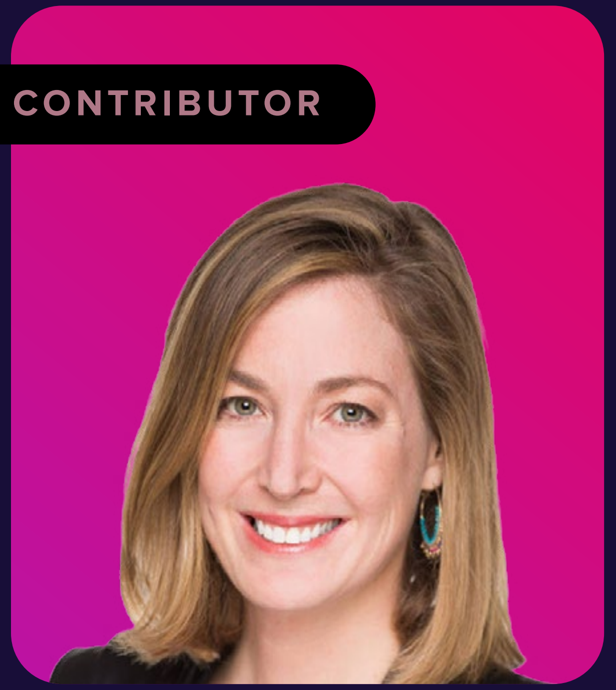

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1 Profitability Driver 1: The Definition of Profitability

Nearly all enterprise-level consumer product brands have their roots in selling to brick-and-mortar retailers. Ecommerce is a channel that has generally been added after decades of managing customer-level profit and loss statements (P&Ls) for key accounts.

One report respondent argued: Since those traditional retail numbers drive a great portion of the company's overall revenue, they also determine the P&L structure.

This is where the attempt to fit a square peg into a round hole begins.

Profitability Metrics

One critical report finding: The very definition of profitability across companies is not consistent.

> **Contribution margin:** Contribution margin was mentioned as a preferred metric by several respondents as being effective since it's "fully loaded" with all selling expenses and marketing costs. There is nowhere to hide.
>
> **Net income from operations (NIFO):** NIFO was the preferred profitability of one respondent's company. This metric is even less forgiving, particularly when ecommerce is a fledgling channel. The risk with either metric is that ecommerce gets loaded up with costs that aren't scaled to the size of the channel.

Whichever metric is chosen, challenges arise when other departments have different goals.

As one report respondent commented: "Internally, we've got salespeople that are commissioned on gross sales. We've got marketing people and ecommerce people bonused on EBIT [earnings before interest and taxes]. So, as you can imagine, the conversations between the two groups don't get any better over time."

Stated Focus

A company's strategic priorities are also a key driver. Respondents stated a range of corporate priorities other than profitability, such as market share and top-line revenue growth. These goals can sometimes be at odds with profitability.

The definition of "market share" for some respondents was problematic. Respondents cited limitations with the ability to accurately measure market share using the incumbent analytics providers, who focus on publishing market share from traditional retailers rather than digital platforms.

Line Item Inclusions

"Sometimes I feel like it's not apples to apples." — Report Respondent

Which line items are factored into the profit metric on the P&L are also highly variable. Several respondents have the company's customer care team in their department budget, with the rationale being that a call center's number is displayed on the company website. However, customers call the helpline for all sorts of questions for purchases from every channel, including brick-and-mortar.

Rolling up all channels into a single P&L may not be realistic for all companies. But the digital channels get loaded in a way that the brick-and-mortar channels don't in a P&L.

With digital channels generally being smaller, allocating expenses that should be spread out proportionately can quickly burn through any profitability the digital channels may have enjoyed. P&L inclusions can also make or break the business case for future ecommerce investment.

Some examples below show P&L inclusions that may be included in an ecommerce department's budget or factored into the profitability key performance indicator (KPI).

1. Salaries and wages, which could include:
   - Ecommerce-dedicated full-time equivalent (FTE)
   - Retailer.com FTE, who might also support brick-and-mortar retail accounts too (problematic)
   - Digital/ecommerce center of excellence team
2. Freight, returns, shipping
3. Customer care/call center team
4. Software costs
5. Warehouse costs

Real-Life Profitability Wins

Several respondents said that understanding all the contributing data points in the P&L was the single most important factor in improving profitability. With a detailed business intelligence type of approach to measurement and diagnostics, companies can identify powerful solutions.

The Voice of the Customer

One report respondent said: "Our ability to be able to look at that voice of customer data for product returns, reviews, and ratings, has allowed us to make engineering changes [and] product packaging changes. And so that's where you start to improve profitability. Every single percentage point changes and improves your profitability in that way."

Line-by-Line Inquiries

In another case, while investigating the Amazon channel in-depth, where profitability was poor, a respondent discovered that certain items like coupons were being apportioned to all channels, including Amazon, which does not accept coupons. Line-by-line inquiries are one way to claw back profitability.

Accounting Practice Differences

Several respondents stated that a purely financial view of the business could be arbitrary: "[Profitability] really is just the way that your internal finance team treats [digital channels], whether they heavily allocate resources against it or not."

Another respondent believes accounting practices should not drive and govern their business decisions: "We are making business decisions because of the accounting practices, and that's incorrect. It is limiting us from a business perspective."

This respondent also believes that trying to influence and change accounting practices is not realistic; developing specific metrics that give the ecommerce team a more accurate sense of customer contribution is the worthier cause.

Internal Alignment

The information flow between the finance team and ecommerce leaders was also mentioned as a challenge for some. In one case, the digital leader of a consumer packaged goods (CPG) brand had no insight into any profitability metric, only receiving top-line revenue targets each planning cycle. Such centralization of information forces teams to act in silos and stunts investment in long-term solutions.

Another respondent cited conflict between internal channels as slowing down the company's digital advancement. "There [are] all these fights over whether it's head resources, media dollars, et cetera, over which channels to drive to — when in [the] reality of our business, all digital channels are underfunded."

Channels Within Ecommerce

Several respondents noted that direct-to-consumer (D2C) channels are generally their least-profitable channels. One cause of this is the required marketing spend to attract customers.

As one respondent remarked: "The historical model for D2C is that you're going to spend an enormous amount of money in advertising and above-the-line awareness. So, you're eating into almost all of your profits to be able to drive the traffic and drive the eyeballs to your website. You're paying for the traffic, essentially. So, from a least-profitable channel, D2C would probably be number one."

A consensus from respondents was that the ecommerce channel should separate D2C from online marketplaces like Amazon.

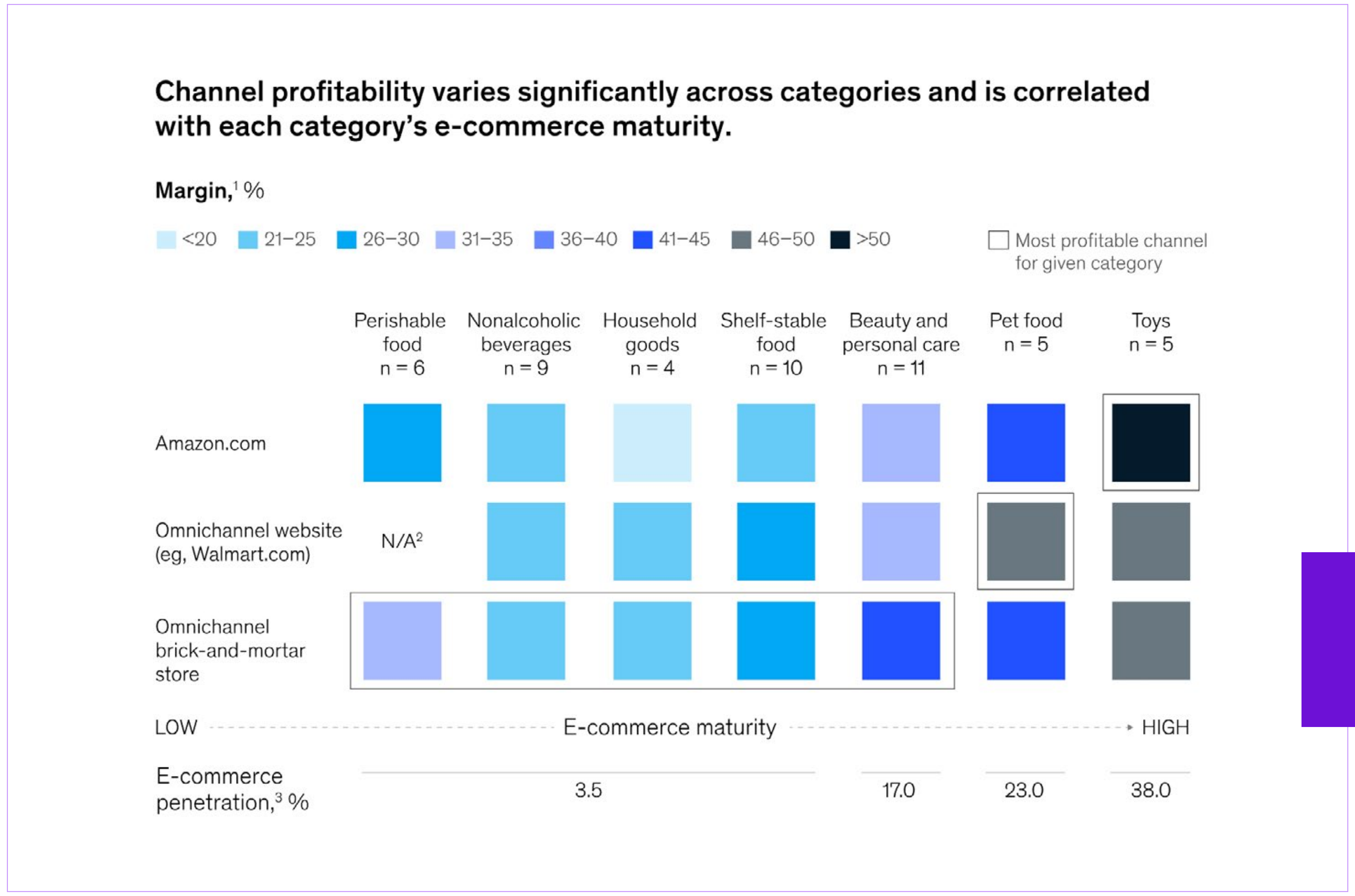
While it may be difficult for some brands to decouple from a channel-based view of the world, the Digital Shelf Institute (DSI) challenges brands to reconsider a "retail channel" strategy with a "go-to-shopper" strategy, given the increasingly recognized halo effect of sales between channels.

While D2C may be dilutive when considered as a standalone channel, it may serve a critical strategic role beyond its contribution to profit.

Scale

A recent survey by McKinsey and Company, “High growth, low profit: The e-commerce dilemma for CPG companies,” confirmed what many respondents to this research hypothesized: Scale and maturity are a driver of overall profitability.

McKinsey surveyed 50 CPG executives who are decision-makers in their company’s ecommerce business and found that a category’s ecommerce penetration rate appears to be positively correlated with higher online margins.



Takeaways and Solutions

Remember: Information Is Power

Advocate hard for better visibility into profitability metrics and understand every data point contributing cost or income to the P&L. Educating departments on the factors that drive their profitability targets can unleash creative, collaborative solutions.

Some respondents have seen success by bringing this to the right people’s attention. One respondent noted: “Our global finance lead for digital commerce has actually issued a formal set of changes to the global accounting policy as a result [of profitability investigations] to make sure that there was consistency across the markets. Because we weren’t looking at apples for apples P&Ls for a while.”

One area to focus on is warehouse loading. Ensure the warehouse costs are distributed appropriately and not all allocated to the D2C business, for example.

Source: McKinsey Ecommerce Decision-Maker Survey, “High growth, low profit: The e-commerce dilemma for CPG companies,” March 2021

Automate

Try to automate and manage as much as possible using software, which can be allocated into the capital expenditure (CapEx) budget rather than people expenses, which hits the P&L.

'Harmonize' Global P&L Structure

Some respondents have seen positive benefits with attempting to "harmonize" a global P&L structure.

Try a Thought Experiment

Thought experiment: Could you do something unexpected or revolutionary by managing each SKU as its own business? Several respondents recommended this approach.

One respondent said: "We're really making a big, big push right now into item-level profitability, item-level tracking. Internally, what we call managing each product as a business."

The profitability model of the SKU might initially suggest that it shouldn't be sold online, but after some inquiry, solutions like multipacks might be discovered on a SKU-by-SKU basis.

Consider Separating D2C From Marketplace Channels

If you're staying with a dedicated ecommerce P&L, consider separating D2C from marketplace channels. Different levers are available: For example, increasing average order value (AOV) is possible on D2C but not on marketplace channels.

There's also a case for D2C channels to provide value in non-financial dimensions. Namely, collecting customer and behavioral data and building a direct relationship with the customer. If the objectives of a D2C channel are different from marketplaces or retailer website channels, it may not be wise to lump all of "digital" together.

Find 'Quick Wins'

Consider the "quick wins" shared by respondents in this section and what similar investigations you could initiate:

Voice of the customer data and product return data might uncover issues with product packaging.

Coupons and discounts that are channel-specific, which were being apportioned to all channels.

Develop Specific Metrics

If P&L structuring is outside of your control, could you develop specific metrics to provide the ecommerce team a truer sense of customer contribution?

2 Profitability Driver 2: Product Category and Price Point

Some aspects of a company are relatively fixed, such as product category, price point, and supply chain. These “unchangeable” factors have a significant impact on the profitability of the company’s ecommerce channel.

Trends observed across categories include:

> More expensive items with an average selling price (ASP) over $200 can often be more profitable on ecommerce than traditional brick-and-mortar retail channels.
>
> CPG brands generally struggle with profitability in ecommerce channels relative to brick-and-mortar retail channels. One exception is beauty products, which often carry a higher profit margin.

As one respondent said, “If it doesn’t start with a product having 40-points-plus [gross profit margin], it makes ecommerce a tough go.”

? Ecommerce is a less profitable channel than selling to brick-and-mortar retail — true or false for you?

Respondent With ASP > $200	Respondent With ASP > $200	Respondent With ASP of About $10
More profitable. Amazon is one of their most profitable accounts.	B2B ecommerce is the most profitable, and D2C is the least. Traditional retail is in the middle.	Ecommerce is less profitable than traditional retail.

Pricing

The DSI argues that in the past, it was relatively easy for brand manufacturers to design pricing for their portfolios in partnership with a retailer in the form of manufacturer suggested retail pricing (MSRP).

But today, pricing is controlled, tracked, and matched in real-time by retailer algorithms. This process can quickly erode brand equity, retail margin, and the “right to sell” on a given retail platform.

Brands must assume that their lowest price will be matched and build their pricing strategy around that reality. Minimum advertised price (MAP) policies can be used as a preventative tool but can’t be relied on as a standalone strategy. MAP alone cannot address the root causes of retail arbitrage.

The DSI suggests creating exclusive items for priority channels, so their margin is protected from erosion, and proactively planning your pricing strategy using knowledge of the effects of pricing algorithms.

Packaging

One respondent said that revisiting packaging design was one of their top-three biggest drivers of profitability: “Our packaging being mostly on store shelves can become quite expensive, especially for lesser, smaller items. So, we’ve had a team that has been constantly working on revising packaging.”

Manufacturing and Logistics Costs

There's a difference between brands that own their manufacturing versus those that use contract manufacturers.

As one respondent said: "When you own the factories, you have to keep the factories busy. So, that means you gravitate towards your lower-cost products in order to create flow. That's millions in product just keeping that factory humming." The respondent added that an appropriate allocation of warehouse costs across business units is critical.

The McKinsey survey found that shipping and warehousing costs are significantly higher for CPG companies across all categories when they sell their products on Amazon at 9.3% of gross sales, compared with only 7.3% for brick-and-mortar retail channels.

Bundling and Multipacks

One fairly straightforward fix that many brands have pursued is to take unprofitable SKUs and determine if and how they could be reconfigured in bundles, multipacks, or bulk sizes.

As one respondent recalled: "I think we've done a really good job of creating new product kits. Not fully new products, but bundles of products that work really well, profitability-wise, specifically for Amazon. The challenge for us there has been gaining scale on those SKUs so that they actually start to make up a meaningful part of our mix because, without that, it kind of becomes an issue."

Scale

Several respondents made the hypothesis that profitability scales with the size of the channel relative to others. This belief could be due to correlation rather than causation — a larger ecommerce channel could be thriving because of inherently good profit margins. Conversely, when the ecommerce channel is less profitable, it could be forced to remain small.

Takeaways and Solutions

While you can't simply change your product category or ASP on a whim, there are some ways to address these challenges.

Consider Bundling and Multipack Profitability

Consider bundling and multipacks on marketplaces if the SKU can't be profitable on its own.

D2C Offers More Leverage Points for Profitability Improvement

While it can be a less profitable channel initially, a D2C ecommerce channel offers many more leverage points to improve profitability than marketplaces typically do. Various techniques exist to increase average order, decrease customer acquisition costs, and improve customer lifetime value (CLV).

'Hyper-Scrub' Assortment by Channel

Consider dynamic portfolio management. Some respondents have had success in "hyper-scrubbing" the assortment by channel (i.e., only selling profitable SKUs specific to that channel).

But don't immediately discount the value of the long-tail items in your assortment. Some brands find these items to be a differentiator in terms of assortment. Create more defensible pricing and margins and a way to identify breakout winners.

Launch MAP and Infringement Program

Initiate MAP and deploy an effective infringement program, which may help reduce future price-matching issues with the marketplace operators and resellers. But be aware that this is not a standalone strategy, as MAP doesn't resolve the new algorithmic reality of retail pricing.

Create 'Tentpole' Products

Create "tentpole" products that meet a retailer's exclusivity requirements. Such items can't be algorithmically repriced.

3 Profitability Driver 3: Media Spend and Attribution

Media spend is often one of the largest expenses for a brand's ecommerce channels. A key question that brands grapple with around media spend and attribution: Which portions of above-the-line and below-the-line ad spend should the ecommerce team carry?

One respondent noted: "It's straightforward to allocate shopper marketing spend to an individual retailer — almost all of the benefit of that campaign is realized in sales for that customer account. But there has proven to be a positive halo effect across all retail channels with Amazon advertising campaigns. Even though other channels get the benefit of a successful Amazon media campaign, the Amazon channel is the one that usually gets attributed with the full cost of that campaign, thus impacting the profitability of that channel."

Rationalizing Brand and Performance Media

Many companies have only recently started to recognize the halo effect of retail media. A Digital Shelf Institute study, "The Full Revenue Impact of Retailer Ad Platforms," used anonymized data from dozens of brands to discover:

> Retail media spend with one retailer influences shoppers wherever they ultimately choose to make their purchases, online and offline at other retailers.
>
> Both brands and retailers have measured up to a **range of $7 to $11** spent in-store for every dollar spent online generated by retail media campaigns.
>
> Retailer media spend drives other incremental benefits like improving repeat purchases, goodwill of partners, and social validation.

These findings mean that the traditional distinction between online and offline and above-the-line and below-the-line ad spend are arbitrary at best.

One respondent said: "Marketing has their spend target, ecommerce team has their spend target. There's a lack of synergy there."

Several respondents say they would benefit from rationalizing their brand and performance marketing spend, given the halo effect of advertising across all channels. One respondent said their company already uses this model.

There is no designation between brand-based and performance-based media. All digitally-run media is lumped together and not allocated to specific channels like D2C, marketplace, and retailer websites.

Instacart is a particularly challenging channel from this perspective, as many companies consider Instacart media spend as "digital," but sales materialize at the retailer customer level (Costco, CVS, Sephora, etc.) on the P&L.

How Much To Spend

The McKinsey survey found that CPG brands spend an average of 7% to 9% of gross revenues on retail media networks. This amount appears to be sufficient for maintaining market share.

Brands looking to gain market share or accelerate growth spend three to five percentage points more on retail media networks than their category average. And when a brand launches a new SKU, they might spend double or triple the average of their category to support the launch over six or 12 months.

One respondent in our report said that their Amazon performance marketing spend as a percentage of revenue, known as total advertising cost of sales, hovers around 4%, but establishing specific targets can be limiting.

This respondent added: "Amazon will say, you should be around two to four percent of your total sales, which is fine, but it shouldn't be your goal. What I do is try to find that ceiling on a per-ASIN [Amazon Standard Identification Number] basis. If my daily spend on a certain ASIN is $500, we're going to crank that to $1,500 and see where the cliff really is. That's the only way we've learned."

Improving Performance and Efficiency

Media spend is often one of the largest expenses in a retail brand's P&L. Improving the return on investment (ROI) is, therefore, one of the most powerful profit-enhancing activities. There are many ways to audit and improve the ROI of performance media spend, which can be managed internally or by outside vendors.

Ecommerce media has the benefit of being fast to deploy and responsive to both market needs and internal budget needs.

As one respondent said: "What is so compelling about Amazon is the speed at which you can execute dollars. This is pretty unique in our landscape, where it can be end of Q3, and we think we're going to over-perform the year, and we feel like we have some initial investment we can put into the business. There are not many channels that we can execute very quickly."

Brands can choose a growth strategy or a profit strategy for their paid media efforts, both of which will have different ROI profiles. Understanding which strategy should be applied to which product, on which channel, and at what point in the product life cycle, is essential to effectively deploying the retail media budget.

Takeaways and Solutions

Reallocate Co-Op

One respondent has reallocated significant funds away from retailer co-op, given that co-op fees offer a largely immeasurable benefit. In contrast, Amazon Marketing Services (AMS) and equivalent retailer performance advertising programs are highly measurable. The respondent noted: "We can calculate to the penny what a million dollars in co-op with retailer X will translate to with AMS."

Consider what analysis would be required to calculate the value of co-op spent in performance advertising spend.

Leverage 'Halo Effect' Findings

Use the DSI findings on the "halo effect" of retail media spend and the experience in your own company to consider a business case to eliminate the distinction between brand and performance marketing on retail media platforms and centralize spend in one department.

Consider Shifting Focus

Some brands have had success in shifting the focus of their vendor negotiations with Amazon away from focusing on profitability, pricing, and assortment. Instead, move to gain alignment on marketing investment.

As one respondent said, "We took those marketing dollars and shifted them to a greater collaborative spend in exchange for a broader portfolio [to Amazon]."

Could a commitment to certain advertising and promotional thresholds move your negotiations forward?

4 Profitability Driver 4: The Amazon Relationship

There was divergence among the pool of respondents regarding whether a seller, also known as a third-party (3P) seller, or vendor, also known as a first-party (1P) seller, relationship was more profitable for brands.

In many situations, the most profitable model varied across a brand's assortment.

With Amazon being the largest source of ecommerce revenue for most brands, reviewing the selling relationship and tightening trade terms with Amazon can be one of the highest leverage activities for a brand in improving their profitability.

Standing Your Ground

When Amazon identifies a SKU as unable to turn a profit, it may want to remove the SKU from the channel. This is commonly known as the Amazon Can't Realize a Profit (CRaP) program.

But this can be detrimental for the brand, as it allows Amazon to negotiate lower prices or delist the product. The product either becomes unavailable to purchase, driving the customer into the arms of a competing alternative, or the void may attract unauthorized resellers to sell the product.

Ultimately, when Amazon deems a product unprofitable, it represents lost revenue opportunities for the brand. But "standing your ground" in negotiations was mentioned by several respondents.

One CPG respondent cited an example of a SKU in a high-volume pack configuration. Amazon was comparing the per-unit price of this SKU to a competing smaller-volume pack and using that data point to rationalize driving the selling price down.

Both the brand and Amazon were losing money, though the product was selling wildly.

The respondent took the hard stance of delisting the product — much to Amazon's chagrin and escalating negotiations. The ultimate outcome was that the brand agreed to invest in Amazon media spend to transfer demand to the profitable SKU.

But the respondent acknowledged that this tactic would not work for all brands: "Obviously we were big enough to have a conversation. I recognize there are many small brands that don't have that muscle to have that."

In other cases where brands don't have the same amount of leverage and delisted their products, Amazon has reacted by changing terms in the vendor agreement, reducing purchase orders. Or, in one case, developing a competing private label product and running display advertising campaigns on the brand's competing SKUs.

Hybrid Model

Several respondents are operating a hybrid 3P/1P relationship with Amazon. In some cases, this is despite pressure from Amazon to only operate with a 1P model.

One respondent doesn't take the threat seriously, given their brand's clout in the category. Another respondent in the CPG category, who is only profitable on the 1P channel, operates a 3P channel only because Amazon will not place adequate purchase orders for their assortment.

Operating the 3P channel is more of a protective measure against unauthorized 3P resellers.

For some, their 3P channel is the only way they can achieve profitability on certain SKUs. In other cases, Amazon would not physically pick up 1P vendor orders on SKUs that didn't meet Amazon's profitability thresholds. (For example, high-footprint, low-margin items.)

This problem was exacerbated in 2020 with limits imposed by shipping carriers. Another respondent uses their 3P model for selling excess and obsolete inventory.

Amazon Net PPM Program

The Amazon Net Pure Profit Margin (PPM) program, offered to a small number of Amazon's largest vendors, can help profitability in the right circumstances.

One respondent, who cited Amazon as one of its most profitable channels, said there are three main benefits of the Amazon Net PPM program at their company:

Benefit 1: It focused the company's conversations with Amazon on a single metric (i.e., the pure profit margin) rather than continuous back-and-forth on items like freight and returns metrics.

Benefit 2: Rather than simply funding the gap to make Amazon whole at the end of a quarter based on the PPM target, the company will allocate the requisite amount to Amazon Advertising. The respondent highlighted: "It counts [towards the net PPM target], and it's better than writing a check."

Benefit 3: Amazon Net PPM waives the requirement for brands to give Amazon the first right of refusal on their assortment. This waiver means that a brand can pull products from Amazon because they are not profitable.

Takeaways and Solutions

Choose the Right Channels for Your Brand

Some brands without significant clout in their category are nervous about establishing a 3P Amazon channel. Some have had success using third-party resellers (Etailz, Netrush, Fortress Brand, etc.) to create distance.

Develop a Model for Reviewing Amazon Purchase Orders

Some vendors have suggested that bulk recommendations from Amazon rarely make sense (e.g., if you drop the price, they will often increase the purchase order).

Consider the Amazon Net PPM Program

Consider the Net PPM Program if it is offered to you. Typically this program is only offered to very large vendors.

What's Next?

Just 10 conversations with ecommerce executives at large branded manufacturers unearthed a huge well of need and opportunity. Some companies have cracked the code on these items, while others are earlier in the process.

But a custom approach is needed given inherent differences in each brand's financial focus, category specifics, organizational setup, and other factors discussed in this report.

Whatever the specific pain points are in your organization, there are three critical needs for ecommerce executives to focus on:

- Data to make your case;
- Cross-functional silo-crashing and collaboration;
- Realigning incentives for an omnichannel world.

Profitability is a thorny topic — and the general tone of the interviews was one where most were eager to understand the mechanics of both measurement and leverage points at other companies.

One common request was that any benchmarks would be organized by product category, recognizing the wide divergence of experiences between product category and average selling price. In practice, it’s challenging to acquire the volume of responses necessary to create true industry benchmarks.

There have been impressive results from digital and ecommerce leaders within larger companies, which deserve to be shared and built on by the wider community. By compiling these root causes and best practices, we hope to have moved this meaningful conversation forward.

About the Digital Shelf Institute

The Digital Shelf Institute (DSI) is a community dedicated to developing and sharing the best actionable insights and strategies for brand manufacturers to win on the digital shelf.

Become a Member

About Bobsled Marketing

Bobsled Marketing is a digital marketing agency with years of proven results and experience in helping brands scale on Amazon and leveling up their sales.

Learn More