JIBC

Journal of Internet Banking and Commerce

An open access Internet journal (http://www.icommercecentral.com)

Journal of Internet Banking and Commerce, Jan 2016, Vol. 21, no. S2

Special Issue: Recent Research on E-commerce and M-commerce

Inorganic Growth only Route to Achieve Economies of Scale for Indian E-retailers

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ABSTRACT

Indian e-retail market has come a long way since inception of leading player, Flipkart, in 2007. The market has tremendous opportunity to grow due to fact that the current penetration of e-retail in overall retail is significantly low and penetration of internet in India is also significantly low. Rising penetration of internet, coupled with increasing use of smartphone, computers will attract the consumers to the online channel. However, price differentiation from traditional retail, offered in the form of discounts by e-retailers will remain the key driver of the growth. Based on a survey it is found that majority of the people will switch back to traditional way of shopping as the look and feel of product is generally not available in online channel despite the benefits provided such as wider portfolio, easy delivery, easy return, convenience, etc. Consumers find discounts and offers as the primary reason for the change in consumer behaviour and shift of channel. On the other hand, the e-retail companies cannot afford to sell the products at heavy discounts as it leads to diseconomies of scale where companies incur heavy investment in logistics and technology and also offer discounts to generate volume. Amidst this, the in-organic style of growth will be an ideal strategy for companies to grow. Growth by mergers and acquisitions (including all forms like forward, backward, or parallel integration) will not only help the company diversify its product portfolio but will also give the companies an upper edge to save on customer acquisition cost, logistic lost, infrastructure development cost, and technology cost. Leading global players like Amazon Inc. adopted a similar strategy to grow in the international market. Amazon Inc. which is one of the leading players in the e-Commerce market acquired 57 companies since 1998 to clock revenue of around USD 89 billion in the year 2014 while its major rival eBay Inc. could reach USD 18 billion in 2014 with 3 acquisitions since 1998. This article covers if a similar paradigm will be seen in the Indian economy too, where the indigenous companies will re-look at their strategies in order to be profitable in the dynamically changing, fastest growing e-Commerce market of India. An early adoption of in-organic growth to scale up operations in the geographically diversified and huge economy like India will only help these players become profitable. Absence of right strategy mix will result in players bleeding and the bubble will eventually burst.

Keywords: E-commerce; E-retail; Strategy; Economies of scale; Volume; Global players; Inorganic growth; Acquisitions

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INTRODUCTION

What is eRetail?

Internet space has emerged not simply as a mode of transmitting information but as a means of capital accumulation by conducting business [1]. The use of internet has evolved over a period of time from mails to a channel for sale and distribution. The distribution of goods continues to grow exponentially as does the research interest in the space.

The term e-Retail embraces all the ways of engaging into purchasing a product via electronic medium. Doing business via internet is not only quicker but also much cheaper than other traditional methods. This difference sets aside e-Retail from traditional retail. It is also thought to overturn classical rules pertaining to time, space and price. E-Retail business comprises of the following two business models:

• Online retail: In this business model the company sells products online. The company markets products to customers using the internet and also undertakes responsibility for the delivery of those products, either through his own network or through a third party. In this model, the company usually stock inventory of goods and thus bear inventory risk

• Online marketplaces: Online marketplaces include all web-based platforms where sellers display products for other customers/ buyers to purchase online. The key difference between online retail and online marketplace is that the online marketplace does not take any inventory risk and merely provides a platform for the buyer and seller to transact

Graphically the segments can be represented as in Figure 1.

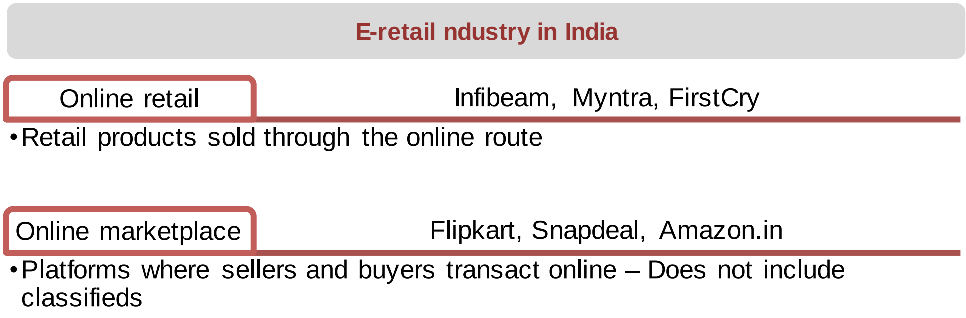


Figure 1: e-Retail- structure.

E-retailing in India has increased from just 0.1% of total retail sales in 2007-08 to 1% of total retail sales in India by 2014-15 and is expected to account for ~3 per cent of total retail sales by 2017-18 (CRISIL Research, 2015).

The reasons for the growth has been twofold - first, the number of people connected to the internet has increased substantially (internet penetration increased from 1% in 2005-06 to 19% in 2013-14 [1,2]), while at the same time the present internet users making purchase on the internet has increased two-fold.

LITERATURE REVIEW

In the awakening of dot com bubble, the potential of internet based businesses coupled with digital era has attracted a flood of research [3]. E-retailing has attracted eyeballs across the globe and fair amount of research is done in the area due to the nascent penetration of the industry itself. The preponderance of this work may be attributed to the importance placed on the sustainability and success of e-retailing in Indian market.

During the early 1990s, globalisation of the retail sector became a much accepted fact which resulted in altering both the commercial landscape and also the nature of consumer society in the developed economies such as US, UK. Though location remained a key success determinant for the traditional brick and mortar retailers (referred as traditional retailers hereafter), the importance of location reduced substantially in the context of e-retailing [4]. Emergence of companies such as Amazon Inc. (1994) resulted in a paradigm shift in the global market and efficient and effective delivery of products to the end consumer evolved as the success factor for e-retailers [5].

In the context of developed economies, researchers argued that order fulfilment has remained the most critical aspect for success of e-retailers and players outperforming in the domain garner higher share [6,7]. Further, it has been shown that the effective order fulfilment has been a significant determinant of customer satisfaction and retention [8,9].

However, the same model is not really applicable in the Indian market where the market is predominantly diversified. In the Indian market, much attention was directed to establishing strong web presence, attracting consumers to the website, providing easy usability of the website, providing attractive discounts and offers and easy payment option such as cash-on-delivery (COD) [10,11].

Concept of e-retail was seen as a tool to empower retailers and provide an opportunity to serve national and global consumer markets without bearing the 'set up' and 'accumulated' sunk costs [12] of embedded store networks. The internet retail sales initially soared significantly. For example: In US, the sales increased from USD 42 billion in 2002 to USD 236 billion in 2014 (US Census) while in developing markets such as India, the e-retail grew from Rs 15 billion in 2007-08 to Rs 360 billion in 2014-15 [2]. This rapid growth of e-retailing undoubtedly reflects the compelling advantages that the model offers over traditional retail stores such as greater flexibility, enhanced market outreach, faster transactions, broader product portfolio, and convenience. Consumers are able to compare and contrast competing products and services with minimal expenditure of personal time or effort. However, e-retailing also comes with its own set of challenges. The model which was initially viewed as a 'disruptive technology' with the potential to rewrite the rules of competition and provide 'First mover advantage' to firms adopting the channel [13] did not prove its viability. Soon fundamental flaws in the business models were found [14-16]. Disparity between sunk costs and actual revenues in addition to 'fulfilment' expenses of picking and delivery were rapidly demonstrated to be 'killer costs', whilst issues of 'tactility' and 'sociality' resulted in consumers switching players and channels [17,18].

In the developed countries (US, UK) in order to combat rising competition and improve profitability while not jeopardising the revenue growth the companies adopted the strategy of acquisition to reduce the order fulfilment cost.

In fact, researchers argued that acquisition of start-ups is one means by which the potential economy-wide effects of novelties developed by innovative entrants are realized. The literature on "Entrepreneurship systems" argued that innovative small firms and established businesses complement each other [19-21]. While the new entrants bring in the technology and innovation, the established player complement with resources to scale up. Economic theory identified various motives behind acquisition such as achieving market power [22], technology sourcing [23], creating synergy gains [24] lowering transaction costs [25].

When it comes to acquisitions of start-ups, there are two primary ways/motives:

1) Vertical- When a company acquires another firm operating in business which is a part of acquirer's value chain. This is primarily done to improve operations and reduce cost
2) Horizontal- A situation where a company acquires another firm in similar business primarily to increase its geographical presence

The motives of the acquiring firms and the potential consequences for the acquired start-ups show that acquisitions could be a "win-win" post-entry event [23,26].

METHODOLOGY

The researchers conducted in-depth interviews with managers in e-retail companies, investors (including angel investors, venture capitalists, and private equity players) and the managers involved in mergers and acquisitions. Their insights, along with the results from the previous discussed literature review were used to develop the hypothesis and test the same. Further, the case of developed economies was taken and applied in context of the developing economy (India in this case) to arrive at the conclusion. In our development of hypotheses, we used following parameters for measuring e-retailing performance:

• Revenue (revenue growth)
• Profit Margins (we define profit margin as (sales revenue - cost of goods sold) / sales revenue)
• Acquisitions
• Total cash available

Global Players Shifting Focus on Emerging Market

Foreign e-Retail companies such as Amazon Inc. and eBay Inc. are gradually shifting their focus to emerging economies, with eBay Inc. and Amazon Inc. generating around 50 per cent of their revenue from non-US regions (Figure 2).

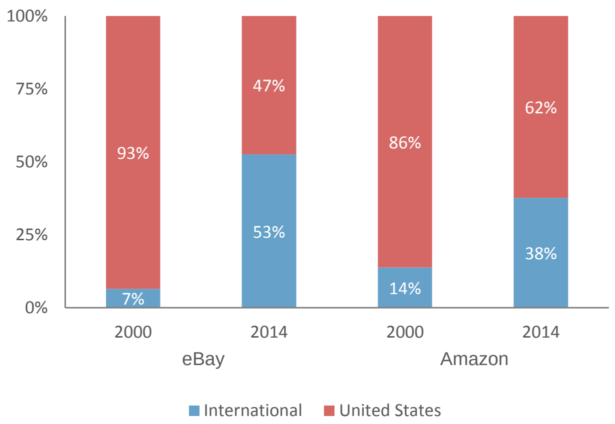


Figure 2A: Emerging markets adding more to coffers…

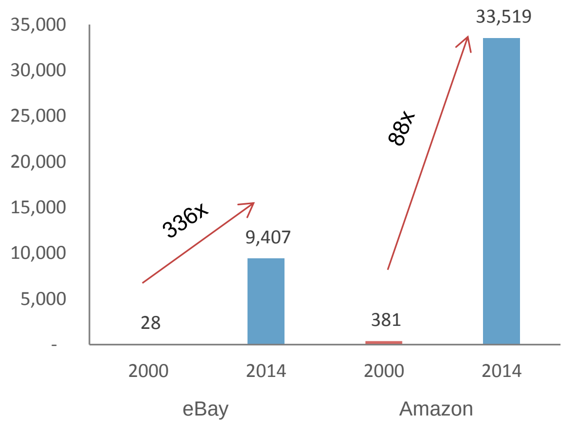


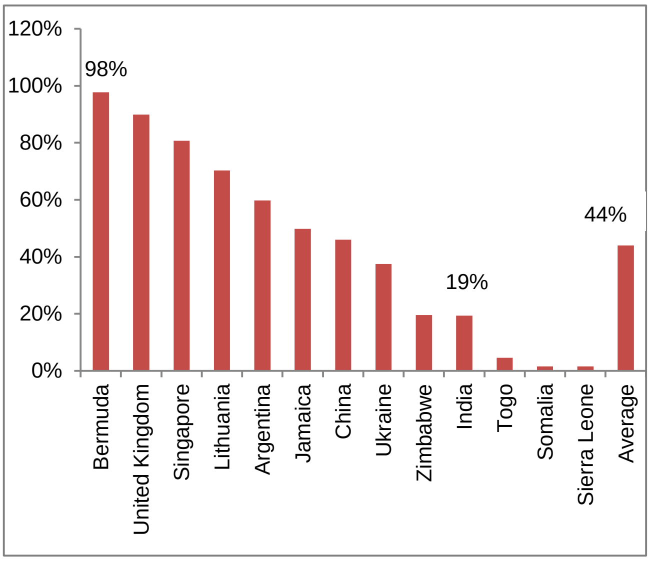
Figure 2B: International revenues gallop [49].

This indicates that the global players are shifting their focus to tap emerging economies where penetration of e-Retail is significantly low. One of the significant developments in the Indian e-retail market is the entry of Amazon Inc. in India in June 2013. The company previously entered the market as Junglee.com in 2012 succeeded to analyse the demographics and customer profile of the Indian market. Similarly, eBay Inc. too have a presence in the Indian market. Companies such as Alibaba group invested significantly in Indian player Snapdeal, PayTM indicating its future plans to enter the Indian soil. Thus, it won't be wrong if we say that the global giants are making use of inorganic/ organic strategy for widening geographical presence.

As India Remains a Promising Market among Emerging Economies

In most developing countries, internet use and eCommerce practices are yet to reach a critical mass to take effect and encourage businesses to opt for eCommerce innovations.

India is a country which accounts for nearly 17 per cent of the total world population [27], next only to China. However, with slow adaptation to technology, penetration of internet has been minimal in the country. The following chart indicates that the internet penetration in India is below average at around 19 per cent whereas the global average is around 44 per cent with maximum penetration being 98 per cent. India currently ranks 140 of 199 countries in terms of internet penetration. The low level of information and communications technology (ICT) diffusion in an economy though limit the level of eCommerce awareness but also provides an opportunity for growth provided internet adaptability increases (Figure 3).



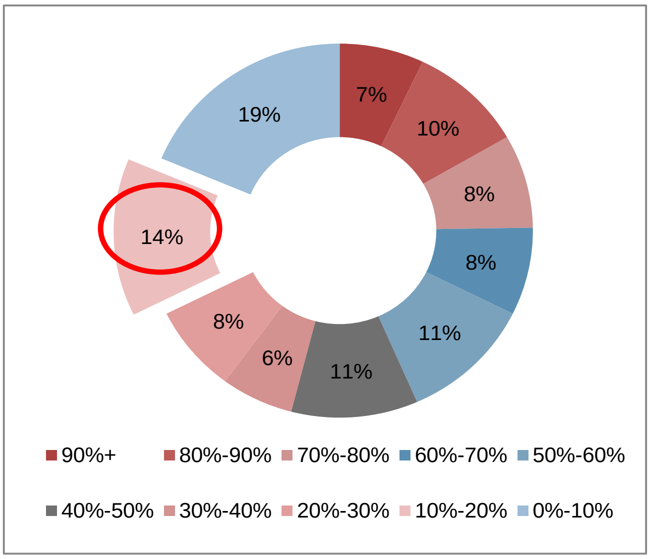


Figure 3: Low penetration of internet in India vis-à-vis global average; 2/3rd countries has higher penetration [50].

But the internet penetration has increased from 1% in 2005-06 to 19% in 2013-14 [2]. In addition, most businesses in developing countries such as India are small. This restricts them from investing in IT and thus opens up opportunity for online marketplaces that help in connecting these small businesses with the sellers. The practice of doing business electronically, dealing with non-cash payments, anonymous and electronic-based intra and inter-business relations, all of which are important in eCommerce, are not common for businesses in developing countries. Thus, success on depends imbibing the culture with the help of e-retailers.

Further, we have computed the total opportunity provided by the Indian economy for the e-retailers. As per the per capita consumption expenditure (reported by NSSO) in urban and rural areas, the total opportunity for e-retail market is estimated to be around Rs 7.7 trillion (Annexure 3).

Price Point: Only Differentiation from Traditional Brick and Mortar Retailer?

With sharp growth in volumes as well as the number of players in the e-retail segment, many traditional retailers have increased focus on their online sales channel. While the online sales for traditional retailers are very small in comparison with e-retail companies at present, this scenario could change quickly.

Traditional retailers have realised that e-retailers is a threat to their business and having an online presence is critical to be able to effectively compete with them. Pricing has become an indispensable tool for retailers and has become an important issue for retailers in the context of multiple channels [28-31]. In concrete, multi-channel retailers face the challenge whether to price products at parity across channels or to sell the same product at different prices in each channel.

Diverse research has shown that consumers perceive price discrimination unfair [32-34]. Also channel-based price differentiation is likely to evoke a feeling of unfairness in consumers' mind [35].

Theorists usually assume that the online channel provides cost advantages in their models [36-38] and consumers expect a fair price for a product to be lower on the Internet [39].

The following hypothesis helps us in understanding consumer buying behaviour when there is no price differentiation in products sold through online channel and traditional channel.

Ho: p=0.80, 80 per cent of the customers move to traditional retailers as they don't find any cost benefit

Ha: p<0.80, Less than 80 per cent of the customers move to traditional retailers

Confidence interval, $\alpha=0.05$

Sample size: 9550, Number of success expected: 0.8×9550=7640 (Table 1).

Table 1: Using 1 proportion test, we find the following.

Test of p= 0.8 vs p< 0.8					
Sample	**X**	**N**	**Sample p**	**95% Upper bound**	**Exact P-Value**
1	7640	9550	0.8	0.806717	0.504

Since, p>0.504, we fail to reject the null hypothesis. This indicates that probability of 80 per cent customers showing a change in behaviour is significantly high.

Further, based on the responses collected from around 9550 individuals of the age group 18-35, it is found that around 54 per cent of the individuals will prefer to shop from malls (or traditional retailing format) if the price of product is same in both online channel and traditional channel (Figure 4).

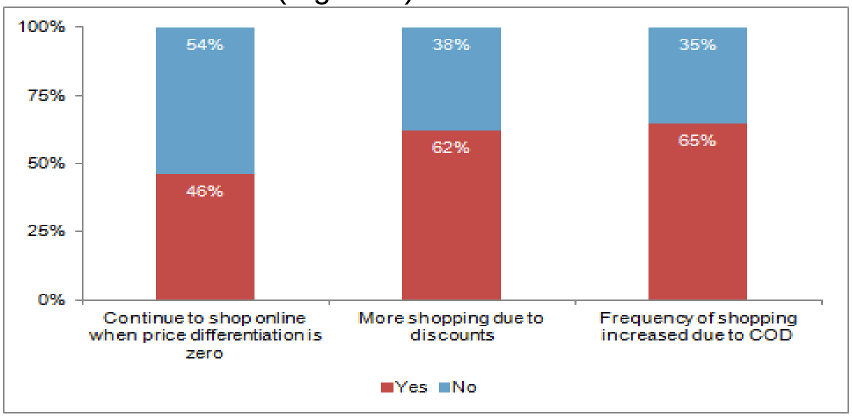


Figure 4: Over half of the people prefer to choose traditional method of shopping over online [51,52].

No discounts, option of quality check, option to try and buy evolved as the primary reasons as to why the customers' will make a shift to traditional retail. Some of the individuals responded saying "If same product is available at same price, it doesn't really make a sense to buy online. It is always better to check the product and buy". Many other responders gave reasons like "Online shopping will take minimum 1 day in delivery whereas in traditional shopping one can get the product instantly". Thus, it is evident that price point plays a vital role in determining consumer behaviour.

Around 62 per cent of the responses stated that they shop online primarily for discounts and deals which help them get attractive price point.

It is thus evident that the consumers tend to shift to online channel for heavy discounts. This discounts, deals and availability of various coupons help the companies in the e-retail space generate volumes. However companies compromise on profitability. E-Retailers undoubtedly save big buck on lease rentals vis-à-vis traditional retailers and also get better deals from manufacturer in lieu of volumes they generate but the investment in logistics and information technology is huge which leads them to diseconomies of scale.

High Growth, Still a Rocky Road: Competition to Surge as Players' Respond Aggressively

Academic research usually mentions ecommerce as a sound strategy and an ideal opportunity for developing countries to cash in on new economic avenues. The literature on the adoption of innovation promotes several dominant perspectives.

Technological imperative model such as innovation, technology acceptance (such as compatibility, relative advantage, ease of use, usefulness) are key drivers of adoption. E-retailers have been offering similar services like same say delivery, single day delivery, free shipping, express checkout, pick-up point, and cash-on-delivery. Organizational imperative models assert that the key determinants of adoption reside in organizational strategy. They look at organizational characteristics such as specialization, functional differentiation as major determinants of adoption of e-retailers. In India, some of the players are entering into exclusive sale deals (For example: Flipkart with Xiaomi, Amazon with Karbonn Android One). Also, players are becoming innovative and are selling products such as stamps (Snapdeal), automobile (Snapdeal has partnered with Mahindra), real estate (Snapdeal has tied up with Tata Value homes). Further, niche segments have also evolved in the space (For example: Zopnow, Bigbasket, etc. are selling groceries online while Bluestone, Voylla are selling artificial and real jewellery of gold, diamond, etc.)

This innovation will continue as the players jostle to capture a larger share of pie in the market. All the players which have evolved in the Indian market are offering similar services which are expected to result in severe competition leading to price war.

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At the cost of margins leading to diseconomies of scale

E-commerce forces companies to find new ways to expand the markets in which they compete, to attract and retain customers by tailoring products and services to their needs, and to restructure their business processes to deliver products and services more efficiently and effectively.

E-retailers are primarily focusing on customer retention and organise flash sales, bumper sale, season sale etc. where the products are sold at throw away prices. These offers and discounts are aimed at increasing consumer base and increasing volumes. However, doing this the companies enters in diseconomies of scale and becoming profitable remains a distant dream (Table 2).

Table 2: Company Reports.

		Flipkart		**Amazon**		**Snapdeal**		**Myntra**	
Net Sales	**Rs Crore**	**2012-13**	**2013-14**	**2011-12**	**2012-13**	**2012-13**	**2013-14**	**2011-12**	**2012-13**
Operating	Rs Crore	1180	2846	36	112	34	168	67	212
Net Profit	Rs Crore	-276	-382	5	-20	-120	-265	-49	-218
OPM	Per cent	-23	-13	13	-18	-356	-157	-73	-60
NPM	Per cent	-24	-14	7	-22	-276	-127	-76	-63

Economies of scale without inorganic growth?

Economies of scale occur when a firm's long run average cost per unit fall as its production increases. A firm efficiency affected by its size where large firms are often more cost efficient due to the fact that they clinch better deals from the manufacturers and have high bargaining power from both buyers and sellers thus achieving economies of scale.

In e-Commerce market, the method of inorganic growth helps the parent company to diversify its product portfolio and also increase logistic capabilities. Further, the acquirer gets access to the customer base of the company acquired. Few researchers have examined the effect of acquisitions on firms' risk. Studies such as Mandelker's [40] and Jensen and Ruback's [41] posit acquisitions may lead to changes in firms' risk through changes in firms' mix of products or through diversification of their cash flows.

Global e-Commerce players including Amazon Inc and eBay Inc have utilised their huge cash piles well to acquire numerous smaller companies over the past few years (Annexure I). These acquisitions have undoubtedly helped the companies expand into varied geographies and also diversify their product portfolio. It has also helped in maintaining cost efficiently by backward/forward integration thereby helping in better profitability without jeopardising on the discounts/offers. For example: Amazon Inc. has cash reserves (cash, cash equivalents and marketable securities) of $17.4 billion, and earned revenues of over $89 billion in 2014. Similarly, eBay reportedly has cash reserves of over $10.1 billion and recorded revenues of $18 billion in 2014 (Figure 5).

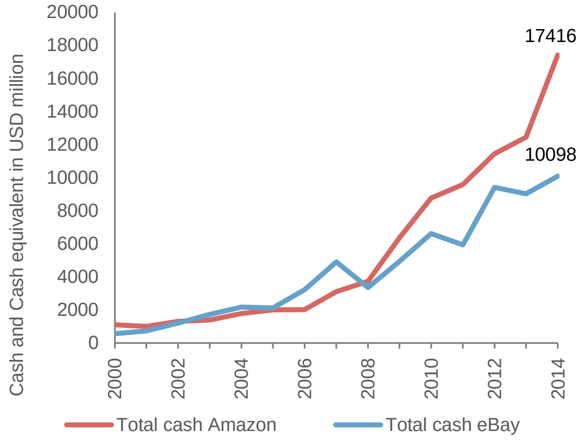
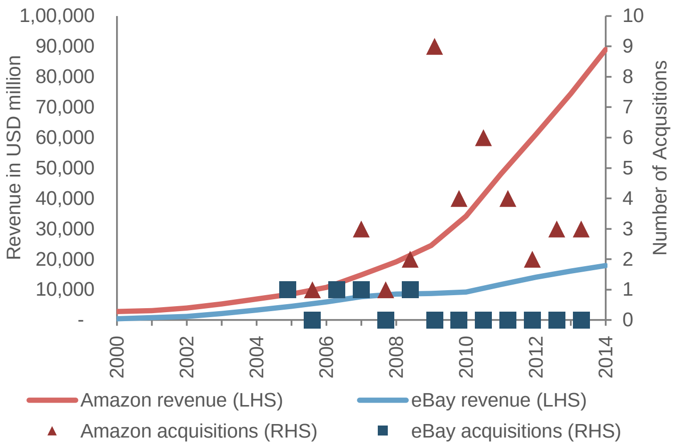


Figure 5A: Minting big: player sitting on huge cash piles…



Source: SEC Filings

Figure 5B: Acquisitions resulted in faster revenue growth.

Researchers such as Luo and Tung argued that multinational enterprises undertake acquisitions to access ‘‘strategic resources and reduce their institutional and market constraints at home. The literature provides a variety of possible driving forces behind acquisitions. Some researchers have found that acquisitions may increase market power [42] improve efficiency [43] reduce operating costs [44] and transaction costs [45] and/or enhance the management of resource dependency [46,47].

Scholars have also explored cross-border M&A's as a preferred entry mode in emerging economies (EE) from the perspective of firms based in developed economies (DE) [48].

Further on applying correlation on Amazon's acquisitions and operating profit we find over 67 per cent of the profit can be explained with the help of acquisition. The P-value which is less than 0.05 make the correlation significant (Table 3).

Table 3: Strong positive correlation between acquisitions and operating profit

parameter	**unit**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
Amazon Acquisitions	No's	1	1	3	1	2	9	4	6	4	2	3
Amazon Operating profit	$Million	271	440	432	389	655	842	1129	1406	862	676	745
Pearson correlation	0.67											
p-value	0.024											

Note: Data for operating profit and acquisitions is taken from company filings with SEC

Source: Author computation

Indian Players Need to Re-Look Strategy Before Global Firms Take Advantage

Flipkart acquired leading online fashion e-retailer Myntra in April 2014 for around $300 million to fill a void in Flipkart's portfolio - giving it a presence in the fashion and lifestyle segment. Snapdeal, too acquired companies like esportsbuy.in and Shopo.in in April 2012, and May 2013, respectively to diversify portfolio in segments like online sports goods and handicrafts (Annexure 2). The acquisitions are likely to provide the companies additional revenue, higher customer base in coming years. However, profitability will remain a constraint. Amidst this, Indian players need to re-look their strategy as it is important for companies to maintain economies of scale. For a vast, demographically diversified country like India, where logistics is a prevailing issue, it is almost difficult for an e-Commerce company to build its own delivery network. Thus, the companies have to grow by mergers and acquisitions to gain access of geographies captured by other players. This will help the companies widen their portfolio thereby widening customer base. Acquisition and merging with the big Indian players will help the small companies and big players to maintain on-up volume as compared to global counterparts. This will also help in achieving huge volume, efficiency in terms of service and delivery and price competitiveness the three pillars of survival in eCommerce battle.

CONCLUSION

Thus it can be concluded that India is undoubtedly having huge potential for growth for e-retail. As the penetration of internet, smartphone, computer increases the consumers will increasingly switch to online channel for shopping. However, with the typical mindset of the people, discounts and offers will be the primary driver for change in behaviour. For the players, it will be difficult to cope up with discounts, and offers while incurring fulfilment costs such as logistics and technology cost. The companies will fail to make profit under such scenario. Thus inorganic way of growth will be an ideal way for companies in India to grow. Acquisitions will help in increasing penetration, diversifying product portfolio, and minimising logistic and customer acquisition cost thereby reducing operating cost and the companies will be able to enter economies of scale while improving profitability.

FURTHER SCOPE OF RESEARCH

E-Retailing entails wide array of categories/segments such as apparels, electronics, grocery etc. The current research and the literature talks a lot about the growth, dynamics at an overall level and the strategy the players should adopt to grow with improving profitability. However, much less is known about the segments. The research can be extended to the segments in order to understand the difference across segments and its response to consumer behaviour and right strategy for players in different segments. The research could go beyond even analysing what works, but rather why it works or not, how, and under what circumstances.

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Annexure 1

Target	Year	Comment
Amazon Inc. acquisitions		
Twitch	2014	Live streaming video platform
Kiva systems	2012	Technology firm
Zappos	2009	Online shoe and apparel retailer
Shopbop	2006	Designer clothing and accessories retailer
BookSurge	2005	Print on demand company
Joyo.com	2004	Chinese eCommerce website
CDNow	2003	Online retailer
eBay Inc. acquisitions		
StubHub	2007	Online marketplace for non-travel ticketing
Craiglist	2004	Classified advertisements website
PayPal	2002	Payment solution provider

Note: Some notable acquisitions are only shown in the table above

Annexure 2

Target	Year	Comment
Flipkart acquisitions		
WeRead	2010	Social book discovery tool
Mime360	2011	Digital content platform company
Chakpak.com	2011	Bollywood news site
Letsbuy.com	2012	Indian e-retailer in electronics
Myntra.com	2014	Indian e-retailer in fashion and lifestyle
Snapdeal acquisitions		
Grabbon.com	2010	group buying site
esportsbuy.com	2012	online sports goods retailer
Shopo.in	2013	online marketplace for handicrafts

Note: Some notable acquisitions are only shown in the table above

Annexure 3

Following assumptions have been taken into consideration to compute the opportunity size:

- Around 30 per cent of the food items can be purchased online in rural areas while around 60 per cent of the food items can be purchased online in urban areas
- Around 50 per cent and 90 per cent of non-food items (includes consumer goods, toiletries, household products, lifestyle products etc) can be purchased online in rural area and urban areas respectively.
- Percentage estimated taken based on survey response taken from around 100 people in the different age group (18-35 years) across different income bracket spread across different cities
- NSSO data gives the estimate of consumer expenditure across rural and urban areas per capita per month. Data is available for 62nd round conducted in June 2010. Data for current year is computed taken into consideration inflation factor across categories, assuming demand of any category is inelastic to price change due to inflation.