

The Health and Beauty Sector Online

A familiar story of conflicting data, struggling online retailers and some promising market niches

In the spring issue of *Research Quarterly*, ICSC surveyed the online grocery business and concluded that the Internet offers conventional real estate-based grocery stores a good opportunity to add value for their customers. This time, the focus is on the other end of the neighborhood shopping center—the drugstore.

Like the grocery business, a number of upstart Internet retailers jumped in early and offered consumers the whole range of drug/health and beauty products (drug/HBA). Also like the grocery business, the conventional drug/HBA retailers have been quick to defend their territory. In some respects—particularly in the prescription drug part of their business—they began with some advantages over their pure Internet rivals that the land-based grocers didn't have over theirs. These advantages have severely tested the viability of the pure Internet companies and limited the growth of online drug/HBA sales. However, there are certain drug/HBA product lines that strongly lend themselves to being bought and sold over the Internet, and these lines are likely to drive online growth in the segment.

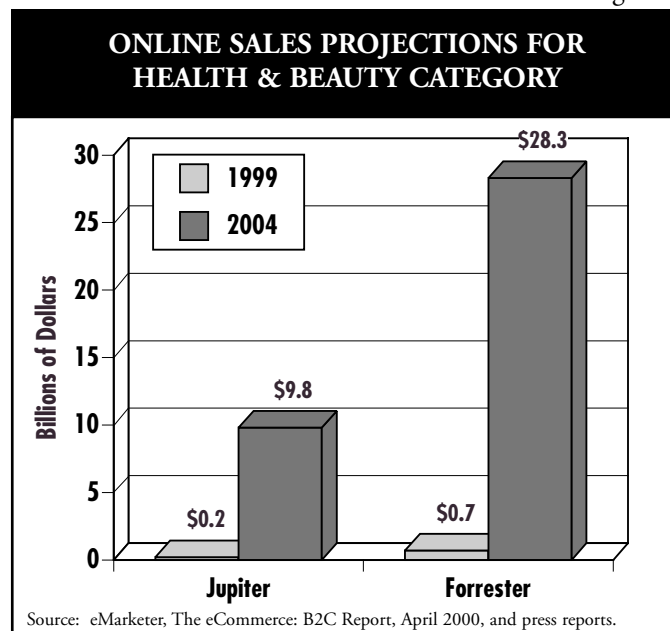
This article first surveys online sales projections for the drug/HBA segment. It then looks at the leading online retailers in the segment, the obstacles they face, and the advantages they have in attempting to expand market share and achieve profitability.

SALES PROJECTIONS

Figure 1 shows two online drug/HBA sales projections for 1999 and 2004. Online sales in the segment don't currently amount to very much if these estimates are to be believed.

Unfortunately, current sales data are variable in quality and there is no reference point to determine which is right and which is wrong. For example, the NRF/Forrester Online Retail Index puts health and beauty sales at \$498.745 million for January through April 2000.

Figure 1



Drug/HBA sales are not particularly seasonal (33% of 1999 drugstore sales came in the first four months of the year, according to Census Bureau data), so a reasonable annualized figure would be on the order of \$1.5 billion.

However, further analysis reveals some significant data conflicts. The *measured* NRF/Forrester number for the first quarter of 2000 is \$386.628 million. Harris Interactive, which also measured first quarter sales, came in with a number less than half NRF/Forrester's: \$153 million. Meanwhile, NPD Group weighed in with a significantly higher number—\$517 million—for the February–April 2000 quarter. Each of these sources claims scientific data collection methodology.

The Internet economy data problem has, until recently, been seen mainly as the lack of a statistically sound methodology for forecasting. That, in turn, is largely attributable to the absence of historical e-commerce data and experience upon which to base forecasts. We don't, so to speak, know the "shape of the curve." However, analysts need to also focus on how companies are sampling, weighting and making statistical inferences from



the data they are collecting on current spending behavior by consumers.

Although the data problem prevents us from coming up with an accurate assessment of the current size of the online drug/HBA market, we assume that it is unlikely to be more than a couple of billion dollars this year, and probably substantially less.

DRUG SALES AND THE INTERNET: ALMOST A “NATURAL”

At first sight it's hard to understand why the online drug/HBA market has been laboring. It appears to be a natural segment for Internet sales because health is information-intensive and the Internet is an ideal medium for delivering information along with products. Consumers can easily research medicines and purchase them at the same Web site, or at least at the retail Web site associated with a health services portal. According to market research firm Cyber Dialogue, researching health issues online is the sixth most common reason that people use the Internet.¹

The Internet has two other big things going for it when it comes to drugs/HBA: first, consumers can conduct their transactions confidentially and anonymously—the Internet takes the embarrassment out of sensitive drug/HBA purchases. Second, there are a large number of consumer goods found in drugstores that are non-perishable and need to be periodically replenished—shampoo, toothpaste and so on—thus lending themselves to home delivery, provided that the consumer is farsighted enough to order in advance of need.

However, there are a number of hurdles to be overcome in the consumer's mind.

Convenience

The Internet may be a very beneficial medicine-purchasing channel for the disabled and other individuals who have difficulty leaving their homes. However, despite

the mantra that a big reason why people shop on the Internet is convenience, many consumers still think it's more convenient to shop at a local drugstore. One reason is that drugstores are virtually everywhere—according to the National Association of Chain Drug Stores, there are more than 50,000 pharmacies in the United States.

Not only that, but consumers often can't wait for delivery of medicines. The very nature of illness usually calls for treatment without delay. If a consumer wants to obtain a prescription medicine from an online drugstore, he/she must first mail in the prescription or have his/her doctor call it in. Then there is order processing and shipping time. As a result, online drugstores typically advise customers to expect about a week to elapse between sending in the order and receiving the shipment, even when the customer specifies an “express” delivery method. For example, Internet drug/HBA retailer Drugstore.com's delivery schedule for a new prescription is 5–8 days with overnight delivery—it costs \$11.95. For refills, overnight delivery takes 2–3 days. One of Drugstore.com's main rivals—CVS.com—advises customers to expect a wait of 3–6 business days with overnight express delivery at a cost of \$10.95.

Prescriptions, Ethics and Regulation

Another major stumbling block with online purchase of prescription drugs is that it is first necessary for a doctor to issue a prescription—usually preceded by a physical examination. However, some less scrupulous online drugstores are sidestepping this requirement, a practice that is attracting adverse attention from state and federal regulators. The U.S. Food and Drug Administration has identified a large number of online pharmacies, many of them located outside the United States, which sell prescription drugs online either without a prescription or after the patient has filled out an electronic questionnaire. Some sites are also vehicles for sale of illegal or FDA-non-approved drugs.²

¹ Testimony by Jane E. Henney, M.D., Commissioner of Food and Drugs, Food and Drug Administration, before the Senate Committee on Health, Education, Labor and Pensions, March 21, 2000.

² Testimony by Jane E. Henney.



Privacy

Protection of consumers' privacy has become a high-profile issue in recent months, and there is no area where protection of confidential or sensitive consumer information is more critical than healthcare.

Although there have been calls for regulation of healthcare sites and the Federal Trade Commission is currently considering such a move, the industry is now attempting to preempt legislation by policing itself. A group of health-oriented Internet companies, including online drugstore PlanetRx.com, recently formed the Health Internet Ethics group and advanced a set of ethical and privacy standards for themselves. The guidelines take the form of a sliding scale, ranging from lesser protection for transactions like cosmetics purchases to maximum protection for information about a consumer's health.

While these first steps at self-policing are important, many consumers may feel uneasy about putting their personal health information out in cyberspace.

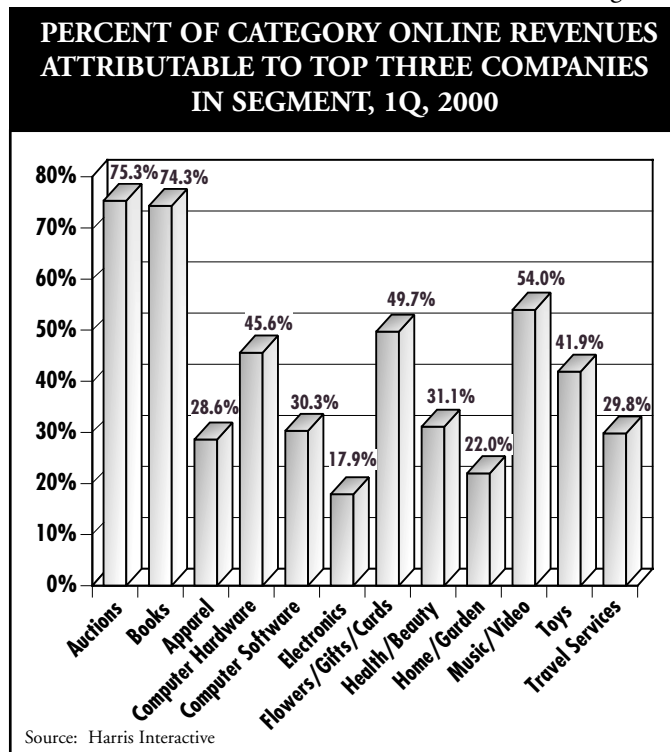
THE LEADING COMPANIES

The online drug/HBA market is relatively fragmented compared to some other online segments: there are a large number of retailers and none is particularly dominant in terms of market share. According to Harris Interactive, the top three drug/HBA sites accounted for 31% of revenues in the first quarter. (See Figure 2.)

Like most online retail segments, no Internet drug/HBA firm has yet made a profit. Also, like many other Internet companies, marketing expense accounts for an extraordinarily large share of revenues as companies attempt to rapidly build their brands.

Only two of the major drug/HBA retailers—Drugstore.com and PlanetRx.com—are independent public companies. In 1999, Drugstore.com lost \$116 million on net sales of \$35 million, while PlanetRx.com lost \$98 million on sales of \$9 million.

Figure 2



As Table 1, on page 21, indicates, Marketing and Sales Expense was easily the largest cost item on the balance sheets of both companies in the four quarters ending March 2000: for Drugstore.com it amounted to 151% of net sales while for PlanetRx.com it amounted to 459% of net sales.

Other online drug/HBA companies didn't quite make it to IPO before the downturn in e-commerce stocks that occurred during the first quarter of 2000. Most notable among them was DrugEmporium.com, a subsidiary of Drug Emporium, Inc., which lost its second chief executive in eight months in March and was forced to cut 20% of its workforce.

Despite these gloomy early results, the Internet companies have worked diligently to compete with their land-based rivals. Among their tactics:

- They are selling their own generic drug brands, made by the same manufacturers that produce generics for land-based drugstores. For online retailers, this is part of brand



building—they want the labelled bottles to act as a lingering advertisement for their products.

- They have formed alliances with pharmacy benefit management companies (PBMs) to gain access to millions of potential customers whose prescription drugs are covered by corporate health plans and HMOs. PlanetRx.com made an alliance with Express Scripts, the third-largest PBM, covering 36 million customers; Drugstore.com made a similar deal with Rite-Aid, whose PBM covers 50 million customers; CVS.com allied with Merck-Medco, the largest PBM, with 51 million customers. Without these deals, online drugstores would be limited to selling beauty products, over-the-counter drugs and prescription drugs not covered by health plans.
- They have also made strategic investments in beauty-related Web sites to bring together the separate drug and HBA subsegments represented in drugstores—e.g., Drugstore.com’s purchase of Beauty.com (an online retailer of prestige beauty products).

CONCLUSION

Online drugstores face many obstacles to their survival, and given the fragmented nature of the industry it is inevitable that some merger activity will occur over the coming months. The weaker companies will be weeded

out and the survivors will presumably be in a better position to take on their land-based rivals, or at least become more attractive acquisition targets.

Although there is undoubtedly a niche for online drug/HBA sales, the ubiquitous corner drugstore will continue to capture the overwhelming majority of drug/HBA sales in the foreseeable future.

Table 1

FINANCIALS FOR FOUR QUARTERS ENDING MARCH 31, 2000— DRUGSTORE.COM AND PLANETRX.COM		
	Drugstore.com	PlanetRx.com
Net Sales	\$56,934	\$17,710
Cost of Sales	\$59,364	\$14,933
Marketing and Sales Expense	\$86,220	\$81,295
Technology and Content	\$19,146	\$18,130
General and Administrative	\$14,219	\$7,852
Charitable Contributions	\$3,600	\$0
Amortization (intangible assets & stock-based compensation)	\$35,305	\$38,626
Total Operating Expenses	\$217,854	\$145,903
Operating Loss	\$160,920	\$143,126

All figures in thousands.
*Drugstore.com’s data are for four quarters ending April 2, 2000.

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