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Cooper Smith | March 19, 2015

BUSINESS INSIDER

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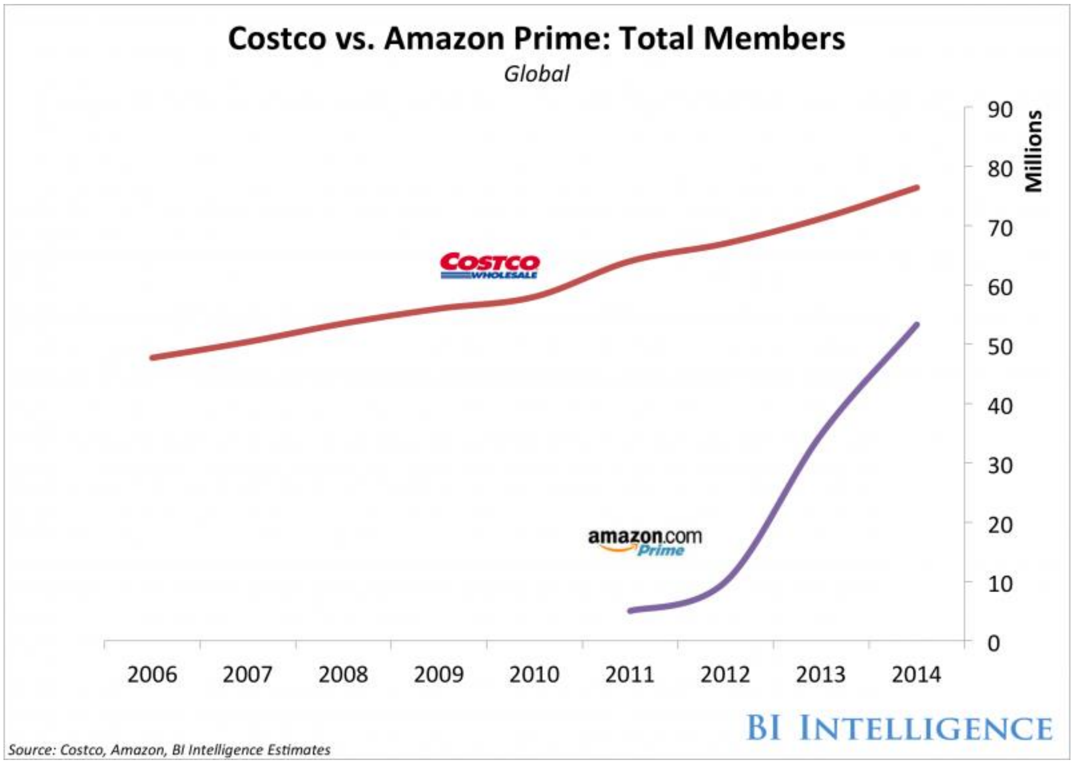
Key Points

- **E-commerce membership programs are taking the Costco model and updating it for the online shopping age.** Amazon, Google, Instacart, Jet, and Sephora have each formed some type of members-only program for online shoppers that gives consumers added benefits in exchange for an up-front yearly fee.
- **Membership programs offer retailers a number of advantages, including increased spending.** About 40% of Prime members spend more than $200 on Amazon over a 90-day period compared to 13% of non-Prime customers. Once customers pay an up-front fee to a retailer they are likely to return and shop more often in order to realize a greater return on that initial payment.
- **But there are also major challenges for retailers operating membership programs.** The services offered to members often come with added costs for retailers, such as absorbing delivery costs, which

may not be easily recouped. In addition, retailers must clear a high bar in order to convince customers that they are offering a service that's actually worth paying extra for.

- **Free delivery and lower prices are the top benefits retailers include in their membership programs.** 74% of US consumers say that free delivery motivates them to shop more online, and 50% say lower prices do, according to Boston Consulting Group. While Amazon Prime emphasizes free delivery, lower prices are the primary attraction of soon-to-launch Jet.
- **Amazon Prime is an example of how offering more services to members, including access to exclusive products and media, can help make a membership program more attractive.** Overstock.com and Uber are retailers that do not have membership programs right now but have begun experimenting with expanding their services.
- **The membership model is proving especially attractive for grocery delivery companies.** Although Instacart doesn't break out what percent of customers are part of its membership program, the grocery delivery startup is reportedly handling over $1 million in sales a week, and accounting for up to 5% of weekly sales for some Whole Foods locations.



Download the charts and data in Excel »

Introduction

Amazon's Prime service, for which Amazon shoppers pay $99 per year in exchange for a bevy of benefits, is the most widely known and used online membership program. It's been so successful for Amazon that other online retailers are beginning to explore and launch up-front, fee-based membership programs.

Programs with membership fees are not new; Costco pioneered the offline model with its bulk discount shopping club over 30 years ago. But for membership programs to take off, they must offer consumers a strong enough incentive to pay an up-front fee. This can include access to faster and cheaper delivery, discounted merchandise, or even exclusive merchandise. As more online retailers explore the model, it's likely they will come up with new incentives that might make a membership worth the price.

Membership programs offer retailers a number of advantages:

- They're an opportunity to get consumers to shop habitually at the same merchant, thereby capturing a larger share of their online spending.
- They can also help retailers reach new consumer segments, assuming the incentives behind the membership program are strong enough to entice those who would not ordinarily shop online.
- Finally, membership programs offer retailers an additional revenue stream beyond product sales.

While e-commerce membership programs can help retailers establish loyalty among their customers, these programs are distinctly different from traditional points-based loyalty programs and more recent e-commerce subscription-based shopping services like Birchbox.

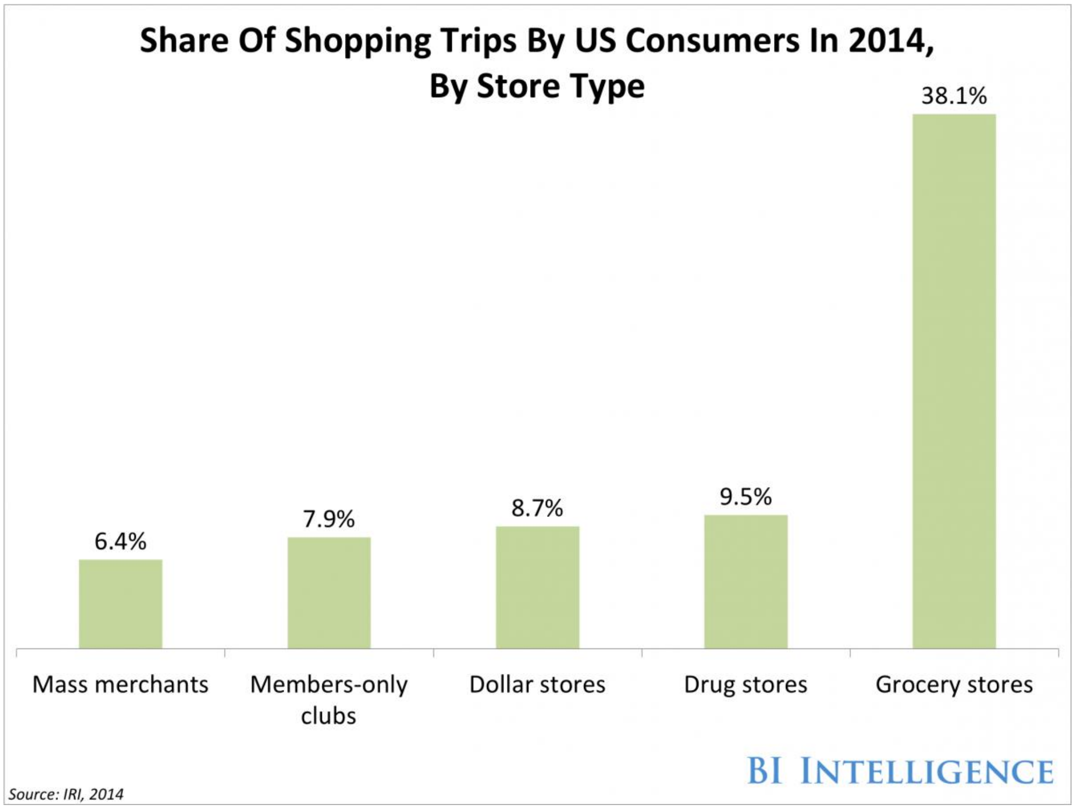
Companies we refer to as having membership programs offer some sort of shopping club or additional, ongoing benefits to customers for an up-front fee. For our purposes, this is how we define membership-based shopping programs.

Examples of online retailers that offer membership-based programs include:

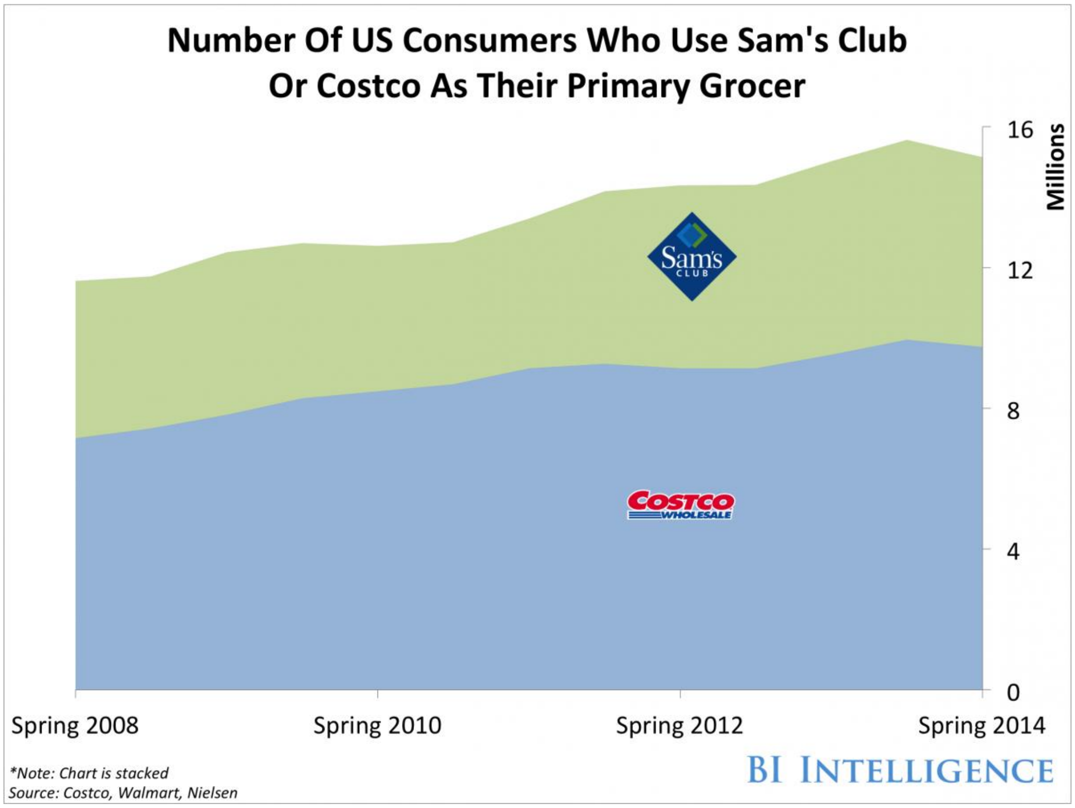
- Amazon, with Amazon Prime
- Jet, a discount shopping site that will launch soon
- Instacart, a grocery delivery service which offers both a la carte and membership-based shopping
- Sephora, which just started a program offering free two-day delivery to paid members

In this report, we will assess the advantages and disadvantages of e-commerce membership programs for the retailer, as well as what consumers might look for in these programs and what incentives are needed to get people to sign up. We also include examples of how some e-commerce companies are structuring membership programs and provide an outlook for other retailers and product categories that could benefit from employing the membership model.

Because Amazon Prime is the most mature and far-reaching online membership program, it provides a useful benchmark for what services these e-commerce companies might offer and the advantages and challenges that come with launching such a program. We'll use Prime throughout the report as a touchstone, and also discuss new programs from both established and nascent online businesses.



Advantages of membership programs



Membership programs are already popular for consumers shopping offline.

- **8% of store visits in 2014 occurred at members-only shopping clubs such as Costco and Sam's Club,** according to market research firm IRI. That's more visits than mass merchants like Target saw.
- Costco and Sam's Club boast nearly 16 million US customers total who use the up-front fee-based bulk shopping warehouses as their primary grocer.

As online shopping becomes more mainstream, we expect shopping clubs to become more commonplace in e-commerce as well.

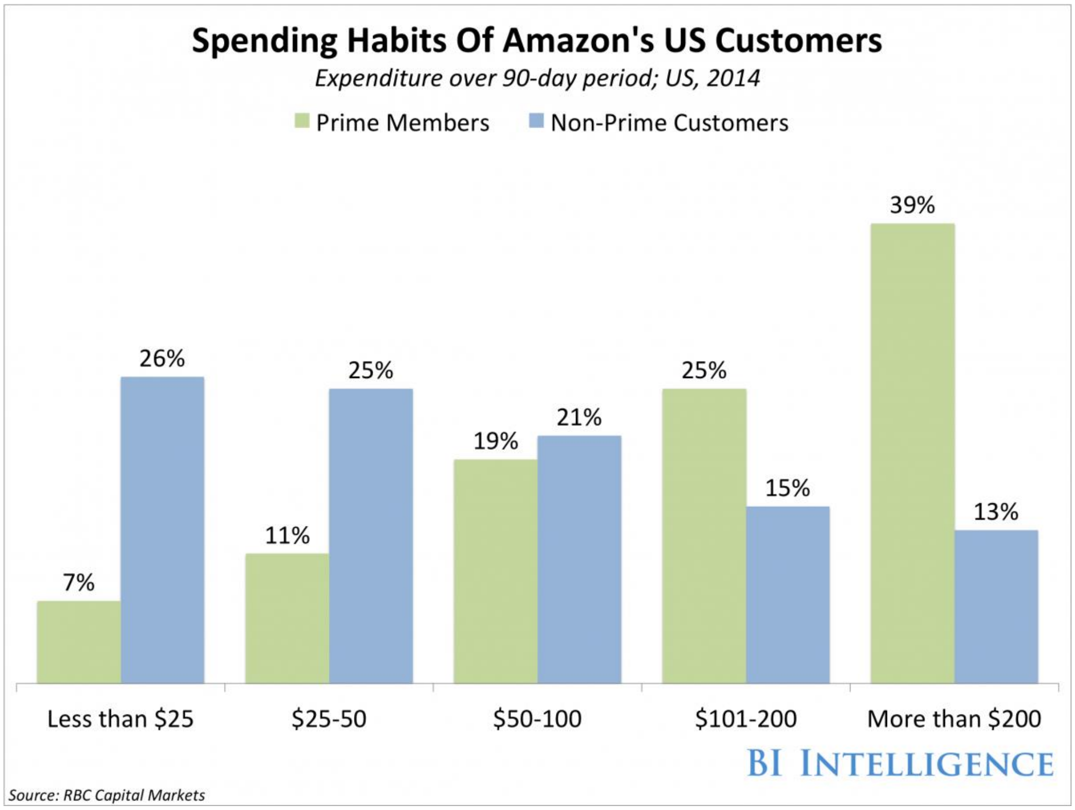
There are three potential advantages for an online retailer to having its own membership program:

1. **Capturing a larger share of customers' spending.**
2. **Acquiring new customers.**
3. **Gaining a new revenue stream.**

Customers who pay an annual fee to participate in shopping programs end up spending more than customers who do not participate in such programs. That's because these programs have to give their customers strong incentives to pay an up-front price. Customers then want to recapture that initial spending by using a program's services more frequently, whether those services are free shipping or discounted merchandise.

For example, Amazon Prime members end up shopping more on Amazon than non-Prime customers.

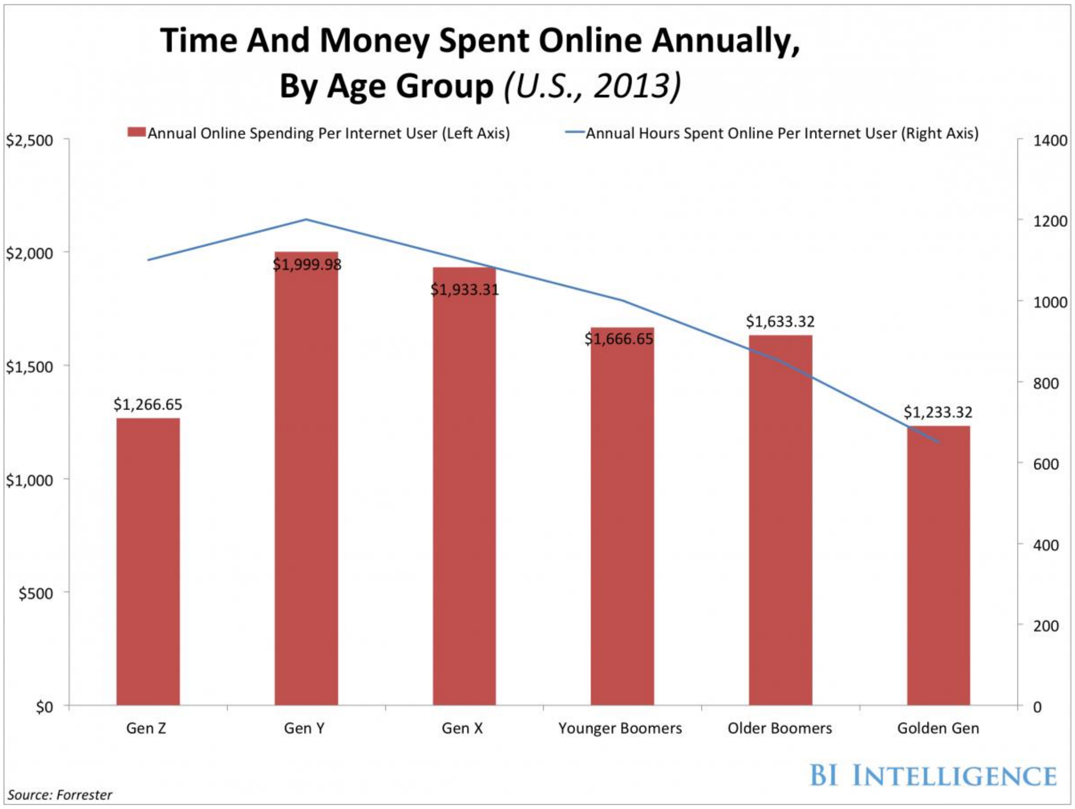
- **39% of Prime members spend more than $200 on Amazon purchases over a 90-day period, compared to 13% of non-Prime customers,** according to RBC.



Similarly, e-commerce startup Jet, which will launch in the first half of 2015, offers members discounts on household goods, similar to Costco's model, and this alone should incentivize more shopping on the site. But the e-commerce platform goes even further and gives consumers a reason to buy even more products every time they fill they up their shopping basket. Discounts add up as consumers rack up more purchases from the same local retailer. (Jet partners primarily with local retailers and has very few of its own warehouses.) In this way, there's a twofold reason for members to migrate more shopping onto the platform.

Membership programs can also help retailers acquire new customer segments — including those who might not typically shop with a retailer if there were not the added benefits that come with the membership program.

- **A greater share of Prime members are over the age of 40 than non-Prime members.** 62% of Prime members in the US are 40 years of age or older, compared to 50% of non-Prime customers who fall into that age bracket, according to data collected by comScore.
- **Prime is particularly attractive to senior-aged shoppers** — an age demographic that hasn't traditionally been Amazon's core customer, or the core audience for online shopping. Only 12% of non-Prime customers are over the age of 60, but 20% of Prime customers fall into the older age bracket.


Time And Money Spent Online Annually, By Age Group (U.S., 2013)
Annual Online Spending Per Internet User (Left Axis)
Annual Hours Spent Online Per Internet User (Right Axis)
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Gen Z
Gen Y
Gen X
Younger Boomers
Older Boomers
Golden Gen
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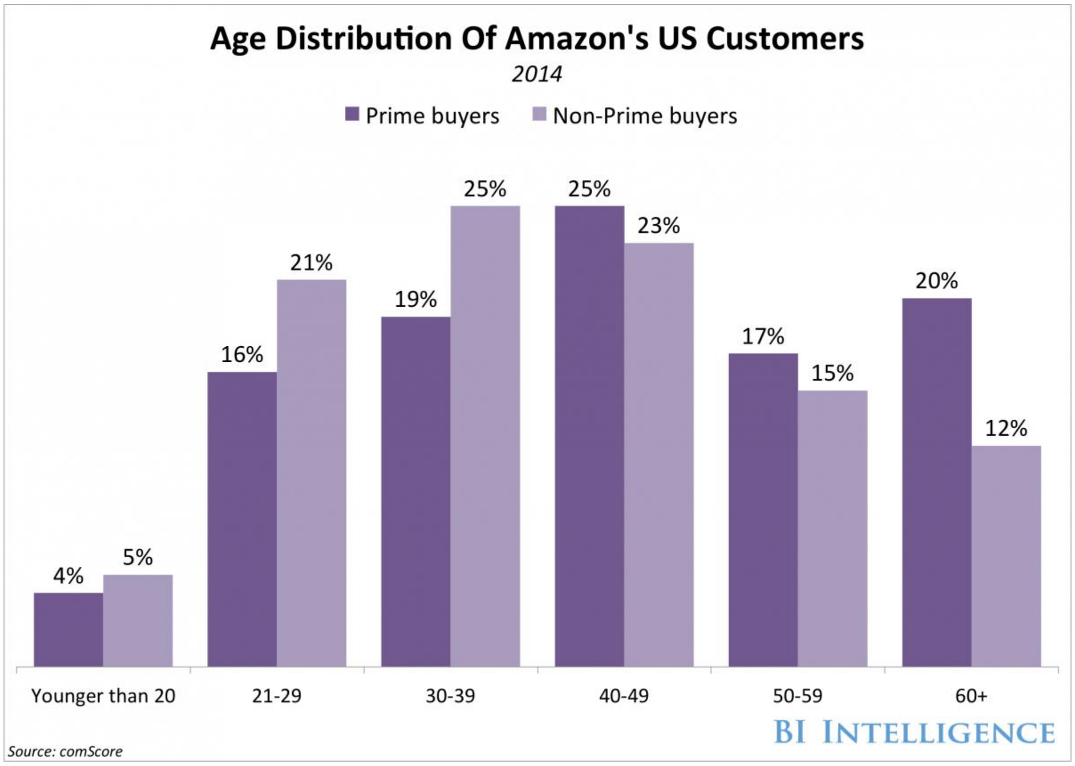
Source: Forrester


Age Distribution Of Amazon's US Customers
2014
Prime buyers
Non-Prime buyers
4%
5%
16%
21%
19%
25%
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23%
17%
15%
20%
12%
Younger than 20
21-29
30-39
40-49
50-59
60+
BI INTELLIGENCE
Source: comScore

Gaining an additional revenue stream is another potential benefit of membership programs. Since customers pay an up-front fee to join the program, this is money the retailer would not otherwise earn. But, that said, there are also costs to operating membership programs, and these costs vary depending on the benefits given.

In the case of Amazon, membership revenue likely helps offset the cost of offering free two-day shipping, but it is unlikely to fully cover those costs. Jet, on the other hand, expects to rely entirely on annual membership fees of $50 per person in order to generate revenue. The company says it does not take a cut of any sales made on its site. (Amazon *does* take a cut of third-party sales.)

Disadvantages of e-commerce membership programs

There are some significant disadvantages to operating e-commerce membership programs. **The biggest disadvantage is that it can be a major cost center for some online retailers, depending on what benefits the retailers offers to customers.**

Free delivery, for example, adds up. The current UPS rate to ship a five-pound package in two days in the US is between $15 and $30, depending on whether air transportation is required. Since Amazon says 80% of its shipments are five pounds or less, let's say that the average Amazon shipment weighs four pounds. If you assume that ground transportation is how the majority of packages are shipped, we'll say that the average cost per package is $16. A high-volume retail partner such as Amazon probably gets a discount of around 50% from UPS, reducing the cost per package to $8.

Amazon's gross margin before fulfillment costs is 24%, according to its recent earnings report. So in order for Amazon to cover the $8 per package shipping cost, the minimum order value has to be $33.35. Any order less than that minimum means that Amazon is losing money on the order. But there is no minimum purchase requirement on many items for Amazon Prime members to receive free shipping. Prime customers could ask Amazon to deliver something as low-cost as a roll of paper towels, forcing Amazon to absorb considerable costs.

Beyond delivery costs, making the broader economics of e-commerce membership programs work can be challenging.

One of the main reasons that membership shopping programs fail is that they don't scale fast enough to support costs or bring in retail partners or suppliers. For example, grocery retailer Meijer operated a membership shopping club called SourceClub in 1992, but never made it past seven stores in the US. The club was shut it down after two years.

If Jet doesn't scale fast enough then it will be difficult to attract retail and brand partners that want to use it as a sales and distribution channel; if Instacart, the grocery delivery service discussed later on, doesn't scale, then its delivery costs will exceed the money that it brings in.

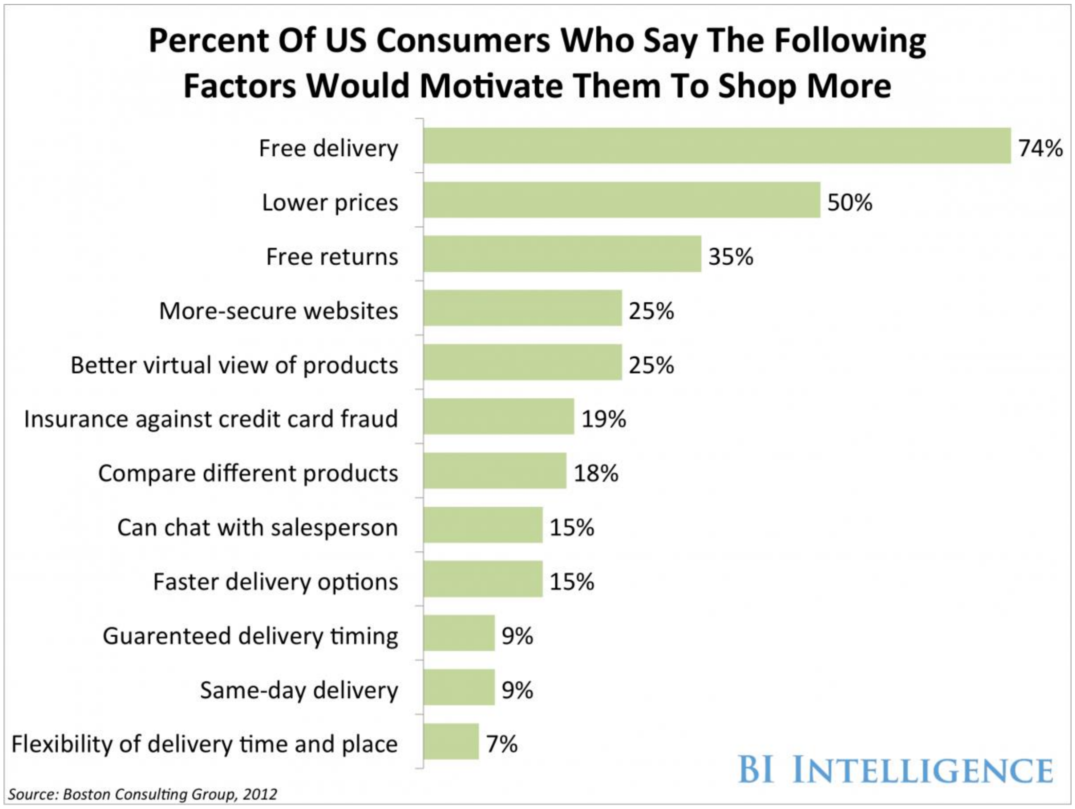
Scaling a membership service begins with generating enough consumer interest. Unlike with other types of e-commerce programs in which people can try them to see whether they like what they get and then decide whether to return to the marketplace, membership programs require an up-front fee, creating a significant immediate barrier toward gaining consumers.

The need to scale fast and quickly bring consumers on board is likely why Jet is planning to spend $100 million on marketing in its first year of operations. That's also why many retailers and delivery services offer a free trial for people who sign up to a membership program. Google Express offers three-months free for new customers, Amazon Prime has a one-month free guarantee, Instacart Express members get the first 14 days free.

But not all those free trial sign-ups convert into paying customers. Seventy-percent of the 10 million people who signed up for Amazon Prime over the holidays converted into customers after their free trial, according to estimates from Consumer Intelligence Research Partners.

Even after someone makes it past the free trial expiration, retention can be challenging on an annual basis. Approximately 16% of Amazon Prime members cancel their membership after one year, according to Consumer Intelligence Research Partners. This is likely why Amazon continues to roll in additional benefits to its Prime program. For example, it doesn't cost Amazon anything to offer Prime members early access to products, but it's still seen as an extra benefit to the customer.

Consumer attitudes toward e-commerce membership programs



Consumers need a strong incentive to pay the up-front price for membership programs, so retailers offering these programs need to make sure it's clear that purchasing a membership is it.

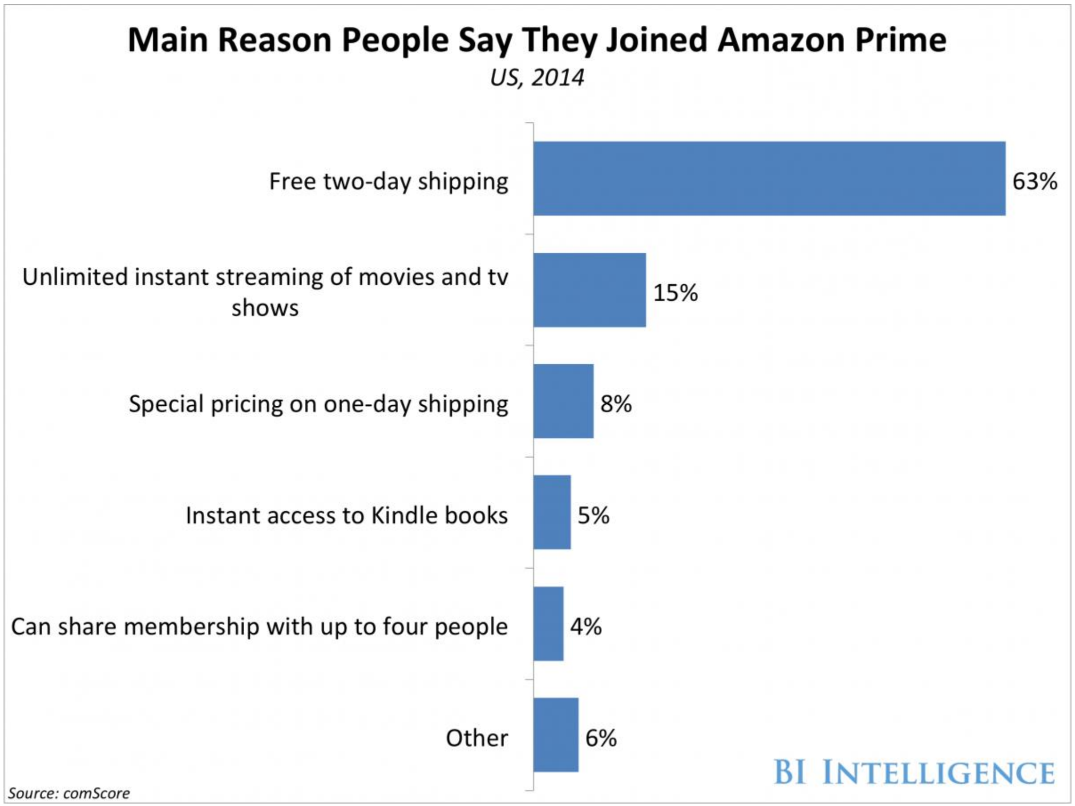
Across all age groups, consumers say that price is the biggest factor when determining where they shop, according to the National Retail Federation. So discounts and savings are typically the cornerstone of e-commerce membership programs. Those savings can either come from discounts on products or discounts on delivery fees.

Amazon opts for the free delivery model as a primary membership benefit, and in fact, 63% of Amazon Prime members say free two-day shipping is the primary reason why they joined the service, according to comScore.

Jet will focus on discounted products, rather than free delivery, but it will encourage shoppers to shop more. This, in turn, will reduce customers' and local retailers' delivery costs. Cheaper products are also the value behind a Costco membership.

Retailers shouldn't limit the benefits of their programs to mere savings, however. For example, Amazon bundles other services into its Prime program, including access to movies and music streaming.

While none of these other services come close to being as compelling a reason to join Amazon Prime as free shipping, it's possible that when people are deciding whether or not to join the program, access to premium media content makes the up-front fee look like a better deal.



Few retailers can compete with Amazon in terms of reach and ecosystem of offerings. But the company does provide a model for giving consumers a compelling add-on to membership, and other retailers may eventually try moving in this direction.

Surplus online retailer **Overstock.com,** for example, announced in early January that it will launch a pay as you go video-on-demand service in the style of Amazon Instant Video. While Overstock does not offer a membership product right now, it could potentially start bundling its products with media and perhaps even create a membership layer. (Amazon Prime is both a bundled and membership program and the two aspects of the program reinforce each other.)

Uber is another company that could launch a Prime-like program. Uber's core business is a mobile app that lets people coordinate on-demand car service. However, it has experimented with letting people order other on-demand services via its app such as food delivery. Uber's entry into these other businesses makes sense. The company has more than 10,000 drivers on the road in New York City alone, and like any car service, there is down time when drivers are in between rides. We could see Uber eventually bundling its transportation and delivery services into a premium membership where customers pay an annual fee in exchange for lower rates on rides and deliveries.

Amazon also keeps expanding the privileges it offers Prime customers, including opportunities to buy new devices like the Echo home assistant, before they are made available to the mass market. Access to exclusive products is another reason consumers might be inclined to join membership programs.

Examples of e-commerce membership programs

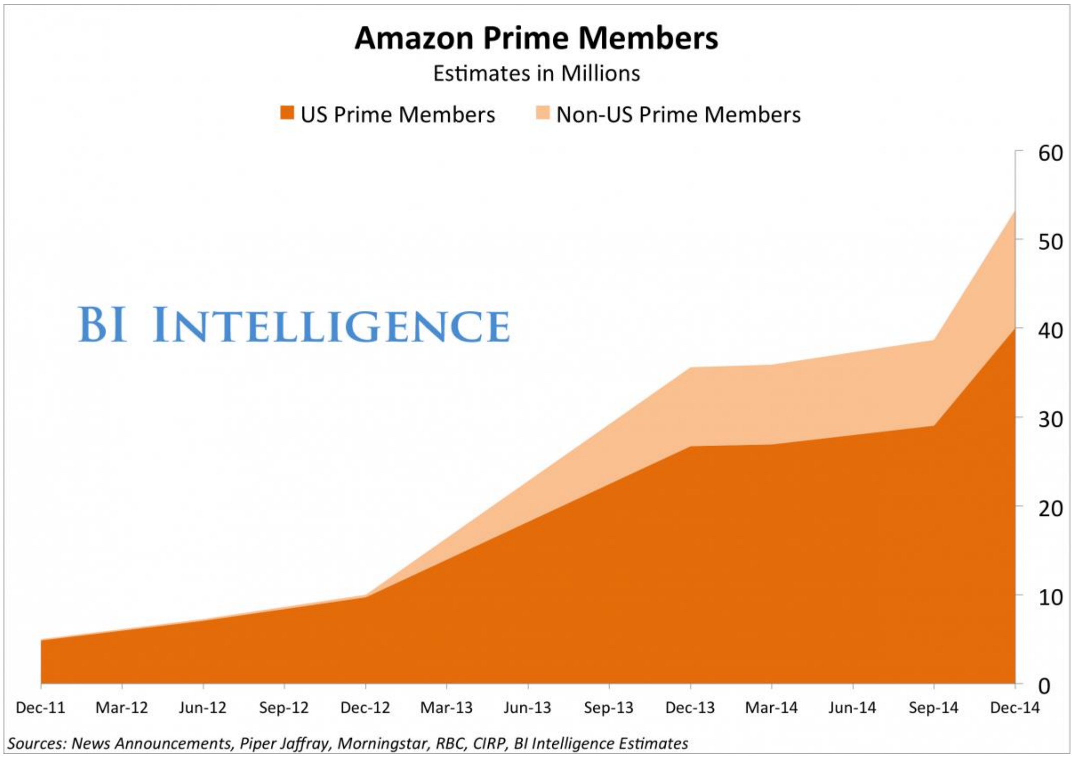
Membership-based shopping programs aren't anything new in retail. Costco (originally Price Club) first-introduced the concept in the 1980s when it let customers buy merchandise in bulk at wholesale pricing — but they had to pay an annual membership fee. Wal-Mart quickly followed suit launching Sam's Club.

Today, e-commerce companies are reinventing the Costco model.

Here's a look at the way the major companies offering e-commerce memberships structure their services:

Amazon: Amazon charges Prime customers $99 annually in exchange for a bevy of benefits ranging from free two-day shipping to access to premium video and music content, as we've said. We estimate that there are approximately 53 million Prime members worldwide — and 25% of those members live outside the US.

Amazon raised the price for Prime membership in March 2014 by $20, but based on the growth trajectory of membership, most consumers seem to find that the services they get from Prime are worth the additional cost. After a brief stall in growth after the price was raised, Prime memberships once again took off in the run-up to the holidays last year. Upping the fee for membership likely helped Amazon recoup some of its costs from offering free two-day shipping to members, among other cost-intensive benefits.



Jet: The new e-commerce startup based in New Jersey that is using the membership model to create a sort of discount-buying club, akin to Costco, but updated for the internet.

The company asks customers to pay $50 annually for a membership in exchange for access to products that are supposedly 10% to 15% cheaper than anywhere else. Shipping is not included in the fee but the company will use an algorithm to pair consumer product needs with the closest and cheapest shipping option among its local retail partners.

Products sold by Jet will span all major merchandise categories, except for automobile parts. The company's retail partner agreement is intentionally vague when it comes to what exactly brands and merchants can sell via Jet. We expect Jet to position itself as a mass merchant with the scale and diversity of offerings rivaling that of Amazon or Wal-Mart.

Jet claims that it can earn enough money off of its subscription fees alone that it won't need to take a fee off of individual retailer's product sales, as Amazon does.

In addition, the company encourages consumers to buy more products at once, which helps reduce shipping costs for the local retailer.

Sephora: The cosmetics retailer recently launched a members-only shopping program called Flash. Members pay $10 annually and receive free two-day shipping, or overnight shipping for $5.95 on all online orders; and, there's no minimum purchase value required. Sephora can likely keep membership fees low because most products the company ships are small, so delivery fees are lower.

When testing the new program, Sephora said that Flash members spent "twice as much" as non-Flash members. That uptick in buying behavior could help Sephora increase its 22% share of the beauty product market in the US — particularly at a time when shoppers are going online more frequently to find beauty products.

Americans spend nearly $300 billion a year on health and personal care products (which includes beauty products), but less than 7% of those sales currently occur online. However, we estimate that by the year 2020 11**%** of those sales will occur online.

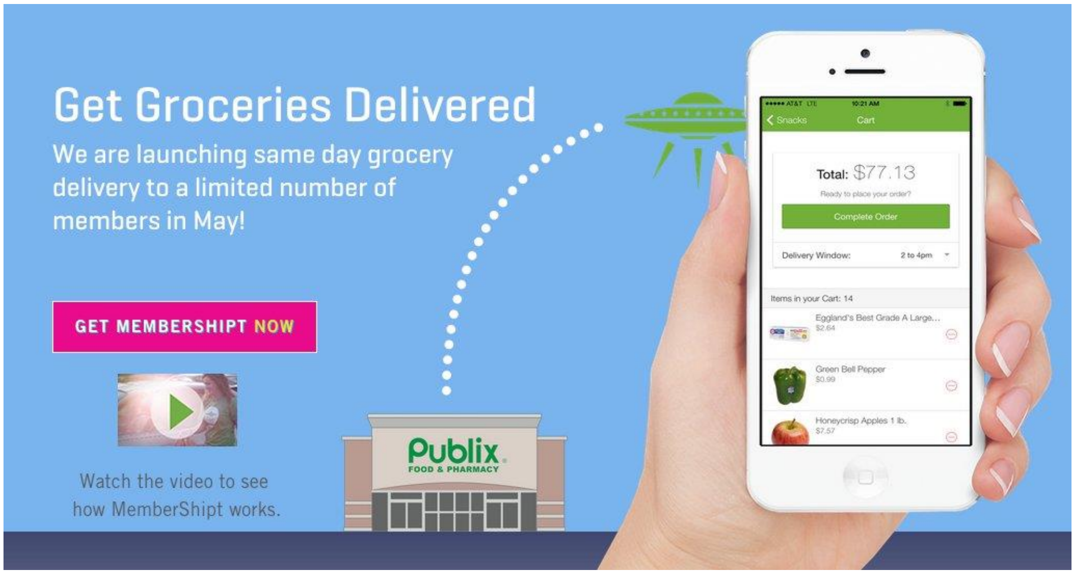
Google: The tech giant also has a membership tier to enroll in **Google Express,** its delivery service available in five markets. Members can pay either $10 per month on a monthly basis, or $95 for the whole year and receive **free same-day delivery** from local stores on all orders of more than $15; a delivery fee of $3 is tacked on to orders that are less than $15. Compare that to non-members who have to pay $5 for delivery on orders over $15 and $8 for orders that are under $15.

There are additional advantages to being a Google Express member, besides lower shipping costs. For example, up to two people per household can share a membership, and they are given priority over non-members during peak delivery periods.

Google Express sells from retailers including Target and North Face and offers goods that run the gamut from groceries to apparel. Compared to other grocery delivery membership programs such as Instacart and Shipt, which we'll describe below, Google Express has a broader range of retail partners where customers can order from.

Google is going all-in on its delivery service; last year the company said that it would invest $500 million in Google Express to expand nationwide.

Grocery delivery services employing the membership model



One e-commerce segment that is using the membership model to drive increased sales is new grocery delivery companies. The grocery industry is huge, bigger than any other retail segment, at $600 billion a year in revenues in the US. But it is also the most untapped retail segment for online sales. Only 1.5% of groceries will be sold online this year.

Startups and established retailers and tech giants are beginning to go after the space aggressively and membership is a key component of many of these companies' business models.

Membership helps secure consumers as repeat customers and allows the companies to lower individual shipping fees on every order. Shipping fees are typically a big barrier to grocery delivery because orders must be delivered fast to guarantee freshness. By asking consumers to pay a membership fee to offset delivery costs, the premium to buying groceries online is lessened.

The grocery delivery model is attractive because it guarantees that customers are getting fresh food straight from their local supermarket, without having to waste time in the store. The typical American family of four visits the grocery store twice a week, according to the USDA.

Instacart: The grocery delivery service partners with Whole Foods, Costco, and Safeway, among others, and offers a membership program called Instacart Express, which costs $99 annually — in exchange, members get free two-hour delivery on all grocery orders. Customers who use Instacart but do not sign up for the membership program must pay $3.99 per delivery.

The company doesn't break out how many of its customers are part of the membership program, but Instacart is reportedly handling more than $1 million in orders a week. In fact, Instacart is already accounting for up to 5% of weekly sales at some Whole Foods locations.

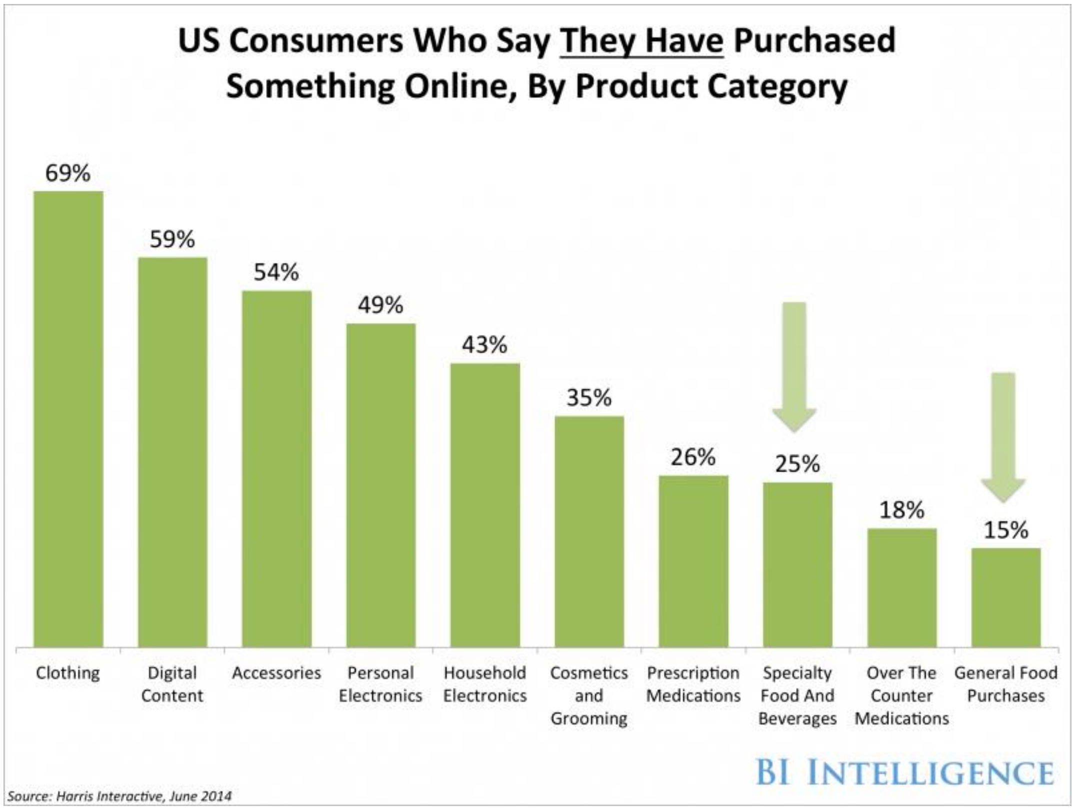
Shipt: This is another service very similar to Instacart, which has its own grocery delivery membership program called **MemberShipt**. Members pay $49 annually and get free one-hour deliveries on orders over $35. Shipt is the delivery partner for Publix — one of the five largest supermarket chains in the US.

Thrive Market: The newly launched organic grocer and wellness retailer asks customers pay an annual fee of $60 for access to products that are supposedly "always 25 or 50 percent" cheaper compared to competitors. (There is no nonmembership version of the service.) Thrive Market has referred to itself as a sort of Costco-like retailer for health-conscious consumers. The major difference is that Thrive Market customers don't have to buy items in bulk like they would have to do if shopping at Costco.

In addition to discounts, another incentive that Thrive Market offers customers is free shipping on all orders that total more than $50, and orders less than that typically have a delivery fee of just $5 attached to them.

- While 78% of consumers say they prefer to buy general food items in-person, a lesser 57% say they prefer to buy specialty food and beverage items in-person.

So the combination of competing on selection (hard-to-find grocery items) and cost (wholesale pricing and low delivery fees), could help Thrive Market, with its membership-based e-commerce model, take market share away from competitors like Whole Foods.



THE BOTTOM LINE

- **E-commerce membership programs are taking the Costco model and updating it for the online shopping age, giving consumers added benefits in exchange for an up-front yearly fee.**
- **Membership programs offer retailers a number of advantages, including increased spending by customers.**
- **But membership programs often come with added costs for retailers, such as absorbing delivery costs, which may not be easily recouped.**
- **Free delivery and lower prices are the top benefits retailers include in their membership programs.** While Amazon Prime emphasizes free delivery, lower prices are the primary attraction of soon-to-launch Jet.
- **Retailers can also think about expanding the benefits of their membership program in the vein of Amazon Prime.**
- **The membership model is proving especially attractive for grocery delivery companies.** Instacart, Thrive Market, and Shipt all offer memberships.

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