Connected Commerce: Beyond Bricks and Clicks

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The world is not just being recreated click-by-click instead of brick-by-brick; it's being reimagined. In the second installment of our Convergence series, which examines five growth themes that are shaping the future of investing, Hugo Scott-Gall spoke with Global Research Analyst Jay Kannan, CFA, about what we call "connected commerce," which covers the entire architecture of the digital economy.

Comments are edited excerpts from our podcast, which you can listen to in full below.

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What is connected commerce?

Jay: We think of connected commerce as an integrated shopping experience—anytime, anywhere shopping. There used to be two discrete experiences, offline and online. It's now come together in an omnichannel world, bricks and clicks.

In other words, it facilitates the end-to-end consumer journey across offline and online mediums, then collecting the data to change future consumer behavior?

Jay: Yes, and many of these insights are then fed back into the dropper funnel, which then creates a flywheel effect of sorts. It can drive even more monetization for merchants and a more enjoyable experience for customers.

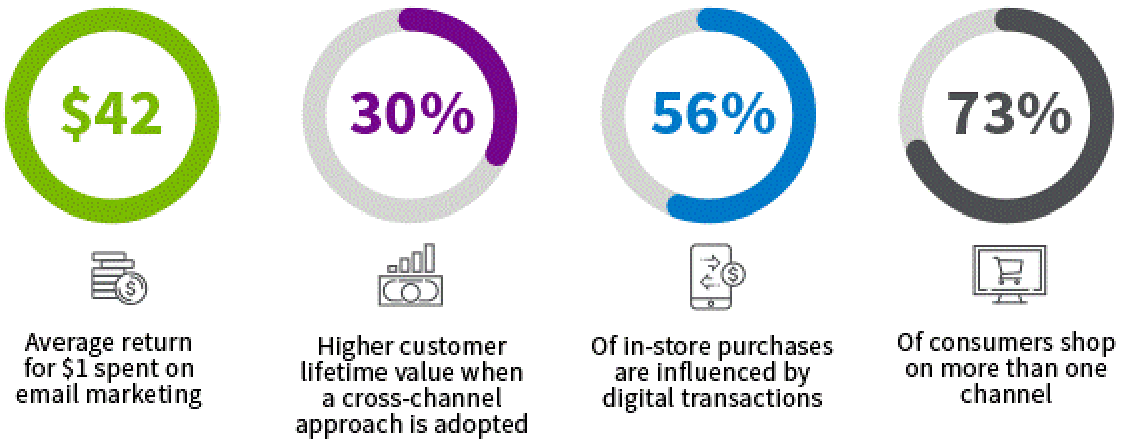
It's often assumed that we took the architecture from the old, physical world and recreated it click-by-click instead of brick-by-brick. But that's actually wrong, correct? This is a new way of doing things.

Jay: I think that's fair. We're bringing together the best of the offline and online experiences, then connecting them in a way so they can talk to each other, sharing insights about what a consumer likes. If you prefer a widget of a certain brand or a certain size offline, there's a good chance you'll have similar interests online as well.

Who is sitting at the middle of the whole architecture? Who owns the must-have pipes that it all has to go through?

Jay: If you think about the value chain in connected commerce, merchants are at one end, consumers are at the other, and there is a wide set of intermediaries in the middle facilitating interactions between merchants and consumers. Intermediaries are essentially the platforms that enable payment transactions or related services, such as mobile e-wallets for consumers who don't have access to the traditional banking ecosystem.

The Rise of Omnichannel Marketing



Source: dotdigital Group PLC, as of 2020.

The online economy feels very smooth compared to how it used to feel. Is it complete? Or will we look back in 10 years and say the system back in 2020-2021 was antiquated?

Jay: I believe we're still in the early innings of online or omnichannel penetration of the commerce opportunity. The current environment, in which many of us are at home, accelerated the pace of many consumers transacting online. Still, less than a fourth or a fifth of global commerce is conducted over the internet.

The CEO of Stripe, a large payments company, says the company's mission is to increase the gross domestic product (GDP) that is transacted over the internet. That means there is a lot further to go when it comes to connected commerce.

What are the problems and pain points to deal with?

Jay: The simple low-hanging fruit is reducing friction between the different platforms, the types of authentication, the types of payment methods, the commissions that are paid, and simply the leakage of the dollar a consumer spends versus the dollar a merchant receives. If we can create more efficiencies, the consumer and the merchant can probably transact at a price that is much closer than what it is today.

What about this idea of leapfrogging, where you didn't have to disrupt something that wasn't there?

Jay: Look at the spread of telecommunications services over the past three to five decades. In developed markets we had fixed-line telephony. That transitioned to mobile phones you could use to text or make calls. Finally we had the advent of data. In emerging markets we leapfrogged much of that, going from absolutely no connection (or maybe snail mail or telegram) to the smartphone. The smartphone revolution increased penetration, availability of cheap access to fast data, and differentiated forms of payments—allowed for this leapfrogging.

In the past when someone bought something, merchants received no feedback. You didn't understand why they went to that place, what they were searching for. You could argue that today a lot more is understood, but are we still quite early on that journey? Does that tie back to what you were saying about the GDP of the internet?

Jay: A good way to think about this might be to think about the evolution of the advertising business model.

Back in the day, which I consider level one, we had basic offline ads, like billboards you drove by every day. You always saw the same billboard.

Level two was online advertising, which was more contextual. If you went to a sports website, you saw an ad related to sports. If you went to an e-commerce website, you likely saw an ad related to shopping.

Then came search, which I define as level three. Depending on what you searched for, you received an ad that was a little more targeted but couldn't really capture ultimate intent. And you often didn't transact at that level.

We're now moving into level four or level five, where merchants or ecosystems can track a consumer's journey. They see some of your past behavior in terms of transactions, intent, or what you may be looking for, and there are predictive analytics that help enhance the customer experience.

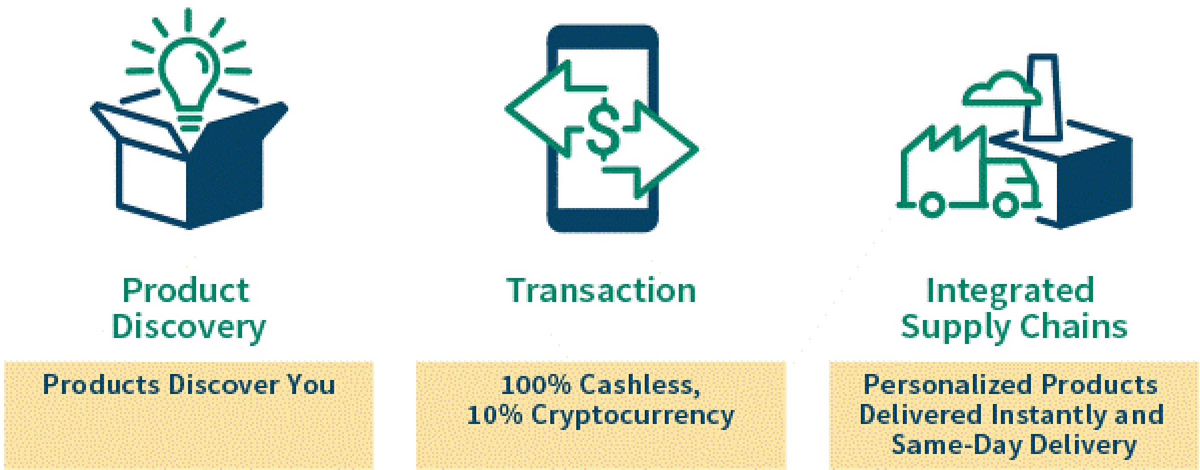
Where can we go from here? We can do a lot more with intent. We can have business models where companies are essentially paid based on the return on investment you get for the marketing spend, so cost per converted customer as opposed to cost per impression or cost per showing an ad.

Merchants, the other stakeholder in the ecosystem, can also implement just-in-time inventory management based on predicted customer behavior. For example, grocery behavior, for the most part, is predictable. It's likely that you'll order the same amount of milk every week if the number of people in your household remains constant.

Is technology removing friction from the consumer shopping experience?

Jay: The old world of commerce involved numerous pain points stemming from the fact that the different parts of the shopping experience did not interact. In the new world, the different parts of the shopping experience form an integrated ecosystem where data and insights (enabled by technology) are shared to influence other parts of the value chain. Ultimately, this helps improve the overall experience for all stakeholders: customers, merchants, and brands.

Technology Removing Friction from the Consumer Shopping Experience



Source: William Blair as of February 2020.

As a technology analyst, the business of forecasting growth is central because it's such a dynamic, fast-growing area. How do you approach that task?

Jay: It can go in so many different directions, so as much as we'd like to explore, we sometimes have to bring it back to growing revenue pools and exploitable opportunity sets within them.

We often try to think about first principles—the overall revenue pie and how this may either be growing in different areas of the economy or shifting as a result of technological changes—as a starting point.

There are quite a few bread crumbs that we find along the way. This can involve reviewing funding activities. We often look at what the smartest venture capitalists or private equity investors do as a guide for what might be changing in the economy.

We also try to either speak with who we believe are the cleverest minds, be they academics or scientists or entrepreneurs in innovative companies. We'll use some of that as a mosaic to identify patterns.

This idea of identifying of patterns makes me think about the idea of recombinant innovation—when you take two things and put them together, they produce something that you wouldn't necessarily predict, like a TikTok or Pokémon or virtual reality.

Jay: I remember first thinking about this a few years ago because the phrase "recombinant innovation" comes from *The Second Machine Age*, which was a book whose author taught at my graduate school.

Think about leisure time over the past 10 years. While time devoted to online leisure has largely remained flat, that time has moved toward some combination of gaming or consuming content, either audio or video. Then we add a lot of these other elements, like commerce.

Very often now you have one platform that uses communications technology but solves different problems. It takes up a fair amount of your leisure time, allows for entertainment, allows for shopping, and uses some form of underlying payments technology to enable all of that.

Of the growth themes that sit within your coverage in the broader tech sector, which do you think are underestimated?

Jay: If I had to classify growth as it relates to the technology sector, I'd probably bucket it into five categories about which we feel very excited.

The first is ubiquitous connectivity, which is more devices, more connections. The second is digital enterprise 2.0, which is more enterprises adopting digital infrastructure (cloud infrastructure for the most part). The third is next-generation computing, which is an increase in both our need and capacity to consume more processing power. The fourth is the digital lifestyle, which is services like classifieds or food delivery. The fifth is de-globalization, which we've seen for both geopolitical reasons and as a result of supply-chain disruptions over the past year or so.

Having set the framework for where we think growth might be, one aspect of growth that is likely underestimated is the digitalization of the consumer. That's happening in different parts of the world but in smaller, atomic business models. These models could be geography-specific (so in countries that are late on the adoption curve) or consumer-specific (where behavioral shifts haven't taken place to the extent that they have in certain other parts of the world).

What have you learned from an area that has been consistently underestimated rather than overestimated?

Jay: We often say innovation or technology is incremental until there's a step-function change at some point, and then it becomes radical.

Think about smartphone penetration, especially in emerging markets. The secondary and tertiary impacts of that have been underestimated. Think about the change in consumer behavior resulting from smartphone penetration—overcoming illiteracy, innovation around payment systems, localized solutions for localized problems.

It's often easy to suggest that one global technology can be adopted around the world, but often that's not the case. We underestimate the ability of local, innovative companies to produce solutions that cater to their local markets.

Give me some low-probability but high-impact things that could radically change the economy, the way we live, your area of technology more broadly.

Jay: Let's perhaps start with the more obvious ones. Faster rollout of 5G could lead to new business models—smart cities, fixed wireless, social use-cases—reaching parts of the population who don't have access to high-speed, broadband internet today. And connected autonomous vehicles could lead to greater efficiency or better safety outcomes.

When we think of less obvious ones, let's think about broadly what's happened as a result of the current environment. We've seen increased personalization of technology, such as wearable devices or even smart fabric (which may not be so much of a moonshot five years from now), and that data is being used to predict health outcomes or leading us to eating healthier, exercising more, speaking with one another, things like that.

We can also think about the commercialization of drones, where packages are delivered by drone as opposed to being delivered by a person.

5 Growth Themes Shaping the Future
The more we ask how the world is changing today, the better we can position our clients for tomorrow.

Jayesh Kannan, CFA, is a global equity research analyst.

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