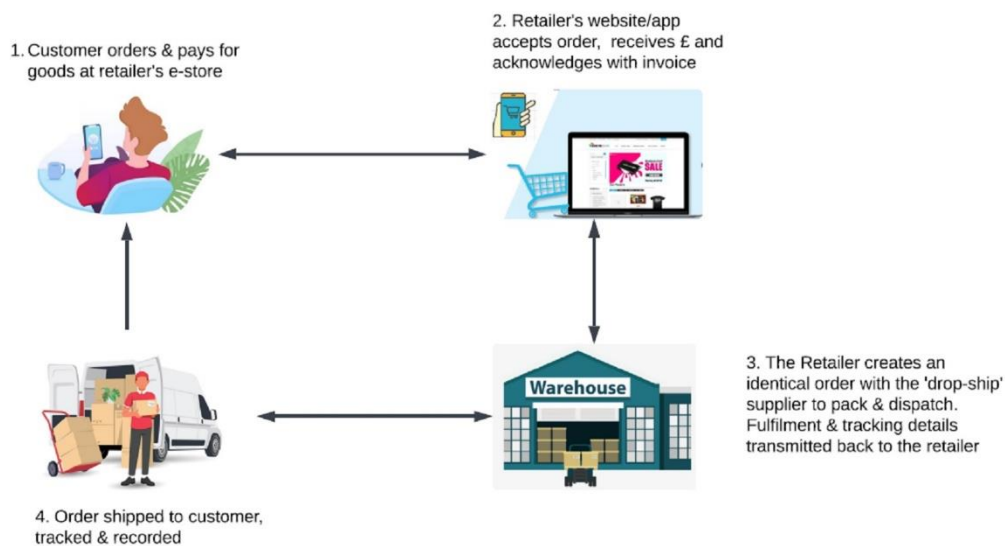


Drop-Shipping: The ideal ecommerce business model?

By Peter Domanski co-founder of Kegsoft Partnership, February 2024

This is a Kegsoft case study article – Superficially, drop-shipping presents a seductive route into ecommerce without significant starting capital, however, in practice it's rather more challenging and requires considerable business and IT acumen. KBL (Kegsoft Business Language) is particularly useful & suited to drop-shipping enterprises enabling business users to create processes for automating tasks and managing essential information exchanges between their online store and suppliers.

Drop-Shipping Business Model



Drop-shipping is an increasingly popular business model for web-savvy ecommerce entrepreneurs as it eliminates the online seller's need for warehousing, packaging, and product shipping. It's a fulfilment method that enables an ecommerce business to sell products without the upfront costs for stocking and logistics. A customer visits the retailer's website or uses an app to make and prepay an order which the retailer relays to a third-party supplier / wholesaler who then ships it from their warehouse directly to the customer.

The online retailer acts as a middleman between customers and suppliers without handling the product or managing physical inventory - a significant advantage for small businesses or entrepreneurs who are just starting out. The retailer concentrates on positioning the products details and prices on their website, handles SEO, marketing and sales processes and when a sale is made, instructs the supplier(s) to ship the products to the customer. With cash taken upfront the retailer can pay the supplier immediately (if no wholesale account) and the retailer keeps the margin between wholesale costs and retail sales prices. The financial risk to both parties is thus low.

Drop-shipping now encompasses a whole range of goods & services and many Third-Party suppliers have adopted technology to become fulfilment specialists, which benefit both online entrepreneurs

and 'bricks and mortar' wholesalers. For the retailer, there are off-the-peg, web-based ecommerce packages with an 'ecosystem' of plug-compatible apps for social media, SEO and specialist functions so starting-up and configuring your store is easy and affordable.

Pros of the Drop-shipping Business Model

- **Low startup costs:** You don't need to invest in stock upfront, which means you can start your business with minimal capital.
- **Easy entry:** You don't have to be an IT guru or internet wizard to get going – just some business sense.
- **Low overhead costs:** You don't need to worry about warehousing, packaging, or shipping, which can save you money on rent, utilities, and logistics staff costs.
- **Flexible location:** You can run your business from anywhere with an internet connection, which gives you the freedom to work from a small or home office.
- **Low financial risk:** Orders are prepaid and since you don't need to buy inventory upfront, you pay your supplier to fulfil them as you go
- **Wide range of ecommerce options:** You can start-up your eshop, configure it and add functionality without the need for expensive IT resource
- **More suppliers adopting to drop-shipping technology:** An increasing number of suppliers are happy to work with you and have adopted streamlined procedures

Can a drop-shipping business have a frictionless operating model?

The ideal drop-shipping business would operate seamlessly with a smooth pipeline of receiving orders through to delivery, the operators would not even notice that other suppliers and distributors were doing fulfilment. However, would-be entrepreneurs and those looking to expand their enterprises, should not underestimate some challenging operational details that underpin the apparently simple business model. We'll look at these further but the fundamental reason for caution is that drop-shipping requires a 'virtual' online store *without control of all its end-to-end logistical processes*, instead there's dependence on good supplier relationships, stability and trust between retailer and supplier(s). The number of extra moving parts in the sales pipeline can create friction so for scaling up, good operational design and discipline is essential even for simplest drop-shipping business.

Pay attention to detail and avoid complexity

All businesses benefit from a robust operating model and none more so than drop-shippers as the bigger the scale, the greater the need for operational effectiveness. Drop-shipping is notorious for throwing up issues with data management and proliferating 'exception processes' which are generally manual workarounds, thereby more prone to human error. Cumulate Issues can seriously disrupt operational routine by creating complexity and stress that absorb precious time & resources.

Order cancellations, replacing damaged goods, returns and other delivery issues are normal events traders factor in but with drop-shipping these events are more awkward as fault resolution and remedy is complicated by extended lines of communications and divided responsibilities. It's a no brainer then, to minimise the operational scenarios which generate these events. In our experience the biggest drop-shipping sins to avoid are:

- Accepting orders for products that are out of stock (OOS)
- Accepting orders using wrong prices
- Publishing the wrong / outdated descriptions for products

- Applying the wrong delivery charges
- Late delivery / missing items

These errors require human intervention that cost time, money and your reputation. Very often the root cause comes simply down to lack of synchrony with suppliers' data, which, if avoidable is symptomatic of inadequate operational procedures. If you sell from your website at a loss or when the items are out of stock - they affect profitability and reputation. There is no hiding place online from bad customer reviewswhich really can destroy your business. Let's look in a little more detail:

Cons of the Drop-shipping Business Model (business challenges)

- **Low profit margins:** Not buying products in bulk, means you won't get the same discounts as traditional retailers so profit margins will be lower and suppliers who service drop-shipping also factor in their extra staff & logistics costs. If volume-related discounts are available, starting out, with no track record, you will probably be put you on basic rates. Also note the card providers / payment gateway you use will cost you an extra 1% or so per transaction until you reach a threshold trading volume.
- **Lack of end-to-end process oversight:** When working well, drop-shipping is great trading model but when parts in the chain fail – e.g. problems with products, warehouse issues or incorrect customer delivery, resolution requires communication with suppliers & shippers which can be frustrating and time-consuming.
- **Quality control:** You lack QC on the products shipped, the shipping times, and the packaging, if your supplier's quality slips so does yours, which can lead to customer dissatisfaction and negative reviews.
- **Your Ts & Cs must be in lock-step with your suppliers:** Care is needed setting your website terms & conditions (e.g. delivery times, returns policy) as you cannot easily make them more favourable than those of your suppliers. NB 'distance selling regulations' apply in the UK, if your trade is B2C but your suppliers' Ts & Cs are B2B (trade), be careful as your suppliers' terms could be incompatible
- **Slow shipping times:** Unlike conventional distributors, you don't have stock stored behind your office so are unable to personally walk a parcel through to dispatch, instead you are only as good as your supplier who has their own stock-picking processes, working hours, capacity, SLAs. Customers have got used to Amazon's speed of delivery so if you promise Next Day Delivery you have live up to it most of the time. Late delivery is probably the most common complaint you are likely to receive
- **Returns & refunds:** You don't have a warehouse so returns are to your supplier (who gives you an RMA - Return Merchandise Authorisation number), your supplier has to refund you on receipt of goods and you refund the customer – this can be time-consuming & confusing to the customer, it also impacts cash-flow.
- **Warranties:** for higher value items, you need to pay particular attention to guarantee periods & details, particularly, who is responsible for actioning returns, arranging manufacturer servicing, refunds etc.
- **Website conformance & product display standards:** If you use PPC (pay per click) such as Google Shopping, you must use correct GTINS / barcodes for products, have VAT price & delivery costs fully displayed. You must also avoid plagiarism on descriptions and not offer prohibited products otherwise your PPC service could be temporarily or even permanently suspended. Conformance to Google's (and other) standards are regularly patrolled and liable to be enforced without warning.
- **Competitive market:** Drop-shipping is a popular and ease of entry leads to intense competition. Other than lowering your prices, squeezing profit margins, you'll need to work on your USP to succeed so develop charisma and find ways to differentiate yourself from other sellers. You will

have difficulty competing against more efficient, high-volume sellers who use more sophisticated order management and bigger budgets for marketing

- **Competing is expensive:** Getting visitors to *your* website rather than competitors is a black art. 'Organic' marketing alone probably won't keep you in business so like many online sellers you will need pay-per-click (PPC) services such as Google Shopping in which you bid against others for clicks (visits). This is costly and may not result in conversions to sales so you also need superior presentational, SEO and marketing resources to attract attention and gain return regular customers
- **Relationship vulnerabilities:** If you build your enterprise with dependency on just one or two suppliers there is risk that their sales strategy or ownership could change. They might start their own retail website or form an exclusive distributor arrangement with another retailer. These matters can pose existential threats to your sustainability. Diversification is key BUT adding suppliers has its own problems.
- **Accidental mis-selling can happen quickly:** Customers are good at finding lowest prices and items advertised in stock for sought-after products. If you mis-price (too low) or show an item in-stock that isn't – you are a magnet and orders *will* arrive - bad for your bottom line and / or reputation.
- **Exposure to Fraud:** ecommerce businesses are under continual attack from fraudsters, your card processor will often indicate 'high risk' transactions which you can refuse to process. However, if you do fall prey, say to a fraudster using a stolen card, drop-shipping does complicate recovery because of extra parties in the supply chain. Good procedures and vigilance are imperative. Note, payment gateways & card providers will nearly always take the side of the card holder (victim) and 'chargeback', in which the bank will take back the money from your account, it will then be for you to recover the goods. Through experience, it's unlikely that you'll get a refund from your supplier.
- **Constant attention to detail:** There are a plethora of minor details and conundrums for a drop-shipping enterprise to work out. For example, as your suppliers are doing the fulfilment rather than you, brand building is more difficult, take packaging & documentation, will your supplier use your brand imagery and communications details on the customer delivery note and packaging? And take the example of a customer basket with products from different suppliers, the combined value of the order may exceed your free delivery threshold but you may still have to pay the individual shipping costs to each supplier – how will you deal with this so you don't make a loss?

Cons of the Drop-shipping Business Model (technical challenges)

These factors are significant for larger enterprises and those ambitious to scale-up.

- **Volume needs automation:** Efficiency and frictionless trading keeps your costs down and keeps you competitive. For managing transactions and products at volume, automation is essential – manual processing is not scalable, you will need access to good business design and analysis skills.
- **Access to technical skills needed:** Depending on the nature & scale of the enterprise, data management, systems development & applications integration require high levels of technical skill which can be initially costly. Pay-as-you-go 'generic', plug-in services for standard data interfacing are available once architecture and processes are developed but prepare for expense if you push at the boundaries of bespoke innovation.
- **No common supplier standards:** Ts & Cs, technology platforms, product details & specs, access to inventory, price lists and pricing structures vary for each supplier so it's operationally taxing as you strive to standardise and automate what should be common processes. Corporate retailers may be able to dictate how their suppliers' interface with them but second tier retailers and new entrants don't have this luxury.
- **Synchronising your store and supplier stock levels:** To display accurate product stock levels and status on your website you synchronise your virtual store inventory with the suppliers'. How

frequently you synchronise will depend on trading volumetrics – (e.g. commodity-type products sell faster than capital items). A resync may be necessary >1 per day, particularly if your supplier is servicing multiple outlets who are also decrementing the stock levels. Some suppliers provide a live inventory feed so you can automate updates.

- **Synchronising with your supplier's cost prices:** Setting your sales prices using latest supplier prices is imperative. The frequency of cost price (wholesale) change is entirely dependent on your supplier(s). For commodities and in times of economic turmoil, prices can change rapidly. At Kegsoft we manage an ecommerce store with tens of thousands of products and anticipate 100s of price changes every day and 1000s monthly so automated pricing algorithms are essential. Many suppliers provide up-to-date price data feeds on demand for download, however, you must be prepared for prices published *ad hoc* on pdfs, weird spreadsheets and even by email.
- **Alternative suppliers for same products:** This is a tough one. Products *usually* have unique identities defined by the manufacturer (but alas, not all), these are referred to as GTINs and or Barcodes, but the maker may also allocate a separate catalogue product code. Suppliers (/distributors) may use manufacturers' codes for their inventory but just as likely allocate their own product codes (or SKUs) so it's common for the same product to be referred to with different product codes by different suppliers. Selecting the supplier to use (based on advantageous inventory / cost price) and the product code to publish on your website and cross-referencing supplier codes for price comparison is technically challenging. You probably require a technical compromise and even manual intervention / override.
- **Setting your delivery charges:** Shipping charges are usually added at checkout depending on value, dimensions and destination (postcode) but you are not doing fulfilment and it's your supplier who calculates what to charge you when *you* make the order on behalf of your customer. Your supplier is likely to use a logistics service charging software (e.g. DHL, Parcelforce, etc.). Your challenge is to anticipate shipping charges for the customer at your checkout. Often this is simplified when your supplier sets charge bands by value & area BUT unless you use a postcode (PAF) checking package you can still be caught out by non-Mainland postcodes. When shipping a freezer, your supplier can distinguish between a Home Counties address and the Scottish Highlands but can your website?
- **Managing product details:** Product details from your supplier may change without warning (colour, specs, packaging, delivery period, warranty, etc.) and keeping up to date using information buried in a spreadsheet or pdf can be challenging
- **Pricing Strategy:** Small numbers of products, say from specialist suppliers, which change infrequently, can be priced manually - perhaps by managing a spreadsheet with margin calculations and updating the website product by product once a quarter. However, for large numbers of products with different brand and price tiers, limited offers, alternative suppliers and competitor pricing intelligence, the use of logic-based algorithms becomes essential – more so if you are managing frequent cost price changes which need to be actioned immediately.
- **Quality control:** You don't have control of physical stock, warehouse logistics or shipping but your virtual store depends on high quality data management without which your enterprise would be impossible to run. Fortunately, you can do straightforward data quality (DQ) checks on the vital components you do control. These include ensuring your product inventory is up to date (e.g. not offering obsolete or withdrawn items, correct descriptions & expected delivery times). You can also do sense checks & validation on your pricing and other key elements.
- **CRM (Customer Relationship Management):** With potentially more complex interactions with customers and suppliers and with some cases being drawn out, maintaining a reputation for good customer service is a strong reason for implementing a CRM or diary function, it has added benefits for management reporting, quotation follow-ups and generally utilising customer history information.
- **Change control:** As the enterprise develops, the number of components to manage is likely to increase and operationally complex. Drop-shippers are vulnerable because of limited control of supplier and service elements so when change is proposed or imposed it may be operationally destabilising. For changes which you have little or no control, you must be ready to assess impacts and react quickly. Even proposals to acquire new suppliers can impact. A strong grip on

strategy is needed and the use of conventional, easy-to-use planning tools is highly recommended. Maintaining a **Risk Log** is one way of keeping tabs on anticipated adverse events and the use of **SWOT Analysis** keeps an eye on the horizon (Strengths, Weaknesses, Opportunities & Threats).

So where does Kegsoft fit in?

Kegsoft is a partnership of professionals with broad business and technical experience in a wide range of commercial sectors. We are the creators of KBL (Kegsoft Business Language) a smart IT tool designed to close the gap between business users and IT specialists. KBL is ideal for building processes to manipulate and interface data particularly where different technologies have to be bridged. KBL-based solutions to 'Nitty-gritty' processes and procedures can easily be turned into tactical (or strategic) applications which, for example, may take the form of a functions menu for controlling data movements and other actions on a regular basis. Our expertise lies in automating manual processes and workarounds with 'apps' that create incremental functionality without adding complexity. KBL is easy to learn and we encourage *business users* to maintain and even create their own functions using our KBL Studio.

Kegsoft has been involved in drop-shipping ecommerce for a number of years and has designed a platter of techniques to create and maintain inventories and sales pipelines as frictionless as possible. We are used to dealing with 100s of brands, 1000s of products across numerous suppliers simultaneously so have both business and technical expertise. These are some of the functions we have created for daily use:

Product Management

- Automatically create e-store ready records from distributor spreadsheet-based specifications by converting data column entries into formatted HTML
- Add & subtract product tags (e.g. using APIs) to and from e-store records for classification, marking and other product group selection for bulk editing
- Bulk product update functions

Inventory Management

- Synchronise e-store stock levels (on demand) with appropriate supplier – usually by API updates directly into the ecommerce platform, either for full / selective inventory or by delta change depending on volume and e-store server performance
- For products sourced by multiple distributors, set & resolve primary and secondary suppliers with which to synchronise e-store stock levels
- Validate e-store inventory against suppliers' stock levels for new, obsolete and updated products

Price Management

- Bespoke price algorithms based on price tier, brand, supplier restrictions, desired margin requirements, overrides, rounding, break-even point with appropriate safeguards
- Synchronise e-store cost prices with appropriate supplier (wholesale) prices, calculate margin with appropriate algorithms, update e-store (usually by API)
- Bulk update and manual adjustment facility by multiple selection criteria (brand, price tier, last change date, tag etc.) for use with limited time promotions and competitive adjustment
- Competitor price data comparison and for matching, automated adjustments algorithm

Data Quality Management

- Inventory and cost price synchronisation status checks
- Sales price sense checks (margin within acceptable limits)
- Bespoke validation processes

These functions roll off the tongue easily but in fact, involve multiple business logic steps and decision making, they also have to be executed in correct sequence and in a timely manner. Moreover, functions must be delivered to the end users in a logical, understandable fashion and generate an audit trail. In short, they have to be woven into the fabric of the business operating model in the form of data management apps - otherwise they too become further exception processes and manual workarounds ...which, in truth, may sometimes be needed but *such ad hoc* functions should be minimised.

If Kegsoft can be of assistance in an advisory or technical capacity to help you set up or improve your ecommerce enterprise please contact us via www.kegsoft.com