Online Returns Management Strategies

by Sean O’Neill and Julian Chu

Returns management is gradually becoming one of the critical areas that online retailers are focusing on to cut costs and improve customer relationships. How can more effective returns management and reverse logistics strategies help to achieve both of these objectives?

Executive Summary

Growing Importance of Returns Management

Many online retailers have pushed online returns management to the wayside, as they have focused on other key logistical issues such as fulfillment. However, the potential benefits a retailer can realize through improved returns management, both in terms of customer satisfaction, as well as cost savings, are substantial. From a customer relationship perspective, returns policies can actually improve a customer’s overall experience with the retailer, thus enhancing customer loyalty and increasing sales. From a cost perspective, the effective management of returns can help reduce lost revenue, inventory cycle time, and processing costs, while also maximizing value recovery for returned products.
In this eStrategy Consulting Study, Mainspring Inc. (now a wholly owned subsidiary of IBM) concludes:

- Product returns impose significant financial costs on a retailer’s business.

- Current online returns management policies and practices are detracting from the customer experience and hurting customer satisfaction.

- Reverse logistics needs to be managed along four dimensions: consumer management, physical logistics, diagnostics and processing, and disposition.

- Third-party reverse logistics providers can add value to both pureplays and multi-channel retailers.

E-commerce executives need to understand the full impact that returns have on their businesses. High returns rates and the complexity of many returns policies impose additional costs on retailers that could be reduced through partnerships with third-party logistics agents or through better customer management.
Methodology

This eStrategy Report is based on an eight-week consulting study of online returns management strategies completed by Mainspring Inc.’s eStrategy Direct online consulting service. A Mainspring Inc. strategy consulting team conducted research and analysis to assess the drivers of online returns, the components of the reverse logistics activity chain, consumer reactions to online returns policies, and the associated implications for online retailers.

The underlying eStrategy Consulting Study provides an in-depth assessment of the costs of returns, the competitive landscape amongst third-party reverse logistics providers, customer experience and needs, and technologies which may help minimize returns of online purchases. The Study is designed to help e-business executives identify and assess strategic alternatives, then determine their best path forward.
Key Findings

Product returns impose significant financial costs on a retailer’s business

Returns of online purchases have an immediate and lasting impact on a retailer’s bottom line. In 1999, the value of returned goods purchased online was $600 million, and the cost of processing those returns $468 million, according to Forrester Research. By 2003, the value of returned goods is likely to rise to $11.5 billion, with the cost of returns processing jumping to $9 billion.

Total Cost of Online Returns, 1999-2003

Source: Forrester Research
Returns have a number of direct and indirect costs for both the retailer as well as the distributor or manufacturer. From a retailer perspective, online returns reduce net revenues, while still burdening the retailer with the original costs associated with inventory, product packaging, shipment from the manufacturer, and end fulfillment to the consumer. Additionally, the retailer faces customer service and processing costs for the return itself. When trying to dispose of the returned product through resale or other means, the retailer may have to pay for new packaging as well as moving the product to its ultimate point of disposition.

Indirectly, a defective product, or one that has not been fulfilled properly, may have a negative impact on the retailer’s reputation and brand, thus leading customers to shy away from using the retailer in the future. A high rate of returns may also reduce the bargaining power a retailer has with its suppliers, if that retailer is not able to consistently recognize sales.

### Types of Online Returns Costs

<table>
<thead>
<tr>
<th></th>
<th>Direct Costs</th>
<th>Indirect Costs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Retailer Costs</strong></td>
<td>• Lost consumer revenue</td>
<td>• Lost bargaining power with suppliers</td>
</tr>
<tr>
<td></td>
<td>• Original costs of bringing the product to market</td>
<td>• Negative impact on brand</td>
</tr>
<tr>
<td></td>
<td>• Customer service costs</td>
<td>• Weakened competitive advantage due to customer dissatisfaction</td>
</tr>
<tr>
<td></td>
<td>• Processing costs for returns</td>
<td>• Impact on customer lifetime value and switching costs</td>
</tr>
<tr>
<td></td>
<td>• New forward-logistics costs to resell product</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Increased inventory cycle time</td>
<td></td>
</tr>
<tr>
<td><strong>Distributor/Manufacturer Costs</strong></td>
<td>• Lost revenue from retailers</td>
<td>• Retailer frustration with product returns processing</td>
</tr>
<tr>
<td></td>
<td>• Processing costs for returns</td>
<td>• Impact on customer lifetime value due to customer dissatisfaction</td>
</tr>
<tr>
<td></td>
<td>• Increased inventory cycle time</td>
<td>• Added burdens and distractions for forward-logistics operations</td>
</tr>
<tr>
<td></td>
<td>• New packaging costs for disposition</td>
<td></td>
</tr>
</tbody>
</table>

Source: ReturnBuy.com

Distributors and manufacturers face many of the same costs as retailers.
Returned products are often sent back through the supply chain, leading distributors and retailers to lose revenue from retailers. They may also bear processing costs associated with returns, coupled with an increase in inventory cycle time for a product (due to the time required to process the return).

Indirect costs for distributors and manufacturers include the added complexity and distractions to forward-logistics operations associated with disposal of returned products, in addition to potentially strained relations with retailers over returns management issues. Manufacturers may also feel the effects of customer dissatisfaction with the returns process, and the lifetime value of an individual customer may decrease due to that customer’s poor experience with the manufacturer’s product.

These costs need to be managed through more efficient returns management, but more importantly through management of customer relationships. By providing customer-friendly returns policies, along with a higher level of online customer service and product presentation, retailers will be in a better position to manage costs.

**Current online returns management policies are detracting from the customer experience**

Online retailers have generally not looked at returns management as an essential means of improving the customer experience, yet customer dissatisfaction with online returns policies can be detrimental to both customer acquisition and retention. Slow to adopt a proactive approach toward reducing returns incidence and improving a customer’s returns experience, retailers are now beginning to understand the impact returns have on their overall online business.

Returns rates are driven by three primary factors, above and beyond defective or damaged products. First, product representations online often do not accurately or effectively portray a product’s color, size, or features, leading consumers to feel that the product they purchased is not the product they received. Second, consumers may often purchase multiple products of a personal nature, such as two pairs of shoes of different sizes, in order to ensure that they receive one that
is to their satisfaction, then returning the unwanted items. Since this phenomenon is widespread in catalog retailing, it is actually somewhat encouraging that anecdotal evidence on online returns rates shows them to be significantly lower than that experienced by typical catalog operations.

Finally, a retailer’s return policies can have a significant impact on a consumer’s willingness to make returns, due to issues of cost, convenience, and crediting.

- **Cost** – Consumers may face a variety of costs associated with a product return, including shipping fees, restocking fees, and other direct and indirect costs. Shipping fees become an issue in those frequent cases where the online retailer does not provide an offline return option, and in some cases may be borne by the consumer even when an item is defective or delivered in error. Many online retailers charge restocking fees of up to 15 percent of the total purchase price, even if the product remains unopened in its original packaging. Other costs include the time and fuel involved in driving to a delivery service location in order to send a product back to an online retailer. Unwillingness to pay anything to return a product actually leads many consumers to keep an unwanted product rather than return it to the retailer. According to a recent survey by NFO Worldwide, about a quarter of online consumers would rather keep a product than pay return shipping fees!
Returns Management

Willingness to Pay a Fee to Return an Online Purchase


- **Convenience** – Online retailers vary in how easy they make the returns process for consumers. Those policies that are most well received by customers are those that simplify the returns process, allowing customers to return online purchases to nearby offline locations without much hassle. However, in many cases, customers need to repack the product and bring it to a shipping agent for delivery to the online retailer’s warehouse for quality check and return approval. By forcing customers to jump through hoops to physically return a product, retailers risk damaging their customer relationships. Customers will not look on the buying experience favorably if they feel that the retailer is not seeking to make every interaction smooth and hassle-free.

- **Crediting** – Consumers often face lengthy delays in being credited for
goods they've returned to an online retailer. Customers are generally displeased that they are charged immediately upon purchasing a product, yet must wait a week or more in some cases to be credited for a return. Where an online retailer does not allow for offline returns, crediting options may also be more limited; those customers who might opt for store credit or product exchange cannot be served as effectively.

Time to Credit Customer After Return

Source: Electron Economy.

Online retailers must carefully consider the consequences of their returns policies. In some cases, it may make sense to discourage consumers from
making frequent and frivolous returns through fees and other indirect costs. However, there may be a greater benefit in improved customer satisfaction and loyalty by implementing more liberal returns policies. One of the key questions is whether a new approach to reverse logistics can provide an improved customer experience while remaining cost-effective.

**Reverse logistics needs to be managed along four dimensions**

In order to efficiently manage the costs associated with returns, as well as to improve customer satisfaction, the returns process needs to be managed along four dimensions:

- **Consumer Management** – Consumer management is the first step of reverse logistics, where the customer interacts with the retailer or a partnering company in order to initiate the returns process. Retailers must provide an adequate level of customer service to help consumers identify whether the product that they wish to return is truly defective. During this initial step, the retailer can capture information on who is returning the product, as well as what product is being returned and why. This information can then be used to enhance merchandising decisions. Customer return behavior should also be tracked in order to minimize fraud and identify customers with a high returns frequency.

- **Physical Logistics** – Effective management of physical logistics is critical to minimizing the increase in inventory cycle time that results from product returns. The retailer must ensure that a return is sent to a return processing center as soon as possible, enabling the product to be returned to market within a relatively short time frame. Once a disposition method has been selected, the retailer or its logistics partner needs to ensure that the product is delivered quickly and accurately to its ultimate destination.

- **Diagnostics and Processing** – Diagnostics and processing is perhaps the most important step in the reverse logistics activity chain, as it serves both
to strengthen customer relationships as well as to determine what value the retailer can actually recover for a returned good. The retailer or third-party agent must address key questions around product type, product return volume, preferred inventory cycle time, and manufacturer return rules. Once a product has been received at a centralized returns center, it may be sorted by type or manufacturer. As part of returns tracking, the retailer is kept informed about the number and type of products in the centralized returns center, data that feeds into the process of choosing disposition options. A quality check is performed on the product to determine whether the customer should be credited for the return, based on the customer’s initial reason for the return. In order to improve customer relationships, the quality check must be executed quickly, allowing customers to be credited as soon as possible. Reverse logistics operations must be able to handle the inherent complexity of dealing with thousands of SKUs and intricate variations in manufacturer or retailer returns policies, based on time since purchase, product condition, and other related factors.

- **Disposition** – A retailer’s disposition options depend on partnerships with disposition and logistics agents, as well as the importance a retailer places on value recovery over brand. Retailers have numerous options for disposing of a returned good: restocking the product, returning it to the manufacturer, reselling the product at an outlet store, selling it to a gray market retailer or through an online auction house, recycling, donating to charity, or throwing it away outright. In general, retailers should select the disposition method that will allow for the greatest recovery of the product’s initial value. However, in cases where a retailer does not want to denigrate their brand equity or that of the product, such as for luxury goods, the retailer might refrain from selling that product through discount channels. In all cases, given a product in excellent condition, the preferred disposition method is restocking, enabling the retailer to minimize the overall cost of the return by reselling the product at the original price. Disposition options that require working with a third party, such as online auctions and gray market sales, require the retailer to split the proceeds with the partner, thus reducing the value recovered.
Third-party reverse logistics providers can add value to both pureplays and multi-channel retailers

Third-party reverse logistics providers can be instrumental in minimizing costs across the four dimensions of the reverse logistics activity chain. Their attractiveness to any given retailer depends on a number of factors including returns volume, product type, customer type, and disposition needs. As returns management has grown in importance to online retailers, the number of third-party reverse logistics providers has increased as well.

There are two main groups of players. First, traditional delivery firms such as UPS and FedEx have begun to enter the reverse logistics market, transporting returned goods to and from centralized returns centers and providing consumer management services (e.g., granting return merchandise authorization numbers and providing return shipping labels online). Companies such as USF Processors also provide diagnostics and processing services, warehousing returned goods and determining the method of disposition.

The second group of players in the marketplace includes new Internet-focused ventures, including Return.com, ReturnBuy, and ReturnExchange. These competitors generally focus on consumer management, providing retailers with software or hosted services designed to monitor customers and their return habits, granting return merchandise authorization numbers, and reducing cases of fraud. In some cases, these firms are also providing diagnostics, processing, and disposition services to their retail partners, crediting customers, and running online auctions.

- Pureplays can work with a third-party reverse logistics company to fill the need for a physical presence in the marketplace. Pureplay e-tailers that have no physical locations can partner with a third-party reverse logistics company to address this missing capability. The third party would either arrange for pick-up at the customer’s door, run its own drop-off depots, or partner with offline storefronts, such as Mail Boxes Etc., to create nearby locations where consumers can easily return products.
Multi-channel retailers may outsource reverse logistics for reasons of efficiency and expertise. Bricks-and-clicks retailers typically have more complex needs around consumer management, compared to pureplays. In order to manage customer relationships effectively, they need to track individual consumers’ activities across all their purchasing locations, whether online or offline. In some cases, working with a third party may be a better solution than building that capability internally from scratch. In others, the third party might simply offer greater economies of scale and therefore lower costs. In addition, some third-party logistics providers aggregate returns data across retailers, enabling clients to analyze the frequency with which individual customers return products across multiple retailers, providing a more complete picture of their behavior and helping to reduce fraud. Customer return information can also be linked to merchandising and inventory systems to assist with demand planning and real-time inventory monitoring.
Implications

Reduce Returns Incidence

Reducing returns incidence is the most critical returns management issue that online retailers face. By minimizing returns rates, online retailers can lower their costs and boost customer satisfaction. In order to do so, they must address the key drivers of returns. First, online product presentation needs to be enhanced to more accurately portray how a product appears in reality, thus reducing customer confusion or dissatisfaction. Some retailers are deploying enhanced color and 3-D imaging capabilities provided by imaging firms such as TrueSpectra and RichFX. Others are trying simple fixes like online templates of shoe sizes that customers can print out and compare to their own feet. However, in the long run, the real challenge is not simply to try to recreate the offline shopping experience – it’s whether online retailers can creatively harness the unique capabilities of the Web to provide online consumers with greater degrees of certainty about the products they purchase.

Second, retailers need to ensure that an order is fulfilled accurately. The correct items should be received at the customer’s door in secure packaging, in excellent condition, and within a reasonable time frame. While great strides have been made in this area, one still hears horror stories about the wrong products being shipped or items being damaged in transit, because of poor handling or packaging.

Third, customer service must be geared to eliminating product returns, by helping customers learn to operate products properly or directing them to local repair services for minor problems. By subsidizing such small repairs, retailers may be able reduce the volume of products that travel through the reverse logistics chain and thus their overall costs.
Simplify the Returns Process

Making the returns process easier on customers will not only improve the customer experience, but may increase revenues as well. According to a recent Mainspring survey, 58 percent of respondents felt that an online retailer’s returns policy was extremely or very influential to their decision to purchase from that retailer. In fact, high satisfaction with a retailer’s returns policies may make consumers more inclined to spend more and shop more frequently with that retailer online.

Retailers have a number of options for simplifying the returns process. Return authorization procedures should be streamlined, such as providing the customer with an authorization number for the return as soon as one is requested. When possible, retailers should try to avoid charging return fees, thus establishing a greater level of customer goodwill. For multi-channel retailers, a cross-channel returns policy can be a means of eliminating additional returns fees. Additionally, customers tend to feel a greater level of convenience, and often a higher comfort level, when returning online purchases to an offline location. Finally, retailers should strive to make the crediting process as fast as possible. Consumers will generally be more willing to make an online purchase if they believe that they will be credited quickly for any product they choose to return.

Investigate Upsell and Cross-Sell Opportunities

As retailers become more sophisticated about managing returns, they may be able to use the returns process as a means of enhancing customer loyalty and share of wallet. Customer service staff responding to customer concerns about an order could be empowered through IT-based tools to immediately call up a customer’s history, review whether that customer has returned any products in the past, and what that customer’s concerns have been. Armed with this information, they could investigate upsell or cross-sell opportunities, help customers decide what products may also or better fit their needs, and assist them through the purchase transaction.
Evaluate Need for Outside Assistance

When considering whether to use a third-party reverse logistics provider, multi-channel retailers as well as pureplays must ask themselves a number of questions.

- First, consider your returns volume. Those retailers that experience a moderately high volume of returns generally have more to gain from a third-party partnership, because of the partner’s ability to focus exclusively on efficiently transporting and processing returned goods.

- Second, identify the type of products that are being returned most frequently. Products that have a short lifecycle or low margins should generally be processed by a third party. Some retailers, acting on their own, are unable to return products back to the marketplace in under eight weeks, which is far too long for seasonal products. Reverse-logistics specialists may also be able to handle returns for low-margin products more cost-effectively.

- Third, understand the type of customers you are dealing with. Where retailers are seeing a high rate of fraud or non-defective returns, third parties may be more effective at monitoring and managing customer behavior.

- Finally, determine your priorities with regard to disposition. If value recovery is a primary concern, working with third-party providers may be preferable, as they tend to have a wider network of disposition partners, allowing for the optimal disposition option to be chosen.
Regardless of whether an online retailer handles returns management alone or by working with a reverse-logistics specialist, the process must be made efficient in order to reduce costs, and simplified to improve the customer experience. The returns process should be as seamless an experience for the consumer as the initial purchase. (Whether the purchasing experience itself is optimal is another matter, of course.)

In the end, a customer-friendly returns policy may lead to an increase in sales without a corresponding increase in returns, allowing online retailers to reap the benefits of enhanced customer service without the potential costs.
Authors

Julian Chu is an Executive Consultant with IBM’s Strategy & Change consulting group. He specializes in helping executives in the retail and consumer goods industries develop and implement leading-edge e-business ventures and initiatives. Julian can be reached at jichu@us.ibm.com.

Sean O’Neill is a Consultant with IBM’s Strategy & Change Distribution practice. Sean helps consumer goods and retailing executives understand the impact the Internet is having on their businesses. He can be reached at soneill@us.ibm.com.