



Business Models and Strategies: The B2C Space

CHAPTER 3

LEARNING OBJECTIVES

By the time you complete this chapter you will be able to:

1. Describe the special economic issues that affect e-business.
2. Explain the concept of a business model.
3. List the various types of revenue models that are prevalent in e-businesses.
4. Explain the process of value creation.
5. Name and describe the business models that are most common in the B2C marketplace.

Our examination of value nets in Chapter 2 makes it clear that organizations that existed prior to the advent of the Internet can take advantage of opportunities and prosper as a result of Internet-enabled business processes. Firms that have made this move are thriving because they have been clever enough to understand the characteristics of the new economy, to reengineer their business process to take advantage of them, and to execute at Internet speed.

Another category of enterprises is also part of the overall transformation that we are calling the new economy. These are firms that have created whole new business models as a result of the Internet. They represent businesses that have the Internet as part of their corporate DNA and could not exist without it. They are taking advantage of the new economics shaped by the Internet and creating value in ways that were previously unthinkable. In time, many existing firms that survive the transformation will adopt some or all aspects of these models. Both pure-play Internet enterprises and firms with their roots firmly in the physical world represent models that are important to the future of e-business.

The Economics of E-Business

The advent of the Internet as a medium of commerce shattered many of the economic principles that guided the industrial age. The economics of the information age is founded on a new set of principles, some of which are the opposite of traditional economic doctrines. In order to understand the power of the new business

models, we need to understand the economic parameters that affect revenue, costs, and value creation.

1. The economy has shifted from an environment of scarcity to one of abundance.

In the old economy, tangible resources were the foundation for the creation of economic assets. These resources had finite limits and, as they became more desirable, they became more valuable. In the new economy, information becomes more valuable as it is shared, as discussed in Chapter 1. That makes information an asset that grows in value as it is employed for productive purposes, not one that depreciates with use.

Amazon.com, generally acknowledged to be the initiator of many aspects of current Internet business models, provides examples of persuasive information use everywhere the visitor turns on the Web site. As Amazon's merchandise lines have increased beyond books, the site has been carefully organized by product category in a way that is simple to decipher and use. Searching is easy and reasonably accurate. Products are described both briefly and, with a single click, in detail.

One of Amazon's great early innovations was in its use of customers to provide some of the interesting and useful informational content on the site. Amazon has only a few professional reviewers, who cannot pretend to be familiar with all the books offered. Consequently, Amazon asks visitors to review books—and then asks readers to rate the usefulness of the reviews. Content is greatly expanded beyond what Amazon could manage on its own, and every visitor, whether he buys a book or not, has a chance to interact with and become involved in the site. Amazon was also one of the first to give personalized recommendations based on the customer's purchase pattern. If the customer buys several books on advertising and marketing communications, the recommendations for other advertising and marketing communications books are usually quite accurate. If, however, the customer throws in a purchase from a completely different category—say he buys a book on spirituality—the predictive model tends to become a bit confused. The information, however, remains an interesting and potentially useful adjunct to a visit.

More recently, Amazon has used collaborative filtering technology (software that performs statistical analysis to determine patterns of activity) to generate personalized recommendations for books, CDs, and videos. The user gets an individualized recommendation: "People who bought *Internet Marketing* also bought *E-Commerce*." It also produces "Purchase Circle" recommendations; "This book is also popular at the Acme Corporation," or "See what books are popular at Your School."

2. Both business and consumers have a glut of choices in the marketplace.

Amazon.com based a substantial part of its initial business proposition on the fact that it has access to essentially every book in print and many that are not. The implicit message was that there were hundreds of thousands of book stores but only one place to come for one-stop shopping for any title the customer desires. An edited selection, no matter how large, could not have accomplished the same positioning. Amazon maintains the immodest vision of "Earth's Greatest Selection."

This is not to say, however, that niche positionings are ineffective in this landscape of endless choice. Take, for example, HotHotHot.com, a purveyor of "the hottest

products in its niche.”¹ The online business was a creation of Perry and Monica Lopez, who own a little hot-sauce store in Pasadena, California. They later sold to Golden Holdings, a small producer and distributor of gourmet foods. The product line includes delicacies such as Mean Devil Woman, Jamaica Hellfire, and its best-seller, DOA-Cyanide Hot Sauce. Each month it features best sellers from its line and at least one specialty item (Figure 3.1).



FIGURE 3.1 Monthly Feature on HotHotHot.com

Source: www.hothothot.com

According to Ben Arora, the vice president for Internet operations, the site has never advertised on television or done much media advertising of any kind.

Instead, the site relies on word of (burnt) mouth, like when a visitor orders, say, Blair's Sudden Death Jersey Shore hot sauce and tells a friend. Customer acquisition costs are therefore limited to the expense of running a bare-bones site with a few drawings and icons directing visitors to a product catalog, which lists inventory by heat level, country of origin, ingredients, and name.

Arora says . . . his company now averages revenues of about \$25,000 a month. That's a pittance compared with what most sites take in, but then again, most sites can't boast HotHotHot's gross profit margins, which are consistently in the 40 to 45 percent range. With a tight rein on marketing and other costs, "we do make a profit," Arora says.²

¹"HotHotHot," *ecompany.com*, August 2000, p. 78.

²Ibid.

3. Transaction and coordination costs are disappearing.

Just as the disappearance of friction in value chains fosters efficient relationships between a large number of specialized partners, it also permits the development of new business processes and models. Affiliate marketing is a creature of the Internet that would not be possible if transaction and coordination costs were a significant factor.

Amazon began its program in 1996 and had over 500,000 associates as of early 2002. On its site, where it does most of its affiliate recruiting, it has a flowchart that describes the affiliate program with beautiful simplicity (Figure 3.2).

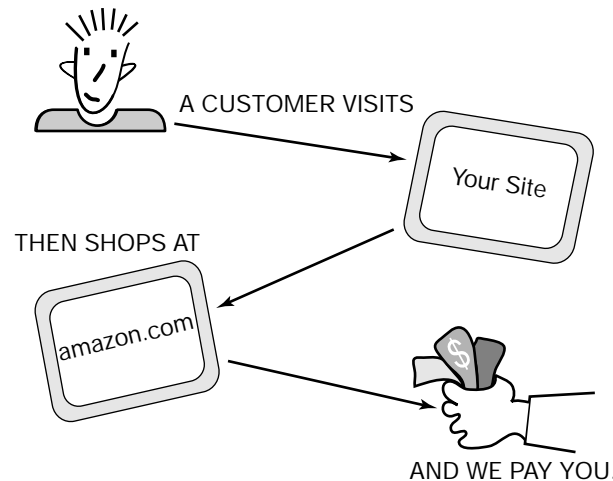


FIGURE 3.2 Amazon.com Affiliate Program Flowchart

Source: www.amazon.com. Used with permission.

The “Join Associates” page describes Amazon Associates as ranging “from AOL.com to Zorro.com.” It explains that the site owner receives a commission of up to 15 percent on referral sales without the expense and hassle of developing a transactional site and carrying out fulfillment and customer service functions. The process is simple: just establish one of three types of links; anyone with a Web site can do it! The prospective associate can register online by agreeing to Amazon’s operating principles and filling out a simple form.³ It appears that the affiliate acquisition program is essentially cost free. Software monitors the sales attributed to linked sites and issues royalty checks. There is undoubtedly some human monitoring of the process to ensure that linked sites are suitable companions for Amazon, but the program is an excellent example of almost nonexistent costs for both transaction and coordination. Amazon does not disclose the proportion of sales that are achieved through associate referrals—neither does it attempt to estimate the advertising value derived from the presence of the Amazon.com logo on over 500,000 Web sites!

³www.amazon.com.

4. It is possible to calculate demand with precision.

Whether it is Dell manufacturing computers to order or Amazon fulfilling orders for books that are not inventoried, demand forecasting can be a real-time operation on the Web, not a hazy prediction of the future. While this has obvious benefits, it also increases the speed of the product life cycle. Winners can be spotted quickly, as can losers. The latter are quickly eliminated with little opportunity for products to catch on and grow slowly but steadily.

5. Switching costs approach zero in the absence of actions by marketers.

Just as visitors can find their way to a Web site with the click of a mouse, they can find their way out equally quickly. Low switching costs are a built-in feature of the Internet because of the common TCP/IP platform that eliminates the need for unique hardware or software connections. The issue of making it unattractive for customers to switch vendors is so important that we devote a chapter to relationship marketing programs.

Internet businesses of many types have concluded that when a visitor/customer invests time in creating a personal page, that visitor will return more frequently. Portals like Yahoo! and subscription services like WSJ.com go to considerable lengths to encourage visitors to develop a custom page and to continually enhance the content and services that are available through those pages. Amazon takes it a step further, effectively creating a personal page for each registered visitor upon each visit. The page greets the visitor by name and offers product recommendations in several categories. A link on the entry page connects the visitor to a "New For You Home Page" that extends more personalized recommendations. Even more compelling are services such as its patented 1-Click process that "remembers" your purchasing information, eliminating the need to fill out lengthy forms. The books Amazon sells are a standardized commodity; services like this make the customer experience nonstandard and encourage repeat transactions.

6. Costs for many products follow a model of high fixed development costs and virtually no variable cost of production.

A company like Amazon.com spends a massive amount of money purchasing off-the-shelf technology as well as developing its own. It must then embed all this technology in an easy-to-use Web site. Having made that initial investment, the front-end cost of serving each incremental customer is almost nonexistent. That remains true until the capacity of the site is reached, at which time another large investment in additional site capacity is required. This part of the equation reflects the familiar stair-step pattern of fixed cost that tends to be true in most industries. It is the almost complete absence of unit variable costs of production and customer service that is different in the Internet environment. On the back end, especially in the fulfillment arena, there are also significant economies of scale but the physical processes of picking (retrieving products from inventory), packing, and shipping orders for tangible products incur significant unit variable costs that must not be ignored in modeling total costs of doing business.

7. Scale is more likely to be defined by number of customers than by production capacity.

Retailers like Amazon.com do not have production capacity in either the physical or cyber worlds. As noted in the previous chapter, manufacturers like Cisco who are

skilled in the creation of value nets are doing less and less of their own production. The lack of assets devoted to production leverages the returns to scale that are the result of large customer bases.

The issue for Internet retailers is investment in distribution capacity, as suggested in the previous section. Amazon.com began by not warehousing any of the books it sold. Over time, however, it found that it could not provide the level of customer service that would keep Amazon at the forefront of its industry without distribution centers located near population centers. The construction of several huge warehouses has clearly added a fixed cost element.

Each one of these seven economic characteristics is different from what we have learned to expect in the absence of the Internet. Some, like the virtually infinite amount of choice, are the direct opposite. The Internet has rewritten the economic rules and permitted the creation of new forms of business. There is one rule, however, that even the Internet cannot obliterate.

Each one of us has only 24 hours in a day, 7 days in a week. That appears to be an immutable law of nature. It means that, in the fast-paced Internet environment, the most scarce resource of all is *time*—the time of both the consumer and the business customer. Because time cannot be expanded it becomes a precious resource. There is only so much time that customers are willing to devote to commercial activities, on the Web or anywhere else.

There are two implications of the shortage of time for businesses on the Internet:

1. The battle to attract visitors to Web sites is exceeded only by the struggle to keep them on the site once they arrive.

There are hundreds of thousands of Web sites and more being added on a daily basis. Although a large portion of them do not have a commercial purpose, the choice of sites to serve any stated need is usually great. Commonly, only a few of the many sites that have a product or service that might meet a given need are visited by the potential customer. Then, if the initial entry point is not attractive and easy to use, the visitor is gone in a mouse click, often never to return. No transaction was completed and the marketing resources spent on customer attraction were wasted.

2. Valuable time spent on the Internet is not often devoted to the pure advertising that exists there.

Advertisements on the Web tend to be viewed as an intrusion, even more than in other media. The competition for the attention of the Web visitor is intense, and pure advertising material is not often the winner of that competition.

The underlying message is that marketers must focus on the customer experience as the single most compelling factor in the acquisition and retention of customers. In order to do this they must combine the best of the technological capabilities with the most thorough understanding of customer needs and behavior. In the contemporary economy products are often standardized, but value can be added by careful construction of the shopping and use experiences. Time-pressured customers, whether consumer or business, are looking for ease and convenience and are willing to pay for them.

The business models that are prevalent in the current Internet economy are the ones that have incorporated and taken the greatest advantage of the new rules. The ones that will survive in the long run are those who understand that the imperatives of back-end costs and profitability have not been invalidated by the new rules of the Internet. The plethora of existing business models needs to be examined in detail. An evolutionary process can already be observed, though the final result is still very much in question.

The Evolution of Internet Business Models

Ever since the Internet became available for commercial purposes in the early 1990s, forward-thinking business leaders have been searching for models that would be successful in the new environment. Jeffrey Rayport puts the search for workable Internet business models in an evolutionary perspective:

In just three or four short years, e-commerce has evolved at lightning speed through a succession of persuasive business models and approaches. The only problem: Each business model seemed viable only for a few minutes or hours, not weeks or months or years. Moreover, each successive iteration seemed to invalidate much of what had come before.

Consider that in the beginning there was a marvelous model for making money in the online environment. It was called the *content* business. . . . People who supplied content to online services (AOL was but one of many such services just a few years ago) got credit for helping keep users online. Since users paid by the minute or hour, this generated connect-time revenues that were allocated according to a negotiated split between content providers and online services. When the numbers of users became large, these deals could generate unexpected riches. . . . When AOL saw its franchise under threat from Internet service providers, who from the start offered flat-rate monthly pricing, it shifted course to an “all you can eat” pricing plan. . . . AOL . . . was simply bowing to the inevitable market structure imposed on the online world by the Web. There, countless sites offered up their information-based wares free of charge to anyone who might surf to their home page or drill down to their sites through search engines.

The very ideas of selling content or metering usage suddenly went from viable and commercially attractive to insupportable and economically naïve. After all, audiences are valuable—and charging for usage is a deterrent to use. So along came the second major commercial model in the online world: the *advertiser-driven* business model. . . . Acknowledging the reality of the online world as a virtual theme park where most rides are free, e-commerce players focused on finding ways to generate revenues based on the sheer volume of traffic that some sites could achieve. Of course, this was a time-honored practice: on Madison Avenue, and in the halls of media conglomerates for many decades, it was, perhaps crassly, termed “selling eyeballs” to advertisers. . . . If traffic and audience size are measurable, then there is even a rational basis for pricing, which allows everyone to heave a great sigh of relief and get down to business in a serious way. . . .

The commercial promise was crystal clear: When Yahoo! could report 140 million page views a day, Gamesville could boast more than four hours a month per average user on the site, or Amazon.com could register more than six million customers, there was a payback for helping advertisers reach their audiences. For everyone else, however, the model did not hold up. Sure, it generated revenues, but

so did the lemonade stand you set up as a kid. For most players, advertising just was not a business. Enter economic model No. 3: *e-commerce*.

E-commerce referred to the practice of selling real products for real money through online channels. The argument was that a lower-cost channel structure resulting from the “disintermediation” of middlemen such as distributors, wholesalers and bricks-and-mortar retailers could reward new intermediaries, such as Web-based retailers, with fatter margins, even as those Web players shared overall channel cost savings with end-users or Web consumers through lower prices. However, the most celebrated of such e-commerce businesses, Amazon.com, managed to raise more questions about e-commerce in many people’s minds than it answered.

For one thing, Amazon.com did not disintermediate its channel because it depended critically on existing physical book distributors. . . . Moreover, Amazon.com spent so heavily on marketing, brand awareness and technology that it has yet to record a profit despite achieving gross margins of a healthy 19 percent.

Finally, Amazon.com expanded into the sales of non-book items, with an apparent lack of regard for the underlying profitability of these new lines. . . . Reasonable people can, and do, disagree about Amazon.com’s future. . . . But while skepticism about Amazon.com may not be justified, a beady eye should surely be cast on many Internet startup companies that have followed in its wake but with a twist. Consider economic model No. 4: e-commerce companies in which strategy revolves around the idea of never making a profit selling real products for real money. Examples are abundant. They range from established players such as Cendant’s C.U.C. International unit (which sells goods through its shoppers’ clubs offline and on the Web at cost and makes money on membership fees), to new entrants such as Buy.com (which markets products across diverse categories at or below cost simply to capture customer relationships on the Web and exploit them commercially at a later date). Perhaps most extreme is Idealab!’s infamous Free-PC, a Web business that gives personal computers to consumers in exchange for detailed information about themselves and a continuing marketing relationship. All of these businesses claim that the land rush is now and it is for customers, not physical assets or market share—and that dollars will follow where consumers begin to tread.

As The Industry Standard magazine recently observed, the magic word these days is “monetize.” The monetizing concept argues that online businesses must first capture large audiences of users or shoppers, and then later monetize those audiences through subscription fees, advertising and e-commerce through a variety of cross-selling, up-selling and service-based approaches sometime in the indefinite future. . . . The investment is in customer relationships, and harvest time is yet to come.⁴

AOL (see Figure 3.3) illustrates all of these steps except lack of profitability; it is one of the few Internet-based businesses that became profitable early and has remained so. AOL has always had subscription revenue, but in the early days it also relied heavily on advertising, as shown on the December 1996 home page. That page announces the new unlimited usage policy and the coming introduction of the immensely popular Buddy List. By December 1998 there was a great deal more content, a personalization option, and a shopping channel. Advertising was still in evidence, as it also was in December 2001. However, on the 2001 home page you see, in addition to AOL’s own house advertising, an emphasis on member services, and shopping opportunities are prominently featured midway down the page.

⁴Jeffrey F. Rayport, “The Truth About Internet Business Models,” Third Quarter 1999, www.strategy-business.com. Dr. Rayport is founder and CEO of Marketspace LLC, a Monitor Group Company.

This brief history of Internet business models makes it clear that the evolution is still in process with no end yet in sight. Or, to put it another way, we do not yet know how many profitable Internet business models there are and what they look like. For that reason it is useful to consider the fundamental process of value creation by the business enterprise.



(a)



(b)

FIGURE 3.3 The Evolution of AOL

(a) December 1996: Mostly content; some interactivity. (b) December, 1998: Increasing e-commerce. (c) December 2001: Heavy personalization; emphasis on interactive services and e-commerce.

Source: The Internet Archive, <http://web.archive.org>.



(c)

FIGURE 3.3 (Continued)

Enterprise Value Creation

In order to understand the basic foundation of value creation by the business enterprise, we should first look at the revenue models that are available to it. Then we can look at how value is created in the market space occupied by the business.

Internet Revenue Models⁵

Rayport's chronology of business models suggests that there are several revenue models, that is, ways businesses can realize revenue on the Internet. Chief among them:

- *Access to the Internet.* A few firms will make money by providing Internet access. Market research firm Jupiter Communications predicts that over time, only broadband access will be a profitable offering.
- *Membership or subscription revenue.* As indicated in the previous section, it is difficult to persuade customers to pay for Internet content. Even though some content sites like the online version of the *New York Times* charge for articles retrieved from their archives, it is doubtful that these small unit transactions contribute much to the profitability of the site. Memberships or subscriptions seem to be a somewhat easier sell for strong real-world brands who can leverage that credibility onto the Web. The *Wall Street Journal* is one of the relative few that have been able to profitably employ this model.

⁵Much of the content in this section is based on a Jupiter Communications Executive Program report, "Internet Business Model Implications," January 2000, www.jupiter.com.

- *Syndication or licensing of content.* Although it has proven difficult to persuade customers to pay for content on the Web, someone must create that content. Physical-world publishers already have content they can migrate onto the Web, although most seem to be creating additional Web-only content to add to the attractiveness of their site. Software firms may choose to license their product to users instead of selling it outright. They may collect revenue based on the number of users, as the creators of most B2B software products typically do, or they may charge on a usage basis like search engine Inktomi, which charges licensees on a per-inquiry basis.⁶
- *Advertising revenue.* As Rayport indicated, the justification given for assuming high customer acquisition and retention costs is often to “monetize” the customer base by selling advertising on the site. The click-through rates on banner advertising, the most common format, are very low, and some advertisers are deserting them, although it is not yet clear that there is a viable alternative. In addition, as the predicted shakeout in B2C firms takes place, there will be fewer businesses to place advertising. On the other hand, physical-world firms are purchasing more Internet advertising. The jury is still out on the quality of the advertising revenue stream, but it is clear that few sites can depend on advertising revenue to sustain them.
- *Transactions revenue.* Sites of all kinds, whether it is their major objective or not, are trying to realize revenue from e-commerce. There are many ways in which they can attempt to do so, ranging from affiliate programs like Amazon’s to the auction pages that one now sees on sites as varied as Yahoo! and USA Today OnLine.
- *Services revenue.* As discussed in the previous chapter, firms like Dell and Cisco are providing customer service on the Web as a value-added element of their offering. Many more firms will do so as they discover the power of self-service in the customer service arena. It seems likely that, over time, some firms will charge for some of their service, either by charging for entrance into some parts of the database or by using a service contract model.
- *Sale or licensing of software or systems.* As marketers of all kinds develop a better understanding of how the Internet can enhance their business, many of them see a need to develop specialized systems. These systems may become an important source of competitive advantage, and some firms will guard them closely. Others, however, will find additional revenue opportunities in the sale or licensing of specialized software. In Chapter 2, we referred to the system development efforts of Life Time Fitness, a chain of health clubs. It operates in six states in the upper Midwestern United States. That leaves a great deal of territory in which it does not compete. This provides an opportunity to leverage its development expenditures by marketing its internal system to other regional fitness chains and to other firms in the hospitality industry who need a membership management system. That is its plan, and it reports a level of initial interest that has led it to create a software division called Averissoft.⁷

⁶For more on syndication arrangements on the Internet see Kevin Werbach, “Syndication: The Emerging Model for Business in the Internet Era,” *Harvard Business Review*, May–June 2000, pp. 85–93.

⁷Paul McDougall, “Decoding Web Services,” October 1, 2001, www.informationweek.com.

These revenue models are not mutually exclusive. Many firms do, in fact, pursue multiple revenue streams, and it seems likely that, going forward, most sites will need to do so in order to be viable. Chances are that additional revenue models will be revealed in this process. The challenge for all Internet marketers is to choose a value proposition that taps into viable revenue streams.

Creating Value

Strategists assure us that value creation occurs—economic value is created—when an enterprise has competencies that can be profitably employed to meet customer needs, as illustrated in Figure 3.4. That is not a new idea. The preceding chapter emphasized the importance of identifying core competencies and focusing on them while off-loading other functions to more skilled and/or lower-cost value chain partners.

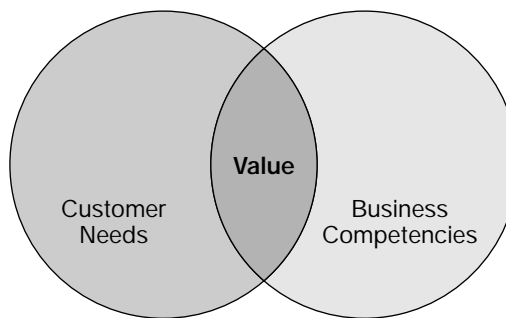


FIGURE 3.4 Enterprise Value Creation

In analyzing value creation it is important to realize that the customer-needs equation has also evolved. Customers are aware of their power in the new channel of distribution. They have high expectations, and they want to be in control. This leads to a reprioritizing of customer needs in many situations. This is especially true in the B2C space where customer information provision and service, with a few notable exceptions, is often severely deficient in the physical world.

Jupiter Research has an empirical assessment of consumer needs in the Internet retail environment and recommendations about what kinds of marketing and Web site practices can be used to meet those needs (Figure 3.5).

None of the consumer needs are new but some of them have fallen by the wayside in the era of mass retail merchandisers. It can also be argued that some needs like convenience, selection, and information can be better met by a well-run e-tailing operation than by a mass merchandiser.

Looking at the other high-priority needs, good prices have been a prominent feature of many early B2C Internet business models. The highest priority need—immediacy—is arguable; some consumers want to shop and take their purchases home with them; others find rapid delivery not only acceptable but an agreeable substitute for the detested mall shopping experience. The disparity suggests consumer segments. With digitizable products there is no argument; demand can be

Needs	Tactics					
	Ease Returns	Expend Selection	Offer Unique Product	Customer Service	Localize Inventory	Premium Servicing
Immediacy	×				×	×
Save Money	×	×			×	
Convenience	×	×		×	×	×
Selection		×	×			
Information				×		
Ease of Use	×	×	×	×	×	
Sample Product	×					
Trust	×			×	×	×
Entertainment						
"They Know Me"			×	×		×
Prestige			×	×		×

FIGURE 3.5 Mapping Consumer Needs to Retail Tactics

Source: www.jup.com. Used with permission.

fulfilled immediately. Other needs, such as sampling the product, are not easily met on the Web for tangible products but are ideally suited to digital products like software. The needs also include ease of use, a requirement of the Web site itself, and trust, which must be established for Web enterprises. It is interesting to note that Jupiter suggests no specific retail tactics for the entertainment need, although some retailers have become very skilled at the experiential aspects of their business.

Referring more explicitly to the manner in which value is created in virtual space, Jeffrey Rayport and John Sviokla⁸ see value as having three dimensions—content, context,⁹ and infrastructure. In the physical world, it has often been difficult to separate the three for the most efficient value creation. In the cyber world, they can be divided and one or more dimensions can be handed off to suppliers or partners. Take, for example, the case of a portal like Yahoo! Because it began as a search engine, its business proposition is based on content from other sites. Because it was an early mover, Yahoo! had to create most of its own initial infrastructure. The early context, or presentation, of the material to the Web surfer was a bit primitive by today's standards but a huge improvement over earlier search engines like Gopher.

In moving from a search engine to a portal, Yahoo! has not only increased the amount of content it can access in conducting searches, it has also added different types of content. Yahoo! offers news, stock quotes, shopping, auctions, and entertainment ranging from live Webcasts of sporting events to fantasy sports leagues.

⁸Jeffrey F. Rayport and John J. Sviokla, "Managing in the Marketplace," *Harvard Business Review*, November–December 1994, pp. 141–150.

⁹The Merriam-Webster online dictionary defines context as "the parts of a discourse that surround a word or passage and can throw light on its meaning" (www.m-w.com). Information technology usage of the term "context" can refer to anything from the type of system a user has (a desktop PC with a large monitor vs. a handheld device with a tiny screen, for example) to the person's customer status (order placed but not yet received, for example).

Personal services available through the portal range from a personalized page to bill-paying services. When Yahoo! bought GeoCities in 1999 it added not only a substantial number of registered members, but also an entirely new—and very sticky—activity by incorporating the largest supplier of free consumer Web sites into the Yahoo! space.

Context in a sense remains the same; a home page that is a portal, or gateway, to a wealth of information and activity. It is worth noting that, in spite of all its technology and the massive amount of content, the Yahoo! home page remains visually clean and uncluttered, enticing the visitor to delve further into the contents, not distracting him with vivid color, a jumble of content, or animation.

Infrastructure has undergone even more drastic transformation. Yahoo! started with Jerry Yang and David Filo writing original code in their Stanford dormitory room. In 1998 Yahoo! announced the addition of the Inktomi search engine to its technology repertoire. According to an Inktomi press release at the time:

Yahoo!, which is the most popular navigational guide to the Web, was founded on the principle of building a directory around subject-based, demographic and geographic content. Unlike search engines, which use automated “spiders” to electronically crawl the Web to capture and store sites in the search engine’s index, Yahoo!’s staff of experts appropriately categorize content based on a Web site publisher’s description of the content when the site is submitted for inclusion in the directory. Yahoo!’s directory features content and services within relevant context that can be browsed quickly and easily. The Inktomi search engine will be integrated with these services to provide users with additional search capability on the Web. Page views generated from Inktomi search results will become part of Yahoo!’s advertising and merchandising inventory.¹⁰

Translated, the press release seems to say that the Yahoo! process for documenting Web content was an extremely labor-intensive one which they were forced to supplement with an automated process. And since Inktomi had an award-winning search engine, why should Yahoo! invent its own? The subject was in the news again in June 2000 when Yahoo! announced that it was retaining Inktomi for its newly announced corporate portal business but transferring its default search engine business to a competitor with the interesting name of Google.

There are many such examples of Yahoo!’s use of other software services in spite of its irrefutable technological prowess. The strategic conclusion seems to be that Yahoo! has developed core expertise in acquiring and retaining customers and that it is outsourcing as much of the content and infrastructure functionality as it can.

W. Chan Kim and Renée Mauborgne seem to summarize the whole issue of value creation in the virtual world when they point out that it requires a new managerial mind-set. They reinforce what good marketers knew long before the digital age—that competition can come from unexpected directions. Consequently, the marketer must look at customer needs and all possible ways of fulfilling needs and delivering benefits. The fact that the Internet permits needs to be met and benefits to be delivered in entirely new ways only complicates an existing situation.

¹⁰“Yahoo! Selects Inktomi as Its Default World Wide Web Search Engine Partner,” Press Release, May 18, 1998, www.inktomi.com.

The first step is still to identify customer needs. The second step is to look as widely as possible for ways in which the firm can help customers meet those needs. They use Quicken, the accounting software for households and small businesses, as an example.

Software for personal and small business uses had been available for some time, but had not achieved significant market penetration. Existing software was accounting-oriented and could not be described as user-friendly. Quicken also recognized that another competitor had gone unrecognized by the industry, even though it long predated PC accounting software. The pencil had existed for several hundred years and was still the personal financial management tool of choice for many people (see Figure 3.6). According to Intuit founder Scott Cook:

“The greatest competitor we saw was not in the industry. It was the pencil. The pencil is a really tough and resilient substitute. Yet the entire industry had overlooked it.” . . . Intuit focused on bringing out both the decisive advantages that the computer has over the pencil—speed and accuracy—and the decisive advantages that the pencil has over computers—simplicity of use and low price.¹¹

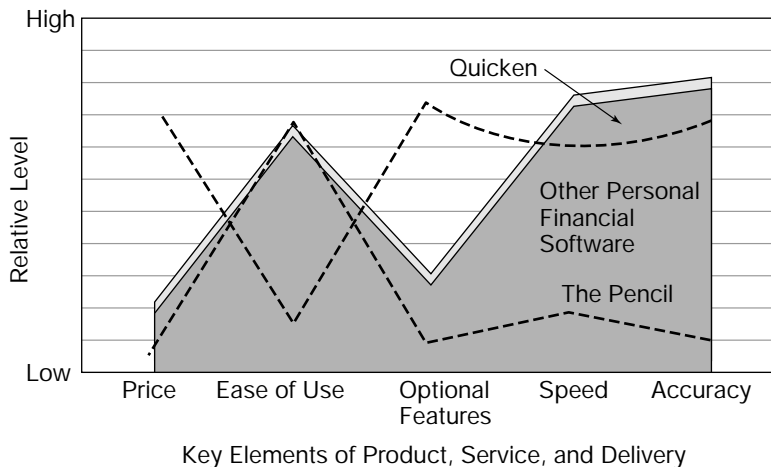


FIGURE 3.6 Quicken's Value Curve

Source: *Harvard Business Review*. Used with permission.

Quicken also broke away from the debit and credit format of conventional accounting software. With a user interface that looks like a personal checkbook, it almost lives up to its advertising claims of requiring no learning time on the part of the new user.

Kim and Mauborgne advise managers to ask four questions when attempting to configure a new value curve:

- Which elements should be *eliminated* that the industry has previously taken for granted? Quicken eliminated arcane accounting conventions and modeled the user interface on the manner in which consumers are accustomed to handling their personal finances.

¹¹W. Chan Kim and Renée Mauborgne, “Creating New Market Space,” *Harvard Business Review*, January–February 1999, p. 86. Used with permission.

- Which elements should be *reduced* below the current industry practice? Intuit has priced its personal financial management software affordably from the beginning. Now its Web site offers tax submission using the TurboTax software at low cost or, in some instances, free of charge. Figure 3.6 also suggests that Intuit eliminated optional features included on other offerings, presumably ones it found that customers were not using.
- Which elements should be *raised* well beyond the current industry level? Speed and ease of use are critical to the customer, so Intuit concentrated on those dimensions of the product.
- Which elements can be *created* that customers want and the industry has not previously offered? Quicken's success can be attributed to its overall offering—an easy-to-use software package that is fast, accurate, and moderately priced. Intuit's key insight—its new creation, if you will—was to recognize that consumers don't want to learn accounting; they want to balance their checkbook and pay their bills. As Intuit moved onto the Web it has added a host of free services including investment analysis, tax analysis, and frequently asked personal financial management questions. Only the context of the Web allows a company to embed these kinds of services in its offering in a way that adds value to the basic product or service.¹²

Marketers are accustomed to thinking in terms of customer needs, making that aspect of value creation part of their traditional toolkit. Strategists think of core competencies, so locating the intersection of the two should not be especially difficult for the skilled marketing strategist. However, “thinking the unthinkable”—creating value from activities and services that could only be imagined prior to the Internet—is not easy for anyone. This will be the true value added by expert e-marketers going forward.

Having examined the basic underlying concepts and economics of Internet business models, we need to look at actual business models that have emerged. We should keep two things in mind. First, this is all a work in progress. Some of these models may soon disappear. It is likely that others will appear. Second, there is no generally accepted taxonomy of Internet business models to structure our review.

Internet Business Models¹³

The term “business model” is frequently used, but less frequently defined. In the context of the Internet, it seems to be commonly assumed that we are primarily talking about the ways the enterprise uses to generate revenue—the revenue models we have just discussed. Probably the reason for this emphasis is that the revenue side of the business seems to be the most changed by the Internet. Although the basic cost

¹²W. Chan Kim and Renée Mauborgne, “Creating New Market Space,” *Harvard Business Review*, January–February 1999, pp. 83–93. Used with permission.

¹³General sources for this section were: Varda Lief, “Anatomy of New Market Models,” Forrester Research, Inc., February 1999; Mary Modahl, *Now or Never*, New York: HarperBusiness, 2000; Evan I. Schwartz, *Digital Darwinism*, New York: Broadway Books, 1999; Don Tapscott, David Ticoll, and Alex Lowy, *Digital Capital: Harnessing the Power of Business Webs*, Boston: Harvard Business School Press, 2000; Kevin Werbach, “Syndication: The Emerging Model for Business in the Internet Era,” *Harvard Business Review*, May–June 2000, pp. 86–93; “Business Models for the New Economy,” Cambridge Technology Partners, January 2000.

elements that you would find on any business's income statement are little changed by the Internet, it is a great mistake to ignore the cost side of the business equation. Cost elements do not change, but the relative weights of various costs may change significantly. Comparing catalog marketers to retailers gives a good example. Most retailers of necessity spend extensively on their stores, both to permit attractive presentation of merchandise and to offer the shopper an enjoyable experience. Most retailers today try to have as little as possible in the way of warehouse facilities, preferring to receive shipments directly from the manufacturer. The pure catalog merchant does not have stores, except possibly for an outlet or two. It does, however, have large investments in and operating expenditures on warehousing and order fulfillment facilities. Many contemporary marketers have major efforts in both retail and catalog channels (Talbot's, Sharper Image, and Williams-Sonoma are good examples). They find it necessary to have separate management and accounting groups for retail and catalog because the two channels are operationally so different.

A functional characterization of business models includes costs as well as other operational issues that are important to understanding the nature of business models. According to Henry Chesbrough and Richard Rosenbloom, the functions of a business model are to:

- Articulate the *value proposition*, that is, the value created for users by the offering based on the technology
- Identify a *market segment*, that is, the users to whom the technology is useful and for what purpose
- Define the structure of the *value chain* within the firm required to create and distribute the offering
- Estimate the *cost structure* and *profit potential* of producing the offering, given the value proposition and the value chain structure chosen
- Describe the position of the firm with the *value network* linking suppliers and customers, including identification of potential complementors and competitors
- Formulate the *competitive strategy* by which the innovating firm will gain and hold advantage over rivals¹⁴

While this description does a great deal to aid our understanding of the subject of business models, it also poses a danger. By making more explicit the various elements of a business model, it begins to sound like a business plan. *A business model and a business plan are two distinctly different entities.* A business model is a conceptual description that can be given a name, like "aggregator." A business plan is a detailed document that is prepared for strategic guidance and to aid in the acquisition of resources, either internal or external. There is clearly some similarity of content between the two, but they are not synonymous.

There are a number of strategic dimensions on which marketers could attempt to categorize Internet business models including degree of integration, locus of control, and primary source of revenue. However, it is not clear which are most useful and, since models are evolving and enterprises are consolidating, many Internet

¹⁴Henry Chesbrough and Richard S. Rosenbloom, "The Role of the Business Model in Capturing Value from Innovation: Evidence from Zeros Corporation's Technology Spinoff Companies," Harvard Working Paper #01-002, January 2002, <http://digitalenterprise.org/>.

TABLE 3.1 Internet Business Models

The B2C Space	The B2B Space
Aggregator	ASP
Bricks 'n' clicks	Infomediary
Content provider	Marketplace
Consumer portal	Machine-to-machine
Peer-to-peer	

businesses have characteristics of more than one model. Consequently, it will be sufficient for our purposes to discuss them in terms of models that are most commonly used in the B2C space and those that are most prevalent in the B2B space (Table 3.1). Throughout, we will note that even this categorization is not clear-cut and that several of the models are currently in use in both marketplaces. It is likely that, as the Internet matures as a commercial medium, and especially as it becomes evident which revenue streams are the most viable, the topic of Internet business models will become more orderly.¹⁵ As Rayport pointed out, *content provider* seems to have been the original Internet business model, so that is a good place to start.

Content Providers

The content model is the traditional media model in which content, the entertainment and information that draws an audience, is provided free (radio and network television) or at a price far below the total cost of production (magazines and newspapers), and advertising provides the primary revenue stream. Its heritage probably explains why it was the original Internet business model. In the days before avenues to profitability on the Internet were clear, the goal was to attract a sizable customer base which would, in turn, attract advertisers, leading to profitable advertising-supported Web sites. This is the “monetization” discussed by Rayport earlier. Large, general-purpose (or, perhaps more precisely, mass-targeted) sites found this impossible and took action to increase their sources of revenue. Some added “tiers” of paid subscription services to their free content. Others became portals, as we will discuss in the next section.

There are several reasons why advertising revenue is often insufficient to produce profitable operations. First, sites that attract a relatively untargeted visitor base (general news, for example) cannot command a high CPM (cost per thousand advertising impressions), even if they have a large audience, which is in itself unlikely if they offer unfocused content. Second, many advertisers were not satisfied with “click-through” rates, even though they often approximated response rates in traditional direct marketing, as we will discuss in more detail in Chapter 7. Third, the barriers

¹⁵For a more parsimonious typology of business models that does not distinguish between B2C and B2B models, see Michael Rapp’s Open Courseware Web site, <http://digitalenterprise.org/models/models.html>.

to entry in the Web site arena are very low, and a huge amount of advertising inventory quickly came online, further depressing advertising rates.

Does that mean that sites that are primarily content providers are road kill on the Internet superhighway? No, it does not. The *E-Commerce Times* conducted an analysis of the financial status of five publicly traded content sites. Andover.net is a site for Linux (a free operating system that competes directly with Microsoft Windows) programmers. CNET.com is a multimedia producer of Internet and computer-related content that targets the more technically oriented among us with news, product reviews, and Web development content. Internet.com is a news site for Internet professionals. Yahoo! we have already classified as a portal, not a simple content site. The fifth, the ZDNet Group, provides news, product reviews, and downloadable software. The *E-Commerce Times* analysis showed that all five sites had experienced substantial growth in revenue although only two of them (Yahoo! and ZDNet) had become consistently profitable by 1999. All seemed to be intent on pursuing their content-based model.

Yahoo! aside, do you see a pattern in the nature of these sites? They are all targeted to Internet professionals who have two desirable characteristics as an advertising audience. First, they are upscale. They have money to spend, either as individuals or as corporate decision makers. Second, they are denizens of the Internet; willing to get news there and to buy products online. They are a highly desirable target market, and advertisers are willing to pay a premium to reach this audience.¹⁶ Customized news sites like Individual.com and WSJ.com that are targeted to business or other professionals find that users are willing to take out paid subscriptions because they provide convenience in locating essential content and avoiding time-consuming Web searches. The paid subscription model, however, has not been successful in consumer markets.

Content sites are also realizing revenue by syndicating their content to other sites. Most e-commerce sites provide news as a way to make their sites more sticky and to build community through devices such as discussion of relevant issues. Many of them make deals with individual content providers to provide filtered news items to their commerce site. To smooth this process, content syndicators have emerged. As an example, iSyndicate aggregates content from more than 2,500 content providers and disseminates it to Web sites in vertical markets ranging from financial services to high tech to non-profit.¹⁷ Finally, widespread availability of broadband may give an impetus to content sites, especially game sites and others that have a great deal of multimedia.

It appears that e-marketers have learned two important things about content in the early stages of the Web. Content is important to draw people to a site and to encourage them to return frequently. However, it is difficult to make money off content alone. It looks as if only content sites targeted to desirable upscale audiences and syndicators will become profitable solely on content.

Other content sites have gone in a different direction. They have added other functionality to their content and have transformed themselves into portals.

¹⁶"Special Report: Publishing Money Online," April 3, 2000, www.ecommercetimes.com.

¹⁷www.yellowbrix.com, May 23, 2002.

Portals

The early directories (such as Yahoo!), search engines (such as Lycos), and pure content providers (such as the “Pathfinder” site of Time Warner, which is no longer in existence as a locatable site) soon found that advertising alone was not going to provide sufficient revenue to support a complex site targeted to a mass audience. They did as much as possible to increase the stream of advertising revenue. One approach was to make sites more “sticky” (rough translation: more interesting) so visitors would stay longer and rates for advertising on the site could be raised. Another was to make deals for special placements on the sites (to be discussed in detail as a customer acquisition technique in Chapter 8). For the more popular sites like AOL and Yahoo!, the placement deals could be the source of large up-front payments. However, advertising revenue was still not sufficient, and it was clear that pure content models were unlikely to be profitable. Hence, the emergence of the portal. By 1998 the search engines and directories had taken on that appellation.

The everyday definition of the word *portal* is clear. It is a doorway or entrance to something. The Internet definition is not so clear. Because the original players in this space evolved from search engines or directories, search is one key function. Live links to content ranging from weather to breaking news to daily horoscopes offer easy access to desirable material. Free e-mail services were made available and later some portals began to offer free Internet access.

E-commerce offers a revenue stream, so that was an obvious early addition. Affiliate or partnership programs are one way to offer merchants a listing on the portal (an already-established travel site, for example) instead of investing directly in building e-commerce capability. The e-commerce programs have gradually become more sophisticated than simple merchant directories and links. The Excite portal has a service called Freetailer that offers free storefronts to retailers. This includes 25 megabytes of storage space, Excite’s shopping cart and secure transaction server, and traffic reporting. Excite provides a site authoring tool and several tutorials including “How to Sell Online” and “Bringing in Traffic.”¹⁸ It is not easy to find out what the costs to the retailer are, but there is obviously a per-transaction cost (Excite offers the first 100 transactions free) and perhaps also a percent of the revenue.

Portals have also added community-building functions like chat rooms, daily surveys, and discussion forums to bring visitors back often for engaging interactive activities. When Yahoo! purchased the well-established GeoCities site, it acquired a membership service that brings users back frequently for stays that tend to be much longer than the average on the Net.

A main feature of portal marketing programs is their personalized pages. The goal is to make the personalized pages so useful and attractive that users identify them as their “start pages” to come up automatically when the computer is turned on. This guarantees visits and encourages attention to the content, including e-shopping opportunities. There is understandable confusion between the concepts of portals and start pages; a user can frequent many portals but, at any given time, has only one start page.

¹⁸www.freetailer.excite.com.

The idea of a portal as a gateway to a massive amount of useful content is so compelling that all sorts of special-interest portals have emerged. They serve identified target segments, usually with specialized content and activities.

Specialty Portals

No official taxonomy exists for the huge number of portals currently available to the Net user. However, two identifiable groups are niche portals and voice portals.

Niche Portals Literally hundreds of portals appeal to targeted segments of Internet users. They typically do not register among the top 10 most visited sites in any given month; the largest numbers are registered by the general-interest portals like AOL and Yahoo!¹⁹ Some of the larger special-interest portals, as measured by traffic statistics, include CNET and ZDNet (Internet-related content); iVillage and Women.com (topics of interest to women); iWon, Coolsavings, and FreeLotto (contests, coupons, and incentives). Visitor numbers for the huge sports portals ESPN.com and CBS.SportsLine.com are reported as part of the traffic of their parent companies, Disney and Viacom respectively. All of these sites offer access to content from a variety of sources. Coupons and free offers are intrinsically compelling to certain market segments. The sports sites are particularly entertainment-oriented with access to mega-content. They have been especially aggressive in adding streaming media featuring sporting events to their sites. Both ESPN and CBS SportsLine also offer extensive programs of fantasy sports, which firmly attach players to their computers for substantial periods of time. They also offer large quantities of sports-oriented merchandise. Sites like iVillage and Women.com have found that women respond especially well to community-building activities like chat, including sessions led by experts in fields from parenting to gardening. Some of these features are shown in Figure 3.7, which presents a portion of the home page of iVillage and ESPN's Fantasy Racing site. Not only is the content of these two targeted sites totally different, notice that the overall look of each page is appropriate both to the target market and to the reasons they come to the site.

The common theme of the sites categorized as niche portals is that they appeal to a specific, identified target market. The iVillage and ESPN Fantasy Racing sites are not targeted to all women and all men. They are targeted to segments (probably lifestyle segments) of the demographic markets, segments that want different experiences and functionality from sites they frequent. The most successful sites have in-depth knowledge of their target segment and make their site content and design reflect that. Even so, it is not yet clear that a large number of niche sites can attain stand-alone profitability.

Voice Portals Voice portals represent a different type of portal; one that is based on technical functionality. As the name suggests, these portals respond to the spoken word. Except for adaptive computing applications (accommodations for the physically challenged user), who would want to speak to his computer, you ask! Answer the question by looking at how many people are walking down the street—or worse, driving down the expressway—talking on their mobile phones. With each passing day more of these devices are Internet-enabled, and they are forecasted to be a

¹⁹For site traffic data on a weekly or monthly basis go to Nielsen Net Ratings (<http://www.nielsen-netratings.com/>) or Media Metrix (www.mediametrix.com). Both have reports on Web traffic for many countries in addition to the United States.



FIGURE 3.7 Two Niche Portals Targeted to Females and Males, Respectively

Source: The screenshot from www.ivillage.com made available courtesy of iVillage, Inc. ©2002 iVillage Inc. All rights reserved. iVillage and the iVillage logo are trademarks of iVillage Inc. Used with permission.

major factor in the Internet space by the mid-2000s. The voice portals, however, are currently accessible from any phone, cellular or regular. Currently major applications appear to be activities like going to a pay phone to check the weather or standing on a street corner and using a wireless device to locate the nearest recommended Chinese restaurant. In both cases it is easier to do this using voice commands as

opposed to entering numbers on a keypad, be it large or small. Voice access will be a boon to m-commerce (mobile commerce) as it evolves over the next few years.

Voice portals are a special case of portals based on a technology, although in this case they do appear to meet a real marketplace need. Will there be other types of portals that offer special functionality as the Internet grows? It will be a development to watch for.

Internet Service Providers Versus Portals

Portals offer one type of gateway to the Internet. Another means of access is the internet service provider (ISP), national or local, who offers an entrance ramp onto the Internet but less in the way of content and services than the massive portals. In the B2C space, access provision is dominated by AOL, a portal. The free ISP model, in which access is provided free of charge in return for acceptance of a constant advertising presence on the user's screen, is struggling to survive. In the B2B space, ISPs have turned into or have been replaced by application service and managed service providers (ASPs and MSPs), which will be discussed in Chapter 4.

Although portals and ISPs provide access to the Internet, these business models could not exist in isolation from other Net models. Other types of e-businesses offer both content and e-commerce. An important model that combines both content and commerce is the aggregator.

Aggregators

In their book detailing a number of Internet business models, Don Tapscott, David Ticoll, and Alex Lowy say that aggregators “organize and choreograph the distribution of goods, services, and information. They intermediate transactions between producers and consumers, creating value for both and for their shareholders. An [aggregator's] value proposition depends on six complementary variables: selection, organization, price, convenience, matching, and fulfillment.”²⁰

This is a familiar model, not unlike the catalog model of direct marketing. Amazon.com is an aggregator that deals in physical products, from books to patio furniture. Most retailers are aggregators, combining merchandise from a variety of suppliers into an edited selection for their customers. Among those who have made successful moves onto the Web are cataloger L.L. Bean (www.llbean.com) and retailer Neiman-Marcus (www.neimanmarcus.com).²¹ The aggregation of physical products is, in fact, a common business practice. The aggregation of services is less common, however.

An exception is the manner in which some financial services institutions are offering customers access to information about their accounts in other institutions. Figure 3.8 shows the Chase Online Plus product of Chase. This free consumer service urges customers to “get all your online accounts together.” The accounts can

²⁰Don Tapscott, David Ticoll, and Alex Lowy, *Digital Capital: Harnessing the Power of Business Webs*, Boston: Harvard Business School Press, 2000, p. 67.

²¹For an interesting case history of a failure, see Gary J. Stockport, George Kunnath, Rashida Sedick, “Boo.com—The Path to Failure,” *Journal of Interactive Marketing*, Autumn 2001, pp. 56–70.



FIGURE 3.8 Chase Online Plus: Aggregation in Consumer Banking

Source: www.chase.com. Used with permission.

include everything from credit card accounts to frequent flier programs. The real aggregator in this application is an Internet infrastructure firm called Yodlee that describes itself as an “account aggregator.” The free service on its own Web site offers access, via a single personalized page, to a wide variety of individual accounts including credit card, banking, investment, shopping, e-mail, and news.²²

Aggregators exist in large numbers in B2B markets also. The move of B2B content onto the Web was typified by content from large trade publishers and the catalogs of B2B vendors, large and small. Moving catalogs onto the Net and making them easy to use was more difficult than many firms originally anticipated. As a consequence, successful early entrants like W.W. Grainger and Marshal Industries have added the offerings of other industrial suppliers to their own, effectively becoming aggregators.

Bricks 'N' Clicks

Although aggregators can and do exist in both B2C and B2B markets, one of the key Internet business models is intrinsically B2C. It goes by the captivating title of bricks 'n' clicks (BNC). In the B2C space the BNC model is very important as existing companies attempt to integrate the Internet into successful physical-world businesses.

This model represents one of the gigantic struggles of the transformation to e-business. There has been great conflict in channels as existing retailers and wholesalers have worried, sometimes correctly, that e-commerce would cannibalize

²²www.yodlee.com.

their businesses. Reluctant to jeopardize channels built with great expense over long periods of time, some firms have elected to follow a go-slow strategy that has left them behind the transformation curve. Others have gone forward on the assumption that, if your business is going to be cannibalized, you should cannibalize it yourself, not wait for a competitor to do it. This is a sometimes painful recognition of the seemingly inexorable trend to online purchasing in many consumer and business markets.

It is not an entirely new dilemma, however. Many retailers faced the same issue in the 1980s as direct marketing became an important channel. Those who were daring enough to move into another channel, whether it was retailers adding a catalog or catalogs beginning retail chains, often experienced success. The success could be synergistic, not just additive. Multiple channels enjoyed promotional economies of scale as well as purchasing economies. They gave customers choice. And skilled direct marketers used devices such as credit cards to build customer databases that spanned both their direct and retail channels. The result was a much more complete picture of their customer behavior and data that fueled growth in areas including the issuance of specialty catalogs and the location of new retail stores. Retailer/direct marketers ranging from Sharper Image (consumer electronics) to Talbot's (women's specialty clothing) to Williams-Sonoma (upscale kitchen items) experienced the synergistic benefits of multiple channels.

In the Internet economy the same can be true. Office suppliers Office Depot and Staples have experienced similar synergy. Both of them have successful retail, catalog, and now Internet channels. Customers may choose to locate items and acquire information at the Web site and then go into a store to make a purchase and take the item directly to their business or home. Or they may choose any of a number of other reasonable channel combinations, depending on their own shopping propensities and time constraints.

Charles Schwab

One of the best examples of the problems and opportunities involved in trying to integrate physical and cyber strategies is the discount brokerage Charles Schwab. Mr. Schwab founded the brokerage that bears his name in 1975 after the Securities and Exchange Commission eliminated fixed-rate commissions on stock brokerage trades. In order to eliminate the conflict of interest inherent in the practice of compensating brokers based on their clients' trades, Schwab employed salaried brokers. The discount brokerage did not offer investment advice or actively manage client portfolios. It provided an objective environment in which consumers could make their own investment decisions and experience superb customer service when it was needed. In the mid-1990s the cost to execute a trade at Schwab averaged \$80 as compared to trades executed through full-service brokers which could cost hundreds of dollars. It offered a wide variety of financial services products, and conducted business in over 200 retail branches and a full-service telephone call center.

Schwab CIO Dawn Lepore recounted the evolution of the online trading capability in a speech in 1999:

When we saw the opportunity to plunge into online investing in 1985, we took it and introduced a software product called the "Equalizer®"—which had a small, dedicated user group of about 6 people who met in a Silicon Valley garage. In the late '80s and early '90s, with the advent of Windows, we were able to build a much more

user-friendly software trading product called Streetsmart®, which became a big success with about 200,000 to 300,000 customers.

By the end of 1995, we had created e.Schwab™—a separate, stand-alone division of Charles Schwab that catered to online customers at a much lower price point [\$30 per trade for lots of 1,000 shares or less] than our existing business. By mid-'96, we felt that Internet technology was strong enough, and we added web trading. This was a dramatic event. It was the equivalent of having a whole new world-wide free telephone system available overnight.²³

e.Schwab was created as a separate division that reported directly to President David Pottruck:

"We had to figure out how to compete with these small brokerages [deep-discount brokerages including E*Trade and Ameritrade], says Pottruck. "So we needed a group that felt like they did: nimble, unshackled from the larger bureaucracy." . . . But there was also an element of caution in e.Schwab's quarantine from the rest of the company. Says Dan Leemon, head of strategy: "We created e.Schwab because we wanted to learn. But we did not want to risk the whole company. By the middle of 1996, e.Schwab was ready. . . . The only publicity for the launch was an announcement at the annual shareholders' meeting.

Despite the lack of fanfare, the new service was an immediate success. Says [Gideon] Sasson [a member of the development team]: "We were totally unprepared. Customers began voting with their keyboards, and in two weeks we reached 25,000 Web accounts—our goal for the entire year." By the end of 1997, all online accounts, both at e.Schwab and at regular Schwab, had grown to 1.2 million. Online assets mushroomed 94%, to \$81 billion. . . . Schwab executives were ready to declare victory.

For customers, though, the online brokerage's independence had a downside. Regular Schwab phone reps and branch officers could not help e.Schwab customers; except for one free phone call a month, all questions had to be addressed to e.Schwab via e-mail. If you couldn't part with the option of speaking to a human, you could keep your regular Schwab account and still trade online. However, you got only a 20% discount off the regular Schwab commission schedule.²⁴

Customers were dissatisfied with this uneven situation. "It was confusing and kludgy," [Charles] Schwab recalls. "It wasn't Schwab-like in its customer focus. It was obvious that customers didn't feel good about the nonintegrated services."²⁵

The financial implications of integrating the two divisions and instituting a flat charge of \$30 per trade were immense. Schwab executives believed they risked a decrease of as much as \$100 million in revenues. Charles Schwab and David Pottruck believed there was no alternative and bet the business on integration. Revenues did initially decline, but within a year online assets nearly doubled. The number of online accounts doubled and then doubled again the following year.

Schwab President David Pottruck says:

We don't believe that the future is about the physical world versus cyberspace. It's not bricks and mortar versus the Internet. It's about integrating both—putting

²³ "E-Commerce Is More Than Dot Com," Speech by Dawn Lepore, Vice Chairman, EVP & CIO, Charles Schwab, Inc., May 1999, 1999 Forrester Forum Series.

²⁴ Erick Schonfeld, "Schwab Puts It All Online," *Fortune*, December 7, 1998, www.fortune.com. Used with permission.

²⁵ "Charles Schwab: Beating Weblets at Their Own Game," *Forbes*, July 24, 2000, www.forbes.com.

together the best of what's available through physical distribution with the best of the web world. At Schwab, we call it building a company with "clicks and mortar." The companies that can put them together and create a seamless opportunity for customers will be the biggest winners.²⁶

The Schwab example calls for full integration between the existing bricks-and-mortar and the Internet businesses. Writing in the *Harvard Business Review*, Ranjay Gulati and Jason Garino argue that there are degrees of integration along a continuum ranging from spin-off of the Internet business to full integration. They identify four decision elements:

- The degree to which the *brand* is transferable onto the Internet
- The necessary *management* skills to develop and manage an Internet business
- The required *operational* skills and infrastructure in the areas of distribution and IT
- Having or being able to acquire the necessary human and financial *resources* to enter the Internet arena²⁷

Finding the right answers to the problems of integrating real-world and cyberspace enterprises will continue to vex many businesses for some time to come. Locating the appropriate mix and executing the integration is going to be critical for many businesses, however. Thoughtful observers of the space are predicting that the most successful e-tailers are likely to be the multichannel retailers who give consumers choices in where to browse and where, when, and how to purchase.²⁸

The BNC model represents large businesses with roots in both the physical world and in cyberspace. Seemingly at the other end of a continuum of size and complexity is the newest Internet business model, peer-to-peer.

Peer-to-Peer²⁹

The Internet public became aware of the peer-to-peer (P2P) model, which enables users to transfer files directly, in early 2000 when the popular download software for music files, Napster, became a media event. It was already well known to a dedicated following mostly composed of teens and young adults. It emerged from the shadows when colleges began to filter Napster from their networks. The music files that students were downloading in computer labs and dorm rooms were clogging networks and devouring storage space. The music industry's unwavering opposition to Napster forced first its sale to European media giant Bertelsmann and later a court-ordered filtering of all copyrighted material on the site.

²⁶"Clicks and Mortar," Speech by David Pottruck, President and Co-CEO, Charles Schwab, Inc., July 17, 1999, Internet Summit.

²⁷Ranjay Gulati and Jason Garino, "Get the Right Mix of Bricks and Clicks," *Harvard Business Review*, May-June 2000, pp. 107-113.

²⁸See, for example, Joanna Barsh, Blair Crawford, and Chris Grosso, "How E-Tailing Can Rise from the Ashes," *McKinsey Quarterly*, 2000, 3, www.mckinseyquarterly.com.

²⁹General sources for this section are: Jason Fry and Megan Doscher, "How Will the Record Labels Remember Napster's Summer?" June 30, 2000, www.wsj.com; Lauren Goldstein, "Tune In," *eCompany*, December 1999, www.ecompany.com; "I Want My MP3," *wsj.com* Issue Briefing, nd, www.wsj.com; www.webopedia.com.

Even though the survival of Napster itself may be in question, the popularity of P2P is inescapable, and we need to understand the larger technological context. Boiling a lot of technology down to its essentials we have the following:

- The *MP3* file format refers to the file extension of the MPEG digital video and audio compression standard. MPEG essentially removes visual data that the eye cannot see. MP3 removes sounds the human ear cannot hear. The result is digital files that are much smaller than they would be without compression, allowing for relatively easy transmission and storage. The recording industry has opposed MP3 from the beginning because it does not include copyright protection.
- The original *Napster* model used the MP3 format to permit P2P sharing of audio files. Napster is software that a user downloads free of charge to a PC or other digital device. The software enables the user to search the hard drives of all other Napster users who are online at that time to find music files. Once a file is located it can quickly be downloaded to the user's computer. The upside is that it is quick and free. The downsides are several. The effectiveness of the search is unpredictable because the ability to find a specific file depends on other users who have the file being online when the original user is trying to locate a file. The digital audio files hog storage space on the user's computer. The "always on" feature of Napster provides a potential gateway for viruses, as do all "always on" technologies. None of the drawbacks was seen as sufficiently serious to deter users whose numbers quickly swelled into the millions. Napster's unwillingness to deal with the copyright issue, however, was the downside that, in the end, could not be ignored.
- *Gnutella* is a more recent entry into the field of peer-to-peer file sharing using free software easily downloadable from the Web. Gnutella allows all types of files, not just digital audio, to be shared between users. In addition the software effectively treats each user's computer as a server, making it relatively impervious to shutdown by an outside agency.

The battle between the music industry and the purveyors of download software seems likely to continue for the foreseeable future. David Kirkpatrick, writing in *eCompany* magazine, puts it in a larger perspective:

In the furor over Napster-induced intellectual-property theft, people seem to have missed the fact that peer-to-peer information swapping among companies is already rampant. Reaching into another company's systems and pulling out a piece of data is not much different from grabbing the latest Steve Earle song from a friend's hard drive. Businesses need and want this kind of sharing: Its most common (if least elegant) form is the business-to-business exchange, which is nothing more than a way to expose and connect one company's systems to those of another. . . . The Holy Grail is a seamless integration of information inside and outside a corporation.³⁰

That brings the topic of business models essentially full circle—from newly emerging peer-to-peer back to content models, albeit new content models founded on sophisticated new technology. However, rather than assuming that this represents some sort of completion, it seems wiser to assume that it is another evolutionary step in the development of Internet business models.

³⁰Amy Kover, "Who's Afraid of This Kid?" *eCompany*, March 2000, www.ecompany.com.

In order to understand Internet business models we must understand the changing economics of the Internet. There are revenue models and cost models which take advantage of the special capabilities of the Internet. It is also crucial for e-marketers to understand the manner in which they can use these special capabilities to create value for customers and other stakeholders. There are multiple models in both the B2C and B2B spaces, and they are in a state of considerable flux. The turbulence is exaggerated by the fact that some of the models seem unlikely to produce a profit—in the near term or even in the foreseeable future. This seems to ensure that existing models will be refined and new ones will emerge. All marketers need to be alert to changes in order to develop strategies that not only take advantage, but also assist in the creation, of viable Internet business models.

In consumer markets, the aggregator model is similar to an online catalog in which the products of many manufacturers are gathered in a single focused site. The bricks 'n' clicks model is usually exemplified by a physical-world retailer who has successfully added the Internet channel to a preexisting business model. Consumer portals provide gateways to the Internet. Some portals are broad and targeted to a mass Internet market. Others are more specialized, targeting a particular demographic, lifestyle, or activity market segment. Content providers specialize in providing content; many of them are, in fact, aggregators of content. Finally, the peer-to-peer model describes situations in which people interact directly with one another over the Internet. This model has received a great deal of publicity in recent years as a result of the controversy over Napster, but it has broader applications that are now becoming evident.

Business models are defined according to the value proposition offered to a specified market segment, the internal value chain that is used to produce and distribute a product or service, the cost structure and profit potential of the offer, the external value network, and the enterprise's competitive strategy. We will use the same concept to discuss business models in the B2B marketplace in the chapter that follows.

affiliate program	disintermediation	subscription
bricks 'n' clicks	monetize	syndication
business model	peer-to-peer	value creation
collaborative filtering	portal	
content	revenue model	

1. In what ways has the Internet changed key economic parameters? Identify some B2C firms that are taking advantage of the special opportunities offered by the Internet economy.
2. How have Internet revenue models evolved from the original content model? In your opinion, which model(s) offer the best opportunities for sustainable long-run profitability? Why?
3. How has the presence of the Internet affected both fixed and variable costs for both pure-play and BNC e-businesses?
4. Choose an e-business that you believe fits into one of the B2C business models. Research its business model and examine the site itself in considerable detail. Be prepared to discuss both the revenue and cost models of your chosen site and to explain how it adds value for its target consumers.

Exercises

5. The text implies that multichannel retailers are more likely to experience long-run success in the Internet economy than are pure-play Internet retailers. Be prepared to take a position on this conjecture and to defend your position.

1. Choose one of the Web sites you are following for a detailed study of the business model it represents. Carefully examine the way(s) in which it obtains revenues, and try to find out from its own reports or from industry sources what its current revenue is and what weight is given to each of its revenue streams. Then make your assessment of the manner in which the enterprise (both the Web site and any physical-world business components) creates value for its target customers. Be prepared to present your analysis in class.
2. Think again about the retail entity from which you bought the material for this class (see exercise 2 in Chapter 2). Analyze all of the ways in which that enterprise attempts to create value for its customers. Also consider the nature of its revenue model and whether it has only a single revenue stream, or multiple sources of revenue.