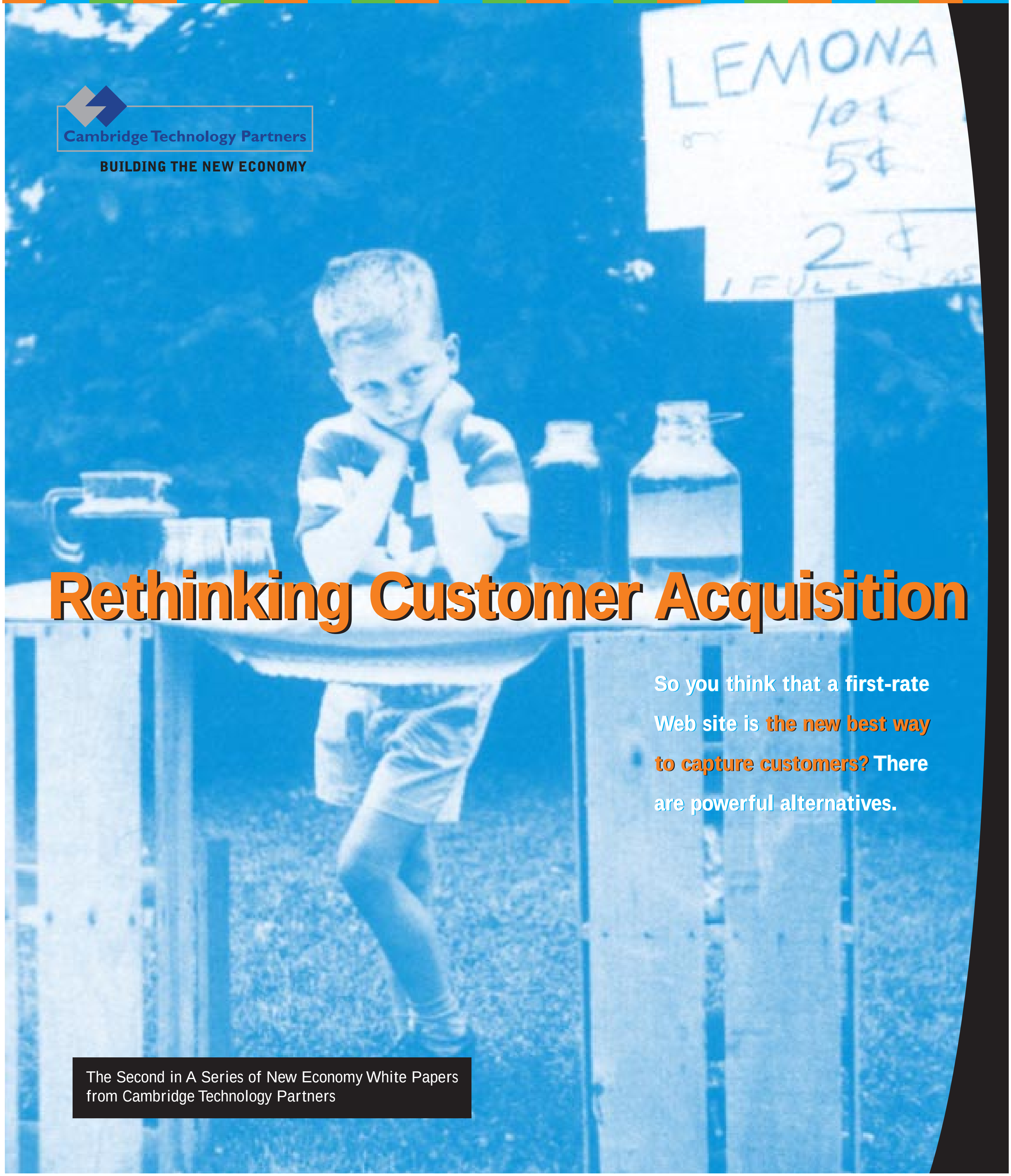
Cambridge Technology Partners

BUILDING THE NEW ECONOMY



Rethinking Customer Acquisition

So you think that a first-rate Web site is the new best way to capture customers? There are powerful alternatives.

The Second in A Series of New Economy White Papers from Cambridge Technology Partners

Web Site or E-Market?

You're probably no different from many business people who saw in the Web the ultimate tool for touching new customers all over the world. You marveled at the apparent economics of the medium when compared with proven but costly approaches such as advertising and telesales and direct mail, and you were delighted with the infinitesimal expense of scaling to reach more prospects.

Sorry to tell you, but your enthusiasm may be misplaced.

In our first white paper in this series – the New Economy Primer – we cited "customer-centricity" as one of six key characteristics of winners in the "New Economy," and explained why today's customers increasingly call the shots. In this position paper, the second in our New Economy series, we'll demonstrate that a "herd-mentality" emphasis on Web sites as the premier customer-acquisition vehicle often leads only to an escalation of sales expenses. In a medium where business models are evolving faster than the technology they are built upon, we argue that "e-markets," or electronic markets of buyers and sellers, can prove much more cost-effective at driving the right new customers toward you. Traditional Web sites encourage interactions with the host company; e-markets turn Web display screens into pathways to a galaxy of participants.

While it's still early in the game, **some clear guidelines have emerged** as to exactly what constitutes a successful Internet-based customer-acquisition strategy, and we lay them out in this paper. Although some experts insist that the Internet is the tail that wags the dog, Cambridge maintains that it's still the fundamentals of your business, and not the technology, that will help you determine how to use the Web to acquire and retain customers.

E-markets or Web sites? Or a combination of the two? **You've got some decisions to make.**

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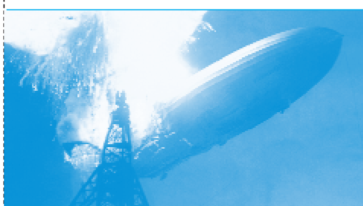
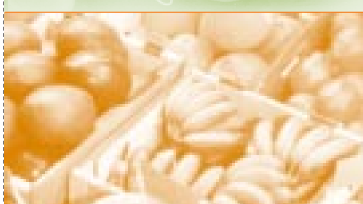




Introduction:

Assumption Destruction

Most new "dot.com" businesses are built with the assumption that they can acquire customers more effectively and efficiently than traditional brick-and-mortar businesses. But that's not a universal truth.

Conventional wisdom argues that you must take to the Web or be left behind. But does that urgent exhortation apply equally to every business competency?

One of the primary business competencies that was quick to exploit the Web was customer acquisition – the ability to effectively and efficiently establish relationships and execute transactions between interested trading partners over the Internet. It seems an unshakable tenet of faith that the Internet possesses unique economies of scale for the job. Indeed, the Internet is still being hyped as a cost-effective means of winning the hearts and minds of customers. Amazon.com, which started as an online bookseller and has exploded into offerings as varied as videos, toys, and auctions, has become the poster child of the "New Economy" by capturing customers using the Internet. Under the rubric of "build it and they will come," more Web sites have been built than roadside billboards.

And here's a paradox for you: many of today's billboards actually advertise Web sites. What does that say about the efficacy of the Internet as a means of capturing customers?

Only recently has the cost of customer acquisition using Internet techniques come under closer scrutiny. At a recent conference run by market researcher Jupiter Communications, a poll of Internet executives revealed that the cost of customer acquisition was viewed as the most important metric when assessing the efficacy of Internet-based marketing. Acquisition costs were deemed more important than cost per click, cost per lead, or cost per sale combined.

At the same time, the number of Internet-based options for capturing customers is increasing. Consumer portals, once the darlings of eyeball aggregation in cyberspace, are proving less than cost-effective. For instance, NASCAR advertising – ads pasted on stock cars that travel too fast to be seen – shows a better rate of return than most Internet-only marketing. NASCAR advertising averages a 5.0:1 sales-to-marketing return ratio, while the average for so-called dot.com firms, according to a recent Business Week survey, hovers around 2.7:1. While many such Internet businesses use multiple marketing techniques to drive revenue, some that have relied primarily on Internet-only marketing deals, placing banners and buying real estate on others' sites to drive revenue, have seen their sales-to-marketing ratio fall to as low as 0.5:1. That's not a promising prospect unless there's lots of volume waiting to be discovered.

The E-Markets Option

Most firms have built their Web presence step by step. Initially, they construct a site that is largely "brochureware" – a marketing vehicle containing product, service, and corporate information. Later, they might add transaction processing so that customers can buy online. Later still, they may provide customer services and access to technical support over the Web. Through each of these phases, more and more of the business's information systems begin to touch the Web.

Today, both "B2B" (business-to-business) and "B2C" (business-to-consumer) businesses have numerous choices of how to find and transact business over the Internet. Building and maintaining a proprietary Web site remains a viable and attractive option, as a means of building brand, facilitating transactions and enhancing customer service. But it's not the only one.

E-markets, such as category portals and auctions sites, are proving to be enormously successful; in many instances, they furnish both the buyer and seller an easier, more cost-effective means of doing business. One B2B auction service – FreeMarkets OnLine – has seen the amount of business it handles soar from $4 million in 1996 to $501 million in 1998, with projections that it will host nearly $1.5 billion in transactions in 1999. The same is true in the B2C world. In 1998, eBay handled approximately $47 million worth of transactions in what it estimates to be a $100 billion market. It's no wonder that key cyberspace players such as Amazon, priceline, and CNet are rushing into auction-based business models.

While the odds are high that your business will eventually build a Web site if it hasn't already done so, the probability is equally high that you may not need one to successfully conduct business over the Internet. For instance, private auctions can now be established directly between buyers and sellers. Sellers bid directly on the buyer's requirements. The connection between these parties might be made over the Internet but no sophisticated, highly interactive Web sites need be built to convey value, acquire customers and complete transactions. Instead, it will be key to know how well suited your value proposition and competitive positioning are to customer-acquisition options. Anticipating how Internet technology will affect changes in customer behavior will be even more important. Finally, understanding exactly what your options are and how they are likely to change over time will be critical to helping you select the Internet-based customer-acquisition strategy best suited to your needs.

Much conventional advertising – such as ads pasted on NASCAR stock cars that travel too fast to be seen – shows a better rate of return than most Internet-only marketing.

The Calculus of Customer Acquisition:
How Buyers and Sellers Act

An ideal marketing mechanism offers much lower transaction costs and higher value for both suppliers and buyers. A cost breakdown for each side points to the advantages of e-markets.

The science of commerce is never exact. That's partly because commerce itself is poorly bounded and influenced by a host of intractable factors. But it's mostly because people are involved, and where people are involved, emotions can't be far behind. Hence analysts often invoke the psychology of the market to explain what just happened on Wall Street.

The same is true for marketing and sales. An emotional or visceral response to a product or service, leading to an impulse purchase, can be a primary factor in the creation of demand. Factors such as fashion, convenience, and entertainment also enter the picture. Nike doesn't sell sneakers – it enhances your self-esteem.

> Internet executives view the cost of customer acquisition as the most important metric when assessing the efficacy of Internet-based marketing.

Just Do It. However, in a world populated with rational actors, both buyers and sellers need to be able to satisfy their objectives using an exchange or marketing mechanism that services their needs within reasonable costs. Therefore, a rational marketing mechanism would be one where the investment made or the cost incurred in completing the transaction is commensurate with the value exchanged by the parties involved. On that basis, alternative marketing mechanisms could compete for both buyer and seller endorsement.

One need look no further than electronic stockbrokers to see how quickly market mechanisms can be adopted when they are proven to lower transaction costs. Upstarts such as E-Trade and Ameritrade have brought even the venerable Merrill Lynch and Fidelity Investments quickly to heel, causing them to rethink their long-standing business models in less than a year. If the costs to complete a transaction exceed the value derived by either the buyer or the seller, chances are that marketing mechanism will not survive.

A great deal of emphasis has been placed on the value of the Internet as an ideal medium for commerce. This stems in part from the Internet's unique cognitive and entertainment capabilities. But its real value as a marketing mechanism rests on its ability to reduce transaction costs – the costs of bringing buyers and sellers together to facilitate the exchange of value. For instance, the ability to conduct searches is still one of the primary reasons cited by most consumers for why they employ Internet Service Providers. In some respects, the Internet has become the consummate trading medium as search costs for buyers have plunged nearly to zero. The same may not be true for sellers. In many instances, the acquisition costs of securing customers over the Internet exceed those customers' lifetime value. At the same time, sellers, both online and off, have relied on "information asymmetry" – having more relevant data than the customer – to support and pay for inefficient marketing practices. (Customer ignorance has funded more than one Internet business plan.) Today's suppliers can even use "counter-technology" to combat the mechanisms, such as agents or "bots," that customers have been using to neutralize information disparities. However, while techniques such as bot blocking and banner solicitation might work for a while, sooner or later the customer will discover where real value exists and go elsewhere.

Three Basic Transaction Costs

Buyers and sellers routinely encounter three basic costs to the completion of a transaction, whether or not it is completed over the Internet. Transaction costs can be difficult to examine and evaluate. They are often disguised, and in some cases are practically invisible.

Economists know them as:

1. **search costs – to find and evaluate competing substitutes.**
2. **ex-ante costs – related to the structure of terms and conditions of the transaction.**
3. **ex-post costs – required to warrant the satisfaction of the parties involved.**

Regardless of which exchange medium is employed, those costs will invariably be encountered. However, with the advent of the Internet, many of them can be reduced, significantly mitigated or eliminated entirely depending upon how buyers and sellers choose to interact. It stands to reason that all things being equal, the market mechanism that facilitates the completion of transactions to the mutual satisfaction of both buyers and sellers will be the one that has the least amount of total costs. Since in the end almost all transaction costs are borne by the buyer, both in terms of their investment in the process as well as the price paid for the product or service acquired, buyers hold the cards when it comes to determining the optimum market mechanism.

Let's look at the value equation for each side.

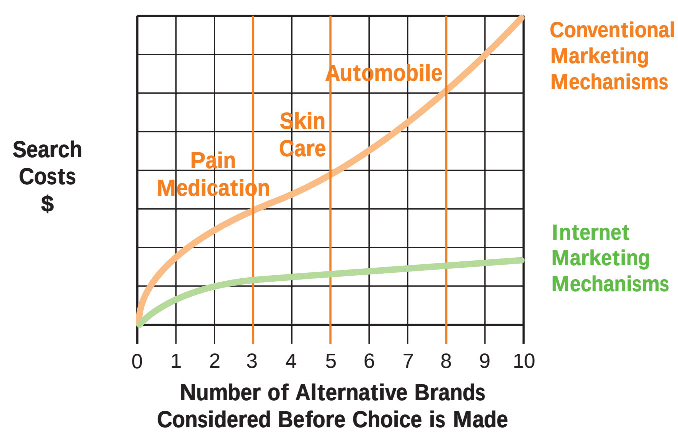
Buy-Side Costs

Traditionally, the largest investment made by buyers is directly related to search costs. Anyone who has purchased a home, a car, or a PC is familiar with the time invested in finding and considering alternatives. Both online and offline branding strategies have focused on how to influence buyer behavior during this particular phase, with the aim of narrowing the set of alternatives considered. In the era of mass marketing, trusted brands gave the buyer the option of eliminating the need to search and evaluate alternatives altogether. Usually that meant that the buyer would pay a slightly higher cost for the branded item, but would do so knowing that the premium paid would be less than the cost of finding suitable alternatives.

> In many instances, e-markets furnish both the buyer and seller an easier, more cost-effective means of doing business.

The Internet has completely restructured the economics of search. The marginal cost of finding the next suitable alternative is quickly approaching zero. Where once consumers faced the daunting challenge of trading search costs against the increased utility of the items considered, they can now conduct open-ended evaluations over a potentially infinite number of alternatives at practically no cost. Take home mortgages, for example. Instead of being held hostage by local banks, consumers can go online and look at hundreds of different mortgage providers at no additional cost. At the same time, that has afforded vendors

The Internet Slashes Buyer Search Costs



Source: Cambridge Technology Partners

unprecedented opportunities to replace branded entities as the incumbents in customers' minds. If brands no longer serve to eliminate the number of alternatives considered, customer loyalty may soon be all but dead. (See New Economy Primer, page 37.)

Apart from the cost incurred by engaging in a process that culminates in a transaction, buyers also bear the sellers' cost of sales and marketing. For consumer goods this can range anywhere from 5 to 45 percent of the total cost of the product or service acquired. Frequently, other indirect costs, such as distribution, warranty and taxes, find their way into consumers' wallets as part of the cost of sales as well, even if they have little impact on consumers' perceptions of the value being acquired.

In most cases, though, those costs are invested in brand building, market signaling and demand generation. They are directly related to the market mechanisms employed. If 45 percent of a product's purchase price is devoted to demand generation – finding the customer – and a customer can find the product for free using the Internet, it stands to reason that anyone purchasing the product offline is paying too much. In such instances – numerous everywhere from automobiles to financial services – traditional marketing mechanisms will quickly collapse. Suppliers will either reduce the prices of their products and rationalize their economic models to reflect new marketing mechanisms or become quickly exposed as hopelessly uncompetitive.

The other primary costs related to the marketing mechanism are those involved in the negotiation of terms – ex-ante costs – and those relating to the indemnification of the parties in terms of their satisfaction with the transaction – ex-post costs. If the exchange is to occur directly with the supplier, it's usually the supplier that dictates terms. In the case of auctions, the terms are usually negotiated prior to the auction commencing or are provided by an intermediary and then subscribed to by buyers and sellers alike. In the case of e-markets, the terms are often set by the intermediary – the market manager – but can be tailored by the parties once a transaction is contemplated. Suffice it to say that the costs related to the creation of terms would for the most part be of little consequence in the selection of a marketing mechanism.

Scam Artists

However, the indemnification of the satisfaction of the parties to the transaction could be an entirely different matter. The Internet is still a largely unpoliced frontier, populated with as many charlatans and scam artists as honest brokers. The National Consumers League estimates that Internet fraud increased by 600% in 1998 alone, at an estimated cost in the billions. It seems that trust is as perishable as loyalty in the vastness of cyberspace. (See New Economy Primer, page 44.)

In those instances where the transaction occurs directly between the buyer and seller, it would be incumbent upon the buyer to clearly establish the means by which the transaction will be validated. This is a case where brands can play an important role. Branded entities often ensure customer satisfaction. Why would Federal Express promise to deliver absolutely positively overnight if it wasn't prepared to back that up? However, where the transaction occurs between parties unknown to each other, trusted intermediaries can serve in a similar capacity. Here, e-markets can establish rules of engagement, monitor conformance of rules by transacting parties and guarantee the satisfaction of the parties.

> Since in the end almost all transaction costs are borne by the buyers, they hold the cards when it comes to determining the optimum market mechanism.

In many instances, e-markets have a distinct advantage over branded entities in the indemnification of transactions since the liabilities incurred can be spread over a larger number of transactions and a larger number of constituents. Consequently, the burden of liability cost incurred by any single transaction should be proportionately lower for transactions occurring in e-markets than for transactions made directly between buyers and branded entities.

Sell-Side Costs

For most organizations, being on the Internet is nothing short of table stakes – in order to play you must be wired. But wired how, and for what purpose? Is "brochureware" sufficient to establish customer relationships? Are new customers likely to find you or will you still have to go looking for them? If the Internet can give buyers the opportunity to locate suitable alternatives at no additional cost, can it also give sellers the opportunity to find additional buyers at no additional cost? Theory suggests that, just as with customer search costs, at some theoretical volume the marginal costs of customer acquisition using the Internet magically fall to zero. At that point the cost to acquire the next customer, and the next and the next, is essentially free.

> There's a high probability that you may not need a proprietary Web site to successfully conduct business over the Internet.

But that's the theory. As we will see later on, theory and reality have yet to keep close company on this issue.

One issue foremost in the minds of most vendors when contemplating the Internet is a notion called "owning the customer." "Owning" refers to the ability to influence an increasing proportion of the customer's purchasing decisions; Amazon frequently says it's in the business of owning the customer.

Customers who provide one supplier with all their business for a given category of product or service are sometimes said to be owned by that supplier.

Customers For Hire

But there's a crucial decision to be made: whether you own or simply rent the customer. An ownership strategy implies that there is some form of leverage that should accrue due to a sustained relationship. Very often that leverage is deemed to rest with the cost of customer acquisition. The cost to acquire a customer for a solitary transaction can be high, but if there are numerous transactions from the same customer, the cost can be amortized over multiple revenue opportunities. Retailers understand this and focus on ownership, particularly if they can service multiple needs from a single customer relationship. Same story with service companies: E-Trade started as a discount broker but quickly moved to become a full-fledged financial-services company. In such instances, rich interactive Web sites that get the customer to return can be an attractive marketing mechanism.

However, where there's little lifetime leverage from maintaining a relationship, there's little need to establish a direct connection to the buyer. Ownership may have little value if the product in question does not lead to a buying decision that is repeated with any regularity. Demand for many types of products can be random and frequently not repeated by the same customer in a predictable manner. If the customer is inevitably going to grow out of the product, seeking to sustain a relationship has little if any value. The same movies are rarely ordered twice; video games appeal to a very specific age and gender. And day traders aren't exactly prized for their loyalty to the equities they buy.

Understanding these subtleties can make a significant difference to how you choose to employ the Internet to secure customers. Where transaction costs cannot be amortized over a single customer, they can often be amortized over a larger volume of transactions through a marketing mechanism shared by many buyers and sellers. Conventional channel strategies have relied on these principals for years and they still apply online. Where customer ownership is not an issue, or simply isn't feasible, e-markets may be the preferred option.

> Where value is derived through sustained relationships, direct market mechanisms including highly interactive, proprietary Web sites should be considered.
>
> Where demand is random and relationships have marginal value, a more indirect e-market approach could be more appropriate.

Chances are, when it comes to acquiring customers, economies of scale will be a function of the way in which transaction costs are amortized rather than the sophistication of the technology employed. It may be the case that you can borrow your customers much more cheaply and much more profitably than owning them.

Selecting The Right Option:

What Works Where

There's no shortage of customer-acquisition mechanisms in the wired world. It helps to know how each works – and when it is effective.

Not all of the array of available Internet customer-acquisition alternatives will work well for your business. Yet you may be forced to deal with some of them because they may be used effectively against you. Moreover, industry dynamics dictate that the option you employ today likely will not be the one that you employ six months or a year from now. Knowing how each is best employed, and when, is the first step in selecting the right one for your business.

Today, the alternatives have begun to coalesce around a few distinct options, among them direct-to-customer Web initiatives and a handful of distinct intermediary models. Each has proven successful. For example, network-systems giant Cisco Systems is renowned for its use of direct-to-channel-partner Internet techniques in a B2B application.

There are also several intermediary models comprising different types of portals. Portals, designed as e-markets, consist of trading communities built around some form of affinity – a customer demographic or association. That could be a collection of similar items grouped by buyer interest such as plastics, chemicals, toys, or mortgages, often referred to as a category or vertical portal. iVillage.com, which focuses on women's interests, would be an example of an affinity portal that serves as a market mechanism for products and services that cater to women. Millionaire.com caters to well-heeled buyers. Rounding out these trading communities are auctions and malls.

Auctions – originally conceived as a convenient means of liquidating eclectic, perishable, or overstocked items – have quickly gained influence as more and more items have become subject to reverse-bid markets. Malls, on the other hand, are usually constructed by intermediaries whose business models are predicated on servicing the secondary needs of the trading community. Very often, mall creators derive their revenues by facilitating functions such as providing financing to the transactions that occur within the e-mall. Visa, the credit card company, along with its member banks and trading partners, has constructed consumer malls using this model.

A rough segmentation of these alternatives can be made on the basis of brand awareness and product differentiation. The broad rule of thumb is this: where brand awareness is high and product differentiation is clear, direct Web strategies are often successfully employed. Where brand awareness is not as strong, trading communities often emerge to service both buyer and seller needs. But as we'll see, the choice must be much more nuanced than that – and more dynamic too.

> If the costs to complete a transaction exceed the value derived by either the buyer or the seller, chances are that marketing mechanism will not survive.

Trading communities are usually designed to satisfy the needs of a particular constituency - either buyers, sellers or intermediaries. The motivation of each will in part dictate the behavior of the community as well as provide clues as to how its boundaries and economics might evolve. Since most such communities are intended to service the interests of a given group, each will likely do so at the expense of some other constituency. Therefore, competition between trading communities is likely to occur that will influence the evolution of their size, shape, and efficacy over time.

While it is entirely feasible for any given firm to participate in all available marketing mechanisms simultaneously, it would not be possible to accomplish this without taking on additional cost. (An exception might be airlines, which successfully sell direct, through travel agents, and via online bids.) In some ways, these mechanisms are mutually exclusive in the way they influence customer behavior. For instance, it would be difficult to auction a product or service and then expect buyers to flock to your Web site and buy direct. So the selection of a given mechanism will limit downstream opportunities.

For most organizations, the choice will come down to one of making increasing investments in a direct, proprietary Web strategy or an indirect, e-market Internet initiative.

The True Costs of Traffic

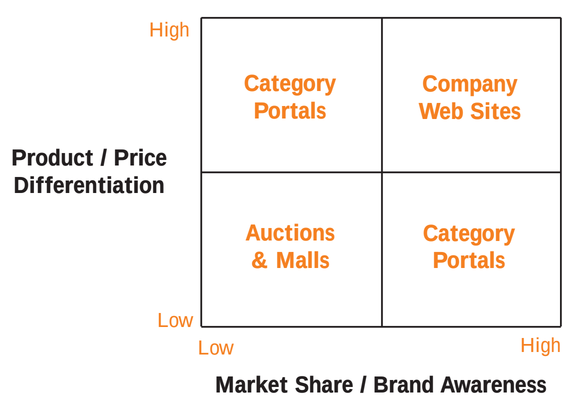
A significant number of firms take to the Web with the assumption that the cornerstone of their Internet strategy will be a highly interactive, proprietary customer environment designed to build relationships and drive transactions.

Perhaps they're unaware that even the most aggressive Internet-based marketing shops usually augment their online initiatives with other types of marketing media.

One of the unique properties of the Internet is that along with well-established brands, businesses that never existed outside of cyberspace can also be easily found. When looking for child-safe toys, for example, you might not expect to find iVillage in your travels, but using conventional search terms, chances are you'll find it anyway. This stems in part from the search capabilities that were the original basis for the construction of mega consumer portals such as America Online, Lycos, Excite, and AltaVista. Consequently, the cyberspace playing field between well-established brands and total newcomers levels out very quickly.

Framework For Segmenting E-Market Structures

"Me-Too" Products Are More Suited To E-Markets



Sources: McKinsey & Co.; Cambridge Technology Partners

If you've built your customer-acquisition strategy on a proprietary Web site and your customers don't use the Web to beat a path to your door, sooner or later you'll be in the business of helping them find you, or in Web parlance, driving traffic to your site. As soon as that occurs, acquisition techniques and acquisition costs become a genuine consideration. In general, acquisition strategies that rely on a proprietary Web site must eventually focus on site traffic.

A recent survey by market analyst Forrester Research uncovered some curious findings when it came to which traffic-driving techniques were deemed most popular and most effective. Banner advertising and radio buttons, two of the most popular traffic-driving options, were ranked as two of the least effective. At the same time, affiliate programs and television, two of the least preferred methods of driving site traffic, were deemed to be some of the most effective.

How Top Traffic-Driving Tools Fail

Ranked by popularity

89%	Banners
77%	E-mail to customers
55%	Buttons
45%	Public relations
34%	Magazines
34%	Sponsorships
32%	Newspapers
32%	Radio
30%	Direct mail
30%	Television
23%	E-mail to opt-in lists
17%	Outdoor
17%	Affiliate programs

Ranked by effectiveness

Affiliate programs	4.3
E-mail to customers	4.3
Public relations	4.1
Television	4.0
Outdoor	3.7
E-mail to opt-in lists	3.5
Direct Mail	3.4
Magazines	3.4
Radio	3.4
Sponsorships	3.3
Buttons	3.2
Banners	2.8
Newspaper	2.6

Q: Which traffic-driving techniques do you use today, and how effective are they?
Percentages represent share of 47 marketing managers interviewed. Effectiveness ratings represent average scores based on a scale of 1(poor) to 5(great)

Source: Forrester Research

Standard techniques for driving traffic to the Web can result in customer-acquisition costs of up to $350 per customer compared to, say, $70 for credit-card marketing.

Tenancy deals, where vendors pay steep fees to occupy choice locations on major consumer portals, have also proven less than fully effective. Last year, DLJdirect, E-Trade, and Waterhouse securities each paid America Online $25 million apiece to take up residence on AOL's site. They opted to pay such fees despite the fact that another research house, Jupiter Communications, has found that at best, non-exclusive tenancy deals drive less than 25 percent of site traffic and can drive as little as five percent of measured hits.

Other research indicates that such traffic-driving techniques typically result in customer-acquisition costs of between $250 and $350 per customer. Compare that to $50 to $70 per customer for credit cards and $100 per customer for long-distance telephone service using conventional marketing mechanisms. If those Internet marketing efforts are augmented, as they frequently are with conventional media such as magazines, television, newspaper and radio, acquisition costs increase. If you add sophisticated response- and relationship-management software, such as tools from Epiphany and Manna, costs increase again. Pretty soon you're talking real money: it's not unusual to see total direct-acquisition costs reach a range of $300 to $500 per customer.

Since few consumer products would be considered good candidates at those acquisition rates, the lifetime value of the customer relationship becomes a key consideration. If the relationship so created provides for multiple revenue streams combining both product and service opportunities or additional opportunities to service the customer over the life of the relationship, those costs can be easily justified. Yet the Internet, with few exceptions, is not especially well regarded as a mechanism for creating long-lasting customer relationships.

A good candidate for an e-market, and one that appears to be emerging, would be for labor.

Today, firms whose primary Internet acquisition strategy is based on a proprietary Web site are actively experimenting and refining the role their Web sites play in capturing and servicing customers. In some instances, they've added interactive features that allow product simulation or comparisons, occasionally referred to as action-based marketing. Other firms have specialized the roles their sites play, using them to bridge conventional and online customer-acquisition strategies.

Increasingly, marketers have come to realize that regardless of how well suited to the Internet a business model might be, a proprietary Web site will at best be only a component of a much larger and fully integrated customer-acquisition strategy.

E-Markets Defined

They're variously referred to as vertical or category portals, trading communities, product exchanges, affinity sites, e-malls, auction sites, electronic communication networks, and a host of other names. So what are they?

E-markets are Internet destinations specifically designed to facilitate the buying and selling of goods and services between a specific set of customers and suppliers. A recent study by market analyst the Gartner Group estimates that within the next three years, as many as 10,000 such destinations could be built to service discrete marketplaces before an inevitable consolidation commences.

The factors driving their creation are not unlike what's propelling the consumer portal craze, but instead of the aggregation of eyeballs, it's the aggregation and satisfaction of demand that matters. In some cases, and for certain types of products and services, e-markets will probably never become the most desirable means of transacting business. However, it's beginning to appear as if they will become the preferred option for a very large universe of items up and down the value chain, from the consumer to raw materials. The reason is simple: properly conceived and constructed, e-markets meet a greater share of both buyer and seller needs at a lower cost than competing alternatives.

Fee Collectors

E-markets lower transaction costs in a number of important ways. While their economic models are still evolving, it seems that their overall expense will be a function of the value exchanged. Right now, e-markets collect fees from a number of different sources including registration, advertising, and transactions. In the future, it is entirely feasible that a host of additional services will emerge, such as market analytics, settlement services, and embedded enterprise resource planning (ERP) and logistics. Each of these services will be merchandized separately and tailored to specific client needs.

For the time being, however, it appears that e-market fees, given rates of competition, will hover between two and five percent of the value exchanged. Additional services might increase that figure slightly. Compare that to the 45 percent direct marketing and sales expense many products bear today. Also, compare it to the potential expenses of a proprietary Web site option. At an average acquisition cost of $400 for a proprietary Web site, the comparable e-market fee would result in a value exchange of between $8,000 and $20,000. If the lifetime value of your customers doesn't exceed those figures, then chances are a proprietary Web site will not be your most desirable customer-acquisition option.

Virtuous Cycle

Once established, e-markets can quickly gain share. As share grows, the knowledge of the market expands to capture an increasing number of participants. Greater participation increases the volume and lowers the cost of transactions in a virtuous cycle of growth. Markets can establish rules and monitor behavior, thereby lowering the cost for participants to engage in transactions. They can furnish buyers and sellers with information on opportunities and transactions, thus eliminating asymmetries. For instance, the cost of locating customers can be dramatically lowered through reverse-bid auctions in which buyers signal their intentions to buy and sellers bid on the buyers' business.

E-markets are also better positioned to use the information about participants to remove risks and increase satisfaction. For instance, eBay maintains a buyer's rating board where buyers can comment on whether they are satisfied with the performance of sellers. Suppliers that perform less than satisfactorily are quickly identified and made known to the rest of the trading community.

In general, the economic costs for participation in an e-market will vary by the type of market, category portal, affinity site, e-mall, and the basis of the value exchange, direct sales, auctions, etc. But for e-markets to become the preferred online marketing mechanisms, they need to be efficient. There are a number of factors that can increase efficiency.

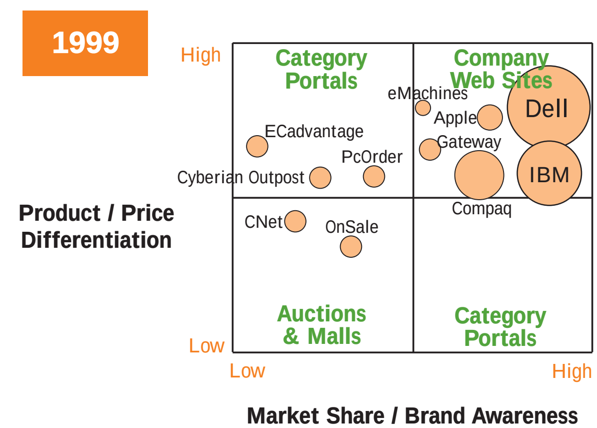
In the next section, we explore some of those factors in detail.

> Where there's little lifetime leverage from maintaining a relationship, there's little need to establish a direct connection to the buyer.

Case Study:

Market Evolution in the PC Industry

The PC Industry Will Move From Web Sites...



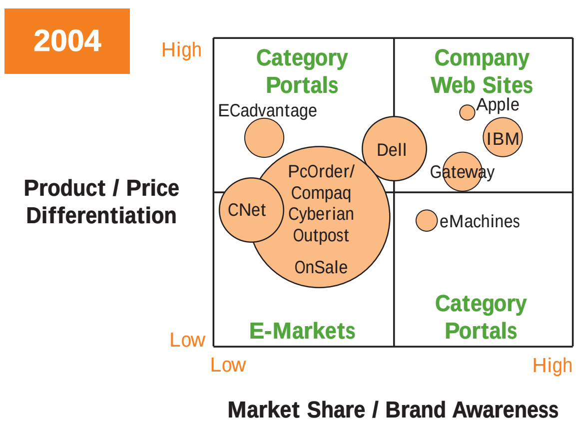
Source: Cambridge Technology Partners

The PC industry is unique in the annals of Internet marketing. Many of the industry's leading players were first to employ the Internet as a means of attracting buyers, educating prospects and transacting business. Few other sectors have the duration or depth of experience of using the Internet thus. In effect, organizations such as Dell, Hewlett-Packard and Gateway pioneered the use of Internet market mechanisms.

Recently, a number of e-markets, category portals and auction sites have joined the mix of mechanisms servicing the market for PC and related products, providing a unique perspective into the competition and evolution of Internet-based marketing mechanisms.

Dell is widely credited with being one of the most accomplished practitioners of direct Internet marketing. Dell Direct has attained legendary stature in the industry for its use of the Internet as a direct marketing tool. Within the last 12 months, however, a number of independent market entities have appeared to rival Dell's dominance there. E-markets, including category portals such as pcOrder and Cyberian Outpost and auction sites such as OnSale and CNet, have emerged as customer-friendly alternatives to vendor-only options. While small in size, these entities are quickly attracting attention and growing share.

...And Toward E-Markets



Source: Cambridge Technology Partners

PC products and markets have many of the attributes that support the creation of e-markets: a large volume of contestable transactions, numerous buyers and sellers, undifferentiated products and suppliers. Based on projections, those emerging e-markets – both category portals and auctions sites – are beginning to siphon share from the larger direct marketing players.

This being the New real-time Economy, the responses haven't been long in coming. Recently, Dell announced that in addition to enlarging the number of products available from its site, it would also host auctions. In a related move, Compaq announced that it would forego building a direct Internet strategy, opting instead to partner with pcOrder as its primary marketing partner. And Gateway has indicated that it intends to accelerate plans to become an Internet service provider. We estimate that within the space of two years, e-market entities should be roughly at parity with respect to the volumes that they service against direct marketing players such as Gateway and Dell.

In all likelihood, the success of PC-based e-markets will eventually force consolidation, and category portals and auction sites will begin to merge. Some analysts believe that as the margins for their products continue to evaporate, PC manufacturers will abandon direct Internet marketing altogether in favor of becoming ISPs and consumer portals and competing with the likes of America Online. While it is too soon to tell which of those e-markets will eventually garner the greatest volume, the one that affords the customer the greatest leverage will likely become the dominant Internet PC marketing mechanism.

Influence Factors

Four Key Levers Impact Your Decision

So which customer-acquisition mechanism works best for your needs? The answer will become clearer as you test your situation against the attributes detailed here:

1 Critical Mass

To take shape, e-markets require what some proponents call the right critical mass. Applied here, the term refers to the total number of constituents – buyers, sellers, and intermediaries – and the total number of contestable transactions – bids, proposals, settlements – that need to be involved to facilitate the exchange of goods and services. When there is a lack of sufficient volume of either constituents or transactions, it's much less likely that an e-market will dominate.

Several new specialized trading communities underscore the point. TPS Register is a buyer-built consortium for the purchase of maintenance and repair order (MRO) materials; through TPS, buyers consolidate requirements and contract with a relatively fixed number of sellers to obtain better deals. Often, if the buyers and sellers for a given product are few and well known to each other, the market is closed and hosted privately or by a trusted third party such as FreeMarkets or PlasticsNet.com. Entities such as Accompany and Mercata perform the same kind of service for consumers who wish to aggregate volume to obtain greater purchasing power.

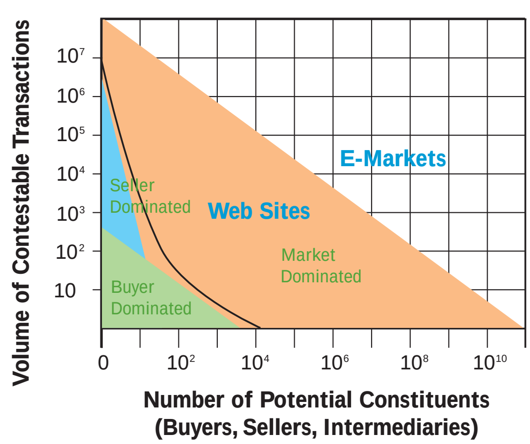
However, while those mechanisms do facilitate transactions, they don't constitute dynamic trading communities since the number of constituents and volume of transactions is constrained through buyer cooperation.

A good candidate for an e-market, and one that appears to be emerging, would be for labor. For years, economists considered the job market to be made up of positions advertised but not filled together with the rate of unemployment in the general population. In truth, the labor market is much larger than that since every large organizational hierarchy is, in fact, a pool of captive labor. If those captive pools could freely flow to where demand existed, a true market would arise. The same would be true for health care, education, communication and utility services and a host of other instances where value is exchanged.

2 Product Suitability

Consumer packaged goods companies realized quickly that product attributes play a significant part in determining what role Web sites can play in the marketing and sales of products. Truth to tell, Web sites have done very little to

E-Markets Thrive On Many Deals, Many Players



Source: Cambridge Technology Partners

The Internet, with few exceptions, is not especially well regarded as a mechanism for creating long-lasting customer relationships.

enhance the brand or increase the sales of a number of consumer-oriented products. Companies as large and as sophisticated as Coca-Cola, Proctor & Gamble and McDonald's have struggled to hit upon Internet-based techniques that enhance their brand, provide for unique differentiation, or influence buying patterns.

Other products are uniquely suited to the Web. Very often they are information-based products that can be rendered in bits and sampled as well as marketed over the Internet. For instance, software, music and entertainment can all be sampled, purchased, and downloaded directly over the Web. (See New Economy Primer, page 9.) Commodity-based products such as raw materials, electric power, or telecommunications have such low information content and switching costs that higher investments in Internet marketing techniques might accomplish little more than adding costs and lowering margins.

The attributes of the product or service should be carefully examined when considering an Internet strategy. If the product is extremely complex and requires a great degree of application specificity, conveying that information over the Web might have tremendous value. If the product requires a sustained service relationship, as many high-tech products do, a robust Web presence could be valuable too. However, that may not be the case where the actual transaction or exchange of value is accomplished using the Internet. Very often the nature of the product will dictate the type of Web presence to be maintained.

3 Customer Suitability

Products that have a high emotional appeal or services that require intimate customer knowledge are well suited for higher-cost direct marketing initiatives. By the same token, if the prospect pool is relatively small, well defined and easily identified, transacting business directly would be a preferred option.

Mapping Business Attributes

	Proprietary Web Site	Shared E-Market	Example
Brand/Market Leadership	Strong	Weak	American Express
Customer Relationship	Sustained	Temporary	Monster.com
Value of Relationship	High	Low	Fidelity
Suppliers/Buyers	Few	Numerous	FastParts
Product/Service Complexity	High	Low	Cisco
Demand	Predictable	Random	Instinet

Source: Cambridge Technology Partners

Generational considerations should also be a consideration. People often use only the technology with which they gained familiarity during a given portion of their lifespans. For many classes of products – toys and retirement homes are two examples – the buyer and the user might not be the same. Product complexity and the ability of customers to acquire product knowledge independently or assimilate information can also be critical. Dell is frequently cited as a paradigm of direct online marketing of a highly technical, complex product. How did the customers who buy from Dell direct acquire their knowledge of PCs? Was it from Dell? Or did the customers actually gain that knowledge from their work or from school – or from browsing for hours in Computer City? Marketing mechanisms need to be consistent with the customer's ability to acquire sufficient information to make decisions. In Dell's case, traditional channels provided a valuable service by creating a well-informed prospect pool that could buy online.

For many classes of products, the roles of physical and online channels are actually reversed. Customers go online to learn, but engage in transactions face to face. That's particularly true of products that have a high service component and where personal chemistry is critical. For instance, you might determine a physician's qualifications online, but would you actually select your personal physician without ever bothering to meet her? However, direct methods are often more expensive, and customer lifetime value might dictate a lower cost strategy.

4 Competitive Position

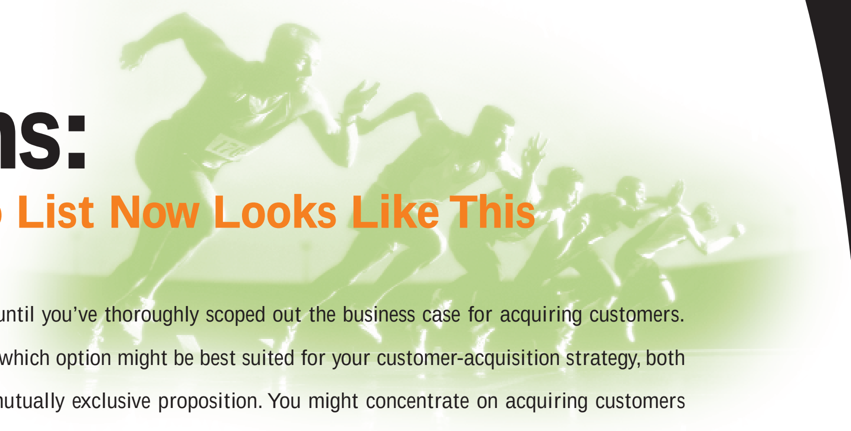
If you're building a new dot.com company, your options will probably be different from those of an established brick-and-mortar player. The same might be true if you are a market leader versus a market follower. Firms that have unique value propositions and distinct product or service offerings are often better suited to go it alone with a direct-to-buyer Internet strategy. Those could be firms that have established product or price leadership, unique skills and capabilities, or businesses that are sole-source players for the markets they service. In such situations, customers will probably shoulder a disproportionate share of the transaction expense in order to engage in an exchange.

> If you're building a new dot.com company, your options will probably be different from those of an established brick-and-mortar player.

However, if you are one of many firms competing to service a particular market, the burden of winning new customers will have to be borne directly if it can't be shared with customers or competitors. That's where joining or even creating an e-market can often provide competitive advantage. While there's risk – choosing to participate in an e-market may open your firm to the possibility of being co-opted by competitors – the strategy may compensate by improving the economics of customer acquisition while simultaneously diminishing the prospects of players which choose not to participate. (See Case Study)

Action Items:

Your To-Do List Now Looks Like This



Don't even think of evaluating competing technologies until you've thoroughly scoped out the business case for acquiring customers. A number of different criteria can be used to determine which option might be best suited for your customer-acquisition strategy, both now and in future. In most instances, it will not be a mutually exclusive proposition. You might concentrate on acquiring customers through an e-market and dedicate your Web site to service and retention. You might use a proprietary Web site to drive traffic to an e-market, or use your presence in an e-market to engage prospects for your site. Very often a given customer-acquisition strategy and corresponding market mechanism may evolve based on customer behavior, product attributes, technology and competitive response. Ultimately, understanding the dynamics of your business, your products, customers, competition and technology will be the only way to determine a successful Internet customer-acquisition strategy.

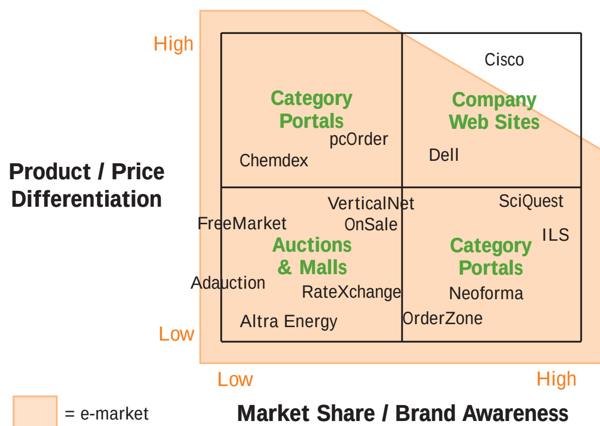
A good place to begin is with a simple segmentation analysis. Here's how it might go:

1) Start by profiling your customers. Define your customers along as many dimensions as you believe to be relevant: age, income, purchases, location, affiliations, technology sophistication, credit history, etc. While it may sound easy, many companies will find that while they have tremendous amounts of data about their customers, they actually know very little about them. In which case, you might even try talking to them. Examine their buying behaviors. Why do they buy from you and why do they go to competitors?

2) Next, profile your marketing and channel mechanisms. Map your customers and products into their preferred channels. Examine the economics and profitability of each customer/product segment based on the dominant marketing mechanism employed. Determine if any segments have switched channels or might be candidates to switch sometime in the future. Look for channel substitution opportunities.

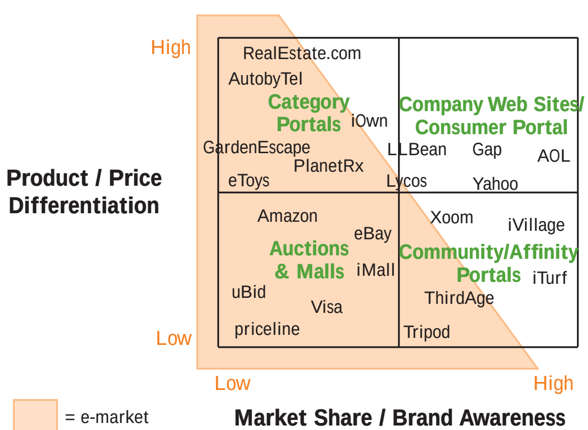
3) Begin to map your Internet options. Don't constrain your thinking: don't assume that a Web site is your only option when your customers may have already used priceline.com and don't understand why you haven't embraced it. Next, determine which online option provides your customers, not you, the greatest amount of advantage, and begin to plot a course on that basis.

E-Markets Dominate B2B Transactions...



Source: Cambridge Technology Partners

... And Complement B2C Transactions



Source: Cambridge Technology Partners

Harley-Davidson

For some organizations – those with a single product or service and a homogeneous customer base – this analysis will be quick and straightforward. Motorcycle maker Harley-Davidson has a relatively simple product with a high degree of emotional appeal; it could easily transact business through its Web site, but the company recognizes that its customers have a strong affinity for their dealers, which often are the center of a local biking community. So Harley's Web site is designed with this in mind, providing the feel and excitement of the experience, but leaving the sale of bikes to local dealers. For other companies whose product and service lines are broad and highly intertwined, a more detailed and painstaking analysis will be in order. For instance, financial giant Citigroup might conclude that it needs a hybrid strategy. Citigroup may opt to invest heavily in a direct, proprietary online presence for its private banking clients. At the same time, it might consign most of its insurance products to an e-market such as InsWeb, and then develop a cross-selling strategy to move customers with different needs and demographics to the products and services most appropriate for them.

While the number of potential options is very large, some rules of thumb are beginning to appear. In general, for products and services where there are numerous buyers and sellers and a relatively large number of contestable transactions sufficient to create critical mass, e-markets will emerge. In many instances, their economics will be very compelling for both buyers and sellers. In most categories of consumer products, brand strategies and direct market mechanisms will continue to prevail. For B2B products and services, e-markets will probably become the dominant market mechanism for all but a handful of items. Organizations that can maintain price, product or competency leadership can successfully build and sustain direct Internet relationships.

Ultimatum

In the wired world of the New Economy, customer acquisition will be the first of many strategic decisions that companies will encounter. They will also face brain-bending challenges in customer fulfillment, supply-chain efficiencies, process integration, and strategy development and implementation – all among the themes that we will address in the continuing New Economy white paper series.

While a number of options might be suitable, the preferred customer-acquisition strategy would be the one that anticipates the evolution of customer advantage. We've noted several reasons why the buyer will determine the dominant market mechanism for any class of goods or services, and we've made it plain that if your acquisition strategy does not furnish the customer some form of distinct advantage, chances are someone else or some other mechanism will.

Sellers may yet realize their dream of quickly and inexpensively finding qualified buyers when reverse-bidding mechanisms like priceline.com become the dominant marketing mechanism. However, few vendors may relish this prospect if and when it does become a reality. But until then, most sellers will have to determine which Internet strategies are best suited to their business models. For the growing number of situations in which the buyer will likely opt out of direct marketing mechanisms and opt in to e-markets, vendors will have little choice but to follow their customers, trimming their economic models, selling practices and Internet strategy accordingly.

> When properly conceived and constructed, e-markets meet a greater share of both buyer and seller needs at a lower cost than competing alternatives.

Further Browsing:

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Glossary of Terms

agents
Technological search tools that buyers or sellers may enlist to balance "information asymmetry," helping them find and sort out relevant product or service information in the vastness of cyberspace.

auction sites
Online e-markets that allow customers or sellers to bid on desired items or needs.

banner ad
Cyber-advertisement, typically small (and in the shape of a rectangular banner). Once clicked on, it links or "drives" the customer to the Web site that substantiates the ad content.

bot blocking
Use of intelligent software agents to screen out unwanted online inquiries.

brochureware
Web marketing vehicle largely containing an organization's product, service, or general information, usually in the form of a direct, sometimes condensed translation of the printed collateral to electronic format.

category portals
Online trading communities built around an affinity such as a customer demographic or type of product.

contestable transactions
Transactions where the outcome has not previously been negotiated or determined.

customer ownership
The ability to influence an increasing proportion of customers' purchasing decisions to the point where they provide one supplier with all of their business for a given category of product or service.

driving traffic
The act of directing customers to a Web site through any number of techniques including banner ads, radio buttons, hot links.

e-markets
Electronic markets or communities of buyers and sellers, usually implying many participants.

ex-ante costs
The costs related to the structure of terms and conditions of the transaction.

ex-post costs
The costs required to warrant the satisfaction of the parties involved.

information asymmetry
When one party to a transaction has more relevant information than the other.

search costs
The costs to find and evaluate competing substitutes.

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