THE E-MARKETPLACE INVESTMENT

Avoiding a $15 Million Mistake

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EASTON CONSULTANTS, INC.

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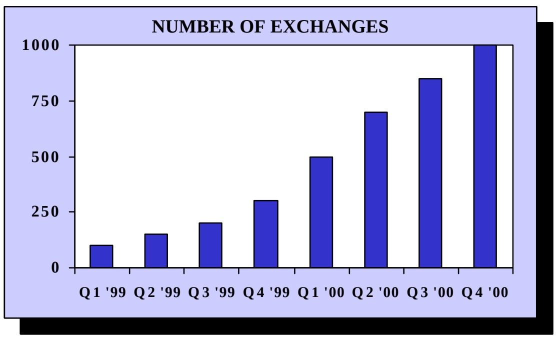
Investing 101

1999 was the Year of the Dot.Coms; 2000, the year many failed. In their stead rose a new breed of high-flyers called "e-marketplaces" or "exchanges," replete with soaring market valuations, scores of business magazine articles, and revenue and profit estimates that would make Cisco stop cold. Indeed, 2000 was their year of hype; what will 2001 hold?



The rise of e-marketplaces has put significant pressure on both buyers and vendors to respond. Buyers understandably cannot resist the allure of an exchange. They see the exchanges as an easy way to create greater "transparency," correcting the information imbalances they suspect their vendors profit from. They expect auctions and price comparison functionalities to drive down prices. They expect greater collaboration with trading partners through the exchange. They see the aggregation of vendors as an easy way to ensure supplier liquidity, hoping the exchange will allow for seamless substitution of vendors and thus a greatly increased total inventory from which to buy. Consequently, buyers have demanded vendor participation, asking their long-standing trading partners to join exchange after exchange, requiring exchange participation for contract renewal, and very publicly channeling more and more of their business through the exchanges.

As a result, vendors are feeling pressure to participate in the exchanges lest they lose important accounts, and are flocking to e-marketplaces en masse. Each vendor that decides to migrate to an e-marketplace inspires a competitive response from other vendors… and thus the exchanges grow in size and number.

In the case of a third-party operated site (as opposed to buyer-centric or seller-centric models), the exchange operators themselves are also catalysts for growth. They point to estimates that predict online business-to-business e-commerce will grow to over $6 trillion by 2005 and, when, multiplied by their expected 1-5% toll charge on each transaction, they are able to make an extremely compelling argument for vendor participation. In fact, the argument is so compelling that the exchange operators, looking both to raise capital and to secure long-term relationships, routinely ask that the vendors take equity in the exchange as part of the participation agreement.

The result is sobering. Large companies, especially diversified companies, typically have dozens of exchanges—including buyer-centric, seller-centric, and third-party operated sites—vying for their attention, at least 5-10 of which may be central to their business. E-marketplaces typically ask for investments of $1-3 million, offering 1-3% equity and the right to participate in return, and buyers helping to start an exchange are often required to make a similar investment to cover start-up costs. With the typical large company eventually investing in 3-5 exchanges, the total necessary investment can be significant—as much as $15 million. What are these vendors and buyers buying with their money?

Unfortunately, the clamor to respond to the various demands and arguments for participation often drowns out the need for a thoughtful investment strategy, and when it does, corporate checkbooks may be opened without an investment goal in mind. But $15 million deserves thought—serious thought. Will the company profit from investing in an e-marketplace? If so, how? Will the investment strengthen or weaken current trading relationships? Where will the company stand if the e-marketplace fails? Does the considerable potential of the e-marketplace model actually fit the company's business? Where else might the company spend its money? How will the investment affect the company's customers, its supply chain, and its corporate strategy?

In short, is the $15 million buying anything more than e-real estate, worthless equity, and a multi-year headache?

Conventional Wisdom is Not Enough

Companies considering investments in e-marketplaces feel short on time. Internet hypesters, as well as business partners, are telling them to act now, to jump on the e-marketplace opportunity immediately, to act without traditional and thoughtful consideration of the long-term return on the investment. But the "don't think: act!" mentality towards multi-million dollar investments is folly, as many of 1999's darling dot.coms have learned in 2000. As with any other investment, companies considering investments or reinvestments in e-marketplaces need to think seriously about their long-term return.

But anticipating risks and long-term returns is complicated. Often the company's return is wrapped up in the success of the exchange itself, as e-marketplaces often push participants to take equity positions and to help design and implement the exchange's business plan. This leaves the vendors and buyers in a dual role: they are both participant and owner, and they thus have a double stake in seeing the e-marketplace succeed. How do they begin assessing and analyzing an exchange's prospects?

As with every new, exciting, and entertaining business trend, a sizeable body of conventional wisdom has grown up around the rise of the e-marketplace with varying degrees of hype and insight, and it has been captured on the pages of countless business magazines. Executives considering participation in an e-marketplace could do worse than to start by acquainting themselves with this conventional wisdom, for they will likely avoid many obvious—and non-obvious—pitfalls as a result.

But executives could not do worse than to mistake the conventional wisdom, which provides exhaustive documentation of critical success factors for *any exchange* in *any business*, with an understanding of how to build competitive advantage in *their own, particular business* and for *their own, particular companies*. The same conventional wisdom lessons are available to all exchanges, and thus the valuable lessons will be a part of all viable exchanges. But the lessons do not explain how an exchange can succeed in a given business, or how a specific company can capitalize on the exchange model and profit from it.

Conventional wisdom is best thought of as a list of entrance requirements: it sets out basic rules of the game, but does not identify which skills will help you win. The entrance requirements are not the sources of competitive advantage. The sources, which will determine whether a company is well suited for exchange participation, vary from business to business.

A few, representative examples of the conventional wisdom surrounding e-marketplaces help make the point:

- *Lesson #1: "Auctions are not enough"*

  This is a very good point, and important to any company considering investment in an exchange. The costs of providing auctions on an exchange will continue to drop, allowing every exchange to offer them, should they choose to. And in every business where there is a demand for auctions, every successful e-marketplace serving the business will offer them—and no successful e-marketplace will be able to use auctions as a competitive differentiator. The general lesson that "auctions aren't enough" begs a specific question: if auctions are likely to become ubiquitous and thus will not provide competitive advantage, what will?

- *Lesson #2: "Successful exchanges will offer value-added services"*

  Very true. Business intelligence data about markets and trends, content management that connects databases and manages documents, customer services such as e-CRM and problem tracking, dynamic pricing, financial services such as escrow and insurance, marketing communication assistance, sophisticated shipping interfaces, etc., all help differentiate e-marketplaces and increase their value to the vendors and buyers. The best value-added services for a particular user group will quickly be offered by every exchange that serves that user group, however, and soon every competing e-marketplace will offer the same array of value-added services. At this point, the lesson is no longer helpful: having certain value-added services is indeed a critical success factor, but only certain services will give an exchange a competitive advantage. Which services those are, how they should tie together, and whether it's best to buy or build them, will vary across businesses.

- *Lesson #3: "Businesses often do not have credit cards, so offer alternatives"*

  The importance of this lesson cannot be understated—offering automated payments, or some other payment mechanism, is crucial for a successful e-marketplace. But simply knowing that buyers need a payment mechanism is not a competitive advantage. The key is to understand what mechanisms and services a specific set of buyers requires—the proper suite of financing, escrow, automation, etc.—and then to find a way to keep the suite proprietary and leverage it to increase revenue and profit.

- *Lesson #4: "Marketplaces must integrate with ERP and legacy systems"*

  Integrating with ERP systems can help raise switching costs for vendors and buyers, thus helping the e-marketplace, and can help maximize the cost savings for the participants. Except in the cases of infrequent transactions, an e-marketplace can create a competitive advantage through integration, and in this respect the conventional wisdom delivers a valuable insight.

  But there are two further considerations that conventional wisdom overlooks. First, it is very costly to integrate with enterprise systems, and vendors and buyers typically—and rightly—pick and choose with whom to integrate very carefully. The goal of integration may be a good one in some cases, but it makes the sale much more complex, and significantly increases the cost of adding each participant. Furthermore, many companies use a legacy system, have "best of breed" modules, or have installed only part of a unified ERP system. Integrating with these different enterprise systems could cause a significant spike in cost, and the piecemeal upgrades to single modules at these companies could cause integration troubles after the initial sale.

  The second consideration conventional wisdom overlooks with respect to integration is the likelihood of open or standardized ERP platform protocols. In the same way that operating systems and I/O ports for PCs moved from proprietary to open during the 1990s, enterprise systems are adopting integration standards that allow for easier integration with third-party vendors such as e-marketplaces. This development will, of course, reduce the cost of integration. It will also eliminate the switching costs for vendors and buyers, and in doing so diminish the competitive advantage an e-marketplace can achieve by integrating into enterprise systems. When the ERP platforms open up, every successful exchange will offer integration, and it will no longer provide any particular exchange an advantage.

The list of entrance requirements is considerably longer than these few examples, but the point holds for all of them: the valuable lessons in the press are available to all competing e-marketplaces, and all competitors will eventually benefit from them equally. As difficult as the entrance requirements may be to meet, they are only the baseline for competition. More is needed for competitive success—a lot more.

The real advantage comes from understanding the difference between the entrance requirements and the sources of competitive advantage, and that difference depends on a subject conventional wisdom is historically unable to address: the particularities, exceptions, and nuances of the business.

The Bedrock of Developing Insight: How will an exchange enhance your business?

The goal for an executive considering an investment in an e-marketplace should be to understand what value the exchange might bring to the business. How will detaching the exchange of information from the physical processes involved in a trade or collaboration improve the organization? Will it reduce costs? Will it expand the market? Will it allow for advantageous customer poaching, more fluid competition, or maybe enhanced service? Understanding the values of the exchange, *and how they relate to the dynamics of the particular business it is trying to serve,* is crucial to a responsible analysis of any potential investment.

Three areas of consideration merit particularly close attention: Market suitability, cost-savings suitability, and the one-to-one opportunity.

- *Market Suitability*

The suitability of an exchange to a particular market depends on the answers to four important questions:

1. How core are the products to each participant?
2. How often will the supported transaction take place?
3. How much customization does each transaction require?
4. How well do the trading partners know each other?

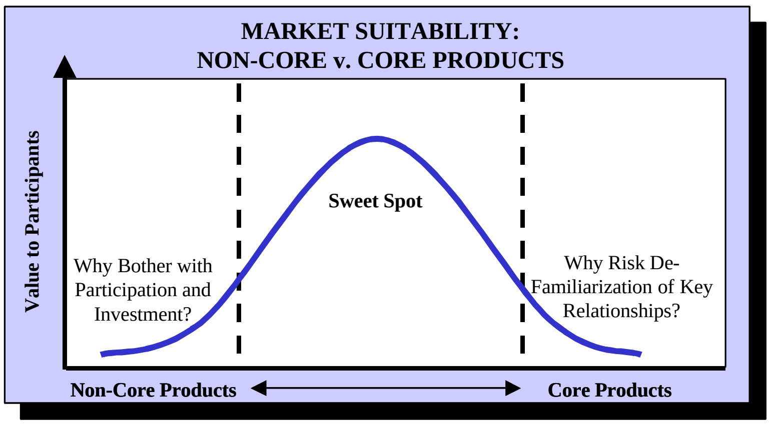
A company's answers to these questions, both today and as they are likely to change in the future, will help determine its exchange strategy. As an example, consider the first question: *How core are the products to each participant?*

Exchanges are typically most useful for products not considered core to the business—that is, products that are not specifically designed to enable crucial business processes and that do not flow directly into finished goods. For such non-core products, exchanges:

- *Streamline transactions the participants view as distractions* from their main profit-making activities, allowing them to focus organizational resources on core processes; and

- *Do not threaten to de-familiarize important relationships.* E-marketplaces that encourage multi-vendor comparisons can subvert a "preferred vendor" relationship. For non-core products, this subversion does not threaten the relationships on which a participant depends, and as a result is typically acceptable to most companies.

Trading core products through an exchange is a different story. The de-familiarization can threaten relationships with decades of development behind them, and as such is potentially disastrous. Companies trading core products through an exchange will eventually find steady, trustworthy business partners, at which point they will migrate off the exchange (often to a company site) to avoid paying the exchange's fee and to solidify advantageous partnerships. Where core products are involved, exchanges can help companies find one or two long-term trading partners, but rarely become a successful long-term channel themselves.



The same sorts of relationships can be mapped out and assessed for the other three questions as well, and the composite picture of the market suitability for an exchange is crucial to a company's exchange strategy. Although market suitability alone is not reason enough to participate or invest in an e-marketplace, knowing the market is ill-suited for an exchange might be enough reason to table the topic and focus management attention elsewhere.

- *Cost-Savings Suitability*

Moving B2B transactions online can capture significant cost savings by making transactions more efficient, improving order accuracy, improving logistical planning, etc. But exchanges do not typically offer across-the-board cost reductions to their participants: a paper producer's decision to sell through an e-marketplace may cut down on its customer service or vendor exploration costs, for instance, but it is unlikely to reduce more significant costs in the business, such as the acquisition costs of raw materials.

Executives considering investment in an exchange should be sure that the real cost savings for the organization are important to the business model. All too often, companies cede important strategic ground when joining an exchange only to attain insignificant cost savings in an already efficient department. Worse yet, leading companies who currently enjoy scale efficiencies often have competitors who really can capitalize on the cost savings of the exchange, and participation in the exchange thus diminishes any scale advantage the leader previously enjoyed.

- *The One-to-One Opportunity*

In some cases, e-marketplaces can greatly enhance a company's ability to adopt an increasingly successful customer-centric strategy. E-marketplaces allow vendors to collate information about their buyers faster than ever before: every purchase or product preference gives the vendor a more complete picture of that customer, and thus gives the vendor an opportunity to offer related—and often unrelated—products and services that can increase the size of the sale.

When a PC vendor, for example, receives orders from a customer for a 3-D graphics card, a joystick, and a large monitor over the course of a year, it can safely assume the customer enjoys arcade-style video games. The exchange platform can collate this information faster than ever has been possible, potentially even aggregating sales data across participating vendors, allowing the PC vendor to respond faster and more confidently with promotional offers for high-margin video games.

ASSESSING THE ONE-TO-ONE OPPORTUNITY

Company's Marketing Strategy	Business' Fit for One-to-One Marketing: **One-to-One Marketing Enhances Business**	Business' Fit for One-to-One Marketing: **One-to-One Marketing Does Not Enhance Business**
Customer-Centric	**Invest:** Develop One-to-One Marketing Tools *Caution*: Could Make One-to-One Marketing Available to Competitors	**Look Elsewhere:** One-to-One Marketing Should Not Drive Investment *Reevaluate Strategy:* Customer-Centric Strategy Not Appropriate
Not Customer-Centric	**Participate:** E-Marketplace Might Facilitate Strategy Change *Reevaluate Strategy:* Company is Missing One-to-One Marketing Opportunity	**Look Elsewhere:** One-to-One Marketing Should Not Drive Investment

Businesses that lend themselves to customer-centric strategies, and companies that recognize and capitalize on this opportunity, can benefit from an e-marketplace's one-to-one marketing opportunity—provided that the e-marketplace offers this functionality. Companies for whom the one-to-one opportunity is a crucial reason to participate should consider taking enough equity in the exchange to ensure that the exchange develops these one-to-one marketing tools.

Beware the Dangers

But even e-marketplaces that are well suited to the businesses they serve may not deserve the significant investment they are asking for. A host of dangers surround exchanges, and the future of any particular e-marketplace may not be as bright as many analysts believe.

- *Revenue Realism*

Most e-marketplace revenue estimates are grossly overstated, perhaps even by an order of magnitude. Although e-marketplaces allow for some (often considerable) transaction efficiencies, there is no reason to think that the e-marketplace itself will be able to capture much of the exchange volume as revenue, let alone profit: why shouldn't the savings be passed on to the customer, or to a third party?

TOLL CHARGES: FIVE MAJOR EXCHANGES	
NYSE	0.0082%
Nasdaq	0.0128%
AMEX	0.0729%
London Stock Exchange	0.0038%
CME	0.0001%

Much of the overstatement is a result of unlikely "toll charge" estimates. Most e-marketplaces currently charge or plan to charge fees amounting to 1-5% of the dollar volume passing through them. But the performance of "real world" exchanges suggests that toll charges will not be that high. The New York Stock Exchange, for instance, processes approximately $9 trillion in trades each year, but only keeps approximately $750 million as revenue—0.008%, not the 1-5% the e-marketplaces expect. The Nasdaq processes almost $6 trillion in trades and has annual revenues of only $740 million, or 0.013%. And the point holds true for the AMEX, London Stock Exchange, and Chicago Mercantile Exchange as well: none earn revenue in excess of 0.1% of their transaction volume.

- *Non-dollar Costs*

There are more costs to participating in an exchange than the upfront dollar investments. Setting up the exchange and ensuring its success requires significant management attention and IT resources, amounting to significant time costs. Executives will also need to think about repercussions across the organization, including (but not limited to) sales force reduction or retraining and customer service process changes. And for both dollar and time costs, there is an opportunity cost to investment: would the time and money be better spent elsewhere?

- *E-marketplaces Can Commoditize Products*

One popular feature of e-marketplaces is their ability to facilitate price comparisons. But a vendor's marketing and pricing strategies are often based on product differentiation or related services, not on product comparison. Exchanges often require vendors to describe their products along a finite set of easily searchable parameters, however, severely diminishing a vendors' ability to differentiate its products.

PC manufacturers have faced this problem for years. There are as many as 100 differentiating characteristics to PCs, any of which might provide strong ground for consumer preference. But most buyers compare PCs across only a limited number of characteristics—price, processing speed, memory, peripherals, service, software, and maybe one or two more—leaving little room for PC marketers to explain why their design, components, engineering, etc. are real advantages. The fewer dimensions a consumer considers, the more every PC begins to look alike. In the extreme case, where a consumer only looks at price, PCs truly reach commodity status, and product differentiation is impossible.

E-marketplaces can force many types of vendors into exactly this position, and in doing so run the risk of destroying a vendor's competitive advantage or blocking the buyer's product selection flexibility. Moreover, commoditization in its extreme can result in uninformed purchases, leaving buyers with products that do not fit their needs.

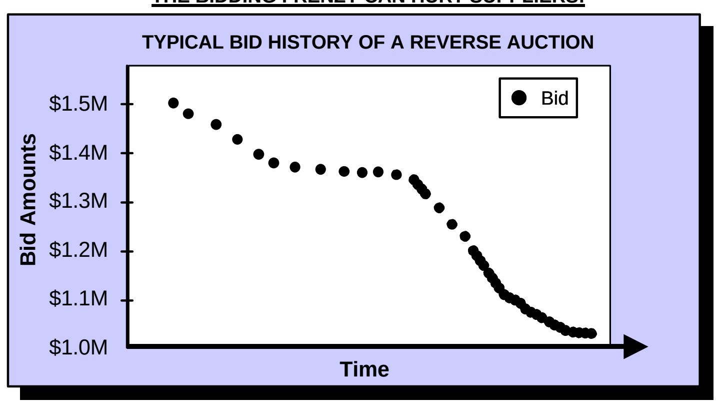
- *Supply Chain Subversion*

The e-marketplace presents a compelling model for procurement, and as a result, buyers have been quick to pressure vendors into joining exchanges. Buyers are often especially interested in using auction technology to drive prices down.

Pressuring vendors for a better price is nothing new to buyers. Even in the age of collaboration, strategic alliances, and sole sourcing, buyers distinguish themselves in part by driving prices incrementally lower each year, and the e-marketplace is yet another new tool to do the same old job. But it is an extremely powerful tool, one that can shrink the bidding process to a matter of hours and force suppliers to make bids they have not yet analyzed carefully. At Easton, we repeatedly hear about vendors participating in reverse auctions, forced to bid lower and lower to keep a major client, and having to decide, often in a matter of minutes, whether to lose a major client and go out of business today, or to accept an unprofitable contract and go out of business in a year.

Any experienced buyer knows that driving prices down to save cost is one thing, but driving important business partners out of business is another. E-marketplace auctions may indeed allow buyers to save 20% or more on price in the short term, but they risk losing the consistency of a healthy and stable pool of suppliers, the advantages of good working relationships with important business partners, and the security of quality products if they squeeze suppliers too tightly. Any of these dangers could more than nullify the 20% price savings in the long run.

THE BIDDING FRENZY CAN HURT SUPPLIERS:



- *Losing touch with customers—and suppliers*

Vendors who participate in e-marketplaces may think they are reaching customers they traditionally would not sell to, and in many instances they are right. But vendors are also making an important strategic choice by joining e-marketplaces: they are deciding to allow a third party to mediate their customer relationships. As mentioned above, there are cases where the exchange presents a One-to-One opportunity; in other businesses, this mediation can destroy customer loyalty and negatively impact customer service.

The mediation can also have negative effects on buyers. As vendors lose touch with their customers, their commitment to service and support can fall off dramatically. It has already happened in the airline industry, where travelers who purchase tickets through third party aggregators are often moved to the bottom of the standby list when bumped from a flight.

Conclusion: Buy something more than e-real estate!

An investment of $15 million, plus the time and opportunity costs of ensuring success, should return more than a few virtual storefronts. It should return a new, profitable channel that complements your corporate strategy, protects the advantages you currently enjoy, or provides opportunities for new competitive advantages. To avoid buying nothing but e-marketspace, be sure to:

- *Know your business within an e-business context*: Does it lend itself well to an e-marketplace, and will the cost savings enhance your competitive position? Knowing your business will help you decide how to deal with exchanges. Are you in the rare situation where your corporate strategy should become exchange-centric? Does the exchange model threaten your competitive position, and if so, can you circumvent or kill it?

- *Think in terms of competitive advantage, not in terms of features*: Uncover the drivers of market interest in exchanges and leverage them into competitive advantage and a profitable niche. Do customers want transaction histories and analytics? Are they looking to use the e-marketplace as a risk hedge, making futures and options important services? Are vendors trying to move market share, poach customers, or cut costs? Go beyond the literature, find sources of competitive advantage, and pursue them vigorously.

- *Manage an e-business portfolio:* Investments in e-business can fuel corporate development in both the long- and short-term, but you should diversify those investments carefully. Exchanges are only one type of investment with certain types of value to your organization. Each e-business investment will carry a different potential value to the organization and require a different amount of development time; the key to long-term success is to diversify across both dimensions.

EXAMPLE OF AN E-BUSINESS PORTFOLIO:

INVESTMENTS

Value to Organization	Concept	Early	Middle	Late	Roll-Out
Cost Reduction	✓	✓	?	✓	✓
Revenue Increase	✓	?	✓	?	✓
Other	✓	✓	✓	✓	?

Development Stage

- *Most importantly, do not forget the bottom line:*

Your investments are supposed to make money!

Not every investment will be a success. Risky tests and pilots have value. But your total portfolio of e-business investments can be enormously successful. Long-term planning should consider what is best for the company—your company's exchange strategy should be flexible, supportive of the overall corporate strategy, and should result in profit. Now is the time to think seriously about your e-marketplace investments, not $15 million later.

ABOUT EASTON CONSULTANTS

At Easton Consultants, we work with our clients to develop winning strategies for the new economy by helping them assess new business initiatives, revamp old strategies, launch new products, or diversify into strategically advantageous new markets or businesses.

We invite you to visit our web page at www.easton-consult.com, where you can learn more about Easton's approach to e-business and corporate development. In particular, we suggest the following pieces relating to this paper:

- *Choosing an Internet Business Model to Fit Your Corporate Objectives*
- *How High Tech Firms Find Replacement Technology*
- *One-to-One Pricing in the New Economy*
- *Marketing Levers in the Network Economy*
- *Linking Strategy to What Customers Value*
- *Characteristics of the New Economy*

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