



# The eEconomy: It's later than you think

By Richard M. Melnicoff

Because eCommerce is changing the underlying economics of business, industry leadership today is no guarantee of success tomorrow.

Nimble new competitors, energized by these new economic realities, can create better, cheaper value propositions more quickly—and steal market share. To survive and thrive in the eEconomy, established companies must undergo a complex, painful transition. Here's why.

In H. G. Wells' classic *The War of the Worlds*, an English village awakes one day to discover that it has been invaded by decidedly unpleasant beings from Mars. Panic and confusion seize the villagers as the destructive intent of the newcomers becomes clear. "All our work undone," one local cries out. "This must be the beginning of the end!"

Did similar thoughts cross the minds of greeting card companies when E-greetings sent more than 250,000 digital greetings last Christmas Day? What about all those publishers of classified ads looking on as Monster.com stomped onto the nation's desktops? And it's safe to assume that even the titans of Wall Street were rattled last September 1, the day schwab.com scored 20 million hits.

Just as with Wells' Martian attack, the reality becomes clearer with every new conquest: Whether you sell fine wine or turbines, nimble new competitors with superior value proposi-

tions can enter your market tomorrow with all the scale they need to grab significant market share.

Why do electronic commerce contenders seem so alien? And how is it that highly successful firms, pursuing some of the most carefully thought-out strategies in the world, keep getting caught off guard by them? The answer is these established organizations are still fighting to win a game that no longer exists. Most of them continue to make the assumptions, and accept the constraints, of traditional economics and strategy. But today's electronic economy—fueled by a unique convergence of computing, communications and content technologies—is subject to an entirely new set of rules.

Five long-held, basic "truths" in particular appear to be crashing down around us, creating immediate and sizable threats to established organizations. One is the wisdom of vertical integration. Another is the earning

power of physical assets. The other three have to do with natural limits to growth, the channel power of producers and the prudence of fast-following.

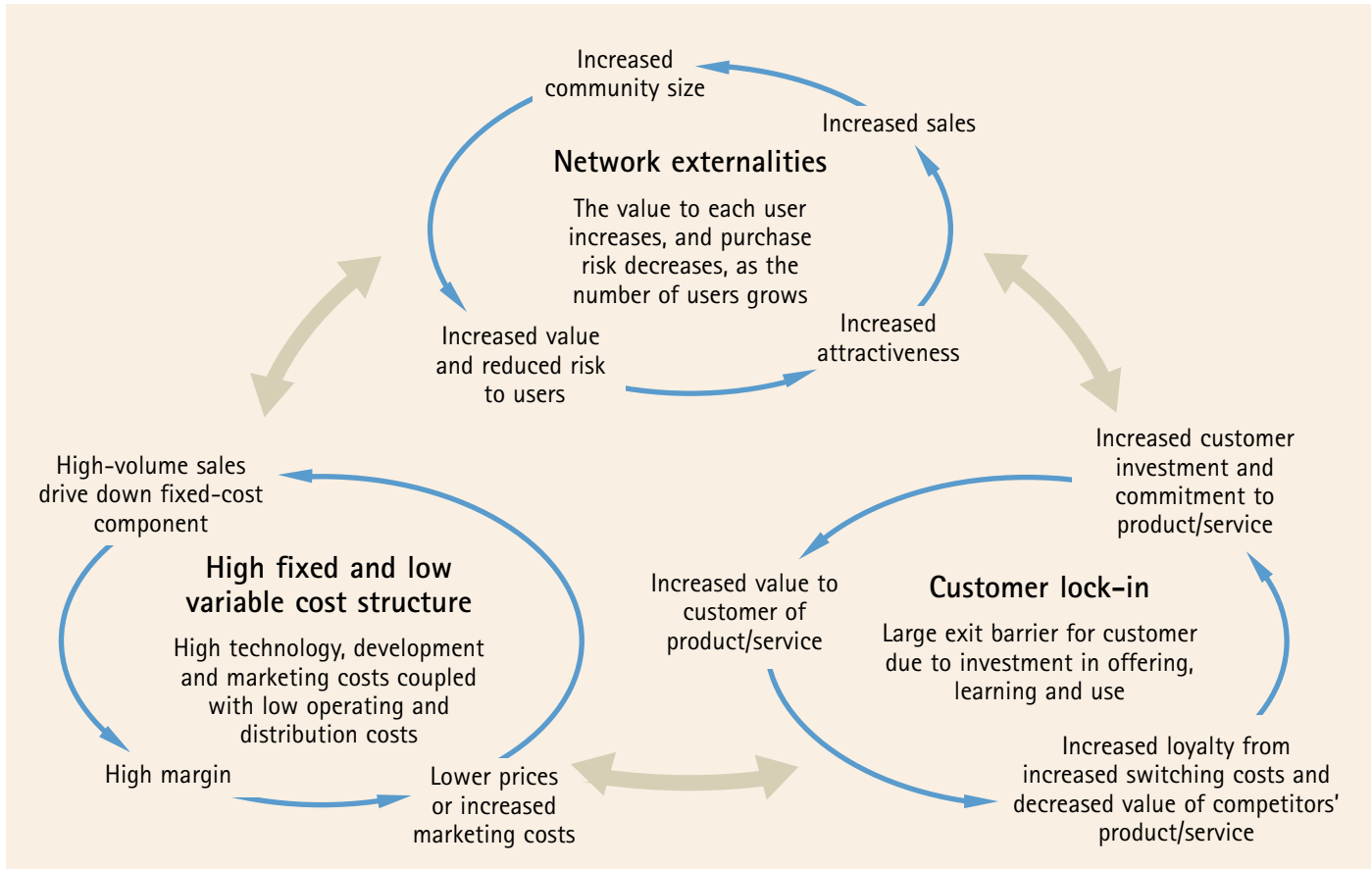
## **Vertical disintegration**

For the past century, many firms have lived by that catchphrase of self-reliance: If you want something done right (and on time), do it yourself. Given the high costs and risks of transacting business with others, it made good economic sense to, say, make most of your own parts if you were an automobile manufacturer, or to own your own fleet of trucks if you were a food processor.

eCommerce has changed all that. Communications and information technologies often make it more effective and less expensive to collaborate with outsiders than to own all the resources associated with your business. Although coordination and day-to-day control might be a little more difficult (but certainly much less so than they would have been

## eEconomics: Increasing returns to scale

Three powerful forces—high switching costs, benefits of multiple users and a low variable cost structure—will give early leaders in the eEconomy increasing returns.



SOURCE: ADAPTED FROM "INCREASING RETURNS AND THE NEW WORLD OF BUSINESS," W. BRIAN ARTHUR, HARVARD BUSINESS REVIEW, JULY-AUG 1996.

years ago), you more than make up for the difficulty in quality, flexibility and cost. The result is that specialists are cropping up in practically every major business activity, from product design to delivery, and it's now possible to pull together a virtual organization that employs only "best-of-breed," cost-effective contributors at each point.

Even more to the point, that pulling together can happen rapidly in response to changing conditions. An established organization, proud of the capability it spent years developing, can see its performance matched—even outstripped—virtually overnight by a faster-moving, smarter competitor or even some confederacy of upstarts. It's the story

of garden.com. Almost all of its plants are shipped to consumers directly from suppliers—only 3 percent are kept in inventory. Instead, garden.com focuses on offering customers the best in quality, variety, information, advice and convenience, while at the same time using Web technology to let customers virtually plan their gardens. Clearly, it is smart to slam-dunk the part of the value chain most valued by customers and team up with the best for the rest.

The problem for traditional companies, of course, is that they already own large expanses of their value chains. For these firms, integrating for maximum customer value can't happen until after they've *disintegrated*. A daunting prospect? The alterna-

tive is worse. In a world where the costs of collaboration and interaction are low, vertical integration driven by anything but customer value can't be sustained. Specialized niche players or smarter, faster competitors will attack any weak parts of your value proposition and marketing position. If you're not the absolute best at performing a function that can be bought elsewhere, don't do it.

### Return on intangibles

Another increasingly obsolete commercial reality is the centrality of physical assets. Businesses have always competed on the strength of their "intangibles"; along with their property, plant and equipment, they needed great product design, technological innovation, market insight,

management know-how—and strong customer relationships. But these intangible assets were often considered meaningless in isolation and of little value when separated from a business's physical core.

In such a world, a firm could focus on an intangibles-based strength like branding, and collaborate with others in the business of manufacturing. But it wouldn't happen very often. Intellectual property was a cost of doing business and an ultimate source of value, but not a source of revenue itself. Basically, the effort of collaborating with manufacturers to produce the goods would be so great that the returns just wouldn't materialize, or the manufacturers would wipe out most of the developer's profits in the negotiations.

What eCommerce has allowed firms to do is to bring intangible assets to the fore—to tease out the value they add, and even to make a business of them, pure and simple. By making inter-firm collaboration easy and inexpensive, eCommerce allows intangible assets to be leveraged across a much larger buyer base. Time and space constraints no longer apply, so they no longer have to be co-located with the tangible means of production.

Just ask Wall Street. Today's eCommerce start-ups make it abundantly clear that market value accrues fastest for those who travel lightest. Consider eBay: It went public last September, and the market valued it at \$1.88 billion, topping the \$1.02 billion value of auction house Sotheby's. eBay has almost no physical assets.

Investors' love affair with "dot coms" isn't all irrational exuberance. In fact, they continue to understand that market valuations reflect expectations of future cash flows. But

there's a profound shift under way in what drives cash flows. The workings of the eEconomy simply don't rely on the physical assets so important to the Industrial Age. Instead, returns, cash flows and resulting market valuation are being driven today by firms' intellectual property and customer relationships.

Again, bad news for those established organizations that already own large, traditional asset bases. Most, of course, also have loads of intellectual capital and strong customer relationships built up over years. But the margins they could be earning on those intangible assets are eroded by the underperforming physical ones.

#### **Increasing returns**

One could scarcely find a better example of classical economic thinking than the concept of diminishing returns to scale. Basically, it teaches us that no business can keep growing profitably forever. Yet this law isn't nearly as important in the eEconomy. Why not? In part, because information travels light. When operations depend more on bits than on atoms, scale doesn't translate to mass. Once the substantial up-front investments are made—for things like research and development, and technology infrastructure—each unit sold thereafter costs no more than the last to deliver, and in the case of information-based products, the costs approach zero. Even more important, businesses that rely on connectivity can enjoy so-called network effects, where the value of a unit actually rises with the number of units in use.

Increasing returns are also fueled by "lock-in" to a given seller's product. Since the ability to work together is dependent on industry standards, markets rapidly converge on the likeliest standard to win out. And once a single standard begins to take hold, the

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cost to switch to an alternate becomes quite high. This is why Beta couldn't survive among consumers once VHS became dominant, for example.

It's not that decreasing returns aren't the law of the land anymore. They are—when we're talking about physical assets. Increasing returns apply only to the intangible value-drivers in a business. And, in fact, they have always applied there. But again, in the industrial economy, the economics of things like intellectual property and customer relationships were rarely thought about in isolation. Now, in the eEconomy, they're not so inextricably bundled up with the physical assets of a business—and finally unbound, they can dance to their own tune.

What does the law of increasing returns mean for strategy? Most strikingly, it means that in any given business, one player—maybe two—will come to dominate the market. Moreover, the die is often cast early on. Once a strong lead is established, that leader will pick up momentum and will stand to gain an insurmountable advantage—unless the leader makes a serious mistake or until a competitor finds a way to change the game again (or at least a better way to appeal to a subset of customers). This is why Wall Street is so tolerant of some currently unprofitable Internet companies: Analysts realize that for companies pursuing increasing returns to scale, every dollar must be plowed into winning market share.

#### **"Perfect" information**

One classic modeling assumption of economics is actually becoming more true as we move into the eEconomy—the notion that actors in an economy have the benefit of "perfect" information.

Of course, information has never been perfect. Because it has been dif-

ficult and expensive to procure, some players in the market have had more than others. Consumer goods manufacturers, for instance, traditionally have spent great sums of money to collect information about buyer needs, preferences and behaviors. It was considered a breakthrough when marketers could understand customer segments—essentially translating one big, opaque customer base into several big, opaque customer bases.

Consumers, by contrast, had little clue at all—about quality, price, availability, alternative sources. Objective, reliable information was very hard to come by in any inexpensive way. Think about it: The consumer's primary sources of information were advertising and the next-door neighbor!

Enter the Internet. Sellers are able to get not just segment-level but individual-level understanding of customers' habits and hopes. At the same time, they're able to tailor the products they deliver to suit individual customers' interests. This is having a huge impact on how customer-driven firms do research, product design, service, promotion and more. It allows sellers to expand the choices they offer all customers, and tailor their individual offerings more precisely to what a given customer wants.

The other revolution is for buyers, who now find it easier and cheaper to obtain comprehensive information about a vendor, its products and its pricing relative to nearly every one of its competitors. As a result, sellers are seeing the power they gained from information inequality wrested away, in some cases to the extent that even pricing isn't their prerogative. Travel sites like Priceline.com now invite consumers to name their price for air travel to a desired destination, which airlines with otherwise

empty seats can take or leave.

"Perfect" may still not be the best way to describe information in the marketplace, but it has come a long way. Strategists must now worry about learning to filter information, make sense of it and act on it faster than others.

#### **No time to spare**

One last reality of the eCommerce environment that is rewriting the rules of strategy is its very virtuality. Once upon a time, commerce depended upon the design of the product, the means of production, marketing, planning and sales personnel being coordinated by a single entity and coming together in a physical place, like a store. For would-be sellers of goods, this meant that market entry took time and a great deal of money. If they weren't willing or able to ante up all of these elements, they weren't going to be in the game. These capabilities had to be "under one roof" thanks to the prohibitive costs and complexity of managing cross-industry.

In eCommerce, this isn't the case because coordination can be achieved virtually, at low cost. Whole supply chains can be forged quickly and connected through desktops. And whether the seller is really in Boston, its "warehouse" a totally different company in Topeka, and the payment processor still another firm in Bangladesh are considerations largely irrelevant to consumers as long as their expectations for quality, price and service are met.

Again, this all looks like opportunity unless you're a traditional, established company—in which case, it looks like a major threat. What will keep anyone with a registered URL from entering your market and stealing your share? Not much, it turns

out. But then, with your customer and market know-how, what will keep you from doing the same—and even better?

Senior business executives, like military generals, are often chided for always being well prepared to fight the last war. In the face of new economic phenomena and trampled traditions, it will not work to redouble your efforts, essentially aiming to do all the same things you've always done, but better. Meeting these challenges means beating the new entrants at their own game. They started with a clean slate—so get one of your own, and start drawing.

Your first step must be to reevaluate your entire business model. At a loss for where to start? Here's a list of questions that, at the very least, must be answered:

- What do consumers ideally want to buy?
- What business should I be in?
- What is the most effective value proposition in the short, medium and long run?
- What roles should I play—make, sell or service—and who are my customers?
- Who are my competitors, and how do I need to be positioned?
- What is my operating model?
- With whom should I partner/network?

Your answers, if they are guided by a deep understanding of the economic implications and opportunity of the eEconomy, will produce a very different picture of your company from the one you see today. Bring that picture to life with a compelling, enterprise-wide vision for your future in the eEconomy; you'll need this vision to bring everyone on board who will help you get there. For many companies, achieving that vision will require

building greater expertise in the strategic and operational application of technology—which, for better or for worse, is driving the rapid evolution of eCommerce. But you'll certainly need to temper that technology focus by applying cross-disciplinary, cross-functional and cross-industry perspectives and expertise—because industry boundaries will be shaped by customer needs rather than by core competencies.

In the end, of course, strategy is only as good as its execution. Your new economic strategy will need to be translated into changes related not only to technology but also to processes and people. And finally, because you are an established organization and not a start-up, moving from where you are now to the future you envision will mean executing a complex, global change program—on a large scale.

All in all, it's a great deal of work—but hardly impossible, once the full force of your assembled resources is aimed in the right direction. The first step is to take the threat seriously. Issues like the Year 2000 problem, the emergence of the European Monetary Union and global financial uncertainty are often cited as more pressing by today's executive teams, and as reasons for deferring decisions on the eCommerce front.

Five years hence, these will be seen as the momentary distractions they are. It's critical to get past any denial in your managerial ranks that the economy is in the midst of a rapid transformation, and that immediate action is required.

At this stage of the formation of the eEconomy, complacency is the greatest danger. Tentative, incremental steps are likely to yield only tentative, incremental results. A whole new form of competition has arrived on your shores—and it's hungry. ■



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