“I have lived a long, I believe, a useful life, but I can truthfully say that I have never seen a problem solved.”

Charles de Gaulle

COMPETING IN CHAPTER 2 OF INTERNET BUSINESS

The Cor Wit Lecture, presented on Tuesday 16 November, 1999 by dr Peter G.W. Keen
Cor Wit Professor at the Faculty of Technology, Policy and Management of Delft University of Technology for the academic year 1999-2000
Mijnheer de Rector Magnificus,
Leden van het College van Bestuur,
Collega hoogleraren en andere leden van de universitaire
gemeenschap,
Hooggeachte leden van het Curatorium van deze leerstoel:
het ir. C. Wit Fonds en in het bijzonder ir. C. Wit,
Zeer gewaardeerde gasten van het ir. C. Wit Fonds
en Koninklijke KPN,
Gewaardeerde toehoorders,
Dames en heren,

I thank you for the privilege of being a part of the adventure in re-
search and practices taking place in the Netherlands in its contribu-
tions to the revolution in business that is loosely termed Internet
commerce but that is really about commerce. I welcome the opportu-
nity to present to you in this inaugural Cor Wit lecture my own views
on how executives can position their organizations to take a lead in
this very new business world and to briefly discuss ongoing research
that I am involved in at TU Delft, under the leadership of Professor
Henk Sol.

The issue for both research and practice in Internet commerce is now
defining effective business models for this new era. Business models
are the basic blueprints for organizations: the fundamentals of logis-
tics, long-term customer relationships, channels, capital and cost
structures, branding, and niching. Since the Internet changes the rules
of competition in all these areas, companies everywhere are struggling
to evolve, adapt, replace and even abandon their historical strategies,
and their executives need help here. The role of practical research is to
provide that help. My own work has largely focused on making sense
of what is happening in Internet business through an in-depth analysis
of companies' successes and failures. I look for patterns that will help senior managers "get it" - understand the future opportunities and options and make policy choices.

Our research at TU Delft goes beyond this. We aim at helping them see the future through simulation: translating concepts, formulae and numbers into visual models that enable decision makers to apprehend the dynamics of this new market rather than just intellectually comprehend the many abstractions, claims, theories, forecasts and anecdotes that comprise most of the Internet business discussion. It applies the engineering perspective to simulation modeling, aiming at capturing the dynamics of processes, logistics and business flows. This new work at TU Delft on Vision Support Systems reinvigorates the field of Decision Support Systems, in which Professor Sol and myself have been colleagues for almost two decades. We want to help managers envision the future of commerce, to have clear maps and pictures, and, quite literally, to build a vision. We see visual thinking as the core of decision making and communication. The CEO of a major US financial institution told me recently that his dilemma is that "I just do not see what the bank will be in five years." Unless managers can see the future of their organization in the next chapter of Internet commerce, they will be unable to take charge of change. Our hope is to help them be change leaders, not followers.

Again, I thank you, Mijnheer de Rector Magnificus, for the invitation to hold the first Cor Wit chair. I thank the Ir. C. Wit foundation and KPN for realizing this.

INTRODUCTION: BUSINESS MODELS FOR A NEW COMPETITIVE ERA

Today, business on the Internet amounts to just 1-2% of most industries' total market size. Yet it has already transformed the very basic rules of competition in book retailing, distribution, auto dealerships, personal computer sales, supply chain management, travel agencies, telecommunications equipment manufacturing, and securities trading, to name just a few examples. Banking, insurance, supermarkets, government, real estate... All these are racing to adapt to the Internet, as either an opportunity or a threat.

It's not the size of the Internet market nor forecasts of its growth that drive this, but the degree to which it changes the rules of the business game and thus forces companies to rethink their business models. The most remarkable, and for business managers, far-reaching outcome of the first four years of Internet commerce - the first chapter in the business story - is that the victims of the intruders that changed an entire marketplace were not weak firms or badly managed ones, but outstanding companies.

Amazon, for instance, fractured the business model of Barnes and Noble, by far the most dominant force in book retailing. That model rested on location of superstores. It is still a superb competitor - bold, innovative, and superb in service - but it's rather like a person walking around with fractured ribs. It's still healthy and looks fine, but is hurting badly. Dell fractured the business model of Compaq, still the world leader in personal computer sales, but badly hurt by Dell's brilliant use of directing selling and streamlining of every aspect of its logistics and management of working capital. Dell competes against Compaq and other leading personal computer companies with less than half their overhead, greater customer loyalty, faster time to market, and dramatically higher return on capital - over 200%.
Perhaps the most impressive example of an entire industry’s business model being fractured is online securities trading. Just two years ago, Merrill Lynch sat at the top of the hill. At the bottom were a few new Internet trading companies. In the middle was Charles Schwab, the company that created discount commission brokering via phone. As online trading grew, Merrill Lynch’s Vice-Chairman publicly dismissed it as a threat to America’s financial health. A few months later, when over half of Schwab’s revenues were from Internet trades and online trading amounted to one-third of total industry volumes, Merrill surrendered and announced its own Internet plans. Within the next few months, industry developments included several securities exchanges’ plans to extend their trading hours, new online exchanges, and online trading firms moving abroad to create a totally new market and customer base. Merrill is still a fine firm but it will have to reinvent itself.

This is what electronic commerce is now about: rethinking the fundamentals. What will our company look like four years from now? What will our industry look like? These are the questions executives have to answer to avoid the fracturing of their own business models. This is a new situation for most managers and most companies. Previously, information technology supported the existing business model and strategies to implement that model. It is only very recently that the Internet moved IT into the mainstream of every element of business performance.

It is even more recently that Internet business shifted from a limited Web presence to a pervasive business expansion. It began roughly four years ago as a race to dot.com your company - to build a presence in this exotic new info-, cyber-, e-, wired- space, market, society, community. Call that Chapter One; the era of Web sites. We’re now in Chapter Two: the long haul to create and sustain value - economic value in terms of return on the heavy capital investment that Internet business demands, marketplace value through the long-term customer relationships that build new brand equity and profits, and organizational value through momentum, mobility, productivity, and new cost structures. Chapter One of the Internet was about dot.com. Chapter Two is about dot.value. The firm’s business model has to be about dot.value, too. Getting up on the Web is not a business model for Chapter Two. It’s a necessary first step to get into the online competitive arena. But after that - the “electronic” part of e-commerce - the issues all address the “commerce” part. It’s here that managers need to “see” ahead.

Why make the distinction between Chapter One and Two and thereby risk adding yet one more piece of jargon, potential technobabble and hype -and-hope to the Internet tower of babble? I do so because it’s very clear that 1999 saw many abrupt shifts in the basics of Internet business that make it essential for managers to look ahead and to accept that their business models, no matter how successful today, need review. They can’t treat Internet business as a matter of Web sites. Exhibit 1 lists just some of the 1999 shifts that indicate an entirely different situation from just one to two years before and hint at just as much difference coming up for 2000-2001. The examples add up to a real economy - not just a promise of future growth and profitability. Every illustration in Exhibit 1 is from a company that is well beyond the take off stage in Internet business. Together, they are part of the Chapter Two commerce agenda, not the Chapter One Web site electronic presence.

What Exhibit 1 shows is simple: it really is time to get down to business. The United States is around two years ahead of Europe and Asia in this regard, according to most expert assessments, with which I strongly concur. Europe is two years ahead in the area of wireless technology, which is clearly the next major innovation in electronic commerce, through the convergence of digital cell phones, Internet connection and voice and data integration. Each gap is closing fast, but it should be a concern to any European executive or policy maker
that, as Exhibit 1 indicates, the number of U.S. companies with Internet commerce revenues of over a billion dollars is already in double figures, but to my knowledge there is not a single one at that level in Europe. There should and easily could be. It's not a matter of technology availability, though lack of the same access to venture capital as in the United States has been a barrier to innovation by startup firms, as has the high local phone tariffs in many countries. These barriers are coming down. For Europe to catch up, the issue is simple: management vision of the business model.

**Exhibit 1: some 1999 business events and impacts**

- An in-depth, cautious and meticulously researched study by the University of Texas reports that Internet companies are 50% more productive in terms of revenues per employee that non-Web ones and that the total Internet economy was $500 billion in 1999, 70% growth over 1998.
- American Online is generating over a billion dollars of after tax cash flow. Its advertising revenues for Quarter 2 are over $300 million, with a backlog of $1.5 billion. 1999 revenues were $4.8 billion, with profits of $396 million. The figures for 1992 were $26.6 million sales and $3.5 million profits.
- 80% of Cisco's more than $6 billion of orders made over its online Internet service are never handled at any step by the company, nor does it ever take delivery of the parts or finished goods. Online links to foreign contract manufacturers, third party logistics firms and other collaborators deal with this virtual inventory.
- The US Department of Commerce reports that 40% of all new car buyers in 1998 used the Web in their search and evaluation of options.

**THE NEW INTERNET BRANDS AND PORTALS**

All this adds up to an irreversible transition from the Web site - the dot.com - as the focus of planning and investment to the customer relationships, collaborations, alliances, acquisitions and marketing offers that turn the site into something so new that we’ve lacked any words for it. “Portal” has become the general term for these new brands, new middleman players in supply chains, new hubs, gateways, portals, junction boxes, and channel killers - new somethings.

These are strange creations in many ways, so that perhaps it’s appropriate to use a strange word like “portal” to describe them. They destroy industry categories - what “industry” is Amazon or America Online in, for example? They build very large revenue bases - and for some, very large cash flows - with massive productivity rates. The average US company generates $160,000 of revenues per employee. The same study that reports this item concludes that the figure for Internet companies is 65% higher - on average. Here are just a few examples from Internet businesses that all have sales in excess of $100 million a year and far above average business-generation productivity: E*Trade $415 thousand revenues per employee, Preview Travel $1 million, eBay $546 thousand, CD Now $627 thousand and Cyberian Outpost $981 thousand.

Most of these high productivity companies are bolted together electronically, not built organizationally. Think of how long it would take to build a $1 billion business from scratch in the old style: all the functional areas, processes, head count, equipment, offices, training, reporting relationships and the like. Billion dollar portals use a new generation of software to link to masses of other companies in effect to rent, borrow or pay for these capabilities as needed and are “large” firms within a year or two of starting their operations. If they need shipping and logistics, they link to, say, UPS - and don’t even see the goods. Credit financing? Another API (application program inter-
face) to MBNA or e-Credit.com. The procurement department? It’s in the customized Web site provided to your firm by Dell or built for you by Ariba. You want more business going through your site? Add links, ads, sponsorships, orders, to and from just about anything from anyone from anywhere.

This ability to substitute electronic external links for internal operations and do so on the fly - no waiting, and with everything happening automatically - shifts the nature of online business itself, away from the Web site as a sort of storefront to a company as a complex of services within a complex of marketplaces. One representative example of this new dynamic is VerticalNet. It creates trading hubs for over 40 business communities that include food ingredient makers, adhesives, solid waste management, and paints. For it to set up a portal to link buyers, sellers and trading partners, an industry must contain at least 3,000 companies and those companies must have 40,000 buyers and a total of $10 billion in sales. This scale means that these trading communities in themselves constitute mini-economies.

VerticalNet hosts for $6,000 per player per year what is in effect a massive market of company storefronts, passing on sales leads, managing auctions, creating new sales avenues, bringing communities together on line for news, promotions, etc. It creates major opportunities for companies to sell in areas where they have no sales force (40% of VerticalNet’s traffic is now international, with companies reporting sales orders from countries they have no presence in whatsoever). So, VerticalNet is (1) creating marketplaces, (2) creating communities, (3) inventing new modes of transaction, selling, and trading, and (4) creating its own long-term relationship base - it has a 90% renewal rate. It’s still a tiny company in terms of revenues and number of employees but what it is doing is as different from the standard Web site as that was from the physical site it substituted for.

This example illustrates why it’s helpful to make a differentiation between Chapter One and Chapter Two of Internet business. This is all a very new style of doing business. It’s not about the Web site, “the” Internet, or online extensions of operations. Those are the necessary Chapter One infrastructures - and for many companies this is still the agenda for getting into the competitive game - but Chapter Two is about how you make use of these foundations. It’s about creating dynamic services via customer relationships, collaborations, community building, market inventions, revenue makers, cost savers, balance sheet transformation, and business processes.

Such e-services (a term invented by Hewlett-Packard) are the new, new opportunity. The Web is the old new opportunity. That may seem a little flip but consider that Amazon is, four years after it was founded, a mature company. It’s now an e-services company, not a Web site for books. Its goal is to create and maintain lifelong and fully personalized relationships and customized offers as a dynamic portal. No firm can compete against an Amazon via a dot.com Web site - it’s what’s behind the Web site that creates the new, new opportunities for Chapter Two. The Web site is now an old opportunity. The tone of a report by the well-respected and down-to-earth Gartner Group, a firm that specializes in information technology, is almost amusing in its sense of worry about the future of Internet business. It reports that the growth in 1997 was 326% but that for 1998 it expected figures to show “only” a 135% increase. It sees the Web beginning to mature as a channel and sees only a 51% annual growth for 2002. Additional growth will come from the new. Another report describes Amazon as “an anachronism” - an old-style Internet company! Growth will come from the new. In other words, trying to imitate an Amazon is to look back, not ahead.

There will continue to be plenty that is new on the Internet. It is an innovation machine, and is also in many ways a laboratory for experimenting with business models and technology designs. But “new”
is not equivalent to “startup” and innovation is not the domain of the small entrepreneurial organization. That’s another message from 1999, which saw many of the “old” firms, largely dismissed as has-beens in Chapter One, demonstrate that good business wins every time and becomes even better when the Web is appropriately included within their services, relationships and operations. Obviously, in many instances such companies started their move several years earlier but they really announced the new business era in 1999. Federal Express, for instance, was 70% of the way to its stated goal of having every customer transaction handled via the Web. The operational savings on Web initiation and tracking of shipments - 60 million messages a day - indicate the general scale of opportunity in Chapter Two. Most of these messages replace a phone call to its 1-800 number center. Each of these costs Fedex about $10. On the Web, the cost is under 10 cents, a 99% reduction. Dozens of firms report comparable savings and improved customer service as a result.

UPS, Fedex’s main and historically much older rival, made 1999 the year it moved from being a package company to a formidable Internet third-party logistics partner. UPS delivers 55% of all goods ordered online, and at any moment in time 5% of US Gross Domestic Product is somewhere in its systems. Now, it’s an API (application program interface) a software link between partners in a supply chain and between manufacturers and their end customers. All the distribution steps involved in fulfilling an Internet order from a customer to Gateway, for instance, are processed by UPS. It assembles the components of the order, which may come from several manufacturers at different locations. Gateway doesn’t touch, say, the Sony monitor or Epson printer you order. The API to UPS gives Gateway a superb distribution “department.”

UPS even handles the tuning of Fender’s guitars in its Netherlands shipping hub, saving weeks on delivery time by their not having to be sent to a Fender location, and in doing so UPS cuts Fender’s costs by 9%. The guitars can be taken out of the box by the customer and used immediately, instead of waiting for the expert tuner to arrive. UPS is an electronic partner with Open Market, a leading Web commerce company, in a software venture that provides “end-to-end” Web transaction handling - from order to delivery to after-sales support. Hewlett-Packard and UPS have set up a collaborative partnership to ensure rapid transportation of electronics components from HP production plants in Asia to European customers. Fender, UPS, HP, and Open Market are separate companies, of course, but the electronic collaborations create something new - an e-services complex.

All the items listed in Exhibit 1 are about business, not technology. Of course, they are selective and I could just as easily list disasters and disappointments of 1999 - failed IPOs, plummeting stock prices for many Internet business leaders, and above all the continuing lack of profits for all but a handful of companies, most of whom were profitable before they added the Internet to their business resource base. Even where that was not so, it’s not a surprise that they are not making profits. It took CNN and USA Today a full decade to reach break-even, and in its first years Federal Express often came within a few days of being unable to meet its payroll.

Infrastructure-based innovations are almost by definition initially unprofitable, because the infrastructure that enables the business payoff has to be paid for in advance, often many years in advance. The cost of Chapter Two infrastructures is huge. While a company can build a Web site for some thousands of dollars, supporting it with marketing, customer service, operations, and other investments is millions. Forbes states that the average first year marketing cost for a company to build a presence on a portal such as AOL or Yahoo! is $5 million. First USA, Bank One’s credit card subsidiary, has five-year deals with each of these costing it $50 million and $90 million, respectively. Amazon is still spending more on marketing than on technology - over 20% of its revenues. AOL spent half a billion dollars to build its cus-
tomber base. This is a very expensive business game to get into. Marketing is the equivalent of R&D, an investment for the future. This is why the fastest growing Internet companies are unprofitable. They are racing to build their infrastructure. As with R&D, the gamble may not pay off. Perhaps Amazon will fail to achieve profitability, but that’s not the business model issue. It’s already redefined its industry.

There are many other redefinitions on the way. Exhibit 1 does not include the flood of 1999’s new companies with new offers and ideas. They number in the many thousands. If we even assume that 99% of them will fail, that still means out there there’s an E-Bay (profitable almost from its start and with 80% margins - when its computers are up), an Amazon (1% share of the market but the rule-setter), an Exodus, Ariba, E*Trade, Egghead (a close to comatose bricks and mortar retailer that literally closed up shop and is now a $150 million online player), eToys, or Onsale, just to name a few companies that began as dot.coms and look like e-services winners.

1999 was a business news year. That makes it very different from 1997, when the news largely centered on multimedia and entertainment, and from 1998, when most of the action came from new technology services. In 1999, these continued, but much of the innovation was in the area of logistics and supply chain management - perhaps the single highest payoff productivity opportunity for any firm. New ventures like Ariba, Chemdex, e-Steel, Paper Exchange, and PlasticNet bring together players in a purchasing, supply or distribution chain and make them partners in a relationship that optimizes the entire value chain. Ones like Dell and Cisco made their online supply chain management a cost and service edge that has left most of their competitors struggling to rebuild their own business models. They have far lower overhead, faster time to market, smaller inventories, faster conversion of orders into cash, and a far higher return on invested capital. The market rewards them with a stock price that enables them to make large acquisitions without either needing to bor-

row or to dilute their equity. Just as Toyota redefined the rules of manufacturing competition through just-in-time, total quality management and the complex of business processes that it calls the Toyota Production System, Cisco and Dell have redefined their industry. Previously successful large competitors are struggling to redefine their business models, in the same way and to the same degree that US and European car makers had to rethink their own basics to meet the Toyota challenge.

1999 also saw what may be one of the most far-reaching of all Internet business innovations: dramatic new approaches to pricing, including Priceline.com's "name your own price." Accompany's online group pooling to create buying power that drives the price down the more people that come into the bidding, and a wide range of auctions mechanisms. (The most well-known of these, E-Bay, saw some truly unusual extensions of its consumer site. In August, 1999, it banned an effort to auction a kidney, with the reserve price being $3.5 million. It also stopped efforts to sell stocks, companies, a baby, and Internet address names.) These innovations illustrate the laboratory nature of the Internet. At any point in time, companies are trying out wild ideas, which may or may not work, but when they do they are soon spotted and imitated. It's clear that one of the long-term impacts of Internet business in Chapter Two is the ending of fixed pricing as the standard. It will be the next price, your personal price, and our price. Dynamic pricing plus the 10-15% lower price compared to the average that is commonplace in Internet business make the Web an intensely anti-inflationary force. It also puts huge pressures on companies, whether online or offline, to find costs efficiencies to offset their loss of profit margin.

There is one final point about 1999 as a force for business change that also affects the basic economics of firms: this was the year when what may be termed give-it-away-free.com took off. Here are just a few of the 1998 purchase items that were the give-aways of 1999, with ex-
amples of providers: electronic mail (Microsoft’s Hotmail with 40
million users), Internet access (the UK’s Freeserve, that both started a
massive trend in Europe and was the first player to put a stumbling
block in the way of America Online’s previous year of glorious for-
ward progress), Web site design and hosting (MySchwab, MyYahoo,
MyAmazon, Dell’s Premier Pages and many others), and personal
computers (HP, Compaq, Compuserve - note, though, the “free” does
come with strings attached). It is very clear that local and long dis-
tance phone calls will be give-aways soon. Qwest has already started
along this path, offering 150 minutes a month of free long distance in
return for signing up on its ISP service.

In September, Sun Microsystems announced a challenge to Microsoft
when it bought a small company to provide word processing, presen-
tation, spreadsheet and calendaring software free via the Web. Again,
it may or not work but it certainly sent a seismic tremor across the
Seattle region. It’s a free version of apps-on-tap. Microsoft immedi-
ately responded with an announcement that it would distribute its own
office software via the Web. This may mark the beginning of the end
of the CD-ROM and floppy disk as the primary vehicle for software
installation - turn on the Internet tap instead of tear open the box.

THE MANAGEMENT CHALLENGE: WHAT IS OUR BUSINESS
MODEL?

All these forces of change are accelerating fast and Internet business
in 2001 will be as different from that of 1999 as 1999 was from that of
1997. They pose a major challenge to managers everywhere:

What is our own business model for competing in this new world?

A business model is the basic blueprint for a company into which it
fits its Internet business priorities, strategic plans, and execution. The
phrase is everywhere now - you can hardly find any issue of a busi-
ness magazine or an Internet publication that doesn’t use it some-
where. This is a very recent development. Previously, the articles
would have used the word “strategy.” Business model has replaced
strategy as the focus of discussion because strategy is defined within
the givens of business - the givens of industry, customer base and
behavior, channels, pricing, marketing, and competitors.

There are no “givens” now. Every company has to look at Chapter
Two of the Internet economy in terms of business model, not dot.com.
It’s the business model that creates advantage, not the Web site. The
site is a means, not an end. In Chapter One, the difference between
means and end was obscured by the newness of the technology. I de-
scribe Chapter One as the race to dot.com. Companies saw the new
competitive players like Amazon, Yahoo and AutoByTel creating
massive market growth through their Web sites. They thus equate
Internet business success with Web site success and looked to create
their own “right” Web site. It’s now very clear that much more is
needed beyond the site. But it’s not at all clear what that exactly that
extra something is. Hence the shift from “strategy” to “business
model” as the focus for innovation.
There are many business models being tried out on the Internet. From my own analysis of as many company examples of success and failure in Internet business, I conclude that there are six general sets of business drivers - what I term “value imperatives” - that underlie the successes of so many companies that they are helpful “templates” for others to use in their planning for Internet Chapter Two. By template, I mean that they offer a basic blueprint that can be adapted to the firm’s own context, priorities, and competitive position. Every firm’s business model is to some extent unique, but it must respond to these value imperatives, either using them as an opportunity or reacting to them as a competitive necessity. These are the general forces of change in Chapter Two. An imperative is not a strategy; strategy is about the “how” of planning and execution. Imperatives address the “why.” They implicitly begin with “Regardless of how we do this, it is absolutely vital that we......”

The six value imperatives that drive business models and that begin with that sentence are:

1) Perfect your logistics, through supply chain management, operating resource management, win-win trading partner collaborations, and electronic out-tasking.

2) Perfect your long-term customer relationships, through repeat business generation, customer self-management, community, collaboration, massive cross-selling, and life-time relationship-focus.

3) Harmonize your channels, through “seamless” links between Internet, call center, and physical channels, and by strengthening your distribution system while at the same time strengthening your own brand.

4) Build a powerful portal/hub brand, through incentives for customers to routinely “park” at your site like parking at Wal-Mart and then exploring other stores in the mall, aggressive customization and personalization, community focus, generation of revenues and fees as a host, and selective use of “give-it-away-free.com.”

5) Transform your capital and cost structures, through moving towards negative working capital, slashing GSA (General Selling and Administrative expenses), leveraging cash flow generation on minimal physical balance sheet “assets”, reducing cost of capital by building a Price/Vision premium in market evaluation, and using the valuation advantage to buy needed capabilities at low capital dilution.

6) Build value-adding intermediation, through providing a hub that offers reliable information and advice that link buyers and sellers, offering more efficient processing of transactions between trading partners, and building win-win relationships along an entire business chain.

I do not have space in this short lecture to discuss these value imperatives in detail, and instead will provide brief examples of their main business implications and examples of companies whose business model is based on them:

**Perfect your logistics:**
This is a core imperative for business in general, regardless of industry. The Internet accelerates many trends that began a decade or more ago: streamlining of procurement, distribution and physical logistics, elimination of documents in relationships between customers and suppliers, reduction of inventory and outsourcing of functions. It so accelerates it that logistics leaders like Dell and Cisco are in a different league from most of their competitors. The average profit margin in manufacturing is around 5% and in financial services 12%. When a competitor has a 40% edge in overhead costs, 40% lower working capital, and comparable advantages in distribution, and labor produc-
tivity, the situation is rather like trying today to compete without personal computers, fax and call centers; it can be done, but it’s hardly the mark of a well-run firm.

The main reason for the rapid growth of business-to-business trading hubs in the United States is the primacy of logistics as competitive necessity. General Electric’s TPN (Trading Partner Network) reduces it prices on bids from suppliers by 5-15%. Hubs that link customers and suppliers in fragmented industries where information flows are complex and limited typically reduce the fees and commissions of brokers and other intermediaries from 40-60% to 5-10%.

If I were asked to identify one single reason why business executives in the Netherlands must take the lead in their company’s business model planning for Chapter Two, it would be the logistics imperatives. My message is that literally you cannot afford not to be a leader in logistics.

Perfect your customer relationships:
The book retailing industry has almost no customer loyalty and repeat business basically rests on location and size of store. Amazon has a repeat business rate of over 70% but its costs to acquire a customer are more than its average transaction revenue. Its business model is not about selling books but building lifetime relationships. Its future rests on this. So, too, does the future of most companies whose basic business is likely to be affected by Web competitors who think in Chapter Two terms.

We are seeing the death of the transaction economy. It is harder and harder to make money on transactions alone, for the reasons that I discussed earlier: the disinflationary nature of Internet business that cuts prices 10-15%, give-it-away-free.com, and the cost of marketing. Chapter One was mainly about the Web site as a transaction storefront, with “hits” the main measure of success. For Chapter Two, the drivers are relationship, collaborations and community - making the site personal, encouraging customer self-management of their account, adding more and more offers through collaborations with other companies, and building interaction through e-mail, seminars, chat rooms and feedback.

It may be another 3-5 years before the full implications of the shift from a primarily transaction economy to a relationship economy become clear. How much time do executives have left to define their firm’s business model for the transition?

Create channel harmony:
No aspect of Chapter One Internet business more illustrates its limited view of commerce than the issue of channel management. Most companies saw the Internet as a channel that would replace other channels. They worried about channel “conflict” - the online channel competing with established offline ones. Many began to use their own Web sites to compete against their own distributors. Others enthusiastically assumed that a “virtual” channel would have such massive cost advantages that Internet “clicks” would soon displace “bricks and mortar.”

Now, the new cliché is “clicks and mortar” - making all channels work together on behalf of the customer. Charles Schwab, the securities discount broker, is the exemplar here. Whereas online trading companies offered very low transaction fees and minimal service and Merrill Lynch offered outstanding service at high commission rates, Schwab offered the best of both. It cut its commission drastically but even so at $29.95 it remains far higher than the $6 fee charged by several “pure” online players. It’s Schwab’s superb harmonization of all its channels - phones, branches, Web, and personal contacts - that makes it the leader in the industry.

By contrast, several companies that thought in terms of channel conflict, not channel harmony, have paid a large competitive price for
their choice of an ineffective business model for Chapter Two. Compaq is the best-known instance: by deciding to use the Internet to bypass its own distributors in order to respond to Dell’s growing logistics, service and price advantage, Compaq basically turned them into competitors. They reacted aggressively to block Compaq. Similarly, several clothing manufacturers directly competed against their own retailers, in the belief that having a strong brand plus a Web site meant high sales at high margins. It didn’t. The result was angry retailers and blurred brand image.

The Internet is obviously a channel that can conflict with existing ones. But it does not have to. Chapter Two is about harmonization, with companies like Sony using the Web to strengthen its distribution network by steering pre-qualified customers to the most suitable distributor while at the same time strengthening its own brand. Fruit of the Loom provides free Web site design to its main distributors for the same reason and even allows them to sell competitors’ goods on the site.

Channel management is a priority agenda for all firms in Chapter Two. They need clear thinking here. The stakes are huge.

Build a powerful portal/hub brand:
This is, of course, the biggest game of all in the Internet arena: the creation of new online brands that have the strengths and hence brand equity of a McDonald’s, Sony, Coca Cola, Ikea, Volkswagen and the like. Clearly, Yahoo, AOL and Amazon are now power brands as portals. Cisco and Dell are not so much Internet brands but their brand strength significantly rests on their Internet logistics and customer service.

These brands are what a leading writer, Geoffrey Moore, terms “gorillas” (In his co-authored book The Gorilla Game). Gorillas are the few companies that emerge from a group of innovators in a new and volatile industry to so set the terms of competition that however well the others do, they are chimpanzees by comparison. They build a level of incremental market share that in itself leads to more market share. An example here is Microsoft’s dominance of its industry, which moved software and hardware developers to build for Windows first and Macintosh second, if at all. That in turn reinforces Microsoft’s position and the cycle continues (to the degree that the US courts have just ruled that Microsoft is now a monopoly).

Gorillas are able to command high stock prices that allows them to acquire other companies through an exchange of equity at very low cost of capital. When Cisco bought Ceren in late 1999, it “paid” $6.9 billion in stock, a mere 3.3% of its capitalization. Its rivals would be diluting their equity by a huge factor, which means in effect that they cannot make comparable moves. Similarly, the power hubs command a premium fee for a presence on their portal. AOL and Yahoo generate around a billion dollars each from companies that want to be spokes on their hub.

The entire issue of branding and portal power is driving both much of Chapter Two business and investors’ response. There are, of course, many non-U.S. offline power brands. There are as yet no non-U.S. online power brands. That ought to be a major concern for both business executives and policy makers.

Transform your capital and cost structures:
We can see the impacts of Chapter Two business models on the economics of the firm. Basically, the successful firms are showing a transformation of traditional financial structures. Here are just a few instances that add up to a new agenda for every firm:

Online transaction margins are 60-85%: this is distorted by the heavy costs of marketing that reduce the average margin and hide the high incremental margin of repeat business. EBay’s margins
are 85%. Financial service companies’ margins are improved by a huge factor through online operations and are in the same range. If - and it’s a big if - a company can build a large customer base with continuing repeat business and add more and more services, then it becomes a profit machine. AOL is an instructive example here. It took well over a decade to reach breakeven, spending half a billion dollars on marketing to get there, as I mentioned earlier. Now, it generates 20 cents of after tax cash flow per $1 of revenue. The incremental margin structures of Internet business are very steep: high losses per transaction below breakeven and high profits above it.

Working capital demands are far lower for online leaders than comparable offline competitors. In particular, even when they are not yet making profits on paper, they are generating huge positive cash flows on limited capital investment. Amazon is operating at a positive cash flow from operations, and is at an annualized rate of sales of close to $2 billion on a total balance sheet capital base of around $70 million. Dell sells around $20 million of goods a day via the Internet on around the same capital. It has negative working capital: “assets” of $2.6 billion versus “liabilities” of $3.2 billion. In the new competitive environment, balance assets are really liabilities which tie up shareholder capital.

Chapter Two winners have entirely different balance sheets, incremental margins, overhead structures, cost of capital and a premium price in the marketplace. In other words, they compete from an entirely new position of economic strength. Investors reward them by valuing them on what I term their Price/Vision ratio rather than the established Price/Earnings basis. P/Es reflect an assessment of the business as is - its current and near-term flow of business results. Price/Vision reflects the business as it can be. In other words, the market is paying a premium for the firm’s business model. This gives them a massive advantage in terms of cost of capital that they can use to buy time - the firm evaluated on its P/E ratio has to produce earnings now - and buy companies. This is the Gorilla’s edge.

The gorillas go where they want. In most instances, they do so internationally through a local alliance and extension of their online Web operations. Amazon is a major player in European book retailing. Yahoo has 80 million subscribers worldwide. E*Trade moved into Japan as soon as that nation at last deregulated security commissions. It should be a major concern for companies across the world that so many U.S. firms have the advantage of low cost of capital, massive customer base, and portable business models - ones they can take more or less anywhere. And they will.

Build value-adding intermediation:
The final value imperative is the fastest-moving. Historically, information technology has largely been a force for disintermediation, the elimination of middlemen. The obvious example is the automated teller machine, which takes the human teller out of the loop. Now, Chapter Two Internet business is increasingly about value-adding intermediation, new hubs and portals that add value in the interactions among companies in a supply chain, or in helping consumers find trusted information and locate the best deals. There has been explosive growth in business-to-business hubs, as I mentioned earlier. For the consumer looking for a car, mortgage, insurance policy, or vacation package, these new intermediaries act as a broker, scour the Net for options, and provide easy-to-access information. For a business looking to auction of spare inventory, locate goods or streamline its supply chain relationships, they do the same. In the area of software, we are seeing the single most dramatic shift in many decades. New hubs, called ASPs (application service providers) provide apps-on-tap. BSPs (business services providers) provide software and services focused on a single function such as human resources. Within a year or so we will see more and more of the alphabet covered by xSPs. Internet hosting
services, software on demand, auctions, and many other types of hub are the next wave of Internet labs.

CONCLUSION: SEEING THE BUSINESS MODEL

For me, these six value imperatives are not a forecast or theory. They capture what I see going on today and moving fast toward to tomorrow. 1999 was the transition year from an economy in which the Internet was a small factor to one where it affects just about every industry and changes the dynamics of the basics of business. My list of value imperatives is indeed about basics: logistics and the costs of doing business, customers and relationships, channels, brands, financial structures, and market niches. There’s not much they don’t affect.

So, as I stated earlier, it doesn’t matter that the Internet still accounts for 1-2% of an industry’s sales. Forget the forecasts. Accept as a manager that your firm must rethink, adapt, update or even jettison many of its existing assumptions, practices and processes and must do so quickly. They must take the lead in Chapter Two not leave it to their information technology staff or a consulting firm to come up with the right Web site strategy.

In my lecture, I sketch out just a few components of Chapter Two Internet business. What motivates my presentation is my concern that too many of the executives I work with do not have Chapter Two in their line of sight. By line of sight, I mean the areas of business that they are highly focused on and where they look directly ahead, scanning the landscape, alert to threats and opportunities, and ready to move fast. For many senior managers, information technology in general is not in their line of sight. They delegate responsibility for it, because it is not central to business strategy and hence not central to their own attention.

How can Chapter Two be brought into their line of sight? There’s so much hype about the Internet and so much uncertainty and volatility that executives have both little reliable information available and little in their own experience to guide them. Forecasts vary wildly and are
close to meaningless. Resting management priorities on forecasts gets in the way of action. It creates a Chapter One mistake: ignoring the Internet as business, most obviously thinking that because, say, online retail sales are just 1% of the total market and forecasts show it will just double to 2% in the next three years, then there’s little need to move now. Or, conversely, being told that they will constitute 60% of sales in 2003 and then looking backwards and saying we’d better buy a dot.com or set up our own. Forget the forecasts. Build your business model, carefully consider capital and payback, and get your people behind you.

Forecasts are more crystal ball gazing than guidelines and even the historical figures are all over the place. Sales over the Internet in 2002, for instance, will be either (a) $7.7 billion or (b) $1.3 trillion. In 1998 they were (a) $3.3 billion, or (b) $300 billion. Amazon (a) is losing $5 a sale and shows no sign of ever making money, or (b) is on target for becoming as large and profitable as Wal-Mart. Advertising on the Internet in 1997 was (a) $400 million or (b) $906 million.

These are all figures from well-respected sources. One could list dozens more such (a) versus (b) number gaps about the scale of Internet business. We might also add a third category: (c) only God knows, and He or She’s not telling. They just don’t help business managers answer the question that’s firmly in their minds: What do we do about Internet business and do it today? The answers they get from planners, advisers, consultants, educators and book writers are either (a) make sure you have some dot.com presence on the Web, or (b) transform your entire business model and go for broke (the pun is intentional), or (c) wait and see. The first answer sees the Internet as just part of the business scene. The second sees it as now driving business. And the third avoids a position. So, what does the manager do?

My own answer to the question is: ignore the answers. They’re irrelevant to executive management, whether online business today is small or large, how big it’s going to be, or whether or not the strategies of companies like Amazon, E-Bay, AutoByTel, Yahoo! and other new Internet brands are flawed or genius and their stock prices correspondingly overhyped or realistically valued. Irrelevant.

The issue is seeing the future: visualizing how and where the value imperatives open up new threats and new opportunities. Executives need to accept that these are the realities, not the hypotheses, of business today. That’s a necessary starting point. I define leadership as taking the business to a place it’s not on target to move to. In our research at Delft, we take on the challenge of developing tools and methods for helping them in this regard. We see a major gap in the management discussion being the lack of appropriate simulation tools. Simulation helps make the possible real. That’s what’s missing in much of the discussion of Internet business - making it real. There is plenty of abstraction and plenty of stories and surveys but they do not do much to help leaders lead.

We plan to change that.

Peter Keen
Delft, November 1999
In the ‘Cor Wit Lecture’ at the Auditorium of Delft University of Technology, Peter Keen extensively deals with the issue of defining effective business models for the new internet era. ‘Chapter 2. Business models’ are the basic blueprints for organizations: the fundamentals of logistics, long-term customer relationships, channels, capital and cost structures, branding, and niching. Since the Internet changes the rules of competition in all these areas, companies are struggling to evolve, adapt, replace and even abandon their historical strategies. What will our company look like four years from now? What will our industry look like?

Chapter One of the Internet was about *dot.com*. Chapter Two is about *dot.value*: the long haul to create and sustain value, i.e. *economic* value in terms of return on the heavy capital investment that Internet business demands, *marketplace* value through the long-term customer relationships that build new brand equity and profits, and *organizational* value through momentum, mobility, productivity, and new cost structures.

Peter Keen elaborates on the *management challenge*: business models for competing in chapter 2 of the Internet and offers a guidance that could be helpful for both practitioners as researchers.