Internet Startups in the New Economy: So Why Can't They Win?

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It wasn't that long ago that some were arguing the rules of economics, and of business, no longer applied; that the Internet changed everything. The great wave of Internet startups was playing the game in ways few had contemplated before, and business would never be the same. While there will certainly be winners among the legions of online startups, and some may yet succeed in rewriting the rules of business, there are important questions that have yet to be answered on why many of the online pioneers have faltered. Where did they go wrong? What are the lessons to be learned for the startups still in the game, and the many more that have yet to be hatched? Fundamentally, our analysis of more than fifteen old and new economy companies developing Internet strategies indicates that not only do new economy startups face many of the same rules that old economy companies do, but these rules often favor the old economy companies in their battle with the Internet startups. What's more, far from being dinosaurs, old economy companies enter the game with many advantages that cannot be easily matched. This article explores the underlying reasons for this turn of events that few would have predicted as recently as 12 months ago.

Why Internet Business Models Don't Automatically Win

After a period of "irrational exuberance", no one doubts that Internet startups must be profitable to survive. As basic as the notion of profitability is to following the progression of the new economy, however, it is really only a starting point to a deeper understanding of life in the Internet era. The real question is this: What does it take for Internet startups to be profitable, and further, to earn a return in excess of the cost of capital invested? The answers – perhaps not surprisingly – can be found by bringing the Internet economy back to first principles – the strategy of the firm.

Prodigy Communications, Inc.

Consider the case of Prodigy Communications. Prodigy was founded in 1984 as a joint venture among IBM, Sears, and CBS to offer "videotex" services, such as news, advertisements, shopping, and communication, from a PC. With the initial low penetration rates of PCs and modems in homes, however, it was not until 1989 that Prodigy services were first marketed. By that time many of the services we know today were already available,

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including email and, in 1994, access to the World Wide Web. Indeed, when Prodigy first went online, it was praised as the network of the future. At its height in 1994, Prodigy had 2 million subscribers and innovative services. Yet this first mover that could fairly be credited with creating primary demand for online services fell to a distant third behind AOL and CompuServe just two years later. Why did the front-running Prodigy fall from grace?

The company made a series of operational and organizational mistakes from which they could not recover. For example, when customer usage of email accelerated in 1993 the company imposed a 25 cents charge for each email above the 30-email limit each month. Customer reaction was swift – complaints surfaced on Prodigy bulletin boards and 18,000 customers joined the "Cooperative Defense Committee" to protest the user fees. Prodigy responded by abruptly closing some customer accounts without explanation or prior notification. The company did not do much better in managing customer expectations of online chat rooms, banning discussions of any sex-related topic, including AIDS. Later, with Windows becoming the standard operating system for PCs, Prodigy focused on developing their own non-Windows compatible proprietary interface.

Prodigy also suffered from the bureaucratic and political headaches of operating under two large, established corporate parents (CBS had dropped out in 1986), who were often in disagreement on strategy. This became particularly evident after AOL began their "free trial" marketing campaign that saw them send millions of diskettes to potential customers. Prodigy's response was hampered by the continuing efforts of IBM and Sears to extricate themselves from the business, one in which they had invested perhaps $1.2 billion by the time they sold the company to a group of investors in 1996. Internally, conflict between senior executives with large-company perspectives and younger employees driven by technology and entrepreneurship created havoc. In the end a company that was first to see, and capitalize on, the huge opportunity that became the Internet fell victim to basic management mistakes – misunderstanding customers, putting technology in front of markets, and succumbing to bureaucracy.

While Prodigy was founded ten years before the World Wide Web gained prominence, the lessons that come out of this story are perhaps even more relevant in today's Internet world. In an age where entrepreneurs like Value America founder and CEO Craig Winn argue, "the old models don't necessarily work", it's easy to discount traditional management practices. However, in spite of changes wrought by the Internet, there are in fact some old rules that very much do work. And the fundamental insight here, at once both absorbing and apparent, is that if your strategy's wrong, being an Internet player won't save you. The success of Internet startups, like all companies, depends on four basic attributes of strategy: customers, capabilities, competitive advantage, and internal consistency.

Customers

Customers are at the heart of all business. Without someone to purchase your product or service at a price in excess of total costs, there can be no

profits. For business-to-consumer (B2C) online startups in particular, there is a fundamental need to develop and retain customers. Web-based B2C companies face significant startup costs from building distribution and logistics warehouses and expertise, achieving customer awareness, and developing website capabilities. These costs – which are relatively fixed in nature – are in addition to the variable costs of running the business – merchandise, payroll, marketing, and order fulfillment. While pricing points must cover the variable expenses, profitability depends on generating enough total revenue to amortize those fixed costs away. Hence, customers are at the center of the B2C business model – scale is critical for survival, and scale means enough customers spending enough money to make all the numbers work.

Unfortunately, the scale imperative tends to create some serious dysfunctions. First, companies seeking scale run the risk of over-emphasizing revenues, and under-emphasizing profits. The thirst for revenue growth at Internet companies is actually quite analogous to the emphasis on market share at many film studios. In both cases revenues are seen as an important measure of success, but in fact it is possible to have exploding revenue without any profitability. For example, after Sony acquired Columbia Pictures in 1989 it generated enormous overhead and was overspending on production, so while their market share went from 9% to almost 20% three years after the acquisition, they were losing buckets of money. In a similar vein, Amazon.com in the fourth quarter of 1999 increased sales by 157% to $650 million, but simultaneously announced that losses would increase because of inventory and other cost increases. The dual risks of such business models are whether breakeven will be reached before losing solvency, and whether the cost of investment capital can ever yield returns commensurate with risk.

Second, the importance of scale tends to work against the successful creation of niche strategies in online markets. Even leaving aside the need for some type of competitive advantage, online companies targeting very narrow niches such as socks (socks.com) or even narrower niches (KneehighSocks.com) stand little chance of long-term survival because the essentially fixed costs of the Internet do not shrink in size enough to make up for the greatly reduced total revenue potentials of such companies. It is more economical for an Amazon.com or Wal-Mart.com to sell socks than it is for a dedicated niche startup.

The third dysfunction of the scale imperative relates to the cost and challenge of acquiring customers. As a virtual unknown in the marketplace, it is critical for online startups to position their products to a carefully segmented and targeted customer. While this may sound like Marketing 101 – which it is; the STP (segmentation-targeting-positioning) framework is taught as standard fare in introductory marketing courses – B2C firms have an even more basic task, which is to acquire the customer in the first place. And it is here that e-retailers have stumbled, typically underestimating customer acquisition costs and then adopting such questionable practices as paying excessive fees to portals to promote their companies, running irreverent and unfocused advertising, relying on huge discounts and product give-a-ways to generate traffic, and purchasing banner

ads on other web sites in helter-skelter fashion. For example, Pets.com spent $460 on ads in 1999 for every $100 in sales generated, and eToys plowed 37% of sales back into advertising; both companies are now defunct. And the hyped but ill-fated health care website Dr.Koop.com paid $145 million to AOL and the Go Network for the right to provide health care content on these portals. Paying too much to acquire customers that don't buy enough has been the Achilles heel of the B2C startup class.

Each of these problems raises questions about the inherent superiority of Internet business models. They also leave to the side the challenge that all companies face – customer service. Online businesses – because they separate the customer from the product or service in both time and space – must especially assure customers that they can be trusted. Unfortunately, as with many new businesses, building customer trust and confidence is not an easy task. As one unhappy online bank customer put it in an email to Internet service reporter Gomez Advisors, "I can only judge that either they did not read my e-mails or had a committee that decided (1) how to avoid answering my queries, and (2) how to annoy the hell out of me." Customers come first in all businesses – Internet startups hold no particular immunity to the challenge of acquiring, retaining, and satisfying sufficient numbers to be profitable.

Capabilities

All organizations must develop internal capabilities – processes, systems, and routines that help to cut costs or promote revenue. While capabilities may run the gamut from speed to market to corporate culture, they tend to rely on one central ingredient at their core: the ability to efficiently transform inputs – resources, people, and ideas – to outputs that are valued by customers. While competitive advantage requires the development of capabilities that are not easily copied, many online startups, like other entrepreneurial ventures, have stumbled creating even the basic capabilities that all businesses need to survive. From back-office operations to customer service fulfillment, distribution, procurement, and vendor management, attracting and retaining customers requires deep capabilities that take time to develop.

Many web companies start out with a vision of "changing the world", but the reality of establishing effective routines and operations turns out to be much more complicated and difficult. For example, Healtheon/WebMD was created out of a series of mergers of related companies to link patients, doctors, insurers, and other health-care players online to cut costs and improve services. However, the massive task of making all this happen is daunting; what will account for the eventual success or failure of this company will be its ability to execute.

For B2C companies, the challenge of meeting customer needs is akin to what mail order companies have been dealing with for years. What makes a customer want to buy online? The typical answers are convenience, price, even speed. In truth, it is quite a bit quicker to drive over to your local bookstore or Wal-Mart to buy what you need than to order over the Web and wait for next-day or next-week delivery (which is not free at all!). And while convenience and price are potential benefits to consumers, there are other

attributes of the buying experience that may be even more fundamental: trust and service. In the same way that mail order customers must be willing to trust a company to ship a product after they have paid for it (this gap between paying for a product and receiving it does not exist in brick and mortar retailers), e-retailers must deliver trust. This requires tremendous execution skills in customer service – not a trivial undertaking. Online merchants blinded by easy money, stock valuations, and the "coolness" of selling on the web can easily fall short on this critical dimension. In fact, the track record of e-retailers in customer service is not stellar. For example, a recent survey conducted by Jupiter Communications of leading e-commerce sites found that fully forty-six percent of the sites either failed to display a support email address, took five or more days to respond to a customer enquiry, or never responded at all – an increase of 8 percent from the same period a year earlier.

Internet companies have no special immunity to the challenges of creating efficient capabilities. The irony has been that the Internet has been viewed as a "giant steamroller" crushing inefficient companies that "just don't get it". In truth, most online startups have struggled precisely because of their inefficiencies. Execution counts. Paying attention to the details has always been important, as has creating an organization culture, talent pool, and resource base to effectively implement strategy. For example, many online startups have been unable to take advantage of one of the greatest potential assets of e-commerce – customer-specific data – because they lack the skills to do so. The bottom line is that capabilities are important for all businesses, whether Internet related or not.

Competitive Advantage

The third fundamental pillar of strategy is competitive advantage, which arises when a company's internal capabilities offer superior customer satisfaction relative to competitors'. Like the other dimensions of strategy, competitive advantage is relatively straightforward, but of bedrock importance. The problem for e-commerce startups, unfortunately, is that even when they are able to develop capabilities, they tend to offer little protection from the onslaught of similar, and often superior, offerings from competitors. It all starts with the inability of most Internet startups to create barriers to entry. Being first to market with a novel idea may not in itself be enough to keep other competitors from entering the same market, and once that happens the online startups must offer superior customer satisfaction. This is a very tall order when the customer has so many choices, as they do in many of the online categories.

The number of online companies in many sectors has swollen with the rush of funding availability. Traditional competitors have jumped into the Internet arena as well, quickly becoming major players because of such inherent advantages as size, customer position, and established infrastructures. What sort of competitive advantage do the new online startups have against such established companies? Perhaps greater expertise in website development and software engineering, but surely that pales in comparison to what large, established companies bring to the table. One other presumed advantage for the

Internet startups is even more ephemeral – that established companies might be unable to adapt to the online world, leaving the playing field wide open for the startups. A game plan that relies on the other guy either not playing the game, or making mistakes – lots of them and for a long time – is seldom the best way to build a business. While there is no doubt that many large, established old economy companies will be slow to the Internet, and will make mistakes, their advantages make them daunting competitors. For example, Wal-Mart.com's relationship with the giant retailer gives it access to millions of customers worldwide and to Wal-Mart's legendary logistics expertise.

The history of the catalog business further substantiates this argument. While the pace of growth in the early years of the catalog business was red hot (Sears Home Catalog grew at almost 70% rate during company's first five years), catalogs never replaced physical retailers. In fact, many of the most successful catalogers – L. L. Bean, J. Crew, and Victoria's Secret among them – have become shopping center staples, where they often generate more sales per square foot than their non-catalog competitors. The disadvantages of the catalog business – customers can't touch the product and returns are costly – are mitigated in the physical store environment, and this too suggests that online retailers may need to adopt more hybrid forms to compete effectively with established brick-and-mortar players. It also means that the e-retailer advantage in reduced overhead may be ephemeral if success depends on a multi-channel attack strategy.

Internal Consistency

Successful strategies require internal consistency. Capabilities must fit market dynamics, and internal systems must support those capabilities. Consider the boom in business-to-business market exchanges. The primary purpose of such companies as PurchasePro.com is to enable buyers to drive down the prices they pay vendors. Does that make sense? Certainly from the buyers' point of view, it is highly attractive, and the web can increase competition among vendors for business. However, vendors' have reason to be a little more ambivalent. In fact, many suppliers see the movement toward such exchanges as highly threatening and disruptive to their business, not to mention as a potential restraint of trade as well. Indeed, many online exchanges are finding it difficult to get suppliers to sign up. Driven by price, most B2B exchanges are implicitly designed to lower vendor margins. Other suppliers are banding together just like their customers are. Many of the biggest auto suppliers to the auto industry, including Dana, Delphi Automotive Systems, Eaton, Motorola, TRW, and Valeo, for example, are planning their own marketplace to offer a countervailing force to the auto industry exchange.

So will it work? In industries where vendor products and services cannot be differentiated, B2B marketplaces will hasten a move toward commoditization. In fact, we should expect the development of markets for vendor supplies to become akin to how pork bellies and other commodities are bought and sold. Once this happens, there will be room for only one B2B company in each "commodity"; after all, are pork bellies traded on numerous

exchanges? Perhaps we will even see a very small number of B2B companies like VerticalNet – which has created marketplaces in dozens of industries – left across the board, since the mechanics of trading are not much different whether you're selling pork bellies or silver. Of course, there's another perspective on this that tends to be overlooked. Namely, vendors' goods and services are not all commodities, and they have very powerful incentives to do everything they can to ensure they do not become commodities. As a result, B2B exchanges predicated on cutting costs to buyers might be seen as inherently limited; vendors might be willing to sell their excess capacity or lower-quality products through exchanges, but why would they be willing to do so for their differentiated offerings?

Questions about internal logic and consistency can be raised about many business-to-consumer startups as well. For example, more cosmetics dot-coms were created in the boom years than there are shades of lipstick. The basic notion was that by selling direct to customers, these online startups could bypass the distribution channel, offer greater selection, and remove the overhead that comes with brick and mortar, landing these businesses in the sweet spot of lower prices and higher margins. Aside from the fact that there are virtually no barriers to entry in online cosmetics, this business model was predicated on two rather naïve assumptions. First, that the major manufacturers like L'Oreal and Estee Lauder would give up control of distribution to the new dot-coms, and second, that women would give up the practice of trying out new products in stores. Established cosmetics makers held the upper hand because of the power of their brands, making it highly unlikely that they would step to the side and let the myriad and inexperienced dot-coms carry their products. Further, since it was a simple matter to set up online sales of cosmetics – witness the some 200 companies created for this purpose – the Estee Lauders of the world created their own website. Successful strategies almost always focus on helping the customer solve their important problems; the online solution appears to solve a "convenience problem" that few women seemed to value highly. In sum, the likelihood that a classic B2C model in cosmetics will be successful is not high.

As one final example, consider the myriad of websites such as Buy.com created to sell at a lower price than everyone else. The idea that such a strategy is completely imitable is of course self-evident. In addition, with the rise of comparison-shopping tools like mysimon.com, it is exceptionally simple for customers to search for the lowest price available for almost any product sold on the Internet. While being a low cost producer has its advantages, few pure online players are likely to have the resources needed to meet this goal. It would seem rather ill conceived to compete on the basis of price in this environment, yet many online startups have done exactly that. With market dynamics militating against a low price strategy, this is another good example of how Internet business models require not just internal consistency, but customers, capabilities, and competitive advantage to win.

Conclusion

In sum, Internet business models will rise and fall on the same fundamentals that affect all businesses, and strategy is at the center of these fundamentals. While the early hyperbole of the Internet has given rise to the "Superman theory of dot-coms", the truth is much more mundane. When we take a closer look at the nature of strategy and competition in the Internet era, we make a fascinating discovery: the more things change, the more they stay the same.