For the pioneering U.K. startup, clicks without bricks and building share without care led to a first-mover disadvantage.

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Scrambled Egg

The Making and Breaking of an Online Bank

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by Victoria Griffith

Illustration by John Hersey

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On April 15, 2000, Mike Harris, CEO of the British online bank Egg PLC, was glued to the computer screen as he watched the Internet stock bubble burst. The Nasdaq plummeted 355 points that day, and London technology stocks followed suit. For Egg, which was about to launch an initial public offering, it was a moment of crisis. "My first thought was, that was it, we'd never be able to pull it off," said Mr. Harris. "It was a nightmare."

At 8:00 that evening, with the U.S. markets still churning, Mr. Harris and some co-workers went to a London pub around the corner from his office for some sorely needed drinks. Pulling out his cell phone, Mr. Harris called Jonathan Bloomer, then the newly appointed CEO of the U.K.'s Prudential Banking PLC, and Derek Higgs, an executive director. Prudential, a London-based financial services group that has no ties to U.S. companies with the same name, had launched Egg just 18 months earlier, and had been looking forward to the initial public offering for an infusion of cash.

As the gloomy group sipped beers, they weighed the pros and cons of the IPO. Mr. Bloomer was pushing the offering. "I think we should just go for it," he told his colleagues. "To not do it now would show a tremendous lack of conviction." Although Mr. Harris was still skeptical, his Prudential bosses won him over.

Two months later, Prudential sold 20 percent of its stake in Egg for £150 million ($218 million). At 160 pence, the shares traded on the low end of the initially forecast range. Still, media commentators hailed Egg for its courage in going ahead with the deal. The decision to proceed with the IPO reflected the company's overall strategy, which was based on speed and innovation. Like many Internet groups, Egg hoped to capture investors' enthusiasm for Web-based businesses and run with it. Momentum was the company's mantra.

By some measures, it appeared Egg had succeeded. Founded in October 1998 as a telephone bank, Egg turned to the Internet early on to stem the flow of loss-leading deposits. Seeking to establish a massive online presence in less than two years, Egg spent aggressively and won customers faster than its founders ever dreamed possible. In its first four months, Egg had opened nearly 400,000 accounts and drawn several billion pounds in assets — a target the business had aimed to meet after five years of operation.

By April 1999, Egg began limiting new accounts to those opened on the Internet. Five months later, it added a credit card service, and in early 2000, the bank launched an online fund supermarket and introduced a shopping channel. The company also offers loans, mortgages, and insurance products under the Prudential brand through its Web site, www.egg.com. As of March 2001, Egg had 1.35 million customers and 1.75 million accounts.

Yet Egg has never stopped struggling to figure out its value propositions or how it would make money. Nearly a year after its debut as a publicly traded company, Egg's independent ambitions seem problematic. Although its share price, by March, had rebounded to its IPO level of 160 p, the company is still losing money; its pretax loss was £155 million in 2000 and £150 million in 1999, or roughly £305 million ($448 million).

As investors increasingly insist that online ventures make money, the bank finds itself in a defensive position. Management says the company expects to break even toward the end of 2001, but it isn't clear how long the red ink will continue to flow.

As a first mover in the hot arena of online banking, Egg was widely admired in the U.K. But, despite the praise Egg received for a bold beginning, few observers today expect the company to dominate online banking in the U.K. Some industry analysts' outlooks are even more pessimistic. "We are broadly skeptical about stand-alone Internet banks, not least because the potential market already looks oversupplied," ABN Amro Bank analysts Richard Coleman and Peter Walters wrote in a report last year. "Egg's brand value, customer loyalty, and cross-selling ability are all, in our view, questionable."

Indeed, Egg's trials and tribulations are classic illustrations of the fallacies inherent in early Internet business models. Many stand-alone online banks, in the U.K. and the U.S., are in trouble, in part, because they overestimated consumers' eagerness for the convenience of banking online and underestimated people's desire to have the option to speak in person with tellers and get money from automated teller machines. In November, Egg announced it would consider opening physical branches, a radical departure from its original strategy.

Once considered the ascendant commercial medium in financial services, digital delivery of money and money management products and services via the Internet is now recognized as one channel among several. This multichannel reality has torn asunder independently branded Internet banks, such as Egg in the U.K. and WingspanBank.com in the U.S., while strengthening the position of Prudential's bricks-and-mortar peers that abjured the stand-alone strategy, such as Barclays PLC and Midland Bank PLC (which was acquired by HSBC Bank PLC in 1992 and took its parent's name in 1999). On top of that, virtual banks' attempts to build market share quickly by offering higher interest rates and lower fees than traditional banks, although effective in attracting customers, have created a strategy expensive to sustain.

Now many of London's High Street banks — bricks-and-mortar companies that two years ago were written off as losers in online banking — are seen as formidable competitors on the Web. At last count, retail-banking leader Barclays had 28 percent of the online banking market in the U.K. and Lloyds TSB Group PLC had 23 percent. Egg claimed only a 7 percent share.

Barclays has slowly refined its strategy to leverage online banking to complement its other distribution channels and enhance the value of all its products and services. Of this decision, Ian Richardson, e-commerce director at Barclays, says: "When Egg started, we were pondering if we should do something similar. But after a lot of research and thought, we decided not to break away. That was fool's gold. The idea that with a new entity you could ditch your legacy and move at Net speed was just an illusion.… You may shut out some old problems, but you also have new risks: new employees, new systems, and a new brand to market."

The First-Mover Myth

Many of Egg's pressing challenges today are wrapped up in what may be its undoing — the need for speed. As has been shown repeatedly in these early Internet days, being first does not necessarily ensure an enduring advantage. In fact, moving quickly can make it difficult to move well.

Since its inception, Egg has been driven by speed. In 1997, Mr. Harris says, he was asked by Prudential to start thinking about what a "big" online initiative would look like. "Big" in Webspeak also meant fast, so Mr. Harris and his colleagues began to put together plans for an online bank that would quickly challenge the institutional status quo.

In October 1998, the group decided on its brand and officially separated from Prudential's commercial banking group. During the first few months of its existence, Egg took deposits for savings accounts via the telephone, by mail, and over the Internet. Knowing customers are usually reluctant to switch banks, Egg offered a rate substantially higher than that of its traditional competitors and guaranteed that rate through the end of 1999.

Egg's exceedingly rapid growth in its first few months in business made some observers wonder if the company would become the United Kingdom's answer to the American online retailer Amazon.com Inc. Launched in 1995, that celebrated Internet company had turned executives all over the world into firm believers in the "first-mover advantage." The idea was to become the dominant

Exhibit 1: **Other U.K. Online Consumer Banking Sites**

Name	Stand-Alone Internet Bank	Online Channel	Affiliation
Smile www.smile.co.uk	X		Co-operative Bank PLC
The Co-operative Bank www.co-operativebank.co.uk/		X	Co-operative Bank PLC
Nationwide Internet Banking www.nationwide.co.uk		X	Nationwide Building Society
Cahoot www.cahoot.com	X		Abbey National PLC
Abbey National eBanking Service www.abbeynational.co.uk		X	Abbey National PLC
Firstdirect.com www.firstdirect.com	X		HSBC Bank PLC
HSBC Internet Bank www.hsbc.co.uk/ebank/		X	HSBC Bank PLC
The Royal Bank of Scotland Online & PC Services www.rbs.co.uk		X	The Royal Bank of Scotland
Halifax www.halifax.co.uk		X	Halifax PLC
Intelligent Finance (IF) www.if.com	X		Halifax PLC
NatWest.com www.natwest.com		X	National Westminster Bank PLC
The Woolwich www.woolwich.co.uk		X	Woolwich PLC
First-e the Internet Bank www.first-e.com/uk	X		Banque d'Escompte
Barclays-Online Banking & Services www.barclays.co.uk		X	Barclays PLC
NetmasterGold.co.uk www.netmastergold.co.uk		X	Norwich and Peterborough Building Society
Citibank Direct Access www.citibank.com/uk/intbank		X	Citibank.com
Alliance & Leicester www.alliance-leicester.co.uk		X	Alliance & Leicester PLC
Lloyds TSB Internet Banking www.lloydstsb.com/services/internet		X	Lloyds TSB PLC

Source: Gomez Internet Scorecard, Winter 2000, from UK.Gomez.com, a division of Gomez Advisors Inc.

player — to “occupy a space,” in Internet parlance — before competitors even perceived the market's potential.

Could Egg become another Amazon? Probably not. Amazon benefited heavily from an early media deluge about its novel name and business model that allowed the company to establish its brand rapidly without spending heavily on marketing. Egg, while it received some coverage, was not unusual enough to attract that sort of mass-scale media attention. Today, the bank claims that 79 percent of people surveyed in the U.K. recognize the name; however, the image the brand conveys is unclear.

In fact, the world's growing obsession with the Internet in the late 1990s — and its diminishing novelty — meant Egg's first-mover position was so fleeting as to be meaningless. Even at its launch, some of the largest High Street banks, such as Barclays, Lloyds TSB, and the Royal Bank of Scotland Group PLC, were experimenting with an online presence, even if they were moving slowly. After an early, small-scale experiment with Web banking called B2, Barclays, for example, kept its online service in-house to support its existing businesses.

By early 1999, the field was getting crowded, and the traditional players' cautious start looked smart. "Everyone thought [the former] Midland was foolhardy because they delayed [an online] launch a couple years ago," says William Mayon-White, a visiting professor at the London School of Economics and an online banking consultant. "Any bank that said it wouldn't launch within the year then was looked at as a risk. Now, it looks like it was the right proposition."

Today, the online banking sector in the U.K. includes a mix of independent online brands launched by established players (with quirky names like Smile and Cahoot) as well as online services associated with old-line banking names, such as Barclays and Lloyds, that consumers know and trust. (See Exhibit 1.) Bob Head, one of Egg's founders, defected in 1999 to launch the online bank Smile, which is tied to the Co-operative Bank PLC. Abbey National PLC launched Cahoot in June 2000. This was followed by the launch in September 2000 of Intelligent Finance (known as IF), a subsidiary of Halifax PLC, a former U.K. building society turned bank.

There are now at least a dozen online banking operations in the U.K. Unfortunately, as the number of Web-based banking services has snowballed, user interest has not kept up. The added competitive pressures make the profit payoff more elusive for every player. Lloyds TSB projects that 2.25 million people in the U.K. will use Internet-only banking by the year 2003. With some companies, like Egg and Barclays, already at or above the million-customer mark, and other players predicting more than a million online customers within two years, something has to give. Either customer growth projections are way off, or all stand-alone online banks are in for a rough time.

Market research also suggests the rush to pan for Internet gold in the U.K. may have led companies to seriously overestimate Britons' initial appetite for virtual accounts. Even if they want to, in 2001, most U.K. citizens can't bank online from their homes. According to a global survey released in October 2000 by Deloitte Consulting, just one-quarter of British households have a personal computer of their own. Although the government is working to change this, and there is a noticeable emerging urge to bank by mobile phone in the U.K. and throughout Europe, only one in 50 Britons today links to the Internet through a wireless device for any purpose at all, according to the Deloitte survey. (For more wireless developments in retail finance, see "Why Banks and Telecoms Must Merge to Surge," page 48.)

Furthermore, a 2000 survey of major regions by Cendant Direct Marketing, a division of the U.S.-based Cendant Corporation, found that just 15 percent of Europeans who responded to the survey already bank online, or even like the idea. Of those who were enthusiastic, most said they prefer to deal with established banks. This is not a repudiation of the channel; it simply reinforces the notion that name-brand banks probably have the edge over stand-alone startups.

Meanwhile, forecasts from the International Data Corporation show Western Europe's online banking customer base growing from 18.6 million in 2000 to 57.9 million in 2004. Such projections are not lost on Lloyds TSB, which is wisely looking beyond the U.K. market. It opened its Evolve online banking service in Spain in September, and plans to expand it to the rest of Europe.

Rocky Road to Growth

The public's slower-than-expected embrace of Internet banking is no doubt one reason Egg is backing away from being purely virtual. But it also suggests that Egg and other startups like it, which wanted to establish their e-businesses fast, probably had more time than they thought to test and fine-tune their strategy.

Consider Egg's experience with the old-fashioned loss-leader strategy. Loss-leading on a grand scale involves offering such good deals that customers find them difficult to pass up. A company registers losses for a number of years, until it has killed off the competition, and its customers are hooked on its products. Then the company can raise its prices and begin to register profits.

To win customers at its launch, Egg needed to give them a good reason to open an account with a new bank. Marketing personal checking accounts, in management's judgment, was not the way to go. It is difficult to get people to switch banks once they have services such as automatic wage deposit and bill payment set up; processing checks is expensive; and Egg did not have any ATMs, a service customers with checking accounts expect these days. So Egg's loss-leader solution was to offer savings accounts with interest rates higher than those of traditional competitors. Egg guaranteed those rates through the end of 1999 to show it was serious, but it also bore tremendous short-term losses.

Egg's loss-leader approach was inspired early on by the experience of First Direct, a telephone banking service that won a large market share in the U.K. in the 1990s. First Direct was a classic loss leader, backed by the deep pockets of Midland. "Customers switched to First Direct for price," says Mr. Harris. "But they stayed with them for service. We want to follow that model."

Yet First Direct and Egg had starkly different strategies. For one thing, they moved at different velocities. First Direct was based on a slow, lower-cost buildup. It took the bank a decade to build a customer base of 1 million; it took Egg just 18 months.

Egg's loss-leading on a shoestring is also a rocky growth proposition. First Direct, by contrast, did not have to tap the public markets, and had a more reliable funding source — its parent, Midland. Traditionally, loss-leading is conducted by large, profitable corporations that can fund new ventures through earnings from other operations. These are the so-called deep pockets that can carry a subsidiary through the tough, early years.

Finally, First Direct faced a very different competitive scenario. In the 1980s, there were very few telephone banks in the U.K., so First Direct was running in an open field. Egg is competing in a crowded market.

Egg's strategy had other problems. Although the high-interest, low-fee savings offerings were clearly the easiest way to win customers quickly, Egg did not initially attract the young, tech-savvy, and upwardly mobile under-30 customers who are its target. The online bank won't reveal its customer demographics, but bank analysts say — based on outflows from more conservative banks — a large portion of Egg's early converts were actually elderly savers searching for the best interest rate. In its haste, Egg scrambled its strategy; even though its hip branding was on target for younger customers, it missed the fact younger people aren't generally savers. Although more expensive to offer, personal checking was a more attractive service for this group.

Worse still for Egg, the kind of customers it did win are hard to keep. Savers in search of the highest interest rate are by definition a disloyal bunch. The first sign of trouble came early last year when Egg lowered its rates to be more in line with the market, and elderly savers began pulling their money out. Deposit growth slowed, then turned negative in early 2000. In the third quarter alone, the Internet bank saw a net outflow of £433 million ($625 million) in retail deposits. In the final months of the year, Egg shed another £154 million ($222 million).

Some growth in new accounts, opened by younger customers, offset the decline in savings revenues. But these customers also had much lower savings balances. The demographic shift caused average deposits per customer to drop more than 6 percent in three months, from £13,200 ($19,055) in December 1999 to £12,350 ($17,828) in March 2000.

Before the Internet, no company would have considered loss-leading without the commitment of a wealthy parent group. But the Net took loss-leading to a new level, because stock markets were willing to finance start-ups before they moved into the black. In 1995, the successful public offering of the Netscape Communications Corporation showed investors were eager to back these loss-making new ventures. Prudential hoped to capitalize on this trend.

Faced with difficulties in its core business, Prudential intended from the beginning to sell its stake quickly in Egg. Given the investment climate at that time, Prudential's managers figured that much of the cost — and therefore the risk — of establishing a venture like Egg could be transferred to the public. "An IPO was part of the strategy of Egg from the early days," Mr. Harris recalls. The trouble, as Egg soon discovered, is that market sentiment can rapidly turn. Once investors' feelings about a company sour, funds dry up. If the new venture is loss-making, it runs the risk of running out of cash for continuing operations.

"The problem with loss-making companies is that eventually they have to ask someone for more money, whether it's their parent group or Wall Street," says Dan Smith, CEO of the fiber-optics group Sycamore Networks Inc. "You run the risk that when you need a new cash infusion, they may not be willing to give it."

Egg said at the end of last year it had enough cash to keep going for 12 to 18 months without a cash infusion, by which time it hopes to break even.

Cross-Selling Dreams

Never mind that the average deposit size is shrinking, Egg's management argues. The key to profitability lies in its ability to "cross-sell" its products. Cross-selling, or get-

Like many managers before the dot-com bubble burst, Egg's executives assumed that Internet brands could be thrust upon the public almost overnight.

ting a single customer to purchase multiple products, has long been the dream of the financial industry, because it has the potential to boost revenues dramatically and reduce marginal costs at the same time.

In some other industries, cross-selling has worked well. A loyal customer of the clothing retailer The Gap, for instance, may purchase both adult and children's apparel. Because each advertising dollar the company spends supports the umbrella brand and everything underneath it, the company can increase incremental revenues at low cost.

Yet cross-selling in the banking sector has remained largely an unrealized hope. Theories abound as to why this is. "The reason cross-selling hasn't worked [in banking] is that not everyone is great at everything," says Ben Ensor, a financial services analyst with the technology research firm Forrester Research Inc. "A great mortgage lender with very competitive rates may not be very good at managing funds. The consumer doesn't want to buy dogs, so they take that part of their business to another bank."

Egg planned to get around this weakness by launching a financial clearinghouse, selling multiple products from different financial institutions. The group was perhaps following the example of the U.S. online bank Wingspan, which tried to do the same thing (with limited success, analysts say).

But Egg's cross-selling record to date has been dismal. The group had 1.35 million customers and 1.75 million accounts at the end of last year. That means that a maximum of 400,000 customers held more than one account at the bank. Even traditional banks, terrible cross-sellers themselves, do better. Barclays, for instance, has a cross-sell ratio of about one to two — that is, each customer can be expected to purchase two products from the bank.

Again, Egg's obsession with speed may have worked to its detriment. One reason the company has had little luck cross-selling could be that it has few of its own products to sell. It takes time to build brand recognition and successful products, even in the Internet Age.

The Brand Fallacy

Like those launching other Internet companies at the time, Egg's founders believed from the start that the company's success required its independence. The IPO proceeds were not the only perceived advantage in separation from Prudential. By creating a new, more entrepreneurial entity, Egg hoped to attract a more dynamic staff. Management thought it could also make decisions more quickly if freed from the bureaucracy and red tape of the parent company.

"The IPO means we are much more in the public eye and there is more pressure to perform," says Mr. Harris. "As a division of Prudential, it would have been all too easy to fall back into their protective arms and lose our innovative momentum. I believe First Direct never fulfilled its potential, as an independent would have."

There was never any discussion over whether Egg would be a separate brand; the only question was which name to choose. "It was just a given that there would be a new name," says Bob Head, the Egg co-founder who went on to found Smile. He recalls the branding of Egg nostalgically as an example of the "democracy" of Internet companies. In 1998, Prudential ordered market tests of potential names for the new bank. The name Egg had appeared on the lists early on — no one remembers who thought of it — but Prudential's managers didn't like it. "A guy called Clive, who was buried in the marketing department doing research, kept sticking it back [on the

Barclays' cautious approach appears to be paying off. Using its own name and institutional backing, it has a 30 percent market share in online banking.

list] so it went out for research by mistake," Mr. Head remembers. "It turned out that Egg got the best results. By disobeying orders, Clive came up with a name."

Although the incident is a great example of innovation in a flat organization, it may also be a sign of weak leadership. For all the time spent discussing branding at the new entity, no one ever considered the value in using the old Prudential name. Like many managers making these decisions before the dot-com bubble burst, Egg's executives assumed that Internet brands could be thrust upon the marketplace almost overnight.

That assumption was seriously challenged in 1999, when startups began spending millions of dollars on advertising campaigns to shore up their new brands. In most cases the spending spree proved futile. For Egg, not using the Prudential name may have been a failed opportunity to use a proven brand, built up over decades. "If we were to make the decision today, we would definitely consider hanging on to the Prudential brand," says Mr. Head. Fidelity Investments, which recently launched an online service in the U.K., stuck with the Fidelity name. "But back in 1998, a new brand was the thing to do," Mr. Head explains.

Besides ignoring the value of the Prudential brand, Egg's managers may have erred in assuming the new company had to sport a stylish name. They were, again, following the fad. U.S. companies like Yahoo Inc. were all the rage, and Prudential wanted a name with similar spirit. Yet Egg may be more appropriate for a food company than a bank. Egg's original customers — many of them elderly people looking for a better savings rate — likely put little stock in the cool brand. Even for younger people, it isn't clear that the Egg name was a memorable marketing attraction. "Other than being quicker to type in [than Prudential], the Egg name may have had no value," says London Business School Professor Mayon-White. "Do we really want our bank to be trendy?"

National Westminster Bank PLC, sensing a backlash against such Internet trendiness in the financial sector, began to air a television commercial in mid-2000 featuring an elderly woman who enters her local branch. Instead of tellers and lines, she finds herself in a funky coffee bar. "I remember when this used to be a bank," she sighs. The commercial — one of the most popular of the year — struck a chord with the English.

Will High Street Win?

When Egg was formed two years ago, Britain's traditional banks were considered almost certain losers in online banking. The banks were too plodding and cautious, said observers. Or were they? HSBC doesn't think so. The bank opted to build an online service that can be accessed through satellite television. When the company first announced its plans, analysts thought the group had committed a serious error. Now that it seems clear it may take longer than expected for the PC and wireless mobile banking channels to blossom, introducing a television-based distribution channel seems like a reasonable move.

Meanwhile, the cautious approach of Barclays to developing online banking services, its decision to stick with the Barclays name for those services, and its institutional backing appear to be paying off. After a slow start, a nearly 30 percent market share in online banking in the U.K. is not a bad beginning. For its part, Barclays was leery of the costs of building a separate brand and believed separate branding would make cross-selling more difficult.

"We knew that building a separate brand would cost hundreds of millions of dollars over three to five years.

You're also creating a situation in which it becomes very difficult to cross-sell," says the bank's e-commerce director, Mr. Richardson.

Further, Mr. Richardson says Barclays believed it was better off leveraging its current assets, including its IT infrastructure and 10-million-strong customer base. "We want to use the synergies from Barclays online to serve customers at Barclays. If you create separate technologies, systems, and staffs, it becomes very difficult to put them together later. And you have to put them together to gain economies of scale."

Opportunity or Bust

Egg describes itself as an "opportunistic" company, and some of Egg's products are very innovative. By using the Egg card at the company's e-shops, for instance, consumers can purchase a number of products at a discount. The company started out as a savings bank, and added a credit card less than a year later. And when Egg launched its "fund supermarket" in 2000 (which placed Egg in competition with its parent), it introduced a service that was innovative for the U.K. financial services sector, although it wasn't a big hit with customers.

Opportunism, while useful in the short term, can make it difficult to build a coherent strategy for the long term. Some analysts wonder if Egg knows where it is heading, or if it is fully attuned to the risks it faces. Egg seems to be transforming itself again into an e-commerce site and a portal. This, says Egg management, is simply a function of the demands of the marketplace. "The market is changing so rapidly that the concept of Egg had to change too," says Mr. Harris. "It will probably change again in the next six to 12 months," he predicts.

But by setting itself up as a clearinghouse rather than just a provider of financial services, Egg is exposing itself to even more competition. "Egg's move to becoming a portal and an e-shopping site puts them directly up against companies like Yahoo, which understand this channel a lot better than they do," says Nick Jones, an analyst with Jupiter Communications Inc. "It's also technically intensive, and may require a big investment in systems support."

Egg is a product of dominant management thought in the late 1990s, when speed was king and boldness was rewarded. But its preoccupation with being first may have clouded its judgment. Egg considered corporate independence essential. It also turned out to be expensive. Flexibility was considered the way to go. Yet pursuing the latest hot market could exhaust Egg's resources before it has a chance to build a profitable business.

To be sure, in many respects Egg has done well, especially for a startup in a conservative industry. It leads its online rivals in market reach; it's been on a growth track; and its margins have improved steadily. The bank's share price has reflected investor optimism, outperforming the broad market and its industry sector in early 2001.

Egg faces a harsh critic in Professor Mayon-White, who says, "Egg is just a flash in the pan. It misread the market and should not have launched in the first place; it's just been one big expensive exercise." Yet such an extreme view discounts Egg's resilience and its drive to chart a new course in retail banking. While it may seem to be in search of an identity, Egg is also on a creative mission to find the customer base and the products that can make its business work.

"At the moment, we offer products and services from four main areas — banking, investments, insurance, and online shopping. However, we're committed to expanding our range in the future into any area where we can offer a great service and real value for money," Egg currently proclaims on its Web site. In an Internet world where no business is what it appears to be and business models change every day, this could be one Egg worth counting on even before it is fully hatched. +

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Resources

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