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The next wave of online business models must focus narrowly, rather than blindly pursuing scale.

by Tim Laseter

During the early days of the Internet, popular wisdom highlighted the power of the new virtual business model that could reach a mass market without the bricks-and-mortar constraints of the "old economy." Venture capitalists threw money at the lucky start-ups and encouraged them to get big fast before competitors could gain a foothold. Operating strategies were all about "scalability." Although that model worked fine for a few companies, like Amazon and eBay, it proved a dead end for most. Today a simplistic approach built around mass markets and scalability is a near-certain recipe for failure.

That's not to say that we won't continue to be amazed by growth phenomena — like Facebook and Google — that expand quickly by creating fundamentally new business models. But most Internet businesses are simply offering a new twist on an old business idea and, accordingly, seek to displace existing companies. No longer expecting every new idea to transform the old economy, entrepreneurs (and even venture capitalists) are beginning to realize that scale is the result — not the cause — of business success.

A careful look at some past successes and failures as well as a few emerging Internet stars reveals that a clear focus on distinct capabilities has led to success. And, perhaps surprisingly, the old model of mass-market scalability is being turned on its head by a new local focus. Instead of using the virtual nature of the Internet to reach a geographically unconstrained mass market, new companies are building distinct capabilities at a local level to attract loyal customers. Those capabilities — not scale — provide the barriers to entry that allow these companies to outperform their competitors. Much as in the old economy, leading Internet businesses are gaining scale by replicating their success rather than pursuing scale as the key to success.

The Fallacy of Scale in B2B

An examination of "B2B e-marketplaces" — a class of early Internet companies that sought to transform business-to-business transactions — demonstrates the fleeting value of scale and the virtual enterprise. Consider FreeMarkets Inc., founded in 1995, which offered to save companies up to 15 percent on their purchases through the use of online auctions. FreeMarkets used the Internet to help its clients tap a broader range of suppliers and create more competitive market dynamics through real-time feedback showing the latest price reduction. Over the course of a few hours, the clients confidently discovered the absolute rock-bottom prices by pushing every supplier to its "walk away" point. The traditional methods of issuing requests for quotes, then conducting multiple rounds of negotiations with a narrow list of candidates, took far longer and often left money on the table for the supplier to claim. The success FreeMarkets achieved led to a December 1999 initial public offering (IPO) that raised nearly US$200 million at a stock price of $48 per share. By the end of the opening day, the price had skyrocketed to close at $280 per share, which valued the company at a staggering $8 billion, despite its having revenues of only $13 million in the

Illustration by Lars Leetaru

first nine months of that year.

Not surprisingly, the big industrial customers using the online auction services of the startups concluded that owning a B2B e-marketplace could be worth even more than the savings from the auctions. General Motors Company, which had accounted for 17 percent of the revenues earned by FreeMarkets during the nine months prior to the IPO, announced a consortium with rivals Ford Motor Company and Daimler-Chrysler AG just months later, in early 2000. The new entity, Covisint, would offer online auctions to its members and would also automate information sharing and a host of transactions among the Detroit Three automakers and their suppliers. The virtual scale of FreeMarkets was quickly trumped by the actual scale of existing players.

But the massive complexity costs of collectively redesigning the critical interfaces among all the vehicle manufacturers and hundreds of suppliers swamped the anticipated benefits of economies of scale. As the Internet bubble burst, the auto companies realized that each of them worked with suppliers in different ways and had little desire to standardize, especially because each had the scale to develop its own Internet software tools independently. FreeMarkets then acquired the auction services business line of Covisint in 2003 before being subsumed under Ariba Inc. in 2004. Also in 2004, the collaborative software tools developed by Covisint were sold to the Compuware Corporation, which repurposed the software for a broader set of smaller companies that lacked the scale to develop their own tools.

So much for using the Internet to fundamentally transform the staid industries of the old economy. Maybe scale was not all it was cracked up to be.

Scale in Internet Retailing

But perhaps FreeMarkets and even e-marketplaces in general were simply flawed business models. Or maybe the business-to-business market suffers from too much inertia to allow a startup to succeed. After all, Amazon and eBay offer great models of success in the business-to-consumer (B2C) market, even though B2B mostly offers Internet failures.

Amazon built its scale via a combination of an initially narrow focus and a major investment in unique capabilities.

True, Amazon, a "pure play" startup founded in 1994, has come to dominate online retailing. With $34 billion in 2010 sales, Amazon is 2.5 times bigger than the second-largest online retailer and more than 70 times the size of the 50th-ranked one. Although a powerful example, Amazon's success needs to be put into context: Online retail sales account for less than 4 percent of total retail in the United States. So Amazon may appear to be a big fish, but it is really just a medium-sized fish in a relatively small pond compared with the ocean of total global retail. The next 10 companies on the list of the top 500 Internet retailers as published by *Internet Retailer* magazine all existed well before the World Wide Web came to our offices and homes, and have more sales in total than Amazon. Big-box office-supply retailers Staples, Office Depot, and OfficeMax take up three of those 10 slots. And although the online channel accounted for less than 1 percent of its total sales, Walmart garnered sixth place. Even the perennially troubled Sears made the top 10 by channeling 6.3 percent of its $44 billion in sales through the Internet. You have to drop to 12th place to find another pure-play online retailer, Newegg, a purveyor of computer hardware and software that was founded in 2001. Netflix, founded in 1997 and 14th on the list, offers another example of a company launched on the promise of the Internet. However, Newegg, Netflix, and Amazon are the only three nontraditional retailers in the top 25.

The vast majority of the pure-play startups that sought to dominate the mass market proved to be spectacular failures. One of the earliest flameouts, Value America Inc., offers a classic case of unbridled pursuit of scale. Founded in 1996 and funded by such heavyweights as FedEx founder Fred Smith and Vulcan Capital (the venture company of Microsoft cofounder Paul Allen), the company sought to sell anything and everything online. Value America used the deep pockets of its investors to buy full-page advertisements in *USA Today.* At the end of its first day of trading as a public company in April 1999, the company achieved a valuation of $2.4 billion; it filed for bankruptcy a mere

16 months later, in August 2000.

Webvan Group Inc. similarly sought to be a one-stop shop by delivering everything to the consumer's door. Funded by a record-breaking $400 million in four rounds of venture capital financing, Webvan launched operations in Oakland, Calif., in June 1999. By the end of the year, it had raised another $400 million to initiate nationwide expansion in the form of 26 additional distribution centers, each carrying a price tag of $35 million. But revenues did not come as quickly as expected. Rather than meeting the projections to generate positive cash flow in five quarters, the Oakland facility was operating at less than 30 percent capacity utilization at the end of 2000. By the spring of 2001, Webvan was losing $100 million per quarter and its stock price had dropped from a high of $34 at its initial public offering to less than 30 cents. It shut down in July 2001, just over two years after it began online operations.

Amazon may appear to be a lucky exception, but in reality it built its scale via a combination of an initially narrow focus and a major investment in unique capabilities. Although Jeff Bezos chose the name *Amazon* as a nod to the world's most voluminous river, with a vision of being Earth's biggest store, he started by focusing on the inefficient supply chain of bookselling. From this base, Bezos invested in technology and operational capabilities that would provide a source of competitive advantage. Amazon's website defined the standards for online shopping convenience, with innovations such as its patented one-click shopping feature. Unlike other startups, Amazon did not seek to outsource fulfillment, but instead sought to become the industry leader by continuously investing in and improving this critical capability. Not until 1999 — five years after the company was launched — did Bezos make the claim (publicly and audaciously, in a *Time* magazine article) that Amazon fulfillment centers were being designed to handle "Anything, with a capital A."

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Lessons in Focus

Amazon has gained scale through its success rather than seeking scale as the key to success. In doing so, it followed a path similar to that of Walmart, the dominant mass-market player of traditional retailing. As the world's largest company, Walmart certainly benefits from scale economies, but it did not become the world leader because of a scale advantage. When Sam Walton opened his first Walmart in 1962, he had already spent 17 years learning about retail. His new chain built discount stores in smaller, underserved cities and towns in the southern United States. It took 30 years of steady growth for Walmart to pass the then-dominant discounters, Kmart in 1990 and Sears in 1992. Walmart's revenues now total $419 billion, nearly 10 times the combined sales of those formerly dominant rivals, which now operate as the Sears Holdings Corporation after a survival merger in 2005.

Many of the recent success stories of the Internet demonstrate the value of focus over scale. Two of the best examples are Zappos.com Inc. and Quidsi Inc., both high-profile acquisitions by Amazon over the last two years. In 2009, Amazon closed a $1.2 billion acquisition of Zappos, its biggest deal ever. Zappos, founded in 1999, focuses on shoes, a tough category to sell on the Internet because customers want to try shoes on to ensure proper fit, and they often return them. So Zappos focused not only on shoes, but more importantly on building a set of capabilities to attract and retain loyal customers. (See "At Zappos, Culture Pays," by Dick Richards, *s+b,* Autumn 2010.) Under the leadership of CEO Tony Hsieh, the company moved its headquarters to Las Vegas in 2004 because of difficulty finding good customer service staff in San Francisco. Las Vegas already had a large call-center industry and a 24-hour-a-day culture fitting for an online business. But Zappos also rewrote the rules of the typical call center to build a capability far different from the traditional mass market–focused model of other online retailers. Amazon tries to encourage customers to interact through the Web rather than the phone, whereas Zappos encourages members of its "customer loyalty team" to connect emotionally with the customer whenever possible. Team members are not measured on call productivity — that is, how quickly they can process a customer and get off the phone. Instead, company lore celebrates the record for the longest call with a single customer, now standing at around eight hours.

Zappos cares about cost — one of its 10 core values is "Do more with less." But according to VP of

Merchandising Steve Hill, "We price competitively, but we do not compete on cost. That's not the way to attract loyal customers." Zappos has nurtured those loyal customers to drive the growth of a $4.3 billion online shoe market — and come to dominate it. Amazon was losing the game in the category despite its industry leadership and the extensive shoe offering on its main store and through a separate website, Endless.com, which it launched in 2007. The Zappos focus on customer loyalty was trumping Amazon's cost-based, mass-market model.

In November 2010, Amazon announced another large acquisition: Quidsi, the parent company of Diapers.com and Soap.com. Again, both sites sold products that Amazon already offered online. But Quidsi was succeeding by building capabilities focused tightly on the needs of its core customer base: busy new parents. It now hopes to grow by following the evolving needs of this clear demographic segment.

Instead of seeking to serve the mass market on the Internet, companies are starting to leverage the Internet at a local level.

Focus on Local Capabilities

The latest trend on the Internet takes to the extreme a focus on capabilities rather than scale. Instead of seeking to serve the mass market from a virtual node on the Internet, independent of geography, companies are starting to leverage the Internet at a local level, turning the scale-based model on its head — and perhaps putting the final nail in the coffin of the original Internet model.

Consider one of the latest phenoms, Groupon, which captured headlines in December 2010 by rejecting a $6 billion offer from Google. Groupon started in Chicago in November 2008 and quickly expanded to Boston, New York City, and Toronto. In 2010, it expanded to nearly 500 new markets in North America and Europe, a staggering pace of nearly 10 cities per week.

A fairly simple concept has fueled this phenomenal growth. In each of its 500 markets, Groupon offers a "daily deal" that taps the marketing dollars of local businesses (a market in which Google has struggled). Consumers in the local market see promotional discounts from local merchants ranging from 50 to 90 percent off. Unless a predefined number of Groupon customers make a purchase, the deal does not "tip"; no one gets the bargain and the merchant pays nothing to Groupon. But the need to tip the deal encourages buyers to solicit their network of friends and family members to join the deal directly or through various social media such as Facebook. By early 2011, the company had offered more than 100,000 deals in partnership with 58,000 local businesses.

Groupon certainly gains scale economies by serving so many locations, and the model has strong network effects. It boasts more than 50 million subscribers, which obviously attracts merchants interested in offering deals. But most deals are local and, accordingly, the relevant number for most merchants is not the 50 million subscribers but instead the number of local subscribers.

To ensure successful execution, Groupon uses the Internet and its global scale to attract customers through mass-market advertising. But it also has to ensure its deals will appeal to its local customer base by vetting the local merchants in each city. Groupon has developed deep capabilities for identifying targeted merchants within priority cities, and it turns down the vast majority of the proffered merchant deals. With a promise of at least one deal a day in each city served, the company must have an effective and efficient set of routinized processes for working at the local level.

Some lesser-known examples of the emerging local focus are beginning to attract the attention of venture capitalists. Like Amazon before it, J. Hilburn — a Dallas-based startup — seeks to disintermediate an inefficient supply chain used by traditional local players. Founded in 2007, J. Hilburn offers custom-tailored clothing made from high-quality fabric, but at a price within the reach of most business professionals. The company makes use of the Internet to eliminate both the need to hold inventory and the risk of unsold products by procuring to order along a focused supply chain. In 2010, the company sold 60,000 custom-tailored shirts made from Italian fabric at its factory outside Macau, China, at prices ranging from $80 to $150 each.

To offer custom-made shirts, the company needs a local capability, provided by a network of "style advisors" who go to a client's home or office to take tailoring measurements. As is the case in other direct-sales businesses, the style advisors receive a commission on their own sales as well as on the sales of other advisors they recruit to their network. J. Hilburn currently employs more than 500 style advisors, typically women with school-age children seeking extra income. Although potential customers can visit the company's website to initiate the purchase process, a search for the name of a style advisor is limited to a maximum of 30 miles from a given zip code. Despite the importance of its virtual model, building the local network remains key to J. Hilburn's ability to fully leverage its Internet-enabled supply chain.

The clearest example of turning the old model on its head can be found in the grocery industry and the infamous "last mile" terrain that Webvan sought to tackle with the "get big fast" model of scalability and a mass-market focus. (See "The Last Mile to Nowhere: Flaws & Fallacies in Internet Home-Delivery Schemes," by Tim Laseter, Pat Houston, Anne Chung, Silas Byrne, Martha Turner, and Anand Devendran, *s+b,* Third Quarter 2000.) Unlike Webvan — or even the largely successful FreshDirect — Retail Relay Inc. seeks to minimize capital investment and avoid the pursuit of scale economies and mass-market consumers by building uniquely local capabilities. Founded in 2007, the company offers online grocery shopping in Charlottesville and Richmond, Va., in partnership with local retailers, farmers, and employers through its website, RelayFoods.com. (Disclosure: I have served as an advisor to Relay since its founding.) The site offers more than 15,000 items in each city from a combined network of roughly 90 local farms and stores, and taps into the food movement popularized by Michael Pollan in the *New York Times* bestseller *The Omnivore's Dilemma: A Natural History of Four Meals* (Penguin Press, 2006). Instead of targeting major metropolitan markets, Relay scales its operations to smaller cities and towns. It can afford to serve these less-dense populations by offering a mix of pickup locations throughout the area rather than seeking to serve all customers through a home delivery model.

Like Zappos and Quidsi, the company does not seek the generic mass-market customer but instead focuses on a particular demographic — in this case, time-strapped "locavores" — that it can serve with a superior business model and turn into loyal customers. Relay views its ties to the local community as its competitive barrier to entry.

The Relay model stands in stark contrast to the failed models of the past as well as the current competition. Amazon also launched an experiment in online grocery, Amazon Fresh, in 2007. Although it is well aware of the challenges faced by Webvan and other online grocers, Amazon cannot ignore groceries, which represent a huge portion of total retail sales, if it expects to be Earth's biggest store. Doug Herrington, the company's VP of consumables, told *Bloomberg* magazine in September 2009, "We have a lot of confidence in the long-term economics. For a significant portion of the population, they're going to find that the convenience, selection and pricing of online grocery shopping is going to be really compelling."

Although the thin margins and operational complexity in grocery have constrained Amazon from extending its pilot efforts beyond Seattle and London, no pure-play Internet retailer is better positioned for the challenge of precise, cost-effective delivery. Amazon can leverage its technological and operational expertise in a scale-based model once the market reaches the necessary size. Similarly, online grocer Peapod, founded in 1989, can leverage the existing footprint and scale of its parent, the $39 billion, Netherlands-based global grocer Royal Ahold NV, which operates hundreds of supermarkets in the U.S., including the Stop & Shop and Giant chains.

Execution Matters

Focusing on developing loyal customers and unique, local capabilities does not guarantee success on the Internet. Companies must inevitably fend off the competition by executing their strategies well. In September 2010 — about halfway between its first and second funding rounds in Groupon — Battery Ventures founder Rick Frisbie told the *Wall Street Journal,* "I'm still not absolutely convinced that Groupon will be the kind of success we hope it will be." He went on to explain that the company faces immense competition and a potentially indefensible position despite its current dominant market leadership.

Consider even the highly lauded Facebook. It leveraged its eye-popping growth rate to attract investors to fund investments in capabilities that attracted more and more users, which in turn attracted more investors, and, finally, some advertising revenue. Facebook has such a large base of users that it can help advertisers seek tightly focused customer segments. But now that Facebook has provided a blueprint, could a new competitor focus on a specific segment and steal those advertising dollars? Unlike the loyal customers of a Zappos or a Quidsi, the mass market can be quite fickle. As a reminder, Facebook CEO Mark Zuckerberg, who was named *Time*'s Person of the Year for 2010, might want to think about past magazine covers featuring the CEOs of what *Time* described as famous Web flameouts: Friendster, Napster, and Pets.com. Groupon founder Andrew Mason reportedly keeps these on display alongside his own *Forbes* cover in his Chicago headquarters, as a constant reminder that competitive advantage can be fleeting and that scale isn't everything.

For most aspiring Internet entrepreneurs in today's online environment, the most likely paths to success will start with focus, build on success, and then — and only then — lead to scale.

Author's Note: *A host of collaborators have helped discern the evolving trends on the Internet, including former Booz & Company colleagues Barrie Berg, Silas Byrne, Chris Capers, Anne Chung, Anand Devendran, David Evans, Pat Houston, Angela Huang, Brian Long, David Torres, and Martha Turner. More recently, academic collaborators Ken Boyer, Brent Goldfarb, David Kirsch, Eve Rosenzweig, Aleda Roth, Johnny Rungtusanatham, and, especially, Elliot Rabinovich have helped shape my thinking.* +

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