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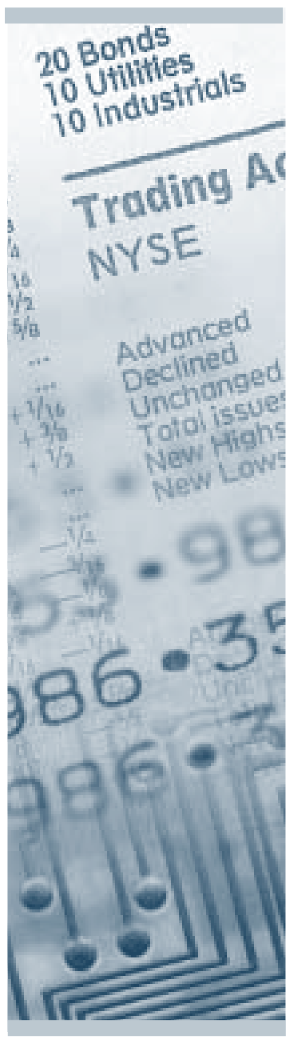

Assuring the Price is Right Online

eStrategy Brief

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In 1999, more than 300 Internet companies went public. While average revenues were about $18 million, average costs were twice that amount, leading to losses of about $18 million. At first, investors assumed this was a good thing—that growth should be the primary objective, profits could be generated later. But as losses grew worse, investors grew skeptical. Stock prices of e-tailers plummeted: CDnow dropped 44 percent in the second half of 1999; eToys fell 35 percent; Beyond.com, a whopping 72 percent. Even the mighty Amazon lost 25 percent in the last two months of 1999. Investors demanded evidence of a real business model, with real economic value. And Buy.com, which built its brand on beating any price on the Web—even if that meant selling below cost—had to revise its proposition to go public.

Then came Christmas 1999. The lesson: too many customers were happy with Internet prices. Almost none were happy with service quality. The choice: should e-tailers raise prices to help fund the services that customers are now demanding, or simply generate bigger losses and hope somehow to survive or be acquired? In a world where competitors are pricing below cost, should a traditional company match prices online (creating significant problems for its offline business), or build a sustainable business model and wait for its competitors to fall apart? These are life or death decisions, and many companies have inadequate experience dealing with them. Where to start?

Be clear on where competition is misplaced: don't price in a manner that turns core channels into competitors.

Size up the competition

First, size up the competition. Analyze your economics relative to theirs and understand industry dynamics. If you determine competitors are pricing below cost, you need to decide how long they can sustain it. If they have deep pockets—and you do, too—you may have to match their prices, signaling that they can't win with these tactics and encouraging them to return margins to sane levels. Or, in a branded industry, differentiate, price sanely and let the competition give away margin. If competitors can't sustain the losses, you may let them implode and pick up the pieces afterwards.

Barnes & Noble bought Books.com, a foundering cut-price e-tailer, and now sells online at only three percent below the offline price. Buy.com had to abandon its zero-margin approach to attract more financing; even with cut-throat pricing it couldn't achieve the scale necessary to survive on advertising revenues alone.

At the same time, be clear on where competition is misplaced: don't price in a manner that turns core channels into competitors. Both Levi's and Reebok have pulled out of the Internet in part because direct sales irritated distributors. 3Com Direct prices its Palm V almost 20 percent above low-price distributors like eCost.com and Buy.com. It's not giving away profits; it's providing visitors to its site an expected service—the ability to purchase—but at a price point that won't alienate its existing channels.

Introductory pricing or loss-leading works only where you can hook customers securely enough to cross-sell higher margin goods or ongoing services. And such a strategy is less likely to take in an environment where consumers can switch retailers with the click of a mouse and cherry pick free offers.

Don't bank on price increases

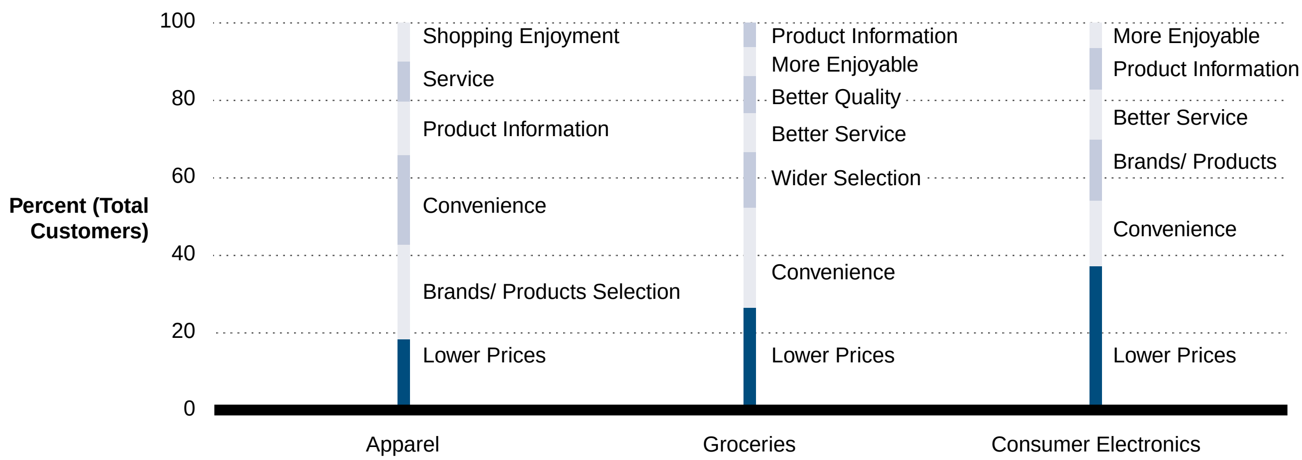
Next, lead with your true value proposition. Use the Internet to create profitable customers. It may seem at first glance that loss-leading dominates Internet retail. Amazon offers 50 percent off all bestsellers; CDnow offers 30 percent off recent top albums. The Internet does allow consumers to spot bargains and change retailers instantly, but so far price-based competition remains concentrated in commodity products like books, music, and consumer electronics. Meanwhile, the low-price players, like Buy.com, Onsale, and Accompany, are bleeding losses. Their promise to achieve profits through access to large customer bases is wearing thin.

The fact is, early adopters of a new technology, like the Internet, are usually less price-sensitive and more convenience driven. Therefore, cut-price retailers are probably leaving money on the table. Penetrating a more typical slice of the population brings in lower incomes and greater price sensitivity. Just think of the price trajectories of cell phones, computers or broadband access—all straight down.

Trials or temporary promotions with built-in switching costs are one thing. Witness how AOL has grown its 20 million customer base through offering one month's free trial, at the end of which customers are reluctant to change their e-mail addresses. But changing price expectations is another. Just ask the online publishers. *The Wall Street Journal* signed up 600,000 subscribers for an introductory offer of free news online. When it introduced a fee, subscribers dropped to 50,000, and then slowly climbed back to 150,000. *Business Week, Fortune, The Economist,* and *TheStreet.com* all are grappling with the same dilemma—how to convert freebies into profitable revenue streams?

Introductory pricing or loss-leading works only where you can hook customers securely enough to cross-sell higher margin goods or ongoing services. And such a strategy is less likely to take in an environment where consumers can switch retailers with the click of a mouse and cherry pick free offers. Witness last year's fiasco over PC deals with Internet sign-up. Microworkz of Seattle began pitching a computer and Internet service deal for $299 in the spring of 1999. By summer, its chief executive officer resigned amid customers' complaints that they did not receive computers, and the Internet service provider ended its partnership. New York-based Enchilada.com stopped accepting free orders for Internet sign up in July, and DirectWeb.com of New Jersey stopped shipping free PCs in October. FreeMac.com has promised 1 million free iMacs but has yet to give one away. It ended its free program in late November with one million people on its waiting list. Executives involved in such debacles blame the problem on scale. The bottom line is that companies should invest in great online services at the outset, and price them accordingly. If you plan to raise prices later, then strategically test the waters now. Don't just hypothesize a pricing strategy—confirm it.

Figure 1: **Customer reasons for making Internet purchases**



Source: Bain & Company/ Mainspring Online Retailing Survey (n=2116), December 1999

Bolster your brand

To get your value proposition right, understand what you stand for, and why. The message you send customers online and off should be consistent. Customers know that the Internet cuts costs for some retailers. If you have a reputation for passing on distribution savings to customers, for example by selling financial services direct, then you need to offer discounts online. On the other hand, take Wal–Mart: its position is "Always Low Prices." So what would the company be signaling if it went online with even lower prices? Would that suggest to customers that there is "fat" in the offline world and undermine its position? Or consider Neiman Marcus: it has built a brand around quality and service. Competing online on price would only confuse customers and erode the brand.

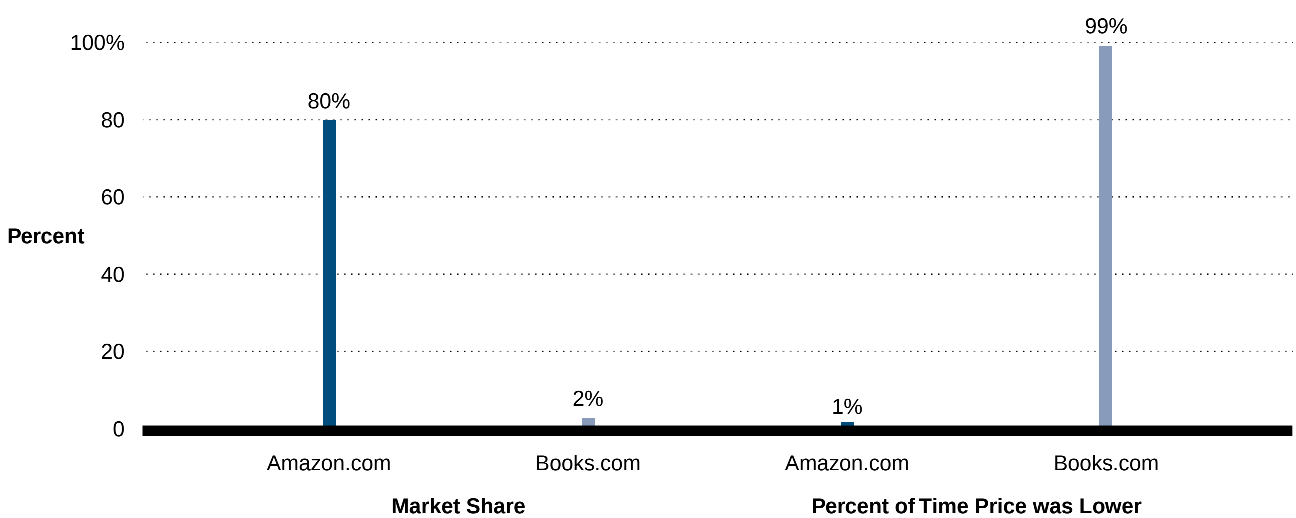
Indeed, bolstering brands through consistent pricing gives bricks–and–mortar companies a tremendous advantage online. The sheer number of e–tailers is overwhelming to most consumers. Concerns about transaction security and stories of goods failing to appear mean that consumers are unsure of whom to trust. Many consider brand a key purchase criteria. ***(Figure 1)*** In response, pure–play retailers are spending huge sums on brand building. Internet firms spent about $2 billion on offline advertising in 1999, and only a handful are achieving their goal. Today, five percent of sites experience 75 percent of hits. That gives street–level retailers with trusted brands a head start in cyberspace and strong rationale for integrated pricing. Consider Toys "R" Us. It launched its defensive Internet play in 1998, a year after the online leader, eToys, and experienced difficulties.

By Christmas 1998, Toys "R" Us's web sales had barely blipped. Then the company neglected to develop adequate order handling and fulfillment capabilities, generating widespread bad press. Nonetheless, the company kept its pricing consistent and has closed on eToys fast: the 1999 battle for holiday traffic was fiercely fought, with eToys emerging only just ahead.

Consistent pricing that bolsters brand doesn't mean all customers need to pay the same price. Rather, companies can use different selling vehicles and offerings to reach different types of customers.

Pure plays with brand equity can position themselves upstream, too. For example, the overall price of books on the Internet varies 33 percent, and the most strongly branded online bookseller, Amazon, often prices higher than its competitors. Its prices are 3–13 percent more than the likes of Kaboombooks, Books a Million, and Buy.com—and Amazon still enjoys dominant share. By contrast, the market share of the former Books.com, whose prices were lower than Amazon's 99 percent of the time, never exceeded two percent.[1] ***(Figure 2)*** Clearly, consumers are willing to pay for a trusted, consistent brand.

***Figure 2*: Market share vs. relative pricing**



Source: "Frictionless Commerce? A Comparison of Internet and Conventional Retailers," MIT Sloan School of Management, August 1998.

[1] *Since the study, Books.com has been acquired by Barnes & Noble.*

Segment for premium pricing... or bargain hunting

But consistent pricing that bolsters brand doesn't mean all customers need to pay the same price. Rather, companies can use different selling vehicles and offerings to reach different types of customers.

Some will want top-quality service, speed, ease of shopping, and rewards—and be willing to pay a premium. After all, such differentiation requires investment. What has Amazon done with the $80-to-$250 million it's gained from its price premium? Besides building its brand, it prioritized investment in customer support, product selection, patents to protect its state-of-the-art "1-Click" shopping model, and order fulfillment—in short, top-quality service. Now it's moving to reduce operating losses. And Amazon is not alone. Many others on the Web are achieving price premiums by building their brands—including awareness of their sites—and differentiating their services.

Online grocers invest in tailoring refillable shopping lists and loyalty rewards. Companies such as Dell have invested in capabilities that are difficult to replicate, like superior inventory management and manufacturing. Other successful examples of premium-priced service differentiation include enhanced delivery (e.g., Staples' next-day delivery promise); online customer feedback and shopping assistance (e.g., Amazon's customer-written book reviews and purchase suggestions); customization (e.g., Procter & Gamble's Reflect.com, which by customizing health and beauty products can charge salon-like premiums); and third-party endorsements (e.g., Microsoft's endorsement of Internet site hosting service providers), which enhance consumer trust. Service differentiation and trust in the brand allows Schwab to charge $29.99 per stock transaction—versus $8 at even cheaper discount brokerages—and still capture 70 percent of the pool of profits in online trading.

Such differentiation serves both to justify premiums and to protect them by effectively erecting switching costs. What satisfied customer wants the trouble of reconstituting shopping lists? Rewriting his or her personal profile? Setting up accounts with another broker?

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But some segments don't care about speed or service; they want a bargain. The same company offering high, fixed prices to its time-sensitive customers can offer bargains to price-sensitive customers through Internet auctions and other so-called "dynamic pricing" vehicles. Indeed, the Web has struck a revival in dynamic pricing, where vendors adjust prices in real time, based on observed, rather than estimated, supply and demand, as in the old farmer's market or village bazaar. Today, these dynamic models most often are used for distressed or perishable inventory, like clearance goods or airline tickets. These models not only allow retailers to perfectly price differentiate, but also allow consumers the thrill of the hunt. ***(Figure 3)*** The future sees firms increasingly using the Web to segment pricing according to different customer needs.

Develop a financial vision, not a pipe dream

So how, in the end, do you know if your online pricing strategy is right? How do you know you aren't substituting fantasy for financial vision? So many hot Internet IPOs have missed targets by a mile. Fashionmall's losses have been 17 percent[2] more than expected; Value America's 1999 profits are expected to come in 33 percent below nine-month-old forecasts. This, despite meeting revenue targets. The list goes on. One has to ask whether these companies truly did their homework. Did they include in their business models the fundamentals of intelligent financial planning? Did they assess conversion rates of browsers to shoppers? Retention rates of customers? The lifetime value of loyal customers? And did they understand what pricing strategy would correctly signal their value proposition

***Figure 3*: Dynamic pricing models**

	Overview	Examples
Ascending Auctions	Goods are allocated through a bidding process that determines which customers are willing to pay the most.	• eBay • Onsale • uBid
Descending Auctions	Goods are allocated to customers on a first-come, first-served basis as the price declines over a given period, or until the supply is exhausted.	• Basement.com
Reverse Auctions	Sellers, rather than buyers, compete to offer the lowest price for goods.	• eWanted • FreeMarkets • Nextag
Name Your Own Price	Customers make an offer to a seller or group of sellers for goods based on their estimate of the seller's lowest acceptable price.	• Priceline • Expedia (on hotel reservations only)
Demand Aggregators	Sellers offer tiered pricing to ad hoc buying cooperatives in which the unit price declines as the quantity purchased increases.	• Accompany • ActBig • Mercata

Source: Bain & Company/ Mainspring Analysis

[2]Source: Gruntal & Co, 5/1999

and attract the right customers to begin with? Online businesses, like bricks-and-mortar companies, need to do the research—to understand their customers' needs and competitors' cost structures relative to their own—and price for profitability.

After all, appropriate pricing is fundamental to getting your marketing mix right in any business. The Internet is a new channel—not a whole new ballgame. For some companies, low prices will be the right answer. But any company can drive customer traffic with unsustainable price cuts—just ask Caldor, Crazy Eddie, 47th Street Photo, or any other defunct retailer. Popular Internet metrics like "traffic," "click-throughs," "eyeballs," and just plain revenues are wrong-minded. Look instead at the pricing strategies of retailers who are creating and keeping profitable, lifetime customers—The Gap, Dell—to measure success. Then ask, and answer, the full gamut of hard questions: how much should you invest in price reductions versus service versus marketing versus capabilities? Who are your most attractive customers and what is the right pricing model to go after them?

The IRS distinguishes between a "business" and a "hobby" based on whether the activity in question is designed to be profitable and achieves its design within a few years. From the numbers posted on last year's Internet IPOs, too many online operators are making a hobby of bad business. To be successful, you need the right pricing strategy—or you may go out of business altogether.

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Bain & Company: Strategy for sustainable results

Bain is one of the world's leading global business consulting firms. Its 2,500 professionals serve major multinationals and other organizations through an integrated network of 26 offices in 18 countries. Its fact-based, "outside-in" approach is unique, and its immense experience base, developed over 27 years, covers a complete range of critical business issues in every economic sector. Bain's entire approach is based on two guiding principles:

1) working in true collaboration with clients to craft and implement customized strategies that yield significant, measurable, and sustainable results, and

2) developing processes that strengthen a client's organization and create lasting competitive advantage. The firm gauges its success solely by its clients' achievements.

Bain & Company's global e-commerce practice helps businesses achieve outstanding results in the new economy. We work with traditional companies to launch and manage online operations, and with pre-IPO clients to hone business models and accelerate to market. We also work with entrepreneurs to incubate new ideas into viable businesses, in some cases taking equity stakes through our bainlab subsidiary. Our e-commerce practice professionals work around the globe in every major industry.

Mainspring eStrategy Consulting

Mainspring is the leading eStrategy consulting firm that focuses exclusively on developing actionable Internet strategies. It enables Fortune 1000 companies to protect, evolve, and transform their business for sustained competitive advantage by offering an integrated process of business, customer, and technology strategy planning. Its proprietary process hinges on the following activities to help guide clients effectively through eStrategy development:

- Building the Business Model
- Creating the Customer Experience
- Defining the Solution Architecture
- Commercializing the Business Plan

Working with Mainspring, companies identify, define, and formulate a portfolio of strategic Internet initiatives that are customized for their business and designed to create sustainable competitive advantage.

Mainspring's core services include eStrategy Consulting, eStrategy Direct, and the eStrategy Executive Council. These services are provided to companies in the financial services; retail and consumer goods; technology, communications, and media; and manufacturing industries. Mainspring was founded in 1996 and has offices in Cambridge, Massachusetts and New York City.

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