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Will Your Business Model Float?

Everyone has ideas about how to make money on the Web. Some of those ideas are better than others.

By E.B.Baatz

Hatching an online business ain't easy. You've got to convince investors to fund you, advertisers to support you and customers to visit you. But why should any of those people do any of those things when they· and perhaps even you· don't understand the business you're operating?

The fact that the business models emerging on the Internet are still fuzzy around the edges is no reason to get discouraged. Historically, some of the best ideas have taken a while to come into focus. Take nitrous oxide, for example. Laughing gas was discovered in England in 1772, and by the turn of the century scientists were talking about it in lectures, and the curious were attending ether frolics at entertainment halls. But it was not until 1846 that someone got the bright idea of using the gas to dull pain during surgery.

Of course, no one is laughing today at the difficulties of discovering ways to make money on the Web. "The problem is that the development of the Internet is happening so quickly that we are at a loss to find any business models to put it in," says Howard Anderson, managing director of the Yankee Group. "We search for analogies....and all those analogies are right for a while, and then they are wrong."

The solution, for many established companies and startups, has been to apply traditional business models such as advertising, subscription services and retail sales to the Web, sometimes giving them a little interactive fillip. Hybrid models that allow businesses to market ancillary services to their product lines have sprung up as well. For example, FTD Inc., the flower delivery service, now offers to e-mail customers reminders of birthdays, anniversaries and other bouquet-worthy dates.

Some people, however, believe that for Web businesses to thrive they must cast off their old skins to emerge as new· and, for now, unrecognizable· creatures. "Most people have come to the conclusion that there are entirely new business models on the Web, but we haven't broken the code yet," says Bob Weinberger, vice president of marketing at Open Market Inc., a Web software developer.

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This article looks at the advantages and drawbacks of some common Internet business models as well as at some companies that are trying to break the code.

1. The Advertising Model

Because much of the Web looks at first glance like a traditional publishing medium, advertising has emerged as the dominant business model to date. HotWired Ventures LLC, for example, charges companies as much as $15,000 a month to post banners about their products and services, and advertisers pay between $8,500 and $20,400 for space on Netscape Communications Corp.'s site. Market research company Jupiter Communications pegs the average ad revenue for leading Web sites at $1.2 million for 1995.

Although high-tech sponsors are predictably numerous, Web advertisers are not limited to companies targeting get-a-life engineers. Rather, they represent a range of Fortune 1000 companies. Gatorade, for example, turned up on ESPNet SportsZone, which also signed up AT&T Corp., Visa International and others for what Jupiter calls a "groundbreaking" $100,000 per quarter. And Bill Gates' latest partner, NBC, has doled out some of its ad budget to Infoseek Corp., HotWired and Yahoo Corp.

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"Advertising revenue is a juicy target," says Eric Schlachter, a lawyer at law firm Cooley Godward and an adjunct professor of cyberspace law at Santa Clara University. "With TV, cable and classified advertising collectively generating [tens of billion of dollars] in revenues last year, everyone wants a piece of the action." For now, however, the online piece is small: A Forrester Research Inc. study from June 1996 predicted that companies will spend $10 million to advertise on the Web this year. By 2000, the study said, that figure will grow to $2.2 billion.

Not surprisingly, the owners of many sites have found advertising a very hard sell indeed. It's not just that potential sponsors don't "get it," although that's certainly been the case. It's also that many ad sales efforts fail because companies don't understand how the Web changes communication between consumer and advertiser. "The traditional advertiser is centered on the firm broadcasting a message to the consumer, with the flow of information predominantly from seller to buyer," says Richard T. Watson, a University of Georgia business professor and co-author of Metamorphosis: An Introduction to the World Wide Web and Electronic Commerce (John Wiley & Sons

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Electronic Commerce (John Wiley & Sons, 1996). "The Web puts this flow into reverse, and this shift in communication patterns is profound."

What this shift enables is one-to-one advertising· or "narrowcasting"· which is wonderful in theory but often difficult in practice. And it has caused advertisers and Web publishers to scratch their heads about how to price ads on the Web and monitor their effectiveness. The result is that advertisers are starting to experiment with alternatives to the traditional cost-per-thousand model. "The technology is coming so that advertisers can target their audience, track click-through and pay only a nickel an impression," says Dykki Settle, vice president of technology for Ventana Communications Group, the official publisher of Netscape computer books.

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-Eric Schlachter

That's precisely what The Proctor & Gamble Co. started doing in May 1996 in a well-publicized deal with mega-index Yahoo. Rather than paying a set fee to place its banner on Yahoo's site, P&G is paying only for customers who actually click on that banner.

Even more innovative is the approach taken by CyberGold Inc., a startup masterminded by software entrepreneur Nathaniel Goldhaber together with advertising heavyweights Regis McKenna and Jay Chiat. CyberGold charges an advertiser only for visitors who have actually clicked through its site. And the Web surfer who moves past the initial banner gets rewarded by CyberGold with "digital currency," that can be "spent" online for merchandise, discounts and the like. "It's analogous to Publishers Clearing House," says André Marquis, director of marketing for CyberGold. "The potential for reward increases the farther into the Web site the consumer goes, and the advertiser, via CyberGold, pays the consumer for his attention."

While outfits like CyberGold try to quell the confusion about tracking and billing, several high-profile failures have recently dimmed the prospect for online ad sales. In April, Time Inc. New Media's senior vice president announced that the company's Pathfinder Personal Edition service would shift to a subscription model because an "advertising model doesn't support the cost of creating content." And Songline Studios Inc.'s Web Review, which had attempted to operate a free information service supported by advertising, pulled the plug in May. At the time, president Dale Dougherty said Web Review would return only if at least 5,000 people agreed to pony up $19.95 each for a

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six-month subscription.

2. The Subscription Model

Time's and Songline Studios' decisions to pursue a subscription model· in which customers pay to access information· make sense from a normal economic perspective. But not much is normal on the Internet, where consumers expect lots of free information. And the economics of free stuff, except in the software industry, doesn't look so good.

"Web site entrepreneurs are not prepared to hear that the subscription model is uniquely unsuited to the Web environment," says Schlachter. "The problem is that it's not clear that any profits are going to be available in Webspace by trying to mimic the commercial online services. Prodigy is not and never has been profitable, and neither are most commercial bulletin boards."

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>
> -Jim Sterne

Jim Sterne, president of Target Marketing of Santa Barbara and a columnist for WebMaster, agrees. "The only one I've seen so far that makes sense is The Wall Street Journal, because the price is right and the brand is trusted," says Sterne. At $29 per year for readers who subscribe to the paper version and $49 for nonsubscribers, a personalized Journal is a bargain. "If The Wall Street Journal doesn't make it, no one will," says Sterne.

Other high-profile publishers that have experimented with the subscription model include the San Jose Mercury News and USA Today .(USA Today decided against selling subscriptions in August 1995, at the same time it abandoned its proprietary Internet access business.) But no one is talking about how many customers they've signed up, so their success is tough to gauge. Paradoxically, some argue that the existence of vast quantities of free information on the Net will actually make people more willing to pay for the best stuff. "As the amount of free garbage on the Web goes up, more people will be willing to pay for branded information," says Settle. He mentions stock investment and pornography sites as examples of flat-fee subscription services that are reportedly doing quite well online.

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>
> -Esther Dyson

Even if mass marketing a subscription service to consumers doesn't work, business-to-business niche subscription services may have a chance. For one thing, as more and more of the Web is commercialized, the freebie culture starts to disappear. Also, a Web startup can survive a long time with minimal capital equipment costs and with no expenses for printing, advertising or direct mail. "If a company can advertising or direct mail. "If a company can build subscribers in a small but rapidly growing market with [low costs] and maintain that share when the market gets bigger, it should reap good profit margins," says Mary Meeker, an analyst of new media at Morgan Stanley & Co.'s equity research department.

Another approach with revenue potential is microsubscriptions, whereby hundreds of thousands of users pay pennies for snippets of information. Instead of paying $20 for an entire cookbook, for example, a consumer would shell out five cents for a single recipe. The software for accepting such minuscule sums is still a work in progress, but "any publisher with any technical savvy is looking into micropayment standards for the Web browser," says Settle.

3. The Retail Model

Drowning out the noise around advertising and subscribing, Web retailing is now generating the biggest buzz. While retail shopping on the Internet amounted to just $254 million at the end of 1995, that number will grow more than 10 times to $2.7 billion by 1997, according to the Yankee Group.

One of the biggest success stories in this area so far has been the Internet Shopping Network, which sells approximately $1 million worth of computers and other products every month. But ISN's approach has hardly been innovative: In fact, it precisely mimics that of its parent company, cable TV's Home Shopping Network. "We work very much like a normal retailer, except we use e-mail," says Bill Rollinson, co-founder of ISN.

Companies that are both making money and pushing the retail envelope share three characteristics, says Gregory Wester, director of interactive commerce at the Yankee Group. First, they have created strong brand identity. Second, they know their customers. And third, they sell inexpensive consumer products such as flowers, books and CDs that the buyer doesn't spend much time deciding to purchase.

Net retailers also have a better chance if they aren't bogged down by established, expensive distribution networks. There are 5,000 to 8,000 sites selling products through Web catalogs, and many more are coming online every month, according to Craig Danuloff, president and CEO of ICat Corp., which helps companies set up such catalogs. "The high-profile success of a company like Amazon.com Books has an impact on the market," says Danuloff.

"It's radical. Amazon has no capital, no infrastructure, no warehousing, no customer

Finding it Online

Cisco Systems Inc.
(http://www.cisco.com)

CyberGold Inc.
(http://www.cybergold.com)

Webwatch by Eric Schlachter
(http://www.boardwatch.com/mag/95/jul/bwm39.htm)

GeoSystems Global Corp.
(http://www.geosys.com)

IBM Corp.
(http://www.ibm.com)

ICat Corp.
(http://www.icat.com)

Industry.Net Inc.
(http://www.industry.net)

Internet Shopping Network
(http://www.isn.com)

MapQuest
(http://www.mapquest.com)

The Internet Report (excerpt)
(http://www.ms.com/misc/inet/morganh.html)

Open Market Inc.
(http://www.openmarket.com)

PhotoDisc Inc.
(http://www.photodisc.com)

Ventana Communications Group

(http://www.vmedia.com)

Yankee Group
(http://www.yankeegroup.com)

Request Reprints

service, no shipping. All they do is market books on the Web, and their sales are exceeding the busiest single B. Dalton bookstore."

Other companies, adopting the "safety in numbers" maxim, are flocking to Internet malls. In this model, a single operator gathers numerous businesses on one site, often hosting them on its servers. Tenants benefit from mallwide promotions and increased traffic; the operator takes a cut of the revenues and/or a location fee. Online malls generally fall into two categories: horizontal, in which a variety of business types are represented, and vertical, in which many players from a single industry share the site. "Everyone was talking about the mall Web model in 1995, but I'm bearish now," says Schlachter. "I'm doing a deal now where the mall operator wants 50 percent, and I am skeptical. I simply don't see the mall adding much value." Sterne likewise thinks Web malls are, well, "stupid." In real life, says Sterne, "there is value in driving to one place where all the stores are together, but on the Web, all the stores are just 24 inches from my nose. And I can create my own 'sporting goods mall' on the Web, for example, simply by typing in 'sporting goods' in Yahoo."

Still, some of the more specialized, business-oriented malls are flourishing. Industry.Net Online Marketplace, for example, features a collection of Web business centers for such industrial products as fluid power pumps and bearings. Industry.Net Inc. reportedly generates about $20 million a year in Web business alone, and Online Marketplace is generally considered one of the earliest and most successful vertical malls. But once again, the lines are blurring. CEO Jim Manzi, who recently assumed the helm at Nets Inc., (a holding company formed from the merger of Industry.Net and AT&T Corp.'s New Media Services unit), says Industry.Net's main competitors are Cahners Publishing Co. and Thomas Publishing Co., both traditional print publishers. And Manzi, the former chief of Lotus Development Corp., says he sees a future in which the company will act more as a broker, facilitating and charging for transactions between buyers and sellers.

4. The Software Model

The only established business model that can credibly claim to be new and largely Net-specific was pioneered by the software industry. The obvious reasons: Engineering and programming types swarm over the Net like algae in red tide, and the product itself can be distributed, as well as marketed, over wires.

But software is also unusual because it operates under a principle of "increasing returns" in which market leaders win big and losers are crushed, according to W. Brian Arthur, a professor at Stanford University and the Santa Fe Institute. Under this model, the more software a manufacturer gives away, the more likely it is that the product will become a standard. That leads to higher returns, which can then be used to kill the competition. Today, selling software at cost· or even at a loss· in order to move higher margin upgrades, support services and, as in the case of Intuit Inc., even checks, is the norm in the packaged software industry. Netscape, of course, stands as a shining example. Computer games, such as Doom, have also prospered using this model.

Another advantage to the Internet is that it offers transaction options· such as pay-for-use· not available to the shrink-wrap market, according to industry expert Esther Dyson. "The market, with the Internet leading the way, is moving in the direction of compensating people for services related to information, not the information itself. So the 'book' model of the software package will become less prevalent in the Internet marketplace," says Dyson.

The popularity of procuring software over the Net is changing life even at the most established companies. In August, IBM Corp. announced a service, called AlphaWorks, that lets Web users download work-in-progress software for free from the company's research facilities. Instead of spending months preparing lengthy market research studies before releasing a product, IBM will now be able to gather statistics based on Web hits, do its marketing plan on the fly and roll out new Internet products much more quickly.

"It used to be that we didn't talk about unannounced products and we didn't release a product until we had a 35-page license agreement, so this is a big, big change," says Andrew C. Morbitzer, IBM's manager of AlphaWorks advanced Internet technology.

5. Emerging Models

The Web's most interesting models are those for which we don't yet have names. Like doctors working with laughing gas in the 1800s before the legitimizing moniker of "anesthesia," entrepreneurs in basements and office towers around the world are creating new business models without the words to describe them.

A startup called Onsale, for example, operates like a cross between a retail store and a game (see WebMaster, January/February 1996). The company buys refurbished and close-out products, including PCs and car audio systems, then sells them in a Dutch auction (in which the top five bidders get the product for the second-highest bid). Customers tack e-mail messages onto their bids to psych out the other players, and winners get their names posted on the site.

Another business with an unusual model is GeoSystems Global Corp. The company, which offers several services on its MapQuest site, is pursuing the subscription, advertising, and software and services models simultaneously.

A spinoff of R.R. Donnelley & Sons Co., GeoSystems has been making maps for decades, moving to a CD-ROM format six years ago. But the company's executives were disappointed with the results. "We always felt that applications for electronic mapping should be taking off faster, but it didn't really accelerate until the Web was invented," says Perry Evans, vice president and general manager of the company's Internet Business Unit.

Now Geosystems makes money by creating and hosting digital maps for companies like The Sharper Image for a fee of $15,000 to $25,000 per year. "The company sends us a file with store locations, and we geocode the stores on our server," Evans explains. An even newer service, called MapQuest Connect, allows companies to dynamically code maps on their own servers. And in order to build a strong consumer franchise and open up a new advertising revenue stream, the MapQuest services allow visitors to plot their own geographic landmarks· home, church, etc.· on maps residing on the site.

Then there's PhotoDisc Inc., which sells stock photography over the Web to designers and site developers. The company started off using the Web to market its CD-ROM products and then, for a three-month period in 1995, allowed customers to download one free image each. Now it sells stock photos, for prices as low as $9.95 and as high as $189.95, to Web publishers over the Internet.

That would seem to be a fairly standard transaction model, but the marriage of software with the stock photo business has produced something more unusual. PhotoDisc is using technology developed by Virage Inc. that allows customers to search for photos based on criteria such as texture and color or to isolate a piece of a photo, for example, a nose on a face. Such features have generated a surge in demand, according to the company: PhotoDisc generated $300,000 in sales in its first six months, from 60,000 hits and 1,000 unique visitors per day. Those figures are now "screaming upwards" according to Vice President of Business Development Bill Heston, who says the company currently brings in as much as $100,000 per week.

"We're still working on our pricing model, and the business model is emerging rapidly," says Heston. "But we're starting to see that we're selling not just images. We're selling an image acquisition tool right at the desktop."

That's a whole new way of thinking for a company born in brick and mortar. But on the Web, nothing less will do.

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