BAIN & COMPANY

B2B exchanges

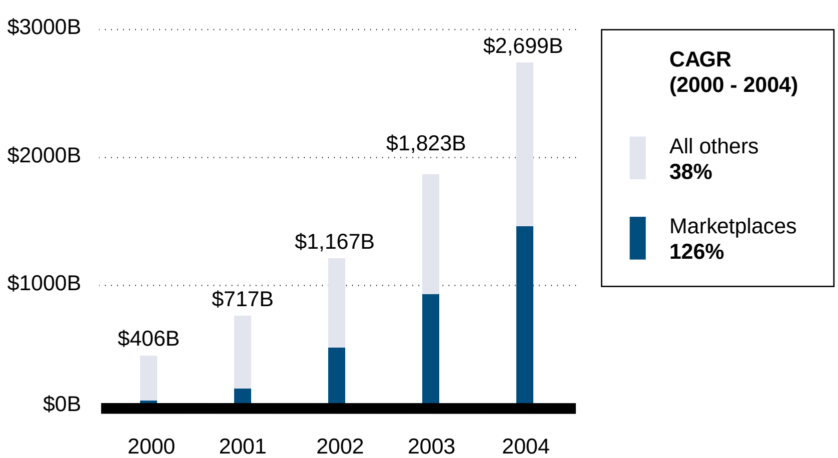
The narrow path to victory

By Michael Collins & Phil Schefter

The hype is over for business-to-business (B2B) exchanges. The true path to value is just emerging.

Last fall, market researchers estimated anywhere from $1 trillion to $2 trillion of commerce would accrue to electronic exchanges over the next four years, and the stock market went wild. ***(Figure 1)*** By March, 700 exchanges had sprouted in North America alone. Then, in April, the stock market caught on to a dirty little secret: most exchanges, premised on thick margins, high volumes and low capital requirements, had yet to host a transaction, and for those that had, typical margins were razor thin. Stock prices of B2B marketplace darlings like Ariba and VerticalNet plummeted 60 percent to 80 percent.

***Figure 1*: B2B growth forecasts**



Source: Analyst Reports

Michael Collins is a vice president in Bain & Company's Chicago office. Phil Schefter is a Bain vice president in Boston.

Figure 2: **There are many marketplace models emerging**

Types of Vertical Marketplaces

	Seller Centric Sites	Auction Sites	Multi-Vendor Catalogs	Exchange	Collaborative	Buyer Centric Network
Description	• Easy to use site to purchase from one seller	• Match buyers/ sellers through real-time spot markets	• Online, easy to search "mega" catalogs	• Environment for buy/sell transactions - RFP/RFQ - negotiation close - links to supply chain	• Align demand with available capacity	• Proprietary network from one company to selected suppliers
Examples	• Cisco.com	• Free-markets	• Ventro (Chemdex)	• E-steel	• Collabria	• Dell extranet

Auction

Horizontal Enablers

Auction	Procurement	Supply chain	Web stores	Database

Source: Bain & Company Analysis

But the road to victory for these exchanges isn't closed, it's just narrow. The truth is, most exchange operators still lack a viable plan to get from marketplace to market value. We don't mean inflated stock prices, vulnerable to puncture, but true market value where buyers and sellers are better off because the marketplace reduces real costs all around and enables new services.

The true path to value creation

The true path to value creation looks something like this: Buyers are exposed to new sellers, sellers are exposed to new buyers, product, search and transaction costs are reduced, information exchange is enhanced and, ultimately, supply-chain relationships are improved and costs drastically reduced as information is shared and leveraged across industry participants. We've seen this scenario on the B2C side in the success of eBay and Priceline.

But the opportunity is narrow because it focuses on a few sweet spots in the market—where supply and demand are fragmented, or transaction costs are high, or the pricing mechanism is inefficient, or there are imperfections in balancing supply and demand. ***(Figure 2)*** Even once on the path, there's a bog to cross: swift growth to scale. Market leader Ventro's Chemdex, which aggregates bio-reagents for academic researchers in myriad universities and private laboratories, has hit several of these sweet spots and is leading the charge in the fragmented life-sciences market that has historically had high search costs.

Need for scale

But Chemdex still has some distance to go to achieve the scale that will drive profitability. In fiscal 1999, it had \$30.8 million in revenue, accelerating to \$54 million for the 12 months ended March 30, 2000. Apply that scale to a less-than-perfect scenario where you have highly evolved distributors, low margins and consolidated supply, and you've got a losing proposition. Take VerticalNet, another early mover in exchanges, which operates marketplaces and communities for commodity industries with entrenched distribution networks like water, gas, and paper. It lost \$53.5 million in 1999 on just \$20.8 million in sales.

Indeed, the early stock-price and earnings winner in electronic marketplaces appears to be Oracle, the software company behind many industry consortia and some exchange applications, whose share price has surged in the past year. Ariba, likewise, focused on enabling exchanges, has seen its stock price rebound.

Converging online and offline marketplaces

Another challenge in moving along the path to success is uneven powers of propulsion. The big companies like the consumer-products manufacturers have something to sell, but lack speed, technology and management teams dedicated to operating an online marketplace. Even the auto makers, who have put hundreds of millions of dollars of business through their announced exchanges, are not yet operating a true digital marketplace where value-added services are better off for buyers and sellers. Most are merely automating an auction RFP process, with phones and faxes as well as the Internet. Meanwhile, the pure plays like VerticalNet, with no historical supplier or customer relationships, which are struggling with access to transactions and liquidity, actually do have aggressive management teams and cutting edge technology.

To get through the bog, both big companies and pure plays should take a lesson from B2C survivors and *ally with scale players* that need their know-how. For example, in auto retailing, online seller CarsDirect.com recently announced an alliance with major offline dealers United Auto Group and Penske Automotive. The move stands to accelerate a convergence of bricks-and-mortar megadealers with online auto sellers in a way that should give customers the true market value of broader selection and a more efficient buying process.

Other ways to win

There are other ways to win in B2B marketplaces. Some B2B marketplaces will become viable by *building value-added services* around the core exchange. They'll bring customers through the door on low-margin transactions, then keep them coming back for add-on, higher-margin sales of financial services, logistics, information or analytical services. On this front, analysts have noted that the New York Stock Exchange, which does $7.3 trillion of transactions, earns only about $100 million of profit. By contrast, an information service like Dow Jones earns three times that profit; Schwab, six times; and I-banker Goldman Sachs, 26 times.

Some marketplaces will win by *leveraging the software* they are creating for the exchange, and morphing into software houses or ASPs or both. A lot of money has been poured into creating technology platforms for deep, vertical-industry problems. This semi-custom software could be sold in the traditional manner of software (up-front licensing fee and implementation plus ongoing services and consulting) or as a Web service provided through an application-service provider. A number of players are exploring variations on this theme.

Still other exchange operators will discover that marketplaces deconstruct into a series of overlapping extranets, and most of the value is in the *supply-chain savings,* not the buy/sell savings.

Finally, many will decide that the structure of venture capital backed independent exchanges or consortia of two or three major players is wrong. They will decide that a *true industry consortium* like VISA or MasterCard, is the best model to allow all participants to realize the value of the exchange without falling victim to control issues or unrealistic economic expectations.

So there is a path to victory for exchanges, and the marketplaces themselves are hewing the way. The winning marketplaces must quickly determine which models will work with their company and their industry and with equal alacrity redirect the vast financial and human resources misdirected today.

Bain & Company: Strategy for sustainable results

Bain & Company is one of the world's leading global business consulting firms, serving clients across six continents. It was founded in 1973 on the principle that consultants must measure their success in terms of their clients' financial results. Bain's clients have out-performed the stock market three to one.

With headquarters in Boston and offices in all major cities throughout the world, Bain has worked with over 2,000 major multinational and other corporations from every economic sector, in every region of the world. As a complement to its strategy consulting practice, Bain has established bainlab, an active incubator and accelerator of Internet companies, which brings to bear Bain's intellectual property and execution capability in identifying and building profitable Internet businesses. For more information visit www.Bain.com and www.bainlab.com.

BAIN & COMPANY

BAIN & COMPANY, INC.
Two Copley Place
Boston, Massachusetts 02116
(617) 572 2000
www.bain.com