The internet economy: A primer on the current revolution

John Battele

John Battele is CEO and founder of The Industry Standard and its Web site, thestandard.com, which furnish credible, timely, and strategic information about the Internet economy. As a cofounder of Wired magazine, he helped define the rules of the Internet Economy and carve the cutting edge of the digital culture, He is a frequent guest commentator on "The NewsHour with Jim Lehrer, CNBC and CNNfn, and he has written for The Los Angeles Times and MacWeek. John holds a master's degree in journalism with an emphasis in new media, and a bachelor's degree in anthropology from UC Berkeley.

From smoke-spewing factories to underground networks of cable and fiber optics, the old industrial-economic order is shifting to a new economic order that presents a dazzling array of opportunities, along with intense competition for the minds and hearts of consumers, according to John Battelle, founder and CEO of "The Industry Standard."

Information technology is responsible for the shift, said Battelle, adding, "Between the old and the new, is this wonderful period of turbulence where we're figuring out what this new order is. It's an amazing, exciting opportunistic turbulence."

Battelle, whose two-year-old magazine provides strategic insights on Internet and e-business issues, doesn't agree with those who say the U.S. is in a bubble economy. "But I think we're in a frothy economy. There are hundreds of millions of bubbles, and they're all bursting and forming and bursting and forming. It's very exciting, but it can be very confusing as well."

Industries of Industries

Battelle defines the Internet Industry as an "industry of industries." Unlike information technology, which is a vertically integrated industry served by layers of vendors; supply chains, etc., the Internet Industry spreads out horizontally, cutting across all businesses and industries with its far-reaching applications and possibilities.

As the Internet revolution heats up, there are people in the forefront who are "shifting the present and the future of business through the application of Internet technologies and services." They are changing the rules of business, creating new business models and figuring out new value propositions.

These new leaders are not necessarily IT people. "They are business strategists, finance people, marketing people and the legions of people who help them do that: professional services groups, bankers, lawyers, recruiters and so on," said Battelle.

This is the audience that "The Industry Standard" has been able to identify; it's an incredibly powerful market. Family income is $180,000; average age is 37; net worth is $1.4 million. On average, they are younger and richer than their counterparts in the old economy. They are well educated: 80 percent have bachelor's degrees, 40 percent have master's degrees. "Half the Harvard MBA class went to Internet startups last year, the other half dropped out and started Internet companies.

Half the GDP

Whether you're a startup or an established business, joining the Internet economy costs huge sums of money. Businesses will spend more than $4 trillion in the next four years to become Internet-ready, according to Battelle. "Half a trillion was spent in 1999, an amazing amount of money, close to half the GDP of the United States."
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Where do these dollars go? The bill for the Web agency, the company that designs and builds the site, typically runs $7 million to $10 million. Another $4 million to $5 million is needed for infrastructure, back end systems and the software and the hardware upon which the software runs. Additional sums of money will be spent on retraining the sales staff so that they understand how this new channel works and how to direct their efforts for maximum results.

"The Internet is not just a vertical IT spend. It's an economic spend against all of your operating units and all of your segmentations," said Battelle.

"Most Internet startups now have Web site building budgets between $5 million and $50 million, depending on what they're doing. That's a onetime pop. Then there's an ongoing execution against that."

The next wave

In the '60s and '70s, the first wave of information technology gave businesses the tools to automate internal and external operations and increase efficiency. Then came the PC revolution, which changed the way that people work. The Internet revolution, here and now, is the next wave. "It enables efficient one-to-one relationships on an unprecedented scale, and represents a much more dramatic shift in the sorts of things you can do that you could not do before," said Battelle.

"This is a really big wave," he continued, "as big as the entire economy because we're talking about the ability to touch customers in the marketplace through every single device that you possibly can."

The technology exists now to do this.

As an example, Battelle talked about a system currently in use at the New York Palace Hotel. "Guests do not have to wait for an elevator. When they leave their room and the door closes, the elevator system is automatically notified to come to their floor. So by the time you walk to the elevator, it's there."

The dot-com bubble

Though the Internet economy is hot, not all Internet companies are going to survive. "I don't think the dot-com bubble has burst, but I think it has deflated significantly," said Battelle.

Business-to-consumer enterprises are not attracting much venture capital. But there is a lot of venture capital going into Internet business-to-business companies. Finance people are now demanding results, not hype, and "the pressure to produce is very rapid, rigorous and cruel." Battelle believes this kind of rigor "is going to be good for the Internet marketplace and good for business."

But what accounts for the losses racked up by companies with high valuations, such as Amazon? "Right now there's a window of opportunity in this turbulent period of economic shift to get into a lot of really profitable businesses." The theory is: "Loss lead now, spend as much as you can during this period, provided you're leveraged against it. You have to be as well positioned as Amazon. And many Internet businesses are doing that right."

With this strategy, "there is a large opportunity to build businesses that over a longer period of time are going to have extremely high margins by investing significantly right now."

In many cases, however, the market has priced the present value of a stock based on estimates of future earnings. "An astonishing amount of execution risk has been put into the current price of a stock. A
company with $340,000 in trailing revenues is worth a billion and a half in market cap. I just fundamentally can't accept that, because I don't think it's tenable going forward."

Margin in the mind

For all its innovation, the Internet operates on the same fundamental business principles that sustained the old industrial-economic order in the past century. But there are differences. The Internet makes these principles work in more deliberate ways. In an Internet economy, buyers get stronger, fortified by information. They can compare on price, on product value and against different suppliers.

"The ability of companies to build margin based on ignorance of the buyer, which is fundamentally what a lot of businesses have been built on in the past 60 to 70 years, is going to go away," said Battelle.

Buyers don't just get information on the Internet; they leave tracks that can give sellers valuable insights into how people behave when they buy or when they browse. "Every transaction, every behavioral attitude that you can capture is yours to keep and analyze forever."

Of course, there are ethical issues that enter into the equation. "You have to make sure that your policies are disclosed and that you protect customers' privacy," said Battelle, adding that "It's a win-win for the buyer and the seller to have this kind of information."

The challenge for the merchant is "to learn how to use that information to build what I call 'margin in the mind.' The margins are no longer in your price. The margin is in your value equation to the customer, which is in the mind."

Anyone who has purchased something from Amazon.com knows how this works. Buy a book, and the next time you come back, Amazon remembers who you are, what you bought and for whom. It then makes suggestions for other purchases based on this information. This translates into high value for the customer, even though the same book may be available somewhere else for less money.

"It's service and the margin in my mind that Amazon knows who I am. And when I go back to the Palace now every single time I go to New York, it's because I know the elevator's going to come up when I walk out the door.

"It's using the technology, and using it to be a better, more efficient merchant."

Disintermediation

If cyberspace becomes the preferred place to shop, will traditional buying sources be disintermediated? Will retailers and other service providers be replaced by a faceless Web site that can explain, educate, sell, and take your money with just a few keystrokes? While people are talking about this possibility, the issue is misunderstood, said Battelle.

There are certain industries that are indeed becoming disintermediated; automobile dealers are one of these. Buyers can get on the Internet, find exactly what they want, make a quick trip to a dealer to test drive the vehicle, then get back on the Internet to buy it through an auto broker such as AutoBuyTel. "Buyers save money, the broker makes some money, and the dealer is shut out."

On the surface, this is not a happy proposition for dealers. But this does not mean that the rows of auto dealers that line major arteries are going to disappear. They will, however, have to rethink their value to
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the consumer. "There's a lot of room there, and AutoBuyTel is not disintermediating; in my opinion, it's re-intermediating. It is rethinking the concepts of how you become an intermediary and forcing the dealers into a new business model."

According to Battele, four out of five dollars that are spent at a dealer showroom are for products and services other than the car: insurance, financial services, repair, and accessory sales. "That's where the money is. If dealers reorganize their business structure around that, taking care of the customer from the point of sale forward, they will become very viable businesses."

In this model, the dealer is the place where the customer comes to pick up the car. In return, the dealer gets to meet the customer face to face and start a long and profitable relationship in terms of service.

Intermediation

If you can't fight it, join it, goes an old saying. Used right, the Internet can be an important tool for dealers in defending their turf. By setting up a local Web site and encouraging interaction with customers, dealers can add a layer of intermediation that allows them to build margin in the mind of the customer. The site could perform a valuable service by answering questions and providing information and solving the individual customer's problem.

"Creating that intermediation between you and the customer is crucial to being able to develop a one-to-one relationship with that customer," said Battele. "That's what the Internet is all about."

This concept also comes into play when trying to mitigate the effects of hyper-competition.

It used to be, in the not so olden days, that competition was clear cut. If you sold life insurance, you knew that your competitors were other life insurance brokers and agents. But today, the lines between some industries are blurring. At a conference where Battele was a speaker, a life insurance agent lamented, "My competition is AmeriTrade, Charles Schwab, E-trade, E-loan. They're selling all the products that I sell from my office in Des Moines. And they're doing it online."

The agent then asked, "How can I possibly compete with that?"

Since very few of the agent's customers actually came into his office to conduct business, Battele recommended that the agent develop an intermediation site where he could serve the needs of thousands more customers on the Web than he could in face-to-face meetings. Thus, he would be able to leverage his time and his knowledge and build margin in the customer's mind.

Important consumer sector

The people who regularly log on to the Internet to research products and services and make their buying decisions based on what they learn are turning out to be "the most important new economic sector of consumers," said Battele. It's important to understand them because they differ from the past 15 generations for whom radio, TV and print were the most important media.

The "Internet generation," as Battele calls them, "has a set of expectations and demands about the way businesses react to them, and it's nothing like it used to be." Interaction is high on their list of expectations. So is good Web design that provides ease of navigation.
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These Internet consumers "are nonlinear thinking, very protective of electronic rights. They will turn on you if they think you're messing with their personal data. They're optimistic about the future, and any place they touch they assume it is going to be as smart as the smartest part of the network."

On the other end of the spectrum, the Internet generation is "your worst customer service nightmare. They're frighteningly demanding, very short of time, inattentive, irritating, and rigorous. But they're also loyal. If you can just push that intelligence out and show them you understand who they are, they will stay with you forever. And that's what Amazon's figured out."

Internet rules

Battelle offered a couple of rules to guide the business person in pursuit of Internet revenues.

First, it's important to recognize that "the most valuable resource in the Internet economy is human attention. Your ability to capture that attention and turn it into value is the foundation of your business."

Second rule: "It doesn't matter what business you're in; with a Web site you're in the media business. You are in the business of mediating your relationship with your customer through an information technology experience. And if you don't think you're in that business, you won't win because it is core to your business."

Before the advent of the Internet, media was something you bought from an advertising agency. The TV and radio commercials or print ads drove people to your products. "That's not the way media is understood anymore. Media is part of your business and you need to develop an aptitude for it."

Understanding how the Internet works to foster strong customer relationships is key to survival in competitive times. Said Battelle, "There are tens of thousands of people employed by companies right now who are reinventing how corporate America interacts with their customers through the Web. The efficiencies you gain from doing that are incredible. But if you get that wrong, if you can't push your business model through that Web site, you'll lose."

Internet growth:

- It is projected that there will be 320 million Internet users in 2002, up from 100 million in 1998.
- There are half a billion Internet devices today; two years ago the number was 78 million. Things like cell phones, toasters, hand held computers, hotel televisions will all be internet devices; many of them already are.
- Today, e-commerce accounts for $1.4 trillion, up from $200 billion two years ago.
- In the U.S. and Canada, over 40 percent of the people over 16 years of age are on the Web. What does this mean for business? "A large group of customers are now online, and they have online expectations."
Customer profiles have always been available through demographically coded mailing lists. However, the Internet offers much more cost-efficient ways to reach your marketplace, said Battelle. When he launched "The Industry Standard," he used what he calls "the Wella Balsam effect." I got two friends to tell two friends to tell two friends, and so on. My Web site does 6,500 subscriptions a month without any promotion."