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How to dominate the online auction market

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Executive Summary

Background

eBay Inc history:

September 1995: funded as a sole proprietorship.

May 1996: incorporated in California.

April 1998: reincorporated in Delaware.

September 1998: completion of initial public offering

October 2002: acquired PayPal

Product

Online Auction: Every day, 24 hours a day, 7 days a week, 365 days a year, millions of people from all over the world go shopping at online auctions. This is not an exaggeration - eBay, with a 76% share of the auction site market, reports 42.7 million users and a growth factor of 100% per year

Porter's Five Forces Analysis

Rivalry

Rivalry is very intense. Yahoo had to give up Japan and Australia online auction sites in 2003 because of low margin in this market even if Yahoo made great investment in these two sites beforehand.

- *Number of firms*

Online auction firms: www.eBay.com, www.overstock.com, www.ubid.com, www.yahoo.com, www.amazon.com, www.CQout.com, www.bidville.com, etc. The large number of firms in this market reflects the intense competition among those sites. Margin profit is decreased to a relatively low level. eBay could still survive because of its scale of economy and good reputation. However, eBay's growth in 2004 was much smaller than in 2003. Shareholders put much pressure on eBay, and eBay had to readjust its pricing on varied services on the short run

in order to satisfy people's short term expectation. However, he is risking his long term revenue and reputation.

- Fixed costs

Essentially, fixed costs on online auction market are rather low: purchasing programming technology patents, web, administration, credit, accounting, staff, and daily operations.

- Product differentiation

Differentiation depends on how the transaction is performed. There is not too much difference among different online auction companies in web processing efficiency and shipping efficiency, but eBay is more convenient than others, due to their lengthy expertise in the market. eBay differentiated itself by integrating PayPal payment system, which is famous for its security, cheap rate and network utility. eBay offers a cheap transaction fee rate, as well. It has greatest number of users by far, which offers excellent network utility.

Amazon used to be a substitute product provider. However, since 1999 Amazon added auction module in its business. eBay likewise encroached on Amazon's niche by adopting fixed price functions like "buy it now" button and purchasing www.half.com. eBay and Amazon have been less different and therefore rivalry has increased a little.

However, there is still an obvious gap between them in terms of business model and software development. Amazon built its reputation with high-end users. It has a friendly and succinct transaction interface, which offers superior product mix. Amazon is utilizing Porter's value strategy and has not changed this for years. On the other hand, eBay is a large community of small buyers and sellers who deal with single-item transactions at negotiable prices. It has created cost advantage by scale of economy. Most goods traded on eBay are secondhand, and eBay's inventory changes more rapidly than Amazon's. eBay is actually taking Porter's cost strategy. Different business models result in different financial performance. eBay generated \$441 million profits in 2003 on \$2.17 billion revenue compared with Amazon's much smaller \$35 million profit on far more revenue -- \$5.3 billion. eBay has a more liquid and efficient financial structure. Besides, these two companies are both valued by their own network/community. Most customers don't switch between auction and fixed price retail very often partly because they are rooted in the community culture of either network. They don't have incentives to change their current method of transaction if it is satisfactory. Different business models and different networks are enough to place these two companies in different niches without too much rivalry.

Barriers of New Entrants

New entrants seize every opportunity to expand their market share. eBay still has a dominant market share of online auction. His reputation is a sweeping force in maintaining his good performance. However, eBay has to be cautious in every marketing decision. His mistakes will be taken advantage by these new comers.

For example, www.bidville.com, an online auction site, recently experienced a dramatic increase in new member registration after eBay announced they would raise their listing fees for sellers. eBay took a prompt response by resuming the listing fee back to the original level. eBay didn't win anything in this price adjustment and readjustment, but eroded his reputation. Essentially in this online auction market, whoever has the most name recognition, wins the game. Right now, Bidville's disadvantage in name recognition puts Bidville out as a possible alternative to eBay's market space temporarily. eBay should think about more to maintain his name recognition on the long run.

- Patents

eBay does not hold any key patented technology. A new entrant could easily emulate eBay's interface.

- High cost of entry

eBay's most effective barriers are its large network and credible reputation. It is rather difficult for a new entrant to build a new network starting with no users. (We can verify this by how new air ticketing companies grow.) The only way to start a network from a reasonable size is to derive an online auction market from an existing online website company which already has a network, just as Yahoo and Amazon did. A new entrant must also demonstrate creditability and capability to customers and payment providers (credit card, PayPal, eWallet, etc.). New entrants must prove their guarantees of efficient and safe transactions, to both buyers and sellers.

Why would buyers and sellers bother to switch from a sound existing online auction site to a new one? Incentives to switch include discounts, coupons, accumulative reimbursement like frequent miles, complements from other services an entrant or their cooperating company offers, and higher-quality service in terms of timely and elegant shipping. All of these are trivial but not necessarily effective sales methods. Effectiveness depends on a comprehensive sales strategy which is based on keen insight of business dynamics and human group dynamics. It is hard for a new entrant to find an experienced strategist, and even if it does, there is still no guarantee to gain market share. This market is basically first-mover dominant. Furthermore, it is unlikely for payment companies like credit card companies or other electronic payment providers to support a new entrant, because profitability is unclear.

The revenue for successful new entrants will be low at the beginning and stable on the long run. However, expenses will be extremely high at the beginning. A new company rarely survives within a short term unless it has a very generous percentage of leverage or a large amount of venture capital, and leverage is only available for public companies. Therefore, a new entrant can likely only be an existing company that operates in other markets. It should either be sufficiently self-funded or have a very strong, persuasive income statement and business plan to prove liquidity and gain leverage. Since the internet bubble, venture capitalists are very cautious in investing in IT companies, especially Business-to-Customers or Business-to-Business e-commerce companies. (Check the performance of eBay during and after internet bubbles.) Essentially, the scale of economy is very obvious in the online auction market. The value of an online network is proportional to the number of users squared. The scale of economy will naturally lead to a monopoly.

A new entrant should either license a fraud prevention system or employ a third-party payment platform company that already integrates fraud prevention system in its service.

- Brand loyalty

First of all, eBay has been operating in this market since the beginning of e-commerce. A lot of e-commerce companies have failed since the internet bubble. eBay has successfully survived because of the convenience and simplicity of its service. It has gained popularity and built loyalty among customers. It has a secure identity system, and every user has a record of past transactions. eBay has a sound rating system for every buyer and seller to establish credibility amongst the users. eBay's user accounts work like passports of their personal credit and reliability. Most customers of eBay are long-term users; therefore, they will not attempt fraud in their transactions. If they do, their rating suffers. All customers tend to trust each other because transactions are transparent to the 3rd party supervisor, eBay. eBay has successfully turned their online auction site into a community which has a cohesive culture. Photos of items to be sold greatly enhance the community value and establish amiability and trust between sellers and buyers. (eBay's success has influenced Amazon to adopt a similar policy in its online transactions recently.) New entrants are competing against a community as well as a company. It is rather difficult to build a new culture and a new community.

There might be some other specialized auction niches available, but eBay offers nearly any product available. For example, eBay has online auctions for cars. However, since cars are large purchases, people tend to be cautious in purchasing them. They must inspect the cars in person, and the buyers and sellers tend to haggle in person. Online auctions don't seem conducive to the secondhand car market. As one would expect, eBay doesn't have much revenue from car transactions, and any other online car auction websites are not likely to generate high revenues. Such specialized auction markets have uncertain viability.

In the example of a car transaction, there are two types of creditability involved. One is buyers' trust of eBay: Will eBay protect the buyers' privacy? The other is buyers' trust of sellers: Will sellers defraud the buyers or exaggerate the quality of their cars? Shipping is also a major cost in this transaction. Most buyers obviously favor in-person transactions. There is little market space for online auction providers. In fact, there are free online bulletin boards that provide used car sale information. They make it difficult for paid online car auctions to exist at all. Mostly, the viability of such specialized auction markets is doubtful. Therefore, there is limited chance for new entrants.

Substitute Products

The most important merit of fixed-price online retail is that a buyer does not have to wait for an auction to end. It is appealing to shoppers who prefer straightforward sales. They value their time more than the small price change. It is basically a tradeoff between time and price. Since online auction and fixed online retail target people with different personalities, these two products essentially don't conflict with each other. eBay

expanded its market by adding fixed-price features to its online transactions, such as “Buy It Now”. Half.com is a fixed price online retail web site which is owned by eBay. This shows that eBay is flexible in its business model. On the other hand, Amazon, a traditional online fixed-price retail web site, launched its auction feature in 1999. Here, fixed-price retail acts somewhat like a complement. However, it is a complement only when a company is involved in both types of sales. It is especially beneficial for the company’s network utility. eBay expanded its community (network) by adding fixed-price retail feature, as Amazon did by adding auctions. Both of them successfully combined these two functions together, which merged these two markets into one, and gave customers greater convenience by allowing them to decide which way to purchase goods impromptu. However, there is less differentiation between eBay and Amazon.

Traditional retail is more prevalent when the buyer must check the product in person or shipping is difficult or expensive. eBay has had to build a strong creditability by making sure all the descriptions of online items to be sold are precise, complete and correct. Without this reliability, customers would switch to traditional retail stores. For those goods which are hard to price without observation, eBay cannot supplant traditional retail. This is particularly true for specialized items such as cars, jewelries, and plastic surgeries, all of which have too many details to be taken care of online. Online transactions seem impossible for these goods.

The switching cost from online auction to traditional retail or fixed-price online is essentially high. For fixed-price online, sellers have to pay the storage fee for Amazon’s storage plant. For traditional retail, sellers have to pay for the storage fee and shelf rental fee. These extra fees, which are switching costs, are enough to discourage single item sellers, who are main customer category of eBay, to switch.

Buyer Power

- Customer’s price sensitivity

Online auctions don’t charge sellers for storage of their goods. Fixed-price sites might charge sellers for storage. Traditional retailers incur overhead costs. Sellers have incentives to sell via online auction. On the other hand, online auctions mainly deal with unpackaged new products or secondhand products. Most buyers of such products are familiar with eBay, so sellers are more prone to sell via online auction. Buyer bargaining power is weakened.

- Customer’s negotiating power

As I analyzed above, eBay is a large network of small buyers and sellers who mainly deal with single-item sales. A seller generally sells one item to one buyer on eBay, so eBay has high prices and high margins when providing services for many buyers and sellers.

Supplier Power

Suppliers to eBay offer technology patent, legal support for intellectual property, and fraud prevention systems. eBay has great pressure to prevent fraud, since its reputation is at stake. Buyers and sellers care about very much about their security. Online auction fraud in 2004 made up 16% of all consumer complaints last year, and 48% in the subset of internet-related complaints, topping the list. eBay has 0.01% fraud rate of all transactions, but these isolated incidents receive wide media coverage, which discourages many potential customers. eBay is still improving its fraud prevention system. The fraud prevention system is launched by Microsoft Inc. and Visa International Inc. As this system is necessary to eBay, it has little leverage to negotiate a better price.

Many online retail systems need fraud prevention system, but there is only one supplier in the market. It has great bargaining power.

Complements

PayPal, as an online payment solution, is a good complement of eBay's online auction business. PayPal is a neutral intermediary based on the financial infrastructure of bank accounts and credit cards, supported by a proprietary fraud prevention system. Transactions on PayPal are of low risk to both sellers and buyers.

PayPal accepts money from the buyer in one of the three ways.

- Charging the buyer's credit card
- Debiting the buyer's checking account
- Charging from the buyer's PayPal account. The buyer can always send check to his/her PayPal account.

Then PayPal will email the seller about the payment made by the buyer. The seller will receive money in one of the three ways.

- The seller might have his own PayPal account. The payment will directly transfer to his/her account.
- The seller might receive a check from PayPal.
- PayPal directly deposits the payment into the seller's checking account.

Buyers care about security. Buyers' credit card numbers are only shown to PayPal. That is safer than online payment directly by credit card.

Buyers also care about the cost. For transactions between PayPal customers, there's no transaction fee. PayPal makes money on the float - when customers' money sits in their account, PayPal is collecting interest on it. Customers generally don't care about the interest that PayPal collects on their deposits.

Customers also care about ease of use. PayPal is one of the simplest services for online transactions. All a buyer has to do is to provide his/her name, e-mail address, credit card information, and billing address.

For business accounts on PayPal, merchants are charged a 2.2% discount rate + 30 cents on the transaction. It is better than the rate charged by merchant banks for accepting credit cards, in most cases.

eBay Micro Strategies

- ❖ Increase brand recognition
- ❖ Expand the auction market by introducing PayPal to more online auction markets
- ❖ Credit card companies charge more for Internet-enabled merchant accounts (the accounts the merchants need to accept credit card payments on the Internet), because of the high cost to main security. Therefore, credit cards become too expensive for smaller purchases. PayPal might negotiate with credit card companies for smaller fees for their subscribers. They can cooperate to share the market in the following way: Merchant accounts on PayPal will be charged less by credit companies than those on other online payment platforms. Therefore it can increase the number of small purchases on eBay auction.
- ❖ Nowadays, credit cards are the primary means of purchasing air tickets and recording frequent flier miles. eBay should enter the air ticketing markets. It definitely can offer the same service with PayPal. PayPal should cooperate with more airlines and online ticketing websites. If they can integrate PayPal into ticket sales websites, eBay will have a huge potential market in air ticketing and also increase its network utility.
- ❖ eBay should acquire a greater online auction market share by educating online customers that PayPal is the online currency.
- ❖ Yahoo's wallet failed in the online marketplace. It was not easy to establish their own online payment platform, partly because the online payment concept goes against Yahoo's traditional business model. PayPal should make use of its competitive advantage and offer Yahoo and other websites its specialized solutions.
- ❖ Perfect its proprietary fraud prevention system, which is essential to its success.
- ❖ eBay should let its customers, cooperative online transaction sites, online airline ticketing sites, and credit card companies all feel that transactions through eBay will lower their costs and be more valuable.
- ❖ eBay should cooperate with shipping companies, and make its online transactions more lucrative

- ❖ eBay should work with Phish Report Network and other anti-phishing organizations more efficiently in order to prevent fake online auction sites taking its market share and damaging the whole market's reputation
- ❖ eBay should work with software developers to improve the security, efficiency, and adaptability of its database.
- ❖ eBay should convince customers that there is no intentional bidding up behavior involved in its online auction practice
- ❖ Develop real name feature for customers.
- ❖ Put some restrictions on new sellers in expensive merchandise transaction or large volume sale until they have a good track record.
- ❖ Expand to international market, decrease national boundary barriers in terms of payment (credit card/PayPal) and shipping. Cooperate with local equivalent companies or localize by itself.
- ❖ Mediate between buyers and seller at Security Center. Respect both sides' privacy. Solve conflicts in conservative way. Don't take risk of eBay's reputation.

eBay Today

eBay is the world's foremost online marketplace. Through reliable customer service, efficient information exchange, and by utilizing the latest technology, eBay has created an auction-based market community of an efficiency unheard of prior to the internet revolution.

Competitive Advantage

eBay has used its first-mover advantage to establish itself as the most reliable and, more importantly, largest auction house on or off the internet. In 2003 alone, more than 30 million people exchanged over \$20 billion. Due to the size and diversity of its user base, eBay is able to offer a wider selection of merchandise than any online retailer. This is made feasible by the virtual nature of eBay's market: sellers can market obscure items to a global market as easily as and more cheaply than they could put an ad in their local paper.

Famous for matching buyers and sellers across the world with the most extreme items, eBay has developed incalculable value in its brand name. eBay has become a household word synonymous with an eclectic online marketplace. eBay comes to the mind of any buyer looking for that rare or rarely-cheap item; any seller hoping to get rid of practically anything knows a buyer is lurking somewhere on eBay. The site has become an easily identifiable rallying point akin to a popular dance club on a global scale: everyone who's anyone is there—and everyone else too.

eBay's Macro Strategy

eBay seeks to maintain a high level of consumer patronage by capitalizing on its unique positioning as an internet marketplace.

Globalization. Since eBay is a virtual marketplace, eBay can establish language-localized sites in other countries that have access eBay's full auction database. Since the seller

handles the shipping details, each seller may determine the extent to which they enter the global market. eBay has already expanded into 150 countries around the world. International transactions require little additional bookkeeping cost while their benefit to the consumer is enormous: every buyer and seller has access to the largest market possible.

Communication. By allowing buyers and sellers to meet and communicate online, eBay is able to minimize the costs of remote market research and individual exchanges of information across states and borders. This interplay is essential to mutually amicable transactions on which eBay is based. To encourage fair transactions eBay provides an efficient feedback system to allow buyers and sellers to benefit from collective experience, giving customers a strong social incentive to honor each transaction.

Integration. Through its acquisition of PayPal eBay gained not only market share, but vertical integration key to its long-term success. By embracing the payment method most commonly used on its site rather than forcing an unpopular one on its user base, eBay has not only retained the existing PayPal user base but expanded to those consumers previously unsure of which method to use. In 2003 there were 40 million PayPal accounts—almost twice as many as the previous year—and these customers transferred \$12 billion across 38 countries.

Diversification. In addition to normal auction bidding, eBay now offers a Buy-it-Now option. Sellers set fixed maximum prices at which the auction will close before it begins. This attracts auction-wary consumers from other e-commerce sites outside of the strict auction market and effectively competes with amazon.com and froogle.com for fixed-price transactions. By allowing independent sellers to maintain storefronts online, eBay seeks to extend its position to include an even wider range of transactions, thus not only broadening its appeal but securing ties to more conservative consumer bases.

The Future of eBay

Industry Trends

What originally began as a small industry of auctions for collectibles has mushroomed into a behemoth encompassing individual sellers, small businesses, and large retailers. The e-commerce industry is constantly growing, and many businesses rely on the reputation of eBay or one of their competitors to sell their products. As the market grows, a wider demographic range of consumers will be purchasing an increasing number of products online. For example, teenagers are the target consumers of very recent products such as cell phone ring tones and games, many of which are available exclusively online. As such varied consumer groups are emerging in the online market, there is more room for differentiation; perhaps some niches are being created. Therefore, the barriers to entry will decrease as the market expands.

Competitive Trends

eBay has a solid foothold as the canonical online auction site. They have a niche as an enormous community with an extremely high success rate of matching buyers and sellers. eBay is distinguished by its availability of single, used, and/or rare items, and for its floating prices. They are adequately differentiated from their competitors, and they possess roughly 70% of the online auction market share. However, due to the relatively low switching costs and entry

barriers inherent in a web market, eBay must continue to be rather defensive of their position, against current competition and potential new entrants.

Current Competitors

Amazon and Yahoo Auctions are the main competitors of eBay. Ubid.com has 14% of the market share, but they have a different niche than eBay by appealing to business-to-consumer transaction. Amazon may pose a threat to eBay's utter dominance; they are consistently bringing retailers into e-commerce. However, this comes with a great burden. Whereas eBay has virtually no overhead, Amazon needs to store and move vast quantities of inventory. Currently, Amazon's revenues are considerably greater than eBay's (about twice as much), but their costs are so high that eBay's annual profits are roughly ten times Amazon's.

Alternatively, Amazon might choose to expand its auction operations, trying to nudge eBay from its niche. Amazon would have to establish a network, a community, on the scale of eBay's in order to challenge them directly. Although this could be time-consuming and costly to implement, focusing on transactions in which they are merely the broker and bear no cost could greatly increase their long-term profits.

Yahoo poses little threat to eBay. While they theoretically have potential for growth similar to Amazon, they lack Amazon's reputation. They also lack the cost-free transactions in which eBay luxuriates.

New Entrants

Online auctioning doesn't have high costs of entry, especially the way eBay operates: All a new entrant needs is merchant software; there is no need for warehouses or expensive machinery. However, many companies have tried to enter this lucrative market and have failed.

New entry is difficult because eBay has an enormous community, which gives tremendous network value to both buyers and sellers. Any entrant would have to build up a network from scratch. Conceivably, if a new company entered a niche market, e.g. auctions of teenage clothing and cell phone accessories, they could survive, but such a market would likely be too small to gain any measurable market share.

Alternately, a website that already has a large community would be able to enter more easily. For example, Craig's List has a network of millions of users, who rely on it for matching them up with people who can fulfill their specific needs. It would be simple enough to add an auction section to the site, and take advantage of this existing network to compete with eBay.

Froogle, a new service from Google, may forever change the way online shopping is done. While it currently is a beta version, it looks to be a promising engine for online shoppers to quickly search nearly all online stores for the products they desire. While Froogle isn't an entrant to the online auction market (yet), it is certainly the beginning of a powerful new substitute service. Froogle may be very dangerous to eBay for many reasons. Google already has a huge network of search-users and advertisers. If vendors (especially specialized vendors, as many on eBay are) can set up their own online stores and be found for free on Froogle, they have less of a reason to pay eBay for its high access. eBay certainly still has a lot going for it, (security and reputation) but may soon find its network challenged by Froogle users.

eBay's Response

eBay recently started Business.eBay, a new business-to-business online auction that spans all sectors, from mining to farming. eBay is aware that they may need to accommodate larger retailers in order to grow, and to challenge Amazon's growth in this direction.

If Amazon decides to challenge eBay's community appeal, then eBay must block this attempt any way they can. A simple method would be to start a price war. eBay's costs are so negligible compared to Amazon's that Amazon could not possibly survive a price war. eBay could almost give away auctions to sellers, whereas this sort of competition would bankrupt Amazon.

If a new entrant emerges, eBay's best bet is to rely on the value of their community. Even a company trying to enter into a niche market would have a difficult time building a network large enough to attract eBay customers. In the rare case of an established community site entering into online auctioning, eBay should engage in a price war if they believe this site's community is comparable to theirs. eBay is famous for their extreme efficiency, and any entrant would likely be somewhat inefficient due to their inexperience.

eBay's best response to Froogle is to assert their security and reputation to their users: If you buy from eBay, you know you will have a safe and fraud-free transaction, especially if you pay with PayPal. On the other hand, if someone buys from an online shop found on Froogle, he has no idea how reliable the vendor is, or if his credit card information will be safe. If buyers are reluctant to engage in potentially insecure transactions outside of eBay, buyers and sellers alike will continue to complete their transactions through eBay.

Summary

eBay virtually monopolizes the online auction market, due to their large network value, extremely low costs, reputation for security, and efficient operations. When confronted with competition, eBay either relies on its community niche, or buys out the competition (i.e. Half.com and PayPal). They have created a market where entry is very difficult, and competitors are relatively powerless, particularly given the threat of a price war. These advantages should ensure eBay's continued domination of online auctions in the future. However, they should court larger retailers, as Amazon has, to expedite their growth. eBay is likely to stay the leading online auctioneer for quite some time, as long as they remain adaptable to the ever-dynamic online market. eBay has proven to be a successful chameleon in the past, making lucrative acquisitions and modifying its business model, depending on the state of the online market. As long as eBay continues to aggressively maintain its community and reputation of security, it will dominate the online auction market.

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