

"Under the Buzz"

Insights into B2B Net Markets

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Under the Buzz is an electronic "viewletter" authored by Philip Lay, managing director at the Chasm Group, a Silicon Valley strategy consulting firm. It is published each month, and delivered free to subscribers via e-mail. It is also posted on the Chasm Group website at: <http://www.chasmgroup.com>. Back issues can be downloaded from the site at: http://www.chasmgroup.com/underthebuzz_archives.htm.

In this month's issue:

1. eMerge Interactive: First-Prover Advantage in Action

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1. eMerge Interactive: First-Prover Advantage in Action

In successive recent editions of *Under the Buzz*, we have discussed a number of key chasm-crossing strategies for digital marketplaces. These include:

- (1) Building first-*prover* advantage in the bowling alley, as contrasted with first-mover advantage in the early market, by focusing on establishing a firm, upward trend in transaction frequency and satisfaction;
- (2) Focusing on specific constituencies within their "value webs," distinguishing their primary target customers (sellers *or* buyers, who fund the business by paying fees for services rendered) from secondary target customers and other target groups;
- (3) Segmenting the target market into addressable and winnable target segments, rather than trying to "boil the ocean" by creating traction with every constituency at once;
- (4) Keeping their sights on suitable short-term performance metrics that reflect their current liquidity-building purpose, in addition to big-picture metrics that will be proved out over the longer term. This will make it easier for current customers, partners, and investors to understand the business and determine a basis for investing in it or not.

This issue is dedicated to testing some of these ideas against the real-life case of eMerge Interactive, the beef industry market maker that went public several months ago (stock price at 10/13: \$13.31). Besides describing the basics related to eMerge's business, our objective is to assess how far the company has come in building sustainable viability. We contrast expected benefits (price visibility, cost savings, etc.) facilitated by eMerge for ranchers, feedlots and others, with some *unexpected* - and even more significant - outcomes that are beginning to take shape. For a detailed description of eMerge Interactive's business, I recommend a paper titled "eMerge Ropes in the Beef Industry Value Chain", which you can find on the company's web site (www.emergeinteractive.com), as well as on the web site of Internet Capital Group

(www.internetcapital.com), the preeminent B2B investment company that is one of eMerge's principal backers.

Even if you have no direct interest in the beef production industry, I recommend that you read on to find out the relevant lessons that this case provides for all B2B market makers – especially those that focus on finding new ways to unlock new value throughout the value chain of their industry, rather than merely focusing on cost savings.

eMerge Interactive - Key Information, Indicators, and Metrics

My assessment is that eMerge is on course to become a significant player in the B2B world, based on its powerful vision and promising execution to date. Amid all the debate about the ability of net market makers to build a sustainable business, I believe that eMerge is developing an exciting future for its current core business, in addition to opening up exciting expansion potential in similar food production industries, as well as future opportunities to license its technologies and know-how to other countries. Below are the key descriptors, indicators and metrics we are using to assess eMerge Interactive's progress to date:

Business/industry: Value chain integrator for the U.S. beef industry.

Business model: Initially, eMerge started out as a seller-oriented marketplace, enabling ranchers to sell their cattle more cost-effectively to stockers and feedlots. Significantly, the company is now becoming a powerful value chain integrator (see section below titled "Giant Leap value proposition"), aiming to unlock new value at each link in the chain, thus benefiting every participant and revolutionizing the U.S. beef industry.

In fact, Chuck Abraham, the company's CEO, states unequivocally that eMerge is not (just) a digital marketplace. Indeed, he prefers to describe the company as a value chain integrator comprising four main components: (a) an information management infrastructure providing instant real-time information on prices, etc., (b) an interactive marketplace hosting online cattle auctions, (c) online monitoring of key performance measures aimed at enhancing the quality of the end product (i.e., tracking each animal's growth from birth to harvesting), and (d) a nationwide network of livestock assimilation and marketing facilities.

Revenue model: eMerge's revenues come from transaction fees from cattle sales (including live auctions), license fees from ASP services, and (future) sales of non-cattle business products, including different types of electronic tracking and monitoring equipment currently being test-marketed. Current trends indicate that these last two revenue sources may become increasingly prevalent in the mix.

Basic value proposition: Cost savings throughout the value chain, from ranchers to consumers, resulting from reduced hand-offs in moving cattle, reductions in weight loss and morbidity, real-time information on prices, live auctions, pedigree-tracking using eID tags, and other services.

"Giant Leap" value proposition: A key component in a B2B market maker's long-term viability is, in my view, the grandeur of its vision. The industry-transforming proposition that eMerge is pursuing is nothing less than to "de-commoditize" beef products - by taking a relatively inefficient, traditional low-tech value chain, then integrating and compressing it into an efficient, open value network. In other words, supermarkets and restaurants can now charge prices with differentials of up to 80% for specific types of beef, based on demonstrated quality differences relative to each animal's pedigree, vaccine and/or feed regimen. A second dimension

of perceived value by end-consumers is a more consistent eating experience. By way of an example from a different industry, in the beverage business, drinking water has experienced a similar phenomenon of de-commoditization. As consumer tastes have evolved in recent years, producers and bottlers have begun to charge significantly differentiated prices for sparkling and still water, which is also available in many new flavors.

To quote Chuck Abraham, “The product itself is tracked through the production cycle to harvesting – a unique aspect of our company’s business vis-à-vis other digital marketplaces”. In the past, it has not been technically or economically feasible to tag each animal in a herd from birth to harvesting. This fact, combined with the increasing preference of consumers to pay hefty premiums for organic beef products, allows for the effective de-commoditization of beef in the U.S. When this technology is applied to other live-produce markets in the U.S. and around the world, it could revolutionize the profitability of these industries, and lead to much healthier products in general.

This de-commoditization occurs in two forms: (1) Upon sale to stockers and feedyards, then later to packers, cattle are sold at a premium compared with previous prices, because there is greater assurance of quality in the breeding and feeding. (2) Over time, meat products will start becoming branded in the supermarket to a degree that has never happened, affording even higher revenues throughout the value network.

Target constituencies in value web: Ranchers, auction barns, order buyers, feedlots/stockers, packers, supermarkets, and consumers. eMerge started by focusing attention on stockers and feedlots, providing them with information services on where to buy cattle. As the company has implemented its live auction capabilities, eMerge’s emphasis has shifted towards ranchers as its main target customer, because they stand to gain more from the new service in new profit opportunities than any other constituency.

- Primary target customer: Cattle ranchers – esp. small to medium producers (50% of total market)
- Secondary target customer: Stockers and feedyards
- Tertiary target customer: Meat packers
- Other beneficiaries: Large corporate/supermarket alliances (e.g., Cargill/Kroger).

Target market segmentation and problem-solving criteria:

- Value chain: Beef production – from ranch production to supermarket
- Geography: U.S. (possible strategy for other geographies: license technology and services to other market makers)
- Demographics: Ranchers – 1m., feedlots and stockers – 700, packers – 100 or so.
- Fragmentation index: The “front-end” of the industry is highly fragmented - 50% of all ranchers (= 500,000 or so producers) sell to 1,000 auction barns, that deal with 4,000 order buyers representing 700 feedyards.
- Size dimension: Focus is mainly on small-medium ranchers, who have most to gain, especially in the short term.
- Key problems experienced by ranchers: Extremely low profitability, caused by:
 - (a) price swings in medicine, equipment and supplies for breeding/fattening steers,
 - (b) high rates of weight loss and morbidity between ranch and feedlot,
 - (c) undifferentiated sale prices, independent of animal quality, feed/vaccine regimen, etc.

Metrics Model for Net Market Makers

Although eMerge is clearly aiming to provide the “giant leap” contribution of de-commoditizing the entire U.S. beef industry, to the benefit of virtually every member of its value web, its main focus to date has been to help solve the problems of the small and medium sized ranchers who make up 50% of the total market for production of beef cattle.

In this section, we are combining the metrics published in Under the Buzz #4 (August) for measuring market penetration achieved by seller-oriented market makers that are attempting to become first-provers in the bowling alley, with metrics related to the big-picture goals. The objective is to suggest a vocabulary and method for measuring viability on the way toward the longer-term business objectives that many B2B market makers are pursuing.

First-Prover Advantage: Short-term Metrics for Seller-Oriented Marketplaces

In crossing the chasm toward the bowling alley, eMerge is attempting to achieve first-prover advantage in the cattle industry. If it achieves this feat, not only would eMerge prove its basic viability as a business, but it might also stand a fair chance of succeeding in similar industries, including the pork and chicken production sectors.

1. Primary customer’s metrics – **Cattle ranchers, especially smaller-medium producers:**
 - (a) Transaction satisfaction: *Results to date suggest that ranchers are repeating their sales activity and referring eMerge services to colleagues.*
 - (b) Margin per buyer over given period: *Ranchers appear to be the biggest winners on the marketplace, with their net income increasing by percentages as high as 348%.*
 - (c) Revenue growth compared to alternative channels: *Chuck Abraham reported that at a recent live auction thirty Texas ranchers selling to twenty feedyards obtained an average of \$70 per head more in sales revenue than would have occurred in offline sale.*
2. Secondary customer’s metrics – **Stockers and feedyards:**
 - (a) Transaction satisfaction (increased price visibility; speed and convenience of transaction): *eMerge reports stockers and feedyards experiencing better results from lower weight loss and morbidity, and more assured quality of animals.*
 - (b) Direct or indirect cost savings and/or new relationships: *eMerge reports net income increases of up to 43% for stockers and up to 188% for feedyards.*
 - (c) Supply/demand chain economies (simple and/or compound)
3. Seller-oriented market maker’s metrics - **eMerge:**
 - (a) Accelerated path to profits from growth in transaction/subscription revenues: *eMerge needs to track \$ per head of net value they are creating for their target customers (i.e., starting with the ranchers), and \$ per head of what they get paid to deliver this value.*
 - (b) Gross margin per repeat customer: *Look for a constant or increasing value capture % for eMerge to demonstrate the exponential growth potential of the model.*
 - (c) Growth of repeat purchases and referrals leading to new revenues/relationships
4. Key anti-metrics for **eMerge**’s long-term viability:
 - (a) High ratio of profitable deals not closed by ranchers
 - (b) High ratio of *unprofitable* deals *closed* by ranchers
 - (c) Low repeat/referral rates between ranchers and buyers

Industry-Transformation Effects: Long-term Metrics for Value Chain Integrators

As the business develops and eMerge is able to deliver value chain integration benefits to greater numbers of its constituents, we would expect the key performance metrics to evolve as follows:

A. Transaction satisfaction indicators (qualitative):

Clear and repeated evidence of small-medium ranchers placing the bulk of their sales through eMerge, as opposed to just a portion, as is the case today. Also, we should expect to see increasing evidence of rapid sales growth occurring based on word-of-mouth, spreading to the larger producers who are responsible for the other 50% of all beef-cattle production.

B. Financial performance indicators (quantitative):

Hardening evidence of gains in net income throughout the current value chain, benefiting ranchers, stockers, feedyards, and packers. Subordinate indicators relative to reduced weight loss and morbidity should also solidify.

C. Industry-transformation indicators (value chain integration benefits):

The key metric here should be (i) a dramatic widening of the gap separating the minimum price paid by consumers for commodity beef products and the maximum price paid for differentiated cuts and brands, including prime cuts, as well as organic, hormone-free, kosher, and other products, and (ii) evidence of increased revenues throughout the value “web” of the beef industry towards the \$3bn.-5bn. per annum estimated by eMerge.

Todd Hewlin, managing director at Internet Capital Group, adds these specific additional results to track in eMerge’s growing contribution as a value web integrator:

- (i) *Track whether eID plus unique animal record are becoming the standard in the industry for describing beef quality (i.e. the “new” grade A). This would be an indicator of value web formation, like WIN API for software compatibility or Nielsen Data for media performance tracking.*
- (ii) *Positive effect over time of eMerge’s proprietary cause/effects data base linking rancher inputs with “finished goods” quality/price per pound, resulting in ranchers adopting new feed and vaccine regimens, new weaning practices, etc. This type of consequence would position eMerge as a key influencer of purchase decisions for feed, medical supplies, and ancillary services.*

Explanatory Notes

At a basic level, **Seller-Oriented Marketplaces** aim to provide (a) target sellers with qualified leads to increase their sales revenues, and (b) buyers with increased visibility to suppliers’ prices and product availability. As a measure of their relative attractiveness to sellers and buyers, SOMs should produce quicker, simpler and more satisfying transactions and relationships than are available through alternative channels or competing online marketplaces. They should be able to monetize their services by charging sellers fixed or variable percentage fees per transaction, as well as subscriptions for access to the marketplace, and possibly fees for customization, facilitation, financing, support, and other services.

In contrast, we assert that **Value-Chain Integrators** aim to transform the shape of their target industry by facilitating cumulative and multiple economic benefits along the traditional value chain, by effectively turning the chain into a web of mutually beneficial relationships between all the main constituencies.

In upcoming issues:

- New Managerial Skillset: Crafting Service Level Agreements for the Internet Era
- More Net Market Maker Case Studies Demonstrating Sustainable Liquidity, Leading to Scale
- Key Fulfillment Areas for B2B Commerce: Finance, Supply Chain/Logistics, CRM
- Critical Success Factors: The Need for Strategic Alignment in Internet Startups

Under the Buzz offers a monthly commentary on the business-to-business e-commerce sector. The goal is to provide provocative and accurate insights into the latest events and thinking shaping the rapidly evolving business-to-business marketplace. *Under the Buzz* will focus on developments and competition in digital markets and e-infrastructure.

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