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Methods may have changed, but have the customers?

To make a success of e-business ventures, managers must understand the behavior patterns of potential buyers, argues Eric Johnson

Now that the dotcom bubble has burst, we can see that many of its breathless pronouncements ignored business reality, and that the new sources of revenue and profit it promised have not yet come to fruition. However, just as the late 1990s were dominated by overreaction and hype, there is now a danger that managers and investors have not learned some hard lessons of the past three years and are ignoring genuine, fundamental changes in technology and business.

Mistake 1: Competition is just a click away

Many observers predicted that the Internet would heighten competition, do away with customer loyalty and put great price pressure upon producers. It is fortunate for the beleaguered e-commerce industry that this simply did not happen. Yes, prices did fall, as they should for any important new efficient technology. However, differences in prices did not disappear, but persist for goods that seem very similar, such as airline tickets, books or compact discs.

In the past two years, research studies have backed up this claim. Academics from Carnegie Mellon and MIT examined the book and CD markets and found that identical items differed in price by as much as 33 per cent across different sites, A study at the Wharton School found that the cost of identical airline tickets differed by as much as 10 per cent across sites.

This is all the more surprising when we consider that certain search engines, known as 'bots", can easily scour different web-sites for the cheapest prices. By typing in a book title at a site like Dealtime.com, one can check the price, postage and tax from many retailers. It is common to find big differences: one of this author's books, for instance, ranges from $13.50 to $27.60 for a new copy, sent by regular mail.

In fact, price bots may have failed for another reason: price is not the only thing customers care about. As a result many price bot companies have had to change their business models. BizRate.com, for example, now pushes banner advertisements along with its advice. Others display "featured stores" first, presumably because these stores sponsor the link. Many people predicted that price bots would be widely used and very successful, yet today none are in the Nielsen NetRatings top 25 Properties. Moreover Michael Smith of Carnegie Mellon and Eric Brynjolffsen of MIT found that even those who use price bots do not always select the cheapest option.

Mistake 2: Consumers will shop around

Why are prices not at rock bottom? Why can one merchant charge so much more than another? The evidence is that although the "competition is only a click away", shoppers do not make that click. With colleagues at Texas, Wharton, Accenture and the University of Western Australia, I have researched the surfing habits of shoppers. Against conventional wisdom, these shoppers show enormous loyalty. The average book buyer, for example, visit only 1.1 online bookstores a month, and more than 70 per cent of them visit only one store. Moreover, they do not seem to get more sophisticated as they get more experience with the net. As we track people over time, we do not see an increase in shopping activity.

This is not to say that unhappy customers do not switch; we found that in one product category, buyers were so unhappy with their purchase experiences that they were more likely to go the competition than return. But once they had a satisfactory experience, they did not want to change again. The lesson is that customer loyalty, and perhaps customer value, is greater on the net than we might have thought.

Mistake 3: Start free, raise prices later

One of the great fads behind many internet business plans was to offer a product or service free in the hope that prices could be raised later, once customers found out how wonderful the product was or how the service changed their life.

The problem with this idea is that raising prices turned out to be very difficult. For example, Slate, the Microsoft online magazine, attempted to move from being a free site to charging a fee of $20 a year. This would have seemed reasonable or even cheap for any daily publication, but customers wouldn't bite. Less than a year later, fewer than one in 10 readers had signed up for the paid content and Microsoft rescinded the plan.

This episode is consistent with a basic rule of behavioural economics called loss aversion. While people are pleased with a price cut, they hate the equivalent price increase much more. Research by the late Amos Tversky and Daniel kahneman put the increased pain at somewhere between two and three times the amount of pleasure derived from the price decrease. These effects seem to be particularly strong when the old price is well remembered – and no price is better remembered than free. Additionally, research shows that the increased impact caused by price increase is greatest when moving away from zero.

Lesson 1: Learning and loyalty online

How do companies create loyal customers on the web? Are the rules very different online? Yes and no. While the basic ideas of customer retention are no different, the mechanisms are quite different in cost terms.

In the physical world, well-designed stores encourage customers to stay and return. Part of this design is about making it easy for customers to find what they want and buy it. The same principle applies online, but with a difference: good navigation schemes are essential but, unlike a physical store, an online store can be made different for each customer to ease their shopping experience. A website can remember my credit card information, my preferences for aisle or window seats and, most powerfully, my own customized portfolio. Online, the cost of doing this is much cheaper than offline, but it requires a deep understanding of customers' needs.

Steven Bellman of the university of western Australia, Gerald Lohse of Accenture and I have studies how people make repeat visits to online stores. Most pundits thought that spending more time on a site was a sign of a good customer. We predicted just the opposite: while "sticky" sites might be good for media properties, we argued by analogy to physical stores that a good online store was one where I can find things and purchase them quickly and easily. By looking at the visits of consumers over time, we were able to show that people tended to make purchases at stores where they oriented themselves quickly.

For example, in Figure 1, we show that the fifth visit to Amazon takes a customer about half as long as the first. In terms of time, this represents a saving of about three minutes –a competitive advantage for Amazon. Since they have not familiarized themselves with another site, it "costs" consumers time, in this case about three to four minutes, to use another site. The easier a site is to use, the more likely it is to "lock in" customers.

Lock-in occurs not just because the customer learns about the site, but also because the site learns about the customer. Displaying my stock portfolio the way I want it will make my trips to a website more efficient and pleasant and suggests a switching cost: were I to change brokers, I would have to do it all over again.

EBay is an excellent example of how information can generate lock-in. One of the biggest challenges of conducting online auctions is to make sure that the parties involved will deal with each other honestly because it rates users on the history of their prior transactions, eBay can provide buyers with some assurance about sellers' credibility. This is a key element to ebay, which charges for its services, maintaining an 80 per cent market share when its rivals Yahoo! And Amazon were offering their auctions for free. In this case and others, information about market participants, not price, drives loyalty.

LESSON 2: The power of defaults

Many web users will have come across websites that say something like: "Uncheck the box if you would prefer not to receive emails from our partners." Though confusing, this an effective way of increasing the acceptance rates of such offers. Both online and offline the use of default options turns out to have powerful effects on consumers.

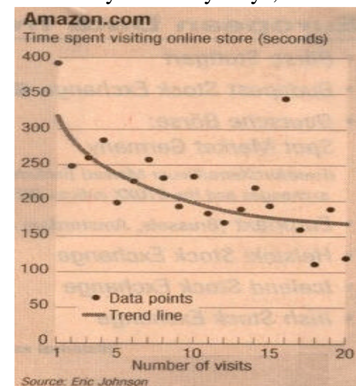
Offline studies of pension behaviour by bridgette Madrian of the University of Chicago and Dennis Shea show that simply having a "default" rate of contribution to a defined contribution plan can produce big changes in the amount invested. We have shown similar effects in offline insurance decisions and in decisions to opt in and opt out of future mailings.

There is no doubt that online retailers also use this tactic. Consumers who visit the Dell site often type in a code that they have seen in a newspaper or television advertisement. This brings them to a "default" computer that Dell believes is appropriate for that audience. While people then have the option to change the make-up of the computer by customization, the influence of the default creates a particular mix of computers across the company's sales.

LESSON 3: pricing and mental accounting

Offline, one tends to pay a given price for a given object. Online, pricing can be more complicated. For example, when buying internet access, I can pay for the minutes I use, a flat monthly rate, or I can pay for a year in advance. These time frames are not equivalent and generate different consumer behaviour.

John Gourville of Harvard Business School has shown that portraying services such as cable TV as "the same price as your daily cup of coffee" gets a much better consumer reaction than pointing out they cost the equivalent of more than $275 a year. In traditional economics and mathematics these are the same thing. In the real world, people regard them differently. In many ways,



the lessons learned from the web correspond to behavioural and not traditional economics.

The future

The hype and hope of electronic commerce can be summarized with two observations. First, Internet use is still growing. According to Nielsen netRatings, the average web user spends more than 11 hours a month on the Internet and the average office user 26 hours. The picture is similar worldwide. In Germany, for example, the average home user surfs the web for more

than nine hours a month; in Hong Kong, more than 16 hours. Web traffic has not declined.

The second observation is that generating profit from these customers is not as easy as many had thought. The online advertising industry has collapsed, in part because it is easy to demonstrate its short-term ineffectiveness. Moreover, like all advertising, its longer-term effectiveness is also hard to demonstrate.

The immediate impact of e-business has been that it has enabled companies to reduce the cost of their processes, while making their products and services more accessible to customers. The longer-term impact will come when companies use the web to improve their understanding of customers and their foibles, and to find out how to help them. The technology may indeed have changed, but customers are by no means more rational online than off.

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