B2B netmarkets: The froth is gone, but opportunities remain for financial services firms

Business-to-business (B2B) netmarkets were one manifestation of the Internet phenomenon that was supposed to revolutionize the way business was done, bringing buyers and sellers together to realize pricing efficiencies. How has the reality matched up against the hype, and how can financial services firms play a role? While they haven’t lived up to initial unrealistic expectations, netmarkets nevertheless will play an important role in bringing process (and pricing) efficiencies to B2B transactions.

By Christa Maver and Dan Latimore
What happened to the B2B netmarket?

Netmarkets have, in many senses, paralleled the path taken by the larger Internet over the past several years. In early 2000, B2B netmarkets were on the rise and analysts saw no end to their inevitably robust growth. Transaction volume of public exchanges was expected to reach over US$1 trillion worth of B2B commerce by 2004, with the number of exchanges topping 10,000.

No more than half a year later, excitement was already waning and today, analysts who forecasted astronomical growth are scaling back their predictions dramatically. The B2B exchange model itself is on its third iteration. Netmarkets within each industry have begun consolidating by shutting down, merging, or morphing into new business models.

Conversely, B2B e-commerce has flourished so greatly that analysts have revised forecasts upward. Newer estimates for B2B e-commerce are, on average, 50 percent higher than those of early 2000. This suggests that not only is there an important role for netmarkets to play, but also that by developing a more realistic set of promises, netmarkets can still capture a significant portion of B2B commerce.

In a recent study by the IBM Institute for Business Value, our consultants conclude that:

- Netmarkets will succeed, but in a different way and on a different timetable than originally predicted.
- Value-added services remain the best way for financial services firms to get involved.
- The distinction between public and private exchanges will disappear; and financial services firms can play the crucial role of liaison.

In less than five years, we have seen three incarnations of the B2B netmarket. Though they all exist today, the following figure illustrates when each type dominated.
The three types of netmarkets

Source: IBM analysis

The original: The public independent

The first type of netmarket, the independent (or third-party) public exchange was expected to shift the power structure within industries. Despite the excitement surrounding them, these public exchanges were plagued with a series of internal and external problems, and they never achieved widespread participation. Internally, they focused on price efficiency, yet lacked liquidity. They also failed to adapt to external challenges from new competitors who solved these problems better than they did.

From the beginning, the fundamental business model of public exchanges was flawed. These exchanges focused on cost savings rather than increased efficiency, order matching rather than collaboration, and expected to earn much of their revenue from transaction fees. The underlying assumption was that exchanges were going to take over the supply chain and bring every industry’s buyers and sellers together at a single, virtual location. In reality, though cost savings and order matching are worthy benefits, they’re certainly not enough to revolutionize a supply chain, particularly when set against the backdrop of longstanding relationships.
The other critical failure was lack of liquidity. Suppliers who would have provided this liquidity had no real incentive to join public exchanges. If anything, they had incentives not to join. Being part of a public exchange would introduce pricing pressure, create the potential for forfeiting any sort of brand advantage, risk failure due to lack of necessary technical infrastructure, and increase overall costs by the transaction fees that the exchanges often intended to charge the seller.

The external reason independent exchanges did not gain popularity was the increasing competition from a new type of exchange: the consortium. By 2000, the large industry players that independent exchanges were hoping to attract began to form their own exchanges that built on the lessons learned from public exchanges. Small, third-party exchanges had neither the brand nor the funding to compete against these industry leaders.

**A new model: The public consortium**

The growth of consortia was more than an attack on public exchanges. The industry-led exchanges were, in fact, better positioned to generate transactions and therefore attain liquidity. They could leverage investments necessary to build and maintain an exchange and thereby enjoy a stake in the growth projections that analysts were promising. Many believed that consortia would be the most cost- and time-efficient way for suppliers to interact with the industry.

Yet they too had difficulties. In addition to the problems facing the independent exchanges, consortia had to battle the challenges that occur when industry competitors come together. For one thing, achieving success required sharing a minimum level of sensitive information with industry competitors. Even those that were willing to cooperate had to deal with the fact that their technology platforms were not compatible. They also found it difficult to achieve neutrality. Third parties ran the independent exchanges, which gave customers confidence that the exchange owner would not push one supplier over another. Regardless of whether or not this was the case with consortia, it was hard to overcome the perception of the potential for bias.
Finally, in order for the consortium to be successful, it needed to have top industry players, but many of them did not need to join an exchange to pick up additional customers. A standalone brand was more powerful than a membership card in an unknown exchange. As this was a new business model, participating companies had no benchmark to gauge which platform to choose.

These shortcomings led to the next step in the evolution of exchanges: the private exchange.

The private exchange: Worth the hype?
The private exchange is the third and most current iteration of the netmarket. Fifteen percent of the Fortune 2000 companies have one; 33 percent are predicted to have one by 2005; and by one estimate, 90 percent of B2B commerce was conducted over a private exchange last year. Private exchanges are run by a single company. They are usually formed when a company has existing relationships with multiple suppliers and wants to make its interactions with them more efficient. Private exchanges include everything from the traditional one-to-one Electronic Data Exchange (EDI) system to more current one-to-many versions using Extensible Markup Language (XML).

Until private exchanges emerged, the benefits of netmarkets were restricted almost exclusively to price improvements. Private exchanges introduced increased process efficiencies by providing a security-enhanced trading platform, addressing members’ unique needs and priorities, and facilitating collaboration with a realtime flow of information.

Consolidation shows signs of life in public exchanges
With private exchanges taking center stage, public exchanges have been undergoing massive consolidation. Despite the setbacks, however, they can still enjoy success: consolidation does not indicate failure. In fact, it may indicate which netmarkets will thrive in the future. When high consolidation couples with revenue growth for a particular industry, it is a sign of success. Currently, commodity-type industries in which relationships are less crucial—like metals, computers and chemicals—are evolving with no more than one or two exchanges per industry. With the promise of netmarket success, financial services firms should be ready to get involved.
While the three types of netmarkets are still jockeying for position, the best point of entry for financial services is clear: become a value-added service provider. Understandably, financial services institutions (FSIs) are apprehensive about entering this space. Internet history is filled with failed attempts from those who either tried to start a netmarket where they had little expertise or joined a netmarket only to find little revenue and squeezed margins. Rather than sponsor or join a netmarket, financial services firms should generally be examining how to offer the much-needed specialized services surrounding the netmarket transaction.
The core of B2B exchanges is order matching and specifying terms. Revenue models were initially based on transaction fees, in which sellers and buyers were charged a percentage of each completed transaction. This model was predicated on two assumptions:

- A single exchange would attract a significant share of the transactions for an entire industry.
- Customers would pay a sizable commission for the order matching service.

Neither assumption came to fruition. Industry liquidity has failed to consolidate into a single pool, and order matching has become a commodity.

Not being able to earn sufficient returns on a commodity service in a fragmented market, both public and private exchanges have been forced to alter their revenue models. Turning to a value-added services model will allow exchanges to differentiate themselves in the marketplace and potentially earn economic profit.

There is a broad array of value-added services that exchanges can offer with a transaction, but because they cannot cost-effectively provide all of these services in-house, they will have to turn to outsourced providers. Financial services firms are well positioned to generate revenue as value-added service providers in certain areas. The field is wide open, and FSIs can enjoy a first-mover advantage if they approach netmarkets before they build relationships with other providers.

**Optimizing revenue potential**

In determining which services to offer, FSIs should assess which service will bring in the most revenue. Revenue potential is a factor of three key components:

- FSI fit—How appropriate is the service to financial services?
- Outsourcing need—Which type of netmarket needs my service?
- Revenue model—Is revenue per-seat (license) or based on volume (market)?

The first two components address simple but necessary questions: Is my firm, the financial service institution, well-suited to providing this service? Even if it can provide the service, do
the netmarkets need me to provide it, or can they do it themselves? The third component, the revenue model, will help financial services to determine if this service: (1) Will be profitable for public or private exchanges, and (2) Should be part of a short- or long-term strategy. The two are closely connected. Because private exchanges currently dominate, and public exchanges are still in the midst of a shakeout, there are more opportunities to service private companies. In this case, the per-seat, or license, model will be more profitable than the per-volume one, because each private exchange brings another potential set of licenses. Over the long term, however, when public exchanges reach their consolidated state of one or two per industry, services from per-volume revenue will be more profitable than those from per-seat revenue. In this case, the transaction volume, not the number of exchanges, will determine profitability.

Financing and payment facilitation revenue

B2B netmarkets today offer two main benefits: process efficiencies and pricing efficiencies. Process efficiencies refer to the high level of control, service and customer interaction that come in a one-to-one environment. Pricing efficiencies refer to the ease of price comparison in a many-to-many environment. Process efficiencies are today associated with private exchanges, while pricing exchanges tend to drive public exchanges. Today’s buyers want both. They may go to public exchanges for a price check and private exchanges to transact with their suppliers; but, over time, they should be able to do this simultaneously.
Eventually, buyers will force the linking of public and private exchanges. Process efficiencies will be worked out and perfected on the private exchanges, and over time, they will be applied back to public exchanges. Once this happens, there will be a shift in value propositions. With a morphed or linked public exchange that offers both pricing and process efficiencies, private exchanges will need to link to public exchanges in order to keep buyers. The private exchange will no longer be the star of the show.

Financial services institutions have an important role to play in the linking of public and private exchanges. Being value added service providers puts FSIs in the unique position of liaison between exchanges. This gives them the chance to become a crucial player in the linking of public and private exchanges.

Currently, public and private exchanges are not able to transact with each other because they operate on different platforms. FSIs are left with two choices:

- Invest to develop systems that can “speak” with each platform, or
- Serve a limited set of platforms and risk abandoning potential customers.

FSIs need an established set of standards to promote universal participation. As value-added service providers, FSIs will have built relationships with multiple public and private exchanges. In building and maintaining these relationships, FSIs have the potential to become experts in communicating with or across diverse platforms. They will be well positioned from a business and technology standpoint to bridge the gap between standards if, in fact, this will help them drive their core business.
Financial services institutions must act as liaison between public and private exchanges

Conclusion

The expectations for netmarkets were set so high that they were almost bound to fall short of the dizzying demands that people placed on them. Yet netmarkets themselves are not flawed, but are evolving. What business model has not experienced rounds of trial and error before hitting its stride with customers, investors and analysts? At the core of the evolved netmarket is a model built on sound principles: pricing and process efficiencies. Growth will be slower than originally expected, so plan your investments and participation accordingly, but by all means, plan. Netmarkets have high potential for future success. And when they do succeed, if you are not an established value-added services provider, helping to facilitate the linking of public and private exchanges, your chances of tapping into this significant revenue opportunity will be far lower than those of your peers.
About the authors

Dan Latimore is the Global Financial Services Sector Lead for the Institute for Business Value. The Institute develops intellectual capital to support IBM consultants and to drive insights for clients of the Business Value Alliance, a network of firms who seek to realize business value at the intersection of business and technology. Membership in the Alliance is cross-industry. He can be reached at dwlat@us.ibm.com.

Christa Maver is a Research Associate with IBM’s Insitute for Business Value Financial Services practice. Her work focuses on uncovering and analyzing trends in various financial industries to provide clients with real, timely data to support their business strategy needs. She can be reached at cmaver@us.ibm.com.

References


2 IBM Institute for Business Value analysis.