

e-Commerce

Jeffrey F. Rayport
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Harvard University and

Marketspace, a Monitor Group Company

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e-COMMERCE

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MISSION STATEMENT

This text and companion casebook, *e-Commerce* and *Cases in e-Commerce*, are the first volumes produced for the McGraw-Hill/MarketSpaceU learning series on e-commerce. McGraw-Hill/MarketSpaceU was created to develop exceptional higher education teaching materials on the latest business practices and theories by leading thinkers in the field of e-commerce. McGraw-Hill/MarketSpaceU is committed to providing the business instructor a comprehensive set of pedagogical tools with the most current materials in an easy-to-use learning system that includes textbooks, casebooks, video interviews, and Web support for teaching the state-of-the-art in e-commerce business practice and theory. We aim to equip present and future executives, managers, and strategists in becoming successful creators of value in the New Economy.

To accomplish this task, we offer a suite of cutting-edge tools to help you navigate the world of e-commerce:

- *e-Commerce* text
- *Cases in e-Commerce*
- McGraw-Hill Online Learning Center (OLC)
- MarketSpaceU.com
- PowerWeb in e-Commerce

For more information about these tools, see page xviii.

ACKNOWLEDGMENTS

We are grateful to a team of outstanding colleagues who have made the preparation of this book possible. We acknowledge specific contributions chapter by chapter throughout the book, but we want to thank heartily and with great enthusiasm our colleagues in Marketspace, a Monitor Group Company, who constituted the core team for this work: Yannis Dosios, Leo Griffin, and Michael Yip. Yannis and Leo contributed extensively to many of the chapters in the book while Mike worked tirelessly over many months in a variety of capacities—content, editorial, and project management—to ensure we stayed the course.

We also wish to acknowledge the valuable contributions to portions of the manuscript from Jennifer Baron, Wendy Cholbi, Tom Copeland, Lisa Ferri, Sharon Grady, Ellie Kyung, Peter Meyers, Nancy Michels, Rafi Mohammed, Mark Pocharski, Marco Smit, and Toby Thomas. We also wish to thank Steve Libenson, John Trinidad, Yakir Siegal, Scott Daniels, and Alex Scherbakovsky for their advice, comments, and contributions. We thank Kim Bender for her work on the companion casebook. And we also thank JoAnn Kienzle and Jason Park for their valuable editorial and administrative work on the project.

This book also draws from the video production work of Lori Cohen and her crack team as well as the Web content under the direction of Josh Clark and Steve Szaraz. In managing the project, we are indebted to Rafe Sagalyn, our literary agent, and Alan M. Kantrow, our local knowledge management czar.

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Finally, none of this would have been possible without the generous support and enthusiasm of Mark Fuller, Joe Fuller, and Mark Thomas, cofounders and leaders of Monitor Group, a strategy consulting company and merchant bank based in Cambridge, Massachusetts.

ABOUT THE AUTHORS



Jeffrey F. Rayport, founder of Marketspace, a Monitor Group Company, is regarded as one of the most influential thinkers in the field of e-commerce. He launched the first e-commerce strategy course at the Harvard Business School nearly six years ago and to date has written nearly 100 case studies on e-commerce. His second-year elective course on this subject consistently enrolled nearly half of the Harvard Business School class of 800 students. From 1997–1999, he was voted “best professor” at Harvard Business School by the student body, and he was the first Harvard Business School professor to

receive this award three years in a row.

Dr. Rayport’s research has focused on the impact of information technologies on service management and on marketing strategies for business and has involved a wide array of high-tech and service firms, industry associations, and professional practices. In addition to his HBS case studies, he has written numerous articles on New Economy topics that have appeared in industry and popular business publications.

Dr. Rayport earned an A.B. from Harvard College, a M.Phil. in International Relations at the University of Cambridge (U.K.), and an A.M. in the History of American Civilization and a Ph.D. in Business History at Harvard University. His doctoral research examined diversification strategies among the regional Bell operating companies after the breakup of AT&T, with a focus on the transformation of high-tech companies from technology-driven to marketing-oriented firms.



Bernard J. Jaworski is a cofounder and senior advisor at Marketspace, a Monitor Group Company, and holds the Markets Chair within Monitor University. He has been the Jeanne and David Tappan Marketing Fellow and a tenured Full Professor of Marketing at the University of Southern California. He previously served on the faculty at the University of Arizona and was a visiting professor at the Harvard Business School. In 1997, he received the Golden Apple Award as the MBA teacher of the year at USC. Dr. Jaworski is one of a few two-time winners of the prestigious Alpha Kappa Psi award for best market-

ing practice article published in the *Journal of Marketing*. He currently serves on the review board of the *Journal of Marketing*, the *Journal of Marketing Research*, the *Journal of Business-to-Business Marketing*, the *Asian Journal of Marketing*, and other journals.

About MarketspaceU and the Contributing Authors

MarketspaceU is a community of award-winning academics and talented business practitioners dedicated to developing managers for the New Economy. We are part of Marketspace, a Monitor Group Company, founded in 1998 as a multimedia enterprise to provide advice on, research about, and analysis of the impact of new

media and technology on businesses. Marketspace activities include consulting to freshly minted dot-coms, as well as to Global 1000 companies, and providing New Economy insights to the public through a variety of media that includes the Web, television, and print.

Drawing upon the resources at Marketspace and at other Monitor Group companies, as well as from a network of academic institutional partners and CEO visionaries, MarketspaceU.com brings together the diverse talents of practitioners, management consultants, academic experts, and writers.

WHAT LEADERS IN THE NEW ECONOMY ARE SAYING ABOUT *E-COMMERCE*:

In today's turbulent Internet-driven business environment, clear and understandable rules to the New Economy are hard to come by. Jaworski and Rayport have taken a dizzying amount of research and boiled it down to exactly that. The framework they present is not only clear and graspable, but also universal. Their new rules of business management are as applicable to General Motors as they are to Yahoo! Inc.

Tim Brady

Sr. Vice President of Network Services, Yahoo! Inc.

Finally someone has put it all together! These leading thinkers have put in one place a brilliant and comprehensive framework for thinking through, planning, teaching, and managing e-Business. And—beyond that—this book is a portal to a stream of the most complete set of online, video, and other resources for e-Business learning to date. Great insights. Powerful tools.

Ralph Oliva

*Executive Director of the Institute for the Study of Business Markets
and Professor of Marketing, Pennsylvania State University*

This is a wonderfully designed pedagogical device. The chapters build foundationally, so as to empower the student to deal with unique New Economy concepts, like the DCF approach to valuation, etc., towards the end. The chapters are filled with case vignettes, viewpoints, and thought bytes that draw the self-selected readers in and engage them in a sophisticated debate regarding the Internet economy. The highlight of the book, for me, was the way linkages were provided to existing management concepts. Thus, the reader is not left wondering what the connection to the old paradigm is; in fact, the reader gets a working dose of those ideas in the book chapters. This makes the book a stand-alone, comprehensive text with cutting-edge tone and content.

Kastori Rangan

*Eliot I. Snider and Family Professor of Business Administration
Harvard Business School*

e-Commerce is the first textbook to show how firms gain competitive advantage in the New Economy. The authors introduce a number of new and innovative concepts, frameworks, and tools that benefit both students and managers. This book is destined to become the standard New Economy text in leading MBA programs.

John Quelch

Dean, London Business School

Of all the Internet textbooks I have seen, *e-Commerce* by Rayport and Jaworski does the best job making both an intellectual and practical contribution to electronic commerce. Students and managers alike will come away with a better understanding of the nature of electronic commerce, how it has changed the existing business model, and its likely impact in the future.

Particularly valuable are the chapters on Business Models (Chapter 3), the Customer Interface (Chapter 4), Implementation (Chapter 6), Metrics (Chapter 7), and Valuation (Chapter 8). Together with its companion casebook, *e-Commerce* will soon become the electronic commerce textbook of choice.

Russ Winer

*J. Gary Shansby Professor of Marketing Strategy
University of California at Berkeley*

PREFACE

To say that the Internet changes everything is, in some high-technology circles, almost a cliché. But this book makes a strong argument for the truth of that now familiar phrase. Or, put differently, the application of new media and information technology to business—which, of course, includes the Internet and the World Wide Web—has not only changed what we know about management, strategy, and business design, but also has assured us of a continuing and unfolding impact on what managers do and how businesses operate in the foreseeable future. All hype aside, there is truly a revolution here, and we have little choice but to embrace it.

We aim to equip present and future executives, managers, and strategists in becoming successful in this sweeping change. This book is the entry point into a learning system that includes this textbook, a companion casebook, video interviews, and integrated Web support for teaching the state-of-the-art in e-commerce business practice and theory.

The most succinct way of characterizing this revolution is to understand that we are operating today in what some call the New Economy. While there are many definitions of this term, New Economy businesses have several key traits in common. Successful New Economy firms must be able to accomplish each of the following tasks:

- Create value largely or exclusively through the gathering, synthesizing, and distribution of information. Success is predicated on creating value by tapping the power of electronic information networks and new media interfaces.
- Formulate strategy in ways that make management of the enterprise and management of technology convergent.
- Compete in real time rather than in “cycle time” and operate in a constantly responsive dialogue with their customers and markets.
- Operate in a world characterized by low barriers to entry, near-zero variable costs of operation, and, as a result, intense, constantly shifting competition.
- Organize resources around the demand side—e.g., customers, markets, trends, and needs—rather than around the supply side, as businesses have done in the past.
- Manage relationships with customers and markets often through “screen-to-face” channels and interfaces, meaning that technology rather than people manages these relationships.
- Use technology-mediated channels, which means that ongoing operations are subject to measurement and tracking in unprecedented and granular ways.

Taking these themes together does more than furnish a rigorous understanding of what business managers and pundits alike mean when they talk about doing business in the New Economy. Each of these statements implies significant changes in how New Economy practitioners determine strategy, deploy resources, operate firms, manage relationships with their markets, and measure results. This does not mean that everything we know about business up to this point becomes irrelevant and obsolete, but it does mean that significant changes in the environment of business justify—indeed, demand—radically new approaches to thinking about strategy and management.

As a result, we strongly argue in the following pages that the revolution in business is, in fact, larger than any one particular technology, including the Internet, and that it is more profound than any one innovation, including the World Wide

Web. We are entering a world in which a new array of considerations—issues that were once peripheral to management or completely outside its scope—have now taken center stage. These include technology, interface design, real-time market metrics, and deep understanding of customer attitudes and behavior. For anyone who is considering a career in business of any kind that impinges on these New Economy realities, a deep understanding of these themes is essential to business success, if not business survival.

In this sense, we have created this set of materials to be not only about technology but also about a world enabled by technology. Increasingly, the New Economy is built of businesses that exploit, at their core, a variety of technological innovations. These innovations have proven necessary, but not sufficient, in the creation of a viable business proposition. Rather, they have created a flood of new entrants in practically every sector of the economy, most with some kind of new technology-enabled approach to changing the way traditional industries work; this, in turn, has resulted in a flood of venture capital and private equity into the New Economy sector that has further fueled the pace of innovation and competition.

However, it would be a mistake to interpret these developments as a sign that technology is the new competitive weapon for business. Rather, it is the new definition of the minimum entry price—or what gamblers would call “table stakes”—of doing business. Put differently, technology is no longer the scarce resource. Indeed, it is ubiquitous in the New Economy. The scarce resources are the talented individuals with management, strategy, and executive skills tailored to doing business in the New Economy.

This constitutes the goal of the learning system that includes this textbook. Again, we are here to provide tools to present and future executives, managers, and strategists in becoming successful creators of value in the New Economy. While this involves a solid grasp of relevant technology and new media forms, it demands just as solid a grasp of how the functions of the manager and executive have changed in this new world.

It is no coincidence that today in Silicon Valley—easily “ground zero” of the Internet business revolution—there are no less than 400 CEO positions on offer with few if any candidates to fill them. The Valley is a place rife with ideas, entrepreneurs, and capital; it’s a place where the idea of a shortage in *anything* seems almost a contradiction in terms. Yet there is truly a shortage of one critical skill set, and that is the ability to manage effectively at the highest levels in the world that the New Economy has wrought.

You, the reader, are the person with the potential to develop such skills. And this is an exciting notion. There could not be a better time in the history of business to have the skills for doing business in the New Economy. With these at your fingertips, the world will truly be your (high-technology) oyster.

Approach

This book is written for present and future practitioners in New Economy businesses. As such, it provides both a deep exploration of core concepts of New Economy management and strategy. It is also enriched by a wide variety of examples, case studies, and explanations culled directly from practice. We take this approach for a variety of reasons.

New Economy management and strategy are being invented in real time as we go to press. Every marketplace business we have studied—and our work is based on nearly 100 case studies completed at the Harvard Business School over the last six

years—has been engaged in the creation of “new science” for doing business. The true insights will be generated at this stage by deep observation of both new and established businesses wrestling with New Economy challenges. Thus, we take a militantly field-based and practitioner-focused perspective on this work. This is not to say that management theory is irrelevant. Existing concepts and theories such as “network effects” and “increasing returns to scale” do apply. However, in general, that practice is far ahead of theory at this time in history.

The result presented in this book is a collection of rigorous concepts, frameworks, and approaches that represent an entire applications suite of tools for doing business in the New Economy. Observation of business practices, while often fascinating and instructive, is not enough. We have taken our knowledge of practice as developed through case studies and followed through with conceptualization. These tools represent a critical source of competitive advantage for companies and their managers, and we have tested them with our own students in MBA and executive education programs and with our consulting clients in the context of their own businesses. In other words, these are “road-tested” approaches to New Economy business, developed out of rigorous observation from the inside of such businesses and then tested in real firms.

Because New Economy businesses operate in rich media or new media environments, we have endeavored to make this book a rich information environment. We provide deeper exploration of topics that appear in the text through Drill-Down sidebars. Point-Counterpoints highlight the two sides to some of the unresolved debates in New Economy businesses. POVs are sidebar commentaries from leading practitioners in the New Economy. We transcribe excerpts from videotaped conversations with thought leaders in the New Economy into Sound Byte sidebars. And at the end of every chapter, Schwab serves as a living case study to which we apply the ideas and concepts presented in each chapter. We show exactly how these ideas apply, and we help you see the ideas in action in ways that have created substantial value for a company doing business in the real world.

You will see that every chapter has a variety of standard features that augment the text. You can count on these to enrich your understanding of the material covered, to introduce new and often controversial perspectives, and to provide greater detail on topics of current and future salience.

In addition, you will see that every chapter begins with a chapter overview to help you get a quick grasp on the topics discussed in that segment. In addition, we provide study questions to guide you in reading the material. And of course, context is important; we frame every chapter in the first few sections by consistently indicating each chapter’s connection to the previous one, the overall purpose of the chapter, and an overview of its organization. This way, before you even think about reading any one section of this book, you will have all the information you need to judge its relevance and anticipate its approach.

Content and Organization

The book is organized around the decision-making process we propose for formulating New Economy enterprise strategy. There are six interrelated, sequential decisions to this strategy—market-opportunity analysis, business model, customer interface, market communications and branding, implementation, and evaluation. These decisions are made in the context of a changing market-level infrastructure. The infrastructure includes factors related to the network infrastructure and media convergence.

As such, the sequence and topics of chapters reflect the intellectual architecture of our approach to managing in this field. Chapters are organized to reflect the framework sequence of the decision-making process.

Chapter 1—Overview: Many students and clients constantly ask us what's different about managing in the New Economy. In this chapter, we set forth those differences in detail, attempting to frame the unique attributes of the New Economy and the implications for managers and strategists. In doing this, we present a working definition and framework for the study and practice of e-commerce. We also review the e-commerce landscape to provide context for discussions throughout the rest of the book. Notably, we divide the world of New Economy businesses into several key groups, including business-to-consumer, business-to-business, and consumer-to-consumer.

Chapter 2—Framing the Market Opportunity: In this chapter, we revisit the basics for any business to construct an original New Economy approach to formulating business strategy. In so doing, we focus on the players who make up the dynamics of any business—customers, competitors, and strategic partners. The goal here is to understand what market analysis becomes in this new world and to introduce a process not only to understand the market but also to identify those portions of the market that are unserved or underserved. This chapter identifies five conditions that must be carefully analyzed to determine if there is a market opportunity for the firm.

Chapter 3—Business Models: While many believe that Internet businesses in many cases do not have business models, we strongly disagree. There may be poorly articulated models out there, but a business-model definition is essential to competition in this new space. Here we introduce the four components of the marketplace business model. These are: (1) the value proposition or cluster, (2) the product offering that we call a marketplace offering, (3) the resource system that the firm selects to deliver the offering, and (4) a financial model that enables the business to generate revenues, cash flows, and, ultimately, profit margins or valuation potential. These four choices constitute the foundation of the strategy decisions that we explore throughout the book.

Chapter 4—The Customer Interface: The visible presence of most e-commerce businesses is a digital or rich media interface. While New Economy businesses may make substantial use of traditional offline interfaces—such as retail points of sale, printed catalogs, stand-alone kiosks, and call centers—they rely primarily on a virtual storefront connected to the Internet. In this chapter, we fully develop the set of design tools and elements that we refer to as the 7Cs of the customer interface. These elements include content, context, community, commerce, customization, communications, and connection. In particular, we focus on the levers management can use to create competitive advantage and generate customer value through these essential elements of interface design.

Chapter 5—Communications and Branding: In the demand-oriented world of the New Economy, there is nothing more valuable than mindshare or the ability to attract and hold the attention of markets and customers. The traditional tools of attention management are marketing communications. In this chapter, we explore the variety of traditional and new media communication approaches that provide competitive advantages to New Economy businesses. And we delve into the extraordinary power of brands in this new, information-

enabled world. Many believed that the Web would create a world of downward price pressures and rapid commoditization of goods and services of all kinds. As we explain, the opposite has occurred. Brands are more important than ever—and some would argue that, at least in business-to-consumer ventures, they are essential to success.

Chapter 6—Implementation: If strategy is about “what to do,” implementation is about “how to do it.” In most management texts focused, as this one is, on strategy, implementation is often left to the last chapters. Indeed, in the management literature, it has constituted a “poor cousin” of fashion-forward fields such as strategy, marketing, and finance. Doing business in the New Economy demands a different approach. Because such businesses operate in constant dynamic dialogue with their markets, it is difficult—and unproductive—to approach strategy and implementation in a linear, sequential fashion. Rather, they are two elements in a real-time cycle, wherein each set of decisions pertaining to strategy and implementation must constantly be reevaluated, based on new data one from the other. In this chapter, we consider both the “delivery system” and innovation components of strategy implementation.

Chapter 7—Metrics: The dynamic relationship between strategy and market feedback demands new approaches to measurement and evaluation of business results. We know that e-commerce businesses offer unprecedented opportunities for capturing information on how markets operate and how customers engage in search and shopping behavior. Because this kind of data is available in rich granular forms and, as importantly, in real time, we introduce a new management tool called the Performance Dashboard. It is a set of metrics that reflect both the early warning indicators of the progress of an e-commerce strategy, as well as outcome measures, such as customer satisfaction and financial performance.

Chapter 8—Valuation: One of the more provocative aspects of the e-commerce revolution has been the extraordinary valuations that Web-based businesses have achieved in the capital markets around the world. These range from Yahoo!, the Web’s leading search engine, which is worth more than General Motors, to America Online, which achieved a valuation so high that it acquired Time Warner, the world’s largest media conglomerate. They also include phenomenal valuations outside the United States, such as the Hong Kong-based Pacific Century Cyberworks, a holding company of Internet business investments, which achieved a valuation at one point so rich that it threatened to acquire Hong Kong’s national telecommunications giant, and the India-based Wipro, an Internet services firm that, after an offering on its country’s national stock exchange, became the most highly valued company in India’s history. We attempt to cut through the mystique and hype surrounding such valuations with the aid of one of the world’s leading experts on corporate valuation, Tom Copeland. This chapter provides an overview of how to determine or project the valuation of an e-commerce business.

Chapter 9—Network Infrastructure: In traditional business, we all know what retail points of sale look like and how trucks transport raw and finished goods on the nation’s highways. In the New Economy, the infrastructure of economic activity—primarily oriented around the processing and shipment of information—is both less visible and less familiar. In this chapter, we explore how the market-level dynamics that operate outside the formal boundaries of the organization provide the infrastructure for traditional and

new business approaches. We provide an overview on hardware, software, servers, and the parts that make up the enabling “railroad” for the New Economy. The chapter also provides a brief overview of several notable public policy issues that have implications for business and society.

Chapter 10—Media Convergence: What rides on the “rails” of this new infrastructure is a wide variety of content and media. In this chapter, we examine media undergoing transformation from analog to digital and the consequences of value migration from old media to new media, media megamergers, and synergies.

Supporting Materials

To facilitate the teaching of the book content, we realize that instructors need teaching support materials. In an effort to assist instructors, we have developed a support package that includes: (1) an instructor’s manual, (2) the McGraw-Hill/Irwin OLC for this book at www.mhhe.com/marketspace and its companion casebook, and (3) the website (www.marketspaceu.com) that includes advanced supplemental materials.

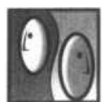
USER'S GUIDE

Textbook Navigation

Because New Economy businesses operate in rich media or new media environments, we have endeavored to make this book a rich information environment. You will see that every chapter has a variety of standard features that augment the text. You can count on these to enrich your understanding of the material covered, to introduce new and often controversial perspectives, and to provide greater detail on topics of current and future salience. Look for the following features as you read.



- **Drill-Downs:** These sidebars provide deeper explorations of topics that appear in the text by taking a focused approach to issues that some readers will find essential at a level of detail inappropriate to the main body of our work. For example, not every reader will want to explore the intricacies of collaborative filtering or viral marketing, but many will find these additional materials useful. Think of Drill-Downs as hypertext—there when you need them, out of your way when you don't.



- **Point-Counterpoints:** These segments acknowledge the reality that many debates in New Economy businesses—such as whether profits matter or whether Internet company valuations are rational—remain unresolved. Rather than take an artificial approach to these issues and present the “right” answers, we make the case for and against. Of course, we do have our points of view, and you will find these clearly indicated.



- **Sound Bytes:** The MarketSpace Center has invested heavily in new media and video products that lend unique insights into the New Economy. The interviews featured in the Sound Byte sections are transcribed excerpts from ongoing research and videotaped conversations with thought leaders in the New Economy such as Netscape cofounder Marc Andreessen, Ethernet inventor Bob Metcalfe, and the creators of ICQ instant messaging, Yair Goldfinger and Sefi Vigiser. These interviews represent fresh, up-to-date, and exclusive perspectives on the state of play in the field. Longer streaming video excerpts are available on the website at www.marketspaceu.com and full interviews are available on videotape for purchase.
- **POVs (Points of View):** Throughout the chapters, we have included sidebar commentaries from leading practitioners in the New Economy—people who have invented new business approaches, developed new network architectures, created major Web brands, and influenced policies in the field. These comments are excerpted from articles published in leading periodicals of the New Economy, such as the *Industry Standard*, *Upside*, and *Business 2.0*.
- **Schwab Case Study:** At the end of every chapter, we visit one company, broker Charles Schwab, that the world has come to admire as the leading example of a “clicks-and-mortar” player—an established business that led the way in developing Web-based brokerage services while maintaining its leading brick-and-mortar franchise throughout the United States. Despite a raft of competitors from the Internet world, such as E*Trade, Ameritrade, and Datek Online, Schwab has held its

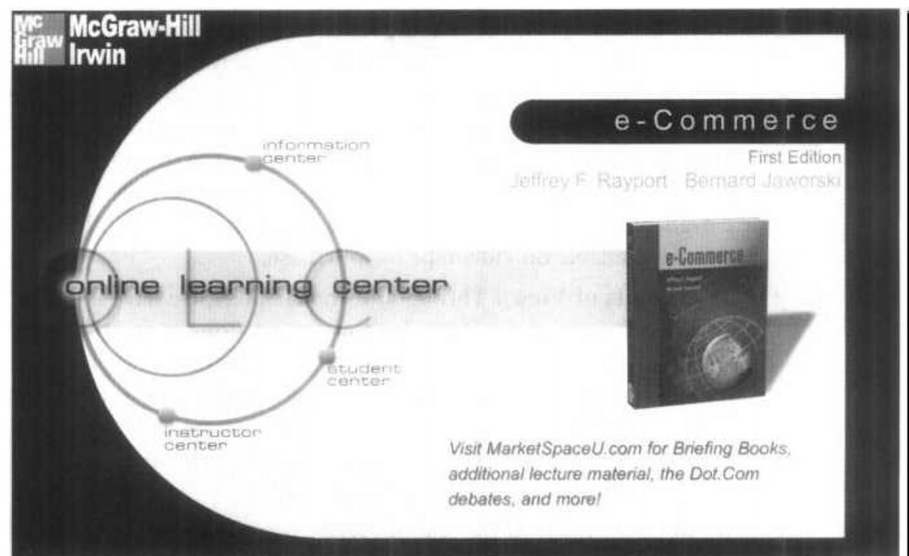
own as the category dominant competitor, forcing even an old-line wire house such as Merrill Lynch to enter the online fray, even as it continues to maintain 40,000 brokers on its payroll around the world. Schwab serves us as a living case study to which we apply the ideas and concepts presented in each chapter. We show exactly how these ideas apply, and we help you see the ideas in action in ways that have created substantial value for a company doing business in the real world.

Supporting Materials

To facilitate the teaching of this book's content, we realize that instructors need teaching support materials. In an effort to assist instructors, we have developed a comprehensive support package that includes materials available on the Web.

- **Cases in e-Commerce:** Available separately for purchase, a casebook complements our textbook and charts an educational course through the key practical issues in the New Economy business landscape. Case studies—long used in clinical psychology, medical, and business school programs—are designed to facilitate a *healthy debate* on the alternative solutions to a particular problem. Today, there are precious few case studies that illustrate “what works” in the New Economy, and in our casebook we have assembled a unique and comprehensive selection that is directly relevant to the New Economy.

Qualified adopters of *e-Commerce* or *Cases in e-Commerce* will also have access to two unique supporting websites, McGraw-Hill's Online Learning Center (OLC) and MarketSpace's www.marketspaceu.com, with a wide variety of additional materials available to support the text.



- **McGraw-Hill/Irwin OLC:** McGraw-Hill/Irwin continues its leading role in providing excellent support to instructors in higher education. Instructors using this textbook to teach an e-commerce course or module are able to access the McGraw-Hill/Irwin OLC at www.mhhe.com/marketspace for sample