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Instructor's Manual: Chapter 2
E-commerce Business Models and Concepts

Teaching Objectives

Identify the key components of e-commerce business models. Describe the major B2C business models.
Describe the major B2B business models.
Explain the key business concepts and strategies applicable to e-commerce.

Key Terms

business model, p. 58
business plan, p. 58
e-commerce business model, p. 58
value proposition, p. 59
revenue model, p. 60
advertising revenue model, p. 60
subscription revenue model, p. 60
freemium strategy, p. 60
transaction fee revenue model, p. 61
sales revenue model, p. 61
affiliate revenue model, p. 61
market opportunity, p. 64
marketspace, p. 64
competitive environment, p. 64
competitive advantage, p. 65
asymmetry, p. 66
first-mover advantage, p. 66
complementary resources, p. 66
unfair competitive advantage, p. 66
perfect market, p. 66
leverage, p. 67
market strategy, p. 67
organizational development, p. 67

management team, p. 68
seed capital, p. 68
incubators, p. 69
angel investors, p. 69
venture capital investors, p. 69
crowdfunding, p. 69
e-tailer, p. 74
barriers to entry, p. 74
community provider, p. 74
content provider, p. 76
portal, p. 77
transaction broker, p. 80

market creator, p. 81
sharing economy (mesh economy), p. 81
service provider, p. 82
e-distributor, p. 84
e-procurement firm, p. 84
B2B service provider, p. 84
scale economies, p. 84
exchange, p. 84
industry consortia, p. 85
private industrial networks, p. 85
industry structure, p. 86
industry structural analysis, p. 87
value chain, p. 90
firm value chain, p. 91
value web, p. 92
business strategy, p. 92
profit, p. 92
differentiation, p. 93
commoditization, p. 93
strategy of cost competition, p. 94
scope strategy, p. 95
focus/market niche strategy, p. 95
customer intimacy, p. 95
disruptive technologies, p. 96
digital disruption, p. 96
sustaining technologies, p. 96
disruptors, p. 96

Brief Chapter Outline
Tweet Tweet: Twitter's Business Model?
2.1 E-commerce Business Models
    Introduction
    Eight Key Elements of a Business Model
        Insight on Society: Foursquare: Check Your Privacy at the
    Door Raising Capital
        Insight on Business: Crowdfunding Takes off
    Categorizing E-commerce Business Models: Some Difficulties

2.2 Major Business-to-Consumer (B2C) Business Models
    E-tailer
    Community Provider
    Content Provider
        Insight on Technology: Battle of the Titans: Music in the Cloud
    Portal
    Transaction Broker
    Market Creator

Figures

Tables

Teaching Suggestions

This chapter attempts to briefly summarize the variety of ways that the Internet, Web, and mobile platform can be used to build new business firms—firms that generate revenue and hopefully a profit. The challenge in this chapter is to focus on some simple, unchanging realities of the business world that have nothing to do with the Internet, and then to understand how the Internet can be used within this framework to develop new businesses. What pundits now say about the Internet is, "The Internet changed everything, except the rules of business."

The chapter starts out with the tale of Twitter and business model in the opening case, *Tweet Tweet: Twitter's Business Model*. Twitter has amassed some very significant online assets in the form of a large audience, and behavioral data on this audience. Twitter is now monetizing these assets, by selling online advertising space in the form of Promoted Tweets, Trends, and Accounts, as well as other methods detailed in the case. Class discussion questions for this case might include the following:

What characteristics or benchmarks can be used to assess the business value of a company such as Twitter?

Have you used Twitter to communicate with friends or family? What are your thoughts on this service?

What are Twitter's most important assets?

Which of the various methods described for monetizing Twitter's assets do you feel might be most successful?

Key Points

Business Models. One of the most abused phrases in the e-commerce lexicon is "business model." Put simply, a business model is a plan for making money. Like all models, a business model has several components. We have described eight components: customer value proposition, revenue model, market opportunity, competitive environment, competitive advantage, market strategy, organizational development, and management team. Students need to have a good understanding of each of these elements.

We discuss both business and social issues in the *Insight on Society* case, *Foursquare: Check Your Privacy at the Door*, which focuses on Foursquare's location-based services business. Location-based services, which involve the merger of geo-positioning technology (GPS) and the Internet, promise to deliver advertising and useful content to users based on their location. However, this same technology results in the ability for a company to track a user's whereabouts. While encouraging users to engage with their friends by posting their locations, these services pose significant privacy issues that users should consider. Class discussion questions include the following:

What revenue model does Foursquare use? What other revenue models might be appropriate?

Are privacy concerns the only shortcoming of location -based mobile services?

Should business firms be allowed to call cell phones with advertising messages based on location**?**

Raising Capital. This section provides an overview of the primary ways that e-commerce start-ups raise capital, including seed capital, incubators, angel investors, venture capital investors and crowdfunding, a new method recently enabled by the Jumpstart Our Business Startups (JOBS) Act. The *Insight on Business* case, *Crowdfunding Takes Off* provides a further look at crowdfunding phenomenon. Some of the class discussion questions you might want to pose to your students include the following:

- What types of projects and companies might be able to most successfully use crowdfunding?
- Are there any negative aspects to crowdfunding?
- What obstacles are presented in the use of crowdfunding as a method of funding start-ups?

E-commerce Business Models. With several million commercial Web sites to consider, there are a great variety of e-commerce business models. Many firms pursue multiple business models at once. Nevertheless, there clearly are dominant patterns to all this variety on the Web. We describe seven different and typical e-commerce B2C business models in Table 2.4: E-tailers, Community Providers (including social network sites), Content Providers, Portals, Transaction Brokers, Market Creators, and Service Providers. Students should be able to describe how each of these models typically expects to generate revenue and earn profit.

The *Insight on Technology* case, *Battle of the Titans: Music in the Cloud* examines how changes in Internet technology, such as the development of cloud computing, are driving the emergence of new business models in the online music business. Some questions that might help drive class discussion of this case include the following:

- Have you purchased music online or subscribed to a music service? What was your experience?
- What revenue models do cloud music services use?
- Do cloud music services provide a clear advantage over download and subscription services?
- Of the cloud services from Google, Amazon, and Apple, which would you prefer to use and why?

B2B Models. While B2C e-commerce is measured in hundreds of millions of dollars, B2B e-commerce is measured in trillions of dollars. B2B e-commerce is several orders of magnitude larger than B2C e-commerce. We describe the major generic types of B2B e-commerce as e-distributors, e-procurement companies, exchanges, industry consortia, and private industrial networks. Each of these models has a distinct revenue model.

E-commerce Enablers: The Gold Rush Model. Companies whose business model is focused on providing the infrastructure necessary for e-commerce have been instrumental in the development of e-commerce. Table 2.6 provides a list of the major players.

How the Internet Changes Business. The Internet has the potential for changing business in three major areas:

- Industry Structure
- Industry Value Chain
- Firm Value Chain

The Internet can change industry structure by introducing substitute products, increasing the bargaining power of suppliers or of consumers and buyers, and by changing existing barriers to entry. Figure 2.3 provides a graphic illustration of these concepts. The Internet can change industry value chains insofar as suppliers, manufacturers, distributors, retailers, and customers can interact in new and different ways. You can use Figure 2.4 to review this concept. Firm value chains (see Figure 2.5) can be directly affected by e-commerce through its potential impact on how the business performs various business processes such as warehousing, manufacturing, sales and customer support. For instance, Amazon uses the Internet to provide consumers with access to a much larger inventory of books than traditional retailers and to accomplish order entry, provide post-sales support, and offer ordering from its suppliers.

Finally, e-commerce and the Internet can change business strategies by allowing the firm to develop new ways of differentiating its products in the marketplace, lowering costs, or changing the scope of its operations. For instance, Dell uses e-commerce as a way of achieving lower costs in the PC business and has created an entirely new way of organizing large-scale production—build to order. Table 2.8 summarizes the basic business strategies that your students should be familiar with.

Students will likely have heard or seen reference to the terms "disruptive technologies" and "digital disruption." A new section on business model disruption examines how e-commerce technology has radically changed entire industries, driving incumbent firms out of business, spawning new firms, and in some cases, radically changing the entire industry.

Case Study Questions

1. *Compare Pandora's original business model with its current business model. What's the difference between "free" and "freemium" revenue models?*

   In its first business model, Pandora's service was free but limited in access. In the current model, it provides more access and uses ads to pay for servicing the non-payers. It has found most success with Pandora One, a premium service that provides higher quality streaming music, a desktop app, fewer usage limits, and most importantly, no advertising. Freemium revenue models offer customers a superior service in return for paying subscription fees, while "free" revenue models are typically based on advertising support.

2. *What is the customer value proposition that Pandora offers?*

   Users can create multiple personal radio stations that play musical genres they like without paying a cent (or for subscribers, $36 a year). This service introduces users to musicians who are similar to the artists users enjoy.

3. *Why did MailChimp ultimately succeed with a freemium model, but Ning did not?*

Ning failed because it was not able to convert eyeballs into paying customers. In addition, the cost of adding additional users was not zero, or close to it. The more free users Ning acquired, the more it cost the company. MailChimp could scale much more easily without adding a lot of capacity and infrastructure given the simplicity of its service when compared to social networking.

4. *What's the most important consideration when considering a freemium revenue model?*

The most important consideration is that the marginal cost of servicing an additional free user must be close to zero. It also makes sense for a company where the value to its potential customers depends on a large network, like Facebook. Other considerations to take into account include that other revenue streams such as advertising will be needed to cover costs and a solid customer value proposition is required to attract initial users (even when the service is offered for free) and ultimately, subscribers willing to pay a subscription fee.

End of Chapter Questions

1. *What is a business model? How does it differ from a business plan*?

A business model is a set of planned activities (business processes) that are designed to result in a profit in the marketplace. A business plan on the other hand, is a document that outlines the details of a business model.

2. *What are the eight key components of an effective business model?*

The eight key components of an effective business model are:
Value proposition
Revenue model
Market opportunity for the firm (the marketspace and how big it is)
Competitive environment for the firm (who the competitors are in the marketspace)
Competitive advantage the firm brings to the marketspace (the unique qualities that set the firm apart from others in the marketspace)
Market strategy the firm will use to promote its products and services Organizational development of the firm that will enable it to carry out its business plan

Capabilities of the management team to guide the firm in its endeavors

3. *What are Amazon's primary customer value propositions?*

Amazon's primary customer value propositions are unparalleled selection and convenience.

4. *Describe the five primary revenue models used by e-commerce firms.*

The five primary revenue models used by e-commerce firms are:

The advertising revenue model
The subscription revenue model
The transaction fee revenue model
The sale revenue model
The affiliate revenue model

The advertising model derives its profit by displaying paid advertisements on a Web site. The goal is to convince advertisers that the site has the ability to attract a sizeable viewership, or a viewership that meets a marketing niche sought by the advertiser. Firms that use the subscription model offer users access to some or all of their content or services for a subscription fee. Firms that use the transaction fee model derive profit from enabling or executing transactions. For instance, transaction fees are paid to eBay when a seller is successful in auctioning off a product, and E*Trade receives a transaction fee when it executes a stock transaction for a customer. In the sales revenue model, companies draw profit directly from the sale of goods, information, or services to consumers. In the affiliate model, sites receive referral fees or a percentage of the revenue from any sales that result from steering business to the affiliate.

5. *Why is targeting a market niche generally smarter for a community provider than targeting a large market segment?*

Targeting a market niche is generally a smarter strategy for a community provider than targeting a large market segment because targeting large market segments will only pit a company against bigger and more established competitors. Small sub-segments of larger markets have a greater potential for growth without the intense competitive pressure. Communities that place a strong emphasis on the advertising revenue model will find marketers more interested in placing ads on a site that targets a specific niche.

6. *Would you say that Amazon and eBay are direct or indirect competitors? (You may have to visit the Web sites to answer.)*

Amazon and eBay are direct competitors because they sell products and services that are very similar, and they sell to the same market segment. They both sell books, music, computers and software, games and toys, electronics, tools, movies and DVDs, and camping equipment. However, eBay has a consumer-to-consumer business model while Amazon has a business-to-consumer business model. Even though eBay sells new, overstocked, remaindered, and used products at discounted prices, the two compete for essentially the same market segment of consumers. eBay may attract the bargain hunter variety of shopper who would not stop at Amazon first, but it is still essentially the same market segment.

7. *What are some of the specific ways that a company can obtain a competitive advantage?*

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Some specific ways a company can obtain a competitive advantage are by developing a global market while its competitors only have a national or regional market; by obtaining favorable terms from shippers, suppliers, or labor sources that its competitors do not have; by developing a more experienced, knowledgeable, and loyal employee base than its competitors; by obtaining a patent on a product that its competitors will not be able to imitate; by having an inside track to investors willing to put up capital; by establishing a powerful brand name or a popular image that it will be difficult for competitors to duplicate; and by any type of asymmetry that will give it more resources than its competitors in any area such as financial backing, knowledge, information, and/or power.

8. *Besides advertising and product sampling, what are some other market strategies a company might pursue?*

One market strategy is to form strategic alliances with business partners who will help you to attract new customers and extend your market reach. Another market strategy is to use product name, packaging, and advertising to create a distinct mood or feeling about each of your product lines, and carefully target each line to a specific audience. Some firms may choose to pursue a marketing strategy that positions them as a "one-stop shop," which carries a broad based line of products, saving the customer search time. Others may choose to position themselves as category experts who have an in-depth and "personal" knowledge of their customers. Such firms will offer extensive customer support networks to assist their customers in their purchasing decisions and will advertise themselves accordingly. One critical factor is that a company needs to find a way to differentiate itself from the competition.

9. *How do venture capitalists differ from angel investors?*

Angel investors are typically wealthy individuals (or a group of individuals) who invest their own money in an exchange for an equity share in the stock in the business. In general, angel investors make smaller investments (typically $1 million or less) than venture capital firms, are interested in helping a company grow and succeed, and invest on relatively favorable terms compared to later stage investors. Venture capital investors typically become more interested in a start-up company once it has begun generating some revenue, even if it is not profitable. Venture capital investors invest funds they manage for other investors such as investment banks, pension funds, insurance companies, or other businesses, and usually want to obtain a larger stake in the business and exercise more control over the operation of the business. Venture capital investors also typically want a well-defined "exit strategy," such as a plan for an initial public offering or acquisition of the company by a more established business within a relatively short period of time (typically 3 to 7 years), that will enable them to obtain an adequate return on their investment.

10. *Why is it difficult to categorize e-commerce business models?*

It is difficult to categorize e-commerce business models because the number of models is limited only by the human imagination, and new business models are being invented daily. Even within the broad-based generic types, there are overlaps, and fundamentally similar business models may appear in more than one. The type of e-commerce technology used can also affect the classification of a business model. Also, some companies may employ multiple business models. For example, eBay is essentially a C2C marketplace, but also functions as a B2C market maker, and in addition, has an m-commerce business model.

11. *Besides the examples given in the chapter, what are some other examples of vertical and horizontal portals in existence today?*

Some other examples of vertical portals (vortals) include ESPN (sports), iVillage (women's issues), Bloomberg (business), NFL (sports), WebMD (medical issues), Gamers (games), Away (travel), and Sina (China and Chinese communities). Some other examples of horizontal or general portals include Lycos and Sympatico.ca (Canadian). Note that many of these can also be considered community sites as well.

12. *What are the major differences between virtual storefronts such as Bluefly and bricks-and-clicks operations such as Walmart? What are the advantages and disadvantages of each?*

The major difference between virtual storefronts and bricks-and-clicks operations is that virtual storefronts do not have any ties to a physical location. The major advantages of the virtual storefronts are that they have low barriers to entry into the Web e-tail market and that they do not bear the costs associated with building and maintaining physical stores. The disadvantages are that they must quickly build a brand name from scratch and become profitable with no prior brand name or experience which can be very difficult. The major advantages of the bricks-and-clicks operations are that they have an already established brand name, an established customer base, an established sales force, and the resources to operate on the very thin margins associated with the retail industry. It is also much less expensive for them to acquire new customers than it is for the virtual storefronts. The major disadvantages of the bricks-and-clicks firms are that they face new competition in an extremely competitive environment from new firms who may have more expertise at building credible Web sites, and who can focus exclusively on building rapid response order systems.

13. *Besides news and articles, what other forms of information or content do content providers offer?*

Besides news and articles, content providers may also supply music, photos, video, artwork, educational materials, or games.

14. *What is a reverse auction? What company is an example of this type of business?*

A reverse auction is one in which a consumer offers to pay a certain price for a product or service and the bid is either accepted or not. The premier example of this type of business is Priceline, in which the consumer makes an offer for airline tickets, hotel rooms, car rentals, and other travel accommodations.

15. *What are the key success factors for exchanges? How are they different from portals?*

The key factor to success for exchanges is size—the size of the industry and the number of registered users. If the industry the exchange seeks to serve is not large enough, the site will most likely not survive. The site must also be able to reach a critical mass by attracting both a large number of sellers and a large number of buyers or customers will go elsewhere. An exchange is a digital electronic marketplace where suppliers and commercial purchasers can converge to conduct transactions. Most portals operate in the B2C sector rather than the B2B sector and their main business objective is to be a destination site for consumers. Although some portals provide a shopping component, that is not their main business objective.

16. *How have the unique features of e-commerce technology changed industry structure in the travel business?*

The ubiquity of e-commerce has created new marketing channels and expanded the size of the overall market. The global reach of e-commerce has changed industry structure by lowering barriers to entry, but at the same time expanding the market. The costs of industry and firm operations have decreased, enabling global competition. The universal standards of e-commerce have also lowered barriers to entry and intensified competition. However, firms have cheaper costs for computing and communication enabling broad-scope business strategies.

The richness of e-commerce reduces the strength of distribution channels, decreases a firm’s reliance on traditional sales forces, and helps a firm develop better post-sales support strategies. Firms can use the interactive properties of e-commerce to develop differentiation strategies and customization techniques to reduce the threat from substitutes. Interactivity, personalization, and customization techniques also decrease a firm’s reliance on traditional sales forces, helping them to reduce operational costs. Using these techniques, some firms are successful in differentiating themselves from the competition, thereby raising barriers to entry for potential competitors. The information density of e-commerce weakens powerful sales channels, shifting some bargaining power to consumers. It also lowers the operational costs for firms associated with obtaining, processing, and distributing information about suppliers and consumers.

17. *Who are the major players in an industry value chain and how are they impacted by e-commerce technology?*

The major players in an industry value chain are the suppliers, manufacturers, distributors, transporters, retailers, and customers. E-commerce technology has helped manufacturers to reduce the costs they pay for goods through the use of Web-based B2B exchanges. Some manufacturers have also developed direct relationships with their customers online thereby eliminating the distributors and the retailers from the value chain. Distributors can develop highly efficient inventory management systems to reduce their costs and retailers can develop highly efficient customer relationship management systems to strengthen their services to customers. Customers can use the Web to search for the best quality, delivery, and prices, thereby lowering their overall transaction costs and reducing the final price they pay for goods.

18. *What are four generic business strategies for achieving a profitable business?*

Generic business strategies for achieving a profitable business include differentiation, cost, scope, focus, and customer intimacy. Differentiation involves setting your firm or product apart from the competition by establishing some unique property or consumption experience that your competitors do not have. A firm that adopts a cost strategy must have a unique set of business processes, a unique resource, or a low cost supplier. It is essential that other firms in the marketplace do not have access to, or cannot duplicate, this because it will allow them to charge a lower price while still making a profit. A scope strategy sets out to compete in all markets around the globe, rather than just locally or regionally. A focus strategy, on the other hand, is a plan to compete within a narrow market segment or product segment. Specialization strategists seek to become the premier provider in a small market segment or niche. A customer intimacy strategy focuses on developing strong ties with customers in order to increase their switching costs.

19. *What is the difference between a market opportunity and a marketspace?*

Marketspace is the area of actual or potential commercial value in which a company intends to operate. Market opportunity refers to the overall potential financial opportunities available to the firm in that marketspace.

20. *What is crowdfunding and how does it help e-commerce companies raise capital?*

Crowdfunding involves using the Internet to enable individuals to collectively contribute money to support a project. The concepts behind crowdfunding have been popularized by Kickstarter and Indiegogo, but they were not able to be used for equity investments in for-profit companies in the United States due to securities regulations. However, the passage of the Jumpstart Our Business Startups (JOBS) Act in 2012 and issuance of enabling regulations by the Securities and Exchange Commission in July 2013 has enabled companies to use the Internet to solicit wealthy ("accredited") investors to invest in small and early-stage start-ups in exchange for stock. Equity crowdfunding investments by non-accredited investors (people with a net worth of less than $1 million and who earn less than $200,000 a year in the previous two years), although approved by the JOBS Act in concept, will not be allowed until the SEC passes further implementing regulations.

Projects

1. *Select an e-commerce company. Visit its Web site and describe its business model based on the information you find there. Identify its customer value proposition, its revenue model, the marketspace it operates in, who its main competitors are, any comparative advantages you believe the company possesses, and what its market strategy appears to be. Also try to locate information about the company's management team and organizational structure. (Check for a page labeled "The Company," "About Us," or something similar).*

   Instructors may want to provide some parameters for students in choosing a company (i.e., sector [B2C, B2B, etc.]; industry [retail, services, etc.]) to limit student search time. Students can be asked to provide either a written report or an oral report accompanied by a slide presentation.

   A student choosing a company such as PetSmart might provide the following information:

   > PetSmart is a B2C e-tailer. Its main customer value proposition is that it offers the broadest assortment of pet supplies at the lowest prices. PetSmart uses a sales revenue model; it operates in the specialty retail marketspace, and focuses on the pet supplies niche. PetSmart is the leading online pet supply company; many of its original online competitors, such as Pets.com and Petstore.com, have gone out of business. Its main competitors appear to be local pet stores and pet supply catalogs and PetSmart's main comparative advantage is its brand name. PetSmart appears to be using a "bricks-and-clicks" market strategy; it started as a traditional pet supplies retailer with hundreds of physical "superstores" and leveraged its brand to the online environment. Its marketing strategies include: pricing (low prices); providing interesting content and community on its Web site for its target market; affiliate marketing; and e-mail marketing through free e-mail newsletters. Information about PetSmart's management team and organizational structure is available if the student follows the "Investor Relations" link from its "About Us" page.

2. *Examine the experience of shopping on the Web versus shopping in a traditional manner. Imagine that you have decided to purchase a digital camera (or any other item of your choosing). First shop for the camera in a traditional manner. Describe how you would do so (for example, how you would gather the necessary information you would need to choose a particular item, what stores you would visit, how long it would take, prices, etc.). Next, shop for the item on the Web. Compare and contrast your experiences. What were the advantages and disadvantages of each? Which did you prefer and why?*

   The purpose of this assignment is to help students understand how e-commerce differs from traditional commerce. In reporting on this project, students should identify the product they shopped for and detail how they traditionally shopped for the product. For example, they might have gathered information about the product from newspapers and magazine articles, advertisements, called or visited one or more stores, or perhaps shopped for the product via mail-order catalog. They should note what stores, if any, they visited or catalogs they looked at; how long it took them to find the product they were seeking; the level of service; the stores' policies (e.g., on returns); and how long it took them to find and purchase the product.

For their Internet shopping experience, students should prepare a comparable analysis. They should explain their strategy for finding information on the product (e.g., identify the search engines, if any used, the searches performed, and links followed), and then describe the shopping experience at the company from which they have decided to "purchase" the product.

They should report which shopping experience was quicker, easier, more convenient, which offered better prices, and any other specific advantages or disadvantages of each type noted. They should explain which experience they preferred and why.

3. *Visit eBay and look at the main types of auctions available. If you were considering establishing a rival specialized online auction business, what are the top three market opportunities you would pursue, based on the goods and auction community in evidence at eBay. Prepare a presentation to support your analysis and approach.*

   One way a student might approach this project is to look at the different categories in which eBay conducts auctions. A student might choose to focus on those areas which have the most auctions; on commodity items such as books, electronic equipment; on a niche area; or on categories in which eBay does not appear to be strong (i.e., few auctions, or not covered in the list of categories).

4. *During the early days of e-commerce, first mover advantage was touted as one way to success. On the other hand, some suggest that being a market follower can yield rewards as well. Which approach has proven to be more successful—first mover or follower? Choose two e-commerce companies that prove your point and prepare a brief presentation to explain your analysis and position.*

   For students that argue for first mover advantage as a way to success, examples might include Amazon, Yahoo, Travelocity, eBay, VeriSign, Priceline, E*Trade, and PayPal. Although each of these has encountered competition, their early arrival and commitment to becoming the predominant player in their respective marketspace have helped to assure their continuing success.

   Those who argue for market followers can point to the demise of many of e-commerce's first movers. Examples might include Pets.com, Garden.com, Webvan, eToys.com, Kozmo.com, and theGlobe.com. They might point instead to companies who were not among the first on the Web, but today are successful such as Walmart.com, JCPenney.com, PetSmart.com, Williams-Sonoma.com, Fidelity.com, and Bluenile.com

5. *Select an e-commerce company that has participated in an incubator program such as Y-Combinator,TechStars, DreamIt Ventures, Capital Factory, or another of your choosing, and write a short report on its business model and the amount and sources of capital it has raised thus far. Include your views on the company's future prospects for success.*

   Student answers will vary depending on the company chosen.

6. *Select a B2C e-commerce retail industry segment such as pet products, online gaming, or gift baskets, and analyze its value chain and industry value chain. Prepare a short presentation that identifies the major industry participants in that business and illustrates the move from raw materials to finished product.*

   Instructors may want to suggest industries in order to limit student research time and provide an example that shows the type of information that should be included in a presentation. A sample presentation on the industry for gourmet gift baskets would include some of the top industry participants: iGourmet, Harry & David, GiftTree, as well as mention a large number of independent, small gourmet gift-basket companies. The firm value chain of a small gourmet gift basket would involve primary activities of designing the gift baskets (identifying which gift baskets to produce and the items in each basket) ordering wholesale items to include in gift baskets, repackaging items into separate gift baskets and wrapping gift baskets, selling gift baskets, and mailing or delivering finished gift baskets. For the industry value chain, the value chains of suppliers and manufacturers of gourmet food items, such as chocolate and cheese, would be included, along with the third parties involved in sales and retail (Internet service providers), and distribution (such as the USPS, FedEx).