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eBay's Secret Ingredient

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If your customers gladly held your inventory, shipped your products, and did all your marketing, you'd make money online too. Only question: Can eBay keep growing and not destroy the social capital that is its unique competitive advantage?

After all these years, Lu Matis, a housewife in Flemington, N.J., has finally figured out how to "monetize eyeballs" on the Internet. Her secret? She sells them on eBay ([EBAY](#)). Glass eyeballs, that is, handblown and hand-painted by German artisans at the end of the 19th century and kept as prosthetic inventory in doctors' offices. Matis got 700 of them a year and a half ago from a dealer for about \$7 a pop, but on eBay they fetch anywhere from \$20 for a brown eye to \$40 for a blue, gray, or green one. "I pay my son's college this way," Matis says. "They are gory to look at, but once you realize the work involved, it is like having a piece of Tiffany glass." Her customers range from collectors to jewelry makers to a guy who glued them to his steering wheel. "Where else could you possibly sell these?" she asks.

Matis's ocular oddities are proof positive that eBay has come a long way on its quest, as CEO Meg Whitman explains it, "to build the world's largest online trading platform where practically anyone can trade practically anything." eBay has gone well beyond collectible Elvis prints and Beanie Babies -- or glass eyeballs, for that matter. A motorcycle is sold on eBay every 18 minutes, a laptop every 30 seconds, and a book every 4 seconds. You can buy time-shares in Hawaii, restaurant equipment, gardening tools, or your pick of goods in 18,000 other categories. eBay traded \$9 billion worth of goods in 2001 -- equivalent to roughly 20 percent of all consumer e-commerce that year. More than \$1 billion of that total was estimated to come from autos alone, a category that did not even exist on eBay two years ago.

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"If you had asked me in September 1998 [when eBay went public] if eBay would be in the used-car business, I would have said no," Whitman observes. Today, eBay is the largest online seller not just of autos and collectibles but also of computers, photo equipment and supplies, and sporting goods. To further promote the brand, it is developing with Sony a TV show profiling eBay users and the items they buy on the site. It is beginning to attract larger corporate sellers such as Disney ([DIS](#)), IBM ([IBM](#)), and Home Depot ([HD](#)). And the company is expanding internationally, with operations in 18 countries. In 1999, for instance, eBay Germany reached only 6 percent of the country's Internet users. Now, one out of every four German Web surfers visits the site. Back when she was gearing up for the IPO, Whitman would tell investors that she was going after a \$100 million slice of the U.S. collectibles market. Today she estimates the size of the markets that eBay addresses at \$1.7 trillion.

At one level, this success is easily explained. eBay has come closer than any other creation of the Internet boom to realizing the promise of the virtual corporation. With no inventory, no warehouses, and

no sales force, eBay's electronic bazaar, run properly, is a profit-spewing machine.

Far less understood, however, is the invisible fuel that powers that machine: eBay's unique ability to attract vast amounts of what economists call social capital. The rest of us might call it trust, or goodwill, or credibility. Whatever you call this resource, eBay, in its vast community of buyers and sellers, deploys more of it than almost any company in memory. Social capital is what enables eBay to harness the creativity of the millions of entrepreneurs on its site striving to meet the most capricious demands of the even more numerous buyers who also congregate there. eBay's own customers do much of the company's work, bringing it countless new products and marketing techniques, picking up shipping costs, handling customer service. The high octane of eBay's social capital explains how, even in a down economy, with its dotcom brethren wounded and dying, eBay nearly doubled its profits in 2001 to \$90 million. Revenues -- bolstered by healthy online Christmas shopping -- were \$750 million, or equivalent to about 8 percent of the value of all the goods that were traded on its site. By 2005 the company expects to be raking in \$3 billion in revenues and \$1 billion in operating profits.

But getting there is far from a sure thing. To reach that goal, the company will have to more than triple the number of its registered buyers and sellers to 150 million. Yet some of the very steps eBay is taking to drive growth and keep its stock at a lofty price/earnings ratio of about 80 (on 2002 estimates) are straining the vital bonds between the company and its core customers. Out in the eBay community, it turns out, it's hard work to keep the social fabric from tearing.

As has been well chronicled, eBay takes advantage of the low communication and transaction costs of the Internet to bring its buyers and sellers together. The company takes a commission -- typically 1 to 5 percent -- on every trade on its electronic exchange; the rest of its revenues come from listing fees and other charges. eBay is considered the classic example of a company benefiting from so-called network effects. The more buyers who go to eBay, the more sellers they attract, who in turn draw even more buyers as the site becomes a larger source of supply with more competitive prices. This positive feedback loop magnifies the volume of trade on the site, and thus revenues to eBay, while making it increasingly difficult for other auction sites to survive.

But there is more to it than that. "eBay's business is so new that it's not well understood," says Rajiv Dutta, eBay's chief financial officer. "There is an enormous amount of subtlety and complexity underneath." eBay, according to Dutta and other eBay executives, is not so much a conventional company as a self-regulating, complex system. And indeed, eBay has few of the characteristics typical of traditional corporations -- especially rival retailers such as Wal-Mart. "We have no real cost of goods, and customer acquisition is largely driven by word of mouth," Dutta says. Wal-Mart has nearly \$16 billion in long-term debt; eBay has virtually none. Free of many of the costs that almost every other corporation must bear, eBay's business throws off an increasing amount of cash, reflected in operating margins that have gone from slightly negative in 1999 to 19 percent in 2001. (Wal-Mart's operating margin is about 5 percent.) Dutta expects operating margins to hit 30 to 35 percent by 2005, which is how he gets to that \$1 billion operating-profit target.

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Such an achievement would be pretty spectacular, but it cannot be reached on the strengths of new-wave financials alone. Social capital is the crucial hidden asset that could make it possible. The forms of capital that most people are familiar with are physical (stores, factories, machinery), human (education, skills, expertise), and financial (cash, debt, equity). Social capital flows from social relationships -- things like membership in old boys' networks, trust, reputation, and social norms that allow people to do more work (such as coffee breaks). eBay's network effects are an extremely valuable form of social capital, but there are others. What eBay has figured out how to do is tap into the social capital created on its site by the millions of people who trade there, and convert it into profits.

One source of eBay's social capital is its feedback system, whereby buyers and sellers can rate each other. People need such confidence-building mechanisms to buy stuff from faceless strangers. Negative feedback is posted very rarely (less than 1 percent of the time, according to a study by University of Michigan economist Paul Resnick), but sellers are afraid of getting any negative comments and go to great lengths to avoid them. It's not uncommon for sellers to be brutally honest about their wares, going

so far as to describe every nick and scratch. "Every time you get a negative feedback, your sales go down," says Howard Getz, who does 600 auctions a week in collectibles such as Barbie dolls and *Star Wars* figures. Displaying a buyer's negative comment by a seller's name is like letting a disgruntled customer leave a sign in a store for all subsequent customers to see.

Like other kinds of capital, social capital earns a return. One of the unique ways it pays off at eBay is in the thousands of small pricing and product selection innovations its members make that keep eBay's merchandising always in tune with the whims of the economy. "No single company could react as quickly as our millions of users do," Whitman explains. MIT economist Erik Brynjolfsson concurs: "If you had a central purchasing department, you would not have all the creativity that the millions of people have who are posting on eBay trying to meet unmet needs and develop products that might otherwise have gone unnoticed." Glass eyeballs, unused vacation real estate, even packing supplies for other eBay sellers -- eBay users create markets where none existed before. They then absorb expenses, such as inventory, marketing, and shipping, that eBay itself would have to eat if it were a conventional company. Users even help out with customer support, as anyone who has ever visited an eBay discussion board knows. "Here you have people who are volunteering their time," notes Dan Ariely, a behavioral economist at MIT. "That is the amazing thing."

To keep the community of users happy, Whitman and her lieutenants spend a lot of time listening to their customers and observing trends on the site. Every morning, for example, Whitman is handed a report excerpting comments posted on eBay's discussion boards. And the company regularly conducts intense all-day focus groups, called Voices, with representative buyers and sellers.

The most important way that eBay manages its marketplace, however, is by organizing itself as a collection of startups. Each major category (books, collectibles, music, real estate, tickets) has its own manager. So does every country (eBay runs the number one auction sites in Australia, Britain, Canada, France, and Germany, among other nations). These managers are the stewards of the social capital on their turf. They must be experts in their particular markets and make sure nothing impedes trade there.

They are also responsible for the growth of their niches. When they notice that activity around certain items, such as tickets or automobiles, is growing organically, they signal up the chain that it's time to carve out a new category. "We decide to expand the trading platform based on where users want to go," Whitman explains.

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Sometimes, that is away from auctions. So eBay is adding fixed-price components to its site as well, an unabashed challenge to Amazon's ([AMZN](#)) business. In 2000, eBay acquired Half.com, a fixed-price online store for discounted commodity goods that is being integrated into the regular eBay site. "Half.com is bringing the Amazon buyer into person-to-person trading," says Jeff Jordan, head of eBay's U.S. operations. And about 45 percent of all eBay auctions now have a "Buy It Now" button that lets the first bidder end the auction by agreeing to a preset price. All told, about 19 percent of sales on eBay are now fixed-price rather than auction.

One of the most promising avenues for future growth hinges on eBay's ability to court a whole new class of customers: big corporations. Disney, IBM, and Home Depot, among others, are dipping their toes into eBay's market for discontinued goods, excess inventory, and returned items. Even Dell ([DELL](#)), which arguably does not need any help with online commerce, sells refurbished off-lease PCs on eBay. It's just another sales channel. Governments are getting into the act too. Seventeen state governments, up from zero in 1998, are using eBay to liquidate foreclosed assets.

The giant sellers are proceeding cautiously and so far account for less than 3 percent of eBay sales. But eBay is working on them -- and urging them to expand their offerings to the types of fixed-price, in-season items that make up the bulk of the economy. In a pitch to the Gap clothing chain, for instance, eBay would say, "We have 10,000 Gap items on eBay right now, so whether you like it or not, we are a channel." Or, as eBay marketing VP Bill Cobb likes to tell reluctant corporate sellers, "We have the technology, the marketplace, and the buyers. Why are you going to do it on your own? Nobody visits your site."

Disney uses eBay to auction collector's items such as ride vehicles from its theme parks, animation cels, and movie props. Recently a statuette used by animators during the making of the film *Monsters, Inc.* went for \$3,556. "We create archival items every time a park or a new movie opens," says George Grobar, the head of auctions for Disney's Internet group. Many of the objects used to end up in landfills, but by using eBay, Grobar says, Disney can sell them cost-effectively -- and generate promotional buzz.

IBM has gone further. By selling mainly laptops that are reaching the end of their product cycle for about \$1,000 each, Big Blue has become eBay's single largest seller (although it accounts for less than 0.1 percent of the site's total sales). The computer giant is finding that rather than stealing sales from IBM.com or other channels, eBay auctions are bringing new clients into the IBM tent. Some 79 percent of its eBay customers -- half of which are small businesses -- are new to IBM. "We see eBay as an incredible growth engine for us," says IBM.com auction manager Paul Canham. Indeed. Canham's sales on eBay are growing more than 40 percent per *month*.

But the question remains: Will the forces pulling eBay in so many different directions undermine its social capital? After huge surges in 1999 and 2000, eBay's listings growth (a major contributor to revenues) has slowed dramatically. To meet its dramatic financial goals, eBay must continue to expand aggressively into new categories, geographies, formats, and customer types. But the faster eBay grows, the greater the risk to its social capital.

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There are already signs that its expansionary strategies are beginning to alienate existing users. For instance, one of the basic principles that eBay has tried to maintain is neutrality. The company avoids taking sides between buyers and sellers whenever possible. That is what the feedback system is for. But the Switzerland stance increasingly does not wash with the people who are the source of all of eBay's revenues: the sellers. The most vocal are those who sell more than \$2,000 a month on eBay, known as Powersellers.

Eric McKenna of Pittsburgh quit his sales job at a paging company about two years ago to sell guitars on eBay for \$500 to \$3,500 apiece. When he had a problem with a deadbeat buyer and wanted eBay to yank him from the site, customer service reps kept explaining to him that they could not do that, and that eBay was a social phenomenon where different rules applied. "I don't want any of your socialistic b.s.," McKenna would tell supervisor after supervisor. "You are a company. I am a goddamn Powerseller! I am paying you 1,000 bucks a month, and I want service." To eBay's credit, the deadbeat was finally barred from the site. But if McKenna wants preferential treatment from eBay for his BoogieStreet Guitars, imagine what IBM will want.

eBay insists that it will maintain a level playing field. "Our vision of eBay consists of a marketplace where your next-door neighbor can compete side by side with large corporations," Whitman says. Indeed, if you search for IBM laptops, you will see IBM's listings alongside auctions from other sellers. From the prominence of the listings, it's impossible to tell which are the next-door neighbors and which is the \$86 billion corporation.

The level playing field approach, however, can create another problem. If customers stop benefiting from the relationships they make through eBay, all of the company's accumulated social capital goes out the window. In the original collectibles and antiques categories, for instance, eBay has created such an efficient market that average selling prices have declined 30 percent during the past year, according to the Internet Antique Shop. Gary Sohmers, an appraiser on *Antiques Road Show* and Boston radio host who has been selling pop culture collectibles online for years, is not happy about this trend. He says of dealers' feelings for eBay: "We all hate it. They leveled the playing field, but unfortunately they leveled it underwater."

Another uproar centered on the controversial checkout feature that eBay introduced last fall, which automatically exchanges information between the buyer and seller after an auction. eBay says it is meant to standardize the old procedure, in which buyers and sellers e-mailed one another after an auction to arrange delivery and payment. But many sellers despised the imposed feature, not only because they felt it was clumsy but also because they thought that eBay was trying to come between

them and their customers -- a violation of the social compact. "I was mad as a wet hen," says Frances Neale, a seller of used books on eBay. eBay responded to sellers' concerns by making the feature optional, but Neale still sees the new checkout system as symptomatic of eBay's larger push to embrace corporate sellers and to further automate the interaction between customers. "I think they want to be the complete system for the large brick-and-mortar companies that want to be on the Web," she speculates.

eBay would be wise to quash that fear quickly. The company derives much of its social capital from the fact that its site is a place where people transact with people, not with large, impersonal corporations. The irony is that, so far, the corporations on eBay are typically the ones adjusting the way they do business. Buyers are just so much more demanding on eBay. Winning bidders expect an e-mail response the next day, not in six weeks, and shipping had better not cost half as much as the entire product.

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Some observers argue that eBay could afford to be at least a little less solicitous of its buyers and sellers (as a recent price hike demonstrates). After all, where else are they going to go? But the company knows deep down that its future hinges on figuring out how to continue to grow and appeal to multiple constituents without depleting its crucial social capital. At one recent Voices focus group attended by people who trade in autographs, car stereos, and Renaissance gowns, Jordan acknowledged that "the challenge is expanding eBay to car stereos and all the other things you sell without leaving behind the core." Indeed, the difficulty of relying on a resource that does not appear on your balance sheet is that you won't know it is missing until it is already gone. ♦

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