Men: looking for that special gift for your Cleopatra, but don’t want to spend a lot of time shopping? Want to give the “Big Rock” certified by the independent Gemological Institute of America (GIA) or the American Gem Society Laboratories (AGSL) without spending a mountain of cash for the engagement experience? How about 40% less than retail prices? Not sure about the future value of diamonds? Then how about pearls, gold, or platinum?

Your answer has arrived: BlueNile.com offers you an online selection of over 50,000 diamonds for that special someone. You can buy them cut and polished, or put them into settings like rings, bracelets, earrings, necklaces, pendants, watches, and brooches that you can choose online. All the diamonds are graded by the 4Cs: carats (size), cut, color, and clarity, and a report for each diamond prepared by the GIA is available online.

BlueNile.com started out as RockShop.com in March 1999 in Seattle, Washington. In May 1999, the company purchased Williams and Son, a Seattle jeweler with a Web site, and changed its name to Internet Diamonds, Inc. In November 1999, the company launched the Blue Nile brand and changed its name to Blue Nile Inc., opening up its Web site, BlueNile.com, in December 1999. In May 2004, Blue Nile went public at $20, and jumped to $28 (a 38% pop) in the first day of trading. The received wisdom of Web gurus in 1999 was that the Internet would never be a place where fine jewelry could be sold. Why?

Purchasing jewelry, especially high cost diamonds, is what marketers call a “significant event.” Typically, gifts of diamonds are associated with a significant emotional event, such as an engagement, marriage, or an anniversary. Generally, the event is shared with a significant other and often involves shopping together for the gem. Shopping on the Web (alone or
together) hardly matches the emotional impact of walking into Tiffany's or any other
established retail store, with marvelous clear glass cases filled with brilliantly shining
baubles, attended by a small army of unctuous perfumed sales clerks that make you feel
so special. Diamonds represent a significant cost, and there is significant uncertainty
about their value and pricing. Surveys show that most shoppers believe jewelry is high-
overpriced, but they lack the knowledge and information to negotiate a better price or
even judge the quality of what they are buying. Consumers generally have no rational way
to compare diamonds, and face a limited selection at a single store, often in a high-pres-
sured environment where sales employees are helping several customers at the same
time. Most experts thought that, given the emotional significance and uncertainty of
purchasing diamonds, few consumers would heighten the built-in anxiety by going to a
strange Web site and plunking down $5,000 or more for a diamond they could not see
or touch for several days.

But jewelry and high fashion retailers are leading the second act of online retailing,
bursting on the scene in 2004 with high growth rates and spectacular average sales
transaction levels. As it turns out, the retail jewelry industry is an ideal candidate for
Web sales. Here's why.

The $51 billion traditional jewelry industry is a byzantine, fragmented collection of
126,000 physical stores in the United States, including 28,000 locations classified as
specialty jewelry stores. About 95% of all retail jewelry firms operate only a single
store. To supply this fragmented market, several layers of wholesalers and middlemen
intervene, from rough diamond brokers, diamond cutters, diamond wholesalers, jewelry
manufacturers, jewelry wholesalers, and finally, regional distributors. Oddly, the source
of raw mined diamonds is monopolized by a single company, DeBeers, which controls
over two-thirds of the world market. The fragmented supply and distribution chains add
to huge markups based on monopoly set prices for the raw diamonds. The typical retail
store markup for diamonds is 100%.

But starting in 2003, Web diamond sites have garnered over $2 billion of the U.S.
jewelry market. Start-ups such as Blue Nile, Ice.com, Abazias.com, Diamond.com, and
even Amazon are transforming the high-end jewelry business. Blue Nile, for instance, has
simplified the supply-side of diamonds by only ordering and paying for a diamond after
the customer has ordered it. Blue Nile has cut out several supply-side layers of middle-
men and instead deals directly with wholesale diamond owners and jewelry manufactur-
ers. Blue Nile minimizes its inventory costs and limits its risk of inventory markdowns.
On the sell-side of distribution, Blue Nile has eliminated the expensive stores, sales
clers, and beautiful but expensive glass cases. Instead, Blue Nile offers a single Web
site. At this single Web site, Blue Nile can aggregate the demand for diamonds of thou-
sands of unique visitors and present them with a more attractive shopping experience
than a typical retail store. The result of rationalizing the supply and distribution chain is
much lower markups of 15%. For example, Blue Nile will purchase a pair of oval emer-
ald and diamond earrings from a supplier for $850 and charge the consumer $1,000. A
traditional retailer would charge the consumer $1,700.

Blue Nile and other start-ups have improved the shopping experience primarily by
creating a trust- and knowledge-based environment that reduces consumer anxiety about
the value of diamonds. In essence, Blue Nile and the other online retailers give the consumer as much information as a professional gemologist would give them. The Web site contains educational guides to diamonds and diamond grading systems, and provides independent quality ratings for each diamond provided by non-profit industry associations, such as the GIA. There's a 30-day, money back, no-questions-asked guarantee.

Despite its lower gross margins due to its low prices, Blue Nile has higher net operating margins than its chief offline physical store competitor, Zales Inc., the country's largest jewelry chain. To get an idea of Blue Nile's efficiency, in order to sell $129 million in jewelry, a traditional physical store chain would need 116 stores and 400 workers. Blue Nile achieved $129 million in sales with one Web site, a 10,000-square-foot warehouse, and 115 workers.

Sales at Blue Nile have grown from $72 million in 2002 to over $200 million for the fiscal year ended January 1, 2006. As of February 2006, the stock is trading in the $30 to $35 range, down from a 2005 high of $44 because of slower than expected revenue growth, even though revenues and earnings hit record highs. The company has reported it was negatively impacted by rising prices for polished diamonds and was prevented from raising prices lest its customers go elsewhere on the Web. Because Blue Nile does not have its own inventory of diamonds, it is highly susceptible to price swings in the wholesale price of diamonds. Still, with average purchases running at almost $1,500 (compared to $300–$400 for a mass-market jeweler), over 150,000 unique visitors per month, average customer income over $80,000, a conversion rate of over 4%, a firmly established brand name based on a trusted shopping environment, the future for BlueNile.com looks, well, sparkling.

INSIGHT ON BUSINESS

MERLOT BY MAIL

Many new companies are encouraged to break the rules, think "outside the box," and do things differently in order to succeed online. Unfortunately, when it comes to the wine industry, breaking the rules was a strategy for failure.

In May 2005, in an eagerly anticipated decision, the Supreme Court ruled that state laws that prohibit residents from ordering wine directly from out-of-state wineries while allowing them to order from in-state wineries are discriminatory and anti-competitive. Despite the ruling (which applies only to discriminatory state laws favoring in-state wineries), the wine market, along with caskets and automobiles, continues to be shaped by Prohibition-era rules in many states. Beverage sales have been controlled by the states ever since the end of Prohibition in 1933. Ever wonder why beer and wine are so expensive? Many states require wineries to sell to licensed in-state wholesalers, who in turn must sell to licensed distributors, who in turn must sell to licensed liquor stores or retail outlets. Each layer in the distribution scheme takes a percentage cut, raising the costs.

The idea of selling wine directly to customers over the Internet is completely contrary to the legal institutions established to control the sale of beverages, in particular to prevent the sale of alcoholic beverages to minors. For instance, to receive wine by mail in Montana, you need to become a state-licensed "wine connoisseur"—which costs $50. Under the Supreme Court ruling, states that wish to continue to control the sale of alcoholic beverages can continue to do so by instituting laws that apply equally to both in- and out-of-state wineries, for instance, by requiring that all alcohol sales take place in person. This is the route taken by New Jersey, which has banned in-state shipments rather than allow out-of-state shipments.

The Supreme Court decision has focused renewed attention on Internet wine sales and Wine.com (formerly known as eVineyard.com) and referred to in the following text as Wine/eVineyard.com to distinguish it from the original Wine.com, which eVineyard.com acquired in 2001.

Wine/eVineyard.com is one of the very few wine retailers left standing after hundreds of millions of dollars were invested in competing online wine merchants by leading venture capital firms. Started in 1999, long after rivals Wineshopper.com and the original Wine.com, with just $20 million in financial backing and 48 workers, versus Wine.com's $200 million financing and 265 employees, the company experienced 1,000% growth in customers and revenues from 1999 to 2001, even before the acquisition of the nearly defunct Wine.com in 2001. In 2002, eVineyard dropped its original name and emerged as the "new" Wine.com. By 2004, Wine/eVineyard.com was shipping wine to more than 100,000 customers in 36 states and Washington, D.C., and had revenues of $32 million, an increase of more than 40% from 2003.

While Wine/eVineyard.com cannot offer the personalized counseling that an on-site sommelier in a corner wine store can, it does offer more than 14,000 premium wines and hundreds of wine accessories. Customers can search for wines by brand, vintage, vineyard, rating, price, name, or variety, as well as view winemakers' notes, learning which wines go best with different foods; they can even query a wine expert in its Live Talk chat room. For many wine buyers, such convenience appears to be winning them over.

(continued)
This takes us to Wine/eVineyard.com's business model. Why did it succeed when so many rivals failed? The early first movers in the industry, in a rush to get to the marketplace first, worked through state wholesalers, distributors, and even retailers. In the process, these first movers had such high costs that they were doomed to never be profitable. But Wine/eVineyard.com chose a different, slower growth path of purchasing its own wholesale licenses and distributorships in each state where it wanted to do business. Thus, it can sell directly to the consumer using its own state-based distribution system. By making the effort to obtain state licenses and operating within the established structure for wine sales, Wine/eVineyard.com is racking up gross margins of 32%. That's significant, given that the company does not carry inventory and does not have to split its take with retailers, as many former wine online retailers did. Working through retailers and paying a fee to use their licenses, VirtualVineyard, the old Wine.com, and Wineshopper earned a much smaller percentage on each sale, ultimately causing their financial undoing.

According to CEO George Garrick, the Supreme Court's decision should not have much impact on Wine/eVineyard.com's business, since it focuses on wineries, rather than retailers. Much more important is the company's recent deal with Amazon.com, which directs Amazon.com customers interested in purchasing wine to the Wine/eVineyard.com Web site. The deal provides Wine/eVineyard.com with access to Amazon's millions of customers and helps increase consumer awareness that wine can be purchased online.

Analysts estimate the size of the wine market to be around $22 billion, with online wine sales currently comprising less than 1%. Wine/eVineyard.com believes that its deal with Amazon.com is the first step in significantly increasing that share.

**Sources:**
- "Wine.com CEO George Garrick on 'Playing by the Rules,'" by Keith Regan, E-commerce Times, May 18, 2005;
- "Supreme Court Ruling Makes the Net More Viable for Small Vineyards," by Eric Chabrow, InformationWeek, May 16, 2005;
- "Supreme Court Clears Way for Online Wine Sales," by Declan McCollough, CNetNews.com, May 16, 2006;
- "Cross-Border Internet Wine Sales Get High Court Blessing," by Keith Regan, E-commerce Times, May 16, 2005;
- "Amazon.com Launches Partnership with Online Wine Retailer," by Elizabeth M. Gillespie, Seattle Times, May 4, 2005;
- "Online Wine: Pull Out the Stopper," by Spencer Ante, Business Week, November 21, 2004;
- "Possible Anti-competitive Barriers to E-Commerce: Wine," Federal Trade Commission, July 2003;

**Barriers to entry:** Can new entrants be barred from entering the industry through high capital costs or intellectual property barriers (such as patents and copyrights)?

**Power of suppliers:** Can suppliers dictate high prices to the industry or can vendors choose from among many suppliers? Have firms achieved sufficient scale to bargain effectively for lower prices from suppliers?

**Power of customers:** Can customers choose from many competing suppliers and hence challenge high prices and high margins?

**Existence of substitute products:** Can the functionality of the product or service be obtained from alternative channels or competing products in different industries? Are substitute products and services likely to emerge in the near future?

**Industry value chain:** Is the chain of production and distribution in the industry changing in ways that benefit or harm the firm?
INTERNET TAXATION: THE TAX MAN IS COMING

If you're not required to pay sales taxes on goods purchased from an out-of-state catalog company, should you be required to pay sales tax when you purchase the same goods online? Currently, U.S. Supreme Court rulings forbid a state from forcing a business to collect state or local sales taxes unless the company has a physical presence (or "nexus") in the state. From the consumer's perspective, not having to pay sales tax on a purchase amounts to as much as a 13% discount off a product bought locally. For instance, the New York City local sales tax is 13%. Local bricks-and-mortar businesses believe this policy is unfair. Physical storefronts argue that free online retailers from the vexing process of collecting sales tax amounts to an unfair subsidy of their operations. And given the sophistication of the technology used to power retail Web sites, such businesses should be forced to accurately calculate and collect sales tax from every consumer, just as local merchants do.

This perspective is wholeheartedly supported by state and local governments, which have been losing revenue from every Internet purchase (just as they lose out on most mail-order and catalog purchases). A recent study found, for instance, that state governments and local revenue losses would be $45 billion in 2006, and $55 billion in 2011, equivalent to a loss of 3%-10% of total state tax collections. Local governments lost about $13.7 billion in e-commerce-related taxes in 2005. Currently, as much as one-third of local government revenue comes from sales tax.

Online retailers, on the other hand, have complained from the start that it is unreasonable for governments to ask them to determine the appropriate tax rate from among the 7,600 different state and local taxing jurisdictions. Moreover, they argue that many of the goods they sell—such as apparel and food—are exempt from sales taxes in many states. Many states continue to resist a single uniform, across-the-board sales tax on all products, and have a hard time agreeing on a digital means of identifying products. Instead, they insist on maintaining local and state tax exemptions for various types of goods. For instance, New Jersey refuses to put a sales tax on clothing (thereby attracting New York shoppers next door). In some states, orange juice is taxed as a fruit juice; in others, it is not taxed because it is considered a beverage.

Another issue, argue online retailers, is determining which taxing authority gets the collected money. The answer depends on which nexus, or physical location, is used to calculate sales tax. Is it the location of the customer, the warehouse where the inventory is stored, the point from which it is shipped to the customer, or the location of the company's headquarters? For companies with both physical storefronts and Internet operations, sales tax calculations could be even more complicated.

The National Governors Association (NGA) has taken the lead to develop a uniform state sales tax rate. Called the Streamlined Sales Tax Project, the NGA has come close to forging an agreement among states on how to tax Internet commerce. In November 2002, the NGA approved a proposal to radically simplify sales taxes collected by 7,500 different local taxing authorities. The agreement was distributed at the beginning of 2003 to state legislatures for implementation by those states wishing to participate. Since that time, 18 states have passed amendments to their laws sufficient to be in substantial compliance with the agreement. And as of Fall 2005, 13 of those states (Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota...
states to ensure that online pure-play companies such as Amazon are forced to collect sales taxes as well. Currently, Amazon and most other pure online companies who do not have a physical presence (or “nexus”) in any state, still do not collect sales taxes. The reasons given by Wal-Mart and others for their turnaround on the tax issue is that they now want to develop a more integrated retailing approach, which requires them to use the local stores as pick-up and return points for customers.

However, many e-commerce firms continue to resist. eBay, for instance, has called the new Streamlined Sales Tax Project “remarkably unsimplified.” According to eBay, it “opposes raising taxes on the Internet or its uses, as well as any attempt to impose remote sales tax collection burdens on the smallest sellers who can least afford it. This is certainly not the time to impose a major new tax burden on Internet vendors working to implement successful new business models, nor is it wise macro-economic policy to impose what is effectively a tax increase on American consumers.”


has a long way to go. In the eyes of many critics, Amazon has shown it can be a very profitable book seller, but it has yet to demonstrate it can be a profitable general merchant in the long run. For instance, in 2005, net sales grew 23% to $8.49 billion, but net income dropped to $359 million, due, according to Amazon, to the unfavorable impact of changes in foreign exchanges rates, the $40 million patent settlement, and $95 million in income tax expense (compared to $233 million in income tax benefit for 2004). Analysts expressed particular concern that Amazon’s 4th quarter results showed a 43% decline in net income despite record sales during the holiday shopping period. Amazon attributed its lower earnings primarily to its free shipping incentives and continued investment in technology, but analysts also cited increasingly stiff competition from other online retailers, such as Wal-Mart and eBay.
The original idea was simple and leveraged many of the unique features of e-commerce technology: Create a Web site listing thousands of products where consumers can compare prices, features, consumer reviews of the actual product performance, and reputations of merchants, and then make a purchase. The idea first appeared in the mid-1990s in academic papers on potential uses of the Web and Internet, and was referred to as "shopping robots." Today, shopping bots have become big business. Now referred to as comparison shopping sites, with products tracked numbering in the millions, they are being snatched up by some of the biggest names in business. For instance, the leading stand-alone comparison shopping site, Shopping.com, with an estimated 25 million unique monthly visitors in 2005, was purchased in June 2005 by eBay for $634 million. (Shopping.com was formerly known as Dealtime.com, and also includes Epinions.com, an online consumer review and ratings platform). The second leading site, Shopzilla.com (which also operates a user product review site called Bizrate.com), was also purchased in June 2005, by E.W. Scripps Co., for $525 million. Other competitors that have not yet been acquired include NexTag.com and Price-Grabber.com. General merchandisers such as Amazon, portals such as Yahoo and AOL, and search engines such as Google have also developed their own comparison shopping capabilities.

About 60% of consumers have used a comparison shopping Web site, according to Jupiter Research. The number of shoppers visiting such sites is also growing rapidly. Visitor growth rates from 2003 to 2004 ranged from over 100% for NexTag.com and Shopzilla.com to over 50% for Shopzilla.com. Shopping comparison sites have become attractive acquisition candidates because they have done very well in attracting visitors, and are also profitable. For instance, both Shopping.com and Shopzilla.com had estimated revenues in the $130 million range in 2005.

Comparison shopping sites focused originally on tracking online prices for electronic consumer goods and computers. Consumer electronics are fairly commoditized products by a few branded manufacturers, with standard features, making it fairly easy to compare one product to another. Type in digital camera, select the number of megapixels you want, enter the price and zoom range, press the Enter key on your keyboard, and you will receive a long list of cameras and dealers. You can refine your search as you move along the purchase process, and explore the reputation of dealers before you decide to purchase.

However, although Shopzilla.com and Shopping.com claim they track over 10 million items from 33,000 different online retailer databases, very few of these items are so-called "soft goods" purchased by women, who have risen to equal the purchasing power of men on the Web. In 1998, 65% of Web purchases were made by men, while today, 61% are made by women who are much more likely to be looking for soft goods, such as apparel, jewelry, accessories, luggage, and gifts. In fact, these are among the fastest growing consumer product categories on the Web. For this reason, the shopping comparison sites are currently adding soft goods to their services. Shopping.com, for instance, now lists 200,000 apparel items.
But the process of comparison shopping for soft goods is not as simple as for hard goods such as digital TVs or digital cameras. The strength of a comparison shopping site is to present highly similar or identical items from different merchants at varying prices and reputation levels. Generally, these kinds of electronic goods have a limited number of suppliers (mostly solid brand names) and limited features. But in more complex product areas, such as apparel or jewelry, such standards do not exist. In fact, manufacturers of these products emphasize their uniqueness, not their similarity. One solution is to focus on the brands of soft goods and not the price: bags from Gucci, sweaters from Benneton, and mountain climbing gear from REI. Yahoo and search engines such as MSN and Google are moving closer to the brand model of comparison shopping as price becomes a less powerful factor in consumer purchases of soft goods.

As more and more attention focuses on comparison shopping sites, the sites themselves continue to innovate and add features. Shopzilla, for instance, has developed a data categorization technology that it calls Robozilla that is designed to help expedite the shopping process. PriceGrabber is focused on adding product tours and more content, such as user and third-party reviews, and discussion boards. NexTag will be offering consumer e-mail price alert and product price history charting, and for merchants, a new data feed auto-import option. New companies are also continuing to enter the market every day, such as Become.com, which, unlike many other comparison shopping sites that rely on feeds and sponsored listings, uses a Web crawler similar to Google's. Become.com launched in April 2005 as a shopping research site, with an index of more than 3.2 billion of shopping related information from more than 40 million Web sites. In July 2005, Become.com launched the beta version of its integrated comparison shopping service, which enables users to both research and compare products at one site.


Both Web-only and established offline retailers wishing to strengthen their e-commerce revenues will be favorably affected in the future by new retailing technologies—from extending high speed Internet access to the majority of potential consumers, to mobile commerce using cell phones, to new services such as enhanced comparison shopping sites, as described in Insight on Technology: Using the Web to Shop Till You Drop.