When Exposure-Based Web Advertising Stops Making Sense (And What CDNOW Did About It)

Donna L. Hoffman and Thomas P. Novak
eLab
http://ecommerce.vanderbilt.edu/
Owen Graduate School of Management
Vanderbilt University

Contact:

Professor Donna L. Hoffman
Hoffman@ecommerce.vanderbilt.edu
615-343-6904
615-343-1378 Linda Roberts, assistant
615-343-7177 fax

A shorter version of this manuscript emphasizing CDNOW's experience, "Acquiring Customers on the Web," will appear in the *Harvard Business Review*, May/June 2000.

Draft Date: January 2000

When Exposure-Based Web Advertising Stops Making Sense (And What CDNOW Did About It)

Internet advertising is rapidly emerging as a key strategic tool in the battle for online customers. Managerial attention is increasingly shifting to online advertising as a viable mechanism for generating traffic and stimulating trial at consumer-oriented Web sites. According to eMarketer, total Internet advertising revenues exceeded $3 billion in 1999 and the category is growing far faster (112%) than traditional mass media advertising vehicles like cable (13%), television (7%), and print (6.2%).

For the first time ever, in 1998 Internet advertising surpassed outdoor advertising expenditures (estimated at $1.6 billion for 1998) and is poised to overtake business papers soon. A recent PricewaterhouseCoopers survey put fourth quarter 1998 advertising spending up 95 percent over the same quarter a year earlier, and 34 percent higher than the third quarter of 1998. The Internet advertising industry has now logged over three years of revenue growth and online advertising revenues are expected to hit nearly $13 billion by 2003[1]. The increasing popularity of the Internet as a communication medium and online retailing environment for consumers makes it clear that online advertising deserves serious and focused management attention.

Advertising on Web sites is attractive because it represents an innovative media buy for many firms, while at the same time retaining comforting parallels to existing marketing efforts in the "real world". While these parallels may appear to reduce the risk of initial online commercial efforts, in our experience they also carry a different risk of obscuring more innovative media strategies that ultimately represent the path to greater online profits.

Optimal online advertising takes advantage of the fact that the Internet is a many-to-many communication model that reverses the traditional one-to-many broadcasting paradigm. Because it is interactive, firms can not only address consumers, but consumers can communicate with firms and provide content of their own to the medium. Much to the chagrin of many firms, this consumer-supplied content is quite often out of their direct control.

The Web allows an unprecedented level of consumer choice in an environment that economists would argue approaches one of full information. Additionally, consumers have much more control over the consumption of content online, compared to traditional media. These factors are causing the balance of power to shift in favor of consumers. It is against this complex and rapidly evolving backdrop that firms are struggling to develop coherent Internet advertising strategies.

As with advertising programs in the real world, online managers want to know whether advertising is achieving the company's business objectives. Traditionally, however, advertising has not been able to provide meaningful measurements of results. At best, conventional broadcast and print advertising has only allowed measurement of the mass amount of advertising

---

1 Although, for perspective, it's important to note that the online advertising industry still represents only about 2 percent of the total $170 billion advertising industry overall.

delivered - as opposed to actually consumed - usually expressed in terms of exposures or impressions and at best broken down by demographic or psychographic segments.
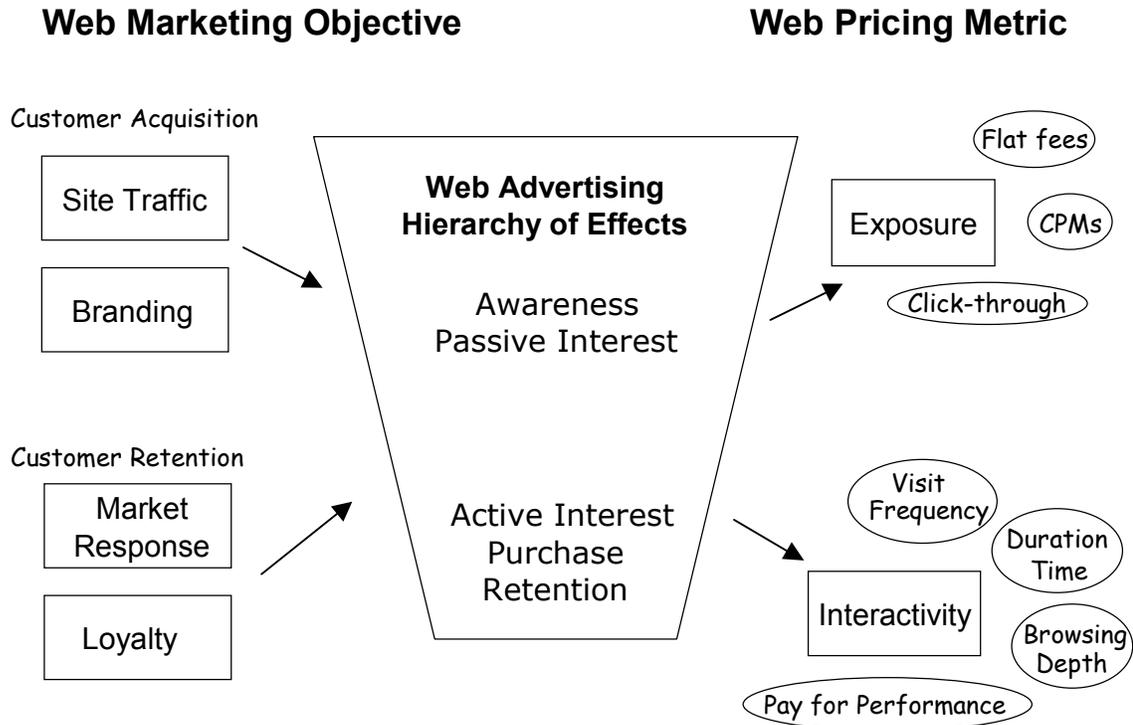
Thus, for managers seeking measurable results from online advertising, traditional media models offer little guidance, and may even hinder the process of capturing the value in consumer response in virtual environments. Further, the Web possesses unique characteristics compared to conventional media. These differences warrant new strategies. Borrowing advertising practices and metaphors from traditional media like exposure-based advertising pricing models and billboard-like "banner ads" is likely to be appropriate only for limited advertising objectives such as awareness in the context of branding goals.

The Web belies John Wanamaker's oft-quoted lament that "I know half the money I spend on advertising is wasted, but I can never find out which half." For the manager concerned with reaching business objectives, the Web promises the precise quantification of the effectiveness of a particular advertising campaign in terms of those objectives - for the first time in the history of media. But how should the manager use online advertising to reach those objectives?

Base Online Advertising on Performance, Not CPMs

Traditional broadcast media rely on exposure based pricing models, where the cost of an ad is a function of the total number of impressions delivered by the vehicle. The way for a broadcaster to maximize profits under this cost-per-thousand (CPM) model is to deliver the largest possible audience to the advertiser. Although exposing a broad demographic target to a commercial message can satisfy awareness and branding objectives, smaller, more targeted segments with whom the firm can interact are actually worth much more if they are exactly the customers most likely to give the desired market response.

Exhibit 1:
Link Online Advertising Efforts to Business Objectives

Web Marketing Objective   **Web Pricing Metric**

Customer Acquisition

| Site Traffic |

| Branding |

Web Advertising
Hierarchy of Effects

Awareness
Passive Interest

Flat fees

| Exposure | CPMs

Click-through

Customer Retention

| Market Response |

| Loyalty |

Active Interest
Purchase
Retention

Visit Frequency

Duration Time

| Interactivity |

Browsing Depth

Pay for Performance

[Sidebar to figure: Online, managers must confront two sets of objectives, broadly characterized as customer acquisition and customer retention. Customer acquisition includes generating initial traffic to the site and building the online brand identity. Customer retention involves attracting visitors over time – visitors who engage in the desired customer responses (for example, responding to requests for demographic information or purchasing an online offering) on a regular basis. In other words, the objective here is to *convert* casual visitors into regular online *customers*. In the parlance of traditional marketing, the manager can think of these as the trial and repeat problems, respectively. Research shows that the Web is unquestionably useful as a branding mechanism, largely through the development of brand image and efforts focused at brand reinforcement. In the case of such objectives, exposure-based pricing metrics such as flat fee sponsorships, CPMs, and even CPC -cost-per-click - (i.e. click-through rate) models may be appropriate. Yet, the real strength of the Web lies in the fact that it is the ideal medium for implementing an interactive direct model of sales response. This means that the Web is ideally suited to generate - and track - product leads, collect real-time information on customer tastes, and seamlessly satisfy the ultimate fulfillment of the order. In these cases, the best metrics are unquestionably those tied directly to interactive customer behavior. These include measurements based on frequency of visits, time spent at the site, navigation patterns at the site, and, as we discuss in this article, pay-for-performance models in which the advertiser pays only when the desired response has been achieved.]

Despite the fact that the Internet promises to be the most accountable medium ever, Internet advertising efforts at the end of the twentieth century still favor banner ads based on exposure-based CPM or click-through rate metrics. The primary reasons for this are that such metrics are widely understood by traditional media executives and are easy to implement.

But, are current online advertising efforts effective? Motivated by a desire to draw executable analogies with traditional media, managerial efforts to date have focused on advertising on those Web sites with the largest numbers of visitors. But treating the Internet as if it were just another mass medium like TV or print leads to suboptimal media plans. Web "portals" like Yahoo and MSN, two of the largest Web sites in 1999 in terms of traffic, necessarily attract the widest variety of consumers. Yet viewing individual Web consumers seeking customized online experiences as largely interchangeable units of a mass "audience" – reflecting the traditional broadcast bias of "more is better" - is actually hindering the development of more effective targeted ad strategies.

Of course, portals can segment within their site and target specific pages and/or sections for specific advertisers. The question becomes whether ad rates are overly influenced or inflated by the total number of visitors for an ad buy that is actually targeted to only a subset of these visitors. That is, would someone pay more for a particular number of exposures to a targeted ad at Yahoo than they would for that same number of exposures at a lower-traffic site that was as equally well-targeted?

Predictably, online managers are increasingly dissatisfied with banner ads and flat fee portal deals. A recent benchmarking survey revealed that a majority of leading executives in the US marketing and advertising industry would invest more heavily in Internet advertising if only they could measure the return on their online investment. It should not surprise the reader that these same executives complain that Internet advertising CPMs and CPCs are too expensive.

It's no wonder then that managers are seeking an alternative to the exposure-based advertising model. With the total number of Web pages rapidly approaching one billion (800 million at last count) – and many of those commercial and seeking advertising - there is now significant unsold inventory in the online advertising industry. Online properties, the so-called "dot-coms," are increasingly buying ads in offline media. Combined with the fact that consumers no longer "click-through" banner ads at the rates they used to – average click-through rates have plummeted from their giddy highs of 10% or more a few years ago to an average of under 1% - mean that CPMs have fallen dramatically in the past few years. Average CPMs are now near $30, down from $40 only two years ago, although prices vary widely depending on the Web site and can range from a low of a few dollars on some advertising networks up to a high of around $100 or more for one of the top portals.

But since the objective online is to attract and retain customers, the critical issue is customer acquisition costs. Using current figures, a CPM of $35 means that the cost to expose a single visitor to a banner ad is 3.5 cents, or $0.035 per impression. This doesn't sound so bad, except that the objective is not mere exposure, but some sort of response. Now suppose (generously) that the clickthrough rate is 1%. This means that the net cost to the advertiser to attract a single

potential customer is $3.50 (since the clickthrough rate is $3.50). If the conversion to purchase rate is 1%, then the customer acquisition cost is $350. With overpriced CPMs and trivial clickthrough rates, the customer acquisition costs through banner ads at many commercial Web sites are almost triple those of traditional media. And for expensive flat fee sponsorship deals with portals, the situation may be even worse. Recent studies show that after two or more years online, most consumers bypass portals altogether when navigating e-commerce sites. No wonder that advertisers are choking on customer acquisition costs that can easily exceed $500 or more on the top portals.

But the real problems arise when we consider the net result of such advertising efforts over the lifetime value of each customer. Even the following simple example illustrates the problem. For sake of argument, let's assume that the average online customer spends $50 at an advertiser's Web site on her initial visit. Further assume that our advertiser's gross profit margin is 20%, so that the average customer provides $10 average profit on that initial transaction. Now, let's assume that 50% of the advertiser's customers return on another visit and click their way through to an additional $100 worth of purchases. This gives another $10 of gross profit. If another 10% of the site's customers come back and conduct yet another $100 worth of business, that's another $2 and so on. In this way, the gross profit per customer approaches $25. As long as the advertising costs per customer are below $25, no problem. But remember that the cost per customer is $350, which means, when the advertiser does the math, that the site is actually losing $325 per customer!

So, while Internet advertising continues to gain legitimacy - consumer advertisers, not the computing industry, lead the industry in online spending – it is not surprising that managers are still confused about what the Web represents as a marketing medium. In effect, there is no broad sense of the best strategies for success. Simply put, advertisers are unsure how to measure the return on their advertising dollars. It is clear that moving to methods that tie advertising to sales is the way to prove the effectiveness of Internet advertising. Not only that, but many executives, particularly those at large firms, have clearly signaled that their skittishness in embracing online advertising rests primarily with the need to prove accountability.

Not surprisingly, advertisers are demanding, and receiving, accountability. Procter & Gamble, the nation's leading traditional advertiser, was one of the first companies to move to results-oriented pricing for Web based advertising. In April 1996, Yahoo agreed to Procter & Gamble's requirement that it be paid only for the click-through on P&G's banner ads, and not on the basis of mere exposures. This is because clickthroughs represent a measure of active interest in the advertiser's message, as opposed to the passive interest a consumer is assumed to show when she browses a page containing an advertiser's banner ad.

We argued above that the unique characteristics of the Web are causing the balance of power to shift in the direction of the consumer. The Web's ability to provide measures of accountability is also shifting the balance of power between the Web sites that serve as vehicles for advertising (what we call the Web provider) and the advertisers, giving rise to more collaborative relationships among them. The Web provider naturally favors guaranteed revenues from delivering "eyeballs" under the argument that moving to a results-oriented model holds that Web

provider "hostage to the creative." Yet the Web advertiser rightly reasons that it makes no sense to pay for that "half" of advertising, now precisely measurable in terms of business objectives, which is wasted.

## The Web as a Direct Model of Sales Response

A dot-com that wants to communicate with its customers need not be tethered to exposure-based advertising practices on loan from traditional media. Already, more and more firms are recognizing that the Web is the perfect medium for an interactive direct model of sales response.

Savvy Web providers, instead of viewing themselves in traditional media vehicle terms, are increasingly building unique cooperative marketing arrangements with Web advertisers where both share the responsibility for achieving marketing objectives. These pay-for-performance advertising strategies – either being paid (Web provider) or only paying (Web advertiser) when some form of e-commerce is actually generated - executed jointly by Web providers and Web advertisers, offer the most innovative and effective set of strategic options for managers interested in achieving results-oriented objectives on the Web. They also enable resourceful Web advertisers to get their money's worth and are more likely to lead to long-term online profitability. Pay-for-performance advertising works and keeps Web advertisers focused on what counts: knowing exactly how their marketing efforts pay off.

In pay-for-performance ad strategies, the Web provider displaying the ad shares more in the risks and rewards of advertising placement than has traditionally been the case. The revenue gained by achieving a particular market response, such as a product sale, is shared between the Web advertiser and the Web provider.

Thus, the Web provider markets an offering for a Web advertiser on its site and is compensated by the Web advertiser according to quantifiable performance. The reliance on market response puts more responsibility on the Web provider for results and the Web advertiser and Web provider function more as active partners in a cooperative arrangement than would otherwise be the case under the mass media driven impression-based advertising pricing models. This new and evolving form of online advertising turns traditional media rules literally inside out.

Exhibit 2: Pay-for-Performance Advertising
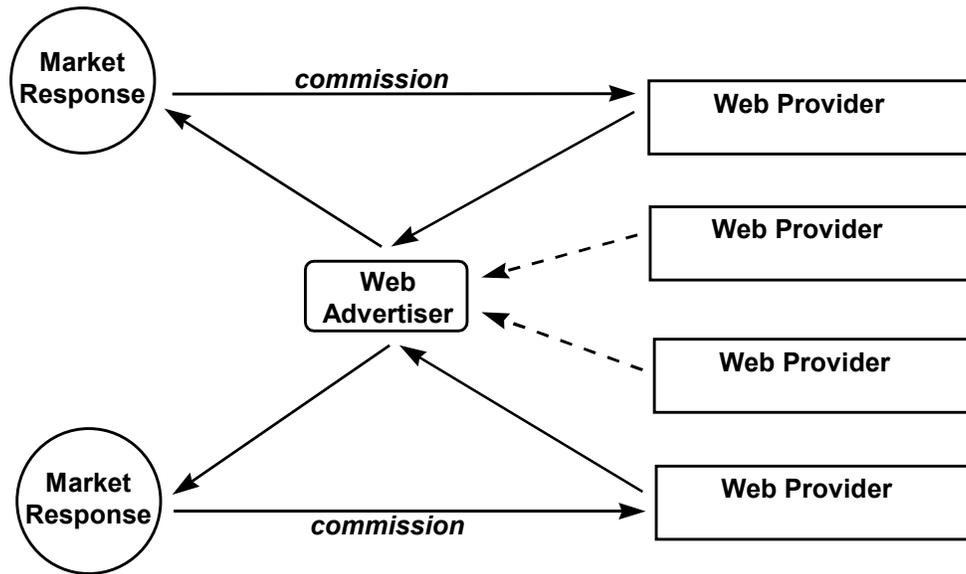
How It Works at CDNOW

The Evolution of CDNOW's Pay-for-Performance Strategy

Despite the fact that Amazon.com garners most of the media attention for pay-for-performance Internet advertising – what Amazon.com calls its "Associates Program" and what is now called affiliate advertising in the industry – CDNOW, launched in August 1994, actually pioneered what is rapidly becoming an important new form of new media advertising. Indeed, by 2004, Forrester Research estimates that half of the projected $33 billion in worldwide online advertising spending will be performance-based. Jupiter Communications further estimates that fully twenty-five percent of Internet retail sales will be acquired through sites using the affiliate advertising model by 2002.

In November 1994, almost a full year before Amazon.com even launched its Web site, CDNOW began its Buy Web program. In this first application of what have come to be known as "affiliate" or "associate" programs, CDNOW introduced the idea of click-through purchasing through independent online storefronts. The idea was that music-oriented Web sites could review or list albums on their pages that their visitors might be interested in purchasing and offer a link that would take the visitor directly to CDNOW where it was available for purchase.

Jason Olim, CDNOW's CEO and co-founder, explains that the idea for this type of "remote purchasing" actually arose as a result of conversations with Geffen Records in the fall of 1994. Executives there wanted the ability to sell artist discs directly from their site but didn't want to do it themselves and wondered if they could link to CDNOW for fulfillment. Olim realized that CDNOW could link directly from the artist on Geffen's Web site to his Web site, bypassing the

CDNOW home page and going directly to the artist's discography page. In this way, CDNOW linked Geffen Records to CDNOW and the affiliate advertising format was born.

Creating this shared interest between Geffen and CDNOW – at the time with no specific exchange of value around the link - was an important inspiration because it represented the most powerful way for both Geffen, and especially CDNOW, to build their online businesses in these early days of the commercial Web. In the fall of 1994, the main way to promote a commercial Web site was to get it listed on the now defunct NCSA Mosaic's "What's New" page or the Global Network Navigator's Whole Internet Catalog page. In those early days of the Web's commercial development, the concept of online advertising had yet to emerge as a mechanism for building and directing traffic. Thus, Geffen and CDNOW could cooperate and share responsibility for achieving their respective business objectives. In this win-win advertising strategy, Geffen promoted and enabled the sale of its artists' discs online and CDNOW actually sold the discs.

Following this advance, CDNOW formally introduced the concept as "BuyWeb" in the fall of 1994. Olim believed this would be a very powerful way to promote the site. At first, it was simply a technology that allowed Web site owners, referred to as "members," to link directly to an artist's page. Over time, the BuyWeb program grew. In 1994, CDNOW had a dozen or so members, but no money changed hands.

By 1995, there were a few hundred affiliate members in the BuyWeb program. At that time, CDNOW launched a revenue sharing arrangement where they began to pay small commissions to Web site owners who used the technology. This gave member Web sites the inducement they needed to join the program, and provided them with an important opportunity to make money on the Internet. CDNOW created a methodology that enabled them to track purchases that online customers made and pay the referring Web sites 3% of the revenues from the discs that CDNOW sold that were directly attributable to the links. The technology allowed CDNOW to explicitly track when a visitor clicked through from say, the Geffen site, by encoding the Geffen name in the URL. Subsequently, the commission percentage was raised to 15%.

In this way, small Web sites like Lauri's Dreamy World and Mass Confusion Music created value for CDNOW by recommending various compact discs to their cyberbrowsers that could be purchased on CDNOW's Web site.   The links that such sites placed next to their music reviews gave their visitors the option of effortlessly purchasing the reviewed disc on the CDNOW site. Lauri's Dreamy World and Mass Confusion Music received value in the form of the commission paid by CDNOW each time a visitor clicked on the CDNOW link and purchased the highlighted CD.

The BuyWeb program evolved into "Cosmic Credit" in the spring of 1997. Unlike high-profile Web portal sponsorship deals, CDNOW's Cosmic Credit program targets low-volume, nonprofessional sites of music fans. In late 1999, CDNOW created the Cosmic Music Network on top of the Cosmic Credit program. The Cosmic Music Network builds on the success of the Cosmic Credit program by allowing unsigned artists to put up a Web page at the CDNOW site, upload music that fans can download for free, and link their work to more well-known bands

elsewhere in the CDNOW store. Today, CDNOW pays referring sites anywhere from 7% to 15% on a sliding scale based on volume when visitors click through and make a purchase on the CDNOW site.

The Cosmic Music Network is significant for a number of reasons. First, it gives CDNOW a staggeringly large number of potential marketing partners. Second, the program, which has over 250,000 members, is one of CDNOW's most significant sources of customer acquisition, allowing the company to advertise to potential customers it would otherwise not be able to reach. No way could CDNOW afford the administrative burden of buying advertising on all 250,000 of these sites, and there is no market for an intermediary to do so cost-effectively. The mere administrative expense of filing that many insertion orders would be prohibitive. But members identify and sign themselves up automatically for the Cosmic Music Network with a few clicks on CDNOW's site, so the system is not only affordable but grows naturally. As the Web expands, so can this strategy, meaning that CDNOW can potentially enroll millions of members into the program.

Third, and most important, unlike banner ads, revenue-sharing programs are "webby" by nature. They build on the interconnections intrinsic to the Web and on the Web's ability to monitor and track activity in real time. With the Cosmic Music Network, CDNOW knows for a fact how many visitors arrive from each member's site and how many visitors are converted into buyers. In this way, CDNOW can precisely calculate the relative effectiveness of each of its online marketing investments. Armed with the number of visitors, the number of new customers, the number of repeat customers referred from each member's Web site, along with the profit contribution of each customer, CDNOW has everything it needs to estimate the lifetime value of a customer by source of acquisition. And with that figure, CDNOW has a very powerful yardstick by which to measure the effectiveness and determine the proper mix of all its marketing efforts.

The benefits of this new model of advertising should be readily apparent. With banner ads sold on the basis of CPMs, there is simply no effective way for online advertisers to measure consumer response. With BuyWeb, CDNOW knows for a fact how many visitors arrive from each member site and how many are converted into buyers. In this way they are able to precisely calculate the relative effectiveness of the media buy. Armed with the number of visitors, the number of new customers, and the number of repeat customers referred from each member Web site, they have the components to estimate the lifetime value of a customer by source of acquisition. This accountability, more than anything else, is driving the trend toward pay-for-performance advertising and shifting the balance of power in the industry.

No Good Early Options

In the early days of the commercial Web - around late 1994 and early 1995 - few Web publishers or advertisers understood the value of the Web as an advertising medium, let alone what price to assign to online advertising. Managers working with traditional media certainly understand the value of a 30-second television spot or a classified ad in the back of the book, due to factors

including industry norms, program ratings, years of marketing research, and managerial experience. But except for a handful of pioneering online programs like CDNOW's BuyWeb, which produced measurable results, there was simply no way to know.

This presented a dilemma for those managers who wished to advertise online. CPMs were inflated and flat fee deals were even worse. There were no guarantees and there was no rationality to the market. It didn't take much for the would-be online advertiser to see that current CPMs were a bad buy.

Many of the early online selling efforts were conducted by magazine sales people with little experience regarding how new media actually worked. In the absence of such knowledge, they quite literally invented CPM rates in the low $70s or charged flat fees from $5000 to $10000 per month to advertise on some of the earliest commercial Web sites. As such, the media buy in those early days worked something like this. The advertising salesperson would say, "The magazine has 100,000 readers. This Web site has 100,000 subscribers. The magazine charges $10,000 for a full page. The Web site will charge $10,000 a month."

Then, CDNOW would ask the salesperson, as any online advertiser might, "Okay. What will I get for that? For example, how many visitors?" The sales response was "No guarantee on visitors to your site. No guarantee on click through. No guarantee on impressions." Although they quickly gave on impressions, Web providers, borrowing again from traditional print advertising norms, would talk about their "circulation," which in this context actually meant their unaudited number of unique visitors.

It didn't take long for CDNOW to determine that those current CPMs were inflated and an obvious bad buy. At the flat rate of $10,000, the ad would never even generate enough revenues to cover its costs. Consider the following. Suppose the price of a single banner ad exposure (i.e. one page view) was 7 cents, since the Web provider demanded a $70 CPM, and that 1% of the visitors that saw the banner actually clicked through. In that case, a single click cost seven dollars. But since only a small percentage of those visitors to CDNOW through that link were actually converted into paying customers, the customer acquisition costs were actually sky high. Assuming a 1% conversion rate, the cost to acquire that new customer was $700.

CDNOW's early forays evaluating customer-buying patterns enabled them to estimate the value of each CDNOW customer. In this way, they were able to determine how much each customer would contribute to gross profit over time. Because $700 was more than the value of a customer, they knew the cost of advertising was too high.

Customer Acquisition and Advertising Strategy

In the five years since CDNOW first introduced the concept of pay-for-performance advertising, the firm now finds itself with a much wider array of strategic advertising options to choose from. For example, CDNOW will pay a CPM with guarantees if it is inside their cost of acquiring a customer. In fact, they regularly buy advertising on the basis of exposures and visits, as long as

the media buy keeps them on the "right side" of their customer acquisition costs. This makes sense for CDNOW since it knows exactly what the cost per customer is and, therefore, the value of a single customer.

A critical component of CDNOW's advertising strategy is the careful management of the sources of customer acquisition. CDNOW acquires customers from eight different sources: (1) The Cosmic Credit program - a risk-mitigating strategy at a low price; (2) Strategic partnerships, usually exclusive, with powerful partners such as Yahoo and Lycos, - some are risk-mitigating but they come at a high price; (3) Online advertisements like banner ads - not risk mitigating, moderately expensive, but risk is managed through careful selection of sites; (4) Word of mouth – the most powerful online source of customers and for CDNOW, as for many successful online retailers, where the lion's share of its customers come from; (5) Radio; (6) TV; (7) PR and (8) a trivial number of free links that CDNOW did not purchase directly or enter into a specific relationship with.

CDNOW further segments its customers according to whether it "tags" them or not. A tagged customer is a new customer that CDNOW is able to specifically identify as acquired through either the Cosmic Credit program, one of its strategic partnerships, or a banner ad. Fifty percent of CDNOW's advertising budget is placed with strategic partners and online ads. Customers acquired through tagged sources account for 40% of CDNOW's new customers.

Untagged customers are those who type CDNOW's Web location directly into the browser or follow a free link. Powerful, though largely unaccountable, forms of offline advertising undoubtedly influence these customers, including word of mouth, radio and television spots, publicity campaigns, and a small number of free Web links. These untagged sources account for 60% of customers new to CDNOW. The company allocates 50% of its advertising dollars to TV and radio. Word of mouth customers are considered free.

Despite the fact that CDNOW does not know the path by which its untagged customers were acquired, it is still able to judge the overall value of its different offline advertising efforts. For example, market tests provide information on TV and radio advertising, and surveys give information on the impact of publicity.

However, the accountability inherent in the Web means that CDNOW can determine precisely how effective each of its online advertising efforts are, including which creative works best and which sites make for the most effective vehicles. Note that this powerful accountability is unique to online media.

In any given time period, let's assume for illustrative purposes that CDNOW's cost per customer, that is, its average cost of customer acquisition, is $50, calculated over all media and customers acquired during that period. Then, Cosmic credit customers are nearly free, costing the company around two dollars in terms of cost per customer, the strategic partnerships and television advertising are higher than the average cost per customer. In this way, it is easy to see that there are both expensive and inexpensive sources of customers, calculated against the average cost-per-customer. But there are ancillary benefits to the higher cost of advertising, for example the

influence on word of mouth that helps to bring the costs down. Looked at another way, CDNOW's advertising budget brings in 45% of its new customers and the rest are free.

Exhibit 3: CDNOW's Comprehensive Advertising Strategy Includes Both Online *and* Offline Media

Media	Type	Budget allocation (%)	Contributed customers (as % of total).	
Radio	offline	16	8	expensive
TV	offline	16	7	
Print	Offline	16	5	
Strategic Partner	online	24	20	
Online Ads	online	24	5	
Subtotal:		96%	45%	
Cosmic Credit	online	2	15	cheap
Public Relations	offline	2	5	
Word of Mouth	offline	0	30	
Free links	offline	0	5	
Subtotal:		4%	55%	
Total:		100%	100%	

As Exhibit 3 makes clear (figures shown do not represent CDNOW's actual advertising program and are for illustrative purposes only), CDNOW has a highly comprehensive advertising strategy, with programs in both offline and online media. Its programs are sophisticated and run the gamut from pure revenue sharing deals to inventive hybrid programs. However, its pure CPM buys are disappearing and even with its biggest and most powerful partners, CDNOW media buys are sliding toward the revenue-sharing end of the distribution. Contributing to this shift is the fact that the quality of CDNOW's revenue-sharing partners, in terms of traffic and conversion rates, are improving steadily.

Clearly, revenue sharing advertising strategies are an important element in the online advertiser's revenue model. They offer two key benefits to advertisers like CDNOW: they mitigate risk and they provide opportunities for advertising to be purchased at lower prices. For CDNOW, the value of the Cosmic Credit program will only increase with time. Once CDNOW acquires these customers, they are highly likely to re-enter CDNOW directly at a later date, further increasing the revenue stream.

Revenue Sharing Today

CDNOW is far from alone in relying on a pay-for-performance advertising program to contribute to its online revenues. Amazon.com launched its own "Associates Program" in 1996 and now has over 350,000 affiliates. By one estimate, sixteen percent of online marketers participate in a revenue sharing affiliate program. Thousands of other sites, including the successful online marketers Rei.com and Dell Computers, have strong affiliate programs, though CDNOW and Amazon have amassed the largest number of marketing partners. Barnes and Noble.com is catching up with its rapidly growing program. The online company pays commissions ranging between 5 and 7 percent and had well over 100,000 affiliates by mid-1999.

For many sites, affiliate programs are an important component of profitability. Payment is either by flat fee or commission. Most commissions fall in the 8-12% range, though some can go as high as 25%. In just the third quarter of 1998, the popular technology site CNET for example, facilitated over $80 million in sales for dozens of its online advertisers, receiving a flat fee for each and every referral in the process.

Affiliate programs are not only growing rapidly, but they are becoming increasingly sophisticated. Third party networks like LinkShare and BeFree have emerged to offer commercial Web sites the e-commerce opportunities, along with the management systems, services, and software necessary for navigating the details of an affiliate program. In one of the latest evolutions, firms like Vstore.com provide Web server space and design templates to mom and pop vendors who want to set up shop on the Internet, but don't possess the requisite technical know-how and resources to do so independently. Such firms pay their affiliates commissions on each sale generated through the storefront.

For Best Results, Don't Forget Objectives

Critical to the success of revenue sharing programs is their lack of exclusivity. Most affiliate programs are open to any site that wishes to participate. Details of the program are posted on the Web advertiser's site for anyone to read. The process of becoming an affiliate is straightforward: the prospective affiliate simply reads the contract, accepts the terms, and fills out a registration form. Typically, the affiliate controls the content, creative, and placement of the ad. The Web advertiser pays only for advertising that delivers its desired outcome. Note that the Web advertiser does not pay affiliates for exposures based on page views, or mere click-throughs, but only for click-throughs that result in actual leads or sales.

Open agreements maximize the potential number of Web providers who can deliver customers to a particular Web site, and increase the opportunities for precise targeting. Such actions move the Web advertiser away from the traditional exposure-based mass media model toward more effective, targeted marketing programs. CDNOW, for example, uses its open revenue sharing program to selectively target online customers with widely varying musical tastes ranging from classical to rap music.

An open program also encourages appropriate Web providers to self-identify to those Web advertisers that market products relevant to the site's audience. As the Web provider now bears the opportunity cost of an advertisement that fails to deliver the desired result, he or she must carefully evaluate potential advertisers to determine which offer the best opportunities for generating the desired market response.

Clearly, advertisers have an economic incentive to make their revenue sharing programs available to all Web sites that wish to advertise the firm's message in exchange for payment if the desired response is achieved. There are no theoretical restrictions, economic or otherwise, on the potential number of sites a firm can use to distribute its message to consumers. Thus, the revenue sharing model follows directly from the many-to-many communications model underlying the Web. This contrasts the one-to-many broadcast model that rewards only those few marketing channels that can attract the largest number of visitors.

In this results-oriented paradigm, advertising is priced as a simple function of the desired market response. Measurable responses include key marketing objectives like unit sales, software downloads, qualified leads, product inquiries, and the like. A prime advantage of revenue sharing is that Web advertisers can quickly account for their advertising expenditures. With a traditional impression-based ad buy, the advertiser must attempt to measure the desired outcome indirectly, or worse, be forced to *assume* a relationship between exposures and objectives. Thus, results-oriented advertising is the answer for marketing managers who are being asked to justify new media advertising budgets.

Because relationships are more cooperative under results-oriented advertising efforts, the advertising effort is enhanced. Both the Web provider and the online advertiser share in the responsibility for a successful effort. Compare this to the perverse situation in the broadcast television medium, where despite declining audiences, advertisers are forced to pay the networks ever-higher rates to reach fewer and fewer mass-market households. This situation persists only because advertisers have no obvious mechanisms to demonstrate declining outcomes.

Forecasting the Future

As the number of commercial Web sites continues to explode, the marketing problems of attracting target consumers to a particular Web site, engaging them interactively within the site, and then securing repeat visits, have become acute. Pay-for-performance advertising programs create a critical link in the value chain by delivering consumers, for a fee, to a particular commercial Web destination.

Such programs are important because they suggest a new business model for Web-based commercial efforts. Results-oriented advertising focuses management attention on the development of a long-term marketing strategy, as opposed to short-term tactical media buys. Characteristically, revenue sharing agreements often have an unspecified term extending into perpetuity, with changes to the commission rate allowed as market forces dictate.

Mass media driven impression-based advertising will likely never completely disappear. However, we predict that revenue sharing advertising strategies, motivated by the business imperative of measurable results, will become increasingly prevalent as advertisers continue to demand accountability for their Web advertising expenditures.

The large portals continue to face stiff pressure to move toward results-oriented pricing models and away from straight CPMs. The pressure is felt most acutely from giant online advertisers like Procter & Gamble. Significantly, actions of these advertisers offline may foreshadow what's in store online. The powerhouse P&G is joining firms such as Ford Motor Company, AT&T, and Kraft, in the move away from straight commission structures to performance-based advertising payments to its agencies in the physical world. Such activities will only accelerate the growth of pay-for-performance advertising in the online world.

As the revenue sharing model proliferates, the need for additional infomediaries will naturally arise. These ancillary intermediaries will most likely serve as clearinghouses and networks. Some will serve Web publishers seeking favorable commission structures; others will support Web advertisers seeking appropriate Web publishers as vehicles and coordination of commission payments.

As the Web continues to mature as a uniquely addressable mass market, advertisers will seek out specific target segments of potential customers and the corresponding Web sites that can deliver those customers. This will contribute to the continued explosion in open revenue sharing advertising programs. As pay-for-performance programs continue to proliferate, mom and pop Web sites will be able to participate in the profit potential of the Web. This in turn will stimulate more commercial entrants, and more customers for those entrants, into the online marketplace. In this way, the Internet will begin to reach its potential as arguably the most important business phenomenon of the new millenium.