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TAOBAO VS. EBAY CHINA

*Ten to 15 years from now, I think China can be eBay's largest market on a global basis.... We think China has tremendous long-term potential and we want to do everything we can to maintain our No. 1 position.*¹

— Meg Whitman, eBay CEO, 2004

By 2008, Jack Ma, CEO of Alibaba.com Inc., was in a position to consider how to fortify Taobao's dominant position in China's online consumer-to-consumer (C2C) market. Ma and his company had come a long way since May 2003, when they first launched the Taobao website. Back then, eBay China dominated the fledgling market, holding over 70 percent share. It had entered China with its acquisition of the start-up EachNet, and was actively building upon that company's first-mover advantage. But by 2006, Taobao would overtake eBay China. As Taobao grew explosively, eBay China's market share would fall dramatically and it would bow out, transferring its operations to a joint venture partner.² Although eBay would nominally continue to operate in China, it was no longer a concern in Ma's plans for Taobao—which by 2008 held over 80 percent of the market. How had this upstart company overwhelmed the world's most formidable player in the online C2C space?

THE BIRTH OF CHINA'S ONLINE C2C MARKET³

Online auctions got off to a slower start in China than in some of the world's more developed economies. China had a low Internet penetration rate, lacked norms and laws to support online exchange, and had not yet developed the technological and financial infrastructures needed to

¹ "eBay Expects Great Things of China," CBS News, April 13, 2004, <http://www.cbsnews.com/stories/2004/04/13/tech/main611598.shtml> (February 6, 2008).

² "eBay JVs with Tom Online," *People's Daily Online*, December 21, 2006, http://english.people.com.cn/200612/21/eng20061221_334655.html (February 1, 2008).

³ Unless otherwise noted, this section is based on information from "EachNet.com," GSB Case No. SM-91, https://gsbapps.stanford.edu/cases/detail1.asp?Document_ID=2810.

Xiaoqu Luo and Mi Feng prepared this case under the supervision of Professor William Barnett as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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facilitate online auctions. Any firm wanting to succeed in China's online C2C space would need to overcome these obstacles better than its competitors did.

China lacked norms and laws regulating online behaviors and preventing online fraud. Bo Shao, founder of EachNet.com, explained: "In the U.S. if you place a bid, it's a contract, and by law you need to fulfill that bid if you win the auction. That's very clear. People would be afraid of getting sued if they did not abide by that contract. In China people don't care. 'I place a bid, I don't want it anymore, tough luck.'" In 2002, a survey conducted by China Internet Network Information Center found that 13.9 percent of online buyers had the experience of not receiving goods they had paid for. This problem also introduced the possibility of legal liability for online auction firms. Early start-ups in this space argued that they should be treated like a telephone company, so that they would not be held liable for the misbehavior of users.

Unlike the U.S., where most users could use credit cards to complete transactions conveniently, Chinese consumers lacked a comprehensive online payment system. Debit cards were common in China, with about 300 million cards issued by mid-2001. However, each city had a separate payment gateway to process these cards, so a card from one city often could not be used at the issuing bank's system in another city.⁴ This lack of integration made it very difficult for auction sites to handle debit card payments online. The credit card option was even worse. Because China's credit system was not developed, Chinese banks were cautious about issuing cards and the application process was complicated. By 2001, there were only about 25 million credit cards issued in China, accounting for less than 1 percent of consumer spending (compared to about 25 percent in the U.S.), and credit cards were accepted at only about 3 percent of China's shops.

As the need for better credit card services intensified in the early 2000s, various institutions responded. In 2001, Bank of China and China Construction Bank started accepting credit card applications online. At the same time, a large number of credit verification companies emerged to help banks work around the lack of a personal credit scoring system in China. These companies checked the backgrounds of applicants through various channels, including meeting the applicants in person. In February 2002, the People's Bank of China, China's central bank, announced a project to enable the four largest banks to process cards across cities and banks.

In the wake of these changes, China's Internet industry experienced remarkable growth during the first years of twenty-first century. According to China Internet Network Information Center, during the period from 2001 to 2007, the number of Internet users in China climbed dramatically from about 34 million to 210 million⁵ (see **Exhibit 1**). The use of bank cards in China also increased greatly over these years. In 1995, the total number of bank cards (debit and credit) was only 14 million, over a population of over a billion. By the end of 2002, the number of bank cards increased to 490 million, and by the first quarter of 2004 this number had climbed to 690 million. By May 2008, the total number of issued bank cards in China went over 1.6 billion, of which 110 million were credit cards.⁶ The card processing system had also been greatly

⁴ China Merchants' Bank did have an integrated nationwide debit-card system by 2001. However, market share of this bank was low.

⁵ *China Online Shopping Research Report*, iResearch Inc. 2008.

⁶ The numbers were according to the following Internet resources:

http://number.cnki.net/show_result.aspx?searchword=%E5%85%A8%E5%9B%BD%E9%93%B6%E8%A1%8C%

improved. By the end of 2002, most bank branches in China had been integrated into a single card processing system (China UnionPay), which was able to cross-process any bank card issued by a domestic bank.⁷ Such development, together with the increased penetration of the Internet in China, led to a substantial increase in online shopping in China. According to a research report issued by iResearch Inc., by the end of 2007, the gross transaction volume of online shopping in China had reached 56.1 billion RMB (approx. \$8 billion), increased from 0.6 billion RMB (approx. \$85 million) in 2001. Particularly for C2C transactions, the volume increased from 0.4 billion RMB (approx. \$56 million) to 51.8 billion RMB (approx. \$7.3 billion).⁸ (See **Exhibits 2 and 3.**)

The growth of China's online infrastructure opened the way for the country's first online C2C auction websites. Earlier online shopping websites mostly followed Amazon.com's business model, the one usually referred to as B2C. By 1999, C2C websites were among the hottest area of investment in China for VC firms. EachNet.com and Yabuy.com both were started in June 1999. Around the same time, Netease and Sina, two of the largest Internet companies in China at the time, also started auction services. Among these and many other start-ups, EachNet would quickly take the lead, so that the burst of the Internet bubble in 2000 would strengthen its position by eliminating weaker rivals. By the middle of 2001, EachNet held 90 percent of China's Internet C2C market.

The Rise of EachNet.com⁹

EachNet was founded in 1999 by Chinese entrepreneurs Bo Shao and Haiyin Tan, American-trained MBAs inspired by eBay's success in the U.S. But copying eBay in China turned out not to be an easy task. One major problem faced by Shao and Tan was users' reluctance to complete transactions online. Many customers used the website to negotiate deals, but then met in person at a public place to examine the goods and make payments. Because of this, as well as the lack of an efficient delivery system in China, most trades on EachNet were occurring only between people in the same city, and users of EachNet concentrated in the few very large cities such as Beijing and Shanghai.¹⁰

EachNet's management decided to facilitate this specific pattern of trading, and set up trading booths in the physical world. Users could take advantage of services available at these booths to complete their transactions, and they could also use the computers, digital cameras and scanners available there to register for a user's account or upload pictures of items to the website. On a typical weekend day, traffic at a trading booth might be in the neighborhood of 200 persons. However, it was costly for EachNet to maintain a large number of trading booths in each city,

[E5%8D%A1%E6%95%B0%E9%87%8F](http://www.chinanews.com.cn/cj/xfsh/news/2007/04-06/909646.shtml), and <http://www.chinanews.com.cn/cj/xfsh/news/2007/04-06/909646.shtml> (July 25, 2008).

⁷ According to China UnionPay's corporate website:

http://corporate.chinaunionpay.com/infoComIntro/chanye/file_2607676.html

⁸ "Demographics of Chinese Internet Users," China Knowledge, <http://www.chinaknowledge.com/Marcom/Book-ChinaConsumer.aspx?subchap=4&content=16> (February 6, 2008).

⁹ Unless otherwise noted, this section is based on information from "EachNet.com," GSB Case No. SM-91, https://gsbapps.stanford.edu/cases/detail1.asp?Document_ID=2810.

¹⁰ Realizing low Internet penetration rates in smaller cities, EachNet actually focused on providing its services on a city-by-city basis for three cities in China: Shanghai (headquarters city), Beijing and Guangzhou.

and most users still preferred meeting at a location convenient to them. Therefore, as users were getting more used to services available online, EachNet gradually closed down these trading booths, the last one surviving until early 2001.

Management at EachNet also faced the problem of processing payments, given the limited options available to Chinese consumers in 1999. So management worked with delivery companies to create a cash-on-delivery system, with the delivery companies acting as collecting agents. This service was set up by June of 2000, and although not perfect, it offered significant improvements in consumer-to-consumer transactions. Also, EachNet's management worked with major banks to facilitate online payments. EachNet formed partnerships with the four largest banks in China¹¹ to encourage heavy users to get credit cards. By early 2002, about one-fourth of EachNet's users were paying with credit cards, half with debit cards, and the rest with postal money orders and other means.

To facilitate online transactions, EachNet's management also experimented with an escrow service, starting in October 2000. EachNet worked as a collecting agent between the buyer and the seller, and held the buyer's payment to the seller until the delivery of goods was confirmed by the buyer. As compensation, EachNet charged 3 percent of the transaction amount as the service fee. However, this service did not really take off, and by the middle of 2001 only 2-3 percent of transactions took advantage of this service. EachNet management also considered offering a PayPal-like service. In the summer of 2001, the plan was to launch this service in the first quarter of 2002, and then make it mandatory in two months. But the plan was dropped in early 2002, and the escrow service was suspended around the same time.

EachNet's management implemented several measures to fight against online fraud. First, although EachNet had a user rating system like that of eBay, EachNet only allowed each account to rate another account once every three months, making it more difficult to use pseudo accounts (or friends' accounts) to artificially inflate ratings. Second, for reported cases of fraud, EachNet had a special team of employees to conduct investigations. Punishments for proved cheaters ranged from a warning to permanent rejection from the system. However, concerned about the cost in time and resources, EachNet did not pursue legal actions against fraud and abuse. Third, EachNet was particularly cautious at the point of user registration. At the very beginning, EachNet only required an e-mail address to register for an account. However, EachNet soon discovered that this policy left too much room for abuse. In May 2001, EachNet management implemented a complicated policy to require ID verification for new account registration. Under this policy, applicants had to verify their identity through one of the following options: 1) faxing a copy of national ID card; 2) applying with a debit card or credit card; 3) receiving a password through cell phone; 4) receiving password by mail at the home address; 5) applying with an ISP e-mail account. In March 2002, the company replaced this policy with a simpler and more effective one, the "Real Name Program." Under this program, an applicant only needed to submit her/his name and national ID number. China has a very strict citizen registration system and the Public Security Bureau keeps a database of such registration information. EachNet successfully negotiated access to this database and therefore was able to verify the applicant's identify information effectively.

¹¹ The four are: the Industrial and Commercial Bank of China, Bank of China, Construction Bank of China, and Agricultural Bank of China.

In April 2000, EachNet management found themselves under stricter scrutiny when raising capital, since the capital markets had become less favorable to internet startups. That year EachNet's valuations had been lowered several times, and investors had nearly pulled out more than once. Under those circumstances, EachNet's management was under pressure to prove the company's ability to earn revenue, as well as to consider different options for financing.

Early on, EachNet had offered all services for free, and the only source of income was advertising on their website. But this income was far from adequate to offset EachNet's costs. So in August 2001, management decided to charge listing fees to sellers. EachNet's management also planned to charge commissions on transactions on its website, starting from late 2002. With these sources of income, EachNet's management hoped to improve their ability to raise capital in the future. Yet Chinese Internet users had become used to free services, and they found no reasons to respond positively to EachNet's fee schedules. Not surprisingly, on the implementation of listing fees, the number of auctions on EachNet.com fell dramatically.

Meanwhile, eBay approached EachNet¹² in early 2001 to discuss the possibility of investment or outright acquisition. eBay's CEO Meg Whitman even made a trip to Shanghai in May 2001 to meet with Shao and his business partners. EachNet's difficulties raising capital made the eBay option attractive. As for eBay, it had recently failed in Japan and was looking for another approach to Asian expansion. eBay management also thought that there was a strategic fit between EachNet and itself. As William Cobb, eBay's senior VP for global marketing, commented at the time: "He (Shao) had studied eBay up one side and down the other and had really tried to adapt a lot of the eBay principles to the market."¹³

eBay acquired one-third of EachNet's shares in March 2002, and the other two-thirds a year later. In total, eBay paid \$180 million for EachNet. This price was a record high in China's emerging Internet industry then, and was widely recognized as a strong signal of foreign investors' elevated interest in China's fast-growing Internet industry.¹⁴

eBay China

Providing an online platform for millions of users to buy and sell, eBay was known to be a global leader in Internet C2C services. eBay was founded in September 1995 as an experiment, by an engineer named Pierre Omidyar. Yet within a few years eBay grew to be a business worth billions of dollars. In September 1998, eBay went public on NASDAQ and before long was considered to be one of the most successful Internet companies in the world.

With capital from its IPO and the accompanying higher pressure for growth, eBay soon reached out of United States for additional growth opportunities. In 1999, soon after its IPO, eBay took over a four-month-old local auction website in Germany (Alando de AG) for an estimated \$47 million and started its first non-U.S. operation. Later in the same year, eBay launched its own

¹² Some other sources believe it was EachNet that first approached eBay instead of the other way around.

¹³ Robert D. Hof. "eBay's Patient Bid on China," *BusinessWeek Online*, March 15, 2004, http://www.businessweek.com/magazine/content/04_11/b3874019.htm (February 5, 2008).

¹⁴ Richard McGregor, "Deal Inflates Entry Costs for Foreigners," *The Financial Times*, 25 June 2003, p. 29.

site in the U.K. and a joint venture in Australia.¹⁵ Despite various challenges, eBay's operations in these markets were successful. In 2000, eBay added Japan, Canada, France, Taiwan and Austria to its list of marketplaces. During its annual financial analyst meeting that year, eBay concluded that among the five overseas markets where it had operations, eBay was the leading online trading platform in four—Australia, Canada, Germany and the U.K., and was at least twice as large as its nearest competitors in terms of GMS (Gross Merchandise Sales).¹⁶ In 2001, eBay invested in Korea's Internet Auction Co. and in MercadoLibre, Latin America's leading online auction company. In Europe, eBay acquired iBazar for about \$130 million, which introduced the company into Italy, the Netherlands, and Spain. And eBay established operations in Ireland, Singapore, New Zealand, and Switzerland.^{17,18} By the end of 2001, eBay had expanded its operations to 17 markets around the world, and had spent more than \$1.6 billion on international acquisitions.^{19,20}

With a strong presence in most of the major Internet markets, eBay had set a good foundation for its ambition to become the dominant online trading platform around the world. But in early 2002, eBay officially admitted that it had failed in Japan, and announced its decision to close the Japan website on March 31.²¹ Since its official launch in February 2000, eBay Japan had been struggling and its market share was a distant fourth place by the time it finally exited. Meanwhile, the same month it exited Japan, eBay announced its entry into China through its investment in EachNet.²²

eBay had high hopes for China. Soon after the acquisition of EachNet, eBay's CEO Meg Whitman stated that eBay considered China to be the company's second most important target market, after the United States.²³ According to Whitman: "Ten to 15 years from now, I think China can be eBay's largest market on a global basis as we build up the local trade and the export trade.... We think China has tremendous long-term potential and we want to do everything we can to maintain our No. 1 position."²⁴

Leveraging eBay's Global Strategy and Organization

eBay management planned to leverage its worldwide capabilities in order to compete against home-grown rivals in China. Decision making at eBay China was centralized to eBay

¹⁵ Eric Schonfeld. "The World According to eBay." *Business 2.0 Magazine*, January 1, 2005, http://money.cnn.com/magazines/business2/business2_archive/2005/01/01/8250238/index.htm (February 26, 2008).

¹⁶ "eBay Inc. Outlines Global Business Strategies," eBay Inc., September 20, 2000. <http://news.ebay.com/releasedetail.cfm?ReleaseID=26939> from eBay's corporate website (June 30, 2008).

¹⁷ Eric Schonfeld. "The World According to eBay," op.cit.

¹⁸ eBay Inc. <http://news.ebay.com/history.cfm> from eBay's corporate website (retrieved February 25, 2008)

¹⁹ eBay Inc. "eBay Inc. Outlines Global Business Strategies," op. cit.

²⁰ Eric Schonfeld, "The World According to eBay," op cit.

²¹ "eBay to Quit Japan," *Japan Today*, February 27, 2002, <http://archive.japantoday.com/jp/news/203332> (June 30, 2008).

²² Ina Steiner, "eBay Teams Up with Chinese Marketplace," AuctionBytes.com, <http://www.auctionbytes.com/cab/abn/y02/m03/i18/s01> (February 6, 2008).

²³ Doug Young and Scott Hillis (Reuters), "eBay, Yahoo Bid for China's Online Auction Market," *USA Today*, April 13, 2004. http://www.usatoday.com/tech/news/2004-04-13-yahoo-vs-ebay_x.htm (February 6, 2008).

²⁴ Associated Press. "eBay Expects Great Things of China," CBS News, April 13, 2004, <http://www.cbsnews.com/stories/2004/04/13/tech/main611598.shtml> (February 6, 2008).

headquarters in the U.S.²⁵ Immediately eBay augmented EachNet's leadership to facilitate integration into eBay's global strategy and organization. In July 2003, James (Xigui) Zheng joined EachNet as its CFO. Zheng was born and grew up in China but had attended graduate school in the U.S. Before joining eBay China, Zheng had spent about five years in eBay headquarters, eBay Korea and eBay Taiwan. In September 2003, a high-ranking executive from eBay Germany was appointed as eBay China's COO.²⁶

eBay corporate changed the Chinese operation in several ways to align it with eBay's worldwide systems. eBay China's platform was changed significantly in terms of listing categorization, interface styles, and technologies. To facilitate maintenance across the whole global platform, eBay China's servers were moved from China to Silicon Valley, and maintenance of the website was primarily carried out by engineers at eBay's California headquarters. Similarly, eBay China's pricing was changed to conform to that of the parent company. EachNet had already started charging for listings, but eBay's takeover led to more significant changes.²⁷ eBay's senior VP for global marketing, William Cobb, observed: "We're mainly interested in making sure that we structure this to have long-term sustainability. We have the essential eBay formula—insertion fees, final-value fees, and features fees—though at a lower level."²⁸ In September 2004, over a year after eBay completed the acquisition, eBay China was officially moved onto eBay's global platform, and a mirror site www.ebay.com.cn was launched simultaneously. Shao commented at the time: "In the long term, becoming part of the global network will help our growth rate. But it's harder to say in the short term."²⁹

As it integrated the Chinese operation into its global platform, eBay corporate also changed the structure of leadership in its Asian operations. In August 2004, eBay created a regional layer between eBay headquarters and eBay China, to be known as eBay Asia. This organization was located in Korea, and was headed by eBay Korea's CEO, Jae-Hyun Lee.³⁰ eBay Asia was to coordinate eBay's operations in Asia, and did not have its own separate online marketplace. In November 2004, Shao stepped down from the CEO position. CFO Zheng took over Shao's role as the company's head, but with a title of COO.³¹ By the end of 2004, EachNet's integration into eBay was largely complete, just in time for the company to compete with an increasingly visible Taobao.com.

²⁵ "eBay's Tom Online Deal: Timely Lessons for Global Online Company Managers," *Seeking Alpha*, February 14, 2007, <http://seekingalpha.com/article/27041-ebay-s-tom-online-deal-timely-lessons-for-global-online-company-managers> (February 6, 2008).

²⁶ "Dr. Stefan Groß-Selbeck," *Xing*, http://www.xing.com/profile/Stefan_GrossSelbeck (December 17, 2009).

²⁷ Sherman So and J. Christopher Westland, "How eBay lost the China market," *Global Times*, August 10, 2009 (December 17, 2009) and Justin Doebele, "Standing Up To a Giant," *Forbes*, April 25, 2005.

²⁸ Robert D. Hof. "eBay's Patient Bid on China," *BusinessWeek Online*, March 15, 2004, http://www.businessweek.com/magazine/content/04_11/b3874019.htm (February 5, 2008).

²⁹ "eBay's China Site to Join Global Network," *China Daily*, September 17, 2004, http://www.chinadaily.com.cn/english/doc/2004-09/17/content_375458.htm (July 16, 2008).

³⁰ "eBay To Set Up Asia-Pacific Headquarters in South Korea," *Asia Pulse*, November 16, 2005.

³¹ "eBayEachnet to Fight to the Bitter End," *SinoCast China IT Watch*, January 10, 2005.

Taobao Rivals eBay China

During the period from late 2002 to early 2003, when eBay was acquiring EachNet, one man was particularly concerned with the development, and quietly evaluated the progress of eBay. He was Jack Ma, founder and CEO of a leading Chinese Internet company, Alibaba.com Inc. Ma was a legendary business figure in China, who progressed from being a college English teacher to one of China's earliest Internet pioneers. Very different from other Internet entrepreneurs in China, who normally had a strong technical background and graduated from an elite university, Ma attended a local college in Hangzhou and taught English at another local college after graduation. He had almost no knowledge of computers, but happened to come across the Internet during a trip to the U.S. during the 1990s. On his return to Hangzhou, Ma founded one of the earliest business websites in China, and then in 1999 founded the business-to-business (B2B) website Alibaba.com. By 2002, Alibaba.com had grown to be the leading B2B website in China.³²

When eBay acquired EachNet, Ma felt that eBay could become a serious threat to Alibaba. According to Ma: "In China, there are so many small businesses that people don't make a clear distinction between business and consumer. Small business and consumer behavior are very similar. One person makes the decisions for the whole organization. We launched Taobao not to make money, but because in the U.S. eBay gets a lot of its revenue from small businesses. We knew that someday eBay would come in our direction."³³ As eBay's Cobb observed at the time: "This is also a model where people can start their own business. So it really comes together quite nicely in China. We've received great support from the government because they've realized how we can empower entrepreneurs and provide access to the rural areas."³⁴

Taobao.com was headed by Tongyu Sun, one of Alibaba.com's founders. In Chinese, the phrase "Taobao" actually means "searching for treasures." While this meaning shares the spirit of "Alibaba," the link between Taobao and Alibaba remained secret at first. For over two months after the launch, few people knew Taobao.com was part of Alibaba, not even most employees of Alibaba. But in July 2003, Ma thought the website was ready to go head-to-head against eBay China, and officially acknowledged the affiliation between Taobao and Alibaba.³⁵ At the news conference, Ma also announced that Alibaba would invest 12 million US dollars into Taobao.³⁶

Ma viewed Taobao an underdog in this competition. Management chose the image of a worker ant to be Taobao's mascot, with the idea that Taobao employees needed to unite and fight to the end. In a late 2004 celebration for Alibaba's fifth birthday anniversary, employees of Taobao waved flags featuring worker ants, showing their determination to defeat their powerful rival.³⁷ At the time, Taobao might in fact have looked like an ant to eBay. In 2004, when asked about

³² "Jack Ma," Encyclopedia of World Biography, <http://www.notablebiographies.com/newsmakers2/2007-Li-Pr/Ma-Jack.html> (December 17, 2009).

³³ Susan Kuchinskas, "Jack Ma, CEO, Alibaba," Internetnews.com, October 22, 2004, <http://www.internetnews.com/ec-news/article.php/3425421> (February 8, 2008).

³⁴ Robert D. Hof, "eBay's Patient Bid on China," *BusinessWeek Online*, March 15, 2004, http://www.businessweek.com/magazine/content/04_11/b3874019.htm (February 8, 2008).

³⁵ May need to footnote this paragraph if Total Telecom is not source

³⁶ "China's Alibaba Opens Doors to Online Auctions," *Total Telecom*, July 11, 2003.

³⁷ Justin Doebele, "Standing Up to a Giant," *Forbes*, April 25, 2005, <http://www.forbes.com/global/2005/0425/030.html> (February 11, 2008).

potential challengers in China, Cobb only mentioned 1Pai,³⁸ a joint venture between Yahoo! and Sina (China's leading Internet portal service company). Cobb viewed Internet C2C as eBay's primary expertise, and did not think that it could be matched by its competitors in China.³⁹

Ma's plan for Taobao was to compete in a different way than eBay. In Ma's opinion, despite eBay's huge success in other countries, the war eBay faced in China would present new challenges. Ma commented in 2005: "eBay may be a shark in the ocean, but I am a crocodile in the Yangtze River. If we fight in the ocean, we lose—but if we fight in the river, we win."⁴⁰ Ma gained some of his confidence from one of his most important business partners—Masayoshi Son, Founder and CEO of Softbank Capital. After all, it was Yahoo! Japan, backed by Softbank, that defeated eBay in Japan. The founding of Taobao was believed to be a co-effort between Son and Ma, with Softbank providing the much-needed capital.⁴¹ Ma was optimistic about this partnership: "We were both thinking the same thing: Son kicked eBay out of Japan. I have the same chance in China."⁴²

Competing for Customers

Taobao approached advertising very differently than did eBay China. eBay's approach was to invest heavily in its marketing campaigns in China, and to sign exclusive contracts with almost all the major Chinese websites. These contracted websites then were forbidden to sell advertisements to eBay's competitors. This exclusion was important to Taobao, since it badly needed publicity.⁴³ To deal with this problem, Ma and his team switched to the "ants' way." They took advantage of the enormous number of computer bulletin board services (BBS) in China, and posted thousands of messages there to introduce Taobao to Internet users. According to Ma, this grassroots approach to online marketing worked well, and Taobao continued this approach even after most of eBay's exclusive advertising contracts expired. "They (eBay) have deep pockets, but we will cut a hole in their pocket," Ma was quoted saying.⁴⁴

Taobao launched with an entirely no-fee model. It further extended the no-fee plan for three additional years starting in October 2005. According to a survey taken in 2005, a significant number of eBay China's users were migrating to Taobao because of the free services.⁴⁵ eBay China responded by defending its fee structure, noting that "free is not a business model," and that quality service made such fees necessary.⁴⁶

³⁸ Later in 2005, 1Pai was actually absorbed by Taobao due to Alibaba's acquisition of Yahoo! China.

³⁹ Robert D. Hof, "eBay's Patient Bid on China," *BusinessWeek Online*, March 15, 2004, http://www.businessweek.com/magazine/content/04_11/b3874019.htm (February 11, 2008).

⁴⁰ Ibid.

⁴¹ Alibaba raised \$82 million in early 2004 and announced that much of this money would be used on Taobao.com. Softbank Capital was the leading investor in this investment and provided most of the capital. (Reuters. "World Business Briefing Asia: China: Web Auctioneer Raises Cash," *New York Times*, February 18, 2004).

⁴² Justin Doebele, "Standing up to a Giant," op. cit.

⁴³ Ibid.

⁴⁴ Ibid.

⁴⁵ Ling Liu, "Bidding Fierce for Chinese Online Buyers: Great Prospects for eBay Growth, but Local Competition is at Its Heels," *San Francisco Chronicle*, May 30, 2005, p. E-1, <http://www.sfgate.com/cgi-bin/article.cgi?file=/c/a/2005/05/30/BUGLHCVKI81.DTL&type=printable> (February 14, 2008).

⁴⁶ Sumner Lemon, "eBay China Decides 'Free' Is a Business Model," *InfoWorld*, January 20, 2006, <http://www.infoworld.com/t/business/ebay-china-decides-free-business-model-258> (Feb. 6, 2008).

Taobao designed its categories in accordance with the typical structure of a Chinese department store, with separate sections for men's and women's departments. By contrast, eBay China used the category structure set by eBay's global platform. Taobao focused on fostering a sense of community on its website, by setting up online forums for its users and by encouraging interactions between sellers and buyers. Because of the no-fee policy, Taobao was less concerned with offline transactions among those who used the online service only to initiate dealings. (Such transactions would mean a loss of revenue for a fee-based service like eBay China.) To facilitate communication, Taobao integrated an instant messaging service into each seller's webpage, and allowed sellers to provide full contact information, including phone numbers, on their own web pages. Some industry insiders argued that heavy communication among Taobao users substantially increased their sense of community. As a consequence, Taobao was generally perceived as informal and friendly compared to eBay China.⁴⁷

Competing in Payment Services

Management at Taobao thought it was important to offer payment mechanisms as part of their service because of China's poorly developed e-business infrastructure. So the workforce at Taobao worked feverishly to launch its integrated payment system, AliPay, within three months of the website's official launch in 2003. Ma and his team had longstanding relationships with key government officials and leaders in the Chinese banking industry, and were able to secure the cooperation of key banks in China to process payment transactions. AliPay also provided escrow services for buyers. It held the buyer's payment until the merchandise was actually accepted by the buyer, and provided insurance for buyers in case of fraud to protect them from financial losses. Taobao also made efforts to facilitate the delivery of transacted merchandise. In 2005 and 2006, Taobao struck deals with several leading logistic companies in China to provide customized services at discounted prices to users of AliPay. The company's technology teams, meanwhile, integrated delivery service requests into AliPay's user interfaces.

eBay China also had been developing a payment system, "An Fu Tong" (Secure Pay), building on the payment and escrow systems developed earlier at EachNet. This service was launched in October 2004. The escrow service would hold the buyer's payment until delivery was confirmed, while the payment system was similar to PayPal's.⁴⁸ Meanwhile, eBay corporate acquired PayPal in 2003 and soon bundled this service with its U.S. website. eBay corporate had high hopes for PayPal in China, appointing eBay executive Jeff Liao, originally from Taiwan, to head PayPal China. Liao had planned an immediate launch upon his arrival in January 2005, but encountered serious institutional obstacles that delayed launch until July of that year.⁴⁹

PayPal's problem in China stemmed from the Chinese government's tight control of financial service providers. Chinese retail financial services were closed to wholly-owned foreign companies at that time. To manage this problem, Liao carefully orchestrated PayPal's entry by

⁴⁷ Jin Sun, "eBay Leaves China to Reduce Its Loss, and Ma Yun Wins the War Through Strong PR," (in Chinese), *First Financial Daily*, December 22, 2006, <http://tech.163.com/06/1222/02/32TO84ST000915BF.html> (February 13, 2008).

⁴⁸ Mylene Mangalindan, "Hot Bidding: In a Challenging China Market, eBay Confronts a Big New Rival," *The Wall Street Journal*, August 12, 2005.

⁴⁹ "eBay Inc. and TOM Online Announce Joint Venture Agreement To Enable Next Phase of E-Commerce Growth in China," *Business Wire*, December 20, 2006.

partnering with a local company. But PayPal still was scrutinized by the government. In particular, PayPal was prohibited from offering international transactions and flexible credit—services that leveraged its global platform and would give it an advantage over Taobao.⁵⁰

After launch, eBay China found that its customers often confused An Fu Tong and PayPal. This confusion led to serious problems, since customers would mistakenly think that the transaction system had erred when, in fact, they were mistakenly moving between separate systems. In response, the company emphasized that the two services were distinct, and that each focused on different stages of the transaction. But the problem of customer confusion had taken a toll.

While AliPay was rapidly being adopted by Taobao's users, online payments were growing slowly within eBay China. During 2005, 79 percent of listings on Taobao.com accepted online payments, while that number for eBay China was 21 percent.⁵¹ In the wake of this success, Taobao's management made AliPay available to merchants other than those on Taobao.com. The company also extended its insurance service to all transactions that occurred through AliPay, even those not on Taobao.⁵²

Competing for Partnerships

2005 saw both Taobao and eBay China forming key partnerships. In April, Taobao and Sohu (one of China's leading portal websites) entered into a partnership, giving Taobao a foothold in online advertising. eBay China's exclusive contracts with nearly all the major websites in China made this partnership particularly notable.⁵³ In May, MSN China announced its decision to select Taobao instead of eBay China as its exclusive partner for MSN China's shopping channel. This decision was regarded as a substantial recognition of Taobao's rising position in China's Internet C2C market, especially given the fact that MSN's partner for its shopping channel in the U.S. was eBay.⁵⁴

eBay China, meanwhile, announced in June 2005 a partnership with Global Resources, a leading international trade information provider in Greater China area. The partnership was intended to take advantage of eBay's global platform to attract international business people to the website. Under the plan, Global Resources' clients would have opportunities to sell directly to Chinese customers, and manufacturers in China would also have opportunities to sell through eBay's global platform.⁵⁵

⁵⁰ Andrew Yeh, "For Chinese, payments are online hurdle," *Financial Times*, FT.com, October 19, 2006.

⁵¹ AFX. "eBay's Whitman to Make Frequent Trips to Shanghai, PayPal's Launch Planned," AFX News Limited, June 13, 2005, <http://www.forbes.com/business/feeds/afx/2005/06/13/afx2089062.html> (February 14, 2008).

⁵² "Websites Warmly Embrace AliPay's Internet Trust Scheme," *SinoCast China Business Daily News*, August 16, 2007.

⁵³ "Sohu dumps eBay Eachnet, signs exclusive ad deal with Taobao," *Interfax China IT & Telecom Report*, April 15, 2005.

⁵⁴ Jin Chen, Cheng Zhang, YuFei Yuan, and Lihua Huang. *Understanding the Emerging C2C Electronic Market in China: An Experience-Seeking Social Marketplace*. *Electronic Markets*, 17(2), 86. (2007).

<http://home.aubg.bg/students/YHY040/E-bay/25049078.pdf>.

⁵⁵ "Global Resources Allies with eBay to Co-develop Chinese Market," *SinoCast China Business Daily News*, June 17, 2005.

The Problem of Counterfeit Merchandise

As online C2C business took off in China, the market was flooded with counterfeit merchandise—especially in categories such as clothing and accessories. Very few online sellers were authorized vendors of branded goods, and as their sales volume rapidly increased it was impossible for the auction sites to monitor all merchandise. Few buyers complained, however, because the prices of these goods typically reflected their “knock off” status. More broadly, such counterfeit trading was widely seen in China as a fact of life, especially in categories such as clothing and accessories where some experts estimated 70 percent of all C2C sales were of counterfeits. Online C2C sites were becoming aggregators for the highly fragmented counterfeit goods industries of China.⁵⁶

To the online C2C firms, the downside of counterfeit sales depended on the potential for legal action by brand-name manufacturers. In China at the time, no online service providers had been held liable for damages due to counterfeiting among users. For example, in September 2005, a seller on eBay China was sued in a local court of Qingdao for selling counterfeits and was found guilty. But eBay China was not held liable in the ruling, although it was sued together with the seller. Similarly, in 2006, Taobao was sued by PUMA in a local court in Guangzhou for infringing upon PUMA’s trademark rights. PUMA argued that Taobao.com provided service to 43,932 online shops that were found distributing counterfeit PUMA garment products. Taobao and its online shops were requested by PUMA to immediately stop the infringement and compensate RMB1million Yuan (approx. US\$0.125 million). The court decided to support Taobao’s defense that it was beyond the online auction firm’s ability to supervise and control all its online shops’ activities.⁵⁷

By contrast, eBay China was especially vulnerable to negative fallout from Chinese counterfeiting. Given eBay’s global platform, any counterfeit seller in China could list goods on a system that would be displayed on eBay websites around the world. Consequently, the sale of counterfeits globally on eBay exploded after the company’s expansion into China in 2004.⁵⁸ This fact raised a serious dilemma for eBay corporate. The worldwide organization could be subject to legal actions in the U.S. and Europe because of the availability of these counterfeits in such regions. Yet if eBay became strict regarding counterfeits, it would lose a significant portion of the Chinese market. Taobao, as a purely Chinese operation, faced no such bind.

Events several years later would serve to illustrate the different situations faced by eBay and Taobao. In 2007, LVMH, filed a complaint against Taobao regarding fake LV handbags sold on Taobao.com. But this complaint did not lead to any consequential legal actions in China—only an agreement between the two that Taobao would respond to LVMH’s future complaints in an

⁵⁶ “Counterfeit Fashion Generates 15 BLN Euro Turnover in Italy,” ANSA - English Media Service, November 17, 2003.

⁵⁷ “PUMA Sued ICP for Selling Fake,” *Guangzhou Daily*, April 25, 2007, <http://www.hfgip.com/1b.aspx?id=3D920DB1-B1FE-4C16-9B96-C854C0157264> (retrieved 25 July 2008).

⁵⁸ Brad Stone, “eBay Reports Progress Against Fraud,” *International Herald Tribune*, June 14, 2007, <http://www.iht.com/articles/2007/06/14/business/ebay.php> (retrieved July 24, 2008).

“effective manner.”⁵⁹ By comparison, when LVMH sued eBay in a Paris court in 2008, it won the case. Analysts then began to question whether the ‘business model’ of a global online C2C platform would be viable—a question that eBay and eBay China had already been asking several years earlier.

The Endgame

As eBay China’s performance continued to slip in 2005, many began to re-evaluate its strategy and organization. Some questioned the wisdom of eBay’s global decision-making process. The former head of strategic planning at eBay China, Charles Shen, complained: “As the service is now running from the global platform in San Jose, California, if we have to add a new feature, it takes quarters, instead of months. Taobao is more flexible and faster in responding to users.”⁶⁰ Shao later would echo this view, saying that the complexity of eBay’s global platform severely dragged down the speed of decision making in its China operation. He claimed that a 9-week decision in the former EachNet had become a 9-month decision in eBay China.⁶¹

Centralization also harmed eBay China’s technical performance. One industry insider explained that eBay global normally maintained its servers on Thursdays at midnight, in order to better prepare the website for the week’s peak traffic on Friday. But Thursday midnight in Silicon Valley would be Friday afternoon in China. Consequently, regular server maintenance at eBay’s headquarters coincided with eBay China’s heaviest traffic of the week, resulting in performance problems and customer complaints. eBay China had tried to coordinate with eBay headquarters to set up a different maintenance schedule, but was not successful.

eBay corporate also saw the need for a change in its China operation, and so shook up the company’s leadership. Ten months into Zheng’s leadership of eBay China under the COO title, eBay announced in September 2005 that Martin (Shih-Hsiung) Wu, Microsoft China’s CEO, would replace Zheng and take the title of CEO. Wu was born and raised in Taiwan, but later got his master’s degree in computer science in the U.S. He moved from the U.S. to Japan when he was with Kodak, and then joined a Taiwan technology firm and started working in mainland China. By the time he joined eBay China, Wu had served as a high-ranking executive in several international IT companies’ China operations, including Lotus, Intel, and Microsoft.

Wu promptly initiated several strategic changes at eBay China. In December 2005, the company stopped charging maintenance fees for online stores. One month later it also eliminated the transaction fee. Two months after that, in March 2006, eBay China established a partnership with one of China’s largest electronics chains, YongLe Electronics. According to the agreement, EachNet.com would become the exclusive online stores for YongLe. Wu stated that the company would continue to explore the B2C market through such partnerships.⁶²

⁵⁹ Yating Cheng, “Online Shopping: Flooding of Fakes and Lack of Regulations,” *Global Entrepreneurs*, March 10, 2008, <http://tech.sina.com.cn/i/2008-03-10/16502068134.shtml> (July 25, 2008),

⁶⁰ “eBay Ousting as Market Leader Blamed on Cultural Clash,” *South China Morning Post*, September 19, 2006, p. 12.

⁶¹ Zhonghui Lei, “Bo Shao: Free Service from Taobao Damaged E-commerce in China,” (in Chinese) *21st Century Economic Report*, February 1, 2007, <http://www.techweb.com.cn/people/2007-02-01/149552.shtml> (February 15, 2008).

⁶² Hua Chen, “YongLe Opened Online Stores through Partnership with EachNet,” (in Chinese) *Oriental Morning News*, March 30, 2006, <http://tech.sina.com.cn/i/2006-03-30/0835883188.shtml> (July 24, 2008).

But as eBay China's performance continued to decline, Wu did not stay long at the CEO position. In September 2006, Wu was replaced by PayPal China's CEO Jeff Liao, who continued to head PayPal China as well as eBay China. Many industry insiders regarded this consolidation to be a sign that eBay had given up on eBay China. And so it was that in December 2006, eBay paid \$40 million to Tom Online to hand over its control of eBay China—again to be called EachNet—to the joint venture partner.⁶³ eBay corporate then quietly decreased integration between EachNet and its global platform. In 2007, EachNet was entirely cut off from eBay's global platform and relegated to domestic trading within China only. Also in 2007, PayPal was taken off the EachNet website, leaving An Fu Tong as the website's only online payment service.⁶⁴

eBay had repeatedly expressed its commitment to the market in China and emphasized the essential role of this market in eBay's future plan for growth. And so eBay corporate soon opened another China site in 2007, www.ebay.cn. This site was fully integrated into eBay's global platform and was directly controlled by eBay corporate. Management at eBay corporate explained that www.ebay.cn was designated to international trade, while EachNet.com would focus on domestic C2C.⁶⁵

Becoming a Profitable Company?

Although Taobao had emerged as the clear leader in China's online C2C space, it was under constant pressure to generate revenue. In May 2006, shortly after its promise to offer all services free for three more years, Taobao made its first try at a fee-based service. This service was based on the "bidding for ranking" logic and reserved the best slots in each channel for bidding. After three years' free service, this new product soon became a PR disaster. Many users complained that this new product violated Taobao's promise of free service. Meanwhile, there were many complaints about the functionality of the product. Under pressure in the media, Ma decided to call a stop to the fees—but he did so in a strategic way. Instead of simply taking the product offline, he laid the product's fate at the users' hands; Ma asked users of Taobao.com to vote to decide whether the product should be continued or not. On June 12, 2006, after 10 days' voting, it was finally announced that 61 percent (127,872⁶⁶) of the votes were against the new product and it was therefore suspended. Although the maneuver was impressive, the failure was still bitter. Alibaba.com Inc. might not be short of cash to support three more years' fully free services on Taobao.com, but the event did remind Ma that there was a long way to go to make money out of Taobao.

⁶³ Keith Bradsher, Howard W. French, and Rujun Shen, "For eBay, It's About Political Connections in China," *The New York Times*, December 22, 2006 and John Liu, "EBay folds China unit, strikes Tom Online deal: Pays \$40 million. New venture set up with billionaire," *The Gazette* (Montreal), December 21, 2006.

⁶⁴ Li Na, "The Emergence of TOM EachNet," *China Business Feature*, Feb 22, 2007, http://www.cbfeature.com/special_coverage/news/the_emergence_of_tom_eachnet/is_wang_leilei_a_chess_piece_or_a_flag_person/ (December 17, 2009).

⁶⁵ "RIP ebay.com.cn," *tamebay*, August 31, 2007, <http://www.tamebay.com/?s=eachnet> (December 17, 2009) and Shaun Rein, "eBay's Tom Online Deal: Timely Lessons for Global Online Company Managers," February 14, 2007, <http://seekingalpha.com/article/27041-ebay-s-tom-online-deal-timely-lessons-for-global-online-company-managers> (December 17, 2009).

⁶⁶ According to news release from Taobao.com http://forum.taobao.com/show_thread.htm?thread=5409015&forum=14

Taobao soon tried to charge fees again using a very different approach. Later in 2006, Taobao launched the beta version of a new service called “Mall of Brands,” which was essentially a B2C service, and soon started charging on certain value-added services related to this product. In January 2008, Taobao announced that the redesigned B2C platform was to be officially online on March 1, 2008, and the service would be entirely fee-based. For this new platform, users could enjoy a free trial period varying from 3 to 7 months. But after that, a long list of fees would incur, including transaction fees (a certain percentage of transaction volume), technical service fees, storage fees, and listing fees.⁶⁷ Not surprisingly, this plan of fees again caused uneasiness among its potential users. But this time, the objection was not as pronounced as in 2006, and management at Taobao was determined to go ahead as planned.

⁶⁷ Jie Zhou and Lin Jin, “New B2C Platform of Taobao Charges for Revenue,” (in Chinese) *Shanghai Business*, January 30, 2008, <http://finance.sina.com.cn/chanjing/b/20080130/00414468696.shtml> (February 16, 2008).

Exhibit 1
Number of Internet Users in China (in millions)

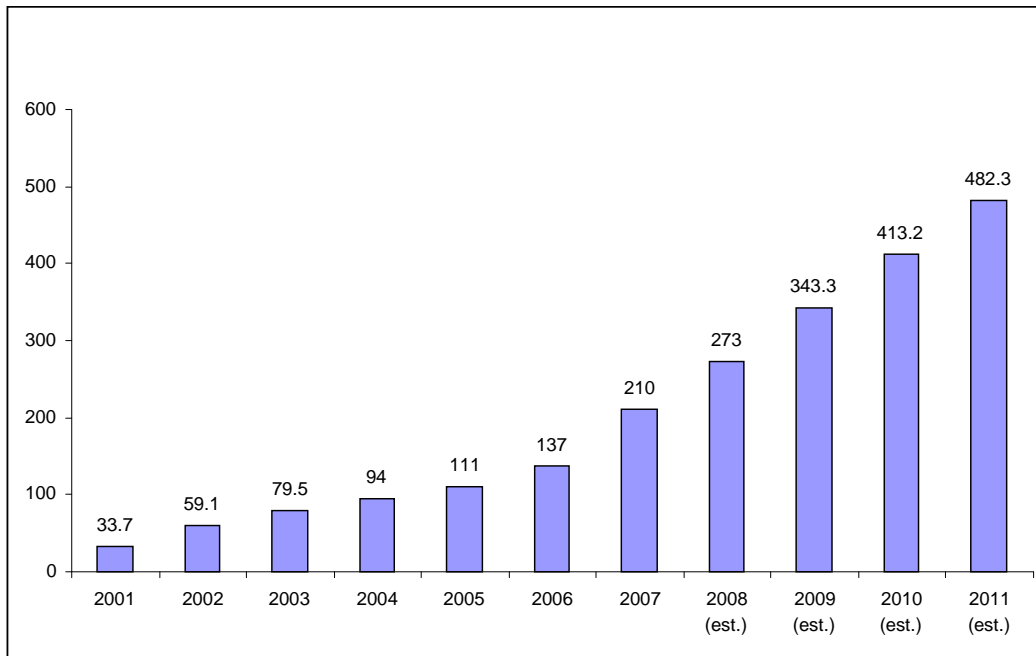
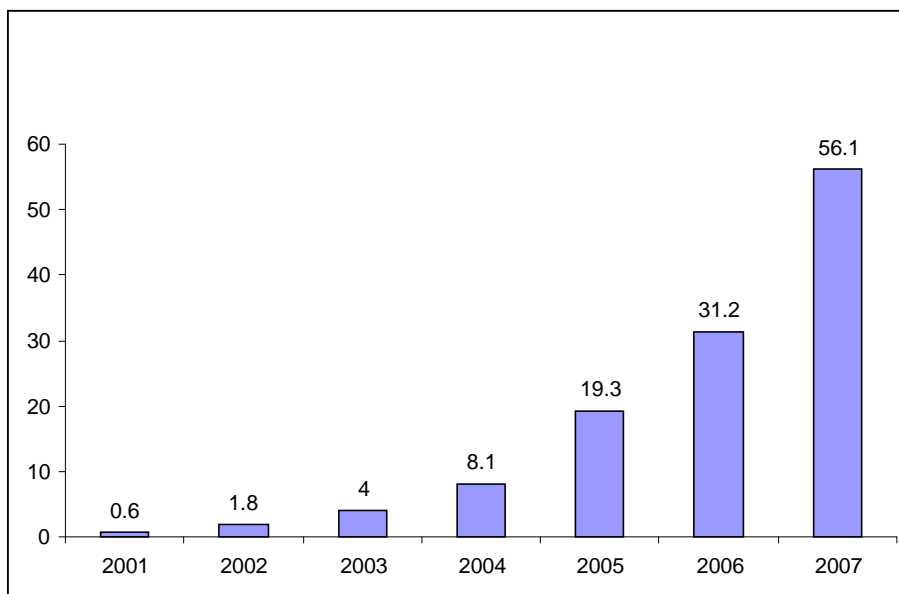


Exhibit 2
Transaction Volume of Online Shopping in China (RMB, in billions)



Source: Compiled by authors from iResearch Consulting Group data.

Exhibit 3
C2C Transaction Volume in China (RMB, in billions)

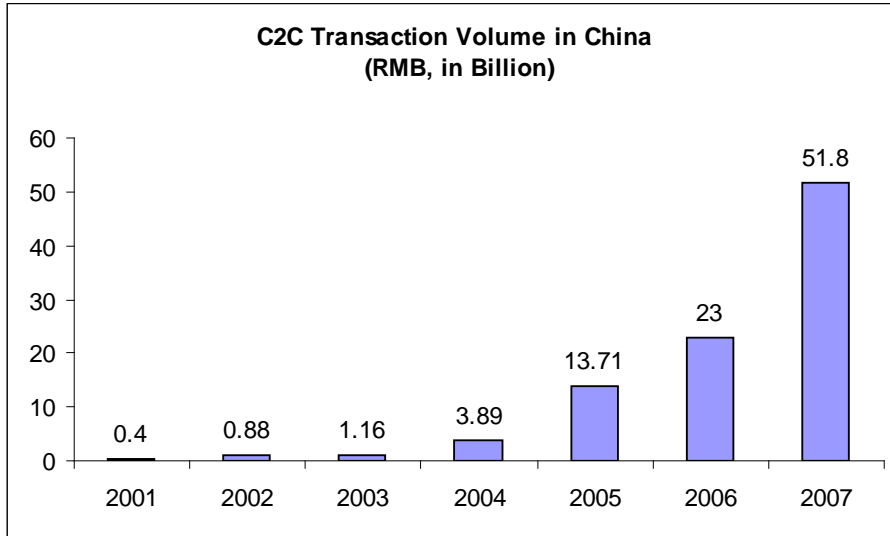
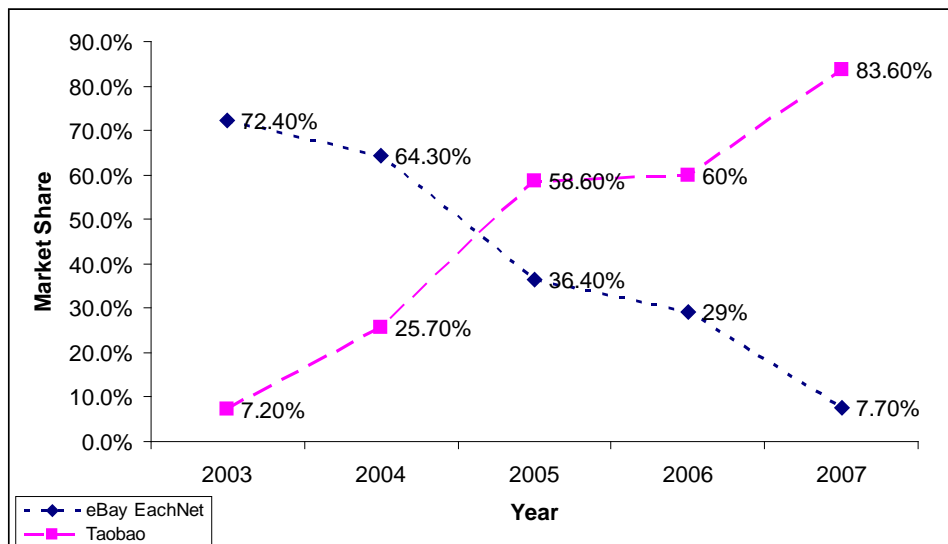


Exhibit 4
eBay EachNet and Taobao's Market Shares



Source: Compiled by authors from iResearch Consulting Group data.