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How Small Companies Compete with — and Beat — Big Ones Strategy lessons from TaoBao's defeat of eBay in China.

By Felix Oberholzer-Gee

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In an era driven by network effects, smaller players struggle to compete against bigger platforms. The trick to gaining ground on a much larger rival, says **Harvard Business School professor Felix Oberholzer-Gee**, is choosing a strategy that can't easily be imitated.

A good example is TaoBao's strategy for displacing eBay in China. Back in 2007, eBay was the world's largest consumer marketplace, and TaoBao was an underdog with bold new ideas about how to build trust with customers who were reluctant to shop online.

"In fact, the market that Taobao targeted ended up being so much more important than eBay's market," Oberholzer-Gee tells Cold Call host **Brian Kenny**. "[A]nd eBay eventually left China."

Key topics include: sales, hiring, compensation and pay, communication, performance management, and leadership development, competition, competitive markets, and innovation.

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HANNAH BATES: Welcome to *HBR On Strategy*, case studies and conversations with the world's top business and management experts, hand-selected to help you unlock new ways of doing business. In an era driven by network effects – how can smaller players compete against bigger platforms? Today, we bring you a conversation with Harvard Business School professor Felix Oberholzer-Gee – who says the trick to gaining ground on a much larger rival is choosing a strategy that *they* can't easily imitate. This episode breaks down TaoBao's strategy for displacing eBay in China. Back in 2007, eBay was the world's largest consumer marketplace, and TaoBao was an underdog with a new strategy to pivot away from

B2B sales and engage consumers directly. This episode originally aired on *Cold Call* in July 2021. Here it is.

BRIAN KENNY: According to Smithsonian magazine, Dan Kohn, founder of NetMarket, conducted the first end-to-end online sales transaction, when he sold his CD of Sting's, "Ten Summoners Tales" to a friend in Philadelphia for \$12.48, in 1994. It was an inauspicious beginning to what has become a \$1.7 trillion global industry. According to retailer.com, 50% of e-commerce sales were made through online marketplaces in 2019. A number that is expected to grow rapidly in the coming decade. Digital natives could be forgiven for assuming that it's always been this way, but of course, like every other disruption in business, the evolution of e-commerce has involved fierce competition and strategic gamesmanship between global players on a rapidly changing landscape. And to the victor go the spoils. Today on Cold Call, we welcome professor Felix Oberholzer-Gee to discuss his case, entitled, Alibaba's Taobao. I'm your host, Brian Kenny, and you're listening to Cold Call on the HBR Presents network. Felix Oberholzer-Gee is an expert on competitive strategy and international competition. He is the author of the newly published book, *Better Simpler Strategy, a Value-Based Guide to Exceptional Performance*. He's also a podcaster, he's the co-host of a fabulous podcast called *After Hours*. Along with other HBS faculty, Youngme Moon, Mihir Desai, and various guests that are popping in and out. It's one of my favorite shows. Felix, I'm thrilled to have you on Cold Call today. Thanks for joining me.

FELIX OBERHOLZER-GEE: It's great to be here. Thank you, Brian.

BRIAN KENNY: What I really want to do is use this case that we're going to talk about today as a way to hear about some of the ideas in your new book. I know that the case is a good stepping off point for that. The book is about strategy and that's something that you think deeply about and that you teach about here at the school. I think people will really enjoy listening to the story about Taobao, which is part of Alibaba. Let's just dig in. Tell me what would your cold call be to start this case in the classroom?

FELIX OBERHOLZER-GEE: Like many faculty members, I have a few go-to cases that I just love teaching. I must have taught the Taobao case dozens of times. If I could teach it tomorrow, I definitely would. It's a case about an underdog in an industry landscape that is typically dominated by big platforms. Of course, we're thinking of Taobao as China's equivalent of, perhaps, Amazon today. But at the time of the case in the early 2000s, eBay, interestingly was dominant in China. Just like it's almost unthinkable how you might compete against Amazon in the United States, it was almost unthinkable how you might compete against eBay in China at that particular time. Then, of course, Alibaba did it. And Taobao is now the top dog, faces new competition, interestingly also, in China today. But it's a story of being the small player, the small company in a market that is dominated by a big platform. The case develops an idea, that is featured prominently in the book also, what I often refer to as "Strategies for Underdogs," what can you do that the big player cannot easily imitate?

BRIAN KENNY: This case takes place in the mid-2000s into the early 2010 timeframe. How does it relate to the questions that you try to answer as a scholar and, importantly, how does it surface in the book that you've just published?

FELIX OBERHOLZER-GEE: The big question is really how you compete as a smaller player against the big platform. The big platforms, and this is a theme that I explore at length in the book, the big platforms, they all benefit from what we call network effects. Network effects are a mechanism that renders a platform or a business, or a product more valuable if more people use it. Imagine, you're the only person on Facebook, it's not such a great experience. The more people join, the more valuable it becomes. The question then is, "If the big platform is so far ahead, what can you do to catch up?" The Taobao versus eBay story set in China explores the possibilities. Taobao uses really two things I think that I see in lots of other markets, and that I describe in the book also, about how smaller platforms can compete. The first idea is really the big network benefits from an increased willingness to pay. Willingness to pay, one of the key strategic variables in thinking about competitive strategy, is the most a customer would ever pay for a product or a service. If my company benefits from network effects, that's elevated irrespective of the quality of the service or the attractiveness of the platform to begin with. So, the smaller player needs to think about, "How can I increase my customers, my client's willingness to pay without having the benefit of scale?" For instance, if you have an idea that involves significant fixed cost, that's probably not a leading candidate to compete against the big platform, because the big platform can spread fixed costs much more easily than you can. Not surprisingly, what we see Alibaba do, is implement a whole range of ideas that are essentially low cost or variable cost, so that the big platform, if it decides to imitate, doesn't have a natural advantage in this imitation process.

BRIAN KENNY: For people who aren't familiar with Alibaba, maybe you can describe them before we dive into those details. What is Alibaba? And a little bit about Jack Ma too, the founder. He's a colorful character.

FELIX OBERHOLZER-GEE: Yes, certainly. He's a teacher originally. The first really big business that he built is Alibaba, the name of the group today. Alibaba is really a B2B business. It allowed many smaller and medium-sized Chinese companies to start selling online. Start selling online domestically, that was important. But I think even more important is selling internationally, because it wasn't easy for Chinese businesses at that point in time to reach their overseas customers. When you think about just how dramatically important exports are for the Chinese economy, in part, this was facilitated in a really big way by Alibaba. eBay and Alibaba didn't really touch one another for quite some time, because ebay, just in the US, was mostly a consumer oriented site, and Alibaba competed in this B2B space. Then, in the Chinese context, eBay had a really quick increase in what they call power sellers. Power sellers are people who are essentially middlemen. They look a little bit like individual customers, and they look a little bit like an actual B2B business with B2B transactions. Naturally, Jack Ma, was very concerned about eBay encroaching on Alibaba's turf. That triggered the response that, interestingly, during the SARS epidemic, he decided, "We're going to build a business called Taobao," which means "hunting for treasures", that is squarely in the C2C space. The team that developed the business was locked up in Jack Ma's apartment in Shanghai. They couldn't go outside just like during COVID we can't go outside, because SARS was potentially even more fatal than COVID-19 today. So, they used that period of time when they had engineering resources that couldn't really go anywhere. They used that period of time to build a competitor. eBay had 85% market share at the time. So, how on earth would you ever compete? The case, essentially, allows students to see what kinds of variable cost ideas that a company might have, in order to increase its customer's

willingness to pay. The discovery is that it's a different design. It's a whole suite of features that are, interestingly, not really directed at eBay's customers in the first place. This is early days of the internet. It seemed mildly crazy to buy something online. Many people waited on the sidelines. In the book, these groups of people I call "near customers." They're almost in the market, but not quite. Their willingness to pay, it's just slightly shy of the price that you would have to pay. It has to do with lots of concerns. I'm giving someone my financial information. Maybe are going to send me the packet that I ordered. Maybe you're not going to send me the product. Maybe the product will be broken. Taobao developed a whole range of features that essentially built trust among near customers. That has two effects. One is, you're not really fighting for the same group of customers that eBay already owns. That's much easier to do than luring customers from a big platform that benefits from network effects. It solves a major issue in the development of e-commerce. In fact, that market, the market that Taobao targeted, ended up being so much more important than eBay's market and eBay, eventually, you might remember they left China.

BRIAN KENNY: Let's talk a little bit about Meg Whitman and the way that she was sizing this whole thing up. eBay, at this time, already had expanded into the European market. They were obviously ... they were founded in the US, so they had cornered that space. How were they thinking about the China market? What did they think the opportunity was there?

FELIX OBERHOLZER-GEE: They were extremely optimistic about the prospects of eBay in the China market. They had made a minority investment first, in a business that was built by two HBS graduates who started Taobao. Then eventually they took over the company. If you look at the China market, everything looks perfect. It looks like we have deep local knowledge because we have these two local founders who really understand the local market. We have 85% market share, which is decisive if you think about competition between different platforms. In public statements, Meg Whitman is just very optimistic. China is eBay's to lose. There isn't really competition in sight. One of the really interesting dynamics that we end up talking about in the classes, if the entrant goes after near customers, that's not something you easily see in your own data. You don't realize that someone else is catching up on you because that someone else is actually not exactly catering to the people you serve, to begin with. By the time you notice that someone else, Taobao, is actually so big that now the network effects tip what used to be this wonderful protection that eBay had, in that they had the biggest network effects, now turns against them because they're relatively small and Taobao has a greater customer size, has greater network effects. So, there's really two ideas that are at the center of the case. First is the idea that if I compete against someone with network effects, I need to find alternative ways to build willingness to pay over time. I need to do it in a cheap, variable cost matter. The second idea is, if I go after near customers, that's actually much more promising, much easier to do. In particular, it's not so concerning for my rival because you don't actually see in your data what is happening, possibly until it's too late.

BRIAN KENNY: How important is local knowledge to this case? In other words, Taobao, obviously they're from China, they understand the Chinese culture. They understand the buying habits of Chinese people. The case alludes to eBay going into Japan, and having a rough go of it. And I'm wondering what do they take away from that? Did they do anything differently when they went into China, or should they have?

FELIX OBERHOLZER-GEE: It's a beautiful example of strategic learning. I usually start the class by asking everyone, "What happened in Japan?" eBay, globally. So many markets, so successful. Then, all of a sudden, you strike out in Japan and that discussion builds two insights. The first one is this network effect story, so that everybody knows about the importance of network effects for these platforms. The second insight is really the insight around just how important local knowledge is. For instance, eBay was completely used to using credit cards. Japanese customers, cash on demand. The eBay model is essentially 'used products' model in the United States. Everything that's been sitting in your garage for a long time and you haven't had a chance to think about it. That's a prospect for a sale on eBay. In Japan, people were interested in new products. No one was interested in the second hand or rarity products. There is a particular amount of local knowledge that you need in order to be successful. What's really beautiful about eBay's strategy, is when you see ... They lose Japan, and then when you see what they do in China, they buy a local business, started by our alums that has 85% market share. That, of course, gives you this amazing confidence that there's really nothing that can go wrong. Because, now you have both of these things. You have network effects, and then you have local knowledge, and you should be just okay until you're not, because you have a rival that competes in very smart ways.

BRIAN KENNY: There were some pivotal decisions that the Taobao team made early on, as they were moving down this path and they set their sights on eBay. Can you describe what some of those important strategic calls that they made early on were, and how they impacted the trajectory of Taobao?

FELIX OBERHOLZER-GEE: One major decision was to organize the Tao website in the exact same manner that Chinese department stores are organized. The reason why this is important, is remember we're trying to cater to these near-customers that are nervous about buying online. If I go online and I look at the website and now, "Oh my God, I know how things are arranged here." This is exactly what the Chinese department store looks like. That's of course a big advantage. Then, really, one of the most important things that they did was the creation of Alipay. Alipay is essentially an escrow service. The seller of a product is not being paid until the recipient acknowledges that he or she has received a product. In a low trust environment where the internet was relatively novel, that played an enormous role. In the book, I call this a complement. A complement is a product or a service that increases willingness to pay for something else. That was really a key decision, that every company that has complements needs to very carefully think about, "Do you provide these complements just for your own product?" Then that means you have a leg up in the market relative to the competition, "Or do you provide it for the entire market?" In which case you help the market as a whole grow. Let me give you an example. Tesla superchargers, you have a choice. You could make these chargers so that they only charge Tesla cars, in which case Tesla has an advantage against all the other producers of electric vehicles. Or you could decide, "No, actually the big problem with electric vehicles is that we don't have enough charging stations period." So, you make it available to everyone. That really fuels the market as a whole. It does away with that relative advantage, but it fuels the market as a whole. In the case of Alipay, very smartly, and after a hot internal debate, Alibaba decided to make Alipay available to everyone. Then, from there, it grew its financial services business, which is probably now as valuable as the remaining e-commerce businesses that they've built over time.

BRIAN KENNY: That's amazing. It also makes me think of PayPal, which I think started as an eBay service, and has now being used across all these other platforms. Is that a fair comparison?

FELIX OBERHOLZER-GEE: That's right. When eBay purchases PayPal, the idea is exactly this idea of a complement. That's something that is an interesting decision to make. Do you want a complement to be in-house, or do you want the complement to be provided by someone who's a different entity, possibly by lots of different entities? Think of Apple. It used to be all the profits came from the hardware side. Now, all of a sudden, we see such a dramatic increase in the profits that come from the software side. That's the power of complements. You get to shift profit pools back and forth, essentially responding to competitive pressures. As long as you are way ahead in hardware, you make all your money on hardware. When that's a little less obvious, you start making money on services. You see the same within Amazon. You see the same within Alibaba group. This is now, literally, dozens of companies with dozens of opportunities to shift profit pools among these companies, in really interesting ways. That's maybe the third big lesson, other than network effects, near customers, is just the importance of these complements to make your company grow, and to put your company in a favorable competitive position in the market.

BRIAN KENNY: Those are great examples. I'm wondering in the book, you must provide some other examples of companies that have faced similar scenarios as Taobao was facing, these underdog firms. Are there any that you can share with us? We still want people to buy the book by the way.

FELIX OBERHOLZER-GEE: There's a really interesting example that involves Facebook. Facebook, obviously, building a small business first, which is a little counterintuitive. Social networks have these network effects. Why on earth would you restrict who can be on Facebook to begin with? In the beginning, it's literally only Harvard, then it's the Ivy League universities. Then they grow very slowly. The intuition here is that if you target a particular subset of the market where people highly-highly value being connected to one another, that can be as powerful. It can be as successful as being an average platform where you meet lots and lots of other average people. You value connections, but there's nothing particularly special. You see this in social networks, you see this in dating platforms. We have interesting differentiation strategies, depending on to what extent you cater to a niche, and to what extent you build one platform serves all kinds of businesses that then benefit from network effects. But the network effects are not super-super strong, because I don't highly value being connected to people in Norway, because I don't know anyone in Norway, as opposed to all, the platform is relatively small, but I value everyone else who happens to be on this platform. It's a counterintuitive way of building platforms, where the fact that you're small, the fact that you're niche, actually ends up being an advantage, at least in the early days of building the business.

BRIAN KENNY: Yeah. We've had several episodes of Cold Call where we've talked about platform companies. It's an increasingly important aspect of the landscape these days in business, or these marketplaces. Do you think, is it easier now for an underdog to penetrate a marketplace, to penetrate the big players in the space because of the internet and the asset light nature of businesses that are

marketplaces? Could you have done this with some of the more mature industries that are more asset-based?

FELIX OBERHOLZER-GEE: We used to be super optimistic that essentially any platform business will be winner take all. The entire Silicon valley enthusiasm for no profits but lots of growth, rested in good part on this notion that eventually you be completely dominant because these are all winner-take-all markets. Now, you see time after time after time. Well, winner take most, but probably not winner take all. The question is, “What is it about the platforms that gives them significant power, but makes them not be a clear winner that would then allow you to raise prices and create really great returns for the original investors?” There are a few things. Geography is one. If you’re Uber, you have to fight for every market individually. If you have lots of drivers in San Francisco, that doesn’t really help us in Boston because we’re not in San Francisco. There is that interesting differentiation place that we just talked about in the context of Taobao and the Facebook story. Then, there’s also something that I often describe as the implicit orientation of a platform. The best example that I can think of, is competition between Amazon and Etsy. When Etsy, the handmade, hand curated platform, when Amazon enters their space by creating Amazon handmade, people are super pessimistic about the likelihood that Etsy can survive. Why? Why all the network effects are on Amazon side. Now, of course, we know, oh my God, Etsy has done so incredibly well. What’s different about the two? Amazon in the end is always in the customer’s corner. Every contentious decision, every big decision that they make is really with amazing focus on customers. Etsy, much more focused on makers, much more focused on the producers on the platform. So, you get the type of differentiation that doesn’t really ... In many ways, they’re close substitutes, but it’s just enough differentiation that actually there’s room for both companies in the marketplace. So, that’s a third reason. I have a chapter in the book that is called Strategies for Underdogs, which essentially talks about all of these different ways that smaller platforms can survive. But the upshot is, of course, that investors’ expectations that may have been led by ... In a few years, this platform will be globally dominant or will be dominant at least in the North American or in the Chinese market. Those expectations are often disappointed now because people have become really smart, and they’re building small, powerful businesses that then limit the opportunities for the really large platforms.

BRIAN KENNY: This has been a super interesting conversation. I’ve got a couple more questions before we let you go. I want to go back to the Taobao case for a minute, because one of the central questions in the case has to do with the revenue model of which Jack Ma is quoted in the case, I think is saying, “We don’t have a revenue model.” I’m just wondering, I know there’s a B case about this. Can you talk a little bit about what they attempted to do and what the reaction was by the customer base?

FELIX OBERHOLZER-GEE: Often as a small platform, your fees, your price is zero. Because otherwise you don’t stand a chance to begin with. Then once eBay leaves, of course, there’s the question, how are you going to make money? That question is pretty important because, at that point in time, Alibaba is a publicly traded company in Hong Kong and Taobao is privately owned in China. So, you’re writing a check to a private entity which is never the easiest thing to do. It easily raises a shareholder suspicions about what’s going on. Their first idea is to auction off spots on the

website. A little similar to the classic Google model with one twist. If you click but don't buy, then you don't have to pay the fee. It's a classic auction, but you don't owe Taobao anything, unless you actually get a benefit as the seller, which was an interesting model to think about. When they introduced it, as always on the internet, once you raise prices, it was enormous backlash. But what was interesting about the response, was that about 40% of the market or so, they actually liked that kind of a model. When they dug a little deeper and looked at the motivations for people to favor, or disfavor, this new monetization scheme, they saw that there's a substantial portion of the market that believes, maybe rightly so, maybe not, we don't actually know, that the companies that bid high on these auctions, they have higher prices and they have higher quality products. Taobao seized on the data, seized on this insight, and created what's now called The Mall, the TMall, which is essentially just Taobao at higher prices with better quality, and then an easy monetization model that essentially monetizes the sellers on the market side. That then was really, financially speaking, the big breakthrough that made the company really successful and really valuable. It was smart interpretation of the data that they got back that then helped them figure out what's a really promising monetization model, given the peculiar circumstances in the Chinese market at that point in time.

BRIAN KENNY: Just bolsters the argument that we continue to hear about data analytics and how important they are, how important it is to understand the numbers that you're looking at, and how they inform decisions that you can make.

FELIX OBERHOLZER-GEE: Asking your customers about important strategic decisions, which is not that common. We typically think, AB testing some small element on the website, yes, of course we'll easily follow customers. But making big decisions about, "How do you monetize? What does your strategy look like?" It's much less common to really, truly directly take customer feedback the way Taobao had done this, but which turned out to be, in this particular case, really-really successful.

BRIAN KENNY: Felix, we have time for one more question with you and what I'd like to know is, as people hear you talk about this case, what's one thing you'd like people to take away from the case? What's the big lesson here?

FELIX OBERHOLZER-GEE: There's all the tools, obviously. There's understanding, willingness to pay, understanding network effects, understanding near customers. But there's also an interesting moment in the case conversation. Students, essentially, make the argument that eBay loses the Chinese market because they don't understand the Chinese customer. Taobao, it's more local. They have all the insights and it's not surprising that they win. Then we look a little more closely in the case and we see an early landing page for Taobao. And the landing page looks nothing like a landing page in China needs to look at to be appealing to customers. One of the things that we talk about in the class, is that you often have these priors, these insights that you think, "Yes, the local company knows better, or the foreign company is at a disadvantage because it's not quite as close to customers, or because it has to coordinate activities with headquarters in San Francisco." Then before you know it, once you have a strong prior, you just exclude all the information that is inconsistent with what you believe. That's a really nice experiential moment. Of course, we all know confirmation bias is prevalent, and you can give a lecture on confirmation bias and students will nod, it's not going to change anything, I don't

think. But if you can create an experience in the classroom where you can show everybody ... Sometimes it's interesting. Even once some students see that they suffer from confirmation bias and they interpret the data correctly, many others will not follow. The confirmation bias in this case is so strong, that even in the face of being taught, what the data tell you is not so easy for you to see how you were biased by the priors that you had to begin with. I think definitely one of the things that sometimes students talk about later on sometimes, many years after graduation, when they arrive back and they give me examples about their experiences in the business world, that's a moment that many people will refer to because, I guess, it's really close to home.

BRIAN KENNY: Yeah. Very interesting. I'm sure any listener out there who is thinking about starting up their own marketplace or platform now has some great insights for what to look at. Felix, thank you so much for joining us today. Really enjoyed it.

FELIX OBERHOLZER-GEE: It was my pleasure to be here. Thank you for the invitation, Brian.

HANNAH BATES: That was Harvard Business School professor Felix Oberholzer-Gee – in conversation with Brian Kenny on *Cold Call*. If you liked this episode and want to hear more of Harvard Business School's legendary case studies in podcast form – search for *Cold Call* wherever you get your podcasts. We'll be back next Wednesday with another hand-picked conversation about business strategy from the Harvard Business Review. If you found this episode helpful, share it with your friends and colleagues, and follow our show on Apple Podcasts, Spotify, or wherever you get your podcasts. While you're there, be sure to leave us a review. If you're looking for another weekly dose of hand-curated business and management expertise, check out *HBR On Leadership* to help you unlock the best in those around you. We're a production of the Harvard Business Review – if you want more articles, case studies, books, and videos like this, be sure to subscribe to HBR at [HBR.org](https://hbr.org). This episode was created and produced by Anne Saini, Ian Fox, and me, Hannah Bates. Special thanks to Maureen Hoch, Adi Ignatius, Karen Player, Ramsey Khabbaz, Nicole Smith, Anne Bartholomew, and you – our listener.