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INTRODUCTION

The Internet and electronic commerce are said to support new organizational structures for firms and their value networks.[1] In the process they are said to be altering the competitive dynamics of entire industries. If these claims are true, we would expect evidence of such organizational changes to show up first in industries that are early adopters of these technologies.

One of the leaders in adopting e-commerce and the Internet has been the computer industry, which is using them for distribution, coordination with suppliers and customers, and revamping internal functions. Gateway, Inc. is an interesting case, as it has been implementing new strategies for e-commerce and developing Internet-based products and services at the same time as it has gone through a major strategic and organizational transition. Gateway is using the Internet as a key tool to support its transformation from a highly focused consumer PC vendor to a more diversified seller of hardware, software and services to both consumer and business markets. It also is using information technology and the Internet to support the creation of a new organization form—the value web—in which it coordinates a network of business partners to reach new markets and offer a broad array of products and services.

Company background

Gateway was founded by Ted Waitt on a South Dakota farm in 1985. Waitt used his grandmother's certificate of deposit as collateral to borrow $10,000 and start what was then called the TIPC Network. Waitt and his partner Mike Hammond sold PC parts over the phone, directly to consumers. Within two years, they offered their first complete computer system and targeted knowledgeable buyers. By eliminating resellers, Gateway was able to offer these buyers a full-featured system for around the same price as competitors' stripped-down systems. Sales took off. The following year they changed the name of the company to Gateway 2000.

Gateway distinguished itself with its down-home advertising campaigns that played up its Midwestern roots (right down to the cow-spotted PC boxes), and by providing personal service to the consumer from the time of sale through the many phone calls that consumers often needed to get their PCs set up and running. Gateway's only sales channel was the telephone, as it eschewed developing a corporate sales force or using retail outlets and other resellers.

This business model was simple in concept, and was supported by a simple organizational structure. Gateway was a link in a linear supply chain, buying components from suppliers and assembling them for sale to the final customer. This model was lean and efficient, and provided

[1] See Malone, 1987; Powell, 1990; Wigand 1997

steady profitable growth. Sales surpassed $1 billion by 1992 and $5 billion by 1996. In 1999, Gateway joined the Fortune 250, with more than $8.6 billion in sales and 21,000 employees. On a unit-basis Gateway is now the third largest PC manufacturer in the U.S. and the sixth largest in the world.

However, by 1997, the PC market was changing dramatically, with prices falling, and companies such as Apple, Packard-Bell and AST drowning in red ink. Gateway saw its profits shrink by over 50% in 1997, and founder Ted Waitt decided that he had to make drastic changes if his company was to survive. Since then, Gateway has gone through a major reorganization and implemented a number of new strategies to accelerate growth through diversification.

In 1998, with the millennium approaching, Gateway dropped the "2000" from its name, and surprised many inside and outside the company by moving its corporate headquarters to San Diego, California. At the same time, Gateway announced a major executive talent search which filled 10 of the top 15 spots within the organization, including the President, Chief Operating Officer, Chief Information Officer, Chief Accounting Officer, Chief Financial Officer, and Chief Technology Officer. In late 1999, Ted Waitt relinquished the title of CEO to Jeff Weitzen, while staying on as chairman.

Since early 1999, Gateway has announced a flurry of alliances with the likes of GE Capital, NECX, Sun Microsystems, Office Max, eSoft, and Verio. Most important is a wide-ranging relationship with AOL that includes product development, cross-selling of products and Internet services, and an $800 million investment by AOL in Gateway.

To implement its new strategies, Gateway is employing the Internet as a sales channel, as a platform for offering new services, and as a tool for integrating its value network (customers, suppliers, business partners). In its own version of a “bricks and clicks” strategy, Gateway also has opened hundreds of Gateway Country Stores, which offer a physical world location for customers who want to see and touch a product, talk to a sales person, or learn to use a new application. The Gateway@work web site and Country stores also offer various services to small business customers. In 1999, Gateway also became the first PC maker to offer Internet service to consumers, featuring its Gateway.net service on new PCs.

Gateway’s goal is close integration of its three major channels (Internet, stores, telephone sales), so that customers can move from one channel to another, and information gathered via any channel would be available any time the customer comes into contact with Gateway. This integration of information would be available from the first time a customer calls, comes into a store, or registers on the web site, through purchasing, technical support, services, and future marketing efforts.

As of mid-2000, Gateway had made major strides in expanding its consumer market reach through new channels and alliances, and had surpassed its initial goals for non-PC revenues. It also had managed a major organizational revamping while sustaining revenue and profit growth. On the other hand, its efforts to better integrate its distribution channels was lagging, its business division was struggling with declining sales, and integration between the consumer and business divisions was very limited. As it moves forward, Gateway must continue to use the Internet to reach out to consumers and business customers in new ways, while catching up on the process of internal integration and coordination of its value network through IT and electronic commerce.

Competitors

Gateway's major competitors in the U.S. are Dell, Compaq, IBM, Hewlett-Packard, Apple, Micron and eMachines. Given Gateway's emphasis on the consumer and small business markets, it competes most directly with Compaq, HP, Apple, Micron, and more recently, eMachines. Among other vendors, Dell has begun to target the consumer more aggressively, while IBM has pulled back from the retail consumer market to focus on Internet sales. All of the major PC makers are trying to reach the small and medium-sized business (SMB) market, but they face strong competition from the "white box" market of PC clones built by resellers.

Outside the U.S., Gateway is active in a limited number of markets, such as Japan, Australia, several Asia-Pacific countries, and parts of Europe. In those countries it faces the major U.S. vendors such as IBM, HP, Compaq and Dell, as well as local brands (e.g. Fujitsu and NEC in Japan), and the white box makers who have a large market share in many countries.

Gateway's new strategy of offering services such as Internet service, training, financing and small business services puts in competition with a different set of companies such as ISPs, trade schools, finance companies, and small and large consultancies. Its entry into the information appliances market could match it up with makers of consumer electronics, set-top boxes, cellular phones, and whatever other devices are developed in this emerging market. In each case, Gateway will face an entirely different set of competitors than the PC companies it is accustomed to battling.

BUSINESS STRATEGY

For the first decade of its existence, Gateway had a very simple strategy: direct sales of PCs built to customers' orders. Gateway's target market was the experienced PC consumer, and its sales and distribution channel was the telephone. It assembled PCs at its own plants as orders were received, and shipped them directly to the customer. This business model had the virtue of simplicity, and it also offered important advantages over the indirect sales model that was predominant in the PC industry.

A key advantage of direct sales is that expensive inventory does not build up in the channel and lose value before it can be sold, and new products can be introduced without having to clear out old inventory in the channel. Also the PC vendor has a direct relationship with the end customer, unlike indirect vendors whose channel partners generally refuse to reveal even who that customer is. Finally, customers often pay for the final product before the vendor pays suppliers for the parts that go into the PC, so that direct vendors Dell and Gateway both operate on a negative cash conversion cycle.

Another major benefit of the direct relationship is the ability to collect information about customer preferences and concerns. Gateway stresses to its employees that its direct customer contacts (estimated at 300,000 per day in 1999) represent a chance to influence the consumer's purchase decision and enhance the company's image. It also presents an opportunity to gather information on customer preferences, which is especially important in the consumer market where PCs are purchased one by one and tastes can be unpredictable.

Selling direct was slow to take hold in the consumer PC market, as consumers were accustomed to looking at products in a store, talking to sales people, and taking home the products they selected. Gateway's direct approach gained acceptance partly by virtue of consumers gaining more experience and confidence in selecting PCs. Many buyers now prefer to configure a PC to meet their own needs, rather than choose among the models carried at a retail outlet. Here, Gateway's build-to-order production system gives it a big advantage over competitors, as it could offer the customer a much wider variety of configurations than a retail outlet could possibly carry.

Gateway also took a number of steps to make consumers more comfortable with the direct sales process. First, it launched a highly successful advertising campaign showing workers at its South Dakota plants "building a Gateway for you." Gateway's folksy image and distinctive boxes with black and white Holstein cow patterns gave it a strong positive brand awareness among consumers.

Second, Gateway placed a high value on customer service. Gateway's sales people helped inexperienced users select models and configurations to meet their needs and give them confidence to buy a PC over the phone. Technical support people worked with customers for as long as it took to solve their problems. This direct interaction with customers has helped Gateway avoid the high rates of product returns that have devastated other companies in the consumer PC market, where return rates often top 20%. By contrast, Gateway's return rates are around 1%.[2] By holding the client's hand from sale through technical support, Gateway could help prevent the frustrations that can lead inexperienced users to throw up their hands and return a balky PC for a refund.

As a result of its strong service orientation Gateway has always ranked at or near the top in user ratings for service and support, and has built loyalty among its clientele. The company estimates that 60% of its sales are to repeat buyers or people referred by existing customers.[3] In a poll conducted by Harris Interactive Inc., Gateway ranked sixth among 40 high-tech companies in overall corporate reputation, and was in the top ten for products and services, emotional appeal and social responsibility.[4]

While this strategy had important benefits, it also had weaknesses. For one, it limited Gateway's market reach to a specific market segment (consumers willing to purchase by phone) and expanding that segment required costly marketing and advertising. Also, Gateway's consumer focus left it out of the corporate market, which buys more profitable servers and notebooks,

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[2] Gateway estimates that its cost of permanent returns is $38 million, plus another $8 million for replacing faulty systems. This total of $46 million is considered a serious problem, but is still less than 1% of sales, a low level compared to other consumer PC vendors. Source: *Connecting*, March 2000 (Gateway in-house newsletter).
[3] Gateway 10-K for fiscal year ending December 31, 1999.
[4] Ronald Alsop, "The Best Reputations in High Tech," *The Wall Street Journal*, 11/18/1999: B1.

while Gateway relied mainly on desktop sales. Most ominously, falling PC prices threatened the profitability of a revenue model built on pure hardware sales.

Gateway's new business model

Gateway sums up its new business vision as becoming a "trusted provider of integrated solutions." CEO Weitzen admits the phrase "sounds kind of trite," especially the overused "solutions" term,[5] but it does emphasize Gateway's function as an integrator of hardware, software and services, rather than simply a hardware manufacturer.

Gateway began the transition to this new business model around 1996, and then moved dramatically in 1998. It has attempted to build on its fundamental strengths in manufacturing, customer service and brand recognition while extending its reach to a larger customer base and offering new products and services. These strategies can be grouped broadly into four major categories: (1) Expanding market reach, by developing new marketing and distribution channels (2) targeting business customers; and (3) development of new revenue sources, through the so-called "beyond-the-box" strategy aimed at selling non-PC products and services; (4) creation of a business ecology through alliances, acquisitions and partnerships.

Expanding market reach

The first major move to expand the company's market reach was the introduction of the Gateway Country Stores in 1996. The stores reach out to consumers who are uneasy buying a PC without actually seeing it, or who want to deal with a sales rep in person rather than on the phone. There was skepticism from some analysts when the Country Stores were announced, as it seemed to be moving Gateway away from its lean, low-cost business model by investing in higher overhead retail operations. This is probably true, but the company argues that the stores have been profitable and the expanded market reach justifies the cost.

Other market expansion initiatives involve partnerships. In early 2000, Gateway announced a deal with Office Max to install a Gateway "store-within-a-store" in 1,000 Office Max locations in the U.S. These stores will be run by Gateway personnel, much like the Country Stores, allowing Gateway to expand its reach while retaining control of the customer relationship.

In April 2000, Gateway announced an agreement with Rent-Way in which Rent-Way will offer Gateway computers, complete with Internet access exclusively to customers on a weekly rental basis. In addition, Rent-Way will integrate Gateway computers and services throughout its network of 1,100 stores across the country, and is subsidizing Gateway computers for its 1,100 managers and 150 regional managers.[6] The same month, Gateway made an investment in Quepasa.com, an Internet portal that serves the Hispanic community in the U.S.

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[5] Michael Kanellos,"Gateway chief looks beyond the desktop," CNET News.com, May 30, 2000

[6] "Gateway Extends Brand Reach Through Strategic Alliance With Rent-Way Rent-Way, the Nation's Second Largest Operator of Rental Purchase Stores, Will Offer Gateway Computers, Internet Access and Accessories in 1,100 Stores Across the Nation," Gateway press release, April 21, 2000.

Gateway is now trying to exploit a new trend toward employee PC programs, whereby companies provide PCs and Internet access for employees' home use. Gateway landed a deal with Avon to provide PCs and services to Avon's 500,000 sales representatives. Avon representatives will receive 800-number help desk support and can participate in training courses and receive personalized service at Gateway Country Stores throughout the U.S.[7] Soon afterwards, Gateway entered a formal arrangement with Consumer Financial Network (CFN), a provider of employee services, to jointly market PCs, Internet access, financing, training and other products and services for corporate employee PC programs. Gateway also announced a $150 million investment in CFN, a subsidiary of Web consulting firm iXL.[8]

Selling PCs through employee benefit programs is an interesting strategy, especially for Gateway. A hybrid between corporate and consumer sales, they allow Gateway to sell thousands of units at a time without the heavy marketing expenses that would be required to reach so many consumers individually.[9] They may also give Gateway an entree into corporate accounts that would otherwise be difficult to penetrate.

Targeting the business market

By 1996, Gateway found that it was making around $1 billion in revenues from business and government customers even though it had made little effort to sell in those markets (cite IDC report). A significant share of these sales came from small businesses who liked the company's product quality and customer service orientation. In addition, it was selling PCs in small lots to larger corporations, as well as government and educational institutions, although it lacked a full line of products and support for those customers. So Gateway decided to develop strategies and capabilities to go after the business market in a more coordinated manner.

In its first major move, Gateway purchased Advanced Logic Research Inc. (ALR), in June 1997 for $194 million. This gave Gateway a more complete product line for business customers, including high margin servers. It then set up a separate business division in ALR's Irvine, California location (since moved to nearby Lake Forest) with profit and loss responsibilities in the U.S. market. This provided the organizational structure to develop and implement strategies for the business market.

In order to reach the business market without creating a large in-house sales force, Gateway has developed partnerships with Sun, GE Capital IT Solutions, and Unisys to sell and support Gateway products. It also has developed a network of about 1000 resellers, most of whom serve the small business market. The Gateway Partners Program was established in April 1998 to institute long-term, strategic relationships with value-added resellers (VARs). The program seeks to develop partnerships with small and medium-sized resellers who focus on value-added services rather than carrying hardware inventory (IDC, 1998).

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[7] "Avon Announces Agreement to Provide Internet Access to Sales Representatives," Avon press release, April 18, 2000.
[8] "Gateway and CFN Announce Joint Effort to Help Companies Bring Workers Online," Gateway press release, May 25, 2000.
[9] Melanie Austria Farmer, "Gateway, iXL venture eyes employee PC programs," CNET News.com, May 25, 2000

Attempting to increase its sales to larger corporations, government and education, Gateway launched the Major Accounts Program in April 1997 to sell products and provides services to major accounts. At the end of 1998, the Major Accounts Program had 75 sales and on-site technical employees for the government and education division.

The business division has been most successful in the government and education markets, where it has seen double digit growth since its inception. It has been less successful in the large corporate market, where major accounts are locked up by IBM, Compaq, Hewlett-Packard and Dell, all of which have more resources, fuller product lines and more experience serving the corporate market. As a result, Gateway has emphasized the small and medium-sized businesses (SMB) in its more recent initiatives.

Gateway's SMB strategies target companies with three to one hundred employees, not including home offices which are under the consumer division. To serve SMBs, Gateway is using all three of its channels—phone, Country Stores and the Internet—and some direct sales people. There are telephone sales representatives who specialize in serving small businesses. Also, many of the Country Stores have Business Solution Centers, and one-third are staffed by Internal Business Account Representatives (IBARs). Also, to better serve SMBs, Gateway plans for each store to have a network specialist, many of which will be third party partners. As for the Internet, the business division is developing a major e-commerce strategy to serve SMBs, as will be detailed below.

Gateway's business sales in the U.S. totaled \$3.2 billion in 1999, up from \$3.07 billion in 1998.[10] The company expects business revenues to reach \$4 billion in 2000. However, in the first quarter of 2000, business division sales actually declined 19% from the previous year.[11] Gateway admits that service and support operations for the business division are not as fleshed out as in the consumer division yet, but it is developing programs to improve the situation.

Diversification of revenues: "Beyond the box"

The third major strategy has been to diversify Gateway's product and service line to capture revenues from non-PC products and services. These include peripherals and software, financing, Internet access, training, and small business services.

Gateway moved in this direction when it introduced its Your:)Ware program in 1998, bundling hardware, software, financing and Internet access under one monthly payment. Your:)Ware allows customers to trade-in their PCs after two years for credit toward a new system, helping alleviate concerns about the rapid obsolescence of new PCs.

The diversification strategy moved into high gear in 1999, when Gateway announced its "beyond the box" strategy and set a goal of having 30% of net income come from non-PC sales by the end of 2000,[12] then revised that target to 40%.[13] The company has developed what it calls its

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[10] Gateway Inc. Form 10-K for the fiscal year ended December 31, 1999.
[11] "Gateway Posts Record First Quarter Earnings" Gateway press release, April 13, 2000.
[12] New Home. New Ceo. Gateway Is Moo And Improved
David Kirkpatrick

"hexagon strategy" which identifies six revenue streams: (1) systems, (2) software and peripherals, (3) service and training, (4) Internet access, (5) portals and content, and (6) financing. Beyond the box revenue accounted for approximately 13% of net sales and 25% of income in the first quarter of 2000.[14]

In order to sell a wide variety of add-on peripherals and software online, Gateway partnered with online merchant NECX in 1999, and eventually acquired the company in 2000. Also in 1999, Gateway set up its own Internet Service Provider, Gateway.net, and signed up over 1 million subscribers by the end of 1999. This meant that nearly a quarter of Gateway's PC buyers chose Gateway.net as their ISP. In October, 1999, the company launched consumer PC training, a business projected to contribute more than $150 million in revenue in 2000.[15] More than 20,000 Gateway clients per week already purchase training through one of the company's three training methods, either instructor-led at the Country Stores, on-line via the Internet, or on CD-ROM.[16]

Another example of the "beyond-the-box" products and services Gateway is version 2.0 of Your:)Ware, which includes packages of hardware, software and training that allow customers to use their Gateway PCs for applications such as digital photography, music recording, and financial analysis. Each of the packages includes peripherals such as a digital camera, scanner, or CD recorder, along with related software and training courses.[17]

Creating a business ecology

Gateway realized that it lacked the resources to execute its new business model and strategies entirely on its own. Therefore, it has been creating a business ecology via alliances with partners who have complementary capabilities. These alliances discussed in the context of strategy, organization or e-commerce throughout the paper, and are summarized here in Table 1. In most of these cases, Gateway maintains control over the customer relationship, or shares that relationship with its partner. In some cases, there is collaboration with a business partner to develop new products, services or distribution channels, while in other cases, Gateway simply contracts with an outside company to provide a specific service to its customers.

12/20/1999, Fortune Magazine, Page 44

[13] 4Q results press release.

[14] Gateway 10Q for quarter ending March 31, 2000.

[15] Gary McWilliams, "Gateway to Sell Training Gear For PC Music and Finance Photos," The Wall Street Journal**,** 4/3/2000, Page B14

[16] "Gateway Launches Your:)WareSM 2.0: Innovative Solution Bundles That Teach Consumers How To Get More From The Internet, Digital Photography, Music and Personal Finance Software," Gateway press release, April 3, 2000

[17] "Gateway Launches Your:)WareSM 2.0: Innovative Solution Bundles That Teach Consumers How To Get More From The Internet, Digital Photography, Music and Personal Finance Software," Gateway press release, April 3, 2000

Table 1. Gateway's business alliances

Partner (date of announcement)	Nature of partnership
Unisys (1997)	Unisys provides integration and support services to Gateway business customers
GECITS (1999)	GECITS resells Gateway hardware and provides integration, support and maintenance to business customers
NECX (1999, Gateway acquired NECX in 2000)	NECX runs the Gateway Accessory Store. Since acquisition, NECX CEO runs Gateway's consumer e-commerce business
America Online (1999)	Sharing of Gateway customers' ISP business, AOL operates Gateway.net and provides content, cross-marketing of products and services, joint development of Internet appliances, AOL invested $800 million in Gateway.
British Telecom (1999)	Developing and marketing wireless Internet devices
Office Max (1999)	Gateway "store within a store" to be set up in 1000 Office Max outlets, cross-marketing of products and services
Sun (2000)	Sun offers Gateway PCs to its corporate clients, Gateway markets Sun hardware to its clients.
eSoft (2000)	Joint effort to provide Internet hardware and software to small businesses
Rent-Way (2000)	Rent-Way leases Gateway PCs on short-term rentals
Verio (2000)	Verio provides web hosting services for Gateway small business clients
CFN/iXL (2000)	Joint effort to pursue corporate employee benefit PC opportunities

The most important alliance clearly is with AOL, involving an $800 million investment in Gateway by AOL, cross-marketing of products and services, moving Gateway.net to AOL's infrastructure, and development of new hardware devices. There was a close fit between the two companies, each of which is a leader in a different aspect of the consumer IT market. In the words of Jeff Weitzen:

"One of the principal things that drove our relationship with AOL to begin with was that we had a very common vision of where the world was going and neither of us had the ability to deliver on our own...(W)e were either going to strike up a partnership with them or we were going to wind up competing with them. What was clear was that AOL had the communications and the content capabilities, but they didn't have device capability. At the same time, they saw that they had to have a partnership with someone that was going to be able to network devices together."[18]

Most intriguing could be a joint effort to develop three new Internet appliances for the home market, to be delivered in late 2000. The strategy behind these devices is to create a revenue stream through services offered for a specific environment. For example, the first device will go in the kitchen, and may offer recipes supplemented by streaming video of a demonstration on how to prepare a dish. Partners such as an online grocer might offer delivery of ingredients or other related services.

The other initial products are a portable wireless web pad, and a low-cost desktop device similar to the kitchen pad. Gateway and AOL see the development of these products and services as a market development effort and a chance to learn what capabilities consumers might desire in the "wired home" of the future. The fact that the devices will use the Linux operating system and

[18] Michael Kanellos, "Gateway chief looks beyond the desktop," CNET News.com, May 30, 2000.

microprocessors from startup Transmeta also moves Gateway out of the Wintel PC architecture and takes at least a step toward the "post PC" world.

Some of Gateway's other alliances are attempts to reach new markets, either by segment (such as the Sun and GECITS partnerships for the business market or CFN for employee programs) or geography (Office Max), or demographic (Quepasa.com). Others involve offering new services, such as Verio for Internet hosting and eSoft for network services (Table 2).

Table 2. Comparison of Gateway's old and new business models

	Old business model	**New business model**
Vision	Direct seller of build-to-order PCs	Trusted provider of integrated solutions
Customers/market segmentation	Consumers	Consumers plus business (Large, SMEs, government, education)
Products	Desktop and notebook PCs	PCs, servers, Internet appliances, PDA, cell phones
Services	Technical support	Technical support, Internet access, training, financing, web hosting
Revenue model	One time revenues from PCs and peripherals	Recurring revenues from PC sales and upgrades, plus non-PC products and services
Channels	Separate channels—phone, Country Stores, Internet	Integrated Gateway channels, plus partners (Office Max, AOL, resellers)
Internet, E-commerce	Internet as another channel	Internet and E-commerce as complement to other channels and as a platform to integrate the firm's value network (suppliers, customers, business partners)
Business ecology	Intel, Microsoft, component suppliers	Intel, Microsoft, AMD, Transmeta, AOL, Sun, NECX, GECITS, Office Max, eSoft, Verio, CFN

ORGANIZATION OF BUSINESS ACTIVITIES

Gateway is organized into four business units with profit and loss responsibilities. These are:

- Gateway Home—Consumer market in the Americas
- Gateway Business—Business market in the Americas
- Europe/Middle East/Africa (EMEA)
- Asia-Pacific (APAC)

Within the U.S., the consumer and business divisions share resources, particularly call centers, IT infrastructure, and the Country Stores, but each pursues independent product, sales and marketing strategies. The European and Asia-Pacific operations follow broad corporate strategies, offer roughly the same products lines as the U.S., and share some resources, but otherwise operate quite independently. In the words of one Gateway executive, Gateway is "an international company, but not a global one," meaning that the company operates internationally, but does not coordinate most activities globally.

To discuss Gateway's business organization, we look at how the basic functions of product development, component sourcing, manufacturing, marketing and distribution, and service and support are provided, distinguishing the operations of the four formal business units.

Product development

Gateway offers different product lines tailored to different market segments. Performance, Select, Profile, Astro and Essential desktops are sold primarily to the consumer market. GP, Select SB and E-series desktops, E-Series workstations, and Gateway (formerly ALR) servers are sold to the business, government and education markets. There is also the Solo line of portables, with models for each market, and the Destination PC/TV. The same product series are offered in international markets, with necessary adaptations made for power supplies, software languages, keyboards and other national differences.

Gateway's ability to produce and support its products is complicated by the large number of models and configurations the company offers to satisfy its heterogenous consumer market. At one time, there were 7 million possible configurations for all of Gateway's products, although Gateway is trying to reduce the complexity of its product line now. While Dell offers two basic desktop lines, two notebook lines and a server line, Gateway's product line at one point in 1999 offered "42 system boards, 76 hard drives, 32 video cards, 27 processors, 83,000 parts and...7 million possible unique systems."[19] In order to implement its Six Sigma quality program, Gateway plans to reduce the complexity of its product line.

Gateway's expenditures on research, development and engineering in each of the last three years were less than 1% of net sales. Gateway works with components suppliers to incorporate new technologies into its product, and focuses on process engineering and designing products for ease of manufacture. More recently it has put more emphasis on product design, both to improve the styling of its PCs and to develop non-PC devices.

Sourcing

Gateway relies on contract manufacturer Solectron to assemble motherboards, and purchases other components from suppliers such as Intel, AMD, Creative Technology, ATI, Seagate, Maxtor, and various Taiwanese, Korean and Japanese components manufacturers. To support Gateway's build-to-order processes, many suppliers warehouse their components in caged areas within Gateway's plants, known as Centers for Production Replenishment (CPRs), or supplier hubs. These areas are run by third party companies, who maintain ownership of the components until they are pulled for use, meaning that Gateway does not have to carry inventory on its books.

The use of CPRs not only lowers Gateway's inventory costs, it also relieves the company of a function that is not a key to its competitiveness. This practice is common among PC vendors, who are moving to outsource many non-core functions.

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[19] "Six Sigma: the whys, whats, whos, hows—and some early wins," *Connecting* (Gateway in-house newsletter), Vol. 2, No. 2, March 2000, p. 2-3.

Manufacturing

In the United States, Gateway manufactures desktop PCs for both the consumer and business markets in North Sioux City, South Dakota, Hampton, Virginia, and Salt Lake City, Utah. PC servers are manufactured for business customers in Lake Forest, California. For notebook PCs, a Taiwanese supplier, Quanta, produces the base units, and final configuration is done in Salt Lake City. Third-party suppliers manufacture the configuration for the Gateway Profile and Astro desktop PCs, with little or no final configuration needed from Gateway.

Internationally, a plant in Dublin, Ireland, makes PCs and servers and does final notebook configuration for the European market, while a Malacca, Malaysia, plant performs the same functions for the Asia/Pacific region. Gateway also is beginning production in Brazil through its investment in local PC maker Vitech.

While Gateway is more of an assembler than a manufacturer (e.g., it does not do any board production in-house), its build- and configure-to-order capabilities are a key competitive capability. With fifteen years of experience in BTO/CTO production, Gateway is able to turn around an incoming order in four to seven days, a figure comparable to Dell. This is despite the fact that most of its orders come in one at a time from individual consumers, rather than in the larger lots that Dell's BTO process usually handles.

The production process makes heavy use of information technology. The JD Edwards order management system releases an order to the factory floor, and it is then fed into custom-developed manufacturing and status tracking systems. Each component is bar coded and scanned as it is released to the floor, and again as it is installed into a PC. This ensures that each order has the right components, and allows quality problems to be traced to a particular assembly team or component supplier. When assembly is completed, the JD Edwards system is notified, and the appropriate updates are made to inventory, billing, and accounting records.

Distribution

Gateway utilizes three main sales channels for the consumer market: telephone sales, online sales, and company-owned stores. These are referred to as "call, click or come in." It argues that these channels are complementary, as over half of its customers use at least two of the channels. For instance, a customer might go to a store and look at different models, then go home and configure and order a PC online or by telephone.

The company employs 3900 telephone sales personnel taking orders from consumers and business customers.[20] It boasts of more than 300,000 customer contacts per day — via web, store or phone. 50,000 contacts per day are via phone or store and therefore involve direct interaction with Gateway employees, who have the opportunity to enhance Gateway's reputation with customers and learn about their preferences.

Gateway added 38 Country Store locations during the first quarter of 2000, bringing the total to 318 locations worldwide. There were 260 locations in the United States, 27 in Europe, and 31 in

[20] Gateway 10-K for fiscal year ending December 31, 1999.

the Asia-Pacific region. Gateway plans to add another 60 or more Gateway Country Stores worldwide in the second quarter of 2000. In addition, Gateway has another 197 Gateway store-within-a-store outlets within Europe and 48 in the Asia-Pacific region. Gateway also had opened 35 stores within OfficeMax locations in the United States at the end of March, 2000, giving it a total of 575 retail locations worldwide.[21] The company estimates by the end of 2000, 80% of the U.S. population will be within driving distance of a Country Store[22].

The Country Stores now account for nearly half of Gateway's revenues (Table 3), and have given Gateway a means for attracting a new class of customer, particularly first-time buyers who may be uncomfortable buying on the phone or online. Gateway also is using the Country Stores to offer new services such as training classes an small business services.

Gateway's third major distribution channel is the Internet, which will be discussed below in detail. Gateway began selling online in 1996, and pure online transactions now account for nearly 10% of sales. A much larger number of customers use the web to gather information and try out different configurations before calling in or visiting a store to make a purchase.

In addition to the three main channels, Gateway sells to the business market through about 900 resellers, which account for 5-7% of sales. It also has a direct sales force who sell to large corporate and public sector customers, although actual orders are usually placed through internal phone sales agents.

Table 3. Breakdown of sales by channel

Country Stores	45%
Telephone sales	40%
Internet	10%
VARs	5%

Source: Estimated from company interviews and analyst reports

Service and support

Providing technical support is critical to Gateway's success, particularly in the consumer market where customers often run into problems getting a PC to work. Gateway employs over 6,600 customer and technical support representatives providing comprehensive service and support, equal to nearly a third of Gateway's 21,000 total employees.[23] While this support level is costly, it has helped Gateway maintain very high customer satisfaction ratings, which is a key to its success in getting repeat business and word-of-mouth referrals.

In order to reduce the need for costly technical support personnel, and to make it easier to resolve problems that come up, Gateway now loads "Go Back" software on its PCs, allowing the user to return the computer to its configuration before a problem occurred. Gateway also offers online support at its web site to help users solve more common problems, and download fixes such as software patches.

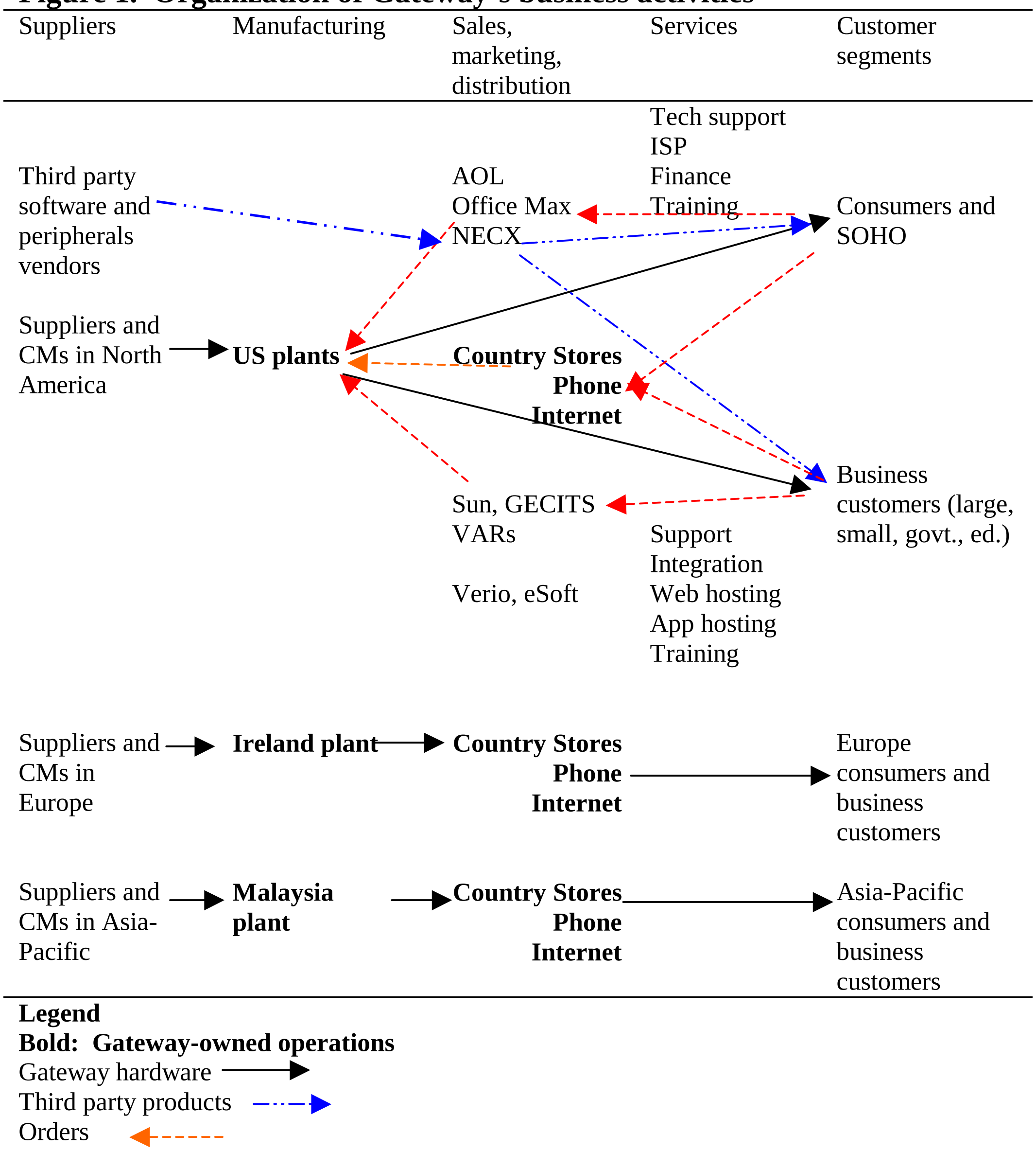
[21] "Gateway Posts Record First Quarter Earnings" Gateway press release, April 13, 2000.
[22] David Kirkpatrick, "New Home. New CEO. Gateway Is Moo And Improved, Fortune Magazine, 12/20/1999, Page 44.
[23] Gateway 10-K for year ending December 31, 1999.

Summary

Figure 1 shows graphically how Gateway's business activities are organized for the four major customer segments. Notice that the U.S. consumer and business segments share manufacturing and distribution channels, although they offer different products and services for each market. This shows that there is some leverage of Gateway's investments in stores, call centers, and IT. However, integration among the channels is limited, and there is still a lack of coordination between business and consumer divisions, in spite of the overlap in areas such as employee PC programs.

As noted before, Asia-Pacific and Europe operate quite independently, sharing product lines but operating separate manufacturing and distribution networks.

Figure 1. Organization of Gateway's business activities



THE INTERNET AND E-COMMERCE

Gateway started selling online in the spring of 1997, but only started developing an e-commerce organization and strategy around 1999. It now uses the www.gateway.com web site to provide product information, to sell PCs and associated third-party products online, to provide customer service and support, and to offer "beyond the box" services such as training. The site points business customers to www.gatewayatwork.com which sells business products online and has services for small business customers. There is also an extranet, eSource, which offers special capabilities for business purchasing.

Role of the Internet and E-commerce at Gateway

Gateway uses the Internet and e-commerce to support each of its new business strategies. First, E-commerce expands Gateway's market reach by serving customers who prefer to shop online, and by complementing existing phone and store sales by providing product information and the ability to price different configurations. Second, it supports the "beyond the box" diversification strategy by making it easier to offer a range of new products and services, including software, peripherals, training, Internet service and content. This diversification into new market segments was seen in the creation of the Gateway.net ISP, the acquisition of NECX, and a content deal with Yahoo! More dramatic was the agreement announced with AOL in 1999, which allows Gateway to offer a wider range of services, content and shopping.

Third, Gateway is using the Internet to serve the business market by offering an extranet for online procurement, and offering various small business services such as training, human resources, and web site operation. Its goal is to create a "virtual company" with the capabilities of a larger organization for small business customers.

Finally, in addition to its various efforts to reach new customers and offer new products and services, Gateway also is using e-commerce to try to reduce its SG&A costs, which were 15% of sales in 1999. It expects that e-commerce will reduce the need for personnel to handle transactions, and expects that automation of technical support will reduce costs and increase customer satisfaction.

Online sales to consumers

Consumers can select, configure and order PCs on the Gateway.com web site. They also can buy a wide range of software and peripherals from the Gateway Accessory Store, which is run by NECX. In April 2000, Gateway completed the acquisition of NECX and put NECX chief executive Henry J. Bertolon in charge of a new, 250-person subsidiary that combines Gateway's online consumer PC business with NECX 's computer and peripherals sales. The two web sites carry 30,000 computer and computer-related products.[24]

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[24] Gary McWilliams, "E-Business & Technology: Gateway Near Pact To Buy the Rest Of NECX Direct," The Wall Street Journal, 3/6/2000, Page B8

The two stores have separate check-out systems, but Gateway plans to integrate the two into a "one and done" experience for the customer, with one transaction for hardware, software and peripherals. However, as of June, 2000, these plans had yet to be executed.

The company says that online sales are a function of traffic, conversion and price:[25]

- Traffic: Gateway creates awareness of the site with online and offline advertising
- Conversion (from visits to sales): The key to improving the conversion rate has been to improve the site, making it easier to go through the whole selection and buying process online. The average customer configures eight different systems online, but most still phone in the order. However, the company says they improved their conversion rate by 50% in second half of 1999.
- Price: Gateway has been able to add other products and services to the PC purchase to keep the average total sale in the $1800 range, compared to $900 for typical retail computer stores.

Gateway's relationship with AOL has important implications for Gateway's e-commerce strategies, as it helps to extend Gateway's reach and offer new services to consumers online. For instance, Gateway negotiated advertising on AOL's site in return for featuring AOL on Gateway PCs. Also, AOL and Gateway are opening a joint online store to sell software. This store is aimed at the Gateway and AOL customer audience and is a separate entity from the Gateway Accessory store which also sells software.

The Office Max deal also involves electronic commerce, as Gateway will place OfficeMax.com's electronic commerce icon on every Gateway computer produced during the next five years. For any purchase made through this instant link, Gateway will be paid a bounty. Conversely, OfficeMax will feature a link to Gateway on its Web site, and Gateway will pay OfficeMax a bounty on purchases made through this connection.

Gateway would like to convert more sales to online sales, as profits are highest and costs lowest through that channel. One executive mentioned a goal of having one-third of all sales completed online, up from the present 10%. So far, however, Gateway seems content to let customers choose which channel they use to buy its products, and makes no effort to push them toward online sales.

Internet Service

Gateway was the first PC vendor to offer its own Internet service, Gateway.net, which began operation in 1999. This was an important part of the "beyond the box" strategy, as it used the PC sale to capture the recurring Internet service revenue and keep the consumer more closely tied to Gateway after the sale. Gateway entered an arrangement with Yahoo! to create a personalized portal for Gateway.net customers, called GatewayMyYahoo!

The AOL partnership changed Gateway's Internet service strategy significantly. Customers who buy a Gateway PC now can choose what type of Internet access service they want with it, either Gateway.net or one of AOL's brands (AOL or Compuserve), and have the required software preloaded on their machine before it's delivered to their home. In order to avoid any conflict of

[25] Interview with Gateway executive.

interest, the deal was set up so that each company gets the same amount of money, no matter which service the customer chooses. In addition, AOL is taking over the network operations, registration, billing and customer service for Gateway.net, and will provide content as well. This allows Gateway to take advantage of AOL's economies of scale in those areas, while still retaining control of marketing and customer relationships.[26]

Business customers: Gateway@Work

Gateway launched the Gateway@Work brand name for its business division with a $50 million advertising campaign in early 2000. Visitors to the Gateway web site see products and services for businesses on one side of the home page. From there, business customers are directed to the Gateway@work site. By Gateway's admission, Gateway@Work has not been a major success so far, partly due to lack of content. The company doesn't expect to get a large share of its business revenues online for some time, but plans to use the site to offer valuable information and services on the site. Some of these include the eSource extranet and services such as web hosting, a small business portal, access to electronic marketplaces, and web management tools.

eSource

Part of Gateway's business strategy is eSource, a simple extranet for business customers to order online. ESource does not offer the kind of customization available on Dell's Premier Pages, where customers can link directly to their internal procurement systems. Instead, it offers features to make ordering easier from Gateway, especially for SMBs, who generally don't have complex ordering processes and do not use electronic systems such as EDI. In the future, Gateway plans to enable the eSource site with XML technology so it can integrate with various third party electronic buying networks (such as CommerceOne or Intelisys) more easily. ESource includes the following features:[27]

- Customized Catalog. A customized home page, plus the ability to customize the product catalog to reflect arrangements negotiated by Gateway and the customer.
- Specific Product Range. Employees who sign in see only the products selected for purchase, with prices that reflect any special discounts negotiated by the customer.
- Employee Purchase Program. Lets companies offer their employees Gateway products at special prices.
- Affiliate Network Programs. Catalog customization supports programs that allows affiliates or partners to benefit from the buying power of the customer's network.
- Full-Featured Shopping Cart. Shows all the items selected for purchase and lets customers change the order by modifying quantities or removing items altogether. Customers can save the shopping cart contents as a quote for later reference.
- User/Account Management. Each eSource account comes with customization features, that let businesses set up employee ID/passwords, multiple billing/shipping locations and manage multiple accounts.
- Quote Retrieval. A special quote feature gives fast access to pricing information and the ability to print it out. Each quote remains in the system for up to 45 days. Special messages on the home page alert customers before a quote expires.
- Quick Order Status. A special Order Status page displays all the details of current open orders and provides access to the approval process, order history and other order information.
- Order Review and Approval. eSource also allows employees to browse the catalog and select products for ordering. Each order is then reviewed by authorized administrators who can approve or reject them.

[26] James Niccolai "AOL , Gateway in broad Internet partnership" *Network World Fusion* 10/22/1999
[27] From Gateway web site

Small business portal

Gateway is developing what it calls a small business portal. The goal is to help SMBs with three things:

- Information to run the business: This is information content geared to small businesses, and will be provided online through Gateway's small business portal.
- Services to run the business: Gateway will work with partners to provide a variety of services. These could include human resources administration, employee training programs, and accounting services.
- Using the web to extend the reach of the business: Gateway will help SMBs reach new markets by offering web hosting services along with assistance in setting up an e-commerce site. Gateway also will help clients integrate their e-commerce applications to internal information systems, which might include financial applications such as Intuit's Quick Books. In addition, Gateway will create buying communities, which will agglomerate the buying power of Gateway's SMB clients to help them get better prices from suppliers.

Gateway can make money in different ways from these services. In the case of buying communities, Gateway will charge a small transaction fee. It might do the same with customers' online sales. Some of the other services might be provided on a subscription basis.

Web hosting

In April, 2000, Gateway announced a partnership with web-hosting company Verio to provide web site development, hosting and support services for SMBs. There are five levels of service available, ranging from $19.95 to $69.95 a month. At the low end, an EZ Website client receives a working site and up to seven pages of web space and 10 e-mail addresses. Other options are available at higher service levels, including multimedia, forms, databases, e-commerce, e-mail autoresponse, etc.

Each site is hosted in a secure, shared server environment, with automatic daily data backups and server redundancy. Gateway also provides 24-hour, 7-day a week phone support, and an online help database with information on Web-hosting problems and solutions.

Web services and management tools

Gateway is working through an alliance with eSoft to provide a combination of web-hosted applications services with web management capabilities that run on a local server at the company's site. This allows companies to keep web sites, e-mail and virtual private networks on a local server, protected by a local firewall. It also allows smaller companies to take advantage of web-hosted applications when they may lack the bandwidth to run those applications entirely from a remote location.

Gateway will combine eSoft software with its servers and Internet access for small business customers. The idea is to offer services or "solutions" to customers while creating demand for profitable server sales. Through its relationship with eSoft, Gateway will enable its SMBs to establish an on-line presence and secure networked operations with a host of infrastructure applications and Internet management systems, including firewall protection, web hosting, virtual private networks and network management services.

Electronic markets

Electronic markets are emerging as a major format for e-commerce. These include vertical industry markets such as Chemdex, National Transportation Exchange, and MetalSite, as well as horizontal markets created by vendors such as Ariba and Intelisys. For small businesses, markets are being developed that bring buyers and sellers together and facilitate transactions. Not surprisingly, Gateway has been approached by many of these companies who would like to offer Gateway PCs to their members.

Gateway sees these electronic markets as a wave of the future, especially for reaching the diverse and decentralized SMB market. Gateway is selecting which markets to participate in based on their affinity with Gateway's target markets, and on reputation and ties to established companies. The company already has become a supplier for eScout, an electronic marketplace affiliated with CommerceOne that links over 1,000 community banks and 3,500 small businesses.[28] It also is working with eVisa, which is creating a portal for SMBs to enable them to see their account information online and enter into buying communities. Gateway is likely to join a marketplace being developed by small business software specialist Intuit and e-commerce software provider Intelisys.

Global E-commerce

E-commerce plays a smaller role in many markets that have lower Internet penetration levels and lack the infrastructure and financial mechanisms to handle online transactions easily. However, the company has developed web sites offering online buying in a number of markets, including Germany, France, Sweden, the Netherlands, Japan, Australia, New Zealand, Singapore, Malaysia and Hong Kong.

In Asia, the most receptive market has been Japan, where Gateway's web site has won several awards and Gateway is highly rated for customer satisfaction. Online sales account for about 10% of revenues in Japan, and 3-5% in Hong Kong, Singapore and Malaysia. The web site also plays an important role providing information for customers who ultimately buy by phone or in a Gateway store. In Japan, Gateway's web site sells PCs, software, peripherals and office furniture and also auctions PCs. Japan is the only Asia-Pacific market in which the Gateway.net Internet service is offered. In other countries, Gateway has partnerships with ISPs, such as AOL in Australia and Star Hub in Singapore.

Like all PC makers, Gateway depends heavily on Asia as a supply base and utilizes Asian contract manufacturers for assembly of various products. While Gateway has achieved rapid order fulfillment, it has not developed electronic links with most of its Asian suppliers. For supply chain management, Gateway is implementing i2 applications with suppliers. Beyond that, it only uses EDI with its freight forwarders (shippers), and allows YCH to manage components replenishment in the Malaysia plant warehouse. In the future, Gateway may forego EDI and outsource e-commerce with suppliers to a third party.

[28] From eScout web site, http://www.escout.com/news/commerceone.html

EDI

Before 1999, Gateway used EDI mainly as a standalone application for taking orders from business customers or resellers. Orders taken via EDI were actually transferred by hand into the J.D. Edwards order management system. EDI also was used with some suppliers, but not extensively. In 1999, Gateway launched an EDI initiative to get off the standalone system and into a true integrated EDI environment.

Gateway is concentrating first on implementing EDI with business customers and partners such as NECX. The key goal is to serve business customers who want an EDI option for ordering. Now, business customers using eSource can use EDI to place orders and be invoiced, using Sterling Commerce's GenTran EDI translator as well as Gateway's communication software.

Most of Gateway's component ordering is still done using paper-based transactions. EDI is used with less than 2 dozen suppliers. The company plans to put a solution in place that can do business electronically with suppliers if suppliers want it, as more suppliers are moving that way. However, implementing EDI with suppliers is lower on the list of Gateway's priorities, as resources are strained trying to put customer systems in place.

As Gateway's business from supply chain to sales is increasingly based on e-commerce, the scope of EDI will expand beyond invoicing and into process improvements. Suppliers should be able to look into Gateway's systems to see inventory levels of their components while Gateway should be able to check with suppliers for component availability. This will happen when Gateway and its suppliers have the necessary IT capabilities. Gateway executives admit that the company needs to get its own IT house in order to achieve such integration.

EDI is a first step, but Gateway is looking into other technologies such as XML and OBI for possible use. The company also has been approached by Commerce One, Ariba and others to use their applications and services. An issue is whether to have a single "point of truth" for Gateway's rules for configurability. Now the rules reside in Gateway's order management systems. If they went with Ariba or Commerce One, those companies would have their own systems, which would have to be kept consistent with Gateway's configurations.

Organization of e-commerce

E-commerce operations, including Gateway.com, EDI, and the reseller program, are located at the San Diego headquarters under the direction of Vice President for E-commerce, Chuck Geiger. There is a steering committee for e-commerce that includes Geiger and representatives from the four business units, as well as from NECX.

According to Geiger, the e-commerce operation is organized like a product development unit, and includes the following functions:

- Design—web, HTML etc.
- E-commerce application development
- Application support

- Operations—mainly managing the relationship with Exodus, which hosts Gateway.com (until it is brought back in-house)
- Quality assurance
- Strategy R&D group—Their job is to track new technologies and develop strategies to take advantage of new capabilities.

Performance of E-commerce

Online sales account for about 10% of the company's total sales, according to Gateway. This makes Gateway the second largest online computer vendor, after Dell, and the sixth largest online retailer overall, with estimated sales to consumer of $250-300 in 1999.[29] According to IDC figures, Internet direct sales accounted for 8.0% of Gateway's sales in 1999, rising to 8.9% in the fourth quarter, second highest among PC vendors (Table 4). Still, Dell has been able to extend its lead, possibly because it has been more aggressive in pushing e-commerce and has offered more benefits to customers for using e-commerce, and perhaps also because its primarily corporate customer base sees more benefits from e-commerce than do the consumers who make up the bulk of Gateway's customers.

Table 4. Internet direct sales as share of total PC revenues

Company	**Internet as share of revenues (%)**	
	1999	Q4'99
Gateway	8.0	8.9
Dell	11.7	15.1
Apple	6.4	6.5
Compaq	1.3	1.8
HP	1.4	1.7
IBM	3.8	4.4

Source: IDC

Gateway says that the average selling price of an online purchase is higher than on phone sales, although not as high as store sales. Sales through resellers to the business market have higher average prices because they often include servers.

Profitability is highest on web sales. Looking only at direct costs, Gateway estimates that web sales are about 1.5 times as profitable as phone sales, and twice as profitable as store sales. These costs do not include the infrastructure involved (data centers for web, call centers for phone, rent for stores). Gateway has not calculated the different returns on investment in each type of infrastructure, but points out that the web site can scale up to a much larger capacity more cheaply than stores or call center capacity can be added.[30]

Challenges for e-commerce

Gateway's legacy of telephone sales means that the "call" channel still receives a large share of marketing resources. Gateway would benefit if more customers ordered online, where profits are

[29] "Top 100 Internet Retailers," National Retail Federation
[30] Estimates from interviews with Gateway executives

highest, but it has yet to create incentives to push business in that direction. Also, the success of the Country Stores has encouraged the company to invest in opening more stores, which to some extent diverts resources from e-commerce.

There is also the problem of new technologies promising more than they can deliver. For instance, developing a common order entry system for all three channels and having access to customer information available from stores, telesales or the web is taking more time and energy than expected. The company has had to build this system itself as it could not find a packaged application that was up to the task.

One of the problems facing Gateway is a shortage of skilled workers to carry out its e-commerce initiatives. For instance, the Business Division's e-commerce manager estimates he would need a team of 45 people to handle business development and execution of e-commerce strategies, but he only has seven people. The corporate e-commerce team has similar shortfalls in staffing. These problems are nothing unusual in the IT industry, but present a potential bottleneck for future growth. For instance, the company originally planned to have a single shopping cart for Gateway.com and Gateway Accessory Store shoppers by October 1999, but as of June 2000, there were still two separate systems. Likewise, months after launching Gateway@work, there was little content available and the web site was attracting little traffic.

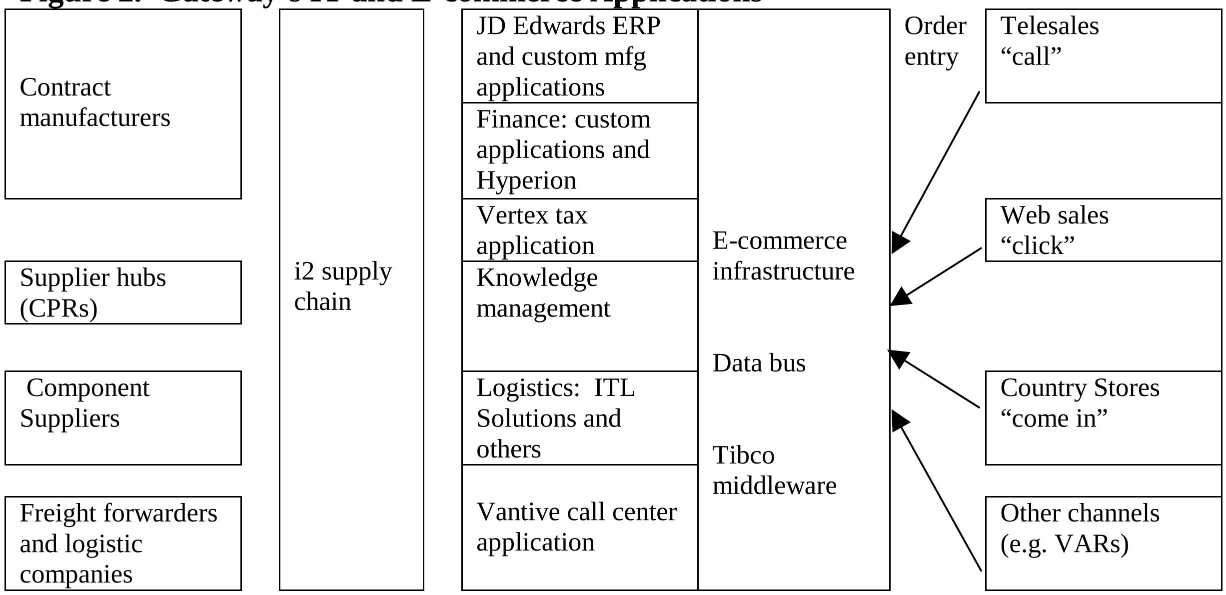
Internal IT Systems

Gateway's key IT applications include the J.D. Edwards enterprise resource planning system, i2 supply chain management software, Vantive customer relationship management software, Hyperion EssBase, and custom programs for finance and manufacturing. J.D. Edwards is used for order management, finance and manufacturing, and is linked to the home-grown finance and manufacturing applications. Gateway is in the process of moving from J.D. Edwards 7.3 to J.D. Edwards One World, and in the process is moving from the IBM AS/400 platform to Sun Solaris.

In 1999, Gateway outsourced its global infrastructure to Lockheed-Martin, including telecommunications, data centers, and e-mail. Lockheed-Martin is also responsible for supporting Gateway's J.D. Edwards systems in Europe. J.D. Edwards and Vantive (help desk/CRM) applications were outsourced to Keane in the U.S. and to NTI in Japan. The goal was not to save money, but to allow Gateway's IT staff to concentrate on strategic applications, especially e-commerce.

Gateway is in the process of integrating various applications to create one seamless enterprise information system linking all major business processes (Figure 2). A key element is the implementation of Tibco middleware which allows different applications to talk to each other, and also takes orders from any channel and directs them to a single order fulfillment system.

Figure 2. Gateway's IT and E-commerce Applications



IT Infrastructure

Gateway.net is hosted by Gateway, but is being transferred to AOL. Gateway.com is hosted by Exodus in New Jersey, but will be transferred to Gateway's data center in Colorado. All Asia-Pacific sites share one server farm in Singapore. However, Gateway is looking to use their data centers in Colorado and South Dakota to host all web sites worldwide.

COMPANY PERFORMANCE

In an industry marked by extreme turbulence, Gateway has been a steady performer, with consistent growth in revenues and market share throughout the 1990s. It is the only PC maker to be profitable every year of the decade, although net income fell from 10.4% of revenues in 1992 to 1.7% in 1997 before rebounding to 4.5% in 1998. In 1999 Gateway beat the PC industry average in measures such as inventory turnover, return on assets and return on equity. Still, Gateway trailed Dell on each of these measures, and its market capitalization was only about one-eighth of Dell's.

Revenues and market share

Gateway revenues have grown rapidly (from $1.1 billion in 1992 to $8.6 billion in 1999), but its work force has grown even faster (from 1,369 to 21,000). As a result, revenues per employee have decline markedly since 1991. Net income has grown steadily, except for one-year downturns in 1994 and 1997 (Table 5).

Table 5. Gateway's performance from 1991 to 1999.

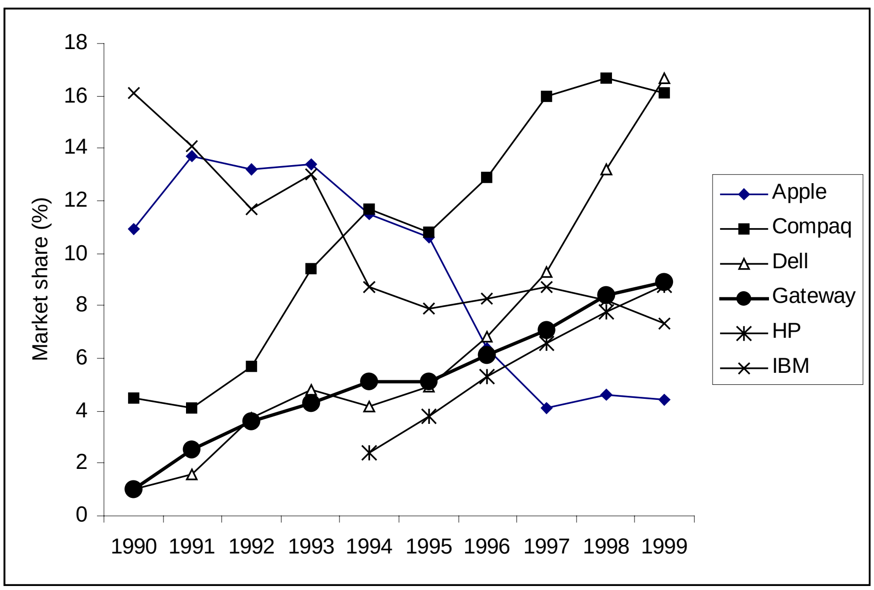
Year	1991	1992	1993	1994	1995	1996	1997	1998	1999
Revenue	627.0	1107.1	1731.7	2701.2	3676.3	5035.2	6293.7	7467.9	8645.6
Net Income	39.0	106.0	151.2	96.0	173.0	250.7	109.8	346.4	427.9
Net Profit Margin	6.2%	9.6%	8.7%	3.6%	4.7%	5.0%	1.7%	4.6%	4.9%
Employees	657	1,369	2,832	5,442	9,300	9,700	13,300	19,300	21,000
Rev/Emp ($000)	954	809	611	496	395	519	473	387	412

Source: Hoovers Online and Gateway annual reports

Gateway's sales are dominated by desktop PCs, as its market share in portables and servers has lagged its success in desktops. This is largely due to Gateway's dependence on the consumers, who do not purchase servers and are less likely to buy portables than the business customer. Gateway's non-PC "beyond the box" business reached 25% of operating income in Q1 2000. The company does not report specific sales levels for software, peripherals, Internet service, and other non-PC sales.

Gateway has grown to become the third largest PC vendor in the U.S. and is number six worldwide with sales of 4.6 million PCs in 1999. Its market share has grown in the U.S. from just 1% in 1990 to 8.9% in 1999 (Figure 3). Gateway's average selling price for comparably equipped PCs has been lower than other major PC brands for years, but its gross margins have been slightly higher than the industry average.[31]

Figure 3. U.S. PC market share, 1991-1999



Source: IDC

Gateway's consumer business accounts for the bulk of sales, but a smaller share of profits. The business division accounted for 65% of the company's operating profits in 1998, and about half

[31] Jan W. Rivkin and Michael E. Porter, "Matching Dell," Harvard Business School case #9-799-158, June 6, 1999.

of total profits in 1999 (Table 6). In the first quarter of 2000, however, business sales declined by 19% from the previous year, while consumer sales surged by 27%.[32]

Table 6. Gateway revenues and operating income by business unit

	1997	1998	1999
United States			
Net Sales			
-Consumer		3,339,712	4,158,379
-Business		3,072,692	3,225,008
Total U.S.	5,303,828	6,412,404	7,383,387
Operating Income			
-Consumer		296,390	473,124
-Business		560,752	474,599
Total U.S.	597,091	857,142	947,723
EMEA*			
Net Sales	634,616	570,191	543,182
Operating Income (loss)	(11,566)	(6,005)	(8,807)
Asia-Pacific			
Net Sales	355,236	485,330	715,842
Operating Income (loss)	(9,733)	1,153	33,049

*Europe, Middle East, Africa
Source: Gateway 10-K for year ending December 31, 1999

The U.S. accounts for about 85% of total sales, with Europe and Asia-Pacific making up the rest. Asia-Pacific has been the fastest growing region and has become profitable since 1998, while sales in Europe have been in decline and Gateway has been losing money there. However, in the first quarter of 2000, European revenues grew by 31% over the previous year as the impacts of a reorganization of the business unit are felt.

Operating efficiency

In 1999, Gateway's inventory turnover rate was 36 times per year, higher than the industry average of 24, but lower than Dell or Apple (Table 7). In the first quarter of 2000, Gateway reached a rate of 41.5 turns per year.[33]

Gateway's cash conversion cycle reached negative 10 days in 1999, meaning Gateway was getting paid ten days on average before it paid its suppliers and creditors.[34] This number is made possible by the economics of build-to-order, where many customers pay up front with a credit card, while Gateway pays its suppliers on normal terms (e.g., 30 days net).

One blot on Gateway's performance has been the continuing growth of overhead (SG&A) as a percent of revenues (from 7% in 1994 to 12.5% in 1997, and up further to 15.1% in 1999). This level is comparable to Apple and Compaq, but much higher than Dell's 9.4%. If this is due to investments in infrastructure that will support rapid growth in coming years, e.g, Country Stores, information technology, and Internet development (as is stated in Gateway's 10-K for 1999, p. 15.), then it may not be a bad sign. But it could be a sign that "beyond the box" means a shift to

[32] "Gateway Posts Record First Quarter Earnings," Gateway press release, April 13, 2000.
[33] Gateway 10-Q for Q1, 2000
[34] Gateway 10-K for year ending December 31, 1999

a higher overhead business model, which is supportable only if non-PC business brings commensurately higher gross margins.

Table 7. Performance comparison of leading PC makers

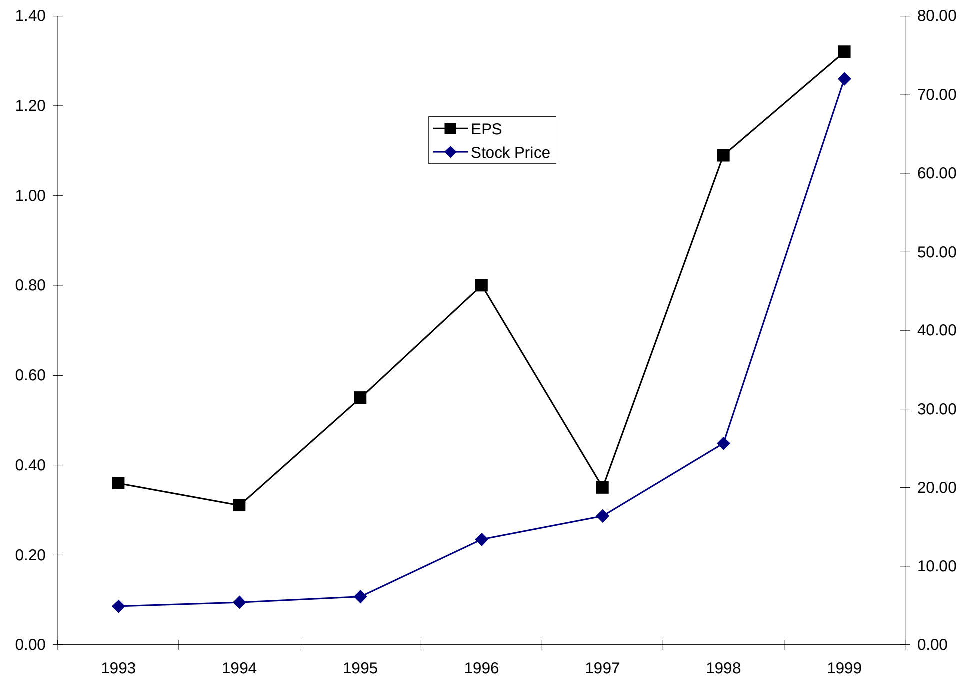
	Gateway	Dell	Apple	Compaq*	PC Industry
Profitability					
Gross profit margin	22.0	20.7	28.0	22.7	23.9
SG&A as % of revenues	15.1	9.4	16.0	16.5	N/A
R&D as % of revenues	<1	1.5	5.0	4.3	N/A
Operating income as % of revenue	6.9	9.0	5.8	1.6	N/A
Net profit margin	5.2	6.6	9.7	1.4	4.1
Return on equity	23.0	31.4	17.1	4.1	12.7
Return on assets	11.7	14.5	9.6	2.2	6.7
Return on invested capital	23.0	28.6	15.5	4.1	12.3
Operating Ratios					
Inventory turnover	36.8	59.9	243.2	14.2	24.2
Asset turnover	2.5	2.8	1.2	1.5	1.9
Growth rates					
12-month revenue growth	13.2	38.5	15.9	10.7	19.9
12-month net income growth	25.5	14.1	47.8	n/m	n/m
36-month revenue growth	16.0	48.2	-4.6	23.9	21.8
36-month net income growth	32.7	47.2	n/m	n/m	n/m

* Compaq data includes former Digital Equipment and Tandem businesses, and so is not directly comparable to pure PC makers.
N/A: not available
n/m: not measurable
Sources: Hoovers Online and company annual reports and 10-K reports

Financial performance

Gateway's return on assets, return on equity and return on invested capital are all nearly double the PC industry average, although they still fall short of Dell's performance (Table 7). Gateway's stock has performed well since 1995, and was especially hot in 1999, when it nearly tripled in value. Since then, it has dropped from a high of $84 to $50 in early May, 2000. The decline is partly due to the general slump in technology stocks, and partly due to Gateway's disappointing performance in late 1999, when it was hurt by a shortage of Intel chips.

Figure 4. Gateway earnings and stock performance



Source: Gateway annual reports and Hoovers Online

CONCLUSIONS

Gateway has undergone a major transformation of strategy and organization in the past two years, bringing in new management, developing new distribution channels, targeting new markets, and developing new partnerships and alliances. The company faces the challenge of changing to meet new market demands and opportunities while retaining the excellent reputation and customer relationships that made it successful in the past.

Gateway's is still early on in its transition from a hardware supplier to more of a services and solutions provider. In the words of its CEO, "If there is a 10-step process to making that transformation, I'd say we're at step two."[35] The first step was to expand "beyond the box," by offering add-on hardware, plus software and services to meet the needs of different customers. However, the PC is still at the core of Gateway's business, as Gateway bundles other products and services with the PC, or offers them as add-ons. The "box" will continue to be part of the solution offered to customers, although the box might increasingly be an Internet appliance instead of a PC.

The Internet and e-commerce play a critical role in Gateway's new business model, not as a replacement for other channels, but as a complement to them. In fact, Gateway has simultaneously invested in "clicks and mortar," building its own retail outlets even as it develops its online business. This strategy has higher costs than a more pure Internet strategy, but it also

[35] "Gateway chief is looking beyond hardware," interview with Jeffrey Weitzen, *Infoworld*, June 5, 2000, p. 18.

expands Gateway's market reach while retaining the operational efficiencies of the direct sales, build-to-order system.

The role of e-commerce in the consumer market is magnified by the Gateway/AOL relationship. Already, the companies have arranged cross-selling agreements and are sharing ISP revenues. More importantly in the long run, the two are developing a new technology platform to deliver services over the Internet to the home. If successful, this will accelerate Gateway's shift from a hardware manufacturer to a company providing services and solutions on the Internet.

In the business market, Gateway is using the Internet to develop solutions for small businesses, including information content, business services, and assistance in developing their own online business. Gateway has developed eSource, an extranet to help customers manage procurement. However, given its target market of SMBs, it would be difficult to try to work with each client individually to set up an extranet for procurement, so Gateway is looking at the potential of the many electronic markets that are springing up. This differs from Dell, whose main focus is providing highly customized services for large corporate customers.

Most of Gateway's e-commerce efforts have aimed at expanding or improving customer relationships, rather than the supply chain. This priority is driven by the strategic emphasis on developing new revenue sources. It also recognizes that Gateway's manufacturing and order fulfillment processes were already in relatively good shape thanks to years of refining the build-to-order production model. In time, Gateway will focus on implementing e-commerce with its suppliers, but that is not the first priority.

The payoffs from e-commerce come in several forms. First, online sales are 1.5 to 2 times more profitable than store or phone sales. Second, using the Internet allows the company to offer new services at a low marginal cost to large numbers of customers. Third, many customers prefer to buy online, so an easy-to-use web site with attractive bundles of hardware, software and services appeals to this market segment.

To improve efficiency and develop better information to serve customers and run the business, Gateway is working to integrate order fulfillment, customer service information and financial information. This involves using middleware to link different sales channels into ERP, supply chain, financial, and customer service applications. Eventually it will result in a "one and done" shopping experience for customers, better information to support customer service and technical support, and a common customer database to better track and meet changing demand.

To summarize, e-commerce at Gateway does not replace other PC distribution channels, but complements them as Gateway continues to grow its core PC business. More importantly for the long run, the Internet provides a platform for offering services and information to both the consumer and business markets as Gateway expands its non-PC business. This transition is not easy, however, and Gateway has struggled somewhat as it tries to carry out a number of new strategies at the same time. E-commerce is clearly a work-in-progress at Gateway, and one that will evolve as the company continues its transformation and responds to external market and technology trends.

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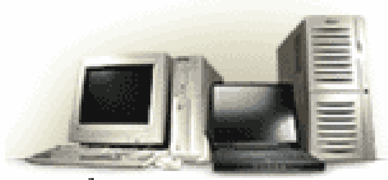

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