######  **Published: Sunday, January 7, 2007**

 [](http://www.nytimes.com/)

**SEATTLE —** Mark Vadon is one of the world's top diamond retailers, but wholesalers often decline to meet with him on the convention floor at jewelry trade shows.

At the very least, many ask him to flip over his name tag so that no one knows who he is or what company he runs.

There was a time not long ago when pundits generally dismissed Vadon's company, the online jewelry purveyor Blue Nile, as one of the dot-com boom's more lame-brain creations. People might be willing to buy a book online, or a compact disc, maybe a toaster, they said, but a $3,000 diamond engagement ring? The jewelry industry, or at least the high-end jewelry trade, seemed impervious to the Internet.

Not any more. Only a decade after it was founded in the infancy of the Web, Blue Nile ranks behind only Tiffany in diamond ring sales, according to industry analysts. Experts also say that probably only Tiffany's and Zale, which operates more than 1,500 chain stores in the United States and an additional 800 kiosks, bought more diamonds from wholesalers than Blue Nile last year.

While Blue Nile has grown — and its stock has soared 54 percent, to $38.53 a share on Friday from $25 when it was first sold to the public in May 2004 — Main Street jewelers have seen their profit margins shrink and many of their brethren shutter their store doors. As a consequence, many retail jewelers refer to Blue Nile as the "evil empire" — or worse.

So far, the Blue Nile effect has been felt mainly by mom-and-pop jewelers; much larger high-end retailers like Tiffany have been affected only on the margins. And Blue Nile's influence is limited largely to diamond sales, particularly diamond ring sales, but those are often the cash cow for smaller jewelers, accounting for a disproportionate share of their revenue.

"Blue Nile is just busting the chops of everybody, especially in the sale of diamonds," said Ken Gassman, a former Wall Street financial analyst who runs the Jewelry Industry Research Institute. Diamond jewelry accounted for nearly half the $59.4 billion in jewelry, including watches and costume pieces, that U.S. retailers sold in 2005, Gassman said.

Blue Nile operates no stores, so jittery men browsing its Web site in search of an engagement ring that matches their love and budget cannot compare diamonds side by side or even see what they have bought until they tear into an overnight-delivery package.

But still they buy. The average diamond ring bought at the Blue Nile site costs $5,500, twice the industry average of $2,700, Gassman and other analysts say. The Blue Nile finance chief, Diane Irvine, said that nearly every day the company sold a ring costing $20,000 to $40,000. Last month alone, more than a dozen people bought diamonds that were so expensive, at $50,000 or more, that Blue Nile delivered them in armored trucks with armed guards. All sales come with a 30-day money-back guarantee.

Shop owners, if they wish to curse anybody, might better aim their invective at one of their own, Doug Williams, a Seattle jeweler who in late 1995 took to heart all the radio advertisements he was hearing that implored business owners to adopt an Internet strategy.

The personal computer boom had been very kind to Williams, who for years had made a good living selling jewelry to Microsoft employees and other newly minted millionaires. Yet when he paid a consultant $2,000 to create a basic Web site he called Internet Diamonds, he did not even own a personal computer.

"I was like a caveman looking at a television," he said of the first time he visited his online creation.

Vadon stumbled on Williams's site after a frustrating visit to Tiffany's store in San Francisco, where he had gone in search of an engagement ring. This was late in 1998, and Vadon, a recent graduate with a master's degree in business administration from Stanford University, was a well-paid management consultant at Bain & Co.

The two rings that Vadon was considering, at $17,000 and $12,000, would have represented the most expensive purchase of his life, automobiles included. So in search of what he described as a "Consumer Reports-like site," Vadon ventured online, where he discovered a basic tutorial written by Williams. There he learned enough to consider trade-offs involving size, shape and his tolerance for imperfections — and he found, for $5,800, a diamond ring nearly identical to the less expensive of the two he had viewed at Tiffany's. He bought it.

By chance, Vadon was in Seattle on business a few weeks after he bought his engagement ring, and he stopped at Williams's store. When Vadon offered that he had probably been a very good customer, Williams told him not really: he sold one or two diamonds a day online, and at just under $6,000, Vadon's purchase was more or less an average sale.

Standing inside Williams's modest, two-employee store near the Seattle airport, Vadon made a quick mental calculation. At that point he may have known little about diamonds, but he recognized that an Internet site that cleared $250,000 a month in revenue despite having no advertising budget and a bare-bones design could be extremely valuable. So at dinner that night, he offered Williams $5 million, which he did not have, for an 85 percent stake in his company, a deal penciled on a napkin and contingent on his raising the money.

Vadon was then 29 and, unlike most of his Stanford classmates, had shown no great interest in the Internet. He had no experience selling jewelry. But this was Silicon Valley circa 1999, so in just eight weeks he raised $6 million to buy the site and speed up its development. Over the next 12 months he raised an additional $44 million without, he said, having to work terribly hard at it.

After the dot-com bubble burst, "there was this giant sigh of relief" among jewelry retailers, said James Porte, the former chief marketing officer of Diamond.com who now runs a marketing firm in Fort Lauderdale, Florida. "People hated Diamond.com and Blue Nile and the rest of them, and so they could say, 'See, I told you it would never work.'"

When Blue Nile refused to die, jewelry store owners reacted by pressuring wholesalers to cut off its supply. "People would meet at conferences and talk about embargoes like this was the Cuban missile crisis," said a New York-based diamond wholesaler and Blue Nile supplier who declined to be quoted by name because, he said, "I don't need the grief."

It is easy to sympathize with a small retail jeweler confronting a rival like Blue Nile. Overheads eat up just 13 percent of its revenue, compared with 30 percent to 40 percent at a traditional Main Street retailer.

That allows Blue Nile to sell its diamonds at roughly 20 percent over cost and still make money, Vadon said, and analysts confirmed his estimate. By comparison, the typical jewelry store sold its rings for 48.7 percent above cost in 2005, though that was down from 51.6 percent in 2002, an annual survey by Jewelers of America found.

As a result, Gassman, the analyst, found in one study that Blue Nile sold rings for 35 percent less than comparable rings at Zale.

David Sternblitz, the treasurer of Zale, in Irvine, Texas, said: "The Internet business serves a target customer looking for a commodity that's basically sold on price. There's still a large segment of the population that wants to come into a store and inspect the jewelry and wants the extra services we provide like cleaning and repair."

In addition to its lower overheads, Blue Nile has a second advantage, at least over smaller jewelers. It bought roughly $170 million of diamonds last year, giving it the purchasing power to sometimes sell its diamonds at a cost below the wholesale price available to smaller stores.

For now, diamond rings account for 70 percent of Blue Nile's sales, and other diamond purchases — diamond post earrings, for instance — account for an additional 20 percent.

The mark-up on designer jewelry as well as on pearls and colored stones like sapphires and emeralds still exceeds 50 percent, according to Jewelers of America.

But diamonds serve as the financial backbone for so many jewelers, and while some have tried to match Internet prices, many still refuse to compete on that basis.

"Their attitude is, 'Our prices are higher, but we provide you services, and we'll hold your hand, and we'll wrap it up all pretty' and such," Gassman said.

Will that work?

"I think it's relevant that we have seen an acceleration in the closure of specialty jewelers in recent months," he replied.

1. **Describe BlueNile’s advantages over a traditional jewelry chain. Can conventional jewelers successfully copy BlueNile? Why or why not?**
2. **Consider two firms in the same industry (Dell and Apple are examples) that have different value components. Why do you think these firms have different value chains? What role do you think technology plays in the way that each firm competes? Do these differences enable strategic positioning or not? Why?**

