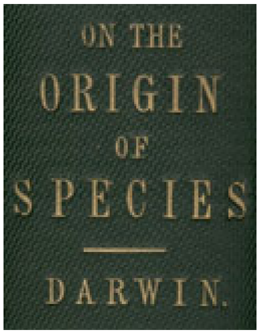
THE DARWINISM OF INTERNET BUSINESS MODELS

By Michael Zeisser



The stock price fluctuations of internet companies such as Facebook and Zynga in 2012 have been nothing short of dramatic, causing much discussion about the IPO process, greed, and new bubbles. While these factors may contribute to volatility, the fundamental truth is that consumer internet business models are far from established - in fact, they appear to be evolving more rapidly than ever before.

This is true not only for start-ups, but also for established internet companies. The acceleration in formation of new business models for start-ups (i.e., flash-sales, social sharing, subscription eCommerce, web2local, deal-of-the-day, community marketplace, micro-blogging) has led some analysts to declare a new age of internet innovation. Big internet companies are changing just as remarkably. For example, Amazon now sells billions of dollars in advertising on its site as if it were a media company: Groupon recently went from selling coupons for local services to selling physical products (a memory foam mattresses is one of my personal favorites); and, with its recent acquisition of Karma, Facebook is now also a digital retail company.

This situation presents an enormous challenge for investors, who must look at the world through a prism of wealth creation and creative destruction. Predictable business models give investors a chance to anticipate the ultimate structure of an industry. Industry structure, in turn, drives profitability and return on capital. In the search industry for example, Google has won by far the dominant market share and thus earns the highest profit margins; in contrast, the flash-sales industry is emerging as a perfectly competitive industry, with a dozen meaningful competitors and no clear winner – profitability in that industry is either non-existent or marginal. Where would you rather have put your money? The problem is that current consumer internet business models are neither stable nor predictable. So what is an investor to do?

ENGINEERING AROUND USERS, NOT CONSTRAINTS

The single most important lesson we learn from the short history of the consumer internet industry is that winning internet business models are engineered around consumers. In fact, consumer internet businesses must be designed, architecturally, to be more consumer centric than their physical world equivalents. This is because, fundamentally, the internet increases transparency and information availability to reduce friction, and thus shifts market power to users relative to physical world models. Therefore, competitors can and will exploit every opportunity to be more consumer centric, a dynamic fuelled by the quasi absence of barriers to entry into the industry.

As a consequence, physical-world businesses can only serve as imperfect models for internet-based businesses. This is exacerbated by the fact that traditional business systems were built around constraints imposed by the physical world. For example, a catalog assortment had to be optimized against the cost and constraints of adding pages to a book relative to the economics of mailing against prospect lists, not against differentiated insights into the needs of target consumers. Many, if not most of these constraints disappear in a digital environment, which creates the opportunity to redesign business systems and models around consumers, not physical-world limitations. Sticking with retail industry examples, Amazon has achieved such consumer-centric design though innovations like Prime and Marketplace that have no equivalent in physical retail. Similarly, we can see from companies such as Fab.com, to name just one, that there is a lot more room for further innovation of the basic retail idea. It appears that we are at the early stage of the emergence of digital commerce businesses that have no precedent in the physical world, and which take full advantage of the native capabilities of the internet platform to reinvent and reinterpret retail in a digital environment.

Designing businesses around consumers not constraints comes instinctively to consumer-internet entrepreneurs, but it requires a complete mindset change for executives in traditional, physical consumer companies. As an illustration of consumer-centric business design, here is how the founder of the largest sports nutrition destination on the web talks about his business starting, of course, with the user in mind: "No consumer wakes up in the morning thinking today I want to buy protein powder; they wake up thinking I want that girl in school to notice me, or I want to feel better about how I look. Therefore, my company never thought of itself as a store; instead, we set out to build the best company in the world to help users reach their fitness goals through products, information services, and community support". As a result, his company today is not only the #1 sports nutrition eCommerce destination on the web, but also features the largest community of athletes and a content/how-to section that would put any fitness magazine to shame.

This example reveals two drivers of a possible theory of evolution of business models away from conventional definitions. The first driver is to build the new models on deeper - and ideally proprietary - insights into consumer needs and wants, which reveal more precise opportunities for companies to be useful. The second driver is to serve a broader range of consumer needs than those addressed under conventional business definitions. This can be accomplished by thinking more expansively about the components of a company's value proposition (i.e., functional, emotional, social).

In hindsight, we can see how many first generation internet companies largely copied conventional, physical business models in the early 2000s. Since most of those are no longer around, we now know that it is not sufficient for a pure-play consumer internet company to just replicate a physical-world business model on the internet. Physical-world incumbents lead their markets for a reason. They possess more resources and capital than their challengers, and even if they stumble for a long time, in most cases they will eventually leverage their capabilities and catch-up. Back in the early 2000s, many investors underestimated the competitive advantages of incumbency, and overestimated first-mover advantages.

Discerning investors must tell the difference between a fad, an unsustainable copy-cat, or a truly consumer-centric business model that is grounded in insights, ideally proprietary, about the users it serves. This is the key to navigating the evolutionary dynamics in consumer business models. Unfortunately, it is only half of the battle.

STRUCTURE + CONDUCT = PERFORMANCE

Warren Buffett once said that "when management with a reputation for brilliance tackles a business with a reputation for poor economics, it is the reputation of the business that remains intact." This wisdom tells us that structural industry characteristics trump almost everything else in determining investment returns. However, this assumes rational competitive behavior -- the other factor that drives investment performance is the conduct of the companies that compete in the marketplace. For example, if Groupon and LivingSocial get into a price war and lower their commissions to local merchants in the marketplace, they simply lower the pricing umbrella for all coupon companies and reduce the profit pools available to all competitors as well as to their investors. This example illustrates the other challenge in making investments and predicting returns -- not only are the business models in flux over long periods of time, which makes it virtually impossible to anticipate what industry structures will look like, but the intense competition between companies creates a high risk that profits - and returns above the cost of capital - will be eroded away because business leaders make foolish operating decisions.

Picking investable consumer internet business models is not for the faint of heart. Some of the best investors in the world think it simply cannot be done, that it is speculation, not investing. Having said that, I am convinced that the changes in consumer retail, media, and services of the last 15+ years will likely pale in comparison to what will happen in the next five, and therefore the wealth creation opportunity remains unparalleled in our lifetimes.

As investors set forth to get their piece of the prize, they must always keep in mind what Charlie Munger said about investing (as only he can say it), "it's not supposed to be easy. Anybody who finds it easy is stupid."

October 2012