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Cut to the Chase

Network Effects

WHAT are network effects?

- A network effect is described in economics and business as when the usage of a good or service increase the value of that product to others.
- Simply put, the more the number of users on a cellular network the more the number of people it will attract. Technology companies have used the network effects to great effects. Companies such as Google, Facebook, Uber and Amazon thrive on such network effects. All of these services have the most number of users on these networks which makes other people want to be on their network instead of a competitor's network.

WHY network effects are so valuable?

- Network Effects are the opposite of Economies of scale because they produce greater value for the marginal increase in cost. As Networks grow larger, the cost increases, but the value of the product increases faster. Economies of Scale arise when there's sufficient volume of production to massively reduce the costs. A mobile phone manufacturer selling more phones every year can be attributed to the economies of scale while users installing same chat messenger that their friends use is attributed to network effects.
- Substantial network effects can create effective barriers to entry and therefore degree of monopoly power. For example, it would be inefficient to have two or three different types of telephone which couldn't communicate. Initially, there were two types of Video recorders (VHS and betamax) But, there were strong network effects from concentrating on one type of video. Eventually VHS came to dominate and Betamax faded away.

WHY do start-ups chase these network effects?

- When one type of technology dominates, it is very hard for a new firm to enter the market with a different technology. As the usurping technology should be markedly better by at least 10X in order for the consumers to even think about shifting to a different technology from the one that they already on.
- In tech, significant market adoption of a proprietary format or a closed eco- system can create a network effect and a competitive advantage for a business that is similar to supply-side economies of scale. But network effects are potentially more powerful. Unlike supply-side economies of scale, the benefits of demand-side economies of scale can increase in a nonlinear manner, especially in software businesses. This means that the

benefits realized by Google are far larger than those realized by a large steel or cement producer based on supply-side economies of scale. Google has at least two beneficial demand-side economies of scale — one for search and one for advertising targeting — that are mutually reinforcing and accordingly give it a strong moat.

- Once the startup has established enough market presence it is very difficult (not impossible) to unseat its position. For example, Uber clearly has a lead in taxi aggregator business around the world and all other startups in that space remain their closest second – for example –Lyft in the US, Ola cabs in India etc. China was the only market where Uber had to give up its position to its local rival Didi Chuxing. Didi had already established huge market presence before Uber entered China making it difficult for Uber to make any more inroads.

How does network effects benefit in the end?

- The idea is to initially attract users with a simple and single focus tool and then, over time, get them to participate in a network. The tool helps get to initial critical mass. The network creates the long term value for users, and defensibility for the company.
- Creating extremely tiny markets and dominating them. Facebook got started at Harvard, initially limited to users within the class/group. They grew quickly within the group and scaled rapidly once they launched it globally.
 - » Snapchat is a good example of how both these features were responsible for the company's growth. Snapchat allows the users to send photos for a predetermined amount of time after which they automatically gets deleted. In other photo sharing networks such as Facebook, Instagram or Twitter one had to manually delete photos that are transient in nature and could take up a lot of time. Snapchat on the other hand made addressed this problem and by setting a limited time for photos and even notifies users of screenshot taken by the receiver, a feature sadly absent in other social networks.
 - » Talabat is one example of a Middle Eastern company using its network effect to great use. It has used its pioneer status to cement its position and currently leads the online food delivery segment. It lists the most number of restaurants on its website and as a result it also enjoys a massive following among the people ordering food in the region.

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