What is your unfair advantage?

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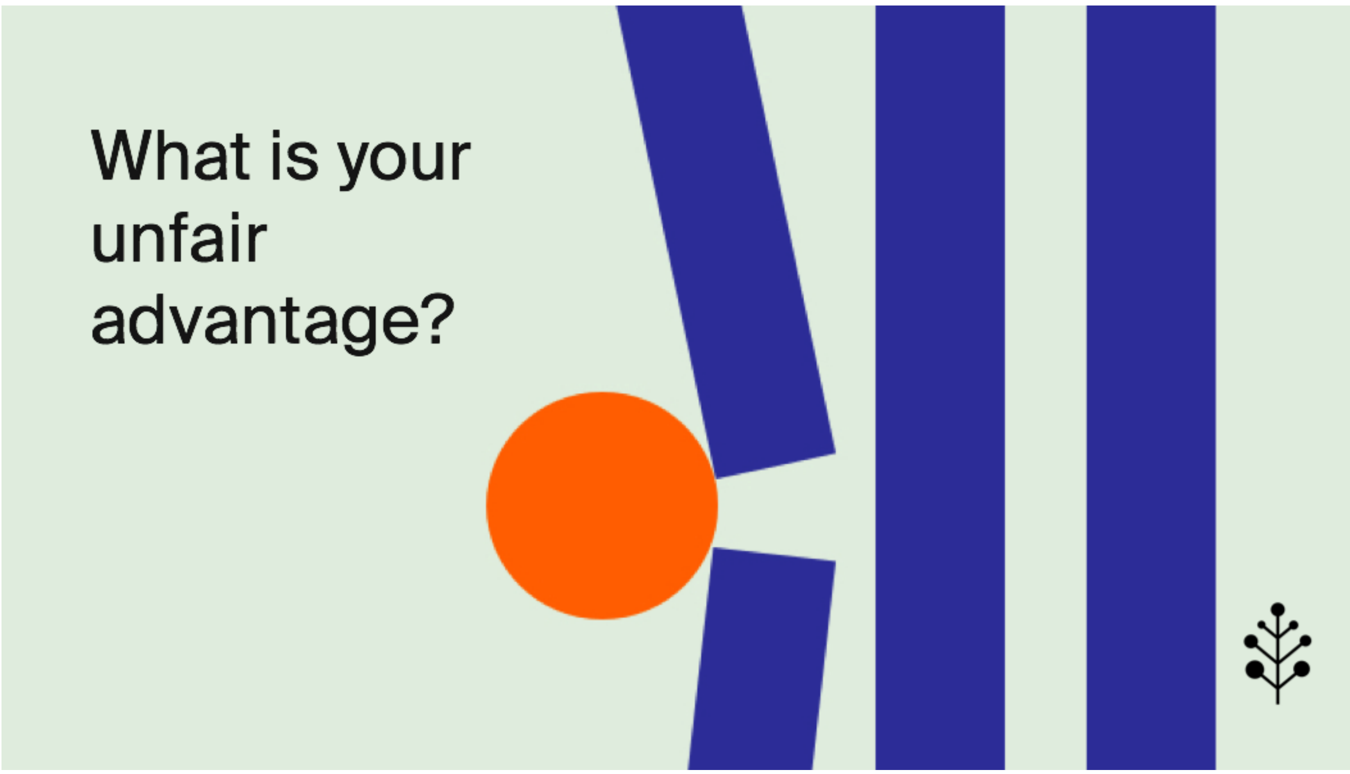


What separates a good business from a great business?

A good business solves a painful problem in a delightful way for customers. Think about your favourite coffee shop, or that vintage clothes store you love.

A great business does all this, **plus it has an unfair advantage that makes it increasingly difficult for competitors to challenge them over time.**

This post exposes the ways a business can build structural advantage into their business model from the very beginning.

> "The key to investing is not assessing how much an industry is going to affect society, or how much it will grow, but rather determining the competitive advantage of any given company and, above all, the durability of that advantage. The products or services that have wide, sustainable moats around them are the ones that deliver rewards to investors." Warren Buffett

So what gives a company an unfair advantage?

It varies depending on the type of company you want to build, but there are several characteristics investors often look for when considering whether to invest in a company.

Incorporating one or many of these into your business could mean the difference between $1 million in annual revenue and $1 billion.

Let's start with the best known of all:

Economies of Scale

The larger you grow, the cheaper your costs become relative to competitors.

Wal-Mart is a great example of this —

1. Promise the lowest price and generate demand from consumers

2. Use that demand to bargain with suppliers — "what discount can you offer if we 10x the order?"

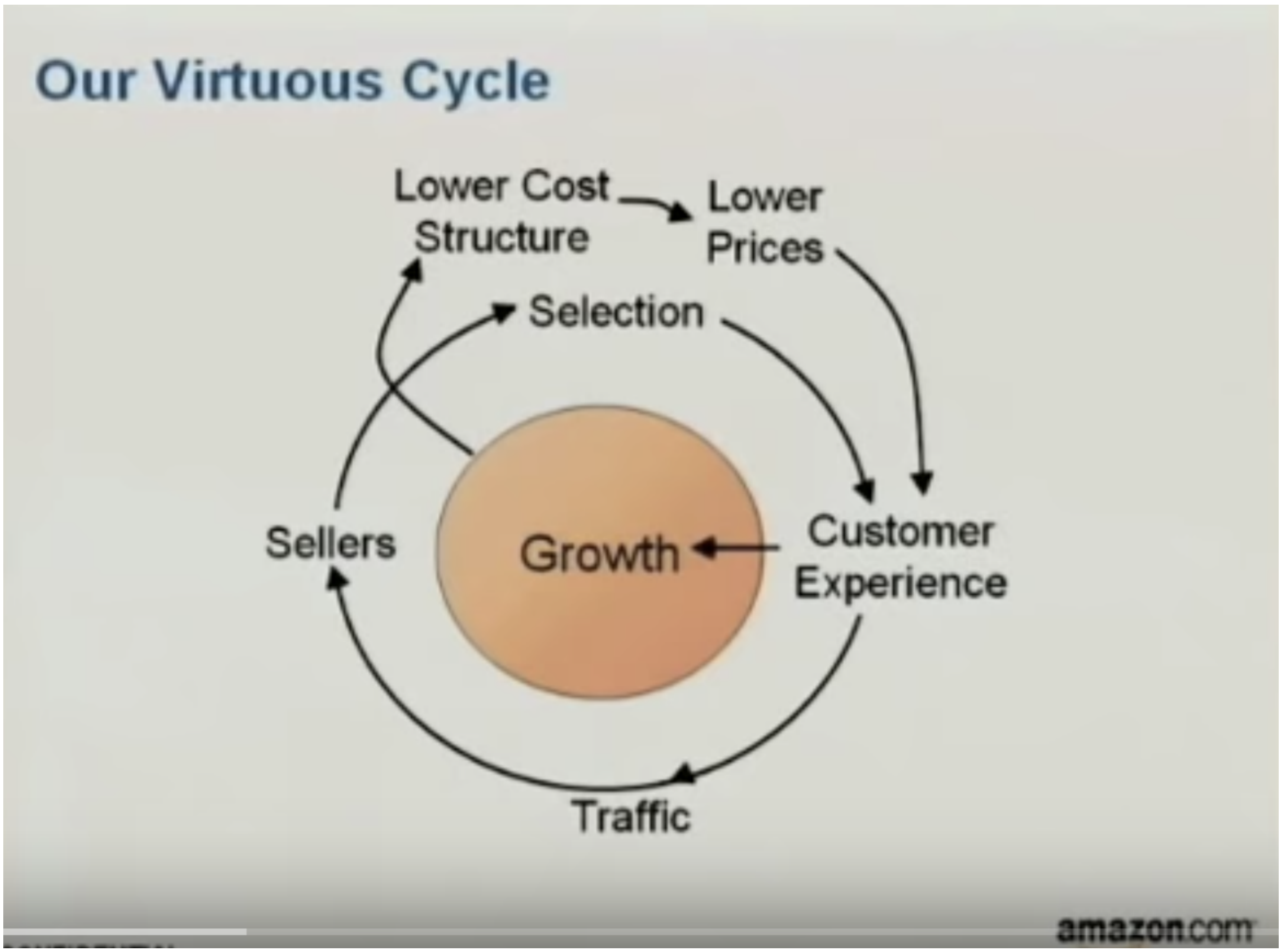
3. Invest in complex technology to simplify the supply chain, further driving down your costs vs competitors.

4. Use the advantage gained in 3 & 4 to lower your prices again

5. Repeat

Amazon took this a step further by allowing third party sellers to list products on their e-commerce platform and eventually use Amazon's infrastructure to store and distribute their products, which further reduced Amazon's costs as they scaled.

Jeff Bezos famously drew the **'virtuous cycle'** on a napkin in 2001 at the first Amazon offsite:



By delivering a great customer experience selling its own products, Amazon.com gets more traffic.

More traffic means more potential buyers

Which in turn attracts third party sellers to the website,

Resulting in a wider selection of products to customers, Further improving the customer experience.

Amazon can then reinvest their revenue in infrastructure (fulfilment centres and robotics) to bring costs down further and reduce prices for both suppliers and customers.

By continually reinvesting earnings in infrastructure, Amazon eventually offers Fulfilled by Amazon as a service to third party sellers, reducing distribution costs for these sellers and tying them to Amazon.

With so many products using FBA, Amazon soon offers guaranteed 1 day delivery through Prime, which significantly increased consumers' annual spend.

With each step Amazon makes it harder for competitors to challenge them.

No one can provide a greater selection of products, at such competitive prices, with such quick delivery.

Amazon repeated this model with AWS — using their considerable investment in internal data centres to offer flexible cloud services to companies all over the world at a fraction of the cost and headache of maintaining their own servers.

AWS is now Amazon's largest business unit, surpassing all of North America e-commerce.

Network Effects

Network effects occur when the value of the network increases as more people join the network.

Systems with network effects generally have direct interactions between users over a defined interface or protocol.

Think about how much more useful the telephone network became when everyone had a telephone. Or how much more valuable Instagram is when all your friends are posting photos.

As a result, **the larger your business gets, the harder it becomes for a competitor to challenge you.**

Investors love network effect businesses because they tend towards monopoly. The structural advantage you've accumulated over time through building a dense network of strong connections between nodes makes it difficult for any competitor to challenge you. This gives you pricing power, which enables sustained profits over the long term.

That's often why VCs pour large amounts of capital into these businesses quickly to ensure they get to scale before their competitors, developing such a dense network of nodes that any competitor coming in will offer a significantly worse experience for early users.

Switching Costs

How hard is it for customers to leave your product?

Some products make it super easy to sign up, and exceptionally hard to leave.

Think Salesforce and SAP…

These products are called Systems of Record, and become invaluable to customers once all their data is captured inside the product. Imagine how hard it is to change CRM when you have 8 years of data in Salesforce.

Switching costs are an unfair advantage because customers are willing to pay a higher price for your product simply to avoid the hassle of changing to a competitor.

But that doesn't mean you should use the excuse to deliver a poor customer experience. Instead, you use your active customers as a distribution channel for new products that improve their user experience and build in defensibility.

Salesforce is a master of this — they opened up a platform on top of their CRM and allowed third parties to build solutions for specific customer use-cases — improving niche user experiences for Salesforce customers, and generating revenue from each transaction. Salesforce even has a venture fund to invest in the best of these solutions and further integrate them in the Salesforce experience.

Brand

How do customers feel when they hear your name?

Building a trusted brand takes a long time — you need to set customer expectations of the value your company will create, and consistently fulfil those expectations over time.

Brand is why people choose to pay luxury prices for a Louis Vuitton handbag and a Barry's bootcamp workout.

To build a loyal brand following, you need your customers to feel like part of a tribe — by using your product they are demonstrating to others a part of their identity.

I'm the type of person who goes to Crossfit.

I'm the type of person who rides a Harley Davidson.

In B2B, this means creating a category…. there was no such thing as conversational marketing 3 years ago, Drift invented it and last year Gartner created the category and labelled them a 'Cool Vendor'.

Brand can be a fierce unfair advantage, but brands are delicate and need to be managed carefully.

Your employees need to live the brand values throughout the supply chain — from manufacturing to packaging and distribution — so customers experience what they expect from your brand at every interaction.

The very best brands build a community of loyal followers who are actively engaged in living the brand values and spreading the word. When people you trust recommend a product to you, you are much more likely to believe them, so nurturing your budding community can lead to strong organic growth over the long term.

Building a Talent Brand

While a strong customer-facing brand can attract loyal customers, **a strong talent-facing brand can entice the most talented employees in the world to work on hard problems at your company.**

That could be SpaceX for aerospace engineers or Google for machine learning.

In these areas one talented employee could be worth 100 average employees, enabling the company that acts as a talent magnet to **build the best solutions to the most difficult problems consistently over time.**

Regulation

In highly regulated industries, simply complying with existing regulation can be an unfair advantage.

Within healthcare, new medical devices need several regulatory approvals to show they meet manufacturing requirements and demonstrate conformity with health, safety, and environmental protection standards.

In banking it can take years of work and millions of dollars for neo-banks to secure the banking licenses required to take deposits from consumers.

The time and capital it takes to comply with existing regulation provides a solid barrier to entry — no brand new startup can spin up a landing page and compete with you, so you have a solid head start. Don’t waste it.

IP

This can include trademarks, copyrights, patents, and trade secrets. **They’re most useful when the product is likely to stay on the market in its current form for a number of years** eg. in biotech or telecommunications.

When your product is iterating constantly as is typical in software, patents can be difficult to maintain, and even more difficult to defend when your competitor has a war chest and an extensive legal team.

Holding IP is a significant barrier to entry forcing competitors to solve the problem in a different way, however at some point your competitor will develop an equally functional (or superior) solution, so you need to continually invest in R&D to stay one step ahead.

But unfair advantages don’t last forever

Andy Grove famously declared *“Only the paranoid survive”*.

Even if you've built several of these elements into your business, **you need to constantly monitor how the market is evolving and adapt your strategy.**

Brands can go out of fashion, startups can lose talent, and new competitors can find better ways to serve your customers.

Uber is a great example of this — early on investors believed the 'network effects' of Uber would create a winner-takes-all dynamic in the taxi market. However in 2019 most consumers have several ride-hailing apps on their phone and select a provider based on price.

It turns out that once you get to a 3–4 minute wait time, the incremental benefit from more drivers in the network becomes marginal.

So Uber is seeking new ways to build defensibility into their business — embedding the app in other products (eg the Qantas app and Facebook Messenger) to create a distribution advantage and building out new products like Uber Freight.

There are many ways to build a great business

From software to hardware and e-commerce, there are multiple ways to build a sustainable competitive advantage into your business.

So when you're first starting out, make sure you think through how you want to include one or many of these into your business model, and dedicate resources to reinforcing those elements as you grow.

And there's never been a better time to get started…

Everyone thought network effects were over…. then Slack came along.

Some exceptional brands have been built in the last 5 years…. Everlane, Glossier, Dollar Shave Club and Who Gives A Crap.

And the proliferation of neo-banks in finance and AI-driven diagnostic tools in medicine demonstrates that entrepreneurs are not afraid of tackling industries with high regulatory barriers to deliver a vastly improved customer experience.

If you're building your business and looking to raise money, get in touch with me at jackie@airtree.vc

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