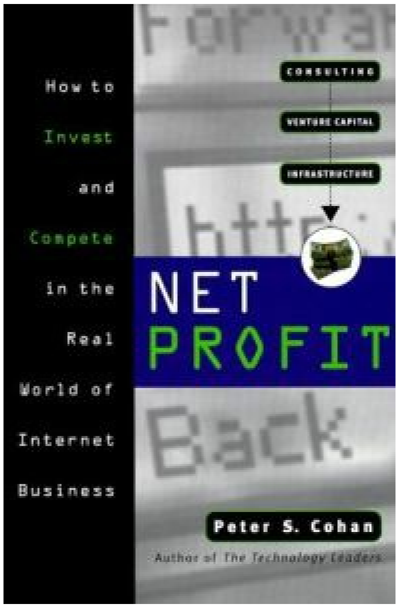

Book Net Profit

How to Invest and Compete in the Real World of Internet Business

Peter Cohan
Jossey-Bass, 1999

Recommendation

At the peak of the dot-com bubble, buying Internet stocks was momentum investing at its most pure - get in when a new stock or sector is on its upswing, and get out while the gettin's good. But Peter S. Cohan has created new criteria for Internet investors to apply in the traditional method of fundamental analysis. Instead of looking to old-line gurus like Graham or Buffet for advice, Cohan draws on the business strategies of John D. Rockefeller to come up with fresh e-commerce attributes like economic leverage, closed-loop solutions and adaptive management for investors to measure. *BooksInShort* recommends this book to executives, employees and students with equal vigor, although consider yourself forewarned that Cohan's extended barking-dog analogy will grate on your nerves. Nevertheless, anyone who invests in Internet companies or even traffics in Internet commerce for business or pleasure will gain insights from this book, regardless of whether Cohan's investment criteria prove to have staying power.

Take-Aways

- Use John D. Rockefeller's business strategies to help evaluate investment opportunities in Internet companies.
- A choke point permits the user to gain economic leverage.
- The "net profit retriever" is a metaphorical dog that helps you make sound investments in Internet businesses.
- The net profit retriever uses three criteria and barks at each: economic leverage, closed-loop solutions, and adaptive management.
- The net profit retriever needs to bark three times to uncover an Internet investment.
- The "Web business pyramid" helps Internet business managers make informed decisions.
- Lossware, brandware, and powerware are the three levels of the Web business pyramid.
- The "Web application pyramid" helps non-Internet business managers make informed decisions.
- The net profit retriever only barks twice for Amazon.com, because the company lacks sufficient economic leverage.
- When you mention Kleiner Perkins, the net profit retriever barks three times loudly.

Summary

Making Sense of the Internet

How does an investor make sense of the Internet? Asking the question creates an emotional dilemma. On one side is the desire to get a piece of the action; on the other side is the fear that the Internet is a straw house doomed to collapse in the near future. What does an investor do?

> "Internet stocks appreciate much more than NASDAQ in a market upturn and decline about the same as NASDAQ in a downturn."

You can find the answer to this question in the business strategies of John D. Rockefeller. An Internet investor who reviews Rockefeller's ownership of Standard Oil can determine that the most successful Web businesses will find the choke points in the Internet economy the same way Rockefeller found the choke points in the oil economy. Track Rockefeller's reasoning that the oil drilling business had a low barrier to entry which encouraged thousands of companies to prospect for oil, but refining and transportation were choke points in establishing the commodity's value. Rockefeller turned his awareness into a business strategy by investing in oil refineries and negotiating volume discounts on railroad transportation of oil products. By controlling the movement and refinement of oil, Rockefeller controlled its value.

> "Technology for its own sake is not enough to make a profitable business."

As an investor, compare John D. Rockefeller's business strategy with the business strategies of Internet companies. Three companies stand out: Cisco Systems, Kleiner Perkins, and AOL. Cisco Systems dominates its industry because its routers are network architecture choke points. Kleiner Perkins dominates because its business relationships (technology sources, top management teams, and first-class underwriters) are Internet equity investment choke points. Finally, AOL's mastery of content production and consumer promotion gives it community choke points.

Assessing Internet Business - Three Frameworks

Anyone can be a more intelligent Internet investor. Three practical frameworks can increase your savvy: the "net profit retriever," the "Web business pyramid," and the "Web application pyramid." Each framework is designed to meet the needs of a specific audience. The net profit retriever is a framework for the Internet investor, the Web application pyramid serves the Internet business manager, and the Web application pyramid is a framework for the non-Internet business manager. To increase your Internet business intelligence, use all three. Even if you are not an Internet investor, these frameworks will help you understand the Internet's impact.

Making the Net Profit Retriever Bark

The net profit retriever is a golden retriever that has three nostrils, each trained to sniff out a distinct investment element of Internet companies - industry, strategy, and management. Every time the retriever finds a strong scent, it barks. Find an Internet company that makes the net profit retriever bark three times, indicating a worthy investment. The net profit retriever barks at:

- Economic leverage -Companies in the industry sell a product so important to its customers and in such scarce supply that they can charge a very high price. For instance, if an industry comprising ten companies controlled all the world's water supply, that industry would have virtually unlimited economic leverage.
- A closed-loop solution - The company provides all the service a customer needs to get the economic benefit of the product or service. In the water supply example, the company finds the source, purifies bottles, delivers water, stocks the water in your refrigerator and fills a glass with chilled water for you, thus providing a closed-loop solution.
- Adaptive management team - A management team that can adapt effectively to rapid change. If, for example, people decided to change their drinking habits from water to milk, how fast could the company's management team adapt and get a limitless supply of milk into the distribution channel? Agile companies have a management team that can adapt rapidly.

The Web Business Pyramid

The Web business pyramid has three levels:

1. Lossware - Web businesses that are destined to lose money comprise the bottom of the pyramid. They face a great deal of competition because entry barriers are very low. They spend money in an apparently endless loop of marketing. They often achieve competitive parity, without competitive advantage. Many do not survive this level and sometimes the entire industry segment disappears. An example of lossware competition is the Web browser business.
2. Brandware - This group of business has the potential to be profitable if the most heavily promoted brand survives and the weaker ones fold. Although the barriers to entry are quite low, consumers express little interest in sifting through different vendor offerings. Brandware customers tend to purchase from the vendor with the most compelling market message, who are perceived as being able to survive inevitable industry consolidation. Yahoo is a Level II brandware company.
3. Powerware - This refers to businesses that generate consistently high returns. Powerware companies are highly profitable because they enjoy economic leverage and offer customers closed-loop solutions. Their economic leverage comes from offering a product or service that is scarce because most competitors have been squeezed out. By offering closed-loop solutions, powerware businesses make the switching costs between vendors and customers high enough that new entrants are effectively prevented from entering the industry.

   "Web content firms must resist arguments that it is useful to give away content just because it can be delivered over the Web."

Sometimes brandware businesses can evolve into powerware businesses. Such movement occurred in venture capital, as business strategies resulted in economic leverage and closed-loop solutions.

The Web Applications Pyramid

The Web Applications Pyramid also has three levels.

1. Online brochures - This bottom-of-the-pyramid use places product literature, annual reports and other information traditionally in print form on a Web site.
2. Front-end transactions - The middle of the pyramid refers to gathering information for online orders and using that information in a non-integrated order-fulfillment process.
3. Integrated transactions - Top-of-the-pyramid applications integrate front-end transactions with back-office fulfillment processes. Companies such as Dell and Cisco lead the way in Level III Web Applications.

Internet Business Segments

Internet businesses are companies that derive some or all of their revenues through the Internet. The Internet business model includes nine distinct segments, each with unique competitors, customers, profit dynamics and requirements for competitive success. How does the net profit retriever react to each of these nine segments?

1. Net infrastructure company - The retriever likes Cisco. All three nostrils swell with good scents. The router is a choke point and, over the years, Cisco has leveraged it to generate high margins and high customer switching costs. Cisco's very strong adaptive management recognizes and purchases companies and technologies that might affect its highly leveraged market position.
2. Web consulting company - The retriever's nostrils flare for Sapient's aggressive market actions. By switching early to a fixed time/price billing, Sapient gained economic leverage over companies that continued time and materials billing. As its profits rose, customers perceived that they were receiving greater value from their relationship with Sapient. The company developed Web-based, closed-loop solutions. To sustain 60% annual growth rates Sapient's management has implemented an aggressive employee acquisition and retention program.
3. Internet venture capital industry - The net profit retriever barks three times. The industry rejects 99% of all business plans, thus gaining economic leverage. It builds management teams and arranges financing, thus providing closed-looped solutions. And, it moves rapidly into new business areas, such as technology, thus showing adaptive management. (If you mention Kleiner Perkins, the dog will bark again out of respect for John Doerr).
4. Internet security segment - The net profit retriever cannot even manage one bark. This industry does not have leverage. It may

yet be absorbed into network operating systems. The industry recognizes the need to provide closed-loop solutions, but no one provider has emerged as dominant. Finally, neither Checkpoint nor Network Associates' management has established adaptive abilities over time.

5. Web portal - The net profit retriever likes Yahoo, but cannot bark three times. The management of Yahoo has proven itself to be highly adaptable, moving the company from a search engine to major portal, but it has failed to provide all the elements of a closed-loop solution to its customers. This segment is awaiting final consolidation and until that occurs, it does not have the economic leverage to drive up advertising rates.
6. Electronic commerce - The net profit retriever barks twice for Amazon.com, but sneezes with its third nostril. Amazon makes it sneeze vigorously when it comes to closed-loop solutions and adaptive management. Alas, e-commerce does not have any economic leverage. When it comes to e-commerce and economic leverage, this dog don't hunt.
7. General technology consulting - The net profit retriever sneezes three times for general technology consulting Web-content companies, but runs away from general and Internet-only Web content companies. General technology consulting Web content companies, such as Gartner Group, have economic leverage, offer closed-loop solutions, and have adaptive management. General and Internet-only Web content companies, like CNET, fail on all three criteria.
8. Internet service providers - The retriever runs away without sneezing even once. The entire industry has no economic leverage, offers no closed-loop solutions, and - although some ISPs have shown an ability to adapt - the industry as a whole fails in this area too.
9. Web commerce tools - The net profit retriever fails to sneeze. This industry inherently lacks economic leverage and, by definition, offers open-loop solutions. Management adaptability across the industry has been mixed, with Macromedia and Sterling Communications being more effective than Open Market and Net Gravity.

Net Profit Principles

The Internet investor needs to use the net profit retriever to help determine which Internet companies present good investment opportunities. In using the retriever, remember the following principles and strategies. Apply them to the three criteria you are evaluating: economic leverage, closed-loop solutions, and adaptive management.

> "The recent evidence on click-through rates is not overly encouraging."

The seven principles of economic leverage are:

1. The Internet is not a broadcast medium.
2. Internet buyers behave differently than buyers influenced by other media.
3. Customers who purchase over the Internet are loyal to their own interests.
4. Barriers to entry are very low in most segments.
5. Mobility barriers are also low in most segments.
6. It is more profitable for Internet businesses to serve organizations than individuals.
7. Giving away products and services to build market share is a common strategy.

> "Competition among Web portals is not driven by technology considerations. The driving force behind the competition for eyeballs has to do with programming and promotion."

The five strategies favoring closed-loop success are:

1. Start with the market, not the technology.
2. Use Web technology to enable better business process.
3. Raise switching costs.
4. Build barriers to entry.
5. Create partnerships to get the capabilities to close loops.

> "A by-product of the investor loyalty resulting from effective brand management is a high market capitalization."

The five principles of effective adaptive management are:

1. Be paranoid.
2. Make the customer your firm's North Pole.
3. Managing growth depends on hiring and retaining smart people.
4. Banish the not-invented-here syndrome.
5. Be prepared to reinvent the company.

About the Author

Peter S. Cohan is a technology and business expert who runs his own consulting practice. He is a commentator on CNBC's *Today's Business* and *The Money Wheel* and is also the author of *The Technology Leaders,* voted one of the top ten business books of 1997 by Management General. Additionally, Cohan was bigtipper.com's Top Tipper of 1998, based on the leading performance of his CNBC stock picks. He lives in Marlborough, Massachusetts.