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A Summer Contemplation: Digital Extensions and Platform Businesses?

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The digerati (Amazon, Google, Facebook, Alibaba and so on) have been all over the news for the last few years for a number of reasons, including their extensions into all sorts of industries. The most recent example is Amazon's acquisition of Whole Foods. LEF's Bill Murray wrote about this, and even more recently about the digerati's forays into financial services.

Although they are clearly special cases – with super-deep pockets, amazing technical infrastructures, rich talent pools and powerful brands – we at LEF feel that they can give all of us clues to our potential futures. Bill Murray and Glen Robinson are writing now about the future of the IT organization drawing partly on digerati examples, but here we focus on a different angle: business extensions in the 21st century.

Let's take two very different businesses – a maker of sports shoes and a maker of car windscreens. Traditionally, how might they think about growing their top line? Typically, there have been five ways they might rationally think of extending:

1. **Do more of the same**. Fight for more market share, capture more customers, maybe extend into new geographies. Just like all the other examples here, this can be achieved organically or through M&A.
2. **A business line extension**. Extend the range of products and services by adding offerings that are adjacent to what you do already. For example, the maker of sports shoes might add socks and other sportswear, and the maker of car windscreens might expand its portfolio to include headlights and mirrors. This makes sense because your customers commonly buy those things, and associate you with this domain.
3. **A brand extension**. Enter businesses that are not similar in terms of product, but similar in terms of brand association. The maker of sports shoes may buy a sports team or open a sports venue. The windscreen company might move into markets associated with vision, like glasses.
4. **A capability-based extension.** Monetize the capabilities that you have in other ways. For example, the sports shoe maker may be able to make beds or some medical devices using some of their shoe-making infrastructure. The windscreen maker may be able to make TV screens. (Probably not, but it's just for illustration.)
5. **An opportunistic extension.** It may just be that an opportunity comes up – for example, the factory next door becomes financially distressed and needs a quick sell.

But how do businesses look to grow in the 21st century? How and where should companies look to expand in the next few decades? The short answer is that the five approaches listed above still make sense, but there are now two new considerations:

Digital extensions are a special case of capability-based extensions (item 4 above). Companies that have specific digital capabilities can often leverage them to extend into areas that otherwise wouldn't make sense. Amazon's move from online bookseller to online marketplace to cloud provider is a classic example here. Common capabilities that can be leveraged into other industries include digital infrastructure (either owned or in the cloud), information and analytics, and digital talent. About ten years ago, Dave Aron worked with a Telco in the former Soviet bloc that recognized it simply had the best IT people and data centres in its country, so began selling IT services.

Digital blue oceans and new business models refer to discovering/opening up whole new markets, serving previously unfulfilled customer wants or needs, and/or serving them in a completely different way. An example of the latter would be if a white goods company like Whirlpool or Haier shifted from selling individual products to selling 'house as a service', where you paid (say) $200 per month, and those companies provided you with fridges, freezers, dishwashers and washing machines, rightsized them, maintained them and upgraded them for you over time. They may also, with your permission, use the information they capture about your usage patterns to improve their products, tune their inventory levels and maybe even monetize separately. This pattern of moving from products to services, which we could call *servicization*, is a common pattern that could be applied to many B2B and B2C industries.

One of the most exciting of these patterns is the **platform business model**. Famous examples are Uber and Airbnb. Unfortunately, there is a terrific amount of hype and confusion about what a platform business is, and the word 'platform' is used in lots of other contexts, including technical platforms, which are related but by no means the same.

So what is a platform business?

A conventional business buys in raw materials/components from suppliers, processes them into its products and services, then sells them to customers. We may call such a business a *linear* business, because we can lay out the supply chain in a row: Suppliers → Company → Customers.

A platform business, on the other hand, facilitates value exchanges between two or more groups in an ecosystem. For example, a credit card business (such as Mastercard) is a platform business that facilitates value exchanges between merchants and consumers. A stock exchange facilitates transactions between buyers and sellers of shares. A (heterosexual) dating agency can be considered a platform business that facilitates meetings between men and women. iTunes is a platform for makers of content to exchange value with buyers of content. A car windscreen company might extend into a platform for buying and selling automotive parts.

As the examples above show, the notion of a platform business isn't completely new, but what is new is the ability to apply it in many more contexts, at larger scale, and sometimes in a more real-time context. eBay, Alibaba, Airbnb, Uber, iTunes/Google Play/App Stores are all famous recent examples of platform businesses.

Platform businesses are interesting and different in a couple of ways:

1. They operate a different economic model, called **two-sided** or more generally **n-sided economics**. Traditional linear businesses have a linear economic model: suppliers provide supplies at price X; the company incurs cost Y turning supplies into the end product; then sells the product to customers at price Z, and makes a profit of Z−(X+Y). The sports shoe company buys rubber and laces and machines for $20, spends $30 making and marketing the shoes, sells them for $100, and makes $50 profit. One long, linear value flow. A two-sided model is more complicated. Here there are two value flows. Mastercard may or may not charge you for having a card and will almost certainly charge you for credit you carry on the card; that is value flow one. It also charges merchants a few percentage points on every sale; that is value flow two. Depending on the precise business model, a platform provider (like Mastercard) may seek to make a profit off one or both value flows, or it may be happy to make a loss, provide services free, or even pay one side to subsidize the other side. A rather distasteful example, but a nightclub (also a kind of platform) may offer one gender (usually women) free entry whilst asking men to pay.

2. **Indirect network effects**. When you buy a sandwich, you don't care who else buys a sandwich. The value relationship is purely between you and the sandwich – the taste versus the price. But some products become more valuable to each person if more people buy it. Think of a proprietary videoconferencing system: if you're the only one that has one it's useless; if every office in your company has one it's quite useful; if every company in your ecosystem has one, it's extremely useful. The internet itself is a great example of network effects. Metcalfe's Law, named after the founding father of Ethernet (a networking protocol), states that the value of a network is proportional to the square of the number of participants in the network. Network effects change the economics considerably, making it imperative to get large numbers of users on a network, even if you make a loss on some or all of them initially.

But indirect network effects are even more interesting. In a two-sided economic model, the more participants in group B there are, the more value members of group A get from the network. So, for example, participating in the Mastercard, Visa or Amex merchant programme is much more valuable to merchants when there are more consumers using that platform. Similarly, consumers are much more likely to pay/participate in a credit card platform if they can use it in a wide variety of places. As the number of sides in a network increases, the indirect network effects become more and more interesting.

We can see examples of four archetypal platform business models in the market:

1. **Exchanges.** These enable buyers and sellers to meet. Stock exchanges and online auctions are good examples. The value that is provided by the platform is the bringing together of the parties, helping them find each other, establishing the ground rules of exchange, and in some cases underwriting the exchange. Consequently, participants in the platform may well need to jump through some hoops to be allowed in (for example, putting money in escrow and passing creditworthiness checks/audits).

2. **Transaction platforms**. These are similar to exchanges, but focus mainly on providing the mechanics for transactions to take place. In a very rudimentary sense, cash itself is a transaction platform; but credit card companies are perhaps a clearer example.

3. **Advertising-supported models**. Here, consumers of content get access to that content, often free or at a discounted rate, but receive advertising messages. This may be a two-sided model (if the platform provides the content) or a three-sided model (where content creators, content consumers and advertisers all exchange value through/with the platform). Many commercial TV station models are supported by advertising, as is much internet search, including Google.

4. **Technical platforms** such as software platforms. Technical platforms provide standards to make sure everything fits together, and building blocks that can be used to quickly create a solution. The shape and size of railway rails is a good example of standards, allowing the train industry to work. Microsoft Windows was very helpful to developers when it came along because they didn't have to create their own methods of displaying windows, managing mouse movements, and so on. It was also very helpful to PC users, because it meant that anything written to work with Microsoft Windows would work on their Windows PCs. Home automation platforms like Hive and Nest are great examples of platform businesses, as are cloud models, blockchain-based models, and IoT models such as GE's Predix and Amazon's Greengrass.

Dave wrote about *platformization* in chapter 53 of The Essence of Strategy.

For completeness, it is worth reflecting that platforms are not without their risks. Getting locked in to one platform is never a powerful position for consumers, players or even sometimes for the creators of platforms. Also, when platforms become too popular, the search costs in finding value partners within the platform can be more challenging (a diseconomy of scale) and performance in transaction platforms can suffer (a problem some blockchain-based platforms are suffering from at the time of writing). More subtly, platforms can limit the nature of your business transactions (in the way that Dave wrote about in a LinkedIn article, Jumping Off The Shoulders of Giants; or the Hidden Dangers of Platform Ecosystems).

So, the summer reflection is this: how might digital extensions and new business models, and in particular platform business, affect your organization's future?

- Could/should your business extend based on digital capabilities? If so, which capabilities – infrastructure, information or talent?
- Are there others from completely different industries who could cross over and disrupt your business based on their digital capabilities?
- Which parts of your business are susceptible to platform business models? Front/back/middle?
- Might you become a platform provider, player or consumer in part of your business identified as susceptible to platforms?
- If you are participating in an existing platform (as opposed to creating your own) which one(s) should you choose?
- Having looked at your answers to the above, what other capabilities, talent and resources do you need to experiment or move forward with your ideas?

Have a great summer, everyone.

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We believe that as business and IT become inseparable, virtually every aspect of work and the modern firm will need to be reimagined, and this creates exciting new digital opportunities.

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