The new economy is still reeling from the routging of the dot-com business. Many people feel a desperate need to make some sense of what has happened over the last 12 months. Simply calling it “collective madness” or “a speculative bubble gone over the top” just doesn’t feel very helpful. We want to know what actually happened so that we can learn from this experience for the future.

There are many observers on the sidelines telling us that they “told us so.” For example, Warren Buffet said in April 2000 that “the Internet will not create any more wealth than a chain letter.” But that was not the common view at that time. Most of us sympathized with Gary Hamel’s suggestion that “we must all become revolutionaries.” The overwhelming view was that this was a new era, not just a technological change, but a new economy – promising the unprecedented “Long Boom” that would benefit all.

One current view is that the speculation is over, and we are back to normal. This may or may not be true, but it is not much of a lesson to take forward. Too many people put their money where their mouths were to write this off as speculative madness. What were the “new economy” people thinking, and what went wrong with their model?

Another view, clearly not shared on the Nasdaq today, is that the Internet has not gone away. The current low point is the aberration – this is a “V-shaped correction” – and growth will resume shortly. Bob Metcalfe believes that there’s a new boom coming “which I currently place at approximately 2004.”

Others suggest we are looking in the wrong direction altogether. The Center for Research in Electronic Commerce at the University of Texas notes that by its measurement of the Internet economy, dot-coms represent less than 10 percent of those businesses measured in the research. Rather it is the use of Internet technologies by traditional companies that continues to drive growth in the Internet economy, leading to more jobs and increased revenue.

I suggest that the notion of the new economy put ideas in our heads of a marketplace with “new rules.” (Remember “first-mover advantage,” “increasing returns,” “feed the Web first,” “plentitude, not scarcity,” and so on?) These ideas led to business models based on “give-away” and “cash deficit.” We now know there were flaws with the way these ideas were applied. Maybe the time has come to try out Percy Barnevik’s suggestion that there always was only the one economy in which a new technology was trying to find its way. This raises the question whether the old and tested laws of economics provide any help in making sense of the last 12 months. I believe they do.

By looking at business ideas from a solid economic perspective, I believe it is possible to understand why many believed that there was so much value in this strange, new, profitless way of doing business, and what went wrong with it so quickly. To illustrate this I will take a micro-perspective on business, asking the basic questions around the sources of business success and how that success can be dissipated. I argue that the same basic success formula applies to both old and new
companies. Starting from there, but taking account of the very different dynamics of old and new business, will allow us to get some perspective on what we have just experienced.

**Back to basics – a generic model of the Business Idea**

Let's follow a budding entrepreneur who sets out to realize a dream that has been taking shape in his mind over some time. What is he actually thinking and how do these thoughts steer his actions toward success?

**Scarcity and customer value**

Value is associated with scarcity. In a market economy, surplus and profitability tend to disperse toward points of scarcity, away from points of abundance. This, in essence, is the economy's “invisible hand” that drives entrepreneurial initiatives to the bottlenecks in the system, the points of scarcity, forcing businesses to pay attention to unfulfilled customer needs and unrealized potential customer value. The new entrepreneur has such an idea in his head. He has identified a need that is either not met or is only partially met, and he has decided to make a contribution. For example, dot-coms saw such possibilities in new, more convenient market places, based on the new technology. Or, they associated value with the reduction in transaction costs, leading to the customer value of price transparency.

The successful, existing company has in principle the same interest. The difference between it and the entrepreneur's start-up is that, over time, successful companies tend to take the needs of their customers for granted. Many of them are often too busy keeping things going efficiently to worry about why customers continue to line up in front of “the shop.” However, in our dynamic world, what is a scarcity today may become an abundance tomorrow, and value will have moved to another place in the economic system.

Losing touch with customers and their value systems is a well-known hazard faced by old, established companies. For example, IBM in the early 1990s was late in seeing the need for distributed computing capacity evolving to the desktop. Microsoft initially missed the emergence of the Internet. The entrepreneur does not have this problem. Customers are his starting point.

**The entrepreneurial invention**

Recognizing potential customer value alone is not enough. The entrepreneur also needs to have an idea of how he is going to make a contribution toward relieving the scarcity. He is looking for a new way that will set him apart from the rest of the world and make him a preferred supplier. A successful entrepreneur will have invented an original product, something no one has thought of yet that will give him a unique position from which a scarcity can be alleviated and customer value created. For example, Netscape understood that the potential of the Internet could take off only if a powerful browser could be put on the desktop. Yahoo saw the potential value of a ubiquitous capability to quickly search a rapidly expanding Internet.

The ideas of “original invention” and “scarcity” actually go together. If the solution had been available already, others would have exploited it and the scarcity would no longer exist.

**The activity set**

Our entrepreneur is now ready to start the ball rolling. He will team up with a number of colleagues to create a management team, and together they will line up financial backing. They will then start the business and make the necessary investments in resources. In time, their offering will hit the market. This is the moment of truth – when the idea is tested in earnest for the first time. Although many start-ups do not survive this critical test, some do as evidenced by Southwest Airlines. The unique activity set Southwest's leaders invented is based on opening up new travel opportunities at low ticket prices, made possible by limited service, lean productive crews, high aircraft utilization, short-haul point-to-point routes between mid-sized cities, and frequent reliable departures. They never looked back. Let's assume our new company similarly hits the jackpot.

**Competitive advantage**

Success is based on inventing an offering that addresses a real scarcity in the world, charging a price for it, and inventing a way of making it available that is cheap enough to leave a high margin. This is the principle of competitive advantage. Michael Porter accordingly has argued that it can come from two sources:
(1) Producing a differentiated offering that constitutes new value customers cannot find elsewhere, and which will make them prepared to pay extra for acquiring the additional features.

(2) Producing a non-differentiated offering in a new way that allows it to enter the market at a new, structurally low cost.

For example, Southwest Airlines is primarily a cost leader. Amazon is trying to provide more for its customers, offering differentiated services that are not available in bookshops. B2B exchanges try to differentiate themselves by offering the largest markets to their customers, increased market size being a clear advantage to buyers and sellers.

Either way, differentiation or cost leadership will allow the new business to make a super-normal return, and in that way generate the resources to expand the business and reward the entrepreneur for his initiative. The process I have described is depicted in Exhibit 1.

**Investing in the future**

Our entrepreneur may be tempted to rest on his laurels at this stage and rake in the cash, much like many dot-com entrepreneurs have behaved. In fact, he may have created a “coup,” but he has not yet created a business. The business illustrated in Exhibit 1 is not sustainable. If it is successful, it will draw the attention of the world, and others will start thinking: “Hey, if they can do that . . .” Very quickly, the entrepreneur will see similar businesses popping up in the marketplace, engaging in increasingly severe competition. The favorable margin will come under pressure, and the number of good days will be limited.

An early example of this phenomenon in the PC business was Osborne Computers, makers of the first portable PC. Compaq decided it could do the same thing, maybe even slightly better. When Compaq appeared on the scene with a competitive product, Osborne had no defense and quickly went under. Dot-coms are very familiar with this series of events. Copying what others are doing is relatively easy in the digital world, and every good idea quickly has many followers. If there is one lesson in recent history, it is that a healthy business idea has to be based on two areas of attention:

(1) building the business; and
(2) protecting the business.

A successful entrepreneur has thought about how to protect an initial success and will act swiftly to put barriers in place in order to lock in the situation for himself.

**Distinctive resources and competencies**

Lock-in of a unique activity set and of the competitive advantage that comes from it is achieved by building distinctive resources and competencies not available to others. Some of these resources are hard assets, some are softer, such as embedded know-how. For example:

- Sunk investments in specific assets that have no productive use except for the business for which they have been made act as distinctive resources, since their opportunity cost is low or zero, creating a clear barrier for the potential competitor who still has to incur the full cost.

- A grocery store may protect itself against potential competition by acquiring a favorable site for its next store, where competitors cannot follow. A bus company may own the concession for a profitable bus line, or an oil company the concession for a cheap oil or gas reserve. Patents provide legal protection against competition and companies that have invested in them, such as pharmaceutical companies, enjoy a period of legalized monopoly rents.

- Similarly, a well-recognized brand constitutes a powerful lock-in device. There is real differentiation value for customers in not having to repeatedly scan the whole market to find an offering they can trust. However, building a brand is not a simple matter,
and requires a lot more than a financial investment, as many dot-coms have experienced recently.

- The “softest” competencies are often the most effective barriers, as they are the most difficult to emulate. Codified knowledge can be reproduced; uncodified, tacit knowledge can only be learned in a long and slow process.

A business that wants to survive needs to develop a virtuous (positive feedback) loop that feeds back some of the benefits of its unique performance into investments that maintain distinctive resources and competencies, allowing the firm to continue to operate a unique activity set from which competitive advantage is derived. The overall system, which we call a Business Idea, is shown in Exhibit 2.

A Business Idea is a representation of the underlying success formula of the firm. It has to be distinguished from a “business model,” which is a term used frequently to describe the interface between the business and its customers, and in particular how products are used as price carriers. The Business Idea is a more general, higher-level representation of the whole business and the way in which it makes (or intends to make) money.

There are two basic parts to the Business Idea:
1. the loop that ensures continued success and growth; and
2. the ongoing awareness of the evolving scarcities in society, leading to entrepreneurial inventions that keep the firm’s activity set in line with the dynamic needs of the world.

Some firms are highly entrepreneurial but forget to protect and grow the business through the positive feedback loop. Others become very much involved with organic growth but lose the art of maintaining the entrepreneurial link with the outside business environment. Both of these efforts will end in failure. Only the ongoing consideration of both parts of the success formula will create a business that can hope to survive the turbulent business environment of today.

The Business Idea includes a positive feedback loop. This means that if the idea is functioning appropriately it is a principle for growth. Most companies equate success with growth, but what can spiral upward can also move in the opposite direction. This is why most business leaders believe that “growth is not optional.” Not growing would put a business too close to the fine line separating success from failure.

**Application in the dot-com world**

**Increasing returns**

What about “first-mover advantages,” so popular in dot-com business plans? Being a first-mover won’t guarantee success. The advantage may be short-lived – until competition gears up – as experienced by Osborne. Thus, being a first-mover does not automatically provide barriers to entry; in the dot-com context, something more is involved.

When dot-coms talk about first-mover advantages, they try to suggest “increasing returns” in their business. Increasing returns arise in networks of communicating elements (often called “network effects”). If I am the only one owning a telephone, there is not much reason for other people to buy one. But the more people who own telephones, the higher the value for someone who doesn’t have one. This suggests a market with positive returns: the more we sell, the stronger the demand for even more. In older economics literature, these situations were called “natural monopolies,” but this term is not used much today as the word “monopoly” may be misleading.

**Network effects**

Let’s look at Microsoft’s Windows software. Strictly speaking, Windows is not a monopoly, as there are effective alternatives around, such as OS/2, Linux, and the Apple OS. However, Windows drives a general-purpose, software device. A customer may not know what software she will want to use on her PC in the future, but with Windows installed on the vast majority of PCs, the chances of software incompatibility is very small. However, if she goes for a minority system, such as Linux, it is quite likely that she will experience problems, so she does not really have an alternative. The more Windows is in use on PCs, the more value it represents for additional buyers.

A similar argument applies for communications between PCs. For practical purposes, we are locked into Windows, at least for now. This is the consequence of network effects, which apply as long as the world of desktop computing and operating systems is still subject
to fast development and there is no time for Windows “clones” to take off. Constant innovation is fundamental for Microsoft. As soon as this dynamic slackens off, we can expect competitors to jump in and take market share away from Microsoft.

Even at the top of the dot-com boom last year, it was possible, with a bit of imagination, to justify the values quoted, but this could be based only on very strong network effects. These effects may justify large, up-front investments in building market share (the “give-away economy”) to lock in the market and bring home the benefits of increasing returns and the associated monopoly rents.

It is now becoming clear that these benefits failed to arise because the conditions for network effects were not in place:

◆ Many dot-coms did not exploit any network effects at all, but simply set up shop in an alternative marketplace. For these businesses, there was no reason to believe that they would do any better than the old bricks-and-mortar variety. In fact, with emulation so much easier in the digital world, competition will be more severe.

◆ For many dot-coms, a network effect could be argued to exist, for example in B2B markets. If a market attracts more buyers, more sellers will find it attractive to offer their merchandise there. And with more sellers, buyers will be increasingly attracted to access the broader range and competitiveness of the offerings. However, it is increasingly clear that the value of this market-related network effect must not be overstated. As John Kay pointed out, this was demonstrated when the London stock exchange became part of a merger discussion in the context of which a value was placed on it. Many people were surprised to see the relatively low value assigned (around £500 million) especially as compared to the values put on B2B dot-coms at that time. Markets have a network value, but this value must not be over-estimated.

◆ Finally, B2Bs have not shown the degree of dynamic innovation that was part of the mechanism for creating increasing returns in the more successful networked markets, such as for Windows. It seems that a much more static state of affairs prevails than in the software industry, and, for this reason only, a more severe competitive environment must be expected. For example, Jupiter Media Metrix predicts that fewer than 100 of the existing 500 European B2B exchanges will survive.

Using the Business Idea to analyse your business
How can the concept of the Business Idea be used to rationalize the outlook for a newly conceived business? Its most important use is in raising important questions which, as history now shows, are not automatically on the agenda of the upstart business and its financial backers. The seven boxes in Exhibit 2 can help to identify these make-or-break questions:

◆ Understanding evolving needs in society. What are the scarcities in society we focus on? What is the customer value that generates revenue?
◆ The entrepreneurial invention. What inventive, original insight generated this business opportunity?
◆ The unique activity set. What are the unique activities that will create the customer value? What are we providing better than anyone else?
◆ The competitive advantage. What competitive advantage is being exploited? How do competitors do this? What is different?
◆ The results obtained. How is the financial surplus realized? What aspect of the offering is the price carrier?
◆ The strategic investments (in assets and learning). How do we sustain and grow our distinctive competencies over time? What specific investments do we make in distinctiveness?
◆ The distinctive competencies. What resources and competencies that we apply to create our unique activity set are ours alone? What is the system that binds our distinctive resources and competencies together?

A thorough strategic conversation focused on these questions, in which one of the participants plays the role of a tough “devil’s advocate,” will gradually build up a picture of the underlying Business Idea that is shared by the management team. The attention should not be focused on the hard quantifiable aspects of the business only. The softer, people aspects are often of greater importance in understanding the success formula. It is only when satisfactory ideas have been formulated in all boxes, both hard and soft, that moving forward with the business makes sense.

This discussion can focus on existing businesses or new business ideas. For the existing business, the value of this exercise relates to an increased focus on what matters most for the future. For new businesses, the value of a systematic thinking process ensures that all
important questions have been considered before big commitments are made.

It is important to realize the limits of the process. The conceptual success formula does not guarantee success. For example, the process may identify a particular network effect as the basis of the Business Idea and how it will be exploited. It does not tell us how big the network effect actually is. That requires research with real customers, answering questions such as:
- How big is the advantage experienced by a customer working in a larger, rather than a smaller, market?
- Are there any countervailing effects?
- What price premium may the market leader expect to realize?

Armed with that information the entrepreneur is then able to calculate how much he can invest in achieving the market share required. At that point, a judgement can be made on whether that represents a worthwhile investment. Good business planning remains important, but without a solid, underpinning business idea, the business plan is not much more than a piece of fantasy.

For example, let’s look at a business proposed by a couple of inventors after they acquired a patent on an invention that promises a more efficient process of producing printed-circuit boards. The scarcity and the original invention to address it are clear. The activity set points toward the need for a significant investment in selling the invention. The competitive advantage is obvious, based on comparing the cost of this process with its more expensive alternative. The inventors are convinced they have an excellent business proposition to show their VC advisers.

But when it comes to investments into the future of the business, the situation is less clear. There are no particular ideas to upgrade the invention and to safeguard the proprietary situation after the patent expires. Apart from the patent, there are no additional distinctive resources or competencies on offer that the business can be based on. The inventors have no ideas to offer on how elements can be added to the invention to extend the effective period of legal protection. The investors now must take into account that there are no strong reasons to believe that any competitive advantage will remain after the patent expires and must make a judgment on whether their investments will pay back before this happens.

**Conclusion**

The Business Idea provides a method to consider the future viability of a business proposition in all basic aspects that together make for longer-term success.

If many dot-coms had gone through a similar thinking process they may have discovered a few common flaws before committing themselves:
- over-estimation of growth in demand;
- severe over-estimation of network effects;
- ignoring the low barriers to entry;
- lack of ideas on protecting the business in the future.

Now that the boom is behind us and we have more realistic expectations of these value generators, it is important again to evaluate ideas on such terms that have stood the test of time.

**References and further reading**