Eleon Capital Management Ltd.

- MARKET OUTLOOK -

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NET ASSESMENT

DECEMBER

A 'network effect' exists when the value of a good or service increases as more people use the good or service. As each new customer or user is added, the willingness of all participants to use or pay for the network services increases. This is, in essence, what Warren Buffet was referring to when he purchased Apple stocks – he referred to the ecosystem that Apple stocks had created, viewing it more as a consumer goods company (with a significant large IT element) instead of an IT stock.

As investors, we are interested in situations where network effects are powerful and where a company can capture the economic benefits from them. Where a network effect for a company exists and is, in effect, durable and sustainable, such a company will generally exhibit high upfront capital expenditure and after that, low incremental capital expenditures, rapid sales growth, and rising margins as each total user or customer added has meagre incremental costs and high returns on invested capital.

'*Network* effect' generally can be the result of three categories: transactions, i.e. as more buyers and sellers join the network, the value grows; community networking, where the value derives from increased membership and the interactions or communications between them and the parallel services running concurrently with those interactions, for example, advertising; and complementary where the value derives through the availability of ancillary and complementary goods and services.

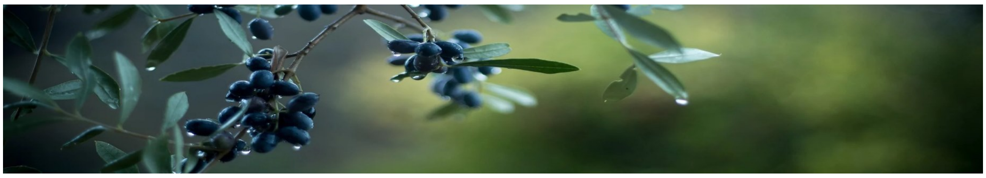
There is a general misconception that firms with the first-mover advantage will capture the bulk of the economic benefits of these network effects. Instead, it is generally those firms that get to critical mass first that are most likely to capture those benefits, provided there is no better alternative substitute for those services or goods. Most investors need to correct their understanding of 'network effects' to understand the durability and sustainability of 'network effects' and if they genuinely exist. Companies often capture or create some 'network effect' only to supersede it by some alternative competitor, rendering that 'network effect' obsolete. In this instance, the 'network effect' was transitory or illusionary. A firm's ability to lock in users or customers and high associated switching costs are key to a network business's sustainable competitive advantage.

Over the last year and a half, I have analyzed two investment propositions whose success or failure will largely be determined by their 'network effects' strength and durability. Both stocks are good businesses with a high return on investment capital (ROIC), decent growth prospects, highly cash-generative and perceived strong competitive advantages. Both stocks are IT-related, one focused on payment processing and the other primarily on advertising. Both stocks were in our investable universe and had significant share price gains. However, over the last two years, both saw significant share price decreases for various reasons, mainly due to growth and misallocation of capital concerns. This prompted my interest in the inclusion in our portfolios.

Year to date, one of the stocks has continued its downward trajectory, returning approximately -20%, whereas the other has seen a significant rebound, returning approximately 180%. Although the final verdict is still unclear, one possible explanation for their divergent performances could lie in the strength of 'network effects' and their growth prospects. A scuttlebutt investigation of each company indicated that for the one company, customers were largely attracted to its high and growing active user base and the high impact of reaching these users at a relatively low cost.

In contrast, for the other companies, users were mainly indifferent to the various means or products accessible to them to undertake their transactions. There appears to be a strong 'network effect' in the former, whereas in the latter, there is not. Provided the former company focuses on its core competencies. It is prudent in its capital allocation towards growth and should continue to prosper. In contrast, the latter needs to engage more actively with its customers to protect its network advantages.

In conclusion, 'network effects' are a powerful source of value creation and competitive advantage for companies that can harness them effectively. However, not all network effects are equal, and investors should be careful to distinguish between different types and sources of network effects and the potential threats and challenges they may face. A company that can achieve critical mass, offer a superior value proposition, and fend off competition and disruption will enjoy the benefits of network effects for a long time.   20 December 2023



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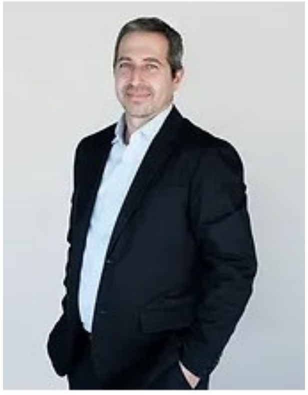

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