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## Zero Switching Costs Are Here

By Love Goel

Why did Google pay \$1.65 billion for YouTube? Why is Facebook valued at over \$10 billion? The same reason that Google outpaced Yahoo!, Facebook decimated MySpace, and Apple drove Sam Goody to bankruptcy. The same phenomenon that helped firms such as Amazon.com, AOL, eBay, and Dell come out of nowhere to dominate and then with equal speed lose their groove. You live by the sword, you die by the sword. That sword is zero switching costs.

Switching costs are familiar to most people. They are the penalty we pay in terms of hassle, inconvenience, and learning curve when we switch phone companies or laptops or Internet access providers. Many times we also pay monetary costs such as break-up fees, signing deposits, and gas, tolls, and parking expenses.

Companies have long counted on switching costs to keep us from ceasing to buy from or switching to the competition - a.k.a. churn. In fact, airlines and retailers often create loyalty rewards programs to reduce churn. At the same time, companies luring our business try to take the sting out of switching costs - and counter the rewards of the competition's loyalty programs - by offering discounts, fee waivers, or special rewards.

Zero switching costs, an economist's ideal where consumers can buy products and services from multiple vendors without paying penalties for doing so, is increasingly becoming a reality. The Internet has given customers access not only to more information about products and services but also to tools to help them efficiently find, compare, and buy these products and services.

Before e-commerce, a shopper might have driven 30 minutes to the mall, spent a few minutes more searching for a parking spot, then navigated store aisles looking for the right shelf before finally perusing the merchandise. He might then have ended up buying a shirt or a bedsheet or a toy even if it wasn't exactly what he wanted because he dreaded the prospect of investing time and money in the same process of driving, parking, navigating, and perusing all over again with no guarantee that he could find a better alternative at the next store. That repeated investment was the switching cost. But now the competition is just a click or a Google search away, eliminating the penalty for continuing to shop for the ideal item.

This new reality is creating a new set of customer expectations that in turn are requiring companies to re-create many aspects of their business, such as their "hook" - the reason customers shop or use products and services from them. The hooks can range from price (Wal-Mart) to convenience (Netflix) to selection (online shoe merchant Zappos) to video entertainment (YouTube) to customization (Dell) to utility (Google) to business model (eBay)... to myriad combinations thereof.

Getting this formula - the combination of product, price, promotion, personalization, postsale service - right for the target market and superior to the competition is the single most important determinant of a company's likelihood of survival and success in a world of zero switching costs. In the past, several companies in a category could rely on a hook that was 60% or 80% effective, because by the time customers made a purchase decision in a store they had already made an investment of time and money. It happened to me recently at Blockbuster. After spending 45 minutes picking out four DVDs, I was asked to sign up for a new membership because I had forgotten my card and it had been more than three months since I'd been there (even though I had my driver's license and two other forms of ID). It was company policy, the store clerk explained. Twenty minutes were wasted for him, me, and the 10 people in line behind me as he processed something that he had done a few months prior and that he knew was in the system. But nobody left the line, because we had already invested time finding the videos of our choice for the weekend.

Retailers, not just Blockbuster, mistakenly use revenue or new members as a proxy metric for customer relationships or loyalty. Nothing could be further from the truth.

It takes a zero-switching-cost world to find out what your customers really think about you. Once exposed to this world, established companies quickly discover that their brands, distribution, and capital are inadequate to win - as has happened to Blockbuster in its battle against Netflix. Those 10 people may have waited behind me in line that time, but it's safe to say that a number of them won't be waiting in a Blockbuster again any time soon - if ever.

Blockbuster isn't the only traditional merchant to suffer from the erosion of switching costs. IBM fell prey to Dell, jewelry store chain Zales to online jeweler Blue Nile, Sony to iPod, and MTV to YouTube.

We already know that category winners end up taking dominant market share globally - anywhere from 50% to 90%. More important, customers typically start their Web experience for particular categories at the industry-leading site, which raises the bar and makes it even more difficult and expensive for others to compete.

This lesson was learned the hard way by offline retailers who sell jewelry, video rentals, shoes, and music and by others who trade stocks or sell hotel reservations and airline seats: As many as 80% or more of such transactions now occur online. Some department store or specialty retailers might hide their heads in the sand because online sales account for only about 5% market share in some of the categories in which they compete. What they forget is that two out of three American shoppers research products, prices, and availability online before deciding which offline store to buy from.

This principle also underscores the need for continuous innovation from past winners such as Amazon, Dell, and eBay. Just like the companies from which they wrested dominance, these innovators of old cannot rest on their laurels, because the competition will take away business by providing superior customer experience at comparable or better costs. Now when the competition innovates, a company does not have just a bad quarter; it has a bad future or really no future at all unless it can at least catch up to, if not leapfrog, the competition. That's why Google, to preserve its dominance, has made a disproportionate amount of investment in research and development and innovation to stay ahead of the competition - and it has acquired YouTube, a category killer in its own right.

What's more, communication among customers is now free, quick, and viral. Not only can people e-mail family and friends about pet peeves and great finds, but they can also use the tools (bulletin boards, messaging) of a company (Friendster) to create a mass exodus to the competition (MySpace) as they did recently. Or they can post videos on YouTube to highlight the overheating of

Dell laptops by showing them catch fire, or post a recording of an AOL service rep frustrating a consumer's attempts to cancel subscription. The reverse holds true too, with customers waxing eloquent about the coolness of iTunes, BarterBee, or Digg.

Business, like life, is complicated. Simplistic, black-and-white constructs do not do justice to that complexity. But sometimes relatively simple concepts such as zero switching costs help us see the world a little more clearly than does, say, the prism of a kaleidoscope.

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