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Digital Business 2020: Getting there from here!

Commentary

Making Dollars & Sense of the Platform Economy

Making Dollars & Sense of the Platform Economy

By Anand Chandramouli

As market dynamics change, organizations must figure out how and where to plug and play with emerging platforms that create economies of scale and new forms of value.

Platforms are proliferating across industries at the speed of digital. Underpinned by the Internet, and powered by social, mobile, analytics and cloud technologies (aka, the SMAC Stack), platforms are upending long-held conventional wisdom about how markets work, the role of intermediation and transparency, and the variety of interactions and transactions they enable.

Platforms vary widely in their focus; while some support broad, horizontal markets, others target specific business functions or industry sectors. As they grow in stature, they empower both business professionals and consumers, and amplify trust by reducing informational asymmetry between market participants. Platforms also deliver a rich customer experience through digital technologies that immediately recognize market participants via their Code Halos,[1] and drive down the cost of service intermediation. In short, platforms are ushering in an economic shift, in which market participants win with scale and ubiquitous reach.

The growing popularity of platforms is tied to shifting economic assumptions caused by the digital economy. Consider the argument made by economist Ronald Coase in his seminal article "The Nature of the Firm,"[2] in which he examines the primary driver for forming partnerships and companies instead of trading bilaterally. In an inefficient market, he argues, it makes more sense to conduct business through a centralized company because it helps minimize transaction costs (hiring, negotiating, contract enforcement) for value creation.

Now, what if the market rigidities[3] and inefficiencies that made those economics compelling were to change? What happens when the transaction costs of exchanging value, outside the company, decline to below the company's in-house costs? In such a scenario, the economic rationale for the company ceases to exist. That's exactly what's happening amid the unfolding Code Halo™ economy and the emergence of open application programming interfaces (APIs) powering more transparent and digital markets. In this environment, the market is unbundling – and the centralized company concept is under siege.

A Micro-Platform Economy Emerges

This reality is fully apparent in the financial services industry, where sweeping changes (i.e., increased regulatory scrutiny, tightening profit pressures and inroads made by insurgent, nonbanking competitors) underscore the disruption of businesses with high in-house transaction costs. Industry segments such as payments, peer-to-peer lending, trading and personal wealth management are all being transformed by the dynamics of the platform economy.

Fidor, a German bank that originated after the 2008 financial crisis, is a textbook case of a bank-led suite of componentized financial services. By developing a core platform and a series of APIs, the mobile-only bank has generated a modular bank offering. While Fidor manages the customer interface, it partners with online loans company Smava to provide peer-to-peer lending; distributed financial technology provider Ripple Labs, Inc. to provide a cryptocurrency payment acceptance capability; and portal provider Sharewise to provide an equity investing and trading platform.

Beyond financial services, business functions such as human resources and related services are similarly becoming componentized through modern business platforms. Services such as recruiting, benefits administration, payroll, contract staffing, workforce analytics and even culture management are all being altered by platform approaches. For example, companies can blend the platform services of RealMatch Ltd. (recruitment), Zenefits (benefits management), ShiftGig (on-demand staffing), SyncHR (real-time HR operations data), CultureIQ (culture surveys and reporting tools) and Visier (workforce analytics) to devise an HR function.

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Platform Disruption

As platforms proliferate, they are disrupting long-held assumptions about how businesses and markets operate.

Here are a few areas experiencing the most change.

Periphery Becomes the Core

Platforms are changing traditional notions of businesses' core value propositions, often elevating formerly peripheral services and under-utilized assets to a central role. For example, Uber doesn't employ drivers or own cars, nor does fellow platform economy forefather Airbnb own rooms; both connect consumers with assets, bringing to market the untapped social, economic and environmental value of idle/under-utilized assets.[4]

Additionally, platforms make a virtue of non-core, peripheral activities. Consider the list of services Uber offers that traditional taxi services don't:

- Payment infrastructure that enables efficient transactions.
- Identity infrastructure, to screen out customers with negative credentials.
- Sensors that trace customers and cars in real time.
- A self-governing system in which riders and drivers who fall below a predetermined rating are reviewed, and corrective actions are initiated.

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With the advent of digital technologies, these services have become central to offering a rich service experience, making the traditional classification of core/non-core functions obsolete.

Atomization of Company Structure

Platforms also empower individuals to do what it used to take an entire enterprise to accomplish. As technology drives down transaction costs, platforms are delivering physical services by atomizing company operations (i.e., deconstructing organizations into their smallest elements). Today, the individual can and has supplanted the company, thanks to the operating efficiencies enabled by the digital ecosystem.

Platforms augment individual capacity with appropriate tools, making a "franchise of one"[5] an operating reality. Consider Zopa, a peer-to-peer lending platform on which individuals are financiers, and Kickstarter, a crowd-funding platform for new projects, on which individuals are the angel investors.

As digital technologies take root, the agency of the traditional company will give way to the agency of the individual. An atomized company is a logical extension of an atomized society, mirroring individual aspirations, one in harmony with the other.

Democratization of Information

Platforms also overturn another long-standing problem of inefficient markets: unequal access to information. Information asymmetry between buyers and sellers tends to distort free markets and buyer behavior, eventually leading to market failure. In "The Market for Lemons,"[6] economist George Akerlof describes how information asymmetries prevent the efficient exchange of mutually beneficial goods and services, using the example of used car markets.

In a used car market, buyers lack adequate information to distinguish the lemons (bad cars) from the plums (good cars), leading them to view every car with suspicion and decreasing their willingness to transact. This, in turn, distorts the seller's behavior, who is discouraged from selling higher quality cars. Over time, information asymmetry leads to an adverse selection process, driving out the plums and leaving the market with a profusion of lemons.

Likewise, information asymmetry also leads to moral hazards. In an asymmetric field, the better-informed party would exploit asymmetries to profit in a dishonest way. Asymmetry of information ultimately scorches the market, forcing governments to enact consumer protection regulations.

Successful platforms, aided by digital technologies, have to a large extent overcome the problem of information asymmetry by increasing information transparency, and building in reputational mechanisms (such as rating systems, feedback opportunities and provider profiles) to create trust.Such reputational mechanisms are not perfect, of course; coarse or biased reputation measures can prevent buyers from making proper inferences, or buyers may form opinions based on a single transaction experience.[7] In other cases, sellers may manipulate their reputations by underpricing.[8] On balance, however, the use of reputational mechanisms can help

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platforms identify and promote quality sellers,[9] and well-designed reputation mechanisms can substantially improve transaction efficiency.[10]

As platforms begin to make inroads into delivering sensitive and critical services, information asymmetry in business processes present an opportunity for digital entrepreneurs.

Platforms Shape Next-Generation Business Models

Scale and a near-monopoly market share is in the DNA of these platforms. There's no second Amazon in sight, and the valuation difference between Uber (at $62.5 billion[11]) and Lyft (at $5.5 billion[12]) – as well as Alibaba's number one position in China and WhatsApp's global market share in text messages – underscores how the network effect creates big winners.

To achieve platform dominance, or at least set out on a mission of disrupting the next set of services, we believe organizations need to consider the following:

- **Transaction costs matter.** Always look for the total transaction costs to deliver any service. Lower transaction costs drive the migration of services from traditional companies to networked platforms. Strive to lower the barriers to entry for suppliers (service providers) and customers to drive down costs.
- **Peripheral services can make a difference.** In the digital world, as interactions complement transactions, value is created at the point of use. What's considered to be a peripheral or non-core service will increasingly make a difference. Look out for areas in which non-core services can be turned into delighters with digital technology.
- **Atomize the company.** Reducing the entry barriers for suppliers will result in atomization of operations. Through atomization, organizations give agency to the individual and unleash the flexibility and dynamism of the "franchise of one," while reducing transaction costs.
- **Information asymmetry.** Look for businesses/processes plagued by information asymmetry. Those are the sweet spots, ripe for disruption with digital platforms. Successful platforms through real-time reputation mechanism have to a large extent addressed this problem and made a big difference.
- **Open APIs fuel platform companies.** APIs enable the digital ecosystem of platforms. While APIs save time and cost, watch out for the downside risks. What if the company shuts down the APIs your app/platform depends on? With a smart risk-adjusted business model, APIs are game-changers.
- **Platforms shape the business model.** Be agile, and be open to build/buy/rent/partner decisions.
- **Winner takes it all.** History shows there's no silver medal in the platform race. The winner tends to take it all. Participants need to pick a sweet spot and go for the kill.

Note: Code Halo™ is a registered trademark of Cognizant Technology Solutions.

Footnotes

[1] For more insight, read our book *Code Halos: How the Digital Lives of People, Things, and Organizations are Changing the Rules of Business*, by Malcolm Frank, Paul Roehrig and Ben Pring, published by John Wiley & Sons, April 2014, www.wiley.com/WileyCDA/WileyTitle/productCd-1118862074, or visit our website, https://latestthinking.cognizant.com/code-halos.

[2] Ronald Coase, "The Nature of the Firm," 1937, http://www3.nccu.edu.tw/~jsfeng/CPEC11.pdf.

[3] Market rigidity implies that current pricing doesn't reflect changes in supply and demand, and that something is standing in the way of market balance.

[4] The power of technology to unlock the social, economic and environmental value of under-utilized assets is an underpinning principle of the collaborative economy, according to Rachel Botsman, founder of The Collaborative Lab, http://rachelbotsman.com/thinking/.

[5] The term "franchise of one" refers to sole proprietorships that through digital technologies appear as full-fledged, vertically integrated companies.

[6] George A. Akerlof, "The Market for 'Lemons:' Quality Uncertainty and the Market Mechanism," *The Quarterly Journal of Economics*, Vol. 84, No. 3., pp. 488-500, August 1970, http://www.jstor.org/stable/1879431?seq=1#page_scan_tab_contents.

[7] Chris Nosko and Steven Tadelis, "The Limits of Reputation in Platform Markets: An Empirical Analysis and Field Experiment," National Bureau of Economic Research, January 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2548349##.

[8] Ying Fan, Jiandong Ju and Mo Xiao, "Losing to Win: Reputation Management of Online Sellers," Ideas, February 2013, https://ideas.repec.org/p/red/sed013/192.html.

[9] Chris Nosko and Steven Tadelis, "The Limits of Reputation in Platform Markets: An Empirical Analysis and Field Experiment," National Bureau of Economic Research, January 2015, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2548349##.

[10] Gary E. Bolton, Elena Katok and Axel Ockenfels, "How Effective Are Online Reputation Mechanisms? An Experimental Investigation," *Management Science*, May 2002, http://pubsonline.informs.org/doi/abs/10.1287/mnsc.1030.0199?journalCode=mnsc.

[11] Eric Newcomer, "Uber Raises Funding at $62.5 Billion Valuation," Bloomberg Technology, Dec. 3, 2015, http://www.bloomberg.com/news/articles/2015-12-03/uber-raises-funding-at-62-5-valuation.

[12] Eric Newcomer, "GM Invests $500 Million in Lyft," Bloomberg Technology, Jan. 4, 2016, http://www.bloomberg.com/news/articles/2016-01-04/gm-invests-500-million-in-lyft-to-bolster-alliance-against-uber.

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