



HARVARD | BUSINESS | SCHOOL

DOCTORAL PROGRAMS |

DISSERTATION ACCEPTANCE CERTIFICATE  
(To be placed in First Library Copy)

The undersigned, approved by the Chair of the Doctoral Programs, have examined a dissertation entitled

**Strategies to Grow Network Goods**

presented by **Tina Tang**

candidate for the degree of Doctor of Business Administration and hereby certify that it is worthy of acceptance.

Signature.....  
*Michael Luca*

Michael Luca, Chair

Signature.....  
*Marco Iansiti*

Marco Iansiti

Signature.....  
*Ramon Casadesus-Masanell*

Ramon Casadesus-Masanell

Signature.....  
*Hong Luo*

Hong Luo

Date.....  
*9/10/15*

This Page Intentionally Left Blank.

# Strategies to Grow Network Goods

A dissertation presented

by

Tina Tang

to

Harvard Business School

In partial fulfillment of the requirements

for the degree of

Doctor of Business Administration

In the subject of

Technology Operations Management

Harvard University

Cambridge, MA

September 10, 2015

Copyright 2015 Tina Tang

All rights reserved.

# Strategies to Grow Network Goods

## Abstract

A network good is a product or service which becomes inherently more valuable as its adoption increases. The mechanism driving this value varies by context: for example, a software ecosystem produces more software as the installed base of its consumers and developers grows; the quality of content improves as a information aggregator collects information from more users; and the liquidity of an exchange-traded product increases as more investors trade the product. I begin my thesis with a puzzle: why are new network goods more likely to succeed in some markets than others? I show, both via a formal model and empirical analyses, that the likelihood of a network good's success depends on structural features of the innovation and its market. Tailoring entry and growth strategies to fit these features present new opportunities for established firms and entrepreneurs.

# Contents

<b>1</b>	<b>Acknowledgments</b>	<b>vi</b>
<b>2</b>	<b>Introduction</b>	<b>1</b>
2.1	Motivation . . . . .	1
2.2	How Network Goods Grow . . . . .	2
2.3	Research Scope . . . . .	4
<b>3</b>	<b>Classic Theories of Network Goods</b>	<b>5</b>
3.1	Network Effects and Coordination . . . . .	5
3.2	Barriers-to-Entry in Network Markets . . . . .	7
3.3	Growth of Network Goods . . . . .	7
<b>4</b>	<b>Lean Entry in Network Markets</b>	<b>12</b>
4.1	Introduction . . . . .	12
4.2	Model . . . . .	13
4.2.1	Consumers . . . . .	13
4.2.2	Firm . . . . .	16
4.2.3	Assumptions . . . . .	17
4.3	Relationship Between Network Structure and Growth . . . . .	19
4.4	Core Result of Lean Entry . . . . .	24
4.5	Strategic Implications . . . . .	25
4.5.1	When to Use Lean Entry . . . . .	26
4.5.2	Lean Entry in Real-World Networks . . . . .	29
4.5.3	Diffusion and First Mover Advantage . . . . .	36
4.6	Discussion . . . . .	37
<b>5</b>	<b>First Mover Advantage of Exchange-Traded Products</b>	<b>39</b>
5.1	Introduction . . . . .	39
5.2	Literature . . . . .	40
5.3	Empirical Design . . . . .	41
5.3.1	Data . . . . .	41
5.3.2	Summary Statistics . . . . .	43

5.3.3	Hypotheses . . . . .	49
5.4	Results . . . . .	51
5.5	Discussion . . . . .	58
<b>6</b>	<b>Growing Digital Content: the Case of Yelp.com</b>	<b>60</b>
6.1	Introduction . . . . .	60
6.2	History of Content Generation on Yelp . . . . .	60
6.3	Data and Hypotheses . . . . .	65
6.4	Results . . . . .	67
6.5	Discussion . . . . .	79
<b>7</b>	<b>Summary and Conclusion</b>	<b>80</b>
<b>8</b>	<b>Appendix</b>	<b>86</b>
8.1	Lean Entry in Network Markets . . . . .	86
8.1.1	Proofs . . . . .	86
8.2	First Mover Advantage of Exchange-Traded Products . . . . .	94
8.3	Growing Digital Content: the Case of Yelp.com . . . . .	105

# 1 Acknowledgments

I'd first like to thank my Dissertation Committee.

Marco Iansiti, you have been a part of my growth as a doctoral student from the very beginning. You helped shape my general interests and brought in a unique perspective spanning the boundary of academia and technology businesses. You were generous with your time and always pushed me to accomplish more. Your steadfast belief in my work has been an incredibly motivating force.

Ramon Casadesus-Masanell, you fundamentally influenced my thinking of Strategic Management theory. You enthusiastically reviewed my drafts and equations, responding to questions and half-baked ideas with remarkable speed and insight. You gave me opportunities to work on projects that shaped me as a scholar, and introduced me to the larger community of Strategy scholars which I will forever be grateful.

Hong Luo, you were instrumental to helping me develop clear thinking. From you I learned to be perpetually curious and ask questions that gets to the heart of complex subjects. I found your perspicacity and dedication deeply inspirational. Thank you so much for sharing your ideas, time, and energy.

Michael Luca, my committee chair, I couldn't have done it without you. You helped me with so many essential milestones: polishing my identity as a scholar, navigating the job market, meeting other members of the academic community, and pushing my papers to completion. Your clear thinking, amazing generosity, and high standards helped make this a success.

I'd like to thank the faculty and staff at Harvard Business School for their kindness and generosity in guiding my way. Acknowledgments are owed to Professor Lauren Cohen, who gave me rare and unique opportunities to advance my research on exchange-traded products; Strategy professors Andrei Hagiu, Eric Van Den Steen, Cynthia Montgomery, and Dennis Yao, who read my drafts; TOM Professors Karim Lakhani, Ananth Raman, Shane Greenstein, Mike Toffel, Pian Shu, and Feng Zhu; Jen Mucciarone from the doctoral programs who has been a valued friend and advisor; and the assistants and staff at HBS who made it a pleasure to work there.

Last but not least, I'd like to thank my family for their tireless support throughout this process. It hasn't always been easy, but because of you it's been fun. Rosen, Jeff, Mom, and Joey, I love you. I can't thank you enough for the work you have put into this journey and me.



## 2 Introduction

### 2.1 Motivation

What do innovations such as digital content aggregators, software ecosystems, and exchange-traded products have in common? They are all examples of network goods. A network good is a product or service which becomes inherently more valuable as its adoption increases. The mechanism driving this value varies by context: for example, a software ecosystem produces more software as the installed base of its consumers and developers grows; the quality of content improves as a information aggregator collects information from more users; and the liquidity of an exchange-traded product increases as more investors trade the product. Despite their variety, many network goods exhibit common patterns of market entry and growth, suggesting the potential for management and economics research to inform innovators in network industries.

Both technological and economic forces drive the need for new research. The prevalence, significance, and variety of network goods have risen exponentially in the last decade. The mid 2000's saw the introduction of technologies such as social media platforms, smartphone applications, and crowdsourced systems enabling society to connect, share information, and transact more efficiently. Along with these technological changes, changes in the distribution of company size and industry structure have transformed the business landscape. Since the dot-com bust of 2000, entrepreneurship rates in the technology sector have actually declined and average firm size has increased, in no small part due to the scale economies of network goods.

I begin my thesis with a puzzle. Why do new network goods succeed more frequently in some markets than others? For example, it is rare for new market exchanges and software systems to displace an incumbent technology, yet entry of new goods happens relatively frequently in markets for social media, communication technologies, and other digital technologies. Case studies of the former type include consumer marketplaces such as Ebay, Craigslist, and Amazon, financial exchanges such as NYSE and Tokyo Stock Exchange, and operating systems such as Microsoft Windows; case studies of the latter include Facebook, Twitter, Skype, and WhatsApp.

Though the management and economics literature on network goods dates back to classic industrial organization theories of the 1980's, relatively little consensus has emerged on a unified, empirically tested theory to address this puzzle. To fill the gaps, I draw on existing economic theory, extend the theory with a novel modeling approach, and enrich the theory through empirical analyses. A persistent theme throughout my thesis is that network goods can be highly dissimilar, and thus explaining phenomena with a simple, unified theory is both challenging and impractical. However, with new quantitative tools and data

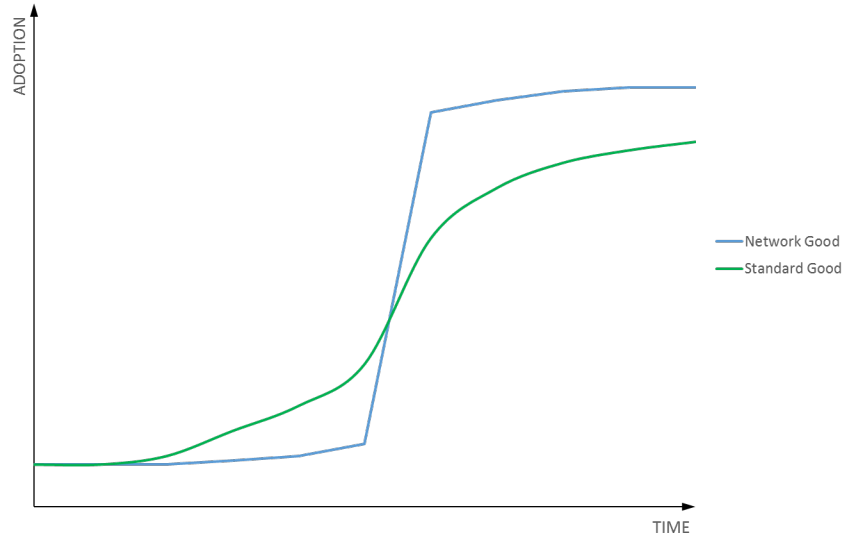
at our disposal, we can nonetheless distill flexible frameworks to explain and predict a surprising number of real-world cases, spanning the realms of technology to financial innovation.

## 2.2 How Network Goods Grow

A definitive feature of a network good is that adoption by one consumer creates a positive externality, conferring net positive utility from himself to all other current and future adopters of the good. Economists have dubbed these externalities “network effects,” goods exhibiting network effects “network goods,” and markets of adopters of these goods “network markets.” A firm producing a network good must coordinate consumer adoption to enter a network market. If there are other goods and firms in the market at the time the firm enters, it must compete with these incumbents in order to grow.

Economic theory suggests that network goods grow differently from standard goods, the key difference being the network good’s discontinuous growth trajectory as opposed to the s-curve growth trajectory of a standard good (see figure below). Discontinuous growth occurs when the market “tips,” or quickly transitions from adoption of one good to another. The logic is as follows: if enough consumers decide to coordinate on adoption of a new good, it becomes much more valuable due to network effects, and adoption snowballs. Market tipping allows an entrant good to displace an incumbent good. By the same token however, tipping favors incumbents if the entrant cannot build enough early momentum. This dual nature of a network good’s growth has also been dubbed the “winner-take-all” phenomenon.

Figure 1: Growth of network vs. standard good.



Recent economic research suggests that though markets are not always winner-take-all, they nonetheless exhibit patterns of discontinuous growth. When consumers have different taste preferences for the new and old goods or network effects are non-uniform, goods can coexist even if the majority of the market adopts one good <sup>1</sup>. Indeed economic theory suggests there are a multitude of stable market shares (“equilibria”) that can manifest in a network market, and goods can grow discontinuously from one equilibrium to another.

Thus from a potential entrant’s perspective, the question of how to grow a network good becomes exceedingly complex. Given a cornucopia of equilibrium outcomes, what strategy should a firm employ? Two distinct entry strategies have been popularized by technology entrepreneurs, the first during the dot-com era and the second around the wave of digital innovation in the mid 2000’s. The first strategy involves a “go-big-or-go-home” approach and is currently believed by management scholars to be the optimal strategy to enter network markets. Such a strategy often involves large investments in marketing and infrastructure to build demand-side or supply-side economies of scale, internet startups Ebay and WebVan being perhaps the most famous examples.

The second entry strategy, which I research in this thesis, involves minimal early investments in marketing and infrastructure development and results in a gradual and contained growth trajectory. For example, Facebook employed a strategy of contained growth during its early years by limiting adoption to university campuses before opening to the world at large. Since network goods grow discontinuously, a strategy which

<sup>1</sup>To take smartphone operating systems as an example; at the time this is written approximately 80% of global smartphones consumers have adopted Google’s Android platform, but there nonetheless remains a healthy 15% minority which prefers Apple’s iOS

purposefully contains this snowball effect is counterintuitive and seems unlikely to succeed. My thesis shows that such a strategy can nonetheless be successful given certain features of a network market and good. For ease of reference, I shall refer to the second entry strategy as “lean” entry throughout my thesis, and the resulting growth trajectory as “diffusion,” as opposed to tipping.

## 2.3 Research Scope

Some definitions are in order before proceeding. First, we must define growth. The concept of firm growth in management scholarship dates back to Penrose’s theory of the firm (1959) and Schumpeter’s theory of “creative destruction” (1961). My thesis does not aim to make predictions about growth of a firm or industry, a far more complex and ambitious topic than the growth of a single good. Moreover, I often take the perspective of the entrepreneur producing a single good, for which firm and good growth are inextricably linked.

To measure a network good’s growth, one might track a number of performance variables, including adopter growth, product growth, revenue growth, and profit growth. While I focus primarily on adopter growth, the metric for growth is formally defined when presented in context.

Regardless of how growth is measured, for a good to grow, a firm must first enter a market, attract an increasing number of adopters over time, and prevent incumbents or new entrants from eroding its market share. Thus any theory of entry and growth must answer the following 3 questions, addressed in the scope of this thesis:

1. How can a producer of a network good successfully enter the market?
2. How can a producer of network good attract an increasing number of adopters over time?
3. How can a producer of a network good sustain adoption and/or erect barriers against incumbents and new entrants?

A fourth and final question, outside the scope of my thesis but equally important for growth, is how a producer of a network good can grow the total size of the market. As we shall see in context, growing the total size of a network market does not necessarily invite entry <sup>2</sup>. In network markets, the dynamics of market and industry growth may disproportionately benefit incumbent goods, thus placing further urgency on questions 1-3.

---

<sup>2</sup>In contrast with markets studied in the classic empirical industrial organization literature such as Bresnahan and Reiss (1991) who find that towns with larger populations invite more entry of service providers such as doctors, dentists, druggists, plumbers, and tire dealers.

To answer the questions above, I present a set of three self-contained research papers whose methodologies and results mutually inform each other. The first paper proposes a novel theoretical framework to explain the puzzle of disparate patterns of entry in network markets. The second and third paper presents contrasting empirical contexts of two network goods: one a financial innovation, and the other a digital innovation. Finally, the conclusion interprets the empirical results of papers two and three in the context of both classic and novel theories of network goods. The first paper appears in chapter 4, the second in chapter 5, and the third in chapter 6. The conclusion appears in chapter 7. I begin my exposition with a brief overview of the existing literature on network goods in chapter 3.

### 3 Classic Theories of Network Goods

The industrial organization and strategic management literatures have established several stylized facts of network markets. First is that network effects cause consumers to play a coordination game when making adoption decisions: for a new network good to successfully enter the market, some consumers must adopt it simultaneously (coordinate). Second, when there are switching costs, such as technology lock-in, search costs, or transaction costs, this need for coordination creates barriers-to-entry which makes entry for newcomers very difficult. Third, network goods tend to have discontinuous growth trajectories marked by rapid success or failure (“tipping”), rather than the diffusion s-curve typical of many other innovations. I now explain in further depth our current state of knowledge and the intellectual gaps my thesis attempts to fill.

#### 3.1 Network Effects and Coordination

Classic theories of network effects show that consumers coordinate on the adoption of a single, or few dominant network goods. In the simplest model of a network market proposed by Farrell and Saloner (1986) [15], adoption consists of a game where a consumer in the market can adopt either an old or a new network good (for example, an old versus a new technology). Since a good becomes more valuable as its adoption increases, rational consumers necessarily coordinate either on the old good, an outcome which the authors call consumer inertia, or coordinate on the new good, which the authors call consumer momentum.

For example, consider the following static game with two players, illustrated in normal form. Since coordination yields an additional  $\alpha$  units of utility over a good’s intrinsic value of  $x$ , the game’s equilibria consist of “adopt good A,” “adopt good B,” or mix between A and B with 50% probability. Only the first two equilibria are stable. One can easily generalize this game to one with  $n$  players, yielding stable equilibria

“all consumers adopt good A” and “all consumers adopt good B.” The dual nature of equilibria reflects the “winner-take-all” phenomenon, where consumers eventually converge on a single dominant good, despite the fact that its competitor may have equal or even greater intrinsic value [28] [29].

		PLAYER 2	
		A	B
PLAYER 1	A	$x+\alpha, x+\alpha$	$x, x$
	B	$x, x$	$x+\alpha, x+\alpha$

**Example 3.1.**

More recent economic theory shows that many network markets are not winner-take-all. If consumers have differing preferences, that is some consumers have intrinsic utility  $y < x$  for good A while others have  $y > x$ , then goods A and B can coexist and there are multiple equilibria market shares. However, coordination still occurs. Indeed, in the revised game below, all consumers with higher preference for good A will coordinate on good A, and all consumers with higher preference for good B will coordinate on good B, as long as the fraction of consumers who prefer A versus B are approximately equal (precisely, between  $\frac{1}{2} - \frac{y-x}{2\alpha}$  and  $\frac{1}{2} + \frac{y-x}{2\alpha}$ ).

		PLAYER 2				
		Type 1		Type 2		
		A	B	A	B	
PLAYER 1	Type 1	A	$y+\alpha, y+\alpha$	$y, x$	$y+\alpha, x+\alpha$	$y, y$
	B	$x, y$	$x+\alpha, x+\alpha$	$x, x$	$x+\alpha, y+\alpha$	
	Type 2	A	$x+\alpha, y+\alpha$	$x, x$	$x+\alpha, x+\alpha$	$x, y$
	B	$y, y$	$y+\alpha, x+\alpha$	$y, x$	$y+\alpha, y+\alpha$	

**Example 3.2.**

These examples illustrate that consumer coordination is a fundamental feature of network markets. The outcome of competition may not be winner-take-all; but, as we shall see below, market shares usually favor the incumbent. This is due to switching costs, which a consumer incurs when switching from a good they have already adopted to a new good.

## 3.2 Barriers-to-Entry in Network Markets

Though consumers are unbiased toward the new or old good in a frictionless market, they tend to coordinate on incumbent goods when it is costly to switch to new goods. In other words, coordination acts as a barrier-to-entry in the presence of switching costs [16]. To understand this, consider that in the first game above, any positive cost  $\gamma > 0$  of adopting good  $B$ , corresponding to payoffs  $(x + \alpha - \gamma, x + \alpha - \gamma)$ , will render “adopt good A” a unique equilibrium.

Switching costs tend to be common in network markets, especially when there is learning or search associated with adopting new goods. They may lead to a net utility loss for consumers despite the utility gain from network effects, if a dominant good is inferior to barred entrants. For example, I show in section 5 that startup exchange-traded products generally fail to gain traction in markets with incumbent ETPs, despite offering lower prices (expense ratios) and identical quality (fund composition).

The strategic management literature has suggested several “go-big-or-go-home” strategies to overcome these barriers-to-entry. Examples include preannouncing a product before it is released [30], using penetration pricing [48] [19], bundling with existing goods [13], or investing in product quality [49]. All involve building early demand-side economies of scale from actual or expected adopters. As a consequence, they tend to be capital-intensive, and are not always feasible or profitable in practice.

## 3.3 Growth of Network Goods

Classic theories of network effects show that adoption of network goods grows discontinuously rather than follows a standard diffusion s-curve [10]. However, discontinuous growth, or tipping as it is sometimes called, generally *will not* occur if early adoption falls below a critical mass [14]. This has lent additional support for the large-scale entry strategies described above.

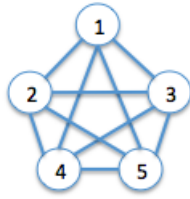
Only recently have scholars pointed out that models from the classic theory rely on a crucial assumption: that externalities have homogeneous or “global” network structure. Examples of homogeneous network structure include, in the language of graph theory, a “complete” network where every consumer (node) is linked to every other consumer (node), and a bipartite network containing two sets of consumers, with edges distributed evenly between the two sets<sup>3</sup>.

---

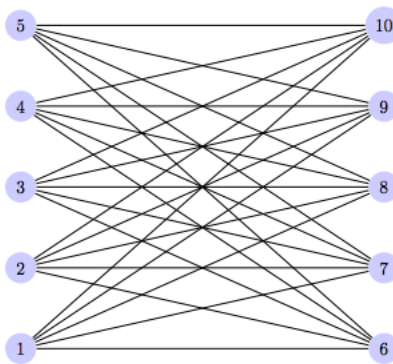
<sup>3</sup>In this thesis I consider only bipartite networks where every node on one side is linked to every node on the other side.

**Example 3.3.** *Graphical Examples of Network Markets*

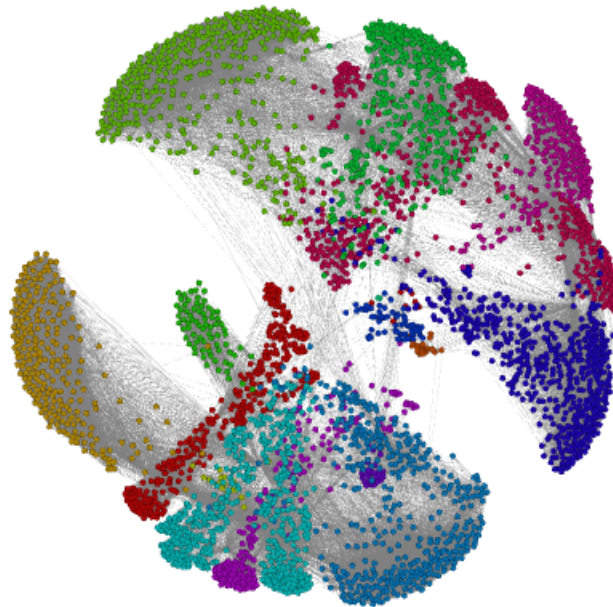
*A Complete Network with 5 nodes*



*A Bipartite Network with 10 nodes*



*An Incomplete Network (Data from [34], visualized with Gephi)*





The assumption of homogeneous network structure has remained unchallenged in part because it accurately reflects the nature of many network goods. For example, externalities generated by transaction-driven goods such as market exchanges are approximately similar to the structure of a bipartite network. A key feature of transaction-driven network goods is the anonymous nature of consumer interactions; this is what creates structural homogeneity in the distribution of links between consumers.

In contrast, interactions for socially-driven network goods are not anonymous. For example, consumers using a social media platform benefit from adoption of only a subset of other consumers, i.e. their friends. In this case externalities have network structure which is “incomplete” or “local”: containing communities of consumers, varying node degrees (number of links), and other heterogeneous structural features. The figure in Example 3.3 depicts an actual friendship network from social media platform Facebook.

Example 3.4 illustrates case studies of successful transaction-driven versus socially-driven network goods and their respective entry (launch) strategies. While purely anecdotal, it is nonetheless interesting to note that entry strategies differ widely between transaction-driven and socially-driven network goods. In particular, “lean” entry strategies where companies purposefully restricted early adoption to a subset of consumers appear more frequently in the list of socially-driven network goods. Among examples of transaction-driven network goods, the only companies which restricted early adoption were Craigslist, Groupon, and Uber, which all serve markets with incomplete network structure due to concentration of externalities within cities.

**Example 3.4. Examples of Transaction-driven vs. Socially-driven Network Goods**

Examples of Transaction-driven Network Goods					
Company	Product	Launch year	Competitors	Market's Network Structure	Launch strategy
Ebay	online marketplace	1995	first mover	complete	bundling: third party licensing
Craigslist	online marketplace	1995	Newspapers, mailing lists	incomplete (complete within cities)	lean entry: San Francisco
PayPal	payment system	1998	credit cards	bipartite	bundling: with Ebay
Amazon Marketplace	online marketplace	2000	Ebay, Rakuten	bipartite	bundling: with Amazon.com
Vanguard (ETFs)	Exchange-traded Fund	2001	incumbent ETFs	bipartite	bundling: with mutual funds via share class
Airbnb	online marketplace	2008	hotels	bipartite	bundling: Craigslist platform integration
Groupon	online marketplace	2008	first mover	incomplete (bipartite within cities)	lean entry: Chicago
Uber	ride sharing technology	2009	taxis, Lyft	incomplete (bipartite within cities)	lean entry: San Francisco

Examples of Socially-driven Network Goods					
Company	Product	Launch year	Competitors	Network Structure	Launch strategy
Yelp	review aggregator	2003	CitySearch, Yellowpages	incomplete, not bipartite	lean entry: San Francisco
Facebook	social media platform	2004	Myspace, Orkut, Friendster	incomplete, not bipartite	lean entry: college students
Reddit	social media	2005	Digg	incomplete, not bipartite	paid content generators
Twitter	social media platform	2006	first mover	incomplete, not bipartite	public launch
Spotify	social media	2006	Pandora, iTunes	incomplete, not bipartite	lean entry: sweden, beta by invite only
Dropbox	software	2007	first mover	incomplete, not bipartite	lean entry: Digg, closed beta
Zynga	social media	2007	traditional video games	incomplete, not bipartite	bundling: Facebook
Pinterest	social media	2008	first mover	incomplete, not bipartite	lean entry: bloggers, 9 month closed beta
WhatsApp	communication technology	2009	iMessage, Skype	incomplete, not bipartite	public launch
Kickstarter	crowdfunding	2009	IndieGoGo	incomplete, not bipartite	lean entry: musicians and artists
Venmo	payment system	2009	PayPal, credit cards	incomplete, not bipartite	lean entry: college students, beta by invite only
Instagram	social media platform	2010	first mover	incomplete, not bipartite	bundling: Facebook, Twitter
Snapchat	communication technology	2012	Facebook, WhatsApp	incomplete, not bipartite	lean entry: california grade schools

More recent economic literature has explored properties of markets with incomplete network structure, or “local” network effects [44] [8] [33], but our understanding of entry and growth in these markets is still in its infancy. In particular, there has been little research on how firms can tailor their entry and growth strategies to appeal to structural features of the market. In contrast, a rich Marketing literature studies how firms can encourage the growth of *viral* goods by targeting adoption of subsets of consumers (“seeding”) [20] [4].

An important result emerging from the marketing literature is that it is optimal for firms to seed consumers central to the network [7] [23] [5]. It has an appealing intuition since well-connected consumers, such as those with more links to others in the network, allows a viral good to reach a wider audience. Unfortunately, strategies for the growth of viral goods do not directly extend to network goods.

Their mechanism of growth differs in at least two ways. First, viral goods grow through probabilistic transfer rather than consumer coordination. Therefore their method of transfer is closer to that of an epidemiology model than a network effects model. Second, once a viral good is transferred there is no effect on other adopters if the adopter who transferred the good stops adopting; therefore stability of adoption is generally not a concern. Not so with network goods: an equilibrium adoption level in a network market can easily be reversed if some adopters stop adopting.

To summarize, the current state of our knowledge is that network markets contain barriers-to-entry, the growth of network goods follows a discontinuous trajectory, and that these phenomena are driven by fundamental features of the market (i.e. consumer coordination) rather than firm actions. We have limited knowledge about entry in markets with arbitrary network structure, the process by which discontinuous growth occurs in general network markets, and their implications for firm strategy. These are the intellectual gaps my thesis seeks to fill.

## 4 Lean Entry in Network Markets

### 4.1 Introduction

This paper examines the entry and growth strategy of a firm producing a single good with network effects. The firm's profit rests on the adoption of this good, which is produced with zero marginal cost but is costly to launch. An example of such a firm would be a start-up company producing a digital product with network effects.

Conventional wisdom from researchers and industry experts suggest that consumer coordination and switching costs in network markets create barriers-to-entry favoring incumbent goods. The claim is that when it is costly to switch to a new good, all consumers will coordinate on the old good due to network effects. The "10x" rule of thumb espoused by Andy Grove of Intel offers a sense of magnitude for the difficulty of entry: new technologies must be ten times better than old technologies to succeed. Case studies of persistent incumbent network goods include technology standards such as the QWERTY keyboard, software platforms such as Microsoft Windows, and market exchanges such as Ebay.

This paper shows that contrary to conventional wisdom, network effects do not create barriers-to-entry in all network markets and can even facilitate entry in some network markets. In markets where network effects are structurally homogeneous, as depicted in classical theories of network effects, entry is indeed difficult. However, this paper shows that the strength of barriers-to-entry in network markets is determined by a structural metric related to network cohesion. Firms can seed subsets of consumers with cohesive network structure, including "boundary spanners" within these subsets, to grow adoption discontinuously.

The motivating example for this paper is Facebook's entry in the market for social communication technology. Social communication technologies are a particularly apt example of a market where the structure of network effects is incomplete. Facebook started up its adoption by appealing to a small cohesive group of early adopters: students at elite universities. Few believed it could enter the industry through a niche market and "gradually through [a] carefully calculated war against all social networks, become the one social network to rule them all" [1]. The main goal of this paper is to show, through a formal model, a plausible mechanism for this counterintuitive outcome.

To do this, we introduce a formal model of the growth of a network good in a network market with arbitrary network structure. Growth occurs as a dynamic graphical game between consumers, who myopically best respond to the adoption of their peers. The firm can endogenously affect growth of its good by seeding early adopters. We show that barriers-to-entry can be an order of magnitude weaker in markets

with heterogeneous (“incomplete”) network structure than in markets with complete or bipartite network structure. We also derive a set of three strategic implications using this model: 1) lean entry strategies are especially useful when start up costs are high 2) a firm should strive to be a first mover whenever possible, and 3) a firm can predict its likelihood of success using information about network structure.

The formal model of discontinuous growth in this paper is similar to the approach taken by Morris (2000) [36], who uses a graphical game of binary choice to show conditions under which the behavior of a seeded set of players on an arbitrary network can spread to the population at large. It verifies the intuition first introduced by Rohlfs (1974), who suggested that firms can exploit heterogeneity in network structure to lower the cost of entry. To the best of the author’s knowledge, no prior work has formalized Rohlfs’s insightful observation, explored its strategic implications, or tested its validity on real-world network data.

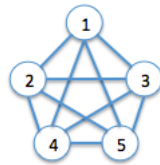
## 4.2 Model

### 4.2.1 Consumers

Let there be a network of consumers linked by a set of undirected interactions. Consumers may interact socially, via economic transactions, or shared use of a technology. Interactions between consumers generate direct positive externalities. For example, consumers of a social communications technology benefit from the participation of other consumers with whom they interact.

Let nodes  $N = \{1, \dots, n\}$  represent the set of consumers and links  $L = \{l_{ij} | i, j \in N\}$  represent their interactions, where  $l_{ij}$  exists if and only if  $i$  and  $j$  interact and  $l_{ij} = \emptyset$  otherwise. Call consumers with whom  $i \in N$  interacts the *peers* of  $i$ , denoted  $L(i) = \{j \in N \text{ s.t. } \exists l_{ij} \in L\}$ . Consumers and interactions form a *network*, given by graph  $G(N, L)$ . A network  $G(N, L)$  is *complete* if  $L(i) = N \setminus \{i\}$  for all  $i \in N$  and *empty* if consumers do not interact, that is  $L = \emptyset$ . A network is *incomplete* if it is neither empty nor complete.

**Example 4.1.** *Example of a complete network where  $L(i) = N \setminus \{i\}$  for all  $i \in N$ .*



Suppose each consumer  $i \in N$  can choose one of two options: to adopt or not adopt an entrant firm’s

network good, denoted by  $x_i = 1$  and  $x_i = 0$  respectively. Let consumers' choices be captured by state

$$x = (x_1, \dots, x_n),$$

where  $x \in X = \{0, 1\}^n$ , and let  $\|x\|$  denote the number of adopters in this state, or  $\|x\| = \sum_{i \in N} x_i$ .

Consumers hold intrinsic value  $\theta$  for the good, and externality value  $\alpha$  for each peer adopting the good. I assume for clarity that all consumers value the focal good equally and benefit equally from their peers. Suppose further that consumers hold values  $v = (v_1, \dots, v_n)$  for their outside option. Consumer  $i$ 's payoff is captured by a utility function  $U_{\gamma i}(\cdot)$  with parameters  $\gamma = (\theta, \alpha, v)$ :

$$U_{\gamma i}(x) = \theta + \alpha \sum_{j \in L(i)} x_j \quad \text{if } x_i = 1,$$

$$U_{\gamma i}(x) = v_i \quad \text{otherwise.}$$

Letting  $U_\gamma$  denote the vector of utility functions  $(U_{\gamma 1}, \dots, U_{\gamma n})$ , define a *network market* as a nonempty network of consumers and vector of utility functions  $\{G, U_\gamma\}$ .

I assume a consumer does not adopt a network good unless he or she strictly prefers it over their outside option. Thus from the utility functions above, a rational consumer adopts if and only if the number of his or her adopting peers exceeds a certain threshold, or  $\sum_{j \in L(i)} x_j > \frac{v_i - \theta}{\alpha}$ . Call this threshold

$$t_i = \frac{v_i - \theta}{\alpha}. \quad (1)$$

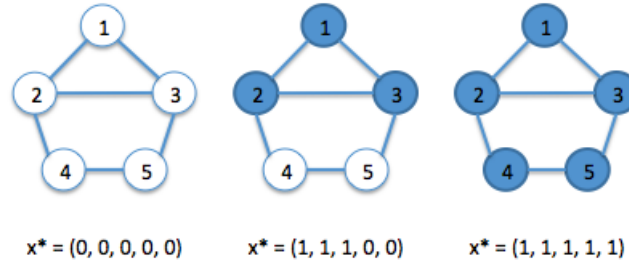
and let  $t$  be the vector of consumers' thresholds. Note  $t_i$  depends on the value of a consumer's outside option and thus may differ for each  $i \in N$ .

The setup above describes a graphical game where agents are consumers, actions are adoption or non-adoption, and payoffs are utilities from the entrant's network good and the outside option respectively. A consumer's best response is to adopt if and only if the number of his or her adopting peers exceeds its threshold:  $b(\cdot) = (b_1(\cdot), \dots, b_n(\cdot))$  such that  $b_i(x) = 1$  if  $\sum_{j \in L(i)} x_j > t_i$ , and  $b_i(x) = 0$  otherwise. We can characterize the outcome of diffusion  $x^*$  as a pure strategy Nash equilibrium where each consumer plays a best response to the adoption of their peers:

$$b_i(x^*) = x_i^* \quad \forall i \in N. \quad (2)$$

Since multiple states may satisfy condition (2), call the set of equilibria  $X^*$ . Here let us make an important observation: any game in a network with complete network structure such as example 4.1 supports only two equilibrium states: “all adopt” and “none adopt,” but incomplete networks (networks which are neither empty nor complete) may support many equilibrium states with partial levels of adoption. Thus in general, the number of equilibria in  $X^*$  may be quite large. The example below illustrates this observation (for simplicity assume thresholds are  $t_i = 1$  for all  $i \in N$ ).

**Example 4.2.** *Multiple equilibria in a market with incomplete network structure.*



This multiplicity of equilibria in incomplete network markets allows only part of the market to adopt the entrant’s good in equilibrium, and outcomes are not binary as they are in complete networks. When the market shifts from one equilibrium to another, it undergoes a process whereby demand either grows or wanes discontinuously. Call this the diffusion process (DP).

Suppose consumers react in a sequence of states  $\{x^\tau\}_{\tau=1}^\infty$  to an initial state  $x^1 = x$ . Call this sequence *locally rational* if and only if at each iteration  $\tau > 1$ , either  $x_i^{\tau+1} = x_i^\tau$  or  $x_i^{\tau+1} = b_i(x^\tau)$  for all  $i \in N$ . That is, the sequence of behavior is locally rational if and only if at each iteration, consumers either do nothing or they best respond to the previous state of adoption.

Starting from an initial state  $x$ , let the diffusion process (DP) be defined as follows: first all consumers  $i \in N$  whose best response is 0 switch their actions to 0, and this subtractive process repeats until no further consumers wish to switch to 0. Then, all consumers  $i \in N$  whose best response is 1 switch their actions to 1, and this additive process repeats until no further consumers wish to switch to 1. It is easy to show that DP is locally rational and is guaranteed to reach an equilibrium.

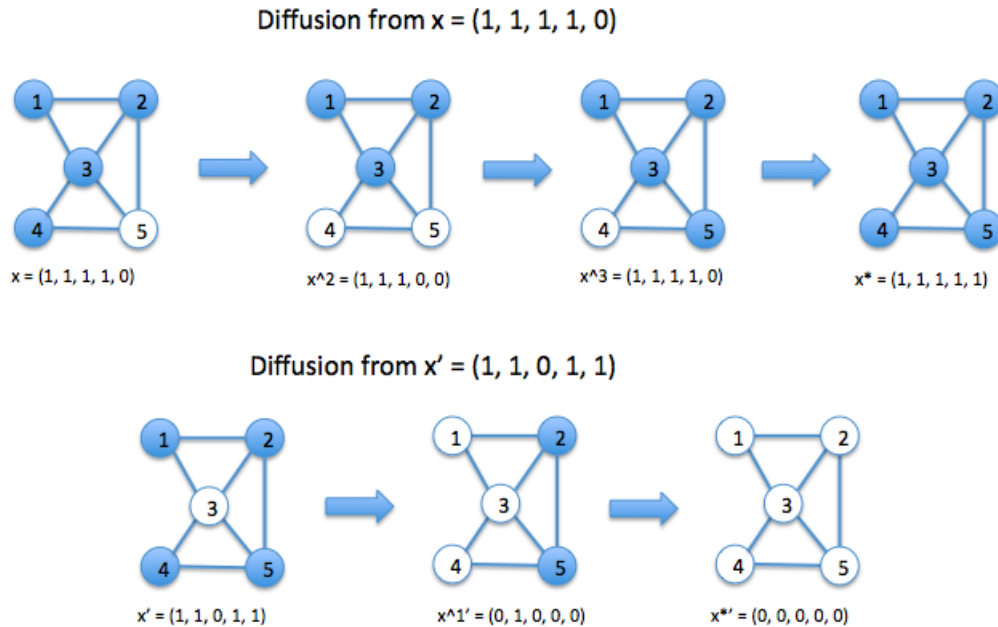
More importantly, DP reaches the lowest equilibrium reachable by a locally rational dynamic process in the following sense: say that DP *reaches* an equilibrium  $\phi(x) \in X^*$  from state  $x$  if it stops at some iteration  $\tau = T < \infty$ . Call state  $y \in \{0, 1\}^n$  *weakly lower* than  $y'$ , denoted  $y \preceq y'$ , if and only if  $y_i \leq y'_i$  for all  $i \in N$ . A similar ordering holds for states with weakly ( $\succeq$ ) *greater* adoption. Proposition 8.1 in the appendix shows if  $\phi'(x)$  is the outcome of any other locally rational dynamic process, then  $\phi(x) \preceq \phi'(x)$ . This feature of DP

is nontrivial and allows us make the most conservative predictions about demand for the entrant's good.

DP has the intuitive property that weakly greater initial states reach weakly higher equilibria, a property I formalize in Proposition 4.1 below. However, the outcome of DP depends not on the mere number of early adopters, but on their structural identity. States with greater *numbers* of early adopters do not necessarily reach higher levels of demand. Example 4.3 shows DP in the same network from initial states  $x$  and  $x'$ , both which contain four early adopters, but the first reaches an equilibrium which is lower than the second (again let thresholds  $t_i = 1$  for all  $i \in N$ ).

**Proposition 4.1.** *Demand  $D(x) = \|\phi(x)\|$  is weakly increasing in greater initial states of adoption: for  $x \succeq x'$ , it holds that  $D(x) \geq D(x')$ . However,  $D(x) \geq D(x')$  does not imply  $x \succeq x'$  or  $\|x\| \geq \|x'\|$ .*

**Example 4.3.** *Diffusion from two different states in a market with incomplete network structure.*



#### 4.2.2 Firm

Let there be an entrant firm capable of producing a single network good at zero marginal cost to serve the network market described above. Its action space consists of three decisions, made sequentially: enter if profit is positive, start up demand by “seeding” a state of early adoption, and charge a static price to consumers. An example of such a firm would be a start-up aiming to displace an incumbent technology. I assume the firm does not face competitive response is thus optimizes profit as a monopolist for the duration of the model.



The firm's good is characterized by two parameters:  $\theta$  indicating intrinsic quality relative to quality of the outside option, and  $\alpha$  indicating the strength of adoption externalities. Unless otherwise specified, I assume these parameters are exogenous.

To start up demand for its good, the firm seeds a state of early adoption  $x$ , from which DP reaches  $D(x)$ . For example, the firm may seed through beta testing, marketing, or targeted discounts. Assume the firm seeds only once: the firm cannot seed adoption in periods  $1 < \tau \leq T$  due to the speed of diffusion. The firm has perfect information of the market when seeding. Let the cost of seeding be given by the function  $c(|x|)$  where  $|x|$  is the number of early adopters. Assume costs increase monotonically in  $|x|$  and exceed zero when  $|x| > 0$ .

The market undergoes a diffusion process (DP) immediately after seeding. Define *growth* to be the difference between the number of early adopters  $|x|$  and equilibrium demand  $D(x)$  reached by DP. Assume the firm charges zero price to consumers before and during DP. After the market reaches equilibrium, the firm charges a price  $p_i$  to consumer  $i \in N$  equal to  $i$ 's willingness-to-pay (WTP). For example, in a complete network market, all adopters have the same value for the firm's good in equilibrium, given by  $\theta + \alpha(n - 1)$ ; the firm charges price  $\theta + \alpha(n - 1) - \epsilon$  such that adoption continues to be incentive compatible in equilibrium. Henceforth I omit  $\epsilon$  for notational clarity.

The firm's profit function is

$$\pi(x) = \sum_{i \in N} \phi_i(x) p_i - c(|x|), \quad (3)$$

where  $\phi_i(x)$  is  $i$ 's equilibrium state of adoption,  $p_i = \theta + \alpha \sum_{j \in L(i)} x_j$ , and  $c(|x|)$  is the firm's seeding cost.

### 4.2.3 Assumptions

The model above makes three major assumptions. First, it assumes that competitors do not respond strategically to the entrant's actions. Second, it assumes consumer choice is binary and that consumers are myopic when making decisions. Third, it assumes firms have perfect information of network structure. I will now discuss conditions under which these assumptions are likely to hold.

*Assumption 1: Incumbent Inertia*

The model above assumes that the firm producing the incumbent network good does not respond strategically to actions of the entrant firm. In particular, it assumes the incumbent firm does not "counterseed" in response to the entrant's actions. This assumption is a simplification made for model tractability and would likely be invalid in a highly competitive environment where firms frequently update their information and

have the ability to act with great speed. For example, the model would likely be a poor fit for a context in which incumbent firms collect data on customer networks and carefully monitor competitor growth. In fact, any counterseeding by the incumbent, even if it is untargeted, will make the entrant good's growth more difficult than what the model dictates.

However, several case studies in the brief history of network goods have shown that incumbents in established industries often do not respond strategically or respond too slowly to the entry of "disruptive" technologies. Examples include film producers' response to digital camera technology, video rental companies' response to online streaming video, print newspapers' response to online classifieds, MySpace's response to Facebook, and more recently, taxi companies' response to ride-sharing applications.

Though examining reasons why this occurs is outside the scope of this thesis, there are several reasons why it might hold in practice. One is that incumbents do not perceive entrants to be a threat due to their low early market share. Another reason, captured by the theory of Disruptive Innovation, is that incumbents cannot predict future changes in consumer tastes and technological quality. My model offers two additional explanations for lack of incumbent response: the fact that growth of the entrant good can stagnate at low equilibria (hiding its ultimate potential to quickly grow to greater equilibria), and the difficulty of counterseeding in a complex environment.

To flesh out the first explanation, my model shows that a market with arbitrary (incomplete) network structure generally supports several demand equilibria, each of which can seem like a point of diminishing growth for the entrant good from the perspective of an unsuspecting incumbent. However, small perturbations to adoption can easily cause demand to grow to a greater equilibrium, or diminish to a lower equilibrium. Therefore, while an entrant good may appear to stop growing for a time, it may simply be reaching an intermediate equilibrium which belies its ultimate potential for growth.

As for difficulty of counterseeding, the model does not assume that firms know exactly which subsets of consumers to seed, even with perfect information of network structure. This is because finding a globally optimal seed set in an arbitrary network market is NP-hard. The purpose of my model is to show what *could* happen if the entrant, perhaps by luck, seeds a favorable group of consumers which then sets off rapid growth. The entrant's outcome may not be deterministically replicable by either the entrant or incumbent.

#### *Assumption 2: Binary Consumer Choice*

The second major assumption of the model is that a consumer can adopt only one of two goods, when in reality he or she could have multiple goods to choose from, and adopt more than one at the same time. Again this assumption is made for model tractability. This assumption is more likely to hold in a world

where the choice set is small and consumer attention is limited. If there are multiple goods to choose from and consumer choice is closer to random, the model would not be appropriate for predicting competitive outcomes. Similarly, the assumption of consumer myopia reflects decision-making in a world with sufficient complexity. If the world is so simple that consumers can predict the future and game firms' entry decisions, then alternative models, such as ones where consumers have rational expectations of future market shares, would likely offer more accurate predictions of market outcomes.

One potential justification for this assumption is that, barring cooperation between firms, the size of the choice set does not affect the model's results. For example, a model allowing consumers to adopt more than one good at a time, or "multi-homing" in the two-sided platforms literature, can be reduced to a threshold model by mapping a continuous action space representing consumption allocation to a binary action space representing whether a good receives the largest share of consumption. Similarly, a model allowing consumers to choose one of multiple goods could be generalized to the threshold model in equation 1 as long as a consumer compares the entrant's good to the *best* of her outside options.

#### *Assumption 3: Perfect Information*

Finally, the model assumes the entrant firm has perfect information of network structure. I make this assumption because the lower cost of data storage and analysis is increasingly allowing firms to have near perfect information of markets and consumers. For example, companies often collect competitor and consumer data in order to make strategic decisions. Due to advanced data collection techniques, an entrant could feasibly know detailed features of an entire market, including its network structure. Moreover, having perfect information of network structure does not imply a firm can seed optimally. In other words, an entrant can use data on network structure to *improve* but not optimize their entry and seeding decisions, which I later demonstrate using a simulation.

Where this assumption is likely to be invalid is if the incumbent purposefully obfuscates or distorts information as a way to fool the entrant, via signaling or other means. Since observing growth of the incumbent's good yields information about network structure to the entrant, this "information" can be strategically manipulated. In addition, firms may have asymmetric information due to differing abilities to collect data about each other. Such a model, while potentially insightful, is outside the scope of this thesis.

### **4.3 Relationship Between Network Structure and Growth**

So far we have characterized diffusion as a sequence of consumer best responses to the adoption of their peers. I now show that the path of diffusion has a one-to-one correspondence to a metric of network structure which

I call  $t$ -cohesion, where  $t$  is the vector of consumer thresholds. By characterizing DP as a function of network structure, we can derive insights about how the network structure affects entry and growth.

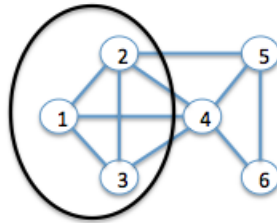
Recall consumer  $i$ 's best response is to adopt a network good if and only if its number of adopting peers exceeds its threshold  $t_i = \frac{v_i - \theta}{\alpha}$ . Assume henceforth that consumers' outside option is an incumbent network good. In this case,  $v_i$  is a function of  $i$ 's number of nonadopting peers. Normalizing  $\theta$  to be the intrinsic value of the entrant's good relative to the outside option, we get  $v_i = \alpha(d_i - \sum_{j \in L(i)} x_j)$ , where  $d_i$  is  $i$ 's total number of peers or *degree*. Thus,  $i$ 's best response to adopt if and only if

$$\sum_{j \in L(i)} x_j > \frac{d_i}{2} - \frac{\theta}{2\alpha}. \quad (4)$$

Note that when  $\theta = 0$ , the expression above simply states a consumer needs more than half their peers to adopt the entrant good before they switch from the incumbent good to the entrant good.

This leads us to define network cohesion and its relationship to diffusion. Consider a set of consumers  $A \subset N$ . A priori, each consumer  $i \in A$  has a proportion  $p_i$  of its peers within  $A$  and the rest outside of  $A$ . For example, a consumer in  $A$  which has two peers within  $A$  and three outside of  $A$  has  $p_i = \frac{2}{5}$ . The proportion of a consumer  $i$ 's peers within  $A$  can be denoted  $p_i = \frac{|L(i) \cap A|}{d_i}$ , where  $|\cdot|$  is set cardinality. Define  $A$ 's *cohesion* to be the value of the smallest  $p_i$  of a consumer in  $A$ . The example below shows a set of consumers whose cohesion is  $\frac{1}{2}$ .

**Example 4.4.** A weakly  $\frac{1}{2}$ -cohesive set of consumers



Network cohesion describes the proportion of interactions consumers have with other consumers in a set versus with the network at large. For example, a community of consumers segregated by age, religion, or political preference may be highly cohesive, choosing to interact primarily with one another. Loosely speaking, the more cohesive a set of consumers, the greater fraction of externalities exist *within* themselves versus *between* themselves and others.

Taking a slight modification of the definition above, call  $A$  strictly (weakly)  $t$ -cohesive if  $p_i$  is greater than (at least)  $\frac{t_i}{d_i}$  for every  $i \in A$ . A set of consumers would fail to be strictly  $t$ -cohesive if some  $i \in A$  does

not have enough peers in  $A$ , i.e.  $|L(i) \cap A| \leq t_i$ . Note that when  $\theta = 0$ , thresholds are  $t_i = \frac{d_i}{2}$  and  $t$ -cohesion reduces simply to  $\frac{1}{2}$ -cohesion.

Our first result relating diffusion to network structure is that a state  $x$  is self-sustaining if and only if its adopters are strictly  $t$ -cohesive. A state is self-sustaining if adopters in the state continue adopting even if no additional consumers adopt during the diffusion process. In contrast, if a state is *not* self-sustaining, early adopters may stop adopting before their peers have a chance to best respond and early adoption will not be stable.

Let  $A(x)$  be the set of adopters in a state  $x$ , and say that  $x$  is self-sustaining if it is a best response for all  $i \in A(x)$  to adopt given that all other consumers  $j \in A(x)$  adopt. We can relate sustainability of early adoption to network structure by the following proposition:

**Proposition 4.2.** *State  $x$  is self-sustaining if and only if  $A(x)$  is strictly  $t$ -cohesive.*

Our second result relates to the outcome of diffusion: what demand can the firm expect in equilibrium? The answer again depends on  $t$ -cohesion. Proposition 4.3 below shows that adopters at *every* period of diffusion form a strictly  $t$ -cohesive set which is nested within the set of adopters in the subsequent period of diffusion. Networks which facilitate diffusion contain a sequence of nested and successively larger  $t$ -cohesive sets of consumers which gradually decrease in the proportion of their interactions with the rest of the network. This structure allows adoption to diffuse from a central  $t$ -cohesive set and proceed outwards, like a sequence of nested Matryoshka dolls.

**Proposition 4.3.** *Assume  $x$  is self-sustaining. At every iteration  $\tau \in \{1, 2, \dots, T\}$ , the diffusion process reaches a strictly  $t$ -cohesive set  $A(x^\tau)$  such that  $A(x) \subset A(x^{\tau-1}) \subset A(x^\tau) \subset A(x^T)$ .*

Diffusion also stops at the boundary of a strictly  $t$ -cohesive set of nonadopters, if one exists. Let  $C = N \setminus A(x^T)$  be the set of nonadopters in equilibrium. The following corollary states that diffusion stops when nonadopters are too cohesive among themselves.

**Corollary 1 (4.3).** *Let  $d$  be the vector of consumers' degrees in the network. When the outside option is a network good, diffusion stops at iteration  $\tau = T$  where the complement of  $A(x^T)$ ,  $C = N \setminus A(x^T)$ , is weakly  $(d - t)$ -cohesive.*

Propositions 4.2, 4.3, and 1 show that network cohesion is a double-edged sword for growth of a network good. On the one hand, cohesion of early adopters is necessary because otherwise early adoption is not sustainable and leads to zero demand growth. On the other hand, when early adopters are too cohesive,

adoption cannot diffuse widely. In addition, when nonadopters in some period of diffusion are too cohesive, diffusion stops and adoption of the entrant's good will be fragmented.

For example, it may be easier to convince a community of consumers of the same age, religion, or political preference to sustain early adoption of a good due to externalities within themselves, but it is simultaneously difficult to exploit subsequent demand growth due to the lack of externalities between themselves and others. Similarly, a cohesive community of nonadopters may never adopt a mainstream network good because they value an alternative good highly within themselves.

This brings us to the result that consumers which stimulate demand growth have an almost equal number of nonadopting peers as adopting peers in some period of DP. I borrow terminology from the sociology literature and loosely interpret these consumers as “boundary spanners” [2], in reference to individuals with dispersed ties to multiple groups of agents in a network.

Formally, call consumer  $i$  a *boundary spanner* if  $|L(i) \cap A(x^{\tau-1})| = \lfloor t_i \rfloor + 1$  and  $|L(i) \cap A(x^{\tau+1})| = \lfloor t_i \rfloor - 1$  where  $i$  adopts in period  $\tau \in \{1, 2, \dots, T\}$ . Boundary spanners allow the firm to balance the sustainability properties of proposition 4.2 with the diffusive properties of proposition 4.3 when seeding. Contrary to the Marketing literature on viral diffusion, these critical consumers are neither the most “central” to the network, nor “brokers” who link otherwise disconnected parts of the network.

### Networks Optimal For Growth

To make asymptotic predictions about seeding and demand growth needed for our main results about lean entry, we must derive some sort of demand function predicting the bounds of diffusion from a fixed number of early adopters  $\|x\|$ . Networks which are optimal for demand growth, in the sense that DP reaches the highest possible equilibrium demand from  $\|x\|$  early adopters, have nested  $t$ -cohesive network structure and maximize the number of links between successive  $t$ -cohesive sets. In particular, optimally diffusive networks contain as many boundary spanners as possible given reasonable assumptions about their frequency of occurrence in the network.

Recall that nested  $t$ -cohesive networks contain a sequence of nested and successively larger  $t$ -cohesive sets of consumers which gradually decrease in the proportion of their interactions with the rest of the network. Formally, a network has nested  $t$ -cohesive structure if there exists a sequence  $\{A_k\}_{k=1}^T$  of  $t$ -cohesive sets in the network such that  $A_1 = A(x)$ ,  $A_{k-1} \subsetneq A_k$ , and  $|L(i) \cap A_{k-1}| \geq \lfloor t_i \rfloor + 1$  for all  $i \in A_k \setminus A_{k-1}$ .

For a nested  $t$ -cohesive network to be optimal for demand growth, it must have the additional property that  $|L(i) \cap A_{k-1}| = \lfloor t_i \rfloor + 1$  for some consumers  $i \in A_k \setminus A_{k-1}$ . Assume there are a fraction  $\gamma$  of such boundary spanners in the network. The intuition is as follows: given a finite number of early adopters, there

are a finite number of “incoming” links between early adopters themselves. To satisfy  $t$ -cohesion, the number of incoming links limits the number of “outgoing” links from the early adopters to other consumers in the market. The *optimally diffusive* network simply maximizes the number of outgoing links in each period of diffusion while preserving  $t$ -cohesion, assuming the fraction of boundary spanners satisfies  $\gamma < \frac{\alpha}{\theta}$ .

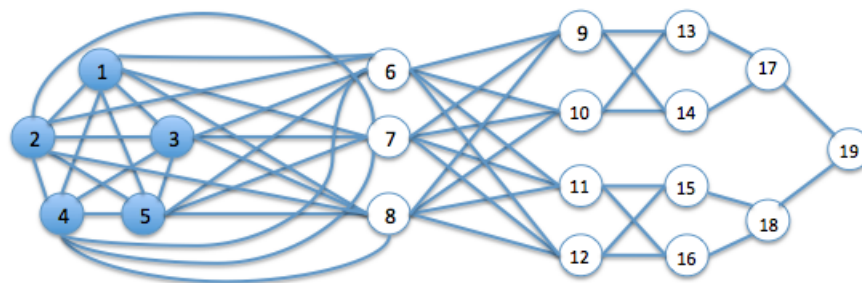
Proposition 4.4 shows that demand has a closed form  $\bar{D}(x) = \|x\|(\|x\| - 1) + \frac{\theta}{\alpha}\gamma n$  in an optimally diffusive network, where  $\gamma$  is the fraction of boundary spanners. For the remainder of the analysis below, assume the fraction of boundary spanners satisfies  $\gamma < \frac{\alpha}{\theta}$ , such that  $\frac{\theta}{\alpha}\gamma < 1$ .

**Proposition 4.4.** *Demand from seeding state  $x$  is weakly bounded above by  $\bar{D}(x) = \|x\|(\|x\| - 1) + \frac{\theta}{\alpha}\gamma n$  for any market of size  $n$  with arbitrary network structure, where  $\gamma$  is the fraction of boundary spanners during diffusion.*

In the special case when  $\theta = 0$ , every consumer  $i$  in an optimally diffusive network has exactly  $\lfloor d_i/2 \rfloor + 1$  peers adopting immediately prior to  $i$ 's adoption; that is, every consumer is a boundary spanner during diffusion. Demand reaches the upper bound  $\bar{D}(x) = \|x\|(\|x\| - 1)$  from  $\|x\|$  early adopters, assuming  $x$  is  $t$ -cohesive and nested in the center of a sequence of larger  $t$ -cohesive sets. By construction, the network supports only two equilibria, “all adopt” and “none adopt.” The example below illustrates this corollary of Proposition 4.4.

**Corollary 2** (4.4). *In the special case when  $\theta = 0$ , the class of optimally diffusive networks have nested  $t$ -cohesive structure and for each  $A_k \in \{A_1, A_2, \dots, N\}$ , all  $i \in A_k \setminus A_{k-1}$  have  $\lfloor d_i/2 \rfloor + 1$  peers in  $A_{k-1}$  and  $\lfloor d_i/2 \rfloor - 1$  peers in  $A_{k+1}$ .*

**Example 4.5.** *An optimally diffusive network when  $\theta = 0$  and  $A(x) = \{1, 2, 3, 4, 5\}$ .*



Proposition 4.4 yields a class of networks which describes the “best-case” network given a “worst-case” diffusion process: DP predicts a lower bound on demand in a given network, and reaches the greatest possible demand in the class of optimal networks. Therefore, the closed form demand function above dictates the

minimum number of early adopters a firm must seed to ensure demand reaches a target value  $n$  in *any* network market with a fraction  $\gamma$  of boundary spanners. Proposition 4.4 implies a firm must seed at least an order of  $\sqrt{n}$  early adopters to reach full demand  $n$  as  $n$  grows large. I revisit this result in the next section.

#### 4.4 Core Result of Lean Entry

Conventional wisdom from the network effects literature posits that a firm must make great initial investments in scale to displace an incumbent network good. But while this wisdom holds for markets with complete and bipartite network structure, the strength of barriers-to-entry are weaker in markets with optimally diffusive network structure and a firm needs to seed only *square root* as many early adopters to enter. This is the core result of “lean entry.”

##### Minimal Scale and Barriers-to-entry

Let us begin by clarifying a key assumption. Call the fewest number of early adopters a firm must seed to earn positive profit its *minimal scale* needed for entry. As before, assume the firm can only seed once and has perfect information of the market’s network structure when seeding. Define *barriers-to-entry* to be an entrant’s cost of seeding its minimum scale. Assume in this section that entry is profitable if and only if the firm seeds the lowest possible state reaching equilibrium demand  $n$ . Note the “only if” part acts as an intentionally conservative assumption. The “if” part requires seeding costs not to grow too quickly in the number of early adopters, an assumption which is relaxed in the next section.

##### Core Result of Lean Entry

When the market has complete or bipartite network structure, a firm’s minimal scale grows linearly with size of the market  $n$ . Barriers-to-entry are consequently strong. As a rule of thumb, the firm must seed more than half the market to enter. This follows directly from the observation that a firm must seed a  $t$ -cohesive set for adoption to be self-sustaining, but the smallest  $t$ -cohesive set in these markets contain more than half the total number of consumers.

Recall the expression for thresholds when the outside option is a network good:  $t_i = \frac{d_i}{2} - \frac{\theta}{2\alpha}$ . Since  $d_i = n - 1$  for all  $n$  consumers in a complete network, it is easy to verify that sets of fewer than  $\lfloor (n - 1)/2 - \frac{\theta}{2\alpha} \rfloor + 2$  consumers are not  $t$ -cohesive in a complete network because every consumer in this set would have fewer peers in the set than her threshold. Thus when  $\theta = 0$ , the firm’s minimal scale in a complete network is  $\lfloor (n - 1)/2 \rfloor + 2$ . This result generalizes to arbitrary  $\theta$  as long as  $\theta$  is independent of  $n$ . A similar result holds for bipartite networks.



**Lemma 4.1.** *The minimal scale required to enter a complete or bipartite network market of size  $n$  grows in the order of  $O(n)$  as  $n \rightarrow \infty$ .*

Barriers-to-entry in optimally diffusive networks, on the other hand, are considerably weaker: the firm's minimal scale grows at most with the square root of  $n$ . This result follows from Proposition 4.4 which states that diffusion from state  $x$  reaches demand  $D(x) = ||x||(|x| - 1) + \frac{\theta}{\alpha}\gamma n$  in an optimally diffusive network. Setting demand to  $n$ , we see the firm can seed a state with  $O(\sqrt{n})$  early adopters to reach positive demand.

**Lemma 4.2.** *The minimal scale required to enter an optimally diffusive network market of size  $n$  grows at most in the order of  $O(\sqrt{n})$  as  $n \rightarrow \infty$ .*

The minimal scale needed to enter an optimally diffusive network market of size  $n$  therefore reaches at most the *square root* of the minimal scale needed to enter a complete network market of size  $n$  as  $n \rightarrow \infty$ . Since this relationship is independent of the seeding cost function, it follows that barriers-to-entry in a complete (or bipartite) network market are at least quadratically greater than barriers-to-entry in a comparable optimally diffusive network market *for any* market parameters  $\theta, \alpha$ , and  $c(\cdot)$ . This is the core result of lean entry.

**Proposition 4.5.** *Barriers-to-entry are at least quadratically greater in a market with complete network structure than in a comparable market with optimally diffusive network structure, irrespective of quality of the entrant's good and its seeding cost function.*

## 4.5 Strategic Implications

Proposition 4.5 shows that barriers-to-entry in network markets can be far weaker in a market with incomplete network structure than in markets described by classic theories of network goods Reference Chapter 3.. This formally proves the intuition first laid out by Rohlfs in his 1974 paper on entry in network markets: that sets of self-sustaining (t-cohesive) consumers can greatly reduce the cost needed to “start up” demand for a network good. A firm choosing to enter such a market can seed these sets of consumers at a relatively low cost and grow via diffusion (DP), a “lean” entry strategy. Specifically, a lean entry strategy entails a sequence of actions: enter an incomplete network market, seed a self-sustaining set of adopters, and charge a price equal to consumers' WTP in the equilibrium attained by DP.

This section derives three insights into when and how a firm can successfully implement a lean entry strategy. First, lean entry is a profitable strategy even when seeding costs are high, specifically when costs grow too quickly in the number of seeded adopters to enter a complete network market profitably. There is

a sweet spot of seeding cost functions where a firm can and should employ a lean entry strategy. Second, the likelihood of successful entry in an arbitrary network market can be predicted by the firm. I run simulations using data from real-world networks to show how firms can identify markets where a lean entry strategy is likely to be profitable. Finally, the minimum scale needed to enter a market is always lower if consumers have not already adopted an incumbent network good, irrespective of network structure: this creates a first mover advantage. A lean entry strategy is thus neither necessary nor optimal when firms can enter complete network markets as a first mover.

#### 4.5.1 When to Use Lean Entry

Recall that the firm's action space consists of three decisions, made sequentially: enter the market if profit is positive, start up demand by "seeding" a state of adoption, and charge consumers a price equal to their willingness to pay. The results below indicate a firm can take this sequence of actions for an optimally diffusive network market, seeding in the order of  $\sqrt{n}$  as established by Proposition 4.5, and make positive profits. The profitability of entry depends on how quickly seeding costs grow relative to the number of seeded adopters. The seeding cost function should also be the major strategic consideration when a firm is deciding which market to enter, if it has a choice between entering a complete vs. optimally diffusive network market.

To obtain these results, we shall compute a range of cost functions where entering 1) an optimally diffusive network market yields greater profit than 2) not entering and 3) entering a complete network market. Assume market parameters and seeding costs are exogeneous and the size of the market  $n$  is large. Let us first derive equations for optimal profit for each of the three cases as a function of  $n$ , and then compare their asymptotic behavior when  $n$  goes to infinity.

1) *Profit in an optimally diffusive network market.* In an optimally diffusive network market, there are generally multiple intermediate equilibria in addition to the equilibria "all adopt" and "none adopt". Here we assume the entrant firm chooses to target the equilibrium "all adopt" with demand  $n$ , and thus seeds  $O(\sqrt{n})$  early adopters. Note that when costs are sufficiently low, i.e. bounded above by  $c(\|x\|) < \|x\|^{2(k+1)}$ , it is optimal for the firm to target the maximal equilibrium.

To derive the profit function, assume the average degree of consumers in the optimally diffusive network is a  $k$ -th order polynomial function of  $n$ , that is,  $\frac{1}{n} \sum_{i \in N} d_i = O(n^k)$  where  $0 < k < 1$ . For example, the average degree could be approximately  $\sqrt{n}$ . This *average degree assumption* places a minimum bound on the density of adoption externalities in the market: whereas complete network markets have  $O(n^2)$  links, we

consider an optimally diffusive network with  $O(n^{k+1})$  links. Lemma 4.3 proves that such a network indeed exists.

**Lemma 4.3.** *There exists an optimally diffusive network of size  $n$  with  $\frac{1}{n} \sum_{i \in N} d_i = O(n^k)$  where  $0 < k < 1$ .*

Suppose the firm charges a consumer's full willingness to pay for its good in equilibrium, or  $p_i = \theta + \alpha d_i$ . Under the average degree assumption, profit in an optimally diffusive network market is asymptotically equivalent to

$$\pi_L(n) = n(\theta + \alpha n^k) - c(\lceil m \rceil) \text{ where } m^2 - m = (1 - \frac{\theta}{\alpha})n. \quad (5)$$

2) *Profit from not entering.* The firm earns zero profit in this case:  $\pi_B^* = 0$ .

3) *Profit in a complete network market.* Since complete networks support only two equilibria, "all adopt" and "none adopt," it is profitable for a firm to enter a complete network market if and only if revenue from serving the entire market exceeds the cost of seeding its minimal scale. If the firm enters, it seeds  $\lfloor (n-1)/2 - \frac{\theta}{2\alpha} \rfloor + 2$  early adopters and charges a consumer's full willingness-to-pay (WTP) for its good, or  $p = \theta + \alpha(n-1)$ . Optimal profits in a complete network market of size  $n$  is thus

$$\pi_C^*(n) = \alpha n^2 + (\theta - \alpha)n - c\left(\lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 2\right). \quad (6)$$

To make the exposition as clear as possible, let  $\theta = 0$  throughout the remainder of the analysis. These results generalize fully for  $\theta > 0$ , as proved in the appendix. Furthermore for notational clarity, note that  $c(\lfloor (n-1)/2 + 2 \rfloor) > c(n/2)$  and  $c(\lceil m \rceil) < c(\sqrt{2n})$ ; thus it is sufficient to work with these bounds on costs of seeding a complete and optimally diffusive network market, respectively.

I first show conditions under entering an optimally diffusive network is profitable (i.e. greater than profit from not entering). Under the assumptions made above, optimal profits from these decisions are  $\pi_L^*(n)$  and 0 respectively. For  $\pi_L^*(n) > 0$  to hold as  $n \rightarrow \infty$ , there must exist  $n_0$  such that

$$c(\sqrt{2n}) < \alpha n^{k+1} \quad (7)$$

for all  $n > n_0$ . This expression holds if seeding costs are bounded above by a  $2(k+1)$ -ic polynomial, where  $k$  depends on the average degree of the network. In other words, the seeding cost function must increase sufficiently slowly in the number of early adopters for entry to be profitable. As an example, if the average

degree is  $\sqrt{n}$  (i.e.  $k = 1/2$ ), then entry is profitable if seeding costs grow less than cubically in the number of early adopters.

Now suppose the firm has not yet chosen which market to enter. This situation may arise in reality, for example, when a firm has a core technology which can be “pivoted” toward one of two product-markets. Given this context, let us establish conditions under which the firm earns greater profits by entering an optimally diffusive network market than by entering a complete network market.

Call optimal profits in these markets  $\pi_L^*(n)$  and  $\pi_C^*(n)$ , respectively. For  $\pi_L^*(n) > \pi_C^*(n)$  to hold as  $n \rightarrow \infty$ , there must exist  $n_0$  such that

$$c(n/2) - c(\sqrt{2n}) > \alpha n^2 - \alpha n^{k+1} - \alpha n \quad (8)$$

for all  $n > n_0$ . This expression holds if the seeding cost function increases more than quadratically in the number of early adopters, that is, if cost grows faster than revenue from externalities in the complete network.

Putting conditions 8 and 7 together, we see that the firm earns greatest profits by entering an optimally diffusive network market (lean entry) if and only if the form of the cost function is bounded below by a quadratic polynomial and bounded above by a  $2(k + 1)$ -ic polynomial determined by the average degree assumption. For example, when the average degree is  $\sqrt{n}$ , the firm earns greatest profit from lean entry if the seeding function increases more than quadratically but less than cubically in the number of early adopters.

**Proposition 4.6.** *Under the average degree assumption, profits are asymptotically greater from entering an optimally diffusive network market than from not entering the market or entering a complete network market when the seeding cost function satisfies  $\|x\|^2 < c(\|x\|) < \|x\|^{2(k+1)}$ .*

To illustrate Proposition 4.6 with an example, suppose again that the average degree of the optimally diffusive network is  $\sqrt{n}$ . When the seeding cost function grows slower than quadratic in scale, the firm earns greatest profit in a complete network market, followed by the optimally diffusive network market and finally the non-network benchmark. When the cost of seeding grows between quadratic and cubic in scale, the firm earns greatest profit in the optimally diffusive network market, followed by the non-network benchmark, and earns negative profit in the complete network market. Finally, when the cost of seeding grows faster than cubic in scale, the firm earns negative profit in both the optimally diffusive or complete network market. The table below illustrates the relationship between seeding costs and relative profits in this example.

Table 1: Relative profits when  $\theta = 0$  and average degree is  $\sqrt{n}$

Relative Ordering					
$c(\ x\ ) < \ x\ ^2$	$\pi_C^*$	>	$\pi_L^*$	>	$\pi_B^*$
$\ x\ ^2 < c(\ x\ ) < \ x\ ^3$	$\pi_L^*$	>	$\pi_B^*$	>	$\pi_C^*$
$c(\ x\ ) > \ x\ ^3$	$\pi_B^*$	>	$\pi_L^*$	>	$\pi_C^*$

Proposition 4.6 says there is a “sweet spot” of cost functions where lean entry is most profitable. In general, profits depend on a balance between the value of adoption externalities and seeding costs as  $n$  grows large. If seeding costs grow slower than adoption externalities, markets with complete network structure are most profitable because they maximize the number of links between consumers. If seeding costs grow faster than adoption externalities, optimally diffusive network markets are more profitable, but when costs grow too fast, the firm is better off not entering a network market at all.

It is interesting to observe that relative profits from entering each type of market do not depend on parameters  $\theta$  and  $\alpha$  when  $n$  grows sufficiently large. Mathematically, this is because  $\theta$  and  $\alpha$  appear only as scalar multiples of  $n$  in the equations for price and seeding costs, so these parameters do not affect the outcome of the asymptotic analysis. There is also an intuitive explanation for this result: whether lean entry is a profitable strategy in large markets depends far more on seeding costs and network structure than on the quality of the firm’s good or the strength of network effects.

Another implication of the results above is that if given a choice, a firm should enter a complete network market unless the cost of seeding increases too sharply with respect to the number of seeded adopters. This is because though incomplete networks are generally easier to enter, they also contain less value a firm can potentially capture due to fewer externalities. Note however, start-up firms often cannot enter complete network markets due to the large capital investments that must be made up front to build critical mass.

#### 4.5.2 Lean Entry in Real-World Networks

The core result of lean entry is that barriers-to-entry are weaker in optimally diffusive networks than in complete or bipartite networks. This claim can be generalized to an arbitrary network market. In addition, the firm can predict the likelihood that lean entry is profitable by simulating entry and growth outcomes.

To illustrate this, I run a set of simulations on data sampled from a Facebook network, a scientific coauthorship network, and an email network; representing a market for a social media platform, collaboration software, and communications technology, respectively. Each trial of the simulation involved seeding a set

of consumers with an algorithm and running DP. The size of the seed set (scale), demand attained by DP, and resulting profit was then recorded.

The results indicate that lean entry appears to be a viable strategy in real-world networks. Indeed, in all the networks studied, the minimal scale needed to enter profitably was less than the scale needed to enter an equivalent complete network ( $n/2$ ). Whether lean entry is profitable depends on how well it is implemented at the tactical level: specifically which algorithm was used to seed. I show that a simple “greedy” seeding algorithm initialized at random consumers in the network can estimate minimal scale and barriers-to-entry as well as predict the likelihood that lean entry will be profitable. An “optimal” seeding algorithm identifying a highly diffusive  $t$ -cohesive subset(s) of consumers approximates the firm’s optimal profit in an arbitrary network market. I compare these algorithms against the performance of a random seeding algorithm to show that large-scale seeding is neither necessary nor sufficient for a firm’s success.

#### *Data and Algorithms Description*

I used network data from Stanford Large Network Dataset Collection [34] for the simulation. The first data set is a social network with individual profiles and profiles of their friends collected from Facebook via a survey app, then combined to form a single network. It represents a market for a social media platform such as Facebook or Google Plus. See Example 3.3 in Chapter 3 for a visualization of this network. The second data set is a scientific collaboration network where there exists a link between two consumers if they coauthored a published paper together. It represents a market for a collaborative productivity software such as Dropbox or Mathematica. The third data set is an email network collected from Enron and made public by the Federal Energy Regulatory Commission. It represents a market for a communications technology such as Skype or WhatsApp.

Each data set contains a set of consumers (nodes)  $N$  and pairs of undirected links (edges) between them,  $L$ . All networks are undirected, in the sense that externalities are symmetric between pairs of consumers. A table with summary statistics of the data appears below.

	Nodes	Edges	Avg Degree	Stdev Degree	Avg Clustering
Facebook	4,041	88,235	44	52	0.61
Coauthorship Network	5,242	14,496	11	16	0.53
Email Network	36,692	183,831	20	72	0.50

I apply three algorithms to seed the data sets described above: a “random” seeding algorithm that randomly seeds a specified number of consumers from the network; a “greedy” seeding algorithm that starts

from a focal consumer, seeds more than half its peers, and so on; and an “optimal” seeding algorithm that attempts to approximate the smallest  $t$ -cohesive set in a network by removing one consumer at a time from the maximal demand equilibrium.

The random seeding algorithm simply seeds random sets of  $k$  nodes. It was applied for 100 trials at various  $k$ s. Only the best trial out of 100 trials for a given  $k$  was recorded.

The greedy seeding algorithm first initializes the seed set with a randomly selected node, then proceeds to add just more than half the peers of each node in the seed set until there are no more peers to add. Peers can be prioritized by degree, where prioritizing low-degree peers generally reduces the size of the smallest simulated seed set but prioritizing high-degree peers is generally more profitable due to wider diffusion. The greedy algorithm was applied for 200 trials to each of the three networks (100 prioritized by high-degree peers and another 100 prioritized by low-degree peers). All trials were recorded.

The optimal seeding algorithm first computes the maximal equilibrium according to [26], Chapter 9.8. Next, it removes one node at a time from the set of consumers adopting in maximal equilibrium, proceeding if the remaining set is  $t$ -cohesive. The algorithm stops when no more nodes can be removed<sup>4</sup>. Low-degree nodes can be removed prior to high-degree nodes to improve algorithm performance. It was applied for 10 trials each to the Facebook and Coauthor networks; it was not applied the Email network since the trials were computationally intensive.

### *Simulation Results*

Figures 2, 3, and 4 below show the outcomes of the simulation. Profit was calculated based on a function with parameters  $\alpha = 1$ ,  $\theta = 0$ , and  $c(|x|) = |x|^{1.5}$ , and price charged to consumer  $i$  is equal to her degree. The dotted curve shows a profit function with these parameters where price is approximated by the network’s average degree. The area to the left of the dotted curve indicates the space of profitable trials.

---

<sup>4</sup>The proof that the algorithm’s output is a  $t$ -cohesive set relies on intuition similar to the proof for Proposition 4.4.

Figure 2:

### Facebook Network: Entry Simulations

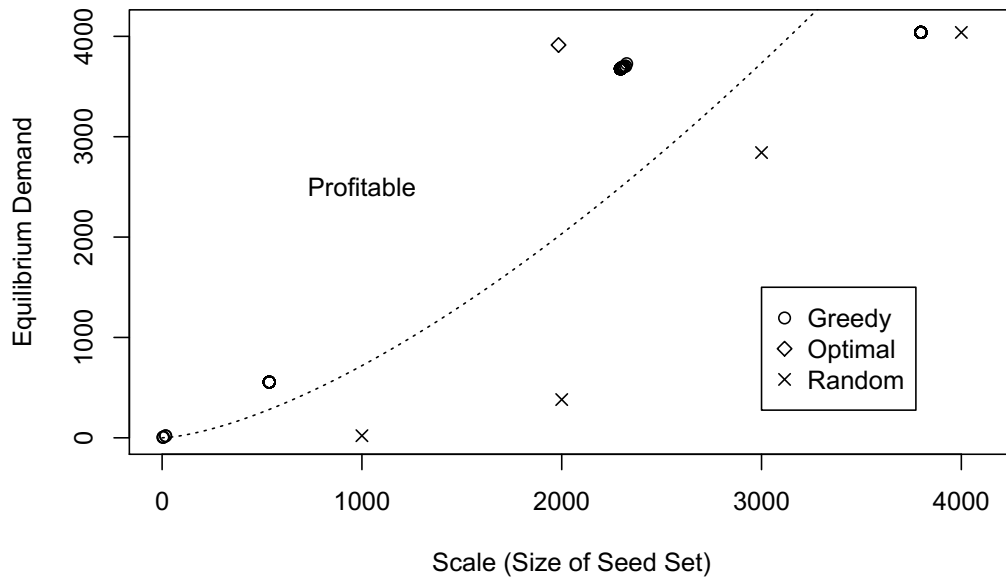




Figure 3:

### Coauthor Network: Entry Simulations

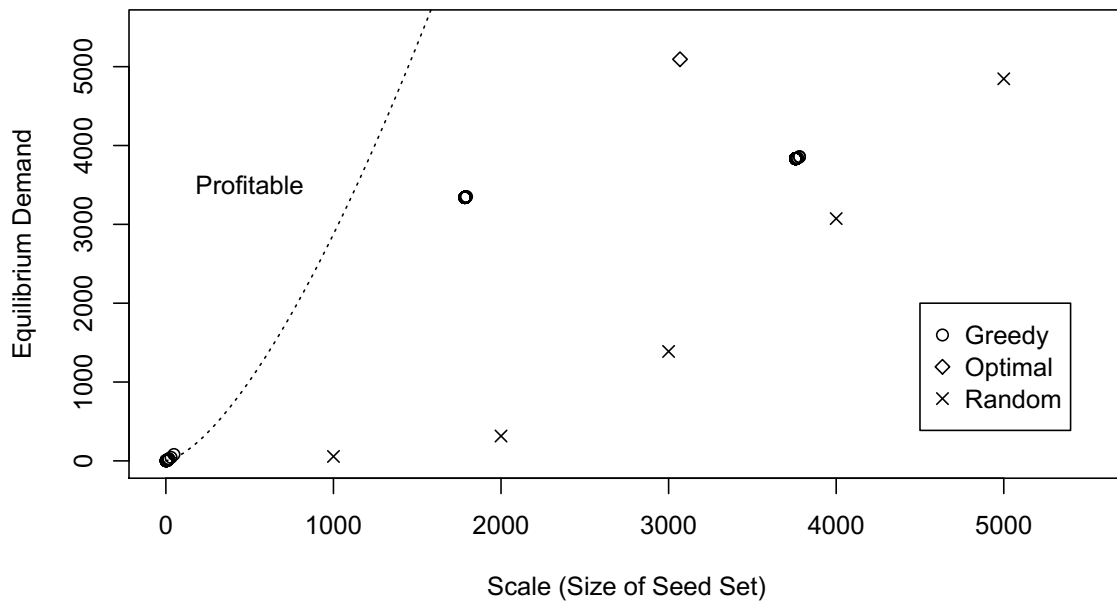
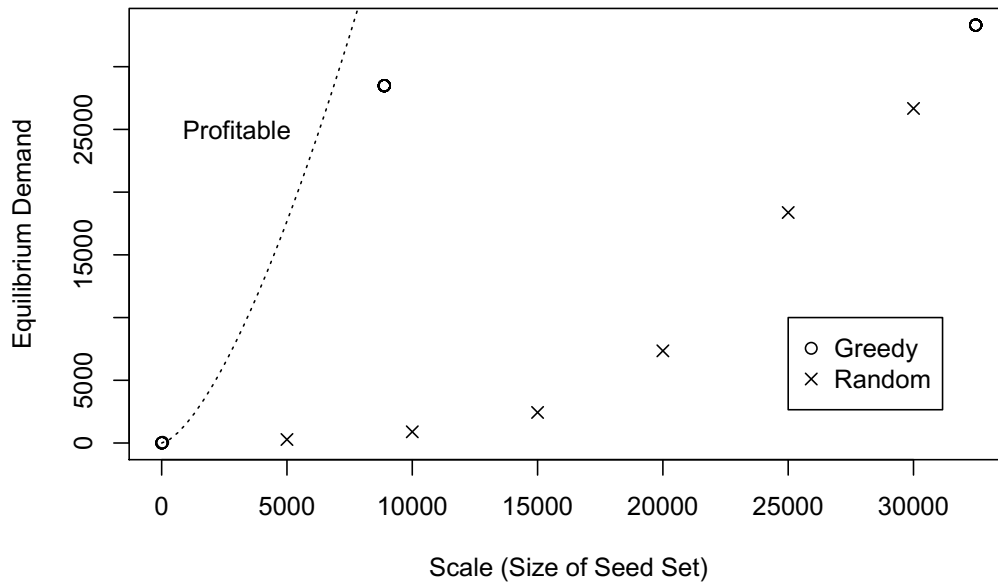


Figure 4:

### Email Network: Entry Simulations



In all the networks studied, the minimal scale needed to enter profitably was less than the scale needed to enter an equivalent complete network ( $n/2$ ). In the case of Facebook (Figure 2), the minimal scale was 4; for the coauthor network (Figure 3) it was 2; and for the email network (Figure 4) it was 3. Barriers-to-entry, calculated using the cost function above, were thus 8, 2.8, and 5 respectively; in contrast, barriers-to-entry for an equivalent complete network with an equal number of nodes would be 90889, 134261, and 2485121 respectively.

From 200 trials of the greedy seeding algorithm, we see that the percentage of profitable trials were 52, 28, and 14 respectively. In other words, lean entry in the Facebook network was the most frequently profitable of the three networks studied. There are two reasons for this. First, the frequency of  $t$ -cohesive sets in the network determines profitability. Clusters of outcomes of the greedy algorithm indicate  $t$ -cohesive sets found by this algorithm (due to the random nature of the algorithm, there are some slight random variations between the sets). All three networks had a number of  $t$ -cohesive sets, but Facebook had 4 unique clusters while the coauthor and email network both had 3. Second, the distribution of degrees in the network determines profitability, with higher degree consumers being more profitable. This is easy to understand because higher degrees results in greater externalities and more value generated from adoption. The Facebook network has higher average degree and lower proportional variance than the other networks. Finally, the network's diffusiveness determines profitability. If we measure diffusiveness as the ratio of scale to equilibrium demand, the email network appeared to be the most diffusive, with a demand of approximately 28K reached from a scale of approximately 9K. However, its diffusiveness did not compensate for its comparatively low average degree and high degree variance.

From 10 trials of the optimal seeding algorithm, we see that the algorithm had poor performance on the coauthor network but was profitable for Facebook (Figure 2). The table below shows the best trial of the greedy algorithm as the "optimal" profit for the email network. Note that in all three cases, optimal profit in a complete network of equivalent size is vastly more profitable than optimal profit in the incomplete network (the reverse is true with sharper cost functions, as indicated by Proposition 4.6). This is due to the vastly higher average degree of the equivalent complete network: 4040, 5241, and 36691 respectively. However, we would probably observe more frequent entry in the incomplete networks if resource-constrained firms are unable to seed the minimal scale required to overcome barriers-to-entry in a complete network.

	# Trials Greedy Seed	% Profitable Greedy Seed	Min Scale	Optimal scale	Optimal demand	Optimal profit
Facebook	200	52%	4	1984	3914	83844
Coauthorship Network	200	28%	2	3068	5094	-113595
Email Network	200	14%	3	8883	28487	-266340

### 4.5.3 Diffusion and First Mover Advantage

So far, we have assumed in our analysis that the entrant firm is a second mover, and all consumers have adopted an incumbent network good at the time of entry. This assumption is easily generalized to allow a proportion of consumers to have adopted a non-network good at the time of entry. In this case, barriers-to-entry are weaker. This is because a consumer with more peers adopting an incumbent network good always has a weakly higher adoption threshold compared to if she had fewer peers. Though the principles of  $t$ -cohesion still apply, lower thresholds make seeding less costly. Growth also occurs faster, meaning that DP requires fewer iterations to reach equilibrium demand. In the extreme, if the firm is a first mover, the smallest self-sustaining set contains only two members.

To formalize this observation, suppose  $y_i^* = 1$  if consumer  $i$  has adopted the incumbent's good at time of entry and  $y_i^* = 0$  if  $i$  has adopted a non-network good with quality  $\theta$ . The entrant firm, as before, seeds state  $x$ . Recall from section 4.2 that consumers have thresholds  $t_i = \frac{v_i - \theta}{\alpha}$ , where  $v_i$  is the value of consumer  $i$ 's outside option.

For consumer  $i$  who has adopted the incumbent's good at time of entry, her outside option has value  $v_i = \theta + \alpha \sum_{j \in L(i)} (y_j^* - x_j)$  and thus her adoption threshold is:

$$t_i^\tau = \sum_{j \in L(i)} (y_j^{*\tau} - x_j^\tau) \quad (9)$$

where  $y_j^{*\tau}$  or  $x_j^\tau$  are equal to 1 if peer  $j$  adopts the incumbent's or entrant's good in an iteration of diffusion  $\tau$ . If  $y_j^{*1} = 1$  for all  $j \in L(i)$ , this translates to the  $\frac{1}{2}$  proportional threshold we saw earlier: a consumer adopts the entrant's good if more than half her peers have already adopted.

For a consumer who has *not* adopted the incumbent's good at time of entry, her outside option has value  $v_i = \theta$  and thus her adoption threshold is  $t_i = 0$ . This implies that a consumer of a non-network outside option needs only *one* peer to adopt for the pair's adoption to be self-sustaining.

Therefore the entrant's start-up costs weakly increase in the market's adoption of the incumbent's good at time of entry,  $y^* = (y_1^*, \dots, y_n^*)$ , because it takes weakly more early adopters  $\|x\|$  to reach the same demand.

**Proposition 4.7.** *For any seed state  $x$ , demand  $D(x)$  for the entrant's good is weakly lower when adoption of the incumbent's good is greater at time of entry:*

$$\text{If } y^* \succeq y^{*'} \text{ then } D(x|y^*) \leq D(x|y^{*'}).$$

Proposition 4.7 implies that given two identical network markets, a firm should enter the one where fewer consumers have adopted an incumbent good. Of course, the decision of which market to enter in reality requires many more trade-offs than the model addresses, including the cost of product development, resources of incumbent firms, and so on, which are outside the scope of this paper. However, the theory does suggest that the speed of late entry is important, and that becoming a first mover through radical innovation may be more profitable than displacing incumbents through incremental innovation.

Ironically, complete network markets are actually ideal for diffusion if the firm is a first mover since any two consumers form a self-sustaining set. DP requires only one iteration for adoption to diffuse to the entire network, reflecting the tipping phenomenon of classic network effects theory. The result also holds for bipartite markets where all consumers on one side are linked to all other consumers on the other side. Combined with the observation that complete network markets can be more profitable due to a greater number of externalities, this implies that a first mover given the option to enter a complete network market should not use a lean entry strategy.

## 4.6 Discussion

The model in this chapter showed that barriers-to-entry in markets with network effects may be weaker than previously characterized. The minimal scale needed to enter depends on the network structure of externalities between consumers: the structural property of cohesion lowers minimal scale. But cohesion is also a double-edged sword, stifling diffusion when too severe. Early adopters which span the boundary between cohesive adopters and the rest of the network help balance this tension. In incomplete network markets with a large fraction of “boundary spanners,” seeding a small number of early adopters can lead to growth that is rapid and discontinuous. This is the core insight behind the strategy of lean entry.

A lean entry strategy can even the playing field between established firms and entrepreneurs. If entrepreneurs face resource constraints when seeding early adopters, it can be the only viable entry strategy. Even in the absence of resource constraints, a lean entry strategy can be more profitable than alternatives when the cost of seeding grows quickly in the number of early adopters. Its likelihood of profitability can be predicted with simulations on real-world network data; for one of our networks lean entry was profitable over 50 percent of the time.

Sometimes, employing a lean entry strategy may lead to lost opportunities. Becoming a first mover in a new network market may be far more profitable than displacing an incumbent in an established one. In the real world, firms may also have endogenous influence over network structure. Though outside the scope of our model, future research might explore how firms can design optimal network markets to build a competitive advantage. For example, a firm might first enter an incomplete network and later increase the density of externalities to strengthen barriers-to-entry against new entrants. Anecdotal evidence suggests some firms have already implemented such practices, whether intentionally or by trial-and-error. For example, though Facebook entered its market by way of college students, it quickly evolved into a two-sided platform linking users, application developers, and advertisers.

## 5 First Mover Advantage of Exchange-Traded Products

### 5.1 Introduction

Exchange-traded products hold over \$1.5T investor funds in the U.S. and have experienced tremendous growth and innovation over the last decade. These products include exchange-traded funds (ETFs), structured as open-ended investment companies, and exchange-traded notes (ETNs), structured as debt securities. Like mutual funds, ETPs allow investors to track an index, commodity, or basket of assets; like stocks, shares of ETP also trade on US equity exchanges. For example, an ETF holding gold as its underlying asset enables participants of the New York Stock Exchange to buy or sell gold by trading shares of the ETF.

Because of the products' popularity and ease of imitation, the ETP industry tends to be intensely competitive. This pattern of innovation followed by free entry has led to led most ETPs to become commodities with arguably little to no product differentiation within markets. For example, several firms have issued gold ETFs, both holding nearly identical underlying assets, i.e. gold bars kept in high-security vaults. At first glance, it appears an investor can just as easily buy one gold ETF as another, and would thus pick the one with the lowest price, known as an ETP's *expense ratio*.

Yet puzzling performance differences persist between competing products. GLD and IAU, two nearly identical gold ETFs both holding gold and trading on the same equity exchange, show a large disparity in their assets under management (AUM), a proxy measure for investor demand. GLD, the first mover in this market, has historically held over 80% of the total market AUM while charging *higher* expense ratios than IAU.

These persistent performance differences are typical across ETP markets. Industry experts believe they are caused by a first mover advantage. The ETP industry offers an unprecedented setting to test theories of first mover advantage, due to both the sheer number of markets and amount of observable data within each market. This allow an improved empirical design in at least three dimensions. First, while product failures (exits) may not be observable in most industries, historical stock data is free of this selection bias as it tracks the precise dates of ETP entry and exit. Second, ETPs competing within the boundaries of a market are nearly identical in composition, providing a natural control for unobserved product differentiation. Moreover, any remaining quality differences are observable, as product composition is clearly stated in fund prospectuses and regulated by the SEC. Finally, since most firms issue many products, unobserved heterogeneity at the firm level can be removed from measurements of first mover advantage at the product level.

I exploit these institutional features to test for the existence of first-mover advantage of ETPs. The

unit of observation is a product rather than a firm. ETP performance is measured by AUM and likelihood of survival relative to competitors within a market. I estimate the impact of being a first mover on ETP performance across approximately 300 markets while controlling for firm and cohort fixed effects, and find a large and statistically significant impact which can be interpreted as causal.

I hypothesize that three mechanisms may drive first mover advantage at the product level: liquidity, switching costs, and firm strategy. Analogous to network effects, investors' preference for liquidity can cause adoption for an incumbent product to snowball while creating barriers against new entrants. Switching costs may drive first mover advantage if investors incur significant capital gains taxes, brokerage fees, or search costs by switching to a competing product. They can also reinforce barriers to entry caused by liquidity. Finally, the interaction between firm strategy and a product's order of entry may drive first mover advantage if firms learn or are able to capture superior resources when launching first mover products.

## 5.2 Literature

A longstanding aim of research in strategic management is to explain why some firms earn supranormal profits compared to industry benchmarks. At one end of the debate, scholars in strategic management have focused on features of firms themselves such as leadership, resource acquisition, and organizational structure. At the other end, scholars have focused on features of markets and industrial organization such as market structure, competitive positioning, and order of entry.

The order of entry framework used to explain firms' supranormal profits is also known as the theory of "first mover advantage." According to this framework, first mover firms tend to become the "dominant" firms in the industry. Scholars have introduced a multitude of theories to explain first mover advantage, including pricing and output (Stackleberg 1934), learning and experience ([6], [42]), product proliferation (Hotelling 1929), switching and search costs ([32], [18], [43]), technological advantages [35], and network effects ([17], [31]).

Empirical studies of first mover advantage have reached contrasting conclusions. In support of the theory, scholars have shown learning [27], product proliferation and branding ([40], [41], [25], [9]), search costs [24], and supply-side economies of scale [45] to lead to superior first mover performance. But other studies have been inconclusive and even shown evidence for a first mover *disadvantage* ([21], see [39] for a survey). To date, there is still insufficient evidence for first mover advantage as a general phenomenon across markets and industries, in part because of methodological limitations such as survivorship and sampling bias, unobserved firm-level heterogeneity, and lack of controls for firm tenure (see [47] for a meta-analysis).



My paper attempts to extend and clarify work in the first mover advantage literature by first testing for first mover advantage in a novel industry where many of these confounders are directly observable, and second, developing a novel empirical framework which exploits institutional features to help control for product and firm-level heterogeneity.

My paper attempts to speak to a parallel but related literature which has held an ongoing debate about the sustainability of competitive advantage. This literature researches whether competitive advantage, such as that provided by first mover advantage, can be preserved or is necessarily competed away over time. On the pro side of the debate, scholars have made two arguments in favor of sustainability: that a firm's institutional context, such as its culture and network, allows it to sustain a competitive advantage [37]; and that sustainable competitive advantage is driven by resources that are valuable, scarce, and difficult to copy, including intangible resources such as brand [11] [38] [22]. More recent work in this literature has focused on identifying barriers to imitation. My paper may provide a particularly interesting contribution to this debate since it finds evidence of sustainability, but appearing in a context where intellectual property is highly transparent and easily imitable.

The final stream of literature my paper speaks to is the literature on innovation and competition in the finance industry. Prior work from this literature focuses on firm incentives to innovate, such as risk sharing, incomplete markets, agency issues, transaction costs, and response to regulation <sup>5</sup>. However, I believe there is much more to be found. To date, few studies have studied competition in financial industries; given the public data sources available, this remains an untapped source of insights for the field of strategic management.

## 5.3 Empirical Design

### 5.3.1 Data

Two data sets were created for the purposes of this study. The first is a cross-sectional data set of the performance and attributes of approximately 1700 ETPs across approximately 300 markets (henceforth called "markets"). Cross-sectional data was collected in December 2013. The second is a panel data set tracking the entry, exit, and performance of these ETPs over time (henceforth called panel). I used the markets data set to measure differences in *equilibrium* performance between first and late movers in the same market, whereas I used the panel data to measure differences in ETP survival rates and growth.

To build these data sets, I combined and cross-validated data from the Center for Research in Security Prices (CRSP) stock files, the CRSP mutual fund database, Bloomberg, Morningstar, and the SEC Edgar

<sup>5</sup>For a survey, see Allen & Gale (1994) [3], Duffie & Rahi (1995) [12], and Tufano (2003) [46]

database. CRSP stock header files tracked ETP performance, including AUM, trading volume, and entry and exit. The CRSP mutual fund database, Bloomberg, and Morningstar track data on product attributes such as expense ratios, portfolio holdings, and fund structure. In addition, Bloomberg and Morningstar include ETP market specifications which formed the basis of my construct of market boundaries.

To create market boundaries, I first identified market boundaries by matching ETP product attributes from the CRSP mutual fund database as well as product categories from Bloomberg and Morningstar. Each ETP was labeled with 4 attributes: type (fund or note), leverage factor (-1 for inverse ETPs, 2 for 2x leveraged ETPs, etc.), category (based on Bloomberg and Morningstar product categories), and category refinement (based on string matching of CRSP product attributes). I then labeled two ETPs as belonging to the same market if and only if they shared all 4 attributes. Table 2 contains examples of the final 10 largest and smallest ETP markets.

Next, I assigned a launch order to every ETP within a given market by ordering ETPs by their inception date as determined by the first day of trading on an equity exchange. I assigned an order of 1 to the earliest ETP in a market, 2 to the second, and so on. If two ETPs have the same inception date, they received the same launch order. An ETP was labeled as a first mover if its launch order was 1. For a visual illustration of this process, please see Figure 11 in the Appendix.

To filter for observations of equilibrium performance, I dropped markets that had less than two ETPs competing within its boundaries, and markets which had been formed after 2011. For the remaining markets, I calculated assets under management (AUM) by multiplying equilibrium (December 2013) outstanding shares by share prices (net asset value or NAV). I calculated notional trading volume by multiplying the number of traded shares by share prices. I calculated market shares by scaling an ETP's AUM by the total market's AUM.

To create the panel data set, I used monthly outstanding shares and share prices from the CRSP stock file from January 1993 to December 2013. Survival was calculated by identifying whether an ETP's end date of trading on an exchange was before December 2013. Growth rates over  $\tau$  periods were calculated from AUM observed in months  $t$  and  $t + \tau$ . In addition, I collected a monthly panel of historical expense ratios from the Morningstar ETF database.

To identify important historical events and changes in industry structure or regulations I used qualitative data from SEC filings such as shareholder reports and investor prospectuses. Where useful I supplemented this with sources such as Wall Street Journal, the Financial Times, and Harvard Business School cases.

There were some minor issues with missing data. 16 ETPs had missing expense ratios because they

were no longer actively traded. For the panel data set, I imputed missing expense ratios using the earlier observation when multiple observations appeared over time. In addition, some ETPs were missing data on their AUM in the first days of trading (Initial Capital), though this does not affect the regression analysis.

Table 2: 10 Largest and Smallest Markets by Number of Products

Market Name	Unique Products	Unique Firms
F Sector Fund-Financial Service Financial	17	10
F Emerging Market-Equity Diversified Emerging Mkts Large Cap	15	10
F Country Fund-Japan Japan Stock	14	9
F Sector Fund-Real Estate Real Estate	14	4
F Sector Fund-Technology Technology	14	8
F Corporate/Preferred-High Yld High Yield Bond	13	7
F Growth	13	6
F Sector Fund-Energy Equity Energy	13	8
F Growth-Large Cap Large Growth	11	8
F Sector Fund-Health & Biotech Health Healthcare	11	8
F Sector Fund-Undefined Equity Natural Res Global Metals	2	2
F Sector Fund-Utility Industrials	2	2
F Value-Large Cap Large Value Russell 1000	2	2
F Value-Small Cap Russell 2000	2	2
N 2x Blend Trading-Leveraged Equity	2	2
N Commodity Commodities Agriculture Livestock	2	2
N Commodity Commodities Precious Metals	2	2
N Commodity Commodities Precious Metals Gold	2	2
N Commodity Commodities Precious Metals Platinum	2	2
N Country Fund-India	2	2

### 5.3.2 Summary Statistics

#### *Overall Summary*

The summary statistics in Table 3 show the final markets data set used for the analysis. After applying filters, there were a total of 1095 ETPs in the data set. The smallest market contains 2 ETPs while the largest contains 17. Since some firms issue multiple products in a single market (for example, two growth stock ETFs with similar holdings), there are at most 10 firms competing in a single market. Products have on average 614 days, or about 2 years, before a competitor enters the market. Entry has, however, become more frequent over time.

Though the earliest ETP was launched in 1993, the average and median ETP was launched in 2008. In general, products start with very little initial capital in the first days of trading: on average 75K, though some start with as much as 22M.

The average expense ratio in the data set is 0.52%, or 53 basis points. However, expense ratios have a relatively large spread: the lowest is 4 basis points while the the highest is 4.2% <sup>6</sup>.

AUM also has a large spread. 181 products had shut down (died) at the time observations were taken; they have AUM of 0. In contrast, the most popular ETP has 133B of AUM. The distribution is right skewed: while the average AUM in the data set is 1.2B, the median AUM is 28M. The 25th percentile is 3.5M, and the 75th percentile is 220M. Notional volume, or average dollar volume traded over 3 months at the time of data collection, is strongly correlated with AUM and thus shows a similar distribution.

Table 3: Markets and Products Summary

Statistic	Mean	St. Dev.	Min	Max
Refined Market Size	6.3	3.8	2	17
Firms Per Market	4.5	2.3	2	10
Launch Rank	3.6	2.8	1	17
Days Before Competitor Entry	614	843	0	5,817
Inception Year	2008	3.5	1993	2012
Initial Capital	75K	716K	123	22M
Expense Ratio	0.53	0.32	0.04	4.2
AUM	1.2B	5.8B	0	133B
Notional Volume	47M	617M	0	20B

### *Firms*

Table 4 shows that there are a total of 55 firms which have issued products in the final data set used for analysis. Most firms issue either ETFs or ETNs, though a handful issues both. This can be seen by comparing the “ETFs” column with the “Total Issued” column. In addition, it appears that there is some degree of specialization among firms, though firms issuing the most products (iShares, State Street, Vanguard, PowerShares, etc.) directly compete with one another in multiple markets. Figure 13 shows that specialization tends to occurs for niche products, such as “alternative” leveraged/inverse products, which are generally used as trading instruments rather than for buy-and-hold purposes.

Three firms dominate the industry: State Street Global Advisors (SSgA), BlackRock (brand name iShares), and Vanguard. Together they hold over 85% of the industry’s AUM and approximately 40% of first mover products. State Street was the first firm to launch an ETP: the S& P 500 ETF SPY in 1993. However, it has lower AUM and has launched fewer products than competitor BlackRock, which entered the industry in 1996. BlackRock holds over 40 % of the industry’s AUM and has launched the most products

<sup>6</sup>Higher expense ratios are generally charged by actively managed funds, a relatively new phenomenon in the industry

as well as the most first movers. A visualization appears in Figure 12 in the Appendix. Vanguard entered the industry in 2001. Though a late entrant with comparatively few products and few first movers, it has a disproportionate amount of AUM.

Table 4: ETP Issuers (Firms)

Firm	ETFs	Leveraged	First Movers	Survived	Total Issued
iShares	218	0	88	218	219
PowerShares	136	0	29	108	136
State Street Global Advisors	111	0	31	109	111
First Trust	62	0	2	62	62
Vanguard	61	0	15	61	61
Guggenheim Investments	60	2	7	60	60
WisdomTree	40	0	9	30	40
Van Eck	35	0	10	35	35
ProShares	31	26	15	31	31
Barclays Funds	0	1	14	22	22
Deutsche Bank	17	0	9	22	22
Global X Funds	22	0	3	13	22
Emerging Global Advisors	20	0	2	20	20
Claymore (Guggenheim)	19	0	2	0	19
PIMCO	16	0	2	16	16
FocusShares	15	0	0	0	15
Schwab Funds	15	0	0	15	15
Direxion Funds	14	9	8	10	14
Russell	13	0	2	0	13
UBS AG	0	1	2	13	13
AdvisorShares	12	0	1	12	12
Merrill Lynch	12	0	4	0	12
IndexIQ	11	0	2	7	11
Northern Trust Corporation	11	0	1	0	11
Northern Trust	9	0	1	9	9
Rydex (Guggenheim)	9	8	0	0	9
United States Commodity Funds LLC	9	0	2	9	9
Royal Bank of Scotland NV	0	0	0	8	8
Columbia	7	0	0	5	7
Credit Suisse AG	0	0	0	7	7
Xshares	7	0	3	0	7
ALPS	6	0	1	3	6
SPA	6	0	0	0	6
VTL Associates, LLC	6	0	0	6	6
Adelante Shares	5	0	0	0	5
Ameristock Funds	5	0	0	0	5
ETF Securities Ltd	5	0	0	5	5
Old Mutual Global Index Trackers	5	0	0	0	5
Teucrium	3	0	0	3	3
Nuveen	2	0	0	0	2
Swedish Export Credit Corporation	0	0	0	2	2
AlphaClone	1	0	1	1	1
Citigroup	0	0	1	1	1
ETF Advisors	1	0	0	0	1
Exchange Traded Concepts, LLC	1	0	0	1	1
Fidelity Investments	1	0	1	1	1
Goldman Sachs	0	0	0	1	1
GreenHaven	1	0	0	1	1
Huntington Strategy Shares	1	0	0	1	1
International Securities Exchange	1	0	0	1	1
Javelin	1	0	1	0	1
JPMorgan	0	0	1	1	1
Morgan Stanley	0	0	0	1	1
Pax World	1	0	0	1	1
Precidian Funds LLC	1	0	0	1	1
Sprott	1	0	0	0	1
Ziegler Capital Management	1	0	0	0	1

### Competition and Industry Growth

The ETP Industry overall has grown rapidly. A visualization appears in Figure 10 in the Appendix. The growth of the industry has led to a greater frequency of entry over time. For example, Table 5 shows that while the median duration before competitor entry was roughly 5.5 years for an ETP launched before 2000, the duration was reduced to a mere 3 months by 2011. The number of products launched overall increased sharply around 2005. Overall industry growth is also reflected in the time it takes before a second mover enters the market compared to a third or fourth mover, though there, strategic factors are also likely at play.

Table 5: Days Before Competitor Entry by Inception Year

	Min.	1st Qu.	Median	Mean	3rd Qu.	Max.
Before 2000	84	544	2,051	2,439	4,413	5,817
2001	84	1,077	1,587	1,588	1,796	3,542
2002	0	472	1,526	1,323	1,754	3,381
2003	42	919	1,201	1,454	2,286	2,797
2004	64	201	630	631	886	2,556
2005	13	178	329	610	774	2,288
2006	0	31	172	475	642	2,316
2007	0	72	202	446	754	1,992
2008	0	237	665	671	1,092	1,668
2009	0	134	308	363	533	1,162
2010	0	36	193	221	348	986
2011	0	24	85	168	282	694

Table 6: Days Before Competitor Entry by Order of Entry

Order of Entry	Min.	1st Qu.	Median	Mean	3rd Qu.	Max.
1st	0	139	472	956	1,547	5,817
2nd	0	91	311	614	886	3,760
3rd	0	90	301	527	790	2,693
4th	0	54	176	420	671	1,878

In general, larger markets (as measured by total market AUM, a proxy for total demand) experience more entry. For example, Table 7 shows that markets with 2 or 3 entrants have lower total AUM than markets with 4 or more entrants. However, demand appears to be distributed unevenly across competitors. There is a sizeable difference in AUM between a market's first and second mover, and this difference does not appear to narrow based on the size of the market.

The difference in performance between early and late movers appears to hold more generally. Figure 5 shows that a product's order of entry appears to have a strong correlation with its AUM: on average, first movers seem to have significantly greater AUM than late movers (note the linear relationship in logs). Again, it is worthwhile to emphasize this pattern does not appear to be driven by market size; it is not merely the case that larger markets invite more entry and thus each late entrant receives an evenly smaller market share.

Table 7: AUM by Market Size

Market Size	Number of Markets	Avg. Market AUM	logAUM 1st Mv. - logAUM 2nd Mv.
2	88	1.1B	16.884
3	49	3.4B	16.874
4	37	10.2B	18.497
5	23	5.1B	18.404
6	17	8.7B	16.741
7	8	3.8B	13.176
8	8	10.1B	19.789
9	7	8.4B	19.263
10	7	7.3B	12.912
11	5	9.1B	20.063
13	3	14.1B	19.354
14	3	8.5B	18.651
15	1	64.8B	22.063
17	1	14.1B	20.240



Figure 5: AUM by Order of Entry



### 5.3.3 Hypotheses

I consider two measures of first mover performance: demand (measured by AUM and market shares), and survival rates.

The simplest measure of an ETP's performance is demand, driving the total amount of capital held by an ETP at any point in time. Demand comes from two sources: market makers, who create large blocks or "creation units" of ETP shares on behalf of the sponsor firm and resell them on a secondary equity exchange (such as NYSE ARCA or NASDAQ), and buy-side investors (market takers), who buy or sell shares of an ETP only on the secondary exchange.

If there is greater demand for first mover products, we should observe that they have higher assets under management (AUM) and market shares relative to their competitors. The reason for this is that AUM

measures the total investor funds held by an ETP, plus investment returns. Since the returns of products competing within a market are identical, demeaning AUM or calculating market share removes the effect of fund returns and thus only measures demand from market participants.

Another measure of an ETP's performance is survival. ETP survival is often a reasonable proxy for profits, as firms generally shut down a product when it is unprofitable. Thus if first mover ETPs are more profitable than competitors, we should observe that they have a higher likelihood of survival.

An product's profitability is generally determined by two factors: its revenue to the issuing firm, and variable costs. The majority of revenue derives from the expense ratio charged to investors as a percentage of AUM. A small amount of revenue also comes from fees charged to market makers. Variable costs of managing an ETP include custodian fees, manager salaries, transaction costs from rebalancing holdings, and profit sharing with distributors and affiliates.

Since we cannot observe all variable costs, we cannot measure an ETP's exact profits. But a rule of thumb proposed by industry experts is that it takes \$20M – \$30M of AUM for a product to survive. Using average industry expense ratios, we can back out variable costs to be approximately \$100K annually, though larger ETP issuers likely incur lower costs.

Several factors may explain why first mover products perform better than market benchmarks. Many do not reflect a true first mover advantage, as they are not causally driven by a product's order of entry. Such spurious drivers of "first mover advantage" include price and product differentiation exogenous to order of entry, differences in product tenure, and firm heterogeneity.

Despite these caveats, a first mover advantage does appear plausible in the ETP context. Moreover, due to the availability of data on expense ratios (price), product composition (by definition nearly identical within market boundaries), product inception dates, and issuing firms, we can remove much of the spurious causes of superior first mover performance listed above. I thus hypothesize:

**Hypothesis 5.1.** *First mover exchange-traded products (ETPs) have higher equilibrium AUM, market shares, and survival rates than competitors. Moreover, these performance differences are not driven by product differentiation, expense ratios (price), differences in product tenure, or firm heterogeneity.*

To test this hypothesis, I estimate a firm and market fixed-effects model of log AUM as a function of a first mover dummy and product-level controls. In order to interpret the coefficients on first mover as a causal measure, my empirical design assumes that all differences in ETP performance within a market are due to order of entry after accounting for firm fixed effects, market fixed effects, and controls.

Controls include equilibrium expense ratios ( $Expense_i$ ) and product tenure (inception year dummies  $Y_i$ ). Adding market fixed effects implicitly controls for product differentiation. As a robustness check that market boundaries are correctly drawn and thus adequately control for product differentiation, I estimate the model using only products tracking the same indices (thus having identical composition by definition).

I also estimate a model of AUM market share  $Share_i$  as a function of a first mover dummy, firm fixed effects, firm-first mover interactions, and controls. To calculate market share, I divide the AUM of an individual ETP  $i$  by the total AUM of all ETPs in  $i$ 's market and multiply by 100.

Finally, I estimate a logit model of ETP survival  $Survive_i$ , where survival is defined by whether an ETP has positive AUM in equilibrium. I use the same independent variables and controls as in the models above, but use only firm fixed effects since there is no reason to assume inherent differences in survival rates across markets.

Regression specifications appear below, where  $\rho$  is the coefficient of interest. The subscript  $i$  indicates an ETP,  $First_i$  is a first mover dummy,  $First_i * F_i$  is a firm-first mover interaction,  $F_i$  is firm fixed effects,  $M_i$  is market fixed effects,  $Expense_i$  is expense ratio, and  $Y_i$  is inception year:

$$\log(AUM_i) = \beta_0 + \rho First_i + \beta_1 Expense_i + \beta_2 Y_i + F_i + M_i + \epsilon_i \quad (10)$$

$$Share_i = \beta_0 + \rho First_i + \beta_1 Expense_i + \beta_2 Y_i + F_i + \epsilon_i \quad (11)$$

$$\text{Logit}(Survive_i) = \beta_0 + \rho First_i + \beta_1 Expense_i + \beta_2 Y_i + F_i + \epsilon_i \quad (12)$$

## 5.4 Results

Consistent with hypothesis 5.1, I find that first mover ETPs have several times greater AUM, market share, and likelihood of survival than market competitors. These performance differences persist even when accounting for product differentiation, expense ratios (price), differences in product tenure, and firm heterogeneity.

As stated in the table 8 below, first mover ETPs have approximately 5 times higher AUM than late movers in their respective markets. If all spurious drivers of first mover performance are indeed fully accounted by product differentiation, expense ratios, differences in product tenure, and firm heterogeneity, this bump in AUM can be interpreted as the magnitude of first mover advantage from a demand perspective: first movers are on average 5 times more in demand than late movers. A 95% confidence interval, while large

(approximately 2 - 10 times higher AUM), is significantly different from 0.

Similarly, first mover ETPs show approximately 45% greater market share than late mover competitors. A 95% confidence interval is approximately 41% - 49% and is significantly different from 0. Again we can interpret this figure as an estimate of first mover advantage from a demand perspective if our controls account for spurious drivers of first mover performance.

Finally, first mover ETPs have approximately 4 times higher odds of survival than their late mover counterparts. The odds ratio can be calculated precisely by exponentiating the coefficient in table 8. A 95% confidence interval is approximately 2.5 - 6 times greater odds of survival, again significantly different from 0. We can interpret this figure as an indication of first mover advantage from an operating profit perspective if our controls account for spurious drivers of first mover performance. It does not indicate whether this bump in operating profit is depleted by differences in fixed costs when launching first versus late movers.

Table 8: First Mover Performance: AUM, Market Share, and Survival

	<i>Dependent variable:</i>		
	<i>Fixed Effects</i>	<i>Fixed Effects</i>	<i>Logistic</i>
	log AUM	Market Share	Survive
	(1)	(2)	(3)
First Mover	1.596*** (0.383)	0.453*** (0.020)	1.350*** (0.473)
Expense Ratio	-3.139*** (0.851)	0.031 (0.041)	-4.995*** (1.168)
Inception Year	-0.313*** (0.065)	-0.002 (0.003)	-0.002 (0.096)
Firm FE	Y	Y	Y
Market FE	Y		
Observations	1,079	1,065	1,079
R <sup>2</sup>	0.699	0.508	
Adjusted R <sup>2</sup>	0.492	0.482	
Log Likelihood			-136.365
Akaike Inf. Crit.			382.729
F Statistic	33.239*** (df = 53; 760)	19.712*** (df = 53; 1011)	

Note:

\*p<0.1; \*\*p<0.05; \*\*\*p<0.01

#### Robustness Checks

While the differences between first and late mover performance appear large, these figures must be interpreted with caution. If there are unobservable drivers of first mover performance which are *not* caused by order of entry, these figures likely overstate the magnitude of first mover advantage due to omitted variable bias. Although I accounted for the major spurious drivers of first mover performance noted by the theory and past empirical studies of first mover advantage, my methodology cannot remove all bias.

To further test the extent to which the results above are valid, I run three robustness checks. First, I test whether controlling for unobserved firm-level heterogeneity was important for removing endogeneity from the First Mover coefficient. If unobserved firm-level factors such as strategy, branding, or operational efficiencies is not important for AUM, then removing the firm fixed effect from regression 10 should not affect the First Mover coefficient. I find evidence that adding this control does remove a portion of the endogeneity, as seen by the lower mean coefficient and non-overlapping confidence intervals of First Mover in Table 9.

Next, I test for residual variation in the First Mover variable given all the controls in regression 10. If there is little to no variation in the First Mover variable after accounting for controls; then the results of Table 8 would be invalid due to collinearity. Table 10 shows that while there is some correlation between First Mover status and controls, there is still variation in First Mover status after accounting for firms, expense ratios, and inception year, as seen by the reasonably low R-squared of this test.

Finally, I test for remaining endogeneity in the First Mover variable by running the same analyses on a subset of markets: those whose first mover experiences competitor entry in 1-90 days. Looking at this subset of markets is interesting because for nearly identical products that are launched close together in time, the First Mover coefficient should be more accurately measuring a First Mover Advantage, free from endogenous drivers of first mover performance. For example, the disparity in performance of GLD and IAU, which launched a month apart and both were issued by experienced firms who submitted their prospectus to the SEC at nearly the same time, is likely wholly driven by a First Mover Advantage.

I find that, while the coefficient for Regression 10 is lower for this subset of ETPs, it is still positive and significant at the 10 % level. Its confidence interval also overlaps with that of Table 8. The coefficient for Regression 11 is also lower and has a confidence interval which does not overlap with that of Table 8; however it is still positive and significant at the 1% level. Finally, the coefficient for Regression 12 shows no significant difference, though a wider confidence interval due to the smaller sample size. The results of this test suggest that, while there may be some level of endogeneity in the coefficients estimated above, it more accurately represents a true First Mover Advantage rather than endogenous drivers of First Mover performance. It is also interesting to note that the coefficient on Expense Ratio is greater for this subset of

ETPs, suggesting that price is a bigger driver of performance when consumer switching costs are less of an issue.

Table 9: Test for Firm-level Heterogeneity

	<i>Dependent variable:</i>		
		log AUM	
	(1)	(2)	(3)
First Mover	4.214*** (0.475)	2.070*** (0.559)	1.546*** (0.379)
Expense Ratio		-2.839*** (0.817)	-2.911*** (0.813)
Inception Year		-0.513*** (0.080)	-0.296*** (0.061)
Firm Fixed Effects	N	N	Y
Market Fixed Effects	Y	Y	Y
Observations	1,109	1,092	1,092
R <sup>2</sup>	0.085	0.158	0.689
Adjusted R <sup>2</sup>	0.065	0.120	0.492
F Statistic	78.833*** (df = 1; 851)	51.977*** (df = 3; 832)	30.863*** (df = 56; 779)

*Note:*

\*p<0.1; \*\*p<0.05; \*\*\*p<0.01

Table 10: Test for Variation in First Mover Status

<i>Dependent variable:</i>	
First Mover	
Expense Ratio	0.067 (0.077)
Inception Year	-0.092*** (0.005)
Firm Fixed Effects	Y
Market Fixed Effects	Y
Observations	1,092
R <sup>2</sup>	0.455
Adjusted R <sup>2</sup>	0.325
F Statistic	11.848*** (df = 55; 780)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01



Table 11: Markets with 1-90 Days between First and Second Mover Entry

	<i>Dependent variable:</i>		
	<i>Fixed Effects</i>	<i>Fixed Effects</i>	<i>Logistic</i>
	log AUM (1)	Market Share (2)	Survive (3)
First Mover	1.023* (0.573)	0.286*** (0.028)	1.478* (0.859)
Expense Ratio	-8.508*** (1.483)	-0.228*** (0.072)	-4.885*** (1.460)
Inception Year	-0.346*** (0.087)	-0.020*** (0.004)	0.081 (0.110)
Firm FE	Y	Y	Y
Market FE	Y		
Observations	612	612	612
R <sup>2</sup>	0.678	0.554	
Adjusted R <sup>2</sup>	0.507	0.554	
Log Likelihood			-85.542
Akaike Inf. Crit.			281.084
F Statistic	17.856*** (df = 54; 457)	10.492*** (df = 54; 457)	

Note:

\*p&lt;0.1; \*\*p&lt;0.05; \*\*\*p&lt;0.01

## 5.5 Discussion

This paper shows evidence of superior first mover performance in the ETP industry. First movers have greater demand (AUM), market share, and survival rates than their competitors. Moreover, this difference in ETP performance appears to reflect a true first mover advantage rather than product differentiation, expense ratios (price), differences in product tenure, or firm heterogeneity. The advantage has persisted, at least for some products, over the course of decades.

These results offer two major contributions to scholarship. First is to provide a richer understanding of the theory of first mover advantage in a novel empirical context and with a novel empirical design. The empirical design in this paper attempts to remove many of the factors confounding prior studies of first mover advantage, such as unobserved differences between firms and products, and survivorship bias. As far as the researcher is aware, no previous research has studied first mover advantage at the product level. This paper shows that such an empirical design may lead to more accurate and precise measurements of first mover advantage than analysis at the firm level.

Second, this paper improves our understanding of innovation management and contributes to the sustainability of competitive advantage debate. Though first mover advantage alone does not imply firms earn supranormal returns to innovation, evidence of greater operating profits is consistent with the hypothesis that innovation, at least in the context of financial products, leads to competitive advantage. Moreover, this competitive advantage appears to be sustainable over the course of decades. Future work may estimate the magnitude of returns to innovation and explore counterfactuals of how innovation incentives change with respect to market or regulatory parameters.

This paper also has implications for firms competing in the ETP industry. Understanding the magnitude of first mover advantage can help issuers of ETPs allocate resources more effectively for growth. My results suggest that order of entry is an important factor to consider when launching ETPs. For regulators, the magnitude of first mover advantage can provide a signal of socially suboptimal levels of innovation in the ETP industry is socially suboptimal. For example, first mover advantage may lead to too much innovation if the proliferation of new markets leads to greater investor search costs and a reduction in liquidity.

The finding of such a strong first mover advantage in the ETP industry merits further research to determine its drivers. One likely driver of first mover advantage is product liquidity, which loosely speaking, is the willingness of market participants to buy or sell an ETP at a particular point in time. Liquidity may act as an investor coordination mechanism analogous to network effects. This may then create barriers-to-entry, or what Duffie and Rahi (1995) [12] call “the preemptive value of liquidity.”

Investor switching costs can also drive first mover advantage. Transaction costs such as capital gains taxes and brokerage fees may prevent investors from adopting a competitor's product even if it has a lower expense ratio. In addition, it may be costly for investors to assess the portfolio holdings, risks, and legal structure of new ETPs. For example, Hortacsu and Syverson (2003) [24] attribute price dispersion in the highly related mutual fund industry to search costs.

Other potential drivers of first mover advantage in the ETP industry include firm learning and strategy. For example, firms become more effective at launching ETPs as they grow their product portfolio, R& D and management costs may become lower with experience, or firms may learn to negotiate better deals with ETP distributors. A firm may also strategically launch first movers, offering lower fees to market makers because they expect higher buy-side investor demand, or preemptively securing scarce resources such as popular stock indexes so that they are unavailable to late movers.

A particularly interesting example of an ETP issuer which has grown successfully despite entering late in the industry is Vanguard. Vanguard was likely able to overcome first mover advantage due to three important factors: its reputation for low-cost index investing, vast supply-side economies of scale, and the creation of a new share class which effectively bundled ETPs with its standard mutual fund portfolio <sup>7</sup>. The creation of this share class allowed their existing investors to incur virtually no transaction costs when switching from mutual funds to ETPs, thus seeding sufficient liquidity for the new products to take off.

---

<sup>7</sup>See HBS case study "The Complexity of Vanguard's Entry Decision into ETFs, 2014; by L. Cohen, C. Malloy, and T. Tang.

## 6 Growing Digital Content: the Case of Yelp.com

### 6.1 Introduction

This chapter investigates the growth of review aggregator Yelp.com, a socially-driven network good which seems to have used a lean entry strategy.

Yelp, a review website for restaurants and small businesses, is one of many modern technologies which relies on users as its primary producer of value. Other digital goods including content aggregators, social media platforms, and open source software rely on users to generate information, profiles, or software, which are then consumed by other users.

Despite the importance of user-generated content production for these digital goods, we know little about the mechanisms by which content production grows. First, who are early producers of user-generated content? Second, to what extent does early content production drive later content growth? Finally, what does this imply for the strategic decision-making of a firm such as Yelp?

Using review data from Yelp.com from 2005 to 2014, this paper seeks to answer these questions. We find that early producers of Yelp's user-generated content were largely concentrated in a single city, but spillover effects drove a large fraction early content production in other cities. The magnitude of the spillover is highly correlated with the volume of tourism between cities. We also find that early reviews produced by tourists is predictive of later review growth, more so than early reviews produced by local reviewers. We hypothesize that the latter finding indicates the presence of a network effect.

### 6.2 History of Content Generation on Yelp

Yelp was founded in 2004 in San Francisco. During Yelp's early growth period from January 2005 to March 2007, the website had over 30,000 reviewers. 16,000 of these reviewers were concentrated in San Francisco, with less than 1000 total reviewers in most other U.S. cities.

Yelp's entry strategy was to focus its marketing efforts on driving adoption in San Francisco prior to March 2007 while relying on organic content growth in most other cities. 10 cities other than San Francisco showed reviews during this period. Table 12 shows that of these, only four cities (Boston, Seattle, New York, Los Angeles, and San Diego) had more than 1000 early reviewers. Yelp's market penetration, measured as the percentage of total historical reviewers, was less than 2 percent in most cities. Its percentage of historical content generated prior to March 2007 was also less than 2 percent. Because company employees posted restaurant listings in each city early on, the percentage of restaurants listed during this period was much

higher, at around 30 percent.

Who were early reviewers in these cities? Table 15 shows that a large percentage of early reviewers were tourists from San Francisco. In most cities, less than half of all early reviewers were local residents of that city. The remaining early reviewers were tourists from cities other than San Francisco. For example, and tourists from San Francisco left 367 reviews for restaurants in Portland prior to March 2007, and tourists from Seattle left 189 reviews.

Around March 2007, Yelp shifted its strategy to focus on national and later international expansion. For example, Yelp began to send direct mail to local businesses in cities outside of San Francisco. It also hired what are known as “community managers,” local marketers who organize events aimed at increasing local adoption. Starting around 2008, Yelp’s digital content grew quickly. Figure 6 shows the growth of total reviews over time in each of the 11 cities with early adoption, including San Francisco.

Table 12: Yelp's Growth in San Francisco versus 10 Early Adopting U.S. Cities

	Early Period (1/2005-3/2007)			Percent of Total Historic		
	# Restaurants*	Monthly Reviews	# Reviewers**	Restaurants*	Reviews	Reviewers**
San Francisco	2,736	20,799	16,190	56%	7%	5%
Boston	748	342	1,898	45%	4%	2%
Seattle	1,311	397	1,810	40%	2%	1%
New York	3,652	914	3,915	35%	2%	1%
LA	1,766	497	3,059	25%	1%	1%
Washington D.C.	718	145	786	29%	1%	1%
Philadelphia	612	74	403	19%	< 1%	< 1%
Las Vegas	501	85	869	14%	< 1%	1%
San Diego	1,024	169	1,163	26%	< 1%	1%
Phoenix	321	31	221	14%	< 1%	< 1%
Portland	619	71	466	20%	< 1%	1%

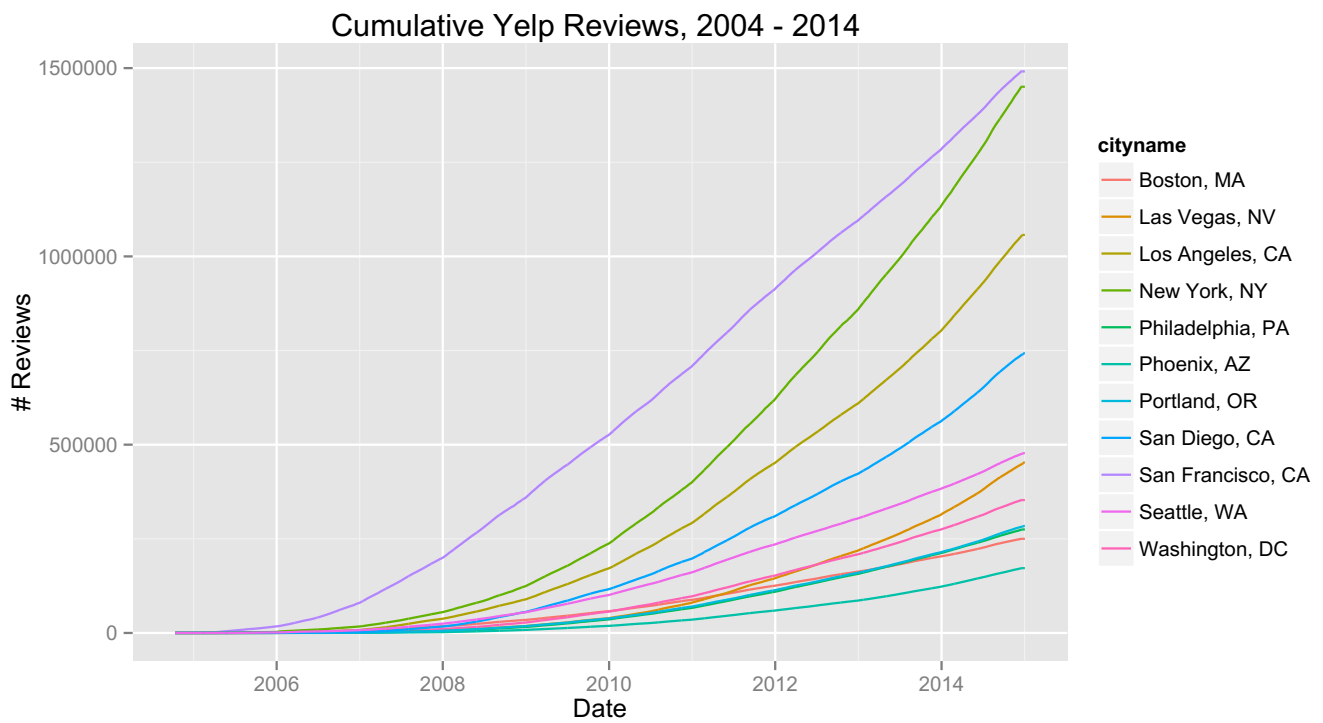
\*To account for restaurant turnover, this figure excludes restaurants in bottom 25 percentile of reviews.

\*\*An individual who reviewed at least 1 restaurant in focal city.

Table 13: Composition of Early Reviewers

	% Local	% From SF
San Francisco	80%	–
Boston	53%	12%
Seattle	55%	17%
New York	46%	22%
LA	52%	22%
Washington D.C.	38%	21%
Philadelphia	18%	22%
Las Vegas	4%	46%
San Diego	36%	27%
Phoenix	38%	24%
Portland	35%	34%

Figure 6: Yelp's Content Growth





## 6.3 Data and Hypotheses

### *Data*

We gathered Yelp review data during the years 2005-2013, for restaurants in 11 major U.S. cities including San Francisco. Review data contains the day, month, and year of review; the name, ID, self-reported location, friends, and total reviews of the reviewer leaving the review; the name, ID, location, and genre of the restaurant being reviewed; and attributes of the review itself such as star rating and content. We choose to examine restaurants because they comprise the highest percentage (approximately 40 percent) of businesses listed on Yelp prior to 2011. Since the restaurant industry is marked by frequent turnover, we excluded restaurants in the bottom 25 percentile of reviews in each city.

In addition to Yelp review data, we gathered data on airport traffic from the Bureau of Transportation Statistics. This data contains a record of every flight arriving or departing between two airports in a given day (we aggregate it to the monthly level). The data also provides city names associated with each airport code. City names from the flights data were linked to self-reported reviewer locations in the Yelp data by relabeling locations with its corresponding metropolitan statistical area (MSA). For example, a review of a New York City restaurant written by a reviewer in "Cambridge, MA" would be relabeled "Boston, MA" and linked to all flights from Boston to New York City.

Tourists are identified by self-reported reviewer locations: a review is classified as "tourist" if and only if the reviewer's reported location is not contained within the metropolitan statistical area (MSA) of the restaurant receiving the review. For example, if a reviewer from Cambridge, MA reviews a restaurant located in Boston, MA, the review is labeled as a local review. If, on the other hand, a reviewer from New York, NY reviews a restaurant in Boston, MA, the review is labeled as a tourist review.

### *Hypotheses*

The production of content by tourists corresponds to a spillover effect, in the sense that the production in one market had increased its production in adjacent markets. We hypothesize that the spillover effect is large in magnitude and drove the majority of Yelp's early content. To measure the magnitude of the spillover, we count the total number of reviews written by tourists across the early adopter cities.

**Hypothesis 6.1.** *Spillovers from tourism drove the majority of Yelp's content production in cities outside San Francisco prior to March 2007.*

We are further interested in factors which might affect the magnitude of the spillover, especially those that are strategically relevant to Yelp. We hypothesize that volume of tourism between cities is correlated

with the magnitude of the spillover. In particular, reviews written by tourists from city  $i$  to city  $j$  should increase (decrease) if tourism from city  $i$  to city  $j$  increases (decreases). To measure tourism between cities, we count the monthly number of flights arriving from city  $i$  to city  $j$ .

**Hypothesis 6.2.** *The average number of Yelp reviews written by tourists from city  $i$  for a restaurant located in a city  $j$  increases (decreases) as the number of flights from city  $i$  to city  $j$  increases (decreases).*

To test hypothesis 6.2, we run a regression with year-month and city  $j$  fixed-effects:

$$Y_{ijt} = \rho X_{ijt} + T_t + C_j + \epsilon_{ijt} \quad (13)$$

where  $Y_{ijt}$  is the total number of reviews left by tourists from city  $i$  for restaurants in city  $j$  in month  $t$ ,  $X_{ijt}$  is the number of flights arriving from city  $i$  to city  $j$  in month  $t$ ,  $T_t$  is a year-month fixed effect,  $C_j$  is a destination city fixed effect, and  $\epsilon_{ijt}$  is an error term.

We also run the corresponding cross-sectional regression:

$$Y_{ij} = \alpha + \rho X_{ij} + \epsilon_{ij} \quad (14)$$

where  $Y_{ij}$  is the total historical number of reviews left by tourists from city  $i$  for restaurants in city  $j$ , and  $X_{ij}$  is the total historical number of flights arriving from city  $i$  to city  $j$ .

Finally, we are interested in whether network effects played a role in Yelp's growth. One plausible mechanism generating network effects on Yelp is the positive externality a user receives from patronizing businesses endorsed by another user. This interpretation of network effects implies that a review of a restaurant written today should increase the likelihood a Yelp user will patronize the restaurant and write a review of it tomorrow. The magnitude of the externality may depend on how valuable the endorser's opinion is to the recipient; for example, it could be larger if the endorser were more trustworthy or more similar to the recipient.

We hypothesize that the number of tourist reviews written during Yelp's early growth period is positively correlated with the number of later reviews, produced by both locals and tourist. Similarly, we hypothesize that the number of local reviews written during Yelp's early growth period is positively correlated with the number of later reviews. Though a correlation, if found, would not be sufficient to show the existence of network effects, lack of a relationship between the number of early and late reviews would provide evidence against its existence.

**Hypothesis 6.3.** *The number of tourist (local) reviews generated in period 1 for a restaurant  $i$  is positively correlated with the number of total reviews generated in period 2 for restaurant  $i$ .*

To test this hypotheses, we run a cross-sectional regression of a restaurant's total reviews prior to 2008 ( $p = 1$ ) on its tourist and local reviews after 2008 (inclusive,  $p = 2$ ):

$$R_{i2} = \alpha + \beta T_{i1} + \rho L_{i1} + \epsilon_{i2} \quad (15)$$

Where  $R_{ip}$ ,  $T_{ip}$ , and  $L_{ip}$  indicate total, tourist, and local reviews for restaurant  $i$  in period  $p$ , respectively. We repeat the regression above with  $T_{i2}$  and  $L_{i2}$  in place of  $R_{i2}$ .

## 6.4 Results

We find that out of 73,592 reviews written prior to March 2007 in the 10 early adopting cities (excluding San Francisco), 32,406 or 44% were written by tourists. Out of 14,590 early reviewers, 8,124 or 56% were tourists. The proportion of tourist reviews varies across cities, with Las Vegas having the greatest percentage of early tourist reviews at 90%, and Seattle having the lowest percentage of early tourist reviews at 30%. Details of these results appear in Tables 14 and 15 below.

These statistics show that spillovers from tourism made up a large proportion of Yelp's content production in cities outside San Francisco prior to March 2007. Though the majority of reviews at the aggregate level are produced by local reviewers (thus inconsistent with hypothesis 6.1), spillovers make up the majority of reviews in 4 out of 10 cities excluding San Francisco. In addition, the majority of content producers are tourists in 7 out of the 10 cities.

Table 14: Percent of Early Reviews by Tourists

	<i>Early Reviews</i>		
	Total	Tourist	% Tourist
San Francisco	108,640	20,799	19%
Boston	9,247	3,739	40%
Seattle	10,718	3,261	30%
New York	24,674	10,689	43%
LA	13,413	5,270	39%
Washington D.C.	3,918	1,864	48%
Philadelphia	1,995	1,631	82%
Las Vegas	2,297	2,069	90%
San Diego	4,571	2,589	57%
Phoenix	825	431	52%
Portland	1,924	863	45%
Total ex. SF	73,582	32,406	44%

Table 15: Percent of Early Reviewers who are Tourists

	<i>Early Reviewers</i>		
	Total	Tourist	% Tourist
San Francisco	16,190	3,241	20%
Boston	1,898	894	47%
Seattle	1,810	819	45%
New York	3,915	2,100	54%
LA	3059	1,481	48%
Washington D.C.	786	484	62%
Philadelphia	403	331	82 %
Las Vegas	869	835	96 %
San Diego	1163	742	54%
Phoenix	221	137	62%
Portland	466	301	65%
Total ex. SF	14,590	8,124	56%

In cities outside San Francisco, the magnitude of spillovers relative to total reviews and reviewers declines over time. Figure 7 shows that the percentage of reviews generated by tourists from San Francisco in the other 10 early adopting cities declines from approximately 20% in 2005 to less than 5% by 2011. This trend also holds for reviewers: Table 16 shows that the total proportion of tourist reviewers declines from 56% prior to March 2007 to 43% thereafter, and tourist reviewers from San Francisco comprise only 5% of total reviewers in these cities during the later period. The decline in the relative magnitude of spillovers over time is due to rapid growth in local adoption after 2008 (Figure 18 in the appendix shows a visual example).

In contrast, spillovers increased in San Francisco. Figure 8 shows that the percentage of reviews generated by tourists in San Francisco rose from less than 20% in 2005 to nearly 30% in 2014. This contrast indicates early adoption in cities outside San Francisco was below the equilibrium level, likely due to Yelp's lean entry strategy of focusing on adoption in San Francisco prior to March 2007.

Figure 7: Reviews from SF Tourists Decline Over Time



Figure 8: Reviews from Tourists Increase in San Francisco

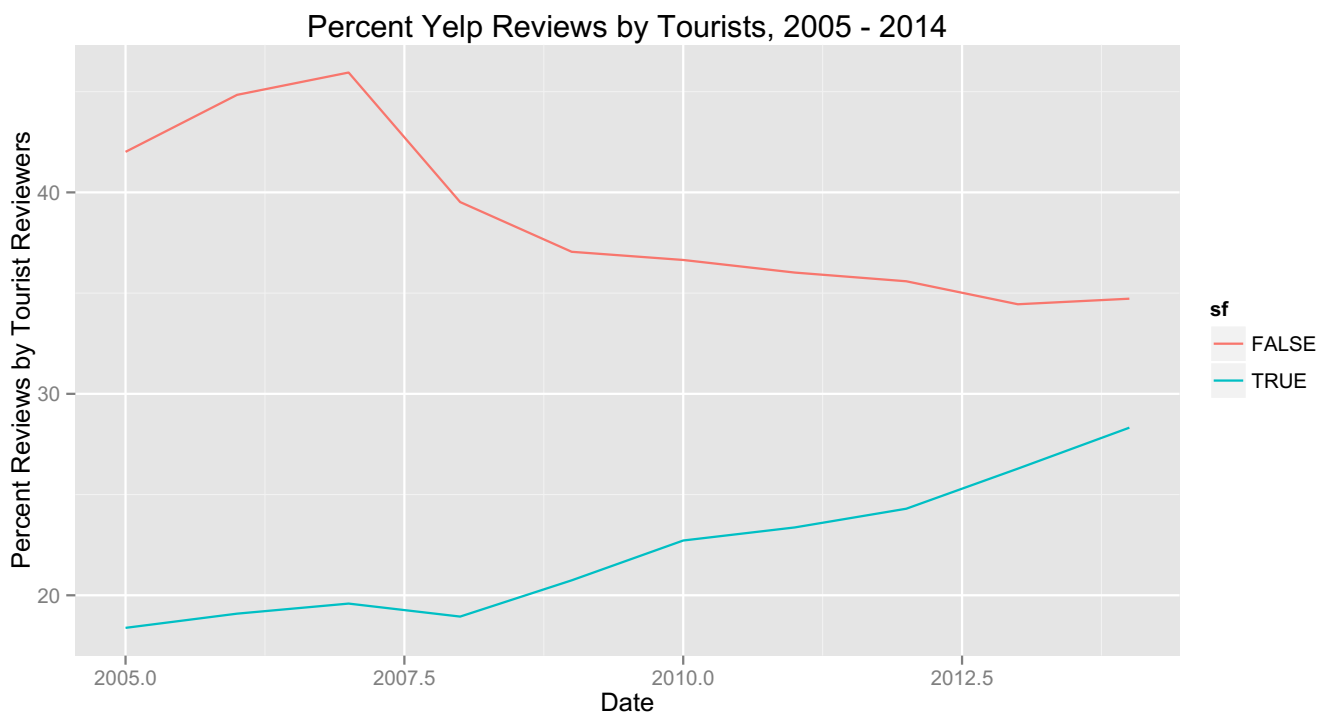


Table 16: Percent of Late Reviewers who are Tourists

	<i>Late Reviewers</i>		
	Total	% Tourist	% SF Tourist
San Francisco	348,955	35%	–
Boston	93,454	44%	4%
Seattle	135,209	38%	6%
New York	385,385	45%	5%
LA	327,395	27%	5%
Washington D.C.	118,886	48%	4%
Philadelphia	83,220	56%	3%
Las Vegas	165,035	72%	10%
San Diego	226,503	42%	6%
Phoenix	66,331	31%	3%
Portland	90,406	41%	6%
Total ex. SF	1,691,824	43%	5%



We find evidence consistent with hypothesis 6.2 that tourism volume is correlated with the magnitude of spillovers. Tables 17 and 18 show that an increase of 100 flights from city  $i$  to city  $j$  in a month is correlated with an increase of approximately 15 monthly tourist reviews. In other words, cities that have more tourist traffic between them also have a greater magnitude of spillovers.

This relationship can also be seen anecdotally in Figures 19 and 20 in the Appendix, which show reviews of restaurants in Seattle and Boston, respectively, generated by tourists from the top five cities of tourist origin in each destination city. Not surprisingly, most of the spillovers are generated by tourists from geographically proximate cities. For example, the top city of origin for tourists in Seattle is San Francisco, while the top city of origin for tourists in Boston is New York.

Table 17: Cross-sectional Regression of Reviews on Flights

<i>Dependent variable:</i>	
Reviews by Tourists from Origin City	
Flights from Origin City	0.151*** (0.008)
Observations	654
R <sup>2</sup>	0.333
Adjusted R <sup>2</sup>	0.332
Residual Std. Error	3,723.189 (df = 652)
F Statistic	325.845*** (df = 1; 652)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01

Table 18: Fixed Effects Regression of Reviews on Flights

<i>Dependent variable:</i>	
Reviews by Tourists from Origin City	
Flights from Origin City	0.148*** (0.002)
Year-month fixed effect	Y
Destination city fixed effect	Y
Observations	25,701
R <sup>2</sup>	0.224
Adjusted R <sup>2</sup>	0.221
Residual Std. Error	77.474 (df = 25606)
F Statistic	78.764*** (df = 94; 25606)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01

Our findings are mixed for hypothesis 6.3. Table 19 shows there is a strong positive correlation between early tourist reviews and future total reviews: an additional tourist review in period 1 is correlated with approximately 22 additional reviews in period 2. Tables 20 and 21 show that this correlation is stronger for future tourist reviews than future local reviews: an additional tourist review in period 1 is correlated with approximately 9 local reviews versus 13 tourist reviews in period 2.

Surprisingly, there does not appear to be a positive correlation between early local reviews and future total reviews, once accounting for early tourist reviews. In fact, an additional local review in period 1 correlates with 2 *fewer* tourist reviews in period 2, though it correlates with 1.4 additional local reviews in period 2. Moreover, early local reviews are less predictive of future local reviews than early tourist reviews.

Multiple factors may be driving these results. First, and the most plausible, is that restaurants which receive more tourist reviews in period 1 are inherently different from restaurants which receive more local reviews in period 2. For example, tourists are more likely to patronize and review renowned restaurants than unknown restaurants. The coefficients in column 1 of Tables 19, 20, and 21 are not therefore interpretable as a network effect.

We ran a robustness test which tried to remove some of the omitted variable bias by controlling for the restaurant's average rating, a proxy for restaurant quality. We find that controlling for average rating does not meaningfully change the coefficient. These results thus suggest that at least part of the correlation may be driven by a causal mechanism whereby early tourist reviews drive future reviews. Further research must be conducted to fully separate restaurant-level unobservables from a causal relationship between current and future reviews.

Table 19: Effect of Early Reviews on Late Reviews

	<i>Dependent variable:</i>	
	Total Reviews, Period 2	
	(1)	(2)
Tourist Reviews, Period 1	21.579*** (0.217)	21.525*** (0.214)
Local Reviews, Period 2	-0.589*** (0.076)	-0.620*** (0.075)
Avg Rating		57.095*** (1.719)
Constant	90.650*** (1.125)	-110.930*** (6.170)
Observations	45,841	45,841
R <sup>2</sup>	0.330	0.346
Adjusted R <sup>2</sup>	0.330	0.346
Residual Std. Error	228.378 (df = 45838)	225.680 (df = 45837)
F Statistic	11,280.820*** (df = 2; 45838)	8,069.203*** (df = 3; 45837)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01	

Table 20: Effect of Early Reviews on Late Local Reviews

	<i>Dependent variable:</i>	
	Local Reviews, Period 2	
	(1)	(2)
Tourist Reviews, Period 1	8.697*** (0.140)	8.661*** (0.138)
Local Reviews, Period 1	1.432*** (0.049)	1.411*** (0.048)
Avg Rating		38.652*** (1.108)
Constant	65.153*** (0.726)	-71.314*** (3.976)
Observations	45,841	45,841
R <sup>2</sup>	0.299	0.317
Adjusted R <sup>2</sup>	0.299	0.317
Residual Std. Error	147.341 (df = 45838)	145.423 (df = 45837)
F Statistic	9,774.968*** (df = 2; 45838)	7,095.605*** (df = 3; 45837)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01	

Table 21: Effect of Early Reviews on Late Tourist Reviews

	<i>Dependent variable:</i>	
	Tourist Reviews, Period 2	
	(1)	(2)
Tourist Reviews, Period 1	12.882*** (0.097)	12.864*** (0.096)
Local Reviews, Period 1	-2.021*** (0.034)	-2.031*** (0.033)
Avg Rating		18.442*** (0.769)
Constant	25.497*** (0.500)	-39.616*** (2.759)
Observations	45,841	45,841
R <sup>2</sup>	0.333	0.342
Adjusted R <sup>2</sup>	0.333	0.342
Residual Std. Error	101.539 (df = 45838)	100.908 (df = 45837)
F Statistic	11,462.760*** (df = 2; 45838)	7,929.614*** (df = 3; 45837)
<i>Note:</i>	*p<0.1; **p<0.05; ***p<0.01	

## 6.5 Discussion

Yelp is an example of a digital good that employed a lean entry strategy to grow and displace incumbent goods in the market. Despite the presence of competitors such as YellowPages and CitySearch, Yelp focused most of its marketing efforts on driving adoption in San Francisco during its early growth period from January 2005 to March 2007.

This strategy was effective in large part due to spillover effects which drove user-generated content growth in most other cities outside San Francisco. Approximately 25% of early content in cities outside of Yelp's San Francisco headquarters was produced by tourists from San Francisco, and an additional 19% was produced by tourists from other cities. Spillovers are stronger between cities with high tourist traffic; we find that for every 100 flights between two cities, tourists from the origin city leave on average 15 reviews for restaurants in the destination city.

Though the percentage of content from spillovers has since declined in most cities due to rapid adoption by local producers, their importance is magnified by a strong positive correlation between a restaurant's early spillover content and future total content. Restaurants that receive more early reviews by tourists tend to receive more reviews in a later period by both tourists and locals. Surprisingly, the same is not true of restaurants that receive more early reviews by locals. These findings merit further research to test for the existence of network effects and measure its impact in driving Yelp's growth.

We believe our research has relevance to scholars of user-generated content (UGC) and knowledge spillovers. As far as we are aware, ours is one of the first papers to quantify knowledge spillovers as a function of tourism volume in the context of user-generated content production. We show that spillovers for digital goods are often directly measurable, and thus circumvent the challenge of identification experienced by most of the prior literature.

Our research also provides insights for practitioners. Technology companies often base their choice of which markets to enter on demographic variables such as population, income levels, and internet penetration. For example, Yelp prefers to enter new cities where it predicts high levels of adoption by the local population. Yet our results suggest that spillovers may be even more important than characteristics of the local population for driving early content growth. A firm might thus prioritize entering cities which receive a high volume of spillovers from cities where its product is currently popular, or cities which may drive a high volume of spillovers to new markets of interest.

## 7 Summary and Conclusion

I began my thesis with a puzzle: why are new network goods more likely to succeed in some markets than others? I showed, via a formal model, that since the strength of a market's barriers-to-entry varies according to its network structure, the likelihood of success depends on features of the network good and market themselves. While markets for transaction-driven goods may fit the conventional wisdom that incumbents are difficult to displace, markets for socially-driven goods may actually be fertile ground for entry and growth of newcomers.

The theory of lean entry, corroborating classic theories of network effects, says firms need to seed more than half of the market to grow in a complete or bipartite network. We saw this manifest in markets for exchange-traded products, where the failure of entrant products to build adequate liquidity may be a primary driver of first mover advantage. Due to the massive scale needed to enter, assets under management (a proxy for investor demand) of most late entrants remains low, despite investments in marketing, lower pricing, and usually comparable distribution channels.

The theory also says that, in contrast with classic theories of network effects, seeding relatively few early adopters can lead to discontinuous growth in markets with diffusive network structure. We saw this manifest for digital content aggregator Yelp, which employed a lean entry strategy of focusing on seeding early adopters within San Francisco but later exploited a spillover effect to grow.

Finally, the theory shows *which* networks are most likely to be diffusive: those with cohesive subsets of consumers that also contain boundary spanners. We saw in the case of Yelp that local users within cities are cohesive while tourists between cities act as boundary spanners. Though tourists drove a negligible fraction of Yelp's later growth, their influence on Yelp's early growth was potentially magnified by a network effect whereby early spillover content drove later content production.

From a prescriptive point of view, producers of network goods should tailor their entry and growth strategies to fit features of the market and the good they are trying to sell. They should pay close attention to how network effects are generated, in particular whether the network good is transaction-driven or socially-driven. For example, strategies which proved successful for Vanguard's exchange-traded products included bundling with an existing class of investment products, which helped seed liquidity critical for entry. For socially-driven network goods such as Yelp, such initial scale was neither necessary nor sufficient for growth.

The final insight for practitioners is that network effects alone do not guarantee a competitive advantage. Because barriers-to-entry in network markets are weaker than previously thought, paying high acquisition prices for socially-driven network goods may not be justified by the theory of network effects. To recall a



historical example, AOL acquired communications technology ICQ in 1998 for 400M, a record price at the time. Network effects generated by a large installed base of Instant Messenger and ICQ users seemed to give AOL a massive advantage against competitors in this market. Less than 10 years after the acquisition, AOL's Instant Messenger was displaced by new digital communications technologies such as gChat, Skype, and Facebook.

## References

- [1] Sean parker on why myspace lost to facebook, <http://techcrunch.com/2011/06/28/sean-parker-on-why-myspace-lost-to-facebook/>, Accessed: 2014-07-12.
- [2] Howard Aldrich and Diane Herker, *Boundary spanning roles and organization structure*, Academy of Management Review **2** (1977), no. 2, 217–230.
- [3] Franklin Allen and Douglas M Gale, *Financial innovation and risk sharing*, MIT press, 1994.
- [4] Sinan Aral, Lev Muchnik, and Arun Sundararajan, *Engineering social contagions: Optimal network seeding in the presence of homophily*, Network Science **1** (2013), no. 02, 125–153.
- [5] Sinan Aral and Dylan Walker, *Identifying influential and susceptible members of social networks*, Science **337** (2012), no. 6092, 337–341.
- [6] Kenneth J Arrow, *The economic implications of learning by doing*, The review of economic studies (1962), 155–173.
- [7] C. Ballester, A. Calvo-Armengol, and Y. Zenou, *Who's who in networks. wanted: the key player*, Econometrica **74** (2006), no. 5, 1403–1417.
- [8] Arup Banerji and Bhaskar Dutta, *Local network externalities and market segmentation*, International Journal of Industrial Organization **27** (2009), no. 5, 605–614.
- [9] Ernst R Berndt, Linda Bui, David R Reiley, and Glen L Urban, *Information, marketing, and pricing in the us antiulcer drug market*, The American Economic Review **85** (1995), no. 2, 100–105.
- [10] Luis MB Cabral, *On the adoption of innovations with networkexternalities*, Mathematical Social Sciences **19** (1990), no. 3, 299–308.
- [11] I. Dierickx and K. Cool, *Asset stock accumulation and sustainability of competitive advantage*, Management Science **35** (1989), no. 12, 1504–1511.
- [12] Darrell Duffie and Rohit Rahi, *Financial market innovation and security design: An introduction*, Journal of Economic Theory **65** (1995), no. 1, 1–42.
- [13] Thomas Eisenmann, Geoffrey Parker, and Marshall Van Alstyne, *Platform envelopment*, Strategic Management Journal **32** (2011), no. 12, 1270–1285.

- [14] David S Evans and Richard Schmalensee, *Failure to launch: Critical mass in platform businesses*, Review of Network Economics **9** (2011), no. 4.
- [15] J. Farrel and G. Saloner, *Installed base and compatibility: Innovation, product preannouncements, and predation*, American Economic Review **76** (1986), no. 5, 940–955.
- [16] Joseph Farrell and Paul Klemperer, *Coordination and lock-in: Competition with switching costs and network effects*, Handbook of industrial organization **3** (2007), 1967–2072.
- [17] Joseph Farrell and Garth Saloner, *Installed base and compatibility: Innovation, product preannouncements, and predation*, The American economic review (1986), 940–955.
- [18] Joseph Farrell and Carl Shapiro, *Dynamic competition with switching costs*, The RAND Journal of Economics (1988), 123–137.
- [19] D. Fudenberg and J. Tirole, *Pricing a network good to deter entry*, Journal of Industrial Economics **48** (2000), no. 4, 373–390.
- [20] A. Galeotti and S. Goyal, *Influencing the influencers: a theory of strategic diffusion*, RAND Journal of Economics **40** (2009), no. 3, 509–532.
- [21] Peter N Golder and Gerard J Tellis, *Pioneer advantage: marketing logic or marketing legend?*, Journal of marketing Research (1993), 158–170.
- [22] Richard Hall, *A framework linking intangible resources and capabilities to sustainable competitive advantage*, Strategic management journal **14** (1993), no. 8, 607–618.
- [23] Oliver Hinz, Bernd Skiera, Christian Barrot, and Jan U Becker, *Seeding strategies for viral marketing: an empirical comparison*, Journal of Marketing **75** (2011), no. 6, 55–71.
- [24] Ali Hortacsu and Chad Syverson, *Product differentiation, search costs, and competition in the mutual fund industry: A case study of s&P 500 index funds*, The Quarterly Journal of Economics **119** (2004), no. 2, 403–456.
- [25] Mark A Hurwitz and Richard E Caves, *Persuasion or information? promotion and the shares of brand name and generic pharmaceuticals*, Journal of Law and Economics **31** (1988), no. 2, 299–320.
- [26] M. Jackson, *Social and economic networks*, Princeton University Press, 2008.

- [27] Boyan Jovanovic and Saul Lach, *Entry, exit, and diffusion with learning by doing*, Tech. report, 1988.
- [28] M. Katz and C. Shapiro, *Network externalities, competition, and compatibility*, American Economic Review **75** (1985), no. 3, 424–440.
- [29] ———, *Technology adoption in the presence of network externalities*, Journal of Political Economy **94** (1986), no. 4, 822–841.
- [30] ———, *Systems competition and network effects*, Journal of Economic Perspectives **8** (1994), no. 2, 93–115.
- [31] Michael L Katz and Carl Shapiro, *Product introduction with network externalities*, The Journal of Industrial Economics (1992), 55–83.
- [32] Paul Klemperer, *Markets with consumer switching costs*, The Quarterly Journal of Economics **102** (1987), no. 2, 375–394.
- [33] Eocman Lee, Jeho Lee, and Jongseok Lee, *Reconsideration of the winner take all hypothesis: complex networks and local bias*, Management Science **52** (2006), no. 12, 1838–1848.
- [34] Jure Leskovec and Andrej Krevl, *SNAP Datasets: Stanford large network dataset collection*, <http://snap.stanford.edu/data>, June 2014.
- [35] Marvin B Lieberman and David B Montgomery, *First-mover advantages*, Strategic management journal **9** (1988), no. S1, 41–58.
- [36] S. Morris, *Contagion*, Review of Economic Studies **67** (2000), no. 1, 57–78.
- [37] Christine Oliver, *Sustainable competitive advantage: Combining institutional and resource-based views*, Strategic management journal **18** (1997), no. 9, 697–713.
- [38] Richard Reed and Robert J DeFillippi, *Causal ambiguity, barriers to imitation, and sustainable competitive advantage*, Academy of management review **15** (1990), no. 1, 88–102.
- [39] William T Robinson, Gurumurthy Kalyanaram, and Glen L Urban, *First-mover advantages from pioneering new markets: A survey of empirical evidence*, Review of Industrial Organization **9** (1994), no. 1, 1–23.
- [40] Richard Schmalensee, *Entry deterrence in the ready-to-eat breakfast cereal industry*, The Bell Journal of Economics (1978), 305–327.

- [41] Avner Shaked and John Sutton, *Product differentiation and industrial structure*, The Journal of Industrial Economics (1987), 131–146.
- [42] A Michael Spence, *The learning curve and competition*, The Bell Journal of Economics (1981), 49–70.
- [43] Dale O Stahl, *Oligopolistic pricing with sequential consumer search*, The American Economic Review (1989), 700–712.
- [44] A. Sundararajan, *Local network effects and complex network structure*, B.E. Journal of Theoretical Economics **7** (2007), no. 1, Article 46.
- [45] Peter Tufano, *Financial innovation and first-mover advantages*, Journal of Financial Economics **25** (1989), no. 2, 213–240.
- [46] ———, *Financial innovation*, Handbook of the Economics of Finance **1** (2003), 307–335.
- [47] Pieter A VanderWerf and John F Mahon, *Meta-analysis of the impact of research methods on findings of first-mover advantage*, Management Science **43** (1997), no. 11, 1510–1519.
- [48] H. Varian and C. Shapiro, *Information rules: a strategic guide to the network economy*, Harvard Business Review Press, 1998.
- [49] Feng Zhu and Marco Iansiti, *Entry into platform-based markets*, Strategic Management Journal **33** (2012), no. 1, 88–106.

## 8 Appendix

### 8.1 Lean Entry in Network Markets

#### 8.1.1 Proofs

**Lemma 8.1.** *Diffusion reaches a unique equilibrium  $\phi(x) \in X^*$  from any initial state of adoption  $x \in X$ . Moreover,  $\phi(x)$  is weakly lower than the equilibrium reached by any locally rational diffusion process from  $x$ .*

*Proof.* 8.1 Take the diffusion process with starting state  $x^1 = (0, \dots, 0)$ . We have proved that this process reaches an equilibrium  $x^*$ . That equilibrium is an equilibrium for the model of demand, since for every  $i$ ,  $b_i(x^*) = x_i$ .

For complete networks, the set  $X^* = \{\text{“all adopt,” “none adopt”}\}$  is analogous to the familiar fulfilled expectations equilibria of Katz and Shapiro (1985), since network utilities corresponding to a complete network are identical to network utilities in a reduced-form model of network effects.

Observe since  $L(i) = N$  for all  $i \in N$  in a complete network, value of the network must be the same for all agents. Thus we can translate our framework into the Katz and Shapiro framework by assuming a price  $p$  (in our case zero) and random distribution of  $\theta$  over  $[0, 1]$  (in our case a null distribution where  $\theta$  equals a constant), by normalizing  $\alpha = \frac{1}{n}$ , and by letting  $q^* = \sum_{i \in L(i)} x_i^* = \|x^*\|$ . Define a marginal consumer of type  $\hat{\theta}$  as a function of  $\alpha, n, p$ : let  $\hat{\theta}$  be the lowest type such that  $\hat{\theta} - p + \alpha q^* \geq 0$ . In equilibrium, all agents with types greater than or equal to  $\hat{\theta}$  must adopt. If we assume  $n$  is large enough for the random draw on types to be approximately continuous, in expectation this yields  $1 - \hat{\theta} = 1 - p + \alpha q^* = \frac{q^*}{n}$  as the unique fraction of the market which adopts in a fulfilled expectations equilibrium, or  $q^* = \frac{n(1-p)}{1-\alpha n}$ .

We will now prove the second part of the Lemma. From an initial state  $x$  and an arbitrary locally rational diffusion process  $\{y^\tau\}_{\tau=1}^\infty$ ,  $y^1 = x$  converging to equilibrium  $y^*$ , we will show that the diffusion process reaches a weakly lower equilibrium than  $\{y^\tau\}_{\tau=1}^\infty$ .

As above, note that in the diffusion process, agents drop out until we reach a state in which everyone who is adopting is best responding. More formally, in the diffusion process,  $x^1 \succeq x^2 \succeq \dots \succeq x^{\tau_0}$  for some  $\tau_0$ , after which there are no more agents  $i$  such that  $x_i^{\tau_0} = 1$  and  $b_i(x^{\tau_0}) = 0$ . After that,  $x^{\tau_0} \preceq x^{\tau_0+1} \preceq x^{\tau_0+2} \preceq \dots \preceq x^{\tau^*}$ , where  $x^{\tau^*}$  is the equilibrium reached by the diffusion process. Note that the set of adopters in  $x^{\tau_0}$  is self-sufficient. Let us call this set  $\bar{x}$ .

Note that the set of adopters in  $\bar{x}$  is contained in the initial state:  $\bar{x} \preceq x$ , and also note that any locally rational diffusion process will retain  $\bar{x}$  within the set of adopters. More formally,  $\bar{x} \preceq y^\tau \forall \tau$ .

Indeed, assume the opposite, and suppose that  $i$  is the first agent within the set of adopters in  $\bar{x}$  to switch from  $x_i = 1$  to  $x_i = 0$ , and that it happens on some step  $\tau$ :  $x_i^\tau = 1, x_i^{\tau+1} = 0$ . Then, at that step,  $b_i(y^\tau) = 0$  must be zero, which is not possible, since the set of adopters in  $y^\tau$  would contain all the adopters in  $\bar{x}$ , which means that  $b_i(y^\tau) = 1$ , and so we have a contradiction.

Therefore,  $y^* \succeq \bar{x} = x^{\tau_0}$ . Thus, for every  $i$  for which  $b_i(x^{\tau_0}) = 1, b_i(y^*) \geq b_i(x^{\tau_0}) = 1$ , and so  $y^* \succeq x^{\tau_0+1}$ . By the same logic, that leads to  $y^* \succeq x^{\tau_0+2}$ , and so on, we conclude that  $y^* \succeq x^{\tau^*}$ .  $\square$

*Proof. 4.1* Let  $\{x^\tau\}_{\tau=0}^\infty$  and  $\{y^\tau\}_{\tau=0}^\infty$  be the two processes, with  $x^1 = x$  and  $y^1 = y$ . As discussed above, in each process, adopters drop out, after which the adopter base grows, until we reach an equilibrium:  $y^1 \succeq y^2 \succeq \dots \succeq y^{\tau_0} \preceq y^{\tau_0+1} \preceq \dots \preceq y^*$ . Note that  $x \succeq y \succeq y^{\tau_0}$ , and since the adopters in  $y^{\tau_0}$  are a self-sufficient set, then by the same argument as in the proof of A4.2.,  $x^\tau \succeq y^{\tau_0}$  for every  $\tau$ , and so  $x^* \succeq y^{\tau_0}$ , and again as above, this leads to  $x^* \succeq y^{\tau_0+1}, x^* \succeq y^{\tau_0+2}$  and so on, until  $x^* \succeq y^*$ .

To prove  $D(x) \geq D(x')$  does not imply  $x \succeq x'$  or  $\|x\| \geq \|x'\|$ , we provide a counterexample. Consider a network  $G(N, L)$  which consists of two disconnected subgraphs: five nodes whose links form a pentagon and five nodes forming a complete subgraph. Let there be no links between nodes in the two subgraphs.

Assuming thresholds for adoption are  $t_i=1$  for all  $i \in N$ , Seeding any three adopters in the pentagon leads to demand 0, while seeding any three adopters in the complete network leads to demand 5. This concludes the proof.  $\square$

*Proof. 4.2* A state  $x$  is self-sustaining if and only if for every agent  $i$  in  $A(x)$ , the best response given the status quo is to remain an adopter of the entrants good. When the status quo is  $y_i^* = 1 \forall i \in N$ , this is equivalent to more than half of  $i$ 's peers are in  $A(x)$  for every  $i \in A(x)$ , which is the definition of  $\frac{1}{2}$ -cohesion. In general, this is equivalent to more than  $t_i$  of  $i$ 's peers are in  $A(x)$  for every  $i \in A(x)$ , which by a simple reordering of  $\rho_i > \frac{t_i}{d_i}$ , is the definition of  $t$ -cohesion.  $\square$

*Proof. 4.3* First, note that in Proposition 4.2, we established that once the diffusion process has reached a self-sustaining state, the process only takes us to weakly greater states.

We will prove the first claim of our proposition by induction. By Proposition 5.3.,  $A(x^1)$  is  $t$ -cohesive. Suppose that  $A(x^{\tau-1})$  is also  $t$ -cohesive; we will show that  $A(x^\tau)$  is also  $t$ -cohesive. If  $x^{\tau-1} = x^\tau$ , our claim is obviously true. Assume  $x^{\tau-1} \neq x^\tau$ .

Take an agent  $i$  which joins the set of adopters on step  $\tau$ , i.e.  $i \in A(x^\tau) \setminus A(x^{\tau-1})$ . Then,  $b_i(x^{\tau-1}) = 1$ , which means that more than  $\frac{t_i}{d_i}$  of their peers are in  $A(x^{\tau-1})$ , and so more than  $\frac{t_i}{d_i}$  of their peers are in

$A(x^\tau) \supset A(x^{\tau-1})$ . Additionally, for every agent  $j \in A(x^{\tau-1})$ , more than  $\frac{t_j}{d_j}$  of their peers are in  $A(x^{\tau-1})$ , and so more than  $\frac{t_j}{d_j}$  of their peers are in  $A(x^\tau) \supset A(x^{\tau-1})$ . Thus,  $A(x^\tau)$  is also  $t$ -cohesive.

Now, suppose that for some  $\tau$ , there is no such  $i \notin A(\tau)$  such that more than  $\frac{t_i}{d_i}$  of its peers are in  $A(x^\tau)$ . This means that there is no agent which isn't currently adopting the entrants good, whose best response in step  $\tau$  would be to adopt. Therefore, the diffusion process will not add any further adopters. It will also not remove any adopters, since  $A(x^\tau)$  is  $t$ -cohesive and thus self-sustaining, and so diffusion has reached an equilibrium.  $\square$

*Proof. 1* (Corollary to Prop 4.3) Suppose that for some  $\tau$ ,  $C = N \setminus A(x^\tau)$  is weakly  $(d - t)$ -cohesive, that is every  $i$  has a proportion of its peers in  $C$  of at least  $(d_i - t_i)/d_i = 1 - t_i/d_i$ . In the case when the outside option is a network good, this is equivalent to saying the proportion  $\rho_i$  of  $i$ 's peers in  $A(x^\tau)$  is no more than  $t_i/d_i$  for all  $i \in C$ . This means there is no consumer in  $C$  whose best response is to adopt, and since  $A(x^\tau)$  is self-sustaining, diffusion has reached an equilibrium.  $\square$

*Proof. 4.4* Suppose every consumer has already adopted a network good and we are now interested in diffusion of an identical competing (focal) network good. Let the diffusion process be described by the nested  $t$ -cohesive sets  $A_1 \subset A_2 \subset \dots \subset A_T$ . Let the number of links between adopters in  $A_1$  be denoted  $l$ , and let the minimum threshold for adopting a network good (versus a non-network outside option) be denoted  $\lfloor t \rfloor$ .

We will assign  $2l$  unique labels, numbered 1 through  $2l$ , to nodes in  $A_1$ : for every node, assign as many different labels as the number of the node's peers in  $A_1$ . We will then reassign the labels to nodes that adopt the focal good. Eventually, every node that adopts the focal good will be assigned at least one unique label; at least one will get  $\lfloor t + 1 \rfloor$  and some others may get more than one. That will conclude our proof that diffusion reaches a strict upper bound  $\bar{D}(x) = \|x\|(\|x\| - 1)$  (subtracting  $\lfloor t \rfloor$  if it is greater than zero).

Note that for each adopter of the focal good in  $x$ , we have more links connecting it to other adopters in  $x$  than "outgoing links." On every step of the diffusion process, the same will hold: for a node  $i \in A_j \setminus A_{j-1}$ , there are more links from  $i$  to nodes in  $A_{j-1}$  than links from  $i$  to nodes outside of  $A_{j-1}$ . Using this fact, we will assign labels along the path of diffusion using iteration.

Step 0. Begin the method of reassigning labels by having each node  $i$  in  $A_1$  "give" a label to each of its peers outside  $A_1$ . Since  $i$  has more links within  $A_1$  than without, it will retain at least one label for itself. Also, note that every node  $j$  in  $A_1$  will have received a number of labels equal to the number of links from  $j$  to  $A_1$ .



Step 1. For each node  $i$  in  $A_2 \setminus A_1$ , reassign one label to each of its peers outside  $S_1$ . Again, this means that every node in  $A_2 \setminus A_1$  will retain at least one label for itself.

In step  $m$  of our labeling method, let each node  $i \in A_m \setminus A_{m-1}$  reassign the labels to each of its peers outside  $A_m$ . Since we know that  $i$  in  $A_m$  has so far received 1 label from each of its peers in  $A_{m-1}$ , and  $i$  adopted on the  $m$ -th step of the diffusion process,  $i$  must have strictly more neighbors in  $A_{m-1}$  than peers outside of  $A_{m-1}$ , and thus outside of  $S_m$ . This means that  $i$  will retain at least one label for itself.

We can repeat this method until we reach  $A_T$ , the last step of the diffusion process. Note that for every node in  $A_T$ , there will be at least  $\lfloor t + 1 \rfloor$  labels reassigned and retained by each node in  $A_T$ . Every other node will have received and retained at least one label. Since we started out with  $2l$  labels, this concludes the proof that diffusion reaches a strict upper bound of  $\|x\|(\|x\| - 1)$  adopters.  $\square$

*Proof. 2* We can use the same labeling method to show that networks which maximize diffusion when  $\theta = 0$  are nestedly  $\frac{1}{2}$ -cohesive such that each adopter is a boundary spanner between two nested sets. Maximum diffusion from size  $\|x\|$  occurs when the network can be broken up into components  $A_0, A_1, A_2, \dots, A_T$  such that:

1.  $A_0$  is a complete subgraph of size  $\|x\|$
2. For every  $s \geq 1$ , the nodes of  $A_s$  have no links to other nodes in  $A_s$ , and each node  $i$  in  $A_s$  has exactly 1 more links to  $\cup_{j=0}^{s-1} A_j$  than to  $\cup_{s+1}^k A_j$ .
3. If the minimum threshold for adopting a network good (versus a non-network outside option) is at least one, the last component  $A_k$  has exactly 1 element, with exactly  $\lfloor t + 1 \rfloor$  links. If the minimum threshold is less than one, then  $A_k$  can have as many elements, but each of them has one incoming links and no links exist between nodes in  $A_k$ .

Following labeling method, note that conditions 1-3 above are necessary and sufficient to ensure exactly  $|A_i|$  labels remain assigned to the nodes of  $A_i$  on the  $i$ th step of the diffusion. For the final step, note that each of the nodes in  $A_k$  needs to have more than  $t$  links coming in, so each node in  $A_k$  needs to retain at least  $\lfloor t + 1 \rfloor$  labels for itself. To minimize the number of “excess labels” in this last phase,  $A_k$  needs to have only one node if  $t \geq 1$ .  $\square$

*Proof. 4.1* Since every node is connected to every other node in a complete network, a state  $x$  is self-sustaining only if each seeded node is connected to more than  $\frac{n-1}{2} - \frac{\theta}{2\alpha}$  other seeded nodes. Note that the subgraph defined by the nodes in  $A(x)$  is complete, and each node in it has degree  $\|x\| - 1$ . Thus for  $x$  to be self-sustaining, it is necessary for  $\|x\| - 1 \geq \lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 1$  or equivalently  $\|x\| \geq \lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 2$ . Observe that

this lower bound is also sufficient for diffusion to reach demand  $n$  in one iteration, since every node in the entire network would be connected to more than  $\frac{n-1}{2} - \frac{\theta}{2\alpha}$  seeded nodes. It is the minimal scale because  $x^* = (1, 1, \dots, 1)$  is the lowest equilibrium with nonzero demand.

The seed state  $\lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 2$  is bounded above by a scalar multiple of  $n$  as  $n \rightarrow \infty$ , which completes our proof that the entrant must seed more than half the market to enter a complete network.

I now show that an entrant must seed more than half of a bipartite network in order to enter the market. Suppose we have a bipartite graph with  $N_1$  sellers on one side of the network and  $N_2$  buyers on the other side. Let  $S_0 \neq \emptyset$  be a self-sustaining set of adopters; without loss of generality, assume that  $S_0 \cap N_1 \neq \emptyset$ . Let  $x$  be a seller in  $S_0 \cap N_1$ . Since at least half of  $x$ 's peers must be in  $S_0$  in order for  $x$ 's adoption to be self-sustaining, and  $x$  is linked to all buyers in  $N_2$  and no other consumers, it must be that  $|S_0 \cap N_2| > |N_2|/2$ .

Similarly, consider a buyer on the other side:  $y \in S_0 \cap N_2$ . Since  $y$  is linked to none all sellers in  $N_1$  and no other consumers, it must be that  $|S_0 \cap N_1| > |N_1|/2$  in order for  $S_0$  to be self-sustaining. This argument shows that  $|S_0| = |S_0 \cap N_1| + |S_0 \cap N_2| > |N_1|/2 + |N_2|/2 = |N|/2$ , in other words at least half the market must adopt the entrant's good for its presence in the market to be sustainable.  $\square$

*Proof. 4.2* This follows directly from Proposition 4.4. In the optimally diffusive network described there, DP reaches at least  $D(x) = \|x\|(\|x\| - 1) + \frac{\theta}{\alpha}\gamma n$  adopters from  $x$ . This is true for arbitrarily large  $\|x\|$ , so set  $D(x) = n$  for an arbitrarily large  $n$  and solve for  $x$ . DP reaches demand  $n$  from  $\|x\| = m$  early adopters, where  $m$  is the smallest integer for which  $m(m-1) + \frac{\theta}{\alpha}\gamma n \geq n$ . By definition, the minimal scale needed to enter cannot be more than  $m$ .

Since  $m$  is bounded above by a scalar multiple of  $\sqrt{n}$  as  $n \rightarrow \infty$ , this completes our proof.  $\square$

*Proof. 4.5* This follows from 4.2 and 4.1, since in a complete network, minimal scale to entry grows in the order of  $O(n)$ , and in an optimally diffusive network it grows in the order of at most  $O(\sqrt{n})$ .  $\square$

*Proof. 4.3* Take an arbitrary number  $m$ . We will show that there exists an optimal network of size  $m(m-1)$  with average degree  $m$ .

Denote the nodes  $a_1, \dots, a_m; b_1, \dots, b_{m(m-3)/2}; c_1, \dots, c_{m(m-1)/2}$ . Let the nodes be connected as follows:  
 $\{a_i\}$  is an  $m$ -clique;  
 $b_1$  is connected to  $m$  of the  $a_i$ -s;  $b_2$  is connected to  $m-1$  of the  $a_i$ -s, and so on, until  $b_m$  which is connected to 1 of the  $a_i$ -s.  
 $b_{m+1}$  through  $b_{m(m-3)/2}$  is connected to 1 of the  $a_i$ -s each, in such a way that every  $a_i$  has exactly  $m-2$  edges connecting it with some of the  $b_i$ -s.

$b_i$  and  $b_j$  are connected iff  $|i - j| \leq m - 1$  for every  $i$  and  $j$ .

$b_{m(m-5)/2+2}$  is connected to 1  $c_i$ ;  $b_{m(m-5)/2+3}$  is connected to 2  $c_i$ -s, and so on until  $b_{m(m-3)/2}$  which is connected to  $m - 1$  of the  $c_i$ -s, in such a way that each  $c_i$  is connected to exactly one of the  $b_i$ -s.

Note that if the firm seeds  $\{a_i\}_{i=1}^m$ , that is a self-sustaining state because each  $a_i$  will have  $m - 1$  edges to other  $a_i$ s and only  $m - 2$  edges to non-adopters. On each iteration of the diffusion process the  $b_i$ -s will adopt in order starting with  $b_1, b_2, \dots$ : For example, on the first round of diffusion,  $b_1$  is connected to  $m$  adopters (the  $a_i$ -s) and  $m - 1$  non-adopters,  $b_2$  through  $b_m$ . On the next iteration,  $b_2$  will be connected to  $m$  adopters (the  $a_i$ -s it is connected to, and  $b_1$ ) and  $m - 1$  non-adopters again.

This continues until  $b_m$ . Now for  $b_{m+1}$  through  $b_{m(m-3)/2}$ , again, on each round, take the node with lowest index which has not yet adopted, and note that it is then connected to  $m$  adopters ( $m - 1$  of the  $b_i$ -s and 1 of the  $a_i$ s) and  $m - 1$  non-adopters ( $b_i$ -s and in some cases, a number of  $c_i$ -s).

Finally, by the time all the  $b_i$ -s have adopted, each  $c_i$  will have exactly 1 adopting neighbor and 0 non-adopting, so they will all adopt as well.

Thus, we have provided an example with  $n = m + m(m - 3)/2 + m(m - 1)/2 = m(m - 1)$  nodes which diffuses from initial seed size  $m$ . Let us count the total number of edges:

$m(m - 1)/2$  from  $a_i$  to  $a_j$ ;

$m(m - 2)$  from  $a_i$  to  $b_j$ ;  $(s - 1) + (s - 2) + \dots + (s - m + 1)$  from  $b_i$  to  $b_j$ , where  $s = m(m - 3)/2$ ;

$m(m - 1)/2$  from  $b_i$  to  $c_j$ , or a total of

$$\begin{aligned} m(m - 1)/2 + m(m - 2) + ((m - 1)s - m(m - 1)/2) + m(m - 1)/2 = \\ m(m - 1)/2 + m(m - 2) + (m - 1)m(m - 3)/2 = \\ \frac{m^2 - m + 2m^2 - 4m + m^3 - 4m^2 + 3m}{2} = \\ \frac{m^3 - m^2 - 2m}{2} = \frac{m(m + 1)(m - 2)}{2} \end{aligned}$$

Since the total sum of nodes' degrees is twice the number of edges, this means that the average degree in

our network is  $\frac{m(m+1)(m-2)}{m(m-1)} = \frac{(m+1)(m-2)}{m-1} > \sqrt{n}$ . □

*Proof.* 4.6 Recall that  $\pi_L(n) = n(\theta + \alpha n^k) - c(m)$  where  $m^2 - m = (1 - \frac{\theta}{\alpha}\gamma)n$ ;

$$\pi_C^*(n) = n(\theta + \alpha(n-1)) - c(\lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 2);$$

$$\pi_B^*(n) = n\theta - 1.$$

Suppose  $\|x\|^2 < c(\|x\|) < \|x\|^{2(k+1)}$ . We will first show that  $\pi_L(n) - \pi_C^*(n) > 0$  as  $n \rightarrow \infty$ . Since  $c(\|x\|) > \|x\|^2$  asymptotically, the term with highest polynomial degree in  $\pi_L(n) - \pi_C^*(n)$  is  $c_C(n) = c(\lfloor \frac{n-1}{2} - \frac{\theta}{2\alpha} \rfloor + 2)$ . Observe that  $c_C(n) \rightarrow +\infty$  as  $n \rightarrow \infty$ . Thus, there exists  $n_0$  such that  $\pi_L(n) - \pi_C^*(n) > 0$  for all  $n > n_0$ . And since  $c(\|x\|) < \|x\|^{2(k+1)}$ ,  $\pi_L(n) = \pi_L^*(n)$ .

We will now show that  $\pi_L(n) - \pi_B^*(n) > 0$  as  $n \rightarrow \infty$ . The term with highest polynomial degree in  $\pi_L(n) - \pi_B^*(n)$  is  $\alpha n^{k+1}$ . Since that term grows to  $+\infty$ , there exists  $n_1$  such that  $\pi_L(n) - \pi_B^*(n) > 0$  for all  $n > n_1$ . It follows that  $\pi_L^*(n) - \pi_B^*(n) > \pi_L(n) - \pi_B^*(n) > 0$  for all  $n > n_1$ .

We have shown that for sufficiently large  $n > \max(n_0, n_1)$ , the firm achieves greater profit in the optimally diffusive network than in both a complete and empty network. □

*Proof.* 4.7 Let us denote with  $x'^*$  and  $x^*$  the entrant's demand equilibrium given adoption of the incumbent's good  $y^*$  and  $y^*$  respectively. We will prove that  $x^* \preceq x'$ . Let  $\{x^\tau\}$  and  $\{x'^\tau\}$  be the diffusion process that reach those equilibria, and let us also denote with  $\{y^\tau\}$  and  $\{y'^\tau\}$  the respective incumbent's adopters in each step of diffusion.

Suppose that the initial state  $x = x^1 = x'^1$  is such that every agent who adopts is also already best-responding. Then, each diffusion process will only add new agents to the set of adopters of the entrants good, and it will do so in a way that the set of adopters remains self-sustaining. On the other hand, the set of adopters of the incumbents good will only be reduced during the diffusion process.

Note that if on a given step  $\tau$ ,  $x^\tau \preceq x'^\tau$  and  $y^\tau \succeq y'^\tau$ , then the same is true for step  $\tau + 1$ . Indeed, take an agent  $i$  that switched on step  $\tau + 1$  from not adopting the entrants good, to adopting it. Then, the best response for  $i$  given adopter set  $x^\tau$  and status quo  $y^\tau$  is to adopt the entrants good. Thus, the best response for  $i$  given adopter set  $x'^\tau \succeq x^\tau$  and status quo  $y^\tau \preceq y'^\tau$  will also be to adopt the entrants good. Thus,  $x^{\tau+1} \preceq x'^{\tau+1}$ . Analogously,  $y^{\tau+1} \succeq y'^{\tau+1}$  (since every agent  $j$  who dropped out of  $y^\tau$  also dropped out of  $y'^\tau$ ), and so the equilibrium reached by  $\{x^\tau\}$  is weakly lower than the one reached by  $\{x'^\tau\}$ .

Note that the above claim is true if the two diffusion processes start off from different initial self-sustaining

states of adoption: that is, we only need  $x^1 \preceq x^1$ , not  $x^1 = x^1$ , and the above argument still holds.

Going back to the general case, in the first phase of the two diffusion processes (when agents drop the entrants good), the adopter bases reduce to self-sustaining sets  $x^{\tau_0}$  and  $x^{\tau_0}$ . We will now show that  $x^{\tau_0} \preceq x^{\tau_0}$  and  $y^{\tau_0} \succeq y^{\tau_0}$ , and combined with the above argument, this will conclude our proof. Note that since  $x^{\tau_0}$  is self-sustaining given a status quo  $y^{\tau_0}$ , and since  $y^1 \preceq y^1 \preceq y^2 \preceq \dots \preceq y^{\tau_0}$ ,  $x^{\tau_0}$  is both contained in  $x^1$ , and self-sustaining given status quo  $y^1$ . We will show by induction that for every step  $\tau$ ,  $x^\tau \succeq x^{\tau_0}$  and  $y^\tau \preceq y^{\tau_0}$ .

Suppose the opposite: let  $\tau+1$  be the first step for which the above is not true. There are two possibilities. First, there is an agent  $i$  for whom  $x_i^{\tau_0} = 1$  and  $x_i^\tau = 1$  but  $x_i^{\tau+1} = 0$ . Since  $x^\tau \succeq x^{\tau_0}$  and  $y^\tau \preceq y^{\tau_0}$ , that is not possible, since then  $x_i^{\tau+1} \neq b_i(x^\tau)$ .

Second, it could be that there is an agent  $i$  for whom  $y_i^{\tau_0} = 0$  and  $y_i^\tau = 0$  but  $y_i^{\tau+1} = 1$ . Again, since  $x^\tau \succeq x^{\tau_0}$  and  $y^\tau \preceq y^{\tau_0}$ , the best response for  $i$  given entrant adopter set  $x^\tau$  and status quo  $y^\tau$  cannot be more favorable for the incumbent than  $x^{\tau_0}$  and  $y^{\tau_0}$ , and so we have a contradiction again, which completes our proof.  $\square$

## 8.2 First Mover Advantage of Exchange-Traded Products

Figure 9: ETP Construction

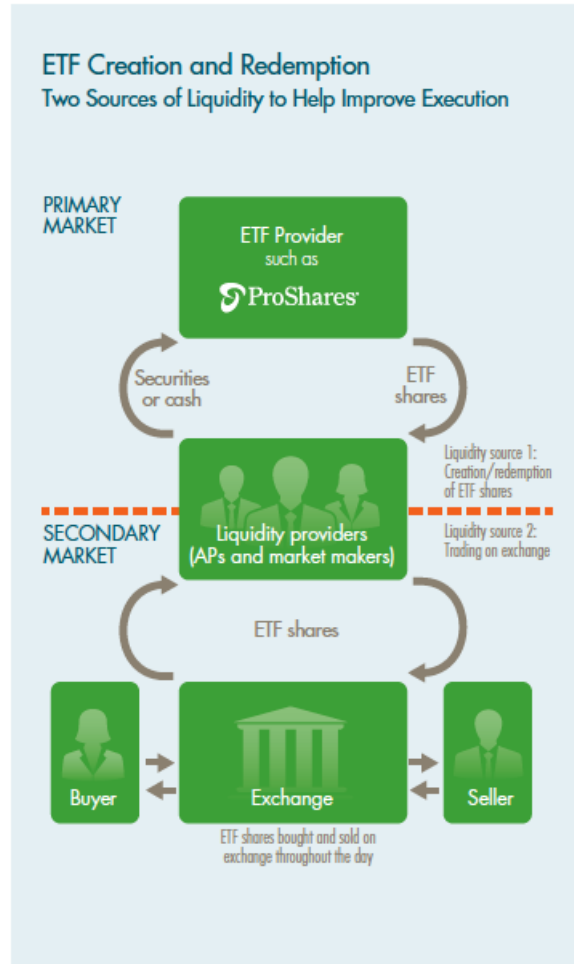


Figure 10: ETP Industry Growth

### ETPs Issued from 1993 to Present

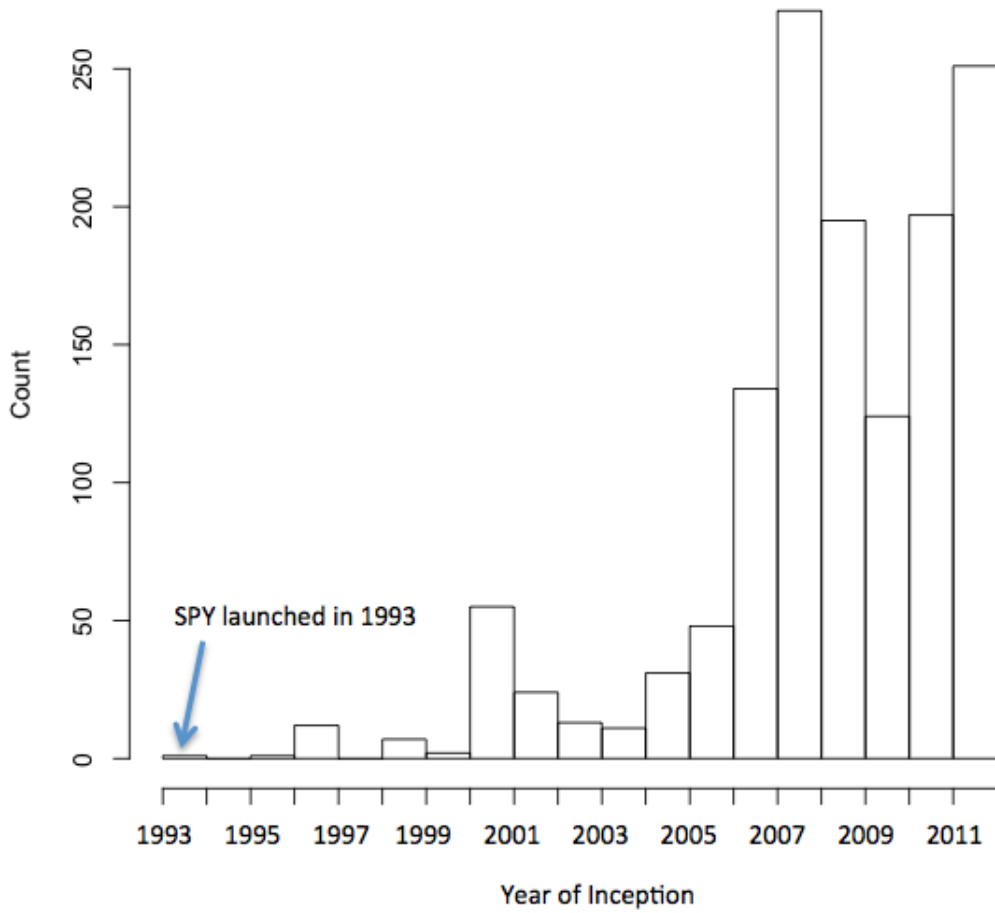




Figure 11: Example of market construction

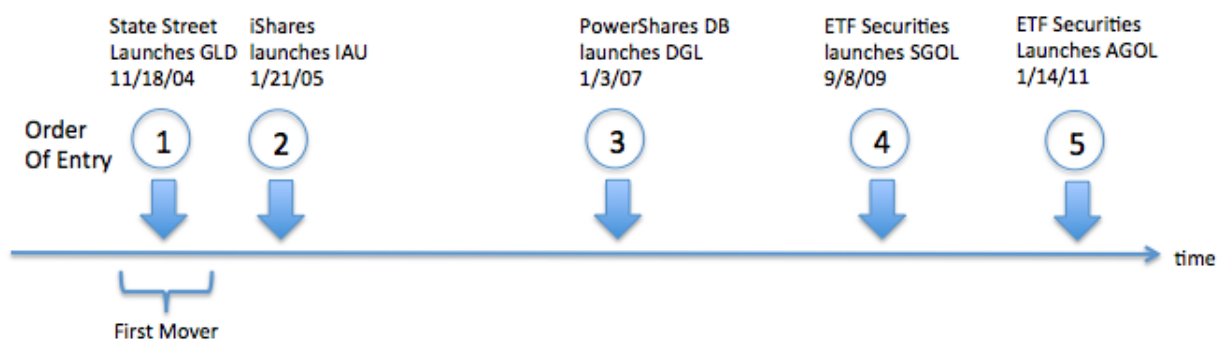


Figure 12: ETP Issuers, products, and AUM

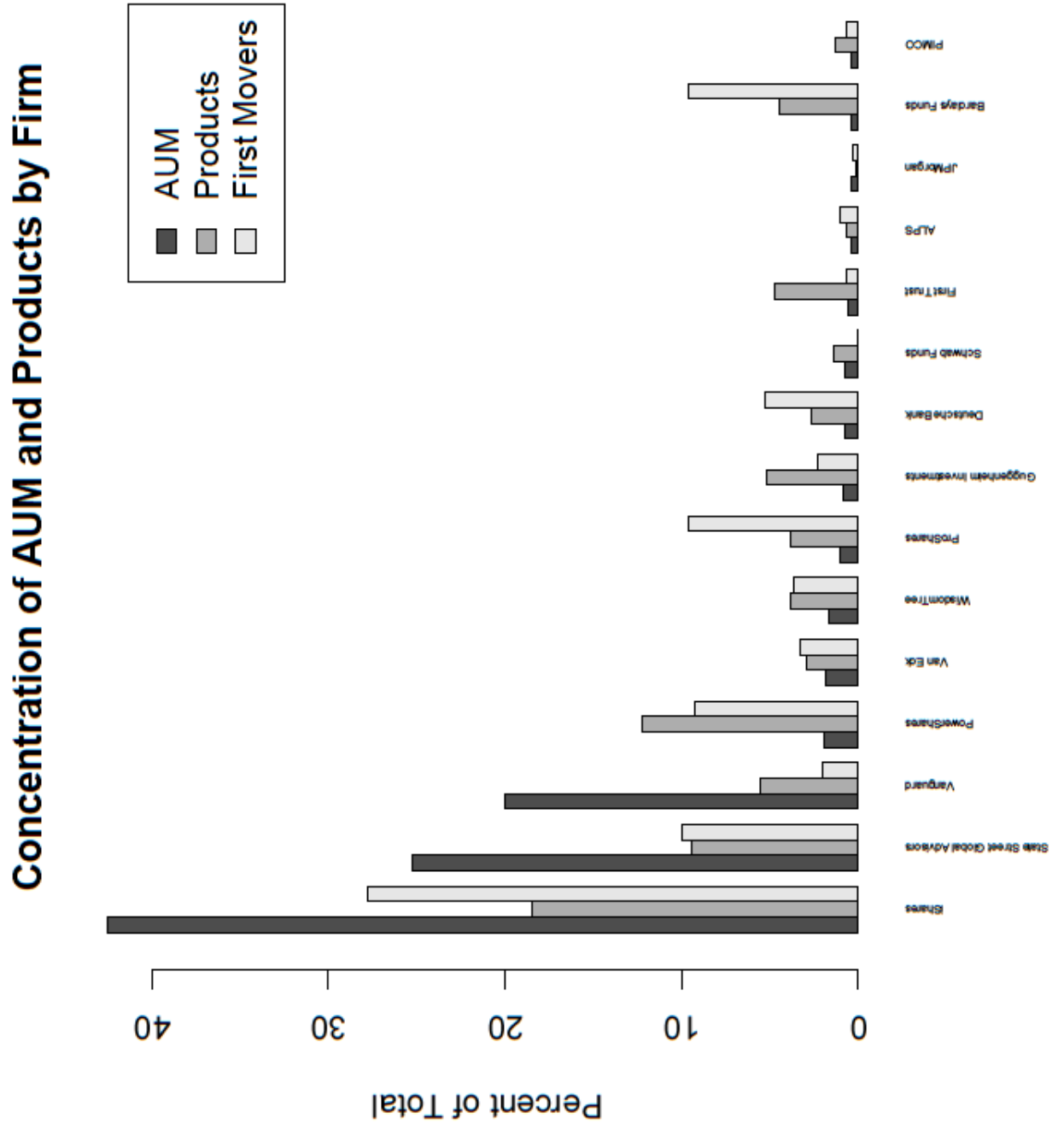


Figure 13: Firm Specialization

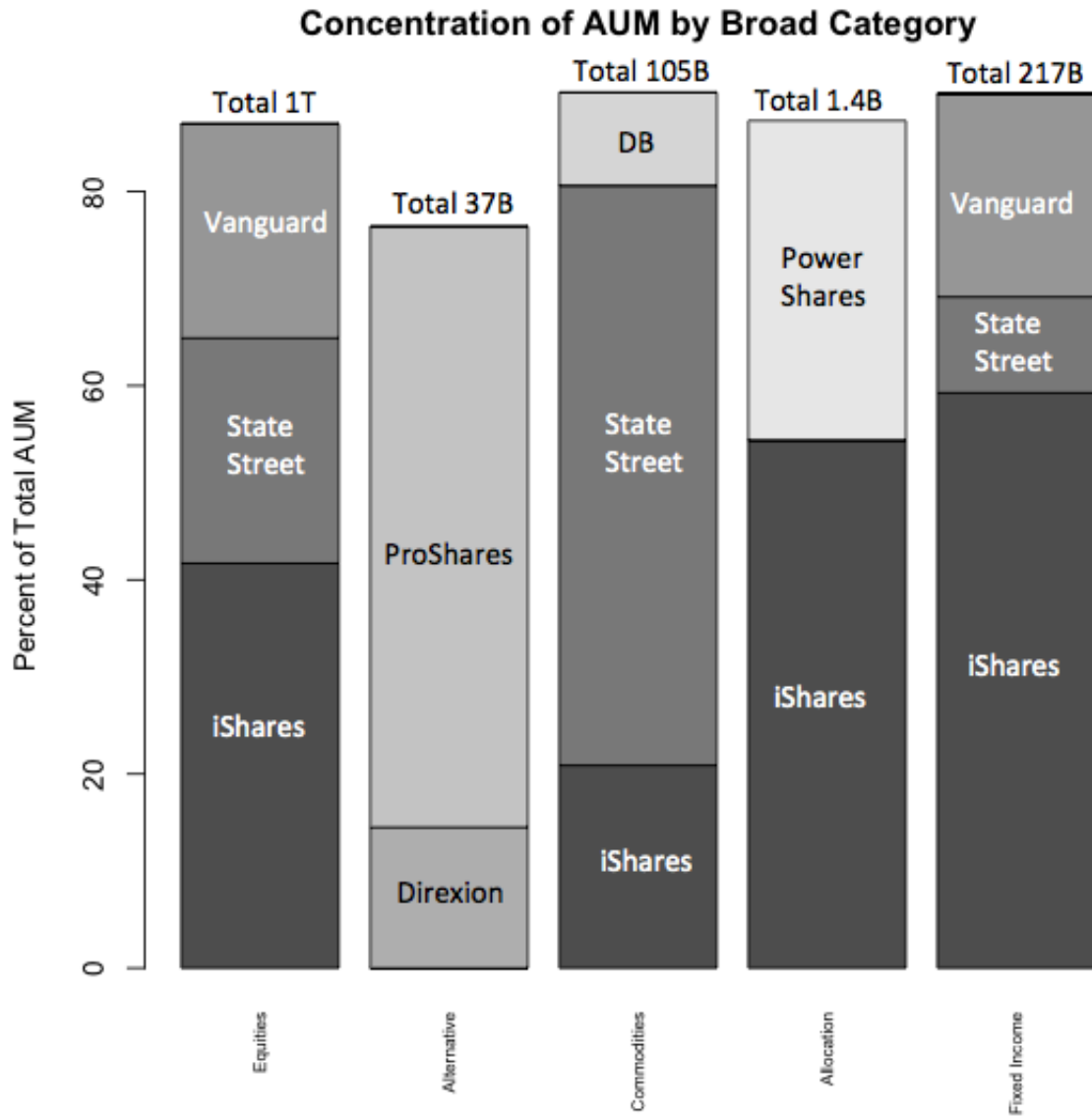


Figure 14: Example of competition in an ETP market

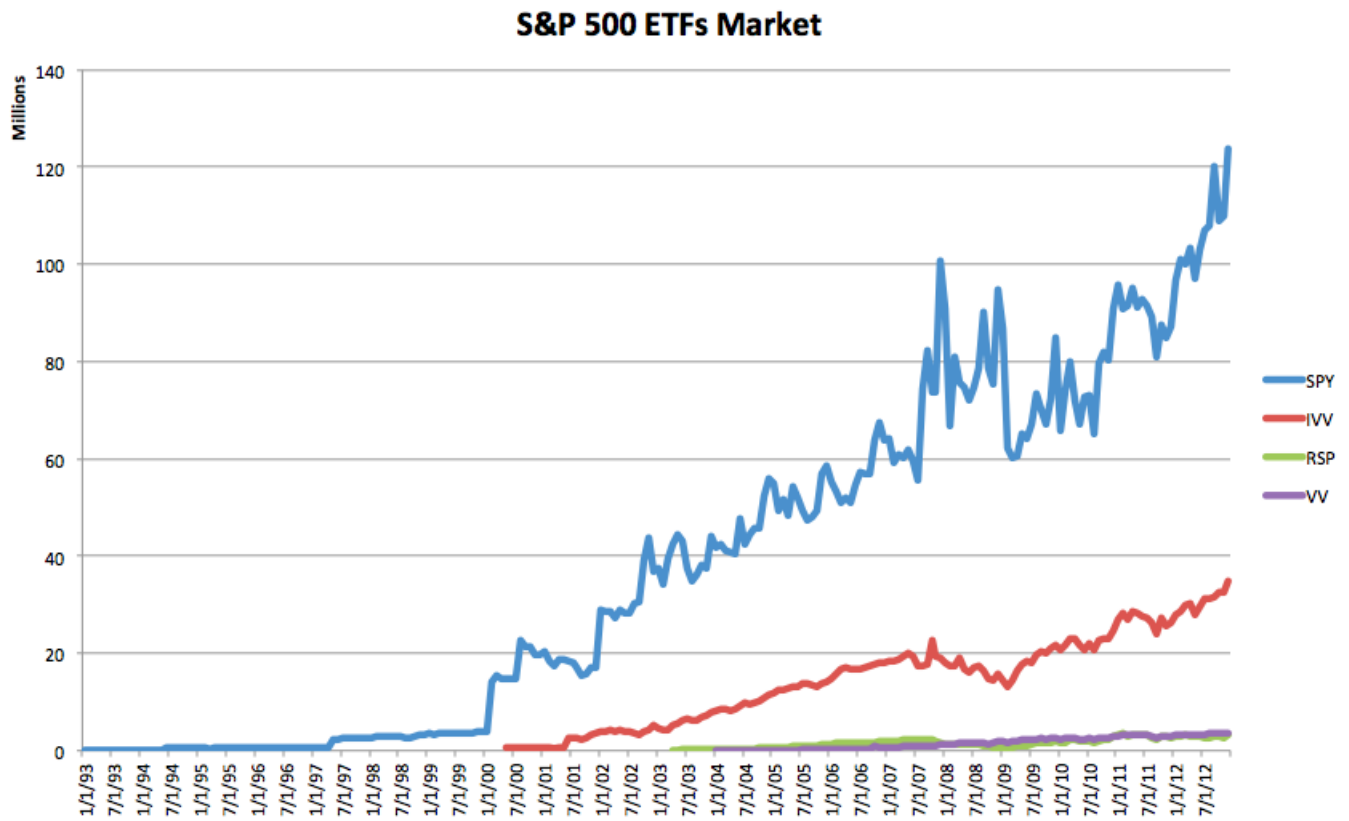


Figure 15: Example of competition in an ETP market

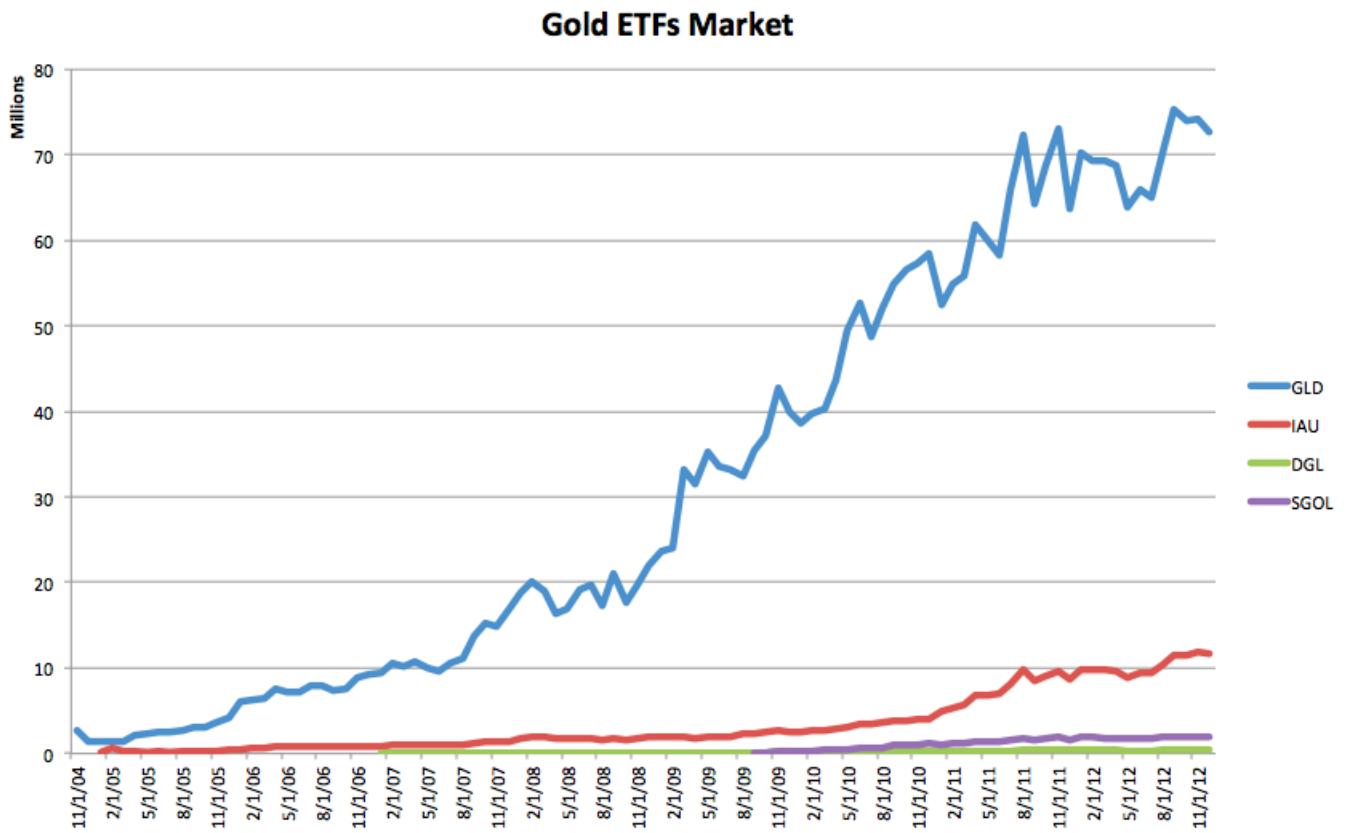


Figure 16: Example of competition in an ETP market

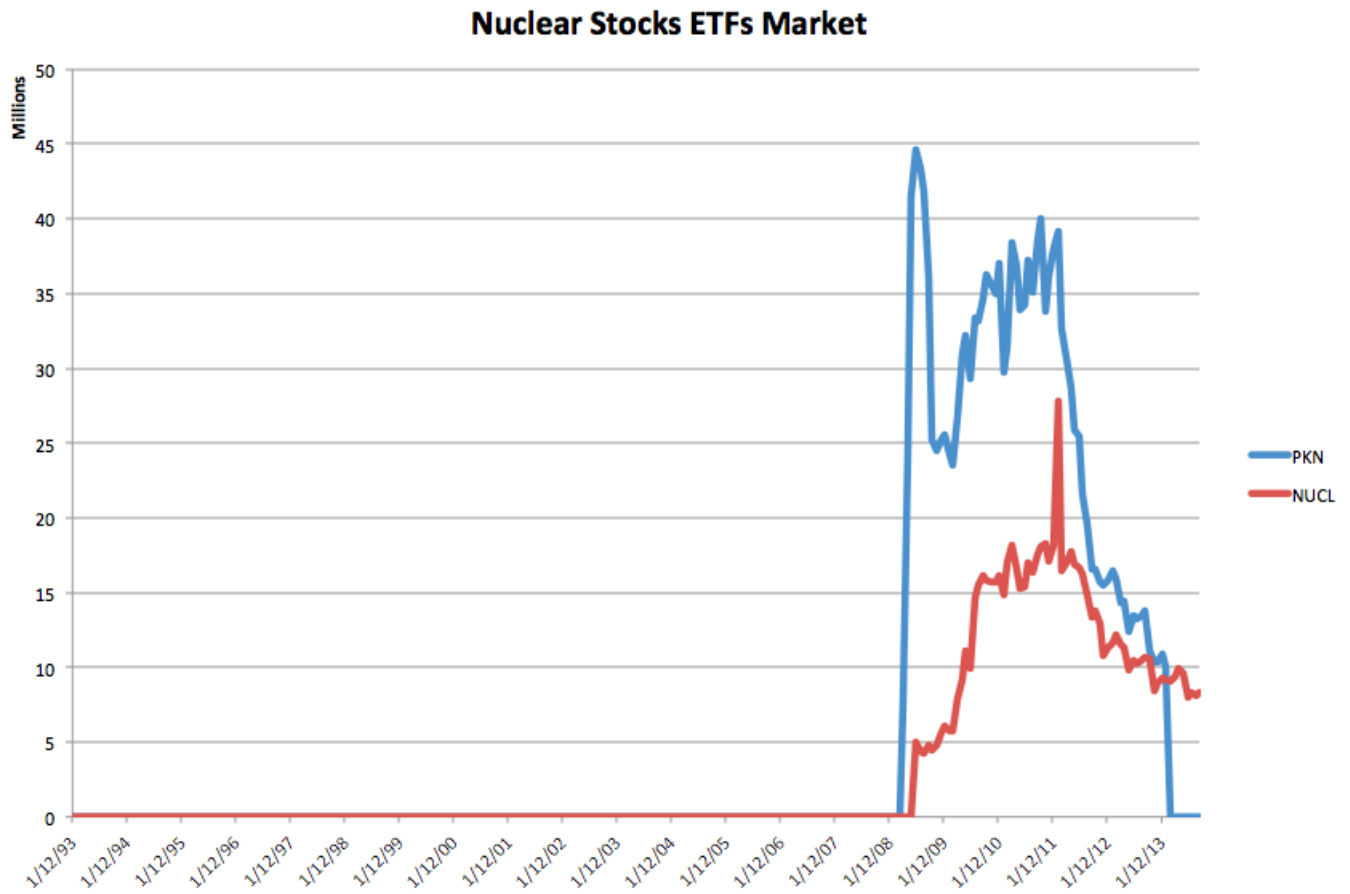


Figure 17: ETPs which have died since 1993

### ETP Liquidations from 1993 to Present

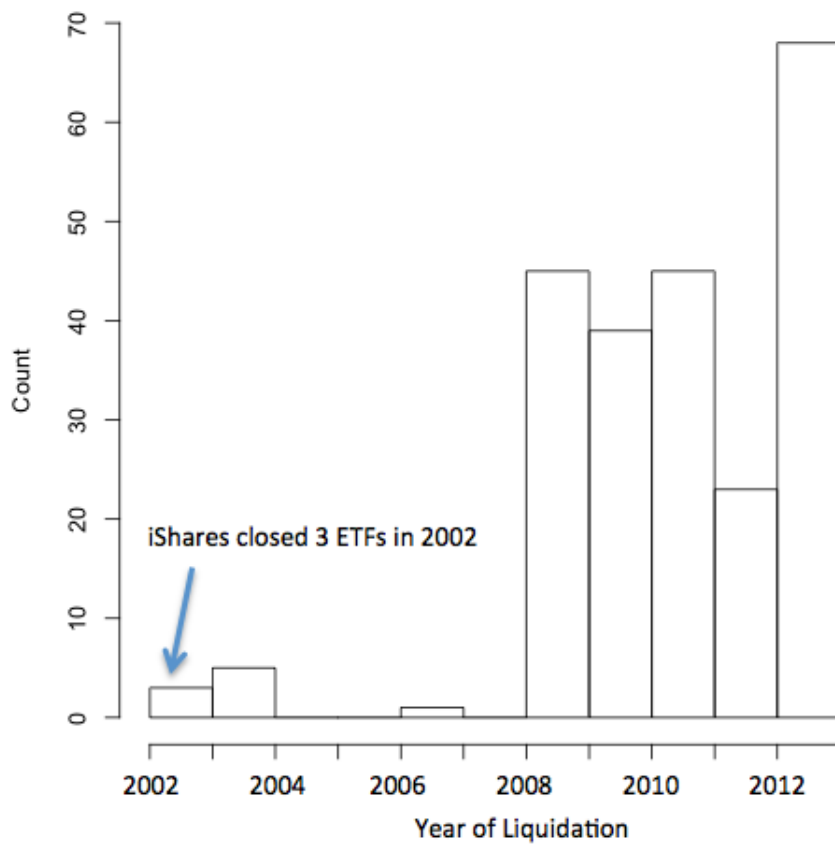


Table 22: Correlation Table for AUM Difference between 1st and 2nd Mover

Correlated Variable	log AUM Difference
Market Size	0.062
Market Inception Year	-0.268
Days before 2nd mover Entry	0.265
First Mover initial capital	0.072
First Mover 6 month AUM	0.140
Second mover initial capital	0.036
Second mover 6 month AUM	0.034



### 8.3 Growing Digital Content: the Case of Yelp.com

Figure 18: Growth of Local Reviews in Phoenix, AZ

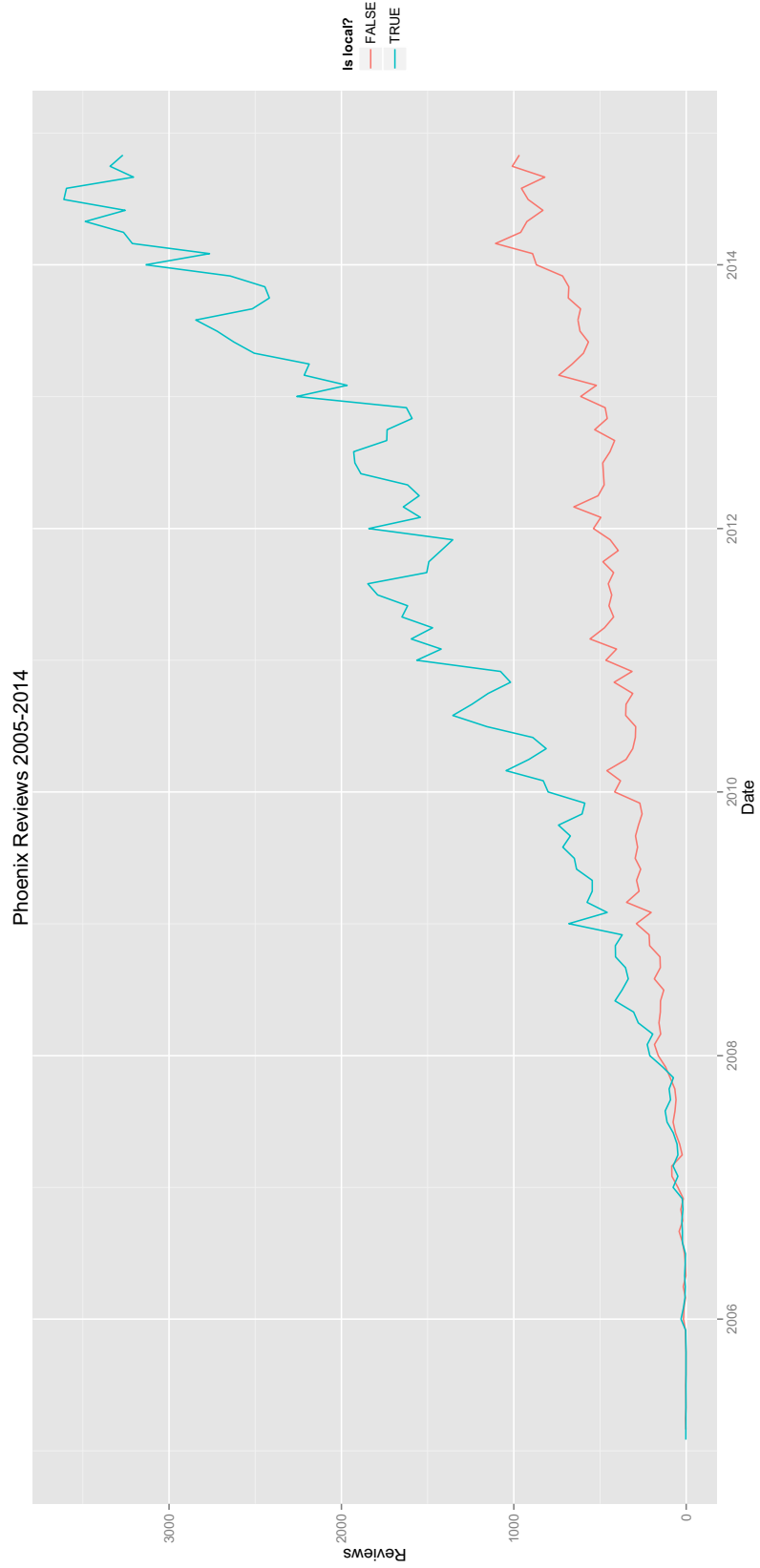


Figure 19: Tourist Reviews in Seattle

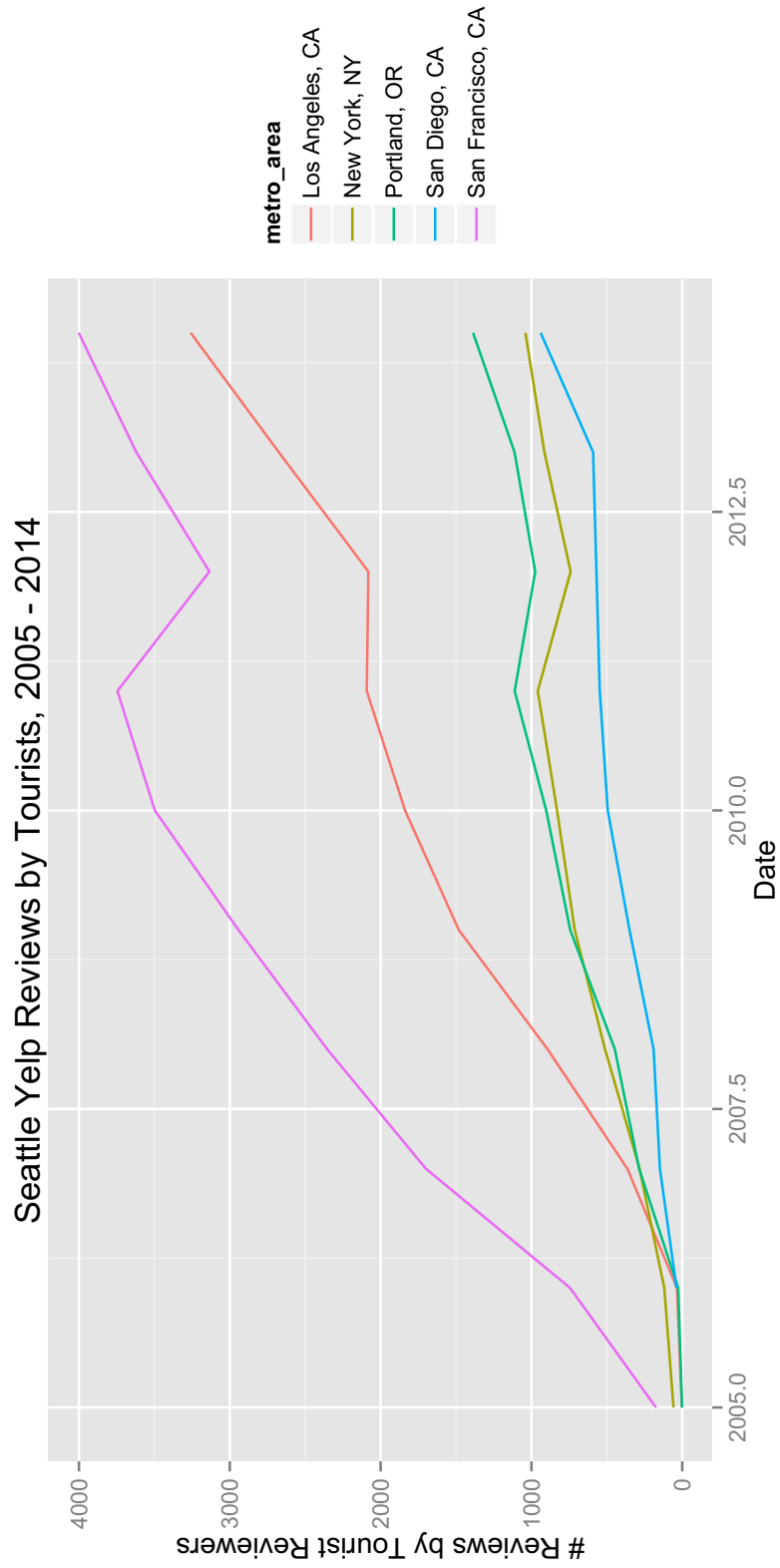


Figure 20: Tourist Reviews in Boston

