

# BETTER, CHEAPER, FASTER

## WHY COMPANIES THAT REDUCE FRICTION WIN



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## Modest Proposal – Better, Cheaper, Faster: Why Companies That Reduce Friction Win

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## EPISODE SNIPPETS

### UNDERWRITING THE FUTURE

- Two different theories for investing: underwriting the past and underwriting the future.
- **Underwriting the past** involved looking quantitatively at historical performance and trying to focus on business fundamentals irrespective of a view on the future. Investors who underwrite the past want as much certainty as possible.
- **Underwriting the future** is more qualitatively focused and requires an investor to be comfortable with uncertainty as they build a view on the future of a company through strategic analysis. **The best performing investors over the past 20 years belong to this group.**
- **Many of the most successful companies look silly early on**, but they are able to get to such a massive scale that they are able to build an ancillary economic system around themselves.

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### DIFFERENCES IN ONLINE BUSINESSES

- Getting to a 10x+ better experience often requires removing friction from a process.
- **OPPORTUNITY in industries where the supply side has been significantly impacted by COVID-19, but demand will eventually normalize.**
- Online businesses can be categorized into a 2x2 matrix. Product verse service on the Y-Axis and homogeneous verse heterogeneous offering on the X-axis.
- The quadrant that no one has quite figured out yet is "heterogeneous services" since they are localized, require significant transaction volume, and are extremely hard to build due to the cold start problem. **It is almost inevitable that a company that provides digital-like local services across a variety of categories is built eventually.**

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### IAC – BUSINESS BREAKDOWN

- IAC is "maniacally focused and maniacally talented at taking a product and figuring out ways to bring users to it in an economically efficient manner and making a lot of money doing it."
- The conglomerate has focused on acquiring or incubating companies that are at the forefront of digital shifts, growing them, and eventually spinning them out. They are the kings of acquiring and monetizing users in a digital environment.
- Barry Diller's superpower has been his ability to understand the disruption that two-way interactivity would have on traditional media and allocate resources towards companies poised to take advantage of that trend.

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## INTRO

Patrick (00:02:02): My guest this week goes by the pseudonym [Modest Proposal](#). He's both a close friend and one of the most respected thinkers on financial Twitter. I field more inbound questions about him than just about anyone, and you'll see why in this episode. We discussed many of the biggest themes in today's stock market, from consumer to technology, to marketplace, and local home services businesses. As always Modest brings specific insight and general frameworks to the discussion. I talk to him as often as I can because I learn something new each and every time and this discussion was no exception. Please enjoy my conversation with Modest Proposal.

## UNDERWRITING THE FUTURE

Patrick (00:02:32): So, you sent me a message not long ago saying that you had been thinking about something for 18 months, which is this idea of investing being about underwriting the past versus the future, and I want to set that as the frame for this conversation. Can you open by explaining the big concept here so that we can dive into all aspects of it?

Modest Proposal (00:02:55): Sure. I think the stereotype of the classic value investor is very quantitatively focused, very focused on the past trying to find a margin of safety based on what a company has done and not trying to be too smart and figure out what they're going to do. Obviously, having a view to the future, but being far less important or even in the case of classic nets, price to book, that kind of thing. That is almost necessarily a rear-view mirror approach.

That is what worked for a long, long time. There were folks throughout hundred years of investing all the way back to [Phil Fisher](#), he was always talking about look to the future and look at the qualitative aspects of business. There's a Buffett quote from a long, long time ago that biggest outcomes in his life have come from qualitative insights even though the vast majority of his capital at that point was spent on the quantitative.

As we talked about last time, the value quantitative rear-view methods have certainly struggled through 2018 and today, they've done far worse in the intervening period. I think everybody has come to the realization that underwriting the future now has been what's successful and is probably a skillset that you really need to have. That comes with an entirely different set of tools and way of looking at the world.

So, I just think it's a shift that even if you are a "value investor", bucketed into that, we're not going to go buy [Snowflake](#), but we might look at banks and all the stuff that is bracketed in their wheelhouse. You still need to be able to separate those that have an interesting qualitative future from those that don't because one thing that we've seen over the last couple of years is even within sectors, the best companies have wildly outperformed and have gotten far better valuations than the middling companies.

So, even if you're looking at a "value sector", the qualitative insights have separated wildly the best and the median, and certainly the worst. So, I think it's forced investors to develop new muscles, left some behind, for sure, who's skillset was right for a different era.

As I always caveat, you never want to say it's totally different, and that may never come back, but there may be periods where that works again. I certainly think if you believe like I do that the market is on a relentless march towards increasing efficiency, that some of that rear view underwriting and simply quantitative methodology is becoming less and less valuable and competed away.

Patrick (00:05:42): Can we talk about the toolkit that you referenced? So, muscles, however you want to refer to it. What do you think the essential tools are in that toolkit to be able to do a good job underwriting the future versus the past?

**POWER + BUSINESS**

**Tenets of Power**

- Rendition
  - Influence Center
    - Political Power
    - Economic Power
  - Social Networks
    - Economic Power

**WITH HAMILTON HELMER**

Well, one of the qualitative insights and what you're really looking for is those businesses that could escape the base rate. I think having those skills and tools and muscles to be able to properly identify businesses that can escape the base rate has been varied valuable. I assume it will be on a go forward basis as well.

Then I think the last thing is it's still trying to have somewhat of a contrarian streak at some point, but looking for the qualitative insights and that moment of change and saying, "Perhaps this business that has been underappreciated is about to go through a moment of change," and you can see that and maybe you're not paying a whole lot for it. Certainly, first principle is being much, much better business and competitive strategy analyst.

### Underwriting the Past vs Underwriting the Future

<i>Quantitatively focused</i>		<i>Qualitatively focused</i>
<i>Trying to find a margin of safety on what a company has done</i>		<i>Trying to understand how businesses will perform when undergoing change</i>
<i>Has a view on things, but focus is looking at historical metrics</i>		<i>Focused on building a view of the future through strategic analysis</i>
<i>Wants as much certainty as possible</i>		<i>Comfortable with uncertainty</i>
<i>Has struggled over the last 20 years</i>		<i>Includes the best performers of the last 20 years</i>
<i>Returns competed away through market efficiency</i>		<i>Start trends because they are able to de-risk shifts by developing differentiated insights</i>

Patrick (00:09:01): Do you think that is a case to be made that the single most important tool is whether or not you internalize [Brian Arthur's](#) idea of [increasing returns to scale](#)? It seems like if you've got that, if you grew on to that 20 years ago, you're in a completely unfair competitive position doing business analysis relative to everybody else. Do you think that that will continue to be true going forward and do you agree with the idea in general?

Modest Proposal (00:09:25): I think. Certainly, over the last 20 years, if you did nothing else but invest on that idea, you have wildly outperformed. I would say today, every single manager has probably read that and thought about it. It's obviously not the clear source of alpha that it may once have been, but I still think the ability probably to apply in novel ways is going to be an advantage.

We talked about last time that the scale of mobile has just changed everything. I still just come back to legacy networks, physical networks versus today's virtual networks, a large in the Western world, leaving aside China and India, a large physical network has 30, 50, 60 million subscribers. If it's a mobile network, maybe 100-120 million. We're talking about a world where Facebook is approaching 3 billion users. So, that idea that the big can grow into these massive [TAMs](#) and not run into diminishing returns has just played out on a massive, massive way.

I'm not sure it will be the same level of advantage it was, but I do think that, one, understanding and internalizing, and then, two, being willing to look at things that may look silly, a priori and saying, "No way," but then using the increasing returns framework to say, "Wait a minute. What if they do get scale? What happens then?"

I think we've been far too quick that the vast majority of people to scoff at a lot of what has transpired over the last 15-20 years because of the scars of the late '90s, and that if you were able to apply an increasing returns framework to some of these novel ideas, you would have been able to look forward and say, "I don't really know how they're going to make money, but I know that they're going to have a massive economic ecosystem surrounding them, and if they are serving their customers well-enough to get really big, they'll probably be able to pull in ancillary economics and prosper."

**Patrick (00:11:36): Can you define silly and what you mean by it? I'm assuming one definition is like a hilariously small TAM or something, but what exactly do you mean by silly and are there any examples that pop to mind of something that might have looked maybe trivial or silly at the start that's now huge just to cement the idea?**

Modest Proposal (00:11:52): I always point to [Airbnb](#). I mean, the idea in 2009 of saying, "Yeah, I'm going to rent out my room to someone," because remember, yeah, today, it's a very professionalized operation. There are property managers and their entire building is built to special purpose, but at the outset, a lot of the room nights being booked on Airbnb were sharing.

The idea that that was going to be some world-beating threat to shoulder nights at hotel rooms just seemed laughable to someone like me who doesn't particularly like strangers staying in my house, but the insight clearly was there is a demand for this and consumers are coming to it.

Being able to say, "Okay. If the consumer signal is there on room sharing, what about when you're not in your apartment? Will people take down the whole apartment? Okay. If they'll do that, what about a house?"

I think it's the ability to see a company "laddering up" I think is the term and moving further from their initial point of entry, the initial wedge they have with the consumer and finding those next steps up and up and up and taking the business model bigger and bigger and into larger temps.

For me, that is the one that when I first heard and I contrast that to [Uber](#) living in New York City where cabs are central to your existence, and I'm not a big fan of driving. So, whenever I would go on business trips, I hated renting cars, and I'd always try to leverage cabs to the extent I could.

The first time I saw Uber, I was like, "This is the greatest idea in the world." So, whereas, with Airbnb, it's like, "Who would let anyone stay in their house?" I think it's that second idea of silliness that a lot of people have thrown at even companies that go public where you still look at it and say, "Eh, people are just wasting time on this [Facebook](#). Look what happened to [MySpace](#). It's going to go away."

I think it's the inability to put aside your priors and your preconceived notions and say, "Why are all these users here? Why are all these consumers using this? What are they doing and what can they be doing there? How could that company further fulfill their needs and wants and economically, what does that mean for them?"

## CONSUMER SIGNAL AND NONLINEAR BEHAVIOR

Patrick (00:14:00): Can you say more about this term you just used. I think it's a [Rich Barton](#) term, "consumer signal," and you also used the phrase before we hit record that I was fascinated by, which is when you remove friction, you unlock nonlinear behavior. I think consumer signal and then nonlinear behavior are related. Can you flush those two concepts out a bit?

Modest Proposal (00:14:17): Yeah. I think particularly as you move from analog to digital, the holy grail there is two things. One is providing the stereotypical, the term, is a 10x better experience, but if you can provide a meaningfully better consumer experience in a digital environment, that is step one towards building a big business. The second thing is oftentimes that 10x experience is consistent with removing friction from a process.

I just mentioned Uber and I always think it's funny when people scoff, "Oh, this was no innovation. They just layered an app on top of taxis."

If you think about what it actually took and still does take to catch a taxi at 5:30 PM in the rain on 5th Avenue, I would say that Uber has introduced and removed some friction from that process. One way you can tell that that happened, I was actually looking at these numbers the other day. It's back in 2014 as [Aswath Damodaran](#) sized the market for taxis in the US I think at 11 or 12 billion dollars, and said, "This market will grow 6%-7%. So, in 2019, that would have it be something like 14-15 billion dollars, I think.

[Lyft](#) in 2019 did around \$11 billion in gross bookings. Uber as we know from our data and things like that, it's probably roughly twice their size, maybe 1.8x, maybe 1.9x. So, call it \$20 billion in bookings. So, those two did \$31 billion in bookings in the United States in 2019.

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I think all you can conclude from that is that by removing the friction of finding or calling a cab company, you enabled a nonlinear change in behavior, and the consumer signal clearly was the minute that people got their hands on a ride-sharing app they started using it dramatically. Rich used it in the context of when they first started offering [Zillow](#) homes they could see that people clearly wanted to sell their home this way. So, that was the first time I had heard it.

Really, what it is indicative of is you've got product market share is that the consumer is speaking with their actions that we want this product. Generally, it is because you have removed friction from a historically painful experience.

Patrick (00:16:29): I think [iBuying](#), when we're talking about Zillow here, iBuying is a really interesting example here of if you just use the past as your lens for how to analyze something, you might miss a very interesting trend. Can you talk about the experience you had when you first encountered the idea of iBuying and talked to maybe those legacy lens wearers that we're thinking about the same concept?

Modest Proposal (00:16:53): I joke I'm a pretty late adopter. I'm not downloading apps first and generally not getting devices first. There've been three things in the last 15 years that I said holy (beep) at. One was Uber. We just talked about it. The day I saw it, I was like, "This is the greatest thing I've ever seen."



The second one was [AirPods](#). The minute they came out, I put them in and I was like, "This is so much better than having wired headphones." The third one was iBuying. The minute I heard about it, I was like, "This is so obviously better than the existing way of selling your home," and a lot of people at the time I remember traditional real estate people and any man on the street that heard the idea said, "No, you're just a home-flipper. What happens if prices go down, and your balance sheet..." Abstract a level above.

Ask yourself. Are you solving a consumer problem here? Is this the most painful experience of a consumer's life? Yes, it's the largest transaction they do, but it's also probably the most painful transaction they're involved in.

So, if you can provide a better way to do that, don't you think you're going to find some consumers who want to? If they do, don't you think over time you can build an ecosystem around, there are five and a half million existing home sales a year, plus or minus.

The addressable buy box, you can debate whether it's a million homes would satisfy the current framework of which they're doing. Is it two million? Is it half a million? It doesn't matter. You'll have \$300,000 transactions.

So, you could say, "Well, look, this is going to be a multiple hundred billion dollar economic activity taking place, and we know all the economic activity that goes on around the sale of a home.

You could say, "Well, it's a 100x better experience. We now know that there's a tremendous consumer signal for it, but even at the time it seemed obvious to me people do want to transact in this way.

I think that companies are starting to figure out. It's only four or five years since the launch, and they're starting to feel their way towards building that economic ecosystem around it, but that was one of the those where Uber and iBuying and what I said about them as they're so much better because there is so much friction being taken out of the system.

**Patrick (00:19:09): I've seen you joke that if you let a business survive long enough, it will eventually sell ads. It makes me think of this interesting idea, which is maybe the best modern way of thinking about business is just facilitating as many either social or financial transactions between parties as possible because around that ecosystem will just come attention that can be monetized whether that's related services in the case of iBuying or something else.**

**Can you talk through businesses that have done something interesting there like I think [Instacart](#) is maybe a good example with ads? What are your thoughts on this just make the business goal to facilitate lots more transactions of some type between two parties?**

Modest Proposal (00:19:47): Yeah. I joked last time, maybe the people talking about eyeballs were right. It's the most scoffed at remembrance of the late '90s, but if you think about the challenge today, the scarce asset in the digital world is distribution and audience. That's the hard thing to build. It's the reason why people joke that [CAC is the new rent](#). It's acquiring and maintaining audience is extraordinarily difficult and expensive.

So, if you have built a product and brought a product to market that consumers love and you have been able to build a big user base on the back of that, that is going to be really valuable to other people as well.

So, I think there's an increasing realization that not only are you trying to build products and services that consumers love because, hopefully, you can make money bringing those products and services to them, it's that once you do that, if you build a big robust engaged audience, that's also really valuable to the people who have not done that.



The Instacart story, and I'm not familiar with all the details here, but my understanding is from the beginning, the unit economics there were fairly challenged. If you think about it, that makes a lot of sense. You have a person going to a store, picking groceries, and delivering them, and groceries is a notoriously low margin business. That's a fairly labor-intensive process. The take rates that you charge are lower because grocery is a lower margin business.

The offset there is the basket size can be bigger, but, again, my understanding is at the outset, unit economics were upside down. So, a linear thinker and folks on the outside would probably look at that and say, "These guys are selling a dollar for cheap, and they're losing money on every transaction and, of course, consumers are gravitating towards this. They're getting free money."

Well, one day, and they got to a certain size and scale and all of a sudden, CPG companies said, "Hey, wait a minute. What milk are they buying?"

Well, what if we advertise our milk in their basket because one of the things you learn in grocery is that people tend to shop a list. So, if you can get on that list, you become a habitual repeat purchase. So, obviously, it becomes incredibly valuable to the brands to get on to that list.

So, if you tens of millions of customers buying their groceries through your application and you turn around and go to the purveyor of goods and say, "How much is it worth to you to get onto these lists?" It's worth a lot. I think I jokingly say on a long enough timeline everyone sells ads. You can look at any e-commerce type. Amazon has sponsored listings. They're advertising business is now their third largest and fastest growing ecosystem.

eBay is running promoted listing. Etsy just started running promoted listings. Uber is now running the rolling out ads in their Eats product, where restaurants and it turns out, again, CPG companies, actually, which they talked about this week. I was a little surprised to hear but CPG companies are coming to Uber and saying, "We'd like to put advertisements for Coca-Cola in front of your Eats buyers irrespective of what restaurant they're ordering from."

So, again, it's this notion of classic [aggregation theory](#). You've aggregated a large audience by virtue of winning their trust. They want to consume whatever it is you're offering, and others are willing to pay to access that demand pool.

## IMPACTS OF COVID ON BUSINESSES

**Patrick (00:23:11):** What are your thoughts on the drastically changed nature, this is all related to everything you just said of e-commerce, and I'll just say digital penetration more generally speaking? What do you think businesses should be thinking about? Obviously, there was a step change function. Everyone has seen that graph now that the steady churn up of a couple of percent per year of e-commerce penetration, and then it doubled in two months to 30 something percent. What are your thoughts on that? Do you think that some portion of that just stays forever? Do you think that it creates pockets of opportunity for certain types of companies, challenges others? I'd love to hear what you think about e-commerce and digital.

**Modest Proposal (00:23:47):** The competing channel was shut down for two months. So, the fact that it was revelatory, that e-commerce took a lot of share struck me as curious. I have consistently and historically said that e-commerce is a very difficult business, perhaps worse than physical retailing and nothing about my views there have changed.

I think that this was certainly a unique time period where competing channels were shut, so you had very high intent consumers online. What that meant was an enormous amount of demand spilled into the e-

commerce channel at the same time that advertising costs were able to come down because you had high intent consumers that you are not having to nudge into demand.

I think there are some behaviors that will definitely see noticeable change. I think online grocery is one that is likely to benefit on an ongoing basis. That's a product line where, historically, there was some reluctance to engage in online buying. People would like to touch their fruits and vegetables. I live in New York City. I've used [FreshDirect](#) for a long, long time. I still do prefer to do shopping in person, but knowing the convenience of it, the vast majority of our grocery shopping is now done that way.

So, I think bringing that product to a lot of customers that probably would not historically have tried it is going to see some real impact there. I said one day I think digital fitness probably is going to see a permanent change in behavior. I think a lot of other categories, what probably happens is you have a step up in dollar volume, but I don't know that the rate of change there is going to be on a permanent basis going forward change too, too much.

I think if I abstract a level above this, you and I have talked about this offline, what I actually find most interesting in the competitive analysis of e-commerce and how people are thinking about this is no one is thinking about the second order effect. You had [Gavin Baker](#) on earlier this year, and he talked about how to date it had been a first order world. It still has been, but as I think through second order effects, I'm intrigued that people have not started to ask what happens if everyone now has to compete in e-commerce?



**Listen to the latest podcast with Gavin Baker, founder and CIO of Atreides Management, [here](#).**

Something we talked about last time was when you're a small focused competitor and the only thing you do is X, it's existential to your being and you probably spend all your time thinking about it, and you do it better than everyone else.

In the digital world, you've probably competed against a lot of offline retailers and sellers of goods, who maybe dabbled in digital, but didn't really like it or maybe didn't at all because they looked at the unit economics of it and faced the classic [innovator's dilemma](#) of, "Should I get into that?"

When the offline world shut down, every single company, it became existential to have a digital presence. I don't think people are in a number of cases are thinking through the implications of what it means that it became existential for every physical retailer and every physical seller of goods and services to have a digital presence because on the other side of the COVID spike, whenever demand does normalize, the competitive situation is just going to be very different.

Whether or not in the long term this is an increasing returns world and the digital disruptor will take 80% of the share, that might still be the case, but I have to believe the next three, four, five years in a number of categories, the competitive intensity is going to be dramatically different because these companies, the offline companies were forced to go all in.

I remember something Gavin Baker has talked about, which is when there changes in competitive intensity in tech, the impact is nonlinear, meaning that the cost of acquiring customers and potentially the price cuts is just dramatically more so. That to me is something I have spent a lot of time thinking about, which

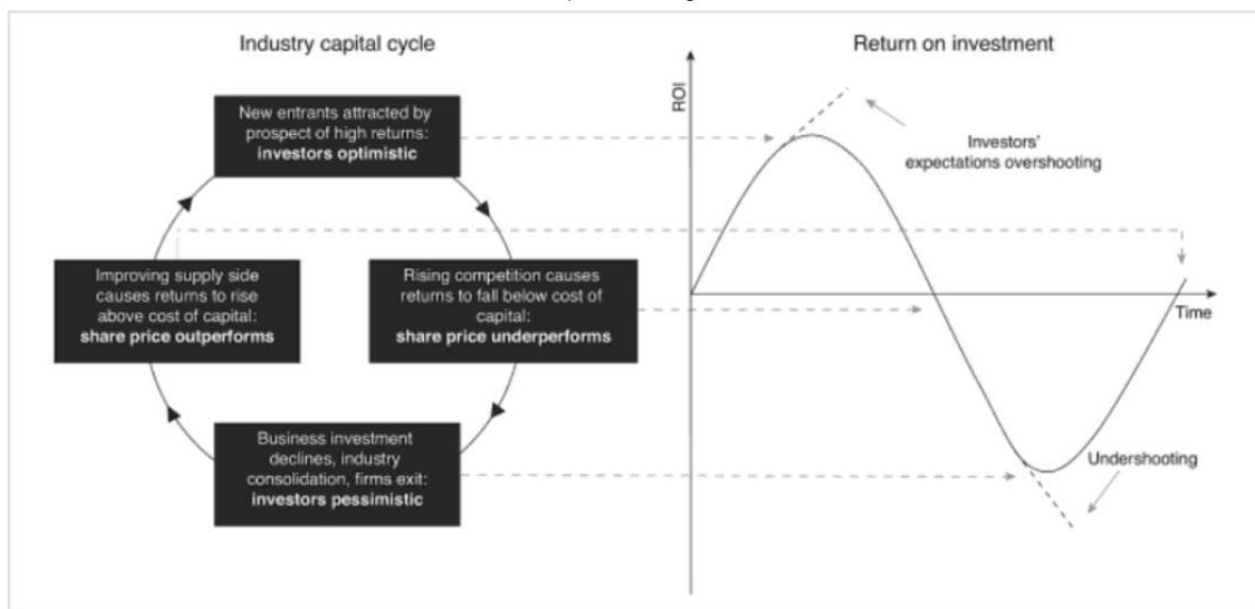
categories may see that nonlinear rising competitive intensity in an already very difficult business of e-commerce might see it get even worse.

**Patrick (00:27:56):** What about non-e-commerce, stepping away from e-commerce, but still staying on long term impacts of COVID with a business like [Sysco](#), where there's this interesting effect where even prior to COVID, we had this rich getting richer, higher returns on capital to the biggest, most successful firms in public markets, a lot of these digital businesses, but it seems like COVID, again, talking about existential risk, just permanently impaired or destroyed or put out a business, a lot of small businesses. That are technically competitors of big public companies in various different markets. So, what do you think about that situation that there was this one-time extinction event? Those businesses aren't coming back.

**Modest Proposal (00:28:33):** So, the flip side of what I just talked about, which was you have a big demand surge today. Everyone can see that. Everyone's excited about it. Everyone's paying for it. They love paying up for the certainty of demand today is there are lots of places where demand has been impaired. Let's focus on sectors where it hasn't been destroyed. It's been temporarily depressed.

There's a framework going back to [Marathon Asset Management](#) called the capital cycle and thinking through industries and businesses in a capital cycle framework, which is much more focusing on the supply side than the demand side. Historically, they were talking about heavy duty industries and the classic example you can look at here is commodities. The cure for high prices is high prices because high prices incent the addition of supply.

### *Marathon's Capital Cycle Framework*



So, if you look at the 2000s, China entered into the world economy in a big way. That demand shock overwhelmed supply and prices surged. Over the intervening four, five, six years, it takes a lot of time to bring on mining supply, the supply responded. It did what capitalism is supposed to do. Tens of billions of dollars went into that. We got to 2010 and 2011 and China had reached the end of their ability to grow at super normal rates. All of a sudden, there was a lot of supply, and it's not a surprise commodity prices have never recovered.

So, that's the traditional classic capital cycle framework, but if we apply that to today, you mentioned Sysco. That's certainly one where you can look at restaurant demand is definitely down and that market is pretty

interesting in that Sysco is much, much bigger than its competitors, but it only has something like I think 16%-17% share. There is a very long tail of food distributors servicing independent and chain restaurants.

If you can take the view that in three, four years people will want to go back to restaurants, then what's likely to happen in the intervening period is that a lot of that long tail of supply or competition is going to go away. Sysco is not going to go away.

So, if you just say that, again, a GDP-type grower, a business that probably grows in line with GDP, maybe more, maybe a little less, normalizes post-COVID. The demand situation is not the question. The question is "what does the supply situation look like?" and it might be much more favorable.

I think there are pockets there where everyone today is hyper focused on where is demand being impacted. I have heard less. I know there are people definitely operating under this thesis, but definitely less than the mainstream investment world of people trying to figure out where is there a much more favorable supply situation on the backside of this where we believe the demand normalizes.

Another one you and I have talked about is [Ulta](#), which is a retailer of beauty, skin care, hair care. I was reading a note from one of the analysts the other day. I think department stores still do seven or eight billion dollars in prestige beauty sales. Well, we know not only because of COVID but even pre-COVID that those businesses were dramatically challenged and shutting down.

You have [JCPenney](#) shutting a lot of doors. You can go down the list of department stores. Those are shutting down. So, some portion of that sales I would assume in two, three, four years, the demand for beauty, hair care, and skin care products normalizes. I don't think that there's a trend that's going to permanently change the demand for those goods.

You might have a situation where the supply side competition is dramatically impacted. So, it's thinking through, are there more opportunities to find places where from a capital cycle framework you're going to find on the other side of this normalize demand but far less supply?

## THE DIFFERENT TYPES OF ONLINE BUSINESSES

**Patrick (00:32:26):** I'm staring at an exhibit that you sent me, which has two axis. It's a 2x2 matrix. I want to talk through it. So, the vertical axis is a spectrum from product to service, and the horizontal X axis is a spectrum from homogeneous to heterogeneous, and then you've placed a few, and I can remind you of what's in which corridor on the chart, but walk me through this segmentation. Why did you lay this down? What's interesting about these two variables to you? Then we'll talk specifically about local and home services.

**Modest Proposal (00:32:55):** I think what I was doing when I was working on that was trying to think through what are the differences in types of online businesses that have evolved from classic third-party marketplaces to first-party sellers of goods, and then why are things that have a nexus to the real world so different than those.

In that framework, a service was generally something where there had to be a physical nexus, something had to happen in person. So, if you just start with heterogeneous seller of goods, that's a classic market. I think anytime you talk about marketplaces to me, you just always have to start with eBay because if people haven't read [The Perfect Store](#), I think it's one of the most fantastic business books about the origin story of eBay. If you read it in concert with [eBoys](#), which is about [Benchmark](#) and their investment in eBay, it's a phenomenal one, too, but The Perfect Story in eBay shows you literally it was perfect.

I joked with someone the other day. Product market fit is when your second employee is someone who's opening envelopes of money. eBay was such a good fit. Sellers were voluntarily sending in checks. [Pierre](#) had to hire someone, "Hey, can you help me deal with all these checks that are coming in?"

*Product market fit is when your second employee is someone who's opening envelopes of money.*

So, if you think about what they did was they brought buyers oddball, heterogeneous goods in contact with sellers of oddball, heterogeneous goods. The ability to match them not on a local basis like at your antique store but globally, talk about a friction unlock when the difference is walking down main street in your town in Pennsylvania or accessing the seller pool of the entire world you unlock nonlinear behavior. So, when I think about a heterogeneous goods, what I'm generally thinking of there is a traditional third-party marketplace.

Now, homogenous goods, you can have some debate about this, but if you're a classic DTC seller today, you come up with a brand and you sell that product direct to consumer, that was hot for a while. Those are not generally good businesses. The problem is you're ultimately competing on your brand because the product is fungible. Other folks, you can think of some of these [Away](#), sell suitcases, and they got knocked off dramatically right away.

Almost by nature you go down any category there's no secret once you start selling the product. Once you start selling a mattress direct to consumer, 500 mattress sellers emerge. So, that's been a less defensible business.

Then you started getting into the services, and here I think is where on a prospective basis, I think it's pretty well-known today. Marketplaces, third-party marketplaces are very good businesses. I think people have come to a pretty strong view on what first-party selling is.

Amazon makes money. A few other people make money. In general, it's a very difficult sale because you're competing in a price-transparent, high returns, high shipping cost world. No one has really made much of a go there.

Then you start getting into these physical nexuses. Let's talk about ride sharing. So, ride sharing there under my framework was homogenous service, which is essentially that the supplier is a commodity in that you might care between X and black, but within Uber X, you don't care if it's a Prius or a Camry. The supply of the service is relatively homogenous.

There, there's real questions. Are there network effects here? I didn't really talk, obviously, the reason that heterogeneous product has this tremendous out-sized impact is that network effects they're just massive. As you add more sellers, buyers come because they can find more products. As you add more buyers, sellers want to access that demand. Classic network effects.

So, the question with ride sharing was, and I think people still debate it today. I have views on this, but are there network effects when there's a commoditized service being offered and particularly where it seems like that network effect is localized because of the physical nexus? I think it's clear there is a network effect because if you try to start a ride sharing business without any suppliers, it's not going to work. So, you do need drivers and they do want to access the customers. So, as you add each additional to the sides, to the side of the marketplace, you got a better and better business.

The wrinkle that we learned was the network effect mattered up to a point and it was really on arrival time of the driver. So, what I think Lyft found was when they were able to cut arrival times of their drivers, I forget if it was three or five minutes, but basically get under that promise, they could also kickstart their network effect even if Uber was already there.

It's clearly a less defensible network effect than a monopoly like third-party marketplaces might be, but even then when you have one and two, to become the third purveyor of a ride sharing network in a market is almost impossible, and I'm not really sure sustainable in the long term.

So, what you probably have is an emergent duopoly in certain markets where someone has spent the capital. I think longtime shareholders of Uber have talked about this that but for Lyft's ability to raise a bunch of money and bear the cost of building the network to get under that for five minutes, Uber probably could have run away with this.

I think today you're probably in some equilibrium where in the market that someone has established that strong second position, they can function because the network works, but there are no new entrants, and in markets where they weren't able to achieve scale, the incumbent has much more monopoly-like characteristics.

That's those three quadrants as I thought through them. Then the fourth quadrant, which is very interesting and really has not been done is what I characterize as heterogeneous services. This is being able to on a local level with a physical presence provide a digital on-demand like service across multiple, multiple categories. Essentially, it's attacking low because the challenge with local is you need frequency to really build a marketplace.

The average I think when they disclosed it Lyft riders, it's 38 or 39 times a year. Food delivery was high single digits going into the low double digits. To really stand up a local business, you need very high frequency because the average transaction sizes tend to be small and the average gross profit dollars per transaction tend to be very small. So, without high frequency, the aggregate gross dollars per customer is simply not enough to overcome the cost of building that network.

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So, the one that jumped out at me and that I put on that slide was home services, and it's one that I've spent a lot of time thinking about. It's a very interesting category because a number of folks have tried to do the traditional de novo startup here, where from a cold start you build both sides of them out. It has not worked. The reason it has not worked is you have the cold start problem. You have to spend a ton of money acquiring demand. You have to spend a ton of money acquiring supply, and even if you do bring a 10x better product to bear, the frequency has historically not been proven high enough that you can make enough money doing this.

A good example is house cleaning, which is the highest frequency use case here. I think it was [Homejoy](#), [Handy](#), a number of folks. They went after this category and Handy was probably the most successful and they had an exit to a company called [ANGI Homeservices](#) that we'll talk about in a second, but even then, and they were very good at what they did. They had high fulfillment rates. They had high NPS. The business could not scale before they ran out of money.

So, there's one really interesting question is, what if you start out with an existing asset in place and you don't have to do the cold start problem? That's what ANGI Homeservices is trying to do. They own a business called [HomeAdvisor](#), which is in a sense a marketplace. It's a two-sided network where consumers come in and they submit a bunch of information about a type of project they'd like to work on.

Now, on the other side of that, you have 250,000 or 220,000 what they call SPs, service providers, who are trying to access that demand pool. Historically, this has been what you might characterize as a lead gen



business where they would then forward on that project to two, three, four service providers who have the opportunity then to connect to the customer.

The point is what you have in place is an asset, which is around 26 million service requests a year coming from something like 15 to 18 million households. So, you don't have the cold start problem. You have the demand side. So, the question now is, okay, can you fulfill that demand in an on-demand environment and build the product that everyone knows is 10 times better and further own the demand in a way that overtime this becomes the go-to?

I will say we talked earlier about iBuying and Uber. It seems to me from first principles, it is so obvious that everyone, 40 and below, 38, whatever it is, would much prefer to go into their app and book a plumber that way than to have a conversation with someone and try to talk through and, "Aah, I can't come next Tuesday. How's next Thursday?" "No. Next Thursday I got to take the kids to the doctor."

You go in the app. It shows that the plumber is available Tuesday at 12:30. Done. Book. That seems so obvious to me. You almost ask why this doesn't exist. Well, there's a really good reason it doesn't exist is it's really hard to build.

So, HomeAdvisor talks about I think they do 500 services in 400 markets. If you think about that matrix, that is a really complicated matrix to get right and to get not only the demand pulled in, where I think it's self-evident overtime, the demand will want this, but can you fulfill it on the supply side? What's so interesting to me about this is it's been tried before, but it's never succeeded in this heterogeneous services and can, by virtue of leveraging an existing asset and demand pool, can you beat the cold start problem and build the product that everyone knows should exist? Let's be honest. There's almost no reason to believe it won't exist in 10 years. It's just what's the path there.





**Patrick (00:43:51):** I'm thinking now about your earliest points about underwriting the future. We've also joked in the past that if you had to just confine yourself to one sector or industry to make investments and use communications because you'd always have the monopoly to pick from, it makes me wonder like, what is the argument for focusing on anything but marketplaces, communications, network effect-driven businesses in this world that we live in? Is it just price? Is it just that these things could get so dramatically overpriced or fairly priced because everyone gets it? I would just be curious to hear your thinking and so much of your thinking seems to center on businesses that have one of these features. What's left out? What other features of business fascinate you that we haven't talked about?

Modest Proposal (00:44:31): Yeah. I wish you had asked me that question about seven years ago and told me to just do that. I think some of it is just my background as a traditional generalist of sorts, although I have narrowed my focus or eliminated certain categories. I am at heart a generalist and I'm always looking for interesting asymmetric opportunities in all sectors.

I would say being honest with myself, the vast majority of my alpha has come in consumer internet and communications-type businesses. So, you're probably right. I should focus on that, but there are certainly times where the conditions that I look for, which is oftentimes overreactions in good businesses to temporary hiccups occur outside of the space, but if I was resigned to having to only invest in one space, yeah, it certainly would be this.

Now, I joked about that communications one, but then I thought more about it, and it's even better. If you have the opportunity to invest in the unregulated monopoly networks, you should do that. What's so fascinating to me as someone who has spent 15 years studying the regulated communication networks which are the cable and telecom companies, who are regulated by the FCC, some may argue not strenuously enough, some may argue too strenuously, but the fact is there is the telecommunications act under which they operate.

The largest communications networks are nominally regulated by the FTC, but not under any formal congressional law. My takeaway from that was if you ever see a business that looks like a monopoly and it doesn't have a regulator, probably go spend a lot of time on that one and less on the regulated monopolies! Although you can say that regulated monopolies come with their advantages, which is usually they earn very good returns, but perhaps not super normal because they won't be allowed to do that.

**Patrick (00:46:29):** What else that you've been exploring in markets given the current dynamics has your attention most? We could stick with marketplaces. If there are features of marketplaces that you've been unpacking or exploring in more detail or really any other major topics that you think are important right now.

Modest Proposal (00:46:43): Within marketplaces, I have always been fascinated by the ride sharing guys because of the dynamic I talked about where if you did a market sizing exercise five, seven years ago, you were just so wrong. It strikes me that the consumer signal is massive there. Prior to going public and immediately after going public, I think there were real questions about the underlying unit economics of that business.

Maybe I do the math wrong, but when you decompose Lyft's financial statements into per ride economics, it certainly looked to me like by the end of 2019 they were earning something like a dollar plus or minus in what I call contribution profit per ride. Now, they call it contribution something else, which is a bananas definition, but I think of contribution as revenue minus gross profit minus the cost of operations minus marketing, which is essentially how much are you making per ride to fund the expenditures in R&D and G&A?

When Lyft went public, they in the fourth quarter of '18, I think they were losing 20 cents a ride on that basis. You read the S1 and you look at this and you look at their history and you said, "No. This actually is an

upside economic model." Then by the end of 2019, one year later, you had a business that appear to be making, it could be 95 cents, it could be a dollar. Don't know the exact number, but it did seem to prove out the thesis that, "Wow! This is a unit economic viable business," and now the question is, are there enough rides in the system to cover the R&D and G&A that they spend, and you could probably start to conclude yes. Both they and Uber, obviously, at that time were pointing towards EBITDA breakeven in the near future.

So, I think the dynamic there is interesting because to this day, in spite of that, it does seem like the bias and the prejudice is against them being good businesses. I think the other issue is what we talked about the network effects aren't quite as dominant as they may be in other areas.

Uber, in particular, is a horrendously complicated business to get your arms around because multi-product, multi-country, but I am intrigued on the ride sharing side, and food delivery similarly is one that I think is even less proven than ride sharing because we don't really have a pure play logistics operator out there. I'm very anxious to see [DoorDash's](#) numbers and try to perform a similar calculation as I've done on Lyft because not only will that give you insight into DoorDash's economics, but then you can start to map that onto [Uber Eats](#) and the logistics businesses that [Just Eat Takeaway](#) and [Delivery Hero](#) and some of these other folks are building around the world.

So, again, looking at these businesses where demand is very high, consumer signal very strong, but there's still an element of scoffing or perception of silliness persists and is there an opportunity there? It's TBD.

I think, obviously, you have to talk about the impact of macro and rates and all that. Certainly, we have seen a surge in demand for two things. One is businesses that have duration, their cash flows are long in the future, and then businesses where the certainty is very high.

I think it's actually two different strategies. It's a quality bias, and then there's a growth bias because there are businesses that grow 5%, 6%, 7% a year, where their pricing is every bit as anomalous, you would say historical to past valuations as the growth stuff, and it's because of the very high level of certainty that people are ascribing to the business models and certainty of terminal value there.

I think that's type of business. The other is obviously the long duration high growth companies. We're culminating on September 2nd. There was just a rush into businesses growing 20%, 30%, 40%, 100% and people saying, "I am going to pay a very high price for this in a very low rate world." So, that dynamic cannot be avoided because the bifurcation of the market from the last time we talked when we both were commiserating over the struggle that value and other strategies had undergone and how spreads were somewhat elevated.

Well, spreads today are other than looking at March, April timeline of this year, there are still at historical anomalies. So, that bifurcation I think is something that everyone has to wrestle with and how does it close because history says it will.

## IAC – BUSINESS BREAKDOWN

Patrick (00:51:21): I'd love to try a new experiment as we try to steer the podcast towards really educating people on businesses and business strategy, point out that's the new toolkit is understanding competitive strategy, positioning, product, et cetera, by exploring a single business in a little bit of depth. I think with you, it's hard to choose a business other than [InterActiveCorp \(IAC\)](#).



So, I'm going to ask a series of questions that I'll refined through time, but, hopefully, will become somewhat standardized with a whole bunch of different guests to really learn from unique aspects of individual businesses. These can be points of inspiration. They can be points of competitive analysis. More than anything, they should just be fun.

So, I think the way to begin on Interactive, a business that you know very well, is that just ask what the most unique or interesting aspect of that business is relative to others that you've explored.

Modest Proposal (00:52:12): I think what's very interesting about them is, and I've never actually heard them express it this way, but when I think about what their core expertise is, it's pretty simple, which is acquiring and monetizing users in a digital environment. That sounds incredibly mundane, but if you look back at the history of the company from '99 on, they were very early into online dating, into online ticketing, into online travel, online home services.

In each of these, and even we can talk about their search and applications business, which is probably the best example because it's such a silly product, is that they are maniacally focused and maniacally talented at taking a product and figuring out ways to bring users to it in economically efficient manner and making a lot of money doing it.

*[IAC is] maniacally focused and maniacally talented at taking a product and figuring out ways to bring users to it in economically efficient manner and making a lot of money doing it.*

Certainly, there's a lot behind that. They've figured out how to build products that people love and all that, but they have oriented themselves in very large end markets with high growth ahead and they have figured out how to operate in them in economically attractive manner, and they've done it across so many markets and so many times that you would say there's a repeatability to it.

So, if you look at an investor and you say, "Is there a persistence to their strategy?" you would have to conclude that after 20 years, 25 years of doing it, there is a persistence to their success in finding new digital end markets to enter and acquiring a bunch of customers and make a lot of money on them.

Patrick (00:53:49): Maybe we could take a step back and assume that someone very smart is listening but somehow has never heard of InterActiveCorp and its story. You could describe briefly the background of the business or how it came to be and literally what it does and what it's done through its history.

Modest Proposal (00:54:04): That would be a complicated exercise. I think the best way of describing it is it has been [Barry Diller's](#) vehicle for making investments in the digital landscape. There was a period of time in the late '90s where there was a traditional media component to it and all that, but if we just focus on the main drivers of value over time, what they have successfully done is what I just said, which is they had entered large growing end markets that were migrating from offline to online and made a ton of money in them.

Travel is... they were very early in travel. They ultimately acquired by the end they had [Expedia](#), they had [Hotels.com](#). They bought [Tripadvisor](#). That business was spun out into its own because the online travel market is an enormous market and that business could stand on its own. So, they were very early to that, and talking about picking friction out of a process, no one our age remembers what it was like to deal with travel in a pre-digital world, but you can only imagine. You're calling hotels. You're calling multiple airlines, "Hey, how do I get to Boston two Tuesdays from now? What are the available flights?" You could just think of that process.

So, digitizing that process, they were very early, too, and Expedia has obviously gone on to be one of the two largest global OTAs ("Online Travel Agency"). Online dating, a market that they purchased [Match](#) very early on. They purchased [OkCupid](#), [Plenty of Fish](#), and then they incubated [Tinder](#), which has revolutionized the dating category by virtue of its mobile first nature and global presence. So, another end market.



They had bought [Ask Jeeves](#), an also ran search engine and that combined with a desktop toolbar business that you and I would probably never downloaded desktop toolbar, but a lot of people did, and they managed to make a couple hundred million dollars a year in EBITDA in this business for a long, long time, and it funded a lot of what they did.

So, over time, they've moved into travel. They owned [Ticketmaster](#) at one point. Then in 2008, having already spun off Expedia, they did what was called the quad spins, and they broke up into a bunch of companies, spun off [ILG](#). They spun off Ticketmaster. I might have forgotten all of them, [LendingTree](#). Essentially, they deconglomeratized, and Diller has said, they are the anti-conglomerate, and from there, they rebuilt the business around Match and then subsequent to that, a business that they owned and operated for a long, long time and not gotten much traction in ServiceMagic, which was rebranded as HomeAdvisor, and there, that business is now undertaking the exercise of becoming the dominant on-demand player in home services.

Now, they're looking to plant new flags. They just bought [Care.com](#), and that was a business I knew well, which was a public company and was really struggling under the weight of being public, not having much capital, and really stagnating. I'm enormously optimistic about that because if you think about the world today the value of child care, just look at the challenges people are facing in COVID, I don't think businesses are going to go forward without having some sort of benefit for backup care for their employees. That plays right into the market that Care.com plays on the business-to-business side.

Then on the business-to-consumer side, they've spent something like \$400 million in advertising over the last decade building that brand. They bought the business for \$500 million. Just finding new verticals to bring that expertise that they have and figure out a way to delight customers and make a lot of money doing it.

**Patrick (00:57:41):** Can we say a bit more about that expertise specifically the secret sauce or the ways in which they are so good at bringing people into these ecosystems? One thing you've mentioned over and over again reminds me of Rich Barton's idea of power to the people, which is that many of those businesses fundamentally what they did great was surface information for consumers easily on internet, and whether that's the what flights are available or who wants to go on a date or whatever it might be, is that the primary driver do you think of their repeated success was just making stuff legible to software and consumers on the internet?

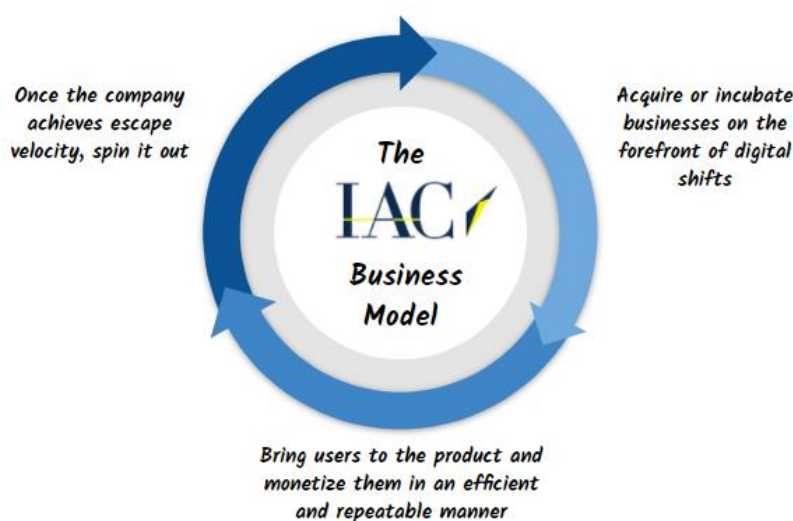
Modest Proposal (00:58:17): I think, I don't want to disparage them, that might be giving them a little too much credit because in many cases other than Tinder, certainly, I don't think they were the category initiators. I think it was more that they had the ability to very early on spot that those were going to be big end markets, and that someone else had figured out this legitimacy issue. So, I think it's one step further in the process, but what they then did was turbo charge that exercise.

I'll be honest. Because I'm not an operator, because I'm not on the inside and having seen how other folks would try to scale these businesses versus how they do it, I don't really know why they are so good at it. I know in talking to them and their executives and people who have left and people who have competed against them, people find them they're machine-like, they're very workman-like. They don't have Utopian dreams. They are very workman-like in what they are trying to do day in and day out, get better and better and better, and the digital customer acquisition world is much like that. It is a hand-to-hand battle each day to get customers, and you have to do it in an intelligent way with a certain set of skills. I think it's being very good at identifying these large-growing end markets, finding assets that are already there, and then turbocharging them into leadership positions.

**Patrick (00:59:36): Can you say more about what you think Diller's superpowers are as a leader of this business and what makes him so unique because he seems to be such a unique player in the landscape?**

Modest Proposal (00:59:47): Look, again, I have not spent any time with him, so I don't have that firsthand knowledge. I've read many of the books and articles talking about his interregnum in the early '90s when he was looking for his next thing to do. At the time, he went to go visit with cable operators, media operators, and he saw [QVC](#) and it really changes his view on where the world was going and probably kickstarted the entire Interactive exercise, which was he saw the two-way communication involved in someone putting on a TV show and then viewers at home interacting by calling in and buying, and that the hosts were speaking to the audience.

So, that was really a foundational experience for him, and whether it was pattern matching or just incredible foresight, he was able to leverage that learning and say, not dissimilar right, if you read [The Everything Store](#), if you read the background of [Jeff Bezos](#), he was at a hedge fund and he said, "This internet is going to be huge. I got to figure out how to get involved." I think to Barry Diller's credit, he saw that two-way interactivity was going to leave the traditional media world in the dust, and the future was finding a way to participate in that. He's traded a bunch of assets. He bought. He sold. He's made a bunch of mistakes, but they've been able to find these big growing end markets and participated in them in an enormous fashion.



**Patrick (01:01:18):** What if anything else, do you find fascinating about it that others out there might not know as a closing thought for why you've spent so much time exploring this company?

Modest Proposal (01:01:28): I think it's curious as the company has noted in the current environment that people put conglomerate discounts on them and they have a couple of billion dollars in cash, so effectively haircutting cash. There are [SPACs](#) trading at 8% to 20% premiums to cash, but even leaving aside the SPAC phenomenon. If all you said was, "This is a vehicle that has compounded mid to high teens for 25 years," which any asset manager would kill for. They are sitting on a handful of cash to be deployed. Perhaps the usual market skepticism is this isn't going to go well, but you would think that they would get the benefit of the doubt in that situation, but they certainly don't. So, I think that's one thing overlooked.

Then two, I think rather than myopically fixating asset-by-asset, which I understand why people do. I mean, if I was new to the company, the first thing I would try to do is understand each asset and what's it worth and why is it doing what it's doing. I do operate from one level above in thinking about what their core expertise is and saying, "Okay. How is that core expertise being applied to each of these assets?"

I think that might be a little nuance. I'm never arrogant enough to say I'm thinking about this business completely different than anybody else or anything like that. I might have slightly different frameworks to do the analysis, but there are a lot of very smart people who spend a lot of time thinking about Interactive.

**Patrick (01:02:56):** If people are interested in Interactive and want to study other companies, what would be the one, two or three related other companies that you would encourage people to go explore?

Modest Proposal (01:03:05): Well, I have friends if I don't say [Liberty Media](#) will probably stab me when I'm not looking. So, it's a similar type situation where its owner operators are very, very long track records in the media and communication space. So, that's certainly one.

Look, there aren't a whole lot trying to do what they're doing in the public market. Certainly, Facebook and [Google](#) have aspects of it because they acquire companies and move into different areas. Facebook probably more so because they ... I think something that's super interesting [Mark Zuckerberg](#) and Facebook is they're hyper aware of whenever the next platform shift occurs.

They have done everything in their power to make sure they are participants in that. They've placed some bets that may not end up being correct, but they've been very aggressive in looking for big large growing markets, where all this is going and playing there. I would never draw comparisons between the two because Facebook is the best non-search ad unit ever invented. It's connected half the world. Instagram is the digital shopping mall, but whether it's Oculus, whether it's WhatsApp, thinking about what the future large consumer end markets are and how can we participate there is what comes to mind. In a small and mid-cap scale, Interactive is relatively unique in the repeatable process of find end market, enter, spit out company as standalone, do it again.

*Interactive is relatively unique in the repeatable process of find end market,  
enter, spit out company as standalone, do it again.*

**Patrick (01:04:35):** Well, this has been so much fun as every single one of our conversations is. I learned a ton new stuff. New things to think about. As always, thank you so much for your time.

Modest Proposal (01:04:44): Thanks so much.