

Chapter 5: The value-profit paradox, the Cruelty of Competition and the drivers of success.

This chapter makes three points. First, that great profits do not necessarily flow from creating great value. The share of the value going to producers depends on the degree of competition in the producing market. Second, competition is very, very bad for profits. Since the Internet has few fewer entry barriers than one finds in many brick-and-mortar markets, this bodes poorly for high profits. Third, the causes of success in Internet undertakings are going to be virtually the same as those in brick-and-mortar industries since the differences between them are usually far less than has been claimed.

The Internet is going to create great value. That is not in dispute. What do I mean by this? First, consumer's are going to be better off as they voluntarily adopt this new technology. Consumers, after all, wouldn't make the switch unless they were better off.⁴⁵ Just about everyone recognizes this creation of value, which is why firms stampeded to get a piece of the action. This is why venture capitalists were lining up at the doors of every startup dotcom, hoping to get a piece of the action. This is why the media focused so much energy and attention on a business story that normally would have been expected to remain hidden in the business section but instead appeared on the front page. This is why Time magazine named its man of the year an entrepreneur whose firm had as yet (and still has not yet) turned even one penny in profit.

Does this mean that producers must gain wealth as this new technology filters through the economy? The commonly accepted answer is "yes," and that is **myth number 3**, because the correct answer is actually 'no'.⁴⁶

Notice that I am not saying that some producers will not do very well, only that the typical or average producer need not do well even though the market is growing. This is what happened to DRAM memory chip manufacturers who ran into very low profits even in the face of ever-increasing sales of computers and an ever-increasing appetite for memory.

This seeming paradox is due to the fact that value creation doesn't necessarily get converted into wealth creation for producers. If there are few

⁴⁵ Unless one believes a result of the 'network externality' literature that the market can not coordinate their behavior and that there is either excess inertia or excess momentum. This seems little more than a theoretical musing, however, since my extensive research with Margolis shows that there is no evidence to support these beliefs.

⁴⁶ This point, of course, is neither shocking nor new, but it has been largely ignored in the current discussions about the Internet economy. As the stock market swoons this point of view will come out of the closet. But it should have been heard earlier, and it is true always and not just for the Internet.

enough producers, a situation commonly known as monopoly, much of the value will go to producers. If there are too many producers, much of the value will go to consumers.

This is not very different than the odds of striking it rich in a gold rush. These odds are much greater when few people know about the gold than if everyone knows about it. This simple point seems almost entirely overlooked in today's overheated market, but it has strongly negative implications for profits. Today, just about everyone is headed for the fabled gold out there in the ether.

It is also important to understand that the profit generation in product markets work just the opposite of stock market profits. In the case of stocks, the more people that jump on the bandwagon, the higher the stock price goes and the greater everyone's profits. For firm's competing with one-another, the more producers that enter the industry, the lower everyone's profits turn out to be. The willingness of the capital market to fund untested Internet companies, and the publicity and expectations surrounding the Internet auger poorly for the likelihood that these companies will do well in the real market.

A. The Diamond Water Paradox

The dichotomy between value creation and dollar generation can be traced to a famous analysis known as the diamond-water paradox. The meaning of economic value, and how markets translate (or fail to translate) such value into revenue, profit, and wealth is at the heart of this issue.

Think for a moment about water (air could be an equally good example). How valuable is water? We need only notice that all known forms of life would die without water to reach the obvious conclusion that water must be very valuable. But does this large value translate in revenues and wealth? Have any entrepreneurs made great wealth from the sale of water? Are any great companies, such as AT&T, IBM, or Microsoft, based upon the sale of water? The negative answers to these questions is consistent with common observation that water is normally treated as a 'throw away' type of item. No one gets upset if someone wastes a few gallons of water, unless you happen to be in a desert or other arid location. The reason that water is treated so cavalierly is that water has a low price, it is inexpensive.

That a product can be so valuable, yet so cheap, is the essence of the paradox. We need not spend time examining the flip side that complete the paradox—i.e., the fact that diamonds do not have much value, yet they are very expensive.

The paradox is solved, or explained, by an understanding that the generation of total value has little to do with market revenues or prices. That is because price is determined by the value of the *last* unit consumed, the last unit being known in economic parlance as the marginal unit. The first gallon of water per day, and even the first billion gallons of water per day, are extremely valuable, since people use several gallons for drinking, cleaning and watering plants. But if every person were to have a stockpile of ten thousand gallons a week, the value of an additional gallon of water, the ten thousand and first gallon, would be very low. Ten thousand gallons a week would take care of just about every conceivable use that a person might have within a week, so an additional gallon would be worth almost zero.

Market prices are formed by the interaction of supply and demand. Although the demand for water is enormous, reflecting water's tremendous value, the supply is larger yet, causing the value of the last consumed unit of water to be very low. Thus water has a very low price. This also explains other instances where prices don't seem to reflect overall value, such as the fact that truck-drivers might get paid more than schoolteachers, or that finance professors get paid more than economists. Teaching may, from societies vantage, be a more valuable activity than driving trucks, but if there is a larger supply of teachers, so that an additional teacher brings less additional value than brought by another truck driver, then truck-drivers will have higher wages.⁴⁷

The point of this example is to illustrate how it can be that a product might provide enormous value but very little in the way of revenue or profit.⁴⁸ The very abundance of air and water makes it impossible to generate wealth in spite of the great value created. Therefore, the creation of great value is not by itself the key for producing profits.

This is of importance when trying to understand the financial implications of the Internet. Just because it produces great value does not mean that it also will produce great wealth.

B. The Cruelty of Competition and Attempts to Subvert It.

The second key factor relating to the revenues and profits likely to flow from activities conducted on the Internet concerns the level of competition.

⁴⁷ Once it is understood how markets work, it becomes clear that certain attempts to equalize wages across occupations thought to provide similar 'value', a movement know as 'comparable worth', are misguided and essentially destructive.

⁴⁸ Food can also be used since even though world population continues to increase to unprecedented levels, food production capacity continues to outstrip it and prices fall along with profits. That is why there is less land devoted to farms, and the government has had to step in and try to artificially restrict output so as to increase the profits of farmers.

The more competitive an environment, the more difficult it is to generate profits. I can not overstate the importance of this.

What do I mean by competition? The two key elements are whether other firms can enter the industry easily, if they should want to compete with incumbent firms, and whether it is easy or difficult to mimic what the incumbent firms have already accomplished.

This differs slightly from the typical economic textbook definition of competition. In most economics texts, a model of *perfect* competition includes free entry and exit, free information about prices and production processes, and a large number of very small firms.⁴⁹ The main difference in these definitions is that the definition I am using doesn't require a large number of firms. Economists generally understand that markets can be very competitive even without a very large number of very small firms, and the latter assumption is usually included to make our models more tractable.

What does this mean for firms doing business on the Internet? Mainly that they are captives to the same forces at work in the brick-and-mortar economy, and that competition is probably the single most important element controlling profitability in either venue.

Competition works to reduce prices and profits in an industry. Potential entrants examine the financial returns expected if they were to enter a particular industry. If they find a market where firms seem to be making easy money, they try to enter with all alacrity so they, too, can take advantage of the high profits that are currently being earned. It is not the intention of the entrants to reduce the profits of those in the industry. But as more firms enter a market in the hopes of striking it rich, or earning above normal returns on investment, the market becomes less profitable for all involved.

It becomes less profitable because the entry of new firms and new productive capacity increases the output available for consumers to purchase. Where shortages may have once been common, now surpluses begin to replace them. We all know that a common response to surpluses is to start to hold 'sales' events, and begin marking down prices.

We can see this at work in the automobile market. In the 1980s American automobile manufacturers discovered that consumers were switching their taste's away from conventional automobiles and toward vans and minivans. Automobile manufacturers lucky enough, or with enough

⁴⁹ This assumption is normally included so that the demand curves facing individual firms can be drawn as being horizontal.

foresight, to anticipate this trend, found it easy to sell all the vehicles that they made. The Japanese automobile companies were late to catch this trend and the leading producers of minivans, such as Chrysler, enjoyed high sales and profitability. The movement toward mini-vans was itself in part a function of the decreased cost of gasoline which made ownership of these larger vehicles more affordable and the movement of the baby-boomers into midlife, where their children were getting cramped in the sedans that had been popular until that time, and where a large seating and towing capacity provided badly needed utility.

Eventually the Japanese producers caught on to this trend and produced their own line of minivans, decreasing the profitability of minivans. But by then the market had morphed into one where SUVs were now the hot items. These vehicles provided the space of a minivan without the stodgy association that was then being made between minivans and suburban moms carting around multiple children and consumers switched to them in droves. Again, the American automobile producers were there first, and they racked up impressive sales and profit figures. But competition reasserted itself when European and Japanese producers finally were able to produce their own models, several years later. The market became flooded with models from Lexus, Mercedes, Suzuki, Isuzu, Toyota, as well as new American entries from Lincoln, Cadillac, and others. Once again, competition reared its ugly head and worked to reduce profitability in the industry. Now, with gasoline prices having increased and SUV capacity at an all time high, we are about to see profits in the SUV market come crashing down.

Not necessarily for all producers, however. Some producers always do a better job than others, and those who can better meet the demands of the market will earn higher returns than others. But the typical firm, what is called the 'representative' firm in economic models of competition, will not be able to earn above normal profits. And it will have been competition that has removed those profits. This is why competition is so good for consumers, but so bad for producers.

The importance of competition can be seen by noting the resources that firms are willing to spend attempting to *reduce* the amount of competition that they face.

American automobile producers have successfully lobbied for decades to restrict the imports of foreign automobiles. Farmers, for decades, have successfully lobbied to make it more difficult for competitors to enter and sell agricultural products, taxicab owners have succeeded in making it impossible for entry to occur in the taxicab business, and doctors have imposed barriers restricting the entry new doctors that could be trained. In each of these markets strenuous attempts have and continue to be made to

reduce competition by restricting entry. The purpose was to raise the prices and revenues of the sellers in those markets by weakening competitive pressures.

The taxi illustration is both fascinating and a useful illustration of the impact of entry on competition and profits.

At one time there was free entry into the market for individuals with vehicles willing to transport others for a fee. One by one, the governments in virtually every major city in the US and Canada began to enact legislation making it illegal to engage in a taxi-cab type service without having official permission from the government. The key element in the regulation was that this official permission is not dependent on having a safe cab or good driving record. You can have modern and comfortable cabs, staffed by trained English speaking drivers, knowledgeable about the geography of the city and with impeccable driving records, but that will be insufficient to allow you to enter the cab business. Instead you also need to have a piece of paper, known as a medallion, which gives you permission to be in the cab business.

“Surely”, you ask, “anyone with such clean cars and efficient drivers would receive a medallion, wouldn’t they?” The answer is ‘no’. Medallions are not just given out, no matter how worthy a firm might be. Instead, someone wishing to enter the taxi industry has to buy a medallion from someone else who is willing to leave the industry. In a city such as New York, a medallion for a single cab costs several hundred thousand dollars.

What is the point of having medallions? It is not to ensure that cabs are safe and drivers knowledgeable, since these requirements are independent of medallion ownership. Neither is it to guarantee that cab owners have sufficient financial resources to meet any suits that might arise in the courts because of potential liability should an accident occur. No, the medallion exists for one, and only one purpose—to restrict competition in the taxi cab business.

The beneficiaries of this system are actually the original cab owners when the medallions were first instituted and competition was first restricted, because they were given the medallions for free. This phenomenon of giving away ‘rights’ to compete in a market that is about to be made less competitive happens often enough that it has developed its own terminology. The process of allowing current market practitioners to receive a free ‘medallion’, or right to be in the market, is known as ‘grandfathering’. The act of lobbying the government to grant rights such as these is known as ‘rent-seeking’, where rent has the somewhat archaic meaning that economists still use, of profit.

Government, you see, is the ultimate creator of monopoly. The best way to reduce competition is to make it illegal, something that government's have done for a very long time. Some of this is the standard fare of copyrights and patents, policies enshrined in the constitution for the purpose of providing inducements for the creation of more inventive and artistic activity.⁵⁰ Sometimes, as was the case with the Hudson's Bay company, a monopoly was granted in order to help explore new territory, or similarly with the claims staking process in a gold rush. Much monopoly granting, however, serves a far narrower purpose of enriching some set of producers for no apparent reason other than to enrich those producers, and to impoverish others. Taxi-cab medallions are an example of the latter form of enrichment and impoverishment.⁵¹

After the local city government grants taxicab medallions, it usually increases the number of medallions, if at all, by an amount far smaller than the growth in demand for taxi-cab rides. This, therefore, makes the activity of providing taxi-cab rides more profitable.

The fact that it costs \$250,000 in New York for a piece of paper that provides permission to own a taxicab reveals the success of that program in generating profits. After all, why would an investor pay anything beyond the cost of the cab, the insurance, the gasoline and the driver? He must believe that after covering all the costs associated with running a taxicab business, that the cab must provide a profit, over time, of at least \$250,000. Otherwise it would make no sense to pay that much for the medallion.

The irony in this is that competition once again reasserts itself. Not in the taxicab business, where the number of cabs is kept artificially low, but in the market for medallions, where competition for medallions increases the price of medallions to the point that the typical, or representative cab owner, can not expect to earn above normal profits. The price of medallions, therefore, sops up all the profit due to restricted competition, and those who buy the medallions fail to earn any 'monopoly' profit. All the profit goes to those who first received the medallions for free.

Don't think that taxi-cab medallions are not some exotic throwback to a previous era, or some endangered species of poor government. When the government allocated television and radio frequencies, the same behavior

⁵⁰ The Internet is both a potential threat and a potential tool for these purposes, a subject taken up in considerable detail in chapter xx.

⁵¹ It is not a zero sum game, but a negative sum game. This means that the gain to taxi cab owners is actually less than the loss to consumers, and it is this element of the policy that economists most object to.

took place. When the government restricts the acreage that farmers can plant, this is the same type of policy. When the government

C. Implication for Internet Firms

So what does this have to do with the Internet, which after all is the putative topic of this book? There are two implications. First, that competition will erode the profits for many firms doing business on the net. Secondly, that we should expect the government to try to find some way to restrict competition on the net, just as it has in virtually every other realm of enterprise.

The impacts of competition on the profitability of Internet firms are long-run implications, meaning that entry, or lack of entry, will lead to certain level of profits that might last for a long time afterward, depending on what other factors change. Current profitability, based on the size of the current Internet investment and whether it is too much, too little, or just right, is a short run factor.

i. Short Run Results

The Internet entered the public's consciousness in the mid-1990s. For business it was a new opportunity, a new frontier. New opportunities provide the possibilities of great wealth and profits. But they are no guarantee. In order for profits to flow in abundance, investments in Internet activities, which creates the supply of Internet products, needs to not overwhelm the very large value that will be created by the Internet.

How will this first generation of Internet investments do? Will all the money fed to the Internet start-ups by venture capitalists turn out to be like the market for water, with the resulting output of Internet firms overwhelming the demand? Or will the recent few years of investment turn out to resemble the market for diamonds, where prices will be very high for the Internet services because the demand for their services will be large relative to the supply?

**should I answer here, or refer the reader to a later chapter?

ii. Long Run Results

The easy of entry into Internet businesses does not bode well for the long term profitability. As much or more than brick-and-mortar firms, competition is likely to drive profits toward a normal, or what economists call a zero economic, return.

The general rule, then, is for entrepreneurs to go where there are many consumers but not too many producers. Unfortunately, this is not a very useful rule since it is easier to say and understand than it is to do. This rule will hold equally for Internet firms. Nothing about the Internet or network effects alters this strategy.

iii. Can Competition on the Net be Controlled?

Will the Internet prove to be an arena where government can not regulate entry in such a way as to reduce competition? Certainly, optimistic libertarians have tended to view the net as an untamable environment, outside of the control of governments or any large organizations. Whether this is true or not in general, my focus is on the narrower claim that government's will not be able to control the entry of businesses on the net.

It is far from clear that this will be the case. Let's take the case of entertainment as a starting point since this has been a focus of government regulation both on the net and in almost every other market environment.

**

D. Investment Returns in Cyberspace

Because free entry is a current characteristic of the Internet, I expect profits will be driven down to an ordinary level in a long run time frame. In the shorter period of the next few years, however, the question is whether the current investment is large enough to meet the coming demand, or whether it is too small or too large. I do not claim to know the answer to this question. But I will discuss the size of the investments in Internet markets—by IPOs, venture capitalists, and traditional firms. The enormity of these investments suggest that short-run profits may be negative or at least below normal.

Chapter 6: Margins and Profits on the Net.

The factors of easy entry into online retailing, misguided over-investment in retailing web sites, and well-informed consumers benefiting from the informational benefits of the Internet, will conspire to keep profits in the online retailing sector down. Since Internet retailers provide very low value-added, margins will be very small.

In the long-run, virtual stores have certain advantages and disadvantages relative to brick-and-mortar retailers. The main advantage, the lack of physical storefronts, should translate into lower costs. It has often been presumed that these lower costs will translate into above normal profits for a lengthy period of time.

In fact, these lower costs will lead to lower margins, at least in a long run competitive environment. Even Internet skeptics, such as the Perkins brothers, authors of the *Internet Bubble*, did not realize that the margins will be smaller, not larger, for the online versions of retailing businesses.

Proper estimation of the profit margin on sales is required for any investors wishing to calculate the proper value of Internet firms based on projected sales, or for firms trying to evaluate the contributions to the bottom line from their new Internet subsidiaries. Yet it appears to be the case that, like the Perkins brothers, most Internet analysts are overestimating margins on sales for several reasons.

First, there is a general misunderstanding about margins, and the relationship of margins and return on investment. As a purely accounting matter, margins will tend to *fall* as costs fall, the opposite of what is often assumed. Second, although it is true that a firm that can reduce its costs will generally increase its return on investment, its returns will *not* increase if all competing firms also experience similar reductions in cost.

A. Understanding Profit Margins

The cause of these lower margins seems somewhat counterintuitive, at least at first. The cause of the low profit margins is the fact that the Internet can reduce the cost of doing business. Wall Street analysts in the halcyon days of Internet investing, R.I.P. 1999, liked to drool over Internet startups because they believed that virtual storefronts would be less expensive than creating real storefronts. Virtual storefronts do not require real estate, plumbing, showrooms, dressing rooms, heating, or air conditioning. Virtual storefronts can be scaled up without having to hire additional employees in many different locations. Virtual storefronts should be less expensive.

Of course, barebones warehouses also are less expensive than elaborate showrooms, yet many products, automobiles for one, are sold in establishments not anything like a barebones warehouse. Cost minimization is not the same as profit maximization. In 0 above, I discuss a host of reasons why Internet retailing did not and will not live up to the lofty expectations its proponents first envisioned.

It is useful to spend a little time talking about *profit margins*. There is an important definitional concern that needs to be made right off the bat. Profit margins measure the rate of return on sales. This is quite different than the rate of return on investment, which is often called the profit rate.

More generally, if firms in industry A have a smaller investment relative to sales than do firms in industry B, then for a similar level of competitiveness, the margin on sales will be smaller for firms in industry A. It is also the case firms in industry have a smaller value added. For example, if the average firm in industry A invests \$1 million to generate yearly sales of \$1 million, and the average firm in industry B invests \$3 million for yearly sales of \$1 million, and typical firms in each industry earn an annual 10% return on investment, firm A generates \$100,000 profit for a 10% margin, whereas firm B generates \$300,000 profit for a 30% margin. The following discussion refers to margins on sales, not returns on investment.

Grocery chains are famous for their low margins, only pennies on the dollar. So are dry goods retailers. The leading grocery store chains, such as Albertson's and Kroger's generate margins on sales of x and y % respectively, which are extremely low compared to most other firms and industries. Even the enormously successful Wal-Mart has a profit margin on sales of only z %. Firms in industries that have small value added often trumpet this fact to demonstrate how competitive their market is, playing on the common misconception that margins on sales bear any relationship to the degree of competition.

Of course, these low margins have nothing to do with any extra competitiveness of the grocery industry, but instead are due to the low value added per dollar of sales. The restaurant business, for example, has historically been at least as competitive, with new entrants dying by the droves, yet the margin on sales for the typical restaurant is ten times as high as that for the typical grocery store. The grocery business distributes products after others have already created most of the value, whereas restaurants themselves create much of the value of their products. Economic theory correctly predicts that the markups and margins will be smaller for Albertson's and Kroger's than for McDonald's and Wendy's.

What does this discourse on profit margins have to do with Internet firms? Most analysts have assumed that because firms doing business on the net will have lower costs, that this will translate into the ability to generate higher investment returns and higher margins than their brick-and-mortar counterparts. At one level this seems to make sense. After all, firms that have managed to achieve a cost advantage over their competitors, everything else equal, do earn higher profits and margins.

But as we have seen, *margins* are importantly related to value added and investment per dollar of sales. If Internet firms actually have lower costs, then they also will have lower investment required per dollar of sales, which should be expected to translate into lower margins. On the other hand, if Internet firms were to have higher returns on investment, this should help increase profit margins. I do not believe that Internet based firms are going to have higher returns on investment, however, at least not in the 'long run.'

B. The Nature of Competition in These Markets

The impact of competition on profitability has already been discussed in section B. Unrestricted competition, it was pointed out, tends to force profitability to levels just barely adequate to justify the investments that were made. Naturally, this would also lower profit margins from levels that might be achieved in a less competitive market.

In the previous section I demonstrated that, for any level of competition, decreases in cost will result in lower profit margins on sales, under the assumption that profit rates on investment remain constant.

In this section I examine the assumption that profit rates in Internet based business will be the same as in the brick-and-mortar versions of those industries. The key to the profitability of these Internet based industries, relative to their brick-and-mortar counterparts, depends on whether Internet based firms will compete mainly against the brick-and-mortar firms in the same general business, or whether they will compete mainly against other Internet-based firms. This question of who Internet-based firms compete with will have different answers depending on the particulars of the industry, with no generally true answer possible.

In many instances, brick-and-mortar retailers will coexist side-by-side with online retailers, just as mail-order firms have coexisted with brick-and-mortar retailers. In other instances Internet-based firms will largely replace brick-and-mortar firms. A third possibility is that Internet-based firms will form a minor niche in a market largely dominated by brick-and-mortar firms.

The nature and end result of competitive forces in these markets will be dictated by the underlying economic forces discussed in 0.

Therefore, the cost advantage of online retailers over brick-and-mortar retailers is largely irrelevant for profitability, just as discount houses are not necessarily more profitable than full service providers.

is to understand that online retailers are going to compete mainly with other online retailers, not brick-and-mortar retailers. That is because consumers will segment themselves into those who prefer virtual and those who prefer brick-and-mortar retailing.

In the long run, entry (or exit from an overpopulated Internet marketplace) will return profits to a normal level. A normal level, however, implies very small margins for virtual retailers since their investment is relative to sales is even smaller than for brick-and-mortar retailers. This low investment relative to sales is why brick-and-mortar grocery stores have always had very small margins.

To understand this we have to dig a little deeper. Economists consider markets competitive when easy entry keeps the typical firm in the industry earning only normal returns on investment—in other words, returns unimpressive enough to keep potential entrants uninterested. In less competitive industries, those where entry is more difficult, even average firms can earn above normal returns on investment.

If all the firms in a competitive industry achieve a reduction in costs, their profits, after an initial and temporary rise, will return to normal when new capacity and new entrants suck any excess profits up. Memory chip manufacturers, for example, constantly have falling costs, but new investment in fabrication plants at every uptick in profits eventually pushes profits back to the low levels that plague very competitive industries.

This is the standard textbook result for competitive industries. How do we know this model of competition is not just some aberrant creation from professors too long ensconced in their ivory towers? Because there is overwhelming evidence to support many of its implications, including the key implication for our purposes—that industries with lower costs per dollar of sales also have lower margins.

My point is that even if the level of competition within Internet industries is equal to that of their brick-and-mortar counterparts, the typical Internet firm will earn lower margins on sales *because* it will have lower costs. The logic goes from similar returns on investment to dissimilar margins on sales.

Which brings us to the denouement of this little story. If Internet retailers have lower costs than brick-and-mortar retailers there are two possible long-term outcomes, but the stores on the net will have lower margins than current brick-and-mortar firms under either outcome.

First, assume that consumers find brick-and-mortar firms and net firms to be perfect substitutes for one another, so, for example, consumers might be completely indifferent between buying a book online or buying a book in a physical store. If so, all the brick-and-mortar booksellers will be driven out of business by the more efficient Internet sellers, just as horses and buggies were driven out of business by automobiles. This may take a while, but eventually the industry would consist only of Internet booksellers, and their margins would be lower than was the case for the previous generation of booksellers since their costs, investments, and value added per dollar of sales are lower.

Far more likely, in my opinion, will be a scenario where some consumers prefer to buy online, and other prefer to buy in brick-and-mortar stores, just as some consumers have preferred shopping by mail-order and others by traversing shopping malls. Competition in each segment will occur largely between firms in a segment, just as convenience stores largely compete with other convenience stores and supermarkets with other supermarkets. Assuming that each market is competitive, every drop of excess profit will be squeezed out of the market for the typical firm, but since the investment per dollar of sales is lower for Internet firms, so too is their average margin on sales.

This is not to say that some Internet retailers will not have higher margins than others. Even with lower average margins for Internet firms, those who have figured out how to give consumers the most bang-for-the-buck, to lower their costs below those of other firms *in their industry*, or to find a niche that is difficult for other potential competitors to imitate, will earn above normal returns, just as superior brick-and-mortar firms earn above normal returns.

Similarly, low margins for Internet companies do not mean that they are poor investments just as supermarkets (or Wal-Mart, for that matter) are not and were not necessarily bad investments. The cautionary tale is that when estimating future profits for Internet businesses one should use lower margins than for similar brick-and-mortar business firms when calculating future profits and cash flows based on sales estimates. Don't get suckered by the claims to the contrary. Otherwise you will overpay when calculating the value of Internet properties, whether stocks or entire businesses, or might overestimate the benefit to your bottom line if your Internet business is developed in-house.

C. Informed Consumers??

During their startup phase, new and growing markets are frequently more profitable than older established markets. This occurs after firms go through their early 'losing-money' startup phase. This is because demand in these markets tends to outstrip supply, although capacity eventually catches up with demand. But it need not work out this way, particularly if suppliers over-anticipate demand and in so doing oversupply the market, leading to below normal profits during this startup phase. In either case, however, the market will eventually shake out and establish its own profit level that will depend on the level of competition and the variations in efficiency and quality.

It is hard to imagine that the current rush to the Internet is not indicative of over investment as already discussed in 0 section D. Surely, the immensely large negative profits generated by most Internet retailers appear to be more than just normal startup costs.