

## The Longest Tail in the Room

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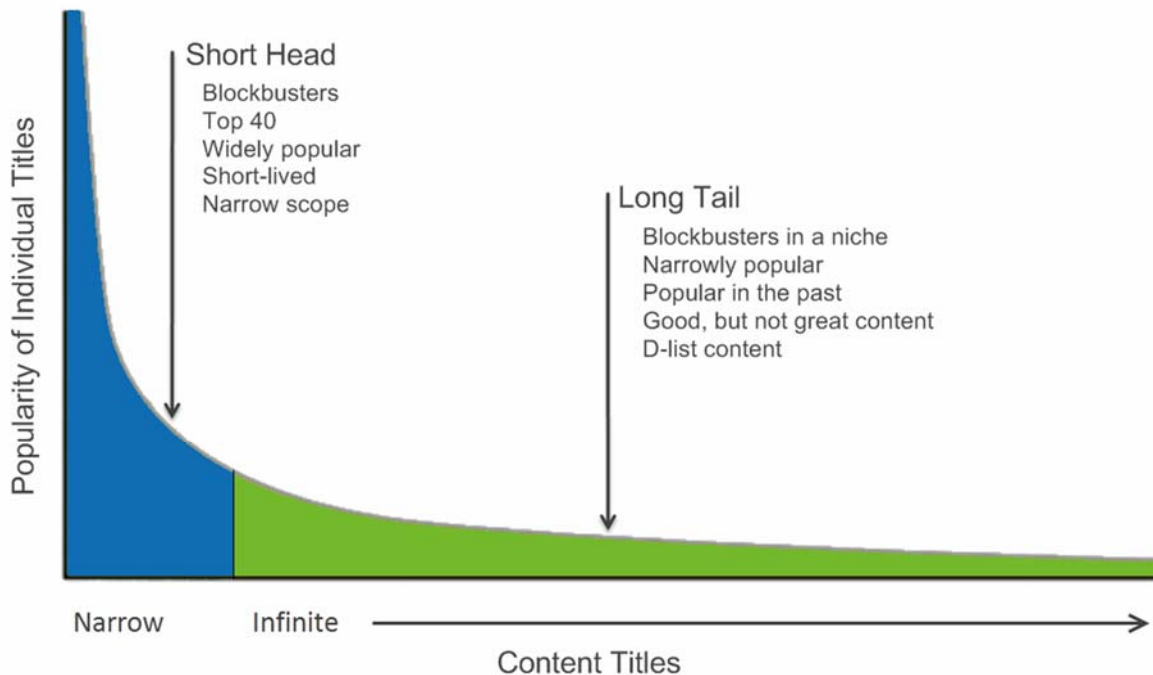
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The book, "The Long Tail," by Chris Anderson, explains in very simple terms how the Internet enables new business models by opening markets to the "long tail." In short, while a brick and mortar store can carry a fairly wide selection of products, due to its limited market reach, it can't carry everything.

A great example is even a very large bookstore in a very large metro market can't afford to carry nearly the selection available at **Amazon (AMZN)**. With a click of the mouse, AMZN has global reach. That means even if AMZN is offering a title that only one in ten million customers might want to buy, its market potential is still over 700 copies, and with only 10% market penetration it could still sell over 70. Using the same data, a brick and mortar store would have to have a market reach of 100M before it could project selling even one copy.

In his book, Anderson uses **Wal-Mart (WMT)** as an example. There, due to limited shelf space, a given store might only want to stock the current top-40 books. In the following chart, this represents the "head" of the business. The potential volume for the tail that follows declines quickly, but is a viable market for the vast reach of the AMZN business model.

### The Long Tail



AMZN embraced this model to build its foundation books. While this was a very successful business model that clearly disrupted traditional brick and mortar book stores, AMZN quickly learned it could leverage the long tail presence it developed across many other market sectors.

In the book market there are a finite number of publishers, and that allowed AMZN to establish the supply side of its business model fairly easily. However, since there was really no limit to the number of markets and products AMZN could pump out to its customers, it needed to do something differently to develop a supply of other products. To accomplish that goal without any material capital investment, AMZN grew a “second tail” that reaches into the supply channel. It looks just the same as its customer tail with large suppliers making up the fat end and many small suppliers driving its length at the skinny end.

In a nutshell, that’s what makes AMZN work – it is the “fat cat” with two long tails that owns the connection between millions of buyers and sellers. While the model differs in obvious ways, that is more or less the same story for **EBay (EBAY)**.

While AMZN and EBAY swing long tails in the western markets, China-based Alibaba makes them both look like “bobcats” In the China market.

Alibaba was founded in 1999 by former school teacher Jack Ma, and is expected to go public in the near future. However, this is not about the investment case for Alibaba as much as it is about its business model and why it is bringing economic growth to rural China.

China is famous for economic cycles, which for the most part, have ended with peasant uprisings in the past. Historically, China’s economic cycles have created wealth along its larger coastal cities, and while the peasants in the mostly agricultural provinces to the west have migrated to provide labor, the people from these provinces have never really shared in the opportunities enjoyed along the coastal provinces. While income inequality has become a popular headline subject in the U.S. recently, the separation between feast and literal famine in China has historically been many orders of magnitude worse.

Chinese leaders have been mindful of this during the most recent economic cycle and have instituted a variety of policies to encourage economic development in the western provinces. As a matter of fact, one of the first steps China took to spur the current cycle was to encourage better production from these farming communities.

Under communist rule, farmers were required to give all of their products to the government, and in exchange, were paid roughly \$5 per day for their toil. As you might imagine, this weighed heavily on productivity – why grow more when you know you won’t benefit. To fuel its broader economic ambitions, Chinese leaders knew the country would need more food, so one of the first steps they took was to allow these farmers to keep all they produce over a certain amount. Again, as you might imagine, there was a boom in farming productivity. However, with no industry to leverage, opportunities for real economic advancement in the western provinces remained limited, and young people were still forced to migrate to the coast and take hard labor jobs at low relative wages.

This worked for a while, but Chinese leaders mindful of history knew they needed to deliver opportunities closer to home. In an effort to do this, the Chinese government provided tax incentives for large companies and subsidized the building of monstrous industrial cities in western provinces. Some succeeded, but in far too many cases, a number of these industrial cities are largely uninhabited ghost towns.

## **Back to Jack**

Early in his career, Jack Ma was labeled as a cheat and a madman. His ideas upset those who had already established power in the private sector, and likely the government officials too. However, he pressed on with his dreams of building what is now the longest tail in the

world; and in doing so, succeeding where every government regime in the history of China has failed.

This is not so much the story of Jack, or even Alibaba, but a story about how and why capitalism works, and with that, some good lessons about building business models.

Capitalism is about creating an environment of opportunity. Capitalism is not about “equal outcome;” as a matter of fact it is the antithesis of that. China tried equalizing outcomes, and under those policies the Chinese starved with the poorest Chinese suffering the most. China also tried to orchestrate the distribution of growth with policy, and while that didn't fail as miserably as communism did, it most certainly didn't succeed. Jack Ma is succeeding.

While the vast population of China would seem to be a natural for a long-tail business model, the logistical challenges were daunting to say the least. How do you connect the largely unconnected, and how can you establish commerce between willing buyers and sellers that don't have any means to exchange money?

In the U.S. PayPal, which is now a part of EBAY, had it relatively easy. Most Americans have banking or checking accounts, and virtually everyone has a credit or debit card. While bank accounts and credit cards are common in large Chinese cities (the fat part of the tail), Ma needed to extend the tail to reach people who scraped by from yuan to yuan (the local Chinese currency), and had no banking or credit arrangements. To accomplish this, Ma created Alipay, which now has more than 800M users.

To develop opportunities for the poorest Chinese, Ma created Taobao, which translates loosely to “Treasure Hunt.” Here even basket weavers can set up an online offering to sell in an EBAY like environment for free. Taobao now has 7M sellers.

Ma added a twist to the Taobao concept by creating the opportunity for entire villages to band together and create a village “store.” The requirement is fairly simple – at least 10% of all residents must participate, and the village total revenue must exceed \$1.6M.

There are many stories about how Taobao has created not just a new middle class in rural China, but even a growing upper class; I read about one Taobao seller who claims to have generated \$1.3M in sales for woven baskets. I'm sure there have been failures too, but the Chinese don't spend much time lamenting that; their natural focus leads them to pick up broken pieces and try again with no apparent decline in optimism that things will work out this time or grudge against those who have found success.

Interestingly too, Ma has become one of the most revered individuals in China, with popular slogans about him now covering government propaganda posters in large Chinese cities. No one seems to care that Ma is making billions from his innovations and efforts while some workers at the end of this very long tail make what we would consider to be menial wages. Even at the tip of the tail people seem to be thrilled with new opportunities, and focused much more on the dream of growing their position than worrying about who might be doing better.

The Alibaba umbrella extends far beyond the Alipay commerce services and the Taobao portal that has brought opportunity to areas of China that have been impoverished for all of history. It also includes TMall where 70,000 brands like **Apple (AAPL)**, **Gap (GAP)** and many others are offered. This is the high-end portal where Ma charges participants large

annual fees for a virtual storefront exposure. Ma has even launched his own brand, Munuan, on TMall.

According to reports, the model is working not just at the bottom and the middle, but also at the top. As it was reported earlier this year, Alibaba's Q4 2013 revenue was about \$3.5B and its net profit was a whopping \$1.35B. This success is obviously supporting the value of **Yahoo (YHOO)**, which owns a 40% stake that it bought in 2005 for only \$1B, and is cause for both investment bankers and investors to anxiously await the eventually Alibaba public offering, but again, this is not so much about that investment case. This story is chock full of good lessons that can be applied in many other ways.

At the foundation, Alibaba teaches us much about simple human nature – all we really want is opportunity. Give people real opportunity and they don't have time to complain about who is in the lead – with real opportunity, human nature leads us all to believe we can improve our situation, and for some of us, dream that we might catch up to the leaders.

From 50,000 feet, Alibaba teaches valuable macroeconomic lessons that are still evidently a mystery in the U.S. While our Ivy League schools still teach failed demand side Keynesian economic theory, Alibaba is a case study that proves the supply side theory is really the only answer. For centuries more Chinese leaders than I can count tried and failed to lift the persistent poverty in the western provinces with the blunt instruments of policy and subsidy.

With absolutely zero political clout or subsidy, Alibaba is delivering where governments have failed by simply providing an opportunity and incentive to supply. It matters not if it's jewelry, simple clothing, or weaving a million dollars of baskets from native plants; the supply side wants to work. In a free market, the supply side will persist until it discovers what it can sell.

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Chart source: Learning Solutions Magazine, David Wilkins, August 17, 2009