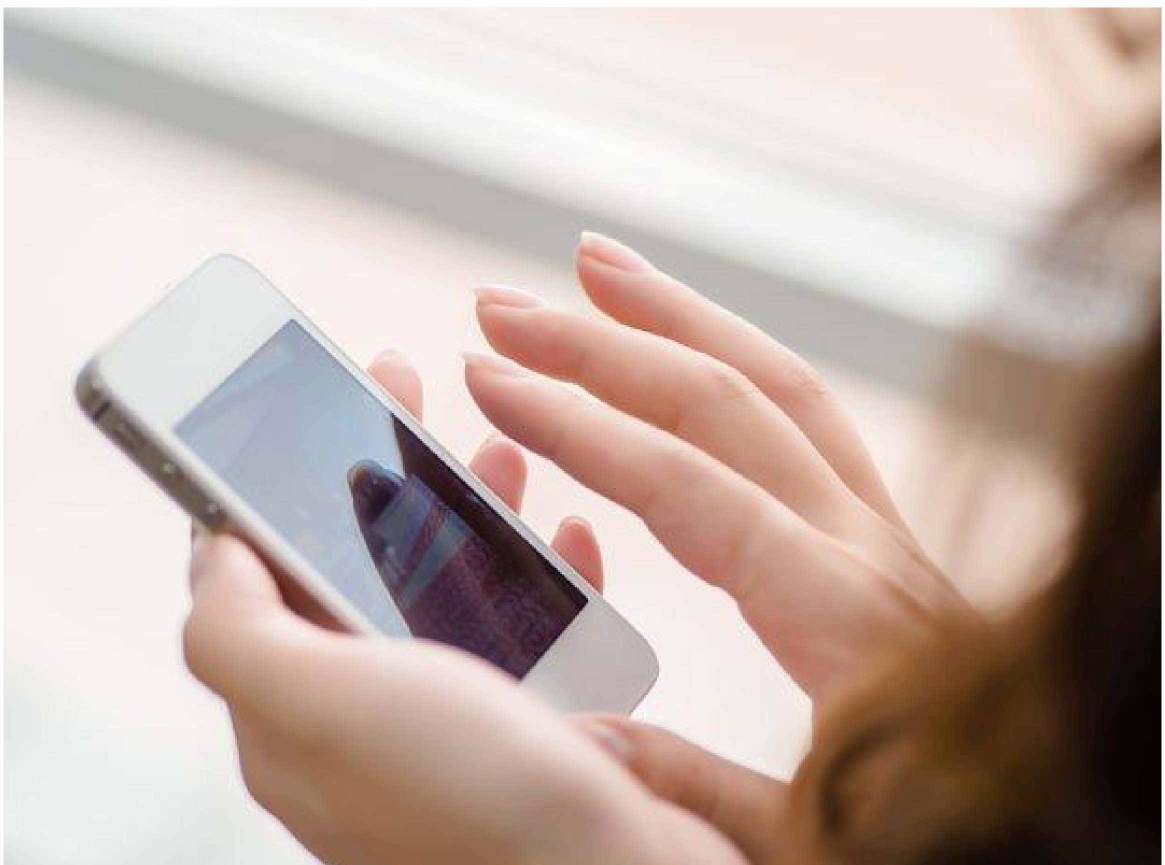
FINANCIAL POST

FP ENTREPRENEUR

Do investors consider apps to be businesses?

Brad Cherniak | September 8, 2014 | Last Updated: Sep 8 10:32 AM ET



Fotolia *Technology has enabled companies to combat this by becoming virtual businesses, with few fixed assets or employees. Their marginal cost approaches zero, which is a good thing, but also a challenge. It means a near-zero barrier to entry to the app's space.*

There is a lot of confusion about whether an app is a business. More specifically, can it be financed? Can it be sold as a business?

To answer these questions, I need to back up a step and look at the milieu an app — and by that I mean a piece of software code that for any purpose is distributed via the web to business and/or consumer end users — operate in. With dynamic design, the app can be accessed on essentially any platform, from desktop to mobile, but I am not talking about SaaS-based software platforms designed to solve more fulsome enterprise business challenges.

The app paradigm The following are most valued in an app outside what it actually does, which is to inform, entertain, or assist: It should have a drop-dead simple user interface, and require little to no active instruction by the seller regarding how to use it; it should require little to no installation beyond a download, or click; it must require little to no customization as part of the initial sales cycle; all this should remain true for the life of the app; and it should cost almost nothing to the user.

Because users make no investment in time or cost to activate or use the app, there is little legacy investment or sunk cost. This is fantastic news for the user, and indeed apps have benefitted people in spectacular ways.

For the developer it can be termed perfect competition. And the economics of perfect competition are stark. Companies are forced to price their offering down to their marginal cash cost to survive. The app world has already established zero pricing as the de facto base standard. Few investors will knowingly invest in a company faced with perfect competition, although it is a situation that never really existed until the app.

Technology has enabled companies to combat this by becoming virtual businesses, with few fixed assets or employees. Their marginal cost approaches zero, which is a good thing, but also a challenge. It means a near-zero barrier to entry to the app's space.

The dominant cost for app developers is marketing and promotion, both necessary to be discovered in perfect competition, if only fleetingly. There is currently a mad rush to establish the definitive, sustainable app business model … such as advertising revenue-based, freemium models, or simply becoming a tool to be tucked into a platform such as Google or Facebook.

But there are none yet. A real challenge for investors and buyers. So it is often not the quality of the app that drives success or failure, it is the paradigm of perfect competition.

Guaranteed loss Near-perfect competition can be daunting, but entrepreneurs are remarkably adaptive and innovative. Like cactuses that seem to grow without water or nutrients, a way to survive is found.

The bigger issue as it pertains to whether an app is a financeable or saleable business goes to the nature of business itself. Every business, web-based or traditional, faces the atrophy of its business lines, and must continually introduce new products or services to maintain sales in the longer haul.

This requires significant infrastructure in terms of research and development. R&D is a game of numbers and a probability-weighted product pipeline can be constructed much like a sales prospect pipeline. A business works when the operation finds enough success consistently over time to overcome the failures.

The new app is by definition an initial success if it exists at all. The question is, what comes next? Few apps have an established R&D infrastructure. As a result, they often end up as one-hit wonders. The chances of developing a hit app in the first place are akin to being hit by lightning. It may happen once, but what are the chances of it happening twice? Ask Zynga.

Investors or buyers generally won't want to fund the costs of creating the infrastructure and getting through the period of trial and error to find your next product, and your third, and so on. They prefer to fund or buy businesses that are coming out of this economic foxhole, not going into it. Trial and error, even if successful, takes time, and time eats into annualized investment returns.

The app represents the nexus between a new technology and social revolution in the social web, and the classical economics of business, which are still very applicable. We are in uncharted territory, and may be for years. So, how does an app become a business, if it is not? That is for future columns to explore.

Brad Cherniak has spent more than 20 years as a principal, advisor to and investor in private companies. He is co-founder and partner at Sapient Capital Partners, a Toronto-based advisory firm to companies from early stage to $50-million in revenues. His column appears monthly in the Financial Post. He can be reached at brad@sapientcap.com *and you can follow him on Twitter as @SapientCapital.*