Network Effects: A True Measure of Quality

In 1876, Scottish engineer Alexander Graham Bell was credited with inventing the world's first telephone. When it was first invented, what would you have paid for it? I'd argue, nothing. It was only with the creation of a second telephone, connecting a pair, that it gained utility. Each additional user, however, significantly enhanced the telephone's value, increasing the total number of connections exponentially. The power of network effects is as relevant to today's markets as it was in the age of Alexander Graham Bell. In this article, I highlight some of Aeon Investment Management's portfolio holdings: two of which stand to benefit from building a strong network, while contrasting this with one where network effects are not present.

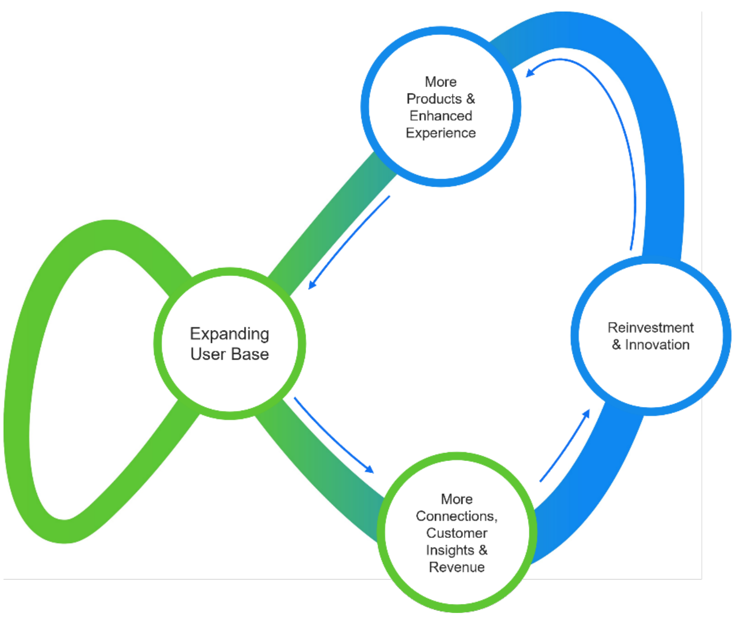
Defining Network Effects: More Than Just Scale

Michael Mauboussin, author of Expectations Investing, defines networks effects as follows,

> *"A network effect exists when the value of a good increases because the number of people using the good increases. All things being equal, it's better to be connected to a bigger network than to a smaller one."*

Unlike economies of scale, which are fundamentally cost-driven, network effects are a demand-side force. Mauboussin highlights three key features regarding network effects:

- **Exponential Value Creation**: Value grows faster than user count
- **Defensibility**: High switching costs and user "lock-in"
- **Virtuous Growth Cycles**: Success breeds more success, resulting in a winner-takes-all-or-most scenario



The mechanism shown paves the way for pricing power as well as sticky, recurring revenue streams. Mauboussin and others have found that in sectors where network effects are genuine, market share becomes a major predictor of long-term profitability. In terms of valuation, Aswath Damodaran (a professor of finance at NYU Stern and a leading authority on corporate valuation) argues that companies with outsized network effects may command a premium that is not reflective of what they earn today – or even two to three years out – but rather of what they can earn in the long-term as their network compounds through time.

Capitec

Capitec, once a challenger in South African retail banking, has harnessed digitalization and simple, affordable offerings to rapidly expand its user base. In their July 2025 AGM, their CEO highlighted their journey, from 25 thousand clients in 2004 to 25 million today. Today, Capitec is a platform business built on a strong retail banking client network, with around 70% of profits attributed to non-banking activities. Amongst these activities, its mobile virtual network operator (MVNO), Capitec Connect, reached 1.6 million active SIMs – a 74% jump in just one year. As more customers adopt the platform, Capitec can offer richer services at a lower marginal cost, improving loyalty and cross-sell, while benefitting from data-driven insights only possible at scale.

Uber Technologies

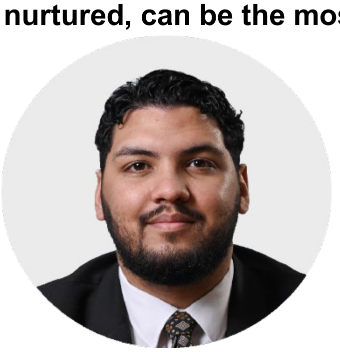
Uber operates as a two-sided network, connecting drivers and riders. The larger the network of drivers, the lower wait times and fares – thus attracting more riders, who in turn draw more drivers as their earnings potential grows. Despite rapid innovation in the robotaxi space, with Tesla and Alphabet (Waymo) looking to compete in ridesharing, the strength of Uber's network is of significant value, leading many autonomous vehicle manufacturers and innovators to partner with Uber so they can tap into their existing network.

Final Thoughts on Network Effects and Quality

Many investors have turned Nike Inc. into a case study for why scale, brand recognition and market share do not automatically result in sustainable earnings growth, with the company recently reporting revenue declines of 10%, losing market share to new running brands, On Cloud, Brooks and Hoka. At a 1994 Berkshire Hathaway shareholder meeting, Warren Buffett said,

> *"I don't understand the likelihood of permanence of their competitive position over a 10- or 20-year period. Some businesses are a lot easier to understand than others, and Charlie and I don't like difficult problems. We'd rather multiply by 3 than by Pi."*

As a customer of Nike, my utility doesn't increase if more people start wearing Air Force Ones. While Nike remains a strong brand at significant scale, leading to pricing power and cost advantages, its moat is less durable due to absence of strong network effects. **Network effects, when present and properly nurtured, can be the most powerful indicator of true quality.**



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