Sunk costs and competitive advantage in the era of digital business

The capabilities a digital platform develops through strategy and commitment will determine its success or failure.

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Nokia famously lost its dominant market position when it failed to embrace the smartphone. By the time the need for change was clear, the Finnish telecommunications firm had effectively locked itself out of the market by not investing early enough. Companies can also lock themselves into a market, by making strategic investments that are too difficult or costly to pull out of.

The theory of commitment in competitive advantage, developed by IESE professor emeritus Pankaj Ghemawat in his 1991 book *Commitment: The Dynamic of Strategy*, suggests that, for successful firms, committing to developing superior capabilities is key to creating and maintaining competitive advantage. These superior capabilities often hinge on “irreversible decisions” — strategic investments that are too difficult or costly to reverse once begun. These might include things like production facilities or strategic assets.

A firm shows commitment when it persists with a certain strategy over time. It can be seen as a constraint, but it also breeds specialized competencies and assets that are specific to that firm — and therefore the building blocks of its competitive advantage. Commitment isn’t necessarily a recipe for success, but it needs to be reckoned with.

This influential book has underpinned many management decisions over the last 30 years. But the world has changed. Companies like Airbnb and Uber are global success stories despite owning almost no physical assets. Does Ghemawat’s theory of commitment as a defining factor in a firm’s success remain relevant today? IESE professors Bruno Cassiman, Joan Enric Ricart and Giovanni Valentini explore how it applies in the new business reality — specifically for digital platforms (think Booking.com or your favorite restaurant reservation app).

Strategic commitment in the digital space

The short answer? A resounding *yes* for the continued usability of the theory.

The authors first examined the unique circumstances that apply to digital platform businesses — factors that don’t apply to traditional businesses — and then analyzed how the principles of commitment would still apply.

Rather than working on a simple model of “company sells product to customer,” digital platforms tend to mediate between one group with a need and another group with possible solutions, extracting value from both sides. Platforms must aim to attract the largest number of users in the early stages, since the greater the number of users, the more valuable the ecosystem for the entire network, frequently resulting in a winner-takes-all network effect.

And although the investment circumstances are different (Booking.com won’t be sinking costs and locking itself into a large production facility when it doesn't, in fact, produce anything), digital businesses must still commit to some potentially irreversible strategic decisions.

Success-defining choices

Over half of the failures of platform businesses spring from wrong choices in two key areas: architecture and governance. Both determine the user experience and the value the user is able to extract from the platform. And both are factors that can become irreversible.

Architecture determines what kind of transactions can be made. There have been examples where architecture commitment prevented a company from changing course. For instance:

- Booking.com found out about the pitfalls of architectural commitment the hard way when Airbnb came onto the scene. The platform wasn't designed to list apartments, and by the time it had created the flexibility to do so, it had lost out to its competitor. It had been effectively locked out by its initial architectural choices.
- Conversely, Amazon made the difficult choice to break down its unwieldy single-application system when then-CEO Jeff Bezos observed his developers in a constant struggle with the hardware server team. Breaking the entity down into microservices led to many new features and Amazon's most profitable business, Amazon Web Services. The change boosted the value of the whole ecosystem, but it was a hard-won battle: Bezos enforced the new way of working by threatening to fire anyone who didn't enable the change.

Equally, **governance** decisions can be more irreversible than expected. These are policies governing who has access to the platform or which user base pays for services.

- When the freelancer platform Upwork tried to charge businesses rather than the freelancers for its services, it struggled to implement the change. Companies, used to getting the service for free, were resistant.
- Twitter is the latest high-profile casualty of commitment challenges relating to governance. Attempts to monetize blue ticks for verified accounts fell flat when users rebelled and caused havoc by creating fake celebrity and corporate accounts. The new CEO, Elon Musk, was himself trolled under the new system.

Commitment and flexibility in the digital era

Commitment to irreversible decisions still serves to build the firm-specific capabilities that give digital businesses competitive advantage. But Ghemawat's book also highlighted the importance of flexibility — of pacing commitment in times of uncertainty until more information is available.

Uncertainty is a constant for digital platforms. Fortunately, the cost of trial and error is relatively low. And with feedback from users often available in real time, adjustments can be made with greater flexibility.

Even so, the importance of flexibility should not detract, in managers' minds, from the strategic value of commitment.

About the research

The authors examined Pankaj Ghemawat's still prevalent management theory of commitment and competitive advantage with regard to digital platforms. They considered how platform businesses differ from physical ones and analyzed whether the principles of commitment still applied.

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