The Sunday Brief: Why Do Big Companies Make Crazy Decisions?
April 15, 2012

Greetings and Happy Tax Day from Dallas and Kansas City. This week has not lacked for news, and in thinking about a common theme for the week, I have to question, "Why Do Big Companies Make Crazy Decisions?"

Before we go into the details, I wanted to thank several of you for forwarding the SB to friends. We had just over fifty requests for new additions to the email list, and several of you asked for a formal blog site to allow for likes, comments, and reposts. I will have that up with the next SB. We are working on a really snappy site (yes, I learned my lesson about the importance of design) and it's taking a bit longer than expected. If you like what you read, please pass it on to a friend, and I will gladly sign up new readers with an email to sundaybrief@gmail.com.

Speaking of last week's SB, which, in case you forgot, dealt with the launch of the Lumia 900 by Nokia, Microsoft, and AT&T, several analysts and reporters jumped on the story, including this particularly excoriating summary by Information Week. As of this morning, the Lumia Cyan and Matte Black phones are the #1 and #2 phones on Amazon's sales list, and the Black version of the phone is out of stock on AT&T's site (note: the inventory depletion may not be a surefire sign of the Lumia's success, but rather a temporary matter as consumers traded in Lumia 900s with data connectivity issues for those that had updated firmware). While the Lumia exceeded sales expectations, they were nowhere close to those of the iPhone 4 (two million in the first three days) and the iPhone 4S (four million in the first three days). While the black Lumia 900 is out of stock, the HTC Titan II with a faster processor and a 16 Mexapixel camera (really) is readily available for $199.

Enough about last week's Windows phone blitz (launching on Easter Sunday was truly a crazy decision). This week, we had the clash of the titans with Microsoft's peers grabbing the headlines. First, it was Facebook's acquisition of Instagram for $1 billion. Wow, that's a lot, especially given the fact that three days earlier Instagram had just closed a round valuing the company at $500 million. Really. The control premium was 100%. To gauge the Venture Capital community's reaction to the fact that their portfolios could be worth a lot more thanks to billion dollar decisions, have a look at this Washington Post video. The fella from Spark is about to come out of his seat he's so happy! Overvalued? – heck no!

The fact is that Facebook is a big company. And they made a crazy decision. They needed no consultant to give them a market assessment – Facebook *is* the market leader for social media (contrast that to News Corp's acquisition of MySpace). They needed no discounted cash flow analysis with dozens of sensitivities. They needed no personnel transition/ integration plan – Instagram has a dozen employees. What they needed was a hip, new community to bolster their valuation. The needed the eyeballs and their associated on-line minutes. And it was going to cost $1 billion to get them firmly in the Facebook grasp. **Reason #1 in the "Why Do Big Companies Make Crazy Decisions?" – sometimes a strong offense is the best defense**.

Facebook beat Twitter and Google (who already owns Picassa) to Instagram. Forget that PicPlz, Steply, Viddy, CamWow, Pic Stitch, Picframe, Diptic, Hipstamatic and dozens others are available at the iTunes and Android app stores. Facebook wins today, but who wins tomorrow, and do they win for a lesser valuation? Crazy behavior indeed. Google and Twitter are chuckling.

But that was not all this week – we had more crazy decisions, when the Justice department brought to light Apple's crazy decision to work with publishers to raise prices on e-books purchased through the iBookstore to combat another crazy decision by their competitor, Amazon, to charge lower prices on books. For a copy of the complaint, click here and for a good synopsis of the situation, click here. At the heart of the decision to aggressively fight the Obama administration is **Reason #2 in the "Why Do Big Companies Make Crazy Decisions?" – because an intrusive government must be stopped.**

At the heart of the case is the business decision by Amazon to adopt a "wholesale model" for e-book pricing. For example, Amazon might agree to purchase the latest novel by Mary Higgins Clark for $10.45 and set a price for the novel of $9.99. If they did this forever, it would be an absolutely crazy decision unless they charged an excessively high amount for the reader (that would be the "razor/ razor blade" business model made famous by Gillette last century).

Amazon, however, charges next to nothing for their reader, whether it's the basic model for $79 or their Kindle Fire for $199. While neither of these models will dent the popularity of the iPad, the fact that Amazon appears to be willing to sell a product for close to cost threatens the long-term hardware margins of the world's largest technology company.

Apple takes a different approach to e-books than Amazon, allowing the publisher to set the price of the book and taking a percentage of the revenues generated by its sale. This retail commission approach has been Apple's business model for digital goods sale since iTunes set up shop a decade ago.

Different strokes for different folks – right? Can't two different business models exist for the same business? Yes they can. Agency and wholesale models have been around for a long time. The core of the case is not the legality of the model, but whether Apple served as the "ring leader" with five very powerful publishers to kill the Kindle. With three of the five publishers in question already settling their cases, the prospects for a full trial are high.

One crazy decision (by Amazon) begets an equally crazy decision (by Apple). For our summer thriller, we have two titans of tech involved in a dramatic business model chess match with the DOJ on Amazon's side (at least today). John Grisham has nothing on this courtroom saga.

Finally, we have Google. They reported spectacular first quarter operating income of $3.39 billion, up over $1 billion from their 1Q 2011 operating income. Revenue growth was still strong at 24%

and costs were favorable to expectations because they hired fewer people than analysts expected (although they topped 33,000 full-time employees in the quarter, up from 20,000 at the beginning of 2010). Google now has slightly less than $50 billion in cash and marketable securities on hand and about $5.5 billion of short and long-term debt. With a market capitalization of slightly more than $200 billion after Friday's trading, their cash makes up just under a quarter of the company's total value.

No crazy decisions in this earnings report. Sure, they are finishing up the purchase of Motorola, which will yield a treasure trove of patents but also brings a struggling handset/ tablet unit. And concerns about the effect of mobile search results on earnings need to be watched carefully. But Google is an Internet powerhouse, and a key source of innovation and leadership across the globe.

Google's founders issued an announcement with the release, however, to issue a new non-voting class of stock. Splits occur all the time, and Google was due for a stock split anyway. This event is different, however, because it solidifies decision-making control with three individuals: Co-founders Larry Page and Sergey Brin, and current Chairman Eric Schmidt.

Currently, Page and Brin control more than 50% of the voting power through a Class B structure. This structure would not change – Google would simply issue new shares that enjoy economic but not voting power. The rationale for this change is clearly laid out by Larry and Sergey in a letter to their fellow shareholders:

> *In our experience, success is more likely if you concentrate on the long term. Technology products often require significant investment over many years to fulfill their potential. For example, it took over three years just to ship our first Android handset, and then another three years on top of that before the operating system truly reached critical mass. These kinds of investments are not for the faint-hearted.*
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> *We have protected Google from outside pressures and the temptation to sacrifice future opportunities to meet short-term demands. Long-term product investments, like Chrome and YouTube, which now enjoy phenomenal usage, were made with a significant degree of independence.*
>
> *We have a structure that prevents outside parties from taking over or unduly influencing our management decisions. However, day-to-day dilution from routine equity-based employee compensation and other possible dilution, such as stock-based acquisitions, will likely undermine this dual-class structure and our aspirations for Google over the very long term. We have put our hearts into Google and hope to do so for many more years to come. So we want to ensure that our corporate structure can sustain these efforts and our desire to improve the world.*

This leads us to **Reason #3 in the "Why Do Big Companies Make Crazy Decisions?" – because doing anything else would result in abject disaster.** They know better. To be clear, nothing the Google founders are doing is inconsistent with the original structure they proposed in 2004. And they clearly are on a roll with Android, Chrome, and YouTube. It is completely their prerogative to enjoy decision-making rights, especially given their daily involvement in the company. And, as many business publications have pointed out, no one is requiring current Google investors to stay. They can certainly sell their Class A (and in the future Class C) shares at any time.

What grates is the hubris. Even if the current two-class equity structure had continued, the probability that any future business decision would have been out of line with the founders' thinking (and that Larry and Sergey's 49%, 47% or 45% stake would have been outvoted) is remote. There are three types of decisions that would rise to this level:

a. A substantial acquisition (likely additional vertical integration, potentially into content)
b. A decision on potential dividends and/or debt to equity structures ($50 billion is a lot of money)
c. A restructuring of the company that would spin out a major portion of the company (e.g., separating search from subscriber-based services such as social and email)

Retaining control is important, and there are many cases of shareholder activists who brought disaster to companies with their short-term financial focus (and industry ignorance). There are other alternatives than perpetual control, however, and this move should serve as a question mark for future investors.

Big companies have the luxury of making decisions that smaller companies would hesitate to make. Some of their decisions are rational and thoughtful. Many, however, are head scratchers. Three of those perplexing decisions happened this week, and given human nature, it's likely these will not be the last ones we see in 2012.

Next week, we dive into the analytical deep end of the pool with a preview of the US wireless earnings and subscriber growth. Enjoy the remainder of the week!