Instagram for $1 Billion: What is it Really Worth?

Facebook has just acquired the maker of the iPhone application Instagram, which lets users do simple photo editing and sharing with friends, including social-network functions such as "like" and comments.

The application itself is in no way complex enough to explain the $1 Billion price (even the valuation of the company on Feb 2., $30 million, would be a rich price for such application). The earnings are not either: There are no revenues at present because the firm has concentrated on building a user base, and has not launched any revenue model, such as advertising or other commercial tie-ins.

So what is driving the price? One, the user count is increasing very rapidly, going from 15 million in early December to 27 million now. Well, it is probably more because I am writing 36 hours after the original Wall Street Journal article. Two, the application has high engagement, meaning that users spend a lot of time with it. There are probably some other reasons as well, such as the speculation that Facebook felt a need to defensively grab this firm before someone else did, but those two explanations sum up a lot of the appeal. What we have is a valuation based on the network effect: users find an application much more valuable because others (especially their friends) also have it, and this network effect makes them reluctant to change to a competing application that offers the same functions, or even a better one. Once the network effect is established, Instagram may be able to reduce the user value, such as by devoting part of the screen to advertising, and the users will still remain loyal.

Or will they? Under what conditions can the network effect unravel? The answer is in theory surprisingly simple, but hard to do in practice. A business based on the network effect can be taken apart through knowledge of how diffusion processes work. First, make a better product. (This could be a problem in the Instagram case: possibly the simple photo editing and sharing is all its users need or want.) Next, generate adoption of your new product by technologically curious "innovators". This is easy to do; a certain proportion of the population like to try out new things to see if they are better than what they currently have. Among these innovators you will find some opinion leaders that others pay

attention to: make sure to announce their adoption if you can, and give them tools to invite their friends. Social network sites do this through their "friend" or "link" contact requests, and any application that tries to break into a network-effects market needs such a function. If the business you are competing with is well established, find a segment where it is weak and start there. If your service is really good, it will naturally start eating into the next segments of the population from there: The early adopters, who are influenced by the first innovators, the early majority, who are the friends of the early adopters, and the late majority, who come on board when something is so big that everyone is telling them about it. Even if your service is not that much better you may be able to find ways of rewarding users to stay (usually through neat product features) while waiting for the other to make some misstep, like putting too much advertising on the screen.

Businesses built on network effects have customer loyalty that makes them valuable beyond what a simple examination of the product or the revenues would suggest. But they are not isolated from competition and they are not licenses to print money. A business built on network effects can be beaten by another business that also uses network effects, plus good product design.

Raice, Shayndi & Spencer E. Ante. 2012. Insta-Rich: $1 Billion for Instagram. Wall Street Journal, April 9 2012.

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