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KILL ZONE

Sai Krishna Kamepalli
Raghuram Rajan
Luigi Zingales

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ABSTRACT

Venture capitalists suggest that incumbent internet platforms create a kill zone around themselves, where any competing entrant is acquired quickly. Consequently, financing new startups becomes unprofitable. We construct a simple model that rationalizes the existence of a kill zone. The price at which an acquisition is done depends on the number of customers the entrant platform can attract if it remains independent, which in turn depends on the number of apps that have adapted to the platform. The prospect of a quick acquisition by the incumbent platform, however, reduces the app designers' benefits from adaptation, making it harder for a technological superior entrant to acquire customers. This reduces the stand-alone price of the new entrant, decreasing the price at which they will be acquired, and thus reducing the incentives of VCs to finance their entry. We discuss the policy implications of this model.

Sai Krishna Kamepalli
Columbia University
Department of Economics
420 W 188th Street
New York, NY 10027
krishna.kamepalli@columbia.edu

Luigi Zingales
Booth School of Business
The University of Chicago
5807 S. Woodlawn Avenue
Chicago, IL 60637
and NBER
luigi.zingales@ChicagoBooth.edu

Raghuram Rajan
Booth School of Business
University of Chicago
5807 South Woodlawn Avenue
Chicago, IL 60637
and NBER
raghuram.rajan@ChicagoBooth.edu

A data appendix is available at <https://www.nber.org/data-appendix/w27146>

There is a growing worry that digital platforms (multi-sided markets that offer digital services to customers, often for free) might gain market power, distort competition, and slow innovation. A specific concern is that such platforms might acquire any potential competitors, dissuading others from entering, and thus preventing entry from serving as the competitive threat that keeps monopolistic incumbents on their toes. In a sense, such platforms create a “kill zone” around their areas of activity. This is not just a theoretical possibility. For instance, Albert Wenger, a managing partner at Union Square Ventures and an early investor in Twitter recently declared the “Kill Zone is a real thing. The scale of these companies [digital platforms] and their impact on what can be funded, and what can succeed, is massive.”¹

The notion that platform acquisitions discourage new investments is at odds with a standard argument in economics (see Phillips and Zhdanov (2013), and for related evidence); if incumbents pay handsomely to acquire new entrants, why should entry be curtailed? Why would the prospect of being acquired not act as an extra incentive for entrepreneurs to enter the space, in the hope of selling out at hefty multiples?

We start by checking whether there is any evidence that easier acquisitions can deter entry. Figure 1 shows that the number and the dollar value of new start-ups in the social media space have dropped dramatically in the last few years. By itself, this fact is consistent with a number of explanations. One is the existence of a “kill zone”, whereby the acquisition of an important new entrant in the social media space by an incumbent digital platform signals the ease of possible future acquisitions, and discourages rather than encourages new investments in the space.

To probe deeper, we collect data on the number of deals and dollar amounts invested by venture capitalists in a sector around the time that major acquisitions are announced by Facebook or Google in that sector. In the three years following an acquisition by Google and Facebook in a certain industry sector, VC investments in that sector (normalized by total investments in the software industry) drop by over 40% (see Figure 2a) and the number of deals falls by over 20% (see Figure 2b). We will elaborate on these figures shortly, but they suggest there may be something special about acquisitions by multi-sided platforms that deters further investment in that space. What might it be?

The standard economic argument of acquisitions incentivizing entry relies critically on the acquisition price for firms being adequate compensation for innovation. This may not hold in the context of acquisitions by digital platforms, because the economics of digital platforms differs significantly from

¹ <https://promarket.org/google-facebooks-kill-zone-weve-taken-focus-off-rewarding-genius-innovation-rewarding-capital-scale/>. Also see the Economist (2018) <https://www.economist.com/business/2018/06/02/american-tech-giants-are-making-life-tough-for-startups>, *Assessing the Impact of Big Tech on Venture Investment*, OLIVER WYMAN (July 11, 2018), <https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/july/assessing-impact.pdf>, and Ian Hathaway, *Platform Giants and Venture-Backed Startups*, IAN HATHAWAY BLOG (Oct. 12, 2018), <http://www.ianhathaway.org/blog/2018/10/12/platform-giants-and-venture-backed-startups>

the textbook neoclassical economics of firms. To show this, we build a simple model of platform competition that contains the key novel ingredients present in this space: First, platforms are multi-sided. On one side, there are customers, who cannot easily multi-home (that is, use different platforms at the same time). On another are app designers (or content providers or influencers), who can multi-home, but face a cost of adaptation. On the third side, there are advertisers, who pay to access the customers.

Second, there are important network externalities. Customers chose platforms with more apps, and app designers go to the platform where customers are. Third, customers and app designers start out with the incumbent, and face switching or adaptation costs. In the presence of network externalities, this affords the incumbent a large incumbency advantage.

The stand-alone market value of the entrant platform represents the entrant's reservation value in any bilateral merger negotiation with the incumbent. It will be critical in determining the acquisition price. Since the value in the multi-sided platform comes from advertisers, who will pay for the customers they can access, the entrant's stand-alone value is driven by the total number of customers who switch to it. In turn, the number of customers joining the new platform depends upon the quality of the new platform and the number of app designers present on it.

The adaptation decision by the app designer is therefore crucial. Importantly, it is greatly affected by the ease with which acquisitions are cleared by the anti-trust authorities (we focus in the paper on ease as measured by the time to clearance – shorter is easier -- but an equivalent approach would be to proxy for ease with the probability of clearance – higher is easier). If app designers expect the new platform to be acquired expeditiously by the incumbent, they will be reluctant to pay the adaptation costs, unless the new platform is of significantly higher quality than the incumbent one. After all, they know that if the entering platform's technology is a net improvement over the existing technology, the incumbent will integrate it smoothly with the existing platform, with new features melded with old features so that existing apps work seamlessly without any additional costs. Thus, the expectation of a merger soon after entry will dissuade many designers from incurring the additional cost to adapt their apps to the entrant platform early – instead they would rather wait for the merger to be consummated when they can adapt costlessly. In turn, the low number of apps on the entrant platform will deter customers from switching to the entrant platform, reducing the acquisition price, and discouraging entry.

Put differently, think of app designers as bees: in pursuing their own interests they generate a positive externality. Because of this externality, any environmental condition that affects bees' incentives to roam across flowers has a much bigger effect than its direct effect on bees' welfare. The same is true here. Any environmental condition that reduces the app designers' incentives to switch to better platforms has a negative effect on the system.

If it is so important for an entrant to avoid being acquired easily, why doesn't it commit to it? An entrant entrepreneur will try her best to portray fierce independence, committing to upholding the "purity" of her new technology. In fact, the often-claimed presence of super egoistic CEOs/founders, driven more by a vision than by money, can be interpreted as their attempt to commit credibly to never sell their platform. So can the prevalence of the dual-class share structure that entrusts the founders with ultimate control. Nevertheless, in a world of rational agents, it is hard to see how the entrepreneur can credibly commit not to sell when selling maximizes her profits (given that a monopolist's profits are greater than the sum of the profits of two duopolists).

Could the new entrant resolve this impasse by paying the app designers to adapt to her platform? It might not be clear ex-ante what apps are likely to be most appealing to customers, and whom to pay. Also, the incumbent usually has deeper pockets than the entrant, and more knowledge about app designers. Therefore the incumbent is more likely to succeed in a war of payments. Finally, and most important in our model, the payment would destroy the signal of quality sent by adaptation. Customers are willing to adopt a new platform because they infer from the quantum of adaptation that the new platform has high quality. The moment app designers are paid to adapt, the signal from adaptation gets greatly attenuated.

We conduct a numerical analysis of welfare for a reasonable set of parameters. A regime that makes acquisitions by an incumbent more difficult (that is, by delaying the time to acquisition) has two effects. On the one hand, it potentially increases the new entrant's payoff conditional on the merger, increasing entry and innovation. On the other hand, it delays the moment when the quality improvement is enjoyed by all customers and it forces some customers to pay the switching costs and some designers to pay for the adaptation costs, expenses that could be prevented in a more tolerant acquisition regime. The optimal merger regime, thus, will balance these two forces.

There is a parallel here to exclusionary conduct. If everyone expects the incumbent to use exclusionary contracts (or other anticompetitive behavior) to prevent customers from leaving its platform, this expectation alone will decrease the value of any new entrant. In turn, this will discourage entry. The point in our paper is that exclusionary conduct may occur by the very nature of online platforms, network externalities, and switching costs, without the incumbent engaging in explicit anti-competitive actions. Indeed, the very act of liberalizing the take-over regime can be anti-competitive. Importantly, the effects of some traditional anti-competitive actions can be magnified. For example, the creation of any artificial switching cost can have a disproportionate effect on deterring new investments.

Our model can help us think of policies that may increase innovation in digital platforms, if the concerns about a "Kill Zone" are warranted. Importantly, innovation increases if we increase interoperability across platforms (i.e., we make network externalities available to all). With

interoperability, the new entrant obtains the incumbent's network externalities. Consequently, platform competition will then be primarily on intrinsic quality differences, increasing the return to innovation. If there is a policy conclusion to be drawn from our model, it is this: interoperability across platforms helps resolve many of the distortions in digital platforms because it reduces the incumbency advantage from network externalities and switching costs.

The rest of the paper proceeds as follows. We discuss the evidence in section 1, outline the model in section 2, present the analysis in section 3, discuss alternative assumptions in section 4, discuss possible extensions in section 5, relate to the literature in section 6, and then conclude.

1. Evidence of a “Kill Zone”

To investigate the possibility of a “Kill Zone”, we would like to study the impact on start-up investments of a decision by antitrust authorities to strike down a big acquisition by a major digital platform. Unfortunately (for our analysis), we have not observed any such decision yet. Therefore, we need a different strategy.

We focus on completed acquisitions. All major acquisitions are reviewed by the US Federal Trade Commission (FTC). That a large transaction is not blocked sends a powerful signal that other similar transactions will be allowed in the future. In particular, we analyze the effects of Facebook and Google's acquisitions of large software companies from the beginning of 2006 to the end of 2018. We focus on Facebook and Google because they are two prominent incumbent multi-sided platforms that charge a zero monetary price to ordinary customers. We restrict attention to their major acquisitions because their clearing the FTC review conveys a stronger signal of the FTC's likely attitude towards similar acquisitions in the future. Finally, we focus on software companies because we are looking for start-ups that can develop into potential substitutes (or complements) to the incumbent platforms.²

² The model in the paper treats the entrant as producing a substitute to the incumbent. The logic of the model, however, holds if the entrant produces complementary services. Assume the complement company (DoubleClick, a company that displays and tracks banner ads across a network of websites) provides an essential service that makes the platform (Google) more attractive to users (in this case, advertisers). Assume that the platform already provides that service, but in a less effective way. If the platform is prohibited from acquiring the complement, users will switch for the particular complementary function to the complement producer, enhancing its value from the network externalities it obtains (in this case, the additional information it gets from diverse users to improve its product). If the platform can acquire the complement, potential switchers may be reluctant to incur switching costs, continuing to use the lower quality service provided by the platform until the acquisition takes place. Given that the complement is thus also lower quality as a stand-alone entity (having attracted fewer switchers and having less data to use in product development), its acquisition price will be lower than if mergers had been prohibited.

The source of our data is *Pitchbook*. We select all the software companies purchased by Facebook and Google for more than \$500M between 2006 and 2016. There are 9 acquisitions that satisfy these criteria: 7 by Google and 2 by Facebook. We list them in Table 1.

Pitchbook classifies venture capital financing according to two criteria: 1) Financing Stage, which classifies the stage of development at which a firm is financed (Accelerator/Incubator, Seed, Angel, Early Stage, Later Stage); 2) Financing Rounds, which track the sequential order of external financing. We focus on the first round of VC financing (which we will term *new deals*) as a proxy for new entries and also on investment in early stages (from Accelerator-Incubator to Early Stage).

For all nine acquisitions, we collect the *total dollar amount* invested by venture capital companies in start-up companies operating in the same “space” as the company acquired and the *number of VC deals* funded. We determine whether a start-up belongs to the same space as the acquired company (and is thus “treated”) based on a text-based measure of similarity produced by *Pitchbook*. Similar to Hoberg and Phillips (2016), *Pitchbook* applies a machine-learning algorithm to companies’ business descriptions to measure their degree of similarity.³

We collect data on similar startup companies (to the target) for each of 7 observation years for each of the 9 acquisitions – the 3 years before the acquisition year + the acquisition year + the 3 years after. So we should have data on similar start-up companies for 63 observation years.

In Figure 2a, we plot the normalized relative amount invested in treated companies, around an acquisition event. For each acquisition, we identify as “treated” the startups with an 80% or higher Pitchbook similarity (see above) to the company acquired. For each of the 63 observation years [= (3 years before+ acquisition year + 3 years after)*9 acquisitions], we sum the investment across treated startups. To adjust for cyclicalities as well as changes in overall financing conditions or economic outlook, this sum is deflated by the total investment made that year by venture capitalists in the software sector (defined by Pitchbook as belonging to the industry sector ‘software’). This ratio, which we label relative investment, is expressed in percentage terms. Since each acquisition has a different number of comparable “treated” startups, we normalize the seven annual observations of relative investment for each acquisition by the relative investment in the year of the acquisition. This normalized relative investment is therefore 1 in the year of the acquisition for all acquisitions. Then, we average these ratios across the nine events using event time, as is commonly done in event studies. As we can see from Figure 2a, the normalized relative level of investment drops over 40 percent in the three years following an acquisition.

As a comparison, we selected all software acquisitions (100% stake) other than those by Facebook or Google for more than 500M dollars between 2006 and 2016. There are 178 such acquisitions

³ <https://techcrunch.com/2018/06/19/pitchbook-now-offers-users-suggested-companies-when-they-search/>.

for which we have data. The software industry exhibits a strong downward trend of relative investment in the three years before an acquisition, a trend that is reversed in the three years after the acquisition, unlike the continued downtrend when a platform acquires.

In Figure 2b, we plot the normalized relative number of startup investments. The pre-event trend decline in the relative number of deals is not surprising. In early stages, VC investment rounds are more frequent (Gompers, 1995). As firms mature, rounds become less frequent: hence a decline in the raw number of deals. The pre-event decline, however, accelerates substantially after a Facebook/Google acquisition, as Figure 2b shows, in contrast to the normal acquisition in the software industry. While the normalized relative number of deals falls by over 20 percent in the 3 years following the Facebook or Google acquisitions, they are relatively flat for other software acquisitions.

These findings are substantiated in unreported regressions in the Internet Appendix C. Relative investments drop by 0.97 percentage points after acquisition. Given the average relative investment is 2.1 percent, this corresponds to a 46% drop in the three years after an acquisition. The relative number of deals drops by 0.85 percentage points after an acquisition in the same space. Given that the sample average is 1.7 percent, this is a 50% drop. All this suggests that there seems to be a phenomenon worth understanding.

2. The Model

Is it possible that the prospect of early acquisitions discourage entry? In a standard neoclassical model, the answer should be “No!”. In this section, we explore whether the presence of network externalities and switching costs might alter this answer.

Consider an incumbent platform I, which is threatened by a new entrant platform E. Without loss of generality, we will assume the quality of the incumbent is normalized to zero. The quality increment of the new entrant is θ , which could be negative. There are two sets of agents that are relevant to platforms: a continuum of *customers* with measure 1, and *app designers* with measure normalized to λ . All agents are risk-neutral and maximize expected utility, and the per-period gross discount rate is 1. The first period starts at date 0, and the life of the technology is T periods (we elaborate shortly). Dates -2 and -1 should be interpreted as just instants before date 0.

2.1. App designers and information

At date -2, everyone observes a common signal about E’s quality increment relative to I, where everyone’s posterior belief of quality after observing the public signal is distributed normally with mean q and precision α . This common signal includes the fact that the entrant has entered, as well as a plethora of

analyst reports and newspaper and magazine articles. Each app designer also sees a private signal of incremental entrant quality: $x_i = \theta + \eta_i$, where η_i is random noise, distributed normally with mean zero and precision β . We assume that at date -2, each app designer has adapted her app to the incumbent platform. So the key question is whether app designers will adapt their app to the entrant platform. If they choose to do so at date -2 after seeing the signals, they face a one-time incremental adaptation cost s . We assume for now that app designers can “multi-home” so if they chose to adapt to the entrant platform, they can still continue serving all their customers who remain on the incumbent platform.

2.2. Customers

At date -1, shortly after the app designer decision, customers make their choice of platform. They start on the incumbent platform. Customers do not have the time or patience to multi-home, so they want to be on only one platform. They care about the incremental quality of the entrant platform θ .

They also value having more app designers who produce apps for the platform they are on – this adds to the range of activities they can undertake on the platform and the number of other customers they connect to, and is thereby a source of network externalities. For example, there are thousands of very useful apps for Facebook, like Livestream, which allows you to broadcast live, Shopify that lets you share collections and sell products directly from your Facebook page, and Hootsuite Analytics that allows small businesses to track their social data.⁴

So the customer’s valuation of the entrant platform also goes up in the product of the total measure λ of app designers and the share p of app designers who decided to create apps for it. Overall, the customer’s per period incremental benefit from the entrant platform is $(\theta + \lambda p)$, where each of these are common knowledge at the time the customer makes his decision (we will explain how the customer learns θ later). Each customer i has a one-time cost of switching c_i which is distributed uniformly $[0, \bar{c}]$.

App designers clearly benefit from having additional customers on the platform they cater to. Each app designer sees the commercial value of a platform as the measure of customers who are on it.

2.3. Merger

We are interested in studying the effect of acquisitions on the incentives to enter. Thus, we assume that the intent to merge is announced at time 0 and the merger will take place only at time m , where the parameter m proxies for the liberality of the anti-trust regime. In a liberal anti-trust regime, the

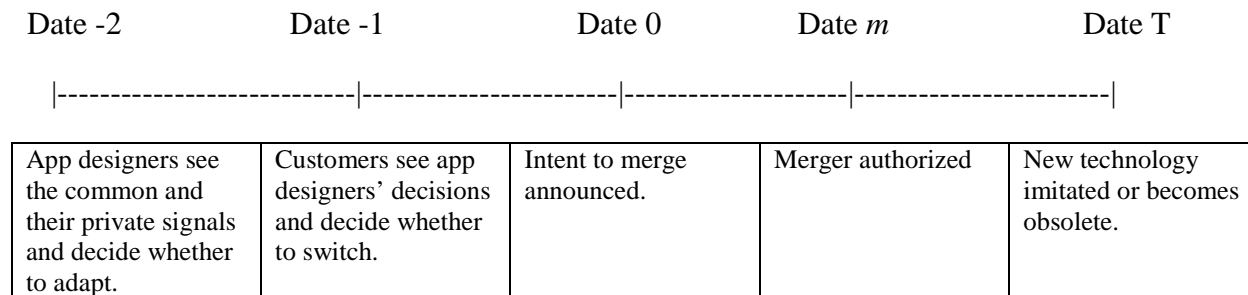
⁴ <https://www.socialmediaexaminer.com/15-types-of-facebook-apps/>.

anti-trust authorities impose few requirements on the candidates and bless any proposed merger quickly, while in a tough regime anti-trust authorities impose many requirements and take a long time to approve a merger. At the liberal extreme, m will be a low number. At the tough extreme, $m \geq T$, which indicates the authorities never approve over the useful life of the technology.⁵

The share of the merged value each party gets is determined through a bargaining process we will specify shortly. The companies, like the customers, know the true θ when they bargain. If they do merge, the superior technology – which is the entrant’s if $\theta > 0$ -- will be adopted by the merged entity at time m . The acquirer in the merger ensures a seamless interface for all apps, regardless of whether they adapted earlier or not, so adaptation costs are zero at that point. So are customer switching costs. All apps and their customers now enjoy the superior technology seamlessly.⁶

Note that T reflects the technology’s useful life before new innovation displaces it, or before imitation circumvents any patent protection. If the incumbent can copy the new technology right away, $T = 0$, and merger policy will be irrelevant. In what follows, we will assume the non-trivial case, $T > 0$.

The timeline is as follows



3. Analyzing the Model

We start by analyzing the customers’ switching behavior, which is based on their observation of the adaptation decision of the app designers. Then we determine the adaptation decisions by the app designers anticipating customer behavior, and given the information they see. We postpone discussion of the merger for later, assuming for now it always takes place in equilibrium given that it is ex post efficient to get all customers and designers on the same platform because of the presence of network externalities.

⁵ With a little notational complexity, we could have m be the probability of the merger being approved each period conditional on it not having been approved before, rather than the time to the merger. The qualitative results would be similar.

⁶ In equilibrium, the precise timing of the merger negotiations is not relevant. Adaptation and switching will take place anticipating that the merger will take place, and that the platforms will become seamless only at m .

In the presence of network externalities, choice is usually difficult to model because of the possibility of multiple equilibria – if the designer believes everyone will adapt to the entrant, she will expect more customers on the entrant platform, and hence has more incentive to adapt herself. If she believes no one will adapt, she has commensurately much lower incentive. To finesse the problem of possible multiple equilibria in the presence of network externalities, we use the technique of global games (for an excellent overview, see Morris and Shin (2003)).

3.1. Analysis of Customer Switching Behavior

The per period value to the customer from the entrant platform is $(\theta + \lambda p)$, and the value from staying with the incumbent platform is λ since all the apps are already there. Given the customer expects the merger to take place in m periods (when all customers and designers will move seamlessly to the same platform), he will switch only if $[(\theta + \lambda p) - \lambda]m > c_i$. In words, the per-period benefit multiplied by the time remaining before the merger should exceed switching costs. Given c_i is uniformly distributed

$U[0, \bar{c}]$, the mass of customers switching is $n = \text{Min} \left[\text{Max} \left[\frac{[(\theta + \lambda p) - \lambda]m}{\bar{c}}, 0 \right], 1 \right]$. The corner

solutions add notational baggage but little insight. So, for simplicity, we will assume parameter values

such that the mass of customers switching is interior and $n = \frac{[(\theta + \lambda p) - \lambda]m}{\bar{c}}$. This, of course, requires

$\theta > 0$, that is, the entrant has superior quality.

3.2. Analysis of Designer Adaptation Behavior

App designers have a posterior expectation q of θ after seeing the public signal. Combined with the private signal x_i they observe, each app designer i will have a posterior belief of the quality differential

with mean $\rho_i = \frac{\alpha q + \beta x_i}{\alpha + \beta}$ and precision $\alpha + \beta$. Designer i 's valuation per period of the entrant platform

is driven by the measure of consumers she expects will switch to it and is $\frac{[\rho_i + \lambda p(\rho_i) - \lambda]m}{\bar{c}}$, where

$p(\rho_i)$ is the share of designers she expects will adapt, given her belief ρ_i . So she will adapt if the benefits over m periods outweigh the adaptation cost, s ; that is, if

$$\left(\frac{[\rho^i + \lambda p(\rho^i) - \lambda]m}{\bar{c}} \right) m \geq s$$

Simplifying, we get the designer adapts if

$$\rho^i + \lambda p(\rho^i) - \left(\lambda + \frac{s\bar{c}}{m^2} \right) \geq 0 \quad (1.1)$$

3.3. The Date-0 Adaptation

The app designer's decision problem is typical for a global game (see, for example, Morris and Shin, 2000, 2003), and allows us to obtain a unique equilibrium.⁷ To solve it, we first conjecture that the designer will follow an adaptation strategy where they adapt if their expectation of the entrant's quality differential exceeds a threshold ρ^* . When a designer at the cusp of adapting observes a signal x_i (and thus has a posterior belief $\rho_i = \rho^*$) and chooses to adapt, she will have to assume that the fraction p that will adapt should have a posterior at least as high as hers. Since $\Pr\{\rho_j > \rho_i | \rho_i\} = 1 - \Pr\{\rho_j \leq \rho_i | \rho_i\}$, we need to determine the probability that $\rho_j \leq \rho_i$. Conditional on ρ_i , x_j will be distributed with mean ρ_i and

a precision $\frac{1}{\frac{1}{\alpha + \beta} + \frac{1}{\beta}} = \frac{\beta(\alpha + \beta)}{\alpha + 2\beta}$.

Thus, we can write $\Pr\{\rho_j \leq \rho_i | \rho_i\} = \Pr\left\{\frac{\alpha q + \beta x_j}{\alpha + \beta} \leq \rho_i | \rho_i\right\} = \Pr\left\{x_j \leq \rho_i + \frac{\alpha}{\beta}(\rho_i - q) | \rho_i\right\} =$

$\Pr\left\{\eta_j \leq \rho_i + \frac{\alpha}{\beta}(\rho_i - q) - \theta | \rho_i\right\}$. This simplifies to

$$\Pr\left\{\eta_j \leq \frac{\alpha}{\beta}(\rho_i - q) | \rho_i\right\} = \Phi(\gamma(\rho_i - q))$$

where Φ is the cumulative standard normal distribution and $\gamma = \sqrt{\frac{(\alpha + \beta)}{(\alpha + 2\beta)} \frac{\alpha^2}{\beta}}$.

For $\rho^i = \rho^*$ to be the adaptation threshold, a necessary condition is that

$$\rho^* + \lambda p(\rho^*) - \left(\lambda + \frac{s\bar{c}}{m^2} \right) \geq 0 \quad (1.3)$$

or

$$\rho^* + \lambda \left(1 - \Phi(\gamma(\rho^* - q)) \right) - \left(\lambda + \frac{s\bar{c}}{m^2} \right) \geq 0 \quad (1.4)$$

⁷ We structure it as a global game to obtain a unique solution. Without the global game structure we would have to focus on an arbitrarily chosen equilibrium.

$$\rho^* - \lambda \Phi(\gamma(\rho^* - q)) - \frac{s\bar{c}}{m^2} \geq 0 \quad (1.5)$$

Let $S(\rho) = \rho - \lambda \Phi(\gamma(\rho - q)) - \frac{s\bar{c}}{m^2}$. For $\rho^i = \rho^*$ to be the adaptation equilibrium, it should be the case that $S(\rho)$ is increasing in ρ given the parameters (q, m) .

Theorem 1: For $\gamma < \frac{\sqrt{2\pi}}{\lambda}$, the function $S(\rho)$ is always increasing in ρ given (q, m) and there is a unique adaptation equilibrium.

Theorem 1 provides the necessary condition for the existence of app designers' unique adaptation equilibrium (see Internet Appendix A for the proof). Intuitively, provided that the private signals of the app designers are precise enough (β is high relative to α), every app designer follows the adaptation strategy at the critical value ρ^* . The condition here is similar to the one in Morris and Shin (2003) for the existence of an unique equilibrium.

3.4. Merger Regime and Comparative Statics

We are interested in how changes in the merger regime affect outcomes, with a lower m implying a more liberal merger regime. In Figure 3, we plot the optimal adaptation point and the fraction of app designers adapting to the new technology as a function of q for different merger regimes m . For a given m , we can see that as q (i.e., app designers' quality expectation) increases, app designers start to adapt at lower levels of their private signal, since a stronger public signal of quality will induce adaptation even when the private signal is weaker. Furthermore, for a given q , the optimal adaptation point decreases as m increases since more app designers adapt for any given q . Figure 3 immediately suggests Corollary 1.

Corollary 1: The optimal adaptation point decreases and the fraction of app designers adapting to the new technology increases in the app designer expectations of quality q and in the number of periods m that the app designers expect the entrant to remain independent.

Proof: See Internet Appendix A.

Intuitively, the longer the entrant platform will remain independent, the more app designers will switch to the entrant for a given app designer quality expectation q (as long as q is positive). This larger fraction of app designers adapting increases customers' valuation of the entrant's platform. Of course,

independent of the network externalities produced by the app designers, an increase in m also increases the measure of ordinary customers that will switch to the entrant, since they too can amortize switching costs over more periods. This increase in the measure of ordinary customers implies an even greater incentive for app designers to adapt. Thus, an increase in the time till the merger has a mutually reinforcing effect on app designers to adapt and customers to switch.

3.5. Learning from Observing Adaptation

We have assumed that customers see the public signal and the number of app designers that adapt, p , and then make their decision. Note that an app designer i adapts if $\frac{\alpha q + \beta x_i}{\alpha + \beta} > \rho^*$, so that x_i is above the critical value $x^*(\rho^*, q) = \frac{\alpha + \beta}{\beta} \rho^* - \frac{\alpha}{\beta} q$. Since $x_i = \theta + \eta_i$, the observed extent of adaptation $p(\theta) = 1 - \Phi(\sqrt{\beta}(x^* - \theta))$. Thus observing p and knowing q , the public signal, and hence x^* , customers can back out θ -- essentially, any noise in app designers' private signals is smoothed out in the aggregate. Importantly, customers' can infer θ from the app designers' behavior only if the app designers' decision to adapt is affected only by the information the app designers have. If app designers were paid to adapt (see discussion in Section 4.4), customers would be unable to infer θ .

3.6. The Bargaining over the Merger: No Breakdown

Let us now turn to the merger negotiations after adaptation and switching decisions are made. The platform service is given for free to ordinary customers in exchange for their data. Thus, a platform's profits derive from the revenues a platform can get on the advertising side. In turn, the value of a platform to advertisers is a function of the number of customers a platform has: more customers on the platform means more eyeballs that will see the advertisement. More customers also mean more data for the platform and thus better targeted advertising. Recall that the number of customers that switch is

$n^E(p, \theta, m) = \frac{[\theta + \lambda p - \lambda]}{\bar{c}} m$, where p , the number of designers that adapt, is endogenous, and

increasing in q and m . Suppose advertisers pay a platform with n customers $\psi(n)$ for each customer they have access to, where ψ is increasing in n . So if the entrant is assumed to go it alone for the remaining $T-m$ periods and not merge, its value (this value will be important in the merger negotiations) is given by

$$V^E(p, \theta, m, T - m) = \psi^E \cdot n^E \cdot (T - m),$$

where $\psi^E = \psi(n^E)$. Clearly, $\frac{dV^E}{d\theta} > 0$. Thus, the stand-alone value of the platform to advertisers need not be a direct function of the quality of the platform θ , which only affects customer experience, but it may be an indirect function through the number of ordinary customers the platform can attract.

Similarly, the value of the incumbent when a new entrant captures n^E customers is given by

$$V^I(p, \theta, m, T - m) = \psi^I [1 - n^E] (T - m),$$

where $\psi^I = \psi(1 - n^E)$. Finally, let $V(1, m) = [\psi(1)](T - m)$ be the present value of the profits that a merged platform with all the customers gets in the advertising market after a merger at date m .

Since ψ is increasing in the number of customers on a platform, $V(1) > V^I + V^E$, and the two platforms are better off merging. Since both I and E know θ , bargaining will take place under symmetric information and thus it will lead to the efficient outcome. The only question is at what price.

In the bargaining, we assume that with probability μ the incumbent makes a take-it-or-leave-it offer to the entrant. With probability $1 - \mu$, it is the other way around. So μ is the bargaining power of the incumbent. The entrant's payoff in case of merger at m is

$$\Pi^E(p^m) = \mu V^E(p^m) + (1 - \mu)[V(1, m) - V^I(p^m)],$$

where p^m is the adaptation induced by the merger regime m , that is, based on the app designers' assumption that the merger would have taken place at m . In addition, of course, they get their stand-alone valuation for the m periods before the merger takes place of $\psi^E \cdot n^E \cdot m$. So the entrant's total value on entry is $\psi^E \cdot n^E \cdot m + \Pi^E(p^m)$.

One case where it is easy to see outcomes is when ψ' is very small so that ψ is virtually a constant. In that case, there is little surplus created by the merger, bargaining power becomes irrelevant, and each platform gets its outside option in the merger negotiation. The entrant then gets $\psi n^E T$, which clearly increases in m because n^E increases in m .

For the more general case where ψ' is not small, we can still easily see the consequences of two extreme cases. Suppose $m = 0$ so the merger regime is very liberal. In that case, no designer will adapt, no customer will switch, and the entrant's stand alone valuation V^E is zero. Since $V^I = \psi(1)T$, which exactly equals $V(1, 0)$, the entrant's payoff, $\Pi^E(p^0) = 0$. Since the merger takes place immediately, the entrant's total value is also zero.

Importantly, advertisers do not care about the quality improvement directly, they care only about eyeballs. So if the entrant fails to attract any customers, the incumbent controls access to all customers, and gets the entire surplus no matter what the incumbent's bargaining power.

At the other extreme, we have $m = T$ so that no merger is allowed over the life of the technology.

In that case, the entrant gets $\psi^E \left[\frac{\theta + \lambda p^T - \lambda}{\bar{c}} T \right] T + 0$ where the term in square brackets is the number of customers the entrant attracts, and ψ^E is evaluated at that number. Note that the number of customers the entrant attracts, and hence the entrant's stand-alone value, is maximized by prohibiting mergers. If the entrant's bargaining power $1 - \mu$ is zero, the entrant's stand alone-value is the entrant's merger payoff, so a prohibition on mergers maximizes the entrant's payoff. When the entrant's bargaining power is not zero, however, the entrant's payoff depends also on the joint value created in the merger. In this case, the entrant's payoff is not necessarily maximized at $m > T$.

The important point, however, is that entrants who anticipate being acquired have to focus not just on the incremental new technology they bring to the merger but also on ways to preserve their standalone value (so as to extract more in the merger negotiations). In our model, that stand-alone value is augmented by the customers they attract. Interestingly, though, the stand-alone value need not enhance the combined value, and any costly action taken to augment the stand-alone value is wasteful rent seeking. Nevertheless, it may be necessary to enhance the acquisition price and thus increase the incentives for innovation.⁸

3.7. Ex Ante Investment

Thus far, we have assumed that the entrant's technological improvement θ was manna from heaven. More realistically, this improvement is the result of some ex-ante investment in innovation made by the potential entrant.

Let us assume the potential entrant draws quality improvement θ which is distributed between $\underline{\theta}$ and $\bar{\theta}$ according to pdf $\omega(\theta)$.⁹ After observing θ , the entrant decides whether to pay the investment cost

⁸ The additional cost of such entrant actions to protect their property rights, including possibly wasteful innovation around the incumbent's patents so as to be able to create a standalone business, would imply that the cost of innovation is lower to the incumbent than to the entrant; the latter has to go the extra mile to extract a higher acquisition price from the incumbent. This is one more reason why permitting mergers tends to favor the incumbent.

⁹ Nothing hinges on the entrant knowing the exact value, the entrant could well just learn the distribution, though this would complicate the algebra. We assume in this analysis that all the public information contained in the entry decision is unearthed by analyst reports and journalist columns, so the distribution of q given θ is not affected by entry, or the merger regime. Put differently, suppose Δ^m is the information revealed by entry given the merger

C^E and enter the market. Since the value captured by the entrant depends on the app designers' posterior expectation of quality q , a random variable, the entrant decides to enter the market if the expected value of entry (expectation taken over the distribution of q given m and θ) is greater than the investment cost. So for any given m and θ , the entrant enters if

$$E_q \left[\psi^E \cdot n^E \cdot m + \Pi^E(p^m) \right] \geq C^E.$$

The expression on the left-hand side is increasing in θ . So let Θ^m be the threshold value of θ at which the left-hand side equals C^E . Figure 4 presents the value captured by the entrant as a function of the quality improvement θ for different merger regimes. These are plotted for two different values of incumbent bargaining power μ . Note that for high values of θ , the entrant value increases with m , regardless of whether incumbent bargaining power is low or high. With sufficiently high quality improvement, the stand-alone value enables the entrant to grab a significant share of the surplus generated by the merger, and we have already seen that it increases in m .

In contrast, for low values of θ , the effect of merger regime on the entrant value depends on incumbent bargaining power for a given investment cost C^E . As m increases, the stand-alone value increases as does the number of periods for which it is the sole determinant of entrant value, while the share of value contributed by the surplus generated by the merger decreases as the number of periods during which the entities are merged falls. The higher the incumbent's bargaining power, the more stand alone values matter even in this phase. This is why a strong anti-trust regime (high m) enhances entrant value and entry more clearly when the incumbent's bargaining power is high ($\mu = 0.8$) than when the incumbent's bargaining power is low ($\mu = 0.2$). Overall, however, the value captured by the entrant is not monotonic in the merger regime m for low levels of θ .

Figure 5 presents the threshold Θ^m as a function of merger regime for different values of incumbent bargaining power. Intuitively, the higher the bargaining power of the incumbent, the higher is the quality threshold for the entry and this detrimental effect of incumbent bargaining power on entry substantially increases when merger regime becomes relatively liberal. Also, provided that the incumbent bargaining power is sufficiently large, entry decreases as the merger regime becomes more liberal. Theorem 2 formally presents these results.

regime m and P is the public information revealed by analysts and media, then we assume that $\Delta^m \subset P$ for all m so that $E(\theta|\Delta^m, P) = E(\theta|P) = q$ and $\sigma(\theta|\Delta^m, P) = \sigma(\theta|P) = \frac{1}{\sqrt{\alpha}}$. Additionally, the entrant has no credible way of signaling quality to the app designers – indeed, the public signal is the best the entrant can do.

Theorem 2: (a) Given investment cost C^E , there exists a $\hat{\mu} \in [0,1]$ such that for incumbent bargaining power $\mu > \hat{\mu}$, the threshold quality improvement for entry Θ^m decreases as m increases. (b) For any given merger regime m , the threshold quality improvement for entry, Θ^m , decreases as the incumbent's bargaining power μ decreases.

Theorem 2 implies that entry decreases with a more liberal merger regime when incumbent bargaining power is sufficiently high, and entry decreases when the incumbent bargaining power increases for any given merger regime. This result immediately suggests corollary 2 (see proofs in the Internet Appendix A).

Corollary 2: For incumbent bargaining power $\mu > \hat{\mu}$, a more liberal merger regime will reduce entry.

3.8. Welfare

Consider the decision a benevolent planner would make. While benevolent planners rarely exist, this provides a useful benchmark to analyze the impact of alternative rules. Benevolent planners care about the customer enjoying the quality improvement. If they could control the decision to enter and also enforce mergers, they would compel entry if $\theta T \geq C^E$, that is for all $\theta \geq \theta^{FB} = \frac{C^E}{T}$ and force an

immediate merger. Social welfare is $T \int_{\theta^{FB}}^{\bar{\theta}} \theta \omega(\theta) d\theta$.

If the benevolent planner cannot control the entry decision directly, they can do so indirectly by changing the merger regime m . Note that entry may be excessive if advertisers see substantial value ψ in reaching consumers and are willing to pay for it (this is at best a transfer and hence not something the planner cares about). It is easy to see that there are situations where $\theta^{FB} > \Theta^m$, that is, in the market equilibrium there is too much entry. In such a situation, if the conditions of Theorem 2 apply and Θ^m decreases in m , the social planner will want to make the merger regime more liberal.

Even if $\theta^{FB} < \Theta^m$, that is, the socially optimal quality threshold for entry is lower than the privately optimal quantity of entry, it is not always the case that the social planner wants to increase m (assuming the conditions of Theorem 2 where Θ^m decreases in m prevail) because m has three additional effects. First, with a positive m , the quality improvement is enjoyed by all customers only for $T - m$

periods. Second, for the first m periods the quality improvement is enjoyed only by $n^E \leq 1$ customers.

Third, $p^m \lambda$ designers incur the adaptation cost s , and customers incur switching cost

$\frac{[(\theta + \lambda p^m - \lambda)m]^2}{2\bar{c}}$. So social welfare is

$$\int_{\Theta^m}^{\bar{\theta}} E_q \left[(mn^E + (T - m))\theta - p^m \lambda s - \frac{[(\theta + \lambda p^m - \lambda)m]^2}{2\bar{c}} \right] \omega(\theta) d\theta$$

In the extreme case of the entrant having no bargaining power, a higher m increases the entrant's profits and therefore entry, but also postpones the time when all customers can enjoy the quality improvement (though it also increases the number of customers who enjoy the quality improvement pending merger). It also forces more designers to spend adaptation costs as well as more customers to incur switching costs. While a zero m can be ruled out because it would imply zero entry, the optimal m from the benevolent planner's perspective will differ based on parameters. In what follows, we compare social welfare under the first best with social welfare when entry is endogenous for a specific set of parameters with different values of μ and m .

As Figures 6 and 7 show, the optimal m depends very much on the incumbent's bargaining power. If the incumbent's bargaining power is low, the optimal merger regime is a very tolerant one (low m). By contrast, if the incumbent's bargaining power is high, the optimal merger regime is a very restrictive one (high m). If the incumbent has very high bargaining power, it is optimal in this specific example to prohibit mergers ($m \geq T$). In Internet Appendix B we show the robustness of these results to changes in the basic parameter values.

3.9. Determinants of Bargaining Power

Given its criticality to the efficiency of outcomes, what can we say about the incumbent's bargaining power? First, in a standard Rubinstein (1981) game, each party's bargaining power is inversely related to its degree of impatience or effective discount rate. The cost of capital of an incumbent – having undertaken a successful and often lucrative IPO, and enjoying a high stock price, is much smaller than the cost of capital of an entrant. This difference alone could explain why μ might be high.

Another important factor in determining the degree of impatience is the threat of replication. If the incumbent has the ability to copy the new entrant's innovation, the longer the period over which bargaining takes place, the higher the risk of replication. This increases E's impatience and thus I's bargaining power.

In many real-world situations, negotiations take place under the veiled (and sometimes not so veiled) threat by the incumbent to drive the entrant out of business with aggressive behavior if it does not sell out. The incumbent's threat is maximized when it can easily replicate the technological features of the new entrant. But even without this possibility, there are many ways in which an incumbent can make the new entrant's life difficult: from slashing prices on the revenue side of the platform to using its lobbying power. Most (if not all) these behaviors could be deterred by an active antitrust authority, but the recent record on this front in the United States has been quite weak.¹⁰ The awareness of this record can only increase the incumbent's bargaining power.

Last but not least, in the presence of network externalities, markets tend to be winner-take-all. Thus, the risk for any participant is not to be worth less: it is to be worth zero. Entrants are less suited to bear this risk, since they tend to have a more concentrated ownership structure than established incumbents whose shareholders are better diversified. This comparative disadvantage in bearing the risk of failure further weakens the entrant's bargaining power vis-à-vis the incumbent.

Finally, a caveat. Notice that within our model a lower incumbent bargaining power μ will always improve efficiency, since it will not affect decisions ex post, but it will increase entrant investments and entry ex ante. This might not be true in a general model, where the incumbent also invests in innovation. Furthermore, any incumbent is a former start-up, thus the model should not be taken literally as suggesting minimizing μ is optimal.

3.10. The Bargaining over the Merger: What if the talks break down?

Clearly, if a merger will take place at date m , neither the customer nor the app designers have any decisions to make. What about the out-of-equilibrium possibility that bargaining breaks down and the merger does not take place? The merger may collapse because of a breakdown in the bargaining or because of some glitches in the merger approval process. Let us assume that the news about a breakdown becomes public knowledge at m .¹¹ If so, the companies will survive a further $T - m$ periods independently with their different technologies.

If the merger talks break down, we assume the incumbent and entrant will not enter into merger negotiations again, and this fact is abundantly clear to all designers and customers.¹² If so, customers who

¹⁰ See, for example, the battle between Quidsi and Amazon detailed in Khan (2017) and Stone (2013).

¹¹ This timing seems most natural, especially if the terms of the deal are not clear until the anti-trust authorities impose all their conditions, but the model could easily accommodate a breakdown time other than m also.

¹² Typically, parties engaged in merger negotiations rarely get back together once the talks break down. Merger negotiators often say the trust is irretrievably broken. At any rate, any "outside option" bargaining game simply assumes that talks break down irretrievably if any party goes for its outside option. Interestingly, if parties resume at short intervals to restart the negotiations, and everyone finds it credible that they aim to reach a resolution, then no

have not switched will have to decide whether to switch to the entrant. Importantly, no customer will switch back to the incumbent; when they switched with full information soon after date 0. The benefits of switching then were sufficient to outweigh the switching costs, and the benefits to staying switched will continue to be positive. However, designers who have not adapted to the entrant will have to decide whether to adapt, and then customers who have not switched to the entrant will have to decide whether to switch.

The circumstances under which these decisions will be made will differ from those at date 0. First, the technology is now available for the remaining life $T-m$, which will differ from the merger horizon m that figured in decisions earlier. Second, customers with low switching costs have already migrated to the entrant platform. Thus, only customers with higher switching costs still have to choose. Third, customers, having spent more time on the incumbent platform and gotten used to it, will have higher switching costs, which we assume to be $C(m)c_i$ where $C(0) = 1$ and $C' > 0$. Fourth, when customers moved to the entrant platform at date 0, they either reconnected with their existing apps on the new platform, or found new substitute ones if their favorite apps had not adapted. If an app designer on the incumbent platform chooses to adapt now, it will be hard for them to attract customers who moved earlier. We assume that the per-period benefit to an app designer who adapts after the merger talks break down is ϕ times the measure of customers who switch after the merger talks break down, where $\phi \leq 1$. Put differently, the new adaptors can target new switching customers, but prior switchers have made their allegiances to apps. Of course, earlier adaptors may also be able to target new switchers as they come to the entrant platform. If so, $\phi < 1$.

In what follows, we obtain sufficient conditions for no additional switching or adaptation to be the unique equilibrium. The marginal customer who did not switch at date 0 had switching cost $[\theta + \lambda p - \lambda]m$, which is now multiplied by $C(m)$. The remaining life of the technology is $T - m$, and the per-period benefit from switching if no new designer adapts is $[\theta + \lambda p - \lambda]$. So assuming no additional designer adapts, no customer switches when merger talks break down if $T - m \leq mC$, that is, if $T \leq m(C + 1)$. And if no customer switches, no additional designer wants to adapt. So no switching and no adaptation is an equilibrium if $T \leq m(C + 1)$.

What is a sufficient condition for this equilibrium to be unique? Let us conjecture a post-bargaining-breakdown equilibrium where p^+ designers in all adapt to the entrant platform. The value of a

new customer will switch and no additional designer will adapt, given the short interval and sizeable switching and adaptation costs.

customer switching for the remaining life of the technology is $[\theta + \lambda p^+ - \lambda][T - m]$. This, divided by $C(m)$ then will represent the date-0 switching cost of the marginal customer who switches post

breakdown, so the measure of new switchers is $\frac{[\theta + \lambda p^+ - \lambda] \frac{[T - m]}{C(m)} - [\theta + \lambda p - \lambda] m}{\bar{c}}$. So a sufficient

condition for no additional designer to adapt is $\phi \left(\frac{[\theta + \lambda p^+ - \lambda] \frac{[T - m]}{C(m)} - [\theta + \lambda p - \lambda] m}{\bar{c}} \right) < s$, where

ϕ is the share of switching customers the designer can hope to get. Since the incentive to adapt is maximized when the maximum new customers switch, and the maximum new customers switch when the maximum designers adapt so that $p^+ = 1$, there is no post-breakdown equilibrium where a designer adapts if $\theta \frac{[T - m]}{C(m)} - [\theta + \lambda p - \lambda] m < \frac{s\bar{c}}{\phi}$ or $T \leq m(C + 1) + \left[\lambda(p - 1)m + \frac{s\bar{c}}{\phi} \right] \frac{C}{\theta}$. If we want a condition free of endogenous parameters, we would set $p = 0$ in this condition to get a more stringent sufficient condition that works for all p , which gives us the condition $T \leq m(C + 1) + \left[\frac{s\bar{c}}{\phi} - \lambda m \right] \frac{C}{\theta}$. It is a weaker condition than $T \leq m(C + 1)$ if the term in square brackets on the right hand side is positive, that is if adaptation costs s are large, customer switching costs have a high range \bar{c} , or ϕ is small (indicating late adapters find it very difficult to attract customers on the new platform when competing with early adapters).

Corollary 3: (i) If $T \leq m(C + 1)$ there is an equilibrium where there are no additional switches or adaptation after the merger talks break down. (ii) If $T \leq m(C + 1) + \left[\frac{s\bar{c}}{\phi} - \lambda m \right] \frac{C}{\theta}$, this is the unique equilibrium.

Note that a very small m will make it hard for condition (i) to hold if C is not large or technological advances are not very quick. Yet in practice, a minimum m is required for anti-trust authorities to do the necessary due-diligence, even if they want to promote mergers. To the extent the time for minimal diligence is measured in quarters or even years, condition (i) will hold in a reasonably fast moving young industry, which is our focus.

Corollary 3 states the conditions under which the dynamics of the game after a merger breakdown is straightforward – no customer or designer alters their earlier decisions after breakdown when the remaining life of the technology is not long relative to the pre-merger period. The longer the time to the merger approval, the more those customers who want to switch will do so, while customers who do not switch will become more attached to the incumbent platform. Conversely, the less the remaining life of the technology, the less switching will occur after a breakdown in talks. Given no customer switches (especially if C is high), no designer will adapt either, especially if the adaptation cost s is high, or the designer’s ability to attract late-switching customers, ϕ , low. In our analysis, we have assumed the conditions of corollary 3 hold.

4. Alternative Assumptions and Robustness

We have made a number of assumptions in deriving our results. They include (i) app designers face adaptation costs, (ii) customers face switching costs, (iii) customers care about network externalities, (iv) the platforms are multi-sided. Which of these assumptions are crucial for the results, and which ones are for plausibility? Would alternative assumptions also work? These are the questions we turn to in this section.

4.1. Costs

Clearly, the key channel through which a more liberal merger regime (a lower m) works is through the shortening of the period in which adaptation or switching costs are amortized. If customers have zero switching costs, then they all switch to the entrant after observing date-0 designer adaptation iff $\theta + \lambda p - \lambda \geq 0$. While the problem for the app designer becomes harder to solve (the app designer adapts if $\text{Prob}[\rho_i + \lambda p(\rho_i) - \lambda > 0] \geq \frac{s}{m}$) it has a similar structure, and our results on a liberal merger regime discouraging innovation will continue to hold.

Customer switching costs matter in our set up primarily in eliminating the possible flip-flopping of customers between platforms in the out-of-equilibrium possibility that bargaining breaks down. If customers choose once and for all, positive customer switching costs are not essential to our analysis.¹³ However, if designers also have zero adaptation costs, then the last term in this inequality is zero, m no longer appears in the inequality describing the app designer’s decision, and the key channel through which a liberal regime discourages innovation is shut off. Thus positive designer adaptation costs are necessary.

¹³ For many new products (say a book or a platform), the maximum interest is during the early buzz when customers are willing to find out more about it, hence the marketing adage “You never get a second chance to make a first impression.” Given this, it is plausible that having chosen at the early stage, customers do not choose again.

4.2. Network Externalities

What about the assumption that customers care about network externalities? If customers did not care about network externalities (that is, the measure of app designers on a platform), the app designer's adaptation decision would not matter to them. Customer i would switch if $\theta > \frac{c_i}{m}$. Thus, the liberality of the merger environment would still play a role in their decision to switch to the new entrant, but only through their own switching cost, c_i . Thus if customers switching costs are all zero, the liberality of the merger environment would not have an effect on the entrant platform's ability to attract customers in the absence of network externalities.

4.3. Assumptions about the app designers

We could consider alternative interpretations for the app designers. App designers are isomorphic to content creators or influencers who will adapt their content to the entrant platform if their expectation of the quality of the entrant platform is high enough. Think about the decision of Instagram influencers whether to create content also for TikTok. App designers could also be technology influencers: technologically sophisticated customers whose early adoption verifies the quality of the entrant platform. In this case, their adoption transmits their information to ordinary customers, while contributing to network externalities by being customers themselves.

We have assumed that the app designers can multi-home. Our model can easily handle the case when they cannot. The ordinary customer switches now if $[(\theta + \lambda p) - \lambda(1 - p)]m > c_i$, where the incumbent's quality is no longer λ but $\lambda(1 - p)$, the measure of designers that choose to stay. The rest of the derivation of the threshold adaptation point is straightforward. Importantly, the incumbent has less of an advantage, and, ceteris paribus, the threshold adaptation point is lower.

4.4. Assumptions for plausibility.

Some assumptions in the model are for plausibility. For instance, nothing requires the public signal q to be informative, though it allows us to capture the effect of a public perception about the entrant's quality. The private signal that designers get, though, has to be somewhat informative, else it would simply be ignored, and we would not get an unique equilibrium.

4.5. Multi-Sided Platforms

We have assumed multi-sided platforms. Clearly, different users -- app designers, advertisers, and ordinary customers – see different aspects of the platform. Importantly, that the platform is multi-sided explains why a group of users does not internalize what the platform does with another group. For instance, if the platform harvests more data and is able to sell targeted ads at a higher price to advertisers, the welfare of ordinary consumers is not affected. This is consistent with the apparent behavior of most customers, who do not perceive the cost of giving away their data.¹⁴

Implicit in this separation is the idea that the entrant platform cannot charge a negative price, that is, subsidize app designers to join them (and thus attract customers). There are a number of reasons why we think the entrant will not offer to pay the adaptation cost for any app designer willing to adapt.

First of all, customers learn from app designers' adaptation decisions. If those decisions are paid for, the app designers lose their role in transmitting information about quality. In standard models of advertising (Nelson (1970, 1974)) the cash burned in ads signal the quality of the product. Here it is the opposite. Without any cash payment, the information naturally flows to customers. The introduction of cash payments destroys the credibility of the information flow, making entry much more costly. Indeed, with the highest quality entrants most inclined not to pay so as to maximize the credibility of the designers' decisions, lower quality entrants will be tempted to follow suit.

There are also many practical reasons why payments are not so easy to organize. In practice, different designers will have different adaptation costs, something we have assumed away for simplicity. A uniformly high flat payment will be very costly, a uniformly low payment ineffective in attracting designers, and one targeted at reimbursing specific costs may be hard given the information requirements. Furthermore, the incumbent is unlikely to sit quietly – it will offer to match the offer or even pay more if a designer does not adapt, reinstating or even effectively increasing adaptation costs. The deep-pocketed incumbent has far more ability to succeed at this game.¹⁵ Put differently, the cheapest way for the entrant to attract app designers and customers may be to build a better quality platform.¹⁶

¹⁴ Here we assume that targeted ads increase the efficiency of advertising, without affecting the welfare of the people targeted. We could also assume that the platform extracts back some fraction of the utility customers get by giving advertisers access. So long as the fraction is not greater than or equal to 1, and so long as it is constant across platforms, we could allow ordinary customers to internalize the cost of advertising without changing the results qualitatively.

¹⁵ In particular, suppose that after paying the cost C^E to enter the market, the entrant will engage in Bertrand competition with the incumbent to pay the app designers. Given the status quo advantage (as well as the larger capital hoard) the incumbent enjoys, the new entrant would have to pay a large share of its ex-post profits to defeat the incumbent. This payment will greatly reduce (and possibly eliminate) the profitability of the project, leading to less innovation and entry.

¹⁶ One question is why the new entrant will not vertically integrate with the app developers. The main reason why it might not be efficient for the new entrant to own the app designers is that when they are independent the choice of these app designers to join the new platform provides a signal to consumers about the quality of the platform. In

Also, if the flat fee is attractive, a number of “fake” app designers will create nonsense apps for the platform in order to collect fees. Screening out such fake designers will, once again, require a costly administrative structure that the incumbent is more able to afford than the entrant. To be sure, the entrant can freeride on the screening by the incumbent by paying only those designers that have demonstrated success on the incumbent’s platform. However, it is precisely these designers who can be bribed most easily to stay back with the incumbent.

An alternative is to pay app designers based on performance (contingent pay). That is precisely the nature of the current payoff structure, where the designer’s payoff is based on the customers the platform attracts. Of course, the entrant platform could pay designers more than what they would ordinarily earn, but this could create a costly war with the incumbent. Furthermore, the entrant may end up paying for app designers who might be content with the non-pecuniary benefits of reaching large audiences.

Broadly, therefore, paying for adaptation (or for non-adaptation) will tend to benefit the incumbent rather than the entrant. Flat payments will not eliminate our effect, especially if the incumbent can match or even exceed them. Contingent payments work better but have to go beyond what a designer can naturally earn to make a difference.

This is not to say that clever ways of paying for adaptation cannot be identified. The internet browser Brave has launched a reward system to pay customers for using its product and watching its ads.¹⁷ To get around the afore-mentioned problems, Brave chose to pay users with its own cryptocurrency called Basic Attention Tokens or BAT. BATs are utility tokens that are not convertible into dollars, but can be used to buy ads from Brave at a pre-determinate price. The idea is that their value will increase with the use of the browser. If – in addition—these tokens are traded, their values can signal to unsophisticated customers the value of the new technology. Indeed, Li and Mann (2019) have shown that token offerings can help mitigate coordination problems. Of course, with ordinary customers, there is no separate signaling through their choice, unlike with our designers. Paying designers with tokens could erode the signaling value of their choice, as much as paying them with money will.

5. Related Literature

fact, in the model, we assumed that by observing the app designers’ decisions the consumers can infer the true θ . If app designers were vertically integrated, there would be no signal and consumers would have little idea about the quality of the new entrant. Thus, an integrated new entrant would have to spend a lot on advertising (see discussion above). Thus, an advantage of non-integration is the saving in ad expenses. Of course, there are many other reasons why integration could prove costly, including dis-incentivizing designers from innovating, as in a Grossman and Hart (1986) model.

¹⁷ <https://www.wired.com/story/brave-browser-will-pay-surf-web/>.

Schumpeter (1934, 1942) are, of course, the seminal contribution to the study of incentives to innovate and compete. He noted, among other effects, the possibility that the incumbent monopolist has a lower incentive to innovate for fear of cannibalizing its existing technology, a higher incentive to innovate for fear of losing the monopoly entirely, and a greater incentive to innovate given the size of the market it has access to. Aghion et al. (2005) subsequently argue for an inverted U-shaped relationship between competition and innovation.

The classic analysis of the effect of antitrust enforcement on incentives to innovate is Segal and Whinston (2007). In their model, where there are no network externalities, voluntary licensing agreements (and equally mergers) raise both parties' payoffs and thus increase innovation. In this framework, Cabral (2018) introduces the distinction between radical innovation (competition for the market) and incremental innovation (competition within the market). He shows that antitrust restrictions on acquisitions (or technology transfers) can lead to lower incremental innovation but higher radical innovation. The negative impact of mergers on radical innovation, however, comes from an "opportunity cost" effect. By increasing the payoff of incremental innovation, mergers reduce the additional payoff of radical innovation. Callander and Matouschek (2020) reach a similar result by focusing on rent seeking. With incremental innovation, the entrant's product is closer to the incumbent's business, and is more liable to be taken over when mergers are allowed (so that the incumbent can shut down a competitive threat). In our model we only have radical innovation. Nevertheless, mergers can reduce the incentive to innovate because of the impact they have on the difficulty of attracting customers away from the incumbent.

On the empirical side, Phillips and Zhdanov (2013) provide evidence consistent with the idea that a more active market for mergers and acquisitions encourages innovation by small firms, while enabling larger firms to optimally outsource R&D to them. By contrast, Seru (2014) finds that firms acquired in diversifying mergers tend to reduce the scale and novelty of R&D activity relative to potential targets that escaped being acquired. He finds that the effect stems from inventors becoming less productive after mergers, and associates it with the centralized nature of conglomerates reducing incentives to innovate. Phillips and Zhdanov reconcile their results with Seru's by arguing that large firms (such as conglomerates) have lower incentives to innovate, and prefer acquiring innovative small firms, and this may be an appropriate division of labor. Our paper, of course, focuses on a subset of acquisitions – specifically, platform acquisitions – and explains why the analysis and outcomes may be different there.

Cunningham, Ederer, and Ma (2021) examine acquisitions by pharmaceutical companies and find that acquired drug projects are less likely to be taken to full development when they overlap with the acquirer's existing drug portfolio, especially when the acquirer faces limited competition and has a long time to expiry on existing drug patents. While such "killer acquisitions" may stop further R&D on

competing products and pre-empt future competition, they may also reduce resultant product quality. Cunningham et al. do not focus on how this alters ex-ante incentives to innovate, the central concern in our work.

Another related paper is Wen and Zhu (2019). They examine how app developers on the Android mobile platform alter efforts as the threat of Google’s entry increases. They find that developers reduce innovation and raise prices for the affected apps in an attempt to milk their value before actual Google entry. They also find developers shift efforts to unaffected areas. Of course, their focus is not on acquisition but on competition from the platform. Relatedly, a number of policy papers assess the costs and benefits of platform acquisitions (see, for example, Bourreau (2019) and Hylton (2019)).

In the legal literature, a number of scholars have focused on the unique attributes of online platforms in necessitating a rethink of antitrust law and practice. Khan (2019) argues that platform owners control access to customers and when they sell services on the platform, have a special ability to foreclose competitors. Unlike Khan, we do not focus on the anti-competitive actions of incumbents but suggest the nature of platforms may have a chilling effect nevertheless. Wu (2018) argues that a variety of network products compete for customer attention, and ought to be seen as competitors when traditional antitrust theory would ordinarily dismiss any competitive link. While this is a different point to the one we make, the notion that new technologies create new ways that competition can be affected is similar.

Finally, Bryan and Hovenkamp (2019) present a theory of competition amongst innovating firms and find that start-ups are biased towards innovations that help the leader increase its lead after acquisition (which eventually diminishes competition and innovation as the leader’s advantage increases) rather than help a follower catch up (which would increase the competitive pressure in the industry to innovate). They argue that mandating compulsory licensing of new technologies when the startup’s acquirer is dominant in the industry may help preserve competition and incentives for startups to innovate. Unlike us, their focus is not on industries where there are two sided platforms with network externalities. Our work should be thought of as complementary to theirs.

6. Policy implications and Extensions

Our model is stylized. Nevertheless, it is helpful in thinking what policy tools would be more effective in addressing the problems created by a “kill zone”.

6.1 Anti-Trust Policy

First of all, the model makes it clear that prohibiting mergers to address a “kill zone” problem might not be appropriate under all circumstances. While prohibition does help motivate more entry under a variety

of circumstances, it does so at the cost of delaying the enjoyment of the superior technology by high-switching-cost customers. It also will imply fewer apps available to customers on the entrant platform than on the merged platform, reducing their welfare.

As the discussion in Section 3.7 suggests, in most cases it is better to delay mergers rather than prohibit them. In this way the efficient solution will always be reached eventually. This strategy is not without costs either, since too many app designers and customers will have to pay the switching costs. In this case, the optimal delay depends on the relative importance of ex-ante underinvestment vis-à-vis switching costs.

6.2 Interoperability

A crucial ingredient in our model are the frictions in switching between different platforms. If there were none, both for customers and for designers, network externalities would cease to matter, and so would the effect described in our model. The assumption of frictions is realistic in many situations but is not always driven by technological considerations. The reason why photographs cannot simultaneously be posted on Facebook and Snapchat is not technological in nature.

In 2008 Power Ventures, a small California startup, offered middleware to manage all relevant social media simultaneously. Facebook sued Power Ventures and succeeded in making its strategy illegal.¹⁸ In a similar way, the existence of network externalities associated with a platform is not just an inevitable consequence of a technology, but a combination of technology and standards. In the early phone industry, there were enormous network externalities associated with a network because one could only call people on the same network. When the U.S. government mandated interoperability among the various phone-service providers, network externalities associated with specific networks disappeared. Something similar can be done for social media. If the government mandates a common Application Program Interface (API), it will be easier for intermediaries to connect customers participating on different social media. So, both the switching costs and the network externalities are greatly reduced, if not eliminated.

In our model, when everyone can get access to the whole network, there is no distortion in the incentive to innovate because the better product will always prevail. Thus, by forcing interoperability, the regulatory authorities can restore the proper incentive to innovate. Conversely, any powerful incumbent's action to reduce interoperability might warrant anti-trust scrutiny.

¹⁸ <https://www.eff.org/cases/facebook-v-power-ventures>. Strategic barriers to entry might exist even in the absence of network externalities (Edlin and Stiglitz (1995)), but its effects are greatly amplified in the presence of network externalities.

6.3 Data Ownership

We have assumed no constraints on the entrant's ability to innovate. In the digital world, past customer-generated data are crucial to fine tune new products offered to consumers. Thus, incumbent-collected data on the customer represents an important barrier to entry for newcomers – effectively haircuts the possible θ for any investment C^E . The greater the access entrants have to customer data, the more they can fine-tune their products, leveling the playing field with the incumbent. Thus, the default allocation of data ownership crucially influences competition and innovation. Rules that allow incumbent platforms free use of their accumulated data make it easier for the incumbent to exploit their network externalities, not just in their main line but also in different lines of business. If a platform, for example, can freely use its customer information to market a new cryptocurrency, it can easily gain a head start vis-à-vis any other cryptocurrency. Thus, the incentives to innovate in any area where an existing platform can expand are curtailed by the possibility that the incumbent platform may have a data advantage.

The new European data protection rule – also known as GDPR – limits the use of these data by incumbents, unless they have asked explicit authorization from the customers. In so doing, it reduces the incumbent's advantage somewhat, promoting innovation. Of course, it also means that entrants will have to ask each customer for permission to use their data, increasing their costs of fine-tuning also.

There have also been proposals to allow customers to own their data, and sell it to whomsoever they desire (see Lanier (2013), Posner and Weyl (2018)). This would level the playing field, provided data collectors are compensated for their cost of collection, and data intermediaries arise to facilitate storage and sales.

6.4 Patent Protection

In a similar vein, it follows that the more an incumbent can freely copy the technological innovations of new entrants, the worse the incentives of early adopters to switch to a new entrant will be, and thus the lower the incentives to innovate will be. This feature is not unique to our model. Even in a neoclassical model of competitive innovation, innovation incentives will be more muted if intellectual property is not protected. In our model, however, the effect is much stronger. In the traditional duopoly setting, if the incumbent perfectly imitates the innovation of the new entrant and it sells it at the same price, the new entrant still can sell its product. In our model, if the incumbent perfectly imitates the new features of the entrant, the new entrant will not be able to attract customers because the incumbent's network externalities will dominate. Thus, in the absence of any patent protection, the incentives to enter with a superior product will be severely curtailed.

Note, however, that very strong patent protection system can be a double-edged sword, because it protects incumbents' property rights too, possibly creating an insurmountable advantage over potential

entrants (see Bryan and Hovenkamp (2019)). To properly derive the optimal degree of patent protection, we would need to model the incumbent's incentives to innovate. This is outside the scope of this paper.

6.5 Keeping out Foreign Incumbents

The possibly adverse effects of incumbent platforms acquisition on innovation and entry may perhaps also be gleaned from the history of digital platforms in the United States, China, and the EU. The EU, which has a market as large as the United States, did not produce its own home-grown giants. By contrast, China, which blocked the acquisition and entry of foreign platforms, created an ecosystem of platforms (from Ali Baba to Baidu and Tencent) that rivalled those in the United States. A possible explanation, consistent with our model, is that EU entrants had to contend from the beginning with US incumbents, who built extensive networks in Europe early on. By contrast, Chinese entrants did not have the same problem. Of course, the Chinese government has recently tried to limit the expansion of large incumbent platforms. Whether this creates space for new entrants remains to be seen.

In the future, India might provide an interesting testing ground. Initially, India had allowed relatively free entry to foreign-owned platforms. Recently, however, it has introduced a new set of rules hamstringing the dominant incumbent foreign-owned market places, Amazon and Flipkart (owned by Walmart), with the intent of creating more incentives for domestic entrants. Its recent ban on a variety of dominant Chinese platforms like ByteDance's Tik Tok seems to have led to a number of domestic startups attracting investment.¹⁹ Only time will tell if this approach is successful in growing domestic champions.

The above argument is nothing more than a variant of the standard argument for protection of "infant" industries proposed by Alexander Hamilton and developed by Friedrich List. Network externalities just make the case much stronger. In addition, our model suggests that the "infant" industry protection argument can be used not just in new industries, but also in developed ones, like the software industry in the United States. Of course, all the traditional caveats associated with the infant industry argument still pertain here.

7 Conclusions

Venture capitalists claim that acquisitions in the start-up space done by powerful incumbent platforms, such as Facebook and Google, create a "kill zone." This idea seems at odds not only with

¹⁹ "India Takes a Risk by Encouraging National Interest", by Henny Sender, Financial Times, July 14, 2020, <https://www.ft.com/content/a147fe8c-0ab3-460f-b9e2-f4d51a545085>

standard textbook economics, but with logic itself. Why should the prospect of being acquired at hefty multiples *discourage* new entry?

In this paper we construct a simple model that rationalizes this result. In the presence of network externalities, app designers generate an important externality: they facilitate the adoption by customers, helping the market converge to the platform with the superior technology. These app designers, however, face significant adaptation costs, so they will adapt to the new entrant only if the benefit of adaptation is reasonable large. This benefit is a function not only of the technological difference of the new platform, but also of its persistence as independent entity. Since a merger immediately transmits the superior technology to everybody, it reduces the benefit of adoption for early adopters. The prospect of a merger reduces adaptation by app designers, making it harder for a technological superior entrant to acquire customers. This difficulty in acquiring customers reduces the stand-alone price of any new entrant, decreasing the price at which they can be acquired and thus reducing their incentive to innovate.

There is a trade-off between static efficiency (the consumer welfare created by mergers) and dynamic efficiency (incentives to innovate) in our model. This typically suggests a merger regime which neither prohibits mergers nor approves them too quickly or easily. Another policy option is to reduce switching costs by mandating interoperability. The broader point of this paper, however, is that new technologies work through channels that simply were not present in the old technologies. Therefore policies have to be reevaluated in the light of these developments.

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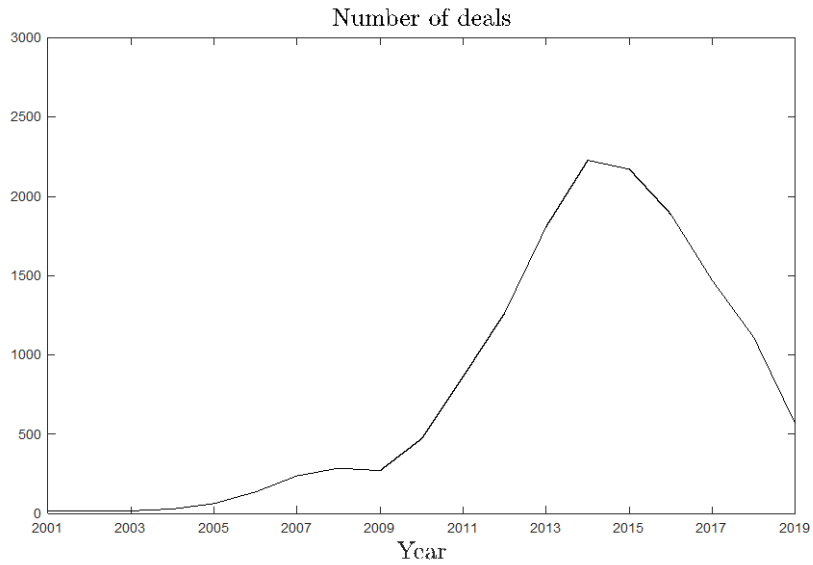
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Figure 1: VC Investment and Deals in the Social Media Space

Figure 1a plots the number of early-stage start-ups financed by a venture capitalist in the social media space. Figure 1b plots the dollar amount of funding going to early-stage financings of start-ups in the social media space. Source: Pitchbook.

(a) Number of Deals



(b) Investment: Dollar amount financed (in million \$)

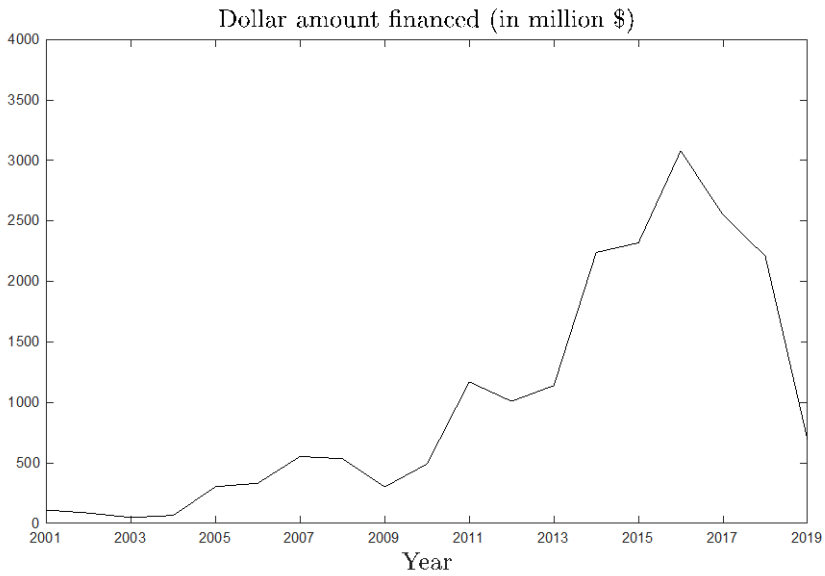
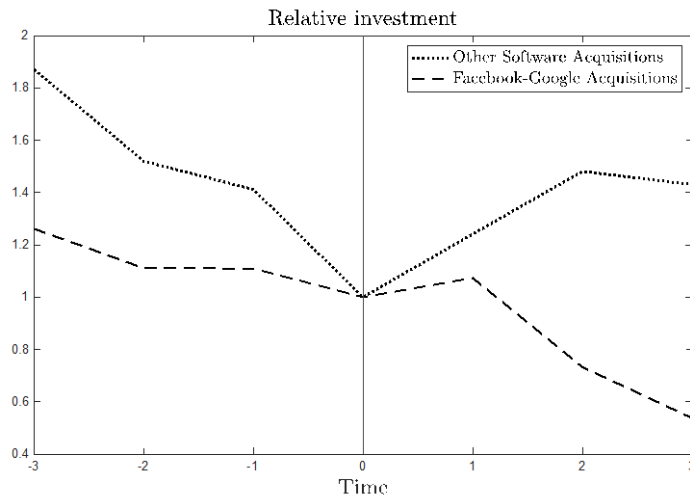


Figure 2: Effect of Acquisitions on Amount of Investments and Number of Deals

In Figure 2a, the average normalized relative VC investment in early stage companies similar to the one acquired is plotted in event time both for Facebook/Google acquisitions and for other acquisitions in the software industry between 2006 and 2016. To adjust for cyclicalality, the amount of investments in comparable “treated” companies is divided by all VC investments in early deals in the software industry made in the same year. This ratio, relative investment, is then normalized by the relative investment in the year of the acquisition, so that the normalized relative investment is one in the year of the acquisition for each acquisition. The normalized relative investment in each acquisition-year is then averaged across the nine Facebook/Google acquisitions. As a comparison, we repeat this plot for all other acquisitions in the software industry. In Figure 2b, the average normalized relative number of VC investments in early stage companies is similarly computed for the Facebook/Google acquisitions as well as the other acquisitions in the software industry. Source: Pitchbook

(a) Normalized relative investment before and after an acquisition



(b) Normalized relative number of deals before and after an acquisition

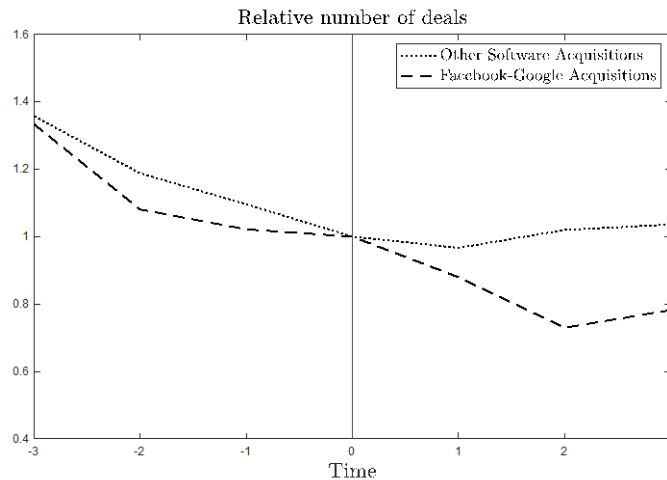


Figure 3: Optimal Adaptation Point and Fraction of App Designers Adapting as a Function of Quality Expectations

The top panel shows the optimal adaptation point as a function of app designers' quality expectations for different values of m , the merger regime. The bottom panel shows the fraction of app designers adapting to the entrant as a function of app designers' quality expectation for different values of m . The chosen model parameters are $\lambda=0.4$, $s=1$, $\alpha=16$, $\beta=100$, $T=10$, $\bar{c} = 10$.

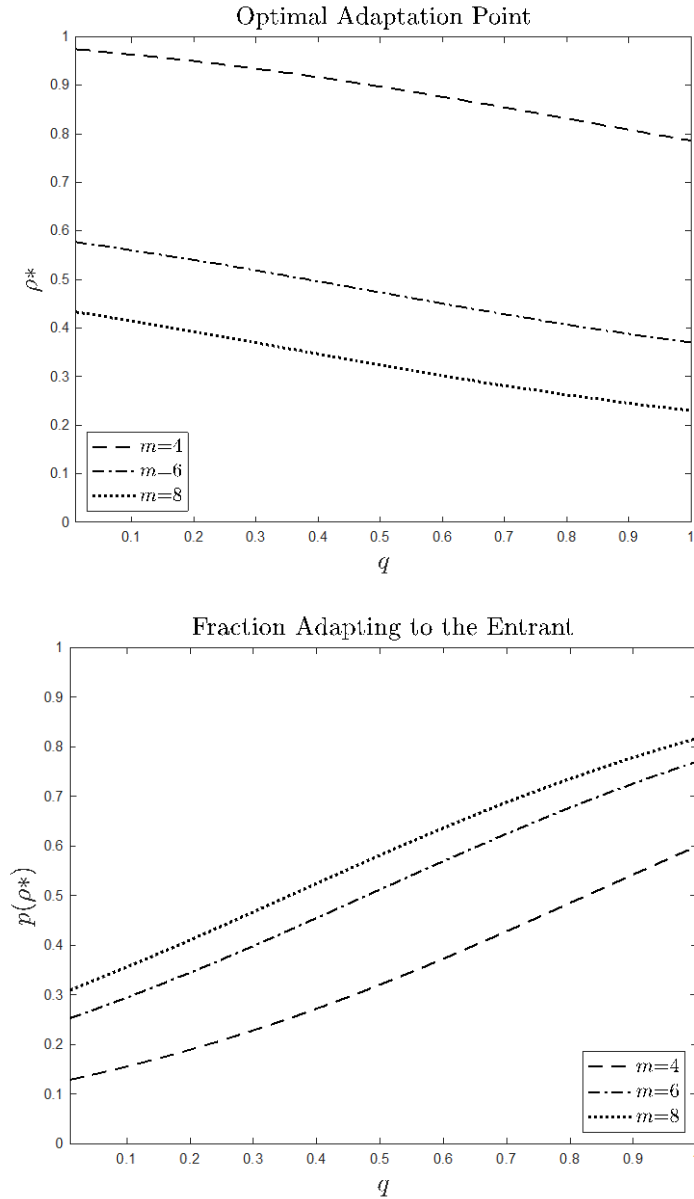


Figure 4: Value Captured by Entrant as a Function of Technological Improvement

We plot the value an entrant can capture as a function of the quality improvement θ for different merger regimes m . The top panel plots entrant values for a low value of incumbent's bargaining power and the bottom panel plots entrant values for a high value of incumbent bargaining power. The chosen model parameters are $\lambda=0.4$, $s=1$, $\alpha=16$, $\beta=100$, $T=10$, $\bar{c} = 10$, $C^E = 1$, $\psi(n) = \zeta_0 + \zeta_1 n^{\zeta_2}$ with $(\zeta_0, \zeta_1, \zeta_2) = (0, 1, 2)$

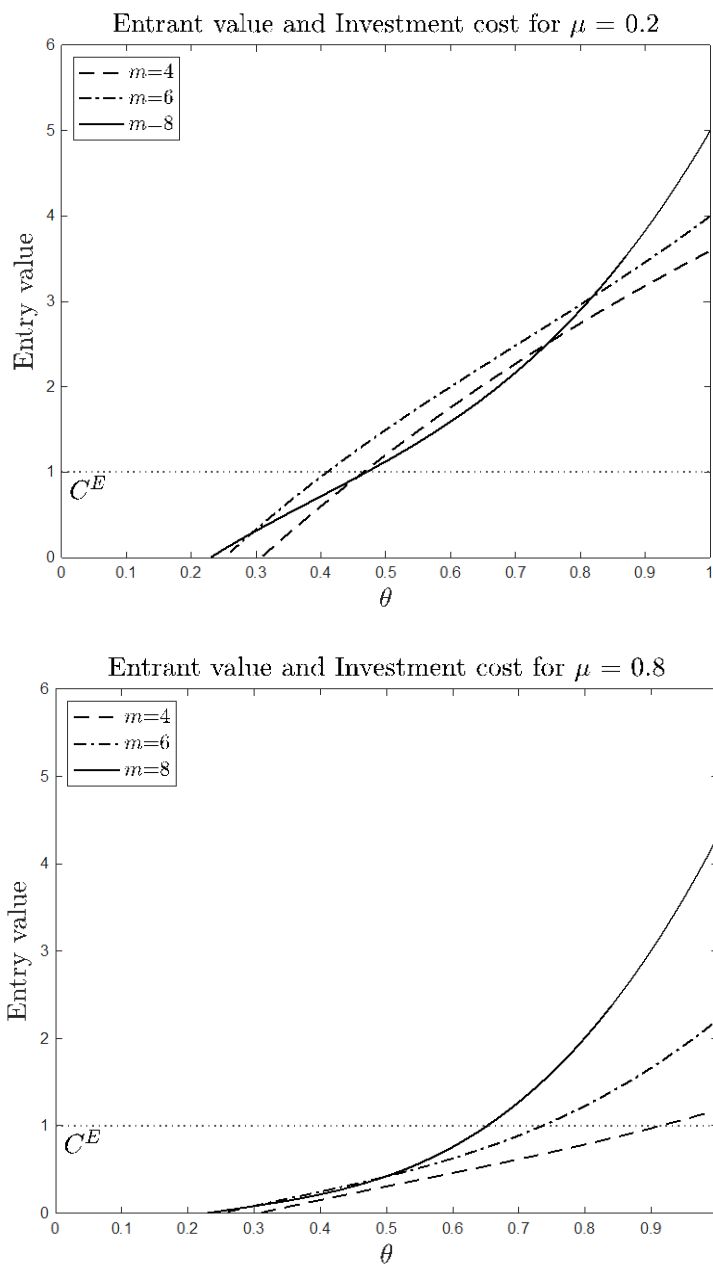


Figure 5: Adaptation Threshold Θ^m as a Function of Merger Regime

We plot the threshold value of quality improvement at which a potential entrant will enter as a function of m for different values of the incumbent's bargaining power. The chosen model parameters are $\lambda=0.4$, $s=1$, $\alpha=16$, $\beta=100$, $T=10$, $\bar{c}=10$, $C^E=1$, $\psi(n) = \zeta_0 + \zeta_1 n^{\zeta_2}$ with $(\zeta_0, \zeta_1, \zeta_2) = (0, 1, 2)$.

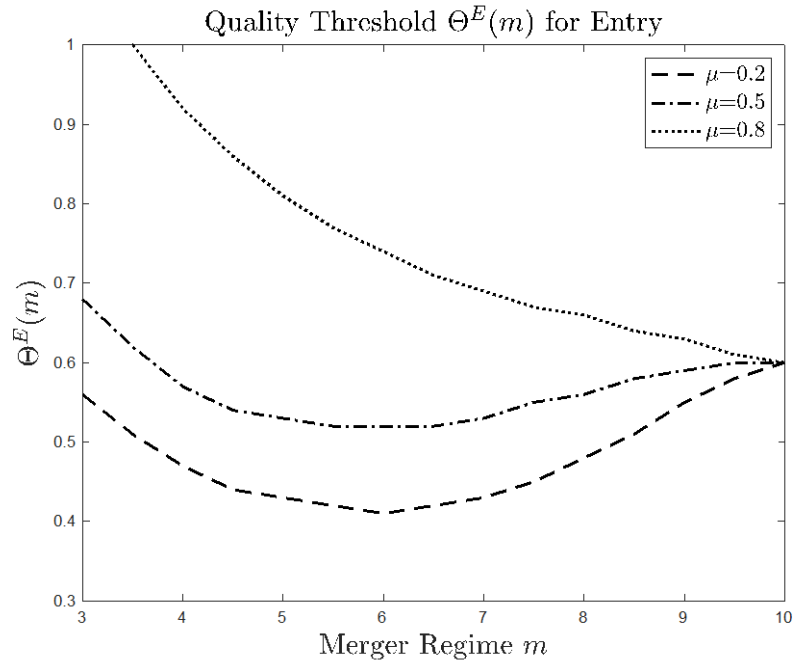


Figure 6: Welfare Relative to First Best as a Function of Merger Regime

We plot expected social welfare as a fraction of welfare under the first-best scenario as a function of merger regime m for different values of incumbent bargaining power. The chosen model parameters are $\lambda=0.4$, $s=1$, $\alpha=16$, $\beta=100$, $T=10$, $\bar{c}=10$, $C^E=1$, $\psi(n) = \zeta_0 + \zeta_1 n^{\zeta_2}$ with $(\zeta_0, \zeta_1, \zeta_2) = (0, 1, 2)$.

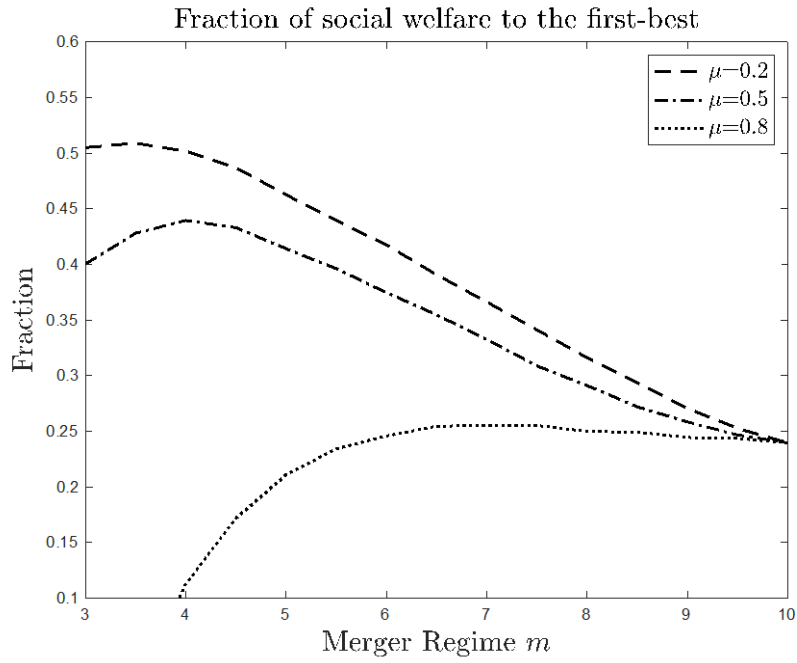


Figure 7: Welfare Relative to First Best as a Function of Merger Regime

We plot the merger regime m that maximizes the social welfare as a function of the incumbent's bargaining power. The chosen model parameters are $\lambda=0.4$, $s=1$, $\alpha=16$, $\beta=100$, $T=10$, $\bar{c} = 10$, $C^E = 1$, $\psi(n) = \zeta_0 + \zeta_1 n^{\zeta_2}$ with $(\zeta_0, \zeta_1, \zeta_2) = (0, 1, 2)$.

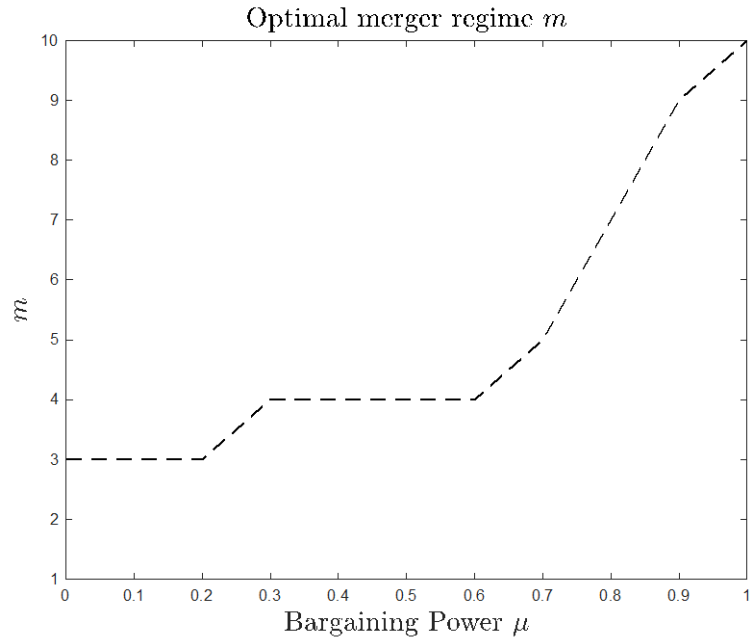


Table 1. Acquisitions Considered

The list of all software companies acquired by Facebook or Google for more than \$ 500 million between the beginning of 2006 and the end of 2018 is listed. Price paid is the total amount paid in millions of dollars to acquire the company. Software Sector presents the primary industry of the target company in the software sector. Each target company is categorized as either a substitute or a complement based on its complementarity with respect to the acquirer. Source: *Pitchbook*

| Year | Acquirer | Target | Price paid (\$M) | Software Sector | Complementarity |
|-------------|-----------------|---------------|-------------------------|--------------------------|------------------------|
| 2006 | Google | Youtube | 1,650 | Multimedia and Design | Substitute |
| 2007 | Google | DoubleClick | 3,100 | Internet | Complement |
| 2009 | Google | AdMob | 750 | Vertical Market | Complement |
| 2009 | Google | Postini | 625 | Network Management | Complement |
| 2011 | Google | ITA Software | 676 | Vertical Market | Substitute |
| 2012 | Facebook | Instagram | 1,000 | Social Platform | Substitute |
| 2013 | Google | Waze | 966 | Communication | Substitute |
| 2014 | Facebook | WhatsApp | 19,000 | Communication | Substitute |
| 2016 | Google | Apigee | 625 | Development Applications | Complement |