Business Model Warfare

The Strategy of Business Breakthroughs

By Langdon Morris

Senior Practice Scholar
Ackoff Center for the Advancement of Systems Approaches (A-CASA)
The University of Pennsylvania

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Introduction

The average lifespan of a major corporation isn't very long. If current trends hold, only one-quarter of today's S&P 500 companies will be part of the index by 2020, and the other three-quarters probably don't even exist yet.[1]

In today's turbulent markets, companies that were once dominant are struggling to survive, and managers are constantly probing to understand what makes the difference between success and failure. Looking at today's companies, for example, we might ask why the market capitalization of Southwest Airlines is greater than that of United, American, Delta, and Northwest Airlines combined? Why is GM's Saturn subsidiary successful while its Oldsmobile unit is being put out of business? Why are Fedex, Charles Schwab, and Home Depot widely admired while Webvan and AtHome and Netscape are gone, and Enron, WorldCom, Xerox and apparently quite a few others resorted to falsified accounting to preserve the illusion of success when failure loomed?

There's a story behind each of these business successes and business failures. Sometimes it's a story of a great idea; sometimes it's one that failed. Sometimes it's a story of insightful management, or management that failed. But almost always it's a story about change. Change in the market; change in the economy; change in a particular product or service that transformed a failure into a success, or vice versa.

While we study the stories to learn about the specific changes, events, insights, and breakdowns in each case, we also look for broader and deeper explanations that show how change applies across industries and the whole of the economy.

The broader patterns are the subject of this white paper. Here we propose a specific model explaining how large companies create and sustain market leadership, or the traps that they fall into that prevent them from doing so.

Part I: The Mortality of Companies

The capacity of organizations to adapt to rapid and unexpected change is frequently discussed, but managing for adaptability is a little understood and poorly practiced art even as the pace of change continues to accelerate. In reality more big companies are going out of business faster than ever before.

In searching for hard data about company mortality we found three sources: The *Fortune* 500 list, The *Forbes* 100 list, and The S&P 500 list.

The Fortune 500

We studied the Fortune 500 list beginning in the year it was first created, 1955, and continuing through 2001 to identify the companies that were on the list one year but not the subsequent year. These are the living examples of what we might call the relentless progression of competition. We found that over this span of 46 years, an average of 30 companies per year left the list.[2]

In some years there were more departures, in some years fewer, but the overall trend showed consistent turnover of about 6% each year.

If the impact of decay was random among companies then over a period of only about 17 years the entire list would turn over and an entirely new set of companies would be listed. But of course it doesn't happen that way. Instead, some companies are ephemeral visitors to the Fortune 500, while others endure for decades. A study by planners at Shell found that by 1983, one-third of the companies listed among the 500 in 1970 had not only fallen from the list, but had gone out of business altogether.[3] That's an average mortality rate of 12 companies per year, or one per month. They also found that a multi-national corporation comparable in size to a Fortune 500 company could only be expected to survive for between 40 and 50 years.

The Forbes 100

In 1917, Forbes magazine created its own list of the largest 100 US companies. By 1987, 61 of those companies no longer existed. Over the seventy year span, in other words, an average of about one company per year disappeared. Of the remaining 39 original companies, 18 were still large enough to remain on the list in 1987.

However, of the 18 companies, only two had managed to perform better than the overall stock market during the seventy-year period. While the combined annual growth rate (CAGR) of US public companies from 1917 to

1987 was 7.5%, the 18 surviving companies managed a combined average of only 5.3%. In other words, an investor in market index funds would have done substantially better than an investor in these 18 companies. (This assumes, of course, that any investor would have had the incredible foresight to pick the 18 surviving big companies from the original list of 100.)

The S&P 500

The S&P 500 list provides a third reference point. In 1957, the S&P listing of 90 top companies was expanded to 500. By 1997, only 74 of the original 500 companies remained, an average mortality rate of more than 10 per year.[4] But a more detailed analysis shows that the rate of mortality has been steadily increasing, with far more companies failing as the end of the century approached. The average life span of an S&P 500 company has steadily decreased from more than 50 years to fewer than 25 today.

These three slices of history convey a clear pattern. Projecting the pattern forward as we noted above, it's likely that about a third of today's major corporations will survive as significant businesses for the next twenty-five years. "Most will die or be bought out and absorbed because they are too slow to keep pace with change in the market. By 2020, more than three quarters of the S&P 500 will consist of companies that we don't know today."[5]

This trend in corporate mortality is, in other words, a serious issue with significant implications.

Part II: It's the Business Model

The context of business strategy is the marketplace in which it is played out, so discussions of strategy must begin with reference to the market. Today, the three most critical market factors are accelerating change, increasing competition, and increasing complexity.

While each of these forces presents its own particular problems, the impact of all three acting together significantly compounds the problem, composing a "change conspiracy" that poses far greater challenges. The results are a drastically compressed planning horizon for every company and the need for faster responses throughout the organization.

These conditions are taking a heavy toll on companies, industries, and entire nations, and bringing severe stress to the business leaders who grapple with these issues day after day. On the news you'll hear a long list of struggling enterprises, notable not only for the steep slide that many have recently endured, but also because it was not so long ago that they were held in high esteem. Among them are Vivendi, United Airlines, K-mart, Xerox, WorldCom, Tyco, Arthur Andersen, USAir, AOL Time Warner, Adelphia, Xerox, HealthSouth, and Qwest, and many others.

While these companies struggle to right themselves, Argentina, Brazil, and their South American neighbors struggle to keep their economies viable in the new and demanding framework of global markets, while Japan struggles with a bout of deflation that has already lasted a decade.

Meanwhile, other companies fall more slowly. For example, steel industry icon Bethlehem Steel, once a member of the elite Dow Jones index, was recently delisted from the New York Stock Exchange when its stock value fell below one dollar per share, and as noted above, GM is dropping the Oldsmobile brand due to its declining market share. Another example is Sears, which dropped its own catalog some years ago, only to then buy Lands' End. The company is also trying to sell its profitable financial services unit to raise cash to buttress its faltering retail unit.

These failures make dramatic stories that are illustrated by the sad losses suffered by individuals and families struggling to survive the economic losses and emotional strain. As more and more companies fail, it is slowly becoming clear that these are no longer unusual events.

In spite of the attempts by governments, central banks, and multilateral organizations such as the UN, WTO, and the World Bank to reduce the impacts of change, it's clear that the forces of change are far stronger than ever before.

Turbulence continues to increase, which means that business failures will continue to be common occurrences going forward. And managers wonder obsessively deep into the night, What should my company be doing differently?

Creative Destruction

While the sense of crisis and the time compression caused by the change conspiracy is certainly real, the underlying dynamics of the competitive marketplace are not new. Sixty years ago, economist Joseph Schumpeter described the overall capitalist process as "creative destruction," and he pointed out that the natural behavior of capitalist systems brings revolution not as the result of vague external factors, but from within. Change, Schumpeter observed, is the common condition, not stability. And in a prescient comment about prevalent management practices at the time (and still today), he wrote, "The problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them."[6]

The significance of this comment is nearly impossible to overstate. While so many observers and managers focus their attention on how businesses perform in today's markets, Schumpeter points out that it is in the very nature of market evolution to weaken some companies while creating opportunities for others. Therefore, just as important as today's market structures, or today's technologies, or today's competitive advantage, is how the forces of change will affect a firm tomorrow and the day after.

But unfortunately, the instinctive habit of management is to look backwards to the past to guide a course into the future. In an era characterized by a change conspiracy, this approach cannot succeed.

Military leaders are familiar with this problem. They refer to it as "preparing to fight the last war." Such preparations, even fully implemented with rigor and discipline, consistently fail. Whether it's armored knights slaughtered by the crossbow, France's Maginot Line (a 20th century monument to backward thinking), the Polish horse cavalry that rode out to face Hitler's blitzkrieg, the American army reduced by Viet Cong guerrilla fighters, or civilian aircraft hijacked and turned into guided missiles, the history of warfare and of business is the history of innovations that render past strategies ineffective.

However, the misplaced focus is usually evident only in hindsight, when wars, market share, jobs, or stock value have already been lost. For managers as for generals, hindsight is not sufficient. It is therefore essential to have an effective way not only to look toward the future, but to create it. It is on this imperative that this report will concentrate.

Innovation

The term “creative destruction” gives us a warning, a name, and a general explanation for the waves of change that move continually through the marketplace, and it helps us direct our attention toward understanding the forces of change rather than the illusion of stability. The term helps us see that the waves of change are themselves created, either intentionally or unintentionally, not by mysterious forces, but as a result of purposeful innovation in the competitive arena of the market.

However, innovation is a word that means different things to different people, and since it’s a very important word to this report we’ll define it carefully.

We note, first of all, that the word “innovation” refers to an attribute, a process, and a result. Innovation is a process that happens somewhere in your company, or perhaps in someone’s mind. The result, in any case, can be an insight, a new idea, a product, a strategy, or perhaps a new business process. It may be a question, a theory, or just a fear. But whatever it is, one of the qualities that will distinguish the new thing is its “innovativeness.” This innovativeness refers to its distinctiveness, its originality, perhaps its usefulness, and most importantly its value.

“Innovation” also refers specifically to that new thing itself that the innovation *process* has produced. To be considered an innovation in business, the result must be increased value in the form of new or improved functionality, reduced cost, a price increase (good for the seller), a price decrease (good for the buyer), better margin for the seller, or some combination of these.

According to this definition not every new or different idea qualifies as an innovation. In fact only a small percentage qualify. Innovative ideas, by definition, create value for their users and valuable competitive advantage for their owners, as well as economic rewards.

However, even innovations that do not have much impact on the market can be significant and critically important, especially if they happen to help a company keep up with or surpass its competition. In this context innovation can be used to defend, to block competitors from gaining our share even as it can also be used to attack.[7]

Hence, the approach that Peter Drucker labeled as "fast-follower" is a defensive strategy employed by companies to block the growing effectiveness of a competitor's offering. For example, Netscape Navigator had a strong head start in the browser market, but Microsoft's Internet Explorer quickly overtook Netscape and forced it to seek refuge as a subsidiary of AOL.

In high tech and particularly software markets, a variant on this strategy is known derisively as "vaporware." Here the defense consists of product announcements, not actual products. In the early days of the database market, vaporware announcements were prolific while actual new products came trotting along sometimes years later. In the course of one of these transitions Borland died a quick death long before its promised software reached the market.

While these aspects of innovation and the innovation process occur in the life cycles of individual companies, innovation is also a significant factor in macroeconomics at the level of nations and the economy as a whole. Economists know that it is only through effective innovation that real economic growth occurs, because the underlying economic impact of innovation is to make resources more productive, which literally *creates* wealth for society. Hence, innovation is crucial to the economic viability of nations.

But when discussing innovation the focus must remain on individuals and individual companies because it is their work that drives the economy forward. Thus, just as innovators drive microeconomic change in specific markets and macroeconomic change in economies, it is innovators who trigger creative destruction in their search for commercial success and competitive advantage. Among the companies widely admired today - and we have so far mentioned Southwest Airlines, Saturn, Charles Schwab, Home Depot, and Fedex - most have attained their success precisely because they have innovated. Through their innovations they brought structural change to their markets; their motivation was to gain advantage within the capitalist process precisely as Schumpeter described.

But the innovator's role is only half of the equation. Customers are the ones who determine the real value of innovations because they are the ones who pay for them. Market behavior is an aggregate reflection of each consumer's drive to find the most attractive offers, and to maximize value received for cost incurred. As innovation is the process of creating higher value offerings, buyers naturally gravitate to innovative products.

But perhaps "gravitate" is the wrong word. Perhaps it is more accurate to say that capitalist markets devour innovations, hungrily consuming them the way a very hungry lion consumes a fresh kill. The capitalist system depends for its dynamism on the market's appetite for innovation, which has shown itself to be generally insatiable.

Inherent in the dynamics of market demand is the process that drives competition through innovation. The waves of change launched by innovators are countered by competitors who innovate in order to defend their existing positions, or to attack with ambitions of their own.

All of this serves only to drive the process of change still that much faster throughout the economy. Accelerating change and the convergence in the marketplace of many competing innovators results in greater complexity for all, a landscape of acute danger and astonishing challenge. Any enterprise that intends to survive must somehow innovate, because innovation itself is the only defense against innovation. Through innovation you may catch up if you are behind, or even take the lead.

Thus, we see clearly that the future of each and every firm is determined largely as a function of its ability to innovate effectively. Innovation is therefore a mandate, an absolute requirement for survival.

And it is a problem. A great, bumbling, stumbling problem, because managing the innovation process is one of the most challenging issues facing any organization. It is extraordinarily difficult to do well, in part because, as with top management, R&D organizations are often focused on the wrong objectives, as we will discuss below.

The Many Dimensions of Innovation

Creative destruction is fascinating from a macroeconomic perspective, and it raises tough microeconomic questions about change and change management in individual firms. In particular, it brings focus to how managers handle change, and it highlights the necessity of constant regeneration of the business from within through the R&D process and other creative endeavors.

While leaders of successful companies show a knack for reinventing their organizations in clever ways, among the failures we see repeatedly the consequences of not understanding or following Schumpeter's advice. Too many managers assume that change is the aberration, and they behave as if the market is stable. Perhaps the business school curriculum is partly at fault, for the very notion of a Masters in Business Administration assumes that the critical competence is *administration*, implying that continuing and well-controlled operation under managerial control is the focus, intent, and purpose of management.

For most managers, however, the ability to create is far more important than skills related to control. Furthermore, as Russ Ackoff points out, a serious flaw in the traditional MBA curriculum is that in the real world managers are not presented with tidy and objective "cases" to solve[8] - they must first figure out what the problem is, which can itself require a great deal of creativity.

In reality change is the norm and stability is an aberration. Managers grapple with the disruptive forces of change and they figure out for themselves what lessons and challenges present in the current situation, and what responses will be most effective in harnessing change so that their organizations can survive.

In today's competitive environment it's likely that somewhere a new innovation is about to appear that will dramatically impact on current structures. And yet the relentless day to day demands on managers' time immerse them in a flood of pressing issues and many simply fail to recognize important underlying factors that portend significant disruption. Consequently, managers tend not to account adequately for systemic change, and they are surprised and unprepared when they should not be.

Did personal computers and networked workstations surprise the computer industry? Absolutely. Did the high performance sport shoe surprise the staid sneaker marketplace when Nike invented the category? Did efficient and high quality Japanese cars surprise the Detroit automakers? Did the cellular telephone shock the entrenched telcos? Yes, yes, and yes.

Occasionally we even see a company whose leaders, judging by the evidence of their behavior, prefer go out of business rather than do the work of adapting to change. RCA, Woolworth's, Smith-Corona, and Polaroid are recent examples.

As it is imperative for the organization to be continually engaged in the process of innovation, the question is where should efforts to innovate be focused. There are, it turns out, many possibilities.

To examine these possibilities we devised an imaginary and archetypal large organization with products and services in many different markets, extensive operations in numerous locations, and a predominantly internal support structure. We find that in such an organization there are at least 37 distinctive opportunities for innovation.

37 Possible Innovation Targets

business structure
    alliances
    capital formation
 	
administration
    information flow
    automation
    insourcing / outsourcing services
 	
organization
    structure type
    facilities infrastructure
    IT infrastructure
    employee / contractor mix
    employee experience
    decision making processes
    facilities effectiveness
    process to improve processes
 	
customer experience
    communication process
    crm
    brand / image
    advertising
    feedback
	customer service
	    service process
	    communication
	
	supply chain
	    distribution system
	    manufacturing
	    communication
	
	product
	    product offering
	    product availability
	    technology (hidden)
	    technology (evident)
	    manufacturing
	    R&D
	    user interface
	    packaging
	    functionality
	    life cycle model
	    sales model
	    sustainability
	    after-sale service
	    distribution

The first thing that jumps out from this list is that the vast majority of these opportunities do not involve new technologies embedded in existing or new products. In spite of the widely-held assumption to the contrary, “innovation” is by no means limited to “technology.” The lesson: technology innovation by itself has rarely been sufficient to ensure the future, and it is certainly not today.

Interestingly, this is the case even when innovative technology is at the core of the offering. A good example is Xerox. Chester Carlson’s technological innovation was a stunning breakthrough, and a testimony to his insight and persistence. The Xerox story is also testimony to the difficulties of forecasting the market for genuinely new products. Many industrial giants of the day, including IBM, Kodak, and GE, each rejected Carlson’s technology.

When he finally did find a partner, tiny Haloid Company, getting the technology to market entailed far more than simply building new machines. The success of the company in its early years was largely due to its innovative approach to distribution - leasing the machines on a per-use basis instead of selling them outright. Today, however, Xerox is a company in difficulty, threatened by far more creative competitors whose own innovations in distribution and technology have largely surpassed Xerox's. Again and again we see the inexorability of creative destruction.

Did Xerox top management believe that the market was stable, and that their incumbent competitive advantages would persist? If so, they were clearly mistaken, and now another generation of top management has the task of cleaning up a mess.[9]

But the problem was not that Xerox failed to recognize the importance of innovation. In fact, they generously funded technical R&D that surpassed the efforts of most other companies, creating the legendary Palo Alto Research Center, PARC, from which sprang an amazing string of enormous breakthroughs in many dimensions of technology.

And even as the company entered its period of decline, it was still producing astonishing technological breakthroughs. It's Docutech system, for example, a self-contained digital printing plant and bindery, did what no copier had done before. But within a relatively short period of time, Xerox competitors had machines that matched or surpassed the Docutech in every respect.

This illustrates one of the most vexing problems associated with technological innovation: In today's environment, technology is one thing that a determined and adequately-financed competitor may readily replicate or bypass. Patents offer limited protection, but sometimes they simply provide stimulus and insight for others determined to be still more inventive.

It is for this reason that investor Warren Buffet has said that he does not invest in technology companies. He has recognized that the underlying rate of change in technology markets is so fast that it simply does not allow sufficient defensible competitive advantage.

Thus, a focus on technology breakthroughs to the exclusion of other aspects of innovation is misplaced. Given the complexity inherent in today's technologies, you simply can't count on being able to out-R&D the market on a consistent enough basis to sustain a competitive advantage. Sooner or later, and probably sooner, every technology meets its match or its superior, and it's probably coming from a competitor.

But for the brief interval while a particular technology is superior it can be the basis upon which to build something of truly critical importance: strong relationships with customers. Innovation efforts must therefore include the creation of new approaches that help strengthen the bonds with customers, and they should draw from any of the 37 dimensions that might provide differentiation. Strong customer relationships help companies survive the inevitable periods when their technology will not be the best.

The experience of another technology giant, IBM, underscores the significance of innovation that is not just technological. Over the years, many of IBM's successes have come not as a result of technological leadership, but because of its close relationships with its customers. IBM is not actually a technology leader in many of its product areas, but for decades IT managers have struggled with the choice between leading edge technology offered by IBM's competitors, and IBM's own systems which were often just slightly above average. But even though its technology may not have been the best, IBM made sure that it was a safe choice for customers because the company made consistent and unsurpassed efforts to provide exemplary service. The adage was that nobody ever got fired for choosing IBM.

Now we see that over the years an increasing proportion of IBM's revenues and profits have come from its services organization. By 2002, services accounted for more than 50% of revenues. So is IBM a computer company? Well, yes. Its high profile research efforts in areas such as super high-density magnetic storage drives and the Deep Blue chess-playing supercomputer are well publicized initiatives that keep this idea in the public's mind.

But the IBM services organization is far more significant today because the relationships that are created and sustained through services are the real key to the company's future.

Ford provides another clear example. The original Ford cars of the early 1900s were certainly innovative for automotive engineering, but equally important to the company's success was the innovative production process (the first vertically integrated assembly line), the distribution system (the dealer network), and the company's pricing model that ensured affordability. All of these innovations enabled Ford to create an enduring relationship with American car-buyers and build a significant share of the market.

By the 1920s, however, GM had copied and largely caught up with Ford's innovations, and began introducing some of its own. A minor GM innovation with major impact was the availability of cars in colors other than black.[10] Ford suffered steady decline thereafter, and was rescued from what might have been fatal demise only by the enormous demand for military vehicles caused by World War II. After the war, the company soon staggered again, and was nearly bankrupt by the late 1950s.

The Ford story illustrates two important aspects of competition in nearly every market. First, each industry has its own rhythm of technical innovation, driven largely by advances in materials and methods. These advances often lead to cycles of changing market dominance. In the auto industry, Ford was supplanted by GM, and more recently GM by Toyota and Honda.

The second aspect, however, is what seriously complicates the focus on technology. Ford's choice of black paint was an economic one, part of a relentless strategy of minimizing costs. From 1903 through World War I, this strategy was a significant contributor to the company's success. But in the 20s, the nature of the market itself was changing, and Ford's success as a cost-cutting pioneer did not serve him when market dynamics began to favor factors related to comfort and style.

Within the framework of any given market cycle a company can grasp and sustain leadership, but the greater challenge is managing what happens when a new cycle begins. As it turns out, very few companies sustain leadership positions beyond a single cycle because they don't grasp the significance of change. Too often they rely on technology to provide differentiation, and technologies are so frequently surpassed. While one set of products and services may be exceptionally well-suited to the market at a particular point in time, it's rare for a company to successfully adapt its products and services to changing market conditions quickly enough to sustain the leadership position.

Companies therefore cede market dominance when their competitors attack them in areas where they are not prepared to defend themselves. Chances are they have positioned their defenses in a way that leaves them vulnerable. Sears, for example, allowed Wal-Mart to establish itself in the smaller rural markets that Sears had abandoned or ignored. Wal-Mart then applied innovation processes throughout its growing supply chain to significantly lower its overall operating costs, at which point it went after Sears and K-Mart in their urban markets. Sears became a second-tier player almost before it realized what had happened, while K-Mart eventually found itself in bankruptcy.

Similarly, by focusing on annual style changes in their competition with one another, the Detroit automakers overlooked the importance of underlying quality improvements. When quality suddenly became an important attribute for American buyers, the Japanese manufacturers began taking market share. Before 1980, GM didn't take the Japanese seriously as competitors, and it didn't take the issue of quality seriously either. Today GM is still struggling to catch up to Japanese quality standards, and as a result GM's share of the American car market declined from 50% to less than 35% between 1980 and 2000.

It takes exceptional discipline and clarity of vision to defend a competitive advantage and carry it through to a next generation of offerings. With success comes growth, and as a company increases in size and scope, the nature of management's challenges change considerably. Managing Xerox at the start-up stage was an entirely different problem than steering the global copier colossus.

When a company is small, top management is usually in direct contact with customers as a natural part of its role in the company. But as managers deal with the complexities of larger enterprises and multiplying layers of organization, they become further and further removed from a direct experience of the market. Without direct contact they are intuitively forced to rely on past experiences, and they have a progressively more difficult time hearing the voice the market.

In addition, the need for extensive administration ultimately distracts management from the business of innovation, while dysfunctional and bureaucratic behaviors grow endemic inside of large organizations and result in huge distortions to the flow of information. Corporate politics gets more and more attention, and emphasis shifts to internal events, while key external factors become obscured from view. Meanwhile, change waits for no organization, and innovations from competitors are introduced without sufficient response.

In the 1950s, IBM's mainframe business, though dominant, was a tiny thing compared to its size a decade later. It's one thing to be an innovator in a small market, and quite a different matter to bring creative drive to a large operation. As a company grows and the stakes become higher, the risks that the small company has taken as a matter of course are now subjected to a lot more scrutiny and reaction times slow. More levels of management have a stake in major decisions; time lags in decision making are longer. In extreme cases, "analysis paralysis" sets in.

Smaller, more nimble competitors have less to lose, fewer people to convince, and often a sense of desperation that sharpens top management's perception of market needs. In fact, the well-tuned senses of entrepreneurial top managers become magnets for capital – small new companies are founded specifically to attack new market niches that only their top managers even recognize.

The result of this complex process is a pattern that repeats with astonishing regularity. As innovative companies grow they tend to become followers rather than leaders. Nevertheless, their sheer size, combined with control of distribution channels, makes them formidable competitors even when their subsequent innovations are really copies.

Another factor heavily influencing market evolution is that at any given time in any given market only a few critical value dimensions yield the key combination that proves most attractive to customers. Whichever company happens to have just the right mix available gains a temporary advantage, but the emphasis remains on "temporary" because the market's need change and very few companies sustain leadership over a long period of time.

We find countless examples of companies that have distinguished themselves by focusing on one or another of the many dimensions of innovation, but then fade into obscurity when the dimension in which they were particularly strong became a secondary or tertiary concern of customers.

From a manager's perspective, 37 dimensions of innovation presents a daunting challenge. Even if you're GE, GM, or IBM, 37 arenas for innovation are clearly too many to address at once. Which brings us to a critical dilemma that confronts managers every day: How to choose? In what aspects of a business should efforts at innovation be focused? Should a company apply itself to innovation in its products and services, or its brand, or its organization, its leadership team, its technology, its capital structure, or any of the others among the possible targets.

Or should it choose any of them?

Individual factors may explain the success achieved by this or that company in this or that market, but it's obvious that while any of the 37 areas may be important, no one of them consistently explains emerging success and failure. Wouldn't it be far more useful to have a robust explanation of the emergent successes as well as the astonishing failures, and thereby a better way to both examine the competition and to direct innovation efforts!

In search of such an explanation we could ask, What makes Fedex, Fedex? Or, What makes Schwab, Schwab? Or, What makes Home Depot, Southwest Airlines, or any flourishing company successful? Is there a way to accurately describe success and to explain how success emerges?

If we take this seriously what we're really looking for is more than innovation localized to a particular dimension, but a comprehensive innovation framework.

Competition & Business Models

When you look at our list of 37 possible innovation targets you see interesting potentials, but you also see a fragmented world. Viewed as a list of possibilities, each target stands separately, interesting perhaps, but alone. This may be useful for analytical purposes, but it's also fundamentally distorted because by looking at an inventory parts you'll surely not get a real appreciation for the whole.

But what if you could look at the problem of innovation as a whole, as one process? What would you see?

You might see this: Yesterday a whole range of tough competitors were creating new products, services, distribution systems, brands, and infrastructures that are bringing change to the market today. Recognizing the immanence of the creative destruction that will result from this, we accept the absolute imperative of innovation. And now we are confronted with the following question: How do we innovate with a clear focus not on the parts of the system, but the system as a whole?

To accomplish this we would first have to understand what the "whole system" is. It's not a particular department, a product, a service, or a brand. It is the entire organization together as one thing, working together to deliver value. For this new integrated whole to be a useful managerial concept we need to give it a name, and design a process through which it can help us manage the enterprise more effectively.

This whole is the "business model," a comprehensive description of business as an integrated system functioning in an intimate relationship with the broader market. In this concept, the individual components of an organization do not matter as much as the way they work together to enable the organization to create value and deliver it to customers.

A business model is therefore a description of a whole system, a combination of products and services delivered to the market in a particular way, or ways, supported by an organization, positioned according to a particular branding that, most importantly, yields a particular set of strong relationships with present and future customers. Further, a business model describes how the experiences of creating and delivering value may evolve along with the changing needs and preferences of customers.

Understanding Systems and Business Models

To make this approach useful we first need to understand some critical characteristics of the whole. In particular, we need to know how this whole is different from the parts that comprise it.

A key insight is that the distinguishing characteristic of any system is that its outputs emerge not as a result of any single part but as a result of the way the parts are connected together.

An excellent example of connectedness is an airplane. Each of an airplane's component parts, and even its major sub-assemblies, has the absolute tendency to fall towards the ground. Take them up to 35,000 feet and let go, and they invariably tumble straight down. It is only - only, only, only - when all the parts are assembled just so, and working together properly, that the system we call the airplane manifests "airplaneness" and actually flies.[11]

Similarly, a system we call "a company" consists of many different parts. It participates in other systems we call "markets," which in turn are part of a still larger system we call "the economy."

If you take a part of a company - say the accounting department - and put it into a market by itself, what you have is approximately … nothing. The accounting department has no relevance outside of the larger company because accounting is only meaningful when there are transactions that have to be accounted for.

Similarly, manufacturing requires a sales force, distribution, and customers. Marketing has no purpose independent of a company's identity, its products and services, and the perceptions of outsiders.

This tells us that the success of a company is not attributable just to one or another part, even as the reality of flight is most assuredly not an attribute of a single part of the airplane.

There's another aspect of the airplane analogy that's also important, one that has to do with the process of optimization. Let's say we have a nicely functioning airplane and we want to improve it. We might want to make the engines more powerful so the plane can go faster. But that might put too much stress on the airframe, or the wings, or it might change the control properties of the plane and make it unflyable. Hence, the ability of the system to function is entirely dependent on the mutual fitness of the parts. No part can possibly be optimized except in the context of all the rest. Instead, we must direct our efforts toward optimizing the system as a whole.

The product that cannot reach the customer provides no value; the service that cannot be delivered provides no value; distribution systems lacking effective products provide no value. So the optimal approach to marketing depends on the actual products that you're manufacturing and the customers for whom they're intended. Manufacturing, marketing, and sales have to fit together, and the definition of this fitness is the business model.

Consider a few somewhat oversimplified examples of what happens when the parts don't fit together well. Imagine a company with an amazing breakthrough technology, but a sales force that is incapable of selling it and a senior management that is largely indifferent to prospective buyers. Actually, that's not so difficult to imagine, nor is it all that oversimplified. Xerox had this experience.

After all, Xerox is the company that for all intents and purposes invented the personal computer at PARC back in the early 1970s. Naturally, Xerox wanted to make money from this profound invention, but because Xerox management didn't actually understand who would use the product, or what for, they tried to push it through an entirely unsuited distribution channel, to a market that was neither prepared for it nor able to understand it. It went nowhere.

Well, it went nowhere for Xerox that is. But a few other companies did make excellent use of Xerox technology, and in subsequent years they have made billions - yes, billions - by applying Xerox inventions to their own products and services. In particular, Apple, Microsoft, and 3COM were three big beneficiaries, and none of them have paid so much as a dime in royalties to Xerox.

Now imagine a company with a brilliant sales force that is also adept at bringing back news from the marketplace, but the company ignores the warnings? This happened to IBM, when it overlooked the emerging workstation market and allowed Sun to become the market leader when IBM failed to even make an attempt to address the new client-server IT paradigm.

Or let's look at cars. GM has a vast dealer network that is deeply embedded in the commercial fabric throughout North America (and in fact the entire world), but the company somehow can't manage to produce an Oldsmobile-branded car that enough people actually want to buy. The pipeline is there, but little is coming through it, so GM has been compelled by its persistent lack of innovation to shut down the Olds line.

To repeat, then, a "business model" is a description of the entire marketplace and the relationship of the company to that commercial environment. It is a precise definition of who customers are, and how the company intends to satisfy their needs both today and tomorrow. A business model also includes a specific assessment of today's competitors, and tomorrow's, and the technologies that will be embedded in various competing versions of products and services.

If Xerox had been thinking about its personal computer technology in terms of a business model, perhaps the results would have been different. If IBM had understood that workstation computing was a new and important business model, perhaps Sun would never have attained prominence. If GM had considered the business model underlying its Oldsmobile line, perhaps it would still be viable. In each of these examples it is impossible to know the root causes of the problem without knowing the actual people involved, but the results strongly suggest that top management was probably not asking the right questions, and they were probably not having the right kind of conversations about the future and how to adapt to it.

The realization that for the company it is the business model that matters drives a new approach the competitive marketplace and the way that companies should organize themselves to compete. In particular, it gives us a new way to think about adapting to change, or how to create it. Today and going forward what we're talking about is not just competition between companies, but competition between business models.

Or, in other words, *Business Model Warfare*.

Business model warfare characterizes the process of winning and losing that marks the creatively destructive marketplace, enables us to define a set of principles and skills that will enable managers to be effective at this game. Not that it's a new game, however. This is the way business has always been; and for just as long, managers have been falling into the trap of focusing too much on today and not enough on tomorrow.

Winning and Losing at Business Model Warfare

As we have noted, in addition to erroneous assumptions about stability, managers also fall into the trap of focusing too much of their attention inside their own organizations. This is a particular danger with middle managers who are under pressure from the hierarchy of organizational authority. Their instinctive sense of self-protection forces them to pay great attention to the behavior of senior management and often less attention to customers.

To engage in business model warfare, managers cannot be internally focused on products, services, or administration to the exclusion of the critical relationships between these elements, and the even more crucial interactions between a company and its customers. Thinking about innovation in the business model as a matter of the overall relationship between the company and its customers, rather than innovation isolated in this or that aspect, may therefore yield greater insight and better management performance: it's not a coincidence that the winners in business model warfare are usually those who manage their customer relationships in the most effective way possible.

Some examples. Japanese auto manufacturers are the source of many business model innovations. They applied their increasing expertise in manufacturing quality to create new, affordable high-end product lines, and now Lexus, Acura, and Infiniti are among the most admired cars worldwide and the most profitable segments of their businesses.

They continue to steadily increase their share of the American auto market, and their innovations in alternative fuels, far in advance of American manufacturers, may also win them added market share in the future as buyers develop a preference for fuels other than oil.

European giants Auchan and Carrefour redefined the French grocery business in the 1960s by applying new cash register technology to create the hypermarket, and at about the same time, Novotel introduced a new kind of hotel.

In the 1970s, Nike redefined the nature of competition in the sports shoe and sports apparel business by transforming star athletes into marketing icons, first with runner Steve Prefontaine and later with Michael Jordan. In so doing Nike created new markets for its shoes and clothing, and surpassed Adidas to become the global leader in a ruptured market. Nike's core business model innovation was turning its brand into a key element in the self-identity of its customers, which comes pretty close to the ideal when we're talking about the company-customer relationship.

American Express once dominated the credit card industry, and carefully cultivated an image of prestige and exclusivity. Visa entered into competition by creating a global network that was far more fluid and flexible, and has now surpassed American Express. Visa charged lower rates to merchants, making its services more attractive, and built its brand on ubiquity - Visa cards are available everywhere. And while each individual issuer has its own cards, the Visa brand cleverly maintains its underlying presence since it is owned by its member banks, all 65,000 of them. This is an organizational innovation of the first caliber, developed by Dee Hock and now articulated by him as an example of the "chaordic" organization, one that effectively balances chaos and order in service to continuous adaptation.

Dell created a commercial powerhouse by completely re-inventing the manufacturing and distribution process and building machines to order, rather than to inventory, thereby introducing an entirely new business model to the personal computer industry. Mass customization at a competitive price defined a new kind of customer relationship in the PC industry.

Southwest Airlines developed an approach to the airline business unlike any of the airlines that were established when the company was founded, and has sustained its unique business model to become the most financially successful company in a highly troubled industry.

One of the most interesting things about Southwest is that there isn't much technology evident in the business. What is apparent is that the leaders of Southwest thought through the air travel business in a comprehensive way, and avoided falling into traps that have hurt others. The company is not burdened by restrictive labor agreements that now weigh so heavily on its competitors; by design, the company does not operate out of airports that charge high fees; and it does not participate in centralized reservations systems. The company has not attempted to be something that it is not, a mighty global airline, but has instead focused on understanding its niche and serving it profitably.

Today, as a result, the market value of Southwest is more than twice that of United, American, and Delta Airlines - combined. Yet the revenues of Southwest are a small fraction of any of them. Why is this? Because Southwest is the only airline that's profitable. The company has a business model that is entirely suited to its market, and investors reasonably believe that it has the best prospects in the industry. Tomorrow it's possible that a competitor's innovation or some other change in the market landscape could change that perception, but for today the market has expressed its expectations.

Understanding Customers

As we examine industry after industry, we see that wherever there is an exemplar, a company that stands head and shoulders above others, that company is almost always a business model innovator that is applying creativity in dimensions other than technology to become a market leader. This does not, however, mean that every business model innovator is also a market leader, for innovation is a risky enterprise. Many new business models fail, as we have seen with the collapse of the short-lived internet boom.

Like Southwest, Fedex is most notable not so much for the pioneering idea of overnight delivery, nor for its innovative use of information technology to track packages, nor its positioning as a reliable, courteous, and service-oriented alternative to the post office. It is all of these factors, and more, integrated together as a coherent system. The fusion of these elements into an effective organization is precisely what we mean by the business model. And when we compare the Fedex model with the US Post Office model, we see consistent innovativeness on one side and astonishing stagnation on the other. Fedex has a history of change and development that the post office lacks. Certainly the post office is hampered by its own history as a government agency, its rigid labor relations, and even by its extremely broad mission. Just as certainly we see a business model that is failing, one that is losing market share to a host of competitors and becoming marginalized on the fringe of economic viability.

It's interesting to see how the post office did attempt to defend itself from Fedex. In the mid-1990s the post office introduced a guaranteed 2-day delivery service in a package very similar to Fedex's, and available at just 25% of the cost. After a while, however, it became apparent that 2-day service wasn't actually a guarantee, just an intention. While for many customers this may have been acceptable, it shows how little the post office management understood that Fedex's reputation for reliable execution was as important as the fact of its timely deliveries. Aside from its questionable notion of what constitutes acceptable delivery, it's probably a moot point until the post office realizes that another element of its business model is obsolete, namely the requirement that customers must wait in long lines to get service. If the post office ever wises up and solves either or both of these two problems, Fedex will have someone besides the brown trucks of UPS to worry about.

In contrast, UPS has carefully followed innovations from Fedex with its own, and now with its acquisition of Mail Boxes Etc. it has introduced a new dimension to competition among package delivery services. How will Fedex respond to this new maneuver in the business model war?

Home Depot also exemplifies the successful integration of numerous factors to create a business that is so appealing to customers and so devastating to competitors. Impressive scale on two dimensions - gigantic stores and a huge number of them - leads to high sales volume that enables the company to charge the lowest prices. The local hardware store or lumber yard can't compete unless it, too, undertakes its own business model innovation and positions itself as something that Home Depot cannot be. Which would be highly personalized service, fast transactions, proximity, better selection, different products ….

What we see consistently across all of these examples, and with widespread consistency across the entire history of business, is the following:

It's rarely, if ever, a single innovation that propels a business to success. It is, instead, a suite of innovations that complement one another and work together to provide a novel or distinctive value proposition that underlies success. The key is not necessarily the product or service itself - which could be highly innovative or even just acceptable - but something brought to market in an innovative way, supported in an innovative way, branded in an innovative way, but in the end always an approach that builds enduring relationships between the company and its customers.

Furthermore, the core of the innovation value proposition need not be built around a technology per se. In the examples cited above - Toyota, Honda, Nissan, Nike, Visa, Dell, Fedex, Home Depot, Southwest Airlines, and Ford (in the early days) - proprietary technologies play a part in the company's success, but there is always much more. The key to success is a focus not on technology itself, but technology applied in a business process to optimize the relationship between the company and its customers. In today's environment nearly any technology can be, has been, and will be copied, so the important competitive advantage is knowing how to use technology in a way that adds the greatest value for customers. It's when enough people believe that a $40,000 Lexus performs as well as or better than a $65,000 Mercedes that the structure of the market undergoes a profound change.

With all of this in mind, we now have a better way to characterize marketplace competition, creative destruction, and innovation. We see that effective innovation is not a matter of exploiting individual technologies nor of exceptional performance in any other individual element of a business, but rather a matter of harnessing the business model itself, which may but does not necessarily include technologies among its many possible dimensions.

To state it more simply, what's happening continuously in the marketplace is competition between business models themselves. The Lexus business model is different than Ford's business model, or Daimler Chrysler's, etc.

What this means is the winners at business model warfare have generally applied innovation to create competitive advantages, building stronger relationships with customers by developing business models that fit closely with customer needs and preferences.

Winners who have figured out these principles then seek to sustain their advantages through further business model innovations that defend newly-won territory and extend into new domains. It is therefore the business model itself that must be the focus of innovation, and innovation in any or all of the 37 possible dimensions must be undertaken in service to a larger framework that is defined by the business model itself.

Summary of Business Model Warfare

We will summarize our concept of Business Model Warfare in three propositions:

One: A "business model" defines a broad competitive approach to business, and articulates how a company applies processes and technologies to build and sustain effective relationships with customers. These relationships are the most critical factor. Creating them, understanding them, preserving them, enriching them, and extending them are the critical attributes of success. Everything that is done must be in service to these relationships; they are the point.

Two: Every successful business model earns some sort of competitive advantage to the extent that it serves successful relationships. However, any advantage may disappear overnight should a competitor devise a superior model, thereby displacing the company in the relationship with the customer. The life span of any business model is therefore limited, and due to the general unpredictability of change, its time frame is indeterminate. Managers who have the good fortune to preside over a successful business model should never lose sight of the ephemeral nature of their advantages, and must focus not on administering the (illusory) stability of today, but on preparing for or precipitating the inevitable change of tomorrow.

Three: Since business models are a more comprehensive way of understanding the focus of competition, they must also be the focus of innovation. Relentlessly changing conditions means that business models evolve rapidly, and business model innovation is therefore not optional. While innovations in any area within an organization may be important, innovations that pertain broadly and directly to the business model will be life-sustaining.

Based on what we have discussed here, the pattern of company mortality is a real and significant phenomenon, a result of the acceleration of change throughout the economy that operates on both demand and supply.

Demand is enormously influenced by innovation - new products and services coming into the market significantly affect the fate of all market participants.

The perspective from the supply side is a bit more complicated, but the pattern is also evident. Because the market is so transparent and the performance of every public company is subject to detailed scrutiny by investors and analysts, subtle changes in an organization's performance can lead to broad swings in stock price.

Improving performance and increasing stock price are a self-feeding cycles that create more favorable conditions for companies to develop and implement future innovations, both by improving stock currency for making acquisitions and by lowering the overall cost of capital. Conversely, declining performance and a falling stock price can lead to a downward spiral that makes it progressively more difficult for companies to compete for attractive acquisition fodder, and which can also increase the cost of capital that could be invested in innovation-related activities such as R&D and product development. Get ahead and push farther ahead; get behind and fall farther behind.

The data cited here show that over the medium term the majority of companies will get trapped in the downward spiral and one way or another most will disappear.

The prevalence of this trap suggests that while managers may be thinking and worrying about change and its impact on their companies, about competition and about competitive advantage, they must be doing so in a way that is simply not effective. Hence, we suggest that thinking about and enacting business model innovation may be a productive remedy for established businesses.

But the need for good thinking about business models is as important for new businesses as it is for old ones, and among the many examples consider the spectacular rise and equally spectacular collapse of Webvan, in which more than a billion dollars of capital was invested and lost. Its management - including a renowned CEO who had formerly been the head of Andersen Consulting - was so confident of what they were doing that they invested hundreds of millions of dollars of capital in a distribution infrastructure even though market demand that would generate a return was completely unproven. They believed that they could make the business work, and apparently fooled themselves into thinking that their own belief was sufficient basis for betting their capital on a business model that had never actually been fully tested. In the end, hundred-million-dollar warehouses were built but never used, never generating even a cent of return.

Thus, in spite of abundant talk about change, the temptation to build a business according to a fixed structure that is expected to endure for the long term remains strong. Never mind that the long term is completely unpredictable. Another way to say this is that management remains unrepentantly focused on stability and continuity, instead of on disruption and change.

For these reasons it remains relevant to discuss managing for change as an absolute requirement, but many (most?) managers still aren't very good at dealing with it. Nevertheless, recognizing change in the marketplace and adapting to its turbulent evolution are the realities that confront all executives, for although we remember periods that seemed stable, they are in fact long gone and never to return.

As markets continue to evolve and competition becomes ever more demanding, engaging in Business Model Warfare therefore becomes not just an interesting possibility, but perhaps a requirement. To survive, all organizations must develop a comprehensive innovation framework, and the perspective offered by the Business Model Warfare framework can help leaders to be more effective.

In the end, when we look at the business world it's clear that the story of change is still the important story to tell, and the process of leading an organization in the face of change remains the critical skill.

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Our research on Business Model Warfare is continuing, and additional publications are being prepared. Please contact Langdon Morris if you would like to discuss having your firm join this project. We also welcome any feedback you may have on this white paper. You can contact Langdon at LMorris@innovationlabs.com.

Based on this and other active research activities, InnovationLabs has developed the Accelerated Strategy Design Service to help organizations understand and implement new business models. You can learn more at www.innovationlabs.com.

Footnotes

[1] Richard Foster and Sarah Kaplan. *Creative Destruction*. Currency Doubleday, 2001. P. 14.

[2] This research was conducted at the University of Pennsylvania by project team member Geraldine Sawula.

[3] Arie de Geus. *The Living Company*. Harvard Business School Press, 1997. P 1.

[4] Richard Foster and Sarah Kaplan. *Creative Destruction*. Currency Doubleday, 2001. P. 8.

[5] Richard Foster and Sarah Kaplan. *Creative Destruction*. Currency Doubleday, 2001. P. 14.

[6] Joseph Schumpeter, *Capitalism, Socialism, and Democracy*, Harper & Brothers, 1942, 1947, 1950 p. 84.

[7] Don Wilson has contributed this insight, and many others that have substantially improved this report.

[8] Russell Ackoff. *The Democratic Corporation*. Oxford University Press, 1994. P. 210.

[9] A small, but important footnote to the Xerox story is that at one time in its history the company was so successful and so dominant that it was literally forced by federal government regulators to license its technology to competitors. With this strange turn of events the company's downward slide began.

[10] A minor but interesting detail is that Fords were originally brown, until a company engineer pointed out to Mr. Ford that black paint covered better and would therefore be less expensive. The point for Ford was thus not the color, but the principle of cost control. He understood well that lowering the cost of manufacture was the key to developing the market in the early years, but when this changed in the more mature market of the 20s, his company lagged as its business model lagged.

[11] John Gall, *Systemantics: The Underground Text of Systems Lore*. 1986. P. 158.