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Business Model Warfare

The Strategy of Business Breakthroughs

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Abstract

There's a story behind every business success and every business failure, sometimes the story of a great idea; sometimes 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. Hidden behind many of these changes, or sometimes as a result of them, there is change in what customers experience, and as a result, a change in their perceptions and attitudes, and then in their buying habits. Companies soar, or collapse, as a consequence. 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 often Business Model Innovations, the subject of this white paper. Here we propose a specific model explaining how large companies create and sustain market leadership in today's market, or the traps that they fall into that prevent them from doing so.

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Introduction

The average lifespan of a major corporation isn't very long. The rate of change throughout the economy is such that a surprising number of new companies are being born and then growing to be quite large very quickly. At the same time, many older and well established firms are falling by the wayside just as fast, or faster. Hence, just because a company is listed in the S&P 500 or the Fortune 500, or any other of the biggest and most powerful and influential firms does not mean that it can look forward to a long and happy life ahead, as the mortality rate is high, and increasing. Many companies that we today consider to be leaders will be gone by tomorrow, or the day after, while companies that we haven't yet heard of, and indeed which may not even exist today, may will in many cases become next week's industry giants.[1]

This problem of accelerating change is one of the most challenging issues facing business and government leaders today, not only in the developed world, but everywhere.

In these turbulent markets where companies that were once dominant are struggling to survive, managers are constantly probing to understand what makes the difference between success and failure.

Looking at the recent past, for example, we might ask what happened to Nokia, or Blackberry, or Kodak, or Sony, Sears, Xerox, Blockbuster, Pontiac, Lehman Brothers, and so many other great brand names. Why was GM's Saturn subsidiary a breakthrough in the 1990s and 100% dead in 2008? At the same time, how did Google, Facebook, Amazon, Fedex, Charles Schwab, and Home Depot become so big so fast, so widely admired?

There's a story behind every business success and every business failure, sometimes the story of a great idea; sometimes 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. Hidden behind many of these changes, or sometimes as a result of them, there is change in what customers experience, and as a result, a change in their perceptions and attitudes, and then in their buying habits. Companies soar, or collapse, as a consequence.

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 in today's market, 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.

From the first year the Fortune 500 was created, 1955, and continuing through 2001 we identified the companies that were on the list one year but not the subsequent year as living examples of what we might call the relentless progression of competition. 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 very large 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.

In 1917, Forbes magazine created its own list of the largest 100 US companies, and over the seventy-year span 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 list provides a third reference point. The mortality rate S&P 500 companies has been steadily increasing, and the average life span has steadily decreased from more than 50 years to fewer than 25 today.[4]

The three slices of history convey a clear pattern, and projecting the pattern forward suggests that about a third of today's major corporations will survive as significant businesses for the next twenty-five years. Richard Foster and Sarah Kaplan comment that, "Most will die or be bought out and absorbed because they are too slow to keep pace with change in the market."[5]

That's the key issue – keeping page with change in the market; and of course it's very difficult to do. Where, then, to focus?

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 market dynamics. Today, the most external critical factors are accelerating change, increasing competition, new technology, and increasing complexity, while the two major internal drivers are innovation and corporate decision making.

While each of the external ones presents its own particular problems, the impact of all four acting together significantly compounds the problem, composing a "change conspiracy" that increases the danger exponentially. The results are a drastically compressed planning horizon for every company, the need for faster responses throughout the organization, and the accelerating rate of corporate failure as leaders simply fail to master these dynamics.

Indeed, 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, as mentioned, Nokia, Sony, Kodak, Sears, Xerox, and many others.

While these companies struggle to right themselves, even entire nations struggle to keep their economies viable in the new and demanding framework of global markets. A decade ago Argentina, Brazil, and their South American neighbors were caught in a deep decline; currently Greece, Spain, and Ireland are notable for their struggles, while Japan struggles with an economic restructuring that has already lasted nearly two decades.

The parade of failures makes for dramatic stories that are illustrated by the sad losses suffered by individuals and families struggling to survive the economic and emotional strains, but as more and more companies fail, it is becoming clear that these are no longer unusual events.

In spite of the attempts by governments, central banks, and multilateral organizations such as the IMF, WTO, and the World Bank to reduce the impacts of change, it's evident 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 I 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. In the 1940s the brilliant 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 of capitalism, not stability. And in an utterly 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 leaders 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 enticing 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 forward at a 90 day sales forecast and the next quarterly report, or backwards to the past, to guide a course into the future. Neither approach is adequate to the challenge that is the focus of this paper.

We call this short-term mentality the "logic of operations," and it is characterized by a pattern of behavior whose goal is to create a stable, scalable enterprise that returns strong, steady profits to its stakeholders. The qualities that are important from this perspective include predictability, the capacity to forecast future growth, revenues, and profits, and as a result tremendous emphasis is placed on management of today's business. Standardization, policy, procedure, organization structure, and short-term decision making are tuned and fine tuned.

The problem, of course, is that the obsession with predictable scalability ignores the realities of external change, and in an era characterized by the nasty change conspiracy, the obsession with the short term cannot and does not succeed.

To take Nokia as a poignant example, it does no good to be far and away the globe's leading cell phone maker, the firm with 9 of the top 10 selling phones worldwide, as Nokia was in 2007, when the iPhone comes along. Since the introduction of the iPhone, Nokia's market capitalization has dropped from a nice high of $150 billion in 2007, to a rather sad $27 billion today (February 2014). That's $123 billion erased as its prospects transformed from bright to dismal. With top management looking backward instead of into the future, Nokia did not have a ready response to the iPhone. It quickly became a sad story for a lot of people.

Nokia's 2007 Annual Report is written in glowing language that is highly optimistic. Military leaders are familiar with this problem, which they refer to as "preparing to fight the last war." Such preparations, even fully implemented with rigor and discipline, consistently fail if the style of warfare has in the interim changed. Whether it's armored knights slaughtered by the long bow, France's Maginot Line, the 20th century's iconic monument to backward thinking, the Polish horse cavalry that rode out to face Hitler's blitzkrieg, the American army confounded by Viet Cong guerrilla fighters, civilian aircraft hijacked and turned into guided terrorist missiles, or a new class of weapon based on the cell phone, the "IED," "improvised explosive device," the history of warfare is the history of innovations that render past strategies ineffective. This is also the history of business.

Hence, the relevant question is, What is your strategy for dealing with accelerating change?

Part of the challenge with this type of thinking is that the misplaced focus is usually evident only in hindsight,

when wars, market share, jobs, or stock value have already been lost. You have to find a different way of thinking, and a different way of working.

When things are moving so fast, in fact it's a new kind of radar that you need, along with a different approach to making decisions. For business leaders as for generals, hindsight does not provide sufficient preparation, and it is therefore essential to have an effective way not only to look toward the future, but even better, to create it. It is on this imperative of innovation that this report will now 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 "fighting the last war" warns us as well that we have do it differently if we're going to survive. Both help us direct our attention toward understanding the forces of change rather than supporting the illusion of stability, and also remind us 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. That's right ... your rivals in the marketplace or the battlefield are targeting you. There is a business, or more than one, whose innovative thinkers are working right now to take away your share of the market, for innovation is indeed the weapon of choice.

What is your best response?

Innovations of your own.

In fact, innovation may be your only possible valid response.

However, innovation is a term that means different things to different people. Since it's a critically important concept to this report and to your business, we'll pause here to 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 each case, can be an insight, a new idea, a product, a strategy, a new or improve business process, or perhaps a new business model (we'll get to defining "business model" shortly). 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.[7]

The label "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 have only minor impact on the market can be significant and critically important, especially if they help a company to provide its customers with a superior experience. 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.[8]

Hence, the approach that Peter Drucker labeled as "fast-follower" is a useful 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 became a fast follower and quickly overtook Netscape, forcing it to seek refuge as a subsidiary of AOL. (AOL grew dominant for a short time, acquired Time-Warner, and then itself collapsed into near-irrelevance before being reinvented.)

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 Google, Amazon, Facebook, Charles Schwab, Home Depot, and Fedex - most have attained 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, and they succeeded in doing so.

But the innovator's role is only half of the equation. Customers are the ones who determine the 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. 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.

It's an endless cycles that serves only to drive the process of change still that much faster and more widely 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. An enormous, thorny problem for enterprises, because managing the innovation process is one of the most challenging issues facing any of them. 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 leaders and managers handle change, and it highlights the necessity of constant regeneration of the business from within through the R&D process and other creative and innovation-seeking endeavors, that is, on activities that are directly intentionally at creating innovations.

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 to their companies than skills related to administrating and controlling. 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[9] - they must first *figure out* what the problem is, which can itself require a great deal of insight and creativity. And for the most part, textbooks don't help.

In today's markets change is the norm and stability is an aberration. Leaders 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. Somewhere in the competitive environment it's likely that a new innovation is about to appear that will dramatically impact on the current structures that your business depends on.

And yet the relentless day to day demands on every manager's time immerses them in a flood of pressing issues, and many simply fail to recognize important underlying factors that portend significant disruption. Consequently, they 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? And did the smart phone radically disrupt the cell phone makers? The answer to all of these questions, of course, is "Yes." This can happen only because leaders are looking in the rear view mirror, gazing backwards at what they have accomplished, instead of forward at what must be accomplished.

Occasionally we even see a company whose leaders, judging by the evidence of their behavior, prefer to go out of business rather than do the work of adapting to change. It can be intellectually as well as psychologically difficult to shift the focus from the operations mentality and actually confront the need to do things in a very different way.

During his tenure as CEO of IBM, during which he turned the company from a disastrous decline, Lou Gerstner commented that, "Many successful companies that fall on hard times – IBM, Sears, GM, Kodak, Xerox – saw clearly the changes in the environment. But they were unable to change highly structured organizational cultures that had been born in a different world."[10]

Even today, the local Sears store appears to be caught in a time warp, its merchandising showing all the leading edge ideas of 1975. Have their merchandising directors never seen an Ikea store, much less an Apple store? I don't have much confidence that Sears will be around much longer. What, one wonders, could they possibly be thinking? But they're not alone, for as we noted at the very beginning of this paper, companies are dying every day, even big ones that you'd think would know better.

And as Mr. Gerstner points out, a primary reason seems to be that some leaders actually make the choice for their enterprise to fail, to die, rather than confronting the need to change and adapt, that is, to innovate.

And while it is imperative for organizations to be continually engaged in the process of innovation, an

important question concerns where those efforts to innovate should be focused. Because there are, it turns out, a great many possibilities.

To examine this 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 suggest that in such an organization there are at least 38 distinctive opportunities for innovation.

38 Possible Innovation Targets

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." One of the lessons is that technology innovation by itself has rarely been sufficient to ensure the future, and it is certainly not today. Nokia, to go back to that sad story, has mountains of great new technology. In its halcyon days, it was one of the world's greatest technology innovators, and its massive R&D budgets were the envy of companies worldwide.

But in fact, Nokia's collapse was one of the most effective messengers of an important lesson, which is that it's not a question of how much you spend on innovation, but rather the process you use to manage that effort. Booz & Co. has shown us through some great research that spending a lot on R&D is surely no guarantee of future business success:

Table 1: 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
  - automation
- 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

"Yearly R&D spending among the world's 1,000 largest public corporate R&D spenders has hit a record high of US$638 billion, according to global management consulting firm Booz & Company in its ninth annual Global Innovation 1000 study. However, despite the sustained overall increase in R&D budgets over the last decade, this year's findings show once again that higher spending doesn't guarantee bigger payoffs. Indeed, the 10 most innovative companies our study identified this year financially outperformed the world's top 10 spenders, despite actually spending significantly less on R&D."[11]

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 the opportunity to acquire Carlson's technology at bargain prices.

When he finally did find a partner, it was tiny Haloid Company that stepped up, and together they found that getting the technology to market entailed far more than simply building new machines. The success of Haloid-become-Xerox 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. This brilliant insight propelled Xerox into the top echelon of American business, where it remained, however, only for a few decades. Today 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 inexorable power 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 managers has the task of rebuilding the company.[12]

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. It was at PARC, in fact, that the personal computer as we know it today was invented. Not only was the investment substantial, but so were the results.

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.

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.

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 each of the 38 dimensions that might provide differentiation. Strong customer relationships help companies survive the inevitable periods when their technology will not be the best.

The experience 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 was not actually a technology leader in many of its product areas, but for the decades of the 1970s, '80s, and '90s, IT managers 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. Because 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 among IT executives was that, "Nobody ever got fired for choosing IBM."

Over the years an increasing proportion of IBM's revenues and profits have come from its services organization, and the major transformation led by Louis Gerstner was a massive shift from product-based revenues to services. 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.[13] 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. Today, we wonder if Tesla will be a future industrial giant. And what new car company that we haven't heard of yet will be the leader in 2025, or 2035?

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 growth. But in the 1920s, the nature of the market itself was changing, and Ford's success as a cost-cutting pioneer did not serve so well when market dynamics began to favor factors related to comfort and style.

The point is that 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. And this is what makes the work of Gerstner so significant at IBM. In the face of a major shift in the market, the company faced the choice to reinvent itself or collapse, and Gerstner in fact led the process of reinvention with great success.

Many of the negative examples already mentioned confirm how extraordinary this was.

Xerox led the copier market, but has nearly collapsed in the age of the PDF.

Kodak was the world's number one manufacturer of film, but collapsed when digital cameras displaced film cameras.

Nokia led the cell phone market, but was not prepared for the smart phone market.

Sears led American retail for decades, but lost out to Wal-Mart when discounting and supply chain management became the key differentiators.

Between 1995 and 2004, Coca-Cola dropped 50% of its share price when customers switched their preference to healthier beverages (and much as IBM did, it has since recovered).

There were many happy and charming bookstores all over America until Amazon.com undercut their prices by 20 or 30%, and now there are almost none.

So the point is clear – just because the current structure of the market favors your solution absolutely today, does not mean that the structure of the market tomorrow will also favor you. While one set of products and services may be exceptionally well-suited to the market at a particular point in time, it's surprisingly rare for a company to successfully adapt its products and services to changing market conditions quickly enough to sustain its leadership position.

Chances are they have positioned their defenses in a way that leaves them vulnerable, and indeed it is common for companies to cede market dominance when clever competitors attack them in areas where they are not prepared to defend themselves.

Sears, for example, allowed Wal-Mart to establish itself in smaller rural markets that Sears had thought unfeasible. 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 soon found itself in bankruptcy. (And then, strangely, CEO Edward Lampert decided that a merger of the two failed companies was the best solution for both. So far the results have not been so good.)

Similarly, by focusing on annual style changes in their competition with one another, the Detroit automakers largely ignored the importance of underlying quality improvements. When quality suddenly became an important attribute for American buyers in the 1970s, the Japanese manufacturers began taking market share. Before 1980, GM didn't take the Japanese seriously as competitors at all, 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, to 18 % today.

During his unsuccessful 10 years as CEO of GM between 1998 and 2008, Rick Wagoner saw the company's market valuation drop by 90%, and losses totaled more than $80 billion. This, together with the story of Nokia, shows just how bad things can get when a company loses its fit with the market, and competitor innovations take hold in the market.

It takes exceptional discipline and clarity of vision to defend a competitive advantage and carry it through to a next generation of offerings, and not to be cruel to Mr. Wagoner, but in hindsight he just wasn't the right guy for the job.

The challenge, particularly for a board of directors, is to know who *is* the right guy, or woman, for the job, because the CEO must look after both the current business and also the future, and these two facets require quite different expertise and viewpoints.

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 managers are often in direct contact with customers as a natural part of their role in the company. But as they deal with the complexities of larger enterprises and multiplying layers of organization, they often become further and further removed from 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 a changing market that was different than the one they remember.

In addition, the need for extensive administration ultimately distracts management from the business of innovation. At the same time, dysfunctional and bureaucratic behaviors grow endemic inside of large organizations, and result in huge distortions to the flow of critical information about the changing external market. 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.

Hence, 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. Sometimes they slow disastrously. 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 entrepreneurs and the capitalists that back them 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 faded into obscurity when the dimension in which they were particularly strong became a secondary or tertiary concern, or a non-concern, of customers.

From a manager's perspective, however, 38 dimensions of innovation presents a daunting challenge. For old school giants such as GE, GM, or IBM and new school leaders such as Apple, Google, or Cisco, 38 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 38 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? Of course.

In search of such an explanation we could ask, What makes Apple, Apple? 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 question seriously, what we're really looking for is more than innovation localized to a particular dimension, but rather a comprehensive innovation framework.

The Business Model

When you look at our list of 38 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 imminence 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, provides experiences to customers that yield a particular set of strong relationships with them. Further, a business model describes how the experiences of creating and delivering experiences and value may evolve along with the changing needs and preferences of customers.

To make this approach useful we will 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 such 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.[14]

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 (unless you want to run an accounting services company). 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 any 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. Indeed, Coca Cola discovered this a decade age, when the world's most proficient marketing machine lost half of its market valuation because … the market for Coca Cola stopped growing. This misfit between product and market was devastating to stock price, partly because mired in its past, the company's leadership failed to notice what was happening. This oversight enabled Pepsi to shoot ahead in terms of market capitalization; it also cost the CEO of Coke his job.

Certainly the optimal approach to marketing depends on the actual products that you're manufacturing and the customers for whom they're intended. Product design, manufacturing, marketing, and sales have to fit together, and the definition of this fitness *is* the business model.

Consider another example 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; Xerox had this experience.

After all, Xerox is the company that literally 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 and Microsoft were big beneficiaries.

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 computer workstation market, a device occupying a market niche between the PC and the mainframe, and allowed Sun to become the market leader when IBM failed to even make an attempt to address the new client-server IT paradigm. (Sun, it should be noted, also subsequently faltered, and became part of Oracle.)

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 couldn't manage to produce an Oldsmobile-branded car that enough people actually want to buy. Although its headquarters was packed with thousands of very bright minds, GM was compelled by a persistent lack of innovation and a chronically worsening shortage of capital to shut down the Olds line. And then it did the same with Saturn, Pontiac, and Hummer; the death of these brands was another aspect of Rick Wagoner's unsuccessful legacy.

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 provides a specific assessment of today's competitors, and tomorrow's, and the technologies that are and 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 is that for the company it is the business model that matters, and which must drive any new approach the competitive marketplace as well as how it should organize itself to compete. This 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, and enables us to define a set of principles and skills that will allow 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 upper levels in the hierarchy of organizational authority. Their instinctive and entirely logical sense of self-protection forces them to pay great attention to the behavior and desires of senior management, but sadly less attention is often paid 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. Remember the metaphor of the airplane, and the critical role of the connections in its capacity to fly. 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 ways possible, by creating compelling experiences across many different dimensions.

Some examples:

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

They continue to steadily increase their share of the American auto market. Further, Toyota's innovations in alternative fuels with they hybrid Prius line, far in advance of American manufacturers, won it added market share as buyers develop a preference for fuels other than oil. The Prius was the best selling car in California in 2013.

Looking to Europe, retailing 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 own 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. Nike, in fact, elevated brand management to unprecedented heights, and has demonstrated how central the concept of brand management is in today's market.

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, flexible, and low cost, and has far surpassed American Express. Visa charges lower rates to merchants, making its services more attractive, and built its brand on ubiquity – Visa cards are available and accepted everywhere. Visa's first forty years prior to its recent IPO were built on 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 innovation and 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. But in an impressive display of changing market structures, the company's unique business model lost its charm, and founder Michael Dell took the company private in 2013 in his attempt to recreate the magic of its past.

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 for the decades leading up to the systemic crisis in airline industry that resulted from the terror attacks of September 11, 2001.

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 hurt others. The company is not burdened by restrictive labor agreements that now weigh so heavily on its competitors; by design, the company did not operate out of airports that charged high fees; and it still 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.

Exemplars

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, and is applying creativity across many dimensions of customer experience to become that 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, just as old ones do.

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. No, 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 and buckets of money, and facing a host of competitors as it becomes 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.

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 pay and 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 …. Ace has recognized this as its niche, in which it is doing quite well, positioned as the anti-Home Depot, and also demonstrating how the evolution of business models creates new opportunities.

So 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, and 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, Nike, Visa, Fedex, Home Depot, Southwest Airlines, and Ford (in the early days) – proprietary technologies do play a part in the company's success, but there is always much more later. The key to success is a focus not only 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* the technology in a way that adds the greatest value for customers. When enough people believe that a $45,000 Lexus performs as well as or better than a $65,000 Mercedes, it is then 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 that of Mercedes, etc.

What this means is that 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 across multiple dimensions.

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 38 possible dimensions must be undertaken in service to a larger framework that is defined by the business model itself.

Part III: Mapping the Future

As I mentioned above, during the last ten years we've had ample opportunities to explore business model innovation in our work with organizations in a great many industries, and to develop tools and models that our clients have used to help them chart their future course. One of those tools has proven particularly useful, and I would like to introduce it to you here. We like it because it is both an analytical and a predictive tool, and because it seems to explain a great deal of what's actually happening.

In particular, we wish to address these questions:
Where are we today, where are our competitors, and in which direction lies our future?
What business models will be successful in the future?
In which direction should we direct our innovation efforts?

In response to these questions we have devised a market map as a simple matrix. We label the horizontal axis "market size," and the vertical axis "customization" (or "differentiation").

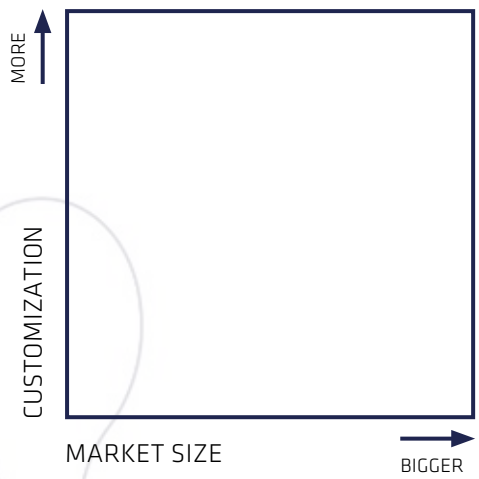

Figure 1

Moving from left to right means accessing more customers, which in turn implies that the price decreases. Hence, the business model intent of both Wal-Mart and Ikea is to move progressively to the right. "Lower prices every day" is not a Wal-Mart advertising slogan by accident, but a central element of the company's value proposition. Hence, the lower right hand corner of the matrix designates the largest mass market, the one with the lowest prices and the least customization. In the US we have a company called "the dollar store" that occupies that spot. Everything in the store, predictably, costs $1.

Moving from bottom to top, meanwhile, means increasing customization and differentiation. Therefore, the upper left corner is where you'll find the exclusive products that only the richest people in the world can buy. Private yachts and jets, Picasso and Van Gogh paintings, mountain-top estates and private islands.

The lower left corner of the matrix is a therefore a Dead Zone – if there were such a thing as high prices and no customization, this is where you would find it.

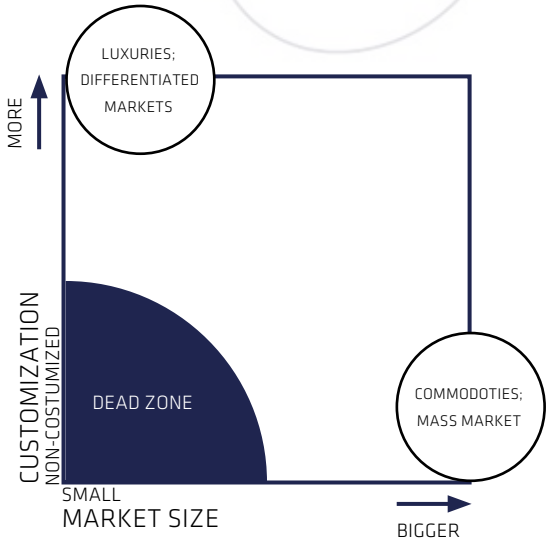

Figure 2

No business would consciously choose to occupy this spot.

What this map enables us to do, therefore, is to determine our relative place in the market, to study the behavior of our competition, and then to help us plot our future course.

As an example of how we can use the model, let's take the hypothetical example of Sears, which as I noted,

was at one time the dominant American retailer, an innovative company that grew to enormous size and influence. Sears did this by offering great value, and it was very specifically targeted at the core of the market.

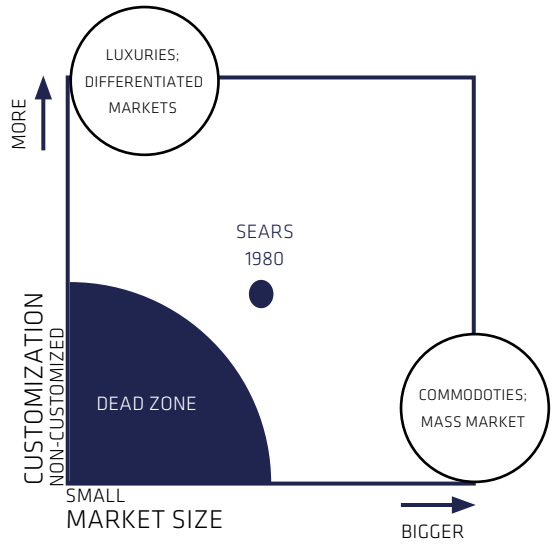

Figure 3

Both as a matter of its business design and its marketing, it strived to be the iconic American retailer. Headquartered in the center of the country, in Chicago, the company exuded confidence and reliably produced handsome profits for many years. Figure 3 shows Sears happily at core in 1980.

However, Sears had a young rival at that time, and within 20 years the rival had far surpassed it. Wal-Mart out-innovated Sears, and while Sears suffered significant declines, Wal-Mart grew very fast, both in the US and throughout the world.

Our market map of 2000 shows that the overall size of the market has grown significantly, which reflects the normal process of economic growth. The map also mentions a key factor, which is that overall customer expectations changed from 1980, and parts of the market that were quite viable in 1980 have been overtaken by the dead zone by 2000. Sears, which stayed resolutely where it was, and therefore did not adequately innovate its business, was simply swallowed up by the staying the same. Changing customer expectations put it squarely in the expanding Dead Zone.

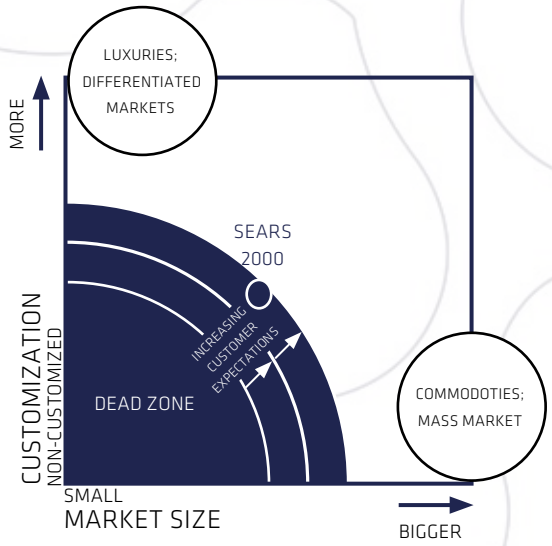

Figure 4

Wal-Mart, however, demonstrated the qualities necessary for continued success. By developing new innovations in its supply chain, product designs, and in fact across the entire scope of its business model, it succeeded in moving its business model both upward, with higher quality products, and to the right, with progressively lower prices. (figure 5) (It should be noted that Wal-mart's employment policies remain controversial, and one can argue that its success is based in part on a practice of under-paying its employees by manipulating the labor laws of the US. For the purposes of this paper we leave this issue aside, but we acknowledge the ethical problems associated with this practice, and the likelihood that future changes to its business model may be forthcoming as a result.)

Wal-Mart, and another successful business model innovator Ikea, both continue to aspire to move both up, toward more customization, and to the right, toward ever lower prices. And so do all of their competitors. Including, of course, Amazon.

By 2020 we can easily imagine Sears totally buried in the Dead Zone, and indeed with a massive infusion of innovation it's hard to imagine Sears surviving at all, while Wal-mart will probably continue to move up

and to the right, even as the Dead Zone chases it up and outward. Hence, the Wal-mart of 2020 will be the same as the Wal-mart of 1980 in name only, as creative destruction chases it ever forward.

So they will ask themselves how else they can customize the experience of shopping with them? Amazon does so through its delivery services, and its offer to get your purchase to you within two days, or a day, or even hours in some cases. Amazon also offers recommendations customized to your interests, based on statistical analysis of the behavior of millions of its customers. How will Wal-mart do that?

Netflix does the same thing, and because viewer recommendations are so important to its business, in 2009 the company Netflix sponsored a contest in which it paid a prize of $1 million to the programmers that best improved the accuracy of user recommendations. It's quite obvious that the goal of the prize is also to move Netflix up on the map, toward still better customization.

You might also be able to use this map to help you think about the future of your business, and to compare your own company's performance to your competitors, as we have compared Sears and Wal-mart. As another example, let's look at Mercedes and Lexus. Earlier I mentioned that a $45,000 Lexus competes successfully with a $65,000 Mercedes, which on the map looks something like this.

Figure 6

The $20,000 Chevrolet, meanwhile, purposefully sits in the center of the market, similar in brand identity and corporate culture to Sears. For a long time this was a profitable spot, but no more. So like Sears it was swallowed up by growing customer expectations. The failure of Chevrolet to innovate was indeed a big part of the problems that Rick Wagoner was unable to fix, and a significant contributor to the drastic decline of GM.

The point of all this is obviously that you can also use this framework to think about the aspects or dimensions of your business where customization can be offered, and where it can be improved by lowering prices, thereby moving your entire business model continually upward and to the right. This may not be optional, and indeed, when we look at the companies that have failed, we often see that their competitors offered either lower prices, or more customized solutions, or both.

For example, you may remember that in its early days, Google had a lot of search engine competitors, but over time they have all fallen away simply because the search results that Google provided were simply better, i.e., more customized to the specific requirements of searchers. Remember, though, that this does not mean that Google will forever be entrenched as the exemplary occupant of the g-spot (in which case the name of that spot on the matrix may have to be changed), because there is no end to the business factors that *could* become important in a future market, and which some firm other than Google may master. As I noted above, it is very often when the key drivers of competition change that old companies are pushed aside, and new ones take their places as leaders. And this happens precisely because it is the new firms that master then new competitive factors first.

To take the example of but one company, we may be looking at such a process right now with Microsoft. The company is a tech colossus, dominant in many fields, but still struggling to adapt to change. Sales of the PC are declining worldwide, down 10% from 2012 to 2013. Sales of tablets, on the other hand, increase, but Microsoft is not benefitting significantly from this because it did not foresee that market, and came quite late with its Surface. Microsoft Office and Microsoft Windows remain dominant software products for PCs, but if PC sales continue to fall, then the company will find itself fighting a rear guard action to preserve the past, rather

than a proactive one to create the future. We could well foresee that when PC sales drop below some currently-unknown threshold that Microsoft may follow in the footsteps of Nokia or Kodak, passing the threshold of non-sustainability below which the company implodes.

But the leaders of Microsoft are obviously very smart, and they see what's happening as well or better than us outsiders. So will they lead their company to create the next generations of products and services and business models to sustain Microsoft in the years ahead? Will they be able to create better business model and new products and services that move up and to the right on the matrix, faster and better than their competitors? The hypothesis of this paper, and the logic of business model warfare, suggests that this should be one of their overriding objectives, and perhaps a convenient (although certainly quite simplified) way to assess any given decision or proposed initiative.

We will follow this closely, but no matter what happens, it seems that concepts and principles explored here may be useful as we seek to understand the patterns of change in the marketplace, and to predict the outcomes of decisions yet to be made.

The upper right corner, meanwhile, remains an interesting sort of business Nirvana. Here you might find an entirely customized product, which is affordable by literally everyone, because it's free. But surely this could not be the location of any company, for how would it survive?

In fact, however, there are currently two companies occupying that corner, and their astounding success has been achieved precisely because their product (well, service really) is utterly free and yet totally customized to the uniqueness of your specific requirements.

One of these companies is Google, which is happy to provide you with a fully customized web search at any time, day or night. It takes only milliseconds, and it did this approximately 2 trillion times in 2013, or 6 billion times per day, 4 million per minute, and thus 70,000 per second. (I found that out by doing a Google search, of course.[15])

It is in honor of Google that I have named the sweet spot in the upper right corner, somewhat tongue in cheek, the "g-spot." (I hope they don't mind.) Google's business model has created a good number of billionaires precisely because it is so well and uniquely positioned, and also because they do seem to fully understand the extraordinary position they occupy, and because they are managing the firm to exploit and extend their significant advantage.

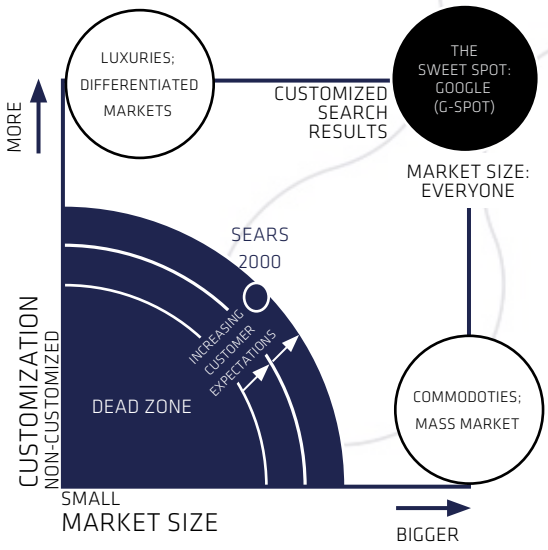

Figure 7

Microsoft's Bing, meanwhile, plays fast follower. (It is a position we are accustomed to seeing a Microsoft product occupy.)

The other company now occupying the g-spot, beside Google, is Facebook (the "f-spot"?), which is also free.

Interestingly, Facebook is also built entirely on the concept of total customization, but in Facebook's case, the customization is provided by you, the user. And nearly a billion of us are happy to oblige. Facebook has also created billionaire owners, and they also seem to understand their unique situation.

Actually, Google also relies on us to customize, as we are the one who are creating the 180 million + web sites that Google then searches for us, for free. This profound partnership between content creators (us), platform creators such as Facebook, and content locators such as Google and Bing, constitutes a hugely

significant phenomenon for future business model innovators to understand, exploit, and further develop. It is here that we can anticipate many surprises in the future, particularly as computers become faster, more powerful, and less expensive.

Oh, wait... there's another example where the model shows its validity. The PC itself, as s device, has gotten considerably less expensive, massively more powerful, and exceptionally more customizable, over the last 30 years. The entire PC industry has moved significantly up and to the right, especially if you consider your smart phone to be a PC, which would be an accurate characterization. Today's iPhone, for example, is the rough equivalent in computing power of a supercomputer from three decades ago. Now, if the folks at Nokia had been thinking about their product in these terms, rather than "cell phone," then perhaps they would have been better prepared for what the iPhone did to their business model.

So you get the point. For the majority of companies that operate in the physical world of products and services, for which they must charge money to survive, the g-spot is an enticing destination that they will never actually attain, but toward which they must always strive. Although I have indeed tried, I have yet to identify any competitive advantage that cannot be represented on the map, which suggests that it may valid very broadly. (If you can think of counter-examples, I would be happy to learn about them from you.)

E-world companies, meanwhile, can and quite happily do occupy that coveted spot.

Summary of Business Model Warfare

There is of course a lot more that could be said, but we'll leave that for another time. For now, I'll summarize the concept of Business Model Warfare in these 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. The experiences that customers have, and the relationships that companies build with customers, are the most critical factors. 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. We can visualize that relationship by understand the market as a two-dimensional map, on which we plot market size (i.e., price), and product//service customization. These two dimensions tell us a great deal about the value proposition underlying any business model.

Due to competitive forces, the life span of every business model is therefore limited, and due to the general unpredictability of change, its time frame is indeterminate. Leaders 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 only on administering the (illusory) stability of today, but on preparing for or precipitating the inevitable change of tomorrow by understanding how costs can be lowered while customization is simultaneously increased.

Three: Since business models themselves are a more comprehensive way of understanding the focus of competition, they must also become a focus of innovation itself. 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.

Four: The model tells us that we must aspire to move upward and to the right, and that the dead zone is chasing us that way. If we stop, the dead zone threatens to swallow us, as indeed it has done for so many failed business models.

Five: 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 both 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 leaders may be thinking and worrying about change and its impact on their companies, about competition and about competitive advantage, many have been 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 exercise for established businesses.

And 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 team – including a renowned CEO who had formerly been the head of Andersen Consulting – was so confident of what they were doing (i.e., their business model) 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 massive 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 such a management approach that remains unrepentantly focused on stability and continuity, instead of on disruption and change, will be unpleasantly surprised in the end.

For these reasons it will remains imperative to discuss managing for change as an absolute requirement, but many (most?) business leaders nevertheless still aren't very good at dealing with it. Recognizing change in the marketplace, anticipating, and adapting to its turbulent evolution, these are the challenges 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 comprehensive innovation frameworks, and perhaps 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.

Endnotes

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 Langdon Morris. *The Innovation Master Plan*. Innovation Academy, 2010.

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

9 Russell Ackoff. *The Democratic Corporation*. Oxford University Press, 1994. P. 210.

10 Louis Gerstner. *Who Says Elephants Can't Dance*. HarperCollins, 2004

11 Booz & Company. "Booz & Company Announce Its Ninth Annual Global Innovation 1000 Study" Oct 28, 2013. http://www.booz.com/cn/home/press/displays/2013-global-innovation-1000-cne

12 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, utterly not of its own doing, the company's downward slide began. Hence, some blame for Xerox's demise does fall on misguided US government regulators.

13 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.

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

15 http://www.statisticbrain.com/google-searches/

About the author

Since 2001, Langdon Morris has led the innovation consulting practice of Innovation-Labs LLC, where he is a senior partner and co-founder. His work focuses on developing and applying advanced methods in innovation and strategy to solve complex problems with very high levels of creativity.

He is recognized as one the world's leading thinkers and consultants on innovation, and his original and ground-breaking work has been adopted by corporations and universities on everycontinent to help them improve their innovation processes and the results they achieve.

His breakthrough white paper, Business Model Warfare is a landmark in the field, and is used as astandard reference at universities and corporations worldwide. His book Fourth Generation R&D, coauthored with William L. Miller, is considered a classic in the field of R&D management, and his more recent works The Innovation Master Plan and Permanent Innovation are recognized as two of the leading innovation books of the last 5 years.

He is formerly Senior Practice Scholar at the Ackoff Center of the University of Pennsylvania. He has taught MBA courses in innovation and strategy at the Ecole Nationale des Ponts et Chaussées (France) and Universidad de Belgrano (Argentina), and has lectured at universities on 4 continents, including Chaoyang University of Technology (Taiwan), Conservatoire Nationale des Arts et Métiers (France), University of Colorado, University of North Carolina, and Rochester Institute of Technology (USA), and Shanghai Jao Tong University (China).