

PERMANENT INNOVATION

Succeeding in today's business world is a matter of spawning innovation or of responding astutely to other business's innovations. Constantinos Markides helps us understand what business model innovation is, how to foster it, and how to react to it.



It was the great Austrian economist Joseph Schumpeter (1883-1950) who pithily defined capitalism as creative destruction. If anything, the pace of creative destruction has increased since Schumpeter's passing. Relentless innovation and its concomitant destruction epitomize 21st century capitalism.

Indeed, at its apex, the theory or the practice of capitalism has become the theory or practice of innovation. Constantinos Markides, the Robert P. Bauman Professor of Strategic Leadership at the London Business School and author of *Game-Changing Strategies: How to Create New Market Space in Established Industries by Breaking the Rules* (2008) helps us understand what

business model innovation is, when established firms practice it and how established firms can respond to start-up business model innovation.

How to create

At the outset of his book Markides distinguishes between different types of innovation. For him there are three of them: product innovation, technological innovation and business-model innovation. The business-model innovation is what *Game-Changing Strategies* allows us to better understand.

A business model is a set of mechanisms that allows a company to create value. Business models are like spatial mathematics – they can have any number of dimensions. Examples

of recent scholarly proposals are Hambrick and Frederickson's five-dimensional model, and Slywotsky and Morrison's eleven-dimensional model. Markides, for purposes of his book, prefers the good old Euclidean three-dimensional model which he proposes in its Who-What-How variation. A business model is the sum of the answers that a company gives to the three questions: Who should I target as customers; What products or services should I be offering them; How should I do this in an efficient way? (see Chart 1)

A business model innovation must not only be new to the innovating company but also new to the world. That means that the innovation is creating new market space - it either attracts new customers into the market or it encourages existing customers to consume more. Business model innovation does not transfer value, it creates value. And it does so not by creating new products or services but by redefining an existing product / service and how it is provided - Amazon did not discover a new service (bookselling); it redefined the way books were sold.

In discussing innovation

situated in the Who dimension, Markides cites the example of the rental car company, Enterprise. Enterprise chose as its customers people in need of a replacement vehicle rather than travelers (Hertz and Avis's customer base). This new customer base led in turn to a new service attribute: rather than having the customer come to the Car Enterprise for his vehicle, it would go to the customer with it.

As an example of innovation in the What dimension, the book cites the example of Swatch. Swiss watch manufacturers (SMH) had dominated the industry until the 1970s when, under competitive pressure from Asian low-cost quartz watches, their market share plummeted from 50% to 15%. Rather than offer the same product attributes as the Seikos and Timexes, Swatch decided to emphasize an attribute that the competition had neglected, superiority in style. Or to put in another way, innovation in design.

Innovation in the How dimension, according to Markides, often consists of businesses building on core competences to create a new way of doing business that is different from existing competitor's practices. Here he

cites the example of Canon which transferred its competences to the photocopier industry, thus differentiating itself from the then leader, Xerox.

When to create

Most business-model innovation is undertaken by start-up firms, and not by established market leaders. So when do established firms innovate? A first case is when the established business model is failing. The book offers the example of the Danish bank Lan&Spar. In the 1980s Lan & Spar was in poor financial health and relatively small (42nd in Danish bank rankings). In 1988 a new CEO was installed

who brought with him a fresh, business model, direct banking (first via the telephone, later via Internet). Thanks to this business-model innovation Lan & Spar emerged as the most profitable bank in Denmark and grew in size, moving to tenth position.

Or, the established firm is entering a different established market. This was the case of Canon entering the established photocopier market, innovating along the How dimension. By selling, unlike Xerox, to SMEs and individuals as contrasted with large corporate users, and via a dealer network rather than leasing via a sales force, Canon succeeded in establishing itself

as a leader in a market outside its established line.

A third type of business-model innovation trades in superior sensitivity to market needs. The established firm uses a business model innovation to scale up a market that is in its formative years. It competes by producing items that the market will find more desirable than existing offerings. Among the illustrative examples that Markides cites is Texas Instruments which scaled up the market for pocket calculators that had been pioneered by Bowmar.

How to respond

As mentioned, most business model innovation is undertaken by start-up firms, and not by established market leaders. As often as not then, the established firm is not proactively creating business models as reacting to innovative ones. Markides outlines five possible responses (see Chart below).

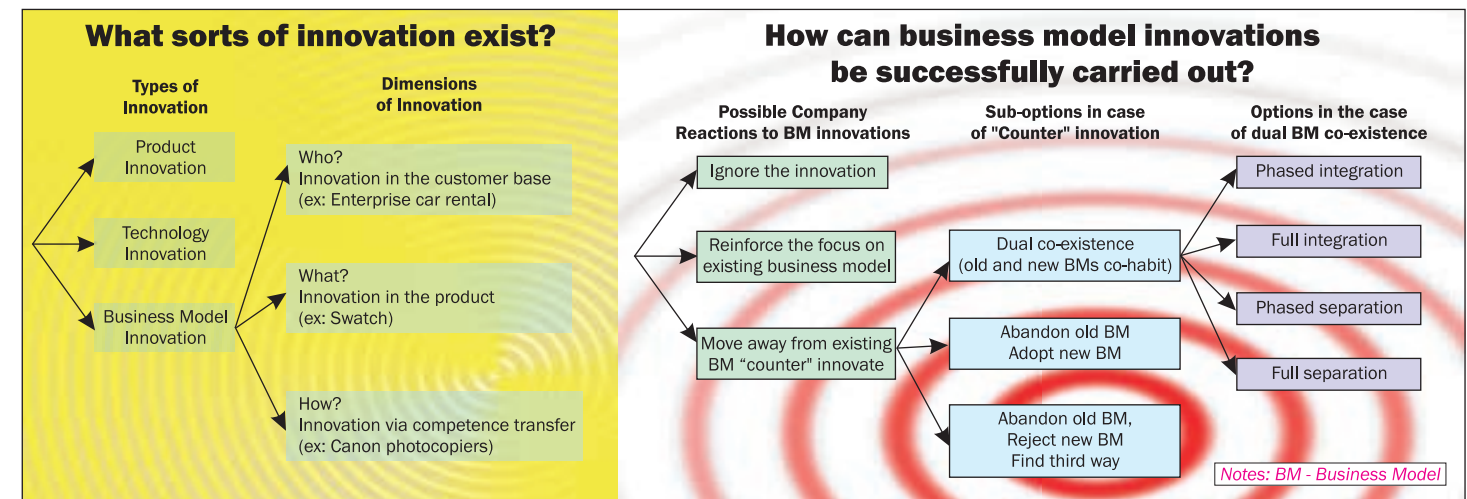
The first response is to ignore the new business model. Markides insists that there can be three good reasons for established firms to duck innovative challenges. The first

reason concerns customers. Established customers by definition are interested in the customary product and may not be counted on showing interest in a new line. The new line may, of course, draw new customers. But by managing two lines instead of concentrating on just one, management is running the risk of losing managerial focus. The second reason concerns internal management habits (and skills). The innovative product may require a set of business practices different from, or even contrary to, the established firm's established ones. The third reason concerns volume and profitability. Exemplar here is Hartford Life Insurance. Hartford could ignore the innovation of telephone or Internet sales because it was intent on serving only the top 5% of affluent Americans who were not responsive to such sales methods.

The second response is reinforcing focus on the established business model. The idea here is to seek improvements within the established business model to enhance competitive edge. Markides's example is Gillette's response to disposables.

GAME-CHANGING STRATEGIES:
How to Create New Market Space in Established Industries by Breaking the Rules

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Gillette did not migrate to disposables nor did it simply continue to sell the same old blades; it improved its established products, blades and razors, by introducing the Mach-3 and Sensor models. But here caution is needed: the reinforced-focus response carries with it three potential hazards-- failing to avoid over-engineering the product; failing to sense the terminal nature of a market decline; failing to respond adequately to innovative competition.

The remaining responses all involve increased movement away from the established business model. One is to go dual, to maintain the established business model while introducing an innovative one. An example here is Nestlé maintaining its established coffee business while entering the innovative espresso sector. The second is to abandon the established model and to migrate to the innovative business model while scaling it up. Markides's example here is Charles Schwab which did not introduce the online brokerage business model but which migrated to it and then beavered to dominate it. A third response consists in abandoning the established model, in rejecting the innovative business model and coming up instead with a third business model. The example here, already broached above, is SMH/Swatch. When confronted with the disruption of low-cost quartz watches (Timex and Seiko) SMH did not cleave to its established model (low-style mechanical watches), nor did it move to the innovative business-model (low-style, low-cost, quartz) but invented a new business model (relatively low-cost but high-style quartz).

Organisational structure

The book's proposal here intersects with an important debate among strategy scholars. The debate concerns the desirability of being focussed on one market only, or to be present in two or several markets. Michael Porter, arguably the most prominent strategy scholar alive, has been the standard bearer for the first camp, arguing that building competitive advantage is best achieved by focussing on one strategic position. More recently, Clayton Christensen, a colleague of Porter's at the Harvard Business School, has been the spokesman for the believers in multiple business models. He argues that an established firm could and should respond to a business-model challenge by entering that market but that the established firm should do so by creating a separate organization. In Christensen's view, separate business models require separate organizations.

Markides believes with Christensen that it can make sense for established companies to adopt new business-models. Where he differs with Christensen is on the question of the organizational response. Christensen promotes one solution: separation whereas Markides provides alternatives to separation. Markides relies here on some of his previous research: he studied 68 firms which established a second business model in their primary industry. Forty-two of these firms went the separate-unit way, but only ten were successful. Separation proved to be neither a necessary nor a sufficient measure for attaining success.

For Markides the organizational response must be

CONSTANTINOS MARKIDES



Markides's career path from a high chair in a Cyprus village to a big chair in London was one of those that is propelled by adversity. It also led to an Indian connection

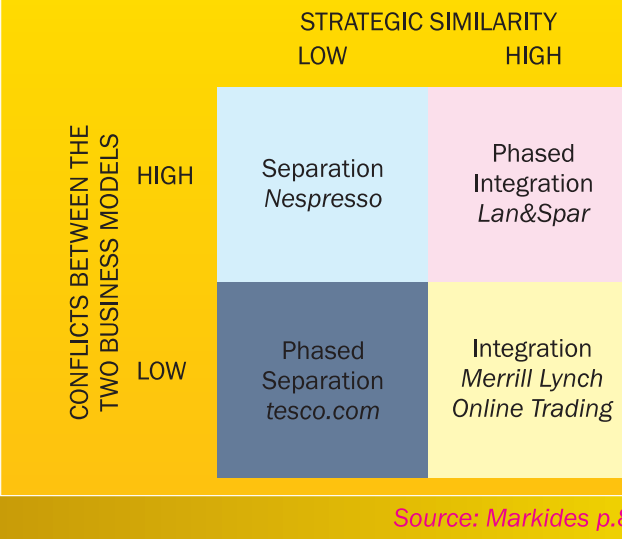
The holder of the Robert P. Bauman Chair of Strategic Leadership at the London Business School (LBS) grew up in Cyprus. When Turkey invaded Cyprus his family was forced to flee the country, impoverished. He was set to attend British university when Margaret Thatcher came to power, hiking tuition fees for foreigners, forcing Markides to cross the Atlantic for a scholarship at Boston University. From there he crossed the Charles River to get an MBA and a DBA at the Harvard Business School. He has written six other books, dealing with strategy and innovation. The second one All the Right Moves: A Guide to Crafting Breakthrough Strategy was short-listed for the Igor Ansoff Strategic Management Award.

But like most villagers-born, there was a practical side to the professor. For instance, when in 1996 Sara Lee Douwe Egberts, a major Dutch player in the coffee market, came to LBS seeking help in devising a growth plan, Markides was assigned the project. He worked with a team of twenty Douwe executives investigating strategic possibilities. In the end, five specific innovations were proposed of which one, the SENSEO coffee machine, has been bigbucks successful. This machine, as everyone by now knows, uses pods to make individual cups of roast coffee (but understandably not the Turkish kind) and that it is priced for the mass market. Fifty percent of households in Holland and nearly a third of households in Germany now own one.

But back to his persona as professor. In the Robert P. Bauman Chair in Strategic Management, Markides succeeded the well-known Indian management teacher, Sumantra Ghoshal. Markides spent several years with Ghoshal as a colleague at LBS and was particularly impressed, even influenced, by one of Ghoshal's quirks: insistence on the need for business academics to become less insular, to seek ways to make more of a difference. As a sign of his reverence for Ghoshal and of the need for business researchers to focus on application, Markides has created an annual conference at LBS named the Sumantra Ghoshal Conference on Managerially Relevant Research.

A final sign of Markides's attachment to innovation and to Ghoshal's motherland is a case study he has just completed. The subject is Reuters Market Light. Here's what this business looks like, using Markides's Who-What-How schema. Who(m) is Reuters Market Light serving? Indian farmers. What is it offering? Agricultural information of use to that farmer (prices, weather, etc...) How? By sending SMS messages daily to the farmer's mobile telephones at a price the farmer can afford. Ghoshal would no doubt have approved Markides's interest in Reuters Market Light as a vector of life-improving innovation. ■

MANAGING DUAL BUSINESS MODELS



based on two factors: how similar the old and new markets are; how much conflict there is between the old and the new business model. By attributing low and high values to these two factors, Markides arrives at four situations and organizational responses. In addition to separation then, he introduces phased integration, integration and phased separation (see Chart 3).

Low similarity of markets and high conflicts logically result in Christensen's option, separation. Separate organizations allow one to minimize internal contradictions. As an example of the separation strategy, Markides cites Nespresso which, if treated integrally with the established line, could have cannibalized sales of Nescafé. In addition its yuppie image conflicted with that of the more staid established Nestlé organization.

Which is to say that if the conflicts are high while the similarity of markets is also high it makes sense to start out separately (minimize conflicts) while trying to bring the business units together over time (maximize synergy). This organizational response of moving from separation to integration is called phased

integration by Markides. An example here involves the reintroduction to readers of the Danish bank Lan&Spar, when it went into direct banking. Initially the businesses were kept separate to avoid massive cannibalization, but compatible IT structure and common meetings made it possible to integrate over time.

If conflicts are low and market similarity is high then it makes sense to integrate from the outset. Where the conflicts are low, the innovative business can be run from within the established business. Markides's example here is Merrill Lynch that launched an online trading channel within the established business. The online products were integrated with the established products in the menu of choices offered the customer.

If conflicts are low but market similarity is also low it makes sense to start out together, taking advantage of established knowledge and practices, but to separate over time as the new business unit gains knowledge of the initially unfamiliar market. This response of moving from integration to separation is what Markides calls phased separation. His example here is of tesco.com. The online distribution business

was grown slowly from within the established grocery business, and separated as it grew in volume and moved into areas outside Tesco's grocery specialization.

Ambidexterity

Markides is always paying attention to the play of opposites. This appears clearly when he counsels the practice of ambidexterity. By ambidexterity, he means the capacity to entertain some integrative attitudes in a situation of separation, or some separative attitudes in a situation of integration. He proposes that separation or integration have greater chances of succeeding if they are ambidextrous. For example, from his research into separations he concludes that successful separators maintain some integrative attitudes: they grant somewhat less strategic and incentive-system autonomy and they tend to hire an insider rather than an outsider for the new business unit. Similarly, in the context of integration there should be some sense of separation at work. Markides suggests that the greatest risk with integration lies in suffocation by the imposition of existing policies, the initiative of newly founded firm. Returning to the quantitative research, 51 of the 68 firms he surveyed failed in their dual business model projects; 32 of the 42 separators failed; 19 out of the 26 integrators failed. That's a lot of failure - ambidexterity might have brought that rate down somewhat.

Implementation

Whatever the organizational response chosen, Markides

suggests that two further elements can play a key role in seeing an innovative business model successfully through: positive crisis and ICT. Positive crisis is a response to the fact that successful established organizations are characterized by high inertia. To put it in Newtonian terms they are traveling at an excellent but uniform constant speed and it is going to take a force to produce an acceleration. A successful implementation in an established organization requires a leader who provides that force, who is willing to destabilize a smoothly running machine. Jack Welch is an example of such a practitioner of positive crises.

The second element after positive crises, is the positive use of ICT (information and communication technology). Markides offers several examples of technology enabling an innovative business model. Enterprise, in reaching out to a new set of customers, developed a car reservation system, Automated Rental Management Systems (ARMS), which allows insurance companies and auto repair shops to manage the rental process simply and electronically. The user-friendliness of the system has led twenty-two of the twenty-five biggest insurance companies in the US to adopt the system. As Markides sees it, innovators entertain a special relation with ICT. Innovators do not wait: they are not afraid to develop their own ICT or to import ICT from other industries. CEOs in innovative firms are technology evangelists, the good news being that technology is an enabler of business-model innovation. ■