

# **Strategic Innovation**

Costas Markides  
London Business School,  
Sussex Place, Regents Park,  
London NW1 4SA  
England

Phone: (+44) 20 7000 8740

Fax: (+44) 20 7000 7001

E-mail: [cmarkides@london.edu](mailto:cmarkides@london.edu)

## **CHAPTER 1**

**What *Exactly* is Strategic Innovation?**

Every company wants to achieve growth and profitability and what better way to do so than by creating totally new market space. Who wants to get messy and bloodied by fighting battles for market share with competitors in existing markets when there's virgin territory to discover and colonize? Therefore, discovering (or creating) new market space through innovation should be the goal and ambition of every company.

While this is pretty obvious and non-controversial, the devil is always in the detail. For example, what exactly does the phrase: "create new market space through innovation" mean? As we all know, there are different kinds of innovations with different competitive effects, each one capable of producing huge new markets. Which of these should a company then pursue to create new market space? And are the prerequisites for achieving one type of innovation the same as those for achieving another type of innovation?

New markets could be created in a variety of ways. For example, Apple, 3M and Nestle created new market space by discovering the iPod, Post-It and Nespresso respectively (i.e. through product innovation); Enterprise Rent-A-Car did it by creating the "replacement" market in the rental industry (i.e. through clever market segmentation); Schwab and Amazon created new market space by utilizing the internet to grow online brokerage and bookselling respectively (i.e. through business-model innovation); and Canon, Honda and P&G did it by scaling up existing product niches (the copier, motorcycle and disposable diaper markets, respectively).

The point is that "innovation" is not one thing. There exist different types of innovation—such as product, technological, business-model and so on—all of which are capable of creating new market space. And it should come as no surprise to hear that what a company needs to do to achieve one type of innovation is totally different to what it must do to achieve another type of innovation. This implies that the question: "how can I make my company more innovative" does *not* make sense! A useful prescription cannot be given unless we first specify what specific type of innovation we aspire to achieve.

Imagine going to the doctor because you don't feel well. How would you react if the doctor prescribes a medicine to you without first identifying what you are suffering from? It sounds silly, yet this is exactly what most of us do when it comes to prescribing advice to companies on "how to become more innovative". Since there are different types of innovation that a company could aspire to achieve, prescribing the same "medicine" for all is like taking the same medicine for whatever disease one has!

This book is concerned with one specific type of innovation—namely strategic innovations. By this we mean something concrete which we describe in the next section. Strategic innovation is as capable of producing huge new markets as any radical technological or product innovation. Our objective in this book is to explore how companies achieve strategic innovation.

## **The Innovation is in the Business Model**

Strategic innovation is the discovery of a fundamentally *different* way of competing in an existing industry. Another way of putting it is that strategic innovation is the discovery of a different *business model* in an industry. For example, the way Amazon competes in the book retailing business is manifestly different from the way Barnes & Noble competes. Similarly, the way Charles Schwab, easyJet and Dell compete in their respective industries is substantially different from the way their competitors such as Merrill Lynch, British Airways and HP play the game.

What exactly is a business model? Different people have given different answers to this question (e.g. Black and Fregersen, 2002; Markides, 1997; Mitchell and Coles, 2003; Slywotzky, 1996; Slywotzky and Morrison, 2002). For example, Slywotzky (1996) and Slywotzky and Morrison (2002) argue that a business model is made up of the decisions that a company makes on eleven dimensions. On the other hand, Hambrick and Fredrickson (2001) identify five key elements that make up a business model. And Mitchell and Coles (2003, p. 3) provide a definition that includes six main elements, namely: "...the who, what, when, where, why and how much a company uses to provide its goods and services and receive value for its efforts."

For the purposes of this book, I will use a simpler definition for business model based on the pioneering work of Derek Abell (1980). For the rest of the book, a business model is taken to be the sum of the answers that a company gives to these three questions (Abell, 1980):

**Who** should I target as customers?

**What** products or services should I be offering them and what should be my (differentiated) value proposition?

**How** should I do this in an efficient way?

While I do not pretend that the definition adopted here is exhaustive or better than all the others proposed by other people, I do believe that it is adequate for the purposes of exploring business-model innovation.

The "Who-What-How" decisions define the parameters within which the company will operate. By definition, they also define the terrain for which the company will *not* fight: the customers it will *not* pursue, the investments it will *not* finance, the competitors it will *not* respond to. As a result, these decisions are painful to make and are often preceded by internal arguments, disagreements and politicking. But unless a decision is taken, the company will find itself spreading its limited resources too widely with no clear focus or direction.

The answers to the Who/What/How questions form the heart of the strategy of any company—in fact, some will argue that the answers to these questions *is* the strategy of a company. One could enlarge this definition of strategy to incorporate the "When-Where-Why" questions as well but the added complexity is not necessary to understand how and when companies could pursue strategic innovation.

To qualify as an innovation, the new business model must not only be “new” to the innovating company but *new to the world*. For this to happen, the new business model must be offering something that nobody else is currently offering. This might seem an unusually high hurdle to jump over but what it effectively means is that the innovation must not only steal market share from established competitors but *should also enlarge the existing economic pie*—either by attracting new customers into the market or by encouraging existing customers to consume more.

This implies that strategic innovation is much more than the discovery of a radical new strategy on the part of a firm. For example, IBM’s change of strategy in the early 1990s, radical as it may have been, is not a strategic innovation. On the other hand, companies such as Amazon, Schwab, Dell, IKEA, Swatch and Southwest are considered strategic innovators because they introduced new business models in their respective markets that attracted new consumers or got existing consumers to consume more (and so enlarged their markets).

It is important to note that business-model innovators do not discover new products or services—they simply redefine what an *existing* product or service is and how it is provided to the customer. For example, Amazon did not discover “bookselling”—it redefined what the service is all about, what the customer gets out of it and how the service is provided to the customer. Similarly, Swatch did not discover the watch—it redefined what this product is and why the customer should buy it. In short, the innovation is in the discovery of a different business model (not product) in an existing industry.

Making an assessment whether a new business model is really different from an established one is, obviously, a very subjective exercise. Nevertheless, it is possible to measure “difference” in a systematic way. For example, table 1 lists a number of questions that could be asked to assess whether a new business model in an industry is different to the existing one.

**Table 1: Competitive dimensions for new business models  
(Slywotzky, 1996)**

<b>Competitive Dimension</b>	<b>Key Questions</b>
Fundamental Assumptions	Compared to the existing business, does the new strategic position aim to satisfy a different set of customers’ priorities? Are the profit drivers for the new business different from those of the existing business?
Customer Selection	Compared to the existing business, does the new strategic position aim to serve a different type of customers?
Scope	Compared to the existing business, does the new strategic position involve a different product or service? Does the new position require a different set of

	activities?
Differentiation	Compared to the existing business, does the new strategic position have a different basis for differentiation? Is the value proposition for the new business different than that offered by the incumbent firms in the existing business?
Manufacturing/Operating System	Compared to the existing business, does the new strategic position involve a different kind of manufacturing or service delivery economics and methods?
Organisational Configuration	Compared to the existing business, does the new strategic position involve a different organisational structure?
Go-to-Market Mechanism	Compared to the existing business, does the new strategic position use a different distribution method to deliver the products or services to the market?

In chapter 2, I will describe how new business models invade an industry and what characteristics they all share. My goal is to show that established firms (as opposed to start-up firms) will find strategic innovation very difficult to achieve. But before exploring this issue in more detail, it may be helpful to understand how the ideas for a new business model emerge.

### **How to Discover New Business Models**

How could a company proactively and systematically go about thinking and developing a new game plan? A lot has been written on this issue, especially on how established companies could strategically innovate in their industries (e.g. Hamel, 2000; Kim and Mauborgne, 1997; Markides, 1997, 1998; Slywotzky, 1996). While the list of tactics that a company could use to enhance its corporate creativity is infinite, we'd like to focus on five generic approaches:

- (a) Redefine the business you are in.
- (b) Redefine the WHO--Who is my customer? This basically encourages a company to think of "new" customers or "new" customer segments and then develop a game plan that serves these customers better.
- (c) Redefine the WHAT--What products or services am I offering to these customers? This encourages the company to think of "new" customer needs/wants and develop the game plan that better satisfies these needs.
- (d) Redefine the HOW--by leveraging existing core competences to build new products or a better way of doing business and then find the "right" customers for it.
- (e) Start the thinking process at different starting points. For example, instead of thinking "This is my customer, this is what he/she wants and this is how I can offer it", start by "What are my unique capabilities, what specific needs can I satisfy and who will be the "right" customer to approach?"