Strategic Innovation

Constantinos Markides

By breaking the rules of the game and thinking of new ways to compete, a company can strategically redefine its business and catch its bigger competitors off guard. The trick is not to play the game better than the competition but to develop and play an altogether different game.

In spring 1902, Jim Penney opened his first dry-goods store in Kemmerer, Wyoming, and began his attack on the big retail chains of the time, including Sears and Woolworth, which date back to 1886 and 1879, respectively. By 1940, J.C. Penney had grown to 1,586 stores and annual sales of $302 million.

- In January 1936, Lever Bros., a subsidiary of Unilever, introduced a new food product in the U.S. market, a vegetable shortening called Spry. The new product went up against Procter & Gamble's established market leader, Crisco, which had been introduced in 1912. Spry's impact was phenomenal: in a single year, it had reached half the market share of Crisco.
- In the early 1960s, Canon, a camera manufacturer, entered the photocopier market — a field totally dominated by Xerox. By the early 1980s, having seen such formidable competitors as IBM and Kodak attack this same market without much success, Canon emerged as the market leader in unit sales. Today, it is a close second to Xerox.
- In 1972, Texas Instruments, a semiconductor chip supplier, entered the calculator business — a field already occupied by Hewlett-Packard, Casio, Commodore, Sanyo, Toshiba, and Rockwell. Within five years, TI was the market leader.
- In 1976, Apple introduced the Apple II in direct competition to IBM, Wang, and Hewlett-Packard in the professional and small business segment and Atari, Commodore, and Tandy in the home segment. Within five years, Apple had become the market leader.
- In 1982, Gannett Company Inc. introduced a new newspaper into a crowded field of 1,700 dailies. By 1993, *USA Today* had become a top-selling newspaper with an estimated 5 million daily readers.
- In 1987, Howard Schultz bought Starbucks Coffee from the original owners. In the next five years, he transformed the company from a chain of 11 stores to some 280 stores in 1993. Sale revenues grew from $1.3 million in 1987 to $163.5 million in 1993.
- In the late 1980s, Yamaha tried to revitalize its declining piano business by developing digital technology so customers could either record live performances by the pianists they'd chosen or buy such recordings on diskettes and play the same composition on their pianos. Sales in Japan have been explosive.

These are certainly nice success stories, but there is more to them than that. The common theme underpinning all these accounts is simple: the companies succeeded dramatically in attacking an established industry leader *without* the help of a radical technological innovation. This feat is not easy. Existing academic evidence shows that attacks on established leaders usually end up in failure — notwithstanding recent well-publicized cases of market leaders, such as IBM and General Motors, losing big to new competitors.[1] A series of studies show that the probability of a first-ranked firm in a particular industry surviving in first place is about 96 percent — almost a certainty.[2] For the second-ranked firm, the probability of survival is

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91 percent, and for the third-ranked firm, 80 percent. In fact, most of the turnover that occurs among the top five in an industry is due to mergers rather than to new entrants that outcompete market leaders.

Thus, despite some well-documented cases of dramatic success in competing with an industry leader (e.g., Xerox versus Canon or Caterpillar versus Komatsu), the vast majority of attackers fail quite miserably, while established leaders hang on to their market shares for long periods. This is exactly the reason why the success stories I first mentioned are so interesting. Not only have the companies not failed in attacking the established leaders, they have actually succeeded in dramatically increasing their market share and sometimes even emerged as the new industry leader. And they did all this without riding the wave of technological discontinuity. How did they do it?

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The Common Element

After studying more than thirty successful attackers, I believe that the simple answer is that they broke the rules of the game in their industry. The common element in all the successful attacks is *strategic innovation.* Significant shifts in market share and fortunes occur not because companies try to play the game better than the competition but because they change the rules of the game.

Consider, for example, the case of Canon. Back in the 1960s, Xerox had a lock on the copier market by following a well-defined, successful strategy. The main elements of Xerox's strategy were: It segmented the market by copier volume and consciously decided to go after the high-speed copier market to tap the corporate reproduction market. This inevitably defined its customers as the big corporations, which by itself determined the distribution method that Xerox adopted — a direct salesforce. At the same time, Xerox decided to lease rather than sell its machines, a strategic choice that had worked well for the company in its earlier battles with 3M.

This strategy proved to be so successful that several new competitors, such as IBM and Kodak, tried to enter this huge market by adopting the same or similar strategies. Canon, on the other hand, decided to play the game differently. It segmented the market by end user and targeted small and medium-sized businesses, while also producing personal copiers for individuals. Canon also decided to sell its machines outright through a dealer network, and, while Xerox emphasized the speed of its machines, it concentrated on quality and price as its differentiating features. As a result, whereas IBM and Kodak failed to make any significant inroads in the market, Canon emerged as the leader, in unit sales, within twenty years of attacking Xerox.

Another classic example of a company breaking the rules of the game in its industry is Apple Computer. In the mid-1970s, the established leader in the computer business was IBM. The main elements of the successful IBM strategy were to target corporations as customers; to manufacture the heart of the IBM computer, the microprocessor; to write its own software programs; and to sell the computers through a direct salesforce. Apple totally changed these norms: it targeted individuals and small businesses as its customers, purchased its microprocessors from an outside source, and distributed its machines through retail stores across the country. Apple quickly emerged as the new market leader.

There are many other examples of companies that broke the rules. Dell Computer bypassed intermediaries and sold directly to the end consumer. Hanes Corporation created a totally new distribution outlet for women's pantyhose — supermarkets and drugstores. Nucor Steel completely rethought the steel fabricating process and formed minimills. Toyota developed a new inventory and manufacturing philosophy in the car industry. Medco Containment Services provided companies with prescription drugs through the mail rather than through retail drugstores. Perdue differentiated what was widely considered a commodity, chickens. Timex sold cheap watches through drugstores. Southwest Airlines flew point to point rather than using the hub-and-spoke system.

These examples highlight my thesis: without the benefit of a new technological innovation, it is extremely difficult for any firm to successfully attack the established industry leaders or to successfully enter a new market where established players exist. The strategy that seems to improve the probability of success in those situations is the strategy of breaking the rules — strategic innovation.

However, it is *not* enough to proclaim the virtues of breaking the rules and to prompt companies to "just do it." It is easy to argue for innovation and to dissect strategic successes afterward. Over and above deciding *when* it makes sense to break the rules and when it is better to play the existing game (an extremely difficult question in itself), the real question is: How do innovative strategists hit on their strategic masterstrokes? In other words, how do strategists think of new ways of competing in a market when everybody else seems to miss them? Is there a systematic way of thinking about the issues that allows a company to come up with ideas that break the rules?

> How to break the rules depends on the business that the firm is in as well as the firm's strengths and weaknesses.

Companies do new or even crazy things, like using a new distribution method in the industry (Hanes), a new selling approach (Bank One), a new manufacturing method (Toyota), or totally bypassing distribution intermediaries (Dell Computer). Their actions, however, are nothing more than the manifestation of innovation.[3] The real question is: "What allowed these companies to think of all these possibilities? What are the sources of their innovation?

Before tackling the issue of how to come up with new strategic ideas, I will make five crucial points:

1. The strategy of breaking the rules is not new. Nor is it something that has suddenly become important because of a more demanding competitive environment. As any military historian would tell us, this old concept is something that military strategists (from Alexander the Great to Hannibal to the South Vietnamese generals in the 1960s) have used to their advantage. Any guerrilla army's tactics — adopted when the odds are stacked against it — are nothing more than breaking the rules. As the company examples suggest, the strategy has been used throughout business history as well.
2. Breaking the rules is *one* way to play the game. All firms should not adopt it, and they should not adopt it all the time. Whether a company should break the rules depends on factors such as the nature of the industry, the nature of the game, the industry payoffs, the firm's competitive position, and so on. Firms have to consider, evaluate, and make decisions on these factors individually.
3. How to break the rules depends on the business that the firm is in as well as the firm's strengths and weaknesses. Whether a company should bypass intermediaries (like Dell) or reposition its product (like Perdue) depends on market realities. The basic criteria for deciding whether to adopt a particular tactic are customer needs or wants and company strengths and weaknesses.
4. The strategy is, by definition, risky. Yet a company can manage the risk, primarily by experimenting in a limited way or limited area before fully adopting the new strategy.
5. Coming up with new ideas does not guarantee success. It's one thing to think of a new idea but another to make it work. The whole organization must be managed appropriately to give the new strategy a chance.

Sources of Strategic Innovation

How can a manager systematically think about breaking the rules? Suppose you are determined to go out and break the rules. How do you do it? How do innovative companies hit on their strategic masterstrokes? As any manager knows, there is nothing more difficult than coming up with really new ideas.

Based on my research, I believe strategic innovation happens like this: As already proposed by Abell, all companies in an industry have to decide three basic issues at the strategic level: *Who* is going to be our customer? *What* products or services should we offer the chosen customer? *How* should we offer these products or services cost efficiently?[4] The answers to the who-what-how questions form the strategy of any company. Some will argue that the answers to these questions *are* the strategy of a company (see Figure 1).

The answers that a company gives to the who-what-how questions are conditioned by what that company thinks its business is. Who you see as your customers depends on what business you believe you are in. If, for example, you think you are in the electricity business, the customers you see will be different from those of the company that believes it is in the energy business. I return to this crucial point later.

Every company makes choices with respect to the who-what-how questions. Thus some companies may choose to focus on specific customer segments and offer specific products or services. Others may choose to be global players offering one or many products or services. Yet others may choose to focus on a specific technology or distribution method and offer specific products or services to one or many customer segments.

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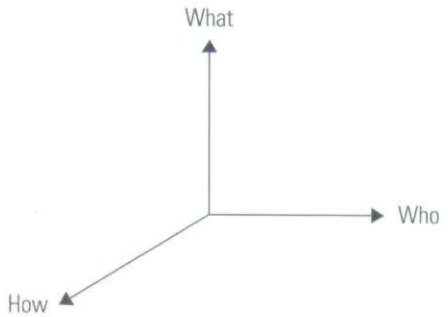
Once they've made a choice, companies are not stuck with these choices forever. A company can always change its customer orientation or product offering, which may be difficult but not impossible. However, over time, a given industry positioning map becomes filled, i.e., most of the possible customer segments are taken care of; most products and services are offered in one form or another; and most possible distribution or manufacturing methods or technologies are utilized.

Strategic innovation occurs when a company identifies gaps in the industry positioning map, decides to fill them, and the gaps grow to become the new mass market. By gaps, I mean: (1) new, emerging customer segments or existing customer segments that other competitors have neglected; (2) new, emerging customer needs or existing customer needs not served well by other competitors; and (3) new ways of producing, delivering, or distributing existing or new products or services to existing or new customer segments. Gaps appear for a number of reasons, such as changing consumer tastes and preferences, changing technologies, changing governmental policies, and so on. Gaps can be created by external changes or proactively by the company.

Figure 1 Strategic Positioning Map



Obviously, the first requirement for becoming a strategic innovator is to identify gaps before everybody else does. However, being the first to identify the right gaps does not guarantee success; a company has to competitively exploit the gap. Based on my research, I believe that companies can identify positioning gaps and thus hit on their strategic masterstrokes in various ways: by accident or luck, by experimenting, through a series of seemingly unrelated steps or actions, or through a proactive thinking process. I now focus on the last option — the thinking approach.

Five Ways to Kick-Start Strategic Innovation

How can a company proactively and systematically think about and develop a new game plan? Five generic approaches of the successful strategic innovators can provide clues:

1. Redefine the business.
2. Redefine the *who.* Who is our customer? A company should think of new customers or new customer segments and develop a game plan that serves them better.
3. Redefine the *what.* What products or services are we offering these customers? A company should think of new customer needs or wants and develop a game plan that better satisfies these needs.
4. Redefine the *how.* Companies should leverage existing core competencies to build new products or a better way of doing business and then find the right customers.
5. Start the thinking process at different points. For example, instead of thinking, "This is our customer, this is what he or she wants, and this is how we can offer it," start by asking: "What are our unique capa-

What Are Mental Models?

A prerequisite to strategic innovation is an honest, fundamental questioning of the mental models or industry recipes that seem to govern the behavior of any individual or organization.[a] A mental model is nothing more than our beliefs about an issue — our family or our business or the world as a whole. Thus, for example, when a person says, "I think everybody should go to church on Sunday," he or she is simply expressing his or her mental model. Other words for the same thing are rules and regulations, habits, managerial frames, assumptions, mind-sets, paradigms, conventional wisdom, industry recipes, customs, institutional memory, and so on.[b]

Research has shown that every human being has a mental model, which develops over time primarily through education and experience. Similarly, organizations develop mental models, manifested in the culture, routines, and unwritten rules of behavior. Thus we hear statements such as, "This is how we do business in this industry," which are the expression of that organization's mental model. Like those of individuals, organizational mental models develop over time through education and experience.

Mental models can be good because they allow us to process information and make decisions quickly. However, very strong mental models can hinder active thinking and the adoption of new ideas because they act as filters that screen incoming information. As a result, if we have very strong mental models, we tend to hear what already supports our existing beliefs and ways of operating, while any new information that does not support what we believe we discard as wrong or not applicable. It is therefore essential that we routinely question our mental models. Questioning does not necessarily mean abandoning. We can question our mental models and decide that nothing's wrong with them. But the questioning should allow us to think actively about assumptions we make about our business and about our behavior in that business.

Usually, human beings and organizations escape their mental models only after a crisis. Many firms discover new ways of competing only when their backs are against the wall. Outsiders who have different mental models from prevailing ones can also be catalysts in prompting an organization to rethink its business. Thus a new CEO, especially one from a totally different industry, can kick-start the strategic innovation process.

Benchmarking can also encourage active questioning of existing mental models and open minds to other possibilities. Or the company can develop an attitude that continually asks why — for example, "Why are we selling our products like this?" When this question is legitimized by, for example, stories of organizations that are profitably selling their products in a different way, the *why* question can produce powerful results. Another tactic is to create a crisis by giving the organization a new objective to aim for — a strategic intent.[c] If people think it is a worthwhile, challenging objective, they will soon realize that it cannot be achieved by doing the same old things better. They'll recognize that they have to think and behave differently to achieve the goal.

There are many tactics that a company can use to escape its mental models.[d] Strategic innovation will not occur unless a company first questions those models.

a. A very good discussion of mental models and how to escape them is found in:
J.C. Spender, *Industry Recipes* (Oxford, England: Basil Blackwell, 1990); and
P. Grinyer and P. McKiernan, "Triggering Major and Sustained Changes in Stagnating Companies," in H. Daems and H. Thomas, eds., *Strategic Groups, Strategic Moves, and Performance* (New York: Elsevier Science, 1994), pp. 173-195.
A very practical discussion is found in:
J.A. Barker, *Paradigms: The Business of Discovering the Future* (New York: HarperCollins, 1992).
b. A recent survey of the academic literature has identified eighty-one words that have been used to describe the same thing. See:
J. Walsh, "Managerial and Organizational Cognition: Notes from a Trip down Memory Lane," *Organization Science*, volume 6, May-June 1995, pp. 280-321.
c. See G. Hamel and C.K. Prahalad, "Strategic Intent," *Harvard Business Review*, volume 67, May-June 1989, pp. 63-76.
d. Other tactics to use to question mental models include: monitor the company's *strategic* health as opposed to its *financial* health, experiment with new ideas, benchmark, ask the "what if" question, monitor maverick competitors and new entrants, talk with noncustomers, bring in outsiders, institutionalize a questioning culture, develop the right incentives, etc.

bilities? What specific needs can we satisfy? Who will be the right customer to approach?

Next I explore each method in turn.

Redefine the Business

Every individual's behavior is conditioned by his or her mental model of the world. Similarly, the behavior of every organization is conditioned by its dominant mental models (see the sidebar). Perhaps a company's most dominant mental model is its perception of what business it is in. The definition that a company gave to its business long ago, either explicitly or implicitly, conditions how that company sees its business, which, in turn, determines how it is going to play the game, i.e., its strategy. Perhaps the most effective way for a company to start playing the game differently is by questioning the existing definition of its business.

My research suggests that successful strategic innovators all follow very different tactics from those of every other competitor in the industry. Behind these tactics is the thinking process that managers went through and the questions they asked to come up with the tactics. In most cases, the source of strategic innovation is an honest questioning of the answer that managers gave long ago, either explicitly or implicitly, to the question: "What business are we in?"

What business a company believes it is in determines who it sees as its customers, its competitors, its

competitive advantage, and so on. It also determines what the company thinks are the success factors in the market and thus ultimately determines how it plays the game. If a company starts playing the game in a totally different way from everyone else, the reason may be that it is playing a different game altogether.

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For example, Hal Rosenbluth, president and CEO of Rosenbluth Travel, described how he transformed his company from a $20 million business in 1978 to a $1.3 billion global travel management company by 1990: "Our biggest competitive advantage was to understand that as deregulation changed the rules of travel, we were *no longer in the travel business so much as we were in the information business"* [emphasis added].[5] This fundamental rethinking of its business led Rosenbluth to take a series of actions (such as acquiring computers and airline reservation systems, developing a private reservation data system and relational databases, and so on) that, to an outsider, may have seemed very strange. However, all these actions made perfect sense. If you are in the travel information business, this is what you need to do be successful. Rosenbluth claimed that the company had undergone a similar transformation 100 years before, when his great-grandfather had an insight about the business. He realized that "he wasn't just in travel, selling tickets to people who wanted to cross the Atlantic. He was in family immigration, getting whole clans of people successfully settled in America."

Such redefinition of the business is at the heart of strategic innovation. Many of today's strategic innovators started on their revolutionary journey by first redefining their business. Thus Howard Schultz, president of Starbucks, does not believe he is in the coffee business; instead, he is in the business of creating a consumption experience, of which coffee is a part. A visit to one of his stores is "romance, theatrics, community — the totality of the coffee experience."[6] If you think you are in the experience business rather than the coffee business, you will behave very differently from any competitor that thinks it is in the coffee business — not better, just differently.

In another example, Apple Computer's Steve Jobs and Stephen Wozniak did not think they were in the computer business. To them, computers were supposed to be fun. This mind-set led to Macintosh's user-friendliness and to the physical interaction with the computer via a mouse. And Leclerc in France does not see itself as being in the supermarket business, but as a crusader out to change retail distribution in France. Once we understand its conception of who it is, many of its strategic tactics (such as undertaking more than 1,400 legal cases against distributors in France) begin to make sense.

Such redefinition of the business can come only if companies ask: "What business are we really in?" While asking the question does not ensure a new or even better definition, discovering something new will *never* happen if companies never ask the question.

• **How to Define the Business.** There is no right or wrong way to define the business. You can never know beforehand whether a certain definition will be a winner.[7] The important thing is to ask the question, to think of the implications of a possible redefinition, to assess what new tactics to adopt if you were to redefine, to think whether your core competencies will allow you to carry out these tactics efficiently, and so on. Thus, asking the question is only a trigger to thinking actively.

If we look historically at the issue of how to define the business, we can identify three schools of thought. Traditionally, companies defined their business by the *product* they were selling. Thus there were companies in the car business (Ford), the airplane business (Boeing), or the cigarette business (Philip Morris). However, after Levitt's article in the early 1960s, this way of defining the business came under severe attack.[8] Levitt argued that defining the business by product is too narrow and can lead a company astray. He championed the notion that a company should define its business by the *customer function* it is trying to fulfill. Thus "the railroads are in trouble today . . . because they let others take customers away from them because they assumed themselves to be in the railroad business rather than in the

transportation business. The reason they defined their industry wrong was because they were railroad-oriented instead of transportation-oriented; they were product-oriented instead of customer-oriented."

This way of looking at the business emphasized the importance of customers and encouraged companies to identify the underlying functionality of their products. By asking what benefits the customer derives from a product, a company can identify its true value-added and define its business. Thus, instead of thinking of your business as the car business, it is better to think of it as the transport or entertainment business or whatever other function your product is fulfilling. A third perspective has emerged that argues that companies must think of their business as a portfolio of *core competencies.*[9] For example, Sony might say it is in the business of selling pocketability, or Apple might say that it is in the business of supplying user-friendliness.

Not one of these three approaches to defining the business is the right one; each has its merits and its limitations. What is a good definition for one company may be bad for another. It all depends on each company's unique capabilities and which definition allows the company to employ its capabilities in the best possible way and thus gain competitive advantage. What usually kick-starts strategic innovation is not the adoption of any one of the three approaches. Rather it is continual switching from one definition to another and continual thinking about the business implications for the company as it switches from one definition to another. The breakthrough usually comes when a company has a dominant way of defining its business, say, customer-driven, and suddenly begins thinking of its business in a different way, say, product-driven.

A company should go through a four-step exercise to define its business:

1. *List all possible definitions of the business* (for example, BMW is in the car business, the prestige car business, the transport business, the ego business, the business of satisfying the transport needs of yuppies, the driving business, the engineering business, the up-market global car business, and so on). Make the list as long as possible.

2. *Evaluate each definition according to a series of criteria.* If we define our business as *x*, who are the customers and what do they need? Who are our competitors? Can we satisfy these customer needs in a unique or better way relative to our competitors? Is our definition of the market attractive (i.e., growing in the future, protected by barriers, and so on)? What will be the key success factors in this business? Can we deliver? How do our competitors behave and what does that imply about how they have defined the business? Does this definition allow us to satisfy our personal objectives for this company? The same questions should be used to evaluate every possible definition. The goal is to identify the definition that gives your company maximum leverage relative to competitors.

3. *Choose one definition.* This is a crucial step. Making a choice implies certain follow-up decisions, for example, that the company will invest in certain products or certain country subsidiaries and not in others. It also implies that certain managers will lose out in the next budget round and others will win. As a result of the serious implications that this decision entails, most companies fail to choose a definition.

> Very few companies decide explicitly what business they are in, let alone think about how to redefine the business.

4. *Ask these questions* — If our competitor redefined the business, what strategy would it be following? How can we prepare for it?

This is the process that a company should go through to decide how to define its business. Imagine the power of revisiting these questions every year or two — including a follow-up question: Have any changes occurred that make another definition of the business more attractive to our company? This is the source of strategic innovation. Just when everybody else has settled into a certain accepted definition and behaves accordingly, you "discover" a new definition that allows you to start playing the game differently and catch everybody off guard. But, again, to discover a new definition, you must continually explore.

Very few companies decide explicitly what business they are in, let alone think about how to redefine the business. Yet this is the most important element of any

strategy. Even the few companies that go through this exercise explicitly either fail to make a specific decision or, having decided what business they are in, fail to revisit the decision, believing that it is cast in concrete, never to be revisited.

Redefine the *Who*

The second source of strategic innovation is a fundamental rethinking of "Who is my customer?" Implicit in this is the notion that the choice of customer is a strategic decision: companies should choose their customers strategically rather than accept as a customer anyone who wants to buy. The criterion for choosing who will be a customer should be an assessment of whether a customer is "good." The trick, therefore, is to identify which customers are good for the company (and keep them or go after them) and which are not (and avoid or get rid of them). A good customer for one company may be a bad customer for another, depending not only on the customer's intrinsic characteristics (willing to pay on time, able to pay, profitable) but also on whether the company is able to serve that customer better or more efficiently than its competitors as a result of its unique bundle of assets and capabilities. How many companies think about this question explicitly and proactively? How many have explicit criteria by which they judge every customer? More importantly, how many companies get rid of existing customers that they have identified as bad customers?

> How many companies get rid of existing customers that they have identified as bad customers?

In terms of strategic innovation, the purpose of thinking strategically about this question is either to identify new customers or to resegment the existing customer base more creatively and thus form new customer segments. Many companies seem to believe that new customer segments emerge only when new customer *needs* emerge. New customer needs are certainly an important source of new customer segments (and something that I discuss in more length later) but are not the only one. Often, customer needs remain the same, but customer *priorities* change; for example, customers still need warmth and style in their overcoats, but, compared to thirty years ago, style has risen, for whatever reason, on the list of customer priorities. Thus a company that identifies such changing priorities, not needs, can carve out a specific niche of customers who value style highly.

Similarly, a company can identify a specific customer segment that competitors are not currently serving. The reason this segment is not served is not because companies do not know about the needs of those customers. They may know the needs but have decided that the customer segment is not big enough to go after, or that they cannot serve this segment profitably. If a new company can serve this niche efficiently, it has a new customer segment at its disposal, not because any new customer needs have emerged but because the company has found a more efficient way to fill existing needs.

Another way to identify new customer segments is by more creatively segmenting the existing customer base to put different segments together according to a new logic. Recombination of customer segments may also allow a company to create a new need and grow a particular segment.

My goal is not to make an exhaustive list of all possible ways a company can identify new segments. Rather, I suggest that new customer segments can be developed not only from new customer needs but in various ways. However, a company cannot identify new segments unless it proactively thinks about who its customer really is.

Inevitably, if a company identifies a new customer base, it will start behaving in a way that best satisfies the specific needs of those customers. This behavior will most likely be different from that of established competitors who are serving different customers. Thus the company will be breaking the rules.

Consider, for example, the Canon case: Whereas Xerox leases big photocopiers to corporations through a direct salesforce, Canon sells its personal photocopiers to end users through a dealer network. Thus Canon has adopted a different product, along with different selling and distribution strategies. It is breaking the rules. But how did Canon think of these new rules? Could Canon have started by identifying individuals as a potential customer segment and then asked what these individuals wanted? To Canon, the answer

was small personal copiers. It then asked, "How can we get these copiers to them?" Through dealers. Thus the innovative Canon strategy is nothing more than doing exactly what is needed to satisfy the needs of its chosen customer segment.

Many companies that are strategic innovators began this way. They identified a customer segment (usually but not always the low end of the market) or a niche that was not currently served by existing competitors. Then they designed their products and delivery systems to fit the requirements of this customer segment. This source of strategic innovation underpins the success of companies such as Wal-Mart, Canon, Apple, Southwest Airlines, the Body Shop, Texas Instruments (in personal calculators), Lan & Spar Bank, J.C. Penney (in the early 1900s), *USA Today*, Komatsu, Honda (in motorcycles and cars), and so on.

For example, at a time when other airlines were using hub-and-spoke systems, Herb Kelleher, CEO of Southwest Airlines, decided to break the rules: "We wound up with a unique market niche: we are the world's only short-haul, high-frequency, low-fare, point-to-point carrier. . . . We wound up with a market segment that is peculiarly ours, and everything about the airline has been adapted to serving that market segment in the most efficient and economical way possible."[10] Little-known Enterprise Rent-A-Car, America's biggest rental firm, has a strategy that focuses not on the traditional customer segment, people who rent cars at airports, but on people who rent cars not only at airports but wherever they need them. As a result, the company has positioned its 2,400 offices within fifteen minutes of 70 percent of the U.S. population and picks up customers from their homes at no extra cost.[11]

For the choice of niche to qualify as strategic innovation, it must grow to eventually become the mass market, and the company's way of playing the game must become the new game in town.

Merely choosing a niche is not strategic innovation. For the choice of niche to qualify as strategic innovation, it must grow to eventually become the mass market, and the company's way of playing the game must become the new game in town. Thus the choice of the *right* niche qualifies as strategic innovation. Therefore, strategic innovators emerge in this manner: At a given time, the mass market is served by a number of competitors. A new company spots a segment or a new niche and goes after it. The existing competitors do not bother because the company is not really taking customers away from them (i.e., they still control the mass market). Given the way the new company plays the game in its little niche, they may not even see it as a competitor. Then, suddenly, the niche grows, and the niche company emerges as the new market leader. All other competitors take notice and search frantically for a response. In the meantime, academics the world over label the new company a maverick competitor that won by breaking the rules. This scenario seems to fit perfectly the success stories of companies like Canon, Apple, Southwest Airlines, Wal-Mart, Dell, Snapple, CNN, MTV, Nucor, and so on.

What eventually led to these companies' success was the choice of a specific market niche that grew phenomenally. But what does it mean when the niche grows to become the new mass market? That what was important to only a few people is now important to almost everybody. For example, concern for the environment grew in the 1980s and along with it the fortunes of the Body Shop. How did this happen? Either the need was already there and a company was lucky or quick enough to climb on the rising wave just in time, or the company helped grow this need so as to exploit it. Thus the important thing is to pick the right niche.[12]

How do strategic innovators pick the right niche? There is really no magic formula. Picking the right niche requires a deep understanding of customer needs and priorities and how they will change. It also requires the courage (most vividly evident in entrepreneurs) to risk pursuing what appears to be a promising customer segment but which may turn out to be a fatal mistake.

Redefine the *What*

The third source of strategic innovation is an honest rethinking of the question: What products or services

should we be selling to our customers? Implicit is the notion that the choice of products or services is a strategic decision: companies should decide strategically what to offer their customers. Many companies seem to believe that the choice of customers automatically leads to the choice of products and services to offer. This may be true, but, from a strategic innovation perspective, it also helps to think of the *what* first and then think of *whom* to target. Thus, instead of saying, "These are our customers, so let's think what they want so we can offer it to them," it may help to start like this: "These are the products and services that we want to offer, so let's think about who would want to buy them."

> A company can think ahead and identify new services to offer before the customer even thinks of them.

Thinking strategically about what to offer the customer should be part of any strategy process. However, for strategic innovation to occur, a company would have to be the first to identify new or changing customer needs, wants, or priorities and therefore be the first to develop new products, services, or better ways to satisfy these needs. For example, at Canon, strategic innovation may have happened in this way: Canon somehow identified (through customer surveys or observation or whatever) that customers did not like waiting in line to use the central photocopier. As a result, Canon came up with the idea of developing personal copiers to serve this need. But, if that were the Canon product, the customer would automatically emerge as the individual to whom Canon would have to sell through dealers. Thus Canon ends up with a strategy that is totally different from Xerox's. How then did Canon identify customers' changing needs or priorities? More importantly, how did Canon go from hearing people say, "I don't like standing in line" to developing the personal copier? In other words, how do strategic innovators identify new customer needs and the products to satisfy those needs?

The first and obvious way to identify new customer needs is, of course, to ask the customer. However, although absolutely necessary, simply asking the customer or monitoring customer changes in most cases does not lead to strategic innovation, because the customer can only tell you of needs or wants.[13] What must be done to satisfy them requires a creative leap by the company. And this is extremely difficult.

Consider, for example, the case of a German company that manufactures coffee percolators.[14] When it asked customers what they wanted from their percolators, they answered, "Good quality coffee." The problem was that what the company needed to do to achieve this customer need was not immediately obvious. It required a lot of creativity to come up with concrete ideas to satisfy this need. Usually, customer needs or changing customer behaviors are obvious. The real innovation is to go beyond the obvious — to truly understand what is behind what the customer is saying and what products or services the company can develop to satisfy the customer's needs.

Asking customers is only one way to identify new products or services. Equally important is to develop a deep understanding of the customer's business and how the customer is satisfying its own customers' needs. In this way, a company can think ahead and identify new services to offer before the customer even thinks of them. How can you better understand your customers' business? There are several tactics: talk to the customers' customers, talk to their competitors, talk to their suppliers, talk to their employees, understand their value chain, become partners with customers, monitor noncustomers, monitor new entrants, and so on.

To truly understand the customer, a company needs to become customer-oriented, rather than supply-oriented. A company that aspires to be more customer-oriented must, at the very least, change its underlying culture, structure, systems, and incentives to allow its people to achieve this goal. Simply pronouncing the virtues of customer orientation without fundamentally changing the underlying organizational environment will not deliver any results.

Outside benchmarking can be a useful source of new trends and new products. For example, Hanes had its innovative idea to distribute women's pantyhose through supermarkets when, in 1968, the president of Hanes' hosiery division, Robert Elberson, noticed that a West German pantyhose manufacturer had introduced its line to supermarkets in several metropolitan

areas in the eastern United States. Similarly, Kresge Co. transformed itself into Kmart in the late 1950s, after its president Harry Cunningham had spent two years studying discount stores, especially Korvette.

Another useful tactic is to experiment continually with new products until you hit on a latent, not obvious need. For example, more than 1,000 new soft drinks appear annually in Japan; only 1 percent survive.[15] A company cannot create a new niche or discover a latent consumer need unless it tries.

Redefine the *How*

Asking customers, thoroughly understanding the customers' business, or becoming a truly customer-oriented company can all be important drivers of strategic innovation. But is that enough? For example, did Sony come up with the Walkman by focusing on the customer? Did Yamaha develop its electronic pianos as a result of deeper customer understanding? Although the answer to both questions may be yes, this line of questioning points to another possible source of strategic innovation: building on the organization's existing core competencies to create a new product or a new way of doing business that is totally different from the way competitors currently do business.

What Honda learns as it gains experience in managing its dealer network for small cars may help it improve the management of its largely separate network for motorbikes.

Consider the following scenario: Canon begins by considering its already-established dealer network that sells cameras to end consumers. In thinking about diversifying into the photocopier business, it therefore recognizes the need to leverage this dealership asset along with its knowledge of marketing to the end consumer. This line of thinking lets Canon identify end consumers as potential customers and so develop the personal copier that it then distributes through dealers.

This plausible scenario suggests that a company can create a new game by leveraging its existing competencies. The classic case, as the Canon example suggests, is to take the knowledge of doing business in one market and utilize it in another market. Thus Canon has developed a deep knowledge of the end consumer as a result of its camera operations and also has an established dealer network. What better solution than to take these two valuable assets and utilize them in the photocopier business by developing personal copiers and targeting the end consumer. To an outsider or to Xerox, this may be breaking the rules, but to Canon, this is simply leveraging its existing strengths.

3M provides another example of the same principle. In 1995, 3M sold nearly $1 billion in microreplication products, ranging from smart adhesives to liquid crystal display film. All these products stem from a single technology, which was first applied in the overhead projector lens thirty years ago. According to the inventor of the first microreplication product, Roger Appeldorn, nobody planned these products: "We didn't sit down and say, 'Microreplication is the next thing to do; let's go do it.' It doesn't work this way. It evolved. It reached a critical mass. And it suddenly proliferated."[16]

Leveraging existing core competencies is certainly one way to create new products or new ways to compete. However, most major breakthroughs occur not so much from amortizing existing competencies but from exploiting them to create and accumulate new strategic assets more quickly and cheaply than competitors. Companies can dynamically exploit existing core competencies in three ways:[17]

1. Share Core Competencies. A company can use a core competence amassed during the building or maintaining of a strategic asset in one small business unit (SBU) to help improve the quality of a strategic asset in another SBU. For example, what Honda learns as it gains experience in managing its dealer network for small cars may help it improve the management of its largely separate network for motorbikes. Similarly, when Canon had successfully established itself in both the camera and photocopier businesses, many of the strategic assets that underpinned the respective SBUs could not be shared directly. The dealer networks and component manufacturing plants were largely specific to each SBU. But, in the course of producing and marketing cameras, the camera division extended this ini-

tial asset by a mix of learning by doing and further purchases of assets in the market. As a by-product of this asset accumulation, the camera business also developed a series of competencies such as how to increase the effectiveness of a dealer network, how to develop new products combining optics and electronics, and how to squeeze better productivity from high-volume assembly lines.

Because Canon is in two businesses, cameras and photocopiers, in which the processes of improving dealer effectiveness, speeding up product development, or improving assembly-line productivity are similar, it can improve the quality of the strategic assets in its photocopier business by transferring competencies learned in its camera business and vice versa. This relatedness — similarities in the processes required to improve the effectiveness and efficiency of separate, market-specific stocks of strategic assets in two businesses — opens up opportunities for asset improvement advantages that allow a company to play a different game in a different market.

Honda can use the experience of building motorbike distribution to form a new, parallel distribution system for lawn mowers.

2. Reuse Competencies. A company can use a competence developed during the building of strategic assets in existing businesses to create a *new* strategic asset in a *new* business faster or more cheaply. For example, Honda can use the experience of building motorbike distribution to form a new, parallel distribution system for lawn mowers, which are generally sold through different outlets. Similarly, by operating in the photocopier market and building the asset base required to outcompete rivals, the Canon SBU accumulated its own, additional competencies that the camera SBU had not developed. These included building a marketing organization targeted to business rather than personal buyers and developing and manufacturing a reliable electrostatic printing engine.

When Canon diversified into laser printers, the new SBU started with an endowment of assets, additional assets acquired in the market, and arrangements to share facilities and core components. But, even more important for its long-term competitiveness, the new laser printer SBU was able to draw on the competencies of its sister businesses in cameras and photocopiers to create new market-specific strategic assets faster and more efficiently than its competitors. This kind of relatedness, in which companies can deploy the competencies amassed by existing SBUs to speed up and to reduce the cost of forming new market-specific strategic assets for a new SBU, is the asset-creation advantage that companies can use to break the rules.

3. Expand Competencies. A company can expand its existing pool of competencies because, as it builds strategic assets in a new business, it learns new skills. For example, in the course of building a new distribution system for lawn mowers, Honda may learn new skills so it can improve its distribution system for motorbikes. Similarly, in creating the assets required to support the design, manufacture, and service of the more sophisticated electronics demanded in the laser printer business, Canon may have developed new competencies to improve its photocopier business. Alternatively, combining the competencies developed in its photocopier and laser printer businesses may have helped it to quickly and cheaply build the strategic assets required to succeed in a fourth market — plain-paper facsimile machines.

Strategic innovation takes place when a company tries to satisfy customer needs based on new strategic assets that are unfamiliar to existing competitors. In the process, the assets of established players become obsolete. Maverick competitors create such new assets by utilizing their core competencies to either develop new assets or bundle existing strategic assets in unique combinations. Successful innovators need therefore to identify and deploy the right core competencies. A better understanding of changing customer needs can lead to a better understanding of which core competencies to emphasize and develop. Similarly, a better understanding of a company's core competencies can lead to better segmentation, choice of customers, and a more productive development of new strategic assets that allow the company to break the rules.

Start the Thinking Process at Different Points

The final source of strategic innovation is the thinking

process for developing new ideas. New ideas emerge more easily if managers can escape their mechanistic way of thinking and look at an issue from different perspectives or angles. The goal, therefore, is to start the thinking process at different points. For example, instead of thinking, "This is our customer, this is what he or she wants, and this is how we can offer it," start by asking, "What are our unique capabilities, what specific needs can we satisfy, and who will be the right customer to approach?"

At the strategic level, a company has to decide the who, the what, and the how: Who are our customers? What do they want? How can we satisfy these wants? The thinking process could, therefore, go through three stages: Start by defining who the selected customers are and then decide on the what and the how. Or start by deciding first what products and services to offer and then decide the who and the how. Or start with the how and then decide the who and the what.

Another useful thinking process is to take the accepted definition of the business as given and then try to think of (1) new customers or new customer segments, (2) new customer needs, or (3) new applications of core competencies. After coming up with a number of ideas, a company can revisit the question, "What is our business?" and, for every possible new definition, repeat the three steps. Again, the objective is to see the business from as many different perspectives as possible so managers can find new ways to play the game.

Conclusion

I began by identifying Canon as a strategic innovator that beat the industry leader, Xerox, by breaking the rules. While there is no question that Canon broke the rules in the copier business, consider the different ways Canon *may* have come up with its innovative strategy:

1. While Xerox plays the game, believing that it is in the photocopier business, Canon begins by seeing itself in the consumer electronics business — perhaps a legacy of its success in the camera business. By thinking of itself as a consumer electronics company, Canon immediately recognizes that the way to play this game is through low price and high quality. It therefore puts all its energy toward developing a reliable copier at an affordable price. When it introduces such a copier, the first users report how good and cheap this wonderful new machine is, and millions of people suddenly discover that they too need a personal copier at home. The personal copier market explodes, and Canon emerges as the market leader.
2. Based on its experiences in the camera business, Canon starts by identifying individuals as a promising customer segment. Its answer to the question, "What do individuals want?," is small personal copiers. And to, "How can we get these copiers to them?," through dealers. Thus the innovative Canon strategy, when compared to Xerox's strategy, is nothing more than doing exactly what is needed to satisfy the needs of the chosen customer segment.
3. Canon somehow (through customer surveys or observation or whatever) discovers that customers do not like to wait in line for the central photocopier. As a result, Canon comes up with the idea of personal copiers. But if that is the Canon product, the Canon customer automatically emerges as the individual to whom Canon has to sell through dealers. Thus, again, the strategy ends up being totally different from Xerox's.
4. Canon begins by considering its already established dealer network that sells cameras to end consumers. By thinking about diversifying into the photocopier business, it therefore recognizes the need to leverage the dealership asset along with its technology and its knowledge of marketing to the end consumer. This line of thinking lets Canon identify end consumers as the potential customer and develop the personal copier, which it then distributes through dealers.

Coming up with new ideas is one thing; succeeding in the market is another.

Each scenario or a combination may have taken place. Perhaps all did. A company can use any one or a combination of the above tactics to strategically innovate.

• **Two Caveats.** It is worth reemphasizing that coming up with new ideas is one thing; succeeding in the market is another. Many readers may rush to identify numerous companies that appear to have strategically innovated in the manner described, only to go bankrupt

in a few years. Osborne Computer is one example. Very much like the founders of Apple Computer, Adam Osborne founded Osborne Computer in 1981 to sell portable personal computers. He went after a new customer niche, one of the sources of strategic innovation. Osborne remarked, "I saw a truck-size hole in the industry, and I plugged it."[18] Osborne Computer grew to $100 million in sales within eighteen months, only to go bankrupt in 1983.

There are many stories of companies that strategically innovated but failed. People Express's failed strategy has similarities to the successful strategy of Southwest Airlines. The demise of the retail chain Next in the United Kingdom contrasts sharply with the success of the Body Shop, even though both companies strategically innovated in the same way, by identifying new customer needs.

Similarly, there are numerous examples of companies that tried to strategically innovate by redefining their business, only to discover that it did not guarantee success: Xerox's attempts to go from the copier business to the office of the future business to the documents business is one case. The failed diversification attempts of the 1960s and 1970s on the shaky ground of a broader business definition should be a warning. Nor is initial success through strategic innovation a guarantee for long-term success — witness the declining fortunes of Apple Computer and Kmart.

All these examples of strategic innovations that failed make the point that any idea, however good, is bound to fail if it is not implemented effectively. Even worse, any idea, however good and however well implemented, will eventually fail if it is not supported by continual innovation. This, however, should not detract from the value of generating new ideas that break the rules. Just because good ideas are only *one* element that determines corporate success and do not guarantee success does not mean that companies should not bother coming up with new ideas.

Finally, I have presented my ideas as if one individual or a group somehow comes up with all these ways to break the rules in a rational manner. This is certainly one way for strategic innovation to take place, but not the only way. A company must also strive to institutionalize innovation by establishing the appropriate culture, structure, incentives, systems, and processes that somehow allow innovation to happen as part of daily business. How 3M has institutionalized innovation can be a model for other companies that aspire to the same goal. Similarly, a company may want to identify specific obstacles or constraints that prevent it from being entrepreneurial and find ways to remove or bypass them. These are important issues, but not my major concern here. I have been concerned only with the rational approach to strategic innovation. By not discussing institutionalized innovation, I do not suggest that it is unimportant. It is a topic that deserves a separate article. ◆

References

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2. S. Davies, P. Geroski, M. Lund, and A. Vlassopoulos, "The Dynamics of Market Leadership in U.K. Manufacturing Industry, 1979-1986" (London: London Business School, Centre for Business Strategy, working paper 93, 1991); and
P. Geroski and S. Toker, "The Turnover of Market Leaders in U.K. Manufacturing: 1979-1986" (London: London Business School, mimeo, 1993).
3. Whether these new approaches make sense for a particular firm (i.e., whether they will lead to success or failure) depends primarily on the economic merits of these ideas and the company's ability to deliver them competitively. For example, do these new moves allow the company to offer something new to the customer (that he or she wants)? Do they allow the company to offer something better or more efficiently? Are the new offerings something that the customer values? Thus the success of the new ideas will depend on customer needs and on the core competencies of the innovating company.
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5. H. Rosenbluth, "Tales from a Nonconformist Company," *Harvard Business Review,* volume 69, July-August 1991, p. 32.
6. C. McCoy, "Entrepreneur Smells Aroma of Success in Coffee Bars," *Wall Street Journal,* 8 January 1993, p. B2.
7. The whole purpose of redefining the business is to identify a specific definition that allows you to maximize the impact of your unique capabilities relative to your competitors. Thus what is a good definition for your company may be totally inappropriate for another company; and what is a good definition for your competitor — given its particular strengths — may be totally inappropriate for you. Thus what is a "good" definition is in the eyes of the beholder. However, even if you can find a "good" definition for your company, you just enhance your chances of success, but this does not mean that you are guaranteed success.
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11. "America's Car Rental Business: Driven into the Ground," *The Economist,* 20 January 1996, pp. 76-79.

12. This point is also raised by Gerard Tellis and Peter Golder. Their argument is that "strategic innovators" have a vision of the mass market and actively try to produce quality products at low prices to make them appealing to the mass market. Thus the secret of their success is the fact that they target the mass market and succeed in serving it. Although I agree with the point, my research suggests that the importance of luck, good timing, and external events should not be underestimated as ingredients in the success of the strategic innovators to "pick" the right niche at the right time. See:

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