



Michael Raynor

***The Innovator's Solution:
Shaping Ideas Into Disruptive Strategies
That Create New Markets And Booming Growth***

October 17, 2006

Session Summary

NEXT SESSION

November 16, 2006

Dan Ariely

***The Startling World of Behavioral Economics:
How People Really Make Decisions When Money's Involved***

Behavioral economics is the study of how people really act when money is involved. It's not just fascinating in itself, revealing deep truths about human nature; it's also incredibly useful. You shouldn't make any major decisions about money – your company's or your own – without considering the surprising discoveries from this fast-growing field. No one understands or communicates them better than Dan Ariely, who is the first person ever to hold concurrent appointments at MIT's business school and its famous Media Lab.

MICHAEL RAYNOR — SESSION SUMMARY



Michael Raynor appeared at The Masters Forum on October 17, 2006. He's the co-author, along with Clayton Christensen, of *The Innovator's Solution: Creating and Sustaining Successful Growth*. The book's website is www.theinnovatorssolution.com.

Some Key Points

Each person will take from this presentation what is most relevant to him or her. Some of the key points Raynor made, which are discussed in more detail in the rest of this document, can be summarized as follows:

- ▶ It is extremely difficult, nearly impossible, to sustain profitable growth over long periods of time. Far fewer than five percent of American companies have been able to accomplish that.
- ▶ The principal problem in sustaining growth is that companies develop products that *overshoot* customers' requirements – the products' performance is better than what many customers want – and then competitors offer disruptive innovations, with less performance for less money, which capture market segments from the incumbents.
- ▶ Executives of incumbent companies see themselves as having virtually no incentive to compete in the “less for less” parts of their markets.
- ▶ The competitors use the “less for less” foothold for an “upmarket march,” building their own sustaining innovations and taking away larger and larger chunks of the incumbents' customer base.
- ▶ In addition to low-end disruption offering less for less and thereby taking away existing customers (which incumbents often see coming but don't fret about), there is also new-market disruption that brings products to a whole new segment of customers. Incumbents usually don't see this kind of disruption coming until it's too late to do anything about it.
- ▶ Innovation is the key for industry challengers and also for incumbents. In most companies today, innovation is largely a random process.
- ▶ Successful innovation has three elements: finding a foothold, growing, and then repeating the process. Finding a foothold involves creating and capturing value. Growth requires utilizing strategic advantage, breaking tradeoffs, and adapting. Repeating the process is a matter of shaping ideas, targeting non-consumers, and being impatient for profits but patient for growth.

The Challenges of Growth

Raynor said the myth of Sisyphus, who spent “an eternity at hard and pointless labor,” is “a very good representation of the fate that awaits every publicly-traded company.” To please shareholders, companies have to push the rock (earnings, share price) up the hill, but each time they do it better, just creates a new baseline for doing it all over again. He quoted President George W. Bush as saying, “Expectations rise above what was expected.”

Raynor said, “There’s at least a 95 percent failure rate out there: the vast majority of firms are unable to grow profitably over any meaningful period of time.” Among the reasons he cited for that failure rate are that competitors emulate successful innovations (as has been the case with airlines’ frequent-flier plans); capital markets often have already priced growth into their assessment of a company’s value (Wal-Mart); companies lose focus and they drift (he cited the inroads that Cetaphil made into Neutrogena’s market after Johnson & Johnson bought Neutrogena); and companies can fill their niches so successfully that there’s nothing left to do (Dell, he said, has “essentially run out of things where their particular capabilities are applicable.”)

He said, “Everything comes to an end – No matter how great your strategy, sooner or later it’s over.”

Overshooting

Incumbents, focusing on the largest and most profitable market segments, find themselves “delivering levels of performance that some less-demanding segments of the market aren’t willing to pay for.” That situation is “overshoot,” and it gives new entrants a foothold to provide something, which Raynor called “less for less,” that the “less-demanding segments” want. He showed how delivered pizza has overshot, making room for frozen pizza, which is now enjoying 25 percent growth in a market that’s only growing at 3 percent. The Toyota Corona was, he said, “a really terrible car,” but at its low price it appealed to customers who couldn’t afford new cars and didn’t want to buy a used car. Toyota’s American success was built on the disruptive success of the Corona.

What’s A CEO To Do?

When executives investigate investments in “less for less” segments, they find themselves saying, according to Raynor, “My customers hate it, my investors hate it, and my organization hates it. Am I going to invest in this? Of course not.” Raynor concluded that historically, “Even if you know that this is what’s coming, you’re simply unable to invest in these new opportunities.”

Marching Upmarket

Once a competitor has gained a foothold, it can execute an “upmarket march” through its own sustaining innovations (that is, innovations that improve the performance of its product) and wind up taking important business away from the incumbents. He provided examples of, among other things, how minimills did that to integrated mills in the steel business; Toyota

did it in the automobile business; Sony in the consumer electronics business; and Honda in the motorcycle business.

Two Kinds of Disruption

“Less for less” is one kind of disruption, called “low-end” disruption: incumbents see it coming but they don’t fret about it (this is happening today, he said, with Verizon vis-à-vis internet-protocol phones; and has happened with State Farm vis-à-vis GEICO). Disruption also takes the form of “new-market” disruption, which incumbents don’t see coming until it’s too late to do anything about it (the story of the disk-drive industry has been one of new-market disruption, which is also exemplified, he said, by Charles Schwab vis-à-vis Merrill Lynch and Dell vis-à-vis Compaq.)

Innovation Disarray

Raynor said, “Right now, in most organizations, innovation is largely a random process.” He showed data that demonstrate, “Whether or not you get funded [for an innovation project] is a coin-toss process, and whether or not you succeed is a coin toss.”

He said that many companies and observers act as though “continuous ideation” is the best source of new ideas – “that somehow there are thousands and thousands of potentially successful ideas and the key to innovation is to find the few gems that are in there.” But, he said, “the key is to shift the orientation from mining the organization for a few good ideas to shaping the ideas that are there into things that can actually be commercialized successfully.” In fact, he said, “everybody knows” what the key growth opportunities are – they can be gleaned from reading a few months’ back issues of industry journals – and “the trick is to have processes in place that shape those inputs to . . . create something that is commercially viable.”

He said, “We need to bring some structure to this, to get past the need for a genius and past the randomness of most organization’s processes.” That’s what he and Clayton Christensen set out to do in writing *The Innovator’s Solution*.

How to Grow

All disruptive opportunities to create value begin where there has been overshoot, Raynor said. The process for creating value entails first finding a foothold within that overshoot and capturing the value that is created. Then, the process of growing – the “upmarket march” – requires using structural advantage, breaking tradeoffs, and adapting, particularly regarding the value chain. Since all good opportunities end, companies have to become adept at repeating the process by shaping ideas, targeting non-consumers, and making money.

Finding A Foothold

Value is created where overshoot exists. The “critical element” in this regard, Raynor said, is to connect with a job that customers or potential customers are trying to get done. That is different from the conventional approach of segmenting customers based on demographic, economic, or other attributes. Research by a fast-food chain, for example,

showed that adult customers consuming milkshakes for breakfast constituted one of two significant spikes in daily sales. The other spike was at an early dinnertime for families, where treating a child to a milkshake was important. The milkshakes in those two primary uses were, in Raynor's words, "being hired to do completely different jobs" – something that would not be discovered by focus groups. "Connecting with the job is really the only useful way to segment customers, and it's how an organization can identify opportunities to create value," he said.

To capture created value, it is necessary to understand what dimensions of performance matter most to the customer and focus on them. He said, "Focus on that part of your industry's ecosystem that actually delivers the performance that your customers value."

Growing

One aspect of growth is to achieve and retain a structural advantage – "the ability to deliver a certain level of performance at a cost your competitors cannot match." In the steel-industry example he used earlier, for example, minimills could deliver a given quality of steel for 30 percent less than the integrated mills, as a function of the fundamentally different technology they were applying. Similarly, credit card companies get a payment of about 2 percent from the merchants they serve, and they return about 1 percent of that to card holders; but Google, because it is involved in many online searching tasks and handles the final payment ("search to purchase" involvement), can charge about 10 percent to the merchant and give back about 2 percent to the buyer. What Google is doing gives it a dramatic structural advantage.

When structural advantages are correctly understood, they can be extended. "The way to continue to grow," Raynor said, "is to extend your structural advantage and break the tradeoffs that define somebody else's competition." Holiday Inn, he said, failed when it tried to extend its advantage in the low-cost-to-serve, low-performance end of the market into higher-end hotels. Canon, on the other hand, first sold its personal copiers to customers Xerox did not want, but it was able later to extend its structural advantage to deliver high-performance copying at a lower price, which Xerox couldn't do. Raynor said about Canon's success against Xerox: "This was not a function of who had the better innovation process, it was not a function of who had smarter engineers, it was not a function of who knew more about their customers, it was not a function of who wanted it more. It was all a function of an initial structural advantage and what their respective starting-points were. That's what determined who was able to break the tradeoffs that had previously defined competition in this market."

Whatever successes a company has enjoyed through structural advantages and breaking tradeoffs, things still change, and adapting becomes necessary. The key dimensions of performance shift over time. The four dimensions are functionality, reliability, convenience, and price, and, Raynor said, "These things actually cycle through in pretty predictable fashion: functionality – a device that actually works – is usually the first dimension. Then competition shifts to reliability. Once reliability has been overshot, convenience becomes the issue, and finally it all comes down to price."

As the basis of competition shifts, companies must adapt their value chains accordingly. When functionality is the central concern, design, production, and distribution should all be retained within the company. As reliability emerges, the distribution function can be outsourced, and the emergence of convenience calls for a fully modularized value chain. When price emerges, Raynor said, “you need to be fully interdependent again.” He said that Apple, with its persistent insistence on remaining highly integrated and fully interdependent all the time, “hasn’t figured this out.” Apple, he said, is “like a broken clock” – right some of the time but wrong most of the time.

Repeating

Focusing on the subject of shaping ideas instead of just “finding” them, Raynor said that ideas are shaped in several key ways that fall under the general heading of targeting non-consumers. The disruptive strategy is to produce worse products – ones that are “demonstrably inferior with respect to the established measures of performance,” in Raynor’s words – and then, he said, “sell them to customers that are economically unattractive.” Within that rubric, he added, “you have to find a way to make money anyway.” Overall, he said, “this is a high bar.” Sony, for example, took the transistor and developed far worse products than RCA made, sold them to teenagers, and then marched upmarket from there to become “the dominant consumer electronics company of our age.”

While undertaking such disruptive ventures, Raynor said, “the Zen of growth is that the best way to find growth is not to look for it.” It is necessary to insist on making money, because profits demonstrate that customers value what you are doing and they will pay for more of it, but as for growth, “the best way to ruin it is to insist that it get really big really fast.” He said, “One of my favorite expressions these days is that nothing big starts big.”

Concluding, he said that companies have to be able to “walk and chew gum at the same time,” doing everything they can to defend their entrenched businesses while also simultaneously finding and starting new businesses that will march upmarket to become industry leaders.



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