Innovative Strategies That Change the Nature of Competition

LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

1. Discuss innovative strategy and the differences among the types of innovation.
2. Identify the different categories of innovative strategies.
3. Describe the accelerating pace of innovation and the product, business, and industry life cycle.

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Innovative Strategies in Home Movie Entertainment

TRIPPLAAR KRISTOFFER/SIPA /Newscom

In the early 1980s, a radical, new product was introduced to the market by Japanese companies Sony and Panasonic: the home video player. For the first time, consumers could purchase or rent a movie and watch it on their video player in the comfort of their own home whenever they wanted. Video players gave rise to video rental stores—a less expensive alternative to buying movies. By the early 1990s, Blockbuster had built 3,400 stores and dominated the home video rental market.[1] The company reached its peak in 2004 with close to 9,000 stores and more than $6 billion in revenue.[2] Blockbuster invested heavily in its stores and inventory—each store carried more than 1,000 different movies—so that customers could conveniently find a store and the movie they wanted to rent. The cost of each store ranged from $225,000 to $750,000.[3]

Blockbuster's leaders quickly discovered that Blockbuster didn't make money from the videos sitting on the shelves. It needed to get customers to rent the DVD and return it as quickly as possible so Blockbuster could rent it to another customer. To encourage customers to return the DVD rentals quickly, Blockbuster charged late fees that were unpopular with customers but helped Blockbuster get the DVDs returned quickly. Blockbuster's overall strategy worked well until Netflix entered the movie rental business in 1997. Instead of building stores, Netflix rented DVDs over the Internet and shipped movies directly to the customer's home. Rather than charge a per-use fee, Netflix charged customers a monthly subscription fee that allowed them to rent one to eight movies at a time. From the customer's perspective, the downside of renting movies over the Internet was that it required planning ahead—no impulse movie watching. You couldn't just

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pop down to the Blockbuster store and grab a movie to watch. But the upside was the ability to access 90,000 movies. Netflix shipped movies from 50 strategically located warehouses around the country to ensure that most customers got their orders within two days.[4]

This business model gave customers more movie options to choose from, and because Netflix customers paid a monthly fee, their business model profited in the opposite way of Blockbuster's. Netflix made money when customers *didn't* watch the DVDs they ordered. As long as the DVDs sat unwatched at a customer's home, Netflix didn't have to pay return postage or mail out the next DVD. And because Netflix didn't have to build stores, hire sales clerks, or buy a huge inventory of DVDs to put in each store, it had more than a 30 percent cost advantage over Blockbuster. It was able to share some of this cost advantage with customers in the form of lower prices, and keep some of this advantage in the form of higher profits.

If Netflix took Blockbuster to the mat, Redbox tagged in for the pin. Blockbuster's primary advantage over Netflix was the ability to provide movies for the impulse movie watcher. Redbox entered the market renting movies through vending machines. Each vending machine cost approximately $15,000[5] and was placed in convenient and well-traveled locations like grocery stores, pharmacies, convenience stores, and even McDonald's. By 2013, Redbox had placed more than 47,000[6] vending machines around the United States, making them far more accessible than a Blockbuster store for most customers. Because vending machines were cheaper than stores, Redbox could rent movies at the low price of $1.20 per night and still make money. By 2010, Blockbuster had filed for bankruptcy. Netflix's market value as of January 2017 was more than $60 billion, and Outerwall's (Redbox's parent company) market value was over $1 billion.[7] But the battle for home video entertainment isn't over. Apple, Amazon, and Microsoft have attempted to leverage their online capabilities and customer bases to win share in the video on demand (VOD) and Internet video on demand (iVOD) markets. For example, Amazon offers free streaming of older movies and pay per view for newer movies to its Amazon Prime members. Moreover, Hulu (backed by NBC Universal and Fox) first offered free streaming service (supported by advertisements) and, now, only Hulu Plus, a subscription-based service like Netflix. The market entry of these new competitors—each attempting to gain advantage by leveraging different capabilities—suggests that new innovative strategies will continue to emerge in the home movie entertainment industry.

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The opening case illustrates how Netflix and Redbox used innovative strategies to defeat Blockbuster in the video rental business. Innovation is a powerful driver of competition and competitive advantage. New entrants, in particular, have strong incentives to offer different value propositions than incumbents—and preferably in a way that is hard to imitate. Strategies that offer a different value proposition to customers using different resources and capabilities are often referred to as "innovative strategies," "revolutionary strategies,"[8] or "disruptive innovations."[9] Famed economist Joseph Schumpeter argued that competition is a process that is driven by the "perennial gale of creative destruction."[10] Innovative strategies—such as the ones launched by Netflix and Redbox—simultaneously create and destroy value. This is what makes strategy a dynamic process. The strategy that worked yesterday might not work today—and what works today might not work tomorrow. Consequently, companies must be able to innovate and change in order to weather the storms of creative destruction that will certainly come their way. The primary focus of this chapter is to examine innovation-based strategies—such as the ones used by Netflix and Redbox—that prove to be revolutionary or disruptive in their industries.

What Is an Innovative Strategy?

invention The creation of an idea or method; a novel concept.

innovation The conversion of a novel concept (an invention) into a product, process, or business model that generates revenues and profits.

To understand innovation, it is first important to understand the difference between an invention and innovation. **Invention** describes the creation of a unique or novel concept, method, or process that is often turned into a tangible outcome—such as new product. An **innovation** is the conversion of a novel concept (an invention) into a product, process, or business model that generates revenues and profits.[11] Innovation differs from invention in that innovation refers to the use of a novel idea or method, whereas invention refers more directly to the creation of the idea or method itself.[12]

For example, the scientists at Xerox PARC (Palo Alto Research Center) invented the computer mouse as a new way to navigate a computer. This invention would allow users to select from images and menus on a computer monitor through a Graphical User Interface (GUI). But it was Steve Jobs and Apple computer who launched the Macintosh computer—the first

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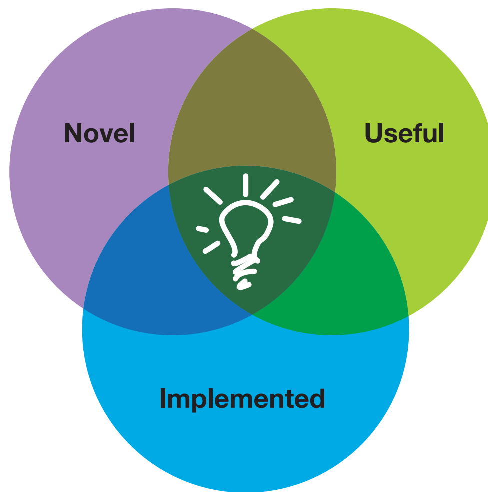

FIGURE 10.1 Definition of Innovation

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commercialized microcomputer that came with a mouse and graphical user interface. Apple's Macintosh turned Xerox's invention into an innovation that could generate revenues and profits. In similar fashion, the Wright brothers invented the airplane at Kitty Hawk, but Boeing and others commercialized the idea by designing and building commercial aircraft that could be sold as products. As shown in Figure 10.1, an innovation needs to be (1) novel, (2) useful, and (3) successfully implemented, in order to help companies succeed in the marketplace.

Incremental Versus Radical Innovation

Innovation enables firms to deliver value in new ways. Innovations fall into two general categories: incremental innovations and radical innovations. An **incremental innovation** builds on a firm's established knowledge base and steadily improves the product or service it offers.

incremental innovation Building on a firm's established knowledge base to create minor improvements to the product or service a firm offers.

For example, when Gillette offers a razor with five blades instead of four, or when Samsung offers a TV with an LED screen instead of a plasma screen, those are incremental innovations. In similar fashion, when any company makes incremental improvements to their operations to accomplish a task faster, better, or with fewer resources, these are also incremental innovations. Incremental innovations are also sometimes called "sustaining" innovations because they sustain a company's current product offering and revenues.

In contrast, a **radical innovation** draws on a different knowledge base, technologies, or methods to deliver value in a truly unique way. Examples of products based on radical innovations include the computer (versus the typewriter), CT scanner (versus the X-ray), cell phone (versus the landline phone), and MP3 player (versus the CD player).

radical innovation Innovation that draws on a different knowledge base, technologies, or methods to deliver value in a truly unique way.

Processes can also be based on more radical innovations. For example, Toyota engineer Taiichi Ohno developed a set of flexible production techniques, often referred to as *lean manufacturing*, that minimizes inventories and waste despite being designed for rapid product changeovers.[13] This system of production was significantly different from the mass production system developed by Henry Ford that was based on standardization, significant automation, and few product changeovers. Toyota's deployment of its "flexible" or "lean" production system has helped it produce high-quality cars at low cost and propelled it to worldwide leadership in the automobile industry.

Strategies that draw on more radical innovations often use new technologies or employ a fundamentally different business model than rivals, meaning they create, deliver, and capture value through very different resources and capabilities. As illustrated in the opening case, Netflix used the Internet, software, and warehouses to deliver video rentals in a radically different way than Blockbuster. Redbox uses vending machines to rent videos, which requires different technologies—and a very different distribution system—than those used by either

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Blockbuster or Netflix. This chapter focuses on *innovative strategies* that are based on more radical innovations.

innovative strategy A strategy that introduces a fundamentally different business model than rivals.

We define an **innovative strategy** as a strategy that introduces a fundamentally different business model than rivals. The term business model refers to the rationale of how an organization delivers and captures value. More specifically, business models typically differ on one of three dimensions:

revenue model The approach, or pricing strategy, a company uses to get paid for the value it delivers through its business model.

1. The choice of customer segments to serve and the unique value (value proposition) offered by the company
2. The choice of activities the company performs and the resources used to deliver value to customers
3. The way a company generates revenue streams to get paid for the value it delivers. The term **revenue model** is sometimes used to refer to the approach, or pricing strategy, a company uses to get paid for the value it delivers through its business model (see Strategy in Practice: Understanding Business Models)

Strategy in Practice

Understanding Business Models

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Over the past few years, the term *business model* has often been used to describe a company's strategy. Perhaps the most comprehensive approach to defining a company's business model has been developed by Alex Osterwalder and Yves Pigneur in their tool, the Business Model Canvas.[14] They argue that there are nine components to a business model and firms can innovate by changing one or more of those components as they seek to deliver and capture value. The nine components are:

1. *Value propositions.* A firm seeks to solve customer problems and satisfy needs with a particular unique value or value proposition.
2. *Customer segments.* The value propositions are designed to meet the needs of one or several customer segments.
3. *Channels.* Value propositions are delivered to customer segments through communication, distribution, or sales channels.
4. *Customer relationships.* Customer relationships are established and maintained with each customer segment.
5. *Revenue streams.* Revenue streams result from value propositions that are successfully offered to customers through pricing strategies.
6. *Key resources.* Key resources are the assets required to offer and deliver the company's value proposition.
7. *Key activities/capabilities.* Value propositions are developed and delivered through key activities or capabilities.
8. *Key partnerships.* Some resources and activities that are critical to delivering the value proposition are outsourced to partners outside the company.
9. *Cost structure.* The business model elements above result in the cost structure for delivering the value proposition to the customer. These costs must be covered by the revenue streams in order for a firm to be profitable.

To illustrate, Amazon has a different business model than Barnes & Noble (B&N), with the most obvious difference being *channels*—Amazon sells books over the Internet rather than through bookstores. But this means that Amazon's *value proposition* is different, as are its primary *customer segments*. Amazon's primary customer segment prefers the lower prices that Amazon offers but it also likes the convenience of shopping from their computers or cell phones. In contrast, B&N's customers like the ability to get their books immediately and may enjoy the shopping experience at a B&N store. To deliver their value propositions through the distribution channels they've chosen, each firm must be good at different *activities* and have different *resources*. For example, Amazon needs to be good at writing software and fulfilling orders from warehouses, whereas Barnes & Noble has to be good at finding the best locations for its stores, designing stores to create a great shopping experience, and efficiently operating each store. Amazon and Barnes & Noble are described as having different business models because they differ on most, if not all, of the nine components of the business model canvas.

In some cases, firms deliver similar value to similar customer segments—and might even use similar resources and capabilities to deliver value—but they may differ in their pricing strategy or their approach to generating revenues streams and capturing value. For example, Apple, Spotify, and Pandora use different revenue models or pricing strategies to generate revenue streams. Apple makes money by selling songs and albums over the Internet for a specific price. In contrast, Spotify provides consumers with unlimited access to all songs in its library for a monthly subscription fee. Pandora uses a "free" revenue model like a radio station, and provides songs via the Internet that are tailored to a listener's preferences. Pandora makes money by selling advertising.

Companies sometimes attempt to change their business model in response to competition. For example, Barnes & Noble added the online book retailing business model to its bricks-and-mortar bookstore business model in response to Amazon's entry into book retailing.[15] In similar fashion, Apple launched iTunes Radio in 2013 to directly compete with Pandora.[16] In this way, it has imitated Pandora's business model including the revenue model for capturing value. In most cases, the company that is first to launch a business model has a first-mover advantage because it becomes known as the pioneer. In order to successfully compete with pioneers, second movers must offer unique value relative to the first mover—for example, lower prices, more features, or greater convenience—to lure customers in their direction.

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