Creating competitive advantage: Lessons from Smart Innovators

Konstantinos G. Apostolatos and Stephan Friedrich von den Eichen

They exist in every industry and everywhere around the globe - companies that consistently outperform their competition. But what do they have in common? To understand this phenomenon the authors take a close look at what a number of highly successful, fast-growing, medium-sized, entrepreneur-driven but otherwise ordinary companies do to outsmart their competitors. These are the companies that create new markets, expand the market or gain significant share, and they have profound lessons for us all.

- The problem with most companies is they don't know what business they're in.
- Make sure the dog wants to eat the dog food. No matter how ground-breaking a new technology, how large a potential market, make certain customers actually want it.
- Even turkeys can fly in a high wind. In times of strong economies, even bad companies can look good.

Eugene Kleiner, founding partner of Kleiner Perkins Caufield & Byers

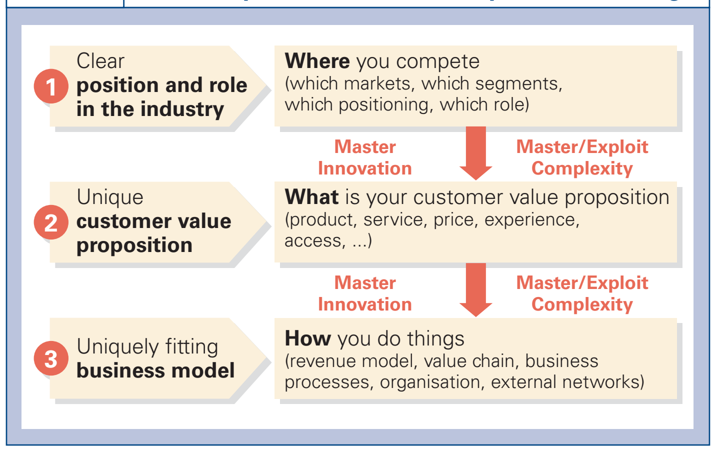
Looking through the lists of the best-performing companies over the last few years, such as the Fortune 500 and Business Week Top 100, it is clear that success in business is not purely about being in the right industry or in the right geographical markets. The majority of today's most successful companies are differentiated neither through industry nor geography.

Several academic researchers have been trying to define the secret of success of companies which consistently outperform their competitors in terms of shareholder value creation over a long period of time. Recent examples have included the excellent work of Collins and Porras of Stanford University, as described in their book Built to Last. These researchers have primarily examined large developments at large corporations over the last century.

But, looking at today's world, what explains the rise of companies such as Starbucks, MySpace or YouTube, to name a few? We do not intend in any way to replicate or challenge such excellent past research. However, we have had the chance to work extensively on strategy formulation with both small and large companies, entrepreneurs and multinational corporations, as well as a number of leading venture capitalists. This experience has led us to postulate that successful entrepreneurs tend to create competitive advantage in four basic ways:

- They identify a clear **position and role** in their industry in a sizeable, growing market.
- They establish a **unique value proposition** for their customers that clearly addresses a “pain point”.
- They develop a uniquely fitting **business model** that enables them to deliver the value proposition more profitably than their competitors can.
- And, while applying these three strategies, they **excel simultaneously in innovation and mastering and/or exploiting complexity**. This ability makes the difference, and is the essence of what we call Smart Innovation.

Exhibit 1 | **How companies can create competitive advantage**



To explore this further, we undertook to understand what a number of highly successful, fast-growing, medium-sized, entrepreneur-driven but otherwise “ordinary” companies do to outsmart their competitors: those that created new markets, expanded the market or gained significant share. Our primary focus has been exceptional companies - companies that are relatively young yet with an established track record, whose success in terms of growth and profitability is based on radical or business-model innovation. We defined exceptional companies as

those that demonstrated an economic value performance in terms of relative shareholder value creation, substantially superior to market indices and relevant competition, over a significant period of time (five years appears to be a minimum). High-growth companies that were not yet profitable were not part of our consideration. Our findings were based on desk research and interviews with the CEOs of such companies.

Clear position and role in the industry: OSIM Corporation

We defined exceptional companies as those that demonstrated an economic value performance in terms of relative shareholder value creation, substantially superior to market indices and relevant competition, over a significant period of time.

Many of the entrepreneurial companies we have studied identify first a sizeable growing market, with the potential to create, say, a US $ 1 billion company. They study the value chain that exists or could be set up to serve that market. Then they select for themselves the position they could occupy in the value chain, and which positions should be left to others. Likewise, they define the role they are capable of playing. While doing so, they investigate how they can take the lead in redefining the industry boundaries or industry rules that are currently considered immovable by its incumbents. For example, they may decide to take the lead in the consolidation of their fragmented industry. Or, on the contrary, they may decide to focus exclusively on the fastest-growing or most profitable niches, leaving it to the incumbents to cope with the legacy segments. For example YouTube is a popular free website which lets users upload, view, and share video clips. There is a wide variety of site content including movie and TV clips and music videos, as well as amateur content such as video-blogging. YouTube has only been around since February 2005, but they’ve seen massive growth - they’re serving 100 million YouTube videos daily, redefining the rules in the media industry and forcing media giants to enter defensive alliances with them.

The Singaporean company OSIM, which supplies healthy lifestyle products, is another case in point. Realising that it cannot be best-in-class in all aspects of the value chain, OSIM avoids complexity by focusing on its core capabilities: branding, marketing & sales, product development, and research & development. For other activities, OSIM relies on partners (see insert next page).

Healthy lifestyle

OSIM is a Singapore-based supplier of healthy lifestyle products, such as massage chairs, calf and foot massagers, handheld massagers, fitness equipment such as treadmills and bikes, and hygiene equipment such as air purifiers, steam/vacuum equipment.

OSIM has a strong record of innovation, especially in its massage product range. OSIM has distinguished itself by focusing on the entire body, with a separate product range for different body portions, including head and face. This has resulted in products like eye massagers and iMedic pillows and supports. Its iSqueez foot massager is a recent example of a blockbuster product. For 2006, OSIM was aiming to launch at least three new blockbuster products every quarter, as opposed to only one before.

OSIM believes that it cannot be best-in-class in all aspects of the value-chain. It avoids complexity by focusing on its core capabilities. These are identified as branding, marketing & sales, product development, and research & development. For other key activities, OSIM relies on partners. All manufacturing is outsourced to various parties, using a strict quality assurance and control system.

OSIM uses a unique co-innovation approach to boost its product pipeline and add to the niche products that OSIM designs entirely itself. Numerous ideas are often generated by various sources, from OSIM's own team to external partners such as business associates, customers, suppliers, then designed together with OSIM's own team, and finally outsourced to manufacturing partners for production. OSIM also partners with research institutes and universities for longer term R&D. This approach has enabled OSIM both to have low overhead costs and to keep the relevant core competencies within the company. As Mr. Tan Kia Tong, Chief Technology Officer of OSIM, explains: "We want to focus on areas of competence in which we can excel and remain very flexible."

OSIM proactively manages its product portfolio by regularly reviewing and in some cases eliminating existing products. It always has the next two generations of a product ready to launch "at the appropriate time". If competitors introduce products similar to OSIM's, OSIM normally withdraws its product from the market and introduces a new product with better features than those that are available in the market.

Unique customer value proposition: Cerner Corporation

The second factor that distinguishes the entrepreneurial companies we have studied is their obsession with establishing a unique value proposition for customers. They study customer groups in the markets they want to address in order to identify "pain points" in customers' experiences with existing offerings: the way customers obtain access to the product, the pricing scheme of the product, the real-life usage of the product, the service offered along with the product, etc. They use these insights to parcel the market into distinct segments, some of which they then select for them to serve with a unique solution with a measurable benefit. By doing so, they avoid the commodity trap, in which the lack of unique product attributes for which customers are willing to pay leads to a downward price spiral in the industry. They develop offerings that warrant a price premium and are not rapidly imitated. For example, the recent amazing success of MySpace has been the ability to create a unique global community of young people with more than 100 million members in just three years.

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US-based Cerner Corporation, which supplies healthcare information technology solutions worldwide, is another fitting example. Its value proposition is to provide a single source of medical information at the point of care, thus creating the paperless medical practice (see insert next page). It is a classical case of viewing complexity as an opportunity to innovate. Cerner has developed an innovative solution that explicitly tackles the complexity issue in the administration of medical records, for the benefit of both doctors and patients. Cerner is growing at a steady 25 percent per year and has outperformed the S&P 500 and Nasdaq indexes by as much as 50 percent over the last three years.

Medical Information from a single source

Cerner Corporation supplies healthcare information technology solutions worldwide. It designs, develops, markets, installs, hosts and supports software information technology and content solutions for healthcare organisations and consumers. The company implements and supports software solutions and hardware that provide healthcare providers with secure access to clinical, administrative and financial data in real time, addressing a tremendous "pain point" of medical administration in today's healthcare system. Cerner's products and services also provide access to an individual's electronic medical record at the point of care, as well as organising information for the specific needs of the physician, nurse, laboratory technician, pharmacist and other care providers, plus front and back office professionals.

The value proposition is to create a single source of medical information at the point of care, thus creating the paperless medical practice. The benefits are multiple:

- Doctors have increased their patient throughput by 20-40 percent;
- Digital medical records allow payments by insurance companies in less than one-fourth of the time they used to take;
- Patient charts and information can be securely accessed any time, anywhere;
- Doctors' reports are produced and stored in the patient's medical record in less than one tenth of the time;
- There is an ability to import, store, integrate, analyse and present information from several sources of medical data, and flag problems that a patient might experience;
- Using Cerner's software every patient is scored on admission for vulnerability to bedsores - based on age, medical problems, test results and other characteristics.

Uniquely fitting business model: New Wave Group

The third factor that distinguishes the entrepreneurial companies we have studied is their fascination with creating an operationally excellent business model. They purposefully look for ways to design efficiency into their operations structurally, i.e. when their operations are created. Unlike incumbents, they don't have to weed out inefficiencies – which inevitably will crop up again some time later – because they have an operations model in which the factors that traditionally lead to inefficiency have been taken out at the design stage. As a consequence, they can bring their unique value proposition to their customers profitably, or more profitably than their competitors can.

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In order to design efficiency into their operations, they question the traditional set-up of the value chain, the conventional organisational models, the habitual processes and the historic capabilities used in their industry. Very often they exploit a network of partners, smartly optimising the revenue model, the degree of interconnectivity and efficiency of the value chain, among other things. For example the Easy Group (easyJet, easyRent, easyInternet, etc.) has been very successful by developing a low-cost, standardised no-frills business model (it always aims at a cost level that is 25 percent below the incumbent's), allowing it to under-price competitors and as a result grow rapidly and profitably.

A telling example is the New Wave Group, a Swedish growth company that designs and distributes clothing articles and gifts (see insert). It is highly successful in a highly competitive market, with businesses that normally appear rather unsexy. And it has made winners out of brands that were heavily loss-making in the hands of their previous owners. As Torsten Jansson, CEO of New Wave Group, explains, the key ingredients of the company's success include the following:

- Focused position in the value chain. New Wave Group is almost exclusively a development, marketing and distribution company, without manufacturing, unlike most of its competitors. As a result, it has a relatively low fixed-asset and cost base.

- Economies of scope. New Wave Group leverages its product portfolio across its two business areas. More than 80 percent of its products are sold identically in both the Profiling area and the Retailing area.

- Unique customer understanding. New Wave Group has deep and unique intelligence about and understanding of customer needs and their willingness to pay. Its "customer closeness" approach includes having advisory boards in each geographic area, on which key customers serve as members. It also holds two detailed development meetings with all key customers annually. This intimate approach has two benefits. First, it leads to innovative and high-quality product designs. Second, it significantly lowers marketing and promotion costs for reaching key customers.

New Wave Group has managed to grow and make money consistently where others have failed. It has done this by, on the one hand, innovating its product offering through close understanding of customer requirements, and on the other minimising complexity through focus.

- Clearly targeted segments. New Wave Group makes clear choices in its product portfolio, and stays away from the most price-sensitive market segments.

- Lean structure. Product development and design, purchasing, warehousing and logistics are services shared between the two business areas. Corporate headquarters are very lean (Torsten Jansson does not even have a secretary), while at the same time local entrepreneurship is encouraged in marketing and sales.

- People and values. New Wave Group is a very tightly knit, ambitious (Torsten jokes "We have not acquired Nike, yet!") group of associates with a simple set of 13 corporate values.

In summary, New Wave Group has managed to grow and make money consistently where others have failed. It has done this by, on the one hand, innovating its product offering through close understanding of customer requirements, and on the other minimising complexity through focus.

Hot growth at New Wave

Torsten Jansson, a high-school dropout and an entrepreneur with heart and soul, established what is now the New Wave Group in Sweden in 1990, when he was 19, immediately after his military service. New Wave Group designs, acquires and develops quality articles mainly in the clothing, accessories and gifts domain. It serves two main segments: its Profiling business area serves companies via independent distributors, while its Retailing business area serves consumers.

New Wave Group stood at number 30 in Business Week's Europe's 100 Hot Growth companies in 2004. Between 1992 and 2005, sales grew from € 5.7 million to € 333 million, i.e. at a compound average annual rate of 37 percent. In the same period, net profit grew from € 400,000 to € 27 million, i.e. at a compound average annual rate of 38 percent. Between January 2000 and January 2006, its share price increased at a compound average annual rate of 30 percent.

New Wave Group has developed or acquired an increasingly complex and, at first sight, not closely related portfolio of products. In the Profiling business, its portfolio includes promowear, give-aways and workwear. In the Retailing business, it includes sportswear, textiles, gifts, shoes and towelling. The company typically fully owns its brands (such as Grizzly, Toppoint, Orrefors, Costa Boda, Craft, Nordica, Umbro…) but it does not manufacture the product.

Smart Innovation: excelling in innovation and mastering complexity

Conventional wisdom has it that innovation and complexity are at odds with each other: the more new products you introduce, the more complexity you create, to the point where the costs of complexity outweigh the benefits of innovation. The companies we have studied demonstrate that there is no such axiomatic trade-off between innovation and complexity. They innovate to seize the complexity opportunity and achieve extraordinary business performance - one of the key factors of Smart Innovation as we define it at Arthur D. Little.

Just to re-state the point, let's use the extreme example of eBay. eBay's trading platform involves a great deal of complexity, with already more than 100,000 product categories, more than 200 million users in 55 geographic areas, and an overall gross merchandise volume traded exceeding US $ 50 billion as of June 2006. Clearly eBay has been able to innovate, while at the same time being able to thrive on complexity, with operating margins (35 percent) and operating cash flow (165 percent of net income) that are unheard of in the retail industry.

The company A Raymond is a similar example (see insert). This Franco-German automotive supplier, through its FACIL joint venture, enables its car-assembly customers to export, so to speak, part of their complexity to FACIL, which has found innovative ways to cope with this complexity in a way that is profitable for both itself and its customers.

Fasten seat belts at A Raymond

The A Raymond group is a family-owned Franco-German global automotive supplier specialising in customised fasteners and bonding technologies, with more than 2,700 employees. Together with the KAMAX Group, a German family-owned global component specialist for high-strength screws with 2,500 employees, it established a 50/50 joint venture company called FACIL in Belgium in 2000.

This joint venture company introduced the "Fastener Service Provider" concept. Its purpose is to remove non-value-adding complexity at automotive original equipment manufacture customer sites through product-oriented innovation of the sourcing and supply chain processes. Working for Ford Motor Company in Genk, Saarlouis and Valencia, FACIL has taken over complete responsibility for more than 400 parts (10 percent of all vehicle part numbers) and the volume of on average 50 suppliers per vehicle. This initiative reduced yearly costs for Ford by 10 percent in the first year and 5 percent in each of the subsequent years. At the same time, the initiative generated additional revenues and profits for FACIL's parent companies, and by providing additional customer value helped them to avoid getting stuck in the commodity trap.
Hans-Juergen Lesser, board member of the A Raymond Group, talked to us about the way FACIL seized the complexity opportunity. "In the automotive industry, material costs account for only 15 percent of total costs," he said. "Logistics, assembly and overheads account for the other 85 percent of the 'installed costs' of a fastener. In the past, innovations occurred mainly on the product and process side. The cost reduction potential of the outsourcing of engineering, supply logistics, sourcing and quality management to one full-service provider remained untapped so far. This kind of business model innovation was therefore the target of our innovation efforts."

"Engineering is an important lever to reduce non-value-adding product complexity at the customer side," he said. "The key is the early involvement of our resident engineers in the product development process, especially to enforce decision making in the parts release process. Based on clear cost reduction targets and functional requirements, we are then able to reduce complexity for our customers by helping them to get rid of variants, by introducing innovative assembly solutions and by taking over the responsibility for complete support processes such as logistics, sourcing and quality management for all fasteners in a vehicle."

Insights for the executive

Executives of established players can apply the insights derived from the above examples of entrepreneurial companies to their own company or business unit. Many established players already do so to a greater or a lesser extent. For example, GE Healthcare applies the concept of "lead users" pioneered by MIT's Eric von Hippel to identify unique customer value propositions. GE Healthcare calls these well published doctors and research scientists from leading medical institutions "luminaries". It brings up to 25 luminaries together at regular medical advisory board sessions to discuss the evolution of GE's technology. It then shares some of its advanced technology with a subset of luminaries who form an "inner sanctum of good friends". GE's products then emerge from collaboration with these groups.

But even if you do already systematically apply one of the insights gleaned from entrepreneurial companies such as those described in this article, we would encourage executive boards to consider the four factors together and develop a 5-10 year agenda addressing the four key questions:

1. How could we take the lead in redefining the industry boundaries or industry rules that are currently considered immovable by established players like ourselves? What is the risk of a new entrant or start-up doing just that to us?

But even if you do already systematically apply one of the insights gleaned from entrepreneurial companies such as those described in this article, we would encourage executive boards to consider the four factors together and develop a 5-10 year agenda addressing the four key questions.

2. What are the as-yet undiscovered "pain points" in the experiences our customers have with the products or services currently offered by the established players? What unique and hard-to-imitate pain-relieving solution could we offer? How can we create a truly unique customer value proposition?

3. How could we re-design our business model in order to create a truly unique and smart business model, which fits with our strategic positioning? What could we do to both make a sustainable quantum jump in efficiency and erect barriers to imitation?

4. What innovations could we pursue to eliminate needless complexity in our business? How could we seize the complexity opportunity, i.e. simplify life for our customers through innovation, or else find a way to manage necessary complexity more profitably than our competitors?

While these questions are quite fundamental, we would argue on the basis of our experience that executive boards often fail to consider them adequately:

- They often do not put themselves at sufficient distance to consider how the company can define its future role in shaping or leading the industry;

- They seldom test the uniqueness of the company's customer value proposition in a truly thorough and challenging way;

- They frequently look upon the company's business model just in terms of cost and efficiency, without considering fundamental structural or organisational changes;

- They rarely take the simultaneous mastery of innovation and complexity as a key perspective for designing the company's strategy.

CEOs should challenge their senior management to initiate this discussion and develop a "Smart Innovation CEO Agenda". Many will undoubtedly consider such a journey to be daunting. But ample evidence suggests that the potential returns make it a very attractive endeavour. By addressing the four questions listed above in concert, you have the potential to enter a game usually played only by entrepreneurs, new entrants and start-ups. If you play it smart, you may even outsmart them all.

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Konstantinos G. Apostolatos
…is a Director in Arthur D. Little's Rotterdam and Brussels offices. His fields of interest include business and operational strategy, innovation and corporate finance.
E-mail: apostolatos.konstantinos@adlittle.com

Stephan Friedrich von den Eichen
… is Director in Arthur D. Little's Wiesbaden office, Head of the Strategy & Organisation Pratice Germany & Austria. He specialises in corporate strategy, value adding partnerships and co-innovation.
E-mail: friedrich.v.d.eichen.stephan@adlittle.com