The critical interplay among innovation, business models and change

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Introduction

As corporations and executives increasingly focus on innovation, there's a risk that the vital interplay between innovation, business models and systemic change isn't fully appreciated. From our perspective, innovation almost always impacts three constituents: the customers, the competitors or market, and finally the innovator itself. These impacts frequently have business model implications. Realistically, any really interesting innovation, regardless of its intended outcome, is also a business model innovation.

Any innovation creates change, to three vital constituents: customers, market or industry, and the innovator itself.

As we consider the amount of change innovation creates, and its impact on business models, it becomes clear that good innovators must have the capability to change capably and consistently, and must be able to evolve their business models as they innovate.

It's important that innovators understand the potential change that innovation creates, and anticipate the impact of the change on the two external constituents (customers and the market) and how those impacts may require or force change on the innovator itself. Innovators often act as if they can create innovations that affect the customer and the market, but that the innovator is somehow immune from the impacts and potential changes. This thinking is unrealistic and potentially dangerous. We believe that the best innovators are the most adept at making and sustaining change.

Innovators aren't immune to the change they hope to create for customers and the industry or market.

While some organizations are beginning to understand how to define innovation, they don't fully grasp the full scope and range of innovation opportunities available to them. These same organizations fail to understand the symbiotic relationship between *innovation* – creating something new and valuable – and *change* – the change created by new products or services that confronts customers, markets and sometimes the innovator itself. Most importantly, these organizations fail to understand why the ability to change is so critical to successful innovation and corporate survival. We certainly need better descriptions of the breadth, depth and scope of innovation in order to fully appreciate and understand its impacts on three principle constituents.

We need to understand the symbiotic relationship between innovation and change that confronts customers, markets and the innovator itself.

In this paper we'll examine the impact of innovation on the three defined constituencies and describe why innovation and change are interlinked. Further we'll explain why the creation of new products and services may require that markets and business models adapt and change, ***leading to the conclusion that many innovations, regardless of their intended outcome, are also business model innovations as well***. Through these conclusions we demonstrate that good innovators must be constantly evolving their business models, and must be capable of consistent change.

Due to the change created by new innovation, many innovations are also business model innovations.

Until we understand the scope and impact of innovation, we can't fully grasp the nature and amount of change that innovation can unleash. The interplay between innovation, business models and change is too important to be ignored for each of the constituents involved but most importantly for the innovator themselves. It strengthens the delivery impact significantly.

The dynamics of innovation and change

As we described above, many corporations haven't carefully defined the scope of innovation activities and don't recognize the impact of innovation and its incumbent requirement for change. We've defined the three constituents that are impacted by change: customers, competitors or market, and the innovator itself. Let's now describe three tiers or scope of impact an innovation can create:

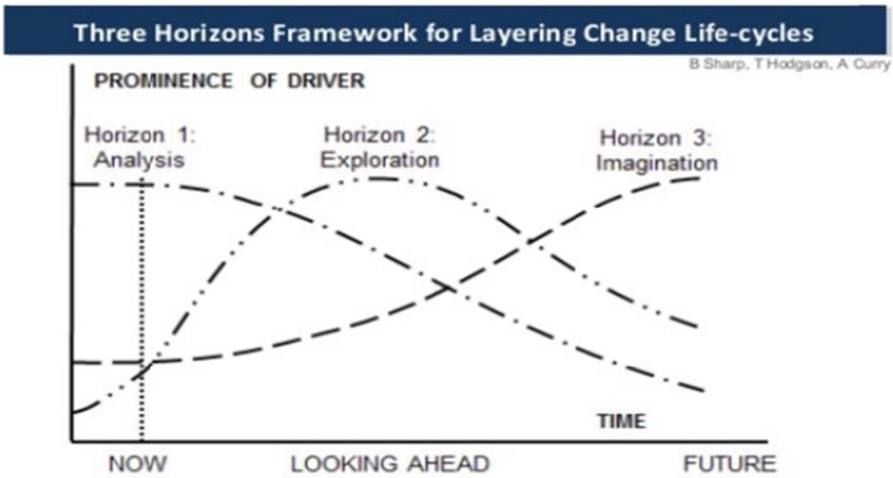
- Incremental: Making changes to existing products and services with little change to an industry or market. Customers may need to change to some degree to adopt or adapt to a new product. Competitors and markets will ignore or quickly match the new capabilities or features.
- Breakthrough: Making changes to the existing industry or business model. A company may discover innovations that impact the industry's operations, structure or business model, in effect forcing change on its customers, its industry and by extension, itself. A breakthrough innovation extends or changes an existing technology, capability or market in such a way that customers and competitors must change to some degree.
- Disruptive: Innovating to create a new market or industry, or innovating in an existing adjacent industry. An innovator may identify or discover needs that allow it to create a completely new market, segment or industry, or enter an existing market, segment or industry and change it or disrupt the adjacent market. Disruptive innovation requires change on the part of the customer, and creates such drastic change that competitors are forced to change or remove themselves from the market.

What's important to understand is that every innovation creates change, and the amount and impact of change that occurs is different across these three distinct types of innovation.

Applying the three horizon framework to innovation and change

To explain the impacts of innovation and the change it creates, we'll use an accepted framework (the Three Horizons) to consider the impact innovation has on change capabilities and business models. Here we introduce the three horizon concept to better understand the range of innovation outcome and the potential change requirements.

The 3 HORIZONS framework



The three horizons framework provides distinct horizons, requiring different outcomes and approaching the scope of innovation in mindsets. Usually it is represented by a typical XY plane, whereas Y is amount of scope / need/ value / change over x, the time each takes/ seen / needed

What's important to understand is that every innovation creates change, and the amount and impact of change scales out across each of these three horizons. For greater clarity, let's examine each of the three horizons in a bit more detail.

Defining Horizon One - Operating in the Now

Horizon One defines the portion of the potential innovation space that is most similar to existing services or solutions. The typical innovation focus in Horizon One is on improving efficiency or cutting costs.

Innovators working within this space are typically creating small but useful changes to existing products and services, offering the new solutions to existing customers and prospects. The anticipated outcome is "incremental" change, easily adopted by existing customers and no real threat to the market, competitors or the industry. This innovation is based on existing capabilities with the intent of maintaining or growing existing share in the existing markets. It relies on existing capabilities and emphasizes excellent operational execution, with less focus on new needs or expanding the competitive market space.

The internal change focus is on improving execution and increasing efficiency. There's little change required for external constituents. Consumers are already familiar with the products and have some expectation of improvements or modifications. Competitors and the industry at large isn't significantly impacted by the innovation.

The vast majority of innovation activity is "incremental" innovation, because the risks are low, and market knowledge is relatively high.

Defining Horizon Two - Looking ahead, anticipating change

Horizon Two is the portion of the potential innovation space that focuses on extending existing capabilities into new markets or introducing new capabilities into existing markets. Horizon Two is the mid-point between "incremental' change in Horizon One and "disruptive" change in Horizon Three.

Companies innovating with this horizon anticipate "breakthrough" innovation, usually extending a known technology into a new market, or introducing new technologies or capabilities into the existing marketplace. Breakthrough innovation often requires extending to new capabilities as well as building on existing capabilities, with the intent of expanding markets and the competitive space.

The innovation arising from the 2nd horizon requires more experimenting than Horizon One innovation, and often leads to some change for all three constituents. Internal change in this horizon is focused on experimenting and extending capabilities. Consumers may experience change due to the introduction of new technologies or capabilities. Competitors will experience change due to the broadening of industry definitions or modifications to industry or technology conventions.

Operating in Horizon Two the innovator begins to stretch its horizons, using either new technologies, extending or establishing new practices or capabilities as they explore and enter new markets or shape existing ones differently.

Defining Horizon Three- The future, defining change and transforming

Horizon three is the portion of the potential innovation space that seeks the most significant innovation change as the innovator seeks to create new markets or dramatically change or disrupt existing markets, or create completely new technologies or capabilities.

When companies conduct "disruptive" innovation the anticipated result is market or technology disruption, creating new market dominance by upending existing products, technologies, capabilities or markets or creating entirely new products or markets. Innovating in Horizon Three requires significant discovery and learning while building and adapting new capabilities. A successful innovation will create disruption for all three constituents. This is the space where the most change will occur.

Consumers will find a completely new, novel and valuable solution to an existing problem or challenge, and must change their actions or behavior to adopt it. Disruption of industry expectations and norms will force competitors to react, and may cause so much change that they cannot respond to the speed and scope of the change. *The innovator themselves must change*, in order to provide all of the features and capabilities the disruptive innovation requires in order to be adopted by consumers. These internal changes will be based on exploring new technologies, evolving business models and expanding the definition of the market or solution.

Those attempting Horizon Three innovation are creating entirely new capabilities or technologies, creating new segments or markets, or both

Relating innovation and change within the three horizons

As we define each of the three horizons and the anticipated innovation outcome, we can begin to document the differences among the potential outcomes, in terms of approach, the leverage of new or existing capabilities, intent and strategy, and many other factors.

	Horizon One	**Horizon Two**	**Horizon Three**
Outcomes	Incremental	Breakthrough	Disruptive/Radical
Type	Core	Growth	Future
Working approach	Plug n Play	Read and React	Learn and Leverage
	Horizon One	**Horizon Two**	**Horizon Three**
Capabilities	Based on existing	Connecting to new	Adapting to emerging
Strategic focus	Exploit and	Expand and Build	Explore unknowns

	Optimize	New Options	and future spaces
Intent	Secure existing markets	Build and extend	Explore and disrupt
State	Business as Usual Leveraging on the existing, extracting the optimum	Transforming, building resilience sustaining and extending	Adaptive, exploring potential from new options
Focus	Good execution	Frequent Experiment	Explore and discover
Change Impact	Little change to any of the three	Some change to all three	Significant change to all three
Approach emphasis	Superior Execution	Positional Advantage	Foresight and Visionary

Understanding the decision making, strategy, intent and emphasis required for each horizon helps delineate the commitment, resources and effort involved, and begins to signal the scope and impact of potential innovation and the change the innovation can create, for customers, markets and the innovator.

These ideas culminate in a rather interesting conclusion, which is that *any innovation, especially in horizon two or horizon three, regardless of its intended outcome (product, service, channel or business model) is also by definition a need to reflect on a business model innovation change*. Will the innovation significantly change the existing business model or distort or disrupt the model. This means that innovators internal to an industry will be constantly evolving the model from within, questioning it, evaluating changes, and new entrants and disrupters will seek to change and challenge existing models from their external perspective. Both of these facts lead us to the conclusion that good innovators must excel at sustained change and business model evaluation.

Most corporations don't understand how much change is created by innovation.

As we begin to understand the Three Horizons and the anticipated impact an innovation can have in each of these horizons, we can begin to grasp the amount of change innovation creates, and which constituents will feel the brunt of that change. Clearly, as we've demonstrated above, breakthrough and disruptive innovation outcomes create change for customers and for competitors and markets. More importantly, these innovations create change impacts that will force innovators to change as well.

Each horizon has a different and direct influence on innovation outcomes and the change these require

This is often an unexpected outcome of an innovation activity, as many innovators believe themselves to be inoculated from the change their innovation creates.

Many corporate innovators hope to create significant impact and to disrupt their competitors with new products that in turn also delight their customers. Yet few innovators think carefully about the ripple effects of breakthrough or disruptive innovation. They prefer to conduct what we'll call "guided missile" innovation, assuming that they can create meaningful and valuable change for customers and disruptive and destructive change for competitors while remaining isolated from the change their new products and services create. This naïve assumption is dangerous and almost always wrong. Innovation in almost any form may require that the customer or market change. It's very likely that these innovations will require that the innovator change as well. We simply cannot expect to create change in the marketplace or in the customer base without also expecting to change as innovators.

The assumption that innovation will impact the customer and competitors but won't force the innovator to change is dangerous, and almost always wrong.

Let's examine the change each constituent will experience.

Now that we've established the different innovation horizons and the potential impact of an innovation in these three horizons, let's detail the type and scope of change that's possible for each of the three constituents, focusing on breakthrough and disruptive (Horizon Two and Horizon Three) innovation specifically.

Customer

A breakthrough or disruptive product or service will cause change for consumers, as they adjust their actions and behaviors to adapt to new solutions and features. Consider for a moment the different forms a new innovation can take. According to Doblin, there are over ten different "types" or forms of innovation outcome, including products, services, business models, channels and others. The innovation itself can offer dramatically more capabilities or benefits over the product or service it replaces, or can significantly reduce issues or challenges when attempting to do a specific "job". In either case, the customer must change their actions, behavior or belief to adopt the new innovation. Ideally the customers and prospects anticipate the change and are eager for the change, because it either simplifies their lives or offers them more value. From their perspective the change is significant but reasonable because it offers them more value than the existing offering. While customers may expect and embrace change, that same openness isn't true for competitors or the industry.

<u>Competitor or Industry</u>

If a new product or service is truly breakthrough, or disruptive it will have significant impact on the current competitors and the industry. Regardless of the "type" of innovation (product, service, business model, etc.) the introduction of a breakthrough or disruptive innovation introduces change in the conventions and expectations of the industry, which may force competitors to compete in a new or different way than they have in the past. Look no further than the music retailing and distribution business before iTunes disrupted the marketplace. The major retailers sold albums on physical media in retail stores. After iTunes the majority of music was sold online, often as single songs as digital media. A broad portion of the music retailing and even music publishing industry was affected, in some cases made obsolete. Breakthrough and disruptive innovation creates change that can be dramatic or destructive for competitors or the industry.

<u>Innovator- *the critical initiator and effective change manager / sponsor*</u>

Clearly, customers must change to adopt a breakthrough or disruptive product. Additionally, breakthrough or disruptive products or services will force competitors and the industry to respond. If these two conditions are true, then it should be obvious that the third constituent – the innovator itself – must change as well. While this seems obvious in the abstract, many innovators still want to practice what we earlier called the "guided missile" approach, which imagines creating change for the customer and the industry while protecting or maintaining existing internal structures and processes.

<u>*This thinking is dangerous, for several reasons:*</u>

First, any innovation that will radically impact the customer or industry will have an effect on the innovator.

These effects will be in terms of the uptake of existing products or services, in terms of existing customer expectations and industry conventions. Innovation can change existing channels, products, services, processes and business models. The innovator is not immune from the change the innovation creates and the ripple effects that will follow the introduction of the innovation. Change will happen – there's only the question of whether or not the innovator understands the size and scope of the change they are attempting to create.

Second, an innovator that creates a new product or service which modifies customer behavior or industry norms must be prepared to compete in the new reality.

This means that to survive, the innovator must be changing its processes and business models as it perfects its innovation – changing at the same time it develops innovative products or services. Apple could not disrupt the music retailing industry unless it was prepared to license single songs and accept payment through iTunes. It had to be ready with the total solution, not just components of a solution, and to do this it had to think through all aspects of the change and create solutions that addressed or resolved any concerns.

Third, radical or disruptive innovation doesn't simply create discrete products but disrupts an existing system.

In this regard radical or disruptive innovation is similar to "crossing the chasm" – few consumers will adopt a radical new innovation until the "whole product" exists, which means the innovator must think through the core products and ancillary or anticipated products, services and business models that must exist in order for consumers to acquire the product.

Breakthrough or disruptive innovation must be a "holistic" innovation, considering all of the factors that consumers need in order to adopt the solution, in a sense thinking through an entire "ecosystem" for the new product or service and delivering much if not all of it at the same time. A radical or disruptive technology or product which does not fully address the "whole product" needs is very likely to fail.

For these reasons, innovators must develop change capabilities, and be able and willing to change as they create and commercialize new breakthrough and disruptive solutions. In many cases the internal changes may coincide with the development and commercialization of the innovative product or service.

Change is deeply bound up in innovation

What these conclusions tell us is that, especially for breakthrough or disruptive innovation, change is intricately bound up in innovation, both for external consumers and the market at large, as well as for the innovator itself. While the innovator may escape meaningful change when conducting incremental innovation, the innovator has no choice but to change as it creates breakthrough or disruptive innovation, in parallel with the development of the innovation.

To succeed at innovation, corporations must be capable of agile, consistent change. Innovation will require the corporation to change, sometimes *simultaneously with the innovation it creates.*

There's no escaping the conclusion that breakthrough and disruptive innovation activities demand a concurrent change activity on the part of the innovator. In fact this insight is important. Creating a new idea is relatively simple. Developing the idea into a valuable product is more difficult and complex. Understanding the impact the new product may have on each of the three constituents is perhaps the most valuable insight, and only those innovators which are willing and able to change will succeed.

Markets today are far more volatile and disruption is occurring at faster rates. Innovators must counter these factors with greater agility, flexibility and adaption to achieve greater speed and the ability to innovate and change in parallel.

Perhaps the most significant barrier with change has to do with historical perspective. In the past, most corporations thought about change as a short, painful, disruptive experience from one "steady state" to another, more beneficial "steady state". Corporations expected to remain in these "steady state" conditions for long periods of time, interrupted only occasionally by difficult but short and infrequent change activities. This is the predominant expectation about change, and it is wrong.

Increasingly, innovation and change will occur far more frequently, and "steady state" periods will shrink. This means the most common state corporations will experience is not "steady state", but change and innovation activities will become the predominant state.

The logical conclusion is that corporations that build and sustain change capabilities and reduce the fear and uncertainty of change will thrive. Relying on innovation capabilities alone is not enough – successful corporations will combine good innovation expertise with good change capacities in order to become far more agile and adaptive. Good innovators will be able to change regularly and at speed. Others will simply cease to exist.

A final conclusion to draw is that almost any innovation even incremental change to an existing product or service will have an impact on other factors, potentially creating change in channels, business models, service deliveries, key relationships and even industry boundaries and conventions. This is true whether the innovator currently resides within the industry framework or seeks to disrupt the industry from the outside (which is probably more likely).

Thus we can say that most corporations must be much more adaptable and prepared to change as a condition of their own innovation activity, as well as anticipating changes thrust on them, their industry models and their customers by other familiar competitors as well as new entrants and industry or market disrupters.

Every innovation can create a requirement for change, and every opportunity for change creates an equal and opposite opportunity to resist changes or sacrifices market positions, products and revenue to sustain existing models and operations.

Which takes priority: Business Model innovation or Change capacity?

These ideas lead to an interesting dilemma of sorts: if most innovation is also a potential business model innovation, and business model innovation requires internal and external change, which capability is the driving factor? Which one should a company develop first? We believe developing these capabilities can happen in parallel, but require different thinking and skills.

Recognizing the need for business model innovation when creating new products and services is a matter of perspective and scope. Innovation teams need to consider the desired innovation outcome and the ripple effect the innovation will have on their customers, the market and the company. This enlarged thinking will drive better innovation solutions and help the company recognize the potential for change.

Recognizing the potential for change is valuable, but having the capability to change to deliver the true value that the innovation creates is vital. This means that an innovative company must develop new change capabilities and models as it expands its understanding of the breadth and depth of its innovation impacts.

Fortunately these two actions can be taken simultaneously. The concept of scope, breadth and depth and potential impact of innovation can be changed through new perspectives and new training of innovation teams, while other teams focus on existing cultural barriers and overcoming inertia to introduce new change capabilities.

Three actions: Recognition, Framing and Building Capabilities

Now that we've defined the potential scope or impact of innovation across the Three Horizons, and established that innovators aren't immune from the change their innovations create, we need to define a methodology to ensure that innovators are prepared to conduct innovation and change simultaneously and consistently. We've defined three key steps to assist potential innovators in order to help them evaluate their change capability and define their innovation and change goals.

First, we need a clear recognition of the current state and future state.

This action defines a classic assessment of the existing expectations and capabilities of the organization. Does the executive team understand the interlinkages of innovation and change? Does it understand the increasing pace of innovation, and the need to become much more adept at change? What are the strategic imperatives about change?   What are the dominant expectations about the frequency and role of change? The recognition phase should lead to a number of audits and strategic reviews, to assess where the organization has key strengths and gaps. Equally the recognition should create a sense of urgency about the scope and scale of change that is required. Unless the corporation is confronted by an important, urgent need to change, and builds its capacity for change constantly, the resistance to change will be too high to overcome. We've linked to presentations with more detail on the audits.

Second, innovation and change must be defined using the Three Horizon Approach.

Once strengths and weaknesses are understood, we also need to understand corporate expectations and goals. A good place to start is to think of the three horizons as a portfolio of investment opportunities, and determine how much time and resources should be invested in each horizon and what the expected risks and returns should be. Perhaps the executive team is content to focus on horizon one innovation and nothing else. If that is the case then the executive team should convey that intent and 1) ensure that the necessary skills to win at the chosen strategy are in place and 2) ensure that all innovation is focused on this horizon.   We've linked to a presentation that provides more detail around the framing aspects.

Third we need to build our changing capabilities, capacities and competencies.

Once we understand the existing capability for innovation and change, and further the amount of innovation needed across the three horizons, we can then understand the amount and frequency of change that is required, and build capabilities to 1) innovate more effectively and 2) create the capacity to change more readily. There are a number of important skills that must be developed or extended in order to innovate and change regularly and capably. Finally the leadership team must instill in these organizations the commitment to sustained change. As Andy Grove said years ago, "only the paranoid survive". A constant state of innovation and change capability and vigilance must be a component of building innovation and change capabilities. We've documented these in a presentation.

These three phases are important to pass through

First, it helps to move towards the state of being fast, more responsive, agile and aware. To have a more complete vision in order to innovate recognizing where change impacts and why and when. Second, these capabilities, the competencies and capacities that are built up become vital when thinking about change as you recognize the 'changing state'. Firms that can act capability at speed, adjust direction or intent and have good awareness or vision can change without significant impact. Unfortunately, these capabilities are not evident in most large corporations as the change impact is not considered as it should be. It is this lack of impact awareness that can significantly contribute to organizations continuing to be restricted, inflexible and short-sighted as they have not updated their understanding of innovation and its change impact on themselves or what they are seeking to influence for the other principle constituents.

We believe it is critical to complete each of these three steps to have successful, sustained innovation, where change is fully addressed as part of the innovation equation.

Conclusion

As we noted before

> ***Change will happen, it occurs constantly, all around us – there's only the question of whether or not the innovator understands the size and scope of the change they are attempting to create and their ability to shape and influence it, for their growth advantage and sustaining needs.***

We've developed the idea that many product or service innovations are eventually also business model innovations, which create change for all three constituents. This means that innovation will create change, not only for the external consumer, but will require change for the innovator as well.

Innovators cannot defend themselves from change, or avoid the "ripple" effects of change. As the pace of innovation increases, corporations must increase their internal capability to change, meaning more cultural awareness of the need for rapid and continual change, as well as moving towards the necessary characteristics for change required in today's and tomorrow's market conditions through adaptiveness, speed, agility.

This move towards a different style of organization leads to one other conclusion: good innovators will spend some significant portion of their time and attention innovating internal structures and processes, constantly improving the corporation's ability to change, while also creating new products and services meant to encourage customers to change.

It simply won't be possible to innovate without the accompanying capacity to change, which will require innovation and improvements to existing internal cultural beliefs, operational practices and organizational structures.

This is why we argue that the interplay between innovation, business models and change is important to understand. Corporations that hope to compete must focus on doing all three effectively.

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