Breakthrough Thoughts
by Jan Torsilieri and Chuck Lucier

How to Change the World

Strategic innovation is an art form, much like jazz, that requires the discipline to learn and the talent to improvise.

There was a time not long ago when most managers tried to win by being a little faster, better, or cheaper than their competitors; by squeezing a bit more from employees or customers, or by managing the largest possible enterprise and enjoying economies of scale. No longer. Today's standard is much higher: CEOs must strive to be extraordinary business leaders like Ford, Morita, Agnelli, and Walton. They must change the world. It's the only sure bet for creating superior long-term value for shareholders, and turning employees' stock options into real money.

Changing the world begins, of course, with a great idea — something conventional wisdom suggests is in short supply. But today's economy is awash in great ideas — there were 84 IPOs in the first 10 weeks of this year alone.

The hard part isn't the idea; it's turning the idea into a real, earth-shaking strategic innovation that serves a well-known customer need in a dramatically better way — e.g., Southwest Airlines' offer of fun flying experiences for the price of bus fare, or the Dell Computer Corporation delivering exactly the computer a consumer wants at a low cost.

The companies that successfully changed the world, at least in the 55 industries we have studied, excelled in strategic learning. They learned step-by-step, through trial and error, over time. On average, strategic innovators needed five years to evolve their breakthrough business systems. Some of the biggest winners took longer: McDonald's, for example, took 14 years to develop the business system that created the fast-food industry.

But contemporary strategic innovators don't have the luxury of learning incrementally over such a long time. In today's hypercompetitive environment, how many innovators can count on complacent competitors, like those who gave Wal-Mart's Sam Walton and Nucor's F. Kenneth Iverson the time to develop industry-toppling business systems? How many "dots" will sustain their market value through five years of learning? "Launch and learn" is no longer good enough. Today, the principal management challenge is to accelerate strategic learning.

Companies can learn faster by employing three strategic learning disciplines: knowing where you are, sensing opportunities, and analyzing bets.

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We talk about "disciplines" instead of "process" precisely because disciplines are not a reproducible sequence of steps that guarantee success. The idea of discipline may seem counterintuitive in an economy running at Internet speed. But disciplines actually accelerate learning by channeling creativity, focusing experiments, forcing deliberate choices about where to spend time and money, and reducing time wasted because of miscommunication, repeated mistakes, and blind alleys.

Knowing where you are, the first discipline, starts by reminding yourself of the core "big idea" by asking: What is the central customer need that is being addressed? How will we serve that need dramatically better? Managers then must assess where they stand on the three critical elements of the integrated business system that defines a strategic innovation:

1. **The value proposition to customers:** Which customers have you been targeting? How strongly are they attracted to your value proposition? With what alternatives are those customers comparing you? What about other customers? How rapidly are you growing in each segment?

2. **The business model:** How much of an advantage do you enjoy over competitors? Are you close to the 40 percent average unit-cost advantage enjoyed by such successful past innovators as McDonald's, Midas, Nucor, Home Depot, and Southwest Airlines? To what extent will the initiatives under way close the gap? How rapidly have you been improving over time?

3. **The economic model:** Where are you making and losing money? To what extent will your economics improve as you scale up? How rapidly is your profitability improving?

While CEOs can rely on their own perspective and their personal learning to determine where they are, it's much more powerful to mobilize the thinking of the entire management team. By participating in periodic, informed discussions about the state of the business, the team stays focused on the big idea, shares a common understanding of the state of play, and identifies key issues to resolve. Successful innovators in the old economy typically met quarterly to discuss where they were; on Internet time, we recommend meeting at least monthly. The hierarchy-flattening Net, where everyone has a voice, can help facilitate this process, but be careful: Each team member's version of dead reckoning does not necessarily triangulate into an accurate GPS location.

Successful innovators must not only listen to, but also make sense of, opportunities in the world around them — the second strategic learning discipline. This requires a sensing network to scan and collect data, the filtering and clustering of the data into useful information, and action planning by the management team about the information's implications. When Charles Schwab & Company's customers complained about a pricing structure that gave some online traders bigger discounts than others, Schwab executives saw in the complaints an implied opportunity. They moved to a single pricing structure for all online customers, even those who wanted to use bricks-and-mortar services, and bet the business on an innovative business system that has all the earmarks of a strategic breakout.

A sensing network must address each element of the business system, sensing the market, the business model, and the economic model. Don't waste time with competitive intelligence. Companies leading their industries will create rules that others must follow. Too often, focusing on competitors dooms a would-be innovator to become a follower.

Market sensing is nothing more than systematically listening to customers (and, less often, to potential customers), generalizing from what they are saying, and taking appropriate action. In the old economy, market sensing was usually grounded in face-to-face contact. Senior managers at Harley-Davidson Inc., for example, spent time each month on a bike, on the road, with Harley enthusiasts. Information technology now enables more rapid collection of information on a larger scale, but even in the New Economy, direct contact with customers increases the likelihood that managers will hear the subtleties of what customers are saying. Intuit Inc., for instance, screens help-desk calls to target new functionality for its Quicken home-finance software.

Business-model sensing identifies opportunities to improve a company's processes and structures for delivering customer value. Wal-Mart's fabled Saturday morning meetings, where managers and employees representing stores in every region gather at headquarters, are a powerful example of business-model sensing. Managers review the details of performance, compare stores, identify concerns and opportunities, and offer solutions. Systematic postmortems can serve as the basis for business-model sensing in project businesses. Many companies today base their programs on the U.S. Army's "after-action reporting" system, in which troops in the field identify and record lessons learned after every operation, no matter how small. The lessons are transmitted to a central coordinator to update procedures or to use in real-time operations.

Business-model sensing combines two things: the internal data that helps tune and evolve the business model, and the external data that highlights major improvement opportunities. For example, by benchmarking, one e-drugstore discovered the need to reduce its 120 days of inventory to the 60 days of conventional retailers and the 30 days of wholesalers. Relationships with leading vendors can also help companies identify and capture major opportunities. For example, the British Petroleum Company partnered with Schlumberger Ltd. to gain access to experts and develop the horizontal drilling techniques needed to rapidly and cost-effectively exploit deep-water reserves.

Economic-model sensing means understanding profitability by business, customer, or market segment; by product line; and by geography. The business should understand not only the facts about profitability today, but also the estimated profitability from the business as it scales up. Our experience is that even the largest and most established dots haven't systematically evaluated their profitability. Since the stock market is now demanding profitability from the first wave of Internet IPOs, we anticipate economic-model sensing will receive much greater attention.

The third strategic learning discipline is to use analysis to help place the best possible bets. The key word is "help": Successful breakthrough innovators find a middle ground between the entrepreneurial, "just do it" philosophy and the "analysis paralysis" that afflicts so many large companies.

Analysis is particularly helpful in making better decisions in the following ways:

- **To set priorities and improve the economics.** Like the Pareto analysis of defects (the first step of total quality management), an ordered list of problems and opportunities focuses the team on the highest impact issues, not just the issues that are top-of-mind. During the race to change the world, a company has only enough time to launch initiatives that have significant impact. To capture

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the benefits, it's helpful to estimate the magnitude of the benefits, identify what else has to change to realize the benefits, and update day-to-day financial and operating objectives.

• **To eliminate unlikely solutions.** Although brainstorming about problems and opportunities yields a variety of alternative solutions, simple back-of-the-envelope analysis can demonstrate that many of the alternatives are unlikely to succeed, concentrating the team's attention on the few that can work. If any of the dots that bought television advertising on this year's Super Bowl had stopped to consider that the crowded field and commodity commercials could dilute its brand, it could have diverted millions of dollars to more effective marketing.

• **To uncover the underlying opportunity.** Just as a doctor identifies and treats diseases, not just symptoms, a team addressing a major challenge must use analysis to locate the underlying drivers. For example, why are e-tailers' distribution costs much higher than those of their conventional competitors? Is it a lack of scale (remedied by increased volume), a steep learning curve (remedied by time and experience), inefficient execution (remedied by systems and processes), or something else?

The three strategic learning disciplines alone won't ensure that you change the world — any more than meditating, fasting, and acting kindly will turn you into Gandhi. Like a professional musician, you need discipline to use the disciplines. And that demands both relentless effort to know, sense, and analyze, and the ability to place bets that pay off. CEOs need to learn enough to place good bets, and management teams have to develop superior execution. But they must also move quickly enough to change the world before competitors do.

Of course, it's not all discipline. Strategic innovation remains an art form. Like bebop in the jazz world, the best strategic innovations emerge out of rule-based improvisation. The disciplines — knowing, sensing, and analyzing — provide common information and engender shared insights and values that together enable a kind of innate coordination, ensuring that the improvisation is neither harshly dissonant, nor predictable like elevator music.

But it's not all improv, either. Even jazz bands need leaders — especially when they're just starting out. A strong leadership team remains a sine qua non for a company trying to change the world. The leaders are the conductors, reviewing innovations across the organization for consistency and arbitrating conflicting efforts. They are the coaches, challenging teams to create even larger improvements, faster. They are the entrepreneurs, deciding where to bet the company. They are the visionaries, updating the business vision and sharing sensing information so that teams across the company make consistent decisions.

Humans learn automatically. But we learn more quickly and effectively when we impose a discipline on ourselves — when there's some thread, frame, or rhythm to our lives. For organizational learning to be more than the sum of the learning of individuals, a company needs that rhythm — created by the dynamic interaction between top management and the performers across the organization. Everybody makes music, but there's direction and discipline with the art — which results in a world-changing innovation. +

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