SPOTLIGHT ON BUSINESS MODEL INNOVATION

The CEO's Role In Business Model Reinvention

A forward-looking CEO must do three things: Manage the present, selectively forget the past, and create the future. *by Vijay Govindarajan and Chris Trimble*

Spotlight

ARTWORK Damián Ortega,
Concrete Cube (black), 2003,
cast concrete with black pigment

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CONSIDER A FEW of the great innovation stories of the past decade: Google, Netflix, and Skype. Now ask yourself, why wasn't Google created by Microsoft? Netflix by Blockbuster? Skype by AT&T?

Why do established corporations struggle to find the next big thing before new competitors do? The problem is pervasive; the examples are countless. The simple explanation is that many companies become too focused on executing today's business model and forget that business models are perishable. Success today does not guarantee success tomorrow.

To assess your company's vulnerability, try this diagnostic: On separate index cards, write down all the important initiatives under way in your organization. Then create three boxes and label them "Box 1: Manage the Present," "Box 2: Selectively Forget the Past," and "Box 3: Create the Future."

Next, take a few minutes to imagine your industry in five, 10, or even 20 years—as far out as you can reasonably foresee. Consider all the forces of change your industry faces—technology, customer demographics, regulation, globalization, and so on. With those forces in mind, put your organization's initiatives in the appropriate boxes: those intended to improve today's business performance in box 1; those aimed at stopping something—underperforming products and services, obsolete policies and practices, outdated assumptions and mind-sets—in box 2; and those that prepare your organization for the long term in box 3.

For companies to endure, they must get the forces of preservation (box 1), destruction (box 2), and creation (box 3) in the right balance. Striking that balance is the CEO's most important task, but most companies overwhelmingly favor box 1. Forces of preservation reign supreme. Forces of destruction and creation are overshadowed, outmatched, and out of luck.

To be sure, the work of preservation—the day-to-day execution of the existing business model—is

vitally important. CEOs must get box 1 right or their tenures will be short. They must concentrate daily on performance excellence and continuous improvement, as companies such as Wal-Mart and Southwest Airlines have done for years. The best box 1 companies are sleek and efficient, like a well-designed automobile. They coordinate an astonishingly complex array of human actions like so many gears, pistons, and camshafts.

But CEOs are not *just* responsible for box 1. They must also get boxes 2 and 3 right. Sadly, most chief executives ignore destruction and creation until it is too late. They bow to a myriad of short-term pressures: intense demands for quarterly earnings, risk aversion, discomfort with uncertainty, resistance to change, linear extrapolation from past experience,

If organizational memory is not tamed, it gets in the way of creation. Before you can create, you must forget.

and unwillingness to cannibalize established businesses. As a result, many companies fail to transform themselves.

The failure may not be immediately apparent, but sooner or later most industries go through nonlinear shifts that threaten incumbents. For instance, breakthroughs in genetic engineering have revolutionized the pharmaceutical industry. New concerns about environmental quality have posed serious threats in energy-intensive sectors. Globalization has opened up India and China, where unfamiliar rivals are challenging established companies with ultra-low-price products.

While most companies neatly manage linear change, they are left befuddled by nonlinear change. Transformation efforts look meek at best, like futilely trying to turn a car into an airplane by bolting on two wings. Consider, for example, Sony's lagging positions in portable music players and electronic book readers, or Nokia's and Motorola's struggles to keep up with the rapid evolution of smartphones.

To win both today and tomorrow, CEOs must operate in all three boxes simultaneously. They must recognize that boxes 2 and 3 are not about what the business will be doing in 20 years; they are about the preparations it must make today. That's easier said than done, for it's not only a matter of balancing resources across the three boxes. The CEO must also know exactly what to destroy and what to create.

On the surface, box 2 is about pruning lines of business that are underperforming or no longer fit the company's strategy. Some companies do that consistently. For decades, for example, Corning has been eliminating mature businesses, such as cookware and light bulbs, to focus on high-growth opportunities. And when Japanese firms commoditized the market for dynamic random-access memory—a key component in PCs—Intel cofounder Andy Grove shifted the company into microprocessors. Such divestitures are traumatic but not conceptually mysterious. Pruning simply requires commitment from powerful executives.

It's harder to take a knife to a less-evident box 2 menace: organizational memory. As managers run the core business, they develop biases, assumptions, and entrenched mind-sets. These become further embedded in planning processes, performance evaluation systems, organizational structures, and human resources policies. Organizational memory is particularly powerful in companies that tend to promote from within and to have homogeneous cultures, strong socialization mechanisms, and long track records of success. Such deeply rooted memory may be great for preservation (box 1), but if it is not tamed sufficiently (box 2), it gets in the way of creation (box 3). That's why all box 3 initiatives must start in box 2. Bottom line: Before you can create, you must forget.

To understand how a company can manage all three boxes successfully, let's look at Infosys Technologies Limited of India.

Business Model Transformation At Infosys

On July 31, 2006, Infosys chairman N.R. Narayana Murthy stood before thousands of employees in Mysore, India, and pressed an orange button. Half a world away, trading commenced on the Nasdaq. His remotely ringing the opening bell, part of Infosys's 25-year anniversary celebration, symbolized how the global economy was being transformed.

For people trying to understand the offshoring phenomenon, Infosys was exhibit A. Indeed, it had inspired Thomas Friedman to write *The World Is*

Flat. The company had demonstrated that its core service, custom software development for corporations, did not have to happen at the client site. Most of the work could be done thousands of miles away in talent-rich but low-cost India. Infosys dubbed its approach the "global delivery model."

Infosys's rapid rise is legendary in India. In the 1980s the company was just a small group of programmers who had traveled from South Asia to the United States to offer their services. But in the early 1990s India's rapid deregulation and the rise of the internet opened the door for the global delivery model. Today Infosys is a $5 billion IT services firm with more than 100,000 employees and a market cap of nearly $40 billion.

During the late 1990s, with revenues growing rapidly, Infosys could easily have focused on preservation. But Murthy was intent on challenging the biggest companies in the IT services industry, including IBM and Accenture. He and then-CEO Nandan Nilekani had a hypothesis about how the industry would evolve. The company's most demanding clients were frustrated by having to work simultaneously with multiple services firms, each lacking full accountability. Eventually, Murthy and Nilekani believed, clients would hire just one firm that could deliver end-to-end IT services. The hypothetical company would provide a management consulting team that would redesign operations and write specifications for new IT systems. That same company would then develop, test, install, and maintain the new hardware and software—and might even accept responsibility for executing routine client operations such as transaction processing.

This implied a dramatic industry transformation. If multiple rivals moved toward end-to-end services, former partners would become rivals. The industry would have room for only a handful of very large players. Infosys intended to be one of them— and to use its mastery of the global delivery model to outperform rivals. To accomplish that, the company needed to create several new services even as it continued executing its existing, fast-growing business. By pushing into boxes 2 and 3, Infosys grew 25-fold, from $200 million to $5 billion in the past decade. Revenues from services other than its original offering—custom software development—grew from a small base in the 1990s, to 40% by 2003, and to nearly 60% by 2010.

Infosys succeeded in avoiding the box 2 hazard of organizational memory. By building a parallel

Idea in Brief

Forward-looking CEOs must harness the power of the past, the present, and the future in three critical disciplines.

	BOX 1 MANAGE THE PRESENT	BOX 2 SELECTIVELY FORGET THE PAST	BOX 3 CREATE THE FUTURE
	YOU ARE ACCUSTOMED TO	YOU MUST RECOGNIZE THAT	SO THAT YOU CAN
STRATEGY MAKING	Data-driven analysis	Rich data about the future are not available. The best you can do is to consider long-term trends and potential nonlinear shifts.	Create a separate, parallel strategy–making process for box 3. Involve nontraditional voices.
ACCOUNTABILITY	Strict accountability for results	The alternative to accountability for results is not anarchy. It is a different kind of accountability.	Hold leaders of box 3 projects accountable for running disciplined experiments.
ORGANIZATIONAL DESIGN	Perfect alignment	An organization that is perfectly aligned can operate only in box 1.	Create zero-based, custom-built subunits for box 3 projects.

"box 2/3" world with different people and distinct processes, it was able to create the future while sustaining excellence in box 1. In the process, Infosys paid especially close attention to three critical disciplines: strategy making, accountability, and organizational design.

Strategy Making

The central tenets of strategy making are well known. It should be an analytical, data-driven process that rigorously identifies customer needs, differentiates the company from rivals, and maximizes profits. But despite its many merits, this process also systematically squeezes out box 3 thinking. Leaders who insist on rigorously analyzed data tend to resist making change on the basis of limited evidence or weak signals. The result: a short-term mind-set; a strict focus on existing customers, not emerging ones; an obsession with today's rivals, not potential entrants; an emphasis on leveraging existing competencies rather than building new ones; and a tacit assumption that lines of demarcation between markets are fixed.

Box 3 strategy making is very different. Endeavors of creation must begin with a destructive (box 2) action—abandoning traditional strategy practices in favor of new ones. Box 3 strategy is not about linear extrapolation from the past; it's about trying to anticipate nonlinear shifts. That's a tough—but necessary—concept to grasp if you're a senior leader who rose to the top of an organization by excelling in box 1.

Infosys smartly brought nontraditional voices into the box 3 strategy process. For example, it di-

Thirty percent of participants in any strategy discussion should be younger than age 30, because they are not wedded to the past.

rectly engaged a subset of its clients, in group and one-on-one meetings, to challenge the company's long-range assumptions and to make provocative suggestions for future growth. As a direct result of this interaction, Infosys chose to redouble its investment in an experimental business unit that offered packaged software for Indian bank branches—and to adapt it for worldwide use.

Infosys relied even more heavily on input from young employees. It assembled a Voices of Youth panel of high performers who participated annually in eight senior management meetings. In putting together this team, Murthy cited what he calls the "30/30 rule": 30% of participants in any strategy discussion should be younger than age 30, because they are creative and not wedded to the past. In addition, Infosys created several inventive and colorfully named mechanisms—strategy graffiti walls, knowledge cafés, jam sessions, and speed-geeking—to continually attract thousands of young employees to the process. Jam sessions, for instance, are fast-paced roundtable meetings in which each participant has just one minute to give an impromptu response to questions such as "How can Infosys win in emerging markets?" The company even developed software that automated the process of sifting through huge volumes of responses, to identify common themes and unique ideas. Murthy credits youth involvement for sparking more than 10 R&D projects at Infosys, on topics ranging from health care to sustainability to education.

Accountability

To succeed at preservation (box 1), successful companies develop mechanisms that hold individuals accountable for results. Those who deliver on time, on budget, and on spec should earn raises and promotions; those who don't are probably better suited for other careers. Companies with demanding performance cultures, such as GE, tend to do very well in box 1. But, again, initiatives to create the future must begin by forgetting the past. Strict accountability for results must be left behind to allow for conjectures about potential nonlinear shifts. Those conjectures are best tested by running disciplined experiments.

For example, in 1999 IBM launched an effort to multiply computing speeds by a factor of 500. IBM's conjecture was that the next generation of supercomputers would not run on one super-fast chip but on huge networks of ordinary chips. IBM's machine, dubbed BlueGene, would, as imagined, run massive simulations for scientists who study climate change, particle physics, cellular processes, and more. The big unknown, however, was the relationship between the number of chips and the volume of communications among them. It was possible that the network that tied the chips together would clog up like Los Angeles freeways at rush hour. To pinpoint when that would happen, IBM developed a systematic test plan. It first built a prototype with just two chips, then four, then eight. It ran disciplined experiments with each prototype. If BlueGene were to fail, IBM would learn at the lowest cost possible. By 2007 the company had succeeded in building a 212,992-chip BlueGene, the fastest supercomputer in the world.

When leaders of box 3 initiatives learn fast (and at minimal cost), they make better decisions. They either find success or exit quickly and cheaply. But disciplined experimentation is not easy. As we describe in our book *The Other Side of Innovation,* best practices for planning experiments look almost nothing like best practices for ongoing operations. Therefore, it's critical to use distinct methods to evaluate the results of box 3 initiatives and the performance of their leaders.

Consider the negative consequences of subjecting a leader to a traditional, results-focused performance assessment while she operates in box 3. Uncertainties are high, and assumptions often prove wrong, yielding disappointing results and leaders who get defensive about them. Open discussion disappears, learning ceases, and bad decision making tends to ensue. Instead, leaders should be held accountable for learning quickly from disciplined experiments that they conduct in box 3. Administered properly, this form of accountability is anything but forgiving. It requires intense reasoning and ruthless analysis of assumptions.

Infosys has developed a very strong culture of accountability for results. In fact, it created an acronym

for its expectations of business unit leaders' actions—namely, that they be predictable, sustainable, profitable, and de-risked: PSPD. Still, Infosys maintains different kinds of expectations for new services—standards that allow for greater uncertainty but are no less forgiving.

In 2002 Infosys launched a fundamentally new (box 3) business for the company: Infosys Consulting. Instead of producing custom software, the new consulting unit would advise clients on redesigning their operations; rather than calling on heads of IT, it would serve general managers. The core business of software programming was almost a science, whereas Infosys Consulting was more of an art.

Murthy and Nilekani knew it was unrealistic to expect its new service to immediately deliver predictable, sustainable, profitable, and de-risked results. So they exempted it from traditional performance review forums and had it report to an internal board of directors. That board looked for clear signs that Infosys Consulting was headed toward success. For example, it expected an upward trend in per-employee revenues as time dedicated to selling services declined and time dedicated to delivering services rose. The board also altered expectations about forecast accuracy for Infosys Consulting: not 99%, as required of established units, but 50%, at least at first. As the team learned, its forecasts naturally improved.

Organizational Design

To achieve day-to-day excellence (box 1), companies must do more than hire and train outstanding individuals. They must optimize the way individuals collaborate—through job specifications, organizational designs, and work processes. When all individuals are perfectly aligned, companies become works of high art. However, a box 1 work of art is also a highly specialized machine. As such, it's unrealistic to expect to be able to just "squeeze in" a box 3 project. Special teams are essential. The first step in building them is a box 2 action—dropping standard organizational practices. Box 3 projects require zero-based, custom-built subunits.

Forming these subunits is an act of creation even more significant than generating a breakthrough box 3 idea. As we explained in "Stop the Innovation Wars" (HBR July–August 2010), it's much like building a new company from scratch. Outsiders play a critical role by bringing in new skills and catalyzing change. They are powerful box 2 agents because they naturally challenge assumptions.

The High Jump "Industry"

The history of the Olympic high jump event illustrates the importance of adapting to nonlinear change. It has evolved through four distinct "business models."

Early on, the "scissors" style dominated the sport. It was much like hurdling. All high jumpers used the scissors approach, so winning meant being the best at it. The high jumpers were operating in box 1 (preservation). Had they been businesspeople, they would have been competing on cost, market share, and margins.

High jumpers remained in box 1 at their peril, however. Even the best athletes could improve upon the established technique only incrementally. The approach had severe limitations because the jumper's center of gravity had to rise much higher than the bar.
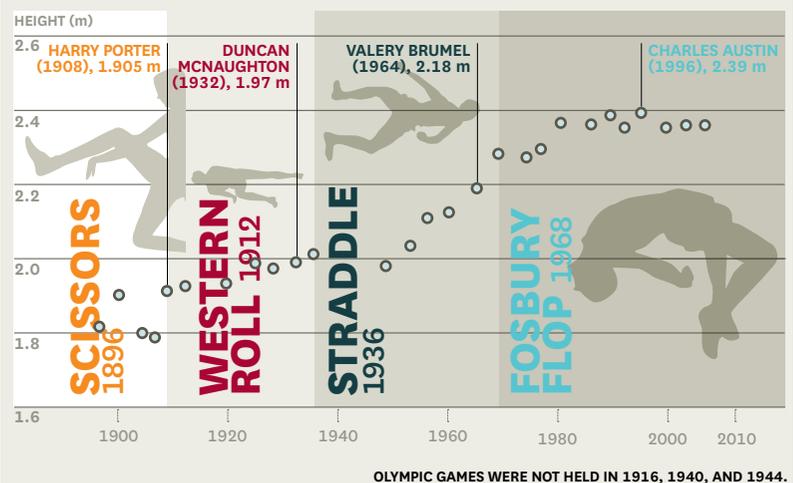
More-innovative jumpers broke the high jump down into two fundamentals: raising one's center of gravity (jumping higher) and raising it no more than necessary to clear the bar (avoiding "wasted lift"). It turned out that although finding ways to jump higher was quite difficult, athletes could find plenty of opportunities to avoid wasted lift. High jumpers created three new styles.

First, they invented the "western roll," in which jumpers launched and landed on the same foot and kept their backs to the bar. Then they discovered the "straddle," in which they launched and landed on opposite feet and faced the bar. Finally, in the 1968 Olympics, Dick Fosbury created the surprising Fosbury Flop, which required twisting 180 degrees and landing on one's head. To succeed, Fosbury had to unlearn everything his coaches had taught him about speed, angle of approach, and technique.

Each new jumping style transformed the high jump "industry." The innovators had to somehow forget best practices (box 2) and create next practices (box 3). Many other jumpers, trapped by the forces of preservation (box 1), failed to remain competitive.

OLYMPIC GOLD MEDAL WINNERS IN HIGH JUMP

HEIGHT (m)

2.6 — HARRY PORTER (1908), 1.905 m — DUNCAN MCNAUGHTON (1932), 1.97 m — VALERY BRUMEL (1964), 2.18 m — CHARLES AUSTIN (1996), 2.39 m

SCISSORS 1896 — WESTERN ROLL 1912 — STRADDLE 1936 — FOSBURY FLOP 1968

1900   1920   1940   1960   1980   2000   2010

OLYMPIC GAMES WERE NOT HELD IN 1916, 1940, AND 1944.

The Transformation Process in Hindu Mythology

Hinduism provides a unique window into the three perspectives we focus on in this article: managing the present, selectively forgetting the past, and creating the future. The religion recognizes many gods but only three main deities: Vishnu, the god of preservation (box 1); Shiva, the god of destruction (box 2); and Brahma, the god of creation (box 3).

The Hindu mythmakers even paired each of the three gods with symbolically relevant wives. Vishnu was married to Lakshmi, who bestowed wealth—just as box 1 produces current income. Shiva's partner was Parvathi, who symbolized power, a vital box 2 necessity when selectively destroying the past. Brahma was betrothed to Saraswathi, who symbolized creativity, ideas, and knowledge—critical inputs in formulating box 3 strategies.

According to Hindu philosophy, the balanced interactions among the three gods create a continuous preservation– destruction–creation cycle that helps sustain all forms of life in a circle without a beginning or an end. Achieving that continuous cycle is a goal worthy of any farsighted organization.

Infosys Consulting was a box 3 project, so Murthy and Nilekani created a new, distinct subunit. They hired an outsider with 15 years of consulting experience to lead the effort, and they lured several more senior partners from other consulting firms. Then, rather than creating a unit based on Infosys's existing organizational structure, they studied other firms' processes and organizational designs and altered them for the global delivery model. Today Infosys Consulting generates more than $100 million in revenues annually.

That's a much more favorable outcome than what happened when one of the Big Three U.S. automakers first entered India in the early 1990s. The tremendous economic divide between India and the United States demanded a box 3 approach to making an automobile. Rather than creating a zero-based subunit in India to spearhead the effort, however, the company engineered the car in Detroit and, to cut costs, decided to put power windows only in the front doors. That decision initially seemed reasonable, but at that time any Indian who could afford a car could also afford a chauffeur. The owner, sitting in the back, had to use hand-crank windows. It's one reason why this U.S. automaker is still largely irrelevant in one of the world's fastest-growing automotive markets.

Prioritizing for the Long Term

As we have discussed, the secret to winning over the long run lies in knowing what to forget and what to create. Still, every box 3 initiative requires a tough first step: making the commitment to launch. Shifting resources from the present to the future may be the most difficult challenge for CEOs, given the enormous short-term pressures they face routinely.

In its early days, Infosys had a *Fortune* 10 client that accounted for 25% of its revenues and was demanding substantial price concessions. Murthy walked away and accepted a devastating blow to short-term performance. His simple rationale: Infosys would never agree to a price so low that it would have to sacrifice service quality or cut investments in people, training, R&D, and technology. Doing so, he reasoned, would damage the brand and undermine the company's future.

The most intense short-term pressures come not from clients, however, but from Wall Street, which demands reliable earnings growth and richly rewards CEOs who deliver it. This powerful box 1 incentive cripples the forces of destruction and creation because box 3 projects inevitably have a worse-before-better impact on the bottom line. Further, CEOs' tenures are short relative to the rhythm of transformation efforts. By the time box 3 projects pay off, many will have retired, so they are tempted to focus on the immediate and leave on a high note.

Murthy, by contrast, views Infosys as a lifelong endeavor. His approach to investors has been steadfast: Relentlessly promote long-term potential; immediately share short-term disappointment. Murthy volunteered the bad news of the loss of the major client to investors within 48 hours. Then he returned to finding the right balance among the forces of preservation, destruction, and creation. This balance is the secret to Infosys's mastery of both the present and the future, and it must be the foundation for any business institution that aspires to endure for generations. �