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The Challenge of Disruptive Competition

The fallacy of marginal cost thinking.

by Michael T. Newsome

Businesses in the Northwest and across the country have traveled a relatively rocky road over the past five years. Many have failed or been absorbed by competitors. Survivors have slimmed their cost structures and focused on core businesses and customers, re-establishing a successful business model for the new environment. A large number of managers have learned that cutting marginal customers, employees, and products has contributed to a winning strategy. We sense in many industries a degree of renewed stability.

As we enter a new year, it seems appropriate to remind business owners and managers that today's winning strategy provides little assurance of continued success as conditions change. Innovation eventually impacts all businesses and industries. The failure to detect and respond to innovative challenges serves as a primary reason why long-standing successful companies end up faltering and fading away. It is not always the emergence of a superior mousetrap that catches everyone off guard. Often it starts with lesser, non-competitive firms nibbling at the margin, taking unwanted scraps, serving those marginal customers with a lower cost structure and inferior products, eventually growing into a true competitor for core customers and products.

DISRUPTIVE COMPETITION

Clayton Christensen, at the Harvard Business School, introduced a concept in the mid-1990's that he labeled disruptive innovation. He defined this as a product or service directed toward a new group of customers. More often than not, the new product is neither technologically complex nor cutting edge. It is generally the introduction of a product configured in a simpler, lower-cost package than prior alternatives. According to Professor Christensen, disruptive competition generally manifests itself in one of two ways:

1. Low-end disruption encroaches on the most price sensitive segment of an existing market, which is over-served by established providers in terms of quality and/or features. The introduction of a simpler, less costly approach attracts low-end customers. Over

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time, these new competitors steadily refine this cheap, yet functional, alternative to increasingly garner greater defections from traditional suppliers.

A classic example of low-end disruption began in the steel industry in the late 1970's when mini mills (e.g., Nucor, CMC) used low-cost scrap steel to drive vertically integrated producers (e.g., US Steel, Bethlehem) out of the low-margin, niche rebar market. In the ensuing years, these mini mills honed the quality of their product and progressively captured the much larger, higher margin markets for structural and sheet steel. By 1990, virtually the entire steel industry had been rationalized and reconfigured.

2. New-market disruption targets customers in fringe markets that are deemed too small to attract the interest of the existing incumbent market leaders. Targeting these unserved customers with new products/services triggers the creation of a new market niche. Incremental product improvements over time lead to customer defections from traditional market leaders. By the time the market incumbent begins to notice defections to the new market, it's simply too late. Market disruption has set in.

No stronger example exists of new market disruptive innovation than the now ubiquitous cell phone. A new industry sprung up and the giants of wired telephony have gone by the wayside. Moreover, cell phones continue to disrupt. Here is a modest list of products that cell phones have or are supplanting: watches, cameras, wallets, calendars, credit cards, event tickets, maps, flashlights, notepads, photo albums, thermometers, music players, TVs . . . the list goes on.

NEW MARKET INNOVATION:
Wireless cell phones
DISRUPTED:
The wired telephone industry

Everywhere one looks in the economy there is evidence of "disruptive innovation" undermining the market share, and hence, the profitability and value of well-managed companies with longstanding track records of stability and earnings.

In reality, this is merely the process of creative destruction at work, as described by the economist Joseph Schumpeter in 1942, with a bit of a twist. The challenge of disruptive competition to existing business models is not easily thwarted. Few companies detect the threat of disruptive competition. Often, it is only identified in hindsight. It is Professor Christensen's view that, "all innovative ideas start out as half-baked propositions." Even when it is identified early, managers of existing market leaders often view defection of low-end customers as beneficial. It reinforces the conventional business wisdom—tighten

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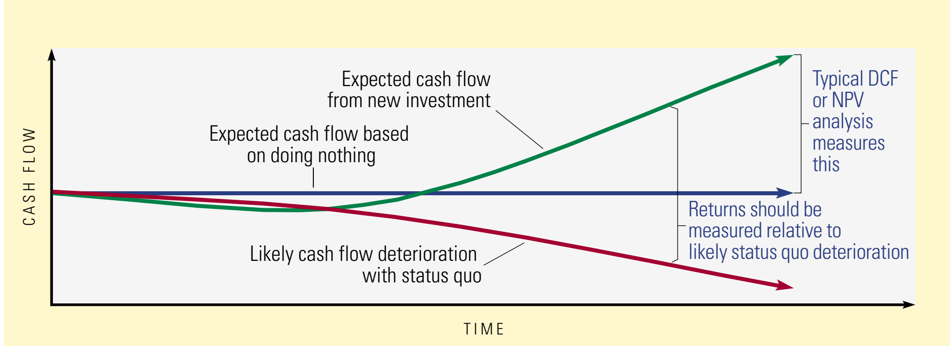
the focus on its best (i.e. most profitable) customers. Managers seldom imagine the potential of a completely new market. Experience has shown that incumbent businesses rarely overcome disruptive entrants.

THE CONSTRAINTS OF MARGINAL THINKING

Upon detection of disruptive threat, the response is invariably influenced by:

1. An unwillingness to impair existing fixed and sunk costs;
2. An inability to imagine that the future dynamics will differ from the present; and
3. An overweighting of the risk of change relative to the risk of failing to change.

The conventional bias puts forth the view that the business has far too much invested in infrastructure, systems and talent to move away from a successful business model to address a marginal competitor. Management often fails to see that the status quo leads to a deteriorating slope of performance as competitiveness erodes, rather than the stable cash flow trajectory they imagine. Future marginal costs associated with new processes or products might be materially less than today's marginal costs. Upstart disruptive competitors are not encumbered by this paradox. The full cost and marginal costs of competing are one and the same to them.



Henry Ford summed up this problem very simply: "If you need a machine and don't buy it, then you will ultimately find that you have paid for it and don't have it."

RESPONDING EFFECTIVELY

Firms that effectively respond to disruptive challenges pursue a two-prong approach to addressing the genuine needs of the customer:

1. They reposition their core business to focus on their strongest customer relationships and competitive advantages in a disrupted market by revisiting what the customers value and willingly pay for.
2. They concurrently develop a separate business, with its own profit formula, that adopts and builds on the disruptive innovations to compete head-to-head with the new entrants.

Maintaining a successful business over the long haul is difficult. One must continually look beyond the horizon to plot a course while keeping a watchful eye in the rearview mirror, because competitors, both new and old, work constantly to pass you by. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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