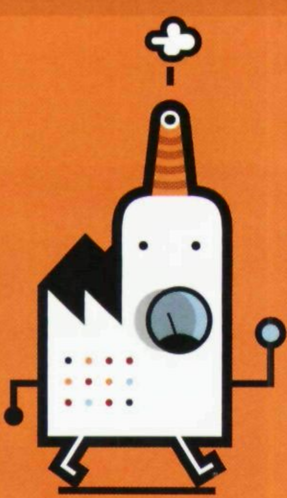
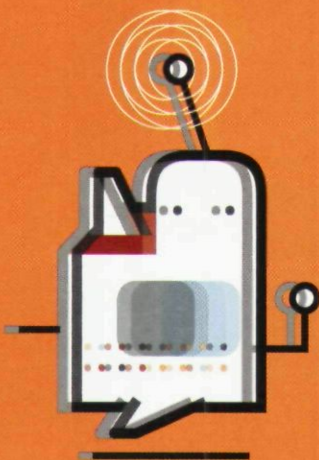
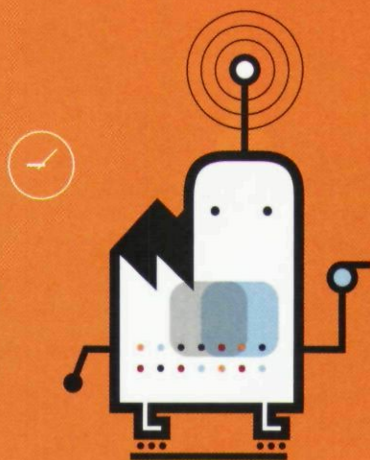
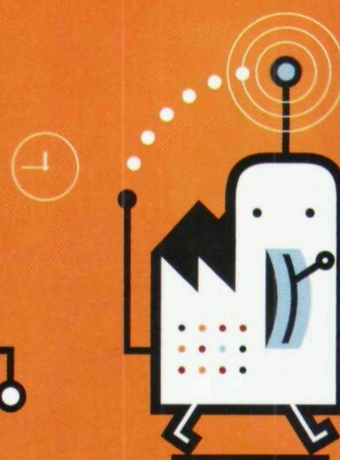
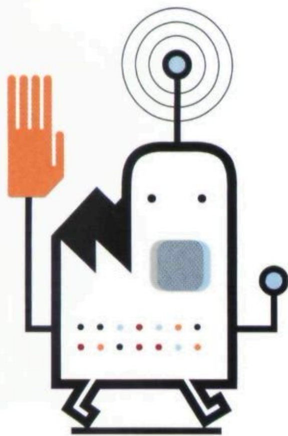
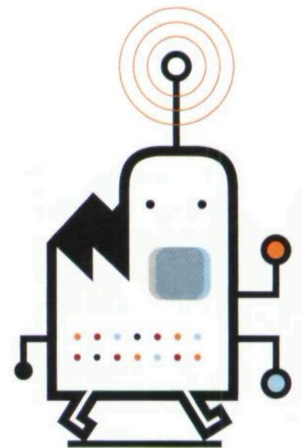






Industries follow distinctive change trajectories. Investments in innovation are more likely to pay off if you take those pathways into account.



HOW INDUSTRIES CHANGE

by Anita M. McGahan

YOU CAN'T MAKE INTELLIGENT INVESTMENTS within your organization unless you understand how your whole industry is changing. If the industry is in the midst of radical change, you'll eventually have to dismantle old businesses. If the industry is experiencing incremental change, you'll probably need to reinvest in your core. The need to understand change in your industry may seem obvious, but such knowledge is not always easy to come by. Companies misread clues and arrive at false conclusions all the time. Sotheby's, for example, invested in online auctions (its own Web site as well as a venture with Amazon) as if the Internet were just another channel; in truth, the new technology represented a fundamental shock to the industry's structure.

To truly understand where your industry is headed, you have to shut out the noise from the popular business press and the pressure of immediate competitive threats to take a longer-term look at the context in which you do business. That is what some of my colleagues and I did. The research described in this article is based on a high-level look at a variety of businesses from a broad cross section of U.S. industries. The research, which began in the early 1990s and continues today, originally focused on how industry structure affects business profitability and investor returns. This statistical analysis yielded several hypotheses about how industries evolve, which were then tested and refined in a series of case studies on industry structure, industry change, and competitive advantage.

LEO ESPINOSA

The conclusion, which I'll oversimplify here for the sake of clarity, is that industries evolve along four distinct trajectories – radical, progressive, creative, and intermediating.[1] Moreover, a firm's strategy – its plan for achieving a return on invested capital – cannot succeed unless it is aligned with the industry's change trajectory. The four trajectories set boundaries on what will generate profits in a business. Many companies have incurred losses because they tried to innovate outside of those boundaries. One of the most famous examples is Xerox, which is legendary for its innovations and for its struggle to harvest profits from them. By the mid 1980s, the copier manufacturing industry had matured around a business model that emphasized creative "hit products." Meanwhile, the personal computing industry was in its infancy, and even though Xerox PARC had pioneered PC inventions such as the graphical user interface and the mouse, the company was unable to make inroads in this burgeoning industry that required an entirely new set of business activities.

No innovation strategy works for every company in every industry. But if you understand the nature of change in your industry, you can determine which strategies are likely to succeed and which will backfire.

Four Trajectories of Change

Before we look at the four trajectories of industry evolution in depth, it is worthwhile to recognize that they are defined by two types of threats of obsolescence. The first is a threat to the industry's core activities – the activities that have historically generated profits for the industry. These are threatened when they become less relevant to suppliers and customers because of some new, outside alternative. In the auto industry, for example, many dealerships are finding that their traditional sales activities are less valued by consumers, who are going online for data on the characteristics, performance, and prices of the cars they want. The second is a threat to the industry's core assets – the resources, knowledge, and brand capital that have historically made the organization unique. These are threatened if they fail to generate value as they once did. In the pharmaceutical industry, for instance, blockbuster drugs are constantly under threat as patents expire and new drugs are developed.

The exhibit "Trajectories of Industry Change" maps the relationships between these two threats and the following four change trajectories. *Radical* change occurs when an industry's core assets and core activities are both threatened with obsolescence. This trajectory is closest to the concept of disruptive change that Harvard's Clayton M. Christensen discusses. Under this scenario, the knowledge and brand capital built up in the industry erode, and so do customer and supplier relationships. During the 1980s and 1990s, an estimated 19% of U.S. industries went through some stage of radical change. A good example is the travel business. Agencies' core activities and core assets came under fire as the airlines implemented systems to enhance direct price competition (such as SABRE and other reservations systems) and as the agencies' clients turned to Web-enabled systems (such as Expedia, Orbitz, and Travelocity) that offered new value (online monitoring of available flights and fares, for instance).

Industries evolve along four distinct trajectories – radical, progressive, creative, and intermediating – that set boundaries on what will generate profits in a business.

When neither core assets nor core activities are threatened, the industry's change trajectory is *progressive.* Over the past 20 years, this has been by far the most common trajectory; about 43% of U.S. industries were changing progressively, including long-haul trucking and commercial airlines. In those industries, the basic assets, activities, and underlying technologies remained stable. Innovators like Yellow Roadway, Southwest, and JetBlue succeeded not because the incumbents' strengths became obsolete but because the upstart firms had smart insights about how to optimize efficiency.

The other two change trajectories – *creative* and *intermediating* – have been neglected in the management literature, possibly because of their nuances. Creative change occurs when core assets are under threat but core activities are stable. This means that companies must continually find ways to restore their assets while protecting ongoing customer and supplier relationships; think of movie studios churning out new films or oil companies mining for new wells. About 6% of all U.S. industries are on a creative change trajectory.

Intermediating change occurs when core activities are threatened with obsolescence – customer and supplier re-

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lationships are stretched and fragile – while core assets retain their capacity to create value. Sotheby's, for instance, is as good as it ever was at assessing fine works of art, but, because of the technology that made eBay possible, the auction house's matchmaking activity no longer creates as much value. The challenge under intermediating change is to find ways to preserve knowledge, brand capital, and other valuable assets while fundamentally changing relationships with customers and with suppliers. During the 1980s and 1990s, approximately 32% of U.S. industries went through some form of intermediating change.

Radical Change

Radical transformation occurs when both core activities and core assets are threatened with obsolescence. The relevance of an industry's established capabilities and resources is diminished by some outside alternative; relationships with buyers and suppliers come under attack; and companies are eventually thrown into crisis. Radical industry evolution is relatively unusual. It normally occurs following the mass introduction of some new technology. It can also happen when there are regulatory changes (as in the long-haul, trunk-route airline industry of the 1970s, for example) or simply because of changes in taste (U.S. consumers' retreat from cigarettes over the past 20 years, for instance).

An industry on a radical change trajectory is entirely transformed – but not overnight. It usually takes decades for change to become clear and play out. The end result is a completely reconfigured – usually diminished – industry. The overnight letter-delivery business is currently in the early phases of a radical transformation that began about ten years ago. As Internet usage has become more prevalent, e-mail (especially securely encrypted e-mail) has loomed as a threat to this industry. Yet the volume of overnight letters is increasing; business is still thriving, because the threat is still in its infancy.

That is part of the good news associated with radical transformation: Industries that are on a radical change trajectory often remain profitable for a long time, especially if the companies in these industries scale back their commitments accordingly. Businesses also have time to develop strategic options that can be exercised in the future if they recognize the trajectory they are on early enough. For example, Federal Express's acquisition of Kinko's will help FedEx create deeper relationships with small and midsize businesses that need document storage, management, and dissemination services.

The only reasonable approach to radical change is to focus on the endgame and its implications for your company's current strategy. Exiting isn't the sole option; sometimes a few survivors can sustain profitable positions after others leave the industry. The computer mainframe business, for example, is still quite large despite the threat from PC and workstation manufacturers.

To consider the best strategy when your industry is on a radical change trajectory, look at your productivity figures, the pace and timing of the transition in the industry, and buyers' switching costs. Early-moving companies might employ a staggered strategy – pursuing incremental improvements to established businesses' activities and conducting selective experiments in developing new assets. That is how encyclopedia companies responded to the radical threat that online search engines posed: They experimented with new electronic products and services while creating new distribution channels, marketing their existing products aggressively, and updating their inventory management systems.

Historically, many organizations confronted with radical change in their industries have abandoned their established positions and moved into emerging lines of business – incurring enormous risk in the process. Several typewriter makers, for instance, attempted to enter the PC manufacturing business only to cut short their efforts as the demands of the emerging industry became clearer. (IBM succeeded with this strategy, but its success in the PC industry was closely related to its experience in other areas of computing.) The alternative – reinvesting in the established industry – is also risky because it commits the firm to an approach that may become unprofitable. Companies dealing with radical transformation must accept the inevitability of the change and chart a course that maximizes returns without accelerating commitment to the troubled business – much easier said than done.

Intermediating Change

Intermediating change is more common than radical industry evolution. It typically occurs when buyers and suppliers have new options because they have gained unprecedented access to information. The core activities of industries on an intermediating change trajectory are threatened. But the core assets of these industries – knowledge, brand capital, patents, or even specialized factory equipment – retain most of their value if they are used in new ways. In effect, industries are on an intermediating change trajectory when their business activities for dealing in both downstream and upstream markets are simultaneously threatened. Intermediating change is occurring in auto dealerships, for example, for a number of reasons. First, traditional auto sales activities are becoming less relevant because of the Internet and because vehicles now last so long that consumers buy cars less frequently. Second, car manufacturers are seeking closer relationships with drivers and, as a result, are starting to share the management of customer relations with their dealers; in some cases, they're trying to take over customer relations completely. Finally, individual dealers are

losing control of inventory management as IT and sophisticated financing create economies of scope that can be exploited only by larger, integrated companies.

Managing a company in an industry that is experiencing intermediating change is extraordinarily difficult. Of all the change trajectories described in this article, this one is perhaps the most challenging because companies must simultaneously preserve their valuable assets and restructure their key relationships.

Executives tend to underestimate the threat to their core activities by assuming that longtime customers are still satisfied and that old supplier relationships are still relevant. In reality, these relationships have probably become fragile. The value of core assets often escalates, which compounds managers' confusion. For example, auction houses initially had a flurry of heightened interest in their accumulated appraisal experience because eBay had created so much excitement about auctioning.

During periods of intermediating change, pressure in the industry tends to build until it hits a breaking point, and then relationships break down dramatically only to be temporarily reconstituted until the cycle is repeated. Consider large brokerage firms. They had long confronted criticism about conflicts of interest in their analyst organizations. But the straws that broke the camel's back were the recent market downturn and accounting scandals – both of which were tied to fundamental changes in the information available to investors and companies seeking investment capital. The core assets in investment brokerage – including the systems for evaluating securities and for processing trades – retained their value, yet old relationships no longer offered the same opportunities to generate profits.

Companies facing intermediating change must find unconventional ways to extract value from their core resources. They may diversify by entering a new business or even a new industry. Or they may sell off assets or services to former competitors. In the music industry, for instance, recording companies are beginning to sell their services à la carte to aspiring musicians rather than make huge investments in the artists up front and incur all the costs of artist development (radio promotions, choreography, and image management, among other expenses). The customer and the activities have changed, but the core resource – the recording companies' ability to develop new artists – retains its value. In another example, some traditional auctioneers, threatened by eBay, have capitalized on their appraisal expertise online; for a fee, they will certify the value of the wares being exchanged on the Internet. By reconfiguring old assets in new ways, these companies are dealing effectively with intermediation.

Initial returns under this change trajectory may be relatively high and then drop dramatically only to recover temporarily. The recording companies' profits, for example, have been volatile as the companies adapt to intermediation with varying levels of success. A plateau in per-

Trajectories of Industry Change

When determining which type of change your industry is going through – and, no doubt, it is going through some type of transformation – you need to consider whether there are threats to your industry's **core activities** (the recurring actions your company performs that attract and retain suppliers and buyers) and to your industry's **core assets** (the durable resources, including intangibles, that make your company more efficient at performing core activities).

Core assets \ Core activities	Threatened	Not Threatened
Threatened	**Radical Change** *Everything is up in the air.* Examples: makers of landline telephone handsets, overnight letter-delivery carriers, and travel agencies	**Creative Change** *The industry is constantly redeveloping assets and resources.* Examples: the motion picture industry, sports team ownership, and investment banking
Not Threatened	**Intermediating Change** *Relationships are fragile.* Examples: automobile dealerships, investment brokerages, and auction houses	**Progressive Change** *Companies implement incremental testing and adapt to feedback.* Examples: online auctions, commercial airlines, and long-haul trucking

formance can create the illusion that reinvestment in the business as usual is a good idea. But organizations that recognize the trajectory their industry is on can turn relatively calm periods into opportunities for strategic transformation.

Creative Change

In industries on a creative change trajectory, relationships with customers and suppliers are generally stable, but assets turn over constantly. The film production industry is a good example. Larger production companies enjoy ongoing relationships with actors, agents, theater owners, and cable television executives. Within this network, they produce and distribute new films all the time. This combination of unstable assets (new films) and stable relationships (with buyers and suppliers) makes it possible to deliver superior performance over the long term. Indeed, the top companies in creative change industries usually retain their standing for long periods.

Other industries evolving on creative trajectories include pharmaceuticals, oil and gas exploration, and prepackaged software. In pharmaceuticals, companies research, develop, and test new drugs and then use their administrative and marketing skills to commercialize them. In oil and gas exploration, companies manage their portfolios of exploration ventures and maintain relationships with refineries and distributors. In the prepackaged software industry, developers create and test multiple applications in the hopes that one or more will become a killer app. By applying well-honed user-testing and marketing skills, the industry leaders perpetuate their success.

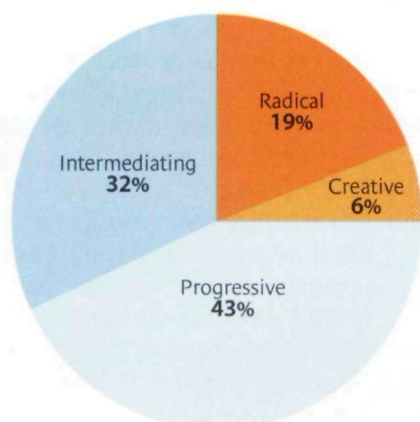
The creative change trajectory, like the intermediating trajectory, has not been studied extensively. It is easy to mistake it for radical change, despite the stability of relationships within the network. When this mistake is made, companies can overreact and neglect important relationships that are critical to their profitability. For example, some pharmaceutical companies became so focused on emerging methods of drug discovery that they invested capital exclusively in new research relationships and did not develop appropriate sales forces in new markets.

Innovation under creative change occurs in fits and starts. Although there are several long-standing formulas for making hit movies, for example, occasionally a new genre or technical approach to filmmaking emerges. Similarly, companies in the pharmaceutical industry have been experimenting with new methods of drug discovery over the last 15 years. Despite these changes, the companies that lead these industries are not new entrants. They have retained their strength by capitalizing on their networks of relationships.

There are many ways for companies in an industry on a creative change trajectory to generate strong returns on invested capital. For instance, the leading companies in these industries tend to spread the risk of new-project development over a portfolio of initiatives. As a result, their returns are less volatile than those of smaller competitors. Other tactics include outsourcing project management and development tasks.

A Fair Share?

The four change trajectories are not at all evenly distributed among industries. Surprisingly, given the time and attention much of the management literature devotes to it, radical change affects less than one-fifth of all industries. More prevalent are progressive and intermediating change. The percentages shown are estimates of the distribution of change trajectories among U.S. industries between 1980 and 1999, based on variability in revenues and assets among large firms.



Progressive Change

Progressive evolution is like creative evolution in that buyers, suppliers, and the industry's incumbents have incentives to preserve the status quo. The difference is that core assets are not threatened with obsolescence under progressive change, so industries on this trajectory are more stable than those on a creative change trajectory. Today's discount retailing, long-haul trucking, and commercial airline industries are evolving in this way.

Progressive evolution is most similar to the kind of change that Christensen refers to as "sustaining." Progress occurs, and technology can have an enormous impact, but it happens within the existing framework of the business. Core resources tend to appreciate rather than depreciate over time. Progressive change doesn't mean that change is minor or even that it is slow. Over time, incremental changes can lead to major improvements and major changes. Think of what has happened in discount retailing over the last ten years. Wal-Mart's cumulative impact has been extraordinary, and the company has developed unprecedented clout. But the retailer developed

that advantage by deepening existing customer and supplier relationships, not by seeking out entirely new ones.

The most profitable corporate strategies in progressive change industries generally involve carving out distinct positions based on geographic, technical, or marketing expertise. The goal is to build resources and capabilities steadily and incrementally. Companies rarely get into brinkmanship or eyeball-to-eyeball competition, and they don't have to put large amounts of capital at risk before learning whether an innovation creates value. Instead, their performance depends on their quick responses to feedback. Southwest Airlines, for instance, tests new flight routes but isn't afraid to pull out if a route ultimately doesn't work under the company's approach to air travel.

Successful companies in progressive change industries tend to be viewed by the financial community as minimally risky with the potential for only moderate returns. Over the long run, though, these companies can actually create very large total returns for investors. *Money* has reported that the two companies that had generated the greatest total return to shareholders during the magazine's 25-year history were none other than Wal-Mart and Southwest.

Which Trajectory Are You On?

Identifying your industry's evolutionary trajectory on the fly is difficult. It is easy to become distracted or confused by conventional wisdom, customer demands, and competitors' moves. To ensure accuracy, your analysis must be focused and systematic.

The first step is to define your industry. You can begin by identifying the companies in your industry that share common buyers and suppliers. Many economists use a 5% rule to assess whether the commonality is sufficient to qualify the firms as direct competitors: If a 5% price fluctuation by one company causes customers or suppliers to switch to another company, the businesses qualify as direct competitors. When a group of companies intend to appeal to the same buyers and rely on the same suppliers, you have additional evidence that they are direct competitors. And when companies use similar technologies to create value, it is likely that they qualify as direct competitors.

The second step is to define the industry's core assets and activities. Here is an easy way to test whether something is core: If it were eradicated today, would profits be lower a year from now, despite efforts to work around what's missing? If the answer is yes, then it definitely qualifies. In the auctioneering industry, for example, the capacity to evaluate works of art is a core activity. In the soft-drink industry, Coca-Cola's brand is a core asset. The disappearance of either of these capabilities would seriously damage profitability in their respective industries.

The third step is to determine whether the core assets and activities are threatened with obsolescence. To qualify, the threat must make core assets and activities potentially irrelevant to profitability. It must be significant enough to jeopardize the survival of at least one industry leader and widespread enough to influence every company in the industry. Once you know whether core activities and assets are threatened, you can identify which of the four trajectories applies to the industry you are studying.

The final step in the diagnosis is to evaluate the phase of the evolutionary trajectory. This step is important: Industry change generally takes place over a long period, and the options for dealing with change typically drop off sharply through each phase. (See the sidebar "The Industry Life Cycle Revisited.")

It is also essential to note that an industry generally evolves along just one trajectory at a time. It almost always starts out on either a progressive or creative trajectory because, collectively, companies in the industry can't capture value without a clear model for organizing their core activities. Over time, the industry may feel pressure to change these activities – driven by, for example, customer demands and new technologies. The threat of obsolescence can catapult the industry on to either a radical or an intermediating trajectory. As the industry restructures its core activities and assets, the threat of obsolescence may fade, marking the industry's transition back to a progressive or creative trajectory. A company that has survived these transitions can sometimes retain profitability, although it almost always must operate at a smaller scale and with a very different approach.

Industries do not shift their trajectories very often; no industry that I have studied has shifted between evolutionary paths more than once in ten years. So it is a good bet that a given industry has been on a single evolutionary trajectory for at least a few years. And while it is sometimes possible for individual companies to influence the trajectory of an entire industry, the effort required is almost always too great to be worthwhile, and failure can be devastating to the company's profitability or even its survival.

Capitalizing on Industry Evolution

Understanding industry change can do more than help you avoid mistakes. The rules under each trajectory can help you forecast early on how change will occur in your industry – and help you determine how to exploit change as it occurs. It would be impossible to list here all the possible contingencies for change on each trajectory and at each stage. But here are a few general insights:

Analyzing Radical and Intermediating Change. As noted earlier, companies operating in an industry that is on a radical or intermediating change trajectory must perform a balancing act – aggressively pursuing profits in the near term while avoiding investments that could later prevent them from ramping down their commitments. To

The Industry Life Cycle Revisited

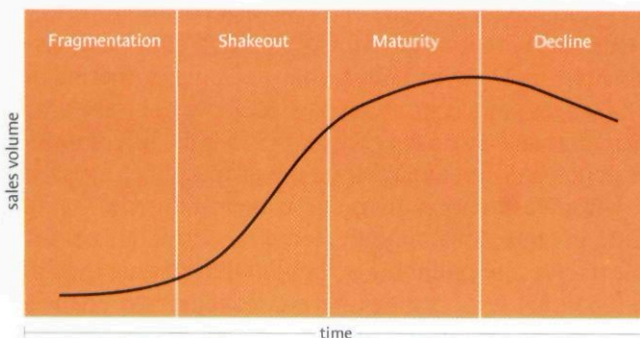
Once you've determined which change trajectory your industry is on, you'll need to figure out which phase of change the industry is experiencing. The classic industry life cycle model is relevant for understanding the phases of progressive and creative change. But this model does not apply to industries that are experiencing radical or intermediating change.

In the traditional life cycle model, industries begin in a period of *fragmentation* as companies experiment with different approaches to a market. The companies offer a variety of products and operate at low volumes. They tend to be entrepreneurial, private, and focused on serving narrow geographic areas. Over time, the industry experiences a *shakeout,* usually because a specific business model achieves greater legitimacy than any other. Competitors become more efficient, the volume of sales increases, and the industry generates unprecedented value for suppliers and buyers. When industries reach *maturity,* sales growth slows, and leaders often lock their positions. As the volume of sales drops, industries move into *decline.* In this phase, companies often search for incremental improvements in efficiency to recover profitability. (See "The Traditional Model" below.)

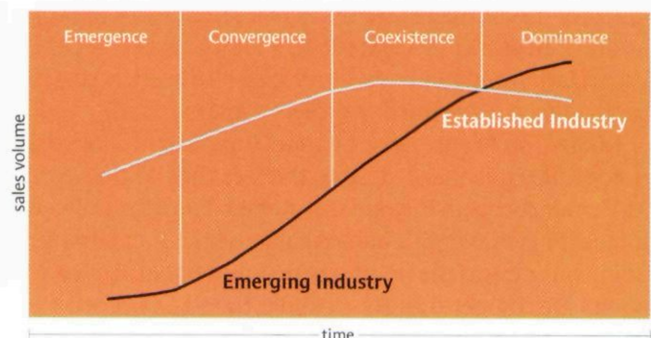
But if you apply this model in industries that are experiencing radical or intermediating change, you may end up trying to renew your position in an industry that will no longer generate significant returns. Or you may end up missing opportunities in both the established and emerging industries.

A more accurate model for those on radical or intermediating trajectories is the one below, which reflects changes in the ways buyers and suppliers respond to the level of the threat of obsolescence. (See "An Alternate Model.") During an initial period of *emergence,* upstart firms warrant attention but may not be significant enough to prompt established companies to restructure. As the new approach *converges* in volume, established companies may react by reconfiguring some of their activities. During a period of *coexistence,* buyers and suppliers become increasingly sophisticated at evaluating the new approach, and as a result, new opportunities for value creation may emerge even in the old industry. During a final phase of *dominance,* the industry's products and services are evaluated on new criteria that reflect the popularity of the new approach.

The Traditional Model



An Alternate Model



get the right balance, put yourself in the suppliers' shoes as well as in those of the buyers. What new options are emerging?

Take the example of auto dealerships, which are on an intermediating change trajectory. They are locked into multiyear pacts with the manufacturers, their suppliers. Yet the intermediation of the dealers presents new opportunities for the automakers to relate to consumers: What are the trade-offs for the manufacturers if they advertise collaboratively with the dealerships rather than directly to consumers? How can the carmakers pull off something like this without violating their contracts with the dealers? Only with unconventional thinking – beyond standard market research and advertising plans–can the manufacturers find answers to these questions.

Radical and intermediating change also call for new ways of dealing with competitive threats. Instead of viewing rivals in conventional terms, consider whether you can use alliances to protect common interests and defend against new competition from outsiders – or to facilitate consolidation. When some regions of the U.S. became overcrowded with auto dealerships, affiliated car lots (Honda dealers in adjacent towns, for instance) merged.

Under radical and intermediating change, it is also important to interpret conflict within your organization in a new way. "Civil wars" can emerge within an organization

as divisions with exposure to different segments of the business develop opposing views about the nature and pace of change. It is uncanny how frequently this happens. Strong, central leadership is required to deal with the problem effectively.

Surviving Radical and Creative Change. Under these conditions, it is smart to evaluate how quickly your core assets are depreciating. The easiest way to do this is to identify how much you are spending to renew them. Investing in a full-blown cost-accounting effort is worthwhile since the value of your assets may vary across different segments of the business in surprising ways. The goal of this analysis should be to distinguish the segments in which you can protect your competitive position from those in which your position will erode quickly. Often, this assessment yields important information about the value of intellectual property and how it can be guarded more intensively. For example, a film studio might discover that, in some geographies, losses from video piracy outweigh the potential profits from distributing content, at retail, on videotape or DVD.

To navigate radical and creative change trajectories successfully, companies must have the mettle to disappoint some buyers and suppliers, regardless of their track records, if the risks are too high. Despite Marlon Brando's box-office successes during the 1950s, film studios were reluctant to work with him because of his personal idiosyncrasies. The stakes in developing new films are simply too great for producers to take many risks. Because of the volatility of new-asset development, it is also crucial to cultivate relationships with investors to ensure quick access to capital when a worthwhile project comes around.

Managing Progressive Change. Progressive change is not simple to manage, despite the fact that neither core assets nor core activities are threatened. The accumulated impact of incremental changes can raise the standards for doing business to the point where only a handful of companies are competitive. For example, the standard-bearers in discount retailing (Wal-Mart and Target among them) have relentlessly managed incremental changes in activities for decades. As a result, only a few national retailers have competitive cost structures on a large scale. Ultimately, one of the most successful strategies for companies in industries on a progressive change trajectory is to develop a system of interrelated activities that are defensible because of their compounding effects on profits, not because they are hard to understand or replicate. Consider that very little about Wal-Mart's approach is secret. The company's efficiencies have accumulated ever since Sam Walton built his first distribution centers decades ago.

Adapting to the Stages of Change. As we've noted, all four trajectories typically unfold over decades, which means organizations have time to outline strategic options for the future. As change happens, fighting it is almost always too costly to be worthwhile. In the late

stages, companies invite trouble by sticking with outdated budget systems and cost-accounting processes. Organizations must reconfigure themselves for lower revenue growth and develop the ability to move activities and resources out of the business.

Diversifying Your Business. Some of the most exciting opportunities associated with industry evolution relate to diversification across industries. By participating in more than one industry on a progressive trajectory, Wal-Mart has enhanced the effects of its powerful distribution systems. And with its acquisition of Kinko's, FedEx has diversified in response to radical change. Some of the major challenges of diversification have to do with sharing core activities and core assets across divisions on different trajectories, and developing clear lines of authority for resolving disputes between divisions as their industries create different investment requirements. It is virtually impossible to diversify profitably without understanding the differences in the trajectories and phases of industry change.

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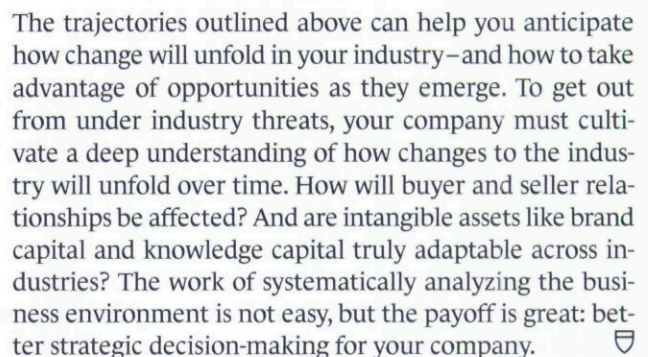

The trajectories outlined above can help you anticipate how change will unfold in your industry–and how to take advantage of opportunities as they emerge. To get out from under industry threats, your company must cultivate a deep understanding of how changes to the industry will unfold over time. How will buyer and seller relationships be affected? And are intangible assets like brand capital and knowledge capital truly adaptable across industries? The work of systematically analyzing the business environment is not easy, but the payoff is great: better strategic decision-making for your company.

1. This article builds on the author's "How Industries Evolve," *Business Strategy Review,* Autumn 2000.

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