

**THE  
INNOVATOR'S  
SOLUTION**

**CREATING AND SUSTAINING  
SUCCESSFUL GROWTH**

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## CHAPTER ONE

# THE GROWTH IMPERATIVE

*Financial markets relentlessly pressure executives to grow and keep growing faster and faster. Is it possible to succeed with this mandate? Don't the innovations that can satisfy investors' demands for growth require taking risks that are unacceptable to those same investors? Is there a way out of this dilemma?*

This is a book about how to create new growth in business. Growth is important because companies create shareholder value through profitable growth. Yet there is powerful evidence that once a company's core business has matured, the pursuit of new platforms for growth entails daunting risk. Roughly one company in ten is able to sustain the kind of growth that translates into an above-average increase in shareholder returns over more than a few years.<sup>1</sup> Too often the very attempt to grow causes the entire corporation to crash. Consequently, most executives are in a no-win situation: equity markets demand that they grow, but it's hard to know *how* to grow. Pursuing growth the wrong way can be worse than no growth at all.

Consider AT&T. In the wake of the government-mandated divestiture of its local telephony services in 1984, AT&T became primarily a long distance telecommunications services provider. The break-up

agreement freed the company to invest in new businesses, so management almost immediately began seeking avenues for growth and the shareholder value that growth creates.

The first such attempt arose from a widely shared view that computer systems and telephone networks were going to converge. AT&T first tried to build its own computer division in order to position itself at that intersection, but was able to do no better than annual losses of \$200 million. Rather than retreat from a business that had proved to be unassailable from the outside, the company decided in 1991 to bet bigger still, acquiring NCR, at the time the world's fifth-largest computer maker, for \$7.4 billion. That proved only to be a down payment: AT&T lost another \$2 billion trying to make the acquisition work. AT&T finally abandoned this growth vision in 1996, selling NCR for \$3.4 billion, about a third of what it had invested in the opportunity.

But the company *had* to grow. So even as the NCR acquisition was failing, AT&T was seeking growth opportunities in technologies closer to its core. In light of the success of the wireless services that several of its spun-off local telephone companies had achieved, in 1994 the company bought McCaw Cellular, at the time the largest national wireless carrier in the United States, for \$11.6 billion, eventually spending \$15 billion in total on its own wireless business. When Wall Street analysts subsequently complained that they were unable to properly value the combined higher-growth wireless business within the lower-growth wireline company, AT&T decided to create a separately traded stock for the wireless business in 2000. This valued the business at \$10.6 billion, about two-thirds of the investment AT&T had made in the venture.

But that move left the AT&T wireline stock right where it had started, and the company *had* to grow. So in 1998 it embarked upon a strategy to enter and reinvent the local telephony business with broadband technology. Acquiring TCI and MediaOne for a combined price of \$112 billion made AT&T Broadband the largest cable operator in the United States. Then, more quickly than anyone could have foreseen, the difficulties in implementation and integration proved insurmountable. In 2000, AT&T agreed to sell its cable assets to Comcast for \$72 billion.<sup>2</sup>

In the space of a little over ten years, AT&T had wasted about \$50 billion and destroyed even more in shareholder value—all in the hope of *creating* shareholder value through growth.

The bad news is that AT&T is not a special case. Consider Cabot Corporation, the world's major producer of carbon black, a compound that imparts to products such as tires many of their most important properties. This business has long been very strong, but the core markets haven't grown rapidly. To create the growth that builds shareholder value, Cabot's executives in the early 1980s launched several aggressive growth initiatives in advanced materials, acquiring a set of promising specialty metals and high-tech ceramics businesses. These constituted operating platforms into which the company would infuse new process and materials technology that was emerging from its own research laboratories and work it had sponsored at MIT.

Wall Street greeted these investments to accelerate Cabot's growth trajectory with enthusiasm and drove the company's share price to triple the level at which it had languished prior to these initiatives. But as the losses created by Cabot's investments in these businesses began to drag the entire corporation's earnings down, Wall Street hammered the stock. While the overall market appreciated at a robust rate between 1988 and 1991, Cabot's shares dropped by more than half. In the early 1990s, feeling pressure to boost earnings, Cabot's board brought in new management whose mandate was to shut down the new businesses and refocus on the core. As Cabot's profitability rebounded, Wall Street enthusiastically doubled the company's share price. The problem, of course, was that this turnaround left the new management team no better off than their predecessors: desperately seeking growth opportunities for mature businesses with limited prospects.<sup>3</sup>

We could cite many cases of companies' similar attempts to create new-growth platforms after the core business had matured. They follow an all-too-similar pattern. When the core business approaches maturity and investors demand new growth, executives develop seemingly sensible strategies to generate it. Although they invest aggressively, their plans fail to create the needed growth fast enough; investors hammer the stock; management is sacked; and Wall Street rewards the new executive team for simply restoring the *status quo ante*: a profitable but low-growth core business.<sup>4</sup>

Even expanding firms face a variant of the growth imperative. No matter how fast the growth treadmill is going, it is not fast enough. The reason: Investors have a pesky tendency to discount into the *present* value of a company's stock price whatever rate of growth they *foresee* the company achieving. Thus, even if a company's core business is growing vigorously, the only way its managers can deliver a rate of return to shareholders in the future that exceeds the risk-adjusted market average is to grow *faster* than shareholders expect. Changes in stock prices are driven not by simply the *direction* of growth, but largely by *unexpected* changes in the *rate of change* in a company's earnings and cash flows. Hence, one company that is projected to grow at 5 percent and in fact keeps growing at 5 percent and another company that is projected to grow at 25 percent and delivers 25 percent growth will both produce for future investors a market-average risk-adjusted rate of return in the future.<sup>5</sup> A company must deliver the rate of growth that the market is projecting just to keep its stock price from falling. It must *exceed* the consensus forecast rate of growth in order to boost its share price. This is a heavy, omnipresent burden on every executive who is sensitive to enhancing shareholder value.<sup>6</sup>

It's actually even harder than this. That canny horde of investors not only discounts the expected rate of growth of a company's *existing* businesses into the present value of its stock price, but also discounts the growth from new, yet-to-be-established lines of business that they expect the management team to be able to create in the future. The magnitude of the market's bet on growth from unknown sources is, in general, based on the company's track record. If the market has been impressed with a company's historical ability to leverage its strengths to generate new lines of business, then the component of its stock price based on growth from unknown sources will be large. If a company's past efforts to create new-growth businesses have not borne fruit, then its market valuation will be dominated by the projected cash flow from known, established businesses.

Table 1-1 presents one consulting firm's analysis of the share prices of a select number of *Fortune* 500 companies, showing the proportion of each firm's share price on August 21, 2002, that was attributable to cash generated by existing assets, versus cash that investors

expected to be generated by new investments.<sup>7</sup> Of this sample, the company that was on the hook at that time to generate the largest percentage of its total growth from future investments was Dell Computer. Only 22 percent of its share price of \$28.05 was justified by cash thrown off by the company's present assets, whereas 78 percent of Dell's valuation reflected investors' confidence that the company would be able to invest in new assets that would generate whopping amounts of cash. Sixty-six percent of Johnson & Johnson's market valuation and 37 percent of Home Depot's valuation were grounded in expectations of growth from yet-to-be-made investments. These companies were on the hook for *big* numbers. On the other hand, only 5 percent of General Motors's stock price on that date was predicated on future investments. Although that's a chilling reflection of the track record of GM's former management in creating new-growth businesses, it means that if the present management team does a better job, the company's share price could respond handsomely.

Probably the most daunting challenge in delivering growth is that if you fail once to deliver it, the odds that you ever will be able to deliver in the future are very low. This is the conclusion of a remarkable study, *Stall Points*, that the Corporate Strategy Board published in 1998.<sup>8</sup> It examined the 172 companies that had spent time on *Fortune's* list of the 50 largest companies between 1955 and 1995. Only 5 percent of these companies were able to sustain a real, inflation-adjusted growth rate of more than 6 percent across their entire tenure in this group. The other 95 percent reached a point at which their growth simply stalled, to rates at or below the rate of growth of the gross national product (GNP). Stalling is understandable, given our expectations that all growth markets become saturated and mature. What is scary is that of all these companies whose growth had stalled, only 4 percent were able to successfully reignite their growth even to a rate of 1 percent above GNP growth. Once growth had stalled, in other words, it proved nearly impossible to restart it.

The equity markets brutally punished those companies that allowed their growth to stall. Twenty-eight percent of them lost more than 75 percent of their market capitalization. Forty-one percent of the companies saw their market value drop by between 50 and 75 percent when they stalled, and 26 percent of the firms lost between 25

TABLE 1 - 1

**Portion of Selected Firms' Market Value That Was Based on  
Expected Returns from New Investments on August 21, 2002**

<i>Fortune</i> 500 rank	Company Name	Share Price	Percent of Valuation That Was Based on:	
			New Investments	Existing Assets
53	Dell Computer	\$28.05	78%	22%
47	Johnson & Johnson	\$56.20	66%	34%
35	Procter & Gamble	\$90.76	62%	38%
6	General Electric	\$32.80	60%	40%
77	Lockheed Martin	\$62.16	59%	41%
1	Wal-Mart Stores	\$53.88	50%	50%
65	Intel	\$19.15	49%	51%
49	Pfizer	\$34.92	48%	52%
9	IBM	\$81.93	46%	54%
24	Merck	\$53.80	44%	56%
92	Cisco Systems	\$15.00	42%	58%
18	Home Depot	\$33.86	37%	63%
16	Boeing	\$28.36	30%	70%
11	Verizon	\$31.80	21%	79%
22	Kroger	\$22.20	13%	87%
32	Sears Roebuck	\$36.94	8%	92%
37	AOL Time Warner	\$35.00	8%	92%
3	General Motors	\$49.40	5%	95%
81	Phillips Petroleum	\$35.00	3%	97%

Source: CSFB/HOLT; Deloitte Consulting analysis.

and 50 percent of their value. The remaining 5 percent lost less than 25 percent of their market capitalization. This, of course, increased pressure on management to regenerate growth, and to do so quickly—which made it all the more difficult to succeed. Managers cannot escape the mandate to grow.<sup>9</sup> Yet the odds of success, if history is any guide, are frighteningly low.

### **Is Innovation a Black Box?**

Why is achieving and sustaining growth so hard? One popular answer is to blame managers for failing to generate new growth—implying that more capable and prescient people could have succeeded. The solve-the-problem-by-finding-a-better-manager approach might have credence if failures to restart growth were isolated events. Study after study, however, concludes that about 90 percent of all publicly traded companies have proved themselves unable to sustain for more than a few years a growth trajectory that creates above-average shareholder returns.<sup>10</sup> Unless we believe that the pool of management talent in established firms is like some perverse Lake Wobegon, where 90 percent of managers are below average, there has to be a more fundamental explanation for why the vast majority of good managers has not been able to crack the problem of sustaining growth.

A second common explanation for once-thriving companies' inability to sustain growth is that their managers become risk averse. But the facts refute this explanation, too. Corporate executives often bet the future of billion-dollar enterprises on an innovation. IBM bet its farm on the System 360 mainframe computer, and won. DuPont spent \$400 million on a plant to make Kevlar tire cord, and lost. Corning put billions on the line to build its optical fiber business, and won big. More recently it sold off many of its other businesses in order to invest more in optical telecommunications, and has been bludgeoned. *Many* of the executives who have been unable to create sustained corporate growth have evidenced a strong stomach for risk.

There is a third, widely accepted explanation for why growth seems so hard to achieve repeatedly and well, which we also believe does not hold water: Creating new-growth businesses is simply unpredictable.

Many believe that the odds of success are just that—odds—and that they are low. Many of the most insightful management thinkers have accepted the assumption that creating growth is risky and unpredictable, and have therefore used their talents to help executives manage this unpredictability. Recommendations about letting a thousand flowers bloom, bringing Silicon Valley inside, failing fast, and accelerating selection pressures are all ways to deal with the allegedly irreducible unpredictability of successful innovation.<sup>11</sup> The structure of the venture capital industry is in fact a testament to the pervasive belief that we cannot predict which new-growth businesses will succeed. The industry maxim says that for every ten investments—all made in the belief they would succeed—two will fail outright, six will survive as the walking wounded, and two will hit the home runs on which the success of the entire portfolio turns. Because of this belief that the process of business creation is unfathomable, few have sought to pry open the black box to study the *process* by which new-growth businesses are created.

We do not accept that most companies' growth stalls because the odds of success for the next growth business they launch are impossibly low. The historical results may indeed seem random, but we believe it is because the process for creating new-growth businesses has not yet been well understood. In this book we intend to pry open the black box and study the processes that lead to success or failure in new-growth businesses.

To illustrate why it is important to understand the processes that create those results, consider these strings of numbers:

1, 2, 3, 4, 5, 6

75, 28, 41, 26, 38, 64

Which of these would you say is random, and which is predictable? The first string looks predictable: The next two numbers should be 7 and 8. But what if we told you that it was actually the winning numbers for a lottery, drawn from a drum of tumbling balls, whereas the second is the sequence of state and county roads one would follow on a scenic tour of the northern rim of Michigan's Upper Peninsula on the way from Sault Ste. Marie, Ontario to Saxon, Wisconsin?

Given the route implied by the first six roads, you can reliably predict the next two numbers—2 and 122—from a map. The lesson: You cannot say, just by looking at the result of the process, whether the process that created those results is capable of generating predictable output. You must understand the process itself.

### The Forces That Shape Innovation

What can make the process of innovation more predictable? It does *not* entail learning to predict what *individuals* might do. Rather, it comes from understanding the *forces* that act upon the individuals involved in building businesses—forces that powerfully influence what managers choose and cannot choose to do.

Rarely does an idea for a new-growth business emerge fully formed from an innovative employee's head. No matter how well articulated a concept or insight might be, it must be shaped and modified, often significantly, as it gets fleshed out into a business plan that can win funding from the corporation. Along the way, it encounters a number of highly predictable forces. Managers as individuals might indeed be idiosyncratic and unpredictable, but they all face forces that are similar in their mechanism of action, their timing, and their impact on the character of the product and business plan that the company ultimately attempts to implement.<sup>12</sup> Understanding and managing these forces can make innovation more predictable.

The action and impact of these forces in shaping ideas into business plans is illustrated in a case study of the Big Idea Group (BIG), a company that identifies, develops, and markets ideas for new toys.<sup>13</sup> After quoting a senior executive of a multibillion-dollar toy company who complained that there have been no exciting new toy ideas for years, the case then chronicles how BIG attacks this problem—or rather, this opportunity.

BIG invites mothers, children, tinkerers, and retirees who have ideas for new toys to attend “Big Idea Hunts,” which it convenes in locations across the country. These guests present their ideas to a panel of experts whose intuition BIG executives have come to trust. When the panel sees a good idea, BIG licenses it from the inventor and over the next several

months shapes the idea into a business plan with a working prototype that they believe will sell. BIG then licenses the product to a toy company, which produces and markets it through its own channels. The company has been extraordinarily successful at finding, developing, and deploying into the market a sequence of truly exciting growth products.

How can there be such a flowering of high-potential new product opportunities in BIG's system, and such a dearth of opportunities in the large toy company? In discussing the case, students often suggest that the product developers in the toy company just aren't as creative, or that the executives of the major company are just too risk averse. If these diagnoses were true, the company would simply need to find more creative managers who could think outside the box. But a parade of people has cycled through the toy company, and none has been able to crack the apparent lack of exciting toy ideas. Why?

The answer lies in the process by which the ideas get shaped. Midlevel managers play a crucial role in *every* company's innovation process, as they shepherd partially formed ideas into fully fledged business plans in an effort to win funding from senior management. It is the middle managers who must decide which of the ideas that come bubbling in or up to them they will support and carry to upper management for approval, and which ideas they will simply allow to languish. This is a key reason why companies employ middle managers in the first place. Their job is to sift the good ideas from the bad and to make good ideas so much better that they readily secure funding from senior management.

How do they sift and shape? Middle managers typically hesitate to throw their weight behind new product concepts whose market is not assured. If a market fails to materialize, the company will have wasted millions of dollars. The system therefore mandates that midlevel managers support their proposals with credible data on the size and growth potential of the markets that each idea targets. Opinions and feedback from significant customers add immeasurably to the credibility of claims that an idea has potential. Where does this evidence come from, given that the product hasn't yet been fully developed? It typically comes from existing customers and markets for similar products that have been successful in the past.