

Creating and Capturing Value: From Innovation to Architectural Advantage

Professor Michael G Jacobides, Associate Professor of Strategic and International Management at London Business School discusses the opportunities to create and capture value in a competitive environment and how gaining an “architectural advantage” may be key to discovering the secret to success.

What is changing in the competitive landscape?
How are things today different from what they used to be?

What’s different today is that industries change – and change fast. Sectors shift from integration to dis-integration; as we have seen with the mortgage market, what used to be a process housed in one large financial institution is now done by an ecosystem of diverse, partly competing, partly collaborating firms. From automobile to pharma, value chains break up; new types of competitors come in. Outsourcing and offshoring, for instance, is a symptom of this changing division of labour – this redefinition of “who does what” in a sector, and the emergence of new markets along a value chain. At the same time, there is a push for the creation of new, all-in-one service provision, and previously isolated sectors converge.

What does this mean for how firms compete?

Firms do not only compete in a sector – they compete to shape the structure of a sector. Successful firms understand that a key driver of success is to shape their competitive environment - redefining “who does what”, and thus shaping “who takes what”. Take mobile phones today: The devices we hold in our hand are made by a myriad of different participants, each specializing in a part of the value-adding process. But the real challenge is to redefine the different rules and roles in the sector. Who will be capturing the benefits from the increased music download on phones, for instance? Should carriers be “utilities”, device manufacturers responsible for the high value-add components? What is the role of those who can provide digital content in the sector? Different firms are trying to re-shape the sector to suit their strengths and their position. Google, for instance, has just introduced a new “platform” it developed, called “Android”, which makes it easy for many developers of both hardware and software to coalesce with it, to enable the emergence of a new type of mobile phone, perhaps with new types of mobile services. It’s using its strength



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in search technology and software development to re-shape “who does what” in the mobile telephony world, and then, from a position of power, reshape “who takes what”. Google’s strategy is to keep the “bottleneck”, while it harnesses the energy of loads of potential manufacturers of devices and resellers of frequency. It’s about shaping the nature of a sector and creating what I’d call “architectural advantage” – the ability to control an industry without even owning it.

Could you give us any example of how firms have gained such “architectural advantage”?

Take the PC sector. While the battle was initially between IBM and Apple, computer manufacturers soon lost their footing to the makers of CPU’s (like Intel) and makers of OS/GUI like Microsoft, as the industry unbundled, and value migrated from one part of the value chain to the other. What Microsoft and Intel did was to control the architecture of the PC sector. Slowly, they dominated key parts of the value chain (the “bottlenecks”). They then worked in unison to ensure that their part of the value chain became increasingly important, and that just assembling PC’s became a commodity through re-shaping the “rules and roles” in the sector.

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They did so by alliances, by standardizing the parts of the sector they didn't participate in, and by leveraging the energy of those who worked with them. They controlled the sector without owning it; they created an ecosystem of interdependent firms where they captured the critical parts.

So once you capture the bottleneck, and build architectural advantage, you're home free?

No! What's interesting is that this is a never-ending battle to redefine sectors. In the PC sector, Google is trying to erode Microsoft's edge, by creating new ways of paying for software services, and by capturing the externalities of advertising. And Google is a great example of a company that tries to reshape all sorts of sectors – from advertising to medical information provision. Both Google and Microsoft are now working on a template that will help store and manage medical information; and they both want to become the firms that control the access from and ability to leverage what hospitals and doctors and insurance companies are doing in-house. Successful firms have understood that growth and profits comes from re-defining sectors and finding new, creative ways of coming up with an architecture of firms that jointly develop products and services, and that's changing the way we think about competition. This is what is causing the greatest part of value re-distribution in today's economy.

What does this mean for innovation?

Quite a bit! First, it's becoming increasingly clear that the firms that succeed are not those that develop and conceive of the new ideas, technologies, or products – but rather, those that implement successful ecosystems, architectures of co-dependent firms around them. Take iPod as an example. Apple does precious little of the actual technology development; it orchestrates an eco-system of interdependent firms to help it bring about and develop a product. It produces nothing at all – it manages the key interfaces, and determines what the products will look like, working closely with SE Asian firms. But it develops software,

design, and manages iTunes – arguably, the cornerstone, the bottleneck in its own architecture. So innovators need to think harder about how they can capture more of the value they create; but at the same time, firms that want to be successful should look outside their own boundaries and see how they can tap into other firms' energy to build success. What determines success today is less how innovative you are, and more how effective you can be in being the bottleneck around a key innovation or cool new feature. Innovation is not about the creative genius of a solitary inventor; it's about new ways of orchestrating and managing the benefits we can create. And that will transcend the boundaries of traditional sectors.

How wide-spread are these trends? And what can firms do to respond?

These changes are very wide-spread, and are certainly not restricted to the technology sector. Services of all sorts and descriptions are being redefined, and with regulators being more progressive, lots is at stake. From health-care to education, from government to media, from advanced manufacturing to support services, sectors are being re-defined in the world over. To get a sense of the magnitude of this change, just look at the statistics that show the number of alliances – we have witnessed a dramatic increase over the last decade. And the firms that benefit are those who understand just how to turn these alliances into a success.

The bottom line is that we should care, as this changes how firms should compete and how they should look at building and capturing value – what we're working here at London Business School to help them do. This is about a new way of thinking about strategy – it's about shifting your mentality from “tactical warfare” to “guerrilla fighting”. And we have learnt all too well what happens to those who keep fighting guerrilla wars using a tactical combat mentality.