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Disruption Ahead: Six Signs You're Vulnerable & Three Ways to Respond

Perspective by Waterstone Management Group

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Disruption is a constant across technology sectors. Whether it's SaaS stealing share from traditional software businesses or "sharing economy" apps killing traditional services industries, disruption is everywhere. If you are an executive in a technology business, you need to not only be thinking about what disruptions your company can spearhead, but also be ever vigilant about where and how your company might itself be a target of disruption.

Disruptive Innovations

There are many examples of disruption across technology sectors, with huge implications on industry revenue and market capitalizations. The following table highlights a few such examples:

Disruptors	Company Story	Industry Changes
Google	Google's search-based advertising platform transformed the industry by making ads extremely targeted, market priced, and performance based. It achieved a market cap of over $450 billion within 16 years from startup.[i]	Since its mid-1990s inception, internet advertising has mainly risen at the expense of print. Between 2003 and 2013, the internet's share of global advertising rose by 17%, while newspaper's share fell by 14%.[vi]
salesforce	Salesforce's SaaS model transformed the ERP industry, reducing many traditional expenses and complexities of enterprise software implementations. Salesforce first targeted smaller businesses with a less expensive, user friendly product that was initially ignored by incumbents SAP and Siebel.[ii]	As a result of Salesforce's SaaS model, traditional software companies began to shift away from large upfront licensing fee options, to adopt more of a "pay-as-you-go" or "pay-as-you-consume" model. Many incumbents either exited or purchased cloud services to compete.
NETFLIX	Netflix effectively changed the way people consume media. In 1997, it created a unique personalized video rental solution. In 2007, it added online streaming to its model, one of the biggest disruptions to DVD sales and rentals. As of December 2014, Netflix had over 60 million global subscribers.[iii]	After the launch of Netflix, Blockbuster entered the DVD by mail business. Yet the company still struggled to stay relevant through the many industry transformations. As revenue and profits continued to decline, Blockbuster declared bankruptcy in 2010.[vii]
airbnb	Airbnb, founded in 2008, shifted demand away from the hotel industry. Its marketplace allows anyone from private residents to commercial properties to rent out excess space. The site features rentals in 190 countries[iv] and recently acquired $2.3B in funding, with a $20B valuation.[v]	Airbnb achieved an estimated 155 million guest stays in 2014, nearly 22% more than Hilton Worldwide, which had 127 million guest stays in 2014.[viii]

Six Red Flags of Vulnerability for Incumbents

How do you know if your company is vulnerable to disruption? In Waterstone's experience working across the gamut of tech sectors, we see certain red flags that are hallmarks that a business is ripe for disruption. Following are six such red flags:

1. **Abnormally High Margins:** Are the operating profit margins in one of your businesses significantly higher than your competitors' or those in other parallel industries? If so, you are vulnerable. You can bet that new competitors are looking at those margins and trying to figure out how to disrupt your business; more than likely some of your customers will be susceptible to a new offering at a lower price point. Examine each major source of your profits and ask yourself, "Could a competitor have a sustainable business at 50 percent of our margins?" Amazon founder Jeff Bezos famously quipped, "Your margin is my opportunity."[ix]

   Example: Famous for 60+ percent gross margins[x] on shaving products, Gillette has been disrupted by subscription-based start-ups like Dollar Shave Club that offer very similar products at less than half the price.

2. **Stale Technologies in a New Technology World:** Is there an open technology movement afoot in your industry? Do you have proprietary technology, perhaps that you've underinvested in, that hampers your customers' choices? Are new technologies reshaping similar industries (e.g., proprietary hardware giving way to software on commodity hardware)? If so, you are vulnerable to disruption by a new technology gaining traction.

   Example: In the mid-1990s, the market for proprietary servers (with an average sale price of $80,000) rapidly collapsed with the introduction of commodity x86-based industry standard servers, priced 85% lower. Within a few years, the average sale price for proprietary servers had been cut in half while the volume of industry standard servers grew by 10x.[xi]

3. **Unserved Low-end or Niche Market Segment:** This is the classic "Innovator's Dilemma" that Clayton Christensen examined. Is there a set of customers with lower/different needs and profit margins that your company has decided against serving because they are unprofitable and would distract from your core, higher-end customers? If so, you are vulnerable to being disrupted by a challenger who can figure out how to serve this segment's specific needs with a lower-cost, less-comprehensive offering.

   Example: Salesforce initially targeted the low end of the CRM market with a simpler, lower-priced SaaS offering, while incumbants were offering unneeded complexity at higher prices, justified by other market segments.

4. **Privileged Access to Supply or Customers:** Do a select few companies in your industry control the supply of goods sold? If so, you should be wary of challengers seeking to upend that paradigm, either by breaking down the barriers to entry or expanding the supply in previously unthought-of ways.

   Example: Airbnb and Uber leveraged technology and peer-to-peer sharing to increase the supply of hotel rooms and taxis, respectively.

   Similarly, if your industry has gatekeepers who control distribution to customers, look out for challengers bringing a more open model to the market.

   Example: The media industry has been hard-hit by how easily individuals and companies can reach their customers with alternative content: online news organizations and commentators, blogs, podcasts, vlogcasts, etc.

5. **High Level of Coordination Required Between Stakeholders:** Does your industry rely on complex interactions between different parties or a high degree of coordination within your customers' organizations? If so, you are vulnerable to disruption from a challenger introducing a new paradigm with a new technology, which either automates the coordination or addresses the segments that do not require coordination to the extent that existing solutions provide.

   Example: Credit card payments, which have long required a complex set of processes, have been challenged by simpler peer-to-peer transfers enabled by PayPal and Square, among others.

6. **Extremely Fragmented Industry:** Are there a lot of niche players and no one company determines the direction of the industry? If so, you may be at risk of displacement by a larger entrant offering better products and/or pricing enabled by economies of scale, often made possible by the internet. While historically a diverse set of competitors might have evolved based on geography or a small set of similar customers, connectivity and the rise of platform technology is breaking down those barriers.

   Example: Smaller niche retailers were disrupted by big box stores, which were in turn disrupted by national/global e-retailers.

Be alert to these red flags. Ensure that your planning processes specifically address these potential harbingers of vulnerability. And, once you find a looming disruption, address it head on through focused analysis and a deliberate decision to ignore, fight, or embrace the disruption.

Factors that Impede Incumbent Response

Companies facing industry disruptions oftentimes find their ability to respond hindered by internal factors, including:

- **Assets Optimized for the Legacy Model:** A company's core technologies, knowledge, skillsets, and processes may be built around the "old" way of doing things, and competing in the market disruption might require a new set of assets.

  Example: Print advertisers were unable to respond to more targeted online, search-derived advertising being pioneered by Google because their business model, processes, and technologies were all oriented around print.

- **Inflexible Legacy Pricing Models:** Adjusting pricing models to respond to niche market challenges may put revenues from core product lines at risk by making it difficult to justify the pricing disparity. Additionally, investors may be wary of pricing model changes that lower revenue forecasts.

  Example: On-premise, license model software companies struggle migrating to a subscription offering, in large part due to the reduced license revenue in the early years of transition.

- **Underestimating Challengers' Ability to Be a Viable Threat:** Sentiments similar to "we don't compete with them" have been group-think harbingers of doom to many companies that fail to recognize that the challenger's unique value proposition might be valued more than its own.

  Example: When the iPhone launched with a consumer focus, featuring a virtual keyboard and built around a highly social ecosystem, RIM didn't see it as a significant threat to its enterprise-focused Blackberry products because it perceived its customers as favoring security and typing on a physical keypad.

While these factors can act as barriers, incumbents must not allow them to bind their reactions too strongly. There are ways to react to a disruption that balance maintaining legacy offerings and operations while positioning for success in the new world.

Three Ways to Respond to a Disruptive Innovation: Ignore, Flight, or Embrace

When faced with a disruption, a company can respond in three ways—it can choose to ignore, fight, or embrace the disruption. Which response (or responses) a company selects should be based on what it believes about the nature of the disruption, its power to combat adoption, and its ability to successfully pivot its business model.

IGNORE

Choosing to ignore an innovative disruption means making no direct response to it. The company would continue business as usual without changing any processes or products, but still maintain a watchful eye over any further industry changes. To choose this response, the company must believe:

- Disruption will not grow to significantly impact profitability.
  - Customers will not find the disruption's value proposition compelling enough to switch.
  - Disruptor's lower cost/pricing model will not exert pricing pressure on current products.
- Competitors will not embrace the disruption, thus discouraging adoption.
- Incremental profitability from fighting or embracing the disruption is not compelling versus the investment it would require.

Ignore

Considerations:

- How are other incumbents likely to respond?
- Will likely incumbent responses impact ignore/fight/embrace decision?

Example:

- Competitors didn't try to follow Redbox in creating DVD rental kiosks. Netflix continued business as usual, acknowledging Redbox as a competitor, but not taking direct action.

FIGHT

A market incumbent can acknowledge the impact a disruption may have, but might not be ready to embrace it. Instead, the company can fight adoption of the disruption by trying to make it less attractive from an economic or technology perspective. Choosing to fight makes sense if the incumbent believes:

- The disruption could negatively impact revenue and profitability if left unchecked.
- It has the power to suppress adoption of the disruption.
- The incremental profitability from embracing the disruption is not compelling versus the investment required to fight it.
- Embracing the disruption is not possible due to limited assets, technology, capabilities, and resources.

There are many ways an incumbent can fight adoption of a disruption. The goal should be to minimize the disruption's specific perceived value advantage and/or limit customers' ability to select it. Strategies that include more than one approach are most successful:

- Launch bridge products built on core strengths that remove many of the gaps between current offerings and the challengers' offerings.
- Offer favorable terms to lock existing customers into longer contracts in order to gain time to react with more competitive offerings.
- Shift competitive messaging to focus on capabilities where there is a clear advantage over the challenger.
- Adjust pricing models (or lower pricing) to make adopting the disruption less attractive to customers who are at risk of shifting.
- Lobby for new regulations that remove/limit the challenger's ability to compete.

Fight

Considerations:

- Evaluate tactics at each business design area, particularly creating networking effects, and changing the economics
- Is it possible to make adopting the disruption less attractive to customers than current state?

Examples:

- Hotel industry is lobbying for tougher regulations against short term rentals.
- Taxi industry is attempting to block Uber from picking up at airports.

Fight Example: The Taxi Industry

The taxi industry is fighting the burgeoning car sharing and car services industries by lobbying for tighter rules and regulations for these companies. Various taxi associations have lobbied for standardized fares for app-based ride companies, mandatory 24/7 insurance coverage for all drivers, background checks, and to enact privacy safeguards, among other things.[xii] Currently, only a handful of major U.S. airports allow drivers of UberX, Uber's low-cost service, to pick up passengers, but most have put up resistance. In South Florida, for instance, police have been citing drivers for picking up passengers at Fort Lauderdale-Hollywood International Airport without proper permits. Additionally, Broward County Commission authorized fines up to $1,000 for drivers violating county laws.[xiii]

EMBRACE

Embracing a disruption often means big investments for incumbent companies as they shift their business to stay relevant in the new world. They will likely have to build new capabilities in parallel with running their legacy business. This is a big decision and should be embarked upon if they believe:

- They don't have the ability to successfully fight adoption of the disruption—the disruption will hit them regardless of their actions.
- Incremental profitability from embracing the disruption outweighs the cost of investment and/or the cost of not embracing the disruption.
- The management team has the ability to transform the company to succeed in the disrupted world.

Embracing a disruption implies some level of transformation, and management teams must consider balancing legacy operations and revenues with what it will take to succeed in the disrupted world. The key is to separate legacy and new to the degree that makes sense. Sometimes the incumbent can take a measured pace to adopting the disruption by introducing a new product line while maintaining the legacy product families. This is particularly true when the incumbent has long-standing customers who will work with the company to transition on a multi-year journey. When faster change is required or there is a vast operational difference in delivering the new products versus legacy products, the better approach is often to stand-up a new business unit or acquire a challenger.

The underlying strategy of the response should:

- Allow the new team to "own" the disruption and focus on developing winning strategies while allowing the legacy business to fight the disruption and capture as much economic value as possible.
- Create a brand that can communicate strong positioning around the disruption while the legacy business can communicate the continued ability to meet customer needs.
- Manage the businesses according to the metrics that make sense for the investment and revenue strategies, and compensate management teams accordingly.
- Continue to support legacy business in case disruption turns out to be more hype than reality.
- Give product management and development teams freedom to optimize offerings for their segments without having to make trade-offs that would make their offerings less compelling than their competitors' offerings.
- Develop new partnerships even if they might create conflicts for the legacy business.
- Compensate sales teams on metrics appropriate for their respective products.

Embrace

Considerations:

- How can company embrace disruption? Adopt, accelerate, leap-frog, etc.?
- How can company capitalize on new strategic control points?
- What partnerships could strengthen strategy?

Examples:

- SAP bought Success Factors to rival Salesforce.
- Oracle acquired RightNow.
- Avaya launched VoIP product lines in parallel with traditional PBX products.

The decision to introduce a new product line within an existing business unit or to stand-up a new business unit should be informed by the degree to which there are overlapping elements (e.g., governance requirements, underlying technologies, product development organizations, etc.).

Incumbent companies that successfully develop a business to compete with a disruption often find that the legacy business can continue operating profitably for a number of years. During that time, the new business unit should communicate to legacy customers that it can help them migrate to the new world when they're ready—through services, by the nature of their product line, etc. Eventually, management teams may decide that the legacy business should be discontinued or divested.

Embrace Examples: Oracle and SAP	In the wake of Salesforce's success, both Oracle and SAP chose to embrace the industry transition to SaaS and Cloud services. In 2011, Oracle acquired RightNow, a SaaS company focusing on customer service.[xiv] In the same year, SAP announced plans to acquire Cloud-based software provider Success Factors, which manages employee performance.[xv] In both cases SAP and Oracle recognized the disruption of Salesforce and the need to react directly to maintain relevancy in the industry.

Conclusion

As industries evolve, companies need to continually adjust their strategies and tactics. Oftentimes, an incumbent company's response to a disruption will evolve over time and can include more than one response type. That's ok; they are not mutually exclusive. When a disrupting technology first appears, it might be best for a company to ignore it. Only when the disruption has enough momentum should they consider fighting or embracing it. Even then, those two can be done in parallel with different business units.

There is no universal response strategy that will work in all industries and for all types of disruptions. In-depth analysis of the value drivers and projected impact of the disruption is required, as is the careful evaluation of the universe of potential responses and the management team's ability to execute them.

Waterstone Management Group helps technology companies and investors create measurable value by identifying and capitalizing on disruptive growth opportunities and driving excellence in Services, Cloud, and Customer Success performance. To learn more about disruptive growth and the best way to respond, please contact:

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