Value innovation: a leap into the blue ocean

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Corporate strategy is heavily influenced by its military roots. The very language of strategy is imbued with military references – chief executive ''officers'' in ''headquarters'', ''troops'' on the ''front lines.'' Described this way, strategy is about confronting an opponent and fighting over a given piece of land that is both limited and constant. Traditionally, strategy focused on beating the competition, and strategic plans are still couched in warlike terminology. They exhort companies to seize competitive advantage, battle for market share, and fight over price. Competition is a bloody battlefield.

The trouble is that if the opposing army is doing exactly same thing, such strategies often cancel each other out, or trigger immediate tit-for-tat retaliation. Strategy quickly reverts to tactical opportunism. So where should companies turn for a more innovative approach to strategy?

The answer lies with something we call blue-ocean strategy. We argue that head-to-head competition results in nothing but a bloody red ocean as rivals fight over shrinking profits. Success comes not from battling competitors, but from making the competition irrelevant by creating ''blue oceans'' of uncontested market space. The creators of blue oceans don't use the competition as their benchmark. Instead, they follow a different strategic logic that we call value innovation. Value innovation is the cornerstone of blue-ocean strategy. We call it value innovation because instead of focusing on beating the competition in existing market space, you focus on getting out of existing market boundaries by creating a leap in value for buyers and your company which leaves the competition behind.

These ideas challenge conventional strategic thinking and are supported by extensive research. Over the past decade, we have created a database that covers more than 30 industries going back over 100 years. So what does all this data show?

We believe that the business world has been overlooking one of the key lessons of wealth creation in history. Our research indicates that the major source of wealth creation over time is not the industry that a company plays in *per se.* Nor did we find permanently great companies that consistently created and captured wealth.

History reveals that there are neither perpetually excellent companies nor perpetually excellent industries. Companies and industries rise and fall based on the strategic moves that are made. Consider *In Search of Excellence,* the bestselling business book published in 1982. Within just five years, two-thirds of the identified model firms in the book had declined. Likewise for those sample companies in *Built to Last*, another bestselling business book. It was later found that if industry performance was removed from the equation, some of the companies in *Built to Last* were no longer excellent. As Foster and Kaplan point out in their book *Creative Destruction*, while the companies listed certainly outperformed the market, some did not outperform the competition within their entire industries.

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The performance consequences of blue oceans

We set out to quantify the impact of creating blue oceans on a company's growth in both revenues and profits in a study of the business launches of 108 companies (see Figure 1).

We found that 86 percent of the launches were line-extensions, that is, incremental improvement within the red ocean of existing market space. Yet they accounted for only 62 percent of total revenues and a mere 39 percent of total profits. The remaining 14 percent of the launches were aimed at creating new blue oceans. They generated 38 percent of total revenues and 61 percent of total profits.

Given that business launches included the total investments made for creating red and blue oceans (regardless of their subsequent revenue and profit consequences, including failures) the performance benefits of creating blue waters are evident.

So if there is no perpetually high-performing company and if the same company can be brilliant at one moment and wrongheaded another, it appears that the company is not the appropriate unit of analysis in exploring the roots of high performance. There are no perpetually excellent industries either. Five years ago, for example, people envied companies in the IT industry; yet today the reverse is largely true.

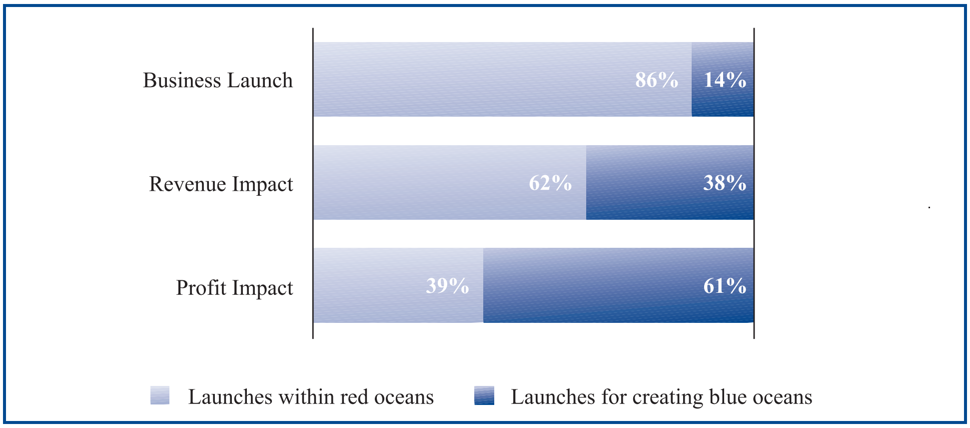
Our analysis of industry history shows that the strategic move, and not the company or the industry, is the right unit of analysis for explaining the root of profitable growth. And the strategic move that we found matters centrally is the creation and capturing of blue oceans.

Strategic moves

By strategic move, we mean the set of managerial actions and decisions involved in making a major market-creating business offering. The strategic moves we discuss – moves that have delivered products and services that opened and captured new market space, with a significant leap in demand – contain great stories of profitable growth. We built our study around these strategic moves (over 150 from more than 30 industries spanning from 1880 to 2000) to understand the pattern by which blue oceans are created and captured and high performance is achieved.

A snapshot of the auto industry from 1900 to 1940 is instructive. In 1908 Henry Ford created the auto industry as we know it with the Ford Model T. Prior to Ford, consumers had two choices: horse-drawn buggies or expensive custom-made automobiles. Ford created a blue ocean by making the automobile easy to use, reliable, and priced so that the majority of Americans could afford it. Ford's market share went from 9 to 61 per cent. The Model T, then, was the strategic move that ignited the automotive industry. But in 1924, it was overtaken by another strategic move, this time by General Motors. Contrary to Ford's functional one-color

Figure 1 The profit and growth consequences of blue-ocean strategy



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one-car single model strategy, GM created the new market space of emotional, stylised cars with ‘‘a car for every purpose and purse’’. Not only was the auto industry’s growth and profitability again catapulted to new heights, but GM’s market share jumped from 20 to 50 per cent while Ford’s fell from 50 to 20 per cent.

Move forward to the 1970s when Japanese car companies created the blue ocean of small, gas efficient autos. And then to the 1980s when Chrysler created the blue ocean of minivans. All these companies were incumbents. Moreover, the blue oceans made by incumbents were usually within their core businesses. In fact, most blue oceans are created from within, not beyond, red oceans of existing industries. This challenges the view that new markets are in distant waters. Blue oceans are right next to you in every industry. Issues of perceived cannibalization or creative destruction for established companies also proved to be exaggerated. Blue oceans created profitable growth for every company launching them, start-ups and incumbents alike.

Over our study period of more than 100 years, we found a similar pattern in other sectors. In short, the strategic move that matters most to both an industry’s long run profitable growth and that of individual companies is the repeated creation over time of new market space that captured a mass of buyers. Blue-ocean strategy is about creating and executing such strategic moves that unlock uncontested market space which render competitors irrelevant. In contrast, red ocean strategy is about how to out-compete in the existing market space.

Sailing into a blue ocean

To understand the power of strategic moves that create blue oceans consider the US wine market. Conventional wisdom caused wineries to compete on the prestige and the quality of wine at a price point – traditional competitive strategy. Prestige and quality were viewed as a function of adding complexity to the wine based on taste profiles shared by wine makers and reinforced by the wine show judging system. The wine experts concur that complexity – layered personality and characteristics that reflect the uniqueness of the soil, season, and winemaker’s skill in tannins, oak, and aging processes – equates with quality.

Then along came Casella Wines, an Australian winery. Casella redefined the problem of the wine industry as how to make a fun and non-traditional wine that’s easy to drink. Why? In looking at the demand side of alternatives of beer, spirits, and ready-to-drink cocktails, which captured three times as many consumer alcohol sales as wine, Casella Wines found that the mass of American adults saw wine as a turnoff. It was intimidating and pretentious, and the complexity of taste – even though it was where the industry sought to excel – created a challenge to the inexperienced palate. With this insight, Casella was ready to challenge the industry’s strategic logic and business model. To do so it considered four key questions outlined in an analytical tool we call the four actions framework.

First, which of the factors that the industry takes for granted should be eliminated? Second, which factors should be reduced well below the industry’s standard? Third, which factors should be raised well above the industry’s standard? Fourth, which factors should be created that the industry has never offered?

The upshot of this analysis was that Casella Wines created [yellow tail]: a wine whose strategic profile broke from the competition and created a blue ocean. Instead of offering wine as wine, Casella created a social drink accessible to everyone. By looking at the alternatives of beer and ready-to-drink cocktails, Casella Wines created three new factors in the US wine industry – easy drinking, easy to select, and fun and adventure. It eliminated or reduced everything else. [Yellow tail] was a completely new combination of characteristics that produced an uncomplicated wine structure that was instantly appealing to the mass of alcohol drinkers. The result was an easy drinking wine that did not require years to develop an appreciation for.

This allowed the company to dramatically reduce or eliminate all the factors the wine industry had long competed on – tannins, complexity and aging. With the need for aging reduced, the working capital required was also reduced. The wine industry criticised the sweet fruitiness of [yellow tail] but consumers loved the wine.

Casella also made selection easy by offering only two choices of [yellow tail] – Chardonnay, the most popular white wine in the USA; and a red Shiraz. It removed all technical jargon from the bottle and created instead a striking and instantly recognizable label featuring a kangaroo in vibrant colors. It also scored a home run by making wine shop employees ambassadors of [yellow tail], introducing fun and adventure into the sales process by giving them Australian outback clothing, including bushman hats and oilskin jackets to wear at work. Recommendations to consumers to buy [yellow tail] flew out of their mouths.

From the moment [yellow tail] hit the retail shelves in July 2001, sales took off. In the space of three years, [yellow tail] emerged as the fastest growing brand in the histories of both the Australian and US wine industries and the number one imported wine into the US, surpassing the wines of France and Italy. By August 2003, it was the number one red wine in a 750 ml bottle sold in America, outstripping California labels. By the end of 2004, [yellow tail's] moving average annual sales were tracking at 11.2 million cases. What's more, whereas large wine companies developed strong brands over decades of marketing investment, [yellow tail] leap-frogged tall competitors with no promotional campaign, mass media or consumer advertising. It didn't just steal sales from competitors it grew the overall market. [Yellow tail] brought over 6 million non-wine drinkers – beer and ready-to-drink cocktail drinkers – into the market. Novice table wine drinkers started to drink wine more frequently, jug wine drinkers moved up, and drinkers of more expensive wines moved down to become consumers of [yellow tail].

A market universe of two oceans

To understand what Casella achieved, imagine a market universe composed of two sorts of oceans – red oceans and blue oceans. Red oceans represent all the industries in existence today. This is the known market space. Blue oceans denote all the industries not in existence today. This is the unknown market space.

In the red oceans, industry boundaries are defined and accepted, and the competitive rules of the game are known. Here, companies try to outperform their rivals to grab a greater share of existing demand. As the market space gets more crowded, prospects for profits and growth are reduced. Products become commodities, and cut-throat competition turns the red ocean bloody.

Blue oceans, in contrast, are defined by untapped market space, demand creation, and the opportunity for highly profitable growth. Although some blue oceans are created well beyond existing industry boundaries, most are created from within red oceans by expanding

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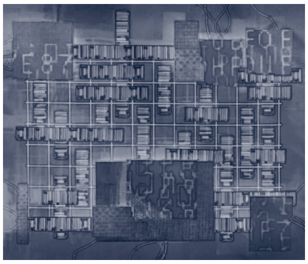

existing industry boundaries, as [yellow tail] did. In blue oceans, competition is irrelevant because the rules of the game are waiting to be set.

It will always be important to swim successfully in the red ocean by out-competing rivals. Red oceans will always matter and will always be a fact of business life. But with supply exceeding demand in more industries, competing for a share of contracting markets, while necessary, is not sufficient to sustain high performance. Companies need to go beyond competing. To seize new profit and growth opportunities, they also need to create blue oceans.

Unfortunately, blue oceans are largely uncharted. The dominant focus of strategy work over the past 25 years has been on competition-based red ocean strategies. Some discussions around blue oceans exist. But until now there has been little practical guidance on how to create them. That's why in our book, *Blue Ocean Strategy*, we provide practical frameworks and analytics for the systematic pursuit and capture of blue oceans.

The expansion of blue oceans

Although the term blue oceans is new, their existence is not. They are a feature of business life, past and present. Look back one hundred years and ask, how many of today's industries were then unknown? The answer: many industries as basic as automobiles, music recording, aviation, petrochemicals, health care, and management consulting were unheard of or had just begun to emerge at that time. Now turn the clock back only 30 years. Again, a plethora of multi-billion dollar industries jumps out – mutual funds, mobile phones, gas fired electricity plants, biotechnology, discount retail, express package delivery, snowboards, coffee bars, and home videos to name a few. Just three decades ago, none of these industries existed.

Now put the clock forward 20 years – or perhaps 50 years – and ask yourself how many now unknown industries will likely exist then? If history is any predictor of the future, again the answer is many of them.

The reality is that industries never stand still. They continuously evolve. Operations improve, markets expand, and players come and go. History teaches us that we have a hugely underestimated capacity to create new industries and re-create existing ones.

In fact, the half-century-old Standard Industrial Classification (SIC) system published by the US Census was replaced in 1997 by the North American Industry Classification Standard (NAICS) system. The new system expanded the ten SIC industry sectors into 20 sectors to reflect the emerging realities of new industry territories. The service sector under the old system, for example, is now expanded into seven business sectors ranging from information to health care and social assistance. Given that these systems are designed for standardization and continuity, such a replacement shows how significant the expansion of blue oceans has been.

The importance of creating blue oceans

There are several driving forces behind a rising imperative to create blue oceans. Accelerated technological advances have substantially improved industrial productivity and have allowed suppliers to produce an unprecedented array of products and services. The result is that in increasing numbers of industries, supply exceeds demand. The trend towards globalization compounds the situation. As trade barriers between nations and regions are dismantled and as information on products and prices becomes instantly and globally available, niche markets and havens for monopoly continue to disappear.

The result has been accelerated commoditization of products and services – something the financial services industry knows all about. The effect is to increase price wars and shrink profit margins. In overcrowded industries, differentiating brands becomes harder in both economic upturns and downturns.

All this suggests that the business environment in which most strategy and management approaches of the twentieth century evolved is increasingly disappearing. As red oceans become more and more bloody, management will need to be more concerned with blue oceans than ever before. That is why the future belongs to companies that can create and execute on blue-ocean strategy.

The war or competitive battle analogy we have used for strategy so far has its limits. It is based on an assumption that there's only so much territory that exists. So it's been about dividing up that territory by competing against one another. There's been a winner and a loser. But our research shows it's not a zero sum game. You can create new land. Business history shows us that contrary to perceived wisdom, the number of market spaces that can be created is infinite.

There is, however, a hugely under-estimated capacity to create new territory – new industries and markets. The number of industries is ever expanding – and the pace is accelerating. The implications for chief executives and their advisors are profound. Some industries die, some persist. But new industries are constantly being created. It is like a galaxy of stars – infinite. Transpose that onto the future, and the obvious conclusion is that the biggest industries today are unlikely to be the biggest industries 30 years hence.

Minimizing risk and maximizing opportunity

Some would think that blue-ocean strategy may be inherently more risky. Far from it, blue-ocean strategy is about risk minimization and not about risk taking. Of course, there is no such thing as a riskless strategy. Any strategy, whether red or blue, will always involve risk. Nonetheless, when it comes to venturing beyond the red ocean to create and capture blue oceans there are six key risks companies face: search risk, planning risk, scope risk, business model risk, organizational risk, and management risk. The first four risks revolve around strategy formulation, and the latter two around strategy execution.

Each of the six principles in *Blue Ocean Strategy* expressly addresses how to mitigate each of these risks. The first blue ocean principle – reconstruct market boundaries – addresses the search risk of how to successfully identify, out of the haystack of possibilities that exist, commercially compelling blue ocean opportunities. The second principle – focus on the big picture, not the numbers – tackles how to mitigate the planning risk of investing lots of effort and lots of time but delivering only tactical red ocean moves. The third principle – reach beyond existing demand – addresses the scope risk of aggregating the greatest demand for a new offering.

The fourth principle – get the strategic sequence right – addresses how to build a robust business model to ensure that you make a healthy profit on your blue ocean idea, thereby mitigating business model risk. The fifth principle – overcome key organizational hurdles – tackles how to knock over organizational hurdles in executing a blue-ocean strategy addressing organizational risk. The sixth principle – build execution into strategy – tackles how to motivate people to execute blue-ocean strategy to the best of their abilities, overcoming management risk.

These six principles aim to make the formulation and execution of blue-ocean strategy as systematic and actionable as competing in the red oceans of existing market space. In creating blue oceans, they guide companies in a way that is both opportunity maximizing and risk minimizing.

Blue-ocean strategy is a dynamic process

Blue-ocean strategy should not be a static process. It must be a dynamic one. Consider The Body Shop. In the 1980s, The Body Shop was highly successful, and rather than compete head on with large cosmetics companies, it invented a whole new market space for natural beauty products. More recently Body Shop has struggled. But, that does not diminish the brilliance of its original strategic move. The problem was that The Body Shop didn't realize what made it a brilliant strategic move. Its genius lay in creating a new market space in an intensely competitive industry that historically competed on glamour. Once it had created a blue ocean, the company focused on mining that new market space. That was OK while few players imitated it but as more and more competitors jumped into its blue ocean and it became red, the company became involved in a bruising battle for market share. This was the wrong strategy.

Once a company has created a blue ocean, it should prolong its profit and growth sanctuary by swimming as far as possible in the blue ocean, making itself a moving target, distancing itself from potential imitators, and discouraging them in the process. The aim here is to dominate the blue ocean over imitators for as long as possible. But, as other companies' strategies converge on your market, and the blue ocean turns red with intense competition, companies need to reach out to create a new blue ocean to break away from the competition again. This is where The Body Shop stumbled.

Blue-ocean strategy shows companies not only how to create and capture blue oceans but also how to monitor when it is time to reach out for a new blue ocean. In this way, blue-ocean strategy presents a dynamic iterative process to create uncontested market space across time.

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Competitive strategy,
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Market position,
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