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## The Incumbent's Advantage

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**Abstract:** One of the most important decisions in responding to a technological or strategic innovation is choosing how to organize the new venture. Separating the new venture from the old organization reduces conflict and enables the new venture to generate speed and focus. On the other hand, keeping it integrated allows the venture to leverage valuable resources and skills from the existing organization. In this paper, we examine the advantages and disadvantages of different approaches to organizing the new venture, both early and late in the innovation's life cycle. We find there are three viable approaches to organizing. Of these three, the choice of using separated or integrated approaches to launch the innovation depends on each firm's unique capabilities and competitive situation. However, all three viable approaches are characterized by integration later in the life cycle. This integration is truly the incumbent's advantage: linking the people, processes, infrastructures and resources of the new and old to create powerful competitive synergies. We describe the three viable approaches and illustrate with examples of how firms used each effectively.



## The Incumbent's Advantage

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### *Introduction*

Many people talk about major strategic innovations as if they're short-term games. If a firm gets a fast start and achieves rapid time to market, it's bound to win the race. Unfortunately, competition is a marathon, not a sprint. Like the fabled *Tortoise and the Hare*, the fast-moving early leader often runs out of steam later. Winning at an innovation means more than starting fast. It means choosing the right strategy for whole race—both the early and late stages—in order lead the pack at the end.

The most fundamental strategic decision in responding to a potentially disruptive innovation<sup>1</sup> is structuring the relationship between the innovating team and the rest of the firm's capabilities. Choosing the separated approach—creating a “spin-off” or autonomous organization to address the innovation—can have value early in the game, but can also make integration very difficult later on. The integrated approach can encounter difficulty early, but can enable a firm to use the incumbent's advantage—leveraging across the new and the old to move very powerfully later in the game.

In this article, we describe different ways to compete in a potentially disruptive innovation. We find that there are three viable approaches to adopting a potentially disruptive innovation: separating the innovators early in the game and then integrating later (the Separated-the Integrated approach), entering early with an integrated approach and continuing in an integrated way (the Integrated Leader approach), or waiting until the innovation matures and entering in an integrated way (the Integrated Follower approach). Each firm can choose the approach that's right for its particular combination of capabilities and competitive conditions, but all approaches end in integration.

### *The Lure and Dangers of Autonomy*

It can be tempting to create a highly separate unit to address a disruptive innovation. After all, big incumbent companies tend to be slow to change. Separating the innovators enables them to be fast, furious and focused. They can make decisions quickly, adapt rapidly to changes in the competitive environment and give a firm a foothold in an emerging market segment.

Creating an autonomous unit also makes life easier in the existing organization. Middle managers don't see their colleagues fighting for resources and stealing customers. In addition, senior managers don't need to spend much of their time resolving conflicts between the old and the new.

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<sup>1</sup> See, for example, Christensen (1997) or Charitou and Markides (2003) for examples of disruptive strategic innovations and incumbent responses.

Isolating the innovators from the conflicts in the old organization can isolate them from the organization's powerful assets. Sure, a spin-off can use some parts of the old, such as money or information systems. But, they typically can't negotiate across the two businesses to find ways that the old can help the new to scale, or to find ways that the new can help the old work better. Instead, separated innovators end up playing the startups' game, on the startups' field, with the startups' rules.

Take the example of high-end workstation vendor Silicon Graphics (SGI). In the early 1990s, SGI faced the challenge of Windows NT. The threat was major, and highly "disruptive" to SGI, beyond the technical challenges of replacing SGI's Unix-based operating system with NT, and porting applications over. NT forced the company to focus on different customer segments, and in so doing to hit much lower product cost trajectories. SGI created an autonomous venture aimed at developing products for NT. The new unit was separated both physically and organizationally. It had its own P&L and was not only encouraged to develop a brand new design for the new products, but also to implement new approaches to supply chain management, operations and sales.

While quick to get things going, this "textbook" move virtually killed the company. How? Three reasons: First, developing the new organization and the new capabilities from scratch was much more challenging than had been forecasted. This caused massive inefficiencies and delays across the board—products were late, buggy, and had insufficient sales channel push. Second, the completely separate unit had a difficult time leveraging SGI's traditional capabilities and company relationships in product development, operations or sales. Finally, the move caused frustration and disappointment for the organization that was "left behind" to continue to manage the older products. Those products, which still provided the company's lifeblood, suffered as a result.

As one might expect, the NT venture was able to act quickly, and independently of the legacy of SGI's existing business. But the efforts ran out of gas when the venture began to reach scale, and SGI's traditional assets (in technology development, architectural design, operations, supply chain, channel management, etc.) became sorely missed. Eventually, SGI reintegrated the NT unit, but it was unable to garner significant internal support and the large NT market remains only a small part of SGI's business.

### ***The Value and Risk of Integration***

We found in our research that separated innovators almost always need to be reintegrated at some future time in order to scale effectively. For example, we examined a sample of 31 ventures that were created as spin-offs to address the challenge of the internet. Some of the firms chose spinning out after failing to be able to develop the innovation internally. Others did so in order to capture stock market premiums going to dot-com oriented firms. Still others did it because experts told them it was the right way to organize. Regardless of the motivation, the results were the same. Of the 31 independent internet units launched from 1999–2000, none survived as an independent organization by 2002. This does not mean they went out of business. In fact, 77% were reintegrated into their parent companies. But, this re-integration can be very difficult, and can hurt the performance of parent and child alike during the transition.

Some findings from our study of online retail help ground these observations. They show that, for incumbent retailers, autonomous online ventures were much less efficient at generating revenue than integrated e-commerce operations. The differences are striking. We compared financial performance for five B2C e-commerce retail spin-offs in calendar year 2000 versus the more-integrated approaches of ten other retailers. All fifteen companies were large firms with broad experience in retail. Online revenue per employee in spin-offs averaged about a third of the more integrated firms. Return on marketing was similarly inefficient. The spin-offs were unable or unwilling to leverage existing capabilities, and paid a price for it. In the short term, they could be propped up by spending large amounts of money acquiring customers. In the longer term, however, these separated ventures simply could not compete as autonomous units and were either re-integrated or shut down.

To repeat, firms that launched e-commerce through autonomous divisions encountered two layers of problems. First, by not leveraging existing assets, they were much less efficient at generating revenue. That is, they bought revenue rather than building a loyal customer base. Second, when the parent firms attempted to re-absorb these independent ventures, they often had difficulty. The autonomous groups had become too different from their parent firms, in terms of technology, processes, people, and relationships. Reintegrating was a painful process that nearly killed many of the e-businesses.

Unfortunately, the integrated approach is far from easy. It requires an organization to have the integrative capabilities to balance the old and the new while allowing both to flourish. It requires the senior management team to encourage integration while discouraging turf battles. The innovating team must have a strong leader who is respected in both the old and the new, and a team of innovators who can bridge the gap between the old and the new. Finally, the old must have an architecture of systems and processes that allows the new to be added easily, or the new must have an architecture that allows increasing levels of integration with the old.

Many firms fail at the integrated approach because they fail to structure the team appropriately, build the right architecture or provide the right leadership in the new and the old. But, with the right integrative capabilities and processes, the integrated approach can provide tremendous advantages in terms of efficiency and market power.

Our findings about the long-term issues of autonomous units apply in many other contexts besides e-commerce. In the example presented earlier, SGI was building a new, disruptive, computing platform, and found that its spin-off was too far from the parent to be able to scale. Similarly, financial services provider State Street Bank, which used a set of highly autonomous units to build new businesses in the late 1990s, found in 2001 that it needed to integrate more tightly in order to leverage efficiencies across units.

Even Johnson & Johnson (J&J), which is well-known for its 192 autonomous operating companies, does not practice complete autonomy. Each new operating company is encouraged to use a centralized IT infrastructure service from its first day. In addition, many of J&J's marketing-focused operating companies utilize J&J shared services companies for R&D and manufacturing. J&J has even created sector-level organizations in order to build powerful synergies between different operating companies in a single industry sector. For example, it is

implementing a common CRM application across four operating companies in one industry sector in order to improve regulatory compliance and generate sales and marketing synergies.

### ***Relative Advantages of Separated and Integrated Approaches***

The evidence presented above does not mean that spin-offs are always a bad idea. After all, re-integrating a spin-off does not necessarily imply failure. But, it does imply that if a firm launches a spin-off, it should be aware of the difficulties involved. Spin-offs can provide short-term payoffs, but do not tend to last forever in a separate form. Unfortunately, spinning an organization off can create conditions that make it very difficult to spin back in again.

Let's look at the online pharmacy experience of the two largest U.S. drug store chains. In August 1998, faced with announcements that well-funded startups were about to enter the online arena, CVS and Walgreens needed to consider how to respond. CVS executives initially considered building the internet store internally, but then decided to look externally. They spent \$30 million in May 1999 to acquire a startup. After the acquisition, CVS management established some reporting relationships inside headquarters, but left the e-commerce group intact 3000 miles away in Seattle, with its own president and all the functions it needed to be a self-sustaining organization. CVS changed the site's name and look-and-feel, and relaunched it as CVS.com in August 1999. There were some links to the offline business, such as allowing online customers to pick up prescriptions in a store or using offline's buying power for products, but these links were not tightly integrated.

Walgreens took a different route. After significant internal debate, they decided to use a more tightly integrated approach to moving online. In building their online site, Walgreens used people from its traditional organization that were familiar with its business and technology approach, and located the online team at headquarters. They used contractors to do much of the initial site development, but also relied on internal employees to provide critical experience. They linked the website tightly to Walgreens' existing systems for pharmacy dispensing, health insurance processing and customer prescription history. They even changed processes in over 3000 stores to help the online business and, ultimately, the firm as a whole.

Walgreens' online organization was integrated with the offline business from the start. At launch, customers had real-time access to order status, and could even get an email when their prescriptions had been filled and were waiting at a store. Soon, in-store pharmacists began taking customers' e-mail addresses and making them instant online customers, with full prescription and payment history available through the web page. If online customers chose to receive a prescription by mail, their order was handled on the same processing lines as the millions of mail-service prescriptions that Walgreens was already filling for offline clients. Later, when non-pharmacy functionality went online, those orders were filled from an existing Walgreens distribution center.

As expected, the CVS approach was faster. CVS launched its site earlier than Walgreens and, for the first year, had a higher quality site with more functionality and more customer traffic. Walgreens, on the other hand, missed its announced launch date by six weeks, and then launched with only pharmacy functionality. The non-pharmacy part of the site came a year later.

CVS.com's early lead was not sustainable, and Walgreens' tortoise soon overtook CVS' hare. CVS decided to reintegrate the CVS.com organization when it found that integrating processes and decisions across 3000 miles and two distinct organizational cultures was difficult and expensive. In the process of moving from Seattle to Rhode Island, CVS.com lost its most senior managers and half of its staff. It also lost its marketing focus, and online traffic suffered as a result. In the two years since, online performance has improved significantly. However, the transition was difficult, especially because CVS.com was so different from the CVS organization in many fundamental ways.

### ***Choosing the Right Strategy***

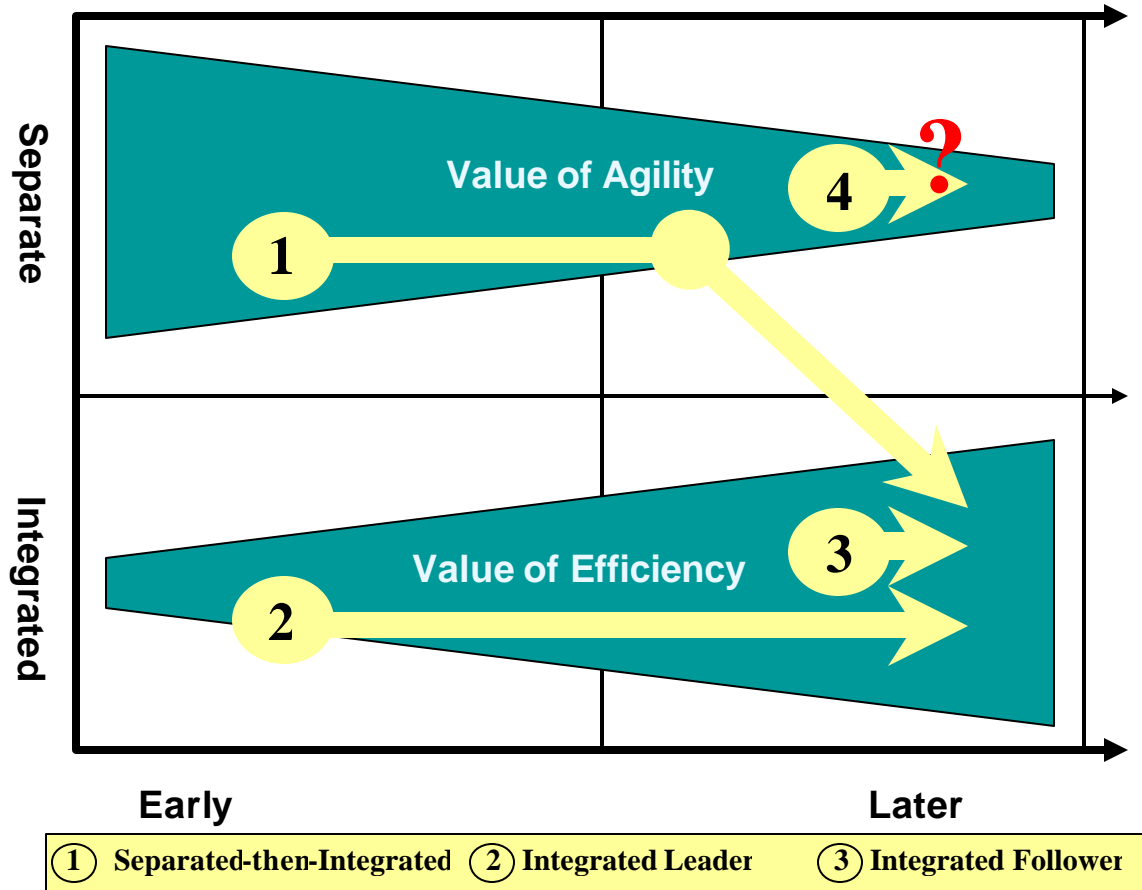
So, how can an executive think about choosing the right strategy for an innovation? The two choices of structure and entry timing depend on a firm's particular capabilities and competitive situation. Figure 1 shows the relative advantages of being separated or integrated, both early and late in the game.

#### **Early in the Life Cycle**

Early in the life cycle, there's a great deal of uncertainty. It's not clear whether the innovation will be successful in the market, or what features and pricing will work. As a result, there is a lot of jockeying for position as firms try new variations to see what sticks. Early in the life cycle, there's a real premium on speed and learning—being able to try new versions of a product or service to match the changes in the market.

The separated approach can be very useful at this stage of the game. Separated innovators can be fast, furious and focused. But, they also can spend a lot of money and effort responding rapidly to every whim of the marketplace. What's worse, they can end up varying too far from a firm's existing capabilities, making reintegration very difficult, as in the CVS experience.

The integrated approach can be useful early in the life cycle because it is much more efficient. But it requires a great deal of management attention to remove roadblocks and resolve conflicts between the old and the new. This can be very difficult, and thus the integrated approach can run the risk of never launching anything at all. Because of the difficulties of integration, especially early in the life cycle, the innovation created by an integrated team may be slower to launch or have less initial functionality than separated teams, much like the Walgreens case.



**Figure 1: Three Viable Approaches to Innovation**

### Later in the Life Cycle

Later in the game, the situation is different. As the innovation becomes better defined, there is less value in being able to quickly make major changes. By this time in the life cycle, customers have a good feel for what they want, and providers have converged on a similar set of features in their products or services.<sup>2</sup> Now the game is all about efficiency and quality—delivering the highest-quality product or service at a price customers are willing to pay. Here, it is important to be efficient in scaling the business and providing the product or service.

Later in the life cycle, the integrated approach usually outperforms the separated approach. It can use more resources from the parent company in order to scale the business. As in the Walgreens case, this approach also enables the company to find creative solutions that combine new and old for the advantage of both. The separated approach, on the other hand, has far fewer advantages later in the life cycle. It is relatively inefficient and has more difficulty leveraging the advantages of the parent.

<sup>2</sup> For more on industry dynamics and incumbent responses, see Utterback (1994) and Anderson and Tushman (1990).

So, strategically, there are three viable approaches to adopting a disruptive strategic innovation. A firm can:

1. Use the Separated-then-Integrated approach, entering early with a separated approach, knowing that at some point the inefficiencies of this approach will require re-integration.
2. Use the Integrated Leader approach, entering early with an integrated team, knowing that a good deal of management influence will be needed to make the innovation happen, but that it can reap important gains through efficiency and leveraging its market power.
3. Use the Integrated Follower approach, waiting until the innovation converges on a dominant feature set, and then entering powerfully, in an integrated way, to grab a share of the new market.

The fourth approach, being separated late in the life cycle, is usually not competitively viable. We describe the approaches below.

### **(1) Separated-then-Integrated**

Entering separated and then integrating at a later date can blend the early hare with the later tortoise. However, it requires the right architecture for processes and systems, and the right set of rules for the new organization *from the beginning*. Otherwise, the new group becomes ever-more-different from the old, making integration tougher and tougher.

Charles Schwab, when using the Separated-then-Integrated approach for online trading, avoided some of the reintegration difficulties of CVS. To provide focus and promote aggressive growth, Schwab set up its online brokerage business, e-Schwab, as an independent unit reporting directly to Co-CEO David Pottruck. This allowed e-Schwab to focus on fierce competition with E-trade and Ameritrade, even if this meant taking customers away from Schwab's traditional retail brokerage.

What is less well-known is that e-Schwab leveraged a variety of existing offline capabilities and systems. E-Schwab executives used a simple rule: deviate from the offline only where it is absolutely essential to ensure the required focus. So, the unit was led by a highly respected senior executive from Schwab's traditional retail organization and staffed with a mix of experienced Schwab people, new hires and consultants. E-Schwab's technology platform was designed to integrate with Schwab's traditional IT systems: internet trading essentially became a different front end for their legacy trading system, and integrated with other existing on-line channels and PC-based applications (such as Schwab's own Streetsmart, Intuit and MSN). Furthermore, as e-Schwab evolved, the team paid careful attention not to alienate people from the traditional retail business. Managers from e-Schwab met regularly with their colleagues in the traditional organization to resolve issues. They could do this because they already knew and liked each other, having worked together in Schwab's traditional business for many years.

These integration decisions had deep implications for e-Schwab, including restrictions on pricing models and system architecture. But they allowed e-Schwab to immediately leverage the company's traditional assets and capabilities to trump the competition. The strategy was very successful, and by early January 1998, e-Schwab was the most successful online broker in the USA with 1.2 million online accounts.

In early 1999, Schwab realized that it needed to integrate the online and offline businesses but, they did not encounter the same integration problems that CVS did. Even though reintegration had not been formally planned, Schwab had built in an option to do so. The careful attention to integration and alignment at many points made re-integrating very quick and relatively painless. By paying attention to integration even during the “separate” phase, Schwab was able to execute smoothly on a “Separated-then-integrated” strategy.

The Separated-then-integrated case can work well if a company can't find the organizational will to do the innovation in an integrated way (at least early in the game). It can also be useful if the innovation is so uncertain that the existing business cannot get motivated to do it. But, like Schwab, firms that choose this option need to manage divergence from the old and continually build-in ways to re-integrate when the time comes.

## **(2) Integrated Leader**

Entering early with an integrated approach has higher early risk, but higher long-term potential. Unless managed appropriately, integrated ventures can stall due conflicts between the new and the old, or because of simple inertia. Even if launched, the ventures may be slower than their more separated competitors. However, they have the potential to outperform separated approaches (and startups) over time because they are more resource-efficient and can use creative ways to leverage the firm's powerful existing assets for the innovation.

Of course, the integrated approach is no picnic. In order to get focus and to coordinate across the new and the old, the Integrated Leader approach requires a full-time dedicated manager, skilled team members, lots of management attention, and many communications links between the new and the old. Walgreens was able to do this successfully, but over half of the incumbent pharmacy retailers that used the integrated approach were unable to launch a competitive online pharmacy in their first attempt. Their online pharmacies sputtered along until they could reorganize with the right level of skills and management attention to build a viable bricks-and-clicks business.

Walgreens' approach required constant involvement from the CEO down. For example, Walgreens held monthly meetings of the top 12 managers in the firm in order to make sure that offline units knew what online was doing, and what they needed to do to help the online be successful. In addition, the effort was initially led by a well-respected executive who could make informal connections to the rest of the firm and who was trusted to look out for the interests of Walgreens as a whole.

Interestingly, these meetings did more than help get Walgreens.com launched. They created relationships that can now help both sides of the business. In regular meetings between online and offline executives, the nature of the conversations has changed from “What's online going to do to me now?” to “Can online do this to help me?”

## **(3) Integrated Follower**

Entering later in the game with an integrated approach is especially useful if the innovation appears to be very disruptive and its viability is unsure. Often, a firm can be better off waiting for the innovation to take shape before taking action. Then, once the decision is made, an executive can build a stronger business case for the change. The Integrated Follower approach may also

require changes in the old business in order to host the existing and the “disruptive” ones at the same time in the same organization.

Investment powerhouse Merrill Lynch used the Integrated Follower approach very successfully for online trading. Merrill was slow to adopt online trading because it was highly disruptive to Merrill’s existing business. Merrill’s traditional formula for success in the brokerage business was built around generating world-class research personally delivered by 14,000 financial consultants. Online trading, in which customers could trade without advice or even forethought, did not offer these protections. In fact, online trading was so disruptive to Merrill’s value proposition that Launny Steffens, head of the retail business, noted *“The do-it yourself model of investing, centered on Internet trading, should be regarded as a serious threat to America’s financial lives”* (Gasparino and Smith 1999).

Online trading was also a threat to the financial advisors, who earned up to 65% of their salaries from commissions. Online trading would reduce these commissions severely. Merrill’s commission system had always been problematic, causing all sorts of incentive problems, but it had traditionally been very difficult to change.

When organizations like eTrade and eSchwab seriously threatened Merrill’s business, however, management decided to act. And when it acted, Merrill did so in an integrated way. Instead of launching an external venture that could compete in the online trading channel without requiring Merrill to change its existing business model, Merrill’s managers decided to take the problems on directly. They launched an online channel within the existing business, and used the online initiative as an opportunity to fundamentally rework the existing compensation system.

Merrill announced two products, Unlimited Advantage and the web-based Merrill Direct. Both products leveraged Merrill’s traditional capabilities and customer base, and were positioned as offerings that were integrated with the company’s existing operations and IT infrastructure (albeit with great pain), and offered both new and old customers a complete menu of integrated choices for trading and asset management.

The products were extremely successful and neutralized the advantages gained by Merrill’s faster-moving online competition. Perhaps even more importantly for the long run, the efforts changed many of Merrill’s traditional ways of doing business, including the compensation structure of the typical broker. Brokers moved from being paid a commission per trade to being paid a percentage of the assets they managed.

The strategy, championed passionately by Chairman David Komansky and led by former internet non-believer Launny Steffens, worked brilliantly. Leveraging deep integration across services and product lines, Merrill has outsold Schwab, its strongest online competitor, every month since the fourth quarter of 1999. Merrill embraced the new operating principles of the internet at its very core, and re-invented one of its most traditional business operations.

The Integrated-Late approach can work if (1) the company can afford to wait and (2) senior management makes a convincing case for change and then consistently pushes to implement the change powerfully.

First, as it turns out, few innovations change the world overnight so many leading firms can afford to wait a bit. But, waiting doesn't mean ignoring. Incumbents should use the time wisely to understand what is needed if they decide to act. Merrill studied online trading extensively, including surveying online and offline brokerage customers at different points in time. Then, it used what it learned to build a strong product mix that both internal and external customers liked, while building a powerful internal case about the need to change.

Second, once the decision has been made, the firm should implement in a convincing and powerful way. This approach takes a tremendous amount of direction from the top down. After Komansky made his announcements, everybody in Merrill knew the direction the firm was taking. Merrill was changing its whole organization and senior management would not tolerate anything or anyone who stood in the way.

#### **(4) What About Separated-late or Separated-forever?**

Approaches that involve separation in the long term are usually not viable. These approaches can have difficulty building the scale and market power to sustain momentum for later parts of the marathon. If considering a long-term separated venture, one can ask the following question: If the innovation can't leverage your existing assets, why are you considering it? Other firms, whose assets can be useful in the innovation, will be able to compete much more effectively.

Some firms will create a separate unit once a new business becomes too big to be part of another unit. However, the drivers for this action are different from the reasoning we describe. It's no longer a question of helping a fledgling business to thrive, but rather a question of giving a mature business the same levels of resources, controls and top management visibility that other major business units get.

Other firms will call a venture "autonomous" if its sales and marketing organizations are different from other business units. But, like J&J and other firms have found, long-term viability rarely comes from complete separateness. Successful "separate" marketing ventures still typically leverage manufacturing, financial and other assets from the parent organization.

#### ***Conclusion***

When faced with a potentially disruptive innovation, choosing between separated and integrated approaches can be complex. We've identified three viable approaches to the problem: Separated-then-integrated, Integrated Leader and Integrated Follower. Choosing the right strategy depends on the unique set of assets and capabilities firm possesses for the particular innovation it is facing. We presented some ideas that can help make the decision. If the firm has the integrative capability and the organizational will to take an integrated approach, then it can begin to benefit from the combination of new and old early in the game. If not, it can watch and wait, and act in an integrated way when the time is right and the organization is ready. Or, it can use a separated approach, but prepare all along to reintegrate later when it is clearer that the innovation has value and viability.

Regardless of the approach, two things are clear. First, all three approaches end in integration. Integration is the incumbent's advantage. It gives the venture the option of building on the parent company's powerful assets. It gives the parent a chance to learn from the venture and improve

older, broken, existing businesses. It even gives the parent and child a chance to optimize across the whole portfolio—creating a combination that is much stronger than the sum of its parts (like Merrill Lynch and Walgreens have done, and Schwab and CVS learned how to do.)

Second, in all three approaches, senior managers need to take an active role in balancing the old and the new. It may seem easier to spin off the innovators in order to avoid having to manage conflicts between the new and the old. Unfortunately, those conflicts are unavoidable. Spinning off simply delays the inevitable. And, it can make integration more difficult since the innovators and the rest of your firm become more and more different over time. By managing conflicts throughout the life of the new venture, managers can shape the evolution of new *and* old, rather than fighting fires that arise later. They also create processes and relationships in both organizations that help to not only manage conflicts, but also identify powerful strategies that combine both the new and the old.

So, our message is clear. The effectiveness of an incumbent's response to technological or strategic change should be measured not by its speed, but by its impact, and impact, for established firms, typically comes from integrating new technologies and practices with existing assets and capabilities. Choose a launch strategy that is the best fit with your integrative capabilities. Then, if you choose to be separate early, be sure you can integrate in the end. Autonomy may win sprints, but integration wins marathons. And competition, like life, is a marathon.

### ***About the Research***

This research draws on our experiences working with more than 100 firms over the course of three studies from 1995–2003. Early studies examined drivers of successful product development processes in high-technology firms such as IBM, Microsoft and Sun Microsystems (see Iansiti 1997). These included sets of in-depth interviews at each firm (often lasting several days), as well as questionnaires and statistical analyses.

Many of the cases we describe in this paper come from non-high-tech settings, reflecting our most recent research in how incumbents addressed the challenges of e-commerce (see Westerman 2002). These studies include interviews, questionnaires and financial analyses with more than 50 retailers, ranging from \$5 million to \$30 billion in size, as well as in-depth case studies on notable non-retail firms such as Tyson Foods, Merrill Lynch and Li & Fung. We supplemented this work with archival analysis on the fates of 31 internet spin-offs, using a variety of library databases.

While methods and industries varied across the studies, the message was the same. Firms that were able to build the structures and processes to leverage existing capabilities in their new products and services outperformed those that could not do so.

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