APPENDIX A

A Sketch of the Historical Pattern of Blue Ocean Creation

AT THE RISK OF OVERSIMPLIFICATION, here we present a snapshot overview of the history of three American industries—automobiles, computers, and movie theaters—from the perspective of major product and service offerings that opened new market space and generated significant new demand. This review intends to be neither comprehensive in its coverage nor exhaustive in its content. Its aim is limited to identifying the common strategic elements across key blue ocean offerings. U.S. industries are chosen here because they represent the largest and least regulated free market during our study period.

Although the review is only a sketch of the historical pattern of blue ocean creation, several patterns stand out across these three representative industries.

- There is no permanently excellent industry. The attractiveness of all industries rose and fell over the study period.
- There are no permanently excellent companies. Companies, like industries, rose and fell over time. These first two findings

both confirm and add further evidence that permanently excellent companies and industries do not exist.

- A key determinant of whether an industry or a company was on a rising trajectory of strong, profitable growth was the strategic move of blue ocean creation. The creation of blue oceans was a key catalyst in setting an industry on an upward growth and profit trajectory. It was also a pivotal determinant driving a company's rise in profitable growth, as well as its fall when another company gained the lead and created a new blue ocean.
- Blue oceans were created by both industry incumbents and new entrants, challenging the lore that start-ups have natural advantages over established companies in creating new market space. Moreover, the blue oceans created by incumbents were usually within their core businesses. In fact, most blue oceans are created from within, not beyond, red oceans of existing boundaries. Issues of perceived cannibalization or creative destruction for established companies proved to be exaggerated.[1] Blue oceans created profitable growth for every company launching them, start-ups and incumbents alike.
- The creation of blue oceans was not about technology innovation per se. Sometimes leading edge technology was present, but often it was not a defining feature of blue oceans. This was true even when the industry under examination was technology intensive, such as computers. Rather, the key defining feature of blue oceans was value innovation—innovation that was linked to what buyers value.
- The creation of blue oceans did more than contribute to strong, profitable growth; this strategic move exercised a strong, positive effect on establishing a company's standing brand name in buyers' minds.

Let's now turn to these three representative industries to let the history of blue ocean creation speak for itself. Here we begin

with the auto industry, a central form of transportation in the developed world.

The Automobile Industry

The U.S. auto industry dates back to 1893, when the Duryea brothers launched the first one-cylinder auto in the United States. At the time, the horse and buggy was the primary means of U.S. transportation. Soon after the auto's U.S. debut, there were hundreds of auto manufacturers building custom-made automobiles in the country.

The autos of the time were a luxurious novelty. One model even offered electric curlers in the back seat for on-the-go primping. They were unreliable and expensive, costing around $1,500, twice the average annual family income. And they were enormously unpopular. Anticar activists tore up roads, ringed parked cars with barbed wire, and organized boycotts of car-driving businessmen and politicians. Public resentment of the automobile was so great that even future president Woodrow Wilson weighed in, saying, "Nothing has spread socialistic feeling more than the automobile . . . a picture of the arrogance of wealth."[2] *Literary Digest* suggested, "The ordinary 'horseless carriage' is at present a luxury for the wealthy; and although its price will probably fall in the future, it will never, of course, come into as common use as the bicycle."[3]

The industry, in short, was small and unattractive. Henry Ford, however, didn't believe it had to be this way.

The Model T

In 1908, while America's five hundred automakers built custom-made novelty automobiles, Henry Ford introduced the Model T. He called it the car "for the great multitude, constructed of the best materials." Although it came in only one color (black) and one model, the Model T was reliable, durable, and easy to fix. And it was priced so that the majority of Americans could afford one. In

1908 the first Model T cost $850, half the price of existing automobiles. In 1909 it dropped to $609, and by 1924 it was down to $290.[4] In comparison, the price of a horse-driven carriage, the car's closest alternative at the time, was around $400. A 1909 sales brochure proclaimed, "Watch the Ford Go By, High Priced Quality in a Low Priced Car."

Ford's success was underpinned by a profitable business model. By keeping the cars highly standardized and offering limited options and interchangeable parts, Ford's revolutionary assembly line replaced skilled craftsmen with ordinary unskilled laborers who worked one small task faster and more efficiently, cutting the time to make a Model T from twenty-one days to four days and cutting labor hours by 60 percent.[5] With lower costs, Ford was able to charge a price that was accessible to the mass market.

Sales of the Model T exploded. Ford's market share surged from 9 percent in 1908 to 61 percent in 1921, and by 1923, a majority of American households owned an automobile.[6] Ford's Model T exploded the size of the automobile industry, creating a huge blue ocean. So great was the blue ocean Ford created that the Model T replaced the horse-drawn carriage as the primary means of transport in the United States.

General Motors

By 1924, the car had become an essential household item, and the wealth of the average American household had grown. That year General Motors (GM) unveiled a line of automobiles that would create a new blue ocean in the auto industry. In contrast to Ford's functional, one-color, single-model strategy, GM introduced "a car for every purse and purpose"—a strategy devised by chairman Alfred Sloan to appeal to the emotional dimensions of the U.S. mass market, or what Sloan called the "mass-class" market.[7]

Whereas Ford stuck with the functional "horseless carriage" concept of the car, GM made the car fun, exciting, comfortable, and fashionable. GM factories pumped out a broad array of models,

with new colors and styles updated every year. The "annual car model" created new demand as buyers began to trade up for fashion and comfort. Because cars were replaced more frequently, the used car market was also formed.

Demand for GM's fashionable and emotionally charged cars soared. From 1926 to 1950, the total number of cars sold in the United States increased from two million to seven million a year, and General Motors increased its overall market share from 20 percent to 50 percent, while Ford's fell from 50 percent to 20 percent.[8]

But the rapid growth in the U.S. auto industry unleashed by this new blue ocean could not last forever. Following GM's surging success, Ford and Chrysler jumped into the blue ocean GM had created, and the Big Three pursued the common strategy of launching new car models yearly and hitting an emotional chord with consumers by building a wide range of car styles to meet various lifestyles and needs. Slowly, bloody competition began as the Big Three imitated and matched one another's strategies. Collectively, they captured more than 90 percent of the U.S. auto market.[9] A period of complacency set in.

Small, Fuel-Efficient Japanese Cars

The auto industry, however, did not stand still. In the 1970s, the Japanese created a new blue ocean, challenging the U.S. automobile industry with small, efficient cars. Instead of following the implicit industry logic "the bigger, the better" and focusing on luxuries, the Japanese altered the conventional logic, pursuing ruthless quality, small size, and the new utility of highly gas-efficient cars.

When the oil crisis occurred in the 1970s, U.S. consumers flocked to fuel-efficient, robust Japanese cars made by Honda, Toyota, and Nissan (then called Datsun). Almost overnight the Japanese became heroes in consumers' minds. Their compact, fuel-efficient cars created a new blue ocean of opportunity, and again demand soared.

With the Big Three focused on benchmarking and matching one another, none had taken the initiative to produce functional, compact, fuel-efficient cars, even though they did see the market potential for such vehicles. Hence, instead of creating a new blue ocean, the Big Three were dragged into a new round of competitive benchmarking, only this time with the Japanese; they began to invest heavily in the production of smaller, fuel-efficient vehicles.

Nevertheless, the Big Three were still hit by a dive in car sales, with aggregate losses mounting to $4 billion in 1980.[10] Chrysler, the little brother among the Big Three, suffered the hardest hit and narrowly escaped bankruptcy by virtue of a government bailout. The Japanese car producers had been so effective at creating and capturing this blue ocean that the U.S. automakers found it hard to make a real comeback; their competitiveness and long-run viability were thrown into serious question by industry experts across the world.

Chrysler's Minivan

Fast-forward to 1984. A beleaguered Chrysler, on the edge of bankruptcy, unveiled the minivan, creating a new blue ocean in the auto industry. The minivan broke the boundary between car and van, creating an entirely new type of vehicle. Smaller than the traditional van and yet more spacious than the station wagon, the minivan was exactly what the nuclear family needed to hold the entire family plus its bikes, dogs, and other necessities. And the minivan was easier to drive than a truck or van.

Built on the Chrysler K car chassis, the minivan drove like a car but provided more interior room and could still fit in the family garage. Chrysler, however, was not the first to work on this concept. Ford and GM had had the minivan on their drawing boards for years, but they had worried that the design would cannibalize their own station wagons. Undoubtedly they passed a golden opportunity to Chrysler. Within its first year, the minivan became Chrysler's bestselling vehicle, helping the company regain its position as one of the Big Three auto manufacturers. Within three years, Chrysler gained $1.5 billion from the minivan's introduction alone.[11]

The success of the minivan ignited the sports utility vehicle (SUV) boom in the 1990s, which expanded the blue ocean Chrysler had unlocked. Built on a truck chassis, the SUV continued the progression from car to utility truck. First designed for off-road driving and towing boat trailers, the SUV became wildly popular with young families for its carlike handling, increased passenger and cargo space over the minivan, and comfortable interiors combined with the increased functionality of four-wheel drive, towing capabilities, and safety. By 1998, total sales of new light trucks (minivans, SUVs, and pickups) reached 7.5 million, nearly matching the 8.2 million new car sales.[12]

As history reveals, GM and Chrysler were established players when they created blue oceans. For the most part, however, these blue oceans were not triggered by technological innovations. The underlying technology had been around; even Ford's revolutionary assembly line can be traced to the U.S. meatpacking industry.[13] The attractiveness of the auto industry was continuously rising and falling and rising again, driven, to no small extent, by blue ocean strategic moves. The same is true for the profitable growth trends of companies in the industry. Companies' profit and growth were linked in no small way to the blue oceans they created or failed to create.

Almost all these companies are remembered for the blue oceans they have created across time. Ford, for example, has suffered significantly at times, but its brand still stands out largely for the Model T it created some one hundred years ago.

The Computer Industry

Let's now turn to the computer industry, which supplies a central component of work environments across the globe. The U.S. computer industry traces back to 1890, when Herman Hollerith invented the punch card tabulating machine to shorten the process of data recording and analysis for the U.S. census. Hollerith's tabulator completed the census tabulations five years sooner than the preceding census.

Soon after, Hollerith left the census office to form Tabulating Machine Company (TMC), which sold its tabulators to U.S. and foreign government agencies. At the time, there was no real market for Hollerith's tabulators in business settings, where data processing was accomplished with pencils and ledgers that were easy to use, inexpensive, and accurate. Although Hollerith's tabulator was very fast and accurate, it was expensive and difficult to use, and it required continuous upkeep. Facing new competition after the expiration of his patent and frustrated after the U.S. government dropped TMC due to its steep prices, Hollerith sold the company, which was then merged with two other companies to form CTR in 1911.

The Tabulating Machine

In 1914, CTR's tabulating business remained small and unprofitable. In an attempt to turn the company around, CTR turned to Thomas Watson, a former executive at National Cash Register Company, for help. Watson recognized that there was enormous untapped demand for tabulators to help businesses improve their inventory and accounting practices. Yet he also realized that the cumbersome new technology was too expensive and complicated for businesses when their pencils and ledgers worked just fine.

In a strategic move that would launch the computer industry, Watson combined the strengths of the tabulator with the ease and lower costs of pencils and ledgers. Under Watson, CTR's tabulators were simplified and modularized, and the company began to offer on-site maintenance and user education and oversight. Customers would get the speed and efficiency of the tabulator without the need to hire specialists to train employees or technicians to fix the machines when they broke down.

Next, Watson decreed that tabulators would be leased and not sold, an innovation that helped establish a new pricing model for the tabulating machine business. On the one hand, it allowed businesses to avoid large capital expenditures, while giving them the flexibility to upgrade as tabulators improved. On the other hand, it

gave CTR a recurring revenue stream while precluding customers from buying used machines from one another.

Within six years, the firm's revenues more than tripled.[14] By the mid-1920s, CTR held 85 percent of the tabulating market in the United States. In 1924, to reflect the company's growing international presence, Watson changed CTR's name to International Business Machines Corp. (IBM). The blue ocean of tabulators was unlocked.

The Electronic Computer

Skip ahead thirty years to 1952. Remington Rand delivered the UNIVAC, the world's first commercial electronic computer, to the census bureau. Yet that year only three UNIVACs were sold. A blue ocean was not in sight until IBM's Watson—this time his son Thomas Watson Jr.—would see the untapped demand in what looked like a small, lackluster market. Watson Jr. realized the role electronic computers could play in business and pushed IBM to meet the challenge.

In 1953, IBM introduced the IBM 650, the first intermediate-sized computer for business use. Recognizing that if businesses were going to use the electronic computer, they wouldn't want a complicated machine and would pay only for the computing power they would use, IBM had made the IBM 650 much simpler to use and less powerful than the UNIVAC, and it priced the machine at only $200,000, compared with the UNIVAC's $1 million price tag. As a result, by the end of the 1950s IBM had captured 85 percent of the business electronic computer market. Revenues almost tripled between 1952 and 1959, from $412 million to $1.16 billion.[15]

IBM's expansion of the blue ocean was greatly accentuated in 1964, with the introduction of the System/360, the first large family of computers to use interchangeable software, peripheral equipment, and service packages. It was a bold departure from the monolithic, one-size-fits-all mainframe. Later, in 1969, IBM changed the way computers were sold. Rather than offer hardware, services, and

software exclusively in packages, IBM unbundled the components and offered them for sale individually. Unbundling gave birth to the multibillion-dollar software and services industries. Today, IBM is the world's largest computer services company, and it remains the world's largest computer manufacturer.

The Personal Computer

The computer industry continued its evolution through the 1960s and 1970s. IBM, Digital Equipment Corporation (DEC), Sperry, and others that had jumped into the computer industry expanded operations globally and improved and extended product lines to add peripherals and service markets. Yet in 1978, when the major computer manufacturers were intent on building bigger, more powerful machines for the business market, Apple Computer, Inc., created an entirely new market space with its Apple II home computer.

However, contrary to conventional wisdom, the Apple was not the first personal computer on the market. Two years earlier, Micro Instrumentation and Telemetry Systems (MITS) had unveiled the Altair 8800. The Altair was released with high expectations in computer hobbyist circles. *Business Week* quickly called MITS the "IBM of home computers."

Yet MITS did not create a blue ocean. Why? The machine had no monitor, no permanent memory, only 256 characters of temporary memory, no software, and no keyboard. To enter data, users manipulated switches on the front of the box, and program results were displayed in a pattern of flashing lights on the front panel. Unsurprisingly, no one saw much of a market for such difficult-to-use home computers. Expectations were so low that in that same year Ken Olsen, president of Digital Equipment, famously said, "There is no reason for any individual to have a computer in their home."

Two years later, the Apple II would make Olsen eat his words, creating a blue ocean of home computing. Based largely on existing technology, the Apple II offered a solution with an all-in-one design in a plastic casing, including the keyboard, power supply, and

graphics, that was easy to use. The Apple II came with software ranging from games to businesses programs such as the Apple Writer word processor and the VisiCalc spreadsheet, making the computer accessible to the mass of buyers.

Apple changed the way people thought about computers. Computers were no longer products for technological "geeks"; they became, like the Model T before them, a staple of the American household. Only two years after the birth of the Apple II, Apple sales were more than 200,000 units a year, with Apple placed on the *Fortune* 500 list at three years of age, an unprecedented feat.[16] In 1980 some two dozen firms sold 724,000 personal computers, bringing in more than $1.8 billion.[17] By the next year, twenty other companies entered the market, and sales doubled to 1.4 million units, racking in almost $3 billion.[18]

Like a stalking horse, IBM waited out the first couple of years to study the market and the technology and to plan the launch of its home computer. In 1982, IBM dramatically expanded the blue ocean of home computing by offering a far more open architecture that allowed other parties to write software and develop peripherals. By creating a standardized operating system for which outsiders could create the software and peripheral components, IBM was able to keep its cost and price low while offering customers greater utility. The company's scale and scope advantages allowed it to price its PC at a level accessible to the mass of buyers.[19] During its first year, IBM sold 200,000 PCs, nearly matching its five-year projection; by 1983 consumers had bought 1.3 million IBM PCs.[20]

Compaq PC Servers

With corporations across the United States buying and installing PCs throughout their organizations, there was a growing need to connect PCs for simple but important tasks such as sharing files and printers. The business computer industry spawned by the IBM 650—and jumped into by HP, DEC, and Sequent, to name a few—offered high-end enterprise systems to run corporations' critical

missions, as well as numerous operating systems and application software. But these machines were too expensive and complex to justify handling simple but important needs such as file and printer sharing. This was especially true in small to midsize companies that needed to share printers and files but did not yet require the huge investment of a complex minicomputer architecture.

In 1992, Compaq changed all that by effectively creating the blue ocean of the PC server industry with its launch of the ProSignia, a radically simplified server that was optimized for the most commonly used functions of file and printer sharing. It eliminated interoperability with a host of operating systems, ranging from SCO UNIX to OS/3 to DOS, that were extraneous to these basic functions. The new PC server gave buyers twice a minicomputer's file and print sharing capability and speed at one-third the price. As for Compaq, the dramatically simplified machines translated into much lower manufacturing costs. Compaq's creation of the ProSignia, and three subsequent offerings in the PC server industry, not only fueled PC sales but also grew the PC server industry into a $3.8 billion industry in less than four years.[21]

Dell Computer

In the mid-1990s, Dell Computer Corporation created another blue ocean in the computer industry. Traditionally, computer manufactures competed on offering faster computers having more features and software. Dell, however, challenged this industry logic by changing the purchasing and delivery experiences of buyers. With its direct sales to customers, Dell was able to sell its PCs for 40 percent less than IBM dealers while still making money.

Direct sales further appealed to customers because Dell offered unprecedented delivery time. For example, the time it took from order to customer delivery at Dell was four days, compared with its competitors' average of more than ten weeks. Moreover, through Dell's online and telephone ordering system, customers were given the option to customize their machines to their liking. In the mean-

time, the built-to-order model allowed Dell to significantly reduce inventory costs.

Today Dell is the undisputed market leader in PC sales, with revenues skyrocketing from $5.3 billion in 1995 to $35.5 billion in 2003. Its U.S. market share grew from 2 percent to more than 30 percent in the same period.[22]

As with the auto industry, the blue oceans in the computer industry were not unleashed by technology innovations per se but by linking technology to elements valued by buyers. As in the case of the IBM 650 and the Compaq PC server, the value innovation often rested on simplifying the technology. We also see industry incumbents—CTR, IBM, Compaq—launching blue oceans as much as we see new entrants, such as Apple and Dell. Each blue ocean has reinforced the originating company's standing brand name and has led to a surge not only in its profitable growth but in the profitable growth of the computer industry overall.

The Movie Theater Industry

Now let's turn to the movie theater industry, which offers a way for many of us to relax after work or on weekends. The U.S. movie theater industry can be traced back to 1893, when Thomas Edison unveiled the Kinetoscope, a wooden cabinet inside which light was projected through a reel of film. Viewers saw the action through a peephole one at a time, and the performance was called a "peep show."

Two years later, Edison's staff developed a projecting kinetoscope, which showed motion pictures on a screen. The projecting kinetoscope, however, did not take off in any meaningful way. The clips, each several minutes long, were introduced between vaudeville acts and at theaters. The aim was to lift the value of live entertainment performances, the focus of the theater industry, rather than to provide a discrete entertainment form. The technology was there for the movie theater industry to ignite, but the idea to create a blue ocean had not yet been planted.

Nickelodeons

Harry Davis changed all that by opening his first nickelodeon theater in Pittsburgh, Pennsylvania, in 1905. The nickelodeon is widely credited with launching the movie theater industry in the United States, creating a huge blue ocean. Consider the differences. Although most Americans belonged to the working class at the beginning of the twentieth century, the theater industry until then concentrated on offering live entertainment, such as theater, operas, and vaudeville, to the social elite.

With the average family earning only $12 a week, live entertainment simply wasn't an option. It was too expensive. Average ticket prices for an opera were $2, and vaudeville was 50 cents. For the majority, theater was too serious. With little education, the theater or opera just wasn't appealing to the working class. It was also inconvenient. Productions played only a few times a week, and with most theaters located in the well-heeled parts of the city, they were difficult to get to for the mass of working-class people. When it came to entertainment, most Americans were left in the dark.

In contrast, the price of admission to Davis's nickelodeon theater was 5 cents (thus explaining the name). Davis kept the price at a nickel by stripping the theater venue to its bare essentials—benches and the screen—and placing his theaters in lower-rent, working-class neighborhoods. Next he focused on volume and convenience, opening his theaters at eight in the morning and playing reels continuously until midnight. The nickelodeons were fun, playing slapstick comedies accessible to most people regardless of their education, language, or age.

Working-class people flocked to nickelodeons, which entertained some seven thousand customers per day. In 1907 the *Saturday Evening Post* reported that daily attendance at nickelodeons exceeded two million.[23] Soon nickelodeons set up shop across the country. By 1914 the United States had eighteen thousand nickelodeons, with seven million daily admissions.[24] The blue ocean had grown into a half-billion-dollar industry.

The Palace Theaters

As the nickelodeon's blue ocean reached its peak, in 1914 Samuel "Roxy" Rothapfel set out to bring the appeal of motion pictures to the emerging middle and upper classes by opening the country's first Palace Theater in New York City. Until that point, Rothapfel had owned a number of nickelodeons in the United States and was best known for turning around struggling theaters across the country. Unlike nickelodeons, which were considered lowbrow and simplistic, Rothapfel's Palace Theaters were elaborate affairs, with extravagant chandeliers, mirrored hallways, and grand entranceways. With valet parking, plush "love seats," and longer films with theatrical plots, these theaters made going to the movies an event worthy of theater- or operagoers, but at an affordable price.

The picture palaces were a commercial success. Between 1914 and 1922, four thousand new Palace Theaters opened in the United States. Movie-going became an increasingly important entertainment event for Americans of all economic levels. As Roxy pointed out, "Giving the people what they want is fundamentally and disastrously wrong. The people don't know what they want . . . [Give] them something better." Palace Theaters effectively combined the viewing environment of opera houses with the viewing contents of nickelodeons—films—to unlock a new blue ocean in the cinema industry and attract a whole new mass of moviegoers: the upper and middle classes.[25]

As the wealth of the nation increased and Americans headed for the suburbs to fulfill the dream of a house with a picket fence, a chicken in every pot, and a car in every garage, the limitations of further growth in the Palace Theater concept began to be felt in the late 1940s. Suburbs, unlike major cities or metropolitan areas, could not support the large size and opulent interiors of the Palace Theater concept. The result of competitive evolution was the emergence of small theaters in suburban locations running one movie per week. Although the small theaters were "cost leaders" compared with Palace Theaters, they failed to capture people's imagi-

nations. They gave people no special feeling of a night out, and their success depended solely on the quality of the film being played. If a film was unsuccessful, customers saw no reason to come, and the theater owner lost money. With the industry increasingly taking on a has-been status, its profitable growth was flagging.

The Multiplex

Yet, once again, the industry was set on a new profitable growth trajectory through the creation of a new blue ocean. In 1963, Stan Durwood undertook a strategic move that turned the industry on its head. Durwood's father had opened his family's first movie theater in Kansas City in the 1920s, and Stan Durwood revitalized the movie theater industry with the creation of the first multiplex in a Kansas City shopping center.

The multiplex was an instant hit. On the one hand, the multiplex gave viewers a greater choice of films; on the other, with different-sized theaters in one place, theater owners could make adjustments to meet varying demands for movies, thereby spreading their risk and keeping costs down. As a result, Durwood's company, American Multi-Cinema, Inc. (AMC), grew from a small-town theater to become the second largest movie company in the nation, as the blue ocean of the multiplex spread across America.

The Megaplex

The launch of the multiplex created a blue ocean of new profitable growth in the industry, but by the 1980s the spread of videocassette recorders and satellite and cable television had reduced movie attendance. To make matters worse, in an attempt to capture a greater share of a shrinking market, theater owners split their theaters into smaller and smaller viewing rooms so that they could show more features. Unwittingly, they undermined one of the industry's distinctive strengths over home entertainment: large screens. With first-run movies available on cable and videocassette

only weeks after release, the benefit of paying more money to see movies on a slightly larger screen was marginal. The movie theater industry fell into a steep decline.

In 1995, AMC again re-created the movie theater industry by introducing the first twenty-four-screen megaplex in the United States. Unlike the multiplexes, which were often cramped, dingy, and unspectacular, the megaplex had stadium seating (for unobstructed views) and comfortable easy chairs, and it offered more films and superior sight and sound. Despite these improved offerings, the megaplex's operating costs are still lower than the multiplex's. This is because the megaplex's location outside city centers—the key cost factor—is much cheaper; its size gives it economies in purchasing and operations and more leverage with film distributors. And with twenty-four screens playing every available movie on the market, the place, and not the movie, becomes the draw.

In the late 1990s, average per-customer revenues at AMC megaplexes were 8.8 percent above those of the average multiplex theater. The cinema clearance zones of movie theaters—the radius of the area from which people will come to the cinema—jumped from two miles in the mid-1990s to five miles for AMC's megaplex.[26] Between 1995 and 2001, overall motion picture attendance grew from 1.26 billion to 1.49 billion. Megaplexes constituted only 15 percent of U.S. movie screens, but they accounted for 38 percent of all box-office revenues.

The success of the blue ocean created by AMC caused other industry players to imitate it. Too many megaplexes were built in too short a time, however, and many of them had closed by 2000 because of a slowing economy. Again the industry is ripe for a new blue ocean to be created.

This is only a sketch of the American movie theater industry, but the same general patterns appear as in the other examples. This has not been a perpetually attractive industry. There has not been a perpetually excellent company. The creation of blue oceans has been a key driving factor in a company's and the industry's profitable growth trajectory, with blue oceans being created here

mainly by incumbents such as AMC and Palace Theaters. As history reveals, AMC created a blue ocean in the U.S. movie theater industry first with the multiplex and then with megaplex, twice resetting the course of development for the entire industry and twice bringing its own profitability and growth to a new level. At the heart of these blue oceans was not technology innovation per se but value-driven innovation, what we call value innovation.

Looking across the sketches of these three industries we find that whether or not a company can attain sustained profitable growth depends largely on whether it can continuously stay in the forefront during consecutive rounds of blue ocean creation. Lasting excellence is scarcely achievable for any company; to date, no company has been able to lead journeys into blue oceans continuously over the long run. However, companies with powerful names are often those that have been capable of reinventing themselves by repeatedly creating new market space. In this sense, there have been no perpetually excellent companies up till now, but companies can hope to maintain excellence by adhering to excellent strategic practice. With marginal deviations, the pattern of blue ocean creation exemplified by these three representative industries is consistent with what we observed in the other industries in our study.

APPENDIX B

Value Innovation

A Reconstructionist View of Strategy

THERE ARE BASICALLY TWO DISTINCT VIEWS on how industry structure is related to strategic actions of industrial players.

The *structuralist* view of strategy has its roots in industrial organization (IO) economics.[1] The model of industrial organization analysis proposes a structure-conduct-performance paradigm, which suggests a causal flow from market structure to conduct and performance. *Market structure*, given by supply and demand conditions, shapes sellers' and buyers' *conduct,* which, in turn, determines *end performance*.[2] Systemwide changes are induced by factors that are external to the market structure, such as fundamental changes in basic economic conditions and technological breakthroughs.[3]

The *reconstructionist* view of strategy, on the other hand, is built on the theory of endogenous growth. The theory traces back to Joseph A. Schumpeter's initial observation that the forces that change economic structure and industry landscapes can come from

within the system.[4] Schumpeter argues that innovation can happen endogenously and that its main source is the creative entrepreneur.[5] Schumpeterian innovation is still black-boxed, however, because it is the product of the ingenuity of entrepreneurs and cannot be reproduced systematically.

Recently, the *new growth theory* made advances on this front by showing that innovation can be replicable endogenously via an understanding of the patterns or recipes behind innovation.[6] In essence, this theoretical advancement separated the recipe for innovation—or the pattern of knowledge and ideas behind it—from Schumpeter's lone entrepreneur, opening the way for the systematic reproduction of innovation. However, despite this important advance, we still lack an understanding of what those recipes or patterns are. Absent this, knowledge and ideas cannot be deployed in action to produce innovation and growth at the firm level.

The reconstructionist view takes off where the new growth theory left off. Building on the new growth theory, the reconstructionist view suggests how knowledge and ideas are deployed in the process of creation to produce endogenous growth for the firm. In particular, it proposes that such a process of creation can occur in any organization at any time by the cognitive reconstruction of existing data and market elements in a fundamentally new way.

These two views—the structuralist and the reconstructionist—have important implications for how companies act on strategy. The structuralist view (or environmental determinism) often leads to competition-based strategic thinking. Taking market structure as given, it drives companies to try to carve out a defensible position against the competition in the existing market space. To sustain themselves in the marketplace, practitioners of strategy focus on building advantages over the competition, usually by assessing what competitors do and striving to do it better. Here, grabbing a bigger share of the market is seen as a zero-sum game in which one company's gain is achieved at another company's loss. Hence, competition, the supply side of the equation, becomes the defining variable of strategy.

Such strategic thinking leads firms to divide industries into attractive and unattractive ones and to decide accordingly whether or not to enter. After it is in an industry, a firm chooses a distinctive cost or differentiation position that best matches its internal systems and capabilities to counter the competition.[7] Here, cost and value are seen as trade-offs. Because the total profit level of the industry is also determined exogenously by structural factors, firms principally seek to capture and redistribute wealth instead of creating wealth. They focus on dividing up the red ocean, where growth is increasingly limited.

To reconstructionist eyes, however, the strategic challenge looks very different. Recognizing that structure and market boundaries exist only in managers' minds, practitioners who hold this view do not let existing market structures limit their thinking. To them, extra demand is out there, largely untapped. The crux of the problem is how to create it. This, in turn, requires a shift of attention from supply to demand, from a focus on competing to a focus on value innovation—that is, the creation of innovative value to unlock new demand. With this new focus in mind, firms can hope to accomplish the journey of discovery by looking systematically across established boundaries of competition and reordering existing elements in different markets to reconstruct them into a new market space where a new level of demand is generated.[8]

In the reconstructionist view, there is scarcely any attractive or unattractive industry per se because the level of industry attractiveness can be altered through companies' conscientious efforts of reconstruction. As market structure is changed in the reconstruction process, so are best-practice rules of the game. Competition in the old game is therefore rendered irrelevant. By stimulating the demand side of the economy, the strategy of value innovation expands existing markets and creates new ones. Value innovators achieve a leap in value by creating new wealth rather than at the expense of competitors in the traditional sense. Such a strategy therefore allows firms to largely play a non–zero-sum game, with high payoff possibilities.

How, then, does reconstruction, such as what we see in Cirque du Soleil, differ from the "combination" and "recombination" that have been discussed in the innovation literature?[9] Schumpeter, for example, sees innovation as a "new combination of productive means."

We have seen in the example of Cirque du Soleil a focus on the demand side, whereas recombination is about recombining existing technologies or productive means, often focusing on the supply side. The basic building blocks for reconstruction are *buyer value elements* that reside across existing industry boundaries. They are not *technologies* nor *methods of production*.

By focusing on the supply side, recombination tends to seek an innovative solution to the existing problem. Looking at the demand side, in contrast, reconstruction breaks away from the cognitive bounds set by existing rules of competition. It focuses on redefining the existing problem itself. Cirque du Soleil, for example, is not about offering a *better circus* by recombining existing knowledge or technologies about acts and performances. Rather, it is about reconstructing existing buyer value elements to create a new form of entertainment that offers the fun and thrill of the circus with the intellectual sophistication of the theater. Redefining the problem usually leads to changes in the entire system and hence a shift in strategy, whereas recombination may end up finding new solutions to subsystem activities that serve to reinforce an existing strategic position.

Reconstruction reshapes the boundary and the structure of an industry and creates a blue ocean of new market space. Recombination, on the other hand, tends to maximize technological possibilities to discover innovative solutions.

APPENDIX C

The Market Dynamics of Value Innovation

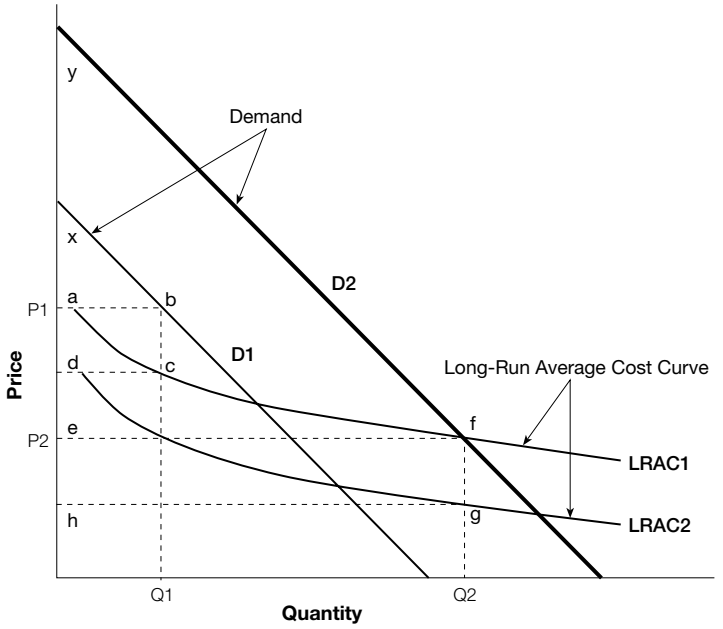
THE MARKET DYNAMICS of value innovation stand in stark contrast with the conventional practice of technology innovation. The latter typically sets high prices, limits access, and initially engages in price skimming to earn a premium on the innovation, only later focusing on lowering prices and costs to retain market share and discourage imitators.

However, in a world of nonrival and nonexcludable goods, such as knowledge and ideas, that are imbued with the potential of economies of scale, learning, and increasing returns, the importance of volume, price, and cost grows in an unprecedented way.[1] Under these conditions, companies would do well to capture the mass of target buyers from the outset and expand the size of the market by offering radically superior value at price points accessible to them.

As shown in Figure C-1, value innovation radically increases the appeal of a good, shifting the demand curve from D1 to D2. The

FIGURE C-1

The Market Dynamics of Value Innovation



price is set strategically and, as with the Swatch example, is shifted from P1 to P2 to capture the mass of buyers in the expanded market. This increases the quantity sold from Q1 to Q2 and builds strong brand recognition, for unprecedented value.

The company, however, engages in target costing to simultaneously reduce the long-run average cost curve from LRAC1 to LRAC2 to expand its ability to profit and to discourage free riding and imitation. Hence, buyers receive a leap in value, shifting the consumer surplus from axb to eyf. And the company earns a leap in profit and growth, shifting the profit zone from abcd to efgh.

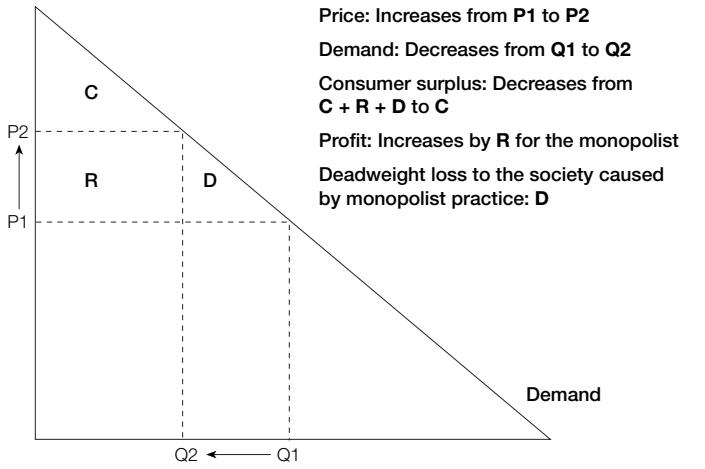
The rapid brand recognition built by the company as a result of the unprecedented value offered in the marketplace, combined with the simultaneous drive to lower costs, makes the competition nearly irrelevant and makes it hard to catch up, as economies of

scale, learning, and increasing returns kick in. What follows is the emergence of win-win market dynamics, where companies earn dominant positions while buyers also come out big winners.

Traditionally, firms with monopolistic positions have been associated with two social welfare loss activities. First, to maximize their profits, companies set prices high. This prohibits those customers who, although desiring the product, cannot afford to buy it. Second, lacking viable competition, firms with monopolistic positions often do not focus on efficiency and cost reduction and hence consume more scarce resources. As Figure C-2 shows, under conventional monopolistic practice, the price level is raised from P1 under perfect competition to P2 under monopoly. Consequently, demand drops from Q1 to Q2. At this level of demand, the monopolist increases its profits by the area R, as opposed to the situation of perfect competition. Because of the artificially high price imposed on consumers, the consumer surplus decreases from area C+R+D to area C. Meanwhile, the monopolistic practice, by consuming more of the society's resources, also incurs a deadweight loss of

FIGURE C-2

From Perfect Competition to Monopolist Practice



area D for the society at large. Monopolistic profits, therefore, are achieved at the expense of consumers and society at large.

Blue ocean strategy, on the other hand, works against this sort of price skimming, which is common to traditional monopolists. The focus of blue ocean strategy is not on restricting output at a high price but rather on creating new aggregate demand through a leap in buyer value at an accessible price. This creates a strong incentive not only to reduce costs to the lowest possible level at the start but also to keep it that way over time to discourage potential free-riding imitators. In this way, buyers win and the society benefits from improved efficiency. This creates a win-win scenario. A breakthrough in value is achieved for buyers, for the company, and for society at large.