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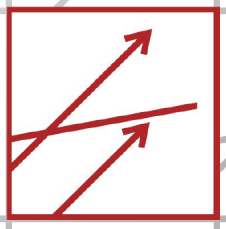
Helping Companies Succeed

Theories at Work at Rose Park



Executive Summary

The theory of **Disruptive Innovation**, popularized by the late Professor Clayton Christensen's best-selling book "The Innovator's Dilemma," explained how large, successful, and well-managed companies could be challenged and even overrun by smaller entrants into their markets. Over the past twenty-five years, disruption has become a rallying cry for Silicon Valley and entrepreneurship more broadly; it is hard to go a single day in startup circles without hearing the word 'disrupt.'

In **Selecting Investments**, we introduced how we at Rose Park use Disruptive Innovation and related frameworks when identifying and selecting investment opportunities. This companion document will illuminate how we apply these frameworks to guide founders who seek to build disruptive, generational companies. Specifically, we will review four key frameworks that are salient for company building:

Disruptive Innovation

The mechanism by which a smaller entrant with fewer resources can challenge large incumbents in an industry. Disruptive entrants first develop a business model selling products that are simpler, more convenient, or more accessible than incumbent offerings, typically catering to niche or new market segments. Over time, as disruptors successfully move up-market, they begin to challenge established incumbents who ignored the threat from below.

Good Money, Bad Money

Capital provided to startups is often patient for profits but impatient for growth. However, disruptive innovations typically require capital that is patient for growth but impatient for profits. A profit-first approach confirms the long-term viability of the business model and enables a disruptor to avoid competitive responses from incumbents who are actively seeking growth opportunities.

Capabilities and Business Models

The structure of any enterprise is best characterized by its resources, processes, and priorities. These represent a firm's business model and dictate what the firm can or cannot accomplish. A startup can disrupt incumbents insofar as its business model and corresponding capabilities are distinct.

Jobs To Be Done

The progress a customer is seeking in their distinct circumstances and context. Each Job is comprised of functional, social, and emotional components. Successful companies not only have a deep understanding of the Jobs of their customers, but their entire organization is structured to consistently help customers get their Jobs done.

The startup journey can be a treacherous and uncertain one, full of pitfalls and setbacks. Just as a compass and a map provide necessary orientation and navigation to traverse new terrain successfully, the frameworks introduced here are essential tools for any founder with ambitions to disrupt even the most entrenched incumbents.

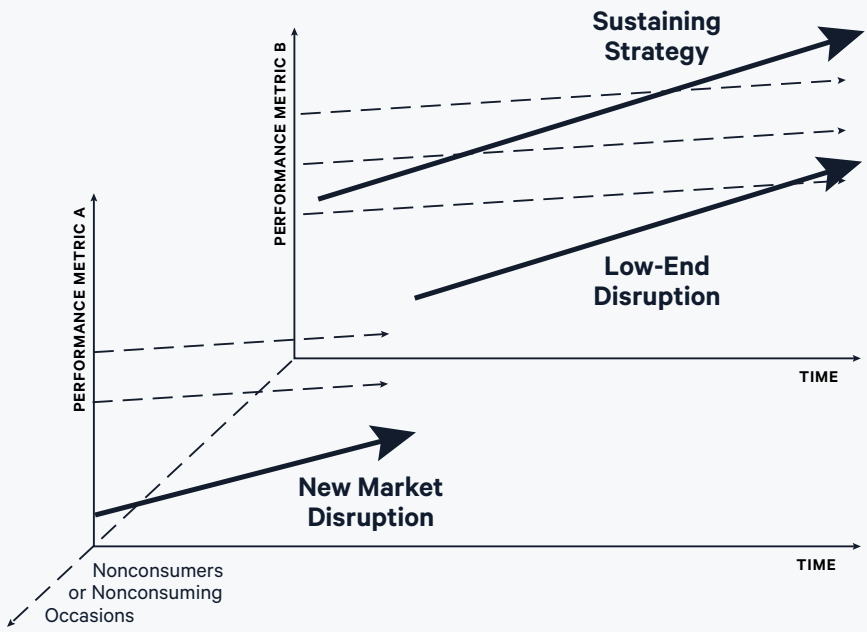
Disruptive Innovation

In Selecting Investments, we introduced the use of Disruptive Innovation and related frameworks when identifying and selecting investment opportunities. As a brief refresher, sustaining innovation is the process of taking existing products and services and making them better. Incumbent firms generally pursue a strategy of sustaining innovation for obvious reasons: as a firm improves its offerings in ways that customers already value, customers are happier, profit margins tend to increase, and shareholders reap the rewards of focused attention to a clear market opportunity. In short, managers pursue a strategy of sustaining innovation because it is the 'right' thing to do.

In contrast to sustaining innovations, a disruptive innovation seeks to exploit opportunities outside the contours of existing market offerings. Specifically, a disruptive innovation either serves customers at the low end of an established market (who aren't willing to pay for premium performance) or potential customers who aren't in the market at all due to financial, geographical, or other access constraints (we refer to this as *nonconsumption*). By targeting these initial customer segments, a disruptive innovation does not have to outperform an incumbent's best product offering. Instead, it merely needs to be good enough for those who are overserved by what the market offers or who lack market access altogether. These types of customers typically value affordability, accessibility, or convenience—precisely what a disruptive innovation provides.

Importantly, by focusing on customers that incumbents are not motivated to capture, a disruptive strategy provides a founder with a window of opportunity to develop asymmetric advantages against incumbents. These could be technological know-how, a leaner supply chain, lower-cost distribution, and many other capabilities that incumbents are not motivated to (and thus will not) develop. Collectively, these asymmetric advantages ultimately manifest in a business model—a set of resources, processes, and priorities—that incumbents cannot easily replicate.

Over time, as the disruptor's product offering improves, customers who once flocked to the incumbents will gladly adopt more convenient, accessible, and lower-cost solutions. Whether it be large companies moving to cloud-based software or individual consumers ditching inefficient, expensive American-made vehicles for inexpensive Japanese models, once customers begin leaving incumbents to consume the entrant's offerings, disruption is underway.



The Disruptive Innovation Model: Incumbents (represented by the top line) continue to move up-market via sustaining innovation, often outpacing performance offered by technological advancements. This creates customers who are 'overserved', and thus are willing to adopt affordable 'good enough' solutions provided by disruptors (the bottom line).

BOARD ROOM INSIGHTS

- **Avoid the sustaining innovation game:** Founders naturally explore market opportunities among customer sets with which they have experience. However, while leaning into known market pathways, a founder can quickly set out on a path of sustaining innovation, i.e., trying to serve mainstream customers, only 'better.' Empirical research predicts that such a road will be difficult; very capable incumbents are highly motivated to respond to any entrant that starts swimming in incumbent waters.
- **Identify nonconsumption:** Instead of evaluating existing market offerings and asking, "How could things be better," a disruptive mindset starts by considering for whom existing solutions are more than good enough or building solutions for those who lack access to a particular market offering altogether. These are opportunity spaces that incumbents are very likely to ignore.

> To pursue a disruptive strategy, especially in the earliest days of company building, a founder is best served by ensuring that their capital providers are aligned on a 'patient for growth' strategy.

- **Stay focused:** Disruption is about what a company chooses *not* to do as much as it is about what it chooses *to* do. Founders must be staunchly committed to the affordability, convenience, and simplicity they are providing to their customers and avoid the temptation to replicate incumbent business models. This can be especially difficult when customers begin asking for product features typical of incumbent offerings. When this occurs, founders must renew their commitment to the customers who value the 'good enough' performance being provided.

Good Money, Bad Money

At Rose Park, we view capital less in terms of its source (whether venture capital, corporate capital, or friends and family) but rather in terms of its *goals*. A helpful framework when navigating disruption is to consider capital as either being **patient for growth, and impatient for profit**, or conversely, **patient for profit, and impatient for growth**. Most large and established firms are driven by the latter (seeking growth over profit) because stock prices (and the source of public market or late-stage capital) can only outperform analysts' expectations where there is considerable growth. Over time, large organizations start to eschew opportunities that appear small or unknown in favor of products and services that have defined and immediate growth potential.

A focus on growth is not exclusive to large organizations; it readily manifests itself in the startup world among founders who prefer to demonstrate exciting growth metrics even if the economics of the business aren't quite yet figured out. So long as additional capital is available to invest in the business despite its losses, a startup may choose to continue its focus on growth at the expense of profitability.

When Honda entered the United States as a tiny motorcycle manufacturer in 1959, they launched the small, affordable Super Cub, marketing to consumers who weren't traditional motorcycle riders on account of costs and accessibility barriers, rather than competing directly with established makers of large, popular motorcycles such as Harley Davidson. The Super Cub offered unique advantages: it appealed to casual riders seeking convenient transportation that didn't take up much space, featured a small 50cc engine that made it approachable for new riders, and was priced at just $295 compared to traditional motorcycles that cost well over $1,000.

By focusing on early profitability despite the unclear addressable market within this segment, Honda was able to build a foothold that allowed them to develop manufacturing expertise, a distribution network, and the brand recognition needed to expand into larger and more established motorcycle markets later. If the company had tried to scale immediately in the traditional motorcycle market, it would have required a level of upfront investment and likely burned through its resources before gaining a foothold against established competitors.[1,2,3]

For a startup focused on a disruptive strategy, we have found that a 'patient for growth, impatient for profit' orientation provides a much more enduring advantage. The reason for this is twofold: first, a truly disruptive opportunity often appears small at the outset, so by definition, one that promises instant growth is more likely to be in the realm of sustaining innovation, i.e., opportunities that incumbents are already evaluating and trying to capture.

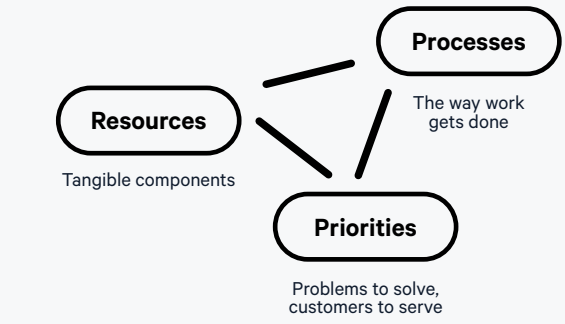
Second, by focusing first on profitability, a disruptive founder can begin to build out a capability set that incumbents are unable to replicate. If the startup can make money in ways that incumbents cannot, then the move up-market promises ever more powerful advantages once the disruptor is competing head-on with established incumbents. By that time, even if an incumbent wanted to respond to the disruptive threat, it would not have the ability to profitably do so.

BOARD ROOM INSIGHTS

- **Find 'aligned' capital:** A startup's strategic choices are heavily influenced by its capital sources. To pursue a disruptive strategy, especially in the earliest days of company building, a founder is best served by ensuring that their capital providers are aligned on a 'patient for growth' strategy.
- **Experiment before scaling:** The size of a disruptive market is often unknowable at the outset; otherwise, incumbents would have already exploited it. Patience for growth ensures that a founder can properly assess the opportunity and craft their business model accordingly to capture the market.
- **Market insurance:** Positive cash flow allows the firm to weather the unpredictability of market expectations. For example, company valuations in the decade before 2022 were driven almost exclusively by growth, with the implicit assumption that profitable economics would follow a firm with an explosive growth rate. This siren song unfortunately befuddled many founders and investors alike; once the market shifted its focus to profitability, company valuations fell by over 50% by Q4 2022, and Seed to Series A graduation rates took a nearly 5x hit in 2023 after falling from 25% to 5%.[4,5] Focusing on profitability early positions founders to weather this type of uncertainty.
- **Build the foundation:** The simplest and surest way to guarantee a firm will have the opportunity to move up-market and compete with incumbents in a consistently advantaged way, rather than remaining a low-end or niche solution, is to demonstrate profitability early. Every company's cost structure determines the customers it can and cannot serve, and thus the lower a disruptive entrant can profitably begin, the greater the potential upside.

Capabilities and Business Model Theory

The capabilities of an organization determine what it can and cannot accomplish. We have found it helpful to understand the capabilities of any firm through three foundational elements—**resources, processes, and priorities (RPP)**. Together, these elements constitute a firm's business model.[6]



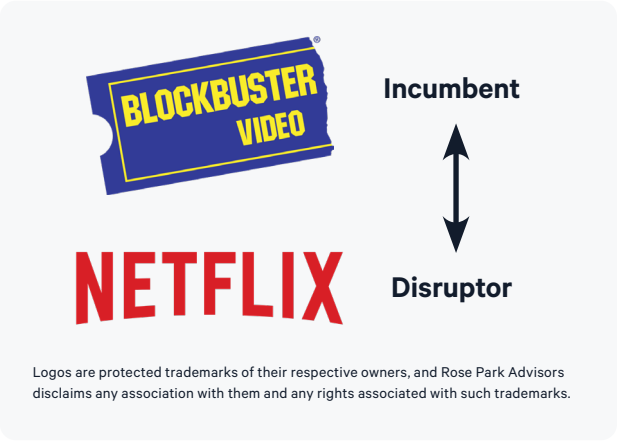
Resources are the tangible components of an organization that can be bought, sold, hired, or fired as circumstances dictate. These consist of people, infrastructure, cash, relationships, equipment, technology, and information. Processes represent the way work gets done. These include patterns of interaction, coordination, decision making, product development, and so on. Some processes are very visible, while others are less so. Unlike resources, processes are generally less fluid and not meant to change. Finally, a firm's priorities are determined both by the problems they aim to solve and the customers they serve, as well as how the firm makes money. Priorities typically act as constraints on a business when new opportunities are presented, such that only those that align with existing priorities are given serious consideration.

We previously introduced the idea that capabilities play in the context of disruption, i.e., by establishing a foothold among different customer segments than incumbents (rather than competing head-on), disruptors develop capabilities that incumbents are not motivated to replicate. By the time an incumbent officially recognizes and acknowledges the threat, it is simply too late to develop these capabilities. Christensen famously wrote that "a firm's capabilities become *disabilities* when disruption is afoot."

A storied example illustrating the role capabilities play in disruption is seen in Blockbuster and Netflix, the latter of which began sending DVDs over mail (and eventually online) while the former was well-established, serving customers at physical retail stores. Around the time of Netflix's founding (1997), Blockbuster was a multi-billion-dollar behemoth. It maintained thousands of stores, each with thousands of titles for rent, and it was estimated that each store earned an annual operating profit of $162,000. Its primary resources consisted of relationships with film studios and a sprawling real estate footprint, its processes involved purchasing and maintaining access to top releases and managing returns from its customers, and its priority set was oriented around maximizing revenue for each title, including capturing late fees from its customers (which at one point represented 10% of company revenues).

Netflix, in contrast, developed an entirely different set of RPPs. Without real estate, the company learned to master distribution through arrangements with the postal service and the buildout of distribution centers. Due to the cost of accessing the latest movie releases, Netflix developed software to learn more about customer preferences and taste, the result of which was not only a longer tail of rented movies but also improved inventory management and cost control. Finally, a priority on customer access (versus one-time rental) led the company to pioneer a subscription-based revenue model, one that would endure as it moved to an online delivery model.

Blockbuster management saw Netflix on the horizon, though, as we have learned about how much credence incumbents give to disruptive entrants, management viewed Netflix as serving a 'niche' market. One spokesperson for the company declared, "We have not seen a business model that's financially viable long-term in this arena. Online rental services are serving a niche market." From the perspective of Blockbuster, this was likely a very accurate statement. The company's well-established RPPs blinded management's ability to see any reason to develop meaningful capabilities



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for an online world. Even as stores began to shutter in the mid-2000s, in 2007 Blockbuster's board brought on James Keyes, the former CEO of 7-Eleven, to bring operations and retail expertise (i.e., not online distribution) to the company.

By the time Blockbuster tried to compete with Netflix head-on with Blockbuster Total Access and Blockbuster Online, the company was not able to generate sufficient cash flow to continue with online-focused approaches. Blockbuster filed for bankruptcy in 2010, and at the time of this writing, Netflix's market capitalization is over $400 billion.

BOARD ROOM INSIGHTS

- **Develop distinct capabilities:** A helpful question for a founder to ask when pursuing a disruptive strategy is, "Am I building the same set of capabilities as incumbents in my industry?" If the sales motions, suppliers, customers, data sets, pricing structures, and the talent being hired all mirror that of the incumbent, it's a good sign that a founder will end up in a battle of sustaining innovation.
- **Evaluate RPPs early and often:** A concerted focus on RPPs is useful in any founding context, in a disruptive one. Whether launching a new product or experimenting with a new pricing model, founders are wise to reflect on whether company priorities and processes are in place to accomplish the stated objective. This can be especially useful when capital constrains what a company is able to accomplish or when founders are considering what to outsource versus perform in-house.
- **Profit formulas bring focus:** The priorities of any firm are primarily manifested through the profit formula it establishes. Over time, how the company chooses to make money will determine the resources it acquires and the processes it develops.

Jobs To Be Done

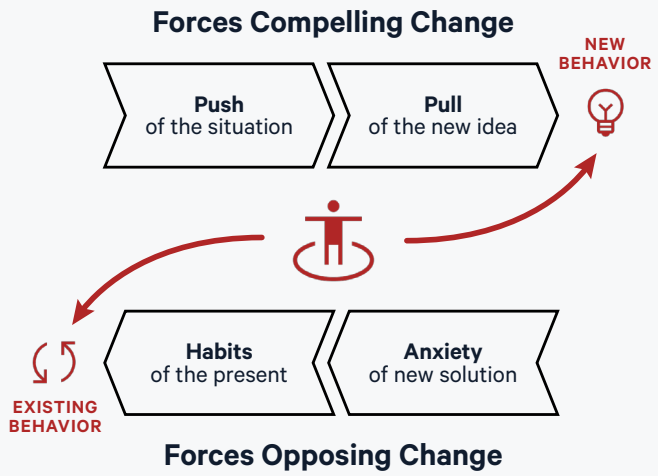
While each of the frameworks introduced here and in Selecting Investments offers key strategic insights for founders in a disruptive context, perhaps none is more practical than **Jobs To Be Done (JTBD)**. As a refresher, when we refer to a 'Job,' we mean the progress that a customer seeks in a particular circumstance. The progress customers seek is often not purely functional—most Jobs To Be Done are also comprised of social and emotional dimensions that surround a purchase decision. For instance, a consumer may want clear skin (functional) to feel more confident (emotional), so that they can impress a romantic interest (social).

Founders can discover JTBD in the wild by looking carefully at the tradeoffs individuals make in the pursuit of progress, and for many, the tradeoff is to simply go without. For example, plenty of older individuals who would have otherwise wanted to advance their careers simply didn't have the time or money to pay for college degrees until Southern New Hampshire University's (SNHU) College for America came on the scene in 2013. SNHU's affordable, time-agnostic, competency-based approach catered to nonconsumers of college education by directly addressing adult learners' Jobs To Be Done.

There were plenty of online college offerings before SNHU, including market-leading University of Phoenix.[7] However, these offerings were exclusively time- or credit-hour-based, meaning students had to pay for each credit required to complete a degree. SNHU introduced a competency-based model that gave adults the opportunity to demonstrate skills developed over their professional lives, allowing them to gain credits for past experience. This reduced the required number of credits to complete the degree. Together with cost-saving measures in curriculum design and instruction, SNHU's completion rate exceeded other offerings even as it cost 30% less than competitors.[8]

While many JTBD examples come from consumer contexts, the framework is in business-to-business (B2B) settings. For example, a supply chain software platform might help operations managers shorten delivery times (functional), reduce workplace stress (emotional), and earn recognition within their organizations for efficiency gains (social). In these contexts, understanding the underlying Job can be the difference between offering another tool and delivering a solution that becomes essential to how the customer operates.

Product marketers and advertisers are quick to highlight a product's features or attributes to convince potential customers why one product is superior to another. Customers, however, do not make purchase decisions on the level of features; they operate at the level of progress. Consider, for example, the case of Bob Moesta (co-creator of the JTBD theory), who once worked with a Detroit-based building company seeking to improve sales of its 'empty-nester' condominium complex. Many people came to inspect what could only be described as 'feature-rich' units, with high-end touches like bay windows and granite countertops. But the prospective customers cared far less about these features than they did about the functional and emotional toll of downsizing. Specifically, they needed time and space to let go of their cherished family memories and they wanted adequate space for their family's dining room table, which represented years of family dinners and holiday gatherings.



The Forces of Progress: The top row consists of positive forces, which include Pushes (things that cause people to want change) and Pulls (a clear vision of a solution to a problem), and the bottom row are negative forces that include Anxieties (things that prevent a customer from choosing something new) and Habits (inertia that prevents change when the status quo is working). When the pushes and the pulls overcome the habits and anxieties a customer faces, a customer will ultimately make a purchase decision to capture the progress they are seeking.

By increasing the length of the dining room to provide adequate space for tables and by providing an on-site storage unit to give customers time to sort through their cherished belongings, sales grew by 25%. This growth was even more unprecedented amidst the backdrop of the broader Detroit real estate market, which was experiencing a 49% decline in sales.

An organization that is oriented squarely around JTBD can be highly defensible, particularly once customers recognize a firm's brand as being the one that will consistently bring the progress they are seeking. This often results in a firm becoming a 'verb' that is used in customers' everyday speech, such as 'googling' for information or 'photoshopping' a picture. As a firm predictably and repeatably nails a Job To Be Done, the risk of customer churn or losing out to competition decreases.

Maintaining consumer sentiment as the best solution to get the Job done requires consistent focus on the customer, especially as an organization starts to scale. Brian Chesky, CEO of Airbnb, lamented the company falling further away from the customer JTBD during a growth period: "As we went on this hyper-growth rocket ship from 2009 to 2019, over the ten-year period, I think we got further and further removed from the customer. We went from us talking to customers, to hiring people to talk to customers, to people who manage people who manage people who talk to customers."[9]

> We affirm that a disruptive approach promises the most impact on markets, consumers, shareholders, and society at large.

BOARD ROOM INSIGHTS

- **More than 'pain points':** The nuance of a customer's JTBD goes beyond mere 'pain points.' Successful founders identify the struggling moments in all their functional, social, and emotional complexity and can articulate the forces at work when customers make purchase decisions.
- **Stay focused on the 'Job':** Once a startup launches its first product, customers will clamor for additional features and improvements. Some of these requests will be germane to the JTBD being addressed, while others are distractions. We find it helpful to advise founders to evaluate feature requests in terms of whether they will ultimately help a customer feel that their Jobs are getting done more effectively.
- **Align the organization:** The resources, processes, and priorities of a firm need to communicate to current and prospective customers, "We understand you." This becomes increasingly important as a company grows, lest customers leave to find better alternatives.
- **Look beyond the metrics:** Negative company performance metrics (whether shrinking conversion rates, increased churn, or customer acquisition costs) are typically lagging indicators of a company that has lost perspective on the customer's JTBD. We advise founders to first look at their products and their customers before pointing the finger at operational shortfalls.

Conclusion

A founder's journey when building a business is replete with strategic choices. If better decision-making can improve the success odds for a startup even slightly, the impact on teams, customers, and shareholders is immense. We believe the frameworks introduced here provide founders with a vital foundation upon which to make strategic choices that will improve the odds of success. This belief is rooted not only in the empirical research of the late Professor Clayton Christensen, which demonstrates the benefits of a disruptive strategy, but in the numerous founders who have been inspired by his research and who have built remarkably successful enterprises.

While every startup opportunity is distinct, the initial choice of customers, maintaining an 'impatient for profitability' mindset, carefully evaluating RPPs, and remaining laser-focused on customer Jobs To Be Done are essential to any founder seeking to build a disruptive business, and we at Rose Park guide founders accordingly.

Endnotes

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