ENTREPRENEURSHIP

The **New-Market** Conundrum

In emerging industries the usual rules of strategy don't apply.

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ABOUT THE ART

In his photographs, Julien Mauve imagines what it would be like to discover an entirely new world. His work explores our desire to affirm our presence in the landscapes around us.

IDEA IN BRIEF

THE CHALLENGE

Executives struggle to formulate strategies and business models for newly emerged markets because the forces of competition there are constantly in flux. In such an environment, conventional strategic approaches just don't work.

THE INSIGHT

Research shows that in brand-new markets, the most successful start-ups practice something we call parallel play, *exploring and testing their world the way young children do.*

THE CONCEPT IN PRACTICE

Early on, forget about differentiation. Instead, observe what others in the market are doing and borrow from them. Experiment relentlessly and then commit to a single template for creating value. But don't go full speed ahead with it; leave your model purposely undetermined and wait until the market settles before optimizing it.

The past two decades have seen the birth of an unprecedented number of new-to-the-world markets.

Technologies such as cloud services, warehouse robotics, and smartphones have redefined entire industries, making old business categories obsolete. A steady stream of emerging innovations—from commercial drones and autonomous trucks, to virtual and augmented reality, to plant-based meat substitutes—suggests the era of market creation will continue for the foreseeable future.

From a strategic point of view, new markets are like science fiction's wormholes, where conventional rules of time and space do not apply. In new markets the questions that typically define a company's strategy—where to play and how to win—have no easy answers. Large companies that invest millions may find themselves outflanked by brash start-ups; today's winners may be tomorrow's losers. PayPal, for example, is now the clear leader in online payments, but in the market's first years the top competitor was a company called Billpoint. 23andMe took an early lead in personal genomics, but who will ultimately dominate that market remains up in the air.

It's tempting to think of pioneers of new markets as conquering a totally foreign terrain with no recognizable landmarks or proven navigational tools. But in our research into

patterns of success and failure in new markets, we've uncovered something unexpected. Over the past few years, we've conducted more than 200 interviews with entrepreneurs and corporate innovators in fields ranging from personal genomics and augmented reality to drones and technology-enabled finance ("fintech"). What we learned is that the most successful of these pioneers follow the same set of implicit rules and share specific behaviors. These rules and patterns often defy conventional precepts of strategy and business building, however. In our eyes they amount to a new strategic framework—one that can help other innovators chart a course in new markets and avoid the pitfalls they present.

An Alternative to **Conventional Strategy**

In traditional business thinking, the essence of strategy is choosing to perform activities differently than rivals do. A winning strategy positions a company to deliver some sort of value better than anyone else does: to serve a particular set of customers more effectively or to provide greater benefit at lower cost, whatever the source of the intended advantage may be. The job of the strategist is to identify competitors—both existing and potential—and then outmaneuver them. Venture capitalists reinforce this mindset by requiring founders of start-ups to list their competitors and explain how they plan to distinguish themselves from the pack.

In a new market, however, this approach makes little sense. When a market (or a business category) is just forming, a company can't possibly know which points of distinctiveness are likely to be most important to customers. Moreover, the competition typically consists of small ventures that are equally in the dark. Conventional strategy frameworks just don't apply. An analysis of Michael Porter's famous five forces that affect a competitive environment—existing rivals, the bargaining power of suppliers and of customers, alternative offerings, and new entrants—is apt to be less productive when those forces are in constant flux and may suddenly emerge or disappear. (Porter has acknowledged as much: In a new industry, he has written, "managers face a high level of uncertainty about the needs of customers, the products and

The behavior of successful new-market pioneers bears a striking resemblance to the behavior of preschoolers.

services that will prove to be the most desired, and the best configuration of activities and technologies to deliver them.")

Established companies by definition have established business models. They know how to create value in a given space, and the primary strategic question is how to do so in a way that outstrips the competition. By contrast, companies in a new market don't know what business model will actually make sense; most can't even answer the age-old questions "Who is the customer?" "What does the customer value?" and "How will we deliver that value at an appropriate cost?" They may have hypotheses, but they cannot know whether their hypotheses will pan out.

Consider the early days of the ride-sharing business. In early 2012, Uber offered black cars operated by drivers with commercial licenses and charged premium prices. Zimride was a carpool-matching service for universities and companies. A company called Sidecar was seeking to become a multipassenger, multistop ride service featuring drivers with ordinary licenses. None of those fledgling business models survived intact.

The uncertainty of new markets requires a different framework for strategic thinking. We call it *parallel play*. Its inspiration comes from an unlikely setting: early childhood. As child psychologists have long known, three- and four-year-olds typically behave in a distinct fashion in a social setting: They play near one another but not together. They keep an eye on what their peers are doing (and sometimes copy them) but then return to their own projects—building a block structure, say, or creating a costume from old clothes. Occasionally, they'll grab a toy from another child. The more precocious among them may pause periodically to assess what they've done and then continue on a slightly different tack. Though aware of other children's efforts, they focus primarily on their own activities and on figuring out what "works" as they make progress toward whatever goal they have in mind.

In our research we asked executives operating in new markets to describe the strategic steps they had taken as their companies and industries evolved. We identified patterns in those descriptions and then compared the patterns with the companies' progress. That's when we discovered that the behavior of *successful* new-market pioneers bears a striking resemblance to preschoolers'. They learn about their markets and their customers—and about what is likely to work—in much the same way that young children learn about their world.

How **Parallel Play** Sets Companies Apart

Parallel play is a natural way to behave when you don't know very much. Three kinds of parallel play behaviors in particular distinguish high-performing new-market companies from their less-successful rivals.

1 **Early on, forget about differentiation. Borrow ideas instead.** Young children learn individually, but because they observe one another, any group of them is performing a kind of collective experiment, enabling each one to learn more than he or she could alone. Indeed, preschoolers often imitate one another. Rarely do they bother trying to outdo one another. Borrowing is also typical of successful new-market innovators. Again, the nascent ride-sharing category offers a good example. Sidecar opted to reduce the complexity inherent in its multipassenger, multistop model and focused instead on one-passenger, one-stop rides. The drivers would be nonprofessionals using their own cars, and the system would include such in-app features as electronic payments, GPS navigation, and a rating system for drivers. Suddenly, those features for creating value made the most sense to everybody. Zimride's service emulated Sidecar closely, and the company eventually changed its name to Lyft. Uber was not far behind, creating what it then called UberX to distinguish the peer-to-peer service from its corporate black-car service.

Astute borrowing can make the difference between a winner and an also-ran. In 1999 Google founders Larry Page and Sergey Brin knew that they had created a search engine superior to anything else available at the time. What they didn't know was how to make money with it. Display ads were out—Page and Brin considered them ugly, and they took too long to load. But the company was hemorrhaging

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cash. The two founders looked around and decided to take an idea from GoTo.com, a rival search engine that was generating ample revenue by allowing advertisers to pay for prominent placement in search results—but charging them only when users clicked on their ads. Google's new product, AdWords, introduced in 2000, maintained the integrity of the search but let advertisers buy small text ads that would appear above the results. Like GoTo, Google charged only for clicks, not for views.

The practice of borrowing runs directly counter to the conventional strategic imperative of differentiation—which traditional strategists argue is essential to avoiding the negative spiral of competing only on cost. But trying to differentiate early on in a new market can lead a company down a blind alley. A more effective approach, we argue, is to treat other companies in the space as peers rather than competitors. When we interviewed executives in a nascent fintech category, we discovered one firm that was so focused on distinguishing itself that it spent millions developing a slick user interface and proprietary algorithms to scrape data directly from brokerage accounts, nearly going broke in the process. Meanwhile, a successful rival pursued a different approach: It reproduced a peer's user interface (rather than spending resources to develop its own) and opted for a financial-analytics provider that other fintech companies had hired to gain access to shared brokerage data. Borrowing enabled the company to develop a working prototype of its product quickly and cheaply.

To be sure, borrowing is unlikely to produce an optimal business model, which is the foundational task of a new enterprise. It won't identify the product that all customers value over existing solutions or the best mechanism to profitably deliver it. But it typically lowers the amount of money and time needed to design a good-enough-for-now offering, by treating peers as a treasure trove of ideas and resources from which a company can draw. Firms can then spend more on other aspects of the business model and on testing assumptions. Borrowing also helps entrepreneurs resist the temptation to strive for an optimal solution right away—an unrealistic and unnecessary aim in a brand-new market. At this very early stage, quickly assembling a rough prototype for hands-on learning is nearly always a more useful aim than pursuing a perfect solution is.

Of course, entrepreneurs could always borrow faulty ideas. But because they focus on how to profitably deliver value to customers, they're likely to be reasonably astute judges of whether a given idea is good.

This is not to say that new-market entrepreneurs don't or shouldn't differentiate. But initially, we argue, their primary competitive focus should almost always be on an existing substitute—what the customer currently uses—not on their new-market rivals. Ride-sharing companies came to view themselves as competition for the taxi industry and ultimately for private car ownership. Google's objective was to supplant conventional advertising. The successful fintech companies we studied saw their true competition as established investment and wealth-management firms. In their messages to prospective customers and investors, they all presented themselves as superior to traditional sources of financial guidance. They mostly ignored their fintech peers (preferring to "play the course, not the players," as one company founder memorably expressed it).

A focus on established substitutes helps entrepreneurs create a realistic value proposition. Peers at this stage are likely to have few users, but established substitutes are already providing value to customers. As one fintech founder noted, viewing established substitutes as the true rivals prevented his team from "worrying about the wrong things." To be sure, this focus can be hard to achieve in practice, as many venture capitalists demand benchmarks against other start-ups, but enlightened investors and founders find other ways to measure progress. "At the early stage we are looking for companies that are nonconsensus, not companies that are better than competitors," says Ann Miura-Ko, a partner at Floodgate, a seed-stage VC firm that has backed Twitter, Lyft, and Cruise Automation. "The point isn't to fit in to someone else's landscape or category."

2 **Test relentlessly—but then commit.** When they play, young children explore a variety of projects but then commit to the one that engages them most. The idea of innovation through experimentation is by now widely accepted, though many companies continue to make the mistake of launching without much testing. But in a new market, we discovered, high-performing ventures didn't just test and learn. They used that learning to choose a single

template for creating and capturing value (that is, for monetization) and spent scarce resources *only* on it.

This goes against conventional strategic teaching, which holds that the cost and the loss of flexibility of commitment can't be justified in uncertain markets. However, our research revealed it to be key to success—provided that firms tested alternative business-model templates first. Less-successful enterprises either committed without testing (often missing out on more-lucrative opportunities) or flitted among several templates, hedging their bets without making a choice.

When the app Burbn—which enabled users located near one another to connect, make plans, and post photos of their meet-ups—proved too complicated, discouraging people from engaging with most of its features, founder Kevin Systrom began running tests to discover a template that captured what users really wanted. The outcome was a business model centered on photo sharing. Systrom next doubled down on making it possible to post a good photo with three clicks and scrapped everything else. He then renamed the app Instagram. Later, Systrom shamelessly borrowed the "stories" feature from Snapchat and incorporated it into Instagram. ("They deserve all the credit," he acknowledged to a reporter.)

Evernote offers a cautionary counterexample. It started as an elegant note-taking app but tried to spin into a lifestyle brand after strong interest from investors. The company built a chat app, a recipe app, a contact-management app, and a flashcard app, splitting itself along two very different

business-model paths: apps with a freemium model (basic product offered for free, enticing users to become paying customers for a higher-end version) and online sales of goods. Although Evernote lives on, it failed to live up to expectations. It started with a strong, useful concept, but the company's lack of commitment to one template for creating and capturing value derailed it.

For new-market enterprises, the choice of a template is a decisive fork in the road. Look at the experiences of PayPal and its erstwhile rivals in the nascent digital-payments sector. Both eMoneyMail and Billpoint forged close relationships with established banks with the aim of combating fraud. Both also limited their markets: After less than a year of operation, eMoneyMail made its service available only to Bank One customers. Similarly, eBay discouraged the use of Billpoint outside its own auction site. Executives at both companies regarded a close banking relationship and a limited customer base as the only ways to elicit trust from consumers and to keep fraud expense within manageable limits. Meanwhile, PayPal took a different road. It committed to an open, stand-alone web-based model available to all and learned from testing that ease of use was more critical to users than tight antifraud controls. Thus, as *Wired* reported, the company came to view fraud as "something akin to an R&D expense." PayPal "reimbursed customers for their losses, learned how the crooks worked, and engineered ingenious fixes" such as the now-familiar "type this" codes presented in a GIF file. Commitment to a different business model encouraged PayPal to innovate in ways that its rivals on another road never even thought about.

3 **Pause, watch, and wait.** Preschoolers' parallel play frequently involves making things, such as a sandcastle or a doll's costume. As we noted earlier, some children stop periodically to reflect on their projects before continuing. We observed similar behavior by high-performing innovators in new markets: After they committed to a general approach to creating and capturing value, they paused and looked around before nailing down the specifics of that business model.

This may be the most striking challenge to conventional theories of strategy, which nearly all assume that commitment and "full speed ahead" are the same thing. At classic lean start-ups, entrepreneurs and corporate innovators try to identify potential customers, pinpoint what they value, and aggressively optimize their operations to deliver it in a profitable way. If something goes awry, the theory is, the venture can quickly pivot to a new business model ("fail fast"). But in an evolving market, trying to perfect a business model—even one that appears to be working well—too early can be problematic. And pivoting can be costly, difficult, and time-consuming, since it typically involves unwinding and rebuilding aspects of a company's business model.

It's preferable, we learned, to leave a business model purposely undetermined. The most successful companies initially specify the basic elements of their business models (for example, a product that some customers will find superior to existing solutions and the resources to deliver it) but leave other elements undefined. In other words, they commit to a single template for creating and capturing value but postpone optimizing it.

Dropbox's early history provides insight into the benefits of watchful waiting. The start-up created enormous value by giving customers instant access to their files from any computer via a simple drag-and-drop interface; it committed to an easy-to-use product and a freemium model for capturing some of that value. Interestingly, though, the venture stopped short of tailoring its offering to consumers (although they were Dropbox's primary users at the time) or building operations around the original and most salient use case (backing up files). With its robust but undetermined model, Dropbox was able to accommodate additional use cases—sharing files and collaboration—and profitable new customers: enterprises. By the time it filed to go public, in 2018, about 30% of its 11 million paying users were on a Dropbox Business team plan.

Any new market is likely to present surprises—unforeseen customers and uses that no amount of testing would have revealed. An incomplete, partially elaborated business model increases the likelihood that innovators will acquire information that they could not easily have anticipated. As one fintech investor described it, "The fewer constraints we impose, the better, because there's more room for emergent behavior, more room to discover." A purposely undetermined business model also allows entrepreneurs' activities to evolve in step with a changing market. Users'

The new-market graveyard is filled with companies that got trapped within their original business models.

preferences shift frequently in nascent markets as people engage with innovations in unexpected ways. For example, the portable-ultrasound pioneer SonoSite created a website (SonoSite Moments) where health care providers could share how they used its ultrasonic stethoscope. That helped SonoSite learn of unintended uses and customers, such as nurses finding patients' veins before inserting a needle and medical missionaries diagnosing heart defects in children. These discoveries enabled SonoSite to adapt its business model accordingly.

The new-market graveyard is filled with companies that got trapped within their original business models. Take Shyp, which aimed to pick up and ship consumers' packages for as little as $5 (on top of postage). The company grew fast for a while, reaching a $250 million valuation; then growth slowed and losses caught up with it. Instead of pausing to explore other potential sources of value—such as shipping for businesses—it kept rushing onward. It ended up shutting down in early 2018. Companies that take a breather before refining their models, in contrast, learn by waiting and observing—which is more likely to produce unanticipated insights than other types of learning are. Because pausing is inexpensive, it is relatively low-risk. Entrepreneurs can readily resume refining the business model when the team is no longer learning much or when peers seem to be sprinting ahead.

Consider the experience of Rent the Runway, a company operating in the brand-new market for stylish rental clothing. Founders Jenn Hyman and Jenny Fleiss initially envisioned a "closet in the cloud" from which women could rent designer clothes for occasions like weddings. They tested the idea by inviting 140 women to two pop-up events. These tests helped them profile potential customers and provided insight into peripheral questions, such as whether renting clothing was an activity that women would do alone or together.

Though the initial business gained popularity, the company wanted to expand its range of offerings. A subscription-based offering of accessories and handbags met with lukewarm success. So the founders turned to watchful waiting: They looked closely at their customers and at how they hoped to use RtR. Most customers, the company realized, spent five days a week at an office. They didn't just want special-occasion clothing; they wanted stylish apparel for work. When RtR expanded in that direction, its growth was assured. Companies in mature markets have long used customers and the insights they provide to drive innovation; new-market companies can too.

It makes sense to ask why committing to a business-model template is effective in new markets but fully executing it immediately is not. Investing in two or more distinct models is simply too confusing and too costly. But once the commitment to one is made, entrepreneurs can moderate the pace at which they refine the elements of the model and gather serendipitous insights through passive learning.

THE PRECEPTS OF new-market strategy do not mean that the conventional rules of strategy should be abandoned. After a few years—the interval varies considerably, depending on the industry—a few companies will become leaders in the new markets. They are likely to reap the usual benefits that strategists identified long ago: network effects, economies of scale, market power, and so on. Rent the Runway now operates in an increasingly crowded market, with both start-ups and established retailers dipping their toes into subscription clothing services, and might need to leave a parallel play approach behind. At some point start-ups grow up, the markets they pioneered become established industries, and they must begin to observe the traditional laws of strategy and focus on competition. Every company that hopes to succeed over the long term eventually will need one or more sources of differentiation.

Entrepreneurs in new markets resemble children in that there is much they don't yet know. They operate in utterly strange but fascinating environments, where discovery and surprise are common. It makes perfect sense, then, that the most successful of them behave like preschoolers, engaging in parallel play and borrowing, testing, and watching to see what happens.

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