

MIT Sloan

Management Review

**Leonard L. Berry, Venkatesh Shankar, Janet Turner Parish,
Susan Cadwallader and Thomas Dotzel**

Creating New Markets Through Service Innovation

MIT Sloan

Management Review

PDFs ■ Reprints ■ Permission to Copy ■ Back Issues

Electronic copies of MIT Sloan Management Review articles as well as traditional reprints and back issues can be purchased on our Web site: www.sloanreview.mit.edu or you may order through our Business Service Center (9 a.m.-5 p.m. ET) at the phone numbers listed below.

To reproduce or transmit one or more MIT Sloan Management Review articles by electronic or mechanical means (including photocopying or archiving in any information storage or retrieval system) **requires written permission.** To request permission, use our Web site (www.sloanreview.mit.edu), call or e-mail:

Toll-free in U.S. and Canada: 877-727-7170
International: 617-253-7170
e-mail: smrpermissions@mit.edu

To request a free copy of our article catalog,
please contact:

MIT Sloan Management Review
77 Massachusetts Ave., E60-100
Cambridge, MA 02139-4307

Toll-free in U.S. and Canada: 877-727-7170
International: 617-253-7170
Fax: 617-258-9739
e-mail: smr-orders@mit.edu

Creating New Markets Through Service Innovation

Many companies make incremental improvements to their service offerings, but few succeed in creating service innovations that generate new markets or reshape existing ones. To move in that direction, executives must understand the different types of market-creating service innovations as well as the nine factors that enable these innovations.

Leonard L. Berry,
Venkatesh Shankar,
Janet Turner Parish,
Susan Cadwallader
and Thomas Dotzel

For decades, the importance of services to the global economy has grown steadily while the importance of goods has declined. In fact, services now dominate, making up about 70% of the aggregate production and employment in the Organization for Economic Cooperation and Development (OECD) nations and contributing about 75% of the GDP in the United States.¹ It's only natural, then, that companies are constantly seeking to provide better services, regardless of whether they are in a "pure" service business or in a manufacturing industry that must increasingly rely on its service operations for continued profitability.

However, most improvements to service activities are incremental. Stores stay open longer; product makers establish Web sites with e-commerce functions; airlines, casinos and supermarket chains enhance loyalty card programs. These improvements are useful and indeed necessary, but they are limited in the kind of returns they can produce. Only rarely does a company develop a service that creates an entirely new market or so reshapes a market that the company enjoys unforeseen profits for a considerable length of time.

One such organization is Enterprise Rent-A-Car Company. Enterprise has been strikingly successful: In an industry long led by The Hertz Corp. and Avis Rent-A-Car System Inc., it exploited a new idea to overtake them both. Founded by Jack Taylor in St. Louis in 1957 as a car leasing business, Enterprise added a rental division in 1962 when Taylor's customers began telling him that they often needed a car when theirs was in the shop for repair. While other rental car companies targeted travelers at airports, Enterprise focused on local customers who needed a replacement vehicle temporarily. This strategy required Enterprise to locate its offices close to where people live and work, and encouraged the company to develop such innovations as its "We'll pick you up" service. Today, Enterprise's revenues exceed \$8 billion, and the company boasts the largest fleet size and the most rental locations in the United States.² Ninety percent of the U.S. population lives within a 15-mile drive of one of Enterprise's offices.³

In effect, Enterprise's innovative view created a new market for car rentals in the same way that FedEx Corp. redefined the package delivery market. Both companies exemplify "market-creating service innovation," which we define as an idea for a performance enhancement that customers perceive as offering a new benefit of sufficient appeal that it dramatically influences their behavior, as well as the behavior of competing companies.

***Leonard L. Berry** is Distinguished Professor of Marketing and holds the M.B. Zale Chair in Retailing and Marketing Leadership at Texas A&M University's Mays Business School. **Venkatesh Shankar** holds the Coleman Chair in Marketing at the Mays Business School. **Janet Turner Parish** and **Susan Cadwallader** are assistant professors and **Thomas Dotzel** is a doctoral candidate at the Mays Business School. They can be reached at L-Berry@mays.tamu.edu, VShankar@mays.tamu.edu, JParish@mays.tamu.edu, SCadwallader@mays.tamu.edu and TDotzel@mays.tamu.edu.*

ice innovation. (See “About the Research,” p. 58.)

Arriving at a Taxonomy of Service Innovations

Service innovations that create new markets differ from each other along two primary dimensions: the type of benefit offered and the degree of service “separability.” On the first dimension, businesses can innovate by offering an important new core benefit or a new delivery benefit that revolutionizes customers’ access to the core benefit. For example, Cirque du Soleil created a new market for live entertainment — a core benefit — by offering a show that is neither a circus nor a dance performance but a hybrid of the two.⁴ The unique shows are a phenomenal success,

Market-creating service innovation promises far greater upside potential than imitative or incrementally improved service offerings. Consider, for example, that market creators Google (incorporated in 1998) and eBay Inc. (started in 1996) have market capitalizations of approximately \$110 billion and \$60 billion respectively, placing them in the top ranks of U.S. companies.

Service innovation differs from product innovation in important ways. First, for labor-intensive, interactive services, the actual providers — the service delivery staff — are part of the customer experience and thus part of the innovation. Second, services requiring the physical presence of the customer necessitate “local” decentralized production capacity. (Customers will drive only so far to eat at a restaurant, no matter how innovative it may be.) Third, service innovators usually do not have a tangible product to carry a brand name.

Over the past year, we have conducted research on service innovation and have developed a matrix that offers a different way of thinking strategically about service innovations that can create new markets. Our research has helped us to better understand how service innovation differs from product innovation, and to envision the central drivers of success in a service innovation effort. Executives who develop an understanding of these issues will be better prepared to lead effective initiatives in serv-

selling 97% of available seats.⁵ The delivery of the service, however, is standard: Customers buy tickets in advance and see the performance in a theater. Conversely, the University of Phoenix Inc. enables students to receive an established core benefit — a college degree — by a new delivery system: the Internet. The University of Phoenix has become America’s largest institution of higher education in just a few years.

The second dimension concerns whether the service must be produced and consumed simultaneously. Health care has traditionally been an “inseparable” service: The doctor must be in the room with the patient. Although patients, for the most part, continue to go to a clinic or hospital when they need health care, the delivery of “separable” care is growing. Doctors and nurses can advise patients via privacy-protected e-mail or voice mail and can monitor patients’ health through telemedicine.⁶ Technology has transformed many formerly inseparable services into services that can be consumed at any time or place. Customers who want to plan a trip no longer have to check their watches to see if the local travel agency is open.

Combining the dimensions of separability and type of benefit creates a two-by-two matrix that can help managers see where their companies fit and how they may seek to innovate. (See “The Four Types of Market-Creating Service Innovations,” p. 59.) For instance, executives from IBM Corp. — which has

About the Research

Our research involved several steps spanning one year. First, we developed and refined a working definition of market-creating service innovations. Then, based on reviews of published materials, we developed a list of services that created entirely new markets. Building on the service management literature, we developed a matrix to classify market-creating service innovations. Next, we analyzed each innovation to answer such questions as: What need did it address? What factors contributed to its performance? Our sources included books, articles, annual reports, Web sites and interviews with company executives. We also identified several market-creating product innovations and collected information on these innovations in a similar manner. Then we compared our analyses of both types of market-creating innovations and developed a list of success drivers for each. Finally, we presented our analysis, results and insights to several academicians and executives involved in service management and innovation management and made refinements as a result of their feedback.

identified service science as the next frontier discipline after computer and information sciences — believe they can use this type of matrix to facilitate strategic thinking about market-creating service innovation. Like many large companies today, IBM is betting on new services for its future growth.

Each cell in the matrix offers a way to imagine a particular approach to market-creating service innovation. It is useful for managers to identify the cell in which they are targeting innovation and to understand the cell's dynamics and leverage points. A failure to do so may lead to lost growth opportunities. Consider Amazon.com Inc.'s creation of the online market for book retailing — a highly innovative separable service. An analysis of the matrix in 1999 might have tempted Amazon's management, flush with capital, to try to acquire the Borders Group Inc.'s Borders bookstore chain, which, at the time, had a minimal online presence. By combining "clicks with bricks," Amazon could have extended its reach into a second (inseparable) cell and created synergies between the two. But the company chose not to do so. Notwithstanding Amazon's bookselling prowess today, this was a lost opportunity for an even larger market impact. What follows is a breakdown of the characteristics of each cell.

Cell 1: Flexible Solutions. This cell describes service innovations that offer a new core benefit *and* that can be consumed apart from where and when they are produced. These innovations allow their users to break free of the constraints of time and place.

An early pioneer of this type of innovation was FedEx. The

idea for the business was born in 1965, when Frederick W. Smith wrote a college term paper about the shortcomings of airfreight shippers using passenger route systems for moving deadline-critical items.⁷ At first glance, it might seem that FedEx was simply offering a new delivery benefit. But FedEx didn't invent the idea of delivering documents and packages by air. The company created a new market for the core benefit: the rapid, reliable delivery of time-sensitive materials. Combining speed and reliability has made FedEx a trusted deadline-beater and productivity booster for many businesses. In fact, executives from Merrill Lynch & Co. Inc. once learned that their employees were using FedEx to deliver documents between floors of its Manhattan headquarters building. FedEx's service was faster and more reliable than interoffice mail!⁸ FedEx has become synonymous with dependable just-in-time delivery. Its results justify its status: A share of FedEx stock purchased in 1978 for \$31.36 was worth more than \$2,600 by July 2005.

Other examples in this cell include Time Warner Inc.'s CNN, the television network that for the first time allowed viewers around the world to watch updated news 24 hours a day, and eBay, the online marketplace that allows buyers and sellers to transact business day or night, weekday or weekend. CNN's business model brought a new core benefit for viewers who couldn't tune in at 6:00 p.m. or 11:00 p.m.; eBay created the first never-closed worldwide garage sale.

FedEx, CNN and eBay offer a valuable lesson to managers. By focusing on a fundamental service benefit that can be experienced separately from the service provider, executives can turn unsolved customer problems into service innovation opportunities that spawn new markets.

Cell 2: Controllable Convenience. Innovations that create markets on the basis of new delivery benefits offer controllable convenience. As with flexible solutions, customers can enjoy the service benefits in this cell at any time and place.

Consider the changes in information delivery created by Google. Of course, Google didn't invent the core benefit of providing information, but its market-creating service innovation is the availability of relevant and rapid Web searches for information on virtually any subject. Paid for by advertising revenue, Google offers free access to an index comprising more than 8 billion URLs. In effect, Google is an information department store available where and whenever it is needed.

Founders Larry Page and Sergey Brin led two crucial innovations that positioned the company for dominance. First, they developed search algorithms that interpret hypertext links to Web pages as votes of importance; the more links, the higher the site rises to the top of the list that searchers see. This approach proved superior to that of competitors, whose search engines operated primarily by looking for keywords and tally-

Even Starbucks' decision to use round tables is deliberate, since research indicates that a customer can be alone at a round table without feeling isolated or uncomfortable.

ing their frequency. Second, Google developed its own serving infrastructure — rejecting conventional, larger server configurations that slow under peak loads — by employing linked computers to quickly find each query's answer. These innovations reshaped the world of Internet searching, and Google now averages more than 80 million users per month. The company's share price more than tripled within a year of its 2004 initial public offering.

Other companies offering controllable convenience include Netflix Inc. and Skype Technologies SA. Netflix offers a familiar core benefit — movie rentals — through a delivery system that combines the Internet and regular mail. Its customers don't have to race back to the store at 10:59 p.m. to return their rentals and avoid late fees. Skype, the peer-to-peer telephone company, offers free calling between Skype members over the Internet (for a small fee, members can connect to any traditional phone worldwide). The company thus uses a delivery innovation to offer the benefit of global telecommunications.

Launched in August 2003, Skype had more than 60 million registered customers by late 2005.⁹ In October 2005, eBay acquired the company for \$2.6 billion, promising additional payments if performance targets are met.¹⁰

Companies should look for innovative ways to put customers in control of how they access a desired service. Creative service system design and technology application can enable customers to reach and use a service more easily — and can open up untapped markets.

Cell 3: Comfortable Gains. This cell refers to service innovations that offer a new core benefit consumed at the time and place of production. These innovations provide comfortable gains — substantially new experiences with direct benefits to customers' emotional or physical comfort.

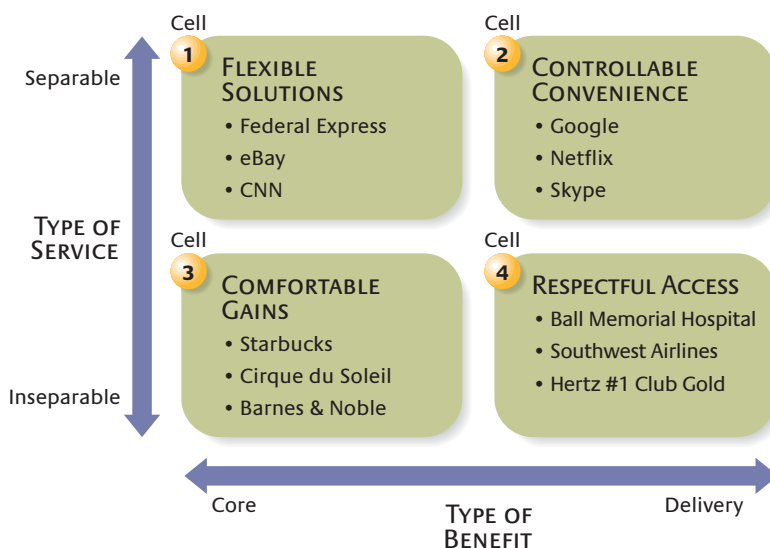
The Starbucks sign has become ubiquitous — so much so that it may be hard to remember life before the coffee retailer became a feature of urban street corners. Coffee shops existed

in abundance before Starbucks Corp. came along, to be sure, but the quality of both the coffee and the customer experience were inconsistent. Since 1987, when Howard Schultz bought the original Starbucks and began its transformation, the company has worked to offer an improved experience for coffee lovers. First, it has brewed coffee of uniform quality and pioneered the development of premium-priced drinks. Second, it has emphasized a relaxing atmosphere. Tables are purposely spaced apart so private conversations can take place or customers can be alone with their thoughts (or their laptops). Even the decision to use round tables is deliberate, since research indicates that a customer can be alone at a round table without feeling isolated or uncomfortable.¹¹ In Starbucks' first 12 years as a public company, its stock value increased by more than 3,000%.

Cirque du Soleil also fits into this cell, as does Barnes & Noble Inc. The United States was populated with bookstores before Barnes & Noble developed its superstores. Barnes & Noble, however, created a new market nationwide based on the idea that Americans of all stripes would

The Four Types of Market-Creating Service Innovations

These innovations can be characterized on two dimensions: (1) whether they offer a new core benefit or new way of delivering a core benefit, and (2) whether the service must be consumed where and when it is produced or can be consumed separately from its production.



respond positively to a radically enhanced core benefit. Thus, its bookstores came to be known for their large stocks of books on an array of topics, easy chairs for reading and co-located Starbucks coffee bars.

Managers of services that are produced and experienced in the same location need to look for creative ways by which the service experience can be made more comfortable, distinctive, enjoyable or memorable. Service innovations in this cell allow customers to benefit from a distinctive experience.

Cell 4: Respectful Access. In this cell, service innovators offer a new delivery benefit, and the production and consumption of the service are inseparable. Companies that create new markets in this space are granting their customers respectful access: They're demonstrating respect for their customers' time and physical presence in using the service. (See "Lowering Stress in the ER.")

Walgreen Co.'s Walgreens, America's largest and fastest-growing drugstore chain, with 2005 sales of \$42 billion, opened its 5,000th store in October 2005. It is the only Fortune 500 company other than Wal-Mart Stores Inc. to achieve sales and earn-

ings gains for 30 years in a row.¹² Walgreens makes its stores easy to get to and easy to get through. Its market-creating innovation is in fact an array of innovations geared to shoppers who place a premium on saving time and effort. Walgreens' strategy is to blanket its markets with freestanding stores that are easily accessible — stores on the corner of "Main and Main." Ample parking, drive-through pharmacy windows, 24-hour stores, wide aisles, low shelves, excellent in-store signage, one-hour photo departments, telephone prescription refills and automated queuing of prescriptions to reduce customer waiting time are all part of Walgreens' strategy of superior access.

Other companies that have created new markets through respectful access include Southwest Airlines Co. and The Hertz Corp. Southwest successfully created a market for affordable, reliable short-haul air transportation, in part by abandoning the hub-and-spoke strategy of its larger competitors. The company flies passengers directly to their destination rather than first taking them to a hub airport. Hertz was the first to create a membership program, Hertz #1 Club Gold, which gave frequent users faster and easier access to the company's core benefit — the temporary use of a car.

Lowering Stress in the ER

Few experiences are dreaded more than a trip to a hospital emergency room. Such trips are usually notable for the anxiety and pain associated with the illness or injury, for the impersonal and crowded waiting area and for long waits for treatment. But one hospital now offers far superior service, reshaping the market for emergency health care in its region and potentially influencing emergency departments throughout the country. The hospital found an innovative way to demonstrate respect for patients in their access to emergency medical services.

Ball Memorial Hospital Inc., in Muncie, Indiana, had been offering a typical ER experience when growth forced construction of a larger facility. The CEO of the hospital's parent, Cardinal Health System Inc., challenged the staff and the architects of the new facility "to think differently about the patient and family experience — to look at [the] service in terms of the patient and not what was most convenient for the staff."ⁱ

The result was the nation's first hospital emergency department with no waiting room. The walk-in area is similar to a small hotel lobby. An arriving patient gives basic information at a triage desk, receives an account number and is escorted (with any accompanying family members) to a private room that has a TV and telephone. A nurse records the patient's vital signs and gathers other health information; a physician arrives within 30 minutes. Patient registration is completed electronically at the bedside.

Ball Memorial's delivery-benefit innovation was the conversion of a soulless, stressful public space into a calm and comforting private space for patients and family. The service process was re-engineered to remove bottlenecks. An electronic board keeps track of all patients. The staff communicates with one another via wireless phones. The department has its own radiology and CT scanner services, which minimize delays in receiving test results. Every patient room has a locked, electronically

controlled medical supply cabinet with automated inventory control and billing.

The results, to date, are encouraging. Previously, Ball Memorial received patient satisfaction scores below the 50th percentile in a national database; in the year after the new facility opened, the scores topped the 80th percentile, while a patient's length of stay dropped by 30 minutes. Local residents are more willing to consider Ball Memorial first when they need immediate medical attention. Although the area's population is shrinking, Ball Memorial's new emergency department saw 17% growth in patient volume from start-up in 2003 to the middle of 2005 — a crucial metric given that 47% of the hospital's admissions come through its emergency department.ⁱⁱ

i. "Want to Keep Patients Flowing Out of the Waiting Room? Don't Have Chairs," ED Management (January 2005):2.

ii. K. Kirby, administrative director of emergency services, Ball Memorial Hospital, interviews with authors, July 7 and Nov. 7, 2005.

By fundamentally enhancing the ease with which customers can experience a service, companies can attract new customers and even create new markets. In the case of inseparable services, a company's greatest opportunity to win is at the service location. The key is to respect the customer's presence and time.

Success Drivers of Market-Creating Service Innovations

Executives who attempt to create a new market through service innovation must concentrate on the tasks that determine success or failure. Our research identified nine success drivers behind such innovations, some of which will be familiar to readers. But the key insight is that the cases studied featured *all* these drivers, with slight variations in emphasis depending on the specific cell in question. (See "The Nine Drivers of Successful Service Innovations.") In other words, the best service innovators take a holistic approach to market leadership. Close examination of the nine drivers reveals how each contributes to successful innovation.

1. A scalable business model. The path to scalability for a product innovation is relatively straightforward. When The Gillette Company comes out with a new razor, for example, it can achieve scale through production economies and distribution benefits. However, many service innovations are people-intensive and thus harder to scale. This is especially true in the cells where service usage is inseparable from production. In these businesses, employees are both the primary cost center and customer-value creator, so their productivity is critical to long-term profitability.¹³

Service providers can consider a variety of strategies to strengthen their business models. One option is to become more capital-intensive. For example, eBay invests in its auction trading platform's features and security technologies, minimizing the need to add large numbers of new employees to serve an expanding market. Another option is to encourage customers to perform more of the service themselves. Hertz #1 Club Gold members can go directly to their rental cars, bypassing the customer service counter. A variable compensation plan that rewards employee productivity is another way to encourage profit growth in labor-intensive businesses. Enterprise Rent-A-Car emphasizes variable pay for its office managers; the more profitable a rental office, the more the manager earns.

Yet another alternative is to create a separable version of the service to extend the market while reducing labor intensity. For most of its history, tax preparation company H&R Block Inc. expanded primarily by opening new retail offices with its own dedicated staff. But it has recently been able to scale the business substantially by creating TaxCut, online and software tax preparation versions of its services.

2. Comprehensive customer-experience management. Services generally involve many more customer "touchpoints," or discrete experiences, than do manufactured goods. These experiences hinge

The Nine Drivers of Successful Service Innovations

There are nine success drivers behind market-creating service innovations. Some are more important for service innovations; others apply to all innovations. The most innovative companies exploit all these drivers.



upon "experience clues" in three forms: *functional clues*, those that point to the technical quality of the offering; *mechanical clues*, relating to nonhuman elements such as the design of the facility; and *human clues*, coming from the behavior and appearance of employees.¹⁴ The clues converge to create a total experience that directly influences the customer's assessment of quality and value.

Customer experience management is relevant to some degree for all market-creating innovations, but it is critical to the success of inseparable services because customers visit the service "factory" and directly experience what occurs there. Starbucks' success, for example, depends on an excellent product (functional), a pleasing physical environment (mechanical) and service-minded employees (the human component). To implement its core strategy, Starbucks must excel in managing all the categories of customer experience clues.

3. Investment in employee performance. The more important, personal and enduring the service, the more pronounced the human effects of the customer-provider interaction. Customers' perceptions of employee effort in delivering service have an especially strong impact on customer satisfaction and switching behavior.¹⁵

Successful service innovators invest in their employees' willingness and capability to perform at consistently high levels. These investments commonly include careful hiring, initial and ongoing training and education, information sharing, performance-based compensation and internal branding (that is, teaching, selling and reinforcing the desired brand image to employees). Cirque du Soleil has more than 30 individuals in its casting department who

Each night, some FedEx aircraft start out empty or partially full so they can be diverted to airports where they are needed because of overload, mechanical or other problems.

travel the world looking for talent. About three-fourths of Cirque du Soleil's onstage performers are former athletes; some have competed in the Olympics. Prospective cast members complete a rigorous 16-week training program in Montreal, receiving instruction in acting, movement, voice and makeup application, in addition to acrobatic and athletic skills. They are paid and housed during the training phase.¹⁶

The importance of investing in employee performance is not limited to companies offering inseparable services. Services are performances, and well-managed companies invest in their performers regardless of whether they are "onstage" or "offstage." A good example is Google, which depends on cutting-edge technology to stay ahead and vies aggressively for technical talent, sometimes even raiding its competitors.

4. Continuous operational innovation. Service businesses are operations-intensive regardless of whether their offerings are separable or inseparable, or whether they provide a core or delivery benefit. It is difficult for imitators to catch up with service innovators that are continually improving operations.

FedEx has been particularly innovative in this area. When it was established in 1973, customers had to call the company to initiate service. FedEx's introduction of drop boxes in 1975 led the company to consider the need to allow customers to track their shipments. As Frederick W. Smith put it, "It was not acceptable ... that customers should be willing to take goods that were very valuable to them into this big anonymous transportation system and hope they came out the other end."¹⁷ In 1984, FedEx began providing free computers and proprietary software to key customers, enabling them to monitor their shipments. In 1994, the company launched fedex.com, the first transportation Web site that offered online shipment tracking.

Starbucks, in addition to serving sit-down coffee drinkers, serves another big market segment: takeout customers who want fast service. In 2005, a Starbucks customer spent about three minutes on average from getting in line to receiving an order, a wait time reduced by about 30 seconds from that of five years earlier. Among the company's timesaving innovations are eliminating credit card signatures for purchases under \$25, inventing a more efficient ice scoop for cold beverages and creating a new position in which an employee "floats" to where he or she is needed most to shorten overall service time.¹⁸

5. Brand differentiation. This success driver is important for market-creating product innovators, but may be even more so for service innovators. Because services are performances, there are no "tires to kick" prior to purchasing. A trusted brand reduces perceived risk. Distinctively communicating a consistent message, performing core services reliably and finding ways to connect emotionally with customers — these factors help build strong, trusted brands.

A strong brand is vital for service innovations in Cell 1: Flexible Solutions. Customers face increased risk with innovations in this cell because they have to evaluate an unfamiliar core benefit and cannot control or observe when or how the benefit is produced. FedEx has invested heavily in keeping its brand positioning promise of on-time delivery by solving problems before they reach customers. Each night, some of the company's aircraft start out empty or partially full so they can be diverted to airports where they are needed because of overload, mechanical or other problems. Also, on-call aircraft and crews (called "hot spares") are on standby each night.¹⁹

6. An innovation champion. Market-creating innovations of all kinds require a champion — a mobilizer of resources, a master persuader and doer, someone who can imagine the possibilities embedded in an idea and lead the transformation of the idea into a market reality. The stories of successful major innovations typically begin with the story of a person: Edwin Land at Polaroid Corp., Ted Turner at CNN or Ray Kroc at McDonald's Corp.

7. A superior customer benefit. Innovations can create new markets only if they offer a clear and better solution to a problem of sufficient importance to stimulate customers to try the product or service — and then to repeat the action and give the product or service favorable word of mouth. Saving customers time and effort is a common benefit of market-creating innovations. In product categories, consider the microwave oven, the videocassette recorder and the cellular telephone; for services, the bank ATM, the online bookstore and the Internet search engine.

8. Affordability. Creating a market requires that customers not only are willing to change their behavior (for a superior benefit), but also have the means to do so. Cost-structure innovation is a

common path to customer affordability. Southwest Airlines was designed to compete on price with automobile and bus travel. The entire operating model — including the use of a single type of aircraft to minimize training and servicing costs, fast airport turnarounds so planes spend more time in the air and no seat assignments — emphasizes cost efficiency.

9. Continuous strategic innovation. Neither service businesses nor their manufacturing counterparts can neglect strategic innovation. Google maintains its strategic edge by allowing technical staff to devote one day a week to work on new business ideas called “Googlettes,” and by sponsoring an online “Ideas List,” open office hours with managers and periodic brainstorming sessions for employees to pitch ideas on new technologies and businesses.²⁰ Netflix is teaming with TiVo Inc. to develop a video-on-demand service that will make movies available over the Internet.

Service Innovation Starts with Culture

The success drivers discussed above require an organizational culture that supports human performance and innovation. For companies operating in the inseparable cells, the quality of employees’ interactions with customers is critical. Competitors can more easily imitate the infrastructure and technology of an innovator like Netflix than they can re-create the employee culture of Starbucks or Southwest Airlines. These companies have invested considerable time, effort and money to build work cultures that amount to a form of competitive advantage. For companies operating in the separable cells, it’s especially important to use continuous innovation to stay ahead of the competition, because these businesses place greater reliance on factors that can easily be replicated.

In addition to fostering a corporate culture that builds human capital, companies seeking to create new markets with services must create a culture for innovation — a “style of corporate behavior that is comfortable with, even aggressive about, new ideas, change, risk and failure.”²¹ Employees must have the confidence to take risks and to freely share thoughts and suggestions with anyone in the organization. They must care enough and trust enough to try to create something new.

Companies that successfully create cultures that value human capital and innovation will see a steady stream of incremental improvements that help the bottom line. But when leaders understand the types of innovations that lead to new markets and work to implement the drivers of success, they also can build new businesses that position their companies for sustained growth and profitability. By thinking about a service in terms of its core benefits and the separability of its use from its production, managers can more easily determine how to out-innovate their competitors.

REFERENCES

1. A. Wölfl, “The Service Economy in OECD Countries,” working paper 2005/3, OECD — Directorate for Science, Technology and Industry, Feb. 11, 2005; and Office of the U.S. Trade Representative, “U.S. Submits Revised Services Offer to the WTO,” press release (Washington, D.C.: Executive Office of the President, May 31, 2005).
2. “Enterprise Rent-A-Car Revenue Exceeds \$8 Billion: Records Set in Revenues, Fleet Size and Locations,” September 21, 2005, www.enterprise.com; and “Car Rental in the United States — Industry Profile,” October 2004, www.datamonitor.com.
3. “Rental Car Industry Expansion into Neighborhoods Fuels and Fills Americans’ Appetites,” Enterprise Rent-A-Car press release, May 18, 2005.
4. W.C. Kim and R. Mauborgne, “Blue Ocean Strategy,” *Harvard Business Review* 82 (October 2004): 76-84.
5. G. Keighley, “The Phantasmagoria Factory,” *Business 2.0* (February 2004): 103-107.
6. L.L. Berry, K. Seiders and S.S. Wilder, “Innovations in Access to Care: A Patient-Centered Approach,” *Annals of Internal Medicine* 139, no. 7 (2003): 568-574.
7. “FedEx Corporate History,” accessed October 30, 2005, www.fedex.com.
8. D. Foust, “Frederick W. Smith: No Overnight Success,” *Business Week*, Sept. 20, 2004, 18.
9. “Skype Gives Small Businesses Market Advantage,” Skype press release, Oct. 25, 2005.
10. “Change in Assets: Item 2.01 Completion of Acquisition or Disposition of Assets,” SEC Filings for eBay, Form 8-K for eBay Inc., Oct. 18, 2005.
11. M. Krauss, “Starbucks ‘architect’ explains brand design,” *Marketing News* 39, no. 8 (May 1, 2005): 19-20.
12. M. Boyle, “Drug Wars,” *Fortune*, June 13, 2005, 79.
13. F. Barber and R. Strack, “The Surprising Economics of ‘People Business,’” *Harvard Business Review* (June 2005): 80-90.
14. L.L. Berry, L.P. Carbone and S.H. Haeckel, “Managing the Total Customer Experience,” *MIT Sloan Management Review* 43, no. 3 (spring 2002): 85-89.
15. S.M. Keaveney, “Customer Switching Behavior in Service Industries: An Exploratory Study,” *Journal of Marketing* 59 (April 1995): 71-82; and L.A. Mohr and M.J. Bitner, “The Role of Employee Effort in Satisfaction with Service Transactions,” *Journal of Business Research* 32, no. 3 (March 1995): 239-252.
16. B. DeSimone, “Cirque’s Siren Call to Athletes,” *USA Today*, July 7, 2005, sec. C, p. 1.
17. D. Joachim, “FedEx Delivers on CEO’s IT Vision,” Oct. 25, 1999, www.internetweek.com.
18. S. Gray, “Coffee on the Double,” *Wall Street Journal*, Apr. 12, 2005, B1.
19. S. Munoz, media relations manager, FedEx, interview with authors, July 8, 2005.
20. B. Elgin, “Managing Google’s Idea Factory,” *Business Week*, Oct. 3, 2005, 88-90.
21. B. O’Reilly, “The Secrets of America’s Most Admired Corporations: New Ideas, New Products,” *Fortune*, March 3, 1997, 60-64.

Reprint 47213. For ordering information, see page 1.

Copyright © Massachusetts Institute of Technology, 2006. All rights reserved.