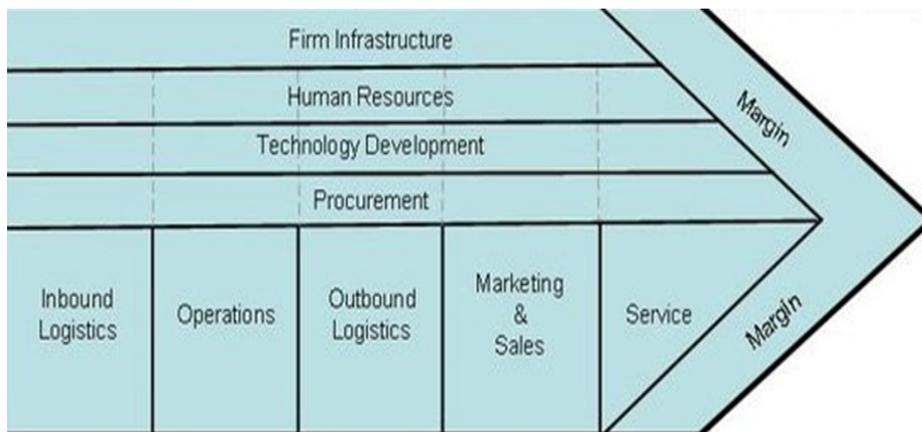


To Innovate, think of your business as a service.  
Henry Chesbrough, Haas School of Business, UC Berkeley

It's getting tougher and tougher to innovate new products. The competition is intense, getting more global than ever, and product lives are getting shorter and shorter. This creates a commoditization trap for those who want to innovate.

The way out of this trap is to rethink your business. Whether you make a product or a service, you'll be able to differentiate more and grow faster if you think of your business as a service.

This doesn't come naturally to most businesses. They conceive of themselves using the value chain concept introduced by Michael Porter (see below). In the famous Porter diagram, services are secondary to the value creation process, which is very product focused. Inputs are transformed into outputs through the process. Services are an afterthought in this view, the last thing you do before you ship it to the customer.

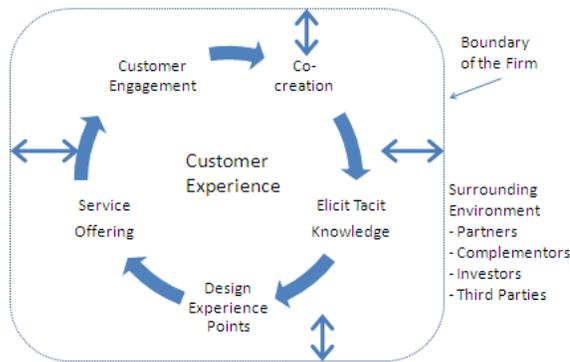


We need to get out of that way of thinking about services. What is a service? One government economist defined it this way:

A service may be defined as a change in the condition of a person, or of a good belonging to some economic unit, which is brought about as the result of the activity of some other economic unit, with the prior agreement of the former person or economic unit.

In terms of your thinking, services make you more customer-focused. Services are the efforts of the firm to more precisely meet the needs of customers, rather than creating one-size fits all products to market common products to everyone. Another way to put it is to follow Ted Levitt, who used to say: "People don't want to buy a quarter-inch drill. They want a quarter-inch hole!" This is how you can differentiate your products, by creating a feedback loop that incorporates the customer into the business creation process. That would yield a process that looks more like this:

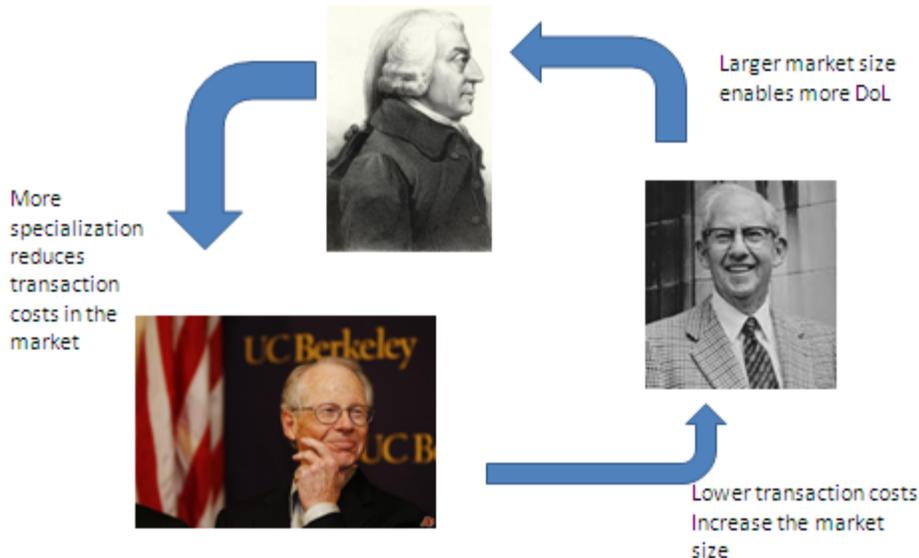
## A Services Value Web



This is also a powerful recipe for growth. If we return to Adam Smith, he taught us that growth and innovation were rooted in a deepening division of labor. Our own Nobel economist at Berkeley, Oliver Williamson, taught us that when transactions costs of using the market are reduced when compared to inside the company, transactions move from the firm to the market. And George Stigler instructed us that the Division of Labor was limited by the extent of the market. If you join these three insights together, you generate a powerful virtuous growth cycle:

- More specialization of labor fosters innovation and growth (Smith).
- Lower transaction costs in the market vs. the firm grows the market (Williamson).
- Larger markets enable more division of labor (Stigler). And so the cycle continues.

## The Virtuous Services Market Cycle



Paychex is a good example of this virtuous dynamic in action. The company pioneered the process of payroll processing outside the firm. By being more focused and more specialized, the company launched itself into the market. As technology advanced, the company got more specialized and more capable. This attracted more companies to turn over their payroll processing to them, and so the cycle repeated.

The other part of the Services Value Web above is that the firm does not perform these tasks solely within its four walls. The outside world is welcomed into the process at many stages. Opening up the firm to include these outsiders can further deepen specialization and accelerate the growth process. This openness will help you rethink your business to escape the commoditization trap, and generate new growth.

