



SOCIAL PROOF, BENCHMARKING & INCUMBENT FAILURE

Why do entire industries stumble when confronted with discontinuous change?

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Apple and other PC manufacturers taking over the computer industry in the 1980s; Southwest and other no-frills airlines driving traditional aviation firms into bankruptcy in the 1990s; and Toyota and other Asian car producers slowly but surely bringing the US automobile industry to its knees since the 1960s ... The pattern repeats itself over and over again in corporate history: a group of small, seemingly powerless start-ups introduces discontinuous innovations in an industry and manages to oust not just one or two, but all established players from their positions. We ask ourselves why established firms often fail collectively when faced with non-paradigmatic change.

All accounts in which established companies have been edged out by smaller creative destroyers show how difficult it can be for the big guys to stand their ground against smaller, innovative market players. Interestingly, in most cases, established players do react to disruptive change. However, they often react too late. And, even worse, if they react, they do so by applying the same business heuristics that they had successfully applied in the “old world.”

Consider, for instance, the music industry. Only after the music majors had already suffered major revenue declines because of illegal peer-to-peer trading platforms, they finally also decided to go online themselves. However, they nevertheless all stuck to their old model of generating revenues, which can be summed up as “record one or two good songs and six or seven mediocre ones and compile them on one album; then, sell the album for 10 Euros or more.” It was ultimately up to Apple, an industry outsider, to introduce a business model – one song for 99 cents – that would suit the new habits of internet users who configure their own collections of the singles they like instead of buying pre-compiled albums. In the end, Apple succeeded while the majors failed. Similar stories can be found in many other industries where all established players fail to respond appropriately to radical changes in their environment.

Why is this so? Research in psychology indicates that when we are confronted with uncertainty we tend to look to others to find cues how to behave. The psychologist Robert Cialdini calls this phenomenon “social proof.” Social proof helps to explain some of the most startling paradoxes in human behavior. For instance, consider the phenomenon of bystander apathy: the larger a group of bystanders of an accident, the more likely it is that the members of this group will refrain from helping the victims of the accident. According to social proof theory, collectives hesitate to help because the individuals in a group imitate the behavior of others around them. If the other individuals in the group are also passive, the bystanders will erroneously consider the apathy of others as a signal that there is no emergency. Social proof also explains why producers of sitcoms place canned laughter after every joke, particularly bad ones, to give the impression that a huge audience is laughing. Oddly enough, experiments have actually shown that just the fact that others are laughing makes it much more likely that the audience at home will start laughing, too.

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Social proof is also a powerful phenomenon in the business world. For instance, when deciding whether to invest in specific stocks, security analysts have been shown to base their decisions to a large degree on what their peers do. Cialdini sums up this pervasive tendency succinctly: "If a lot of people are doing the same thing, they must know something we don't. Especially when we are uncertain, we are willing to place an enormous amount of trust in the collective knowledge of the crowd." [i]

When looking for cues on how to react in uncertain environments managers don't just pick out any company in their industry to follow. Instead, they typically look to their most successful peers that have proven their ability to make the right decisions in the past. In the majority of cases, this behavior is wise since managers can rightfully expect that others, and especially those with a successful track record, have extensively analyzed the data available and thus based their decision on a deep understanding of the situation. Also, market leaders might have better access to market and research data. Thus, most often it is rational to look at what the market leaders do in an industry, since imitating "best-practice" can save time and resources for other activities.

However, while working with established companies, we have observed that when fundamental changes are taking place, looking to others within the industry, and particularly market leaders, can be the recipe for the collective demise of all players in the industry. This is so for two reasons:

First, social proof in response to radical change can lead to a similar type of bystander apathy as the one we described above. When responding to discontinuous change, incumbents hesitate to adopt a new technology because they interpret the non-response of others as a sign that it is not worthwhile to adopt the new technology. Eventually, the entire collective hesitates to react to the change. For instance, partly because of social proof, book retailers in Germany responded too late to the rise of online retailers, especially Amazon. Many owners of bricks-and-mortar book stores we talked to explained that they did not react in the first place because none of their colleagues had done so. It was only after other players in their immediate peer group had started to go online - often under pressure from outsiders, such as consultants and banks - that these retailers started to consider online retailing to be a viable opportunity for themselves. As one manager recalled: "Our former CEO didn't perceive online as a threat; I don't even know if he recognized the internet at all. Only when he saw that everyone was going online, he thought 'I should do that, too. It's a nice thing to have.'"

Second, market leaders are most unlikely to adopt discontinuous innovations because they tend to become risk averse over time trying to protect the success they have achieved in the

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past. As a result of this risk aversion, they also tend to shy away from investing in discontinuous innovations because they have the most to lose if sales of their existing, highly profitable products are cannibalized by the new products. Furthermore, precisely because of their past success, market leaders often become self-complacent causing them to underestimate the potential of new technologies and, ultimately, to respond too late to upcoming radical innovations. By inducing other players to follow the leaders of an industry, social proof can then lead an entire collective of established players to refrain from adopting radical change.

To summarize, the social proof theory suggests that under circumstances of uncertainty managers tend to look to others and in particular to the leaders in their industry for guidance. Yet, under discontinuous circumstances these leaders are likely to fail in their role as a lighthouse in the fog of uncertainty.

What are the implications of our observations? As radical changes become increasingly pervasive in our environment, it is important to re-think who we look to and under which circumstances we do so. Most of the time it is reasonable to benchmark against main competitors or best-in-class in the industry, but in times of radical change it is likely to be a recipe for collective failure.

Therefore, we need to build up an innovation network that includes players within and outside our industry. Only if decision makers adopt a broader perspective will they be able to leverage the benefits of benchmarking during times of continuous change, while at the same time avoid the traps of social proof when it comes to discontinuous change.

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[i] Cialdini, R. 1993. Influence: Science and practice. New York: Harper Collins., pp. 131-132.

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