Innovation-led incubation and value-based pricing:

Or how I learned to stop building faster horse carriages and love disruption

By Matthew Burgess

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Abstract

Innovation is no longer on the list solely for start-ups but has become a strategic goal for senior leadership of small, medium and large sized organisations. However, professional service organisations, and in particular those in the legal industry, are struggling to match other industries in their stride.

Incubation of idea generation, that is largely innovation led, takes place outside the confines of incumbent firms and businesses, such as incubator spaces. However, the two cannot be separate; innovation by itself is insufficient. There must also be an incubation of new concepts, trialled in a constant and disciplined manner designed to achieve successful new business models. In many respects, innovation is a necessary, but not a sufficient, building block of incubation.

Ultimately, the innovators are thinkers; the incubators are the doers. Professional services industries need to embrace innovation led incubation, disrupt themselves, and deliver sustainable success into the future.

About the Author

Matthew Burgess founded specialist law firm View in 2014. For the previous 17 years, he was a lawyer and partner of one of Australia's leading independent law firms and in 2002 was one of the firm's youngest ever partner appointments.

In part leveraging off the skills he has developed in strategically advising a range of extremely successful businesses, Matthew has been the catalyst in developing a number of innovative legal solutions; including establishing what is widely regarded as Australia's first virtual law firm.

In 2015 Matthew won a place on the prestigious Legal Innovation Index announced by LexisNexis® and Janders Dean.

The incumbent's dilemma

Virtually every industry has been affected by the disruptive aspects of technology and are faced by the "Innovator's Dilemma" – a term that describes how incumbents do not consider innovations that will benefit clients in the future because there is no current use for them. The theory, first posed by Clayton M Christensen almost 20 years ago, argues that only rarely can an incumbent firm embrace and leverage disruptive solutions.

On one side, non-technology driven businesses have a limited space for innovation in contrast with online businesses that have effectively unlimited space. It is disruptive innovation that allows for a new solution to create an entirely new market to disrupt, or even replace, existing markets and products. Here the "Innovator's Dilemma" becomes the "Incumbent's Dilemma" where the incumbent must adopt a new technology or business model to adhere to the future needs of clients unbeknownst to them at the present state.

The heart of incubation – being the trial and error iteration of ideas leading to innovation – is having the discipline to ask current clients, historical clients and potential clients the "why" questions, at least five times.

1. Why do you choose to use our solution?
2. Why do you choose not to use our solution?
3. Why will you continue to use our solution?
4. Why might you choose to use other solutions?
5. Why would you recommend our business to a friend or associate?

Importantly, by using the "5 whys", the emphasis is moved away from what a client (or potential client) wants.

More bluntly, Steve Jobs is said to have ensured Apple never used customer focus groups on the basis that they were for the losing firms. Customers cannot be expected to know what they might want. In other words, the "5 whys" provide insight to understand the "job" that the client is seeking to get done.

Incubators trying to stimulate intrepreneurship – entrepreneurship within a company or "internal innovation" – face several challenges, where internal personnel are restricted by a risk mindset, hierarchical conservatism or where effective resourcing and relevant structures are lacking. Intrepreneurship is possible where incumbent firms truly understand that survival is more than simply maintaining (or sustaining) the components of the business model that have historically succeeded.

Critically, the barriers to entry to get a solution to market and then allowing the market to determine whether there is any value, are constantly reducing. Given that quality is entirely subjective, what is often defined by an incumbent firm as "low quality" will be seen by others in the marketplace as "good enough" or even high quality. Branded or designer products are a fantastic example. Sites such as Society6.com allow self-designed or self-branded products to be promoted across a range of items, including t-shirts, hats, protector cases and a multitude of other trinkets.

All of these products can be promoted online, without the incubator ever physically producing any unless a sale occurs. The ability of these business models to only produce product exactly equal to certain demand makes them more agile and profitable than traditional businesses that simply "build and hope the customers will come".

Similarly, industries such as photography, music and book publishing have been radically re-engineered because of the ability to self-publish electronic versions in the marketplace. The cost of electronic versions, compared with the heritage solution, is virtually zero and if physical sales are generated, physical versions can be generated on demand. Ultimately, the reason that incubation is such a powerful driver for wealth creation is that, from a client's perspective, new ideas that work are far more valuable than the making (or manufacturing) of the idea. The concept is probably best understood through the lens of “Stan Shih Smile Curve” set out below.

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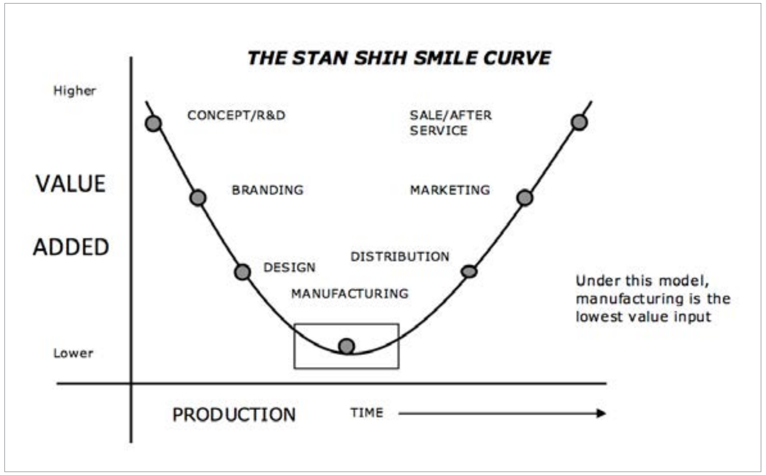


*Smiling Curve first devised by Stan Shih, founder of Acer, an IT company based in Taiwan, around 1992

According to the modelling underpinning the Stan Shih Smile Curve, four broad categories in terms of relative value can be added to a solution, namely:

1. **Competition:** the pressures to adopt and match competitive industry standards;
2. **Product life period:** the amortisation of assets, due to the speed of technology;
3. **Survival:** a domino-effect stemming from inefficient technology, leading to limited strategy, leading to loss; and
4. **Value-add:** the higher ends of the curve add more value, and the lowest value-add of manufacturing.

While most newcomers to an industry focus their energy on the higher value aspects of the curve as they become the incumbent player, virtually all of a firm’s energy and focus moves down the value curve. The incumbent’s dilemma is to strategically and tactfully balance both the internal environment of people and processes and manage the external disruptive environment of clients and competition.

Value creation

Importantly, while there are different price points to match each of the four categories, each has the prospect of driving profitability. Historically, price sensitivity transitions from least to most sensitive through these four components:

1. **Unique services** that combine high levels of customisation, creativity and innovation with minimal client involvement;
2. **Experiential services** where the client is deeply involved in the problem-solving process, including the creative process and execution;
3. **Brand name services**, a nurturing process that includes providing the solution as well as guiding the client through the options and transition; and
4. **Commodity services** where the client is well-informed and knows the process or solution they want performed under set defined standards.

Arguably, due to the internet opening new marketplaces there are two further categories, further down the value chain after commodity services, namely:

5. **Wholesale services** that involve a highly engaged client wanting a specific solution or process at a minimal cost; and
6. **Online services** where the solution or process is only executed upon specific demand from a client that has self-educated themselves on their needs in market.

The internet has also increased the rate at which all technology disruption takes place. Winning firms understand that success ultimately depends on being differentiated or unique, of demonstrable value and delivered in a way that is difficult to replicate. Besides areas such as the "internet of things", production on demand (as mentioned above) and offshoring of professional services, the internet has permanently changed incubation in at least one area – specialisation.

Many argue that for professional firms, specialisation, or finding a niche solution, is arguably the most important determinant of success. Demand is driven by highly specialised solutions. If there is a wide variety, demand generally flattens. The internet allows an almost limitless supply of potential niches, while reducing the cost of creating the niche solution in the first place, and in turn, creating a market. Virtually every ultra-successful internet-enabled solution shows a deep understanding of the critical interplay between:

• having deep specialisation; and,
• having virtually no cost to identifying a market segment.

Some of the highest profile examples of this concept are the business models set out below, whereby each one has an extremely highly focused specialised solution. It is critical to note that even for extraordinarily large businesses, their solutions can be described almost entirely in one sentence:

Facebook:	maintains a level of interaction and contact with family and friends
Twitter:	engages in conversations where less is more
Upwork:	the world's largest request for job proposals
Fiverr:	the world's largest service marketing site
Instagram:	a highly visual conversation
iTunes:	the world's largest music store
Amazon:	the world's largest retailer

Arguably, the ongoing success of each business will depend almost entirely on its ability to retain its deep specialisation.

Benchmarking

Successful firms do not look to their competition as a benchmark. Rather, the focus is on trying to make the competition irrelevant by creating a value equation that simultaneously delivers an integrated outcome not previously achieved. This is achieved in three areas:

1. usability;
2. price point (and value creation); and
3. cost of production.

Arguably, the most important skill of incubators is their ability to look across market boundaries for inspiration and synthesise those ideas into an offering applicable to the industry of their speciality.

In trying to explain this concept, Steve Jobs would often reference the Picasso quotation that: *"Good artists borrow, great artists steal"*. This incubation mantra has led to wide criticism for Jobs and Apple, given their belligerent intellectual property infringement attacks on companies, such as Samsung, for copying their ideas. The critical point of distinction is that Apple devotedly looks across to unrelated industries for some of its most innovative ideas. Apple's allegation is that Samsung simply looks at its biggest competitor (i.e. Apple) and steals their innovations.

Often the simplest, most "unrelated" industry ideas are the best source of value creation . Apple often highlights its use of magnetic power chord adaption for its laptops as one of the best initiatives it has implemented. However, Jobs (as the artist) often shared, proudly, this was an idea "stolen" directly from a Japanese kitchen appliance manufacturer.

Arguably, a key reason for incubation being difficult in implementation is that "success" is measured dependent on the alignment of solution usability, price, value and cost of production. Once the solution is created, the value is delivered through price, usability and cost of production, all of which integrate seamlessly in the realised success. However, simply achieving in one area, such as increased usability, a better price/value equation or decreasing the costs of production, is readily achievable. Standard benchmarking can often provide a useful pathway to achieving one or even two of these objectives. However, it is innovation-driven incubation that is the only way to achieve true success across all three areas. If technology is an enabler to achieving success in these three areas, leveraging the relevant technology is vital.

"The best swordsman in the world doesn't need to fear the second best swordsman in the world; no, the person for him to be afraid of is some ignorant antagonist who has never had a sword in his hand before; he doesn't do the thing he ought to."

– Mark Twain, A Connecticut Yankee in King Arthur's Court (1889)

Pace of change

As Jack Welch (longstanding CEO of General Electric) observed, firms are at significant and potentially irretrievable risk when the rate of internal change is slower than the pace of external change. True incubators understand that plans for the future must be plans for growth and learning. In other words, plan to be wrong and then learn how to be right as fast as possible. A new solution must always be simple, reliable and convenient. It will always be delivered at lower margins to a specific group – profits will follow as market share is secured. In this way if you need to fail to learn, you must fail fast and only for a minor group of clients.

Counter-intuitively, an innovative solution is generally only valued by the least profitable clients, meaning that if a firm chooses to only listen to its best clients to identify new products, it essentially ignores all forms of disruptive innovation. In turn, this ensures that it will fail the "Innovator's Dilemma" test – that is the incumbent firm fails to adopt the new technology needed to ensure it can deliver the future demands of clients. This ultimately means there is a very strong first mover advantage as the incumbents effectively ignore the disruptive model until it is too late.

The four main areas that leading innovators and incubators tend to focus their attention into idea-generation and execution are:

1. **Unchallenged orthodoxies** - the parts of a business model that have remained unchanged and are assumed by industry players to be non-negotiable;
2. **Unappreciated trends** - things happening in other unrelated industries not embraced more widely or considered for their industry;
3. **Unleveraged competencies** - a focus on what the business knows as opposed to what it does can create new value propositions; and
4. **Unarticulated needs** – a focus on the "5 whys" plus "what job is to be done?"

Incubation and disruption are, however, ultimately just as important as maintaining, as far as possible, the profitability of known traditional practices. The challenge is that both require different visions, metrics and practices. The disruptive business models require funding, resource allocation and working environments that are essentially the opposite of those of the traditional firm. History shows that the vast majority of traditional firms are unable to allocate resources away from the primary revenue source because of their focus on short-term profitability and the need to avoid any perception, both internally and externally, that there is a "cannibalising" of the core business model.

The key to sustainable and successful business models, however, is to be self-aware to know that unless cannibalisation occurs, existing lines of revenue will be taken by competitors with complete disregard for the ongoing need of profitability for incumbent firms.

As commonly seen in the embedded and unrestrained model for start-ups, innovative firms find ways to:

- monetise ideas quickly;
- minimise upfront cash expenses;
- release a minimal viable product;
- recycle and reuse what they have immediate access to; and
- understand that everything can look like a failure during the "middle phase" (that is, before it becomes successful).

For successful start-ups, there is a deep understanding that a product in market is better than a delay to launch in order to ensure better quality. In other words, if you are not embarrassed by version one of the solution, you have launched too late. In this context, arguably the best way to achieve success once you have developed the innovative idea is to pursue it with passionate, and the deliberate use of, checklists.

While many incumbent firms and their team members see checklists as dehumanising, outlier firms understand that checklists make sure the likelihood of mistakes is far less and simultaneously focus on avoiding what is often called "fundamental attribution error" - that is, the tendency to attribute behaviour to a person's character rather than to the environment. The bureaucracy and inertia so prevalent in incumbent firms can be largely explained by an over-emphasis on the fear of loss.

In this regard, part of the reason incumbents have such difficulty re-engineering pre-existing business models can in turn be explained by "prospect theory". This theory states that when someone feels entitled to something, the pain of having to give it up is much more intense than the pleasure that would come from an incremental gain of the same size. This means that a successful outcome that is lower than expected will feel like a loss even though it might be a gain. However, disruptive business remodelling requires a healthy risk appetite and passion in the idea that prospect theory suggests is extremely difficult for the incumbent to achieve.

"For success, like happiness, cannot be pursued; it must ensue, and it only does so as the unintended side effect of one's dedication to a cause greater than oneself."

- Viktor E. Frankl, *Man's Search for Meaning* (1946)

Causes, not symptoms

In his title, *The Lawyer Bubble*, Steven Harper details why the legal profession will struggle to reinvent any of the core aspects of their business model, especially in relation to time billing.

While a myriad of reasons are provided, perhaps the most compelling is the argument that universities across the Western world handle educating professional service firm graduates, who specialise in areas rewarded by time billing such as:

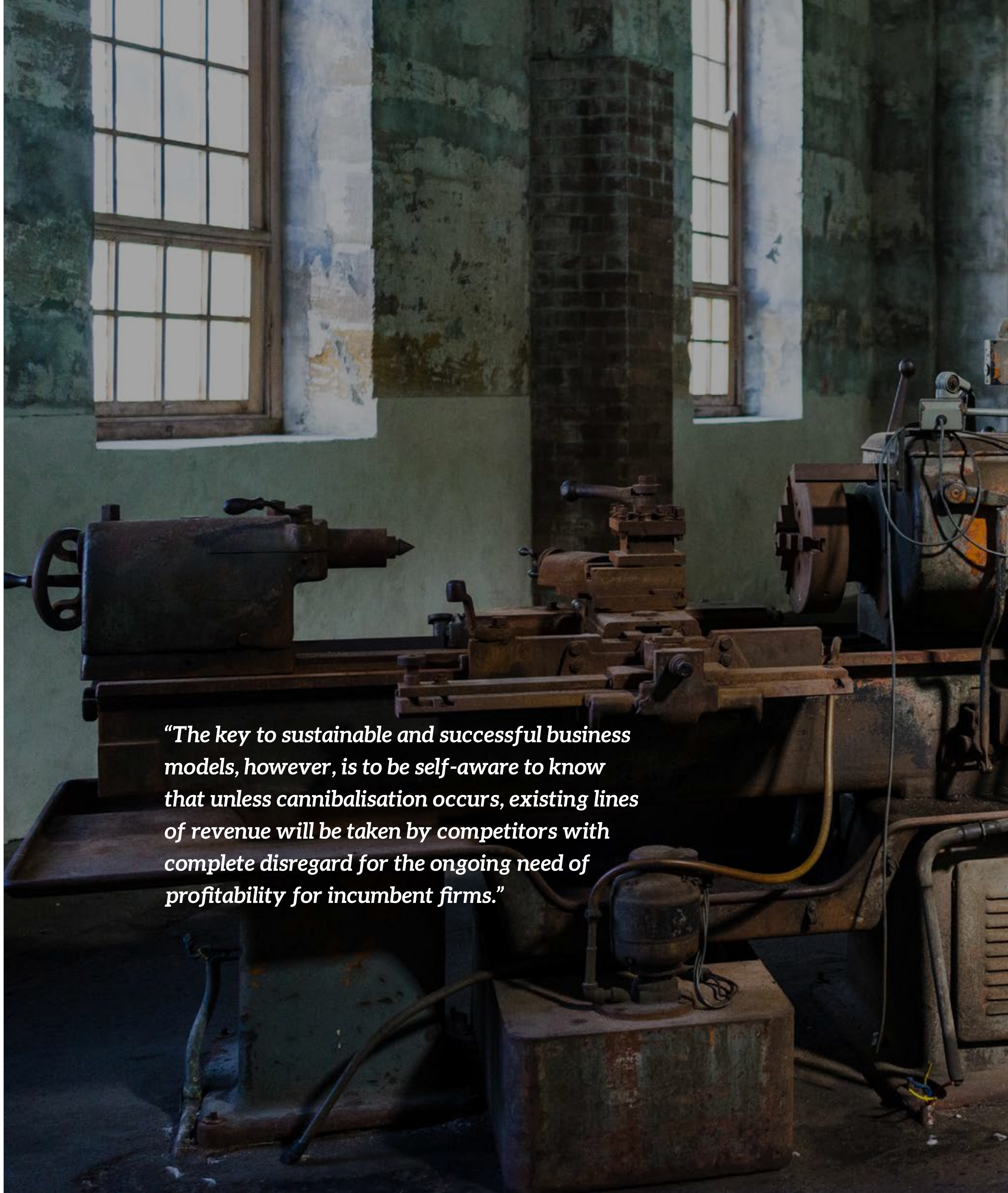
- long hours;
- rote learning;
- technology adverse; and
- conformity to tradition.

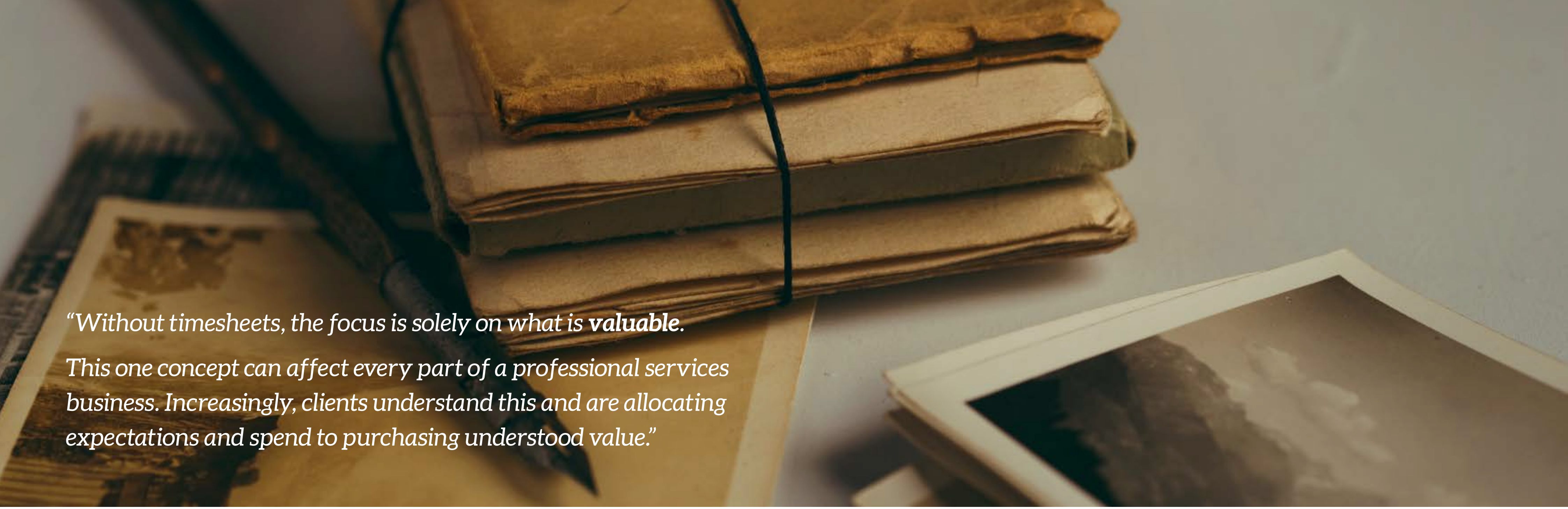
The last point is confronting as it suggests that graduates will not be motivated to challenge the traditional and the known due to the legacy and formality of the profession. This means that alternate ideas, such as bespoke service offering, alternative business models, offshoring, outsourcing and automation are not encouraged to be considered and explored.

Harper argues that any change to the "BigLaw" business model from within the profession will require that the university system rewards students who can demonstrate more innovative attributes than those outlined above.

As important is that the owners of the incumbent firms must themselves create a demand for this style of graduate.

One starting point is to abandon the time billing model. One commonly asked question refers to how fixed-pricing can adapt when there is a significant change of work required. At View Legal, we approach this through the depth of specialisation we have in the areas we provide pricing on, meaning we can provide the fixed pricing early in the process. Where there is significant uncertainty in what might be required, we compartmentalise the process and price-scoping for each step in the process before the work is performed. Where substantial change is required, we do not perform additional work unless the client agrees in advance to adjust pricing for this additional work.





A transition to fixed, and ultimately value-based, pricing has multiple layers of consideration, including:

- **Parkinson's Law** which is a serious challenge even without timesheets. Perhaps counter-intuitively, key performance metrics are often still time-related. This could be maintained with a new metric considering the duration between agreeing on a scope of work and delivering that scope to the client;

- **Communication** both internally and with clients is vital. Many law firms exist because of Murphy's Law, i.e. everything that can go wrong will go wrong. Successful fixed pricing almost entirely depends on carefully planning and agreeing on a defined scope. If there is a legitimate change to scope that could not have been identified at the start of a project, there must be real time communication within the team and immediate engagement with the client;

- **Centralisation** of all team learnings in a logical and easily accessible manner which is a critical discipline that should become automatic. A leading value-pricing thinker, Ron Baker, founder of VeraSage, suggests using After-Action Reviews (AARs) to correct a manner of thinking especially to maintain a productive work during periods of change. An AAR was originally developed by the US Army and is a structured review process undertaken by the people involved in a project that allows for the analysis of what happened, why it happened and how it could be done better;

- **The Goldilocks Principle** which helps explain why many value-pricing firms offer the client alternatives in the level of service provided. The time-billing professions remain essentially the only industry in the Western world that do not empower their clients to choose service levels; and

- **The Donkey Principle** which explains that the best performing professionals in a time-billing model are generally of least benefit in a fixed-price model – the impact of this culturally cannot be underestimated.

There are numerous other impacts for professional firms to move away from the dominant time-billing business model. Many suggest that the most important lesson is the depth of cultural change because timesheets (even when fixed pricing) create a focus solely on what is ***billable***. Without timesheets, the focus is solely on what is ***valuable***.

This one concept can affect every part of a professional services business. Increasingly, clients understand this and are allocating expectations and spend to purchasing understood value.

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