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# Innovating the Value Propositions

**Giorgio Merli***

*Senior Vice President, Solving Efeso International, Professor of Business Sociology, Bicocca University, Milan, Italy*

***Corresponding author:** Dr. Giorgio Merli, Senior Vice President, Solving Efeso International, Professor of Business Sociology, Bicocca University, Milan, Italy, Tel: +374 10 23-72-61;E-mail: g.merli@yahoo.it

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## Abstract

'Traditionally' innovating the value proposition of a company meant reviewing the products with the intent to make them more "innovative" in their content. Today it is important to consider that in the new market context, customers are increasingly inclined to value a product through its utilization function, i.e. to buy it more as a 'service' than as a product. Selling products through the value of their function is defined as "Servitization" of products. This is only one of the new concepts being adopted today by leading companies to innovate their value propositions.

**Keywords:** Innovation; Servitization; Value proposition; Surpeting

## Value Proposition and Competitive Spectrum

The 'Value Proposition' represents what a company offers to the market. It is the tangible element which customers perceive in terms of value for their explicit or underlying needs. Usually these needs are more explicit and objective in 'Business to Business' (B2B), and less explicit in 'Business to Consumer' (B2C).

As we all well know, all companies, in order to gain a competitive edge, should first think of how to propose to the market products or services more attractive than the ones of competitors. This will allow them to stand out from the arena of traditional competition where winning is only possible by offering the same products and/or services at a lower price and/or with better quality.

The "price & quality" challenge is no longer feasible in the long run by companies in western countries challenged by competitors operating in less 'expensive' systems who are perfectly capable of generating good quality performance. This has been proven by competitors from emerging market. Western companies, today, have no other way to win: offering products or service with more "value". For this reason, what they need now is to systematically generate innovative 'value propositions', avoiding like-for-like competition on similar products and/or services. This means to be able to avoid competition by "Surpeting", that means offering to the market something that others are not offering, or seeking areas of business where competitors have not yet entered. Surpeting vs competing should be the new strategic imperative. The "Surpeting" concept, when referred just to the value proposition, is similar to the Blue Ocean concept as developed by Kim W. Chan and Renée Mauborgne [1]. This Strategy is the one that aims to avoid having competitors or, more appropriately, to outpace them by developing and proposing more innovative products and/or services. But today, considering the new market scenario and its trends, the meaning of innovation is more expansive and partially different from the one we had in the past.

The starting point to understand what, where and how innovate should be the understanding of how and where to look for possible valuable innovations that can be quickly converted into business results. For that purpose it is important to be aware of the current development trends of consumer behaviour and that of the market in general (therefore, both B2C and B2B).

The first phenomenon to be considered is the polarization of the behaviour of customers . Current trends show a continuous decline in volume of "average" products in favour of low-priced mass products on one hand (more and more perceived as commodities), and of those with high 'perceived value' on the other.

This phenomenon demonstrates a behaviour that ranges from the historically statistical bell-shaped curve to what can be represented instead with a well-shaped curve as shown in Figure 1.

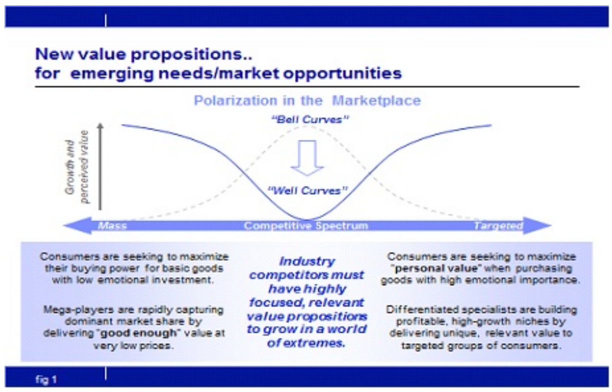


**Figure 1:** From 'bell' to 'well' (source: IBM-IBV).

But the trends of the market behaviours are more articulated. The current Competitive Spectrum is evolving towards a configuration characterized by three areas of needs and offers, each with specific features: the "mass-commodity" business, where the content is a given, the "servitized" business, where products are sold through the service, the "value" business", where premium prices are paid for the perceived value (Figure 2). This spectrum is quite different from the one represented by the Bell-Gauss curves and has a significant effect on the value propositions that companies should develop to address the market if they want to remain as competitive and/or increase their competitiveness.

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Each business area should be managed in a dedicated way. It means that a company should have, first of all, a clear conscious competitive positioning in the competitive spectrum. In addition the Management should develop the ability to renew the company's offering in the business area where it has been decided to compete, in order to comply with and even anticipate to changes in customers' buying behaviour. The capability to develop and manage coherent offerings based on this kind of segmentation is the key to win today.

Let's examine characteristics and related strategies for the three reference arenas.

If a company decides to play in the arena of "Mass Commodity Products", the first competing factor usually considered is the price. With this perspective this business could seem today almost impossible for 'Western' companies. In reality it is not true that it has to be left to others, but merely that it must be tackled differently. In fact, in the low-cost product business, greater margins can almost always be found in the commercial mark-ups rather than in the actual production of those products. Therefore, in such an area the best business lever is to manage the market/customers rather than the product.

Considering the volumes involved, maintaining such a business can be of strategic importance and therefore attention should be focused on its commercial/distribution dimension, developing an adequate and efficient sales and support services network. This is certainly applicable with regard to semi-durable goods (cars, household appliances, etc.) and in cases where the company has direct contact with the end customer. It might not be equally feasible for consumer goods sold by the major retailers, where the brand can easily be "passed over" or subject to "intermediation". So, it becomes necessary to consider more advanced and efficient multichannel methods, including e-commerce.

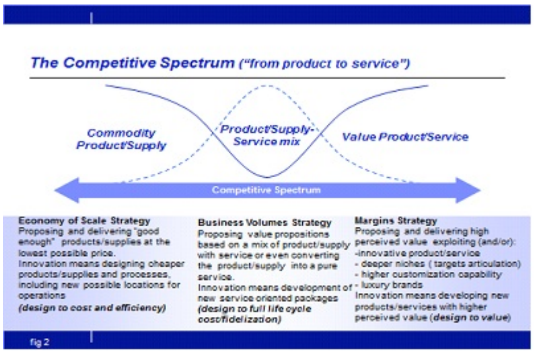


**Figure 2:** The Competitive Spectrum.

For commoditised products the key strategy is to always know how to procure the elements of those products at the lowest possible cost. If the manufacturing of these products has to be maintained inside for any reason, a design and engineering approach must be adopted that focuses heavily on developing low-cost products ('design to cost') and that ensures the cheapest and most efficient production. This could also mean delocalizing production to emerging countries. An alternative is to utilize economy of scale automations, if sustainable.

In many cases, in order to ensure that production costs remain low and can be varied at the same time, production is outsourced. It may well be that production of the higher end products is maintained in-house in order to control the technological know-how and to retain the manufacturing capability.

The most drastic strategic option, as previously stated, is to limit the activity only to the sale of products, acquiring them from completely independent third-party manufacturers (probably based in emerging countries). Some examples of strategies used to this regard can be found in the automotive sector where, to produce low-cost cars, almost all the previously described manufacturing strategies are implemented:

• Manufacturing in company-owned factories located in countries with low production costs (today, for example, Brazil, Turkey, Romania, India, China and South Korea);

• Manufacturing with totally delocalized divisions/brands (such as Renault with Dacia Logan Romania);

• Acquisition of entire companies with product and production know-how, integrating them into a specific brand (for example Chevrolet acquiring South Korean based Daewoo, changing the name marketing the products under the Chevrolet brand);

• Partnerships in economies of scale with competitors for the platforms or even for the entire car with chassis' that are different for the specific brands (several existing cases);

• In-house manufacturing of high-end cars whilst outsourcing manufacturing of lower cost models.

The situation is quite different when considering the "Perceived Value" business arena, where success is based on the ability to offer products/services that are deemed to be "innovative", 'luxury branded', 'niche targeted, or 'customized'. A more large-scale utilization of the "perceived value" As far as the value constituted by the niche product/service is concerned, this refers to the possibility of exploiting niches within an industry, or niches crossing all sectors, to satisfy specific needs of homogeneous groups of customers. In the first case (industry niche) it means, for example, specializing in the supply of machines/devices for some very specific application. In the second case (cross niche), it means offering products and services designed for that specific segment (such as products/services for pets, products/services for persons with celiac disease, etc.) to customers. Strategy could help Western companies to avoid a direct cost-competition conflict with companies in emerging countries. This obviously does not exclude defensive strategies in other areas. In this area, the cost factor is not as important and may even be negligible.

The perceived value is linked to brand values, to the ability to customize, and the ability to create 'unique' value propositions. Often it is manifest in very 'soft' dimensions, consisting of the 'experience/emotion' that the product/service can represent for the customer. Actually, a good part of the increase in perceived value lies today in those service dimensions that create a different "experience" (consider the product-service offered by Ferrari where, more than a car the client can buy the experience to drive it on racetracks with the support of the Ferrari Team).

Another strategy to operate in the 'Perceived value' area is to rely on the possibility of customizing products-services. This makes it possible to distinguish the firm's value proposal from the competitors who supply more standardized products. In this case, the customization is clearly perceived as value by the customer, and thus worthy of a 'premium price'. Therefore, it becomes necessary to develop ad hoc engineering skills and technologies (customization engineering) along with high production flexibility (customized manufacturing), to provide the customer with significant interaction with the in-house engineering and manufacturing processes.

In this case, the customer is no longer a 'consumer', but becomes a 'pro-sumer', i.e. a proactive customer in the supply chain that develops and configures the product or service designed for himself by himself (***). The customer pays an additional price (the premium price) or preference is acquired, with price being equal, for this proactive 'service' placed at his disposal. Some examples of the past include Dell PCs (customer configurable PCs), customized Nike shoes (customer configurable), and the specific chips (ASIC – Application Specific Integrated Circuit) customer engineered using the supplier's facilities. Following this logic in reality production could be 'delocalized', i.e. carried out in the 'user' market or in areas with low manufacturing costs.

Another strategy of Western companies could be to penetrate even further into the respective niche markets, taking advantage of some of their historical capability. Probably, in order to avoid competition with the more mass-oriented manufacturers, this will require greater concentration on even smaller sized niches, thereby increasing the number of even more specialized niches. The greater number results from the fact that a reduction in the range of the niche leads to a requirement to increase the number of niches to at least guarantee the necessary volumes. 'The strategy of the Thousand Niches', linked to the value of 'Made in Italy', might be considered one of the easiest answers by Italian System.

But the large business volumes, i.e. those that will develop and guarantee the jobs needed by European Countries must probably be found in different business areas outside of the commodity products (inevitably produced increasingly abroad and only sold in rich Europe) or products with high perceived value (not generating large volumes).

It is today the business arena of the "Product-Service mix", where products are sold through the service. This is the area historically occupied by "average" products. They represent the greater relative business area, but in their business the relationship with the market, as a trend, is no longer based on offering the product as such.

It is here that major transformations of the offering are needed in order to maintain large business volumes, especially for products with predominantly domestic application (for more internationally targeted products it is better to focus more on 'value').

To better understand the situation, it may be helpful to take a look at the automotive sector. The polarization of consumer behaviour in this market is such that the sales of low-priced cars as well as luxury or niche cars (SUV, City Cars, Green Cars, etc.) have increased in the direct sales mix (via dealers) to the detriment of traditional 'average' cars. But with respect to this decline in the purchase of 'average' cars by consumers, sales efforts are being redirected to another channel which is no longer B2C but B2B.

In fact, in Europe, already about a third of all cars are not sold directly to user customers but, through the concept of 'car fleets', to 'company' customers that allow them to be used by individuals (company fleets, buying consortiums or leasing-rental companies). This means that the traditional 'average' sedan is no longer sold mainly as a product, but as a 'transport service', acquired under a B2B scheme by a Purchasing department.

In this 'offering', the car is only a component of the 'product-service' package that represents the new business object. The increased margin comes more from the financial and service ingredients (financing, insurance, maintenance, etc.) than from the product itself, which merely becomes a vehicle for the new 'service' business. It should be noted how in this set-up the 'service' factor takes precedence over the physical component of the product (i.e. a service is sold with its content of physical product). Therefore, cars are increasingly sold as a 'service' instead of as products. In other words, they are purchased for their purpose/function.

This phenomenon is represented by the term "Servitization". Taking advantage of such trends in buying behaviours can certainly help to increase a company's turnover or to maintain manufacturing volumes for products with low appeal. However, the situation for cars is still a 'competition'-based strategy (considering that by now all manufacturers are doing it).

Applying this strategy proactively to certain markets and/or products would instead be a surpetitive innovation strategy of the value proposition. Innovating to create a competitive edge in this sense means continuously seeking new product/service formulas with an increasingly greater focus on the service dimension. There are already many examples to this regard.

Selling the product through service (examples)

- Cars as managed fleets (fleet management);
- Hardware/Computers as managed or use-based fleets (pay per use);
- Use-based Software/application (on demand);
- Use-based 'insurance contracts' (pay as you drive);
- Products in the supermarket on a 'supplier-managed shelf' (and with private labelling);
- Civil aviation (but also military) through 'cost per flight time' (pay as you fly);
- Earth-moving machinery (or machine tools) based on pay as you work;
- Electric power plant as 'delivered KWH' (in relation to real consumption over time) instead of a power plant plus a maintenance contract (pay per use);
- Creating the customized product (pro-sumership);
- Product as an "experience" (fashion, luxury, etc.).

With the car example, as in all the other traditional products as well, the competition from emerging countries will become stronger and stronger. In businesses based on local service this competition will certainly be less aggressive, considering that:

- Service-delivery is not easy to manage directly by distant third parties
- The local costs are equal for all players.

As previously stated another important factor is the possibility of doing business exclusively with regard to the 'service' component of a product that could be originally a low-cost product purchased from emerging countries. This evolution is common to almost all traditional product sectors. The new potential business, a good part of which replaces the one linked only to the product, must still be sought in this market area.

This is the 'third' behavioural segment of the market, the one between the low-price products and those with perceived value. This is the prevailing way with which the 'average' products are sold today and will be sold even more in the future.

In summary, the market is focusing on three specific new segments (characterized by different buying behaviours):

• Commodities

• Product-service

• High perceived value.

The business-organizational models applied must be able to serve each of these three specific market segments. In fact, the most innovative companies are operating on all three of the previously described areas.

The first consideration to make is that the three previously identified segments require completely different value propositions and market and organization strategies. They cannot be tackled with the same organizational model used in the past when, instead of three distinctive business models, there was a 'continuum' of buying behaviours, and therefore of offerings, based on the Gauss curve (a reference average product with expansion toward richer and poorer products).

In the commodities area in fact there must be cost/efficiency strategies (design to cost with possible production delocalisation's or simple marketing of products imported from low-cost countries). By contrast, in the product-service area there is a need to develop innovative value propositions and to design innovative packages of products-service under a full life cycle cost scheme (since the management cost of the product for its entire life cycle becomes a burden for those who make or manage it). Finally, in the perceived value area, it is necessary to seek innovation of the contents of the product/offering and specific customer management (design to value and customer care).

How such a strategic approach, based on the segmentation of possible offerings on the three identified business arenas, is summarized in Figure 2.

As highlighted above, the three different business streams require different operating models with correspondingly different organizational and process models. Each stream drives an operating model with specific areas on which to invest and explicit understanding of the levers required to compete/surpete. For this reason companies must have highly evolved strategic and managerial capabilities to operate simultaneously with multiple models, and/or to 'navigate' amongst them, or to focus on just one of them. Often there is a need to implement a strategic-managerial 'strabismus' in order to compete over several centres. Much attention must be given to regulating the three operating models in a different manner. The management logic must be properly identified and distinct.

An example of how to operationally manage a polarized strategy is provided by Victoria's Secret, which created two different supply chains for the two lines of products on which it decided to focus. The supply chain for the high-end items (lingerie) was organized to resupply the sales outlets in the shortest possible time. This was done to maximize sales and to avoid losing any sales possibility. The line of high-end items generates high contribution margin products through the perceived value being high. By contrast the line for the 'medium-low' items, relatively generating less contribution margin (such as stockings) was organized to resupply the shelves at the lowest possible cost. The high-end items are shipped by air since the costs of lost sales are much higher compared to the lower cost of using a different type of transport (risk of breaking stocks on the shelves). The low-end items are instead shipped by ship/truck, in quantities according to forecasts and trends, and with what are obviously longer delivery times. Similarly, the marketing activities and initiatives vary depending on the different positioning of the product.

A more elaborate example of the 3 operating models is provided by what is happening in the Fast Moving Consumer Goods business:

• Sale of unbranded products (without labels/white label) at a low price under economy of scale (at discount stores and at cafeterias) with the objective of saturating production capacity;

• Creation of significant business volume by supplying the retailer with private label products, i.e. labelled and priced on behalf of the retailer (in this case they sell the customized management service of the Supply Chain);

• Direct sales of products with their own brand with a high 'perceived value' positioning and high margin (on which specific sell-out and advertising actions are applied to generate sell-through).

• Obviously, the product, marketing, organization and operating strategies for the three business models are quite different from each other. Let's analyse the characteristics of the three operating models.

The "Value Product model" is based on what is mainly a margins strategy (high difference between revenues and costs), thanks to a premium price that the customer accepts by virtue of the perceived value, the emotions and the service received. The overall volumes are generally limited (even if they are sometimes high) and will be realised in multiple market niches supported by high Brand value. This implies an operating model that focuses its key skills on the ability to understand the consumer needs and to create or co-create services and products that generate emotion and loyalty. The main differentiating characteristics for the positioning in the Value Product model depend on the strategic lever used (luxury brand, niche, customization, innovation).

## Luxury (luxury brand)

• Capability of creating emotion;

• Focus on brand positioning initiatives;

• Personalized relationship/service with the customer;

• Design and functional quality of the product consistent with the Brand.

## Niche

• Product/Service;

• Innovation/development of new products for the selected niche;

• Capability of managing the relationship with consumers in the niche (community/social networking);

• Capability of understanding the context and weak signals of industry;

• Innovation/development of specific technologies;

• Relationship with leading customers of the industry;

• Exploration of new niches for application of the company technology.

### Customization

• Capability of creating a flexible manufacturing process;

• Flexible/to order engineering and design;

• Cooperation with the customer (co-creation/pro-sumership);

• Development of distinctive technologies.

### Innovation

• Capability of creating innovative products;

• Capability of carrying out product marketing;

• Capability of developing innovative technologies.

The analysis of the characteristics and needs of consumers, product and service innovation and the ability to deliver them in a satisfactory manner are thus the basic levers behind the success of this model. The ability to create emotion, identification and membership must be pervasive in Luxury companies. In other words, it must involve all company areas, from design to production and from sales to after-sales. It must manifest itself in all possible moments of interaction with the customer.

The "Servitized Product model" is based instead on the company's ability to balance volumes with rather good contribution margin. As previously stated where it concerns consumables, this involves an evaluation of what was once the mass market. Because the model balances volumes with marginality, the organization must have diverse capabilities that channel the two elements into what could be defined as a dual/cross-eyed strategy. The capabilities must be such so as to control costs to ensure operating excellence and to understand the consumer and innovation in the product-service mix. The investments and the budgets are allocated in a balanced manner over the various areas in order to pursue the objectives. The dual strategy obviously entails a certain tension within the company and a possible oscillation toward one of the other two centres, depending on the timing and the influence of a prevailing logic (optimization of costs toward premium positioning). It is also true that if it is possible to find and carry forward the proper balance, correct positioning will also enable generation of greatest absolute profit.

Some companies are making this model work, in some cases recreating a mass market once thought to have been going through a crisis. One case in the shoe sector, and now for clothing in general, is Geox. The company from Montebelluna was able to develop a model based on an important technological innovation able to provide the market with a product in the average price range with high volumes. In this case, we can say that the technology supplies that service of having a 'foot that breathes', 'the skin that breathes' that distinguishes the product and the company. The Brand developed around the technological innovation further strengthens this positioning.

For the case involving semi-durable products such as cars and household appliances, it should be recalled that the main sales method, as already seen, will be that of the product-service package, in which the product will be managed/maintained by the supplier. Therefore, it should be recalled that, in this case, there is a need for design capabilities that can develop the best product to make operating management easy and effective. For the car sector, this refers to the ease and economic management of the fleet. That the product life cycle in this case is often in the hands of the manufacturer (through its full leasing or fleet management company) often generates a strategic need to know how to design a product with the lowest possible cost, from production to disposal (full life cycle cost). Thus, it is important to consider, at a design level, even the reverse logistics costs, understood as the commercial disposal costs of the returned product and/or the physical disposal of that product (in this case with effects on the materials/components to consider at a design level).

For the case involving durable industrial products such as industrial machines and systems, considering that they can be supplied under a pay per use scheme (such as hours used or kwh delivered), it is also important to consider the system financing aspects (Project financing, etc.). Instead, 'Commodity' positioning involves an operating model that focuses heavily on operating excellence and/or on the low purchase costs of marketable products. The absolute profit is generated mainly by the high volumes, while the unit marginality is low. Company efforts and investments are focused on optimizing costs, on defining the production or purchase model of the goods or delivery of the service at a lower cost and on the policies that generate incentives to purchase large volumes, both in terms of a relationship with the consumer and with the channel. The experience given to the customer is consistent with a no-frills model: the image and the marketing investments move in this direction. As already mentioned, in this area it is of fundamental importance to safeguard the last link in the value chain, i.e. the sales link, where the greatest margin is realized. It should be recalled how important it is to have an adequate support service network, to make the model sustainable. Also in this case, a strong Brand will make it possible to improve the positioning, allowing the company to stand out from others and to Surpete.

## The Importance of Service

A review of the previously analysed competitive factors for developing a company's offering shows how Service is in fact the competitive factor for business innovation in all three of the previously described offering centres. Indeed, it is the support/enabling factor in the commodities area, it represents almost the entire subject of the offering in the 'product-service' area, it is innate with the value proposition and can be the differentiating factor in the 'value product' area.

The fact that Service is considered the key factor for Innovation of the offering of companies is effectively summarized by the concept that is emerging in leading companies, i.e. that the main innovation lever is today to be found in Servitization of existing products-services. The Innovation & Servitization binomial is the reference slogan of such an Innovation Strategy. This was already discussed in 2002 by Faiz Gallouj [2] in his book "Innovation in the Service Economy", in which he states that:

*"…modern economies are both service economy and economy of innovation. Paradoxically, they are not regarded as economies of innovation in services…It is as if service and innovation were two parallel universes that coexist in blissful ignorance of each other".*

What is clear is that all economies, once they have gotten past the initial manufacturing industrialization phase, tend to convert into economies based mainly on services (even China, from now on). This appears evident from the analysis of the effect of the services business [3] on the national GDP compared to that of agriculture and manufacturing. In advanced economies, services already represent 75-85% of the GDP and are the driving force for its development. It can be noted how the contribution of industrial production to the GDP, after an initial expansion phase, has decreased to make room for an increase in the services business. However, it should be taken into account that it must not be considered separately from the manufacturing business, and in fact it is the services sector that can maintain the country's industrial system. This applies since, as already discussed:

- Manufacturing industry products are always sold more by services companies (financing, distribution, etc.);
- More often it is service that drives a product on the market (fleets, leasing/rentals, pay per use, on demand, etc.);
- In service one can distinguish the difference between a 'Western' value proposition and one from the emerging countries (it is the only entrance barrier).

## The Life Cycle and Renewability of the Value Proposition

The interpretation of the model that has just been described can also have a significant impact on the strategic design, development and management procedures of the Value Proposition throughout its life cycle. The traditional reference model represented by the product maturity curves, that called for the use of the same sales procedures/channels throughout the life cycle, can be combined quite effectively with the following procedure (with reference to a leading innovation-oriented company in its market) [4]:

- **Stage 1:** development and utilization of an innovative product-service as an offering with great perceived value, with a margins-based strategy (positioning in the right centre of the reference figure). One example was the Blackberry that was just launched on the market as a product with an innovation-based premium price;
- **Stage 2:** sales of the product through service when competition on the product emerges, with potential cancellation of the innovation-based competitive edge. In this step the Blackberry was/is sold through subscriptions/telephone services where the revenues are guaranteed by the subscriptions;
- **Stage 3:** transfer of the patent/know-how utilization right to sellers of Commodities and/or companies that operate in a product economy of scale (think of IBM portable PCs sold to the specialized company Lenovo).

The three stages can be managed in some cases by the same company, but more frequently by different players. The possibility of utilizing the three stages depends on the company's positioning in terms of the ability to innovate and manage the volumes that are generated. Leading innovation companies can launch the product on the market, manage it directly during the perceived value stage, and continue to manage it directly or assign the sales to third parties during the Servitization stage and the Commoditization stage. Within this framework the life cycle of the value proposition should be managed according to a High Value proposition ->Product/Service->Low-price product path, followed by a new value proposition.

We should however also consider that there is a trend relative to the value proposition life cycle that can also be interpreted in terms of a polarization. Some companies are pursuing what are purely 'disposal' strategies, while others are trying to increase the useful life cycle of some of their products; often by utilizing the economic and/or symbolic value of those products. Furniture is a durable good that in the traditional sense of usage had a long life, and therefore should be long lasting, strong and neutral in terms of styling in order to match taste that changed over time. The entry of operators like IKEA has completely changed this approach and even furniture or household objects have potentially very short life cycles. Owing to its moderate cost, some furniture can be considered a disposable object. The clothing sector underwent a revolution about 10 years ago with the introduction of fast fashion. Operators such as Zara introduced business models with collections that lasted 3-4 weeks (compared to the traditional 4-6 months) basing their model on a strong rotation of the assortment in the sales outlet to capture consumers' attention and guarantee a certain exclusivity of garments to the clientele. Also in this case, the mix between fashion content and low product cost induces some consumer segments to consider the product as disposal.

In the fast fashion model the interconnection between the manufacturing, distribution and logistics system and the computerized real-time integration with stores reduces the lead time of the collections to quickly respond to market requests. Examples of the opposing trend are high value economic and/or symbolic products such as Hermès purses, high value and long-lasting garments such as the cashmere items by Cucinelli, Bang & Olufsen hi-fi equipment and design objects in general.

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