Business Model Innovation

By Ralph G. Trombetta, Founder Value Innovation Associates

Are new product and service launches helping you to realize business revenue and profit growth objectives? If not, maybe its time to turn your business model into a platform for innovation and growth.

When was the last time you examined your business model? Many books about innovation and creativity have been written over the past decade. Often these books point to very successful examples of product and service innovation. Implicit in some of these works is the concept of business model innovation.

Business model innovation, a more comprehensive approach to just product or service innovation, integrates many components of a business including the market offering and user experience, the value creation process, and the activity delivery system of a firm. Business model innovation helps companies to go beyond jumping from product to product launch by creating a business platform that can generate a new way of competing in established markets (*see Cell Phone Industry sidebar on the last page*).

What is a business model?

A business model consists of three elements

(a) a customer **value curve or offering** which answers the questions "how does a company create value for buyers?" and "which customer groups are you aiming your offering towards?";

(b) a **revenue and profit model** which answers the question "how can a company ensure that buyers are willing to pay for value and also generate a fair profit for the corporation?"; and

(c) a **delivery and cost model** that answers the question "how should a company organize its resources, activities, and partnerships to delivery the value curve and realize the profit model?".

Disruptive Innovation (C. Christensen) and **Blue Ocean Strategy** (W.C. Chan and R. Mauborgne) provide a set of paradigms, tools, and frameworks for thinking about creating new market space. Embedded in these works is the idea of business model innovation. Business model innovators go beyond just competing with product or service extensions that mimic what already exists in the market. They are not afraid to experiment with strategies that

- Break widely held compromises for buyers,
- Generate new user experiences with total solutions by going beyond traditional industry boundaries
- Redefine existing products or services, and
- Offer less for less with "good enough" disruptive innovation.

In short, business model innovators reconfigure key elements of product, service, and/or delivery that results in a different emphasis than what previously existed in the market.

Consider for a moment the Nintendo Wii. By figuring out why adults did not view video games as a form of entertainment, they were able to redefine what a video game was and create a new experience for adults and seniors. They accomplished this by challenging the conventional wisdom in the video game industry and reconfiguring the bundle of elements that have historically been taken for granted. This resulted in stripping out unnecessary elements that drove up the cost structure of the industry (e.g. high end graphics) and creating new elements that were never offered in the industry such as games that required physical exercise, movement and social interaction; easy to use intuitive game controllers that sense user motions; and family fun. By redefining the core idea of a video game, Nintendo created a new offering that was appealing to people who previously did not care about video games. Oh by the way, the Nintendo Wii also appealed to traditional buyers of video game consoles.

Given the Wii's price point of two to three hundred dollars less than Sony's Playstation and Microsoft's Xbox, Nintendo required a different business model from Sony and Microsoft to support lower profit margins. By using "off the shelf" chips rather than designing specialized chips (like Microsoft and Sony did), Nintendo did not need to hire high priced engineers or develop specialty electronics chip design processes. This allowed them to keep their delivery system costs lower than their competitors and actually played to their strengths; Nintendo started out as a playing cards company. The Chairman of Nintendo summed up the Wii when he said, "we decided that Nintendo was going to take another route. We are not competing against Sony or Microsoft. We are battling the indifference of people who have no interest in videogames" (Fortune, "Wii Will Rock You", June 11, 2007). Sony and Microsoft were locked into high cost business models with highly skilled technical delivery resources. This made it difficult for them to consider a less sophisticated video game that could create unprecedented value for non-gamers. Going after this new market would have required them to create a new business model with a different strategic logic than what they currently had in place.

If you are an established company, when should you consider a business model innovation initiative? What are the signs that might indicate the time is right to start?
Nintendo's starting point for innovation was to redefine a video game and battle the indifference of people who had no interest in video games. Clearly Nintendo was not a first-mover in the video game industry. Their conceptualization of a new type of video game was different, ahead of the market, and most importantly valued by people who didn't play video games. It would have been costly and difficult for Nintendo to compete directly with Sony and Microsoft given the differences in their business models. By creating a new value curve that could leverage their existing internal delivery system, Nintendo succeeded with the Wii. Their business model also provided an engine, i.e. a platform, for generating successive innovative offerings like Wii Fit.

While you might not be so bold as to strike out ahead of the market like Nintendo did to shape a new offering different from the competition, it might make sense for you to pay more attention to changes in your markets that might lead you to proactively consider business model innovation experiments. For example, if you are finding that customers are becoming resistant to price increases this may be a sign that your business model is being challenged.

If customers are leaving you for your competitors or retreating from the entire industry or category, this might also be a sign that the market is looking for a different value curve. These signals may be calling out for you to get started. Sensing weak signals requires companies to have capabilities in place to amplify the weak signals and turn them into new ways of thinking about established business models.

Our industry expertise often makes it difficult for us to see the changes that are occurring in markets before it is too late. IBM in the late 1980s was in a situation where they were defending their long-held business model of selling high margin computer systems. It was not so easy for IBM to acknowledge and understand how new entrants were providing IBM's customers with an alternative value curve that was appealing. IBM's late move to change its business model, despite evidence that it was no longer working, almost resulted in their demise.

In the late seventies and early eighties IBM's value curve was largely about serving Chief Information Officers (CIOs). IBM helped CIOs to keep their business enterprises up and running with large mainframe computer systems supported by technical services. IBM's revenue pricing model included leasing services with product margins of 70-80% for their largest computers. These high gross product margins enabled IBM to deliver technical services to customers who purchased their computers "for free". IBM's "bundled services" business model allowed technical services to be funded from high margin product sales (rather than from separate services fees).

In the mid to late eighties IBM's business model was threatened by the Japanese Computer Manufacturers (JCMs) and midrange computer manufacturers operating with different value curves. IBM's new competitors had business models that supported lower priced products that were appealing to IBM's existing customers. (In fact, IBM's customers when negotiating a contract for a large computer system would use the threat of buying from JCMs as a negotiation point to get lower prices from IBM. Sometimes customers would do this subtly by just placing a red Amdahl coffee mug on their desks).

The new entrant's delivery systems did not have the depth of resources that IBM had and as a result they had lower operating costs that allowed them to make reasonable profits from lower priced products. In contrast, IBM's business model with its heavy fixed costs and semi-variable costs in its delivery system would not allow IBM to earn a reasonable profit with lower priced products. As computer systems became more and more reliable and diagnostic and recovery routines became encoded in software routines in the computers themselves, this further tipped the scales in favor of these newer business models that threatened IBM's core business.

IBM was forced to change its business model to regain competitive advantage in the industry. In the nineties, IBM reconfigured its value curve by reducing its large computer system prices, reducing free product technical support, and raising business process and technical consulting services for a fee. Consultants became an important component of IBM's delivery system and a new important revenue stream. The new business model incorporated changes in product and service mix but also included a new equation for creating buyer value and for making a profit. It required a massive transformation within IBM that took an outsider, Lou Gerstner, to lead. The new entrants, who initiated business model innovation first, drove IBM to change its business model as a way to survive in an industry that it had largely created.

So how do you go about innovating your business model? When should you do this?
This all starts by exploring the issues, frustrations, and latent needs that potential buyers have in your market so that you can formulate new value curves (offerings) to solve those issues and needs. This requires companies to go beyond traditional market research methods such as satisfaction surveys and product-oriented market research. Rather companies must engage in more qualitative research and observational research around the activities that customers go through in their business and personal lives using the products and services that are offered in the market. These "day in the life of" research methods have the potential to generate rich insights that can help corporations to formulate new value curves to redefine the nature of competition in established markets.

After establishing a new value curve, the next step in creating a business model innovation is to construct a revenue model followed by a target profit model. The revenue model is critical to ensure that the value that you will create for buyers with your new value curve is commensurate with how and what customers are willing to pay for the offering. If you get the revenue and pricing model wrong, your value curve may still be valued, but not with the pricing elements or at the pricing level that you have initially set. Getting the revenue and pricing model aligned with the value that potential buyers have for your new value curve is a critical step in business model innovation.

Business model innovation recognizes that it is not enough just to create value for buyers. Successful new business models also must create value for companies. Therefore, it is critical to set a target profit model that allows a company to create a theory of how it will make money from the new value curve. The target profit model is the mechanism for ensuring this.

A target profit model sets up the allowable cost parameters which guides you in architecting your delivery system. Given the allowable cost (resulting from the target profit margin) you are now ready to make strategic decisions about delivery that include which operational competencies, activity systems, and processes to keep in-house and which to outsource. It also guides you to consider where to pursue strategic joint ventures and other streamlining activities to get your costs in line.

If you are an established company, where can you apply business model innovation?
Established corporations can apply business model innovation within their existing markets with existing customers or they can use business model innovation to create new offerings outside their established industries.

Do you have a process in place to sense changes in your market? Do you have organizational capabilities to conceptualize and prototype new business models? As markets continue to change, becoming adept at business model innovation can be critical to successfully competing in the future. After several years of strong success creating new demand in the video game industry, Nintendo's business model has run its course. This example reminds us that business models do not last forever and if companies wish to survive and thrive, they will need to continue to redefine their business models over time.

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Business Model Innovation In The Digital Music and Cell Phone Industry

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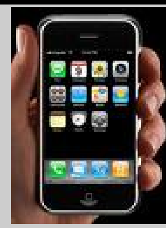

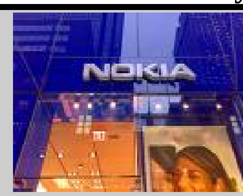

Business model innovation is broader than just product innovation. The mobile phone industry provides a good illustration of this point. Take Motorola for example. In the late 1990s, Motorola was a market leader in the mobile phone industry. They were late to respond to digital trend in mobile phones as their business model at that time was heavily invested in analog phone competencies.

While Motorola focused on a blockbuster product strategy to rival the unexpected mass market success of their RAZR phones, in contrast both Apple and Nokia pursued a more integrated and comprehensive business model innovation approach that went beyond just "swinging for the fences" with gee-whiz products. Sure the iPhone is an innovative product, but Motorola's business model of relying on the phone itself as the engine of growth forced them to continually find the next hot product and generate revenue and profit from product sales which has been difficult post RAZR. As a consequence of this faltering business model, in 2008 Motorola announced that they would be spinning out their mobile phone division only to subsequently defer those plans.

Meanwhile Apple and Nokia approached business model innovation differently with their cell phones by attempting to turn the cell phone into portal for a rich set of end user experiences that redefine what a cell phone is. Apple challenged the industry's business model by initially negotiating an exclusive deal with AT&T that allowed Apple to share in cell phone subscription revenue, an on-going annuity stream over one time product sales (different revenue model from traditional cell phone industry). Of course the sexy phone product innovation enabled them to do this but the point is that they pushed an additional lever in the business model beyond just the product. The App Store and Apple Retail stores have been critical component of Apple's overall business model. Apple's retail and virtual app store are much more than just a place to sell product. They are an opportunity for Apple to reinforce the *Apple experience* with customers, potential customers, and app developers. When the retail stores first appeared, financial analysts criticized Apple for this element. It was hard for them to see why a product company would open retail stores. Little did they know that this would become a critical element in Apple's business model innovation.

Apple and Nokia used their business models as platforms for generating a host of new innovations (bundled services, pricing models, strategic partnerships) in the increasingly mature cell phone industry. However, Nokia's business model in the music industry proved to not be enough to rival Apple. They attempted a partnership with the Universal Music Group, Sony, BMG Music Entertainment and Warner Music Group, called *Comes With Music* to offer unlimited "free music" downloads priced in monthly cell phone service fees. In this defunct and failed business model, Nokia paid the music companies a fixed price each month for each customer using this service – a different but less successful model than Apple.

A key to Apple's music business model success was the introduction of iTunes. Apple's iTunes business leapt past free download services and solved a problem for the Music Industry by providing a reasonable alternative to stem pirating. Apple's search and browsing functions have been considered the best in the industry and offered a leap in value over the free pirate type services. At the time of this writing, new streaming services like Pandora and Spotify have come into the market and Apple is now launching a new music service. Time will tell if Apple's business model will continue to stand out in a crowded space.