BUSINESS MODEL INNOVATION

CREATING VALUE IN TIMES OF CHANGE

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The innovation of business models is a highly powerful tool that can be leveraged by intrapreneurs. Innovating in terms of business models is the best way to achieve sustainable competitive advantage.

INNOVATION AND CHANGE • ENTREPRENEURSHIP

Everyone seeks to innovate in order to maximize revenues and margins. However, this usually requires significant investment: innovation is usually costly, time-consuming and is not guaranteed to be successful.

Is there a way for managers to innovate in their existing markets with their existing products by utilizing their existing resources and capabilities in novel ways? Could they extract more value from their firms' existing resources, and if so how? This question is easier to answer than it appears. Creating a new business model can pave the way for a new form of innovation.

Managers and entrepreneurs (and academics) should care about business-model innovation for several reasons. First, it represents an often overlooked (and hence underutilized) source of future income for their business, an opportunity to create new business or enhanced revenues and profits at relatively low cost. Second, these economic advantages could translate into a sustainable performance advantage, given that competitors might find it difficult to imitate and/or replicate an entire novel activity system (as opposed to copying a single novel product or process, which often undermines and erodes the returns from that product or process). Third, because business-model innovation can be such a potentially powerful competitive tool, managers must be aware of competitors' efforts in this area.

DEFINING A BUSINESS MODEL

We define a business model as the way your company "does business" with its customers, partners and vendors. That is, the system of specific activities that are conducted by the focal firm or by its partners to satisfy the perceived needs of the market; how these activities are linked to each other; and who conducts these activities.

To illustrate the concept of business-model innovation, consider the case of Apple. The company had been focused on the production of innovative hardware such as personal computers. Through the development of the iPod and the associated music download business iTunes, Apple was the first electronics company that included music distribution as an activity, linking it to the development of the iPod hardware and software. Apple thereby pushed many subactivities of legal music downloads to its customers, thus avoiding or reducing additional costs for the firm, while offering a new service. That is, Apple did not just bring a new hardware product to the market; rather, it radically transformed its business model to include an ongoing relationship with its hardware customers (similar to the "razor and blade" model

BUSINESS MODEL INNOVATION REPRESENTS AN OFTEN OVERLOOKED SOURCE OF FUTURE INCOME.

WHY INNOVATE IN YOUR BUSINESS MODEL?

KEYS FOR COMPETITIVENESS

- **It represents a source of future income** which is often neglected or underutilized; an opportunity to create or raise revenue at a relatively low cost.
- **Economic limitations** can be turned to your advantage. Creating a model of sustainable performance that is difficult for your competitors to imitate can be far more beneficial than copying a single product or a new process.
- **Realizing the potential** of this type of innovation raises the alertness of management to moves by the competition in this area and it becomes easier to identify competitive threats.
- **To change the whole system** of operations it is necessary to develop a systemic and holistic approach, which can be draining. For this reason, the options available for designing the business model are rarely questioned. Bear in mind that whatever choices are made will have significant implications in the long term.

of companies such as Gillette) and thereby enhancing its revenue and preserving profit margins. Apple has thus expanded the locus of its innovation from the product space to the business model.

Another example is the fashion retailer Inditex. The firm has made business-model thinking a corporate priority and their annual report begins by explaining the Inditex business model and highlighting its innovative elements. Inditex has made many choices that, viewed in isolation, seem inefficient. For example, for their Zara business, they perform many generic activities largely in-house, such as the dyeing and cutting of fabric, and the washing, ironing, and ticketing of finished garments. Moreover, they outsource sewing to small workshops located close to their Spanish production facilities.

When viewed in isolation, both of these choices seem inefficient, hence questionable. As a whole, however, their carefully designed activity system allows Inditex to bring new fashionable garments from the design stage to the shop floor within record time — days as opposed to months — which makes a big difference in the fast-moving fashion business. Although its competitors have much stronger track records and capabilities in product innovation and logistics, Inditex beats them to the punch through its business model, which relies on standard resources (e.g., people who spot new trends, but do not create them) and off-the-shelf technologies (e.g., standard communication technologies for transmitting real-time feedback from the retail shops to the design teams), but which deploys these resources in activities that are linked and governed in novel ways.

HOW TO INNOVATE IN THE BUSINESS MODEL? A CONCEPTUAL PRIMER

Rapid advances in information and communication technologies have facilitated new types of technology-mediated interactions between economic agents. These developments have enabled firms to change fundamentally the ways they "do business;" namely, the ways they organize and conduct exchanges and activities across firm and industry boundaries with customers, vendors, partners and other stakeholders. In other words, these developments have increased firms' possibilities of purposeful networking, that is, of structuring their destiny within the context of the value networks within which they exist. Senior managers of focal firms can actively design (i.e., construct, link, sequence), in innovative ways, boundary-spanning exchanges and activities. This structure is captured by the firm's business model.

INTERDEPENDENCE IN ACTIVITY

The number of activities that a company carries out is typically large, and for that reason innovating in the business model requires tracing the system of activities.

However, managers need to bear in mind that identifying technologically and/or strategically distinct activities can be conceptually challenging because the number of potential activities is often quite large. Many seemingly inseparable activities can be broken down further, especially given ongoing advances in information and communications technologies. One way to deal with this issue is to define activities at different levels of aggregation, such as focusing on the supply chain operations reference model, which lays out top-level activities (plan, source, make, deliver and return), and also specifies sub-activities that can be delineated at second, third, and fourth levels. At high levels of aggregation, activities could comprise whole business functions, such as accounting and human resource management. At low levels of aggregation (i.e., high levels of decomposition), activities could be as specific as the processing of customer e-mails based on their content, or the translation of product manuals into a foreign language.

INTERDEPENDENCE IN THE DESIGN OF ACTIVITY

The most important design elements characterizing a system of activities are content, structure and governance. These elements can be strengthened, leading to innovation in the business model.

The content of an activity system refers to the selection of activities, i.e., those that are performed. For example, in addition to the typical activities of a retail bank, Bancolombia adopted activities to offer microcredits to reach the more than 60 percent of Colombians who did not have access to banking services. To perform these new activities (and thereby innovate its business model content), the bank needed to train its top management, hire and train new staff, and link the new activity to its existing system (platforms, applications and channels).

In the 90s, IBM changed its focus of interest and moved from being a hardware supplier to a service provider. The company relied on the knowledge and experience it had gained over the years to launch a new range of activities in consulting, IT maintenance and other services. As a result, more than half of the $90 billion in IBM revenues in 2006 came from these activities, which hadn't even existed 15 years before.

The structure of an activity system describes how the activities are linked, e.g., sequencing among activities, and exchange mechanisms among the linked activities.

Consider Priceline.com. This online travel agency has established links with airline companies, credit card companies, and the Worldspan Central Reservation System, among others. Through the introduction of a reverse market in which customers post desired prices for sellers' acceptance, however, the firm has fundamentally innovated the exchange mechanism through which these parties interact and by which items such as airline tickets are sold. Priceline.com has been granted a business method patent on its innovative activity system. The structure of that system distinguishes the firm from other travel agencies.

The governance of an activity system refers to who performs the activities. Franchising, for example, represents one possible approach to innovative activity system governance. It can be the key to unlocking value, as was the case for Japanese retailing when entrepreneur Toshifumi Suzuki realized in the early 1970s that the franchise system developed in the U.S. was an ideal response to the strict regulations imposed by the Japanese government on retailing outlets (e.g., limiting their size and restricting opening times). By franchising Seven-Eleven stores in Japan, Suzuki adopted a novel type of activity system governance and managed to create value through professional management and local adaptation.

DESIGN OF THE MODEL

Managers can innovate in the three design elements of a business model (content, structure and governance) simultaneously.

Lending Club, Prosper and Zopa are aimed at enabling direct small, unsecured loans between individuals. Important business-model design issues for the founders in the early stages of these firms were: (1) whether or not to include a secondary market for trading loans in their activity systems (a content issue); (2) how precisely to link borrowing and lending activities — for example, would they provide an algorithm that automatically matched borrowers to lenders, and if so, to whom and to how many (a structure issue); and (3) who should perform the credit risk assessment of the borrower, the P2P firm or the lender (a governance issue)?

The founders of Prosper made the conscious early decision to let lenders choose the borrowers to whom they wanted to lend their money. This was a structural choice (settling the question of how lending and borrowing activities were linked) but at the same time constituted a decision about governance (the evaluation and selection activities were shifted to the customers and not performed by the firm).

INTERDEPENDENCE IN THE REVENUE MODEL

The revenue model, akin to a pricing strategy for specific products or services, refers to the specific modes in which a business-

RETHINKING THE FIRM'S BUSINESS MODEL CAN PAVE THE WAY TO A NEW FORM OF INNOVATION.

THE PERSPECTIVE OF THE BUSINESS MODEL ALLOWS US TO SEE THE FIRM AS A BOUNDARY-SPANNING SYSTEM OF ACTIVITIES.

MORE INFORMATION:

Universia has published the full version of this article.

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model enables revenue generation for the focal firm. In that sense, a revenue model complements a business model design, just as a pricing strategy complements a product design. Although the concepts may be quite closely related and sometimes even intertwined — for example, in the product world, Gillette uses its pricing strategy of selling cheap razors to make customers buy its rather expensive blades — business models and revenue models are conceptually distinct.

A business model is geared toward total value creation for all parties involved. It lays the foundations for the focal firm's value capture by co-defining (along with the firm's products and services) the overall "size of the value pie," or the total value created in transactions, which can be considered an upper limit to the firm's value capture. The business model also co-determines the focal firm's bargaining power. The greater the total value created and the greater the focal firm's bargaining power, the greater the amount of value that the focal firm can appropriate. How much of the total value the firm actually captures, however, depends on its pricing strategy or revenue model.

SIX QUESTIONS EXECUTIVES NEED TO ASK

As we have seen, the source of innovation seems to have shifted from the product and process to the organization of a firm's activities, specifically, their content, structure and governance. Echoing this shift, practitioners such as venture capital investors increasingly emphasize the importance of "asset-light" companies. Indeed, our own research shows that in a highly interconnected world, entrepreneurs and managers must look beyond the product and process levels to focus on their business model and on ways to innovate it in order to create and exploit opportunities for new revenue and profit streams. In this regard, we suggest that managers ask themselves the following six key questions:

1. **What is the objective of the new business model? In other words, what perceived needs should be satisfied through the design of a new activity system?**
2. **What novel activities are needed to satisfy the perceived needs? (Business-model content)**
3. **How could these activities be linked to each other in novel ways? (Business-model structure)**
4. **Who should perform each of the activities that are part of the business model (e.g., the focal firm or a partner), and what novel governance arrangements could enable this structure? (Business-model governance)**
5. **How is value created through the novel business model for each of the partners?**
6. **What focal firm's revenue model will allow it to appropriate part of the value created from the new business model?**

Addressing these questions and adopting the business model perspective helps managers and entrepreneurs purposefully structure the activity systems of their firms in cooperation and interdependence with other firms and economic agents in their ecosystems. This purposeful design and structuring can be an important source of innovation, in particular during times of change and specifically, during periods of resource scarcity and high uncertainty and volatility in both capital and real markets that adversely affect revenues and profits.

Most importantly, perhaps, the perspective advanced in this article encourages systemic and holistic thinking when considering innovation, instead of concentrating on isolated, individual choices. The message to managers is clear: look at the forest, not the trees — and get the overall design right, rather than optimizing details.