CHANGING THE WAY THE COMPANY DOES BUSINESS

HOW TO INNOVATE IN BUSINESS MODELS

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Entrepreneurs and companies can benefit radically from an innovative business model, but frequently lack the expertise required to build one. With this need in mind, IESE Prof. **Christoph Zott** and Prof. **Raphael Amit** of the Wharton School developed a step-by-step approach derived from the world of design that applies across a range of industries. The model is flexible and can be used both for new ventures and established firms.

STRATEGY • BUSINESS MODEL • INNOVATION

When we think of innovation we usually think of new products, applications or services, but this kind of innovation is often expensive and time-consuming, and has uncertain future returns. Great innovations can be found at all levels of business and sometimes in unexpected places – not only in new products or services, but also in processes and systems.

One such example of a significant source of innovation is, increasingly, the business model. Business model innovation (BMI) does not involve changing products or services, it is a reconfiguration of how the company does business. It might bring together previously unconnected players; it may link current players in new ways, or it can introduce completely new players or mechanisms.

The value of this type of innovation to stakeholders can be tremendous. Economist Intelligence Unit analysts even conclude that how companies do business (as defined in their business model) is often as important, or even more important, than what it does.

CHOOSING A BUSINESS MODEL

The business model is fundamental to a firm's strategy. It is one of the most strategic choices that entrepreneurs and managers can make, because it defines how the firm embeds itself in its context in terms of the networks of companies and institutions and customers that surround it. It stakes out its friends and foes, and helps firms make crucial decisions when it comes to anchoring their competitive advantage.

Take the case of Israeli start-up FriCSo, which developed a friction-reduction technology. They had three very different business models to choose from. As machine manufacturers, they could embed the technology in machines and sell them to resellers and suppliers; as an R&D company, they could license their technology to machine manufacturers; and as a service provider, they could provide an outsourced service to resellers and suppliers in manufacturing.

Each option is very different in terms of costs, core capabilities,

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competition and potential partners. In the manufacturing model it would compete against other established and powerful machine manufacturers. In the licensing model it would partner with them. Each model had different capital requirements –the machine manufacturing model required significant investment, for instance.

Three converging trends have been driving companies to bring innovation into their business models: the digitization of business, the increasing numbers of digital natives who expect a slick online experience, and the increasing importance of customer input and feedback. These developments have spurred firms to fundamentally rethink and reshape the ways they do business. Innovating at the level of the business model is one way to do just this.

BUSINESS MODEL INNOVATION

The business model is an activity system adopted by a firm to meet market needs and create value for stakeholders, whereas business model innovation (BMI) is the design and implementation of an activity system that is new to the firm, or new to the product-market space in which it competes, and recalibrates how it does business in that space.

Modifying an activity alone without changing the entire activity system or the way the company does business does not constitute business model innovation. So implementing new technology does not qualify. Take the adoption of injection-molding technology for making candles. This is a technological innovation that makes manufacturing more efficient, but it is not BMI.

BMI redefines an existing product or service and how it is delivered to the customer. Take the example of Dell. Dell implemented a customer-driven, build-to-order business model, which replaced the traditional build-to-stock model of selling computers through retail stores.

Some consider that BMI enlarges the economic pie by attracting new customers or encouraging existing customers to consume more. Amazon did this through business model innovation.

The newness, novelty or innovativeness of the business model can be in its content (its organizational activities), its structure (exchanges), or its governance (partnerships). And because of the interconnected nature of the business model, a change to any of these parts can lead to further changes at the system-level, resulting in changed functionalities and performance prospects.

Take Apple, for example. In the early years Apple designed, produced and sold hardware. The value in its business model was in the sale of hardware. But once Apple introduced the iPod, it drastically altered its business model by expanding its reach into the music industry and intellectual property realm to claim a stake in how its hardware was used. iTunes was a further breakthrough, which saw Apple convince the music industry to sell by the song while taking a share of every download. All this changed how the company interacted with its product-market space. It continued to produce devices but was involved with the content for those devices. And of course this led to enormous benefits to stakeholders.

THE FIVE-STEP PROCESS

So how can business models be innovated? Business model innovation has been relatively neglected and no generalizable process has emerged. In view of this missing link, we looked at the design process model for inspiration to fill the gap.

This BMI process is drawn from the design process model used by the California design firm IDEO. While the original purpose of the business model was to design new products, it has also been used to design services and entirely new businesses. The process has enormous versatility, which makes it a good framework for BMI.

There are five stages that make up the design process:

1 **Observe.** How do customers use your product, whether it is hospital services, trains or cell phones?

Observation means heading to the source, not to market research experts. The designer needs to develop a deep understanding of the customer experience, especially of the problems customers face when buying and consuming products and services. To increase the chances of generating novel ideas, designers need to be keen observers. New ideas are more likely to come from spotting the incongruous detail in a mechanic's shop than by hiring expert consultants or asking statistically average people to fill out a questionnaire.

All business model stakeholders, (suppliers, partners, and the firm itself) not just end-users, need to be taken into consideration. In business model innovation, the observation stage is broader and more complex than it is for the design of new products or services.

2 **Synthesize.** Take stock, share and make sense of the data received at the observation stage. In BMI, this means gaining a holistic understanding of the challenges and influences of the design process. It means asking important questions: who are our customers? What are their needs and goals? How can we help them solve their problems and where are we falling short in doing this? To what extent do we rely on strategic partners to conduct activities for us? There needs to be a strong sense of the market gap. Synthesis is an attempt to move forward, create a response to the problem and generate solutions.

3 **Generate.** Create potential design solutions; brainstorm. This may involve modifying an existing business model in novel ways or creating an entirely new business model from scratch.

4 **Refine.** Evaluate and concept-test the various proposed solutions. Experiment on a small scale to make sure the innovation is moving in the right direction. This process brings concepts to life; it is a low-risk way to explore different directions. Customer and stakeholder involvement here is crucial as the designers can present their prototypes and observe reactions and get feedback. The stakeholders experience the concepts in a tangible way and the firm can gauge where best to dedicate its resources by classifying the alternatives and evaluating feasibility, viability and desirability. Thus the firm can narrow down the choices for new business model designs and achieve focus and clarity of details.

5 **Implement.** The last stage of the process involves selecting the design that is the best fit. Once the new or modified business plan has been chosen, the firm must make necessary organizational and strategic adaptations. Before a full-scale launch, it can be wise to create a small-scale experiment for the selected business model, allowing customers and other important stakeholders to experience the new model over a period of time, to test key assumptions. Apple did just this in its first location in Tysons Corner Center, Virginia in 2001, before launching its retail stores more widely.

The five stages of business model innovation are linked in a closed loop. Business model innovation design teams may cycle through the process multiple times, even skipping steps, before converging on a new business model design. That design will be novel in terms of its content, structure and/or governance, but to qualify as business model innovation, that novelty needs to be expressed at the system level, and it must be "new to the world."

Business model innovation can span firm and even industry boundaries. The creative process that leads to BMI involves outside-the-box thinking. It involves re-combining resources and capabilities for new innovative outcomes bringing value creation opportunities for the firm and its stakeholders.

This kind of mindful business model design is a first, crucial step toward breakthrough BMI, and it can be considered a firm-level capability. As such, it could become an invaluable tool to help CEOs, entrepreneurs and general managers think more proactively about the way their company is doing business.

BUSINESS MODEL DESIGN COULD HELP CEOS, ENTREPRENEURS AND GENERAL MANAGERS THINK MORE PROACTIVELY ABOUT THE WAY THEIR COMPANY IS DOING BUSINESS

MORE INFORMATION:

Zott, Christoph; Amit, Raphael, "Business Model Innovation: Toward a Process Perspective." In: Christina E. Shalley, Michael A. Hitt, and Jing Zhou. "Oxford Handbook of Creativity, Innovation and Entrepreneurship." Oxford, UK: Oxford University Press, 2015. pp 395-406 (Oxford Library of Psychology).