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# How to Do Business Model Innovation for the Established Firm

By Thomas Bertels

This article provides a systematic framework for helping executives of large, established organizations identify opportunities for business model innovation and organize themselves to pursue these opportunities. While also applicable to start-ups, this article focuses primarily on how to define, challenge, and revamp the business model of an existing business or organization.

In nearly every industry tried and tested business models are coming under attack at an unprecedented rate:Pharmaceutical companies are searching for alternatives to the blockbuster model. Banks are looking for innovative ideas to make up for lost fees and revenues due to new regulations. A drop in advertising revenues and circulation pushes newspapers towards new sources of income. Traditional brick and mortar bookstores are losing out to online competitors that are not encumbered by pricey real estate. Software providers are being threatened by cloud computing. The common root cause at the heart of the problem:a once successful business models.



While large, established companies have many advantages over start-ups (predictable cash flow, established customers, and economies of scale), they have a fundamental handicap: they are heavily invested into the current business model, which makes them vulnerable to new entrants not encumbered by those investments (Dell in its early years is a prime example, when its made-to-order model gave Dell a substantial advantage against its competitors, who were weighted down by legacy retail distribution channels).

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The more successful a business model is, the more difficult it is to anticipate change and be proactive, before margins shrink and market share plummets. And even those who see the change coming are having a hard time convincing their colleagues to act, develop an appropriate response, and implement the shift towards a new business model effectively. Changing a business model of an established organization is difficult – the gravitational pull of the existing business is hard to overcome. The rapid pace of change is forcing every organization to examine its paradigms and find innovative ways to satisfy unmet customer needs profitably. At the same time, changing the business model, the underlying rationale for how a company makes money, is one of the most difficult and risky decisions a leadership team can make.

## What is a business model, anyway?

A business model describes the logic behind how an organization communicates, creates, and captures value. Henry Chesbrough in his book “Open Innovation” suggests that a business model has six functions:

- Articulate the *value proposition* – the value created for users by the offering based on the technology.
- Identify a *market segment* – the users to whom the technology is useful and the purpose for which it will be used.
- Define the structure of the firm’s *value chain*, which is required to create and distribute the offering, and to determine the complementary assets needed to support the firm’s position in the chain
- Specify the *revenue generation mechanism*(s) for the firm, and estimate the cost structure and target margins of producing the offering, given the value proposition and value chain structure chosen.
- Describe the firm’s *position within the value network* linking suppliers and customers, including identification of potential complementary firms and competitors.
- Formulate the *competitive strategy* by which the innovating firm will gain and hold advantage over rivals.

## Do you need a new business model?

Business models have a limited lifespan. Creating an effective business model in the first place is often a process of experimentation of learning and adoption. Once a viable model has emerged, it quickly becomes ‘the way we do business’. The success formula gets refined and perfected over time and rarely challenged. Others in the industry copy the success formula that emerges, and it is not unusual for an entire industry to converge around a single way of doing business, which becomes the paradigm…until a new entrant unconstrained by the industry dogma emerges.

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The more entrenched the business model is, the more significant the opportunity for an outsider to disrupt. Most companies wait until margins start to shrink before they rethink their business model (a phenomenon described as the ‘boiled frog’ syndrome). Many fail to find a better formula or fail when trying to execute the change. There are several scenarios in which an executive should question the existing business model:

- You are introducing an existing product to new markets and need to rethink your value proposition.
- You have a technology, product, or service that has the potential to create a new market.
- You see an opportunity in leveraging new technologies or existing competencies and assets to meet a previously unmet need.
- You want to pressure-test your current model to avoid being blindsided by a new entrant not encumbered by the industry’s conventions.
- You are facing competitors with innovative business models who are starting to capture market share.

## Getting started: Defining the current business model

A good indicator for how unprepared most large businesses are for business model innovation is the degree to which the current business model is defined and shared throughout the organization. Without a good understanding for how the business currently creates value, it is difficult to tap into the creative potential of the entire organization. Defining the current business model is a task for the senior leadership team – not because they know best how the current model works, but also because their buy-in into the process is critical to overcome the inevitable resistance. A good starting point is to define the external and internal dimensions of the current model.

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The **external** dimension is focused on the value proposition to the marketplace and describes the organization's offering targeted to specific segments, its revenue sources, and its relationships with other market participants. The **internal** dimension describes how the firm is configured to deliver against this value proposition: its assets, competencies, business processes, cost structure, and supplier relationships. Exhibit 1 outlines some of the questions a leadership team should consider.

**External Dimension**

- What is the important customer and market need we are addressing?
- What is the unique approach for addressing these needs?
- What is the specific benefits package we offer, and at what cost?
- How is our proposition superior to the competition?
- What is the job the customer wants to get done?
- What segments are most profitable for us?
- Who else is competing with us for these segments?
- What are the sources of our revenue streams?
- How do we price our offerings and extract an appropriate amount of customer value?
- How do we currently partner with other market participants?

**Internal Dimension**

- Where are we positioned in the value chain relative to others?
- How do we ensure we can deliver our value proposition profitably?
- What unique competencies do we possess?
- How do we leverage them to create value?
- What processes are core to deliver the value proposition?
- How efficient and effective are these processes?
- What tangible and intangible assets do we own or control?
- How protected are these assets?
- What is our minimum and maximum efficient scale?
- Where do we have sustainable cost advantage?

When defining the business model for an existing business, the best starting point is the **value proposition**. The value proposition articulates the needs your offering is addressing, your unique approach for meeting those needs, the benefits for the targeted customers, and the reason this offering is superior to what the competition has to offer. Most organizations actually offer a number of different value propositions to specific customer segments – to minimize complexity it often helps to focus on a clearly defined market or product offering.

## The Importance of Fit

The secret behind many successful business models lies in effectively integrating the different elements so that they reinforce each other:

- Southwest airlines low cost value proposition is supported by its *processes* (fast boarding) and *cost structure* (focusing on single type of aircraft minimizing complexity and maintenance cost).

- Apple's business model supports its value proposition of user-friendly technology by leveraging its *network* of developers and focusing on its *competencies* (software development and hardware design) leaving the lower margin manufacturing tasks to its suppliers.

At the very basic level, a value proposition answers the question: Why should anybody buy from us? Consider the original Netflix value proposition: It offered a broad library of DVDs not available in classic brick and mortar video stores, distributed via mail, for a low monthly subscription fee, to customers willing to accept the delay between movie selection and receipt.

Once defined, the business model definition created by the senior leadership team should be shared and refined across the organization.

## A prescription for established businesses

While start-ups have the advantage of not being constricted by an existing business model, established companies can often times leverage existing (and sometimes hidden) strengths to refine or innovate their business model. There are three primary options for an established business that finds itself under pressure to rethink the current business model:

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1. Fine-tune the existing business model
2. Leverage existing capabilities
3. Create a new business model

1. Fine-tune the current business model

Oftentimes, small changes to an existing business model can stave off competitors. Mapping the current business model is the starting point for assessing alternatives:

- Shifting processes that were retained in house to more capable suppliers – a strategy car companies pursued when moving from sourcing individual components and parts to buying integrated systems
- Restructuring revenue streams – for example, a software company adopting a software as a service model
- Developing partnerships to offer a more comprehensive value proposition, a strategy pursued by Apple, whose partnerships with record companies created a seamless customer experience.
- Adopting a franchise model to rapidly gain scale and leverage the assets of others

A good way to get started is to look at areas where the current business model has become an obstacle, and systematically explore alternatives to the current configuration.

2. Leverage existing capabilities

Most organizations have underutilized assets and competencies that can be leveraged into new value propositions aimed at existing or new customer segments:

- Amazon turned unused server space into a successful cloud computing business that reduced computing cost dramatically.
- GE and Dow Chemical license unused patents to entrepreneurs and start-ups.
- Fidelity became a leading 401k plan administrator by leveraging its record-keeping capabilities.

These new value propositions can either supplement the existing business model (and possibly create customer lock-in) or help to enter completely new markets.

3. Create a new business model

Starting from scratch and creating a new business model is the most difficult path for an existing business. For such efforts, the best strategy is to insulate the team charged with creating the new model from the core business but equip them with a map of the current business model as a starting point – the more you can build on existing assets, competencies, processes, and suppliers, the less risky the new venture will be.

## Getting started

So how should one get started? The very first step is to clearly articulate the problem one is trying to solve, whether it is responding to a gradual erosion of margins, finding ways to leverage existing strengths into new markets, or developing viable alternatives for meeting unmet customer needs.

Once the problem to be solved has been defined, the second step is to **create an effective governance structure** for the effort. A stage-gate venture approach where incremental funding is provided to teams as they identify and validate promising opportunities is key. Using several competing teams is often useful to broaden the range of alternatives considered.

It is critical that the teams charged with the task operate outside the traditional hierarchy to avoid constraining the team too much.At the same time one needs to make sure the team can tap into the firm’s current strengths. Depending on the problem, this could involve recruiting outsiders to complement key executives.

> *Rethinking the current business model requires open minds and fresh perspectives.*

Rethinking the current business model requires open minds and fresh perspectives. To avoid the gravitational forces of the existing business, this task is often assigned to dedicated project teams reporting outside the established hierarchy. Team composition is important – a well-balanced team including company veterans open to new ideas, rising stars, and recent hires is a proven recipe. The teams chartered with finding alternative solutions to the problem needs to have sufficient autonomy and funding to be successful. Properly structured, being part of a business model innovation team can be a great vehicle to develop innovation management skills.

Thirdly, **adopt a structured framework**. Mapping the current business model is one thing, identifying creative alternatives is completely different. Most teams benefit from a structured innovation methodology to systematically explore the organization’s core competencies, assess the impact of trends, evaluate alternative scenarios, and understand unmet customer needs. Most importantly, the teams must take a good look at the current dogmas and paradigms that will limit the design space for the new business model. The lifespan of these teams typically ranges from three to nine months, with the final deliverable being one or several alternative business models that can be tested and piloted.

## Conclusion

There is no reason why an established company should not be able to adopt or reinvent its business model. Understanding the current model is key, and the effort invested often pays immediate dividends: it is not uncommon for teams to identify a number of viable alternatives, which can be quickly implemented. Obviously, real breakthroughs take time, but tackling the low hanging fruit and launching a number of trial balloons is a lost cost strategy to lay the ground for a more substantial transformation.

*By Thomas Bertels*

## About the author

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