HARVARD BUSINESS

Innovating Across the Business Model

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A Blueprint for Transforming the Way Your Company Innovates

By

Peter Skarzynski, Rowan Gibson

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CHAPTER 5

Innovating Across the Business Model

WHEN YOU MENTION THE WORD *innovation*, most people immediately assume you are talking about new product development, or cutting-edge technologies that emerge from traditional R&D departments. Yet some of the most successful innovations of our time have been *business model innovations* that break from company or industry norms in meaningful and perhaps even radical ways. They do so by:

- Serving unmet or unsatisfied customer groups
- Providing new or different benefits
- Delivering and/or extracting value in an unconventional fashion

Take eBay's peer-to-peer, Web-based marketplace, Apple's iPod/iTunes platform, IKEA's assemble-it-yourself furniture model, Dell's made-to-order computers, BMW's customize-your-own MINI Cooper, or Zara's continuous product line updates. These are all examples of dramatically different business models (or *existing* business models that have been dramatically reengineered) that create substantial new value for customers and shareholders. What's clear from these examples is that they go beyond pure product or technology innovation. Rather, they create wealth by pushing the boundaries of one or more dimensions of the company/industry business model in a sustainable and profitable way. The problem for many organizations is that they never even think about innovation in this context.

Consider a familiar example: Apple. If someone asked you what has made Apple so successful in recent years, your tendency might be to think right away about a *product*—the iconic iPod. This is quite understandable, given the iPod's highly visible role in Apple's meteoric comeback. But the iPod is actually just the front end of the success story. Less visible than redefining the size, look, and functionality of an MP3 player, Apple's real innovation was creating a digital rights management system that could satisfy the music industry (assuring its members that they were not going to lose control over their intellectual property) while simultaneously creating a legal music download service that would satisfy consumers (giving them a way to browse hundreds of thousands of songs and to buy individual tracks or whole albums at a very reasonable price).

Apple's genuine breakthrough was not good product design; it was a revolutionary business model—one that allowed people to find and legally download high-quality music files extremely easily, transfer them to different iPods, and make a few copies for their friends by burning a limited number of CDs, but that wouldn't allow them to start pirating whole albums and exporting music from China. This was a major reason why the iPod took off as it did: it was the front end of a very smart and highly differentiated platform that worked for both the music industry and the consumer. That platform, the iTunes Music Store—which now also offers digital music videos, television shows, iPod games, and feature-length movies—is at the very heart of Apple's strategic move into consumer electronics, allowing more recent Apple products like the iPhone and Apple TV to sync with PCs as easily as the iPod. In fact, iTunes is the Trojan horse with which Apple plans to capture a significant share of the home entertainment market.[1]

In their book, *Dragons at Your Door*, Ming Zeng and Peter Williamson describe another type of business model innovation—cost innovation—that is currently emerging among dominant Chinese firms like

Haier, Lenovo, and Pearl River Piano. These firms and others share three principal characteristics:

1. High technology at low costs
2. Unmatched choice of products in standardized, mass-market segments
3. Specialty products offered at dramatically lower prices, turning niche segments into volume businesses

As the authors remark, "Imagine a world [in which] high technology, variety and customization, along with specialist products, are available to customers at dramatically lower prices; a world where the value-for-money equation offered to global consumers [is] transformed by Chinese multinationals."[2]

The point we are making here is not that product innovations per se are unimportant. Far from it. Radical product innovations—like the Toyota Prius, the Nintendo Wii, or a blockbuster drug like Viagra—can change customer expectations and behaviors, alter the basic conception of a product or service category, and occasionally even change the future of an industry. Rather, our argument is that taking a holistic view of innovation at the level of the business model is likely to bring more returns for your company in the long term than just thinking about innovation in terms of products, services, technologies, or operations.

WHAT IS BUSINESS MODEL INNOVATION?

At its essence, business model innovation is about creating fundamentally new kinds of businesses, or about bringing more strategic variety into the business you are already in—the kind of variety that is highly valued by customers.

These days, the term *business model* is thrown around very loosely, so you would assume that it is widely understood. The reality is that if you asked a few people in your organization to describe your company's business model, their answers would most likely lack clarity and consistency.

Chances are, everyone would have a vague picture in their minds, but it wouldn't be the same picture—and it would probably not be a complete picture, either. Even if your employees were able to identify some key components of your business model, they might still be unable to recognize or articulate the interrelationships between those components.

A definition would obviously be helpful at this point. We define a *business model* as a conceptual framework for identifying how a company creates, delivers, and extracts value. It typically includes a whole set of integrated components, all of which can be looked on as opportunities for innovation and competitive advantage. In order to innovate at the level of the business model, you first need to unpack it into these individual components and understand how all the pieces fit together in a holistic way.

Figure 5-1 shows a simple framework for unpacking the key components of a business model.[3] It breaks the whole thing down into five basic components: who you serve, what you provide, how you provide it, how you make money, and how you differentiate and sustain an advantage. Considering these components one by one will help you to unpack your business model and articulate it more clearly in its entirety.

To build a breakthrough business model that rivals cannot easily emulate, you will need to integrate a whole *series* of complementary, value-creating components so that the effect is cumulative.

A classic example is Southwest Airlines. Essentially, Southwest offers customers an alternative to traveling by car, bus, or train, giving them a no-frills flight service they can still enjoy through a whole set of complementary activities.[4] The key point is that Southwest's business model differs from those of other major U.S. airlines along several dimensions. It's not just about low fares, point-to-point connections, and the use of a standardized fleet of aircraft (all Boeing 737s). Another dimension is the way Southwest treats its employees—putting them first

Business model:

A conceptual framework that describes how a company creates, delivers, and extracts value

FIGURE 5-1

Unpacking the business model

Who do we serve?	What do we provide?	How do we provide it?	How do we make money?	How do we differentiate and sustain an advantage?
Who are our customers? What market segments do we serve, in which geographies? Who are the buyers of our products and services?	What are the products and services we sell? What benefits and solutions do we deliver to our customers?	What distribution channels do we use? How is our value chain configured? What are the core processes and activities that translate our competencies, assets, and other inputs into value for customers (outputs)? Who are our partners? How do our suppliers and partners help us deliver value?	What do we charge our customers for? What are the major costs we incur in delivering our offering? How do we extract value? What is our pricing model? (e.g., flat rate versus subscription, own rate versus customized, direct versus indirect through third parties, bundled versus priced separately à la carte, set prices versus market-based prices, etc.)	How are we different from competitors? How do customers experience this difference? What differences do they value most? How sustainable is our differentiation? Is it protected by core competencies and strategic assets that we and only we have?

Source: Strategos analysis.

with profit-sharing and empowerment programs. Another is the fun experience Southwest creates on board and in the terminal, with jokes, quizzes, and goofy behavior by the cabin crew and ground staff. Another is the legendary care and attention Southwest puts into its customer service. All of these elements compound to create a business model where, as authors Kevin and Jackie Freiberg put it, "love plays a part in running the airline" (the company even uses LUV as its stock ticker symbol!).[5] Love aside, Southwest's demonstrably successful business model has spawned numerous imitators around the world, including Ryanair, easyJet, JetBlue, and AirAsia.

TWO DISTINCTLY DIFFERENT OBJECTIVES

There are two objectives to innovating at the level of the business model.

One objective is to find breakthrough growth opportunities by *inventing entirely new business models*, never before seen in a particular industry. For example, when the University of Phoenix set out to educate midcareer adults instead of eighteen- to twenty-two-year-old students, or to create campuses in business parks across the United States instead of a single campus in Phoenix, Arizona, or to use Web-based learning rather than bricks-and-mortar classrooms, it was inventing an entirely new business model that in many respects redefines the adult education industry.

The other objective is to drive growth by *evolving the business model you already have*. An example would be Whirlpool's creation of Gladiator GarageWorks: a new business model for Whirlpool based on garage appliances. This growth opportunity leveraged the company's core competencies not just in a new product category (modular storage units and accessories for organizing the garage) but in a new customer segment (male do-it-yourselfers) that was historically underserved by Whirlpool, and in a new "room" of the home (i.e., the garage) that has traditionally been ignored by white goods manufacturers, who tend to focus on the kitchen or laundry room.

Where many companies go wrong is in vigorously pursuing one of these two objectives (i.e., trying to invent entirely *new* business models), while forgetting to pursue the other (i.e., continuously evolving the *existing* business model).

Two distinct objectives of business model innovation

- Trying to invent entirely *new* business models, never before seen in an industry
- Continuously evolving your company's *existing* business model

For example, while Intel was off chasing all kinds of new businesses in other industries, the company came under quite intense criticism for taking its eye off the core microprocessor business and losing ground to rivals like AMD.[6] The important point here is not that Intel ended up neglecting its core business *operationally*, but that it forgot to *innovate* and *evolve* fast enough in the core business to stay competitive.

Conversely, we sometimes see companies—and even whole industries—that put a lot of effort into evolving the core business but that fail to take advantage of some of the more radical business opportunities that present themselves outside the core.

Consider the telecom industry. A few years back, most telecom companies were giving plenty of thought to innovation in things like products and pricing (coming up with "friends and family" packages and so forth), but how many of them were thinking about telephony switching to a completely different kind of network—like VoIP?

Likewise, most airline companies were focused some years ago on how to innovate in things like their loyalty programs, or their onboard catering, or their first-class seating, but how many were thinking about inventing a completely new, low-cost business model for the airline business?

Our argument is that companies need to continuously do both of these things—they need to be evolving the core business at breakneck speed while simultaneously searching for innovation opportunities outside the core.

THINKING HOLISTICALLY

Whether your goal is to invent a completely new business model that revolutionizes your industry or to continuously evolve your company's existing model, you will find that your ideation efforts can be dramatically enhanced by systematically considering each component of the business model as an opportunity for game-changing innovation.

We could illustrate this using the same two examples cited above. The University of Phoenix's rule-breaking innovation emerged from focusing explicitly on several components of the business model that traditional universities had largely taken for granted—that is, who our customers are, which geographies we serve, and how we deliver our service—and then asking whether things could be done radically differently. Similarly, Whirlpool came up with Gladiator GarageWorks by thoughtfully challenging core dimensions of their existing business model—that is, who the customer is, what benefits we deliver, and how we go to market—and then overturning orthodoxies along each of these dimensions. In either case, the challenge is to think holistically about every component of the business model (either your company's existing model or the traditional model of the industry) and then to try to innovate in as many of these components as possible. This helps to ensure that you will be comprehensive in your innovation efforts. It forces you to systematically explore all the potential avenues for business model innovation.

More importantly, thinking holistically helps you to avoid innovation "blind spots" that may be exploited by competitors. Most companies have certain areas in which they innovate a fair amount and other areas that almost never get any attention. This can open up significant opportunities for rivals to innovate along a particular dimension of innovation that has long been overlooked—and thereby gain an advantage.

Take Wal-Mart. The company appears to be very good at innovating along many dimensions of its business model but not so good at others. This has created innovation blind spots that major competitors have been only too glad to exploit. A good example is U.S. retailer Target, a store that generally attracts younger, more educated, and more affluent customers than Wal-Mart. Fans of the store even refer to it as "Targé" (a trend Oprah Winfrey is supposed to have started), giving the name a French-sounding pronunciation to emphasize its more appealing image.

Instead of trying to out-innovate Wal-Mart on things like pricing, supply chain management, or IT, Target has focused on a dimension of innovation that Wal-Mart seems to have overlooked: the overall shopping experience. While it couldn't exactly be described as deluxe, Target's store design offers customers a more upscale environment that generally feels friendlier and more inviting than Wal-Mart's. For example, the aisles are wider, the ceilings are lower, and the merchandise is presented in a friendlier, more attractive way.

Beyond this fundamental difference, Target was a pioneer in making exclusive deals with fashionable designers—like Mossimo, Michael Graves, Liz Lange, and Isaac Mizrahi—and convincing them to design low-cost lines for its stores. It also partners with big brands like Sony to create products that are exclusive to the store, sometimes colored red to match the company's corporate identity. Thus, Target is not just about just low prices; its business model innovation has to do with customer-friendliness, trend awareness, and an ability to *set* design trends through an innovative supply chain model. As a result, it can deliver "proprietary" products rivals can't match. Taken together, these factors mean that Target is competing on entirely different dimensions of the business model relative to Wal-mart—dimensions that Wal-Mart has largely chosen to ignore.

As this example illustrates, your company must learn to view every component of your existing business model as:

- A potential opportunity to create value by departing from industry norms
- A potential blind spot or Achilles' heel that competitors could use to undermine or devalue your position

Rarely do managers look at the logic or architecture of each component as something that represents a designed *choice* that could have been done differently. After a while, it's just "the way we do things around here." And as we saw in chapter 3 of this book, all too often "the way we do things" becomes a set of rigid orthodoxies that are rarely revisited or challenged. Companies tend to stop asking themselves how they could innovate along these long-unexamined dimensions.

Thinking holistically about every component of the business model—and systematically challenging orthodoxies within these components—will significantly extend your scope for innovation and improve your chances of building a sustainable competitive advantage.

ASKING NEW QUESTIONS

The challenge, then, is to take your business model (or your whole industry model) apart, as we outlined earlier in this chapter, and think about every single component as a potential candidate for innovation and industry reinvention. The way you do that is by examining each component of the business model from new perspectives, asking yourself how it could be dramatically redesigned to create new value for the customer.

In particular, you should look at any aspect of the business model that has remained essentially unchanged for five or more years, or where progress has been slow and incremental, or where there has been little or no innovation. The goal is to open up "long ago" choices to scrutiny: to generate a whole set of *why* questions about the taken-for-granted aspects of the business model. For example: Why do we target only these types of customers? Why do we price this way? Why do we sell through these channels? Why are we this vertically integrated?

Here are some focusing questions you can use to drive innovation in the various components of your own business model:

Who Do We Serve?

- Are there types of customers that have been ignored by companies in our industry?
- How might we target a different buyer who values our offering more than the existing buyer?

What Do We Provide?

- Could we deploy the customer benefits we provide in new ways or settings?
- Can we change the benefit bundle in ways that will surprise customers and frustrate competitors?
- Have we defined the customer need we are trying to address broadly enough? Conversely, are we delivering benefits that customers don't really care about?
- Have we looked critically at where we draw the boundary between what we do and don't do as a company?

How Do We Provide It?

- Could we make the process of fulfillment and support substantially easier or more enjoyable for customers?
- Could we reinvent the customer experience in ways that would strengthen the sense of affiliation the customer has with us?
- Are there opportunities for step function improvements in the efficiency or effectiveness of our processes?
- How might we reposition ourselves in the value chain to our advantage?
- What partners or suppliers might we work with to enhance our ability to deliver value to the customer? How might we redefine what each party brings to the table?

How Do We Make Money?

- Can we more closely align what we charge for with what customers actually value?
- How can we improve our cost position without jeopardizing the value we provide to customers?
- Does our existing pricing structure implicitly penalize some customers and subsidize others? Can we change this?
- Can we break the predominant pricing paradigm in our industry?

How Do We Differentiate and Sustain an Advantage?

- How sustainable is our differentiation? Is it protected by core competencies and strategic assets that we, and only we, have?
- Are there any dimensions of differentiation that we or our competitors have not yet explored?
- Have we searched diligently for differentiation opportunities in *every* dimension of the business model?

- Can we exploit our core competencies and strategic assets in new ways to bring value to customers?
- How might we leverage our core competencies and strategic assets in other industry settings?

Finally, you should also ask yourself whether all the components of the business model positively reinforce each other. Are some components of the business model at odds with others?

STRETCHING YOUR BUSINESS MODEL

An excellent way to "stretch" your business model—making it more differentiated and harder for rivals to replicate—is to reexamine every component using your foundation of novel strategic insights (the four kinds of insights we discussed in chapter 3) to spot new opportunities for innovation.

Of course, it is quite possible to ask new kinds of questions about your business model without having done any of the discovery work we outlined in that chapter. However, in our experience, it is much more effective to consider the focusing questions listed above in light of what you have learned about orthodoxies, discontinuities, core competencies and strategic assets, and unmet customer needs. This usually produces better, more grounded answers and prompts much more radical thinking.

For example, you can challenge the internal mind-sets that have built up around your business model by using the *orthodoxy* insights. For each component of your business model, think about the deeply held dogmas or orthodoxies that are related to it (e.g., what orthodoxies do we have about who our customers are, how we interact with them, how we define our products or services, how we make money, how we configure our value chain, etc.?). Now think about what would happen if you overturned or challenged those orthodoxies. What would the new business model component look like?

Next, do the same exercise using the *discontinuity* insights. Pick one or two discontinuities—deep, fundamental changes already at work in the external environment—and ask yourself how they might be leveraged to improve each business model component. How might they require you to rethink or reinvent this component? Look for ways in which you could use these discontinuities to substantially change the way things are done in your industry.

Now look at your insights into *core competencies and strategic assets* vis-à-vis your business model. Ask yourself whether any assets or competencies could be recombined to create new value, or leveraged in their own right to generate growth, or transferred to new opportunities. Think about how you might combine other companies' competencies and assets with your own to radically change the way you do business.

Last, consider the various components of your business model from the point of view of your *customer insights*. Using insights into existing or emergent customer needs that are currently unaddressed, think about how you could change the various components of your business model to meet these needs. How could you create the kinds of benefits that a currently underserved customer group would value?

THE ACID TEST

The exercises we have described in this chapter are designed to help you inject innovation into every component of your business model, making the whole thing more robust. They can be applied to both an existing business model that is in need of some fresh thinking and *entirely new* business models that may emerge from your ideation.

The business model framework brings discipline, clarity, and reality to the task of innovation. It serves as a forcing function to stretch and elaborate your thinking along all these different dimensions, and to check whether there are any avenues for innovation—or any blind spots—that you may have missed.

Whether you are trying to invent fundamentally new business models or evolve the one you already have, the acid test of any business model's potential for creating above-average customer value—and thereby new wealth—is the degree to which it is "radical." Chapter 6 explains why radicalizing ideas, business strategies—and, indeed, business *models*—is so crucial for dramatically enhancing your innovation pipeline.

INNOVATION CHALLENGES AND LEADERSHIP IMPERATIVES

Innovation challenge: How do I keep my current business model fresh and innovative?

Leadership Imperatives

- Make sure that everyone in the company has the same definition of *business model*. Clarify what you mean and adopt a common definition.
- Don't assume that your current business model is the only viable way to do business. Keep challenging it and seeking alternatives.
- Challenge each of the core assumptions of your current business model. Are yesterday's assumptions still valid, or have they become today's orthodoxies? Are they blind spots that your competitors could exploit?
- Innovate new business models while continuously challenging and evolving your current business model.

Innovation challenge: How can I make sure that we are thinking expansively enough in searching for new opportunities?

Leadership Imperatives

- Escape the narrow view of innovation as "R&D" or "new product development." Learn to consider all aspects of the business model as targets for innovation.
- Don't assume that product or service innovation is "better" than innovation in other elements of your business model.
- Use novel strategic insights (i.e., the discovery findings we outlined in chapter 3) to challenge and evolve each element of your business model.

NOTES

Chapter 5

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3. For a more detailed framework, see Gary Hamel, *Leading the Revolution* (Boston: Harvard Business School Press, 2002), chapter 3.

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5. Kevin Freiberg and Jackie Freiberg, *Nuts! Southwest Airlines' Crazy Recipe for Business and Personal Success* (New York: Broadway Books, 1998).

6. Tom Krazit, "Intel Loses Market Share in Own Backyard," CNET News.com, January 18, 2006.