

# Description of the Three Components of ROE

Profit margin is a measure of a company's success at turning revenues into profits. It answers the question: For every dollar of revenue that we generate, how much of that dollar goes to net income (also called profit)? In its most basic form, net income is calculated by subtracting expenses from revenues. As a result, anything that lowers expenses and increases revenues improves profit margin.

Asset efficiency measures the efficiency with which an organization utilizes its assets by answering the question: How many dollars of revenue do we generate for each dollar of assets on our books? Of course, traditional financial measures of asset efficiency often don't reflect the value of intangible assets such as the skills and knowledge of employees, the value of information and know-how captured in databases and computer

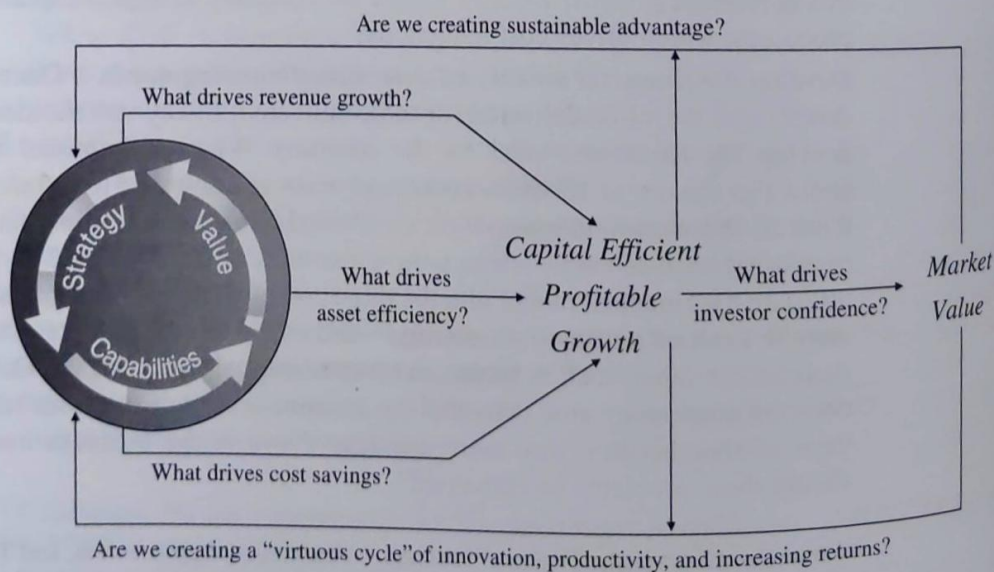
applications, the value of a company's brand and reputation, or the value of its network of business partners and customers. In today's global network economy, these "intangible assets" become even more important as sources of asset value. As a result, forward-thinking executives are expanding the way they calculate the value of their assets to include financial surrogates for intangible assets.

Leverage measures the percentage of a company's assets that would be available to shareholders if the company was sold after first subtracting how much of its assets would be needed to pay off creditors. Understanding a company's leverage enables executives to answer the question: For every dollar of value that I create, how much goes to increasing shareholder value?

In summary, the power of the business model audit does not come from collecting and analyzing independent "buckets" of data. Instead, a business model defines the linkages among key strategy, capability, and value drivers of business performance. Figure 1.3 illustrates these linkages. Refer to Appendix 1A for key questions you can ask to identify the drivers of business model performance. In addition to the role of IT in transforming business models, IT can also be used to develop a business model dashboard and to monitor performance over time.

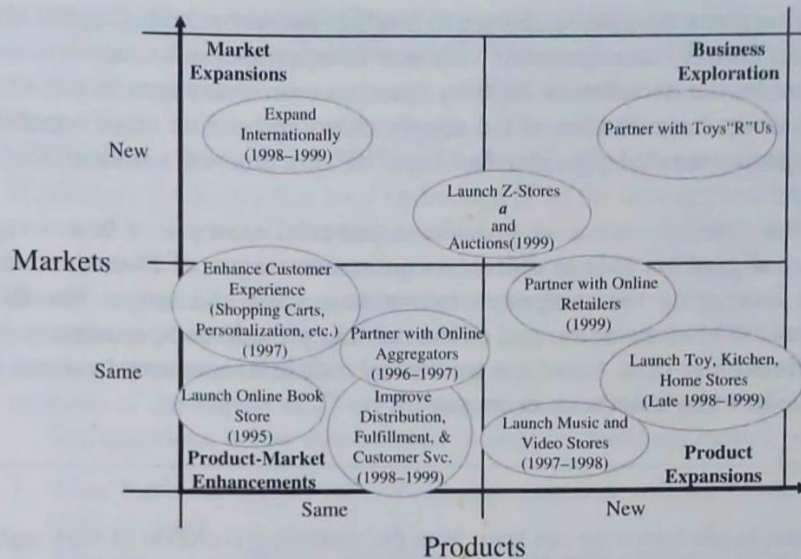
**FIGURE 1.3**  
**Analyzing**  
**Business**  
**Models**

Source: L. M. Applegate, *Crafting Business Models*, Harvard Business School Publishing #808705, 2008.





**FIGURE 1.4**  
Evolving the  
Amazon.com  
Business Model  
(1995–2000)



## Evolving Business Models

Building a successful business is a journey—not a destination. As such, business models, like the businesses they represent, don’t stay static. Instead, they evolve over time as executives exploit opportunities, respond to threats, and build capabilities. There are four key approaches to evolving a business model.

**Enhance:** Incremental improvements to an existing strategy or capability.

**Expand:** Launch new product categories, enter new markets, or expand capabilities.

**Explore:** Launch new businesses and build new capabilities.

**Exit:** Exit a product or market or outsource a capability.

Figure 1.4 shows how these four approaches to business model evolution can be framed within familiar strategic positioning choices. The figure illustrates the evolution of the Amazon.com business model and the choices made by CEO and founder, Jeff Bezos, as he built the company from its first product in 1995 through 2006.<sup>16</sup> More detail on the Amazon.com’s IT-enabled business model is available in the case at the end of Module 1.

As can be seen in the figure, many business model shifts—for example, the decision to enhance a product or improve a process—represent incremental adjustments to a company’s business model. At times, however, executives decide to follow a more revolutionary path and choose to launch—not just a new product, market, or channel—but a new business. These radical business model innovations often

<sup>16</sup> L. M. Applegate, *Amazon.com: The Brink of Bankruptcy*, available from Harvard Business School Publishing in the Crafting Business Models online tutorial. The case covers events in the company’s evolution from 1994–2000. An update is also available that describes events from 2001–2006.



involve more than just a change to product-market positioning but also require entering an entirely new industry with new competitors and a new business network. For example, the decision in 2000 by Amazon.com executives to exit the retail toy business and to use its IT-enabled supply chain and online retail capabilities to become a logistics service provider for Toys “R” Us marked a radical shift in its business model.

The Amazon.com case provides a powerful example of how a company that was “born digital” is able to deliver a continuous stream of IT-enabled innovations while also leveraging the company’s tremendous scale and scope. The IBM, Boeing, and Royal DSM cases at the end of the module provide complementary examples of how firms can use IT to transform traditional industrial economy business models to create value in today’s network economy.

## Summary

If there is one lesson we can learn from the continuing evolution of work and competition in the new economy, it’s this . . . Change the question and you change the game. . . . The old question was “What business am I in?” The new question is “What is my business model?”

*Adrian Slywotzky and David Morrison, 1999<sup>17</sup>*

It’s tough to build a business when the world is changing at **warp** speeds. We knew how to **identify opportunities**, **launch new ventures**, and **build them into successful companies** during the industrial economy but are just beginning to rewrite the rules for success in the network economy. While many long for more stability, savvy entrepreneurs and executives know that it is in just such times of turbulence that opportunities for creating value can be identified and exploited.

Building successful businesses in these challenging times requires that executives understand how to define and execute strategy, develop and leverage capabilities, and create value for all stakeholders. An enterprise’s business model frames these decisions. But each component of the business model is not created in a vacuum. When strategy, capabilities, and value are aligned with each other and with the external environment, a business model creates what economists call a “virtuous cycle” of innovation, productivity, and increasing returns.<sup>18</sup> In contrast, a poorly aligned business model creates a “vicious cycle” that can quickly spin out of control, destroying value. And the more turbulent the business environment, the faster a vicious cycle can destroy your business.

The problem, however, is that tightly aligned business models are tough to change. In today’s turbulent times, business models must be aligned, yet flexible, requiring even more skill and deep understanding of—not just the components of a business model—but also the linkages among those components as a business evolves and grows over time.

<sup>17</sup> A. Slywotzky and D. Morrison, *Profit Patterns* (New York: NY Times Business, 1999).

<sup>18</sup> A summary of the theory of “virtuous” and “vicious” cycles can be found in C. Shapiro and H. Varian, *Information Rules: A Guide to the Network Economy* (Boston: Harvard Business School Press, 1998).



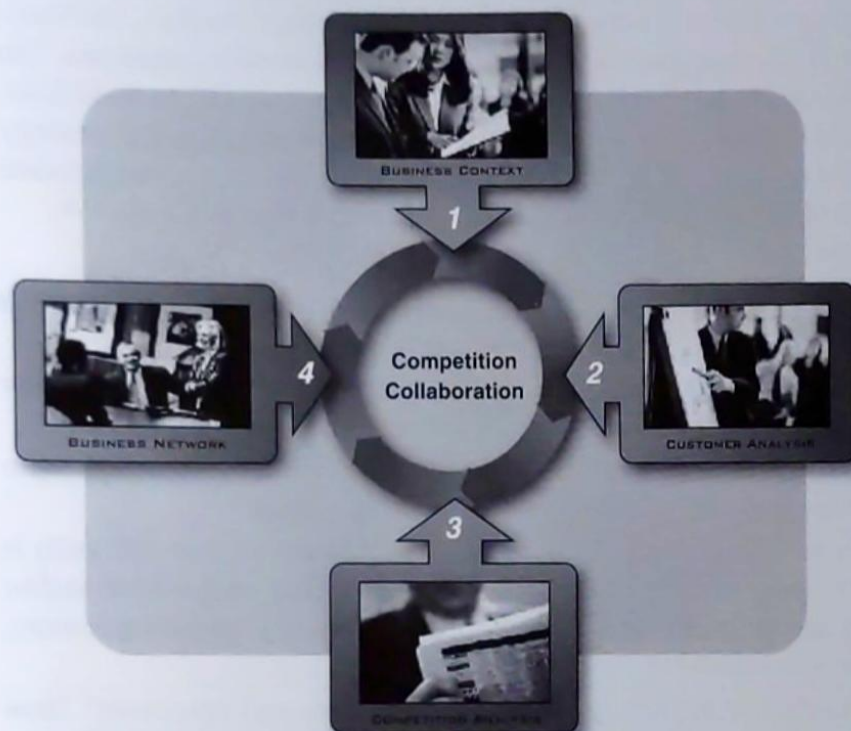
During the last decade IT has dramatically transformed business models in most of the major industries within which firms operate. These transformative impacts have jumpstarted innovation and entrepreneurship in countries around the world, dramatically altering global economics. The remaining chapters in Module 1 provide multiple examples of firms such as Medtronic, IBM, Amazon.com, Boeing, and Global Healthcare Exchange that have embedded IT in the strategy and capabilities of the companies and their respective business networks to transform product, market, and business network strategic positioning and set the innovation agenda in their industries. The Amazon.com and IBM cases also show how these two companies used IT to build lean, yet agile, processes and capabilities that have enabled them to flexibly change strategy in response to crisis and drive increasing returns in good times and bad. A more detailed analysis of the impact of IT on driving economic value can be found in Chapter 4.

The questions below can be used to analyze business model performance.

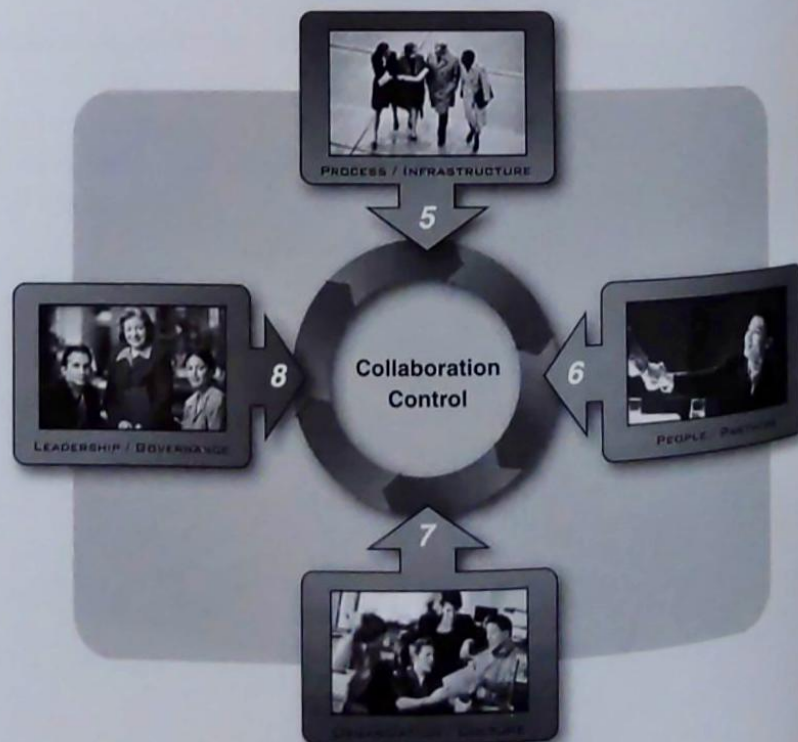
1. What business are we in? Which opportunities will we pursue and which will we NOT pursue?
2. Who are our customers, suppliers, and business partners? What value do we provide to these key stakeholders? What value do we provide to employees and owners?
3. What are the competitive dynamics and balance of power within the industry? Who are our biggest competitors today? Who will they be in the future?
4. What differentiates us from competitors and substitutes? How easy (or difficult) is it for new players to enter our markets, offering a unique value proposition and/or substitute products and services? How easy (or difficult) would it be for customers, suppliers, or partners to switch?
5. How efficient and effective are our core operating activities and processes? How easy (or difficult) is it for customers, suppliers, and partners to do business with us? How easy (or difficult) is it for us to evolve our product-market positioning, to explore new businesses?
6. What are the capabilities and resources needed to execute strategy? Do we have, or can we build, the capabilities required?
7. What are the key business model drivers of capital efficient profitable growth and market value? What role does IT play in enabling the business model drivers of economic value? Can we use IT to develop a business model dashboard and monitor business model performance?

# Analyzing Business Models

## Business Model Strategy Audit



## Business Model Capability Audit



Source: Author.



**Business Model Strategy Audit: Suggested Approach and Sample Questions**

Business Context Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Identify relevant regulatory, societal, and industry trends and disruptors that signal opportunities and threats</li> <li>• Determine approaches to exploiting opportunities and managing risks</li> <li>• Determine which opportunities you will pursue in the future and which you will not pursue.</li> <li>• Answer the fundamental question: What business are we in today and should we be in?</li> </ul>	<ul style="list-style-type: none"> <li>• How favorable (or unfavorable) is the business context within which we operate today and what changes do we anticipate?</li> <li>• Are there disruptive changes on the horizon that would signal entry opportunities or threats to our existing strategy? Can we disrupt the industry and create new opportunities?</li> <li>• Which factors in the business environment help/hinder us in achieving our goals?</li> <li>• What must we do well to succeed? What are the key "failure factors"?</li> <li>• What are the key opportunities and threats? How quickly do we need to respond?</li> <li>• Have we clearly communicated to employees the range of opportunities that they should pursue and, most importantly, which opportunities they should NOT pursue?</li> <li>• Have we clearly identified future opportunities ("growth options")?</li> </ul>
Customer Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Talk with current and potential customers</li> <li>• Visit and watch them perform activities that your product/service offerings support (or will support)</li> <li>• Collect market research and customer information</li> <li>• Conduct focus groups</li> <li>• Involve customers in product design or improvement</li> </ul>	<ul style="list-style-type: none"> <li>• What are the pressing problems ("pains") that customers face? What must our customers (or potential customers) do to succeed and what can we do help them?</li> <li>• How well are customer needs being met today and how much are they willing to pay?</li> <li>• What is the current (and future) size of the customer base?</li> <li>• Are customer markets large and growing? Which segments are growing (or could grow) most rapidly? (Measure growth in terms of revenues, units sold, customer visits, number of customers/users, pricing, etc.)</li> <li>• Which of our current product/service offerings do our customers use today and how much revenue do we generate from each customer (or customer segment)?</li> <li>• What product/service offerings would our customers like us to offer?</li> <li>• What market share/"share of wallet" do we have today? What can we do to grow?</li> </ul>

(Continued)



**Business Model Strategy Audit: Suggested Approach and Sample Questions (Continued)**

Competitor Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Identify traditional rivals, potential new entrants, and substitute offerings</li> <li>• Benchmark current or potential new offerings</li> <li>• Ask potential customers why they use alternatives, what needs are not being met, and what would cause them to switch</li> <li>• Collect competitor data</li> <li>• Talk to experts</li> </ul>	<ul style="list-style-type: none"> <li>• Who are our competitors (including substitute products and services) and how do they differentiate their offerings by feature and price?</li> <li>• What prices do competitors charge and what margins do they get?</li> <li>• How sustainable are competitor positions? Can customers easily switch to other offerings? Who would lose share most quickly in a pricing or feature "war"?</li> <li>• What is the market share and share of wallet of key competitors/substitutes? What potential approaches could competitors take to increase their share? What approaches could we take to preserve or enhance our differentiated position?</li> <li>• How powerful are competitors? How might they respond to changes we might make?</li> </ul>
Business Network Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Identify the core activities, resources, and capabilities needed to achieve your goals (e.g., design, build, market, sell, and deliver products and services, innovate for the future, develop/manage talent)</li> <li>• Identify the support activities (e.g., payroll, recruiting, finance, and accounting) and infrastructure (property, equipment, data centers, networks)</li> <li>• Assess your capabilities and potential supplier and partner capabilities in performing these activities</li> <li>• Compare the cost and risk of performing activities inside versus sourcing from outside</li> <li>• Determine what you will do and what you will source</li> <li>• Develop governance structures and systems for end-to-end processes</li> </ul>	<ul style="list-style-type: none"> <li>• What activities, capabilities, and resources are required to execute strategy?</li> <li>• Which will my company perform and which will we source from the outside?</li> <li>• For the activities we outsource, how will we coordinate and control activities with key suppliers and partners?</li> <li>• How does the quality and cost of outsourced resources and capabilities compare to what we could provide inside?</li> <li>• How powerful are the individuals and organizations that control key activities, capabilities, and resources required to execute our strategy?</li> <li>• What is the source of power of different players in our business network? For example, does demand outpace supply or vice versa? Have suppliers or partners erected barriers to entry or exit or created high switching costs?</li> <li>• What relationships do we have with powerful individuals and organizations needed to execute strategy?</li> </ul>



**Business Model Capability Audit: Suggested Approach and Sample Questions**

Process/Infrastructure Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Build on your business network analysis to identify key activities needed to execute strategy</li> <li>• Group activities into roles that will be performed by people inside or outside your organization</li> <li>• Identify coordinating mechanisms that will enable the flow of goods and information through end-to-end processes</li> <li>• Identify infrastructure requirements</li> </ul>	<ul style="list-style-type: none"> <li>• What are the key activities needed to execute strategy?</li> <li>• How should those activities be grouped together to enable us to focus attention and resources while also developing the expertise needed in the future?</li> <li>• Which of the roles should we perform and which should we source from the outside?</li> <li>• What coordinating mechanisms (e.g., reporting relationships, liaison roles, steering committees) should we use to link activities and roles into efficient end-to-end processes?</li> <li>• What infrastructure (e.g., facilities, equipment, technology) is needed to support end-to-end processes?</li> </ul>
People/Partner Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Identify expertise and skills needed to perform activities and roles within end-to-end processes</li> <li>• Develop job descriptions for key roles</li> <li>• Analyze labor markets and determine which expertise and skills should be available inside the organization and which should be sourced from the outside</li> <li>• Analyze compensation patterns within labor markets and determine the cost of attracting, developing, and retaining talent</li> <li>• Develop and implement recruiting, hiring, development, and performance appraisal systems</li> </ul>	<ul style="list-style-type: none"> <li>• What skills and expertise do we need to perform the activities and roles as specified within our end-to-end processes?</li> <li>• Where do we find the talent we need and what do we need to pay for that talent?</li> <li>• How do we attract, develop, retain, and motivate the talent we need?</li> <li>• Do employees and partners understand what is expected of them, do they have the resources and authority needed to meet those expectations, and do we have performance measurement systems in place that provide them with timely feedback on their progress?</li> <li>• Do current development, compensation, and reward systems motivate employees and partners to work together to achieve shared goals, even as they fulfill personal goals?</li> </ul>
Organization/Culture Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Group employees and partners into work units that make it easy for them to accomplish individual and business goals while also focusing attention and effort and developing expertise</li> <li>• Clarify authority and accountability by role and unit</li> <li>• Develop formal reporting relationships to ensure a free flow of information on expectations and performance</li> <li>• Formalize authority and accountability and ensure people at all levels have the information needed to make decisions and take actions</li> </ul>	<ul style="list-style-type: none"> <li>• Are we organized to focus attention, develop necessary expertise, and reduce the friction that comes when people must work together to achieve shared goals?</li> <li>• Have we organized people into units and developed the reporting relationships needed to ensure authority and accountability for key decisions and actions?</li> <li>• Do we have the formal and informal coordination and collaboration systems required to get work done effectively and efficiently?</li> </ul>

(Continued)



**Business Model Capability Audit: Suggested Approach and Sample Questions (Continued)**

Organization/Culture Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Develop formal and informal coordination and collaboration mechanisms</li> <li>• Clarify values and behaviors and ensure consistency between incentives, performance measurement, and culture</li> </ul>	<ul style="list-style-type: none"> <li>• Do employees and partners at all levels have the information and resources needed to make timely decisions and perform core activities at highest standards of efficiency and quality?</li> <li>• Do they know how to use information to make informed decisions as individuals and teams?</li> <li>• Is information timely, relevant, and easily accessible?</li> <li>• Do we have the information and communication systems in place that make it easy for employees, partners, suppliers, customers, and other stakeholders to do business with us? Are our systems flexible enough to meet future needs?</li> </ul>
Leadership/Governance Analysis	Sample Questions
<ul style="list-style-type: none"> <li>• Identify key positions in your company and evaluate the strengths and weaknesses of people who fill those positions</li> <li>• Evaluate succession plans for key positions and the leaders who are being prepared to take on these positions</li> <li>• Evaluate leadership development and succession planning processes and systems, correct problems, and benchmark against world-class companies</li> <li>• Develop governance systems and structures to ensure strong operating and strategic controls and effective risk/culture management.</li> </ul>	<ul style="list-style-type: none"> <li>• Have the leaders in our company communicated a compelling and clear vision for the future that unites people and partners around shared goals?</li> <li>• Do we have leaders at all levels who can balance creativity and innovation with disciplined execution? Can they set goals, prioritize among competing projects, assemble resources, and deliver results?</li> <li>• Are our leaders well connected inside and outside and do they have a demonstrable track record of success?</li> <li>• Have we identified key positions throughout our company and our partner organizations? Do we have the right people in those positions and do we have an effective succession plan (and planning process) to ensure continuity?</li> <li>• Do we have a high-performing board of directors and executive team and strong governance systems?</li> </ul>



**Example of Amazon.com Strengths, Weaknesses, Opportunities and Threat (SWOT) in Early 2001**

	Opportunities	Threats
Strategy Audit	<ul style="list-style-type: none"> <li>Established retailers desire quick entry into online markets but lack online retail capabilities</li> <li>Toys“R”Us partnership demonstrates revenue and gross profit potential of established company markets</li> <li>Online retail sales growing at 66% and forecasted to reach \$2.7 trillion; key growth segments include digital products, consumer electronics, toys, and home &amp; garden</li> <li>30 million loyal customers and strong brand; repeat customers ↑ to 79%</li> </ul>	<ul style="list-style-type: none"> <li>Online retailers exit the market, dramatically decreasing revenues</li> <li>Increased competition from traditional retailers</li> <li>Investors exert significant pressure for capital efficient profitable growth</li> <li>Increased complexity and speed of the business strain resources</li> </ul>
Capability Audit	<ul style="list-style-type: none"> <li>Visionary, yet pragmatic, management</li> <li>Demonstrated proprietary, best-in-class capabilities in online retailing, customer service, fulfillment, and distribution</li> <li>Excess capacity and demonstrated capability for scaling operating capabilities</li> <li>Inventory turns exceed traditional and Internet retailers</li> <li>Advertising, marketing, and customer acquisition costs per customer while slightly higher than traditional retailers are trending down</li> </ul>	<ul style="list-style-type: none"> <li>Need to leverage existing capabilities to enter new markets and launch new products more quickly and effectively</li> <li>Fulfillment and customer acquisition costs exceed traditional retailers</li> <li>While continuing to decrease, operating and gross margins continue to exceed traditional retailers</li> <li>Gross profit margin lags online aggregators (e.g., Yahoo!) and auction businesses (e.g., eBay) that do not take ownership of inventory</li> </ul>
	Strengths	Weaknesses