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Business model innovation: coffee triumphs for Nespresso

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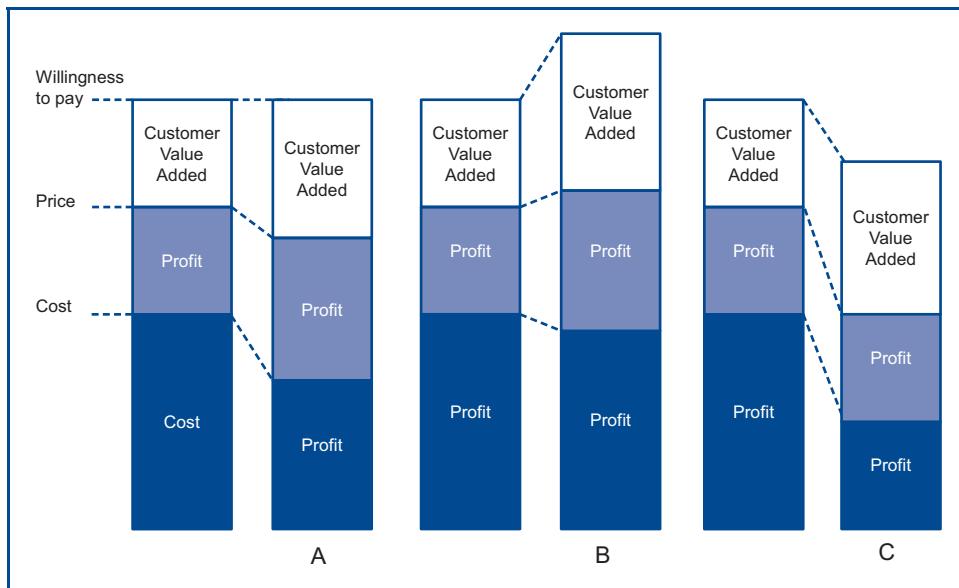
Introduction

According to Michal Porter, strategy is about being different. Over the long run only companies that succeed in building a sustained competitive advantage will be successful (Porter, 1996). Therefore, a company's value creation process needs to be distinct from its competitors. It needs to be both more effective and more efficient. Product innovation no longer offers sufficient competitive advantage in differentiating successful companies (McGrath, 2011). Competitors are quickly able to copy innovations, product life cycles are becoming shorter and competitors from low wage countries have considerable cost and price advantages. At the same time, Information and Communication Technologies (ICTs), offer unprecedented opportunities to rearrange value creation activities in new and different ways. Hence, companies consider business model innovation as an opportunity to build sustainable competitive advantage (Teece, 2010). The IBM CEO study from 2009 highlighted that 70 percent of CEOs regard business model innovation as a strategic priority and 98 percent are working on changing their existing business models. A joint study by *Business Week* and the Boston Consulting Group concludes that business model innovators have higher and more sustained returns than product or process innovators (Lindgård et al., 2009). Amazon, Southwest Airlines, Apple, Nespresso and ING-DiBa are companies that redefined customer value, found new ways to structure their value creation processes and captured that value with great returns. This paper examines the concept of business model innovation and discusses the design of the key elements. Using the Nespresso case as an example, we demonstrate how business model innovation can be implemented successfully. Based on a unique positioning strategy, successful business model innovators align their product and services logic, added value logic, sales and marketing logic and revenue logic to create a system that delivers great returns. The secret of a successful business model lies in its coherence, its uniqueness and the fact that it is difficult to imitate.

Business model innovation: value creation and value capture

A business model defines the way a company generates value (value creation) and how it captures some of this value as profit (value capture) (Teece, 2010). In this sense, a business model represents the "business logic" (Casadesus-Masanell and Ricart, 2010) or in Peter Drucker's words the "theory of the business" (Drucker, 1994). Value creation expresses the benefits the company creates for its customers. The customer value corresponds with the customer's willingness to pay for a product or service. Customer value added results if the product's perceived value exceeds its price. If the product's cost is below its price, the company generates a profit (value capture). Figure 1 illustrates these relationships (Bowman and Ambrosini, 2000).

Figure 1 Value creation and value capture: the relationship among willingness to pay, customer value added, income and expenses



Business model innovation results when a company increases customer value and simultaneously creates a new value creation and revenue model that allows the company to capture some of the value created in a new way.

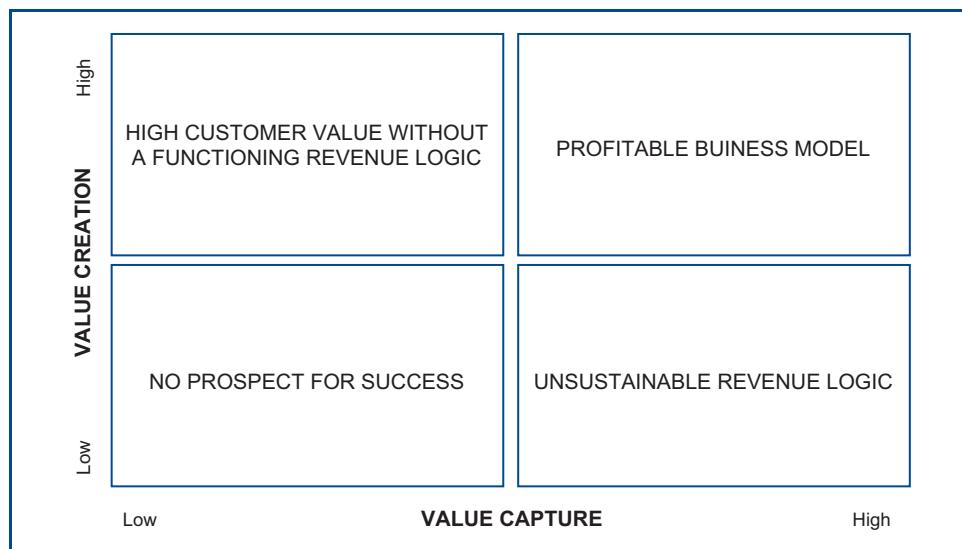
Figure 1 schematically illustrates three types of business model innovation. In the first case (A) the company does not add value to a product or service, but rather the increase of customer-added value results from a new value creation system that allows the company to reduce product costs and prices. Additional value is created for both the customer and the company. The second case (B) shows that an innovation leads to higher willingness to pay because of higher value to the customer. A higher price and a new value creation architecture allow for a higher monetization. In the third case (C) the customer's benefit is reduced by, for example, offering a stripped down version of a product. However, if the price reduction is comparably higher than the benefit reduction, the value for the customer increases. A new value chain architecture allows cost reductions and consequently the profit for the company increases.

Hence, value creation and value capture are two key tasks set forth by a business model (Pitelis, 2009). As corporate practice demonstrates, the development of a sustainable and profitable business model is extremely challenging. The problem is illuminated in Figure 2.

Companies in the upper left corner are creating added value for customers but are not able to turn a portion of it into profit. The total added value goes to the customer. This usually results from a poor revenue logic or from an incoherent value creation architecture. A poor revenue logic is the weak spot in the case of Skype. The added value for customers is immense. With more than 660 million customers worldwide but only about eight million paying premium customers, Skype has yet to find a sustainable revenue logic that allows it to reap any financial benefits. An example for incoherent value creation architecture is Air Berlin. In recent years, the airline showed high growth rates, which indicates that customer value was added. The value is high while prices are low. However, for years the airline operated in the red. Their value creation architecture made it difficult to generate profit at these prices. The hybrid business model between a full-service airline and a low-cost airline lacks coherence.

Companies in the upper right corner have a sustainable, profitable business model. Apple and Nespresso are convincing examples. This research project will take a close look at the business model of Nespresso.

Figure 2 Value creation and value capture: which business models work



Companies with low or no added value for customers, but high profits are not in a sustainable position. They are vulnerable to attacks from rivals with new business models.

Finally, companies, which neither create enough value for customers nor develop a functioning value creation system and revenue model, are doomed for failure.

Components of a business model

Apple, with the iPod, iPhone and iPad, Southwest Airlines, Ryan Air, Nespresso, Facebook, Google, Starbucks, Zara, Enterprise Car Rental, and direct banks such as ING DiBa are examples of successful business model innovations in recent years (Bailom *et al.*, 2010; Johnson, 2010; Markides, 2008, 2010). They all transformed or are currently transforming their industry. What makes these business model innovations so unique and sustained? The answer to the following questions provides the core of their business models:

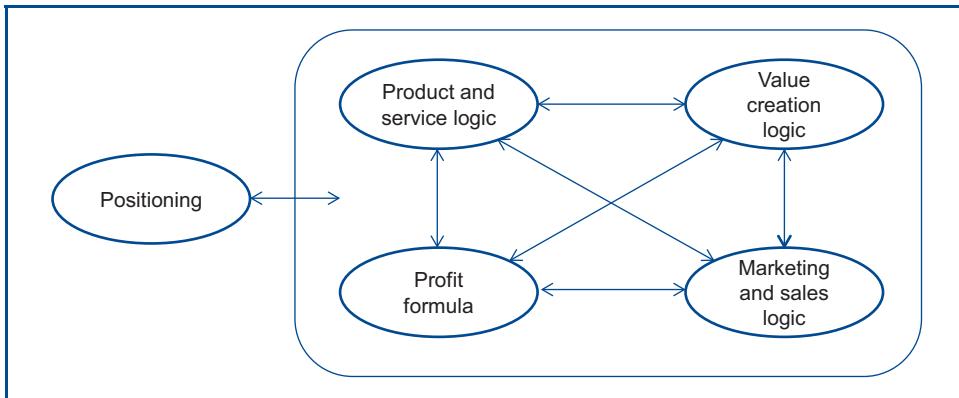
1. How do we create value for customers? (Value creation.)
2. How can we monetize this value – in other words, how can we convert the added value into profit? (Value capture.)

The answers to these two questions are the essence of a business model. As the “theory of the business”, it describes its internal logic and strategy. An effective business model innovation will always embrace these two aspects. In order to turn this “theory of the business” into a successful value-creation system, we suggest enriching these two core questions with two additional questions:

1. How does our value creation system work: how do we organize value delivery and how can we build sustainable cost advantages?
2. How does our marketing and distribution logic function: how do we attract and retain customers?

The starting point, for the design of these four components of the business model, is the company’s positioning in the market with the aim of sustainable differentiation. This refers to the customer needs a company is trying to fulfill with the aim to create and maintain a “monopoly” position in customers’ minds. Market conditions and core competencies provide the framework. These considerations are depicted in the schematic business model in Figure 3.

Figure 3 Components of a business model



Components of the innovative business model

The starting point of business model innovation is a differentiated and innovative positioning on the market, “an organized system for finding a window in the mind” (Ries and Trout, 1981) of the customer. The idea of positioning focuses on the rational or emotional benefits that a buyer will receive by using the product or service. It must be unique and sustainable. Very few companies succeed in positioning themselves sustainably and distinctively. As Ries and Trout outline, companies with a lack of differentiation become interchangeable and mere substitutes. Substitutes are only a small step away from being a commodity, which may intertwine them in irrevocably ruinous price competition. We can summarize the role of the positioning in a business model as follows: Without effective differentiation, there is no positioning. Without positioning, there is no uniqueness. Uniqueness ultimately drives the odds of a business model innovation.

The product and service logic presents the second component of business model innovation. Product and service innovations must be aligned with positioning. These innovations ultimately serve as tools to realize the positioning of the company in the market. Products and services only offer added value if they create a unique product benefit and if the price of the products is below the benefit. Economists label this the consumer surplus.

The value creation logic refers to how the company shapes its activities and processes, to market the product or service. The company needs to consider what its “core” and “non-core” elements are to make a decision on which to source internally and which ones to outsource. The key question is about core competencies and the value creation that can be achieved along the process. The added value logic must be tailored to the positioning, the product and service logic and the revenue logic. A case in point is Apple. Production is outsourced to China while software expertise remains in house: “One of our biggest insights (years ago) was that we did not want to get into any business where we did not own or control the primary technology because you'll get your head handed to you” (Steve Jobs). Companies must decide and depict in their business models which role they will play in the value creation. Today, we are witnessing competition no longer confined within industry boundaries, but rather a competition of value creation architectures across industry boundaries. The competition of the future will be less about competition between companies and more about competition between networks of firms.

The sales and marketing logic defines how to attract and retain customers. It needs to be in sync with the other components of the business model, especially the positioning and revenue logic.

The profit formula builds the core of the business model, consisting of the revenue and cost model, and defines how the company earns its money. Discount stores, for example, build their business models around high volumes. Christensen and Tedlow (2000) describe how in the early 1960s discount stores made money through a completely different business model

and competed successfully with department stores. The business model was based on a low-cost, high turnover model that enabled them to achieve five inventory turns a year with gross margins of between 20 and 25 percent. They concentrated on simple products that could sell themselves, such as branded hard goods in the form of hardware, kitchen utensils, books or packaged personal care products.

The main drivers of the revenue model are also economies of scale or economies of scope, customer lifetime value concept, cross selling, cross-subsidizing model (premium customers “subsidize” non-paying customers in a freemium model such as LinkedIn), third party revenue model (eg Google's pay-per-click advertisements), or razor-blade models. Especially the latter has gained enormous popularity, named after its inventor King Gillette (Anderson, 2008). After the invention of his disposable blade King Gillette sold just 51 razors and 168 blades in 1903. Bitterly disappointed, he then changed his revenue logic: he sold razors for petty cash to the army, gave away razors as extras with Wrigley's chewing gum, coffee, tea, spices, and marshmallows and earned money from the resulting blade sales. The result was one of the most successful business models. This revenue logic provided the basis for many industries: cellphones, inkjet printers, coffee machines and even Apple is using this logic. Apple, however, turned it around: Expensive iPhones and iPads provide access to inexpensive music and free apps.

In the following section, we present one of the most successful business model innovations in recent years. The presented framework portrays the successful business model of Nespresso. Nespresso took new directions for all five components of the business model (see Table I). Their success is based on a unique, innovative and coherent business model.

Nespresso's business model

Nespresso is one of the most successful business model innovations in recent years. Since 2000, Nespresso has grown by 30 percent per year and it is Nestlé's fastest growing business unit. In 2009 sales amounted to CHF 2.77 billion and worldwide every minute consumers drink more than 10,000 cups of Nespresso (Nestlé-Nespresso, 2010).

The positioning

The basic idea of the Nespresso concept is customization. The CEO of Nestlé Coffee Specialties Willem Pronk explained more than a decade ago:

Individualization is a driving force in today's markets – in everything from the telephone to beer to tea to personal computers. The Nespresso system is an innovative concept that offers consumers individual portions of freshly-ground coffee in a range of tastes that result in an exceptional cup of

Table I Core questions of a business model

Component	Questions
Positioning	1. Which basic customer need are we trying to fulfill? 2. How can we establish and retain a unique position in our customers' minds?
Product and service logic	3. Which products and product features are necessary to become indispensable and strengthen our positioning? 4. What is the unique product benefit we offer our customers?
Added value logic	5. How we design our value creation processes to effectively and efficiently bring our offers to the market? 6. What are our core competencies and core processes on which we focus and which allow us to create value?
Sales and marketing logic	7. How do we attract customers? 8. How do we retain customers?
Profit formula	9. Based on which economic rational are we making profits?

“A business model defines the way a company generates value (value creation) and how it captures some of this value as profit (value capture)”

espresso every time. We're convinced of the power of the idea and the technology behind it, and we're aiming to grow this business eightfold to £ 1 billion in the next decade (Kashani, 2000).

Indeed, this idea has led to sustained differentiation on the market: Consumers were given the opportunity to prepare their espressos according to their individual preferences with exquisite crema, aroma and full-bodied taste. A unique positioning resulted from the confluence of a broad variety of choices and an individual coffee experience coupled with convenience.

The product and service logic

Their unique capsule system is perfectly in line with their positioning. Sixteen different tastes are available in individually vacuum-packed capsules that retain the flavor and freshness. While most consumers typically had only one type of coffee in a 250 g or 500 g pack at home, Nespresso now permits indulging in a broad range of tastes unique to each individual coffee experience. The hermetically sealed capsules protect the coffee against air, light and moisture and the flavor, freshness and taste are preserved. However, the quality of espresso not only depends on the quality of the coffee, but also to a great extent on the espresso machine. Water temperature (ideally held constant at 86-91 degrees Celsius) and water pressure are crucial for the taste. Therefore, Nespresso developed its own coffee machine with electronic water temperature control and a patented extraction and brewing system including a 19-bar high-pressure pump (Nestlé-Nespresso, 2010). Exclusive and personalized customer service 24/7 ensures individual attention for each customer. Thus, the product and service logic is perfectly aligned with the positioning.

The value creation logic

Nestlé's core competencies are the production and marketing of food, not the manufacturing of household appliances. Therefore, Nestlé decided to develop the Nespresso system in collaboration with an external design partner and several machine specialists (Nestlé-Nespresso, 2010). A total of 1,700 patent applications were filed. The manufacturing and distribution of the coffee machines is conducted through established manufacturers under a licensing agreement with Nestlé. Nestlé does not earn money through the coffee machines (Kashani, 2000). Instead, Nespresso value chain architecture focuses on advancing the Nespresso system, the coffee production and its marketing. Especially the coffee production is built on Nespresso's key core competencies. It follows the principles of the shared value concept (Porter and Kramer, 2011). In 2003, Nespresso introduced the AAA Sustainable Quality Program, which ensures quality and sustainability in the value creation through generating shared value. By 2013, Nespresso wants to obtain 80 percent of the total coffee from coffee farmers who operate based on the Rainforest Alliance Certificate (Nestlé-Nespresso, 2010).

The sales and marketing logic

To market and sell the product, Nespresso also went in uncharted directions. Previously food retail distribution was almost the only way to distribute products. Nespresso is based on an entirely new concept: the Internet Sales (Nespresso club), exclusive retail boutiques and flagship stores. This provides them with direct customer contact (about 70 percent of the world's 4,500 employees are in direct contact with customers), direct service, an exclusive brand image and ultimately higher margins. Customer acquisition occurs in a number of ways:

- through the distributor of the coffee machines;
- via exclusive, since 2006, advertising ("Nespresso. What else?" with George Clooney); and
- the Nespresso Club with more than seven million members, of which more than 50 percent of new Nespresso Club members are referrals from existing members (Nestlé-Nespresso, 2010).

The profit formula

Nespresso's revenue logic is built on the razor-blade model. High quality coffee machines in elegant design are sold for an economic price through licensing partners. Nespresso does not profit from the coffee machines. Instead they earn money primarily through Nespresso capsule sales. The Nespresso capsule gross margins are estimated to be around 85 percent, compared with 40 percent to 50 percent for regular drip-coffee brands (Levine, 2011). The second component of the revenue logic is the cross-selling of coffee accessories.

What are the secrets of Nespresso's success?

First, Nespresso created a unique, difficult to imitate and internally consistent business model. Second, the business model builds on a unique, sustainable positioning that meets long-term trends in the market (convenience, espresso culture, digitalization in the distribution system). Third, the product (coffee and espresso machine) is perfectly aligned with the positioning and supports it in unique way. Fourth, Nespresso has a very clear answer to the question: What is core and what is non-core. If focusses on its core competences and outsources other activities or cooperates with partners. Fifth, the marketing and distribution logic is perfectly aligned with the positioning and the product logic. Finally, Nespresso has a very clear value creation and value capture system. It creates unique value for its customers and has a clearly defined and well-functioning profit formula.

Nespresso's unique positioning and innovative product are important to H- important, but not enough. The idea to sell coffee in capsules has now been copied many times but what is hard to copy is the entire system – the business model. This non-duplicable business model provides the foundation for sustained success.

Conclusion

Product innovations no longer provide sufficient opportunities for differentiation. Ever shorter life cycles, shorter periods of imitation and increasing competition from low wage countries require new and sustained competitive advantages. Unique, non-duplicable business models are at the root of today's new business opportunities. A company's task is to find new ways to generate added value for customers and to monetize a portion of this surplus value. A business model innovation comprises five components:

1. innovative, unique positioning;
2. a consistent product and service logic;
3. an appropriate value creation architecture;
4. an effective sales and marketing logic; and
5. a profit formula that works.

Using the example of one of the most successful business model innovations in recent years – the Nespresso system – we have exemplified concept of business model innovation. Uniqueness, difficult imitation and especially the individual component's consistency drive its success.

Keywords:

Value creation,

Value capture,

Business model innovation,

Case studies,

Components of a business

model,

Value analysis,

Innovation,

Corporate strategy

“As corporate practice demonstrates, the development of a sustainable and profitable business model is extremely challenging.”

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