Finding Opportunities in Business Model Innovation

By Rita Gunther McGrath

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It is a truism in organizations that it is often easier to punish sins of commission than of omission. Proactive actions that lead to disappointment are punished, while simply doing nothing and keeping the wheels of business turning is in many organizations a safer route to success. One unfortunate consequence is that people in companies cling to existing business models when the conditions that made them successful have changed. Failing to shift resources into new models quickly has been many a firm's undoing. Even when companies do change, it is often a result of unpleasant near-death experiences. Xerox, IBM and Nokia are all firms that nearly went bust before the imperative to do something new overcame the inertia of clinging to the familiar. The pity is that often embracing new business models is an established organization's best hope to re-ignite its growth engine.

The risks of business model inertia

Companies unwittingly put in place systems that, because they are configured to exploit an existing business model, are antithetical to developing new ones. Reward systems encourage executives to meet predictable targets rather than engage in unpredictable experimentation. Established metrics make new projects look unattractive and artificially inflate the attractiveness of the existing business. Companies forget that the competitive life of an asset may well be different from its accounting life. Powerful people see little incentive in redirecting the organization away from models that have favored their skills and capabilities in the past. And the list goes on.

Ironically, even as incumbents cling to business models that are under pressure, rapid growth is captured by organizations which develop new models. Thus, Apple went from the computer business to dominate niches in other industries, such as music and smartphones. Haier innovated entirely new ways of selling small refrigerators globally. Google is using its Android software to capture large portions of the operating system market for smart phones. ARM innovated ways of designing low power consumption chips perfect for the growing market of handheld devices. F-Secure innovated entirely new models when the emergence of the PC industry also introduced the problem of computer viruses, and further extended its advantages when it became one of the first security companies to leverage its capabilities on the brand-new world wide web. Clearly, developing new business models can be an attractive route to profitable organic growth.

Profitable change in business models

Despite a proliferation of definitions, one can have a fruitful discussion of business models by using two simple strategic elements, which I term the unit of business and the key metrics. A unit of business is what you get paid for. As technology has advanced, we have witnessed an explosion of ways that customers might pay to have their needs met. For instance, assets that once needed to be purchased, such as locomotives, can be accessed through service contracts. Services that were once billed on a time spent basis might instead be offered on a per-project or per-solution basis. Solutions (for instance, pregnancy tests) that once required skilled specialists can often now be created on a self-service basis.

Similarly, the operational mechanisms through which one can deliver a unit of business have also changed. Key parameters might be different, even if the unit of business doesn't change. Amazon.com, of course, was a pioneer in this approach, selling the same books as bricks-and-mortar retailers through a novel channel. Dow Corning's low-end offering of silicates, the Xiameter brand of products still sell silicon, but do it in such a way that the company can price these products dramatically lower than their premium branded offers. Since the key operational parameters that underlie a given business model become visible in the metrics used to track them, I call them key metrics.

A key metric reflects the constraints under which a business is operating. In bricks and mortar retailing, the fundamental constraint is how much floor space a shop has. The key metrics thus have to do with numbers that reflect how well that space is being utilized, such as same store sales, sales per square meter, inventory turnover, and so forth. In a consulting business or law firm the fundamental constraint has to do with limited amounts of partner time, which leads to key metrics such as utilization rates and number of billable hours. Innovation can either change the unit of business or the key metrics or both to open growth opportunities.

Table 1 offers examples of companies that were able to create strong growth by introducing innovative business models. Procter and Gamble's Swiffer line of cleaning products took elements from cleaning solutions, the diaper business and its product arms to offer a simpler, more convenient, cleaning experience than the old bucket-and-mop approach. Proflowers cuts out the intermediaries in the traditional florist business to, as it proclaims, sell flowers "direct from the grower to you." Electronic books are an obvious change from hard-cover books. General Electric found that it could profitably offer access to its medical equipment through utilization contracts (in which customers pay only for the capacity they use, rather than buying a piece of equipment). Self-publishing is also a tremendous shift from conventional large-production-run printing.

Table 1: New Growth Categories

Initial Category	Type of Change	Growth Category
Mop and Detergent	Unit of Business and Key Metrics	Procter & Gamble's "Swiffer" line of cleaning products
Retail Florists	Key Metrics	Proflowers - direct from the grower to you!
Hardbound Books	Key Metrics	Electronic books
Medical Device sales	Unit of Business	Equipment utilization contracts
Classic book publishing	Unit of Business and Key Metrics	Self-published best-selling books

Business models and the 'jobs to be done' theory of customer needs

A key trap that many leaders in organizations fall into is making the assumption that those things they spend the bulk of their time worried about make any difference whatsoever to customers. Sad, but true – in most industries the things that are most difficult, cost the most, or require the most significant amount of managerial attention are simply taken for granted by their end customers. Network reliability for telecommunications and IT networks, quality and safety for manufactured goods, managing paper costs and workforce considerations for newspaper executives – all of these things are indeed important, but they are not the basis on which customers choose one potential provider over another. Focusing on them can cause a leader to be blindsided if a different, more convenient way of addressing customers' needs emerges.

Instead, it is useful to consider what the customer is striving to accomplish, a consideration that my colleagues at consultancy Innosight and marketing consultant Anthony Ulwick call the "jobs to be done" of a customer (Bettencourt & Ulwick, 2008; Ulwick, 2003). The premise is that customers hire companies that help them get particular jobs done in their lives. The right way to think about competition is therefore to think about all alternative ways certain customer jobs can get done, rather than about your (or even your industry's) way of addressing the task. Indeed, sometimes the most unexpected form of business model competition arises from outside your industry.

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Consultancy Accenture has studied how companies from one industry enter others (Accenture, 2011). The jobs-to-be-done framework helps explain such moves that might otherwise appear odd. For instance, in response to new health care legislation which provides funding for physicians to create electronic health records, firms such as consumer electronics giant Best Buy and retailer Sam's Club are partnering with companies in the medical field to provide services to physician's offices. The jobs physicians need to get done are to improve the efficiency of their offices, comply with legislation and capture new revenues available from government funds. Previously, they might have 'hired' practice management firms to assist them with these tasks. Today, they might well hire the Geek Squad, Best Buy's consumer services arm, as the lead partner in helping them run their offices, disrupting traditional practice management firms. The point is that the job the customer wanted to get done – making their practices more efficient – does not change, even as the business model used to address that task might well do so.

Ripe for innovation

Growth through business model innovation almost always follows other innovations that release or eliminate a constraint that shaped the business models that came before. Eliminating the constraint can make new models technically feasible, affordable, or scalable. Even better, incumbent competitors frequently don't realize the logic that constrained their previous choices has shifted for some time, giving the innovator a head start.

Traditional banks have largely seen themselves constrained by their physical branches. With the advent of advances in communications technologies, constraints in this industry have been collapsing right, left and center. This creates a plethora of new ways in which banks might serve their customers. ING Direct has eliminated the need for branches. Instead, its customers serve themselves through its internet site, and link to their existing brick-and-mortar banks for those services that they need in person. The Reserve Bank of India has come up the banking correspondent model. In this model, bank representatives are given a territory of people to serve, which they do by providing in-person banking services right in customer's own homes. Technology makes it possible for these representatives to access bank systems that would normally only be available in a branch setting. Ironically, such a service, which in wealthier markets would be the exclusive purview of the rich, is how the bank has decided to serve the poor. In much of Africa, banking is not even done by traditional banks, but rather by mobile telephone operators.

Thus, in contemplating growth opportunities, consider the 'jobs' your customers are striving to get done. It's useful to try to frame what they are trying to accomplish in terms of outcomes, rather than products or services. Then, consider how previous constraints on units of business or key metrics may have changed, creating the opportunity to create something new.

Deutsche Post has conducted just such an analysis to launch what the company terms a "transformation" in its business model. Johannes Helbig, Deutsche Post's Chief Information Officer describes starting with the properties of a traditional letter. Firstly, it is legally binding, as both sender and recipient are identified with a name. Secondly, it is confidential, as only the person to whom a letter is addressed should be able to read it. Third, it is reliable because considerable infrastructure and attention has been given to making stable postal networks accessible to most of the worlds' population. What Deutsche Post is now innovating is a whole set of new businesses around the concept of a trusted transaction. Beginning with what they call the E-Postbrief (or e-letter), the company is creating the infrastructure through which many kinds of trusted transactions, from banking to voting to legal communications can be funneled. If the vision is realized, it could lead to Deutsche Post becoming a trusted information logistics provider, a totally different model than that of traditional letter carrier. Interestingly, despite radical shifts in technology, the needs the company seeks to serve are remarkably stable. As Frank Appel, Deutsche Post's CEO observes, the business model of the letter has lasted "500 years." (Helbig, 2011; Lyons & Buck, 2010). Thus even as traditional letter volume declines, the number of trusted transactions Deutsche Post gets paid to process increases.

Deutsche Post's business model innovation is particularly attractive, as it creates a platform which can be used to deliver many kinds of services, rather than simply offering a transaction. This brings us to the fascinating question of what makes some business models inherently more attractive than others.

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Considerations in business model attractiveness

Clearly, not all business models are created equal. Indeed, many innovative companies have succeeded in creating new models that customers appreciate, but which do not yield economic returns to their innovators. The decision on the part of news organizations to allow their content to be freely available on the Internet might be an example. Skype, might be another. The Internet voice communications company has been extremely successful from a penetration and customer usage point of view, with 660 million active users. Unfortunately, the company is not particularly profitable because its core value proposition is to offer communications services for free to its subscribers.

In general, business models that create exit barriers, for which there are switching costs, which are not transactional and which to some extent lock customers in tend to be more attractive than those in which the opposite conditions apply. Table 2 offers a diagnostic that one can take to assess the attractiveness of a particular model. Simply score a proposed model somewhere between the two statements to assess the extent to which the statement reflects your best guess of where a proposed model falls.

To demonstrate how one might use this diagnostic, let me illustrate with the case of Groupon. Groupon obtains discounts and special offers from local businesses. It then advertises these through a daily emailing to a group of subscribers in the local area. If enough subscribers accept the offer, it "tips" and the subscribers can take advantage of the offer. They often pay something for the privilege which Groupon shares with the providing merchant. Groupon has been described as possibly the fastest growing company of all time.

There are relatively few switching costs in the Groupon model – a customer signs up for free, the process is not onerous or difficult, and there are not customer loyalty, special discount or other anti switching incentives built into the program. Give it a 2. The model is based on individual transactions – users do not subscribe to Groupon, rather each payment is transactional. That's a 1. The user interface for Groupon offers no particular advantage as the offers come by email. Say a 2. The benefits of Groupon (discounted prices and access to vendors you may not have known about) are largely optional or discretionary – it isn't the kind of service one uses for essential goods and services. Perhaps a 2. Groupon does have a strong network externality effect, as its business relies on hundreds of representatives who sign up hundreds of retailers. Let's say that's a 7. There are many and ongoing benefits customers might derive, so that would be a 6. The model does build a form of relationship, but not an embedded or particularly sticky one. Let's say that is a 4. There is modest impact on the customers' experience, as it could mean a new discovery or affordable items, let's say a 4. The model is more or less standalone (at this point) although it could be extended to national campaigns and might be a competitor to firms such as eBay. Let's say a 4. The offers are co-created with the merchants and to some extent the members due to the tipping point nature of the business, so let's say a 6.

Using this analysis, Groupon's business model would rank 36 out of a possible maximum of 70. This would be a 'view with alarm' to me, as there are several elements of the model that do not create stickiness, loyalty or a barrier to competitive imitation. As customers grow more sophisticated, more numb to the idea of a daily email which may or may not offer them something they want and competitors come up with more fine-tuned offers, Groupon's model shows some vulnerability. As a general rule, I would prefer a score over 40.

Closing thoughts

Business model innovation, perhaps because it is happening more quickly and more frequently than it used to, has attracted considerable interest and is beginning to be better understood. As this process unfolds, some assumptions need to be rethought. One is the assumption that business model innovation always harms incumbents and benefits new entrants. There are now emerging any number of examples in which incumbents took the lead to redefine the business model they operate under. Similarly, there are probably an equal number of would-be disruptive new entrants that have not succeeded in growing through business model innovation, often because the models they pursued were inherently unattractive, as our diagnostic might have identified. A key set of issues for leaders to consider is whether they are simultaneously alert to the early warning signs that a business model is facing erosion and to the opportunities presented by the relaxing of constraints that allow enduring customer needs to be met in new ways.

Table 2: Scoring Business Model Attractiveness

The cost to a customer of switching to another provider is relatively low	1 2 3 4 5 6 7	The cost to a customer of switching to another provider once they have signed up with us is relatively high
The model is based on individual transactions which must be re-purchased each time	1 2 3 4 5 6 7	The model is based on a series of transactions (such as subscriptions or long term contracts) which are subject to renewal
The user interface for the model is pretty much the same for all providers (for instance, an ATM interface)	1 2 3 4 5 6 7	The user interface for the model is different for different providers meaning it is easier for users to learn one system and stick with it
The benefits provided by the model are optional or discretionary	1 2 3 4 5 6 7	The benefits provided by the model are required, specified in or mandatory
There are few network effects in this business or we are a late mover	1 2 3 4 5 6 7	We have the potential to create positive network externalities in this model
This model solves the customers' problem once and for all	1 2 3 4 5 6 7	The customers' problem is ongoing
The model is arms-length or transactional	1 2 3 4 5 6 7	The model establishes some kind of relationship
The model has little impact on the customers' experience or the impact is negative	1 2 3 4 5 6 7	The model involves changing the customer experience significantly and the impact is positive
The model operates on a standalone basis	1 2 3 4 5 6 7	The model creates a platform others can use to accomplish their goals
We create the offer	1 2 3 4 5 6 7	The offer is to some extent co-created

About the author

Rita McGrath, a Professor of strategy at Columbia Business School, is one of the world's leading experts on innovation and growth. Her cutting edge ideas help CEO's and senior executives succeed in rapidly changing and volatile environments. She speaks regularly at corporate events, such as the Microsoft CEO Summit and the World Economic Forum meeting in Davos. Her book, *Discovery Driven Growth* was named one of BusinessWeek's best design & innovation books of 2009.

Rita appears regularly on television and radio and is often cited in the press, including The Wall Street Journal, New York Times, Financial Times, and Businessweek, Inc.. She maintains an active blog (see www.ritamcgrath.com) and is featured as a discussion leader at Harvard Business Online. In 2009, she was inducted as a Fellow of the Strategic Management Society, an honor accorded to those who have had a significant impact on the field.

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