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Business Model Innovation

When the Game Gets Tough, Change the Game

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By the late 1990s, Apple's initial pathway to growth was running out of steam. The company's proprietary approach to designing both hardware and software limited it to being a niche player and hampered its ability to compete on price. In 2001, Apple began introducing a series of successful new products and services—the iPod, the iTunes online music service, and the iPhone—that propelled the company to the top of its industry. But the shift wasn't only a matter of product innovation. Apple's success resulted from its ability to define a workable business model for downloading music—something that had eluded the music industry for years.

This combination of product innovation and business model innovation (BMI) put Apple at the center of a market approximately 30 times larger than its original market. It also helped expand the company's share of the traditional computer market, as new customers became so attached to their iPods that they took another look at Apple's computers.[1]

The greater frequency of disruption and dislocation in many industries is shortening business model lifecycles. New global competitors are emerging. Assets and activities are migrating to low-cost countries. Systemic risk is growing as global business becomes increasingly interconnected. Social and ecological constraints on corporate action are emerging. All these factors require businesses to bolster and accelerate innovation. The discipline of BMI offers a fresh way to think about renewing competitive advantage and reigniting growth in this challenging environment.

Business model innovation means more than a brilliant insight coming at the right place and the right time. To confer a reliable competitive advantage, BMI must be systematically cultivated, sufficiently supported, and explicitly managed. In this paper, we will argue that BMI is highly relevant in the current business environment, describe some of the circumstances in which BMI has proved valuable, identify common pitfalls, and discuss how companies can develop a competitive capability in BMI.

What Is Business Model Innovation?

A business model consists of two essential elements—the *value proposition* and the *operating model*—each of which has three subelements. (See Exhibit 1.)

The value proposition answers the question, What are we offering to whom? It reflects explicit choices along the following three dimensions:

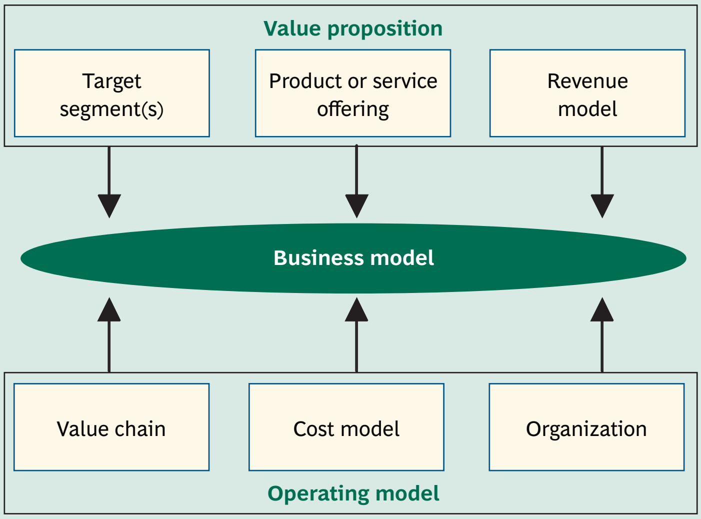
- *Target Segment(s).* Which customers do we choose to serve? Which of their needs do we seek to address?
- *Product or Service Offering.* What are we offering the customers to satisfy their needs?
- *Revenue Model.* How are we compensated for our offering?

The operating model answers the question, How do we profitably deliver the offering? It captures the business's choices in the following three critical areas:

- *Value Chain.* How are we configured to deliver on customer demand? What do we do in-house? What do we outsource?

1. See *Convergence 2.0: Will You Thrive, Survive, or Fade Away?,* BCG Focus, April 2007; and *Searching for Sustainability: Value Creation in an Era of Diminished Expectations,* BCG report, October 2009.

Exhibit 1. A Business Model Typically Consists of Six Components



Source: BCG research.

- *Cost Model.* How do we configure our assets and costs to deliver on our value proposition profitably?
- *Organization.* How do we deploy and develop our people to sustain and enhance our competitive advantage?

As Apple has demonstrated, innovation in a business model is more than mere product, service, or technological innovation. It goes beyond single-function strategies, such as enhancing the sourcing approach or the sales model. Innovation becomes BMI when two or more elements of a business model are reinvented to deliver value in a new way. Because it involves a multidimensional and orchestrated set of activities, BMI is both challenging to execute and difficult to imitate.

Distinguishing business model innovation from product, service, or technology innovations is important. Companies that confuse the latter for the former risk underestimating the requirements for success.

Why Business Model Innovation Is Relevant Today

Business model innovation is especially valuable in times of instability. BMI can provide companies a way to break out of intense competition, under which product or process innovations are easily imitated, competitors' strategies have converged, and sustained advantage is elusive. It can help address disruptions—such as regulatory or technological shifts—that demand fundamentally new competitive approaches.

BMI can also help address downturn-specific opportunities, enabling companies, for example, to lower prices or reduce the risks and costs of ownership for customers. In our experience, the companies that flourish in downturns frequently do so by leveraging the crisis to reinvent themselves—rather than by simply deploying defensive financial and operational tactics. Moreover, during times of crisis, companies often find it easier to gain consensus around the bold moves required to reconfigure an existing business.

BMI may be more challenging than product or process innovation, but it also delivers superior returns. The Boston Consulting Group (BCG) and *BusinessWeek* recently conducted their annual survey to identify the most innovative companies. We analyzed our database of innovators, segmenting them into business model innovators and product or process innovators. Our analysis showed that while both types of innovators achieved a premium over the average total shareholder return for their industries, business model innovators earned an average premium that was more than four times greater than that enjoyed by product or process innovators. Furthermore, BMI delivered returns that were more sustainable; even after ten years, business model innovators continued to outperform competitors and product and process innovators. (See Exhibit 2.)

Many companies pursue BMI as a defensive move to protect a dying core business or defend against aggressive competitors. But we are convinced that BMI can be most powerful when it is approached proactively to explore new avenues of growth.

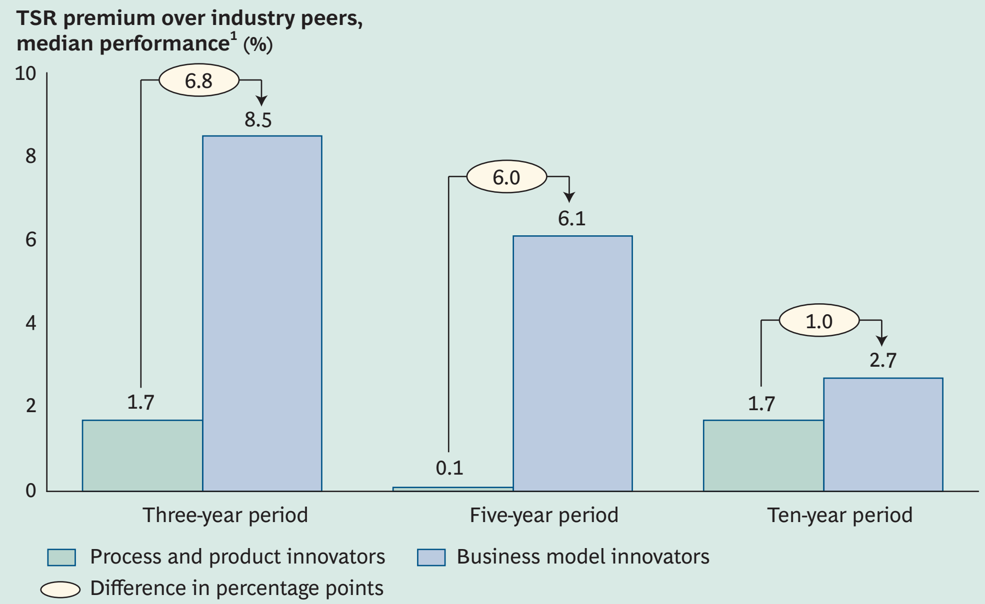
Game-Changing Moves

How a company goes about developing a new business model will depend on its industry and circumstances. Consider the different contexts in which BMI has played a decisive role in a company's success.

Beating Back Intense Competition. In 2001, the Virgin Group entered the Australian airline market with Virgin Blue, an airline that offered low fares with a "premium coach" experience and a fresh brand. The new entrant quickly gained a 30 percent share, severely disrupting the primary incumbent, Qantas. Given its cost structure, Qantas realized that it could not compete with Virgin Blue directly, so it set up a new low-cost business model. Rather than simply copying Virgin Blue's model, Qantas chose to outdo it by creating Jetstar—an ultra-low-cost airline operating as a separate division and designed from the outset to be lower cost than Virgin Blue. Jetstar launched in the first half of 2004, offering new planes and rock-bottom fares. It also boasted the lowest cost structure in the market and has since lowered costs further.

Jetstar's business-model evolution continued when it initiated international service in 2006, making Jetstar the world's first low-cost, long-haul airline. It pioneered a revolutionary pricing approach by offering traditionally bundled services à la carte, enabling consumers to customize the onboard experience with different options for food, comfort, and entertainment. Although Jetstar has replaced Qantas on some leisure routes, its launch has been particularly effective in slowing Virgin Blue's growth plans. Virgin Blue found itself squeezed in a pincer, facing strong competition from Qantas in the leisure and business

Exhibit 2. Business Model Innovators Outperform Traditional Innovators Over Time



Sources: *BusinessWeek*/BCG Innovation Survey, 2008; BCG ValueScience analysis.
[1]TSR premium is defined as the percentage by which the innovators' average total shareholder return exceeded that of their industry peers.

markets. In 2007, Virgin Blue abandoned its discount positioning and shifted its focus to target business travelers.

Extending a Business Model with Current Customers. JC Decaux is the number-one street-furniture company worldwide. The company earns a large part of its revenues by securing an exclusive agreement for outdoor advertising on desirable public spaces, typically in exchange either for returning a portion of the advertising revenue to the municipality or for covering the capital costs of supplying furniture, such as public toilets. In 2006, JC Decaux's ten-year contract with the city of Paris was up for review. At the city's request, the company offered a compelling new value proposition: JC Decaux would build and maintain the world's largest free (or nearly free) citywide network of bicycles and bicycle racks that residents and tourists alike could use for point-to-point transit.

This system of 20,600 bikes is called Vélib', and it is a high-value asset in a world where urban roads and public transit systems are becoming more and more congested and cities are trying to reduce their carbon footprints. The network is expansive—with stations every 300 meters in the city—so there is always a pick-up and drop-off point nearby. It is also popular: more than 80,000 people use the system every day. Other cities are adopting similar schemes, and researchers at MIT are studying Vélib' to assess the future of urban mobility.

Of course, any new business model requires time to work out the kinks. Vandalism has ended up costing the company more than it expected, and it is trying to claw back some funds from the city, which has been allowed to keep the subscription revenues generated by the system. But the core model remains a success, and JC Decaux is actively seeking to extend it into more cities. This new value proposition, delivered with a new operating model, has enabled JC Decaux to maintain its market leadership. Competitors will also find it difficult to replicate.

Extracting Brand Value by Extending the Business Model. Ikea stores are popular in many parts of the world. But when Ikea entered Russia, the company noticed that whenever it opened a store, the value of nearby real estate increased dramatically. So Ikea decided to explore two business models simultaneously: selling through the stores and capturing the appreciation in real estate values through mall development. Ikea's new division, called Mega Mall, now makes more profit on developing and running malls in Russia than on its traditional, standalone retail business. Ikea is a good example of how a company can leverage its existing assets and capabilities to experiment with new business models.

What Can Go Wrong?

The short answer is plenty. Remember, we're not talking about simple product innovation, but innovating simultaneously—and in a coherent and orchestrated manner—across several elements of the business. Therefore, managers should be on the lookout for common pitfalls, including the following problems:

- *Portfolio Bloat.* This can happen when a company has become bogged down in too many uncoordinated, bottom-up innovations. The result is a bloated, unbalanced, and overlapping portfolio of experiments, none of which has enough resources or support to win the favor of senior management.

- *Failure to Scale Up.* Once a project has been piloted and the initial excitement dies down, a lack of attention and resources can keep it from being scaled up successfully. Sometimes this problem stems from ambiguous pilot results because the right criteria weren't established or the right validations weren't collected and analyzed.

- *Pet Ideas.* Every industry has its zombies—projects that don't go anywhere but refuse to die. Managers find it hard to give up their pet ideas. E-detailing—online interactions between drug reps and physicians—is one example from the pharmaceutical industry of a pet idea. Schemes whose time has come and gone need to be put away, so that more promising ideas can gain traction.

- *Isolated Efforts.* The downside of autonomous skunk-works teams is that they can be too distant from the business to influence or leverage it. Consequently, they may lack the resources to validate ideas and the power or credibility to win the organization's cooperation. Companies should carefully consider the advantages and disadvantages before isolating BMI efforts from the mainstream business.

- *Fixation on Ideation.* Some organizations are able to churn out ideas endlessly but rarely move on to piloting and scaling them up. To assume that creativity is the main or only bottleneck to BMI is to grossly underestimate the task.

- *Internal Focus.* A common problem is near-sighted attention to the organization's internal needs at the expense of the unmet and evolving needs of customers. BMI that takes an inside-out approach frequently results in too little change too late and fails to capture the opportunity.

- *Historical Bias.* Organizations must resist the temptation to overvalue past models and undervalue forward-looking, disruptive ideas. Courageous and visible leadership is required to overcome this natural and powerful tendency.

Establishing a Capability for Business Model Innovation

Becoming good at BMI is much like developing any other competitive capability: companies assess the opportunities and identify the most promising projects, prepare the organization to pilot the projects and select the best one for scaling up, and then systematize these one-off efforts by building the platforms and skills needed to repeat the successes. Within these steps, however, a few activities are particularly important when striving for BMI.[2]

Uncovering Opportunities. Before looking for new opportunities, it's important to diagnose the current model to understand its limitations. Look closely at each element of the business model and test how the choice aligns with industry trends, evolving customer preferences, and relative advantage or disadvantage over competitors. Bear in mind that valuable insights are often generated by underserved or dissatisfied customers.

Once a company understands its current choices, it is better positioned to brainstorm new opportunities. To give momentum and depth to this exercise, we've found it useful to apply successful BMI patterns from other industries. Exhibit 3 shows three kinds of BMI patterns: innovations to the value proposition, to the operating model, and to the business system architecture (that is, how the innovation is integrated into the surrounding business network). This menu is not exhaustive, but it is useful for stimulating ideas when contemplating new business models.

Implementing the New Model. The winners in BMI aren't necessarily the originators of new models; more often, they're the ones that are the first to successfully roll out ideas that others may have originated. Therefore, scaling up can be the most critical step for BMI. When government regulation allowed generic parts to be sold and thus wiped out the profits of branded engines and parts, for example, GE Aircraft Engines wasn't the first in its industry to conceive of, or even implement, the idea of pay per use. But the company was the first to reinvent many of the elements in the business model that allowed it to be profitable with a pay-per-use value proposition. And GE Aircraft Engines gave the new business model sufficient resources and autonomy to flourish.

An important choice that incumbent companies must make is whether to embed a new business model in the core business or establish it separately. The benefits of common assets, customers, and capabilities argue in favor of integration. But a significant disruption to the current model argues for a separate approach.

The most difficult cases are those in which management comes to realize that a successful business model has become obsolete and the alternatives are in direct opposition to it. The pharmaceutical industry is currently facing such a situation with its intensive personal-selling approach; consequently, it is having to

2. For details on BCG's customized approach to developing a superior capability in business model innovation, please contact one of the authors.

Exhibit 3. Business Model Innovation Takes Many Forms

Value proposition	**The product as service and outcome** *General Electric*	**The product as an experience** *Apple*	**Trust premium** *Whole Foods*	**Free (or nearly free)** *Google* *Vélib'* *JC Decaux*
Operating model	**Deconstruction** *Li & Fung Limited*	**Integration/ acceleration of the supply chain** *Zara*	**Low cost** *TaTa Motors*	**Direct distribution** *Nestlé Nespresso*
Business system architecture	**Open** *Facebook*	**Person to person** *PayPal*	**Adjacency** *Ikea's Mega Mall division*	**Serial** *Virgin Group*

Source: BCG research.

come up with alternatives.[3] In such cases, either very decisive leadership or competing structures are required to resolve the conflict. Successful business model innovators report that "schizophrenic leadership" may be required in the critical transition period when a company must simultaneously defend its historical business model and embrace and develop what will eventually replace it.

Building the Platform and Skills. The third and final step is to build a platform for systematically managing the BMI process, capabilities, and portfolio of experiments. Most new business models are inherently disruptive and can incur significant internal resistance. BMI requires a distinct set of processes and capabilities to overcome an organization's short-term focus and also to sustain a BMI advantage on a continuous basis.

Questions for Mobilizing the Organization

BMI begins by assessing the company's current context, the needs of its customers, and the models of its competitors. These steps should be completed with sufficient clarity and honesty to reveal what is currently working, what is not, and what might constitute a better value proposition. To that end, we offer the following questions for executives and managers seeking to create a shared awareness of threats and opportunities.

- What compromises does our current business model force customers to make?
- Why are nonusers or defectors dissatisfied with our offering?
- Do we offer customers a better value proposition than that of the competition?
- What alternative models are gaining share at the edges of our industry?
- If we were an industry outsider, what would we do to take advantage of the gaps or weaknesses in our business model?

3. See Judith Wallenstein, Martin Reeves, and Zhenya Lindgardt, "Waking the Giant: Business Model Innovation in the Drug Industry," *In Vivo,* June 2008.

- Do we have a plan for identifying potential business models, implementing them, and embedding BMI capabilities within the organization?
- What do we need to change in our organization and operations to implement a new business model?
- What information would we need to make a commitment to a new business model?
- How urgent is the perceived need for change in our organization?
- How should our ideas be championed?

Companies that remain uncertain about the value of BMI should take note: Apple has not had a negative quarter of year-to-year growth since March 2003, and it is one of the few technology companies that continues to grow during the current downturn. Furthermore, Apple's move in recent years into more profitable product segments has resulted in a substantial improvement in its margins. As a result, the company's market capitalization reached $175 billion in the fourth quarter of 2009—surpassing that of Google.

For companies that have yet to achieve the performance they are looking for, there may be no better time than now to launch new business models or transform old ones. Consider the state of your business today. Could you do what Apple and many others have already done? Could you not only change your company's game plan but also change the game itself?

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