What Business Model Innovation Means For Your Business

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For Your Business

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Introduction

The phrase ‘business model’ has grown in use in recent months. However, there seems to be some confusion as to what exactly the term means, why it is important and how it relates to more established concepts such as business planning. This paper aims to address these deficiencies as well as to describe where business modelling is most useful and what the main types of business models are.

What is a business model?

A business model is simply a ‘description of how your business intends to operate and make money’, or as Alexander Osterwalder, co-author of the book Business Model Generation, says:

“… a description of the value a company offers to one or several segments of customers and of the architecture of the firm and its network of partners for creating, marketing, and delivering this value and relationship capital, to generate profitable and sustainable revenue stream”.

The most basic business model is the direct sales model, which is simply a producer making something and selling it directly to a customer at a profit. However, this straightforward concept has propagated into more complex models in recent years. Entrepreneurs need to be aware of the growing variety of viable business models, given the competitive advantage that can be gained from their effective deployment.

The development of a business model is essentially a strategic initiative, and focuses on how you intend to capture value; i.e., it includes a description of the value proposition. One of the key reasons the concept has become more popular of late is due to the growth of Internet-based services where value need not always be captured from day one, especially when it comes to digital-content-based models with their unique economic characteristics.

As this paper will show, the concept is of importance not just to Internet startups. All businesses can benefit from having a better understanding of the types of innovative business models being deployed across a range of industry sectors and from understanding how they can improve their own existing business models.

Hence the aim of this paper is twofold:

1) to help entrepreneurs understand the importance of finding a credible business model as early as possible on their path to commercial viability, and

2) to help established companies explore opportunities for growth through analysis of successful business model deployments and through critiques of their own models.

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The Business Model: An Introduction

In days of old, most business was arguably a lot simpler; you produced something and sold it for a profit, building up a good reputation over time so as to ensure ongoing patronage. Before the industrial revolution most sales were essentially local, and you had a much greater steer on competition, demand levels, customer preferences and pricing. You probably sold your products directly to consumers as the butcher, baker or candlestick maker.

Fast forward 200+ years and business for most has changed considerably. Firstly, a lot more creativity is needed to get noticed in a time-pressed world (not to mention making a sale). You are also probably facing global competitors, and in many instances a widely dispersed audience who are increasingly difficult to reach in a cost-effective manner. As a result, numerous alternative strategies have emerged to get your product to market and safely into the hands of the paying consumer, and business model innovation has become increasingly popular as a means to ensure you do so profitably.

In many respects business model innovation is not new; price discrimination, where retailers sell what is essentially the same service to people at different price points (i.e. 'early bird' menus in restaurants, old-age pensioner and student discounts, etc.) is a well known business practise that represents a form of business model innovation.

However, the story of modern business model innovation really takes off with Gillette and, in particular, an early marketing strategy they deployed when selling their razor blades. They deduced that they could give away the razor handle for free, and could get consumers to pay for the blades. Of course a razor blade is useless without a handle and vice versa, so the aim was to encourage trial and then to lock the customer in. Given the resultant switching costs and customer inertia, the result was often a lifetime of patronage for the more aggressively priced consumable (despite the fact the initial transaction was a loss-making one for the producer). In essence, by providing something at below the market price, i.e. the razor handle, you can create a market for a secondary product (the razor blade) upon which you make ongoing profits. The perishable nature of the secondary product (the razor goes blunt) coupled with price points that are typically disproportionate relative to their cost results in a highly profitable arrangement for the manufacturer. Add patents into the mix and the producer can essentially act opportunistically and gain monopoly profits as the sole supplier. As Chris Anderson, author of **Freemium**, described;

> "Razors were bundled with everything from Wrigley's gum to packets of coffee, tea, spices, and marshmallows. The freebies helped to sell those products, but the tactic helped Gillette even more. By giving away the razors, which were useless by themselves, he was creating demand for disposable blades. A few billion blades later, this business model is now the foundation of entire industries: Give away the cell phone, sell the monthly plan; make the video-game console cheap and sell expensive games; install fancy coffeemakers in offices at no charge so you can sell managers expensive coffee sachet".

The Business Model: An Introduction

Relationship between a business plan and a business model

It is worth clarifying the difference between a business plan and a business model. A business plan details the business opportunity you are seeking to exploit (usually as a document), whereas a business model takes the form of either a simple verbal description or a one-page visual representation. The business model is typically conceived as part of the same planning process as the business planning creation one. Alexander Osterwalder, co-author of **Business Model Generation**, agrees with the assessment, arguing that:

> "...when you have designed and thought through your business model you have the perfect basis for writing a good business plan."

The important thing to remember here is that you need to consider how complex your business is and who the intended audience for your business plan is. If you are a technology based start-up looking for venture capital, then the VC is likely to want a PowerPoint slide deck, and an executive summary of your business plan. A visual business model outline will also impress. However, if you are a coffee shop looking for more modest investment, the information requirements tend to be less; a simpler business plan should suffice.

Now we turn to some examples of how business models can help entrepreneurs.

Entrepreneurs

With start-ups one of the main challenges is gaining market acceptance and custom in sufficient volumes to transition to profitability. The vast majority of start-ups fail. Hence, a key skill is to know when to 'pivot' to an alternative product iteration until a viable business model gains traction, a concept author Eric Ries first described:

> "I want to introduce the concept of the pivot, the idea that successful startups change directions but stay grounded in what they've learned. They keep one foot in the past and place one foot in a new possible future. Over time, this pivoting may lead them far afield from their original vision, but if you look carefully, you'll be able to detect common threads that link each iteration. By contrast, many unsuccessful startups simply jump outright from one vision to something completely different. These jumps are extremely risky, because they don't leverage the validated learning about customers that came before".

Ries is a key proponent of something called the Lean Startup movement, which argues that startups need to develop products and markets by embracing a methodology focused on testing, agile development, constant iteration in response to customer feedback and customer centricity. Steve Blank, author of **The Four Stages to the Epiphany**, another proponent, agrees, arguing that;

> "A startup is an organization formed to search for a repeatable and scalable business model".

Hence, a strong knowledge of different business models and a willingness to test and learn are important skills for start-ups who may naively feel there is only one primary model for their business.

While Ries and Blank talk about the need for entrepreneurs 'to pivot', the authors of the book **Getting to Plan B**, John Mullins and Randy Komisar, essentially argue the same point, advising entrepreneurs to recognise the importance of having a 'Plan B'. They argue that many start-ups build business plans on flawed assumptions and fail as a result. They prescribe a systematic process which bears many similarities to the Customer Development methodology described by Blank, where the entrepreneur is encouraged to iterate, replicate innovation seen elsewhere, and to ensure that they are learning from their experiences.

It goes without saying that, from their perspective also, strict adherence to a business plan in the face of conflicting customer evidence is the complete antithesis of business modeling and business agility. Interestingly, such flexibility may not always sit well with investors, so it is important to keep them up to speed with regard to any changes in direction. Of course when such changes are in response to evidence from customer feedback, investors are more likely to respond favourably to the changes.

Entrepreneurs

Lessons for Entrepreneurs: Arriving at a viable business model

Given the significant uncertainty entrepreneurs face (not least in terms of customer demand for a new product or service); they need to be increasingly flexible in order to survive. Investors have traditionally wanted some degree of certainty with regard to what type of business they were investing in. In the past such protection was often provided by documents such as the Memorandum of Association which set out the line of activities a company could undertake. However, such inflexibility is no longer appropriate, a point author Steve Blank argues in his blog post where he states that the primary role of an entrepreneur is to iterate and test assumptions and hypotheses they have made with regard to customer behaviour and demand until they find a commercially viable business model.

> "Your startup is essentially an organization built to search for a repeatable and scalable business model. As a founder you start out with:
>
> 1) a vision of a product with a set of features,
>
> 2) a series of hypotheses about all the pieces of the business model: Who are the customers/users? What's the distribution channel? How do we price and position the product? How do we create end user demand? Who are our partners? Where/how do we build the product? How do we finance the company, etc?
>
> Your job as a founder is to quickly validate whether the model is correct by seeing if customers behave as your model predicts. Most of the time the darn customers don't behave as you predicted".

Blank is arguing that the primary function of an entrepreneur is to find a commercially viable business model which can be scaled. Implicit in this view is that, due to the uncertainties and assumptions that entrepreneurs have to make, they need to be completely flexible with their business model. Blank's view is shared by author David Teece, who claims that:

> "A good business model yields value propositions that are compelling to customers, achieves advantageous cost and risk structures, and enables significant value capture by the business that generates and delivers products and services".

Startups often become fixated with developing a product or service to the neglect of other areas, such as:

a) ensuring there is evidence of demand, or

b) that customers can be acquired profitably, or

c) how they intend to create brand awareness

Entrepreneurs

With product-focused offerings, start-ups must remain flexible enough to change course or 'pivot' in response to feedback from customers. As Cambridge, U.K.-based entrepreneur Doug Richards proclaims:

> "One may start a business with the idea that one will sell a product to customers only to discover that no one will pay for it, but they will accept it when it is provided for free. When that's the case, advertisers may pay for the production and distribution of the product".

The level of flexibility advocated here is more suited to technology start-ups and is not possible in all businesses, particularly if there are large sunk costs, significant capital outlays or resolute investors who are 'resistant to change'.

That said, some of the key tenets described above apply to all; maintain a strict customer focus from day one, keep costs down, test frequently and apply learning quickly. Inherent in all of this is the need for flexibility and a willingness to be open to different business models.

In summary, if you are starting a new business (particularly an Internet-based one) and are seeking investment, a presentation of the business model will be an important complement to your business plan. Any prospective investor will be very keen to understand your business model clearly: how you intend to generate cash, and whether it appears that you can do so profitably. However, they will also understand that Plan A's do not typically succeed, so they will be keen that you are not blindly wedded to a business plan that is not achieving its goals.

It is thus recommended that entrepreneurs take time to map out their business model, knowing that all is subject to change depending on feedback from users and subsequent customer adoption rates. Once you have iterated a winning business model you can scale in confidence and move from start-up mode to 'business as usual' as a thriving business.

There are critics who argue that planning and modelling is too time consuming and that entrepreneurs need 'to just get building'. Some of this criticism has come from software developers who prefer 'doing' over 'planning'. However, I personally feel their main arguments against planning and modelling — i.e., that they are too time-consuming and are essentially 'just guessing' — are too simplistic. Most entrepreneurs really benefit from mapping out a business model in advance and also from writing a business plan in tandem. This planning process brings numerous benefits for the entrepreneur, not least an ability to look at the operation holistically, to ensure internal focus and to ensure that cash flow management is a key priority. I do, however, concede that business planning has somewhat of an image problem, wedded as it is in many people's minds to the image of large, unwieldy and impractical documents. Modern business planning is flexible, agile and concise, and more about goal setting than bound physical documents.

Established Businesses

With established companies, business models help companies compete more effectively in an increasingly competitive marketplace. As Mark Johnson, author of **Seizing the White Space**, argued:

> "Business model innovation is the key to unlocking transformational growth--but few executives know how to apply it to their businesses".

We all recognize the world we live in is subject to an increasing number of disruptive trends, where competition is only a click away and new arrivals displace old established incumbents daily. A company's ability to adapt to change will be a key factor in determining whether or not they can survive in the modern world.

As the above has shown, an appreciation of various business model options will serve entrepreneurs and existing managers well. I will now outline why business model innovation will grow in relevance to established businesses.

Business Model Analysis in Established Businesses

Undertaking an analysis of your primary business model and looking for ways to innovate can give your established business a competitive advantage. As David Teece claimed in his paper, **Business Models, Business Strategy and Innovation**:

> "Business model innovation can itself be a path-way to competitive advantage if the model is sufficiently differentiated and hard to replicate for incumbents and new entrants alike".

He goes on to say that;

> "A [business] model must be honed to meet particular customer needs. It must also be non-imitable in certain respects, either by virtue of being hard to replicate, or by being unpalatable for competitors to replicate because it would disturb relationships with existing customers, suppliers, or important alliance partners. A business model may be difficult for competitors to replicate for other reasons too. There may be complicated process steps or strong intellectual property protection, or organizational structures and arrangements may exist that will stand in the way of implementing a new business model. Good business model design and implementation involves assessing such internal factors as well as external factors concerned with customers, suppliers, and the broader business environment".

The argument here is that there are opportunities to grow your business through the adoption of innovative business models rather than just through sales growth, expansion, etc. One of the most powerful examples is the airline industry, where the likes of Ryanair, easyJet and Southwest Airlines have transformed their fortunes within an extremely difficult industry context. This transformation has largely been through the pursuit of a low-cost business model.

Established Businesses

Findings from a recent IBM survey substantiated the view that there was a positive correlation between business model innovation and performance:

> "Companies that put more emphasis on **business model innovation** experienced significantly better operating margin growth (over a five-year period) than their peers".

A robust business model, such as a recurring revenue model, can help even during a downturn, as this quote from Jason Fried of 37 Signals illustrates:

> "The problem with one-off selling is that once the customer pays you once, that revenue stream runs dry…. but with a monthly subscription business model you'll still be earning regular monthly income from your existing customers. The other benefit of monthly subscriptions is that the entry cost is lower for new customers".

In short, there is compelling evidence supporting the view that business model innovation is a worthwhile pursuit for companies looking to grow their businesses. So what are the key steps?

Key Lessons

The following section outlines some of the key lessons an established business can take from others as part of the business model innovation process.

1. Business Model Innovation – Learn from other industries

Business model innovation forces you to take a holistic view of the business to assess unique opportunities that exist outside of innovation solely on the product side. One simple, yet common, form of innovation is replicating business models from other industries. As Mark Johnson claimed in his book, **Reinventing your Business Model**:

> "Business model innovations have reshaped entire industries and redistributed billions of dollars of value".

The low-cost business model mentioned above in relation to airlines such as Ryanair is now becoming more popular in other industries. In the hotel industry, for example, costs are being reduced significantly and the standard business model is being turned on its head. easyHotel is one obvious example where they have transferred lessons learned about low-cost business models from their easyJet airline. The CitizenM hotel in the Amsterdam airport is another such example, where staffing levels are far below industry averages, and customers are forced to 'self serve' more than is usually the case:

> "We looked at every process to see where we could streamline," says Michael Levie of the new hotel chain. "Building costs and personnel costs are the biggest outlay for hotels. So we have no reception or restaurant staff. And the construction is modular. Our hotel rooms are designed as fully fitted units that can be stacked one on top of the other. This way, we've managed to reduce the construction time to ten months, saving on costs".

Both easyHotel and CitizenM have pretty much ignored standard hotel practises and have sought to gain a competitive advantage by driving costs out through clever design and the deployment of a low-cost business model. Incidentally, cost leadership was one of the key generic strategies academic Michael Porter advocated businesses follow in his classic strategy text, **Competitive Strategy: Techniques for Analyzing Industries and Competitors**.

Of course, to take advantage of business model innovation in other industries, managers must keep abreast of what's going on outside their own industry.

Key Lessons

2. Business Model Innovation – Keep abreast of developments

Over time, as new technologies develop and companies replicate models seen elsewhere, more inefficient business models get displaced. One good example is the music industry. While the primary driver of the value is the music produced by the musician, the actual revenue created is dispersed in numerous directions along the path to getting the product into the hands of consumers, as the following breakdown illustrates:

Does a CD have to cost $15.99?
$0.17 Musicians' unions
$0.80 Packaging/manufacturing
$0.82 Publishing royalties
$0.80 Retail profit
$0.90 Distribution
$1.60 Artists' royalties
$1.70 Label profit
$2.40 Marketing/promotion
$2.91 Label overhead
$3.89 Retail overhead

The value dispersion is instructive and hence it is not surprising that digital delivery of music (disintermediating the costly distributor) would emerge as a more compelling business model once the facility (broadband infrastructure, MP3 digital format music files and devices such as the iPhone) was available. The launch of the iPad and the growing popularity of devices such as the Kindle have also begun to drive new hybrid business models for the book industry.

Meanwhile, in the gaming industry, 'free to play' has been a popular model where users play the games for free but pay to acquire virtual goods such as tools which enable you to play the game better, e.g. buying weapons or multiplayer access. This model is more credible as users are actively engaged with the game and typically the cost of virtual goods is nominal.

As micropayments become more ubiquitous, it is likely that business models aligned to micropayments will grow in importance. Hence, it is incumbent on established businesses to follow such trends to ensure that they embrace emergent business models before their competition does. A number of excellent resources exist that can help you track emerging trends, such as the newsletters from Trendwatching.com and Springwise.com.

Key Lessons

3. Business Model Innovation – Undertake competitive analysis

A common means to assess the attractiveness of an industry is to undertake strategic analysis using methodologies such as those prescribed by Michael Porter in his Five Force Analysis. In this seminal text, Porter argues that these following five forces determine the competitiveness of an industry and hence its attractiveness for market entry:

1. The threat of the entry of new competitors
2. The intensity of competitive rivalry
3. The threat of substitute products or services
4. The bargaining power of customers (buyers)
5. The bargaining power of suppliers

Understanding businesses from a business model perspective can also be extremely instructive, as you can build up a narrative regarding how companies perform certain activities to gain a clear understanding as to their strategies. Using this in tandem with Porter's Five Forces will give you a good sense of the competitive landscape which can then help you decide on the optimal strategy to pursue and also to pre-empt competitive threats.

Undertaking analysis of this sort will also help you avoid problems associated with sunk costs. Many industries have been very slow to adapt when faced with disruptive competition; consider Specsavers and 'online only' companies like Glasses Direct, or Encyclopaedia Britannica and the Internet. Lessons from the demise of Blockbusters have probably been the most instructive:

> "Blockbuster's huge investment, both literally and psychologically, in traditional stores made it slow to recognise the Web's importance: in 2002, it was still calling the Net a "niche" market. And it wasn't just the Net. Blockbuster was late on everything—online rentals, Redbox-style kiosks, streaming video. There was a time when customers had few alternatives, so they tolerated the chain's limited stock, exorbitant late fees (Blockbuster collected about half a billion dollars a year in late fees), and absence of good advice about what to watch. But, once Netflix came along, it became clear that you could have tremendous variety, keep movies as long as you liked, and, thanks to the Netflix recommendation engine, actually get some serviceable advice. (Places like Netflix and Amazon have demonstrated the great irony that computer algorithms can provide a more personalised and engaging customer experience than many physical stores.)
>
> Then Redbox delivered the coup de grâce, offering new Hollywood releases for just a dollar. Why didn't Blockbuster evolve more quickly? In part, it was because of what you could call the 'internal constituency' problem: the company was full of people who had been there when bricks-and-mortar stores were hugely profitable, and who couldn't believe that those days were gone for good. Blockbuster treated its thousands of stores as if they were a protective moat, when in fact they were

the business equivalent of the Maginot Line. The familiar sunk-cost fallacy made things worse. Myriad studies have shown that, once decision-makers invest in a project, they're likely to keep doing so, because of the money already at stake. Rather than dramatically shrinking both the size and the number of its stores, Blockbuster just kept throwing good money after bad".

James Surowiecki, The New Yorker
(October 18, 2010)

These examples illustrate that disruptive changes are becoming more common and they pose difficult strategic dilemmas for established businesses that are faced with the decision to do nothing or to compete. Neither of these tend to be attractive options, as competing can often mean cannibalising existing business but at less appealing margins. Ignoring these trends can also serve to escalate the timeframes leading to the incumbent's demise.

4. Business Model Innovation – Consider a hybrid business model

Another trend in recent years has been the growth of hybrid business models, where businesses operate a number of different models in tandem. For example, newspapers make their money from a mix of advertising revenue and the revenue they obtain for the sales of the newspaper. As we have seen in London, models can change over time; for example, the Evening Standard newspaper is now given away free every evening (relying solely on advertising income to sustain it). From a competitive standpoint, the adoption of this model was (and continues to be) very disruptive in an industry that was already struggling due to free content available online.

Sticking with the newspaper industry, the dominant online business model for many years was free online content supported by advertising. However, the commercial viability of such a model is generally not sustainable (most sites lose money), and this tactic also results in lost physical sales as some people substitute a free digital copy for a physical paid one. The Times in the U.K. has recently changed its model to a 'paid for' access one. Whether they can make it a success is debatable, however, given the fact so many free substitutes are only one click away. By way of a contrast, strategy consultants, McKinsey have recently announced that they are removing the pay wall from their McKinsey Quarterly online publication, enabling free access to all.

The online photo sharing website, Flickr.com, also operates a hybrid business model (Teece, 2009), as it derives value from numerous sources, such as:

(1) Collecting subscription fees

(2) Charging advertisers for contextual advertising

(3) Receiving sponsorship and revenue sharing fees from partnerships

Key Lessons

Finally, another great example of a hybrid business model relates to some modern TV productions. Take the popular entertainment show, the X Factor for example; the following include some of the revenue streams associated with the show:

Adverts
Advertising revenue goes entirely to ITV. Slots are already in high demand, with a 30-second ad costing €145,000. Last year's final was said to have earned €16m in advertising for ITV.

Phone Lines
Around a million votes are cast on each of the live shows; the big pay day is the final when around eight million viewers vote.

Sponsors
TalkTalk is the biggest sponsor and gets its logo on the beginning and end of each segment. For this privilege, it recently signed a three-year deal worth €25m.

Hair and Make-Up
L'Oreal is the big beauty sponsor of the X Factor website. It also provides free hair products and make-up for all the contestants and judges. The L'Oreal deal is worth a further €200,000 to the show.

Downloads
Live performances are available for download from iTunes. Each song costs €1 to download, 20c more than the usual rate. The singers are only paid 0.01c per download. The rest of the fee will go to iTunes, ITV, Syco, Talkback and the artist who owns the rights to the original song.

Magazine
Another money-spinning innovation is the X Factor magazine with exclusive weekly access to contestants and judges. It sells for €2.50 and advertisers are assured of a circulation of 300,000.

Tour
Tickets for the X Factor 2010 tour went on sale even before the finalists were announced. The concerts will rake in around €3m in ticket sales. You can double that with merchandise sold at the venues.

In essence, business models are essentially dynamic as new opportunities can emerge at various points on the value chain. The key for entrepreneurs is to recognise that there are numerous ways to capture value from customers and that you need to be flexible enough to work out which ones are likely to drive most value. For established businesses the key is to recognise that business model innovation is one great means by which you can capture additional value while keeping abreast of developments elsewhere.

The next section outlines some of the more popular business models being deployed.

Examples of Well-known Business Models

As mentioned earlier, direct selling was initially the dominant business model for many businesses. Over time production efficiencies coupled with improvements in transportation meant producers could reach a much bigger market, and this resulted in the pre-eminence of the retail distribution model for many years. However the emergence of the Internet as a distribution channel has meant that producers can once again sell direct to customers and disintermediate costly resellers, in effect going the full circle. In practise hybrid models have become the most popular models although not exclusively so. For example, the PC manufacturer Dell is a great example of a company who is very focused primarily on the direct sales business model.

The following list is by no means an exhaustive list of business model applications, but rather is designed to give you a feel for some of the models that are popular at present (business models evolve constantly). Similarly, in many instances the names can vary as they are not typically universally defined.

1. The 'Add-On' model

In this instance, the core offering is priced competitively but there are numerous extras that drive the final price up so the consumer is not getting the deal they initially assumed. If you have recently tried to buy an airline ticket or car insurance, you will have spotted that the number of extras you are offered can almost reach double figures!

For example, I recently purchased a £125 airline ticket on Aerlingus.com and the following represent the list of add ons I was 'tempted' with:

- Flexi Ticket (a mere £189.99 extra for 'full flexibility' defined as lounge access, two bags and a refundable ticket.) I declined the offer but was subsequently offered an 'Upgrade Flight' option on Page 2.
- Checked Bag (£10 extra)
- Extra Weight (for the bag) (£18 extra)
- Sports Bag (£25 extra)
- Travel Insurance (£6.99)
- Airport Lounge Access (again) (£20.00)
- Car Hire Offer (Varied prices)
- Flight Confirmation Text

The above business model is typical of most airlines now and represents a very different business model from the pre-Internet days of buying a physical ticket from a travel agent (and where everything was included in the list price). This up sell/ add on model has become very popular across a diverse range of industries and can also be a growing source of irritation (e.g. I was recently asked three times whether I 'wanted a coffee' when buying a Sunday paper at my local BP station).

Examples of Well-known Business Models

2. The Advertising model

The advertising model became popular with the growth of radio and TV, where the TV stations earned revenue indirectly from people looking to promote services to the audience they attracted, rather than via consumers paying radio and TV stations directly for the consumption of their TV programmes. In recent years a hybrid business model has emerged where the likes of Sky charge a monthly subscription in addition to the fees they gain from advertising. As Chris Anderson, author of **Free: The Future of a Radical Price**, declared;

> "In the traditional media model, a publisher provides a product free (or nearly free) to consumers, and advertisers pay to ride along. Radio is "free to air," and so is much of television. Likewise, newspaper and magazine publishers don't charge readers anything close to the actual cost of creating, printing, and distributing their products. They're not selling papers and magazines to readers; they're selling readers to advertisers. It's a three-way market".

Some Internet businesses derive revenue predominantly as a result of being able to offer advertisers access to highly targeted consumer niches (often in the absence of meaningful revenue from selling their goods or services). Indeed this is Google's primary business model, where companies bid to advertise alongside searches where there is a link to their proposition. It is not surprising that the advertising cost typically increases as purchase intent is signalled more strongly, i.e. product category searches are more expensive than generic long tail ones. The emergence of Google 'pay per click' (PPC) has resulted in a huge shift in advertising budgets away from banner adverts on content sites to Google. Similarly if you run a website which focuses on a narrowly defined topic, it is likely to attract a highly defined niche audience who could be offered complementary products or services with a higher probability of success than blanket mass market advertising.

If an advertising based business model is being considered for your start-up, it is worth noting that nowadays most savvy investors ignore 'vanity metrics' such as Page Impressions/Visitor numbers and want to understand whether the underlying business proposition is profitable. Examples such as YouTube illustrate how hard it can be to monetise free content even when you have significant visitor numbers. In short, this model is in decline for most businesses (but as always there are exceptions like Google and some content rich sites like newspapers). As business model author David Teece argues (2009);

> "The emergence of the Internet, Napster and its clones has obliged music recording companies to rethink their business models, which they have been doing along several fronts. On one front, they are moving to greatly increase the royalty rate for Internet 'broadcast' of their content, while on another, they are moving to capture advertising revenues associated with that content".

Examples of Well-known Business Models

Spotify.com the free music site is another one of those exceptions as it allows you to listen to music for free (but in return you get interrupted by adverts). Not surprisingly the paid Premium version is free of adverts.

However, as I mention above, this business model is increasingly difficult to justify if it is your main revenue stream (particularly as an online business). For a start, the landscape is extremely competitive and advertisers are spoilt for choice (although most limit their advertising spend to where the eyeballs are, i.e. Google and Facebook). Building brand awareness and translating that into site visits is a very difficult and costly challenge. Successes such as Facebook are very much the exception to the norm and, as mentioned, Google and Facebook have really killed this business model for most companies.

3. The Auction model

The auction model is synonymous with eBay.com, these days, but of course auctions have existed for hundreds of years. The tulip market in Amsterdam is one of the more famous long standing examples. There are numerous different types of auctions, from English, to Dutch, Vickrey, Sealed Bid, etc., and they all share certain characteristics: the price of the good is not fixed; each individual assesses the value of the good independently; final value is determined via competitive bids.

This business model has become popular in recent years as the Internet has helped to broaden its appeal, with eBay representing the main example in this category. However it could be argued that a more likely reason for its success has been due to the sheer numbers of prospective buyers who congregate on eBay (representing a large qualified target market for sellers). This perspective is also supported by the fact that the popularity of eBay appears to be waning and a buyer is likely to find increasing numbers of fixed price offers for sale rather than pure play auction ones.

4. The 'Yet to Emerge' business model

A different trend in more recent years has however been the growth of companies (often Internet ones) with undefined business models. Given that Internet companies have much more modest capital requirements than traditional industries, and the product consumption is often digitized, some companies seek to build user numbers and then work out afterward what a viable business model would be. Take the well known social media platform, Twitter.com for example:

> "Twitter has become an influencer in the way information is shared around the world. But while its immediacy, transparency and simplicity offer answers about all things both newsworthy and mundane, one big question about Twitter has gone virtually unanswered: how it plans to turn a profit".

JP Mangalindan, CNN Money
July 9, 2010

The big challenge for the likes of Twitter, Facebook and other social media sites is that attempts to monetise come at a number of costs, often the privacy of the

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user and their ability to use the service without interruptions from third-party advertisers. Monetising a free service invariably degrades the experience for the customer and hence companies need to walk a fine line, as Facebook found to its cost in 2010 when it changed the default setting enabling "everyone" to have access to your Facebook profile, meaning users had to be proactive about limiting access to their accounts. This model is also synonymous with the 'winner takes all' belief, where companies believe that there will only be one winner in some categories and the initial focus needs to be on a 'land grab' where the aim is to attract a significant customer base which can be monetised downstream.

Many businesses offered free Internet services and businesses were valued on the basis of potential rather than underlying profit and loss metrics. There are still remnants of this today, and some spectacular examples like Twitter.com, where the notional valuation of the company is considerable even though existing revenue streams are negligible.

The actual business model is getting lost in the media hype and proliferating user numbers, and it is more a case of 'figuring the business model out at a later stage' than up front. The logic here is simple (but increasingly flawed); if you offer a free service, you remove the biggest risk or barrier to new prospects. Once you have significant volumes of users, you can then 'create a business model' to monetize this large user base. Of course there will be some successes with this model, but for the majority of sites, visitors who do not buy are essentially worthless as companies struggle to bridge the gap between free users and paid (often because users find the free version meets their requirements or the paid version fails to meet them at the price charged).

5. The Franchise model

Opening a franchise is essentially buying a working business model in a particular industry. You pay royalties for the privilege and in return get access to a winning recipe, a support network and an established brand. The main benefits of a franchise business model is that the franchisee gets to reduce the risk associated with opening a new business (in return for a fee) and the franchisor gets to expand their brand without the need to tie up extra capital. Two famous companies operating franchise business models are McDonald's and Subway. But in recent years the model has also become popular in a whole range of industries ranging from pest control to gyms, where the associated brand proposition is questionable at best.

6. The Freemium model

This is where the business gives away something for free in return for your personal details so they can then market to you and hope to build up a relationship so that you buy from them in the future. It is typically used in service-based businesses where the lifetime value of the average customer is high, and is increasingly popular with Internet services such as Spotify, Skype, or Flickr. It is also closely associated with the 'yet to emerge' business model I just described.

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"Once a marketing gimmick, free has emerged as a full-fledged economy. Offering free music proved successful for Radiohead, Trent Reznor of Nine Inch Nails, and a swarm of other bands on MySpace that grasped the audience-building merits of zero. The fastest-growing parts of the gaming industry are ad-supported casual games online and free-to-try massively multiplayer online games. Virtually everything Google does is free to consumers, from Gmail to Picasa to GOOG-411. The rise of "freeconomics" is being driven by the underlying technologies that power the Web. Just as Moore's law dictates that a unit of processing power halves in price every 18 months, the price of bandwidth and storage is dropping even faster. Which is to say, the trend lines that determine the cost of doing business online all point the same way: to zero".

Chris Anderson
Free! Why $0.00 Is the Future of Business

Many of these offerings have similar cost structures where the marginal cost of serving an additional customer tends towards zero as Anderson describes. The core free offering then acts as a gateway to the paid service. For example, with Spotify, the free version comes with adverts, the paid does not. In many ways the best definition of the model predated the name Freemium as Venture Capitalist, Fred Wilson described:

"Give your service away for free, possibly ad supported but maybe not, acquire a lot of customers very efficiently through word of mouth, referral networks, organic search marketing, etc, then offer premium priced value added services or an enhanced version of your service to your customer base".

All of the above is of course premised on the belief that you can convert the free consumers to paid, something that is not always as straightforward as the concept would have you believe. For example, at one point, 'unique visitor' numbers to a site had a large perceived value, but nowadays the focus has definitely shifted back towards firm commercials.

7. The Low-Cost model

The low-cost model can be summed up in one word: 'Ryanair'. This is an extremely well established business model, where the aim is to drive significant volumes of customers (at a low customer acquisition cost) and by charging a very low price. In return, much like the 'add on' business model, revenue is earned from a whole host of ancillary sources – these include:

- Bank card charges
- Advertising on seats
- Lottery ticket sales
- Flight insurance
- Selling train tickets
- Priority seating
- Extortionate charges for excess baggage, reprinting a boarding pass, etc.
- 'Preferred car hire rates'

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The model is not solely about trying to extract extra cash from consumers, but also configuring every single aspect of their business model so as to drive out cost. Examples include buying one type of aircraft to minimise costs, having destination tourist boards pay for newspaper advertising, having staff pay for their own uniforms and training, and so on.

8. The Pay-as-you-go model

With this model, actual usage of a service is metered and you pay on the basis of what you consume. Some mobile phone contracts operate on this basis, i.e. the user can buy credit. Each call is metered and the credit is reduced as the 'minutes' are consumed (in contrast to subscription business models where you pay a monthly fee for calls). In recent years there has been a trend away from outright ownership when consumption is low, towards services based on pay-as-you-go rental models.

For example, recognising that many urban dwellers in cities with well formed public transport infrastructures, e.g. London and New York, did not have their own cars; Zipcar.com designed a model where cars can be hired by members in a scheme similar to car rental. However, the business model is completely different, i.e. cars can be rented by the hour; cars are located in hundreds of locations, users book online, etc. In other words, a member can have painless access to a car pretty much on demand! This simple idea encourages users to consume a service, in this case on-demand access to a car, rather than buying a product–the car. While 'hiring a car' is perceived as more of a considered purchase, checking online to see if the local car is free so you can do a grocery shop is a lot more impulsive and convenient.

Similarly the 'Bag Borrow or Steal' website offers luxury jewellery, sunglasses, purses and handbags for hire. Again the motivations for this service are rooted in a number of evident facts – women like nice bags, some items are not very affordable (particularly when set against the frequency of their use), and carrying a high status brand name bag is viewed as a powerful statement by some women. So the owners of this site decided to use the power of the Internet to target conspicuous consumers and to offer users the option to rent or borrow a luxury bag for 'that special occasion'. Other similar instances to this include luxury car hire, which similarly targets particular audiences such as young cash-rich males, with options to hire a luxury car for a day.

As these above models illustrate, consumption behaviours are changing and a whole raft of business models are emerging to service those who are happy to consume on an ad hoc basis rather than acquire something which will only receive sporadic use.

Examples of Well-known Business Models

9. The Recurring Revenue model (Subscription model)

With the recurring revenue model, the aim is to secure the customer on a long-term contract so that they are consuming your product or service well into the future. Given that the cost of customer acquisition can be high, retaining customers is a primary goal for most businesses. It is synonymous with 'paying via direct debit' (most utilities providers operate under this model). Magazine publishers have also been looking to expand this portion of their business for some time, offering heavy discounts to subscribers (who buy all issues directly), rewarding them over individual discrete purchases (bought on an ad hoc basis from various third parties). This model is becoming increasingly popular as the trend spotting blog Springwise.com recently outlined;

> "The subscription model seems to be spreading like wildfire! Hardly a week goes by without our spotting at least one new subscription-based business, and this week was no exception. The concept this time around? Artisan lip balm, with a new one sent to the consumer's door each month… For £5 per month, the company will send consumers a new flavoured lip balm 12 times a year; with flavours like caramel and mojito, its current line features limited-edition jar labels created by designer Jack Featherstone".

If you are able to design a subscription element to your business you are securing life time value after the initial cost of customer acquisition. Graze.com is a good example of a firm deploying this model – they post out weekly packages of healthy foods to 'graze on'. This model is also associated with Software as a Service [SAAS] applications where consumers access content from the (data) cloud e.g. music from Spotify, data backup services from Carbonite, or news access from The Times.

Examples of Well-known Business Models

10. The Somali Pirate Business model!

Business models do not just apply to legitimate businesses as this post, The Somali Pirates' Business Model by Mark Leon Goldberg illustrates. In the article Goldberg describes how a security report from Somalia details the business model for the pirates;

> "A basic piracy operation requires a minimum eight to twelve militias prepared to stay at sea for extended periods of time, in the hopes of hijacking a passing vessel. Each team requires a minimum of two attack skiffs, weapons, equipment, provisions, fuel and preferably a supply boat. The costs of the operation are usually borne by investors, some of whom may also be pirates.
>
> To be eligible for employment as a pirate, a volunteer should already possess a firearm for use in the operation. For this 'contribution', he receives a 'class A' share of any profit. Pirates who provide a skiff or a heavier firearm, like an RPG or a general purpose machine gun, may be entitled to an additional A-share. The first pirate to board a vessel may also be entitled to an extra A-share.
>
> At least 12 other volunteers are recruited as militiamen to provide protection on land if a ship is hijacked, In addition, each member of the pirate team may bring a partner or relative to be part of this land-based force. Militiamen must possess their own weapon, and receive a 'class B' share — usually a fixed amount equivalent to approximately US$15,000.
>
> If a ship is successfully hijacked and brought to anchor, the pirates and the militiamen require food, drink, qaad, fresh clothes, cell phones, air time, etc. The captured crew must also be cared for. In most cases, these services are provided by one or more suppliers, who advance the costs in anticipation of reimbursement, with a significant margin of profit, when ransom is eventually paid".

As the above illustrates the application of business model innovation exists far beyond the walls of corporate Europe and America!

Summary

This paper is designed to help both entrepreneurs and established businesses alike. If you are looking to build a new business and are about to draft a business plan, the recommendation is that you should also spend time working out your optimum business model. This is best achieved by drafting a visual representation of your business model (you can use this framework to map same). Up until quite recently business plans were largely rigid business templates that were followed without question, and often at quite a cost as this graphic example from Steve Blank illustrates;

> "At $5.2-billion Iridium was one of the largest, boldest and audacious startup bets ever made. Conceived in 1987 by Motorola and spun out in 1990 as a separate company, Iridium planned to build a mobile telephone system that would work anywhere on earth. It would cover every city, town and square inch of the earth from ships in the middle of the Arctic Ocean to the jungles of Africa to the remote mountain peaks of the Himalayas….. The result was a classic startup failure writ large. Iridium followed its original business plan assumptions off a cliff".

Nowadays businesses are encouraged to be more flexible and entrepreneurs are encouraged to test numerous business models until they gain traction with one of them. A key objective arising from the paper is the need for entrepreneurs to test the assumptions that underpin their business models in as low cost a manner as is possible before they invest heavily in marketing.

For established businesses, the lessons are clear. Managers need to be aware that in recent years there has been significant innovation in the range of business models, and some of these innovations may be capable of being deployed in your industry. For example in the gaming industry alone, David Perry, COO of Acclaim Games Inc lists 29 different business models for games that he is familiar with. Managers need to be aware of business model trends that are taking place before they disrupt their industry to the extent that they can no longer compete effectively.

Finally, it is also worth noting that some business models such as the Internet bubble model have largely had their day. Very few investors will invest in businesses these days that have advertising at the heart of their business model. The focus has definitely switched back to building profitable businesses with paying customers, which can only be considered a good thing!

Appendix

Appendix 1: Articles

Anderson, Chris: Free! Why $0.00 is the Future of Business (Wired)

Berry, Tim: Free Content as Marketing, Not Business Model

Blank, Steve: No Plan Survives First Contact With Customers – Business Plans versus Business Models

Carpenter, Steven: 13 Ways To Get To $10 Million In Revenues, Part I (Techcrunch)

Carpenter, Steven: 13 Ways To Get To $10 Million In Revenues, Part II (Techcrunch)

Chesbrough, Henry and Rosenbloom, Richard S.:The Role of the Business Model in Capturing Value from Innovation: Evidence from Xerox Corporation's Technology Spinoff Companies (Harvard Business School)

Fetscherin, Marc and Knolmayer, Gerhard: Business Models for Content Delivery: An Empirical Analysis of the Newspaper and Magazine Industry (2004)

Fried, Jason: The Benefits of a Monthly Recurring Revenue Model in Tough Economic Times

IBM Global Services: Business Model Innovation - the new route to competitive advantage

Johnson, Mark W.: A New Framework for Business Models (Harvard Business Review, 2010)

Johnson, Mark W., Christensen, Clayton M., and Kagermann, Henning: Reinventing Your Business Model (Harvard Business Review, December 2008)

Osterwalder, Alexander: Combining Business Model Prototyping, Customer Development, and Social Entrepreneurship

Osterwalder, Alexander: How Business Models Help Generate Business Plans

Wilson, Fred: My Favourite Business Model

Wu, Susan: Virtual Goods: the next big business model

Appendix

Appendix 2: Books

Anderson, Chris: **Free: The Future of a Radical Price** (2009)

Blank, Steve: **The Four Steps to the Epiphany** (2005)

Fried, Jason and Heinemeier Hansson, David: **ReWork: Change the Way You Work Forever** (2010)

Harvard Business Review on Business Model Innovation, Harvard Business School Press

Johnson, Mark W.: **Seizing the White Space: Business Model Innovation for Growth and Renewal** (2010)

Mullins, J. and Komisar, R.: **Getting to Plan B: Breaking Through to a Better Business Model** (2010)

Osterwalder, Alexander and Pigneur, Yves: **Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers** (2010)

Porter, Michael: **Competitive Strategy** (1980)

Teece, David J.: **Business Models, Business Strategy and Innovation** (2009)

Appendix 3: Tools, Videos & Web

Videos

The New Business Model by Guy Kawasaki

Getting to Plan B by Randy Komisar

How to Choose a Business Model by Roan Lavery

Business Model Matters by Ann Miura-Ko

Creating Startup Success 101 (Powerpoint) by Alex Osterwalder and Steve Blank

Websites

The Business Model Canvas (A great outline you can use to map your business model)

The Business Model Innovation Hub (Exchange knowledge on business model innovation)

Springwise.com (New business ideas from around the world)

Trendwatching.com (Stay abreast of business model innovations)

The Business Model Database (Anders Sandelin's blog where he explores business models and business model innovation)

Appendix

Appendix 4 - Nine Business Model Building Blocks

These nine business model building blocks can be used as a framework when designing your business model.

1. Customer Segments: The target audience for a business' products and services.
2. Distribution Channels: The means by which a company delivers products and services to customers. This includes the company's marketing and distribution strategy.
3. Customer Relationship: The links a company establishes between itself and its different customer segments. Maintaining and nurturing these relationships is referred to as customer relationship management.
4. Value Propositions: The products and services a company offers.
5. Cost Structure: The monetary consequences of the means employed in the business model.
6. Revenue Streams: The way a company makes money through a variety of revenue flows.
7. Key Partners: The business alliances and partnerships the company forges.
8. Key Activities: The activities necessary to execute a company's business model.
9. Key Resources: The resources needed to create value for the customer.

Source: Osterwalder et. al.