

IBM Global Business Services

IBM Institute for Business Value

Paths to success

Three ways to innovate
your business model



Strategy and
Change



IBM Institute for Business Value

IBM Global Business Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Global Business Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information.



Paths to success

Three ways to innovate your business model

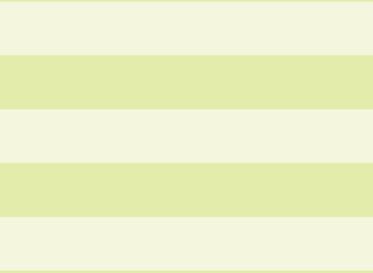
By Edward Giesen, Saul J. Berman, Ragna Bell and Amy Blitz

In today's ever-changing times, innovation in business models is a success differentiator for CEOs, as we learned from the IBM 2006 Global CEO Study.¹ But what is business model innovation and what can we learn from successful business model innovators? Based on our experience, an extensive literature review and an analysis of 35 best practice cases, we first developed a framework for understanding business model innovation. Here, we identified three main types of business model innovations: those in industry models, revenue models and enterprise models. We then compared these three types of business model innovation across the 35 best practice cases and found that each type of business model innovation, used either alone or in combination and with the right strategy and strong execution, can generate success. Among the three types, enterprise model innovation emphasizing external collaboration and partnerships is the most common.

Introduction

As CEOs navigate today's rapidly changing global business environment, their ability to shift direction and introduce business model innovations is proving to be a critical success factor. In fact, we learned from the IBM 2006 Global CEO Study that business model innovation had a much stronger correlation with operating margin growth than other types of innovation.² But what exactly is business model innovation? And what type yields the best results? Neither the CEOs we spoke with nor a review of the current literature provided a clear answer.

So we set out to find an answer. In our research, we first identified three main types of business model innovation, which can be used alone or in combination: innovations in industry models, in revenue models and in enterprise models. We then compared these three types of business model innovation across 35 best practice cases. In this brief, we demonstrate that each type of business model innovation, with the right strategy and strong execution, can generate success.



While each of the three types of business model innovation can lead to success, we found that innovations in enterprise models that focus on network plays (that is, external collaboration and partnerships) are the most common, with 15 of the 35 cases we studied, or almost half, using this type of business model innovation. Moreover, we found that companies using network plays realized similar financial results as companies that used other strategies. We also found that while network plays are being used by diverse companies in different industries and regions, and of varying age, size and other characteristics, this tactic has been a particularly useful strategy for older companies.

So when it comes to business model innovation, many paths may lead to success with collaboration and network plays being the most common approach. The key is to seize opportunity in new ways, particularly during times of significant global economic and industry change like the current period, to better meet customer needs using strategies that fit the overall strengths and vision of the organization. Strong execution must then follow.

Paths to success

Three ways to innovate your business model

Business model innovation matters

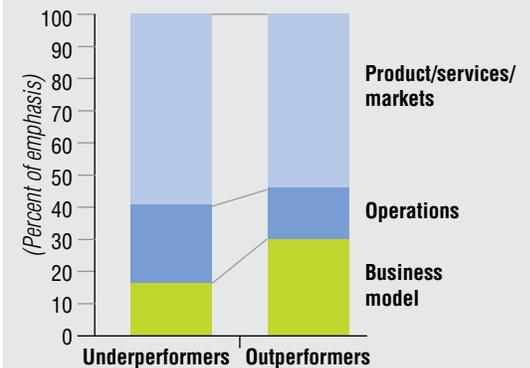
In today's fast-changing business environment, CEOs face tremendous opportunities, as well as threats, from various directions. Consider the Internet. While it may seem like old news these days, the Internet is one factor that continues to transform the global business environment. For example, relatively recent entrants like Google, MySpace and YouTube, to name a few, are demonstrating the ongoing power to introduce new and disruptive business model innovations using the Internet.

Clearly, there is substantial opportunity to leverage that power to create entirely new industries and reinvent existing ones. Add to this the rise of China, India, Russia, Brazil and other emerging markets, and the sense of both opportunities and threats, not to mention confusion for CEOs, expands.

In the IBM 2006 Global CEO Study, which was based on interviews IBM conducted with 765 corporate and public sector leaders worldwide, we found that 65 percent of leaders anticipate fundamental change in their industries in the next two years.³ As a strategic response, many CEOs are innovating in operations and/or products and services. But we found that the financial outperformers put twice as much emphasis on business model innovation as underperformers (see Figure 1). As one CEO told us, "Products and services can be copied; the business model is the differentiator."⁴

FIGURE 1.

Profit outperformers focus on business model innovation more frequently than underperformers.



Note: Based on operating margin growth over five years as compared to competitive peers.

Source: "Expanding the Innovation Horizon: The Global CEO Study 2006," IBM Global Business Services. March 2006.

Probing further, we asked the CEOs who were focused on business model innovation to describe how they were approaching it. The majority cited reorganization and strategic partnerships. This fits well with our understanding of the increasingly extended and geographically integrated nature of enterprises, with technology and other factors enabling broader collaboration among employees worldwide, as well as with suppliers, customers and other partners.

Beyond this broad definition, however, we all – the CEOs, the IBM CEO Study Team, academics and other analysts – felt the need to dive deeper into this matter and ask: What

During periods of seemingly chaotic economic transformation, a company's survival can hinge on its ability to turn away from the old ways of doing things and introduce new business models.

do we mean exactly by business model innovation and, more importantly, what really matters in terms of financial performance? What, overall, are some guidelines for CEOs to follow as they navigate the new competitive landscape?

Building on the work of Fernand Braudel, Carlotta Perez, Alvin Toffler and others, we observe patterns in the seeming chaos of economic transformations such as the current one.⁵ While the specifics of the theories vary, there is a general understanding that what starts as scientific discovery soon generates commercially viable innovations. These innovations then generate an early round of new businesses and new business models that transform the economy.

Eventually, as the adoption of these innovations matures and as opportunities to leverage these innovations in older industries takes place, broader changes in the structure of businesses and in society – at the local, national and global levels – occur. When this happens, there are winners and losers and, often, painful periods of adjustment.⁶

For business leaders, failure to navigate these periods of adjustment can lead to corporate decline or even extinction. To illustrate this, we compared the S&P 500 from 1957 and 2007 and found that even major players fell off the list or disappeared completely, as happened to Pan Am and Bethlehem Steel, for example. In fact, only 16 percent of the companies listed on the S&P 500 in 1957 remain there today.⁷

While post-mortems indicate a variety of causes for corporate decline or failure, one factor that often separates the winners from the losers is an ability to transform, or even to scrap, old ways of doing things and introduce new business models. This may at times require cannibalizing existing lines of business within an organization.⁸ It may also mean moving into new industries, often by leveraging core capabilities while changing offerings.⁹ Or it may mean having to manage diverse business models within one organization. For new firms with no legacies to defend and green fields to explore, the opportunities can be vast. In all cases, a vision of what is possible – not what was – must prevail.

Navigating such change using business model innovation is easier said than done in realtime, however. And CEOs today clearly understand the magnitude of the challenges they face. Is there a roadmap, we asked, that might guide business leaders along the often treacherous path to successful business model innovation?

Our framework for business model innovation

To start with, when we looked more deeply into the topic of business models and business model innovation, we found that, like art, business leaders may know it when they see it, but they have difficulty actually defining it.

Searching the literature on the topic proved similarly fruitless – again with no clear, consistent or generally accepted definition of business models or business model innovation. Many different views exist, each emphasizing different dimensions.

The three main types of business model innovation strategies - industry model, revenue model and enterprise model - can be used alone, or in combination.

To help remedy this, based on our experience, an extensive literature review and an analysis of our 35 best practice cases plus a scan of over a dozen others, we developed a framework for understanding business model innovation and identified three main types of strategies (see Figure 2).

The three types of business model innovation strategies we identified are:

- *Industry model*: This approach involves innovating the “industry value chain.” This can be accomplished via *horizontal moves* into new industries as Virgin has done with its moves from its beginnings in music and retail to such diverse industries as airlines, railways, beverages, financial services, etc., thus leveraging its superior skills in consumer management.

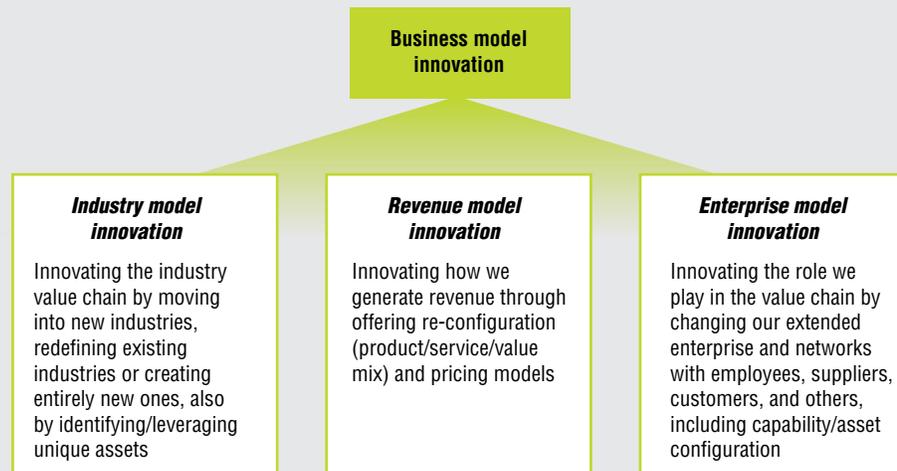
It can also be accomplished by *redefining existing industries*, as Dell has done by eliminating intermediaries and going directly to customers and, as Apple has done by delivering music directly to customers via iTunes.

Perhaps most dramatically, industry model innovation can also involve the *development of entirely new industries or industry segments*, as Google and other search engine companies have done in the past decade with the advent of the Internet. This dimension leverages white spaces in the competitive environment as well as unique assets.

- *Revenue model*: This approach involves innovations in how companies generate revenues by *reconfiguring offerings (product/service/value mix) and/or by introducing new pricing models*. This is a dimension that leverages customer experience, choices and preferences and that can also leverage new technologies.

A good example of an offering innovation is Cirque du Soleil’s redefinition of the circus experience, recombining new and old elements to change the value proposition and reach a new target audience. A classic example of a pricing innovation is Gillette’s strategy of underpricing razors to sell razor

FIGURE 2.
IBM framework for business model innovation.



Source: IBM Institute for Business Value and IBM Global Business Services.

blades. Another more recent example is Netflix's introduction of a new kind of movie rental option, offering consumers monthly subscriptions rather than the once prevailing product-based rental structure. New pricing models also can be seen in digitized modern markets with such offerings as music subscriptions and clips of music for ring tones.

- *Enterprise model*: This approach involves innovating the structure of the enterprise and the role it plays in new or existing value chains. This dimension focuses on redefining organizational boundaries.

Innovations here can be achieved through *integration* as in the Japanese *kieretsu* framework, where what might typically be a supply chain is owned and managed by one firm or conglomerate. Clothing retailer Zara, for example, manages design through delivery, creating feedback loops from customer data at stores back to designers through manufacturing.¹⁰

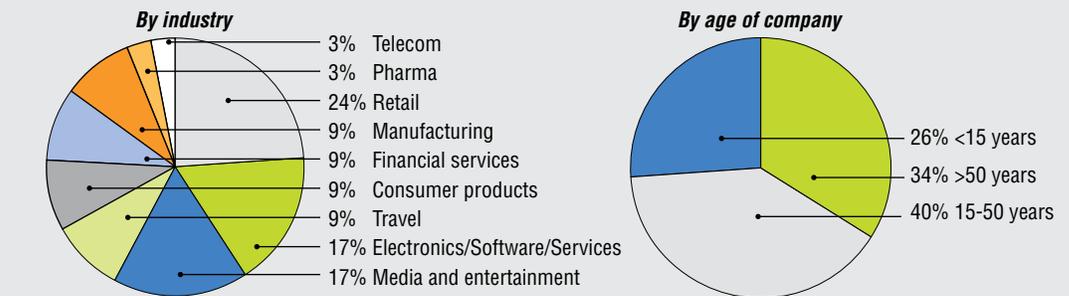
Enterprise model innovation can also be accomplished via *specialization*, wherein organizations focus on core competencies or high-margin activities and outsource the rest. The Indian telecommunica-

tions company Bharti Airtel, for example, focuses on marketing, sales and distribution, outsourcing much of the actual IT and networking functions to external partners.¹¹

Finally, enterprise model innovation can be accomplished via *network plays*, wherein companies rely on external collaboration. For example, illycaffé has partnered with various other companies along its value chain, such as manufacturers of coffee-makers and others, to improve the overall coffee-drinking experience.¹²

Using this three-dimensional framework to describe diverse but often complementary types of business model innovation, we then conducted a detailed analysis of 35 best practice cases using publicly available information. Fifteen of these cases were from the *Business Week* 2006 list of leading business model innovators, including Apple, IKEA, Southwest Airlines and others.¹³ We selected the remaining 20 cases based on a company's reputation for leadership in business model innovation as reflected in analyst reports, interviews with experts in diverse industries and a broad literature review.¹⁴ The cases represent diverse industries, regions and types of business model innovation (see Figure 3).

FIGURE 3.
Breakdown of the 35 best practice cases used in our business model innovation analysis.



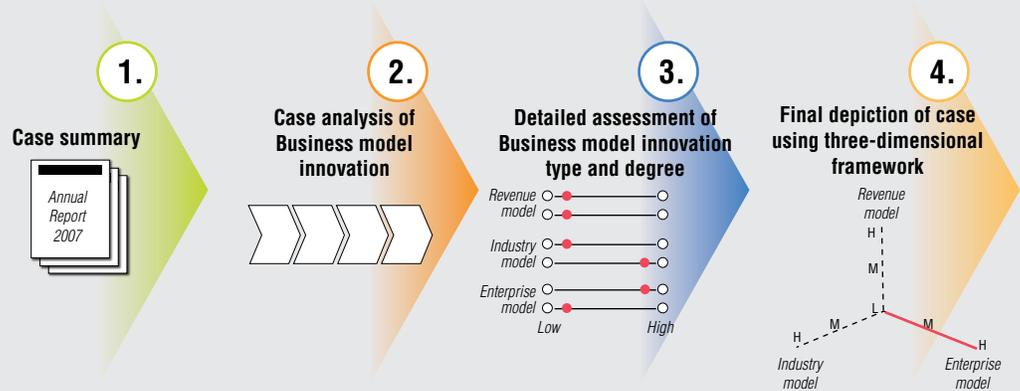
Source: IBM Institute for Business Value.

Companies can use the framework we developed as a diagnostic to identify and evaluate business model innovation options.

Our approach

For each of the 35 best practice cases, we assigned values of *high*, *medium* or *low* along the three dimensions, indicating the type and extent of business model innovations used (see Figure 4). Where companies had tried a variety of business model innovations through the years, we selected one particularly innovative, widely recognized and/or effective example. We then correlated business model innovation with various factors, including *industry*, *period of innovation*, *age of company* and *size of company* by *number of employees*, *revenues* and *assets*. This framework can be used as a diagnostic for identifying and evaluating business model innovation options.

FIGURE 4.
Framework for evaluating business model innovation.



Source: IBM Institute for Business Value.

Finally, we conducted extensive financial analyses for 24 publicly traded companies in our sample. We used operating profit margin compound annual growth rate (CAGR) from 2001-2006 and stock price CAGR from 1996-2006 (or, in cases where the IPO was later than 1996, from the IPO to 2006). We then correlated financial performance with business model innovation, testing for various factors that might influence success.

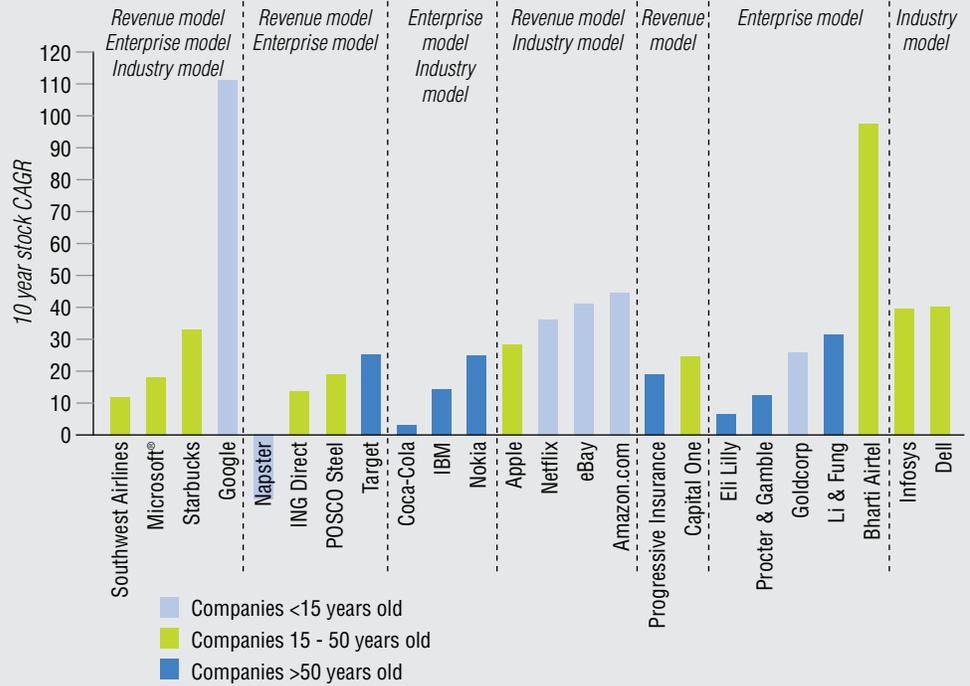
Diverse strategies work but network plays most common

As noted previously, we found from the IBM 2006 Global CEO Study that financial outperformers were putting twice as much emphasis on business model innovation as underperformers. But what exactly, we wanted to know, were top performers doing to innovate their business models and which approaches were most effective?¹⁵

All three paths can lead to success

Based on our analyses (see Figure 5), we found that all three types (or combinations) of business model innovation can lead to successful financial results. We found no significant variation in financial performance across the different types of business model innovation. The good news: With a sound overarching business strategy and strong execution, any of the paths can lead to success.

FIGURE 5.
10 year stock CAGR versus type of business model innovation.



Source: IBM Institute for Business Value analysis of Thomson ONE Banker financial data and company annual reports, 1997-2006.

Much can be learned from entrepreneurs, or those companies in our study with less than 15 years in operation, who often lead the way when it comes to business model innovation. In particular, new entrants such as Google demonstrate the financial rewards to be gained by exploiting new technologies in original ways, introducing in the process extremely disruptive business model innovations.

While breakthrough, headline-grabbing innovations are often initiated by new entrants, however, opportunities for revolutionary change exist for firms at virtually any stage. Nokia, for example, has evolved since its founding in 1865 as a paper mill company, continually reinventing itself and the industries it has entered.¹⁶

Within industries, we find again that many paths can lead to success. Diverse strategies, when aligned with a company's brand, operations, core strengths, and other assets, can work for different companies in the same industry. For example, in financial services, an industry undergoing massive consolidation, Capital One and ING Direct have both been successful using different types of business model innovation.

Where Capital One has developed extensive customer data analysis, customer segmentation and micro-marketing strategies (revenue model innovation), ING Direct has exploited the Internet to lower its operating costs, offer higher interest rates and attract more consumers to online banking – in close cooperation with other financial institutions (enterprise model innovation).¹⁷

Network plays are more common than any other type of business model innovation, and have been particularly useful in helping older companies manage significant global economic and industry change.

Network plays are key

While many paths may lead to successful business model innovation, innovations in enterprise structure that focus on network plays or external collaboration proved to be the most common type of business model innovation in our sample. In fact, 15 of the 35 cases we studied, or almost half, focused extensively on this strategy.

Companies using these strategies had equally strong financial results as those using other types of business model innovation. For example, as noted above, Indian telecommunications maverick Bharti Airtel has developed an organizational structure that is centered heavily on its extended network, enabling it to radically lower prices in order to expand its customer base while specializing in customer relationships, not technology.¹⁸

Among the older companies in our sample, enterprise or network plays were particularly common, enabling them to change course via new partnerships or acquisitions while leveraging their brand, scale, channels or other long-standing strengths. For example, illycaffé has partnered extensively with companies that produce coffee cups and coffee makers in order to enhance the overall coffee drinking experience for its customers, as mentioned previously.¹⁹ In another example, Eli Lilly has established a “research without walls” strategy of partnering with bio-tech companies, academic institutions and others to strengthen their innovation pipeline.²⁰ In these and other cases, relying solely on internal R&D would likely have been more expensive and slower.

This is not to say, however, that such collaboration is easy to implement and manage. From our interviews with the 765 CEOs in the IBM 2006 Global CEO Study, we learned that 76 percent cited the importance of enabling collaborative innovation, yet only 51 percent reported that they were actually doing this to a large extent.²¹

One big challenge is that, as organizations become more global, they face more complex issues related to culture, regulation, technology and other areas. Furthermore, with the growing trend toward extended enterprise models, which involve more external partnerships, collaborative innovation is even harder to do well.

Multiple sources show that failure rates for strategic partnerships exceed 50 percent, with problems related to collaboration across organizations thought to be a key cause.²² The fact that the best practice cases that we analyzed have succeeded in external collaboration shows that those innovation leaders who are able to overcome the gap between idea and execution find a powerful way to differentiate themselves.

In general, the best business model innovation strategies provide a strong fit between the competitive landscape for a particular industry and the organization's strengths, shortcomings and characteristics such as age and size. The questions in the sidebar, *Pinpointing your strengths, shortcomings and options for business model innovation*, can be used to support this decision-making process.

Pinpointing your strengths, shortcomings and options for business model innovation

Understanding ways to leverage business model innovation is a key source of competitive advantage in today's economy. The following questions, based on our business model innovation framework, can help you assess your options and develop a roadmap to effective business model innovation:

Understanding the industry context

- What new business models do you see emerging in your industry? Is the basis for competition changing?
- Where are new and disruptive business models coming from – from within your industry or from new players/other industries?
- What is the degree of change and innovation in your industry? What can you learn from successful business model innovators – either in your industry or outside?

Defining your current position

- How does your degree of innovation relate to your industry? Do you have the balance right between incremental versus more radical innovations?
- Do you drive the change in your industry, or is it imposed on you? Are disruptive models emerging in areas you are not currently focusing on today?
- Which business model innovation paths are you exploring – industry model innovation and/or revenue model innovation and/or enterprise model innovation? Which ones are most aligned with your industry, capability and vision?

Building your capabilities to manage business model innovation

- Industry models: Do you have a systematic way to envision future industry scenarios and implications for your innovation strategy?
- Revenue models: How can you exploit new / emerging revenue models as well as new value offerings, and manage the implications for your business and competitive positioning? Do you have a structured approach to thinking through revenue implications?
- Enterprise models: Do you understand – and leverage – your unique capabilities and assets? What capabilities and processes do you have in place to develop, maintain, evaluate and terminate external collaboration for innovation?

Your answers to these questions can help you determine the areas in which your organization already excels, as well as areas where you can focus your efforts to drive your future business model innovation agenda.

Conclusion

Anticipating massive change across diverse industries, top-performing CEOs are focusing on business model innovation as a path to competitive power and growth. To accomplish this, business leaders can utilize three main types of business model innovation: innovation in industry models, revenue models and/or enterprise models. These approaches to business model innovation can either be used alone or in combination.

The good news is that with the right strategy and strong execution, all paths can lead to successful business model innovation. At the same time, however, enterprise model innovation, emphasizing collaboration and partnerships, is the most common strategy. And the companies we studied that are pursuing enterprise model innovation focusing on collaboration and partnerships achieved financial results comparable to those using other business model innovation strategies.

About the authors

Edward Giesen is the Leader in Europe, the Middle East and Africa for Business Strategy and Component Business Modeling within the Strategy and Change practice for IBM Global Business Services. He can be reached at edward.giesen@nl.ibm.com.

Saul J. Berman is the Services Leader for the Strategy and Change practice of IBM Global Business Services. He is also the Global and Americas Media and Entertainment Strategy and Change Lead Partner. He can be reached at saul.berman@us.ibm.com.

Ragna Bell is the Global Business Solutions Portfolio Manager within Strategy and Change for IBM Global Business Services. She can be reached at ragna.bell@us.ibm.com.

Amy Blitz is the Strategy and Change Lead for the Institute for Business Value within IBM Global Business Services. She can be contacted at ablitz@us.ibm.com.

Contributors

The authors are indebted to many throughout IBM for their substantial contributions to this paper. We thank first Mahesh Ganesan for his extensive role in developing the literature review and the detailed case analyses. We also thank Jamie Bader, Chris Benne, Rob Berini, Alain Biem, Marc Chapman, Michael Gibney, Stephen Hines, Jeff Hittner, Peter Korsten, Daniel Latimore, Dave Lubowe, Lawrence Owen, George Pohle, Stephen Reiser, Robert Scavello for their insights and contributions. In the spirit of collaboration and partnering, we thank these colleagues and many others in the extended IBM team who have contributed to this paper.

About IBM Global Business Services

With business experts in more than 160 countries, IBM Global Business Services provides clients with deep business process and industry expertise across 17 industries, using innovation to identify, create and deliver value faster. We draw on the full breadth of IBM capabilities, standing behind our advice to help clients implement solutions designed to deliver business outcomes with far-reaching impact and sustainable results.

References

- ¹ "Expanding the Innovation Horizon: The Global CEO Study 2006." IBM Global Business Services. March 2006. <http://www.ibm.com/bcs/ceostudy>; In this study, IBM interviewed 765 CEOs, business executives and public sector leaders worldwide to understand the innovation challenges that companies are facing globally.
- ² Ibid.
- ³ Ibid.
- ⁴ Ibid.
- ⁵ Main works by Braudel, Perez and Toffler include: Braudel, Fernand, *Civilization and Capitalism, 15th-18th Century*, Berkeley: University of California Press, 1992; Perez, Carlota, *Technological Revolutions and Financial Capital: The Dynamics of Bubbles and Golden Ages*, Cheltenham, UK and Northampton, MA: E. Elgar Publishers, 2002; and Toffler, Alvin, *The Third Wave*, New York: Morrow Publishers, 1980.
- ⁶ For example, the development of the steam engine at the end of the 18th century soon led to new business opportunities in transportation and manufacturing, which, in turn, led to new ways of producing goods such as cotton. As new business models disrupted earlier ones, some businesses and the social structures surrounding them died while others emerged and replaced them. The U.S. Civil War is one example of the kind of painful adjustment that can accompany such economic change.
- ⁷ IBM Institute for Business Value analysis, using data from the Standard & Poors archives for 1957 and from the Standard & Poors Web site for 2007. The original 1957 list is available at http://www2.standardandpoors.com/spf/pdf/index/030207_86Survivors-Release.pdf
- ⁸ Christensen, Clayton M. *The Innovator's Dilemma: When New Technologies Cause Great Firms to Fail*. Boston, Massachusetts: Harvard Business School Press. 1997.
- ⁹ de Geus, Andre. *The Living Company*. Boston, Massachusetts: Harvard Business School Press. April 1997.
- ¹⁰ Helft, Miguel. "Fashion Fast Forward." *Business 2.0*. May 2002.
- ¹¹ de Asis Martinez-Jerez, F., V. G. Narayanan and Michele Jurgens. "Strategic Outsourcing at Bharti Airtel Ltd." Harvard Business School Publishing. July 12, 2006.
- ¹² "Francis Francis! Espresso Machines Offer Beauty and Superiority for Seamless Coffee Preparation." illycaffé press release, June 27, 2006. http://www.illy.com/usa/about_illy/press_room/press_releases/Francis_Francis_Espresso_Machines.htm
- ¹³ "The World's Most Innovative Companies." *BusinessWeek*. April 24, 2006. http://www.businessweek.com/magazine/content/06_17/b3981401.htm
- ¹⁴ The remaining 20 companies that we selected for our best practice cases analysis included Adsoncars, Bharti Airtel, Capital One, Chongqing Motorcycles, Cirque du Soleil, Coca-Cola, Eli Lilly, Flexcar, Gillette, GoldCorp, Infosys, illycaffé, ING Direct, Li & Fung, Netflix, the new Napster, POSCO Steel, Progressive Insurance, Zara and a major entertainment company.

- ¹⁵ "Expanding the Innovation Horizon: The Global CEO Study 2006." IBM Global Business Services. March 2006. <http://www.ibm.com/bcs/ceostudy>
- ¹⁶ "Story of Nokia." Nokia Web site, <http://www.nokia.com/A4303001>
- ¹⁷ For information on Capital One's micro-marketing strategies, see: Zack, Michael H., "Rethinking the Knowledge-Based Organization," *Sloan Management Review*, Vol. 44, No. 4, Summer 2003, pp. 67-71; For information on ING Direct's approach, see: "ING takes low-cost route to expansion," *The Banker*, September 3, 2003.
- ¹⁸ de Asis Martinez-Jerez, F., V. G. Narayanan and Michele Jurgens. "Strategic Outsourcing at Bharti Airtel Ltd." Harvard Business School Publishing. July 12, 2006.
- ¹⁹ "Francis Francis! Espresso Machines Offer Beauty and Superiority for Seamless Coffee Preparation." illycaffé press release, June 27, 2006. http://www.illy.com/usa/about_illy/press_room/press_releases/Francis_Francis_Espresso_Machines.htm
- ²⁰ "Achieving value through partnership." Eli Lilly and Company. <http://www.lilly.com/about/partnering/alliances/index.html>
- ²¹ "Expanding the Innovation Horizon: The Global CEO Study 2006." IBM Global Business Services. March 2006. <http://www.ibm.com/bcs/ceostudy>
- ²² Ernst, David and James Bamford. "Your Alliances Are Too Stable." *Harvard Business Review*. June 2005.



© Copyright IBM Corporation 2007

IBM Global Services
Route 100
Somers, NY 10589
U.S.A.

Produced in the United States of America
06-07
All Rights Reserved

IBM and the IBM logo are trademarks or registered trademarks of International Business Machines Corporation in the United States, other countries, or both.

Microsoft, Windows, Windows NT, and the Windows logo are trademarks of Microsoft Corporation in the United States, other countries, or both.

Other company, product and service names may be trademarks or service marks of others.

References in this publication to IBM products and services do not imply that IBM intends to make them available in all countries in which IBM operates.