Business Model Innovation

By Olivier Serrat

Who is your customer? What does the customer value? How do you deliver value to customers at an appropriate cost? Business models that focus on the who, what, and how to clarify managerial choices and their consequences underpin the operations of successful organizations.

Sri Kalika Devi

Almost 80 years ago, Joseph Schumpeter,[1] the prophet of innovation, distinguished five types: (i) a new good, (ii) a new method of production, (iii) a new market, (iv) a new source of supply of raw materials, and (v) (the carrying out of) a new organization of any industry (or market). Regrettably, the body of knowledge he engendered then lay dormant until the end of the 20th century, with precious few other insights.[2] In modern parlance, the five cases were reinterpreted as product, process, market, input, and organizational innovations; references to a sixth, innovation in services—a sector that did not exist in Joseph Schumpeter's time—began to show up in the mid-1990s.[3]

> *You may not be interested in strategy, but strategy is interested in you.*
>
> —Apocryphal

So far, so (relatively) still: right until the inception of the online era, pretty much everyone played by the same, slowly evolving rules. However, in the wake of the continuing internet

[1] Joseph Schumpeter (1883–1950), an Austro-American economist and political scientist, held that capitalism can only be understood as an evolutionary process of innovation, the unremitting nature of which wreaks creative destruction in waves favoring those who grasp discontinuities faster. He hypothesized that instability brought about by entrepreneurs, rather than equilibrium and optimization, is the norm of a healthy economy and the central reality for economic theory and practice. See Joseph Schumpeter. 1934. *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*. Oxford University Press. On the process of creative destruction, with which his name is interchangeably associated, he presciently remarked that "… the problem that is usually being visualized is how capitalism administers existing structures, whereas the relevant problem is how it creates and destroys them." See Joseph Schumpeter. 1942. *Capitalism, Socialism, and Democracy*. Harper and Brothers.

[2] Notwithstanding, Peter Drucker was, 50 years later, the first to champion innovation and entrepreneurship as a purposeful and systematic discipline. Helpfully, he identified seven sources of innovation: the first four lie within the enterprise; the others originate outside it. They are (i) the unexpected—the unexpected success, failure, or outside event; (ii) incongruities—discrepancies or dissonance between what is and what is assumed or "ought to be;" (iii) process needs; and (iv) changes in industry (or market) structure that catch everyone unawares; (v) demographics; (vi) changes in perception, mood, and meaning; and (vii) new knowledge, both scientific and nonscientific. See Peter Drucker. 1985. *Innovation and Entrepreneurship: Practice and Principles*. HarperCollins Publishers. Elsewhere, theoretical enhancements cast a barren light on professed levels of innovation intensity: (i) incremental—innovation as improvement, (ii) radical (next generation)—innovation as change, and (iii) systemic (breakthrough)—innovation as revolution.

[3] A familiar definition of innovation transpires from this: innovation is the successful exploitation of new ideas. Then again, if it is deemed a competence and not just a process, innovation is the ability to deliver new value to clients, audiences, and partners.

revolution—notwithstanding the dot.com fiascos of 1995–2000[4]—business model innovation is the rage.[5] (This kind of innovation is often more valuable and transformative than the other types: it reduces risks and, conversely, allows more risks to be taken. It has also, perforce, encouraged organizational innovation; for instance, internet-sped innovative processes and structures include peer-to-peer and open-source organization,[6] collaborative mechanisms that would have been inconceivable to our parents, let alone Joseph Schumpeter.) In the globalized economy, not forgetting that about 2.5 billion people live on less than $2 a day, the growing significance of business models is a logical reaction to excessive choices and associated competition from deregulation and technological change.[7] Undeniably, certainly for customers and organizations alike in high-income economies and increasingly elsewhere too, distinguishing between many products and services on a purely functional basis is not easy.[8] In 2005, drawing from a survey of more than 4,000 senior executives and two dozen interviews with corporate decision makers in 23 countries in Europe, the Asia and Pacific region, and the Americas, the Economist Intelligence Unit urged organizations to revisit their business models, regularly.[9]

> *The real voyage of discovery consists not in seeking new landscapes but in having new eyes.*
>
> —Marcel Proust

The Theory of the Business

The concept of value and the differentiation[10] it rests on are integral to business (and much else). For consumption or use, every organization strives to sell products and services that customers value.[11] To a customer, value added that satisfies tangible needs and intangible wants, and embodies concepts such as brand equity, is what he or she expects from a purchase. The notional value derived from a purchase will abstract what costs—both actual (monetary) and circumstantial (convenience, time, etc.)—a transaction entailed.[12]

> *If life—the craving for which is the very essence of our being—were possessed of any positive intrinsic value, there would be no such thing as boredom at all: mere existence would satisfy us in itself, and we should want for nothing.*
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> —Arthur Schopenhauer

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4 At the time, the concept of business models was just about synonymous with e-business—the use of information systems and technology to manage administration and financial systems, including human resources, as well as external processes such as marketing and sales, supply of goods and services, and customer relationships. (Successful e-business models introduced novelty, created efficiencies compared with existing ways of doing business, forged complementarities, and enabled the lock-in of customers.) Alas, web-based business models that promised wild profits did much to misrepresent the concept and undermine its intrinsic usefulness. Nevertheless, the experience concentrated attention on (possibly different) ways of doing business and, much as the notion of intellectual capital did from the mid-1990s, on nonfinancial value drivers in organizations.

5 Tellingly, *The Economist* launched in 2009 a new column titled Schumpeter to champion the role of innovation and entrepreneurship in modern business and management.

6 The features these working arrangements share are self-governance, adaptive network interaction, and openness to any person who has something to contribute.

7 The rise of new technology-based and low-cost rivals is challenging established players, reshaping industries (or markets), and redistributing profits. This said, exacerbated by economic stagnation in the West, the pressure to penetrate emerging economies and developing countries is driving business model innovation worldwide.

8 Of course, products and services matter: however, they are vulnerable to replication and therefore cannot offer durable competitive advantage.

9 *The Economist*. 2005. Business 2010: Embracing the Challenge of Change. Economist Intelligence Unit. In the private sector, 55% of the executives surveyed declared new business models would be a greater source of competitive advantage than new products and services by 2010. In the public sector, 54% of the executives who responded thought success in 2010 would hinge more on the ability to innovate with delivery channels than with services themselves. (Pursuant to the global financial crisis of 2007–2008, many public sector agencies are in any case cutting services as they struggle to cope with the aftermath of the recession.) In declining order of complexity and degree of change, options for alternative delivery channels include strategic partnerships, joint ventures, outsourcing, shared services, and lead authority models.

10 Differentiation, the result of efforts to make a product or service stand out as a provider of unique value to customers vis-à-vis competitors, is the wellspring of competitive advantage. Nonperformers focus on obstacles; performers focus on results: the sharper the differentiation, the bigger the advantage. Chris Zook and James Allen mapped three major clusters, all of which wear with age, that high-performance organizations relentlessly build day in day out, usually maximizing customer feedback in virtuous cycles; they are management systems, operating capabilities, and proprietary assets. Chris Zook and James Allen. 2011. The Great Repeatable Business Model. *Harvard Business Review*. November. pp. 107–114.

11 Value is created by solving a problem, upgrading performance, or reducing risk and cost.

12 In short, Value = Benefits − Costs.

It follows that the notion of value should dominate any discussion of business models; sorry to say, this is not always the case. What is more, as befits a rapidly evolving field, there is no generally accepted definition of what a business model is: literature offers generic, broad, or narrow typologies that singly or jointly provide incomplete and confusing pictures of the perspectives, dimensions, and core issues of the business model concept depending on the lens used. This ought to matter: after all, if having a good business model is an important goal for organizations, they need a simple, logical, measurable, comprehensive, operational, and meaningful definition to plan, monitor, and evaluate deliverables. (However, most organizations can find it difficult to describe their business model in 25 words or less, let alone explain how it is used to reach decisions.) A business model is not an explanation of how a company hopes to make money; it is not strategy either.[13] A business model is the core design,[14] the logic, that enables an organization to capture, create, and deliver value to meet explicit or latent needs (and in so doing, of course, derive some form of profit itself).[15] (Most likely, the handiest metaphor would embody characteristics of an organization's way of thinking, operational system, and capacity to generate value.) The best customer value proposition is the viable set of means and ends—at their simplest, resources and processes driven by a formula—that does just that.[16] A proposition that is clear, focused, and consistent—no mean feat—is astonishingly powerful: business model innovation in one or more areas of the customer value proposition can forge a stronger theory of the business to enhance, at least for a while,[17] an archetypal large organization's business structure, organization, supply chain, products and services, customer service, customer experience, and administration.

> *Price is what you pay. Value is what you get.*
> —Warren Buffett

> *Markets are designed to allow individuals to look after their private needs and to pursue profit. It's really a great invention and I wouldn't underestimate the value of that, but they're not designed to take care of social needs.*
> —George Soros

> *We don't ask consumers what they want. They don't know. Instead, we apply our brain power to what they need, and will want, and make sure we're there, ready.*
> —Akio Morita

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13 A strategy is a long-term plan of action designed to achieve a particular goal. With respect to business models, it would be the contingent plan to create a unique and valuable position involving a distinctive set of activities, of which business processes and organizational design would be ingredients. (While every organization has some form of business model, not every organization has a strategy.)

14 Design thinking is a compelling process for exploring new ideas: a good business model will be concise yet complete in every important respect. (Each element or building block will have been carefully thought through and individually crafted, yet with an eye to the sum of synergizing parts.)

15 More philosophically—but not less pertinently—business models have been described as stories that explain how organizations work, in short, the theory of the business. See Peter Drucker. 1994. The Theory of the Business. *Harvard Business Review*. September–October. pp. 95–104. Paraphrasing, a theory of the business has three parts: (i) assumptions about the environment of the organization—society and its structure, the market, the customer, and technology; (ii) assumptions about the specific mission of the organization; and (iii) assumptions about the core competencies needed to accomplish the organization's mission. The specifications for a valid theory of the business are that (i) the assumptions about environment, mission, and core competencies must fit reality; (ii) the assumptions in all three areas have to fit one another; (iii) the theory of the business must be known and understood throughout the organization; and (iv) the theory of the business has to be tested constantly.

16 Even if it is only implicit, all organizations operate by way of a business model. (The days of those that do not are now short.) For example, government agencies may depend on fees, service revenues, or taxes but they are still held accountable for meeting public needs. Nongovernment organizations may not provide a financial return to investors or owners but they must still deliver value if they are to attract donations, grants, or membership dues. Social enterprises may be mission-driven but must still know how to scale their activities.

17 Inevitably, every theory of the business—even the soundest—will become obsolete then invalid because the environment of organizations changes constantly. Paraphrasing Peter Drucker further, preventive care, early diagnosis, and cure can help keep to a tolerable level the pain of bringing an organization's behavior in line with the new realities of its environment, with a new definition of its mission, and with new core competencies to be acquired or developed.

Table 1: 37 Possible Innovation Targets

Business Structure	Organization	Supply Chain	Products and Services	Customer Service	Customer Experience	Administration
Capital Formation	Structure Type	Manufacturing	Product Offering	Communication	Brand and Image	Information Stocks and Flows
Alliances	Decision-Making Process	Communication	Product Availability	Service Process	Advertising	Automation
	Process to Improve Processes	Distribution System	Technology (Evident)		Communication Process	Insourcing and Outsourcing of Services
	Facilities Infrastructure		Technology (Hidden)		Feedback	
	Facilities Effectiveness		Research and Development		Customer Relationship Management	
	Information Technology Infratructure		Manufacturing			
	Emplyee and Contractor Mix		Sales Model			
	Employee Experience		Distribution			
			User Interface			
			Packaging			
			Functionality			
			Lifestyle Model			
			Sustainability			
			After-Sales Service			

Source: Adapted from Langdon Morris. 2003. *Business Model Warfare: The Strategy of Business Breakthroughs*. InnovationLabs. Available: www.innovationlabs.com/busmodelwarfare.pdf

There's a Better Way to Do It—Find It!

It is difficult to get a man to understand something, when his salary depends upon his not understanding it!

—Upton Sinclair

Competitive advantage can only be achieved by delivering unique products and services for which customers are willing to pay a premium. To be able to perform at a higher level than others in the same industry (or market), organizations must make choices that optimize their business ecosystem. Joan Magretta thinks their choices must meet two critical tests: the narrative test (the story must make sense), and the numbers test (the profit and loss statement must add up).[18] Across the private and public sectors, there is no single business model as the next figure illustrates. (Organizations that deliver the same product or service can have quite different business models, their relative success hinging on how well they meet customer expectations.) While sundry approaches to fitting systems into a working whole exist, as a select list of currently prominent publications on key elements of a business model demontrates, most pay attention to five interrelated elements: (i) markets, (ii) products and services, (iii) processes, (iv)

You can't do today's job with yesterday's methods and be in business tomorrow.

—Anonymous

[18] Joan Magretta. 2002. Why Business Models Matter. *Harvard Business Review*. May. pp. 3–8.

people,[19] and (v) economics. Notwithstanding the respective strengths and weaknesses of approaches to the subject, the greatest benefits will be reaped when organizations prepare for a successful business model design project, research and analyze the elements needed for the effort, generate and test viable options and select the best, implement the prototype in the field, and continually adapt and modify the business model in response to industry (or market) reaction.

> *In the end, an organization is nothing more than the collective capacity of its people to create value.*
>
> —Lou Gerstner

Figure: Examples of Business Models

Source: Author.

> *If you don't do it excellently, don't do it at all. Because if it's not excellent it won't be profitable or fun, and if you're not in business for fun or profit, what the hell are you doing here?*
>
> —Robert Townsend

[19] Most approaches have strengths but most also fall short of a necessary and sufficient accent on people. Configurations of organizations vary—and will undoubtedly change further in the future—but it is generally accepted that an organization's personnel plays a vital role in its business: individually and collectively, what personnel contributes, looks to get in return, and wants to achieve conditions an organization's ability to capture, create, and deliver value. To engage personnel, the business model that an organization uses to describe, reflect on, and enrich its customer value proposition should therefore be used as the basis for communication and motivation.

Table 2: Key Elements of a Business Model

Chesbrough[a]	Hamel[b]	Johnson[c]	Mullins and Komisar[d]	Osterwalder and Pigneur[e]	Skarzynski and Gibson[f]
Value Proposition	Core Strategy	Customer Value Proposition	Revenue Model	Customer Segments	Who Do We Serve?
Market Segment	Strategic Resources	Profit Formulas	Gross Margin Model	Value Proposition	What Do We Provide?
Value Chain	Customer Interface	Key Resources	Operating Model	Channels	How Do We Provide It?
Cost Structure and Target Margins	Value Network	Key Process	Working Capital Model	Customer Relationships	How Do We Make Money?
Value Networks			Investment Model	Revenue Streams	How Do We Differentiate and Sustain an Advantage?
Competetive Strategy				Key Resources	
				Key Activities	
				Key Partnerships	
				Cost Structures	

[a] Henry Chesbrough. 2003. *Open Innovation: The New Imperative for Creating and Profiting from Technology*. Harvard Business School Press.
[b] Gary Hamel. 2002. *Leading the Revolution: How to Thrive in Turbulent Times by Making Innovation a Way of Life*. Harvard Business School Press.
[c] Mark Johnson. 2010. *Seizing the White Space: Business Model Innovation for Growth and Renewal*. Harvard Business School Press.
[d] John Mullins and Randy Komisar. 2009. *Getting to Plan B: Breaking Through to a Better Business Model*. Harvard Business School Press.
[e] Alexander Osterwalder and Yves Pigneur. 2010. *Business Model Generation: A Handbook for Visionaries, Game Changers, and Challengers*. Wiley.
[f] Peter Skarzynski and Rowan Gibson. 2008. *Innovation to the Core: A Blueprint for Transforming the Way Your Company Innovates*. Harvard Business School Press.

Source: Author.

To say the least, public sector organizations have their work cut out as well. In the words of Gus O'Donnell, "[they are] … too inclined to settle for the legacy structures and systems [they] inherit[ed] from the past, and not good enough at going through a design process that selects and tailors delivery systems that are capable of delivering the required outcome, drawing on a repertoire of approaches to structure, incentives, delivery, relationships, governance, and so on …"[20] (The context of Gus O'Donnell's remarks was the program of capability reviews that the Government of the United Kingdom launched in 2006 for all central government departments. To all but the hard of hearing, it rings a familiar bell elsewhere.) Apart from the kind of return—with financial profit making up the larger distinction—there are no reasons public sector organizations should reap smaller rewards from good business models compared to the private sector.[21] Public sector organizations

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[20] Andy Neely and Rick Delbridge. 2007. *Effective Business Models: What Do They Mean for Whitehall?* Sunningdale Institute. Available: www.nationalschool.gov.uk/downloads/effectivebusinessmodels.pdf
[21] To begin, however, they need to edify their understanding of what a business model constitutes: too often, public sector organizations consider business models merely in terms of resources, key result areas, and outputs.

deal with the allocation, production, and delivery of basic public goods and services at the local, national, regional, or global level. For sure, considerable complexity is added by the political context within which they operate, the heterogeneous nature of most of them, and the resulting slower rate of structural change. Therefore, the value of business models would lie particularly in terms of their ability to help these organizations articulate clearly what they will do and, by the same token, what they will not do. Among others, they can also gauge the coherence between an organization's strategic agenda and public needs, help match public needs to an organization's business processes, make obvious the financial implications of an organization's delivery chain, support diagnoses of the need for change and ways that might be achieved, and facilitate communication within an organization and both to and from it.

Further Reading

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For further information.

Contact Olivier Serrat, Head of the Knowledge Management Center, Regional and Sustainable Development Department, Asian Development Bank (oserrat@adb.org).

Knowledge Solutions

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Asian Development Bank
6 ADB Avenue, Mandaluyong City
1550 Metro Manila, Philippines
Tel +63 2 632 4444
Fax +63 2 636 2444
knowledge@adb.org
www.adb.org/knowledgesolutions