

OLIVER WYMAN

The Discipline of Business Model Innovation

An Introduction to Business Design



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The Challenge of Parallel Innovation

Managers of technology-driven businesses have traditionally had one major innovation cycle to worry about – the product innovation cycle. Several principles drive success: anticipate the next technology wave or new product opportunity, get to market first, achieve relative market share leadership in order to lower production costs, “cross the chasm” from early adopters to mainstream customers, and profit will follow. While this is much easier said than done, the rules of the game are relatively clear.

What has changed over the past 20 years, and has made management significantly more complex, is the emergence of a second, parallel innovation cycle—the business design innovation cycle. Many companies that formerly accepted their business design as a “given” now consider it to be a conscious choice and a competitive weapon. They are using creative business designs to enter new markets, attack incumbents, and renew their own leadership positions.

The management systems for business design innovation are not as mature as those for product innovation. Yet it is easier to trace large shifts in the market value of major technology companies by the business model decisions that they have made (both good and bad) than by unique product inventions.

Consider the following:

- IBM has been the technology and market share co-leader in enterprise computing (along with HP) for decades. Over the past 20 years, IBM’s stock market value has been a veritable roller coaster: up, down, and up again, with swings of \$100 BB in each direction. What happened? IBM’s decision to enter the PC space enthused investors (up) until they realized what a profit-less business design IBM had chosen to deploy in PC’s (down for IBM, up for Microsoft and Intel). Lou Gerstner turned around IBM (up again) by developing and scaling several new business designs -- global services, stand alone software, and technology component sales.
- IBM’s latest business design innovation—the \$2 billion bet behind the Linux open source operating system—may end up having the greatest market cap impact of all. In this case the company affected would be Microsoft, as IBM’s move was designed in part to counter Microsoft’s profit model and strategic control.

- Applied Materials can't always claim that its equipment offers best-in-class performance—that claim is often reserved for competitors who specialize in one step or another of the semiconductor manufacturing process. Applied Materials' value proposition to customers is driven by its business design breadth—its offerings cover so many process steps that it can seamless equipment functionality. That's a value proposition that fabs can't get by using a collection of specialists, and it has special relevance when the fab is trying to make chips with new geometries or material processes.
- Dell has created significant value in PC and adjacent markets without ever being a technology leader. Dell's business design is built around distinctive operational and customer value management processes, which it uses to distribute the technology of others. Dell's business design innovation eventually trumped Compaq's industry-leading PC engineering capabilities.
- It's hard to believe that Microsoft and Apple had roughly the same market capitalization as late as 1990. Apple had the better performing operating system, but its business design logic called for it to use its advantage to sell a few more Apples rather than working to create an OS standard. Microsoft used a very different business design with an operating system that it had licensed, not invented.. We all know the outcome.
- Sun Microsystems obstinately clung to an outdated business design long after it had ceased to be advantageous. Sun has now embarked on a radically different business design of subscription-based computing; the jury is out on whether management has acted too late.
- HP's success in printing is in part tribute to a successful business design. While supplies have always been a part of printer system economic models, IPG took the hardware & supplies model to a level of sophistication that hadn't been seen before. Even with a powerful business model, however, HP cannot respond complacently to past success. It is being attacked from several directions by new business designs. Dell is enjoying early success with its direct customer value management model. Various "Supplies Only" business designs aim to skim ink-related profits without selling hardware. Online and kiosk based photo development services are vying with home photo printing for consumer loyalty. Exploiting early stage commercial markets may require more of a solutions business design than that which HP is accustomed.

Elements of Business Design

The term “Business Model” leads many of us to latch onto the word “Model.” Thoughts turn to P&L spreadsheets, and to costs – “What if I could run my company at 4% R&D instead of 6%?” “What if I could go to market for half the cost that I do now?” These are critical questions to both ask and answer, but we view them as the final steps in a thought process that should start from a very different place than the spreadsheet.

We use the concept “Business Design” because it helps focus the user on the “Design” of his or her business first and foremost. Business Design is a set of structural business choices that together deliver high utility to the customer and high value to the shareholder. There are several key decisions that must be made when designing a business:

Customer selection (including channel): What are the greatest profit growth opportunities that fall within my planning horizon? Which customers are crucial to those opportunities? What high-value customer opportunity should be targeted?

Value Proposition and Customer Priorities: What are the unsatisfied needs that drive the behavior of targeted customers (what would lead them to switch suppliers or pay a premium)? Does my Business Design deliver differentiated benefits on these priorities? Does it hinder my ability to deliver these benefits? What customer benefits are generated by my business design (vs. my product)?

Profit Model: What profit model(s) does my Business Design utilize to capture value? How does high profit happen? Where will my “Profit Zones” be? How do I maximize share there?

Strategic Control: How do I protect the sustainability of out-year cash flows? Why should the investment community be convinced that my cash flows can be trusted in the out years?

Scope: What activities do I need to do vs. allow value chain partners to do? What assets should I own vs. letting value chain partners own? How can I restrict my activities and assets to the most efficient subset that is required to execute my business design well and retain strategic control?

Economic Model: What kind of pro forma economics does my business design produce? What economics does it have to produce to be successful? How do I distinguish the microeconomics of a new business design from its potential economics at full scale? How do I rapidly test, learn, and adjust for improved profitability of a new business design during its initial 12-24 months?

Organizational Systems: How will our functional organizations need to change to deliver a business design (R&D, operations, go to market, etc.)? How will our performance systems need to change (cultural values, leadership skill sets, human capital, metrics and rewards, etc.)? How will our enabling infrastructure need to change to enable the business design to go forward (balance sheet, planning/learning/control systems, information architecture, etc.)?

Key Characteristics of Business Design

Business Design starts with the customer's changing priorities. There is a reason for that. Forty years ago, the customer didn't matter to strategy. In the postwar business landscape of the 1950's and 1960's, customer demand outstripped capacity. It was a supplier's world; sellers were in the driver's seat.

Today, in contrast, the number of customer options is dwarfed only by the amount of information available about each option. There has been a secular shift in power from the supplier to the customer. Highly competitive markets and abundant information have placed the customer at the center of the business universe. In this new environment, successful businesses are those that employ customer-centric thinking to identify customer priorities and construct business designs to match them.

Business Design also focuses on how profit happens. In our research we have found over 40 different profit models at use in business today; where and how to take profits is a hotbed of business creativity. In many ways the proliferation of profit models is also a tribute to the new power of the customer—straightforward “big ticket purchase” profits are increasingly hard to come by. As a result, many business designs now capture the customer relationship at one point in the business design and capture profit at another point—preferably at a time when the customer isn't as price sensitive or is in a weaker negotiating position.

Finally, Business Design focuses on shareholder value. Its components encourage managers to think about the same underlying factors that investment analysts consider when valuing a stock. Customer Selection and Profit Model choices affect a company's ability to achieve growing cash flows. Scope choices affect asset intensity. Strategic control and aligned organizational systems lower the risk of a significant interruption in financial performance. It should not be surprising, then, that companies with a proven record of successfully adjusting their business designs over time—think GE under Jack Welch's leadership—achieve a management-related stock market premium compared to those without such a track record.

Business Design Life Cycle Management

We all know that products have life cycles. Business designs also have life cycles, from value growth to economic obsolescence, due to underlying factors that cause value to migrate from one business design to another. Just as product life cycles are compressing, so are the life cycles of business designs. Rather than life for decades at a time, many business designs now need re-invention every 5-10 years. A senior manager may now experience several reinvention challenges in his or her career.

The life cycle of business designs helps to explain the phenomenon of empty revenue. We've all been taught that relative market share was management Question #1. Achieve leading share positions and profitability will follow. That's no longer true in all cases. Market share has become Question #2. The first question is whether I have an economically valuable business design – if I do, then the laws of market share work for me. But if my business design is outdated, then high market share may well mean that I own a lot of profitless revenue.

Many companies (particularly those with strong product and technology focus) own a portfolio of several business designs but don't consciously recognize them or manage their life cycles. Such companies can be vulnerable to attack from competitors with innovative business designs, and can miss opportunities to create new value growth through new business designs.

Market leaders that integrate Business Design thinking into their management systems find it offers them a valuable source of strategic anticipation. Rather than wait for competitive attacks to occur, incumbent leaders can use business design to go on the attack and creatively exploit the advantages of their leading positions.

We encourage you to apply a business design mindset to your own business by thinking through the following simple but demanding questions:

- How many business designs does your business have? One or more than one?
- How does each business design work? What are the major elements of each?
- How effective is each business design at addressing customer priorities?

- Where is each business design in its life cycle? Value inflow, stability, or outflow?
- How well are your organizational performance systems aligned with your business designs?

With an eye on the parallel innovation cycle of business design, you'll be better positioned to deflect threats and exploit opportunities that come your way.❖

About Oliver Wyman

Oliver Wyman is building the leading global management consultancy, combining deep industry knowledge with specialized expertise in strategy, operations, risk management, organizational transformation, and leadership development. The firm works with clients across a range of industries to deliver sustained shareholder value growth. We help managers to anticipate changes in customer priorities and the competitive environment, and then design their businesses, improve their operations and risk profile, and accelerate their organizational performance to seize the most attractive opportunities.

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