

Stuck? Take a look at your business model

Renee Hopkins

Energy, healthcare and media executives could benefit by rethinking their industry business models, says Innosight chairman Mark Johnson.

Mark Johnson, Chairman and Co-Founder of Innosight, is author of *Seizing the White Space: Business Model Innovation for Growth and Renewal* (Harvard Business Press: February 2010). He talked with Strategy & Innovation editor Renee Hopkins about why business model innovation is important and how companies can master it.

In your book, you say "disruptive innovation and business model innovation are opposite sides of the same coin." How did you get started thinking this way, and why is it important?

We start with the work of disruptive innovation, which says that when you go into a new market that offers an opportunity for new growth, you should come in with a simpler, low-cost approach. This way you can offer products or services the incumbent's not going to be motivated to match, because it's either too small a market, the margins aren't interesting, or it doesn't further the company goals.

Now, why doesn't the incumbent go after the entrant who does something disruptive? Clay Christensen noticed this phenomenon in the disk drive industry—that those who succeeded were not the incumbents, but a new set of companies, the disruptors. That's also what happened with Digital Equipment (DEC), in the minicomputer world. Strangely, DEC didn't go after the personal computer when it came to the consumer market and schools. Why?

It's not that the incumbents couldn't have addressed these technological innovations within their own four walls. But they didn't have a business model that would allow them to take advantage of these technological innovations. Even if you don't define business model as I do in my book, DEC executives had a "theory of the case" of how they did business, how they added value for customers, and how they succeeded in business, which didn't account for the nature of the personal computer and how it was sold uniquely to consumers at first. Therefore they didn't allocate resources to that technology—so it was a resource allocation issue that could have been addressed by business model innovation.

Disruptive innovation and business model innovation are linked, are two sides of the same coin, because disruption isn't inherent in the technology, it's inherent in the business model. Years ago, when we at Innosight were working out the rationale for disruption, we hadn't yet taken it to the next level and explored in detail what a business model was, exactly. So when I had the opportunity to take on this topic with Dan Pantaleo, a VP in Global Communications at SAP (SAP), I jumped on it. What did we mean, when we spoke of disruption in a business model? What does it mean to change a business model? What are the reasons, the circumstances, that would require you to change a business model?

We did realize it's not always one-to-one. Not all disruptive innovations entail business model innovation and not all business model innovations are disruptive innovations. Sometimes companies embark on business model innovation independent of disruption in the classic sense. As I wrote in the book, a great example of that is FedEx (FDX) addressing unmet jobs by creating a whole new business system that one-upped UPS and the Postal Service. FedEx was not really disruptive to either UPS's or the Post Office's business models; in fact, FedEx's system should have been very attractive to either of those companies, since it would have allowed either of them to make more money and higher margins from their most-demanding customers. But it was such a fundamentally different business model from the ones they were

operating under, they couldn't change to grasp the opportunity to fulfill that unmet need, however high the margins may have been.

UPS and the Post Office couldn't change their business models or wouldn't change them?

Whether threatened by classic disruption or not, companies have a tough time changing their business models. In fact, really they don't change them significantly.

Companies that do manage to adopt whole new business models do it by creating whole new business units that have new business models.

They don't do it by taking an existing business unit and turning it on its head. So, Dow Corning didn't change Dow Corning's business model; it really needed to set up a separate unit, which they called Xiameter, where it could operate under a whole new business model.

Have any companies started a new business unit with a different business model that ended up filtering back into the company and changing the way it did business, too?

Xiameter is actually an excellent example of this: it is affecting the larger Dow Corning enterprise. Because if you see what's happening now, Xiameter is becoming a bigger and bigger part of the overall business proposition, and Dow Corning is putting more of its business through the Xiameter model over the Internet. It's not at 100 percent, but the company did announce recently that the Xiameter model would become a much bigger play for the entire business.

Xiameter has made Corning's entire business more resilient by allowing the core business to better set its prices. Xiameter sells at lower margins than Dow Corning's traditional core high-touch model does, but it has avoided a race to the bottom because Dow Corning knows if it's going to get into a low-cost game, it ought to send that business over to Xiameter where it can just use spot-market pricing, and not try to simply negotiate for the low price. That's redefined profitability at the low end and helped better define and focus Dow Corning's core business. (See 'When Should You Innovate Your Business Model?' for more on Xiameter.)

I think also that Hewlett-Packard (HPQ) has been greatly influenced by what its ink-jet printing division has done with the blades-and-razor model, selling cartridges at a higher margin than the printer. And Dayton-Hudson originally set up Target (TGT) as its discount arm, but now Target's all that's really left, if you want to look at it that way—or, they've morphed into just Target. This is, in fact, a business model that has extended to the industry at large, as evidenced by the fact that discount retailing is now 75 percent of the market cap for the entire retail industry. So now the dominant players are the discount retailers.

One of the points you make in your book, and I think you're saying again here, is that one reason business model innovation is so important is that it allows you to experiment with something that might work out, then filter it back in through your company if it looks like the world is changing in that direction.

Absolutely. It allows you to focus on where the world is going and what you need to do to address a specific customer job, unencumbered by your company's existing systems and structure. The process I outline for systematically engaging in business model innovation requires you to start with and stay focused on where the customer is going, where your opportunity is, and then build the right business system to support that.

Then by comparing how different the new business model is from your current one (particularly in terms of margins, overhead, and success metrics), you can get a clear picture of what you'd need to do to grasp the new opportunity. Would it be easy because it dovetails

well with your current model, or would it require you to marshal different resources and processes? Knowing that, if the world really is going that way, then you can be flexible and respond effectively because you've already experimented with and built a business model that will take advantage of that shift.

A great example, though it hasn't completely played out, is Amazon (AMZN).

Jeff Bezos has been relentless in pursuing customer opportunities beyond his current business model. He even says, "I really look where the customer is going and where I need to deliver value for that customer, and I don't care about legacy. I will do what it takes." And you can see his sequential business model innovations, initiated even before the previous business model is fully fleshed out, when he moved from online book retailing to more general retailing, to brokering other vendors' offerings, to even more radically leveraging Amazon's computing expertise to become a cloud-computing vendor of IT services, and then on again, with the Kindle e-reader, to become a hardware manufacturer. Bezos has been criticized by Wall Street for doing what he's doing, and he still did it.

I guess you could say that Apple has done the same thing, shifted its entire focus away from computers, more toward devices and systems like the app store, iPods, and iTunes.

And Apple's (AAPL) even moved off iPods now to the iPhone as a new platform, and of course just announced its new tablet, the iPad. Beginning with the iPhone, applications for small devices have become incredibly important in Apple's business model, independent of the computer. Basically, Apple has taken a giant step past Dell (DELL) in democratizing computing—a further step in the progression from the giant, expensive mainframes, through minis, but beyond the PC—by taking advantage of the shift to smaller computing devices, which is what the iPhone really is. That's pretty cool, because if anybody says, "The iPod isn't going to last because you can get your songs anywhere and we'll be platform-agnostic," Apple can say, "Fine, we're with you."

It's fascinating, that play. Even here at Innosight people said Apple was running into the sustaining space of Nokia (NOK) and other phone companies that would have reason to go after it with a vengeance. But I think what we didn't realize is that Apple was developing so innovative a new business model, integrating the hardware with a crowdsourcing model for the apps in so tight a way, that it was something materially different not just from a phone, but from how the phone manufacturers make their money.

And that's really the point. It's far harder for an incumbent to fight back against a business model innovation than it is for them to match and raise the stakes on a technology innovation.

Do some industries need business model innovation more than others?

Yes—media, no question about it. The newspaper industry has to address the fact that it's been disrupted by Internet technology and the new business models that the Internet has enabled. The newspaper industry has to be open to continuing to devise ways not just to put content online but to develop new business models.

The Internet has just enabled so much. In fact the buzzword "business model" really came with the whole Internet era of the late 1990s and early 2000s. So, yes, media in the broadest sense, whether you're talking about newspapers, journalism, networks, cable, you name it. That's a pretty broad swath.

Of course healthcare needs business model innovation as a way to truly take out costs and create greater value. That's going to be hard for a while—healthcare reform is focused on other priorities, but it doesn't change the fact that business model innovation is needed there.

Nor should healthcare providers sit back and wait for Congress to finish debating the question of coverage (which is really just focusing on one means of increasing access to current models of health care). While some providers do that, others more farseeing will be forging ahead to capitalize on this huge and manifold set of jobs many, many customers need done.

And defense absolutely needs business model innovation, because we're fighting a different kind of war, and in order to fight that war, the organization that's behind the fighting of that war has got to change fundamentally. I think Secretary Gates gets it intuitively, but a lot has to change to enable that to happen.

And finally, energy. Again, that's a term that covers a very large swath of industries—automotive, utilities, oil and gas. As we think about electric vehicles, hydrogen fuel cells, electric grid technologies, and smart grids—renewable energy in general and the integration of different types of renewable energy into a coherent system—that's naturally going to require a different business model than the one that's powering our cars and light bulbs today.

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