[STRATEGY]

The Business Models Investors Prefer

New research suggests that the stock market particularly values business models based on innovation and intellectual property.

BY PETER WEILL, THOMAS W. MALONE AND THOMAS G. APEL

Why are investors so bullish on companies like Apple and Disney? Is it financial metrics, great management, industry prowess, good investor relations or good timing? Probably all of these. But something else may be at work, too. In research we conducted at the MIT Sloan School of Management, we found that the stock market consistently values certain types of business models more highly than others. Specifically, we found that in recent years, investors have favored business models focusing on licensing intellectual property (such as Walt Disney's business model) and a certain kind of highly innovative manufacturing (such as Apple's).

We developed a framework that includes 14 types of business models. (Surprisingly, we found there is no universally accepted definition of the important concept of a business model.) Then, using data from Compustat, we classified all the more than 10,000 companies that are publicly traded on U.S. exchanges within the framework by identifying the percentage of each company's revenue generated through each of the 14 business models; we used a combination of manual classification and a custom-developed rule-based software program. By classifying companies' revenue into these 14 business models, a new picture emerged of not only individual companies, but businesses more generally. The individual classifications were then aggregated to construct an index for each business model. Those indices then allowed us to compare total stock market returns — as measured by changes in stock price plus dividends — for different business models in the U.S. markets over a 12-year period, from 1997 through 2009. The results provide insight into investor treatment of various business models. In particular, the findings underscore the importance of innovation and intellectual property in the U.S. economy.

Our business model framework is based on defining the types of assets a company sells and the rights it grants customers to use those assets. We define four asset types and four ways companies manage asset rights to generate revenue. The four asset types are:

Financial assets, which include cash as well as securities like stocks, bonds and insurance policies that give their owners rights to potential future cash flows;

Physical assets, which include durable items such as computers, as well as nondurable items such as food;

Intangible assets, which include intellectual property such as patents and copyrights, as well as other intangible assets like knowledge, goodwill and brand value;

Human assets, which include people's time and effort. People of course cannot be legally bought and sold, but their time and knowledge can be "rented out" for a fee.

The four ways companies manage assets rights to generate revenue are as:

Creators, which sell ownership of products they have created by transforming or assembling raw materials or components. Ford, 3M and Intel are examples of this type of company;

Distributors such as Wal-Mart or Amazon.corn's retail business, which sell ownership of products they bought but did not substantially change, except by transporting, repackaging or marketing;

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THE BUSINESS MODEL FRAMEWORK

Our business model framework defines the types of assets a company sells and the rights it grants customers to use those assets. We classified all of the companies listed on U.S. exchanges into the framework by identifying the percentage of their revenues generated through one or more of the business models.

Asset Rights	Asset Type: Financial	Physical	Intangible	Human	Share of Total Revenue of U.S.-Listed Firms
Creator	0%	Manufacturer 57%	0%	N/A*	57%
Distributor	Financial Trader <1%	Wholesale/ Retail 14%	~0%	N/A*	14%
Landlord	Financial Landlord 8%	Physical Landlord 10%	IP Landlord 2%	Contractor 8%	28%
Broker	Financial Broker <1%	Physical Broker <1%	0%	~0%	1%
Share of Total Revenue of U.S.-Listed Firms	9%	81%	2%	8%	100%

* not a legal business model

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Landlords, which sell only the right to use assets for a specified period of time; Marriott, Hertz, Accenture and Citigroup are examples of the landlord model. We included in this category companies that employ licenses or subscriptions to sell limited rights to use their intellectual property (IP) assets — companies such as Microsoft and The New York Times;

Brokers, which receive a fee for matching buyers and sellers without ever taking ownership or custody of the product; examples include Charles Schwab, eBay and realtors.

One of the advantages of this framework is that we can compare companies that have similar business models and thus require similar capabilities but operate in different industries. For example, a physical landlord can sell the use of a broad range of assets including hotel rooms, plane seats, software, information or rental cars. We can also assess what business models investors prefer at different times and how a company's business model has changed over time. For example, Disney has dramatically shifted its business model over the last 20 years from renting physical assets like theme parks (65% of revenue in 1984 but only 30% in 2009) to licensing intellectual property (15% of revenue in 1984 but 63% in 2009), with clear investor buy-in for this strategic shift. Disney stock outperformed the S&P 500 stock index over the last five years and beat that index by more than 20% in the two-year period ending December 31,2010.

RELATED RESEARCH

▶T.W. Malone, P. Weill, R.K. Lai, V.T. D'Urso, G. Herman, T.G. Apel and S.L. Woerner, "Do Some Business Models Perform Better than Others?" working paper 4615-06, MIT Sloan School of Management, Cambridge, Massachusetts, May 18, 2006, http://seeit.mit.edu.

Business models provide a cross-industry lens for analyzing how a company is managed and the resulting stock market total return. The differences in the stock market total return of companies deriving revenue from different business models are striking — with returns for different types of business models ranging from about 145% to 240% over the 12 years we studied. An interesting picture emerges:

- Eighty-one percent of total revenue from companies listed on U.S. exchanges comes from physical assets. Manufacturing — creating physical assets — generated about 57% of all company revenues. Manufacturers are generally highly valued by investors, with manufacturers who innovate even more highly valued.
- Twenty-eight percent of all company revenues derives from landlord type transactions but with major differences in total stock market returns. Financial and physical landlords were the poorest performing of the common business models, while IP landlords were the second-highest performing. Contractors — a model that includes consulting firms and other businesses that primarily "rent out" human assets — had performance in the middle of the pack.

Innovative manufacturers — which we define as those who invest more than their industry average in research and development — are the top performers in the market. Apple is an example of an innovative manufacturer. Apple's business model in 2008 was 86% manufacturer, 7% contractor and 7% IP landlord, and the results — products like the iPhone, iPhone apps, iPad, MacBook Air, iTunes — have paid big dividends. This is a powerful combination from an investor perspective.

Returning to Disney, we see that the company's shift in business models over time has played directly into the sentiment of investors. Disney has reduced revenues from one of the least valued business models, physical landlord, while increasing its reliance on one of the most valued business models, IP landlord. And Disney has also retained innovative manufacturing, the more highly valued part of the manufacturing business model.

MARKET PERFORMANCE OF THE MOST COMMON BUSINESS MODELS

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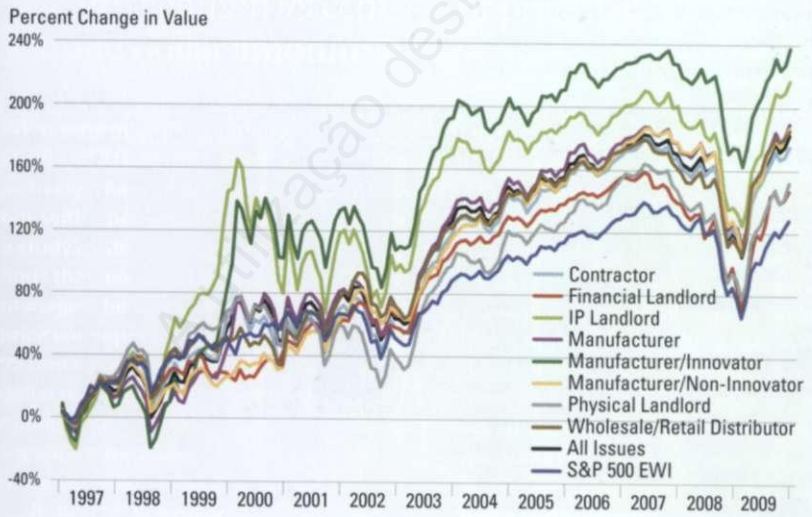

Note: The S&P 500 EWI is the equal weighted index for regular stocks including dividends. The MIT Business Models indices outperform the S&P 500 EWI mostly due to a larger concentration of small-cap companies.

Key Questions for Company Leaders to Answer

Of course, the business models that investors value most today may not be the ones they will favor 10 years from now. But the concept of business model provides a fundamental tool for analyzing many

important strategic decisions. For example, companies can use our framework to help decide when to dispose of one business unit, when to invest in another one and where to look for potential acquisitions. In making these decisions, the framework helps you analyze your business, not just in the context of your own industry, but also in the context of companies in very different industries that have similar business models.

We suggest that leaders should consider the following key questions:

- What are our business models today, and how have they changed over the last 10 years?
- How do our business models compare with those of our traditional and nontraditional competitors?
- How can we adjust our overall business model to include more revenue from the models that are most highly valued today (such as IP landlord and innovative manufacturer) or that we believe will be most highly valued in the future?
- To make any change in our business model, what competencies do we need to further develop, and what strategic experiments can we do today to test new business models for tomorrow?

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