Part 1

The business model

In this section, we explore how the business model came to dominate popular and scholarly conversations about management, especially entrepreneurship. We carefully consider what business models *are* and *are not.* Finally, we explore what we know for sure about business models and how you can use that to build and grow viable organisations. This overview will pave the way for a richer and more practical approach to designing, building and adapting business models for real organisations.

1 Real business models

'I don't have a business model.'

Sal Khan, founder of Khan Academy, which has delivered billions of free education lessons to students around the world

Until the dot-com boom of the late 1990s, no one needed to explain a business model to run a successful organisation. Today, scholars, managers and consultants insist that the business model is the holy grail of organisational survival, scale and profitability.

Have no doubt, the 'business model' can be an important, effective tool in the manager's toolkit. Organisational leaders should know the basic elements of a business model and how those elements work together. A business model provides valuable insight into every organisation, regardless of industry, field, geography or size. Business models are relevant to for-profit and not-for-profit firms alike. Business models can be applied to academic institutions and governments. If there is *organisation,* there is a *business model.*

Why business models work

No one knows.

The simple, unvarnished truth is that the *science* of business models provides no real explanations for how or why some business models work and some fail. We do not have solid research evidence for how entrepreneurs create new business models or a foolproof method for evaluating a business model on paper. A significant amount of rigorous business model research relies on business model definitions that are quite different from how managers think about business models. Even solid scientific findings may not be relevant to entrepreneurs.

The business model is not like most other management concepts. For example, corporate strategy describes how your firm competes against others. As with most management concepts, strategy can be benchmarked against other organisations. If you can make the same product at a lower cost, you may be able to outperform other organisations. That would be a good strategy; implemented effectively, it leads to profits and growth.

A good business model may have no comparison to existing businesses; it might not even be in an existing industry or market!

New business model example: Priceline

What is Priceline? The company has now broadly extended its services, but it is useful to look at the organisation's business model at the very beginning (online in 1998). To the end consumer, it looked like a travel company, but it provided no actual travel services. To the travel industry, it looked like a marketing channel, but there was no formal partnership – Priceline actively hid the names of the travel providers. The business model was brilliant – use the internet to create real-time, blind auctions of extra travel industry capacity such as empty hotel rooms and airline seats. Technically, Priceline was an online auctioneer; at the time, there was no market for 'unbranded' travel.

The business model challenge is deceptively simple. Great business models work because the elements are aligned in support of the value creation process. But even that alignment may not be obvious. Consider Southwest Airlines, the precursor to low-cost air carriers around the world. Nearly everything about Southwest's business model was designed to minimise costs. Southwest flew only one type of plane to optimise maintenance. It flew out of smaller regional airports to minimise gate fees. It kept pricing simple to minimise selling costs. Yet it paid higher than average wages and spent more than other airlines on training and incentive packages. Why? Because in the airline industry small employee errors generate high costs. A late departure could impact multiple routes; if passengers or luggage miss a connection, the airline incurs high costs in customer service. If the firm's profit margin is 10 per cent, then $100 in costs incurred resolving a customer service problem requires $1,000 in additional revenue to make up the loss. Southwest's low-cost business model required a relatively high-cost human resource element. The business model was very effective: for two decades Southwest was consistently more profitable than the rest of the US airline industry. In some years, it was more profitable than the rest of the industry combined.

But Southwest is not the only low-cost carrier model. Ryanair has been extremely successful in Europe with much lower investments in human resources. It uses a dramatically different pricing structure to ensure that planes are full, the single most critical operating rule for airlines. Southwest generally is seen as a great company to work for with great customer service; Ryanair is called out regularly for poor service and has been repeatedly fined by various government authorities for customer service problems. Both 'low-cost carriers' are profitable and growing. In other words, business models are complicated.

Business model do's and don'ts

Do use business model analysis to think about how organisations are designed to create value.

Don't be fooled by the apparent simplicity of high-level descriptions of business models of large organisations. The larger the organisation and the more complex its product/service mix, the more likely that there are multiple business models in play. Large companies that appear to use the same 'business models' may have dramatically different elements working under the surface.

Creating and capturing value

Before we go any further, we need to agree, at least temporarily, on what a business model is. In Chapter 2 we will discuss the history and research on business models, but we need a placeholder to help frame the discussion.

Business models have nearly always been discussed and described in the context of two key organisational concepts. The first is *value creation*. Business models have something to do with how (and why) organisations create value. The second concept is *design*. Business models have something to do with how organisations function, specifically in terms of the structures and relationships that govern behaviours and activities.

In other words, a business model is the organisational design used to exploit an opportunity and create value.

Every organisation exists for a single purpose: to create more value than an individual could do alone. That value could be profit, education, economic growth, social justice, entertainment or any number of other possible outcomes. An organisation uses various forms of capital (human, financial, physical, etc.) to create and capture that value.

Sal Khan originally wanted to provide mathematics instruction, from a distance, to his nephew. He recorded relatively simple videos demonstrating mathematical concepts with a voiceover. Then he made those videos available to his nephew, and anyone else, via the internet. Khan Academy scales that value creation to millions of people globally.

Worksheet 1.1

GETTING A GRIP ON VALUE

Whether you are a business model novice or pro, you need to come to grips with the hard reality of value creation and capture. Go to the 'Worksheets' section of the website for the book. Open or download Worksheet 1.1: Getting a grip on value. Completing the activity should take less than 5 minutes, but you will come back to it throughout the book. All you need to do is clearly and simply explain how your organisation creates and captures value. There is also an example for you to try your hand before the serious business of evaluating your own organisation.

In the specific case of for-profit companies, value created must be *captured* in a familiar form: money. Technically, every good business model captures value. For example, effective non-governmental organisations (NGOs) create change, usually to accomplish a social purpose or agenda. The NGO may use outcome data to fundraise or recruit but, in most cases, the outcome itself does not fuel the organisation's operations. At for-profit companies, the business model should explicitly link value creation and capture, because the financial outputs of the organisation are also an input. The profits fund development and growth and reward the owners.

Business model impact: Khan Academy

Khan Academy has become one of the most influential and controversial educational innovations of the twenty-first century. Teachers and scholars disagree about the effectiveness of independent, distance-based learning without schedules or grades. The raw usage statistics, however, are difficult to ignore. In 2015, the Khan Academy website was visited by more than 15 million unique visitors each month. It offers more than 100,000 different videos and lessons on subjects, ranging from basic addition to quantum mechanics and art history. Those lessons, developed in English, are now available in dozens of other languages. Every lesson and every course is free. Sal Khan may not have had a business model. Khan Academy, however, has leveraged one man's vision for education into a global phenomenon.

Test in the real world

The hard truth is that there is no single, surefire test of a business model other than to try it out in the real world.

The good news is that many business models can be pilot tested. Later in the book we will look at how to transition from a business model design to a real-world test. Unless very large economies of scale or network effects are inherent to value creation or capture, small-scale tests are generally effective for identifying business model bottlenecks and inefficiencies.

The bad news is that business models can be copied. Business models cannot be protected with patents, trademark or copyright. By their nature, business models cannot be hidden as a trade secret. An organisation's business model is, fundamentally, what it does to create value. Customers, suppliers, partners and even competitors are going to have access to some or all of the details. A good business model for one opportunity or organisation may fail for another in the real world. Uber's ride-sharing business model has now been adapted globally by firms such as Grab (Singapore), Hailo (London), Lyft (USA), Ola (India) and Didi (China). But not all of them are identical or successful. Even Uber, which works elsewhere, was not particularly successful in China and had to exit the market.

Business model hazard: replicating FoodUSA.com

Consider FoodUSA.com. Like Priceline and many other dot-com companies, FoodUSA attempted to use the internet to disintermediate a market. In this case, it was the market for meat. Slaughterhouses and processors could post information anonymously about available product on FoodUSA's electronic marketplace and buyers could bid for what they needed. The highly consolidated food industry kept profits relatively low at the slaughterhouses; FoodUSA was designed to shift the balance of power towards the slaughterhouses and the farmers and still take a commission on every sale.

We will never really know if the business model was long-term viable or not. Despite raising millions of dollars of venture capital and facilitating more than $35 million in transactions, FoodUSA was out of business in less than three years. Why? The business model was copied – by a consortium of the food industry companies that purchased meat from the slaughterhouses. Commerce Ventures, LLC was set up specifically to compete with FoodUSA. It was 55 per cent owned by Tyson Foods and 27 per cent by Cargill, two of the world's largest food companies, along with three other meat producing and processing firms. Even though Commerce Ventures never launched operations at scale, the slaughterhouses stopped posting product with FoodUSA. Cash flow stopped, venture capital dried up and FoodUSA was gone. Commerce Ventures did not outcompete FoodUSA, but its presence made the FoodUSA business model too fragile.

A great business model in one industry may not work in another. On the other hand, a dead business model may be resurrected when circumstances change. Industry context, market conditions, and even time, make a difference. For example, there have been several iterations of business models for music sharing online. Napster is gone, but Spotify, iTunes®, SoundCloud and even YouTube have succeeded in different ways, serving different markets, needs and customer segments.

It may be true that no two business models are *exactly* alike. Changes in technological infrastructure can radically rewrite the rules about what business models are viable or even possible. Most underlying business model elements, however, are familiar to most business people. If you have seen 100 business models, the 101st is likely to show some similarities or element patterns to the ones you have already seen. This is why venture capitalists want entrepreneurs to explain a new venture's business model in clear terms, often with visual diagrams. Similarly, start-ups may copy tried and tested models in new markets with adaptations.

In the gaming industry, an ecosystem of businesses supports many similar firms with slight (but important) variations. Major players, such as Sony, Microsoft and Nintendo, develop and publish software to complement their own hardware platforms. But there is also a large ecosystem of players and businesses supporting these players. Supercell, the Finnish mobile game publisher, has major products such as Clash Royale and Clash of Clans, played by 100 million gamers every day. Tencent, a Chinese internet and payments conglomerate, acquired Supercell in 2016 to consolidate their gaming credentials as a global player. If you go further east, you find a variety of platform providers for gamers, such as Garena in Singapore, which targets the Southeast Asian market. Mixi (Japan) started with a mobile game called Monster Strike, but became so popular that it expanded into a social networking site. Gaming is so popular in South Korea that professional gaming is termed officially as e-sport supplied by growing, profitable companies like Netmarble or Gravity. Smaller, niche markets, such as Vietnam, also have reasonably sized gaming companies, such as VNG. Just in this one sector we observe a plurality of business models and businesses that target specific geographic markets and have marginally differentiated capabilities that allow them to flourish. A business model does not have to be unique, but it does have to be differentiated by your firm's resources, transactions and value creation for you to survive and grow.

Video resource

Geoff Yang, founding partner of California's Redpoint Ventures, explains that nearly every business model has been tried somewhere.

The activities and frameworks in this book cannot substitute for real-world testing. They do, however, provide valuable tools for preparing for that real-world testing. They should also provide a troubleshooting guide to fix damaged or broken business models.

Worksheet 1.2

WHAT'S WRONG WITH MY BUSINESS MODEL?

Before you move on to the next chapter and learn about the history of business models, take a look at Worksheet 1.2. Think about what might not be working in your organisation's business model. You might start by thinking about business models of other organisations that you believe do not work well either. The activity should take you only a couple of minutes and will help prepare you for the more detailed business model building activities in the rest of the book.

What makes a great business model?

A great business model is the foundation of a viable organisation. A great business model:

- meets a customer need;
- builds value for the firm and the firm's partners;
- leverages and extends valuable capabilities or resources;
- is efficient;
- differentiates the firm; and
- is sustainable beyond the near-term.

Let us briefly discuss each of these.

Every viable and sustainable organisation serves a core purpose: meeting a need. A great business model might solve a market need and generate revenues and profits; it might address a societal need and generate donations and positive social outcomes. In rare cases, it might create an entirely new need. Regardless, every viable business model meets a need that is not being fully addressed. A business model that does not meet a need simply is not viable.

Meeting a need is necessary but not sufficient. A great business model builds value for the firm and the firm's partners. Business models that do not build value for the organisation are still not viable. Business models that build value for the organisation are viable, but may not be sustainable. Some business models simply transfer value from one organisation to another or across parts of the supply chain. If there is no value creation, then the organisation is likely splitting up value amongst more parties. Great business models are sustainable. They create value for both the organisation and its business partners. That generates a synergistic relationship that benefits all the parties.

At the same time, a business model should leverage and extend the organisation's valuable capabilities and resources. In other words, the business model does not deplete a finite set of resources, like raw materials. Instead, it ensures that the longer the organisation operates, the more effective and valuable it becomes to customers and partners. The most valuable resources are the ones that can be improved, not the ones that get used up. For example, the capability to design high-quality cars is more valuable than the steel that is used in the manufacturing process. The steel is used and replaced, but a top-notch designer becomes more experienced and sophisticated over time.

A great business model is efficient. In the long run, a wasteful business model is vulnerable to industry changes and business model innovation.

Great business models clearly differentiate the organisation from competitors and industry participants. It is common to find numerous organisations in one industry using the same business model. Sometimes, this has been referred to as a sort of organisational dominant design or a special case of contingency theory. The general idea is that organisations tend to migrate to a proven way of doing business and any deviation from that template tends to reduce profitability. The fact is, however, that some of the most effective business models have deviated from industry standard. Consider Alibaba in e-commerce, Southwest in airlines, Apple in computers, Tesla in automotive and Tencent in payments, and so on. At the least, a strong business model ensures that the organisation does not merely replicate what every other firm is doing.

All of these add up to long-term sustainability. The real goal of a great business model is to provide the organisation with the potential to survive and thrive. The best organisations use that success to adapt or innovate the business model to stay ahead of the rest of the industry.

RECAP

- Business models are all about organisational design and value creation.
- An effective business model leverages organisation to scale value creation.
- Business model elements may be aligned in counter-intuitive ways.
- Business models are usually more complicated than they look.
- A good business model in one industry may not work in another.