

Changing Business Models: Surveying the Landscape

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When people speak about "business models," they could be speaking about three distinct things: components of business models, real operating business models, and what we call change models. A business model, strictly speaking, is the organization's core logic for creating value. A change model is the core logic for how a firm will change over time in order to remain profitable. The capacity to distinguish and communicate these models will improve your organization's focus, establish a framework for competing agilely, and position your company to thrive despite industry discontinuities.

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How do companies succeed? They choose an effective business model and execute it superbly. They relentlessly renew their distinctiveness as competitors threaten. And they master the ability to change their business model—again effectively—at a pace that matches the dynamism in their markets.

This isn't easy. Today, executives can't even articulate their business models. Everyone talks about business models but 99 percent have no clear framework for describing their model. They do know what business they're in—they just can't describe it clearly. And if they can't describe it clearly, they can't share it effectively throughout their organization. Furthermore, the familiar three-point strategic frameworks we've all learned at business school aren't comprehensive enough to describe the rich array of business model choices managers face. And the details matter. Small shifts in the business model can have a major impact on profitability.

This research note starts by defining what we mean by a business model. Then it lays out the business model landscape and the common ways models evolve. Finally, we discuss implications for management. Our goal is to provide operating managers with a better roadmap for leading change. Through our interviews with 70 company executives and analysts as well as extensive secondary research, we conclude that:

- **Developing a sound business model matters.** Effective companies know how to make money. And some strikingly new business models have shifted the art of the possible. Innovative firms are using the Internet to create interlocking value propositions for different customer sets. The result? First mover advantages and switching costs increase dramatically.
- **But business models wear out.** Competition catches up, markets shift, technology changes, and firms must alter their business models to remain viable.
- **Leading companies don't just adjust their business models incrementally, however, they master change models.** Heads-up managers know how business models evolve, they know where they are in the process, and they deliberately manage patterns of change.

What is a business model anyway?

Talking about new business models is all the rage. Under the "New Business Model" headline, we hear about e-commerce start-ups that sell through auctions, traditional firms that are

moving to "clicks 'n' mortar" channels, and high tech companies that are exploiting alliances to streamline their supply chains. Frankly, we're confused. It seems that the executives, reporters, and analysts who use the term "business model" don't have a clear idea of what it means. They sprinkle it into their rhetoric to describe everything from how a company earns revenue to how it structures its organization.

We'd like to help straighten out the confusion. If nothing else, we'll all be able to communicate better. And it's just possible that some clear definitions and frameworks will help us sort the interesting opportunities from the blind alleys.

When people say "business model," they're really talking about three different kinds of things: components of business models, real operating business models, and what we call change models.

Components of business models. These aren't really complete business models at all—they're just pieces. Business model components range from revenue models and value propositions to organizational structures and arrangements for trading relationships (see Exhibit 1). Each may be an important part of a business model, but not the whole thing. Since the Internet has dramatically impacted the way firms reach customers, price, and tailor the commerce experience, e-watchers have paid a great deal of attention to new value propositions, new channel configurations, and new revenue models. Many have mistakenly called these business models.

Operating business models. Operating business models are the real thing. **An operating business model is the organization's core logic for creating value.** The business model of a profit-oriented enterprise explains how it makes money. Since organizations compete for customers and resources, a good business model highlights the distinctive activities and approaches that enable the firm to succeed—to attract customers, employees, and investors, and to deliver products and services profitably. Only the business model components that are part of the essential logic are included, so one company's operating model may look dramatically different from another's. Throughout the rest of the paper, we use the term "business model" to mean operating business model.

Change models. A change model goes one step further. It describes how an organization adapts in a dynamic environ-

Exhibit 1: Components of a Business Model

They say "business model," but they mean:

They say "business model," but they mean:	For example:	As in:
Pricing model	<ul style="list-style-type: none"> ■ Cost plus ■ CPM (cost per thousand) 	"Free is almost a default business model on the Web." Fortune, March 1999.
Revenue model	<ul style="list-style-type: none"> ■ Advertising or broadcast model ■ Subscription or cable model ■ Fee-for-service 	"The solution for many established companies and startups [to their difficulty finding good business models], has been to apply traditional business models such as advertising, subscription services and retail sales to the Web..." Webmaster Magazine, October 1996.
Channel model	<ul style="list-style-type: none"> ■ Bricks 'n' mortar ■ Clicks 'n' mortar ■ Direct-to-customer 	"Disintermediation is already taking a hit on the business-to-consumer front, where new business models, such as cobranding and digital channel management — as opposed to channel cannibalization — are beginning to take hold." Computerworld, December 1999
Commerce process model	<ul style="list-style-type: none"> ■ Auction ■ Reverse auction ■ Community 	"Ancient history may perhaps be a good place to find a new business model. Traditional auctions have been held since the time of Babylon. Requirements? A community of interested buyers and sellers, agreed rules of conduct, a time and place. Auctions are a time-honored method of getting the best price for goods." PriceWaterhouseCoopers, August 1999.
Internet-enabled commerce relationship	<ul style="list-style-type: none"> ■ Market-maker ■ Aggregator ■ Virtual supply alliance ■ Value network 	"The real key to competing in the New Economy is in business model innovation. Based on the Internet, fundamentally new models of the firm and its interaction with external entities have emerged...." Business 2.0, November 1999.
Organizational form	<ul style="list-style-type: none"> ■ Stand-alone business unit ■ Integrated Internet capability 	"The eCommerce Steering Committee considered the following electronic commerce business models: skunkworks, standing steering committee, eCommerce executive VP, new business unit, spin off, and outsourcing." Big 5 Consultant, December 1999.
Value proposition	<ul style="list-style-type: none"> ■ Less value and very low cost ■ More value at the same cost ■ Much more value at greater cost 	"There are two basic business models. Companies either compete on price, or they compete on quality." Oil and Gas Industry Analyst, January, 2000.

ment. A change model is the core logic for how a firm will change over time to remain profitable in a dynamic environment. Operating business models create core assets, capabilities, relationships, and knowledge; change models extend and leverage them.

More about change models later. Let's illustrate an operating model by walking through two examples: SupplyGenie.com, an Internet business-to-business office products site, and "Global Tire and Rubber," a traditional consumer products manufacturer.

SupplyGenie.com

- SupplyGenie.com sells office products at dealer cost over the Internet.
- The great prices attract small and mid-sized firms accustomed to paying 25 to 40 percent markups.
- Good service—including wide selection, next day delivery, and phone center support—keeps customers coming back.
- This builds volume.
- High volume enables SupplyGenie to negotiate purchase discounts with wholesale suppliers,
- Which, along with a lean cost structure, gives SupplyGenie its profit,

- And attracts capital for growth.
- Growth and the promise of an IPO help the company attract top talent, which enables them to develop an appealing Web site and to sustain excellent customer service.

This operating business model is not only sound logic, it's "round" logic. The components of the model reinforce each other (see the schematic in Exhibit 2). Pull out or modify any one of the pieces and the structure would have to change substantially.

Furthermore, a firm with several divisions may have several operating business models. How can you tell? If the divisions could be spun off with no impact on their ability to compete or remain profitable, their operating business models are independent.

Global Tire and Rubber

Let's go through another, more traditional example (see Exhibit 3). Around 1990, the operating business model for a firm we'll call "Global Tire and Rubber" had three major value propositions. They attracted quality-focused consumers with premium, branded replacement tires. The company reached these customers through high-service independent and company-owned dealerships and through aggressive advertising of their quality

Exhibit 2: SupplyGenie.com Operating Business Model

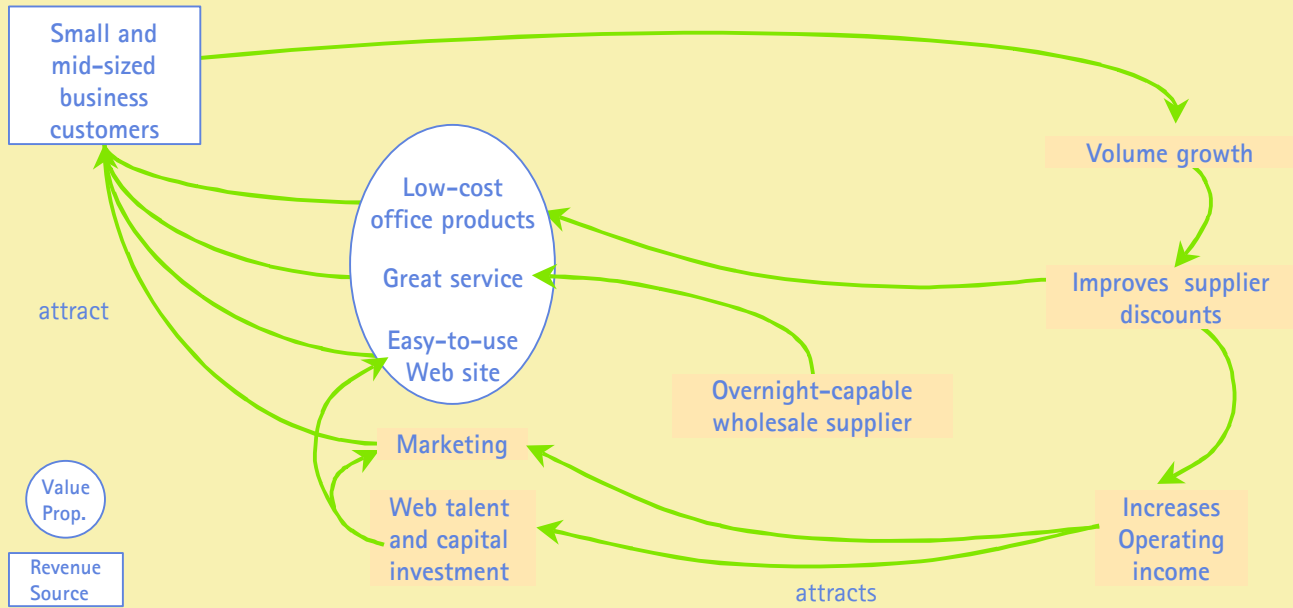
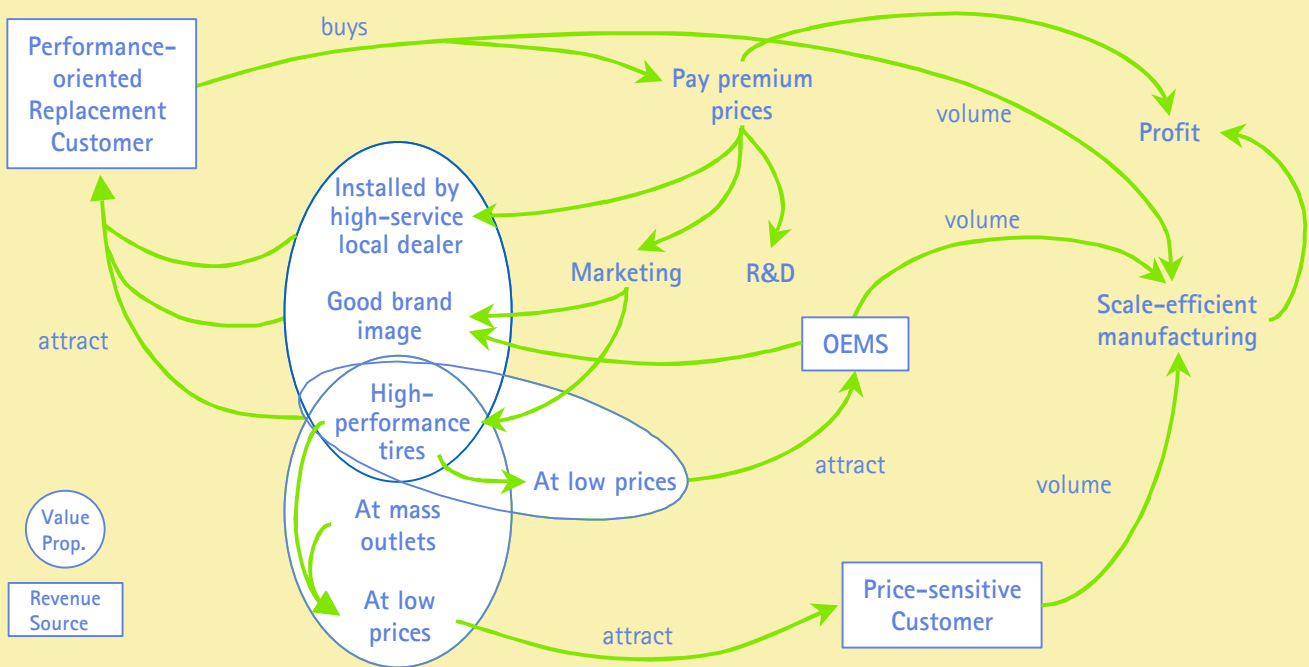


Exhibit 3: "Global" Tire and Rubber Operating Business Model circa 1990



brand. The products were technically superior to other brands because of Global's extensive research and development efforts, and, as a result, the company was able to charge a premium price. Global also marketed the same tires to automobile firms to be sold as original equipment on upscale cars—a second value proposition. Prices—and profits—in this segment were much lower, but the practice substantially enhanced the brand image. Global also marketed a separate, low-price brand through mass merchandisers. Margins in this segment were also low, but the additional volume enabled Global to run manufacturing and logistics at a very efficient scale. As a result, they made money by charging premium prices for their up-branded tires, and by holding a substantial cost advantage for all of them.

Identify Your Organization's Business Model

To outline your organization's operating business model(s), follow these steps (see Exhibit 4):

- Identify all your sources of revenue.
- Lay out the key factors underlying your ability to attract and retain each revenue stream. These are your value propositions.
- Lay out the key factors that enable you to deliver your value propositions profitably and consistently. These make up your delivery model and your funding model.
- Lay out the leverageable assets, capabilities, relationships, and knowledge that result.

Use the information to construct a diagram that shows "round" logic, like the one in Exhibit 2. If your organization has several divisions, ask yourself the question: "Why is this one company?" If you can identify the reason, make sure that factor is prominent in the operating business model. If you can't, show the divisions as separate models.

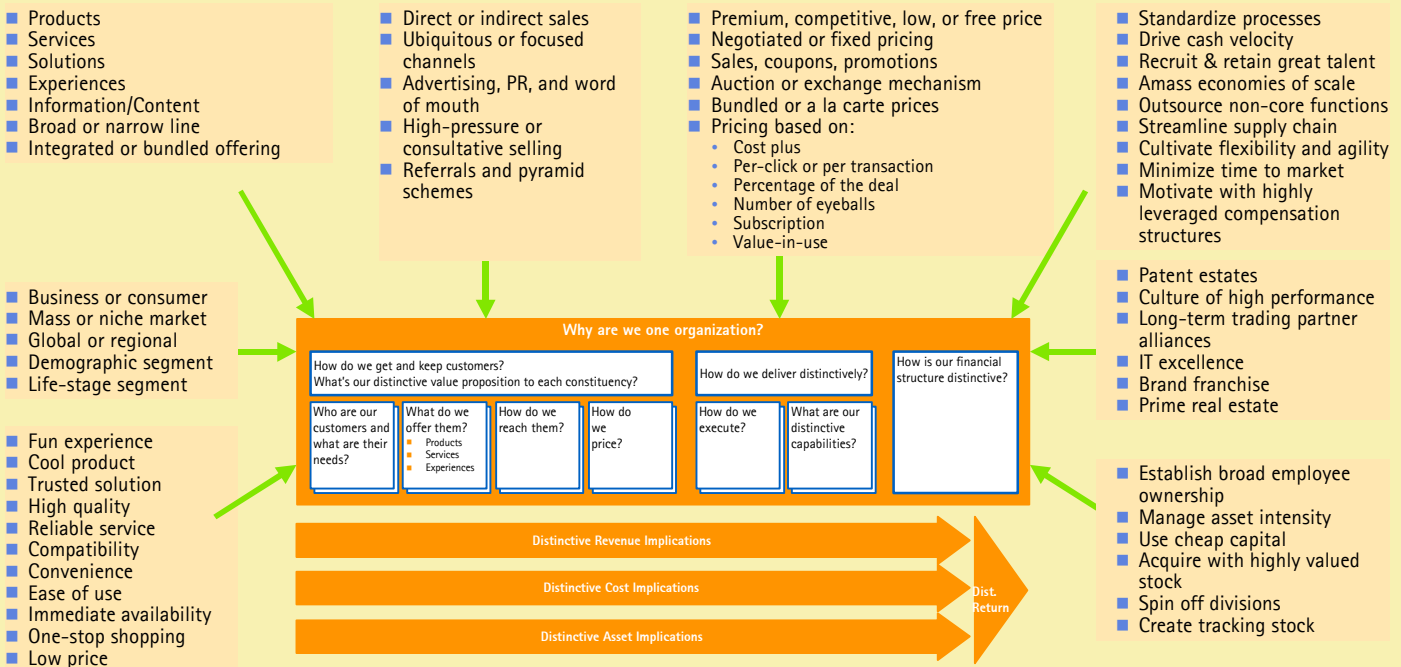
Developing a Business Model

How do managers develop a good business model—one that creates value? Can we identify any overarching principles that lead to business model advantage? This question isn't easy to answer because operating business models are like insects—the diversity of shapes, colors, and sizes is stunning. One small difference in how a company attracts its customers or delivers on its value proposition can make its business model substantially different from that of another firm. (Exhibit 5 shows some of the many choices a firm has in constructing its business model.)

Exhibit 4: Operating Model Framework



Exhibit 5: Examples of Business Model Choices



Despite this diversity, we can list and categorize business models by focusing on two main dimensions: a model's core, profit-making activity, and its relative position on the price/value continuum. (See Exhibit 6 for an overview of operating business models.)

In terms of core activity, a business model can focus on *providing*—making money by selling goods or services. Or it can carve out a *channel* role, profiting through customer-management services that wrap around providers' offerings. These can include highly effective sales techniques, convenient or exciting buying experiences, or advice about the product or service. *Intermediary* models bring buyers and sellers together and make markets.

A business model's relative position on the price/value continuum can range from high-value, premium-priced innovations to low-priced, standardized offerings. In the middle range, models focus on value-in-use distinctions other than unique function or low price. These include attractors like quality, reliability, convenience, ease-of-use, availability, and "coolness," that ephemeral quality that makes one thing more fashionable than another.

Implications

What can we learn from surveying the business model landscape?

No sector of the business model landscape guarantees financial success. God is in the details. We see no silver bullets—no spot on the landscape guarantees financial success. We assessed the effectiveness of the largest U.S. firms, and each performance quartile hosts a wide range of business models (see Exhibit 7).

The most interesting new business models are created by combining features from two or more categories. Home Depot, for example, combines the low price and convenience of one-stop-shopping with the appeal of expert in-store advice. Dell uses its direct-to-customer model to supply price-competitive, reliable computers quickly that are also configured to the customer's needs.

Many so-called "eBusiness" models are improvements, not radical departures from traditional business models. For example, a model that offers free content in exchange for attention to advertising—popular among dot.com firms—has

Exhibit 6: Overview of Operating Business Models

Business Model	Description
Price Models	
Buying club	Round up buyers with attractive prices and use purchase volume to gain discounts. Cost containment, no-frills service, and streamlined logistics keep administrative costs low. Examples: Letsbuyit.com, Costco.
One-stop, low-price shopping	Use low price and the convenience of broad selection to attract buyers, then convert volume into purchase discounts. Keep service extras to a minimum, but deliver fast to keep cash flowing. Examples: Walmart, SupplyGenie.com.
Under the umbrella pricing	Under-price the market leader and use marketing to convince customers your offerings are equivalent. Fast follow in product/service development. Examples: Prime Computer with Digital Equipment in the 1980s, MCI WorldCom with AT&T.
Free for advertising	Offer products or services free to end-users but require them to view advertising. Example: FreePC. <ul style="list-style-type: none"> ■ Pay end-users to view advertising. Example: Cybergold.
Razor and blade	Charge a low price for basic equipment or starter product, and earn profits on the steady stream of consumables it requires. Examples: Polaroid cameras, HP inkjet printers, Gillette razors.
Convenience Models	
One-stop, convenient shopping	Use broad selection and ubiquitous access to attract busy buyers who will pay a premium for convenience. Control costs, deliver fast and build margins by increasing share of wallet. Example: WW Grainger. <ul style="list-style-type: none"> ■ Pull in customers with a frequent-purchase product like gasoline, then sell high-margin convenience items. Examples: Sunoco, Kozmo.com.
Instant gratification	Make expensive products and services easily available to people who can't pay immediately. Make money on high-priced installment credit. Examples: Capital One, MBNA. <ul style="list-style-type: none"> ■ For product firms, manage supply chain for fast delivery to avoid cancellations. Example: Heilig Meyers in the early 1990s.
Comprehensive offering	Offer a package of acceptable quality goods and services to form a single unique offering that competes with best of breed firms. Integrate pricing and delivery to show one face to the customer. Fast follow on development and win on ease-of-use. Example: Mediaone. <ul style="list-style-type: none"> ■ Global model. Use a network of offices around the world to provide a coordinated global offering. Example: Omnicom. ■ Keiretsu. Cross-sell services offered by best-of-breed alliance partners. Examples: TMP Worldwide, CMGI.
Commodity-Plus Models	
Low-price reliable commodity	Attract customers with good prices and reliable service, then standardize operating practices to deliver a highly predictable offering at low cost. Example: Southwest Airlines.
Reliable commodity operations	Predictable commodity service wins customers who pay a small premium. Operating scale maintains margins. Example: UPS, AT&T's consumer business, Key Bank.
Branded reliable commodity	Attract customers with good brand marketing to earn a small premium in price for an efficiently produced commodity. Establish broad distribution and maximize scale-manufacturing benefits. Examples: Aurora Foods, Goodyear.
Mass-customized commodity	Offer "have it your way" model options on top of competitive prices, convenient buying, and fast delivery to win in commodity markets. To make the numbers work, push assets out, inventory turns up, and make processes more direct. Example: Dell.
Service-wrapped commodity	Functionally undistinguished good or service pulls a small price premium when top-drawer customer attention is added. Cost control and scale still critical to maintain margins. Examples: Mindspring, Earthlink.
Experience Models	
Experience selling	Functionally undistinguished product is moved through extensive, aggressive sales force motivated by pyramid commission structure. Examples: Mary Kay Cosmetics, Amway.
Experience destination	Use a carefully designed environment to attract customers who pay premium prices. Manage staff, service delivery, and/or product selection for quality and consistency first, cost second. Examples: Rainforest Café, Disney theme parks, Sharper Image. <ul style="list-style-type: none"> ■ Use an experience destination to support brand marketing. Examples: Nike Town Stores, Nordstrom.
Cool brands	Earn premium prices with competitive products through expert brand marketing. Outsource manufacturing to reduce asset-intensity, but keep tight control on quality and "coolness" drivers. Examples: Gap stores, Nike.
Channel Models	
Channel maximization	Leverage appealing content through as many channels as possible to maximize advertising, subscription, gate, and merchandizing revenues. Example: AOL/ Time Warner. <ul style="list-style-type: none"> ■ Vertically integrate to capture all channel revenues and drive costs down through scale. Ex: Viacom. ■ Focus on a particular target audience. Example: Ziff-Davis.
Cat-daddy selling	Attract customers with a complete selection of readily available products and accessories in a focused category for good prices. Manage supply chain for efficiency and use scale-driven buyer power to get purchase discounts and improve margins. Examples: Toys R Us, eToys.com, Safeway. <ul style="list-style-type: none"> ■ Advice. Provide expert advice about how to use products effectively. Example: Home Depot.

Exhibit 6: Overview of Operating Business Models (continued)

Business Model	Description
Channel Models (continued)	
Quality selling	Attract customers with high quality and/or hard-to-find products for premium prices. Use top-notch buyers to establish and manage supply relations for uniqueness and quality. Provide excellent customer service and convenient buying by managing logistics in an efficient, customer-focused way. Examples: Lands' End, Saks Fifth Avenue. <ul style="list-style-type: none"> High service model. Use over-the-top service and high inventories to satisfy customers. Example: Nordstrom.
Value-added reseller	Sell a comprehensive range of undifferentiated products based on value-added sales and service to a focused market. Attract clients through consultative selling, product availability, service, and promotional pricing. Maintain margins through efficient logistics and effective supplier management. Examples: Ingram Entertainment, Pitman Company, Berkshire Computer.
Intermediary Models	
Market aggregation	Use appealing content and services to draw the attention of an audience in order to convert that attention to advertising and/or commerce transaction revenues. Example: Yahoo.com.
Multi-party market aggregation	Use appealing content, products, and services to draw the attention of one or more audiences. Use the presence of each audience to attract the other. Examples: Beansprout.net, Workscape.com.
Open market-making	Establish a context for fair, open markets. Make money through transaction fees. Examples: eBay.com, Chemdex.com, eSteel.com, NASDAQ.
Exclusive market-making	Bring together specific, highly targeted, qualified audiences for trading. Make money through transaction fees as well additional service or subscription fees. Examples: Edu.com, Orderzone.com.
Transaction service and exchange intermediation	Provide transaction coordination services to all parties in an exchange through ASP-hosted software. Make spot markets between the parties, and provide real-time benchmarking as a value-added service. Outsource software hosting, but control software functionality to fast follow best-of-breed competitors. Use domain expertise to offer accessory and support services. Price by the value of the transaction or service, not the number of transactions. Examples: Celarix, Solbright, PrintConnect.
Trust Models	
Trusted operations	Customers pay premium prices for predictable operations that carry big consequences for failure. Extensive expertise, scale, efficiency, and fault-tolerant processes maintain trust and margins. Examples: Exodus, State Street.
Trusted solution	Customers pay premium prices for important services that provide a total solution. Firms use expertise and alliances to tailor offerings, usually around their own core products. Account management is critical. Examples: AT&T B2B, Boeing, Stonesong Press.
Trusted advisor	Customers pay premium prices for answers. Essential to stay in the information loop and be irrefragable. Example: AJ Neilson. <ul style="list-style-type: none"> Talent model. Incentives are required to retain people. Examples: Merrill Lynch, McKinsey. Process model. Standard approaches allow ordinary people to generate good answers. Examples: Gartner Group, Moody's Investment Service. Media model. High editorial standards draw a discriminating audience that attracts high advertising and e-commerce revenues. Examples: Wall Street Journal, Inc.com.
Trusted product leadership	Develop long-lasting product platform architectures to create a non-disruptive product upgrade path for locked-in customers. Earn an annuity from upgrades, add-on services, technical support, and plug-and-play-modules. Attend to long-standing customer relationships and R&D talent. Examples: Teradyne, Advanced Materials, Intel. <ul style="list-style-type: none"> Content products. Examples: Harcourt, Forrester Research. Outsourced development. Acquire technologies and focus R&D on product integration and comprehensive line. Example: Cisco.
<i>De facto</i> Standard	Develop and use proprietary component technology to provide high product functionality, but also license it broadly throughout the industry to establish it as the dominant design. Maximize combined margins from product sales and royalties. Examples: Sharp in flat panel displays.
Trusted service leadership	Leverage a reputation for excellence to attract great talent, which attracts funding. Get paid before you spend and profit on the float. Manage excellent service delivery that does not undermine talent. Examples: Brigham & Women's Hospital.
Innovation Models	
Incomparable products	Use deep R&D skills to develop and exploit proprietary technology to offer unique products that command high margins. Maximize applications across many markets. Example: Polaroid in the 1960s, Genzyme. <ul style="list-style-type: none"> Scale up manufacturing to stay ahead of competitors on the volume-driven cost curve to maintain price control. Example: DuPont. Make deals with strong marketers to take over product development at a point that maximizes R&D value-add. Example: Aquila Biopharmaceuticals.
Incomparable service	Use aggressive opportunity identification to sell unique services for top dollar. Exit a service line when it becomes commonplace and price competitive. <ul style="list-style-type: none"> Speed model. Emergency room techniques coupled with "do it now" attitude create value. Wheel and deal to secure the right equipment at good prices. Example: Evergreen Aviation.
Breakthrough markets	Invest in opening new markets to gain at least a temporary monopoly. Solidify market hold through intensive distribution and retain margins through careful pricing and operating efficiencies. <ul style="list-style-type: none"> Innovative product model. Combine breakthrough markets with new and different products. Example: AIG Insurance.

Exhibit 7: Business Model Effectiveness

Effectiveness Quartile: 1		Effectiveness Quartile: 2	
Company	Model	Company	Model
<ul style="list-style-type: none"> ■ Bristol Meyers Squibb ■ Applied Materials ■ Cisco ■ Microsoft ■ Harcourt General ■ Schwab ■ Walmart ■ Home Depot ■ W.W. Grainger 	<ul style="list-style-type: none"> ■ Incomparable products ■ Incomparable products ■ Trusted product leadership ■ Trusted product leadership ■ Trusted product leadership ■ Low-price reliable commodity ■ One-stop, low-price shopping ■ One-stop, low-price shopping ■ One-stop, convenient shopping 	<ul style="list-style-type: none"> ■ Pfizer ■ Motorola ■ The Limited ■ DuPont ■ IBM ■ Goodyear Tire and Rubber ■ Fleet Boston ■ Seagate Technology ■ Office Depot 	<ul style="list-style-type: none"> ■ Incomparable products ■ Incomparable products ■ Cool brands ■ Trusted product leadership ■ Trusted solution ■ Branded reliable commodity ■ Reliable commodity operations ■ Low-price reliable commodity ■ One-stop, low-price shopping
Effectiveness Quartile: 3		Effectiveness Quartile: 4	
Company	Model	Company	Model
<ul style="list-style-type: none"> ■ Eli Lilly ■ Abbott Labs ■ Nordstrom ■ AT&T <ul style="list-style-type: none"> • Business • Consumer ■ Wachovia ■ Sunoco ■ Microage ■ MCI WorldCom 	<ul style="list-style-type: none"> ■ Incomparable products ■ Incomparable products ■ Experience destination • Trusted solution • Reliable commodity operations ■ Reliable commodity operations ■ One-stop, convenient shopping ■ One-stop, low-price shopping ■ Under the umbrella pricing 	<ul style="list-style-type: none"> ■ Merck ■ Apple ■ PaineWebber ■ AMR Corporation ■ International Paper ■ 7-11 ■ Kmart ■ Toys R Us ■ MCI Worldcom 	<ul style="list-style-type: none"> ■ Incomparable products ■ Incomparable products ■ Trusted advisor ■ Reliable commodity operations ■ Low-price reliable commodity ■ One-stop, convenient shopping ■ One-stop, low-price shopping ■ Cat-daddy selling ■ Under the umbrella pricing

To assess effectiveness, we looked at the 1000 largest firms in the US. We computed each firm's change in EBITDA and market capitalization for the years 1994 through 1998 relative to its industry. We then ranked the firms on each measure and used an evenly-weighted combined ranking of the two measures to place firms in performance quartiles. We excluded firms for which data was incomplete. We chose a U.S.-only review in order to have consistent accounting data for comparison.

been the long-standing model of the broadcast industry. The auction-type commodity exchange—another hot Internet model—was the foundation of the agricultural economy. The Internet does give new reach and radically improved cost structures to old models, however. So what? Before you hurt your head trying to invent a totally new business model, drive an old one to unexpected levels of profitability with an Internet facelift.

Interlocking value propositions, which look promising for creating durable advantage, are easier to engineer over the Web. What are interlocking value propositions? They are a set of value propositions that leverage multiple aspects of the customer relationship to magnify the value to the customer. These supercharged value propositions deliver increasing returns to scale and hold promise for establishing durable advantage. We identified four potential components of interlocking value propositions.

1. **Vetted advertising.** Websites that include ads for products and services that are particularly appealing to their visitors are increasing value to their customer as they are earning advertising revenues. For example, Inc.com's web site

includes ads for products and services that it ranks excellent in their category - the top 401K programs for small business people or the best small business consulting firms.

2. **Competitive ranking information.** Firms like banks, transportation companies, and software developers that have broad market reach can use accumulated transaction data to help clients assess their performance relative to others in the industry. The more clients join the pool, the more statistically valid—and valuable—the information becomes.
3. **By-product community and trading opportunities.** Firms can enhance the value they provide by putting their customers in touch with each other. Customers can help each other assess products or the trustworthiness of sellers. They can also directly exchange goods and services.

Some organizations combine two or more of these effects. For example, Celarix.com is an Internet logistics ASP (applications service provider). Clients who seek transportation services and carriers jointly use the same, Web-based logistics management system to coordinate shipments. The result? Complete visibility. But Celarix doesn't stop there. It provides a spot

transportation services market—clients and carriers can auction off last minute capacity or get bids to transport last minute shipments. Because the clients and the carriers are already visiting Celarix’s site to manage their planned shipments, the exchange represents obvious additional value. Furthermore, Celarix takes all the transaction data it sees by virtue of its ASP structure, and sanitizes it and boils it down to create management benchmarking reports for clients and carriers. And the more players it serves, the more valid its statistics become.

Solbright has adopted a similar model in the advertising industry, but with a brilliant twist. Instead of pricing by taking a small fee from each transaction that runs through its software, it charges by CPM (cost per thousand views), the standard in its industry. The service it provides is virtually the same regardless of how many viewers end up looking at the ad placed through its system, but this method of pricing allows it to share in its clients’ upside earnings. We expect to see more firms exporting this model to other industries.

Change Models

The business model typology shows business models at a point in time. But most firms’ business models are under constant pressure to change. Innovations in technology, changes in the law, competitive moves, or shifts in consumer tastes can sap an operating model’s profitability. In response, firms tweak, twist, and totally revamp their business models in a wide variety of ways (see Exhibit 8).

We have no evidence that one type of change or another inherently improves profit. We do see a difference between firms that appear to change frantically and without direction and those who are on a charted course of change. That’s where change models come in. A change model is the core logic for how a firm will change over time to remain profitable in a dynamic environment.

We’ve identified four basic types of change models used by the firms we studied: realization models, renewal models, extension models, and journey models (see Exhibit 9).

Exhibit 8: Ways to Change Business Models

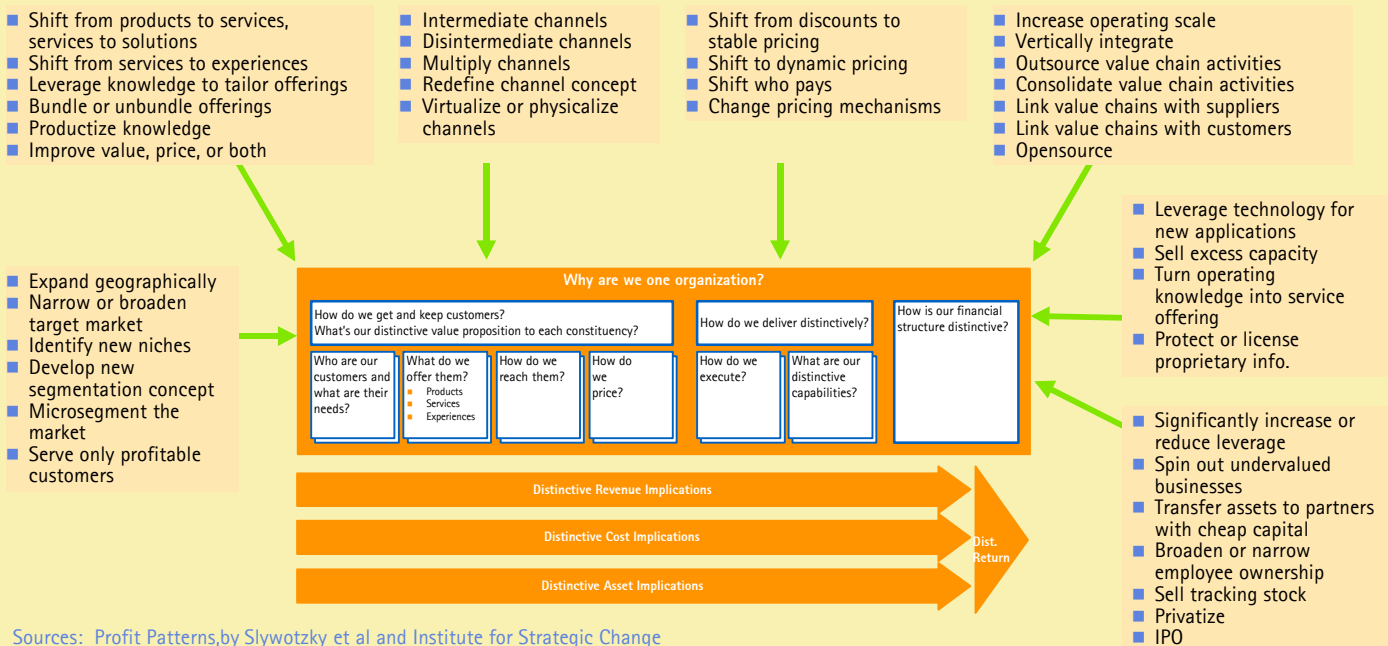


Exhibit 9: Change Models

Business Model	Description
Realization Models	
Brand maintenance	Firms with good brand franchises invest in advertising to maintain the brand's appeal.
Product line extensions	Firms refresh their product lines with "new and improved" line extensions.
Geographic expansion	Many firms expand geographically to grow. Walmart, for example, began as a regional player and now boasts stores around the world. During the 1980s much of Frito-Lay's growth came from geographic expansion as well as growing sales within existing stores.
Penetration	To expand their share of wallet, for example, commercial banks cross-sell existing services to existing customers in order to improve overall profitability as well as customer retention.
Incremental product or service line expansion in one-stop shops	Fred Meyer, a comprehensive one-stop-shop superstore, has incrementally expanded its product and service line to include home improvement, groceries, jewelry, apparel, home electronics, and more.
Additional sales or service channels	The establishment of new sales or service channels on the Internet is quite common today. Wachovia Bank, for example, is augmenting its existing channels with online banking. W.W. Grainger, which attracts customers by making its products widely available, has also added Internet channels to its vast array of physical ones.
Roll up	Key Bank has consolidated fragmented firms to create advantages of scale and cost savings.
Renewal Models	
New service offerings	Evergreen Aviation is always on the prowl for new markets for its premium-priced, "do it now" airborne services. When competition drives margins down, Evergreen exits.
New brands	Aurora Foods buys up poorly performing brands like Lender's bagels and Mrs. Butterworth's syrup and uses its brand marketing expertise to turn them into cat-daddies.
Untouched markets	AIG, a global multi-line insurance company, breaks open entirely new insurance markets, frequently in less-developed countries.
New retailing formats	In addition to keeping their core brand fresh, the GAP and the Limited spawn new store formats that leverage the firms' merchandising, retailing, and brand management expertises.
Disruptive new product or service platforms	Teradyne and DuPont invest in new technologies to create the next discontinuity, not react to it.
Extension Models	
Backward integration	The Gap dumped Levi's and created its own exclusive brand. Safeway and Sainsbury have gone similar routes with private label foods.
Forward integration	Companies like BP/Amoco used to provide oil and gas. Now they operate retail distribution channels as well. Some say they make more on the Twinkies than the gasoline. Media firms and publishers like Harcourt that are pushing their content through every available channel also fall in this category.
Horizontal integration	Firms extend a strong customer franchise to cover new types of products and services. Heilig Meyers sold garden equipment through its furniture stores, and Sears added insurance to its line.
Externalizing an internal capability	Companies can grow organically and in unusual directions by turning an internal capability into a market offering. Dell, for example, is planning to package up a service offering based on its e-business expertise. Ingram Entertainment, a video distributor, will turn its excellent pick-pack-and-ship operation into a third-party fulfillment service for Internet firms.
Journey Models	
Commoditization: from product to price	Firms migrate from business models based research-driven innovation to preference models that emphasize value-in-use such as brand appeal, ease-of-use, service, or reliability. As products or services become further commoditized, they move toward low-cost, operations management models. For example, over the past two decades, Goodyear Tire and Rubber has changed from a product innovation model to a global, low-cost manufacturing model.
Globalization	Globalization is different from geographic expansion. A global firm attracts customers because of its coordinated global reach, not just because of its size. Omnicom and Young and Rubicam both highlight their ability to mount global advertising campaigns.
Avoiding commoditization: from product to service to solution	Firms avoid commoditization by shifting from selling products to offering customer-management services or total solutions. Boeing and Pratt & Whitney are two examples. Their products must continue to perform at competitive standards, but the firms now make their money on the services they wrap around their products. Boeing even attracts airline customers with a total solution—to "do whatever it takes to keep planes in the air."
Up market in products: from price to speed to agility	This is the story of Honda and Dell. Both started off hawking price, but quickly moved up on the value curve to offer reliable, custom-configured products that were available quickly. And both firms continued to maintain price competence as well.
Up market in services: from price to brand or expertise.	Service firms move up the value curve by adding service and brand strength. Insight Enterprises shifted its model from low-value reselling to higher value direct marketing. It meant adding a sizeable staff of aggressive and knowledgeable salespeople, but it also meant higher margins and closer customer relationships. JC Penney is attempting the same shift as it tries to build destination brands.

You'll notice we've left out portfolio management as a change model. Many firms change by buying and selling operating companies to reposition themselves. Seagrams, for example, started as a wine and spirits company, but now they'd classify themselves as an entertainment firm. Nokia didn't focus on telephony until the early 1990s. Before that, they would have been called a regional conglomerate with operating subsidiaries in the rubber and paper industries as well as electronics. Portfolio-level change is certainly important, but unless the firm integrates new acquisitions at the operating level, it doesn't represent a business model change—just new faces in the executive suite.

Realization models

Companies use realization models to maximize the returns from their existing operating logic. They exploit the potential of their current business model in order to grow and profit. Of all the change models, it represents the least actual change. Many of the dotcom companies we interviewed had realization models. They anticipated geographic expansion and growth in their customer base, but no substantial changes in their operating business models.

Let's look at an example. W.W. Grainger uses a realization model to continue to give customers what they want—ubiquitous and convenient access to the broadest possible range of MRO products available. Before the Internet became popular for B2B procurement, Grainger offered customers everything from physical branches to teletype machines for ordering. Adding two easy-to-use Internet sales channels to its existing widespread network didn't change Grainger's business model. On the contrary, Grainger is leveraging the Web to strengthen and maintain its current operating model—to realize its full potential.

A realization model often involves geographic expansion. Mary Kay Cosmetics, for example, has changed its product line only slightly over the past decades, and it has always used an incentive scheme based on performance of the individual in combination with performance of those supervised or recruited by the individual to motivate its sales force. It has expanded internationally. Walmart has grown to become the world's largest retailer by sticking to its operating model and replicating it throughout the world.

Renewal models

Companies that change through renewal consistently and consciously revitalize their product and service platforms, brands, cost structures, and technology bases to counteract natural competitive forces that drive down margins. A renewing firm leverages its core skills to create new—sometimes disruptively new—positions on the price/value curve.

Aurora Foods and the Gap both change through renewal models. Aurora Foods' renewal activity involves consistently purchasing poorly performing brands like Aunt Jemima Waffles and Lender's bagels and bringing them to life with its extensive brand marketing skills and cost cutting measures. Similarly, the Gap uses its capability in brand marketing and merchandising to create entirely new store formats such as BabyGap, Banana Republic, and Old Navy Clothing.

Renewal models are especially common among innovative companies seeking to stay on top of the price/value curve. Teradyne, for example, is a worldwide leader in providing test equipment to the semi-conductor industry. Once fabricators buy and integrate the test equipment into their manufacturing operations, they face enormous switching costs. So Teradyne must provide innovative new features while maintaining the integrity of its technology platform to bring its installed base of loyal customers along smoothly. How, then, does it maintain its product leadership position? Teradyne management launched an internal division with the no-holds-barred charter to find a disruptive technology. It initially targeted a market segment that was not a Teradyne stronghold, but management acknowledged that a successful new technology platform might eventually cannibalize core equipment sales. This is a renewal model because Teradyne understands that the value proposition in its core business inexorably slips away from top product functionality in order to keep the current customers happy. As the upstart division wins business in a new segment, it also holds the potential to reset the game with an entirely new technology platform. And Teradyne is prepared to launch these disruptive divisions continuously to keep a solid grasp on product leadership.

DuPont follows one of the most sophisticated renewal models we've seen. Its vaunted R&D laboratories turn out unique chemicals and materials. DuPont earns premium margins from early adopters but immediately begins scaling up manufactur-

ing to march down the experience curve and keep its unit costs well below those of copycat competitors. When products can no longer be differentiated by feature and function, DuPont continues to command a small price premium because of its solid brand name. Finally, when products are fully commoditized, DuPont exits. And when its core research expertise becomes outmoded, DuPont renews that too. In its agricultural business, DuPont has shifted its research focus from chemical pesticides to genetically-engineered, bug-resistant plants.

Unlike the tamer renewal examples like Aurora Foods and the Gap, creating an entirely new product or service platform means changing your operating business model. When companies like DuPont and Teradyne renew, they establish new capabilities, relationships, and new customers.

Extension models

Extension models expand businesses to cover new ground. An extending company stretches its operating model to include new markets, value chain functions, and product and service lines. New business lines don't replace, but add to existing operations.

Extension models frequently involve forward or backward integration. BP Amoco, for example, extended its vertically integrated oil and gas business to include retail stores at its gas stations as well. And companies like Safeway and JC Penney have augmented their consumer brands with private label brands.

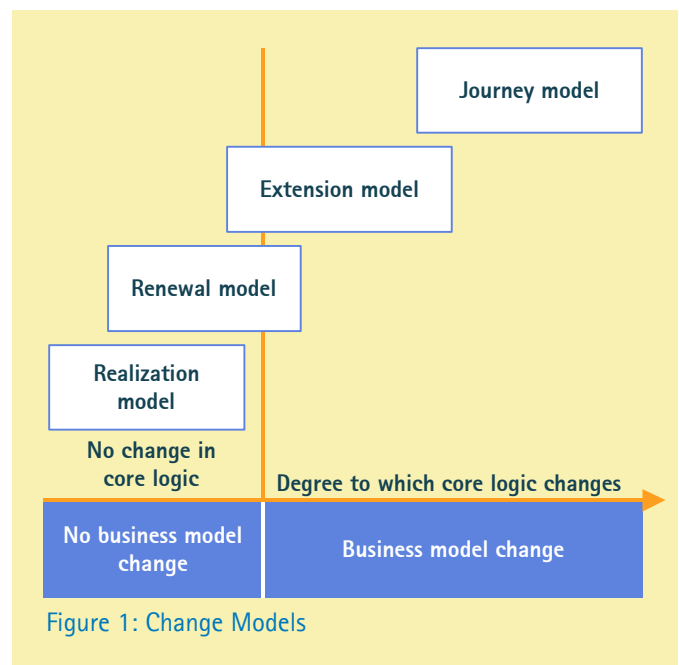
Some of the most interesting extension models leverage a firm's internal capabilities to create a whole new line of business. Bombardier, the Canadian firm that manufactures Ski-Doo snowmobiles, works this way. From its thriving recreational vehicle business, it got into capital leasing. It acquired a regional aircraft firm from which it moved into jet maintenance. Based on its leasing experience and aviation background, it began to market programs for fractional jet ownership to corporations and high-net-worth individuals. Its experience in aircraft led it to an opportunity in rail car manufacturing, which had complementary cash flow patterns.

Journey models

Journey models take a company to a new business model. Unlike an extension model, however, the company moves

deliberately and purposefully to a new operating model and never returns. For example, many firms are globalizing. They establish their presence in markets around the world, they shift their value propositions to highlight their global reach and capability, and they never intend to return to their former status as a focused, local player. In addition to globalization, journey models include migrations up-market and down-market—from price competition to brand or service-based preference or vice versa.

Realization change models do not change a company's operating business model; renewal and extension models can, and journey models do. However, the degree to which the logic changes can vary significantly from firm to firm. Bombardier and BP Amoco both have extension models, for example, but Bombardier's change in core logic is more extensive than BP Amoco's.



Why bother with change models?

Executives had difficulty articulating their business models, and they had even more trouble describing their change models. It appeared as if many executives hadn't thought that far ahead. The companies that did describe their change models clearly—firms like Teradyne, DuPont, and AIG—had created a competency in making the kinds of changes they anticipated.

They built organizational machinery to execute their change models. Teradyne's disruptive technology organization is an example. The Limited—another renewal firm—has a set of practices it uses to create new retail store formats. AIG uses an extension model to break open new insurance market niches in less-developed countries. Because of its repeated pattern of long term investment in developing countries and its experience creating close government relationships, it often holds virtual monopolies for some of its lines.

Journey firms, on the other hand, have a tougher row to hoe. Since they're on a one-way trip, they don't have the advantage of being able to practice the same kind of change repeatedly. We can't prove it from our current data, but we'd expect these firms to fail in their change efforts much more frequently than those with realization, renewal, or extension models.

Implications for Management

Understanding your company's operating and change models pays off. Clarifying them and sharing them throughout your firm will:

- **Improve your organization's focus.** Do the people in your organization understand the operating model and how they contribute to it? Do they know what makes your firm distinctive and how you make money? If they did, they'd be able to make their every-day decisions in a way that supported your profit-making agenda.
- **Establish a framework for competing agilely.** The days of comprehensive annual business plans that actually stick are over. The world just moves too fast. So how do the people on the front lines of your company make change at the pace you need? They master the practices demanded by your change model. For example, one of the major telecommunications firms articulates its change model in one word: "convergence." It's an extension model. Its aim over the next five years is to bring together all its networks and services into a single, comprehensive offering to replace the margins it's losing as the long distance business commoditizes. If it had been able to state its change model clearly several years ago, however, it would not have constructed the three independent networks that it now must consolidate. Firms that consciously identify their change models stand a better chance of executing change effectively.

We welcome your feedback. You can reach Jane Linder at 617-454-8461 or jane.c.linder@accenture.com and Susan Cantrell at 617-454-8697 or susan.cantrell@accenture.com. Copyright Accenture, May 2000, all rights reserved.

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