

Devising a Business Model

[T]he real environment is altogether too big, too complex, and too fleeting for direct acquaintance. We are not equipped to deal with so much subtlety, so much variety, so many permutations and combinations. And although we have to act in that environment, we have to reconstruct it on a simpler model before we can manage with it.

—Walter Lippmann

How does your business work? Which customers does it target? And how does it create superior value for customers and shareholders? If your business has a long successful history, you may be able to answer quickly. But if it is a new venture or a venture in decline, you may have to think long and hard before responding.

This chapter explains why devising a business model is important and how to do it. It provides guidelines for portraying how the business works, how it creates value, and why it is expected to prosper. The chapter begins with a vignette that illustrates why even simple business ideas can raise many difficult questions—questions that must be considered near the start of the planning process.

Q GRIP: A CASE IN POINT

Suppose you had invented the Q Grip Visor Station, shown in Figure 3-1, and wanted to turn your invention into a business. You would have to decide whether to make and market the product yourself or outsource various production and marketing activities. If you were to outsource everything, you would not need a business plan. Instead, you would have to find a company to make your product and one to market it. Or, you would have to find a licensee.

If you were to make and market the product yourself, you would have to buy or lease equipment, a production facility, and warehouse space for storing inventory. For planning purposes, you would have to estimate the cost of equipment, facilities, raw materials, packaging, and labor. You also would have to identify your customers and figure out how to promote and distribute your product.

Figure 3-1 The Q Grip Visor Station

Potential customers for the Q Grip Visor Station include all motorists because, potentially, anyone who drives a car or a truck could use an organizer. You would have to consider pricing by taking costs and customer price sensitivity into account. And if you decided to use wholesalers or retailers, you would have to allow for reseller profit margins.

Additional planning issues would arise if you considered the Visor Station but one of several potential Q Grip configurations. Specifically, Q Grip organizers could be produced not only with clips that fasten to visors, but also with adhesive tape or suction cups that stick to a wide variety of surfaces, including desks and countertops. Hence, the Q Grip organizer has the potential to perform somewhat different functions for motorists, office workers, homemakers, and artists in search of a good place to keep brushes while painting. And since the Q Grip emblem could easily be replaced with a company name, phone number, and web address, the Q Grip organizer also could be marketed to businesses as a promotional give-away for their customers.

As you see, even simple products may raise tough questions. Answering them in a way that portrays the venture clearly begins with delimiting the venture's scope.

DELIMITING A VENTURE'S SCOPE

If Q Grip were your invention, what would you do? Think about your options by considering the following:

- **Product scope:** How many variants of the basic product platform would you offer? Would you stick with the Visor Station, or would you also develop suction-cup and adhesive-tape models?
- **Customer scope:** Which customer segment or segments would you target? Truck drivers? All motorists? Office workers? Artists? Others?
- **Geographic scope:** Where would you try to market your product? Locally? Nationally? Internationally?
- **Distribution scope:** How would you distribute your product? Would you use multiple channels? Which ones? Possibilities include truck stops, automotive stores, catalogs, shopping networks, and eBay. Selling through Walmart may appear promising. But getting into Walmart is difficult, as is surviving the pressures Walmart exerts on suppliers.¹
- **Activity scope:** Which production and marketing activities would you perform, and which ones would you outsource?

Note that choices along any one of these five dimensions tend to affect options along other dimensions. For instance, persuading truck stops to carry Q Grip would be indicated if truck drivers were the chosen target segment, but not if office workers were the main target. Ultimately, all scope decisions must be mutually congruent.

IDENTIFYING THE GENERIC BUSINESS MODEL

Determine which, if any, of the following generic business models characterizes your enterprise.²

Value Chains

Sausage factories exemplify value chains. They have definite input and output ends, which are linked by a process designed to create outputs whose value exceeds the value of inputs. Value chains include manufacturers, assemblers, and resellers.

Manufacturers, such as steel producers, and assemblers, such as Dell, create value by transforming inputs into products whose functionality differs notably from that of constituent inputs. Unlike manufacturers, assemblers create products by conjoining parts or components in ways that leave most parts and components intact. Nuts, bolts, and memory chips go into Dell computers, for example, but are not altered by the assembly process.

Resellers, also called *intermediaries*, create value by making products readily available to customers. Supermarkets, for example, create shopping convenience by amassing vast assortments of grocery and other household items in one place. To appreciate the value they create, consider what grocery shopping would be like if such stores vanished.

As a distributor of entertainment, Netflix is a value chain. The company must acquire entertainment content or legal access to content from suppliers and find customers willing to rent it. Its DVD-by-mail business offers DVDs for rent in the traditional sense, while its video streaming business rents electronic access.

Value Shops

Value shops are exemplified by accounting and consulting firms. They create value by offering complete or partial solutions to clients. MarketStar, for example, offers solutions to marketing problems.³ Clients have included Hewlett-Packard, Motorola, Cisco Systems, and Whirlpool. Unlike some value shops, MarketStar goes beyond offering advice; usually, it also performs various marketing activities for clients. Generally, clients engage value shops to avail themselves of expertise not found in-house and to perform functions they cannot or do not want to perform themselves.

Mediators

Mediators include employment services, dating services, banks, stockbrokers, and eBay. Mediators also solve problems for customers. But unlike value shops, their solutions hinge on orchestrating interactions between customers. Credit unions, for instance, must attract both borrowers and depositors to function. Without deposits, they have no money to lend; without borrowers, they have no means of generating profits. Both depositors and borrowers are customers.

Virtual Businesses

So-called virtual businesses do little more than coordinate outsourced activities, such as product design, production, and marketing. Nike, the shoe company, comes close to being a virtual business. It performs some of its own marketing, but outsources almost everything else.⁴

Franchised Businesses

Many franchisors resemble virtual businesses. They create value by providing ideas and name recognition. They also perform some marketing and managerial functions, but invest very little in facilities, labor, or materials. For instance, a franchisor of pizzerias might own a few restaurants or none at all. But franchisees would own most of them and would have to raise the capital needed to build and operate them. Although pizzeria franchisees usually buy their pizza dough, toppings, napkins, and other items from the franchisor, franchisors typically outsource production and distribution of such items.

To sell franchises and keep franchisees happy, franchisors must help franchisees attract patrons. They usually do so by promoting their brand. Most franchised establishments, such as franchised pizzerias and car dealerships, are value chains.

Licensing Agreements

Intellectual property includes original symbols, phrases, designs, artistic works, brand names, and processes. It may be protected by trademarks, service marks, copyrights, and patents, which convey permanent or temporary legal ownership to an individual or an organization. Miami Heat® and Olympics®, for example, are among myriad registered trademarks. Even the “thumbs up/thumbs down” movie rating gimmick is trademarked.

Owners of intellectual property often enter into contractual agreements that, for a price, grant others access to their property. So, if you had designed the Q Grip Visor Station and had trademarked the Q Grip name, you could try to license the name and the design to a manufacturer. Finding prospective licensees and negotiating mutually acceptable terms are the main challenges licensors face.

Licensing contracts should be studied carefully, with help from legal counsel, but seldom require much business planning on the part of the licensor. Once a contract is signed, the licensor generally stays on the sidelines, unless a licensee violates the contract.

Other Businesses

If your enterprise does not conform to a generic model, consider the similarities and differences between your venture and each generic type. Then, modify the closest generic model to fit your business. Call your modified model whatever you wish, as long as the name fits.

TURNING THE GENERIC BUSINESS MODEL INTO A SPECIFIC BUSINESS MODEL

Identifying the generic business model helps delimit what your business is and is not. However, refinement is required because each generic model encompasses numerous variations. Value chains, for example, include the likes of Walmart, Home Depot, Netflix, General Motors, breweries, taverns, and hotdog stands. To derive a specific business model from a generic model, you must add details. Suggestions follow.

Formulate a Value Proposition

Sound *value propositions* provide compelling answers from a customer perspective to the question, Why buy from us? They are unvarnished truth, not marketing hype. Offerings that cannot be portrayed by compelling, truthful value propositions are more likely to perish than generate enviable profits.

Before you try to write a value proposition, conduct a *value inventory* that answers the following questions: What benefits does our offering afford? What problems does it solve? What differentiates it from competing substitutes? And to whom do differences matter? Again, answers must be objective and candid.

To better understand the instrumentality of a value inventory in formulating a value proposition, consider R. C. Willey Home Furnishings.⁵ R. C. Willey (RCW) operates a network of nine sizable home furnishings stores in northern Utah and six additional stores in nearby states. An expansive warehouse a few miles west of Salt Lake City anchors its highly efficient logistics system.

Without stretching the truth, the company could say the following about itself: Each store offers wide selections of furniture for every room, major appliances, home electronics, and floor coverings at all but the lowest and the highest price points. RCW affords customers not only the convenience of one-stop shopping, but also the convenience of hassle-free financing. Because credit sales are financed internally, customers with established accounts can make purchases almost instantly. RCW is Utah's most trusted retailer and is known throughout the state for offering fair value and excellent customer service.

Accordingly, an inventory, or list, of noteworthy benefits and differentiating attributes should include the following:

- Convenience of one-stop home furnishings shopping
- Wide selections of
 - furniture for every room
 - floor coverings
 - home electronics
 - major appliances
- Competitive prices
- Wide-ranging price points
- Convenient, hassle-free financing
- Customer confidence and trust

Generally, the most profitable, most enduring, and least vulnerable offerings are those that afford targeted customers superior value and cannot be copied quickly or cheaply. If a value inventory reveals nothing special, then the business may be in trouble. Fortunately, the particulars that make an offering special to customers seldom need be radical. For instance, a Thai restaurant may draw a crowd at noon mainly because nearby office workers find its location convenient and relish occasional relief from Italian, Mexican, and burger cuisine.

An effective value proposition derived from the RCW value inventory would look something like this:

R. C. Willey, Utah's most trusted retailer, offers extensive selections of home furnishings, appliances, electronics, and floor coverings at all but the lowest and

the highest price points. Wide assortments, great value, one-stop shopping convenience, excellent service, and hassle-free financing add up to an unsurpassed shopping experience.

For advertising purposes, this value proposition might be reduced to,

Great value, wide selections, easy financing, and awesome service from folks you can trust!

Do firms ever need more than one value proposition? Conglomerates, which consist of multiple unrelated businesses, certainly need at least one value proposition per business. The former conglomerate Beatrice Companies, for example, maintained a portfolio of more than 500 businesses that included Max Factor cosmetics, Samsonite luggage, Culligan water softeners, Avis car rentals, Meadow Gold dairy products, Harman Kardon stereo equipment, and STP automotive products.⁶ No single value proposition could possibly have covered so many diverse offerings.

How many value propositions do companies like RadioShack and RCW need? Both companies sell more than one line of products. However, their product portfolios are much more coherent than those of conglomerates. Companies like RadioShack and RCW certainly should encapsulate what they have to offer in a comprehensive, enterprise-wide value proposition. But they also might formulate additional value propositions for each major department or product line. For example, a few square feet of each RadioShack store are dedicated to new technology, established electronic products, parts, and convenience items, such as batteries and connectors. Formulating a value proposition for each product category, in addition to a company-wide proposition, would clarify each category's contributions to the overall value creation process. Of course, the several subordinate value propositions would have to be consistent with the overall value proposition.

Define the Businesses in 3D

Businesses often are defined by products and activities, such as textile manufacturing, oil refining, grocery retailing, and the like. However, as Derek Abell pointed out, greater strategic insight can be gained from defining a business along the following three dimensions: (1) benefits provided, (2) customer groups served, and (3) technologies employed.⁷

Benefits. Goods and services are bought for the benefits customers expect to derive from them. A new luxury car, for example, provides functional transportation benefits and, possibly, ego-bolstering psychic benefits. Haircuts afford beautification and, perhaps, social acceptance benefits.

Customer groups. To avoid redundancy, customer groups must be described in terms other than benefits. For example, were fuel efficiency listed as a benefit, then defining customers as people who demand fuel efficiency would be redundant and devoid of additional insight. Demographics, lifestyle, and geography are common bases for defining consumer groups.

Technologies. Technologies deliver benefits and information to customer groups. They include

- *product technology*—for example, a recording device may be designed for magnetic, optical, or flash media and may use digital or analog encoding;
- *production technology*—for example, steel can be made using electric-arc or oxygen furnaces; and
- *supply, distribution, and marketing technology*—for example, conventional or just-in-time (JIT) parts inventorying may be used upstream; intermediaries may or may not be used downstream; and products may be packaged, displayed, and promoted using diverse media and messages.

The technologies dimension is expansive. It encompasses products per se and every aspect of making and marketing goods and services.

Flow-Chart the Model

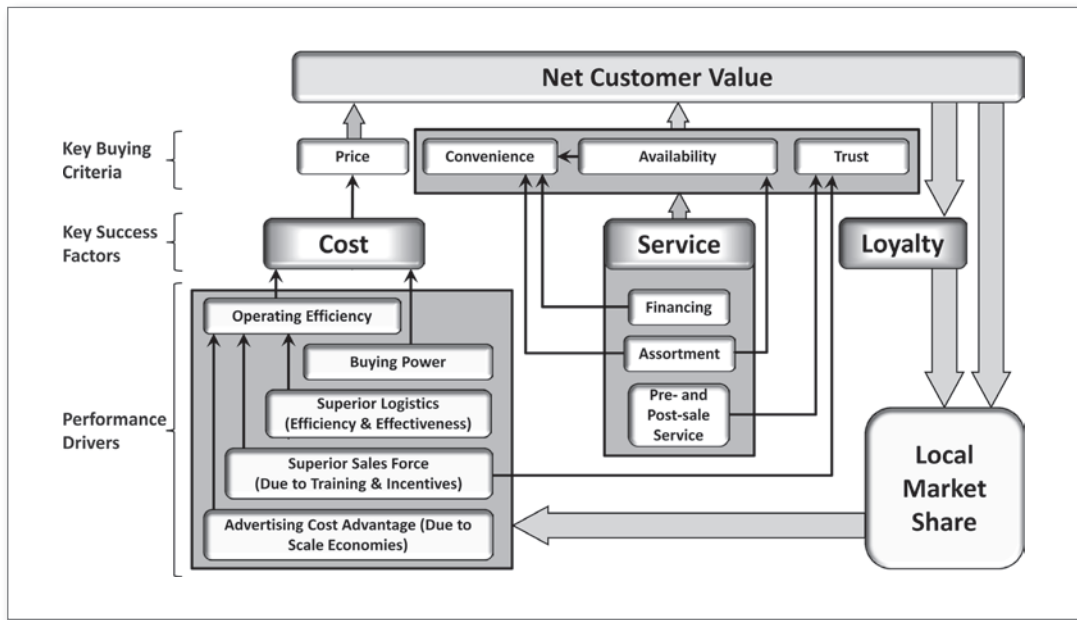
Sketching a flow diagram, like the one in Figure 3-2, may help you as much as readers of your business plan better understand how your business works and why it is expected to thrive. Figure 3-2 goes well beyond merely characterizing RCW as a value chain that retails home furnishings. It conveys how the retailer attracts and retains customers and creates net customer value. Think of *net customer value* as the difference between price and the most a customer would be willing to pay if acceptable substitute goods, services, or vendors were unavailable.

The *key buying criteria* shown in Figure 3-2 comprise the considerations that most affect targeted customers' buying decisions. Availability generally is the first consideration: Only shoppers who think they might find what they want at RCW are apt to visit an RCW store. Further, only shoppers who find merchandise that suits their wants and preferences at RCW will buy from RCW. Price, convenience, and trust generally are important additional considerations in deciding whether to visit an RCW store and in deciding whether to buy from RCW.

The system that enables RCW to offer competitive prices, provide convenient shopping, offer appealing merchandise, instill trust, and earn handsome profits is depicted as two-tiered. Key success factors (KSFs) comprise the first tier, performance drivers the second. Whereas key buying criteria reflect the customer, or demand-side, perspective, KSFs and drivers reflect the supply side. KSFs provide basic answers to the question, On what does meeting customers' buying criteria depend? Ability to profitably offer competitive prices, for example, hinges on cost. And customer loyalty, which greatly affects market share, requires generating superior net customer value.

The noted performance drivers suggest a path toward realizing KSFs, but stop short of showing exactly what must be done. Specifying precisely what should be done to manage the noted performance drivers in the future is a task deferred to a later phase of the planning process.

Figure 3-2 R.C. Willey's Business Model



In sum, Figure 3-2 paints a vivid picture of the focal enterprise's business model and anticipated path to prosperity. Depending on the enterprise, business model diagrams may be more or less complex than the one portrayed.

Note the several *virtuous loops* in Figure 3-2, which are beneficial self-reinforcing sequences. For instance, the diagram shows that market share leadership enhances buying power, which reduces cost and facilitates offering competitive, yet profitable, prices. In turn, competitive prices directly enhance net customer value and indirectly facilitate retaining or expanding market share. Further, the diagram portrays market share leadership as both a key performance driver and a result of perpetually creating superior net customer value.

REMEMBER THIS

Until readers of your business plan can envision your business clearly and understand how it creates value, they will be distracted by lingering questions and are apt to misunderstand what you have in mind. More importantly, you need to understand precisely how your venture works. So, if you are formulating a business plan, draft a verbal description of your business model now. Add a flow diagram if it helps you or your audience grasp the idea.

If your business has a long successful history, you may have no trouble explaining how the business works and creates value for customers and investors. But if it is a new venture or a venture in trouble, portraying it plausibly and precisely as a sales and profit generating system may prove difficult. It may require deep thinking, some research, and several rounds of revision.

Questions for Review and Discussion

Consider opening a hair styling salon for women. You would need stylists, of course. But you could try to attract experienced stylists who have developed a loyal clientele, or you could hire stylists fresh out of styling school.

1. Which of the two kinds of stylists would you try to attract? Why? Consider the pros and cons of your options carefully.
2. Would you hire stylists or rent booths to them?
3. Does your answer to the first question influence your answer to the second question? Explain.
4. Which generic business model would best describe your salon if you hired stylists, rather than rented booths to them? How many value propositions would you need? What would the main selling points of each proposition be?
5. Which generic business model would best describe your salon if you rented booths to stylists? How many value propositions would you need? What would the main selling points of each proposition be?

Notes

1. C. A. Montgomery, R. Kaufman, and C. Winkler, "Newell Rubbermaid: Strategy in Transition," Case 9-704-491, Boston: Harvard Business Publishing, 2005.
2. C. B. Stabell and Ø. D. Fjeldstad, "Configuring Value for Competitive Advantage: On Chains, Shops, and Networks," *Strategic Management Journal*, 19, 1998, pp. 413–437.
3. E. K. Valentin and H. Hess-Lindquist, "MarketStar: A Channel Services Pioneer," *Business Case Journal*, Winter 2006–2007, pp. 32–48.
4. A. Afuah, *Business Models: A Strategic Management Approach*, New York: McGraw Hill/Irwin, 2004, p. 136.
5. R. C. Willey is one of several home furnishings retailers in Warren Buffett's Berkshire-Hathaway portfolio. See E. K. Valentin and J. T. Storey, "R. C. Willey Home Furnishings," *Business Case Journal*, Summer 2002, pp. 99–116.
6. T. Stuart, "Beatrice Companies—1985," in D. J. Collis and C. A. Montgomery, *Corporate Strategy: Resources and Scope of the Firm*, Homewood, IL: Irwin, 1997, pp. 684–700.
7. D. F. Abell, *Defining the Business: The Starting Point of Strategic Planning*, Englewood Cliffs, NJ: Prentice-Hall, 1980.