

Business Models: What Are They and Why Are They Important?

Abstract:

A business model is a template that conveys the essence of how a company creates, delivers, and captures value within a customer segment. It is more detailed than an elevator speech and established corporations as well as startups are beginning to recognize its value from an organizational alignment and strategic planning perspective. This white paper describes the use of a particular format called the Business Model Canvas. The canvas is designed for use in a group setting and enables rapid integration of ideas that generate unique versions of value generating configurations. Thus, executives or startup teams can efficiently create, evaluate, and select what they consider the best competitive configurations and then test them with prospects or customers. This type of iterative process facilitates a robust strategic process that is appropriate for all organizations including startups.

What is a Business Model?

Business model terminology became prominent during the dot-com era due to the impact of the internet on business relationships. For example, analysts would refer to internet startups as having advertising, auction, markup, production, and/or subscription business models. This short hand terminology focused on revenues not on how the firm earns a profit (value proposition). Other published definitions include the following:

- A company's business model deals with the revenue-cost-profit economics of its strategy.
- A unique configuration of elements comprising the organization's goals, strategies, processes, technologies, and structure, conceived to create value for customers and thus compete successfully in a particular market.
- A template or prototype comprising the core set of organizational processes and patterns of behavior that form the basis for continuing viability of the organization.
- A viable business model is a strategy that has a reasonable probability of succeeding if well executed.
- A firm's business model is how it plans to make money long term.
- A business model describes how the engine of the business actually works.
- A business model describes the way in which a company makes money.

Each of these definitions have merit however individually they reflect a different scope and methodology for arriving at a descriptive model. For example, based on these definitions, some practitioners might view the model as a spreadsheet, simulation, document, or graphical representation.

From a pragmatic standpoint the real issue regarding a definition is what role does the business model play in the process of developing a strategic plan and executing it? Is the business model a precursor in the strategy process or a footnote? If the business model is a precursor, then it must take a form that helps to identify opportunities and relationships whereas if it is a footnote, it is a synopsis of the strategy document. Obviously, the precursor view of the model offers the greatest potential for contributing to the quality of the strategic process.

Competitive strategy revolves around the delivery of value to a customer and being rewarded for it. A niche strategy suggests the ability to deliver a unique value to a targeted sub-group of customer

segment. Differentiation implies a value perspective. Lastly, low cost provider suggests the customer perceives little meaningful differentiation among suppliers. Thus, if a business model is going to serve as a precursor it must address customers, the creation of value, and the resultant generation of acceptable profit levels. This suggests the following definition:

- A business model describes the rationale of how an organization creates, delivers, and captures value.

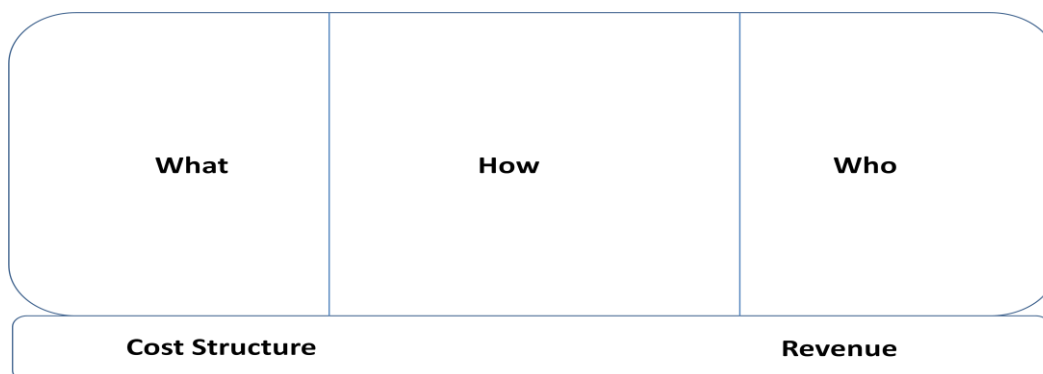
Note that the definition uses the term rationale which implies that it establishes a linkage of cause and effect. Thus, the implication is that the model provides a framework for understanding and communicating the drivers as well the recipients of the value process.

Business Model Role

The format for the business model must reflect its role in the strategic planning process. A business model is a tool that serves a specific purpose within the planning process. If that role is one of facilitating group input, understanding of cause/effect linkage, and commitment to the ultimate strategic choices, then an easy to understand, visual model is desirable. One excellent example of this type of format is one created by Alexander Osterwalder referred to as the Business Model Canvas.

Business Model Canvas

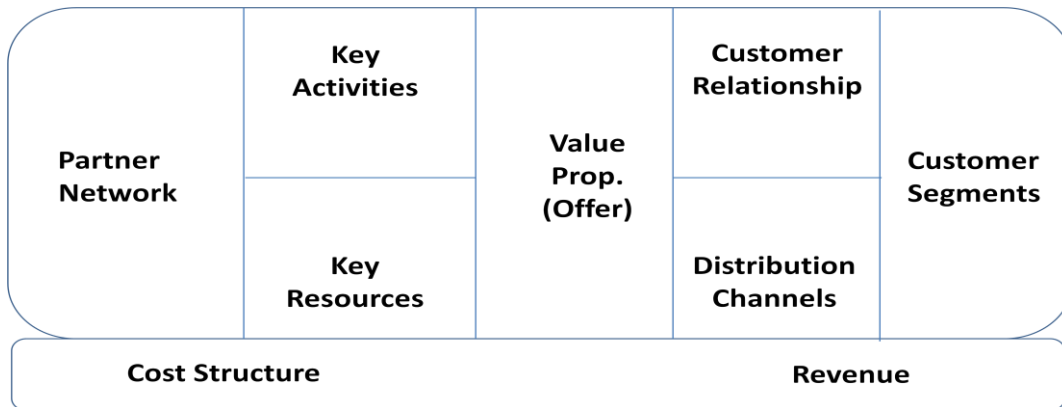
The focus of the Business Model Canvas is to capture a unique configuration of value delivery with a given customer segment. The major configuration elements include: how, what, who, and a comparison of projected cost versus revenue sources. The canvas offers the following format.



This configuration addresses the major elements of a value chain:

1. *Who* pertains to the customer type or segment being served?
2. *What* is the value being delivered?
3. *How* is the value created?
4. *Cost* represents elements of incremental cost associated with the value configuration.
5. *Revenue* reflects how revenue will be captured to create sustainable profitability.

Thus the format fulfills the definition of a business model. However, it lacks sufficient specificity to have credibility as a viable option. To remedy this short coming, the Canvas expands the detail as follows:



The *How* section now provides detail relative to external resources (partners) used to generate value. Which elements within the network are involved and are there key activities/resources that are pivotal to value delivery?

The *What* section becomes the value proposition referred to as the Offer.

The *Who* section is divided into three subsections. The value proposition should be specific customer segment that hopefully is targetable. A business model is only viable if the customer relationship can be sustained i.e. how the relationship is maintained. Lastly, the channel must be identified. Is the channel appropriate for delivering the value proposition.

The profitability of the business model must then be assessed. What incremental costs are involved? How can revenue be captured to achieve target profitability and will this model generate sufficient profit to contribute to total profit and/or meet a reasonable break-even threshold?

Inspiration, Insight, and Commitment

Strategic planning often gravitates to a process of extrapolating history and a commitment to organizational initiatives. This behavior often reflects an organization that has little insight regarding cause and effect and is therefore destined to continue the status quo. With this mindset, the business model tool has very limited potential for success.

If an organization is focused on understanding cause and effect, the Business Model Canvas can be a very effective tool for generating ideas and prioritizing options. The Canvas is really designed for group problem solving. With fairly minimal instruction, a group of functional leaders can rapidly generate a series of models and then review and prioritize them. The best models can be worked is greater detail in preparation for inclusion in the strategic plan. Participation promotes common purpose and commitment. The process can be designed to explain the business model to levels and functions not represented in the original effort thereby gaining insight, feedback, and ownership throughout the organization. Thus, the Canvas becomes an organizational lightning rod for focusing on delivering value and moving the organization cohesively toward a viable strategy of competitive advantage.



About The Author

Glen S. Petersen is an internationally recognized speaker, writer, practitioner, and thought leader. Mr. Petersen has held senior level management positions with systems integration and end user organizations and is the Managing Director of GSP & Associates LLC, a consulting firm dedicated to helping organizations leverage their competitive capabilities.

Mr. Petersen can be reached at 505-401-0199 or gpetersen@competitiveperformance.com