

Chapter 1

What Is a Business Model and Why Does It Matter?

In This Chapter

- ▶ Examining advanced business planning, also known as business models
 - ▶ Speeding time to profit with a better business model
 - ▶ Discovering why governments, families, churches, and businesses all have a model
 - ▶ Predicting the future of business models
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So what is a business model anyway? Is it the way you make money? Yes, in part. Is it competitive advantage? Yes, in part. Is it your business plan? Not really. Simply put, a *business model* is your profit formula. It's the method you use to acquire customers, service them, and make money doing so. I like to break down a business model into three primary areas: Offering, monetization, and sustainability. What is your offering? How will you monetize the offering? How will you sustain it?

Your business model creates not only the formula by which you make money, but also the strategic context of the organization.

Simply put, a business model is the framework of rules and “moral” imperatives within which the business operates. It provides the strategic context for both the long and short term. It defines and articulates strategic intent, which then becomes the common focus and driver among all levels of strategic management (**Mission, Objectives, Strategy, and Tactics**). The combination of these four becomes the compass and laws by which the organization navigates and the glue that holds it all together.

Many managers believe that all they need is a business plan, but business plans are at best reactive. In today's turbulent environment, the best way to be proactive is to have a strong business model. This book outlines an accessible way to refine the essence of your business and build it into a durable and superior model.

History of Business Models

The notion of a business model may be relatively new, but the study of business in general has been going on for centuries. The notion of a business plan has been around since the late 1800s. Since then, business planning has grown from a mere notion to a science. Colleges offer courses in business planning. Software and templates have been created, and the general business public is well skilled in the practice.

Next came the concept of entrepreneurship. If you look at the rise of entrepreneurship, you see that it's grown from a vague concept in the 1960s to a major discipline in which you can now get a business degree. If you talk to recent college graduates about careers, a significant and growing percentage of them want to work for an entrepreneurial company or want to start a company of their own one day. Never before has entrepreneurship been celebrated the way it is today — both in the real world and in the academic world, where special programs and degrees are offered in entrepreneurship.

The study of business models can be called “advanced entrepreneurship.” The business model picks up where entrepreneurship leaves off and will, I believe for reasons that are becoming increasingly apparent, become the next wave of interest within the business community.

Business Models Are a Hot Topic

Aside from simple evolution in business thinking, business models are a hot topic for one reason — speed profit. There used to be an old saying in business, “It takes 15 years to become an overnight success.” The gist of this saying was that a business owner needed to toil in anonymity for 15 years before becoming tremendously successful. Today, business moves much faster, and tremendous profitability can be achieved almost overnight.

Fifteen years ago, Mark Zuckerberg, founder of Facebook, was in middle school. Most people had never heard of Google or Amazon, and Spanx undergarments weren't even a glimmer in Sara Blakely's eye. Today all these entrepreneurs are billionaires. Commerce is worldwide and moves significantly faster, creating better opportunities for better businesses. There's simply no need to slog it out for 15 years.

As businesses became very successful quickly, people started to ask, “How can this happen?” The only logical answer was superior business models. With financial stakes resembling lottery winnings, business models gained more and more attention.



Business models aren't a fad. A strong business model is at the heart of a strong business and is the key to its profitability. Business models take all the complexity of a multibillion dollar business and boil it down to an easy-to-communicate profitable essence.

Who Needs a Business Model?

Why is a business model suddenly necessary? People have operated successful businesses for centuries without a business model — or have they?

Sun Tzu is widely believed to have provided Napoleon with a quantum shift in thinking, which led to the development of the model through which Napoleon's early successes were won. It's argued that when he moved away from the fundamentals of his business model and started to rely heavily on plans that didn't take into account the sustainability of his actions, he was defeated. The one thing Sun Tzu espoused loud and often was to consider all aspects and influences of the job at hand. This concept elevated management to a high art. Sun Tzu believed it was critical not only to lay a great plan but also to be flexible and make excellent decisions when things became fluid.

Whether you're an army general or a donut shop owner, every organization has and needs a business model. Schools have business models. Not-for-profit organizations have business models. Families have business models. Even governments have business models.

Take the example of capitalism versus socialism. Just like the business model determines the operational context of the business, capitalism or socialism determines the operational context of a society. One could argue that capitalism has proven to be a more successful business model for governments than socialism.

Extrapolated to the next level, one could argue that communist societies didn't shift to capitalism for ideological or humanitarian reasons but shifted to a more effective business model for a government.



For your organization to operate at maximum effectiveness, an up-to-date and innovative business model is a necessity.

Value of a Business Model

If you search the Internet you can find many lists ranking the value of top brands such as Coca-Cola, Starbucks, and McDonald's. According to these

lists, the value of these brands is in the billions. The goodwill of these brands has tremendous value, but the brand alone is worth far less than the brand integrated into a strong business model.

A business can profit in many ways. I can start a lawn mowing business, walk across the street, and charge \$25 to mow my neighbor's yard. The business would profit but wouldn't enjoy a strong business model. I could add experience and working smart to the equation and profit a bit more. I could even write a business plan to increase the profitability. But this business model is very limited. In order to create a powerful lawn mowing business, I must add a good business model on top of these other criteria. I call this concept the *profit ladder*. Figure 1-1 shows this ladder.

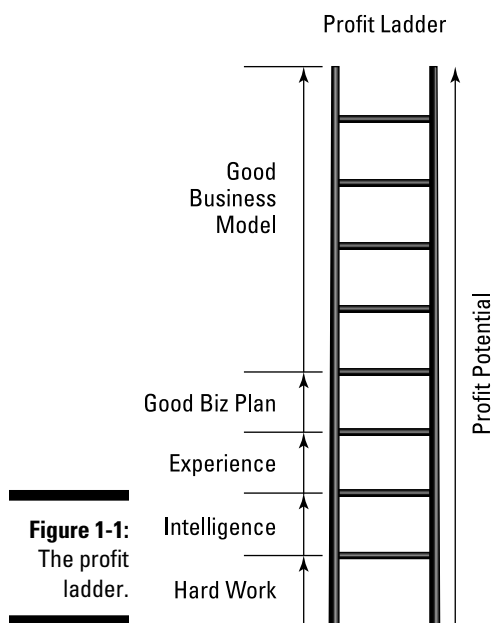


Figure 1-1:
The profit
ladder.

As you can see, the greatest amount of profit is created via the strength of the business model. Hard work, experience, and planning alone can't create an extremely profitable business. You must also have a business model that complements your efforts.

No better example of the value of a business model exists than the growth of franchising. After all, what are you really buying if you buy a franchise? You're buying a proven business model. Here's a brief history of franchising in the United States:

- ✓ In 1898, William E. Metzger of Detroit became the first official dealer/franchisee of General Motors Corporation (GM).
- ✓ In 1899, Coca-Cola sold its first franchise.
- ✓ In 1950, fewer than 100 companies used franchising in their marketing operations. By 1960, more than 900 companies had franchise operations involving an estimated 200,000 franchised outlets.
- ✓ In 1986, the U.S. Department of Commerce estimated that retail sales by franchised establishments represented 34 percent of all retail sales.
- ✓ According to a survey conducted for the International Franchise Association's Educational Foundation, as of 2001, there were more than 767,483 franchise-related businesses.
- ✓ Studies indicate a new franchise business opens approximately every five to eight minutes of each business day, and that franchises are, on average, more profitable than company-owned locations.
- ✓ Scott Shane, author, venture capitalist, and professor of Entrepreneurial Studies at Case Western Reserve University, observes that some 71 percent of start-ups will have gone out of business by year ten. According to the U.S. Department of Commerce, 95 percent of all franchises are successful.

Franchising continues to grow in popularity as entrepreneurs recognize the business model as the core of business success.

Future of Business Models

No one would have imagined the creative business models of today just a few decades ago. No one knows what the business models of tomorrow will be, but here are a few safe bets.

Increased sophistication

Just like entrepreneurship has advanced due to increased emphasis and study, so will business models. As educational institutions add business model study to their curriculum, business models will become more sophisticated. Additionally, as the entrepreneurial community recognizes the value of business models, increased focus outside the classroom will make business models improve at a greater pace than today.

More virtual goods

The Internet may seem like it's been around forever, but the Internet is still a baby. Consumers are still getting used to the purchase of electrons versus the purchase of something you can hold in your hand. Virtual goods commerce is still in its infancy. Even successful companies like Facebook have only scratched the surface of selling virtual goods, relying on old-fashioned billboards (albeit electronic) for the bulk of their revenue.

The business models of tomorrow will find creative ways to develop and sell virtual goods. With instant worldwide access to these goods, a successful virtual product has the ability to make billions in a few days. Imagine a product as hot as a Cabbage Patch doll or Beanie Baby being sold virtually on the Internet.

Intellectual property protection

As the sale of intellectual property and virtual goods becomes more commonplace, look for entrepreneurs to find better ways to protect their valued property. Hopefully, governments will realize the need for protection of ideas in a knowledge-based economy and accelerate this process. Even if governments fail to assist entrepreneurs, they'll find creative ways to leverage worldwide access to sellable intellectual property.

Leveraging transparency

Ask Best Buy, Target, or car dealers how they feel about transparency. You better duck because they'll probably throw something at you. How would you like to be Best Buy, spending millions to display television sets for potential customers only to have them scan the barcode into Amazon's price check and purchase the same TV online?

Information is plentiful and easy to access today. This abundance of information creates a transparency for businesses that's unprecedented. Everything from employee pay, vendor cost, rent, annual profits, and competitor pricing is instantly available. This scourge of transparency is killing many retail business models and making life difficult for many others.

The successful business models of tomorrow will find a way to leverage this transparency rather than fight it. Amazon benefits from pricing transparency while Best Buy suffers because of it. This form of leveraging transparency is rudimentary compared to what you'll see in the future. Successful business models will do more than just offer the lowest price. These models will harness the wealth of information to the benefit of all parties — not just the vendor offering the lowest cost.

The power of efficient operators

Because information is so readily available to customers, the most efficient operators in a market will enjoy expanded benefits. Business models designed to be more efficient, not just cheaper, than the competition will be well known to all potential consumers.

The successful business models will gain efficiency through innovation, not cost-cutting. Amazon is more efficient than many retailers not because it sells on the Internet but because its business model doesn't use retail locations in conjunction with the Internet. Walmart gained competitive advantage in the 1980s by leveraging technology that lowered logistical costs and passed the savings on to consumers — that's a business model. For instance, the use of crowdsourcing can create significant efficiencies in a business model, making the company the most efficient operator. (I address crowdsourcing in more detail in Chapter 20.)

You say business model, I say tomahto

As the old saying goes, "You say tomato, I say tomahto." Businesspeople tend to speak their own jargon, much of it specific to particular industries or occupations. This specialized vocabulary often leads to confusion and the conflation or outright misuse of terms. A business school professor may define a term one way, and a group of business owners in a specific industry may define it another way. Here I give you a list of terms that people often conflate with *business model* and a brief explanation of how each term differs:

- ✓ **Business architecture:** This term refers to a part of an enterprise architecture related to corporate business, and the documents and diagrams that describe that architectural structure of business. Business architecture discusses the functional structure of an enterprise in terms of its business services and business information.
- ✓ **Business foundation:** This term is typically used to describe the key asset of the

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business. This could be an invention like the Xerox copier, an excellent physical location, special talents of the owner, or a way of doing business, as in the case of Virgin Airlines. A business model incorporates the business foundation but adds additional elements.

- ✔ **Business plan:** Many components of a business plan are present in a business model. In particular, the marketing elements overlap extensively. However, the business plan is designed to demonstrate the viability of the business enterprise and covers many operational and financial aspects not present in a business model.

The following terms are subcomponents of a business model:

- ✔ **Customer generation model:** Okay, you can generate lots of customers. Can you make money from them? Can you keep them long term?
- ✔ **Competitive advantage:** A business model is more encompassing than your competitive advantage. You can have competitive advantage but fail to turn it into a solid business model.
- ✔ **Competitive strategy:** The long-term action plan designed to create and increase the company's competitive advantage over rivals. How you'll beat the competition is important, but you need to have a great product and sales strategy in order to do so.
- ✔ **Revenue model:** Your revenue model is the method you use to create sales without regard to how profitable they may be. Your revenue model may create sales that are unprofitable, or the model may work fine today, but can it be sustained?
- ✔ **Profit formula:** Your profit formula determines the methods and amount you profit when you make sales. This is an important part of your revenue model. However, you can have an excellent profit formula but fail to lure buyers.
- ✔ **Strategic advantage:** A strategic advantage is the most powerful weapon in a company's arsenal — think of Coke or the Starbucks brand, the best corner location in town, or a website's lower cost structure than brick and mortar competitors. Many turn-of-the-century steel mills were located in Pittsburgh because of the strategic advantage the local three rivers created. However, you can have a strategic advantage like the best location, but without a strong offering and monetization, you still don't have a strong business model.
- ✔ **Value proposition:** Your value proposition explains why your offering is worth more to the customer than what you're charging as well as why the customer should value your product over competitors' offerings. You can have a strong value proposition but target the offering at the wrong customer segment, have an inadequate monetization formula, or fall prey to pitfalls.