1 Why Do Business Models Matter? The "What, How, Who, and Why" Framework for Understanding Any Business Model

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Why Do Business Models Matter?

In the past few decades, innovations in computing and information technologies have accelerated, instigating a fundamental shift in the economic and competitive landscapes. The changes that this shift has been fueling are pervasive, comprehensive, and disruptive. Often touted as the "digitalization of business," they go far beyond increasing firm efficiency

and profitability through digitizing individual processes or functions within firms. They are profound, holistic, and may shake firms to their core. They encompass every industry in every corner of the world. They present new and exciting business opportunities in industries that were considered all but immune to attacks from newcomers. These developments present enormous opportunities for aspiring entrepreneurs whose innovative business models can disrupt entire industries, as Airbnb did in the hospitality industry, or Uber did in the industry for personal transportation. Managers of incumbent firms need to explore new possibilities for value creation that are anchored in the redesign of their firms' business models, as Charles Schwab, the financial services firm, did when it transformed its business model from call center-assisted trades to enabling clients to trade electronically themselves using a web-based platform. On the flip side, every manager of every well-performing firm needs to take seriously the possibility of eroding margins that result from competitors' business model innovations.

A business model is about "how to do business," and business model innovation is about "how to do business in new ways." Together, they have become crucial strategic issues for general managers, entrepreneurs, investors, and all those aspiring to assume any of these important roles at some point in their professional careers. Hardly recognized or talked about until the end of the last century, the concept of the business model suddenly became "en vogue" in the mid-1990s, emerging as a key topic in conversations about new business opportunities and how to capture them (see Exhibit 1.1). It has since become a core ingredient for opportunity analysis and development, and has yielded the development of important new tools such as the Business Model Canvas.[1] Our book presents an important step forward in several aspects: first, by offering a unique blend of scientific concepts and insights with practical tools and examples; second, by providing an actionable framework for business model innovation that focuses on needs and activities; third, by highlighting the strategic aspects of business model innovation; and, last but not least, by adding a dynamic dimension that considers the entire process – from inspiration to implementation of business model innovation.

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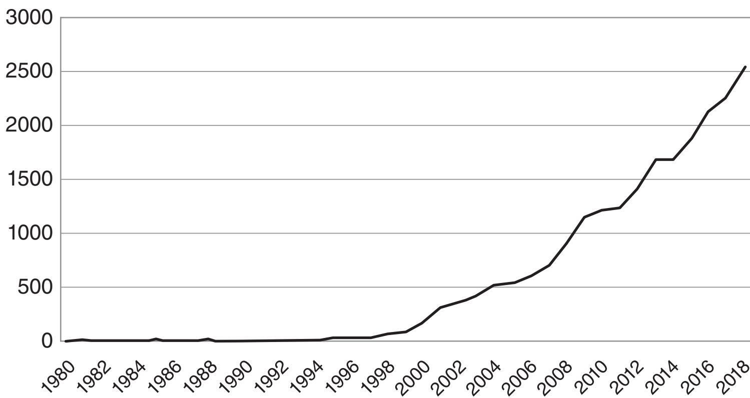
[1] Osterwalder and Pigneur (2010)

Exhibit 1.1 Interest in Business Models as Measured by Published Articles



The "take-off" of the business model as an important determinant of a company's financial performance occurred in parallel with the introduction of the internet, the development of the first browsers (such as Netscape) that made the internet technology accessible to the broader public, and the ability to monetize business model innovation, as evidenced by the sky-high valuations of IPOs (Initial Public Offerings)[2] in the second half of the 1990s and the early 2000s. This period saw the first wave of companies, including Amazon, eBay, Google, and Yahoo, that used internet technology to power their innovative business models and thereby reach millions of customers. Three of these firms had their IPOs in 1996–98 (Google went public in 2004). Compared to their established competitors, these companies introduced entirely new ways of doing business.

Amazon began as an online bookseller, which fundamentally changed the way customers shopped for books. eBay established an online platform

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[2]The term Initial Public Offering refers to the issuance of shares to the public during the first listing of a company on a stock exchange. It marks a change in the shareholding structure of a company from being closely held and privately owned to being a widely held public company. An IPO is often carried out for the purpose of raising a significant amount of capital relatively cheaply to finance the growth of the company and to eventually provide liquidity for early investors, founders, and employees through subsequent secondary share offerings.

where individuals could buy used goods from specific sellers, not unlike a flea market but on a much larger scale, and without requiring the physical presence of either buyer or seller (or, for that matter, the goods being sold). And Google and Yahoo offered new ways for people to search for and consume information, thus also offering new opportunities for advertisers to deliver their messages to large numbers of potential target customers in a highly tailored and personalized fashion.

These early success stories suggested that something about business had fundamentally changed. It was not, as some pundits had initially believed, that the world had entered a new era of boundless opportunities and goldilocks economies in which the received economic laws were no longer valid. The stock market crash of 2001 and the subsequent failures of firms that had once been much hyped about and had attained high valuations (such as Webvan or Boo.com) made this abundantly clear. Yet, despite all the skepticism that followed the initial hype in the wake of the stock market bust, Amazon, eBay, Google, and Yahoo managed to survive, and with them the insight that technology-enabled business model innovations had become a new reality for managers to be reckoned with; that is, managers realized that leveraging and deploying advanced computing and communication technologies in order to create value for a firm's stakeholders presented a fundamental challenge to the status quo of their firms. So, what exactly had changed? What was new?

Quite simply, the business model had become one of the core strategic choices that general managers and entrepreneurs (and those who support and invest in them) need to consider. It answers the question: How should the firm do business?[3] For decades, the key strategic decisions that managers and entrepreneurs were asked to address, which were also highlighted in management courses, centered on: (i) corporate strategy issues, and (ii) business strategy issues. Corporate strategy issues concern the scope of the firm and include such questions as: What industries and product market segments should the firm be in? How should the firm enter these markets (i.e., through mergers and acquisitions, joint ventures, or de novo entry)? When should the firm enter these markets? Business strategy issues center

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[3]Note that this is a colloquial definition meant to give you a first intuitive understanding of the concept; we will present a more formal and rigorous definition below.

on establishing and sustaining the competitive advantage of a firm. They include such questions as how to compete in a particular product market (e.g., compete on the basis of differentiation or cost leadership?), and what resources and capabilities to acquire or develop.

The advent of the internet did not undermine the importance of these classic choices; they remain as valid and relevant as ever. However, it added an essential strategic choice onto the entrepreneur's and general manager's plates, namely the question of *how to do business*. This question does not replace, or diminish the importance of, any of the previously mentioned strategic issues. Rather, it complements them and thus expands the range of strategically relevant considerations for entrepreneurs and managers who are keen on pursuing and exploiting new business opportunities in addition to defending and securing their existing ones. In other words, addressing the business model question has become a strategic imperative for entrepreneurial leaders. Technological change – mainly in information and telecommunication technologies, as we will explain in more depth in Chapter 5 – has enabled the development of entirely new business models, whereas in the past technological change mainly spurred the development of new products and processes.

For example, Reed Hastings and Marc Randolph, the co-founders of Netflix, which was incorporated in 1997, utilized the internet to introduce a business model innovation in the video rental industry. Up until that point, the industry had been dominated by incumbents such as Blockbuster. Now, instead of picking up a movie at a specialized rental shop, customers could receive DVD rentals from Netflix through the mail.[4] This represented a business model innovation, as it involved an entirely new way of doing business, for which Netflix even secured a business method patent. The new model relied on customers selecting and renting movies online instead of going to a shop; burning DVDs in partnership with DVD manufacturers just-in-time as customers ordered the movies; and shipping the DVDs via the United States Postal Service with a pre-paid return envelope directly to the customers.

Senior managers are well aware of the threat posed by disruptive digital newcomers. A survey conducted among C-level executives finds that "competition isn't just coming from new permutations of old industries . . . it's

[4]Teece (2010)

also coming from digital invaders with totally different business models."[5] One of these digital invaders, Uber, was created in 2009. In its last pre-IPO private equity financing round on August 27, 2018, Uber raised $500 million at a pre-money valuation of $71.5bn with reported 2017 revenues of $7.5bn.[6] This compared with a market valuation of about $34bn (about half of Uber's) for Ford Motor Company in late 2018, on annual revenues of approximately $160bn (about 20 times Uber's 2017 revenues).[7] Ford, a pioneering car manufacturer, was founded in 1903, over a century before Uber. Clearly, investors expected Uber to do well in the market for personal transport, estimated at $10tr annually.[8] Another digital invader, Airbnb, a home-sharing company founded in 2008, was valued in 2018 at $31bn on estimated annual revenues of $3.5bn for 2017.[9] This company, which does not own or operate any real estate, was widely considered a challenger to the hotel industry, which had not seen any significant innovation for decades until the rise of home-sharing business models. In comparison, Hilton, an established hotel chain with a well-known global brand, had a market valuation of $21bn that was about 30% lower than that of Airbnb.[10] The differences between the valuations of incumbents such as Hilton and Ford, and the new entrants into their industries such as Airbnb and Uber, respectively, can be attributed in part to their vastly different business model designs. More specifically, it can be attributed to their technology-driven business model innovations. Airbnb did not just invent a new hotel format; it introduced an entirely new method for providing a place to stay for those in need of accommodation.

In a nutshell, business models and in particular business model innovations matter because they are a source of opportunity for entrepreneurs and for entrepreneurially minded managers (who are sometimes called *intrapreneurs*) in established firms. They also matter because they have financial performance consequences. Business model innovation refers to

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[5]IBM Institute for Business Value (2015, p. 5)
[6]Bond and Fontanella-Khan (2018), Hook (2018), and Crunchbase website. Uber. Funding rounds.
[7]Ford Motor Company (2019)
[8]The Economist (2016)
[9]Lex (2018)
[10]Lex (2018)

the conceptualization and implementation of new ways of doing business in order to better address the imperfectly met needs of customers and other market participants such as suppliers. Business models are a locus of innovation and value creation, as the founders of Uber – Garrett Camp and Travis Kalanick – or the founders of Airbnb – Brian Chesky, Joe Gebbia, and Nathan Blecharczyk – can testify. For new ventures as well as for established firms, they open new paths for exploiting market opportunities, beyond coming up with new products or services.

Car manufacturers like Volkswagen (VW) have clearly understood the strategic importance of business model thinking for their own future market positioning and success. Volkswagen's decisive move into the electric car business with a €30bn investment program announced in 2018 is not just product-driven but goes beyond the automobile industry's classic paradigm of competing on product characteristics such as car design, performance, quality, or price.[11] The German company seeks to emulate in the auto industry Apple's platform-driven business model by providing a unifying chassis that serves as a basic building block for different electric car models. Powered by a proprietary operating system that will allow for over-the-air software updates and support various apps, much like an iPhone, the platform is intended to provide a new digital in-car experience. Like the Apple Store or Google Play, the IT infrastructure will be open to third-party apps and so create a "shopping mall" for new digital services.[12] The key idea behind VW's strategy, therefore, is not just to make the production of electric cars cheaper and to establish an industry standard (a goal is for their chassis to eventually be licensed to other car manufacturers), but to get closer to the customer and sell them new digital services on an ongoing basis, much like Apple is doing in the mobile phone business. Like Tesla, VW even aims at replicating Apple's retailing model, bypassing traditional car dealerships and setting up company-owned stores that function as showrooms.[13] These measures go beyond mere product or service innovations; instead, they represent a business model innovation. In the section

[11] McGee (2019)
[12] VW chief operating officer Ralf Brandstätter quoted in the *Financial Times* (McGee, 2019)
[13] Ramsey (2018)

that follows, we offer a more formal and precise definition of our core concepts.

What Is a Business Model?

In what follows we briefly review a range of approaches to defining a business model and identify common themes that form the foundations for our definition of a business model as an interdependent activity system that may span both firm and industry boundaries. The way we define it, a business model is designed to capture a perceived market opportunity in a way that creates value for all stakeholders. We proceed to identify the four dimensions of a business model, namely, (i) its content, i.e., *what* activities the business model is composed of; (ii) its structure, i.e., *how* these activities are linked in the business model; (iii) its governance, i.e., *who* performs the activities that are enabled by the business model; and (iv) its value logic, i.e., *why* does the business model create value and *why* does it also enable value appropriation through a revenue model.

Approaches Towards Defining Business Models

In the academic literature, different conceptualizations of the term "business model" have been proposed.[14] Broadly speaking, some business model concepts center on value creation, while others focus more on mechanisms for value appropriation.

The value creation perspective of the business model, which is the one we embrace in this book, has been advanced to capture the essence of "how firms do business."[15] It describes the business model as a source of innovation when, for example, it connects previously unconnected parties (such as private drivers and passengers in the case of Uber), links stakeholders in new ways, or introduces new transaction mechanisms (as in the case of eBay). Not surprisingly, this view of the business model focuses on activities, and the ways these activities are linked with one another,

[14] Zott, Amit, and Massa (2011)
[15] See Amit and Zott (2001); and Zott and Amit (2007, 2008)

to address the "how to" question. Others have advocated a more encompassing definition of the term, with greater emphasis on value appropriation.[16]

Despite the absence of a clear consensus in the academic literature on a universally accepted definition, researchers have converged on some important common themes that characterize business models. Specifically,

- Business models center on the logic of how value is created for all stakeholders, not just how it is captured by one firm.
- Activities performed by the focal firm play an important role, but so too do the activities performed by partners, suppliers, and even customers.
- Business models emphasize a system-level, holistic approach to explaining how firms "do business."
- The business model is emerging as a new focal point for analysis.[17]

Taken together, these four themes represent a common denominator that points toward the business model as a concept that builds on that of the well-established value chain, which represents the firm's "collection of activities that are performed to design, produce, market, deliver, and support its product."[18] Although the notion of the business model draws on arguments that are central to the value chain framework, in particular that activities and multiple sources of value matter, it extends those arguments in important ways. The business model extends the concept of the value chain by (i) emphasizing value creation and delivery dynamics, (ii) spanning firm and industry boundaries, and (iii) allowing for a non-linear sequencing

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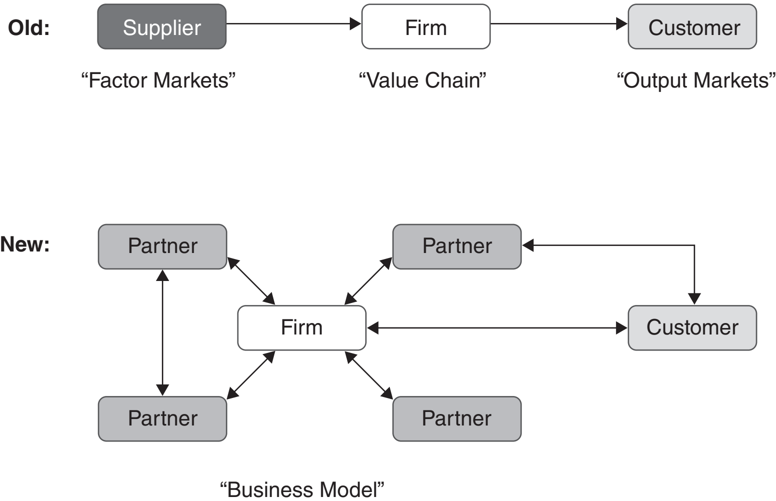
[16]For example, see Osterwalder and Pigneur (2010), or Chesbrough and Rosenbloom (2002, p. 529) who link the business model to the technology management literature and define it as the "heuristic logic that connects technical potential with the realization of economic value," emphasizing its role in linking technology to market outcomes. Consistent with this perspective, Casadesus-Masanell and Ricart (2010) posit that one important component of business models is the set of choices made by management regarding how the organization operates, such as compensation practices, procurement contracts, location of facilities, or assets employed. Another component of business models, according to this view, is reflected in the consequences of these choices, such as low cost or a culture of frugality. For other definitions, see Zott, Amit, and Massa (2011).

[17]Zott, Amit, and Massa (2011)

[18]Porter (1985)

Exhibit 1.2 From Value Chain to Business Model



of interdependent activities. (See Exhibit 1.2.) These are each explained in more detail below.

- *Emphasizing value creation and delivery dynamics*: Amazon has widely deployed artificial intelligence (AI) across its business to help build and deliver value for its customers and partners.[19] Since its early years, for instance, it has used AI algorithms to provide customized product recommendations for customers. These algorithms more generally help Amazon learn about customer preferences and behavior, then dynamically implement this knowledge. This is reflected in a product offering that not only better meets current consumer demand but also anticipates *future* demand. Anticipating demand in turn leads to faster delivery times, as goods can be proactively stocked in strategic locations. In Amazon's model, value creation and delivery therefore become *circular* rather than strictly *linear*. Over time, and as its number of customers (and therefore transactions) has increased, Amazon's algorithms have become more advanced, helping it build a product and product delivery activity system that is highly responsive to customer needs.[20]

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[19]Levy (2018) and Terdiman (2018)
[20]Terdiman (2018)

- *Spanning firm and industry boundaries*: In the early 1980s, TradePlus (today known as E★TRADE) introduced a groundbreaking online direct brokerage platform that enabled the execution of the "first-ever electronic trade by an individual investor."[21] As this new platform removed the need to go through a stockbroker, and made trading significantly more cost-effective, individuals could trade stocks at a highly affordable price. E★TRADE's platform model connects an expansive, industry-spanning range of participants: individual investors, small business owners, companies that are publicly traded, and large market makers such as Citadel.
- *Allowing for a non-linear sequencing of interdependent activities*: On eBay's auction platform, the pricing of individual items is determined via a dynamic auction process. Customers browse product listings, then interact with each other to set the final price of an item (by setting interdependent bids). These customer activities – browsing and bidding – occur simultaneously and interactively, i.e., in a non-linear fashion.

Our Definition: The Business Model as an Activity System

Building on the four themes identified above, we formally define the **business model** as *the system of interdependent activities that are performed by a focal firm and by its partners and the mechanisms that link these activities to each other*. An **activity** in a focal firm's business model can be viewed as *the engagement of human, physical, and/or capital resources of any party to the business model (the focal firm, end customers, vendors, etc.) to serve a specific purpose toward the fulfillment of the overall objective*. An **activity system** is a *set of interdependent and interconnected activities that are centered on a focal firm; it encompasses activities that are conducted either by the focal firm or by partners, customers, or vendors*.[22]

Business models are created by entrepreneurial leaders who shape and design organizational activities as well as the links (transactions) that weave activities together into a system. Such purposeful design – within and across firm boundaries – is the essence of the business model.[23] The architecture of the firm's activity system – shaped by the choice of activities, how they are

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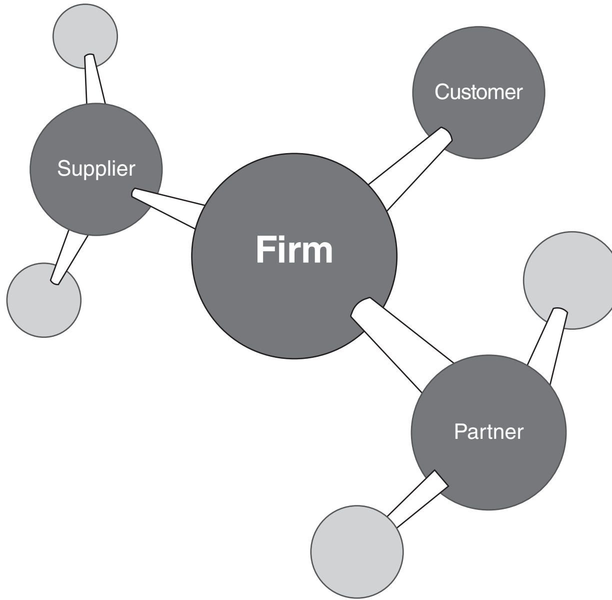
[21] E★TRADE (2019)
[22] Zott and Amit (2010)
[23] Zott and Amit (2009)

Exhibit 1.3 Architecture of Business Model Participants



linked, and who performs them – captures how the focal firm is embedded in its "ecology," i.e., in its multiple networks of suppliers, partners, and customers. (See Exhibit 1.3.)

To fully address a market opportunity, a firm's business model (a.k.a. activity system) may transcend the focal firm and span across the firm and its industry boundaries, but it remains centered on a focal firm, enabling the focal firm not only to create value with its partners through the activities they perform, but also to appropriate a share of the value created. The firm's *revenue model* plays an important role in value appropriation. Akin to a pricing strategy for specific products or services, the revenue model refers to the specific modes in which a business model enables revenue generation.[24]

The conceptualization of the business model as a dynamic activity system that is orchestrated by a focal firm, yet involves external participants (other firms and customers) who carry out some of the activities in the business model system, suggests that a business model can be described by four dimensions that are introduced next. We refer to these as the

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[24] Amit and Zott (2001)

What, How, Who, and ***Why*** of the activity system. These mutually exclusive dimensions not only allow us to analyze, understand, and evaluate existing business models, but they also help illuminate what makes an innovative business model truly novel. Taken together, they constitute the foundational conceptual framework for this book.

The "What, How, Who, and Why" Framework

As mentioned in the previous sections, we conceive of the business model as a value-centered activity system that is designed and enabled by a focal firm in order to meet perceived market needs. The key dimensions of a business model, depicted in Exhibit 1.4, are

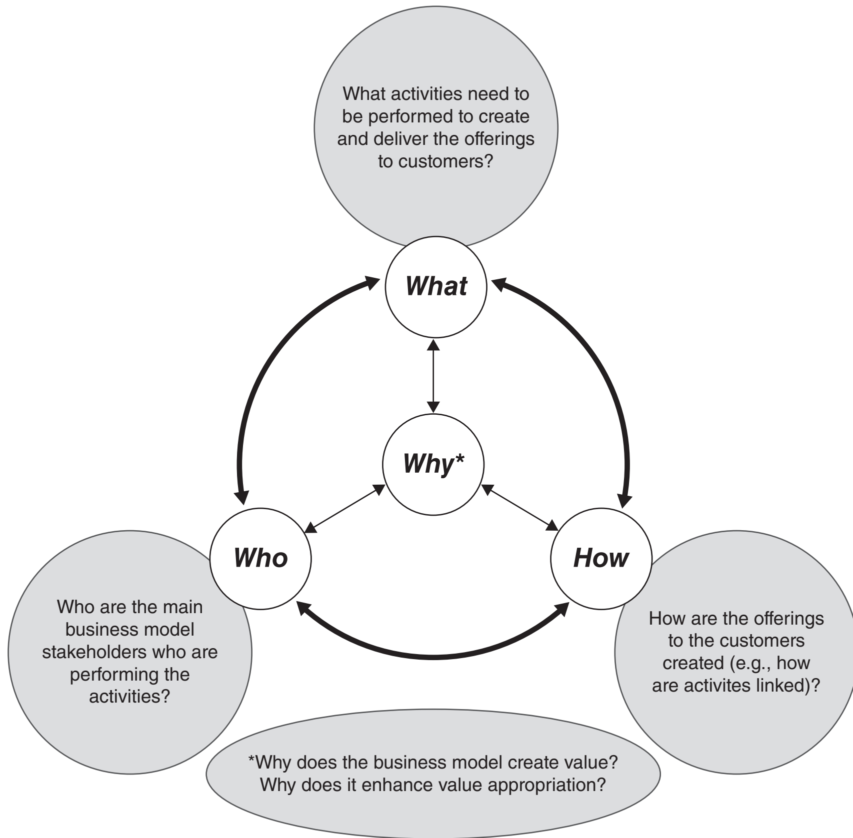
1. Its content, i.e., *what* activities the business model is composed of (***What***)
2. Its structure, i.e., *how* these activities are linked in the business model (***How***)
3. Its governance, i.e., *who* performs the activities that are enabled by the business model (which activities are performed by the focal firm, versus those performed by partners, suppliers, or customers) (***Who***)
4. Its value logic, i.e., *why* does the business model create value and *why* does it enhance value appropriation (***Why***)[25]

The What *Dimension*

All business models are comprised of a set of activities. Most of the core activities are generally performed by the focal firm, but relevant activities carried out by other stakeholders in the business model (such as customers and partners) are also included. These activities, which make up the ***What*** dimension, can – and often do – change over time, and they can represent a source of business model innovation. Apple's set of activities evolved, for example, when it introduced music downloads through iTunes in the early 2000s – a novel activity for the firm. Similarly, IBM was for decades principally focused on producing and delivering hardware, such as large

[25]See Zott and Amit (2001, 2007, 2008, 2010)

Exhibit 1.4 Business Model Framework



mainframe computers. In the early 1990s, however, the company's business model started to shift towards providing services, utilizing the firm's extensive experience and knowledge to provide consulting services, software, and IT maintenance. By 2006, half of IBM's revenues came from this new set of service-oriented activities.[26] Today, IBM is one of the global powerhouses in developing cutting-edge software and cloud computing solutions, such as IBM Watson.

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[26] Zott and Amit (2010)

The How *Dimension*

The structure of the business model describes how its various activities are linked, including the *mechanisms* that link them and the *sequence* in which they are linked. This dimension – the ***How*** of the business model – also refers to the relative position of the various activities within the architecture of the entire system. For example, are they core activities central to the business model? Or, are they peripheral activities playing a supporting role? Established in the 1980s, computer manufacturer Dell introduced a highly innovative business model in its space, which met with great success. The company was a pioneer in the direct-to-customer approach for selling computers, and also became known for its build-to-order model. Up until then, the dominant model in the computer industry had been a build-to-stock one that was dependent on retail brick-and-mortar stores. Instead of building computers from scratch – which would have meant not only assembling computers, but also building all components from scratch, as early computer companies had done – Dell assembled them using components built by suppliers. It also utilized connectivity in its customer-driven supply chain to increase production coordination and agility. The sequencing and prioritization of the activities in its activity system allowed Dell to avoid the retailer markups and stocking costs facing other computer manufacturers.[27]

The Who *Dimension*

The third dimension of a business model is its governance – the ***Who*** of the business model. Governance identifies which stakeholders in the business model perform which activities. Like the other dimensions of the business model, governance can also be a source of innovation and competitive advantage. Going back to the example of Dell, the focal firm (Dell) innovated its business model governance by designing computers, coordinating the production supply chain, and selling the computers directly to consumers. Suppliers, who are essential partners of the focal firm, perform the manufacturing of computer parts. This contrasts with the governance of the

[27] Magretta (1998)

previous dominant model of personal computer manufacturing, in which the focal firms designed and built component parts themselves, and then sold the assembled computers through retail partners.

Or consider LetGo, an app launched in 2015, which is an internet-based platform that connects local buyers and sellers of secondhand goods. Consider as a point of contrast the now-antiquated mode of taking out classified ads in a local newspaper, a model which had existed for decades, if not centuries. In the case of LetGo (or Craigslist, a competitor with a web-based product for local classifieds listings), the platform is now provided not by a newspaper, but by a digital firm. Some of the stakeholder activities are the same (sellers place ads, and local buyers browse through these ads), but the governance (at the level of the platform) is different in that important activities (such as creating listings) are performed by customers, not the firm that owns and operates the platform.

The Why *Dimension*

Finally, the ***Why*** dimension of the business model refers to its value logic, i.e., how it helps the focal firm create and capture value. This dimension is closely related to the concept of the revenue model, which is defined as the modes in which a business model enables revenue generation.[28] Hilti, for instance, is a provider of professional-grade tools primarily for the construction industry. The Liechtenstein-based company, which was founded in 1941, offers a broad range of products such as drilling and demolition, cutting, sawing, and grinding systems, as well as installation and firestop systems. These are delivered by its logistic partners and sold by Hilti vendors, through its website as well as in retail stores. Hilti is one of the most successful B2B direct vendors in the construction industry. In 2016, two-thirds of the company's 24,000-plus employees were employed in sales and technical service, dealing personally with customers on a daily basis.[29] Yet, despite its success with selling products, at the beginning of the twenty-first century the company decided to additionally offer customers the possibility of renting tools. Complementing this shift, the firm's revenue model changed from

[28] Amit and Zott (2001)
[29] Hilti (2016)

one-time transactional sales income to recurring rental income. In other words, the value creation logic – and hence the ***Why*** dimension – inherent in Hilti's business model changed. Hilti's interaction with the customer in the new model does not end with the successful sale of a tool. Instead, the new rental activity implies a necessary, ongoing exchange of information between Hilti and the client on, for instance, tool usage and damages. Hilti then uses that information to identify, offer, and perform new value-creating activities such as tool maintenance, repair, and inventory management.

Implications of the Framework

It is important to emphasize that the business model is about the what, how, who, and why *of the activity system* orchestrated by a focal firm, not about any other possible what, how, who, or why question, insofar as the question is not directly related to a specific activity within the system or the set of activities that comprise the system. For example, what products to sell is an excellent and important question, but the ***What*** dimension of a business model is not about this question. Many firms sell similar products, yet through different (indeed, sometimes vastly different) business models. A consumer loan product (*what product?*), for instance, can be engineered and sold through a classic retail banking model, which relies on customers making deposits (*what activity?*) and the bank running physical branch offices (*what activity?*). Alternatively, it can be sold through a peer-to-peer model that brings together individual participants who buy and sell loans (*what activity?*) on an internet-based platform that is being maintained (*what activity?*) by a focal firm.

We consider the business model of a (new or existing) firm or business unit to be innovative when its activity system is novel in the product-market space in which the firm or business unit operates.[30] For an existing firm, this may imply a significant strategic shift, in particular when the new business model creates new sources of revenues, or when it redefines the rules of competition for an entire industry.

For example, by leveraging connectivity, Michael Dell implemented a customer-driven, build-to-order business model that challenged the

[30]Amit and Zott (2012)

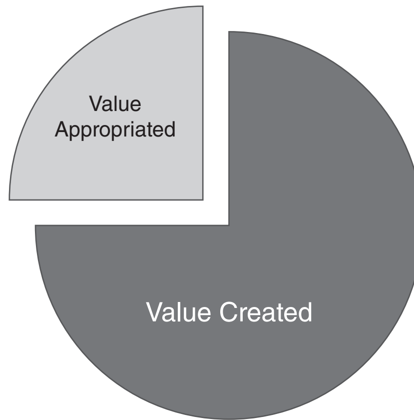
traditional build-to-stock model of selling computers through retail stores. His main idea, in other words, was a business model innovation. And when Apple introduced the iPhone in 2007, and subsequently the App store, it revolutionized the smartphone handset industry, primarily through its business model innovation. Apple's business model shifted from being a product-centric firm – developing, manufacturing, and marketing stylish and expensive bundled hardware and software – to one focused on a powerful platform based on the iOS operating system. The shift enabled Apple to create more value for all business-model stakeholders, such as app developers, telecommunication companies that operate wireless networks around the world, and, of course, users, while capitalizing on the use of its hardware and thereby substantially enhancing its own market value. In other words, innovating its business model complemented Apple's capabilities in product innovation and design. This substantially enhanced value creation for all Apple stakeholders, as well as Apple's own value capture, as evidenced by the enormous increase in the company's stock price and enterprise value after 2007.

Value Creation vs. Value Appropriation in Business Models

As already mentioned, a business model is geared toward total *value creation* – for all parties involved, not just the firm whose business model is under consideration. Total value creation can be thought of as a "value pie." The greater the total value created, the larger the proverbial value pie. Value appropriation, in turn, is the amount of value that is captured by individual stakeholders. In other words, value appropriation can be thought of as the proportionate size of individual slices of the value pie. So not only do you want a bigger value pie – as it means there's more to go around – but you also want a bigger individual slice of that pie (see Exhibit 1.5).

The business model lays the foundations for the focal firm's value capture by co-determining (along with the firm's products and services) the overall "size of the value pie," which can be thought of as an upper limit to the firm's value capture. In addition, the business model also co-determines the focal firm's ability to receive a sizeable slice of the pie by influencing its bargaining power vis-à-vis other business model stakeholders. The greater the total value created, and the greater the focal firm's bargaining

Exhibit 1.5 Value Created vs. Value Appropriated



power, the greater the amount of value that the focal firm may be able to appropriate.[31] This will be explained in greater detail in Chapter 8.

Summary of Key Takeaways and Outlook

In this chapter, we have introduced our definition of the business model as a purposefully designed and value-centered activity system, where an activity is the *engagement of human, physical, and/or capital resources of any party to the business model (the focal firm, end customers, vendors, etc.) to serve a specific purpose toward the fulfillment of the overall objective*, which is typically an unmet or suboptimally met customer need. The concept of the business model first came about in parallel with the proliferation of internet-based technologies and platform businesses in the 1990s. Disruptive new firms pointed to the existence of a new – and fundamental – strategic choice facing managers and entrepreneurs. This choice, of *how to do business*, complements long-standing strategy issues, such as questions of corporate strategy and business strategy.

We have also introduced our business model framework that will be developed in more depth throughout the course of this book. According to our conceptualization, a business model can be described in terms of

[31] Zott and Amit (2007)

four interrelated dimensions: content (***What***), structure (***How***), governance (***Who***), and value logic (***Why***). Each of these can be a source of innovation for a firm. Business model innovation is about *how to do business in new ways*. It can be a crucial source of disruption and competitive advantage, and it goes beyond (but is highly complementary to) existing sources of innovation, such as product or process innovation. Both new firms and established corporations need to be highly cognizant of the opportunities, and challenges, posed to their industries by innovative new business models. In other words, they need a *business model innovation strategy*.

A business model innovation strategy enables an organization to generate a stream of business model innovations. It refers to the choices entrepreneurial leaders must make with respect to the following:

- The design of a new system of activities (***What? How? Who? Why?***); this dimension of a business model innovation strategy is addressed in detail in Chapters 1 through 4 of the book;
- The processes, including their antecedents, by which a new activity system is created; this dimension of a business model innovation strategy is addressed in detail in Chapters 5 through 9 of the book;
- The implementation and ongoing adaptation of the new activity system to ensure coherence (i.e., internal, external, and strategic fit), with the objective of sustaining and improving the focal organization's key performance metrics; this dimension is addressed in Chapters 10 through 12 of the book.

The set of ideas and tools introduced in this book will allow you to adopt a business model mindset, rigorously analyze business models, and learn how to implement business model innovation. Beyond these formal concepts and tools, however, you will also learn to *think as a business model designer*. One of the most important skills needed to become a good business model designer is the ability to think *holistically* about your firm's current or future business model. This ability to "see the big picture" will allow you to conceptualize and innovate at a *system* level. Adopting a design-oriented business model mindset, you will be equipped to design a firm that is ready to meet expected future trends (for example, in technology). Just as importantly, you will also be equipped to design a dynamic activity system that can quickly respond and adapt to the trends you *don't* expect. If you

are an entrepreneur developing an exciting new product, how do you then embed this product in a responsive (and perhaps equally new) activity system that protects you from the competition? If you build an innovative new digital platform, how can you think about maximizing value for *all* members of the activity system? These are just some of the questions of high strategic relevance that we will address in this book.

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