A primer in Entrepreneurship

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Chapter 6: Developing an Effective Business Model

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I. Business Models

A. What is a Business Model?

1. A business model is a firm’s plan or diagram for how it competes, uses its resources, structures its relationships, interfaces with customers, and creates value to sustain itself on the basis of the profits it earns.

2. It’s important to understand that a firm’s business model takes it beyond its own boundaries. Almost all firms partner with others to make their business models work.

3. There is no standard business model, no hard-and-fast rules that dictate how firms in a particular industry should compete.

4. The term business model innovation refers to initiatives such as that undertaken by Michael Dell that revolutionized how products are sold in an industry.
I. Business Models

A. What is a Business Model?

5. The development of a firm’s business model follows the feasibility analysis stage of launching a new venture but comes before the completion of a business plan.

   a. If a firm has conducted a feasibility analysis and knows that it has a product or service with potential, the business model stage addresses how to surround it with a core strategy, a partnership model, a customer interface, distinctive resources, and an approach to creating value that represents a viable business model.

   b. At the business model development stage, it is premature for a new venture to raise money, hire a lot of employees, establish partnerships, or implement a marketing plan. A firm needs to have a business model in place before it can make additional substantive decisions.
I. Business Models

Digression: Dell

In Dell’s case, it needs the cooperation of its suppliers, shippers, customers, and many others to make its business model possible.
I. Business Models

Digression: Dell

Traditional Manufacturer (e.g., Hewlett-Packard or IBM)

- Forecasts demand
- Obtains subcomponents from suppliers
- Makes basic components
- Assembles complete PC
- Stores PCs in warehouse
- Ships PCs to retailer
- PCs sit on retailer’s shelf until sold
- In hands of consumer

Dell

- Customer places order via phone or Internet
- Contract manufacturers instantly view order information and ship component parts
- Dell assembles computer from component parts as they arrive and maintains customer relationship
- Computer is shipped “direct” to customer via UPS or FedEx
- In hands of consumer
I. Business Models

B. The Importance of a Business Model

1. Having a clearly articulated business model is important because it does the following:
   - Serves as an ongoing extension of feasibility analysis;
   - Focuses attention on how all the elements of a business fit together and constitute a working whole;
   - Describes why the network of participants needed to make a business idea viable would be willing to work together;
   - Articulates a company’s core logic to all stakeholders, including the firm’s employees.
I. Business Models

B. The Importance of a Business Model

2. Once a firm’s business model is clearly determined, the entrepreneur should diagram it on paper (to the extent possible), examine it, and ask the following questions:
   - Does my business model make sense?
   - Will the businesses I need as partners participate?
   - If I can get partners to participate, how motivated will they be? Am I asking them to work for or against their self-interest?
   - How about my customers? Will it be worth their time to do business with my company?
   - If I do get customers, how motivated will they be?
   - Can I motivate my partners and customers at a sufficient scale to cover the overhead of my business and make a profit?
   - How distinct will my business be? If I’m successful, will it be easy for a larger competitor to step in and steal my idea?
I. Business Models

B. The Importance of a Business Model

- If the answer to each of these questions isn’t satisfactory, then the business model should be revised or abandoned.

- Ultimately, a business model is viable only insofar as the buyer, the seller, and the partners involved see it as an appropriate method of selling a product or service.
I. Business Models

C. How Business Models Emerge

1. The value chain is a model that many businesses and entrepreneurs use to identify opportunities to enhance their competitive strategies.

2. The value chain also explains how business models emerge and develop.

   a. The value chain is the string of activities that moves a product from the raw material stage, through manufacturing and distribution, and ultimately to the end user.
I. Business Models

C. How Business Models Emerge

b. By studying a product’s or service’s value chain, an organization can identify ways to create additional value and assess whether it has the means to do so.

c. Value chain analysis is also helpful in identifying opportunities for new businesses and in understanding how business models emerge.

d. A firm can be formed to strengthen the value chain for a product, however, only if a viable business model can be created to support it.
I. Business Models

C. How Business Models Emerge

Entrepreneurs look at the value chain of a product or a service to pinpoint where the value chain can be made more effective or to spot where additional “value” can be added.

This type of analysis may focus on
(1) a single primary activity of the value chain (such as marketing and sales),
(2) the interface between one stage of the value chain and another (such as the interface between operations and outgoing logistics), or
(3) one of the support activities (such as human resource management).
I. Business Models

C. How Business Models Emerge
I. Business Models

D. Potential Fatal Flaws of Business Models

Two fatal flaws can render a business model untenable from the beginning:

a. A complete misread of customers.

b. Utterly unsound economics.

Pets.com sported an unsound business model, and failed.
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   D. Customer interface
II. Components of an Effective Business Model

A. Core Strategy

1. The first component of a business model is the core strategy, which describes how a firm competes relative to its competitors. The following are the essential components of a firm’s core strategy.

   a. Mission Statement. A firm’s mission, or mission statement, describes why it exists and what its business model is supposed to accomplish.

   b. Product/Market Scope. A company’s product/market scope defines the products and markets on which it will concentrate.
II. Components of an Effective Business Model

A. Core Strategy

c. Basis for Differentiation. It is important that a new venture differentiate itself from its competitors in some way that is important to its customers. If a new firm’s products or services aren’t different from those of its competitors, why should anyone try them?

   i. From a broad perspective, firms typically choose one of two generic strategies (cost leadership or differentiation) to position themselves in the marketplace.

   ii. Firms that have a cost leadership strategy strive to have the lowest costs in the industry, relative to competitors’ costs, and typically attract customers on that basis.
II. Components of an Effective Business Model

A. Core Strategy

iii. In contrast, firms with a differentiation strategy compete on the basis of providing unique or different products and typically compete on the basis of quality, service, timeliness, or some other important dimension.
II. Components of an Effective Business Model
A. Core Strategy

- Core Strategy
  - Business mission
  - Product/market scope
  - Basis for differentiation

- Strategic Resources
  - Core competencies
  - Strategic assets

- Partnership Network
  - Suppliers
  - Partners
  - Other key relationships

- Customer Interface
  - Target customer
  - Fulfillment and support
  - Pricing structure
II. Components of an Effective Business Model

A. Core Strategy

Primary Elements of Core Strategy

<table>
<thead>
<tr>
<th>Business Mission</th>
<th>A firm’s mission, or mission statement, describes why it exists and what its business model is supposed to accomplish. For example, Southwest Airlines’ Mission Statement is as follows: “The mission of Southwest Airlines is dedication to the highest level of customer service delivered with a sense of warmth, friendliness, individual pride, and company spirit.”</th>
</tr>
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<tr>
<td>Product/Market Scope</td>
<td>A company’s product/market scope defines the products and markets on which it will concentrate. The choice of products has an important impact on a firm’s business model.</td>
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II. Components of an Effective Business Model

A. Core Strategy

| Basis of Differentiation | It is important that a new venture differentiate itself from its competitors in some way that is important to its customers. If a new firm’s products or services aren’t different from those of its competitors, why should anyone try them? Firms often differentiate themselves on the basis of a cost leadership strategy or a differentiation strategy. |

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II. Components of an Effective Business Model

B. Strategic Resources

1. A firm is not able to implement a strategy without resources, so the resources a firm has affects its business model substantially. The two most important strategic resources are discussed below.

   a. Core Competency. A core competency is a resource or capability that serves as a source of competitive advantage over its rivals. Examples of core competencies include Sony’s competence in miniaturization, Dell’s competence in supply chain management, and 3M’s competence in reconfiguring innovation.

   b. Strategic Assets. Strategic assets are anything rare and valuable that a firm owns. They include plant and equipment, location, brands, patents, customer data, a highly qualified staff, and distinctive partnerships.
II. Components of an Effective Business Model

B. Strategic Resources

2. Companies ultimately try to combine their core competencies and strategic assets to create a sustainable competitive advantage. This factor is one to which investors pay close attention when evaluating a business.
II. Components of an Effective Business Model

B. Strategic Resources

Primary Elements of Strategic Resources

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II. Components of an Effective Business Model

B. Strategic Resources

Importance of Strategic Resources

- New ventures ultimately try to combine their core competencies and strategic assets to create a sustainable competitive advantage.
- This factor is one that investors pay close attention to when evaluating a business.
- A sustainable competitive advantage is achieved by implementing a value-creating strategy that is unique and not easy to imitate.
- This type of advantage is achievable when a firm has strategic resources and the ability to use them.
II. Components of an Effective Business Model

C. Partnership Network

1. A firm’s network of partnerships is the third component of a business model. New ventures, in particular, typically do not have the resources to perform all the tasks required to make their businesses work, so they rely on partners to perform key roles.

   a. Suppliers. A supplier (or a vendor) is a company that provides parts or services to another company. Almost all firms have suppliers who play a vital role in the functioning of their business models.
II. Components of an Effective Business Model

C. Partnership Network

b. Other Key Relationships. Along with its suppliers, firms partner with other companies to make their business models work.

i. There are risks involved in partnerships, particularly if a single partnership is a key component of a firm’s business model.

ii. Many partnerships fall short of meeting the expectations of the participants for a variety of reasons.
II. Components of an Effective Business Model

C. Partnership

Network

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European Brands Association des Industries de Marque

AIM®

is the European Brands Association

AIM is the European Brands Association. It represents the branded goods industries in Europe on key issues which affect the ability of brand manufacturers to design, distribute and market their brands. AIM’s membership groups 1800 companies of all sizes through corporate members and national associations in 22 countries.

These companies are mostly active in every day consumer goods. They employ some two million workers and account for over 350 billion Euro in annual sales in Europe alone.

AIM’s mission is to create for brands an environment of fair and vigorous competition, fostering innovation and guaranteeing maximum value to consumers now and for generations to come.

“Europe depends on powerful brands”

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The two companies are building upon Unisys newly announced plan to deliver solutions for secure business operations. The solution, energized by Unisys 3D Visible Enterprise strategy, which is designed to enable a client to see the links among business strategy, processes and IT requirements throughout the entire enterprise and gain visibility into the impacts and costs of strategic decisions at levels even before making them. To support its strategy for solutions delivering secure business operations, Unisys is aligning with an exclusive list of the world’s leading technology providers to deliver customer solutions that harness its partners’ expertise with the power of 3D-VE.
II. Components of an Effective Business Model

D. Customer Interface

Customer interface – how a firm interacts with its customers – is the fourth component of a business model. The type of customer interaction depends on how a firm chooses to compete.
II. Components of an Effective Business Model

D. Customer Interface

Primary Elements of Customer Interface

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<tbody>
<tr>
<td>Target Market</td>
<td>A firm’s target market is the limited group of individuals or businesses that it goes after or tries to appeal to. The target market a firm selects affects everything it does, from the strategic assets it acquires to the partnerships it forges to its promotional campaigns.</td>
</tr>
<tr>
<td>Fulfillment and Support</td>
<td>Fulfillment and support describes the way a firm’s product or service “goes to market” or how it reaches its customers. It also refers to the channels a company uses and what level of customer support it provides. All these issues impact the shape and nature of a company’s business model.</td>
</tr>
</tbody>
</table>
II. Components of an Effective Business Model

D. Customer Interface
Primary Elements of Customer Interface

| Pricing Structure | The third element of a company’s customer interface is its pricing structure, a topic that will be discussed in more detail in Chapter 11. Pricing models vary, depending on a firm’s target market and its pricing philosophy. |
II. Components of an Effective Business Model

Recap: The Importance of Business Models

Business Models

- It is very useful for a new venture to look at itself in a holistic manner and understand that it must construct an effective “business model” to be successful.
- Everyone that does business with a firm, from its customers to its partners, does so on a voluntary basis. As a result, a firm must motivate its customers and its partners to play along.
- Close attention to each of the primary elements of a firm’s business model is essential for a new venture’s success.