

## **What is a business model? A new approach**

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The term “business model” has grown rapidly in importance in recent years, particularly in the venture and innovation communities. Today, executives, entrepreneurs and investors all recognize the importance of having a good business model. They understand that without a good business model, new technologies and products remain good ideas that never translate into value – for their inventors, investors or society at large.

It is ironic, therefore, that there is no generally accepted definition of a business model. And perhaps more than ironic – if developing a good business model is a primary goal for the stakeholders in a business, then they need a clear definition in order to know whether or not they have achieved this goal. Moreover, a clear definition of a business model would help everyone involved in creating and commercializing product and service innovations understand the key elements that need to be addressed to be successful.

A good definition of a business model must be simple, clear and comprehensive. Simplicity will ensure it is easy to learn and remember. Clarity will ensure it is understood, and meets the intuitive “gut feel” test of experienced venture players. Comprehensiveness will ensure that it includes all the key elements that innovation and venture leaders need to consider in creating successful business models.

With a view to developing such a definition, this paper will review several recent approaches to business models. It will then propose a new approach that integrates all the key elements of these approaches, and also meets the “simple, clear and comprehensive” test.

The following authors have presented perhaps the most useful insights into the definition and components of a business model. We urge interested readers to consult the referenced works, as this paper can do no more than present a very short summary of each author’s approach.

### Henry Chesbrough: Open Innovation

In his seminal work, *Open Innovation*, Henry Chesbrough describes the business model as creating and capturing value from technology. He suggests that a business model has six functions:

1. To articulate the *value proposition* – the value created for users by the offering based on the technology.
2. To identify a *market segment* – the users to whom the technology is useful and the purpose for which it will be used.
3. To define the structure of the firm's *value chain*, which is required to create and distribute the offering, and to determine the complementary assets needed to support the firm's position in the chain.
4. To specify the *revenue generation* mechanism(s) for the firm, and estimate the *cost structure* and *target margins* of producing the offering, given the value proposition and value chain structure chosen.
5. To describe the firm's position within the *value network* linking suppliers and customers, including identification of potential complementary firms and competitors.
6. To formulate the *competitive strategy* by which the innovating firm will gain and hold advantage over rivals.

### Gary Hamel: Leading the Revolution

Hamel defines a business model as “a business concept that has been put into practice”. He proposes a business model framework comprising four primary elements:

1. *Core strategy* – this includes the business mission, its product market scope and its basis for differentiation
2. *Strategic resources* – the organization's core skills, assets and processes that deliver the core strategy
3. *Customer interface* – how customers interface with and experience the organization, including fulfillment / support, information / insight, relationship and pricing
4. *Value network* – the organization's external suppliers, partners and coalitions.

These elements are linked in three ways: strategic resources are *configured* to deliver the core strategy; the core strategy provides *benefits* realized through the customer interface; and the *boundaries* of the organization determine what is done internally leveraging strategic resources and what is done externally in the value network.

### Peter Skarzynski and Rowan Gibson: Innovation to the Core

Building on Hamel's and Chesbrough's work, Skarzynski and Gibson define a business model as “a conceptual framework for identifying how a company creates, delivers and extracts value”. They propose five components of a business model:

1. *Who do we serve?* Includes market segments, customers, and buyers.
2. *What do we provide?* Includes products, services, solutions, benefits.
3. *How do we provide it?* Includes value chain, processes, skills, assets, partners, suppliers
4. *How do we make money?* Includes pricing, revenue, costs, profits.
5. *How do we differentiate and sustain an advantage?* Includes differences versus competitors, value to customers, sustainability based on skills and assets.

## Mark Johnson, Clayton Christensen and Henning Kagermann: Reinventing Your Business Model

In their recently published Harvard Business Review article, Johnson *et al.* define a business model as “consisting of four interlocking elements that, taken together, create and deliver value.” These four components are:

1. *Customer value proposition*: Target customer, needs (job to be done), offering
2. *Profit formula*: revenue model, cost structure, margin model and resource velocity (asset turnover)
3. *Key resources*, including people, technology, equipment, information, channels, partnerships and brand
4. *Key processes*, including processes, metrics and norms.

## Alexander Osterwalder and Yves Pigneur: Business Model Generation

In their recent book, Osterwalder and Pigneur define a business model as something that “describes the rationale of how an organization creates, delivers, and captures value.” They propose a framework comprising nine components:

1. *Customer segments*
2. *Channels*
3. *Customer relationships*
4. *Value propositions*
5. *Revenue streams*
6. *Key activities*
7. *Key resources*
8. *Partners*
9. *Cost structure*

## John Mullins and Randy Komisar: Getting to Plan B

In their new and well-received book, Mullins and Komisar define a business model in economic terms: “By *business model*, we mean the pattern of economic activity – cash flowing into and out of your business for various purposes and the timing thereof – that dictates whether or not you run out of cash and whether or not you deliver attractive returns to your investors. In short, your business model is the economic underpinning of your business, in all of its facets.” Their framework comprises five elements:

1. *Revenue model* – includes defining target customers, needs addressed, product offered, timing / frequency of purchase, pricing and cost of customer acquisition
2. *Gross margin model* – margin per product and across the product mix
3. *Operating model* – all other costs, noting difference between fixed and variable
4. *Working capital model* – optimizing current assets and liabilities to maximize cashflow
5. *Investment model* – optimizing capital required pre-launch through to break even.

## A new approach: a simple, practical and powerful business model definition

Over the past few years, we have explored each of the above approaches in practice, by designing business models for dozens of new technologies, products and services. We have conducted countless experiments to see what works most effectively in driving results, working with hundreds of entrepreneurs, investors, product managers, engineers, salespeople and corporate executives.

While all the above approaches have their strengths, in our view they all lack one key element: a sufficient emphasis on the *people* – the core stakeholders – as a primary element of the business model. We believe this is a major omission, as the core players in the business, what they each contribute, what they each are looking to get in return, and what they collectively want to do, are primary drivers of the organization's ability to create value.

Ask any entrepreneur, CEO or investor, and he or she will tell you how much time is devoted to attracting and coordinating key management team members, investors and strategic partners, because of the profound influence these stakeholders have on the business model. In our view, all business models have a major stakeholder component – they only make sense with a particular mix of stakeholders – and as such, this element must be explicitly designed and managed like any other.

With that caveat, the two approaches we like best are those of Chesbrough, and Skarzynski and Gibson. In our view, both of these capture most of the essential elements of a business model, do the best job of presenting the most important primary elements in an appropriate and balanced way, and have the right level of simplicity and clarity. The other models all contribute thinking of value, but we think they are either missing key primary elements, are too complex to be immediately useful, or present a suboptimal mix of primary and subsidiary elements.

With these thoughts in mind, we have evolved the following approach to a business model. We believe it builds on the best of the above frameworks, addresses their weaknesses, and also meets the “simple, clear and comprehensive” test. Perhaps most importantly, it is grounded in extensive practical experience designing and implementing successful business models for a wide range of information, communication, medical and clean technologies.

### **Overall definition**

We like and agree with the above authors who define a business model as being about how a business creates, delivers and captures value. We refine this definition to state that a business model *is the core design of the business, specifically the way it is designed to create, deliver and capture value.*

Thinking in terms of *design* is powerful. A good business model will be simple and elegant, and it will work. Its design will be complete in every important respect. Each element will be carefully thought through and individually crafted, and the sum of the parts will integrate perfectly, harmoniously and effectively. By contrast, a poor business model simply doesn't work. It will either lack some critical elements, comprise the wrong elements, or comprise elements that don't work well together.

### **Key elements**

So what are these elements? More specifically, what are the primary elements of a business model? In our approach there are five primary elements, each comprising several subsidiary elements:

1. *Markets* – this consists of the markets in which the business chooses to compete, and where the business chooses to be positioned within the market’s value network. This includes the customers and needs the business chooses to address, the companies with which it competes, and the companies with which it partners. This element is fundamentally about gaining a deep understanding of markets, customers, competitors and partners, and deciding how to position the business for maximum advantage, as a foundation for the rest of the business model.
2. *Products* – this element is about defining the business’ offering – its value proposition – to its target customers. Essential to this element is thinking about the offering as holistically as possible. It thus includes defining and distinguishing between the core technology, platform and application features; defining the “whole” solution including third party complementary features; and defining the total customer experience and relationship. It also includes the other elements of the value proposition both to the customer (pricing and positioning) and to the business (margins and protection of IP).
3. *Processes* – this element consists of how the business creates, markets and delivers its products and services to its customers. These three core processes – research and product development, sales and marketing, and operations and customer support – are the fundamental engine of the business. In addition, two other core processes must be defined - how the business manages (through strategic and operational planning and control), and how it supports (through HR, IT, finance, legal and other support services), these core activities. Like with the other elements, our definition of processes is holistic: it includes repeatable processes and one-off key initiatives, internal skills and assets, and external supplier and channel partners.
4. *People* – as discussed above, this element is about defining the core stakeholders in the business – the management team and key employees, investors and the board, and key strategic partners. It begins with defining which stakeholders make sense for the business, and how to attract them. It includes defining their joint vision for the business, how they work together, and how they make decisions. And it includes thinking through what they each contribute to the business, and how they each share in the value created and captured by the business.
5. *Economics* – this element is both the result and the enabler of the other four elements. It comprises the key components of the economic model - revenue, costs, investment, funding and cash flow. Central to this element is thinking deeply about the core drivers in the other four elements, how these impact the business’ economics, how they interact with each other, and what tradeoffs must be made between different drivers. Ultimately, the overall focus of the business model is about optimizing its economics – how value can be maximized from limited resources, and how the business can capture its fair share of that value to share amongst its stakeholders .

## Comparing the approaches

By comparing the approaches discussed in this paper, one can see how in many respects the different approaches encompass similar elements. At the next level of detail, the differences become more apparent, but in most cases it is more a matter of how primary and subsidiary elements are grouped, rather than whether or not they are part of the business model.

That being said, we think a quick glance at this table illustrates the power and simplicity of the Blue Mine Group model compared with the other approaches.

Blue Mine Group	Chesbrough	Hamel	Skarzynski and Gibson	Johnson <i>et al.</i>	Osterwalder and Pigneur	Mullins and Komisar
Markets	Market segment Value network	Core strategy Value network	Who do we serve?	Customer value proposition	Customer segments	Revenue model
Products	Value proposition Competitive strategy	Core strategy Customer interface	What do we provide? How do we differentiate and sustain an advantage?	Customer value proposition	Customer relationships Value propositions	Revenue model Gross margin model
Processes	Value chain Competitive strategy	Strategic resources Customer interface Value network	How do we provide it? How do we differentiate and sustain an advantage?	Key resources Key processes	Channels Key activities Key resources Partners	Operating model
People						
Economics	Revenue, costs, margins		How do we make money?	Profit formula	Revenue streams Cost structure	Revenue model Gross margin model Operating model Working capital model Investment model

To date we have found the new approach to the business model that we have developed to be effective and successful. It is built on the work of leading thought leaders like those discussed in this paper, and it also meets the test of “simple, clear and comprehensive”. In practice, we have found that entrepreneurs, managers and investors quickly grasp this approach. It also translates easily into accepted business plan formats.

In summary, the new approach to designing and implementing a business model discussed in this paper provides an elegant, simple and powerful diagnostic toolset and decision making framework for maximizing the value of innovation.

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## Additional reading and resources

### Open Innovation

<http://www.amazon.com/Open-Innovation-Imperative-Profiting-Technology/dp/1578518377>

by Henry Chesbrough

### Innovation to the Core: A Blueprint for Transforming the Way Your Company Innovates

<http://www.innovationtothecore.com/thebook/intro.cfm>

by Peter Skarzynski and Rowan Gibson

### Leading the Revolution

<http://www.amazon.com/Leading-Revolution-Gary-Hamel/dp/0452283248>

by Gary Hamel

### Reinventing Your Business Model (subscription required)

<http://harvardbusiness.org/product/reinventing-your-business-model/an/R0812C-PDF-ENG>

by Mark Johnson, Clayton Christensen and Henning Kagermann:

### Business Model Generation

<http://www.businessmodelgeneration.com/>

by Alexander Osterwalder and Yves Pigneur:

### Getting to Plan B: Breaking Through to a Better Business Model

<http://www.amazon.com/Getting-Plan-Breaking-Through-Business/dp/1422126692>

by John Mullins and Randy Komisar:

## About the author

Michael Lurie is Founder and CEO of Blue Mine Group in San Diego, CA. Blue Mine Group specializes in designing successful business models for technology innovation.