FROM BUZZWORD TO MANAGERIAL TOOL:
THE ROLE OF BUSINESS MODELS IN STRATEGIC INNOVATION

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Innovation is an old and very broad theme in management literature. But most of the time it is only dealt with in relation to innovative products or technologies. Now this sort of approach can lead to a fragmentary understanding of the process, which is why some researchers favour a more comprehensive one. For instance, Van de Ven[1] has written a key article based on interviews with businessmen and deplores the fact that innovation research and, more widely, training only focus on one kind of innovation at a time. Though he agrees that existing studies have given better insight into specific aspects of innovation, he regrets that they only provide a partial answer to the overall problems managers have to cope with[2]. He would prefer a general management perspective on innovation. His definition – "innovation is defined as the development and implementation of new ideas by people who over time engage in transactions with others within an institutional context" – is sufficiently broad to include a wide range of innovation in techniques, products, processes, administration and so on.

The purpose of this paper is to show how the concept of the business model can help us achieve such a more global take on innovation, which we shall call strategic innovation. We shall use an example to explain the attraction of strategic innovation but show how it lacks an operational translation. We shall then show how the idea of the business model, as we define it, can help stimulate managerial thinking and be instrumental in developing strategic innovation.

STRATEGIC INNOVATION IS AN ATTRACTIVE CONCEPT…

The Zara chain, part of the Spanish group Inditex, has taken a new look at the clothing industry and questioned its accepted principles, in particular the relocation of factories and the design of seasonal collections. In the Zara system, most of the fashion-sensitive output is manufactured in Spain. The system is based on a short circuit where design, production, logistics and distribution work in a loop, making it highly flexible and quick to respond to fashion trends. "Instead of offering collections that take one year to get from the drawing board to the customer, Zara has revolutionised the fashion business by revising the ranges in its stores every week. It takes twenty-two days to design, make and sell a model."[3]

Actually, strategic innovation is the source of four benefits with varying degrees of impact on businesses:

- It opens to new market spaces and/or reconstructs market boundaries. For a business, it is an opportunity to explore untapped market spaces. Zara has created a fashion market of top designer-style clothes at affordable prices driven by continuous stock renewal. Strategic innovation invents products and services consumers need but don't necessarily demand. By revealing unexpressed needs it widens markets.

- It sidelines competition. By changing the rules of the market game, it wrong-foots competitors who often find their strengths have become weaknesses and have trouble retaliating. The new rules of the game demand a double effort: first to understand them and then, most importantly and even harder, to unlearn the old rules. Zara has adopted a model of vertical integration which goes against the accepted logic in the clothing industry which outsources manufacturing and sells through independent distribution channels; 80% of its business is vertically integrated and it owns most of its store premises. Its manufacturing division is a cost centre for the sole purpose of underpinning the distribution division. This is what competitors find hard to counter, because strategic innovation is a challenge to the logic of their own operating systems.

- It frequently creates a higher value for the customer at a lower cost. It challenges the dogma whereby a company must choose between offering more at a higher prices and a more ordinary offer at a lower price. The Zara position is to offer its customers high fashion at competitive prices. Integrated production may cost 20% more than outsourced production, but this is compensated for by a faster response time and a lower risk: only 50% of the Zara collection is in the stores at the start of a season, against 80% on average for its rivals (notably H&M). So what Zara loses in production costs compared to its competitors, it claws back in faster stock turnover. Strategic innovation is indeed often a way of giving higher value to the customer while lowering costs and prices.

- For these reasons, it leads to highly profitable growth. Zara's structural profitability is unmatched in this sector: its stores realise an operating margin of about 17% - and nearer 20% in mature countries – compared to 13% to 14% realised by the best-performing clothing retailers such as Next[4].

Strategic innovation is not the sole reserve of the hi-tech sectors. Though the IT company Dell and its online sales and build-to-order manufacturing system is an industry benchmark, strategic innovation is often found in Europe in traditional sectors which have reached maturity or are even declining: furnishings (IKEA and flat-pack designer furniture), clothing (Zara and low-cost fashion), bakery (Paul and tradition bread on an industrial scale), the press (Metro and free dailies), the watch and clock industry (Swatch and plastic fashion watches), the hotel industry (Formule 1 and minimal service), etc. Moreover, strategic innovation is also a matter for smaller businesses. Though we hear more about large corporations, SMEs are far from absent and actually have specific faculties that make them better at strategic innovation.

However, if those examples are interesting for the understanding of the issue of strategic innovation, they don't give managers real instruments to deal with it.

…LACKING TOOLS TO IMPLEMENT IT

There have been an increasing number of books and articles on the issue of strategic innovation over the last decade[5], attributing different names to this phenomenon, including strategy innovation and value innovation, etc. But, as we can see from the table below, which cites the definitions of the main contributors, there is no general agreement as to its definition.

- **Hamel (1998)**

Strategy innovation is the capacity to reconceive the existing industry model in ways that create new value for customers, wrong-foot competitors, and produce new wealth for all stakeholders.

- **Markides (1999)**

Strategic innovation is a fundamental reconceptualization of what the business is all about, which, in turn, leads to a dramatically different way of playing the game in an existing business.

- **Kim and Mauborgne (1999)**

Value innovation makes the competition irrelevant by offering fundamentally new and superior buyer value in existing markets and by enabling a quantum leap in buyer value to create new markets.

- **Govindarajan and Trimble (2001)**

Strategic innovation is [about] changing the rules of the game. (…) When one consistent business model is converted into another internally consistent business model, the rules of the game are changed.

- **Charitou and Markides (2003)**

Strategic innovation means an innovation in one's business model that leads to a new way of playing the game.

- **Schlegelmilch et al. (2003)**

Strategic innovation is the fundamental reconceptualization of the business model and the reshaping of existing markets (by breaking the rules and changing the nature of competition) to achieve value improvements for customers and high growth for companies.

Most recent definitions argue for a more concrete, less metaphorical definition of strategic innovation, in contrast to the current ones: game (new game strategy), military (choice of new weapons), politics (strategy as revolution) physics (breakthrough strategy) or geography (blue oceans of untapped market spaces versus red oceans of competition).

There are few methodological tools and frameworks available, unlike the highly developed ones for classic competitive situations. As noticed by Kim and Mauborgne[6] "strategy thinking has developed an impressive array of tools and frameworks to compete in red oceans, such as the five forces of analysing existing industry conditions or the three generic strategies, but has remained virtually silent on practical tools required to excel in blue oceans. Instead, executives have received calls to be brave and entrepreneurial, to learn from failure, and to seek out revolutionaries. Although though-provoking, these are not substitutes for analytics to navigate successfully in blue waters".

This lack of tools and framework is all the more noticeable when the opening of new competitive spaces throws up opportunities but includes a risk factor. This has to be understood and managed.

It is our belief that the concept of the business model can be the methodological tool that is lacking.

THE "BUSINESS MODEL" CONCEPT…

Business model is a term that first appeared in computing magazines in the 1970s and, after 1995, in computing magazines for the general public before being used in more academic publications. The term is now widely used and, far from disappearing when the internet bubble burst, seems to be on the increase. That said, the notion is still nebulous and needs to be clearly defined[7].

In fact the business model "tells a story" that gives the answers to the following questions: Who are my customers? How does my business give them a real and perceivable value? How does the business produce goods or services with value for the customer and at what cost? How does it generate profit by capturing part of the value it creates? Thus, the business model can be defined as the description of the way a business can create value through the value it proposes to its customers, its value architecture (including its resources and internal and external value chain) and how it can capture the value to convert it into profit.

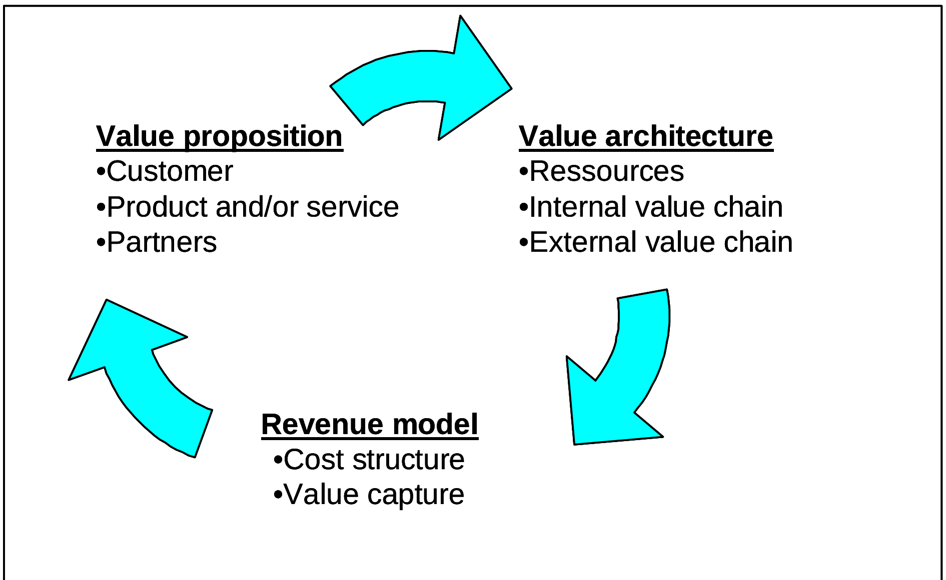
So we can say the business model has three components (figure 1):

- Value proposition, comprising:
  - The type of customer, or the market segment addressed by the business.
  - The product or service or mere information.
  - The partners who form a link between the business and the customer.

- Value architecture, comprising**:**
  - The business's resources.
  - The business's internal value chain.
  - The external value chain, i.e. all the links with partners, suppliers or complementors.

- The revenue model
  - The cost structure, related to the business's value architecture.
  - Value capture by the business.

  These two factors explain the business's profit.



The business model seems to be well suited to changing worlds or to bring about changes. Though the conventional strategy analysis units – business unit, industry and corporation – work well when the fundamental aspects of the business are understood, they are poorly adapted to the current changing environment. As Bettis[8] points out, these units "may be largely out of touch with the evolution of modern competition in a technology-driven, global world that has seen a huge and rapid level of change. The new competitive landscape is currently being shaped".

Likewise, the business model seems relatively independent of the competitive conditions surrounding it. It can cross industry and geographical boundaries: the Zara and Ikea models have been replicated with hardly any difference in a number of European markets; Dell has extended its computer model to include printers; The Easy group has applied its low-cost air transport model (Easy Jet) to car rental (Easy Car).

We believe this definition of the business model is an important input to strategic innovation as it makes it operational.

…AS MANAGERIAL TOOL FOR STRATEGIC INNOVATION

The business model concept indeed builds a bridge between the strategy and the organisational, commercial and financial aspects of the firm. It makes it possible to combine thinking on strategy choices, sources of revenue and cost structure. So, "both in practice and in theory, the concept of the business model forms the link between the (business and corporate) strategy of a company and its operational translation into financial, structural and commercial terms (…) "Part of the alchemy of strategy choices and their operational translation (into revenues) seems more easily understood when seen through the prism of the business model"[9]. The way the concept of the business model has been taken up proves the necessity of intermediate concepts to make strategies operational.

Thus, strategic innovation could be defined as a challenge to the prevailing economic model. It is a radically different strategy which changes the rules of the game by designing a new business model that makes a major change in the value for the customer and/or the value chain, thereby eventually outpacing the competition.
The major change can stress one, two or all the components.

- The change can involve the value proposition. This involves changing the hierarchy of the purchasing decision criteria used by the competition or throwing up new criteria. Kim and Mauborgne[10] suggest four non-mutually exclusive ways of doing this by answering the following question: what factors could be reduced, eliminated, created or raised well beyond industry standards? The objective being to achieve a "value curve" that is utterly different from that of competitors and better meet the needs of customers. For instance, the low-cost Formule 1 hotel chain launched by the Accor group, with minimal service and very basically appointed rooms, is widely different from its competitors in the one- and two-star hotel sector. Formule 1 offers its "low budget" customers an outstanding feature by improving the indispensable elements and limiting the non-essential ones.

- The change can involve the value chain. The different steps of the chain are radically changed so that the outcome is a new offer system. For instance, Swatch analysed the watch industry value chain and discovered that the value was primarily to be found downstream, i.e. in this case, marketing and distribution. They thus decided to change the chain completely by focusing their efforts on the downstream links: a new manufacturing process that reduced the number of working parts from 150 to 50; using international designers to turn the product into a fashion statement; a major marketing effort with 15% of turnover spent on advertising; dropping (at least at first) traditional retailers and opening their own outlets in corners of department stores and airports. All these innovations combined turned the chain into a new offer system that competitors found hard to counter.

- The change can involve the revenue model. The way of generating and capturing revenues is radically changed: rent instead of selling; give away the product and generate advertising revenue instead; radically increase asset rotation and lower margin rates, etc. For instance, free dailies like Metro have completely changed the revenue model of the newspaper business: turnover generated entirely by advertising; lower initial investment, “the key money for its dailies is around 50 million euros, compared to 150 to 200 million for a paid-for daily”; lower production costs through investment in more modern equipment for page layout etc.; skeleton editorial staff (Metro is supported by the Metro Worlds News press agency group); lower printing and distribution costs (the newcomers are not involved by printing union and press distribution syndicate monopolies, a weighty factor in the paid-for papers’ commitments[11].

A definite change to one of these business model components will have an impact on the others, because they are interdependent. Strategic innovation requires a change on at least one of these components. Thus, strategic innovation can however be of differing degrees[12].

TO CONCLUDE: THE CONCEPT OF THE BUSINESS MODEL TO BE DEVELOPED AS A STRATEGIC INNOVATION TOOL

The business model, that we have defined as the description of the way a business can create value through the value it proposes to its customers, its value architecture (including its resources and internal and external value chain) and how it can capture the value to convert it into profit, can be perceived as a useful instrument for developing a strategic innovation. It indeed structures thinking to focus on the strategy with the customer at its centre, but without neglecting the operational and profit aspects of the business’s economic equation.

This implies three educational focuses:

- **Teaching the concept of the business model**

The concept is not widely taught today because academics often consider it to be pointless, or even dangerous[13]. So teachers have to be made to understand how useful it can be in the strategic innovation process to promote it from the status of buzzword to that of an academic concept with the same value as other instruments.

- **Learning how to overcome prevailing mental models**

Creativity is a prime lever in innovation, and this is especially true for strategic innovation since it requires a major change in habits. In the workplace, individuals or groups find their inventiveness is impeded by the rigidity of mental schemes[14]. These play an important part in the way overworked managers process information, because they act as a filter that makes information easier to deal with. Mental models develop in many ways. They are rooted in one's personal experience (early education, national culture, etc.) as well as in the organisation one is part of. Though mental models can help managers to make quick decisions in routine situations, they can act as blinkers to creativity and prevent managers from considering radically innovating moves that challenge current thinking. This rigidity can be apparent at all levels of an industry sector. It is what Hamel and Prahalad have called "industry orthodoxy", the best-known term, which is close to "industry recipes" or "strategic industry framework" [15]

Questioning the prevailing business model can challenge preconceived ideas: what could be the new ways to operate? How to differentiate the value proposition? How to conceive, produce, and commercialize differently? How to change the revenue model? What new combination of the elements of the business model makes sense for the customer and is relevant on an economic level? Therefore, overcoming the nuisance caused by rigid mental models requires unlearning the rules they are rooted in and learning new ones. This is one reason why strategic innovation is often brought into an industry by newcomers to it, for they are not steeped in established rules and don't have to unlearn them.

Training, therefore, but also human resource management in companies should focus on exchange at all levels: cultural, socio-economic, early education, etc. In this respect, MBAs should set an example by developing sources of exchange amongst participants with widely different experience in their cultural and professional backgrounds.

- **Raising awareness of the need to combine intuition and creativity with analytical strictness**

The business model components – value proposal, value architecture, and revenue model – help increase understanding of the need to combine intuition, creativity and analytical strictness in the strategic innovation process. While the first two components require use of imagination, the revenue model is there to remind us of the business's economic requirements. An excellent illustration of this is the early failure of online grocery shopping: value proposal was high for customers, but business developers were inclined to forget that the new value architecture forces them to do at no extra cost what the customer had hitherto done for them, i.e. picking the items off shelves, going through the checkout and taking the shopping home.
The three components thus have to be consistent and this should be emphasised in teaching, which is rather inclined to compartmentalise its subjects: market and customer analyses in marketing, value chain analysis in operation management, revenue model analysis in finance and management accounting.

Generally speaking, a more global take on innovation translates into teaching a more global and less compartmentalised view of management. Student and teachers together must build more bridges between disciplines that are usually kept separate in the management sciences.

About the research

This research is based on the consulting experience of the authors as well as on several specific case studies conducted in Europe, including interviews with over 20 top executives of firms who managed to bring about strategic innovation over the last decade, such as for example Schneider Electrics and Spie Batignolles. The research has not been completed yet, and therefore only the main ideas still to be explored in future work are presented.

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