Business model innovation

Game-changing the future

Part 1 – The need to innovate
Overview
What is innovation and how does it occur? Technological advances are shaping and empowering consumers. We demand more, and better, for less. Forward thinking businesses are changing the way they operate to harness these new technologies and deliver value to their customers in new and interesting ways. They are not just innovating new products and services, but also the way they create and deliver that value to their customers. This is business model innovation.

The need to innovate
Australia’s Gross Domestic Income continues to grow. But in the most recent decade the drivers of growth have been capital investment and favorable terms of trade, and these have been primarily driven by the resources boom. Underlying productivity is, at best, stagnant. Australia faces a significant productivity challenge. But it will not be addressed through incremental efficiency gains. It will only be addressed through step change gains brought about by innovation. We need to shift our focus from doing more of the same, for less, to finding new and innovative ways to create and deliver value.

Looking forward
The business case for innovation is clear. Over the course of our next three publications we will introduce the Business Model Canvas and the concept of Blue Ocean Strategy to provide a framework for understanding innovation. We will then discuss some key enabling technologies and trends and use the framework to understand how innovative businesses are leveraging these, to find new ways to create and deliver value.
What is innovation and how does it occur? Technological advances are shaping and empowering consumers. We demand more, and better, for less. Forward thinking businesses are changing the way they operate to harness these new technologies and deliver value to their customers in new and interesting ways. They are not just innovating new products and services, but also the way they create and deliver that value to their customers. This is business model innovation.
Overview

Over the course of four publications we will examine the need for Australia to harness new technologies and trends to reverse a concerning decline in underlying productivity Part 1 – The need to innovate.

We will then introduce the Business Model Canvas, a template for identifying the drivers of value and innovation within a business Part 2 – What is business model innovation?.

In the third publication we will use the Business Model Canvas to identify and understand some emerging business models that leverage a number of key consumer trends Part 3 – The drivers and enablers of innovation.

In the final publication we will consider how companies should go about innovating and some of the risks associated with it Part 4 – How to innovate.

WHY

The need to innovate
Why do we need to innovate?

WHAT

Understanding innovation
What is business model innovation?

WHERE

The drivers and enablers of innovation
Where is innovation happening? What trends are driving it? What technological advances are enabling it?

HOW

How to innovate
How should companies go about innovating? And what are the risks?
2 The need to innovate

Australia’s Gross Domestic Income continues to grow. But in the most recent decade the drivers of growth have been capital investment and favorable terms of trade, and these have been primarily driven by the resources boom. Underlying productivity is, at best, stagnant. Australia faces a significant productivity challenge. But it will not be addressed through incremental efficiency gains. It will only be addressed through step change gains brought about by innovation. We need to shift our focus from doing more of the same, to finding new and innovative ways to create and deliver value.
The productivity challenge

Over the past 15 years Australia’s Gross Domestic Income has increased, on average, by $30 billion per year, and the rate has been accelerating. But behind the headline numbers is a troubling story. Underlying growth is actually decreasing. We are becoming less productive as a nation. Innovation may be the only way to reverse the trend.

Whilst Australia’s Gross Domestic Income has continued to increase during the 1990s, 2000s and since, the drivers of growth have shifted. Whist Capital and Labour productivity were key drivers of growth in 1993-99 (‘the Golden Age’) and 1999 – 2005 (‘Riding Momentum’), both have significantly retreated in 2005-11 (‘Capital Boom’). It has only been through a positive terms of trade and additional capital investment (driven by the resources boom), that Australia has been able to maintain the continuing increase in Gross Domestic Income.

Ten percent of the economy (the resources sector) has driven a third of recent income growth and more than half of the recent income growth has been due to the temporary effects of positive terms of trade and additional capital.

Whereas between 1999-2005 increases in labour productivity added $43 billion (measured in 2010 real terms) to national income, in the most recent period this has fallen by over 60% to only $17 billion.

“The productivity miracle of 1993–99 actually happened when capital growth was very low – they were getting more output, but without more tools and machinery. Now we have the opposite. They’re getting more tools and machinery, but without the output.”

Chris Bradley, McKinsey principal
The resources boom is already receding. If the underlying decline in labour and capital productivity is not corrected, the implications for future growth are profound.

A recent report by McKinsey (Beyond the Boom: Australia’s Productivity Imperative) suggests future income growth could fall as low as 0.5% per annum if underlying productivity decline is not addressed. McKinsey’s modeling assumes a range of scenarios for terms of trade, investment, and capital and labour productivity. Under the ‘Hangover’ scenario (0.5% per annum growth), terms of trade returns to the long term average, only two thirds of advanced and one third of less advanced investment projects occur, and productivity stays at 2006–11 levels.

The outcome is sobering and the message is clear. If Australia wants to maintain growth rates commensurate with the past two decades, it must find ways to increase productivity returns to long term averages.2

“Incremental productivity improvements will not be sufficient to enable Australian manufacturers to compete in a global and increasingly cost driven market. To compete, Australian manufacturers must innovate and achieve step change.”

Australian Manufacturing: Redefining Manufacturing, KordaMentha, August 2013

Source: Beyond the Boom: Australia’s Productivity Imperative, McKinsey
The innovation response

Australia’s productivity challenge will not be addressed through incremental efficiency gains. Step change productivity is not about doing more with less. It’s about producing things in fundamentally different ways. In short, it’s about innovation.

Productivity is a measure of the ratio of inputs such as labour, materials and capital, to the production of outputs in the form of goods and services.

Too often, the indices of productivity are confused with the determinants of productivity. Traditional measures of productivity such as output per hours worked (labour productivity) or output per unit of labour and capital used (multi-factor profitability) are the scorecard. But they do not show how to achieve the goals.

True productivity is not about doing more with less, nor about working people harder for longer. Contrary to popular wisdom, productivity does not equate with efficiency; it centres on innovation and transformation – of business capabilities, skills, technology and competitiveness. It is focused on producing the same products and services in fundamentally different ways (delivering higher value at lower cost), or producing fundamentally different products and services for which there are no alternatives.\(^3\)

The downward trend in national productivity suggests Australia is not as innovative as it needs to be. The message is sobering, but the opportunities that would flow from ‘getting it right’ are such that those who embrace the challenge may discover a profitable and sustainable future.

The most potent form of innovation is business model innovation. Business model innovation happens when firms find a whole new recipe for business success that changes the game.

“A business model is the ‘recipe’ for how an enterprise creates value for customers, partners and itself, based on its distinctive and superior skills and competencies”

Manufacturing Futures, Australian Business Foundation for the NSW Business Chamber, April 2011
Why business model innovation matters

Process and product innovation alone are often not enough to generate value. Even the most innovative products often fail to fulfill their potential because they are unable to compete within the constraints of an existing business model. Shifts in the underlying model are often necessary to enable to innovative product or process to success in the marketplace.\(^4\)

Case Study: LifeStraw

LifeStraw has developed a personal use straw designed to remove bacteria and parasites from water. It has a growing foothold in the developing world.

Improving the efficiency of production for a typical drinking straws does nothing to address a value proposition directed at the developing world.

Developing an innovative straw-based water filtration product does nothing to address a value proposition directed at the developing world if the product is too expensive for the target market.

The value proposition (and the innovative product) is effectively delivered to the target market through an innovative funding structure, whereby the cost of producing and distributing the straws is met through carbon credits earned by eliminating the need for families to cut down trees for firewood to boil and purify water.
Engines of change

Business models – the underlying structures of how companies create, deliver and capture value – form the engine of business. What new engines will drive business in the future?

The evolution of power

The inner workings of a business model, its products and processes, its interactions with stakeholders, what and how it measures, the transactions it requires, influence a company’s ability to thrive in the future.

Business model innovation ultimately involves a novel form of exchange at some point along a company’s value chain. When that exchange, sometimes completely new, other times just different, creates new value, or distributes value more equitably, then it may be considered innovative.

“Other examples of novel exchanges that provide value to more stakeholders and shift incentives can be found in interactions between a company and its suppliers (SABMiller sourcing from disadvantaged cassava farmers), a company and its employees (the cooperative ownership structure at Ocean Spray) or a company and its community (2 Degrees providing a meal to a hungry child for every health bar sold).”

“The most straightforward exchange is one between a company and its customers. The development of power purchase agreements (PPAs) for solar projects, pioneered by SunEdison, provides a good example of a change in how a solar provider, in this case, captures revenue from its customers. Using PPAs has lowered the barrier for commercial and industrial customers to adopt solar because there is no upfront cost. SunEdison’s customers get cleaner energy at lower rates than commercial power while also taking advantage of renewable energy credits. The use of PPAs helps spread the use of renewable energy and lower costs, providing more value to customers and the system at large.”

Source: KordaMentha

20 Business Models for Sustainability, February 2014, SustainAbility

“Animal power” → “Steam power” → “Internal combustion engine”

Source: KordaMentha
Challenging existing business models

Existing businesses are driven to innovate by one of four primary reasons – *why innovate?*.

Once prompted by one of these drivers, businesses typically focus on one of four routes to innovation – *how to innovate?*.

### Why innovate?

<table>
<thead>
<tr>
<th>Reactive</th>
<th>Expansive</th>
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<tbody>
<tr>
<td>Arising out of a crisis with the existing business model (IBM in the 1990s)</td>
<td>Launching a new technology, product or service (Nespresso, iTunes)</td>
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<table>
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<tr>
<th>Adaptive</th>
<th>Pro-active/explorative</th>
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<tbody>
<tr>
<td>Adjusting, improving or defending the existing business model (Proctor &amp; Gamble 'open innovation')</td>
<td>Preparing for the future (car2go by Daimler, Amazon Web Services)</td>
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### Challenges

- developing an appetite for new models
- aligning old and new models
- managing vested interests
- focusing on the long term

### How to innovate?

<table>
<thead>
<tr>
<th>Satisfy market</th>
<th>Improve market</th>
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<tbody>
<tr>
<td>Fulfill an unanswered market need (Tata car, NetJets)</td>
<td>Improve or disrupt an existing market (Ryanair, Nintendo Wii, Amazon.com)</td>
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<table>
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<tr>
<th>Bring to market</th>
<th>Create market</th>
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<tbody>
<tr>
<td>Bring a new technology, product or service to market or exploit existing intellectual property (Xerox 914, Nespresso)</td>
<td>Create an entirely new type of business (Google)</td>
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### Challenges

- finding the right model
- testing the model before full-scale launch
- continuously adapting the model in response to market feedback
- managing uncertainty
- focusing on the long term

Source: Business Model Generation, Alexander Osterwalder and Yves Pigneur, 2010
Looking forward

The business case for innovation is clear. Over the course of our next three publications we will introduce the Business Model Canvas and the concept of Blue Ocean Strategy to provide a framework for understanding innovation. We will then discuss some key enabling technologies and trends and use the framework to understand how innovative businesses are leveraging these to find new ways to create and deliver value.
Introducing the Business Model Canvas

If business models are the recipe for creating value, what are the ingredients? The Business Model Canvas is a visual framework comprising nine segments, or building blocks, that enable us to identify the key drivers of difference or innovation within an organisation.

The Business Model Canvas

<table>
<thead>
<tr>
<th>Key partners</th>
<th>Key activities</th>
<th>Value proposition</th>
<th>Customer relationships</th>
<th>Customer segments</th>
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<tbody>
<tr>
<td>Key resources</td>
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Cost structure

Revenue streams


Acknowledgement

Our Business Model Innovation series of publications draws heavily on the Business Model Canvas. More information on this tool can be found at businessmodelgeneration.com
Blue Ocean Strategy

Blue Ocean Strategy dismisses the old dichotomy of competing on either price or value and provides a path to the creation of new value propositions that create new, uncontested markets.

Case Study: Nintendo Wii

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<th>Customer segments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Game developers</td>
<td>State of the art chip development</td>
<td>High end console performance and graphics</td>
<td>Motion controlled games</td>
<td>Narrow market of ‘hardcore’ gamers</td>
</tr>
<tr>
<td>Off-the-shelf hardware component manufacturers</td>
<td>New proprietary technology</td>
<td>Fun factor and group (family) experience</td>
<td>Channels</td>
<td>Large market of casual gamers and families</td>
</tr>
<tr>
<td></td>
<td>Motion control technology</td>
<td></td>
<td>Retail distribution</td>
<td>Game developers</td>
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<tr>
<th>Key resources</th>
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<table>
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<tr>
<th>Cost structure</th>
<th>Revenue streams</th>
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<tr>
<td>Console production price</td>
<td>Profit on console sales</td>
</tr>
<tr>
<td>Technology development costs</td>
<td>Console subsidies</td>
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<tr>
<td>Console subsidies</td>
<td>Royalties from game developers</td>
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In our second publication we will show how Blue Ocean Strategy and the Business Model Canvas can be combined to break down and understand the innovative approach Nintendo adopted to allow the technologically inferior Wii to compete effectively against Sony’s Playstation 3 and Microsoft’s Xbox 360.
The drivers and enablers of innovation

In our third publication we will discuss key enabling technologies and trends and investigate how innovative businesses are leveraging these to find new ways to create and deliver value.

Drivers and enablers of innovation

Innovative business models

- Fractional ownership
- Freemium
- Product as service
- Bait and hook
- Long-tail
Notes


2. ibid


5. ibid
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