Getting to high value innovation

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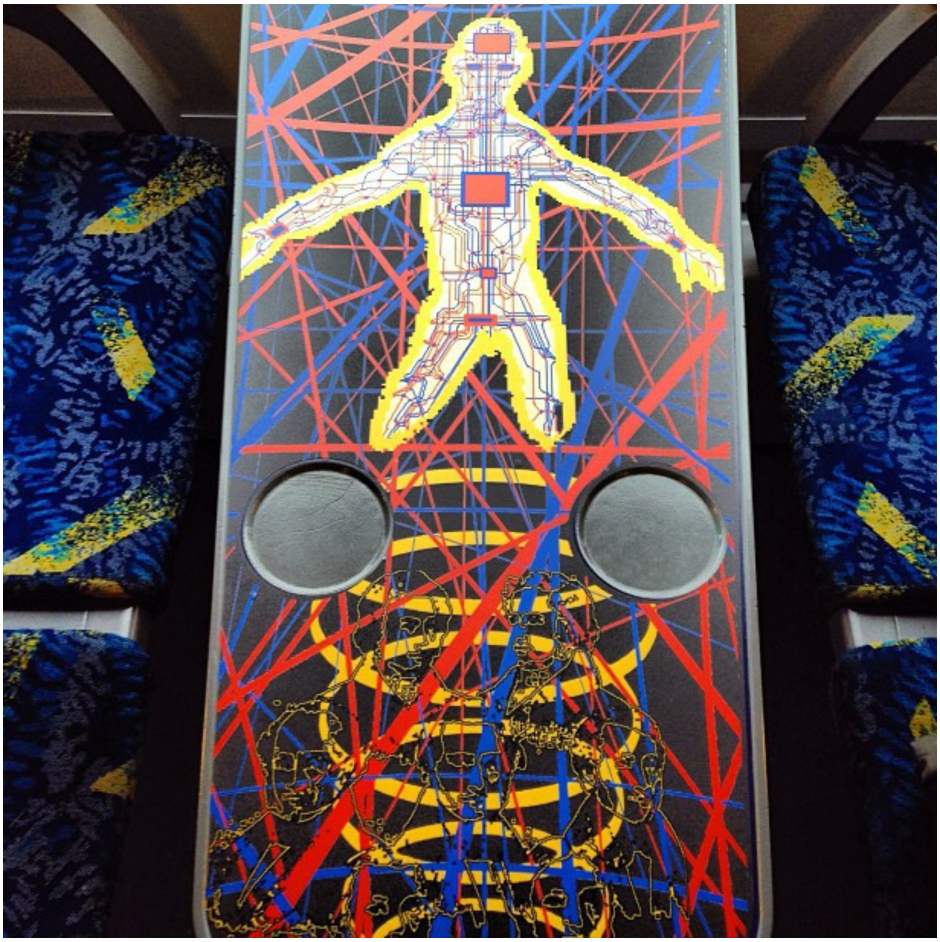


Photo: Igor Schwarzmann

Andrew Curry and Joe Ballantyne write: One of the dirty secrets of business is that most companies grow at around the overall speed of the economies in which they operate. As we see slower growth across most of the world economy, business growth slows too. This creates a fundamental challenge for businesses if they want to maintain their rate of return on investment and avoid pressure from shareholders or investors. It requires them to think about the whole business as an engine for growth as they look for ways to create demand. Business model innovation is back on the agenda.

One reason for this is the traditional solutions that businesses have deployed to gain growth are not as effective as they used to be.

- Stealing share through increased advertising and marketing spend tends to be short-lived.

- Buying share through mergers and acquisitions is known

to be unreliable and has less effect as industries become more concentrated.

- Cutting prices hits margins.

- Incremental innovation has less effect, according to data from Kantar Worldpanel.

A symptom of these issues has been the emergence both of activist investors and the business approach of the Brazilian conglomerate 3G Capital, which owns InBev, Heinz, and Burger King, with its tight, even obsessive focus on cost control. So far the evidence suggests that this boosts profits but doesn't create business growth.

The innovation challenge is that as categories mature, they become "good enough", from the consumer point of view. This means that in turn the added cost of greater functionality or more attributes outweigh the benefits. The investment cost of delivering the innovation starts to rise, which reduces the return on innovation.[1] And without decent returns, investor capital moves on to look for the next big thing.

The same thing is happening now in the ICT sector, where penetration figures indicate a mature market, almost everywhere, replacement rates are falling, and products are being commoditized. Companies such as Apple are sitting on cash rather than investing in innovation; Google is increasingly investing outside of the sector.

So, there are two stages to finding sustainable growth. The first is that you need to identify the new pools of value; even in a slower growth world, there are peaks caused by changes in the overall social and economic environment. The second is to capture a share of that value, through business innovation. Hanging over both of these are questions of scale and of timing: is the opportunity going to be big enough? And if it is, *when* is it gong to be big enough?

These are themes that The Futures Company has been working on in its own research over the past few years. Our recent report, *Defying Gravity*, is about why growth is slowing, and the impact that has on markets. This built on our earlier piece of work, *Unlocking New Sources of Growth*, which described how and where new value pools formed. And *The 21st Century Business*, co-written with Jules Peck, described the type of business that would be agile enough to respond to change in the new business environments of the 21st century.

New pools of value

Our research in *Unlocking New Sources of Growth* identified four pools of new value that companies could look at, summarised in the acronym MVMT.

The first was “Markets”; money moving between countries as some got relatively richer. China, for example. The second was “Values”; shifts in social values and attitudes, which then lead to shifts in buying patterns. An example: shifting demand within the beauty sector, driven by women’s changing ideas about image. The third was “Money,” in which money moves between economic and demographic groups within markets. An example: the squeeze on the earnings of millennials while boomers prosper. And the fourth, obviously, is “Technology,” where changing technologies change spending patterns and also create whole new categories. An example: the way in which Google has become the most valuable advertising platform in the world.

But it is not just about money: timing is also important. The shifts in value identified through the MVMT lens tend to sit on generational rates of change, creating platforms for innovation, rather then corresponding to business innovation cycles. But the second order changes (for example the shift to nail beauty, or the emergence of apps, or the arrival on the global travel market of significant numbers of Chinese tourists) do happen at the speed of one or two innovation cycles. There are clues to be found, as well, as to whether a market is close to take-off, which we spelled out in our Pressure Gauge model in the *New Sources of Growth* report. In other words, business model innovation is not a matter of being lucky enough to stumble over a nugget of gold on the beach: it should be part of a structured innovation process.

Thinking about business models

The notion of the business model is a function of the era of computers and spreadsheets, which made it possible to test business assumptions on the computer screen. But this is a cold-blooded way of looking at it. For a business model is more than a spreadsheet. It is also a story about the business, about how an organisation delivers goods or services to its customers, linking how these are made with how they are sold. For a commercial business, it also tells the story of how it makes money.

> Every successful company is built on "a theory of the business" which connects markets, consumers, capabilities and technology together in a story about how the business works — and every theory of the business becomes obsolete.

The idea of the business model comes from the management academic Peter Drucker, although he didn't use the phrase himself. Drucker argued that every successful company is built on "a theory of the business" which connects markets, consumers, capabilities and technology together in a way of doing business effectively.

And every theory of the business becomes obsolete.

There are signs that your theory of the business may be heading for trouble.

- Next generation innovation offers smaller and smaller improvements.

- Customers find alternatives increasingly acceptable.

- An unexpected failure.

- An unexpected success.

Existing leaders are not always well-placed to transform a business model, since they have grown up with the existing version. There are exceptions: Andy Grove and Gordon Moore at Intel, for example, or Andrea Jung at Avon, or, more recently, Satya Nadella at Microsoft. The story about Grove and Moore is that when Intel was facing a crisis, they chatted about what the next CEO would do after they had been fired. Then they decided to come in the following week and start doing it themselves.

Designed by the B-team: the prototype of the Boeing 747 takes off on its first test flight in February 1969. (Image: The Museum of Flight.)

The limits of innovation

The history of the passenger airliner over the past 50 years represents a cautionary tale about the limits of innovation. In the '60s everyone believed that the future of air travel was supersonic; so much so that the team of Boeing engineers that designed the workhorse 747 plane was the 'B-team'. In the event, the only supersonic airlines that ever saw commercial service were Concorde and the Russian Tupolev TU-44. From a passenger perspective, the time savings on supersonic flight were not sufficiently great to attract more than a handful of travellers, given the increased cost. The industry had innovated beyond the needs of its customers. The flight time on most long haul routes in 2016 is about the same as it was in the 1970s.

Types of business model innovation

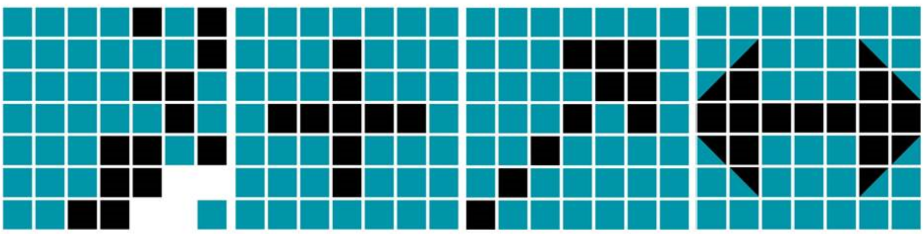
Through an extensive review and analysis of different types of business models, and of business model innovation, Kantar Futures has identified that, at heart, there are four main types of business model innovation: these are:

• **Extracting**: what can be removed?

• **Bundling**: what else can be wrapped into the product or service?

• **Upserving**: what would make the experience richer?

• **Market-making**: how can we better connect buyers and sellers?



Business model innovation. Icons by Augustus Newsam, Kantar Futures

Extracting

Extracting includes consumption to flow, which simplifies the consumer experience by auto-top up); acceleration (e.g. extracting time, as in low-cost airlines and turnaround times); and reduction, what can be taken out. This might involve removing preservatives, for example, or with the supermarket groups Aldi or Mercadona, reducing choice in low interest categories.

The core questions to be asked about Extracting are, “What can I remove or simplify?”. Sitting behind that is a question about the relationship of your product or service to your customers’ time or energy, and behind that a third question about what it is in your product or service your customers really value.

Bundling

Bundling covers changes such as product to service (such as Zipcar), from product to experience (music value has moved from hard-format to events) and from loose to packaged (e.g., from coffee beans to Nespresso.)

The questions that sit behind this are about the core benefit that the product or service provides, whether this benefit is better served through a continuing relationship, and whether this also allows you to change the cost structure for the customer in a way that helps both them and you. Zipcar, for example, bundles the costs of insurance across its complete customer base, which is a benefit for young urbanites for whole insurance is typically expensive.

Upserving

Upserving is about increasing the perceived value of the product or service. This can be through personalisation or customisation, from providing to premium customers benefits associated with the luxury market, or providing aspects of a product or service typically associated with professional users.

One of the core features of up serving is about tailoring or customising an offer, which the customer can experience as a move for them into a premium category. Upserving often benefits from social trends which are about the emergence of amateur enthusiasts or connoisseur around a product or service that has hitherto been the preserve of the business to business sector. (Think of the way in which top-end kitchen equipment has migrated into the business-to-consumer area). Visual cues can be important; an "upserved" product or service often draws on cultural signs from the leading edge for packaging and presentation.

Market-making

Market making includes aggregating, to create network effects; utilising spare capacity, as in Airbnb, lastminute.com, or Stubhub; or trading up, as in a so-called "freemium" model. It is not a purely digital model: farmers' markets, or food markets, also make markets. But typically these are two-sided markets, where a buyer and seller are brought together around a platform, and the platform owner takes a margin for access.

The underlying question is about whether a new market will produce a different benefits proposition for both buyers and sellers, and if so, how issues of access and payment are resolved (and whether the margins for access and payment seem fair to all parties.) From a business model, scaling is normally an essential element for success, especially in digital markets, as is clarity about the benefits that customers will pay for.

Each of these four should have the effect of creating better customer relationships and increasing customer value. In a world where the impact of brands on value appears to be declining, and the value of customer relationships is increasing, this is a significant benefit.

Exhibit: Types of business model innovation

Extracting	Bundling	Upselling	Market-making
From consumption to flow	From product to service	Personalisation/ tailoring	Aggregating
Acceleration	From product to experience	Luxury to premium	Utilising spare capacity
Reduction	From loose to packaged	Professional to consumer	Trading up

Source: Kantar Futures

Innovating across the value chain

Successful business model innovation usually requires innovation in several places across the value chain at the same time. To take the familiar example of Uber, for example, it is riding a wider shift in the car market from product to service. It has innovated at the back end to remove from the process cash payment, a classic customer pain point. Personalised messages about the car and the driver increase the customer's perceived security. It bundles data around its service for the benefit of the customer. And so on.

Nonetheless, business model innovation is a tough proposition, and often perceived as being easier for disruptors than for incumbents. There are familiar challenges for larger businesses about how to scale and how to preserve existing value streams while also innovating about new ones. We will return to this question in a future article.

But the known challenges tend to obscure the advantages of business model innovation.

The first is that when it sticks it is associated with higher levels of returns, perhaps because managers in such businesses are tuned differently to opportunities.

The second is that it often involves changes in processes that are hard to spot from outside or to reverse engineer. As the researchers Karan Girotra and Serguei Netessine observe, “Business model innovation … is about delivering existing products that are produced by existing technologies to existing markets. And because it often involves changes invisible to the outside world, it can bring advantages that are hard to copy.”

The third is that they have the potential to scale. They are a type of innovation where larger businesses have advantages in competing with smaller, more agile firms.

Perhaps for all of these reasons, research done by IBM with global CEOs found that “Companies that put more emphasis on business model innovation experienced significantly better operating margin growth (over a five-year period) than their peers.” In a world of slowing growth, business models are not something that businesses can afford to take for granted any more.

Making this work, of course, still remains challenging. As seen in the Exhibit, it needs businesses to: first, connect what’s happening in their wider business environment to their capabilities; second, to identify the opportunities that represent distinctive opportunities; third, to offer a strategic window for the company; and then to execute operationally to deliver the benefits. We will return to *how* businesses do this in a later article.

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How we can help

Moving successfully to new business models is always a challenge. The Futures Company's Future Dynamics helps established businesses to identify opportunity spaces that are substantial enough to create the potential for innovation.

[1] In the technology sector, for example, in the days when Moore's law still held, each doubling of processor power-to-price ratio also involved a doubling of the cost of building the fabrication plant.

Innovation Business Models Business Strategy