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The New Fashion Show — Innovative Business Models

New revenue streams from new channels, markets or services are prized by companies squeezed by global competition. However, first they have to learn how to create them.

Staring at the massive central chilling plant before him one evening five years ago, David Turner says he couldn't escape the symbolism. His employer, York International, sold billions of dollars worth of commercial cooling equipment annually. But almost all of its products were hidden, woven deeply into customers' facilities.

This looming plant couldn't have been more different. It stood alone, towering, on what had been a parking lot. It was distinctly apart from the dozens of other structures on the Savannah River Site, a sprawling U.S. Department of Energy research and nuclear material production complex that covers 310 square miles in South Carolina.

That stark image struck Turner as he walked nearby. A project manager for York with a background in construction, it dawned on him that the refrigeration equipment wasn't really part of Savannah River, it was just the means to an end.

Plenty of companies didn't really want to own and operate chilling equipment. They just wanted cool air. To Turner, that insight led to an astonishingly simple idea, a new business model that better served the real needs of York's customers. Why not separate that need for cool air from the acquisition of costly equipment? Why not sell cool air as a service?

"All the ideas started trickling down from there," says Turner, 43, now the director of advanced utility solutions for Johnson Controls Inc., the new owner of York International. Soon after, a team of six York employees began mapping out YorkSource, an outsourcing service providing chilled air. York retains ownership and maintenance of the air cooling equipment.

The team spent two years grinding through the financial contracts that form the heart of service businesses. Today, YorkSource has three customers and expects to sign another half dozen this year. The average contract value is \$8-\$10 million. Turner projects the service will bring in \$100 million over the next few years.

The new business model created more than a new revenue stream. Faced with tough competition from larger U.S. competitors, York needed a strategy that went beyond incremental product features or cost-cutting. It had to embed itself into its customers' long-term planning and operating environments. And it had to do so in a way that precluded penetration by competitors.

YorkSource delivers on these goals. The new service enables the company to leapfrog into clients' decision-making pipelines much earlier than equipment procurement. As a supplier of a vital service, YorkSource becomes a key player in the enterprise's physical plant operating strategy. "You become part of their business, their infrastructure," explains Turner. "At that point, any further [building] development is going to be yours."

Change the game

Turner's story reflects the stark reality facing U.S. businesses: Making money by peddling more of the same is no

longer an option. Once upon a business case, companies could stick with what worked and rake in tidy profits. Every now and then, they incorporated a wow feature or two into their products. Buyers kept buying.

But modest product improvement via feature iteration is passé. The big bang of business-model change is in. Bold companies facing competitive challenges have decided to change the game. They are pumping up the volume on commercializing promising ideas — not just line extensions and incremental improvements, but inventive new revenue streams.

Starwood Hotels peddles its Westin chain Heavenly Bed furnishings through Nordstrom department stores and recently appointed its first head of retail sales. Coffeehouse giant Starbucks Corp. has emerged as a potent force in entertainment through partnerships in music CDs, satellite radio and movies. Eyeing the low overhead of direct selling, Binney & Smith, purveyor of the iconic Crayola brand crayons and markers, has launched an in-home sales program for its famous product line (For more details and other examples, see table, *New Model Runway*, below).

Plenty of others want to make the leap into business model innovation. That’s because Wall Street puts a price premium on a company’s ability to sprout new businesses as a sign of corporate vigor — think of General Electric’s long string of earnings growth, high P/E ratio and history of creative business model development.

New Model Runway		
Academics and consultants noted a variety of new business models at a recent “Front End of Innovation conference” and subsequent interviews. Here’s a sampler at the cutting edge of business-model innovation:		
Company	Old model	New model
Binney & Smith (Crayola crayons and markers)	Retail stores	In home parties, a la Tupperware
Legos	Plastic building blocks for toddlers sold via retail	Software publisher and electronics distributor for its Mindstorms programmable robot
Starbucks	Coffee shop	Packager and distributor of music CDs, satellite radio and movies
Starwood Hotels	Offers hotel rooms	Sells branded mattresses and other furnishings
York International	Sell and install air conditioning equipment	Provides chilled air as a services supplier
StataCorp.	Statistical software developer and sold direct	Distributor of user-developed software add-ons via the Internet
Sources: Academics, consultants, company officials and company web sites		

The security analysts’ view is that acquisitions are okay, but homegrown ideas are better. The buzzword *du jour* — “organic growth” — says it all in this age when natural foods attract a premium price over processed goods.

But dreaming up and then commercializing promising business models requires more than funding a “new model development” department, transferring some hot shots from marketing and R&D and giving them a three-month deadline.

Business model innovation isn’t just about creativity or a sudden insight like Dave Turner’s inspiration one night in a South Carolina parking lot. It rests on a set of processes that companies can learn, if they’re properly motivated.

Crazy innovation drivers

For all the coverage of globalization, the more palpable forces bearing down on companies to become more innovative are local rather than global, says Eric von Hippel, a management professor at the Massachusetts Institute of Technology. “Rather than being affected by a larger trend, they see XYZ company doing something, and they have to counter it,” says von Hippel, head of MIT’s Innovation and Entrepreneurship Group and author of several landmark texts on innovation.

Worse, at a time when competitive pressures are more intense than ever, technology is eroding some of the best-known tools companies use to compete. The Internet has undermined traditional, multimillion-dollar branding strategies faster than you can say HTML.

Once-captive customers are now liberated. Thanks to the Internet, they are an increasingly potent force via search

engines and shopping bots. The rise of user-generated content — blogs, chat forums, fan sites, hate sites, video casts, you name it — is further stripping away the power of branding from corporate marketing gurus.

How bad is it? Just ask Land Rover. Type the name of the British carmaker and its Discovery 3 model into MSN, and www.haveyoursay.com, a blog detailing the unhappy experiences of an anonymous owner, pops up as listing number two out of 117,362 — immediately following the car company's corporate web site.

So much for the primacy of branding. "You can no longer hide behind your brand," says Sam Kogan, president of GEN3 Partners Inc., a Boston consulting firm company — founded by Michael Treacy, the author of *Double-Digit Growth* and one of the leading sages of the innovation movement.

Nor can companies take refuge in conventional approaches to innovation. Those approaches are now considered too short-lived to provide an advantage in today's hypercompetitive business environment. "Product innovation no longer works," contends consultant Larry Keeley of Doblin Group in Chicago, considered the leading organization for innovation metrics. "The mean time to clone a new product in financial services is six weeks. That's assuming it's regulated. If it's not regulated, it's six days."

No guts, no long-term glory

Once competitive pressures or other business model drivers appear, most companies don't have the foggiest notion how to develop a new business model. The ability to discuss business models "is extremely rare as a skill," says Keeley. "The vast majority [of companies] act as though business models were ordained by God and should never be challenged. There is both active and passive resistance to it, as a concept and as a skill. It's amazingly difficult to get people to think in terms of business models."

That doesn't surprise Tom Kelley. As general manager of IDEO Inc., the illustrious Palo Alto-based design firm known for its groundbreaking work in industrial design, Kelley says that pursuing new lines of business pries company executives away from the paths they know best. That's a tug they'll resist, even in the face of certain failure if they continue the status quo.

The problem is more than just a comfort zone issue, but basic compensation. If a market's prognosticators pronounce just two decades left of solid growth, 20 years of solid growth sounds pretty darned good for a CEO whose stock options will vest in five years. Furthermore, his executive team probably has five or 10 years to retirement, so they're not concerned about an eventual threat in two decades.

"The incentives and the implicit rules of the game keep you focused on making incremental improvements in the market you own," explains Kelley. Top executives at profitable companies "are really good at their world" and reluctant to enter new ones, he points out. "If I'm out in front of the world with the Securities and Exchange Commission and *The Wall Street Journal* watching me, I don't like being the novice."

It's not just individuals who are reluctant to think outside of their wallet. A moneymaking corporation is by definition organized to support and prioritize around a particular good or service. Trying to wring new business models from it is asking it to perform a task it is not set up to do.

"The reason it has been difficult for established companies to innovate business models is because the process and values [of their companies] are meant not to change," explains Clayton Christensen, Harvard Business School professor and author of several books on innovation including *Seeing What's Next*. Christensen also is the author of the seminal texts *The Innovator's Dilemma* and *The Innovator's Solution*. He has been studying business model innovation and will soon release a report on his findings.

"New business models will never come from marketing or engineering because the way the departments get their ideas funded forces them to do only those innovations that support the current business model," Christensen adds.

Leadership first, vision second

In other words, companies seem hard-wired to stay the course they're on. That's why setting up separate ecosystems to grow new business models works better than trying to encourage them through existing channels. That's one of many lessons learned from experts in business-model development.

Research by consulting firm Peer Insight and others also found that assigning a talented, skilled leader to shepherd a promising idea to profitability is a key step. "The idea is to put a seasoned executive in charge who understands scale and what will be required for success if it gets out there," says Jeneanne Rae, co-founder and president of the Alexandria, VA, company. "Particularly with services, operational excellence is extremely important. You need someone with the sway to make things happen." Rae is a seven-year veteran of IDEO and a noted business magazine columnist on the topic of services innovation.

Rae and other innovation consultants say key ingredients of business model innovation include the right combination of team members, location, philosophy and approach. See the table below, *Business Model Pre-requisites*, for more information.

Business Model Pre-requisites

Experts contacted by Executive Circle offered these tips



Clayton Christensen says "the reason it has been difficult for established companies to innovate business models is because the process and values [of their companies] are meant not to change."

to successfully foster business-model innovation:	
Tactic	Why
High profile, senior executive	Clout and status provides air cover
Team population limit	Small teams more agile
Team population mix	Need fresh ideas as well as industry expertise
Offsite location	Distance protects team from pressures to follow established procedures
Fail fast, fail often philosophy	Due to global economy, must cut losses quickly
Use the web to test	Easy, fast, inexpensive
Rely on new customers for ideas, not just existing customers	Existing customers not able to provide breakthrough ideas
Sources: various consultants and innovation practitioners	

The role of customers in business-model innovation is especially important. But not through the conventional closed-loop tools of focus groups and mail surveys. Those avenues may yield modest product innovation ideas, but not breakthrough business model innovation. Companies must open themselves up to listening and soliciting ideas from non-customers, frustrated customers and third parties outside of their world.

It's a skill that so far hasn't come naturally to the corporate set. Quips IDEO's Kelley: Given the disdain with which companies have traditionally treated consumers' letters, "you'd think they had anthrax and had to be quarantined."

It's all about the lead customers

Companies have to rethink the role of their customers in product development, especially in a business to business context. If necessity is the mother of invention, then desperation is its godfather. Research by MIT's von Hippel shows that many commercially important innovations are developed by "lead users," users who are at the leading edge of a market trend and have an intense need for a product not yet being manufactured.

"These users often actually build what they need," von Hippel emphasizes. "Manufacturers focused on the target market often know nothing of these lead user advancements."

Over one 30-year period, users hatched 80 percent of the major innovations in scientific instruments such as gas chromatographs, von Hippel noted at the April 2006 "Front End of Innovation" conference in Boston.

Von Hippel's research shows that by tracking down and observing lead users, a company can systematically pursue commercial breakthroughs. In many cases, watching customers and supporting their needs led to entirely new revenue streams.

Von Hippel cited two examples at the conference: 1) StataCorp's statistical software programs were augmented by users developing specific vertical market solutions. Instead of just being a software developer, StataCorp now is a publisher of modules created by its customers

2) Legos introduced a robot based on its plastic building blocks and a small microprocessor-based intelligence module, targeted at young boys. However, the geek community embraced the challenge of reprogramming the robot into a more customized gadget. Now the Mindstorms business unit consists of a variety of development kits, games, peripheral devices and other revenue streams. Von Hippel estimates that Mindstorms is now a \$1 billion business for Legos, vastly bigger than the company's initial expectations.

Focus on services

Business model innovation that produces new services-based revenue streams is especially sought after. The concept of introducing a new service on top of an existing product category bedazzles companies — it promises higher margins and lower overhead. However, introducing a new services-based business model is fraught with new complexities for traditional product developers.

Unlike product companies accustomed to prototyping new gizmos in many iterations, services should be quicker to launch, test, evaluate and either expand or abandon. However, some companies go overboard and run into trouble.



MIT professor Eric von Hippel says many commercially important innovations are developed by lead users—customers at the leading edge of a market trend and have an intense need for a product not yet being manufactured.



The one-time nature of a costly pilot rallies its champions to become heavily invested in it, notes Rae of Peer Insight. They become emotionally attached. Rather than viewing the new idea objectively, it becomes their baby that must be defended at all costs. Rae tells of one financial-services company that poured \$500 million into a service pilot before shutting it down as a failure.

The best way to develop new business models inexpensively is to have a platform for testing numerous new concepts. For example, Mayo Clinic runs a lab-like space in one of its buildings for new service delivery models. The world-renowned medical practice can test new ideas in patient care, such as the length of time for a pre-operative visit with the surgeon. Does it need to be one hour, or is it equally effective to meet for 20 minutes and include a video that the patient can view and then rewind and watch again? "If the answer is yes, you can save tons of physician time," says IDEO's Kelley, whose company has consulted with Mayo. The lab space is "a place to try it out, see if it'll work. Then try it again."

Weave a new model on the Web

Sometimes the innovative business model lab is in cyberspace, not Minnesota. The 24/7 nature of most services means that the Internet is an essential element of new business model development. Internet metrics provide swift feedback. Are people clicking on the offering? Does it interest them? Companies can float several marketing campaigns at once and track the messages that trigger the greatest response. They can also kill a flopped business model quickly if it fails to find takers.

Terry Jones has a lot of baggage about failed and successful business models. He founded Travelocity in 1996 and served six years as CEO. No surprise, he's a fan of the online medium's strength as a place to explore the viability of new business models. He recalls his own trial balloon for the online travel agency to become a purveyor of retail goods.

"I thought Travelocity would be a great place to sell travel gear" such as carry-on bags, says Jones, now managing principal for consulting firm Essential Ideas. "You'd think it would fit, that the timing would be right." But the web site's button to view the goods went unclicked. "I learned most people buy luggage when it's on sale, not when they're traveling," Jones adds. "You try to make connections between products but it's not what's in a consumer's head."

The rapid prototyping, testing, analysis and refining nature of the Internet rely on a flexible technological foundation. To be agile in development of new business models, as well as operating efficiently in general, requires people with the right attitude and the right tools.

"No matter how much you automate processes, it's still people who help companies innovate and create customer and partner loyalty," notes Bob Muglia, Senior Vice President, Server & Tools Business at Microsoft. "We believe that the success of any company depends on how well it unleashes the power of people with software that is dynamic, familiar, and widely used and supported."

Steve Ballmer, Microsoft's CEO, notes that a bottom-up approach to innovation provides the most insightful and long lasting benefits to an organization. "Your people drive innovation and they care dearly about what your customers think about you," he says. "They really know where the inefficiencies are inside your organization.

"Furthermore, this flat world in which suppliers and businesses are much more closely linked are driven by a certain kind of connection," Ballmer adds. "You want your people to have the tools that facilitate letting them succeed on your behalf."

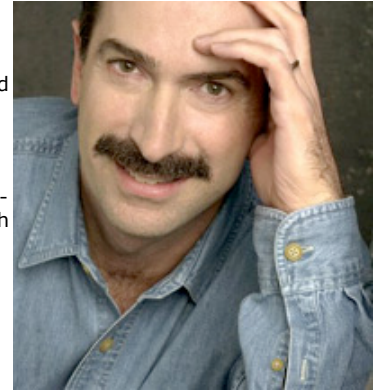
Downplay culture

In addition, getting an organization to foster business model innovation requires a language infrastructure for the staff as well as a technology infrastructure. Forget the pursuit of the "culture of creativity," says GEN3 Partners' Kogan. "Culture is important, but it has been overplayed. Innovation needs a discipline — tools and a framework. It needs to be a profession."

And even big and innovative companies need help when it comes to business models. Christensen recalls that in the late 1990s, he visited Intel's campus 18 times in the course of one year to teach innovation. One hundred managers at a time attended the daylong course Christensen had developed to aid the chip titan in resetting its path for the future. Recognizing, developing and nurturing new business models was a key element to the curriculum.

Since then, Intel has had major successes, such as the Celeron chip that it rolled out at a new price point. The company "is not out of the woods yet," says Christensen, "but [Intel CEO Andy] Grove said to me, 'Your models didn't give us answers, but they did give us a common language and a common approach to framing problems.'"

Add to that much sweat. At York International, Turner credits "dogged determination" with helping to shape the success of YorkSource. But the payoff has a huge upside as the company recasts itself as a partner to building owners, not just a purveyor of equipment. Now, says Turner with satisfaction, "we own the life cycle instead of just the equipment."



Product design wizard Tom Kelley says companies show disdain towards new ideas from their customers.

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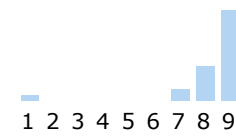
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