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Crafting Business Models

Few concepts in business today are as widely discussed—and seldom systematically studied—as business models.[1]

During the late 1990s, "dot-com" executives and Wall Street analysts routinely justified high valuations by claiming the superiority of emerging Internet business models. They maintained that new business metrics should be applied to calculate economic value and that these business metrics would eventually drive profitability—but only after huge amounts of capital had been invested to "get big fast." Yet few Internet entrepreneurs could trace the path between the new metrics they had chosen—my personal favorite was "eyeballs"—and the tangible economic returns investors would eventually demand. The irrational exuberance for Internet stocks reached its peak during 1999, when the number of Internet initial public offerings (IPOs) surged. During this 12-month period, hundreds of Internet companies went public, and with these IPOs came a flood of public data that highlighted the fatal flaws in many dot-com business models. By early 2000, stock markets had begun to plummet amid concerns about the sustainability of these newly public and not yet profitable Internet businesses.

The resulting backlash caused many to question whether the concept of a business model had been invented simply to justify get-rich-quick Internet schemes. But this is far from accurate. In fact, the concept of a business model can be traced to early management thinking that defined industrial economy industries and the corporations that dominated them. Published in the 1960s, Chandler's *Strategy and Structure* provided an important foundation for defining the underlying economic models upon which businesses were constructed.[2] This path-breaking book described the importance of the alignment of an organization's strategy with the environment within which it operates and with the resources and capabilities required to execute the strategy. It then showed how this alignment drove capital efficient profitable growth and created value for all stakeholders. Chandler's work, combined with a large body of increasingly sophisticated 20th century management research, laid out the theory of the industrial economy business models that guided management practice through much of the 20th century.[3] By the late 1990s, industrial economy business models had become so well defined that the approach to their analysis was fairly straightforward. Executives familiar with an industry understood the roles various firms played and the mechanisms through which each player created and captured value or, conversely, destroyed value.

In today's global network economy, however, new business models are emerging that are radically changing how firms create (or destroy) value within an industry and across industry boundaries. Indeed, as new technologies provide opportunities to radically change business and industry economics, the need to frame strategy and its execution within the framework of a business model has

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Professor Lynda M. Applegate prepared this exercise as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

become an increasingly important management tool—especially for executives and entrepreneurs who are searching for opportunities to create and exploit game-changing innovations.

This tutorial provides the basic frameworks and approaches that executives in established businesses can use to assess their current business models and identify strengths, weaknesses, opportunities, and threats. Entrepreneurs who are searching for opportunities to launch and grow successful new businesses can also use these same frameworks and approaches. See "Recognizing and Shaping Opportunities," *Core Readings in Entrepreneurship*, (HBP #8056) for how entrepreneurs can use the business model framework when launching new ventures.

Business Models Definition

Before describing an approach for analyzing a business model and identifying opportunities for improvement, it is helpful to begin with a definition.

> A business model defines how an organization interacts with its environment to define a unique ***strategy***, attract the resources and build the ***capabilities*** required to execute the strategy, and create ***value*** for all stakeholders.

Using this definition, a business model—whether it is for a publicly traded company, a new venture, or a social enterprise—forms the foundation for how leaders make decisions about opportunities to pursue, businesses to launch or buy, activities to perform, talent to hire, and how to organize to deliver value to stakeholders. For an established organization, business model analysis helps executives understand how their current organizations make and lose money and how to identify and evaluate new business opportunities. For entrepreneurs launching a new venture, the business model becomes a predictive forecasting tool that frames the development of a business plan or pitch and the assumptions used to forecast future financial returns. The key steps in crafting a business model are presented below. Note: While the discussion below is most easily applied in for profit firms, the same analysis can be done for social enterprises where the primary purpose is not to generate profit but to create social impact.

Evaluate Strategic Choices

Competitive strategy is about being different. It is about deliberately choosing a different position and set of activities that enable you to deliver unique value.[4]

Strategy is a series of choices that determine the opportunities you will pursue and the market potential of those opportunities. It involves choices concerning industries within which to compete and the role you will play, markets to enter, products and services to sell, and how you will differentiate your offerings from other alternatives. In his best-selling article, Michael Porter stresses that successful strategies define how a company plans to achieve a distinctive and unique position that "woos customers from established players or draws new customers into the market."

From a business model perspective, decisions concerning your strategy define key revenue drivers of your business and the potential for growth over time. These decisions also determine the revenue-generating capabilities and resource (e.g., sales people, marketing, order fulfillment systems) that are needed to execute your strategy and achieve short-term positioning targets and long-term goals. Steps you can take in analyzing strategic choices are discussed below. (See **Exhibit 1** for a summary.)

Step 1: Analyze the Business Context

Begin by asking: "What business are we in?" Examine ***industry and competitive dynamics*** and consider relevant ***demographic, economic, political, regulatory, and societal*** factors that influence (or could influence) your business. Identify key trends that will either positively or negatively impact your industry and any disruptors—for example, technologies, globalization, new business models, or regulatory changes—that could be a source of opportunity or threat. As you look at the business environment, don't just focus on what's going on now. Ask yourself: "What's changing? Is the wind at my back—or in my face?" And, more importantly: "Will the winds shift in the future and, if so, when do I expect them to shift?"

Step 2: Analyze Market and Product Positioning

Once you have looked broadly at the business environment, focus your attention on the ***markets*** you serve today or will serve in the future. What is the size of the "addressable" market today—that's not just your current customers, but also the potential revenues that could be generated if you had 100% of the market? Is the market growing, holding steady or declining and what is the rate you expect it to change over the next 1, 3 and 5 years? Identify pressing problems your customers face or compelling opportunities they could pursue. Evaluate how your current products and services and those under development provide solutions that address those problems or enable customers to pursue opportunities. Consider the question: "How does what we do (or what we are considering) enable our customers to create value?"

Now that you understand your market, turn your attention to the alternatives customers have for meeting their needs. Evaluate your current ***product and service offerings*** as "solutions" to your *customers'* pressing problems and compelling opportunities. Compare your offerings with alternatives offered by competitors or substitutes. (Note: If you are analyzing the business model for a new business, identify how your entry products, services and "solutions" address pressing problems or compelling opportunities that your target customers will face when you launch.) Identify what makes you different in ways that matter to customers? What capabilities and resources do you have today (or will you need to assemble) to develop and deliver "distinctive and unique" offerings that solve pressing problems for customers or that enable them to pursue compelling opportunities? Will customers pay the price you must charge to make the economics of your business work? How easy or hard is it (or will it be) for customers to understand the value of your offerings vis-à-vis other alternatives? Are your products and services gaining or losing share? Are they competitively priced today and what do you expect will happen with pricing in the future? Do you possess (or can you build) proprietary knowledge, assets, or intellectual property that serve (or will serve) as a barrier to entry?

Step 3: Analyze Your Business Network (or Ecosystem)

Armed with an understanding of your environment and product-market positioning, identify the core activities needed to design, develop, produce, distribute, market, sell and service products delivered to the end consumers of your offerings. What activities do you perform today and what activities do others perform in your business network? Draw your business network, identifying key players (e.g., suppliers, channel parties, logistics players, partners) and the relationships among them. Highlight players that have tremendous power because of proprietary assets or scarce resources, unique capabilities, products and services provided, or value created/claimed. How does the quality and cost of activities performed or products and services provided by others in your business network compare to what could be provided if those same activities, products and services were performed, produced and/or delivered inside your organization? Jay Barney and William Hesterly suggest that you focus on four key questions as you analyze the resources available to you in either your business network or inside your company.[5]

- The Question of ***Value*****:** Does a resource enable you to exploit a valuable opportunity or avoid a threat that can destroy value?
- The Question of ***Rarity***: Is a resource, which you use to make a product or service or that is an integral part of the product or service offering, currently controlled by you, or only available to you? If not, is it only available to a small number of players?
- The Question of ***Imitability***: Do firms without access to a resource face a significant cost disadvantage in obtaining or developing the resource (e.g., Is what you do tough to imitate)?
- The Question of ***Organization***: Is your firm and its network/ecosystem organized to exploit valuable, rare, and costly-to-imitate resources?

Evaluate Resource Requirements and Capabilities

The purpose of organization is to reduce the friction that comes when people – both inside and outside your organization – must work together to accomplish shared goals.

Once you've defined your strategic direction, your long-term, mid-term and short-term goals, and tactical metrics and milestones you need to achieve, the next step is to assemble the resources and build the capabilities required to achieve those goals. These capabilities and resources enable you to execute your current strategy while also providing a platform for future growth. The capability dimension of a business model defines your cost model and the value of your operating assets. The alignment and links among your strategy and capabilities ultimately specify how you will create value for all stakeholders. A business model capability audit frames analysis in the four areas discussed below (see **Exhibit 2**).

Step 4: Analyze activities and processes

Begin your capability audit by turning to the core operating activities and processes that you perform inside your organization that enable you to produce products, deliver services, acquire and serve customers, manage relationships with key stakeholders, and deliver a continuous stream of new products, services, and innovations. Once you've evaluated operating processes, do the same for supporting processes such as talent management, finance, and IT services. Link these internal operations to those activities and processes provided by partners or others outside your organization. Are these processes as efficient as they could be or are there bottlenecks, areas of costly duplication, or sources of friction that slow you down and reduce your ability to compete? Are there production or service quality problems? Do your people and partners have the information needed to coordinate and control processes? Are they motivated and engaged in working together to achieve shared goals? Are you best-in-class in terms of innovation, speed, quality, cost, and productivity?

If you are building a new business or social enterprise, identify the activities that will need to be done to design and build your initial product or service. Identify key suppliers and partners and the activities needed to procure the materials, components and services you will need. Identify key customers and the activities needed to market, sell and serve them over time. How will you coordinate these activities to "reduce friction," remove bottlenecks, and ensure quality?

Step 5: Evaluate people and partners.

Armed with an understanding of end-to-end processes, evaluate whether you have the expertise and talent needed to effectively and efficiently perform these activities—even as you continually innovate to exploit new opportunities and improve performance. How easy or difficult is it (or will it be) to attract, develop, motivate, and retain the expertise needed to carry out specific activities and coordinate and control your operations? Does your company have the reputation and image required to attract and retain top talent? Does your culture and incentives enable you to engage and motivate people and partners to work with you to achieve shared goals? Have you developed clear performance targets, measurement systems, rewards, and boundaries that ensure that everyone understands the strategy and how what they do enables you to execute it? Are rewards (and sanctions) delivered in a fair manner? Keep in mind that performance measures for people and partners are often specific to the roles they have been hired to perform and the specific objectives they need to meet. For example, sales force quality and productivity are often measured in terms of sales per employee, customer retention per employee, and customer profitability per employee while manufacturing employees may be measured using product quality and production efficiency measures.

Step 6: Assess organization and culture.

Once you've evaluated your processes and the activities and people needed to carry them out, assess whether your organization design makes it easier or harder for people to make decisions and get work done. Have you grouped people into work units and provided them with the accountability and decision-making authority they need to do their work, make decisions, and meet performance targets? Have you developed approaches for coordinating work across units? These coordinating mechanisms may include formal reporting relationships, steering committees, liaison positions, and information systems. Does the informal culture support or hinder individuals and groups as they attempt to fulfill their roles and responsibilities? Are your people and partners united around a shared vision and values that enable them to work together to achieve shared goals? Does everyone understand the boundaries for decision-making and action beyond which they must not cross?

Step 7: Evaluate leadership, governance and control systems.

Success over time demands strong leadership. Effective leaders use governance structures and control systems to balance the creativity and vision needed to set goals and prioritize opportunities with the discipline needed to execute and deliver results. Governance systems include: strategic controls (scanning the environment, identifying strategic position today and in the future, setting goals, and prioritizing projects and investments); operating controls (defining short-term objectives, metrics and milestones, controlling current operating activities and projects); effective risk management (identification and management of key risks); and effective development and management of the shared values and culture that guide decisions and actions. Have you communicated a compelling and clear vision for the future that unites people and partners around common goals? Do leaders at all levels balance creativity and innovation with disciplined execution? Can they set realistic long-term goals and then focus performance on short-term metrics and milestones needed to execute and deliver results? Are leaders well connected and have they demonstrated a track record of success? Do you have a high performing board and executive team that work together to closely monitor strategic and operating performance?

Assess Value Created for All Stakeholders

The final component of your business model identifies value delivered to all stakeholders. This stakeholder analysis approach, expands the traditional distinction between "for-profit" and "not-for-profit" organizations to redefine value in a broader view—beyond simply profitability and economic capital to also include other sources of capital, including human capital (e.g. employment, education); intellectual capital (e.g., patents, knowledge creation, expertise); social capital (e.g., relationships, loyalty, engagement); and cultural capital (e.g., values, beliefs, inspiring stories). While the focus of this note is on for-profit firms, it is helpful to identify value metrics for stakeholders beyond financial impact.

Step 8: Identify internal and external stakeholders.

Begin your value audit by identifying internal and external stakeholders. Assess their interests and expectations. What do they require from you and what are they able (and willing) to provide to you? Can you attract, retain, motivate and engage key customers and are they willing and able to pay for the products, services, and solutions? How do the interests of other stakeholder groups (e.g., employees, partners, government, society) influence your ability to attract and serve customers? What are the benefits/value that each of the key stakeholders (or stakeholder groups) receive from doing business with you?

Step 9: Identify business model drivers.

Once you know what your internal and external stakeholders expect and whether the value you are delivering meets their expectations, go back and examine what you learned from analyzing each component of your business model. What are the key opportunities and threats identified during your strategy audit? What are the key strengths and weaknesses identified during your capability audit? Plot key strengths, weaknesses, opportunities and threats using a SWOT Matrix (see **Exhibit 3**). From these lists, identify components of your business model that drive the revenues you generate and the key expenses you incur in operating, organizing, and financing revenue generation. Identify the assets—both tangible and intangible--that you have inside your organization and those that you leverage from outside partners, customers etc. A business model dashboard can help you organize key revenue, cost, and asset turnover/efficiency drivers and to identify key metrics that can be used to analyze business performance (see **Exhibit 4**).

Step 10: Analyze and compare your financial performance.

Once you understand your business model drivers and the value delivered (or to be delivered) to key stakeholders, analyze your financial performance. Does your past performance help inform future performance or will changes in your strategic positioning and/or capabilities influence your projections for future revenues and costs? What assumptions have you made about your strategy and capabilities? How much uncertainty is there in these assumptions?

Given that financial analysis often involves comparisons with other companies or with historical performance over time, financial *ratios* are often used to support business model analysis. While specific financial ratios (see **Appendix A**) provide answers to questions about the economics of your business model, multiple ratios and measures are often required to understand the impact of strategic decisions or investments on economic value. For example, the decision to acquire a company or enter a new international market may involve new revenue streams and costs that change your profit margin while also decreasing cash, increasing debt, or increasing the value of assets on your balance sheet. It is critical to be able to analyze the interaction of these financial metrics to make sound business decisions.

The DuPont Formula, created by financial analysts at E.I. du Pont de Nemours and Company in the 1920s, enables comparison of multiple ratios to assist in strategic decision making. This financial metric (see **Exhibit 5**) relates three different ratios—profit margin, asset turnover (efficiency), and leverage—that combine to determine return on equity (ROE).

While the expanded ROE definition helps analyze key components of economic value, simply looking at financial returns is not enough. This is especially true when the business is growing quickly or you are launching new businesses where future financial returns are speculative at best. When the business environment is rapidly changing and highly uncertain, be sure to go back and understand the drivers of the ratios you are using to analyze your performance. Then assess the level of uncertainty you have in your assumptions about how the drivers will change over time and do a "best-case / worst-case" scenario analysis for each of the key assumptions behind your forecasts.

Step 11: Integrate the Information to Understand Value Linkages and to Identify Shared Value.

As discussed above, the power of the business model audit does not come from collecting and analyzing independent "buckets" of data. Instead, it's helpful to step back and consider what you have learned about key strategy, capability, and value linkages. **Exhibit 6** provides a sample of these linkages. **Appendix B** shows how information collected during your strategy and capability audit can be used to develop performance metrics for your business.

Evolving Business Models

Building businesses is a journey – not a destination.

Business models, like the organizations they represent, don't stay static. Instead, they evolve over time as executives exploit opportunities, respond to threats, and build capabilities. There are four key approaches you can take to evolve your business model.

Enhance: Incremental improvements to an existing strategy or capability.

Expand: Launch new product categories, enter new markets, or expand capabilities.

Explore: Launch new businesses and build new capabilities.

Exit: Exit a product or market or outsource a capability.

The Product-Market Matrix in **Exhibit 7** shows how these four approaches to business model evolution can be framed within familiar strategic positioning choices. Many business model shifts—for example, the decision to enhance a product or improve your capability to penetrate your existing market—represent incremental adjustments to your business model. At times, however, you might follow a more revolutionary path and choose to launch—not just a new product or market—but a new business. These radical business model innovations often involve more than just a change to product-market positioning but may also involve entering a brand new industry with new competitors and a new business network. When evolving a business model it is important to identify what components of your existing model can be leveraged and what you must build or buy (see **Exhibit 8**).

Summary

In turbulent times an enterprise has to be able to withstand sudden blows and avail itself of unexpected opportunities. This means that in turbulent times the fundamentals must be managed and managed well.[6]

It's tough to build successful businesses when the world is changing at warp speeds. We knew how to identify opportunities and build and grow successful businesses to exploit them during the industrial economy but there are new rules for success for the network economy. While many long for more stability, savvy entrepreneurs and executives know that it is in just such times of turbulence that opportunities for creating value can be identified and exploited.

Building businesses in these challenging times requires that executives understand how to define and execute strategy, develop and leverage capabilities, and create value for all stakeholders. But analysis is not enough. You must also develop leadership skills—not just at the top of your company—at all levels. These leaders must be able to use what they learn from their analysis to set direction, execute, and deliver results. They must be able to identify gaps and recognize whether they are "Execution Gaps" (we're heading in the right direction but need to improve our ability to execute) or "Strategy Gaps" (no matter how well we execute, "this dog won't hunt.") **Exhibit 9** summarizes the links between business model analysis and leadership.

A business model frames the "fundamentals" for building successful businesses that can innovate and grow in good times and bad. When your strategy, capabilities, and value are aligned with each other and with the external environment and leaders are able to continually evolve the business model, your business will generate what economists call a "virtuous cycle" of innovation, productivity, and increasing returns.[7] In contrast, a poorly aligned business model and failure of leadership can create a "vicious cycle" and your business can quickly spin out of control, destroying value. The more turbulent the environment, the faster a vicious cycle can destroy your business. The problem, of course, is that tightly aligned business models are tough to change. In today's turbulent times, business models must be aligned, yet flexible, requiring that leaders at all levels inside your organization and in your ecosystem work together to build successful businesses.

Enjoy your journey.

Exhibit 1 Business Model Strategy Audit: Suggested Approach and Sample Questions

Business Context	Sample Questions
• Identify relevant regulatory, societal, and industry trends and disruptors that signal opportunities and threats • Determine approaches to exploiting opportunities and managing risks • Determine which opportunities you will pursue in the future and which you will not pursue. • Answer the fundamental question: What business are we in today and should we be in?	• How favorable (or unfavorable) is the business context within which we operate today and what changes do we anticipate? • Are there disruptive changes on the horizon that would signal entry opportunities or threats to our existing strategy? Can we disrupt the industry and create new opportunities? • Which factors in the business environment help/hinder us in achieving our goals? • What must we do well to succeed? What are the key "failure factors"? • What are the key opportunities and threats? How quickly do we need to respond? • Have we clearly communicated to employees the range of opportunities that they should pursue and, most importantly, which opportunities they should NOT pursue? • Have we clearly identified future opportunities ("growth options")?
Product-Market Positioning	**Sample Questions**
• Talk with current and potential customers • Visit and watch them perform activities that your product / service offerings support (or will support) • Collect market research and customer information • Conduct focus groups • Involve customers in product design or improvement	• What are the pressing problems ("pains") that customers face? What must our customers (or potential customers) do to succeed and what can we do help them? • How well are customer needs being met today; how much are they willing to pay? • What is the current (and future) size of the customer base? • Are customer markets large and growing? Which segments are growing (or could grow) most rapidly? (Measure growth in terms of revenues, units sold, customer visits, number of customers/users, pricing, etc.) • Which of our current product/service offerings do our customers use today and how much revenue do we generate from each customer (or customer segment)? • What product/service offerings would our customers like us to offer? • What market share/"share of wallet" do we have today? How can we grow?
Differentiation	**Sample Questions**
• Identify traditional rivals, potential new entrants, and substitute offerings • Collect and analyze competitor information • Benchmark current or potential new offerings • Ask current customers why they use your offerings, what makes you different from the alternatives, what needs are not being met, and what would cause them to switch. Then talk with potential customers and ask them the same questions about competitor products. • Talk to industry and market experts	• Who are our competitors (including substitute products and services) and how do they differentiate their offerings by feature and price? • What prices do competitors charge and what margins do they get? • How sustainable are competitor positions? Can customers easily switch to other offerings? Who would lose share most quickly in a pricing or feature "war"? • What is the market share and share of wallet of key competitors/substitutes? What potential approaches could competitors take to increase their share? What approaches could *we* take to preserve or enhance our differentiated position? • How powerful are competitors? How might they respond to changes we might make?
Business Network	**Sample Questions**
• Identify the core activities, resources, and capabilities needed to achieve your goals (e.g., design, build, market, sell, and deliver products and services, innovate for the future, develop/manage talent) • Identify the support activities (e.g., payroll, recruiting, finance and accounting) and infrastructure (property, equipment, data centers, networks) • Assess your capabilities and potential supplier and partner capabilities in performing these activities • Compare the strategic value, cost and risk of performing activities inside vs. sourcing from outside • Determine what you will do and what you will source • Develop governance structures and systems to innovate and control end-to-end processes	• What activities, capabilities, and resources are required to execute strategy? • Which will my company perform and which will we source from the outside? • What is the value, rarity, and imitability of capabilities and resources needed to execute strategy and how can I organize to leverage these resources to achieve economies of scale and scope? • For the activities we outsource, how will we coordinate and control activities with key suppliers and partners? • How does the quality and cost of outsourced resources and capabilities compare to what we could provide inside? • How powerful are the individuals and organizations that control key activities, capabilities, and resources required to execute our strategy? • What is the source of power of different players in our business network? For example, does demand outpace supply or vice-versa? Have suppliers or partners erected barriers to entry or exit or created high switching costs? • What relationships do we have with powerful individuals and organizations needed to execute strategy?

Source: Casewriter.

Exhibit 2 Business Model Capability Audit Suggested Approach and Sample Questions

Activities and Processes	Sample Questions
• Build on your business network analysis to identify key activities needed to execute strategy • Group activities into roles that will be performed by people inside or outside your organization • Identify coordinating mechanisms that will enable the flow of goods and information through end-to-end processes • Identify infrastructure requirements	• What are the key activities needed to execute strategy? • How should those activities be grouped together to enable us to focus attention and resources while also developing the expertise needed in the future? • Which roles should we perform and which should we source from the outside? • What coordinating mechanisms (e.g., reporting relationships, liaison roles, steering committees) should we use to link activities and roles into efficient end-to-end processes? • What infrastructure (e.g., facilities, equipment, technology) is needed to support end-to-end processes?
People and Partners	**Sample Questions**
• Identify expertise and skills needed to perform activities and roles within end-to-end processes • Develop job descriptions for key roles • Analyze labor markets and determine which expertise and skills should be available inside the organization and which should be sourced from the outside • Analyze compensation patterns within labor markets and determine the cost of attracting, developing, and retaining talent • Develop and implement recruiting, hiring, development, and performance appraisal systems	• What skills and expertise do we need to perform the activities and roles as specified within our end-to-end processes? • Where do we find the talent we need and what do we need to pay for that talent? • How do we attract, develop, retain, and motivate the talent we need? • Do employees and partners understand what is expected of them, do they have the resources and authority needed to meet those expectations, and do we have performance measurement systems in place that provide them with timely feedback on their progress? • Do current development, compensation, and reward systems motivate employees and partners to work together to achieve shared goals, even as they fulfill personal goals?
Organization and Culture	**Sample Questions**
• Group employees and partners into work units that make it easy for them to accomplish individual and business goals while also focusing attention and effort and developing expertise • Clarify authority and accountability by role and unit • Develop formal reporting relationships to ensure a free flow of information on expectations and performance • Formalize authority and accountability and ensure people at all levels have the information needed to make decisions and take actions • Develop formal and informal coordination and collaboration mechanisms • Clarify values and behaviors and ensure consistency of incentives, performance measurement, and culture	• Are we organized to focus attention, develop necessary expertise, and reduce the friction that comes when people must work together to achieve shared goals? • Have we organized people into units and developed the reporting relationships needed to ensure authority and accountability for key decisions and actions? • Do we have the formal and informal coordination and collaboration systems required to get work done effectively and efficiently? • Do employees and partners at all levels have the information and resources needed to make timely decisions and perform core activities at highest standards of efficiency and quality? • Do they know how to use information to make informed decisions as individuals and teams? • Is information timely, relevant, and easily accessible? • Do we have the information and communication systems in place that make it easy for employees, partners, suppliers, customers, and other stakeholders to do business with us? Are our systems flexible enough to meet future needs?
Leadership and Governance	**Sample Questions**
• Identify key positions in your company and evaluate the strengths and weaknesses of people who fill those positions • Evaluate succession plans for key positions and the leaders who are being prepared to take on these positions • Evaluate leadership development and succession planning processes and systems, correct problems, and benchmark against world class companies • Develop governance systems and structures to ensure strong operating and strategic controls and effective risk / culture management.	• Have the leaders in our company communicated a compelling and clear vision for the future that unites people and partners around shared goals? • Do we have leaders at all levels who can balance creativity and innovation with disciplined execution? Can they set goals, prioritize among competing projects, assemble resources, and deliver results? • Are our leaders well-connected inside and outside and do they have a demonstrable track record of success? • Have we identified key positions throughout our company and our partner organizations? Do we have the right people in those positions and do we have an effective succession plan (and planning process) to ensure continuity? • Do we have a high performing board of directors and executive team and strong governance systems?

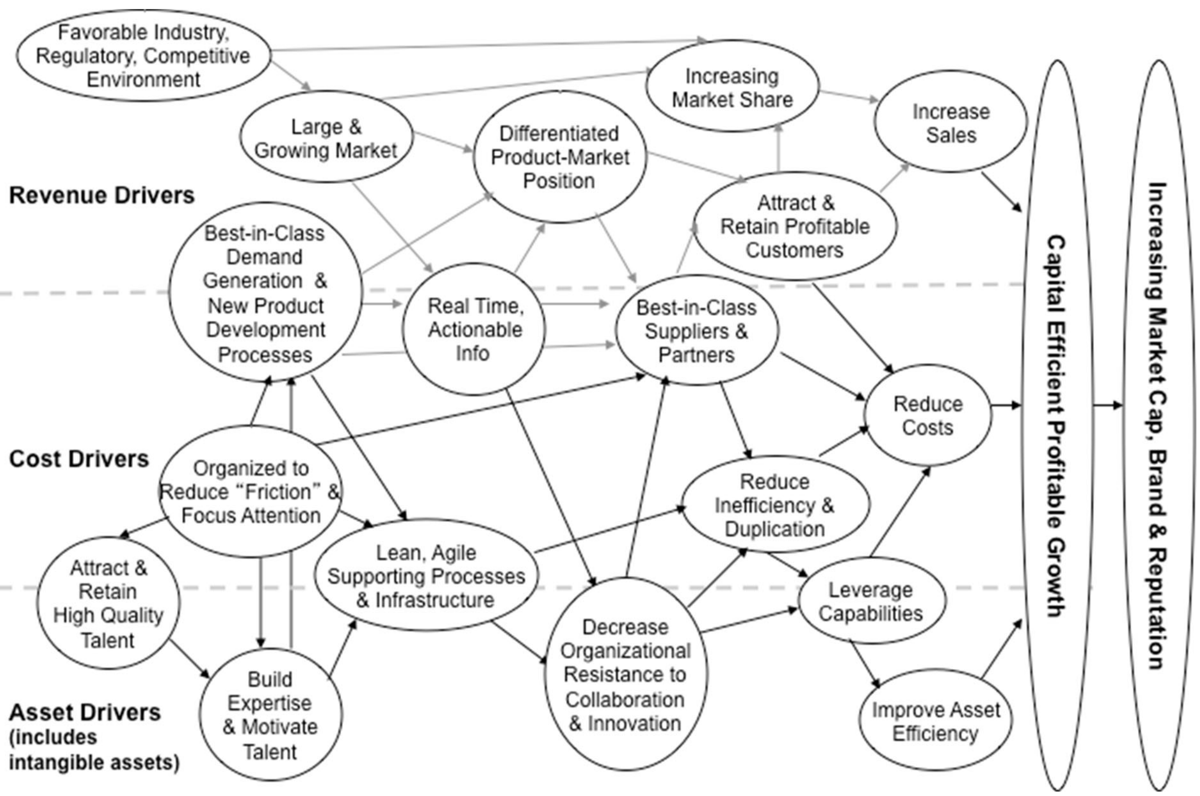
Source: Casewriter.

Exhibit 3 Business Model SWOT Analysis

What are the key opportunities and threats to your current strategy?	
Opportunities	***Threats***
Do you have the capabilities and resources to execute your current strategy?	
Strengths	***Weaknesses***

Source: The origin of the SWOT Matrix is unclear. Some believe that it was first used at the Stanford Research Institute (SRI) in the 1960s and 1970s. The above framework was developed by the casewriter to identify key drivers of business performance when analyzing a business model.

Exhibit 4 Building a Dashboard to Identify Business Model Drivers of Financial Performance



Source: The above framework was developed by the casewriter to identify how key drivers of business performance can be linked to financial performance.

Exhibit 5 Using the DuPont Formula to Deconstruct Return on Equity (ROE)

	Profit Margin		Asset Efficiency		Leverage

$$\text{ROE} = \frac{\text{NET INCOME}}{\text{REVENUE}} \times \frac{\text{REVENUE}}{\text{ASSETS}} \times \frac{\text{ASSETS}}{\text{SHAREHOLDERS' EQUITY}}$$

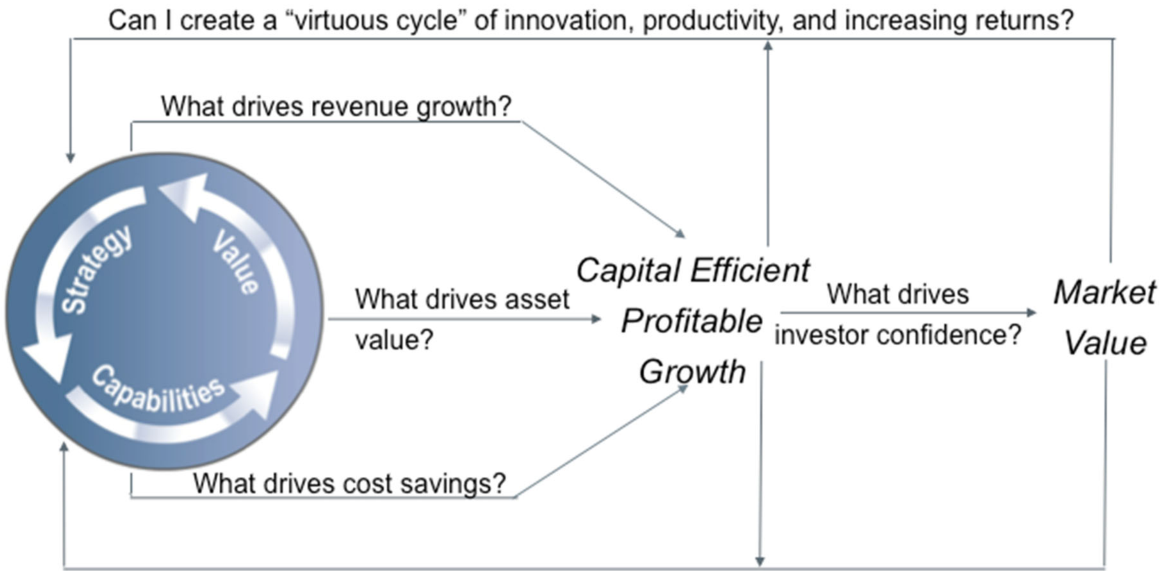
Profit Margin is a measure of a company's success at turning revenues into profits. It answers the question: For every dollar of revenue that we generate, how much of that dollar goes to net income (also called profit)? In its most basic form, net income is calculated by subtracting expenses from revenues. As a result, anything that lowers expenses and increases revenues improves profit margin.

Asset Turnover/Efficiency measures the efficiency with which an organization utilizes its assets by answering the question: How many dollars of revenue do we generate for each dollar of assets on our books? Of course, traditional financial measures of asset efficiency often don't reflect the value of intangible assets such as the skills and knowledge of your employees, the value of information and know-how captured in your databases and computer applications, the value of your company's brand and reputation, or the value of your network of business partners and customers. In today's global network economy, these "intangible assets" become even more important as sources of asset value. As a result, forward-thinking executives are expanding the way they calculate the value of their assets to include financial surrogates for intangible assets that are not already reflected in their balance sheet as patents, goodwill etc.[8] Note: The ratio, Market Value/Book Value, is often used to capture the value of intangible assets and future performance.

Leverage measures the percentage of your company's assets that would be available to the firm's owners if your firm was sold, after first subtracting how much of your assets would be needed to pay off creditors. Understanding a company's leverage enables executives to answer the question: For every dollar of value that I create, how much goes to increasing shareholder value?

Source: Casewriter.

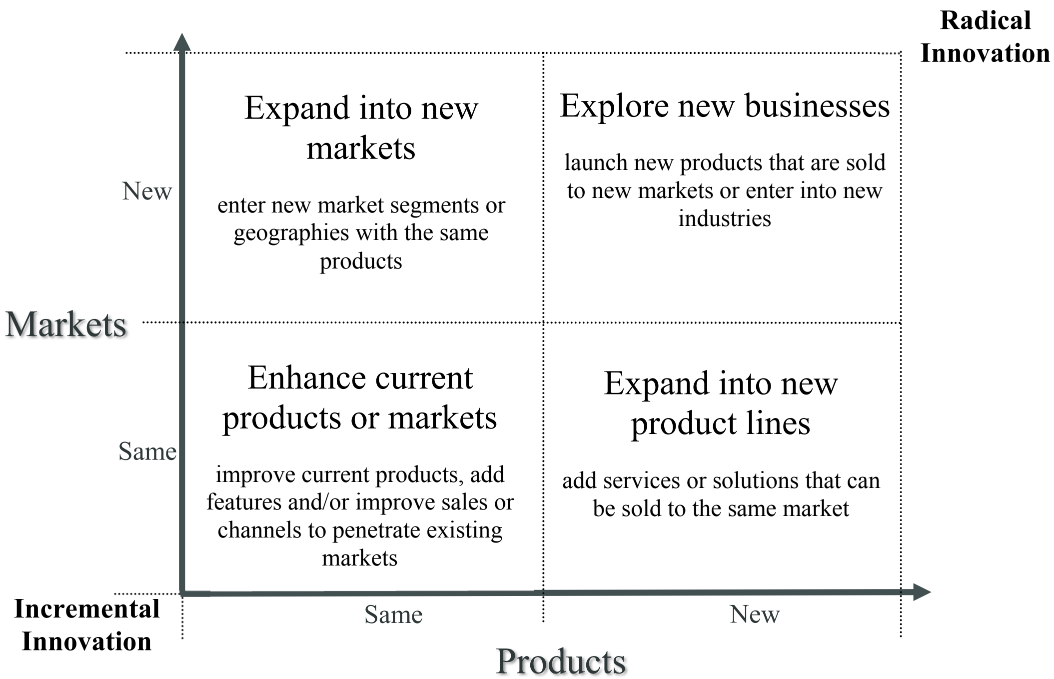
Exhibit 6 Linking Strategy, Capabilities and Value



Source: Applegate, L.M., *Crafting Business Models*, Harvard Business School Publishing #808-705.

Source: Casewriter.

Exhibit 7 Business Model Evolution



Source: Casewriter.

Exhibit 8 Leveraging your Business Model to Improve Economies of Scale and Scope

When evaluating growth options, it's important to answer the questions:

- What can you leverage in terms of your current strategic positioning, capability platform, and performance to exploit a growth opportunity?
- What will you need to build (or buy)?

Business Model Analytics	***Levers for Growth***
Strategy	Positioning
Business Positioning	Are there "white space" opportunities on current "field of play"?
	Should we expand the field play?
Product-Market Positioning	Can I leverage current customers, product designs / platforms?
Network/Value Chain Role	Can I leverage current suppliers, partners, channels?
Capabilities	Platform
Operations, Shared Services & Infrastructure	Can I leverage current operations and infrastructure?
People & Partners	Can I leverage current people / expertise?
Organization & Culture	Can I easily integrate within the existing organization?
Leadership & Governance	Do I have the capacity/capabilities to scale? (e.g., leadership, talent, operations)
Value	Performance
Customer/Employee Lifetime Value	Can I increase revenue?
Efficiency, Productivity	Can I decrease cost?
Cash Flow and Balance Sheet	Can I fund growth opportunities through cash flow or financing?
Economies of Scale and Scope	Can I leverage current assets (including intellectual assets) as I grow?

What are Economies of Scale and Scope?

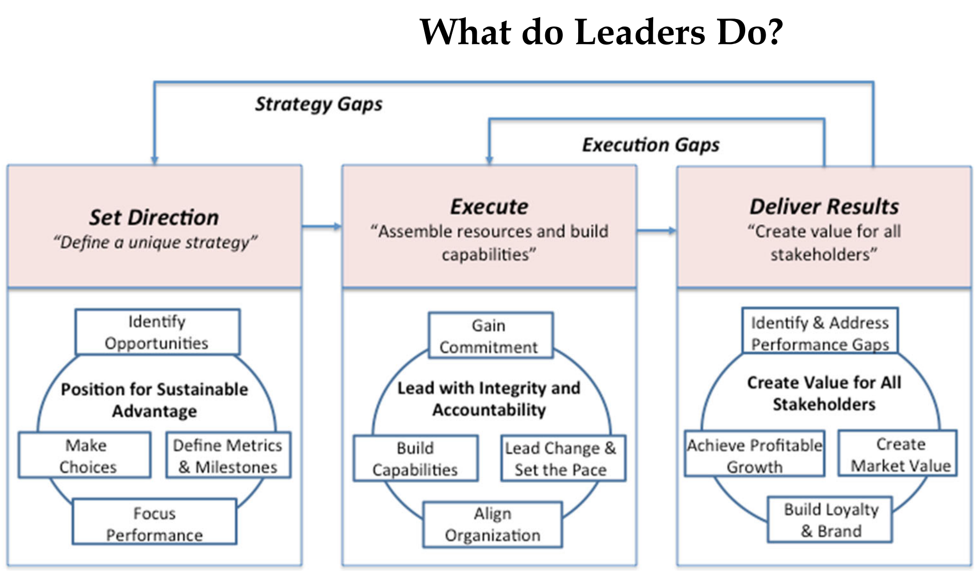
Economies of Scale are achieved when a business is able to pursue a growth option that leverages the current strategic positioning and/or the current operating platform to increase cash flow generated by the *current* business. This cash flow and assets can also be leveraged as a source of the capital needed to *scale* the current business.

Economies of Scope are achieved when is able to pursue a growth option that leverages current strategic positioning and/or the current operating platform to *expand into new markets, launch new product categories, or launch brand new businesses*. Once again, cash flow and assets can also be leveraged as a source of the capital needed to expand the *scope* of the business.

Economies of scale and scope enable a company to generate *increasing returns* and improve margins as an organization grows.

Source: Casewriter.

Exhibit 9 Leadership Roles and Responsibilities



Leader Roles	Set Direction	Execute	Deliver Results
What do you do well?			
What do you need to do better?			
What can you do to improve?			

Source: Applegate, L.M., "Leading High Growth Ventures," Core Readings in Entrepreneurship, Harvard Business Publishing #8082, 2015.

Appendix A: Financial Ratios Commonly Used to Analyze Financial Statements

Profitability measures enable you to answer the question: How many dollars of sales does it take to generate one dollar of profit? Three common approaches are used to analyze profits.

Gross Profit = Revenues – Cost of Sales
Gross Profit Margin = Gross Profit / Revenues
Operating Profit = Revenues – Operating Expenses
Operating Profit Margin = Operating Profit / Revenues
Net Profit (also called Net Income) = Revenues – Total Expenses
Net Profit Margin = Net Income / Revenues
Return on Equity (ROE) = Net Income / Shareholders' Equity

Productivity measures enable you to answer the question: How many dollars of sales or assets are required to generate one dollar of profit? Productivity can also be measured using ratios that show the efficiency of your assets or working capital in generating sales. If your company stores physical goods as inventory, you may wish to also know how quickly you are able to turn inventory into cash.

Return on Sales (ROS) = Net Income / Sales
Return on Assets (ROA) = Net Income / Total Assets
Return on Invested Capital = Net Income / (Total Liabilities and Stockholder Equity) – Current Liabilities
Inventory Turnover = Cost of Goods Sold / Average Inventory
Asset Efficiency = Sales / Assets
Working Capital Efficiency = Sales / (Current Assets – Current Liabilities)

Solvency measures enable you to answer the question: Do I have the assets needed to cover my liabilities and what percent of my assets are available to shareholders after I pay off debt? Short-term solvency can be analyzed by measuring the percentage of current assets needed to cover current liabilities or, in cases where it is important to retire debt quickly, only "quick" assets (e.g., cash and marketable securities) can be used in the calculation of current assets. Long-term solvency can be analyzed using the debt-to-equity ratio.

Current Ratio = Current Assets / Current Liabilities
Debt-to-Equity Ratio = Total Liabilities / Shareholders' Equity

Business value can be analyzed in multiple ways. Book value reflects the value of balance sheet assets. If your firm is publicly traded, its market value reflects the price that shareholders currently pay for equity in your firm and the Price to Earnings (P/E) ratio enables comparison of the value of a firm over time, comparisons with comparable companies, or cross-industry comparisons.

Book Value = Total Assets – Total Liabilities
Market Value = Price per Share X Shares Outstanding
P/E = Stock Price / Earnings per Share

Privately held businesses are often valued based on what a "comparable company" would sell for in the open market.[9] These "market comps" are often based on stock price multiples, such as the P/E ratio, or they may reflect the price per share paid during comparable transactions, such as the price paid for similar acquisitions.

Appendix B: Analyzing Business Model Drivers

What drives revenue growth?

Below are samples of drivers and metrics. Choose among these examples or identify others that are appropriate for your business model.

Strategy Drivers	**Metrics**
Attractiveness of the Business Context	Industry rate of growth or decline, competitive intensity, consolidation or fragmentation Societal, regulatory, macroeconomic, environmental strengths / weaknesses
Market Attractiveness	Market size (e.g., sales, # of customers, units sold) Market growth (e.g., forecasts and historical trends) Level of unmet need ("pain") in customers able and willing to pay Length of time to sell and adopt Frequency of interaction and use of products and services
Product Differentiation	Features of product / service offering and attractiveness to customers Ability to clearly differentiate offerings and pricing vis-à-vis competitors and substitutes
Effectiveness of Demand Channels	Description of sales and marketing channels (roles played, activities performed, power dynamics) Revenues and volume by channel
Capability Drivers	**Metrics**
Effectiveness of Revenue Generating Processes	Product quality (e.g., defect levels, returns, customer satisfaction) Supplier and partner quality metrics Operating process effectiveness (e.g., order fulfillment, sales, marketing, customer service) Innovation process effectiveness (e.g., R&D, business development)
Value Drivers	Metrics
Customer Lifetime Value	Total revenues and revenue trends # of customers and revenues per customer and per transaction % of first time vs. repeat customers Share of market and "share of wallet" Customer satisfaction with products, services, and experience of doing business with you Cost to serve, acquire, and retain Cost to serve: (operating expenses + cost of sales) / # of customers Cost to acquire and retain: (sum of all expenses related to customer acquisition and retention) Customer value: (number of customers) X (average monetary value of each visit) minus (costs to acquire, retain, and serve) Lifetime value: (current value of a customer) X (estimated length of relationship) X (expected percent change in value over time)
Employee Lifetime Value	# of employees and revenues per employee # of offers made and accepted Average length of time to fill key positions Employee satisfaction and retention vs. industry and best practice benchmarks Cost to acquire, develop, and retain Employee value = (number of employees) X (revenues generated) minus (costs to acquire, retain, and "serve") Lifetime value = (current value of an employee) X (estimated length of relationship) X (expected percent change in value over time)

What drives cost savings?

Strategy Drivers	Metrics
Industry Attractiveness	#, size, and power of competitors Competitive intensity and price pressure No single competitor, supplier, or partner controls key resources
Product Differentiation	Price and perceived value vis-à-vis competitors and substitutes Features of product / service offering and attractiveness to customers Ability to clearly differentiate features of offering and benefits
Capability Drivers	**Metrics**
End-to-End Operating Process Efficiency	Cycle time of key processes and activities Operating costs by process, activity, product, customer segment, etc. Costs of supplies, parts, materials, services, etc. Cost of inventory and frequency of inventory turns Historical and potential savings from operating improvements and cost management practices
Product Quality	Cost of poor quality (e.g., returns, rework, waste, compliance) and savings from quality improvements Administrative costs to maintain quality
Value Drivers	**Metrics**
Activity Based Cost	Product costs Fixed and marginal costs
Profit Margins	Gross profit margin = Gross Profit / Net Sales Operating profit margin = Operating Profit / Net Sales Profit margin = Net Income (or EBIT) / Net Sales

What drives asset efficiency?

Asset Value	Metrics
Tangible Assets	Value of Current Assets (e.g. cash and marketable securities, inventory, accounts receivable less allowance for doubtful accounts, etc.) Value of Non-Current Assets (e.g., non-current securities, property, plant, and equipment or PPE etc.)
Intangible Assets	Goodwill Value of patents and proprietary expertise / capabilities Value of loyal, engaged customers and employees Value of brand, image (e.g., Market Value to Book Value)
Productivity	**Metrics**
Tangible Assets	Fixed Asset Turnover Inventory Turnover Capital Turnover
Intangible Assets	Revenues per employee % of Revenues from new products

What drives investor/business owner confidence?

Investor Returns	Metrics
Investor Returns	Return on Equity (ROE) = Net Income / Shareholder's Equity Return on Invested Capital (ROIC) = Profit / (Invested Capital + Capital Expenses) Earnings per share (EPS) = Earnings / # of Shares Outstanding
Investor Perceptions and Expectations	Brand value, image, and ethics Management capacity, leadership and track record of success Strategy and performance guidance Proprietary assets (patents, knowledge, customers, etc.) and differentiation Historical earnings and returns Comparables and sector performance over time
Business Value	**Metrics**
Book Value	Working Capital = Current Assets – Current Liabilities Shareholders' Equity
Market Value	Market Value = Stock price X # of Shares outstanding Price to Earnings ratio (PE) = Stock price / EPS (usually last 4 quarters) Market Value / Book Value Growth Forecasts (especially Capital Efficient Profitable Growth)

Source: Casewriter.

Endnotes

[1] Malone, T. et. al., "Do some business models perform better than others?" MIT Sloan Working Paper, 4615-06, May 2006. ©2006 by Thomas Malone, Peter Weill, Richard Lai, Victoria D'Urso, George Herman, Thomas Apel, Stephanie Woerner.

[2] Chandler, A. Strategy and Structure: Chapters in the History of the American Industrial Enterprise, Cambridge: MIT Press, (reprint edition August 1969).

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[9] See Roberts, M., "Note on Valuing Private Businesses," (HBS No. 201-060).