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The power and peril of business model innovation

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Apple Computer has become the most valuable company in the world by disrupting entire industries, often outside its own core competence. We call this type of radical change “business model innovation.” Unlike product or process innovation, business model innovation changes the very nature of value creation across an entire sector or industry. Apple changed the content management and distribution model in the music industry, and shifted the value proposition from hardware to operating system in mobile phones. Research studies by IBM’s Institute for Business Value and Harvard Business School faculty show that business model innovators outperform competitors in both growth and profit.

But business model innovation is risky. When a firm chooses to focus its limited innovation resources on changing large scale value creation, it gambles the entire firm, not just a product line or service offering. Failed business model innovation can be catastrophic, as the fates of companies like Napster and Enron demonstrate. And even apparently successful business model innovation can fail if the firm can’t respond to changing market conditions. In fact, business model innovators are especially vulnerable to turbulence and competition, precisely because the margin of error is slimmer. This appears to be the case with TiVo, which has seen US subscriptions fall by nearly 50% in the past 5 years.

Our research on innovative entrepreneurs and business model innovation has helped shed some light on the unique characteristics of business model innovators, as well as the processes that help them continue to adapt and succeed. Based on interview and survey data from nearly 1000 firms, we learned that business model innovators share two critical characteristics. First, they are focused on identifying challenges and opportunities beyond their current industry and market. Second, the innovation effort is led directly by the CEO. These factors are consistent regardless of firm size, sector, or geography.

Even more important, however, is what happens during business model innovation. Even as the firm works to change its own value creation systems, it has to keep attention focused outwards. Maintaining a creative culture helps, but two other factors are important. First, successful business model innovators simplify internal structures. In other words, these firms consolidate critical functions and outsource non-critical activities. This helps free up valuable managerial attention towards new opportunities outside the firm. Business model innovators that simplify structures are almost 40% more likely to respond quickly and effectively to change.

At the same time, these firms don’t rely on partners for innovation. This shows just how different business model innovation is from product or process innovation, where collaboration has been a proven source of advantage. Partnering for incremental product feature improvements is straightforward, aligning partner firms towards a clear goal. But innovating a business model may change the goals and priorities of collaborators. Business model innovators that rely on partners for innovation are 30% less likely to respond quickly and effectively to change. In other words, the partnership locks the firm into activities and processes that are costly or difficult to update as new opportunities emerge.

Consider Cellular Dynamics, the business model innovator that leads the world in stem cells for drug development. The firm has entered many partnerships, and even sponsors competitions for new product applications, but it relies on those collaborations for information about market opportunities, not fundamental technology innovation. This has helped the firm be both agile and innovative. It has successively launched three unique cell lines to meet developing market needs, with a fourth coming later this year. And the Wall Street Journal named it the most innovative firm in the world in 2011.

Maintaining flexibility is very important for business model innovators, precisely because getting out in front is no guarantee of staying out in front. After all, only 4 years ago the successful business model innovators in the mobile phone space were Nokia and RIM: one based on highly flexible manufacturing capabilities and the other on a unique online content access system. But without the flexibility to respond to Apple's business model innovation, both firms find themselves in financial jeopardy.

Dr. Adam J. Bock is Lecturer of Entrepreneurship at The University of Edinburgh Business School. He is also the co-founder of three medical device start-ups spun out of university research projects, and the former manager of angel networks that invested more than \$10 million into tech ventures in the U.S. He is the co-author, with Professor Gerry George of Imperial College, of *Models Of Opportunity: How entrepreneurs design firms to achieve the unexpected*, which will publish in February 2012 (Cambridge Press).