

Why Business Models Matter

by Joan Magretta

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“**B**usiness model” was one of the great buzzwords of the Internet boom, routinely invoked, as the writer Michael Lewis put it, “to glorify all manner of half-baked plans.” A company didn’t need a strategy, or a special competence, or even any customers—all it needed was a Web-based business model that promised wild profits in some distant, ill-defined future. Many people—investors, entrepreneurs, and executives alike—bought the fantasy and got burned. And as the inevitable counterreaction played out, the concept of the business model fell out of fashion nearly as quickly as the .com appendage itself.

That's a shame. For while it's true that a lot of capital was raised to fund flawed business models, the fault lies not with the concept of the business model but with its distortion and misuse. A good business model remains essential to every successful organization, whether it's a new venture or an established player. But before managers can apply the concept, they need a simple working definition that clears up the fuzziness associated with the term.

Telling a Good Story

The word “model” conjures up images of white boards covered with arcane mathematical formulas. Business models, though, are anything but arcane. They are, at heart, stories—stories that explain how enterprises work. A good business model answers Peter Drucker's age-old questions: Who is the customer? And what does the customer value? It also answers the fundamental questions every manager must ask: How do we make money in this business? What is the underlying economic logic that explains how we can deliver value to customers at an appropriate cost?

Consider the story behind one of the most successful business models of all time: that of the traveler's check. During a European vacation in 1892, J.C. Fargo, the president of American Express, had a hard time translating his letters of credit into cash. “The moment I got off the beaten path,” he said on his return, “they

were no more use than so much wet wrapping paper. If the president of American Express has that sort of trouble, just think what ordinary travelers face. Something has got to be done about it.”¹ What American Express did was to create the traveler’s check—and from that innovation evolved a robust business model with all the elements of a good story: precisely delineated characters, plausible motivations, and a plot that turns on an insight about value.

The story was straightforward for customers. In exchange for a small fee, travelers could buy both peace of mind (the checks were insured against loss and theft) and convenience (they were very widely accepted). Merchants also played a key role in the tale. They accepted the checks because they trusted the American Express name, which was like a universal letter of credit, and because, by accepting them, they attracted more customers. The more other merchants accepted the checks, the stronger any individual merchant’s motivation became not to be left out.

As for American Express, it had discovered a riskless business, because customers always paid cash for the checks. Therein lies the twist to the plot, the underlying economic logic that turned what would have been an unremarkable operation into a money machine. The twist was *float*. In most businesses, costs precede

revenues: Before anyone can buy your product, you've got to build it and pay for it. The traveler's check turned the cycle of debt and risk on its head. Because people paid for the checks before (often long before) they used them, American Express was getting something banks had long enjoyed—the equivalent of an interest-free loan from its customers. Moreover, some of the checks were never cashed, giving the company an extra windfall.

As this story shows, a successful business model represents a better way than the existing alternatives. It may offer more value to a discrete group of customers. Or it may completely replace the old way of doing things and become the standard for the next generation of entrepreneurs to beat. Nobody today would head off on vacation armed with a suitcase full of letters of credit. Fargo's business model changed the rules of the game, in this case, the economics of travel. By eliminating the fear of being robbed and the hours spent trying to get cash in a strange city, the checks removed a significant barrier to travel, helping many more people to take many more trips. Like all really powerful business models, this one didn't just shift existing revenues among companies; it created new, incremental demand. Traveler's checks remained the preferred method for taking money abroad for decades, until a new technology—the automated teller machine—granted travelers even greater convenience.

Creating a business model is, then, a lot like writing a new story. At some level, all new stories are variations on old ones, reworkings of the universal themes underlying all human experience. Similarly, all new business models are variations on the generic value chain underlying all businesses. Broadly speaking, this chain has two parts. Part one includes all the activities associated with making something: designing it, purchasing raw materials, manufacturing, and so on. Part two includes all the activities associated with selling something: finding and reaching customers, transacting a sale, distributing the product or delivering the service. A new business model's plot may turn on designing a new product for an unmet need, as it did with the traveler's check. Or it may turn on a process innovation, a better way of making or selling or distributing an already proven product or service.

Think about the simple business that direct-marketing pioneer Michael Bronner created in 1980 when he was a junior at Boston University. Like his classmates, Bronner had occasionally bought books of discount coupons for local stores and restaurants. Students paid a small fee for the coupon books. But Bronner had a better idea. Yes, the books created value for students, but they had the potential to create much more value for merchants, who stood

to gain by increasing their sales of pizza and haircuts. Bronner realized that the key to unlocking that potential was wider distribution—putting a coupon book in every student’s backpack.

That posed two problems. First, as Bronner well knew, students were often strapped for cash. Giving the books away for free would solve that problem. Second, Bronner needed to get the books to students at a cost that wouldn’t eat up his profits. So he made a clever proposal to the dean of Boston University’s housing department: Bronner would assemble the coupon books and deliver them in bulk to the housing department, and the department could distribute them free to every dorm on campus. This would make the department look good in the eyes of the students, a notoriously tough crowd to please. The dean agreed.

Now Bronner could make an even more interesting proposal to neighborhood business owners. If they agreed to pay a small fee to appear in the new book, their coupons would be seen by all 14,000 residents of BU’s dorms. Bronner’s idea took off. Before long, he had extended the concept to other campuses, then to downtown office buildings. Eastern Exclusives, his first company, was born. His innovation wasn’t the coupon book but his business model; it worked because he had insight into the motivations of three sets of characters: students, merchants, and school administrators.

Tying Narrative to Numbers

The term “business model” first came into widespread use with the advent of the personal computer and the spreadsheet. Before the spreadsheet, business planning usually meant producing a single, base-case forecast. At best, you did a little sensitivity analysis around the projection. The spreadsheet ushered in a much more analytic approach to planning because every major line item could be pulled apart, its components and subcomponents analyzed and tested. You could ask what-if questions about the critical assumptions on which your business depended—for example, what if customers are more price-sensitive than we thought?—and with a few keystrokes, you could see how any change would play out on every aspect of the whole. In other words, you could model the behavior of a business.

This was something new. Before the personal computer changed the nature of business planning, most successful business models, like Fargo’s, were created more by accident than by design and forethought. The business model became clear only after the fact. By enabling companies to tie their marketplace insights much more tightly to the resulting economics—to link their assumptions about how people would behave to the numbers of a pro forma P&L—spreadsheets made it possible to model businesses *before* they were launched.

Of course, a spreadsheet is only as good as the assumptions that go into it. Once an enterprise starts operating, the underlying assumptions of its model—about both the motivations and economics—are subjected to continuous testing in the marketplace. And success often hinges on management's ability to tweak, or even overhaul, the model on the fly. When EuroDisney opened its Paris theme park in 1992, it borrowed the business model that had worked so well in Disney's U.S. parks. Europeans, the company thought, would spend roughly the same amount of time and money per visit as Americans did on food, rides, and souvenirs.

Each of Disney's assumptions about the revenue side of the business turned out to be wrong. Europeans did not, for example, graze all day long at the park's various restaurants the way Americans did. Instead, they all expected to be seated at precisely the same lunch or dinner hour, which overloaded the facilities and created long lines of frustrated patrons. Because of those miscalculations, EuroDisney was something of a disaster in its early years. It became a success only after a dozen or so of the key elements in its business model were changed, one by one.

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When managers operate consciously from a model of how the entire business system will work, every decision, initiative, and measurement provides valuable feedback. Profits are important not only for their own sake but also because they tell you whether your model is working. If you fail to achieve the results you expected, you reexamine your model, as EuroDisney did. Business modeling is, in this sense, the managerial equivalent of the scientific method—you start with a hypothesis, which you then test in action and revise when necessary.

Two Critical Tests

When business models don't work, it's because they fail either the narrative test (the story doesn't make sense) or the numbers test (the P&L doesn't add up). The business model of on-line grocers, for instance, failed the numbers test. The grocery industry has very thin margins to begin with, and on-line merchants like Webvan incurred new costs for marketing, service, delivery, and

technology. Since customers weren't willing to pay significantly more for groceries bought on-line than in stores, there was no way the math could work. Internet grocers had plenty of company. Many ventures in the first wave of electronic commerce failed simply because the basic business math was flawed.

Other business models failed the narrative test. Consider the rapid rise and fall of Priceline Webhouse Club. This was an offshoot of Priceline.com, the company that introduced name-your-own pricing to the purchase of airline tickets. Wall Street's early enthusiasm encouraged CEO Jay Walker to extend his concept to groceries and gasoline.

Here's the story Walker tried to tell. Via the Web, millions of consumers would tell him how much they wanted to pay for, say, a jar of peanut butter. Consumers could specify the price but not the brand, so they might end up with Jif or they might end up with Skippy. Webhouse would then aggregate the bids and go to companies like P&G and Bestfoods and try to make a deal: Take 50 cents off the price of your peanut butter, and we'll order a million jars this week. Webhouse wanted to be a power broker for individual consumers: Representing millions of shoppers, it would negotiate discounts and then pass on the savings to its customers, taking a fee in the process.

What was wrong with the story? It assumed that companies like P&G, Kimberly-Clark, and Exxon wanted to play this game. Think about that for a minute. Big consumer companies have spent decades and billions of dollars building brand loyalty. The Webhouse model teaches consumers to buy on price alone. So why would the manufacturers want to help Webhouse undermine both their prices and the brand identities they'd worked so hard to build? They wouldn't. The story just didn't make sense. To be a power broker, Webhouse needed a huge base of loyal customers. To get those customers, it first needed to deliver discounts. Since the consumer product companies refused to play, Webhouse had to pay for those discounts out of its own pocket. A few hundred million dollars later, in October 2000, it ran out of cash—and out of investors who still believed the story.

In case anyone thinks that Internet entrepreneurs have a monopoly on flawed business models, think again. We tend to forget about ideas that don't pan out, but business history is littered with them. In the 1980s, the one-stop financial supermarket was a business model that fired the imagination of many executives—but Sears, to cite one example, discovered that its customers just didn't get the connection between power tools and annuities. In the 1990s, Silicon Graphics invested hundreds of millions of dollars in interactive television, but it was unable to find real customers who

were as enchanted by the technology as the engineers who invented it. Ultimately, models like these fail because they are built on faulty assumptions about customer behavior. They are solutions in search of a problem.

The irony about the slipshod use of the concept of business models is that when used correctly, it actually forces managers to think rigorously about their businesses. A business model's great strength as a planning tool is that it focuses attention on how all the elements of the system fit into a working whole. It's no surprise that, even during the Internet boom, executives who grasped the basics of business model thinking were in a better position to lead the winners. Meg Whitman, for example, joined eBay in its early days because she was struck by what she described as "the emotional connection between eBay users and the site."² The way people behaved was an early indicator of the potential power of the eBay brand. Whitman also realized that eBay, unlike many Internet businesses that were being created, simply "couldn't be done off-line." In other words, Whitman—a seasoned executive—saw a compelling, coherent narrative with the potential to be translated into a profitable business.

Whitman has remained attentive to the psychology and the economics that draw collectors, bargain hunters, community seekers, and small-business people to eBay. Its auction model succeeds not just because the Internet lowers the cost of connecting vast numbers of buyers and sellers but also because eBay has made decisions about the scope of its activities that result in an appropriate cost structure. After an auction, eBay leaves it to the sellers and buyers to work out the logistics of payment and shipping. The company never takes possession of the goods or carries any inventory. It incurs no transportation costs. It bears no credit risk. And it has none of the overhead that would come with those activities.

What About Strategy?

Every viable organization is built on a sound business model, whether or not its founders or its managers conceive of what they do in those terms. But a business model isn't the same thing as a strategy, even though many people use the terms interchangeably today. Business models describe, as a system, how the pieces of a business fit together. But they don't factor in one critical dimension of performance: competition. Sooner or later—and it is usually sooner—every enterprise runs into competitors. Dealing with that reality is strategy's job.

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A competitive strategy explains how you will do better than your rivals. And doing better, by definition, means being different. Organizations achieve superior performance when they are unique, when they do something no other business does in ways that no other business can duplicate. When you cut away the jargon, that's what strategy is all about—how you are going to do better by being different. The logic is straightforward: When all companies offer the same products and services to the same customers by performing the same kinds of activities, no company will prosper. Customers will benefit, at least in the short term, while head-to-head competition drives prices down to a point where returns are inadequate. It was precisely this kind of competition—destructive competition, to use Michael Porter's term—that did in many Internet retailers, whether they were selling pet supplies, drugs, or toys. Too many fledgling companies rushed to market with identical business models and no strategies to differentiate themselves in terms of which customers and markets to serve, what products and services to offer, and what kinds of value to create.

To see the distinction between a strategy and a business model, you need only look at Wal-Mart. You might think that the giant retailer's success was a result of pioneering a new business model, but that's not the case. When Sam Walton opened his first Wal-Mart in 1962 in the hamlet of Rogers, Arkansas, the discount-retailing business model had been around for a few years. It had emerged in the mid-1950s, when a slew of industry pioneers (now long forgotten) began to apply supermarket logic to the sale of general merchandise. Supermarkets had been educating customers since the 1930s about the value of giving up personal service in exchange for lower food prices, and the new breed of retailers saw that they could adapt the basic story line of the supermarket to clothing, appliances, and a host of other consumer goods. The idea was to offer lower prices than conventional department stores by slashing costs. And so the basic business model for discount retailing took shape: First, strip away the department store's physical amenities such as the carpeting and the chandeliers. Second, configure the stores to handle large numbers of shoppers efficiently. And third, put fewer salespeople on the floor and rely on customers to serve themselves. Do those things well, and you could offer low prices and still make money.

Walton heard about the new discount stores, visited a few, and liked their potential. In 1962, he decided to set out on his own, borrowing a lot of ideas for his early stores from Kmart and others. But it was what he chose to do differently—the ways he put his own stamp on the basic business model—that made Wal-Mart so fabulously successful. His model was the same as Kmart's, but his strategy was unique.

From the very start, for instance, Walton chose to serve a different group of customers in a different set of markets. The ten largest discounters in 1962, all gone today, focused on large metropolitan areas and cities like New York. Wal-Mart's "key strategy," in Walton's own words, "was to put good-sized stores into little one-horse towns which everybody else was ignoring."³ He sought out isolated rural towns, like Rogers, with populations between 5,000 and 25,000. Being a small-town guy himself, Walton knew the terrain well. The nearest city was probably a four-hour drive away. He rightly bet that if his stores could match or beat the city prices, "people would shop at home." And since Wal-Mart's markets tended to be too small to support more than one large retailer, Walton was able to preempt competitors and discourage them from entering Wal-Mart's territory.

Wal-Mart also took a different approach to merchandising and pricing than its competitors did—that is, it promised customers a different kind of value. While competitors relied heavily on private label goods, second-tier brands, and price promotions, Wal-Mart promised national brands at everyday low prices. To make this promise more than a marketing slogan, the company pursued efficiency and reduced costs through innovative practices in areas such as purchasing, logistics, and information management.

The business model of discount retailing has attracted many players since it emerged in the 1950s. Most of them have failed. A few, like Wal-Mart and Target, have achieved superior performance over the long haul because their strategies set them apart. Wal-Mart offers branded goods for less to a carefully chosen customer base. Target built a strategy around a different kind of value—style and fashion. The losers in the industry—the chronic underperformers like Kmart—are companies that tried to be all things to all people. They failed to find distinctive ways to compete.

A Good Model Is Not Enough

There's another, more recent story that sheds further light on the relationship between business models and strategies. It's the story of Dell Computer. Unlike Sam Walton, Michael Dell was a true

business-model pioneer. The model he created is, by now, well known: While other personal-computer makers sold through resellers, Dell sold directly to end customers. That not only cut out a costly link from the value chain, it also gave Dell the information it needed to manage inventory better than any other company in its industry. And because the pace of innovation in the industry was intense, Dell's inventory advantage meant it could avoid the high cost of obsolescence that other computer makers had to bear. Armed with its innovative business model, Dell has consistently outperformed rivals for more than a decade.

In this case, Dell's business model functioned much like a strategy: It made Dell different in ways that were hard to copy. If Dell's rivals tried to sell direct, they would disrupt their existing distribution channels and alienate the resellers on whom they relied. Trapped by their own strategies, they were damned if they copied Dell and damned if they didn't. When a new model changes economics of an industry and is difficult to replicate, it can by itself create a strong competitive advantage.

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What often gets lost in Dell's story, though, is the role that pure strategy has played in the company's superior performance. While Dell's direct business model laid out which value chain activities Dell would do (and which it wouldn't do), the company still had crucial strategic choices to make about which customers to serve and what kinds of products and services to offer. In the 1990s for example, while other PC makers focused on computers for the home market, Dell consciously chose to go after large corporate accounts, which were far more profitable. Other PC makers offered low-end machines to lure in first-time buyers. Michael Dell wasn't interested in this "no-margin" business. He staked out his territory selling more powerful, higher margin computers.

Then, because Dell sold direct and could analyze its customers in depth, it began to notice that its average selling price to consumers was increasing while the industry's was falling. Consumers who were buying their second or third machines and who were looking for more power and less hand-holding were coming to Dell—even though it wasn't targeting them. Only in 1997, *after* it had a profitable, billion-dollar consumer business, did Dell dedicate a group to serving the consumer segment.

Now that everyone in its industry is selling direct, Dell's strategy has shifted to deal with the new competitive realities. With a decade-long lead, Dell is by far the industry's best executor of the direct-selling model—it is the low-cost producer. So it is using its cost advantage in PCs to compete on price, to gain share, and to drive the weaker players out of the business. At the same time, the company is relying on its core business model to pursue opportunities in new product markets, like servers, that have greater profit potential than PCs. The underlying business model remains the same. The strategic choices about where to apply the model—which geographic markets, which segments, which customers, which products—are what change.

Clarity about its business model has helped Dell in another way: as a basis for employee communication and motivation. Because a business model tells a good story, it can be used to get everyone in the organization aligned around the kind of value the company wants to create. Stories are easy to grasp and easy to remember. They help individuals to see their own jobs within the larger context of what the company is trying to do and to tailor their behavior accordingly. Used in this way, a good business model can become a powerful tool for improving execution. • • •

Today, “business model” and “strategy” are among the most sloppily used terms in business; they are often stretched to mean everything—and end up meaning nothing. But as the experiences of companies like Dell and Wal-Mart show, these are concepts with enormous practical value. It’s true that any attempt to draw sharp boundaries around abstract terms involves some arbitrary choices. But unless we’re willing to draw the line somewhere, these concepts will remain confusing and difficult to use.

Definition brings clarity. And when it comes to concepts that are so fundamental to performance, no organization can afford fuzzy thinking.

1. James C. Collins and Jerry I. Porras, *Built to Last* (HarperCollins, 1994).
2. “Meg Whitman at eBay Inc. (A),” HBS case no.9-400-035.
3. “Wal-Mart Stores, Inc.,” HBS case no.9-794-024.

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Joan Magretta is a senior associate at the Institute for Strategy and Competitiveness at Harvard Business School. She is the author of *Understanding Michael Porter: The Essential Guide to Competition and Strategy*.

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