

# **Tool #3**

# **The Business Model Framework**

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# Understanding the Business Model of the Entrepreneur

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There is a need for a standard framework for characterizing an entrepreneur's business model. Without a relatively consistent approach, it will be difficult to determine whether standard model types exist, the conditions that make a particular model appropriate, the ways in which models interact with organizational variables (e.g., management styles, structures, cultures), and other critical questions. To be of value, such a framework should have certain qualities. Chief among these are the need for it to be reasonably simple, logical and measurable, while at the same time being comprehensive and operationally meaningful.

If the purpose is to model a viable business, then what is the essence of a viable business? For simplicity, let us assume that it is an entity that makes available a product or service to a customer in a manner that allows it to charge more than its expenses while distinguishing itself from others who sell the same thing, in the process generating an acceptable return on investment. Inputs are translated into outputs, and this is accomplished in a way that makes economic sense and is sustainable.

It would appear that, in seeking generalizability, most of the extant perspectives attempt to oversimplify a firm's business model. The challenge is to produce a framework that is applicable to firms in general, but that serves the needs of the individual entrepreneur and the unique combinations behind his/her venture that make it sustainable. Accordingly, a framework is proposed that consists of two levels, or sets of decisions, and these are termed the 'foundation' and 'proprietary' levels. Further, at each level, six basic components are considered.

## The Foundation Level: Defining the Basic Components

At its essence, a well-formulated business model must address six key questions. These questions reflect commonalities among the various perspectives found in the literature (see Table 4). Specifically, the most consistently mentioned components of business models concern the value proposition, the customer, internal processes and competencies, and how the firm makes money. To these four, a competitive strategy element has been added, which captures the need to translate core competencies and the creation of value into differentiation within the marketplace. The inclusion of differentiation reflects an emphasis on competitive strategy by a number of researchers (e.g., Hamel, 2001). It also reflects the almost universal emphasis on resource combinations that are perceived to be unique relative to competitive offerings (e.g., Afuah and Tucci, 2001; Amit and Zott, 2001). Finally, a useable framework should apply to all types of ventures, ranging from lifestyle or managed growth ventures to high potential and speculative ventures. Different models are likely to accommodate different levels of growth, and shorter versus longer time horizons. Thus, the sixth decision area concerns the growth and time objectives of the entrepreneur. Let us examine each of these components in more detail.

**1. How will the firm create value?** This first question is concerned with the value offering of the firm. It includes the particular products or services being sold, the nature of the product/service mix, and the relative depth and breadth of this mix. In addition, the value

proposition is defined by whether the firm provides access to the product or service, or sells the actual product or service by itself, or sells the product or service as part of a bundle or total system. Other issues include whether the firm makes the product or service, outsources product manufacture or service delivery, licenses others to make and sell, acquires the product and re-sells it, or acquires the product and then modifies and re-sells it. Finally, the value proposition is affected by whether the product or service is provided directly by the firm or through an intermediary.

**2. For whom will the firm create value?** This question focuses on the nature and scope of the market in which the firm will compete. Of importance is whether the firm will principally sell to consumers (b-to-c), businesses (b-to-b), or both, and where it falls in the value chain. When selling to businesses, the entrepreneur must further distinguish where in the value chain the firm's customers will be, such as upstream (mining, agriculture, basic manufacturing), downstream (final manufacturing, assembling), wholesaling, retailing, or some combination. The geographic scope of the market should also be specified, such as local, regional, national or international. Ventures also vary in the extent to which their success is driven by a focus on discrete transactions to a range of customers, or by ongoing relationships with particular accounts.

**3. What is the firm's internal source of advantage?** The term core competency is used to capture an internal capability or set of skills that enables the firm to provide a particular benefit to customers. Hence, Federal Express delivers a benefit of on-time delivery based on its competency at logistics management. While a firm might attempt to build operations around any number of competencies, sources of advantage can be organized into seven general areas. These include the firm's production/operating system, capabilities in technology development/innovation, selling/marketing expertise, information management/mining/packaging prowess, competence in financial management/arbitrage, mastery of supply chain management, and skills at managing networks and leveraging resources.

**4. How will the firm differentiate itself?** Explain how you are different. Depending on how they are applied, core competencies can enable the firm to differentiate itself, or produce something perceived to be unique in the marketplace. The challenge of differentiation is to identify salient points of difference that can be maintained over time. Given the ability of companies to quickly imitate one another, the entrepreneur seeks bases for differentiation that are more than cosmetic or transitory. Sustainable strategic positions tend to be designed around one of the following five bases of differentiation: operational excellence, product quality/selection/availability/features, innovation leadership, low cost, or intimate customer relationships/experiences.

**5. How will the firm make money?** How do we monetize? A core element of the firm's business model is its economic model. The economic model provides a consistent vehicle for earning profits. It has four sub-components. The first of these is the firm's operating leverage, or the extent to which the underlying cost structure is dominated by fixed costs, or is driven more by variable costs. The second sub-component is volumes, and whether the firm is organized for high, medium or low volumes in terms of both the market opportunity and internal capacity. The third consideration is whether the firm will be able to charge high, medium or low margins. Finally, the economic model considers how we capture revenue---the number of revenue drivers and whether the revenue sources are fixed or flexible. An example of the former would be a company that sells

ten items based on a fixed price list. Alternatively, a firm that sold a number of value-added services at varying prices depending on the customer segment and market conditions has more flexible revenue sources. This latter factor is the source of many of the creative revenue models found in dot.com businesses.

**6. What are the entrepreneur's time, scope and size ambitions?** What is the intended magnitude of the business? The business model must capture the entrepreneur's objectives and ambitions. As such, the entrepreneur views the business in terms of a growth model. Five such models can be used to characterize most ventures: subsistence, lifestyle, managed growth, aggressive growth, and speculative. With the subsistence model, the goal is to survive and meet basic financial obligations. When employing an income model, the entrepreneur invests to the point that the business is able to generate an ongoing healthy income stream for the principals. A managed growth model finds reinvestment in an attempt to grow at a consistent and ongoing rate (adding new locations, entering new markets, introducing new revenue drivers). With aggressive growth, one is attempting to rapidly scale the business on a national or global level. The speculative model is employed where the entrepreneur's time frame is shorter, and the objective is typically to demonstrate the potential of the venture and then sell it.

These six components of the business model that are addressed at the foundation level, and the specific decision variables within each component, are summarized in Table 1. For three of these components, the entrepreneur or analyst must select one factor from a set. For the other three components, one factor must be selected from each set of factors making up a given sub-component.

#### The Proprietary Level: Creating Unique Combinations

While the foundation level is adequate to capture the essence of any firm's business model, venture sustainability is ultimately dependent on the ability of the entrepreneur to apply unique approaches to one or more of the foundation components. Thus, having determined that the firm will sell some combination of products and services directly to customers, or that it will sell in business-to-business markets at high margins and low volumes, the entrepreneur defines ways to implement such decisions in a novel manner. This is referred to as the proprietary level of the business model, as it entails innovation that is unique to a particular entrepreneur and venture.

Consider the earlier-cited example of Dell Computer. At the foundation level, the company sells a mix of products and services, with a heavier product focus. The product offering is customizable, and is sold through a direct channel in both business and consumer markets. However, competitive advantage derives from unique approaches that are applied to two of the foundation-level components. The so-called 'Dell Direct Method' is the result of proprietary approaches both to defining the value proposition and to organizing internal logistical flows. It is these proprietary concepts that enable the firm to consistently deliver speed and customization at a moderate price, which translates into a sustainable marketplace position.

## Applying the Framework in a Mainstream Industry

Table 2 illustrates the application of the integrative framework to Southwest Airlines. Southwest has a unique business model that has sustained the company's growth for thirty years. Not only has the company achieved profitability every year since 1972, including years when most airlines incurred losses, but it is consistently ranked in the top five among the most desired companies to work for by *Fortune* magazine. The airline has won the so-called triple crown of the industry, for best on-time record, best baggage handling, and fewest customer complaints, in five different years.

The Southwest business model is first captured at the foundation level. Here, the focus is on what the firm is doing, as opposed to how. This level gets at the essence of the firm's approach, and represents a standardized set of questions that can be quantified. Accordingly, comparisons across firms are relatively easy to make at the foundation level, such that standard models can be identified. This ability will be demonstrated below.

At the proprietary level, Southwest has innovated in a manner that has not only produced sustained profits, but has changed the manner in which other airlines operate. From Table 6 it can be seen how they tailor each of the basic components of the model, and how each of the elements is intertwined and internally consistent with the others. Arguably, their model centers on the firm's core competency, which is their production/operating system. It is their unique operating system (e.g., employee hiring, selection of airports and routes, no code sharing, independent baggage handling, standardization of aircraft, etc.) that make possible their unique value proposition (short haul, low-fare, on-time, direct service that is on-time and fun).

As can be seen with this example, the proposed framework is reasonably simple to apply, and each element is measurable. Further, the framework is comprehensive in nature, capturing the essence of a sustainable business in terms of strategy, operations, and financial performance. Sustainability further requires that the components of the model be internally consistent, as can be seen with the Southwest example. This consistency must be found within and between sub-components. Thus, an economic model with high operating leverage, low margins, moderate volumes and fixed revenue sources may, by itself, be untenable. Further, the economics must fit with the customer model. Thus, a given economic model might not be workable when selling in a regional b-to-b market, where significant investment in the development of customer relationships is required. Finally, it should be noted that the framework applies to ventures of all types and sizes. However, firms with multiple divisions or strategic business units may have different models for different divisions.

**Figure 1:**  
**The Core Components of a Business Model**  
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<p>Component one:  <b>How do we create value?</b> (select 1 from each set) <span style="float: right;"><i>(factors related to the offering)</i></span></p> <ul style="list-style-type: none"> <li>• offering: primarily products/primarily services/heavy mix</li> <li>• offering: standardized/some customization/high customization</li> <li>• offering: broad line/medium breadth/narrow line</li> <li>• offering: deep lines/medium depth/shallow lines</li> <li>• offering: access to product/ product itself/ product bundled with other firm's product/service</li> <li>• offering: internal manufacturing or service delivery/ outsourcing/ licensing/ value added reselling (make if production or core activities will be outsourced)</li> <li>• offering: direct distribution/indirect distribution (if indirect: single or multi-channel)</li> </ul>
<p>Component two:  <b>Who do we create value for?</b> (select 1 from each set) <span style="float: right;"><i>(market factors)</i></span></p> <ul style="list-style-type: none"> <li>• type of customer: b-to-b/b-to-c/ both/other</li> <li>• local/regional/national/international market</li> <li>• where customer is in value chain: upstream supplier/ downstream supplier/ government/ institutional/ wholesaler or retailer/ service provider / final consumer</li> <li>• broad or general market/niche market</li> <li>• transactional/relational customer</li> </ul>
<p>Component three:  <b>What is our source of competence/advantage?</b> <span style="float: right;"><i>(internal capability factors)</i></span></p> <ul style="list-style-type: none"> <li>• production/operating systems</li> <li>• selling/marketing</li> <li>• information management/mining/info. packaging</li> <li>• technology/R&amp;D/creative or innovative capability/intellectual</li> <li>• financial transactions/arbitrage</li> <li>• supply chain management</li> <li>• networking/resource leveraging</li> </ul>
<p>Component four:          How do we differentiate ourselves? <span style="float: right;"><i>(competitive strategy factors)</i></span></p> <ul style="list-style-type: none"> <li>• image of operational excellence/consistency/dependability</li> <li>• product or service quality/selection/features/availability</li> <li>• innovation leadership</li> <li>• low cost/efficiency</li> <li>• intimate customer relationship/experience</li> </ul>
<p>Component five:  <b>How do we make money?</b> (select 1 from each set) <span style="float: right;"><i>(economic factors)</i></span></p> <ul style="list-style-type: none"> <li>• volumes: high/med/low</li> <li>• margins: high/med/low</li> <li>• operating leverage (ratio of fixed to variable costs): high/med/low</li> <li>• revenue drivers (how many revenue drivers or product lines and is pricing fixed or flexible)</li> </ul>
<p>Component six:  <b>What are our time, scope and size ambitions?</b> (select 1) <span style="float: right;"><i>(growth factors)</i></span></p> <ul style="list-style-type: none"> <li>• subsistence model</li> <li>• lifestyle model</li> <li>• managed growth model</li> <li>• aggressive growth model</li> <li>• speculative model –start it and sell it</li> </ul>

**Figure 2:**  
**An Application: Characterizing the Business Model of Southwest Airlines**

	<b>Foundation Level</b>	<b>Proprietary level</b>
<b>Component One</b> (factors related to offering)	<ul style="list-style-type: none"> <li>• Sell services only</li> <li>• Standardized offering</li> <li>• Narrow breadth</li> <li>• Shallow lines</li> <li>• Sell the service by itself</li> <li>• Internal service delivery</li> <li>• Direct distribution</li> </ul>	<ul style="list-style-type: none"> <li>• Short haul, low-fare, high-frequency, point-to-point service</li> <li>• Deliver fun</li> <li>• Serve only drinks/snacks</li> <li>• Assign no seats/no first class</li> <li>• Do not use travel agents/intermediaries</li> <li>• Fully refundable fares, no advance purchase requirement</li> </ul>
<b>Component Two</b> (market factors)	<ul style="list-style-type: none"> <li>• B2C and B2B (sell to individual travelers and corporate travel depts.)</li> <li>• National</li> <li>• Retail</li> <li>• Broad market</li> <li>• Transactional</li> </ul>	<ul style="list-style-type: none"> <li>• Managed evolution from regional airline to providing service to 59 airports in 30 States</li> <li>• Careful selection of cities based on fit with underlying operating model</li> </ul>
<b>Component Three</b> (internal capability factors)	<ul style="list-style-type: none"> <li>• Production/operating systems</li> </ul>	<ul style="list-style-type: none"> <li>• Highly selective hiring of employees that fit profile.</li> <li>• Do not operate a hub-and-spoke route system.</li> <li>• Fly into uncongested airports of small cities or less congested airports of large cities.</li> <li>• Innovative ground operations approach</li> <li>• Independent baggage handling system</li> <li>• Use of Boeing 737 aircraft</li> <li>• No code sharing with other airlines</li> </ul>
<b>Component Four</b> (competitive strategy factors)	<ul style="list-style-type: none"> <li>• Image of operational excellence/consistency/dependability</li> </ul>	<ul style="list-style-type: none"> <li>• Differentiation is achieved by stressing on-time arrival, lowest possible fares, and passengers having a good time (a spirit of fun)</li> <li>• Airline that love built</li> </ul>
<b>Component Five</b> (economic factors)	<ul style="list-style-type: none"> <li>• Fixed revenue source</li> <li>• High operating leverage</li> <li>• High volumes</li> <li>• Low margins</li> </ul>	<ul style="list-style-type: none"> <li>• Short-haul routes and high frequency of flights combined with consistently low prices and internal efficiencies result in annual profitability regardless of industry trends</li> </ul>
<b>Component Six</b> (growth factors)	<ul style="list-style-type: none"> <li>• Proactive growth model</li> </ul>	<ul style="list-style-type: none"> <li>• Emphasis on growth opportunities that are consistent with business model</li> </ul>