Innovation

Reinventing Your Business Model

by Mark W. Johnson, Clayton M. Christensen and Henning Kagermann

From the Magazine (December 2008)

Summary.

Why is it so difficult for established companies to pull off the new growth that business model innovation can bring? Here's why: They don't understand their current business model well enough to know if it would suit a new opportunity or hinder it, and they don't know how to build a new model when they need it.

Drawing on their vast knowledge of disruptive innovation and experience in helping established companies capture game-changing opportunities, consultant Johnson, Harvard Business School professor Christensen, and SAP co-CEO Kagermann set out the tools that executives need to do both.

Successful companies already operate according to a business model that can be broken down into four elements: a *customer value proposition* that fulfills an important job for the customer in a better way than competitors' offerings do; a *profit formula* that lays out how the company makes money delivering the value proposition; and the *key resources* and *key processes* needed to deliver that proposition.

Game-changing opportunities deliver radically new customer value propositions: They fulfill a job to be done in a dramatically better way (as P&G did with its Swiffer mops), solve a problem that's never been solved before (as Apple did with its iPod and iTunes electronic entertainment delivery system), or serve an entirely unaddressed customer base (as Tata Motors is doing with its Nano—the $2,500 car aimed at Indian families who use scooters to get around). Capitalizing on such opportunities doesn't always require a new business model: P&G, for instance, didn't need a new one to leverage its product innovation strengths to develop the Swiffer.

A new model is often needed, however, to leverage a new technology (as in Apple's case); is generally required when the opportunity addresses an entirely new group of customers (as with the Nano); and is surely in order when an established company needs to fend off a successful disruptor (as the Nano's competitors may now need to do). **close**

In 2003, Apple introduced the iPod with the iTunes store, revolutionizing portable entertainment, creating a new market, and transforming the company. In just three years, the iPod/iTunes combination became a nearly $10 billion product, accounting for almost 50% of Apple's revenue. Apple's market

capitalization catapulted from around $1 billion in early 2003 to over $150 billion by late 2007.

This success story is well known; what's less well known is that Apple was not the first to bring digital music players to market. A company called Diamond Multimedia introduced the Rio in 1998. Another firm, Best Data, introduced the Cabo 64 in 2000. Both products worked well and were portable and stylish. So why did the iPod, rather than the Rio or Cabo, succeed?

Apple did something far smarter than take a good technology and wrap it in a snazzy design. It took a good technology and wrapped it in a great business model. Apple's true innovation was to make downloading digital music easy and convenient. To do that, the company built a groundbreaking business model that combined hardware, software, and service. This approach worked like Gillette's famous blades-and-razor model in reverse: Apple essentially gave away the "blades" (low-margin iTunes music) to lock in purchase of the "razor" (the high-margin iPod). That model defined value in a new way and provided game-changing convenience to the consumer.

Business model innovations have reshaped entire industries and redistributed billions of dollars of value. Retail discounters such as Wal-Mart and Target, which entered the market with pioneering business models, now account for 75% of the total valuation of the retail sector. Low-cost U.S. airlines grew from a blip on the radar screen to 55% of the market value of all carriers. Fully 11 of the 27 companies born in the last quarter century that grew their way into the *Fortune* 500 in the past 10 years did so through business model innovation.

Stories of business model innovation from well-established companies like Apple, however, are rare. An analysis of major innovations within existing corporations in the past decade shows that precious few have been business-model related. And a recent American Management Association study determined that no more than 10% of innovation investment at global companies is focused on developing new business models.

Yet everyone's talking about it. A 2005 survey by the Economist Intelligence Unit reported that over 50% of executives believe business model innovation will become even more important for success than product or service innovation. A 2008 IBM survey of corporate CEOs echoed these results. Nearly all of the CEOs polled reported the need to adapt their business models; more than two-thirds said that extensive changes were required. And in these tough economic times, some CEOs are already looking to business

model innovation to address permanent shifts in their market landscapes.

> **Pursuing a new business model that's not new or game-changing to your industry or market is a waste of time and money.**

Senior managers at incumbent companies thus confront a frustrating question: Why is it so difficult to pull off the new growth that business model innovation can bring? Our research suggests two problems. The first is a lack of definition: Very little formal study has been done into the dynamics and processes of business model development. Second, few companies understand their existing business model well enough—the premise behind its development, its natural interdependencies, and its strengths and limitations. So they don't know when they can leverage their core business and when success requires a new business model.

After tackling these problems with dozens of companies, we have found that new business models often look unattractive to internal and external stakeholders—at the outset. To see past the borders of what is and into the land of the new, companies need a road map.

Ours consists of three simple steps. The first is to realize that success starts by not thinking about business models at all. It starts with thinking about the opportunity to satisfy a real customer who needs a job done. The second step is to construct a blueprint laying out how your company will fulfill that need at a profit. In our model, that plan has four elements. The third is to compare that model to your existing model to see how much you'd have to change it to capture the opportunity. Once you do, you will know if you can use your existing model and organization or need to separate out a new unit to execute a new model. Every successful company is already fulfilling a real customer need with an effective business model, whether that model is explicitly understood or not. Let's take a look at what that entails.

Business Model: A Definition

A business model, from our point of view, consists of four interlocking elements that, taken together, create and deliver value. The most important to get right, by far, is the first.

Customer value proposition (CVP). A successful company is one that has found a way to create value for customers—that is, a way to help customers get an important job done. By "job" we mean a

fundamental problem in a given situation that needs a solution. Once we understand the job and all its dimensions, including the full process for how to get it done, we can design the offering. The more important the job is to the customer, the lower the level of customer satisfaction with current options for getting the job done, and the better your solution is than existing alternatives at getting the job done (and, of course, the lower the price), the greater the CVP. Opportunities for creating a CVP are at their most potent, we have found, when alternative products and services have not been designed with the real job in mind and you can design an offering that gets that job—and only that job—done perfectly. We'll come back to that point later.

Profit formula. The profit formula is the blueprint that defines how the company creates value for itself while providing value to the customer. It consists of the following:

- *Revenue model:* price x volume
- *Cost structure:* direct costs, indirect costs, economies of scale. Cost structure will be predominantly driven by the cost of the key resources required by the business model.
- *Margin model:* given the expected volume and cost structure, the contribution needed from each transaction to achieve desired profits.
- *Resource velocity:* how fast we need to turn over inventory, fixed assets, and other assets—and, overall, how well we need to utilize resources—to support our expected volume and achieve our anticipated profits.

People often think the terms "profit formulas" and "business models" are interchangeable. But how you make a profit is only one piece of the model. We've found it most useful to start by setting the price required to deliver the CVP and then work backwards from there to determine what the variable costs and gross margins must be. This then determines what the scale and resource velocity needs to be to achieve the desired profits.

Key resources. The key resources are assets such as the people, technology, products, facilities, equipment, channels, and brand required to deliver the value proposition to the targeted customer. The focus here is on the *key* elements that create value for the customer and the company, and the way those elements interact. (Every company also has generic resources that do not create competitive differentiation.)

Key processes. Successful companies have operational and managerial processes that allow them to deliver value in a way they can successfully repeat and increase in scale. These may include such recurrent tasks as training, development,

manufacturing, budgeting, planning, sales, and service. Key processes also include a company's rules, metrics, and norms. These four elements form the building blocks of any business. The customer value proposition and the profit formula define value for the customer and the company, respectively; key resources and key processes describe how that value will be delivered to both the customer and the company.

As simple as this framework may seem, its power lies in the complex interdependencies of its parts. Major changes to any of these four elements affect the others and the whole. Successful businesses devise a more or less stable system in which these elements bond to one another in consistent and complementary ways.

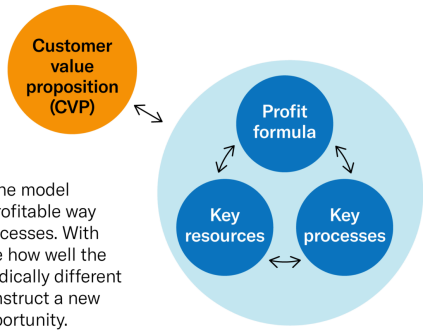
How Great Models Are Built

To illustrate the elements of our business model framework, we will look at what's behind two companies' game-changing business model innovations.

Creating a customer value proposition. It's not possible to invent or reinvent a business model without first identifying a clear customer value proposition. Often, it starts as a quite simple realization. Imagine, for a moment, that you are standing on a Mumbai road on a rainy day. You notice the large number of motor scooters snaking precariously in and out around the cars. As you look more closely, you see that most bear whole families—both parents and several children. Your first thought might be "That's crazy!" or "That's the way it is in developing countries—people get by as best they can."

The Elements of a Successful Business Model

Every successful company already operates according to an effective business model. By systematically identifying all of its constituent parts, executives can understand how the model fulfills a potent value proposition in a profitable way using certain key resources and key processes. With that understanding, they can then judge how well the same model could be used to fulfill a radically different CVP—and what they'd need to do to construct a new one, if need be, to capitalize on that opportunity.



Customer value proposition (CVP)

- **Target customer**
- **Job to be done** to solve an important problem or fulfill an important need for the target customer.
- **Offering,** which satisfies the problem or fulfills the need. This is defined not only by what is sold but also by how it's sold.

Profit formula

- **Revenue model:** How much money can be made; price × volume. Volume can be thought of in terms of market size, purchase frequency, ancillary sales, etc.
- **Cost structure:** How costs are allocated; includes cost of key assets, direct costs, indirect costs, economies of scale.
- **Margin model:** How much each transaction should net to achieve desired profit levels.
- **Resource velocity:** How quickly resources need to be used to support target volume. Includes lead times, throughput, inventory turns, asset utilization, and so on.

Key processes, as well as rules, metrics, and norms, that make the profitable delivery of the customer value proposition repeatable and scalable. Might include:

- **Processes:** design, product development, sourcing, manufacturing, marketing, hiring and training, IT
- **Rules and metrics:** margin requirements for investment, credit terms, lead times, supplier terms
- **Norms:** opportunity size needed for investment, approach to customers and channels

Key resources needed to deliver the customer value proposition profitably. Might include:

- **People**
- **Technology, products**
- **Equipment**
- **Information**
- **Channels**
- **Partnerships, alliances**
- **Brand**

HBR

See more HBR charts in Data & Visuals >

When Ratan Tata of Tata Group looked out over this scene, he saw a critical job to be done: providing a safer alternative for scooter families. He understood that the cheapest car available in India cost easily five times what a scooter did and that many of these families could not afford one. Offering an affordable, safer, all-weather alternative for scooter families was a powerful value proposition, one with the potential to reach tens of millions of people who were not yet part of the car-buying market. Ratan Tata also recognized that Tata Motors' business model could not be used to develop such a product at the needed price point.

At the other end of the market spectrum, Hilti, a Liechtenstein-based manufacturer of high-end power tools for the construction industry, reconsidered the real job to be done for many of its current customers. A contractor makes money by finishing projects; if the required tools aren't available and functioning properly, the job doesn't get done. Contractors don't make money by *owning* tools; they make it by using them as efficiently as possible. Hilti could help contractors get the job done by selling tool *use* instead of the tools themselves—managing its customers' tool inventory by providing the best tool at the right time and

quickly furnishing tool repairs, replacements, and upgrades, all for a monthly fee. To deliver on that value proposition, the company needed to create a fleet-management program for tools and in the process shift its focus from manufacturing and distribution to service. That meant Hilti had to construct a new profit formula and develop new resources and new processes.

The most important attribute of a customer value proposition is its precision: how perfectly it nails the customer job to be done—and nothing else. But such precision is often the most difficult thing to achieve. Companies trying to create the new often neglect to focus on *one* job; they dilute their efforts by attempting to do lots of things. In doing lots of things, they do nothing *really* well.

One way to generate a precise customer value proposition is to think about the four most common barriers keeping people from getting particular jobs done: insufficient wealth, access, skill, or time. Software maker Intuit devised QuickBooks to fulfill small-business owners' need to avoid running out of cash. By fulfilling that job with greatly simplified accounting software, Intuit broke the *skills barrier* that kept untrained small-business owners from using more-complicated accounting packages. MinuteClinic, the drugstore-based basic health care provider, broke the *time barrier* that kept people from visiting a doctor's office with minor health issues by making nurse practitioners available without appointments.

Designing a profit formula. Ratan Tata knew the only way to get families off their scooters and into cars would be to break the *wealth barrier* by drastically decreasing the price of the car. "What if I can change the game and make a car for one lakh?" Tata wondered, envisioning a price point of around US$2,500, less than half the price of the cheapest car available. This, of course, had dramatic ramifications for the profit formula: It required both a significant drop in gross margins and a radical reduction in many elements of the cost structure. He knew, however, he could still make money if he could increase sales volume dramatically, and he knew that his target base of consumers was potentially huge.

For Hilti, moving to a contract management program required shifting assets from customers' balance sheets to its own and generating revenue through a lease/subscription model. For a monthly fee, customers could have a full complement of tools at their fingertips, with repair and maintenance included. This would require a fundamental shift in all major components of the profit formula: the revenue stream (pricing, the staging of payments, and how to think about volume), the cost structure

(including added sales development and contract management costs), and the supporting margins and transaction velocity.

Identifying key resources and processes. Having articulated the value proposition for both the customer and the business, companies must then consider the key resources and processes needed to deliver that value. For a professional services firm, for example, the key resources are generally its people, and the key processes are naturally people related (training and development, for instance). For a packaged goods company, strong brands and well-selected channel retailers might be the key resources, and associated brand-building and channel-management processes among the critical processes.

Oftentimes, it's not the individual resources and processes that make the difference but their relationship to one another. Companies will almost always need to integrate their key resources and processes in a unique way to get a job done perfectly for a set of customers. When they do, they almost always create enduring competitive advantage. Focusing first on the value proposition and the profit formula makes clear how those resources and processes need to interrelate. For example, most general hospitals offer a value proposition that might be described as, "We'll do anything for anybody." Being all things to all people requires these hospitals to have a vast collection of resources (specialists, equipment, and so on) that can't be knit together in any proprietary way. The result is not just a lack of differentiation but dissatisfaction.

By contrast, a hospital that focuses on a specific value proposition can integrate its resources and processes in a unique way that delights customers. National Jewish Health in Denver, for example, is organized around a focused value proposition we'd characterize as, "If you have a disease of the pulmonary system, bring it here. We'll define its root cause and prescribe an effective therapy." Narrowing its focus has allowed National Jewish to develop processes that integrate the ways in which its specialists and specialized equipment work together.

For Tata Motors to fulfill the requirements of its customer value proposition and profit formula for the Nano, it had to reconceive how a car is designed, manufactured, and distributed. Tata built a small team of fairly young engineers who would not, like the company's more-experienced designers, be influenced and constrained in their thinking by the automaker's existing profit formulas. This team dramatically minimized the number of parts in the vehicle, resulting in a significant cost saving. Tata also reconceived its supplier strategy, choosing to outsource a remarkable 85% of the Nano's components and use nearly 60%

fewer vendors than normal to reduce transaction costs and achieve better economies of scale.

At the other end of the manufacturing line, Tata is envisioning an entirely new way of assembling and distributing its cars. The ultimate plan is to ship the modular components of the vehicles to a combined network of company-owned and independent entrepreneur-owned assembly plants, which will build them to order. The Nano will be designed, built, distributed, and serviced in a radically new way—one that could not be accomplished without a new business model. And while the jury is still out, Ratan Tata may solve a traffic safety problem in the process.

For Hilti, the greatest challenge lay in training its sales representatives to do a thoroughly new task. Fleet management is not a half-hour sale; it takes days, weeks, even months of meetings to persuade customers to buy a program instead of a product. Suddenly, field reps accustomed to dealing with crew leaders and on-site purchasing managers in mobile trailers found themselves staring down CEOs and CFOs across conference tables.

Hilti Sidesteps Commoditization

Hilti is capitalizing on a game-changing opportunity to increase profitability by turning products into a service. Rather than sell tools (at lower and lower prices), it's selling a "just-the-tool-you-need-when-you-need-it, no-repair-or-storage-hassles" service. Such a radical change in customer value proposition required a shift in all parts of its business model.

	TRADITIONAL POWER TOOL COMPANY
Customer value proposition	Sales of industrial and professional power tools and accessories
Profit formula	Low margins, high inventory turnover
Key resources and processes	Distribution channel, low-cost manufacturing plants in developing countries, R&D
	HILTI'S TOOL FLEET MANAGEMENT SERVICE
Customer value proposition	Leasing a comprehensive fleet of tools to increase contractors' on-site productivity
Profit formula	Higher margins; asset heavy; monthly payments for tool maintenance, repair, and replacement
Key resources and processes	Strong direct-sales approach, contract management, IT systems for inventory management and repair, warehousing

Additionally, leasing required new resources—new people, more robust IT systems, and other new technologies—to design and develop the appropriate packages and then come to an agreement on monthly payments. Hilti needed a process for maintaining large arsenals of tools more inexpensively and effectively than its customers had. This required warehousing, an inventory management system, and a supply of replacement tools. On the customer management side, Hilti developed a website that enabled construction managers to view all the tools in their fleet and their usage rates. With that information readily available, the managers could easily handle the cost accounting associated with those assets.

Rules, norms, and metrics are often the last element to emerge in a developing business model. They may not be fully envisioned until the new product or service has been road tested. Nor should they be. Business models need to have the flexibility to change in their early years.

When a New Business Model Is Needed

Established companies should not undertake business-model innovation lightly. They can often create new products that disrupt competitors without fundamentally changing their own business model. Procter & Gamble, for example, developed a number of what it calls "disruptive market innovations" with such products as the Swiffer disposable mop and duster and Febreze, a new kind of air freshener. Both innovations built on P&G's existing business model and its established dominance in household consumables.

There are clearly times, however, when creating new growth requires venturing not only into unknown market territory but also into unknown business model territory. When? The short answer is "When significant changes are needed to all four elements of your existing model." But it's not always that simple. Management judgment is clearly required. That said, we have observed five strategic circumstances that often require business model change:

1. The opportunity to address through disruptive innovation the needs of large groups of potential customers who are shut out of a market entirely because existing solutions are too expensive or complicated for them. This includes the opportunity to democratize products in emerging markets (or reach the bottom of the pyramid), as Tata's Nano does.
2. The opportunity to capitalize on a brand-new technology by wrapping a new business model around it (Apple and MP3

players) or the opportunity to leverage a tested technology by bringing it to a whole new market (say, by offering military technologies in the commercial space or vice versa).

3. The opportunity to bring a job-to-be-done focus where one does not yet exist. That's common in industries where companies focus on products or customer segments, which leads them to refine existing products more and more, increasing commoditization over time. A jobs focus allows companies to redefine industry profitability. For example, when FedEx entered the package delivery market, it did not try to compete through lower prices or better marketing. Instead, it concentrated on fulfilling an entirely unmet customer need to receive packages far, far faster, and more reliably, than any service then could. To do so, it had to integrate its key processes and resources in a vastly more efficient way. The business model that resulted from this job-to-be-done emphasis gave FedEx a significant competitive advantage that took UPS many years to copy.
4. The need to fend off low-end disrupters. If the Nano is successful, it will threaten other automobile makers, much as minimills threatened the integrated steel mills a generation ago by making steel at significantly lower cost.
5. The need to respond to a shifting basis of competition. Inevitably, what defines an acceptable solution in a market will change over time, leading core market segments to commoditize. Hilti needed to change its business model in part because of lower global manufacturing costs; "good enough" low-end entrants had begun chipping away at the market for high-quality power tools.

Of course, companies should not pursue business model reinvention unless they are confident that the opportunity is large enough to warrant the effort. And, there's really no point in instituting a new business model unless it's not only new to the company but in some way new or game-changing to the industry or market. To do otherwise would be a waste of time and money.

These questions will help you evaluate whether the challenge of business model innovation will yield acceptable results. Answering "yes" to all four greatly increases the odds of successful execution:

- Can you nail the job with a focused, compelling customer value proposition?

- Can you devise a model in which all the elements—the customer value proposition, the profit formula, the key resources, and the key processes—work together to get the job done in the most efficient way possible?
- Can you create a new business development process unfettered by the often negative influences of your core business?
- Will the new business model disrupt competitors?

Creating a new model for a new business does not mean the current model is threatened or should be changed. A new model often reinforces and complements the core business, as Dow Corning discovered.

How Dow Corning Got Out of Its Own Way

When business model innovation is clearly called for, success lies not only in getting the model right but also in making sure the incumbent business doesn't in some way prevent the new model from creating value or thriving. That was a problem for Dow Corning when it built a new business unit—with a new profit formula—from scratch.

For many years, Dow Corning had sold thousands of silicone-based products and provided sophisticated technical services to an array of industries. After years of profitable growth, however, a number of product areas were stagnating. A strategic review uncovered a critical insight: Its low-end product segment was commoditizing. Many customers experienced in silicone application no longer needed technical services; they needed basic products at low prices. This shift created an opportunity for growth, but to exploit that opportunity Dow Corning had to figure out a way to serve these customers with a lower-priced product. The problem was that both the business model and the culture were built on high-priced, innovative product and service packages. In 2002, in pursuit of what was essentially a commodity business for low-end customers, Dow Corning CEO Gary Anderson asked executive Don Sheets to form a team to start a new business.

Dow Corning Embraces the Low End

Traditionally high-margin Dow Corning found new opportunities in low-margin offerings by setting up a separate business unit that operates in an entirely different way. By fundamentally differentiating its low-end and high-end offerings, the company avoided cannibalizing its traditional business even as it found new profits at the low end.

	ESTABLISHED BUSINESS

Customer value proposition	Customized solutions, negotiated contracts
Profit formula	High-margin, high-overhead retail prices pay for value-added services
Key resources and processes	R&D, sales, and service orientation
	NEW BUSINESS UNIT
Customer value proposition	No frills, bulk prices, sold through the internet
Profit formula	Spot-market pricing, low overhead to accommodate lower margins, high throughput
Key resources and processes	IT system, lowest-cost processes, maximum automation

The team began by formulating a customer value proposition that it believed would fulfill the job to be done for these price-driven customers. It determined that the price point had to drop 15% (which for a commoditizing material was a huge reduction). As the team analyzed what that new customer value proposition would require, it realized reaching that point was going to take a lot more than merely eliminating services. Dramatic price reduction would call for a different profit formula with a fundamentally lower cost structure, which depended heavily on developing a new IT system. To sell more products faster, the company would need to use the internet to automate processes and reduce overhead as much as possible.

Breaking the rules. As a mature and successful company, Dow Corning was full of highly trained employees used to delivering its high-touch, customized value proposition. To automate, the new business would have to be far more standardized, which meant instituting different and, overall, much stricter rules. For example, order sizes would be limited to a few, larger-volume options; order lead times would fall between two and four weeks (exceptions would cost extra); and credit terms would be fixed. There would be charges if a purchaser required customer service. The writing was on the wall: The new venture would be low-touch, self-service, and standardized. To succeed, Dow Corning would have to break the rules that had previously guided its success.

Sheets next had to determine whether this new venture, with its new rules, could succeed within the confines of Dow Corning's core enterprise. He set up an experimental war game to test how existing staff and systems would react to the requirements of the new customer value proposition. He got crushed as entrenched habits and existing processes thwarted any attempt to change the

game. It became clear that the corporate antibodies would kill the initiative before it got off the ground. The way forward was clear: The new venture had to be free from existing rules and free to decide what rules would be appropriate in order for the new commodity line of business to thrive. To nurture the opportunity —and also protect the existing model—a new business unit with a new brand identity was needed. Xiameter was born.

Identifying new competencies. Following the articulation of the new customer value proposition and new profit formula, the Xiameter team focused on the new competencies it would need, its key resources and processes. Information technology, just a small part of Dow Corning's core competencies at that time, emerged as an essential part of the now web-enabled business. Xiameter also needed employees who could make smart decisions very quickly and who would thrive in a fast-changing environment, filled initially with lots of ambiguity. Clearly, new abilities would have to be brought into the business.

When the Old Model Will Work

You don't always need a new business model to capitalize on a game-changing opportunity. Sometimes, as P&G did with its Swiffer, a company finds that its current model is revolutionary in a new market. When will the old model do? When you can fulfill the new customer value proposition:

- With your current profit formula
- Using most, if not all, of your current key resources and processes
- Using the same core metrics, rules, and norms you now use to run your business

Although Xiameter would be established and run as a separate business unit, Don Sheets and the Xiameter team did not want to give up the incumbency advantage that deep knowledge of the industry and of their own products gave them. The challenge was to tap into the expertise without importing the old-rules mind-set. Sheets conducted a focused HR search within Dow Corning for risk takers. During the interview process, when he came across candidates with the right skills, he asked them to take the job on the spot, before they left the room. This approach allowed him to cherry-pick those who could make snap decisions and take big risks.

The secret sauce: patience. Successful new businesses typically revise their business models four times or so on the road to profitability. While a well-considered business-model-innovation process can often shorten this cycle, successful incumbents must tolerate initial failure and grasp the need for course correction. In effect, companies have to focus on learning and adjusting as much as on executing. We recommend companies with new business models be patient for growth (to allow the market opportunity to unfold) but impatient for profit (as an early validation that the model works). A profitable business is the best early indication of a viable model.

Accordingly, to allow for the trial and error that naturally accompanies the creation of the new while also constructing a development cycle that would produce results and demonstrate feasibility with minimal resource outlay, Dow Corning kept the scale of Xiameter's operation small but developed an aggressive timetable for launch and set the goal of becoming profitable by the end of year one.

What Rules, Norms, and Metrics Are Standing in Your Way?

In any business, a fundamental understanding of the core model often fades into the mists of institutional memory, but it lives on in rules, norms, and metrics put in place to protect the status quo (for example, "Gross margins must be at 40%"). They are the first line of defense against any new model's taking root in an existing enterprise.

Financial

- Gross margins
- Opportunity size
- Unit pricing
- Unit margin
- Time to breakeven
- Net present value calculations
- Fixed cost investment
- Credit items

Operational

- End-product quality
- Supplier quality
- Owned versus outsourced manufacturing

- Customer service
- Channels
- Lead times
- Throughput

Other

- Pricing
- Performance demands
- Product-development life cycles
- Basis for individuals' rewards and incentives
- Brand parameters

Xiameter paid back Dow Corning's investment in just three months and went on to become a major, transformative success. Beforehand, Dow Corning had had no online sales component; now 30% of sales originate online, nearly three times the industry average. Most of these customers are new to the company. Far from cannibalizing existing customers, Xiameter has actually supported the main business, allowing Dow Corning's salespeople to more easily enforce premium pricing for their core offerings while providing a viable alternative for the price-conscious.

Established companies' attempts at transformative growth typically spring from product or technology innovations. Their efforts are often characterized by prolonged development cycles and fitful attempts to find a market. As the Apple iPod story that opened this article suggests, truly transformative businesses are never exclusively about the discovery and commercialization of a great technology. Their success comes from enveloping the new technology in an appropriate, powerful business model.

Bob Higgins, the founder and general partner of Highland Capital Partners, has seen his share of venture success and failure in his 20 years in the industry. He sums up the importance and power of business model innovation this way: "I think historically where we [venture capitalists] fail is when we back technology. Where we succeed is when we back new business models."

A version of this article appeared in the December 2008 issue of *Harvard Business Review.*

Mark W. Johnson is a cofounder and senior partner of the strategy consulting firm Innosight and author of *Lead from the Future* (HBR Press, 2020).

Clayton M. Christensen was the Kim B. Clark Professor of Business Administration at Harvard Business School and a frequent contributor to Harvard Business Review.

HK

Henning Kagermann is the co-CEO of SAP AG, in Walldorf, Germany.

Read more on **Innovation** or related topic **Business models**