BUSINESS MODEL DEVELOPMENT GUIDANCE NOTES

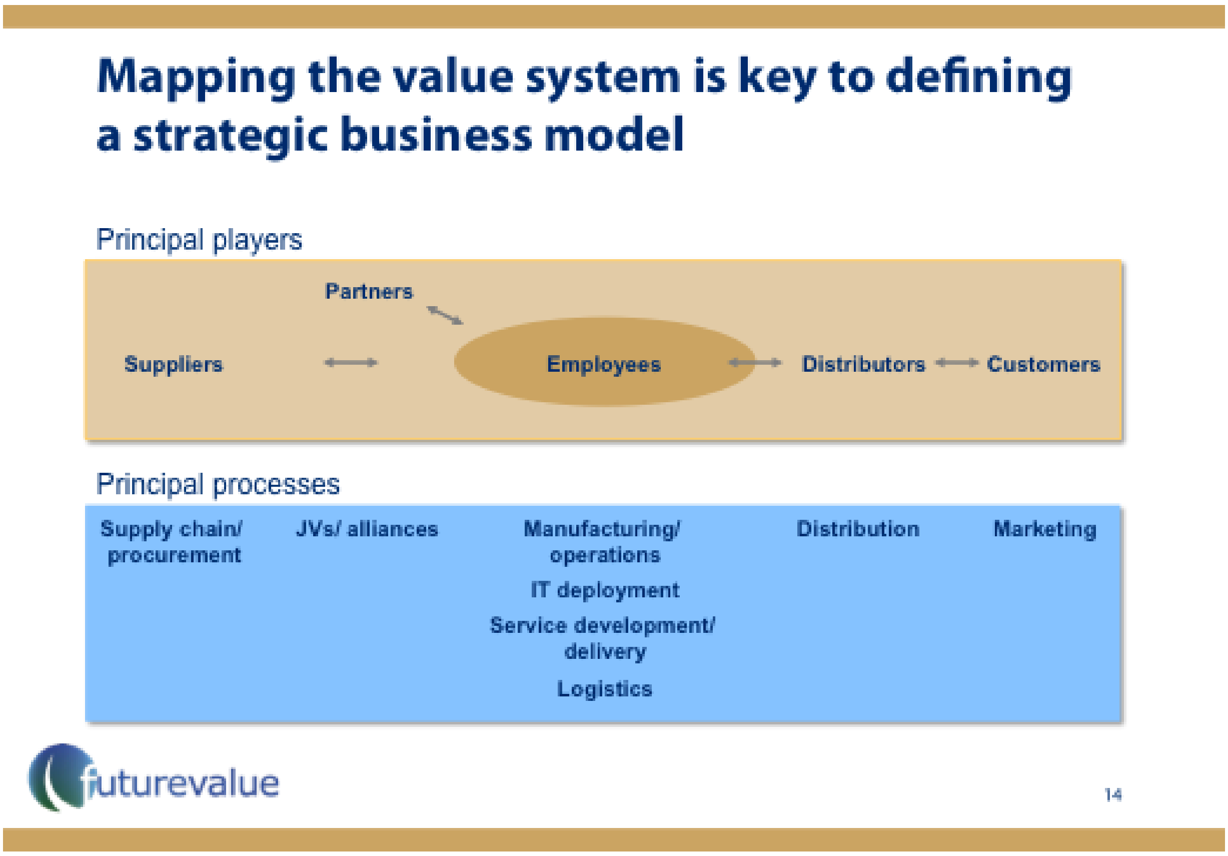
Defining the business model

The business model is, as the name implies, a model, not a process. It should form the foundation for the strategic framework as defined here by FutureValue:

> *"The business model is the foundation of a company's strategic framework and defines the logic of the business. It explains why the business exists, and why it will continue to exist. It requires the business to understand the sources of competitive advantage that contribute to its profitability across the whole value system of the enterprise. A well-defined business model then enables the development and articulation of clear and consistent corporate goals, objectives and strategy."*

Constructing the business model

Constructing the business model needs certainty about the make-up of the business before drafting can commence. It needs an informed and objective external focus with knowledge of the business in the context of its markets, competitors. It requires also knowledge of all the economic stakeholders to map the value system.



It is important to agree first what 'value' and 'value system' mean. 'Value system' refers to the full span of stakeholders engaged in the production and delivery of an entity's product and services, from the end customer right back to the furthest removed supplier. Much of the value system is typically outside the entity's organisational boundaries. 'Value', or sources of 'value', refers to activities that enable an entity to charge ultimately a premium for the product or service that it is providing. 'Value' thus created through these activities may be real and tangible, e.g. product quality, service delivered, efficient operations, reliable procurement; or, it may be perceived and intangible, e.g. brand, relationships, knowledge, convenience, culture etc. The most important sources of value creation usually* focus on the customer but relate to any player in the value system. To identify principal sources of value requires the development of an external perspective of the entity and what confers ongoing competitive advantage.

* **not** where the entity is a 'price taker' as, for example, in natural resources exploration and production

The following six steps will complete the initial analysis stage that must precede the drafting and articulation of the business model:

1 What is the business's value system and who are the principal stakeholders/players across the value system, i.e. customers, distributors, employees, partners, suppliers?

2 What are the principal processes in the value system, i.e. supply chain, manufacturing, operations, IT, logistics, marketing, distribution, etc.?

3 Referring to customers and markets, what are the distinct sources of value they perceive that give competitive advantage, i.e. why do they buy and why do they continue to do so?

4 Referring to other external stakeholders, what are the distinct sources of value they perceive – why do they partner with the entity, why do they joint venture or why do they distribute its products?

5 Referring to the principal processes, in what ways is the business continually investing to develop or maintain distinct advantage, e.g. innovation, systems, processes, knowledge etc.?

6 What is distinct about the treatment of that portion of value created accruing to the business in enhancing the business' sources of advantage, e.g. re-investment and focus of that re-investment, profit sharing, distribution to shareholders?

Developing the business model for a group of entities

Most quoted companies will comprise a number of business entities or reportable segments. The Group business model will show how the Group adds value to its underlying parts. It requires the following steps:

1 Repeat steps 1 to 6 above for each reportable business segment

2 Referring to the list of distinct sources of value – value perceived, created and in development – identified for each entity or segment, look for the common shared sources of value across all entities

3 List and distinguish the sources of value that emanate customers and markets and separate them from those sources of value that relate to investment internally in strengths and resources

So, where a Group of business units is addressing a heterogeneous set of markets, where customers are not shared, the emphasis in the Group business model will be more on distinct sources of value created across the Group relating specifically to resources – e.g. innovation, knowledge, systems, productivity. Where a Group of business units is addressing more homogeneous and shared markets from that Group's perspective the emphasis will be on sources of value perceived – e.g. brand, relationships, service, accessibility, product range, quality. The output of the Group business model should show unequivocally how the Group as a whole adds value to the sum of the parts that are the underlying individual entities or segments.

Articulating the business model

Whether a single entity or a group of entities/segments, the format and layout should be similar. Four relatively short paragraphs should be sufficient to capture the model comprehensively.

1 Describe concisely what the Company does, or what the Group and its segments do
2 Explain the primary sources of value created and as perceived by customers and markets; if this is a Group with heterogeneous non-shared markets across its segments there may not be any collective 'group' added value of this type
3 Explain where the Group/Company is investing internally and developing internally driven sources of value to give itself an edge; explain also the value created through other external stakeholders upstream in the value system
4 Explain the portion of value that becomes available for the owners of the business. How is value captured for re-investment, profit share for employees, distribution to owners.

Example Business Models

Below are three example business models, each in four paragraphs based on the above – core business and needs met; the value created distinctively; the value being developed advantageously; and, the value captured as a result:

A Bank

"XYZ Bank is a UK based financial services group that meets the financial services needs of individual, commercial and corporate customers across the UK, with a range of banking, insurance, investment, debt financing and risk management products to meet those customer needs.

Fundamental to its success is its complete focus on customers and the advantages accruing from this focus. Products matched precisely to customer needs, iconic and distinct brands, multi-channel access and truly customer-oriented employees combine to provide the foundations for strong and enduring customer relationships.

Equally important are the Bank's growing cost-based advantages developing throughout the entire organisation and across its value system. These are to be found in the increasing efficiency of operations and processes, making the bank much better able to address its customers' needs. They are also becoming visible in simpler structures leading to greater agility of the organisation, effectively bringing the bank closer to its customers. These advantages even extend to streamlining how the bank works with its suppliers to help deliver services to customers more effectively.

A more intense focus on how the Bank creates and delivers value means it can now be more certain about the portion of value that it captures. This enables XYZ to strengthen its balance sheet, continue to invest in value for its customers and, in due course, achieve returns for shareholders sustainable over time."

A Telecommunications Group

"Telecoms Group [TG] meets a wide range of communication services needs: for consumers; for businesses large and small, global as well as UK-focused; and for other UK communication providers.

As the leading provider of broadband, fixed line, networked IT and wholesale telecom services TG applies its knowledge, skills and experience to the distinctive benefit of its customers. In particular customers enjoy an *increasing level of service and experience because TG learns faster than its competitors how to do things better for its customers. This includes bringing new ideas, products and services to market faster, cheaper and more effectively. It also means customers value us for what the TG brand stands for: being trustworthy, being helpful, inspiring and straightforward.*

In addition to the benefits customers both perceive and enjoy TG is able to transform the costs of, and ways in which it provide its services. TG is building a better value system – by using IT systems more effectively and driving savings from suppliers, to streamlining internal processes and introducing new ways of working. In this TG Is applying organisational creativity and innovation to be more effective as well as more efficient. It is not surprising then that the Group has been able to deliver a 7% reduction in net operating costs.

Real value creation for customers and better value delivery across the TG value system add up to more value captured in the form of better profitability and increasing cash generated. It means more to invest in TG's future and in core markets, each a focus of one of the Group's strategic priorities."

A London Market Insurer

"LM Insurer meet the needs of clients from around the world who want the security of insurance cover to help them manage complex risk exposures. These clients may also be insurance carriers. As a participant in the unique risk-sharing Lloyd's insurance market in London we are able to develop access and distribution to clients with these needs through the global span and reach of an expansive broker network centred on the Lloyd's market.

'LM Insurer' applies distinctive skills and capabilities to be able to address these client needs. As a specialist underwriter we have developed the ability to balance a portfolio of these complex risks to optimise the use of our capital. To achieve this we have developed expert know-how to underwrite and manage complex risks for profit. This requires the best talent in the insurance industry and, above all, entrepreneurial underwriters empowered and skilled to respond quickly to clients and to brokers. It also requires the ability to blend the face-to-face relationships, still essential to success in the Lloyds' market, with effective use of technology.

How we use and allocate capital is a prime capability and another key source of advantage. Our role as a leading participant in the Lloyd's market is an important aid to the agility we need to share risk and use capital in the most efficient and effective manner. We share risks with other Lloyd's participants. We also retain a high proportion of the risks we write to ensure we understand our clients. Central to our business model, risk sharing is an important tool to help us balance risk appetite, use our capital well and develop understanding of our clients' businesses.

Our knowledge of our markets and the value we create, our organisational capabilities and the skills we apply, and our highly attuned risk-sharing combine to ensure we underwrite more premium and have more invested assets per dollar of capital than our peers. It means we can aim to target an average combined ratio of 90% with low volatility."

Note that a good Annual Report designer should be able to present the model, once clearly defined, in a simple, effective schematic. The definition and exposition has to come first.

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September 2013