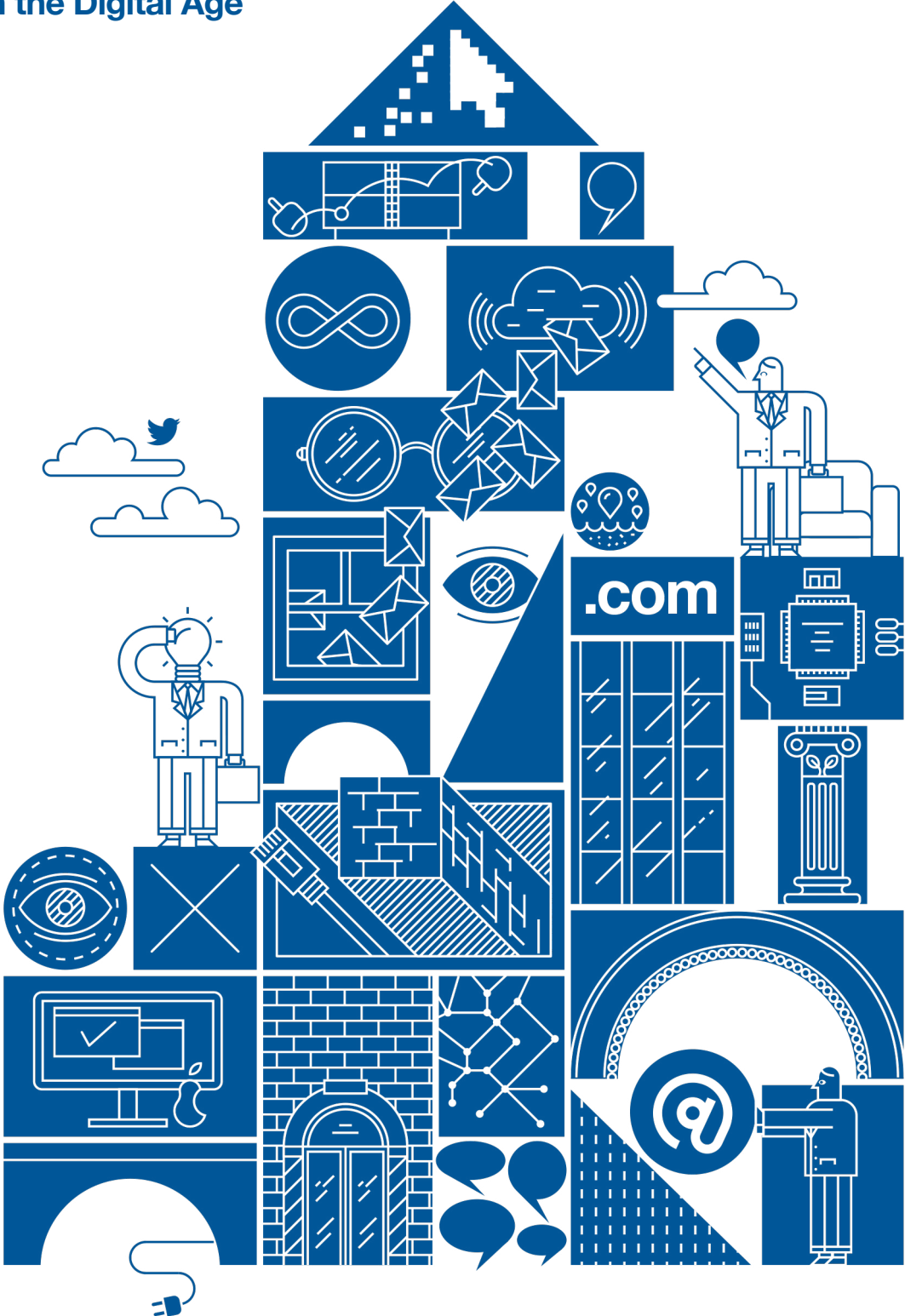


# Reinventing the Company

in the Digital Age



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in the Digital Age

## **Business Models for the Companies of the Future**

Joan E. Ricart

Professor Ricart explains how our hyper-connected, digital high density world is opening up to innovation in business models. Although it is difficult to predict exactly what innovations the future holds regarding business, he catalogs possible emerging business models.

These are concentrated in several groups. The first has the premise that anything that does not create value for the consumer should be removed. The second group is “platforms” business models that serve two or more markets simultaneously. A third group is the “global business” opening up to rapid international growth. He underlines the importance of the “pursuit of excellence” focused on developing innovation in order to promote virtuous circles, which is the primary goal of any good business model.

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### Key Features for the Company of the Future:

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#### **Rebuild the Company From the Outside In**

Make sure everybody is aware of how the value chain and ecosystem serving the customer both create value. Then identify your role in the ecosystem, and understand how it interacts with other ecosystem players and with customers. Next, design your organization so that it creates value for, and through, those interactions. Finally, underpin your whole venture with capabilities that enhance productivity, efficiency and effectiveness. Now you are ready to face a constantly shifting world.

#### **Draw a Visible Distinction Between Management and Leadership Roles**

Effective management drives success in stable markets where the value proposal, the value chain and the role of the company remain largely unchanged from one year to the next. Leadership, however, is called for when our market breaks away on an unexpected course, rendering the old ground rules obsolete and requiring us to take high-risk decisions based on scant information – later, we have to adapt on the fly while the new dynamics play themselves out. Management and leadership, while both necessary for success, are not interchangeable.

#### **Redefine the Role of Middle Management**

We should forget about the hierarchical model whereby a middle manager gets instructions from above, sends them “downward,” then gathers information from below to be reported “upward.” Instead, the middle manager must be put in charge of interactions with customers and partners and empowered to detect, analyze and resolve issues through negotiation, adaptation and reform. She must be given overall control of the relationship with customers and partners, relying on the full support of everyone both “below” and “above” her.

## **Business Models for the Companies of the Future**

The business models for the companies of the future are in the making today. A company that cannot reinvent itself and develop a workable business model has no future at all: it will fade and die. We are in the midst of change and, as Peter Drucker said, where there is change, there is opportunity. Those unable to see opportunity see only threats. The future starts now.

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### **A Connected World**

Every generation believes itself the witness of the greatest upheavals in history. But this belief is questionable. How can we compare the invention of the printing press to the Industrial Revolution or the emergence of the internet? We can't. What we can do is pinpoint some of the features of the changes taking place now, and think about how and why they shape business, government, and society.

The forces driving change today are tied to technology, particularly information and communication technologies (ICTs), as discussed in earlier chapters. Even at the expense of repetition, it is vital to discern the lineaments

of this change—because today change itself is different from the ICT-led developments seen in earlier years.

Technological change is driven by four forces. First, mobility: an explosion in the number of points of contact with the internet. Everyone is connected, anywhere, any time. The connected world embraces not just people but things. All sorts of devices in all manner of places “talk” to each other.

The ease of connectivity multiplies in the “cloud.” Information no longer rests at a single place (although there is a physical sense in which it still does): it is accessible everywhere. Any data you might need is available at any point of contact. You are always connected and have a way in to the information.

This force might seem sufficiently powerful in itself. But, what’s more, it enables different uses of connectivity. People are social beings, and develop

their connections across social networks. They do not just connect: they communicate, interact, influence one another. Social media and broadband connections let us share pictures and videos, chat with our friends, engage in debate—collectivity is experienced as another form of natural human interaction. One of the hallmarks of collectivity is its social angle.

And the weave of connections, interactions, and information brings forth vast amounts of data in an unstructured

form. This information lets us find out what consumers want, what they buy, what they do. There’s a lot we can learn about how to improve our performance, provide services, and interact with users. This is the world of Big Data—the analytical study of huge amounts of information so as to improve the way we live.

When we view these four elements in combination, what we see is not just a connected or “hyper-connected” world: we also find that increased connection enhances interaction. The information we share exponentially drives up “digital density.”<sup>1</sup> As the creators of the concept would have it, “digital density” requires both an increase in the number of connections among agents, and a rise in the degree of interaction and the volume of information they share. When these elements come together, “digital density” grows, setting off the potential for change. The impact of digital density encompasses all sectors of activity. Yet that impact can be dampened by the specific regulatory environment. The fewer the regulatory constraints on the network of connections, the higher the impact. Increased digital density opens the door to innovation in business models. This is an emerging battleground in a competitive world.

**Technological change is driven by four forces. First, mobility: an explosion in the number of points of contact with the internet. The ease of connectivity multiplies in the “cloud”**

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## The Business Model<sup>2</sup>

Let's start from the beginning. What is a "business model," and why has it become more important nowadays? Every enterprise has a business model, and always has. A business model is the logic of the enterprise, the way in which it creates and captures value for its stakeholders.<sup>3</sup> So business models have always existed and always will.

An example drawn from a bygone era may help us understand this concept—the underlying logic by which an enterprise "makes money." Think of the early days of photography, and, specifically, the Kodak company. At one time photography was in the hands of professionals who created black-and-white images on a glass surface. In 1883 George Eastman invented a new process which, he believed, was revolutionary: transferring the complex chemical process of photography to a less delicate, more easily handled medium: roll film, first made of paper and soon to be made of plastic. This marked the emergence of the photographic film reel as we knew it until the digital revolution. But Eastman's invention, great though it was, failed to take off. The quality was not quite as good as that obtained by the conventional method, so professionals gave the new technology a miss.

But Eastman persevered. He realised that, while his innovation was of little use to established photographers, it might be of interest to a different, so far unheeded category of consumers.

Many households would be keen, he thought, to memorialize family events by their own hand, easily and cheaply; recourse to a professional photographer would become the exception. But selling this idea to the public demanded a different business model. First, Eastman had to make available a cheap, easy-to-use camera that used the new reel-based technology. This was something he proved able to develop. Secondly, there had

to be a chain of stores where people could buy the camera and photographic reels, and get their photographs developed. To put these ideas into practice, in 1888 Eastman founded Kodak, and created a wide-reaching service chain which over the years spread around the world. Film reels and development services became available all over the planet.

Based on this new business model, Eastman's invention changed the world of photography. Later, Kodak developed serious capabilities in the fields of

**Kodak developed the first digital cameras and invested heavily in digital for many years. The real difficulty was that digital photography was consigning Kodak's business model—which was hard to change—to obsolescence**

chemistry, optics, and services. Then digital photography made its appearance. Many mistakenly believe that Kodak dragged its feet in the digital age and failed to develop digital technology, but this is far from the truth. In fact, Kodak developed the first digital cameras and invested heavily in digital for many years. The real difficulty was that digital photography was consigning Kodak's business model—which was hard to change—to obsolescence. In the digital world, chemistry is irrelevant. There is no film, no developing. These were the mainstays of Kodak's business model. In digital photography, revenue is generated not by the film, but by the device itself—because film and developing are unnecessary. So all those service centres, all the chemical technology ... dropped off the radar. And the change went even further. Today, a camera is a relatively rare purchase. Mass photography has shifted to mobile phones and tablets—which also let you share your pictures with other people. The change Kodak needed to make was not a technological one, but a change of business model. In this, Kodak failed. The winners in the world of digital photography are those that help people share their pictures (social networks and mobility) and sell and distribute images. These are business models where Kodak's capabilities were of little use.

**While Kodak, at one time, represented the future, the future was wrested from it by technological change. But while some entrepreneurs let the future slip from their grasp, others see it coming. For instance, Zara**

The Kodak example shows what a business model is, and why it is important; it also reveals the impact of technology on how we use things. Photography used to be a handmaiden of remembrance. Images became available only some time after the event (a trip abroad, a celebration); they were shared among narrowly selected circles; they came at a considerable cost. Now it is instantaneous. It is easily distributed anywhere in the world, to anyone, almost at the same time as the event being recorded. Pictures can be posted to open social networks or circulated across large groups of viewers. Quite a different world.

While Kodak, at one time, represented the future, the future was wrested from it by technological change. But while some entrepreneurs let the future slip from their grasp, others see it coming. For instance, Zara (the Inditex group) emerged in the 1970s, when the textile industry in Spain was in decline, having been hit hard by manufacturing in low-cost countries. Amancio Ortega formed a new vision. His insight was that the answer was not to produce large volumes in countries where labour was cheap. It was a matter of quickly making available what women wanted—even if this meant higher production



costs, because the net price would be higher.<sup>4</sup> This idea enabled him to build an empire of labels and establishments all over the world.

While the end product is still just a garment, the business model is radically different. The key is to be sensitive to which specific garment is desired, and then to design, manufacture and distribute it so that as quickly as possible it can be in the hands of a buyer whose choice is already known to us. Today, given the group's sales volume, international expansion, and vast number of points of sale, a lot of skill is needed to do what Zara does: to deliver what a woman wants two to four weeks after her buying preference is detected. Speed allows for minimizing advertising or dispensing with it entirely; this means the net price is higher; and increased margins more than make up for higher manufacturing costs. Zara's business model is now a case study in all the world's business schools: the "fast fashion" model.

So a business model is important: it is the underlying logic whereby we create and capture value for our stakeholders. There always have been opportunities to create new and disruptive business models that change the ground rules of an industry—like Kodak, like Zara. Today, however, technological progress, globalization, deregulation, demographic shifts, and the behavioral changes driven by technology enable us to do things in radically different ways. Not just a little bit better, not just a little bit more efficiently: in a way that is completely different. The opportunities for innovation in business models, and the threats posed by innovations in our competitors' business models, have both increased exponentially. A revolution is under way.

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## Business Model Innovation

Technological change and its related developments allow for far-reaching innovation in business models. The companies of the future will surprise us with novel and original business models. In this new world, opportunities are on the rise. It is by definition impossible to predict what will take us by surprise or what will prove innovative. But we can to some extent cast our gaze over the businesses that are now emerging—because, as we have said, the future starts today.

One strongly rising trend in business models might be dubbed "cost obsession." The paradigm is perhaps the low-cost airline, based on the scheme developed by Southwest Airlines in the United States—the only American airline that has never failed to turn a profit. Southwest decided to fly point-to-point using smaller, less crowded airports, and used a range of operational measures to make sure its aircraft spent more time in the air and carried more passengers on each flight. Costs came down hugely, flights could be sold more cheaply, more passengers became willing to buy—this made routes more profitable, and a virtuous circle took care of the rest.

With variations, this is the business model of Ryanair in Europe, Air Asia in Asia, and any number of other carriers that operate this same model today. Cost obsession has emerged in many other industries. It is present in retail, for instance, Walmart being a prime example. The cost obsession philosophy—developed with care by Sam Walton at Walmart—has spread to an increasing number of sectors. The idea is to get rid of frills and make use of economies of scale, scope, utilization, experience and other factors for the benefit of consumers. Anything that does not create value for the consumer is stripped out.

Another business model category that is powerfully on the rise is the “platform.” This term refers to a business model that supports two or more markets at the same time. A conventional market attracts buyers by providing a venue that supports the presence of sellers, and attracts sellers by the promise of the presence of buyers, all for a specific domain of goods or services. Modern technology, however, removes barriers of time (accessible 24 hours a day) and place (accessible from almost anywhere). Platforms spring up in increasing numbers and compete with one another. One fascinating feature of inter-platform competition is that each platform seeks to achieve network externalities<sup>5</sup> leading to a “winner takes all” outcome. Another feature is that competitors put a lot of effort into raising the costs for the weaker party to switch platforms in a bid to keep members captive. A well-known example is eBay. This platform started out auctioning second-hand goods, then grew into a third-party market where businesses of all kinds sold all sorts of products, creating a huge online bazaar.

Other examples of platforms include game consoles, operating systems, and smartphones. The key variable is the “installed base.” If a video game platform—Nintendo, say—makes big sales, it achieves a large installed base. This makes it attractive to game developers, seeking to reach a wide range of potential buyers. A continued influx of more and (one hopes) better games in turn enhances the attractiveness of the platform, further aiding the growth of the installed base. This entrenches the virtuous circle of this network externality.

A third category of business model is the “global business” that opens up to the world in a brief lapse of time. Take Mango. Unlike Zara, Mango creates its own fashions. The firm designs collections and places them on the market at affordable prices, driven by manufacturing in low-cost countries and the flexibility to produce goods that get sold rather than selling goods that get produced. From the outset, Mango focused on urban, modern, professional, relatively young women.<sup>6</sup> So the target segment was not particularly large, and required operating in fairly big cities. International growth was crucial to achieving economies of scale and attaining the mass that would enable the firm to develop and manage its production and logistics efficiently. Swift

globalization was key. An apposite supporting example is Desigual: though targeting a different segment, its strategy is analogous to Mango's, and its internationalization was even quicker.

Elsewhere, we can look at Metalquimia, a small company in Girona, Spain, which makes machinery for the meat processing industry in a highly specialized niche. Because each individual country's market is so small, internationalization is essential. This enables Metalquimia to learn from its most demanding customers, wherever they may be based, and apply this learning to create an effective innovation process that makes the firm the spearhead of its niche, while lending it the scale for its innovation costs to pay for themselves.

**A third category of business model is the “global business” that opens up to the world in a brief lapse of time. Swift globalization is key**

The example of Metalquimia brings us to a fourth business model category which one might classify as “seeking excellence.” These companies focus on innovation, surprise their customers with new features, and satisfy needs which weren't even there when the product comes out. The paradigm

is Apple. After inventing the personal computer and almost the battle against the Wintel alliance, Apple revolutionized the world of media players with the iPod and the world of telephony with the iPhone—then it created the entirely new world of the tablet, with the iPad. In its own niche, Metalquimia has made analogous breakthroughs.

Irizar, originally a family-owned firm in the Spanish Basque Country, became a cooperative partnership within the Mondragón group, then went its own way in 2005. It makes vehicle bodywork for upmarket buses for a worldwide client base. Its highly distinctive management model is based on independently led teams and on giving everyone who works for the company an ownership stake. This approach enables Irizar to achieve an unsurpassed standard of innovative excellence in the niche market of bodywork for high-end buses.

Each of the businesses mentioned so far operates a distinct business model that supports the specific way in which it seeks to develop its capabilities. However, they all share a continuing pursuit of excellence, distinctiveness of goods and services, and an ongoing bid to innovate.

Distinctiveness of goods and services is achievable through innovation, but can also be the outcome of other factors. Some business models, for instance, are based on “speed”: adapting quickly to customer requirements, as seen in the paradigm case of Zara. Other enterprises find distinctiveness in their quality—whether intrinsic (Rolls-Royce), or linked to a highly characteristic market segment or “tribe” of buyers (Ducati). Still other firms adapt to local tastes or cater to relatively uninformed customers. The common

denominator of these business models underpins a fifth category, “distinctive/adapted.” In the digital world, what’s more, distinctiveness can be taken to an extreme, where the relationship is one-on-one. This model has earned itself the name “long tail.” The concept flourishes on online sales platforms, which might take the form of a “store”—Amazon in its beginnings—or a “bazaar”—eBay. The crux is that drastically lowered transaction costs enable sellers to approach tiny market segments—sometimes comprising a single buyer—almost as efficiently as wide swathes of the market.

These five categories of business models are not exhaustive. There must be others that are unclassifiable now, and still less so in the future—innovation being unpredictable by definition. What’s more, the categories overlap. A case study illustrating one category could just as easily illustrate another. So this outline, rather than providing a taxonomy, merely points out features that make a business model “good” at creating and capturing value. These business model features set in motion virtuous circles<sup>7</sup> and bring about a positive dynamic. The robustness of a given business model is determined by the number of positive dynamics it is capable of enlisting, so lending it the ability to survive competition with other models, both present and potential.

For further insight into these categories of business model, we can look at the virtuous circles that each of them entails. “Cost obsession” business models generate virtuous circles that gradually bring down the cost of manufacturing goods or providing services. The model might be driven by economies of scale (costs decrease as manufacturing volume increases), economies of learning (costs decrease as production accumulates), economies of capacity use (costs decrease as utilized capacity increases), or any combination of these elements and factors relating to scarce resources, such as location, technology or knowledge. To generalize, all these virtuous circles lie on the supply side. We should be aware that the behavior of these costs in the tangible world, which is subject to physical limits, is not the same as in the online world, where scalability may be unlimited.

By way of contrast, the virtuous circles garnered by “platform” models arise from network externalities and the “switch” costs accepted by the customer (“lock-in”)—here, the onus lies on the demand side of the market. These powerful virtuous circles sometimes enable the “winner” to corner

**The robustness of a given business model is determined by the number of positive dynamics it is capable of enlisting, so lending it the ability to survive competition with other models, both present and potential**

most of the demand; but they are fragile, being easily transformed into vicious circles when another firm grabs the “winner” spot.

“Global businesses” also depend on demand-linked virtuous circles, but usually require interaction with a key variable on the supply side. Swift internationalization captures the volume to achieve economies of scale, cover overheads, and reach innovation and brand-value milestones that would be otherwise unthinkable.

The other two business model categories also depend on supply/demand interactions. In the “seeking excellence” model, the key is innovation. Triggering a cycle of innovation is tough, because it requires you to outdo your competitors in several different ways at once to keep ahead. You need to implement best practices, secure employee commitment and attract the best talent—this is hard to keep up sustainably over time.

“Distinctive/adapted” models impose the tough challenge of maintaining a sufficient standard of distinctiveness. Speed of adaptation is the key to winning the ongoing race to be first with what the consumer wants at the given time—the best she can get at that moment, because there is no other comparable choice. There is a constant struggle against the swift “commoditization” of the product or service.

A good business model is one capable of keeping alive a virtuous circle, or a combination of them. And in the competitive setting of the twenty-first century, strength lies in developing better and more innovative business models.

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### **A New Overarching Objective: Reinventing the Business Model**

Information and communication technologies let us address all these five dimensions at once. But whether our intended market is new or already out there, we need to give careful thought to designing a business model capable of triggering virtuous circles. The design-based approach that this requires is something of a newcomer to the field of strategy studies. We need to revive our “design thinking” skills—how to solve problems, how to bring out the strengths of the intended model, how to overcome the barriers thrown up by our environment.

These are the skills that the executives of the company of the future are called upon to develop. First, they must understand the nature of technological change and its implications. Secondly, they must go a step further, and apply their insights to designing a self-consistent entrepreneurial logic that reinforces and protects the targeted virtuous circles more effectively than the alternative approaches to the given market. Because these business models are both complex and holistic, the process of design entails experiment, trial and error, ongoing revision, and learning on the fly. We finally put together a model, but must immediately start to think about how it can be improved and upgraded—because any competitive edge is increasingly transitory and unsustainable.

And, while design is a tough challenge in itself, when we look at the demands of a model equipped with the internal dynamics capable of supporting the logic of the business, we face the further difficulty of remaining strong against the competition. It sometimes happens that a model that is objectively superior when considered in isolation loses the battle against inferior alternatives that enjoy entrenchment, as often happens in the sphere of “platforms.” The older platforms outdo us in terms of user interaction. The installed base of an entrenched platform may prove too powerful an obstacle for an objectively more effective business model starting out with an installed base of zero.

### **The executives of the company of the future need to revive their “design thinking” skills—how to solve problems, how to bring out the strengths of the intended model, how to overcome the barriers thrown up by our environment**

So business model design does not take place in a vacuum but in a setting where our competitors are also making decisions and creating their own business models. This interaction is a key element we need to incorporate to the design process. We must look to both existing and potential alternatives. We must bear in mind the significance of timing. If we move too slowly, we may find our intended space is already taken, and we now need to do something different. Or we might run ahead of ourselves without developing the capabilities needed for the next step. Managing the design process against a background of dynamic interactions is a tough and complex challenge: all the same, it is of the essence of the company of the future.

Developing a novel, innovative business model that is capable of rising to future challenges in an uncertain and connected high digital density environment requires the talent of an entrepreneur. This means the executive of the future must be good at design and strategically shrewd, and also a talented venturer. She must see where opportunity lies, how to ride the wave of change, how to reinvent oneself. We all too often think of a CEO as the steward of an existing state of affairs rather than as the shaper of a new reality. But the lever of change cannot be left in the hands of startups alone—we also need entrepreneurial executives in large, established companies.

The skills of design, strategy, and enterprise will lead to new business models which will change (and already are changing) both companies and whole industries, bringing about new ground rules and new ways of sharing out created value. We need the vision and leadership to transform entire industries from end to end, but we must see that this is done in a

way that brings us a meaningful portion of the value thus created. There lies ahead a tough “game” for senior executives in our century, the leaders of the companies of the future.

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### **Business Models in the Company of the Future**

In this chapter, we referred early on to technological change and the disruptive influence of emerging information and communication technologies. Significant though they are, however, these technologies are merely a medium of support. We must focus on the overarching business model: throughout the business transformation leading to the company of the future, the business model is the driving force. While making use of new technologies, in the awareness of the changes they entail and the swift developments they are still to bring, our real goal is to reinvent business models.

To achieve this we need business leaders with design talent, a flair for strategy, and the courage of the venturer. And even this is only the beginning, because the new era of design will no doubt demand new forms of leadership, a new organizational balance, and new skills in our employees and executives. Execution will be by no means easy.

Building the companies of the future will be tough. Business-building always *has* been tough. Overcoming difficulty is the calling of the effective leader. And today this role inevitably entails reinventing business models so that our business of the present is also the company of the future. The future starts now. We must not tarry in getting ready for it. It is upon our success in this challenge that the well-being of society depends. With leadership comes responsibility. Let’s rise to the challenge today and reinvent the business model.

## Notes

### 1

This concept was coined in the paper by E. Káganer, J. Zamora, and S. Sieber, "The Digital Mind-Set: 5 Skills Every Leader Needs to Succeed in the Digital World", *IESE Insight*, issue 18, 3rd quarter, 2013.

### 2

See also, on business models, the following by R. Casadesu-Masanell and J.E. Ricart:

"Competing Through Business Models (A). Business Model Essentials," Harvard Business School, note 708452 (2008); "Competing Through Business Models (B). Competitive Strategy vs. Business Models," Harvard Business School, note 708475 (2008); "Competing Through Business Models (C). Interdependence, Tactical & Strategic Interaction", Harvard Business School, note 708476 (2008); "From Strategy to Business Models and Onto Tactics," *Long Range Planning*, 43 (2010), pp.195-215; "How to Design a Winning Business Model," *Harvard Business Review*, January 2011, 100-07.

A summary is provided in J.E. Ricart, "Strategy in the 21st Century: Business Models in Action," IESE Technical Note SMN-685-E, 2013.

### 3

"Stakeholder" is a commonly accepted term meaning any party involved in the future of the organization, whether as a shareholder, employee, supplier, customer, government entity, society at large, etc.

### 4

The net price is the sale price adjusted by the effect of discounts and advertising and promotion costs. The resulting price is known as the "net price."

### 5

A network externality arises when the addition of an additional consumer is of benefit to all the consumers already present. This is a natural occurrence in a network setting. For instance, the value of having a telephone connection rises each time a new user joins the network. The same sort of externality arises indirectly on multi-market platforms—when one side of the market grows, value is increased for the other side, and vice versa.

### 6

After a few failed attempts, Mango recently branched out into collections such as HE by Mango (menswear), Mango Kids, Violeta, etc.

### 7

A business model can be formally defined as a set of choices and their respective consequences (see the references indicated at note 2). Choices lead to consequences, which in turn form the basis of further choices. Within this dynamic process the interconnectedness of choices and consequences brings about positive feedback loops, which can be either "virtuous" or "vicious." The emergence of a virtuous circle is a hallmark of a successful business model.



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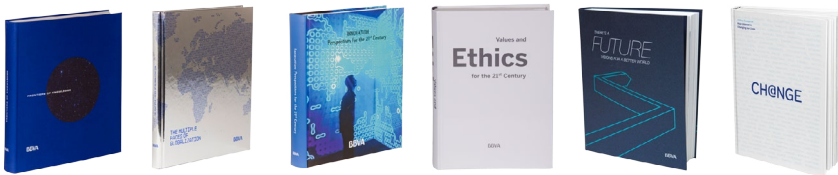
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