

## **Chapter 2**

# **Business Models and Transaction Value, Costs and Risks**

In recent years, business models have emerged as a focal point for enterprise development; for example, the Growth Enterprise Market (GEM) has proposed a series of listing criteria for high-tech companies that includes a new business model. Venture capitalists evaluate a company in terms of its market space, business model, and management. In this context, business models play a leading role. According to research by the American Management Association, enterprises across the globe allocate less than 10 % of their total budgets to develop new business models. In contrast, 60 % of the successful innovations of American enterprises are business model innovations.

However, how do we define a business model? What elements comprise a successful business model? Scholars and business managers are widely divided when answering these questions. A complete set of business model theories must answer the following questions:

First, what does a business model look like?

Second, in what ways business models differ in terms of performance or corporate financial results?

Third, what is the logic behind a business model? In other words, what do we need to do to make a business model work?

## **2.1 The Business Model: A Transaction Structure for Stakeholders**

The essence of a business model defines a transaction structure that involves stakeholders, which can be defined as customers and internal and external parties that include suppliers, distributors, and a company's internal departments. So, where is the boundary between these stakeholders? As independent positioning is a

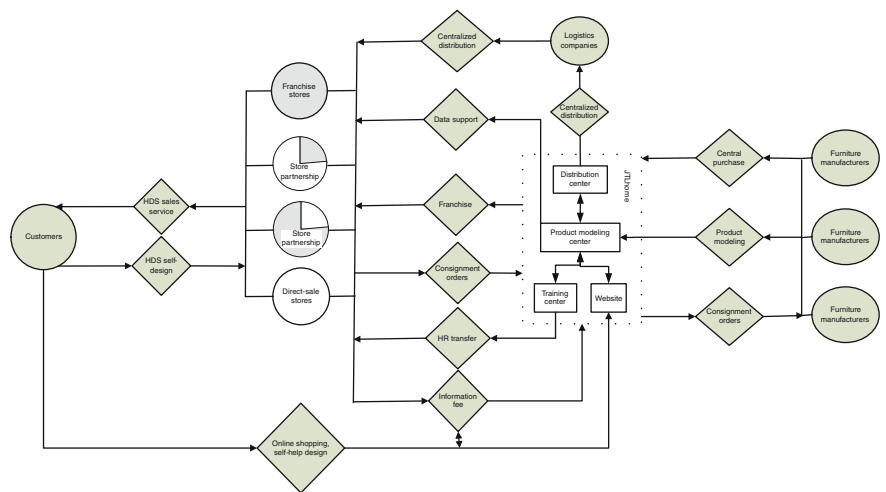


Fig. 2.1 JTLhome’s business models

key measure of an enterprise’s interests, different parties inevitably position mutually-exclusive interests, resources, and gains.

In previous publications, we analyzed the features of JTLhome’s business model (Wei and Zhu 2009). Firstly, by consolidating the interior furnishing and decor industry chain that comprises service providers, suppliers and distributors, JTLhome has minimized its intermediary procedures, lowered distribution costs, and set up a supermarket chain. JTLhome’s furniture stores generally cover 400–1,000 m<sup>2</sup>, which is less than 10 % of the area normally occupied by furniture retailers. Through its product modeling center, the company builds information models for furniture manufacturers’ products. Based on its information system, JTLhome can mass purchase products to meet diverse market demands by transferring POs (Purchase Order) from its information system to its sales outlets. Third-party logistics service providers then distribute ordered furniture to these sales outlets for delivery to customers. JTLhome generates profits from the sale of home furnishings and also from the sales commission of its business partners. The Fig. 2.1 illustrates the transaction structure that covers JTLhome and its stakeholders:

An equal focus on internal and external stakeholders helps an enterprise extend its original boundaries and facilitates the decision-making process. An analysis of JTLhome’s transaction structure, which centers on stakeholders, provides evidence that this approach is effective.

In the Fig. 2.2, the distribution center, product modeling center, training center and website (encircled by solid lines) represent the internal stakeholders. With independent resources, inputs, outputs, and interests, these stakeholders can be separately examined within the transaction structure frame. Sales outlets take different forms such as partnerships, the equity structure, and direct operations and

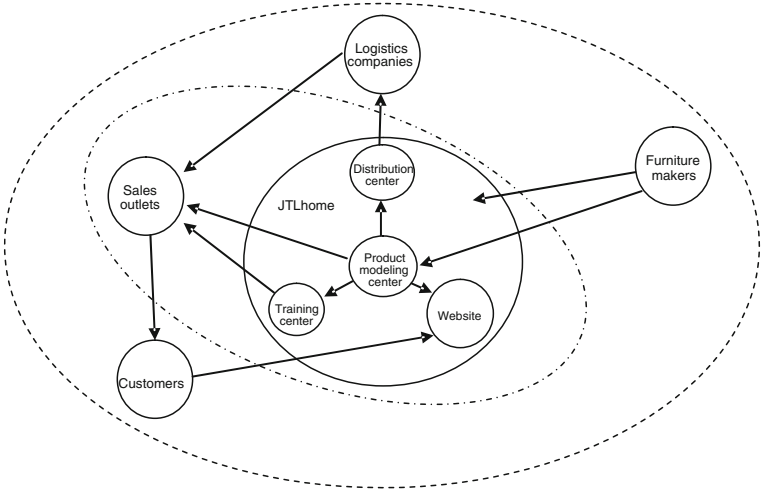


Fig. 2.2 JTLhome’s transaction structure

are classified as external stakeholders. In turn, internal stakeholders comprise sales outlets that deal with customers and furniture makers. Logistics companies, furniture makers and customers are classified as external stakeholders.

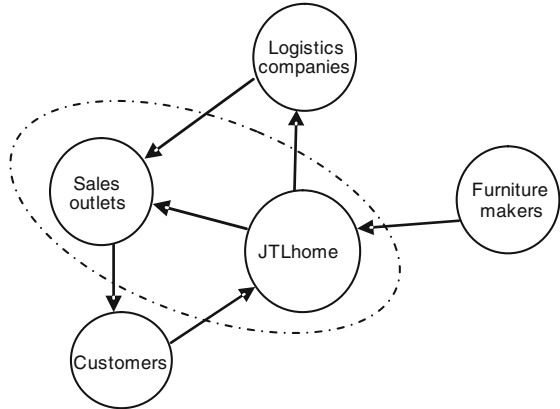
Therefore, we can define the boundaries of an enterprise’s transaction structure in three ways: internal stakeholders only; internal and quasi-internal stakeholders; and all stakeholders. In the Fig. 2.2, these boundaries are marked by different lines. In fact, it is becoming increasingly difficult to analyze an enterprise’s strategic and competitive advantages without considering the external stakeholders, and entrepreneurs may not see the whole picture by managing the internal stakeholders only.

Can business model analysis focus on either the external stakeholders or external and quasi-internal stakeholders only? The Fig. 2.3 shows JTLhome’s transaction structure without the internal stakeholders.

This structure does not reflect the independent resources, inputs, outputs, and interests of the distribution center, product modeling center, training center, or website. Defining the same group of units as internal, quasi-internal, or external arrives at different transaction structures. Analyzing a transaction structure requires clearly defined parties to effectively evaluate the abilities of different business models to create value. The resource flow of one stakeholder among the internal, quasi-internal and external circles under the same business model reveals the dynamics of the model’s evolution and reconstruction.

Many researchers and managers regard the decision to outsource a given business activity as part of the business model design. Nevertheless, business activities are not fully formed before a transaction structure is created, making it impossible to determine whether an in-house or outsourced approach is better. For instance, the decision to outsource logistics—a key part of a conventional furniture

**Fig. 2.3** JTLhome’s transaction structure without internal stakeholders



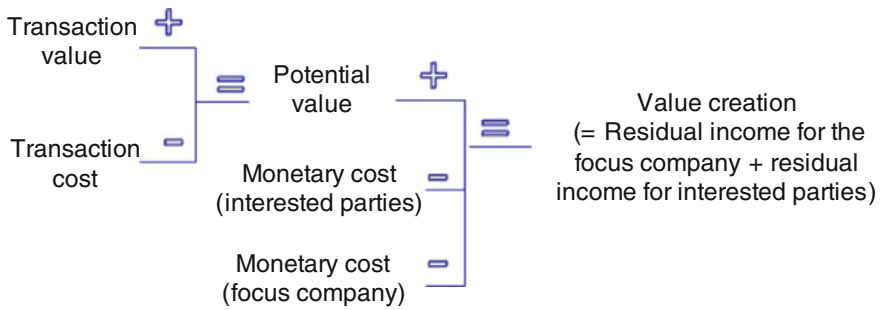
chain store’s business chain—is of vital importance. However, product modeling is absent from the traditional model, meaning that it is impossible to discuss the example of JTLhome’s business model based on the traditional furniture sales pattern. In fact, the decision to outsource logistics can only be made when the product modeling center is incorporated into the transaction structure. The original decision-making process in this regard is based on the assumption that a business model is already in place. Business model innovation is likely to be heavily impacted by making not only the decision to outsource, but all other operational decisions before the stakeholders are defined.

Previous theories highlighted the conflict between integration and specialization. Integration occurs only within the industry and does not cover stakeholders such as the training center. As a transaction structure should holistically represent a business model, it is more useful to examine the transaction structure between various parties based on specialization, integration, and diversification than to set a specific strategy for operational decision-making.

## 2.2 Maximizing Value with a Superior Business Model

As a transaction structure that involves a central enterprise—the focus of the business model—and various stakeholders, a strong business model maximizes value for all parties or the combined residual value for the central enterprise and its stakeholders.

As shown in the Fig. 2.4, a business model can generate a huge transaction value at a certain transaction cost. The difference between this value and the cost creates potential value. In addition to the transaction cost, the central enterprise and its stakeholders must meet a range of costs such as administration and materials. The potential value minus monetary costs encapsulates the value that the business model has created for all stakeholders, and comprises the central



**Fig. 2.4** Value creation

enterprise's residual value (or corporate value) and the residual value of the stakeholders.

For example, JTLhome offers cost-competitive one-stop décor and furnishing solutions for customers and divides a huge number of orders among logistics service providers and furniture producers, which forms part of the transaction value for all stakeholders. Additional transaction costs under its business model include negotiations between JTLhome and the various furniture manufacturers, logistics service providers, distributors, local sales outlets, and the companies that deliver or install its products and solutions for end users. JTLhome also incurs costs by managing its internal units, such as its website and training center. In turn, furniture makers must arrange for production and logistics companies to set up warehouses. These are the monetary costs payable by the central enterprise and other stakeholders. The potential value minus these monetary costs is the value created, which reflects the value of a business model and describes the total residual value of the transaction structure for all stakeholders.

In this context, the inherent value, created value, and residual value sum that a business model yields for the central enterprise and stakeholders are the same thing. We can assess the effectiveness of different business models by using the following formula:

$$\begin{aligned} \text{Business model efficiency} &= \frac{\text{Transaction value} - \text{Transaction cost}}{\text{Transaction value}} \\ &= \frac{\text{Potential Value}}{\text{Transaction value}} \end{aligned}$$

The same business model is equally effective for different markets, including products and customers, and has a similar multiplier effect, which indicates that an enterprise should apply a business model to its markets that generates higher corporate value. An innovative farming technology combined with an innovative business model, for example, can increase crop output by 40 %. The output of each acre of crops is measured in hundreds of yuan rather than the thousands of yuan generated by cash or forest crops. If applied to cash or forest crops, the business model produces far higher yields than for field crops.

For the same markets, different business models generate different performance and multiplier effects. In this case we should opt for more productive business models; for example, China's Aiyaya and Taobao's online stores use different business models to sell accessories, which differ in multiplier effects and generate different corporate value.

Market differences can be measured by transaction value while differences between business models can be gauged by business model efficiency. The following formula calculates the value of combining a market and business model:

The value of combining

the market with a business model = Transaction value  $\times$  Business model efficiency

$$= \text{Transaction value} \times \frac{\text{Potential Value}}{\text{Transaction value}} = \text{Potential Value}$$

Enterprises have limited resource capabilities and consequently a limited selection of markets and business models. They must identify a combination of both that yields the highest market potential and the maximal business model multiplier to maximize created value.

Given different conditions, enterprises can adopt different approaches to maximize business model efficiency.

- **Similar demand and different models**

In this case, we should seek to maximize potential value. There are two options:

- **The same transaction value and different transaction costs—minimizing the transaction cost**

The transaction structure provides each party with a similar transaction value. Except for the equity structure, each stakeholder plays a similar role. As a result, the equity structure determines the transaction cost and minimizing the transaction cost maximizes created value.

A typical example is an agricultural cooperative. [Aalsmeer Flower Auction](#) assigns 'control rights' and 'residual income claims' to the cooperative. The latter returns a residual income to flower growers in proportion to their contribution to the cooperative's transaction value rather than their capital contribution. As well as incentivizing flower growers, this model brings together farmers who individually cannot compete with the dominant market players. As flower growers have similar interests, collective decision-making incurs low costs, positions a much stronger business model, and reduces risks. Not surprisingly, cooperatives are prevalent in agricultural economies.

- **Different transaction values and different transaction costs—maximizing potential value**

Given the same market demand, different groups of stakeholders or the same stakeholders with different roles and relationships may generate different transaction values and costs. In this case, a business model must be designed to maximize the potential value. Xerox provides an excellent example of doing just this. Commercialized in the 1950s, xerography enabled thousands

of clean and clear copies to be produced each day—much faster than the then leading copiers.

However, the cost of a xerography copier was \$2,000 compared with \$300 for a leading copier. Most conventional manufacturers adopted a business model of ‘razors and blades’ by selling a copier at cost to attract customers and then charging high prices for separately sold accessories for high profits. Xerography, however, could not replicate this business model due to the high cost of the technology. Despite widespread doubts, xerography finally gained ground under a new business model launched in 1959. Consumers paid \$95 each month to rent a copier and an additional 4 cents for each sheet over a monthly limit of 2,000 free sheets. To terminate the contract, customers simply had to give 15 days’ notice to the company. The result was amazing: Customers could produce 2,000 high-quality copies per day—the monthly output for other copiers—meaning that the 4 cents per additional sheet became effective on the second day of rental. During the decade that followed, the company’s revenue continued to grow 41 % year on year with an ROE of around 20 %. In 1972, the \$30 million company emerged as a business giant that annually generated \$2.5 billion.

By revolutionizing the ‘razor + blade’ business model in terms of transaction value and cost, Xerox could generate higher potential value and as such achieved remarkable business success.

- **Different demands and the same model—maximizing the created value**

A similar model for different customer demands generates a similar cost structure but different transaction value. Naturally, the central enterprise and stakeholders may incur different costs based on different demands.

For example, a franchise model gives the central enterprise a fixed income while stakeholders (the franchisees) receive a residual income if the franchise fee is fixed, much like the business models for catering and sportswear franchises. Obviously, the transaction cost structure is similar for the two franchise models; however, catering and sportswear differ widely in consumer demand and incur different franchise fees. Therefore, franchisees are certain to generate different transaction value for the central enterprise and incur different costs. The created value (the transaction value minus the transaction cost and monetary costs of the central enterprise and stakeholders) varies with the competitiveness of different business models.

- **The same demands and the same model—maximizing management efficiency**

This represents a simpler scenario in which the transaction value and cost structure are similar, and business strategy and management expertise determine the competitiveness of enterprises.

		Demand	
		Similar	Different
Business model	Similar	Maximizing management efficiency	Maximizing created value
		Maximizing potential value	Maximizing the value of the central enterprise
	Different	Same transaction value with different transaction costs	
		Minimizing transaction cost	
		Different transaction values and costs	
		Maximizing potential value	

2.3 Dynamic Business Model Analysis

Notably, the value of a business model does not necessarily mean the corporate value of the central enterprise. Suppose we have two optional business models: One creates higher business model value but lower corporate value; the other creates lower business model value but higher corporate value. The central enterprise highly favors the second model, the implementation of which varies with the different capabilities and risks it shares with the other stakeholders. Based on its strong financial muscle and business equity, China’s Gome raised the market access cost for home appliance manufacturers to sell in Gome outlets. Inevitably, if home appliance manufacturers make a loss by selling their products through Gome, the stronger companies will instead set up their own-brand stores. Though doing so is costly, it is the rational option by which manufacturers can maximize their own corporate value. The value of Gome’s business model—the central enterprise in this case—is maximized and generates high corporate value only if manufacturers cooperate. However, Gome will inevitably lose some partners if it continues to increase its corporate value. The final balance depends on the interplay between both sides in terms of resource capabilities within the transaction structure.

The value difference between the business model and the central enterprise forms the theoretical foundation for dynamic business model analysis. Changes to dynamic business models can be driven by either internal or external factors.

External conditions such as the market, environment, economy and political climate may alter the positions of the stakeholders in terms of resources and power, which in turn greatly impacts business models. When UT Starcom aggressively promoted PHS, an outdated wireless communication technology, most telecom equipment providers such as Huawei and ZTE did not follow suit. However, as PHS was cheap, it was in great demand in tier-3 and 4 markets. As China Telecom at that

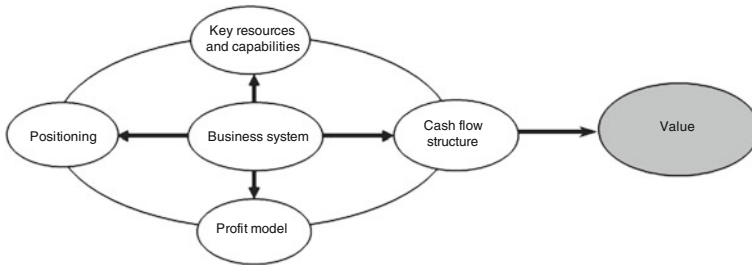


time did not offer wireless services, UT Starcom forged a partnership with the operator under which UT Starcom deployed networks and sold terminals and China Telecom launched the related services. Their cooperation was hugely successful. It enabled UT Starcom's Nasdaq listing and exceeded analysts' profit forecasts for 17 straight quarters. Though China Telecom also grew rapidly as a result, the operator transformed into a full-service operator as 3G took center stage, offering a full range of wireline and wireless services, which immediately marginalized PHS. The transaction structure between UT Starcom and China Telecom broke down, plunging UT Starcom into directional uncertainty. The transaction structure formed in response to market demand disintegrated due to market changes and thus forms a typical example of how a business model is affected by external factors.

Internal factors may also evolve or restructure a business model. Given that stakeholders in a transaction structure have independent interests and resource capabilities, an identical transaction structure, though preferable, may fail to meet new market demands over time. A dynamic transaction structure design is therefore the optimal approach as market changes necessitate the gradual adjustment or even the complete rethinking of previous transaction structures.

When a conflict of interest relating to resource capabilities is insufficient to dissolve a transaction structure, the business model is more likely to evolve over time. Ctrip's business model builds on collecting sales commissions from intermediary services such as hotel and flight bookings. As its market position strengthens, Ctrip has acquired increasingly stronger bargaining and pricing powers, which has led its hotel partners to follow different paths. Some, such as Home Inns, have maintained their partnerships with Ctrip, while others, including Hanting Inns & Hotels, are beginning to develop membership systems independent of Ctrip's network. Equally, some chains such as 7Days Inn are building their own membership systems. These changes will not necessarily revolutionize Ctrip's business model, but will impact on its evolutionary course.

When a conflict of interest relating to resource capabilities is overwhelmingly strong and sufficient to dissolve a transaction structure, the business model is very likely to be reshaped. Estridge—the father of IBM PCs (Wei et al. 2009)—invented open and compatible PC architecture with an Intel CPU chip, an operating system from Microsoft, and components from other suppliers. Combined, these technologies outperformed Apple's closed computer systems. In just four years following the launch of its first PC in 1981, IBM's PC Division grew from nothing to bring in a staggering sales revenue of over \$4.5 billion in 1985. When considered separately, the PC Division ranked as the 74th largest company and the third largest computer producer in the US, only after IBM itself and DEC in terms of sales revenues. However, IBM's transaction structure also cultivated strong rivals such as Intel, Microsoft and Compaq. When Intel and Microsoft forged the Wintel alliance and Compaq beat IBM in unveiling an Intel 386-based desktop computer, IBM finally realized it was facing a crisis. Nevertheless, there was no turning back: IBM's PC Division was struggling to regain ground by rolling out its own chips and OS/2 system but had little success, especially after its head, Estridge, died in a plane



**Fig. 2.5** The six elements of a business model

crash. In 2004, IBM sold its PC business to Lenovo as part of its divestment strategy, marking the end of an IBM-dominated era in the PC world.

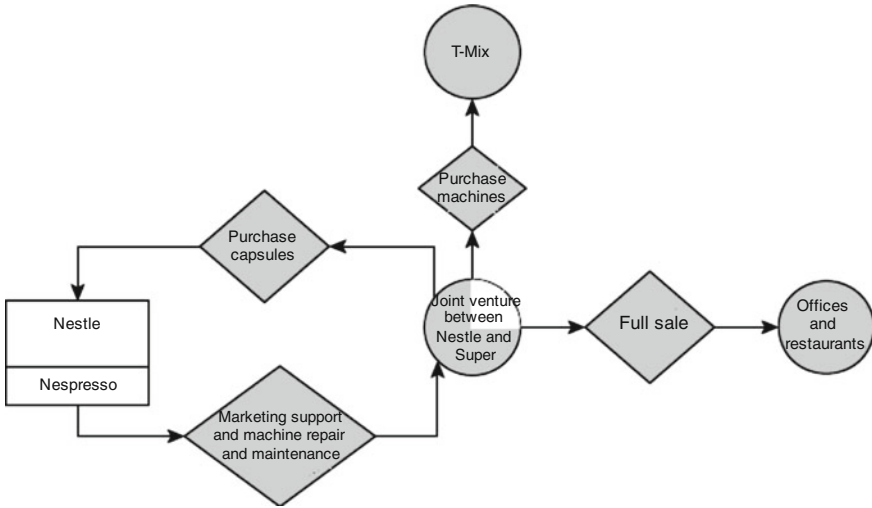
Business model analyses that center on stakeholders with independent interests and resource capabilities can thoroughly and dynamically reveal the operating logic of a business model and forecast its prospects, providing feasible analytics for dynamic evolution and reconstruction.

## 2.4 The Six Elements of a Business Model

A business model creates a complex system that comprises six elements (Wei and Zhu 2009): business system, positioning, profit model, key resource capabilities, cash flow structure and corporate value. As the core of a business model, the business system underscores the configurations, roles, and relationships associated with a transaction structure. Positioning emphasizes the way of meeting the demands of the stakeholders; profit model sheds light on the source of income and expenses in transactions; key resource capabilities highlight the vital resources and capabilities that underpin a transaction structure; and cash flow structure lists the proportions of cash flow in a temporal sequence. These four elements are considered as mappings or reflections of the business system in different contexts. Corporate value represents the ultimate goal and results in the creation of an innovative business model (Fig. 2.5).

- **Business system determines the entities a company selects as its internal or external stakeholders.**

A business system involves configurations, roles and relationships. Configurations denote the network topology of the stakeholders and their connections; roles define the stakeholders with resource capabilities or power; and relationships describe how the stakeholders manage or control each other, specifically how control rights and residual income claims are allocated among them. The configuration of these three factors may affect the value creation of the entire business system.



**Fig. 2.6** Business system before 1988

Before 1988, Nestle's<sup>1</sup> business system involved purchasing coffee machines from T-Mix and coffee capsules from Nestle and then selling and maintaining dispensing machines through Super's marketing channels.

After Paul Gaillard took the helm of Nestle in 1988, the company's business system was transformed into licensing multiple manufacturers to produce—and also repair and maintain—coffee distillers, which Nestle then sold through retailers. Nestle sold its coffee capsules in clubs, which customers could order by phone or fax. As shown in the Figs. 2.6, 2.7, these two business systems differ in network configuration topology.

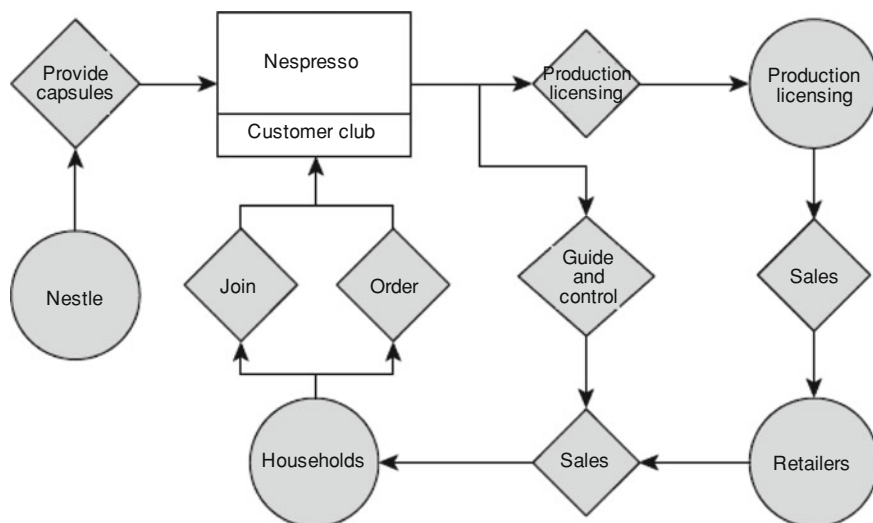
In terms of transaction roles, Red Star-Macalline serves as the commercial property developer in the transaction structure and the furniture manufacturers as tenants; JTLhome possesses a franchise chain that supports its infrastructure and operations, while furniture manufacturers serve as suppliers in one of the business processes. This is the difference between Red Star-Macalline and JTLhome in terms of the roles of stakeholders in the transaction structure.

Relationships in the transaction structure determine how rights are allocated in transactions, including the market and ownership transactions and long-term contracts, the equity structure, stakeholders, and the alliance between the two types of transactions. For example, Red Star-Macalline do market transactions with furniture makers.

- **Positioning defines the way a company meets the demands of stakeholders.**

In this context, stakeholders include internal customers (employees), external customers (suppliers, consumers, service providers, direct and indirect customers)

<sup>1</sup> Adapted from public information on the Internet.



**Fig. 2.7** Business system after 1988

and quasi-internal customers (franchise stores, outsourcing service providers, outsourcing processors).

The method for meeting customer demand outweighs the stakeholders' varied demands. For example, to meet consumers' demand for soybean milk, we can either set up a chain store to sell the milk (such as Yonghe King), sell soy milk grinders for consumers to operate on their own (such as Joyoung), or open stores to grind soybeans and sell soy milk onsite. These models differ in positioning.

The way a company chooses to deal with a stakeholder is determined by the transaction value and cost associated with that stakeholder. The business model for Xerox copier sales offers strong evidence for the transaction value of different positioning approaches. How can copiers that perform better and are more expensive be commercialized? In fact, new and old photocopiers serve the same function. Old copiers are sold to customers to meet demand and have potential value to the extent of their market value. If they are leased and customers are charged fees for copies in excess of a given limit, the potential value equals the market value created by customers' continuous use, which covers the basic copying demand from old copiers and the additional copying activity brought about by new copiers. As such, Xerox analyzed and transformed the method of meeting customer demand, making it one of the greatest success stories in history.

The cost of a transaction consists of three parts: searching, bargaining and implementation. A strong positioning model can reduce one or more of these transaction costs. For example, the chain model reduces the cost of searching by increasing the points of contact with customers; the agency model lowers the cost of bargaining by narrowing the scope for negotiation by both sides of a transaction; the online payment model cuts the cost of implementation by allowing customers

to make payments anytime, anywhere; and the total solution model trims the costs of searching, bargaining and implementation for customers by slashing the number of dealers.

- **Profit model defines the source and charging mode of income and expenses for stakeholders.**

A profit model involves profit source and charging mode.

Profits generated by a given product, for example a spinning machine, may derive from many sources: transferring the product's ownership through retail under a traditional sales model; transferring usage rights by leasing it and charging fees; selling the products it makes such as yarn; or selling the machine to a fixed income fund while at the same time producing yarn to obtain liquid funds, with a fixed income securities-based asset package for the fund management company as part of an investment. Fees can also be charged in various ways: per unit; based on time; or based on the investment value comprising fixed and residual incomes.

The charging model varies with the profit source. For example, Red Star-Macalline collects rent as fixed income from furniture makers who take a residual income; conversely, JTLhome collects a sales commission from furniture makers based on transaction value. In these cases, both sides share part of the profit.

- **Key resources and capabilities describe important resources and capabilities that support a transaction structure.**

Key resources and capabilities support a business model and sustainable enterprise development, differentiate a company from its competitors, and also vary with different business models. Identical business models differ in performance due to varied key resources and capabilities.

In the restaurant industry, key resources and capabilities vary by enterprise level. High-end restaurants are distinguished by environment, unit price and quality; fast food chains pursue the standardization and fast duplication of food items; and meal delivery companies, such as the highly successful FU JI Food and Catering Services, aim to improve the efficiency of central kitchen management and operations.

- **Cash flow structure defines the form of corporate cash inflows and outflows based on stakeholders.**

Many scholars and venture capital investors favor asset-light companies with a cash flow structure that can generate steady, high returns from a small early investment. For example, Goldwind does not produce parts itself, but instead has an extensive network of parts suppliers. This approach allows the company to save considerably on manufacturing costs and create an asset-light cash flow structure. Its annual sales revenue and profit have doubled for five consecutive years after listing, representing a prime example of capital market success.

Moreover, the cash flow structure can be designed. One profit model may match different cash flow structures, such as the pre-paid or post-paid models accompanying mobile phone accounts. The prepayment model enables operators to obtain an ample cash flow from subscribers' prepaid accounts to develop new services, while the monthly payment model requires operators to invest their own cash flow in operations and services. Given that most customers do not wish to outlay a high initial amount, companies can attract more customers by lowering one-time purchases through financial tools such as installments or leasing. By spending a small sum each time, customers enable companies to provide high-quality services that retain or improve customer satisfaction with less cash flow pressures.

- **Corporate value forms the foundation of a business model. A business model is ultimately judged by corporate value (value of the business model or central company). For listed companies, corporate value is reflected in stock value.**

Positioning, business system, profit model and cash flow structure combine to determine the form of a business model. Corporate value provides a way to assess its performance, while key resources and capabilities explain how it works. These elements combine into a complete theoretical framework.

A complete business model should answer the following questions (which can also be used as an assessment tool):

1. Who are the target consumers?
2. What do consumers want?
3. What does the company offer to consumers?
4. What are the features of the company's products or services?
5. How do the products or services meet consumer demand?
6. How does the company acquire products or services for consumers?
7. Who are the stakeholders?
8. What features comprise the deal?
9. How is the transaction structured?
10. Which stakeholders (not necessarily consumers) generate income for the company? Which stakeholders incur costs and expenses for the company?
11. How are products or services charged?
12. What forms do the same sources of income take in terms of timing (which comes first: investment or income? One-time or continuous investment? One-time or continuous income?)
13. What resources does the company need to generate income?
14. What capabilities does it need?
15. How are different models assessed in terms of business performance?

Answers to Questions 1–5 relate to 'positioning' in terms of strategy, marketing and the business model (this is discussed in more detail later). Answers to Questions 6–9 deal with the 'business system'; answers to Questions 10–11

concern the ‘profit model’; the answer to Question 12 falls under the category of ‘cash flow structure’; answers to Questions 13 and 14 are associated with ‘key resources and capabilities’; and the answer to Question 15 involves ‘corporate value’. Combined, these factors describe a complete business model.

## 2.5 Relationships and Differences Between Business Models and Other Management Theories

- **Management model versus business model.**

Business models differ from management models largely in conception, perspective and managed objects. These combine to affect business performance in different ways.

In *Management Control System*, Robert A. Anthony and Vijay Govindarajan proposed a strategy implementation framework that basically outlines a system of management model theories. This framework contends that a management model reflects a company’s implementation mechanism based on six elements (Anthony and Govindarajan 1997): strategy, organizational structure, management control, corporate culture, HR management, and performance. Different areas of management science interpret the system from various perspectives.

The strategy sets the direction of a company by providing a path through which it can realize its long-term goals. Aligned with this strategy, organizational structure determines how a company arranges its departments and posts, including chain of command, span of control and internal relationships. Management control defines a company’s management processes, rules and procedures, including those for strategic and business planning; budget, sales, and risk management; and product development.

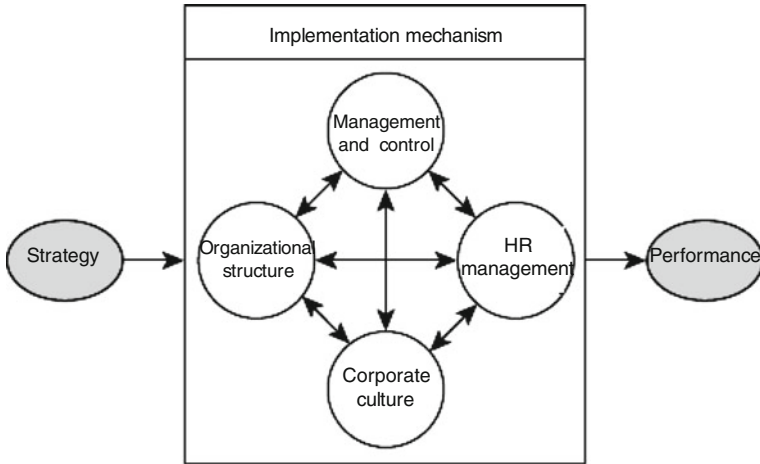
Corporate culture describes the common values and code of conduct shared by a company’s employees (Fig. 2.8).

HR management involves recruitment, training, selection, evaluation and motivation.

HR strategies are implemented based on organizational structure, management control, corporate culture, and HR management. The success of a given strategy is reflected by staff performance.

As the frame of a company’s infrastructure, the business model resembles a battleship: Different battleships are equipped with engines, cabins, decks, barbettes and missiles; they vary in structure and position to serve different functions.

Business models resemble the navy officers that navigate a fleet of battleships: The general assigns tasks to various officers; formulates management control procedures; develops rules that govern the selection, training and motivation of officers; and builds team culture and morale to boost combat power. After equipping the entire fleet and deploying each battleship, the general can decide what kind of officers can best helm the fleet and how combat power can be



**Fig. 2.8** The six elements of a management Model

increased. From this perspective, a business model must be designed before the management model. Business model reconstruction inevitably takes precedence over transformations in strategy, organizational structure and human resource.

A business model determines how a company operates by subsuming individuals, and determines how the company’s rules and procedures are implemented. Changes to these areas may also necessitate the adjustment or optimization of other areas. Business models are industry-independent, and a business model that is effective in one industry can be adapted or reconstructed to fit another.

### • Strategy versus business model

A strategy provides the way for a company to achieve its long-term objectives (Barney 2002). Strategies can be refined (for market development and penetration or product development); integrated (forward, backward or horizontally), diversified (relevant or irrelevant); defensive (downsizing/restructuring, spin-offs or liquidation); or supportive (joint venture, M&As).

Specifically, strategic theory focuses on positioning products in the market against the background of the industry chain. Business models reach beyond both the industry chain and positioning to address the interests and transaction structures of the stakeholders. JTLhome’s transaction structure comprises stakeholders, such as its training center, website and HDS system—features which are not found in the transaction structures of other home furnishing vendors. JTLhome also defines roles differently for furniture manufacturers and logistics service providers.

Strategic and business model theories also differ in defining positioning. In a strategy, positioning is designed mainly to determine what to offer to whom, and focuses more on the target customers and their requirements. Under a business model, positioning defines how to provide a company’s offerings, and centers on the way the demands of stakeholders are met. Therefore, direct sales or distribution



falls within the domain of a business model, while a strategy instructs what to sell to whom.

Moreover, unlike a business model, a strategy implies that the target customers have already been identified. Setting a business model before defining the strategy may greatly limit the parameters within which a business model can be defined. Conversely, pre-defining the business model will broaden the selection of feasible strategies. Therefore, fixing the business model, stakeholders, and transaction structure lays a solid foundation for setting a strategy and clarifies the viable operation solutions. As business models and strategies vary widely in the same industry, companies attain varied financial results. In practice, setting the business model before a strategy enables a company to create an innovative design.

- **Value chain versus business model**

The value chain theory (Porter 1985) developed by Michael Porter generally classifies a company's value-added activities as basic or supportive. Basic activities include production, sales, purchases, delivery logistics, and after-sale services. Supportive activities cover HR, finance, planning, R&D, and procurement. Basic and supportive activities combine to form the company's value chain. Focusing on core business while outsourcing non-core links of the value chain enables a company to create an 'industry value chain'.

Value chain theory is based on classifying traditional industries. This classification is founded on the assumption that the parties and details of a transaction are specified; for example, the logistics and management of shopping malls in traditional furniture chain stores. In today's business world, increasingly overlapping sectors and more diverse transactions complicate value chains and networks. In fact, designing a business model may catalyze or necessitate new transaction activities.

In theory, the basic activities in a value chain are arranged temporally; however, the time sequences of many activities begin to vary as company alliances emerge and the parties involved in a transaction increase.

The theory of value chain centers on activities, while business model theory is built on stakeholders. The same value chain activity can be conducted by different stakeholders in disparate transaction structures. Nestle has continued to produce and sell coffee machines and capsules after undergoing business transformation. From the perspective of the transaction structure in a business model, however, different transaction models and stakeholders are adopted for the same activity, ultimately creating different business models. This causes a huge variation in operational efficiency during the shift from purchasing machines to licensing production; for example, allowing customers to order coffee capsules from clubs or by selling machines and capsules as a package.

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