Business Models
Back to basics

Are traditional business models dead?
Only six of the Fortune 100 companies active in 1940 are active today. But now it’s not about surviving the next 70 years – it’s really, urgently, about the next ten. Massive changes to technology and particularly digital’s unrelenting grip on most aspects of business is accelerating the success of those that get it right – and the decline of those that don’t.

Very few of the business models thriving in 2005 will be around in 2020 in the same form. We can already see a variety of new business models bubbling up in industries from banking to media. But we’ve also seen many companies collapse in the last few years and, more often than not, failure to adapt the business model is a key factor.

Re-engineering operations to cut costs and extend the life of business models has been a reasonable strategy in the past. But there are two trends that will require completely new business models within the current decade:

- people brought up with computers in the home – ‘digital natives’ – will become the dominant type of customer, and
- after years of digital technology changing the way products and services are transacted, we will see it increasingly change the way value is created.

Are you building trust?
At the same time, sustaining and building trust in the business model will depend on you communicating effectively with investors and others about how value is created now and going forward.

The UK governance code already requires that you explain your business model to stakeholders and from next year the board will have to confirm that reporting as a whole (not just the financial statements) is “fair, balanced and understandable and provides the information necessary for shareholders to assess the company’s performance, business model and strategy”.

Most companies are already providing some information about their business model. And we can all see that investors need to understand a company’s business model before they can properly assess its strategy, the risks and its ability to sustain performance over time. If you ask any investor about it, they’re likely to tell you that one of the first things they try to do is form a view on a company’s business model – they just haven’t used a single point of reference before, because the information hasn’t been there.

Articulating your strategy and business model is going to be more important than ever in the next 10 years. But how do you take all the elements into account and communicate them clearly? And can you show that the model is sustainable? How will investors react?
**At a glance**

**Business models – the decade of change**

The changing consumer mix and the rising influence of the Digital Natives will force further change.

**How to become ‘digitally-fit’**

Recognise the different digital waves and get ready for them so that your business model is set up to make the most of the opportunities in the digital economy.

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**Increasing degrees of ‘digital fitness’ required to play and win**

**Increasing issues, threats and opportunities in the ‘digital economy’**

- **First digital wave:**
  - **Digital commerce:** eCommerce is used to transact, to advertise, as a marketing platform and to provide self-customer-care.

- **Second digital wave:**
  - **Digital consumption:** Consumption data is shared with the customer to enable outcomes.

- **Third digital wave:**
  - **Digital identity:** Buying brands and digital identities emerge.

**Next digital wave:**

- **Ongoing operational integration across the supply chain, including suppliers and partners.**

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**Decade of change**

- **Traditional consumer (not digital)**
- **Transitional (switching to digital)**
- **Digital natives (brought up with digital)**
Fiddling while Rome burns?

With so many pressures on business – uncertain economies, wary investors, unprecedented regulation and the like – the last thing CEOs may want is to initiate blue-sky thinking on the business model. But when you think of the ‘stellar’ companies of the last 20 years – do you think of companies with traditional business models? Or companies that have either transformed their business model or come in with a new one?

It can seem more expedient to change the operating model – improve efficiency, find cheaper resources etc. And most companies have been doing just that for the last 20 years. Even today 83% of CEOs we spoke to in the UK are planning cost reduction initiatives this year.

But focusing solely on an operational ‘quick fix’ instead of fundamentally changing the business model could prove fatal in the next 20 years because demographics, technology and globalisation will change two things fundamentally:

• Customers – the majority will be digital natives, and

• The way value itself is created

Technology is changing customer behaviour

We were all ‘traditional consumers’ in 2000, as you can see from the chart on the ‘At a glance’ page, but this year the ‘transitionals’ who have learned to use digital technology will overtake. And by 2020, digital natives – who were brought up with computers in the home – will become the main consumers.

The dominance of these ‘digital natives’ within the next decade will have a dramatic impact because they:

• Expect more because of their rich digital interactions and experiences
• Trust their peers, which influences brand loyalty
• Are well informed because they can easily research and compare information
• Have choices and easy access to alternatives
• Have a voice and can readily share their experiences with your brand with many people

We know that digitally native customers want cheap, intuitive, seamless solutions, and informed suggestions about other things they might need. But at the same time, older customers may still have more traditional expectations. The balance of power is shifting, but the digital dinosaur still has spending power now.

So how do you cater for the dramatically different needs and expectations of today’s customers?

Threats to business – CEOs biggest concerns

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Threat Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>78%</td>
<td>Government response to deficit</td>
</tr>
<tr>
<td>76%</td>
<td>Uncertain economic growth</td>
</tr>
<tr>
<td>65%</td>
<td>Availability of skills</td>
</tr>
<tr>
<td>63%</td>
<td>Tax burden</td>
</tr>
<tr>
<td>63%</td>
<td>Over regulation</td>
</tr>
<tr>
<td>40%</td>
<td>Lack of trust in your industry</td>
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Source: PwC CEO survey – UK findings

The dynamics and alchemy of value creation is changing fundamentally, and this creates both threats and opportunities for growth.

But there’s a big cultural challenge: for the last 20 years most companies have improved performance by focusing on their operating models; now they need to change their business models.
Customer behaviour is only one side of the coin. Digital technology is fundamentally changing the way value itself is created. For example, it is increasing the extent to which ‘information’ (rather than a product) in itself becomes ‘value’ where it allows customers to achieve something they care about. And very often customers haven’t ‘demanded’ this – it is just something that delights them when they find it, like the innovative and successful apps that have emerged over the last few years.

But there are other stakeholders to contend with in the new ‘value ecosystem’. The digital age is stretching the very notion of ‘value chain’ at the seams, and introducing more ‘value networks and communities’ instead. Value is more often co-created by different players, and can manifest itself in outcomes that transcend the typical sector boundaries.

So what’s involved in the new business models?
The essence of an effective business model is now more often about the ability to orchestrate the interactions between all the different ‘players’ in our broader business ecosystems and the customer in a way that:

1. maximises the value delivered
2. makes money out of that value for all players, and
3. gives your company a fair share of that value.

Leading companies will be those who equip themselves with business models that:

• Articulate how ‘value-adding activities’ transform inputs into outputs, and
• Articulate how orchestrating and understanding the interactions between all stakeholders (including your suppliers, suppliers’ suppliers, distributors, customers, customers’ customers, etc.) can create value.

Successful companies are studying those interactions, collecting the data and using the knowledge to evolve their business models.
So take a long, hard look at your business model

These emerging trends create a host of opportunities... and threats. And to navigate these, companies will need to take a long, hard look at their business models; not just the start-ups or the stars-all companies.

But has your organisation explicitly defined and documented its business model? Start-up businesses are usually adept at explaining their business model succinctly – but many larger organisations are out of the habit. It’s almost as if a new language is needed to help us all answer the tough questions about our business models and take action to evolve or transform them.

So if you do find yourself looking down the barrel of your business model, what kind of questions should you be asking?

• What business are you actually in? Are you selling computers, or an experience; watches, or a luxury lifestyle?

• Can the current model survive the mega trends in technology, digital trading, demographics, climate change, etc? Where will value come from in future?

• Go beyond products and services; what customer outcomes are you trying to enable? Are they sustainable under scrutiny and over time?

• Are you driven by your customer? Are you allowing them to create part of the value?

• Where will your critical insights come from? How will you get hold of them and use them effectively?

• Does your customer trust you enough to use information about them for their benefit? If not, why not?

Look for inspiration from real examples

The music industry has undergone enormous change in the last ten years, and HMV’s story acts as a well-documented cautionary tale that should encourage others to innovate with their business model.

The first blow came with the arrival of the internet – the retail channel changed and HMV were competing with companies such as Amazon, with its cheaper operational model, discounts and ratings tool. HMV moved towards a discount strategy, changing its operational strategy but without really changing its business model.

With the advent of iTunes, HMV took another blow. Then the streaming service Spotify arrived on the scene and dealt the knockout punch.

Spotify understood the impact of technology on consumer behaviour. They provided customers with what they’d indicated they wanted – no unit fee and an algorithm to monitor their behaviour and suggest new music.
How do you explain your business model to stakeholders?

Companies are more focused on business model reporting this year. Some of this is driven by the new requirement to report on your business model and some driven by commercial decisions to better articulate what the company does, what it relies on and what sets it apart from competition.

A well articulated business model provides investors with insight into how a company creates sustainable value. The problem is, no one's very clear about how to define 'business model', or what you should say about it to stakeholders. The result is that most companies share an array of different information, some of it useful, but often prompting more questions than providing answers.

As one finance director commented when grappling with their business model reporting: “we know what we do… it’s just very hard to articulate it on paper”.

Our review of how FTSE 350 companies’ report on their business models found that most (77%) do refer to their ‘business model’ and just over half of those companies provide insightful detail. But overall, only 8% of companies clearly connect their business model with their strategy, risks or other areas.

Companies tend to communicate about their business model in one of these different ways, they:

1. Describe how the company is structured and delivers its products and services
2. Discuss the business model in the context of overall strategy – often using the terms interchangeably
3. Explain how they make money (their model for making and selling products)
4. Explore ‘value creation’ activities in free-form style
5. Look at their ‘value chain’, illustrating the way the company operates to add value

Clearly, this mixed picture is not meeting investors’ or other stakeholders’ need to understand the business model and its current and future viability. They’d like to understand your value proposition, profit formula and the key resources required to deliver the proposition. They would then like to know how this business model interacts with your risk profile, strategic priorities and KPIs.
Where to start with explaining your business model

The work of the International Integrated Reporting Council (IIRC) could really help. This global coalition of investors, companies, regulators and other key stakeholders has placed the business model at the centre of their programme to develop an integrated reporting framework that encourages more concise communications of value creation.

To support development of that framework, the IIRC has commissioned a working group tasked with publishing a proposed framework and terminology for companies to use when communicating about their business model. We are one of the lead organisations involved in the working group. In the paper we define a business model as:

“The organisation’s chosen system of inputs, value-adding activities, outputs and outcomes that aims to create value over the short, medium and long term”

By incorporating outcomes, the definition transcends the traditional linear definition (input, activities, output) of a business model. The aim is for companies to provide context not only on what they produce and the key resources/relationships they rely on, but also the impacts (outcomes) they desire/have on stakeholders that create value.

When developing disclosures on your business model, there needs to be real clarity internally about what it is and how it links to both operational and financial drivers of the business.

Consideration will also need to be given to the level of detail that should be disclosed, particularly in organisations with multiple business models. By thinking about what users need, a balance can be struck between disclosure and complexity. If the investment case is based on the ability of the corporate centre to derive value from a diverse range of businesses, then the level of disclosure should focus on the business model of the corporate centre.

It can help to start with some simple questions that stakeholders might ask?

• What do you do and where?
• What resources and relationships do you rely on?
• Who do you interact with and how does that create value?
• How do you make money from that value?
• What differentiates your business from others?
• How will you sustain that value creation and ensure that your business model is versatile?
• How can you share the relevant information about your business model in the context of a changing environment?
• What do your providers of capital perceive your investment case to be? Is this consistent with your view?

“Reporting effectively on your business model today is the first step towards making it fit for the future”

Improving business model reporting
Features that can improve the effectiveness and readability of your business model description include:

- Impact of, and response to, external factors
- Key resources and relationships
- Place in value ‘ecosystem’
- Link to strategy, risks and performance
- Simple diagram or graphic
- Sign-post to further discussion
Topics for 2013

January

**Strategy**
Have a backbone

February

**Business models**
Back to basics

March

**External drivers**
The big picture

April

**Tax**
Tell the whole tax story

May

**Cash and debt**
Cash is still king

June

**Sustainability**
Survival of the fittest

July

**Segments**
Bottom up

August

**Underlying performance**
Flash in the pan

September

**Principal risks**
Not the kitchen sink

October

**KPIs and remuneration**
What gets measured gets done

November

**Corporate governance**
Cracking the code

December

**Integrated picture**
Joining the dots
How can PwC help you?

If you'd like to discuss your business model, please speak to your usual PwC contact, or one of the people listed here.

PwC has a strong network of people who can advise on all aspects of your business model and how to report clearly about it to stakeholders.

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