

Building Scalable Business Models

Many of today's most successful companies are able to leverage business model scalability to achieve profitable growth. Executives need to factor scalability attributes into their business model design or they risk being left behind.

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BUSINESS MODEL INNOVATION has become an increasingly hot topic in management circles, and understandably so. No management activity is more important than having clarity about how the organization creates, delivers, and captures value. It requires, among other things, knowing what customers want, how value can be best delivered, and how to enlist strategic partners to achieve maximum benefit.

Although the ability to develop strong value propositions can enable companies to “get by,” in our view many of today's most successful businesses are those that are able to place themselves in the “sweet spot” of business model scalability. Scalability is about achieving profitable growth and is therefore a fundamental consideration for managers and investors alike. If managers are incapable of factoring scalability attributes into their business model design, they risk being left behind, much the way bookstores owned by Borders Group Inc. were eclipsed by Amazon.com Inc.

Over a five-year period, we studied scalability in the context of more than 90 Scandinavian businesses and also examined the experiences of a number of well-known businesses, including Google, Apple, and Groupon. (See “About the Research,” p. 67.) In the course of our research, we identified five patterns by which companies can achieve scalability. The first pattern involved adding new distribution channels. The second entailed freeing the business from traditional capacity constraints. The third involved outsourcing capital investments to partners who, in effect, became participants in the business model. The fourth was to have customers



THE LEADING QUESTION

How do companies develop scalable business models?

FINDINGS

- ▶ Scalable business models are flexible and turn new resources into increasing returns.
- ▶ Scalability often involves connecting strategic partners to a company's value proposition.
- ▶ One key is to find smart ways to leverage the resources of partners.

and other partners assume multiple roles in the business model. And the fifth pattern was to establish platform models in which even competitors may become customers. Based on these patterns, we have developed a framework for identifying potential levers for business model scalability, along with a road map that managers can use to improve their business models.

Over and above the need to create value propositions that are difficult for competitors to replicate, managers need to develop business models that are capable of achieving positive and accelerating returns on the investments made. When companies restructure or invest in acquisitions, it's common for them to identify synergies that reduce costs and simplify workflows and product offerings. However, simply thinking in terms of synergies isn't enough; such synergies don't necessarily lead to improvements in business model scalability. To achieve scalability, managers and entrepreneurs need to remove capacity constraints. They have opportunities to do this in a variety of ways: by collaborating with partners, by encouraging partners to play multiple roles in the business model, by creating platforms to attract new partners, or even by working with current competitors.

Accelerating Returns to Scale

What do we mean by “scalable”? We use the term scalability to identify where changes in size or volume are possible and seem worthwhile. Scalability refers to a system's ability to expand output on demand when resources are added. Linking scalability to business models provides us with a framework for discussing and estimating business potential, which is important to both executives and many stakeholders because, among other things, it has implications for hiring and skill development. Another important characteristic of scalability is that the organization has sufficient flexibility to grow while incorporating the effects of external pressures, such as new competitors, altered regulation, or macroeconomic pressure.

The first dimension of scalability is the degree to which increased input can create higher output. The second dimension of scalability relates to the ability of the business model to accelerate the returns on the additional investment. Accelerating returns to scale are typically found in business

models where new resources, capabilities, or value propositions provide completely new properties to an existing industry.¹ Amazon.com's retailing business model offers a good example. For example, the company's algorithms introduce customers to products they may not have considered but might be of interest to them as they shop online.

In those situations where returns to scale are declining rather than increasing, managers should figure out how quickly to exit the business. If the returns are falling precipitously, it might make sense to pull out quickly. Even when returns are flat, further investments may be unattractive. As a general rule, executives should invest capital where they can generate increasing returns to scale.

Scalability Patterns in Business Models

A scalable business model is one that is flexible and where the addition of new resources brings increasing returns. In the course of our research, we searched for business model attributes that were sufficiently flexible to cope with internal demands and external forces and where the potential wasn't constrained by physical or material assets (such as labor shortages, machine capacity, cash liquidity, or storage capacity). Below we will examine the five patterns of business model scalability individually.

PATTERN A: Add new distribution channels.

While the notion of selling through multiple distribution channels isn't novel, it's useful to understand what happens when an additional channel is added. As long as the implementation of a new distribution channel does not cannibalize sales in existing channels, adding a new sales channel can allow a company to spread the costs of overhead and reap benefits from increased sales.

We found this to be the case at Copenhagen Seafood A/S, a Danish supplier of fresh fish. The company, which had traditionally sold only to high-end restaurants, added the sale of fresh fish directly to retail customers, enabling it to offer restaurant-quality seafood to individuals at reasonable prices. Because restaurants typically ask for specific cuts of fish, the percentage of waste can be high. By adding the retail channel, Copenhagen Seafood was able to cultivate a new clientele with people who relished the opportunity to buy from a seafood

supplier closely associated with some of the city's best-known restaurants.²

PATTERN B: Explore ways to work around traditional capacity constraints. Scalability often means finding ways to overcome traditional capacity constraints. Obviously, constraints vary from industry to industry. In the pharmaceutical industry, the constraints might involve the cost of establishing research infrastructure and the ability to develop new products and receive approval for new products. However, when viewing constraints from the perspective of business model innovation, companies should ask themselves if they can find ways to work around existing constraints. In the private banking sector, for example, a company might bypass capacity constraints by focusing on customer relationship activities and outsourcing infrastructure management to others. In a similar vein, a consulting company with a business model focused on hourly billing for large government organizations explored bypassing that constraint by marketing standard outputs and simpler reports to a new customer segment consisting of smaller businesses.

PATTERN C: Shift capital requirements to partners. Every organization needs to prioritize its investments and determine which are most critical. CFOs are encouraged to optimize the cash liquidity constraints, cash flow, and working capital attributes of their business models. Given that many companies place a high value on cash, business models that shift capital requirements to strategic partners can be desirable.³

One company we studied was Sky-Watch A/S, a company based in Støvring, Denmark, that develops and manufactures drones suited for a variety of industrial settings. Sky-Watch's business model has fewer resource constraints than some of its close competitors thanks to management's decision to concentrate on turning the core platform into an open platform that allows customers and strategic partners to add their own hardware and software.

PATTERN D: Leverage the work of partners. Companies need to pay attention to what their customers and strategic partners value. Managers should use this knowledge to optimize the value proposition of the products and services they offer to customers. The key is to find smart ways to leverage the resources of partners. For example, Tupperware Brands Corp.,

ABOUT THE RESEARCH

Business models offer a novel perspective from which to understand how companies can become profitable, competitive, and sustainable. They offer distinct recipes for how companies do business,ⁱ including activities and resources, customer relationships, partnering strategies, and revenue models.ⁱⁱ

Our research focused on business model innovation in conjunction with 10 networks of collaborating companies, where the companies were collaborating either through joint ventures or via more open and informal arrangements. The research, which was conducted between 2008 and 2013, was aimed at helping participating companies develop a process for pursuing new global business opportunities and providing a solid base of relevant qualitative data. A total of 92 Scandinavian companies participated. We used longitudinal methods, augmented by a series of semi-structured interviews, to examine business model innovation processes. Our team followed the companies through workshops, company meetings, board meetings, and observations, which were recorded and/or documented with minutes, pictures, or video.

based in Orlando, Florida, is famous for leveraging a community of sales representatives who have an interest in selling the company's food-storage products to a widening circle of people. Groupon Inc. likewise turns customers into partners by giving them incentives to spread the word about the company. Similar strategies can be leveraged for distribution methods, building customer loyalty, giving access to resources, and performing other activities according to the value configuration of the business model.

PATTERN E: Implement platform models. A variation on leveraging partners involves using platform-based business models. Platform models are based on collaboration and can take different forms. For example, PrintConnect.com of Würselen, Germany, operates a web-based workflow platform for printing and packaging that links partners across the value chain. Some platform business models predate the web: Visa Inc., which connects businesses with credit card users, is an example.

When looking at business model innovation from a platform perspective, an important question is, "How do we turn competitors into partners or perhaps even customers?" For example, The Relationship Factory,⁴ a company based in Aarhus, Denmark, that organizes professional networking groups for managers, opted for a platform model to achieve business model scalability. It makes its software platform available to competitors on a private-label basis, thereby providing the company with a supplemental and recurring revenue stream on top of its traditional service-based activities. While

competitors continue to rely heavily on their sale of service hours, the company is able to generate incremental revenue by selling “ease of use” to its competitors as well as benchmarking data across the industry.

A Road Map to Business Model Scalability

The patterns we have discussed above describe how companies can adjust their business models to make them scalable. While traditional thinking typically leads to synergy effects and, at best, positive returns that are linear to the investments, some of the companies we studied showed that it was possible to redesign business models to achieve accelerating returns. However, achieving accelerating returns is not easy. It requires thinking strategically in terms of the value propositions of stakeholders, strategic partners, and customers involved in the immediate business ecosystem. Aligning and leveraging the competencies and motivations of these stakeholders can lead to better cooperation. It can also build greater trust and loyalty among partners, which will pay off in the long term.

To implement the patterns for scalability, it is often necessary to identify activities and resources where collaborating with partners is advantageous and can strengthen the offering’s value proposition to customers. These patterns can assist managers in rethinking how their business models make use of partners, customers, and other stakeholders. Rather than just relying on traditional analytical exercises such as analyzing cost structures, product-segment profitability, and market-segment growth, managers can work on achieving business model scalability by asking a different set of questions. The questions will often lead to the identification of new partners and potentially new roles.

We suggest that companies pursue three steps:

1. Identify potential strategic partners. Scalability

typically involves connecting strategic partners to the value proposition, either through sharing activities or resources. Given that scalability requires thinking beyond simply sharing costs, executives should ask themselves the following:


- Are there potential strategic partners that could perform activities in our business model — or provide resources to it — in ways that would help improve the value proposition to our customers?

2. Ask questions that reveal a road map to scalability. Asking questions can trigger ideas about how to reconfigure a business model. When encountering novel ways of doing business, managers should analyze how such a business model would play out for their own company. We have found that the following questions can be helpful:

- How does this novel business model challenge our existing way of thinking about the business?
- What would we need to do differently to implement this business model?
- Which other companies excel at what we are trying to do, and what can we learn from them?
- What are the key value drivers of this particular business model?
- Could this business model lead to scalability?

Based on the ideas you are able to generate, we recommend using the following questions to help clarify potential avenues for scalability:

- Are there potential strategic partners that can offer features (at minimal or no cost to our company) that enrich the existing value proposition to our customers, while receiving value themselves?
- Are there alternative configurations that free the business model from existing capacity constraints?
- Would it make sense to establish a platform for other businesses to buy into — and thus create alternative ways of generating revenue?
- Is it possible to change the role of existing stakeholders and utilize them in multiple roles in the business model?



Achieving accelerating returns is not easy. It requires thinking strategically in terms of the value propositions of stakeholders, strategic partners, and customers.

- Who would pay for either access to our customer base or knowledge about our customers and their characteristics?
- Which mechanisms are in place to create customer lock-in?
- How agile is our company in reacting to threats from new entrants or new technologies?

3. Analyze the scalability attributes of business model options. When all of the ideas generated have been presented, executives should facilitate a discussion to start to evaluate potential business models. They should analyze the attributes of the various options and consider how they might be configured to achieve accelerating returns on investments.

Traditionally, some companies have developed business models that focus on achieving economies of scale while other companies have been more geared toward creating economies of scope through differentiation. We have found that scalability goes beyond this traditional distinction and that identifying the sweet spot of business model scalability involves identifying accelerating returns on input.

In cases of declining returns to scale, managers should focus on downsizing the business so as not to cannibalize existing value. In cases where the returns on additional inputs are constant, managers should attempt to find ways to increase returns or invest excess capital elsewhere. When the business is able to generate positive, albeit linear, returns on additional inputs, the existence of synergies can make this a favorable place to be, although the company may be stuck with a business model that is at best average. In this case, managers should attempt to improve their business model using one of the five patterns described above.

Having a road map for business model scalability can be enormously helpful for managers, whether they are involved in developing new business models from scratch or innovating, rejuvenating, or redesigning existing business models. Although much of the recent research about business model innovation examines the alignment between value propositions and customer needs,⁵ business model scalability depends on close alignment between the value proposition and strategic partners.

The patterns we have identified as gateways to scalable business models (for example, enriching value propositions, removing capacity constraints,

and changing the role of stakeholders in business models) provide avenues for managers to explore. Identifying business model configurations that allow for such characteristics should be a top priority for managers as they develop and review their corporate strategies.

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