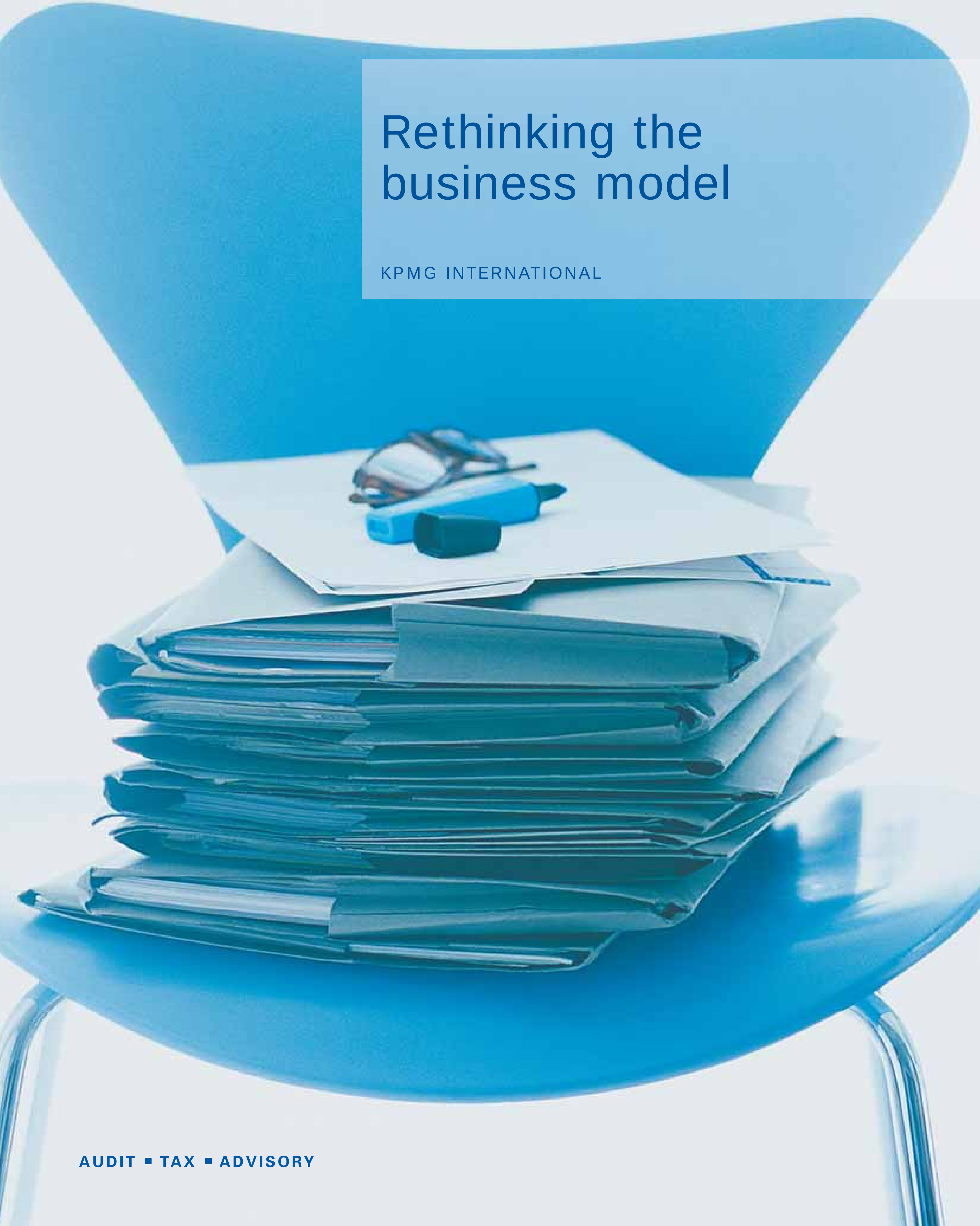
Rethinking the business model

KPMG INTERNATIONAL



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“The basic tasks of any business don't change: companies must manage their costs, grow their revenue and profits, and keep customers happy. But how they accomplish these tasks, as encapsulated by the business model, is changing dramatically”

Global Business Model Survey EIU/KPMG International 2005

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Foreword

Mike Rake, Chairman, KPMG International

The rate of change in the global business environment is unprecedented, forcing organizations to challenge many of the assumptions about how they operate. In the face of more sophisticated customers, an increasingly global economy, tough regulatory demands and technological advances, there is an urgent need to develop flexible, sustainable and profitable business models.

Mike Rake,
Chairman - KPMG International

KPMG International commissioned the Economist Intelligence Unit to produce this report on Rethinking the Business Model to provide further insight into the issues affecting global businesses.

With 93 percent of executives in the survey expecting further changes to at least one aspect of their business model over the next three years, global businesses need to understand what is driving this change, what are some of the key opportunities for growth and how best to achieve success.

The research touches on a broad range of business issues including the globalization of labor and resources which are driving down cost and providing a pool of high-level skills. Strategic alliances are the favored method of enabling organizations to penetrate new markets quickly and there is subsequently a trend towards looser, more flexible and shorter-term alliances – in some cases with competitors.

Clear themes emerging from the research include, the importance of clear strategic vision from management, engagement of employees fully in the business and the creation of a culture that is comfortable with change and uncertainty. However, in embracing change, business leaders also need to manage the accompanying risks as too much disruption can be destabilizing.

Efficient and cost effective operations are another key concern for executives, with cost structures having undergone significant change in the past three years. But it is not just a preoccupation with keeping costs down that is important for businesses over the next three years, it is low cost combined with more strategic and sustainable methods of achieving competitive advantage.

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The trend is moving towards a focus on process optimization, streamlining the supply chain, investing in value-adding technologies and R&D.

The research paints an exciting and dynamic picture for business over the next three years, with senior executives very aware of the need to evolve. Digital technology is providing the means to get ever closer to customers while the global economy is creating new markets and expanding sourcing choices. Those businesses with the insight, vision and ambition to grasp these opportunities can create new business models that offer genuine sustainable advantage.

This research report is not intended to be conclusive. A company's business model is a personal blueprint for that organization and its operations. There is no single formula for success. What this report does try to achieve is to provide a starting point for further debate and discussion on some of the issues affecting boardroom choices around the globe.

Our thanks go to the Economist Intelligence Unit for their insightful research and to all those who contributed their time and experience to this report.

About the research

KPMG International commissioned the Economist Intelligence Unit to produce this report on Rethinking the business model. The report, including the survey and case studies is based on the following research activities:

- The Economist Intelligence Unit conducted a global survey of 336 senior executives, one-quarter of which were CEOs, company president or managing director. A mix of companies participated in the survey, with 41 percent of respondents coming from organizations with over US$1 billion in annual sales revenues. A broad cross-section of industries are also represented.

- To supplement the survey results, the Economist Intelligence Unit conducted over 15 in-depth interviews with senior executives from companies in a range of industries, as well as academics and experts in the field.

The report was written in co-operation with KPMG International; the main author of the report, including the survey commentary and case studies, was Gareth Lofthouse, Director, Europe, Executive Services at the Economist Intelligence Unit. The Economist Intelligence Unit wishes to thank everyone who shared their time and insights during our research. The KPMG's Perspective sections were written by professionals from KPMG's member firms.

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Executive summary

Written by the Economist Intelligence Unit

How will organizations deliver revenue growth in an increasingly competitive and fast-changing business environment? How will they optimize their cost structures while offering more value to their customers? And how must they position themselves in the global value chain to differentiate their organizations and create a sustainable competitive advantage?

These questions are driving companies across a range of industries, radically to rethink their business models, according to this report by the Economist Intelligence Unit, commissioned by KPMG International the Economist Intelligence Unit. The research, which incorporates the findings of a global survey of 336 senior executives, sheds light on how five components of the business model – an organizations value proposition, market segment strategy, value chain positioning, revenue generation model and cost structure – are evolving. The survey was supplemented by in-depth interviews with senior executives from companies that are in the process of implementing new business models, or that are having to adapt their existing models to address new threats and opportunities.

Fully 93 percent of executives in the survey expect further changes to at least one aspect of their business model over the next three years, and almost one-half expect those changes to be "major". The changes are driven primarily by three forces: the need to respond to new opportunities in emerging markets (where the old ways of doing business may not work); the impact of new technology; and changing customer requirements. The ability to adapt the business model swiftly and effectively to these three drivers will set leading companies apart from less-successful rivals.

Drawing on this research, the report reveals where managers should consider focusing their efforts to develop flexible and profitable business models:

- Reassess your assumptions. In the past, many company's business models remained more or less the same for years or even decades. This is no longer the case. A rapidly changing business environment requires corporate leaders to review and adapt their business models more regularly, in some cases on a yearly basis. Inevitably, some companies are better at this than others. Almost half the executives

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“Optimizing business processes by using new technology is seen as a critical strategy for restructuring costs...”

(47 percent) in the survey say they formally review their business models at least once a year. But that still leaves a large proportion of companies that, while acknowledging the need for radical change, still do not review their business models on a regular and systematic basis.

- See value through the customer’s eyes. As they come to terms with new market and customer demands, companies are fundamentally rethinking where and how they add value. Changing the value proposition – defined in the survey as the unique added-value an organization offers customers through their operations – is the area of the business model that executives say will undergo the biggest change over the next three years. According to many of the executives interviewed for this report, this will require companies constantly to review and adapt their business model around the needs of the customer. What makes this more complex is that customer requirements differ from country to country, so often an established business model will need to be adapted as companies enter new markets.

- Develop flexible partner networks. Alliances are increasingly seen as an important element of a flexible business model. In the survey, 61 percent of executives say they will rely on strategic alliances to expand their market share over the next three years, compared with 40 percent that emphasize the importance of mergers and 33 percent that will rely on more formal joint ventures. Executives interviewed for the report spoke of the need for more fluid alliances, where companies that were traditionally viewed as competitors become partners in the pursuit of new markets and opportunities. This is particularly so in the telecommunications, media and entertainment industries, where convergence around digital platforms is forcing companies to create and disband new alliances at a rapid pace.

- Make the step from rationalization to optimization. Intense competition and pressure on margins in many industries will drive companies to seek deeper savings: 44 percent of executives say their cost structure will need to change further. However, there is a sense that the “easy” cost savings have already been made, and that further efficiencies will require more innovative strategies. Optimizing business processes by using new technology is seen as a critical strategy for restructuring costs by 27 percent of executives, compared with only 11 percent that see reducing headcount as major part of their plans. Supply chain optimization, the use of low-cost distribution channels and offshoring will be other important strategies as companies strive to create ultra-lean operations.

“Fifty percent of managers say an uncertain business environment is the biggest obstacle to introducing successful changes to the business model”

- Establish a defendable position in the value chain. Threatened by increased competition from low-cost markets, many Western companies talk about "moving up" the value chain – in other words, concentrating on the technology and skills-intensive activities where their advantage is strongest. The top and third most important strategies for strengthening a company's position in the value chain are to invest in value-added technologies and focus on design and development, according to executives in the survey. The flip side of moving up the value chain is that companies are shifting non-core, or less skills-intensive processes, to more cost-effective locations (either through offshore outsourcing or by establishing their own operations in low-cost markets). Other companies are focusing on what they do best, while completely exiting from business areas where they have no defendable advantage.

- Manage the risks of a business model overhaul. Many executives believe they will need to overhaul their business models over the next three years. The risk is that in introducing sweeping changes, companies make a fundamental mistake – for example, by misreading where the market is heading. Such mistakes are easily made: 50 percent of managers say an uncertain business environment is the biggest obstacle to introducing successful changes to the business model. Identifying where and how the model must change, and implementing those changes effectively, will be a major challenge. In this respect, more rigorous and regular reviews of the business model by management will help. Having established a clear direction, companies will also need to sell the need for deep-rooted and sometimes painful change to employees, to avoid the risk or their new vision being undermined from within.

There is, of course, no single business model for success. Some companies in this report operate several business models to meet the needs of different markets. Others are developing new and hitherto untested models. Nevertheless, managers from all industries face a number of common challenges. This research reveals where business models may need to change most dramatically over the coming years, and sheds light on how managers from leading global companies are realigning their organizations to face the challenges ahead.

The business model and its components

> “The business model is distinct from strategy, although understanding each of its components and how they interrelate can help companies to make better strategic choices”

One of the problems with any discussion of business models is that there is no universally accepted definition of the term. However, one useful way of thinking about business models was put forward by Joan Magretta, a senior associate at the Institute for Strategy and Competitiveness at Harvard Business School. She has argued that business models describe, as a system, how the pieces of a business fit together. The business model is distinct from strategy, although understanding each of its components and how they interrelate can help companies to make better strategic choices.

When answering questions for this research, executives were given the following definitions of the business model and its components:

Business model:

The mechanism by which a business intends to generate revenue and profits.
It encompasses the components below.

Value proposition:

The unique added-value an organization offers customers through their operations.

Market segment:

How organizations target different customer groups, product markets and geographic markets.

Revenue-generation model:

Mechanisms for generating revenue, such as sales, licensing, franchising, pay-as-you-go or leasing.

Cost structure:

The relative proportion of fixed, variable and mixed costs found within an organization.

Value chain:

The inter-linked set of activities required to design, procure, produce, market, distribute a product or service.
A company’s value chain includes the supply chain and its distribution channels/routes to market.

Introduction

The term "business model" entered the popular vocabulary back in the days of the Internet boom, when hardly a day went by without a dotcom announcing a novel money-making scheme.
Of course most of these models turned out to be deeply flawed. As soon as it became apparent that their promised profits were unlikely to materialize, most of the dotcoms went under and the whole notion of the business model became somewhat tarnished.

But a handful of companies did find a way of exploiting the Internet's potential to develop new and profitable ways of doing business: Amazon, e-bay and Dell are three celebrated examples that have since been widely studied and imitated. What distinguished these companies was not the products that they sold, but how they sold them – as encapsulated in the business model. Using the Internet, each of these companies was able to sell direct to consumers without the need for the costly infrastructure and distribution channels employed by their "bricks and mortar" rivals.

Business model innovation didn't stop there, however. Recent research[1] by the Economist Intelligence Unit indicates that the majority of global executives now see their business model as a more important source of competitive advantage than their products (which for many companies are becoming increasingly commoditized). But to deliver that competitive advantage, the business model must evolve and adapt to reflect changes in the business environment. This new survey of 336 senior executives shows that companies in virtually every industry, believe they will need to make major changes to their business models over the course of the next three years. This report seeks to shed light on where change is needed most, and why.

"...the majority of global executives now see their business model as a more important source of competitive advantage than their products..."

[1] Economist Intelligence Unit, Business 2010, 2005.

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1. Carrot and stick: Why business models must change

"The question of where, in this rapidly changing business environment, a company can provide unique value to its customers has become a key concern for corporate leaders"

Written by the Economist Intelligence Unit

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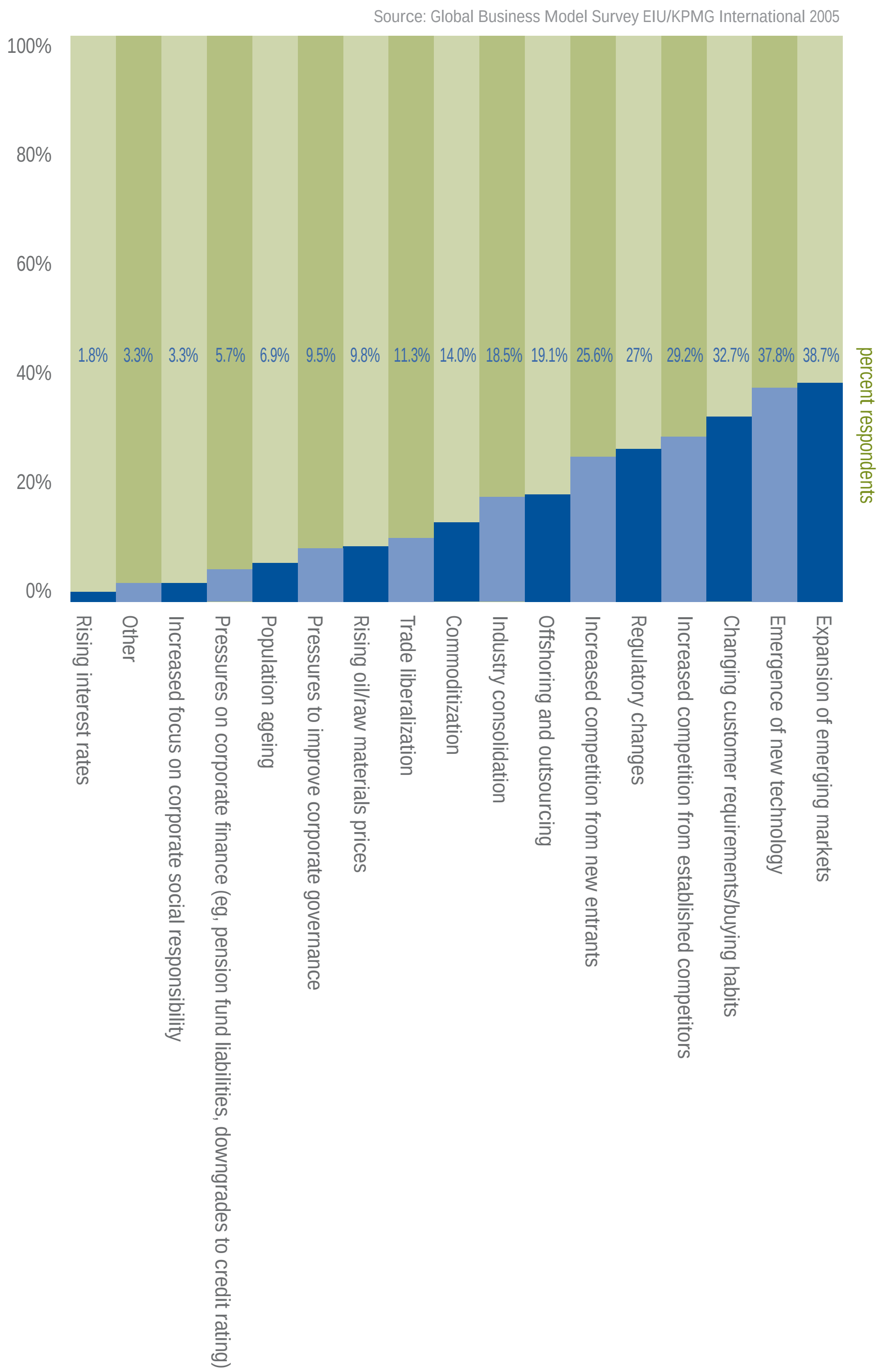
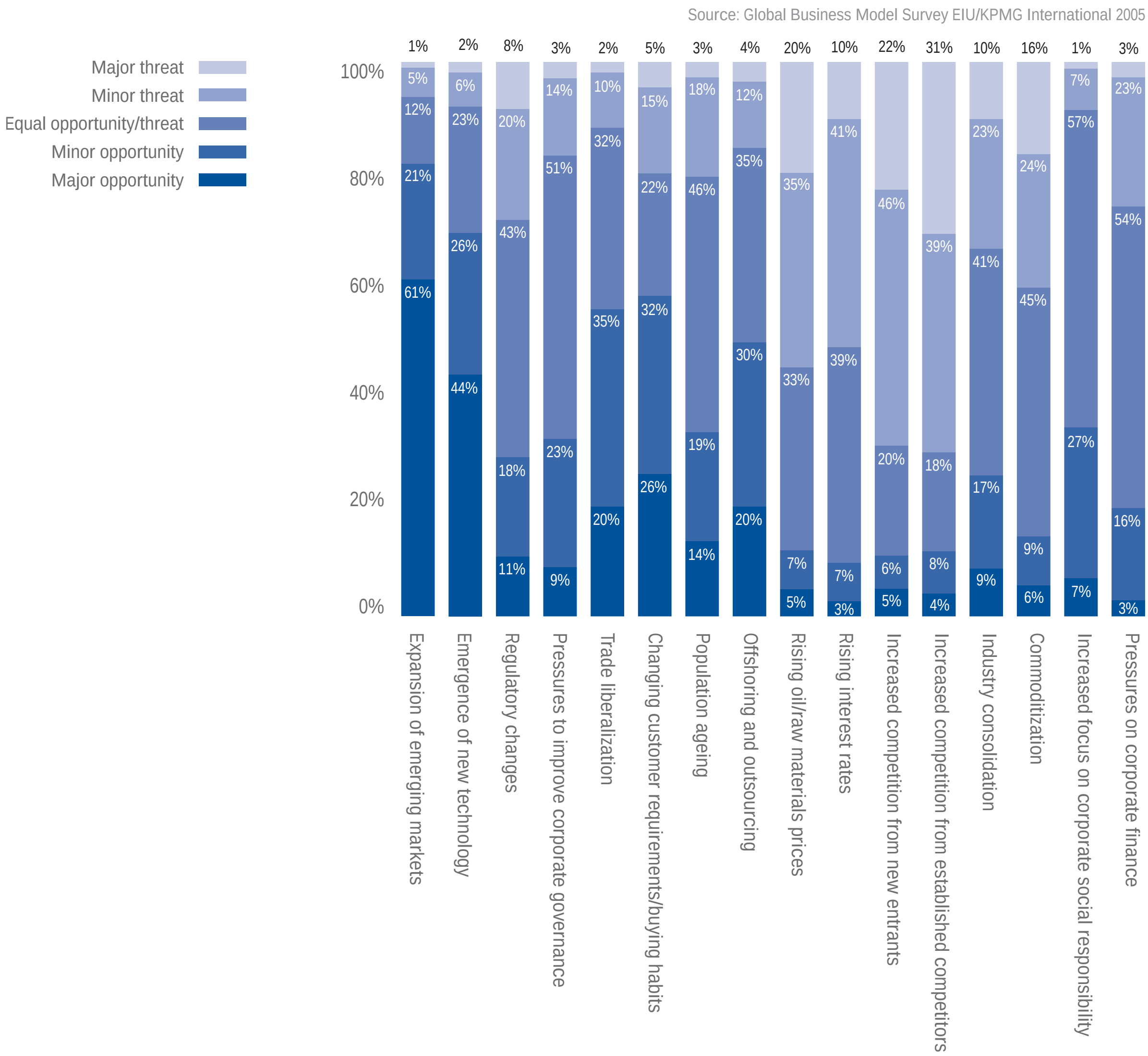
Q1: Which of the following issues will require your company to make the biggest change to its business model over the next three years. (Select three answers only)



Q2: Do you view the following as opportunities or threats to your business? (Percent respondents)



A combination of threats and opportunities are forcing companies to rethink their business models. Fully 88 percent of companies believe that at least one component of their business model has undergone change over the past three years, and 44 percent describe the degree of change as major. But it appears that more work remains to be done: over 93 percent expect further changes to their business model over the next three years.

The biggest incentive for changing the way they do business is the desire to penetrate new markets. A total of 39 percent of companies believe that this will

> "...the biggest perceived threats to business emerged in the form of increased competition from established competitors and new entrants, rising prices of oil and other raw materials, and commoditization"

be one of the main issues that will demand major changes to their business models over the next three years. Manufacturers such as Siemens and ARM, a U.K.-based company whose microprocessors are now present in 80 percent of the world's mobile phones, have had to expand their operations in emerging markets to service fast-growing customer bases. To penetrate new markets effectively, however, companies have found that they need to tailor their way of doing business to local requirements. Western retailers like B&Q, for example, have found customers in China have very different needs from their customers in Europe or North America, and have had to refine their model accordingly.

Around 38 percent of executives also cited the emergence of new technology as an issue that would demand major revisions to the business model. Companies in many industries are exploiting – or coming to terms with – the impact of disruptive technologies such as Internet telephony, digital music and movies, or open source software. John Smith, CEO of BBC Worldwide and chief operating officer of the BBC, says technology is transforming every aspect of the media industry from the way content is produced, to the types of programs that people want (for example, "everything is becoming more interactive"), to how and where media products are consumed. Reaching customers, and making money, using digital platforms remains a major preoccupation for many executives interviewed for this report.

At least the emergence of both new markets and new technology are mainly seen as positive developments by most executives in the survey. Companies are less comfortable with another force that has an impact on their business models, namely changes in customer requirements and buying behavior. One in five companies see changing customer behavior as a threat, while a further 22 percent see it as a mixed blessing. Companies were even more ambivalent about another major business trend of recent years, the pressure to improve corporate governance. Just over one-half of executives saw this as a threat and opportunity in equal measure. However, the biggest perceived threats to business emerged in the form of increased competition from established competitors and new entrants, rising prices of oil and other raw materials, and commoditization.

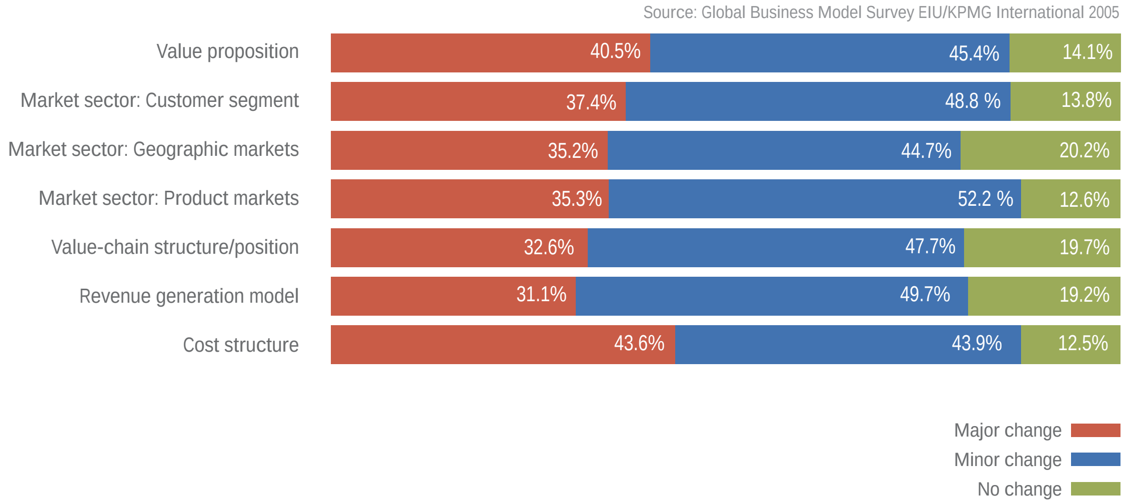
Not only are business models changing, but the focus for that change has shifted. Over the past three years, the area where business models have been revised most has been in the area of cost efficiency: 44 percent of executives cite major changes to their business model in this area, compared with 40 percent that cited major revisions to their value proposition and 31 percent that had overhauled the way they generate revenue.

Look ahead three years, however, and executives paint a more complex picture. The cost structure will still be a major focus for change, according to 44 percent of executives. However, it is their value proposition – defined as the unique added-value an organization offers customers through their operations – that will need to change most significantly, according to 47 percent of executives. Having focused their effort on saving money in recent years, the survey indicates that companies now need to find new models that create value and provide access to new sources of growth.

Keith Ruddle, a fellow in leadership, organization and change at Oxford University, is not surprised to see many companies radically redefining their value propositions: "The things that people made value with are getting commoditized. Companies are having to find new sources of value." The question of where, in this rapidly changing business environment, a company can provide unique value to its customers has become a key concern for corporate leaders.

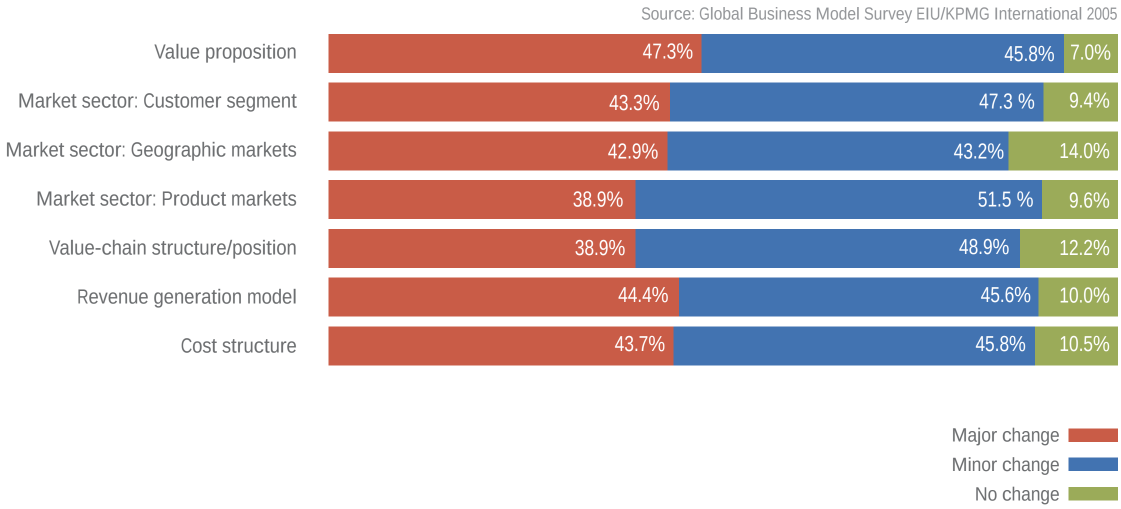
Q3: How much change have the following components of your company's business model undergone over the last three years?

(Percent respondents)



Q4: How much change do you expect the following aspects of your company's business model will undergo over the next three years?

(Percent respondents)



Case study

China models, new and old

Written by
the Economist Intelligence Unit

One company that has found it necessary to refine its business model in order to penetrate new markets is B&Q, the British hardware and home improvement chain. A part of the Kingfisher Group, it entered China in 1997, seeking to replicate the rapid success it had just achieved in Taiwan and to profit from the rise in property ownership across the mainland. The company now operates 27 stores across China, either as wholly owned B&Q outlets or through its home-decorating joint venture with Shanghai Gas Co.

From the start, it decided to concentrate on large "big box" stores in out-of-town locations. Initially, the operation closely replicated the company's hardware-style stores in the U.K., even to the extent of sending a team from B&Q's state-of-the-art warehouse in Yorkshire to Shanghai to recreate the company's complex inventory and delivery system for China. However, the U.K. model almost immediately proved problematic, largely because although China's private property market was growing fast, a host of local hardware stores were opening smaller, more conveniently located and generally cheaper stores.

Faced with such intense competition, B&Q opted to rethink its approach. Its stores now feature room lay-out suggestions and more furniture, accessories and lighting than a traditional B&Q – a major move from the company's usual

format in the U.K. B&Q's Shanghai director of operations, Ian Strickland, believes that B&Q's new-look stores are proving popular because they can offer interior design ideas with all furniture and fittings available in one place – an approach that is as much about educating customers as selling to them.

Eastman Kodak is another company that believes that China is key to its future. But in this case, China represents a new market for the company's long-established business model (based around selling photographic film) at a time when its traditional markets in developed countries are moving towards digital photography.

"In China, we see great opportunity to develop the traditional [film] market in smaller cities and rural areas where about 900 million people live and camera ownership is well below the national figure of 24 percent," says Ying Yeh, chairman of Greater China Region and vice-president at Eastman Kodak. Even these people are likely to make the jump to digital imaging before long. But if in the meantime their first exposure to picture-taking can be through Kodak film, then that will both help establish the Kodak brand name and offer ways of financing the company's transition to digital imaging.

KPMG's Perspective

Making the most of opportunities and risks

Risk Management - an essential and positive discipline designed to help companies achieve their objectives.

That the business environment is in a state of flux and that new opportunities for revenue generation are continually emerging is a fact acknowledged by many senior executives, regardless of the industry in which they operate. Identifying the next big opportunity, while managing the risks, can be both time consuming and resource intensive. But the rewards for those who achieve a correct balance between opportunity and risk can be great. The drivers for change can be diverse, such as expansion of emerging markets, emergence of new technology, changing customer requirements or increased competition from both established competitors and new entrants. Whether these drivers for change amount to opportunities or risks can be difficult to identify initially. However, the potential risks associated with an ever changing business environment can be managed partly through robust internal controls and delivery of relevant and reliable risk information to help enhance informed decision making.

Creating a culture of intelligent risk taking

An enhanced understanding of the risk control environment within an organization, can be an important starting point for executives wishing to grasp opportunities when they arise while making a positive impact on margins. More accurate information can help improve insights on current performance, with the outcome that better business decisions are taken. These factors in turn can help increase the organization's competitive advantage in business and capital markets.

> “robust internal controls enhance informed decision making”

A top-down perspective

In order to strengthen an organization’s risk control environment with the aim of achieving performance improvement, organizations may need to address the issue from both a strategic/top-down perspective and from a deep understanding of how the business operates on a day-to-day basis. Balancing delivery of business improvement with taking risks and embedding controls is vital. The process involves the identification of clear objectives, the risks that may threaten them and the processes and systems that can help achieve them.

Extracting business value from an improved risk control environment

The potential benefit is making controls more focused by linking them to risk, and more efficient by making as many controls as possible automated and preventive. However, risk management is not just about avoiding downside. It’s about realizing potential opportunities and achieving objectives. Failure to manage risk can compromise a company’s ability to succeed, turning strategic goals into own goals.

Avoid the obvious own goal

Risk can be difficult to manage, not least because it can be unpredictable, prone to change and likely to touch many areas of an organization simultaneously.

A strong risk control framework is essential to help with risk definition, control management, and ultimately to goal realization or own goal avoidance. Investing in a robust risk management framework will help support the objectives of the business.

2. Creating value in the customers' eyes

"When considering their business models, executives must think first and foremost about how it relates to the needs of their customers...
80 percent of executives say customers are the stakeholders that are most likely to drive change in the business model..."

Written by the Economist Intelligence Unit

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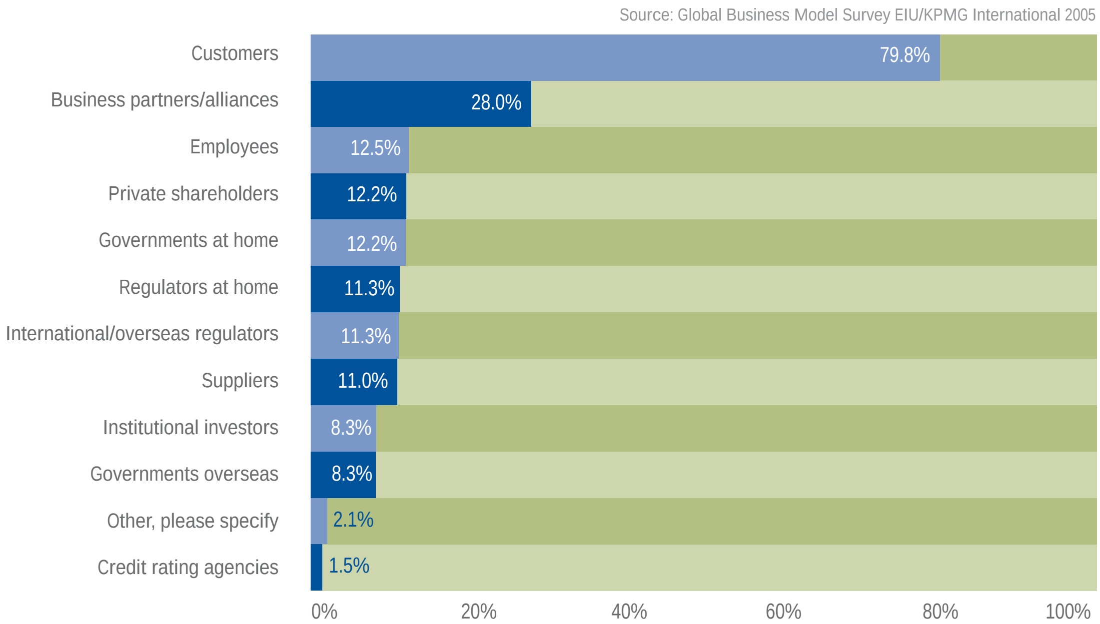
Q5: Which of the following stakeholders do you expect to be the biggest drivers of change to your business model over the next three years. Select two options (Percent respondents)



When considering their business models, executives must think first and foremost about how it relates to the needs of their customers. In the survey, 80 percent of executives say customers are the stakeholders that are most likely to drive change in the business model, much more than the 20 percent that cite investors and shareholders and 13 percent that cite employees as a major force behind business transformation. As Matthew Szulik, CEO of the Linux software company Red Hat, puts it: "Everything begins and ends with the customer."

This may explain why companies view customer service as so important. Fully 59 percent of respondents say quality of customer service is a very significant source of competitive advantage, compared with 45 percent that emphasize quality of products: a finding that stresses the need for customer-centric, as opposed to product-oriented, business models. But what constitutes good customer service is also changing. As the "gold standard" for service rises, quality of service will become one of the areas where competitive advantage is most difficult to sustain, according to the survey.

Creating a more sustainable model for attracting and retaining customers will therefore require companies to define value from the customers' perspective. This will entail learning what different customer "segments" want, and building a business model that is able to service these widely varying preferences quickly and cost-effectively.

To improve their customer insight, several of the executives interviewed for this research reported that their organizations were investing unprecedented resources into customer research. "As an industry, we have historically known very little about consumers…Now we are going to have to invest quite heavily in understanding what consumers are looking for, what the trends are, how they want to consume and experience music…it's a very big change," says Adam Klein, strategy chief for EMI, a music company. Nor is the idea of customer insight unique to B2C companies. Warren East, CEO of ARM, says his company keeps ahead of the technology race by studying the needs of its customers' customers – in other words, the end-users of mobile phones and computers.

The ultimate goal of these efforts is to sense what customers want almost before they themselves know they want it. To capture this information, companies are combining the use of consumer focus groups with hi-tech strategies – for example, analyzing customer or sales data to spot new trends and demand. Inditex, the fashion retailer behind the "fast-fashion" chain Zara, prides itself on its ability to capture and rapidly respond to sales data coming in from its stores. "Our shops are like a nervous system. They provide us with a constant stream of information on what is selling, what isn't selling, and what we could sell more of. We try to react continuously to give them what they need," explains Miguel Díaz, Inditex's head of commercial planning and control.

> "Successful targeting doesn't just mean understanding what customers will buy, but also the social context in which they will use a particular product"

Successful targeting doesn't just mean understanding what customers will buy, but also the social context in which they will use a particular product. Diageo, a beverages company, conducts a huge amount of consumer research in this area. The company gears its strategy around a number of "motivational states", "Being able to sense what customers want is vital, but business models must also be flexible enough to respond to those new requirements with unprecedented speed"

on the basis that what customers want to drink when they are in, for example, "relax and unwind mode" is different to what they want to drink when with friends at a party. Understanding these different motivational states helps Diageo to build attractive brands that its customers will pay a premium for. So important has this idea of targeted branding become that the company has now put 5,000 employees through training to understand how to grow its brands effectively, says Gareth Williams, Diageo's HR director.

Other companies meet their customers' fickle needs by building more flexibility into their production and logistics processes. Zara's success depends on its ability not only to spot new trends, but to deliver new fashions into its stores in a fraction of the time taken by more traditional competitors. Being able to sense what customers want is vital, but business models must also be flexible enough to respond to those new requirements with unprecedented speed.

Case study

Music business goes digital

Written by
the Economist Intelligence Unit

The advance of technology and changes in consumer demand are fundamentally changing the way music is created and sold, observes Adam Klein, EMI Music's executive vice-president of strategy and business development.

Rather than be passive consumers of content who wait for music companies to push products at them, consumers increasingly want to take control of the way they experience music. The result, says Adam Klein, is a new kind of "remix culture" where users expect to co-create their personal music experience from a broad range of music content that can include individual track downloads, ringtones, demos, acoustic sessions, backstage outtakes, artwork and video clips.

The good news about digital music is that EMI doesn't incur the manufacturing costs that arise from producing CDs and tapes. But music companies must invest heavily in new technologies and in developing partnerships to help them reach consumers. To this end, EMI has made "huge investments in digital distribution platforms" to support major online music subscription services such as Apple's i-Tunes. It has also sealed exclusive content deals with partners such as AOL to showcase and distribute content from artists such as Coldplay to fans via broadband, for example. EMI expects that as much as 25 percent of all music sales will be in digital form in five years.

The costs of distributing music over the Internet are so low that, in theory at least, it becomes profitable to target audiences that previously would have been

deemed too niche. Before digital channels, consumers learned about new music and artists on television and radio, which generally play a very limited list of 40 or 50 tracks. Digital channels enable companies like EMI to expose more music to more people without more marketing costs. "Here disruptive technology is ultimately the saving of the music industry," responds Adam Klein.

More controversially, Adam Klein believes that allowing users to copy and share music on a limited basis can complement traditional campaigns to market new artists and music – providing sharing is properly controlled. "Technology allows consumers to very easily put together their own play lists – cutting and pasting music, video and graphics to create a personal expression of their music experience they can share with friends. We've got to be prepared to come up with new ways to allow legitimate sharing to take place," he says.

With this aim in mind, EMI is launching new copy control technology on its CDs that will permit consumers who bought a disc to copy it a limited number of times. The system is designed to allow "fair usage" and sharing of digital assets, while at the same time discouraging music piracy. EMI's technology also allows consumers to send music tracks to their peers in the form of web links. Clicking on the web link allows users to listen to a track a few times, after which they must either buy it or it disappears.

Enabling seamless distribution of EMI's vast digital assets is anything but business as usual, but Adam Klein argues it is worth the effort. "It's the growth engine of the industry. It's about offering consumers a way to buy music they want the way they want it – all the while protecting the value of music for our artists."

KPMG's Perspective

Creating value

Trying to satisfy the customer at any cost can damage your bottom line.

Many companies are expanding their range of products and services in an attempt to give the customer what he or she wants. However, in some cases this has led to excessively large, diverse and complex portfolios that are difficult to manage, driving up costs and causing inefficiencies that ultimately reduce service quality.

Such complexity also means that businesses may be failing to identify the profitability of different customer groups or different product lines, creating a dilution of effort and a lack of focus in their marketing activities.

By identifying those customers that deliver the lions share of profit, businesses can start to target these groups with relevant offerings while pruning back the rest of their portfolio. Reducing the number of products and services can help to cut costs and bring processes back under control.

In addition to asking customers what they want, organizations should also be asking what they don't want. Managers should not be afraid to drop obsolete or unprofitable product lines because, ultimately, it's simply not profitable to try to please everyone all the time.

The supply chain is two-way

Supply chain management has been under the spotlight in recent years and a number of benefits have been realized, helping push through products and services faster and at lower cost. One area that appears to have been neglected is the customer feedback flowing in the opposite direction that should ideally be fed into the marketing process to help refine or change products and services. Any hard earned gains could soon be negated by offering the wrong products or targeting the wrong group of customers.

> "Organizations should be asking what customers don't want and pruning back their portfolios; it's not profitable to try to please everyone all the time"

Technology alone will not give you a better understanding of consumer behavior. Customer Relationship Management (CRM) is clearly an important tool, but this needs to be combined with more intuitive thinking and knowledge gained from those who have day-to-day dialogue with customers. Employees who are customer facing should be contributing to forecasts and market research, giving organizations a better chance of building the right products and services that create value.

3. Partnering for growth

“... the use of alliances is natural as companies strive for more flexibility in their business models: “People are trying to create value fast, and it’s the easiest way to combine resources and competencies so you can compete globally” ”

Written by the Economist Intelligence Unit

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Over the next three years, executives will focus more on how their business models can deliver growth than they did over the past three, when their main preoccupation was cost. That growth will come from building customer loyalty (using the kind of customer-focused strategies discussed previously) but also from penetrating fast-growing emerging markets. Forty seven percent of executives cited Asia-Pacific as the region where they expect the greatest sales growth over the next three years, compared with only 19 percent and 14 percent that expect sales growth to come mainly from North America and Western Europe respectively.

When asked what kind of models they will use to increase their market share over the next three years, the majority of executives – 63 percent – say they will rely on organic growth, whereas mergers and acquisitions (M&A) will feature as an important growth strategy for 40 percent of surveyed companies over the next three years. The total value of global M&A deals has slowly been recovering since the post-dotcom slump, and a number of large deals were announced in Europe at the end of 2005. Even so, the total value of M&A deals this year will be well below where it was in 2000, as can be seen from the table below.

M&A trends

Time period (Announced date)	No of deals	No of deals with known values	Total deal value (incl.est.) (euro millions)
2000	26769	12454	3726445
2001	25066	12785	2179404
2002	27476	14160	1496507
2003	42777	25237	1732355
2004	55237	32299	2294009
2005	53404	31847	2547779

Source: BvD Zephyr, 2005

As companies seek growth in new markets, partnerships and alliances will be more important than outright acquisitions. Sixty one percent of executives say strategic alliances will be a key strategy for expanding market share, while 33 percent will use more formalized joint ventures. Several executives interviewed for the report spoke of the need for more fluid alliances, where companies that were traditionally viewed as competitors become partners.

> "...nurturing partnerships has become a major task for management, with some companies appointing dedicated alliance managers to ensure the smooth running of important partner relationships"

For some companies, the partnering trend also entails tighter collaboration with major customers to develop products and solutions. "For the kind of markets we address, we will increasingly need to partner with the public sector to get major infrastructure projects off the ground, and our business model equips us well for this," explains Robert Blackburn, vice-president of strategy at Siemens AG.

The trend was particularly marked in the information technology (IT), telecoms, media and entertainment industries, where convergence around digital platforms is forcing companies to create and disband partnerships at a rapid pace. As it seeks to build its digital music business, EMI has found that working with new partners often requires the company to revise its business model.
As an example, Adam Klein points to the way mobile telecoms operators like Vodafone, Cingular or Verizon will give away a lot of free music as a marketing tactic to reduce their churn rates. "That means we have to disaggregate our price to them from our price to the consumer…We've got to work with them, while still protecting the value of music for our artists," he notes.

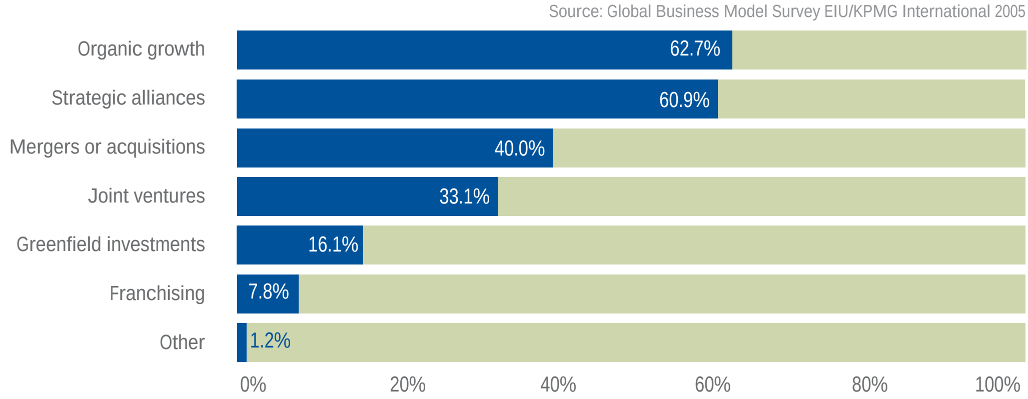
The BBC, the UK's public service broadcaster, is pursuing an "all platform" digital strategy, and as a result has had to acquire some surprising bedfellows (for example BSkyB, which broadcasts BBC channels). "People who were competitors become friends and enemies in equal measure," says John Smith. But partnership is also proving essential to the BBC's plans to penetrate new geographical markets. The BBC believes that the emergence of a large and relatively affluent, English-speaking middle class in India provides an exciting new market for the corporation's products. Reaching this audience requires the BBC to cultivate the right channel partners, says John Smith.

Keith Ruddle of Oxford University believes the use of alliances is natural as companies strive for more flexibility in their business models: "People are trying to create value fast, and it's the easiest way to combine resources and competencies so you can compete globally." The growth in partnership strategies has spawned new management buzzwords like "co-opetition" (where companies simultaneously co-operate and compete with other organizations) and "value constellation" (a network of competing companies that sometimes help each other out). Whatever the strategy is called, however, nurturing partnerships has become a major task for management, with some companies appointing dedicated alliance managers to ensure the smooth running of important partner relationships.

Q9: Which of the following partnership or investment models will your company rely on most to increase market share over the next three years? Select all that apply.

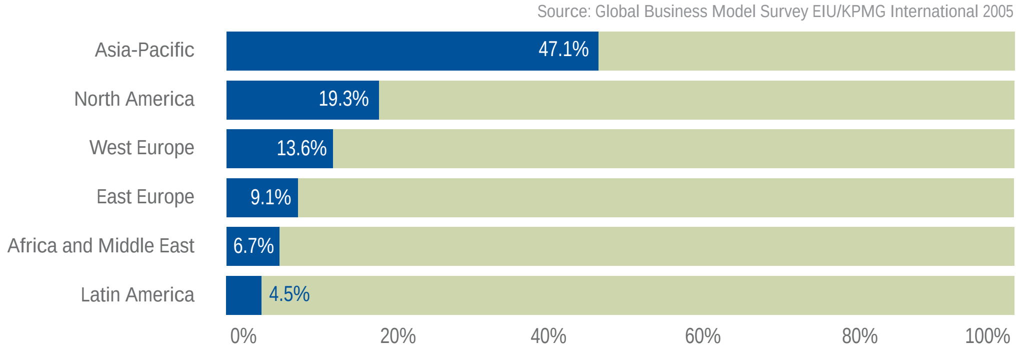
(Percent respondents)

Source: Global Business Model Survey EIU/KPMG International 2005



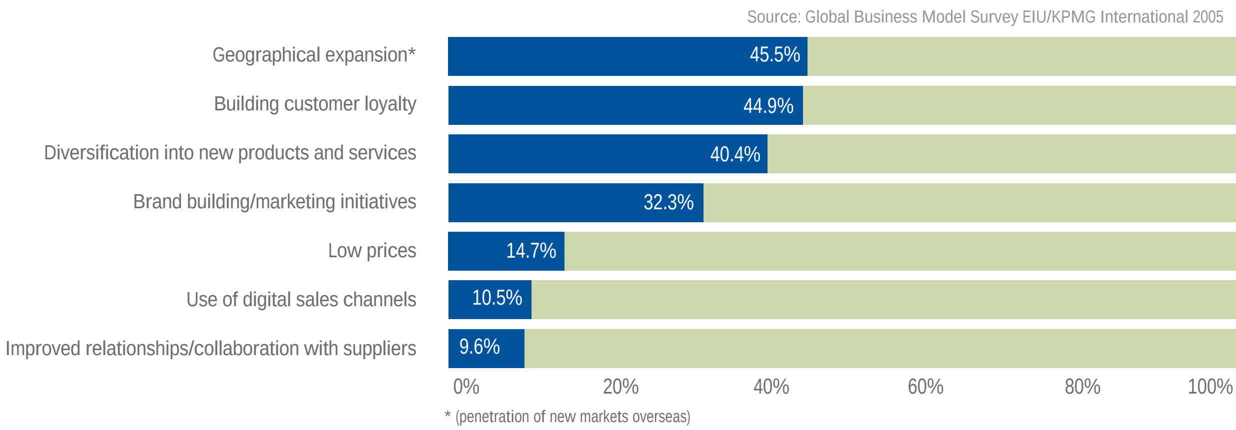
Q10: Which overseas markets do you expect to deliver the greatest sales growth over the next three years?

(Percent respondents)



Q12: Which of the following will be most important for growing your company's revenues over the next three years? Select two options.

(Percent respondents)



Case study

Supplier or partner?

Written by
the Economist Intelligence Unit

Companies need to manage their suppliers effectively, but fashions change in terms of how this is best accomplished. A pendulum swings between seeking to squeeze supplier prices as much as possible to emphasizing the value of lasting relationships over short-term cost reductions.

Traditionally, major U.S. automotive manufacturers have followed a hard-nosed approach to managing their suppliers, with some even on occasion recouping market-driven price cuts by unilaterally mandating reductions from suppliers. In lean times, this is understandable: at Chrysler, for example, purchased materials account for up to 60 percent of the total cost of every new vehicle.

Chrysler Group's CEO, Tom LaSorda, recently admitted that pain was part of the company's history with suppliers. Now, however, it wants improved relations. Mutual antagonism impedes co-operation and communication, hurting everyone's bottom line. Overly clubby vendor-purchaser relations, however, damage transparency and efficiency. To avoid both dangers, Chrysler Group has unveiled a new supplier status – The Highly Integrated Partnership Organization (HI-PO). DaimlerChrysler is currently examining the feasibility of adopting it company-wide.

Robert Schott, vice-president of worldwide procurement and supplier strategy at Chrysler Group, says the company is "putting its money where its mouth

is" in treating outstanding suppliers as partners. The new approach involves an internal and external cultural change. Using a series of metrics for quality, system cost, technology and supply performance, Chrysler now calculates for each supplier a place on a matrix, which is roughly analogous to a stock's position on a risk/return graph. The best performers end up in the "Reward Zone", benefits of which include retention of current business without challenge; first right of refusal on additional business taken from under-performing vendors; and the opportunity to bid for new business. Chrysler will work with companies outside the Reward Zone to help boost their performance, but the poorest performers will inevitably be dropped if no improvement is shown.

Robert Schott believes that transparency and objectivity are the system's strength. Every supplier's complete results will be updated monthly on the Internet, allowing companies to know where they stand with Chrysler and to benchmark against other suppliers. Such openness should, the company hopes, increase trust and co-operation with its suppliers.

KPMG's Perspective

Partnering for growth

Alliances are the middle ground between organic growth and mergers and acquisitions.

Rapid technological advances and the emergence of a genuinely global economy have created exciting commercial opportunities. The focus has now firmly shifted from the control of costs to growth and dynamic expansion. The pace of change is such that companies are needing to adapt their business models and look to penetrate new markets as well as introduce new skills that they don't possess in-house.

Penetrating emerging markets can be difficult without local knowledge and resources, and in some cases regulations insist on local representation. Mergers and acquisitions are an obvious way to buy into a new market, but an increasingly popular alternative is to form strategic alliances and partnerships.

Strategic alliances can in many ways give you the best of both worlds – the flexibility of organic growth and the extra muscle companies get from a merger or acquisition.

A match made in heaven…or hell?

Although alliances can bring many benefits, they can also be a millstone around companys' necks. A long-term alliance can tie a company down to a partnership that may not be working, while restrictive anti-competition clauses could prevent companies from entering into potentially lucrative new markets. It is therefore important that strategic alliances are defined in a Shareholder Agreement between the parties where the respective roles and responsibilities are clearly set out.

Being part of a coalition can also reduce a company's autonomy, forcing it to constantly reach consensus on major and minor decisions, which can be frustrating and time-consuming. This may not suit dynamic leaders who want to move quickly and decisively to rationalize operations or take advantage of new opportunities.

One alternative that is gaining in popularity is 'asset swapping', where two organizations exchange bundles of particular assets that are more valuable to the other party, with any difference in value being paid in cash. This has two key advantages over an acquisition: you can avoid the sometimes spiraling costs of an auction and you only get the assets that you really need, helping to reduce waste.

Ultimately alliances, mergers and acquisitions and cost reduction are not mutually exclusive activities, and in an increasingly dynamic business environment the challenge for organizations is to create a fluid business model that allows them to continually evaluate and develop such options.

“Strategic alliances can give you the best of both worlds – the flexibility of organic growth and the extra muscle you get from a M&A”

4. Rationalize or optimize

“In a highly competitive environment, companies need to be constantly on the search for new efficiencies. But in the “optimize or rationalize” debate, companies must balance the benefits of cost savings against the need for flexibility and speed”

Written by the Economist Intelligence Unit

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Cost-efficiency may take second place to value creation as a priority over the next three years, but almost all managers in the survey will keep one eye fixed on the bottom line. Intense competition and pressure on margins in many industries will drive companies to seek deeper savings: 44 percent of executives say their cost structure will need to change substantially over the next three years.

Some companies believe that by streamlining the business model, they can achieve a sustainable cost advantage over their competitors. Barclays Insurance Services, part of Barclays Bank, believes it can "shake up" the U.K. market for home, travel and motor insurance by offering much lower prices than its competitors. Barclays' insurance business has existed in one form or another for 30 years, but it is only since the company entered a joint venture with Norwich Union that it has been able to deliver the kind of cost-efficiencies that make such aggressive pricing viable. Since the new model and low pricing was launched in April 2005, the company has grown rapidly to the point where it is now underwriting 5,500 insurance policies a week, compared with 1,500 a week prior to the overhaul.

Barclays taps into the combined scale and skills of Norwich Union not only to manufacture attractively priced insurance products, but also to exploit its strengths in Internet distribution. Adrian Grace, the company's managing director, contends that the economies of scale achieved through the joint venture are such that competitors will find it hard to match its pricing. He is counting on this strategy to propel Barclays Insurance Services from a relatively small operator in the insurance market to become a major player in four years' time.

According to Adrian Grace, companies have to be bold to achieve these kind of deep efficiencies. Given that many organizations have already undertaken major cost-cutting exercises in recent years, many of the most obvious opportunities to save money have already been seized. Companies will need to go beyond rationalization (often a euphemism for laying people off), and focus on optimizing their business processes and operations. This is particularly so for the majority of companies in the survey relying on organic growth. Optimizing business processes, for example by automating them using IT, is now seen as a critical strategy for restructuring costs by 27 percent of executives. It therefore appears more important, but also harder and more time-consuming to accomplish than, for example, simply reducing headcount (cited as critical by only 11 percent of executives in the survey).

“Low costs may confer a competitive advantage, but cut too deep and it could cost you the ability to respond to market changes”

Streamlining the supply chain is another important focus, according to the survey. This is more than a matter of relentlessly squeezing suppliers for the cheapest price. Companies are using sophisticated technology to optimize supply and logistics processes: Wal-Mart, for example, is piloting the use of radio frequency identification tags to make its stock replenishment processes more efficient. Companies like DaimlerChrysler are experimenting with sophisticated supplier performance measurement schemes to make sure they are getting excellent value and service, from their suppliers, not just a cheap price (see box on Supplier or partner?). Other companies are centralizing procurement and elevating the status of the corporate purchasing function. A recent survey by the Economist Intelligence Unit showed that, by 2015, over 60 percent of companies will have a chief procurement officer (CPO) reporting directly to the CEO and setting a strategic course for company-wide purchasing – all with the aim of maximizing cost efficiencies.

The third most critical strategy for optimizing the cost base is the use of more economical sales and service channels to reduce costs and thereby offer competitive pricing to customers. It’s a strategy that has been demonstrated to powerful effect by ING Direct, a savings bank that has grown rapidly in nine countries by concentrating on telephone, postal and Internet banking. When ING Direct was launched in 1999, few believed that a business model based simply on low-cost and powerful branding would allow ING Direct to break into the savings markets of mature economies such as Canada, Australia, America and thee large European countries. In practice, the direct banking model paid off very quickly: in 2004, ING Direct contributed a profit before tax of 438 million euro, up from 151 million euro the previous year, its first in profit. So far, seven out of the eight units operated by the bank (the Austrian business is run from Germany) are profitable.

What many analysts underestimated, says Dick Harryvan, ING Direct's general manager and one of the company's founding directors, was the competitive advantage gained from its direct banking model.

The ratio of ING Direct's costs (excluding marketing) to its assets is less than one-fifth that of conventional banks with an expensive network of branches. On the savings business alone – that is, excluding the cost of servicing mortgages and the like – the ratio is lower still, says Dick Harryvan.

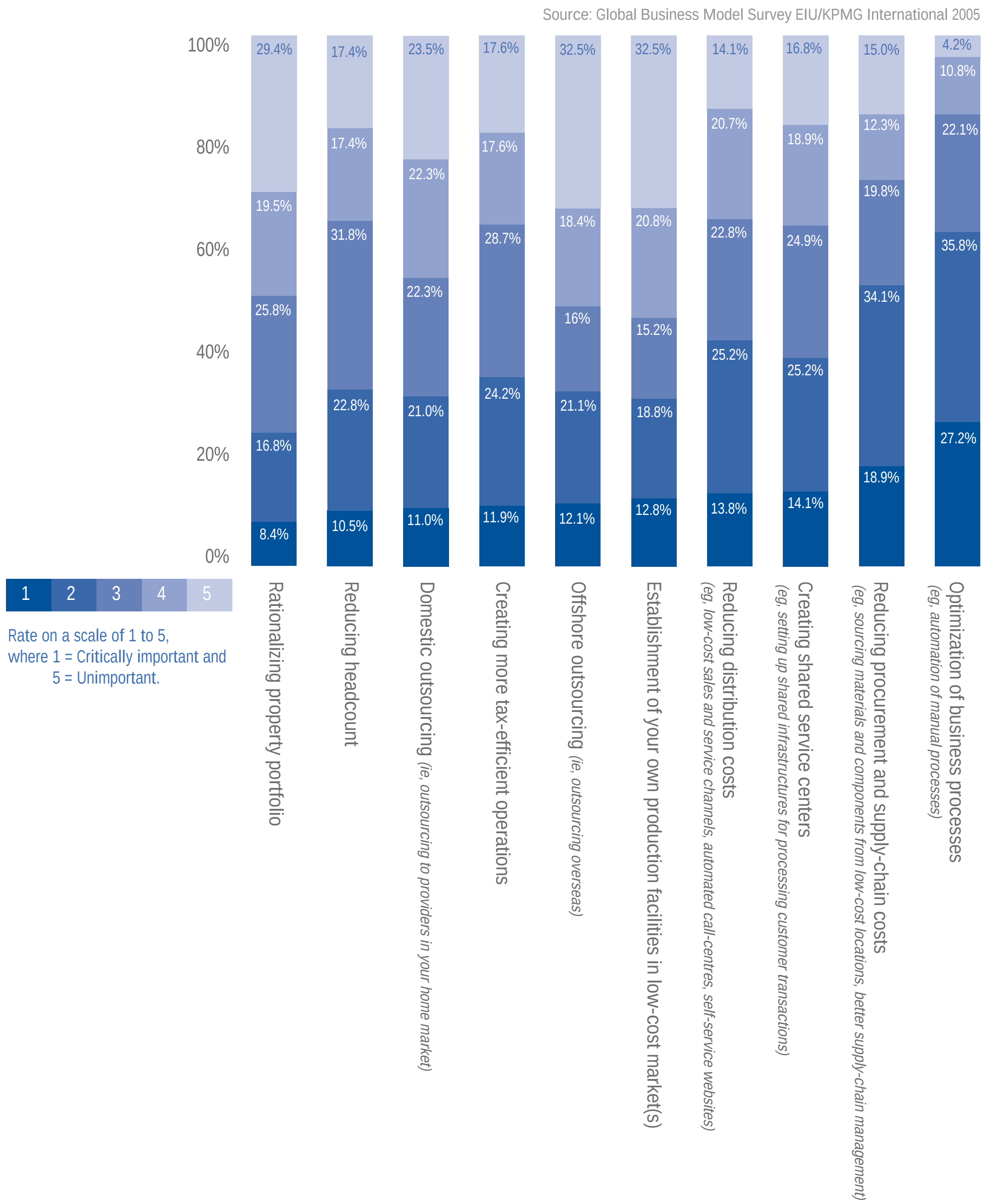
The drive for maximum cost efficiency also motivated another well-publicized change to the business model in recent times, namely the outsourcing and offshoring of business processes. In the survey, one-third of companies say offshoring will be an important or critical strategy over the next three years. Even so, many companies have yet to outsource overseas, and offshoring was surprisingly low down the list of priorities compared to other cost-saving strategies in the survey. This could mean that offshoring needs to be used as just one of a mix of strategies to optimize the cost structure. But it could also represent reluctance by a large number of companies to confront the sensitivities involved in sending jobs overseas. As Christian Ketels, principle associate at the Institute for Strategy and Competitiveness at Harvard Business School, puts it: "Executives seem quite willing to talk about cutting value chain costs, but seem not to want to advocate outsourcing. In practice, these are often

the same and the unwillingness to speak about them together may be a political issue."

In a highly competitive environment, companies need to be constantly on the search for new efficiencies. But in the "optimize or rationalize" debate, companies must balance the benefits of cost savings against the need for flexibility and speed. Zara accepts higher production costs to keep production closer to its key markets, enabling the fashion store to respond faster than competitors to changes in customer demand. "We decided to accept higher costs of production so we can manage the 'fashion risk' more accurately," explains Miguel Díaz. "It's about making quick decisions on purchasing and allocating the right products to the right place at the right time." Low costs may confer a competitive advantage, but cut too deep and it could cost you the ability to respond to market changes.

Q16: How important will the following strategies be for optimizing your company's cost structure over the next three years?

(Percent respondents)



KPMG's Perspective

Rationalize or optimize?

Building cost efficiencies into your overall business model can help you gain a sustainable advantage.

In today's competitive environment, companies are under pressure to manage their costs more rigorously. But organizations are moving beyond just the quick wins and searching for more long term strategies to help enable leaner and ever more efficient operations. Companies' strategies to reduce costs are increasingly closely aligned with strategies to improve overall operational performance — thereby helping to increase shareholder value, customer satisfaction and the confidence of stakeholders.

Streamlining the supply chain

One strategy for integrating cost efficiencies into a company's overall business model is for organizations to assess their supply chains, by looking at supplier relationships and contracts and considering opportunities for outsourcing and offshoring. However, organizations should also beware of the potential risks that such options hold for the business. Nowhere is this truer than in the early days of offshoring, where many companies had their fingers burnt by partnering with poor quality or inappropriate providers.

Similar dangers apply when organizations over-exploit their buyer power to squeeze supplier margins. Ultimately you get what you pay for and the pressure on costs may lead to an unacceptable drop in service or product quality. It should not be assumed that a buyer-supplier relationship is a one-way street: even large, financially powerful companies can become unattractive clients and get pushed down their suppliers' priority list.

It pays to put yourself in your suppliers' shoes, and a number of companies with considerable buyer power continue to put time and effort into understanding and working with their supplier base. Managers visit supplier sites, not just to inspect but also to help them improve their operations, which ultimately leads to improved service.

"A more sustainable alternative to cost-reduction is to develop a business model that is inherently low-cost"

Engaging with stakeholders

Cost reductions, however innovative, can invariably be copied by competitors. A more sustainable alternative is to develop a business model that is inherently low-cost. Telephone banking can successfully cut out the real estate costs of running a high street bank, and often leads to increased profitability per customer through the use of sophisticated profiling and targeting to cross sell insurance, mortgages and other financial products.

Some companies offering direct sales only build 'bespoke' products, reducing working capital and inventory costs and avoiding stockpiling equipment that can quickly become obsolescent. Customers benefit from lower prices and products built to their personal specifications.

Seeking greater efficiency should be high on the business agenda, but whether rationalizing the supply chain or moving to a lower-cost business model, companies should seek to ensure that they continue to meet customer expectations. Any cost-reduction activity that compromises service quality may be counter-productive. Indeed, the objective for many companies intent on striving for leaner operations will be to focus on how to reduce the cost base of the business without adversely affecting top line performance.

5. Reconstructing the value chain

"...with large pools of engineering and technology skills to draw on, and no shortage of ambition, many more Asian companies are likely to start jostling for position at the top of the value chain"

Written by the Economist Intelligence Unit

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Like the term ‘business models’, the concept of the value chain means different things to different people. In the survey, the value chain was defined as the inter-linked set of activities required to design, procure, produce, market, distribute a product. Companies must decide where, in this chain of activities, they can add value.

Many companies talk of moving “up the value chain.” For most companies, this appears to mean concentrating on technology and skills-intensive strategies. The two top strategies chosen from a choice of seven for strengthening a company’s position in the value chain are to invest in technology (cited by 36 percent) and to focus on design and development activities (30 percent), according to executives in the survey. The pressure to invest in these two areas is felt particularly keenly by companies in developed markets, who need to deliver ever more innovative and exciting products to justify higher costs than their emerging-market competitors.

ARM has deliberately focused on staying at the top of the value chain, eschewing manufacturing and instead focusing on cutting-edge microprocessor designs that it licenses to major manufacturers of digital products. “A key change has been that you now don’t need to manufacture these technologies in order to design and sell them. Becoming global without manufacturing – that’s how we’ve done it,” affirms Warren East.

ARM’s licensing model enables manufacturers to subcontract costly and highly specialized research and development (R&D) to a third party. It’s an area where companies in developed markets can actually benefit from the outsourcing of business processes such as hi-tech design. “Owning and maintaining microprocessor architecture costs a lot of money,” explains Warren East. “Effectively, our licensing model means companies can share the cost of doing this with their competitors.”

Moving up the value chain, however, often implies a parallel strategy of farming non-core business activities out to other locations where the job can be done more cheaply. Many companies are disconnecting the front-end of the business from back-end processes such as IT and administration. The back-end can then be centralized to create shared services, or relocated to places where resources are cheaper. General Electric, for example, has created a shared service center called GE Capital International Services (GECIS) in India that provides more than 450 business processes to support the company’s worldwide businesses.

> “The balance is shifting over time, partly because of where the talent is, partly because we are getting more customers in China and India”

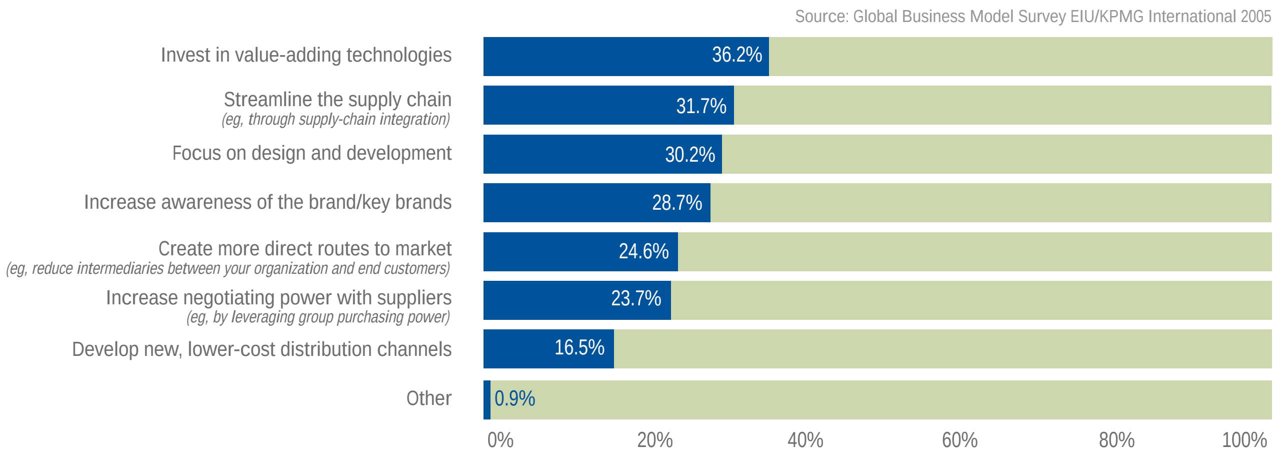
This back-end benefits from greater scale as well as more cost-effective Indian talent. GE businesses can then plug into this centralized back-end, while focusing their own energies on the tasks where the most value is created.

So far, the pattern has been to base less skills-intensive processes in low-cost locations like India, Eastern Europe and China. But if it turns out that skills-intensive tasks can be performed more cheaply and to a high standard in these countries, then the center of gravity for more sophisticated business processes may also begin to shift. Several senior executives from Western companies interviewed for the report comment on the quality of work being done in China or India, and praise the science, technology and engineering talent available in these countries, while bemoaning the dearth of similar skills at home. This is encouraging a growing number of Western companies to tap into R&D skills in emerging markets. Siemens, which spends over 5 billion euro a year on R&D, has set up technology research hubs in Brazil, China and India. “The balance is shifting over time, partly because of where the talent is, partly because we are getting more customers in China and India,” notes Warren East of ARM.

On the flip side of this trend, a growing number of Chinese and Indian organizations are beginning to challenge the West’s monopoly on hi-tech innovation. Lenovo, a Chinese computer company, became a global player at the beginning of 2005 with the acquisition of IBM’s PC business. Huawei, a large Chinese vendor of hi-tech telecoms equipment, invests over 10 percent of its revenue in R&D and is a leader in hot-growth areas such as IP (that is, Internet-based) telecoms networks. Infosys and other hi-tech Indian companies believe they can now compete in areas such as IT consultancy (see box on ‘Mastering global delivery’). Time will tell whether this first wave of challengers will prove successful. But with large pools of engineering and technology skills to draw on, and no shortage of ambition, many more Asian companies are likely to start jostling for position at the top of the value chain.

Q11: Which of the following will your company rely on to strengthen its position in the value chain over the next three years? Select two options.

(Percent respondents)



Case study

Mastering Global delivery

Written by
the Economist Intelligence Unit

Few companies recently have done more to alter the way business is conducted than Infosys. As one of the pioneers of offshoring, the company has been instrumental in changing the traditional approach to providing IT services while at the same time helping to build a booming industry in its own right.

The company's success is based on what it calls its "Global Delivery Model": the idea that processes can be deconstructed into their constituent parts, and then redistributed to the destinations and service providers that can handle them most efficiently. "The key question is, can we disaggregate a business process to make it independent of time zone and geography?" explains Sanjay Purohit, head of corporate planning at Infosys.

Infosys believes this logic applies to almost any business process – and is expanding its suite of services accordingly. The company started out by providing offshore IT services, then moved into infrastructure management and business process outsourcing (BPO). Now it has embarked on a more ambitious path, with the establishment 18 months ago of a new consultancy business – a strategy that brings it into competition with the likes of IBM and Accenture on their home turf.

At first sight, many of the advantages that have sustained the Indian offshoring companies – access to low cost skills in particular – do not appear to apply in a business that requires companies to run large teams of consultants in its clients' markets (typically high-cost western countries). However, Sanjay Purohit argues that consulting can be deconstructed and redistributed just like any other service. He explains that a typical consulting engagement requires both on-site interaction with the client and off-site development, research and analytics.

The latter can be conducted using cheaper, but still highly-skilled staff back in India.An added advantage of this model is that consulting capabilities can be centralized, enabling better knowledge sharing as well as cost-efficiencies to be brought to bear on client projects.

Scalability is another important factor. Infosys is currently running 3,000 projects. But it is the company's ability to grow its talent-base that is most impressive. It recruited over 16,500 people in the past 12 months, screening over 1.3 million candidates in the process. Sanjay Purohit says this requires a highly efficient, but not especially large, HR operation – one that is capable of assessing 10,000 candidates in a single day across seven Indian cities. The company has built the world's biggest corporate training center for IT staff in Mysore, where it is able to educate 4,500 employees simultaneously. Although salaries for Infosys staff are rising by an average of 15 percent a year, the company says that efficiencies achieved elsewhere – in particular, through higher productivity through the use of better technology – mean that wage inflation can be managed.

Nevertheless, Infosys faces several risks. Other large Indian offshoringcompanies offer similar business models and capabilities. Against these competitors, Sanjay Purohit believes the battle will be won on domain expertise, solution capabilities, depth of client relationships and the strength of the Infosys brand.
Other competitive threats come from the Western outsourcing giants who, in response to increased competition, may use their financial muscle to try and buy Infosys's clients. These Western companies are also seeking to build their own global delivery models by relocating services into India and other low-cost countries. Scalability and excellence in execution will be vital defenses against this threat. But this is also an area where Sanjay Purohit feels the Indian outsourcers have an important psychological advantage. "We will go up the value chain, while the traditional IT service providers will move away from their core business model," he observes. "Our change is exciting, energizing. For our competitors, the same model is disruptive, it induces pain and internal conflicts."

KPMG’s Perspective

Reconstructing the value chain

The new global economy is creating a range of outsourcing options, but any decisions should be part of a broader sourcing strategy.

The current trend towards outsourcing has been driven primarily by a desire to cut costs at a functional level, potentially without sufficient consideration of the wider impact upon the business. By outsourcing core activities, organizations can loose control of vital areas of knowledge. And by giving different divisions and subsidiaries the autonomy to outsource and offshore at will, some companies are gaining a massive over-exposure to some countries.

With front, middle and back office all having the potential for outsourcing, the issue should be very much on every Board’s agenda. Yet rather than asking “what can we outsource?”, organizations should be evaluating their entire approach to sourcing and the role it plays in gaining competitive advantage.

By looking at every part of the value chain, businesses can start to determine those activities that are ‘core’, those that are critical and those that are ‘commodities’. They can then assess a range of options such as shared service centers, outsourcing, offshoring and automation. However, any sourcing decision should be at a strategic rather than a tactical level, taking into account service quality, speed to market and of course cost.

Moving up the value chain

While most offshoring has traditionally involved repetitive IT or back office activities, this is now changing. The move towards Knowledge Process Outsourcing (KPO) has seen activities such as research and development

> “Any sourcing decision should be at a strategic rather than a tactical level, taking into account service quality, speed to market and of course cost ”

move offshore particularly to India which has a highly educated, ambitious and low cost pool of talent. India has a very similar legal system to the U.K. and many law firms and internal counsels are making savings by moving high value legal work off-shore.

Organizations should embrace the global economy by re-defining which activities are truly ‘core’ and developing a sourcing strategy with no geographical boundaries. Such an approach can lead to ‘virtual‘ organizations. For example, some mobile phone operators outsource the network, billing, debt recovery and call center and effectively just retain control of the brand. Sportswear companies have radically reconstructed their value chains, moving from being manufacturers to international leisure brands, outsourcing all production. Sourcing from a number of factories gives the flexibility to increase or decrease production levels at short notice to cope with changes in fashion, and avoids the cost of redundant manufacturing facilities and people at times of lower demand.

Deconstructing the value chain also means reassessing the customer proposition. In choosing low-cost financial services, customers understand that they are buying into a relatively lower level of service. Other providers have chosen the opposite direction and differentiate their offer by only using U.K.-based call centers and allowing direct telephone access to branches.

With up to 40 percent of an organization’s cost base having the potential for outsourcing, management can’t afford to ignore the opportunity to access lower cost, highly skilled and flexible resources from around the world. But any sourcing decisions should be at a strategic level to help ensure that the customer offering is enhanced and that core knowledge is retained in-house.

6. Change leadership

"Finding a way to deliver necessary and often significant changes to the business model, while retaining focus, will be a major test for corporate leaders over the coming years"

Written by the Economist Intelligence Unit

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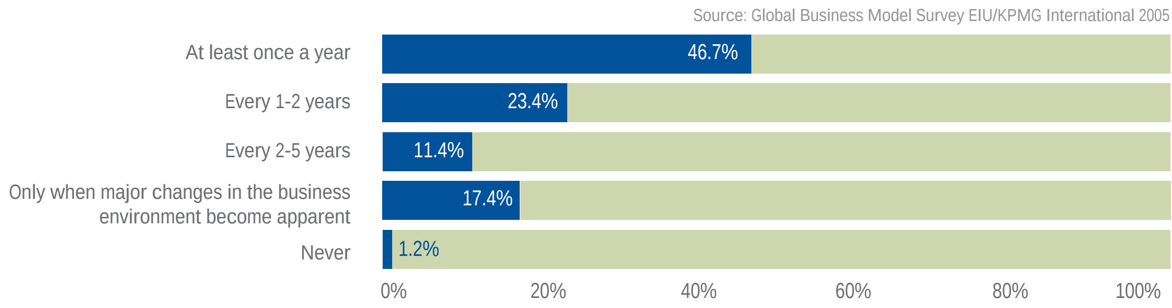
Delivering the scale of change that executives believe is required holds considerable risks for their companies. There are a multitude of barriers to overcome, ranging from lack of resources to inflexible IT systems, and from regulatory hurdles to difficulty in implementing a coherent strategy across different country units or acquired businesses. However, the biggest obstacle of all, cited by over one-half of executives, is uncertainty about where the business environment is heading.

This is partly to do with the sheer pace of change and increased complexity in the business environment. It could also be the result of a lack of strategic vision in senior management, an issue that represents a major barrier to change in its own right according to 36 percent of executives in the survey.

Companies experiencing rapid change in their environment need to analyze their business model more regularly than organizations in a slow-changing environment. For some companies, this has become a rigorous, formal process. Red Hat's key operating executives and board of directors meet every 90 days to review the effectiveness of the organization's business model. At the company's outset, however, Red Hat reviewed its business model even more frequently, at a time when its revenue approach (selling software as a service, not as a proprietary license) had not yet caught on in the market. But this formal approach to business model planning is not restricted to young companies. Siemens, for example, has a dedicated group tasked with updating the company's multiple business models (one for each of the organization's 12 lines of business). Siemens' board also reviews the companies' business models annually to identify where change is needed. "[The business model] has to be maintained as a living, breathing thing," believes Robert Blackburn of Siemens AG.

Surprisingly, given the emphasis on the need for change, many companies are not doing this: only 47 percent of companies formally review the effectiveness of their business model as a whole (as opposed to specific strategies) at least once a year, according to the survey. The rest are at risk of failing to realize when change is needed.

Q18. How often does your company formally review the effectiveness of its business model as a whole (as opposed to specific strategies)?



Often people inside the business pose another formidable problem. Resistance to change from employees is cited by 47percent of companies as a major obstacle to updating their business models. It doesn't help that, in many cases, employees have good reasons to be suspicious of change. Cost-cutting, offshoring and efficiency drives all hold a strong element of threat for individuals in the workforce. Turning those fears into enthusiasm and active involvement in business model change is a daunting task for any manager.

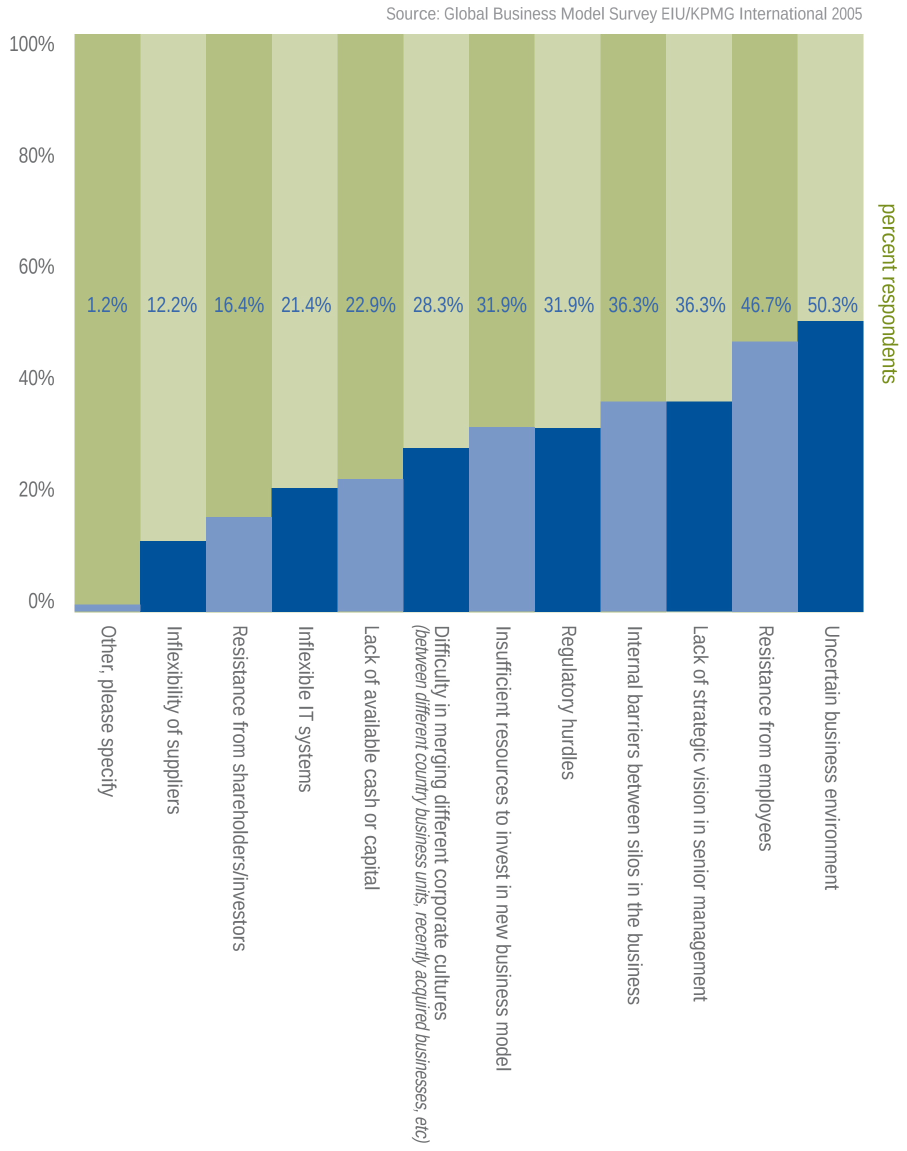
> "Ultimately business models change because "the organization itself learns it has to shift""

Keith Ruddle of Oxford University believes that the problem with shifting the value proposition is that it "exposes the iceberg underneath": all the built-up knowledge, training and habits of the old business model. He argues that change in business models requires commitment from the top, but this is not enough. Ultimately business models change because "the organization itself learns it has to shift". He adds, "You have to engage with massive culture issues down to the front line of the business. Most efforts underestimate the time and effort needed for this 'DNA' shift."

Addressing these cultural issues requires managers to sell change to employees. When Barclays Insurance Services relaunched its product line following a joint venture with Norwich Union, the company started by literally selling its new products to employees. "We believed that if our employees believed in our products enough to buy them, they would become much more effective in selling them to customers," comments Adrian Grace. Diageo, where staff have been through the disruption of several major mergers, emphasizes the importance of keeping staff motivated through a period of major change: "We need to inspire ourselves and our people…to look at what contribution employees can make, and are prepared to make," says Gareth Williams, the company's HR director.

Q20: What do you see as the main barriers to changing your company's business model?

(Select all that apply (Percent respondents))



Selling change to employees can be hard, but there is also the possibility that managers will lead their companies in the wrong direction. Christian Ketels of Harvard Business School sees risk in the sheer scale of change that the survey indicates companies are planning. "Clearly companies understand that the customers are changing, as is the business environment. But strategy needs stability to produce a unique advantage… the degree of change companies are undergoing will not necessary lead to an advantage," he says. Finding a way to deliver necessary and often significant changes to the business model, while retaining focus, will be a major test for corporate leaders over the coming years.

Case study

Business beyond petroleum

Written by
the Economist Intelligence Unit

After the International Panel on Climate Change's 1995 report, BP concluded that governments would probably – and justifiably – take preventative action on global warming. In 1997 it publicly stated its concerns, and left a corporate lobby opposed to the Kyoto negotiations. In 2000 a re-fashioned name that abandoned the original meaning of its constituent initials, a new sun-based logo and a slogan of "beyond petroleum" reflected BP's transformation from an oil to an energy company. Several years on, how has this affected its business model?

According to Nick Butler, the Group's vice-president of strategy, realization that climate change could not be "wished away" was accompanied by an understanding that the world would remain dependent on hydrocarbons in the medium term (by 2015 the company expects renewables to provide just 3 percent of world energy). So, from the late 1990s, BP's business model assumed that, however indispensable, "carbon will be priced".

While BP's main activities are much the same, this shift has engendered large changes in how they are run:

- Cleaner products: Between 2001 and 2004, natural gas rose from 52 percent of the energy BP sold to 61 percent, largely at the expense of oil. Meanwhile, marketing for its new petroleum offering, Ultima, emphasizes environmenta friendliness.

- House cleaning: In 1998 the company committed to a cut in its own CO_2 emissions by 10 percent, a target it reached in 2001 – nine years ahead of schedule. Its current aim is to see no increase in emissions until 2012 despite organic growth in operations.

- Portfolio adjustment: BP recently sold Innovene, its petrochemical business, in a move that is consistent with a focus on energy over petroleum.

- Renewables: Still a comparatively small part of operations, BP Solar – with 30 years' experience and (since 2004) one year of profitability – has grown rapidly into one of the world's largest producers of photovoltaic cells. BP is also considering further wind farms at its refinery sites like the one near Rotterdam. Electricity generation is traditionally the province of utilities, but Mr Butler contends that BP is in the "business of providing heat, light and mobility": its knowledge of the energy market is the competitive added-value that it brings to this field.

This adjusted business model also lets the company perceive technological advances to reduce carbon as business opportunities. It has successfully experimented with CO2 sequestration, a technology to capture emissions and store them in old hydrocarbon fields. Now it has announced a large project in Scotland to separate natural gas into hydrogen and CO2, power an electricity plant with the former, and to sequester the 90 percent of CO2 that could be captured in a North Sea oilfield. The process would provide almost decarbonized electricity and even allow extraction of additional petroleum from the field. Nick Butler noted that, while each new initiative had to be weighed on its merits, BP would consider selling sequestration services should a market develop.

According to Nick Butler, BP's biggest obstacle in integrating priced carbon into its business model was the idea's novelty. The company had to invent, for example, an internal carbon trading system, which helped it to contribute to the creation of the new EU Emission Trading Scheme. The model has already changed many aspects of the company – but has it brought a competitive edge? The initial, internal reduction in CO2 emissions produced significant savings. Nick Butler is the first to admit, however, that any advantage from the other activities will be in the long term, and that this spending is largely a research investment. That said, nothing in the last decade has led BP to question its assumption that the future lies somewhere beyond petroleum.

KPMG's Perspective

Change leadership

Organizations need to embrace change and uncertainty by creating a more fluid business model.

The current pace of change is proving very unsettling for many businesses. We now live in a world where, armed with more information, customers are becoming far more demanding. Regulatory pressure is forcing companies to address their internal controls and become more transparent. Converging technologies are leading to alliances with competitors and the emergence of offshoring is creating fear and uncertainty amongst employees. This pace of change is now endemic and business models need to be more fluid and agile.

Engaging with stakeholders and adapting to change

Organizational change must start at the top and senior managers need to take a genuinely cross-business view by stepping out of their individual fiefdoms. Employees are quick to recognize when there's a lack of strategic vision and unity. Clear, strong leadership is essential.

Many managers are themselves uneasy about how changes may affect their careers and one of the key HR tasks is to recruit and develop people who are comfortable with ambiguity and uncertainty.

Technology can help you compare prices and value, and organizations must adapt to this by placing the customer at the center of their activities and creating a genuine two-way dialogue. Employees are also customers and should be far more involved in the design and testing of new products and services.

> "Managers need to be emotionally mature, and intellectually nimble enough to adapt to complex and changing business relationships"

The post-Enron regulatory environment has created a great deal of fear and companies have to balance the requirement for controls with the commercial needs of the business. By developing a culture of openness and transparency, they can give employees and managers the confidence to take tough decisions and not feel under pressure to constantly react to new compliance requirements or negative publicity.

Outsourcing, and offshoring in particular, has caused fear and uncertainty among employees. Some companies have managed to alleviate much of this fear and uncertainty by treating their employees as adults, openly discussing relevant business issues at an early stage. This has helped everyone to better understand the rationale behind such decisions. Treating people fairly and as adults helps them move on within or outside of the company. It helps to reduce dissatisfaction and keeps morale high. In some instances such an approach has been so effective that the same displaced employees have been prepared to train their replacements.

Business partnerships are also becoming looser, with more short-term alliances being formed, sometimes even with competitors. Managers need to be flexible and emotionally mature enough to deal with such complex and changing business relationships.

Ultimately change cannot be achieved without the buy-in of middle management and engagement of employees. Although strategy is essentially a top-down affair, it should not be directed in the form of missives. Open, honest and relevant communications, with opportunities for feedback, can help spread the strategic vision throughout an organization.

Conclusion:

Rethinking the business model

Written by the Economist Intelligence Unit

The basic tasks of any business don't change: companies must manage their costs, grow their revenue and profits, and keep their customers happy. But how they accomplish these tasks, as encapsulated by the business model, is changing dramatically.

The trend towards global delivery, where processes are deconstructed and shifted to those locations that can do the job most economically and efficiently, is one dimension of this change. Building a customer-centric organization – where customer needs are identified and acted on at lightning speed – is another.

Both these trends require companies to focus clearly on where they can deliver optimal benefit to their customers. That means doing what they are best at, but also partnering with organizations that can complement or augment a company's capabilities in ways that add value to the customer.

In these and other areas, today's managers must preside over a deep-rooted – and often risky – transformation of the business. Having a strategy to address each of these challenges is essential. But companies also need to understand the mechanics of that change – how, for example, the arrival of a new technology affects their approach to market or position in the value chain. Subjecting their business model to regular scrutiny can help companies stay in touch with new – and rapidly evolving – market demands.

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Appendix

Written by the Economist Intelligence Unit

1. Which of the following issues will require your company to make the biggest changes to its business model over the next three years? Select three options.

Expansion of emerging markets	38.69%
Emergence of new technology	37.80%
Regulatory changes	27.08%
Pressures to improve corporate governance	9.52%
Trade liberalization	11.31%
Changing customer requirements/buying habits	32.74%
Population ageing	6.85%
Offshoring and outsourcing	19.05%
Rising oil/raw materials prices	9.82%
Rising interest rates	1.79%
Increased competition from new entrants	25.6%
Increased competition from established competitors	29.17%
Industry consolidation	18.45%
Commoditization	13.99%
Increased focus on corporate social responsibility	3.27%
Pressures on corporate finance (eg, pension fund liabilities, downgrades to credit rating)	5.65%
Other, please specify	3.27%

(Response: 336)

2. Do you view the following as opportunities or threats to your business?

	Major opportunity	Minor opportunity	Equal opportunity/threat	Minor threat	Major threat
Expansion of emerging markets	61.45%	21.08%	11.75%	4.82%	0.90%
Emergence of new technology	43.50%	25.68%	22.66%	6.04%	2.11%
Regulatory changes	10.70%	18.35%	43.43%	19.57%	7.95%
Pressures to improve corporate governance	8.59%	23.01%	51.23%	13.80%	3.37%
Trade liberalization	19.88%	35.47%	32.42%	10.40%	1.83%
Changing customer requirements/buying habits	25.77%	31.90%	22.09%	15.34%	4.91%
Population ageing	13.50%	18.71%	46.32%	18.40%	3.07%
Offshoring and outsourcing	19.51%	29.88%	35.06%	11.89%	3.66%
Rising oil/raw materials prices	4.92%	7.08%	32.62%	35.38%	20.00%
Rising interest rates	2.74%	7.01%	39.02%	40.85%	10.37%
Increased competition from new entrants	5.21%	6.44%	20.25%	46.32%	21.78%
Increased competition from established competitors	3.98%	7.65%	18.35%	39.45%	30.58%
Industry consolidation	8.56%	17.13%	41.28%	22.94%	10.09%
Commoditization	5.96%	9.40%	44.51%	24.45%	15.67%
Increased focus on corporate social responsibility	7.03%	26.91%	57.49%	7.34%	1.22%
Pressures on corporate finance	3.37%	16.26%	53.68%	23.31%	3.37%

(Response: 336)

3. How much change have the following components of your company's business model undergone over the past three years?

	Major	Minor	None
Value proposition	40.49%	45.40%	14.11%
Market sector/Customer segment	37.42%	48.77%	13.80%
Market sector/Geographic markets	35.17%	44.65%	20.18%
Market sector/Product markets	35.28%	52.15%	12.58%
Value-chain structure/position	32.62%	47.69%	19.69%
Revenue generation model	31.10%	49.70%	19.21%
Cost structure	43.60%	43.90%	12.50%

(Response: 330)

4. How much change do you expect the following aspects of your company's business model will undergo over the next three years?

	Major	Minor	None
Value proposition	47.27%	45.76%	6.97%
Market sector/Customer segment	43.33%	47.27%	9.39%
Market sector/Geographic markets	42.86%	43.16%	13.98%
Market sector/Product markets	38.86%	51.51%	9.64%
Value-chain structure/position	38.91%	48.94%	12.16%
Revenue generation model	44.38%	45.59%	10.03%
Cost structure	43.67%	45.78%	10.54%

(Response: 333)

5. Which of the following stakeholders do you expect to be the biggest drivers of change to your business model over the next three years? Select two options.

Customers	79.76%
Private shareholders	12.20%
Institutional investors	8.33%
Governments at home	12.20%
Governments overseas	8.33%
Regulators at home	11.31%
International/overseas regulators	11.31%
Suppliers	11.01%
Employees	12.50%
Business partners/alliances	27.98%
Credit rating agencies	1.49%
Other, please specify	2.08%

(Response: 336)

6. How significant are the following as sources of competitive advantage for your company? Rate on a scale of 1 to 5, where 1 = Very significant and 5 = Insignificant.

	1	2	3	4	5
Quality of customer service	59.28%	25.75%	8.38%	3.59%	2.99%
Skills of management team	51.64%	30.75%	9.25%	5.67%	2.69%
Skills of employees	40.60%	39.40%	13.13%	4.18%	2.69%
Value of intellectual property	29.85%	26.27%	26.87%	11.04%	5.97%
Quality of products	45.21%	35.33%	10.78%	4.19%	4.49%
Choice of products	21.92%	38.44%	28.23%	6.01%	5.41%
Low cost base	22.46%	27.25%	25.45%	18.26%	6.59%
Attractiveness of brand(s)	30.03%	30.93%	21.32%	10.51%	7.21%
Corporate reputation	38.25%	35.84%	17.17%	5.12%	3.61%
Supplier relationships	20.06%	30.24%	26.95%	14.07%	8.68%

(Response: 335)

7. Which areas of your company's competitive advantage will be most difficult to sustain over the next three years? Select two options.

Quality of customer service	27.38%
Skills of management team	22.32%
Skills of employees	31.25%
Value of intellectual property	20.24%
Quality of products	11.01%
Choice of products	14.58%
Low cost base	35.42%
Attractiveness of brand(s)	14.58%
Corporate reputation	8.04%
Supplier relationships	11.31%
Other, please specify	2.38%

(Response: 336)

8. Which of the following strategies will your company primarily rely on to attract and retain customers over the next three years?

Offer unique, highly innovative products and services	36.14%
Aggregate existing products and services to provide end-to-end solutions	13.55%
Tailor existing products and services to precise customer requirements	28.92%
Provide products and services more cost-efficiently than the competition	21.39%

(Response: 332)

9. Which of the following partnership or investment models will your company rely on most to increase market share over the next three years? Select all that apply.

Mergers or acquisitions	40.00%
Joint ventures	33.13%
Strategic alliances	60.90%
Franchizing	7.76%
Greenfield investments	16.12%
Organic growth	62.69%
Other, please specify	1.19%

(Response: 335)

10. Which overseas market do you expect to deliver the greatest sales growth for your company over the next three years?

North America	19.34%
Latin America	4.53%
Asia-Pacific	47.13%
Western Europe	13.60%
Eastern Europe	9.06%
Africa and Middle East	6.65%

(Response: 331)

11. What strategies will your company primarily rely on to strengthen its position in the value chain over the next three years? Select two options.

Streamline the supply chain (e.g., through supply-chain integration)	31.74%
Increase negotiating power with suppliers (e.g., by leveraging group purchasing power)	23.65%
Create more direct routes to market (e.g., reduce intermediaries between your organization and end customers)	24.55%
Invest in value-adding technologies	36.23%
Focus on design and development	30.24%
Develop new, lower-cost distribution channels	16.47%
Increase awareness of the brand/key brands	28.74%
Other, please specify	0.90%

(Response: 334)

12. Which of the following will be most important for growing your company's revenues over the next three years? Select two options.

Diversification into new products and services	40.42%
Geographical expansion (penetration of new markets overseas)	45.51%
Use of digital sales channels	10.48%
Brand building/marketing initiatives	32.34%
Building customer loyalty	44.91%
Low prices	14.67%
Improved relationships/collaboration with suppliers	9.58%

(Response: 334)

13. As a percentage of your company’s total cost base, how much do the following account for?

	0-10%	10-25%	25-50%	50-75%	75-90%	90-100%	Don't know
Employees	9.91%	29.13%	27.93%	18.62%	6.91%	0.30%	7.21%
Outsourced services	56.00%	24.31%	6.15%	2.46%	0.31%	0.31%	10.46%
Supplier costs	23.01%	29.45%	24.85%	11.04%	2.76%	0.61%	8.28%
R&D expenditure	57.58%	24.85%	6.97%	1.82%	0.61%	0.30%	7.88%
Property/Office space	53.50%	27.96%	6.08%	1.22%	0.61%	0.00%	10.64%
IT	50.00%	30%	9.09%	0.91%	0.91%	0.00%	9.09%

(Response: 333)

14. How much will they account for in three years' time?

	0-10%	10-25%	25-50%	50-75%	75-90%	90-100%	Don't know
Employees	9.61%	29.13%	29.13%	18.02%	6.01%	0.00%	8.11%
Outsourced services	38.79%	33.33%	13.03%	2.42%	0.91%	0.30%	11.21%
Supplier costs	25.69%	31.19%	20.49%	9.79%	2.75%	0.92%	9.17%
R&D expenditure	46.85%	31.23%	9.31%	2.40%	1.20%	0.30%	8.71%
Property/Office space	52.12%	28.79%	6.06%	1.52%	0.00%	0.00%	11.52%
IT	46.67%	28.79%	10.61%	3.03%	0.30%	0.91%	9.70%

(Response: 334)

15. How important will the following strategies be for optimizing your company's cost structure over the next three years? Rate on a scale of 1 to 5, where 1 = Critically important and 5 = Unimportant.

	1	2	3	4	5
Domestic outsourcing (i.e., outsourcing to providers in your home market)	10.98%	21.04%	22.26%	22.26%	23.48%
Offshore outsourcing (i.e., outsourcing overseas)	12.05%	21.08%	15.96%	18.37%	32.53%
Establishment of your own production facilities in low-cost market(s)	12.84%	18.81%	15.22%	20.60%	32.54%
Optimization of business processes (e.g., automation of manual processes)	27.16%	35.82%	22.09%	10.75%	4.18%
Reducing headcount	10.51%	22.82%	31.83%	17.42%	17.42%
Rationalizing property portfolio	8.41%	16.82%	25.83%	19.52%	29.43%
Reducing distribution costs (e.g., low-cost sales and service channels, automated call-centers, self-service web sites)	13.81%	28.53%	22.82%	20.72%	14.11%
Reducing procurement and supply-chain costs (e.g., sourcing materials and components from low-cost locations, better supply-chain management)	18.86%	34.13%	19.76%	12.28%	14.97%
Creating shared service centers (e.g., setting up shared infrastructures for processing customer transactions)	14.11%	25.23%	24.92%	18.92%	16.82%
Creating more tax-efficient operations	11.94%	24.18%	28.66%	17.61%	17.61%

(Response: 336)

16. Which of the following is most likely to bring about change in your company's existing funding structure over the next three years?

Need to return capital to shareholders	26.05%
Acquisitions	26.65%
Disposals (subsidiaries)	4.19%
Disposals (assets such as property)	6.29%
Changes in the capital markets	12.57%
Wider choice of available funding options	20.36%
Other, please specify	4.19%

(Response: 334)

17. How important will the following sources of funding be to your company over the next three years? Rate on a scale of 1 to 5, where 1 = Critically important and 5 = Unimportant.

	1	2	3	4	5	Don't know
Equity	22.42%	21.52%	16.36%	10.61%	12.42%	16.67%
Bank debt	5.23%	21.23%	19.69%	17.85%	19.69%	16.31%
Bank loans	6.75%	19.94%	23.01%	17.48%	16.87%	15.95%
Mezzanine financing	2.20%	6.29%	11.64%	10.06%	31.13%	38.68%
Private placements	5.30%	11.21%	11.53%	11.21%	35.51%	25.23%
Bonds	4.63%	9.57%	14.81%	7.72%	37.96%	25.31%
Property/asset-backed lending	3.46%	6.29%	17.30%	11.95%	37.42%	23.58%
Internal cash generation	42.68%	24.70%	12.20%	2.44%	4.88%	13.11%

(Response: 336)

18. How often does your company formally review the effectiveness of its business model as a whole (as opposed to specific strategies)?

At least once a year	46.71%
Every 1-2 years	23.35%
Every 2-5 years	11.38%
Only when major changes in the business environment become apparent	17.37%
Never	1.20%

(Response: 334)

19. Which of the following approaches does your organization use to evolve the business model?

Organic change: Better ways of doing business emerge from experimentation in business units	52.10%
Systematic: Changes to the business model are planned centrally by senior management	47.90%

(Response: 334)

20. What do you see as the main barriers to changing your company's business model? Select all that apply.

Resistance from employees	46.73%
Resistance from shareholders/investors	16.37%
Inflexibility of suppliers	12.20%
Lack of strategic vision in senior management	36.31%
Uncertain business environment	50.30%
Regulatory hurdles	31.85%
Insufficient resources to invest in new business model	31.85%
Inflexible IT systems	21.43%
Internal barriers between silos in the business	36.31%
Lack of available cash or capital	22.92%
Difficulty in merging different corporate cultures (between different country business units, recently acquired businesses, etc)	28.27%
Other, please specify	1.19%

(Response: 336)

In which region are you personally based?	
North America	32.44%
Latin America	4.17%
Asia-Pacific	27.08%
Western Europe	28.27%
Eastern Europe	4.46%
Africa and Middle East	3.87%

(Response: 336)

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