STRATEGIC BUSINESS MODELS

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STRATEGIC BUSINESS MODELS: IDEALISM AND REALISM IN STRATEGY

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INVESTOR IN PEOPLE

For my wife, Nancy, and my children, Sara, Fred, David

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Contents

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List of Figures

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Preface

The capability of modeling business strategy is important to planning and is called a "strategic business model." The technique was introduced by Michael Porter in his value-adding model of business transformations (Porter, 1985). This book describes advances in the technique, including Jay Forrester's earlier approach of depicting the control of business operations (Forrester, 1961).

The importance of a strategic business model as a technique is to assist in discriminating between strategy as "wishful-thinking" and as "future-reality." The major difficulty to successful strategy is (1) to get from the reality of the present and (2) to a desirable future, eventually made real. Wishful thinking is not sufficient as strategy.

For example, in strategy a business is urged to formulate a mission statement. And often such a mission statement has been "to serve customers and benefit stakeholders." And while the intent is desirable (all businesses should serve customers and create profit), it is, in practice, not very helpful. It is an obvious wish, but without operational detail. Which customers and how to provide value to them now and in the future – this is the first real question. Which stakeholders (shareholders, executives, management, labor, public good) and how much to each – this is the second real question. Strategic business models provide a basic technique to figure out, in detail, the realities of the present and the future.

What is unique about this book on strategic modeling is that it provides an analytical technique of six different types, for modeling both manufacturing and financial firms. Previous business modeling did not have this capability, modeling only manufacturing firms. It also enables modeling of conglomerate firms, such as Amazon and Berkshire Hathaway.

Strategic business models are important to understand the transformative operations of an enterprise system for competitiveness in the present and in the future. We will study this technique by applying it to real business cases, some successful and some problematic, and we will see how the reality of the future tested their strategic business models.

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Chapter 1

Modeling Business Strategy

Introduction

A strategic business model is an important and basic technique for business strategy. A four-factor strategic model emphasizes the fundamental factors in any business: *capital*, *profits*, *resources*, and *sales*. And an open-system strategic model places the model within the future environment of the business.

Strategic Business Models

Business organizations are goal-directed and create transformations to reach goals, as an enterprise system. As shown in Fig. 1.1, an enterprise system is an open-system, transforming inputs of resources to outputs of product sales. Also shown in the figure is Michael Porter's model of a goal-directed transformation, shown as a kind of "arrow" (Porter, 1981).

For a production enterprise, the system consists of the coordinated set of productive activities (purchasing, production, inventory) which adds value to resources purchased from the market environment and then sold back into the market as products. Porter's model adds overhead functions to the direct production (transformation) center of the open-system model.

In this two-factor model, *resources* and *sales* provide two basic factors for the direct production transformations of a business operation. But there are also two other basic factors, *profits* and *capital*, that are necessary to an enterprise system. These indicate the factors needed for adding monetary-value in business operations. *Profit* is a measure of business efficiency (the difference between prices and costs of sold products/services). *Capital* is a measure of the asset value of the business, equity as the stock value. Using these, a more general form of business models was constructed as a four-factor model (Betz, 2015).

To construct a strategic business model of any enterprise, one can use the four factors either as inputs or outputs: *resources, sales, profits,* and *capital*. How many types of "business models" can be constructed? Logically, one can list all possible (two by two types of enterprise open-systems) by taking all combinations of the

Strategic Business Models: Idealism and Realism in Strategy, 1–11

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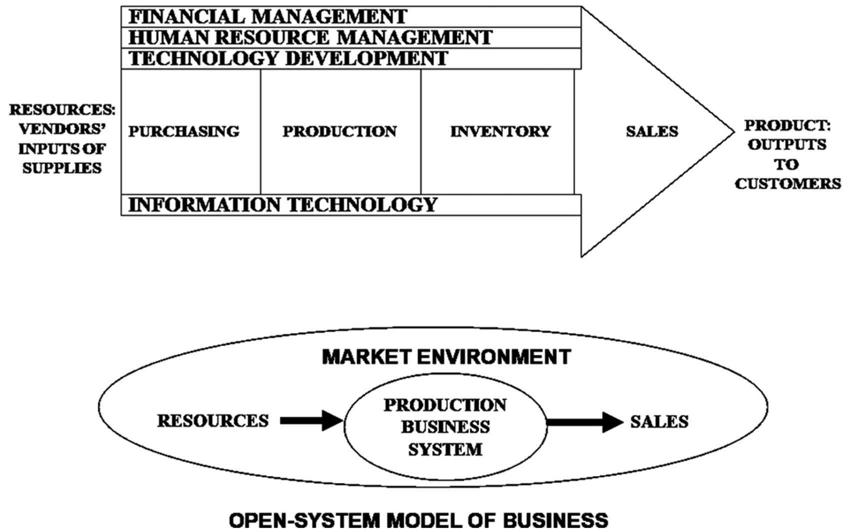

Fig. 1.1: Porter's Value-added Open System Model.

four categories (*resources, sales, profits, capital*) two-at-a-time as inputs and as outputs. Ignoring the order of factors in a combination, one can construct six different models to describe a business, as shown in Fig. 1.2.

The upper box lists the four strategic factors which can be used to construct a strategic business model. The lower box takes them two at a time, as either inputs or outputs, and lists their six logical combinations (ignoring the order of the factors in a combination). The oval depicts the environment for a strategic business model with two inputs and two outputs. Fig. 1.3 sketches the six different forms of strategic business factors.

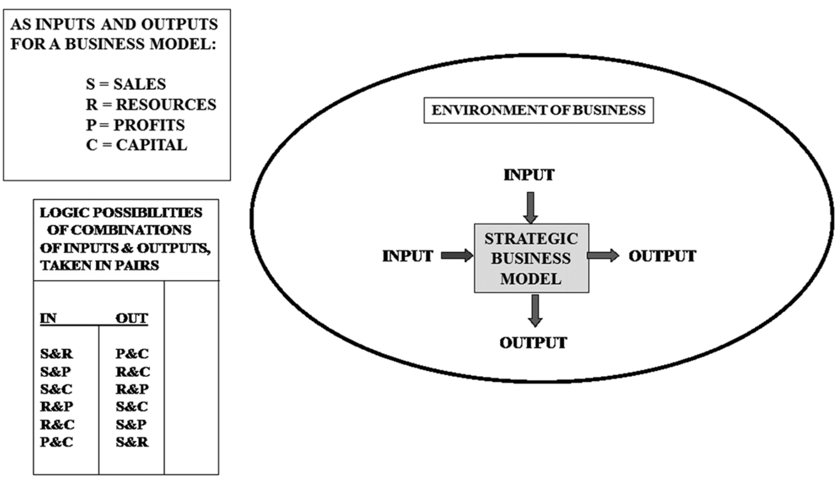

Fig. 1.2: Two Inputs and Two Outputs Strategic Business Models.

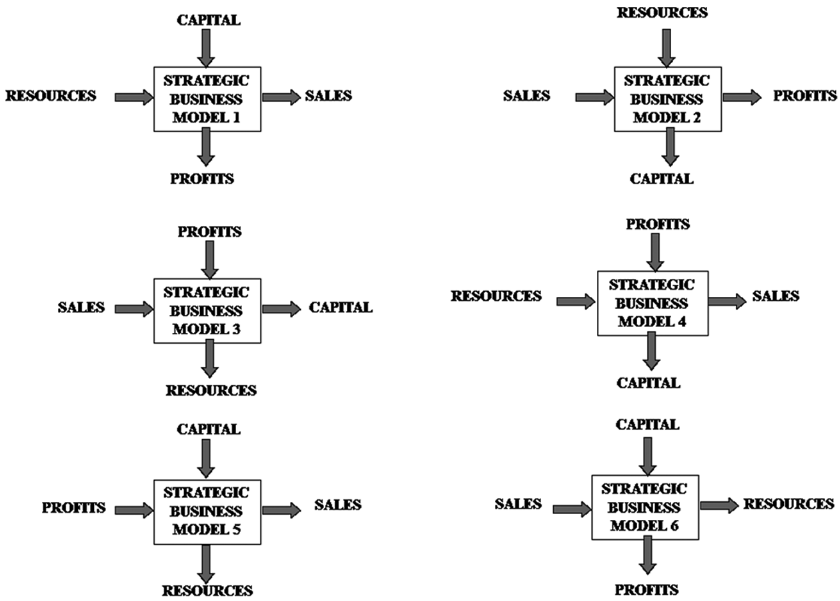

Fig. 1.3: Six Types of Strategic Business Models.

Type 1 model corresponds to Porter's value-added transformation model, with the addition of invested capital as a second input and profits as a second output. (We note that logically one can construct 1×3 models, but these are empirically less interesting than the 2×2 models, shown in Fig. 1.3.)

A business model depicts the operations of a current business in its present competitive situation, and a strategic business model depicts the future operations of the business to face an anticipated future competitive situation. Strategic business models focus strategic change (1) to meet future challenges and (2) to optimize performance measures in the future. Management should focus not only upon successful operation of the present (e.g., current quarter) but also upon preparing now to meet the future challenges (e.g., 2–10 years).

Strategic business models examine whether the present "core ideas" of a business will continue to be viable in the future. About core ideas, Lowell Steele wrote:

> Every business is based ultimately on a few simple ideas, principles, or even assumptions. They address the fundamentals of the business: What products or services do we provide? Who are our customers? How do we compete? How do we define success? How do we behave toward each other? In the aggregate these fundamental features could be termed the concept of the enterprise. (Steele, 1988)

Strategic business models examine such basic assumptions – the fundamentals of a business – as sustainable in the future.

Core ideas are embedded in the "culture" of a firm. Steele emphasized that a business's answers to the fundamental questions of the enterprise is implicit in the shared beliefs and conventions in the culture of the firm. From the experience in successful business operations, managers developed have developed a "business culture" – a culture of shared beliefs and conventions about how the firm should operate, including assumptions about: (1) the nature of the business, (2) the way competitive advantages are gained, (3) a sense of how and why the company became what it is, and (4) conventions about the guidance and operational control of the enterprise. These kinds of issues provide what Steele called the "basics" of a business enterprise. *Strategic business models should address the validity of the shared beliefs and conventions of a business, as continuing into the future.*

Case Study: Amazon Acquires Wholefoods in 2017

First, we use this analysis of strategic models to better understand the strategic differences between Amazon and Whole Foods. In 2017, an example of the need for different types of strategic business models occurred when the Internet firm of Amazon acquired the brick-and-mortar firm, Whole Foods. In this case, the form of a strategic business model for Amazon differs from one for Whole Foods.

Nick Wingfield and Michael J. de la Merced wrote,

> Amazon agreed to buy the upscale grocery chain Whole Foods for $13.4 billion, in a deal that will instantly transform the company that pioneered online shopping into a merchant with physical outposts in hundreds of neighborhoods across the country. The acquisition, announced Friday (June 14, 2017), is a reflection of both the sheer magnitude of the grocery business – about $800 billion in annual spending in the United States – and a desire to turn Amazon into a more frequent shopping habit by becoming a bigger player in food and beverages. After almost a decade selling groceries online, Amazon has failed to make a major dent on its own, as consumers have shown a stubborn urge to buy items like fruits, vegetables and meat in person. (Wingfield & Merced, 2017)

Amazon was one of the first successful Internet retail businesses, beginning by selling books and then expanding into selling many kinds of products, such as music or electronics. Amazon built distribution facilities and purchased products, selling and delivering them to customers, who ordered "online." The acquisition of Whole Foods moved Amazon into running a brick-and-mortar business (wherein customers could walk into a building, select and buy groceries – or, as Amazon planned, order groceries online, and have the groceries delivered).

Wingfield and de la Merced wrote,

> Buying Whole Foods also represents a major escalation in the company's long-running battle with Walmart, the largest grocery retailer

in the United States, which has been struggling to play catch-up in Internet shopping. On Friday, Walmart announced a $310 million deal to acquire the Internet apparel retailer Bonobos, and last year it agreed to pay $3.3 billion for Jet.com and put Jet's chief executive, Marc Lore, in charge of Walmart's overall e-commerce business. "Make no mistake, Walmart under no circumstances can lose the grocery wars to Amazon," said Brittain Ladd, a strategy and supply chain consultant who formerly worked with Amazon on its grocery business. "If Walmart loses the grocery battle to Amazon, they have no chance of ever dethroning Amazon as the largest e-commerce player in the world." (Wingfield & Merced, 2017)

Strategic Business Models: Whole Foods and Amazon

How can one model the business of Amazon and the business of Whole Foods? They must be different models, because Whole Foods is a production-type firm (a retail firm – buying packaged food products and selling these to customers). And, in contrast, Amazon is a conglomerate firm (owning several businesses, including: Amazon's online retailing business and also Whole Foods' grocery business). This case of Amazon's Internet expansion into multiple productive businesses illustrates the need for a complete set of strategic models (including one to depict a conglomerated corporation). While the traditional Porter value-adding business model can depict a single business, such as Whole Foods, it cannot depict the strategy of a diversified corporation, such as Amazon.

Whole Foods acquires food resources from food producers and distributes these (transforming by distribution) to retail grocery stores for sale to customers in the food market (commodity market environment). Fig. 1.4 shows the analysis of the strategy of this kind of productive business in a four-factor model.

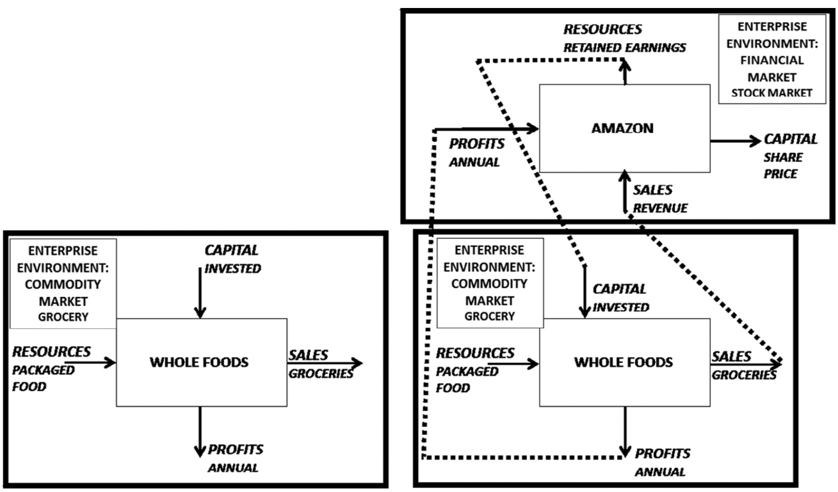

Fig. 1.4: Comparing Business Models for Whole Foods and for Amazon.

Food *resources* is an *input* from the agricultural markets, and *sales* of packaged foods is an *output* to the customers in the groceries market. *Capital* was used to build stores and purchase equipment and inventory and is an *input* to the grocery enterprise system. *Profits* of sales from grocery operations is an output of the enterprise. A production system (such as manufacturing or retailing) can be depicted as Porter value added, transformative system, but with the capital also as an input and profits an output.

But this "production-system" model does not match the reality of Amazon. Fig. 1.4 also depicts Amazon, but as a conglomerate. Amazon is a holding company which owns other businesses, including Whole Foods.

As a conglomerate, Amazon takes *profits* and *sales* from its portfolio businesses (such as Whole Food) as inputs and produces outputs as *resources* and *capital*. Amazon's portfolio businesses report their sales and profits to the conglomerate Amazon's "bottom-line" (balance sheet). Amazon then provides *resources* to its portfolio businesses in the form of investments (such as buying Whole Foods), and Amazon's conglomerate balance statement yields Capital, as Amazon's equity-share price in the stock market.

The strategic business model, for each business in Amazon, transforms value as retail enterprises. Each of Amazon's portfolio companies (such as Whole Foods) takes *resources* as an input (such as packaged food into Whole Foods' grocery stores) and then sells these package foods to customers as *sales*. The invested capital from the conglomerate Amazon is a *capital* input into each portfolio business, and *profit* from *sales* by each business are outputs of each retail enterprise.

Thus two types of business models are needed to depict Whole Foods' operational strategy and Amazon's operational strategy. The need for two models can be seen in the example of Amazon's strategy of acquiring new businesses. Nick Wingfield wrote:

> The company (Amazon) is exploring the idea of creating stores to sell furniture and home appliances, like refrigerators – the kinds of products that shoppers are reluctant to buy over the internet sight unseen …. Amazon is also kicking around an electronics-store concept similar to Apple's retail emporiums …. These shops would have a heavy emphasis on Amazon devices and services such as the company's Echo smart home speaker and Prime Video streaming service. And in groceries – a giant category in which Amazon has struggled – the company has opened a convenience store that does not need cashiers, and it is close to opening two stores where drivers can quickly pick up groceries without leaving their cars, all in Seattle. It has explored another grocery store concept that could serve walk-in customers and act as a hub for home deliveries. Overseas, Amazon is quietly targeting India for new brick-and-mortar grocery stores. It is a vast market, and one still largely dominated by traditional street bazaars where shoppers must wander from stall to stall haggling over prices and deliberating over unrefrigerated meat sitting in the dusty open air. Amazon's internal code name for

> its India grocery ambitions: Project Everest. Last week, Amazon opened its fifth physical book store in Chicago, and it has five more announced locations under construction. (Wingfield, 2017)

A "conglomerate firm" owns several businesses which operate in different commodity markets. Amazon is a conglomerate business, owning different businesses which sell online books, electronics, and other items. Acquiring Whole Foods enabled Amazon to enter the "bricks & mortar" grocery business, connected to Internet shopping. For a conglomerate, such as Amazon, its enterprise-system environment is the financial market. Whereas, for each business (i.e., Whole Foods) owned by the conglomerate, its enterprise-system environment is the commodity market in which its products are sold (i.e., grocery market). This is one strategic difference between a conglomerate and its portfolio of businesses. A strategic output of a conglomerate is *capital*, whereas a strategic output of a portfolio business is a product *sale*.

Accordingly, the strategic factors of conglomerates are these. The output factors for a conglomerate are *capital and resources – capital* as expressed in its stock equity market, and *resources* which the conglomerated can provide as capital invested in its portfolio of businesses. Input factors are the *profits* and *sales* reported by its portfolio businesses to the conglomerate.

From these two examples, one can see the usefulness of analyzing business models for firms with four strategic factors (*sales, resources, profits, capital*) instead of the traditional two factors (*sales* and *resources*). A four-factor strategic business model can distinguish between conglomerate firms and commodity businesses. We will next review how a four-factor model can also distinguish between production firms and financial firms.

Case Study: The Commercial Bank of Wells Fargo in 2016

Wells Fargo is a commercial bank. And traditionally, commercial banks have focused upon accepting deposits from savers (people and businesses) and then loaning money to borrowers (people and businesses). Commercial banks pay interest on the deposits and receive interest from the loans. Profits occur from the difference on the rate of loan interest being larger than the rate on deposit interest. Since loans are for a fixed period, and deposits can be withdrawn at any time, there can be a problem with liquidity for a bank. If deposits are all withdrawn at once, a "bank run," occurs as a bank cannot return all the deposits at once (since most of the capital is loaned out). For this reason, in a nation, banks can borrow capital from a national central bank, to prevent bank runs.

Fig. 1.5 depicts a strategic business model proper for a commercial bank, such as Wells Fargo (and compares it to a production model, such as Whole Foods).

Banks make loans, which must be paid back over time. *Sale of loans* is input to the bank enterprise system, and *Resources* as c*redit* is an output of the system (Resource of credit is to the banks's loan customers). *Profit* is also an output, as the *difference between interest rates* on loans and deposits. *Capital* is an input in the form of *savers' deposits* (and in the form of a *discount-window account* at the central bank,

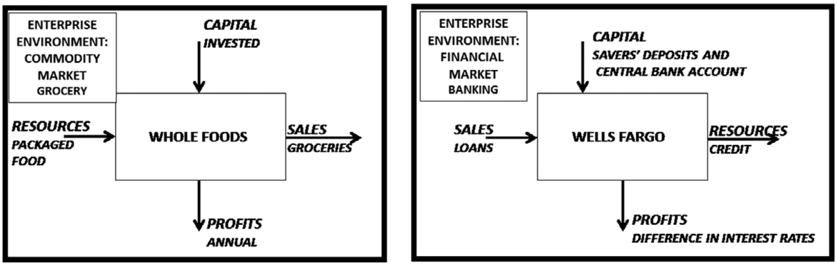

Fig. 1.5: Strategic Business Models for Whole Foods and for Wells Fargo.

such as the Federal Research System in the United States, the US central bank). The *enterprise environment* of a bank system is the *financial market*, for banking. One can see that a financial firm strategically differs from a commodity-production firm in that *resources* are an output (not an input) and *sales* are an input (not an output).

In fact, there is the case of a commercial bank in which executives pushed the wrong strategy upon its employees, forcing employees to behave unethically. This was case of Wells Fargo in 2016. Then the US government finally discovered that Wells Fargo executives had encouraged fraudulent practices in the bank. It learned this from "whistle-blowers," who had tried to call attention to this, beginning with Julie Tishkoff, an employee in 2005.

Stacy Cowley wrote,

> In 2005, the year John G. Stumpf became president of Wells Fargo, Julie Tishkoff, then an administrative assistant at the bank, wrote to the company's human resources department about what she had seen: employees opening sham accounts, forging customer signatures and sending out unsolicited credit cards. She kept complaining for four years, and she was not alone. For years, similar complaints from Wells Fargo workers flowed in to the bank's internal ethics hotline, its human resources department, and individual managers and supervisors. In at least two cases in 2011, employees wrote letters directly to Mr. Stumpf – who became the company's chief executive in 2007, and its board chairman in 2010 – to describe the illegal activities they had witnessed. (Cowley, 2016)

Yet in 2009, Wells Fargo fired Ms. Tishkoff.

Wells Fargo's leadership did not act promptly to correct the abuse. Cowley wrote,

> Since the ethics scandal erupted in public last month (September 2016), Mr. Stumpf has testified twice in front of Congress that he and other senior managers only realized in 2013 that they had a big problem on their hands – two years after the bank had started firing people (whistle-blowers) over the issue. Now, regulators, lawmakers, current and former employees, and others are asking: How was it that this drumbeat of complaints did not set off loud

> alarm bells earlier? And why have the brunt of the firings fallen on low-level workers, not on the managers and executives who shaped the company's aggressive sales culture? (Cowley, 2016)

Why had Wells Fargo executives pushed so hard on employees to generate checking and credit accounts? The push was to increase fees to increase bank revenue, in order to justify high executive bonuses.

Finally, Wells Fargo executives were held accountable for the scandal. Stacy Cowley wrote,

> While questioning Mr. Stumpf in a House Financial Services Committee hearing last month, Representative Maxine Waters, Democrat of California, said. 'It appears that there were activities going on that indicate you may have known much earlier.' Ms. Waters pointed to court filings from 2008 from employees who tried to blow whistles, and to a Wells Fargo sales quality manual that was updated in 2007 – just months after Mr. Stumpf became chief executive, and with his executive guidance – to remind employees that they needed to obtain a customer's consent before opening an account. Ms. Tishkoff was fired in 2009. At least two of her supervisors were aware of her complaints and ignored them, according to a wrongful termination lawsuit she filed against Wells Fargo in 2011. (Cowley, 2016)

In 2016, the supervisors, responsible for the whistle-blowers firing, had still remained with the bank and some became regional presidents. But in October 2016, John Stumpf retired from being Chairman and CEO of Wells Fargo. And Wells Fargo paid $185 million in fines for opening two million customer accounts and credit cards without authorization (Cowley, 2016).

One can partly explain this behavior by Wells Fargo executives – partly on bad business ethics and partly because they had not been using a proper kind of strategic business model (of loans and credit) to optimize profits. Instead Wells Fargo executives were using a Whole Food production model – in trying to make more profits from checking and credit card accounts, even fraudulently obtained checking and credit card accounts. This case emphasizes the importance of using the right strategic business model to guide executive leadership. Executives with wrong business ideas can lead employees to act ineffectually and even fraudulently. *Wells Fargo should have used a conglomerate model and separately model its two businesses of loans and credit cards, both as two financial businesses (using proper banking ethics for each).*

All businesses are complex activities and may appear confusing, as to which factors are critical in a specific business context. A strategic business model assists in making clear how important are the different factors, in the conduct of the business.

Enterprises Systems and Business Environments

The six types of business models provide different models of operational emphasis in current and/or future operations – depending upon what kind of enterprise performance one wants to optimize in business strategy. The advantage of going from a two-factor model to a four-factor model is that the additional factors enables one to analytically model financial firms and conglomerate firms and financial firms.

Earlier in Fig. 1.1, we had noted that Porter's two-factor value-added business model was an open-system model within a business environment. Accordingly, we can also express the generalized four-factor strategic model as a system-model by including notation for an environmental system, enclosing each strategic business model, as shown in Fig. 1.6.

The ovals around the strategic models express what in the field of Logic is called a "Venn diagram." This indicated that all the components within the curve of a Venn diagram are included within the "logical domain" indicated by the curve boundary. All the components of a strategic model are within the boundaries of the environment of a business. The Venn diagram indicates that business activities occur within a business environment. By expressing the strategic business model this way as an open system within a business environment, we are emphasizing that all businesses are a kind of system, which has been called an "enterprise system."

In a business enterprise, policies control procedures which control operations which control activities. Strategic planning for the enterprise focuses upon what policies need to be changed to properly control activities in the future, the long-term of activities. Therefore, a strategic business model formulates the policies that will guide business activities in the future, and these policies need to be correct for success in the anticipated business environment of the future.

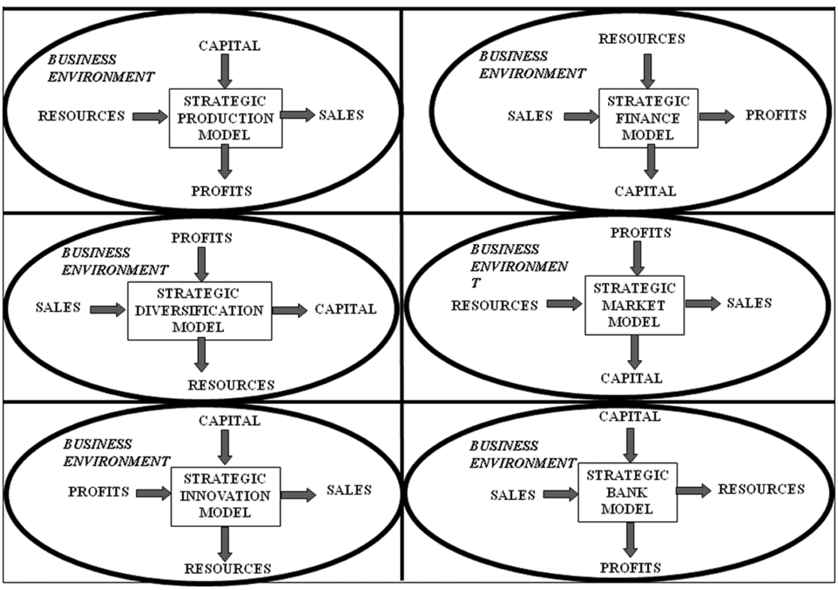

Fig. 1.6: Types of Enterprise Systems Strategic Business Models.

A strategic business model makes explicit the strategic policies of future operations in a future environment. In a later chapter, we will depict how to model the strategic environments of an enterprise system.

Summary

Strategic business models are important and basic to strategic thinking in a business. A four-factor strategic model emphasizes the four basic factors of any business: *capital, profits, resources, sales*. And an open-system model places a strategic model within the environment of the business, economic, political, technological, and cultural societal sub-systems.

> A strategic business model depicts how the relationship of the four business factors (capital, profits, resources, sales) in the basics of an enterprise can make explicit what should be the strategic policies for the reality of future operations. The future environment of a strategic business model depicts the reality of the societal context in which a business will need to operate.

(We note that what is left out of the strategic business model – the overhead activities of Porter's value-added arrow – can be brought back into the strategic model as an embedded operations model – which we review in Chapter 5.)