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# Business model innovation and third-party alliance on the survival of new firms



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## ABSTRACT

In this study, we address the question of how the degree of business model innovation affects the survival of new firms. We present a newly constructed data set of 129 new firms that launched electronic trading platforms in the US bond market between 1995 and 2004 following the advent of Internet technology. We analyze the founding and survival of these new firms during the period of our study. We find that new firms with a high or low degree of business model innovation are more likely to survive for longer than new firms with a moderate degree of business model innovation. We show that partnering with third-party firms with complementary assets reduces the survival of new firms as the degree of business model innovation increases. We discuss the implications of our findings for managers, policy-makers and researchers.

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## 1. Introduction

Business model innovation is increasingly becoming a priority for managers in terms of creating competitive advantage and achieving superior performance (see [Baden-Fuller and Morgan, 2010](#); [Calia et al., 2007](#); [Esslinger, 2011](#)). Studies have shown that firms that have grown their operating margins faster than their competitors have placed twice as much emphasis on business model innovation than have underperformers ([IBM, 2008](#)). Business model innovation is particularly important for new firms because it influences their competitive position and, hence, chances of survival ([George and Bock, 2011](#)). However, there is a lack of empirical evidence regarding the relationship between business model innovation and the survival of new firms. To address this empirical lacuna, in this paper we examine the relationship between the degree of business model innovation and third-party alliance on the survival of new firms in the US bond markets.

Scholars have emphasized the importance of studying the survival of new firms, as it can influence the incentives for firms to invest in costly and risky attempts to pioneer new markets ([Min et al., 2006](#)). Significant work has been undertaken on how incremental and radical innovation affects the survival of new firms; some studies have argued that radical innovation increases the chances of survival of new firms, while others have argued the reverse (see [Buddelmeyer et al., 2010](#); [Sinha and Noble, 2008](#)). However, extant literature has

studied the degree of product and process innovation and its impact on the survival of firms, but not business model innovation. Recently, scholars have emphasized the importance of business models for firm performance ([Calia et al., 2007](#); [Markides, 2006](#); [Patzelt et al., 2008](#); [Zott and Amit, 2008](#)). However, little is known about how business model innovation affects the survival of new firms.

The business model is a structural template that describes the system of interdependent activities transcending the focal firm and spanning its boundaries in order to create and capture value ([Zott and Amit, 2001](#)). In this sense, the business model is the realized strategy of the firm and is a combination of complementary resources that support the commercialization of core products ([Vidal and Mitchell, 2013](#)). It follows that business model innovation involves a more systemic change than product or process innovation because it involves changes to the customer value proposition, value creation and value capture ([Markides, 2006](#); [Velu and Stiles, 2013](#)). Hence, the degree of business model innovation could have a different effect on firm survival compared to product or process innovation. Moreover, the degree of business model innovation needs to be studied by transcending the firm boundary and examining how partner firms with complementary assets might influence firm survival. Although there is an extensive body of literature on profiting from product and process innovation using complementary assets, the role of business model innovation is relatively unexplored ([Teece, 2006](#)).

In order to examine these issues we use contingency theory and profiting from innovation theory to develop hypotheses and to test them empirically. Contingency theory seeks to understand the relationship between certain firm factors and performance ([Zott and Amit, 2008](#)). We explore an organizational structural form, the

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degree of business model innovation as a contingency factor in determining the survival of firms, a crucial form of performance. We then use profiting from innovation theory to develop our understanding of how the degree of business model innovation and partnering with third-party firms with complementary assets jointly impact the survival of firms.

In order to investigate how initial business model innovation affects new firm survival we collected detailed data on every new firm that launched an electronic trading platform in the US bond markets between 1995 and 2004 following the advent of Internet technology. The literature on business models is still at a nascent stage and the business model innovation construct is not well operationalized in empirical studies (see [Baden-Fuller and Morgan, 2010](#); [George and Bock, 2011](#)). However, to make progress in terms of enhancing our understanding thereof, we must – at least at this initial stage in the evolution of research on the phenomenon – focus on its core elements, even if this means sacrificing some of the richness of the phenomenon ([Dasgupta, 2002](#); [Debreu, 1991](#)). In this research, in order to operationalize the degree of business model innovation, we developed a survey to measure the construct at a level that is both abstract and parsimonious enough to permit testable predictions, and yet complex enough to retain the core elements of the phenomenon. In particular, we measured the degree of business model innovation using expert bankers and also collected other detailed data on the platforms to control for factors that might influence survival. To the best of our knowledge this is the first data set of its kind to address the important question of business model innovation and firm survival. We analyze the founding and survival of 129 new firms during the period studied.

The study attempts to make a contribution to the innovation literature by examining the contingent effects of the degree of business model innovation on firm survival and how third-party alliance for complementary assets moderates such a relationship. Our first finding is that new firms with a high or low degree of business model innovation are more likely to survive longer than new firms with a moderate degree of business model innovation. Second, we show that partnering with third-party firms with complementary assets reduces the survival of new firms as the degree of business model innovation increases.

## 2. Relevant literature and hypotheses

Product innovation implies different customer benefits relative to previous products in the industry ([Chandy and Tellis, 1998](#); [Markides, 2006](#)). On the other hand, process innovation involves improvement to the production or distribution processes, which reduces the average costs and increases profit margins ([Cohen and Klepper, 1996](#)). Business model innovation involves the discovery and adoption of fundamentally different modes of value proposition, value capture and/or value creation to an existing business ([Markides, 2006](#); [Teece, 2010](#)). It follows that business model innovations involve systemic changes to the value proposition, value creation and value capture. Despite the importance of business model innovation and the considerable popular interest in such innovation, systematic research on the subject remains sparse. Although much of the literature focuses on the definition of business model innovation, scholars and practitioners increasingly agree on its importance in business strategy ([Johnson et al., 2008](#); [Zott et al., 2011](#)). In order to understand better business model innovation, we need to understand the nature of the innovation.

Scholars have emphasized the importance of classifying the nature of innovation appropriately in order to understand its implications (see [Linton, 2009](#)). Innovations have often been

described as either incremental or radical in order to distinguish between refining and improving an existing design and introducing a new concept that departs significantly from past design (see [Abernathy and Clark, 1985](#); [Henderson and Clark, 1990](#)). Incremental innovation is the introduction of relatively marginal or minor changes to an existing product or process that exploits the potential of an existing design (see [Friedman et al., 2008](#)). Therefore, incremental innovation can be seen as something that is relatively easy for an established firm to implement and which reinforces its dominance, as it requires few modifications to the firm's current routines and processes. On the other hand, radical innovation is based on significant departures from existing design and potentially opens up new applications and markets (see [Friedman et al., 2008](#)). Therefore, radical innovation requires significant changes to the organizational routines and processes of established firms.

The impact of the degree of innovation on the survival of firms has been varied. On the one hand, studies have shown that radical innovation reduces the chances of firm survival as a result of the increased level of uncertainty (see [Buddelmeyer et al., 2010](#); [Christensen, 1997](#); [Utterback, 1994](#)). On the other hand, studies have shown that firms that adopt radical innovation are more likely to survive because of higher returns from adoption as a result of gaining a larger market share (see [Langerak et al., 2009](#); [Sinha and Noble, 2008](#); [Srinivasan et al., 2004](#)). However, extant studies have examined the impact of the degree of product and process innovation, not business model, on firm performance. However, business model innovation involves a more systemic change than product or process innovation. Hence, radical business model innovations can be disruptive when they change the bases of competition by altering the performance metrics by which firms compete ([Daneels, 2004](#)).

Several recent studies have found that competitive pressures have pushed business model innovation to the top of the priority lists of CEOs in order to improve performance ([IBM, 2008](#); [GE Global Innovation Barometer, 2013](#)). Scholars have highlighted business model innovation as a vehicle for corporate transformation and renewal ([Zott et al., 2011](#)). [Demil and Lecocq \(2010\)](#) explain the use of the business model concept as a tool to address change and innovation through a process of experimentation, refinement and reinvention; [Sosna et al. \(2010\)](#) discuss how trial and error learning can act as a basis for business model innovation; and [Johnson et al. \(2008\)](#) articulate cogently that successful business model transformation follows on from a new understanding and redefinition of the customer value proposition. Studies have also highlighted the need for strategic leadership to overcome barriers caused by the cognitive limitations of senior management and asset reconfiguration in order to effect business model innovation for performance improvement ([Aspara et al., 2013](#); [Doz and Kosonen, 2010](#)). [Bock et al. \(2012\)](#) add to this line of inquiry by showing the effect of culture and structure on strategic flexibility during business model innovation. In addition, recent studies have highlighted the importance of service based customer value proposition for business model innovation in the context of technology shifts ([Tongur and Engwall, 2014](#)), the role of technology transfer organizations ([Landy et al., 2013](#)) and embedding cost-effective designs in order to form a commercially viable business concept ([Chen et al., 2014](#)).

The characteristics of new firms have been shown to affect performance, depending on the type of business model pursued by the firm ([Patzelt et al., 2008](#)). For example, in the pharmaceuticals industry, the founding members' experience positively influences the performance of platform firms that focus on the commercialization of research services or enabling technologies, while it negatively influences therapeutics firms that focus on biotherapeutic products (drugs). This is because the therapeutics business

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