

Business Model Design: An Activity System Perspective

Christoph Zott and Raphael Amit

Building on existing literature, we conceptualize a firm's business model as a system of interdependent activities that transcends the focal firm and spans its boundaries. The activity system enables the firm, in concert with its partners, to create value and also to appropriate a share of that value. Anchored on theoretical and empirical research, we suggest two sets of parameters that activity systems designers need to consider: *design elements* - content, structure and governance - that describe the architecture of an activity system; and *design themes* - novelty, lock-in, complementarities and efficiency - that describe the sources of the activity system's value creation.

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Introduction

Consider the case of FriCSO, a young engineering company that has achieved a significant technological breakthrough in friction reduction technology.¹ Friction is the arch enemy of mechanical systems - it reduces the power of machines, leads to overheating, and causes wear, breakdown and seizure in moving parts. Suppose FriCSO's technological invention can reduce friction by over 15,000%: surely such a staggering technology - with clear and wide applicability to products and industrial applications that involve moving parts (such as machine manufacturing, automobile, shipbuilding, etc.) - will be a sure bet for commercial success? Or will it?

Once a target industry (say, automobile) has been chosen, what kind of company should be built to commercialize the intellectual property? What 'model' or 'template' should a firm adopt in order to embed itself into the existing ecology of original equipment manufacturers (OEMs), and the myriad tier one, two and three industry suppliers? Should it choose to become a machine

manufacturer, building machines that embed the new technology, and selling them to the OEMs? Or would it be better to build and operate a factory (a ‘job-shop’) that would perform the surface treatment of moving parts for clients who would outsource that step in their commercial production line to the focal firm’s factory? Or would it be better to opt for a pure R&D firm model, and simply sell the technology (e.g., via licensing agreements) to third parties such as machine manufacturers?

Each of these choices involves a fundamentally different business model, that is, implies a different set of activities, as well as the resources and capabilities to perform them - either within the firm, or beyond it through cooperation with partners, suppliers or customers. And each choice will have implications for the venture’s performance potential - it will affect what capital expenditures are necessary, what prices can be charged and what margins earned, and, perhaps most importantly, which customers and competitors the new firm will deal with. In other words, the design of the business model is a key decision for an entrepreneur who creates a new firm — and a crucial - perhaps more difficult — task for general managers who are charged with rethinking their old model to make their firm fit for the future. Once the template is set, the activities are in place, and the resources have been developed and honed, that template will be difficult to change, due to forces of inertia and resistance to change.

Given the vital importance of the business model for entrepreneurs and general managers, it is surprising that academic research (with a few exceptions) has so far devoted little attention to this topic. We need a conceptual toolkit that enables entrepreneurial managers to design their future business model, as well as to help managers analyze and improve their current designs to make them fit for the future. This article draws attention to the system of activities performed by the focal firm as well as by third parties (partners, suppliers, customers) as part of the focal firm’s business model. We believe that improved knowledge about how to describe the architecture of the activity system, e.g., its key design parameters, will bring the importance of the topic to the forefront of managers’ and researchers’ thinking, and help them design better business models. In particular, we suggest concepts that are intended to:

- give managers and researchers a ‘language,’ concrete tools and a tight framework for business model design that can foster dialogue and promote common understanding;
- highlight business model design as a key task of the entrepreneurial manager;
- emphasize the importance of system-level design, as opposed to partial optimization (for example, whether a particular activity should be outsourced or conducted in house).

We start by describing the firm’s activity system and explain how it captures the essence of its business model, and then support this idea with a brief review of the recent literature on business models. We draw on our own recent work on business models to suggest two sets of parameters that activity systems designers need to consider: *design elements* (content, structure and governance) that describe an activity system’s architecture, and *design themes* (novelty, lock-in, complementarities and efficiency) that describe the sources of its value creation.²

Activity system: key to understanding the firm’s business model

Our previous work notes that the overall objective of a focal firm’s business model is to exploit a business opportunity by creating value for the parties involved, i.e., to fulfill customers’ needs and create customer surplus while generating a profit for the focal firm and its partners. That objective is reflected in the customer value proposition, and has been characterized by Magretta as ‘*the value creating insight on which the firm turns*’.³ An *activity* in a focal firm’s business model can be viewed as the engagement of human, physical and/or capital resources of any party to the business model (the focal firm, end customers, vendors, etc.) to serve a specific purpose toward the fulfillment of the overall objective. An *activity system* is thus a set of interdependent organizational activities centered on a focal firm, including those conducted by the focal firm, its partners, vendors or customers, etc.. The firm’s activity system may transcend the focal firm and span its boundaries,

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