NOT FOR FREE

Revenue Strategies for a New World

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INTRODUCTION

Nothing's Free

Revenue Challenges, Revenue Opportunity

Back in the days of the dot-com bust, it was common to mock entrepreneurs and investors for thinking they could be successful without a clear and credible plan for how their business would make money. Those taunts of start-ups and spin-offs were deserved. Yet over the last decade we've seen established companies with decades of success suddenly find themselves in the same position—without a business model that fits the reality of their competitive market.

Business model disruption is rampant, not because companies have stopped offering products that people want but because consumers stopped being willing to pay for many products at the same levels in the same ways. "Free" took hold of consumer consciousness in no small part because of the hollow promises given by many Internet start-ups. Those first affected by the phenomenon of free, including many businesses in the media industry, have experienced dramatic consequences: the music record labels saw revenue declines of 40 percent from their 2000 high; newspapers lost 85 percent of classified revenue from their print editions between 2005 and 2009; and long-distance telecommunications revenues declined by 80 percent in the first decade of the century.[1] Venerable companies like Warner Music and Time Inc. have started to look a lot more like Pets.com than anyone could have imagined ten years ago. Even nonmedia industries are more affected by free than most would like to admit, as industries as far flung as retail banking, software, and consumer electronics have been pressured to sweeten their offerings with "free" add-ons, additional functionality, and lower prices.

Many traditional companies have spent the past decade doing their best imitation of the little Dutch boy using his finger to plug the hole in the dike. Cable providers such as Time Warner Cable and Cablevision are fighting with content providers over the fees they pay for programming, resulting in a number of high-profile channel blackouts, including one in New York on Oscar night. *Time* magazine is implementing a new paywall model as I write this that will require readers to have some type of subscription to read a story, either to the physical magazine or through an iPad. And the *New York Times* felt that shifting away from free was so difficult, it needed to announce a change in pricing almost a year in advance. The net outcome of these examples seems to be baffled and belligerent customers, confused partners, and less than stellar revenue results.

Yet these examples only offer part of the story. A number of stories coming out of the media industry and elsewhere also show companies going beyond free, and succeeding. These efforts largely involve innovations around the revenue model—the pricing of products, how they are packaged, and who pays for them. Those are the stories I'll tell in this book.

Learning from Media

I suspect that many executives struggling with stagnant or falling revenue, tight credit, and uncertain prospects for growth have taken some solace in the fact that they are not in the media industry. The struggles experienced by many sectors of media are well known: shrinking revenues, consumers who steal the product and then distribute it freely, rapid technology change, competition from a range of sources, and supply chain disruptions and defections. Almost everything that could go wrong for music, magazine publishing, radio, newspapers, and broadcast television has gone wrong in the last fifteen years.

Of course, some of the damage to these sectors has been self-inflicted. From music suing its biggest fans over piracy and then refusing to take the opportunity to sell individual songs as well as albums, to print newspapers waffling between giving content away for free and charging for it, it seems that media has not missed an opportunity to miss an opportunity. Infrequently has any sector in the industry learned from the experience of another sector. As one television executive I spoke to recently told me, "Music may have gotten hit by a bus when peer-to-peer sharing blew up the revenue model, but television is just committing suicide."

It's easy from the outside to engage in a bit of schadenfreude and simply dismiss media's experience as the result of unique circumstances and poor management. That would be a mistake. The reality is that the external and internal factors affecting media are not unique to the sector. In fact, media is the proverbial canary in the coal mine for all sorts of industries. The external trends driving change to the sector are:

- Ubiquitous low-cost communications
- Virtually unlimited low-cost bandwidth
- Virtually unlimited, low-cost, real-time data processing power
- Consumer expectations for personalization, control, relevance, and timeliness
- Rapid technological and competitive innovation

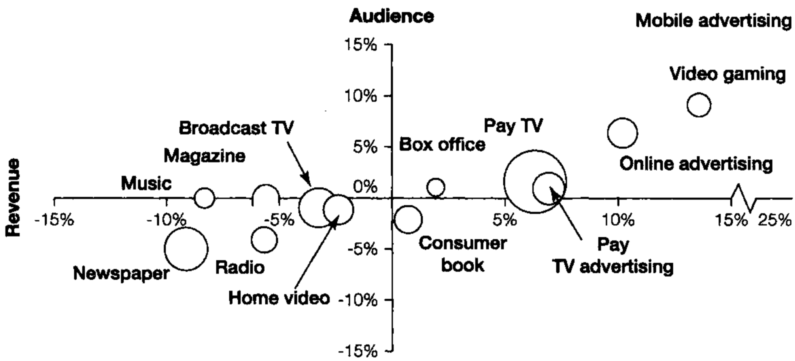
These trends affect many businesses in most every industry. The magnitude and speed of those effects vary, of course, but no industry is immune.

In terms of internal causes, executives in the media industry are neither uniquely shortsighted nor complacent and greedy. The organizational, even human, dynamics that led to many of the mistakes and poor decisions are shared. Numerous influential books and articles drawing from all industries have documented how and why people fail to see challenges and opportunities, execute necessary change, and innovate new solutions: *Good to Great*, *Blue Ocean Strategy*, *The Innovator's Dilemma*, *The Origin and Evolution of New Businesses*, *When Growth Stalls*, *Switch*, and *Leading Change*.

Furthermore, the story of the modern media industry isn't just a litany of failure. Music, print media, radio, and broadcast

FIGURE I-1

U.S. media projected growth, 2008–2012



Note: Size of bubble = 2008 revenues: revenue streams include advertising.

Sources: Veronis Suhler Stevenson Communications Forecast 2009; IBM Institute for Business Value analysis.

television have taken a beating in recent years, especially during the recession. Some companies have their worst years still ahead of them. But others have prospered (see figure I-1). Video gaming has seen double-digit growth. Mobile advertising is expected to explode. Google, Amazon, and Apple are well-known success stories, with growing portions of their revenue streams and value propositions derived from media. Beyond those well-chronicled companies, there are also examples like Redbox (which has captured an 18 percent share of the video rental market in just a few years) and the *Financial Times*, which has grown revenue while its sector peers have seen their incomes crash.[2] Then there are Pandora, Blyk, Spotify, Hulu, Gawker Media, and many other undeniable success stories.

There are lessons to be learned from the media industry, both positive and negative, about how to cope with the economic environment and business context trends that all industries are facing. Those lessons are the focus of this book.

More specifically, I focus on the business model innovations that are required for any company to be successful in an environment of ubiquitous communications, virtually unlimited bandwidth and processing power, changed consumer expectations, and rapid innovation. Business model innovation is a broad topic, so I'm going to focus specifically on the revenue side of the business model equation.

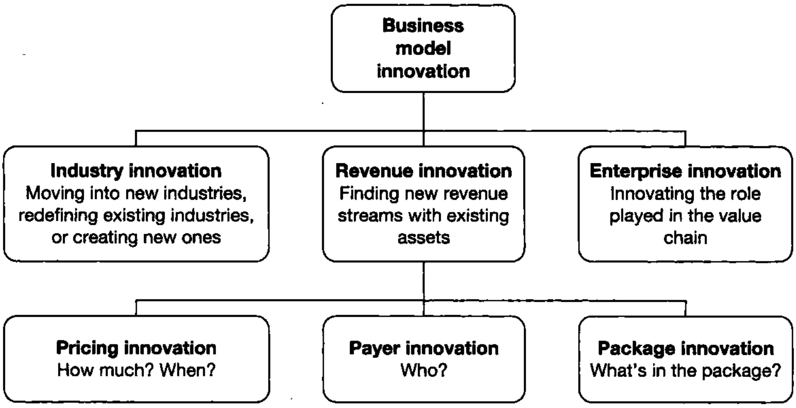
There are countless definitions of *business model*, and I have no ambition to provide a definitive one.[3] What almost all the definitions share is a view that a business model encompasses how a firm creates value, how it delivers that value to customers, and how it captures revenue from those customers. Value creation, value delivery, and revenue capture are obviously interlinked. Changing the revenue model may require changes to how the firm creates and delivers value, and vice versa. Still, it's useful to define business models as including these three broad functions.

Business model innovation likewise takes multiple forms (see figure I-2). The annual CEO study that I run with my colleagues at IBM defines three main business model innovation approaches: industry innovation, enterprise innovation, and revenue innovation. There isn't a one-to-one match between the three functions of a business model and the three types of business model innovation, unfortunately. Just as the functions overlap, these types of business model innovation often involve two or more of the functions.

Industry innovation happens when a firm crosses the boundary from one industry to another. For instance, Virgin's move

FIGURE I-2

IBM framework for business model innovation



from music retail into transportation and financial services, along with the focus on high-quality customer service it brought to those industries, was an industry innovation. Likewise, a company is engaging in industry innovation when it creates an entirely new industry, as Google has done with the search market and as Microsoft did by catalyzing the personal computer industry.

Enterprise innovation in turn involves rethinking the way the firm defines its boundaries. Zara and Li & Fung offer good examples within the apparel industry. In the case of Zara, it expanded the boundaries of the typical apparel firm with its decision to own every aspect of the apparel value chain, so that it could respond quickly to emerging fashion trends. In contrast, Li & Fung dramatically shrank the boundaries of an apparel manufacturing firm by functioning as a service provider that links buyers with a vast network of independent apparel manufacturers. As a result, it offers clients a level of flexibility that it never could have if it owned factories.

Revenue innovation focuses on how the firm captures revenues from the value it creates with its existing assets. Revenue innovation involves three distinct issues: how the value is priced, how the value is packaged, and who is paying for the value. While there have always been myriad approaches to these issues, the general trends of communications and computing ubiquity, along with the change in consumer expectations that has come about partly as a result of the former two trends and the availability of information, have rapidly expanded the possible approaches and therefore the opportunity for innovation.

There are a number of reasons to focus on revenue innovation. The first is its relative simplicity. Industry innovation, enterprise innovation, and revenue innovation are all complex and difficult to achieve, but each is less complex than the one before. For industries and firms that are struggling with stagnant or declining revenue, there is an urgent need to stem, if not stop, the bleeding. Revenue innovation offers the fastest business model innovation path to new revenue streams, certainly far faster and less expensive than the effort required for industry and enterprise innovation.

Second, in situations where industries are being radically transformed or firms are facing bankruptcy or collapse and more extensive business model innovation is required, revenue innovation can often provide several vital benefits: (a) generate funding for more extensive innovation efforts by locating new sources of revenue from existing assets; (b) provide needed insight into how customers and markets are changing, which will guide further innovation; and (c) give a reeling company a few short-term wins and, with them, the confidence it needs to drive more extensive change. Revenue innovation can be a powerful antidote to the fourth stage of decline documented by Jim Collins in *How the Mighty Fall*, where companies often cast wildly about trying to find "salvation."[4]

The third reason to pursue revenue innovation is that it allows for smaller-scale, shorter-term experiments. These efforts help firms identify key talent and unexpected barriers to innovation, and they allow them to derive lessons to apply to more intensive innovation efforts.

In short, revenue innovation matters. Likewise, the media industry is worth looking to for revenue innovation lessons and successes. Nonmedia companies may question the connection, but media has more in common with nonmedia industries than the latters' executives may care to admit. The commonality lies in the major trends that have dramatically changed the environment for media companies. As noted, those trends are ubiquitous communications; virtually unlimited low-cost bandwidth; virtually unlimited low-cost data processing power; changing consumer expectations for personalization, control, relevance, and timeliness; and rapid technological and competitive innovation.

These are all recursive trends—each builds on and extends the others. Processing power in part underlies the rise of ubiquitous communications and low-cost bandwidth. The data and information produced by ubiquitous communications and low-cost bandwidth likewise drive demand for data processing power, further accelerating that trend. Put together, these trends had a major impact on the media industry. The primary product of media could be digitized. So long as processing power and bandwidth were limited and expensive, the product stayed analog, along with all the attendant limitations of physical manufacture and delivery. Once thresholds of processing power and bandwidth were crossed, however, the product broke free from its physical bounds. Not only that, it could be acquired in near real time. The shift to digital and the real-time nature of modern transactions changed the dynamics of the industry. Music was the first to feel the effects, but the tremors quickly reverberated to all parts of the industry.

These trends do not affect only industries whose product can be wholly digitized. For all industries, the rise of ubiquitous communications, virtually unlimited low-cost bandwidth, virtually unlimited low-cost processing power, and changing consumer expectations means that vastly more information is flowing to and from customers, so that even physical products can now have a useful information component. Take, for instance, the automotive industry's pursuit of information services like GM's OnStar and Ford's Sync. Those are digitized information products attached to a quintessential physical product. Or consider the wide range of industrial tool companies that now offer remote monitoring and preventive maintenance services to extend the life of their physical products.

Look as well to health care. A great deal of the argument made in 2010 by those in favor of U.S. health-care reform focused on the cost savings and care improvements that would come by collecting and applying better information: electronic health records can prevent duplicate tests and fraudulent claims; comparative effectiveness data will allow doctors to prescribe less expensive treatments that work just as well; and information from the developing genome sector may in the future help identify in advance the 43 percent of diabetes patients for whom current drugs are ineffective.[5]

This increased information flow is set to grow even more rapidly in the decade ahead as the "Internet of things" that futurists have discussed for the last decade begins to find application in the real world. Over time, more devices will be connected to information networks able to create or react to data. The firm I work for, IBM, bundles these trends together under the rubric of a "Smarter Planet"—a phrase that suggests a world where information is created and consumed everywhere.

The ubiquity of information hinted at by a Smarter Planet drives another of the major trends: increasing consumer demand for personalization, control, relevance, and timeliness. While there's no doubt that these demands have always been latent in consumers, the ubiquity of low-cost communications, bandwidth, and processing power have allowed those latent desires to rise to the fore because those desires can now be met. When communications and bandwidth were expensive, information flowed primarily one way: from producer to consumer. Today, producers can cheaply gather information about not only how many units of a product are sold but how, when, and by whom those products are bought and how, when, and by whom those products are used. Combining that information with cheap data processing power yields the ability to profitably customize products to ever-smaller groups of consumers. As those latent desires are met, consumers will expect that even more of the products they use fulfill their expectations of personalization, control, relevance, and timeliness. Producers that do not deliver to those expectations will lose to those that do.

It hardly bears mentioning that every industry is confronting rapid technological and competitive innovation.

The sum of these trends makes business model innovation critical for growth and success. There is strong research to support this conclusion based on some analysis my colleagues and I at the IBM Institute for Business Value performed when following up on one of our annual CEO surveys. The CEO respondents said unsurprisingly that they expected the competitive and business environment to get more challenging. Many of them also said they were confronting those challenges by focusing on "innovation." But innovation can mean many things—in most cases, when companies mention innovation, they are talking about innovating products; they are not innovating around business models.

So we decided to clarify what types of innovation CEOs were focused on and whether that focus was having a material effect on performance. We found that the firms with the fastest profit growth compared to competitors' over the previous three years had put twice as much emphasis on business model innovation as the average firm in the sample. That's a powerful argument for moving business model innovation higher on your agenda.[6]

Let me also offer a few reasons why I think the experience of media is important to understand and learn from for those seeking insight into business model innovations generally and revenue model innovations in particular. The biggest reason is hinted at in figure I-1, shown earlier. In the figure you'll note that a number of sectors in the industry are in the upper-right quadrant, meaning they are expected to grow their audiences and revenues. In the midst of the "perfect storm" some sectors are profiting. You'll also note that substantial portions of the industry are competing for the preeminent position on the lower left—indicating falling audience and shrinking revenues.

This same chart could be duplicated for individual companies, and the same spread would appear. Some companies are growing audience and revenues—even in challenged sectors—while their peers seem trapped in a downward spiral.

The distribution of success and failure in the media industry is not random. There are ways that portions of the industry have ridden the challenging environment, fought off the negative side of the trends, and succeeded. Likewise, there are strategies and reactions that have failed miserably. Given that the major trends of ubiquitous communications, unlimited low-cost bandwidth, and so on are affecting all industries, learning what worked and what didn't in the media industry will be useful in the development of planning strategies for your company. It's like getting an advance map of previously uncharted territory: you can see where the roadblocks are, why some "surefire" innovations never caught fire, and why some "that'll never work" strategies caught hold.

Another major reason to look to media is that its lessons are already being applied to many other industries. As you move through the book, you'll find that I've documented cases of revenue innovations attempted by media that have been introduced to good effect in other industries. These case studies illustrate the commonalities and differences in revenue innovation as it is applied across various industries. Table I-1 has a sampling of the industries and companies that are using revenue innovation today to improve their top and bottom lines.