

## Innovations in Retail Business Models

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### Abstract

A *retail business model* articulates how a retailer creates value for its customers and appropriates value from the markets. Innovations in business models are increasingly critical for building sustainable advantage in a marketplace defined by unrelenting change, escalating customer expectations, and intense competition. Drawing from extant strategy and retailing research, we propose that innovations in retail business models are best viewed as changes in three design components: (1) the way in which the activities are organized, (2) the type of activities that are executed, and (3) the level of participation of the actors engaged in performing those activities. We propose six major ways in which retailers could innovate their business models to enhance value creation and appropriation beyond the levels afforded by traditional approaches to retailing. We also describe the drivers of business model innovations, the potential consequences of such innovations, and numerous examples from retail practice that highlight our concepts and arguments. In doing so, we provide a starting point for academic research in a domain that is deficient in theoretical and empirical research, and offer retailing managers a framework to guide retail business model innovations for sustainable competitive advantage.

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Globally, retailing is witnessing seismic shifts. The growth of the Internet has powered upheavals in the retail landscape that are revolutionary in scope, and unprecedented in nature. Some firms have created new markets, such as Apple with iTunes, and some have changed existing markets, such as Priceline.com. Today, most large retailers have morphed into multichannel firms, where the same customer visits the retailer via different channels for different purposes (e.g., obtains information online, makes purchases offline, and contacts customer support via telephone). Most have also expanded their focus from selling products to engaging and empowering customers, with the ultimate goal of creating a rewarding customer experience.

As a result, retailing practice is increasingly encompassing a broader range of activities as retailers expand the boundaries of their target markets and develop new ways for interacting with customers and channel partners. For instance, some retailers now use mass customization technologies to provide their

customers with “made to order” products instantly (e.g., Build-a-Bear). Others effectively use technology to streamline the supply chain to rapidly align their product assortment with seasonal trends (e.g., Zara’s “fast fashion” approach of releasing five times as many collections per year as the industry average). Some have devised innovative customer interfaces (e.g., Shop24 dispenses over 200 grocery items 24/7 using automated kiosks). Yet another category of retailers simultaneously cater to multiple niche segments and as a result effectively exploit the “long-tail” (e.g., Amazon.com). Finally, in countries like India and China, the opportunity to satisfy the needs and wants of the populations at the “bottom of the pyramid” has spawned numerous retail innovations, such as Project Shakti implemented by Hindustan Lever, which has enabled poor rural women to become distributors of branded products in villages.

This paper focuses on *retail business model (RBM) innovations*. While many retailers continue to adhere to the adage “retail is detail” (a quote attributed to James Gulliver), retailers at the forefront of innovative practices recognize that paying attention to details is not enough because many specialized firms can execute specific retail activities to near perfection on behalf of retailers (e.g., order fulfillment via UPS or FedEx). A new critical capability involves configuring, and when needed recon-

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figuring individual retail activities and processes into a coherent blueprint, their business model, which outlines the innovative logic for competing effectively in their markets.

How should we think systematically about retail business model innovations? Is there a conceptual framework that provides theoretical insights as well as practically useful guidelines? We address these questions in this paper. Specifically, we first discuss the concept of business model in general and highlight its differences from the related concept of business strategy. Next, we conceptualize retailing business model (RBM) in terms of its three core components, namely, retailing format, activities, and governance, with a particular emphasis on interdependencies among these components that define the retailer's coherent theme. We assert that the purpose of RBM is to create and deliver value to customers, and at the same time, appropriate value from the markets for the retailer and its partners. We then propose that a business model innovation is a change beyond current practice with respect to its three core components and their interdependencies. We also propose a classification of RBM innovations along a set of six design themes, each providing a distinct approach to enhancing value creation or appropriation. We then describe the drivers of business model innovations, the potential consequences of such innovations, and highlight our ideas and arguments with numerous examples from retail practice. We conclude with research opportunities and practice guidelines.

### Business model: definition and usefulness

There is no commonly accepted definition of business model in the literature. Instead, the literature reveals a wide range of definitions that vary in their emphases and scope (e.g., see the 2010 *Long Range Planning* special issue dedicated to business models). Nevertheless, most authors agree that a business model articulates a firm's value proposition, its sources of revenue, the resources used to extract rents, and the governance mechanism that links firm's stakeholders (Zott and Amit 2010). Drawing from this core idea, we propose a working definition of business models: *A business model is a well-specified system of interdependent structures, activities, and processes<sup>1</sup> that serves as a firm's organizing logic for value creation (for its customers) and value appropriation (for itself and its partners).*

The business model represents the firm's distinctive logic for value creation and appropriation (Chesbrough and Rosenbloom 2002; Gambardella and McGahan 2010; Osterwalder and Pigneur 2009; Teece 2010; Zott and Amit 2010).<sup>2</sup> For instance, a business model may outline how the firm creates value for customers via activities related to product development and flexible pricing. A business model may also outline how value is appropriated through, for instance, improved inventory management

and changes to governance structures that reduce opportunity costs, increase customers' switching costs, or lower the leverage that various stakeholders exercise on the firm. Articulating the means by which a firm creates and appropriates value allows for a clearer delineation of the sources of its competitive advantage, which, in turn, facilitates updating and strengthening the business model.

A central aspect of our definition of a business model is that it incorporates interdependencies that transform a set of structures, activities, and processes into an integrated system. A business model is not *only* specified by a revenue model, a cost structure, a set of resources, or a value proposition; it is fundamentally about how these pieces of the business "fit together" to create and appropriate value (Magretta 2002). In this context, "fit" refers to multi-layered interdependencies among the elements of a business model such that the "whole" (business model) is not simply the sum of its "parts" (elements). If these interdependencies reflect a high level of complementarity or synergy among the elements of a business model, then the business model is likely to be more cohesive and effective in achieving its purpose (e.g., Porter 1996). Indeed, complementarities have been highlighted in numerous papers as a source of economic rents and competitive advantage (see Ennen and Richter 2010 for a review). For instance, Milgrom and Roberts (1994) found that the total economic value added by combining two or more complementary factors in a production system exceeds the value that would be generated by applying these production factors in isolation. Conversely, if the elements of a business model, however well designed, do not reinforce each other, synergies are less likely to emerge and the risk of failure will increase. In sum, the beneficial interplay of the elements of a business model is pivotal to its successful implementation. Conceptualizing the business model as an interdependent system thus encourages "systemic and holistic thinking" instead of local optimizations or piecemeal decisions (Zott and Amit 2010).

### Business model and strategy: similarities and differences

Hambrick and Fredrickson (2005, p. 49) define strategy as "a central, integrated, externally oriented concept of how the business will achieve its objectives". At the same time, business model has been described as the "essence of a firm's strategy" (Gambardella and McGahan 2010) and "a reflection of the firm's realized strategy" (Casadesus-Masanell and Ricart 2010). Although business model and strategy share some common roots, they are different in important ways.<sup>3</sup>

First, strategy articulates a certain goal, whereas the business model details the mechanisms that moves the organization towards that goal. In other words, strategy specifies how the firm aims to differentiate from, or compete with, its rivals to achieve competitive advantage (Magretta 2002). It is focused on the firm's (unique) position in the marketplace (Porter 1996). The business model focuses on the organizing logic of *how*

<sup>1</sup> A process can be defined as "a structured and measured set of activities designed to produce a specific output for a particular customer or market" (Davenport 1993).

<sup>2</sup> Value creation implicitly incorporates a firm's ability to deliver this value to customers.

<sup>3</sup> For a more extensive discussion of the differences between business model and strategy, we direct the reader to Teece (2010).

to create and appropriate value in a way that achieves distinctive competitive advantage. It details the structures, activities, and processes (including the required resources) that connect the firm's internal functional areas (e.g., marketing, sales, and finance) and external constituencies (e.g., suppliers, partners) in an interdependent system that delivers on the firm's strategy (Teece 2010). Here, the business model plays a key role in placing the ("internal") organizational system of interdependent activities in a network of ("external") partners, suppliers and customer group(s) that is distinctive to the firm's value proposition to customers. Potentially disparate business models may be consistent with a given strategy, just as many different paths may lead to the same destination.

Second, the adoption of a new strategy typically implies reliance on a new business model, but changes to the business model can be made within an existing strategic framework. For instance, a strategy of low-cost manufacturing may prompt the adoption of outsourcing if, at some point, it is more cost effective than in-house production. Such adoption will require a change to the business model without a significant change in strategy. Thus, a business model may change more frequently than a firm's strategy, although these changes may prompt questions on whether the strategy needs to be updated as well. For instance, Amazon.com has updated its business model multiple times, from creating Prime membership where customers pay upfront a fee for year-long free expedited shipping, to allowing third party merchants to sell on its site, to an added emphasis on creating a preeminent marketplace for digital products, but its strategy has not wavered from being the ultimate Internet superstore.

Third, strategy and business model differ in the level of detail. The business model takes a firm's strategy from a relatively abstract level and translates it into a more specific interdependent mechanism that guides managers in fine-tuning their actions to realize the firm's competitive advantage. For instance, at the strategic level, American Girl strives to be the premier supplier of dolls for children; at the business model level, it focuses on how to make transactions more valuable for both its customers and for itself by seamlessly integrating customer co-creation, add-on services (such as cafés and spas where girls can spend time with their dolls) and complementary products such as accessories for the dolls purchased in their stores.

The preceding distinctions indicate that theory and practice can benefit from the study of business models, in addition to research on strategic positioning. In the following section we extend this conceptualization of business model to the context of retailing and relate it to the extant literature.

### **Retailing business model (RBM)**

Fundamental to the RBM are two unique characteristics of retailing which underlie the rationale behind innovations in RBMs:

1. *Retailers primarily sell products manufactured by others* and, as a result, they rarely derive sustainable benefits from exclu-

sivity in their product assortment. Thus, a narrow focus on product assortment is unlikely to lead to long-lasting competitive advantage, because comparable products may be readily available elsewhere. A successful RBM, therefore, focuses not only on *what* a retailer sells, but more importantly on *how* the retailer sells.

2. *Retailers engage in direct interactions with end customers*, often with a large number of them, unlike most manufacturers. This underscores the importance of the customer interface, and requires that retail business models articulate how the retailer will optimize its direct interactions with end customers to strengthen relationships with them. Retailers appear to be increasingly aware of these trends. As a result, the emphasis in retailing has moved from one focused mostly on transactions, where the goal was to sell goods and services to ultimate customers (Coughlan et al. 2001), to one focused on enhancing the customer experience (Grewal et al. 2009; Verhoef et al. 2009).

Retailers today can no longer be accurately characterized as "merchant intermediaries" that buy from suppliers and sell to customers. Rather, they are best described as orchestrators or conductors of two-sided platforms that serve as ecosystems in which value is created and delivered to customers and, subsequently, appropriated by the retailer and its business partners. Viewing retailing as spaces (sometimes, virtual) for staging customer experiences requires business models that go beyond traditional functions of procuring, stocking, and moving products. Specifically, conceptualizing RBMs in today's world requires explicit consideration of interdependencies among, and choices of: (1) the format that describes the way in which the key retailing activities will be sequenced and executed, (2) the diverse activities that need to be executed to design, manage, and motivate the customer experience, and (3) the governance of actors that perform these activities, the roles they play and the incentives that motivates them. Thus, we propose that the RBM has three interconnected core elements: *retailing format, activities, and governance*, which together with their interdependencies define a retailer's organizing logic for value creation and appropriation.

The *retailing format* refers to the structures for sequencing and organizing the selected retailing activities into coherent processes that fulfill the customer experience. Specifically, the format represents a combination of particular levels of each element of the retailing mix, such as product assortment, pricing strategy, location, customer interface, and so forth (Levy and Weitz 2008). In any product category, multiple formats are usually feasible, and different customers choose the format(s) that best fit their needs. Prior research has extensively studied the determinants of such choices (for a review, see Bhatnagar and Ratchford 2004). For instance, food can be purchased from convenience stores, grocery stores, warehouse stores, online grocers, or mass merchandisers, which all differ in their assortment, pricing, location, interface and the level of convenience offered to customers.

In the past decade, the choices of retailing formats have expanded dramatically driven mainly by changes in the design

of the customer interface and by channel coordination decisions. Customer interface design concerns the way in which a retailer structures the exchange process with its customers. Interface decisions require not only the positioning of the store in terms of pricing, assortment, and overall design (e.g., whether the store should be organized as a convenience store, specialty store, or themed brandstore), but also require selecting the structure of the interface itself (e.g., kiosks, stores-within-a-store, catalogs, e-commerce, or mobile commerce). With regards to channel coordination, the multiplicity of touch points now available to reach the same customer, require retailers to coordinate online and offline channels using multichannel formats such as “click-and-mortar” (e.g., Dekimpe et al. forthcoming; Pentina et al. 2009; Rangaswamy and Van Bruggen 2005; Van Birgelen et al. 2006). This topic has been highlighted in previous literature in areas such as price coordination across channels (Zhang 2009) or coordination through dual franchising (Srinivasan 2006). Thus, business models need to specify how activities should be connected within an overall format to deliver superior customer experiences.

*Retailing activities* refer to acquiring, stocking, displaying and exchanging goods and services that fulfill the customer experience. The specific choice of activities, their structure and sequencing within processes will be guided by the store format adopted. Past research has outlined the role of such activities, for example those related to (virtual) store design and atmosphere (e.g., Diamond et al. 2009), product mix (e.g., Conant et al. 1993), pricing (e.g., Koçuş and Bohmann 2008), branding (e.g., Borghini et al. 2009; Hollenbeck et al. 2008), and communication (e.g., Zhang 2009). Other research has shed light on less visible retailing activities, such as the adoption of new technology (e.g., Padgett and Mulvey 2007) and retailing specific supply chain optimization (e.g., Basuroy et al. 2001). Consistent with the increased focus on customer experience creation and management, some studies have addressed how retailers can design their activities within a certain retail format such that the level of customer engagement is enhanced, for example by strengthening customer-brand identification (e.g., Borghini et al. 2009).

*Retailing governance* refers to the actors involved in creating and delivering customer experiences, as well as the mechanisms (such as contract and incentive systems) that motivate these actors to carry out their roles in fulfilling the customer experience. These actors not only include the retailer and its customers, but also the retailer’s network of partners throughout the supply chain. Their roles transcend the transactional realm, with retailers increasingly relying on both supplier and customer co-creation across a broad range of retailing activities. For instance, customers are co-producers in many retail environments, such as banking (e.g., Internet banking) and grocery shopping (e.g., self-scanning and self-checkout). Further, customer content (e.g., user reviews) has shaped the design of retailer interfaces, while mass customization has strengthened the role of customers in assortment co-creation. Suppliers can also help shape retailers’ assortments and can enhance the customer experience by modifying their own supply chain in response to customer needs (e.g., Coughlan and Soberman 2005).

An important aspect of retailing governance is the incentive structure that motivates and organizes these actors to successfully perform their roles. In the traditional retailing paradigm, the manufacturer-retailer governance mechanisms include concepts such as Efficient Consumer Response (ECR) and Category Management (CM), which describe how incentives and decision rights are allocated to enhance performance (Basuroy et al. 2001; Corsten and Kumar 2005). The scope of incentive structures continues to broaden across stakeholders and activities. Consider, for instance, network marketing organizations (NMOs), which are retail-selling channels that use independent distributors not only to buy and resell products, but also to recruit new distributors into a growing network over time (Coughlan and Grayson 1998). NMOs crucially rely on the incentive structure as it determines whether the social network of distributors will grow successfully.

In sum, a RBM consists of one or more formats, along with the activities and the governance mechanism supporting the format, and the interdependencies among these three elements. Multiple channel retailers may require more than one format, but all these formats have to be integrated in a cohesive business model that preserves and advances the retailer’s brand equity.<sup>4</sup> Cohesiveness among the retailing format(s), activities, and governance is of singular importance; understanding how they connect to form an integrated system ensures that a change to any of them is done in a manner that attends to the synergies that they collectively create. For instance, if market conditions or technological advances prompt a change to retail governance, the first step in redesigning the business model is to examine its linkages with format and activities, followed by appropriate updates to all three elements and their connections, all done in a manner that optimizes the value created and appropriated under the given constraints.

Zott and Amit (2010) have acknowledged the importance of conceptualizing business models as integrated systems and have characterized them using prototypical *design themes* which detail these systems’ dominant value drivers. They suggest a ‘NICE’ framework – *novelty*, *lock-in*, *complementarities*, and *efficiency* – and argue that these themes represent how interdependencies among the elements of a business model are orchestrated. *Novelty* involves introducing new elements related to activities, actors, and/or linkages. *Lock-in* refers to business models that emphasize retention of activities and actors. *Complementarities* involve the bundling of activities and/or linking of specific actors such that the system is bigger than the sum of its parts. *Efficiency* builds interdependencies for lean operations, minimal costs, and/or low coordination costs. However, these themes are conceptualized mostly from the perspective of manufacturing business models.

In the context of retailing, Coughlan et al. (2001) note that retailers may adopt different approaches towards their system of activities, depending upon their input objective (i.e., mar-

<sup>4</sup> If a retailer owns two or more independent retail brands, such as is the case with Walmart and Sam’s Club, separate business models for each brand may be warranted.



gin and inventory turnover) and their output objective (i.e., the service levels delivered to the customer). The former stresses efficiency as the central theme of an RBM, whereas the latter is more focused on the effectiveness of an RBM, which may relate to the design themes of novelty (new ways of providing more effective superior experiences) and/or complementarities (bundling activities to provide a more effective output). Further, in the context of retailing, the design theme of lock-in relates to strengthening the exchange relation with the customer. Thus, taken together, efficiency, effectiveness, and the customer exchange relation constitute primary design themes of the RBM.

The design themes may be further differentiated as primarily focused on either value appropriation or value creation goals. Specifically, we propose that *operational efficiency*, *operational effectiveness*, and *customer lock-in* represent three distinct themes that represent ways in which the RBM may appropriate value; and that *customer efficiency*, *customer effectiveness*, and *customer engagement* represent themes in which the RBM may create value for the customer. Next, we define business model innovation in retailing and discuss how the aforementioned design themes help retailers innovate their business models.

### Business model innovation in retailing

We define a RBM innovation as a change beyond current practice in one or more elements of a retailing business model (i.e., retailing format, activities, and governance) and their interdependencies, thereby modifying the retailer's organizing logic for value creation and appropriation. First, this definition implies that the innovations in retail business models are system-wide changes: even though the change may originate in just one element of the business model, it also triggers changes to other parts of the system. Indeed, an isolated change in one of the business model elements that does not affect the other elements may be a retailing innovation, but would not be considered an RBM innovation. Second, a fundamental aspect of business model innovation is that it is intended to materially alter the firm's value creation or appropriation logic. Therefore, focusing on the potential changes to the value creation and/or appropriation logic is a critical lens for examining and classifying business model innovation. Such a focus helps managers set revenue expectations, and evaluate the firm's performance following the implementation of a business model innovation. Third, we take the perspective that for a change to qualify as a business model innovation, it should be a method of conducting business that has not yet been implemented in practice at the time of its introduction. In other words, such an innovation embeds "new to the world" formats, activities, governance mechanisms, and the interdependencies among them.

To illustrate business model innovation in retailing and to facilitate its critical review and future development, we provide a categorization of the major types of RBM innovations. We expect that such a categorization would lead to more focused research on various facets of business model innovation while also generating prescriptive implications for retailers who seek to update their business models.

Several aspects of business model innovation provide a basis for categorization. First, as we pointed out earlier, an important characteristic of an RBM innovation is whether its primary purpose is to enhance value creation or value appropriation. In practice, many business model innovations are intended to affect both. As such, our classification only reflects the dominant objective of the business model innovation without in any way diminishing or diluting its role for the second objective. After all, business model innovations with dominant focus on value creation are not developed without explicit consideration for its value appropriation potential, and vice versa. Moreover, our framework consists of three themes discussed above for value creation – namely, customer efficiency, customer effectiveness, and customer engagement, and the corresponding three themes for value appropriation – namely, operational efficiency, operational effectiveness, and customer lock-in. Table 1 presents a summary of our categorization, along with examples of business model innovations that subscribe to each design theme. While these examples do not constitute a comprehensive list, they illustrate the different ways in which retailers can innovate their business model to ever changing market and competitive environments.

*Operational efficiency.* In a nutshell, efficiency refers to doing things right, that is, faster, cheaper, simpler. It entails making competent and productive use of resources without wastage. The retailing literature has identified several ways to improve operational efficiency. First, retailers can streamline back end operations to improve efficiency (e.g., by streamlining sourcing, or managing inventory levels for optimal turnaround). Second, retailers have also sought to enhance the store environment in a manner that reduces costs and increases profits. Related research has focused on identifying optimal store layouts, merchandise displays, and shelf allocation, which have all been shown to impact consumers' purchase decisions (e.g., Drèze et al. 1994; Murray et al. 2010). Finally, cost savings can be realized by adopting new technologies that automate processes previously handled by employees. Such technologies can streamline both the store environments (e.g., self checkout technology) and back-end operations. For instance, Netflix's engineers have modified industry-standard bar-code sorting machines to handle the odd-shaped envelopes used to mail out DVDs, increasing the number of envelopes processed to 5,000 envelopes an hour (Stross 2010). Likewise, Zappos has automated its fulfillment center to improve visibility, flexibility, accuracy, and speed. Using the Kiva autonomous robot system, it takes an average of only 12 min from the time an order is placed online to completing the picking and packing of the order, greatly increasing operational efficiency (Scanlon 2009).

The examples above describe how retailers have traditionally improved the efficiency of their current operations without significantly changing their business models. Some retailers, however, have found ways to increase efficiency by completely rethinking operations, with far reaching consequences for all elements of the business model. These retailers have taken the calculated risk of presenting their customers with a new paradigm, one in which the product assortment, pricing strat-

Table 1  
A classification of retail business model innovations along design themes.

	Design theme	Was traditionally implemented as	Innovative ways to implement the design themes	Main premise of the model	Example
Value appropriation	Operational efficiency	Streamlined store environment and back end operations	Fast fashion model	Reduce assortment, implement a fast inventory turnaround	Zara
			Self-service model	Streamline dispensing of merchandise	Redbox
			“Name your own price” model	Minimize unused perishable products	Priceline
	Operational effectiveness	Vendor management; Inventory management; Market research studies	Leverage complementarities	Offer products tied-in with services and company knowledge	Apple stores, Best Buy
Customer lock-in	Subscription-based model		Adjacency model	Capitalize on adjacent demand by expanding outside the boundaries of the business	Ikea’s Mega Mall division
			Leverage exclusive products	Product assortment is unique, inimitable and contains products with a clear and strong value proposition	Target; Trader Joe
Value creation	Customer efficiency	Multiple locations; product displays, sales support, and so forth	Innovative format which facilitates the shopping experience	Store within store	Sephora inside JC Penney
	Customer effectiveness		Depth of assortment	Rely on stakeholders to determine the optimal depth of assortment and supporting services	Automated selling Customer co-creation
	Customer engagement	Reliance on advertising	Rely on added value tie-ins	Supplier co-creation	Amazon affiliates
				Products sourced from sustainable sources, sustainable business practices	Walmart
				Embedding the product into a complex store experience	American Girl

egy or even the store format may be completely different from current practices familiar to customers.

A prime example of an RBM innovation which stems from a pursuit of maximizing operational efficiency is the *fast fashion model*, often associated with the Spanish retailer Zara, which is now the world’s largest clothing retailer by revenue (Bjork 2010). While Zara initially became successful by effectively implementing old-fashioned inventory and brand management methods (Kumar and Linguri 2006), its managers soon realized that maintaining competitive advantage in an industry of ever-shrinking margins requires a completely new business model. The premise of their new business model is simple: use a smaller assortment with faster turning inventory, which would create an aura of exclusivity and cut down on the need for excessive markdowns. In an industry where merchandising is seasonal, Zara shattered industry practice by stocking stores with new designs twice a week (Rohwedder and Johnson 2008). This visible change to their retailing activities was in fact enabled by less visible, but critical changes in the retailing format and activities, driven by sophisticated operations research models which determined the most efficient manner to distribute inventory from Zara’s two central warehouses to its over 1,500 stores worldwide (Caro et al. 2010). Thus, this business model innovation

involved not only significant changes to Zara’s configuration of activities, but also modified how these activities are coordinated, specifically how Zara interacts with its suppliers, who themselves had to alter their operations to accommodate Zara’s new supply chain methods driven by a continuously updated forecasting model.

Redbox, the chain of kiosks dispensing DVD rentals for \$1 per day, is another example of business model innovation whose primary design theme is an increase in operational efficiency. While *self-service* has been present in retail in many forms, Redbox has reinvented the concept and pushed it to where no employees, other than those needed for occasional restocking, are involved in the retail experience. While this innovation was spearheaded by new technology, which enabled the kiosk format, the interdependencies between the three elements of Redbox’s business model also led to changes in retail activities and the governance mechanism. Specifically, the new retailing format is an automated kiosk placed in convenient locations such as McDonald’s and grocery stores. Both the assortment and the prices offered are significantly lower compared to those available from competing retailers. The governance mechanism has also been changed to one where the customer performs the transaction without employee assistance (Krauss 2009). Another

example of how governance can be leveraged to increase operational efficiency is the “*name your own price*” model made popular by Priceline. Allowing customer input into pricing decisions has resulted in minimizing unused products, a practice that can significantly increase efficiency, particularly in the case of perishable products such as hotel rooms or plane tickets.

*Operational effectiveness.* While efficiency refers to doing things right, effectiveness entails doing the right things. Operational effectiveness and operational efficiency are distinct concepts: for instance, reaching 80% of a target market indicates high effectiveness; doing so in a streamlined way, with as little waste as possible, is indicative of operational efficiency. In other words, operational effectiveness is about producing desirable results by operating in a manner that maximizes organizational objectives (such as long-term profits or extent of target market reached). Examples of operational effectiveness in retailing include matching product assortment with demand, or implementing flexible pricing, which extracts maximum profits from the distinct segments in the market. Retail effectiveness has traditionally been realized via investments in marketing research and data management focused on ensuring that customer needs are well understood. Insights from this type of research are then used for inventory and assortment management.

In a quest to significantly boost operational effectiveness, some retailers have gone well beyond matching demand with supply. Retailers have a distinct advantage over manufacturers, in that they are not bound by a set product portfolio; rather, they have a higher flexibility in determining their product assortment and can typically respond to changes in demand faster than manufacturers. Further, innovations in business models that are characterized by this design theme seek not only to optimize demand, but rather to expand demand, or even take advantage of demand in complementary markets that may develop as a result of the retailer’s activities. An example of expanding demand is *leveraging complementarities*: a retailing practice of tying in services, or specific retailer’s knowledge of the products sold. Such efforts are directed by the need to create and manage superior customer experiences. An example of a company that has expanded the frontier in operational effectiveness in retailing is Apple. Primarily a manufacturer, Apple’s ability to leverage its brand and competencies in retailing has led some to call it “America’s best retailer” (Useem 2007). Apple stores are unique environments where customers can not only experience the products, but can also get one-on-one tutorials on a wide range of technical issues, get their computer repaired at the Genius Bar, or can participate in workshops. This opportunity to learn increases the customer value proposition considerably along with the likelihood that customers will know how to use their products and will be more likely to be satisfied with them. This new vision of retail involves significant changes to all three elements of a typical business model in electronics retailing, and the manner in which these elements are connected. First, Apple stores have expanded the range and type of retailing activities provided in such stores. As a result, the governance mechanism that enables their retailing activities is one that educates customers and empowers suppliers to be intelligent co-creators by providing components that best fit the store environment. Finally, Apple

is also reinventing the retailing format, by opening, alongside its regular stores, 15-foot wide mini-stores in selected locations with high pedestrian traffic, while also adapting its assortment and customer interface to this new store format. Not surprisingly, Apple stores enjoy higher sales per square foot than any other retailer (Useem 2007).

Another way of leveraging complementarities, referred to as *adjacency*, is capitalizing on seemingly unrelated demand that has a physical or temporal proximity to the retailer’s current products and services. Some authors have argued that companies which go out of the boundaries of their core business to exploit adjacencies can achieve high profitability (Zook and Allen 2003), but others warn that it is a risky strategy (Stewart-Allen 2009). An example of a retailer that has successfully capitalized on adjacencies is Ikea. Ikea’s managers noticed a dramatic increase in real estate value around Ikea store locations in Russia, and created a new business division, called Mega Mall, to capture this real estate appreciation and use it for mall development (The Boston Consulting Group 2009).

*Customer lock-in.* The design theme of lock-in is intended to decrease customers’ propensity to search and switch after an initial investment, which is determined both by a preference to minimize immediate costs and by an inability to anticipate the impact of future switching costs (Zauberman 2003). In retail, lock-in has traditionally been implemented through mechanisms that create a high incentive for customers to return to a store, such as a membership or a subscription to a retailer’s services (e.g., an extended warranty). Lock-ins, while useful for securing repeat business, can put customer satisfaction at risk. Retailers are now seeking more subtle ways to create lock-in, where loyalty reflects enduring customer relationships rather than constraint-based (e.g., contract or subscription-based) repurchases.

One element of the RBM that has been astutely leveraged to create lock-in is product assortment. Since retailers typically sell someone else’s products, it would appear that product assortment has little potential to be a driver of competitive advantage. Nevertheless, a few retailers have challenged this notion and have built their assortments around products that are unique, inimitable and which deliver a clear value proposition to customers. Target, through exclusive deals with designers Michael Graves, Mossimo, Sonia Kashuk and others, has crafted a hip, stylish brand image not characteristic of superstores. Successfully targeting consumers who value “Cheap Chic”, Target has thrived where undifferentiated competitors such as K-mart have floundered. Another retailer that has built its business model on product assortment exclusivity is Trader’s Joe. This specialty grocer has attained enviable levels of customer loyalty by offering customers unique, high-quality private label products sold at a fair price. Trader Joe’s sells only about 4,000 SKUs, compared to the 50,000 that a typical grocery store sells, and about 80% of them are their own private brand (Kowitt 2010). Like Zara, it has turned a limited assortment into an advantage, perhaps subscribing to the perspective that too many options do not necessarily optimize the shopping experience (Schwartz 2005), but ensuring that the quality of the products more than compensates for the limited choice. Founded in 1967, Trader Joe’s continued success is due in part to its ability to renew its retailing activi-

ties and relationships with suppliers (details of which have been closely guarded by the company) in a manner that always puts it “a set ahead of Americans’ increasingly adventurous palates with interesting new items that shoppers will collectively buy in big volumes” (Kowitz 2010, p. 90). This is yet another example in which the interdependencies among the elements of the business model are critical drivers of value creation and appropriation; the retailing activities involving an assortment centered on exclusive, high quality but reasonably priced products are enabled by an innovative format which relies on efficient sourcing and operations.

Governance can also be leveraged to achieve lock-in. The *cooperative business model* is based on a governance structure where the owners are also customers. Instead of focusing on producing profits for its owners, the cooperative offers its member-owners improved product assortments, better service, or discount prices, uniquely positioning themselves as their outlet of choice for that type of merchandise (e.g., Kazuhiko 2003). Although customer cooperatives are common in banking (credit unions), insurance firms (State Farm), timeshare vacation properties (Hilton), and agriculture (CSA), such an approach is relatively rare in retailing. An example of a company that has successfully implemented this type of business model is REI, a multichannel retail cooperative selling outdoor gear and clothing. Because its business model is both focused on, and empowered by the member customers, REI’s retailing activities have an unrivaled scope, such as opportunities for on-site training (e.g., ski lessons), work out (e.g., rock climbing), or trips offered by its member volunteers. The unique governance system enables high levels of employee commitment, which result in outstanding customer service. REI’s innovative approach to designing and linking the format, activities, and governance of their business model has resulted in a degree of customer emotional attachment and loyalty that amounts to de-facto lock-in.

*Customer efficiency.* Customer efficiency involves making customers’ access to products as easy as possible. Not achieving a high level of customer efficiency not only fails to endear the retailer to the end customers, but also makes it a less attractive partner for manufacturers seeking to place their products in the marketplace. Retailers have traditionally sought to increase customer efficiency by offering the product in multiple locations, increasing the convenience of product displays or offering more sales support. The advent of the Internet has further increased the efficiency of the shopping experience by reducing customers’ search costs and by allowing them to purchase products that were previously not geographically accessible. The Internet has not only enabled selling in multiple channels (e.g., online vs. stores), but also selling across channels, by allowing customers to purchase online and pick up at a store, or access the retailer’s larger online assortment while shopping in store where they can take advantage of customer support.

Recognizing that there is a limit to improving customer efficiency within an existing store format, retailers have come up with altogether new store formats. These innovations are useful illustrations of the interdependencies among the elements of the RBM, as physical changes to format and location typically also trigger changes to a retailer’s governance mechanism. Indeed,

governance needs to account for potentially a new customer base and new customer behaviors brought about by the new format. For instance, Redbox has increased the efficiency of its operations by not only completely automating DVD rentals but the self-service function of the kiosks, and their placement where customers shop most often, have also made it considerably faster and more convenient for customers to rent DVDs.

Another example of reducing the footprint of the store to increase its accessibility is the store within a store concept. This concept has evolved from a dedicated display area for a brand that the retailer was already carrying (Dunkin and Brenner 1989), to a mini-version of an independent retailer’s store being housed inside a larger store, such as a department store (Jerath and Zhang 2010). Retailers are increasingly embracing the store within a store concept: from Best Buy’s Mobile mall stores, to Sears-branded appliance stores inside Kmart, to Sephora inside JC Penney (inside V&D in the Netherlands). The premise behind these new retail formats is to go where the customers are, facilitating their purchase experience. For instance, the Sephora units inside JC Penney increased the brand reach of Sephora to new consumer segments, boosting their fragrance sales while increasing brand awareness, despite being much smaller than the regular Sephora stores. Alternatively, JC Penney, which lacked a beauty department since 2003, gained access to Sephora’s main customer base, 18- to 35-year-old women, who typically spend more per item than JC Penney’s traditional base of middle-aged moms (Porter and Helm 2008).

*Customer effectiveness.* Customer effectiveness refers to the degree to which the retailer is able to facilitate consumers’ realization of consumption goals. Increasing customer effectiveness has traditionally meant increasing the likelihood that customers find products that truly meet their needs. This has typically been achieved by increasing the depth of product assortment, often at the expense of efficiency. Some demand was left unmet, as serving the long tail was seldom considered cost effective.

The growth of online shopping has led many retailers to focus on niche segments and on the long tail. Some simply capitalized on the reduced search costs that the Internet affords and the increased efficiency that arises from warehousing in centralized locations. Others, however, saw an opportunity to innovate their business models by changing their underlying governance mechanisms. Specifically, they passed on to their stakeholders – customers and suppliers – the role of determining the optimal depth of assortment and supporting services that the retailer should offer. Netflix, for example, designed a consumer-based recommendation system that increased customer access to a broader assortment of movies and enabled reinforcement among the elements of its business model. By passing on the task of movie reviewing to customers (rather than to employees) and communicating movie ratings to other customers, movie renters are exposed to a wider set of potential titles (long tail), enhancing customer effectiveness. Simultaneously, because of its interdependence with other aspects of the Netflix business model, cost efficiencies are increased (due to better inventory management) and customer lock-in is enhanced (due to supporting services boosting customer loyalty).



The Internet has also increased the prevalence of another phenomenon which has redefined the scope of product assortments: customer co-creation. Customer co-creation has been embraced by start-ups and established retailers alike, and has pervaded industries ranging from food and apparel retailing to industrial cleaning solutions and many more. Customers can now create their own granola, using favorite ingredients at <http://www.mixmygranola.com>, can customize their cleaning solutions at <http://www.chemstation.com>, can personalize M&Ms with text and pictures at <http://www.mymms.com>, or can build their own sports shoes online using the NikeID system. Manufacturers of established brands such as Nike and M&M can now more efficiently add retail operations, and can use mass customization to strengthen their brand associations and potentially increase loyalty by leveraging the endowment effect and psychological ownership effect that typically arise by co-designing products (Franke et al. 2010). In turn, new retailers such as Mix My Granola can use this tool to create a customer base by tapping into a market that was underserved by mass manufacturers. Whether co-creation is integrated into an existing business model or has triggered the creation of a new one, if supported by appropriate format and activities, it enables a governance mechanism that can create significant value for customers, some of which can be appropriated by the retailer.

Alternatively, opportunities for co-creation can also be extended to suppliers. Amazon.com's product assortment has been expanded through third party vendors to levels that competitors can only marvel at; importantly, this has been achieved with just a nominal increase in the cost of managing additional inventory. Customer effectiveness is increased by Amazon.com's user-friendly interface and streamlined check-out process that applies also to merchandise sold by third party vendors. Still, to reap the benefits of supplier co-creation, Amazon.com has had to update its business model to implement the optimal level of integration of these partners into its operations to maximize sales and minimize any potential brand equity damage that may result from affiliates' actions. Critical to this success are Amazon.com's well-planned format and governance mechanism, which ensure that it retains sufficient control of the customer experience creation, even though it maintains little direct control over order fulfillment.

*Customer engagement.* The theme of customer engagement involves the degree to which the retailer is able to design customer experiences that evoke emotional involvement that goes "beyond purchase" (Van Doorn et al. 2010, p. 254). An engaged customer has well defined perceptions of the retailer brand, often chooses to articulate these perceptions and occasionally identifies with the brand (see Van Doorn et al. 2010 for a review of manifestations of customer engagement across industries). We noted earlier that firms can engage customers through unique product assortments. Nevertheless, changes to product assortments are highly visible, and thus, imitable. A different, and perhaps more enduring way to engage customers has recently emerged: one where added value tie-ins, whether tangible or intangible, make for a multifaceted and emotionally stimulating shopping experience which leads the customers to uniquely bond

to the retailer. Retailers are seeking to redefine their activities in a manner that also allows them to redefine their brand and the meaning that this brand carries in the minds of their customers. Retailers have an advantage over manufacturers in leveraging the engagement design theme due to their direct access to the end customers.

A prime example of how a retailer has sought to engage a specific segment of consumers is Walmart's emphasis on sustainability as a core theme in how they conduct their business, and in the products that they carry. Walmart has three sustainability goals: (1) to be supplied 100% by renewable energy; (2) to create zero waste; and (3) to sell products that sustain people and the environment (Retail's BIG Blog). This emphasis acknowledges the increasing customer interest in green, fair trade and sustainably produced products, and positions Walmart as a pioneer in making such products available to the average customer. This focus on sustainability has impacted not just Walmart's assortment, but also all the functional areas in which various activities are performed, from sourcing, to manufacturing, to internal operations, to inventory management. Thus, retail format, activities, and governance and how they relate to each other have all been significantly modified to accommodate the new emphasis. Walmart's ultimate goal in pursuing sustainability is to seek to increase the loyalty and positive associations that customers have vis-à-vis its brand and become the store of choice for the increasingly large segment of environmentally conscious consumers.

Another way in which a retailer can engage customers is by selling not just products, but an entire experience that – while centered on the products – adds an entirely new exciting layer to the retail setting. Themed brand stores such as the American Girl Place are exponents of a retail brand ideology meant to immerse the customer in a complex experience which includes socialization, co-creation and embedding of the brand into personal memories (Borghini et al. 2009; Kozinets et al. 2008). Retailers that convincingly enact their brand ideology in their stores become a part of their customers' life projects, and consequently occupy a privileged position in these customers' brand hierarchies. Linking retail activities with a set of particular ideologies may require significant changes to a retailer's business model but it is nevertheless a change worth considering given its high upside potential on value creation. The American Girl Place example also suggests that customer effectiveness and engagement are related. If a high level of customer effectiveness is achieved, engagement could, to some extent, ensue. For instance, co-creation has been described by some authors as a form of engagement (e.g., Van Doorn et al. 2010). We argue that simply participating in the design of a product does not necessarily result in customers exhibiting brand- or product-related behaviors that go beyond mere purchase, but has the potential to do so if the newly designed product represents a significant increase in the value perceived by customers. Engagement goes beyond satisfaction; it represents an active, rather than passive involvement with the product or retailer brand. We should note, however, that engagement is typically a hefty goal for a retailer and that direct metrics to assess the extent to which it has been accomplished are not yet available.

The discussion and examples above show that innovating the RBM from the perspective of a particular design theme not only affects one or more elements of the business model (i.e., format, activities, and/or governance), but more importantly, an RBM innovation leverages the interdependencies between the business model elements, making it harder for others to replicate the business model. Thus, an integrated set of changes in the system of format, activities, and governance of the RBM makes business model innovations a potentially powerful source of competitive advantage. Below, we describe different ways in which RBM innovations may contribute to sustainable competitive advantage. However, for retailers to engage in business model innovation, they need to first be aware of the factors that may stimulate or inhibit them to do so. We therefore first discuss some of the main potential drivers and barriers for retailers to engage in business model innovation.

#### *Retail business model innovation: drivers and barriers*

Both internal and external drivers can lead a retailer to innovate on its business model or even create an entirely new business model. With respect to *internal* drivers, one potential driver of business model innovation is a customer-centric orientation. A sustained focus on improving the customer experience may prompt retailers to identify innovative ways to best align their “backstage” (back-office), “frontstage” (physical environment, service employees, service delivery process), and “auditorium” (fellow customers) design areas (Zomerdijk and Voss 2010). Oregon based Umpqua Bank, for example, redesigned its branches to reflect a retail feel that would generate heavy foot traffic. Its patented branch design, aimed to provide a unique customer experience modeled after the hotel industry, has been highlighted as a success story (Banerjea et al., 2006). An emphasis on innovation in general can also lead to business model innovations, as experimentation will motivate and enable firms to discover viable new business models (Chesbrough 2010; McGrath 2010). Research also shows that service providers with an emphasis on innovation are more likely to also introduce service delivery innovations (Chen et al. 2009).

Changing customer values (e.g., McGrath 2010) and technological developments (e.g., Sood and Tellis 2010) are potential drivers of business model innovation *external* to the firm. By focusing on customer value creation, the business model concept promotes managers to take an “outside-in” perspective, requiring them to engage with, and adapt to changing customer values (McGrath 2010). Alternatively, technological developments can also enable firms to successfully design new ways of creating and appropriating value (Padgett and Mulvey 2007). In this respect, the emergence of the commercial Internet has led to many new (and often more effective and/or more efficient) ways of information exchange and transaction (McGrath 2010). This has stimulated market entry of a wide variety of (more and less successful) firms with business models based on electronic platforms for customer interaction (e.g., Mahajan et al. 2002). Information and communication technology has also created new business models based on multiple channels and self-service technologies (e.g., Meuter et al. 2005).

A retailer’s motivation to engage in business model innovation may be inhibited by inertial forces due to either cognitive barriers to change (Chesbrough 2010) or resource commitments (Padgett and Mulvey 2007). Success of the current business may render managers reluctant to change the organizing logic of how value is created and appropriated (Debruyne et al. 2010). Likewise, retailers may be reluctant to change their current business model because of stickiness of resource endowments. Path dependencies and prior investments may limit a retailer’s flexibility to make significant changes to its prevailing logic of value creation and appropriation. For instance, Padgett and Mulvey (2007) argue that incumbent firms have a vested positioning strategy based on the resource base that has been built over the years; changing the positioning may alienate profitable customers and therefore could be both difficult and dangerous. Blockbuster is an example of a retailer whose reluctance to update its brick and mortar business, and delays in adding a mail and digital delivery business, eventually resulted in a Chapter 11 filing. Experimentation (Chesbrough 2010; McGrath 2010) may enable retailers to explore potential ways to innovate their business model without jeopardizing current performance.

#### *Consequences of retail business model innovation*

Can business model innovation lead to competitive advantage? While many of the RBM innovations described above are clever and have the potential to generate new cash flows, they may also be fairly easy to imitate. If the business model is easily imitable, and if barriers to entry are low, the competitive advantage it affords is not sustainable for an extended period of time (e.g., Adner and Zemsky 2006; Makadok 1998). Drawing from our previous arguments, we propose two ways in which retailers can maintain their competitive advantage. First, while the activities and to a lesser extent the governance of a business model may be visible and imitable, the way in which the activities are structured, that is, the format, can offer unique advantages. Replicating the format would require more insight into a retailer’s core processes and the interrelationships that keep these processes running seamlessly. Thus, while it is tempting to ponder innovative retailing activities, it is worthwhile paying close attention to how the format can be simplified, rendered more efficient or transposed into different domains. The resulting business model with enhanced properties of coherence and interdependency between its elements may provide a better protection against competitive encroachment.

Second, pursuing innovations that heighten the uniqueness of the customer experience may also hold the key to maintaining the competitive advantage derived from a business model innovation. If competitors have also devised ways to reduce risk perceptions, leverage new technologies, and leverage partnerships, then a retailer could offer unique value-added services that elevate the customer experience above their expectations, with positive consequences for loyalty, retailer brand equity and repeat purchase. For instance, in the crowded consumer electronics retail market, Best Buy’s well trained floor and Geek Squad associates facilitate and enhance customers’ purchase and the post-purchase experiences, helping Best Buy differentiate itself

from competitors. In the online realm, Alice.com seeks to stand out from similar drugstore retailers by offering a completely new shopping interface that mirrors the customers' cabinets, which in turn is supplemented by value-added features, such as budget and planning tools, which complement the shopping experience. It is important to note that the value-added services in the above examples are not merely additions to the retailers' assortments; rather they allow increased synergy with other activities within the chosen format.

Useful insights can be gathered from the financial consequences of different business model innovation examples we previously discussed. Redbox's revenue grew by 99% in 2009 as it installed over 8,700 new kiosks, or almost one every hour of every day and rented over 365 million DVDs (Coinstar, Inc. at Morgan Stanley Technology, Media & Telecom Conference 2010). Zara also boasts impressive financial figures. Profits at Inditex SA, the owner of the Zara retail chain, have jumped 64% in the first quarter of 2010, while the company's stock has risen 43% in the past 12 months. Zara, now present in 77 countries, also recently launched online operations in 85 countries encouraged by the two million people who have downloaded Zara's smartphone application in the first six months after its launch (Bjork 2010).

The above examples suggest that profits from retail business model innovation can exceed the profits that can be extracted from product or process innovations (which often mainly influence short-term gains). Are there long-term profit gains for innovative business models? An industry study has documented enhanced returns to business model innovations by comparing the premium in shareholder return for innovators against that of the average total shareholder return in several different industries (Lindgardt et al. 2009). The authors report that, on average, product and process innovators gained 1.7% premium over a 10-year period, whereas business model innovators gained a 2.7% premium, that is, a net gain of 1% for business model innovators as compared to product or process innovators. Thus, it appears that the unobserved interdependency aspect of business models provides enduring competitive benefits. Although one might raise questions regarding the direction of the cause-effect relationship here (i.e., whether high performing companies innovate, or whether innovative companies become superior performers), the longitudinal nature of the study engenders some confidence in the conclusions. Nevertheless, because patenting a business model innovation is difficult, the best course of action is to embrace a dynamic perspective whereby the business model is continuously updated as changes in the environment dictate it. Also, in order for the components of the business model to come together seamlessly as updates are being made, an organizational structure which encourages communication across departments, and which takes a systemic view of the activities undertaken by the firm's stakeholders, can help keep the retailer stay ahead of competition.

### **Business models in retailing: a look ahead**

For researchers studying business model innovations in retailing, much work lies ahead. Although the conceptualization we

present here is a start, more research is needed to clarify the concepts and to measure them empirically. A rich theory that elaborates on antecedents, consequences and various facets of business model innovation needs to be developed and linked to extant theoretical frameworks such as value chain (Porter 1998), configurational theories (e.g. Meyer et al. 1993), or the resource based view (Barney 2001). In particular, more theoretical work is needed to specify different modalities of interdependencies among the elements of retail format, activities, and governance, as well as develop empirical models for measuring such interdependencies and their effects on customer experience and retail performance.

For retailers, we have proposed a three-element conceptualization of RBMs and a framework consisting of six design themes that they can use to design innovative business models. The three elements that comprise an RBM – format, activities, and governance – can help retailers to think strategically about the optimal locus of business model innovation, as well as any necessary updates to how these elements are connected. The framework of design themes can also be used as a checklist of expected outcomes with respect to value creation and value appropriation associated with a business model innovation. Finally, the framework may provide performance benchmarks for retailers' current business models, and help them set up continuous improvement processes along as many of the six dimensions as possible. In addition to periodically examining the performance of their business model along each of the proposed six design themes, a retailer would benefit from keeping abreast of the major internal and external factors that might warrant changes to the business models. We summarize below some of these key factors.

*Keep abreast of new technologies.* Retailers should monitor any new technologies that can reduce the cost structure of their business or that can increase efficiencies. Self-service technologies are now pervasive in many stores and have gone beyond the ubiquitous self-service checkout counter. For instance, Stop & Shop Supermarket, a subsidiary of Ahold USA, has introduced wireless-based shopping cart "buddies." Customers can use them to search for the product they need by name or category using a dropdown menu, and the selected products are displayed on a map of the store. The shopping cart buddy can also place deli orders, notify store associates of out-of-stock items and emit electronic rain checks, enhancing and simplifying the shopping experience of the customers who use it. Although retailers could consider the impact of such self-service technologies mainly in terms of the opportunities they afford for product and/or process innovations, they could also gain an understanding of the opportunities and challenges to their business models that arise from technology developments (Grewal et al. forthcoming; Shankar et al. forthcoming).

Another threat that is harder to monitor, but nevertheless important to keep on the radar screen, is that of technologies that could make a retailer's product outdated. Just as stores selling typewriters had to change their business models as PCs became popular, so do booksellers faced with electronic readers, or CD retailers faced with MP3 players and downloadable music. Joining an emerging market or forging alliances with the technology

providers may be the best way to preempt this threat. Jeff Bezos beat Sony to the market with its Kindle, and leveraged the large book inventory that Amazon.com carries by offering an impressive e-book library for Kindle. Barnes & Noble soon followed suit with the Nook, upping the value added by offering free classics that can be downloaded to it and in 2010 a new color version of the e-reader. In contrast, Borders, a once successful retailer, failed to capitalize on this opportunity, reported a net loss of over \$100 million in revenues for each of the past two years, and has filed for bankruptcy.

Sometimes new technologies require thinking outside the box, as they have the potential to introduce completely new retail formats. Hamilton South, a founding partner of HL Group, a retail consultancy, thinks the future of luxury retail may not be online but on television. He envisions a world where viewers use their remote controls to buy the clothing that appears in the programs they are watching. “Retailers need to stop thinking about making shopping entertaining, he says, and concentrate on making entertainment “shopable” instead” (Economist 2009, p. 73). And yet another example of how we will, in the near future, shop differently can be seen in a Cisco ad that has gone viral on YouTube with over 1.7 million views, which depicts a young woman virtually trying apparel on an electronic screen. The ad suggests not only that a radically new customer experience is possible in the near future, but also that retailers will have to yet again rethink the manner in which they manage assortments and inventories, as well as any aspect of the business model that relates to them.

*Keep abreast of new consumer trends.* Even if a retailer’s model is customer centric, it is only as good as the assumptions the retailer makes about what customers value. Accurately identifying the main drivers of customers’ utility function and constantly updating this information is critical to keeping the business model current (see, for example, Reinartz et al. forthcoming). For instance, retail sales of organic foods in the US have increased 17.1% to \$24.6 billion in 2008 (Organic Trade Association press release 2009). Anticipating this change in consumer priorities and modifying their business model accordingly have helped certain retailers, including Walmart, build competitive advantage. Conversely, food retailers that have waited to join this bandwagon may have to face yet another shift in consumer preferences, with some analysts reporting that the organic sector is peaking, and a focus on sustainability, fair trade or localization is now trending up (McKay 2010). Thus, retailers should have in place intelligence processes which ensure that they keep up with what their customers truly want.

The extensive involvement of today’s consumers with social media is also something that can be leveraged to update a retailer’s business model and increase its efficiency. For instance, many retailers show parts of their assortment on Facebook in an attempt to gauge customer interest. Gathering customer reactions to the retailer’s communications on social networking sites can be institutionalized and integrated more systematically with merchandising decisions. Retailers need to think beyond the advertising function of the social networking sites, and find innovative ways to use them as *exchange media*, rather than as *one-way, or even two-way, communication channels*. These

sites are an integral part of the life of many consumers; retailers need to integrate them within their business models.

*Maintain organizational flexibility.* Retailers should maintain organizational flexibility to create a new brand if a new retailing format or concept shows potential, but cannot be directly integrated into their current business model. While in some cases this may involve a simple brand extension (Toys R Us and Babies R Us), in other cases it may require a fundamentally new business model. A good example is Procter & Gamble’s first forays into retailing, the now defunct Reflect.com, an Internet retailer of custom skin care products. While Procter & Gamble’s business model relied on mass merchandising and economies of scale, the business model of its retailing venture Reflect.com had to accommodate customer co-creation and entailed completely different retail format, activities, and governance components, which were difficult to integrate with Procter & Gamble’s core business model.

Another context where organizational flexibility is of paramount importance is in ensuring that the various functional areas that define and bring to life each facet of the business model are in constant communication with each other. If feedback between the functional areas is exchanged on a regular basis, it is more likely that the critical interdependencies between the retailing activities, format and governance components of the business model are maintained and updated for optimal business performance.

Finally, perhaps the best way to ensure that the business model stays current is to start thinking about the next business model innovation as soon as the current one is implemented. Walmart is a prominent example of staying ahead of competition by constantly innovating its business model—from the manner in which Sam Walton chose the location of the Walmart stores, to its innovative inventory management processes, to the way in which this retailer has embraced organic merchandise and now to the sustainability emphasis—and doing so with the nimbleness of a small retailer, rather than that of a large, stodgy incumbent. We hope that the concepts, arguments, and examples we provide in this paper help other retailers to innovate their business models to enjoy sustainable competitive advantages.

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