

Why industrial companies need to lead business model innovation

(PART 1)



ISAAC SARPONG: Isaac is the Partner in charge of Tax Services. He has over 26 years' experience in the provision of multi-faceted advice to both local and international clients in taxation, accountancy, audit & assurance, and corporate law, among others. Isaac is a Chartered Accountant, a Chartered Tax Practitioner and a Lawyer.



If manufacturers don't have a seat at the table, they risk letting others take control of their value chains.

In brief

- Manufacturers can and should become leaders in their value chains.
- New business models based on value creation are at the center of successful growth strategies.
- When value creation opportunities demand capabilities outside core competencies, manufacturers should consider building or joining an ecosystem.

Manufacturers seeking an edge cannot rely on product-centric innovation alone. They must also develop business models to create and capture value in new ways. Combining connected products, customer knowledge and the right ecosystem of relationships can place you in the most advantageous position in your value chain.

For decades, manufacturing business models have largely focused on incremental growth through product improvement or market expansion. However, stagnating growth, market disruptions and diminishing returns from process improvements are challenging manufacturers. In response, some leading firms are broadening their innovation efforts to include their own business models.

Business model innovation can occur on many fronts, including a company's customer base or relationship model; offerings (e.g., a manufacturer expanding into services or experiences); commercial and revenue models; and core competencies. At their core, successful innovations involve

a significant change in the way a firm captures, creates and exchanges value. Value can be more than financial; it may also include intellectual property, data, customer access, human capital, brand permission or other elements related to a company's position in its value chain.

Manufacturers are in a powerful position to become leaders in their value chains. Connected products are generating data rich with potential insights that can drive new services and new business models. Every day, competitors from inside and outside the manufacturing sector are forming ecosystems to manage, and profit from, new ways to deliver customer value. To take their seat at the table, manufacturers must be ready to reinvent their business models – or watch from the sidelines as others take control of their value chains.

Chapter 1

The need for business model innovation has never been more urgent

Overlooking the potential for new business models can create opportunities for competitors.

While manufacturing leaders know that true innovation needs to extend beyond product reinvention, they are more likely in general to turn to digital transformation

efforts rather than innovating business models. The EY CEO Imperative Survey finds 70% of manufacturing sector respondents see technology and digital innovation as a transformation driver for their companies, while only 30% said the same of new business models. Contrast this with the technology sector, which is leading the way with almost twice the focus on business model innovation – and receiving significant investor credit for it.

EY CEO Imperative Survey - Percent of respondents identifying new business models as a top 3 transformation driver in their industry

Implications of moving to "as a service" business model (subscription/consumption) in the technology sector

This disparity underscores a significant risk for manufacturing companies. Overlooking the potential for new business models can create opportunities for competitors from adjacent sectors. The risk is particularly acute when these new competitors are also able to capitalize on evolving customer and consumer (end user) expectations. The most successful industrial firms are already learning from consumer-oriented models in sectors such as technology and consumer.

The results of the recent EY CEO Imperative Survey, which looked at trends among "thrivers" (firms with growing revenues) and "survivors" (those with declining revenues), illustrate the importance of business model innovation and transformation more broadly to successful corporate strategy. Per the survey, 45% of manufacturing thrivers are planning business model change, compared

with just 32% of survivors. Over the next three years, thrivers (45%) are almost twice as likely as survivors (25%) to be planning changes in their innovation processes. Within the same timeframe, 73% of thrivers plan to increase spending on general transformation initiatives, while only 32% of survivors indicated the same. ■

(CONTINUED IN NEXT EDITION)

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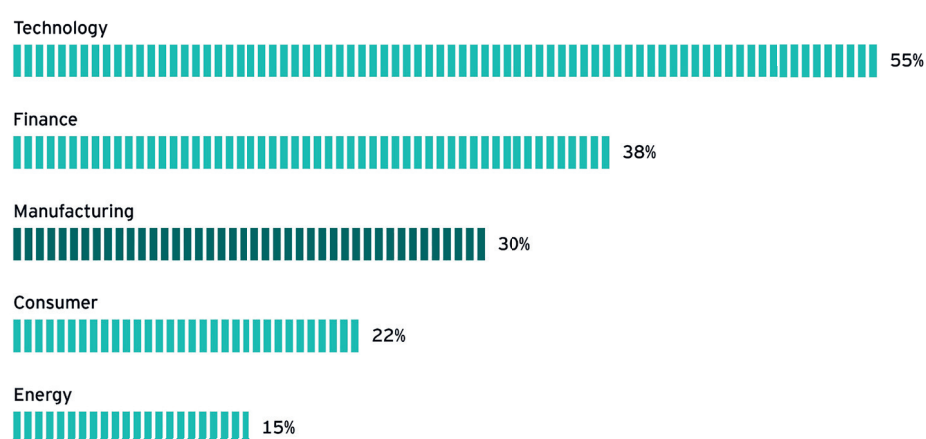
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Figure 1

EY CEO Imperative Survey – Percent of respondents identifying new business models as a top 3 transformation driver in their industry

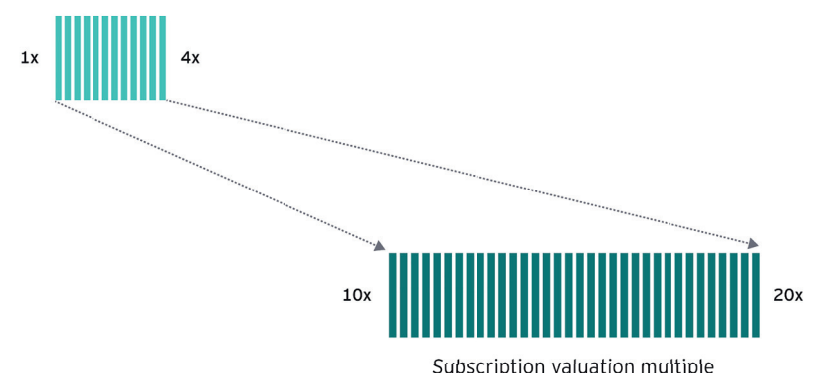


Source: EY CEO Imperative Survey

Figure 2

Implications of moving to "as a service" business model (subscription/consumption) in the technology sector

Hardware/product valuation multiple



Source: EY analysis

Why industrial companies need to lead business model innovation

(PART 2)



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(CONTINUED FROM PREVIOUS EDITION)

Chapter 2

Four ways to build, launch and grow an innovative business model

Manufacturers can thrive in a challenging growth environment by following these principles.

Manufacturers that want to shift from surviving to thriving need to turn their business model innovation intention into action, today. They can do so by building a foundation of innovation on four principles:

1. Strengthen relationships with customers and consumers throughout the value chain

Business model innovation begins with bringing a growth mindset to identifying, understanding and pursuing customers. While most manufacturers are naturally accustomed to considering both direct customers and consumers as key constituencies, leaders should assess all the links in their value chains to ensure a comprehensive understanding of who in the chain is creating the most value and how. Doing so helps leaders align strategic decisions and resources to the needs of constituencies that will ultimately drive revenue growth. This also helps leaders broaden their thinking beyond the immediate next link in the value chain to include a wider range of value creation opportunities.

Thriving manufacturing companies are

1.5x

more likely than survivors to identify changing customer expectations as a major market trend.

In broadening their thinking, manufacturing leaders should also transition from a product-delivery mindset to a value-generation mindset. Implementing these shifts within a company may require both structural and cultural adaptations to best generate value. Leaders must bring a fully open mind to the process of understanding their customers better – and be prepared to disrupt their own teams and structures to maximize value creation. Reorganization without full knowledge of customer needs, on the other hand, can take a company backwards in the value creation process.

Case study: Vehicle maker misses mark on new e-commerce model

A commercial vehicle manufacturer wanted to increase sales of aftermarket parts. To do so, it decided to introduce a new e-commerce business model that would sell parts directly to consumers, rather than through traditional distributor or dealership channels. The company believed that its knowledge of its own products and large base of equipment in the field would be sufficient to guarantee the new model's success. This confidence led the manufacturer to invest millions of dollars in a new digital platform to support the direct aftermarket model – yet it flopped, generating less than US\$100,000 in sales in its first year.

What went wrong? While the firm's willingness to explore a new business model was commendable, it was undermined by two critical mistakes: 1) it did not fully evaluate the needs, preferences and habits of consumers (which strongly favored traditional players' broad, non-OEM-specific catalogs, personalized service and superior logistics), and 2) it did not have organizational structures and procedures in place to enable smaller, quicker business model innovation cycles. Manufacturers must know their customers well and be prepared to fail quickly for innovation to succeed.

2. Establish a presence in the value chain with the strongest market position

As threats from non-traditional competitors rise, manufacturing leaders need to focus their organizations on pursuing and owning value chain positions that offer the greatest opportunities for value creation over time – and embracing the business model innovations required to achieve these goals.

Risk of increasing competition from non-traditional competitors ranks at

#3

behind geopolitical risks and climate change, according to the EY CEO Outlook Survey.

Leaders must assess how their organization's capabilities and offerings align with the value being generated across the value chain. Reviewing one's activities through this lens can help identify whether the value being captured by the organization is properly aligned with the value created for consumers, or if there are untapped opportunities to create new value – and be recognized for it.

Many manufacturers have succeeded at business model innovation by evolving from a product-based model to a new service- or subscription-based model. These new models frequently draw on existing capabilities (e.g., aftermarket repairs and related ancillary services) while deepening or creating new customer or consumer relationships and providing unparalleled ongoing insights into how these constituencies define value.

Case study: Ball bearing company rolls into subscription services

A manufacturer of ball bearings wanted a stronger and more direct relationship with the consumers of its products – factory owners – to improve its value chain positioning. As components in large, highly complex systems, ball bearings can be undervalued as a commodity input. However, improper maintenance of ball bearings can lead to unplanned downtime from equipment failure. This disproportionate impact on what consumers valued most – uptime – helped the firm identify an opportunity for business model innovation.

The manufacturer developed a subscription-based model that positioned the company to sell a service based on the value of machinery performance rather than on the ball bearings alone. Its introduction repositioned the manufacturer in the value chain so that it could interact more directly with the consumer. This new position also afforded greater control over sales of the ball bearings, further enhancing the manufacturer's competitive position.

3. Shift revenue models from delivery of goods to delivery of value

The first two principles underscore how business model innovation can help firms rethink what value they are delivering and to whom. As the preceding case study also demonstrates, it is also critical for manufacturers to explore changes to the "how" – namely, revenue model shifts and tactics that enable them to capture their fair share of the additional value delivered to customers.

For companies to succeed at measuring and pricing value, they need access to data, supported by the right technology to capture, analyze and act on it. Connected products provide manufacturers with a prime opportunity to understand customer usage patterns and to build new offerings – and new business models – based on insights

from this data. Digital transformation efforts undertaken by many manufacturers may create a foundation, but the insights that may foster real business model innovation require more than just the right toolkit. Leaders must be ready to reimagine all aspects of their business through the lens of what they know, via their own data, that the rest of the market doesn't.

Thriving manufacturing companies are

2.5x

more likely to prioritize investments in data and technology over cost reduction efforts.

When working with customer data, trust is essential. If manufacturers are to be paid based on value delivered versus units sold, customers must be willing to trust that data gathered via connected products and services will be used to their benefit as much, if not more so, than that of the manufacturer. Customers should be able to see an accounting of value generated and its alignment with prices or fees, ideally creating a virtuous cycle of openness with the manufacturer. Ongoing transparency makes it easier to identify opportunities that may be addressed by new business models. ■

(CONTINUED IN NEXT EDITION)

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Case study: Chemical sales model moves from volume to value

A large manufacturer of crop protection chemicals faced stagnating sales growth as farmers adopted digital tools to measure field conditions, making them less likely to overbuy. In response, the firm focused its innovation strategy on what its consumers valued – maximizing crop yields. To help address the risks faced by farmers due to factors beyond their control such as weather, the manufacturer created a program based on integrated field management practices that included several significant business model innovations.

Rather than selling through distributors, the new program sold directly to farmers. This new relationship allowed the company to set its pricing based on crop yield rather than product volume sold. If the crop's yield is lower than agreed, the manufacturer pays the farmer for the loss. Under this model, data contributed by farmers was used in predictive modeling and hedging risk at scale, which created a mutually beneficial partnership between the manufacturer and its customers.

4. Build a partner ecosystem to innovate at scale beyond sector boundaries

Business model innovation requires companies to re-examine, and often challenge, their own core competencies. Sometimes a value creation opportunity demands capabilities outside the company's experience or beyond its sector. In these cases, manufacturing leaders should focus on building or joining an ecosystem.²

To build a high-performing ecosystem, manufacturing leaders need to define where partnerships would best support value creation and delivery by extending capabilities, market presence, and innovation more effectively than through organic investment or acquisitions. While ecosystems generally provide value creation opportunities for all participants, leaders seeking to build one should look

for ways to ensure their organization "owns" it for greater control over how the additional value is allocated.

In the EY 2021 Ecosystem Survey,

2 in 3

manufacturing companies say that ecosystems are more effective than traditional growth strategies.

Through these partnerships, manufacturers should also follow leading practices in sourcing, building and managing ecosystems. Ecosystems work best when regular C-suite reviews, KPIs, dedicated budgets and clear organizational ownership are clearly articulated and followed consistently.

Case study: Ecosystems drive the future of e-mobility

Despite rising demand for electric vehicles (EV), many buyers remain on the sidelines due to range anxiety. While advances in battery capacity may help partially close the expectations gap, the lagging buildout of charging networks is a bigger challenge. Many countries still need vastly wider networks to entice drivers to adopt an EV as their primary vehicle.

The successful build-out and maintenance of EV charging infrastructure with enough capacity to support future EV demand will require a large ecosystem of energy, infrastructure and automotive companies as well as government authorities. The range of participants in this anticipated ecosystem model reflects the number of distinct core competencies required to optimize each element of the network, including the manufacturing, installation and maintenance of the chargers, site selection, power delivery, and payments.

Among future e-mobility solutions, it is possible to envision ecosystems enabling the creation of a unified platform supporting all transportation needs. The platform, which would include auto manufacturers, transportation companies and government authorities, as well as adjacent services such as insurance companies, could provide consumers with seamless access to a range of mobility options depending on location, budget and distance to be traveled. This platform would be customer-centric,

enable ecosystem partners to establish a commanding presence along the value chain with the strongest market potential, and shift revenue models to drive maximum revenue for all ecosystem participants.

Chapter 3

Key questions for a business model innovation journey

Answers may help leaders see critical knowledge gaps or risk areas before beginning the process.

As manufacturing companies seek sustainable, profitable growth, the incentives for laying the internal and external groundwork for business model innovation are clear. Nevertheless, it's not surprising that sector CEOs are prioritizing more tangible and predictable actions (e.g., investments in data and technology) over significant changes in their offerings.

Even if business model innovation doesn't appear anywhere on management's to-do list, leaders should still ensure they are thinking carefully about the current and future state of their business model and its relationship to the value chain. The answers to these questions may reveal critical knowledge gaps or risk areas that should be addressed, regardless of the specific solution:

- ▶ Value of offering: Where and how is value created by your company's products and services?
- ▶ Value to customers: Where would your customers say your products and services deliver value? How do you know this?
- ▶ Pricing of value: How does your company set prices? What is the relationship between your prices and the value delivered to customers?

- ▶ Forms of value: What forms of value exchange could you be taking advantage of beyond just fees for products? Would you be better off charging less and receiving additional data, IP rights, or access to new types of customers?
- ▶ Value from competitors: Where are your competitors creating and delivering value?
- ▶ Ecosystem partners: How are partnerships adding to the value of your products and services?
- ▶ Products, processes and people: Do you have the right products, processes and people within your organization to maximize value? If not, where is the greatest need for change? ■

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