

**THE ROLE OF BUSINESS MODEL INNOVATION
IN THE EMERGENCE OF MARKETS:
A MISSING DIMENSION OF ENTREPRENEURIAL STRATEGY?**

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ACADEMIC ABSTRACT

We propose that entrepreneurs who successfully introduce new business models that significantly alter existing market preferences and structures do so through a process that aligns collective interests with their strategic vision of the business model and market. This process combines the experimental and iterative nature of effectuation with a strategic orientation that is fundamentally market driving.

EXECUTIVE SUMMARY

While the business model literature effectively explains how existing market conditions influence business model development and implementation, it does not seem to account for situations where a new business model actually influences market conditions. In addition, despite a rich literature describing the interactions among institutional entrepreneurs that shape new markets (Aldrich & Fiol, 1994; Fligstein, 2001), much less has been written about the specific role of individual actors in influencing and shaping emerging markets in their favor (Santos & Eisenhardt, 2005). Examining business model development and evolution in the emerging market context provides a critical link between the collective actions that facilitate new markets (Aldrich & Fiol, 1994; Fligstein, 2001) and individual firm actions seeking to co-opt market preferences, define firm and market boundaries, and control competitors, suppliers, and future outcomes (Santos & Eisenhardt, 2005). In other words, in the emerging market context the development and execution of a business model requires interaction and alignment between collective interests and those of the entrepreneur, which in turn influences market definition and structure.

This suggests that business models are a key dimension in developing and analyzing entrepreneurial strategy in emerging markets. While the preferences and structures of established markets are relatively fixed and difficult to change, thus constraining the extent and impact of business model innovation, this is not the case in emerging markets. In emerging markets, competing business models are a primary source of innovation that significantly influences market structure and preferences. Through a process that combines the experimental and iterative nature of effectuation with a strategic orientation that is fundamentally market driving, self- and collective interests are aligned to forge actions which result in a predominant (e.g. market defining) business model.

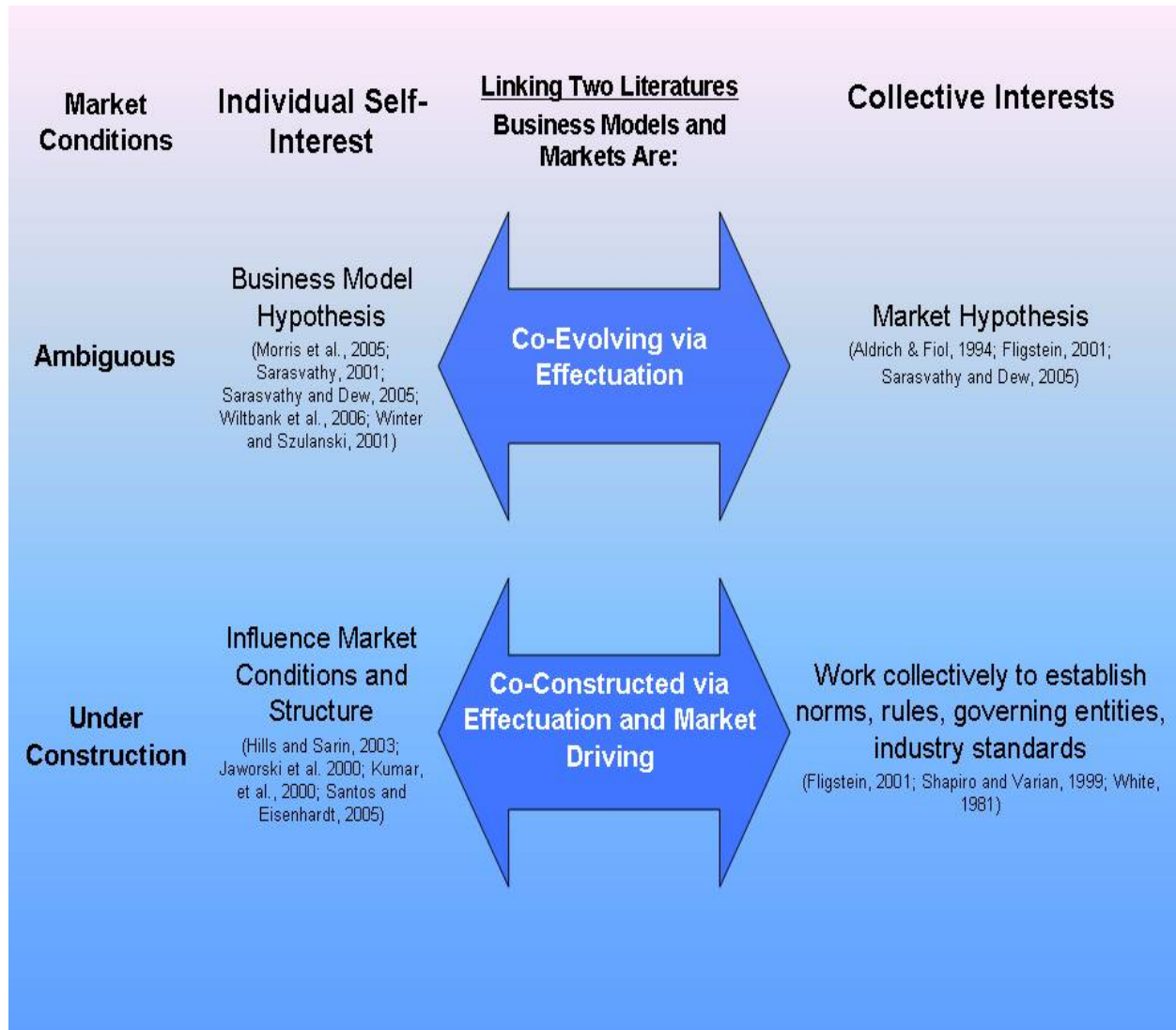
HOW BUSINESS MODELS AND MARKETS CO-EVOLVE

Business models play a pivotal role in emerging markets because they are a mechanism for integrating an individual firm's value chain (Porter, 1985) or value network (Shafer, Smith, & Linder, 2005; Voelpel, Leibold, & Eden, 2004) with the larger business ecosystem (Leibold, Probst, & Gibbert, 2002). Successfully implementing a business model requires the integration of resources, partners, suppliers, customers and other agents into cooperative networks that evolve with market conditions (Leibold et al., 2002; Sarasvathy & Dew, 2005; Voelpel et al., 2004). In the emerging market context, these elements co-evolve and influence each other.

Sarasvathy and Dew (2005) suggest market creation is the result of entrepreneurs experimenting with business models through effectuation. The basic premise of effectuation is that entrepreneurs eschew analyzing expected returns based upon estimated levels of risk and investment and instead choose between possible effects they can create with their given means (Sarasvathy 2001). When new markets are emerging, it is impossible for entrepreneurs to analyze all possible resource arrangements and market opportunities because they are cognitively bounded and have idiosyncratic motivations (Sarasvathy & Dew, 2005). Flooded by a multitude of opportunities, entrepreneurs set out with an initial hypothesis of the market and develop a business model in alignment with that hypothesis. Through multiple entrepreneurs engaging in an iterative process of market hypothesis testing and with their network of stakeholders, order emerges and business models are crystallized while new markets are created. Through this process "those (firms) who come on board, and what they commit to the enterprise, together with other contingencies that occur along the way, determine what opportunity gets created" (Sarasvathy & Dew, 2005: 543).

While we believe that entrepreneurs in emerging markets experiment with business models through effectuation (Sarasvathy, 2001), we also believe that they may also engage in market driving (Hills & Sarin, 2003; Jaworski, Kohli, & Sahay, 2000) to influence the collective action needed to construct a new market. Over time, these interactions enact an increasing level of stakeholder commitment and market constraints that transform market conditions around a (resulting) predominant business model (Sarasvathy & Dew, 2005). This process of simultaneous business model and market evolution highlights the critical role business models have in shaping emerging markets. The interplay between individual and collective action is summarized in Figure 1 (next page).

FIGURE 1
How Self and Collective Interests are Aligned via Business Model Evolution in Emerging Markets



The co-evolution of the direct-to-consumer computer market and Michael Dell's business model also illustrates this interplay. Dell's ultimately successful business model required significant innovations in supply chain practices, which in turn required and resulted in significant changes in channel structures, processes, and supplier performance expectations in the manufacture of computers. Dell also needed to influence and alter consumer expectations related to researching, buying, and installing computers (Park, 2004). However, Dell gained these insights over time and through continuous refinements to his business model. Dell began building computers in his dorm room at the University of Texas, Austin, because he lacked the resources, supply chain relationships or retail outlets to compete via the existing business model for personal computer sales (Park, 2004). This mismatch between the existing model and Dell's resources and capabilities compelled him to experiment with new markets and customer segments, as well as new processes for the manufacture and distribution of personal computers. Through this process, Dell realized that a new business model based on an innovative supply chain strategy was his key

to success. He then proceed to line up key suppliers and convince buyers of the efficacy (semi-customization and value) and ease (intuitive ordering system) of buying computers direct – influencing both market structure and preferences to align with the Dell business model.

EFFECTUATION: MAKING SENSE OF EMERGING MARKETS THROUGH BUSINESS MODEL EXPERIMENTATION

As previously noted, entrepreneurs developing business models in emerging markets begin with a joint hypothesis of a market and a business model that offers the best chance for survival. These entrepreneurs adopt an effectuation strategy (Sarasvathy, 2001) that involves the simultaneous and iterative testing and promotion of these hypotheses (Wiltbank, Dew, Read, & Sarasvathy, 2006). This approach is referred to as the strategy of *affordable loss*, where the entrepreneur avoids making a single large investment in favor of incremental investments so that resources are set aside for downstream refinements or iterations to offerings based on market feedback (Sarasvathy, 2001). The entrepreneur may also enter markets through alliances and other cooperative strategies that spread risk and facilitate market experimentation (Sarasvathy, 2001). What the firm learns through interactions with these various stakeholders provides critical input to strategic decisions about the business model, such as pursuing additional or different stakeholder relationships and alliances, revising the product or service offering, and refining the target market. This process expands both firm know-how (skills and ability to adopt contingencies) and whom they know (networks of partners, supporters, suppliers, customers). Effectuation can play a role in the emergence of business models that become de facto new industry standards (Sarasvathy & Kotha, 2001).

The literature on the emergence of industry standards (e.g. Anderson and Tushman 1990, Hill, 1997; Shapiro and Varian, 1999) identifies two key strategies that are consistent with effectuation: seeking to develop and leverage partnerships and alliances with key / influential industry stakeholders, and seeking to quickly build an installed base of customers. Sarasvathy and Kotha's case study analysis of the evolution of Real Networks (2001) illustrates how engaging in this process radically altered the founder's initial vision of product offering, target market, and value proposition. Several rounds of partner and customer feedback led the firm to become the market leader in the online delivery of audio programming.

Thus, effectuation helps explain the general evolution of markets from hypothesized and competing business models to the emergence of standards, norms, and rules that define and demarcate them. However, we believe the emergence of dominant business models requires more than collective stakeholder reliance on the iterative and somewhat serendipitous nature of effectuation. Individual actors within the collective who seek to dominate markets must also possess a fundamentally market driving orientation to influence market preferences and structure to their advantage. In other words, while effectuation facilitates the refinement of business models and market standards, norms, and rules, market driving facilitates (and in some cases accelerates, e.g., Apple's iPod and iTunes, Dell) the establishment of a dominant market position. Market dominance is achieved by having a business model that is most closely aligned with the standards, norms, and rules of the market.

The role of effectuation in the co-evolution of business models and markets is summarized in the following propositions:

Proposition 1a:

In emerging markets, entrepreneurs develop an initial hypothesis of the market and their business model

Proposition 1b:

In emerging markets, entrepreneurs expect their business model to change via a process of experimentation

Proposition 2:

In emerging markets, entrepreneurs make incremental commitments of resources to their business model

Proposition 3:

In emerging markets, as entrepreneurs, their stakeholders, and their competitors make incremental commitments to adopting collective market standards, norms, and rules as the market evolves, their business models converge around these standards, norms, and rules

MARKET DRIVING: SHAPING MARKET PREFERENCES AND STRUCTURE TO ALIGN WITH THE BUSINESS MODEL

Market driving is a critical theoretical linkage between the individual self-interests of the entrepreneur and the collective action needed for a business model to effectively define the preferences and structure of the market. Market driving (Hills & Sarin, 2003; Kumar, Scheer, & Kotler, 2000) or driving markets (Jaworski et al., 2000) is a calculated and logical strategic process for producing desired outcomes. Market driving consists of a set of behaviors by which firms seek to fundamentally shape market preferences and structures -- referred to as "the rules" by Kumar, Sheer, and Kotler (2000) -- to their advantage. Instead of assessing and reacting to competitor movements, market driving firms engage in the proactive shaping of stakeholder expectations as they relate to the new business model. Similar to effectuation, stakeholder reactions to these efforts shape future efforts at molding expectations. Market driving similarly involves incremental market experimentation to test and refine markets, product offerings, and value propositions (Gatignon & Xuereb, 1997; Hill, 1997). Firms seek to shape market structure via premeditated and deliberate actions aimed at altering the competitive landscape (Jaworski et al., 2000; Santos & Eisenhardt, 2005) and influencing industry standards (Hills & Sarin, 2003; Jaworski et al., 2000).

While the differences between effectuation and market driving are somewhat nuanced in terms of influencing market preferences, there is a distinct difference in the approach to influencing market structure. While effectuation emphasizes the co-opting of competitors, entrepreneurs engaging in market driving seek to circumvent or eliminate the competition as well. Three perspectives of market driving, by Kumar, Scheer, and Kotler (2000), Hills and Sarin (2003), and Jaworski, Kohli, and Sahay (2000), are summarized on the following pages. Propositions related to the objectives and actions of market driving entrepreneurs follow each summary.

Altering Preferences

Kumar, Scheer, and Kotler (2000) believe that firms who engage in market driving create, shape, and accelerate, rather than predict or respond to, potential market or industry movements. Instead of strictly focusing on customer needs, firms that are market driving also seek to shape the evolution of the marketplace. These firms seek to alter the *rules of the game* to their advantage, not simply make the best moves under the current set of rules. They redefine markets and trigger dramatic changes in customer expectations, value propositions, and business processes. Market driving is often done by new entrants who revolutionize an industry by delivering a substantial leap in customer value through either a breakthrough technology or marketing system made possible by a unique business process (Kumar et al., 2000). The authors cite IKEA as an example of influencing market preferences: the company used a combination of logic (lower prices) and irreverence (don't be afraid) in their communications to convince customers of the benefits of buying quality furniture that you must assemble yourself (Kumar et al., 2000). They cite Dell as an example of a company that created a new market structure by ushering in dramatic changes in the way personal computers were made, sold, and distributed. Kumar et al.'s (2000) definition of market driving suggests that the probability of creating a dominant new business model depends on the degree to which the business model is different from current market conventions and solutions. This leads to the following proposition:

Proposition 4: Entrepreneurs adopt market driving strategies when they perceive they have developed business models that will radically alter the price-performance frontier of existing markets

Catalyzing a Market

Hills and Sarin (2003) focus on market driving by firms in high tech industries which exhibit a high degree of technological and market uncertainty and rapid product innovation and obsolescence. Hills and Sarin (2003) believe organizations that engage in market driving serve as change agents or catalysts who actively engage in creating shifts in attitudes, behaviors, and market structures. Market driving requires entrepreneurs to be market leaders who compel others to follow them. The primary objective is to influence the evolution of the market in a direction that is most favorable to the firm in achieving long-term advantage. For example, a clear motivation for Steve Jobs in pursuing the development of iTunes was his belief that if Apple could be the catalyst bringing order to a chaotic online-music market, Apple would be rewarded with a dominant market position. This leads to the following proposition:

Proposition 5: Entrepreneurs adopt market driving strategies when they believe their business model is a catalyst for defining / shaping market standards, rules, and norms

Influencing Market Structure

Jaworski, Kohli, and Sahay (2000) use the terms market driving and driving markets interchangeably. The amount and magnitude of market driving behaviors adopted is a function of the degree to which a firm believes it can influence the definition or structure of a market and / or the behavior of market stakeholders to the firm's advantage. Jaworski, Kohli, and Sahay (2000) believe markets are driven in three ways: market deconstruction, market construction, and functional modification. Deconstruction involves eliminating market players through the reshaping or flattening of channels and changing the parameters of supplier relationships, or

through acquiring, forming joint ventures or merging with, or similarly outflanking competitors. For example, Dell and Amazon.com have each changed the channel structure within their markets. Market construction involves building a new or modified network of players in a market, while functional modification requires changing the functions performed by existing stakeholders. For example E-Bay's business model facilitated the creation of new networks of buyers and sellers that previously had no means of as effectively connecting with one another, while IKEA made the customer a co-producer of their product experience.

According to Jaworski, Kohli, and Sahay (2000), actions that attempt to directly influence market preferences include seeking out and collaborating with providers of complementary products and services, building (e.g. increasing switching costs) or removing (e.g. expanding channels of distribution) customer constraints, and seeking to constrain competitor actions (e.g. locking up key suppliers). Collaborative efforts to drive industry standards are one variation of this strategy that is prevalent in industries driven by technological advances and network externalities (Arthur, 1990) such as consumer electronics, software, and information technology (Hill, 1997; Shapiro & Varian, 1999). For example, the success of the VHS format for VCR machines facilitated the development and expansion of new business models and markets in the entertainment industry. The telecommunications industry provides an example where competing standards for products and services such as wireless data and voice transmission have sometimes hampered their evolution. Therefore the ability to effectively shape market structure requires that the entrepreneur's business model has the potential to create new and innovative channel relationships and/or serve as the foundation for new industry standards.

Proposition 6: Entrepreneurs adopt market driving strategies when they believe their business model will significantly alter existing channel relationships / conventions

Proposition 7: Entrepreneurs adopt market driving strategies to influence industry standards that legitimize their business model

SO WHAT?

Linking effectuation to market driving in the co-evolution of markets and business models offers a new and potentially powerful theoretical foundation for examining how individual entrepreneurs influence collective action (see Figure 1). In the emerging market context, successful business model innovation and market creation depends on the ability to both align individual and collective interests while fundamentally altering existing market preferences or structures. The adoption of an incremental investment philosophy with the goal of iterative and relatively small scale market experimentation allows entrepreneurs to economize on resources while generating insights that lead to further business model refinement. This process leads to additional customer, supplier, and distributor commitments.

Thus effectuation seems to influence the general evolution of markets from hypothesized and competing business models to the emergence of standards, norms, and rules that define and demarcate them. However, we believe the emergence of dominant business models requires individual actors within the collective to adopt a market driving orientation to influence market preferences and structure to their advantage. In other words, while effectuation facilitates the

refinement of business models and market standards, norms, and rules, market driving facilitates (and in some cases accelerates, e.g. Apple's iPod and iTunes, Dell) the establishment of a dominant market position. Market dominance is achieved by having a business model that is most closely aligned with the resulting standards, norms, and rules of the market. However, a business model can only be dominant if has the potential to radically alter existing market conventions, *and* the entrepreneur adopts a market driving strategic orientation to pursue a dominant market position.

There remains an enormous opportunity for generating new insights by examining the co-evolution of business models with market structures, rules, and norms in the emerging market context. Business models are the end-product of strategic actions, resources, and capabilities that collectively enable the firm to create value. Entrepreneurs in emerging markets select opportunities perceived to be a match with their existing resources and capabilities, develop and deploy strategies that uniquely organize those resources and capabilities into an initial business model, then experiment and ultimately refine the business model as more information, resources, capabilities, and opportunities are realized. We argue that past studies which have focused on technology-driven innovation, order of entry, firm age and differences in resources have not sufficiently addressed the role of business models, or why a particular firm achieves (or does not achieve) market dominance. For example, Anderson and Tushman (1990) suggest a major limitation of their study of technology lifecycles and dominant designs is that their findings do little to inform when a dominant design does not emerge (Anderson & Tushman, 1990: 629). Competing business models may be the most salient unit of analysis for examining the emergence and dominance of firms in emerging markets.

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