# CFR Teaching Note #003: Retailing Business Models

Introduction to Retailing (NDH101), 2020

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Retailing has traditionally been defined as a set of business activities that add value to products and services sold to consumers for personal or family use. This definition focuses on retailers serving as intermediaries between channel actors (manufacturers and sometimes wholesalers) and consumers, using a reselling business model where money is earned by the mark-up that such value adding activities enable. Levy et al (2019) discuss how such value can be added by building assortment, breaking bulk, holding inventory, and providing services.

Retailing practice is, however, increasingly comprising a broader range of activities and retailers are expanding their markets and ways for interacting with both consumers and channel partners. Many contemporary retailers are thus moving away from a reselling business model, using other or parallel business models. In fact, innovations in business models appear to be increasingly critical for building sustainable competitive advantage in the retail marketplace. In the following teaching note, we will provide a brief overview of the literature on retail business models.

### *What is a business model?*

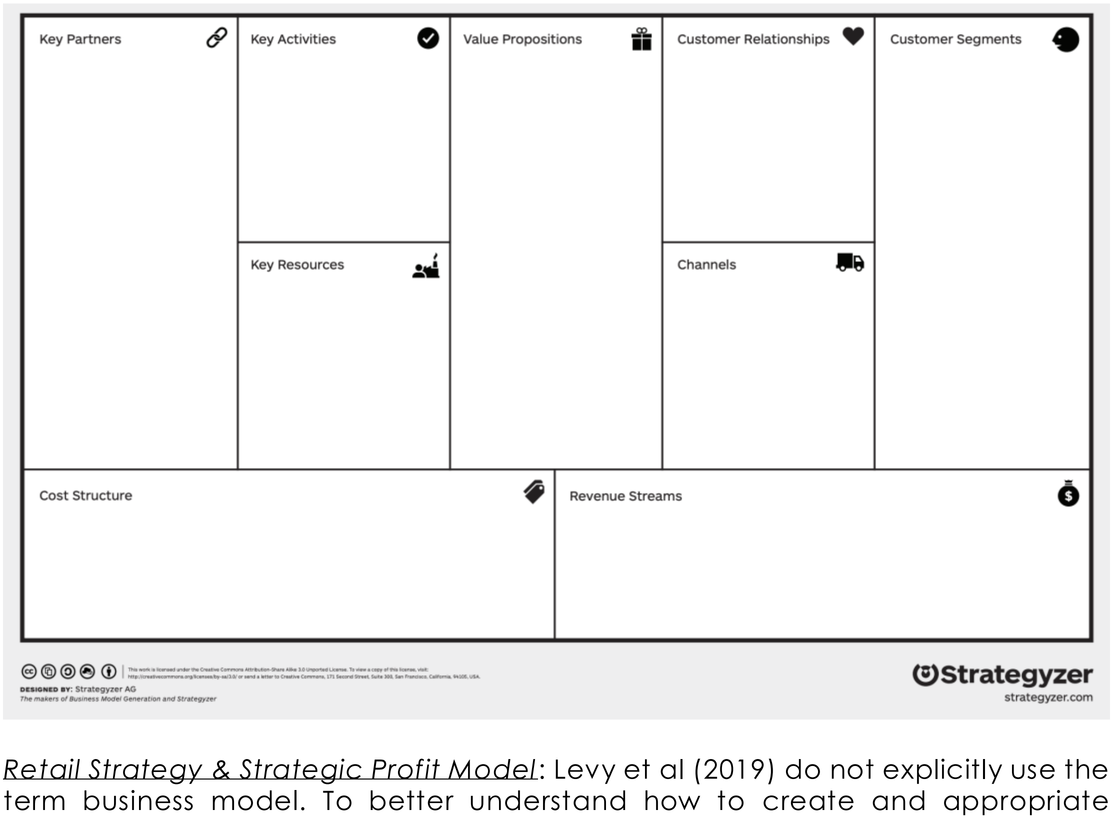
There is no commonly accepted definition of a business model in the literature, but most authors agree that the essence of a business model is that it articulates how a firm creates value for its customers (value creation) as well as how it makes money by offering this value to the market (value appropriation). In the retail context, Sorescu et al (2011) define business model as "a well-specified system of interdependent structures, activities, and processes that serves as a firm's organizing logic for value creation (for its customers) and value appropriation (for itself and its channel partners)" (p. S4).

A key feature of this definition is that it incorporates interdependencies between structures, activities, and processes into an integrated system. Business models are linked with firm strategy, but whereas firm strategy tends to focus on long-term directions and goals, a business model details the mechanisms that move organizations towards that goal. As an example, new strategies typically require new business models, but business models can be changed within the same strategic framework. You could also say that the business model takes the firm strategy which is typically formulated on a rather abstract level and breaks it down into more specific interdependent mechanisms that help finetune actions to realize the firm's competitive advantage.

*Business model frameworks*

Understanding how a company creates and appropriates value is not easy as it requires studying the interdependencies between structures, activities, and processes of an integrated system. In the literature there are several frameworks used to describe and analyze business models in general as well as retail business models in particular. These frameworks can be seen as tools or checklists that help you outline key structures, activities, and processes and thereby better understand their interdependencies. Here is a brief overview of some of the more common frameworks of relevance in a retail context:

<u>*Business model canvas:*</u> Business models are often graphically represented as a canvas (see figure below). The most commonly used canvas was created by Osterwalder and Pigneur (2010) and represents the business model as the combination of nine building blocks. In the middle of the canvas you find the key value proposition (why should customers buy from you?). On the right-hand of the business model canvas you find the customer interface, comprising of customer segments (who are your customers?), channels (how do you reach your customers?), and customer relationships (how do you interact with your customers?). On the left-hand side, you find the internal operations, comprising key partners (who are your partners?), key activities (what activities must you master?), and key resources (what resources will you leverage?). At the bottom you find the profit formula, that is, your revenue streams (revenue models and pricing tactics) and your cost structure (main costs incurred to operate the business model).

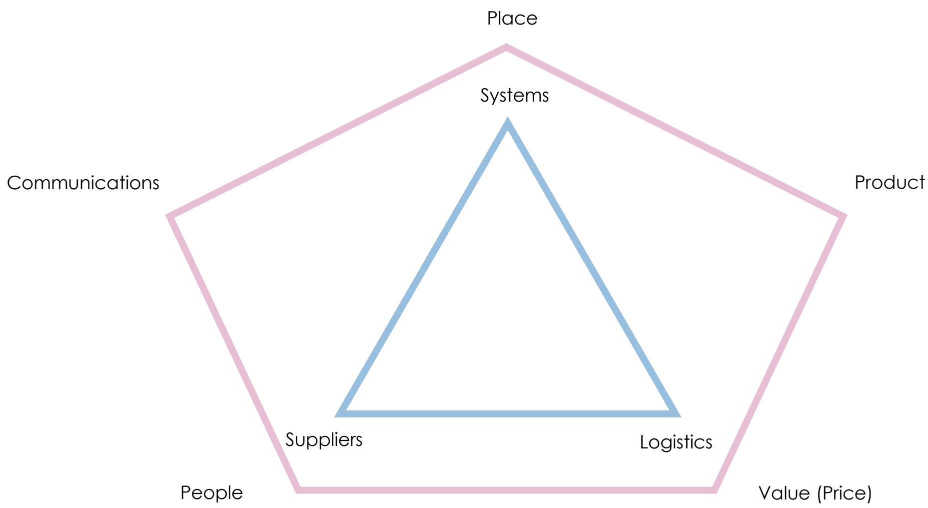



<u>*Retail Strategy & Strategic Profit Model*</u>: Levy et al (2019) do not explicitly use the term business model. To better understand how to create and appropriate value, they focus on retail strategy and its link with financial strategy. In this framework a retail strategy is a statement that defines: 1) the target market(s) towards which the retailer directs its efforts, 2) the nature of the merchandise and services that the retailer offers to satisfy the needs of the target market, and 3) how the retailer develops unique assets that enable a long-term competitive advantage over its competitors. In relation to business models, the retail strategy

thus focuses on value creation. To understand how the retailer appropriates value, Levy et al (2019) introduce the strategic profit model (SPM) that summarizes how the retailer generates returns through the profit margin and/or asset turnover management part.

*Retail Business Model*: Sorescu et al (2011) propose that retail business models comprise three interconnected core elements: retailing formats, activities, and governance. Retailing formats refer to the structures for securing and organizing selected retailing activities into coherent processes that fulfill the customer experience (i.e. the design of the retail mix). Retailing activities refer to acquiring, stocking, displaying and exchanging goods and services that fulfil customer experience (i.e., structure and sequencing of processes that enable the retail format). Retailing governance refers to the actors involved in creating and delivering customer experiences as well as the mechanisms that motivate these actors to carry out their roles in fulfilling the customer experience.

*The Eight Ways To Win in Retailing*: This framework was developed by Ring and Tigert (2017) and identifies five outward-oriented decisions (5) and three internal decisions (3) that together help explain how a retailer creates and appropriates value (= 8 ways to win, see figure below). The five outward-oriented decisions are typically drawn as a pentagon and identify five major customer-facing decisions through which retailers can differentiate themselves in the marketplace, namely: place (what channels are used, how are they located and designed?), product (what assortment is offered?), value (what is the price vs. quality ratio and pricing strategy?), people (what service level, expertise and experience is offered?), and communication (how do we communicate what we have to offer?). The internal decisions are drawn as a triangle that supports the pentagon via operational effectiveness in terms of systems (what processes are used to control flows and operations?), logistics (how are merchandise moved from manufacturer to consumer?), and supplier relationships (how are key relationships managed?). The pentagon thus represents what the customer experiences, whereas the triangle describes how the retailer goes about making it happen.



***What kind of retail business models?***

Different business models often exist within the same industry. For example, in fashion retailing you can find actors who resell other brands (e.g., Åhlens and Boozt), vertically integrated actors who sell their own brands (e.g., H&M or Zara) as well as off-price actors who buy last season ("waste") merchandise (e.g., TJ Maxx) or focus on renting out products via subscription models (e.g., Rent the Runway). Conversely, the same business model can be replicated in different industries. For example, Uber and Airbnb use similar (peer-to-peer sharing digital) two-sided platform business models in the mobility and hospitality industries, respectively.

To be able to discuss similarities and differences across business models they are typically grouped into archetypes. Common business model archetypes in retail are:

*Reselling*: A reselling business model is built on a firm buying products from suppliers and then reselling them to consumers. Ownership is transferred first from suppliers to resellers. Resellers do not enable direct interactions between their suppliers and buyers and typically control how the products or services are sold (e.g., in terms of advertising, consumer services, responsibility for order, fulfillment). The value created and appropriated in reselling is based on intermediation and the fact that a reseller can reduce search and transaction costs for manufacturers and customers. Reselling is the traditional business model in retailing and common examples are Walmart and H&M. Many trading and wholesale companies also rely on a reselling business model.

*Platforms (two-sided)*: A platform business model creates value by connecting two different user groups (typically buyers and sellers). Revenues come from transactions/interactions rather than transfer of ownership. This business model creates value through inputs or technologies that serve as foundations upon which other parties can interact or build products or services that they sell to consumers. The value creation is often dependent on network effects, meaning that the value of the platform increases with the number of users, both from the demand and supply side. To succeed the platform therefore needs to build mass in both user groups. An example of a two-sided platform is Uber that connects (independent) drivers with passengers, eBay that connects (independent) sellers with consumers, and shopping malls that connects retailers with consumers.

*Multi-Sided Platform*: A multi-sided platform (MSP) is a technology, product or service that enables direct interactions between more than two groups (e.g., buyers, sellers, and banks). The value created comes both from its role as a platform and as an intermediary. In retailing prominent examples are Alibaba, Rakuten, and Taobao, and different payments solutions such as MasterCard (banks, merchants, and consumers) and booking services such as Ticketmaster (event venues, artists, and consumers). As a multi-sided platform grows in scope and complexity it is often referred to as ecosystem.

Subscription business models: Subscriptions can be defined as an agreement between a buyer and a seller regarding recurring purchases of a product or service. This type of business model has been common in, for example, media and utilities but is increasingly used by retailers too. Although subscriptions are a specific option available to firms when deciding about their revenue streams model (i.e., the profit formula section in the business model canvas), in a retail context they have a profound impact on both operations and customer interface and can therefore be considered as a business model archetype in its own. In fact, Rudolph et al (2017) outline three types of retail subscription business models, each catering to a different value proposition: increase convenience (predefined subscription), reduce complexity (curated subscription), and stimulate inspiration (surprise subscription). Predefined subscriptions help consumers to solve necessary tasks that they do not want to take care of themselves (e.g., Dollar Shave Club, Linas Matkasse). Surprise subscriptions have the potential to widen consumers' horizons to try out products of the same category (e.g., Glossybox, Adidas Avenue A). Curated subscriptions potentially help consumers in product categories characterized by complexity (e.g., Wine Awesomeness, Five Four Club).

Hybrid Business Models: Companies that have a business in which they serve as an intermediary between buyers and sellers must make a strategic decision when it comes to whether they will use a reselling or platform business model. There is also room to combine the two, which is done for example by Amazon and Zalando who use both resell and platform business model in parallel. In fact, through Amazon Prime Amazon also combines the two with a subscription business model.

### *Why retail business models?*

Today there is not only competition between different retailers, but also between different retail models. On the surface it might look like online and traditional retailers are competing based on channels, but the changes currently happening in retailing are more profound. This competition is not just based on different channels but on different business models, i.e., different "philosophies" on how value is created for the consumer and how it is appropriated by the retailer and its channel partners.

The frameworks introduced in this note can be helpful tools to better understand how incumbent retailers work, but also when thinking about how new entrants can design innovative business models in the retail field.

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Note: access to further insights on the Business Canvas and Eight ways to win frameworks are available via hyperlinks in the text.

CFR Teaching Notes are developed for use in the BSc in Retail Management program at the Stockholm School of Economics. Teaching notes are brief summaries that are meant to complement course readings on important topics not covered in the main textbooks or articles.