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Beacons for Business Model Innovation

How applying two pattern recognition tools can empower companies to pick and develop breakthrough winners in their innovation portfolio.

BY GEOFF TUFF AND STEPHEN WUNKER

Business model innovation is a hot topic in management thinking these days, even though there seems to be little agreement about what it looks like and even less about how to discover it. But there is no reason for business model innovation to feel mysterious or hard to achieve. By using analytic tools that provide better decision-making insights, executives can vastly improve their innovation success rate—and help their business model investments generate bigger returns.

Tupelo, Mississippi has seen its share of people upending tradition. Not only is this small Southern town the birthplace of music revolutionary Elvis Presley, it is also ground zero for a new movement that seeks to transform a totally different field—how we care for our elders. Rejecting traditional models of senior living—those that feature a large medical staff tending to hundreds of patients in an institutionalized setting—a Tupelo doctor created the first “Green House” senior home. These facilities contain no more than a dozen residents. The residents interact with each other in a large common area, play a role in decision-making, and are cared for by a single multi-tasking nurse’s aide. As the name suggests, the place feels like a house, not a hospital or a nursing home. Residents found the Green House experience so compelling that the concept has now been replicated more than 250 times in 36 states. The radical approach to care is mirrored by an equally unique economic model that slashes staffing and overhead costs. Due to the small scale of the facility and the fact that there is just one multi-tasking worker, total staff time is thirty minutes less per resident-day, even while nursing care time (what matters most to the residents) is ninety minutes more. Green Houses are a new business model founded on a total rethinking of the “customer experience” of elder residents.

By contrast, business model innovation in the newspaper industry seems to have lost touch with the customer and has instead become a euphemism for cost cutting. Even some of the leading institutions in the market seem to have done little new except for cutting journalists and putting articles online. Many in this industry seem to have taken an inward-looking view by addressing the simultaneous implosion of advertising and circulation through thinner papers with more wire service stories. A more customer-focused view might have considered the many touchpoints newspapers can have in people’s lives and communities and addressed these challenges through innovations such as the syndication of content and creation of focused reader communities. There is little reason, for example, that newspapers could not have dominated the online classified industry rather than ceding it to online institutions such as Craigslist, Monster.com, and eBay.

Because of the industry’s inward-looking perspective, it is not a shock that newspapers have largely failed to create new business models. The promise of business model innovation—to create new product and service categories that make money in new ways and achieve accelerated growth—generates enthusiasm but comes with a big catch: it requires true integrative change across many

functions of a company, from finance and operations to manufacturing, marketing, and sales. It requires new skills, new behaviors and the courage from leaders to think, act, and lead differently.

THE PROMISE OF BUSINESS MODEL INNOVATION—TO CREATE NEW PRODUCT AND SERVICE CATEGORIES THAT MAKE MONEY IN NEW WAYS AND ACHIEVE ACCELERATED GROWTH—GENERATES ENTHUSIASM BUT COMES WITH A BIG CATCH.

Executives can increase their odds of success by using a rigorous set of decision-making and pattern recognition tools. In this article, we will briefly touch on two critical diagnostic tools, the Ten Types of Innovation® framework developed by Doblin, the innovation practice of Monitor Deloitte within Deloitte Consulting LLP, and Economic Value Estimation framework created by pricing strategist and Monitor Deloitte senior advisor, Tom Nagle.

By taking advantage of these tools, corporate leaders can develop insights that help them analyze which business model innovation projects will offer the most value for customers, allowing them to pick the winners and shut down the losers.

Ten Types of Innovation®: Meshing Inventive Profit Model with New Forms of Customer Engagement

In examining more than 5,000 innovations—successful and not—over the past 15 years, the team at Doblin has classified innovation activities into Ten Types of Innovation. Sadly, most of these innovations have not been successful (defined as returning their cost of capital), achieving in aggregate an abysmal success rate of 4.5 percent. Why? The vast majority of them—and especially the failed attempts—have been centered on product performance and product system innovation (see Figure 1 below). This focus area should not be surprising: new product ideas are easy to dream up and just as easy to kill in the average company’s stage-gate process. If they are lucky enough to make it through to market launch, many product-focused innovators find themselves vulnerable to competitors. This challenge is becoming only more daunting as competition heats up in all corners of the world, especially in emerging markets where patent law may be less effective and mastery of complex distribution systems can matter more than having the best product on the shelf. By contrast, the most successful innovations studied share two important

traits. First, they focus on shifts in the profit model and means of customer engagement. And second, they employ multiple types of innovation—frequently six or more—making them genuinely new and different “business models.” These are breakthrough innovations that are difficult to replicate because they deliver unique value to customers and are integrative in nature (across company functions). In our research, only two percent of the initiatives demonstrated these attributes and yet they delivered 90 percent of the cumulative value of all the innovations studied.

BY CONTRAST, THE MOST SUCCESSFUL INNOVATIONS STUDIED SHARE TWO IMPORTANT TRAITS. FIRST, THEY FOCUS ON SHIFTS IN THE PROFIT MODEL AND MEANS OF CUSTOMER ENGAGEMENT. AND SECOND, THEY EMPLOY MULTIPLE TYPES OF INNOVATION.

In the course of this research, we also discovered that it is very hard to innovate around profit models and customer engagements and *not* pull along other types of innovative change. For real business model innovation, a company must assemble six or more types of innovation, with at least one innovation type coming from each of the three major categories (configuration, offering, and experience). Changing these fundamentals requires significant shifts across the business value chain. For example, it is a steep challenge to build a great, new customer engagement without also innovating your offering, processes, partnerships, and payment terms.

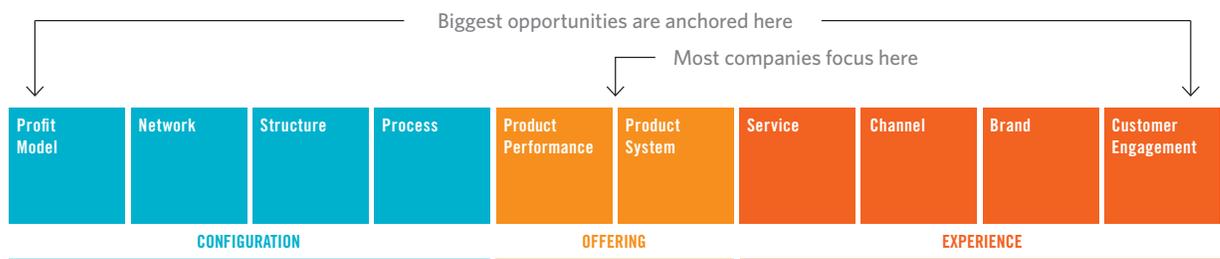
The findings of this research, as documented in Doblin’s book *Ten Types of Innovation: The Discipline of Building Breakthroughs*, lead to a relatively basic condition for innovation success: to join the minority of companies that have really created value from innovation, develop concepts that are “anchored at the ends” of the Ten Types of Innovation spectrum and contain possibilities for at least four additional types of innovation as well. Sometimes, this may involve creating a thrilling experience for your customers and figuring out how to make money from it in novel ways—think Apple® iTunes® application program or Nestlé’s Nespresso. Other times, it may involve delivering at least an acceptable product-service package much more cost effectively than is possible using the accepted business models—think IKEA or Southwest Airlines.

Estimating the Economic Value of Innovative Business Models

Effective business model innovation is the ability to discover new ways of making money. It is often developed by tying scalable revenue or margin opportunities to untapped sources of customer value or by creating value more cost-effectively than the competition. For decades, precepts of good marketing have taught us that offers should satisfy customer needs. The difficulty, of course, is that customers often cannot provide a full and accurate description of what they want. They may not have the language for it, they may be (unconsciously) motivated to obscure the truth, they may be basing their consideration on past experience and it is unlikely they can predict how their needs will evolve in the future.

Figure 1: Ten Types of Innovation®

The most successful business model innovations combine new ways of making money with innovative, great customer experiences.

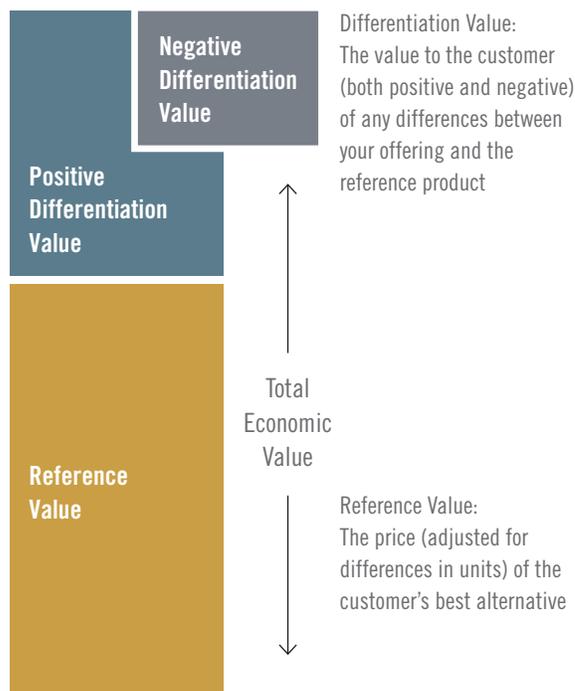


Source: Larry Keeley, Ryan Pikkell, Brian Quinn and Helen Walters. *Ten Types of Innovation: The Discipline of Building Breakthroughs* (Hoboken, N.J.: John Wiley & Sons) 16-17.

Therefore, companies are increasingly tapping into the field of design-driven innovation for inspiration about how to explore these customer needs and desires. Design-driven innovation relies on research methods not traditionally employed by businesses in order to discover insights that may lead to a thrilling customer experience. Video ethnography, field observation, and in-depth interviews—the tools of cultural anthropologists—are behind some of today’s most exciting customer discoveries. These tools provide insight beyond what customers say they want, and into their latent, emerging, and wholly unmet needs.

In order to tie insight to profitable opportunities, we like to borrow the Economic Value Estimation (EVE) tool pioneered by pricing strategist Tom Nagle. EVE is a simple framework used to break down the economic value of an offer into its component parts and compare this value to a next-best competitive alternative (see Figure 2). By combining EVE with non-traditional research techniques (focused on generating new customer experiences), companies can begin to hypothesize what cost and value would be associated with any new offer.

Figure 2: How EVE Pinpoints High-value Innovations



Source: Thomas T. Nagle, John E. Hogan and Joseph Zale, *The Strategy and Tactics of Pricing, Fifth Edition* (Saddle River, N.J.: Prentice Hall), 20.

Establishing the EVE of a potential innovation can help a company establish a threshold for when a project is worth pursuing. Initiatives qualifying as “me-too” or “low-payback” should be scrutinized early in the development process and either killed or reshaped. “High-payback” innovations will either leverage a higher absolute level of value than alternatives or a lower (though still acceptable) level of value using a much lower cost structure. Find the innovations within your portfolio that have the highest ratio of Total Economic Value to Reference Value and those that combine multiple types of innovation (at least six), those are likely your winners. Of course, for a breakthrough innovation creating a new market, a Reference Value will not exist and that in turn will magnify the innovation’s Economic Value.

THESE TOOLS PROVIDE INSIGHT BEYOND WHAT CUSTOMERS SAY THEY WANT, AND INTO THEIR LATENT, EMERGING, AND WHOLLY UNMET NEEDS.

It is enlightening to examine an innovation through the Economic Value Estimation model and the African telecom company Celtel (now owned by India’s Bharti Airtel) provides a vivid example. To address the inefficiencies of cash transactions in third world markets, Celtel launched a mobile commerce service targeting business-to-business payments. Potential corporate customers were initially skeptical of paying Celtel transaction fees until Celtel’s staff rode along with trucking fleets and discovered just how valuable mobile commerce could be. For example, during a typical eight-hour delivery run, three hours could be spent counting cash in very small bills, and cash could be counted eight times between the time it was paid and ultimately banked.

Even more compellingly, Celtel demonstrated how mobile handsets could empower distributors to accept real-time orders and adjust trucking loads for demand swings as they happened, realizing additional revenue potential they were losing out on by taking orders by hand during the prior day’s delivery. Celtel calculated that its services were worth 1 to 4 percent of the total transaction value depending on a client’s circumstances.⁴ Ethnographic research gave Celtel the power to price mobile commerce according to the value it created and develop insights into totally new directions for the service.

Inside the Business Model Innovations at Three Leaders

Geisinger transforms reimbursement model to reward positive patient outcomes. ProvenCare, a system of care for coronary artery bypass grafts (CABGs), uses a bold profit model: for a single fee it guarantees a healthy CABG patient 90 days post-procedure. If there are any complications within that window, Geisinger covers the entire cost of follow-up care. This is a non-trivial guarantee, before this system on average 38 percent of patients experienced such complications. Since the ProvenCare program was introduced in 2006, patients have been less likely to be readmitted; have spent fewer days in the hospital; and are more likely to return directly to their own homes instead of going to a nursing home.¹

MediaTek moves back in the value chain to dominate China's low-cost mobile phone chip sets. MediaTek was founded in 1997 and has become one of the largest fabless semiconductor companies in the world. MediaTek provides a turnkey solution to low-cost phone manufacturers, including the processing chip, software architecture, phone-building instructions, and even dedicated consultants. The company introduced its first low-cost smartphone chipset in 2011 and captured 50 percent of the Chinese smartphone market within 18 months.²

HSBC First Direct creates a branchless bank. First Direct was founded in 1989 based on the insight that a significant number of bank clients did not use branch services and those who used the services reported relatively low customer satisfaction. In order to serve these market segments, First Direct offered a new approach to banking in the U.K.: customers could access all banking services over the telephone 24 hours a day, 7 days a week, 365 days a year. This model was in stark contrast to traditional banks, which were generally open from 9 a.m. to 4 p.m. and closed for most of the weekend. Since then, First Direct has continued to lead in innovative services, such as being one of the first banks with online and mobile banking. As a result, it has attracted more than one million customers since going "branchless."³

Getting Started

Any company that wants to take action on Ten Types of Innovation and EVE diagnostic work will need to start with two fundamental requirements for success:

- ① Understand the basic **operating parameters** of your company to be able to determine what is economically and organizationally viable and what is not.
- ② Know the collection of **profit models** that the business world has used over time and understand how these analogs might—and might not—be applied to your company (See Figure 3).

Operating parameters. The first requirement for success is that you understand the basic operating parameters of your company to determine what is viable. To think about the hidden shackles that prevent business model change, untangle the web of business processes, supply chain partnerships and other relationships that enable a firm to succeed. These include the suppliers, sales channels, and even types of customers to target.

Which of these operating parameters would be threatened by a new business model? How could

a new model start "off the radar" so key stakeholders are not threatened? Think through all of the company's competencies, rules, and behaviors that facilitate the current model, and how these might need to change. For instance, will sales compensation need to emphasize more teamwork than at present? Will the emphasis be on a different sort of buyer—one with an office and not a cubicle?

Proactively addressing these hurdles in focused pilots can reduce an organization's reluctance towards change while at the same time revealing unseen dependencies. Prototyping via pilots enables you to test the flexibility of your company—a key need for business model innovation.

Because these approaches are not simply window dressing and checklists for one-off projects, they must become corporate capabilities that enable a company to sustain its position over time. Senior executives need to lead by example and embed flexibility into their company. Sometimes, the solution is not to invent a completely new way of doing business, but instead to do "old things in new ways" and discover fundamentally cheaper methods to deliver existing sources of value to your customers.

Figure 3: 21 Sample Profit Models from Successful Innovators

TACTIC	DEFINITION	EXAMPLE
Ad-supported	Provide content or services for free to one party while selling listeners, viewers or “eyeballs” to another party.	Google’s AdSense charges sponsors to place links on users’ (free) search results pages; the revenue supported the majority of Google’s operations.
Auction	Allow a market—and its users—to set the price for goods and services.	Electric Authority , in New Zealand, de-centralized energy generation and electricity retailing by creating a whole-sale market for electricity in which generators and retailers can make offers and bids to supply and off-take electricity through trades occurring every half hour.
Bundled Pricing	Sell in a single transaction two or more items that could be sold as standalone offerings.	Verizon created FiOS and bundled together high-speed Internet, cable television, and phone, offering the three services at a single, discounted price.
Cost Leadership	Keep variable costs low and sell high volumes at low prices.	IKEA offers furniture at low prices by selling ready-to-assemble furniture with limited variation by region or country in design, hardware, and instructions.
Disaggregated Pricing	Allow customers to buy exactly—and only—what they want.	Free Mobile , a French telecommunication company, offers monthly contracts starting at €2 for 2 hours of talk, unlimited texts and 50MB of 4G. Contracts are modular and allow customers to easily select the services they desire.
Financing	Capture revenue not from direct sale of a product, but from structured payment plans and after-sale interest.	Kickstarter creates a new opportunity for raising funds for innovative ideas, including Pebble Technology’s E-Watch that raised over \$10 million from nearly 70,000 different investors. Pebble Technology is now developing the next generation smartwatch.
Flexible Pricing	Vary prices for an offering based on demand.	American Airlines implemented “Super Saver” fares in 1977 that enabled variable pricing depending on demand patterns in an effort to fill seats during less-traveled times.
Float	Receive payment prior to building the offering; earn interest on that money prior to delivering the goods.	Next Restaurant diners buy advanced tickets to the restaurant brainchild of Chicago chef, Grant Achatz. By getting customers to pay upfront for their meals, Next earns interest on working capital and limits the risk of empty tables or no-shows.
Forced Scarcity	Limit the supply of offerings available, by quantity, time frame, or access, to drive up demand and/or prices.	Rue La La is an exclusive, invitation-only website where members can buy high-end designer goods at deep discounts—but only for a limited time or until stock sells out ... whichever comes first.
Freemium	Offer basic services for free, while charging a premium for advanced or special features.	Skype developed free Skype-to-Skype calls, but charges a premium for outgoing and incoming calls to landline and mobile phones.

TACTIC	DEFINITION	EXAMPLE
Licensing	Grant permission to a group or individual to use your offering in a defined way for a specified payment.	Apple® iTunes® Store and App StoreSM offer the content that powers its collection of hardware devices. Both stores make money by taking a cut of every song, video, media subscription, and application sold.
Membership	Charge a time-based payment to allow access to locations, offerings, or services that non-members don't have.	Costco's annual membership fees provide members with access to merchandise, travel deals, and insurance, while contributing significantly to the club's profitability.
Metered Use	Allow customers to pay only for what they use.	ZipCar members are charged a small membership fee. Above that, drivers are only charged when they take out a car. This flexible metered use model allows customers to rent cars for as little as an hour at a time.
Micro-transactions	Sell many items for as little as a dollar—or even only one cent—to drive impulse purchases.	Kartrider , an online multiplayer racing game, offered players virtual items in-game, including different types of vehicles and spray paint, that added new functionality for nominal fees.
Premium	Price at a higher margin than competitors, usually for a superior product, offering, experience, service or brand.	Lexus entered the luxury car market with a premium price by creating a quality vehicle and elevated dealership and service experiences. This combination has led to high customer ratings and repeat customer transactions.
Risk Sharing	Waive standard fees or costs if certain metrics aren't achieved, but receive outside gains when they are.	Progressive customers are welcoming the company into their cars to award bonuses based on achieving shared goals. The Snapshot Program gives customers the chance to share their driving habits, which provides Progressive with more data to effectively price premiums.
Scaled Transactions	Maximize margins by pursuing high-volume, large-scale transactions when unit costs are relatively fixed.	Morgan Stanley's costs for managing large sums of money were roughly the same as for small sums, but fees—and thus profit—escalated with larger transactions.
Subscription	Create predictable cash flows by charging customers upfront (a one time or recurring fee) to have access to the product or service over time.	Netflix turned the video rental industry on its head with the implementation of a subscription model (no more late fees!).
Switchboard	Connect multiple sellers with multiple buyers. The more buyers and sellers who join, the more valuable the switchboard becomes.	Ebay collected fees for posting items and took a percentage of every item sold; in return it offered sellers centralized access to millions of buyers and collectors.
User-Defined	Invite customers to set a price they wish to pay.	Radiohead went direct to fans when it offered its album <i>In Rainbows</i> online and allowed fans to set the price they wanted to pay for the entire album.

All company examples are used for illustrative purposes only.

Profit models. The second requirement for success is to understand the types of profit models that exist across the business landscape today. Through its retrospective look at past successful innovations, Doblin has catalogued the 21 different profit models that are typically used by corporations today (as shown in Figure 3).

Knowing these models is necessary but not sufficient for successful business model innovation. To really unlock the potential behind alternate profit models, first understand the orthodoxies of a company and its industry—i.e., “just the way things are done around here”—and then consider how analogous models from other industries might be put to use.

As an example of industry orthodoxy, let’s return to the world of Ad-Supported content as described in Figure 3. One approach is represented by Google’s funding of its billion-dollar business. Known as “do-it-yourself ads,” Google’s AdWords began as simple text advertisements that users bought via a bidding process. Google later implemented a “pay-per-click” model, which meant it only collects a fee from the advertiser when a user clicks on its ad. This shift was effective, as advertising accounted for 91 percent of Google’s \$56 billion in revenues for 2013.⁵

Adapting a different approach to remain relevant in the changing advertising environment, Schibsted Media Group, parent of the Norwegian online classified company FINN.no, allows users to place any ad for free while paying a premium for preferred placement. For instance, advertisers could pay a fee to guarantee a more prominent position on the website or to cross-post their listings in other newspapers within the Schibsted media family.

Finding and using analogies across industries—to apply the business model of one industry to another—can reveal exciting new opportunities. Analogies help companies break free of the orthodoxies of their industry by allowing them to imagine how “borrowing” from another industry can turn their model on its head.

Consider the Netflix subscription model, in which customers stream popular TV shows and movies or exchange DVDs-by-mail for a low monthly fee. Competitors are increasingly following this model as customers turn away from brick-and-mortar, pay-per-rental business. This “subscription” model—well known in the publishing world—could very well have applicability in many other industries. Netflix continues to innovate by shaking up traditional models of paid media content by creating its own. It has developed award-winning television series and extensions of popular shows that are available exclusively to its members.

Taking Action

While many companies have a well-defined process for creating new products, very few have articulated a means for shaping new business models. To start tapping into the enormous value offered by business model innovation, first take a detailed look at what you already have in your portfolio. Carve out the few initiatives that appear to have the characteristics of future winners by using the Ten Types of Innovation and EVE models as pattern recognition tools. If none of the initiatives are winners, focus your team on creating unique, unimagined customer experiences with revenue models that break your industry’s conventional wisdom. To reduce the chance of getting dragged down the route of incrementalism, look for inspiration from the outside.

Three Business Models to Watch

Skype for Business - Leveraging the “Freemium” business model (Figure 3), Skype provides users with free voice and video calls made within its network. For businesses whose employees are frequent users, Skype has begun selling premium services that integrate Skype into a company’s central Private Branch exchange phone system. This service allows for the easy distribution of credit to individual accounts for calls made to non-Skype phones and facilitates both instant messaging and file sharing.

Virgin Pulse - Challenging the “Pay for Performance” business model orthodoxy, Richard Branson’s Virgin Group has created a model it calls “Pay for Prevention.” Virgin Pulse backs corporate wellness programs by engaging employees in measurable activities such as wearing a pedometer and participating in biometric monitoring. At some companies, participants earn reward points based on how effectively they are meeting fitness goals.

eBay Enterprise - Taking advantage of strong e-commerce growth, eBay Enterprise leverages the company’s years of expertise in the online marketplace to create, develop, and run online shopping sites for brick-and-mortar brands. These sites help brands better serve their customers through new sales channels.

Seek insights, perspectives on your industry orthodoxies, and understanding of where the real value lies both for your customer base, as well as for those who are not yet your customers. It is critically important to focus first on the demand side of this work and then wend backwards through the capability, asset, and cost implications.

As with most breakthrough innovation, think about back-of-the-envelope cost calculations—not detailed economic models—and look for opportunities to remove pieces of the cost structure as you explore new user and revenue possibilities.

However, using these analytic tools will not improve the innovation success rate on their own. From the start, careful attention must be paid to process in order to mitigate potential risks such as: the subtle re-direction of new business model efforts to look more like the core business; resistance by business functions impacted by the new model; an inability to rapidly iterate; and an overload of organizational change. To help reduce such risks, a cross-functional governing team of senior executives should be created to establish a clear strategic mandate and set realistic success metrics.

Similar to the approach used by venture capitalists, this team of executives should use frequent board meetings to focus on solving problems as opposed to spending time reviewing presentations by project leaders. They should focus their project leaders on risk mitigation—rather than rapid revenue growth—through the discovery of unknowns and measurement of progress in the early phases of project. Like venture capitalists, the team will prize flexibility and focus innovation project leaders on a small handful of issues at a time. This approach can help reduce the downside of fast change and increase their ability to respond to lessons learned from the marketplace.

This combination of tested analytics tools—the Ten Types of Innovation framework and EVE model—with a strong governance team will help executives vastly improve their innovation success rate. Taking this disciplined approach can help business model innovation projects create value for customers and generate significant returns for the company and its shareholders.

Endnotes

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About Dublin

Dublin is one of the world's leading design-driven innovation practices. Taking a user-centric approach, our multi-disciplinary teams combine strategy and design expertise to help clients set their innovation strategy, build bold breakthroughs, and improve their innovation effectiveness. Headquartered in Chicago with offices in New York and London, Dublin is part of the Monitor Deloitte service offering.

About Ten Types of Innovation®

Ten Types of Innovation is a practical and tangible tool developed by Dublin to help executives and managers develop and implement innovation approaches more successfully in any context, industry or market. Learn more about the *Ten Types of Innovation* book at www.dublin.com/tentypes/



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