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SPOTLIGHT ON BUSINESS MODEL INNOVATION

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Targeting the middle market can be lucrative—but companies won't be able to deliver unless they start from scratch. *by Matthew J. Eyring, Mark W. Johnson, and Hari Nair*





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RIGHT NOW more than 20,000 multinationals are operating in emerging economies. According to the *Economist*, Western multinationals expect to find 70% of their future growth there—40% of it in China and India alone. But if the opportunity is huge, so are the obstacles to seizing it. On its 2010 Ease of Doing Business Index, the World Bank ranked China 89th, Brazil 129th, and India 133rd out of 183 countries. Summarizing the bank's conclusions, the *Economist* wrote, "The only way that companies can prosper in these markets is to cut costs relentlessly and accept profit margins close to zero."

Yes, the challenges are significant. But we couldn't disagree more with that opinion. We have seen the opportunities of the future on a street corner in Bangalore, in a small city in central India, in a village in Kenya—and they don't require companies to forgo profits. On the surface, nothing could be more prosaic: a laundry, a compact fridge, a money-transfer service. But look closely at the businesses behind these offerings and you will find the frontiers of busi-

ness model innovation. These novel ventures reveal a way to help companies escape stagnant demand at home, create new and profitable revenue streams, and find competitive advantage.

That may sound overly optimistic, given the difficulty Western companies have had entering emerging markets to date. But we believe they've struggled not because they can't create viable offerings but because they get their business models wrong. Many multinationals simply import their domestic models into emerging markets. They may tinker at the edges, lowering prices—perhaps by selling smaller sizes or by using lower-cost labor, materials, or other resources. Sometimes they even design and manufacture their products locally and hire local country managers. But their fundamental profit formulas and operating models remain unchanged, consigning these companies to selling largely in the highest income tiers, which in most emerging markets aren't big enough to generate sufficient returns.

What's often missing from even the savviest of these efforts is a systematic process for reconceiving the business model. For more than a decade, through research and our work in both mature and emerging markets, we have been developing our business model innovation and implementation process (see "Reinventing Your Business Model," HBR December 2008, and "Beating the Odds When You Launch a New Venture," HBR May 2010). At its most basic level, the process consists of three steps: *Identify an important unmet job* a target customer needs done; *blueprint a model* that can accomplish that job profitably for a price the customer is willing to pay; and carefully *implement and evolve the model* by testing essential assumptions and adjusting as you learn.

Start in the Middle

Established companies entering emerging markets should take a page from the strategy of start-ups, for which all markets are new: Instead of looking for additional outlets for existing offerings, they should identify unmet needs—"the jobs to be done" in our terminology—that can be fulfilled at a profit. Emerging markets teem with such jobs. Even the basic needs of their large populations may not yet have been met. In fact, the challenge lies less in finding jobs than in settling on the ones most appropriate for your company to tackle.

Many companies have already been lured by the promise of profits from selling low-end products and services in high volume to the very poor in emerging markets. And high-end products and services are widely available in these markets for the very few who can afford them: You can buy a Mercedes or a washing machine, or stay at a nice hotel, almost anywhere in the world. Our experience suggests a far more promising place to begin: between these two extremes, in the vast middle market. Consumers there are defined not so much by any particular income band as by a common circumstance: Their needs are being met very poorly by existing low-end solutions, because they cannot afford even the cheapest of the high-end alternatives. Companies that devise new business models and offerings to better meet those consumers' needs affordably will discover enormous opportunities for growth.

Take, for example, the Indian consumer durables company Godrej & Boyce. Founded in 1897 to sell locks, Godrej is today a diversified manufacturer of everything from safes to hair dye to refrigerators and washing machines. In workshops we conducted

with key managers in the appliances division, refrigerators emerged as a high-potential area: Because of the cost both to buy and to operate them, traditional compressor-driven refrigerators had penetrated only 18% of the market.

The first thing these managers wanted to know, naturally enough, was "Could Godrej provide a cheaper, stripped-down version of our higher-end refrigerator?" We asked them to consider instead the key needs of those with poor or no refrigeration. Did they know what those consumers really wanted? In a word, no. A small team was assigned to conduct detailed observations, open-ended interviews, and video ethnography to illuminate the job to be done for that untapped market.

The semiurban and rural people the team observed typically earned 5,000 to 8,000 rupees (about \$125 to \$200) a month, lived in single-room dwellings with four or five family members, and changed residences frequently. Unable to afford conventional refrigerators in their own homes, they were making do with communal, usually secondhand ones.

The shared fridges weren't meeting these people's needs very well, but not for the reasons one might expect. The observers found that they almost invariably contained only a few items. Their users tended to shop daily and buy small quantities of vegetables and milk. Electricity was unreliable, putting even the little food they did want to preserve at risk. What's more, although they wanted to cool their drinking water, making ice wasn't a job for which these people would "hire" a refrigerator.

The team concluded that what this group needed to do was to stretch one meal into two by preserving leftovers and to keep drinks cooler than room temperature—a job markedly different from the one higher-end refrigerators do, which is to keep a large supply of perishables on hand, cold or frozen. Clearly, there was no reason to spend a month's salary on a conventional refrigerator and pay steep electricity prices to get the simpler job done. And just as clearly, the solution wasn't a cheaper conventional fridge. Here was an opportunity to create a fundamentally new product for the underserved middle market.

Targeting this market has two great advantages. First, it's easier to upgrade the solution to a job people are already trying to do than to create sufficient customer demand where none yet exists—as would-be vendors of purified water and other seemingly essential offerings have found to their dismay.

Emerging markets teem with "jobs to be done." Even the basic needs of their large populations may still be unmet.

Idea in Brief

Multinationals are looking to emerging markets for future growth. But in trying to transplant their domestic business models, they end up slashing margins or confining themselves to the higher-income tiers, which aren't big enough to generate sufficient returns.

They are overlooking a vast opportunity: the underserved “middle market” of people who struggle to meet basic needs such as refrigeration and clothes washing with low-end options because high-end alternatives are beyond their reach.

To exploit this market, companies must identify important unsatisfied needs, devise fundamentally new business models that can meet them profitably and affordably, and carefully implement and evolve the models by continually testing assumptions and adjusting them.

Second, it's easier to reach people who are already spending money to get their jobs done. That's essentially what Ratan Tata did with the \$2,500 Nano. He didn't ask, “How can I get people who've never bought any form of transportation to buy a car?” He asked, “How can I produce a better alternative for people who hire motor scooters to transport their families?” The goal is to redirect existing demand by offering a clear path from an unsatisfactory solution to a better one.

Offer Unique Benefits for Less

To redirect demand, your customer value proposition (CVP) must solve a problem more effectively, simply, accessibly, or affordably than the alternatives. In developing markets, we have found, the components of a CVP that matter most are affordability and access. Let's look at each in turn.

Affordability. Western companies know that they need to come up with lower-cost offerings in emerging markets, but they too often limit themselves to providing less for less. In 2001, for instance, a 300 ml bottle of Coke cost 10 rupees—a day's wages, on average, and a luxury the company estimated only 4% of the population could afford. To reach the other 96%, it introduced a 200 ml bottle and cut the price in half, shaving margins to make Coke more competitive with common alternatives such as lemonade and tea.

In our experience, though, a far more robust approach to creating an affordable emerging market offering is to trade off expensive features and functions that people don't need for less-expensive ones they do need. To get that right requires a clear understanding of the context in which the offering will be sold—which calls for further fieldwork, preferably of a collaborative rather than a merely observational kind. This is good product-development advice in any market. In fact, it applies to indig-

enous players operating close to home, like Godrej, as well as to Western companies confronting the unfamiliar.

Godrej's team designed and built a prototype cooling unit from the ground up and tested it in the field with consumers. Then, in February 2008, more than 600 women in Osmanabad, a city in India's Marathwada region, gathered to participate in a co-creation event. Working with the original prototypes and several others that had followed, they collaborated with Godrej on every aspect of the product's design. They helped plan the interior arrangements, made suggestions for the lid, and provided insights on color (eventually settling on candy red).

The result was the ChotuKool (“little cool”), a top-opening unit that, at 1.5 x 2 feet and with a capacity of 43 liters, has enough room for the few items users want to keep fresh for a day or two. With only 20 (rather than the usual 200) parts, it has no compressor, cooling tubes, or refrigerant. Instead it uses a chip that cools when a current is applied and a fan like those that prevent desktop computers from overheating. Its top-opening design keeps most of the cold air inside when the lid is opened. It

The final design for the ChotuKool (“little cool”) emerged from a cocreation event in Osmanabad, India, in which more than 600 local women participated.



uses less than half the energy of a conventional refrigerator and can run on a battery during the power outages that are common in rural villages. At just 7.8 kilograms, it's highly portable, and at \$69, it costs half what the most basic refrigerator does. Because it's the right size for the job, easier to move, and more reliable in a power outage than a conventional fridge, it surpasses the higher-end offering on the performance measures that matter most to these consumers.

Access. It's not surprising that portability is important to potential ChotuKool customers, given that they move frequently. And because populations in emerging markets tend to be dispersed, obtaining goods and services can be more difficult than in the West. This creates opportunities for companies that solve challenges of access.

In Kenya, for example, banking services are scarce and transferring money is complicated and expensive. Without access to traditional services, many people must use unsafe alternatives such as *hawala*—an unregulated network of brokers operating on the honor system—or transport cash by bus.

It's easier to reach people who are already spending money to get jobs done.

The UK-based Vodafone solved this problem by developing a secure, low-cost mobile money-transfer service. Called M-PESA (*M* for “mobile” and *PESA* from the Swahili word for “money”), the system is operated by Safaricom, Kenya's leading mobile network.

Customers register free with an authorized M-PESA agent—typically a Safaricom dealer, but sometimes a gas station, food market, or other local shop. Once registered, they can deposit or withdraw cash at the agent or transfer money electronically to any mobile phone user, even if the recipient is not a Safaricom subscriber. They can also buy Safaricom airtime for themselves or other subscribers. Customers pay a flat fee of about US 40 cents for person-to-person transfers, 33 cents for withdrawals under \$33, and 1.3 cents for balance inquiries. Vodafone (which owns a significant stake in Safaricom) man-

ages individual customer accounts on its server, and Safaricom deposits its customers' balances in pooled accounts in two regulated banks, so their full value is backed by highly liquid assets.

Since its launch, in March 2007, the service has acquired more than 9 million customers—40% of Kenya's adult population. As of June 2010, the *Economist* reported, M-PESA customers could conduct transactions at some 17,900 retail outlets, more than half of them in rural areas. That figure dwarfs the total number of bank branches, post offices, and Post Banks—which is only about 840 nationwide.

Spurred by the success of its original offerings, the service has expanded to include bill payment, business-to-customer payments such as paychecks and microfinance loan disbursements, delivery of humanitarian aid, and international money transfers. After just three years M-PESA accounted for 9% of Safaricom's total revenue. More important, it has become the engine driving the company's profits, which have shifted dramatically from voice to data traffic. Vodafone has launched similar services in Tanzania, Afghanistan, and South Africa and plans to introduce them in Egypt, Fiji, and Qatar as well.

Failure to address the access challenge is an important reason that so many companies have little success adapting their current models to emerging markets. Time and again, the increased volume they hope will offset slimmer profit margins doesn't in fact result in profits, because the costs of serving far-flung customers in infrastructure-poor developing countries are just too high. But companies that, like Vodafone, devise novel approaches may find them to be widely applicable in many markets.

Integrate the Elements

Business models can be conceived in a variety of ways. Our approach focuses on the basics and also on factors that make it difficult to move from an existing model to a new one—margin requirements, overhead, and “resource velocity” (the capacity to generate a given volume of business within a specific time frame). It has four parts: the customer value proposition, a profit formula, key processes, and key resources the company must use to deliver the CVP repeatedly and at scale. Creating competitive advantage lies in integrating these elements to produce value for both the customer and the company. That's easy to say but devilishly hard to do. Mapping the traditional functions of your company

Building a New Model

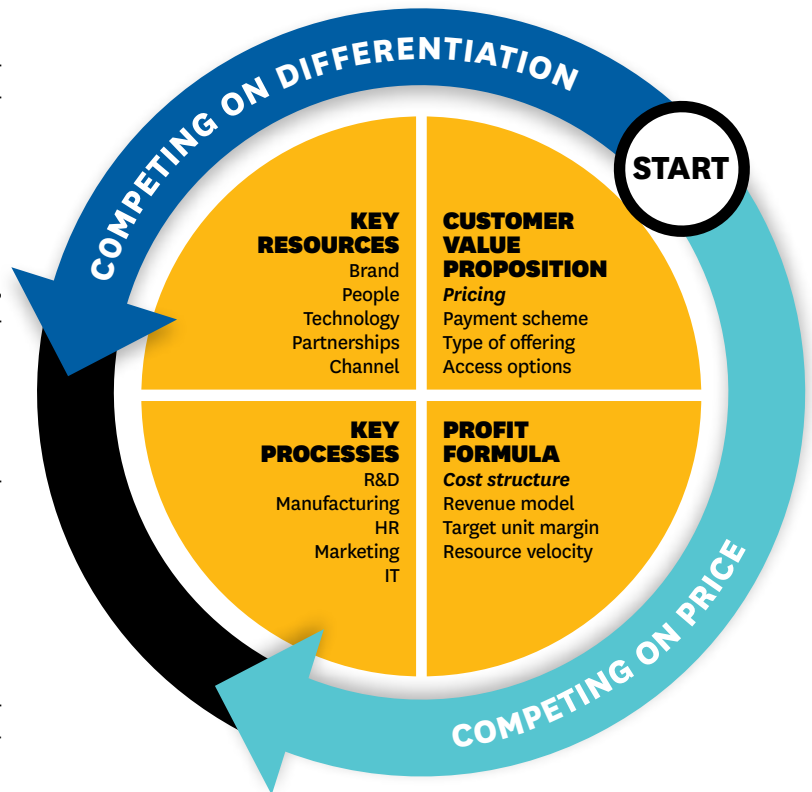
to these broad categories will show you how much you'd have to change to integrate those functions into a new business model (see the exhibit "Building a New Model").

Once you've devised a CVP for your proposed offering, consider the basis on which you compete—differentiation or price. Offerings that compete on differentiation require that you ask, "What do I have to do to produce this?" which leads you counter-clockwise around the model, looking first at what resources and processes are needed, the cost of which (both fixed and variable) will determine what price can deliver the desired profit margin. That's what Whole Foods did when it created a new market for organic foods. Costs drove prices.

For offerings that compete on the basis of price, you move clockwise around the model, again starting with the CVP, but next setting the price, devising a rough cost structure, and then determining what processes and resources (often radically different from those in your current model) are needed to meet your price requirements. Because affordability is so critical in emerging markets, the decision journey is almost invariably clockwise. Innovators start with a revenue model—"We think we can sell this offering to X number of people at price Y"—and then devise the cost structure required to deliver a certain unit margin. Becoming profitable at that margin means operating at a certain resource velocity, which in turn drives decisions about how to organize operations, what materials to use, and other questions.

More often than not, this exercise reveals that a company can't meet its profit goals in emerging markets merely by reducing variable costs in its current profit formula and that a viable model will require changes to fixed costs or overhead as well. That's what Ratan Tata discovered when he set out to produce his \$2,500 car. He couldn't just send the car down the production line and somehow spend less to make it. He needed to reduce fixed costs by designing a car with far fewer parts and changing assembly methods and other key processes. Implementing models that require changes in overhead, margins, or resource velocity tends to be problematic for incumbent companies, which is why it's not surprising that start-ups so often have the edge in bringing to market offerings that require new ways to turn a profit. An open mind is perhaps the most important asset anyone can bring to emerging markets. We learned that lesson when we set out to solve

Business models must integrate four elements: the customer value proposition (CVP), the profit formula, key processes, and key resources. Developing new business models always begins with devising a new CVP. Models designed to compete on differentiation next establish the resources and processes needed to deliver the CVP, the cost of which determines the price required in the profit formula. Models designed to compete on price proceed in the opposite way, establishing first the offering's price, then the cost structure, and finally the processes and resources required.



a basic but knotty cleaning problem for a vast group of frustrated consumers.

Village Laundry Service—which was founded by our company and uses the Chamak brand—was aimed squarely at the emerging middle market. In India people who can't afford a washing machine but want an alternative to laborious washing by hand after a long day's work have unappealing choices: They can patronize a *dhobi* (a traditional washing person), or they can take their clothes to a neighborhood laundry or dry-cleaning establishment. The *dhobis* are cheap, but they use any available water, which can be unhygienic. They slap the clothes against rocks to clean them, which wears down the fabrics, and they don't compensate customers for damage. Turnaround time is five to seven days. A laundry or dry cleaner can do the job in four or five days, generally returns the clothes in good shape, and makes

amends if something goes wrong. A laundry may or may not use clean water, however, and both are far more expensive than a dhobi.

In early 2009 we ventured into several parts of India, from urban slums to rural villages, conducting interviews and immersing ourselves in the lives of the people who faced this frustrating choice. What, exactly, was the job to be done? What sort of laundry service would these customers hire? We discovered several things: The job wasn't to make it affordable for them to clean their clothes the way rich people did; it was to replicate the advantage of a home washer and dryer at a price they could afford. It wouldn't be sufficient to get the clothes back in four days—they'd have to be ready within 24 hours, and at a price well below the laundry's or dry cleaner's. And they'd have to be easy to pick up at a nearby location.

With those requirements clearly in mind, we examined all parts of the business model to come up with an inventive way of extending access while keeping costs low. We immediately realized that it would be hard to create a profitable business that placed many traditional self-service laundries across a town, because demand was unpredictable and upfront capital investment and rental deposits would be high. Our solution: Portable seven-foot-square kiosks, each holding an efficient front-loading washer and a dryer, which can be placed wherever there is heavy foot traffic. Customers drop off their clothes to be washed, dried, and ironed, all within 24 hours. The kiosk's small footprint minimizes rents, and its independent water supply, delivered through a fixed contract, is both less expensive and more reliable than the public utility connection. Covered with ads for the Chamak brand, the kiosks also serve as bill-

boards, reducing the need for paid advertising. We keep transaction costs low through an innovative point-of-sale system, made up of a cell phone linked to a Bluetooth printer and report server, which prints receipts, tracks orders, and captures data on business volume.

After much experimentation, we developed standard procedures for staffing and running the kiosks, including tests to gauge potential operators' aptitude and commitment; simple picture-based operating instructions (much like those used in fast-food restaurants) to ensure consistent service; and a scorecard for traffic level, customer satisfaction, marketing effectiveness, and other variables, allowing us to predict the chances of success at each location and to make operations replicable and scalable.

It is this innovative marriage of a novel solution with all the other elements of the business model that makes Chamak's services affordable and profitable. The model allows the company to charge 40 rupees (about \$1) per kilogram of clothing—little more than what dhobis charge and significantly less than what professional laundries and dry cleaners do (sometimes 90 rupees per garment). Village Laundry Service currently has 5,000 customers patronizing some 20 booths in Mumbai, Bangalore, and Mysore. The company expects to reach breakeven in late 2011. Of course, as with any new business, how Village Laundry Service performs over the long term will depend on a number of hard-to-predict factors.

From Blueprint to Operating Business

Testing and implementing the business model blueprint in emerging markets is as much an art as a science. Having a cadre of global "experts" study the

Four Ways to Uncover Unmet Needs

1 Study what your customers are doing with your product. Be aware that, as Peter Drucker famously said, "The customer rarely buys what the business thinks it sells him."

2 Look at the alternatives to your offerings that consumers buy. Investigate a wide range of substitutes for your products, not just what your competitors make.

3 Watch for compensating behaviors. Discover what jobs people are satisfying poorly.

4 Search for explanations. Uncover the root causes of consumers' behavior by asking what people are trying to accomplish with the goods and services they use.

market for months and create a plan that is then handed over to the local team for execution simply doesn't work. Quick adjustments based on early lessons learned on the ground trump the best and most detailed strategic plan developed before the fact.

M-PESA succeeded in part because Kenya's banking regulator permitted Safaricom to test various business models from the very beginning. Safaricom made the most of the opportunity. It started in 2004 by experimenting with 500 customers and a system designed to allow them to repay microloans. As the company market-tested this concept, it discovered a more-compelling value proposition—namely, a way for urban workers to transfer funds to friends and family members in rural areas. That fundamental insight was the basis on which subsequent services were built, and since M-PESA's commercial launch, its simple but powerful branding message has been "Send money home."

This doesn't mean that expertise is unimportant when launching a new business in an emerging market. But we've found that agile functional expertise is the most critical kind, because the uncertainties in emerging markets are so great. A broad network of resources—including responsive advertising agencies, companies that can produce prototypes on demand, financial service advisers who understand local regulatory guidelines, and a healthy bench of local entrepreneurs to execute the plan—is essential.

The ability to conduct rapid experiments inexpensively and use what you learn from them to hone the business model is essential to success. It allows you to make course corrections before you commit to major operational or strategic investments. Recently a company we incubated was looking to launch a men's grooming business but was uncertain about demand. Rather than commission an expensive 10-city quantitative research study, we rented a small air-conditioned truck and created a mini hair salon on wheels, outfitted with a barber's chair, scissors and other implements, and a mirror. For two weeks we drove the truck around the streets of Bangalore to gauge demand and test various pricing scenarios at various locations. The experiment, which cost all of \$3,000, provided essential answers that no survey could have and demonstrated the business potential for an affordable and convenient Supercuts-like business for men. The company changed from a roving barbershop model to a kiosk-based model and is considering offering additional services, such as facials and skin lightening, that many customers desire.

An open mind is perhaps the most important asset anyone can bring to emerging markets.

Ultimately, the potential for such business model innovations, as for many other disruptive innovations, may extend far beyond the markets for which they were created. G. Sunderraman, the vice president of corporate development at Godrej, sees the ChotuKool as a new growth platform. Unit sales are projected to reach 10,000 in the first year and 100,000 by the end of the second. If Godrej considered the ChotuKool to be simply a no-frills refrigerator for the middle market, it might be content with a moderate penetration rate. But the company's managers regard it as a new product category, based on new technology, that has the potential to perform jobs for people at many income levels. In areas with frequent power outages, the owners of conventional refrigerators might want an inexpensive and reliable backup. Small shops, offices, and manufacturing sites might use it to maintain a supply of cool drinks. Higher-income customers—perhaps in developed economies as well—might use it in their bedrooms, their cars, or their boats. When the technology improves, Godrej believes, it can enter mainstream markets as ChotuKool changes consumers' expectations about refrigerator prices and performance and addresses a need that previously went unmet.

MANY COMPANIES view emerging markets as one large foothold market, and in this they are right. Classic disruptive innovation theory holds that, ideally, innovations should first be introduced in markets where the alternatives fall short on some dimension (typically price) or are utterly unavailable. Emerging markets fit that bill in spades. They are excellent arenas for trying out product innovations far from competitors' prying eyes. But we are convinced that a much greater opportunity lies in viewing these markets not as one vast lab for *product* R&D but as unique environments filled with poorly done jobs that could be creatively addressed with *business model* R&D. Creating new business models will give your company a more enduring competitive advantage. ♥

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