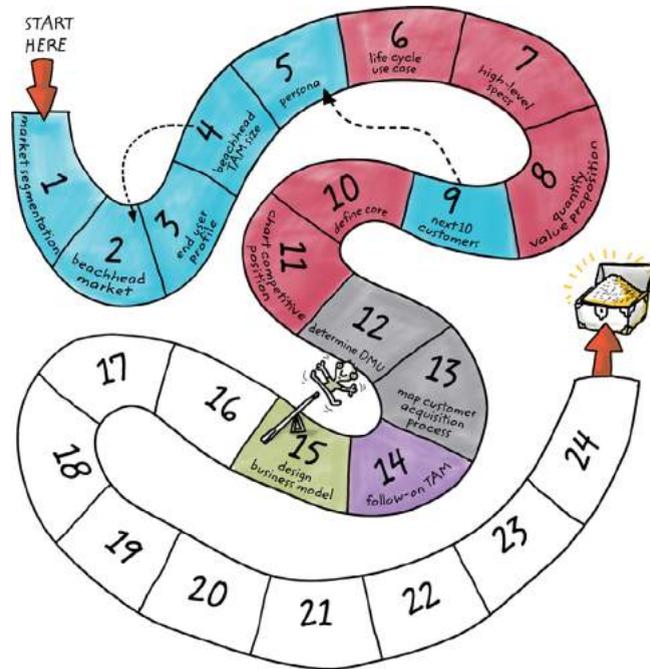


# STEP 15

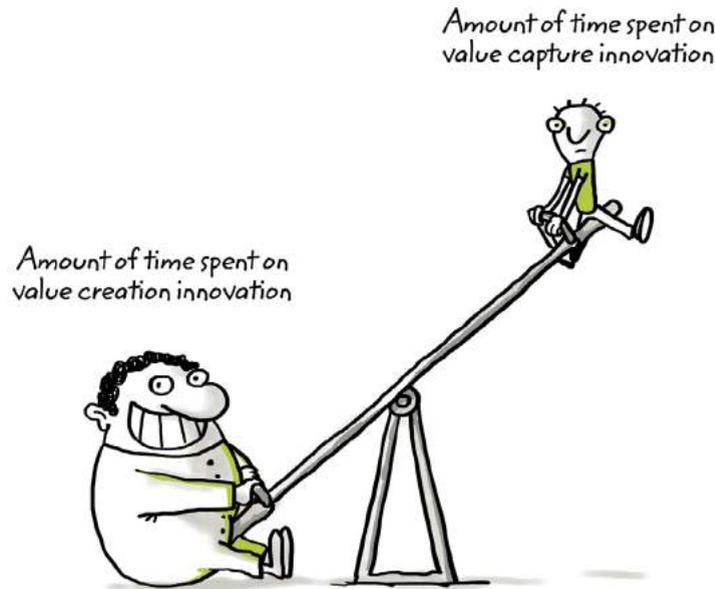
## Design a Business Model



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## IN THIS STEP, YOU WILL:

- Examine existing models across industries for capturing some of the value your product brings to your customer.
- Use the work you have done in other steps to brainstorm an innovative model for your venture.



*Me thinks you need to get things more in balance!*

*How you will capture your share of the value you create is a topic that deserves more attention than entrepreneurs usually give it.*

Entrepreneurs often spend a disproportionately small amount of time on their business model. They invest a lot of time in developing the End User Profile, the product definition, and the value proposition, showing how they will create value for the customer, but barely any time figuring out how that value translates into a profitable business. They are so excited to bring the product to market that they just default to adopting whatever business model is popular in similar markets.

Why spend all this time focusing on innovation related to technology and product design without a commensurate amount of time on innovating with your business model? The track record shows that companies that spend time and effort on innovative business models can see enormous payback.

Google's search product is an excellent example of an innovative business model. Prior to Google, the business model or "value capture framework" of search engines was to fit as many banner advertisements on a page as possible, and to charge as much as possible for them. Google, by contrast, used simple text ads and targeted them based on the keywords used in a particular search. Advertisers found this technique more attractive than banner ads, because they had better data on the effectiveness of individual ads, and could make more effective ads based on the data. This highly innovative business model is what made Google the juggernaut it is today, not the technical proficiency of its search algorithm.

Ironically, this idea of commercially viable contextual search was not Google's but rather came from Overture, an Idealab company that was the first to bring to the commercial market a credible keyword-based advertising solution under the name of GoTo.com. Google simply embraced the idea more enthusiastically and executed a rollout plan that made it the de facto leader in online advertising.

It is a similar story for Apple's iTunes. Before iTunes, the standard method of capturing value for digital music was to charge a monthly subscription fee for access to a library of music, where failure to pay the fee meant access to the music was cut off. Apple successfully differentiated itself with a one-time \$.99 per song charge, after which the user could keep the digital song forever. Initially, this model was perceived as risky, so Apple had to put a lot of effort into getting music labels to agree to the model and to educate users on the model's benefits. The model ended up being a major factor, if not the major factor, in the success of iTunes relative to other music services, with a tremendously positive return on the investment Apple made in carefully and innovatively thinking through the value capture model.

Therefore, make sure to spend time on deciding what your business model for value capture will be and don't just default to the current standard in your industry.

As a new business, you will have many options for business models; but it is very difficult to change a business model once you have established a base of customers. This is one advantage you have over the current entrenched vendors in your industry area. Therefore, evaluate your business model through your customer's perspective when you launch and consider testing different options before you settle in on the business model you will use to capture value.

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## A BUSINESS MODEL IS NOT PRICING

A business model is a framework by which you extract from your customers some portion of the value your product creates for them. It is the idea that the amount of money your venture gets paid is based on how much value the customer gets from your product, and not some arbitrary markup based on your costs. You should constantly be working toward achieving business models and pricing that are value-based even if you have to make temporary shifts along the way to get there (e.g., joint development contracts, government projects, pilot projects where the scope is unclear and the risk is high). However, pricing matters surprisingly less than designing an effective business model, because the latter has a more direct influence on your ability to extract value over the lifetime of your business.

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## KEY FACTORS WHEN DESIGNING A BUSINESS MODEL

When thinking about an appropriate business model for your business, there is no one universally right answer, as it depends on your specific situation. There are four key factors that I always make sure entrepreneurs consider:

1. **Customer:** Understand what the customer will be willing to do. The knowledge you gained from mapping the Decision-Making Unit and Process to Acquire a Paying Customer will be valuable here.
2. **Value Creation and Capture:** Assess how much value your product provides to your customer and when. Then determine which ways of capturing value match up well. Your Quantified Value Proposition will help here.
3. **Competition:** Identify what your competition is doing.
4. **Distribution:** Make sure your distribution channel has the right incentives to sell your product.

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## FREE IS NOT A BUSINESS MODEL

There are two types of “business models,” especially common among web companies. One, “free-mium,” is based on the idea that users get the basic functionality of the product at no charge and pay for premium features, whether through a subscription charge or by purchasing add-ons. The second is “we’ll come up with something later,” relying on investor money to get a sizeable user base before

coming up with ways to be profitable. But neither of these are business models, because you do not have a business until you have someone actually paying money for your product.

In *Predictably Irrational*, author and respected behavioral economist Dan Ariely says that people will behave very positively toward your product when the price is zero because there is no friction to purchasing, as compared to a product priced at any amount above \$0. Free will get many people to try your product, and can be part of an overall strategy to reduce your Cost of Customer Acquisition. However, that is about it, because you have not shown that any of your “customers” would actually pay for your product at any price, even a penny. And while these “customers” are using your product for free, you are still incurring costs to provide your product, so you will need some source of money to keep your business going, such as paying customers.

Instagram is a good example of a “business” that was not actually a business in my mind until it got its first paying customer, Facebook, which acquired the company whole. Such “lottery tickets” can gain a lot of users and can sometimes result in successful acquisitions, but they do not represent a sustainable model for actually staying in business. “Freemium” and “we’ll come up with something later” can be a means to an end, but are not business models, because there is no proven business there.

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## GENERALIZED CATEGORIES OF BUSINESS MODELS

Thinking through some of the common types of business models will help you get a better sense of which is the best fit for you. You will likely decide on a hybrid business model that includes elements from multiple categories. It is a good idea to look at business models in industries other than your own; such lateral innovation often results in creative, effective business models. This list is designed to give you some exposure to the many options available, but you should also think beyond the list when designing your business model.

1. **One-time Up-Front Charge plus Maintenance:** This is the most common business model, where a customer pays a large up-front charge to obtain the product, with the option to secure ongoing upgrades or maintenance of the product for a recurring fee. The up-front charge may need to come out of the customer’s capital budget, especially if the expense is large, and spending from the capital budget requires a potentially long and formal approval process. The ongoing maintenance charge would come out of the customer’s operating budget. For your business, a large up-front infusion of cash is good because it helps offset your high cost of capital, but with this decision you will very likely minimize your ability to secure a recurring revenue stream.

2. **Cost Plus:** In this scenario, the customer pays a set percentage above the cost of producing the product. This is common in government contracts as well as situations where you and your customer want to share the risk of producing the product. The challenge with this model is that it requires agreement on the accounting assumptions, trusting that the numbers are correct and will continue to be correct. This model might also be attractive when your product is immature and there will almost surely be scope creep, but in that case, the offering should mature and you can then migrate to a different business model. It can also create incentives that reward activity rather than progress, which is bad for both you and your customer.
3. **Hourly Rates:** This model also tends to reward activity as opposed to progress, which can be the wrong incentive, but when a project is poorly defined or very dynamic, this might well be the preferred model. A common business model for services firms, it is similar to scenario number 2, but the rates are set by the market demand rather than costs.
4. **Subscription or Leasing Model:** This is a set payment each month or another predetermined and agreed-upon time period. It is a great way to get a recurring revenue stream. There are a number of variations, including:
  - a. *Annual or Multi-Year Commitment:* This locks the customer in and provides them with predictable lower payments as opposed to a one-time up-front payment. One type is a subscription prepayment such as what MIT senior lecturer Howard Anderson used when he founded Yankee Group. He charged an annual fee for a monthly newsletter that would be delivered over the course of the year; the resulting up-front cash flow created less need for capital. (Note: Getting prepayments, even if you have to provide discounts, is generally good for startups.)
  - b. *Month-to-Month Commitment:* This method gives the user great flexibility and you can often extract a much higher monthly payment for this arrangement, compared to an annual or multi-year agreement.
5. **Licensing:** Licensing your IP address to customers and receiving a royalty can result in a very high gross margin (gross margin is the difference between marginal revenue and marginal costs). In addition, if you are licensing your product, you do not have to make big investments in production and distribution capability for a whole product. However, there are many downsides to the strategy. Licensing generally only works when the IP is extremely strong. Another major consideration is that you are relying on existing companies to take your IP and create new disruptive products, which they may be hesitant to do as it threatens their short-term and medium-term interests of maintaining their existing products. Your

customer will be incented to find ways to make products that do not require use of your IP because if they can avoid paying you license fees, they can improve their gross margins. Another downside is that you are not spending time with the ultimate end user learning their needs, so your ability to continually innovate will be limited. Additionally, your royalty rate will generally be equivalent to one-twentieth or less of the revenue per sale; and hence the TAM will as well, because a five percent royalty rate is about the best you can hope for. Still, licensing can be an attractive option in areas like biotech, where re-creating the infrastructure necessary to make whole products is extremely costly.

6. **Consumables:** Another value capture framework that can be advantageous to both the customer and your business is the consumables model. For the customer, the benefit is a low up-front cost, with ongoing costs based on usage, which the customer can usually control. The customer might not have an easy way to pay for a large up-front cost but has much more capability to procure once usage has started. Once usage has started, they can justify the purchase of some consumable product the solution uses. The amount of consumable that needs to be purchased is directly related to usage; and, in many cases, your customer can pass the cost on to their own customers. For your business, it might very well be a way to reduce the friction to capture new customers and thereby reduce the sales costs and also substantially increase the amount of money you will get from that customer over the long term. This is a very popular model for medical devices, but it is also used frequently in the consumer space. A highly visible and well recognized example is the razor/razor blade model made famous by Gillette. HP is another example, where almost all if not all of their profit on printers comes from selling inkjet cartridges.
7. **Upsell with High-Margin Products:** Similar to the consumable business model, the central product is sold at a very low margin, but the overall margin is increased from the sale of very high-margin add-on products. This business model is often used in consumer electronics stores or websites and frequently in new car sales. In a consumer electronics retailer, frequently an item like a camera might be sold at just above cost, which attracts the customer, but then they buy add-ons that have a higher margin and customers are sold a warranty extension for one, two, or three years that also has a very high margin. Like buying a car, it is the additional items like warranty extension, accessories, rustproofing, and the like that are the high-margin products where sellers make the lion's share of their profits.
8. **Advertising:** As with newspapers and magazines in their heyday and now with websites, the ability to attract and retain a desirable demographic can be monetized through third parties who want access to the customers you have attracted. When done properly and on a sufficient scale, this can be a very lucrative model, as Google and others have shown; but many

startups have fallen substantially short when they attempt to rely solely on advertising. For businesses like LinkedIn, advertising is part of a broad portfolio of revenue streams.

9. **Reselling the Data Collected—or Temporary Access to It:** Somewhat similar to the advertising model, reselling user data requires first attracting end users with a free product, then receiving money from third parties who pay for access to demographic and other information about your users. This is a major source of revenue for LinkedIn, which sells a special package for recruiters that gives access to a wide array of LinkedIn user data. The medical industry also resells access to user data for market research.
10. **Transaction Fee:** Online retailers often pay or receive a commission for referrals that lead to sales. One obvious example is eBay, which receives a fee from each successful auction, paid by the seller. The model is similar to how credit card companies work, where a percentage of each transaction goes to the credit card company.
11. **Usage-Based:** A usage-based model—similar to how electric utilities are metered—has been used across various other industries. Cloud computing products, such as Amazon’s cloud service that hosts websites, charge by the amount used. This allows customers more control over their expenses because they only pay for the amount of bandwidth used, rather than paying for extra capacity they don’t use.
12. **“Cell Phone” Plan:** This is a predictable, recurring base fee charged in exchange for a certain amount of committed usage, with additional charges, often at much higher marginal rates, if the customer uses more than their allotted amount. The base charge is generally far less per amount of usage than the overage charge. You get predictability from the base charge, as does the customer, because they know what they can use; but they also have flexibility if they need additional usage. MIT senior lecturer Jim Dougherty, when he was at IntraLinks, used this strategy to effectively monetize its principal product, an online interface for lawyers and investment bankers to securely share documents with clients, in a manner his customer base greatly favored.
13. **Parking Meter or Penalty Charges:** When I lived in Cambridge, Massachusetts, I had always found it curious that the city had incredibly large and expensive parking meters that had to be put in the sidewalk extremely securely. And yet for a long time, the hourly parking rate was only \$.25. It seemed to defy logic that a quarter per hour justified the significant purchase and installation costs of a meter, along with the expense of paying someone to collect the quarters. Of course one day it occurred to me how they made money when I came back to my car and found a \$25 parking ticket that became a \$40 ticket if I did not pay it in 10 days. What a business model! No wonder they have so many parking enforcement people.

But this is the same business model used by credit card companies and (for a while) Blockbuster by charging late fees. The problem that Blockbuster discovered, however, is that loyal customers can become alienated by such late fees, so when Netflix emerged with the tagline “no late fees,” Blockbuster lost significant market share and never recovered. The lesson is, do not take advantage of your customer’s naivete as a central pillar of your business model.

14. **Microtransactions:** A new successful model that came into vogue with online computer games, and is now being tested to try to save newspapers, is microtransactions. In this model, the customer is asked to provide their credit card and then they make very small (defined as less than \$12; often they are \$1 or less) transactions for digital goods (which have virtually no marginal cost because they are electrons). There are many of them so they can add up.
15. **Shared Savings:** This business model is often brainstormed, but rarely used because of the complexities in implementing it, despite its conceptual elegance. In this scenario, the customer pays only once they have realized savings or benefits from the product. One area where this has been used with success is the Energy Efficiency Service Companies (ESCOs) such as Ameresco. It is generally not implemented because it is hard to determine how much savings to attribute to the product, especially over a multiyear time period. One area where this model works, because the accounting is clear, is venture capital, where the general partner gets around 20 percent of the profits from their investments (this is termed the “carry”).
16. **Franchise:** If an entrepreneur comes up with a good idea and is able to implement but does not have the desire, skills, or money to roll it out, they can use the franchise model and get paid a percentage of sales and/or receive a large initial startup fee in return for providing the knowledge and brand that has been developed. You can also make money by selling your brand-name products to the franchises to be distributed.
17. **Operating and Maintenance:** A new business might not want to really sell a product but rather get paid for running a plant or other operation for a fee. While this is similar in some ways to a consulting agreement, the customer has more incentives to control or cut costs, as it will directly impact the customer’s income. This model is common in the energy sector.

This is nowhere near an exhaustive list of business models, but it will help you think about different ways to capture value for your business. There are many options, including crafting a hybrid of the above models or, as you will see in the next section, innovating a new type of business model. Brainstorm and, if possible, experiment with different variations.

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## THINK OUTSIDE THE EXISTING CATEGORIES

A Rhode Island company called Amie Street used an innovative business model to capture value from song downloads based on demand. The very first downloads would be free, but as the number of downloads increased, the company would increase the charge to the customer. Customers were incented to go and listen to music and see if they could pick songs before they became popular. If they recommended a song when it sold for a low dollar amount, and the song later gained popularity and increased its price, the recommender would be given 50 percent of the price difference.<sup>1</sup> Amie Street was bought by Amazon for an undisclosed price in September of 2010; what made Amie Street attractive to Amazon was the company's variable pricing and clever incentive schemes.

Be careful, though, not to spend so much time being clever with your business model that you lose focus on creating value. The two sides to a business, creating value and then capturing value through a business model, should be in balance.

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## SUMMARY

The business model is an important decision that you should spend time focusing on. The decisions you make here will have a significant impact on your profitability, as measured by two key entrepreneurship variables: the Lifetime Value of an Acquired Customer (LTV) and Cost of Customer Acquisition (COCA). Do not focus on pricing in this step, as your choice of business model has a far larger influence on profitability than your pricing decisions.

Once you have established a business model, it is possible but generally not easy to change to a different model. Therefore, choose a business model that distinguishes you from competitors and gives you an advantage over them, because they cannot easily change their business model to match yours.

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<sup>1</sup>Michael Arrington, "Amie Street: Awesome New Music Model," *TechCrunch*, July 23, 2006, <http://techcrunch.com/2006/07/23/amie-street-awesome-new-music-model>.