Startup Business Models and Pricing | Startup School

Video URL

Introduction

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Outline

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we're going to be talking about business models and pricing there's three main things that we're going to cover in this video the first is the nine business models of nearly every billion dollar company it turns out there's just a handful of them that build the biggest winners next we're going to talk about business model lessons from the YC top 100 companies list and finally we're going to cover some startup pricing insights that we've taken from the

9 business models that build billion-dollar companies

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business models that build winners if you're not familiar a business model is a fancy term for how you make money and it turns out the business models are important because we see Founders that often get frustrated when investors won't fund them and their business won't grow and oftentimes they're not sure why and usually this is because they're not using a proven business model and they're actually only a handful of business models that are responsible for nearly all billion dollar companies and rather than trying to reinvent the wheel you should actually just copy one of these and here they are nearly every billion dollar company is one of these Nine business models there's SAS business models which is software as a service which is cloud-based subscription software that customers pay either monthly or annually in order to access the software there's transactional business models that facilitate transactions and take a cut of those transactions these are often fintech companies and then there's marketplaces which facilitate transactions between buyers and sellers these are often referred to as two-sided marketplaces and there's also hard tech businesses there's usage-based business models there's Enterprise there's advertising there's e-commerce and there's bio and so in this video I'm actually not going to get too deep into the specifics of each of these business models instead we're going to have a business model guide that I've put together that's going to be linked in the description down below this guide is going to cover the metrics that matter most for each business model key takeaways for each of them and other similar companies that you can learn

Business model lessons from the top 100 YC companies

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video what I want to focus on is things that we can learn from the top 100 YC companies the top 100 YC companies is pulled from y combinator.com top companies which is a list of the most valuable companies that y combinator has ever funded and so for the purposes of this video I've gone through this list and I've matched each company up with their primary business model to try to see what interesting insights we can get from them now some later stage and larger companies actually have multiple business models however for your purposes as an early stage startup you should just have a single business model that you're focused on and so here they are these are the top 100 YC companies organized by business model and there's some interesting things that we see here first is that that SAS businesses actually make up 31 of the top 100 YC companies transactional businesses make up 22 percent of the top 100 YC companies and marketplaces actually make up 14 so just with these three business models SAS transactional and marketplaces it makes up 67 percent of the top 100 YC companies on the flip side with business models like advertising and e-commerce they barely register on the top 100 YC companies list if you're familiar with startup outcomes and Venture Capital returns you know that there's a power law effect which means that the biggest winners far far outperform all other businesses by orders of magnitude and this is true for the YC top 100 companies list as well turns out that 50 of the overall value of the top 100 YC companies actually comes from just the top ten and so it's interesting to look at what insights we can get from these 10 companies too and here they are these are the top 10 YC companies by value there's Airbnb there's stripe there's instacart there's coinbase there's doordash there's Reddit there's a number of companies here that you're probably very familiar with or use on a regular basis and what's especially interesting is that five of the YC top 10 are actually marketplaces there's Airbnb there's instacart there's doordash there's openc and there's Fair the interesting takeaway here is that marketplaces are most likely to build winner take all companies they tend to become so big and dominant in their industry that it doesn't leave much room or market share for other competitors once marketplaces actually get huge so marketplaces are 14 of the top 100 companies but they actually create 30 of the overall value because so many are represented here in the top ten and while marketplaces are really tough to get off the ground they have a chicken and egg problem where you can't just build your product and then sell it to customers you actually need to solve for both sides of the marketplace the supply and the demand at the same time in order to get customers however once they hit the inflection point and they start to work they get massive Network effects where each new user of the platform increases the value for everybody else that's what makes them dominant winners so you can think of companies like Airbnb if you are looking to rent out a place short term to stay then chances are you would go to Airbnb because that's where all the inventory is similarly if you wanted to buy or sell nfts you would probably go to openc because that's where everyone is that's how these become the big Winners it also turns out that three of the YC top 10 are transactional businesses too so these are companies like stripe coinbase and brex and the main takeaway here is that transactional business is far outperform because they're directly in the flow of funds this means that they are the platform that money flows through making it very easy for them to just take their cut and so transactional companies are 22 of the top 100 YC companies but they actually create 29 of the overall value and this is because there is close to the transaction as possible this was advice that I received during my YC batch back in 2010 and that was to get as close to the transaction as possible if you're a company like stripe that literally processes money for companies or brex that is the corporate card that they use to spend money then you're directly in that flow of funds and so it's really easy to take your cut on the opposite extreme if you are an affiliate business multiple things have to happen before you ultimately get paid which means that you are very far from the transaction which makes those not as good of a business for transactional businesses because they're so close to the transaction they often become critical infrastructure for other companies that they build on top of and that usually means that they are solving a top three problem for them so you can imagine if you use stripe as your primary method to get paid from your customers the thought of ripping that out sounds terrible you would never want to do that and that's why these transactional businesses become so dominant we also see that SAS businesses are most likely to make the top 100 list and this is because they have consistent Revenue so 31 of the YC top 100 companies are actually SAS businesses that's nearly a third and this is because the recurring Revenue makes them great businesses this means that customers keep paying them every single month or every single year until the customer explicitly says to stop so this has lots of benefits including the predictable Revenue that they get which allows them to compound and grow their business we can also see that very few advertising businesses become big Winners and this may be surprising because we're so familiar with so many companies that have built their business off of an advertising business model there's Google there's Facebook there's Twitter just to name a few but really only three percent of the top 100 YC companies use an advertising business model as their primary way to make money and that's because advertising businesses need organic virality to win they need to catch lightning in a bottle and become the Hub where all users go to to hang out or to see live streams in the case of twitch but when that happens they get really strong Network effects just like marketplaces so people go to hangout on Reddit and form communities there because that's where everybody else is people go to Twitch to watch live streams because that's where all the streamers are and so it's really important to remember member that you should not use ads as your primary business model unless you expect to be a top 10 site on the internet otherwise it's too hard to monetize and build a

Overall lessons

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can take away from this list first it's interesting to look at what's not in the top 100 list there are no services or Consulting businesses there and so it can be a good idea to start doing services or Consulting for your customers primarily as a way to learn and make sure that you're building the right product for them but Consulting businesses suffer from having non-recurring Revenue scaling with people rather than software and having very low margins as a result so that's why these businesses are not Venture scale similarly affiliate businesses they tend to be too far away from the transaction that means that you have to acquire a customer so send them off to another product or service hope that they actually make a transaction on that other product or you will get some small commission from that 30 to 90 days later so it's too hard to make a lot of money at scale doing an affiliate business similarly Hardware businesses they require lots of capital to get off the ground to buy physical parts and they have low margins as a result so that makes it really difficult to start these businesses and also to scale them even if they're working just requires so much capital and then businesses that are built on other platforms you don't see in this list either that's because they tend to have a lot of platform risk if your business is built on top of another big successful platform and your business starts to work then it's actually in the interest of that platform to shut you down and capture all of that revenue for themselves so that's why even if these look like they're working in the early days they can be turned off at any moment we also see that recurring Revenue consistently creates winners and this is because it is highly predictable once a customer has committed to pay they're going to continue paying until they explicitly say that they want to stop paying they also have higher customer lifetime values versus one-off transactions and this results in lower customer acquisition costs so you don't have to keep reacquiring customers over and over if you have a one-off transactional business then you have to invest money in acquiring that customer the first time and then also keep putting more money into trying to get existing customers to spend more with you that's not the case with recurring Revenue businesses but recurring Revenue only works when you have strong retention it's not enough for your product to deliver value right up front and then never again you need to keep delivering value over and over again otherwise your customers will churn and stop paying and then you can't scale a leaky bucket if you have lots of churn and to give you an example of that if you had 95 monthly retention for your recurring Revenue product so that means that five percent of your customers will churn and stop paying you every single month and if you started with 100 customers at the beginning of the year then by the end of the year you would only have 54 customers of your original 100. that means that you would lose 46 of your customers in just one year and you would need to get 46 new customers just to break even with where you started the year and let's say for example you had 90 monthly retention instead of 95 just a five percent difference there and that would actually lead to only 28 customers at the end of that first year that's a huge difference and a huge hill to climb so just that five percent difference in monthly retention can actually be the difference between life and death for a startup we can also see that some of the biggest winners are built with Moats there are network effects that many marketplaces have right where each new user increases the value and they become the dominant player in the market there's also lock-in and high switching costs we see this with transactional businesses like stripe if you're the primary way that people actually accept money and process payments then chances are they're not going to switch off of you in SAS businesses you get the recurring Revenue where customers keep paying over and over again until they say to stop you can also get lock in by having customer data on your platform that once they stop paying all that customer data goes away and then Enterprise businesses while they're often difficult and have long sales Cycles to be able to sell into large companies usually once you've sold into the company the churn is a lot lower technical Innovation is another way to build really strong modes and we see this often in hard tech and bio companies especially so you can think of companies like Cruise building self-driving cars and boom which is building supersonic Jets it takes a really long time to even get to a working product for these types of businesses and So for anybody to compete with them it takes years of difficult technical development just to catch up we also see that higher margins and better Union economics can build modes in the example of companies like doordash and instacart they've reached economies of scale where they're so large now that they've been able to drive their costs further down at this scale and improve their margins which new entrants are not going to be able to compete with and finally if you get organic distribution for your product through virality or Word of Mouth you can dominate your Market through that as well if you are able to get users for free because other users of your product tell new users to come join and you're competing with a company that has to pay to acquire their customers then you are going to grow much faster and capture way more of the market so to recap the best businesses generate recurring Revenue have high retention build defensible moats are as close to the transaction as possible they scale with software not people and they're proven and use business models that are familiar to customers and so it's important that you focus on innovating on your product that's what

5 pricing insights from top YC companies

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all right now let's talk about pricing it's important to think of pricing as a tool to help you learn faster it can help teach you who wants your product how much they want it how much value your product provides to your users and which channels you can afford to use to acquire your customers so to help you get started I've compiled five pricing insights from the top YC companies the first is you should charge this is actually the most common mistake that we see Founders make often Founders are afraid to charge for a number of reasons they're often afraid that their customers are going to tell them no they're afraid that their customers are going to walk away and never come back and they're afraid that their customers are actually going to go and use their competitors product but it turns out that charging is actually one of the most effective ways to learn a lot of really important things about your business the first is are your users even willing to pay or not this is often binary where either they're willing to open their wallet or they don't even see enough value in your product to overcome that hurdle it can also teach you which users are most willing to pay if you're trying to decide whether you should go after customer segment a or customer segment B trying to charge and figuring out which one is most excited to pay can give you really good signal on Who wants your product more it can also teach you how much they're willing to pay by setting higher prices you can try to figure out how much value they see in your product even if everyone refuses to pay that's still valuable information for you to get because it teaches you that you haven't built enough value into your product yet or you're talking to the wrong customer segment stripe is a great example of this in the early days stripe wanted to test the amount of value that they were building in their product so while most of their competitors were actually charging around three percent per transaction stripe decided to set their price at five percent per transaction nearly double what their competitors were charging and the reason that they did this is because they wanted to test how much value their customers saw in things like one-click sign up and being able to get started quickly and really in-depth detailed developer API documentation that would help developers get started faster and so rather than trying to undercut the competition in order to win customers they did the exact opposite and set a really high bar for themselves to prove that they had built enough value into their product so where should you begin the first thing that I recommend is that you don't overthink it if you look online there are tons of charts and graphs and formulas and all these different complicated ways to maximize your pricing and figure out the right price to charge but really when you're just getting started the important thing is to just find the right order of magnitude for your pricing and what I mean by that is if you're charging ten dollars for your product and your customers are willing to pay a hundred you should probably change your price you're off by an order of magnitude however if you're charging ten dollars and your customers are willing to pay 15 or 20 don't worry about it you're in the right ballpark which is the really important thing and pricing isn't permanent this is really important it often takes years to iterate and capture the full value of the product that you've built from your customers and so don't worry about capturing that full value early on you'll have plenty of time to maximize that the next Insight is that you should price on value not on cost and so there's three important components here the first is the cost this is what it costs you to be able to serve your customer the next variable is price this is what you're charging and then there's the perceived value that your customers see in your product and so Founders often start with something called Cost Plus pricing I would not recommend this what this usually looks like is looking at how much it costs you to serve a customer and then adding an amount on top of that say ten dollars and that's your price but this actually ignores the full value of what your customers see in your product so the difference between your cost to serve your customer and the price that you charge that's your margin that's how much you make on each transaction and the difference between the price and the value that your customers see in your product that's your opportunity to be able to raise your prices to be able to capture more of that perceived value and now if your cost is higher than your price well that means that you're going to have negative margins and you cannot scale a business with negative margins similarly if your price is higher than the value that your customers see in your product that means they're just not going to buy from you so how do you find your value well there's a couple interesting ways to be able to do this the first is talk to your users you can ask them about the problem that you solve and get them to articulate the value to you and so what this often looks like is if you reach out to a customer and you get them on a call and you can ask them what is the problem that you are hoping that our product could solve for you and they'll often tell you and similarly if you have a user that's signed up for your product but is not actually paying you you can reach out to them and talk to them and ask them the question what problem were you hoping that our product could solve for you and their response is usually going to be one of four interesting things the first is they're probably going to tell you that they were hoping you could help them make more money this is something every company wants or they might tell you that they were hoping that you could help reduce costs maybe your product saves them time or money they might also say that they were hoping that your product could help them move faster maybe they have something they were looking to launch in six months and with your product they can actually get it launched in a couple weeks that sounds really valuable or they might say that your product could help them avoid risk if you help with compliance or offloading something a headache that they don't want to deal with another way to find your value is to keep incrementally raising prices until you get pushback from users and when you keep incrementally raising your prices you will ultimately find the ideal price which is when customers complain but they still pay this is actually a good thing right it overcomes that fear of charging a high price and customers walking away because the ideal scenario is when you tell the customer a price they say they have to think about it they go back and then they come back to you a week later and they say all right that seems good you're the best solution we're willing to pay up on the other side if you were to actually charge a lower price and they say yeah that sounds great and accept immediately well that probably means that you're pricing too low and you're leaving a lot of money on the table which brings me to my third Insight which is that most startups are actually under charging you almost certainly are and lower prices are not a sustainable Advantage sometimes we talk to Founders and they say well our product is just like our large competitor except ours is cheaper and that actually does not sound like a good idea that's not a way to build a winner all that means is that your large competitor can underprice you even way lower than your cost because they have way more money and they're way larger than you until they put you out of business so I do not recommend having price as your only differentiator it also turns out that when you charge more you get higher margins and you're able to build a bigger moat this means if you have higher margins than your competitors you can pay more to acquire a customer which means you can acquire all of the customers before they do it's also important to remember that pricing implies value when customers are evaluating your product they typically don't have a lot of signals on how valuable your product is but the price that you're charging is actually one of the primary ones so if your price is lower than your competitors then your customers might assume that your product is less valuable than theirs similarly if you charge a higher price then your customers might assume that your product is even more valuable than your competitors so that can work really well and so it turns out that raising prices is actually the easiest way to grow Revenue if you have a thousand customers and you want to double your Revenue well it sounds pretty difficult to spend all the time energy and money to go get a thousand more customers however if you're able to just double your price just changing a number on the website or changing the price that you're quoting to customers in a sales call and your product supports that higher value well you've just doubled your Revenue with almost no work at all but what if users won't pay more this usually means one of two things it either means that you need to build more value into your product right maybe the price that you have raised it to is now higher than the value that your customers see or it could mean that you need to solve a bigger problem maybe the problem that you're solving for customers is just a nice to have that they would never be willing to spend a lot of money for so in this instance it usually means you want to move to a more important top three problem that they have there's a third option too which is you could give a lower price in exchange for one of four key things one you could give a lower price in exchange for your first user if you're just looking for initial feedback and getting somebody on the platform totally reasonable to give a lower price for that or if you're talking to a valuable customer that has a recognizable logo that can be another good scenario where you would give a lower price you can then use this logo that you get as social proof to get other customers onto your platform at your regular price also if your product builds lock-in Say by getting customer data on your platform that they would lose if they leave that can be another reason to offer a lower price and if you're able to renew after the first year and bump your customers up to that higher price that can be a good reason to get people in at the lower price because you know you can capture more value from them further down the road it's also really important to remember that pricing isn't permanent this is another common fear that we see from Founders where they're afraid that they have to nail their pricing the first time or they're going to lose their customer and never have a chance to get them again or sometimes Founders are afraid that the set of customers that they're talking to are the only ones they're ever going to get and so they have to close them all and if that's the case you should probably work on a different business but it acts is relatively painless to be able to increase prices on customers over time too and there's a couple different ways to do this you can exclude existing customers by letting them keep their current pricing and only raising prices for all new customers that's one way to do it or you could give advanced notice that you plan to raise prices and as long as you build in enough value into your product to cover that price increase you shouldn't see much churn most people will probably be willing to pay it if you have a sticky product Netflix is a great example of this this chart actually shows price increases that Netflix has made over the last seven or so years and it's really interesting to see that they are not shy about raising prices on their customers and now Netflix has 221 million paid subscribers and they've been able to figure out how to raise prices because that is the easiest way for them to grow Revenue rather than continuing to try to scale subscriber growth at the same rate so if Netflix is a able to find a way to increase their prices on 221 million customers you should be able to figure out how to do it on your handful of early customers as well and the fifth Insight is to keep it simple this is an example of a pricing page for Quicken and as you can see it's very complex there's five different buy buttons there's prices there's 349 399 599 899 there's crossed out prices there's one dollar off with a symbol right next to it it's really complicated to figure out even if you want to be a Quicken customer which plan you should go with and so this likely results in decreased conversion rates so it's important to remember that when you're creating your pricing you don't want it to create friction that prevents customers from signing up and paying you on the flip side here's a great example from gitlab they have three very clear simple plans with clear pricing and so their pricing and their pricing page is not going to

Story of Segment

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paying them and so I'll leave you with this story of segment which helps companies capture and use their customer data when they started out they were a couple of Engineers that were not used to paying for products themselves and so they thought they had to give their product away for free in order to get anybody to use it and then they wanted to raise money from investors so they decided maybe we should actually charge our customers money so we can show Revenue growth so tail between their legs they reached out to all their free customers and sheepishly told them that they were actually going to start charging them ten dollars per month which was a hundred and twenty dollars per year and so they were really nervous about telling their customers this but surprisingly their customers started responding to them with messages like I hope you would charge me more than that otherwise I'm worried about keeping my customer data with you right the low price was signaling to their customers that maybe their product was invaluable or it couldn't be trusted in the long term and so in order to grow even more they hired a sales advisor and that sales advisor told them you should not be charging a hundred twenty dollars a year instead you should be charging a hundred twenty thousand dollars per year this is an Enterprise product and this scared them to hear this it was unfathomable to them that anybody would ever pay a hundred twenty thousand dollars a year for their product and so when they were going into of their first sales meeting with their sales advisor the advisor told them if you don't tell this customer that your price is a hundred twenty thousand dollars then I quit as your sales advisor so they went into the meeting and at the end when it came time to talk price and the customer said so how much is it the CEO got really red and he got nervous and he said a hundred twenty thousand dollars and the customer responded how about twelve thousand dollars and they ultimately ended up agreeing on eighteen thousand dollars as their price so while they didn't actually get the Thousand X price increase they were able to increase their price 150 times from 120 dollars a year all the way up to eighteen thousand dollars a year and it wouldn't have happened if they didn't ask for the higher price and so they used this philosophy to continue growing their deal sizes all the way up to six figures and Beyond and ultimately led to their acquisition by twilio for more than three billion dollars so the story of segment hopefully is instructive to you that they started out giving away their product for free ultimately ended up selling to huge

Wrap-up

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Enterprises and building a business worth over three billion dollars so to wrap up the five key pricing insights the first is you should charge next is you should price on value not on cost the third is most startups are under charging and you probably are too the fourth is that pricing isn't permanent don't have fear that you need to get it right the first time you can change it over time as you learn more and build more value into your product and finally keep it simple don't add complexity which adds friction to customers giving you their money thank you

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