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Different Types of Revenue Models

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Abstract

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1 Introduction

A revenue model gives a business a framework for generating income, and a yardstick by which they can measure their long-term profitability. Understanding the mechanics of a revenue model can help determine a company's success.

A revenue model is a blueprint that shows how a startup business will earn revenue or gross income from its standard business operations, and how it will pay for operating costs and expenses. This model is one of the key performance indicators (KPIs) for a company to measure the profitability of its pricing strategy and product sales.

Revenue model is sometimes used as another term for a business model, which is a structure for generating value for customers. However, these terms are not interchangeable but there is a connection between them. A revenue model is part of a business model, serving to explain how a company's goods or services are made, distributed, and sold for profit.

The purpose of a revenue model is to manage a company's revenue streams, which are its sources of income from target customers in different demographics and locations.

With a revenue model, a business can determine crucial factors that can help it thrive and grow. Companies use the information from a revenue model to determine how much money they will have to focus their sales and marketing on a target audience, develop new goods and services for customers, and ultimately determine their place and future in their particular market. Without a revenue model, companies, and especially startups, can generate costs that can make their business unsustainable.

2 Advertising Based Revenue Model

When you start a for profit business, a key part of your plan is how to generate revenue. Many companies sell goods, services or a combination of the two. Online businesses and media companies often look to advertisers for most or all of their revenue. This is known as an advertising-based revenue model. Online media sites and publishers commonly use the ad-based revenue model because it is difficult to get users to pay for content that they can find for free in most cases. The basic premise is to present news, information or feature articles that attract users and then sell advertising space to businesses that have a message for your audience. Online service providers with in-demand services such as music or picture editing often have more flexibility in that they can make money from paying customers or attract advertisers.

Offering free content or services, especially when it interests a very targeted market segment, can lead to excellent ad revenue opportunities. Sponsors are often willing to pay more to reach a select audience. Ad revenue also allows you to profit from offering solutions that have limited demand from paying customers. Ad models are often harder to predict, though. Your traffic may remain steady, but advertisers may come and go based on economic and industry factors. You also may miss opportunities to get fees from customers who are willing to pay them.

2.1 Example of Advertising Based Revenue Model

Facebook is not a monopoly, but with its more than 3 billion users worldwide across Facebook, Instagram and WhatsApp, it has a dominant market presence among social media and messaging tools. Facebook's gigantic user penetration worldwide is what makes it such a valuable company. Still, when it comes to Facebook's business model and how it makes money, users are not paying Facebook anything. At least not directly.

Facebook makes money predominantly by showing ads from advertisers within its Facebook and Instagram apps. Advertising represented 98% of Facebook's 86bn dollar revenue in 2020. The remaining 2% of revenue came mainly from selling Oculus and Portal devices and also payment fees from developers. The Facebook business model is based on offering its tools and services mostly for free to billions of users and then making money by allowing businesses to show Facebook's users advertising. Advertisers pay the price to Facebook that is determined in an auction, based on demand and supply.

That means that people who use Facebook services (users) are not the ones paying Facebook for it. Real customers are primarily small businesses advertising on some of Facebook's family of apps. Facebook's focus on small businesses became an even more apparent part of the Facebook strategy as it introduced the first version of its e-commerce tools called Facebook Shops.

Facebook is not the first nor the last business with a similar business model. Still, Facebook is an excellent example that this business model is not without issues when the interests of users and customers (advertisers) are not in line.

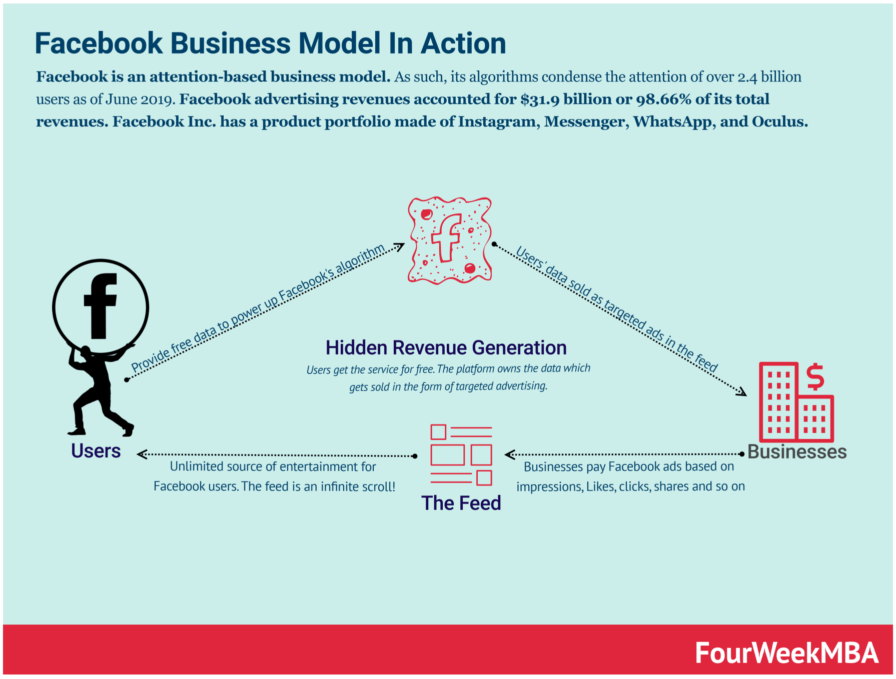

fig1: The above figure illustrate the Revenue generation model of facebook.

3 Subscription Based Revenue Model

The subscription revenue model allows a company's target audience to use a product or service for a predetermined and contracted rate and period of time. It's a popular source of revenue for cloud-based or software-as-a-service (SaaS) companies, and online entertainment hosting companies. This model differs from the licensing model in that the subscription has a fixed term, while licensing continues in perpetuity until the licensee or property owner terminates the deal.

3.1 Netflix Case Study

Netflix is one of the current pioneers of subscription-based content. It runs on a Subscription Video on Demand (SVOD) model. Subscribers pay for a monthly plan and are given access to a vast library of media—any time, anywhere. Thus, subscriptions are Netflix's main source of revenue.

But unlike apps like Spotify which also runs on premium subscription, there's no free option in Netflix. This means all members are paying for the content they want to watch. Users enjoy the convenience of ad-free entertainment, although ad trials have taken place recently.

It also has a DVD rental on a subscription basis, but only the streaming side of the business will be discussed in this blog.

Netflix offers different prices based on the quality of video required-Basic, Standard and Premium. Generally, it provides the first month of subscription for free. Basic with standard resolution is $7.99 a month, but it can only be used one device at a time. On the other hand, for $10.99 a month, one gets HD video on two devices, and shelling out $13.99 a month offers Ultra HD streaming on four devices. Additionally, opting in for Netflix's DVD service will be costly- with their Premium service, as it will be $30 a month when all is said and done.

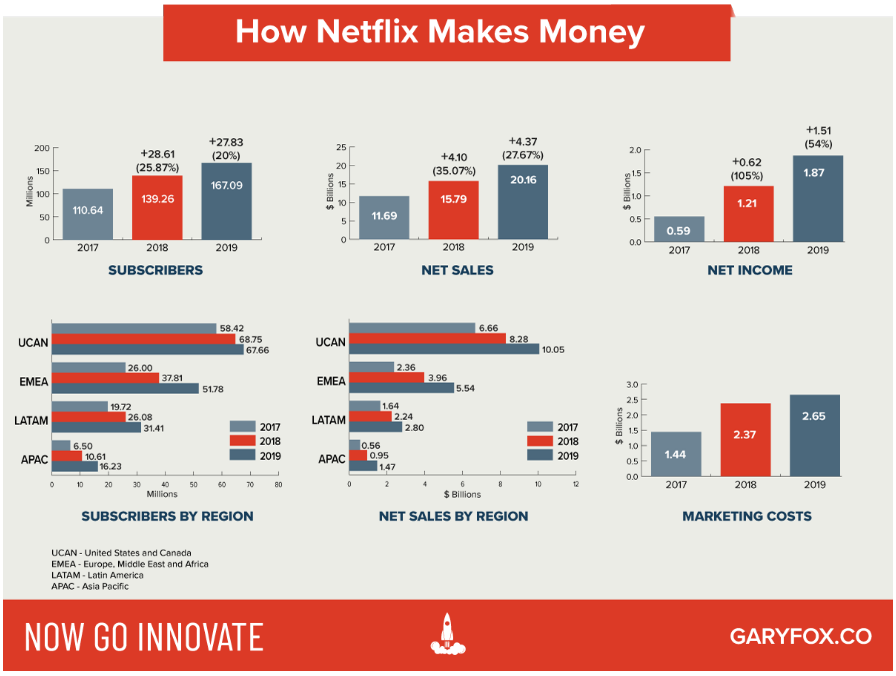

fig2: The above figure illustrate the Revenue generation model of Netflix.

4 Transactional Revenue Model

There are three main approaches to this model:

- You buy the product from one person/company and resell it to another for a higher price.
- You manufacture the product and sell it to a retailer, who then sells it to the end consumer.
- You manufacture the product and sell it directly to the consumer (DTC).

Additionally, you also have the option to sell in a brick and mortar location or go the online route. More companies are opting to go online with ecommerce because it has lower operating cost and the profit margins are higher.
If you have the itch to sell physical or digital products, this could be a good option to consider.

Founded in 1902 as Dayton Dry Goods Company, Target started its first store in 1962 in Minnesota. Unlike Costco or Walmart, Target's market is limited to the United States. However, the company has been ramping up its e-commerce capabilities and is experiencing faster growth in this area. Target is a general merchandise retailer that has its stores operational across the United States in all 50 states. The company had 1868 stores operational as of 2019. Due to the high density of Target stores in the US, around 75% of the residents have a Target store within their easy reach. There are 41 distribution centers to support the operation of 1868 Target stores within the United States. Target has differentiated its business model from other retailers by creating its own range of private label brands. These company-owned brands and products account for around one-third of the total sales of the company. There are 41 brands owned by Target which are both a major source of revenue and a source of competitive advantage for the brand. While Target Corporation sources products from suppliers located all over the world, a large part of its merchandise is made up of the brands owned by the company. The company either produces them in company-owned facilities or gets them manufactured by external manufacturers according to the company guidelines. This has helped it differentiate its product line which drives higher demand for the company. The company generates substantially all of its revenue from the United States. Moreover, Target Corporation operates its entire business as one segment. Efficient supply chain management has also helped the company keep product prices low.

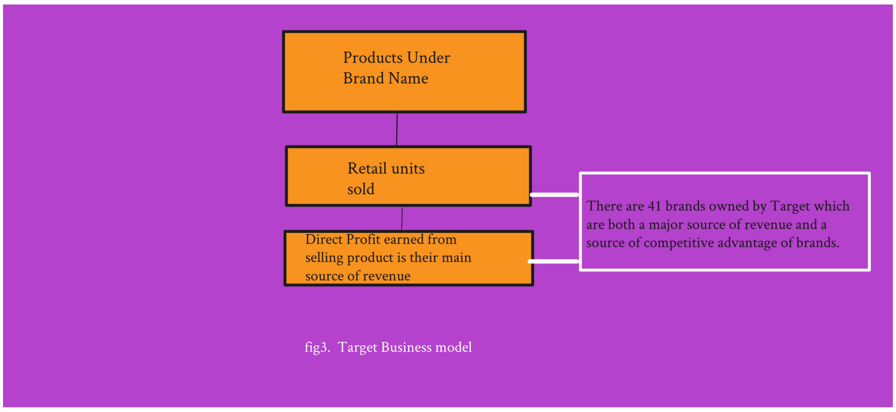

fig3. Target Business model

5 Commission based revenue model

With the commission revenue model, you make money from being a broker or an affiliate–a.k.a. “middleman”–that matches buyers with sellers. Unlike the advertising model, you only make money for successful transactions. It’s usually done through product recommendations or by providing a marketplace.

Mint is an example of a company that uses this revenue model by recommending different financial products to its users. Their users are people interested in personal finance. Banks, credit card companies, and other companies that sell financial services and products allow Mint to recommend their offerings and pay a commission for each successful sale that comes from Mint.

Airbnb and Upwork are examples of the commission revenue model used in a marketplace. For instance, Airbnb sellers–the hosts–list their space for rent to buyers–the guests. In this case, when a guest wants to rent from a host, they pay the nightly rate for the space. Airbnb charges the host a fee when that transaction happens.

The amount you make as a commission is either a flat rate (i.e. 50$ for every successful sale you broker) or a percentage (i.e. 10% of each successful transaction). The more successful “matches” you make, the more revenue you earn.

This revenue model is good if you know how to build a buyer-ready audience. In other words, you're not just building a large audience. You need to build an audience that will buy the products or services you recommend. Otherwise, you won't generate any revenue

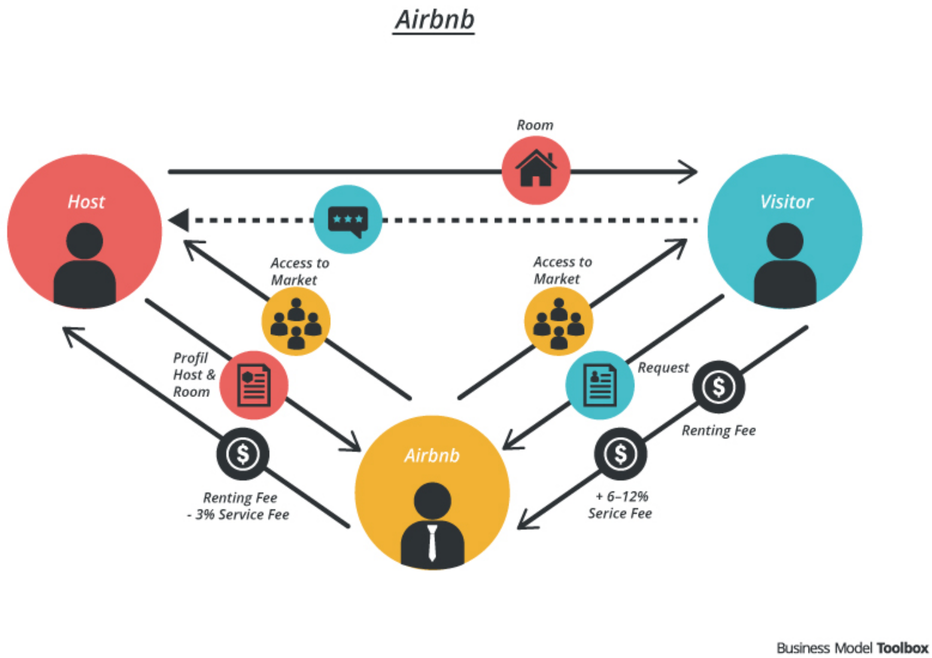

fig4: The above figure illustrate the Revenue generation model of Airbnb.

6 Service Based Revenue Model

The service-based revenue model is one of the oldest ones on our list. For as long as people have been around, they've been exchanging services in some form of another.

One of the biggest benefits of this model is that you can use it to build as big or as small of a business as you want.

For instance, you can be a single consultant that works with a dozen or so clients at a time. Or you can create a large chain that has thousands of clients like Maid Brigade.

If you don't have a lot of money to get started but have time and a specific expertise/skill, the service-based revenue model can be a great fit.