Learning Module 7: Business Models

LOS 7a: describe key features of business models;

A business model outlines how a business is organized to deliver value to its customers. A business model encompasses the following aspects:

a. Target **customers** of the business ("who?").
b. Products or Services offered by the business ("why and often "why").
c. Where is the company selling, and how do the products and services reach customers "where?".
d. The pricing strategy of the firm ("how much?").
e. Important assets, partners, and suppliers the firm requires ("how?")

A business model describes what a business is about, how it runs its operations and generates revenue and profits, and how it differs from its competitors. A business model should outline the **core elements** and their **interactions** without going into the depth of a full-fledged business plan.

Features of a Business Model

A business model should answer the following questions:

a. Who are the target customers (or market)?
b. What does the firm offer?
c. Where does the firm sell its products or services, and does it reach its customers?
d. How much is the pricing?
e. What is the value proposition of the firm?
f. What is the business organization and capabilities of the firm?

We discuss each of the above questions.

1. **Target Customers**

A business model should outline the target customers of a firm. Key issues that should be seen here include the geographies, market segments, and customer segments a firm will serve. Concerning customer segments, a business model can be business-to-business (B2B) or business-to-consumer (B2C) markets.

2. **Product or Services Offered by a Firm**

   A business model should define a firm's offering: products or services offered. Further, it should outline how the products and services differ from the firm's competitors based on the target customers' needs. A well-defined firm offering helps analysts to determine the total amount of capital available for a business and identify important competitors and risks.

3. **Channels of Selling its Offerings (Channel Strategies)**

   A company's channel strategy explains where the firm is selling its products or services and how it reaches its customers. The channel strategy has two functions: sales and marketing and distribution (logistics).

   Analyzing a firm's channel strategy involves differentiating between functions the firm can perform internally and what functions are effectively done by strategic partners and suppliers.

   As such, the anatomy of the channel strategy of a firm includes functions, assets, and other firms:

   - **Function:** selling/display, handling inquiries, order processing, physical distribution, after-sale service
   - **Assets:** Warehouses, retail stores, a sales force, and an e-commerce website.
   - **Firms:** retailers, wholesalers, agents, franchisees

   A firm's channels impact its revenue and cost structures, profitability, and response to internal and external risk factors.

   There are three different types of channel strategies:

a. **Traditional Channel Strategy**

In the traditional channel strategy, finished goods flow from the manufacturer to the wholesaler, then to the retailer, and lastly, to the end customer. Intuitively, it is a common strategy in the product business.

b. **Direct Sales Strategy**

In a direct sales strategy, a manufacturer sells directly to the end customer, disintermediating the distributor or retailer. In other words, the manufacturing firm utilizes its own sales force, which may be a whole department. It is a common strategy in B2B businesses, pharmaceutical firms, and life insurance.

Direct sales may involve an intermediary. In this case, the intermediary works on an agency basis. In this arrangement, a firm pays commissions to an intermediary, but the intermediary does not claim ownership of the goods. A good example is drop-shipping in eCommerce, where an online marketer can initiate a delivery from a manufacturer to the end-user without taking an inventory of the products.

c. **Omnichannel Strategy**

The omnichannel strategy involves the employment of a combination of both physical and digital methods to finalize a sale. For instance, a customer might order a product online and later pick it up at the store or get it delivered to a place of choice.

4. **Pricing Details of a Firm**

A business model should sufficiently explain the pricing details so that the business logic of a firm is understandable. For instance, a business model should have pricing details relative to its competitor(s): is it a premium, parity, or discount compared to competitors? Moreover, a business model should justify the pricing structure.

Pricing is relatively nonessential in a business model of a price-taker firm such as commodity producers. Being "price takers" implies that they must take the prices the market sets. As such, they face high price elasticity and higher pricing risk from competitors. To circumvent this “pricing disadvantage,” the price-takers emphasize on other sources of value, such as cost advantage.

On the other hand, some companies that are price-setters face less pricing risk from their competitors. Therefore, such companies can differentiate their offering to gain pricing power. Price discrimination occurs when firms charge different prices to different customers. Price discrimination aims to maximize revenues based on customers' will to buy.

Types of Pricing Models

A pricing model describes how customers are billed based on the quantity of goods or services they purchase. Due to pricing discrimination, there are many pricing models. A unit of product or service can be specified in many ways, and prices can vary based on factors such as quality or grade, units sold, channel, customer size and type, and unit cost.

Common pricing models include:

i. **Value-based pricing models:** Pricing is based on the value acquired by the customer. For instance, a car manufacturing company may price cars at a premium because their cars have low operating costs.
ii. **Dynamic pricing:** Different prices are charged for different clients at different times depending on variables such as supply and demand.
iii. **Tiered pricing:** Different buyers are charged different prices based on volume or product features.
iv. **Auction/ reverse auction models:** Prices are established via an automated bidding process.

Pricing Models for Multiple Products

Models for pricing multiple products include:

- **Bundling:** Customers are incentivized to combine multiple products (usually complementary goods with high incremental margins and marketing costs). Examples are furnished rental apartments and TV cable subscriptions with internet services.

- **Add-on pricing:** Applicable when a customer purchases extra services or products on the purchase date (for example, an order in a restaurant) or afterward (for example, a change in subscription package). A company usually seeks higher margins on optional features or services. However, excess application of this model can hurt a company's reputation and distort customer goodwill.

- **Razor, razor blade pricing:** Occurs when a low price is charged on equipment and a high price on a dependent accessory. For instance, a relatively low price may be applied to a razor and a high price on the blades.

Pricing for Increasing Growth

- **Penetration pricing:** It is a form of discount pricing where a firm sacrifices margins with the intention of building scale and market share. An example is video subscription services such as Netflix.

  If penetration pricing is applied for an extended period of time, regulators may consider it anti-competitive. Moreover, the investors may question the profitability landmarks of the company.

Pricing Models for Encouraging Trial and Adoption

- **Freemium pricing:** This model is common in digital content and services. It allows customers to access a certain level of usage or functionality for free. An example is video games.

- **Hidden revenue business models:** Occur when a firm provides services for free and generates revenue in a different way. For example, content creators provide “free” content and get paid for advertising in the media sector.

Creating Value through Alternatives to Purchasing

Business models can create value by allowing an alternative form of owning an asset or product. These alternatives include:

- **Leasing:** In this case, a firm transfers ownership to customers who will bear lower costs for capital and maintenance. Examples are real estate and automobiles.

- **Recurring revenue or subscription pricing:** Allows customers to "rent" items for a period of time of their choice. An example is the subscription services in the media industry.

- **Licensing:** A firm receives royalty payments from customers who use intangible assets such as brand names or songs.

- **Franchising:** An advanced form of licensing where a firm (franchisor) gives an entity (franchisee) a right to distribute its products or services in a given jurisdiction. The franchisor gives support such as marketing to the franchisee.

5. **Value Proposition of a Firm**

A business model should outline the value proposition of a firm. A firm's value proposition gives the characteristics of the firm that attract the target customers. Besides, it informs customers' preference of a firm over its competitors.

The value proposition of a firm is built through:

- Service and support, such as effective customer service, from a firm.

- The sale process, such as ease of purchase.

- Features of the product, such as performance and style.

- Pricing as compared to competitors.

In summary, the value proposition considers the following questions: “Who?” “What?” “Where?” and “How much?”

6. **Business Organization and Capability of a Firm**

A business model should outline a firm's business organization and capabilities. This defines how a firm is structured to deliver the value proposition.

A business model should give assets and capabilities (such as skilled labor and modern technology) that a firm must implement. It should also state whether these assets and capabilities are owned (insourced) or rented (outsourced) since it is important in determining business strategies and potential risks.

Within the business organization of the firm and its capabilities, we need to discuss the value chain, and profitability, and unit economics.

Value Chain

Value chain refers to the systems and processes within a firm that creates value for its customers. Note that the value chain only includes functions valued by customers and executed by a single firm. They, however, do not involve physical adjustment or handling of a product.

As such, the value chain is different from the supply chain. The supply chain is the sequence of firm internal and external processes involved in creating products. An example of a supply chain is the production and delivery of products to the end customer.

The value chain can be seen as a bridge between the value proposition of a firm and its profitability. Essentially, the value chain involves three key factors:

I. Identifying the business value chain components conducted by the firm (as originally envisioned by Michael Porter in 1985):
    - **Primary activities:** Inbound Logistics, Operations, Outbound logistics, marketing and sales, and Service.
    - **Support activities:** Procurement, human resource management, technology development, and firm infrastructure.

II. Approximating the **value added** and **costs** with each activity.

III. Identifying **competitive advantage** opportunities.

Profitability and Unit Economics

A business model should highlight how a firm intends to generate profit. Profit expectations can be analyzed by examining margins, break-even points, and unit economics. Unit economics involves expressing revenues and costs on a per-unit basis.

LOS 7b: Describe various types of business models

Conventional Business Models

In practice, most business models consist of these conventional models either individually or combined. Common business models are described in the table below:

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Business Model	Types of Customers	Products/Services	Channel Strategy	Pricing Strategy
Natural resource producer	Refiners Distributors	Usable natural resources and raw materials	Contracts based on spot or forward prices	Spot or forward market prices in the contracts
Manufacturer	Distributors End-users (direct sales)	Finished goods	Distributors Digital of Direct sales force	Price per product sold. Subscription
Distributor	Retailers	Transportation and storage	Retailers	Spread between purchase and sales prices
Retailer	End-users	Finished goods. Customer experience.	Stores Digital or direct sales force	Mark-ups on products sold. Member service fees
Broker	Buyers and sellers	Connecting buyers and sellers.	Salespeople Digital	Commissions Listing fees
Bank	Borrowers	Loans. Leases.	Digital Branches, Loan officers	Loan and lease interest rate margin over interest rate paid for funding
Service producer	Services Businesses	Services.	Digital or direct sales force	Service fees Mark-ups on products used or sold
Software	Services Businesses	Software.	Digital or direct sales force	Subscription fee License costs Maintenance fee

Business Model Variation

In addition to conventional business models, there are other variations. They mainly consist of combinations of conventional models or industry-specific variations. Some of the variations include:

- **Private label or contract manufacturers:** A firm manufactures goods and is marketed by others. Example: Manufacturing might be based in one country and marketing done in another
- **Value-added sellers:** Distribute the products and manage complex elements like installation, personalization, service, or assistance. Example: service-intensive products such as Construction Machinery, enterprise software,
- **Licensing Arrangements:** A product-producing company uses someone else's brand and, in return, pays a royalty. Examples: Payment for the right to use the name of a celebrity
- **Franchise models:** franchisees have a well-defined and exclusive relationship with a franchisor to operate under a specific brand with proprietary products and processes. Common types of franchise models include restaurants, retailers, and auto dealerships.

Innovations of Business Models

The primary emphasis of business model discussions is on innovation. In this vein, the discussions cove on how new business models can introduced or adapted into the existing market.

Business model innovation often goes hand in hand with technological innovation and is typically led by new market entrants rather than established industry players. For instance, consider the airline industry. The business model innovation has been mainly low-cost and ultra-low-cost airlines, with the following innovative features:

- Customer: leisure, mass market
- Product: Point-to-point flights
- Low prices

- No frills, low costs
- Channel: direct, digital sales

Implication of Digital Technology on Business Models

Large-scale business model innovation was around long before the advent of digital technology. However, the rapid and open-ended advance of digital technology has dramatically transformed business operations, evidenced by significant reductions in the costs of communication, information exchange, and financial transactions.

Therefore, some of the implications of the technology on businesses include:

- Location does not matter.
- Outsourcing is easily achievable.
- Marketing is easy and cost-effective to reach certain groups of customers regardless of location.
- Development of powerful network effects that can be easily accessible by many firms.

Network Effects and Platform Business Models

Network effects refer to the increase in the value of a network to its users as more users connect. Network effects lead to the development of different network-based business models. A good example is China's WeChat messaging and payment platform.

Network effects can also apply to pre-internet businesses. For instance, telephone service, payment systems, and financial infrastructure such as stock exchanges.

Classification of Network Effects

Network effects can be classified into one-sided or multi-sided. **One-sided** networks consist of only a single **homogeneous** group using a network. Examples include telephone services and peer-to-peer payment systems, such as Venmo.

On the other hand, multi-sided(two-sided if we only have two types of users in the network) networks consist of more than two or more types of users. An example is credit and debit card networks, whose users consist of the merchant and the cardholder users. Another example includes digital marketplaces.

Network Effect and Crowdsourcing

Network business models frequently leverage crowdsourcing. In crowdsourcing business models, users can contribute directly to the value of a product. Crowdsourcing involves user communities that allow voluntary collaboration among users of a product or users with either low or no regulation.

Examples include social media such as TikTok and Douyin, open-source software, and knowledge aggregation sites such as Wikipedia.

Question

Which of the following is *least likely* found in a firm's business model?

A. Target customers.
B. Financial forecasts.
C. Pricing methodology.

The correct answer is B.

Financial forecasts are detailed information usually found in a business plan.

A and C are incorrect. Features of a business model should highlight the following aspects:

- Target customers (or market) of the firm.
- Offering of a firm.
- Pricing of the firm.
- Value proposition of the firm.
- Profitability and unit economics of the firm.