Chapter 7. What Business Are You In?

How you get and make money drives what metrics you should care about. In the long term, the riskiest part of a business is often directly tied to how it makes money.

Many startups can build a product and solve technical issues, some can attract the right (and occasionally large) audiences, but few make money. Even giants like Twitter and Facebook have struggled with extracting money from their throngs of users.

There's no more iconic symbol of a startup than the lemonade stand, and with good reason—it's a simple, entrepreneurial, low-risk way to learn how businesses operate. And like a lemonade stand, while it might be reasonable and strategic to delay monetization—giving away lemonade for a while to build a clientele—you have to be planning your business model early on.

If we asked you to describe the business model of a lemonade stand, you'd probably say that it's about selling lemonade for more than it costs to make it. Pressed for more detail, you might say that costs include:

- Variable costs of materials (lemons, sugar, cups, water)
- One-time costs of marketing (stand, signage, cooler, bribing a younger sibling to stand in the street)
- Hourly costs of staffing (which, let's face it, are pretty negligible when you're a kid)

You might also say that revenue is a function of the price you charge, and the number of cups sold.

Now let's suppose that you're asked to identify the risky parts of the business. They include the variability of citrus futures, the weather, the foot traffic in your neighborhood, and so on.

One thing we've noticed about almost all successful founders we've met is their ability to work at both a very detailed, and a very abstracted, level within their business. They can worry about the layout of a page or the wording of an email subject one day, and consider the impact of one-time versus monthly recurring sales the next. That's partly because they're not only trying to run a business, they're also trying to discover the best business model.

To decide which metrics you should track, you need to be able to describe your business model in no more complex a manner than a lemonade stand's. You need to step back, ignore all the details, and just think about the really big components.

When you reduce things to their basic building blocks in this way, you come up with only a few fundamental business models on the Web. Interestingly, all of them share some common themes. First, their aim is to grow (in fact, Paul Graham says that a focus on growth is the one defining attribute of a startup).[21] And second, that growth is achieved by one of Eric Ries's fundamental Engines of Growth: an increase in stickiness, virality, or revenue.

Each business model needs to maximize the thrust from these three engines in order to flourish. Sergio Zyman, Coca-Cola's CMO, said marketing is about *selling more stuff to more people more often for more money more efficiently*.[22]

Business growth comes from improving one of these five "knobs":

- **More stuff** means adding products or services, preferably those you know your customers want so you don't waste time building things they won't use or buy. For intrapreneurs, this means applying Lean methods to new product development, rather than starting an entirely new company.
- **More people** means adding users, ideally through virality or word of mouth, but also through paid advertising. The best way to add users is when it's an integral part of product use—such as Dropbox, Skype, or a project management tool that invites outside users outsiders—since this happens automatically and implies an endorsement from the inviting user.
- **More often** means stickiness (so people come back), reduced churn (so they don't leave), and repeated use (so they use it more frequently). Early on,

stickiness tends to be a key knob on which to focus, because until your core early adopters find your product superb, it’s unlikely you can achieve good viral marketing.

- **More money** means upselling and maximizing the price users will pay, or the revenue from ad clicks, or the amount of content they create, or the number of in-game purchases they make.
- **More efficiently** means reducing the cost of delivering and supporting your service, but also lowering the cost of customer acquisition by doing less paid advertising and more word of mouth.

About Those People

Business models are about getting people to do what you want in return for something. *But not all people are equal*. The plain truth is that not every user is good for you.

- Some are good—but only in the long term. Evernote’s freemium model works partly because users eventually sign up for paying accounts, but it can take them two years to do so.
- Some provide, at best, free marketing, and while they may never become paying users, they may amplify your message or invite someone who will pay.
- Some are downright bad—they distract you, consume resources, spam your site, or muddy your analytics.

When you get a wave of visibility, few of the resulting visitors will actually engage with your product. Many are just driving by. As Vinicus Vacanti, co-founder and CEO of Yipit, recalls in a blog post inspired by his company’s 2010 launch:[23]

> *Was that our big launch? Why didn’t more people sign up? Why didn’t people complete the sign-up flow? Why weren’t people coming back? Now that people covered our startup, how are we supposed to get more press? Why aren’t our users pushing their actions to Facebook and Twitter? We got some users to invite their friends but why aren’t their friends accepting the invite?*

The key here is analytics. You need to segment real, valuable users from drive-by, curious, or detrimental ones. Then you need to make changes that maximize the real users and weed out the bad ones. That may be as blunt as demanding a credit card up front—a sure way to reject curious users who don't have any intention of committing or paying. Or it may be a subtler approach, such as not trying to reactivate disengaged users once they've been gone for a while.

If you're a developer of a game that users play once, or an e-commerce site stocking rarely purchased items, that's fine—just get your money up front. If you're a SaaS provider with low incremental costs for additional users, freemium may work, as long as you clearly separate engaged from casual users. If you expect buyers to purchase from you often, you need to make them feel loved. You get the picture.

Segmenting real users from casual ones also depends on how much effort your users have to put into using the application. Some products collect information passively: Fitbit logs walking steps; Siri notices when you've arrived somewhere; Writethatname analyzes your inbox for new contacts. Users don't have to do much, so it can be hard to tell if they've "checked out." It's easier to find disengaged users if they have to actively use the product.

Consider the aforementioned Fitbit, a tiny life-logging device that measures steps, from which it calculates calories burned, miles walked, stairs climbed, and overall activity.

Fitbit users can simply record their steps with a device in their pocket, they can use it to sync data to the company's hosted application, they can visit the portal to see their statistics and share them with friends, they can manually enter sleep and food data to augment what's collected passively, and they can buy the premium Fitbit offering to help them reach their health goals.

Each of these use models represents a different tier of engagement, and Fitbit could segment users across these five segments. And it should: it's perfectly acceptable for a Fitbit user to only use the clip-on device to record the number of steps taken per day, without ever uploading that information, but as a result the company won't be able to monetize that user beyond the initial purchase (through on-site ads, premium subscriptions, or selling aggregate user data, for example). The value of that user is significantly lower. Predicting revenues accurately relies on an understanding of how its different user segments employ the product.

the product.

As a startup, you have a wide range of payment and incentive models from which to choose: freemium, free trial, pay up-front, discount, ad-funded, and so on. Your choice needs to match the kind of segmentation you're doing, the time it takes for a user to become a paying customer, how easy it is to use your service, and how costly an additional drive-by user is to the business.

Not all customers are good. Don't fall victim to customer counting. Instead, optimize for *good* customers and segment your activities based on the kinds of customer those activities attract.

The Business Model Flipbook

A product is more than the thing you buy. It's the mix of service, branding, fame, street cred, support, packaging, and myriad other factors you pay for. When you purchase an iPhone, you're also getting a tiny piece of Steve Jobs's persona.

In the same way, a business model is a combination of things. It's what you sell, how you deliver it, how you acquire customers, and how you make money from them.

Many people blur these dimensions of a business model. We're guilty of it, too. Freemium isn't a business model—it's a marketing tactic. SaaS isn't a business model—it's a way of delivering software. The ads on a media site aren't a business model—they're a way of collecting revenue.

Later in the book we're going to outline six sample businesses. But before we do that, we want to talk about how we came up with them. Think of one of the flipbooks you had as a kid—the kind where you could combine different body parts on each page to make different characters.

You can build business models this way, but instead of heads, torsos, and feet, you have several aspects of a business: the acquisition channel, selling tactic, revenue source, product type, and delivery model.

- The **acquisition channel** is how people find out about you.

- The **selling tactic** is how you convince visitors to become users or users to become customers. Generally, you either ask for money or you provide some kind of scarcity or exclusivity—such as a time limit, a capacity limit, the removal of ads, additional functionality, or the desire to keep things to themselves—to convince them to act.

- The **revenue source** is simply how you make money. Money can come from your customers directly (through a payment) or indirectly (through advertising, referrals, analysis of their behavior, content creation, and so on). It can include transactions, subscriptions, consumption-based billing charges, ad revenue, resale of data, donations, and much more.

- The **product type** is what value your business offers in return for the revenue.

- The **delivery model** is how you get your product to the customer.

Figure 7-1 shows these five aspects, with a variety of models and examples for each one. Remember that this is only a set of examples—most businesses will rely on several acquisition channels, or experiment with different revenue models, or try various sales tactics.

ACQUISITION CHANNEL	How the visitor, customer, or user finds out about the startup	• Paid advertising • Search engine mgmt. • Social media outreach • Inherent virality • Artificial virality • Affiliate marketing • Public relations • App/ecosystem mkt.	• Banner on Informationweek.com • High pagerank for ELC in kids' toys • Active on Twitter (i.e., Kissmetrics) • Inviting team member to Asana • Rewarding Dropbox user for others' signups • Sharing a % of sales with a referring blogger • Speaker submission to SXSW • Placement in the Android market
SELLING TACTIC	What the startup does to convince the visitor or user to become a paying customer	• Simple purchase • Discounts & incentives • Free trial • Freemium • Pay-for-privacy • Free-to-play	• Buying a PC on Dell.com • Black Friday discount, loss leader, free ship • Time-limited trial such as Fitbit Premium • Free tier, relying on upgrades, like Evernote • Free account content is public, like Slideshare • Monetize in-app purchases, like Airmech
REVENUE MODEL	How the startup extracts money from its visitors, users, or customers	• One-time transaction • Recurring subscription • Consumption charges • Advertising clicks • Resale of user data • Donation	• Single purchase from Fab • Monthly charge from Freshbooks • Compute cycles from Rackspace • PPC revenue on CNET.com • Twitter's firehose license • Wikipedia's annual campaign
PRODUCT TYPE	What the startup does in return. May be a product or service; may be hardware or software; may be a mixture	• Software • Platform • Merchandising • User-generated content • Marketplace • Media/content • Service	• Oracle's accounting suite • Amazon's EC2 cloud • Thinkgeek's retail store • Facebook's status update • Airbnb's list of house rentals • CNN's news page • A hairstylist
DELIVERY MODEL	How the product gets to the customer	• Hosted service • Digital delivery • Physical delivery	• Salesforce.com's CRM • Valve purchase of desktop game • Knife shipped from Sur La Table

Figure 7-1. Just like the flipbooks you had as a kid, with more words

Lots to Choose From

There is an abundance of "pages" you can put into the flipbook. The team at Startup Compass, a startup dedicated to helping companies make better business decisions with data, identifies 12 revenue models: advertising, consulting, data, lead generation, licensing fee, listing fee, ownership/hardware, rental, sponsorship, subscription, transaction fee, and virtual goods. Venture capitalist Fred Wilson has a document listing a vast number of web and mobile revenue models, many of which are variants on six basic ones we’ll list later in the book. [24]

Startup Compass also suggests some “fundamental” financial models that combine several pages from the flipbook: search, gaming, social network, new media, marketplace, video, commerce, rental, subscription, audio, lead generation, hardware, and payments.

You can use these “pages” to create a back-of-the-napkin business model. For example, Figure 7-2 shows a sample business model flipbook for Dropbox.

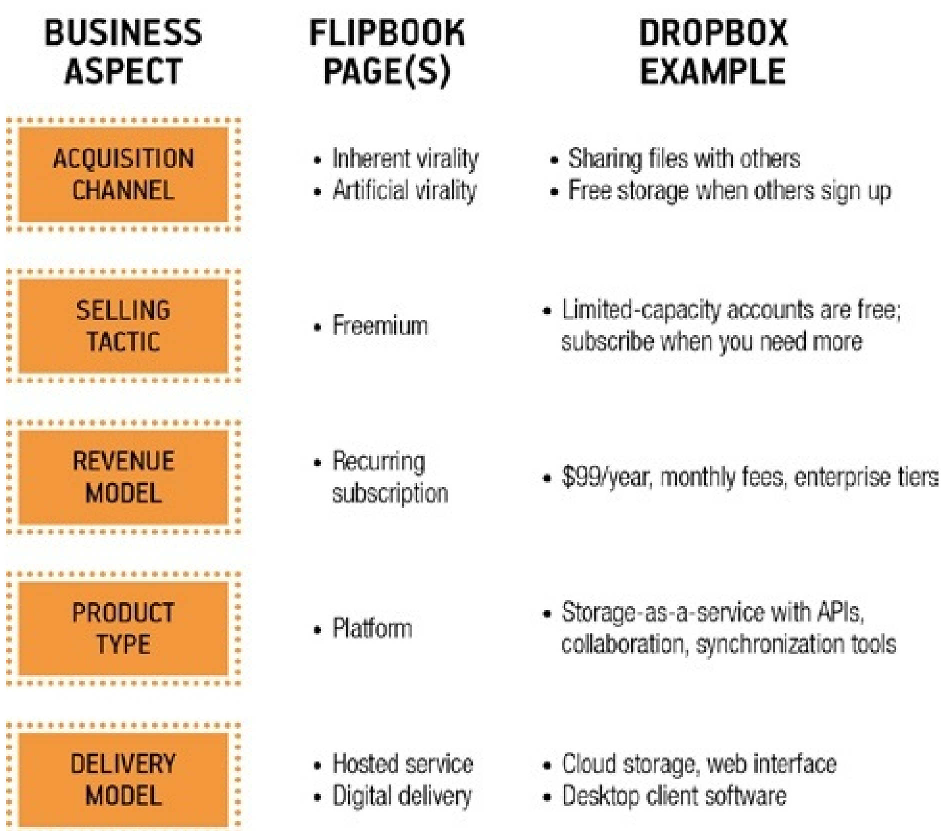

Figure 7-2. Turning the flipbook pages to Dropbox

There’s another advantage of stating business models in a flipbook structure like this: it encourages lateral thinking. Each turn of a “page” is a pivot: what would it mean to offer Dropbox as a physical delivery? Or to charge up front for it? Or to rely on paid advertising?

Six Business Models

In the coming chapters, we're going to look at six business models. Each model is a blend of these aspects, and we've tried to mix them up enough to give you a taste of some common examples. But just like a kid's flipbook, there's a huge variety: from the aforementioned list, there are over 6,000 permutations, and our list of aspects isn't by any means exhaustive.

As if that weren't confusing enough, you can employ several at once: Amazon is a transactional, physical-delivery, SEM (search engine marketing), simple-purchase retailer, but it's also running sub-businesses such as user-generated content in the form of product reviews. So unlike those relatively simple children's books, your business can quite easily be a many-headed monster.

In the face of this complexity, we've decided to keep our six business models simple. We'll talk about several aspects of those businesses, and the metrics that matter most to companies of each sort. Think of it as opening the business model flipbook to a particular "page"—one in which you see elements of your own business.

- If you're running an e-commerce business where you sell things to customers, turn to Chapter 8.
- If you're delivering SaaS to users, turn to Chapter 9.
- If you're building a mobile application and using in-app purchases to generate revenue, head to Chapter 10.
- If you're creating content and making money from advertising, you'll find details on media sites in Chapter 11.
- If your primary focus is getting your users to generate content on your platform the way Twitter, Facebook, or reddit do, turn to Chapter 12.
- If you're building a two-sided marketplace where buyers and sellers can come together, check out Chapter 13.

Most businesses fall into one of these categories. Some won't, but they have close parallels in the real world. A restaurant is transactional, like e-commerce;

an accounting business offers a recurring service, like a SaaS company, and so on. Hopefully, you'll find a model that's close enough for you to learn important lessons about analytics and apply them to your business, as we review the stages of growth in Chapter 14 and beyond.

Pick Your Business Model

In the following chapters we go through six sample business models. Find yours and write it down, then list all the metrics we define in that business model and see how well that aligns with what you're tracking. For the metrics that you're tracking, put down the values as they stand today, if you haven't already. If your business overlaps on a couple of models (which isn't uncommon), then grab metrics from each of those models and include them in this exercise.

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[21] *http://paulgraham.com/growth.html*

[22] *http://www.zibs.com/zyman.shtml*

[23] *http://viniciusvacanti.com/2012/11/19/the-depressing-day-after-you-get-techcrunched/*

[24] *https://hackpad.com/Ch2paBpUyIU#Web-and-Mobile-Revenue-Models*