**What Is a Business Model?**

The term business model refers to a company's plan for making a [profit](https://www.investopedia.com/terms/p/profit.asp). It identifies the products or services the business plans to sell, its identified [target market](https://www.investopedia.com/terms/t/target-market.asp), and any anticipated [expenses](https://www.investopedia.com/terms/e/expense.asp). Business models are important for both new and established businesses. They help new, developing companies attract investment, recruit talent, and motivate management and staff.

Established businesses should regularly update their business model or they'll fail to anticipate trends and challenges ahead. Business models also help investors evaluate companies that interest them and employees understand the future of a company they may aspire to join.

**Key Takeaways**

* A business model is a company's core strategy for profitably doing business.
* Models generally include information like products or services the business plans to sell, target markets, and any anticipated expenses.
* There are dozens of types of business models including retailers, manufacturers, fee-for-service, or freemium providers.
* The two levers of a business model are pricing and costs.
* When evaluating a business model as an investor, consider whether the product being offer matches a true need in the market.

**Business Model**

**Understanding Business Models**

A business model is a high-level plan for profitably operating a business in a specific marketplace. A primary component of the business model is the [value proposition](https://www.investopedia.com/terms/v/valueproposition.asp). This is a description of the goods or services that a company offers and why they are desirable to customers or clients, ideally stated in a way that differentiates the product or service from its competitors.

A new enterprise's business model should also cover projected [startup costs](https://www.investopedia.com/articles/pf/09/business-startup-costs.asp) and financing sources, the target customer base for the business, [marketing strategy](https://www.investopedia.com/terms/m/marketing-strategy.asp), a review of the competition, and projections of revenues and expenses. The plan may also define opportunities in which the business can partner with other established companies. For example, the business model for an advertising business may identify benefits from an arrangement for referrals to and from a printing company.

Successful businesses have business models that allow them to fulfill client needs at a competitive price and a sustainable cost. Over time, many businesses revise their business models from time to time to reflect changing business environments and market [demands](https://www.investopedia.com/terms/d/demand.asp).

When evaluating a company as a possible [investment,](https://www.investopedia.com/terms/i/investment.asp) the investor should find out exactly how it makes its money. This means looking through the company's business model. Admittedly, the business model may not tell you everything about a company's prospects. But the investor who understands the business model can make better sense of the financial data.

**Evaluating Successful Business Models**

A common mistake many companies make when they create their business models is to underestimate the costs of funding the business until it becomes profitable. Counting costs to the introduction of a product is not enough. A company has to keep the business running until its [revenues](https://www.investopedia.com/terms/r/revenue.asp) exceed its expenses.

One way analysts and investors evaluate the success of a business model is by looking at the company's [gross profit](https://www.investopedia.com/terms/g/grossprofit.asp). Gross profit is a company's total revenue minus the [cost of goods sold](https://www.investopedia.com/terms/c/cogs.asp) (COGS). Comparing a company's gross profit to that of its main competitor or its industry sheds light on the [efficiency](https://www.investopedia.com/terms/e/efficiency.asp) and effectiveness of its business model. Gross profit alone can be misleading, however. Analysts also want to see [cash flow](https://www.investopedia.com/terms/c/cashflow.asp) or [net income](https://www.investopedia.com/terms/n/netincome.asp). That is gross profit minus operating expenses and is an indication of just how much real profit the business is generating.

The two primary levers of a company's business model are pricing and costs. A company can raise prices, and it can find inventory at reduced costs. Both actions increase gross profit. Many analysts consider gross profit to be more important in evaluating a business plan. A good gross profit suggests a sound business plan. If expenses are out of control, the [management team](https://www.investopedia.com/articles/basics/03/022803.asp) could be at fault, and the problems are correctable. As this suggests, many analysts believe that companies that run on the best business models can run themselves.

When evaluating a company as a possible investment, find out exactly how it makes its money (not just what it sells but how it sells it). That's the company's business model.

**Types of Business Models**

There are as many types of business models as there are types of business. For instance, direct sales, [franchising](https://www.investopedia.com/terms/f/franchise.asp), advertising-based, and [brick-and-mortar](https://www.investopedia.com/terms/b/brickandmortar.asp) stores are all examples of traditional business models. There are hybrid models as well, such as businesses that combine internet retail with brick-and-mortar stores or with sporting organizations like the [NBA](https://www.investopedia.com/articles/investing/070715/nbas-business-model.asp).

Below are some common types of business models; note that the examples given may fall into multiple categories.

**Retailer**

One of the more common business models most people interact with regularly is the [retailer](https://www.investopedia.com/terms/r/retail-sales.asp) model. A retailer is the last entity along a supply chain. They often buy finished goods from manufacturers or distributors and interface directly with customers.

**Example:** Costco Wholesale

**Manufacturer**

A [manufacturer](https://www.investopedia.com/terms/m/manufacturing.asp) is responsible for sourcing raw materials and producing finished products by leveraging internal labor, machinery, and equipment. A manufacturer may make custom goods or highly replicated, mass produced products. A manufacturer can also sell goods to distributors, retailers, or directly to customers.

**Example:** Ford Motor Company

**Fee-for-Service**

Instead of selling products, fee-for-service business models are centered around labor and providing services. A fee-for-service business model may charge by an hourly rate or a fixed cost for a specific agreement. Fee-for-service companies are often specialized, offering insight that may not be common knowledge or may require specific training.

**Example:** DLA Piper LLP

**Subscription**

[Subscription-based business models](https://www.investopedia.com/ask/answers/042715/how-do-subscription-business-models-work.asp) strive to attract clients in the hopes of luring them into long-time, loyal patrons. This is done by offering a product that requires ongoing payment, usually in return for a fixed duration of benefit. Though largely offered by digital companies for access to software, subscription business models are also popular for physical goods such as monthly reoccurring agriculture/produce subscription box deliveries.

**Example:** Spotify

**Freemium**

[Freemium](https://www.investopedia.com/terms/f/freemium.asp) business models attract customers by introducing them to basic, limited-scope products. Then, with the client using their service, the company attempts to convert them to a more premium, advance product that requires payment. Although a customer may theoretically stay on freemium forever, a company tries to show the benefit of what becoming an upgraded member can hold.

**Example:** LinkedIn/LinkedIn Premium

Some companies can reside within multiple business model types at the same time for the same product. For example, Spotify (a subscription-based model) also offers free version and a premium version.

**Bundling**

If a company is concerned about the cost of attracting a single customer, it may attempt to bundle products to sell multiple goods to a single client. Bundling capitalizes on existing customers by attempting to sell them different products. This can be incentivized by offering pricing discounts for buying multiple products.

**Example:** AT&T

**Marketplace**

Marketplaces are somewhat straight-forward: in exchange for hosting a platform for business to be conducted, the marketplace receives compensation. Although transactions could occur without a marketplace, this business models attempts to make transacting easier, safer, and faster.

**Example:** eBay

**Affiliate**

[Affiliate business models](https://www.investopedia.com/terms/a/affiliate.asp) are based on marketing and the broad reach of a specific entity or person's platform. Companies pay an entity to promote a good, and that entity often receives compensation in exchange for their promotion. That compensation may be a fixed payment, a percentage of sales derived from their promotion, or both.

**Example:** social media influencers such as Lele Pons, Zach King, or Chiara Ferragni.

**Razor Blade**

Aptly named after the product that invented the model, this business model aims to sell a durable product below cost to then generate high-margin sales of a disposable component of that product. Also referred to as the "razor and blade model", razor blade companies may give away expensive blade handles with the premise that consumers need to continually buy razor blades in the long run.

**Example:** HP (printers and ink)

"Tying" is an illegal razor blade model strategy that requires the purchase of an unrelated good prior to being able to buy a different (and often required) good. For example, imagine Gillette released a line of lotion and required all customers to buy three bottles before they were allowed to purchase disposable razor blades.

**Reverse Razor Blade**

Instead of relying on high-margin companion products, a reverse razor blade business model tries to sell a high-margin product upfront. Then, to use the product, low or free companion products are provided. This model aims to promote that upfront sale, as further use of the product is not highly profitable.

**Example:** Apple (iPhones + applications)

**Franchise**

The franchise business model leverages existing business plans to expand and reproduce a company at a different location. Often food, hardware, or fitness companies, franchisers work with incoming franchisees to finance the business, promote the new location, and oversee operations. In return, the franchisor receives a percentage of earnings from the franchisee.

**Example:** Domino's Pizza

**Pay-As-You-Go**

Instead of charging a fixed fee, some companies may implement a pay-as-you-go business model where the amount charged depends on how much of the product or service was used. The company may charge a fixed fee for offering the service in addition to an amount that changes each month based on what was consumed.

**Example:** Utility companies

**Brokerage**

A brokerage business model connects buyers and sellers without directly selling a good themselves. Brokerage companies often receive a percentage of the amount paid when a deal is finalized. Most common in real estate, brokers are also prominent in construction/development or freight.

**Example:** ReMax

**How to Create a Business Model**

There is no "one size fits all" when making a business model. Different professionals may suggest taking different steps when creating a business and planning your business model. Here are some broad steps one can take to create their plan:

1. **Identify your audience.** Most business model plans will start with either defining the problem or identifying your audience and [target market](https://www.investopedia.com/terms/t/target-market.asp). A strong business model will understand who you are trying to target so you can craft your product, messaging, and approach to connecting with that audience.
2. **Define the problem.** In addition to understanding your audience, you must know what problem you are trying to solve. A hardware company sells products for home repairs. A restaurant feeds the community. Without a problem or a need, your business may struggle to find its footing if there isn't a demand for your services or products.
3. **Understand your offerings.** With your audience and problem in mind, consider what you are able to offer. What products are you interested in selling, and how does your expertise match that product? In this stage of the business model, the product is tweaked to adapt to what the market needs and what you're able to provide.
4. **Document your needs.** With your product selected, consider the hurdles your company will face. This includes product-specific challenges as well as operational difficulties. Make sure to document each of these needs to assess whether you are ready to launch in the future.
5. **Find key partners.** Most businesses will leverage other partners in driving company success. For example, a wedding planner may forge relationships with venues, caterers, florists, and tailors to enhance their offering. For manufacturers, consider who will provide your materials and how critical your relationship with that provider will be.
6. **Set** [**monetization**](https://www.investopedia.com/terms/m/monetize.asp) **solutions.** Until now, we haven't talked about how your company will make money. A business model isn't complete until it identifies how it will make money. This includes selecting the strategy or strategies above in determining your business model type. This might have been a type you had in mind but after reviewing your clients needs, a different type might now make more sense.
7. **Test your model.** When your full plan is in place, perform test surveys or soft launches. Ask how people would feel paying your prices for your services. Offer discounts to new customers in exchange for reviews and feedback. You can always adjust your business model, but you should always consider leveraging direct feedback from the market when doing so.

Instead of reinventing the wheel, consider what competing companies are doing and how you can position yourself in the market. You may be able to easily spot gaps in the business model of others.

**Criticism of Business Models**

Joan Magretta, the former editor of the Harvard Business Review, suggests there are two critical factors in sizing up business models. When business models don't work, she states, it's because the story doesn't make sense and/or the numbers just don't add up to profits.1 The airline [industry](https://www.investopedia.com/terms/i/industry.asp) is a good place to look to find a business model that stopped making sense. It includes companies that have suffered heavy losses and even [bankruptcy](https://www.investopedia.com/terms/b/bankruptcy.asp).

For years, major carriers such as American Airlines, Delta, and Continental built their businesses around a [hub-and-spoke structure](https://www.investopedia.com/terms/h/hub_and_spoke_structure.asp), in which all flights were routed through a handful of major airports. By ensuring that most seats were filled most of the time, the business model produced big profits.

However, a competing business model arose that made the strength of the major carriers a burden. Carriers like Southwest and JetBlue shuttled planes between smaller airports at a lower cost. They avoided some of the operational inefficiencies of the hub-and-spoke model while forcing [labor costs](https://www.investopedia.com/terms/c/cost-of-labor.asp) down. That allowed them to cut prices, increasing demand for short flights between cities.

As these newer competitors drew more customers away, the old carriers were left to support their large, extended networks with fewer passengers. The problem became even worse when traffic fell sharply following the [September 11 terrorist attacks in 2001](https://www.investopedia.com/financial-edge/0911/the-impact-of-september-11-on-business.aspx).2 To fill seats, these airlines had to offer more discounts at even deeper levels. The hub-and-spoke business model no longer made sense.

**Example of Business Models**

Consider the vast portfolio of Microsoft. Over the past several decades, the company has expanded its product line across digital services, software, gaming, and more. Various business models, all within Microsoft, include but are not limited to:

* **Productivity and Business Processes:** Microsoft offers subscriptions to Office products and LinkedIn. These subscriptions may be based off product usage (i.e. the amount of data being uploaded to SharePoint).
* **Intelligent Cloud:** Microsoft offers server products and cloud services for a subscription. This also provide services and consulting.
* **More Personal Computing:** Microsoft sells physically manufactured products such as Surface, PC components, and Xbox hardware. Residual Xbox sales include content, services, subscriptions, royalties, and advertising revenue.3

**What Is a Business Model?**

A business model is a strategic plan of how a company will make money. The model describes the way a business will take its product, offer it to the market, and drive sales. A business model determines what products make sense for a company to sell, how it wants to promote its products, what type of people it should try to cater to, and what revenue streams it may expect.

**What Is an Example of a Business Model?**

Best Buy, Target, and Walmart are some of the largest examples of retail companies. These companies acquire goods from manufacturers or distributors to sell directly to the public. Retailers interface with their clients and sell goods, though retails may or may not make the actual goods they sell.

**What Are the Main Types of Business Models?**

Retailers and manufacturers are among the primary types of business models. Manufacturers product their own goods and may or may not sell them directly to the public. Meanwhile, retails buy goods to later resell to the public.

**How Do I Build a Business Model?**

There are many steps to building a business model, and there is no single consistent process among business experts. In general, a business model should identify your customers, understand the problem you are trying to solve, select a business model type to determine how your clients will buy your product, and determine the ways your company will make money. It is also important to periodically review your business model; once you've launched, feel free to evaluate your plan and adjust your target audience, product line, or pricing as needed.

**The Bottom Line**

A company isn't just an entity that sells goods. It's an ecosystem that must have a plan in plan on who to sell to, what to sell, what to charge, and what value it is creating. A business model describes what an organization does to systematically create long-term value for its customers. After building a business model, a company should have stronger direction on how it wants to operate and what its financial future appears to be.