What Is Your Business Model?

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Note: This is a compilation of a series of articles under the title "What is Your Business Model?" that were published at Tekedia.com between September and November 2011. You may find an archive of other articles by me here.

Introduction

We began our discussion four weeks ago with the introduction of a frame of reference that would guide our conversations about entrepreneurship and African start-ups. That raised a number of questions from readers. We addressed those questions here two weeks later. As promised this week we will turn to business models.

Among the numerous questions entrepreneurs and small business owners must ask themselves is the quintessential question; what is my business model?

According to Michael Rappa; "In the most basic sense, a business model is the method of doing business by which a company can sustain itself - that is, generate revenue. The business model spells-out how a company makes money by specifying where it is positioned in the value chain." Alex Osterwalder and Yves Pigneur say that; "A business model describes the rationale of how an organization creates, delivers and captures value."

Other definitions exist, but taken together, these two statements provide us with enough basis for understanding what we should expect to learn from an adequately developed business model.

This article discusses factors investors will be paying attention to when they ask, "What is your business model?" The discussion is presented in four parts; Creating Value, Delivering Value, Capturing Value and Connecting The Dots.

I. What is Your Business Model? – Creating Value

The business model should tell us how the entrepreneur expects to create value. To do this, the entrepreneur must decide what activities are core to the business the entrepreneur wishes to start. For example, the activities that create value for a software entrepreneur will certainly differ from those that create value for a microelectronics entrepreneur. Though the two businesses might rely on software in order to deliver the product or service on which each of them hopes to build a business, one might develop a business model in which software is central to value creation while for the other software might be peripheral by comparison. More specifically, the microelectronics entrepreneur might require a much smaller investment in software design and development in comparison to the software entrepreneur.

The question of how the entrepreneur creates value is also important because the answer to that question will often contribute to an understanding of the customer base that the business can expect to rely on. If an entrepreneur expects to create value by delivering a personalized experience to guests of luxury hotels rated 3-stars or better, one immediately expects that the customer base available is limited to the set of people that can afford to stay in hotels within that category for business or pleasure. Obviously, that means that a large swath of people is excluded from that entrepreneur's expected customer base. It also means that the business must develop a revenue model that will work given the narrow customer base for which the business model has been designed. More on this later.

This might seem trivial at its face. It is not. Understanding the customer base for which the business expects to create value is central to many other decisions that the business will have to make as it matures and approaches the launch of its product or service on the market. How will the business communicate its existence and information about its products or services to its customers? Related to that, through what media should the business advertise itself? Some media will convey high credibility to discerning customers more than others. What is the trade-off? Consumer behavior is dependent on income. Does the entrepreneur understand how this will affect the business that is being established given the decision about how the business will create value? Does this mean that the business will be a price-taker (acceptance of the price as determined by the market), or does this provide the business with some pricing flexibility (pricing power)?

A business model describes how an organization creates value. Do you understand how your business creates value? Does that information affect how you make the numerous other decisions that must be made in every facet of the business? If not, you are running your business less efficiently than possible and leaving your revenue and profit sources open to attack by more astute competitors.

Spend a lot of time thinking about the question; How does my business create value? The answer to that question, and the implications that arise from that answer will improve the decisions you make in other critical areas of your enterprise. Equally important, revisit this question often. Usually the answer will not change. Once in a while, large-scale market dynamics will lead you to modify your answer in a way that could potentially lead your company to profits where others have not started to look yet. That is how some companies create new products and markets, and use first-mover advantage to create defensible positions before their competitors have time to fashion an adequate response.

What problem does your startup solve? That is the crux of the issue. The answer to that question tells you, and your prospective investors how your startup creates value. Once you understand how your startup creates value, it is time to consider how you will deliver that value to your customers.

II. What is Your Business Model? – Delivering Value

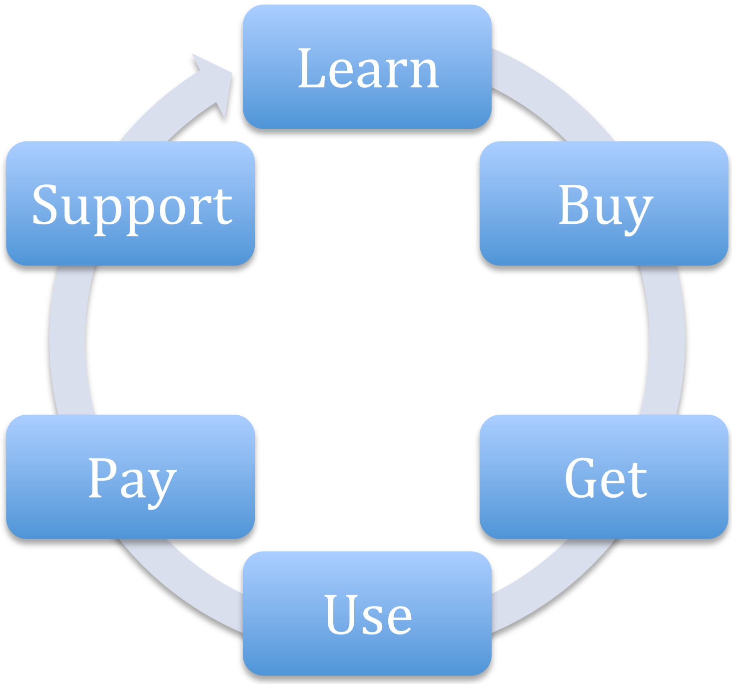
We continue our conversation about business models by focusing on the second question that our definition of a business model raises; how does the business deliver value? An entrepreneur should be able to tell us the process by which the value that his business creates gets delivered to its target customers.

Given a reasonably well developed customer value proposition, our entrepreneur must now decide how that value is going to "be put in the hands" of the people that will become customers of the business. The process of delivering the product or service that the entrepreneur has developed involves several distinct phases; Learn, Buy, Get, Use, Pay and Support. Employees of AT&T are believed to have developed the acronym LBGUPS as a means of remembering the phases of this process as it relates to AT&T's products. It is most effective to think of LBGUPS as a continuous and circular process.

- Learn - when new customers first become aware of the product or service and acquire information and knowledge about how they may benefit from its use. Typically the entrepreneur accomplishes this through some sort of marketing, sales and public relations activity.
- Buy - when customers decide to make a purchase after having learned about the new offering and communicate the desire to act on their decision to someone in a position to initiate the next phase of the process.
- Get - when customers actually take delivery of the new product. This might happen in a store. It might happen online. It might involve shipping the product to the customer. If the customer is buying a service then this typically happens in person, or the service could be delivered remotely.
- Use - when customers actually use or consume the product, or benefit from the service.
- Pay - when customers pay for the product. This might happen simultaneously with buy. Sometimes there's a time lag between buy and pay.
- Support - when customers are provided with additional information that is aimed at resolving any problems they may have encountered during any of the preceding phases. Support should serve as an opportunity to encourage customers to remain, or to come back the next time they need to purchase a similar product or service. This is the role of technical support, customer service and customer relations. Done well, support should lead right back to learn.

The following diagram illustrates the process I have described above.

Figure 1: Customer Value Delivery Cycle - LBGUPS



Our entrepreneur must ask, find and execute or implement answers to a number of questions while going through the process of delivering value to customers. What is the most effective channel for marketing, sales and public relations? Where should we place our product or service in order to enable evaluation by potential customers as they make the buy decision? How do we put the product or service in a customer's hands once that customer has made a purchase? What do we need to do to ensure that the customer uses our product after they have bought it and we have delivered it? How do we ensure that our customers are paying us, in full and on time? What is the mechanism by which we get paid by our customers? What problems might our customers encounter, and how should we help them resolve those problems in order to ensure that they come back to learn more about our other offerings and buy more from us in the future?

Often, each question that the entrepreneur seeks to answer will give rise to other questions that must be answered as well. This process requires trade-offs. It might be too costly to attempt to exploit every possible marketing channel and so the entrepreneur must choose only a few out of many, for example. An over elaborate support structure might prove too expensive to maintain over the long term. Furthermore, that might create bad-habits that the company's revenue structure has not been designed to carry without tipping the company into a position where it is experiencing losses.

Ultimately it is critical that the entrepreneur understand how the business delivers value and how the choices it makes in the process of delivering value to its customers is likely to affect the startup's cost structure. Remember, a business model describes how an organization delivers its value proposition to its customers. Do you understand the process by which this happens for your company? Do you know what steps you can take at each phase of the LBGUPS cycle in order to arrive at an outcome that favors your company? If you have answered "No" to any of these questions, then it is time to do some thinking.

III. What is Your Business Model? - Capturing Value

We continue our conversation about business models by focusing on the third question that our definition of a business model raises; How does the business capture value? An entrepreneur should be able to describe how that entrepreneur's proposed business will create value, deliver that value to its customers and in-turn capture some value for itself and its investors.

Michael Rappa's statement about business models emphasizes the importance of revenue streams. Revenues comprise the cash that a startup's customers exchange for the product or service that the startup provides. In the process of this exchange, a transfer of ownership or usage rights takes place – in an outright sale, the customer assumes ownership. In a lease, licensing or rental agreement ownership remains with the seller, but the buyer is granted usage rights for a contractually agreed period. Revenue streams can be one-off or recurring.

I have no argument against the suggestion that entrepreneurs should focus keenly on developing and growing revenue streams. However, my experience has taught me that entrepreneurs must focus equal attention on profit, and on the related issue of costs.

Why?

In order to reach self-sustaining growth, a maturing start-up must quickly put itself in a position to invest in areas that are critical to its ability to create and deliver value to its customers – it has to invest in those assets that make its revenue streams possible. Costs represent the price the company pays to obtain the resources it must bring together in order to create and deliver value to its customers. A company earns a profit when its total revenues exceed its total costs. A successful business model should lead to an outcome in which customers perceive the entrepreneur as adding value. They demonstrate this by paying more for the product than it costs the entrepreneur to produce it – leading to a profit for the entrepreneur.

Earning a profit makes it possible for the startup company to invest in the assets that are most critical to its ability to create and deliver value. Controlling and managing costs effectively while growing revenues will ensure that the start-up maximizes its profit.

How does your business capture value? You should be able to describe how your startup will grow revenues, manage costs, invest for growth, and maximize profits. Investors understand that profits will not materialize at the very outset. Yet, the entrepreneur must present a plan that leads to profitability within a period of time that investors find satisfactory.

The entrepreneur's conversations about how the startup captures value should not be a static process. It should be dynamic and ongoing. The startup will not be operating in a stagnant market. Therefore, its product and pricing strategies will need to adapt from time to time in response to competition as well as other market forces.

IV. What is Your Business Model? – Connecting The Dots

I am making the observations that follow with a single-product startup in mind. The entrepreneur has formed the startup to operate in an innovative new industry that is still undergoing rapid growth and development.

It is often tempting to assume that one company can simply copy or imitate the business model of one of its competitors. That may work in the short-term. In my opinion that is not an approach that confers a lasting competitive edge, certainly not in fledgling markets and industries, and often not in mature industries either. An important aspect of business model development is the deliberate selection among a number of alternative choices regarding product design, customer development, revenue models and cost structure; the wholesale copying of a business model simply because it has worked for another company suggests the entrepreneur has abdicated responsibility for understanding the dynamics at play in each of those critical areas. That is a recipe for a failed startup adventure and investors would be well advised to maintain a wide berth.

I oppose the wholesale copying of a business model that someone else has developed. However, I am a strong proponent of learning from the experience of others startups in the industry – the successes and the failures. There is real value in knowing what has ensured that some startups thrive. There is even more value in knowing what has proved fatal to others.

It might take several attempts before the startup discovers the business model that works best – reflecting an industry in its earliest stage of development. Even then the business model must evolve with the passage of time. Technology changes. Labor markets shift. National economies expand and contract. Opportunities not present in the past will present themselves in the future. Competitive threats that did not exist at the time the startup was formed appear as soon as other individuals notice a new chance to make money. Regulations emerge as a result of changes in political mood. A business model that does not adapt and evolve reflects a startup entrepreneur that does not grasp the nature, extent and complexity of the numerous challenges that lie ahead. Such startups are bound to fail, or at best, ignore attractive opportunities to increase revenues and profits.

The business model is not the business plan. Your business plan should certainly discuss your business model, yet the two are distinct and different. We will discuss business plans at another time. The business model is a framework within which the startup's activities occur. The business plan is a document whose main purpose is to serve as a record of the startup's goals, the reasons why those goals make sense and can be achieved, the manner in which the goals will be accomplished and the timeline within which the startup expects to implement its plan – presumably the plan is to become profitable as soon as possible within the tenets of the business model.

Do you understand the rationale behind how your startup creates, delivers and captures value?

Is your business model based on an understanding of the unique circumstances of your startup or is it an attempt to copy what has worked for a company you compete against? If it is an attempt to copy, you might be overlooking opportunities to capture value that are available only to your startup.

Coming Attractions

A reader asked the following question after the publication of the 4th installment of the What is Your Business Model? series; "What do you advocate for someone to do when doubts arise because the model is failing? How do you determine that optimality where something is possible and staying put is a waste of time? It happens that someone can fail too early where a little more patience might have turned the table. How do we make this call?”

That is an important question, one I should have tried to tackle as part of Connecting The Dots. I will use it as the basis for the next installment of my column on Tekedia.

About The Author

Brian Laung Aoaeh is an investment analyst at KEC Holdings in New Jersey, where he devotes the majority of his time to assessing potential venture capital investments. Before KEC Holdings, he worked at Lehman Brothers, UBS AG and Watson Wyatt Worldwide.

He holds a BA with a double major in Mathematics and Physics from Connecticut College and an MBA from New York University's Leonard N. Stern School of Business. He is presently a participant in the CFA Program.

He is an unpaid columnist for Tekedia, where he writes about startups, investing and entrepreneurship with a focus on the challenges encountered by African startups.

Brian devotes some of his personal time to volunteer activities related to entrepreneurship and economic development in Africa. He was a volunteer MBA Consultant for the Meltwater Entrepreneurial School of Technology (MEST) in Accra, Ghana between 2011 and 2012. He currently serves as a member of the Board of Trustees for The Kumasi Center for Lifelong Learning (KCLL) in Kumasi, Ghana. He was instrumental in initiating the discussions that led to KCLL organizing and holding Ghana's first ever 10-day training session in microelectronics and embedded systems at the Kwame Nkrumah University of Science and Technology in Kumasi between September and October 2012, in partnership with FASMicro, Nigeria Ltd. - Tekedia's parent company. Brian focuses on growth strategy in his capacity as a member of KCLL's Board of Trustees.

Before his departure for the United States he obtained his primary education at the Bayero University Staff Primary School in Kano, Nigeria. He then studied for the WAEC GCE Ordinary Level at St. Francis Xavier Junior Seminary, in Wa, Ghana and for the WAEC GCE Advanced Level at the Presbyterian Boys' Secondary School in Accra, Ghana.

Brian is a devoted husband and father. He is an ardent supporter of the Super Eagles of Nigeria and the Black Stars of Ghana. In his free time he is a fitness enthusiast, and now has several half-marathons under his belt.