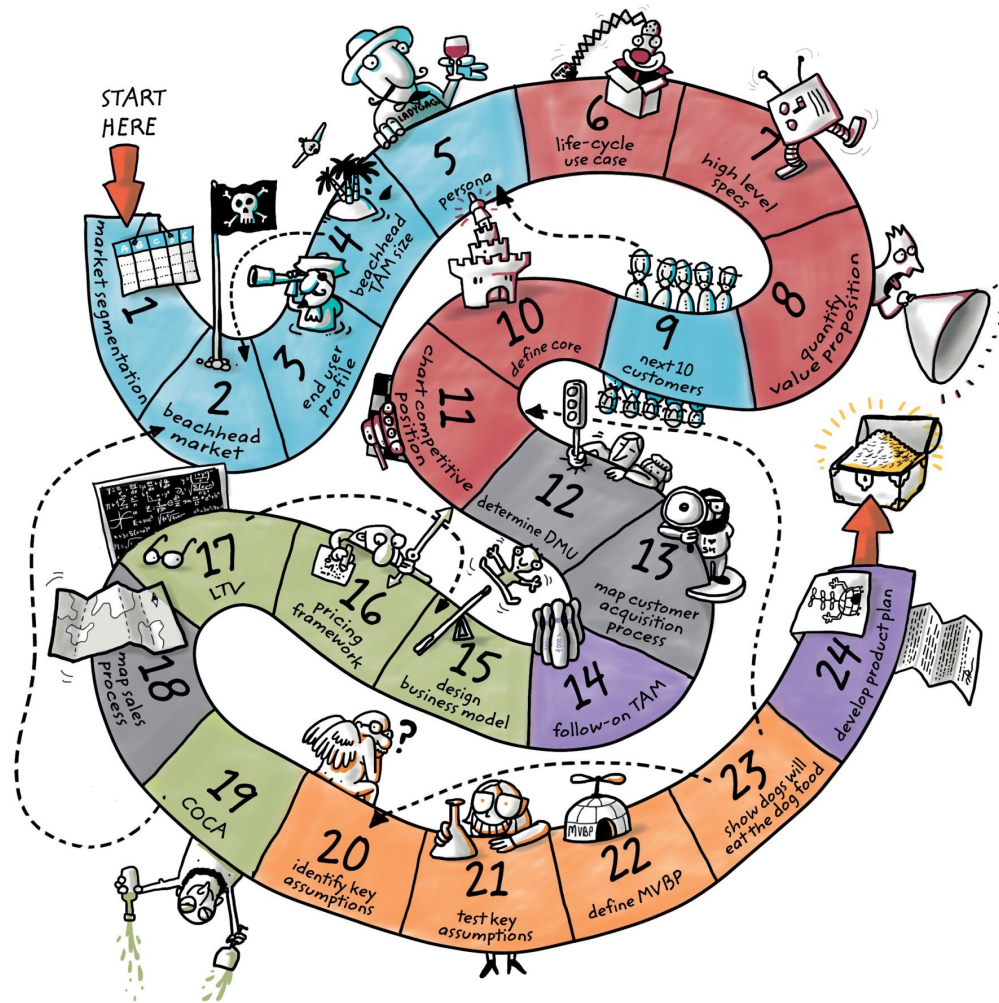


# How Do You Make Money Off Your Product?

Lecture 9 - Part 1  
GSL Peru 2014

## HOW DO YOU MAKE MONEY OFF YOUR PRODUCT?

- 15 Design a business model
- 16 Set your pricing framework
- 17 Calculate the lifetime value of an acquired customer (LTV)
- 19 Calculate the cost of customer acquisition (COCA)



# Follow on TAM



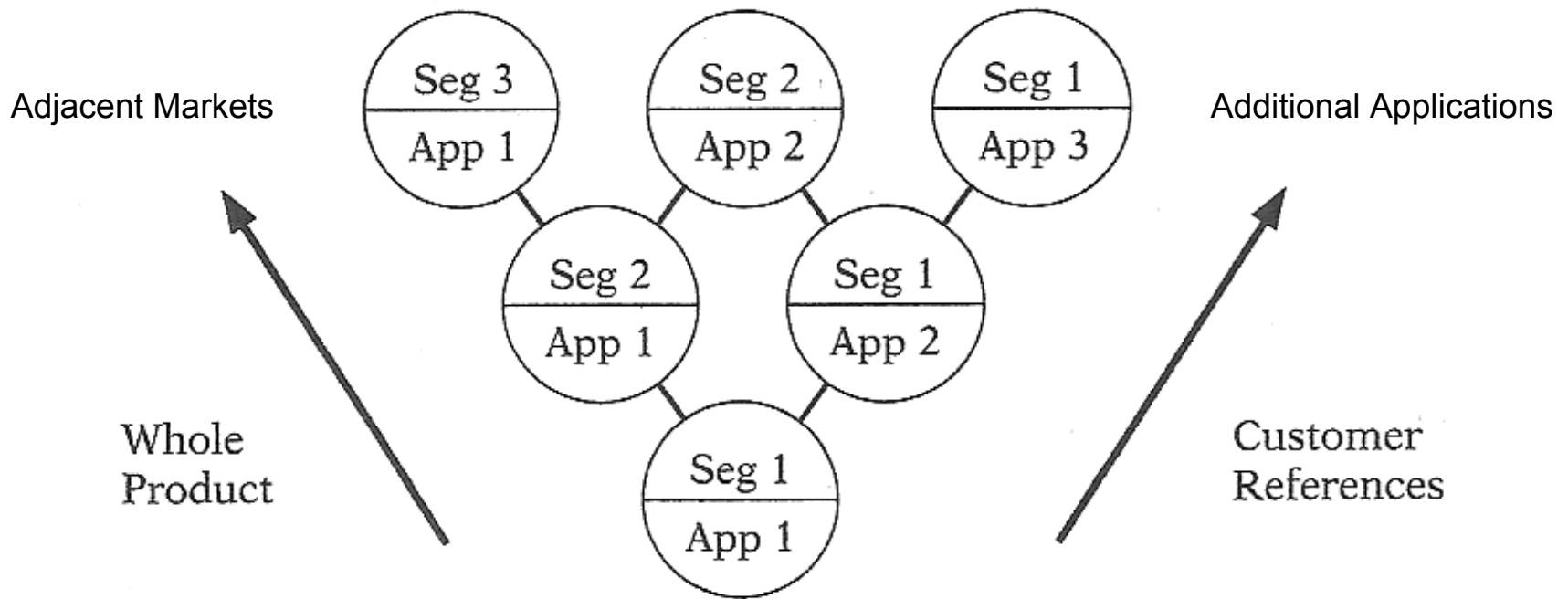
# Broader TAM Sizing

- What?
  - Estimate the annual revenues from the top follow-on markets after your beachhead market
- Why?
  - Shows the potential that can come from winning your beachhead
  - Motivate you to do so quickly and effectively

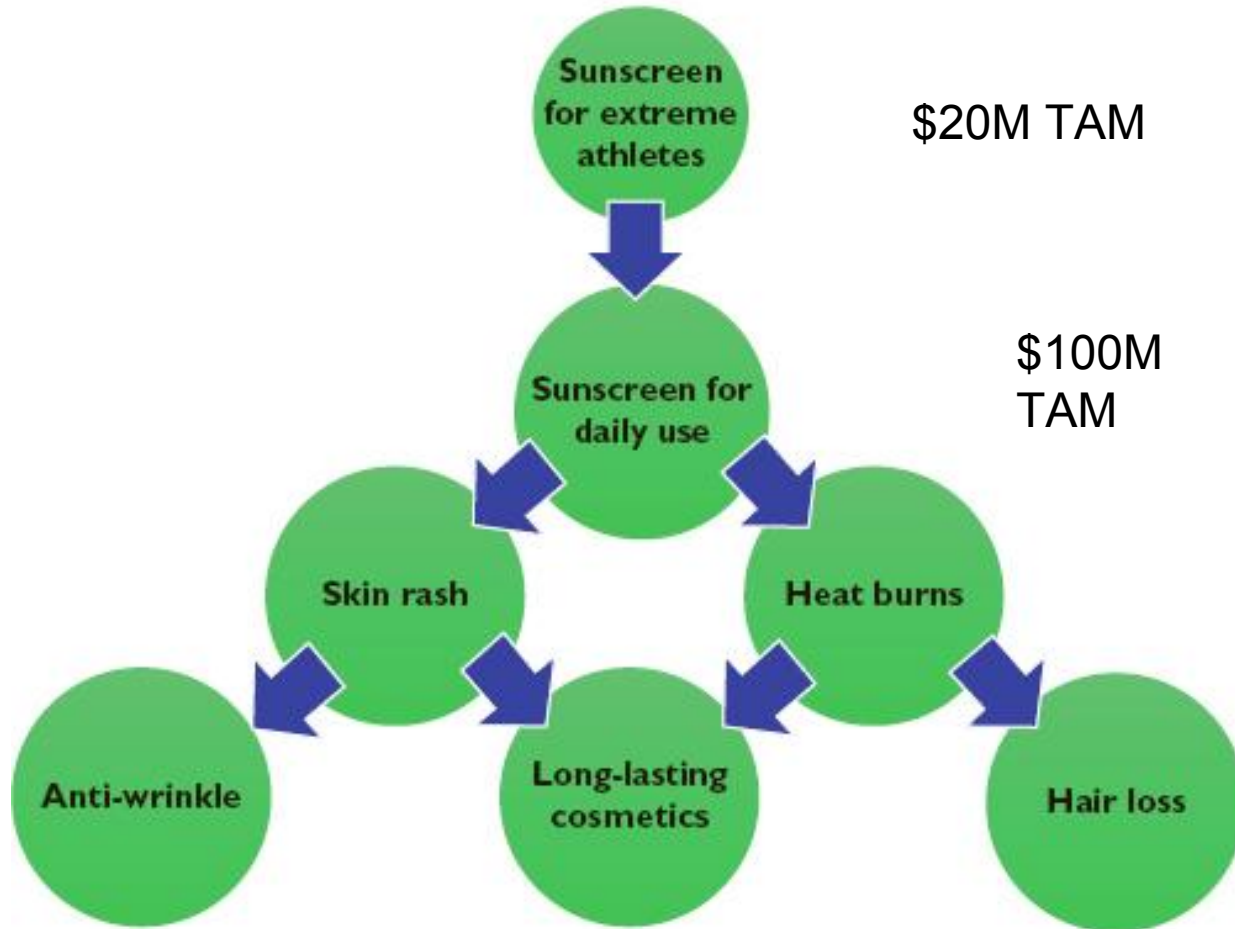
# More...

- Refine the TAM for the initial market and develop an estimate the broader TAM (includes the follow on markets)
- The TAM for the follow on markets will not be as certain and specific as the first market
- **CONSTANTLY** reconsider and update...
  - What is relevant?
  - If I change my strategy, how does this affect my TAM?

# Bowling Alley Market Development



## Broader TAM Sizing Example



**SMART SKIN CARE** *Long-lasting protection for your skin*

# Moving Beyond Beachhead Segment

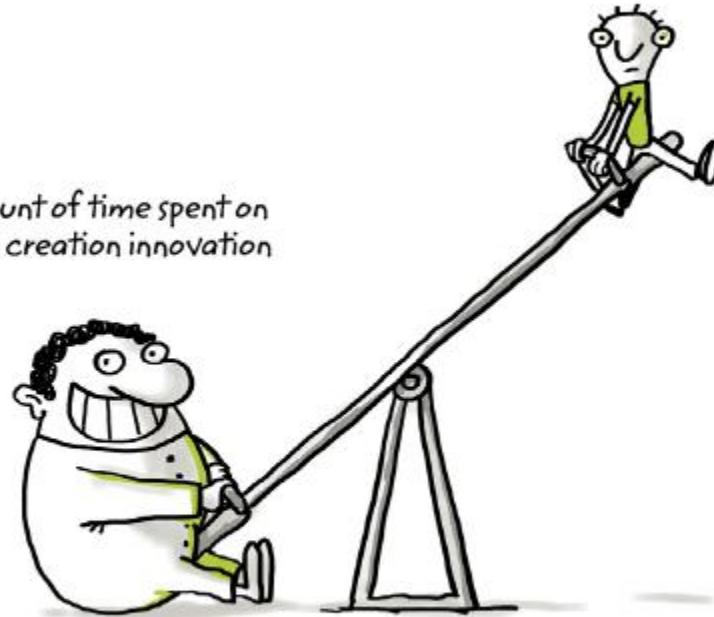
1. Is the target customer well funded and readily accessible to our sales force?
2. Do they have a compelling reason to buy?
3. Can we today, with the help of partners, deliver a whole product?
4. Is there entrenched competition that could block us?
5. If we win this segment, can we leverage it to enter additional segments?
6. Can we show results in an acceptable timeframe?



# Design a Business Model

*Amount of time spent on  
value capture innovation*

*Amount of time spent on  
value creation innovation*



*Me thinks you need to get things more in balance!*

# Why Bother?

\$20-25M =>  
\$60M



\$1 Billion

\$19 Billion



# Business Model

- Way to capture value from customer
- Not pricing! - not how much, but how they pay
- Free is not a business model (Freemium)

# General Categories

- One-time plus Maintenance - classic software model
- Cost Plus - cost of production plus profit - not optimal - does not capture all of the value
- Subscription/Lease - SaaS
  - Annual/Multi-year
  - Month to Month
- Licensing

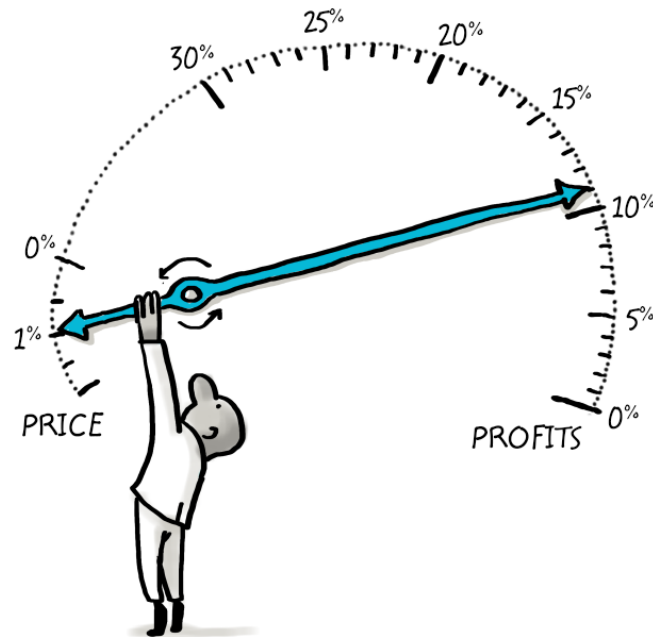
# General Categories

- Consumables - “razor blade” model
- Up sell - loss leader
- Advertising
- Reselling Data Collected - lease access
- Transaction Fee
- Usage Base - Hourly Rates - common service mode - AWS - Taxi meter effect
- “Cell Phone” plan - base plus overcharge

# General Categories

- Parking Meter - Penalty - Blockbuster's, Credit Card
- Microtransactions/In App Purchase
- Shared Savings - customer pays when saving is achieved
- Franchise
- Operation and Maintenance - energy sector

# Pricing Framework



Improving pricing  
can have big effect on profits ...  
but be patient until market matures  
and you have enough info

# Pricing Framework

## What?

- Determine a framework to test pricing for your new product and make a decision on what the initial price will be.

## Why?

- Small changes in pricing can have a huge impact on your profitability.



# Pricing Framework

## More...

- Now that you have a business model, it is time for initial Pricing decisions. Again, always look at this from the customer's perspective as well and not just yours. Consider competition as well when determining your pricing strategy.

# Basic Pricing Concepts

- Costs Shouldn't Be a Basis in Deciding Price
- Use the DMU and the Process to Acquire a Paying Customer to Identify Key Price Points
- Understand the Prices of the Customer's Alternatives

# Basic Pricing Concepts

Different Types of Customers Will Pay Different Prices

- Technological enthusiasts
- Early adopters
- The early majority (pragmatists)
- The late majority (conservatives)
- Laggards/skeptics

# Basic Pricing Concepts

- Be Flexible with Pricing for Early Testers and “Lighthouse Customers”
- It is Always Easier to Drop the Price than to Raise the Price

# A/B Price Testing

- <http://www.quora.com/A-B-Testing/Does-anyone-A-B-test-pricing>
- Daniel Ariely, Predictably Irrational
- Concept of “Decoy” or “Anchoring”

# Scenario #1

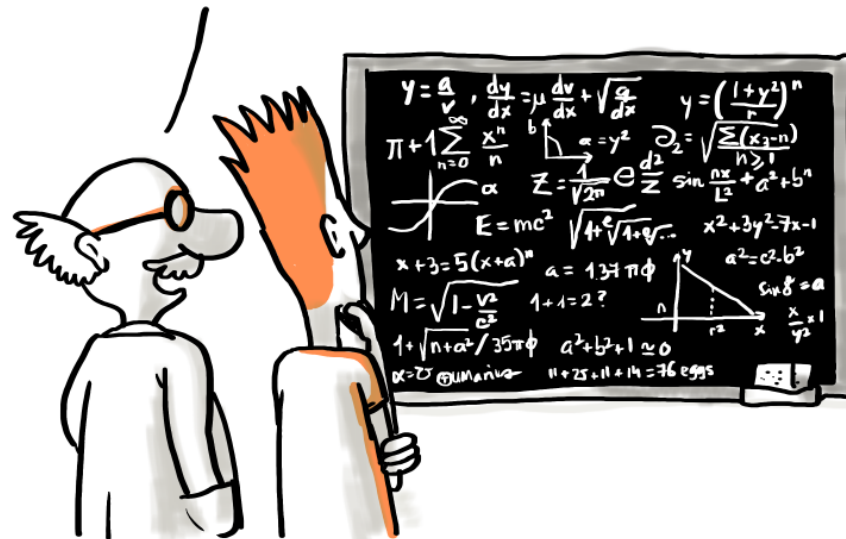
1. Online subscription - \$59/yr
  2. Print & online subscription - \$125/yr
- ~30%+ chose option #2

# Scenario #2

1. Online subscription - \$59/yr
  2. Print & online subscription - \$125/yr
  3. Print subscription only - \$125/yr
- 60%+ chose option #2

# Calculating the Life Time Value (LTV)

Don't worry,  
entrepreneurial math  
is much simpler.  
If the LTV does not equal  
3 times the COCA,  
none of this matters!





# LTV

## What?

- Estimate the Net Present Value of the total profits you will get from a new customer over the life time of that customer.

## Why?

- To complete the unit economics, you now need to estimate & understand the drivers of the Life Time Value (LTV) and it should get to at least 3X the Cost of Customer Acquisition (COCA).

# LTV

## More...

- Determine now the LTV by making assumptions and doing a calculation armed with your business model and pricing decisions. While these might change, it is important to see a potential path to success and doing this calculation will be important to getting you into this mindset. You will monitor this number over time and it is very important. This will be your first calculation of this number.

# LTV

How much a new customer is worth to your venture over the life time with you

$$\text{LTV} = \sum \text{NPV (Profits for 5 years)}$$

# Key considerations

- Gross Margins (Pricing & Costs)
- Cost of Capital
- Retention Rate
- Ability to Upsell or Capture Value in other Dimensions
- Note that Profit is what matters and not Revenue
- Skok's Law: LTV must be at least 3X COCA

# References

New Enterprises Lecture Notes - Bill Aulet

Disciplined Entrepreneur - Bill Aulet