LM07 · CORPORATE ISSUERS · CFA LEVEL I

Business Models

How a firm organizes itself to deliver value to customers — and turns that value into profit.

What This Reading Covers

There is *"no precise generally accepted definition"* of a business model, but the required elements fall into two buckets: a firm's **value proposition** (what value is delivered) and its **value chain** (how the value is delivered). This module builds the vocabulary — WHO, WHAT, WHERE, HOW (much), WHY — and then walks through the major revenue, pricing, and specific business-model types that show up on the CFA exam.

Learning Outcome Statements

LOS a Describe the key features of business models

LOS b Describe various types of business models

Why Analysts Care

The business model drives four financial realities the analyst must understand:

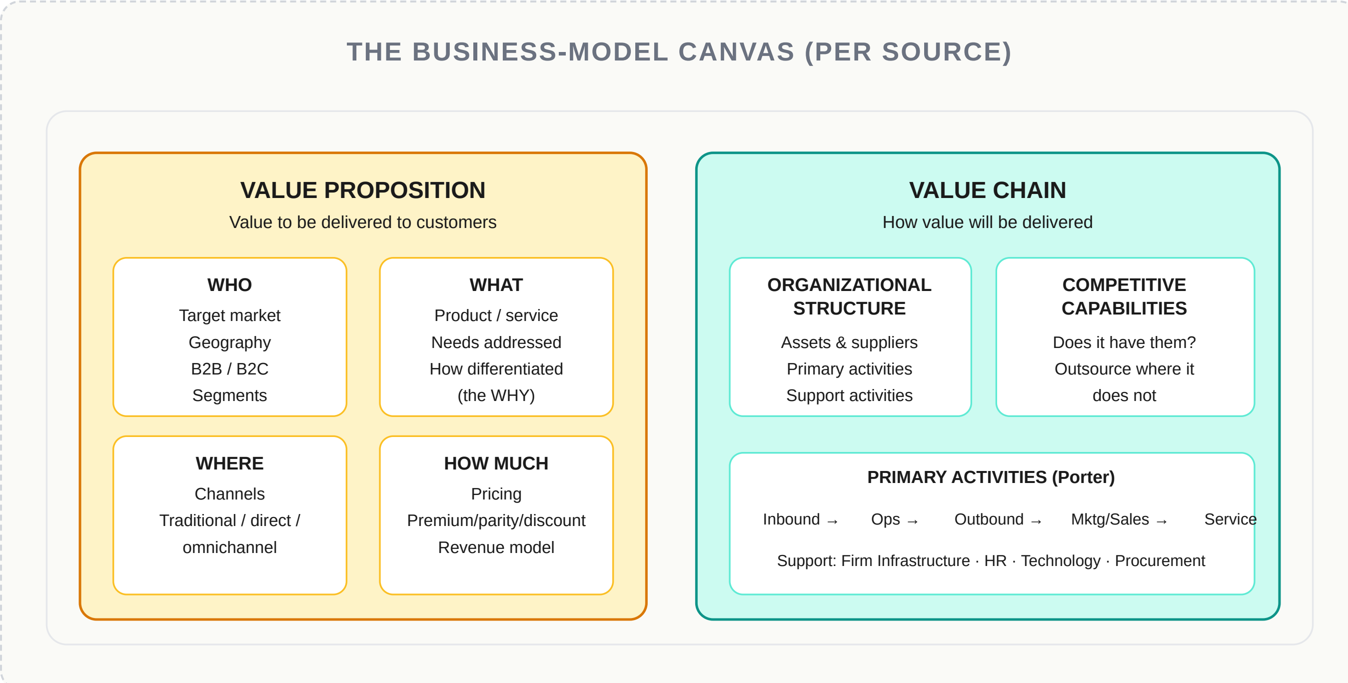
1. **Revenue model** — where sales come from and how they scale
2. **Cost structure** — fixed vs. variable mix
3. **Asset profile** — capital intensity
4. **Financial structure** — how much debt the model supports

Starting point for analysis: annual reports and investor presentations.

Exam Tip: The exam frequently tests whether a candidate can **name** a specific business model (razor-and-blades, freemium, franchise, subscription, crowdsourcing, network effects) from a short vignette. Memorize the defining feature of each.

LOS A · THE TWO-SIDED FRAMEWORK

Value Proposition vs. Value Chain



Value Proposition

The firm's **value proposition** describes the product or service attributes valued by a firm's target customer that lead those customers to prefer its offering over competitors', *given relative pricing*.

It answers four questions: **Who** (target market), **What** (products/services), **Where** (channels), **How much** (price).

Value Chain

The firm's **value chain** refers to how the firm is structured to deliver that value — the systems and processes within a firm that create value for its customers. It includes its organizational structure, competitive capabilities, and the activities it performs (Porter's primary activities: inbound logistics → operations → outbound logistics → marketing & sales → service, supported by firm infrastructure, HR, technology, and procurement).

A firm's value chain should include activities in which it has a competitive advantage; activities where it does not should be outsourced.

Value Chain vs. Supply Chain

Value chain = activities carried out by *the firm* that add value to customers. **Supply chain** = the sequence of processes involved in the production and delivery of a product; it is likely to involve multiple firms.

LOS A · CUSTOMERS, PRODUCTS, CHANNELS

WHO · WHAT · WHERE

WHO — Customers and Markets

GEOGRAPHY

Local · National · International. Defines market size and regulatory complexity.

B2B VS B2C

B2B — customers are other businesses; tailor the product to their needs. **B2C** — consumers; target specific types or segments.

SEGMENTING

Customers segmented by **geography** (as granular as postcode), **demographics** (age — e.g., cruise lines), **seasonal or life-cycle timing** (when customers spend and on what), **behavior** (relationship with the product; early adopter vs late majority).

WHAT (and often WHY) — Product or Service

The WHAT should answer: *how is it different, what needs does it address, why do customers buy it, what job is it being hired to fulfill?*

It allows identification of:

1. **Addressable markets** — how big are they?
2. **Key opportunities** — who else might buy it?
3. **Key risks** — is there a high risk of substitution?

The "what" may (should?) change over time as new technology, delivery methods, and markets emerge.

WHERE — Channels (Sales & Distribution)

How is the product/service sold (sales and marketing) and how is it delivered (distribution)? Key questions:

- Which **functions** will the firm perform (selling/display, physical distribution, after-sales service)?
- What **assets** will be required (warehouse/store, delivery fleet, sales force)?
- Which firms will be **partners/suppliers** (wholesalers/retailers, haulage firm, agents, franchisees)?

Three Channel Strategies

STRATEGY	PATH	TYPICAL USE

Traditional	Manufacturer → Wholesaler → Retailer → End Customer	Mass-market consumer goods
Direct sales	Manufacturer → End Customer	Complex, high-margin products (medical devices, industrial equipment). Historically required a sales force; now complemented or substituted with digital sales.
Omnichannel	Combination of digital + physical	Order online, pick up in store

Channels Impact

Channel choice affects **revenues**, **cost behavior**, and **sensitivity to internal and external risk factors**. Direct sales builds a close relationship with customers and avoids competing with substitutes on the store shelf — but imposes significant costs including fixed salaries.

LOS A · PRICING & REVENUE MODELS

HOW MUCH — Pricing Power and Approaches

Pricing Relative to Competitors

Premium	Parity	Discount
Above competitors	Match competitors	Below competitors

Pricing Power

High competition, low differentiation → low pricing power → firms are **price takers** (commodity producers). These firms are likely to adopt a **cost leadership** model.

Differentiation or scarce capacity → high pricing power → **price setters** — pricing approach is typically *value-based* rather than *cost-based*.

Core Pricing Approaches

APPROACH	HOW IT WORKS
Cost-based (cost-plus)	Set price based on cost plus a target margin. Used by price takers / commodity producers.
Value-based	Price based on value received by the customer. Must estimate the buyer's opportunity cost (e.g., pharmaceuticals — legal substitutes).
Price discrimination	Different channels, customers, different prices. Maximizes profits when customers have different willingness to pay (e.g., senior discounts).
Tiered pricing	Based on volume of purchases, or on product features — a "base" model plus add-ons.
Dynamic pricing	Based on time of purchase, supply and demand (try to get an Uber home on New Year's Eve — peak/surge/congestion pricing).
Auction / reverse auction	Bidding process. Digital technology has enabled automation.

Net Prices

Net prices are prices after specific discounts, promotions, and bundles. The analyst tracks gross vs net carefully — a high list price with heavy discounting implies weaker pricing power than a premium price that actually sticks.

LOS A · PRICING FOR MULTIPLE PRODUCTS + GROWTH

Bundling, Razors, Freemium & Hidden Revenue

Pricing Multiple / Complex Products

BUNDLING

Combining multiple products. Useful for products with *high marketing costs* and *high incremental profit margin* (buy the bundle, the marginal cost of adding an item is low).

RAZOR, RAZORBLADE

Low initial price on the base product (razor), high-margin repeat purchases on consumables (blades). Must prevent generic substitutes.

ADD-ON PRICING

Captive customers — once they own the base product, extras carry high margins (optional products with high markups).

Pricing To Help Growth

PENETRATION

Temporarily low prices to build scale and market share, sacrificing margin. *Effectively a marketing expense.*

FREEMIUM

Basic usage for free (often ad-supported); charge for upgrades or premium features. Common in digital services with **network effects**.

HIDDEN REVENUE

No charge for the service; revenue is earned elsewhere — e.g., online content is free, money is made selling **data** or advertising.

Skimming (context: new-product rollout)

A **skimming** strategy sets a high initial price, harvesting margin from early adopters who value being first, then reducing the price over time as the addressable base widens. It is the mirror image of **penetration** pricing.

Exam Tip: Razor-and-blades, freemium, and hidden-revenue are **definition recognition** items on the exam. From a one-sentence vignette you must name the model. Lock the keyword that triggers each: *consumable refill* → razor/blades; *free basic + paid upgrade* → freemium; *free service, monetize data/ads* → hidden revenue.

QUIZ 1 · FRAMEWORK & PRICING

Test Your Understanding

Q1. Which pair correctly maps the two required elements of a business model?

Q2. A commodity producer in a highly competitive industry with low product differentiation is *most likely* to:

Q3. An online software vendor offers a free tier with basic functionality and charges for advanced features. This is *best* described as:

Q4. Uber's surge pricing on New Year's Eve is an example of:

LOS B · REVENUE MODELS

Revenue Models — How the Firm Gets Paid

REVENUE MODEL	HOW IT WORKS	EXAMPLE
Subscription	Recurring fee for ongoing access. Alternative to ownership; predictable recurring revenue.	SaaS, streaming services
Transaction / pay-per-use	Customer pays per transaction or per unit of consumption.	Pay-as-you-go mobile data
Advertising	Content / service given away; advertisers pay for access to the audience (pay-in-advance from sponsor).	Free-to-air TV, search engines
Licensing	Intangible asset (brand, IP, patent) used by another party in exchange for a royalty.	Brand licensing agreements
Franchising	Comprehensive form of licensing; franchisor earns royalty and is responsible for advertising and product development.	Fast-food chains
Commission	Middleman earns a percentage or per-transaction fee for facilitating a sale.	Brokers, agents, affiliate / referral programs
Data-as-product ("hidden revenue")	Service is free to end-user; revenue comes from selling user data or targeted ads.	Social platforms

Alternatives to Outright Ownership

Increasingly, firms avoid asking customers to *buy* and instead offer *access*. The source lists four alternatives to ownership:

1. **Subscription models** — e.g., software access
2. **Leasing** — for *tangible* assets
3. **Licensing** — for *intangible* assets
4. **Franchising** — a comprehensive form of licensing

Fractional ownership (e.g., time-share arrangements) is also an alternative to outright purchase.

Capital-structure implication

Firms with **subscription-based** revenue models are better able to support high proportions of debt than firms with **pay-per-use** revenue models — recurring revenue is more stable and predictable, so it supports fixed debt service.

LOS B · CONVENTIONAL BUSINESS-MODEL VARIATIONS

Four Conventional Variations

Contract Manufacturers (Private Label)

Produce goods *marketed by others*. The contract manufacturer focuses on efficient production; branding and marketing sit with the buying firm.

Value-Added Resellers

Distribute the product and handle the *complex aspects* — installation, service, integration. Common for complex industrial or IT products.

Licensing Arrangements

Produce under a recognized *brand name* in exchange for a **royalty** payment to the brand owner. The licensor keeps the brand; the licensee does the production.

Franchise Models

The **franchisor** earns a royalty and is responsible for *advertising and product development*. The **franchisee** operates the local outlet under the brand.

Franchising vs Licensing — Side by Side

	LICENSING	FRANCHISING
Scope	Narrow — use of a specific intangible (brand, patent)	Comprehensive — entire business system
Royalty	Paid to licensor	Paid to franchisor
Advertising & R&D	Licensee often responsible	Franchisor responsible
Control	Lower — licensee operates independently	Higher — franchisor prescribes operations standards
Source label	"Produce under a recognized brand name, pay royalty"	"A comprehensive form of licensing"

Business-Model Innovation Enabled by Digital Technology

- **Location matters less** — firms can serve customers anywhere

- **Outsourcing is easier** — specialized providers available globally
- **Digital marketing** can target specific customers cost-effectively
- **Network effects** become available at scale

LOS B · NETWORK-EFFECTS BUSINESS MODELS

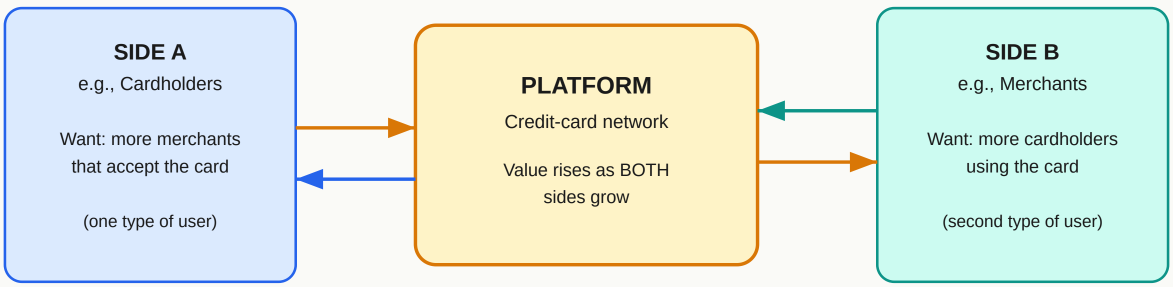
Network Effects, Platforms & Crowdsourcing

Network Effects — Definition

The **increase in value of a network to its users as more users join**. Examples from the source: messaging platforms, payment platforms, social media, payment systems, stock exchanges.

One-sided vs Two-sided Networks

TWO-SIDED PLATFORM DIAGRAM



More users on either side → more value for users on the other side

One-sided network

There is **one type of user** that is valuable to other users. Source example: *Venmo* (peer-to-peer payments — both parties are the same type of user).

Two-sided (or multi-sided) network

Two (or more) types of users whose value rises when the other side grows. Source example: *credit card networks* (cardholders + merchants).

Crowdsourcing

Crowdsourcing — *users contribute to the product; the business facilitates "communities."* The platform does not produce the content itself; it creates the environment in which users create value for one another (user-generated content, open-source-style contribution, reviews).

Exam Tip: Lock the source's exact examples so vignette triggers are unambiguous: **Venmo → one-sided**, **credit-card network → two-sided / multi-sided**, **users contribute → crowdsourcing**.

QUIZ 2 · REVENUE & SPECIFIC MODELS

Test Your Understanding

Q5. A razor-and-blades pricing model generates most of its profit from:

Q6. Which statement *best* distinguishes franchising from licensing?

Q7. A credit-card network that connects cardholders with merchants illustrates:

Q8. A firm with predictable recurring revenue from annual subscriptions is generally able to:

LOS B · BUSINESS-MODEL RISKS

Risks That Sink Business Models

Three Headline Risks the Analyst Must Flag

Pivoting Risk

The original model does not work and the firm must **pivot** — changing the customers it serves, the product/service, the channel, or the pricing approach. Pivots destroy sunk investment in the prior model and often signal that management's initial thesis was wrong.

Regulatory Risk

Digital platforms and data-monetization models face rising **regulation** — privacy laws, antitrust action, content moderation rules, licensing requirements. Risk is greatest where the firm's value proposition depends on permissive legal treatment (e.g., hidden-revenue models based on selling user data).

Competitive Dynamics

Every business model faces **substitution risk**. "The what may (should?) change" as new technology, delivery methods, and markets emerge. Models with low differentiation or easily copied features face faster margin erosion.

Risk & Business-Model Features — How They Combine

FEATURE	PIVOT RISK	REGULATORY RISK	COMPETITIVE RISK
Subscription (SaaS)	Low if customer stickiness is high	Moderate — data privacy	Moderate — feature copying
Hidden-revenue (data/ads)	High if privacy rules tighten	**High** — privacy / antitrust	High — ad spend is cyclical
Razor-and-blades	Moderate	Low	**High — generics on consumable**
Franchise	Low — standardized system	Moderate — franchise laws	Moderate — brand dilution
Network-effects platform	Low once scale is reached	**High** — antitrust attention	Low — winner-take-most

Early-stage vs Mature-stage Risk Profile

The same business-model choice carries different risk weightings through the lifecycle: **early stage** is dominated by pivoting risk; **mature stage** is dominated by regulatory and competitive dynamics as the model becomes a target.

APPLIED · WORKED ILLUSTRATION

Value Creation Through Business-Model Choice

ILLUSTRATION **StreamCo — From Pay-Per-View to Subscription**

SETUP

StreamCo originally sold movie rentals at **$4.99 per transaction** (pay-per-use revenue model). Customers paid only when they watched. Churn was invisible; revenue was volatile.

Management proposes shifting to an **all-you-can-watch subscription** priced at **$14.99/month**. The WHO (consumer households) and WHAT (video content) do not change. The changes are *HOW MUCH* (pricing approach) and indirectly the *value chain* (recommendation engine becomes critical for retention).

QUESTION

Why might switching from pay-per-use to subscription create value even if *total revenue per user is unchanged*? Evaluate through the four analyst lenses (revenue model, cost structure, asset profile, financial structure).

SOLUTION

ANALYSIS

1. Revenue model — shifts from *transaction* to *subscription*. Recurring, predictable cash flow; lower revenue volatility.

2. Cost structure — content licensing is largely fixed; subscription smooths revenue across the same fixed cost base, improving margin stability.

3. Asset profile — subscription model funds investment in a recommendation engine and exclusive content (value chain capabilities), which in turn strengthens the value proposition.

4. Financial structure — per source guidance, firms with subscription-based revenue can support *more debt* than firms with pay-per-use revenue → lower WACC → higher firm value for the same operating cash flow.

TAKEAWAY

Business-model choice creates value independent of revenue total

The same customer base + same product + same average revenue, routed through a *different revenue model*, can produce: (a) more stable cash flows, (b) a capital structure that supports more debt, and therefore (c) a higher enterprise value.

EXAM CUE

When a vignette describes a firm moving between revenue models, run the checklist: (1) how does recurring-revenue visibility change? (2) how does that affect debt capacity? (3) does the value-chain investment requirement rise (e.g., retention engine)? These are the items examiners frame around "why the change creates value."

QUIZ 3 · FINAL & SCORECARD

Final Quiz

Q9. A firm whose users contribute to the product — the business simply facilitates "communities" — is *best* described as using:

Q10. Which channel strategy is *most* typical of complex, high-margin products such as medical devices or industrial equipment?

Q11. A social-media platform that offers its service free to end users and earns revenue by selling targeted advertising and user data is using a:

Q12. Which of the following is *not* one of the pricing approaches described in the source?

Your Scorecard

0 / 12

LM07 Key Takeaways — Exam-Ready Cheat Sheet

The Framework

1. **Two required elements:** Value Proposition (WHO / WHAT / WHERE / HOW MUCH) and Value Chain (organizational structure + competitive capabilities).
2. **Value chain vs supply chain:** value chain = activities *by the firm*; supply chain = production-and-delivery sequence across multiple firms.

3 **Four analyst lenses:** revenue model, cost structure, asset profile, financial structure → profitability.

Pricing Toolkit

4 **Pricing power:** price taker (commodity, cost leadership) vs price setter (differentiation, value-based).

5 **Core approaches:** cost-plus, value-based, price discrimination, tiered, dynamic (surge/peak), auction.

6 **Multi-product:** bundling, razor-and-blades, add-on. **Growth:** penetration, freemium, hidden-revenue. **New-product rollout:** skimming (opposite of penetration).

Revenue Models & Alternatives to Ownership

7 **Revenue models:** subscription, transaction/pay-per-use, advertising, licensing, franchising, commission (affiliate/referral), data-as-product.

8 **Alternatives to ownership:** subscription (software) · leasing (tangibles) · licensing (intangibles) · franchising (comprehensive licensing).

Named Models to Recognize

9 **Conventional:** contract manufacturers (private label), value-added resellers, licensing, franchise.

10 **Digital / network-enabled:** one-sided network (Venmo), two-sided / multi-sided platform (credit cards), crowdsourcing, freemium, hidden-revenue.

11 **Risks:** pivoting risk, regulatory risk (data/antitrust), competitive dynamics (substitution).

Last-Minute Keyword Map

Consumable refill → razor-and-blades

Free basic + paid upgrade → freemium

Service free, sells data/ads → hidden revenue

Users contribute to product → crowdsourcing

Two types of users, each more valuable as the other grows → multi-sided platform

One type of user valuable to other users → one-sided network (Venmo)

Franchisor does advertising & product dev → franchise (vs narrower licensing)

Recurring predictable revenue → subscription → supports more debt

Surge / peak / congestion → dynamic pricing

Differentiation + willingness to pay → value-based pricing

Step 1 of 13