# BUSINESS MODELS & RISKS

# INTRO TO BUSINESS MODELS

Business Model→ Explanation of how the company is or will make money by:

- Rendering a service or providing a product.
- Acquire customers
- Deliver the product
- Make a profit.

What should a business model include:

1. Identify potential customers:
   - How they acquire new customers
   - How much Customer Acquisition Costs (CAC)
   - How they control and improve/ maintain customer satisfaction
2. Description of the service rendered or the product sold.
   - How the product satisfies the needs of customers.
   - Differentiation from competitors ( innovation via features, quality premium, or price)
3. Explanation of the way the firm sells its product / service

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    - Channel Strategy
        - Medium (Physical stores, online, direct mail, use of agents)
        - Manner ( Direct to consumers or via intermediaries such as wholesalers, retailers, or franchisees).
        - B2B vs B2C

Omnichannel Strategy (combines online sales and physical stores)

4. Description of the key assets and main suppliers of the company.
    - Assets (A patent, key software of possessing a skilled workforce)
    - Suppliers

5. Explanation of the Company's strategy in terms of Pricing:
    - Value-based pricing: Price based upon the perception of value by the customer.
    - Cost-based pricing: Price based upon the cost (+ a margin) of production
    - Price Discrimination:
        - Based on Volume (tiered pricing)
        - Based on the time of demands (high prices at prime times and low prices peak- Hotels, airline tickets)
        - Auction Pricing (Google ads, Tiffanys)

5. Explanation of the Company's strategy in terms of Pricing:
   - When multiple products are sold, different pricing models may occur:
     - Bundling (Sale of complementary products as a whole; CFA course + Investing Course)
     - Razors-and-Blades: Initial sale of the OEM at a low margin , but subsequent sale of consumables used with the OEM at a substantial margin ( Gillette, HP, Termofisher)
     - Optional Additional Products: Extras to the automobile

   - Other pricing strategies:
     - Penetration pricing: During an initial time, the firm sells its product at a very low (even negative) margin in order to gain scale and access to a new market (Amazon Prime).
     - Freemium Pricing: Basic product at zero cost and access to additional functionalities for free (Spofity)
     - Hidden Revenue : The cost for the user is zero, but the user is monetized to hidden customers (ad revenue for Google)

   - Alternative to lump-sum outright purchase price:
     - Subscription Model
     - Fractional Ownership (Netjets)
     - Licensing
     - Franchising

5. Explanation of the Company's strategy in terms of Pricing:
   - Value Proposition → Take into account the competitive position of the firm, how the customers will value the product / service of the company. Activities in which firms have to do well in order to excel in execution:
     - Inbound logistics
     - Operations
     - Outbound logistics
     - Marketing
     - Sales and Marketing.

   - Other business models:
     - Manufacturers of private labels:
     - Licensing agreements: (Disney photos in McDonalds Happy Meal).
     - Value-Added Resellers: Aftersales services such as installation, support, service, TaylorMade customization.

   - E-commerce direct sales models:
     - Affiliate Marketing: Payments to other company for achieving results in marketing actions (page views, leads)
     - Marketplace: A platform is provided where sales take place, but the company does not sell its products.
     - Aggregators: The platform is provided but the company product is sold (Spotify)

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- Final considerations:
  - Network Effects: The value of the product increases as its usage grows.
  - Crowdsourcing: Models that benefit from users' contribution (UGC).
  - Hybrid business models: Models that combine platform models and traditional models.

# Describe expected relations between a company's external environment, business model, and financing needs

Both debt and equity capital providers are concerned with the risk and growth potential of the firm.

Lenders want to minimize risks regarding future earnings and cash flows.

Equity owners are more focused on growth potential, but also want to minimize volatility.

The total risk borne by a firm depends on its business model and other risk factors that are a function of:

- External risks.
  - Changes in macroeconomic conditions (inflation, interest rates, and economic growth).
  - Trends in demographics.
  - Political, legal and regulatory changes.

- Company specific risks:
  - Stage of development.
  - Degree of vulnerability to competition.

**FINANCING NEEDS AND THE BUSINESS MODEL**

**Asset-Light models:** Renting vs owning. Assets owned by the franchisees.

**Paid-in-Advance models:** Self financing via working capital (insurance companies and their float)

**Lean-Startup models:** Outsourcing of the vast majority of the workforce in order to reduce to its maximum the level of fixed costs.

# Explain and classify types of business and financial risks for a company

**Macro Risk:** Risk of a negative impact to the Operating Profit of a firm due to economic, political or legal risk factors within a country / region.

- Recession/ Economic Slowdown risk. Cyclical firms are heavily impacted by this risk while defensive firms are more immune to it.

**Business Risk:** Risk of a negative impact to EBIT from both company-specific factors and industry risk factors. Beware of industry classifications (wide enough that the relevant data can be obtained and are useful for assessing the risks but narrow enough to include the risks that affect the business in question).

- Cyclicality of revenues and profits.
- Structure of the industry (low concentration vs high concentration).
- Competitive intensity (The higher the competitive intensity, the lower the profitability).
- Value Chain competitive dynamics: Actions by customers, suppliers, and competitors that affect profitability.
- Long term growth and expectations regarding future demand. (High long term growth potential is more attractive to current firms in the industry but will also attract more potential competitors).
- Regulatory risks and other external risks.

**Company Specific Risk Factors:**

- Competitive Risks: Main risk arises from the possibility of an erosion in the firms competitive advantage. Sources of competitive advantage:
  - Cost advantages such as scale.
  - Product differentiation
  - Network effects
  - Switching costs
- Execution risk
- Product Market risk: Specially acute for early stage firms. Less acute for firms with a wide range of products
  - Growth in demand decreasing below expectations.
  - Changes in consumer preferences
  - Obsolescence derived from disruptions.
  - Expiration of patents.

- Capital Investment Risk: Bad capital allocation decisions that lead the firms to invest in non-profitable ventures / M&A.
- ESG Risk:
- Operating Leverage: High proportion of fixed costs over total costs. (A 10% drop in revenues leads to a 20% decline in EBIT).

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- Financial Risk:
  - Financial Leverage, as Operating Leverage magnifies the variability of results ( Net income will grow much more than 10% with a 10% growth in revenues in a leveraged firm (and vice versa).
  - Consider not only financial debt, but also other debt-like items such as:
    - Underfunded pension obligations.
    - Leases