Revenue Model Migration

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Revolutionizing Global Leadership

Haas School of Business
UC Berkeley EXEC DEV
Center for Executive Development

Session Objectives

- Learn how to identify target customers
- Learn how to develop a value proposition
- Master the most important product positioning strategies
- Learn how to design a revenue model

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Case Discussion Questions

- Target Customers
  - Who are FreeMarkets' target customers?
- Value Proposition
  - How does FreeMarkets create value for its target customers? What should be its value proposition?
- Positioning Strategies
  - How should FreeMarkets position its services?
- Revenue Model Design
  - How do you assess the company's revenue model? What are its strengths and weaknesses?

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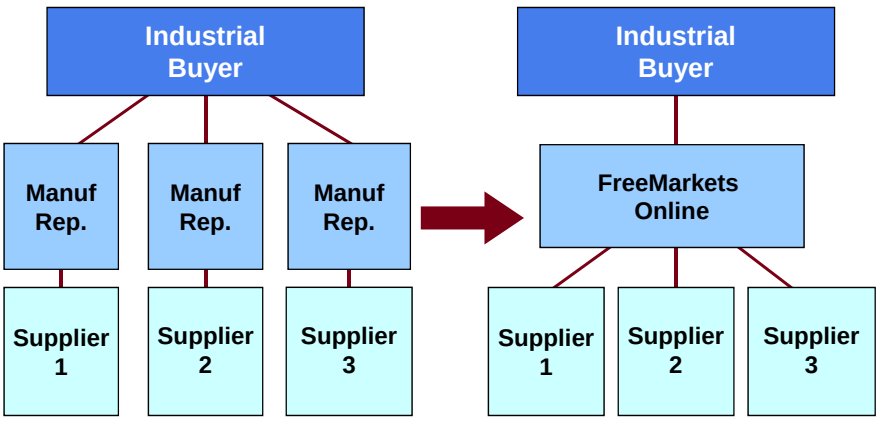
The New Product / Business Idea



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The Business Base Template

Business Case	Descriptions/Quantifications
Sizing of Opportunity	
Target Customers	
Value Proposition	
Positioning	
Revenue Model	

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Sizing of Opportunity

- The types of components in the target market = $300 billion/year
- Exhibit 6 suggests:
  - Average size of award: $1.85 m / CBE
  - $45 K / CBE consulting service fees
- Total potential number of CBE / Year = 300,000 / 1.85 = 162 K
- Total potential service revenue = $ 45K x 162 K = 7.29 B
- Total potential commission revenue = $300 B x 2.5% = 7.5 B
- A potential market size of about $15 Billion!

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Who Are the Target Customers?

- Buyers
- Suppliers
- Buyers and Suppliers

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Who Are the Target Customers?

- Buyers
- Suppliers
- **Buyers and Suppliers**

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Potential Target Customers

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Value Proposition

Buyers:

- Cost savings (an average of **17% (Exhibit 6)**)
  - Introduction to new suppliers
  - An opportunity for the buyer to gain a greater understanding of its own needs (through the specification and RFQ process)
  - Real-time bidding and reporting
- Procurement costs (in terms of personnel, overheads, etc.) **(10%?)**
  - Outsourcing of the RFQ process

Suppliers:

- Eliminate manufacturing reps **(4-7%)**
  - Introduction to new buyers

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Total Value Creation

Buyers

- Cost savings (an average of 17%)
  = $300 B x 17% = 51 B
- Procurement costs (in terms of personnel, overheads, etc.) (10%?)
  = $300 B x 10% = 30 B

Suppliers

- Eliminate manufacturing reps and selling costs (4-7%)
  = $300 B x 5.5% = 16.5 B

Total value creation = $97.5 B

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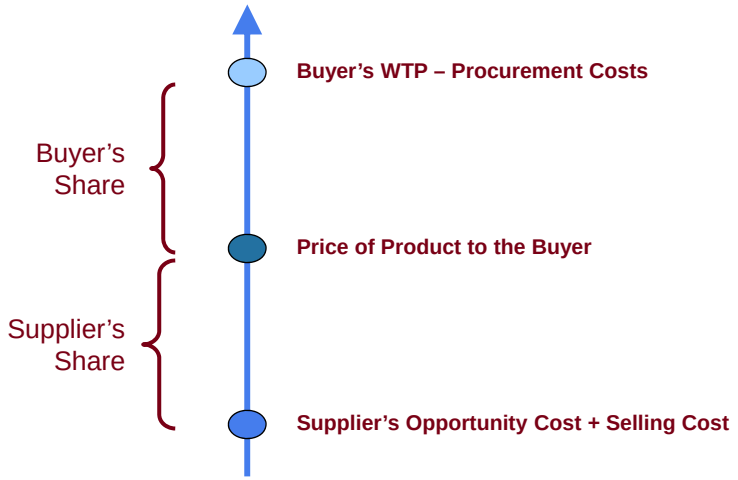
Value Creation / Appropriation (without Intermediary)



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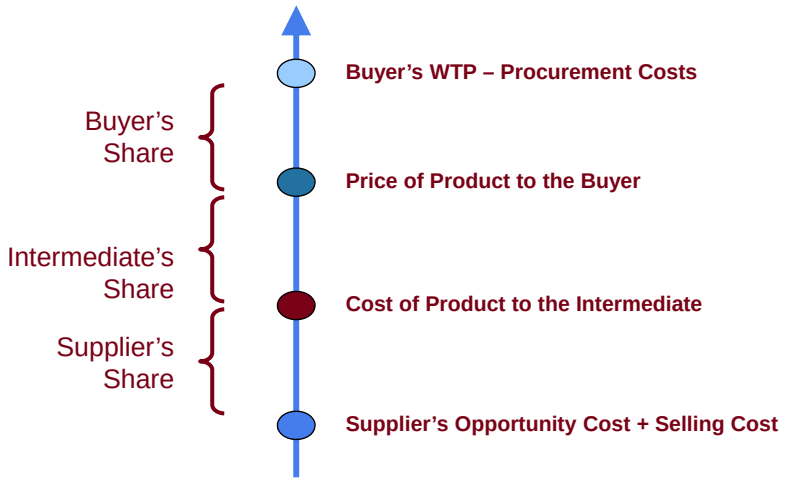
Value Creation / Appropriation (with Intermediary)



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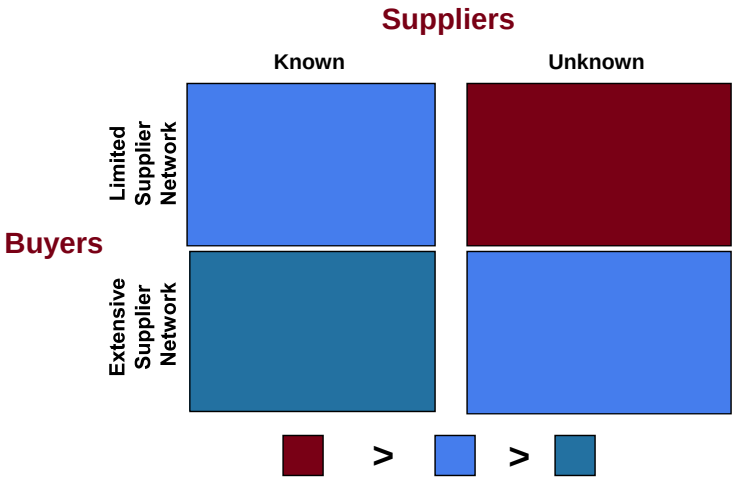
FreeMarkets' Potential Customers



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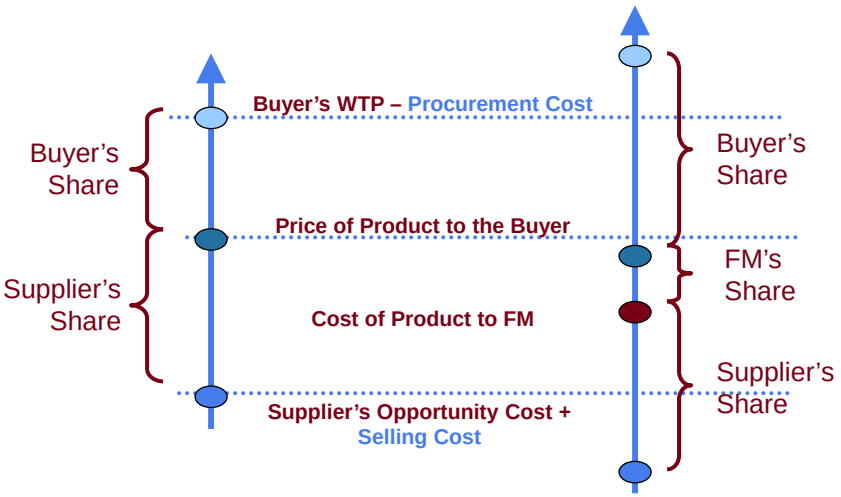
FreeMarkets: Large Value Creation for



Positive value creation by removing procurement and selling costs

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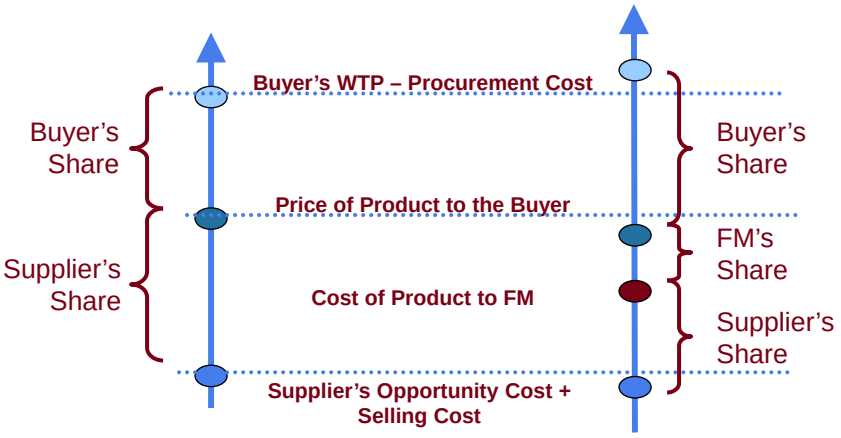
FreeMarkets: Small Value Creation for



Negligible value creation

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Current Positioning

- A hybrid business model of consulting and sales commission services
- Consulting model (**Buyers**):
  - High value-added consulting service
  - Requires investment in human capital (i.e., industry experts) so that FreeMarkets can be perceived as a thought leader
- Sales commission model (**Suppliers**)
  - Smaller than 4-7% in commission
  - New businesses

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Revenue Model

- Revenue model is a hybrid of **service** revenue similar to a consulting firm and **commission** revenue similar to a manufacturing rep.

$$Revenue = \sum_{CBE=1}^{M} Service_i + \sum_{i=1}^{M} Commission_i$$

$$Service_i = Time\ Spent\ by\ Team\ on\ CBE_i$$

$$Commission_i = 2.5\% \times Award_i$$

- *M* is the total number of CBEs

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The Business Base Template

Business Case	Descriptions/Quantifications
Sizing of Opportunity	$15 Billion
Target Customers	1. Buyers (Limited Supplier Network) 2. Suppliers (Unknown)
Value Proposition	1. Cost Savings (51B) 2. Reduction in Procurement Costs (30B) 3. Elimination of Manufacturing Reps (16.5B)
Positioning	1. Consulting Services 2. Sales Commission
Revenue Model	1. Consulting Fees (proportional to time) 2. Sales Commission (2.5% X Awards)

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Three Major Problems

- Value Proposition
  - Dynamics of value proposition
- Target Customers and Positioning
  - Long-term winners and sustained value creation
- Revenue Model
  - Incentive compatibility

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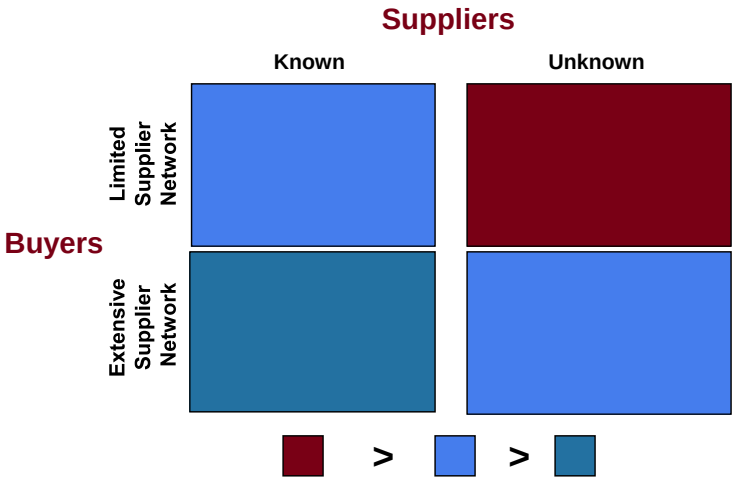
FreeMarkets' Customers



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Phases in Industrial Buying Processes

- Identify Savings Opportunities
- Prepare Total-Cost RFQ
- Identify, Screen, and Support Suppliers
- Conduct On-Line Competitive Bidding Events
- Provide Post-Bid Analysis and Award Support

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Service Revenue Versus Buy Classes

		Buy Classes	
Buy Phases	**New Task**	**Modified Rebuy**	**Straight Rebuy**
Identify Savings Opportunities	Yes	Maybe	No
Prepare Total-Cost RFQ	Yes	Maybe	No
Identify, Screen, and Support Suppliers	Yes	Maybe	No
Conduct On-Line Competitive Bidding Events	Yes	Maybe	Maybe
Provide Post-Bid Analysis and Award Support	Yes	Maybe	Maybe
	5%	**15%**	**80%**

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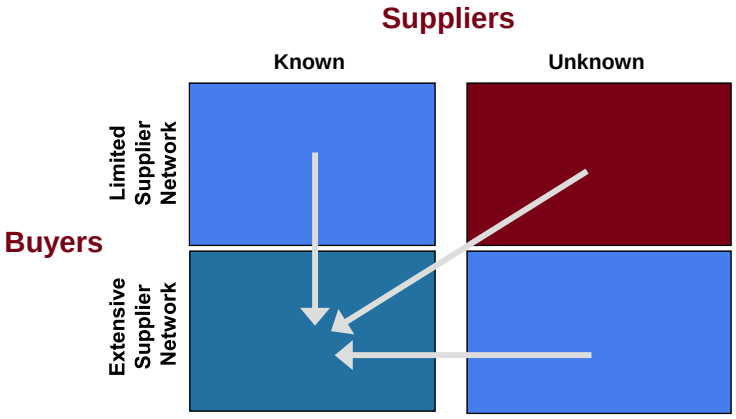
FreeMarkets' Customers



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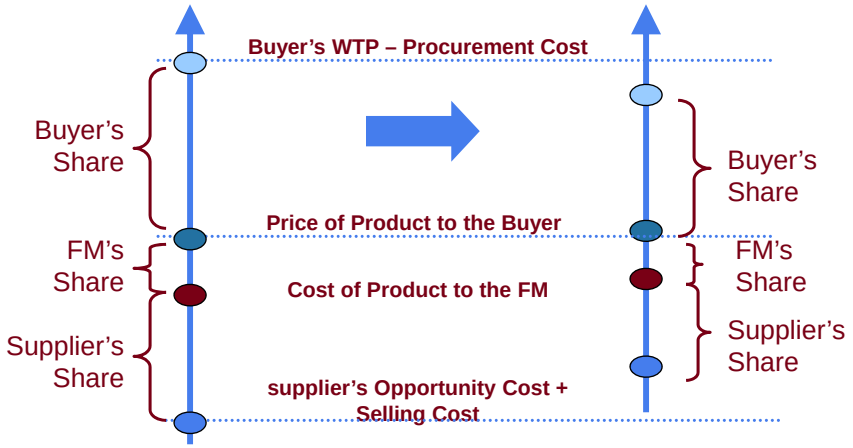
FreeMarkets: Value Creation and Appropriation Over Time



- Value erodes over time
- Who are the long-term winners?

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What Are the Long-term Winners / Losers?

- Exhibit 6 shows buyers enjoy a total savings of $35 million from the 42 CBEs.
- This implies a loss of $35 million from the suppliers' historical revenues
- Reduction of sales commission incurred by suppliers = (5.5% - 2.5%) x 174 million = $5.2 million
- FreeMarkets creates values for the buyers, mostly by taking it from the suppliers

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Who are the Target Customers?

- **Buyers**
  - **Limited supplier network**
  - **Extensive supplier network**
- Suppliers
- Buyers and Suppliers

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Revised Value Proposition

Buyers

- Cost savings
  - Introduction to new suppliers
  - An opportunity for the buyer to gain a greater understanding of its own needs *(through the specification and FRQ process)*
  - Real-time bidding and reporting
- Procurement costs *(in terms of personnel, overheads, and etc.)*
  - Outsourcing of the RFQ process
- Coordination of an extensive supplier network
- Purchase transparency

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Revised Positioning

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The Revised Business Base: Summary

Business Case	Descriptions/Quantifications
Sizing of Opportunity	$7.29 Billion
Target Customers	1. Buyers *(Limited Supplier Network)* 2. Suppliers *(Extensive Supplier Network)*
Value Proposition	1. Cost Savings *(Constant Price Pressure)* 2. Transparency 3. Ease of Coordination
Positioning	1. Smart Sourcing Solutions 2. Supplier Management Solutions
Revenue Model	

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Revenue Model

- Revenue model is a hybrid of **service** revenue similar to a consulting firm and **commission** revenue similar to a manufacturing rep.

$$Revenue = \sum_{CBE=1}^{M} Service_i + \sum_{i=1}^{M} Commission_i$$

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- *M* is the total number of CBEs

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Service Revenue

- FreeMarkets must invest substantially up-front (e.g., industry experts) in understanding a new client's buying process and her product procurement requirements
- Once the RFQ is written and suppliers identified, a buyer merely needs to run the auction again
- The service revenue model does not allow FreeMarkets to benefit from their accumulation of expertise ***because the more they understand the buying process, the shorter will be their engagements, and hence they will collect lower service revenue***

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Commission Revenue

- FreeMarkets' success depends on their ability to find similar suppliers who bid against each other
  - Few suppliers will be happy paying commissions to a company that helps to reduce their margins
  - **The more they save buyers the less they receive in service revenue**
- The value proposition remains only for those small, unknown suppliers that need access to these large buyers
  - **But once the connection is made, there seems like a large incentive for the suppliers to sell directly to the buyer**

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How to Lock-in Customers?

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Types of Lock-in and Associated Switching Costs

Types of Lock-in	Associated Switching Costs
▪ **Contractual commitments**	▪ Compensatory or liquidated damages
▪ **Durable purchases**	▪ Replacement of equipment; tends to decline as the durable ages
▪ **Brand-specific training**	▪ Learning a new system, both direct costs and lost productivity; tends to rise over time
▪ **Information and databases**	▪ Converting data to new format; tends to rise over time as collection grows
▪ **Specialized suppliers**	▪ Finding of new supplier; may rise over time if capabilities are hard to find / maintain
▪ **Search costs**	▪ Combined buyer and seller search costs; includes learning about quality of alternatives
▪ **Loyalty programs**	▪ Any lost benefits from incumbent supplier, plus possible need to rebuild cumulative use

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The Revised Business Base: Summary

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Sizing of Opportunity	$7.29 Billion
Target Customers	1. Buyers (Limited Supplier Network) 2. Suppliers (Extensive Supplier Network)
Value Proposition	1. Cost Savings (Constant Price Pressure) 2. Transparency 3. Ease of Coordination
Positioning	1. Smart Sourcing Solutions 2. Supplier Management Solutions
Revenue Model	1. Subscription Model 2. Maintenance Revenue

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Fundamental Principles of Good Revenue Model Design

1. Incentive-compatibility: The better you do, the more money you make!
2. Lock-in: Figure out a way to lock-in customers so that customers have high switching costs
3. Scalability: Revenue goes up much faster than costs!

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Punchline

- The **target customers** are **long-run winners** as a consequence of your new product or service introduction
- **Position your product** to emphasize its **sustained value** for your target customers
- Ensure that **revenue** components are **incentive-compatible *(the better you are the higher your revenue)***
- Build in a revenue component to **increase customer lock-in**, if possible

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