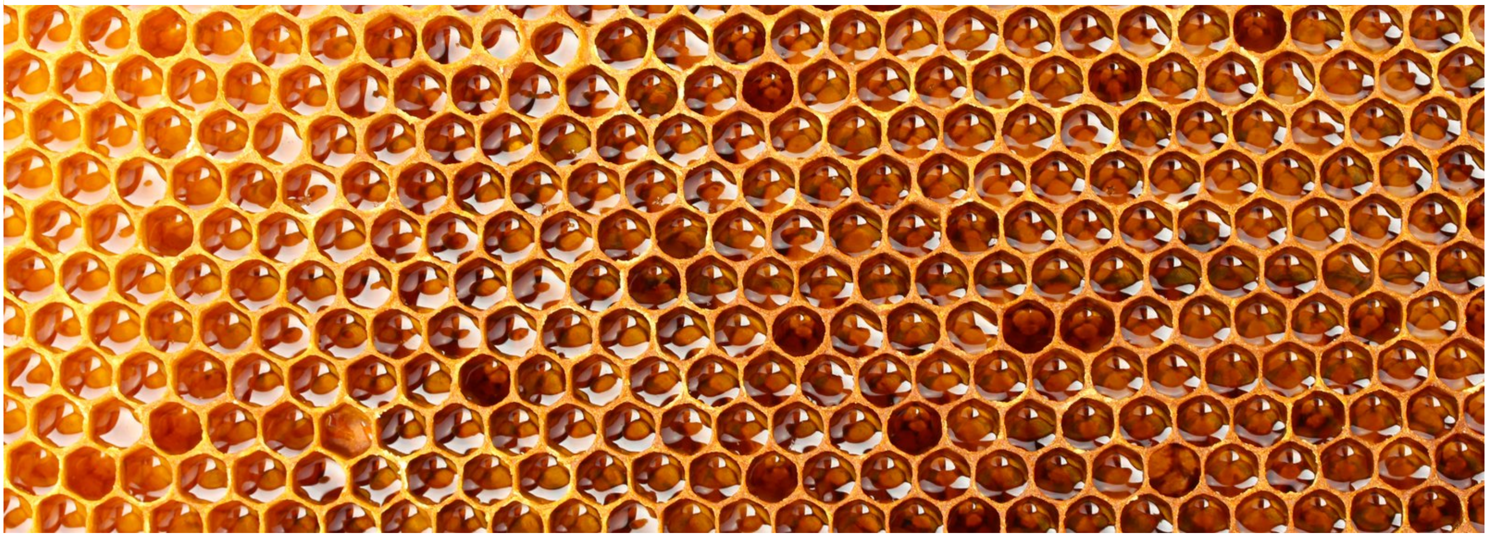

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Revenue Model Types in Software Business: Examples and Model Choice

Reading time: 9 minutes

A business starts with an idea of how to generate value for a customer. So, if it's a person looking for a table, we can produce a table, market it, ship it, receive payment for it — and, that's our business model. The total amount of money earned, in other words revenue, is the coal that keeps our train running. Depending on the business model's complexity, revenue will cover manufacturing, distribution, marketing, and other costs, until we get profit.

But profit doesn't keep the business alive, revenue does. Besides a simple transactional logic, there are many ways we can generate revenue, cover our own expenses, distribute products, and so on. That's even truer for software companies: Web distribution and the nature of software creates various possibilities to monetize code. Think of licensed/freemium apps, service subscriptions, and others. All of these represent a certain mechanism that specifies how business generates revenue. The structure of it is called a *revenue model*.

For those exploring the basics of business strategy planning, we'll elaborate on the definition of the revenue model, and the correlation between business models and revenue streams. We'll also analyze different types of revenue models and look at some examples to scrutinize the pros and cons of each approach. Finally, we'll reflect on how to choose or develop a model for your business.

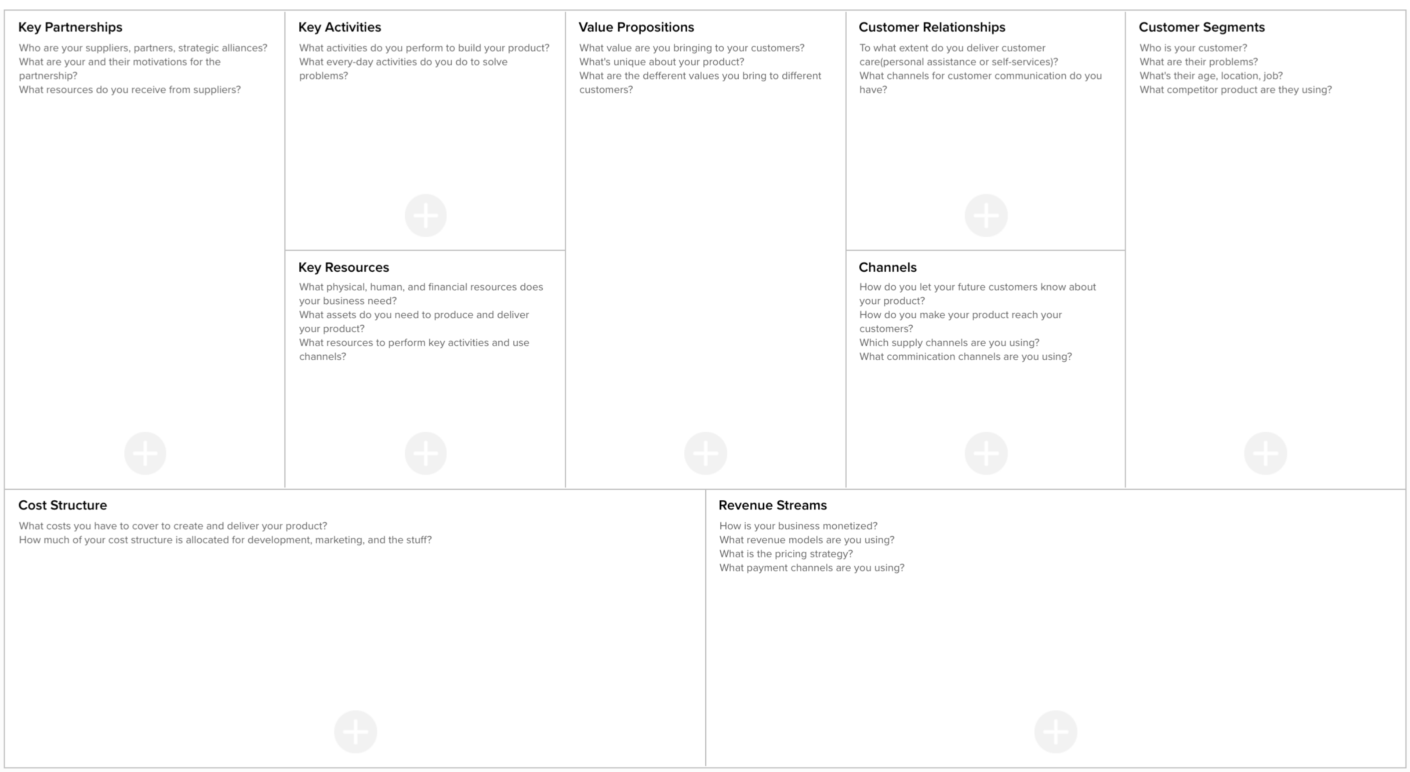
Revenue model basics

To avoid any misinterpretations, let's quickly define the main terms that relate to forming a business strategy. A **business model (BM)** is a broad term outlining everything concerning the main aspects of the business, all of which are contained in the answers to the following questions.

- What value will we create?
- How will we deliver it?
- How will we bring in revenue?
- How will we earn profit?

There are numerous forms of business models that can't be classified in a single list because each part is highly individual to the industry, type of product/service, audience, or profitability. Business models are often depicted strategically on a *business model canvas*. This is a compound representation of all the key elements of a BM.

So, in a nutshell, the BM describes how a business will work from the standpoint of value generation. To describe how the company generates income, revenue models are used.



A business model canvas template by AltexSoft

A **revenue model** is a part of the business model that explains different mechanisms of income generation and its sources. This is a high level answer to the question that asks how we will generate revenue from the value we bring to a certain customer group.

The simplest example of a revenue model is a high traffic blog that places ads to earn profit. Web resources that generate content for the public, e.g. news (value), will make use of its traffic (audience), to place ads. The ads in turn will generate revenue that a website will use to cover its maintenance costs and staff salaries, leaving the profit.

Revenue model vs revenue stream

A revenue model is used to manage a company's revenue streams, predict income, and modify revenue strategy. The revenue itself is one of the main KPIs for a business. Measuring it annually or quarterly, we are able to understand how our business operates in general, and whether we should change the way we sell the products or charge for them.

A single source of revenue a business generates is called a *revenue stream*. These are often divided by customer segments that bring revenue via a given method. The two terms – *revenue stream* and *revenue model* – are often used interchangeably, since from the business perspective, the subscription revenue model will have a revenue stream coming from subscriptions. However, models can name multiple streams divided into customer segments, while the principle of revenue generation (subscription) will remain the same.

Revenue model types

Any start-up, tech company, or digital business may operate with multiple revenue sources and, consequently, with different revenue models. Depending on the industry and the product/service type, the revenue model will look differently.

Here we will pay more attention to the most common revenue models used in the software industry and online business.

Transaction-based model

A **transaction-based model** is a classic way a business can earn money. The revenue is generated by directly selling an item or a service to a customer. The customer can be another company (B2B) or a consumer (B2C). The price of the product or service constitutes the production costs and margin. Increasing the margin, the business is able to generate more income from sales.

Selling products or services entails using different pricing tactics. While some of them may be considered a separate revenue model, these are often used in pairs. Because pricing tactics can be seen as pricing plans in a software business, we can clearly define the following types.

1. **Licensing/one-time purchase**. This entails selling a software product by license that can be used by a single user or a group of users. The general idea is to offer a product that requires making only one payment for it, e.g. Microsoft Windows, Apache Server, a majority of video games.

2. **Subscription/recurring payment**. Unlike licensing, a user receives access to the software by paying a subscription fee on a monthly/annual basis, e.g. Netflix, Spotify, Adobe products.
3. **Pay-per-use**. This pricing tactic is mostly used by different cloud-based products and services that charge you for the computing powers/memory/resources/time used. Examples are Amazon Web Services, and Google Cloud Platform.
4. **Freemium/upselling**. Freemium is a type of app monetization in which a user may access the main product for free, but will be charged for additional functions, services, bonuses, plugins, or extensions, e.g. Skype, Evernote, some video games.
5. **Hybrid pricing**. Sometimes pricing plans are a mixture of more than one. So that freemium plan might morph into some form of pay-per-use tiered plan. After passing some limit in computation or resources, a user can be forced or offered to use another type of pricing, for example Mailchimp, Amazon Web Services, and SalesForce.

Various combinations of pricing tactics can be used simultaneously, which is more often seen in cloud-based products that offer multiple pricing plans at once. The revenue model in this case remains based around the transaction and purchases made by the customers. The difference in pricing tactics will modify how the revenue is generated and basically depends on the type of product/service you sell.

The pros: Full control over the pricing strategy.

The cons: The cons will depend on the industry/product type and pricing tactics, as the model itself imposes constant generation of sales with the help of advertising and marketing strategies. The only con we might mention here is the financial burden connected with sales you will carry on your own.

Examples: Nearly any company that produces and sells its products: Samsung, Rolls Royce, Nike, Microsoft, Apple, Boeing, McDonald's.

Advertisement-based model

The **advertisement-based revenue model** is valid both for online and offline businesses. It's often used by websites/applications/marketplaces or any other web resource that attracts huge amounts of traffic. Revenue is generated by selling ad space. This is one of the most standard methods of gaining revenue.

The pros: Having a high-traffic resource allows you to monetize the ad space nearly instantly. Often, there is a high demand on advertising space, especially with organic traffic and platforms with the target audience.

The cons: Running advertising campaigns to gain web visibility on social networks is a standard marketing activity with targeting instruments more precise than ever. However, advertisements are everywhere, so you might think twice whether you want to distract a user by placing an ad in your app – even if it is a secondary revenue stream.

Examples: YouTube, Instagram, Facebook, Forbes, Google.

Commission-based models

A **commission revenue model** is one of the most common ways businesses make money today. A commission is a sum of money a retailer adds to the total cost of a product or service. A commission can be assigned as a

- **flat rate**, a fixed sum of money for any type of transaction, e.g. a $450/300/1500 transaction is charged with a $20 commission;
- **percent of transaction size**, e.g. a $100 transaction is charged with a 10 percent commission – $10; or
- **tiered commission**, a percent or flat rate that grows based on the transaction volume, e.g. 50,000 transactions are charged with a 4 percent commission, 150,000 transactions with a 7 percent commission.

Marketplaces utilize commissions the most. The commission may be charged per marketplace or transaction. This category also includes businesses that connect service providers/renters with consumers. Think of any ride-hailing company, food delivery, or accommodation service.

The pros: Revenue is easily predictable because of the sheer fee.

The cons: There are many problems bound to the concept of a commission, but the major one goes to the scalability of a business that's attached to a transaction size or volume. In general, dependency on the product supplier's sales makes generating revenue require upfront investments and competitive superiority.

Examples: Booking.com, Airbnb, Uber, Lyft, Ticketmaster, Priceline, or Upwork.

Affiliate model

The **affiliate model** is similar to the commission model The difference is that a business receives its commission from a seller, rather than a customer. The affiliate model is a contract between a supplier of a product/service and a promoter. A promoter can be another business/media resource/blogger that recommends a supplier's product. The income will come as a percentage from sales or registrations done via referral link.

This category of business also includes meta-search engines as a unique example. Meta searches can be found almost everywhere. Their main difference with retailers is that they don't sell products directly but offer comparison and search as a value. Advertising and affiliate programs are the main revenue models used to generate income in this case.

The pros: Just like advertisement, once you have a huge traffic resource, you might apply for an affiliate program to earn money. This will bring you income without any investments because you will basically generate traffic and leads for the affiliate program provider.

The cons: Unfortunately, the percentage of affiliate programs promised to the promoter is quite low. Sometimes it fluctuates between 1-2 percent and requires a high volume of sales generated through your links.

Examples: Blogging, event promoting platforms like Broadway.com or TheaterMania. Various examples of Amazon affiliate websites, e.g. Cloud Living and ThisIsWhyImBroke.

Interest revenue model

An **interest** or **investment revenue** model is any type of business that generates revenue in the form of interest on their loans or deposit payments. So, these are most often banking or electronic wallet companies that work with the financial operations.

The revenue is generated by making a loan to a customer or by a customer depositing or investing money (or other resources) with the business. At the end of a return period, a percentage of the loan sum will return as revenue. Debit/credit money provided with the bank accounts also relate to this model. That's just one of the ways financial companies can make money, combining it with transaction fees for using their e-wallet/bank account.

The pros: The interest rate provides a clear view on what revenue a business will generate, as the percent stays unchanged until the return period is over.

The cons: The regulations of an interest rate impact both the customer and business, and sometimes it depends on the economic environment. Think of currency rate changes that impact potential and existing borrowers.

Examples: PayPal, Paytm, Square, Payoneer.

Donation-based or pay-what-you-want models

This is a revenue model based on investments made by businesses or customers on a voluntary basis. The product or service itself is free to use by default, so that's the primary value a business brings to the customer. The revenue is generated in a form of donations, or sometimes in the form "*pay-what-you-want.*"

It's important to mention that there is a difference between a donation-based business and a charity organization. A donation-based company is still required to pay taxes.

The pros: Because of the free access to the product, some companies manage to get increasingly popular, so that donations become a major part of their revenue.

The cons: As long as this model is never used on its own, the revenue generated by it remains a secondary source because of its random/unstable nature.

Examples: AdBlock, Wikipedia.

How to choose a revenue model for your business?

Prior to choosing a revenue model, you need a fully developed business strategy that will include a prepared business model with all its key instances. That means you must take a few steps prior to selecting the revenue model.

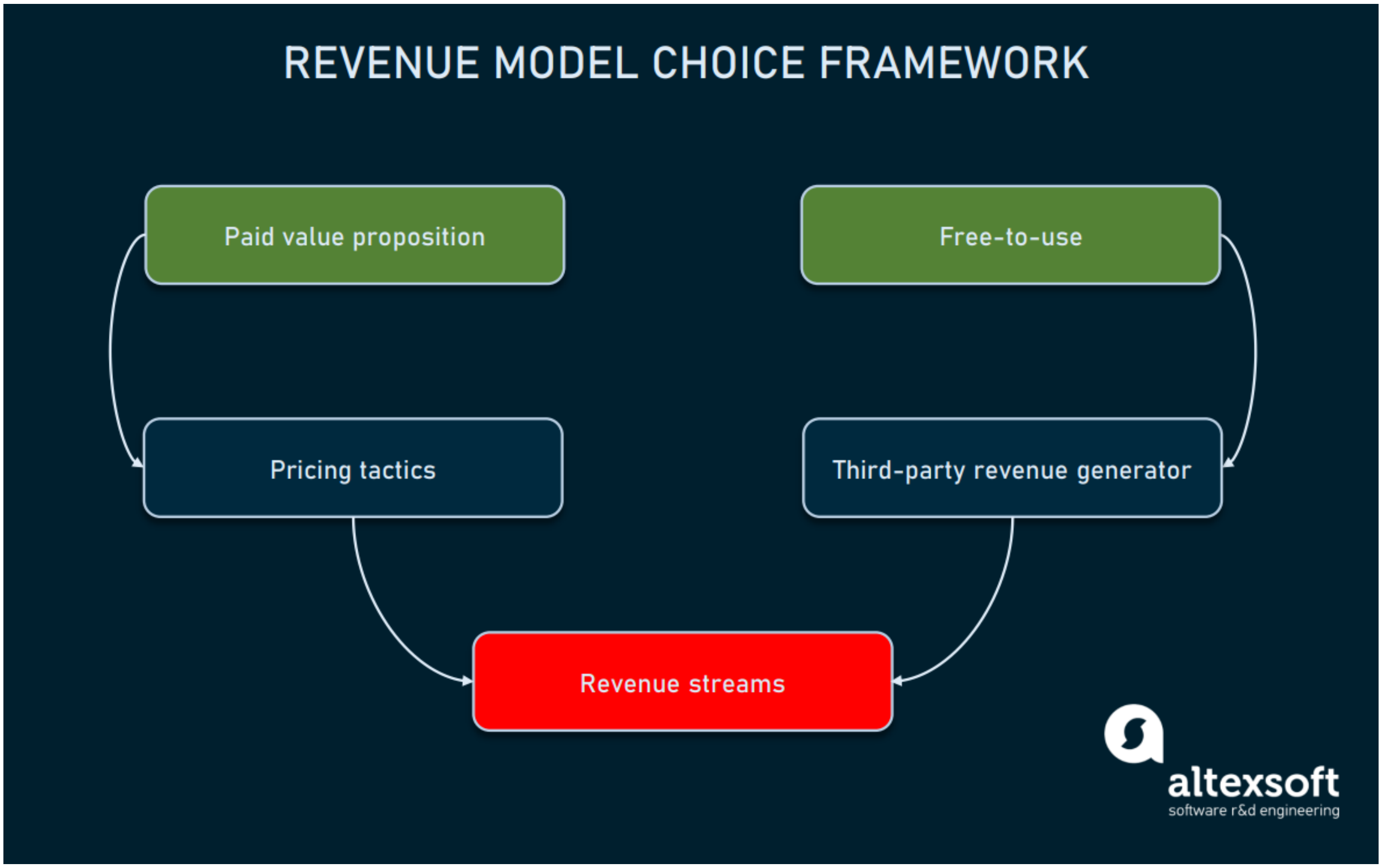
Define your value proposition: Define what your product is and what value it brings to the customer. Not all products can be sold: Just remember when you upgraded your WinRAR to a full license. Also, you can analyze the future traffic for your app to understand if you can use ads in it.

Explore the market state and customer groups. This step is to define your user persona and understand how they usually buy things. Some markets are inclined to purchase just one product, some are inclined to ignore upgrades, or in app purchases. A good example in this field is the death of music selling platforms that were totally replaced by subscription based streaming services like YouTube Music, Apple Music, Spotify, and others.

You may also explore the techniques on how to market your product in our dedicated article.

Analyze competitors and their products. You'll need to learn what mechanisms and revenue streams your competitors use and how they manage their costs. This information will probably show you the market's pitfalls and dead ends.

Looking at this simple matrix below, we can analyze the capabilities and needs of our company to help us decide the type of revenue model to use.



How to choose revenue model framework

Depending on our business model, the product or service we're presenting to the user is a subject of exchange. This is our value proposition on the market, so we are in charge of choosing what we want to get back based on the market factors, target audience, etc.

1. **Paid value proposition**: In most cases, your value proposition costs money to use. Whether it's a service or a software product, a customer will need to pay in some form to gain access to your value. Our revenue model in this case will be based around transactions. So, develop pricing tactics that will depend on the nature of the product, and the type of audience you're trying to reach, type of deployment, specifics of product usage, etc.
2. **Free-to-use value proposition**: If the value proposition doesn't require money to use or we choose it to be free, then we need a third-party to generate revenue for us. This could be anything based on the previously mentioned types, whether it's ad space, donations, affiliate programs, or reselling.

The combination of two will basically present you with the revenue streams that will focus each of the customer segments. In the case of the paid value proposition, each pricing plan will be a separate revenue stream.

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