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How startups make money with subscription pricing

Why do some subscription-based products and services take off while others struggle and fail? The move from standard pricing to a subscription model is tempting for any business. Your customers sign up, put in their credit card, and you get paid every month. Who wouldn't want to do that?

But while generating revenue with a subscription pricing model is easy, profiting from that same model is incredibly difficult. To make the economics of subscription pricing work, the model has to balance customer needs very carefully against what your company can offer at a static price. If that price is too low, you'll lose money. If the price is too high, you'll turn away customers.

I offered my first subscription-based product in 1999 and I launched my most recent subscription-based product two months ago. In every case, I had to reshape my offering to conform to a subscription model that would not only generate revenue, but profits as well.

Here's how to do that.

An overview of the economics of subscription pricing

I’ve written before on how a startup needs to overhaul its business model to make a subscription pricing model work for their customers.

The economics of standard pricing — where the customer pays per unit, per use, or per hour — change completely under subscription pricing — where the customer pays per period for an allotment of units, or usage, or time.

Profit under a basic subscription model becomes a guessing game of hoping the customer doesn’t consume more resources than they’re paying for. That’s a recipe for failure. When that guessing game becomes an exercise in forecasting demand and then meeting that demand, the business becomes more predictable but not necessarily profitable.

The way to get to profit is to play the percentages.

Establish your subscription pricing model on the 80/20 rule

Think of the ideal full-service use case for your business — all the bells and whistles, the white glove version. This is your 100% case.

To make that case profitable under a subscription model, you have to break up the 100% case, maintaining high margins while also maintaining high value. In other words, your customer has to believe they’re getting close to 100% of the value of your 100% case. But you have to provide that value at a level close to 100% of the margin at your 100% case.

Apologies for throwing maths into a blog post. My point is you have to go 80/20 on the aspects of your product or service that deliver the highest value at the highest margins. Your goal is to provide 80% of the value for 20% of the cost.

So to summarize:

1. You have to be very skilled at what it is you’re offering.
2. You have to know which parts of your product or service can be broken out and offered a la carte.
3. You have to reshape those parts into an offering that provides 80% of the value of your full service for 20% of the cost.

Or thereabouts. You don’t have to get there overnight.

For example, with my first offering from Teaching Startup, a subscription-based startup advice product, I can give a pretty high percentage of the value of a startup advisor, not 80%, but a good chunk. The cost is about 0.5% of what I charge for my full-service 100% case. So right now I'm at roughly 30/0.5, and I can tier my way into an eventual 80/20 situation.

Why did I choose the lowest cost/lower value case to start? Because I'm attempting something that hasn't been done before. By starting with a reshaping of the service that only includes the highest value parts of my 100% case at the lowest cost, I'm creating a new market segment. I'm also avoiding the trap of just providing a shitty version of my 100% case for a lower price and not being able to scale.

Subscription is one-size-fits-all, no one is special

When reshaping your offering to fit a subscription model, there are basically two concerns:

1. You'll get overloaded with high-quality/low-margin work that will eat up the subscription fees quickly.
2. You'll launch a low-value product that diminishes your brand.

The challenge is not only putting the right parts into the offering but figuring out how to change the execution of that offering so it serves a wide variety of customers in a single, repeatable, no-customization-allowed package.

So one-size-fits-all. Maybe three sizes fit all, with three tiers at three prices, increasing value as you increase the price, but no more than that. If you allow too much customization, it's no longer a subscription plan, it's a retainer plan — and that diminishes the benefits of the subscription model to both your and your company.

Set limits and caps and make them transparent and clear

To repeat: You want to shoot for 80% of the value for 20% of the cost. If a customer needs 85% of the value, they don't belong on your subscription plan.

It's hard to draw the line and say no to a customer, but you have to, or you won't be able to offer a subscription plan at all. For example, let's say you're offering a plumbing subscription service. The subscription might allow the

customer to have a leaky pipe fixed, it won't allow them to replace a toilet.

So you have to define limits and caps to what you're able to offer. And you have to communicate those limits and caps in a way that doesn't seem like a list of DONT's but more like a list of NEW DOs.

Obviously, this opens up the question — What happens when my subscription customer's toilet explodes?

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Do not mix full service and subscription plans

The answer to that question presents both huge opportunities and enormous challenges. All of it involves the 100% case, and you absolutely need to build a wall between your subscription plan and that case.

Your subscription model has to change the way your service is consumed, and the expectations of your full-service customers and subscription customers should be and must be completely different.

You don't want to lose the customer who is willing to pay full-service prices for the 100% case. But instead of breaking the subscription model to satisfy that customer, have a release valve instead. That could include:

A full-service offering within your own company. Simply put, if you have the experience and bandwidth to offer the 100% case, do that. Be wary though, you'll be running two companies at once.

A managed services offering. This blends the benefits of the subscription plan with some of the white-glove aspects of full service. Caution here as well — the managed services plan is not the subscription plan or the 100% case. It's its own thing.

A marketplace. Here, you're offering access to 100% case vendors and

sharing revenue with them. But again, this is its own offering and should be separate from the subscription model.

Regardless of which backfill option you choose, don’t lead with it, otherwise, you’ll be looking and acting like your incumbents and your competition. If you want to grow and scale with your subscription model, that offering needs to be your focus. All of those release-valve offerings have a low ceiling on margin.

Measure and adjust where needed, then tier up

Your subscription plan MUST work economically for your company, otherwise, it will do more harm than good.

So you need to be constantly measuring and adjusting value, revenue, and profit, and if what you’re offering doesn’t flatten your demand curve or provide consistent recurring revenue at reasonable margins, you’ll need to tweak your model, overhaul it, or create a new tier.

These aren’t easy decisions, and they should be well thought out with ample data backing the decision up. Because if you tweak or overhaul or tier up too often or for the wrong reasons, you’ll eventually backslide into lower quality and/or lower margins as you try to be all things to all customers.

And that’s not why you’re establishing a subscription model in the first place.

This article was originally published on Medium by Joe Procopio

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