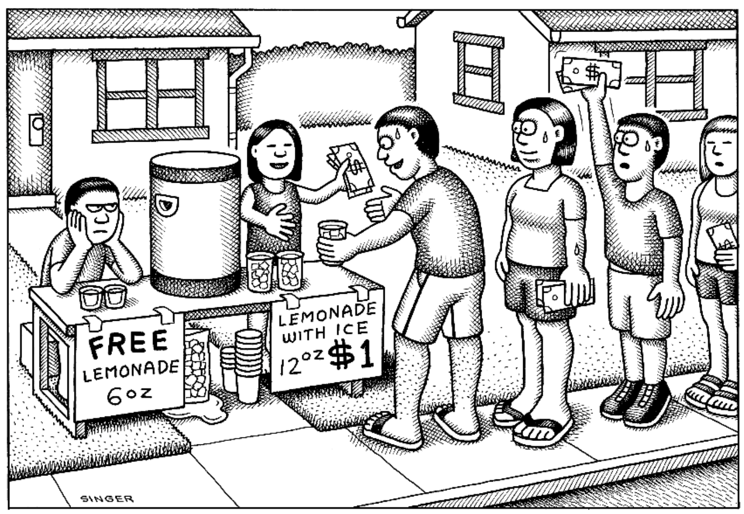
Freemium: Making money by giving products away

By David Robinson

Freemium is a distinct pricing strategy that is more than just a promotional discount. Here's when freemium pricing will work and how to employ it effectively.

Every successful new business venture must make two key pricing decisions: What is the revenue stream and what should be the pricing strategy. The question of revenue stream is simple enough: Who will pay for what? For a manufacturer, the revenue stream comes from the sale of goods at a price higher than marginal cost; a retailer buys goods in and sells them on at a margin sufficient to cover the costs of operation. But what of an internet business where most users pay nothing?



In 2009 the prolific technology writer and entrepreneur Chris Anderson declared that free was the price of the future. Six years later, we see many examples of firms making good revenue while giving their products – or at least *some* of their products away for free. In every case, if the business is to sustain itself, its pricing strategy must be one of two possibilities: Either the business is supported by third party advertising revenue ("ad supported") or the firm choses the strategy of "freemium pricing." Under the freemium model, a firm offers a limited product or service to very many customers at a zero price while reserving important features and benefits for a much smaller number of customers who are prepared to pay. The paying customers find sufficient value to pay a price that covers the costs of their own use and also the costs of providing the free version. Such freemium pricing is particularly suitable for Internet services where the marginal cost of serving a customer is very small. But it can be applied in other contexts as well.

One of the most successful practitioners of freemium pricing is SurveyMonkey: If you want to conduct a quick, online survey of up to 100 respondents, you can construct a questionnaire and use their online poll-taker at no charge. With this strategy, SurveyMonkey has attracted more than 20 million users. Of course, the viable business depends on another group of customers, those who want responses from more than 100 people, who are prepared to pay a subscription for SurveyMonkey's enhanced services.

The freemium strategy is not limited to intangible Internet goods. Vistaprint, a Dutch multinational of French origin that uses mass customization to produce short run print jobs such as postcards and fliers has for years used its "free business card" promotion to encourage people to go order. While the firms does give away millions of print jobs (admittedly with the costs covered in part by "shipping and handling" fees) it brings on more than $1 billion a year in paid print jobs.

The freemium pricing strategy is not just a temporary gambit at market entry. When launching new products, conventional wisdom has it that firms must choose between skim pricing (charging the highest possible price that a few customers are prepared to pay, then riding the price down over time) and penetration pricing (a price that is so compellingly low that almost all customers will buy). A firm that adopts freemium pricing plans to serve a large number of customers at no revenue forever in the hope that their enthusiasm will convince others to pay for an offering with enhanced features.

Freemium pricing is more than just a dramatic sales promotion. The Irish airline, Ryan Air, is famous for offering 1 Euro airfares when it enters new markets. Similarly, Megabus, the Canadian and American brand of intercity buses belong to the Scottish company Stagecoach, has its coaches wrapped with huge signs offering $1 fares. But these are just old fashioned sales promotion—a discount price offered to a few lucky customers who book early on each route. The majority of customers pay the full fare and this is not an application of the freemium model.

Similarly, a free trial before purchase is just a form of sales promotion. In contrast, the freemium pricing model anticipates that some customers will never pay. While a free trial may have its place, it is fraught with difficulty. In the minds of customers it sets the reference price as zero. When faced with the transition from non-payment to paid subscription many customers balk and conversion rates are low. An example of this is the online music service Pandora. The firm soon discovered that conversion rates from the free trial were close to zero—people dropped out or game-played and re-registered for another free trial with a different e-mail address.

As a pricing strategy, freemium is distinct from the ad supported model. The Android Operating System has a greater than 80 percent market share for smart phones. Google gives the Android operating system away to drive mobile traffic to its search and mapping functions from which it earns billions in advertising revenue. Facebook's 1.4 billion non-paying users are "eyeballs" that are sold to advertisers and earn the site more than $12 billion a year—more than enough to keep the site going. Each workday, more than a million British commuters are handed a free copy of the *Metro*, a tabloid daily newspaper that has no purchase price to readers but depends solely on advertising revenue.

Freemium pricing is not the same as:

Penetration pricing
Promotional discounts
Free trial
Advertising supported business

The ad supported pricing strategy only works if there are enough advertisers paying enough money to fund the entire operation. While many fledgling internet businesses promise to become ad supported after they have first achieved a credible mass of free users, the approach is difficult to pull off. This is because the internet whales suck all the plankton out of the water. That is, the most popular sites (Google, Facebook and Yahoo at the moment) attract a share of ad dollars that is much greater than their share of internet traffic. From the point of view of advertisers, this is entirely rational—with a limited promotional budget the advertiser can be much more sure of reaching a planned number of potential customers from one of the top few sites, than from piecing together small numbers of viewers from much smaller sites. Twitter is a very good example of a firm that relies on the ad supported model that can't quite find its way to profitability. After nearly a decade in operation, the company reports more than 300 million active users, but it has yet to turn a profit. Twitter has adopted an ad supported model but faces a dilemma: The more commercial content that's on the site, the less users are interested in using it.

All "free to play" video games are good examples of the freemium model. They can be considered "extreme Pareto" – we no longer expect 80 percent of profit to come from just 20 percent of the customers. Rather, the business model depends on attracting millions of players of whom only a small fraction will make "in game" purchases. For example, at the time of Zynga, the creator of the popular online game Farmville, sought its initial public offering, diligent research by the Wall Street Journal unearthed that fewer than 5 percent of players bought anything at all, not even a $1 bale of hay for their virtual cows. This application of the freemium pricing strategy then becomes vulnerable to the whims of a rather small number of players who may be enticed to the next new game.

Here are simple rules to make the freemium pricing model effective.

The market must be segmentable For freemium to be successful we need different market segments with groups of customers who seek different benefits. If pretty much all customers want the same product features and level of performance, then the freemium model won't work. This is why we see Facebook operated as advertising-supported whereas LinkedIn has been successful with the freemium model. Pretty much all Facebook members want the same features and benefits. In contrast, at LinkedIn most casual users use the online service at no charge as a way to keep up with their business contacts and to online host a brief professional biographical summary. But recruiters want more. They will happily pay a monthly subscription to be premium users of the service. The distinction is that premium users can contact any candidate they identify as being a possible match for an opening whereas ordinary users can only approach other people on the service through an introduction from someone with whom they already share a link.

When freemium works

The market is segmentable
The product has low variable cost
Freemium customers promote the paid version
The free product has fewer benefits over time

The product or service must have a low variable cost For almost all website businesses the marginal cost of an additional customer (think of customer number 1 million at LinkedIn) is close to zero. The full cost of 100 business cards from Vistaprint would be quite high if we allocated all the costs of overhead including head office staff and factory operations. But the cost of one more order at the margin, given that the production and general business functions of the firm are covered by paying orders, is quite small. Neither a dry cleaning store nor a dentist can successfully use the freemium model as in each case the costs of serving one more customer are far from zero.

The freemium customers should act as ambassadors for the paid version Dropbox, a cloud-based file hosting service, deliberately recruited users to upload personal files with the plan that they would then demand cloud-based file storage at work which could be sold to enterprises at a sufficient price to cover the whole operation. The market between consumer and business customers was easily segmented based on the total amount of storage each would use.

Gradually add restrictions to the free version over time When SurveyMonkey first started out its sole restriction was the number of surveys that could be collected. As the service became successful, fewer features from the paid service were available to freemium users as the site restricted copy and pasting of questions and saving results to a .pdf (the results could still be viewed online). This was very successful in convincing more and more users that they needed to opt for one of the firm's paid offerings. Vistaprint has done the same, gradually diminishing the value of its free business card offering by limiting designs that can be used without paying and limiting the type of cardstock available. The firm offers many more full-featured designs and papers but at a price. Again, this moves more and more people who were originally attracted to the free offer into paying customers.

Freemium in context

It goes without saying that the freemium strategy can only be successful if there are enough users of a paid version of the product to make the business achieve breakeven. Chris Anderson warned that in the future many businesses would have to adapt to a direct competitor offering free goods and services. The newspaper business failed to adapt when Craigslist offered free classified online advertising in very many cities worldwide. But Craigslist itself is a very successful practitioner of freemium: While almost all categories of advertisement are free to both the poster and the reader, Craigslist makes more than enough to fund its operation by charging for employment listings.

Freemium pricing is a viable long-run pricing strategy for many new enterprises. Firms that successfully adopt this pricing strategy must be sure that there really are different groups of customers needing different features and that the paying customers are willing to pay a price that covers the entire costs of the operation. If the marginal costs of serving non-paying customers are negligible and if those customers are sufficiently delighted to act as evangelists for the product, freemium pricing can be an enduring business model. ❖