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change

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STRATEGY

Making “Freemium” Work

Many start-ups fail to recognize the challenges of this popular business model.

by Vineet Kumar

Over the past decade “freemium”—a combination of “free” and “premium”—has become the dominant business model among internet start-ups and smartphone app developers. Users get basic features at no cost and can access richer functionality for a subscription fee. If you’ve networked on LinkedIn, shared files through Dropbox, watched TV shows through Hulu, or searched for a mate on Match, you’ve experienced the model firsthand. It works for B2B companies as well—examples include Box, Splunk, and Yammer.

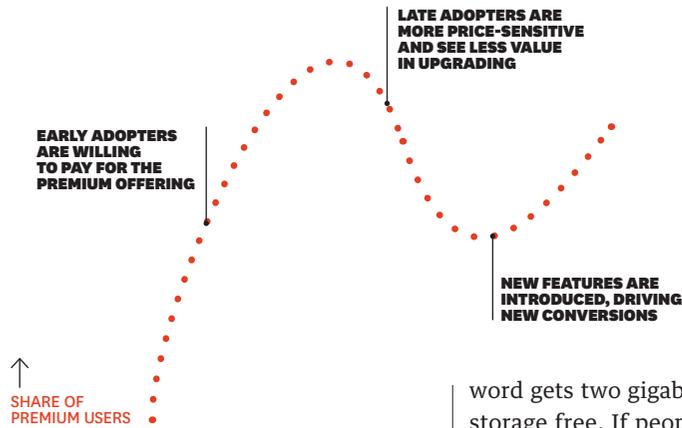
Several factors contribute to the appeal of a freemium strategy. Because free features are a potent marketing tool, the model allows a new venture to scale up and attract a user base

without expending resources on costly ad campaigns or a traditional sales force. The monthly subscription fees typically charged are proving to be a more sustainable source of revenue than the advertising model prevalent among online firms in the early 2000s. Social networks are powerful drivers: Many services offer incentives for referring friends (which is more appealing when the product is free). And freemium is more successful than 30-day free trials or other limited-term offers, because customers have become wary of cumbersome cancellation processes and find indefinite free access more compelling.

But despite its popularity and clear benefits, freemium is still poorly understood. It has inherent challenges, as demonstrated by the many start-ups that have tried but failed to make it work. For several years I have studied freemium models in depth—by coauthoring (with my HBS colleagues Bharat Anand, Sunil Gupta, and Felix Oberholzer-Gee) a case on the *New York Times*'s paywall strategy (a variation of the freemium model); conducting a deep dive into the user data of a storage and synchronization company; and coauthoring (with my HBS colleagues Clarence Lee and Sunil Gupta) a working paper on how freemium companies can use referrals to spur usage and upgrades. Through this work I've come up with six questions that start-ups considering a freemium model should ask.

What should be free? Let's say you've created a digital product that has 20 features and you've chosen five that will be free to anyone who registers on your site. Users who want the other 15 will have to pay. How do you know whether you've made the right choices? And if you suspect that you haven't, what should you do?

Recall that one of the chief purposes of freemium is to attract new users. If you're not succeeding with that goal, it probably means that your free offerings are not compelling enough and you need to provide more or better features free. If you're generating lots of traffic but few people are paying to upgrade, you may have the opposite problem: Your free offerings are *too*



THE LIFE CYCLE OF UPGRADES

Freemium companies typically see the share of paid subscriptions (and therefore cash flow) rise and fall and then rise again in a predictable way over time. Those that don't account for this phenomenon risk failure.

rich, and it's time to cut back. This kind of tuning was evident at the *New York Times* website. After years of unrestricted access, in 2011 the paper began limiting users to 20 free articles a month; people had to subscribe if they wanted to read more. Over subsequent months the company realized it was still giving away too much and was getting too few subscribers as a result, so in 2012 it cut the number of free monthly articles to 10. Start-ups should expect to need similar tweaking to find the optimal balance between traffic and paying customers. The balancing act can be tricky: Users may revolt when asked to pay for things they are accustomed to getting free.

Do customers fully understand the premium offer? Communicating two sets of benefits complicates your marketing efforts. If customers don't clearly grasp what they would gain by upgrading, you will monetize fewer of them than you otherwise might.

Dropbox and LinkedIn are a study in contrasts. The former has attracted 200 million users with a simple proposition: Everyone who enters a username and a pass-

word gets two gigabytes of cloud-based storage free. If people run out of space, they can pay \$9.99 a month (or, alternatively, \$99 a year) for 100 GB of storage. The free version is adequate for basic documents, but anyone who wants to back up photos or other media quickly hits the limit, and the reasons to upgrade are obvious.

For many LinkedIn users, the advantages of upgrading are murkier. I've used LinkedIn for several years to keep in touch with colleagues, and I routinely receive e-mails urging me to upgrade—but the ongoing value of doing so is not apparent. (The company offers four premium subscriptions, some aimed at specific customer segments, such as recruiters or salespeople, and most featuring deeper search functionality, better e-mail capability, and more visibility into who has viewed your profile.) Although LinkedIn is successful—it was one of the first freemium companies to go public—it could probably monetize more users if the distinctions between its free and paid offerings were clearer.

What is your target conversion rate? Imagine that you're the CEO of a freemium start-up and you're handed a report showing your conversion rate (the percentage of free users who have upgraded to a premium plan) for the most recent quarter. What figure do you hope to see?

A rate of 1% is probably too low, especially if you rely on subscription revenue alone. (Some players, including the *New York Times* and LinkedIn, also collect online ad revenue.) It signals either that too much of what you're providing is free—giving users little reason to upgrade—or that consumers don't understand or value your premium features.

But, less obviously, a very high conversion rate isn't necessarily good. Remember that one of the benefits of a freemium model is the ability to generate traffic.

Suppose that 50% of the users of your free product upgrade to premium. You might think that your model is working well; but perhaps your free product is not very compelling, which will limit your potential acquisitions. All other things being equal, you would do better to convert 5% of 2 million monthly visitors, for example, than to convert 50% of 100,000 visitors. The best long-term strategy is generally to aim for a moderate conversion rate (in my research, I've found that most companies' range from 2% to 5%) coupled with a high volume of traffic. If you're targeting a small market, you should aim for a higher rate.

Are you prepared for the conversion life cycle? Let's assume you're attracting plenty of traffic and new users, and your conversion rate is 5%. You want to forecast growth and revenue. Can you simply draw a couple of straight lines, on the assumption that the rate will hold steady?

No. Early adopters are less price-sensitive than others, so they are more likely to upgrade. And often they are people for whom the value proposition is unusually compelling. (For instance, recruiters were

early adopters of LinkedIn, because their business depends on their ability to identify and connect with professionals.) So over time, conversion rates typically dip as the user base expands to include people who are more price-sensitive or who see less value in the service. Although freemium companies universally have a very low marginal cost for each new user—otherwise the model wouldn't make sense—those costs aren't zero. At a minimum, free users put demands on server space and customer service.

Companies that fail to understand these realities may feel a cash crunch as the number of free users grows and the cost of servicing them therefore rises. This is often the reason that companies launched with freemium models pivot away, converting to free time-limited trials or eliminating free offerings altogether. Start-ups that have recently made such a switch include LogMeIn, whose software provides remote access to PCs, and SugarSync, a cloud storage company that competes with Dropbox.

Are users becoming evangelists?

It's important to recognize the full value

of your free users, which takes two forms: Some of them become subscribers, and some draw in new members who become subscribers. In our HBS working paper and in ongoing research, we have found that a free user is typically worth 15% to 25% as much as a premium subscriber, with significant value stemming from referrals. We have also found that firms can increase the value of referrals by carefully managing referral incentives and communications. If you're considering a freemium model, pay close attention to why and how satisfied users might help your product go viral.

Are you committed to ongoing innovation? It's a mistake to see freemium merely as a customer acquisition tool and to drop the free version when new customers stop coming in or when the upgrade rate dives. Users who join late are typically harder to convert; therefore, in order to keep increasing upgrades, you'll need to keep increasing the value of your premium services. Smart companies view freemium not only as a revenue model but also as a commitment to innovation.

Dropbox is a good example. When it launched, in 2008, it was primarily a service for backing up files. It then began offering shared folders, making it a collaboration tool. Newer features allow for automatic syncing of smartphones and other devices and for automatic uploading of photos. Over time the user interface has improved as well. Each new feature has increased the value of the premium offering.

In today's digital era, when the marginal costs of many products are dropping, businesses will increasingly turn to the freemium model. Across industries ranging from media (where companies are forced to rely less on advertising revenue and more on subscriber revenue) to education (where players may eventually seek to monetize mostly free online courses), the model is destined to grow more attractive. Companies can boost their odds of success by considering the six key questions above.

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How Four Companies Use the Model

Among the biggest decisions facing "freemium" businesses are which features to make free and how much to charge for the rest. Here's a look at several approaches:

	Dropbox	LinkedIn	NYTimes.com	Spotify
WHAT IT IS	A cloud storage and file-sharing service	A social media site for professional networking	A digital, enhanced version of the print newspaper	A music streaming and downloading service
WHAT'S FREE	2 GB of storage, with up to 16 GB more for referring friends	Creating a profile, making connections, basic communication	10 articles a month	Unlimited music, interspersed with ads
WHAT'S PREMIUM	100 GB of storage for \$9.99 a month	Advanced searches and communication, starting at \$19.95 a month	Full access, starting at \$3.75 a week	Downloads and ad-free streaming for \$9.99 a month
HOW MANY USE IT	More than 200 million users (free and premium)	277 million users (free and premium) at the end of 2013	53.8 million visitors in December 2013; 760,000 subscribers	24 million users, of whom 6 million are subscribers