Freemium: attributes of an emerging business model

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Origins and types of freemium

An umbrella term for new and old commercial practices

Freemium is a term increasingly used in commerce to designate a business model using two products or services, or a combination of products and services. In such combination, one item is provided at no charge while a complementary item is sold at a positive price. Unlike what economists call tying, the free and commercial items are softly connected: the complement is not indispensable. The practice has existed for decades, although it carried different names and forms. The term Freemium was coined by venture capitalist Fred Wilson in 2006 and is gradually becoming a model that businesses identify with. Freemium relies on a free version of a product or service, and by design there are complements that can take various forms. Commercial transactions happen outside of what is given away. The delta between what is free and what is paid is called product differentiation.

Freemium is sometimes mistaken with two-sided platforms. In the latter case, a company deals with **different groups** of customers. Each constitutes a market side that is statically established. There is no transition or conversion from one side to the other. In freemium however, free and paid users may constitute one general group. Each free user can become a paid user, and vice versa. However, we'll see that even if **not a platform**, freemium may have similar attributes to two-sided **markets**.

Types of freemium

There are four differentiation strategies: by quantity, feature, or distribution.

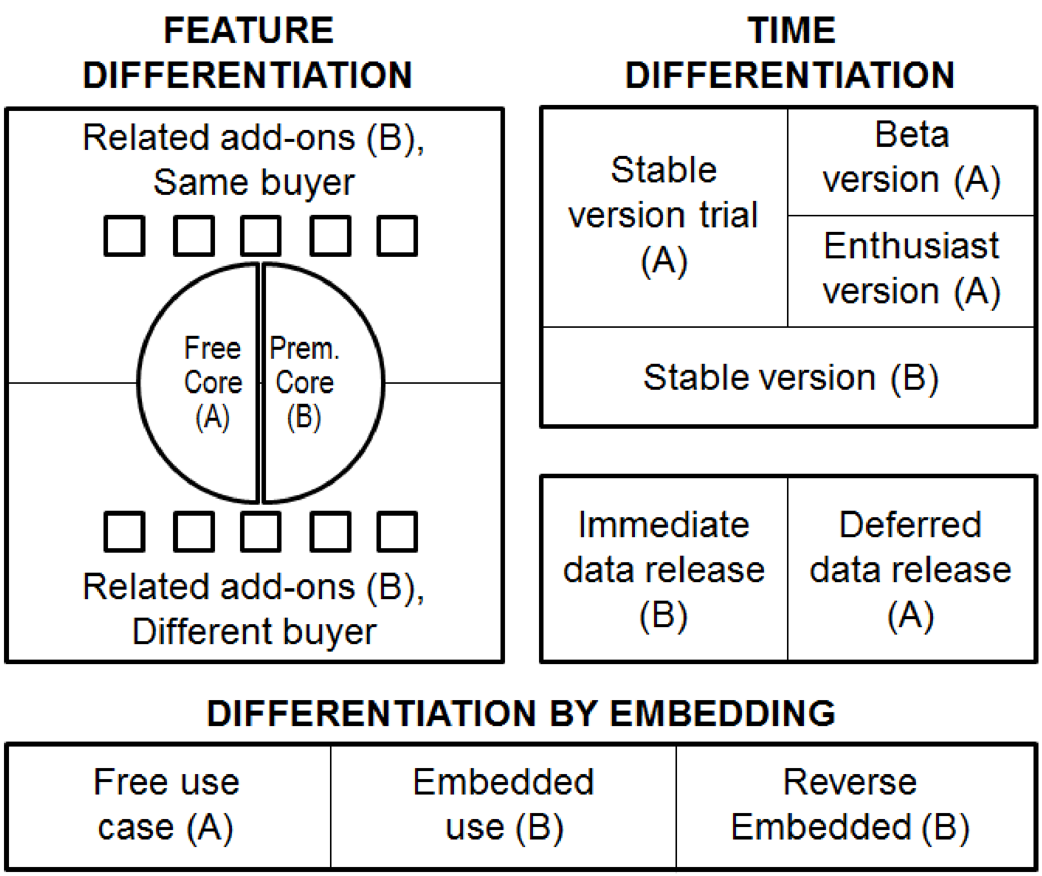
Quantity differentiation is the most ancient: product samples have long been used in pre-sales situations, representing the zero price version of its commercial complement, the full product. Samples are a form of freemium with quantity limitation, in terms of volume. The digitization of the economy through media, software and network services has given rise to another type of quantity limitation: time. Nowadays, web services can be activated and terminated within a defined time period through trial programs that serve as demand generation during pre-sales cycles. Variations of the time differentiation concept also gave birth to maturity: beta, immature versions are often made available to a subset of a user population (for example, developers of software programs) or the entire user base with disclaimers that such product is unstable and unsuitable for general purposes. Other distinctions include enthusiast versions, which contain new features that have not been time tested. In other words, the value from the asset comes from the quantity of time that it has been used, which reflects the amount of users having tested its reliability. Customers pay for maturation of time.

One variant to the time differentiation paradigm includes data release. This is particularly relevant for time-sensitive data such as financial news and generally media-related information. In this model, vendors provide the data at no charge over time, but release it first to paying customers gaining a time advantage over free users.

Feature differentiation separates product functionality and levels of service between a free and commercial set of offerings. At the core, one finds either a product that is limited in functionality (the free core) and another that includes advanced features (premium core). From this epicenter, adjunct services may be added and target either the same user as the free product or a different one within the organization. Feature differentiation can be challenging as it requires trade-offs between growing the free user base and generating revenues. This is the reflective competition dilemma in a book to be published early 2011.

Another type of freemium may allow a commercial model through differentiated distribution and use cases. The split between free and commercial models occurs in the way the product or service is distributed. This scenario is mostly found today in packaged software that includes a user license. The license, open source or commercial, dictates the use cases where the product may be used at no charge and those that require a commercial right. Depending how the end user obtains the product and what she does with it, it is free or it costs money. For example, software may be free to use but not to re-distribute or embed. Alternatively, it may be free for non-commercial purposes or require a fee-based license if the end user utilizes it for commercial purposes.

Figure 1: 13 "free vs. paid" scenarios in freemium (A= free; B=paid)



The nature of freemium is a form of demand generation. Given such demand generation is attained through a product or service and not a traditional advert (banner, catalogue placement, generally, a message), freemium is often seen as a product strategy with a zero price, an odd transaction where the recipient receives a free product without counter party, no requirement to purchase now or later. Viewing the transaction this way would leave the tangible benefit for the provider ignored: the user pays for the free good with an alternative currency, which is mind share. Mind share is the development of awareness for the provider's brand and the consideration for purchase of future commercial products and services. It is in itself a seed of brand equity planted in the recipient and not a currency when the recipient is provided a message, and a message only. Mind share becomes a currency in the context of recipients being provided more than a message i.e. the value of a product or service, monetarily "free". It becomes the currency of exchange. Sales cycles in freemium scenarios therefore have two steps, representing two discrete transactions. The free product plays a dual role: first, that of a product (playing in a market) at a zero price in step 1, and that of an advert for a related commercial offering in step 2.

Table 1: comparison of traditional sales cycles with freemium

	Pre-sales	Transaction
Traditional sales cycle	Advertising (banner, ad words, message) – step 1	Sale of commercial product or service – step 2
Freemium sales cycle (step 1)	Free product or service wins on basis of zero price, value proposition and viral marketing	Free product or service is sold at price of zero. Currency: user's mind share.
Freemium sales cycle (step 2)	Free product acts as the advert for related commercial goods	Sale of commercial product or service. Currency: money.

Freemium as a multi-sided market

Multi-sided (often simplified as two-sided) markets represent a business relationship where a company deals with different groups of customers that are dependent on one another (Hagiu, 2009[1]). This interdependence between one group and another is called indirect network effects. The presence of network effects and the distinct separation of one group of customers versus another, are two factors that define multi-sided markets. In academic literature, two sided markets are often referred to in the context of platforms. Schmalensee and Evans (2007[2]) list four types of multi-sided platforms:

Exchanges: the platform company puts buyers and sellers in contact towards a transaction.

Advertiser-supported media: the twentieth century radio stations, newspapers, televisions and newer businesses including internet search, making content available at no charge to users while generating revenues displaying ads.

Transaction systems, such as credit card companies dealing with consumers and merchants.

Software platforms: end customers purchase computer devices in large part because of the applications that are available on the device. As a result, platform companies must court application developers to work with them while at the same time promoting and selling their products.

Freemium does not involve a platform to operate. Furthermore, free users and paying customers belong to one general category. By these two characteristics, the model does not fit the standard definition of two-sided markets.

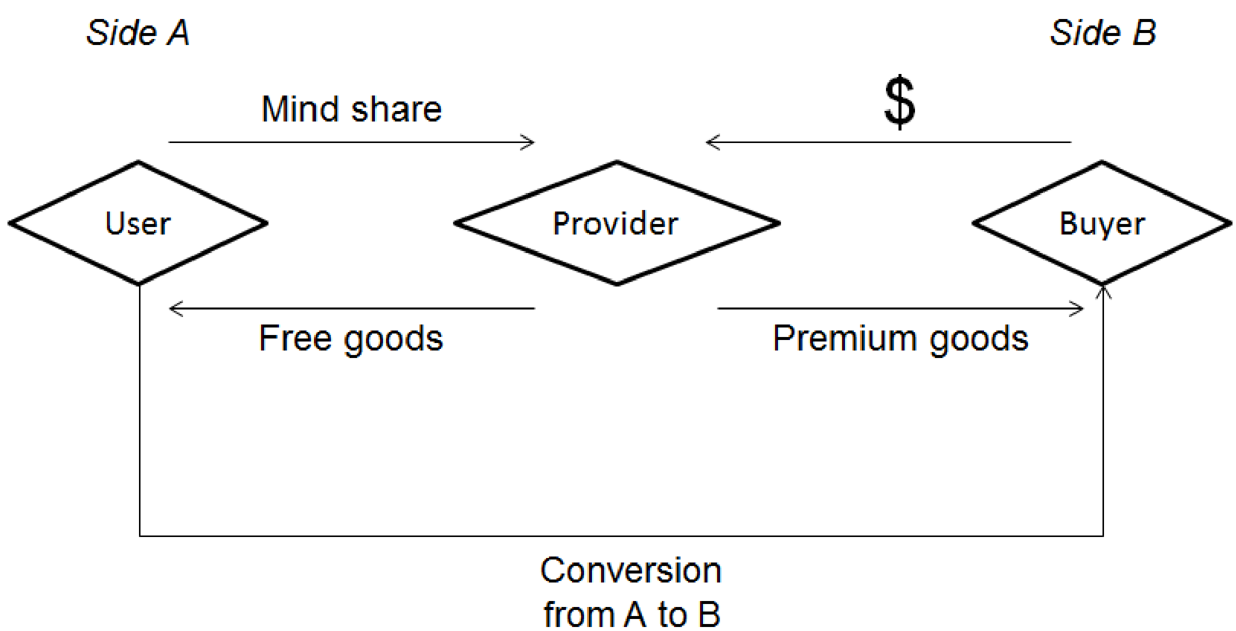
However, a look at the real world reveals a different reality. We can take the example of open source software: models in this industry do require distinct sub-groups of users in order to function. For example, early adopters and technically savvy users are often knowledgeable enough to never have to rely on outside services or tools that facilitate the use of the products. We can refer to this group, or side, with the letter A. In return, these free users deliver value to the provider by testing the product, creating a brand, and sometimes contribute code or bug reports.

A different group of users is more conservative in nature, and often defined at the business or commercial segment of the market. This segment that we can call side B is the one using commercial services and/or feature upgrades from the free product.

Sides A and B have distinct demographics, behaviors and needs. They are sometimes playfully represented by the photo of a Computer Hacker (a technically skilled software professional with an early adopter, trial-and-error bias) and a corporation's Chief Financial Officer (pragmatic, more risk averse and looking for commercial relationships with software providers). Their commonality is that they both represent users, unlike platforms where the two customer groups are distinct by nature.

In addition to being distinct, the two sides of freemium show interdependence: risk averse customers value the fact that early adopters have battle tested the software while providing the vendor positive brand equity that will help it sustain its business over time. Conversely, free users benefit from the presence of commercial customers in the ecosystem: the latter provide vendors the financial resources to produce more free software and share more code. This interdependence mirrors the indirect network effects seen on platforms.

Figure 2: transactions in freemium



[1] Andrei Hagiu: Note on multi-sided platforms, economic foundations and strategy (HBS, 2009)
[2] David S. Evans and Richard Schmalensee: The Industrial Organization of Markets with Two-Sided Platforms (2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=987341