

The Freemium Model

Lately in the startup world, it seems that subscription type models are becoming more and more common for companies offering some type of virtual service. Music streaming startups such as Spotify, Grooveshark, and Pandora, you can listen to music at the click of a button. Now account for the fact that more and more people are purchasing smart phones like the iPhone and Android, giving them internet on the go as well as access to these services, theres really no need for someone to actually purchase songs and put those songs on their mobile device to listen to on the go. They now have more music than they could ever want at the tip of their fingers. The best part? All of these companies offer their services for free. Companies are starting to give away their products for free, but are still making money. But how?

One of the easiest ways that you can draw people to your product is to offer it for free. Its been proven that we, as a society, like to “try before we buy” so that we know that we are going to be purchasing something that will be worth the money. And thus the “Freemium” model was born. The freemium model revolves around giving your product, or a “lite” version of your product, away for free and then charging users for things such as extra features, higher capacities, removal of ads, etc. The interesting thing about the freemium model is that it can be implemented in many different ways depending on the product or service that you are selling as well as the market you are competing in. There are three types in particular that seem to be the most common:

1. Offering your service for free, supported by ads and offering a premium version that doesn't include ads. For this, we'll look at music streaming service Pandora.
2. Offering your service for free, with no ads, but then charging for additional capacity. For this, we'll look at Dropbox.
3. Offering you service for free, but then selling additional features a la carte. This area is a new one and relatively popular among the new sites offering a Platform as a Service (PaaS) such as Heroku.com.

The most common form of the freemium model is giving users the full version of your product, but supported by advertisements, then charge for a premium version of the product which, in Pandora's case, offers a higher quality music stream and no ads. That's not how they originally started out though. Pandora originally had a kind of "reverse-freemium" approach. In the beginning, they would allow users to listen to ten hours of music for free. After that ten hours was up, they would be prompted to pay a subscription fee of \$36 per year. In the first couple of weeks, they had 100,000 people come to the site and listen to their ten free hours of music. When prompted to buy the full subscription, people would just turn away from the site and not come back. In order to bring people in and keep them, Pandora shifted its focus a little bit and removed the ten hour cap, but added advertisements to the website, with Apple being the first to purchase ad space. Now, Pandora has over 20 million unique visitors per month and in 2009, took in \$50 million in revenue. Along with the free service, Pandora offers a premium service called "Pandora One", offering higher quality streams, no ads, and

even a dedicated desktop application. As of 2010, Pandora One has 300,000 subscribers and accounts for about 15 percent of their total revenue. As we can see here, people will use every last drop of a free service, but as soon as you impose a limit to force them to pay, they are very likely to walk away from the product or service.

Freemium is all about finding that breaking point between giving away your product and charging for the same product, but with a few more features or a higher capacity. Enter a company that you should all know; Dropbox. For those of you that don't know, Dropbox offers online storage and allows you to sync your files between multiple computers and mobile devices. Dropbox is an interesting company to look at in terms of how they offer their service and also how they went about marketing their service and drawing users in to use it and grow their user-base. Since the beginning, Dropbox has offered a tiered structure in terms of pricing. All of the tiers are exactly the same feature wise, with the exception of the amount of storage you get in Dropbox's cloud. Have the free version and need more space? Simply upgrade to one of the paid tiers and you have more capacity. In the beginning, through a series of studies of trying to recruit users to sign up for Dropbox, they found that "[the] cost per effective acquisition per paid user was thousands of dollars for a hundred-dollar product." So naturally, they decided to hide the fact that they had a free version to try and draw users to the premium, paid versions. However, they weren't really creating demand from targeting users searching for online storage, they were just collecting those that were looking for it originally. At this point, they made it more clear that they had a free version of the product, dropped their search marketing, and saw the number of users skyrocket.

Well how could this be? Well, Dropbox just learned a very valuable lesson. Turns out that the best way to get users is by user referrals. So now instead of direct marketing to users, they've incentivized user referrals by giving users that refer others to Dropbox, more capacity for the account.

This final type of Freemium models is relatively new to the scene, as is the product and the market that its in. Recently with the explosion of moving things the “the cloud”, startups have been popping up all over the place offering whats called Platform as a Service (PaaS) hosting. The idea here is to offer a simple way for developers, or companies, to deploy web based applications without having to worry about managing a cluster of servers by hand. A little company in San Francisco called Heroku is making large strides in this area by now offering different types of application environments including Ruby, Node.js, Clojure, and Java. Since this isn't a media consumption use case like Pandora, and its not as simple as offering more storage like Dropbox, Heroku has opted to an a la carte version of the Freemium model. Users are allowed to sign up for free and host their applications. Now that you have your free account, say your application has exploded in traffic, you then have the option to pay more for more “dynos” (server processes) to handle the traffic. Need a database? That will also be extra. Everything is based on the free account, then you simply pick and choose the things you want to add on to it making it perfect for people that are hosting like a small blog, to someone thats hosting a web application that needs high availability.

The freemium model definitely has its ups and downs, but in order to execute it correctly, you really need to do research in your market to see how you can best execute it. All of the companies mentioned above had to find a way to make money off of offering their product for free, and all of them did it differently. Generally the larger your target market, the better off you will be. Phil Libin, CEO of Evernote once said “The easiest way to get 1 million people paying is to get 1 billion people using.” If you are going to offer your product for free, you'd better be able to make money off of your users, because the majority of your users are not going to be the ones paying for it. The Freemium model, while proven successful in many cases, may not be the best option. A lot of times its a gamble, but if you can attract massive amounts of people, then it may be worth a shot and could prove successful.