The Reality of Freemium in SaaS

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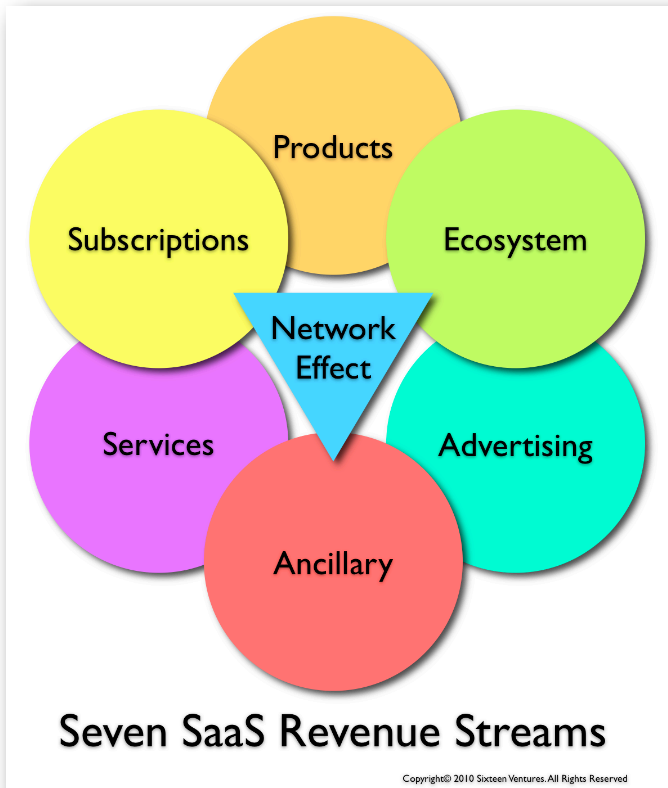
Freemium is Not a Business Model

The "Freemium Model," a *marketing tactic* where a Software-as-a-Service (SaaS) vendor has both a free and paid version of their product, has gained substantial traction in recent years. Freemium in SaaS can be used as an effective go-to-market strategy, but it is the rare case where this method leads to a *substantial increase in paying customers*; it more often leads to increased overhead, negative product positioning, and can lead to overall failure.

Freemium has significant risks associated with it and without fully understanding these risks, and without fully examining the market, their product, and their company, SaaS vendors using the "Freemium model" almost always fail; this paper is designed to stop that.

In 2009, Sixteen Ventures published our "7 SaaS Revenue Streams" report[1]. This report detailed for the first time all possible revenue streams a SaaS company can leverage. The goal was to urge SaaS vendors to look beyond the de facto standard "monthly subscriptions" revenue stream to ensure they are not leaving money on the table and doing a disservice to their stakeholders.



SaaS vendors, especially those in the early stages, must be aware of the seven revenue streams while architecting their product or selecting revenue cycle management vendors[2] to work with. This ensures they will be able to support the appropriate revenue models within the application and back office when the time comes.

What we at Sixteen Ventures did not expect was our promotion of the multiple-revenue stream approach to the SaaS Business Architecture being so misaligned with a portion of the industry who was buzzing about giving use of applications away for free. This paper is designed to compel SaaS companies to take a second look at their plans to use Freemium as their go-to-market strategy and to help them understand what they are getting into.

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[1] See Appendix D - The Seven SaaS Revenue Streams for more details

[2] Revenue Cycle Management refers to the set of processes involved in generating and recognizing revenue: pricing, quoting, subscription management, metering, billing and other back office functions

Baseline Understanding of Free

Freemium - from Wikipedia:
"Freemium is a business model that works by offering basic Web services, or a basic downloadable digital product, for free, while charging a premium for advanced or special features."

To adequately set the stage, the baseline understanding of "free" must be set. These items are the foundation for the points made in this paper:

- Freemium, while having both free and premium components, is *most popular* and well-known for the *free* portion
- Free is not a Business or Revenue Model; money has to come from somewhere
- Free is not a revenue stream (obviously)
- Free is a tactic within an overall marketing strategy
- Free is a marketing tactic that can hurt a brand / market position if not handled carefully
- Free trials or "Try before you buy" are fine, and expected, but free in perpetuity, like Freemium, has potentially negative consequences
- Many times "free" is a cop-out allowing a vendor to avoid asking for money or having to "sell" ("we'll figure out how to monetize later..." or "we just need people in the system to bang around; get them in and we'll up-sell later" or "we'll build the product, raise money, and then hire a sales and marketing person")
- Freemium is usually found in startups; rarely do existing companies wanting to bring a SaaS product to market default to Freemium
- Free users should not be considered Customers since they do not pay[3]

As part of a business model, Freemium has fundamental flaws. The most obvious flaw is that supporting a large base of nonpaying users that will never convert to paying customers can bleed an early stage startup of precious financial resources. In addition, these users can draw on the limited time and attention of the team, taking those resources away from development and support of the premium product that will sustain and grow the company.

While it is the "free" versions of software that get picked up in the blogosphere and social media (for a few minutes, at least), it is also the free products that get lampooned by those very same outlets, and the users, when problems occur. A small base of paying customers can keep both the overhead in check, but also the scale of the venture which the young startup must support.

[3] See Appendix C - Customers vs. Users for a more detailed explanation of the distinction

The support of free users is only half of the problem. With Freemium, it is often referred to as a "numbers game." The more users there are in the system, the larger the number of people that will convert to the premium product. It takes money and resources to acquire those customers, though, so while they use the product for free, to acquire and support them is anything but.

Freemium Success Requires Internal Reflection

Investment in lieu of revenue[4] seems to be on many founders' minds even when investment dollars have been harder to come by. Many startup founders seem to feel like it is easier to pitch investors than to go out and make sales. When this mindset is considered, it is easy to see how Freemium also became so popular with startups; especially those founded by technologists. It takes the pressure off of technical founders who just want to build a product and not worry about "selling."

To ensure that a Freemium strategy is successful, and that the motivation to adopt the strategy is aligned with the vendor's goals, a deep look at the market, the products, and the company is required.

Critical questions for SaaS vendors to ask themselves are:

- First the big one: If no one is willing to pay for our product right away, are we sure there is a market for it?
- Second big question: What is the *quid pro quo*? What is in this for us? Why should we let them use our system for free?
- Do we sign-up for free versions of applications and then stop using them or do we always move onto the premium version? Why?
- How can we monetize users even if they never "convert" to customers?
- How can the users of our system benefit our customers?
- Are our customers just those that pay to use the "premium" version of the system or might they be stand-alone consumers of the byproduct of system usage?[5]
- Can we glean actionable market intelligence from both free users and customers?
- Can we aggregate the network effect data and monetize directly?
- Can we benefit from the "nothing attracts a crowd like a crowd" notion of having a large number of users?

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[4] Investment used to build a user base to a point where revenue can be acquired is okay. In fact, the longer the road to revenue, the more outside investment will be required. This is why bootstrapped startups need to really understand how Freemium and a long lead-up to revenue can affect them.

[5] An example is Twitter which has two disclosed customers as of January 13, 2010; Microsoft and Google. The users of Twitter do not pay, but the customers pay for access to the "firehose" of tweets. It is also wise to remember that Twitter has raised $160M to get to this point and is an *anomaly*.

What's the *Quid Pro Quo?*

Quid pro quo - from Wikipedia:
"Quid pro quo (From the Latin meaning "something for something") indicates a more-or-less equal exchange or substitution of goods or services."

If people are using a system and not adding real value to the ecosystem, not generating actionable network effect data, and not paying to use it and likely will not start, why keep them around? Why should a SaaS vendor care if they have 100k users if only 100 are paying customers? Those 100 customers, and the vendor, are subsidizing the 99,900 users; why?

Assuming free users are "hot prospects" ready to be converted into paying customers is wrong. If the average company[6] employing Freemium has only 1% of it's entire user base paying to use the system, either the "hot prospects" are not as hot as first thought, or no one is doing it right. Likely, they are not hot prospects.

The majority of users likely have no intention of ever becoming a customer. If the users are not likely to convert, should a vendor give up and not attempt to nurture them into converting? Of course not. Justin Pirie, a SaaS Product Management Specialist based in United Kingdom says it well: "in exchange for the use of the SaaS vendor's application, the vendor gets the users' attention." The vendor should take advantage of that attention, but what if they will not convert regardless of the vendor's efforts? Knowing that a significant portion of the user base will never convert to paying customers, it only makes sense to seek ways to benefit from and monetize their usage of the system. That is the quid pro quo.

Their attention is nice to have, but as a business, revenue is critical to have. That revenue will either come directly from the users when they become customers or it will be derived from their usage of the system. The reality is, if the SaaS vendor does not have a way to adequately monetize that attention, for example through up-selling or advertising, then they need to find another way (network effect data, for example) or stop supporting free users.

Not properly managed, free users *will* become a significant drag on the vendor's resources. If the vendor can articulate the strategic and monetary advantage of having 100,000 nonpaying users, great. However, if the vendor cannot articulate this under tight scrutiny, and most cannot, then they should avoid Freemium until they can answer the question; what is the *quid pro quo?*

[6] Aside from confidentially obtained and anecdotal evidence, exact conversion rates are hard to come by since few SaaS vendors leveraging Freemium publicly disclose those numbers. Those that do often distort the true meaning of the numbers or misinterpret the statistics themselves. See Appendix E - Freemium Resources for links to public disclosures of Freemium conversion statistics.

Distribution and Customer Acquisition

While it is true that it might take five times as long to get a paying customer as a free user, going after only paying customers will ensure customer acquisition dollars are used to directly grow revenue. However, as this paper has mentioned and will further illustrate, free users have value when leveraged appropriately.

One way vendors can leverage having a large number of users in a Freemium model is to help create "value pull" when intermediaries[7] such as VARs, System Integrators (SIs) or Distributors are involved in the buying process. This is also effective when the intermediary for the end-customer is the corporate purchasing department.

In a multilayer value chain where an intermediary sits between the vendor and the end-customer, it is often up to the vendor to bypass those intermediaries and create interest with the end-customer (referred to as "pull" through the value chain). The end customer will want the product and therefore pulls on the intermediary to deliver it.

It's the cheesiest...

The retail supply chain is the most visible example of value chain pull. A great example is when Kraft advertises Macaroni & Cheese directly to it's customers on TV, but the customer must buy it at the grocery store. If their grocer does not carry Kraft Mac & Cheese, they will either go to another store or ask them to carry it.

The same type of value pull may be required in the target markets for many SaaS vendors.

Free access to a SaaS application can help the vendor create that value pull with their end-customers by giving them the ability to try it out on their own before going to the corporate buyer. In this case the intermediary is the corporate buyer; do not forget that it could also be a corporate buyer that goes through a second intermediary such as a VAR or SI. The key here is that in a value pull situation, "*Try before you buy*" is required, but something as extreme as Freemium is not.

If the vendor gives the application away for free in perpetuity, what incentive is there for the users to go to the corporate buyer to make a purchase? If the vendor limits the functionality of the free version, this could create a nonstarter scenario. A limited-use version will certainly keep the end-customer from putting time and effort into setting it up, and thus creating barriers to exit. A free trial, on the other hand, might get the end-customer to invest time in the application, which, when presented to the corporate buyer, does not represent only an ongoing $19.99/mo investment, but hundreds or thousands of dollars in sunk people-hours invested in that product.

[7] See Appendix B - Channels and SaaS for more on the unique role of intermediaries in SaaS distribution

Of course they will approve the purchase and will likely make it a group-purchase or buy a "corporate" version.

The Freemium model as an entry point into corporate customers has many potential drawbacks. Quite often the application will be used by employees within an Enterprise that do not know the others are using it because they all have individual accounts on the free version. This will lead to fragmented use within a company with no need to ever consolidate under one, very prompt and reliable, corporate payer. Simply put, the SaaS vendor could be missing out on a large corporate sale because of their use of the Freemium model.

Network-Centric vs. "Network"-Centric

Market position, brand power, and popularity, can drive up valuation in an exit, providing multiples far and above those applied solely to top-line revenue or EBITDA[8]. It is easy to see, then, how some could extrapolate that a large user-base could raise valuation, and that this is potentially more valuable than revenue. With a niche B2B[9] SaaS product, this large user base is likely not going to matter as much as the number of paying customers, unless that glut of users is adding value to the business (i.e. revenue, actionable intelligence, etc.).

Also, remember that valuation only means something at very specific times in private companies (like when the company gets acquired); top-line revenue has value all the time. A SaaS vendor cannot run their business or generate profit without revenue, at least in the long-run. It is wise for SaaS vendors to look at revenue as a metric on which to base their company's standing.

A Venture Capitalist says...

Ivan Farneti, Principal at Doughty Hanson Technology Ventures in United Kingdom says: "Growth without monetization is unsustainable in a competitive market, but profitability without growth (or moderate growth) ensures survival in hard times and the chance to fight another day. That's why very few of my investments in 15 years have gone under."

A large pool of users leveraged intelligently, however, can be quite valuable and lead to more revenue. For example, a SaaS vendor can:

- Up-sell to get them to pay to use the system or to buy more
- Sell information on how they use the system
- Expose their eyeballs to advertisers

[8] EBITDA - Earnings Before Interest, Taxes, Depreciation & Amortization have been subtracted

[9] B2B - Business to Business; refers to companies selling to companies or business-minded individuals; in contrast to B2C or Business to Consumer, where the end-customer is the consuming public

- Learn from their behavior and sell that intelligence to industry
- Learn from their behavior and leverage that in product management
- Build a community from those users and customers
- Leverage community to handle first-level support
- Leverage network effect data to secure better terms with suppliers on behalf of customers[10]

Vendors, users, customers, and partners all benefit from the Network-Centricity of SaaS through Network Effect Data, Collective Intelligence, and a true Ecosystem of users, partners, and integrated third parties to an extent not possible with non-SaaS business architectures. The communities and networks of users and customers of a SaaS vendor can be closely tied into the application, unlike in non-SaaS models where these were simply "bolted on" to the application or completely independent. In legacy products, users could trade experiences and advice about the application, but there was nothing tying the community directly to the application. In SaaS, this all changes.

There are many benefits of SaaS being network-centric; the fact that the one application is used by hundreds, thousands, or millions of users and customers, and that it is hosted or "in the cloud" makes for a potential user experience unlike any behind-the-firewall application. Additionally, SaaS provides end-customers with the benefits of interconnectivity with third party applications and data services, made possible by the network-centricity of SaaS.

SaaS, as a single-instance, multi-tenant application, meaning everyone from Company "A" to Company "Z", logs into the same application, is also "inherently collaborative." Though the core architectural elements of single-instance, multi-tenancy are required for the social nature of SaaS to be taken advantage of, the extent to which the vendor exploits this should be determined by the market. In highly regulated or governed industries, perhaps the collaborative nature of SaaS would be downplayed; but in something like the recent Social CRM movement, perhaps this can be exploited further. The true social nature of SaaS can be seen in everything from collaboration across customer accounts, to more open forums accessible from within the application, to sharing workflows, reports, and other custom objects created by one customer with the rest of the users or customers.

Regardless of the inherently collaborative nature of SaaS, even in a Freemium model, it is critical for the vendor to build an application that has value to the end-customer even if no one else ever uses the product. What makes SaaS so special, when architected correctly, is that the addition of users and customers to the application over time will make the experience better for everyone involved.

There are some applications where the network-centricity is more about the network of users and customers, and less about the functionality of the application as a computer network hub. These

[10] See Appendix B - Channels and SaaS for information on how vendors can leverage network effect data

are more of the "social network" applications like LinkedIn, where the value of the application is directly proportional to the number of active users and customers. Some SaaS applications might fall into this category, but for line of business, departmental, or even horizontal applications such as ERP or HCM [11] this is not the case.

The Freemium Virus

It is often said that as long as the incremental cost to support new users is "near zero" then having a large user-to-customer ratio is fine. Where do those users come from? Freemium in the B2C world is often reliant on virulent methods of customer acquisition which are hard to come by; this is doubly true in B2B. Do they exist? Yes. Has it worked for B2B companies? Yes, but often by accident or right-place, right-time, right-problem-solved.

One key element to the viral nature of Freemium[12] is that simplicity and "cool" have a lot to do with virality. Simplicity is easy to understand; full-featured productivity suites are less likely to "go viral" than, say, single-purpose widgets or iPhone Apps. Cool is relative of course, and an application might be considered "cool" in an industry or niche if it very easily and efficiently solves a problem. Can the application reach a level of virality that will generate enough users that convert to customers to sustain the business as an ongoing concern?

The real problem with many Freemium implementations is the notion that the application will "*sell itself*" once the users sign-up for free. The users will invite their friends, tell other users who will tell others, etc. The SaaS vendor will have a huge army of evangelists promoting their product to their friends and colleagues, and the user base will grow exponentially. This way of thinking is not directly related to Freemium, but quite often where Freemium is found, a significant reliance on "going viral" is found to be in the, or the entire, marketing plan.

None of this is to say a viral campaign with great results cannot happen, nor is it to say SaaS vendors should not consider so-called "viral loops"[13] as part of the product development and marketing strategy. Quite the opposite. However, the truth is, it is difficult to manufacture, predict, or quite often, to replicate the results of these types of strategies and are therefore a long-shot to bet their business success on. They should be used as a part of a larger marketing effort, but likely not the single method of customer acquisition many vendors who employ Freemium seem to rely on.

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[11] ERP - Enterprise Resource Planning such as Plex / HCM - Human Capital Management like Workday

[12] In many cases, Freemium is an extension of the popular-yet-flawed notion of "if you build it, they will come" present with many web-based startups. If it is on the web, the customers will find the product. If it is Free, they will sign-up and use it until they reach some arbitrary usage threshold and then sign-up for the premium product. During this process, they will tell their friends, who will tell their friends, and so on...

[13] "Viral loop" is a loosely defined method of providing mechanisms for users and customers to invite, compel, or otherwise introduce your product or service to their friends and colleagues.

The Perceived Value of Free

If the market the SaaS vendor is entering has significant barriers to entry or market risk and *they still think it is the right market to enter*, perhaps using a free product to get their foot in the door is an appropriate tactic in the overall strategy to achieve revenue. The last part is key; “to achieve revenue.” **Without revenue, their business will fail as, by definition, a business has revenue. Otherwise it is a hobby; even non-profits have revenue.**

As stated a number of times before, free users are not customers. Period. So what is the quid pro quo? What does the SaaS vendor get from the users in exchange for free use of the product? Some would argue that the vendor will get eyeballs to build advertising inventory around, but that is not advisable in a B2B play unless the vendor really knows their market. In most cases advertising is out; either the vendor will not find the critical mass of advertisers necessary to make it a viable revenue stream or they will devalue their brand by having ads all over their product; likely both. A rebuttal to this is often the citing of Google Apps as an example of a successful ad-based Freemium play. Remember, Google is not in the “apps” business, but the advertising business; unless the SaaS vendor is in the advertising business, this is likely not the approach to take.

In mid-market and higher B2B SaaS, the strategy of putting a free pricing tier out there to entice usage of the system and hopefully convert to paying customers later just does not work as well as the SaaS vendors trying this approach hope (too often, hope is a *BIG* part of this process). Foremost is the very real mindset of many business people that, *true or not*, “free = zero value.” Consumers have come to understand that entertainment, games, music, etc., can be obtained for free on the web, so this is not as big of an issue in B2C. And since it is the consumer web experience that has caused a large amount of the uptake of SaaS in the enterprise, it is easy to make the mistake of assuming it is the B2C business models that are part of the attraction in the enterprise.

The fact is that business software consumers are still quite keen on paying for software and often like SaaS for it’s de facto standard subscription model and the ability to pay incrementally over time. Anecdotally, there is a large amount of distrust of “free” products. Business-focused people understand that *free is not sustainable* and they will wonder how long the vendor will be around if they do not charge for their product. They might move on and it could very well be due to the vendor offering their flagship product for free, even if only part of a Freemium tactic. This is all marketing and positioning and comes down to the vendor truly knowing their market!

It is also critical to understand the snowball effect that free has by setting the wrong tone at the outset and hindering uptake of "premium" products and services; especially when they are accompanied by a super-premium price. Christine Ross, Vice President & Research Director at Forrester Research, who works with Enterprises in sourcing software and services, used this analogy: “If you paid $1000 for a suit, you likely wouldn't think twice about spending $20 to dry clean it. In fact you'd likely spend more if you had confidence that the dry cleaner won't ruin it. Now, assume the suit is the same, but you paid $50. Would you still be willing to pay $20 every time it was dry cleaned? I wouldn't."

Further, if the ratio of spending in traditional software to add-on services is 1:1, then a lower license fee means less services spend. Just as for traditional software, for SaaS this ratio varies wildly depending upon a number of factors, but for large, horizontal applications such as ERP, HCM, etc., this 1:1 ratio could be close to reality. The big question then is where this leaves "free?" If free is *not* a nonstarter, then it is very safe to assume the overall *LTV*[14] *will be lower*, even if that number is not calculated until they are a paying customer (taking CAC out of the equation).

Finally, there are some situations where Freemium will simply not work, and it is not a perception problem. To secure their proprietary data, some companies simply prohibit the use of non-approved free services with live corporate data. This means that use of a free-in-perpetuity product by people in a company with these restrictions will lack real data; affecting the value of those users on network effect data, and erasing any "sunk time" investments used as leverage to entice premium-upgrades with corporate buyers. An authorized trial is the only way to go in these situations and is the only way to ultimately get to a sale. This is directly tied to knowing the market; a vendor that does not know that their target customers have this rule in place has overlooked a major threat in their marketing strategy.

The Money Value of Time

It is a safe bet that business customers have a higher money-to-time ratio than the average consumer. This means that out of the gate, anyone looking at a solution to their problem will likely spend money if it can save them time. If they are not turned off by the "free" product from the outset, they might sign-up for the free version; likely they would have been just as happy to sign-up for an account with the same "features" that cost money. If the vendor does not believe in their product and know their market, they could end up leaving a substantial amount of money on the table.

Understanding that it is more about time than money to business customers, SaaS vendors can shape their product and marketing strategies to acquire, and keep, customers from the beginning; not users. A full discussion about keeping customers over the long-term and reducing churn is beyond the scope of this paper, but in the early days of the customer life cycle, keeping customers often means creating barriers to exit.

Many companies that employ the Freemium model simply *do not* build those barriers to exit and often build tools (*one-touch export to competing solutions*, for example) to reduce the barriers even more. The "strategy" is often to get the users in the system for free and then create such an

[14] LTV = Customer Lifetime Value, relies on knowing CAC or Customer Acquisition Costs; See Appendix A - The Effect of Freemium on SaaS KPIs for more

unbelievable experience that they will not want to leave, negating any need for long-term contracts or other barriers to exit.

Businesses that have a problem to solve generally realize that they are going to invest time and energy into a solution to set it up and get it working how they want it to. This is true even though the SaaS industry in aggregate has deluded itself into thinking it is just "push button deployment."

Lessons from Open Source in the Enterprise

While not a perfect analogy, keep in mind that one of the big reasons Free, Open Source software made inroads into the enterprise was not that it was better, faster, or cheaper than commercial software, or that the source code was readily available. It was that companies were started with the primary mission of charging money for, or at least charging to deliver, deploy, and support, the open source products. Enterprises were leery of "free software" that they had the source code for and controlled in-house.

What do they think of free SaaS solutions?

While it might be push-button *provisioning*, the on-boarding process is often the polar opposite. The more complex the problem a product solves, generally the more time the customer must invest to get the product to a usable state. It is up to the vendor to figure out a way to quickly move them into the product initially and then deeper into it while preventing them, in an ethical way, from leaving. Contracts, prepayments, and the like are likely not deterrents to abandoning ship.

If customers have invested significant time in the system, they will be less likely to walk away from that. Which is why many SaaS vendors think: "if I give them a free version, they'll use it and then due to the time investment, not walk away and be forced through some sort of quota or tiered plan to 'step-up' to the premium version." This might seem logical, but the potential limiting factors of the free version (limited functionality, limited storage, the overarching notion of "free = zero value") and the fact that they are likely *willing to pay* for the vendor's product makes this tactic less-than-compelling. At least test both to see which works!

SaaS vendors have an *even more compelling* value proposition that can both increase the uptake but also the barriers to exit for customers, and that is the Ecosystem. Earlier the term "value chain" was used to describe the distribution process that leverages intermediaries[15]. The real opportunities for the SaaS vendor is around Ecosystem, or it's location in the middle of an overall value network rather than a traditional linear value chain. In a value network, the SaaS vendor acts as a hub, where examples of the "spokes" would be users, application customers, network effect customers, customers' suppliers, and distributors.

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[15] See Appendix B - Channels and SaaS for more on the unique role of channels in SaaS distribution

This gives the SaaS vendor a unique opportunity to move deeper into the businesses of the different players, including providing visibility into end-customer usage to intermediaries such as VARs or SIs, positioning themselves as irreplaceable. This is one of well-kept secrets of the most successful SaaS companies, especially privately held niche vertical companies most people will never hear about. Sixteen Ventures works with SaaS vendors take advantage of this unique opportunity during revenue modeling and business architecture.

The Alternative Product Approach to Freemium

The most interesting way Freemium is being employed in B2B SaaS, is not at the pricing strategy level, but at the product level as part of an overall marketing and revenue generation strategy. In this version of Freemium, and after the appropriate market due diligence, companies will build a very simple, single-purpose Alternative Product (AP) that solves an immediate, specific and highly targeted need, but which promotes significant network effect and ecosystem opportunities well beyond that application. This application will be stand-alone, even if on the back end it is tightly coupled with their flagship product.

The quid pro quo is simple; the users sign-up and use this product to perform the specific function for which it was created, and the vendor can monetize it multiple ways. Users of this application will not need to convert to the flagship "premium" product to generate revenue; the product is designed from the ground up to generate revenue by leveraging unpaid users. This AP also has the additional benefit of not requiring the vendor to get into product or feature segmentation between the premium and free versions of their flagship product. Many companies do this wrong anyway, relying on commodity tier or version differentiators like "storage" or "users" rather than segmenting on value-added elements, another discussion beyond the scope of this paper.

This AP strategy has additional benefits beyond indirect monetization of free users. As with any Freemium[16] strategy, the AP can help develop significant value-pull as mentioned earlier. If the AP itself is an extension of or tightly integrated with the SaaS vendor's flagship product or brand, this could certainly be leveraged directly to drive pull on the corporate purchasing department. The result could be to bring the SaaS vendor in on an RFP or as a direct purchase; opening opportunities that possibly would not have been visible to the vendor without this approach or if they had attempted a Freemium approach with the flagship product.

While it is well-known and documented, it is also often avoided as a topic of conversation, but the truth is, startups pose a significant risk to enterprise customers due entirely to the concerns about vendor viability. **A startup offering a "free" version of the product upon which their business is built could appear to be less stable or sustainable than a company with an identical product who charges for use.**

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[16] For Freemium to work, regardless of the methods used, the free product has to function properly. Whether this is an AP or the company's flagship product, it must work.

Leveraging this AP strategy, early stage startups can overcome many of the “viability” issues corporate buyers or influencers might bring up by having already solved problems for employees in a way that does not dilute the value of the flagship product. Done correctly, the AP strategy will also ensure that use of the flagship product inside the corporation will be unified under one corporate payer, thus bridging the single user to enterprise customer gap that is the key to success as an enterprise-focused SaaS vendor.

Regardless of which Freemium method is used, the notion of “if you build it, they will come” is just not reliable. More substantial marketing, sales, and business development is likely going to be required. This AP method could also be used by the marketing and sales departments to get a foot in the door that could lead to acquiring customers in the flagship application of the company. It could also be leveraged in business development with third-parties such as Distributors, Consultants, SIs, and VARs as an outreach tool for them to generate value pull with their, and your, end-customers.

Example AP Freemium Use Cases

Some examples of AP Freemium employed by SaaS companies:

- ASN / Shipping Label Bar Codes (by EDI company)
- Online Reservations for restaurants (by POS company)
- IRS form 1099 Generation (by business tax software company)
- Simple Invoicing (by larger Accounting software company)
- Field Time Tracking iPhone App (by Payroll or Time tracking software company)

What are the AP Freemium opportunities in your target market?

Along with the aforementioned benefits, given the two basic requirements for virality of simplicity and “cool,” the single-purpose AP is also more likely to be spread virally than a larger, full-featured application suite. Done correctly, this product should be very simple, and should solve a real problem for the end-user. While this method is a great way for a SaaS vendor to employ Freemium, few companies employ this strategy, though many could. Also note, if the AP is “cool” enough, the SaaS vendor might be able to charge for it and still benefit from the network effect, ecosystem, and marketing opportunities it creates!

Regardless of the use of the AP, whether as a sales / marketing / business development tool or simply another paid product, the goal is still to generate monetizable collective intelligence, market intelligence, network effect data, and ecosystem opportunities. When employed as part of a Freemium strategy, it keeps the “free” stand-alone product separate from the “premium” product, thereby never hurting the market position of the premium product.

Since every company and market is different, stating definitively that Freemium should or should not be the marketing tactic to leverage is impossible. As long as the SaaS vendor does their homework and fully understands what they are getting into, what the potential ramifications are, and of course, whether offering a free product is necessary or even wanted by your market, they will be more likely to succeed.

Before even exploring Freemium, the SaaS vendors should determine if they need a "Free" version at all; perhaps they can charge for all access to the service. If the vendor decides to leverage the strategy of a single-purpose AP as the "free" offering, they need to understand that it is not without cost; it takes product development, programming, and marketing resources. If the vendor can sell their flagship product and make money doing that, why waste time and resources on the "free" product? The bottom line is, if the vendor does decide to do Freemium, they need to know what the quid pro quo is.

Appendix A - Freemium is a (Big) Numbers Game

Like most marketing tactics, some will find success with Freemium and others will fail miserably. If you understand that it is simply a marketing ploy and don't build your "business" around Freemium, when it doesn't work, you will be in a better position to recover. If you spend all of your time, money, and resources up front attempting to collect some "critical mass" of users thinking that you'll convert them later when you "turn on the revenue tap" you might have a big, negative surprise waiting for you.

There is a quick "*back of the napkin*" formula for figuring out if you have a large enough market for Freemium to work. Essentially it says, are there enough people/companies/potential users of your app for the "numbers game" that is Freemium to work. If not, then Freemium is not for you. You don't even need a fancy calculator for this one. The Formula is simple:

Addressable Market x Reach % x Sign-Up % x 3% =
Potential Paying Customers from Freemium

Here is the example that we'll break down below:

30,000 x 30% x 50% x 3% = ???

Lets look at each element:

Addressable Market: Anyone who might potentially be interested in what you have to offer. To be realistic you should consider actual companies and/or users in this number and not the monetary size of the market. I used the Health Club industry above and in the slide deck so we'll stick with that. In the United States, there are 30,000 health clubs according to an Industry Association.

30,000

Reach %: In the context of SaaS or Web Apps, we'll say this is the percentage of the market that you can actually attract to your website. We'll use some amazingly generous numbers in our math so we can end up dealing with whole, positive numbers. We'll say you have some amazing Rock Star marketing folks who can get 30% of the market to your website, or 9,000 health clubs.

30,000 x 30% = 9,000

Sign-Up %: Of the 30% of the market that you were able to attract to your website, you get your even-more-Rock Star conversion queen to work on the problem of getting them to sign-up for the "Free" part of your Freemium offering. Sure enough, she pulls it off and gets you a sign-up rate of 4,500 health clubs. This is truly amazing.

9,000 x 50% = 4,500

3%: This is the average rate of conversion from Free to Premium for SaaS or B2B Web Apps. You can replace this with whatever number you want, but just keep in mind that 3% is average in B2B SaaS & Web Apps; some do better but many also do worse. This is backed-up by recent industry research from.

4,500 x 3% = *135*

Potential Paying Customers from Freemium: So the answer is, after all of that hard work of getting 30% of the market to visit your site and 50% of those to sign-up for the free version, you are left with only **135** paying customers. ***135***.

From a Revenue Model standpoint, you need figure out how to:
1. Make a ***TON*** of money off of the converted 135
2. Monetize your 4,365 free users (through the other 6 Revenue Streams)

From a Marketing / Business Strategy standpoint, you need to figure out:
1. If you are giving away too much for free (no reason to convert)
2. If you are attracting the wrong users (who will never pay) and if so, why
3. If your users think your product is terrible and are just using it until something better comes along and will never pay you a dime

But overall, the reality of getting 30% of the market to your site and 50% of those to sign-up is a long shot and shows how unrealistic the notion of Freemium is for small industries or niche products. As I said at the Freemium Summit, in these markets, your best bet is to:

Create a solution to a real business problem and charge money for it

Freemium Works better for "narrow band" horizontal products that solve a very specific business problem across all verticals, can leverage a land and expand strategy, can be pulled into a company by the individual users, etc. Think of companies like Yammer, Xobni, Box.net, and YouSendit. These products literally have every business as their possible customers. They have a big enough addressable market to make the formula work, even with realistic reach and sign-up percentages.

Appendix B - The Effect of Freemium on SaaS KPIs

Conversions in the Freemium model, B2B or B2C, are generally quite low, sometimes in the 1% range, and where "really successful" case studies point to 5% monthly conversions (albeit at a super-low price point after 6+ months of active use of the free version[17]), this begs the question:

Does the Customer Acquisition Cost (CAC) go up in a Freemium model? ***Yes!***

Unless the users will only come through word-of-mouth, the cost to support the users is zero, and those users are not part of a scheme to acquire customers, *the CAC will go up*. SaaS vendors must look at conversions and include the acquisition costs for all the "free" users in with the "premium" customers. If it takes 100 users to generate 1 customer, the CAC (one of the Key Performance Indicators - KPIs - used to measure SaaS marketing effectiveness) for that 1 customer includes what it took to acquire the 99 users as well. It is this more accurate CAC number that will be used to figure out the Customer Lifetime Value (LTV).

Standard LTV equation:

LTV = Total Revenue from Customer - Cost of Customer Acquisition - Cost of Serving Customer

This is not as straight forward as it might seem, as there are many elements to consider. First, a user will always have a negative LTV and will add to the overall CAC as they are a marketing expense; they do not generate revenue. If 100% of the customers come in through the same marketing channel and move through Free to get to Premium, it is much easier to get a specific conversion rate and therefore easier to determine an accurate average LTV. This is not always the case, as some will sign-up for the Free version, others will go directly to the premium one, others will churn-out before becoming a premium customer, and yet others will downgrade to lesser tiers or become free users.

It is much easier to do the math if there were 1000 users, 100 converted to being customers, and $100 was spent to acquire and support all 1000 of the users.

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[17] See Appendix E - Freemium Resources for a link to an article on Evernote touting a 5% conversion rate

Which CAC metric is accurate?
$100 / 1000 = $0.10 per user
$100 / 100 = $1.00 per customer

The metric[18] is **Customer** Acquisition Costs, not **User** Acquisition Costs; that $100 was used to acquire 100 customers, regardless of the number of users it brought into the system. The metrics must be examined in the right way to get the true picture. Of course, other expenses that are incurred during the customer acquisition phase, including all marketing and sales expenses, must be included in the CAC calculation as well; especially those costs associated with cultivating users in an attempt to convert.

Does it cost money to send email to the users (through a third-party email service, for example) while they are courted? Sure. Are there any incremental costs associated with provisioning and supporting those users? Add that in, too. Is there a more involved process including salespeople, channel partners, co-marketing, etc. All of this figures into the overall expense associated with ultimately getting that client onboard.

Not all customers are created equal

Another consideration is alternative methods of monetization of users beyond converting them to paying customers. If monetization of users occurs by selling access to their eyeballs to advertisers or aggregating their anonymous data rather than converting them to customers, then they do not have a CAC but are an expense and contribute to the CAC of customers; the advertiser or consumer of the aggregate data. In a situation where there are both application customers and stand-alone customers, each customer will have a CAC figure associated with them; users will figure into those CAC figures as expenses. This can become complex and complicated quickly, but this is really where SaaS gets exciting. It is also why revenue modeling early in the business architecture process is so critical.

[18] This is not accounting advice; seek professional advice regarding proper accounting of expenses and revenue. These statistics are simply used to give executives and investors guidance on how efficiently the SaaS vendor is in acquiring customers on a dollar-basis.

Appendix C - Channels and SaaS

The notion of channels in the distribution of SaaS is a topic with *very little* consensus in the industry. Many people seem to think: "if it's on the web then the web is the channel." This is a very narrow-minded view that can significantly stagnate, if not completely stall, growth. There are industries or market segments where the people making the purchasing decisions do not spend their time searching the web for the best solution. In these cases they turn to *trusted advisors* for recommendations.

Unlike in traditional software where the channel partners had to have some level of technical expertise, with SaaS, that is not the case, significantly expanding the type of company that could fill the role. It is up to the vendor to fully understand the role of intermediaries in their market and how to leverage the existing relationships those third-parties have with their target end-customers.

When considering channels for a SaaS offering, do not focus only on typical technology intermediaries but look to vertical-specific players such as consultancies and Business Process Outsourcers (BPOs), industry and trade associations, or supply chain intermediaries such as freight brokers and food distributors. It is really the technology-centric VARs and SIs that are having the most trouble with SaaS for two reasons: they are misaligned with the SaaS vendors at the business model-level and there is little or no technology to manage. The companies that have traditionally done business through those channels who are moving into SaaS are also having problems figuring out the appropriate way to leverage those relationships.

SaaS vendors need to stop thinking like software companies, and, when it comes to distribution, think more like they are part of a supply chain. The intermediary might "sell" the product to the end-customer, but the SaaS vendor still controls their use of the system. What can the SaaS vendor do to help the intermediary help the end-customer? Can the SaaS vendor help the intermediary make more money, beyond simply selling their solution to the end-customer? SaaS vendors attempting to fit their subscription revenue model into traditional channel relationship are having a hard time attracting intermediaries with purely financial incentives. This is not surprising since it is difficult for SaaS companies to figure out how to compensate their own sales team, let alone how to adequately compensate and motivate channel partners.

Network Effect and Ecosystem, along with Subscription revenue streams can be leveraged in channel distribution deals, with the first two likely being the most lucrative. Freemium can be used quite well when the free product is used to incentivize the end-user to leverage the services of the intermediary, and the SaaS vendor monetizes the relationship with the intermediary rather than the end-user. Like most things, approaching channels in the same way legacy software vendors will cause both the channels and the SaaS vendors to stagnate when the opportunities can be significant.

Appendix D - Customers vs. Users

What is the difference between a User and a Customer, and how is that distinction made in the complex world of SaaS? While this point appears to be a simple one, it seems to cause confusion for many. Adding to the confusion is that every SaaS vendor organizes their access and payer hierarchy differently.

The terms User and Customer are deliberately used, and not interchangeable, as a way to clearly distinguish revenue-generating usage of the system from usage which will not result in direct monetization. It is really very simple:

Customers ***pay*** to access or use the system
Users use the system for ***free***

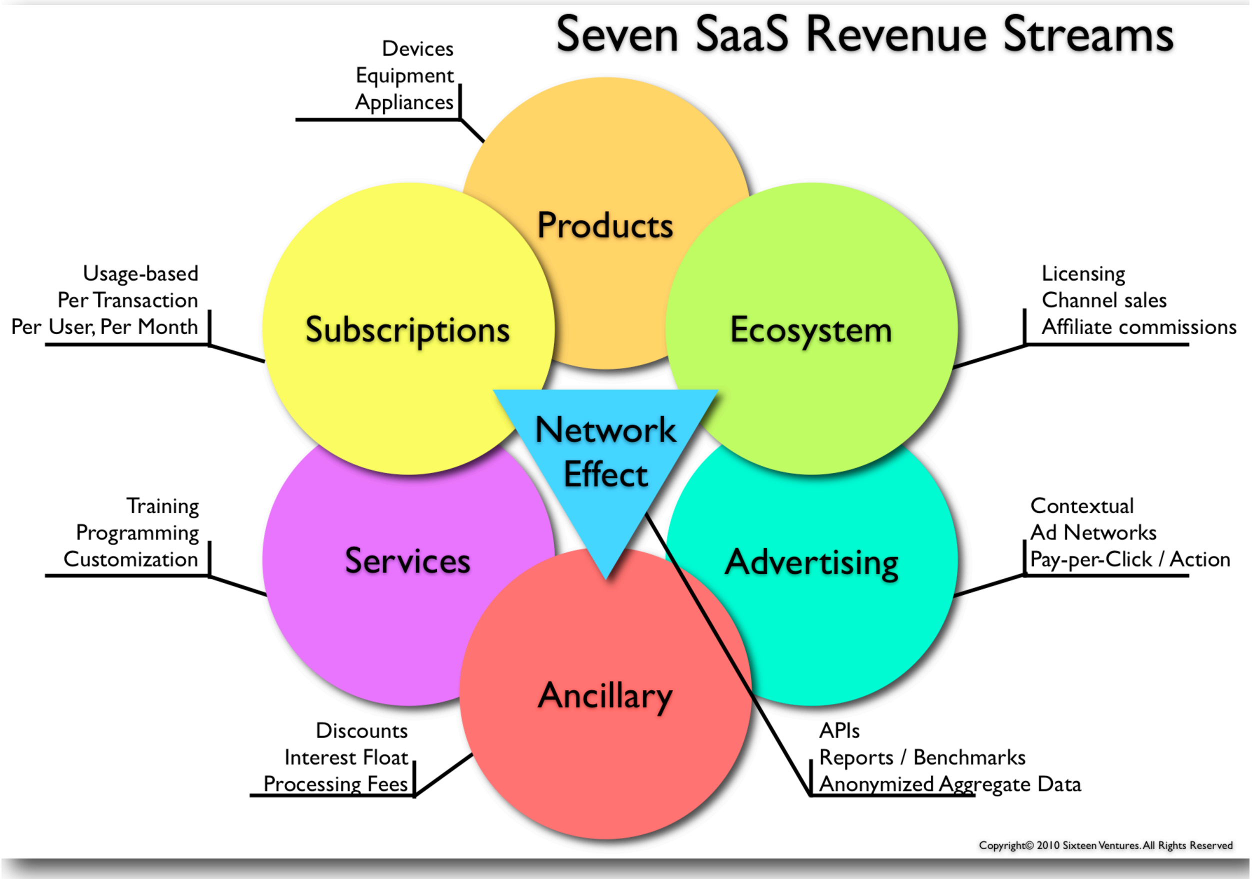
Customers could be individuals or companies. The individual customer will both pay the bill and be the only one that accesses the vendor's system under that account. On the other hand, a company might have 1000s of employees using the system under one account with only one payer. Users could also be individuals or companies, with 1 or 1000s of users, but since there is no payer *they are not customers*.

This distinction is made between application users and application customers, but a SaaS vendor might have customers *beyond* the application. These could include buyers of advertising inventory, anonymous aggregate data, or channel partners paying for access to manage their customers. Unless access to those are given away for free, the consumers of those resources will always be customers.

Clearly delineating free users from paying customers will help the SaaS vendor in understanding who is a drain on precious resources and who is adding value and generating revenue. This is critical in measuring Customer Acquisition Costs and Customer Lifetime Value, two of the key metrics to use to measure success as a SaaS vendor. Free users can help the SaaS vendor generate revenue through indirect monetization (as noted above), but there will always be a customer involved[19] even if the user never becomes a customer themselves.

[19] Revenue can be generated through Ecosystem and Ancillary revenue streams, but those revenue streams often come into play after paying customers are leveraging the system.

Appendix E - The Seven SaaS Revenue Streams



For more information, download the “Seven SaaS Revenue Streams” complete report today!

Appendix E - Freemium Resources

Much has been written, a lot more than is listed here, on the subject of Freemium. These recent articles and posts are great place to start. Read all of these *very carefully (don't just skim)* and most of all, know your market, your product, and your company before jumping into Freemium:

- Biases in Making a Case for Freemium - Iterative Path
- How to create a profitable Freemium startup - Andrew Chen
- Software and Making Money (Presentation Slides Included) - Tony Wright
- Is Your Pricing a Dot or a Triangle? Cindy Alvarez
- Customer Value in the Freemium Model - Marketing Productivity Blog
- 3 key ideas from a recent Freemium dinner conversation - Andrew Chen
- Free financial model for freemium tech startup business - giffconstable.com
- Freemium model for SaaS pricing is broken! Syed Rayhan
- Freemium Business Model | Tyner Blain
- StartupCFO: The cost side of freemium
- The 4 Metrics of User Acquisition and the Customer Bulls Eye - Matt Brezina
- How to make freemium pay | Software as Services - ZDNet.com
- Let's just add in a little virality - Josh Kopelman
- Evernote Reaches Two Million Lifeloggers - Techcrunch - The statistics released by Evernote and published in this Techcrunch article caused a stir as they claimed ~5% conversions from free to paying customers, giving credence to Freemium as a legitimate business model. However, a closer look at the numbers disclosed by Evernote indicates that 1) the 5% conversion is in "users active in the system for at least 6 months" and 2) that only 35,000, or 1.75%, of those 2,000,000 users touted in the Techcrunch article, pay to use the system. This represents an annual revenue of only $1.75 - $2.1M (depending upon the amount paid by customers) after having raised $25M in publicly disclosed funding since Q12006. And this is one of the companies with a "successful" Freemium model.

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- Tim Van Loan, Co-Founder of Recurly (@recurly)
- Clint Wilson, President CNCPartners & Cazoomi.com (@cazoomi)
- Ivan Farneti, Principal at Doughty Hanson Technology Ventures (@ivanfarneti)
- Jeremy Ralph, President, Productivity Design Tools (@PDTiJeremy)
- Michael Dunham, Principal Consultant, Scio Development (@michaeldunham)
- Scott Schnaars, Sales Executive, Socialtext (@schnaars)
- Reuben Swartz, President, Mimiran (@mimiran)

About Sixteen Ventures

Sixteen Ventures is a "sell side" consultancy - we work with SaaS, Web App, Cloud and Mobile App vendors - not customers. We do not work with IT organizations on their Cloud Strategies - we work with the vendors to ensure they get the most out of those Cloud Strategies. Our specialty is Revenue Modeling - developing methods for recurring revenue generation across multiple revenue streams. We consult and educate on Business Strategy, Revenue Model, Distribution & Pricing.

Don't forget - **Pricing is Marketing!** Your pricing must be part of your overall marketing strategy, which must be part of your business strategy. It should not be something that you take lightly or just some arbitrary numbers thrown on a "pricing page."

Need help with your SaaS Pricing Page?

==> Check out the Pricing Page Success Formula video series that will help you ***MASSIVELY IMPROVE*** your sales results or I'll give you your money back! For a very limited time, you can save $100...

About the Author - Lincoln Murphy

My specialty is Revenue Modeling - developing methods for recurring revenue generation across multiple revenue streams - this is especially relevant for companies not looking to directly monetize users (as customers) initially. More than 100 SaaS, Web App and Cloud companies in 14 countries - on every continent except Antarctica - have trusted me and Sixteen Ventures to help them develop their monetization strategies - pricing, distribution & revenue modeling.

These clients have included the biggest SaaS & Legacy Software vendors in the world as well as the smallest early-stage web app startups. We've worked with them all to develop and scale multiple recurring revenue streams and to streamline customer acquisition - including Freemium.

Because of my work on SaaS Revenue Modeling and Pricing, I have been featured in Inc. Magazine, Fast Company, Sandhill.com, Read Write Web, ZDNet and elsewhere. I have also been a speaker at industry events including Softletter's SaaS University, Freemium Summit, SIIA On-Demand, & HostingCon.

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