# Making Freemium Add Up

## An Assessment of Content Monetization

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MIDiA
Insights & Decisions in Action

# About MIDiA Consulting

MIDiA stands for Media Insights & Decisions in Action. Our mission is to help media and technology companies develop purposeful strategies quickly through market understanding, clarity of vision, and workable innovation.

We help media and technology companies make sense of the changes that digital market forces are bringing about. And we help them make profits from digital content.

We are a boutique, media industry focused consultancy that delivers practical, results-driven outcomes.

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# Introduction

The paid content market is finally getting going but it has been a long time in the making. When web business pieced together the remnants of the dotcom bubble, attention naturally shifted to business models that were not beholden to advertising. But Internet users were not ready to cold turkey from free content and most paid content sectors stuttered in the 2000's. Apple's iTunes Store was the key exception and because it drove approximately three quarters of digital music sales, music came to be viewed as the canary in the mine for paid content more generally. It is a rule that is still common intellectual currency, but it is time for a reassessment of music's role in the paid content marketplace. Not just because Apple's unique iTunes ecosystem is not representative of the broader Internet, but also because of the growing success of paid content's *third way*: freemium.

## The Inactive User Challenge

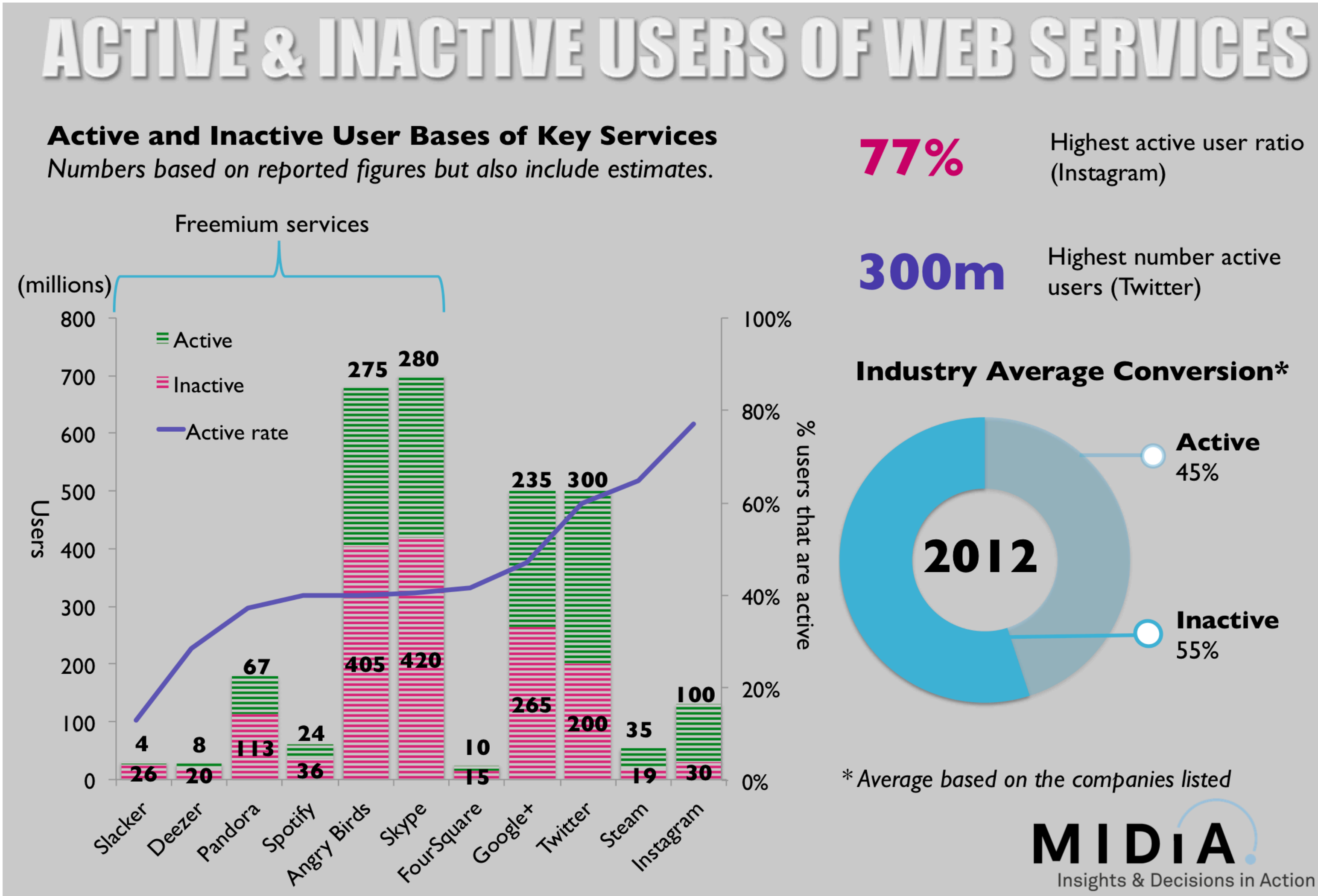
Freemium businesses depend upon harvesting large swathes of users with free tiers and converting sizeable portions of those users to paid products. Spotify, Deezer and others have managed to sign up unprecedented numbers of paid music subscribers with the approach. But the freemium model also results in much larger numbers of users becoming inactive.

This means that there are more dissatisfied, churned out free users than there are active satisfied users. This is a crucial concern for all forms of content because at this comparatively early stage of paid content, word-of-mouth influence is crucial, and right now the numbers suggest there are more net detractors out there than there are net promoters. Not exactly firm foundations for long term growth.

Inactive users though are not just an issue for freemium services, they are a key component of many of the web's most successful consumer businesses that require a user log in, including Internet behemoths like Skype and Facebook. So the problem is not inactive users as a concept, rather how to manage their impact effectively, which raises three key questions:

- What is the optimum active/inactive user rate?
- What is the right strategy for dealing with inactive users?
- How do things differ for freemium services, and why?

To help answer these questions we analysed an intentionally diverse selection of consumer web services, looking at the distribution and scale of their user bases and the relationship of these with their business models.




## Unlocking the Free User Puzzle

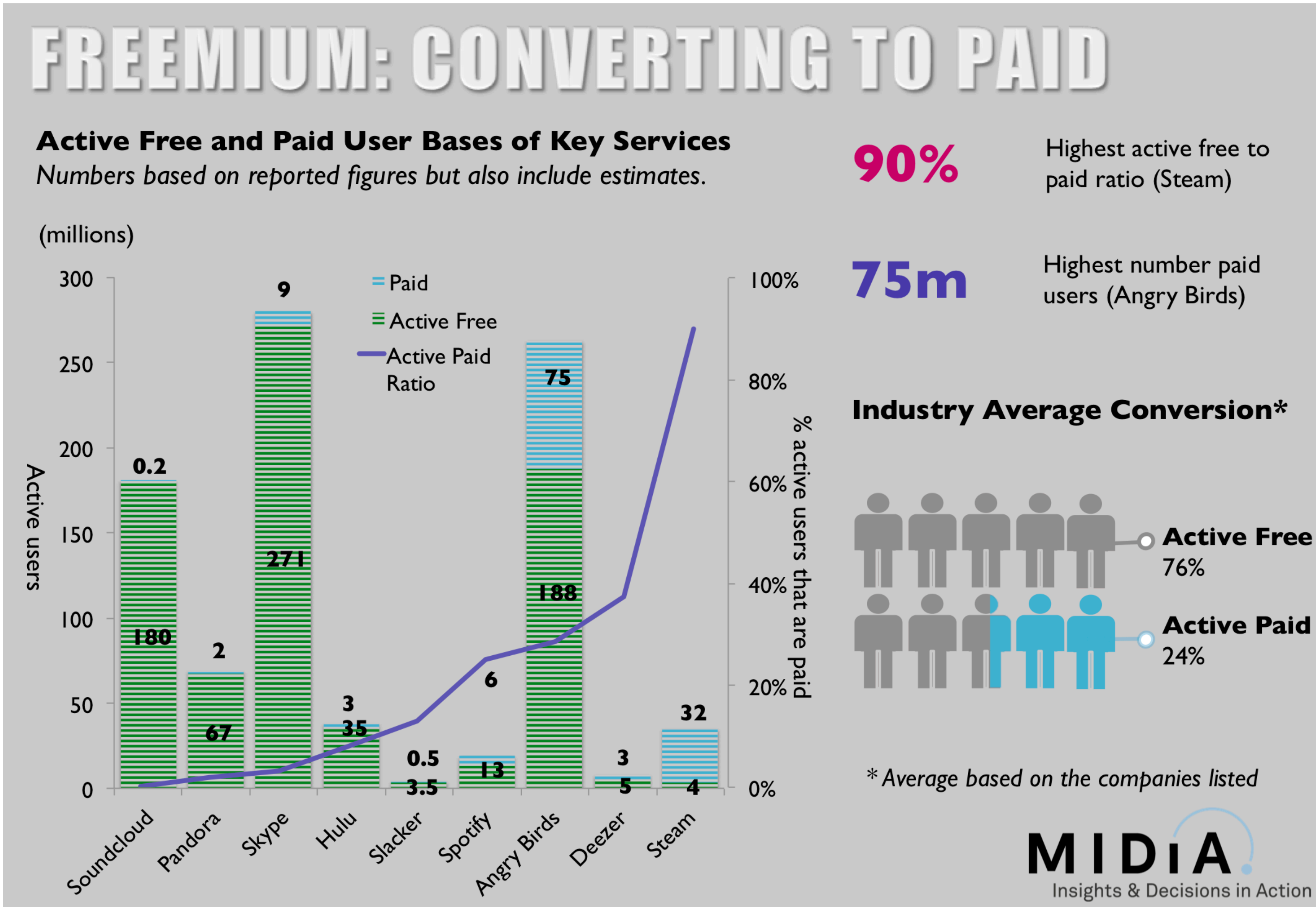
Looking across a selection of leading consumer web services it is clear that there is not a one-size-fits-all rule for active user rates – notes that these numbers include MIDiA estimates - (see figure 1):

- **Active user rates are highest in social services**: in the case of Instagram its registered-to-active user rate is close to 77% of its users are active while for Twitter the rate is 66%, for Google+ it is 47% and FourSquare comes in at 42%.[1] Facebook, a true outlier, is likely to have more than a 90% active user rate, though absence of anything remotely like a recent registered user number makes estimation guess work at best.
- **Freemium services are below average:** all of the tracked freemium services have registered-to-active rates below the 'industry' average rate of 52%. All but two of the freemium services (Slacker and Deezer) have rates between 37% to 40%. [2]

- **Not all active users are created equal:** the distinction between active and inactive is not binary. Some active users can be actually quite passive and not formally 'opting in'. For example an otherwise inactive Spotify user clicking on a stream that appears in his Facebook timeline would become active in doing so but would be highly distinct from a daily user.
- **Content services are smaller scale:** of the content services tracked only Angry Birds nears the massive scale of the social and communication services. This is due in part to Angry Birds being a mobile app, but only in part, because of course all of the other content services listed have mobile apps too.
- **Some services have fewer registered users than active:** for services where user registration is optional active user rates typically exceed registered user rates. For example Hulu has 20 million registered users but 38 million active, while Soundcloud has 38 million registered and 180 million active.

**Key Takeaways:** Inactive users are a key characteristic of all registration based services with free-to-consumer tiers, but the registered-to-active rate is below average for all freemium services. This is because freemium services have to deal with a *double whammy* of inactivity drivers. All services face the challenge of their users simply getting bored with them. But because freemium services have to ensure their free offerings are less compelling than the full fat versions they have to also tolerate users churning out because of dissatisfaction with these scaled-back free tiers.

This does however also translate into unique opportunity for freemium services: inactive users of non-freemium services are usually little more than disinterested consumers, but for freemium services they are also often highly interested customers who simply need hooking up with the right pricing and product**. In short, freemium inactive user bases are priceless qualified marketing lead databases.** The challenge is to separate the wheat from the chaff, to differentiate between disinterested freeloaders and potentially valuable paying customers.




## Converting Free into Paid

For freemium services active user ratios are not an end in themselves but instead a step on the path to converting active free users to paid users. But just as with active user rates, the rates of active users that are paid also vary strongly (see figure 2):

- **Free can be too good:** the four freemium services with the lowest rates of active-to-paid user rates – Soundcloud, (0.1%), Pandora (2%), Skype (3%) and Hulu (8%) – have free tiers that are quite simply good enough for the majority of users, thus reducing the need for many to pay. This is a challenge YouTube will have to address as it introduces premium channels. In the case of Soundcloud the premium tiers are aimed mostly at content creators rather than the much larger base of consumers. For the other three though, it is simply that the free product is so good that the majority of users do not see a reason to upgrade and all three companies have robust business rationale for maintaining this status quo: Pandora and Hulu depend on advertising revenue, while achieving scale and platform reach is key for Skype owners Microsoft.

- **Apps are the mass-market play:** Angry Bird's success has been cited in many a start-up's business plan and although it is a far from typical app story, it nonetheless indicates the capabilities of mobile apps. With approximately 75 million paid users (note the number of paid for apps is higher but includes multiple purchases per individual) Angry Birds illustrates that it is easiest to reach the largest number of paying consumers by charging a small one-off fee.
- **Spotify and Deezer have hit a sweet spot:** although Steam's c.90% active-to-paid rate is hugely impressive, the fact it is predominately a digital retail store makes direct comparisons with pure freemium services problematic.[3] Once the Steam outlier is removed, Spotify and Deezer's 32% and 38% paid user ratios emerge as markedly successful, a solid balance between compelling free tiers and *better enough* paid tiers.
- **Pricing is key:** if the gap from free to paid is high, a significant leap of faith is required from the user. Whereas the gap from zero to $0.99 for Angry Birds free to paid is a modest step, from zero to $9.99 for Spotify or Deezer portable is a much more sizeable hurdle. Thus converting to paid for music subscription services is a more sizeable achievement than for low priced gaming apps. The other consequence is much higher ARPU and pay outs, with Spotify alone set to pay $500 million to rights holders in 2013.

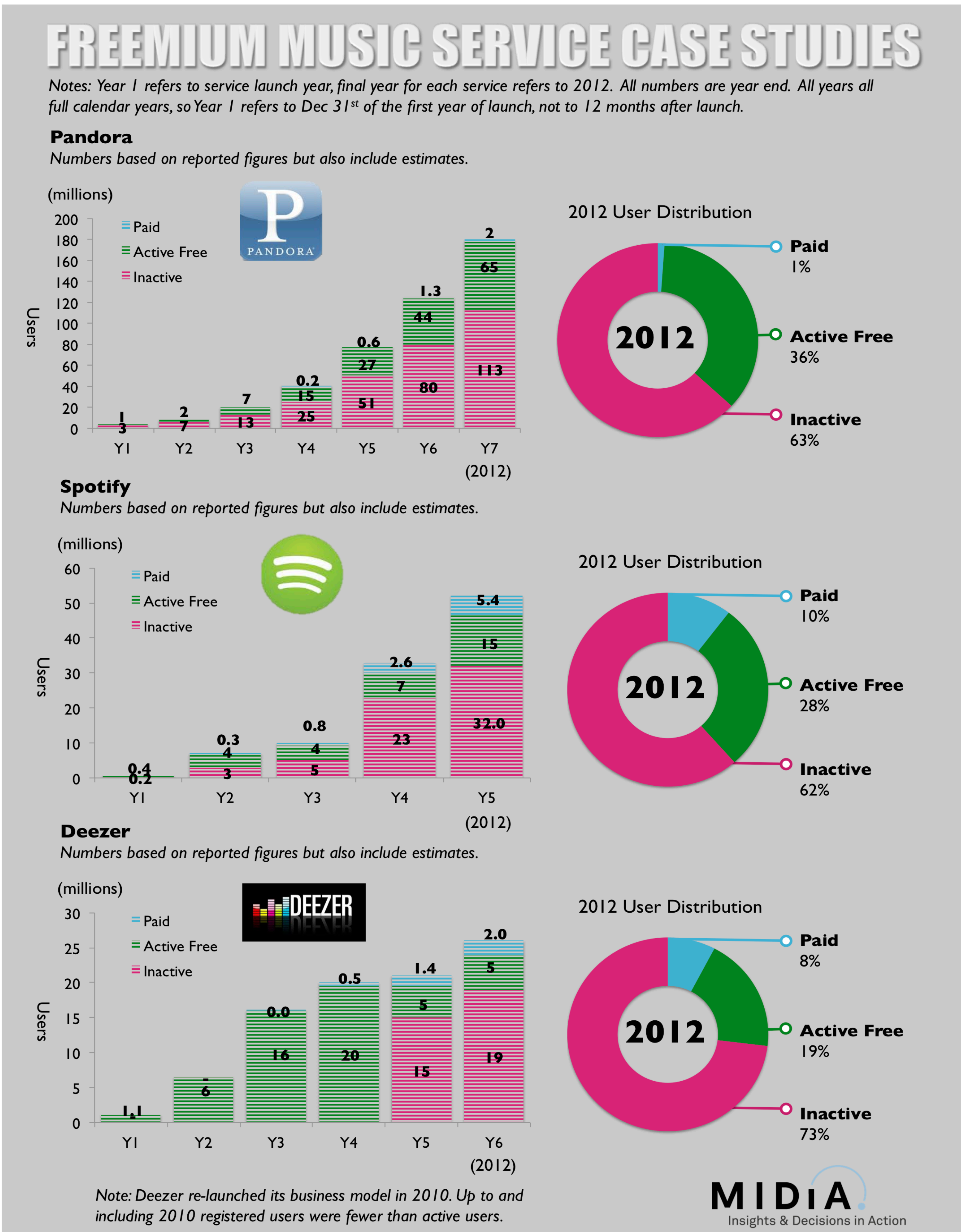
**Key Takeaways:** Some services can afford to have their free tiers effectively prosper at the expense of paid tiers, using free as an aggressive land grab tactic with business models – usually advertising, but not always - designed to shoulder the burden of free users. In effect these are *welfare state* freemium services. But Spotify and Deezer's commercial structures are not designed to support vast swathes of freeloaders in perpetuity. Instead they pursue a *welfare-to-work* approach aimed at converting free to paid.

## Lessons From Music's Freemium Trailblazers

Music services have set the pace in freemium strategy but a closer look at three of the most prominent services reveals that even within the music niche, approaches and metrics vary strongly:

- **Pandora:** launched in November 2005 Pandora was far from an overnight success story but went on to become a genuine digital music powerhouse. The growth catalyst was Pandora's iPhone app. Launched in July 2008, within one year the app accounted for 60% of Pandora's 10 million active users. Prior to the iPhone app Pandora's total active user rate hovered a little above the 20% mark, since it has averaged 26%. Unlike subscription services Spotify and Deezer, advertising is Pandora's predominate business model so its 3% active-to-paid user rate is not a key business metric. Which of course makes the active user rate even more important to Pandora's business.
- **Spotify:** launched in November 2008, Spotify found quick success as a free music service, hitting 6 million users within 11 months of launch. Spotify had however already flicked the switch on its premium business, reaching close to 40,000 paying subscribers in May 2009. Smartphones proved as crucial to Spotify's paid user metrics as they did to Pandora's active user rates. By the end of 2010 (Y3), 16 months after launching its iPhone app, Spotify was nearing 1 million paying subscribers, giving it a 12% active-to-paid rate. By the end of 2012 it was at just over 5 million paid users representing a 28% active-to-paid rate. Over the same period Spotify's registered-to-active user rate declined from 38% to 28%, reflecting Spotify's increasing aggressive growth strategy and the widening of its customer acquisition funnel. But just as Pandora's active-to-paid ratio is less important to its business than the registered-to-active ratio, the mirror opposite is true for Spotify. Paid users conversion is Spotify's predominate objective.
- **Deezer**: although launched in 2007, Deezer's business only acquired its current shape when it pivoted towards a premium

subscription business positioning in 2010. Prior to that Deezer's active users actually outnumbered its registered users. Following the pivot Deezer's user numbers quickly came to more closely resemble those of Spotify. By the end of 2012 (Y5) Deezer had a registered-to-active user rate of 19% and an active-to-paid rate of 28%.



## Conclusions

- **Social and communication services are well embedded:** inactive users are a challenge for all web services with free offerings, but inactivity rates vary markedly. With the exception of Steam, a clear demarcation exists between higher registered-to-active rate social and communication services on one side and lower registered-to-active rate content services on the other. Social tools like Facebook, Google+, Instagram and Twitter gained success by becoming an integral part of their users' regular digital lives. Content services though have an inherently tighter focus and often compete head on with already established free alternatives.
- **Churn risk determines inactivity levels:** Angry Birds and Steam are genuine 21st century content providers, delivering scarce content that only exists for digital technology. Music services by contrast, deliver content designed for analogue devices into digital experiences. A static audio file, streamed or downloaded, leaves most of the functionality of smartphones and tablets untouched. Music is also an abundant commodity. This matters because it means that the 'churn risk' for a music consumer is much higher than for a gamer. A music service user risks little by churning because he can still easily get all the same music elsewhere if he cancels his Spotify subscription. But if you stop playing Angry Birds you'll find few other places where you can hurl bad tempered feathered missiles at egg-stealing green pigs. Similarly churning out of a social network carries a high 'churn risk' for consumers as they will weaken their ability to connect with extended social circles online.
- **Lower active rates correlate with higher paid rates:** music services may have the lowest registered-to-active rates but they also have the highest active-to-paid rates. This underscores the value of casting the initial net wide and also indicates that users that remain active are highly valuable and engaged. Thus music services like Spotify and Deezer appear to have hit upon optimal performance rates for converting free users to paid.

- **Churned out users represent a market risk factor:** there are multiple reasons why free users become inactive, such as not getting enough of a taste of the offering to get hooked, and becoming frustrated with the usage limits of free tiers. To some degree the latter acts as a natural filter, churning out low value customers who have little will or ability to pay and are likely to only ever be a cost to the bottom line. But the risk is that these consumers churn out as net detractors, criticizing the service rather than advocating it. This is a big risk in the early stages of new markets, which is exactly where music and paid content as a whole are now. More needs to be done to ensure churned out users leave on positive terms.
- **The free-to-paid divide needs narrowing:** zero to $9.99 for streaming music on a phone is too great a leap. More needs to be done to bridge the divide. This can be achieved in two key ways:
  1) 3rd party partnerships where some or all of the price is subsidized for a period of time e.g. telco bundles
  2) innovative pricing and packaging where smaller versions of products are made available at cheaper rates e.g. $3.99 for 20 hours of mobile streaming.
  In both instances caution is key. Partner too aggressively and consumers will learn to expect a service should be free. Price too competitively and users will downgrade to cheaper tiers.

Freemium services pin their success on the drug dealer's adage that 'the first hit is always free'. But what is clear is that it can take some time for consumers to get hooked on free content services. There is not a single optimum set of rates for freemium services but what is clear is that the broader picture painted by multiple metrics is crucial for understanding how successful a service might, or might not, be. Registered-to-active rates are just part of the equation, just as active-to-paid user rates are. Questions about the commercial sustainability of the freemium model remain but as long as the key players retain the cash commitment and strategic willingness to experiment with the model, the paid content sector will continue to edge further forwards to sustainability.

# Notes

1 Instagram's exact active user ratio is elusive as the company recently started 'being creative' with its reporting metrics.

2 Although Valve's online gaming platform Steam has an impressive 65% registered-to-active rate it is more a digital retail store than it is a content destination.

3 Though technically a freemium service having recently launched some free games and tiers, Steam's true heritage and core focus are digital retail.

# Appendix

## KEY CONSUMER SERVICES METRICS

*Notes: Numbers based on reported figures but also include MIDiA estimates. Latest numbers used when available, else year-end 2012*

| | Registered | Inactive | Active | Active Free | Paid |
|---|---|---|---|---|---|
| **Skype** | 700 | 420 | 280 | 271 | 9 |
| **Angry Birds** | 680 | 417 | 263 | 188 | 75 |
| **Google+** | 500 | 265 | 235 | 235 | - |
| **Twitter** | 500 | 200 | 300 | 300 | - |
| **Pandora** | 180 | 113 | 67 | 66 | 2 |
| **Instagram** | 130 | 30 | 100 | 100 | - |
| **Soundcloud** | 38 | - | 180 | 180 | 0 |
| **Spotify** | 60 | 36 | 24 | 18 | 6 |
| **Steam** | 54 | 19 | 35 | 4 | 32 |
| **Slacker** | 30 | 26 | 4 | 4 | 1 |
| **Deezer** | 28 | 20 | 8 | 5 | 3 |
| **FourSquare** | 25 | 15 | 10 | 10 | - |
| **Hulu** | 20 | - | 38 | 35 | 3 |

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# About the author

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Mark Mulligan is the co-founder of MIDiA Consulting and is a digital business strategist with 15 years of analysis, consulting and management experience, with a proven record in strategy, thought leadership and business development.

For 11 years Mark was a Vice President and Research Director at Jupiter Research and then Forrester Research, where he led research and analysis into how technology shapes media businesses and the consumer. Mark works right across digital value chains helping media, technology, telco and software companies harness disruption and innovation to pursue disruptive renewal strategies.

Mark provides expertise and insight including: strategic analysis, competitive market assessment, consumer insight and segmentation, user experience and user journey assessment, and product strategy.

Mark additionally works in an advisory and non-executive capacity with a number of early stage start-ups.

Mark is a widely recognized authority on the digital music market and maintains the industry leading Music Industry Blog which counts dozens of CEOs among its regular readership: http://musicindustryblog.wordpress.com/

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