

Under the Buzz **NUGGETS**



Commentary on Business Strategy for Tech Company Executives & Professionals

Vol. 12, Number 4 – Sept 30, 2011

Under the Buzz is an email "viewsletter" published by Philip Lay, managing director at TCG Advisors, a Silicon Valley-based firm that helps executive teams in tech companies to deal with complex strategic, organizational, and operational challenges. Now in its twelfth year, this journal is published periodically and delivered free to subscribers via email on an opt-in basis. It is also posted on TCG Advisors' website, <http://www.tcg-advisors.com/Library/utb/utb.htm>, where back issues are also available.

1. The Engagement Imperative *How to make the freemium model go viral*

With the return to relatively favorable market conditions for IPOs and acquisition during 2011, boards and CEOs of private tech companies have become highly motivated to hone their business credentials and thus take advantage of the new IPO "window" that LinkedIn and a few others helped to open earlier this year. Unless, that is, the recent spate of volatility in global equity markets puts a stop to IPOs once again. Box.Net, DropBox, Evernote, Facebook, Groupon, YouSendIt, Zynga, a host of mobile app vendors and others that operate some version of a freemium business model are, at least in theory, candidates for successful launches onto the public market.

Now the skeptics among us are definitely thinking "What is the difference between Facebook and YouSendIt in 2011 and AOL and Socks.com in 2000?" Back then, companies were getting massive buzz and market cap based on "capturing eyeballs". That is, accumulating unique visitors/customers for future monetization. They traded on potential rather than actual financial results. Wall Street was convinced there were "new rules". It looked to some of the more inebriated among us that the Nasdaq might even pass the DOW Jones Industrial Average. Those times passed pretty quickly. So what is different this time? Well, great hopes are resting on the Freemium business model which has been tested by many internet companies during the past decade or so.

After working with a number of these companies my colleagues and I have developed a "four-gear" model that we believe provides a framework for companies like these to accelerate their

revenue growth and thus create the option of a successful IPO or a high-value acquisition based not only on their popularity but on emerging evidence of long-term financial viability. For example, one of the notable aspects of LinkedIn's successful and much-watched IPO was that over the prior eight years of its existence the company had managed to develop three revenue streams, the most commented-on one being its relatively recent and now fastest-growing corporate recruiting services.

The freemium model stands out in this analysis because, as implied by the term, these businesses usually start by building a business based on providing their services for "free", at a time when their main focus is on acquiring large numbers of visitors, and later registered users who return to the site repeatedly for higher value services. After they have built some degree of critical mass, and in the process attracted some paying customers, as well as investors, partners, and the press, they then turn their attention to converting some of these users into paying customers while continuing to attract new users. At this point, in addition to metrics such as the number of unique monthly visitors, page views, registered users, and other similar business metrics, they begin to focus on tracking more closely the number of paying customers, average-price-paid-per-user, the rate of up-sell to higher-priced consumption tiers, renewal and attrition rates, and so on.

Furthermore, as they discover – via user analytics or even by accident - that hundreds and even thousands of their users work in the same company or government agency, they set up a corporate sales force to manage accounts and negotiate contracts on an organization-wide basis. This has been the case with DropBox, Evernote, Facebook, Yammer, YouSendIt, among others. In the cases of Jive and Box.net as well as Salesforce.com before them, each has begun with a B2B focus, building a direct sales force (inside and/or outside) and generally charging every user, often not using freemium pricing.

The latest version of our model for advising internet companies on how to build a sustainable online freemium-based business today has now evolved from an earlier two-step *Acquisition-to-Monetization* model to a four-gear strategy in which the critical gear to apply is often the third one, *Engagement*. If companies are able to engage their users and paying customers in compelling ways, and to continually refine their engagement programs, the eventual reward can be to achieve significant *virality*, as users beget users, and so on. Now that the freemium business model has established itself as the most frequently used pricing approach by hundreds of pre-IPO internet companies including iPhone/iPad/Android app developers as well as other cloud-based application or infrastructure vendors, it is critical for the entrepreneurs and executives in these companies to adopt a more persistent and creative *engagement* strategy aimed at solidifying the initial demand they have created among end-users into persistent, growing, profitable utilization. Before we forget to point it out, freemium frequently lives side-by-side with advertising-paid revenue generation as is the case with LinkedIn and many other companies, though of course it can be implemented on its own as is more likely to be the case with products and services targeted at business customers.

Without a strong and persistent engagement strategy, companies can fall victim to any number of sins that might trip them up along the way to a successful IPO or an exit via acquisition. Remember how Facebook provoked the ire of its users with Beacon, the ad-based business they started 3-4 years ago without properly considering how zealously their users protect their privacy? Or, consider how YouTube has struggled to build a profitable business despite its massive, "primal" adoption by hundreds of millions of enthusiastic users. Or, even more

disturbingly to the investors (except perhaps Microsoft), how Skype won the acquisition battle with its powerful network effects, resulting in 600m+ users, but has yet to engage its users in the notion of paying for its services to a degree where the company actually turns a profit. There is no lack of examples today of what “premature monetization” – i.e., trying to monetize “eyeballs” without considering how to turn users into persistent customers, in the process suffering an unacceptable rate of attrition as users discover competing services that offer an acceptable (or superior) user experience for less or no money.

Let’s take a look at the four-gear strategy that we have surmised as best practices from the many cases that have passed our eyes in recent years:

Four-Gear Model

1. Acquisition – Whereby the company “acquires” users, who begin to use their services and in the process provide usage data and even feedback that help the company build out a portfolio of products/services over time.
2. Engagement – Whereby the company develops strong user loyalty by becoming hardwired into users’ workflows and habits, and continually finding new ways to keep users coming back rather than get distracted by the latest flashy competitor.
3. Monetization – Whereby they proceed to the “mium” part of the freemium model, transforming users and even companies into paying customers and thus earn fees for the premium services they provide.
4. Virality: Whereby they achieve degrees of entrenchment against competitors through the virtuous cycle in which “satisfied users beget even more users”, or in other words, self-reinforcing network effects. In some cases – in fact, in the most successful companies – developers are attracted to build products on the newly powerful company’s “platform” because of its powerful position in the category, and successful developers beget more developers, which attract more users and customers, and so on.

Cardinal Sin to Avoid

Throughout the execution of the four gears, it is important to avoid committing the sin we alluded to earlier - i.e., *jumping too quickly from Acquisition to Monetization, without focusing sufficiently on different ways of creating sustained Engagement*. You can tell this is happening when as a prosumer or consumer you suddenly start receiving a bombardment of daily or weekly emails urging you to sign up for a “new” or “improved” service as part of a “limited-time promotion” that often becomes open-ended. Often, this is a sign that the board and/or management team have become impatient to achieve sufficient revenue growth to attract the attention of securities analysts and public investors, and have therefore decided to accelerate the monetization gear in readiness for an IPO or to lead to an acquisition. It is also a sign of the urge for instant gratification winning out over thoughtful strategy.

Racing to monetize without first building sustainable Engagement can violate the end-user’s expectations of value vs. cost, thus lowering a company’s defenses against competitors that provide a more comfortable and less invasive user/customer experience. In turn, this error tends to increase user attrition (or reduce usage in other ways) and thus slows down the company’s growth and attractiveness to public-market and even private investors.

Thus Engagement, frequently the most neglected of the four gears, is probably the one that requires the deepest thinking and the strongest commitment in terms of user and customer relationship management. Today, there are a variety of marketing mechanisms to use in order to strengthen customer commitments to the company's services, from creative use of social media and collaboration tools such as Twitter (including Re-tweeting), Facebook, Tumblr (blogging and marketing campaign service), Chatter (especially if you are a Salesforce.com customer), Huddle, Jive, or Yammer. Basic moves can also be helpful, such as smartening up the company web site, organizing it to address the needs of different types of customer (for example, corporate vs. small business vs. prosumer vs. consumer) with different offers.

Other ways of engaging users might include the use of behavioral targeting, a la Amazon, Netflix, and OpenTable, that have developed refined recommendation engines for bringing books, movies, music, or restaurants to the attention of users who have previously bought or consumed a "similar" product or service in the past. Social media sites such as Twitter or Facebook can be used to market products or services that a user's friends or business associates have bought. User-generated content in blogposts, chat forums, and video or photo-sharing sites, can also be highly engaging. Videos or animation 3D animation can also bring to life, for example, health conditions or exercise regimens in an informative and engaging way, and use-case templates or best-practice guides can add appeal to a generic service. Making your application accessible on every mobile device, especially smart-phones and tablets, to provide alerts – including location-based and other services – and enable users to respond, is also becoming an increasingly expected means of interacting with your customers.

In summary, even if your company has established a high degree of virality, you still need to invest creativity and resources in strengthening the level of engagement on the part of your most important users and paying customers. Otherwise, today's engaged user can be attracted to the latest sexy or no-priced offer.

This article was authored by Philip Lay, managing director at TCG Advisors.

Under the Buzz offers commentary on strategic and operational issues facing technology companies and executives. The goal is to provide provocative insights into the latest events and thinking shaping this continually evolving sector. © 2011 - Philip Lay

Disclosure: From time to time, the author and/or his firm may hold investments in, or provide advisory services to, companies cited in this journal.