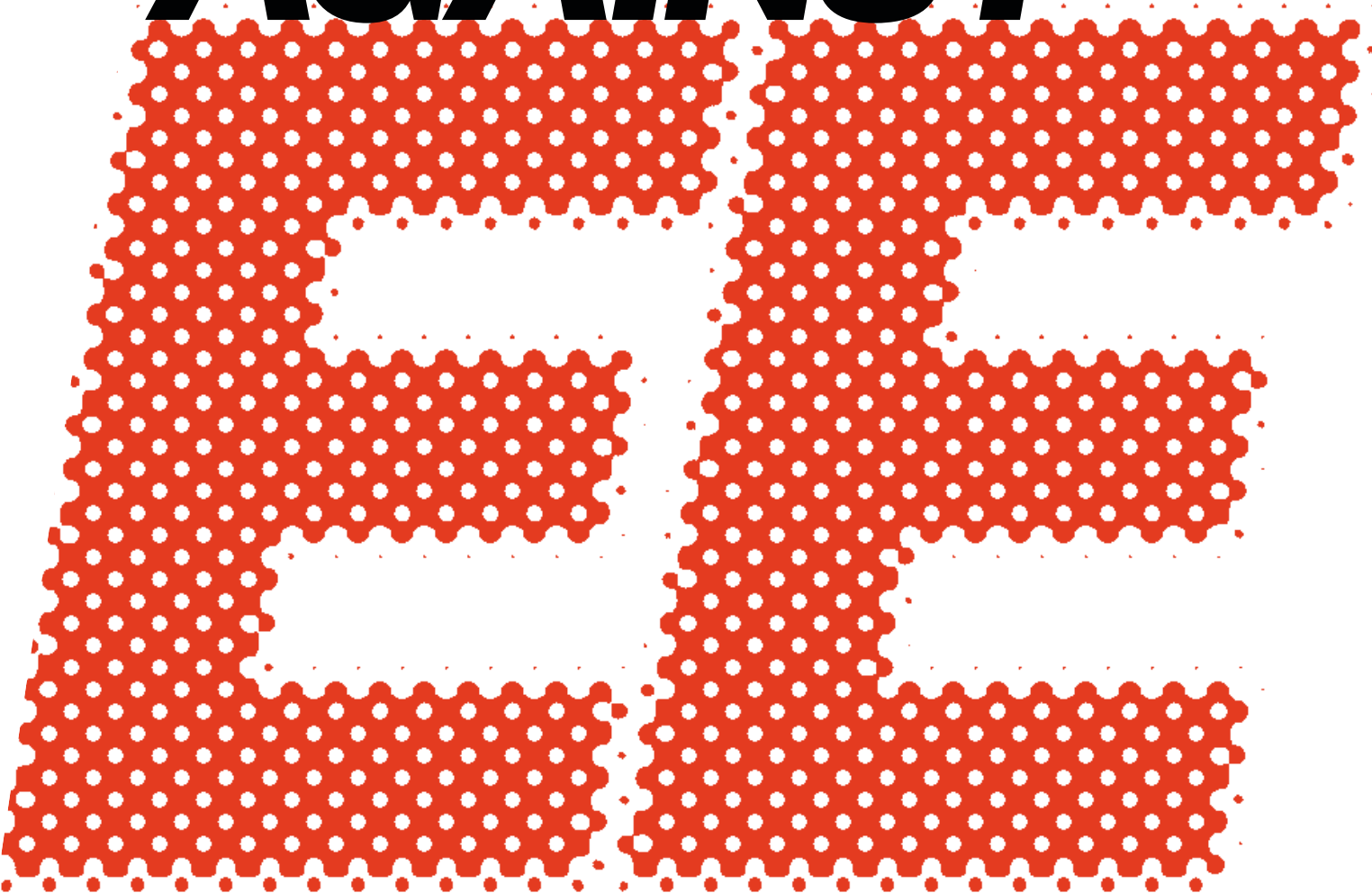

COMPETING



*FREE OFFERINGS ARE RAPIDLY SPREADING BEYOND
ONLINE MARKETS TO THE PHYSICAL WORLD.
HERE'S HOW INCUMBENTS CAN FIGHT BACK.*

BY DAVID J. BRYCE, JEFFREY H. DYER, AND NILE W. HATCH

AGAINST



A new competitor enters your market and offers a product very similar to yours but with one key difference: It's free. Do you ignore it, hoping that your customers won't defect or the free product won't last? Or do you rapidly introduce a free product of your own in an attempt to quash the threat? These are questions faced by an increasing number of companies—and not just in the digital realm. The “free” business models popularized by companies such as Google, Adobe, and Mozilla are spreading to

markets in the physical world, from pharmaceuticals to airlines to automobiles.

How should established companies respond? Clearly, managers are having difficulty figuring this out. For the past five years, we have been studying how incumbents have dealt with competitors employing free business models in a variety of product markets. (See the sidebar “About the Research.”) We have found no examples of companies in the non-digital realm that have prevailed against rivals with free offerings. In fact, in two-thirds of the battles that

have progressed far enough to be judged, incumbents (both digital and physical) made the wrong choice. In a handful of instances, companies that should not have taken action did so immediately by introducing their own free offering—hurting their revenues and profitability. They should have either waited and allowed the attacker to self-destruct or recognized that the two could peacefully coexist.

More commonly, companies that should have taken action didn't do so quickly enough or at all. Surprisingly, these included incumbents that had identified a genuine threat from a new entrant and had all the weapons they needed to win a head-to-head battle: an established customer base, superior product features, a strong reputation, and abundant financial resources.

Why didn't these companies use their formidable assets to fend off free-product competitors? The answer is so obvious that you've probably guessed it: Managers were reluctant to abandon an existing business model that was generating healthy revenues

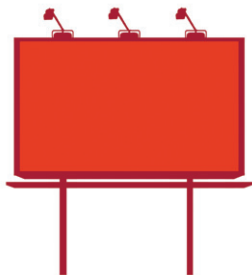
a third party that will pay for access to their users. So it's crucial to determine if the competitor's free offering is generating revenue in some way. Of course, some companies may have enough funding to wait a year or more before they need to monetize their user base. (For example, Skype offered its free phone service for a year before it introduced SkypeOut, a paid service for calling landlines from a computer.) But this scenario can actually benefit an incumbent by giving it time to assess the potential of the model and decide whether to launch its own free product.

We learned that an entrant will usually find a way to turn users into revenue-generating customers if its user base is growing rapidly or if the incumbent's paying customers are defecting to the free offering at a high rate. What rates signal danger? Our examination of the dynamics in a number of markets suggests that if the free offering's user base is growing by 40% or more a year (meaning that it will at least double every two years) or your customer defection rate is 5% or more a year (meaning that you stand to lose at least 25% of your customers within five years), serious trouble may be looming. As the matrix "How Big a Threat Is 'Free' Competition?" shows, assessing those rates (or reasonable estimates of them) helps a company determine the level of threat from the free product and respond accordingly.

Choosing Whether and When to Respond

When both rates mentioned above are high, the entrant represents a *business model* threat. Most established companies must not only respond with a free offering but also radically change their business model to survive. And they need to do so pretty quickly—within two or three years. Many newspapers competing against online rivals that offer free classified advertising or editorial content are in this quadrant. They will continue to deteriorate sharply without a fundamental rethinking of their business model.

Fortunately for incumbents, most threats wind up in one of the other quadrants, which means there may be more time to respond. When the entrant's users are multiplying rapidly but the established firm's customers are defecting slowly, the entrant represents a *delayed* threat. This means the free product or service is attracting either customers from other established competitors or brand-new users. In such cases, your offering can coexist with the free one for at least a few years—especially if yours is targeting



Even companies with formidable assets are slow to fend off free-product competitors. The reason: the ubiquity of the profit-center structure and mind-set.

and profits. But if the answer is obvious, why did managers make this mistake? The reason is the ubiquity of the profit-center structure and mind-set. Drawing from our research on free offerings in online and physical markets, we explore in this article how to assess whether the introduction of a free product or service in your market is a threat and how to overcome the profit-center challenge.

Assessing the Threat

The seriousness of the threat posed by a new entrant hinges on three factors: the entrant's ability to cover its costs quickly enough, the rate at which the number of users of the free offering is growing, and the speed with which your paying customers are defecting.

Some new competitors self-destruct because they can't convert nonpaying customers into paying ones fast enough to cover costs or because they can't find

Idea in Brief

Business models that involve offering a product or service for free and making money in other ways are spreading beyond the digital realm. But managers of threatened companies are having difficulty figuring out how to respond: An ongoing study has found that some companies respond too quickly but most don't do so quickly enough—even when they have sufficient resources.

To assess the threat, incumbents should consider the entrant's ability to cover its costs quickly enough, the rate at which the number of users of the free offering is growing, and the speed with which paying customers are defecting.

A bigger challenge is overcoming the ubiquitous profit-

center structure, which discourages managers from giving away offerings. The remedy is to move P&L responsibility to a senior management group and to assign revenue stream and cost management oversight to separate lower-level groups.

premium segments. This is the situation that Microsoft finds itself in with its Office software: Because of the high switching costs, most current enterprise users aren't defecting, but new users—college students, small businesses, and educational institutions—are increasingly using Google Docs and Oracle's Open Office, both of which are free. (See the sidebar "Why Microsoft Should Take Its 'Free' Competition More Seriously.")

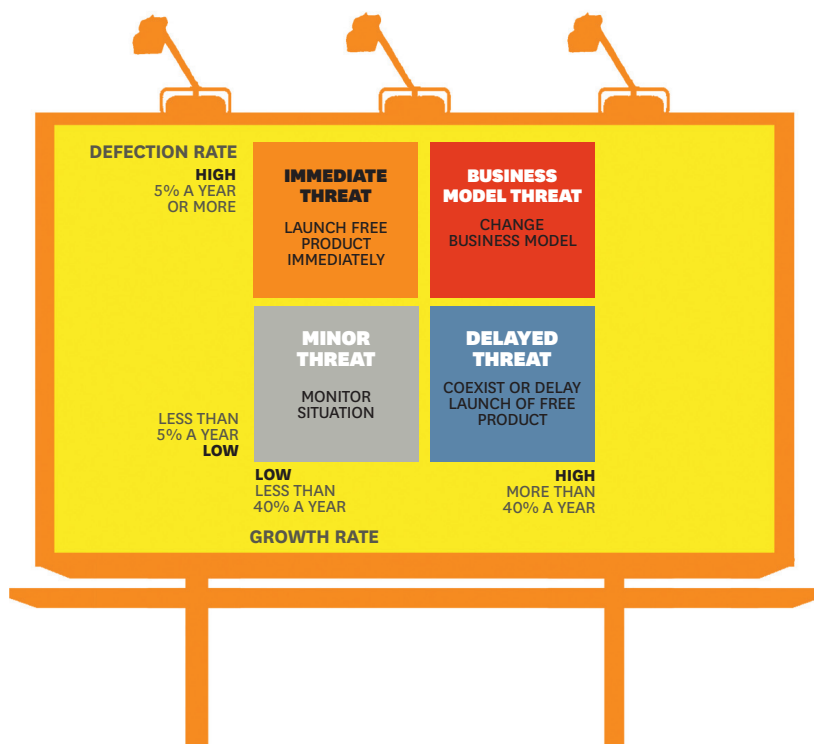
The trick for incumbents facing delayed threats is figuring out exactly when to respond with either a free version of the existing offering or a new free product that appeals to new users. Responding sooner rather than later allows an incumbent to beat back the entrant and probably won't significantly hurt existing sales (because established customers

are switching slowly). As soon as the entrant's users are in the millions, however, the incumbent must respond—as Intuit did when it acquired upstart Mint.com for \$170 million in 2009, eliminating a threat to its Quicken personal finance software and gaining a free online product. (Mint.com had attracted more than 2 million users in just three years.)

When the defection rate among your paying customers is high and the growth rate of the entrant's users is low, the threat is obviously *immediate* because your revenues are rapidly eroding. Even though the free offering has not yet attracted a large following, it's a problem for you and demands a prompt response. It also suggests that you are overserving your customers and thereby inviting disruption. You must quickly figure out a way to launch a free offering.

Finally, when both rates are low, the threat is *minor*. In these cases, the incumbent should continue to monitor the situation.

HOW BIG A THREAT IS "FREE" COMPETITION?



Offer a Better Free

If you've established that free offerings are a threat to your business and have considered the timing of your response, the next step is to figure out *how* to respond. Most incumbents can successfully counterattack by unleashing their arsenal of weapons, which typically includes a large base of users or customers who have made investments in learning how to use the product, advanced technical know-how, substantial brand equity, significant financial resources, knowledge of the market, and access to important distribution and marketing channels. Incumbents can use those assets to introduce a better free product and to employ some tried-and-true sales and pricing strategies to generate revenues and profits: up-selling, cross-selling, selling access to customers, and bundling the free product with paid offerings. (See the sidebar "Four Tried-and-True Strategies.")

Yet, as we mentioned above, incumbents often fail to counterattack. A widely known case in point is the reluctance of almost all major newspapers in the United States to embrace a free business model when Craigslist attacked their profitable classified-ads business. According to our research, Salt Lake City is the only top 50 U.S. metropolitan market for classified ads that is not dominated by Craigslist. The reason? Deseret Media (which includes the *Deseret News*, KSL TV, and KSL NewsRadio) responded quickly to the business model threat by launching its own free classifieds site and making other significant changes. The site, ksl.com, is better developed and easier to navigate than Craigslist, and it leveraged the established KSL brand to attract classified ads.

Deseret Media quickly benefited from network effects: More buyers went to ksl.com than to Craigslist because more sellers were posting there. The site generates revenue by charging advertisers that

COMPANIES THAT PREVAILED

Personal finance software company **Intuit** responded to the threat from free rival Mint.com by purchasing the company. Mint.com, which makes money by selling access to its user base, lets Intuit maintain a free offering separate from its popular Quicken product.

Yahoo, the leading provider of free e-mail, responded to Google's entry by matching, and then exceeding, Gmail's free storage offer.

want to post regular ads as well as classified sellers who want preferred positions. The site's profits now exceed those of the traditional businesses, including the newspaper.

Meanwhile, Deseret Media has changed the newspaper's business model by cutting nearly half its staff and crowdsourcing some of its content. In 2010, the paper increased its print and online audience by 15%, the second-highest growth rate in the industry. Overall, Deseret Media is thriving.

Yahoo is another example of an incumbent that prevailed by introducing a better free product. In 2004, Google launched its free Gmail service, which provided 10 times more storage than Yahoo, the leading provider of free e-mail at the time. As a new entrant, Google could afford to offer significantly more storage because it had relatively few users. A Google executive told us, "We don't do something unless it is an order of magnitude better—maybe five to 10

Four Tried-and-True Strategies

1. UP-SELL

Introduce a free basic offering to gain widespread use and then charge for a premium version.

REQUIREMENTS

- A free product that appeals to a very large user base so that even a low conversion rate of users to paying customers will generate substantial revenues **or**
- A high percentage of users willing to pay for the premium version

EXAMPLES Virtually every iPhone app uses this strategy. One tactic is to offer a free version of the product to consumers and a premium version to the business market, as Adobe does with its Reader software.

Skype, which offers free computer-to-computer calls and charges for add-ons, succeeds with up-selling because it has more than 400 million users, many of whom become paying customers. Flickr, the free photo-sharing site, has a much smaller user base and a low conversion rate. That explains why eBay paid \$2.6 billion for Skype, and Yahoo paid less than \$30 million for Flickr.

2. CROSS-SELL

Sell other products that are not directly tied to the free product.

REQUIREMENTS

- A broad product line—preferably one that complements the free product—**or**
- The ability through partnerships to sell a broad line of products to users of the free product

EXAMPLES Ryanair offers roughly 25% of its airline seats free but cross-sells a variety of add-on services, such as seat reservations and priority boarding. Once on the plane, the customer is sold food, scratch-card games, perfume, digital cameras, MP3 players, and other products. (Ryanair employs a second strategy: charging third parties for in-flight advertisements.) Specialty pharmaceuticals company Galderma rebates out-of-pocket costs for Epiduo, a prescription acne gel, and cross-sells other skin care products.

times better—than what others are offering, particularly if we have to get users to switch from another free product to ours.”

Google’s entry created a dilemma for Yahoo, which generated some revenue from up-selling (persuading users to pay for more storage or other add-ons) but much more from advertisers (its real customers). To match Google’s offer, Yahoo would have had to buy warehouses of servers to provide storage for its 125 million e-mail users—an investment that would have generated no additional revenues.

Yahoo decided to respond in a way that sent a message to Google and to its own e-mail users and advertisers: It immediately announced that it would match Google’s offer of one gigabyte of free storage. A couple of years later, it began to offer unlimited storage. Those moves left Yahoo users with no reason to switch to Google—and left Google with few options for offering a better free product. Although

COMPANIES THAT IGNORED THE THREAT

The major airlines in Europe have been slow to respond to **Ryanair**, which offers free or deeply discounted tickets and charges for other services. Ryanair has made impressive gains in Europe; its share now exceeds that of Air France.

Satellite radio company **SiriusXM**, which offers subscription packages for its more than 180 channels, has done nothing to stem the loss of share to Pandora, which provides free radio over the internet and generates revenue by charging for ad-free service and selling access to its user base to third parties.

the increased costs hurt Yahoo’s profits in the short term, the company’s share of the e-mail market continues to be several times larger than Google’s. But Google has not given up: Gmail now serves as a platform for the company’s other free products, such as Google Docs and Calendar. In the long run, this could make Gmail the better free product.

The most important lesson from these cases? If your user base is vital to your revenue stream, you must quickly offer a free product that is comparable or superior to the new competitor’s. If you can, you should try to crush that competitor or at least prevent it from becoming powerful enough to mount a serious challenge.

Rethink Profit Centers

Two obstacles prevent managers at established companies from making the leap to free strategies. The first is the deeply rooted belief that products must

3. CHARGE THIRD PARTIES

Provide a free product to users and then charge a third party for access to them.

REQUIREMENTS

- A free offering that attracts either many users who can be segmented for advertisers or a targeted group that makes up a customer segment **and**
- Third parties willing to pay to reach these users

EXAMPLES Google, which charges companies to advertise to its millions of users, is the poster child for this strategy. Another example is Finnish telecommunications company Blyk, which offers 200 free cell-phone minutes a month to 16-to-24-year-olds who fill out a survey and agree to receive ads. Blyk then sells access to and information about them. Blyk was recently acquired by Orange, the largest brand of France Telecom.

Generating users does not guarantee success. Xmarks offered web-browser add-on tools that attracted more than 2 million users—and plenty of venture capital. But the company recently shut down because it couldn’t deliver a clear segment to advertisers.

4. BUNDLE

Offer a free product or service with a paid offering.

REQUIREMENTS

- Products or services that can be bundled with the free offering **or**
- A free product that needs regular maintenance or a complementary offering

EXAMPLES Here the “free” effect is largely psychological—the customer must buy the bundle to get the free product. Think of Hewlett-Packard, which often gives away a printer with the purchase of a computer.

Better Place plans to lease electric cars in Israel by bundling a free lease with a service contract. Customers would pay to swap out their battery packs.

Banks are increasingly bundling free services, such as accounts and stock trades, with paid services, such as investment accounts that require minimum balances. But the bundled product doesn’t have to be related to the free one. Banks also give away iPods, iPads, and other products to customers opening accounts.



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generate a respectable level of revenues and profits on their own. The second is the profit-center structure and the accounting system it employs, which both reflect and reinforce this mind-set.

In stable competitive environments, profit centers are a godsend: They push P&L accountability down, usually to the product level; they place revenue and cost streams in the hands of an individual, clearly identifying where the buck stops; and they provide a career ladder for those hoping to oversee units with larger budgets. But profit centers have a dark side: They make it impossible for an organization to consider a product's revenues and costs separately—a perspective that's essential for conceiving and implementing a free-product strategy.

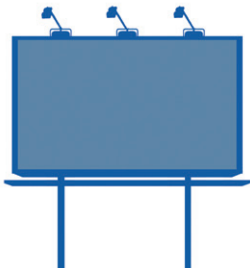
To fix this problem, profit responsibility must be pushed up to a management group that oversees revenue and cost streams from a much wider variety of sources than traditional profit centers do. Clearly, a company that relies primarily on free-product strategies, such as Google, will place this responsibility

much higher in the organization than one that uses free offerings as a small part of a more comprehensive strategy.

In addition to moving profit responsibility higher, companies with free business models generally place responsibility for revenue streams and cost management at lower levels, and in separate hands. *Revenue managers* in these companies pursue all possible ways to increase revenues—except product price. Clearly, the job requires creativity, but revenue is typically generated in the four ways mentioned above: up-selling, cross-selling, selling access to users, and bundling.

A separate set of *product development managers* is responsible for overseeing costs and building in product features that will expand the user base as rapidly as possible. On the basis of conversations with current executives at Google, we estimate that only the CEO and three or four senior vice presidents have P&L responsibility there.

Clearly, tensions can arise between the revenue group and the product development group, and



Why Microsoft Should Take Its “Free” Competition More Seriously

For the past four years, Microsoft's Office software has been under attack from free alternatives: Google Docs and Oracle's Open Office. Although Microsoft finally responded in 2010 with Microsoft Live, a free “cloud” version of Office, it waited too long and was not forceful enough to contain what could become a serious threat.

Microsoft's reluctance to embrace a free-product strategy is not surprising. Its office applications business has long enjoyed a near monopoly and has been highly profitable. And except for price-sensitive users such as college students and public entities, its customers have not flocked to the free products. Indeed, concerns about file incompatibility, the lack of functions in competing products, and the need to teach employees how to use new applications have kept the vast majority of Microsoft's target corporate customers in the fold.

But in our view, Microsoft has erred in not taking the defection among price-sensitive customers more seriously. Our survey of college students suggests that nearly 20% now exclusively use free alternatives, up from about 4% five years ago. According to a competitor, the number of students in the United States using Google Apps has increased from 7 million to 10 million in the past two years, and about 3 million small-business users and some large institutions (including Brown, the California State University system, Gonzaga, the University of Minnesota, the University of Virginia, Vanderbilt, Villanova, and William & Mary) have adopted it as well. This is a big problem for Microsoft: Open Office and Google Docs will continue to improve, becoming more attractive to younger and newer users as well as price-sensitive institutions—especially those overserved by the function-laden Office suite.

So far, Microsoft Live doesn't seem to be effective in countering the free offerings of its competitors. There are several possible reasons. One is that Microsoft, unlike Open Office, doesn't offer a version that can be downloaded to and operated from an individual computer. Another is that Microsoft has not promoted its free product aggressively enough, and, as a result, it is not as well-known as Google Docs.

Judging from Microsoft's half-hearted response to date, the company doesn't want customers switching to its free product. This is a mistake. By sacrificing a portion of revenues from price-sensitive or overserved customers, Microsoft could prevent free-product competitors from expanding their foothold and give itself a better shot at retaining its most valuable customers: the business and power home users who are loyal today but could ultimately defect.

About the Research

For five years, we have been studying companies that face competition from rivals offering free products and services. The 34 incumbents we've been following are in 26 product markets representing the digital and physical realms as well as the intersection of the two. The markets include airlines, automobiles, classified advertising, dermatology pharmaceuticals, internet services, music, office applications, operating systems, personal finance software, radio, and telecommunications. Twenty-four of the battles between incumbents and free-product rivals have progressed far enough for us to judge the incumbents' actions. In two-thirds of those cases, the incumbents made the wrong choice: They introduced their own free offering too quickly, responded too slowly, or did nothing at all.

it pays to spell out how they will be resolved. For example, Google's product development group can nix revenue models it believes would damage the user experience. When the two groups can't resolve disagreements, the senior managers with P&L responsibility—and sometimes even the CEO—arbitrate.

Another culprit that undermines many companies' ability to offer free products is the cost accounting system, which is excellent for averaging costs across large numbers of products and then allocating overhead but not for identifying the *actual* cost of the last product or service sold. The distinction between average cost (what some call variable cost or total cost) and actual cost (what some call marginal cost) is important because the latter is almost always lower than the former, often dramatically so. Think of what it costs an airline to fly an empty seat on an otherwise full or mostly full airplane: essentially nothing. This principle applies in nearly every industry. Once an operation is up and running and costs are largely incurred, generating additional products or services adds very little to total costs. Company leaders can use this notion to their advantage as they consider alternative pricing approaches, such as free offerings. By stepping back from the cost accounting system, they may find flexibility they didn't realize they had.

An example from the pharmaceutical industry illustrates how the profit-center structure and mind-set and the cost accounting system make it difficult for established companies to react when rivals offer free products or services. In 2008, specialty pharmaceuticals manufacturer Galderma (a joint venture of Nestlé and L'Oréal) launched Epiduo, a prescription acne lotion, in the United States. Because Benzac, its other acne product, was about to lose U.S. patent protection, Galderma felt tremendous pressure to build Epiduo's U.S. market share as quickly as possible. But in Europe, the product had met stiff competition from Duac, an acne gel made by GlaxoSmithKline (GSK). Expecting more of the same in the United States, Galderma decided to implement a program to reimburse a patient's out-of-pocket costs for the product for as long as a year. In exchange for rebate coupons, customers gave the company their e-mail addresses. Galderma then sent them skin care tips, acne information, and special offers for its non-prescription products, such as cleansing bars.

Heavily rebating new drugs in the early days to build market share is a common strategy in the phar-

maceutical industry. The hope is that once the company has won a substantial share, health insurance companies will agree to cover the drug, allowing the company to offset its development costs and make a profit before its patents expire.

But incumbents selling established drugs are generally unwilling to take risks with pricing. Their cost accounting systems and P&L structures make them feel that they must cover their substantial product costs—which explains why GSK and other incumbents seemed paralyzed when Galderma launched the rebate program for Epiduo. One GSK executive told us, "We can't afford to match them, and we can scarcely afford to discount. So we're losing share."

In reality, the marginal cost—the material and labor—of a tube of lotion or gel is small (from a few pennies to a few dollars). Therefore, in the short run incumbents would have lost almost nothing if they had deeply discounted their products or matched Galderma's rebate. Moreover, like Galderma, they could have cross-sold products and, by breaking down the walls around P&L centers, used profits from other highly successful products to subsidize short-term losses in dermatology. This would have forced Galderma into the untenable position of giving away its product without growing share. The battle is ongoing, but so far Galderma's strategy has allowed it to gain customers and profitably cross-sell products.

BECAUSE FREE-PRODUCT strategies entail experimentation and, admittedly, some risk taking, embracing them may require a cultural shift. Strong executive leadership will be needed to build the case for mounting a competitive response, revamping organizational structures, and questioning cost accounting information. When a free offering is a threat, few strategies are available besides meeting free with free. Incumbents that spend too much time looking for some other killer strategy often only defer the inevitable. By taking decisive action as soon as the threat is clear, incumbents can survive and thrive. ▾

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