“Remember the Money”

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The "freemium" business model really can work. Look no further than Evernote.

**When Phil Libin** set out to develop the Next Big App, he put forth one cardinal rule: "I didn't want a clever business model." Come again?

"Data analysis, referrals, advertising -- it was all kind of sleazy," says Evernote CEO Libin. "I wanted a clever product. I wanted that product to reach hundreds of millions of people. And I wanted 99% of them to be using it for free."

The "freemium" model -- giving away service to users and making money when some opt to pay for additional features -- has become wildly popular among Silicon Valley entrepreneurs, all banking on reaching the critical mass of a Facebook or Twitter (or being acquired). The competitive advantage is tantalizing. A product that's largely free can't be edged out by something cheaper. "But for most startups, freemium is a cop-out," says Lincoln Murphy, managing director of Sixteen Ventures, a Dallas-based strategy consulting firm. Even if a company can eventually persuade users to shell out for something they've been getting for free, it's extremely difficult to deliver freemium's other requirements: a massive potential audience, next-to-nothing operating costs, a gotta-have-it value to consumers, and a sky-high retention rate. Ning, for example, abandoned the model because its few free-to-paid conversions weren't generating enough revenue, and Flickr hedged its bet by folding premium subscriptions into a larger moneymaking strategy that includes merchandise and advertising. "Freemium is a numbers game," says Murphy. "And most companies lose."

Evernote is a rare exception, remarkable for both the devotion of its users and the slope of its revenue curve. Libin's two-year-old Web and mobile app bills itself as "your external brain," letting its 3 million -- plus users clip Web articles, take photos, record voice or text notes -- and store everything in the cloud. During users' first 30 days, 0.5% convert to its paid version ($5 a month or $45 a year), which offers perks such as added storage space and offline access. At the six-month mark, the rate has gone up to 1%. After two years, almost 6% of the initial group have started shelling out -- and one-third of them are still storing content on a monthly basis.

Those numbers are a testament to the success of Evernote's engagement strategy, which hinges on maintaining a high-quality free product. "The easiest way to get 1 million people paying is to get 1 billion people using," says Libin. Periodically, Evernote unveils features that save users time or make their stored information safer; some updates are free, while others are available only to paid users, such as the ability to revert to previous versions of notes. The add-ons trigger conversions and turn customers into advocates. "The more memories users store in Evernote, the more invested they become," says Murphy. "Whether they're paying for premium access or telling their friends how great it is, they're willing to do their part to keep Evernote around."

From the start, Libin modeled Evernote to be profitable at a 1% conversion rate. It helps that the service relies on word of mouth for customer acquisition, and that most users write their notes on their own smartphones or computers, then sync to Evernote's servers. Right now, roughly 2% of all Evernoters are premium customers, which is good for business. As the service adds more users, both free and paid, Libin wants to maintain that rate at 5% or less. If people start converting en masse, "that means our free product isn't good enough," he says. "And if our free product isn't good enough, what's the point of being freemium?"