Competing Against Free

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.

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 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 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.