Which is better: Many customers at low price-point or few at high price?

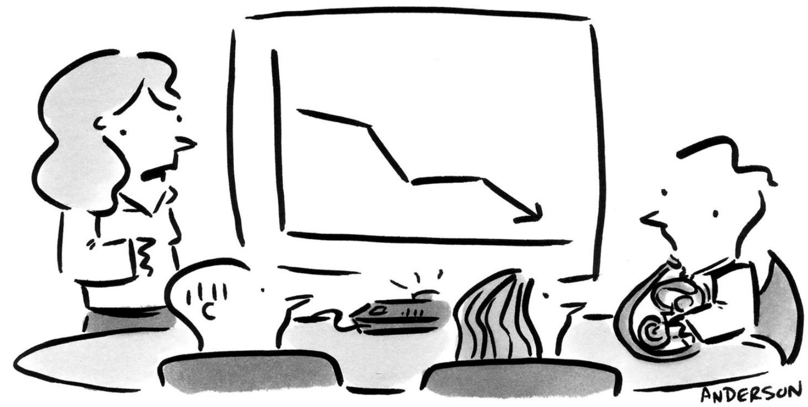
Market size · Market risk · Time · Pivotability · For B · Freemium · Decision

The results of a serendipitous live experiment were recently published as guest posts on this blog. Sacha demonstrated[1] the benefits of selling many copies of an eBook at a low price, while Jarrod pointed out[2] the advantages of higher prices, bringing in more revenue with 1/6th the number of units sold.

The ensuing discussion swirled around the merits of selling more units (i.e. maximizing reach) versus selling more expensive units (i.e. maximizing per-unit profitability). **This is a choice that every startup founder must make**, so I'd like to dig in deeper.

To clarify the discussion, let's use a simpler model:

> Companies A and B both sell products with recurring monthly revenue, and both brought in $10,000 in revenue last month.
>
> Company A has 1,000 customers each paying $10/mo.



"I think if more french horn were going to work, it would have by now."

credit[3]

> Company B has 10 customers each paying $1,000/mo.

Which is better?

Oops, bad question. How about: Which company would you rather own? Or: What primary problem should each company be working to solve? Or: Under what conditions are each of these companies interesting? Or: Which company could raise money more easily?

Let's focus on just one question: **For which company would be easier to raise money?**

Wait! That's shitty! Why the obsession with raising money, what if you don't want a huge company, what if you want to bootstrap, don't you know raising money isn't a measure of correctness or success, …

I agree! But "raise money or not" is also a decision everyone must make, and it turns out that exploring that question will end up answering all the other ones. So let's play!

MARKET SIZE

Suppose the total addressable market is small. In that case, A can't keep growing forever, so its revenue is limited, which is a bad spot. B can extract more money from the limited pool of customers, so that's better. Except, of course, investors don't like small markets!

In a large market, B isn't necessarily bad, but A shows far more potential. Over time companies at small price points are able to increase prices and otherwise extract more money from various customer segments, which means A has a bigger revenue potential.

Perhaps most importantly, A demonstrates that there *is a large market at all*. If you've already found 1,000 customers, there's 10,000, and likely 100,000. If you've only found 10, there *might* be 10,000 out there, but if so, you don't have supporting evidence. Riskier.

Speaking of risk…

MARKET RISK

Many companies die because they can't find enough people to pay. Many more die that way than die because the product sucks or doesn't have enough features or because they don't have a staff designer.

There's a million variables—can you locate potential customers, can you bring them to your website, can you get them to read and click, can you get them to sign up, can you get them to agree to your price. A million variables means it's hard to get it right.

Therefore, an investor is always impressed with a company like A who has made irrefutable progress on this particular front. Having 1,000 people paying you *any* amount of money whatsoever goes a long way. It's a lot harder to get 1,000 paying customers than to add three features,

because the latter is a matter of time and money[4] whereas the former is largely out of your control.[5]

Getting 10 people to pay you—even a large amount—is actually not that hard. If a co-founder has a rolodex in the industry—extremely common—then it would be surprising *not* to find 10 people. That doesn't prove you have a repeatable, scalable method for finding customers, nor that there *are* a lot more potential customers out there.

Market risk is most startups' biggest risk. One interesting way of reducing that risk is to build a company like B where you just don't need to sell very much to achieve your goals. That's awesome because the risk is low when the bar is low. That's not intended as an "insult"—in fact I believe far more companies *should* have this attitude.

TIME HEALS MANY WOUNDS (BUT NOT ALL)

Over the time scale of "years," you can count on certain trends.

For example, **the average cost of customer acquisition diminishes**. Why? Because you get organized around marketing metrics, because your campaigns get optimized, because your landing pages and drip campaigns become stronger, because word of mouth produces sales "for free," and so forth.

Another is that **average revenue per customer increases.** Why? Because new pricing tiers better segment customers, prices go up as reputation grows, you create add-on products and services, you create new revenue through business development, and so forth.

What's *not*true is that you always unlock big growth drivers.Indeed, many companies get stuck at a certain growth rate which, while positive, eats too much money during its slow crawl to cash-flow-positiveness, and by the same math doesn't generate interesting profits after that. Once profitable, at least that sort of company is creating jobs and still could unlock something someday, but of course an investor in general isn't interested in that outcome.

So back to our two companies. Company A has demonstrated that some growth is possible, and where there's 1,000 customers from a shoestring budget there's likely several other growth drivers out there; anyway, one is unlocked. Which is more than you can say for B. So, along one of the dimensions which doesn't automatically improve with time, A wins.

That's why, even if A isn't doing well in other areas, that's not as important. Suppose you argue that $10/mo isn't enough money to be interesting—perhaps, but average revenue increases, so that's not a long-term problem. Suppose you discover that it costs $60 to acquire a new $10/mo customer which is too much to be sustainable—perhaps, but that cost diminishes over time, so it's not a long-term problem.

Investors are of course more interested in where you could be in two years than where you are right now. They're more worried about the problems which don't naturally get corrected over time.

PIVOTABILITY

Nowadays everyone agrees that it's both likely and healthy for an early-stage startup to be on the lookout for an intelligent pivot.

Actually, more than "on the lookout," you should be actively probing the market, which means interviewing customers and non-customers alike, attending industry events to have real conversations (not quipping to each other on Twitter), exploring the metrics of your website, your marketing, and product features, and so on.

One of the most common answers to "what made you successful" is "we decided to stop X and do Y." Therefore, actively collecting the data on what's *actually* happening, what customers *actually* will pay for, where the valuable hole in the market *actually* is—this is one of the most valuable things you can do, and the company which does it best is increasing its chance of success.

Given no other information about the companies, company A clearly has access to far more market data. They have 100x the quantity and range of customers to interview and analyze. They probably have a correspondingly large amount of website traffic to mine. They can subdivide their user population and try four ideas at once, iterating quicker to better information.

Lean Startup tells us that the speed at which theories can be tested is directly proportional to learning; the company who can do that faster and more accurately has a significant advantage.

I posit that this is true regardless of whether you're taking investment.

A FLURRY OF ARGUMENTS IN FAVOR OF B

So it's clear that in general an investor will prefer A to B. But B is preferable in many cases, so let's even the score.

If the cost of support is high, A will kill profitability and B wins.

If the cost of customer acquisition is 10x the monthly revenue or monthly revenue is 1/100th of where it should be to sustain the operations of the company, then the argument of "it gets better over time" doesn't work, because although it gets incrementally better, it's hard to justify orders of magnitude of improvement.

If the human cost of scaling A is higher than B, then at scale B might be much more profitable.

If you're keeping the company small, it's almost always cheaper and more fun to run it like B. You spend less on marketing/advertising/acquisition. Less time training customers. You have more time to make customers love you forever and therefore less churn and a happier general existence. In product development you have the delightful job of serving handful people with homogeneous needs rather than appeasing the disparate needs of thousands people who can't agree on anything. Pretty much everything about it is nicer!

If the market is small, it's hard to get more than a few customers, so you need a business model like B that extracts the most amount of money from the limited available pool.

BUT "FREEMIUM" IS NOT COMPANY A

I often see founders and investors alike using many of the above arguments to argue why a company with 100,000 free users is more valuable than a company with 1,000 paying customers. I disagree.

While it's true that the *potential* for the company with vast numbers of freebie customers is indeed there, there's just too many examples of start-ups with great products, great marketing, huge growth, large customer bases, where they just could not convert enough of the freebies to paid, and even after conversion, not paying enough.

Of course if there *is*a conversion rate, you can start applying the above logic again. Conversions rates increase over time, etc., so as long as the absolute number of paying numbers is interesting and the growth rate is large, you're back to good. Better than good, in fact, because you have more levers to play with in terms of increasing conversions, offering different products, pivoting, etc..

WHICH IS RIGHT FOR YOU?

Hopefully the detail above should be sufficient for you to decide which is appropriate for you.

If I had to boil it down to a sentence it would be:

> If you want happiness and fulfillment from a small company, strive for B; if you want to maximize growth, influence, and financial value, strive for A.

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`https://longform.asmartbear.com/price-vs-quantity/`

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REFERENCES

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