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Keeping an Eye on Skype

by John Wilson, Associate Editor

Earlier this month, the VoIP provider Skype announced plans to move forward with an IPO tentatively valued at nearly one billion dollars. The offering, which was initially announced in August, won't materialize until 2011, despite investor hopes that the company would be ready to go public before the end of the year. Skype is best known for its software that provides a variety of voice and video calling services, at no- or low-cost, over the Internet. Of course, as Skype does not possess its own network infrastructure, these calls are all carried between the service's users by whatever pipes are available; traditionally over a land-line broadband provider, but more recently over mobile broadband as well. Skype's filing with the SEC reveals several interesting facts about the company, not least of which is the fact that the company brought in $406.2 million in the first half of 2010 alone. But more interesting than that, the filing also lays out potential pitfalls before and after the IPO, not just for Skype, but for many OTT (over-the-top) providers.

> **"The real problem for Skype is finding and sustaining revenue streams."**

Revenue Streams

The real problem for Skype, and any company providing low-cost OTT services, is finding and sustaining revenue streams. This problem only intensifies after an IPO; investors usually like to see a return on their investment. Skype's current business model is what is referred to as "freemium"; a model where a large user base which only accesses free content or services is supported by a much smaller population of paying customers. Companies operating on the freemium model want to keep their conversion rate, that is people switching from free to paid services, as high as possible. According Taylor Buley of Forbes magazine, “conventional wisdom has it that a business needs a conversion rate between 5% and 10% in order for a viable business model. With 7% of its active users as paying customers, Skype lands itself squarely within that range.” But later in the same article, Buley warns that “the ballooning non-paying user base — a group whose relative percentage is outpacing paying users, even if its usage growth does not — puts Skype on the hook if something happens to swing paying users’ conversion and usage rates in the other direction.” Adding to Skype’s worries is the fact that 86% of its 2009 revenue came from just one product, SkypeOut, which allows users to call traditional land-line and mobile phones from their computer.

OTT providers like Skype are constantly on the lookout for new revenue streams. One way that Skype is attempting to diversify is by placing its software on new platforms and networks, mainly through software development for smartphones and mobile-broadband networks. But as Skype recently found out, new streams can bring their own headaches.

> **“It remains unclear how Skype plans to monetize new platforms.”**

Cutting Deals with Network Providers: A double Edged Sword

OTT providers can expect long development cycles due to hardware manufacturers’ and network providers’ squeamishness at allowing competitors into their sandbox. The Skype software has been available on the Apple iPhone since March of 2009, but the phone had originally launched in 2007 and it was not until July of 2010 that the software was allowed to make calls over AT&T’s mobile 3G network. Neither Apple (who receives money from AT&T for every iPhone contract) nor AT&T themselves were too excited at the prospect of allowing Skype to compete for call revenue by using AT&T’s own network to provide users competitive calling plans. Even after finally being allowed on the network, it remains unclear how Skype plans to monetize this new platform.

Earlier this year, Skype announced that on August 1st it would start charging iPhone users a "small monthly fee" to use Skype on their handsets. The move seems like the obvious and necessary decision; if the fee is small enough most iPhone users, used to dropping substantial sums on monthly service plans and sometimes equally substantial sums in the iPhone app store, would hardly notice an extra dollar or two a month. Add in some innovative billing solutions in partnership with AT&T and it would seem like the yellow-brick road to revenue. But in July, Skype announced that it was scrapping its plans to charge fees for 3G calls. The official release from the company stated that "with some operators starting to move to tiered pricing models [...] we no longer have plans to charge a supplement to make calls over 3G." The implication is that Skype has or will reach deals with network carriers for a percentage of revenues from Skype calls placed over tiered mobile networks. Tiered networks put an end to most providers current all-you-can-eat data-buffet, so the longer someone talks over Skype, the more data they use, the more revenue is generated. But so far, this is all theoretical. It remains to be seen how generous the network providers will be when it comes to negotiating terms with Skype and other OTT providers.

It's not all doom and gloom for Skype. Despite the current uncertainties surrounding revenue from mobile networks, untapped revenue streams may lie just over the horizon.

Ads to the Rescue?

Many over-night startups have learned the hard way that Internet based ad-revenues alone are not enough to sustain a company with more pizazz and bravado than business plan, much to the Chagrin of venture-capitalists and IT dreamers. But for Skype, who already enjoys a steady stream of non-ad revenue, ad revenues remain a surprisingly untapped asset.

As it stands now, there are no banner ads on Skype's website. But such an obvious source of income isn't interesting; Skype could throw banner ads up tomorrow and see a new revenue stream, but what could really sustain long term growth for Skype and other OTT providers are emerging ad opportunities in partnership with content service providers (CSPs). CEO of digital advertising agency AKQA, Tom Bedecarre, is excited by the possibilities presented by web-integrated mobile voice and video calling; "imagine a telephone feature in an ad to immediately call a toll free number and buy something [...] I'd love to put our clients on Skype."

Even more, undreamed of revenue streams lay in the future, but because OTT providers do not control their own network access, the ability to capitalize on them may be out of their hands. Hardware manufacturers, CSPs and network providers will all doubtlessly want to have their hand in these new revenue streams as well. OTT providers must be able to negotiate effectively with third parties while maintaining a paying customer base if they are to survive well beyond their IPO.