Software Pricing

Introduction

Historically software was priced using a perpetual licence, where a one-off fee was charged to access the software which could be used indefinitely.

Over the last ten years, the subscription pricing model has become more prevalent as software as a service (SaaS) and cloud computing have become more widespread. This has been seen with the immense popularity of companies like Salesforce.com, who provide a service for a regular charge.

Market trends

IDC noted in 2012 that:

- For 16% of the top 100 software vendors worldwide, subscription represented more than 50% of their total software revenue
- For all software companies (offering subscription licences), subscription revenue averaged about $181 million per year, with a median of $13 million per year

Vendor challenges

For customers, the purchase of technology under the subscription model typically offers more flexibility than the one-off perpetual model. This has led customers to increasingly demand a subscription based pricing model. However, for software vendors, subscription licence sales result in lower immediate revenue and a corresponding cash crunch.

To adopt a subscription licensing model, it is important that the software is of high quality and quickly shows benefits to the client. Subscription models often allow the customer to cease usage with a 30-day notice.

Finally, it typically takes a vendor 3-5 years to recoup the revenue from subscriptions that would have come from the perpetual licence payment. However from this point forward the subscription model becomes more valuable because there is no end point to the contract.

Vendor benefits

Despite some of these challenges, research by the Software Equity Group (2015, p8) showed significant valuation benefits for moving to a subscription model – “SaaS exit multiple was over 60% greater than that paid to on-premise software sellers.”

Just as a regular subscription payment is attractive for customers, it also generally increases the predictability of software revenue for the vendor and indicates future financial viability. Customers are also more likely to add on additional licence subscriptions within the same service (up-sell) or with new services (cross-sell) than perpetual licensed software customers (Cloud Strategies, 2013).

Moving to a subscription licensing model can be a means for vendors to differentiate themselves from the competition. Subscription licensing can be used to attract new customers whilst providing an alternative pricing model for existing customers.

As well as providing a more stable revenue profile, software licensing can also help reduce costs. When perpetual licences are sold, maintenance support is supplied to that version of software. This results in many different versions of software requiring support. The move to subscription licensing generally eliminates support needs for legacy versions, as all customers are using the latest release.

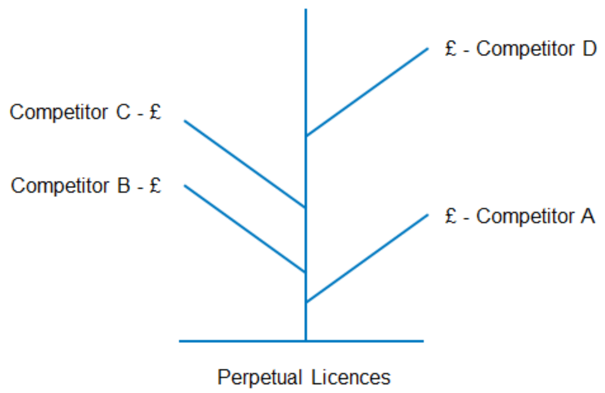

Figure 1 Price Tree

Vendor evaluation of subscription vs. perpetual licensing strategies

There are a number of methods to review the impact of a perpetual versus subscription licence model on revenues and customers.

A detailed audit is needed to understand current customer attitudes towards different pricing models. This should be done using primary research to build a detailed understanding of behaviours and trends, but secondary research is also useful.

The financial impact of adopting a new pricing model needs to be fully assessed and understood. This involves modelling different scenarios and carrying out sensitivity analysis to gauge the consequences of alternative pricing approaches.

A competitor price audit is also important to understand the vendors' relative market positions. This is because price is one of the main points of differentiation between vendors. One useful pricing tool is Price Tree diagrams (Milner, 2015). These allow vendors to evaluate and compare the prices charged by different companies for similar products, both on subscription and perpetual licence price models (see Figure 1).

This price tree competitive data can be used to calculate the total cost of ownership/ revenues for perpetual and subscription offers from different vendors.

If the decision is taken to adopt a new pricing model, the implementation of the new price strategy should be monitored. The following techniques can be used to measure and monitor progress to ensure success:

- Piloting
- A/B testing
- Net promoter score (NPS)
- Surveying
- Anecdotal evidence
- Press coverage

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Further reading

Cloud Strategies (2013) *'SaaS Revenue Models Win in the Long Run'* Available at: cloudstrategies.biz/saas-revenue-models-win-in-the-long-run/

IDC (2012) '*The Rise of Subscription Software Licensing: Overcoming the Software Value Disconnect'* Available at: netsuite.com/portal/pdf/IDC-Subscription-Software.pdf

Milner, N (2015) *'Price Tree Analysis'* Cambridge Marketing Review, Issue 11, Winter 2015, pp73-74

Software Equity Group, LLC (2015) *'The Software Industry Financial Report'* Available at:softwareequity.com/Reports/2015_Soft_Industry_Financial_Report.pdf

Licences	Customer	Vendor
Subscription	• Charged as Opex • Low up-front cost • Small impact on P&L in Year 1 • Impact on P&L on subsequent years • All charge included in one fee • Automatic software updates	• On going relationship with a customer • Opportunities for up-sell and cross-sell • Investors value long-term customer revenue more than a single software licence • Revenue predictability • No need for legacy system support
Perpetual	• Charged as Capex • Large up-front cost and cash outlay • Big impact on P&L in Year 1 • No impact on P&L in subsequent years • Software updates charged as extra	• Large up-front revenue • Price is negotiated once • Ongoing revenue stream from maintenance and professional services
	Factors	

Figure 2 Impact on customers and vendors of perpetual vs subscription licences