

Software Pricing Principles – Some Lessons Learned



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October 7, 2003

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TODAY'S DISCUSSION

Why pricing is important and why superior pricing performance is hard to achieve

- Biggest profit lever
- Many challenges and obstacles

Basic beliefs and approach to software pricing

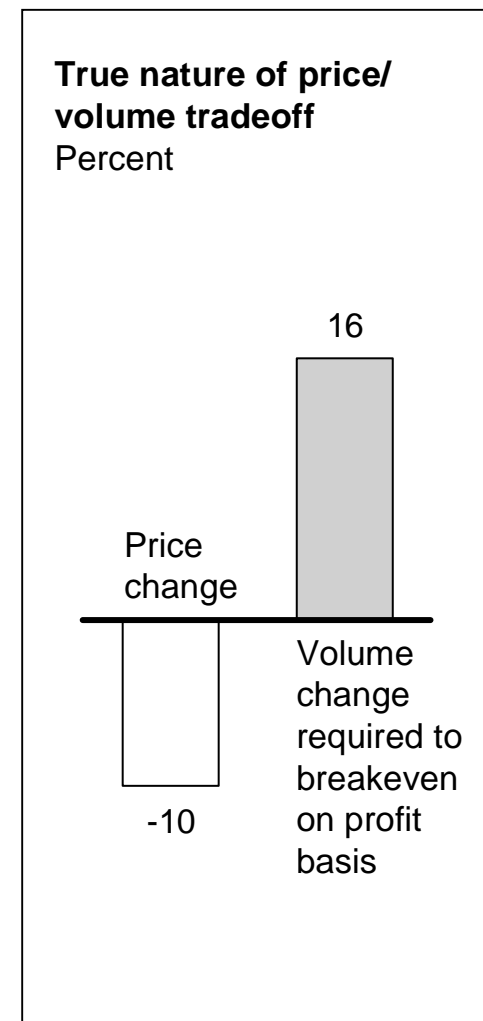
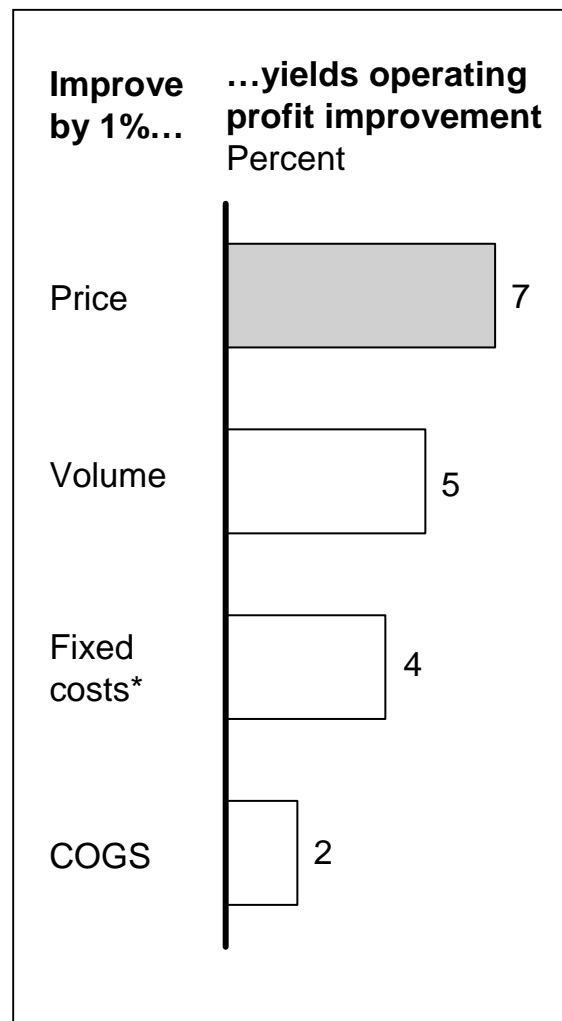
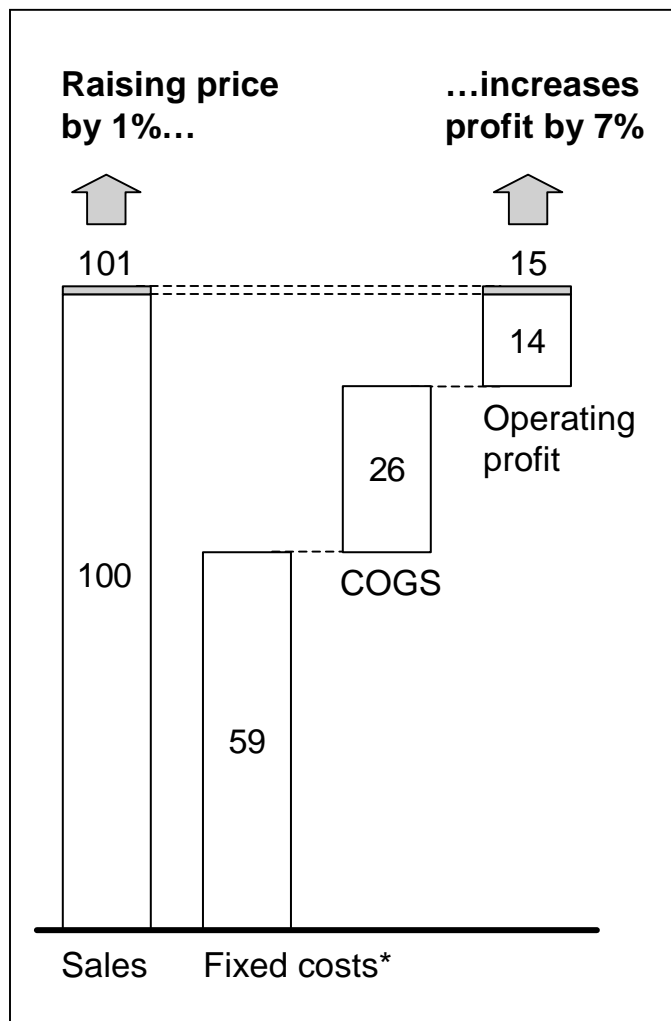
- Substantial upside potential exists
- Manage pricing at 3 levels – strategic, product/market, tactical
- Focus on value creation and frontline execution to unlock near-term opportunities

Real world case examples

- No visibility into underlying performance – “shotgun pricing”
- Poor execution – “no discipline, poor processes, inappropriate models”
- Value misunderstood – “giving away the software prize”
- Customer segments misunderstood – “one size fits all”

PRICING IS BIGGEST LEVER AFFECTING PROFITABILITY FOR ISVs

Average economics for ISVs between \$100 million and \$10 billion in sales

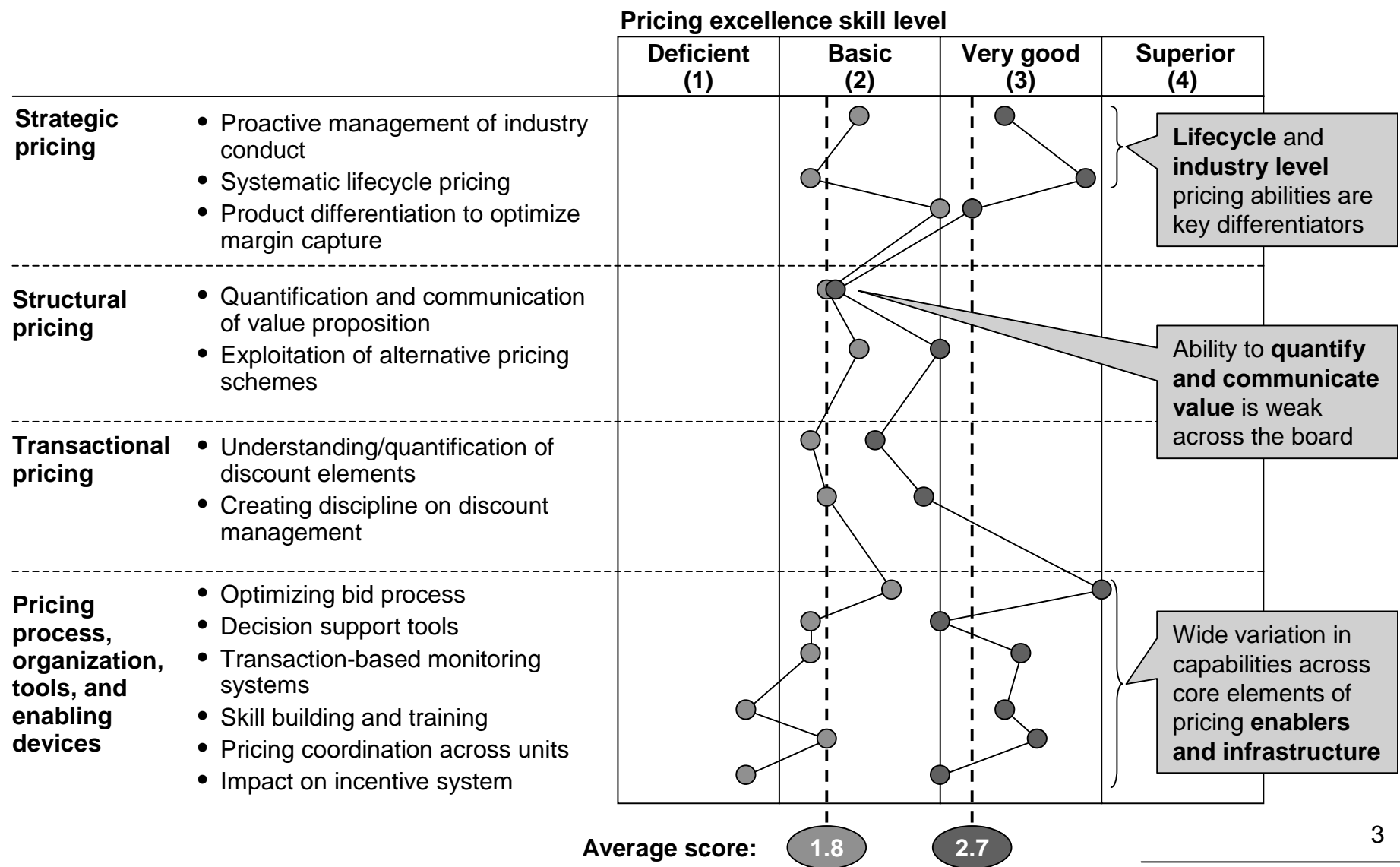


* SG&A, depreciation, and amortization

Source: CompuStat, 2002

MANY TECHNOLOGY COMPANIES FEEL THEIR PRICING MANAGEMENT SKILLS ARE "BASIC"

- Companies in top quartile
- Companies in bottom quartile



SUPERIOR PRICING PERFORMANCE IS HARD TO ACHIEVE

General observations...

- Pricing is often under-managed
 - Top management attention focused elsewhere (e.g., growth, cost reduction)
 - Few dedicated, capable resources
 - Weak processes and enablers
- Limited visibility into actual net (“pocket”) pricing performance
- Poor understanding by frontline decision makers of tradeoffs and implications
- Incentives not aligned to drive improved pricing performance (e.g., sales focused on closing deals rather than margin capture or market positioning)
- “Size of prize” and potential improvement opportunities not fully appreciated

For software vendors in particular...

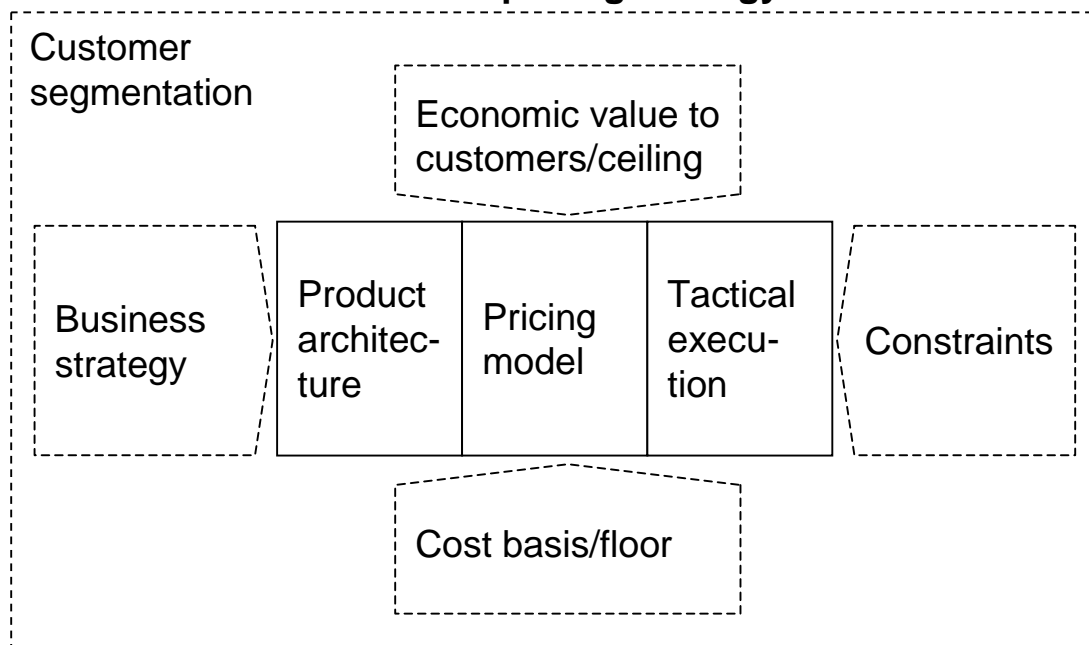
- Marginal costs perceived to be at or near zero – drives bad behavior
- Value associated with software is hard to quantify – less tangible than hardware
- Multitude of alternative pricing models and approaches available – many DOF
- Ad hoc approach to pricing strategy and tactics over product lifecycle (from NPI, through maturation, add-ons, and EOL)
- Discipline lost in rush to get to market and establish presence
- Overcoming “box selling mentality” (for hardware players moving into software)

BASIC BELIEFS ABOUT SOFTWARE PRICING

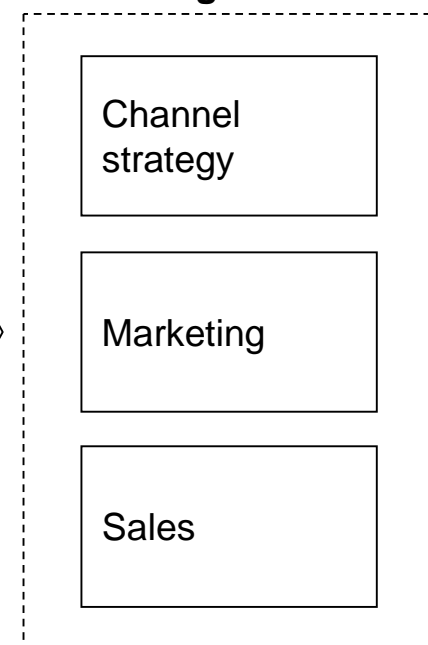
- Inherent malleability of software-based products offers tremendous flexibility in pricing options and architectures
- Trade-offs between different pricing approaches are typically not well analyzed or understood
- Pricing is both a strategic and tactical issue, and generally requires a holistic approach integrated with an overall product/service strategy and practical implementation plan
- Proper pricing execution can create substantial near-term value for software businesses (e.g., 5-10 percentage point improvement in ROS)

PRICING SHOULD BE MANAGED AT 3 LEVELS – STRATEGIC, PRODUCT/MARKET, AND TACTICAL – WITHIN A BROADLY INTEGRATED CONTEXT

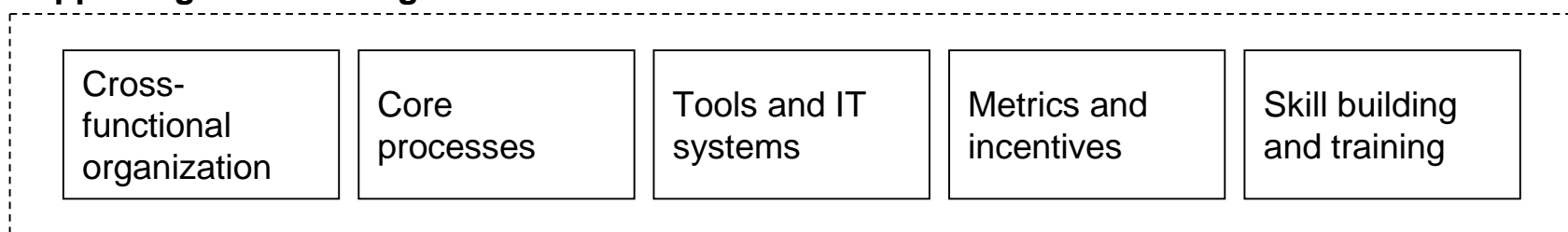
Basic elements of software pricing strategy



Link with go-to-market

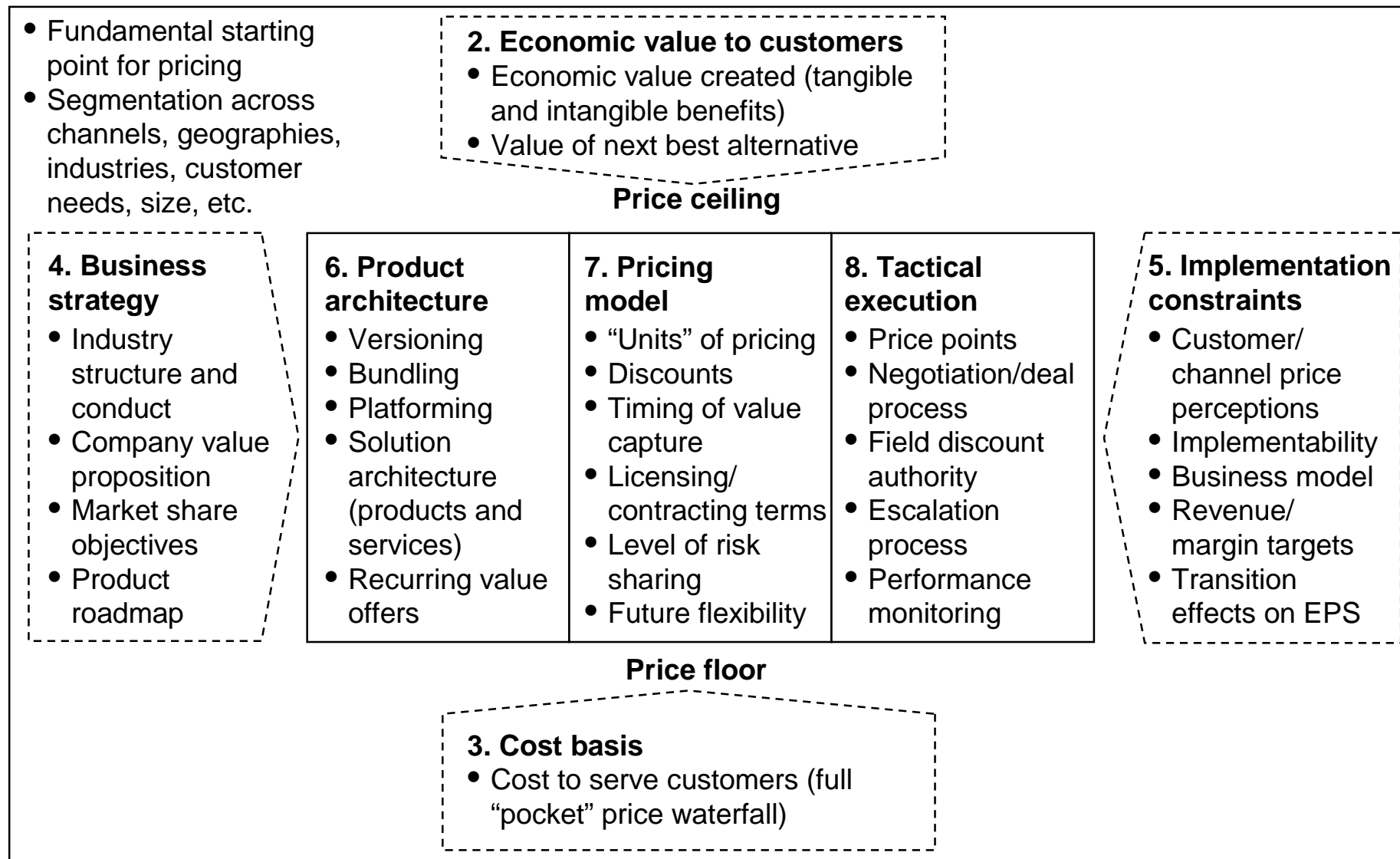


Supporting and enabling infrastructure



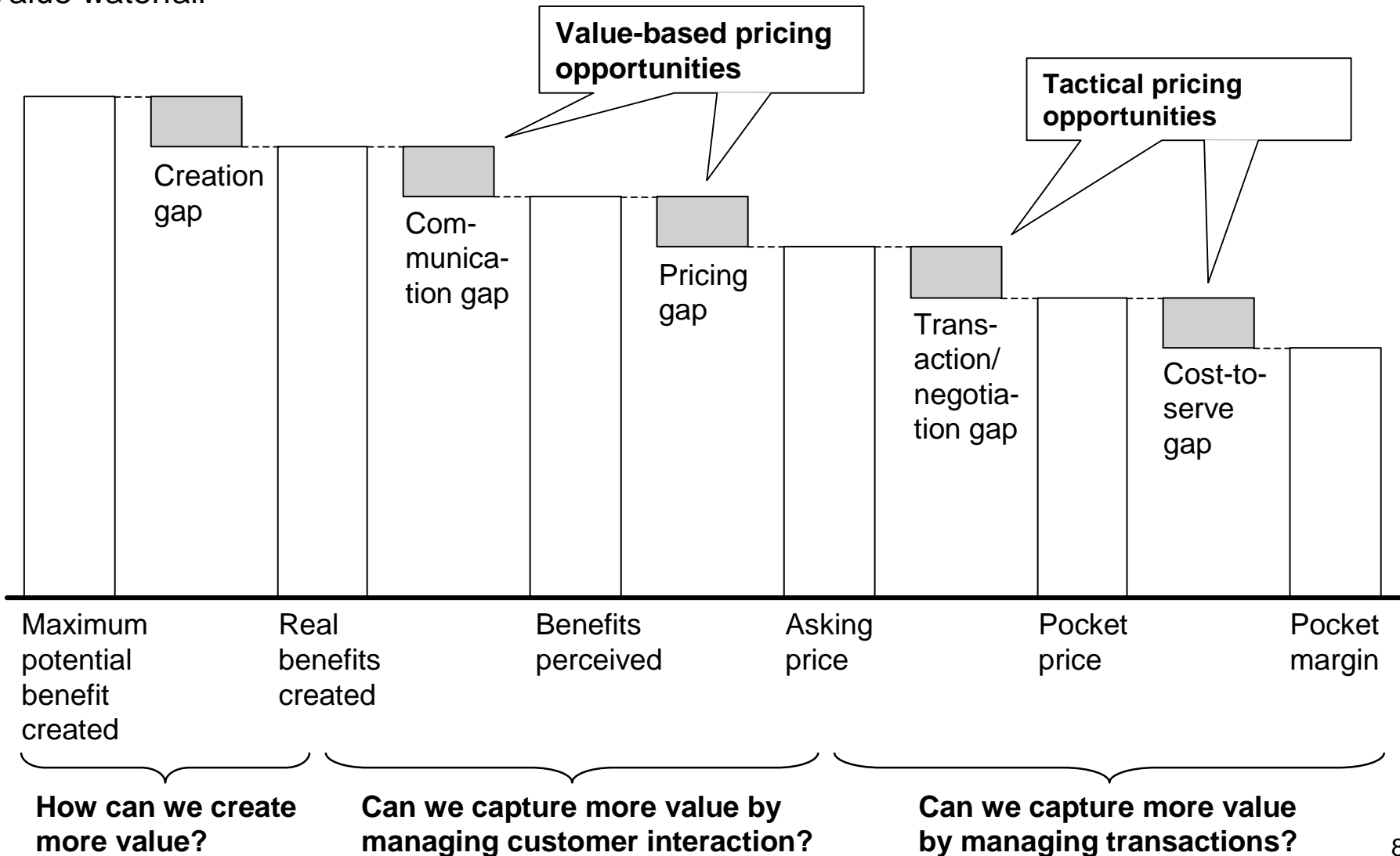
BASIC ELEMENTS OF SOFTWARE PRICING STRATEGY

1. Customer segmentation



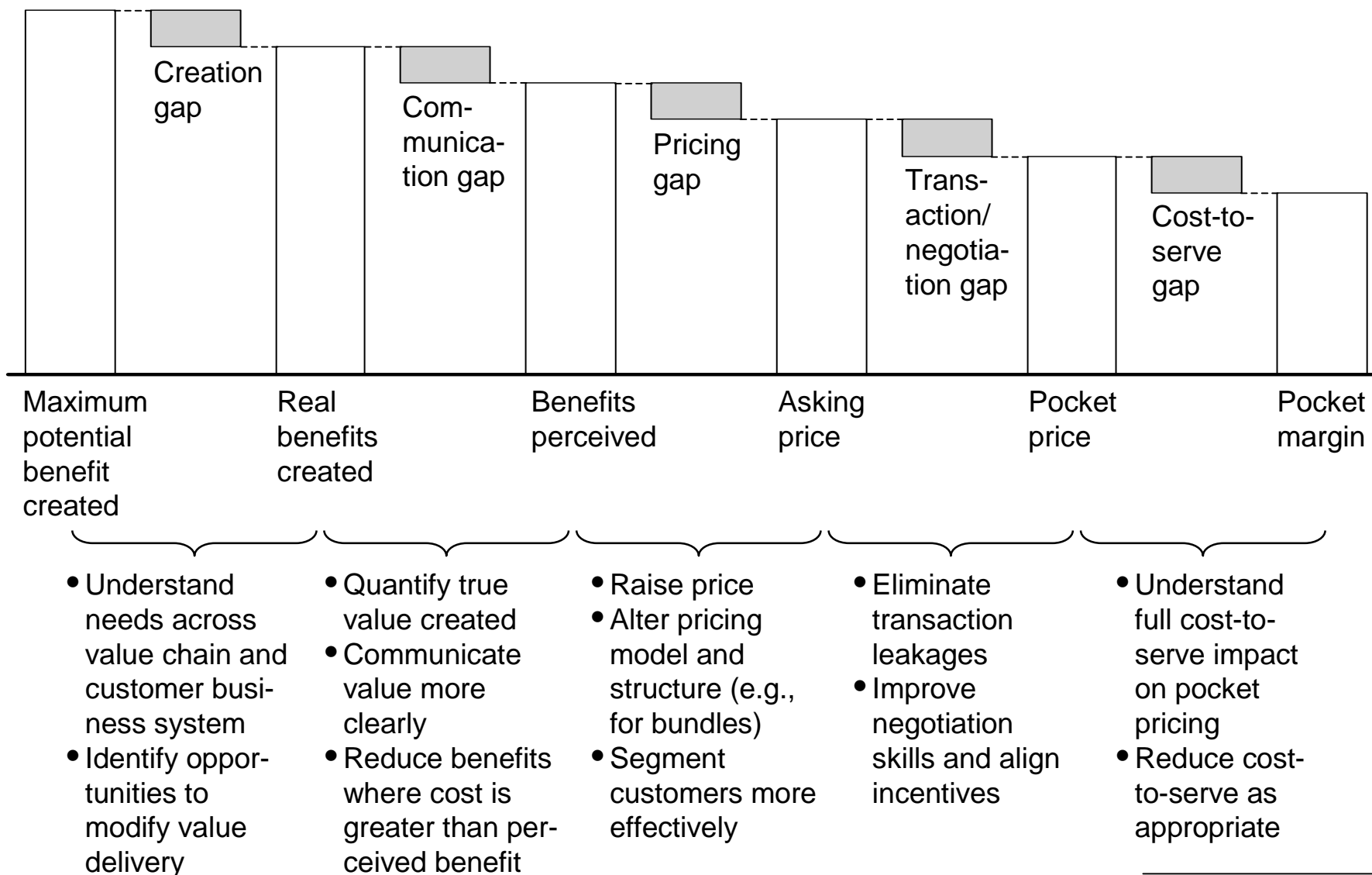
EFFECTIVE PRODUCT/MARKET AND TACTICAL PRICING DEPENDS ON UNDERSTANDING ALL SOURCES OF VALUE CREATION/LOSS

Value waterfall



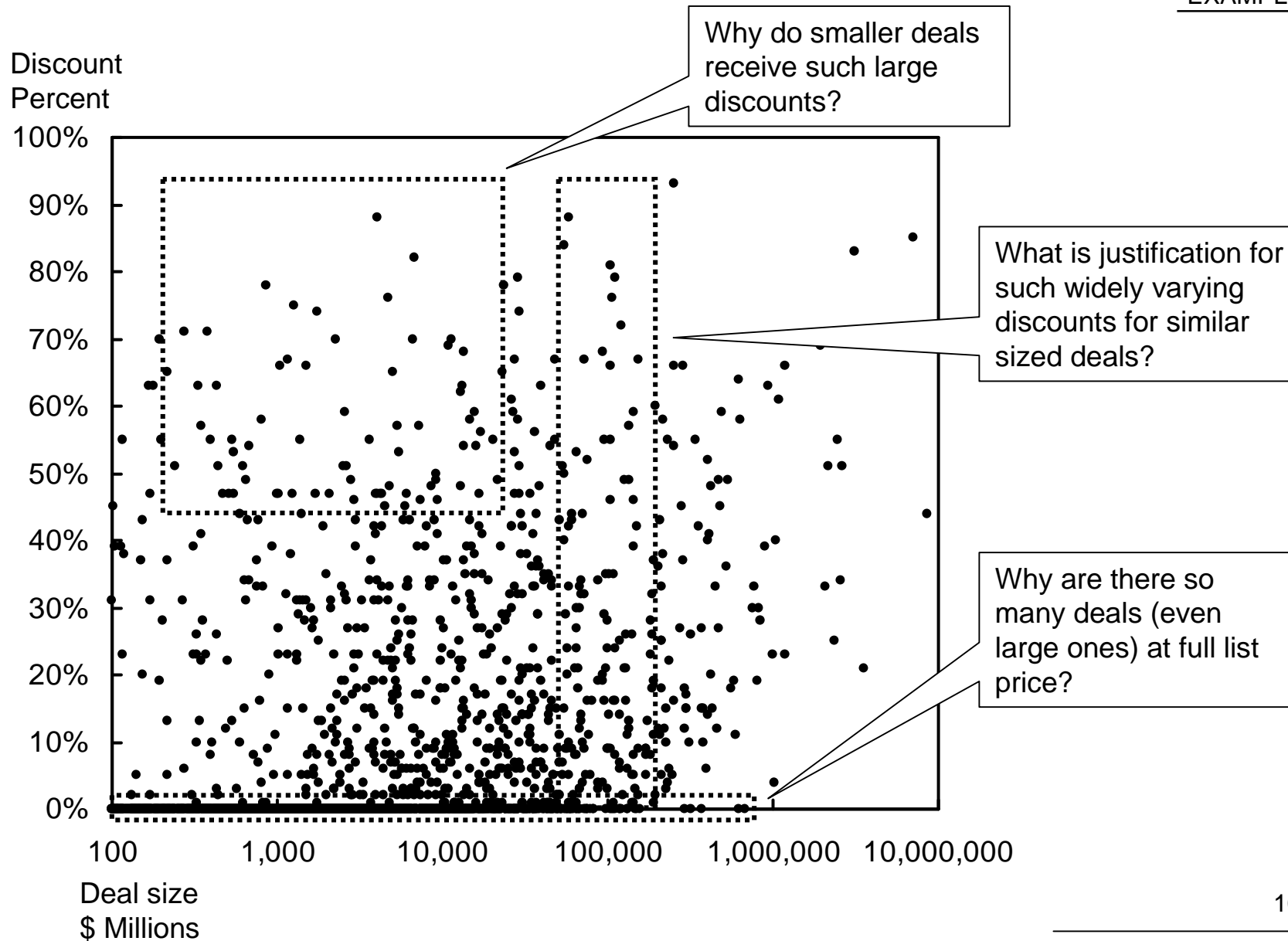
POSSIBLE MEANS FOR CLOSING VALUE GAPS

Value waterfall



WIDE VARIABILITY IN FRONTLINE PRICING (1/2)

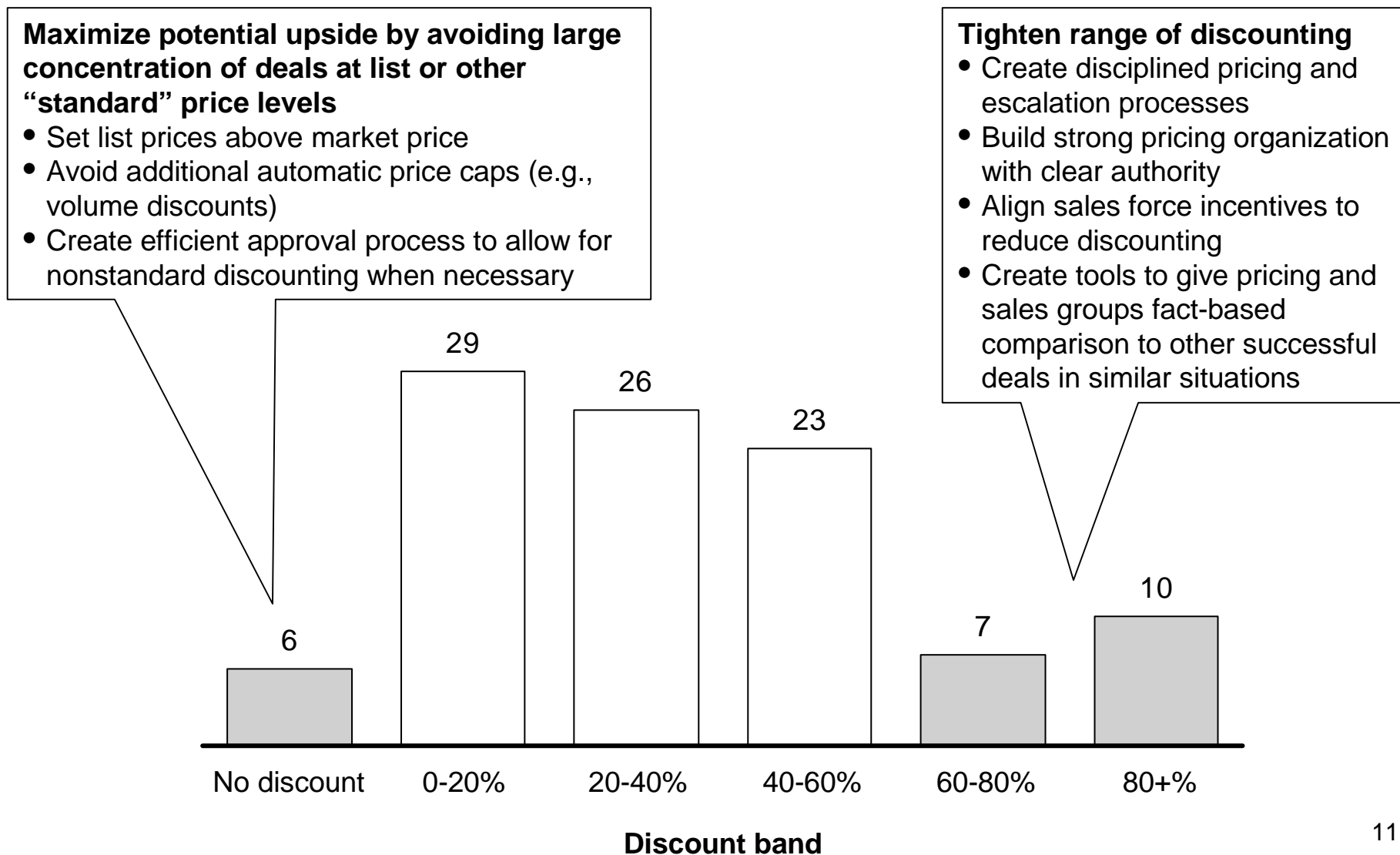
DISGUISED
EXAMPLE



OPPORTUNITIES TO IMPROVE FRONTLINE PRICING (2/2)

Distribution of deals by discount level, percent of total sales

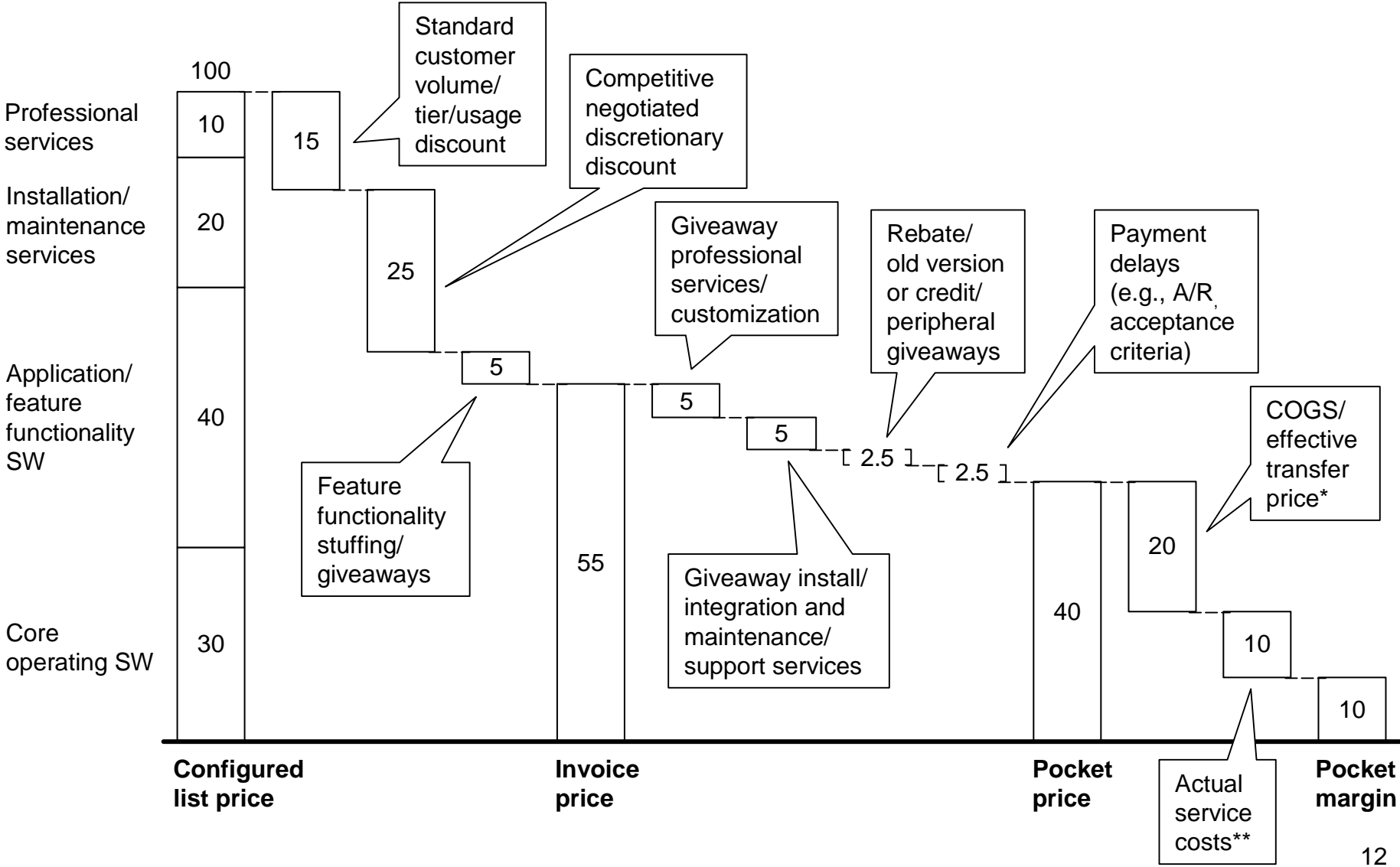
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BEWARE OF ASSUMPTION THAT MARGINAL COSTS ARE ZERO

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Percent, indexed to configured list price



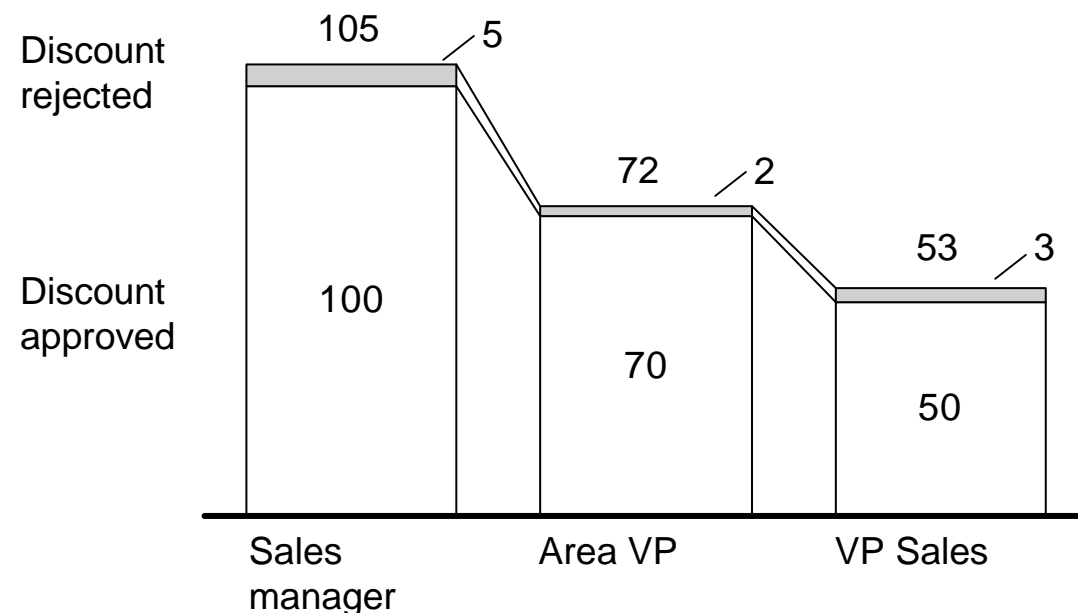
* Includes sales costs, allocated R&D acquisition/goodwill, royalties, license fees

** Including professional, installation/integration, and maintenance/support services

LACK OF ENFORCEMENT AGAINST DISCOUNTING

Approval/rejection of discount for deals

Number of deals



- Managers rarely reject deals due to discount level given to customer
- Sales reps are not afraid to request high level of discount
- Sales reps do not suffer any consequences from offering excessive discounts

Quotes from sales force interviews

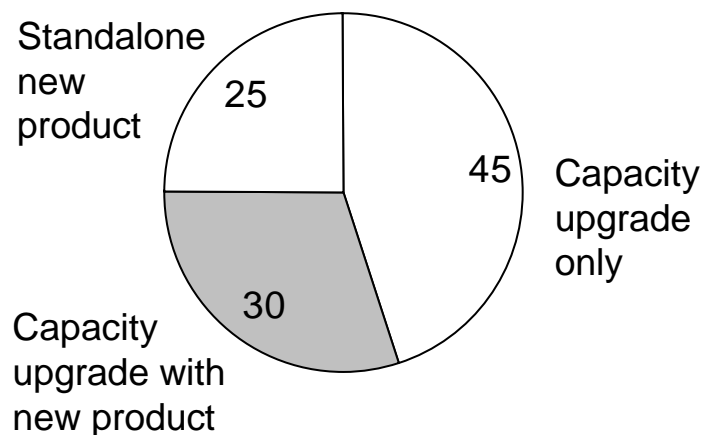
- “Managers are no deterrent, they approve everything”
- “We never walk away from deals”
- “These big deals with huge discounts only get done because of senior management approving them”

BUNDLING OF NEW PRODUCTS INTO CAPACITY UPGRADES

Distribution of deals by type

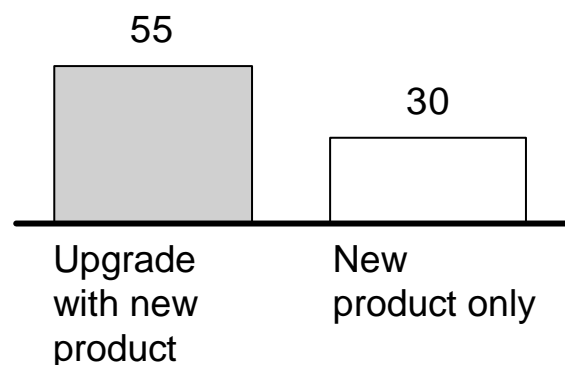
Percent of deals with product list >\$50,000

100% = 500



Weighted average discount of deals

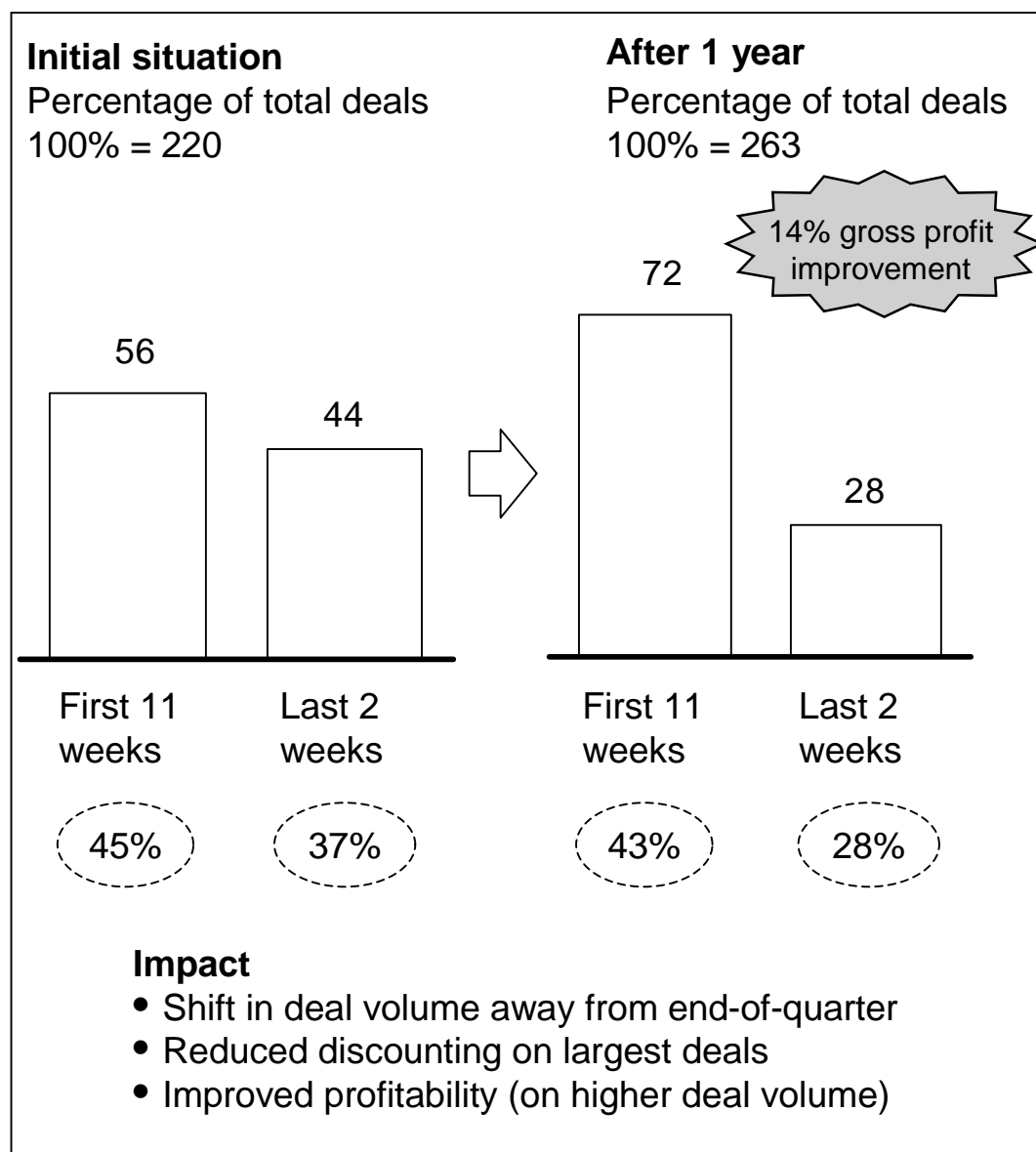
Percent of deals with product list >\$50,000



- Wrapping new products into capacity upgrades often results in heavy discounting and lengthens sales cycle
- Many reps believe they can sell new products standalone at much lower discounts and more quickly...
- ...but, new products are often wrapped into upgrades because of desire to maximize product revenue
- Bundling new products with upgrade may compromise true market value of new products

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IMPACT OF IMPROVING END-OF-QUARTER BEHAVIOR



Average discount

Short- and long-term initiatives were used to affect change

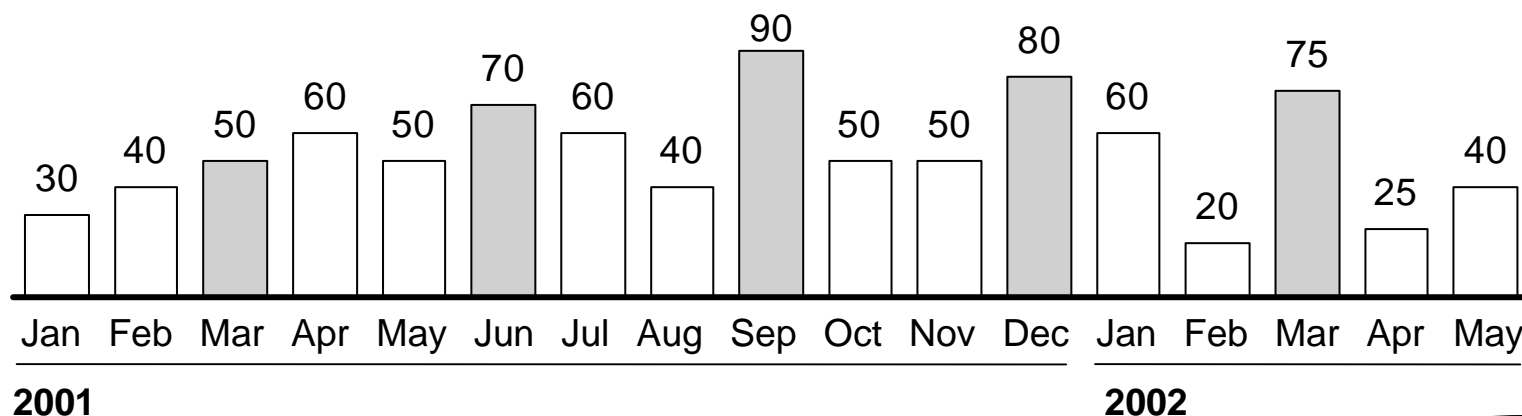
- Internal and external communication strategy
- Marketing role expanded to include
 - Competitive intelligence
 - Price negotiation support
- Sales incentives
 - Mid-quarter quota targets
 - Price realization incentives and penalties
- Commitment to change behaviors
 - CEO approval for EOQ deals over Area VP discount authority

END-OF-QUARTER BEHAVIOR CAN BE MUCH WORSE

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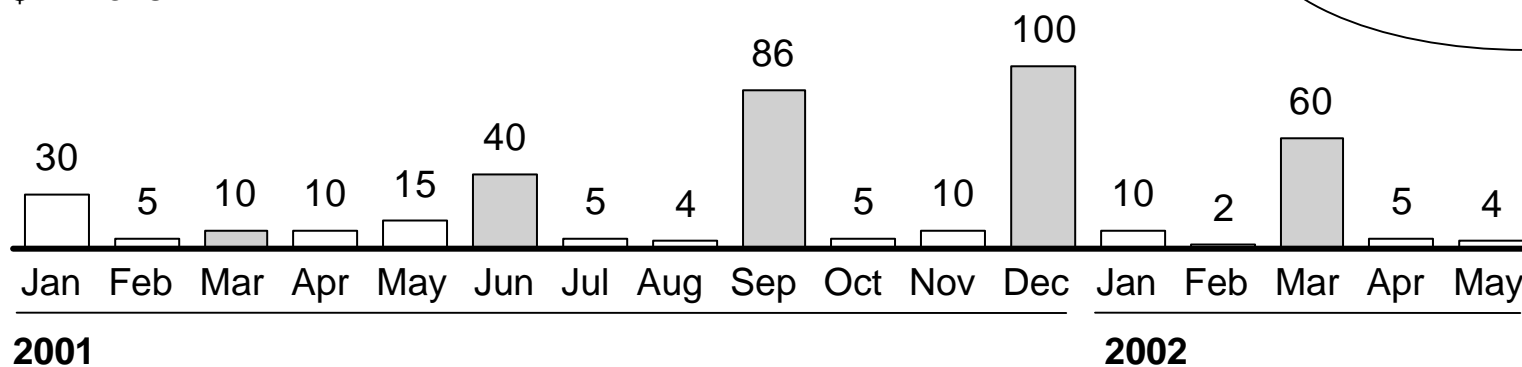
Weighted average discount by month
Percent

Quarter-ending months



List price volume by month
\$ Millions

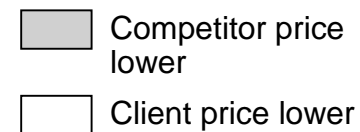
Steep discounting and heavy loading at EOQ



CHOOSING WRONG PRICING PARAMETER CAN SACRIFICE VALUE AND REDUCE COMPETITIVENESS

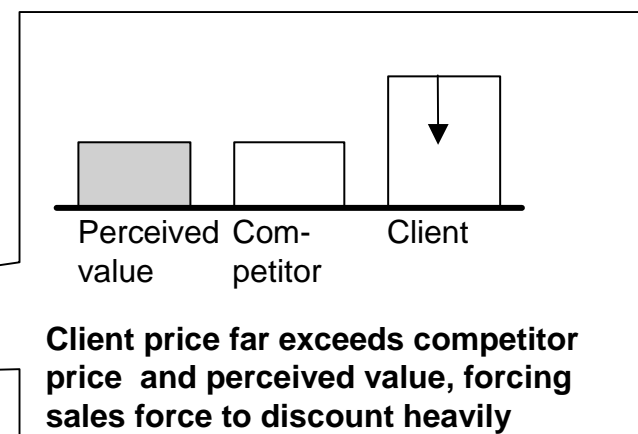
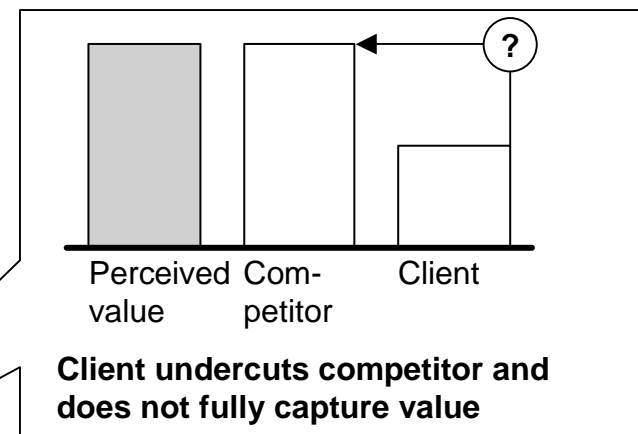
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	<u>Client</u>	<u>Key competitor</u>
Pricing parameter	Capacity	Ports
Alignment with perceived value	Poor	High



Ratio between client and competitor list prices

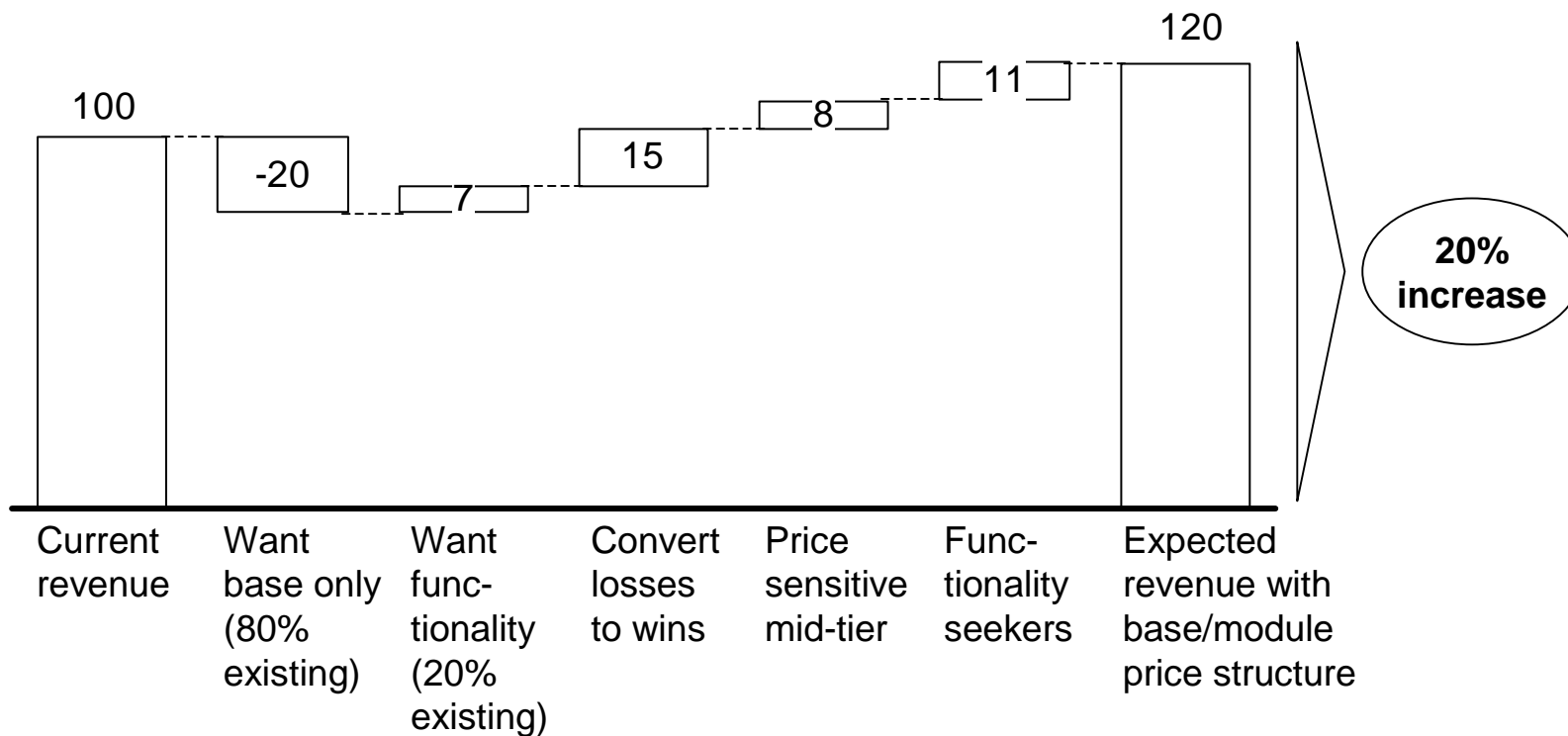
Capacity	Number of ports					
	8	16	32	64	128	256
1	1.2	1.0	0.8	0.6	0.4	0.2
2	1.4	1.1	0.9	0.6	0.4	0.2
4	1.7	1.4	1.1	0.8	0.5	0.3
6	2.0	1.7	1.3	0.9	0.6	0.3
8	2.3	1.9	1.5	1.0	0.7	0.4
10	2.6	2.2	1.7	1.2	0.7	0.4
15	3.3	2.8	2.2	1.5	1.0	0.6
20	4.1	3.4	2.7	1.9	1.2	0.7



IMPACT OF UNBUNDLING SOFTWARE SUITES

Percent

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EXAMPLE



Current revenue Want base only (80% existing) Want functionality (20% existing) Convert losses to wins Price sensitive mid-tier Functionality seekers Expected revenue with base/module price structure

Current customers

New customer segments

Assumptions

Percent change in number of deals

0 20 10 10

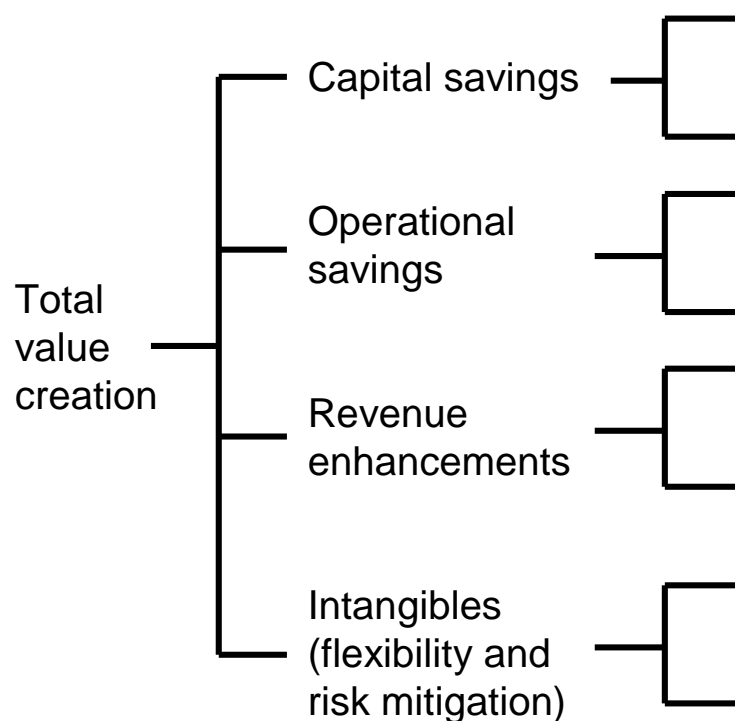
Module*

Base only Base+2 modules Base only Base only Base+1 module

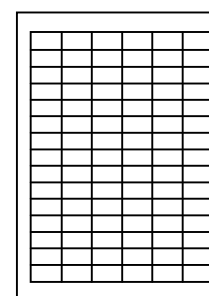
* Base now priced at 75% of original price; incremental modules each priced at 30% of original base price

ECONOMIC VALUE ANALYSIS METHODOLOGY TO ESTABLISH APPROPRIATE PRICE POINTS (1/4)

Step 1: Identify value created by new solution relative to next best alternative and develop pricing model

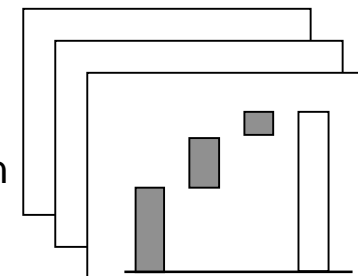


Step 2: Quantify expected value creation and develop supporting materials to convey the message



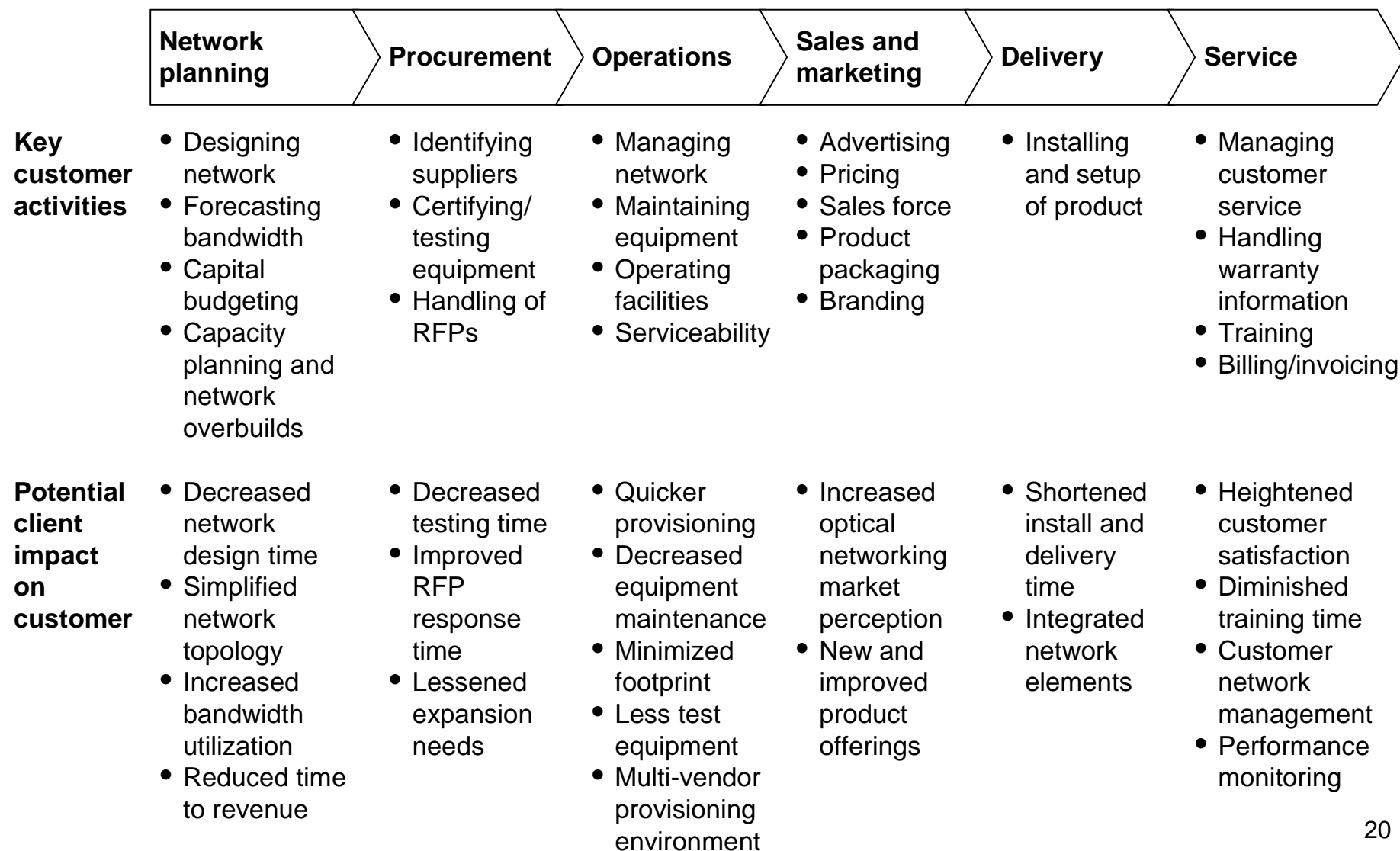
Spreadsheet/
analytic model

Value
argumentation



IMPACT ACROSS CUSTOMER BUSINESS SYSTEM (2/4)

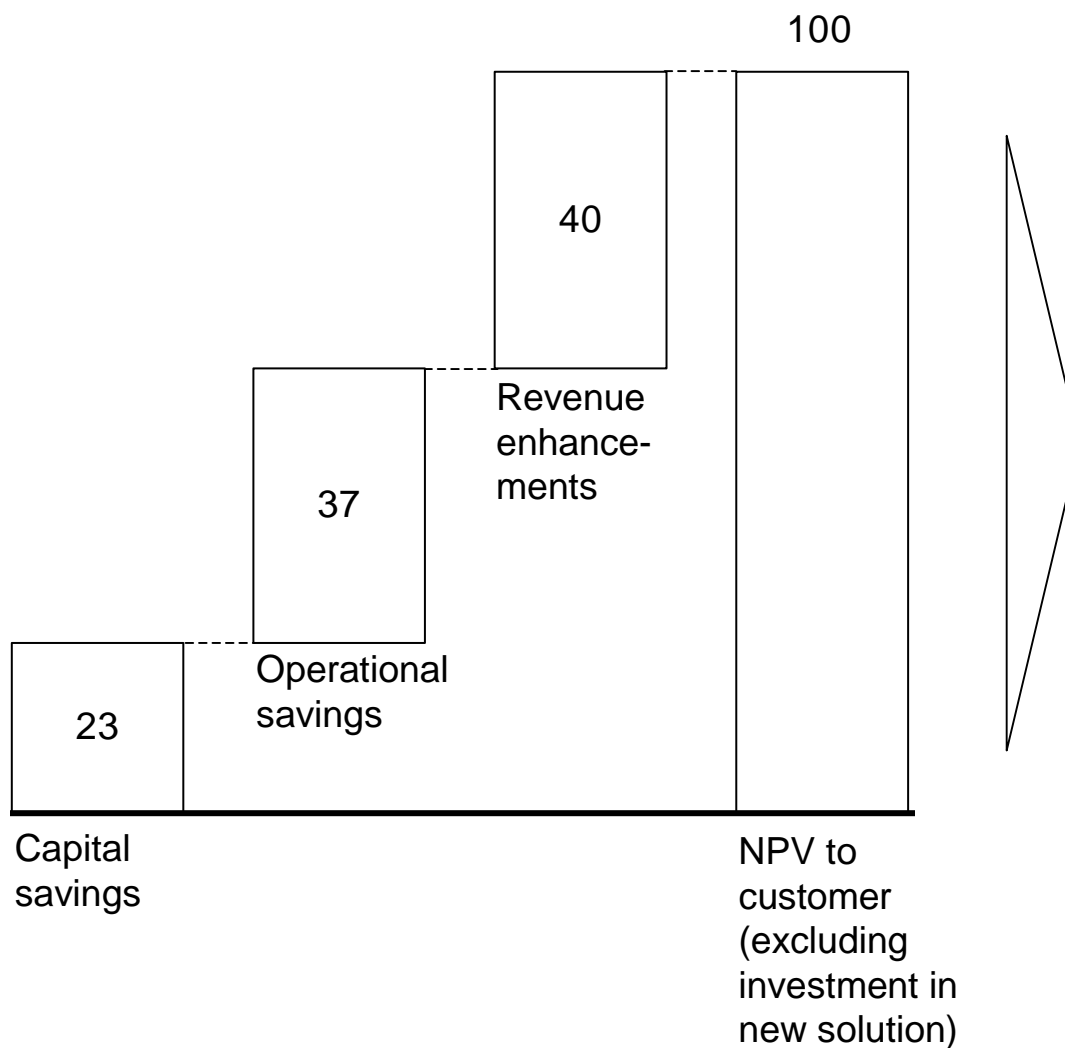
Impact of client product on customer segment (network service provider)



QUANTIFYING ECONOMIC VALUE OF SOLUTION (3/4)

Percent, 100% = 6 year NPV, incremental to legacy technology

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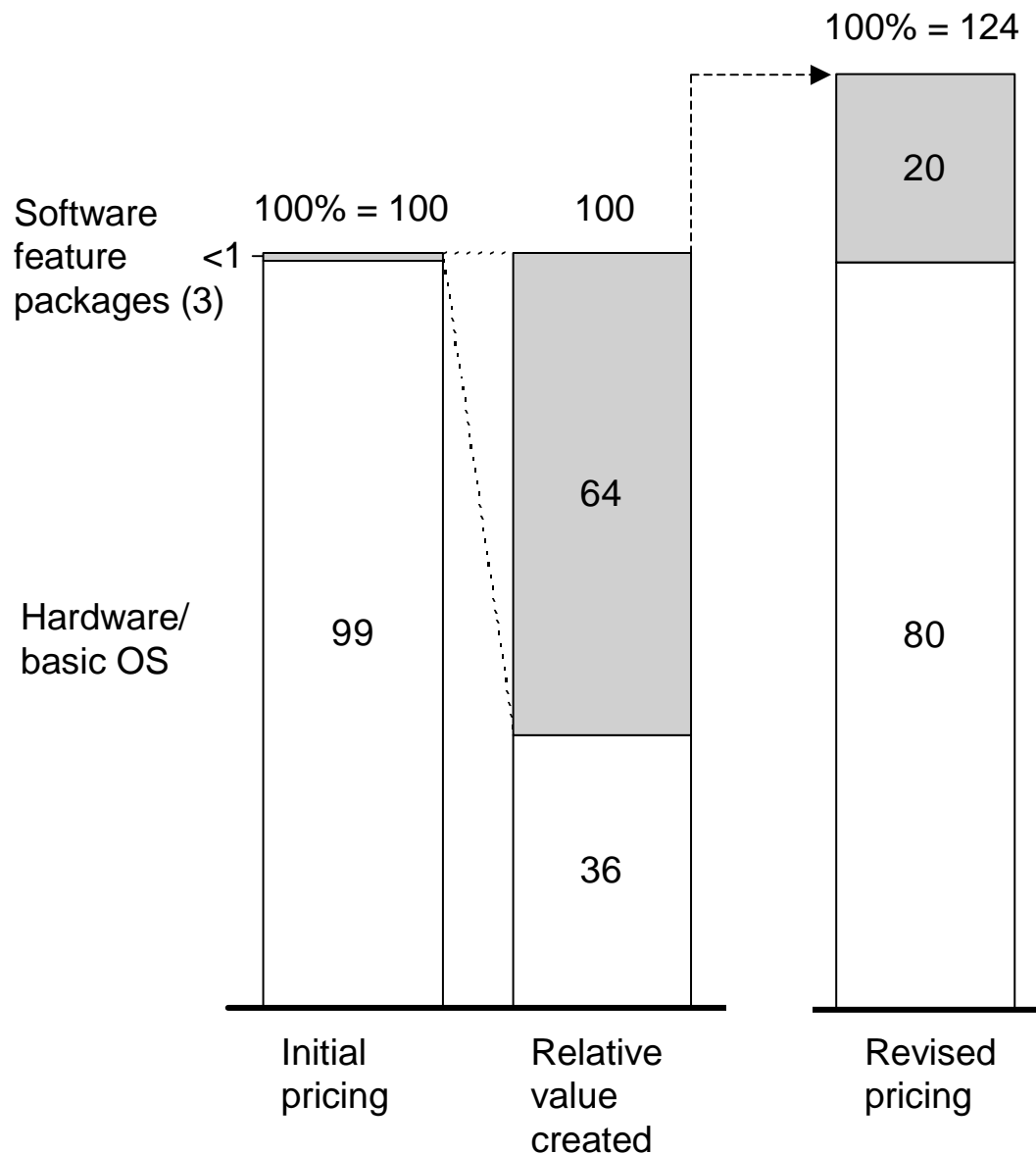


Detailed economic impact analysis showed that new solution yielded 6-year NPV **incremental** to next best alternative that was more than 12 times investment cost (at originally proposed list price)

ALIGNING SOLUTION PRICE WITH VALUE CREATED (4/4)

Percent, indexed to originally proposed list price

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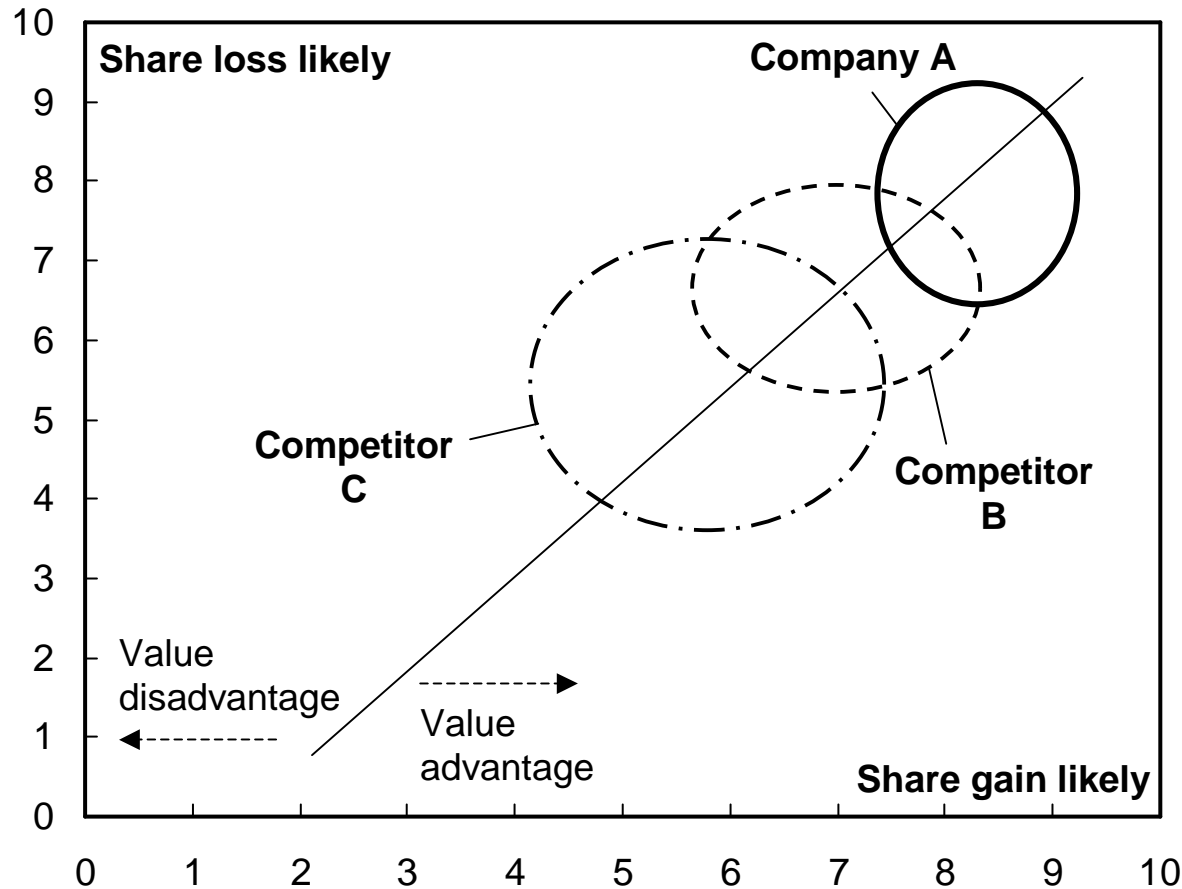
Client increased price of 3 software feature packages by as much as 50X, increasing overall solution price by 24% and software component of total from <1% to roughly 20%

OVERALL PRICE-BENEFIT ANALYSIS SHOWED PRICING WAS ROUGHLY CONSISTENT WITH VALUE (1/4)

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Perceived price

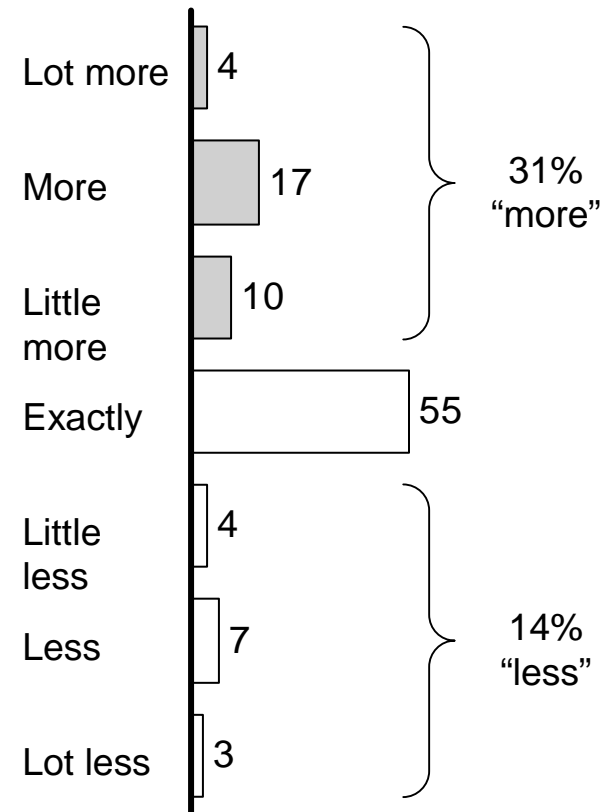
Relative measurement on a scale of 0 to 10



Perceived benefits

Relative measurement on a scale of 0 to 10

“Do you get more/less/exactly what you pay for using Company A’s solution?”
Percent

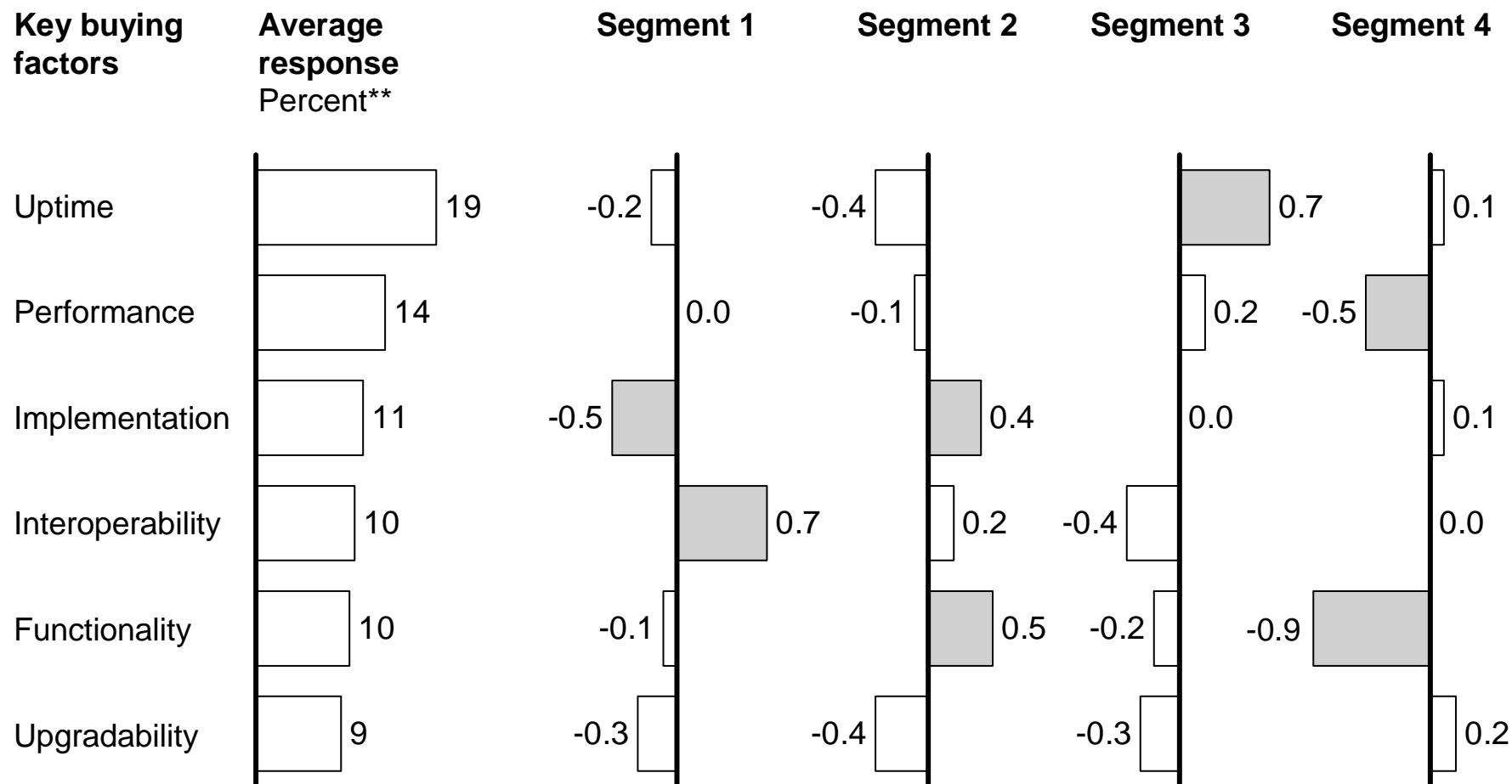


HOWEVER, ANALYSIS OF KEY BUYING FACTORS UNCOVERED DISTINCT CUSTOMER SEGMENTS (2/4)

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■ Key differentiator

Normalized variation by segment

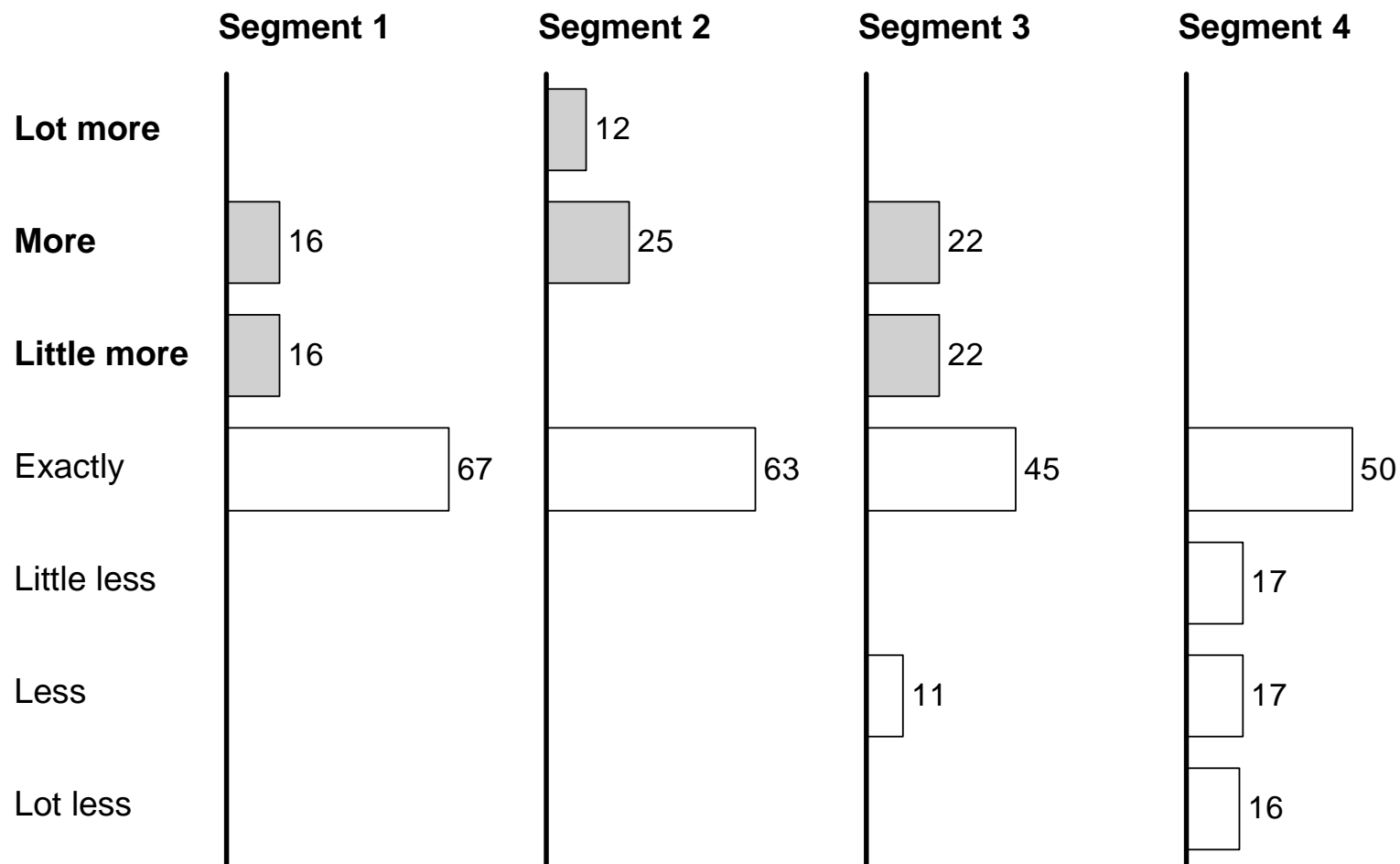


SEGMENTS HAD VERY DIFFERENT PERCEPTION OF VALUE (3/4)

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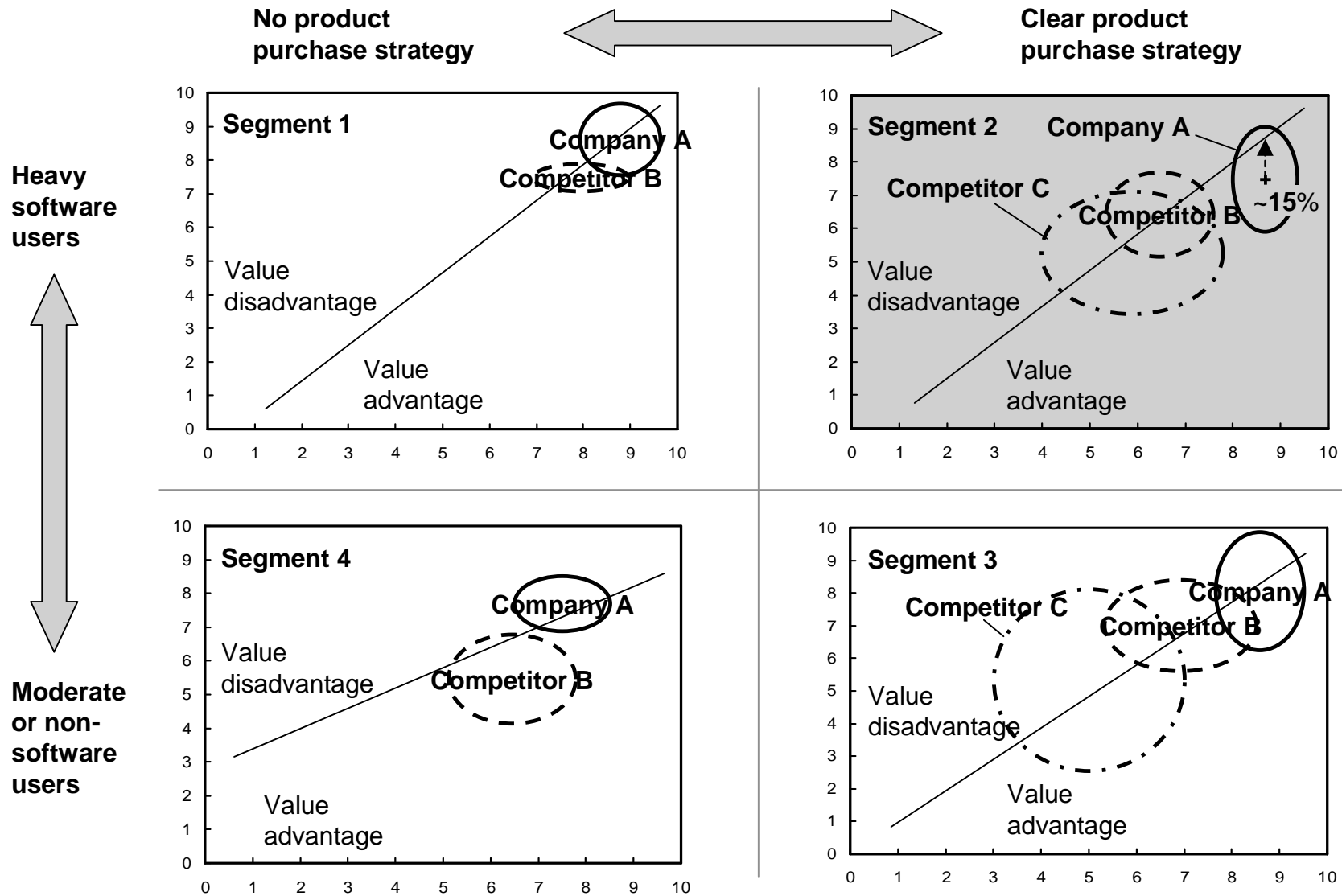
Responses to question: “Do you get more/less/exactly what you pay for with Company A solution?”

Percent of respondents



FURTHER ANALYSIS SHOWED OPPORTUNITY TO INCREASE PRICING IN KEY SEGMENT (4/4)

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INDICATORS OF POTENTIAL PRICING IMPROVEMENT OPPORTUNITY

Tactical opportunity may exist if...

- Account profitability only understood at gross margin level
- No review of account profitability, account pruning, account renegotiation
- Significant negotiated discounts and off-invoice terms exist
- Costs to serve are high and vary across accounts
- Pricing decisions are decentralized or made at field level
- Pricing processes are individual and based on “tribal knowledge” rather than being standardized and replicable
- Real-time decision tools to predict transaction profitability do not exist or are unreliable
- Sales measures and incentives are tied largely to revenues or volume as opposed to net customer/transaction profitability

Product/market opportunity may exist if...

- Distinct customer segments not understood in terms of needs and buying factors
- Segments not targeted with tailored value propositions, economically sound value delivery systems, distinctive go-to-market strategies, and price points
- Missing detailed understanding of customer perception of value differential between own offering and next best alternative
- No centralized tracking of competitor offerings and pricing
- No post mortem reviews of win/lost bids analyzing competitor tactics, customer segmentation, or estimating money left on table

A FEW LESSONS LEARNED REGARDING EFFECTIVE SOFTWARE PRICING

Things to do...

- Set price based on quantified, provable economic value created for customers, considering their next best alternatives
- Segment customers by how they perceive software value (e.g., across channels, geographies, industries, customer size)
- Use creative product architectures to support different prices to different segments and to develop an effective ongoing revenue stream (e.g., through versioning, platforming, services)
- Develop price architecture that links to timing of value creation and offers future flexibility
- Establish price floors to recapture fully loaded development costs

Things to avoid ...

- Offering a “one size fits all” package that effectively leads to some customers receiving more functionality than they want, need, and are willing to pay for
- Delaying new major releases to include customized features that most customers are not willing to pay for
- Discounting heavily to “win every deal”
- Adding on additional services and feature functionality to “sweeten” deal
- Giving away installation, consulting, and other services that customers need and will pay for