

Software License and Maintenance Services Pricing Principles – Best Practices and Case Studies

Homayoun Hatami

SoftSummit Conference

October 2006

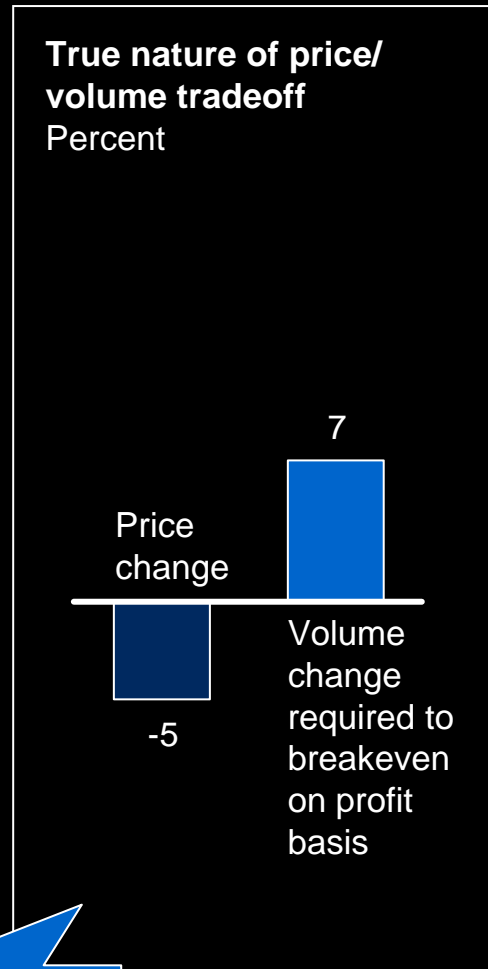
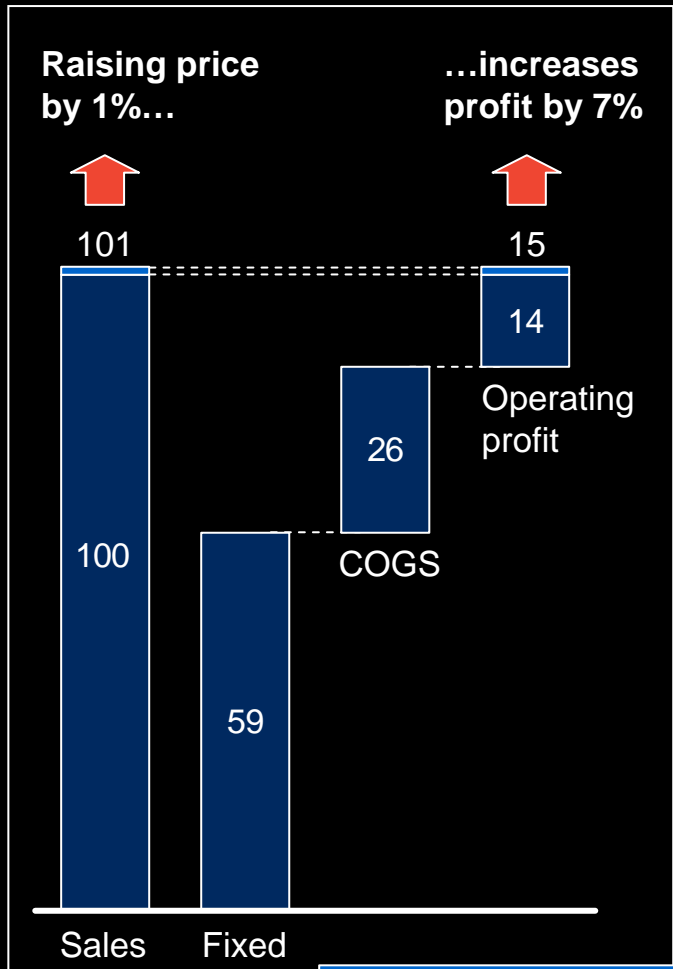
Copyright 2006 McKinsey & Company

TODAY'S DISCUSSION

- **Why pricing is important and why superior pricing performance is hard to achieve**
- Examples of software license and maintenance pricing issues and best practices

PRICING IS BIGGEST LEVER AFFECTING PROFITABILITY

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



How many resources are dedicated to reducing costs or increasing volume vs. improving pricing?

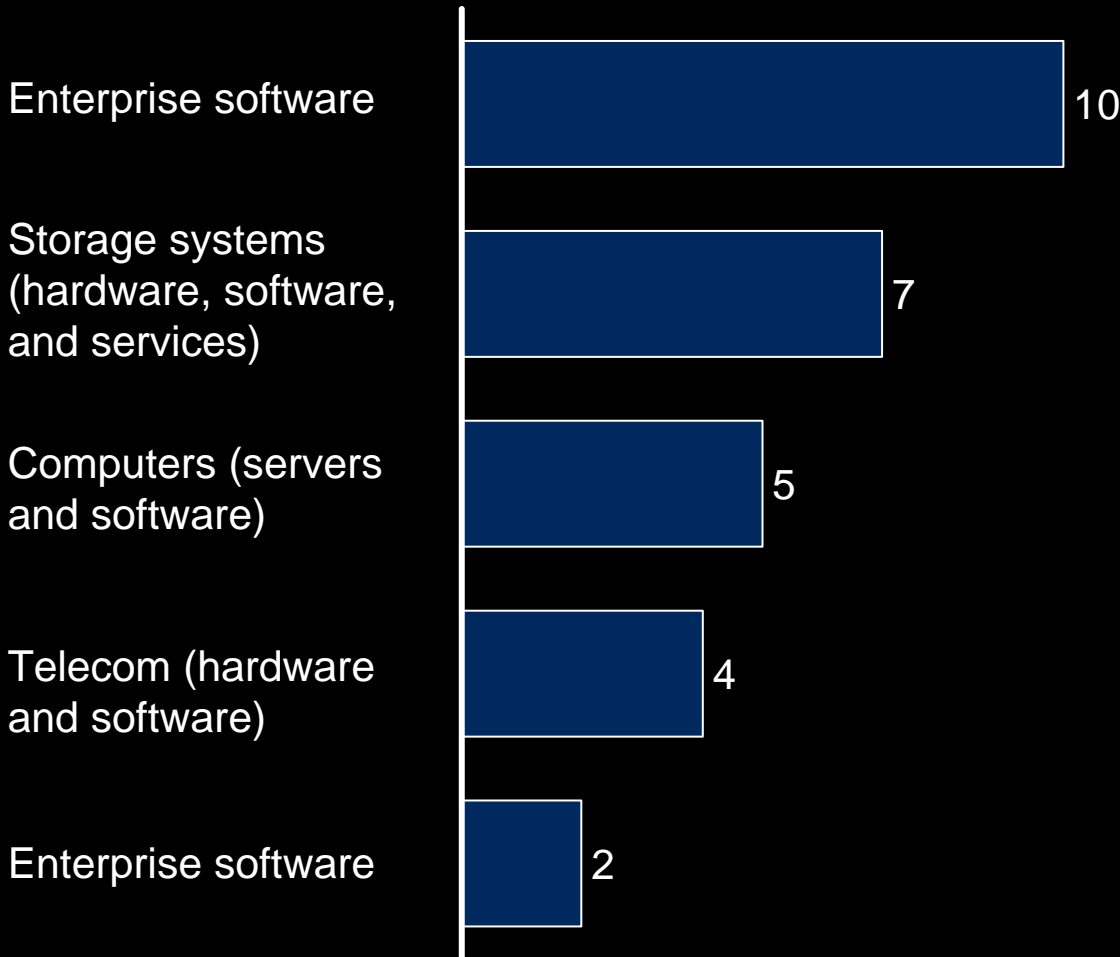
Do price reductions drive sufficient incremental volume?

NUMEROUS CASES SHOW SUBSTANTIAL UPSIDE POTENTIAL EXISTS FROM IMPLEMENTING PRICING BEST PRACTICES

DISGUISED
EXAMPLES

Improvement in return on sales
(within 9-12 months of implementation)
Percentage points

Case example

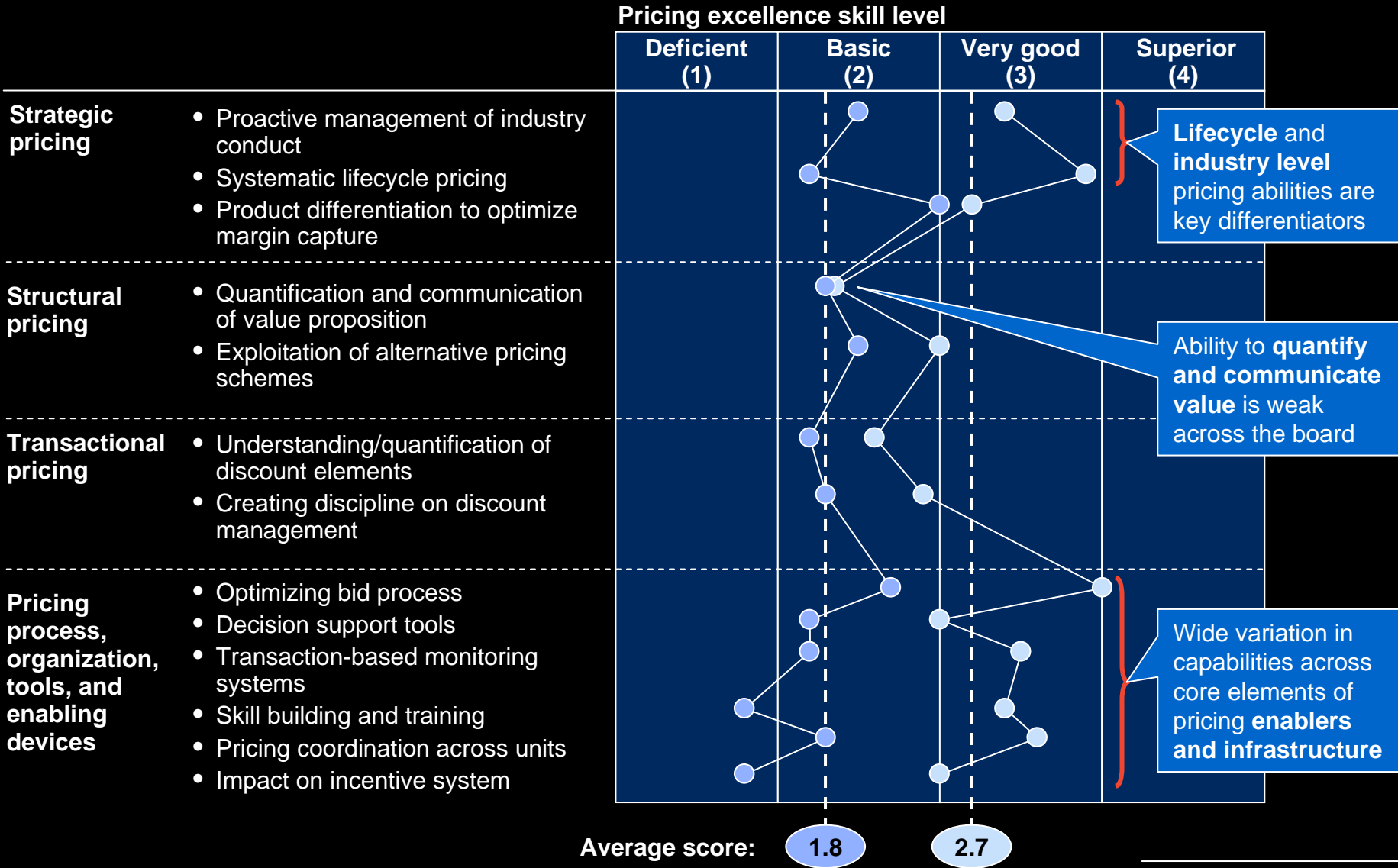


Pricing impact is usually greater in situations with:

- Complex product lines
- Many transactions
- Broad customer base
- High switching costs
- Weak current pricing capabilities

EVEN SO, MANY TECHNOLOGY COMPANIES FEEL THEIR PRICING MANAGEMENT SKILLS ARE "BASIC"

● Companies in top quartile
● Companies in bottom quartile



SUPERIOR PRICING IS CHALLENGING IN GENERAL...

Focus and dedication

- Top management attention focused elsewhere (e.g., growth, cost reduction)
- Limited investment in pricing function and infrastructure
- Few dedicated, capable pricing resources

Visibility into opportunity

- No transparency into actual net (“pocket margin”) pricing performance – across deals, customers, products, markets
- “Size of prize” and potential improvement opportunities not fully appreciated and prioritized along with other initiatives

Frontline pricing performance

- Poor understanding by frontline decision makers of fundamental tradeoffs and implications
- Incentives not aligned to drive improved pricing performance (e.g., sales focused on closing deals – “every deal is a good deal”)

Strategic direction

- Share or volume growth aspirations dominate sales strategy instead of profitable growth
- Price – not value – seen as primary competitive weapon
- Fear of embracing price leadership

... AND EVEN TOUGHER FOR TECHNOLOGY COMPANIES, ESPECIALLY SOFTWARE BUSINESSES

Dynamic environment

- Frequent innovation and short product lifecycles
- Steady growth in feature functionality with often decreasing price/performance ratios

“Winner takes all” mindset

- Potential for high user switching costs, network effects, and emergence of de facto standards drives push to establish presence
- Discipline lost in rush to get to market

Communication of value

- Value delivered is hard to quantify and communicate (e.g., for new innovations, software, and services)
- Marginal costs perceived to be at or near zero for software – leading to extreme discounting

Complexity over lifecycle

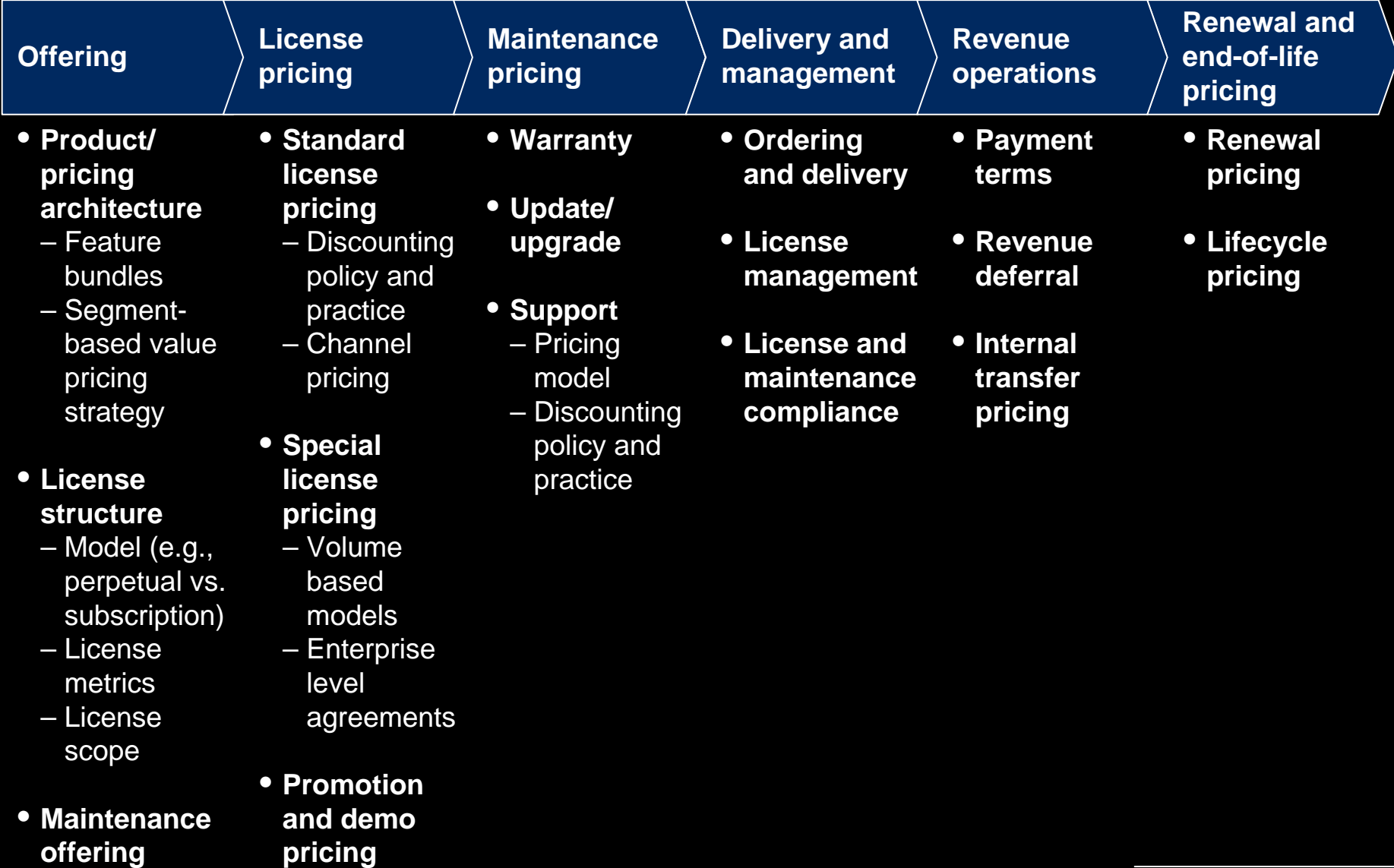
- Myopic view of pricing strategy and tactics over product lifecycle
- Multitude of alternative pricing models and approaches available – many degrees of freedom (e.g., across license/services)

TODAY'S DISCUSSION

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

- **Examples of software license and maintenance pricing issues and best practices**

COMPONENTS OF SOFTWARE LICENSE AND MAINTENANCE PRICING



COMMON ISSUES AND BEST PRACTICE EXAMPLES



- **Product/pricing architecture**
 - Feature bundles
 - Segment-based value pricing strategy
- **License structure**
 - Model (e.g., perpetual vs. subscription)
 - License metrics
 - License scope
- **Maintenance offering**

- **Standard pricing**
 - Discount policy

- **Warranty**
- **Update/upgrade**

- **Ordering and delivery**
- **License management**

- **Payment terms**
- **Revenue deferral**

- **Renewal pricing**
- **Lifecycle pricing**

Common issues	Best practices
<ul style="list-style-type: none"> • “One size fits all” product/pricing architecture 	<ul style="list-style-type: none"> • Unbundle software suites as appropriate to better address underlying segment needs
<ul style="list-style-type: none"> • Price vs. benefit not assessed at segment level 	<ul style="list-style-type: none"> • Analyze differences in value perception by segment and set pricing strategy accordingly
<ul style="list-style-type: none"> • License metrics not aligned with customer value perception 	<ul style="list-style-type: none"> • Align license scaling metrics with fundamental customer impact parameters (within constraints imposed by ease of administration)

- **Promotion and demo pricing**

OPPORTUNITIES TO ADDRESS DISTINCT VALUE PROPOSITIONS IN CUSTOMER SEGMENTS

DISGUISED EXAMPLE

No product purchase strategy

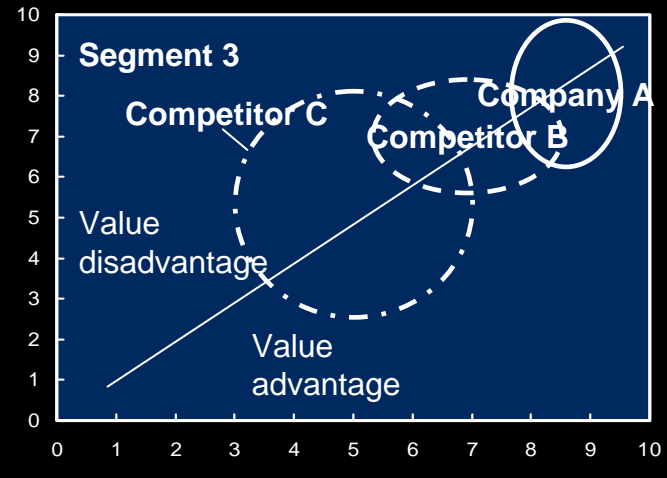
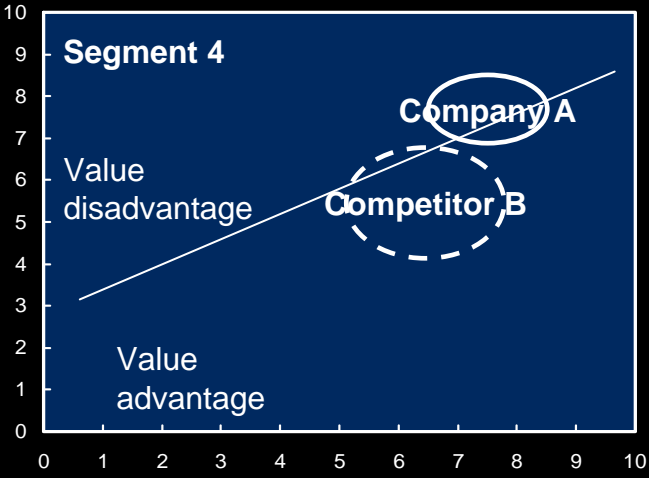
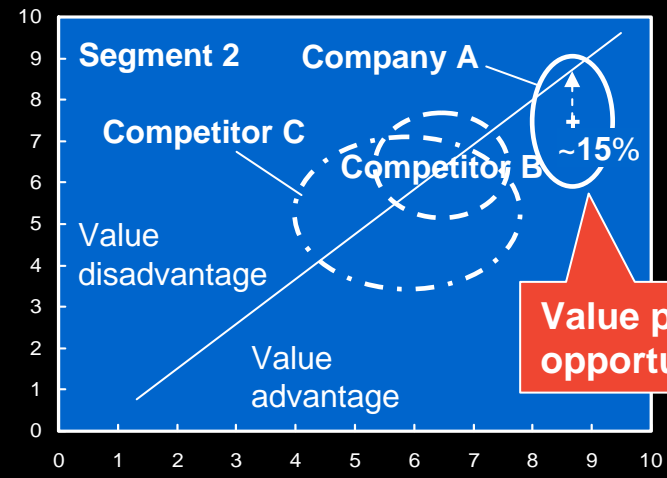
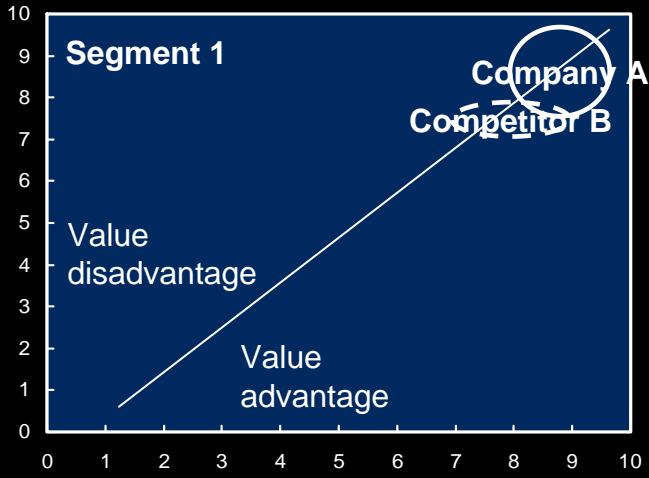
Clear product purchase strategy



Heavy software users



Moderate or non-software users



CHOOSING WRONG LICENSING METRIC CAN LEAD TO HEAVY DISCOUNTING OR BELOW VALUE PRICING

DISGUISED EXAMPLE

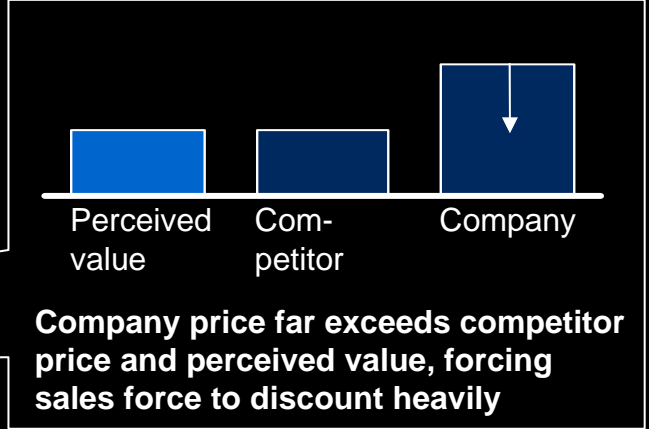
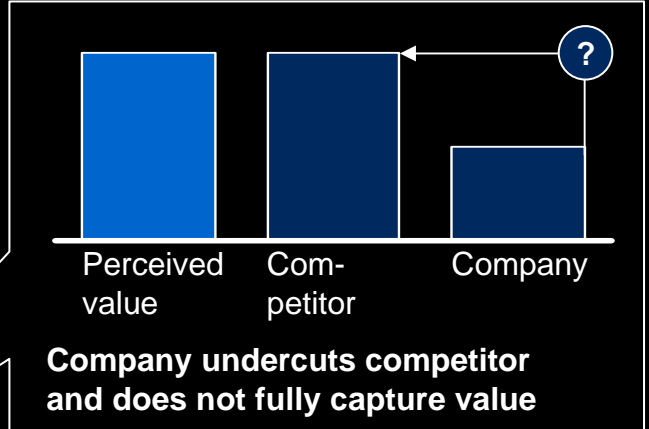
	<u>Company</u>	<u>Competitor</u>
Pricing parameter	Capacity	Ports
Alignment with perceived value	Poor	High

■ Competitor price lower
■ Company price lower

Ratio between client and competitor list prices

Number of ports

Capacity	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	2.0	1.5	1.0	0.6
20	4.1	3.4	2.7	1.9	1.2	0.7



COMMON ISSUES AND BEST PRACTICE EXAMPLES



- **Product/pricing architecture**
 - Feature bundles
 - Segment-based value pricing strategy
- **License structure**
 - Model (e.g., perpetual vs. subscription)
 - License metrics
 - License scope
- **Maintenance offering**

- **Standard license pricing**
 - Discounting policy and practice
 - Channel pricing
- **Special license pricing**
 - Volume based models
 - Enterprise level agreements
- **Promotion and demo pricing**

- **Warranty**
- **Updates**

- **Ordering and delivery**

- **Payment terms**

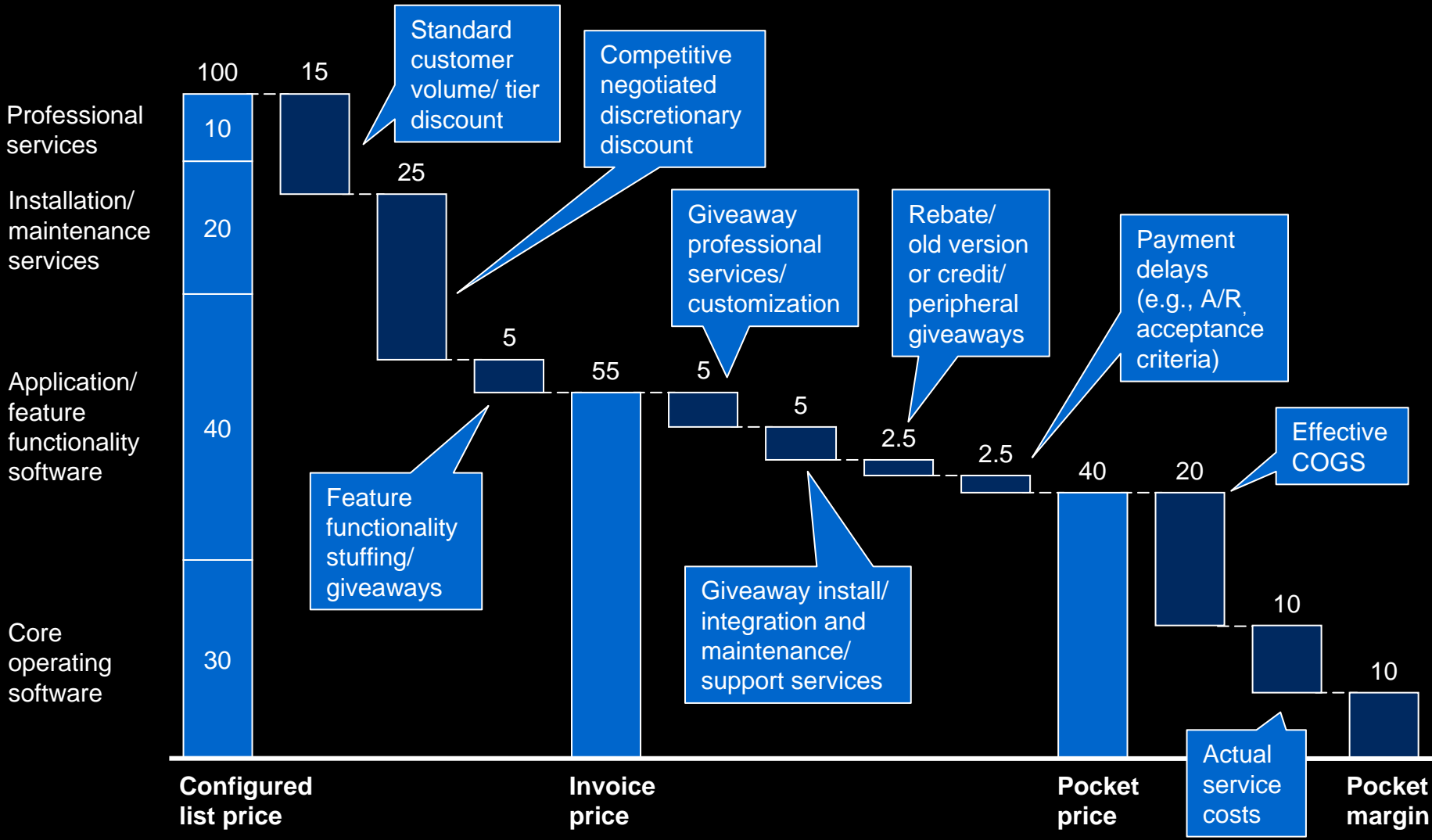
- **Renewal pricing**

Common issues	Best practices
<ul style="list-style-type: none"> • Lack of frontline discounting discipline (e.g., at end of quarter) • Target discount structure does not differentiate by segment • Special license agreements are all “one-off” deals • Enterprise license agreements used with smaller accounts 	<ul style="list-style-type: none"> • Establish discount floors and exception management processes with incentives tied to measurable performance • Differentiate target discounts by segment based on underlying value differences • Standardize volume/ELA deal T&Cs and centralize approval process to ensure consistency • Set rigorous account criteria to qualify deals for ELAs

BEWARE OF ASSUMPTION THAT MARGINAL COSTS ARE ZERO

DISGUISED
EXAMPLE

Percent, indexed to configured list price

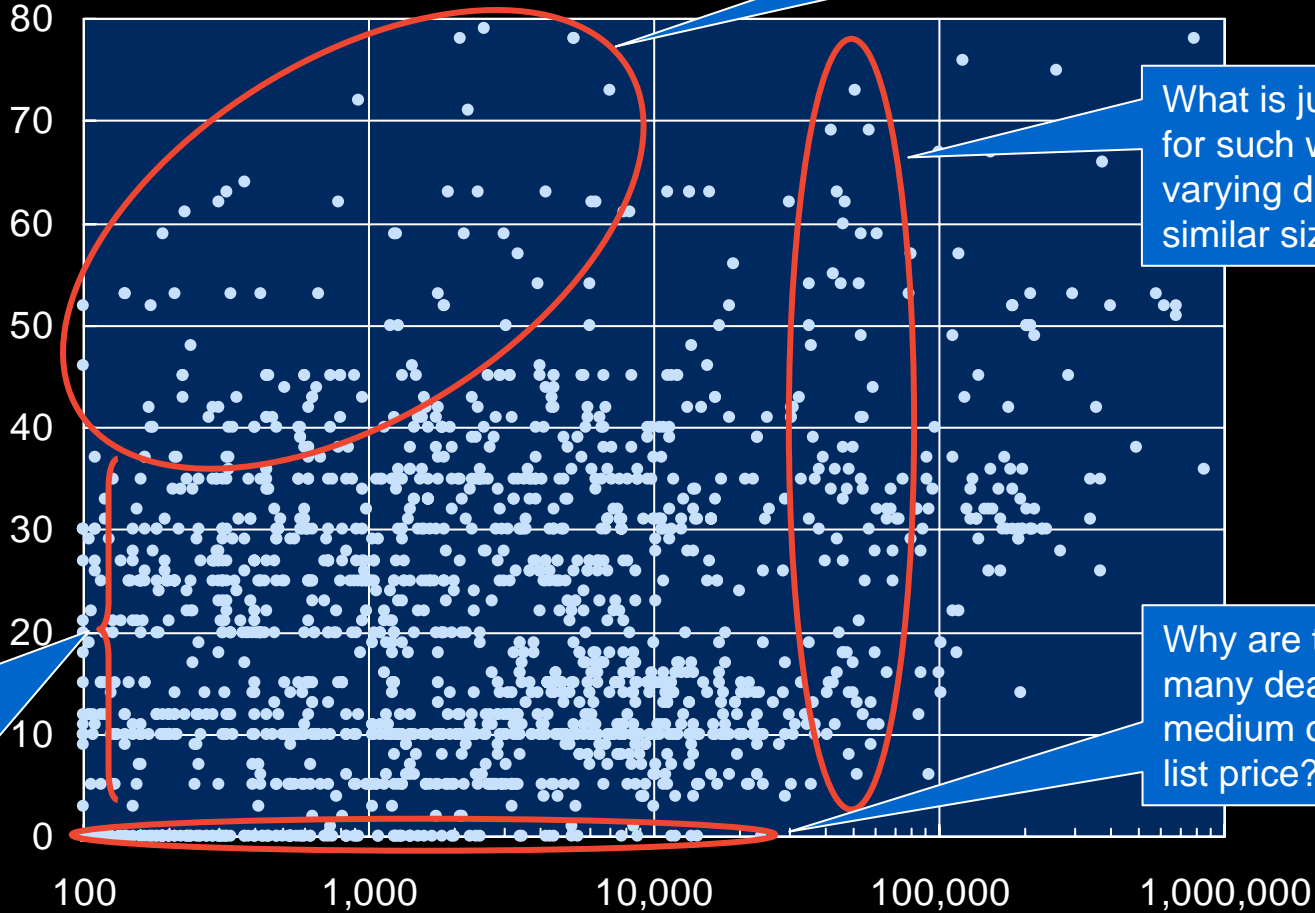


WIDE VARIABILITY IN FRONTLINE PRICING...

DISGUISED
EXAMPLE

Deal level analysis

License discount
Percent of list price



Why do smaller deals receive such large discounts?

What is justification for such widely varying discounts for similar sized deals?

Can sales behavior be changed to limit discounts at "standard" levels?

Why are there so many deals (even medium ones) at full list price?

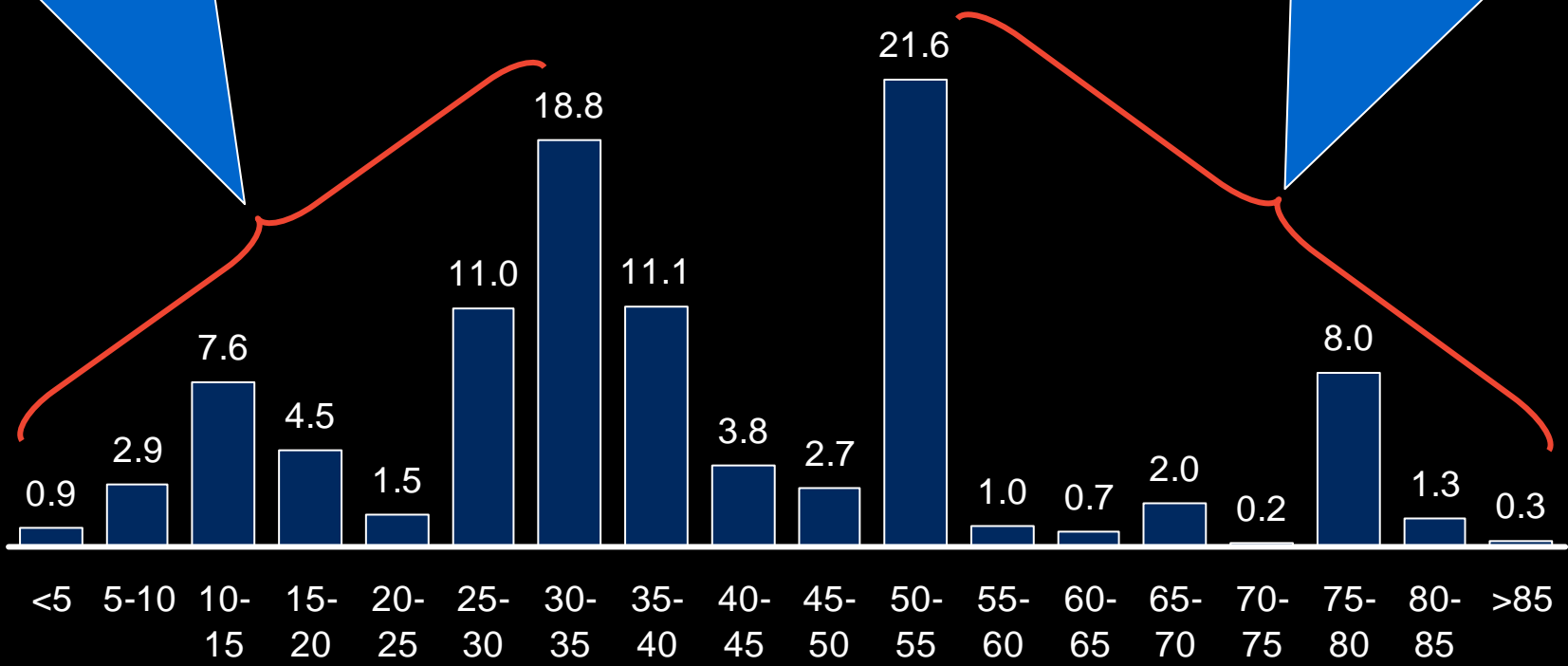
... OFTEN INDICATES OPPORTUNITIES TO IMPROVE FRONTLINE PERFORMANCE

DISGUISED EXAMPLE

Distribution of deals by discount level
Percent of sales

- Maximize upside potential**
- Set list prices competitively and fairly
 - Avoid additional automatic discounts (e.g., volume discounts)
 - Focus marketing program and executive visits

- Tighten range of discounting**
- Create disciplined pricing/escalation processes
 - Align sales force incentives to reduce discounting
 - Create tools to track and support frontline pricing performance

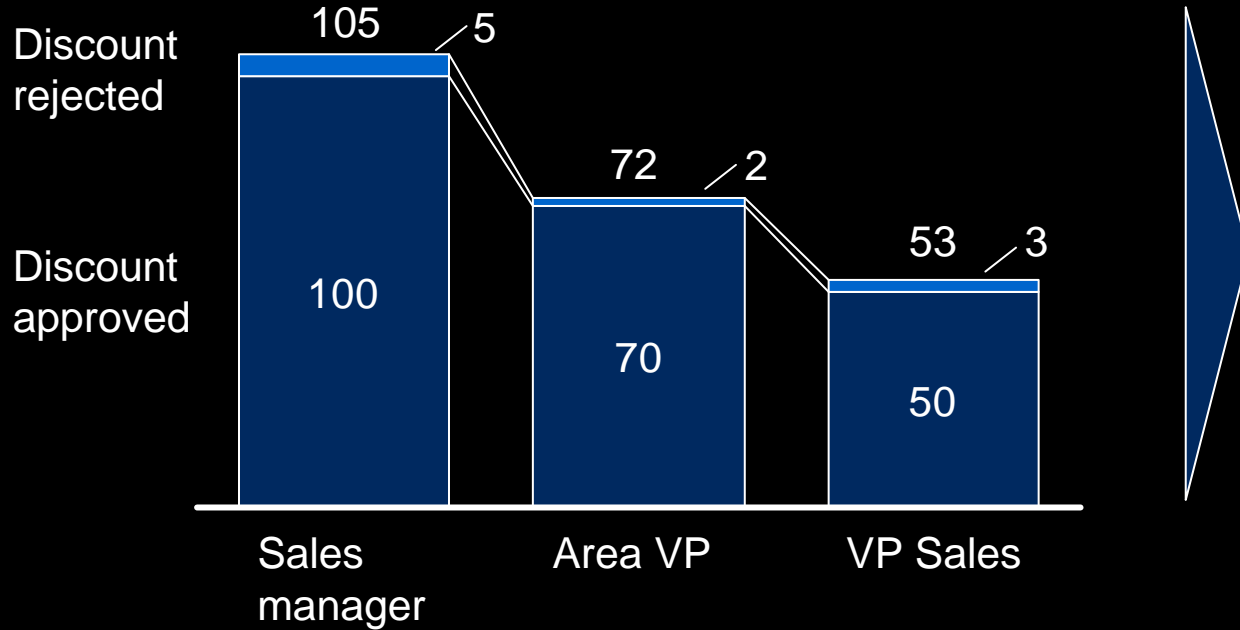


Discount band
Percent of list price

POOR MANAGEMENT OF EXCEPTIONS MAKES IT “EASIER TO NEGOTIATE INTERNALLY THAN EXTERNALLY”

Approval/rejection of exceptional discount for deals

Number of deals



- Managers rarely reject escalated deals
- Sales reps are not afraid to request high levels of discount
- Sales reps do not suffer any consequences from offering excessive discounts

Quotes from sales force interviews

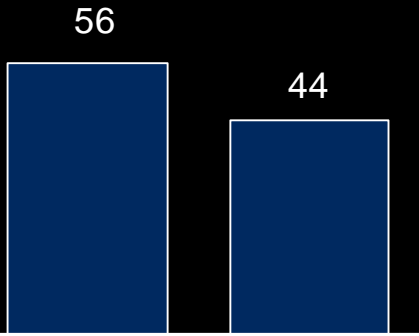
- “Managers are no deterrent, they approve everything”
- “We never walk away from deals”
- “These big deals with huge discounts only get done because of senior management approving them”

IMPACT OF IMPROVING END-OF-QUARTER BEHAVIOR

DISGUISED
EXAMPLE

Initial situation

Percentage of total deals
100% = 220



First 11
weeks

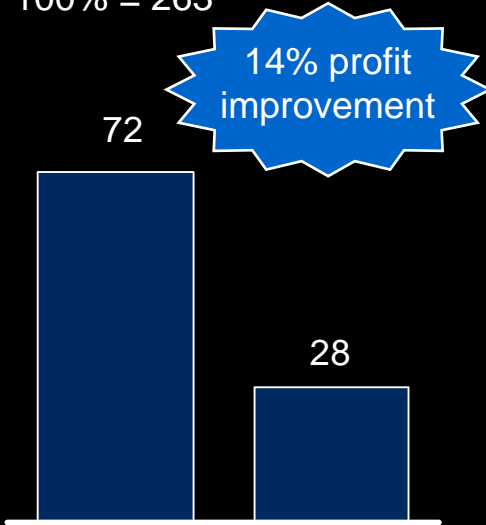
Last 2
weeks

45%

37%

After 1 year

Percentage of total deals
100% = 263




First 11
weeks

Last 2
weeks

43%

28%

 Average discount

Change initiatives

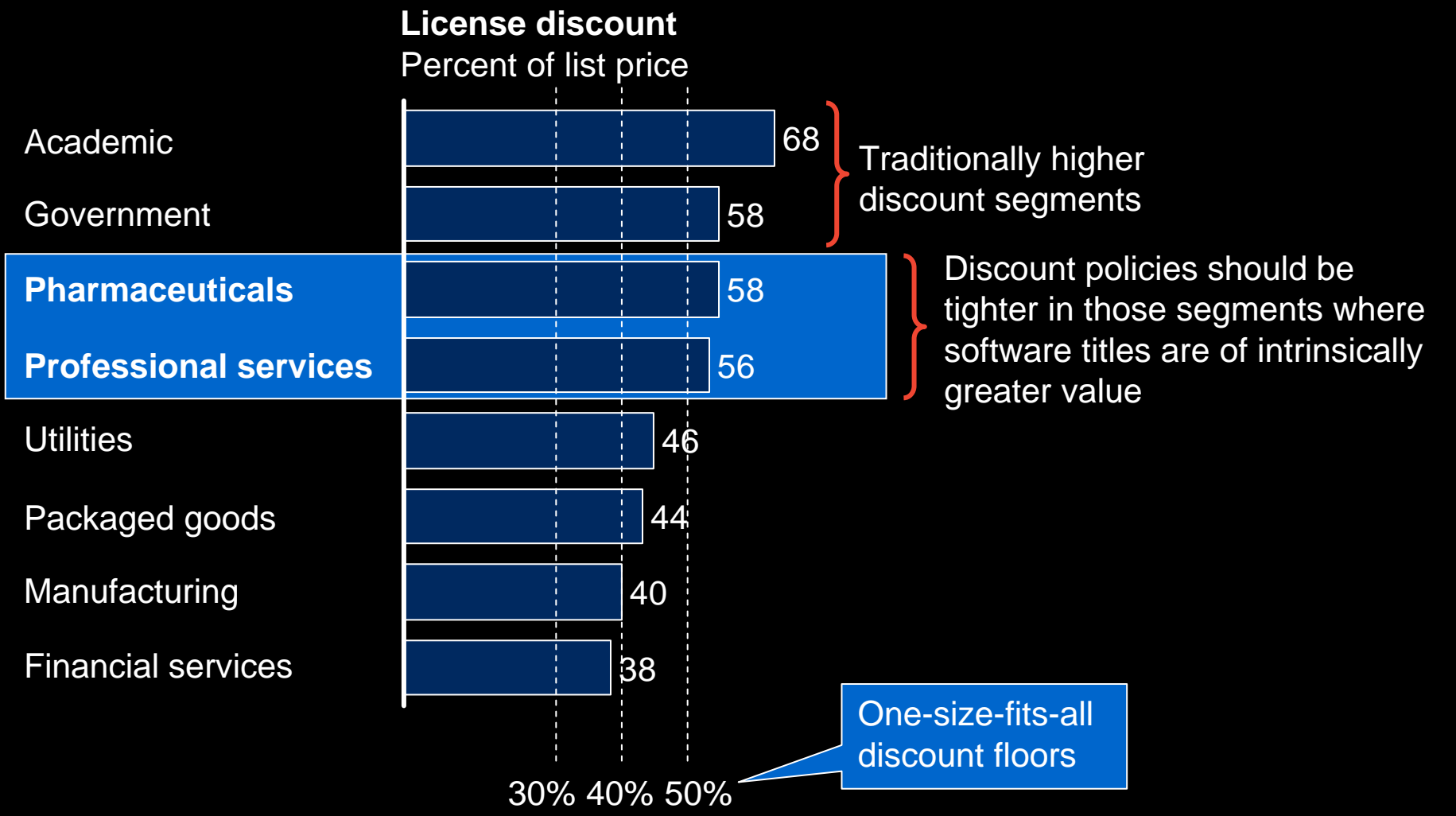
- Marketing role expanded to include
 - Competitive intelligence
 - **Price negotiation support**
- Sales incentives
 - Mid-quarter quota targets
 - **Price realization incentives and penalties**
- Commitment to change behaviors
 - **CEO approval for EOQ deals** over Area VP discount authority
- Internal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

Impact

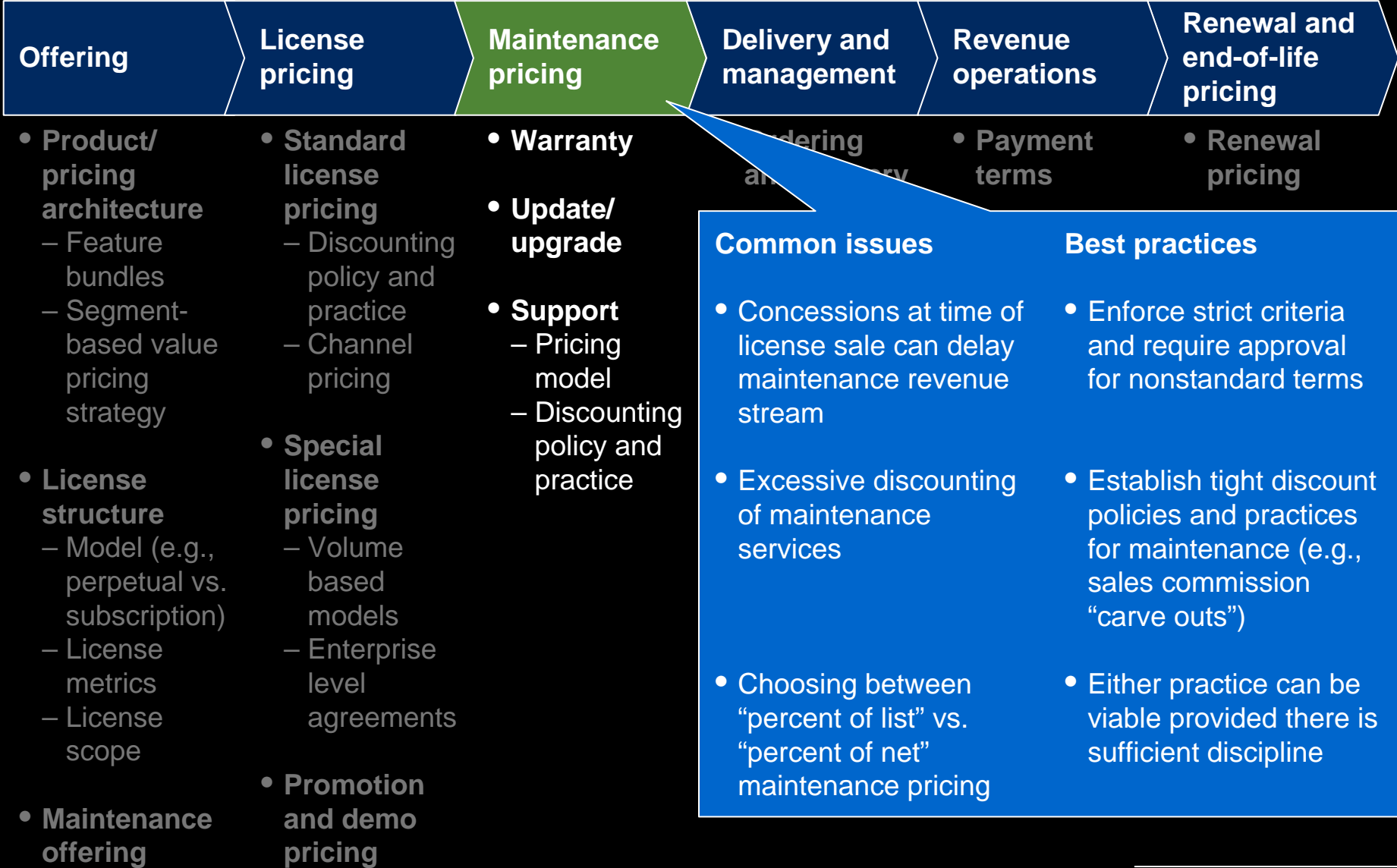
- Shift in deal volume away from end-of-quarter
- Reduced discounting on largest deals
- Improved profitability (on higher deal volume)

DISCOUNTING POLICIES SHOULD REFLECT DIFFERENCES IN CUSTOMER SEGMENT VALUE PERCEPTIONS

DISGUISED
EXAMPLE



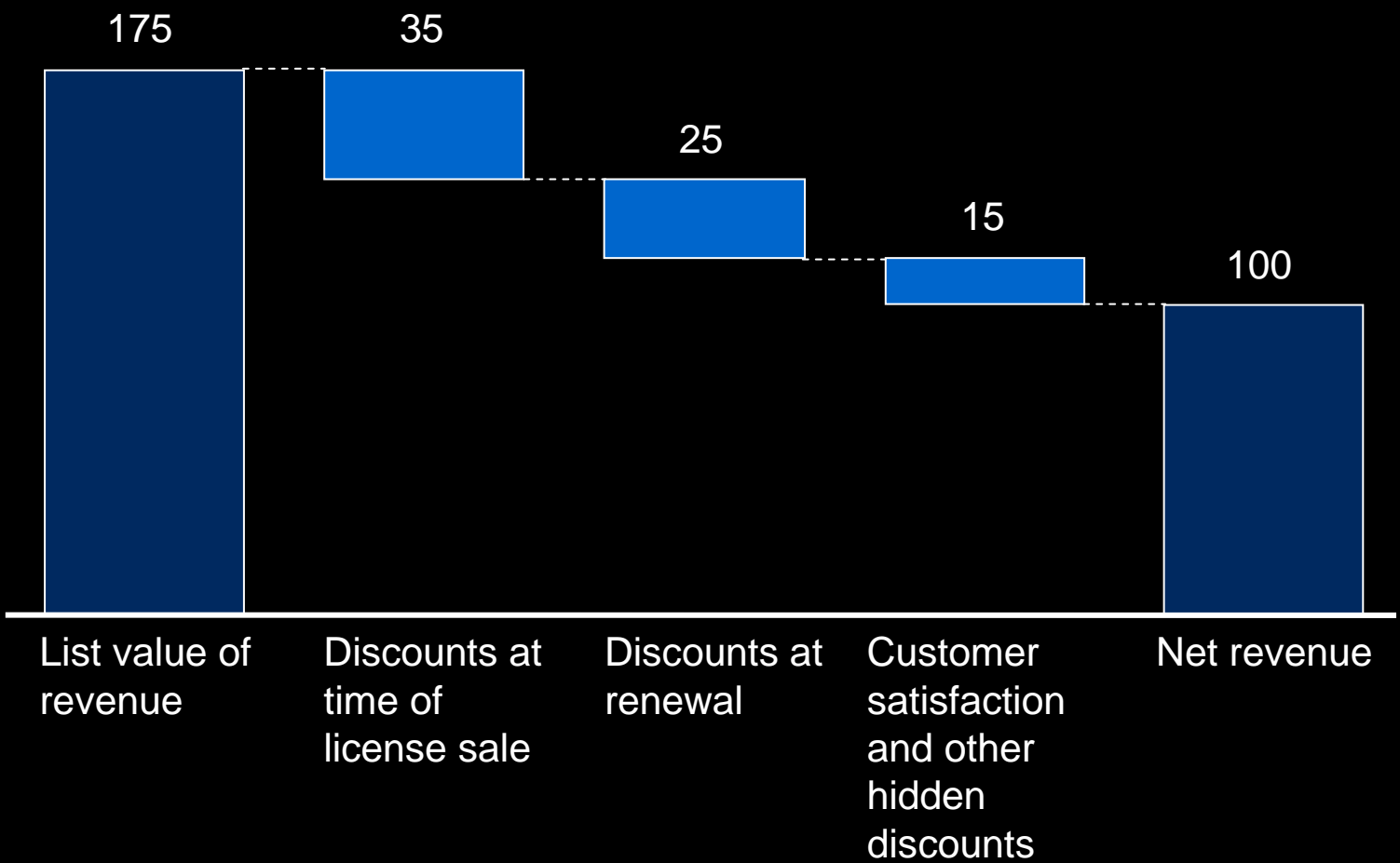
COMMON ISSUES AND BEST PRACTICE EXAMPLES



NET EFFECT OF SOFTWARE MAINTENANCE DISCOUNTS CAN BE SIGNIFICANT

DISGUISED
EXAMPLE

Maintenance revenue, indexed to revenue = 100

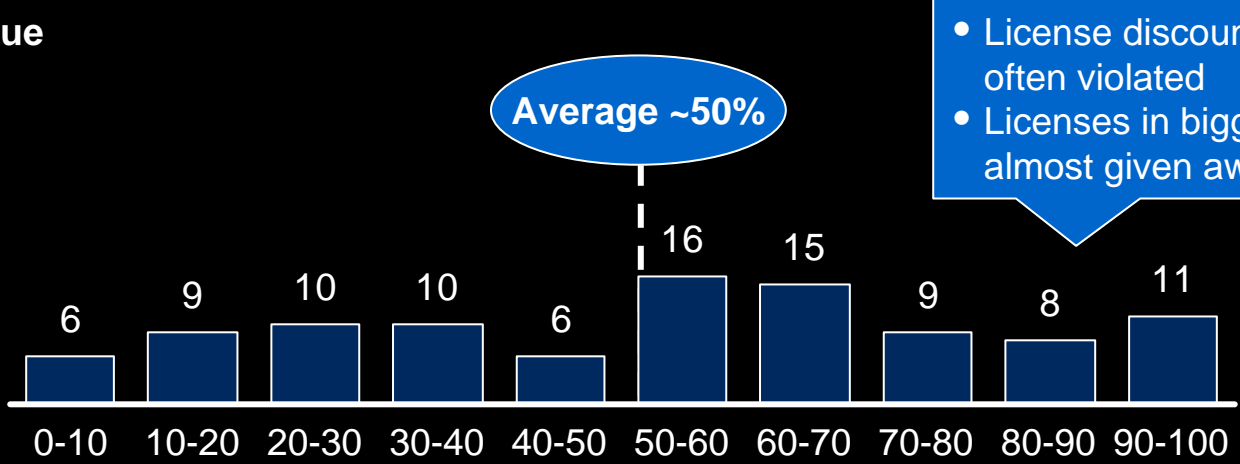


MAINTENANCE SERVICES CAN BE DISCOUNTED MUCH LESS THAN LICENSE SALES

DISGUISED
EXAMPLE

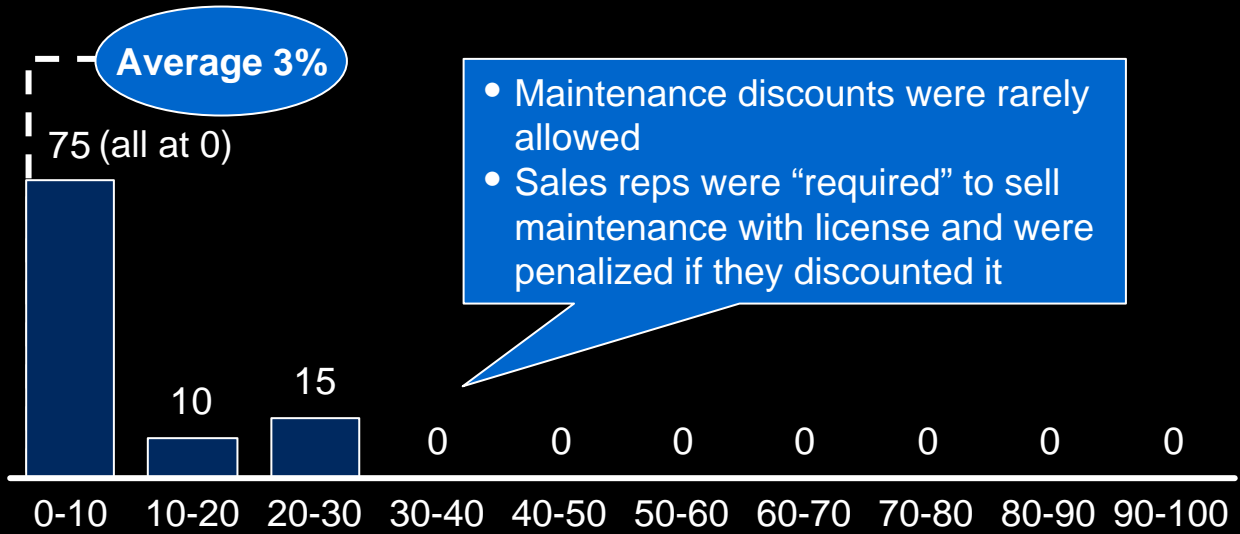
Share of list revenue
Percent

License



- License discounting rules often violated
- Licenses in biggest deals almost given away

Maintenance



- Maintenance discounts were rarely allowed
- Sales reps were “required” to sell maintenance with license and were penalized if they discounted it

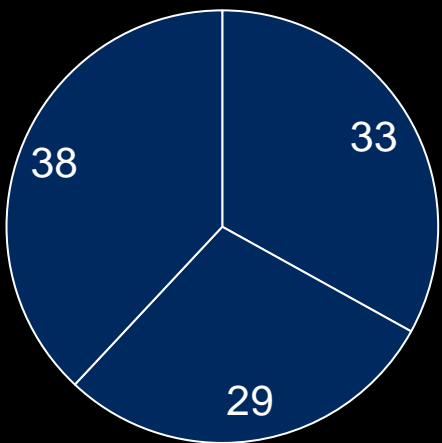
Discount
Percent of list price

THERE IS NO DOMINANT SOFTWARE MAINTENANCE PRICING MODEL

Software maintenance pricing model
Percent, N = 24 companies

Percent of license list price

- Novell
- Peoplesoft
- Progress
- CA
- Sun
- IBM
- EMC
- Filenet
- Legato



Mixed models

- Veritas
- HP
- Caldera
- Linuxcare
- Microsoft
- NCR
- Sybase

Percent of license net price

- BMC
- HDS
- Clarify
- DEA
- IFS
- Network Associates
- Oracle
- SAP



- There is no “right answer” – **either model can be viable**
 - Mix of models used by industry
 - Can usually realize any given absolute price point under either model
- Best choice of model depends on sales objectives, incentives, frontline discipline, and sometimes tactical factors (e.g., systems)

COMMON ISSUES AND BEST PRACTICE EXAMPLES



- Product/ pricing architecture

- Standard license pricing

- Warrant

- Ordering and delivery

- Payment terms

- Renewal pricing

Common issues	Best practices
<ul style="list-style-type: none"> • Inadequate license management tools result in lack of installed base usage information • Entitlement check and enforcement practices for license and maintenance are weak 	<ul style="list-style-type: none"> • Use electronic license management tools to facilitate registration, trial usage, purchase, and customer software asset management • Entitlement systems can limit unlicensed usage and create opportunity for maintenance renewal/ up-sell

- License management

- Revenue deferral

- Lifecycle pricing

- License and maintenance compliance

- Internal transfer pricing

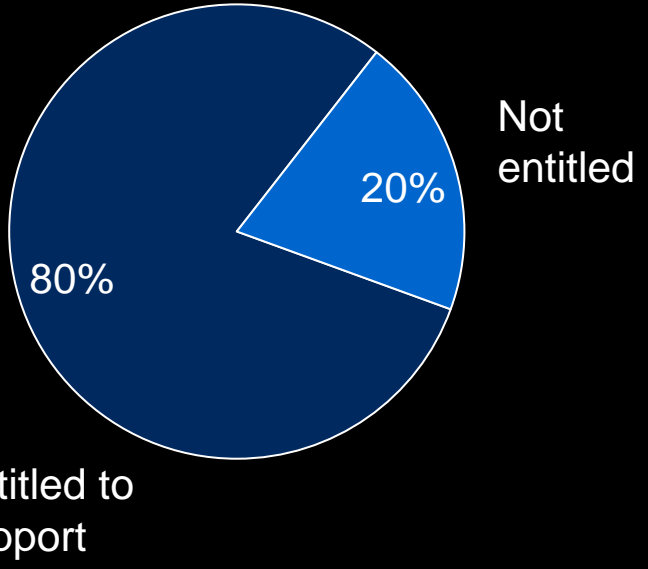
- Maintenance offering

- Promotion and demo pricing

ELECTRONIC LICENSE MANAGEMENT CAN HELP ENFORCE ENTITLEMENT RIGHTS

DISGUISED
EXAMPLE

Breakdown of software related customer service support calls
Percent



- 20% of calls were not entitled to support
 - Significant support cost reduction opportunity
 - Opportunity to upsell/renew maintenance contracts
- Electronic license management tool, combined with entitlement system can:
 - Bring visibility to compliance issues
 - Clamp down on unlicensed usage
 - Lower cost of managing support entitlement

COMMON ISSUES AND BEST PRACTICE EXAMPLES



- **Product/pricing architecture**

- Feature bundles
- Segment-based value pricing strategy

- **License structure**

- Model (e.g., perpetual vs. subscription)
- License metrics
- License scope

- **Maintenance offering**

- **Standard license pricing**

Common issues

- Prepaid or early payment terms often generous beyond sound “give and get”
- Service giveaways and concessions lead to misaligned sales vs. corporate finance deferral methodologies

- **Promotion and demo pricing**

- **Warranty**
- **Update/**

Best practices

- Ensure business objectives and logic underlying prepaid or early payment terms justify margin reduction
- Reducing or eliminating service giveaways and concessions can help reinforce and clarify overall corporate deferral guidelines

- **Ordering**
- **Delivery**

Revenue operations

- **Payment terms**

- **Revenue deferral**

- **Internal transfer pricing**

Renewal and end-of-life pricing

- **Renewal pricing**

- **Lifecycle pricing**

COMMON ISSUES AND BEST PRACTICE EXAMPLES



- **Product/pricing architecture**
 - Feature bundles
 - Segment-based value pricing strategy

- **License structure**
 - Model (e.g., perpetual vs. subscription)
 - License metrics
 - License scope

- **Maintenance offering**

- **Standard license pricing**
 - Discounting policy and practice
 - Channel pricing

- **Special license pricing**
 - Volume based models
 - Enterprise level agreements

- **Promotion and demo pricing**

- **Warranty**
- **Update/**

Common issues

- Inefficiencies in renewal process can void and delay renewal opportunity
- Discount policies are same for maintenance deals at both time of license sale and renewal

- **Ordering and delivery**

Best practices

- Provide sales incentive to renew contracts well before expiration and support reps with efficient renewal process (e.g., inside sales support)
- Tighten discounting policies for renewal and enforce discipline in renewal negotiations

- **Payment**

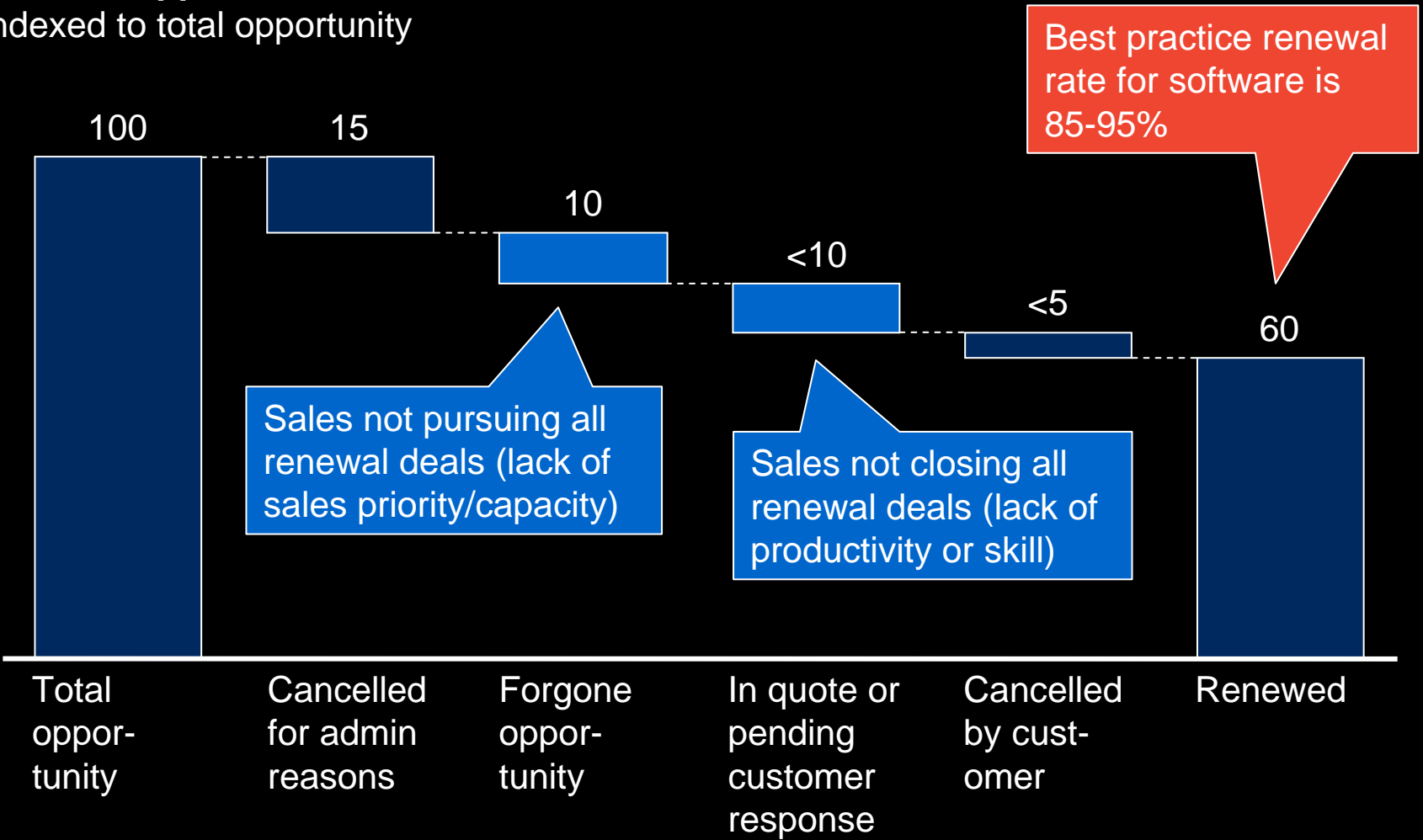
Renewal and end-of-life pricing

- **Renewal pricing**
- **Lifecycle pricing**

INEFFICIENCIES IN RENEWAL PROCESS CAN VOID OPPORTUNITY...

DISGUISED
EXAMPLE

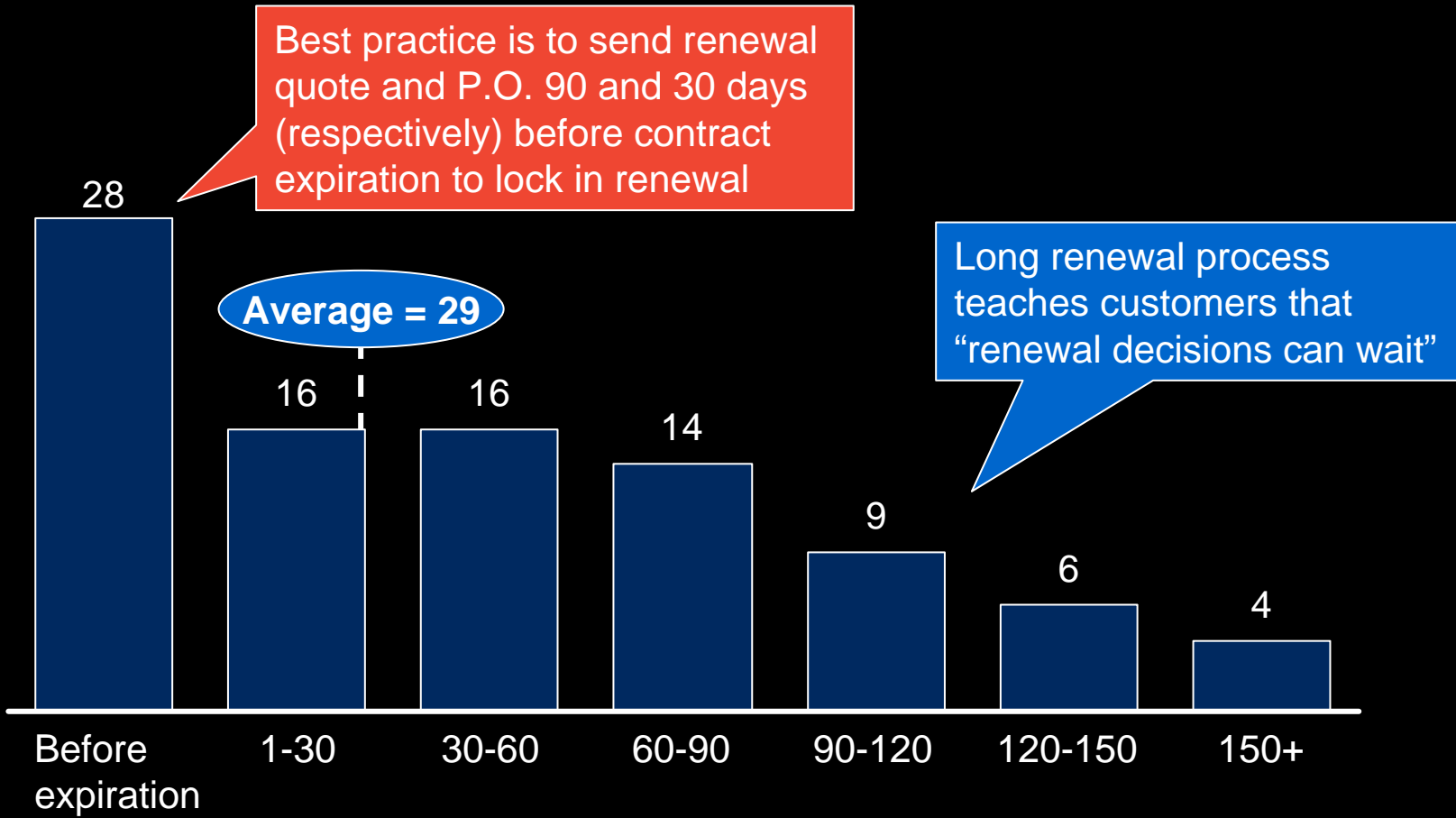
Renewal opportunities
Indexed to total opportunity



... AND ALSO DELAY OPPORTUNITY CAPTURE

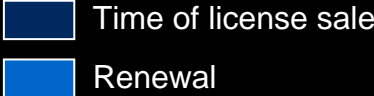
DISGUISED
EXAMPLE

Percent of renewal opportunity value

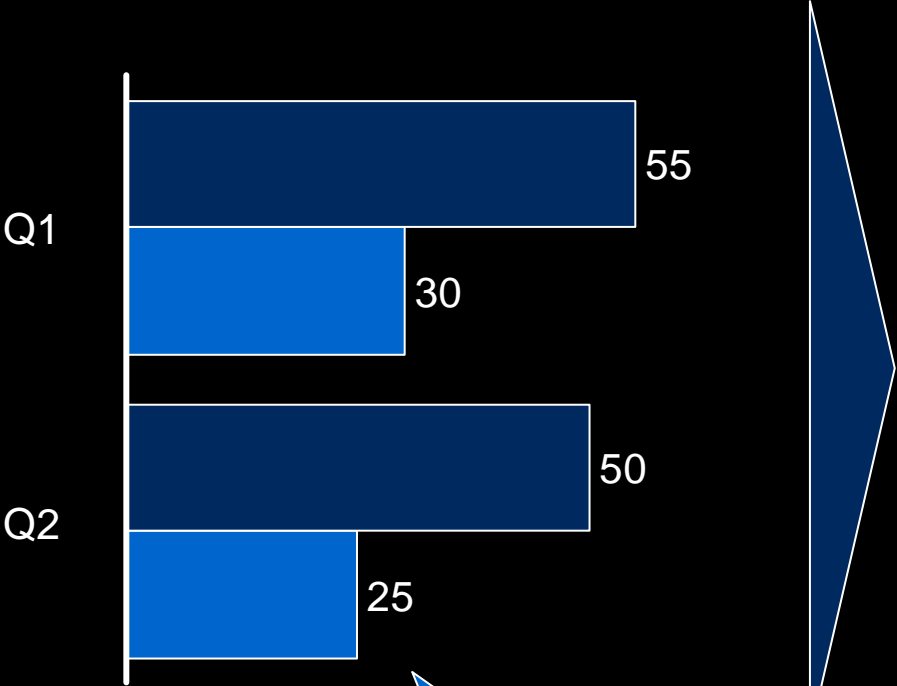


Time to renewal beyond contract maintenance expiration
Days

MAINTENANCE RENEWAL SALES CAN BE DISCOUNTED MUCH LESS THAN AT TIME OF LICENSE SALE



Software maintenance discount
Percent of list price



Same discount floors in place at time of license sale and renewal

- At time of renewal
 - Fewer competitive options are available to customer (e.g., third-party or self-maintenance not always viable for mission critical applications)
 - Renewal approval is scrutinized less than initial license deal, often by different buyers
- Software companies should:
 - Have tighter discounting policies for renewal sales
 - Hold line in renewal pricing negotiations

