
Companies specializing in business software applications have been particularly hurt by the current recession. In past years the E-Business hype and the Y2K scare provided ample opportunity for additional revenue generation. New companies entered a rapidly evolving market. Now the cake is shrinking again.

The general recessionary mood has already raised customers' cost-consciousness. Even the industry's big players—Microsoft, Oracle and SAP—are feeling the heat as customers increasingly look for bargains. How should software makers respond to these pricing challenges?

More bucks for the bang: Pricing for Software Companies

How to fully exploit your product's profit potential

Most companies do not realize their products' sales and profit potentials because they do not exploit pricing opportunities.

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When consumers become more and more cost-conscious pricing offers the greatest leverage to sustain overall profitability. Software makers know this. In the last couple of years industry players have been fiddling around with different pricing models and price levels. Few companies really manage to fully exploit their products' sales and profit potentials. Some recent examples:

- Software makers issue price lists for software products and client support services that, in practice, are irrelevant. The price levels that the top management decides upon are thrown overboard as soon as sales staff enters into negotiations with their clients.
- Companies design software solutions that end up having negative contribution because costs were not sufficiently considered in the pricing decision.

- Software makers are not able to generate continuous revenue streams with individual clients because they do not fully exploit the perceived value of their products and services. Microsoft tries to reverse this trend by entering into a very aggressive pricing and licensing scheme. Yet that may offer more pain than gain.
- Companies introduce innovative pricing models, but customers do not “buy into” the new schemes. Instead, they switch to other suppliers.
- Finally, some software makers set price levels “straight from the gut.” Obviously, they are not able to exploit their customers’ willingness-to-pay.

These examples show that software makers’ pricing policies are far from optimal. Why? There are two main reasons. On the one hand, pricing software is tricky because of the product’s complexity. Some examples:

- Software products typically have high fixed costs and low variable costs. This gives sales managers extra freedom in setting prices, since low revenues per sale already create contributions. Software makers become completely uncertain about what the “right” price actually is. The following example illustrates that among a number of suppliers of comparable CRM software the number of users was reflected completely differently in final prices.

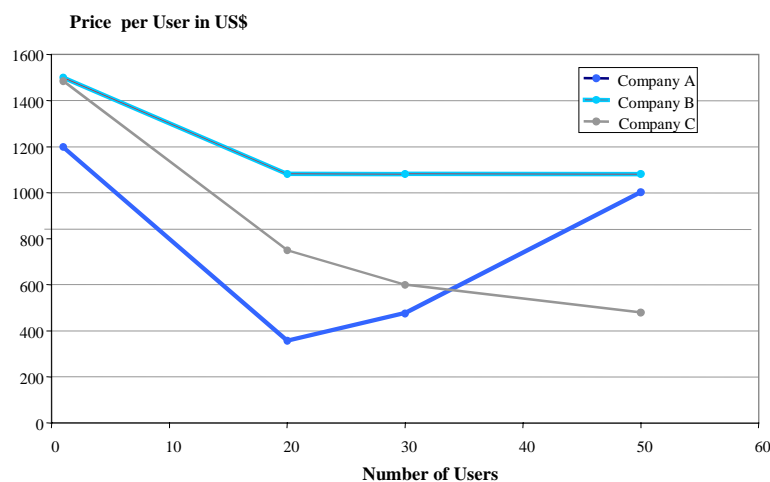


Table 1: Prices for comparable CRM-Systems

Unsystematic pricing is the main reason why companies do not reap the profits they deserve.

- The high fixed/low variable costs structure makes companies agree to hefty price reductions as soon as they encounter price-conscious customers. But quick and dirty does not pay. Literally.
- There are a number of different options that may be worth considering when developing optimal pricing models—purchasing vs. renting software, fixed vs. variable price elements, user vs. usage-intensity related pricing etc.
- Companies usually try to sell customer support and consulting services together with their software products. Intelligent approaches to pricing exploit the resulting interdependencies.

On the other hand, companies do not exploit their products' profit potential because they lack a sound *process* for setting prices.

We will look at both the *product* and the *process* to provide some insights into designing an optimized pricing policy. The three core issues are: developing the right pricing model, setting the optimal price level and enforcing prices.

1. Developing the right pricing model

Pricing for software products

The crucial question in developing a pricing model for software products is which fixed and variable price elements should the model include. A company could use a range of approaches to create variable price elements.

- **Number of users**
- **Bundling vs. no-bundling:** Various approaches are conceivable for pricing features included in a software package. One maker of ERP products has a price list comprising 284 different items and prices for a fairly diverse range of user-needs, whereas another one bundled roughly the same number of items in one price list with seven different anchor prices.

- **User's position within the company**
- **Usage-dependent pricing:** Possible variables may be the amount of time spent, used processing capacity or occupied memory capacity.

Additionally, companies can combine these variable price components with a fixed component. In principle, four different models are feasible, which are shown in graph 2. Choosing the wrong price model can lead to significant problems, both inside the company and **vis-à-vis current and potential customers**. Oracle, IBM and Microsoft are facing increasingly disgruntled customers because they switched from a price-per-user model to a price-by-usage one. Many customers, however, fear exploding prices and are hesitant to order new software. Thus, what has been hailed as today's brightest idea may turn into tomorrow's biggest debacle.

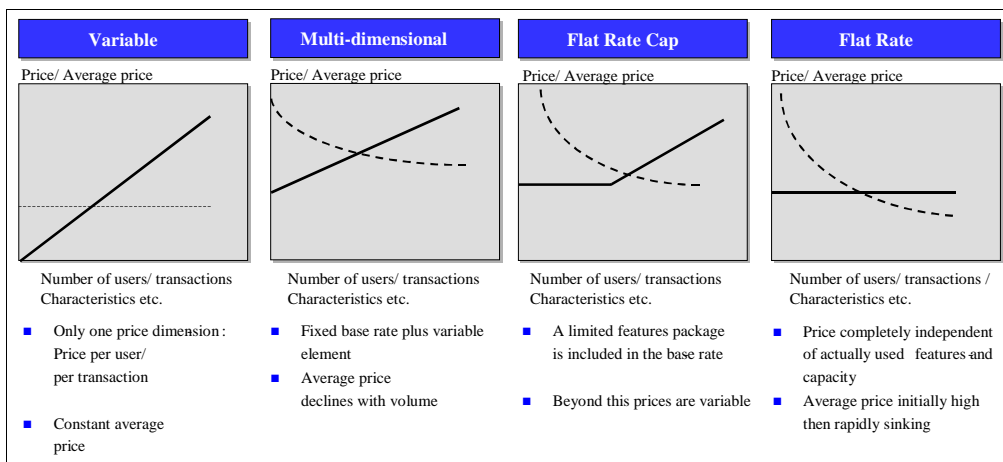


Table 2: Pricing models for software

Pricing your company's consulting services

Do not think that pricing your consultant is just like pricing your customer support service. In fact, it is a whole new ball game.

Business software's complexity means that selling and implementing it requires significant consulting input. Yet in terms of pricing, services are completely different from products. Customers cannot check the quality of consulting before they make their purchase decision. They have to trust the supplier and use price merely as an indicator for quality. Software makers therefore usually have significant flexibility in pricing consulting services. They should use that room to differentiate their own consulting services in terms of both the type of

consulting (concept- vs. implementation-driven) and the consultants' experience.

Consultant's high fixed costs means that high capacity utilization rates are crucial for attaining profitability. Just as with software products, companies can price the accompanying consulting services according to four different pricing models. Given the highly uncertain needs for the necessary consulting services means that the variable model (price per consultant day) is the most frequently used. To reduce uncertainty it is often reasonable for software companies to make a project-specific evaluation of fixed costs based on an analysis of the clients' needs. This allows companies to more accurately evaluate and price the consulting needs.

Software makers need to differentiate prices for customer support services more aggressively. This will significantly boost revenues.

Pricing for customer support services

Pricing for customer support services often are calculated on the basis of the licensing prices and usually lie between 12 and 30 % annually. Companies generally do not take into account, however, that customers derive completely different values from customer support services. The general rule is: 10 % of the customer base creates 90% of the costs. Companies should use pricing to differentiate between different customer support service packages. This is fair and will boost revenues. Various examples for differentiating between service packages are shown below.

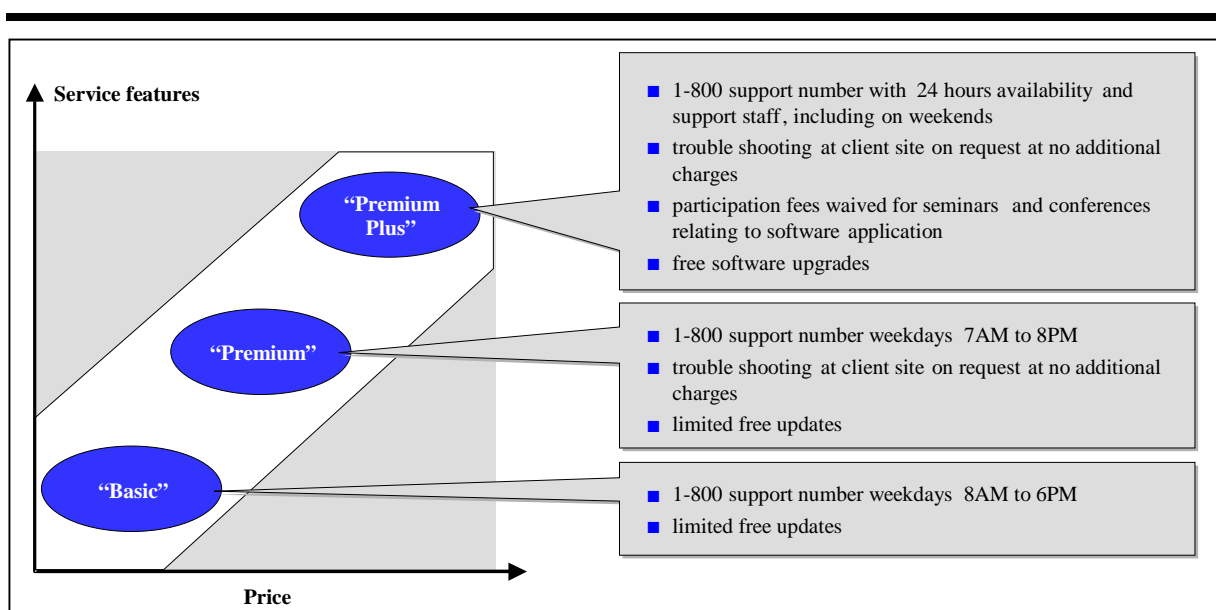


Table 3: Segmenting customer support services

Too often, Management makes pricing decisions based on ‘good feeling,’ rather than thorough analysis.

It is problematic that software updates are often included in the customer support contract. Therefore customers do not have to purchase the new software, and instead receive it as part of the ongoing customer support contract. This massively/significantly influences customers’ future purchasing decisions. Given its pitfalls, such a model warrants very careful consideration.

Choosing the right pricing model

Which pricing model is good for software and customer support services? Faced with this crucial question, management too often relies on ‘educated guesses’ or sheer gut feeling.

A systematic evaluation of the different pricing models, however, can easily provide some vital insights. For any pricing model to work effectively, software makers need to make sure that a number of conditions are met. In particular, the pricing model needs to be:

- accepted by different customer segments
- generate a continuous revenue stream
- leave enough room for further per-client-revenue increases as the client’s demand grows
- increase customer loyalty
- ensure revenue stability
- reflect actual costs
- be easy to communicate
- allow the company to differentiate itself from its competitors.

Any decision on a new pricing model should be made on the basis of a systematic evaluation. In order to develop the best model, data from a variety of sources need to be considered. Competitor and customer data should be combined with internal information on distribution channels in order to generate an overall picture of the company’s pricing needs.

In our experience it often makes sense for the software maker to offer more than one pricing model, thus segmenting their existing and potential customer base into different groups.

Innovative marketing tools enable companies to set optimal pricing levels.

2. Setting the optimal pricing level

The second important step in pricing is to set the optimal pricing level for software, consulting and customer support services. “Optimal” may mean a variety of things: maximizing profits, maximizing revenues or gaining market share. Regardless of the particular objective, companies should not adhere to intuition or general “market trends” in setting the optimal pricing level. Just as with pricing models, systematic evaluation techniques will yield tremendous payoffs.

Probably, the most useful approach is value-pricing. Its underlying assumption is that customers never pay for the product or service itself, but rather for the value that they attribute to it.

Customers purchasing business software packages are not interested in buying single features and modules. Rather, they want to optimize company processes in order to serve their clients faster, more effectively and at lower cost. Key questions in value-pricing are: What value do the software makers’ clients attribute to the product or service and how high is their resulting willingness-to-pay?

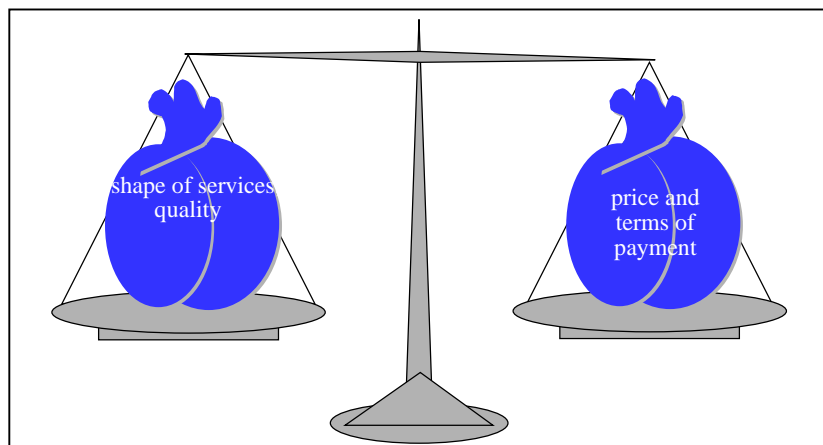


Table 4: The concept for pricing-to-value

Of course companies need to take into account their competitive environment. If a software maker’s products offer significant competitive advantages pricing levels should reflect this superior position. A company has a competitive edge when there is a high overlap between the criteria in which the customer views the company’s products to be superior to competitors and in the criteria that are most important.

To price effectively, companies need to know their own competitive advantages and their customers' preferences.

Clear and consistent pricing policies for sales organizations ensure that those prices are actually enforced.

Most software makers' executives are not really sure about their products' perceived value and possible competitive advantages or disadvantages.

To make sound pricing decisions, however, it is crucial to accurately measure perceived values. Ideally, the source for these data should be the target customer. Sophisticated interviewing methods and analytical tools (in particular Conjoint Measurement) provide information on perceived values and willingness-to-pay. If customer interviews are impossible (for example for cost reasons) it remains important to make quantitative assessments of the competitive situation and willingness-to-pay.

These can be generated in interviews and workshops with members of the sales organization and other market experts.

3. Price enforcement

Ultimately, the success of any pricing concept depends on its enforcement in the market. In our experience, many concepts fail because they lack parallel support measures. Sales managers are left alone to apply the concept and do not know how they can put it into practice in their daily contact with customers.

To limit this danger, clear supplementary pricing guidelines for sales managers are necessary. Although sales managers obviously need flexibility in handling individual customers' expectations, any room for pricing changes needs to be limited and, if made use of, clearly justified. Sales manager need to communicate to potential customers that prices are not set "straight from the gut" and cannot be constantly re-negotiated. Ideally, companies need to develop a guideline enabling sales managers to convince customers based on value- rather than price-considerations.

Such a superior communication policy helps focus on the advantages of the new pricing model. At the same time, companies need to develop an incentive system, which, as one element, rewards sales managers who offer few discounts and sell at high margins.

Summary:

1. Many software makers do not exploit their products' sales and profit potential because they have no systematic approach to pricing.
2. Developing an optimal pricing policy relies on three elements: developing the right pricing model, setting the right price level, and enforcing prices.
3. In each of these steps the particular character of software products and services needs to be considered.
4. Modern marketing instruments ensure that pricing model and price levels focus on the customer's perceived value and thus enable companies to fully exploit customers' willingness-to-pay.
5. Clear and consistent pricing guidelines, argumentative support through briefings and adapted sales manuals, as well as consistent incentive systems ensure that the new pricing models are actively applied within the sales organization.

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