Technology Institute

The future of software pricing excellence: The new state of the art

Executive summary

The current state of pricing in the software industry is, to put it mildly, chaotic. Although vendors have pricing policies and strategies, they often fail to enforce them. More commonly, they change their pricing approaches from one deal to the next, based on a combination of past sales, limited customer information and minimal insight into competitors' prices.

Unsurprisingly, the results are all too often disorganised and inconsistent, increasing risk, degrading efficiency and hindering revenue generation. Yet whilst many industry leaders realise their pricing is suboptimal, they don't know how to fix the problems. Indeed, many don't know where to start the process.

A significant contributing factor is the broader shift in the software industry's approach to software licensing. A small minority of vendors remain committed to the traditional business model based on permanent licensing of software as a product. A company providing infrastructure software sold to data centre managers would fit this model of a traditional pricing model.

However, a small but growing number of vendors—typically start-ups but a handful of notable exceptions like Salesforce.com—are focused exclusively on emerging models, including subscription SaaS with cloud deployment, pay-as-you-go based on actual usage and/or charges for premium features added to free basic services ('freemium'). The remainder, including most consumer and enterprise software companies, are combining both approaches in a hybrid business model. (See Figure 1)

Complicating matters, vendors following every business model may be following industry-leading practices in some aspects of pricing, lagging behind the curve in others and squarely in the mainstream majority in the rest.

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Three different pricing models are in use by software vendors that may be leading edge, in the mainstream or lagging their competitors.

Figure 1: A myriad of pricing strategies for a myriad of business models

	Traditional software pricing model	Hybrid software pricing model (hybrid)	Emerging software pricing model
Pricing strategy	Well-defined but poorly integrated pricing processes	Reactive pricing strategy	Proactive pricing strategy with defined workflow to handle exceptions
	No cross-functional coordination in pricing	Limited cross-functional coordination	Limited cross-functional coordination
Price formulation	Centralised price strategy and execution	Formal customer analytics and market intelligence	Formal customer analytics and market intelligence
	Exceptions are managed *ad hoc*	Centralised price strategy and execution	Centralised price strategy and execution
Transaction management	Decentralised deal management	Centralised deal management	Centralised deal management
	Ad hoc training on product value and negotiation skills	*Ad hoc* training on product value and negotiation skills	Regular training on product value and negotiation skills
Performance management	Underutilisation of available tools	Limited automation of pricing data management	Fully automated pricing data management
	Sporadic measurement of pricing performance	Systematic management of pricing performance against set targets	Regularly performed and systems-based advanced analytics

Lagging Mainstream Leading

Source: PwC

At a time when the enterprise software sales model is shifting from product-based to portfolio-based and customers are adjusting their purchasing decisions to include their perception of added business value, vendors can no longer consider their pricing models incidental. Pricing can, in fact, play a critical role in business strategy.

PwC has developed a powerful methodology that helps its clients become leaders by incorporating software pricing excellence strategy and tactics in the face of changing business models. Software vendors using PwC methodology to develop their pricing strategies have realised benefits in six to 18 months. In addition to a typical ROI of 30x, PwC clients have achieved:

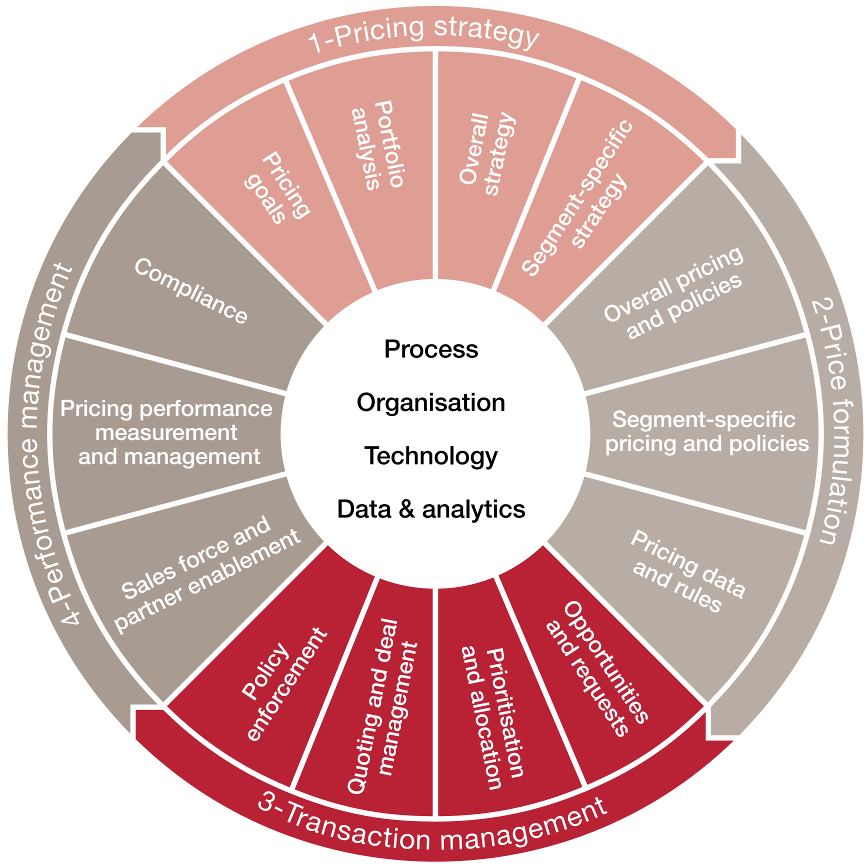
- Higher win rates—closing a higher percentage of sales opportunities can increase revenues by 2-3%
- Improved price realisation—reducing the gap between 'pocket' (real) and list prices at constant business volume can increase gross margins by one to four percentage points
- Decreased revenue leakage—reducing the gap between committed-to purchase and actual purchase volumes can boost revenues by 2-4%

The time to move definitively toward best pricing practices is now. This paper provides a path toward a more coherent, organisation-wide pricing model that delivers proven results by combining analytics with formalised processes and standards.

The PwC pricing excellence framework

Pricing excellence is an ongoing process of optimising the price of goods and services. PwC's pricing management framework focuses on the elements that drive pricing maturity and impact financial results throughout the pricing lifecycle: pricing strategy, price formulation, transaction management and performance management. (See Figure 2) These four elements of pricing work together in a functioning business. Each element affects and is affected by process, organisation, technology and data analytics.

Figure 2: **PwC's pricing management framework**



Source: PwC

Element I: Pricing strategy

To achieve and maintain pricing excellence, companies must first consider the critical building blocks of pricing strategy:

- Understanding what customers value;
- Predicting what the customer is willing to pay;
- Aligning various functional areas (sales, marketing, R&D and finance amongst them) to position products in the marketplace; and
- Ensuring that products meet customer needs at an attractive price
  - Competitive products and their positioning in the marketplace
  - What drives cost to serve

Pricing strategy, therefore, incorporates both pricing goals and customer price thresholds. Understanding what customers value occurs not by guesswork or rudimentary testing, but through a thorough analysis of product use, prior transactions and customer-based segmentation, as well as secondary research. This portfolio analysis and research are designed to answer the following questions:

- What drives value to our customers?
- What is the value of our product compared to alternatives?
- What is the competition's pricing strategy?
- How strong is our brand and reputation?
- Are there significant economies of scale?
- What are the price variations across regions/channels/customer segments?
- What drives cost to serve?
- Where is our product in its life cycle?

The answers to these questions form the basis of the overall and segment-specific pricing strategy. As Figure 3 illustrates, those answers drive development of value-based pricing and other pricing tactics, such as regional or channel price variations.

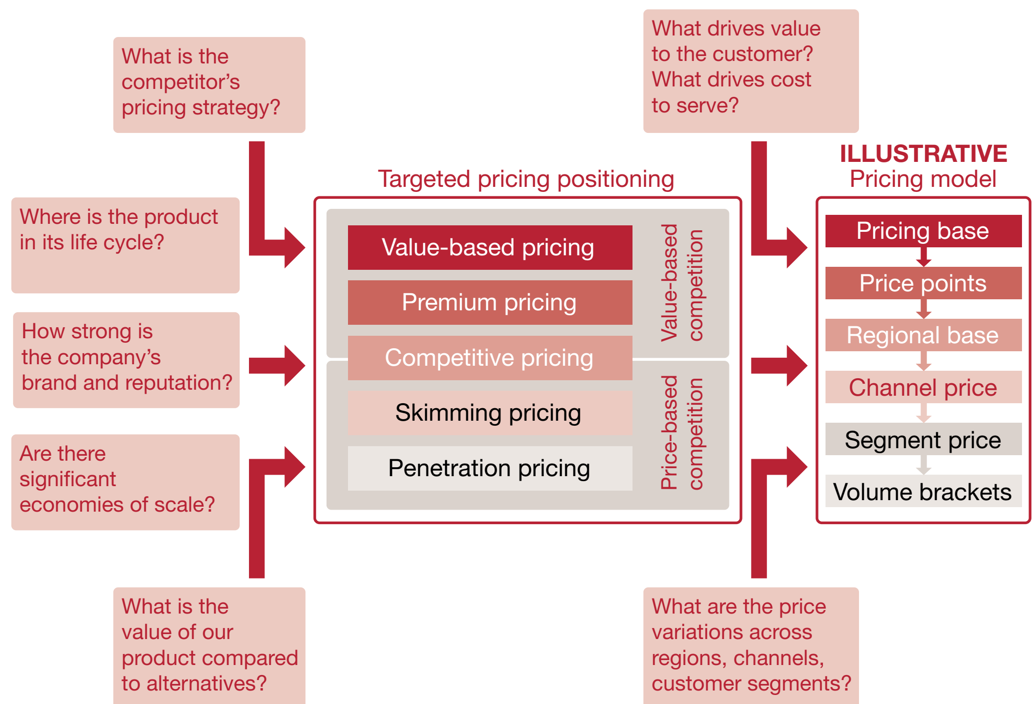
Element II: Price formulation

Solid data about product costs and benefits, customer demands and competing products and services forms the foundation of decisions about base pricing. After creating standardised overall pricing policies, companies can then create segment-specific pricing policies that govern how much and how often to deviate from the baseline.

Access to data about customers, transactions and usage drives further customer segmentation analysis and helps to shape offerings that maximise customer utility, reduce complexity and increase overall value. Combined with historical transactions and secondary research, this analysis helps align prices with customer willingness to pay.

Once a company sets broadly segmented pricing policies, it can apply a price waterfall to each individual transaction. This is a structured approach to calculating the price of a transaction, offering a framework to manage price discounting and shape customer purchasing behaviour. (See Figure 4)

Figure 3: Optimal pricing requires multiple inputs



Source: PwC

The price waterfall is driven by a series of steps:

1. Identifying the right pricing levers given business models, overall pricing strategy, operational factors and routes to market. Recent transaction data helps inform discounting and premium pricing practices in order to reveal trends and develop minimum and maximum values.

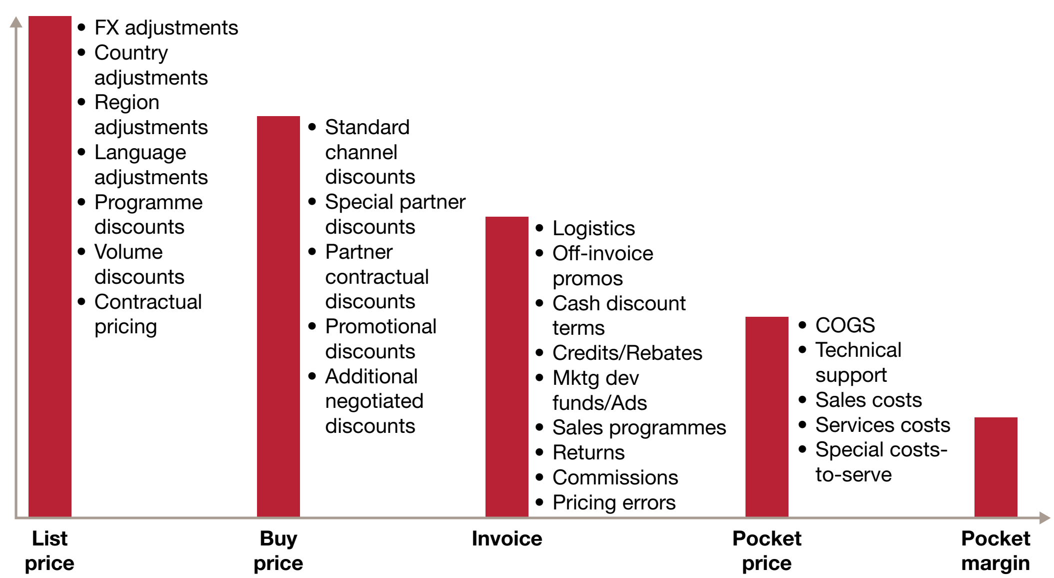
2. Using the identified levers to determine various price levels, such as list price, regional list price, volume price, manufacturer's suggested retail price and invoice price.

3. Defining policies for the use of each pricing lever, including who has the authority to decide when lever boundaries can be exceeded.

4. Developing implementation plans.

With greater visibility into price adjustments, companies can analyse data about customer and market segmentation, product design, discounting, channel strategy and other business decision points in order to refine policies for greater efficiency and profitability.

Figure 4: Analysing pricing waterfalls helps close leaks



Source: PwC

Reviewing the factors that influence the potential flow of cash—beginning with the list price and down through to the minimum required revenue—helps identify and shut off revenue leaks.

Element III: Transaction management

Using the pricing data and rules that emerge from Element II, companies can next segment opportunities, requests and deals into three categories:

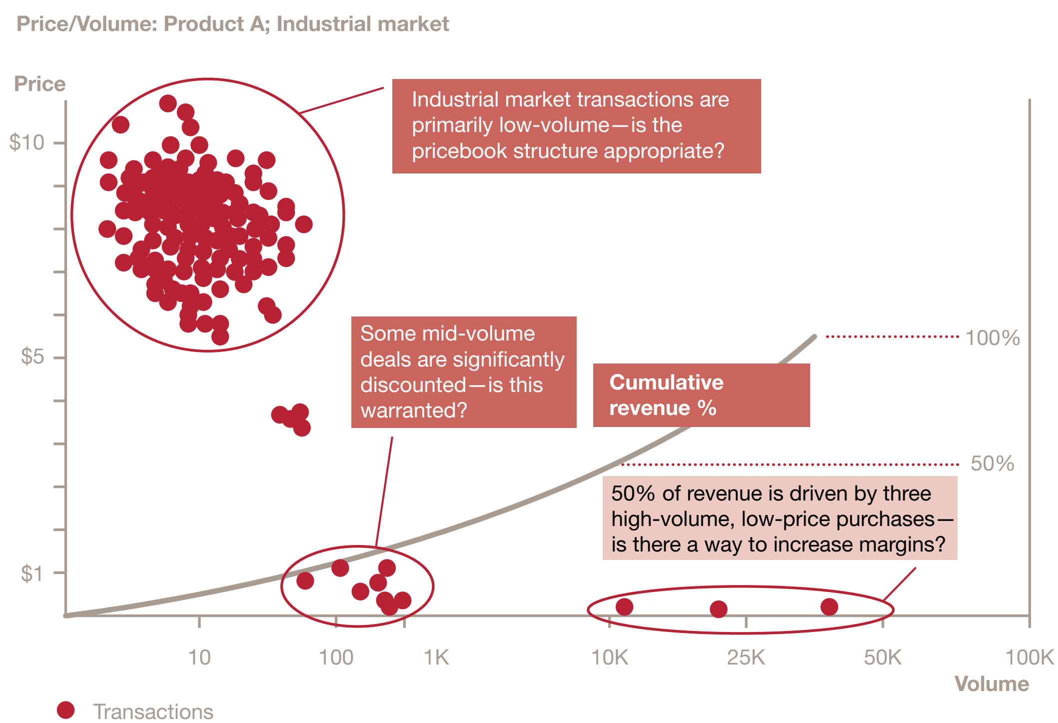
1. 'No-touch' sales of baseline products and configurations that require no internal sales involvement;
2. 'Low-touch' sales of standard and custom products and configurations that may demand minimal internal sales assistance; and
3. 'High-touch' sales at a level of value and complexity that place them beyond standard pricing rules and demand non-standard pricing and/or terms and conditions. Companies may want to create a Global Deals Desk dedicated exclusively to shepherding this type of deal to completion, as high-touch sales require a high level of internal sales involvement.

Systematising pricing and discounting levers in this way greatly reduces the need for 'touches' that use sales resources and increase time-to-quote.

Transaction management differs in one critical way for companies that offer SaaS—these companies have infrastructure costs that the traditional model lacks. These costs must be factored in when setting discounting floors and deal parameters.

Regardless of business model, however, quoting and deal management policies for each category are determined by the deal's overall value to the company relative to the effort necessary to fulfill them.

Figure 5: Analytics highlight price/volume problems and opportunities



Source: PwC

Element IV: Performance management

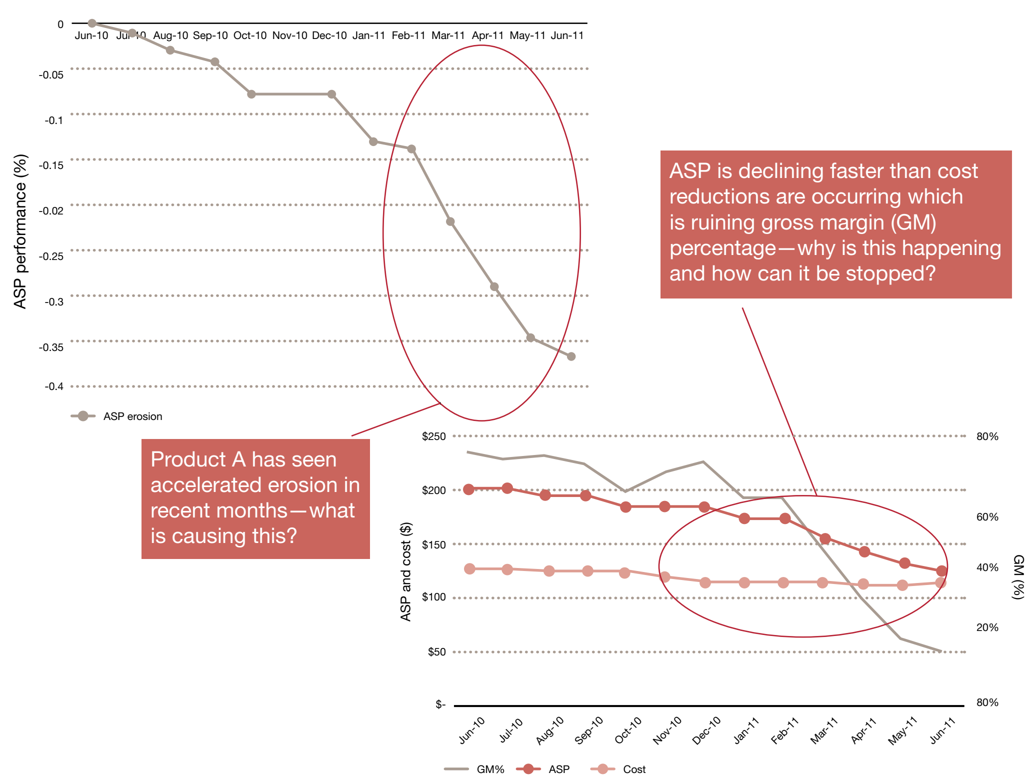
Even a consistent, formalised pricing model needs to be adjusted over time to identify and close profitability leaks as market conditions change. This element of the pricing excellence methodology focuses on post-sales analysis. It enables companies to keep the new pricing programme aligned with overall corporate strategy, mission, goals, processes and resources.

Over the long term, pricing performance management includes answering an array of questions designed to measure, enforce and refine pricing policies. This includes, but is not limited to, answering questions such as these:

- "How consistent is our pricing within segments and customer groups?"
- "Are our promotions working?"
- "How are our channels and/or partners performing?"
- "Are we capturing all of our logistics costs?"
- "How does our commission structure impact margins?"
- "Do our price and margin targets accurately reflect all our costs?"

The answers to these questions help to improve cross-functional alignment and make the pricing model more accurate over time when based on relevant metrics. Performance management powered by analytics identifies products with lagging gross margins, eroding prices (See Figure 5) or with inconsistent volume breaks (See Figure 6).

Figure 6: Analytics highlight average selling price (ASP) declines relative to cost reductions



Source: PwC

The right foundation for pricing excellence

The pricing excellence framework described above cannot function in a vacuum. It depends on a foundation of organisational processes, organisational structure, systems, data and culture. As you can see from Figure 7, the maturity of pricing capability increases as the sophistication of the processes, organisation, technology and data increases as well.

An organisation without standardised pricing processes coordinated across functions has little clarity on pricing strategy. Decentralised pricing strategy and deal management become further complicated when the sales team is only minimally trained in product value and negotiation skills.

Moreover, many organisations underutilise available technology to automate and streamline pricing. Worse yet, many organisations depend on inadequate tools, such as Excel spreadsheets. This dependency on inappropriate tools generally also leaves these organisations without the systems or

Figure 7: The maturity framework can drive the next level of pricing excellence

Pricing capability maturity model

High

Pricing capability model

Pricing capability maturity model	Process	Organisation	Technology	Data and analytics
Strategic pricing management	• Well-defined, fully integrated, and standardised pricing processes including price optimisation • Proactive pricing strategy and execution, defined workflow to manage price exceptions • Systematic and governed cross-functional coordination in pricing	• Fully integrated function to optimise pricing throughout the value chain • Formal customer analytics and market intelligence function • Regular training on product value and negotiation skills	• Complete pricing platform integrating price setting, price optimisation, price management, market and customer data • Fully automated pricing data management	• Regularly performed and systems-based advanced analytics • Systematic management of pricing performance against set targets • Regular tracking of metrics covering strategic and tactical activities • Full understanding of true costs to serve
Tactical pricing management	• Well-defined but poorly integrated pricing processes • Reactive pricing strategy and execution, price exceptions are managed *ad hoc* • Limited cross-functional coordination in pricing	• Centralised price strategy and execution function • Centralised deal management • *Ad hoc* training on product value and negotiation skills	• Price management system has been implemented • Pricing optimisation system integrated with price management • Limited automation of pricing data management	• Regularly performed standard analytics using Excel • Sporadic measurement of pricing performance • Regular tracking of pricing metrics focused on non-strategic activities • Limited understanding of true costs to serve
Informal pricing management	• No formal or standardised processes in place • Lack of clarity on pricing strategy • Lack of cross-functional coordination in pricing	• No centralised price strategy and execution function • Decentralised deal management • Minimal training on product value and negotiation skills	• Excel-based pricing data management • Underutilisation of available tools	• Rudimentary and *ad hoc* analytics • Limited tracking of pricing metrics • Minimal opportunities to analyse meaningful data including true costs to serve

Low

Source: PwC

meaningful data to track and analyse pricing metrics. The resulting lack of insight prevents them from understanding their true costs, to the ongoing detriment of strategic decision-making and the bottom line.

As an organisation moves from informal to tactical pricing management, it begins to define pricing strategies; centralise deal management; implement a system to automate, optimise and manage pricing and pricing data; and track pricing metrics using simple analytic tools.

The next step in the process is progressing to strategic pricing management, the underpinning of pricing excellence. The following chart shows the steps organisations must progress through to achieve pricing excellence. (See Figure 8)

Figure 8: Steps on the path to pricing excellence

	1. *Ad hoc* pricing management >	2. Transaction-based pricing management >	3. Value-based pricing management >	4. Holistic pricing management
Process	No formal or standardised processes in place	Formal and standardised processes for price setting and price management	Formal and standardised processes for price optimisation	Formal and standardised processes for price optimisation throughout the whole value chain
Organisation	No centralised price setting and management organisation	Centralised price setting and price management function	Formal customer analytics and market intelligence function	Pricing organisation has fully integrated function to optimise pricing throughout the value chain
Technology	Underutilisation of available tools or Excel spreadsheet driven	Price management system has been implemented	Pricing optimisation system integrated with price management	Complete pricing platform integrating price setting, price optimisation, management, market and customer data
Data and analytics	Annual price management based on sales data	Quarterly price management based on market and sales data	Monthly price management based on customer and sales data	Ongoing management of pricing based on economic, customer and sales data

Source: PwC

A company can be said to have achieved pricing excellence when it meets all of the following criteria:

Process

- Well-defined, fully integrated and standardised pricing processes including price optimisation
- Proactive pricing strategy and execution, defined workflow to manage price exceptions
- Systematic and governed cross-functional coordination in pricing

Organisation

- Fully integrated function to optimise pricing throughout the value chain
- Formal customer analytics and market intelligence function
- Regular training on product value and negotiation skills

Technology

- Complete pricing platform integrating price setting, price optimisation, price management, market and customer data
- Fully automated pricing data management

Data and analytics

- Regularly performed and systems-based advanced analytics
- Systematic management of pricing performance against set targets
- Regular tracking of metrics covering strategic and tactical activities
- Full understanding of true costs to serve

Software pricing excellence in action

The PwC software pricing excellence methodology is not just a collection of theories; its track record of solving chronic industry pricing problems is proven. Here are three examples of how the methodology has delivered results to our clients.

- ***Improving deal discounting and business visibility***
  A US$30 billion software company had runaway pricing policies. In addition to its 30 different licensing programmes for its SMB and commercial customers, the true cost to serve wasn't clear to many of the people doing the deals, leading to suboptimal margins. In part the lack of cost clarity was due to siloed information and other barriers to cross-functional dialogues. Other challenges included a lack of data and sales metrics.

  After implementation of the PwC software pricing excellence methodology, the company successfully introduced a single relationship-based pricing programme incorporating both perpetual and cloud licensing models. The company saw a 5% increase in volume licensing revenues in one year.

- ***Plugging revenue and margin leakage due to channel mismanagement***
  A US$4 billion digital media software company knew that wide pricing variations by region and channel were hemorrhaging revenues and net income. Highly manual, time-consuming pricing and deal development processes using incomplete customer data were part of the problem. The company lacked the analytics tools to understand and leverage what little data it had. In addition, the company had little visibility into competitive pricing.

  By adopting the PwC software pricing excellence methodology, the company increased revenues by US$90 million in one year, while seeing measurable improvements in cost of sales and customer satisfaction. Furthermore, senior management gained visibility into the status of its licenses in a variety of dimensions: global, regional or channel.

- ***Value-based pricing is real, not just a wish list item***
  Executives at a US$1 billion provider of application software knew they could replace their obsolete pricing strategy with a more lucrative value-based approach. Their customers were experiencing dramatic revenue and profit gains using their applications and the software vendor could see that they needed to revamp pricing to accommodate their clients' demand for additional cloud-based solutions. Using the PwC software pricing excellence methodology, the company developed and implemented a value-based pricing programme that led to a US$25 million increase in annual revenues.

Conclusion

New technology trends enable the creation of new markets and business models for software vendors that require new pricing strategies. For companies ready to shed the old model of undisciplined pricing, inconsistent or *ad hoc* analytics, and decision-making without insight into the competition, improving pricing management is a critical factor in the business model transitions now in play—and a significant tool for identifying opportunities and driving better price decision-making.

PwC can help

If you'd like to discuss the challenge of software pricing in an ever-changing business environment, please reach out to one of our technology industry leaders listed below.

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In addition to the above contacts, Amit Dhir, Director, Management Consulting, provided key insights and clients' real-world experiences for this report.

About PwC's Technology Institute

The Technology Institute is PwC's global research network that studies the business of technology and the technology of business with the purpose of creating thought leadership that offers both fact-based analysis and experience-based perspectives. Technology Institute insights and viewpoints originate from active collaboration between our professionals across the globe and their first-hand experiences working in and with the technology industry. For more information please contact Raman Chitkara, Global Technology Industry Leader.

About PwC

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 158 countries with more than 180,000 people who are committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com.

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