Technology Institute

The future of software pricing excellence: SaaS pricing

Executive summary

Companies making the strategic choice of migrating their software business model from a traditional perpetual license to a subscription license-based software-as-a-service (SaaS) product are doing so to drive stronger long-term relationships and business growth. In the short term, however, this shift can be challenging, as many SaaS providers remain unprofitable for some time. PwC's experience suggests that it takes most SaaS providers at least two years to reach break-even, even though the typical provider spends more than half its revenue to fuel new business development.

The profitability challenge of the new model can wreak havoc on a multitude of other business practices. Software sales teams that focused on the initial transaction now must drive long-term engagements, constantly measuring customer lifetime value, impact on recurring revenues and profitability. Marketing and product teams have to continuously monitor how their products are being used, to better understand the value the customer is extracting from their SaaS offerings. These insights are needed to improve the design, configuration and pricing of new offerings to further drive consumption and recurring revenue.

Pricing management is key to making a successful transition to the SaaS model. Failing to capture the true value of a product does more than minimise or eliminate profits; failing to consider legacy products in pricing strategy or making SaaS products dramatically less expensive can make the SaaS option seem like an inferior, lesser option. Excess discounting can even force a price war amongst competitors that damages the category's entire market.

PwC has identified the characteristics that define the leaders, laggards and mainstream practitioners of SaaS pricing. Laggards typically fail to take hosting costs into account, suffer an inability to adjust prices for different market segments, have far higher transaction costs and suffer other internal issues, along with risking their customers' perceptions of the value of their products. Leaders, however, present pricing that is easy to understand and measure, and they incorporate costs, offer flexibility and monitor their pricing performance. [Figure 1]

Figure 1: SaaS pricing practices—From laggards to leaders

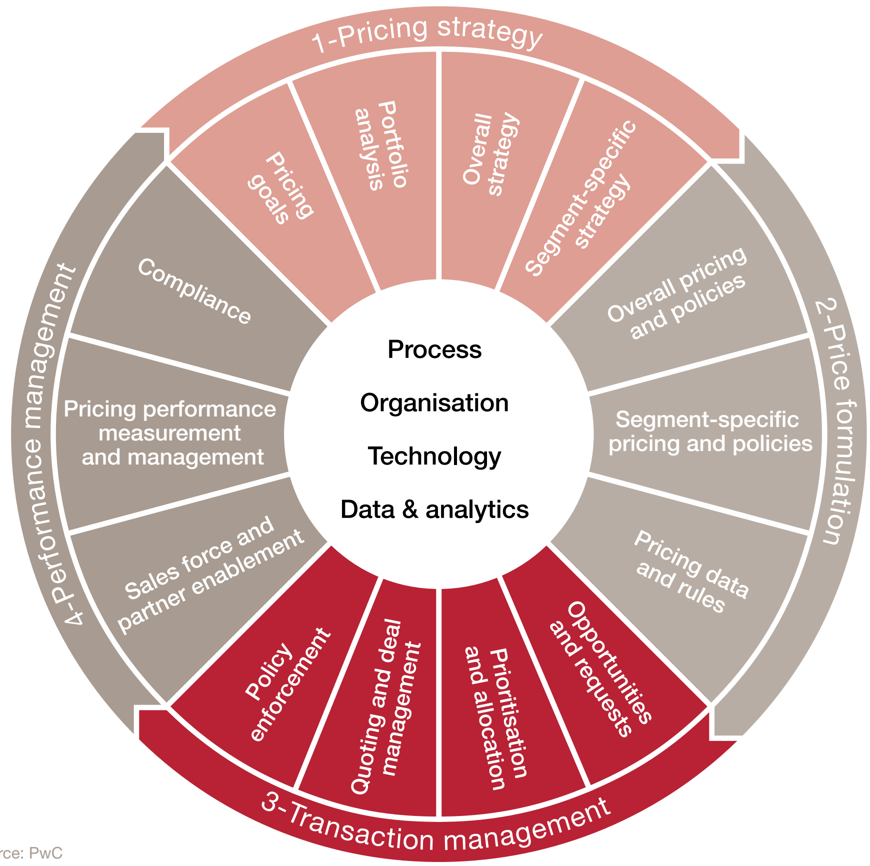
SaaS providers may be leading edge, in the mainstream or lagging their competitors in any or all four areas that comprise pricing management: pricing strategy, price formulation, transaction management and performance management.

	Leaders	Mainstream	Laggards
Pricing strategy	• Pricing metrics are defined as perceived by the customer • Pricing strategy is easy to understand, measure and operationalise	Pricing boundaries for usage, features, time, segment and conversion from trial and freemium are clearly defined	• Pricing is *ad hoc* • Pricing is based on internally-oriented metrics rather than customer needs • Difficult to convert trial and freemium offers to paid customers
Price formulation	• SaaS pricing determined by breakeven point, payment benefits plus hosted cost benefits • Capability to price at the feature level • Legacy products bundled with cloud offerings	• Guided selling • Defined pricing rules that enable up-sell and cross-sell	• Failure to bundle products across business models • Inability to adjust price for different market segments and features
Transaction management	• Low-touch discounts defined by standard price waterfall • Different deal management approval thresholds for SaaS offerings • Real-time profitability and margin analytics to support deals • Models for impact on recurring revenue, future discounts, competitor reaction and price set for the market	Loyalty-based discounts specifically designed around SaaS offerings	• Poor controls around discounting • No or minimal analytics to support deals
Performance management	• Customer retention rates tracked to ensure pricing metric aligns with perceived customer value • Pricing metric aligns with vendor realisation of value • Cost to acquire, cost to serve and churn ratio tracked • Provisioning systems for SaaS track usage, identify revenue leakage, capture feature and functionality usage patterns, define segments and pricing • Appropriate metrics measure sales and channel performance to structure incentives	Leverage data from provisioning systems to run analytics to gain visibility into margins and other sales metrics	Minimal visibility into pricing, cost, usage and sales metrics

This paper explores how software companies can transition effectively to the SaaS model and maximise overall profitability through a holistic approach based on PwC's proven pricing management framework. [Figure 2]

Figure 2: PwC's pricing management framework

For each framework component, companies need to focus on the elements that drive pricing maturity and impact financial results.



Source: PwC

SaaS pricing strategy

Pricing fundamentals apply as much to SaaS products as to any other, as they provide a readily available opportunity for value-based pricing. Common factors contributing value to the SaaS customer include infrastructure benefits, payment benefits, product packaging benefits and ease of maintenance and upgrades.

Determining pricing metrics is vital to pricing strategy, since the pricing metric drives both revenue and perceived value. Questions to consider in defining pricing metrics include the following:

- How will you charge for your services (e.g., by user, by size of data store, by the hour)?

- Will this vary over a given timeframe? Will customer utility or vendor realisation of value change over time? For example, you may initially charge per CPU, but for CPUs with multiple cores, it makes more sense to charge per core.

- How will you position the pricing metric to provide tangible and easily understood benefits for the customer? For example, how will retail consumers respond to '$9.99/month for 30G of storage space' compared to the same offering described as '$9.99/month to store 10,000 photos or eight movies'?

For all customers and routes to market, leading practice is to ensure the pricing metric aligns with both of these factors:

1. Perceived end-customer value, which is important for customer retention

2. Vendor realisation of value, which is important to incentivise the sellers

Another significant aspect of pricing strategy is **packaging—**in other words, what the purchase includes. Many software packages, for example, are offered in an enterprise edition, an edition for small- or medium-sized businesses and a personal edition. This lets buyers choose only the features and functionality appropriate to their needs. Appropriate packaging improves a company's ability to compete on features and functionality rather than getting into a price war. It also allows SaaS vendors to price to a segment based on what that segment values. With SaaS products, package design needs to account for three key sets of data:

- Customer data to identify the relevant segments

- Transaction data to determine an appropriate price based on willingness to pay given historical discount levels (other primary and secondary research can be used to further refine willingness to pay)

- Usage data to design the offering so the customer gets maximum utility from the purchase

Another component of pricing strategy is **the 'freemium' model**, which is commonly used to grab market share or undercut competitors in a number of industries. In one version of this model appropriate for SaaS vendors, customers can use a full version of the software at no charge for a select time period, after which they have to pay to retain access. In another version, customers can get a free scaled-down version of the software with key functionalities disabled, but have to pay to upgrade to the full-featured version. To maximise the effectiveness of 'freemiums', the SaaS provider must:

- Define clear boundaries between the free and paid software (e.g., usage, features, time, applicable segments)

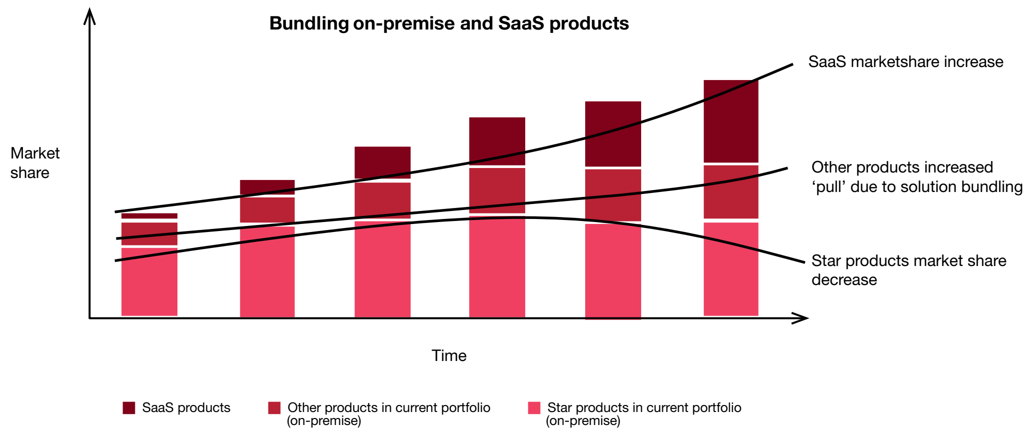
- Provide an easy path to becoming a paying customer

- Track and report routinely on conversion rates

Additionally, a software company with a large existing market can **bundle** its on-premise products with SaaS products as a way to establish its SaaS business. This allows the company to leverage its 'market pull' without cannibalising the market for its star products—a high-value solution the sales force can readily adopt as an additional tactic for selling incremental value to the customer. PwC has seen such bundling lead to a positive impact on expanding the size of the overall market, increased market share, reduced transaction costs and a more profitable SaaS business. [Figure 3] Most commonly, companies bundle laggards with leading products. Leading practice goes beyond this to create bundles based on customer and market analysis. After defining customer and market segments, a company can analyse its current product portfolio and map different product combinations to the identified customers and markets.

Figure 3: SaaS growth can be driven by bundling

Bundling on-premise and SaaS products can lead to sharply higher SaaS market share increases, and frequently can increase sales from non-core products. However, some leading on-premise products may show a market share decline as their SaaS analogues gain increased traction in the market.



Source: PwC

Finally, SaaS pricing strategy depends on policies that guide discounting and margin management. These policies implement strategies that either encourage or discourage regional variations, loyalty and volume discounts and other aspects of SaaS pricing. [Figure 4]

Figure 4: SaaS pricing strategy components

Pricing strategy	Description
Packaging	Adjust pricing based on the product package (e.g., enterprise, small business, personal use; closely tied to product features and functionality)
Regional pricing	Regional variations to pricing as defined by regional hierarchy, for example, EMEA pricing vs. US pricing
Customer/Market segmentation	Price adjustment based on customer and market segment
Loyalty discounts	Discounts provided based on customers historical spend
Volume discounts	Discounts provided based on quantity purchased at the point of transaction
Payment and credit adjustments	Price premiums to provide nonstandard billing options (e.g., quarterly vs. monthly) or extended credit terms (e.g., net 180 vs. net 45)
Usage type adjustments	Variations to price based on license type (e.g., subscription vs. pay-per-use)
Promotions	Pricing lever to promote a product for a limited time in a region
Upgrades/Cross grades	Pricing lever to provide discounts for customer to upgrade to newer version or license higher end products
Channel discounts	Discounts based on partner type (e.g., standard channel vs. specialised partner)

SaaS vendors should pay particular attention to certain aspects of pricing strategy:

- When pricing for different delivery models (hosted vs. on-premise), the list price for hosted offerings should be no less than the break-even point combined with the hosted cost benefits. The break-even point is defined as the point in time where the ratable fees equal the upfront fees for on-premise offerings.

- When pricing for different licensing models (subscription vs. perpetual), the subscription base pricing should be no less than the break-even point combined with the payment benefits realised by the customer. The break-even point is defined as the point in time where the subscription fees equal the upfront fees for a perpetual license.

Price formulation

Typically, to manage pricing by segment, companies define the list price for a base product (usually targeted at the largest segment contributing to revenue) and adjust list price for other segments as a factor of the base product price. Leading companies then use a price waterfall structure coupled with pricing rules to systematically manage pricing globally and across all routes to market, thereby reducing sales touches. The selection of the pricing waterfall levers varies with the various business models supported within a company and should align with the overall pricing strategy. Rules can be established to identify candidates for automated approvals which can further reduce touches. As a leading practice, the defined pricing rules and levers should empower sales to up-sell and cross-sell. [Figure 5]

Figure 5: Pricing lever examples

These examples of systemising pricing and discounting levers also greatly reduce the need and number of labour-intensive customer contacts. SaaS vendors should start with the list price levers and then progress to the regional, end-user and partner pricing levers.

List price

Currency rate adjustment
Local market adjustment

Regional list price

Volume adjustment
Term adjustment
Programme discount

End-user price

Purchase history adjustment
Promotion discount
Additional negotiated adjustments, typically workflow driven
End-user contractual pricing

Partner price

Standard channel discount
Specialised partner discount
Partner contractual pricing

Invoice price

Transaction management

Unlike traditional software products, SaaS has ‘real’ costs, including infrastructure, that must be factored in when setting discounting floors. In addition, because discounts on SaaS products appear long-term on the recurring revenue stream, the discounting approval process must have clearly defined thresholds, roles and responsibilities. Instead of a ‘one size fits all’ approval matrix, SaaS vendors should consider a variety of deal parameters, including size and channel.

To maximise price realisation, standard discounting should be made simple. All potential variables in the discounting programmes should be accounted for to prevent double dipping. The channel and programme structures should be analysed and optimised to distribute customers and partners evenly and prevent the majority from ending up in the highest discounting bucket.

For more complex, high-value transactions that are ‘high-touch’, requiring Sales involvement and negotiations, SaaS vendors need policies and rules to govern the deal. Commonly, negotiated discounts are decision-driven with an established approval workflow. Leading practices for deal management include guidelines such as these:

- Do not exceed established price floor, to protect both product pricing in the market and future revenue streams
- Anchor sales with a suggested sell range
- Provide feedback to Sales on requested discounts, incorporating deal size, product mix, geography and other relevant factors

Across customers and segments, vendors should continuously evaluate the value perceived by the customer, the cost benefits to the customer for the specific deal, costs and margins for each specific deal and the ‘price floor’ for the products in question. Best practices include modeling for significant deals’ impact on recurring revenue, future discounts on up-sell/cross-sell, competitive reaction and market pricing.

Performance management

Developing robust metrics for managing pricing performance—transaction data, costs, market trends, etc.—and analysing them to drive decisions during and after transactions can provide a powerful competitive advantage. For example, real-time profitability and margin analytics are valuable tools for supporting a deal and determining discounts. Analysing captured pricing data also makes it possible to adjust pricing strategy on an ongoing basis, e.g., by monitoring product list prices to ensure they accurately reflect market conditions and adjusting them as needed to eliminate unnecessary discounting approvals.

Leading practices around performance management include:

- Developing an executive dashboard to routinely track pricing performance, key pricing metrics and customer retention rates
- Building a customer lifetime value model for SaaS pricing, factoring in the cost to acquire, cost to serve and churn ratio
- Establishing an integrated provisioning system to deliver data for tracking usage, stemming revenue leakage, shaping products based on feature and functionality usage patterns and defining segments and pricing
- Ensuring analytics capture off-invoice adjustments including, but not limited to, rebates for not consuming full entitlements, penalties due to missed Service Level Agreements and revenue leakage resulting from lack of true-ups (additional charges for consuming above entitlements).

Conclusion

For software companies hoping to pursue new markets and business models by introducing SaaS offerings, pricing management may be the crucial factor determining success and failure. However successful your approach to pricing management may have been under the traditional perpetual license model of software, venturing into SaaS requires an update, with particular attention to SaaS-specific costs and considerations. Taking another look at pricing may be the single most critical factor in determining whether your SaaS venture ends up in the black or in the red.

PwC offers several additional white papers further examining the impact of new pricing, licensing and delivery models on the software industry, including a report focussing specifically on creating a structured framework to support transaction management. These white papers on software pricing excellence are intended to help vendors make wise tactical and financial choices as their product portfolios and business models evolve. Please visit ***www.pwc.com/softwarepricing*** to view or download any article in the series.

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, Brian Hoard, Director, Management Consulting and Suchit Batheja, Manager, Management Consulting, provided key insights and clients' real-world experiences for this report.

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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.

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