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Especially in maturing markets, executive teams are discussing subscription pricing as a possible solution to revenue woes. Here's a quick overview of subscription pricing to enable CMOs to participate in these discussions with confidence.

Subscription Pricing Is Not a Silver Bullet

By Kathryn Roy

Overview

CMOs have a good reason not to focus on pricing much of the time. In enterprise software companies – those selling six to seven figure systems – the primary responsibility for pricing has often shifted to sales and finance. Sales has more first hand data on competitive pricing and only finance has the leverage to rope sales in. Marketing may assist in setting list prices for new offerings and be delegated a role in maintaining the pricing book or system, but – as purchasing managers know so well – salespeople often throw the price book constraints out the window in final negotiations for large deals.

Still, CMOs and other aspiring CEOs need to have a solid understanding of pricing dynamics. Especially in maturing markets, executive teams are discussing subscription pricing as a possible solution to revenue woes. Here's a quick overview of subscription pricing to enable CMOs to participate in these discussions with confidence.

Subscription vs. Perpetual

Under perpetual pricing clients buy the right to use software as long as they like in exchange for an up-front payment. The vendor may require maintenance for the client to access upgrades and may stop providing support for older versions, but the decision about when to stop using the software rests with the buyer. Subscription pricing, in contrast, requires the client to pay a fee for each period (month or year) that the software is in use at the client. Use of the software must cease when the payments end. Salesforce.com is an example of this model.

What attracts vendors to the subscription model is what repels most customers: subscription is cheaper early on, but more expensive longer term.

Buyers Mainly Prefer Perpetual

In most cases, large companies almost always prefer perpetual pricing. They generally aren't cash constrained and they can depreciate large software

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investments over time to approximate the steadier payments of subscription pricing. Smaller companies will have the same preference, except when a software purchase represents a large fraction of their cash or profits, in which case, subscription pricing looks attractively like vendor financing.

Sellers Mainly Prefer Subscription

As a vendor, when should you prefer one pricing model over the other? The answer depends on your company's specific financial goals and your assumptions about customer loyalty. If you aren't under pressure to produce short term cash flow, you will prefer subscription pricing.

Vendor preference for subscription over perpetual pricing also increases with market saturation. When the software industry was booming, there was a natural preference for perpetual pricing. Vendors received cash up front and recognized more revenue early on. Salespeople happily took their commissions up front. As software segments mature, revenue growth falters then turns negative. Perpetual pricing quickly looks miserable compared to subscription pricing. There are fewer big deals to win. Clients become content with later generation releases and drop off maintenance rolls.

You Can't Always Get What You Want

As much as buyers prefer perpetual pricing, they can be forced to use subscription pricing by vendors in some cases. Vendors of hosted software, like Salesforce.com, who can turn off the spigot at any moment, have successfully imposed subscription pricing. There's no spigot that vendors can control when software installed on users' machines, in contrast.

Another case where buyers will agree to subscription pricing is when there is an information collection that is updated regularly. An example is Linux. Companies using Linux value that Red Hat and SUSE keep abreast of the latest releases and conduct base-line testing. It would cost significantly more for the buyer to replicate this work than to simply subscribe to the service.

Microsoft, faced with declining growth in the OS and desktop software markets, attempted to force subscription pricing by increasing maintenance costs and imposing a substantial penalty for upgrading to a future release if any intervening maintenance payments were missed. Basically, this shift told customers, as long as we regularly release updates that you want, it will be cheaper to subscribe.

What can buyers do in the face of vendor-enforced subscription pricing?

Lessons from Specific Company Choices

When Salesforce.com offered subscription pricing, it became imperative that they achieve and maintain market leadership in pricing and features to prevent customer defections. Even now, if and when a competitor appears providing software comparable to Salesforce.com but under a perpetual pricing model, many of the single person shops and large enterprises who use Salesforce.com will likely defect.

Another company, a start-up with a differentiated product, used subscription for the first 5 years. When they realized that the market for their application was too small to achieve the revenue levels needed to go public, they switched to perpetual pricing in hopes that the combination of new sales and conversion of subscription customers would lift them over the IPO revenue hurdle.

They can seek a comparable solution with perpetual pricing. Enterprise customers unhappy with Microsoft's imposition of subscription prices have turned more to open source software.

When a comparable solution to Salesforce.com becomes available where the customer can host the solution themselves, larger customers who were previously constrained to subscription pricing are likely to switch. Small and medium sized customers who want to avoid the burden of hosting their own web-accessible applications are more likely to stay put. Single person shops will shift to non-hosted solutions since they have only one computer to worry about.

One method for securing "subscription" pricing even when non-subscription options are available to buyers is to implement term pricing – tying customers in a multi-year subscription agreement. However, customers aren't dummies; they will often negotiate annual rates that result in costs to them comparable to buying a comparable product under a perpetual license and paying maintenance for the anticipated life of the application. Subscription pricing gives the impression that customers have agreed to pay an annual fee that will be renewed when the contract ends. Their actual behavior will be based on the availability of comparable solutions under perpetual pricing

The Hosted Solution Pitfall

In many cases, executives joining hosted software companies come from enterprise software companies. The software mindset has two drawbacks. First, finance may insist on artificially high prices that deter customers. How you determine margins for *hosted* software must reflect a larger element of semi-fixed (or semi-variable) costs. Some finance departments, desperate to recover these semi-fixed costs, insist on pricing that recovers the semi-fixed expenses based on the current utilization. This tactic results in higher prices, of course, for early (low) utilization rates. In a catch-22, these high prices can actually deter the customers who would subscribe and help justify lower prices at the target utilization rates. The right way to price is based on a reasonable expectation of long-term utilization.

The second drawback is that sales managers may handle discounting just as they would under all software pricing. This can result in discounted pricing that has no hope of recovering expenses even at the target utilization rate.

The Term Pricing Pitfall

Companies selling software along with a large component of services under term pricing – essentially subscription pricing with a multi-year commitment – are susceptible to a revenue recognition trap. Typically, the bulk of the services are delivered early in the agreement, but financial accounting rules require that the services revenue associated with term software licenses be recognized evenly for each year of the software contract. Two million in services delivered in the first year of a five year agreement would result in revenue recognition of $400k / year in services revenue, even when the first year service expense is much greater than $400k. This dynamic sets up a mismatch between the service expense and associated service revenue that hurts companies in the short term but boosts profitability for them as market saturation occurs. Investors have been slow to properly value companies using this model, but seem to be finally coming around.

The Bottom Line

Market saturation is driving many companies to examine subscription pricing. However, subscription pricing isn't the silver bullet many companies would like it to be. The ability to charge a favorable rate through subscription pricing is, just like any favorable pricing, determined by how differentiated your offering is. Customers are very aware of the long term expense of subscription pricing and will seek alternatives as soon as possible.