Soft•letter

Aligning Your Pricing Metrics With Customer Expectations

Jim Geisman is the president of MarketShare, a specialist in software pricing, as well as a frequent contributor to Softletter. In the November 15th, 2005 issue during a discussion we had with him on his advisory article that discussed Microsoft's new pricing scheme for virtual machines, he mentioned the problem many software companies had in aligning their software pricing policies with customer expectations; we also discussed how software companies constantly mistake pricing metrics for pricing levels.

OK, first, let's discuss setting pricing metrics vs. levels. What's the difference?

A pricing metric is the measure or means by which price benchmarks are established on **what** you charge for—such as users, transactions, user-months, etc. As a customer uses more of your software the metric scales. Once you've done that, you can worry about setting price levels and points, but if you haven't aligned your metrics with your customers, the task becomes increasingly complex and illogical.

Let's look at some examples of illogical metrics. Care to provide some?

Sure. Let's take a recent favorite topic of mine, Oracle's per CPU pricing. It requires a customer to think about what's inside the box. Now, multi-core pricing requires the customer to think about what's inside the insides. None of this has anything to do with the value their software offers to customers, in most cases.

For example, we've been working with a company that has developed a software package designed to analyze large datasets to support oil companies' exploration and discovery work. We're talking terabytes of data the software needs to sift through. CPUs are not relevant. What is important to this company's customers is the data and its manipulation; that's where the value of this application lies. Therefore, the company bases its pricing metrics on the size of the datasets the software manipulates. The more data the software manipulates, the higher the price. The company also makes money on data preparation, consulting services, etc.

Well, can't a competitor simply offer to come along and offer to do the same task at less price? *(continued on page three)*

The 2006 CODIEs

This year I repeated my stint as a CODIEs judge and found it a worthwhile exercise. The CODIEs are the software industry's closest thing to the Oscars and offers participants a unique snapshot view of the industry's past and its future.

Since I've taken over the editorship of Softletter, I've kept a careful eye on the SaaS (formerly ASP) market. Last year's CODIEs saw SaaS applications move to the front of the line in many CODIEs categories but this year SaaS basically took over the CODIEs. In practically every category the most significant new applications were hosted applications that service an increasing number of vertical niches. One example that stuck in my mind was Hobson EMT's Answer. The product is designed to develop databases of FAQs used by students attending colleges and universities. I can personally attest to the usefulness of such a product for its targeted audience; my daughter presently attends the University of Connecticut which lacks such a product; her transition to college life would have been made much smoother if UConn offered its attendees such a service.

Another hosted application that stood out was E-commerce provider Volusion. For a starting price of $57 per month, Volusion offers firms an amazing panoply of features, including extensive promotional functions, as well as the ability to sell products digitally via download links you can time limit, generate uniquely, etc. We know of many smaller software companies who still insist on building their own home grown E-commerce backends; in light of the security and liability issues associated with taking money from customers online, never mind the time needed to develop your own E-commerce system, not using a system such as Volusion seems increasingly foolish.

In the Best Business Productivity Solution category, the dearth of client/server and desktop applications was almost shocking and shows clearly the effects consolidation has had on these older, mainstream markets. Whereas in the past CODIEs' judges received stacks of CDs, the 2006 CODIEs featured only three desktop companies competing in this category, Adobe with its Creative Suite, a bundle of their primary desktop applications, a very powerful OCR package from ABBY Software, and FileMaker's database of the same name. Otherwise, SaaS offerings dominated.

The CODIES gave me an opportunity to see how far web analytics have moved beyond simply log file parsing. Offermatica struck us with its ability to allow you to interactively test promotions on your website and quickly adjust offers based on response. SLI Systems Learning Search lets high-volume commerce sites continually refine their search engines in terms of responses to buyer queries. However, we thought the pricing of many of the systems we saw was increasingly unrealistic in terms of the inevitable pricing pressure Google's purchase of analytics firm Urchin in March of 2005 is putting on this market sector.

Speaking of Google, the search engine giant's presence is clearly hovering over many of the SaaS firms we talked to. Microsoft's "Live" initiative is not well understood or feared by the industry (at least, not yet) but Google is another matter; most publishers we spoke to believe Google "gets" SaaS and are wondering if Google plans to simply move into horizontal markets such as desktop search, E-mail, web analytics, and possibly even Microsoft's Office space or whether the company will attempt to roll up vertical markets it's targeted as strategic and/or particularly profitable.

For instance, charge $50 per gig of data manipulation vs. $100?

Yes, and that's where we must distinguish price levels from pricing metrics. You're always going to have competition focused around pricing levels. That's where a software company is going to discuss service quality, reputation, proven capabilities, etc. But if the software pricing model relies on an irrational (from the customer's point of view) metric, pushback from customers will be stronger and based on factors irrelevant to the software's true value proposition.

Let's look at another popular metric then, per user pricing.

Per user pricing can be appropriate in many cases and often makes a lot of sense. But in many cases it doesn't, or at least it's not the most relevant source of value to the customer. Let's take a look at HR software. The number of users of a particular HR software package is probably not, in terms of value, the most important potential pricing metric, (though it may be an significant incidental factor). Then how about charging on the number of employees managed by the package? HR departments must keep track of a constantly changing set of regulations, both local and federal; a publisher of HR software might very well charge a fee for the service of updating a program's regulations database on an annual basis.
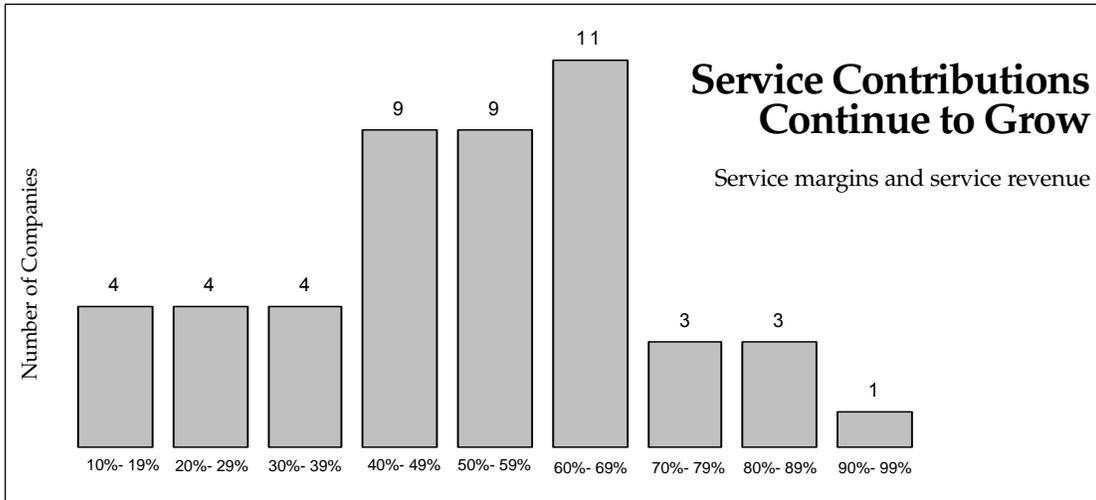
Let me give you another real world example of aligning your pricing metric with a customer's needs. I worked with a company that developed software for the hardware design and simulation business. A key part of the software was providing libraries of virtual parts, i.e., microprocessors, integrated circuits, memory chips, etc. that could be plugged into a virtual machine for prototyping and testing. Initially, the company licensed most parts, especially the more complex ones, on a one at a time, perpetual basis. But their customers were unhappy with this approach. Designers prefer to design; they only used the simulator capabilities of the software on an occasional basis. When they did, they frequently had to go scrambling to purchase a part from the library to execute the simulation, and afterwards often never "used" the part again or only on an occasional basis.

Based on our analysis of their user's needs, this software firm put together a new pricing plan that grouped the libraries into logical chunks of parts that would likely be used together (for instance, PVC parts with PVC as opposed to PVC and cast iron) and allowed their users to license the libraries on a "man month" basis, with the months bundled into twelve packs. Thus, if twelve engineers used the libraries for a month the customer could renew the subscription immediately; on the other hand, if one engineer only used the libraries once every thirty days the license could stretch for 24 months. A "gas tank" model and an example of how a software firm can adjust their pricing metrics to align with a customer's needs and usage.

Jim Geisman, president, MarketShare, Inc, 35 Main Street, Wayland, MA 01778; 508/647-0330. E-mail: jimg@softwarepricing.com. Website: www.softwarepricing.com.

> **"Or what about CRM? Everyone seems focused on charging per user, but other metrics may be more relevant to the customer. For instance, charging for the number of prospects in the system, or by the size of the prospect opportunity."**
>
> *—Jim Geisman*
> *MarketShare*

Service Contributions Continue to Grow

Service margins and service revenue

Number of Companies

10%-19%	20%-29%	30%-39%	40%-49%	50%-59%	60%-69%	70%-79%	80%-89%	90%-99%
4	4	4	9	9	11	3	3	1

Benchmarks: Services Margins

Software as a service (SaaS, the old ASP) likewise returns us to the mainframe days of time-sharing business models and retains its advantages of centralization and cost control. By not having to worry about an endless variety of customer installation configurations, the ratio of value-to-customer over operations costs can be kept high.

It is easier to increase the proportion of a business devoted to services than it is to increase service margins, but those margins steadily increased from the 51% we tracked in 2001 to the present median of 62%. This change takes place even as the industry rapidly increases its services component from the 34% we tracked in 2000 to the 58% of today.

This year we tracked the same 50 companies we covered last year and saw that although the trend is generally upward, not all the companies studied were successful in increasing their profit margin on services. The recent recovery of the software industry has brought a number of interesting trends.

It is natural that smaller companies grow faster than larger companies—they are starting from a smaller base. But the especially rapid growth of the service component appears to bring scalability problems to the smaller businesses: their margins are dropping as their businesses expand (the lowest gross revenue among our 50 last year was $30 million; this year it is $42 million). The larger businesses, on the other hand, are slowly increasing both their service businesses and their service margins over time, although their service-business growth is slower than it is for the smaller firms.

The maintenance/subscription model that originated for mainframes is now sweeping across the lower end of the industry. Its obvious advantage is a steadier flow of revenue than that resulting from periodic upgrade sales, and an opportunity for a tighter, continuous relationship with the customer. Customers naturally seek service from the originator of a product, making the sale of a product-plus-service-contract a more attractive sale than a bare product.

Regis McKenna's "Complete Product" is a necessary condition for profits with Open Source software (OSS). Although OSS creates a third-party support industry, companies like Red Hat have managed to turn their business into 100% service (with margins a third higher than the median).

Total Revenue

	Small <$150M	Medium $150-$299M	Large $300M-$999M	Very Large >$1B
Total Revenue 2003	$940,728	$1,995,051	$8,766,522	$19,399,948
Total Revenue 2004	$1,075,764	$2,058,505	$8,765,130	$20,121,384
Total Revenue 2005	$1,209,653	$2,572,308	$9,923,418	$22,783,953
Cumulative Annual Growth Rate	13.4%	13.5%	6.4%	8.4%

Service Revenue

	Small <$150M	Medium $150-$299M	Large $300M-$999M	Very Large >$1B
Service Revenue 2003	$440,552	$1,023,047	$4,268,497	$6,140,272
Service Revenue 2004	$535.555	$1,177,610	$4,265,807	$6,093,226
Service Revenue 2005	$622,487	$1,575,016	$4,979,570	$6,713,882
Cumulative Annual Growth Rate	18.9%	24.1%	8.0%	4.6%

Service Cost

	Small <$150M	Medium $150-$299M	Large $300M-$999M	Very Large >$1B
Service Cost 2003	$175,179	$450,600	$1,516,880	$3,950,597
Service Cost 2004	$224,080	$468,037	$1,450,930	$3,715,297
Service Cost 2005	$257,097	$567,361	$1,656,577	$3,914,189
Cumulative Annual Growth Rate	21.1%	12.2%	4.5%	-0.5%

Median Service Margin

	Small <$150M	Medium $150-$299M	Large $300M-$999M	Very Large >$1B
Service Margin 2003	54.5%	58.5%	65.0%	52.0%
Service Margin 2004	53.5%	58.5%	68.0%	55.0%
Service Margin 2005	54.0%	63.5%	66.0%	55.0%
Cumulative Annual Growth Rate	-0.5%	4.2%	0.8%	2.8%

Median Service Contribution

	Small <$150M	Medium $150-$299M	Large $300M-$999M	Very Large >$1B
Service Contribution 2003	52.5%	54.3%	46.4%	37.4%
Service Contribution 2004	58.2%	56.9%	50.9%	40.7%
Service Contribution 2005	59.3%	59.2%	57.3%	39.1%
Cumulative Annual Growth Rate	6.3%	4.4%	11.2%	2.2%

Note: Dollar amounts are totals within each size segment and year.
"Services Contribution" is the percentage of revenue from Services.
"Services" are primarily maintenance and professional services.

The Top 50: Profit Margins on Services

	Revenues (000)			Services Margin			Avg.
	2003	**2004**	**2005**	**2003**	**2004**	**2005**	**'03 -'05**
Autodesk	$824,945	$951,643	$1,233,767	87%	87%	94%	89%
McAfee (Network Ass.)	$1,043,044	$936,336	$910,542	85%	86%	90%	87%
NetManage	$65,740	$50,663	$47,666	82%	85%	87%	85%
Citrix Systems	$527,488	$588,625	$741,157	85%	86%	83%	85%
Moldflow	$36,625	$48,673	$64,418	94%	80%	76%	83%
Quest Software	$255,582	$304,288	$389,463	81%	83%	82%	82%
Ansys	$91,011	$113,535	$134,539	82%	76%	78%	79%
Mercury Interactive	$400,122	$506,473	$685,547	77%	76%	71%	75%
Serena Software	$95,775	$105,556	$208,105	77%	75%	73%	75%
NetIQ	$264,138	$217,000	$213,216	76%	76%	74%	75%
Progress Software	$273,123	$309,060	$362,662	68%	74%	76%	73%
Red Hat	$90,275	$124,737	$196,466	66%	73%	81%	73%
Intuit Inc.	$1,597,071	$1,802,224	$2,037,703	66%	72%	75%	71%
Altiris Inc.	$62,876	$99,339	$166,565	72%	68%	66%	69%
Synopsys	$1,176,983	$1,092,104	$991,131	73%	69%	62%	68%
RSA Security	$232,084	$259,866	$307,507	65%	68%	69%	67%
Openwave Systems	$267,955	$290,791	$383,635	63%	71%	66%	67%
Business Objects	$454,799	$560,825	$925,631	66%	69%	62%	66%
Cadence Design Sys.	$1,287,943	$1,119,484	$1,197,480	63%	67%	69%	66%
Sybase, Inc.	$829,861	$778,062	$788,536	62%	68%	68%	66%
Informatica Corp.	$195,441	$205,533	$219,681	59%	65%	67%	64%
RealNetworks	$182,679	$202,377	$266,719	61%	58%	67%	62%
Witness Systems	$67,686	$108,037	$141,335	64%	61%	61%	62%
BEA Systems	$934,058	$1,012,492	$1,080,094	57%	61%	68%	62%
Borland Software	$244,579	$295,236	$309,548	48%	65%	73%	62%
Hyperion Solutions	$510,458	$622,200	$702,593	57%	61%	63%	61%
i2 Technologies	$908,376	$424,929	$389,334	66%	59%	60%	61%
Advent Software	$159,436	$137,159	$149,990	62%	55%	61%	60%
Parametric Technology	$671,940	$660,029	$720,719	56%	62%	61%	60%
FileNet	$347,017	$364,505	$397,558	56%	60%	64%	60%
Manhattan Associates	$175,721	$196,814	$214,919	58%	58%	53%	56%
Vignette	$155,138	$158,314	$177,927	53%	59%	54%	55%
Renaissance Learning	$131,232	$130,544	$114,048	55%	55%	52%	54%
Novell	$1,105,496	$1,165,917	$1,197,696	52%	55%	55%	54%
Agile Software	$70,509	$96,305	$116,987	54%	52%	52%	53%
Saba Software	$44,416	$34,471	$42,210	53%	51%	56%	53%
Wind River Systems	$249,121	$204,119	$235,400	42%	53%	61%	52%
Ascential Software	$113,018	$185,586	$271,879	38%	57%	57%	51%
Interwoven	$126,832	$111,512	$160,388	43%	51%	59%	51%
SumTotal Systems	$30,477	$29,487	$55,204	53%	51%	47%	51%
Kronos	$397,355	$450,694	$518,658	48%	48%	49%	48%
Dendrite International	$225,756	$321,107	$399,197	48%	48%	47%	47%
Security First Technologies	$284,037	$247,618	$241,043	46%	43%	52%	47%
Ultimate Software Group	$55,149	$60,416	$72,028	39%	49%	52%	47%
Siebel Systems	$1,635,307	$1,354,228	$1,339,793	42%	44%	48%	45%
Plato Learning	$82,192	$141,801	$121,804	39%	51%	44%	45%
Adobe Systems	$1,164,788	$1,294,749	$1,666,581	36%	49%	45%	43%
MapInfo	$106,255	$124,673	$149,424	33%	38%	37%	36%
Oracle	$9,475,000	$10,156,000	$11,799,000	18%	15%	15%	16%
Compuware	$1,375,340	$1,264,647	$1,231,839	8%	8%	11%	9%
Median				**59%**	**61%**	**62%**	**62%**

Note: Companies are the same public ones listed in last year's study. They report service revenue separately from licenses and products. "Services" are primarily maintenance and professional services. "Years" may not correspond to calendar years. Figures as based on operations, and generally omit company-wide overheads.

Software Sector Consolidation—Why It Is Important To Pay Attention

By Ward Carter, Corum Group

Waves of acquisitions can roll through a market sector with the ferociousness of Hurricane Katrina. A sector that has not seen much activity suddenly becomes hot, as the major players position themselves to acquire the best technologies/companies in a given market. For example, as the major portals, including Microsoft, Yahoo and Google, all sought to enhance their web-based E-mail solutions, each made key acquisitions. Now, with the major players offering similar capabilities, the demand for technology in this sector is temporarily diminished. If you are in startup mode in the E-mail technology sector, your options are more limited, as the major portals may have satisfied their needs, and as a by-product, also eliminated some companies that could have been your acquirer.

So, paying attention to industry trends is important. Keep an eye on who is being acquired, and what impact that has on your options. Track who is getting funding, and which of the private equity firms are leading those investments. The smart money is looking out three to five years in anticipation of new markets opening, and you need to be taking the same approach as you build your business. Become a student of your market. It's why your company exists, and therefore you should be the expert. By carefully monitoring and analyzing market trends, you can influence how your company is perceived and spend your scarce capital on assets that build the greatest value.

We stress the need for proper timing as a key ingredient to maximizing value in an acquisition. By preparing your company properly, and focusing on those aspects of the business that buyers place value on, you can be in position to see a deal come your way when consolidation begins in your market space. As a Corum client once noted, getting the right deal is a combination of being in the right place at the right time. He could never be sure of the timing, so he went to the right place and waited. Sure enough, when the time was right, he was able to do a deal at a premium valuation because he had built a company that met the needs of a strategic acquirer.

Ward Carter, executive vice president, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: wcarter@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Identix • *Multi-modal identity solutions*	Viisage Technology	$770,000,000 *Terms: Stock*	$79,880,000	**9.64**
A4 Health Systems • *Practice management and electronic health record systems*	Allscripts	$272,000,000 *Terms: Cash and stock*	$75,000,000	**3.63**
Pixar • *Computer animated films*	Disney	$6,300,000,000 *Terms: Cash and stock*	$342,400,000	**18.40**
Goldleaf Technologies • *Remote deposit systems for financial institutions*	Private Business	$17,100,000 *Terms: Cash and stock*	$10,000,000	**1.71**

CORUM
MERGERS & ACQUISITIONS

Online Presentations

- **Brainshark** (www.brainshark.com): Online service that allows you to upload your PowerPoint presentations to a website, then use a dial-in phone connection to record an accompanying voice narration. You can then deliver a link to your audiences who view the presentation on demand. We tested this service as part of our CODIEs stint and found it very easy to use.

- **Camtasia** (www.techsmith.com): Very powerful and easy-to-use screen capture system that allows you to build online software simulations, presentations, etc.

- **Indigo Technical Media** (www.indigotechnicalmedia): Company specializes in high-end multimedia presentations based on Flash technology.

- **Photodex** (www.photodex.com): Desktop-based screen capture and presentation system allows integration of video, files, avi clips into online shows and presentations that can also be burned to CD.

- **Presenternet** (www.presenternet.com) Online service that works particularly well for web-based PowerPoint presentations; does not require a download.

OPEN SOURCE PROGENITOR RICHARD STALLMAN ON EUROPEAN PATENTS: "We have just found out that the European Union is going to make another attempt to impose software patents. There is a proposed directive once again for community patents. In other words, that would retroactively authorize the European Patent Office's flagrant disregard of the treaty that set it up, and that would mean authorizing software patents. So now we get into the situation where there is not much democracy in the European Union. " (Quoted on www.eweek.com/article2/ 0,1895,1911950,00.asp?kc=ewnws011806dtx1k0000599, 01/18/2006)

ISMAEL GHALIMI, CEO OF OPEN SOURCE FIRM INTALIO ON COMPETING IN TODAY'S MARKET: "Enterprise software is a mature market and you can't compete head-to-head against IBM, Oracle or even SAP. You just can't—they have too many resources on the engineering side and they own the customer. It's just brutal out there." (Quoted on http://news.zdnet.com/2100-9595_22-6026171.html?tag=nl.e589, 01/18/2006)

THE ELECTRONIC FRONTIER FOUNDATION ON PROPOSED CHANGES TO "FAIR USE" LAWS: "You say you want tomorrow's innovators to invent new TV and radio gizmos you haven't thought of yet, the same way the pioneers behind the VCR, TiVo, and the iPod did? Well, that's not what the entertainment industry has in mind. According to them, here's all tomorrow's innovators should be allowed to offer you: 'customary historic use of broadcast content by consumers to the extent such use is consistent with applicable law.'

Had that been the law in 1970, there would never have been a VCR. Had it been the law in 1990, no TiVo. In 2000, no iPod." (Quoted on www.eff.org/deeplinks/archives/004340.php, 01/26/2006)