

## OPINION

---



### **Launching a Software Pricing Revolution**

**Sellers must improve price-benefit alignment in order to grow software industry sales.**

**By Erik Keller, Wapiti**

**Dec. 12, 2005**

In the enterprise software market there *were* so many truisms: Hire a large sales force of ex-Oracle or -SAP sales sharks. Get a top notch R&D staff in the Valley. Get a CEO with a long track record. Simply connect the dots and watch the cash roll in.

These software startup SOPs have been supplemented over the past few years by more frugal funding mechanisms as well as having a larger portion of R&D and support services located in low-cost, high-quality regions including India, China, Romania - and Indiana. For some, open-source has become an interesting option.

While these changes are helping companies survive these slow-growth times, they have done little to fundamentally address an important issue that will continue to plague the software industry: the relative cost-benefit imbalance of any given solution. A dramatic shift in software companies' approach to pricing is needed in order to drive industry growth to the next level.

Unlike most other commercial and consumer markets, there is only a slight relationship between the cost (and ultimately the price) of any enterprise-software product and its benefits. In fact, most companies in the enterprise software industry continue to practice one of Peter Drucker's key business sins: cost-led pricing rather than price-led costing.

Regardless of whether a company is building a content management, human resource, order entry or price management solution, the costs of doing business are fairly consistent (see table). But as history often shows us, in the fledgling technology industry, past is prologue.

### Typical Technology Business Models

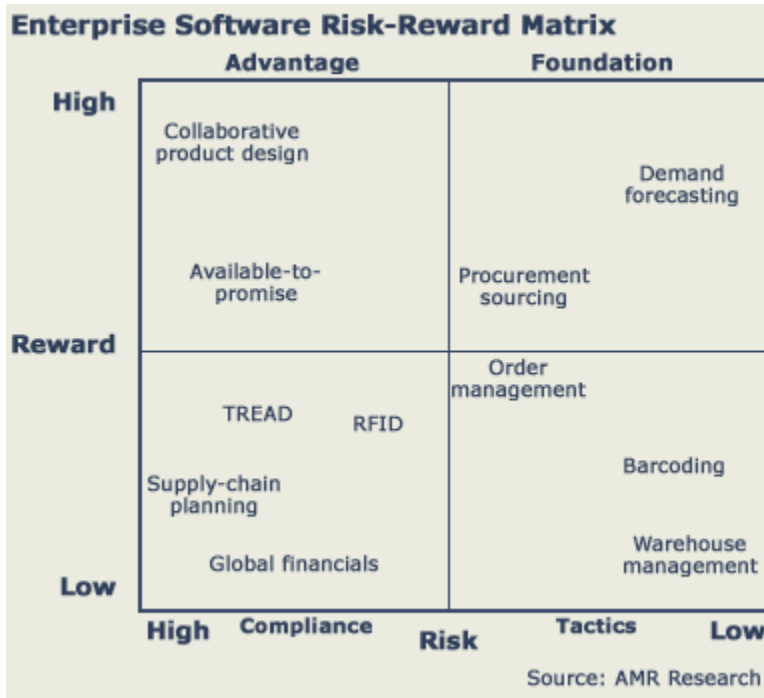
Metric (as a % of revenues)	Software	Services	Hardware
Cost of revenue	5 to 20%	40 to 80%	60 to 85%
Gross margins	95 to 80%	40 to 20%	40 to 15%
R&D	5 to 25%	0 to 0.5%	3 to 15%
Sales/marketing	30 to 40%	5 to 20%	3 to 15%
Administration	5 to 20%	5 to 15%	5 to 15%
Pre-tax margins	Up to 40%	Up to 30%	Up to 20%
Leading example	Microsoft	Wipro (India)	Dell

Source: Technology Paradise Lost, Wapiti LLC

A look at the hardware business model of the 1970s - 1980s was very similar to that of software today. Today a combination of Intel, Microsoft and open source has created a dynamic in hardware that forces every supplier - from makers of cheap PCs to high-end multiprocessor boxes - to adhere to a very draconian business model. These influences have begun to hit the software market.

For example, most enterprise software companies sell their software for hundreds of thousands of dollars give or take. All have elaborate ROI discussions around how their technology will deliver a high and fast return on investment. But the relative impact on shareholder equity and return on equity are rarely discussed. Because everything appears alike, buyers are hard pressed to differentiate between content and customer data management, for example. Without a large, driving initiative such as Y2K or Sarbanes-Oxley, software companies perform sporadically as do their respective markets.

Last year, in my capacity as a Research Fellow in residence at AMR Research (no longer the case), I authored a view of risk-reward for a broad array of enterprise applications. (see chart).



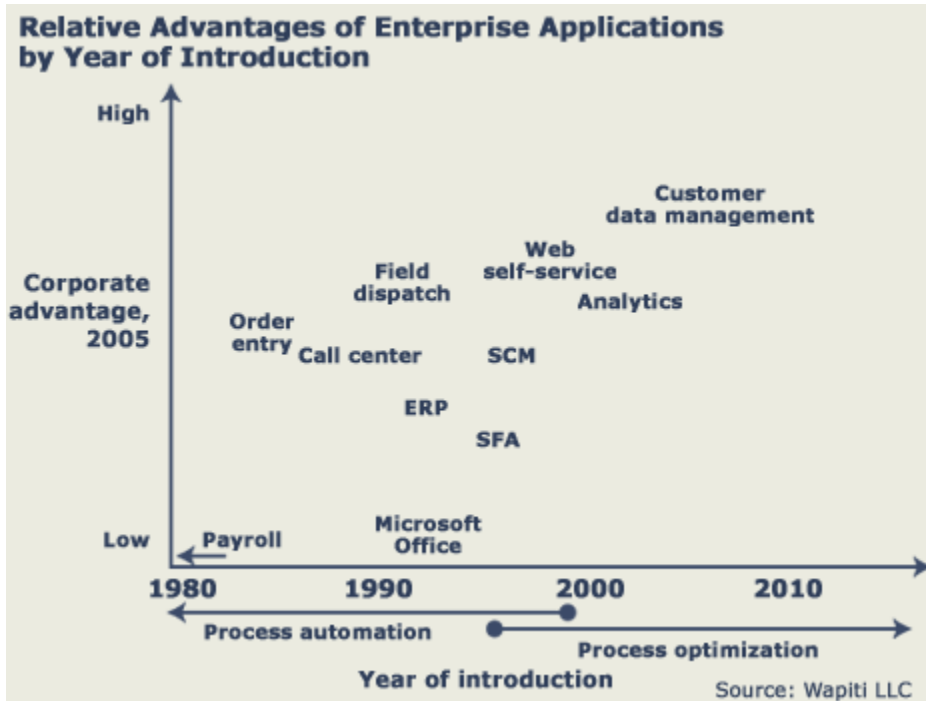
When you look at these initiatives, with few exceptions, there is little difference between the business model of software companies offering such solutions. All have R&D, marketing, sales, and other staffs costing the same per person. All operate in nearly the same fashion forcing them to look very similar from a supply perspective and easy prey for Drucker's cost-led-pricing sin. Yet all have very different risk-reward profiles and thus different value for buyers. And if you haven't noticed, software has a totally different profile than nearly any other market.

Unfortunately, most industry analysts (Wall Street and market research) are unable to identify this issue and offer help to buyers and sellers as to what connotes a good "price" for a given benefit. And there is little chance of this happening as most sector analysts (for example ERP, CRM, SCM, and so on) are as biased toward their market spaces as the vendors they cover. It would be the rare analyst who would write, "My space has become less important to corporate profitability so clients should decrease investments by 30 percent in the coming year." As a result, all analyst reports read remarkably similar in why corporations should invest in a given technology. They sound eerily like Wall Street analysts' reports in the late 1990s were recommending nearly any technology stock regardless of fundamentals.

### A Changing Value Proposition

Part of the challenge for buyers and sellers today is the changing value proposition of software. When the concept of ERP was introduced in 1990, an integrated suite of operational solutions *did* give a company a significant business advantage in the early 1990s and was worth an initial large dollar investment. By the end of the decade, however, an integrated suite was just the cost of doing business. Unfortunately, neither sellers nor buyers changed their respective demand-supply models to accommodate this commoditization.

This is not singular to ERP but, in fact, to every technology investment a company makes. Hot ideas today become the commodities of tomorrow (see chart.) The chart is not meant to be inclusive but rather illustrative, and I have not included areas where I have active investments, But unlike nearly every other industry, a cost - as well as price - reduction has not occurred.



As shown, many technologies have a large initial benefit that will decline over time as more companies implement a given technology. For example, much of the 1990s was about automating processes. The benefits of these technologies continue though do not deliver as much corporate advantage as do those that optimize processes. Companies in these "hot" spaces will not need to play by the same pricing rules as their automation counterparts though they will once they "cool down" and become more common place.

The product lifecycle implies that software companies must actively change their business models to accommodate the time-based loss of value and associated market price. Software executives would do well to consider the example of Toyota, which in 2000 started its Construction of Cost Competitiveness for the 21st Century (CCC21) program. Its goal was to slash supplier costs by 30 percent in five years. It has nearly reached this goal but now it has a new one: meet the costs of China Inc. in the automotive industry.

For technology executives this goal could be translated to meet the cost metrics of open source + India Inc. + SOA + on-demand. And all of this will be a function of how much benefit a given technology delivers. It implies a dramatic slashing of cost and huge productivity increases much as Toyota has done in the automotive industry and as Cisco and Dell have done in hardware.

### A Path to New Pricing

But revolutionizing software pricing is no easy task. To get to price-led costing, software industry executives need to roll up their sleeves and execute a series of challenging actions.

**1. Determine Value.** Software companies must understand the real product value to customers relative to other technologies in the vertical as well as the functional area that they compete in. For example, certain capital-intensive industries derive much advantage from optimizing inventory while most service-oriented ones (not including spare parts) do not. This does not imply that premium pricing can no longer be had but should be considered a temporary phase rather than an assumed long-term rite of a business model.

**2. Build a Cost Model.** After a determination of value is decided, a price-based cost model should be built and tested. Once the new cost model is determined, a slashing of internal costs by more than 50 percent may be needed, as well as new licensing schemes. Such dramatic cuts often imply that existence as a stand-alone company is not viable and that an M&A strategy must be pursued. Conversely, changes can be mitigated if there is a real -rather than a marketing-oriented - way to increase value with a given product or service.

**3. Re-price Based on Value.** Those companies having a variety of products must embrace a portfolio pricing model that varies price according to value rather than a single user price to access solutions across a suite. This implies that the price of products needs to decrease every year, or to increase slightly to acknowledge a large increase in value that is specified by the buyer (rather than mandated by the seller.)

There are many voices today stating that the model for buying and selling enterprise software is broken. If the industry does not learn from the examples of others it will remain broken until a new generation of players emerge that leverage current trends and the status-quo of enterprise software business models to create a value-driven pricing revolution.

*Erik Keller is principal of **Wapiti LLC** and author of Technology Paradise Lost, which predicts the future of IT spending in corporations.*