SaaS Pricing Strategy

How to Craft a Pricing Strategy for your Software, or other Technology, as a Service

Created by Value and Pricing Partners

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INTRODUCTION

According to the Technology Service Industry Association, profit margins on "as a Service" offerings are only half that of traditional technology products. Perhaps that's why Dan Spirek, a software industry veteran and head of HCIT Ventures, said "The motivating question for software companies is how not to die in the SaaS world, while the marketplace and the street are demanding the transition." Why? The business economics of SaaS offerings are stacked against you. Significant investments are required up front, while revenues trickle in over time. All of that means pricing decisions are even more important to your business success. For the traditional tech company, earnings before interest, taxes, depreciation and amortization (EBITDA) is around 15%, meaning a 1% price improvement can improve profits by 7%. With lower margins, EBITDA from SaaS may be 7%. That means a 1% improvement in price can improve profits by 15%. Pricing has an enormous impact on SaaS profitability.

At least part of the problem is that companies are treating "as a Service" pricing as simply a change in product pricing. Managers would be better served by taking the "as a Service" moniker to heart. This is more than simply a change in pricing. It is a change in the nature of the offering. It is a shift from a product offering with necessary services attached, to a service offering with a product as its engine. That shift in mindset opens up a host of pricing possibilities.

INTRODUCTION

Technology products are unique in several respects, with software being at the forefront. They are complex and highly engineered, constantly changing and fluctuating. These products are not fence posts that sit in the ground for 10 years without maintenance. Tech products — from aircraft engines to apps on your tablet — require constant care and feeding. For tech companies, maintenance revenues have been the golden goose that keeps on giving, but they are now at risk in the SaaS world. Each product is part of a bigger system that delivers operating and financial results to buyers. Value delivery, as a result, may be influenced by things outside of your control. In this new environment it is easier than ever for customers to switch suppliers, and the cost to do so is modest. Don’t like Pandora? Switch to Spotify. Don't like QuickBooks? Switch to Xero.

Take a look at how to go about determining a pricing strategy for SaaS, and what you can do to ensure your software — and business — can thrive. For simplicity, the term SaaS will be used, but the same principles hold true for any other “as a Service” offering.

CHAPTER 1

IDENTIFY YOUR CUSTOMERS

It should go without saying that the most important first step you can take with your SaaS offering is to determine your customer base. However, there are a ton of startups and app programmers who don't quite consider their potential customers before they start calculating prices for their software. In some cases, customers won't have a frame of reference when it comes to what they should be paying for your software: the good news is that you get a chance to tell them what it's worth. In other cases, your best customers are your legacy software customers transitioning from a traditional license. They have both a good sense of value delivered and price they are willing to pay. In either case, perhaps the lesson is to do your homework. The opportunity cost in lost sales or missed profits from pricing mistakes are simply too high.

Envision who will be using your offering: Who is your target market? In fact, our recommended strategy for SaaS offerings is "Targeted Pricing". If you have a consumer product, you may ask who your target market is: Is it elite business professionals; Stay-at-home parents; Young students on the go? On the B2B front, it may be a sub-segment of an industry vertical that has a particular pain.

Once you've established your target customers, it's a good idea to do some research into willingness to pay. When an offering is crafted for a target market, it is so easy to make assumptions about why customers want what you provide and what they are willing to pay. The truth is that **customers may value your offerings differently than you do.** There are numerous approaches to getting customer input: choose the best for your situation and budget.

PRICE-OFFER DESIGN

What accounts for the market and financial power of pricing strategy? Look at physics for an important part of the answer. In 1873 James Clerk Maxwell demonstrated that electricity and magnetism are, in fact, one force: electromagnetism. Likewise, Albert Einstein made the case that space and time is inextricably linked, resulting in spacetime. In both cases, physicists created unified theories that were more useful than the previous separate concepts. When it comes to pricing, it is offering design and pricing strategies that are inextricably linked. If you will, the unified theory of pricing strategy might be called Price-Offer Design.

This is where we begin to think of your SaaS offering as a service with a product engine. Here is an example to illustrate: assume your software makes a manufacturing process more efficient. You are serving a market comprised of manufacturers, and that market is segmented. One group of manufacturers might be focused on throughput, producing a commodity every day of the year. Another group of manufacturers might be focused on burst capacity, ramping up to produce a specialty item for 60 days, and then changing to produce a second item for the next 45 days, then ramping down until the next order is scheduled. Your SaaS offering can deliver benefits in both cases. Consider what the ideal service offering would look like for these two manufacturers. For the throughput firm, the big focus would be uptime. Uptime makes or breaks their cost model. Excellent service is defined as maximizing uptime.

In contrast, for the burst capacity manufacturers, the big focus is flexibility. Flexibility permits the manufacturer to achieve the highest productivity of their resources, given the constraint of short production runs. Excellent service in this case is defined as ramping the plant up and down, or transitioning between runs, as efficiently as possible. That efficiency permits them to manage their costs down while flexibly meeting the changing demands of their customers. The outcome they desire is flexibility.

In sum, from an offering design standpoint you see the need for two distinct service offerings for these two segments of manufacturers, even though your core SaaS may be exactly the same. In a world where customers have choices, and can switch between SaaS offerings in a heartbeat, service strength can meaningfully differentiate you and create stickiness with your customers. By segmenting your customer base and defining your "whole offering" based on that segmentation, you have created competitive advantage that expands the overall market for your SaaS product, increases its value delivered and grows share of wallet. You have hit a pricing trifecta!

Now let's connect pricing to value. The throughput manufacturer would be willing to pay a lot for higher uptime, but little or nothing for flexibility. The burst capacity manufacturer would be willing to pay a lot for flexibility, and not so much for uptime. The pricing strategy, then, has price based on uptime value for the throughput manufacturer, and price based on flexibility value for the burst capacity manufacturer. There is integration between the value proposition for each and price for each. The result is pricing that makes sense to customers because it ties what they pay directly to what they value, to their success. This is pricing that not only is conductive to higher profitability, it is conductive to faster growth.

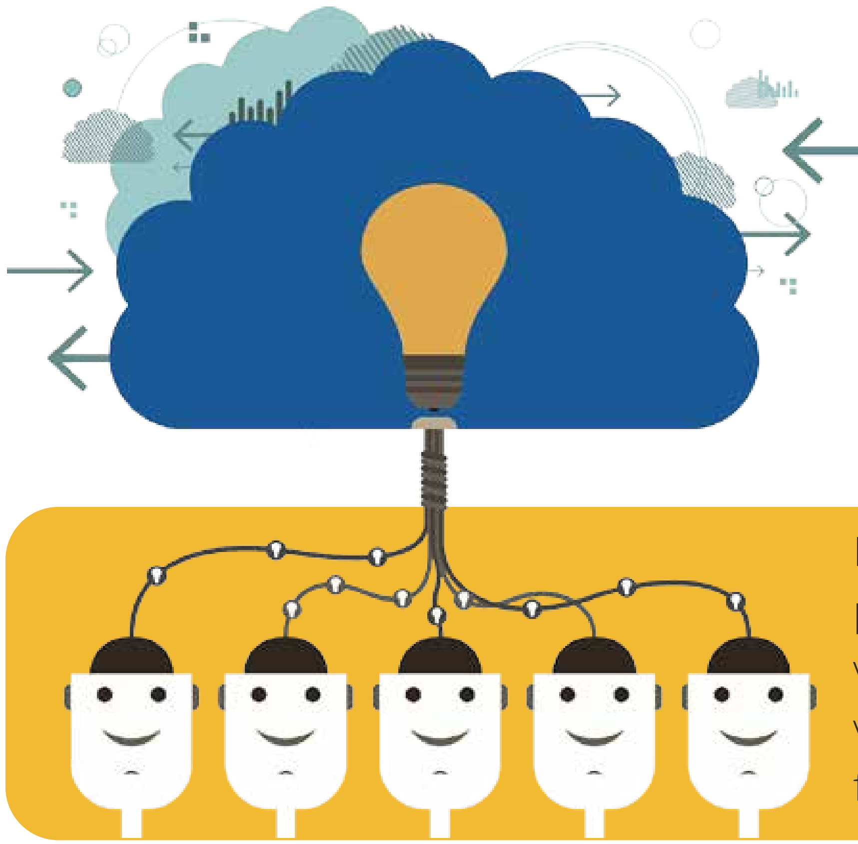
A unified Price-Offer Design is a win-win result for you and your customer, and a tough one for your competitors to emulate. The results are higher price as a percent of value delivered, fewer lost sales, less discounting and time spent in negotiations, potentially lower costs, less price competition, happier sales people and more sales with a shorter time to close. All these benefits of Price-Offer Design cascade through both price management and pricing execution downstream, resulting in compounded financial impact.

The experience of market leaders, like Salesforce.com and Adobe, is that an advantage can be gained by selling value-added services. Even if you only have a core offering targeted to a single market segment at time of launch, there should be a plan to add value-added features and services in a timely manner.

THE IMPORTANCE OF VALUE PRICING

In the emerging world of B4B , where "as a Service" models replace traditional license software, and value added services are instrumental to profitability, cost based or market based pricing simply will not deliver the financial returns necessary to support the business. Lincoln Murphy, a marketing & sales thought leader, defines value pricing on his blog as the following:

"...applying a price to a service that is congruent with the value derived from the services's (sic) use rather than the underlying cost to create and deliver the SaaS, market prices, specific margins, etc. Which makes Value Pricing the most effective method of pricing for SaaS and Web Apps... something like cost+margin just doesn't make sense. The key to Value Pricing is knowing the, well, value of your service as perceived by your target market AND/OR market segments (not all are alike)."



In other words, to price your SaaS based on the typical cost of creation and production values would be making a wrong turn. Rather, when choosing a SaaS price, you need to look at it from your ideal customer's point of view, and determine how they would perceive value – and how much they'd want to pay for it. This is the heart of value pricing: the notion that, when it comes to SaaS, it's better to choose a price based on the customer's perceived value (and desired outcome) rather than the actual cost and margin, or whatever's being dictated by the current market.

In this way, **Price-Offer Design and Value Pricing fit together.** In the design phase we structure the offer and pricing so that it delivers value. This is so that the value can be perceived and the price makes sense in the context of that value. In value pricing we estimate the level of value and decide a price that represents our fair share of value delivered.

CHAPTER 4 PRICING, BUSINESS STRATEGY AND LAUNCH

With the Price-Offer Design in place, you can now decide the role you want pricing to play. Price can be a powerful driver of behavior: sales behavior, customer behavior and competitor behavior. Think carefully and decide, which behaviors do you want to drive?

Let's say we are talking about a new SaaS launch. Price is perhaps the single most powerful communication you have with a customer. In an instant, in very simple terms, your price tells your buyer the value you bring and how that value stacks up relative to the competition. Using an ice cream analogy, you are telling customers whether they should think of you as Ben & Jerry's or Meadow Gold.

From there you need to ask how you want to compete. When Ben & Jerry's launched they wanted to be known as a premium, specialty ice cream brand. As a result, they price positioned their offerings very high, appealing to the least price sensitive group of ice cream customers. Their offering, in turn, is designed to appeal to those buyers. Pricing strategy is aligned with business strategy.

Your SaaS offering may also be replacing a legacy software offering and there will be a transition. Price is an ideal tool to pace the transition from old to new. Basically you have two objectives: Optimize profitability across both products during the transition, and manage transition speed to the new offering to allow for adequate ramp-up. You need also factor in competitive forces in your marketplace.

Launch is a critical time for SaaS offers. You have the opportunity to get some real world feedback on your pricing before that pricing is set in stone. In the B2B world, launch is the time you are working with innovators and early adopters. It is vital that you take that opportunity to document value delivery, and confirm your value price. Then you can use that evidence to make your case more broadly. You will need to cross the chasm to the majority of customers.

CHAPTER 5 GROW YOUR STRATEGY

So, you've launched your SaaS with a solid price point into the market, and everything's going swimmingly — you've been getting purchases and new customers every day. Where do you go from here? After all, in the world of SaaS, you need to stay competitive — especially if you want to keep customers returning for more, and if you want to turn a profit on your offering rather than just making enough to break even.

This is the time when you should be thinking about growing your SaaS pricing strategy. One of the key characteristics of SaaS customers will be looking for new features, upgrades, and updates, and that means you'll likely have to change the price as your software offering expands. But how do you accomplish this without incurring negative feedback, or losing your customers altogether?

The answer here is to take it slow and steady, and to once again do thorough research before making any sudden price-changing moves. In their excellent Slideshare on SaaS pricing , Kissmetrics places emphasis on reaching out to current customers for feedback. Send out electronic surveys, or request feedback via social media communities. Find out what they're enjoying or what needs improving, and build upon their opinions. Once you have a good idea of what your customers are valuing in your SaaS, you'll have a starting point for where you should go with a pricing shift – and what aspects of your software that you need to put the most value on.

GROW YOUR STRATEGY

An important question now becomes: what should become part of your standard offering and what should be value add with an incremental price point? This is a critical question for both building customer loyalty and your firm's financial performance. To answer that question you need to revisit value. **Remember; value gets lost in the pile.** The more stuff you pile into your offering, the more likely the value of individual items gets lost. So when you contemplate new features or services, consider whether that new feature is incremental or truly a step change in value delivered. If it is a step change, then how should you bring it to market?

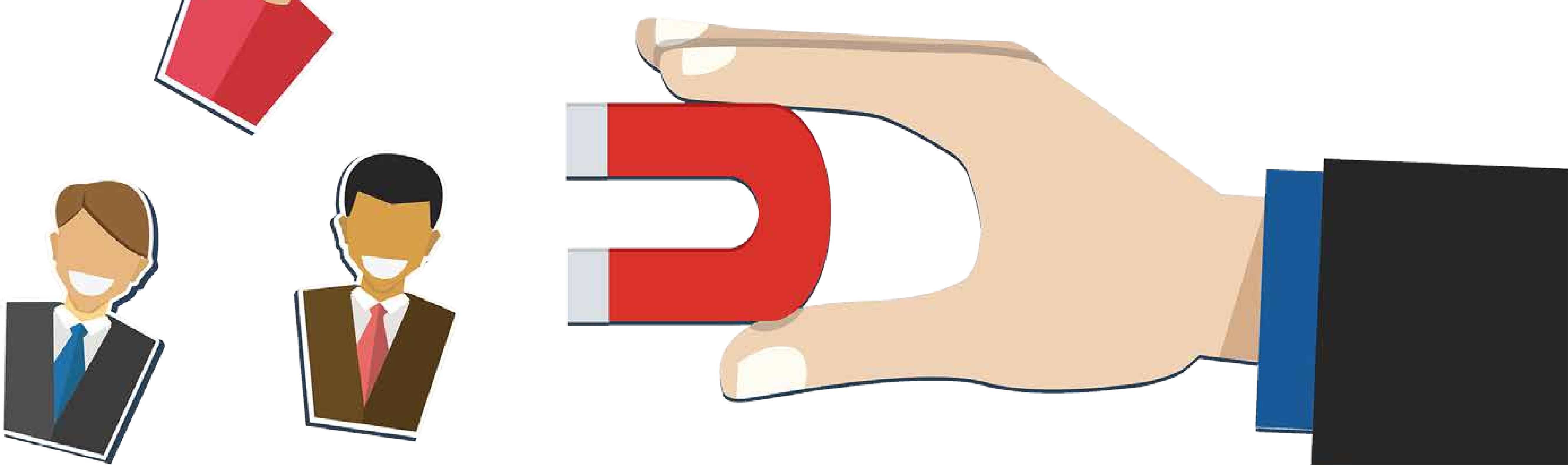
It could be the case with your SaaS that specific types of customers are willing to pay more than others for add-ons. This is when you should look at setting up a tiered system, with features like different plans for customers to get the best value. The higher tier segments should be for the customers who place the most emphasis on value, while price-sensitive customers can be offered a more budget level that still maintains the initial features of the software or app. It's also worth tailoring your price tiers to specific businesses – lower prices and limited features for small agencies all the way up to higher prices and full features for enterprise. If your SaaS is angled towards businesses, this is a good option to expand your corporate offerings.

Another possible outcome is that certain markets and regions will want different features, or place different priorities on specific features. Although it's a positive thing to be crossing over into more than one market, it's definitely something that will also require adjustment in your SaaS pricing strategy. Again, make sure you speak to a wide segment of your customer base in order to find out what features and services they place the most value upon, and keep in mind that this could vary by region. If there are features that additional regions and markets want to see added, look to build them in as part of the higher VIP price tier. Anything that could require extra labor to develop and execute ought to have its costs rolled into a price increase, so you can continue to make a solid ROI on your software.

CHAPTER 6 CUSTOMERS FIRST

Take the time to really connect with your customers and assure them that any price increase — no matter how small — goes directly towards improving services for them. Although you need steady revenue streams in order to keep your business operations growing and flowing smoothly, your customers should ultimately be at the heart of your business decisions. By reaching out to your customer base and making them aware that you're taking their feedback to heart and charging a bit more in order to ultimately improve their user experience, you can help make your audience feel like their opinions are contributing to the continued growth and success of your SaaS.

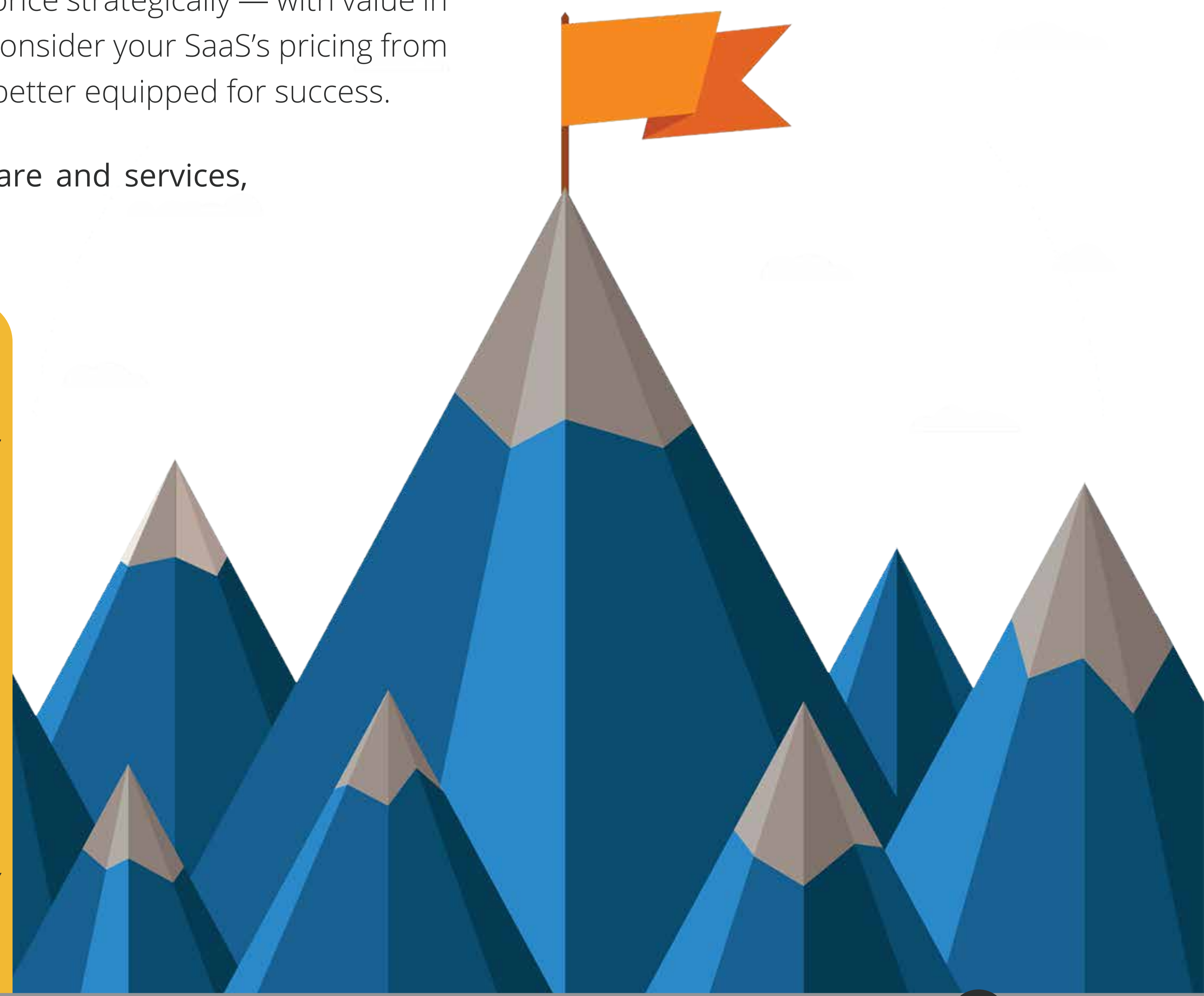
One of the great advantages of value based pricing is that it is win-win for customers. The central thesis is that everyone shares the benefits of value creation. The consumer or business customer is better off as a result of your service. Price is a fair share of creating that new value.



CONCLUSION

Although it can be difficult to determine an initial pricing strategy for your Software as a Service, it might just be because you're using an outdated model that's not suited to the as a service environment. Start by taking the "as a Service" part to heart. Target your customer and think about the value you create. Set your price strategically — with value in mind — and align it with your overall business strategy. Consider your SaaS's pricing from the viewpoint of your ideal customer, and you'll be even better equipped for success.

For more information on pricing strategies for software and services, visit Value and Pricing Partners | valueandpricing.com



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