

# Pricing for **\$oftware** Product Managers

By Daniel Shefer

Pricing has far-reaching effects beyond the cost of the product. Pricing is just as much a positioning statement as a definition of the cost to buy. Price defines the entry threshold: who your buyers are and their sensitivities, which competitors you will encounter, who you will be negotiating with and what the customers' expectations are. Good pricing will remove the price issue from being an obstacle to a sale. Pricing is also used as a weapon to fight the competition as well as gray markets. Pricing is also unique from other marketing decisions for several reasons:

- Price is the only marketing element that produces revenue; all other marketing decisions produce costs.
- Pricing is the most flexible marketing decision.
- Pricing reflects a product's strengths and weaknesses; it implies value as well as positioning.
- Pricing has the most immediate impact on the bottom line. In the high tech industry, a 1% increase in prices can lead to a 10% (or more) increase in profit. This is twice the effect that the same change in volume and fixed or variable costs have on profits.

## Pricing software products

When it comes to pricing software, **Economics 101 does not apply**

When pricing software, the "Economics 101" you learned in college is irrelevant. There are many reasons for this:

- Supply and demand curves are based on the assumption that the marginal cost for manufacturing additional products is non zero and that it decreases with quantity. In the software industry, the marginal cost for an additional copy of software is zero.
- Estimating price elasticity for a specific product is practically impossible. Hence, pricing decisions cannot be based on supply and demand curves.
- Estimating the potential market for a product is possible, but estimating demand is problematic. Most customers tend to be enthusiastic when seeing a new product, but their input is not a good indicator for real demand.
- For enterprise software, sales numbers are too small for a statistically significant study. By the time a company has sold enough licenses, it has advanced to a newer version or the market has changed, or both.
- For most products, there are competing products, and their influence on the demand curve is hard to estimate.
- Product life cycles are short, making comparisons more difficult.
- Purchasing decisions are complex and are influenced by many constantly changing factors. →



# Tips for Setting Prices

## The company's perspective

- Before making pricing decisions, you must thoroughly understand your target market's decision-making and buying processes.
- Properly-priced software will not guarantee the company's profitability.
- When deciding which product competes with your own, the market's perspective is what counts.
- Internal company parameters such as distribution costs come into play only when looking at the potential profitability of the product. I.e., can the company make money selling the product at a given price point?
- The price of the software must be higher than the cost of selling it, and the margins must be higher than the cost of creating, marketing, selling and supporting it or else the product will lose money.
- When new to a market, being a small, unknown company minimizes brand value. Lower, "penetration" pricing may be required.
- If customer segments value the product significantly differently, this may justify segmenting the product for each of these markets.
- When attempting to price commodity products, it is basically the competition that sets the price of the product. Setting a higher price in a commodity market is limited to the company's ability to differentiate the product from its competition. On the flip side, offering a lower price in such a market is sustainable only if the company has a lower cost structure.
- Just like other aspects of the product, pricing needs to follow the technology adoption lifecycle of the product. Early market buyers may be interested in your product but tend not to be willing to pay its full price. It may make sense to price the product at its target price for larger markets and offer early adopters the product at a discount.

## The customer's perspective

- The price has to consider what the customers feel is reasonable. For example, market leaders are expected to charge more. Hence their higher prices can be perceived as "legitimate," up to a certain level.
- Using the pricing model as a differentiator is always worth considering as long as the model is easy to explain and it makes sense to the customer.
- The costs of training, implementing and supporting the product are perceived as additional costs by the customer.
- When setting the price within a range of competing products, it is important to understand how reference prices affect your customer's price evaluation. This is imperative when customers have limited product or price knowledge.

## Guidelines for setting the price of software in existing markets

When setting the price for a software product, classical economic theory comes up short. Here is an empirical, iterative method to arrive at a price.

The purpose of these guidelines is to arrive at the “right” price. This is the price that lets the company accomplish its goals for revenue, profit, market share, renewals, etc. The method detailed below will help you identify the highest price a market with existing competitor presence will bear:

- The price of the software must be less than the ROI it provides. The smaller the ratio of the ROI to the cost of the software, the easier the sale.
- Create a market segmentation chart based on feature sets. Identify all competing products and place them on this chart. Identify and group the value elements in the product that address the needs of each segment. For each segment, identify the features for which customers are willing to pay extra and that differentiate your product from the competitor's. Attach a price tag to the value of each attribute that is not identical such as:
  - The feature and functional differences.

- The difference in brand value that customers attribute to the products.
- The difference in cost for implementing the respective products.
- Any other item that customers attach value to such as localization of the application, geographic proximity (for services), etc.

If the product excels in a certain aspect, then simply add that value to the price, if it lags, simply subtract the value. This step must be iterated for each competing product. The price of the software must be similar or less than that of the main competing product in each segment minus the difference in price that is justified by the functional and other aspects previously identified.

- The price must be below the purchasing authority of the targeted decision maker signing off on the purchase.
- The price should be outside the “Dead Zone” of \$5,000 to \$20,000.
- The price must fit how the market perceives the product category. For example, desktop utilities can be priced up to \$50, productivity tools up to \$500, etc. If the product is priced too high, the price will become an issue. If it is priced too low, customers will perceive it as not worthy.

## Guidelines for setting the price of software in new markets

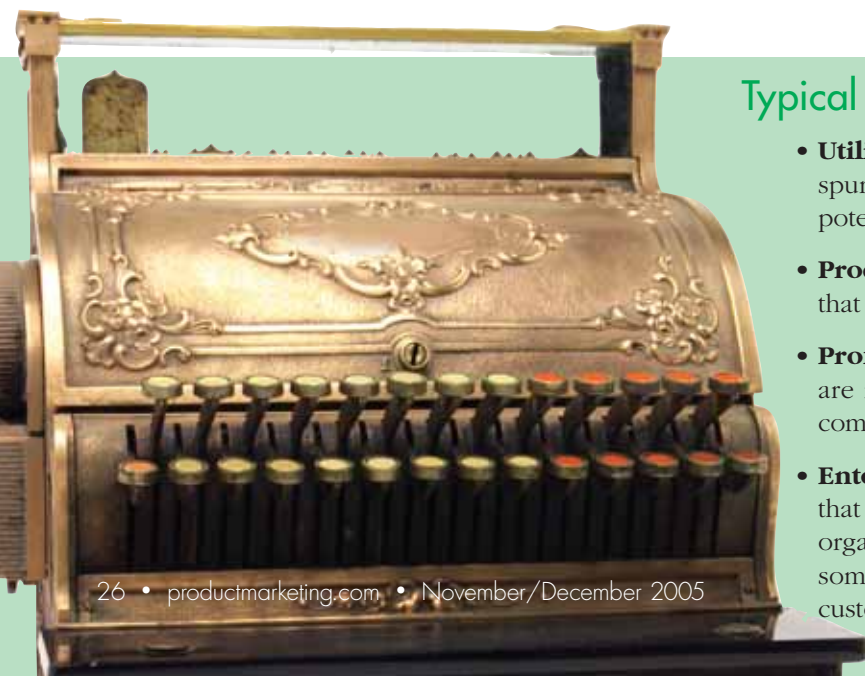
If there are no reference products, the approach is slightly different. The first step in setting a price is identifying how customers will position it in their minds. If the product is perceived by customers as a utility or productivity tool, price it in these ranges—that is, until the product can be positioned (in the buyers’ minds!) as belonging to a higher place in the food chain. See below for examples of products and typical price ranges.

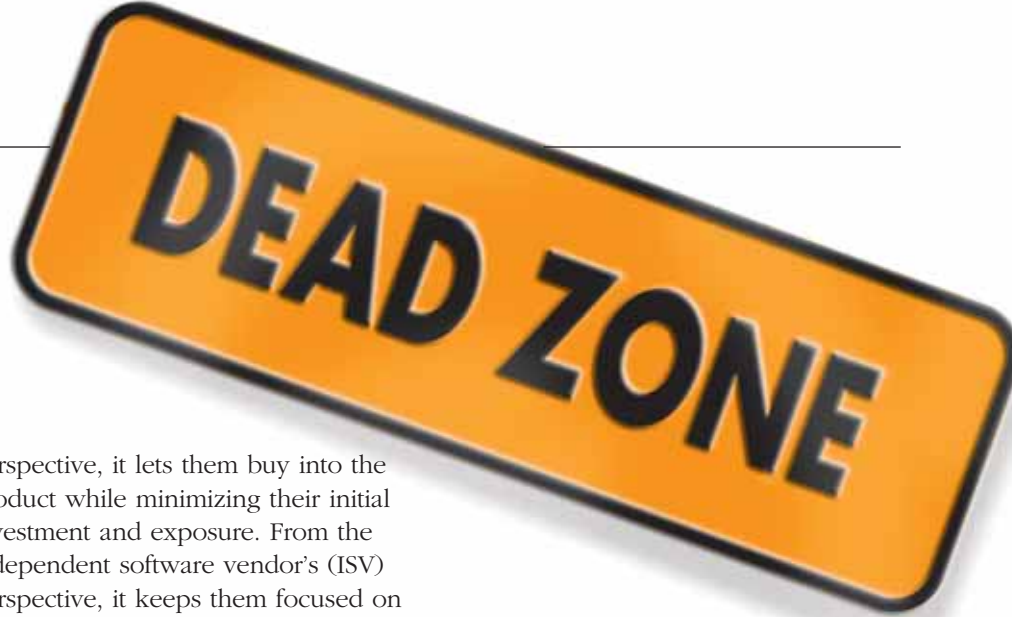
If the product does not fall into the previous category, start by defining the price ceiling. This is the highest price based on a product's benefits. A high price will work if early adopters are willing to pay a premium for a new product. However, this price level may prove to be unrealistic as there may not be a sufficient number of buyers for a new product at that price level.

Then, choose a “penetration” price. Penetration pricing is used when a product is first launched in order to gain market share. A low penetration price is used to discourage competitors from entering the market and to gain market share. Its drawbacks are lower margins, difficulty in raising prices in the future because pricing expectations are now set and the risk of customers perceiving the low price as a low quality indicator.

## Typical software price ranges

- **Utilities: \$50 to \$70.** Purchases of utilities are many times spur-of-the moment decisions. Customers need to feel that the potential financial risk of buying the wrong product is minimal.
- **Productivity tools: \$100 to \$500.** These are purchases that are within the budget of a low-level manager.
- **Professional tools: \$1,000 to \$5,000.** Applications that are required by professionals to do their job, such as computer-aided design tools and many others.
- **Enterprise applications: \$20,000 and up.** Applications that impact many functions and departments in the customer's organization and that require an evaluation process, and sometimes, a purchasing committee. Selling into such a customer is many times a costly and labor-intensive process.





The penetration price has to be sustainable and higher than the company's variable costs. If possible, the price should be low enough to remove the price of the product from the buying decision.

These two markers set the price range for a new product. Follow the relevant guidelines in the previous section to finalize the price point.

### The software price "Dead Zone"

The Pricing Dead Zone is a price range between \$5,000 and \$20,000. Some would even say that the range extends up to the \$40,000 - \$50,000 range. Software products in the Dead Zone are the exception. This is because software priced in this range is hard to sell profitably.

Products that cost less than \$5,000 can be sold over the web or through channels. A purchase of this size is within the decision authority of middle managers, and there is no need for on-site visits to close a sale. More expensive products require higher-level signing authority or purchasing committees. A committee's decision can cause the sales cycle to drag on for months and get entangled in internal politics. These products require sales reps' on-site visits but have to produce enough profit to support this type of sales effort. \$20,000 is at the bottom of the price range that can support a complex sales process. The exact boundaries of the Dead Zone depend on the specifics of how the product is sold.

### Perpetual vs. subscription licensing

Subscription software is an application that is "rented" on a temporary basis. Licensing is usually on an annual basis, but monthly terms also are available. Subscription licensing works when customers see an ongoing benefit from the software. From the customers'

perspective, it lets them buy into the product while minimizing their initial investment and exposure. From the independent software vendor's (ISV) perspective, it keeps them focused on making the customer successful with the product rather than the "fire and forget" approach to selling software.

Moving from a perpetual license to a subscription model increases the vendor's risk as it becomes easier for customers to walk out on them. It may also have a negative effect on the short-term stock price due to Wall Street's focus on quarterly revenue vs. cash flow as the vendor is mortgaging their present for their future. This is because, over time, the income statement reflects the growth from prior years' bookings, as the deferred subscription revenue is transferred to the income statement. Over the long term, the subscription model allows for significantly better revenue visibility and consistency. This is beneficial, as Wall Street loves companies that make their numbers. For example, when signing a three-year license for \$100,000, one-twelfth of it can be recognized each quarter with high certainty. In such a case, cash flow becomes the much more representative indicator of income. This works as long as the renewal rate is high.

By offering a subscription-pricing model, customers face smaller payments. From the sales reps' perspective, a lower initial price lets them aim their pitch lower in the customer's organization. Another advantage for the sales process is that calculating an ROI on a shorter time scale makes it more tangible, hence helping the sale along.

When offering a subscription model, the vendor is betting its future on its ability to keep customers. For hosted apps, setting up a hosting environment can be very costly. The vendor is basically giving customers a loan that will be paid back over the length of the contract. This creates additional risks that vendors may want to avoid.

So now, the bottom line. How much do you charge for a subscription model? There are no axioms here, but many companies charge one-third of the cost of a perpetual license for an annual term. When offering a subscription model, maintenance is usually mandatory.

### Pricing maintenance and support

For enterprise applications, 18 to 20% of the list price is the "standard" cost of support. This usually includes support over the phone for a single contact from the customer during regular business hours as well as product updates (both point and major releases). More advanced packages that include 24/7 support are priced higher, in the 20 to 25% range, and require a minimum of \$30,000 to \$100,000. Minimums of \$200,000 to \$300,000 are the norm for packages that include assigned support engineers. Onsite support should always be priced as an extra. →



Most companies have a no-discount policy on support. That is, even when the software is discounted, the support pricing stays at a percentage of the list price. Very large deals may justify a discount, such as if all support calls are routed from a single person at the customer. One approach is to give away a few months of support during the first year. Psychologically, it is better to give away “months” than to lower the price of the yearly contract.

For non-corporate users, there are two basic models for providing support:

- The per-incident model: The most common model for personal support is “per incident”—that is, a flat rate for resolving each support question, regardless of call length. The median per-incident price for surveyed companies that offer this option is now \$100, with 50% of these companies charging per-incident prices between \$35 and \$185. Support for developer tools and more technically advanced issues run into the hundreds of dollars per incident. For example, a call into Microsoft’s tech support for developers costs \$245. These models typically include a refund if the problem is determined to be a defect in the vendor’s product.
- The per-minute model: A less-popular model is a “per minute” rate. Here, there is less variation in pricing: The median per-minute price is \$2.71 and the 50% range is \$2 to \$2.95. Note that the \$3 per-minute rate is one of the few service prices where there is significant customer sensitivity and pushback.

## Discounting and non-linear pricing

Discounts come in two variations, scheduled and negotiated. Scheduled discounts are those that are pre-approved by the company, based on pre-defined criteria such as the volume of the purchase. Negotiated discounts are an ad-hoc result of the sales process that differ from or go beyond the pre-set scheduled discounts. This article will only discuss scheduled discounts.

## Volume discounts

There are multiple reasons why ISVs offer volume discounts:

- Many times, the utility to the customer of additional licenses decreases as volume increases. To guarantee that the value to the customer is more than the price of the software, the price must decrease as the volume goes up.
- In many sales situations, the cost of sale per unit decreases. This savings can then be passed on to the customer.
- A volume purchase increases the customer’s investment in your product and reduces his or her chance of buying the competitor’s product.
- Large customers are convinced that it is their inherent right to pay less per unit than smaller customers.
- Buying more units now rather than in the future has a discounted current value.

Once a discount is offered, buyers will assume that this discount—or a better one—will be offered for all future purchases.

Before offering discounts, you have to understand the impact on revenue. When offering a 10% discount at a contribution margin of 70%, you will have to increase sales—above baseline—by 17% to make a positive contribution to profit.

## Calculating volume discounts

The way most companies calculate their discount schedules is surprisingly off the cuff. They simply decide how much money they would like to get from a large target customer per user and then draw a curve between the price of one unit and the price of a unit at the high-volume level. They then stand back, look at the curve and play with it until “it looks good.”

Another, more rigorous method for calculating volume discounts is to select a consistent discount rate for every growth in units. For example, a 10% discount on the 10 - 20 units, a 10% discount from the previous price on the next 10 units (which equals a 19% discount from the original price) and so on.

## VAR discounts

Value Added Resellers (VARs) get the software they resell at a discount. Discounts are typically between 40 and 60%, depending on the marketing and sales efforts required by the VAR to promote the software. Many companies design incentives for VARs by creating volume thresholds that increase their discount level. Tier discounts require VARs to commit to sales volume. For example, they may give a 15% discount for no commitment and 35% for very serious ones. VARs receive training and licenses for an additional cost. In comparison, reference partners whose activities are limited to referring customers to the vendor get 5 to 10% of the deal.

When setting a pricing schedule for VARs, take into consideration that the VAR has to make a profit and may be feeding its own distribution channels. This approach is relevant to original equipment manufacturer (OEM) pricing as well.

## OEM pricing

One of the difficulties of pricing OEM deals is that there are no industry standards or accepted price ranges.

When signing an OEM agreement, some companies require an up-front fee for Non Refundable Engineering (NRE), which are efforts needed to tailor the product to the OEM's specific needs. NRE fees include charges for developers, QA and project management. These fees can easily run into the six digits. Some OEM deals will tier their pricing based on the up-front fees and volume commitment. As a rule of thumb, the higher the commitment and up-front fee, the lower the royalties.

## Site licenses

Site licenses give customers unlimited use of a product across their enterprise while paying a flat fee. A buyer's request for a site license is mostly a purchasing ploy. The reasoning is that with a site license, the buyer does not have to worry about counting seats. However, it's only another way to ask: "what is your best price?" One problem with this model is that as a vendor, you lose your ability to track the number of installations at the customer site, and if your product is successful, you will be leaving money on the table. Another drawback of site licensing is that when you sell a site license, you have effectively lost that customer for any repeat sales. If you are concerned about getting the product in front of as many users as possible, just offer steeper discounts to encourage proliferation and use.

Site licenses must provide adequate safeguards so keep usage within the boundary of the site. Customers may not want to count "seats" but they need to have a means for controlling the use of the product. →

## Pricing discrimination

Price discrimination is a technique for maximizing profits by offering the same or similar product at different prices to different customers. The idea behind this is to set prices so that purchasers who are able and willing to pay higher prices do so. Pricing discrimination allows vendors to capture additional market share by addressing segments that attribute a lower perceived value to the product.

Price discrimination can be explicit or implicit. Explicit price discrimination is when a special price is limited to customers who meet certain criteria. For example, academic pricing is a form of explicit price discrimination because only students and faculty can buy at that price. Implicit price discrimination is when all customers are technically eligible for the special price, but the vendor inserts a condition that makes it unattractive to some. For example, rebate programs are a form of implicit price discrimination.

To make pricing discrimination work:

- Each segment needs to have a version unique to that segment
- One market segment cannot buy the product created for another segment
- The difference in pricing must be justifiable and must not create a feeling with customers that they are being treated unfairly

Another common form of pricing discrimination is introductory pricing. The idea behind this technique is to release a new product at a premium price and to lower the price in time. This is a common technique in the computer chip industry where power-hungry buyers are willing to pay extra for the latest and greatest. The reverse can also be true: introduce a product at a significant discount for a limited period to stimulate early sales and then return to the higher list price once the initial surge of excitement has passed.

## Illegal pricing discrimination

The Robinson-Patman Act made it illegal for sellers to directly or indirectly discriminate in the price of similar commodities, if the effect hurts competition. This is especially important when selling to distributors and VARs. For example, if a vendor has two distributors that compete against each other, they have to be offered the same basic terms. If one distributor is allowed to buy software from you at a lower price than another, competition is adversely effected because the second distributor, buying at the higher price, will have a greater difficulty in reselling the software.

It is important to note that there are situations where pricing discrimination is explicitly legal. These include situations where the vendor's manufacturing, delivery or financing costs are different for different customers as well as situations where a competitor dropped its prices. Meeting the lower price is not illegal even if this price is not offered to other customers.

Note that the law applies only to products and not to services.

## Bundling

Bundling is when a group of products (or services) is offered as a single package. By offering bundles, ISVs can increase their sales to segments that would buy only one product. There are two types of bundling:

- **Product bundling.** Product bundling is when two products are integrated into a single package. The purpose of product bundling is to create a combined product that has more value to customers than the separate parts. An example of product bundling is the Oracle ERP® package where the database and application layer are bundled into a single package.
- **Price bundling.** This is when an ISV provides a discount to customers who buy two or more products at the same time.

There are basic differences between price and product bundling. Whereas price bundling is a pricing and promotional tool, product bundling is more strategic in that it creates added value. Price bundling products does not create added value in itself. Therefore, a discount on their combined prices has to be offered to motivate consumers to buy the bundle.

Bundling can be “pure” or “mixed.” Pure bundling is when a vendor does not offer any other option but the bundled products. Pure price bundling is basically forcing a customer to buy at least one product that they are not interested in and can be illegal. Mixed bundling is when a vendor offers both the bundle and the products separately.

## Price bundling is used to:

- Increase sales to segments that have different perceived values for the vendor's products.
- Expose a new product to a large customer base.
- Provide product visibility and a low-cost opportunity for customers to test a new product.
- By offering bundles, vendors make it difficult for consumers to price-shop.

Product bundling is used to create added value for customers. By using integrated products, customers can increase productivity, performance, lower costs of ownership and reduce purchasing costs.

In both types of bundling, vendors can increase customers' switchover costs by selling them more products than they intended to buy.

## Compensating for bundling's effects on profits

An issue that must be addressed when offering products as a bundle is the potential loss of revenue. The higher the variable costs for the products in a price bundle, the larger the increase in sales needed to overcome the discount involved. For example, consider two offerings: a refrigerator and stove costing \$2,000 and \$1,000 with variable costs of \$1,600 and \$800 respectively. The second offering is a bundle of a spreadsheet and a package of financial macros costing \$300 and \$100 with variable costs of \$20 and \$10 respectively. When sold separately, the packages will provide \$600 and \$370 of profit. By offering a discount of 10% on the bundles, the profit will be reduced to \$300 and \$330 respectively. Therefore, the appliances company has to sell 100% more units to make up for the discount vs. the software company that has to increase sales only by 9% to make up for the discount.

## Legal issues when bundling

All mixed bundling strategies are legal. This is because the customer's ability to choose the product they want is not hindered. On the other hand, pure pricing bundling is illegal if the vendor has “market power.” Market power means that the vendor can force a consumer to do something that he would not do in a competitive market or when “a substantial amount of commerce is at stake.”

If a vendor possesses market power, pure product bundling is legal only if the benefits to consumers offset potential damage to competition. For example, in the Microsoft® vs. DOJ case, Microsoft's claim of consumer benefit was enough to justify the integration of Internet Explorer with Windows®. Note that merely combining products together in a single installation does not constitute integration and will be difficult to defend as providing benefit to consumers.

## Unbundling

Unbundling is a process where a product offering is split into modules with some becoming optional. By taking a complex product and splitting it into modules, the product can become attractive to additional segments. Furthermore, each segment tends to become less price-sensitive regarding the modules they need. For unbundling to make business sense, sales to additional customers have to make up for the optional modules that customers passed over. Another drawback of unbundling is the added complexity to the product. After unbundling the product, there are multiple options for customer installations, managing the product and supporting it increase in complexity. One risk of unbundling is that if the product becomes too granular, vendors run the risk of giving the customer a feeling that they are “nickel and dimed.”

## International pricing

The international prices of identical products vary widely compared to U.S. pricing. The “uplift” as it is called, varies anywhere from zero to a premium of 50%. This uplift is justified by increased costs due to the need for localization of the product as well as marketing and sales expenditures the vendor faces in foreign markets. The cost of localizing the software has to be considered, but in many cases is not the bulk of the investment in foreign sales. Higher support costs are due to the additional languages needed, the more expensive labor (at least in Western Europe) and of course increased business risk. On the flip side, in some geographies such as in Asia, services are less expensive than in the U.S.

Note that differential pricing in international markets runs the risk of creating a “gray” market for the product.

Another issue that makes international pricing difficult to manage is fluctuation in exchange rates. There are two approaches to adjusting prices when the exchange rates change:

- Adjust the local price to reflect the price in U.S. dollars. This approach may cause difficulties in countries where the currency’s buying power decreases compared to that of the dollar.
- Adjust the local price to partially compensate for the change in the exchange rate.

Both should be done with an eye on optimizing sales, taking into consideration how revenue is affected as well as the effect the change has on gray market pressures.

## Other pricing issues

### Pricing NRE projects

Non-Recurring Engineering (NRE) is a one-time engineering effort by a vendor that is paid for by a customer. NRE is driven by a feature or capability that a product lacks for which a customer is willing to pay.

In theory, costing an NRE project is easy. Estimate the engineering hours and overhead costs, add a “fudge” factor for uncertainties and risks and multiply it by your grossed cost rate. The result should then be multiplied by a factor of 5 or so. This is assuming that your company spends 20% of its revenue on R&D.

It is critical to understand the reason for this “5” factor, especially when the NRE takes up a significant portion of engineering’s resources. If engineering costs amount to approximately 20% of revenue, an NRE project costing X would have a 5x negative impact on sales. This is because the resources used for the NRE were diverted from producing sale-generating products. This indirect cost must be taken into consideration and not doing so runs the risk of embarking on revenue generating but money-losing projects.

A company that is in good financial condition can follow this procedure for costing NRE projects but a company on the brink will probably not be able to achieve these premiums.

Support and maintenance costs need to be priced as well. If the results of the NRE efforts are not incorporated into the product and are available only to the customer who paid for it, support is extra. These costs should be more than the going rate to compensate for the added difficulty of supporting code which is basically a one off. This is because each maintenance release becomes an NRE project in itself.

### Price wars

A price war occurs when two companies drop their prices regularly to close sales. Pricing wars start once the differentiation between products has eroded. Proper product planning and positioning can help prevent a price war by allowing the leading vendor to charge a premium. However, if two competing products have similar offerings, as the market matures, price becomes a bigger factor in the buying decision. Unless the vendors can extract themselves from the price war with better positioning, the vendor that is able to offer lower prices over time will win the war.

Reducing prices don’t necessarily cause a pricing war. It also depends on where the product is positioned. If it is the highest-priced product, dropping the price to be more competitive will probably not result in a price war. If you are the lowest-priced competitor, you may serve a different customer segment and your competitors may not respond.

Some factors that increase the likelihood of a price war in a given market are:

- A perception by managers that pricing is an easy to implement and reversible tactic
- Commoditized products that customers cannot differentiate between them
- Multiple competitors with manufacturing over-capacity
- Low switching costs between products
- High price sensitivity

One of the ironies of price wars is that while price wars are usually started as an attempt to increase market share, when the dust settles, the respective market shares of the players tend to remain constant but at lower prices and margins.



## Gray markets

A gray market is created when a product that costs less in one market is sold to another market where prices are higher through unofficial channels. There are multiple pressures that can foster the creation of gray markets. These include price differentials or an authorized retailer that can't sell all its inventory and may move the leftovers to unauthorized dealers.

A classic example is the current sale of pharmaceuticals from Canada to the U.S. Canada places limits on the prices of pharmaceuticals and so they are significantly cheaper than they are in the U.S. This creates a strong motivation for U.S. customers to import drugs from Canada. Another example is Amazon.com®. Books sell for different prices on the local Amazon websites. What prevents a German customer from buying a book on the American Amazon website and having it shipped to her home in Germany if she can save money? When it comes to consumer software, where delivery costs are zero, the problem is more pronounced.

Gray markets can damage channel relationships but the aspect that is relevant to this article is the undermining of the segmented pricing schemes. An important aspect of international pricing is the ability to price at the level that each market can bear. When a gray market forms, it can limit the company's ability to charge a premium in a given market.

Gray markets aren't always bad. As long as they do not directly clash with the existing channels, there can be beneficial sides to them such as incremental sales and the ability to reach into untapped markets.

## Price capping

At times, customers may ask for a cap to future price increases. Pricing caps are a negotiation issue. As in all negotiations, never give away something for nothing. Agree to the price cap in return for something that is important to you. This could be a press release, closing the deal by the end of quarter, etc. One trick is to agree to a maintenance cap only if the customer will commit to a number of years or whatever term for which the customer wants price protection.

Just remember that like any forward-looking commitments, potential buyers of your company would not appreciate long-term price commitments that cap your revenue.

One way to reduce the impact of a price cap is to price new features separately. Instead of adding a great new feature into the base product, consider making it an extra option. Offering the feature separately gives you price negotiation flexibility and makes you seem like a larger company with more products. You can always turn back around and offer a discounted "bundle" that includes both the base product and the extra option.

## Two additional issues

- By offering price caps, you may get into legal problems with other customers (see the Robinson-Patman Act).
- If you cap increases to customers, make sure to factor in any up-stream, third-party fees that you owe your suppliers. For example, if you can only increase your price by 5% per year and your suppliers do not have caps on their price increases, your margins could shrink. One way to avoid this is to exclude third-party fees from the price cap.

## How pricing affects sales methods

As a rule, the lower the price of the product, the less effort vendors can spend selling it. Enterprise applications are costly to sell. Marketing programs for generating leads can cost anywhere from \$20 to thousands of dollars per lead at targeted tradeshows. Then there is the time spent by the sales rep qualifying the prospect and traveling to meet him. An onsite sales call typically costs them \$2,000 to \$5,000. It costs roughly \$2,000 per day to send a B2B sales rep into the field. If the sales rep takes a sales engineer with her, this will entail an additional \$2,000. Then there is the rep's compensation to factor in. The bottom line is that fully-ramped sales reps can cost a company \$200,000 to \$250,000 a year and more. Therefore, a direct sales force selling \$2,000 software is simply not a tenable situation.

Companies selling mid-ranged products usually have inside sales reps that prospect and take orders over the phone. When enterprise-wide deals come up, a specialized sales rep is sent onsite. For smaller software packages that vendors want to sell directly, the only solution is to offer the software online and through indirect sales channels such as Amazon.com and CompUSA®.



## Retail pricing

### Natural price points

Natural price points are prices at which there are discontinuities in the price/demand curve. Customers expect to see commodity software products priced at natural price points that are traditionally, \$19.95, \$29.95, \$49.95, \$99, \$199, \$495, etc. The effect of increased demand for a \$19.95 mouse vs. one that costs \$20 may stem from an underestimation mechanism. One explanation is consumers' tendency to round prices down and to compare prices from left to right.

### Temporary discounts

Temporary discounts are used to stimulate short-term increases in sales and for enticing price-sensitive buyers that would otherwise be reluctant to buy at the regular price. A temporary discount can increase customer demand for a product. However, this peak in demand is usually temporary and will many times decrease future short-term demand. Price promotions may entice new, price-conscious buyers, but they can actually hurt future sales to the existing customer base. Promotions are tactical, not strategic, and they need to be managed that way.

By reducing the price of a product, ISVs reduce the risk to consumers trying an unfamiliar product. Assuming that the consumer has a good experience with the product, they will be more likely to purchase it the next time, even without a discount. This is especially true if by using the product, there are significant switching costs for the customer. From a competitive perspective, rebates and other forms of temporary discounts are used to lower prices while attempting to avoid a price war.

When executing a promotion, vendors have to beware that:

- By reducing the price of their product, even temporarily, vendors risk implying that their product has inferior value.
- If a temporary price promotion goes on for too long, customers may begin to expect the lower price. The "reference" price is then perceived as expensive and customers are reluctant to pay it.
- The promotion must be targeted to new buyers and not to repeat buyers.

One way to meet these criteria is by creating a trial offer. This is basically a type of temporary discount. Usually, a condition is attached to emphasize the trial offer's "special nature." This can be done by setting an expiration date to the offer, requiring an additional purchase (a form of bundling) or an exchange of something of value. For example, the customer's agreement to present at a tradeshow on the vendor's behalf.

### Rebates and coupons

Rebates and coupons are discount mechanisms. There are several ways rebates and coupons work:

- A discount at the register. This has a 100% redemption rate and is therefore not used very frequently.
- Coupons at the shelf presented at check-out.
- Mail-in rebates.

Another type of rebate is given to the retailer. These are given after the consumer's purchase and are a form of a discount to the retailer. These rebates are used primarily for adjusting prices to fit the closest natural price point.

Another factor to consider is the cost of administering mail-in coupons. The cost averages between \$1.50 and \$3, depending on the processing services offered with the rebate program.



## Charging for beta software

Most companies do not charge for the Beta versions of their software. Another approach is to charge the customer for the Beta version and then offer a substantial discount for the final release. The company gets to use the beta version of the product, pays for it and is used as a reference account. When the official version is released, the customer will then “buy” it. How long the reduced price is offered once the product has been released is a matter of negotiation.

## Revenue recognition

If a contract calls for onsite training and service to a customer as part of the deal, the revenue cannot be booked until the service is delivered. A simple email from a sales rep stating that they will send someone onsite to help with the implementation can cause problems since it would be considered as an element of the transaction and the revenue would have to be deferred until the company delivered the service.

Make sure the product roadmap doesn't end up in the contract. If the contract mentions future product features or that it will support a new operating system, the revenue cannot be booked until those capabilities are available in the product.

## Pricing post mortem

After setting a pricing model, it is always useful to go back and look at a deal's closing price. In many cases, you will see two things: the average price that deals close at is lower than the list price and a distribution curve of prices. Low closing prices indicate a lack of discipline in the sales force or a price that is set unrealistically high.

When the deal prices fit a wide curve, this is a negative indicator and can be caused by:

- Lack of sales process discipline. Sales reps are closing deals as they see fit, squeezing as much (or as little) as they can from customers.
- Customers varying in the value they perceive and therefore the price they are willing to pay.
- Fragmented buying power. The product is being sold into market segments that significantly differ in their ability to pay for a solution.

## Testing the validity of the pricing model

The pricing model should always be tested against sales scenarios. The best fit should be within the target market. Most models will not be optimized for some segments. In some cases, it may cause money to be left on the table or deals to be lost due to too high of a price. One way to test the fit is to list various sales scenarios and compare the effect on revenue caused by changes of the pricing model and the price points that feed into it. This exercise should be repeated at least twice a year. The assumptions used in the comparison should be validated and the model should be tested on the previous quarters' sales.

Another test for the fit of the pricing model and price point within a market segment is that a comparison with the competitors pricing must be made. Take into account the pricing differential based upon positioning and functional differences. If the differences between your price and that of your competitors' cannot be justified, you will either have to change the model or the pricing factors in it.

The last test is the market. Make sure that your prospects and customers “get it.” The pricing model should be simple to explain. If you need more than a couple of sentences to explain the pricing model, it is too complex.



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## Summary

Understanding pricing is critical to Product Managers. Pricing goes beyond setting a numerical value for the product. It sets customers expectations, positions the product and impacts the way it is sold. Successful pricing is an ongoing effort and should be reexamined continuously as the product goes through its life cycle to ensure congruency among all elements.