Software as a Service Pricing Strategies

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INTRODUCTION

Pricing is a critical decision for any software company. Particularly for startups with emerging technologies, pricing can be one of the most difficult decisions that the company faces. This paper explores several models currently employed by software-as-a-service (SaaS) companies and presents case studies for how companies are utilizing these pricing models in practice. Based on the lessons from these case studies, a framework for making pricing model decisions is derived. Lastly, interviews with real world companies are used to tie the theoretical underpinnings of this paper to real world practice.

KEY PRICING MODELS

This section will discuss four key pricing models for SaaS companies: Freemium, Consumption, Tiered, and Perpetual License. The primary characteristics of each will be observed followed by an examination of the strengths and weaknesses and some important considerations for decision makers to consider when deciding on a pricing model. Finally, a few brief case studies of each model will be discussed to illuminate some of the key points.

FREEMIUM MODEL

One of the most common pricing models that is used by Software-as-a-Service companies in both the consumer and enterprise spaces today is freemium. Briefly, freemium is a business model that offers core services or features for free and charges a premium for more sophisticated components. The general idea is that instead of expensive sales and marketing efforts, a company wants to create a low barrier for interested customers to sample their offering. The key is to generate sufficient interest and combine this with a minimal barrier (i.e. a simple signup and startup process) and a low cost (free for a basic offering) for users to try the product. The intent is that the offering will meet users' needs and entice them to pay for the premium offering. Much of the thinking on this strategy stems from Carl Shapiro's 1983 paper on the optimal pricing of experience goods which argues that customers tend to underestimate the value of an experience good. He defines these as items that one learns the value of through experience. He concludes that the optimal pricing strategy is to offer a low introductory price to lead the customer to realize the true value of the offering.

Freemium models tend to be based on one of four methods for separating the free offering from the premium offering:

Capacity-based freemium: Customers are given a free version up to a capacity, usage, or number of users threshold. This is one of the most common models today. Dropbox is an example of this method. It prices 2GB of storage for free, then incrementally prices 10GB of storage at $10 per month under its "Pro" plan. It also does enterprise sales of 1 TB or more on a negotiated basis.

Feature-based freemium: Customers are allowed to use a free version of the product which has certain key features locked until the customer converts to a paid customer. Skype which augments free VOIP calls with paid dialing to mobile or landline numbers is a prime example of this method. Another example is LinkedIn's Premium Subscription model for professionals. Members are allowed free access to the 220 million-member network, but can upgrade for a monthly fee to get the ability to contact members outside their network, see who has viewed their profile, and advanced search capabilities.

Time-based freemium: This is a typical free trial that expires after a fixed period. There may be some debate as to whether free trial is a freemium model, but the point here is that it is a method that offers users the opportunity to learn the value of the product for free. Much higher conversion rates have been observed when there is greater engagement both before and during the free trial rate with customers. Salesforce.com offers a free 30-day trial of its CRM platform. This trial includes a significant subset of the full functionality so that the user can get a good sense of the value that it adds for them.

Use-case freemium: This is a less common model in which customers can use the offering for free provided they fall under certain specified categories (i.e. non-commercial use, educational, non-profit, etc). AutoDesk or Adobe would be examples of this freemium class for addressing the student market.

Some important considerations for freemium models:

1. Target customers: Freemium is popular precisely because it helps to quickly establish significant market share and adoption. It is therefore most useful for a business that is targeting a rapid scale up, but will likely attract a lot of SMB and Pro-sumers which may not be ideal for your business.
2. Creating value from free users: The "free" only makes business sense if you then get the prem"ium"! It is important to be thoughtful about the value that free customers are adding: For some companies, this is by saving on marketing costs and leveraging viral marketing effects. For others, it is making money through advertising or selling data.
3. Learn from free users: Additionally, companies should keep tangible, salient numbers relating to free users. Companies may want to conduct cohort analysis to understand their conversion rates to paid customers and track viral referrals to gain an understanding of the ROI of these free users.
4. Cost to serve free users: It is important not only to understand acquisition costs of free users, but also the continued cost of serving them. A clear comprehension of this cost along with an estimated conversion rate will allow you to make quick determinations as to the required target market required to make the business economically viable as well as the number of paying customers required to support free members. The costs can include traditional items like bandwidth and storage, but also customer support and service.

5. How big is the market: Freemium adds another conversion step, so having a large market is crucial for this model.
6. Are there network effects associated with the product: Does one user benefit more from having more users of the product or service? This relates to referral rates and also creates switching costs. An example would be an offering like WebEx or GitHub that becomes more valuable as more people use it.

Conversion Rate Optimization

Creating a freemium business model is often about striking a balance between offering too little (not generating enough customer interest to upgrade to the paid version) or offering too much (offering too little incentive for customers to upgrade). The first questions to ask though are which version of freemium to use and around what metrics the free version should be based. Here are a few suggestions for answering these questions:

1. Give enough away for free to gain customer insights: Be prepared to offer your free version as both a means for attracting users to the top of the funnel and for learning more about customer behavior. Before you offer a paid option, have a good sense of how much customers are using the offering and what their use cases are. This will allow you to drive further usage and open opportunities for payment.
2. Align conversion offers around the features that drive repeat usage: Having a strong understanding of what drives repeat usage will deepen the understanding of both use cases and customer needs that the offering is meeting. Build the revenue model around customer needs and repeat usage which are harder for free customers to avoid.
3. Understand that conversions take time: Evernote CEO Phil Libin has discussed the strategy for the company which has an initial conversion rate in the first 30 days of 0.5% as focusing on gathering as many users as possible. By adding new features over time, the company observes a 5.5% conversion rate after 2 years. It is also important to keep in mind that some users will drop off at the pay/don't pay decision point whenever they get to a point where the freemium version does not meet their needs.

CASE STUDY: AtTask vs. Asana

AtTask is a Utah-based startup that has developed a technology solution that it characterizes as Enterprise Work Management. Its SaaS-based platform is meant to assist project teams to better manage work flow, plan, and collaborate. Asana is a collaborative task management tool on the web. Both products are designed to help teams function more efficiently and effectively, but the approach of each is very informative to the discussion of freemium models in this paper.

AtTask leverages a direct sales force to enterprise customers. It offers a free trial version available upon request. Philosophically, AtTask believes that it is much harder for enterprise product adoption to happen virally starting with front line

employees because this class of products often requires companies to change how they work and because buyers (executive decision makers) are not typically the initial users. It believes that change within enterprises must come from the top. Accordingly, AtTask has developed templates and versions of its product tailored to specific functions or project classes. In conclusion, AtTask has optimized its free trial business model based on a philosophy of close customer relationships with senior management and can provide customized solutions for specific niches or tasks.

Asana has a freemium model that allows up to 29 users to use the entire product functionality for free. At 30 or more users, Asana becomes a paid offering. This is a classic capacity-based method of freemium. From a sales perspective, Asana monitors the number of users for each account and proactively reaches out to customers as they approach 30 users.

In terms of adaptation for specific niches or needs, Asana offers an API, but is not actively creating optimized versions of its product for specific sectors or functions. Asana believes that it is meeting the needs of its users (typically front line staff) first and driving adoption through this value proposition. It has created a generalized platform that allows for flexibility and customization by its users to meet their needs and drive widespread user adoption.

[Significant portions of this example are from Dan Woods: http://www.forbes.com/sites/danwoods/2013/03/18/freemium-enterprise-business-models-task-management-attask-asana/]

These are both two very strategic companies looking at a similar market in very different ways, and both could be correct. It is likely that over time one distribution strategy will prove more effective than the other, but the larger point is to recognize the differences in philosophies and goals that each company has and how the business model addresses these differences.

CONSUMPTION MODEL

The consumption model is another popular pricing model as it allows customers to closely tie usage to cost. Also known as "Pay-as-you-go," customers are able to manage their usage of the product or service and therefore the expense related to it. This flexibility is typically valuable for companies that are at the early stage of ramping up their need for a particular product and anticipate greater future usage. At a higher usage level, a locked-in contract may make sense for the customer, but for the scaling-up period, pay-as-you-go might be preferred.

Another important aspect of the consumption model is that it provides for a limited commitment into the future for customers. Unlike traditional license models, customers are able to sever their ties to a product immediately or scale back usage dramatically without a significant negative penalty. Again, implicit in this offering is that users have an understanding of the value per use of the offering, but have either

an unclear view of future use or variability in their use patterns. Therefore, in order to ensure as much flexibility as possible into the future, a pay-as-you-go scheme makes the most sense for the customer.

A downside for a vendor with a consumption model is the lower predictability of revenues. Because of the flexibility afforded to them, customers' usage of the product or service can be variable from month-to-month which will have a large impact on the stability of the vendor's revenues. As companies grow and get familiar with the value proposition of the product, usage should in theory ramp up. Having a strong understanding of the customer base and their needs for the product will help to make decisions about trading off reducing friction for adoption versus stable revenues.

Key metrics for this revenue model include the number of active users, user growth rates, and average revenue per user.

CASE STUDY: Amazon Web Services
Launched in 2006, Amazon Web Services (AWS) is a suite of expanding products and services that constitute an Infrastructure-as-a-Service platform for web-based companies. Its primary products allow customers to have access to Amazon's large-scale, reliable, and efficient IT infrastructure for needs such as storage and content delivery, networking and computation, and application services. Amazon prices the various products on a per-use basis and touts the flexibility, cost-effectiveness, scalability, and security of AWS as an infrastructure solution. The advantages of this pricing model are that it allows Amazon to effectively match pricing to customer need, presents opportunities to upsell new and existing products, and creates fairly significant switching costs as users pay for more services.

CASE STUDY: Twilio
Twilio provides voice, SMS, and other communication services through the cloud. The company follows a "pay-as-you-go" model with a slight variation. Initially, customers will pay two cents per minute for outbound calls and 1 cent per minute for inbound calls with a $1 per month fee for the phone number. It charges under a similar structure for its SMS product. This pricing makes it very simple for its customers to monitor their usage and also to use Twilio on a limited basis and understand the value of the product to their business. As customers scale up their business and their usage of Twilio, the company provides ever larger volume discounts above 500,000 minutes per month. These discounts are tied to usage benchmarks.

CASE STUDY: ZipCar
ZipCar charges a minimal membership fee at signup. Users then log into a smartphone app or website to reserve a nearby car. Using an onboard computer with a satellite link, the car can be opened using the ZipCar membership card, and users pay an hourly rate for usage. Like other consumption offerings, part of the benefit here mirrors those of ownership while removing many of the associated

costs. Payment is made only on the usage of the benefit. A significant factor in the rapid adoption of ZipCar is the design of user processes that include understanding user needs and preferences, selecting convenient locations, intelligent capacity management, and vehicle servicing. The matching of an enjoyable user experience is an important factor in driving greater usage (and therefore high lifetime values) from customers.

TIERED MODEL

Tiered pricing is the most common model for enterprise SaaS, and has a long history as an effective means of price discrimination dating back to enterprise software in the 1980s. The general idea is to tie pricing to some driver of value and usage which can often be seats, modules, data volumes, servers, and many other scale factors. Similar to the cell phone packages with minute bundles, the tiering plans are ideally bundled to encourage customers to upgrade to the next higher level.

The mindset of maintaining a long relationship with the customer supports having a tiered model. As the customer grows, its needs evolve. Part of the sales process is demonstrating that the customer's needs can be met both in the present and in the future through higher tiers that it can "graduate into" over time. This also implies that sales cycles may be longer in order to prove out this value proposition over time.

For a tiered model, it is important to segment appropriately using key metrics as well as intangibles such as customers' expectations of service level. The perception of growth on the part of customers is an important part of psychological pricing that compares favorably to the perception of "being charged more for a service level that I barely need." The selection of the value metric is an important part of this growth perception.

For the company, there are advantages to a tiered model that include predictable recurring revenues, lower average cost of acquisition relative to lifetime value as more revenues come through renewals and upsells, and more stable average selling price as less discounts are needed to keep existing customers. Ultimately, the company has to strike a balance here between providing for customers' needs over a long-term relationship and stable revenues versus a longer and more difficult sales process given the commitment that a customer is asked to make.

Key metrics for this revenue model include net new growth in subscribers, customer renewal rate and churn, and conversion rates between the tiers.

CASE STUDY: Salesforce.com

Salesforce.com is a global enterprise software company best known for its customer relationship management (CRM) software. It offers this software through a bundled cloud-based offering featuring five pricing tiers that range from $5 to $260 per user per month. Salesforce.com also has Force.com which is an integrated platform featuring an API for developers to create their own apps for the Salesforce.com

platform. Access to functionality is also tiered on light and enterprise categories. By creating tiers on multiple product offerings, Salesforce.com allows its customers significant flexibility to structure its offering to the customer's needs. Providing this flexibility is a key for successful tiered strategies.

CASE STUDY: Assistly

With tiered pricing models, bundling and packaging can create situations where certain offerings may be low value to certain customers. Moving up to a higher tier, not all users may use all features equally, so there is an aspect of overpaying for features that are not valued by all users. This leads to a conflict between per-user pricing and tiered pricing.

This issue of per user or per seat usage of assets was addressed in a creative fashion by Assistly (now desk.com, part of Salesforce). Assistly provided a cloud-based customer service platform for its clients and initially used a tiered pricing model. In 2011, with the release of its v2.0, it rolled out a modified pricing model where its customers would be assigned a full time customer service agent for $0. It could then add a "flex agent" for $1/hour or a full-time agent for $29/month (prepaid annually). This combination of consumption and tiered pricing helped its customers better match seats to usage. Again, it is worthwhile noting that this strategy promotes the perception of customers "growing" into their costs as opposed to having a higher price tier forced upon them.

CASE STUDY: HubSpot

Hubspot offers a number of applications for marketers through a SaaS platform. It actually uses a model that is a hybrid of the freemium, consumption, and tiered models. Firstly, the platform's functionality is divided into three service levels (basic, pro, and enterprise) that offer progressively more features. Users can then select the number of contacts and leads that they want access to through the platform which are charged on a per month basis. This model together combines elements of the consumption and tiered models discussed above which allows the customer to select their optimal service level. Lastly, HubSpot allows for a 30-day free trial to take advantage of the benefits of a time-based freemium model.

PERPETUAL LICENSE MODEL

Although the perpetual model is largely being replaced by subscription models in recent years, the model still merits some discussion as it may be optimal in certain cases. Traditional perpetual license models are structured as an upfront payment with 18-25% for "maintenance and support" plus professional services. The high upfront cost and long-term buy-in initially made the adoption of subscription models difficult for CFOs who had already committed to other software packages and paid the perpetual fees. A general rule of thumb was that annual subscriptions were typically priced at a 3-5 year payback on perpetual license fees.

There are still some cases where it makes sense for a customer to consider a perpetual license instead of a subscription (and therefore, for vendors to potentially

offer a perpetual license). For investments of greater than 3 years and when the cost of capital is very low, it makes sense for the customer to run a cost analysis to see if perpetual licensing actually makes more financial sense. Additionally, there are possible tax implications for capitalizing the license as opposed to an annual expense.

CASE STUDY: Oracle
Oracle has steadfastly operated with two separate pricing models for all of its products as either perpetual or term licenses. Oracle does this to provide its customers with the flexibility of a mixed model. This model provides for customers making long-term capital investments in Oracle products to cover baseline usage of assets through a perpetual license, and then incremental usage (i.e. adding temporary seats) under a term scheme. Similar mixed models also exist with pay-per-use regimes coupled with perpetual licenses. Oracle provides licensing credits and upgrades for situations where existing perpetual license customers have their product bundled or discounted with other offerings.

CASE STUDY: Microsoft Software Assurance License Mobility
In July 2011, Microsoft began to offer License Mobility through Microsoft Software Assurance for on-premise applications. On-premise applications for which customers had already purchased a perpetual license could be migrated to the cloud through Microsoft Azure (its infrastructure-as-a-service platform) or other providers. This signaled a move for Microsoft to increased flexibility in meeting client cloud computing and accessibility needs.

It is worth noting that investors – and often customers – prefer simple and pure financial models, but many legacy businesses are in transition and have no alternative but to continue to support their historical perpetual licensing models while attempting to match the subscription approaches by emerging cloud challengers.

OTHER OPTIONS

In addition to the pricing models discussed above, it is important for companies to look at other variables within the pricing model. Here is a brief overview of some of the more popular components.

PRODUCT-RELATED COMPONENTS:

Packaging
Adjust pricing based on the product package (i.e. enterprise, small business, personal use, etc.). Package design and pricing are closely tied to product features and functionality. This is a typical tiered pricing strategy.

Bundling
This is a slightly different tactic from packaging and typically involves bundling complementary products together with the intent of creating market "pull" for complementary products to leverage off star products. Companies normally bundle laggard products with leading products.

This strategy was used by successful on-premise companies to transition to a new SaaS offering. Based on PwC's data, this strategy was shown to lead to sharply increasing SaaS market share as well as increased sales of non-core products in the bundle. It helped these companies to successfully transition out core on-premise products without sacrificing revenues. Two examples of bundling are Sharepoint from Microsoft and Chatter from Salesforce.

PAYMENT AND DISCOUNT COMPONENTS
Prepayment
The practice of offering discounts for upfront payments.

Payment Terms
Price premiums to provide nonstandard billing options or extended credit terms.

Module Discounts
Variations to price based on license type or package purchased.

Volume Discounts
Discounts provided based on quantity purchased at point of transaction.

Discounts for Duration Commitments
Discounts provided for longer-term contracts or contractual agreements between customer and vendor.

Loyalty Discounts
Discounts provided based on customers' historical spend; similar to duration commitments.

Time-Based Discounts
In order to skim innovators in the technology adoption cycle, provide periodic discounts to capture the higher willingness to pay of each group.

Regional Pricing
Regional variations to pricing as defined by regional hierarchy.

Customer / Market Segmentation
Price adjustment based on customer and market segment.

Upgrades / Cross Grades
Pricing lever to provide discounts for customer to upgrade to newer version or license higher end products.

Channel Discounts
Discounts based on partner type (e.g. standard channel vs. specialized partner).

Promotions
Pricing lever to promote a product for a limited time in a region.

DECISION FRAMEWORK FOR SELECTING A PRICING MODEL

STEP 1: WHAT IS THE CUSTOMER'S VALUE OF THE PRODUCT?

The first question in the framework is to consider what the customer's value of the product is. There are several sources of value that a customer can derive from a product. Therefore, it is important for the firm to consider the ROI for its customer. Drivers for ROI can include increased revenue, time savings, efficiency gains, resource or cost savings, or reduced errors.

Additionally, it is important for the firm to consider the customer's price sensitivity, network effects, and attribute tradeoffs as part of the basis for establishing the customer's value for the offering. Attribute tradeoffs may need to be calculated using conjoint analysis. Using the value drivers and exogenous factors discussed above, the firm should be able to establish a demonstrable ROI value for the customer to set the price ceiling.

STEP 2: IS THE CUSTOMER AWARE OF THIS VALUE?

The next question in the proposed framework is to understand if the customer's perceived value for the offering is less than the offering that the firm has calculated. If the customer's willingness to pay is different from the value of the offering to the customer, then this step offers suggestions as to a pricing model. In cases where the customer places a lower value on the offering than the analysis in step 1, a freemium model or a "low introductory" price model will likely have the best results. The most common case of this scenario is a new product that does not have clear substitutes. Because of this, customers likely need time to understand the value of the product and are not willing to pay up to the true value of the offering as determined by the company. If the opposite case is true, and the customer's perceived value is above the ROI calculated in step 1, the firm should reset its ceiling to this higher perceived value and also consider a tiered or perpetual model.

STEP 3: CAN THE CUSTOMER BASE BE SEGEMENTED?

Assuming that the customer's perceived value for the offering is well established and in line with the demonstrated ROI, the firm should look for opportunities to segment the customer base to see if different values can be separated from each

other. Some common criteria to look at across the customer base are searching costs of customers, differences in reservation prices/price sensitivities, and variances in transaction costs. These measures could indicate opportunities to price discriminate.

In particular, high search costs could represent a prospective case for price signaling / reference pricing through tiered pricing. For low reservation costs, using an experience curve pricing model such as freemium or tiered pricing is likely the most successful strategy. Lastly, with special transaction costs, bundling and / or tiered pricing is a potential strategy for capturing additional value.

STEP 4: IS THE CUSTOMER'S DEMAND VARIABLE OR UNCERTAIN?

It is possible, especially for new products or services, that the customer's demand for the product will come on an as-needed basis and will not be consistent. In these cases, a consumption pricing model is favorable as it will capture this variable demand. Tiered pricing may also work in these situations, but may be harder to sell to consumers who do not have strong clarity into their future demand for the offering.

At this point in our model, if a clear pricing model has not emerged, we know that the customer should have a clear perceived value in line with the actual value of the offering, homogenous valuation characteristics, and reasonably certain demand for the offering. If customers are likely to have a long relationship with the company, a subscription model would be ideal. For instance, this could be the case where the product is a platform that has high switching costs. If churn is high, a perpetual model may be preferable in order to secure customer lock-in.

STEP 5: ESTABLISH A PRICE FLOOR

To this point in the model, a demonstrated ROI for the customer has been calculated to establish the value of the offering. Next, an assessment of the customer's value was made relative the ROI calculation. The customer base was then considered for characteristics that would allow it to be segmented and to determine if demand would be variable over time.

We next turn our attention to calculating a price floor. The purpose of this price floor is to determine if the business is economically viable. In other words, if the cost of acquiring the customer is greater than the value that a firm derives from the customer in terms of payment, then the optimal decision is for the firm not to produce. Note that the acquisition cost can change over time, but companies should take this opportunity to have a strong understanding of what this cost looks like in the present and going forward. For freemium models, this includes calculations of the value that free customers bring vis-à-vis acquisition of paying customers versus the cost of serving free customers.

STEP 6: WHAT ARE THE VALUE METRICS THAT ARE MOST IMPORTANT TO THE CUSTOMER?
The final important consideration to make is the value metrics that are important to the customer. With any of the pricing strategies, as the customer grows which metrics will increase? These metrics could be capacity, usage, users, a specific time period, access to certain features, or specific customer segments. Having an understanding of these features will allow the firm to create value through the pricing strategy by setting proper thresholds between pricing tiers.

This paper has attempted to lay out a clear framework for selecting a pricing model. The most important point to make in this framework is that it pays (literally) to know your customers and their preferences. Having a strong understanding of these will allow companies to select an optimal pricing model, develop meaningful metrics upon which to segment, and drive further value for its customers.

COMPANY INTERVIEWS

With a framework for a pricing strategy defined, this paper turns its attention to some real world examples.

Company A: Privately-held Infrastructure-as-a-Service company using a consumption model

Company A selected its consumption model to remove as much friction as possible from the choice that customers faced to trial and ultimately adopt its product offering. In speaking to the CFO, the Company felt that consumption was the most customer-friendly model that they could adopt since it was "pay for what you use," and there was no contract lock-in.

Because of the ease of signing up and the lack of commitment, many managers rightly fear the higher chances of churn. Company A has experienced low churn that is below the benchmark found in the Pacific Crest survey (see Appendix A). It attributes this to customers being able to try and use the service without a contract. Customers ramp up only after having successfully used the service. Further, customers begin to integrate the service into their own platform and applications which increases stickiness. Obviously, this is an ideal scenario for any company. The CFO stated that the Company's pricing model, in addition to being more flexible, is also less expensive than traditional on-premise pricing models. The "no commitment" revenue model coupled with a sales team that was strongly encouraged to use no pressure tactics had gained the company considerable traction.

Due to its consumption model, the company tracks customer usage of its offering, average revenues per user, user growth efficiency, and churn most closely. One

other point to make is that the company spends a lot of marketing resources on engagement with the software developer community. It has created a developer evangelist program which is something that is becoming more common in the industry.

Company B: Publicly-traded SaaS platform using a consumption model

The company's pricing strategy was developed through testing the concept with a smaller client base to determine the value proposition and then finalizing prices accordingly. It initially had a "land and expand" mentality that it found to be very successful. By this, as the number of users increases, the value proposition and the price per user does as well. The company initially experimented with lower price points until it discovered that the product had significant traction and a higher willingness to pay than initially thought. The lower price point allowed customers to try the product and understand its value which eventually led to a higher willingness to pay.

The broader point here is that the company has a performance-based, customer-centric approach where it is actively tracking metrics that are indicators (sometimes indirect) of its customers' success. The company uses data to measure if a customer is underperforming. Management believes that the main reason for churn is decreasing perceived value. Using data to estimate the value that a customer is getting from its product, the company uses this as an opportunity for account management. It has a team of product consultants and enterprise support who help train its customers to more effectively use its product. This also represents an opportunity for upselling. Lastly, and more subtly, this exercise helped the company to obtain intelligence and data to figure out its price point.

Company C: Privately-held content delivery network using a feature-based freemium model

Like Company B, this company also experimented before finding a pricing model that worked for them. The company's most important objective was to generate scale. At scale, its cost structure became more viable and enabled it to undercut its competition. Additionally, scale also has the benefit for the company of offering more value to its customers. With this goal in mind, the company wanted to remove as much friction as possible for its customers and deliberately pushed as many features as possible down to its free plan.

As it did this, it came to the realization that it needed to discriminate based on the size of the customer. One of the most important levers for this discrimination was discovered when it signed up its first large corporate customer. The customer felt that the price point was too low for its own peace of mind. The company created a new pricing tier with dedicated support agents and maximum functionality.

Therefore, the price discrimination strategy was as much psychological as it was financial in this case. Through this approach, the company has found that pricing has actually helped it to reach higher tiers of customers.

The company does not have a dedicated marketing and sales team. Its primary channel is through a network of partners. While the company was in its growth phase, the company took a different approach to looking at its metrics, in particular churn. It used cohorts based on the date of signup to analyze trends. For instance, it looked at all customers that signed up for the product in January. Then, moving out 1,2, and 3 months on, it analyzed churn, conversion rates, and average revenue per customer. It found this exercise particularly illuminating because of the difficulty of collecting data in such a rapid growth mode and the difficulty of having benchmarks. It uses this data and actively reaches out to customers. This has generally served to keep churn rates low.

Company D: Privately-held SaaS platform using a capacity- and time-based freemium model

Company D initially had a 30-day free trial of its product. In late 2012, it rolled out a capacity-based freemium version of its product and had both models running side-by-side. Initial uptake on the capacity-based freemium was moderate, and a greater marketing push took place in the spring of 2013. The significant challenge that Company D faced was to familiarize some segments of the market with its product and establish its value proposition accordingly. This implied a need to focus on educating prospects on the value of the product. As prospects have more complex needs, the product has greater value to them. An ROI model was developed to explicitly demonstrate the value to the prospect and highlight the greater value with increased complexity of prospect needs.

One point that the interviewee brought up is that in enterprise software, products tend to be more technically complex than consumer products. While companies are used to the complexity and have processes in place for evaluating the products (of which ROI is one), the cycle of a technology disrupting the enterprise market is accordingly longer in most cases. An example of this is VMware and virtualization which took customers some time to absorb and realize the value of the product. Enterprise SaaS companies should be aware of this absorption time.

A few other trends that are worth noting from this interview:

1. With the marketing push in the spring of 2013, Company D revamped its pricing model to be simpler which had the effect of shortening its sales cycles.
2. Additionally, the capacity-based free version was used as a means of extending Company D's partnership network. Therefore, there was a sales value and a strategic value to this action on its part.

3. The trend of the “consumerization of the enterprise” has been very noticeable in Company D’s space as the UI from it and its competitors have quickly converged to being nearly identical over a span of less than one year.

CONCLUSION

In this paper, we have covered the dominant pricing models used by enterprise software companies for the past 20+ years and provided case studies to illustrate how companies have used them. We then turned out attention to a framework for thinking about a pricing model for a new business. Lastly, we have summarized interviews with actual companies to demonstrate how theory has been put into practice. Although this paper cannot tell you which pricing model is best for your business, we would like to conclude with a few key points to consider:

1. Companies experiment with their pricing strategies. This is perfectly normal and a necessary process to understand the optimal way to price and collect from your customers. Although you should not be afraid of experimenting, your search should be guided by a logical framework that systematically guides you to the best strategy.

2. A great pricing strategy complements the product offering and the company’s marketing and sales strategy. Great pricing strategies begin with the philosophical underpinnings of the business, focus on customer needs, and support the core strengths of the business. Having this internal alignment with all aspects of the business including the pricing strategy is extremely important. The pricing model should also be simple for customers to understand and evaluate.

3. Data collection and analysis are more important than ever for understanding your customers and making critical decisions quickly. With the myriad data that exists or can be collected, companies that are able to quickly analyze data are at a significant advantage to companies that cannot do this.

4. Minimizing churn is about ensuring customers continue to perceive and obtain value from the offering. Therefore, the best companies tie their data monitoring to metrics that show their customers are succeeding by using their offering and proactively reach out to customers when they are not getting value out of the offering.

5. Participation in the developer community appears to be an industry-standard practice as a means of active engagement and seeding viral adoption. It is also another means of engaging with your customer base in a rich and qualitative way to complement any data collection efforts.

6. Companies need to balance the aggressive goals of hyper growth and frictionless customer acquisition with the practical realities of keeping prices high enough to support the ultimate cash needs of the business. Over time, companies may choose to further reduce pricing in order to bring up market share and lock out competitors, or increase prices to begin to harvest a strong customer base for cash flow. A great pricing strategy will be somewhat unique for each great company.

APPENDIX A: SURVEY OF BENCHMARKING REPORTS

As an appendix to this report, it is useful to consider some real world data and metrics to go along with the models and interviews that are included in this report. We have included a quick summary of some of the key findings from two industry reports below.

PACIFIC CREST SAAS COMPANY SURVEY

We compared some of the results from the 2011 and 2012 Pacific Crest Survey of SaaS Companies. Note that the 2011 survey included 70 private SaaS companies; the 2012 survey involved 83 private companies. 23 companies responded to both surveys.

Here are some interesting trends that we noted:

1. Companies with Internet sales as their dominant sales strategy (as opposed to field, inside, or channel) reported much higher growth rates in 2012 (39%) than in 2011 (23%).
2. Median CAC came down from $0.93 to $0.90 per $1 of new ACV.
3. Additionally, CAC for upsells and renewals came down by more than 30% each in 2012.
4. Internet sales CAC was significantly higher in 2012 vs. 2011 ($1.06 vs. $0.45, respectively).
5. Lower percentage of new ACV from upsells to existing customers in 2012 (19% in 2011 compared to 14% in 2012).
6. Companies are reporting greater use of freemium (feature- and capacity-based) and try-before-you-buy (time-based freemium) models as lead generation sources: 31% of companies expected to generate leads from freemium and 55% from try-before-you-buy in 2012 compared to 26% and 49% in 2011, respectively.
7. Median annual ACV declined significantly from $37,500 to $24,000.
8. Median contract lengths appear to be increasing from 1.5 to 1.7 years
9. Seats and usage / transactions are the primary pricing metrics (~70% of overall respondents).
10. Median annual renewal rates increased from 87% to 93%

11. Gross churn was consistent at 5%.
12. Net churn was consistent at -6%. Net churn takes into account the effects of upsells and renewals compared against revenues lost from non-renewals.

TOTANGO REPORTS ON SaaS METRICS

Totango is a SaaS company that provides user insights for SaaS companies. It published two reports in 2012 that will be summarized below. The first is benchmarking for free trials, freemium, and pricing ("the business models report," 550 company websites analyzed). The second is around SaaS conversion rates ("the conversion rate report," data from 100 companies).

Here are some of the key findings from both reports:

1. Of the 550 companies in the business models report, 17% offer freemium and 44% offer a free online trial. Most of the free trials were for 30 days.
2. 46% of the companies in the business models report use "per user" pricing.

For the conversion rate report, Totango segregated data from credit card-required free trial models, no credit-card required free trial models, and best in class performers.

3. Comparing credit card required / not required, the overall conversion rate after 90 days was better with the not required group due to a lower level of friction at the top of the funnel (initial sign-up).
4. The difference between the average no credit card required trial companies and the best in class was the conversion of free trial to paid customers. This is because the best in class companies monitor active trial users and actively helps other users to achieve success from their trial.
5. Best practices observed for churn was actively looking for warning signs such as non-use or lower perceived value and proactively reaching out to at-risk customers.

APPENDIX B: FURTHER READING

1. Lincoln Murphy's Taxonomy of Seven Different Models of Freemium: http://sixteenventures.com/seven-types-of-freemium
2. 2011 Pacific Crest Survey of SaaS companies: http://www.pacificcrest-news.com/saas/Pacific%20Crest%202011%20SaaS%20Workshop.pdf
3. Malcolm Gladwell's Review of "Free: The Future of a Radical Price" by Chris Anderson: http://www.newyorker.com/arts/critics/books/2009/07/06/090706crbo_books_gladwell?currentPage=all
4. Seth Godin's Response to Gladwell's Review: http://sethgodin.typepad.com/seths_blog/2009/06/malcolm-is-wrong.html