Pricing Your SaaS Product

Final: March 23, 2015

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"Nothing is more critical to a software-as-a-service business than its pricing strategy"

- Steven Sinofsky, Partner, Andreeson Horowitz



Pricing on anything other than value to customer can leave significant amount of money on the table



How would you price Picasso's 1955 "Les Femmes d'Alger (Version O)" at 2015 sale?

Cost-Based Pricing

Price = COGS + Premium

+ 15% Markup	\$383
TOTAL COGS	\$3,550
30 Hrs Labor (\$100 / hr)	\$3,000
Other Supplies	\$100
Fine Brushes	\$100
Deluxe Oil Paints	\$150
5' X 5' Premier Canvas	\$200

\$3,933
Total COGS Plus Markup

Competitor-Based Pricing

Price = Market Price - Discount

"(Version O)" is part of a series for which past auction data exists

V.	Auction	Sale Price	2015 Adj.
Н	1997	\$7.2 M	\$10.6 M
J	2006	\$18.6 M	\$21.6 M
K	1997	\$6.6 M	\$9.8 M
L	2011	\$11.4 M	\$12.0 M
М	1997	\$10.0 M	\$14.8 M
0	1997	\$31.9 M	\$47.1 M

\$19,320,000

Average of adj. benchmark prices

Value-Based Pricing

Price = What It's Worth to Customer

Hypothesized Sources of Value for Buyer at Auction (former Prime Minister Hamad bin Jassim bin Jabir Al Thani):

- Investment thesis that value will rise over time
- · Aesthetics and enjoyment
- · Addition to personal collection
- Perception of owner as an educated person
- Cultural prestige for Qatar

\$179,400,000

Amount of actual sale plus fees



Pricing should be based on value to customer

Cost-Based Pricing

Competitor-Based Pricing

Value-Based Pricing

Use Rarely

Use Sparingly

Use Predominantly

- Revenues will cover costs
- ✓ Requires little research to set
- Prices are in-line with customers' past expectations and vocabulary
- ✓ Direct comparability exists between players (advantageous in an RFP process)
- Maximizes revenue by charging each customer maximum will pay

- One price for all customer segments
- Undercharges customers willing to pay more
- May not stay profitable if costs change
- Competitors may not exist for an innovative product or service
- Can create a "race to the bottom" between competitors, eroding margins
- Requires extensive research and experimentation to refine
- Charging too high a price may create margins that tempt entry of more competitors ("price umbrella")

Virtually never the correct strategy because it undercharge customers willing to pay more, and because your margins may be unsustainable if your cost structure changes

Sometimes appropriate for very mature markets with established price points, but usually not the best strategy because it undercharges customers willing to pay more

Nearly always the best strategy because it secures the greatest possible revenue for a product



How to price your SaaS product

1 Define your upper bound: The maximum value your product has for customers



Competitive Advantage



Customer

2 Define your lower bound: The minimum you must charge to cover your products' costs



Costs (both fixed costs and variable costs)

3 Identify any reasons to charge less than your maximum value



Competition



Discounts

4 Structure your pricing model as a compromise between upper bound and lower bound



Value Metric



SaaS Pricing Models





At most fundamental level, your pricing strategy hinges on how unique your product is

	Unique	Similar to Other Products
Also known as	DifferentiatedCompete on product"Price Makers"	CommoditizedCompete on price"Price Takers"
Your product may be unique in terms of	 Product functionality Customer service Patent exclusivity Brand perception Geographic focus / language Go-to-market strategy 	Price is the only meaningful differentiation
Your customers decide how to buy based on	Whichever product best meets their needs	Whichever product has the lowest price
You'll win by investing in	AdvertisingCustomer insightsResearch and development	 Increasing volume to drive scale Taking out as much cost as possible from the value chain (vertical integration, advertising, labor, etc.)

The more unique your product, the greater your ability to charge a premium





At most fundamental level, your pricing strategy hinges on how unique your product is

Unique

Compete on Product



VISIER

Talent Analytics Software

Talent software is very differentiated: quality and usefulness of analyses, ease of use.

Therefore, customers are willing to pay a premium for the solution that best meets their needs and providers compete on quality

Similar to Other Products

Compete on Price



Payroll Software

Payroll is not differentiated: either employees are paid correctly and on-time, or they are not.

Therefore, price is the most important driver for purchasing. ADP is the largest, oldest player, and its scale keeps costs low, so it is difficult for new entrants to compete

HR Software

Water



Fiji Water

Price: \$5 / bottle

Customers pay more for Fiji Water because it is marketed as elite and because it is sold at high-end locations. Customers pay for how it makes them feel about water.



Grocery Store Generic

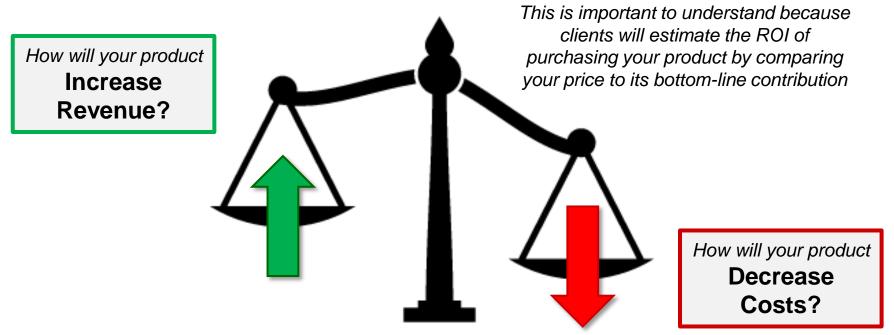
Price: \$0.25 / bottle

At the grocery store, people buy whatever water is cheapest. The grocery store brand thus tries to be cheapest by selling in bulk and owning supply chain (vertical integration)





How will your product contribute to customers' bottom line?



Direct Revenue Contribution

- New leads
- Customer retention

Indirect Revenue Contribution

Brand perception

Direct Cost Cutting

- Price difference from competitor
- Time / labor expense

Indirect Cost Cutting

Reduces errors / risk





What drives your customers' switching costs?

Switching costs are the incremental expenses, inconveniences and risks incurred by your customer when they switch software providers.

They are a double-edged sword for SaaS businesses: at first, an impediment for adoption, and eventually, a tool for retention

Adoption: Minimizing Switching Costs

Freemium models acknowledge the upfront cost of switching and lower the risk of trying new software

Support the migration of data from existing platforms, or the entry of new data into your platform

Minimize re-training costs through product ease-of-use, help desks and training / reference materials

Retention: Increasing Switching Costs

Offer an excellent product and experience that gives customers no reason to look elsewhere

Build a personal, trusting relationship with decision makers

Incorporate network benefits whereby customers benefit from having other customers using your product

Offer data-driven insights that platforms with fewer customers can't match (benchmarks, industry trends, etc.)

Integrate with other business applications

Build a large user base within your customers' companies

Patents and long-term contracts are helpful structural strategies, but are not ultimately sustainable





What are your key customer segments?

What are customer segments?

Customer segments are groups of customers that have similar purchasing behavior.

The results of an effective customer segmentation are:

- Measurable: Quantifiable and based on rigorous measurement
- · Addressable: You are able to affect and influence group behavior
- Stable: Segments are unlikely to change in near future
- Consistent: Groups stay similarly clumped through customer lifecycle

How does segmentation help you price?

- Charge higher prices to customer segments that are less price-sensitive and / or that derive greater value from your product
- Increase your competitive advantage by providing a feature or service especially valuable to a certain segment
- · Prioritize high-profit customer segments and deprioritize low-profit customer segments
- Improve your advertising and marketing by targeting the most effective communication channels and messages
- Boost conversion at different funnel points by refining product and its solutions

How do you create a customer segmentation?

One or a combination of the following may be used to derive a segmentation:

- Existing customer data: Do you see clumps or patterns in usage?
- <u>Customer research</u> (surveys, interviews, focus groups, etc.): What do your customers tell you about themselves?
- External market research: What patterns exist in the broader market?





What are your key customer segments?

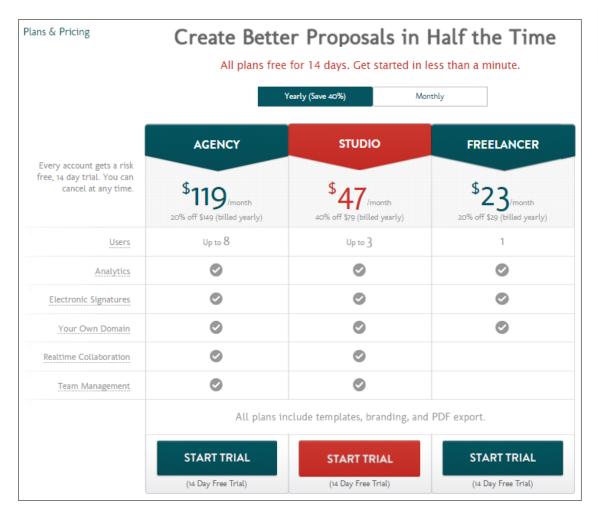
Your customer segments may be described in terms of their...

	Needs	Behaviors	Demographics
Useful For	Creating value propositions	Targeting different segments	Describing customer segments
Answers the Question	What do customers need?	How do customers behave?	Who are our customers?
Data that Measures their Preferences	 Relative prioritization of price, quality, convenience, customer service, etc. How predictable their demand is 	 Sales process Frequency and type of product use Loyalty Tech literacy Price sensitivity Marketing channel usage 	RevenuesNumber of employeesIndustryGeographyBusiness model
How to Find Data	Customer interviews, surveys, focus groups, etc.	 Observations Transaction data Web, app or other tracked interaction patterns 	Customer onboarding questionsSecondary market data





Example of pricing structure broken out by customer segment





Three types of customers use Bidsketch: agencies, studios and freelancers.

Each group has a different price sensitivity, and each group is looking for slightly different features

Though each feature costs roughly
the same to provide,
Bidsketch charges its
least price-sensitive customers
(agencies) the most for this access
and keeps a low price for its most
price sensitive customers
(freelancers)

This way, Bidsketch gets the most money possible from each group: no one overpays, and no one underpays





How price sensitive are your customer segments?

Less Price Sensitive

More Price Sensitive

- High-margin business like financial services
- When your product is necessary for operations (e.g., a factory will pay hundreds of dollars to replace a small gear that has thrown its line out of commission)
- Reacting out of fear: Your product addresses a strategic anxiety and leadership wants to feel they have taken it seriously with an expensive solution (e.g., security software)
- When price is taken as a proxy for quality because your product is not understood well

- Low-margin business like grocery or restaurant
- Supplier oversight exists (government or subcontractor)
- Uncertainty about how much they may use and thus what much eventual price may be





Does your customer understand the value you provide?



SaaS products often face challenges in the gap between the value they can actually provide and the value their customers perceive

- Businesses may be reluctant to change established processes and risk customer-facing mistakes: "Our current solution isn't great, but I know for sure that it works"
- Cost associated with devoting time to transitioning and learning new technology away from revenue-generating activities: "Every minute I spend fiddling with installation is a minute I'm not selling"
- Human beings by nature tend to under-value unfamiliar experiences: "Sure, you'll cut out three complex and time-intensive intermediary steps, but I've gotten so used to them, they don't annoy me anymore"
- Decision makers may lack tech savvy: "Cloud-based? Like it's in the atmosphere?"

Where customers are skeptical of or unfamiliar with your product, the time it takes to better understand its value is effectively a perceived a "price" to its use

Therefore, especially innovative, disruptive or complex products will often benefit from sharply discounted or free trial periods to counterbalance perceived "expense" of using product







<u>Hypothetical</u>: Determining the upper bound for a loan software company

Question	Answer	Pricing Implication	Approximate Upper Bound
How does this product reduce customer costs?	 Increases loan officer productivity such that most customers can <u>eliminate one position</u> Decreases risk of data entry error 	\$20,000 value for typical customer per year	\$20,000 per year
How does this product increase customer revenue?	Typical customers see a 10% lift in renewal rate	\$5,000 value for typical customer per year	\$25,000
How unique is this product?	This product is <u>very unique</u> because it offers features specific to rural customers	High price can be defended	\$25,000
What type of switching costs do these customers face?	Customers face very high switching costs: data migration, re-training officers, high risk if implementation is flawed	Pricing should be lower, especially upfront	\$10,000
Do customers understand this product's value?	Customers are <u>very skeptical</u> of the value. Existing pen-and-paper systems have worked well for a long time, and many decision-makers are not tech literate	Pricing should be lower, especially upfront	\$5,000
What are major customer segments?	Biggest segments are microfinance organizations that are non-profit, and that are for-profit.	Neutral	\$5,000
How price sensitive are customers?	 For-profit orgs are somewhat price sensitive Non-profit orgs are very price sensitive 	Discount for non-profit orgs	\$5,000 \$2,000

Prices cannot be higher than this upper bound (shown here as annual licensing fee, but could be charged in other ways)





What costs does your pricing need to cover to support profitability?

Even if your strategy does not require immediately profitability, you should understand the revenue you need to break even and become profitable

Fixed Costs

Fixed costs are set costs that do not increase or decrease as you sell more products

For example, if you rent office space, your rent is the same regardless of how many subscriptions you sell

Other examples include:

- Executive compensation
- Product development
- Legal approval of products
- Certifications and registrations

Variable Costs

Variable costs rise and fall depending on how many products you sell

For example, if you employ customer service agents, as you gain more customers, you will need to hire more agents to support those customers' needs

Other examples include:

- Data storage and server space
- Advertising
- · Sales commission
- Customer service (training, onboarding, support)
- Third party licenses
- · Risk and liability
- Insurance

Typically most relevant for SaaS businesses

If covering your costs requires a price point that your customers are not willing to pay, you should very seriously reconsider your business model





<u>Hypothetical</u>: Determining the lower bound for pricing for a background check provider

This company provides background check and data reports, and charges its customers based on the number of reports they purchase

Fixed Costs Costs Per Year		
Annual licensing fee	\$10,000	
Executive payroll	\$200,000	
Office Overhead	\$500,000	
Other Overhead	\$50,000	
TOTAL	\$760,000	



Variable Costs Costs Per Report		
Database Fee	\$0.50	
Other Fee	\$0.05	
Report Assembly	\$0.02	
Account Mgmt payroll	\$0.01	
Support payroll \$0.0		
TOTAL \$0.59		



Cost Per Report			
Number of Reports	Cost Per Report		
1,000	\$760.59		
5,000	\$152.59		
10,000	\$76.59		
100,000	\$8.19		
500,000	\$2.11		

To break even, prices per score can't be set below this lower bound





What do you need to know about competitors' pricing?

Competitors' pricing is important context for your pricing decisions:

- Your customers will use competitors' pricing as a benchmark
- Ability to maintain profitability at a lower price point may be an important competitive advantage
- Competitors' structure may be effective and refined over time, and may work for your business as well
- The industry may have common terms, units of sale, contract structure. In such case, you should be able to translate your value into that language (even if you don't adopt the same terms) so that customers can compare pricing and so you can participate in bidding / RFP processes

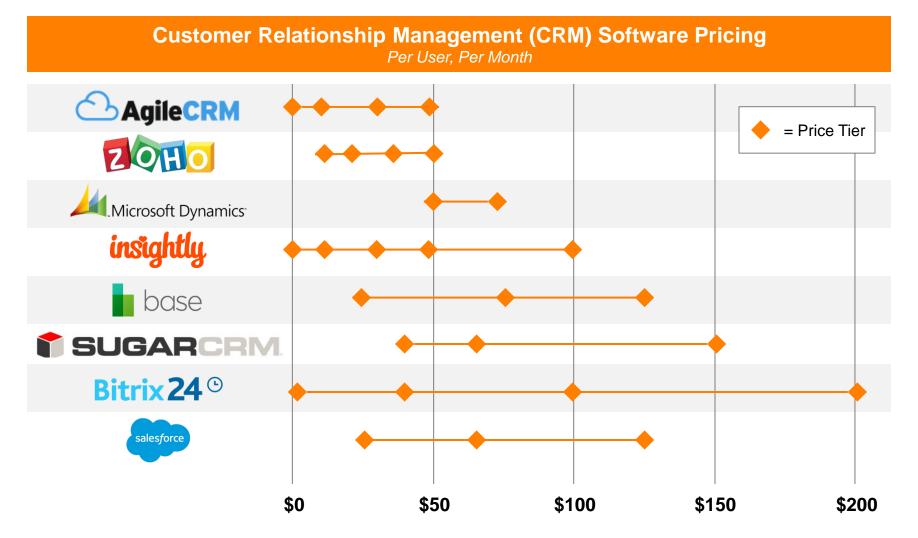
However, beware relying too heavily on competitors' pricing

See Slide 4





Significant variation in SaaS pricing limits usefulness of competitor pricing as benchmark





Should you undercut your competitors' price?

Under certain circumstances, undercutting competitors' prices can be advantageous, even when your product is differentiated by unique or superior features

You have a very different cost structure that your competitors cannot match

You want to take share from an established business

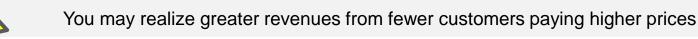
Your volume allows for unit economics that are cost prohibitive for new entrants

While SAP invested heavily to readapt its CD-based HR software for the cloud, cloud-first Workday did not need its pricing to cover those costs and could undercut prices

Constant Contact dominated SME email marketing without competition for a decade. MailChimp offered a pricing tier identical to CC's lowest paid tier for free to entice switching

As the dominant player for remote servers, Amazon Web Services keeps its prices low to starve out new entrants

However, be very careful!



Your competitor may also lower prices and engage in a price war

Customers may perceive your product as lower quality, simply because the price is lower





Discounting: When do you lower your prices?

Think of discounts as a way that you can incentivize customers to behaviors that benefit your company in the long term

Vo	lun	1e
Disc	:OU	nts

The more a customer purchases, the lower price they pay

Hubspot charges \$200 for 100 contacts (\$2 each), \$800 for 1,000 (\$0.80 each) or \$2,400 for 10,000 (\$0.24 each)

Prepayment / Commitment

Customers who agree to a longer commitment pay a lower price

Evernote charges \$5 per month or \$45 per year (effectively \$3.75 per month)

Loss Leader

Selling a product at a loss so customer to buy other products

Printers are often sold to consumers at a loss, and profit then come from selling ink over the lifetime of the printer

Bundling

Most desirable products are paired with less desirable products

Microsoft Office bundles its most popular products (Outlook, Word, Excel) with slower-moving products (OneNote, Publisher, Access)

Referrals

Customers receive a discount when they refer a new customer

Dropbox provides users 500MB storage for each person they refer who subsequently opens an account

Proof-of-Concept

A customer who can provide a newer product with credibility

Postmates delivers Starbucks coffee at a loss in exchange for the marketing opportunity





Selecting a value metric: What are your actually charging for?

Definition

The increment of your product for which you charge for increased access:

- "Our product costs \$X per Y"
- "For each Y, we charge \$X"

Common SaaS Value Metrics

- Users / accounts
- Access to certain features
- Messages / emails

- Contacts
- Bandwidth
- Storage
- · Timeliness / speed
- Customer support

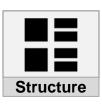
Best Practices

- Rooted in your customer segmentation and linked to your unique competitive advantage for each segment
- Grow with your customer: They pay you more when they are making more money
- Intuitive and in your customer's language. For example, a "mom and pop" business looking for video hosting may not understand bandwidth or its drivers

Avoid or Tread Carefully

- Overwhelming customer with choice. May distract from unique advantage or lead to negative emotions such as confusion or uncertainty
- Being perceived as tricky or trying to take advantage of your customer's ignorance, accidental overuse
- Be cautious about using number of users as your metric. Often, the more people who use your product, the greater the switching cost for the customer, which is to your long-term benefit. Also, there are likely a maximum number of potential users within a company, providing a ceiling to your reoccurring revenues



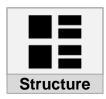


Four common SaaS pricing structures

Free access to core services, and a Freemium premium for advanced or niche services A pricing strategy often combines Consumption "Pay as you go" on a usage basis elements of these **Volume discounts Tiered** at certain levels of usage Perpetual and outright ownership of a software license **Perpetual** This structure was more common for CD-ROM based software and License is rarely used for modern products.



1 Freemium



Definition

Free access to core services, and a premium for advanced or niche services

Assumption

Your customer cannot adequately understand the true value of your product (and thus assess their willingness to pay) without experiencing it

Best Case Uses

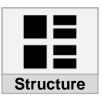
- ✓ SaaS businesses in general are well-suited for freemium models because they make the bulk of their profits on reoccurring fees over a long time horizon, and can thus recoup upfront investment in a customer relationship
- ✓ When customers realize more value with more use, and thus feel they can "afford" upgrade.
- ✓ Large number of free users can allow you to study their behavior and improve your product.
- ✓ When value can be understood quickly and doesn't require complex onboarding / integration.
- √ When free customers provide referrals that can turn into paying customers.
- ✓ When you have received a large amount of funding from investors seeking rapid growth

Watch Out!

- When the cost to serve free users is unsustainable (hardware, human labor, etc.)
- When the free offering is too good and customers fail to convert
- "Free" may give perception of lack of quality
- If you are pursuing a small or very specialized market, freemium may anchor your product to a low price while failing to provide a large volume of customers to convert
- Be careful not to overly rely on "free" to bring users. Marketing is still important







"Freemium" products typical limit service along one or more of these dimensions

Capacity

Limited by number of users, videos, messages, emails, etc.

Feature

Certain features are free, and others are restricted to paying customers

Use-Case

Certain categories of customers use the product for free

Assumes certain customers will be supported indefinitely and never pay

Example



Dropbox provides free storage up to 2GB

Example



LinkedIn displays advanced search fields to all users, but only subscribers can use them

Example



Amazon Prime allows students to use its service for free

Time

A free trial expires after a certain amount of time

Customers pay or leave

Example

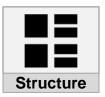


Salesforce offers full access to all features for 30 days





2 Consumption



Definition

"Pay as you go" with a set price per unit of consumption Often combined with volume discounts that may be negotiated as part of a contract

Assumption

Customers understand the value of your product, but can't predict their demand

Best Case Uses

- Very easy to communicate to a customer
- Addresses anxiety around unpredictable usage
- ✓ Higher prices for lower usage pass along increased costs for lower volumes.
- ✓ Flexibility may be part of your value proposition to customers.

Watch Out!

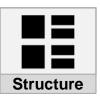
Because revenues may not be predictable, customer base should be diversified to prevent cash flow problems

Example

Amazon Web Services charges customers for only the bandwidth they use each month. Bandwidth usage is often unpredictable for customers and Amazon's ability to cover spikes in traffic is part of its value proposition







Definition

- Volume discounts at certain levels of usage
- Often overlaps with "freemium," where the first tier of use is free

Assumption

Both you and your customer intend to have a long-term, indefinite relationship

Best Case Uses

- A customer's usage is expected to increase over time
- ✓ Increased tiers should be linked to both tangible and intangible benefits (increasing levels of customer service, etc.) to provide a feeling of value
- Provides predictable reoccurring revenue

Watch Out!

- Tier placement should be rooted in data and customer behavior
- Customers may feel locked into an arrangement that may not meet their future needs

Example

Salesforce has five pricing tiers that range from \$5 / user to \$260 / user, depending on included features for their membership





A tiered SaaS pricing model is typically combines customer segmentation or usage levels with value metrics

Customer Segments vs. Value Metric

	Customer Segment		
	Segment A Segment B Segment C		
Price	\$X	\$X	\$X
Metric A	Amount	Amount	Amount
Metric B	Amount	Amount	Amount
Metric C	Amount	Amount	Amount

Example



Weebly offers several packages for make-your-own websites: a "professional" package for businesses that do not sell online, and an "ecommerce" package for businesses that do sell online

Usage Levels vs. Value Metric

	Usage Level		
	X of Metric Y of Metric Z of Metric		
Price	\$X	\$X	\$X
Metric A	Amount	Amount	Amount
Metric B	Amount	Amount	Amount
Metric C	Amount	Amount	Amount

Example



Salesforce charges based only on the number of user accounts with access to the product. Its pricing doesn't vary whether those users are for a hedge fund or a hospital.





What else should you charge for?

Your needs may require charging additional fees on top of reoccurring revenue:

- Set-up, onboarding or installation fees
- Maintenance or service fees
- Consulting, problem solving or other ongoing optimization

However, your preference should be to bake these costs into reoccurring pricing, as charging additional fees can have deleterious consequences

- Increases risk of trying your new product or service
- May prompt reevaluation of continuing with your service
- May cause resentment or feelings of distrust

If you must charge additional fees, preserve your customer's trust:

- Be upfront and honest about the fee structure; don't try to hide them or sneak them in
- Explain why they are necessary and the value they bring to customers' business



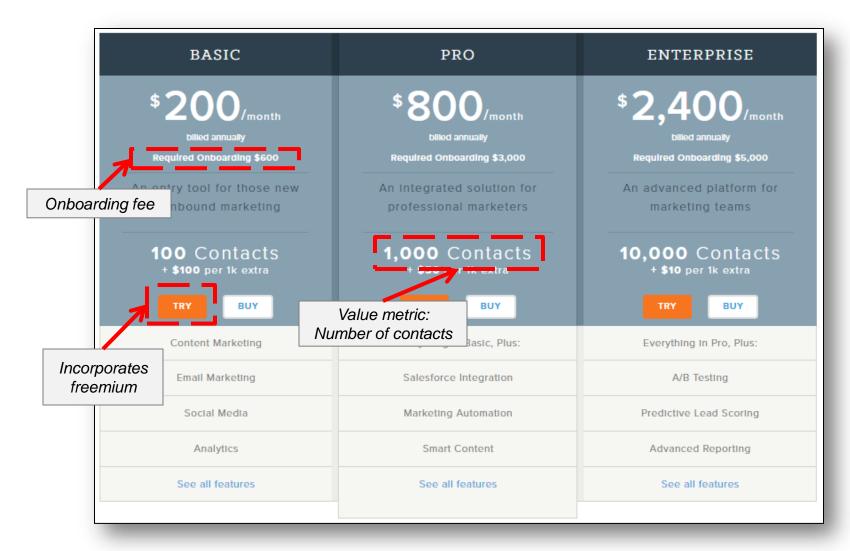
Examples



Hubspot:

Software to manage marketing leads

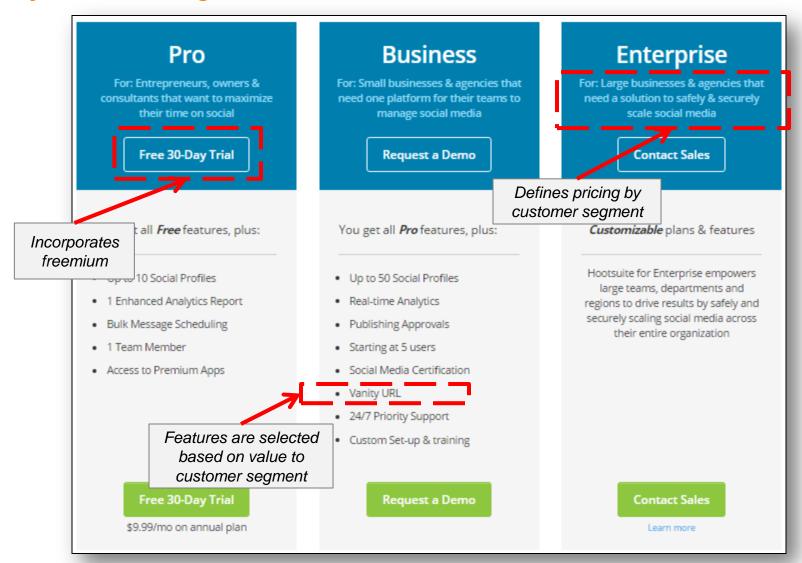




Hootsuite:



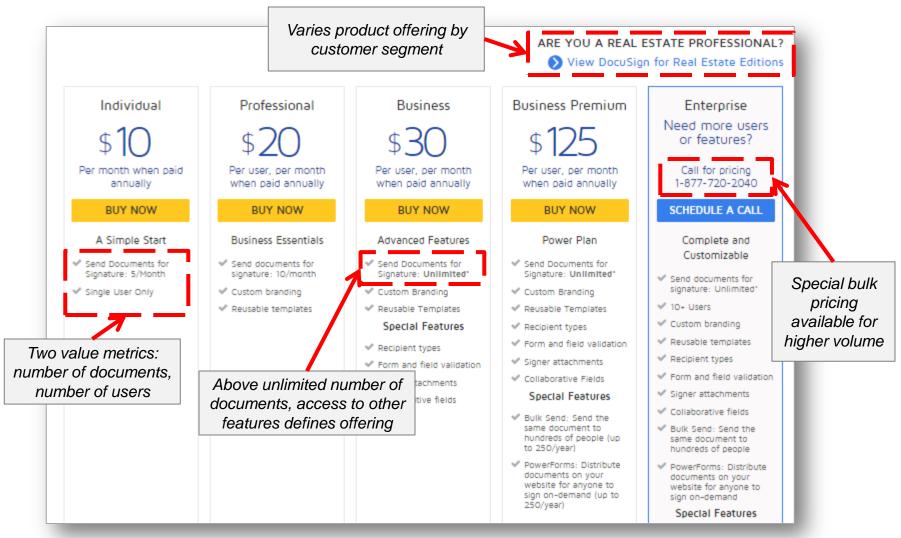
Software to manage social media accounts



Docusign:

eSignatures for legal documents

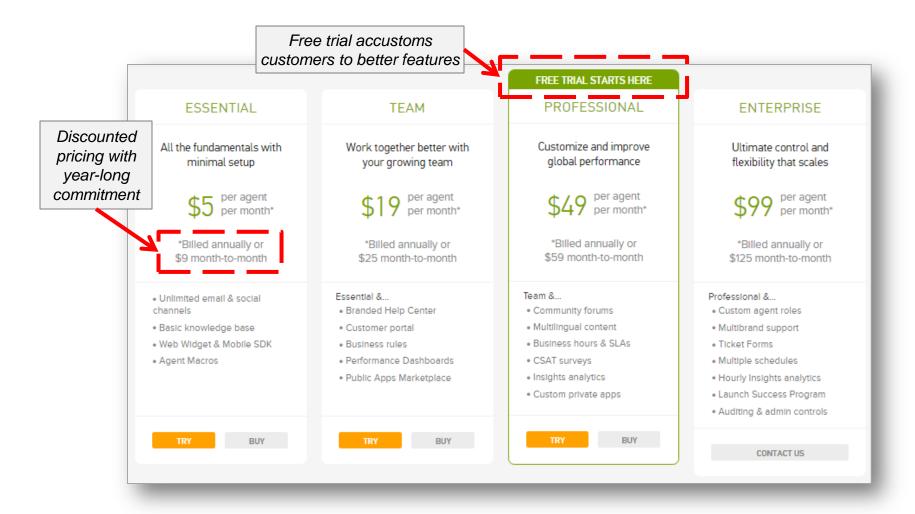




Zendesk:

Helpdesk management for technology companies







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