FINANCIAL TIMES
TUESDAY JANUARY 20 2004

How to rebuild software company valuations

By Jeff Melton and Christian Illek

While software companies desperately search for the next killer application to feed top-line growth in a maturing industry, most could bolster their battered bottom lines with one simple step: selling licences through a subscription model.

Bain's analysis of industry fundamentals and finances over the last three years shows that a subscription model can provide a more reliable and predictable revenue stream than traditional software sales and increase a company's pricing leverage by eliminating a margin-eating "make-the-quarter" mentality. In some cases, the shift has boosted companies' market value as growth in revenues and profits becomes less volatile.

The subscription approach to weathering hard times may prove more immediately helpful than popular efforts to improve the top line. Our analysis of industry data for the past two years shows no correlation between faster sales growth and higher R&D spending, for instance, an approach that many software companies have counted on to kick-start business in a mature market. Similarly, there's no clear link between rising revenues and increasing sales and marketing investments. The reality is that it has become difficult to boost top-line growth with new products.

For Synopsys, a California-based leader in software that enables microchip manufacturers to design complex integrated circuits, the subscription model has yielded positive results. Three years after its conversion, which was launched in 2000, during the software industry's deepest recession, Synopsys has improved its pricing overall by 10-15per cent. Notably, 80 per cent of the company's new bookings come from subscriptions.

Sun Microsystems recently overhauled its software strategy along similar lines. In October, Sun said it would charge customers a per-user fee for some of its software, instead of the ad hoc and complex pricing that applied to hundreds of different software products previously. At the heart of the pricing shift is the Sun Java Enterprise System, a bundle of infrastructure software products that will cost companies $100 per employee for a year's unlimited usage, with a cap at 120,000 employees. Mark Tolliver, Sun's chief strategy officer, said the pricing change "takes us above a pure transactional business, and [gives] us some predictable and recurring revenue."

The emphasis on subscription sales at these two companies represents a considerable switch from the norm. The vast majority of software sold to corporations today falls under the traditional model, where the customer acquires the right to use the software indefinitely. Software providers selling traditional licences typically receive cash and recognise licence revenues immediately.

The subscription-licence model, such as the one Synopsys and Sun use, transforms the software vendor's economic relationship with the customer. The customer pays for licences over time, and the vendor recognizes both revenue streams over the course of the contract. Subscription customers essentially rent the licence for a finite time, along with support. No longer is software akin to a piece of capital equipment, purchased at high-cost for long-term use. Instead, it becomes more like a staple service, used and paid for every day.

The subscription model levels out the peaks and valleys in income that hamper many software vendors. Synopsys's overall revenues are much more stable, for example, since the company shifted to subscriptions.

Viewed another way, subscription models allow software vendors to overhaul organisations that have been built around achieving quarterly quotas-or at least averting end-of-quarter disasters. A shift to subscriptions has the potential to reshape the software industry. Vendors now devote inordinate resources to a dysfunctional dance, hunting for the required major deal, scrambling to "tee it up," adding wasteful layers of decision-making to approve the special terms for closing these deals-and, of course, often wildly discounting prices to nail them shut.

A subscription platform allows software companies to avoid these inefficient practices. They can invest fewer resources in acquiring customers with high-priced salespeople and invest more in serving customers with efficient call centers and better technical support. Software companies that make the most of this adjustment can also expect customer satisfaction to grow-even though customers stand to lose their last-minute bargaining chips.

In fact, customers find lots to like about the subscription model. Subscriptions require lower initial capital outlays, reducing a major hurdle for launching an IT project during constrained times. The model smoothes cash outlays and makes planning and budgeting easier. Customers know that they always have the most current version of the product. And they can focus near-term IT spending on making the most of their existing information architecture, saving resources that used to be spent developing the business case to support or reject the next upgrade. Besides, they have a cleaner process for upgrades and a simpler basis for calculating returns on investment.

Investors have responded enthusiastically. The greater predictability of subscription-based revenues provides more balance-sheet flexibility that, for instance, could make it easier to engineer stock buybacks. As a result, the software-subscription trailblazers such as Synopsys have significantly higher valuation multiples than other technical-software firms with similar growth prospects and have outperformed the Goldman Sachs Software Index during the industry's slump.

For now, the traditional product licence is likely to remain the staple for software vendors. But as the enterprise software sector matures, and the proportion of customers upgrading to the next version declines, software companies selling subscriptions can count on customers returning again and again.

Jeff Melton is a vice president of Bain & Company in San Francisco. Christian Illek is a Bain vice president in Munich.

© THE FINANCIAL TIMES LIMITED 2004