



How SaaS providers can use pricing to achieve their ambitions

By Tim Cochrane, Sachin Shah, Justin Murphy and Jonny Holliday

Tim Cochrane is a partner with Bain & Company's Private Equity practice, based in London. Sachin Shah is a partner with Bain's Technology practice, also based in London. Justin Murphy is a Bain partner with the Technology practice and is based in San Francisco. Jonny Holliday is a principal with the Private Equity practice, based in London.

Fast-growing adoption of cloud software by many customers is forcing providers to tear up their old pricing models. The most effective new pricing model will depend on what a provider hopes to achieve—whether that’s generating strong short-term revenue growth or ongoing profitability, developing a huge user base, maximizing value for an exit event in three years or achieving some other goal.

Software as a service (SaaS) has rapidly penetrated many categories, including payroll, bookkeeping and customer relationship management. It will account for an estimated 22% of all enterprise software applications by 2017, based on a compilation from multiple sources.

For customers, SaaS removes the barriers of high upfront license and service fees, reduces implementation risks and makes it easier for employees to access software. For providers, SaaS delivers stable subscription revenue flows and easier access to some customers, particularly small and medium-sized enterprises (SMEs).

For example, Intuit’s launch of TurboTax on the cloud quickly displaced its desktop offering, despite the sensitivity of putting personal tax information on the Web. Within two years of launch, revenues from online TurboTax users were nearly double the revenues from desktop users. In addition, by building a substantial market share with a strong cloud product, Intuit thwarted Microsoft’s attempts to build out its Money software, which Microsoft killed in 2009.

Like Intuit, many software providers have put SaaS at the heart of their plans for large-scale growth. Battle lines are being drawn between incumbents and new entrants, and between new entrants themselves. Attracted by SaaS providers’ high growth rates, venture capitalists and private equity funds have been making aggressive investments, fueling the competition. Valuations for SaaS providers have risen accordingly, based on the premise that these companies will be able to monetize their growing user base into healthy revenue streams sooner rather than later.

But the shift to a SaaS model can be challenging. It usually takes three to four years to break even. And companies face tricky trade-offs between generating revenues and growing the user base.

Pricing based on internal cost metrics typically leaves a huge amount of value on the table. Instead, companies need to set a clear pricing strategy that is informed by a deep understanding of customers’ needs.

Price is one of the most important factors when customers consider whether to use a SaaS product. This is especially true for SMEs. In more than 80% of the markets Bain & Company examined, price emerges as the key purchase criterion. And for many categories, on-premise software still has a lower total cost of ownership over 5 or 10 years than the SaaS version.

Pricing set casually or based on internal cost metrics typically fails to generate the anticipated growth, or leaves a huge amount of value on the table. Instead, companies need to set a clear pricing strategy that is informed by a deep understanding of customers’ needs. While most customers value ease of integration, some customers put a high value on ease of maintenance and upgrades, while others value around-the-clock support. Some small firms will pay a premium for a trusted brand; others are willing to go with a lesser-known provider if the product is a great fit. Understanding what features customers value most allows a provider to select the right pricing strategy for its strategic goals.

Six ways to price

Bain has identified six broad pricing strategies that cover virtually the entire SaaS landscape (*see Figure 1*):

- **Play the averages.** This one-size-fits-all strategy offers a competitive package at a competitive price. The goal is to win based on the product’s quality and on strong go-to-market execution. New entrants and small SaaS firms typically use this strategy.

How SaaS providers can use pricing to achieve their ambitions

- **Something for everyone.** Tiered price packages, with no free package, target different customer segments and aim to cover the majority of the market’s profit pool. Salesforce.com and Adobe Creative Cloud have both adhered to this model. Providers have to know which product features to turn on and off to appeal to different segments and convince certain customers to pay a premium.
 - **Free disrupter.** Full functionality for free aims to gain clear leadership of the user base. Revenues come from cross-selling or from monetizing the customer base in other ways. Wave, for example, offers free integrated invoicing, payroll and other software to small firms, and provides aggregate customer data to other parties, such as advertisers.
 - **Freemium.** Offering most functionality for free will likely speed up growth of the user base. The provider can then upsell more advanced functionality or cross-sell other products. LinkedIn, the career networking website, and Dropbox, a file-sharing site, both give away ample functionality to build up their base. LinkedIn then charges active job seekers and recruiters for advanced features, while Dropbox charges heavy users.
 - **Premium.** In this strategy, a provider takes the high road by investing to have the best software package, then charges a premium accordingly. A good example is the SuccessFactors human capital management package, now part of SAP.
 - **Integrator.** Offering an integrated proposition at a competitive price allows a provider to win by solving customers’ needs with the broadest or most complete offer, thereby saving customers time and effort. Intuit has taken this approach with its QuickBooks bookkeeping suite.
- Each of these strategies leads to very different growth patterns in the number and type of customers, in the average revenue per customer and in the rate of customer churn.

Figure 1: SaaS providers can choose from among six major pricing strategies

<p>1. Play the averages</p> <ul style="list-style-type: none"> • Offer a competitive package at a competitive price • Win on product and go-to-market execution; do not disrupt profit pool <p><i>Examples:</i> New entrants, very small firms</p>	<p>3. Free disrupter</p> <ul style="list-style-type: none"> • Full functionality for free to gain clear market leadership • Revenue to come from cross-selling and upselling <p><i>Example:</i> Wave</p>	<p>5. Premium</p> <ul style="list-style-type: none"> • Take the high road—invest to have the best product • Charge more than competitors and establish a premium brand <p><i>Example:</i> SuccessFactors</p>
<p>2. Something for everyone</p> <ul style="list-style-type: none"> • Tiered packages targeted at different customer segments • No free offer; aim to win profit pool, not disrupt it <p><i>Examples:</i> Salesforce.com, Adobe Creative Cloud</p>	<p>4. Freemium</p> <ul style="list-style-type: none"> • Offer most functionality for free to grow base • Upsell advanced functionality (e.g., multi-user) and cross-sell other services <p><i>Examples:</i> LinkedIn, Dropbox</p>	<p>6. Integrator</p> <ul style="list-style-type: none"> • Offer an integrated proposition at a competitive price • Maintain profit pool but win through broadest and most complete offer <p><i>Example:</i> Intuit QuickBooks</p>

Source: Bain & Company

A free disrupter, for instance, will maximize growth in the user base and allow the company to rapidly take share, but revenues will stay low until the company devises a clear path to monetization. A something-for-everyone model tends to balance user and revenue growth but risks having some customers choose a lower-priced product, which leaves money on the table.

To be executed effectively, each strategy requires different capabilities. Free disrupter, for example, relies on the ability to run low-cost distribution and support, whereas something for everyone requires that the provider offer many more products and be able to seamlessly turn on and off certain product features.

Discovering what customers will really pay for

Given the inherent trade-offs with each pricing strategy, software providers should first clarify their overarching strategic goals: Increase market share? Maximize profit? Go public, or get acquired in four years? Roll up other software vendors? Maintain independence?

Because of the intense M&A activity in software markets, an overriding goal for some companies is to maximize the enterprise value at the time of acquisition. That means the timing for reaching a target user base and revenue stream must figure prominently in their pricing decisions.

Articulating such goals will help create the appropriate balance between growing the user base—with the potential for future revenues—and growing revenues today. A crucial next step is to understand customers' behaviors and priorities.

To that end, conjoint analysis is one of the most powerful and reliable tools available. This statistical technique allows a company to quantify the influence of different variables—price, functionality, service levels, brand and more—on a customer's decision making. A typical analysis presents customers with, say, eight variables, and three or four choices for each variable. From this set, thousands of price and package combinations can be tested (*see Figure 2*).

Survey respondents rank the variables to define which combination they find most attractive. This output can then be translated to determine a customer's price sensitivity, or the effect on revenues of a price increase or from adding an additional element to the value proposition. Analysis might show, for instance, that a \$5/\$20 monthly tier may be leaving money on the table, because many customers who pay \$5 would be more willing to pay \$10 than leave after a price increase.

Conjoint analysis, combined with competitor analysis, can highlight how effective a company's go-to-market execution is relative to its competitors and whether a company has its fair share of the market, which signals how well it is executing on the current pricing strategy.

With these analyses in hand, a company can determine the best pricing strategy for its particular circumstances. It will still need to respond to future changes in market behavior and customer needs with ongoing tactical interventions. And real-time analysis of current and potential buyer behaviors can serve to refine pricing positions. Setting the right pricing strategy at the start, however, will be the decisive factor in creating long-term value.

IRIS makes its choice

IRIS, the UK's leading provider of accounting services and payroll software, has been innovating in its shift to the cloud in order to improve the user's experience and attract new customer segments. The firm's recent pricing work illustrates how an analytical approach to pricing plays out in practice.

Accountants spend a lot of time translating their SME clients' bookkeeping data into the right format for producing a set of accounts. To significantly reduce this work for accountants, IRIS decided to acquire KashFlow, an online accounting software that accountancies can use to seamlessly connect to their SME customers.

IRIS has already employed a range of pricing models in its cloud division, including a freemium model. However, its strategic goal of disrupting the market and building a new segment among very small businesses, while also growing revenues, required a different approach.

How SaaS providers can use pricing to achieve their ambitions

Figure 2: Conjoint analysis asks customers to choose combinations of different variables

Accounting software example

Brand	License fee	Invoices per month	Core functionality
Brand A	Free	Up to 10	Invoicing
Brand B	\$10 per month	Up to 100	Bookkeeping
Brand C	\$20 per month	Up to 1,000	Entry-level accounting
Brand D	\$25 per month	Unlimited	Full accounting
Brand E	\$30 per month		

Advanced functionality	Integration with payroll software	Onboarding support	Ongoing support
Choices in number of users and currencies	Choices in payroll and bookkeeping data compatibility	Choices in level of online and phone support	Choices in level and type of support

Source: Bain & Company

Conjoint analysis revealed that price, followed by brand, is the most important factor for SMEs purchasing online bookkeeping software. Very small firms are the most price-sensitive segment, suggesting that a free disrupter or freemium model would be most attractive to them. At the same time, larger SMEs have more complex bookkeeping needs and would be likely to pay more for additional features, including unlimited invoices, multiple users and integration with payroll.

The analysis tested other important questions: What fee would the accountants be willing to charge SMEs for the bookkeeping software, and what value do accountants put on having bookkeeping integrated into their accountancy’s software? Our research showed that offering free bookkeeping would add a lot of customers, but many of them would still buy the product if they were charged more per month.

Accountants themselves were sensitive to being charged a fee for integrating KashFlow into their practice software, but would pay a fee for the benefits of reducing their workload and being able to offer reduced prices to their SME customers.

Finally, the research showed that investing to integrate compliance functionality was worthwhile, given that enough users valued the time savings it provides.

Using this market research, IRIS modeled what would happen to the number of users, revenues and market share under different pricing strategies and price points. The modeling results informed a series of workshops to align the management team and board of directors around the optimal pricing strategy and investment required to disrupt the market.

The overall conclusion was clear: A tiered model would generate the most value for IRIS’s customers and hence had the most attractive revenue and user profile. This approach would generate three-and-a-half times the number of users and almost double the revenues relative to the status quo.

As the IRIS experience suggests, firms must align pricing strategies with their overall strategic goals. For software companies that have introduced SaaS offerings, choosing the right pricing strategy—as informed by rigorous customer and competitor analysis—will be a crucial factor in the fate of the business. 

Shared Ambition, True Results

Bain & Company is the management consulting firm that the world's business leaders come to when they want results.

Bain advises clients on strategy, operations, technology, organization, private equity and mergers and acquisitions. We develop practical, customized insights that clients act on and transfer skills that make change stick. Founded in 1973, Bain has 50 offices in 32 countries, and our deep expertise and client roster cross every industry and economic sector. Our clients have outperformed the stock market 4 to 1.

What sets us apart

We believe a consulting firm should be more than an adviser. So we put ourselves in our clients' shoes, selling outcomes, not projects. We align our incentives with our clients' by linking our fees to their results and collaborate to unlock the full potential of their business. Our Results Delivery® process builds our clients' capabilities, and our True North values mean we do the right thing for our clients, people and communities—always.



Key contacts in Bain's Technology and Private Equity practices:

Americas:

Justin Murphy in San Francisco (*justin.murphy@bain.com*)

Asia-Pacific:

Kevin Meehan in Singapore (*kevin.meehan@bain.com*)

Jean-Philippe Biragnet in Tokyo (*jean-philippe.biragnet@bain.com*)

Europe, the Middle East, and Africa:

Tim Cochrane in London (*tim.cochrane@bain.com*)

Sachin Shah in London (*sachin.shah@bain.com*)

Jonny Holliday in London (*jonny.holliday@bain.com*)

For more information, visit www.bain.com