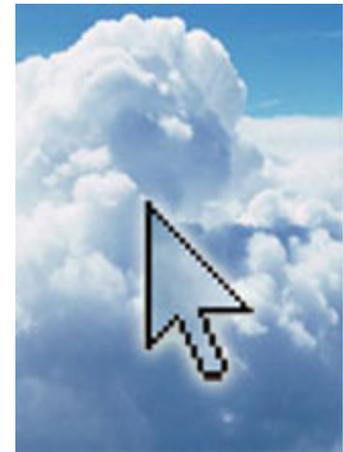


The New Software Pricing Model: Can the Older Giants Compete?

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Cloud computing is not only changing how users access software applications, it's also upending the pricing model for software products. Fading fast are the days when software packages were sold in boxes with a one-time, perpetual software license fee. Instead, consumers and businesses are increasingly turning to subscription models and are buying only those applications they need for particular tasks rather than broad, general-purpose suites.

Meanwhile, software giants, which have traditionally relied on the boxed approach, are trying to keep up with disruptive distribution and pricing models that may threaten their lucrative way of doing business. Microsoft already offers subscription versions of its software under its Azure cloud computing brand, and in June the company launched Office 365, an online version of its Office software suite. Adobe has plans to offer Photoshop and the other applications in its Creative Suite by subscription through its Creative Cloud. Last month, Oracle announced plans to buy RightNow Technologies, which makes customer service software delivered online, for \$1.5 billion.



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Cloud computing is a broad term that refers to technology being delivered as a service over the Internet. Consumers don't actually install the applications on their own computers. Instead, the software is hosted elsewhere, accessed through a web browser and is typically rented under a subscription model. Cloud computing became popular for customer service applications through Salesforce.com, which launched in 1999, but it now extends into a number of other areas. Instead of maintaining data centers and servers, for example, companies can rent Amazon.com's computing infrastructure for pennies an hour -- similar to a utility.

Forrester Research estimates that 31% of companies are now getting their software delivered as a service. According to research firm Gartner, the cloud computing market delivered revenue of \$74.3 billion in 2010, but will swell to \$176.8 billion by 2015 and is expected to deliver a compound annual growth rate of 18.9%. "The old model of selling software in a box or [through] an enterprise server license and then charging for periodic upgrades has been disrupted," says [Kevin Werbach](#), a legal studies and business ethics professor at Wharton. "It inevitably will be overtaken by Internet and cloud-based distribution."

Unlike traditional boxed software models, cloud models are based on monthly fees, and customers can leave at any time. Traditional models require physical installation and a substantial purchase upfront. Once installed, software vendors can charge annual maintenance fees for support and hope that users will pay for future upgrades. Suites from firms like Oracle, SAP and Microsoft are being challenged by services that deliver their wares more inexpensively through a web browser. For example, Forrester calculated that Microsoft's Exchange e-mail program will cost a company with 5,000 employees \$28.22 a month for each user. By comparison, Google's fully loaded corporate suite -- including Gmail, calendar and productivity applications, along with technical support -- for a company with 5,000 users will cost \$8.59 a month for each user.

"New distribution models are changing the price point for everything from computer games to business software," says Kendall Whitehouse, director of new media at Wharton.

The potential disruption is everywhere. In addition to Google's taking aim at Microsoft's Office franchise with web-based services, companies such as Salesforce.com, NetSuite, SuccessFactors and Workday are

aiming to poach business customers from Oracle and SAP. Meanwhile, Zynga, which publishes popular free games primarily on Facebook, is a threat to traditional game powerhouse Electronic Arts (EA) -- as is upstart Rovio with its Angry Birds game, which can be downloaded for free in an ad-supported version or for 99 cents without ads.

Many of the established software giants are moving to hedge their traditional business models in an attempt to address this changing market. For example, Oracle will likely acquire more cloud computing companies over the next 12 to 14 months -- possibly targeting NetSuite, SuccessFactors and other software-as-a-service vendors, according to JMP Securities analyst Patrick Walravens. Such moves make sense, says Wharton management professor [Saikat Chaudhuri](#). "It's better for you to cannibalize yourself in a controlled manner than let someone else do it and hurt you."

[David Hsu](#), a management professor at Wharton, agrees that these companies need to adapt, although business model changes are difficult to engineer. "It's hard for companies to give up their core business," says Hsu. "There's a danger of being too slow, and there's also a danger of going too fast."

Chaudhuri adds that there is a great deal of revenue to protect. The old way of selling and distributing software is lucrative. Salesforce.com, widely viewed as the most successful of the next-generation software companies, is expected to have revenues of more than \$2.3 billion for the year ending January 30, 2011, according to Thomson Reuters. By comparison, Oracle had revenues of \$35.85 billion for the year ending May 31. Microsoft had revenues of \$69.94 billion for the year ending June 30, and SAP is expected to have revenues of \$14.1 billion for the year ending December 31.

Nevertheless, large software companies can't be complacent, because growth rates are likely to slow for traditional software. For instance, Microsoft's fiscal 2011 revenue growth was 12%, but the Windows division sales fell 2% following the Windows 7 launch in fiscal 2010. For the nine months ending September 2, Adobe's revenue growth was about 10%. Other firms are showing somewhat faster growth: For the nine months ending September 30, SAP's revenue growth was 16%, and last year, Oracle's grew 33%.

Meanwhile, cloud-based software companies are consistently growing. Salesforce's fiscal 2011 revenue was up 27%. For its third quarter ending September 30, NetSuite's revenue growth was 23%. And SuccessFactors saw its revenues rise by 77% for the third quarter ending September 30.

Easy to Digest

The software industry is undergoing enormous change, but distribution and subscription pricing are the primary disruptive forces, according to experts at Wharton. Today, "the whole system of licenses and upgrades isn't [seen as] efficient," says Chaudhuri. "The disruption comes when bundles such as Microsoft Office don't make sense anymore. Instead of big suites, lightweight applications will become the norm." Hsu agrees. "Today, [software packages require] large upgrades, but customers don't want to think about the next giant release," he notes.

Large software vendors have received the message and are attempting to make their wares easier to digest. SAP has said it is moving to more incremental upgrades delivered through a subscription. The company also has a suite called Business ByDesign that is delivered as a hosted service. At Oracle's OpenWorld conference in October in San Francisco, CEO Larry Ellison outlined plans to focus on cloud services. The company followed up with the RightNow purchase.

On Oracle's fiscal first quarter earnings conference call in September, Ellison touted the company's Fusion applications -- a hybrid model that includes on-premises software as well as subscription services. "It's very important that we're out in the market now -- not only with our traditional applications, which we'll continue to support for years to come, but also [with] an all new generation of Fusion applications," said Ellison.

Whitehouse notes that Adobe is also working toward a new distribution model for the company's Creative Suite that includes Photoshop and other software tools for content creation. "Creative Suite is a cash cow for Adobe, but the company is moving to a subscription-based approach that will cover their traditional desktop software products along with cloud-based versions and mobile apps," he says, adding that the move could be risky if the company loses revenue from customers who currently pay thousands of dollars

upfront for Creative Suite. Adobe CEO Shantanu Narayen said during a September earnings conference call that pilots for Creative Suite subscriptions indicate that the company can expand its customer base. At Adobe's financial analyst meeting on November 9, Narayen stated, "We will shift our business model aggressively to subscriptions."

Electronic Arts is another established software vendor navigating the new world of software pricing and distribution. On the company's earnings conference call in October, CEO John Riccitiello noted that game releases such as "FIFA 12" and "Battlefield 3" are expected to drive sales. But he also noted that EA's next big release -- "Star Wars: The Old Republic" -- features an online world with a subscription model similar to the popular "World of Warcraft" game by competitor Activision. "EA has roughly one dozen globally recognized brands ... which are at the foundation of our company," said Riccitiello. "Our mission is to transform these brands from a single event every one to two years to 365-day businesses, with packaged good launches sustained by frequent updates, downloadable content and extensions in the social and mobile platforms."

And Microsoft is on the cloud computing bandwagon, too. Speaking at the company's financial analyst meeting on September 14, CEO Steve Ballmer said the company is "betting on the cloud." Most of Microsoft's products can be delivered as a service. For instance, Microsoft charges \$6 a month for each user of its Office 365 suite for small businesses; larger companies pay \$24 a month. The retail price for Microsoft Office 2010 for a home and business account is \$279.99. The price for professional users is \$499.

"The plan for many traditional software companies is to have a hybrid model where they can still get paid for a full purchase of their desktop application, but also develop consistent revenue streams through software maintenance agreements or subscriptions to separate cloud-based offerings," says Whitehouse.

Software for All

While the dominance of large software companies may eventually wane, overall revenues are likely to grow. Why? Instead of buying suites, consumers will buy software in small doses from multiple parties, based on their unique needs.

"Unlike media industries such as music and newspapers, the shift away from the old models in software doesn't mean the overall pie is getting smaller," notes Werbach. "In fact, it's likely to grow, as recurring revenues and micro transactions replace big up-front payments. Look at the Apple App Store.... That represents billions of dollars in revenues for mobile software, which simply didn't exist before."

In fact, mobile app stores have helped to facilitate the breakup of big software releases and suites. Apple sells its iWork software as a suite for \$79.00, but also in parts on its Mac App Store. (The company's Pages word processing program, for example, sells for \$19.99.) In addition, vendors like Apple are pushing no-hassle distribution: The company is selling its latest operating system, Mac OS X Lion, for \$29.99 on its App Store. An alternative to downloading OS X Lion is to order a USB thumb drive for \$69. Werbach adds that smaller companies such as 37 Signals, which makes collaboration apps, and Minecraft, a game development company, are "generating huge revenues because they no longer need to overcome the scarcity of physical distribution."

Chaudhuri likens the shift to how the music industry moved from selling albums to selling single songs on iTunes for 99 cents. "As software is broken down into smaller parts, the pricing can stimulate demand," Chaudhuri says. Large music labels may have suffered, he adds, but a lot of independent artists garnered more distribution than ever before.

In this environment, pricing strategies will be critical. Hsu agrees that low ticket software sales are likely to lead to more volume. The profitability for the industry may be the same, but more players will win. In addition, one application won't fit all. "Consumers aren't really getting a product for less, but they are getting apps that are tailored to one thing instead of a suite," he says.

Hsu expects software companies to deploy various pricing models to maximize profits. Prices could become variable based on demand. For instance, a company could charge more for computing power or access to financial software during demand spikes. In this respect, software pricing could more resemble the schemes airlines use to sell seats. "There will be pricing based on ultimate profits," he says. "With a

new form of distribution, software doesn't have to adhere to any one model. Software publishers can get the same profit, if not more, based on lower prices and a broader audience."

This democratization of software is an ongoing trend and will take years to play out, note experts at Wharton. But which software vendors will ultimately command premium prices? Hsu says that the companies that can charge more for software will have established reputations and the trust of their customers. "With the democratization of software, trust will result in premium returns. The companies that have the reputation will earn the returns. Apple gets 30 cents on the dollar at its App Store because it vets the applications and establishes trust."

Salesforce.com CFO Graham Smith said at a recent investment conference that there will be multiple vendors thriving in the new world order. Some software will be used under the traditional license-and-maintenance revenue model, with various services added, he predicted. "I think we're going to continue in this heterogeneous environment for many years."

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