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3535 Roswell Road, Suite 59
Marietta, GA 30062
770-509-9933
www.pricingsociety.com

Segment Your Way to Greater Profits

Bruce La Fetra, Senior Marketing Consultant for Rubicon Consulting, examines how software companies often fail to understand how different customer groups value their products. This leads to firms' offering both excessive price discounts and too many licensing vehicles. La Fetra shows how companies can develop an integrated approach that targets the right pricing strategy and product offerings to the groups he defines as "Business Professionals," "Aspirants" and "General Users." For more information, you can reach Bruce at: 408-395-3910.

Why do software vendors offer so many buying vehicles?

Most companies say they want to give customers multiple options, or they do it simply because "everyone else" does. **The actual strategic rationale for offering a menu of different vehicles and discounts is poorly understood or forgotten within many vendors; yet it represents the difference between adequate and great pricing.** Great pricing allows a vendor to tailor its offers to various buying groups. This is not illegal discrimination. Rather it merely reflects sellers' taking advantage of differences between users in how they value—and how much they are willing to pay for—products. Understanding this (and successfully putting it all into practice) is fundamental to price optimization. But if it's so essential, why don't more vendors do it well?

Raychem Corporation provides a textbook example of price discrimination's power. Raychem made heat-shrinkable tubing that was used in commercial, automotive, industrial and military applications. While the company had dozens of chemical formulations, a couple were sold into all of these markets, each at a different price with a low-to-high range of about 3X. While the tubing came off the same production line—often the same run—each run was only tested to the relevant specification for the intended market. Since applications ran the gamut from exposure to hydraulic fluid in a M1 Abrams tank to strain relief in consumer electronics, the QA certification was important. This gave the company total protection against customers buying a lower grade product even though some knew it came off the same production run as "the good stuff" that went into military and space hardware. The varying usages drove different pricing for the same product.

What's at Stake

Many vendors face a similar problem: they have multiple volume licensing vehicles, but target them indiscriminately at the entire user base with the well-meaning intent of giving customers more buying options. There is nothing unusual about these vendors' licensing vehicles; they are the same ones most sellers have: contractual, transactional, site and concurrent licensing. Customers like these hydra-headed programs because they give them lots of options (…to game the system and to try to find the cheapest way to buy the products).

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The dilemma faced by all these vendors is how to proliferate for broad use within specific organizations without undercutting the high prices paid by existing customers. The most problematic scenario is when the same or similar applications are used by different user sets for business-critical and non-critical tasks.

Business-critical users (Business Professionals) are willing to pay top dollar. They may not be happy about it, but in the absence of close competitors, they have few alternatives. At the same time, there may be untapped, broader market opportunities with users who are willing to pay only a fraction of the amounts paid by Business Professionals. How does the vendor aim high and low at the same time?

Most sellers respond to this situation by creating an entry-level or "light" version of their application that they can feature, and functionally differentiate, from the premium version. With only two user sets, this solution works well and generally is advisable. The situation gets more complicated when there is a mid-market set of price aware users. These purchasers are eager to use the high-end applications, but are often unable to justify paying top dollar for occasional use.

Some vendors call these users "prosumers," but in an organizational context we refer to them here as "Aspirants." **Typically, if the vendor sells a suite of applications, this often results in the Aspirants buying some (but not all) of the premium offerings at a price lower than what Business Professionals are willing to pay, but far above that which lures General users.** This makes Aspirants an important growth source, so

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the failure to price optimize is a strategic oversight.

In short, charge too much and the vendor is unable to penetrate the Aspirant and General user segments. Charge too little and the vendor risks seeing its lucrative Business Professionals trade down to a lower price band. This is a loss of real, not potential revenue. Because they fear undermining their existing business, many sellers fail to act on the Aspirant opportunity.

In this situation, vendors will often pursue a Gold-Silver-Bronze type product assortment. Not only does this complicate the development process, but also it muddies the messaging and buying processes as well. Customers feel encouraged to base their buying decisions on an analysis of their actual use rather than on their aspirational intent.

In a licensing situation, the solution is to vary the vehicles and offers by user set, so vendors can direct customers to the preferred option. Like water that always flows downhill, corporate buyers are good at finding the cheapest way to purchase a given product, so it is best when the seller can get them to self-select the desired vehicle. Done correctly, the vendor will be able to price optimize for each user set without the customer's feeling manipulated. It's the proverbial having one's cake and eating it too.

Mapping Licensing Vehicles to Objectives

The first step is to think strategically about the objectives for each offering. **Licensing vehicles should be driven by strategy, not the other way around. For example, without considering products, are there different price points or buying behaviors the vendor needs to address?** If the objectives overlap too much, then the vendor probably has too many vehicles and an opportunity exists to simplify the set of offerings. Here are typical options and their distinct objectives:

- **Contractual Licensing** offers volume discounts to the vendor's best customers. Buyers are required to enter into a contract committing them to a minimum purchasing volume during the contracted period. This is a "pull" vehicle, which addresses customers that already want to buy the vendor's products. It contrasts with "push" vehicles (see below) which service situations where the vendor must generate end-user demand before users will buy a product.

  A common error for vendors is to present too many offerings with excessive discounts because they are trying to serve both high- and low-end user segments. Discounts don't really encourage Business Professionals to buy more (see below), but they are demanded by corporate buyers because that is how software is sold. Sellers should understand the discount levels required for a given industry, and resist the urge to add a costly extra tier or two for a vendor's "really good customers."
- **Site Licensing** is designed for large sites with casual usage where the vendor wants to drive broad proliferation. If the customer is likely to buy via another vehicle, site licensing is not to the vendor's advantage. It is a "push" vehicle created to generate demand and should be used to support a proliferation strategy.
- **Concurrent Licensing** is an attractive, but often underutilized way to expand the vendor's reach to a large number of users who are not doing business critical work (i.e. if the license server is occasionally oversubscribed, it's not a disaster). Concurrency should be priced so it is attractive when only low availability levels are required. (The application may not be immediately accessible at all times.) But at high availability levels (immediate access is required), it is more expensive than the corresponding contractual vehicle. **Many vendors discourage concurrent licensing, seeing it as simply a way for customers to reduce the number of licenses they buy. This reflects a problem with the underlying pricing, not with the vehicle itself. Many vendors use transactional licensing to address this need, but concurrency offers additional flexibility and often represents a better choice.** It is a "pull" vehicle so vendors should price to value. Concurrent licenses are usually offered at a premium over a similar number of contractual licenses, but they don't have to be.

Mapping User Sets to Preferred Vehicles

The next section lays out the preferred licensing vehicle by user set from the vendor's point of view. Product selection is used to steer customers to the desired licensing vehicle. In our example, all products are available via contractual licensing, and all or most by concurrent licensing. But only basic products can be purchased via a site license. The view from each user set is as follows:

- **Business Professionals** are interested in

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the professional versions and premium suites. Since these users have no interest in using the basic versions, site licensing is not attractive. Because their usage is business critical, concurrent licensing does not meet their requirement for high availability (access at all times). Thus, the contractual licensing program is the clear choice.

- **Aspirants** are primarily interested in the professional products, but buying a full license for each person or workstation is much too expensive, especially so if several applications are desired. **If forced to buy via contractual licensing at the same premium prices as Business Professionals, customer organizations are likely to restrict who can obtain and install the vendor's applications. This is a missed opportunity for the vendor as it makes adding Aspirants to the Business Professional set more difficult.** High availability, however, is not needed, so concurrent licensing looks attractive as it provides economical access to the professional versions. Aspirants prefer to use the professional versions—and the vendor should reinforce this in its messaging. But, just in case, minimums for the site license are set high enough to exclude most of this group.
- **General Users** will only buy at scandalously low per-seat prices—compared to Business Professionals. However, high minimums and lack of access to professional products are not obstacles in environments where the vendor is trying to drive broad proliferation. Because basic applications are just fine for this user set, these buyers may be successfully isolated from the rest of the customer base. The result is a low-cost, per-user site license that opens up heretofore unaddressed markets without undercutting the highly lucrative Business Professional market.

The Keys to Success

The keys to success are: (a) offering an appropriate range of products to create a sophisticated assortment across customer sets; and (b) targeting access to specific licensing vehicles. If an adequate high-to-low range of products are in place, no new product variations are needed. If only a single product offering exists, a low-end version is needed to isolate the general use market successfully. Where possible, product and licensing vehicle development should reinforce the buying segmentation process. This will provide the vendor with more options and greater clarity from the buyer's point of view.

Figure 1

Customer Type	Contractual	Concurrent	Site License
Loyalist	All products, including Master Suite	More expensive than Contractual in high-use environments	Premium products not available via Site License
Aspirant	More expensive than Concurrency for moderate use environments	Standard and Premium products	Insufficient volume to qualify for Site License
General Users	Too expensive for occasional use	Too expensive for occasional use	Basic products only
	Licensing Vehicle		

Figure 1 provides an overview of the nine buying possibilities available for three user sets and three licensing vehicles. The gray squares describe the disincentives for each user set / licensing combination, which help vendors steer buyers toward the most desirable options—represented by the circles.

This methodology works particularly well when the vendor is a leader in its field and has a strong base of professional users. In this scenario, vendors can skew toward optimized pricing since Business Professionals will be unlikely to defect to competitors because of high prices. For vendors facing a greater competitive threat, the same structure holds, but the achievable price premium for Business Professionals compared to General Users is reduced. **In general, leaders who have less competition at the high end of the market also risk the greatest opportunity cost from inaction, or from a poorly thought out broad market pricing and licensing strategy.**

Summary

Software vendors with a loyal base of users can use licensing vehicles to address the broader market without cannibalizing premium priced vehicles. We've shown here how to balance not only high-value and low-value users, but also how to include a third, mid-market, aspirational customer group in the mix. Since the aspirational set represents a large, ripe, and only partially-tapped, growth opportunity, a vendor must understand how to direct these Aspirants toward the high-end Business Professional set rather than the low-end General users. A properly designed pricing, licensing and product strategy is able to deliver on the needs of each buying group, while also creating unique disincentives to steer specific customers away from non-optimal buying vehicles.