



IT Subscription (Part 2) Why is it happening and what is it anyway?

The Background

Over the next few years, it is asserted by IT analysts that subscription in its various forms will be the predominant way for enterprises to obtain IT services for their business functions.

This white paper is intended to provide further views and information as a background for those interested or involved in this important change of direction in the industry.

Origins

The story of subscription or rental is not a recent one for the IT industry. IBM's original emergence as a computing giant was not just due to its technology but also because its original sales model utilised subscription as a primary sales mechanism to keep the constantly arriving replacement technology flowing into the market. The motivation was also one of economics, with early mainframes being beyond the means of all but the largest organisations, subscription rental allowed smaller organisations with cash flow but without the capital to gain access to the technology.

Even in those early days, the core concepts of subscription were established. For users, there was no concept of ownership or possession, they simply paid for the use of a supplier's equipment.

Over time and to meet the needs of other IT suppliers (the seven dwarfs as IBM called them) and the US Anti Trust regulations, subscription rental became blurred and confused with leasing and the real pay for use service became simply another capital financing mechanism. Its core characteristics and benefits became lost amongst the "what's your rate?" based arguments.

(However, the world has taken a few spins and the IT market has rediscovered that important feature of the early IBM market penetration, now called subscription, and it is interesting to look at some aspects of its re emergence.)

Why is it happening now?

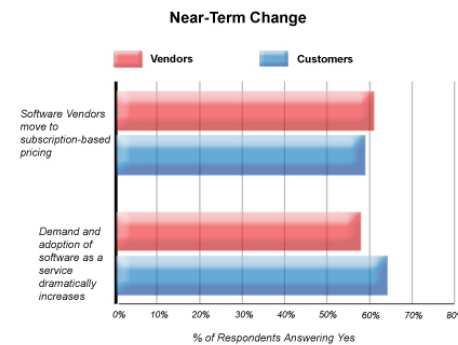
In the last few years a number of technological and service based advancements have changed basic ideas regarding software application delivery and service.

In the software applications area many large core applications are now being made available to SMEs, by downsizing and through subscription, allowing the them to gain the benefits previously available only by large organisations. This development was also enabled by the availability of managed and hosted services to provide the necessary implementation and delivery expertise for the user. Both managed and hosted services both use forms of subscription based pricing based on a number of different pricing metrics.

This trend is not only driven by technology but by the need of suppliers to create new markets for their applications. For example there is only a limited number of organisations capable of affording and implementing a full-scale ERP/supply chain solution in its original form. Subscription enables suppliers to open new markets for their applications by making them financially accessible to a much wider prospect base. At the same time, advances in communications technology has allowed a much wider variety of applications to be delivered as managed/hosted services.

Vendors are struggling with the reality that it is growing increasingly difficult to make money as a traditional software vendor through perpetual licenses.

IDC



The ASP Experience

A few years ago, ASPs (Application Service Providers) introduced users to a range of applications that could be utilised either through a browser interface or a thin client based technology and many seemed convinced that this was the way forward. Concerns about security, the communications technology, available expertise, recovery, systems resilience and a lot of marketing 'hype' hindered the take up of the services and most of the first generation 'providers' are no more.

There is no wholesale movement of vendors offering both perpetual and subscription options. (CRM Daily News)

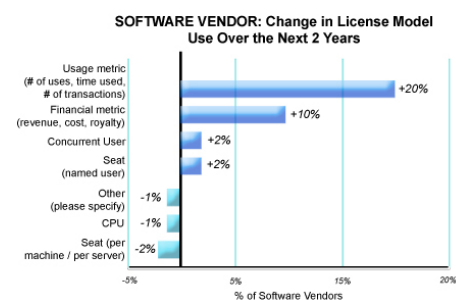


In addition, poor pricing did little to help. For example one supplier offered both a subscription and a capital option with the subscription priced at 20 % of the selling price and was surprised when it did not work. Pricing is now increasingly based on the ongoing value to the user rather than a relationship to an old capital cost and pricing anomalies are seen much less now.

While the use of the ASP name has declined, the concept has matured and developed into a wide range of hosted and managed services with both suppliers and use having an improved understanding of the benefits and the concepts. Perhaps a major highlight of the original ASP concept was that it (re)introduced both suppliers and users alike to subscription / pay for use based software application pricing. For many years up until then anything offered on a monthly/quarterly periodic charge basis was viewed simply as spreading the cost of a capital sum.

Metrics

Subscription also opens up the possibility of new and more dynamic subscription pricing mechanisms. Metrics are varied and ingenious and have been applied to a number of applications ranging from desktop suites to complex ERP and CRM applications. Metrics include licences, number of users, per transaction, time-based, storage capacity, processor time used and so on. Many of these are relatively stable or can be measured within a certain range, however where there is a lot of fluctuation, serious analysis and consideration must be given to ensure that both the supplier's expectation of a return and the user's for a value for money based service are both achieved. With some software suppliers entering into risk sharing arrangements with their customers for these services – failure to accurately predict and account for pricing purposes can have consequences down the line. The graph below from a Macrovision survey illustrates the changes anticipated.



What is Subscription?

The IT industry and the IT financing industry have repeatedly demonstrated their ability to

ascribe different meanings to words to suit the particular purpose being promoted at the times. Words like capital purchase, lease purchase, leasing, rental, subscription, perpetual licence, term licence etc. are each often given different definitions depending on who is defining and the situation they are trying to sustain. However experienced IT finance experts without an axe to grind or a cause to support would agree on the real meaning of each term. In that context here is some subscription specific information and comments.

Subscription is the payment by a user for the use of an asset such as a software application, owned and controlled by a supplier or other provider. There is no concept of ownership by the user or passage of title and continued use depends on the payment of subscription charges as they fall due.

The user is protected from the risks of ownership and obsolescence and no capital budgets or capital payments are involved although in the real world capital sums budgeted for acquisitions are commonly used to prepay subscription charges.

Very importantly subscription is provided directly by the supplier who remains responsible for ensuring that the software continues to be available in a form that meets users' day by day needs and also evolves to meet changes associated with technological advances and changes in business requirements and operations. Subscription should provide for the costs the supplier incurred in implementing the system. This leads to a closer relationship than would exist in a perpetual licence based supply.

Subscription agreement durations can range from months to many years for some large scale outsourced core applications and pricing will take into account the duration of the agreement. Payments can be made in full at the beginning of an agreed term or, more commonly, on a monthly, quarterly or annual basis. As there is no capital alternative, the subscription is related to a view of the ongoing value of the supplier service not to a notional capital cost although there is the conflict of opinions at the moment regarding whether or not a supplier in transition to subscription should also offer an in perpetuity option during the change over period.

In managed and hosted services the subscription charges include recovery of the supplier's investment in the hardware, software and other costs in addition to the management and operational charges.

For the supplier subscription appears to offer the opportunity to gain higher and more certain

A recent observation was made that the large discounts negotiated by users purchasing 'in perpetuity' licences were justified as a provision against the likely future early write off of the software or early termination of a lease created by a need for a major change within the depreciation period. Perhaps this is an interesting accounting concept.



revenues, appeal to a greater number of users at any one time and give the sales director the satisfaction of starting every quarter knowing that 80% of his revenue is already guaranteed from the subscription-based user base.

Subscription has fundamental business change implications for software suppliers who wish to either convert from a perpetual sale based model to a subscription offering or even offer it as an option alongside their standard models. There are still real investment issues associated with hardware, implementation and consultancy services that have to be addressed. These can be met in different ways: with the user paying

some upfront implementation costs and then an ongoing subscription fee, external investment sources or even the supplier covering the implementation costs and recovering them over the period of the service. If the latter option applies, the supplier will have to research how they intend to cover these costs – can they actually afford to offer a subscription model at all?

Research suggests that subscription will give a boost to a stagnant software market and it is predicted to be one of the main drivers for growth over the next few years.

Worldwide subscription business is now put at \$20Bn p.a. and is forecast to reach \$43Bn by 2008.

The Intelco Group

Since its formation in 1988 Intelco has become one of the UK's leading designers and providers of rental and subscription services to software and systems suppliers. These services have enabled suppliers, covering the full spectrum of software and hardware products, to offer payment for use rental and subscription options to their users.

Intelco is at present, focussed on assisting software and systems suppliers make the transition from traditional "in perpetuity" licensing methods into the rapidly growing subscription markets which includes software licensing, hosted services and managed services.

