



## IT Subscription Pricing – Fundamental change is underway

The move to subscription payment systems for applications, managed services and hosted services is gaining momentum. Much informed research shows the extent of this interesting trend.

By 2006	50% of Software Application Suppliers will offer subscription
By 2008	40% of suppliers expect to gain most of their revenue from subscription
By 2008	25% of users believe most software revenue will be from subscription
70% of Users	believe licensing must be simplified

### Why is this change happening now?

Much of the change is driven by the recent move to managed and hosted services where subscription is a fundamental element of offering IT as a service. However, a large part of the change is driven by both users and suppliers recognising that there is some incompatibility between traditional pricing models and the needs of the modern software and service user.

Some of the more important issues with traditional "in perpetuity" purchase of licences include:

- ◆ The high initial cost of the software and systems
- ◆ The high obsolescence risk to the user
- ◆ The constant premature write-off of investment
- ◆ The lack of a second user market for software
- ◆ The focus on cost / price instead of function / service
- ◆ The complexity of existing licensing arrangements

### The Background

The wind of change is blowing across the traditional IT market as users seek to gain more value from their software and systems and look at better ways of using IT.

For many years purchasers of IT products have equated "best value" with "lowest price" which has seldom turned out to be true. Price is an easy target to focus on when justifying that a good deal has been gained for the company. This is true where alternative and more meaningful criteria are difficult to identify and where the IT experts are encouraged to make their recommendation in terms that the decision makers focus on which typically is: "How much will it cost?"

Of course where a system is being purchased outright the considerable capital payment that is a feature of a "sale" is very much worth negotiating down to make real and immediate savings. But this is all about price and has little to do with real value, or quality or performance.

John Glenn, the astronaut is reported to have realised, as he sat ready for the space take off, that he was trusting his life to a space vehicle which had been put together from a package of lowest cost components that NASA had obtained in its buying activities for the space module and rocket. Lowest cost on its own is a dangerous decision criteria.

Fortunately the environment that exists in the IT market does not have the immediate danger of a failed lowest cost product but behind the broad IT market lurks millions of pounds of cost and waste resulting from "the lowest cost is best" tradition.

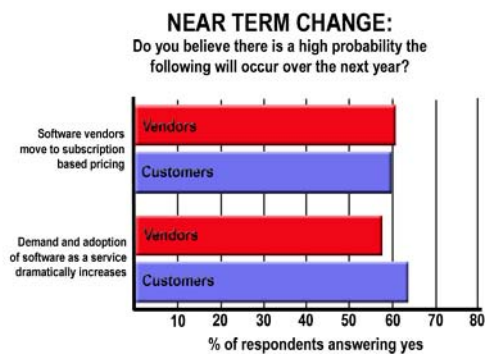
In addition, when the user pays the full capital cost of the software licence or system at the start, the whole risk of obsolescence in the fastest evolving products in the world, falls on them. This can include premature write off, and no available second users market for software or even hardware to mitigate their loss.

The traditional capital purchase approach can leave the user paying too much, too soon and taking the risks. In addition the general IT market is also retarded by the reluctance of user management to make the large capital investment in buying "in perpetuity" licences. This is quite understandable when the average age of a software system between major upgrades is only 3 years.

"In perpetuity" becomes rather meaningless. Ownership is a burden, not a benefit.

## The Arrival of Subscription

However the future is now looking better as the movement from capital purchase to periodic subscription payments for software particularly, and hardware and services gains momentum. The capital investment, the high user risk and focus on price as the important factors changes to payment for use of the software and services as it is being used which is a more relevant and flexible system



Data: IDC Survey of 67 software vendors and 57 customers

Focus on quality, functionality, service, shared risk and a substantially better financial position is attractive to many users. Easy and real cost justification by simple comparison of what is paid and what is received or gained each month for the service by the user removes the arguments surrounding the old ROI approach.

This major movement into subscription which at last matches the needs of the IT software and services market has been pioneered by some of the large software and services providers including Microsoft, Oracle and Computer Associates (but it actually could be available to all IT Suppliers).

An IDC study in America shows that already over 40% of software suppliers and 25% of users believe that a clear majority of software revenues will be based on subscription by 2008. The expectation is that over the next year 50% of software providers will change their licensing model to subscription.

Ken Wasch, President of the Software and Information Association summed up the situation by stating that the software industry is in a period of "dramatic and fundamental change".

## Managed and Hosted Services

Subscription is not just making its mark on the software market. Subscription is clearly an essential element in the rising managed and hosted services industry.

These new service providers aim to take over responsibility from business and government clients, for major IT applications and functions. By using their experience, expertise, focus and special skills, either in house or remotely, they are able to provide better functionality, reliability, system evolution and, possibly even lower cost.

This would effectively relieve the client of the need for resources and special skills and allow the client to focus on core business activities.

These services come in many variants but most often involve the service provider in performing the operational needs of the service and meeting the software, hardware and other costs of the infrastructure necessary for the operation.

The client will pay a periodic subscription charge for the whole service. The client therefore receives the whole function as a charged service as a monthly revenue based subscription expenditure. This avoids all the issues of capital responsibility for providing the IT facilities and for management of the process.

## Software Licensing and Managed and Hosted Services Issues

The move into subscription based systems is providing an excellent market expansion tool for these suppliers and is a great aid to establishing the business value of software and these services.

Researchers studying the place of subscription forecast it to provide a new stimulus to the take up of better applications and services by users through more efficiency, simplicity and cost effectiveness. Hopefully it will remove the main deterrent of large capital demands from the business development equation. However it does seem to leave important issues still to be resolved by suppliers now making the move to subscription.

### *The Issue for the Software Supplier*

Most software suppliers provide "in perpetuity" licences on an outright sale basis for which they are paid at the start of the contract.

A move to subscription would help them to develop their market position and help to confirm the business value of their software where the general view of software providers has always been that software is still under-valued.

The big dilemma for the supplier is the maintenance of their level of revenue achievement where the annual yield with subscription is perhaps one third of the traditional outright sale yield that is being replaced.

Over the life of the software the suppliers are in a much improved position while giving the user a much better cash flow benefit. How does the supplier achieve this transition without demanding a single large upfront subscription payment, which defeats the object of the change? Fortunately there are good solutions available.

### *The issues for the Managed Services and Hosted Services Providers*

These service providers have a substantial but different problem. While there is no problem with the monthly subscription charge for the services there is the question of recovering all the costs of software licences, hardware and set up

costs necessary to support the service in many situations.

The service provider could call on the user to meet these costs up front by making a large payment but this is contrary to the concept of managed and hosted service where the user is looking for an all inclusive subscription charge.

The obvious answer is for the supplier to provide more capital or debt to meet the new need. Both are limited in availability and perhaps detrimental to the short term business performance of the company.

Somehow or other the supplier needs to find a method of providing capital or debt in unlimited quantities in a way which preserves the features of the subscription option without adversely affecting business performance. This is achievable.

#### **Last Word**

Dan Stickel VP of Macrovision STG, as quoted in the 2004 IDC Subscription survey.

"As these techniques and business practices reach new levels of adoption and maturity, we expect to see a very tangible improvement in the relationships between software publishers and their customers as well as their ability to maximise the value of software".

## 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.

