The Rise of Subscription Software Licensing: Overcoming the Software Value Disconnect

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The software industry is at a crossroads. Economic factors, virtualized hardware, and new delivery methods such as software as a service (SaaS) and cloud computing are changing the way customers look at the value of software solutions. As a result, software vendors are looking for different ways to offer solutions to customers. This has driven a rise in the use of subscription software licensing. This Market Spotlight looks at the changes in the software industry and the differences between traditional licensing and subscription licensing. In addition, this document discusses the benefits and challenges associated with subscription software licensing and provides some advice for enterprises that are considering this approach to purchasing software.

The Evolving Software Market

Today’s software licensing landscape can be challenging for both software vendors and customers. Vendors are struggling with the reality that it is growing increasingly difficult to make money as a traditional software company (i.e., through perpetual licensing), and they are being pushed by the current financial climate, as well as other trends including an interest in pay-per-use licensing metrics, to seriously consider alternatives.

Customers believe that current software licensing models are not an accurate or fair gauge of the value they derive from using the software, and they are dealing with slashed IT budgets. At the same time, they need software more than ever.

These dynamics are fueling a powerful and pervasive change in mindset that is impacting vendor and customer notions of how software functionality is accessed and paid for. As a result, IDC is observing vendors of all types considering migration toward subscription licensing, if they aren’t there already.

Many are hoping to attract new customers and keep existing customers with licensing approaches that enable a smaller, up-front purchase. Others are hoping to drive more predictable, linear revenue and differentiate themselves from the competition. In addition, many vendors cite the desire to respond to customer demands for more flexible delivery and pricing options as a key reason for migrating to a new approach.

The trend toward software subscription licensing continues to be a dominant force in the software industry. Software subscription revenue continues to grow rapidly compared with traditional revenue sources, representing a growth opportunity for many software companies. Consider the following data points:

- For 16% of the top 100 software vendors worldwide, subscription represents greater than 50% of total software revenue.
- For all software companies (with subscription), subscription revenue averages about $181 million per year, with a median of $13 million per year.
- For all software companies (with subscription), subscription revenue grew an average of 20% from 2009 to 2010.
In the past, subscription was considered a disruptive force in the industry. However, with more than half of the top 100 software companies reporting subscription revenue, this approach can now be considered mainstream. Furthermore, while projected growth in SaaS is a key factor, a lot of on-premise software is also being offered for subscription.

Subscription software licensing is not a new invention — the economic situation is accelerating a transition that was already taking place. Nor is subscription a panacea, as it brings challenges for customers and vendors.

The Software Value Disconnect

IDC has seen increased pressure to place a greater focus on clearly establishing the business value of software. Many customers feel they have been forced to buy more software than they need and use only a fraction of the capabilities, which contributes to a value disconnect. In addition, software priced according to licensing metrics linked to hardware resources may become cost prohibitive if customers use the product in a grid or virtual environment, causing further misalignment with value.

Customers also are being exposed to new value calculation scenarios; for example, new hardware and software pricing based on usage rather than capacity. Vendor licensing policies that are inconsistent and overly complex — even within the same vendor — also contribute to the value disconnect from the customer perspective.

Market pressures are forcing software vendors to reassess value. Margins are shrinking while the negotiating clout of the customer is increasing. Disruptive business models are emerging, placing pressure on software companies with entrenched traditional business models. As a result, licensing has become a competitive differentiator. In addition, vendors (and their investors) are concerned that traditional licensing models do not yield predictable, recurring revenue.

The traditional software value framework is based on the idea that value is equal to the product as defined by the vendor. Therefore, the traditional strategy is to add features to increase the value of the product. The challenge is that perpetual licensing models are based on the perception that the customer must own the software in order to use it to gain access to positive experiences.

As an alternative to the perpetual license, subscription licensing has evolved over the past decade. Initially, subscriptions provided a "value offering" that included scaled-down functionality to attract customers that could not afford traditional business software prices. Next was a hybrid offering, where the customer chose either a subscription or a traditional license model for the same software, in which the software was also offered via cloud or as a service.

Finally, "premium offering" subscriptions provided the optimal experience and the high worth-and-cost expectations associated with it. This might include the ability to access all of the products in a company's broad portfolio and the highest levels of support for the duration of the subscription.

Offering a subscription approach is one of many strategies that vendors are using to improve customer satisfaction, increase penetration in markets where high up-front licensing costs prohibit adoption, and grow deferred revenue. IDC does not believe that subscription should necessarily be the default software model, but in many situations, subscription will make more sense for customers and vendors.

Benefits and Challenges of the Subscription Model

From the vendor perspective, selling licenses via subscription increases the predictability of software revenue and makes it easier to demonstrate future health. Customers like the low up-front cost of the subscription model as well as the enhanced ability to build a relationship with the software provider. In addition, many customers could never have afforded the software products if they were licensed
under the traditional perpetual model. Subscription licenses help address the risk factors that customers experience with traditional, long-term models.

Some enterprises use the subscription model as a way to try out new technologies and then convert to a longer-term license if they are happy with the product. In addition, subscription allows customers to purchase software from their operating budgets rather than their capital budgets. Also, because subscriptions typically renew annually, the software provider must demonstrate ongoing value and build a relationship with the customer.

However, for this strategy to be successful, quality of technology is of paramount importance because if the client doesn't see returns in a rapid fashion, then it will be unlikely to adopt the approach on a longer-term basis. In addition, the subscription model presents challenges.

From the vendor perspective, moving to subscription revenue can have a negative impact on revenue and ultimately share price. In addition, subscription licensing models require vendors to sell customers on the value of their software on an ongoing basis. Customers like this aspect of subscription licensing because they believe it results in a better customer experience, but most software vendors’ businesses are based on the model of selling the value of the software at a single point in time.

From the customer perspective, the main concern with subscription licensing is that in the long term, subscribing to software may cost more than buying software. The break-even point is typically somewhere between three and four years. After that, subscription will likely cost more than buying a comparable product via a perpetual license. (Note that this factors in licensing costs only and does not consider the cost savings associated with service delivery of software via a SaaS offering. The benefits of SaaS delivery go much further than the subscription licensing approach.)

At the same time, some customers need to pay for software out of capital budgets or prefer to "own" the software — a concept that is not an aspect of subscription. Reducing capital spending could result in losing a deferred tax benefit historically used to offset taxable income.

Conclusion and Essential Guidance

Today's software customers have a choice that would have been made for them a decade ago. In addition, there are benefits to both subscription licensing and perpetual licensing. It's important to understand the strengths of each approach. Most important is for software vendors to offer solutions that directly address the short- and long-term needs of enterprise customers. For example, enterprises in industries that are wary of capital spending — which today includes just about every sector — are more likely to be interested in a subscription approach that moves spending from capex to opex.

IDC offers the following essential guidance to independent software vendors that are thinking about offering subscription licensing models as well as those that are looking to refine their existing subscription approach:

- **Offer customers a portfolio of options** because customer perceptions of subscription licensing models vary widely. This does not mean that vendors need to create several versions of their software: It should be the same software, just licensed in different ways for customers.

- **Include support and upgrades in the subscription cost.** Software customers believe that one of the key problems with perpetual models is that the customer is often faced with high upgrade costs in addition to the cost of software maintenance. According to customers, a key benefit of subscription models is that they pay one price for everything — the software, maintenance, support, and upgrades. Not every vendor that offers subscriptions today takes this approach; however, customers clearly indicate a preference for simplification and bundling.
Set a consistent pricing structure. Software customers are concerned that the software vendor is free to increase the price of the software subscription at will and that customers will have to pay if they want to continue using the software. Some customers will be amenable to signing multiyear contracts to lock in the price of the software.

Provide volume discounts to long-term users. Customers want to see benefits as a result of being long-term customers. These customers believe that they cost less to support than newer customers and want to be rewarded for their loyalty.

Make the sales force agnostic. Sales compensation is one of the most difficult operational challenges of moving to a new licensing model. If the software vendor wants the salesperson to offer customers the licensing model that best meets their needs, the salesperson cannot be personally "disinceneted" to sell software via subscription.

Continuously improve or add value to the product. With subscription licensing, vendors must convince customers of the value of their software on a recurring basis. This is different from the perpetual model where the customer is sold on the basis of software value at a single point in time. In addition, this is more challenging for certain types of software where the customer might not perceive a need for ongoing value.

Investigate ways to improve your relationship with your subscription customers. As with any subscription purchase, to secure a renewal, the service provider needs to focus lots of effort on making sure that the customer is using the service and getting value out of it. In addition, the footprint of a subscription will grow within the organization only if existing users are happy evangelists. As an example, software vendors should run initiatives from their sales, customer service, and training groups to help ensure that customers are having positive experiences.

Remember that subscription is about gaining access to positive experiences. Traditional perpetual license models are based on the perception that the value of software is embedded in the product itself and that all value can be calculated up front. These models do not take into account the customer's experience with the software over time, but subscription models do. The customer experience with the software shapes value perception. Experience-friendly models include subscription approaches that can adapt to changes in a customer's business needs as well as those that scale up or down according to customer usage.

So, which is better — subscription or perpetual? It depends, of course, based on customer preferences and organization. However, the fact remains that subscription licensing is a growing option among customers, especially in an era of SaaS and cloud computing.

Because subscription and perpetual revenues are recognized differently on a financial statement, comparisons can be an "apples to oranges" exercise. However, every ISV should consider offering a subscription software licensing option.