InformationWeek
Business Innovation Powered By Technology
April 19, 2004

CUSTOMER CLOUT

THE RISE OF SUBSCRIPTION-BASED SOFTWARE LICENSES SIGNALS MORE LEVERAGE FOR BUYERS

autodesk®

POWER SHIFT

BY JOHN FOLEY

Viktor Koen

Users gain flexibility and influence with new software pricing models

A ONE-YEAR EXPERIMENT IN SUBSCRIPTION-STYLE SOFTWARE LICENSING BY THE University of Florida's IT department has yielded an enviable outcome: Access to the most up-to-date software, predictable costs, and increased bargaining power, as well as the ability to walk away from it all at any time for any reason. The experience has made the school's decision to renew the license with Mercury Interactive Corp. an easy one. And it shows why subscription licenses are fast becoming a popular way of acquiring new software, accounting for about half of new deals for some vendors.

"This is a good thing for us," says Mike Conlon, the University of Florida's director of data infrastructure. "We didn't put out a big pile of money to get a particular piece of software. And the vendor has a different kind of incentive to be responsive to us—they don't have our money."

Some industry analysts predict subscription-based licensing models are about to break into widespread acceptance as alternatives to perpetual licenses, the status quo in the software industry. Research firm IDC last month predicted "dramatic shifts" in software business models as a growing number of customers shop for more flexible licensing options. "Vendors that can't accommodate these models will eventually be at a competitive disadvantage," predicts IDC analyst Amy Mizoras Konary.

As a result of this change, business-technology managers responsible for software purchases find themselves with more options in dealing with vendors and in stronger negotiating positions. Tech buyers who opt for subscription-based licenses say the deals force their vendors to be more accountable and responsive. "They really want to make sure they keep your business," Conlon says.

Even nonconverts see the logic. "That's the way the industry will be going," says David Gillhouse, VP of IT with Chamberlain Group Inc., a manufacturer of garage-door openers. Chamberlain uses software from 40 or more vendors, but Gillhouse counts Microsoft's Software Assurance program as the only subscription deal among them. "The key in doing those arrangements is in selecting the companies you think are going to add value to your business and be your partner," he says. "As far as a basic business model, I think it's very good."

IDC estimates a quarter of all software sales today are tied to subscription licenses, so the transition is already in gear. In a recent IDC survey, 61% of vendors and 60% of customers say they expect the software industry to move to subscription-based licenses in the next year. And 43% of software vendors surveyed believe a majority of their business will be done via subscriptions six years from now.

"It's good to have an option," says Jim Trupiano, manager of IT contracts and vendor relations at Southern Co., an electric utility. Southern uses SAS Institute Inc.'s data-analysis products under a subscription license and has been approached by three other software companies with subscription offers in the past year. So far, Southern hasn't opted for the new licenses. "You have to look at it on a case-by-case basis," Trupiano says. "It's all in the analysis of the dollars."

The trend is gaining so much momentum that Merrill Lynch software analysts have come up with a new method of assessing and valuing software companies, one that takes into account the growth in deferred revenue that results when vendors move in this direction. "Our view from a Wall Street perspective is, this is starting to ripple through in how the reported [financial] results look," says Merrill Lynch software analyst Jason Maynard. "The way we value companies has to change."

TRADITIONAL SOFTWARE-LICENSING MODELS ARE DYING, LOCHHEAD SAYS.

The brokerage firm has devised a formula, called the Merrill Lynch On-Demand Index, for measuring the performance of software companies using metrics that go beyond the standard stock-price-to-earnings or stock-price-to-sales gauges. Applying the index, Merrill Lynch analysts have crunched the numbers on 75 software companies, including Autodesk, Computer Associates, IBM, Mercury Interactive, Microsoft, PeopleSoft, and SAP, and this week they'll release the results. The numbers will provide a baseline for evaluating companies' future performance.

The trend toward subscription contracts is being driven in part by customers' dissatisfaction with the old way of deal making. Perpetual licenses can entail large up-front costs and annual maintenance fees that can reach 20% of a contract's initial value. Also, because software companies have become dependent on big, onetime perpetual-license deals to meet quarterly forecasts, high-pressure sales tactics come into play.

It's a phenomenon Christopher Lochhead, Mercury Interactive's chief marketing officer, calls "lie until they buy," a stress-filled process familiar to many CIOs. The bare-knuckles approach has left such a bad taste that fewer than 30% of companies surveyed by IDC believe software-vendor licensing practices are fair. "We believe the traditional enterprise-software model is dying," Lochhead says. "The reason is simple—it doesn't work for customers, and, it turns out, it doesn't work for vendors either."

The concept of subscription licenses isn't entirely new. "The ideas have been stewing," says IDC's Mizoras Konary. What's different now is that the hype around ASPs—early proponents of the subscription model—has died down, while more traditional software companies are offering subscription licenses and, in many cases, hosted services that give customers the option of letting the vendor manage the software for them, also on a subscription basis. Subscription licenses represent a growing percentage of overall revenue, ranging from 25% to 45% of new software deals, depending on the companies and software categories involved, according to the Merrill Lynch report to be released this week.

Bella Pictures LLC, a startup that describes itself as the first national wedding-photography company, supports its business using nothing but subscription-type applications: accounting, human-resources, photo-processing, and Salesforce.com Inc.'s customer-relationship-management apps. "Subscription software is a great idea," president and co-founder Tom Kramer says. "We didn't even consider the do-it-yourself, in-house, client-server solution because we knew it would be out of our price range or under-powered for what we needed."

Four years ago, all of Mercury Interactive's money came in the old way, through perpetual licenses and associated maintenance fees. The company introduced subscription licenses in 2000 when it launched a hosted application service, and, since then, subscriptions have comprised a growing share of its revenue. Last quarter, subscription licenses accounted for 51% of Mercury Interactive's new product orders, marking the first time they surpassed perpetual-license fees. "It started off as kind of an interesting experiment," Lochhead says. "Customers adopted it." The company is scheduled to release first-quarter financial results this week.

Software buyers started experimenting with the subscription model during the economic slowdown of recent years, as their companies looked for ways to take on projects without multimillion-dollar capital outlays. They found it adds a new dimension to negotiation dynamics. "It gives [buyers] a carrot and a stick with the vendor in negotiation," says Maynard of Merrill Lynch. "They can better link performance to that negotiation process." Adds Southern's Trupiano: "Vendors really have to stay on top of their game because after two years you can decide not to subscribe again." The average length of one of Mercury Interactive's subscription contracts is two years.

The new types of license options come in many forms, ranging from Salesforce's hosted applications, available only via subscription, to Computer Associates' try-before-you-buy approach, in which customers are encouraged to sign subscription licenses the first time they use a product with the option of securing a long-term perpetual license later. Mercury Interactive offers its older products, such as its WinRunner testing software, under perpetual licenses, while subscription licenses are its preferred way of doing business for all new products. Closely related to subscription licenses are pay-as-you-use models, where costs rise or fall based on usage.

The University of Florida uses products from between 50 and 100 software companies, but its subscription license with Mercury Interactive is the first deal of its kind at the school. "I wish there were more," Conlon says.

Autodesk Inc. designed its fast-growing subscription model to add value for about the same cost as a version upgrade to the company's graphic-design software. For a $420-per-user annual fee, customers of Autodesk's flagship AutoCAD 2005 application get online support, electronic tutorials, and access to regular software updates. For nonsubscribers, the cost of an application upgrade alone is $495 per user. Upgrade once a year, and the subscription option is cheaper.

The definitions can get fuzzy. Some analysts consider Microsoft's Software Assurance program, under which regular product upgrades are offered at an annual premium, a subscription offering, but others put Software Assurance in the maintenance category. For vendors, the difference may be less than it seems because subscription revenue and maintenance revenue often end up in the same financial bucket—deferred revenue.

Merrill Lynch's On-Demand Index should help investors and others make better sense of the financial fine points. In addition to factoring in the license revenue reported on a company's income statement and changes in earnings per share (Maynard calls both "rear-view indicators"), the index tallies changes in a company's deferred revenue and cash flow and reflects how much business comes from software delivered in hosted or outsourced environments. "We're trying to capture the dynamic flow of revenue here," Maynard says.

The approach is far from the norm, and the results may stand conventional investment wisdom on its head. For instance, by standard measures, Mercury Interactive's stock sold at a premium back in February to that of Siebel Systems Inc. Mercury Interactive traded at 44 times Merrill Lynch's estimate for 2004 earnings per share, while Siebel traded at 40 times estimated EPS.

When Merrill Lynch ran the numbers through its new index, however, it got a different outcome: Mercury Interactive's stock was actually trading at a discount to Siebel's when cash generation from subscriptions was included. Mercury Interactive ended 2003 with $150 million in deferred revenue from subscriptions—sales that will get recorded in future quarters—which was 150% more than it had at the end of 2002.

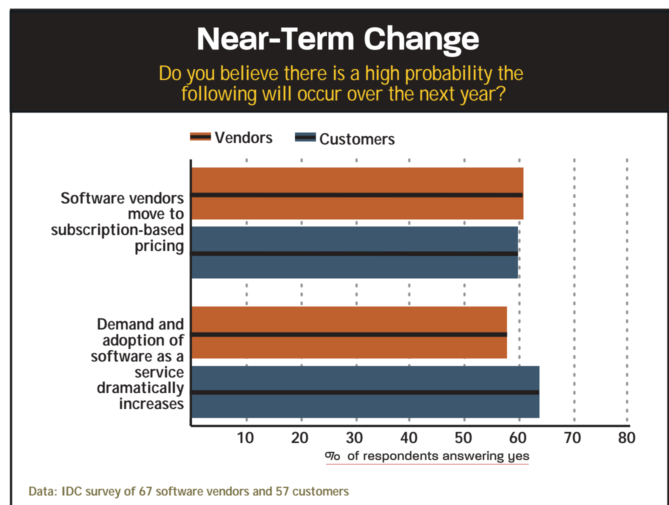
"Taking bookings into consideration, it looks to us like Mercury is much cheaper than conventional [price-to-earnings] wisdom might imply," Maynard and associates wrote in a February report introducing their On-Demand Index. Since then, Siebel's cash flow has improved, while Mercury Interactive's stock price is more in line with its peers' when cash flow is taken into account.

Merrill Lynch buys and sells the stocks of the software companies it tracks, and its investment-banking division sometimes represents them in business deals. But Maynard dismisses any suggestion the index is meant to give new shine to a dulling sector. "I lambasted the software industry," he says of the February report. Maynard points out that Merrill Lynch's analysis could highlight overachievers, but it could also reflect poorly on software companies that lag their peers.

Yet, even proponents of subscription licenses agree they aren't the best choice for every situation. Scott Hicar, CIO of Maxtor Corp., a hard-drive manufacturer, has experience with subscription licenses from Salesforce and RightNow Technologies Inc. and regards subscriptions as easy, flexible, and low risk.

But the last two software deals Hicar signed—one with Vignette Corp., the other with NCR Corp.'s Teradata division—were for perpetual licenses. Hicar says neither vendor pitched a subscription-license alternative, but he would've chosen perpetual licenses anyway. The rationale: Hicar believes perpetual licenses provide a higher return on investment for software that will be deployed for more than a few years, as he plans to do.

Now, Hicar is mulling what to do about Maxtor's enterprise agreement with Microsoft that's about to expire. Microsoft's Software Assurance program doesn't look as attractive, given the flux in Microsoft's product road map, with no clear delivery date for the next version of Windows, he says. "They know they have to put a story together."



But if one of the risks to customers of a subscription model is paying for software upgrades that don't arrive during the life of the contract, the parallel to that problem when signing perpetual licenses is paying for more software than needed. Fewer than 20% of users surveyed by IDC say they're taking full advantage of the software they licensed.

The large amount of licensed but unused software is a key indicator that the perpetual model needs fixing, says IDC analyst Mizoras Konary. It's also evidence of a glaring gap between the cost of software and its value to the customer. "Everybody recognizes some pretty big changes need to take place," she says.

On that point, virtually everyone agrees. The result will be new relationships between software buyers and sellers, represented most visibly, but not exclusively, in the documents that seal their deals. "There's going to be winners, and there's going to be losers," Merrill Lynch analyst Maynard says. "We've got to get on top of this because it's got big repercussions."

Write to John Foley at jpfoley@cmp.com. Visit our Software Tech Center: informationweek.com/TC/sw

autodesk®

Copyright© 2004 by **CMP Media LLC,** 600 Community Drive, Manhasset, NY 11030. Reprinted from INFORMATIONWEEK with permission. 4811