THE CUBE By Monevate
THE MONETIZATION COMMUNITY FOR XAAS LEADERS

Unlocking SaaS Growth with Usage Based Pricing

Masterclass Presented by James Wilton on October 10, 2024

Brought to you by The Cube – our premiere pricing community

Today's Topic

Usage Based Pricing

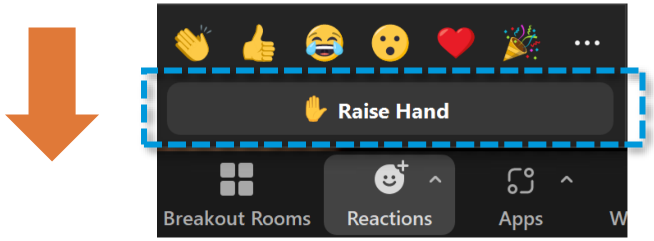
Rough Agenda

- Min. 5 – 35 – Review Core Principals & Cases
- Min. 35 – 55 – Q&A
- Min 55 – 60 – News + Wrap Up

Masterclass Norms

Masterclasses are intended to be interactive events - free to ask questions at any point and engage in the chat.

- **Please be "on camera"** if you are able to be
- **Raise your hand** to ask a question or raise a point



- If you are not able to speak live, **send questions in the Zoom chat**

Our objective today is to answer 4 questions

- **What** is usage-based pricing?
- **In what situations** does usage-based pricing make sense?
- How can I **build a usage-based pricing model that works**?
- How do I **roll it out successfully?**

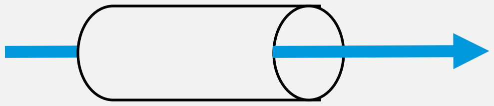
Usage-based pricing simply means monetizing your product based on usage, but there are different forms

Categories of Metric

Category	Description	Example metrics
Internal **Software** usage	How a customer's employees use the product	• # Searches • # Downloads • # GBs • # Sessions • …
External / end-customer usage	How a customer's end customers use the product	• # API calls • # Queries • # Searches • …

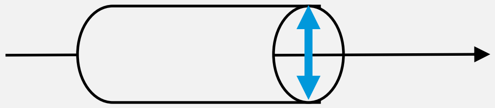
Types of Measurement

Total Amount, i.e. charge for the total amount of usage over a given period



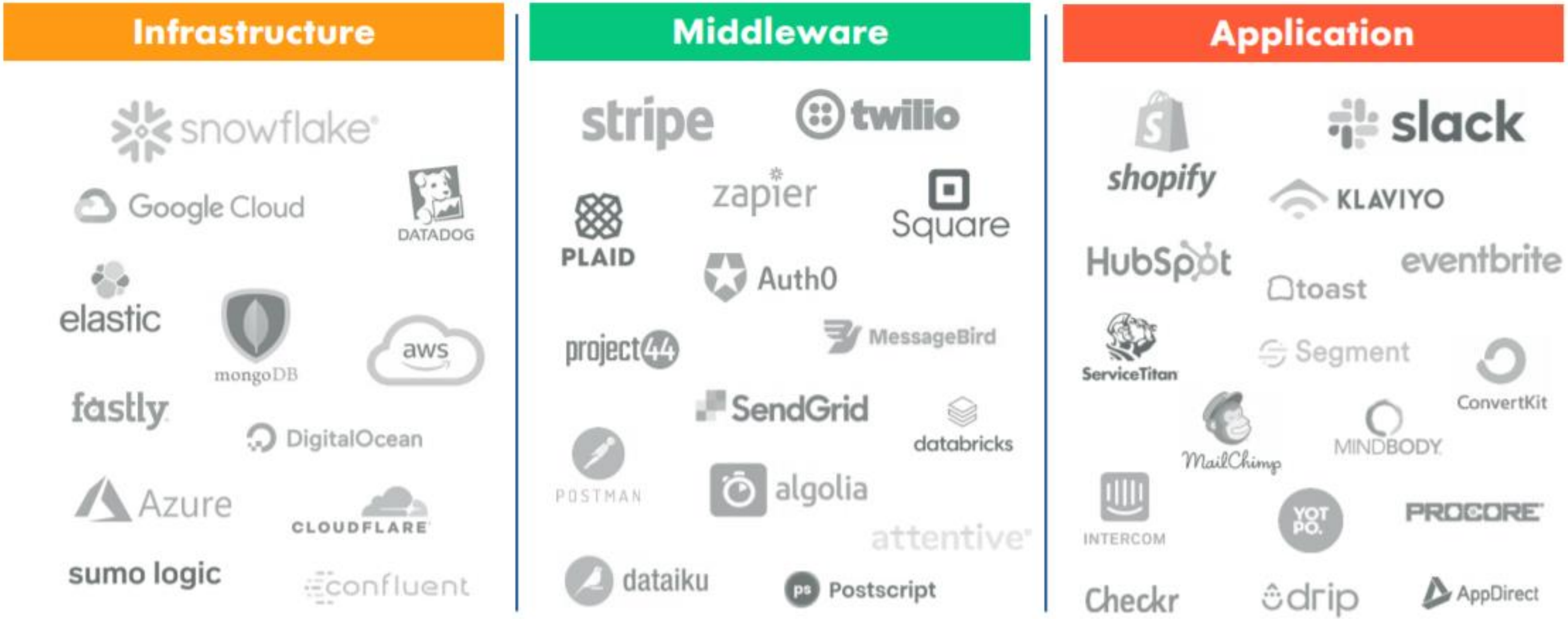
How much flows through the pipe?

Capacity, i.e. charge for a maximum "bandwidth" of usage



How wide is the pipe?

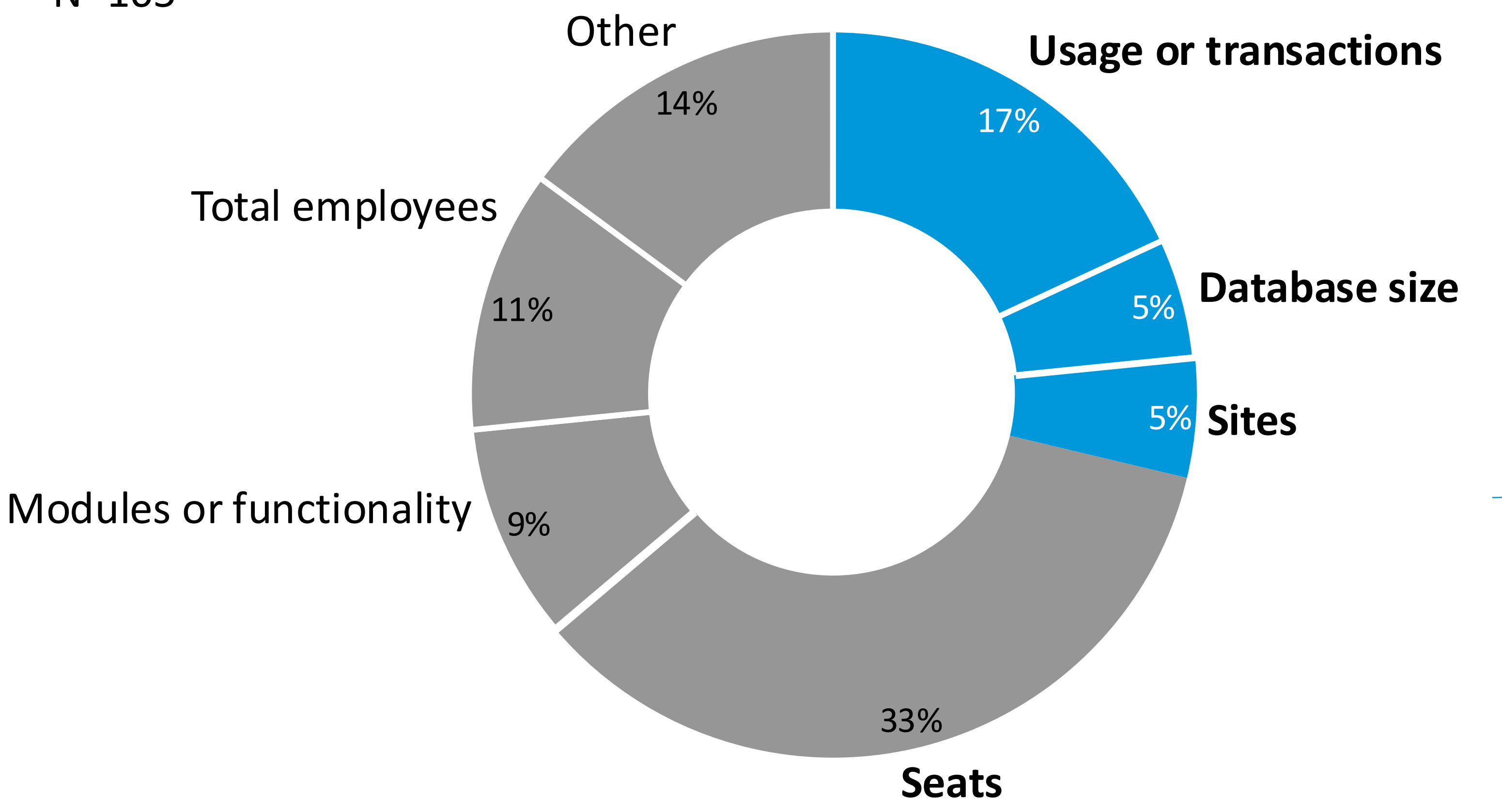
It feels like usage-based pricing is everywhere! Present across all major software sectors



Source: OpenView Partners, Usage-based pricing playbook

In reality, usage-based pricing is still only used in a minority of SaaS companies

Primary SaaS Metric, by respondent
N=105



Only ~1/4 of SaaS companies claim to use some form of usage-based pricing

Source: KeyBanc Capital Markets SaaS Survey 2023

The case for usage-based pricing is clear - there are many potential benefits

- ✓ Tends to **grow** over time → Good for ***Land and Expand***
- ✓ Highly **variability/dispersion** → *Good for **Price differentiation***
- ✓ Covers **costs** (For cloud-hosted players) → ***Protects Margins***
- ✓ Increasingly **familiar** to customers → ***Acceptable***

… but there are also some major pitfalls to avoid

Pitfalls of Usage-based Pricing

- ✘ Not always **value-aligned**
- ✘ **Not predictable**
- ✘ (Default models) **doesn’t count as ARR**
- ✘ **High effort** to implement

Often **not the “right” answer**

(Even if it’s “right”) can be **too challenging to undertake**

3 practical guidelines to make usage-based pricing work for you

1. Choose the right **value-based metric**

2. Create a **predictable architecture** with value-aligned **volume discounting**

3. Use a **usage-based subscription** (or other hybrid) revenue model to lock in ARR

The first step is to choose the right metric – aim to meet key criteria

- Value-aligned
- Growth-aligned
- Acceptable
- Predictable
- Controllable
- Auditable

VALUE-ALIGNMENT is the most important criteria
Determining metric's link to value should be the first step

Does value **truly** increase with usage?

Will the **customer readily see/ agree with** the link?

Is the rate of value increase with usage generally **higher than with other metrics**?

If the answer is NO

Usage-based pricing is likely **NOT the right approach**

NOTE – being aligned to costs is not the same as being aligned to value

Just because a metric is aligned to your **COST**

does not mean it is necessary aligned to your customer's **VALUE**

Don't use a non-value based metric for monetization(!)

"But how do I cover my costs?"

- ✓ Use a different (value-based) metric
- ✓ Cover the cost of *general usage* in your prices
- ✓ Pass through the costs of excessive usage

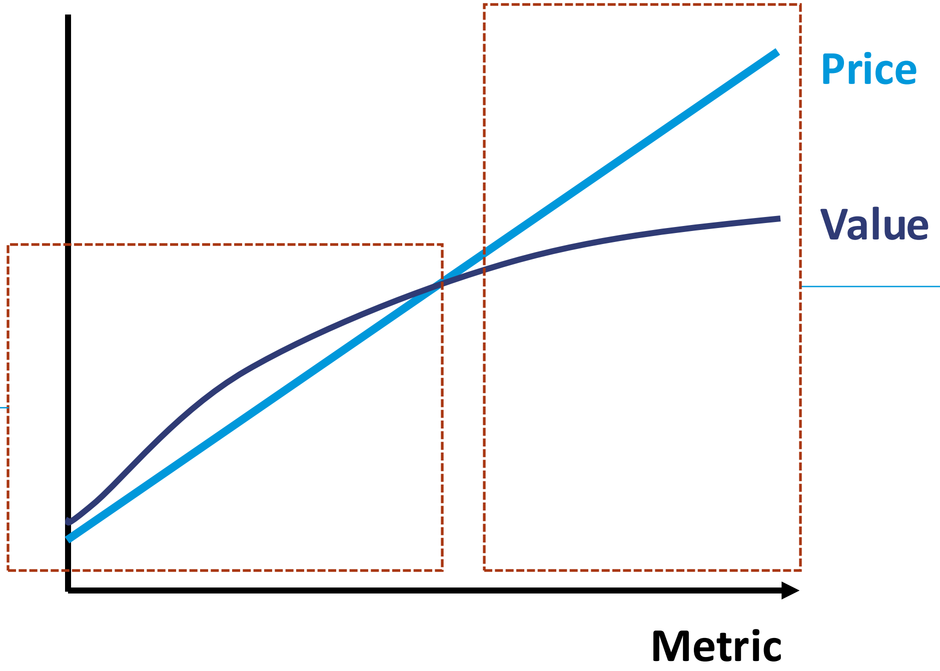
Case Study: Sometimes the alignment between usage and value is tricky, and even growth orientation is not a given

Case Study – Search Functionality Provider

- SaaS company that provides search functionality for e-commerce, websites etc.
- Obvious usage-based metric - **# of end-user searches**
- **However:**
  - Each keystroke is technically a search. **Not value-aligned!**
  - when search algorithm is better, # of searches *decreases*. **Not growth oriented!**
- **Solution:** Use ***Unique Searches*** (i.e. count multiple searches as one within a certain time frame)

Potential issue - The rate at which value increases with a usage-based metric is often not constant at all usage levels

All is well in this region – good alignment between price and value



Here, we have problems

- Value still increases with metric, but not as fast as price
- Customer will feel it is **unacceptable** to be charged these rates for increased usage

Customers feel they are being **"nickel and dimed"** when they have to pay for incremental usage when price scales faster than value

You need **volume discounting**

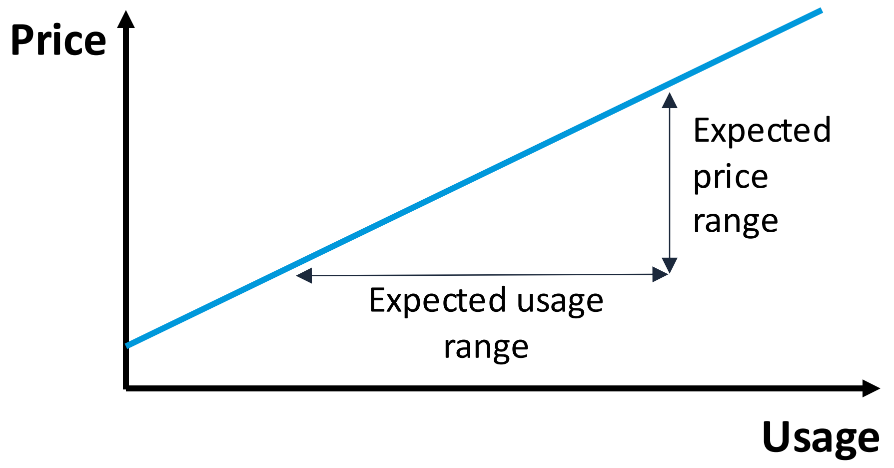
Potential issue - PREDICTABILITY can be a problem, especially for end-customer usage, especially if the link to value is weak

Usage metrics are often scalable (i.e. you can ramp them up and down)**…**

But it's often hard to control (or even *know*) how much **your <u>customers</u>** will use a product

End-customer usage metrics are often **HIGHLY UNPREDICTABLE**

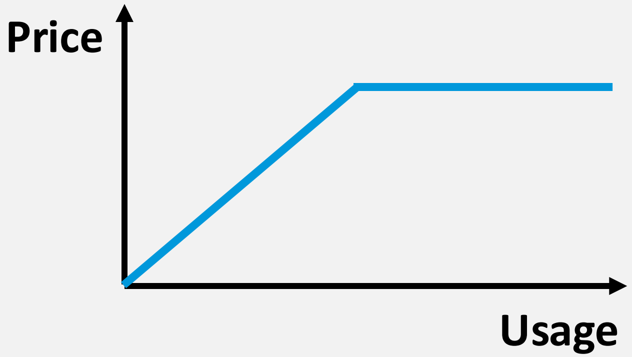
This can make it difficult for your customers to budget…



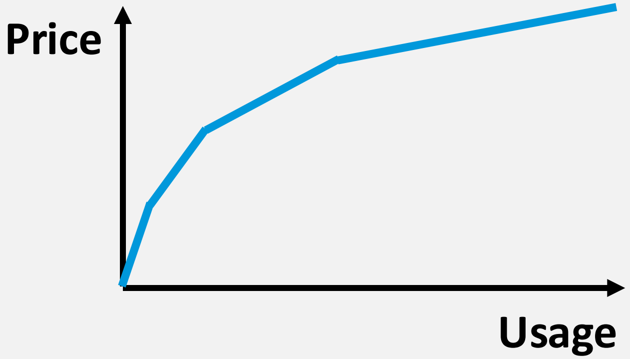
This can become a BARRIER TO SALES

The right PRICE ARCHITECTURE can help you manage value-alignment and predictability challenges

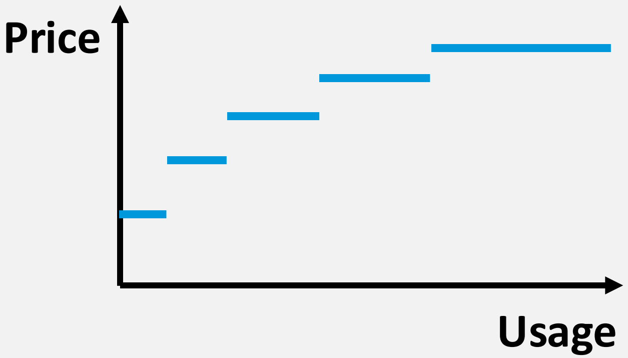
"Caps"



"Sliding Scale"



"Bands"



Hybrid models, including USAGE-BASED SUBSCRIPTION, allow vendors to reap the benefits of usage-based, while retaining ARR

Classic Usage-Based Model

- Usage measured every month/ year
- Charge customers for what they **actually-used**

NOT ARR!

Reoccurring Revenue

"Usage-Based Subscription"

- Customers commit to a certain amount of usage up front
- Minimum price for a month/year is **fixed**
- Price is reset at contract renewal
- Vendor choice: whether to require upgrades if usage-exceeded

ARR!

Recurring Revenue

Hybrid Model

- Any model with both

  (a) a traditional "fixed"" component, and

  (b) a usage-based component

ARR!

(for a portion of revenue, at least)

Case Study: Usage estimates and banding can make usage-based pricing more predictable and acceptable to customers

Context: Software company that offered a low code cybersecurity automation platform to a variety of customers in terms of size and segments

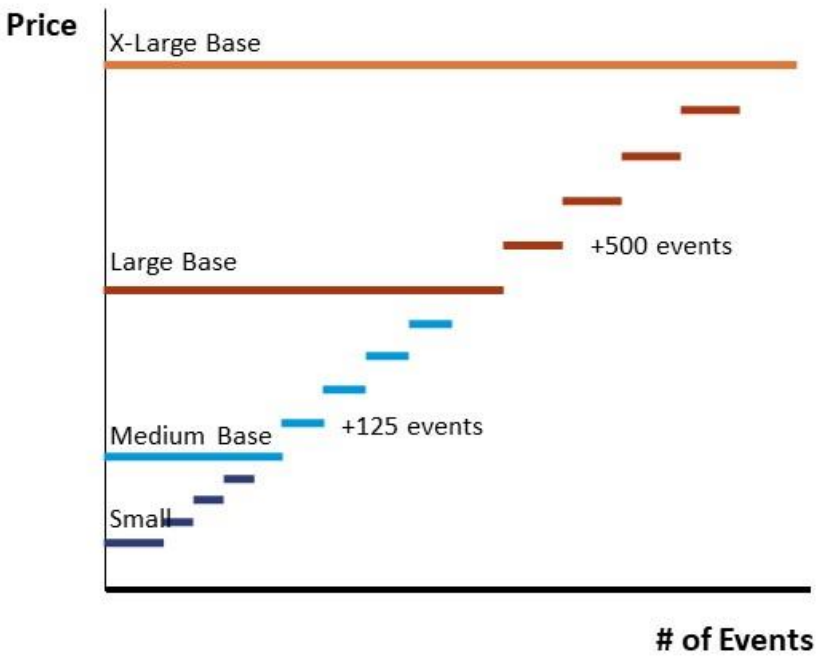
Company knew that they needed to move to a away from "Seats" because…

Not well-linked to value and ROI

Not growth-oriented – unable to **monetize new automation use cases** or **grow # seats over time**

Scaling price based on usage (something aligned to # automations) seemed to be the obvious answer

They designed a banded usage structure to make revenue more predictable for them, and costs more predictable for the customer:

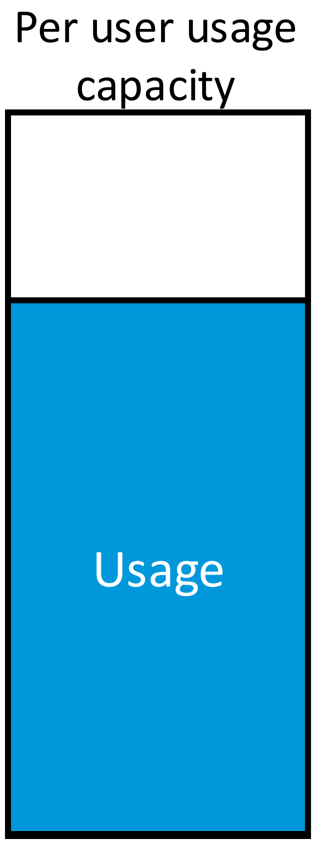


- ✓ **Defined a usage-based metric (events)** that was better linked to value and growth oriented than number of users
- ✓ Used a **banded "base + overage"** price architecture to increase predictability for customers and lock in ARR
- ✓ **Built a "Usage Calculator" tool** that can easily be used by sales reps to **estimate usage for new and existing customers**

Case Study: User-equivalents helped a SW provider bridge the gap between user-based ands usage-based pricing

Context: Revenue lifecycle software provider sought to move to usage based pricing (from user-based) to monetize the additional value received through API use cases

- **Users** worked as a price metric for customers who primarily gain value through users
- **Increasing API usage** meant that some customers could get high value with only a small number of users
- **Expected to be difficult to migrate** customers who see value in users to a usage-based approach



- Set a "**fair" usage limit** (i.e. reasonable non-automated usage) for each user
- If fair usage is exceeded, require **purchase of more seats** to increase the usage capacity
- Use **volume discounting** to make price per user decrease as # of user-equivalents increases
- This means that:
  - ✓ Many **user-based customers will be unaffected** – pricing model will be unchanged
  - ✓ **API-based customers can't "get away"** with purchasing lower # of seats
  - ✓ **Annual commitments** lock in ARR

Transitions from traditional → usage-based pricing typically takes longer than typical pricing transformations

Implementation Timelines

Regular Pricing Strategy Transformation — **3-6** months

Traditional → Usage Based Transformation — **6+** months

Challenges of Usage Based Transformation

Technical

- Measurement
- Reporting
- Billing

Commercial

- Messaging
- Quoting
- Contracting
- Incentives

Be sure that the "juice is worth the squeeze"

Summary – today's key messages

Usage-based pricing is a potentially **powerful revenue-growth accelerator**

It is not always the right answer – check usage-based pricing is appropriate for your business

When moving to a usage-based system:

- Choose the right **value-based usage metric** that will grow over time
- **Produce price architecture** that will manage **acceptability** and **predictability**
- Build a model that will **lock in ARR** (if that's important)
- Consider the **implementation complexity**

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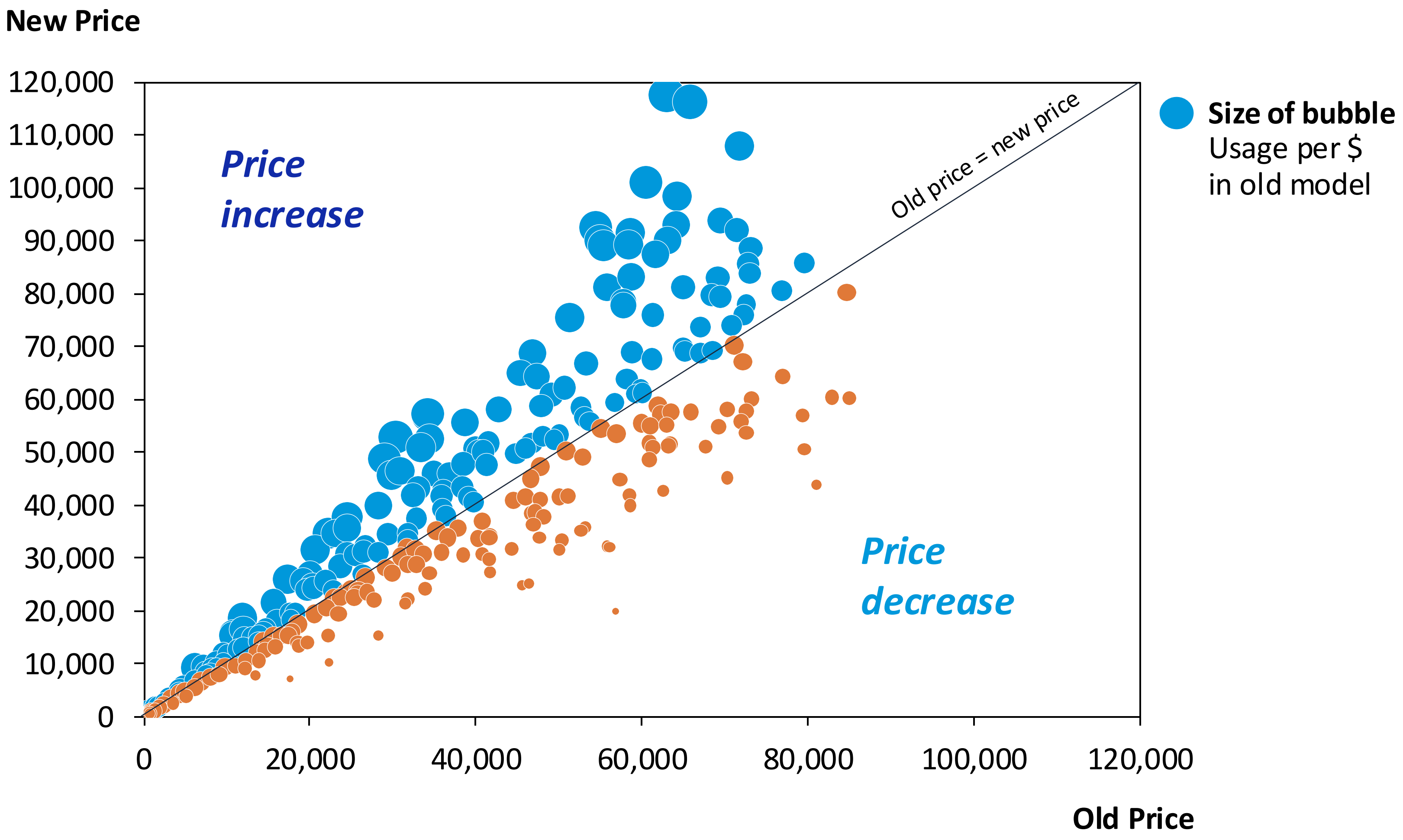
Explore cutting-edge trends in pricing for Gen AI products with SaaS pricing expert Malvika Gupta. Learn best practices for pricing AI solutions and discover why there's no one-size-fits-all approach in this rapidly evolving landscape.

Appendix

Heads Up - Prepare for significant re-pricing of existing customers



When migrating to usage-based pricing, **expect some scatter** in your new prices

Produce a **migration plan** which will focus on re-pricing those who are

- Priced below new target levels
- Priced so high they are an attrition risk