PENTATHLON ventures

# Pricing a SaaS Product: A Multi-Pronged Approach

*Striking a balance between the tangible and intangible.*

Pentathlon is a VC-firm founded by entrepreneurs for entrepreneurs. We help early-stage technology start-ups at the crucial juncture between Pre-seed and Series-A with expertise, eco-system, and capital.

# Executive Summary

Building a SaaS product, designing a winning user experience, acquiring customers, continually improving value delivery to retain those customers...these take countless late nights, sacrifices, blood, sweat, and tears. At the end of it all, how well do entrepreneurs know what it's worth?

Putting a quantifiable value on your SaaS product can present a massive challenge. Not having a pricing strategy equates not knowing your customer. It means you can never be completely sure whether your pricing is driving them away because it's not competitive, or whether it's losing you millions in revenue stacking opportunities. The first growth lever everyone thinks of is customer acquisition, while pricing, with its incredible potential, often goes untapped.

## Why?

Often because pricing optimization involves deep study and analysis. Also, because sometimes the other growth levers can 'appear' easier to apply when targets are steep and timelines are short. Every entrepreneur at some point feels the urgency to make some quick moves and meet quarterly targets. So, most entrepreneurs take the easy way out. They take a page out of a competitor's pricing, maybe base their pricing on how much customers pay for alternative solutions and move on to other battles.

Pricing strategy becomes even more powerful for the same reasons. For the few who follow through and get it right, it becomes a major differentiator and driver of success.

There is a method to this madness. Determining the pricing includes a few intensive steps coupled with research. This paper (and the next few) will take a dive into the five steps of discovering a successful pricing model.

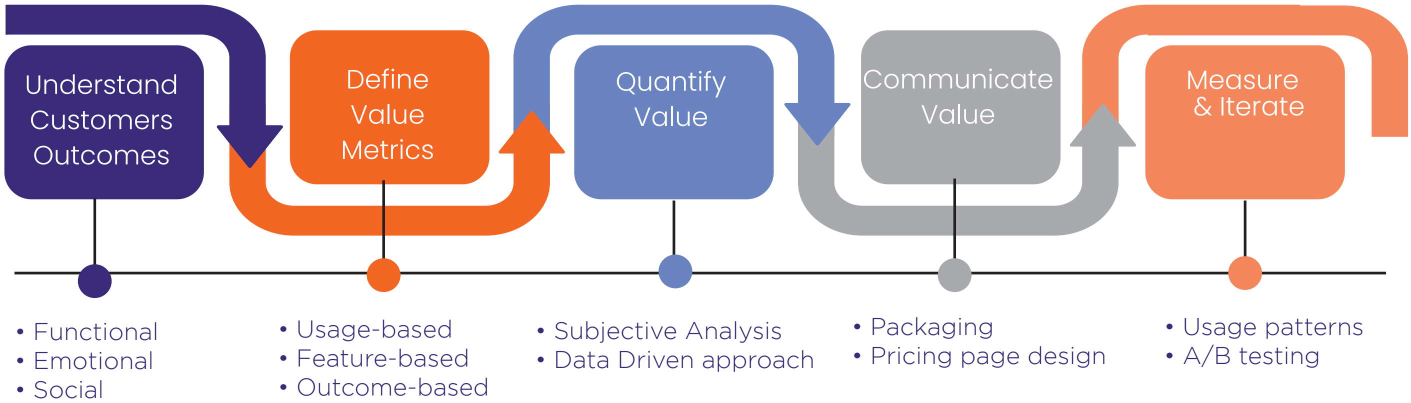
***Saurabh Lahoti***
***Managing Partner,***
***Pentathlon Ventures***

## TL;DR

Life is short, and we know you're busy. Here's a summary of this paper. Read through the rest if you find it worth the time and effort.

The process of determining optimal pricing is really the process of determining the value of your product for customers. Once you get hold of the value metric, customer acquisition and retention naturally follow.

The process of customer development requires an understanding of how the customer thinks about your product. You will also need to focus on the value your product delivers to them along with the monetary value they place on the outcome your product delivers.




**1. Understanding the value of your product:**

The focus is usually on the functional value, which means, what does your product accomplish for the customer? Most **companies ignore the emotional and social value of their product** at this stage.

**2. Defining this value:**

Once the value is understood, the next step is to make it measurable. 'Value metric' is the term used for this measure. Choices from among **'usage-based', 'feature-based', and 'outcome-based' metrics** are studied and metrics are finalized.

**3. Quantifying the value:**

Usage-based metrics link closely to costs and provide the floor for pricing. Putting a dollar value on the features or outcome value defines the ideal pricing because it links directly to functional benefit delivered. Putting a dollar value on the emotional and social values you create helps you define the ceiling, the premium you can charge. **Product-led Growth suggests this value should be 10X of your price** (at least).

**4. Communicating the value to the client:**

Product descriptions, marketing content, and sales content should be aligned with value metrics so that customers can appreciate the product value. **Pricing pages** that are **easy to find**, clear and simple to follow are very important.

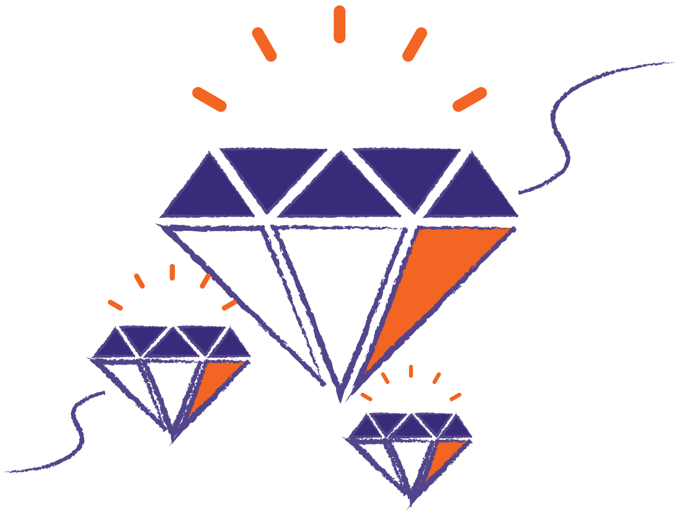
**5. Periodic revaluation of the value:**

The **value metric you chose is not constant.** It needs to be monitored periodically to check the increase or decrease in the real or perceived value of your product.

***The entire process that goes into pricing a SaaS product is labor intensive. However, the gains are asymmetrical.***

# Understanding the value of your product

The big struggle companies face is **'company perception of value' vs 'customer perception of value'**. Founders usually think they know what outcomes their customers expect from the product, but customer research usually reveals differences in the value perception customers have. This is the starting point of the pricing discovery process. An incorrect understanding of the customer will naturally result in an incorrect definition of value, and therefore an incorrect pricing.



> *"Founders have an understandable bias towards their products. The trick, however, is getting into the shoes of the customer."*
>
> ***Shashank Deshpande, Managing Partner, Pentathlon Ventures.***

**Viewing customer value delivery through 3 lenses can help:**

**1 - Functional value:**

Functional value can be seen in terms of the core business outcome that the client wants to accomplish using your product. Functional value is measurable, since it focuses on the results of a task, and often, is the only value companies look at.

**2 - Emotional value:**

How does the client feel once the outcome they want is achieved? Is that feeling part of the outcome they're looking for? Most companies forgo this part of the customer development process, and therefore, fail to understand the overall value of their product. A study by McDonalds showed that many people bought their milkshakes because the thick shake took over an hour to drink through thin straws, which was a great pass-time on the long, boring drive to work! Research can reveal interesting emotional outcomes people seek from your products.

**3 - Social value:**

Do customers seek a boost in their social value from using your product? A manager buying a new software tool might want to appear technologically aware. An employee buying a new reporting tool might want to impress their boss with flashy charts in the next week's reports. Surveying customers can reveal perceptions they want to build about themselves that are tied to using your product.

***When it comes to determining the value of your product, even in the B2B space, feelings and emotions are as important as the outcome delivered by your product.***

## Defining the value that drives your product

**A 'value metric' is the foundation of your pricing strategy**, and the cornerstone of pricing communication such as pricing pages. Make your value measurable, and putting a price on it and communicating it to customers becomes instantly possible. The wrong value metric can derail the entire process. As per Patrick Cambell (CEO of ProfitWell), a good value metric should fulfill three important criteria:

***1) It should be easy to understand, especially by the customer.***
***2) It should be aligned to the value the customer receives from the product.***
***3) It should grow as customers gain more value from your product.***

*"The biggest mistake a founder can make is not analyzing each value metric before finalizing the price."*

***Sandeep Chawda, Managing Partner, Pentathlon Ventures.***

**There are three ways to choose a value metric:**

**Usage-based pricing:**

This method relates to the activity performed with your product. Commonly, this means you charge a per user rate, per X GB of data, per minute of videoconferencing, etc. This method scales as the customer's usage of the product grows. It also minimizes friction as it allows customers to start using the product at low costs. Further, it serves as a clear link between money spent and value gained. Since cloud storage is a major cost component for most SaaS products, this method also helps in standardizing gross margins.

**Feature-based pricing:**

This is a popular pricing strategy, and not just in SaaS. Feature-based pricing is where customers pay for the functionalities they use. If they want more product features, they must upgrade from a basic version to a premium version. Besides encouraging upgrades, this method helps streamline expectations since your customers know exactly what they are paying for. Another advantage is that it helps you allocate resources more efficiently. If certain features of your product are resource-heavy, you can leverage their value by including them in the premium plan.

**Outcome-based pricing (AKA value-based pricing):**

This method focuses on the results clients can achieve with your product and charging based on that. Spend-management software that price based on 'dollars saved', marketing/sales software that price based on leads generated etc. follow this method. Defining value-based pricing metrics means getting as close as possible to customers' ideas of value. It comes as no surprise that companies offering outcome-based pricing experience 40% less churn than companies offering only usage-based pricing, and grow faster than companies offering feature-based pricing.

***It's often not an either-or question. It's important to be aware of all the metrics that can contribute to a final pricing, and to test metrics iteratively to understand which ones work best for your customers.***

# Quantifying the value

With a strong value metric in hand, the next step is quantifying that value - putting a dollar number against each metric.

Many entrepreneurs use competitor pricing as a baseline for their pricing, but this is better suited for commoditized markets where your pricing has to remain within the spectrum of competitor prices. Most start-ups aren't trying to enter crowded spaces as much as disrupt them. Another common mistake is to price based on 'experience and judgement', which isn't very useful when user preferences change as rapidly as they do in today's market.

One useful tool to start with can be the Van Westendrop Price Sensitivity model. This model takes data from actual customer surveys. The survey consists of four questions:

- **What price is too expensive to pay for the product?**
- **What price is too low that will make the client doubt the product quality?**
- **What price is high enough for the client to still consider purchasing the product?**
- **What price represents value for money for the product?**

*"Don't be afraid to charge a premium. SaaS allows discovering the price iteratively based on granular data."*

***Gireendra Kasmalkar, Managing Partner, Pentathlon Ventures.***

The data from this survey is then plotted on a graph, which gives you an 'acceptable' range within which your optimal price must lie.

Taking this range as the limiter, pricing can start stacking up as follows:

**1. The floor :**

Your costs of provisioning for a customer can suggest your minimum price, also known as 'the floor'. This is the minimum price you need to charge to stay afloat. 'Usage-based' metrics defined in the previous step prove useful here. If this price is above or too close to the first question in the Van Westendrop questionnaire, you might need to make a trip back to the drawing board.

**2. The ideal :**

The value your customers put on the functional value they get from your product can help you derive the ideal price. This is the price that customers will be happiest to pay, because it perfectly matches the outcomes they derive from the product. The 'feature-based' and 'outcome-based' metrics you defined in the previous step can help define this number.

**3. The premium :**

The emotional and social value customers derive from using a product, the hardest to quantify, tells you how much more you can charge compared to other products that might deliver the same outcomes. This number could be called 'the ceiling'. Putting a number on this can be an iterative exercise. Conducting a Van Westendrop survey multiple times, stressing on different emotional and social values each time can reveal the degree of difference each factor makes.

Putting all of these together, the ideal price can be derived.

## Communicating the value

Once the value metric is in place and the price is set, it is time to decide how to communicate this to the client. Communication is an important part of the pricing optimization exercise. It reveals some crucial data points:

1) ***How easily a customer is able to understand the pricing model?***
2) ***Does the actual degree of acceptance match the expected degree of acceptance?***
3) ***Did each value metric impact the buying decision as expected?***

Marketing and sales play a vital part in this step. Communication about pricing should be such that a client is able to read, scan, and process the information quickly to make a decision.

Something that many SaaS start-ups still get wrong is the pricing page.

***There are only 3 simple rules to remember about pricing pages:***

1) ***It needs to exist. 'Price on-demand' and 'contact us for pricing' are a sign of a complicated model, undefined metrics, or ambiguous pricing structures.***
2) ***It needs to be easy to find. Don't bury it in the footer.***
3) ***It needs to be simple. Customers should be able to pick which pricing package is right for them within seconds.***

> *"Getting the pricing page wrong is like losing a race by forgetting to cross the finish line."*
>
> **Hemant Joshi, Managing Partner, Pentathlon Ventures.**

A great example of tier pricing is Slack. Slack offers users four different packages, each geared towards a different group of clients. It includes a free trial, a package for small and medium businesses, a large business, and a corporation. Each plan lists the different features available, along with the price mentioned clearly on top.

This logic can be carried forward through all sales and marketing materials. A lot of founders have the wrong idea about 'premium pricing' and think that pricing high automatically conveys high quality or performance. It's the other way around. The functional, emotional, and social value promise needs to come first. Customers need to be educated to appreciate the value you create for them. If they understand and appreciate the value, they will understand and appreciate the price.

## Periodic reevaluation of the value

The market is not static, so pricing optimization cannot be a one-time effort. It is important to continuously review the price as your product grows and evolves. Competitors might enter the scene, forcing you to reevaluate the price. Customer preferences could also change as trends change.

**Some SaaS metrics can be studies before and after a pricing exercise:**

### 1) Churn

This one is obvious. If customer churn reduces, it's easy to tell that clients value the change. It can also help to study change in churn for different customer segments to how the degree to which they appreciate the same value metrics differs.

### 2) Growth in acquisition

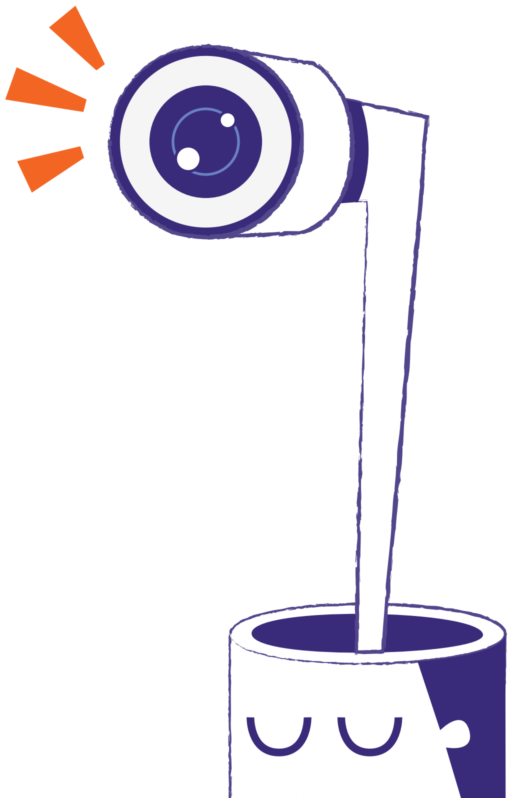
This is equally obvious. If the pricing model gets more customers to sign up, it's a winner. Again, other related metrics like lead velocity in the pipeline and total sales cycle time can also hold useful clues if studies before and after a pricing exercise.

### 3) Revenue efficiency

How much does it cost to acquire a customer now, after the pricing has changed? And how much do we make per customer now, after the change? If the ratio has improved, scalability will improve as well.

***Coupling this study with customer satisfaction surveys and A:B testing pricing models in different customer segments can make the whole process even more powerful.***

> *"The market, your competitors, your customer preferences — none of these ever remain static. Then why should your price?"*
>
> ***Madhukar Bhatia, Managing Partner, Pentathlon Ventures.***



# CONCLUSION

Pricing is not a one-time process. It is a research-intensive process that yields a lot of data. Even in the worst case, the exercise serves to deepen our understanding of the customer and feeds product-led growth efforts by bringing us closer to the customer's idea of 'value'.

A periodic review of the entire strategy ensures that the company is not losing revenue at any point and is keeping up with changing market trends, customer preferences, and competitor moves.

We hope this primer on SaaS pricing has proven helpful. Over the next several months we will dive deeper into individual elements of SaaS pricing. Keep an eye on things by subscribing to the DNA of Scale emailer and checking the Pentathlon blog.

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