Guest

Act, don’t react: Managing inflationary pressures in enterprise software

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We assumed that skyrocketing prices were put to rest decades ago alongside disco fashion and feathered hair. But 2021 saw the U.S. Consumer Price Index climb to 7%. It is an unpleasant reality that inflation is back and shows no signs of abating any time soon.

Continued inflation poses particular risks for business-to-business (B2B) enterprise software developers. Why? Because leaders in high-margin businesses like software are often not as sensitive to margin reductions as those in industries with lower margins. For example, a software business that sees 75% margins fall to 72% will not feel the same impact as a company that drops from 20% to 17%. This is especially true for the increasing number of companies that sell both industrial products and software and it makes understanding costs in today's environment even more critical.

Many software companies operate in ways that obscure creeping cost increases and reduced margins, in part because they rarely track profits and losses (P&L) at the customer level. For example, consider how these businesses typically approach:

Services: Software companies often give away non-contracted services and support in response to customer demands. But those services are not free to provide; they can just appear to be so because they are not actively tracked anywhere.

Research and development (R&D): R&D costs are typically allocated only to the first version of the software. These costs show up in the firm's EBITDA, but not on a non-existent customer P&L. R&D costs of future versions could very well be skyrocketing but hidden from view.

Hosting: Moore's Law states that computing power doubles every 18 to 24 months. But while hosting costs appear to be plummeting at the unit level (from large providers such as AWS and Azure), the newest version of a software product often requires twice as much computing and storage power as the prior version. In most cases, the software company foots the bill for these increased cloud hosting costs.

Inflation is increasing the need for software companies to understand their costs to make sound pricing decisions that will help them protect their margins now and moving forward. While costs are only one input among many that factor into pricing decisions, they are obviously a very important component. To uncover areas of opportunity, software developers should:

Create a customer-level P&L. The customer should be the first unit of measure. Software companies often keep score by measuring the various components of delivery (software, services, maintenance and support) separately. This can cause a tug-of-war for margin as well as suboptimal decision-making. For example, if the services team has a margin target, software licenses may be discounted, reducing long-term customer value. Or services may charge the software team for services consumed at an internal transfer price that includes margin for the services team, obscuring actual costs. In general, software companies should:

Take the time to determine direct costs. Hosting, deployment, service, implementation and support costs are direct costs. But so are program and customer management teams. Software companies should take the time to catalog all costs and scrutinize which are associated with software deployment, delivery and performance.

Stop calculating competing P&Ls. The need to assess service performance and efficiency often drives the practice of separate P&L calculation. It can be acceptable practice to measure and track them to identify areas for improvement, but not for rewards.

Score and manage like this all the time. The cost catalog provides the framework for measurement and improvement at all times, but it is essential to counteract and respond to inflation. Separate P&Ls obscure costs, focus team member attention on internal dynamics rather than the customer and damage overall profitability.

Analyze all P&L line items and catalog which costs have increased over time, especially recently due to inflation. At minimum, doing this will provide a snapshot of the true cost of serving customers, from licenses to services and support. Where trends around increasing costs are found, especially recent ones, there may be opportunities to increase price.

Quantify the value of differentiated software products and services. Not all of a company's software products are differentiated and even some may be only marginally so. Look for products and services that increase revenue for customers or that decrease costs and risk above and beyond what competitors' offerings can do. Too often, software providers fail to recognize or quantify how much their products benefit their customers through risk reduction. *Rising costs, especially around differentiated products, provide a ripe opportunity for price increases.*

Institute policies for sales rep discounting. To facilitate complex, high-value deals, many software companies use a deal desk, a cross-functional team that helps to prevent bottlenecks to close deals quickly. While this seems like a positive practice, it is often achieved by lowering price, sometimes unnecessarily so. The deal desk should provide give-get tradeoffs, so salespeople can be responsive to discount requests while expecting something in exchange (e.g., longer contract terms, more favorable payment schedules, expanded bill of materials, reduction in services, or a reduction training). Give-get tradeoffs enable software companies to meet customers' needs while maintaining pricing integrity .

Even in the face of this unprecedented inflation, increasing prices is easier to talk about than to do. Setting profitable prices in enterprise software requires understanding your economic worth to customers, arming salespeople with give-get tradeoffs acknowledging competitors' strategies and strengths and weaknesses. But make no mistake, understanding how costs are changing and whether, where and how to raise them starts with knowing what your costs are.

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