VMS Market Penetration Strategy

Motivation

One viable growth strategy that has been used successfully outside of CSI is a *market penetration strategy.* The company offers its product at deeply discounted, uneconomic prices, to capture market share. Then, at a later point, prices are raised to a more profitable level. If the product has sufficiently large switching costs, the lifetime value of the customer will be sufficiently high to earn a good return on the initial investment required to acquire the customer.

The initial discounted pricing will generally result in significant losses to the company. The role of VMS is to provide funding for these initial losses, significantly reducing the risk to the operating groups.

Examples

Market penetration pricing is a common pricing strategy in many industries and with many types of products. Netflix is one of the best known examples, where initial cheap pricing, leading to large losses, has been gradually (and recently not so gradually) raised to improve profitably. Prices which were once $8/month for their only offering are now at $20/month for the premium plan.

Penetration pricing is often used in B-to-B industries when there are a large number of small customers. One example is Mindbody in the fitness and leisure space. They incurred huge losses of over $15 million/year over several years acquiring new customers. However, once they had captured a customer, they were consistently able to capture increasing amounts of revenue from that customer. Average revenue per subscriber went from $141 in 2013 to $293 in 2018, when they were bought by Vista.

VMS Venture's Criteria for a "Penetration Pricing" Candidate

- This strategy is intended for an existing business, or part of an existing business. The existing product should have at least $1 million in annual revenues.
- The company must sell in a vertical market where there is the possibility of dramatically increasing market share in a short period of time. Generally, such a market will have:
    - A large number of relatively small customers.
    - Many software purchasing decisions each year.
- The company's product must have high (and ideally increasing) switching costs. The market penetration strategy will not work if customers simply switch to a competitor once prices are raised.

Deal Structure

The exact deal structure is negotiable, and the specifics of the BU and portfolio involved. However, in most cases:

- The company will be setup as a separate legal entity. The shareholders will be the sponsoring operating group, the VMS Fund and the management team of the new entity.

    - We expect that CSI and the operating group will usually retain a majority position in the new entity.
- The operating group will have the option to invest their own capital for a higher equity stake, if they wish.
- In most cases, the new entity will be set-up as a partnership, allowing its tax losses to be passed on to the sponsoring operating group.

Have any questions or possible candidates for this strategy? Please reach out to karl.schabas@vmsfund.com.