

WHITE PAPER

THE IMPACT OF SOFTWARE PIRACY AND LICENSE MISUSE ON THE CHANNEL

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Note: the term piracy here refers to the use of all forms of unlicensed software, from counterfeit software and software downloaded over the Internet to software installed using a volume license beyond what is allowed by that license. Piracy may be deliberate or inadvertent.

EXECUTIVE SUMMARY

"When we find pirated software – ours or the OEM – we cease work until the client purchases the appropriate licenses."

-- Microsoft Certified Partner, USA

The losses to software vendors from piracy and license misuse are well documented in the annual Business Software Alliance (BSA) study of global PC software piracy.¹

What has *never* been documented is the effect they have on all the other companies in the software ecosystems – resellers, VARs, system integrators, service firms, and other ISVs.

This study does just that, building on IDC projects studying the benefits of lowering piracy for local economies and on the impact of the Microsoft ecosystem on those same economies.

The study finds:

- ❑ For every dollar Microsoft realizes from lower software piracy in 2008, other companies in the software ecosystem will realize, in aggregate, \$5.50.
- ❑ This \$5.50 comes from two sources: \$4.37 in increased revenues, \$1.13 in lower costs.
- ❑ The largest portions of the potential revenue increase come from faster sales cycles (31%) and faster product and service delivery (40%); the largest portion of the cost savings comes from lowering the cost of service (64%).

- ❑ Benefits by partner type in relation to each dollar Microsoft realizes from lower software piracy in 2008 range from \$0.54 for logistics oriented partners, such as distributors, to \$1.62 for product oriented partners, such as ISVs.
- ❑ Because a significant portion of unlicensed software is out of compliance inadvertently, an additional opportunity exists to offer customers products and services relating to license and software asset management.

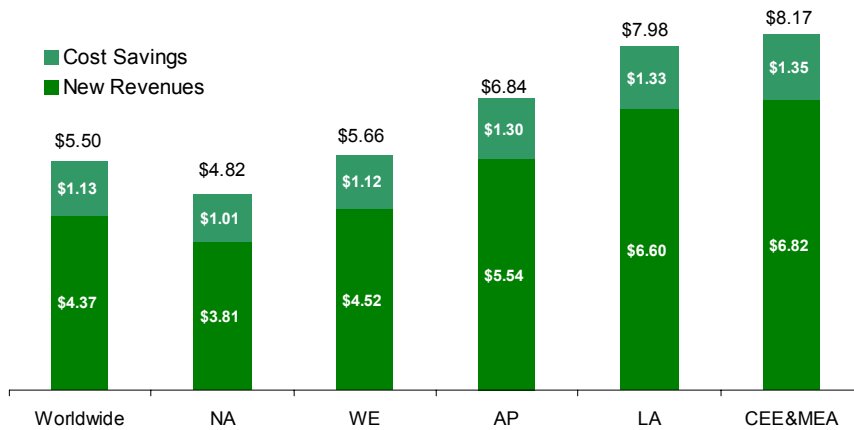
Figure 1 shows the benefits by region.

FIGURE 1

ECOSYSTEM BENEFITS OF LOWER PIRACY

Increased Revenues and Cost Savings in 2008

Aggregate Ecosystem Benefits per \$1 of Lower Software Piracy



Source: IDC Partner Piracy Impact Study, 2008

COMING FACE TO FACE WITH PIRACY

"Even though we focus on enterprise class software, we see a lot of piracy, and it is a big problem. Mostly it is compliance issues rather than outright piracy. And although we see more of this internationally than in the U.S., the U.S. is still a problem."

-- Microsoft Certified Partner, USA

Ecosystem members run into piracy and license misuse every day in at least two ways:

- ❑ They find it in their customer base when deploying new solutions or services.
- ❑ They find it in competition with companies that bundle or otherwise incorporate pirated software into their own solutions, sometimes without customer knowledge.

The unlicensed software gets into customer environments a number of ways, from counterfeiting and Internet downloading to volume license misuse or local purchases of low cost software that seems legitimate but isn't.

In the handful of interviews conducted with ecosystem players for this White Paper, we didn't find any partners who hadn't encountered unlicensed software. And although there may be other partners out there who don't *realize* they have encountered it, it would be the rare partner that wasn't, knowingly or not, affected by piracy and license misuse.

We also discovered that customers violated the terms of a license or used pirated software for a variety of reasons – not always out of the desire to get something for nothing.

Why Customers Pirate

In interviews with software ecosystem members for this White Paper we learned that a customer's decision to use pirated or unlicensed software – if, in fact, the customer knew it was doing so – could come about for a number of reasons:

- As a deliberate attempt to save money
- The pirated software came bundled with the hardware
- Cash flow issues – “the customer has the money, just not today”
- Procurement policies that burden IT staff – who then use demo products to solve immediate IT needs
- Company operations that grow faster than procurement increases legitimate licenses
- An initial solution that has pirated software bundled into it, and when the company goes to upgrade it can't afford the sudden cost to become legal
- A master license agreement that is negotiated elsewhere in the company than where the software is used – confusion between implementers and procurement
- Easily available demo or trial software that ends up deployed as production software; the vendor may never follow up
- Vendor licensing programs that are too complex; users just give up

For many companies, getting “out of compliance” in software licensing occurs over time – which means that getting back *into* compliance can entail a one time financial hit. This creates a challenge for those wanting to be in compliance. Sometimes that challenge is insurmountable.

HIDDEN COSTS, HIDDEN OPPORTUNITIES

"When we run across pirated software in a client, we have to walk away from the deal."

-- Microsoft Certified Partner, Brazil

For ecosystem partners, piracy and license misuse create a hidden tax on operations, one that's not easy to see but that takes a toll anyway. This tax comes in the form of:

- Competition from low cost competitors using pirated or unlicensed software
- Limitations creating a better customer experience via more advanced product features in accounts running pirated software

- ❑ Limitations on the opportunity to up-sell or cross-sell additional products or services in accounts running pirated software
- ❑ Lost opportunity for services revenues in accounts running pirated software
- ❑ Longer sales cycles and project delays when piracy is discovered
- ❑ Time and effort wasted in disputes between clients and software vendors

At the same time, software piracy and license misuse offer opportunity as well. For instance, a lot of license misuse is inadvertent, and savvy firms in the software ecosystem have developed lines of business helping customers "true-up" their software licenses and install more sophisticated software asset management programs.

If the BSA is right and the value of just PC software that was pirated in 2007 was close to \$50 billion worldwide, then the value of *all* software pirated in 2008 could be as high as \$100 billion – bigger than the software market for all of Europe. Drop the piracy rate a few percentage points, and billions would move to the industry's bottom line.

PARTNER ECONOMICS AND OPPORTUNITY

"When we released a new version of our software we found many unlicensed versions of the old software. The client was going to uninstall all our software rather than admit to piracy. To help the client we created a custom install license to help them save face, after which they invested more in us and we kept a customer happy."

-- Microsoft Certified Partner, USA and Europe

"We have made an opportunity of mis-licensing, using it as an "in" to see customers. We have been able to win long term clients by helping them remain compliant."

-- Microsoft Certified Partner, South Africa

As the quotes indicate, ecosystem players often find ways to turn adversity – piracy and license misuse in the customer base – into opportunity. The opportunity can come from new sales or services and in more intangible ways, such as increased customer loyalty.

But how *much* opportunity could there be?

By using the same models developed for the BSA and Microsoft projects mentioned in the executive summary, IDC was able to come up with a relative estimate:

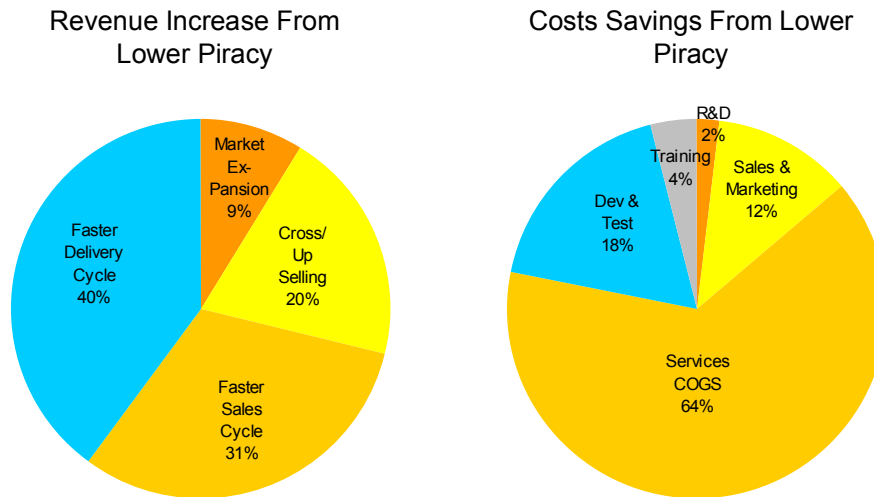
- ❑ For every dollar that Microsoft gains in 2008 from lower piracy of its products, the ecosystem that sells, services, and develops products that run with or on that software, will gain \$4.37.
- ❑ For every dollar of software gained from lower piracy or license misuse in 2008, the ecosystem will save \$1.13.

To come up with these benefits IDC first analyzed the size of the Microsoft ecosystem, then the potential for increased revenues by IT category – hardware, software, services – compared to increased Microsoft revenues. Finally we allocated them by cause, as shown in Figure 2.

Cost savings were developed using estimates of costs as a percent of revenue, and estimating the extent costs associated with incremental revenue dollars would differ from costs associated with overall revenues.

FIGURE 2

WHERE THE BENEFITS COME FROM



Source: IDC Partner Piracy Impact Study, 2008

The basic assumptions on revenue enhancement and cost savings came from our research on partner profitability (see *Bibliography*). From this research we know that the keys to software ecosystem profitability come from three sources:

- ❑ *Business velocity*: bookings per sales person, project revenues, and deals per month
- ❑ *Service fulfillment*: capacity utilization, daily billing rate
- ❑ *Deal execution*: average size, months to make a sale, months to implement a project

Running into software piracy in the client base can affect each of these. Interruption to the sales process by the discovery of pirated software – which can take time to legitimize – slows business velocity. The discovery of piracy can halt solution deployment – which then lowers average capacity utilization and billing rate.

In interviews conducted for this White Paper, some partners told us they have to walk away from projects when they discover pirated software – which obviously affects deal completion stats and the average time to make a sale.

For a more detailed description of how we applied these assumptions and derived revenue benefits and costs, see *Methodology*.

BENEFITS BY PARTNER TYPE

"When customers are found to be non compliant, it creates an opportunity for us to go in and sell our software. Any lead is a good lead."

-- Microsoft Certified Partner, USA

The benefits we have been discussing still seems somewhat abstract. How do they translate to the average ecosystem player – to distributors, small ISVs, VARs, consultants and service firms?

Using IDC's classification of players in the software ecosystem by business model (see *Methodology*), we allocated benefits by partner type. By these partner types benefits vary considerably.

Software ISVs, who are, themselves, candidates for piracy or license misuse, will have more at stake in lowering piracy than hardware OEMs. Labor intensive service firms who have their delivery cycles elongated by the discovery of pirated software at customer sites will feel more pain than retailers with little service content in their product lines.

Figure 3 shows dollars of revenues gained by each partner type for every dollar that Microsoft gains from lower piracy along with the cost savings for every new dollar from lower piracy.

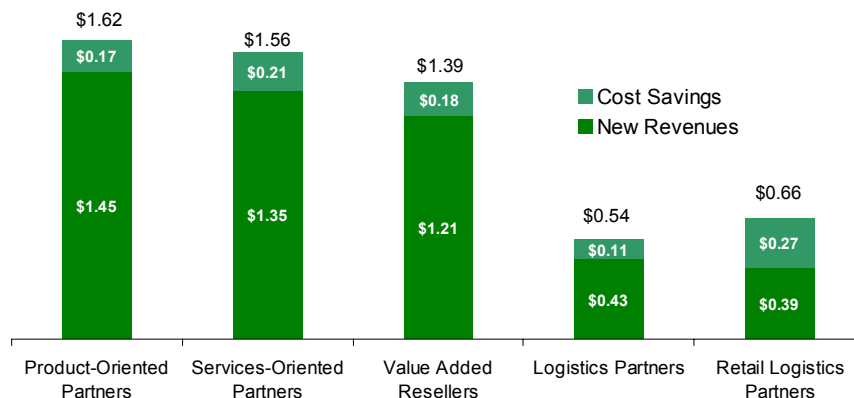
(Since the partners form a value chain from the software developer to the customer – distributors selling products to VARs who sell to customers – the sum of the gains shown for each partner type is larger than that tallied for the ecosystem as a whole in Figure 1.)

FIGURE 3

ECOSYSTEM BENEFITS FROM LOWER PIRACY BY PARTNER TYPE

Revenues and Cost Savings in 2008

Benefits by Category per \$1 of Lower Software Piracy



Source: IDC Partner Piracy Impact Study, 2008

Benefits to partners vary widely by region, in part because piracy varies by region but also because channel dynamics differ.

Table 1 below shows the combined partner-level benefits – increased revenues and lower costs – by region.

TABLE 1

ECOSYSTEM BENEFITS FROM LOWER PIRACY BY REGION BY PARTNER TYPE

Revenues and Savings Combined per Dollar of Piracy Lowered in 2008

Region	Partner Type (Not Mutually Exclusive)					Ecosystem Total*
	Product Oriented	Services Oriented	Value Added	Logistics Oriented	Retail Logistics	
North America	\$1.24	\$1.50	\$1.29	\$0.58	\$0.50	\$4.83
Western Europe	\$1.44	\$1.87	\$1.50	\$0.69	\$0.51	\$5.64
Asia Pacific	\$1.89	\$2.19	\$1.77	\$0.88	\$0.63	\$6.84
Latin America	\$2.28	\$2.47	\$2.04	\$1.03	\$0.74	\$7.93
CEE and MEA	\$2.51	\$2.48	\$2.11	\$1.07	\$0.66	\$8.17
Worldwide	\$1.62	\$1.55	\$1.39	\$0.54	\$0.66	\$5.23

* Double count removed. Double counting occurs between distributors and vendors, and within distribution between resellers and distributors

Source: IDC Partner Piracy Impact Study, 2008

PARTNER STRATEGIES

"We have an open licensing agreement, an honor system. But customers who sign our master agreement also have to agree to be audited, which we do on a random basis."

-- Microsoft Certified Partner, USA

"We have a formal strategy to offer consulting on how to be compliant and to sell asset management services. We have tools and services to help clients monitor usage."

-- Microsoft Certified Partner, USA

Just as there are many ways that pirated and unlicensed software enters the market, ecosystem players have many strategies to deal with it. Some examples from the interviews we conducted for this White Paper:

- ❑ Identifying non-compliant software – as a service or in the process of deployment of a solution – and providing not just notification to the customer, but services to help the customer get back into compliance

- ❑ When encountering non-compliant software, acting as a needed middleman between the customer and the software publisher
- ❑ Working with the software publisher to develop "amnesty" programs to help customers get compliant without breaking them financially
- ❑ Bundling compliant software in with services, essentially covering the license costs with the service fee
- ❑ Requiring customers to agree to random audits as part of the master license agreement and then systematically auditing a subset of the base each month
- ❑ Offering asset management and compliance tools for willing customers
- ❑ Working with the BSA and local associations on education and anti-piracy campaigns
- ❑ Building hooks in their own products to identify non-compliant copies of their own software in an installation

For the most part, the strategies tend to work from the customer outward – first help the customer become aware of the problem in his own organization, then make it as easy as possible for the customer to become compliant. Be the customer's advocate with the software publisher, if necessary.

No one expects to eradicate piracy or license misuse. But ecosystem players can help their customers understand the value of using compliant software and, along the way, increase revenues and lower costs for themselves.

When Customers Get Caught

In quantifying the benefits of lower software piracy, we have *excluded* any quantification of risk. Too many complex assumptions would be involved.

But one of the risks to members of the software ecosystem is the impact of a customer being audited by the authorities, usually the BSA or a local association in cooperation with local law enforcement.

In surveys IDC conducted around the world on deterrents to software piracy several years ago, IDC found that the greatest deterrent was the risk of being audited – at least among enterprises who had been through an audit once.

The greatest pain from an audit wasn't necessarily the cost of legitimate software or fines a company might have to pay for non compliant software – but the disruption to the business during the audit process. Generally each workstation needs to be shut down, a software audit package installed, and the workstation given time to run – which takes it out of productive service. Ouch.

The second greatest pain for the offending enterprise is the loss of "face," or damage to the company's reputation.

A CALL TO ACTION

"We fight piracy in the streets. We work with associations and law enforcement to arrest people selling pirated software. We also help with education programs and anti-piracy marketing campaigns."

-- Microsoft Certified Partner, Brazil

For ecosystem players encountering software piracy or license misuse, there are some concrete steps that can be taken. Reviewing our data and the input from the partners we interviewed, we recommend:

- Changing an informal policy to a formal one if you haven't already – this means all employees will be working off the same policy
- Create and promulgate an articulation of the benefits for clients to use compliant software
- Invest in tools to help customer identify non-compliance and to better manage software assets
- Work with your vendors to provide input on confusing or counterproductive licensing policies; help negotiate compliance terms for your customers
- Work with trade associations on market education, outreach, and enforcement

Finally, it might be wise to investigate within your own company the disruptions, slowed selling efforts, deployment glitches, and services delays you have experienced. Studying this may be the first step toward obtaining the revenue and costs benefits from helping the industry lower piracy.

METHODOLOGY

Background

This study analyses the impact of lowering software piracy on the ecosystem of companies that sell products and services that run on or with Microsoft platforms, that resell or distribute Microsoft products or other ecosystem products and services, or that support and maintain such products.

The study builds on two other important studies: (1) *The Economic Impact of IT, Software, and the Microsoft Ecosystem on the Global Economy* conducted for Microsoft, released in October 2007 and updated in May 2008, and (2) *The Impact of Lowering Software Piracy on Local Economies* released in January 2008 by the Business Software Alliance (BSA). These are referred to below as the *Economic Impact Study* and the *Piracy Impact Study*.

The analysis proceeded in the following steps:

- ❑ Sizing the Microsoft ecosystem, which starts by assembling IDC published market forecasts for IT spending in 2008 by category, and then allocating a portion of that spending to the Microsoft ecosystem, based on published IDC reports on the percent of software and hardware products running on or with Microsoft software. This was an exercise conducted as part of IDC's *Economic Impact Study*.
- ❑ Determining the benefits to each portion of the Microsoft ecosystem if software piracy is lowered. This exercise relies on algorithms developed by IDC in its *Piracy Impact Study* on the ratio of new revenue available (or not) to hardware and software companies, channel firms, and services firms for every dollar of new software revenues resulting from lower piracy.
- ❑ Determining the cost impact from lower piracy by assigning standard costs – for R&D, sales and marketing, development, support, cost-of-goods sold (COGS), etc. – to each ecosystem category and then estimating cost savings on new revenues coming from lower piracy. These estimates were developed with the help of IDC research on key performance indicators (KPIs) and channel profitability developed in past research projects for Microsoft (see *Bibliography*).
- ❑ Assigning the benefits by partner category, which relies on IDC published research on the percent of business mix (e.g., selling own software, distributing hardware, supporting supplier software, etc.) by partner type.

To validate assumptions used in the model that generated the benefit and costs saving figures, we conducted a handful of personal interviews with a mix of knowledgeable Microsoft Certified Partners early in 2008.

Definitions

Microsoft Ecosystem – the companies that derive revenue from selling or distributing products or services that run on or with Microsoft platforms, or from selling and supporting Microsoft software itself

Partners – companies that make up the Microsoft ecosystem. By the term "partner" IDC does *not* mean only companies that are registered or certified in one of Microsoft's many partner programs. All that is required is to be in the ecosystem.

Piracy – unauthorized copying, reproduction, usage, or manufacturing of packaged software. Piracy can run the gamut from unauthorized copying or downloading of software or purchasing software copied illegally, to corporate misuse of volume licenses (deploying more software than paid for).

Piracy Impact – the study calculated different effects from piracy on software, services, and channel revenues and costs. In the case of software creation, we used a linear relationship between a falling piracy rate and growing software spending. For software-related *hardware*, *services*, and *channels* benefits, we assumed that these firms could still obtain some revenues on pirated software. The algorithms tying their benefits to lower software piracy were taken from the IDC *Piracy Impact Study*.

The ratio of new revenues from lower piracy to existing revenues varies by category, with the most direct impact on software companies whose own software is no longer pirated. Reselling firms may have less benefit, as there is a cost to obtaining the legitimate software they now distribute that they might not have had distributing pirated software. For the purposes of developing a meaningful ratio of new revenues to lower piracy, IDC compared the ecosystem new revenues to Microsoft's new revenues if piracy of Microsoft products is lowered. These revenues were then allocated to partner type, based on the make-up of the business model (e.g., 60% product, 20% resale, 20% service).

Revenue and cost categories – these were used in the initial calculation of new revenues and lower costs, and include: hardware sales, software sales, services sales, and hardware distribution, software distribution, and services distribution. The hardware, software, and services spending map to IDC's published numbers for 2008 in IDC's report #212290, "Worldwide IT Spending Forecast, 2007-2012," May 2008. The distribution revenues are derived using estimates of the portion of Microsoft and related software that goes through distribution.

Revenue benefit categories – these were estimated by each of the categories mentioned above by IDC analysts. Percentages varied based on business model of the categories. Assumptions were validated by personal interviews with Microsoft Certified Partners and were cross checked with IDC research on partner profitability (see *Bibliography*).

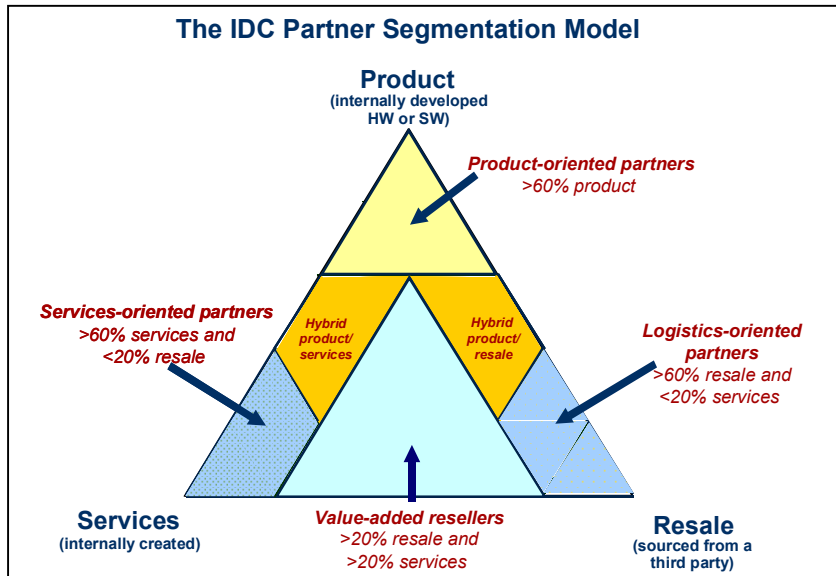
Cost Categories – the expense categories that are used to develop the partner cost benefits, include R&D, product development, product test and integration, sales, marketing, general and administrative, cost of goods sold (raw materials and labor), and training. For each of the six revenue categories mentioned above, a separate cost profile was developed for expenses related to the revenues. E.g., X% of revenues on sales, Y% on R&D, Z% on training. Expenses were taken as a pro forma 95% of revenues. These expenses were then allocated to partner type, based on the make-up of the business model (e.g., 60% product, 20% resale, 20% service).

Partner categories

IDC breaks the ecosystem down in a number of ways – e.g., by software market, agreement type, or customer focus – but the most common way is by business model.

What distinguishes one category from another, when separated this way, is the degree to which the category focuses on creating products, offering services, or reselling the products and services of others.

See the diagram that follows.



The IDC segments covered in this White Paper are:

- ❑ *Services-oriented partners* who derive 60% or more of their revenue from the delivery of internally created services, less than 20% from the resale of third-party products. These include systems integrators and consultants.
- ❑ *Product-oriented partners* who derive 60% or more of their revenue from the sale of internally created products. These may be independent software vendors (ISVs), communications solution vendors, hardware vendors (ranging from major system vendors to white-box assemblers), or other types of technology solution vendors.
- ❑ *Value-added resellers (VARs)* who provide turnkey solutions that bundle hardware, software, and services. They derive 20% or more of their revenue from product resale and 20% or more from internally created services.
- ❑ *Logistics-oriented resellers* who focus on improving the process and reducing the cost of buying third-party products. And derive 60% or more of their revenue from the resale of third-party products and less than 20% from the delivery of internally created services
- ❑ *Retail logistics resellers* who are a subset of the logistics-oriented category.

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<http://w3.bsa.org/globalstudy/>. The study is conducted by IDC.