IDC Analyze the Future

WHITE PAPER

New Generation Software Providers

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INTRODUCTION

This paper has a simple objective. That is to encourage independent software vendors (ISVs) and systems integrators (SIs) to investigate adopting a business model based on providing software as a service (SaaS) rather than software as a product. It will encourage these companies to examine their own position in establishing competitive advantage from the emerging potential of the SaaS business model.

The paper will also look at the reasons behind the market potential, which is being driven by the loosely defined concept of Web 2.0 where profound changes are materialising in the way that human interaction takes place, be that interaction at a social or commercial level. From a commercial perspective, these changes are most obviously displayed by the growth in online marketing and the business demands that such marketing requires in terms of technical infrastructure, community development, networks and supply chains.

To support its arguments, the paper will put forward case studies of two companies (Conchango and NitroSell) that have successfully moved, or are in the process of moving, all or part of their business over to an SaaS-based model, leveraging some of the more business-related aspects of Web 2.0 concepts.

EXECUTIVE SUMMARY

As a go-to-market business model, SaaS is already well established and IDC forecasts that its use will grow significantly over the next four years. This very rapid growth is being driven by a combination of strong end-user demand and software provider competitive positioning.

The logic behind end-user demand is very solid, based, as it is, on a requirement for a software purchaser to see clearly the relationship between the total cost of software and the benefit that accrues to the purchaser. The simple fact is that SaaS achieves far more transparency in associating cost with benefit than traditional software go-to-market models, which is exactly what the end-user community is looking for.

In addition, the major software providers are now accelerating market adoption of SaaS by increasingly bringing SaaS-based offerings to market. This move by the larger players will demand action from their smaller competitors, thereby fuelling SaaS expansion.

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It is true that a small number of UK software providers will see little additional benefit from adopting a SaaS-based business model. For instance, providers with a niche customer base whose users have very restricted, or no, access to the Internet would rather obviously have difficulty using SaaS. However, for the large majority of software providers, SaaS really should be considered as part of their overall portfolio of offerings if they wish to improve their competitive positioning and defend their customer base against competitive threat.

There is little doubt that we are seeing a fundamental shift in the way that software is acquired and used. As a consequence, it is IDC's strong recommendation that every software provider should examine the effect of this shift on their traditional business and how they should respond to the new reality of software purchasing.

The adoption of SaaS, even as an additional, standalone business unit, will open up new revenue opportunities and improve competitive advantage for a software provider. IDC believes that the competitive risk of "doing nothing" will be high, with that risk increasing over time.

WHAT ARE WEB 2.0 AND SAAS?

There is still an interesting debate taking place with regard to the true definition of Web 2.0. This paper will not enter this debate, but in true Web 2.0 spirit, would refer the reader to a comprehensive definition given in Wikipedia at http://en.wikipedia.org/wiki/Web_2#Characteristics_of_Web_2.0. This definition also provides many hyperlinks to definitions of important contributory factors such as the Long Tail effect. For the Web 2.0 ramifications for an ISV's/SI's possible target market, then this paper would refer the reader to http://www.changethis.com/25.05.Web2.0 which provides a good summary of Web 2.0 strategies and lessons for commercial organisations.

The effect of Web 2.0 will depend heavily on the view of an individual person or organisation, but for the typical business customer of an ISV or SI, Web 2.0 will imply the following challenges for software providers no matter how large or how small the business customer is:

- Web-based access to software, providing a central, global access point
- Software that is, or can be, personalised for use by an individual person or organisation
- Tools and applications that are both deeper and richer in terms of their functionality, but which have a simple user interface
- Capabilities that seamlessly pull together all existing and potential systems, information sources and channels within an organisation into a single whole
- Tools and applications that enable full interaction and collaboration by individuals

It is interesting to note that these are some of the drivers being used by the management teams at Conchango and NitroSell to guide their SaaS development work.

These basic software tenets can by applied to a wide variety of software tools and applications and offer wide scope to a software provider to leverage their existing intellectual property (IP) within the context of Web 2.0.

Unlike Web 2.0, SaaS can be considered to be a relatively simple concept. However, the effects of its adoption on a software provider can be broad in scope and deep in consequence. The immediate impact of SaaS thought of by many software providers is that there is usually a change to the traditional perpetual software license model. SaaS business models typically (but not always) look to a subscription system, where a monthly charge is made for the use of software by a user or multiple users. A typical example of this is the charging system used by Salesforce.com.

However, SaaS is actually a model of software delivery rather than a charging mechanism, where the ISV or SI provides network-based access, maintenance, daily technical operation and support for the software provided to the customer. Formally, IDC defines the key characteristics of software delivered by SaaS as being:

- Network-based access to, and management of, commercially available (i.e., not custom) software

- Activities that are managed from central locations rather than at each customer's site, enabling customers to access applications remotely via the Web

- Application delivery that typically is closer to a one-to-many model (single instance, multi-tenant architecture) than to a one-to-one model, including architecture, pricing, partnering and management characteristics

The effects of SaaS adoption on a software provider are discussed later in this paper. The discussion covers, in particular, the issues of software delivery vehicle logistics and the cash flow effect of transition to an SaaS-based business model.

MARKET CONDITIONS AND OPPORTUNITIES

IDC forecasts that worldwide SaaS spending will effectively double from $5.5 billion in 2005 to just under $11 billion in 2009. (This 20% compound growth is highly likely to be experienced in the UK market). So SaaS is already a large market and its very fast growth appears to be unrestrained. For comparison, IDC forecasts that all worldwide software sales will expand at a rate of 8% per annum compound over the next five years.

Such a high relative growth is being encouraged by four primary drivers among end-user organisations of all sizes:

- There is an increasing feeling among software purchasers that the cost of software is disproportionate to the value that it creates.
- There is intense pressure to reduce the cost of acquiring and, especially, administering software. Software purchasers need to validate and demonstrate the value received out of every pound spent.
- Organisations are striving to reduce risk and to establish a far more tangible relationship between benefit and cost. Reduction of risk is now a key issue in software purchases, which in turn demands far greater predictability of software management costs.
- There is now a widely held view that the value of software is no longer determined by features and functions, but by the customer interaction and experience with the product.

All of the above encourage an environment where SaaS can thrive through the combination of:

- Relieving the customer of the risk of managing and providing access to software;
- Providing a predictable cost structure for the provision of a known set of benefits;
- Providing a direct link between monthly cost and monthly benefit and limiting the liability of the organisation if predicted benefits are not accrued.

To a large extent, enterprises are now displaying many of the concerns that have always been expressed by much smaller organisations that do not have extensive IT departments and that have limited cash resources. The small to medium business (SMB) community, in particular, has always been restrained by the risk of the financial commitment associated with a traditional software purchase combined with the increased liability of having to support and manage that software once it has been purchased.

So end-user drivers are very supportive to the expansion of SaaS when compared with traditional means of software acquisition, but what does this really mean to a software provider? Like any market, the situation will simply revert to the standard competitive model, where vendors that respond to well-defined market demands will gain competitive advantage over those that do not respond to those demands.

However, SaaS is not a panacea that will ensure the success of all software providers. IDC believes SaaS will follow the same trend as the overall software market, with certain types of SaaS applications being more readily adopted than others. Although not an exhaustive list, IDC sees particular SaaS-based opportunities in the following areas:

- Digital marketplace infrastructure platforms
- Products that address the Long Tail through the creation of a "lite" version, advertising-supported, or hosted product or service
- Security software for wireless access, for transactions, for compliance, and for collaborative tools
- Interactive applications to improve access. Vertical or task-specific applications for customer support, question answering, or transaction management to make these interactions more humanlike
- Ad hoc querying, monitoring, and mining tools that understand interactions and recommend actions to improve problems in interaction or transaction processes
- Caching and backup software that make it easy for users to work offline and to back up and synchronize multiple devices.
- Integration tools for both data and applications.

The other increasingly important opportunity that SaaS offers to software provides of all shades is the ability to address a target market that stretches from enterprises to SMBs. In particular, the facilities that the Web 2.0-based digital marketplace brings to the SMB community are empowering such companies to compete in a way that they have been unable to do before. All of a sudden they don't need the scale of an enterprise to compete very effectively against competition in their particular niche, no matter how large that competition is.

However, they do need the ability to, for instance, establish an ecommerce or Web store capability, but they typically do not have the cash or the internal skills and resources to develop and then operate one themselves. This newly emerging demand for software and services creates an opportunity for ISVs and SIs that would normally regard enterprises as their "natural home", to extend their scope into both the midmarket and the SMB market.

As most software providers typically target one part of the enterprise to SMB spectrum, a very large number of successful providers will have the ability to open up a totally new source of revenue via an SaaS-based business model. From a business point of view this new revenue source (plus its associated cost structure) can be ring-fenced as an independent business unit and its financial success or failure judged without directly affecting the provider's traditional business. If necessary, this positioning can be put into effect through adopting a partnership-based business model rather than relying on internal skills and resources to implement the new market penetration.

In summary, the SaaS-based market opportunity opening up for ISVs and SIs over the next few years is very significant and very compelling. The opportunities on offer are also spread across a broad spectrum of application/tool sectors and end-user organisation size sectors, thereby offering the market opportunity to a large proportion of the UK community of software providers. There is little doubt that we are seeing a fundamental shift in the way that software is acquired and used, and successful software providers will respond to this market shift.

HOW CAN MARKET OPPORTUNITIES BE COMMERCIALISED?

Although the market opportunities are great and the competitive risk of not responding to the growing market demand is significant, the required changes needed to move to an SaaS business model can be daunting for some. These changes relate to both the mind-set of the vendor's staff and to the operational activities necessary to implement an SaaS-based business model.

Although daunting for some, in reality the changes are not as onerous as might appear at first sight. For most software providers, the tasks will simply require a willingness to change combined with good management, planning, execution and the ability to partner effectively.

However, at the very least, a software provider will have to consider changes to its:

- Cash flow
- Software delivery vehicle (Web-based infrastructure)
- Pricing
- Marketing
- Sales structure, skills, processes and commission plan
- Customer support, training and additional consultancy-based services
- Customer relationship management and sales force automation systems and processes
- Renewals
- The order-to-cash logistics process

To address each of these challenges in detail is beyond the scope of this paper, but for a software provider that continues to target its traditional market (enterprises for instance), the major changes to consider will be reduced primarily to the first two in the list above. Having said this, changes will still need to be made to the others. With regard to these two:

- Cash, and to a lesser extent, revenue recognition will be a major issue for many providers, especially smaller ones. The cash effect of moving completely from a perpetual license model to a subscription-based SaaS model can be significant. This is particularly the case if the provider is used to a regular stream of small to medium-sized deals with the occasional larger deal. This situation will produce a steady "up front" cash inflow that funds the "down stream" costs associated with support, ongoing development and maintenance. Rather obviously, subscription-based SaaS is not like this, with cash inflow being spread over the length of the contract agreed with the customer.

- Equally, establishing the delivery vehicle for the provider's software is an operational task that few ISVs and SIs are geared up to address successfully without undue hardship and cost. Although some providers are prepared to accept the challenge using the internal resources of the company, for the most part this challenge is a real issue without external assistance.

As with any market, as soon as a demand is established, suppliers emerge to fulfil the demand. The Web-based delivery vehicle is an example where Web hosting has been around for many years, and there are now many hosting companies that specialise in the particular requirements demanded by an SaaS provider. A simple Web search will identify many reputable companies with which a software provider can partner to provide it with the necessary SaaS capabilities. For a Microsoft Partner, probably a good place to start is with Microsoft itself, which has recently launched a specialist hosting service for SaaS providers. (See http://www.microsoft.com/serviceproviders/solutions/applicationhosting.mspx).

The cash effect of making a complete transition to subscription charging is a "tougher nut to crack" and partial or limited transition to SaaS might well be the best way forward for suppliers that do not wish to use external assistance to address this problem. Those that are happy to partner externally might care to discuss the matter with their existing financial partners or look to well-established cash providers, such as venture capital or factoring companies, for the necessary working capital.

However, there is a new breed of financial services company emerging that is addressing the problem directly. These offer services that directly address the "cash hit" that software suppliers can suffer when making the transition to SaaS and in doing so ensure that the supplier receives the vast proportion of the value of the SaaS contract immediately. Probably the best known of these in the UK is a company called smartfundit.com (http://www.smartfundit.com/), which is a subsidiary of the established CCL organisation that specialises in IT leasing. In short, the company acts as a consolidator for finance organisations dealing in the high tech market, where those organisations compete to finance the end-user business on offer. In acting as a consolidator of capabilities, smartfundit.com is responding to demands from the end-user market for them to be able to purchase SaaS, while responding to demands from SaaS providers to regularise their cash flows to a more traditional model. Companies like this are also acting as consolidators for advisors and other service providers specifically addressing the demands of transitioning software providers, such as the more complex logistics associated with the "bill and collect" aspect of the SaaS business model.

In summary, the commercialisation of market opportunities presented by a SaaS-based business model is not simplistic, but needs not be as daunting or as complex as many software providers might fear. For those software providers that wish to "go-it-alone" with their establishment of a SaaS-based business, then this is a perfectly reasonable undertaking, but very detailed and **realistic** assumptions must be made in the business planning associated with such a venture. For the likely majority that will prefer to partner with other companies to establish their SaaS business, there are now rafts of companies providing services that have been set up specifically to assist in the transition to SaaS, providing specialist services from pricing to debtor administration.

CONCLUSION

Web 2.0 is changing the way that individuals interact, both in business and socially. SaaS is part of this change and is now an established vehicle for the delivery and use of software. The use of SaaS is growing very quickly within the business community when compared with other software sales. This is based primarily on the view that, for a user, it brings together a palpable link between software cost and the delivery of value. This market driver is very strong and is capable of being sustained for many years to come.

SaaS is also opening up opportunities for SMBs to compete on equal terms with their much larger competitors through the adoption of ecommerce and other applications more closely associated with major enterprises. SaaS enables this for SMBs by removing their software purchase objections, which are traditionally based on cost, risk and operational responsibility.

So for any software provider, SaaS offers new opportunities within established markets plus the new markets offered as SMBs take advantage of their newfound ability to compete on an equal footing for the first time.

How to take advantage of these opportunities? For many software providers the answer will be to partner with a selected number of the companies that are now providing services specifically designed to enable a provider to make the transition from product sales to SAAS. These companies offer services from hosting to financial logistics. In addition, Microsoft partners can look to Microsoft for support and direction through its partner programme. Making the transition might not be easy, but it is typically not onerous, as the experiences and success of both Conchango and NitroSell will attest. (See the case studies below).

In conclusion, SaaS presents a market opportunity that is large, fast growing and long-term. Most software providers should decide relatively quickly whether to grasp this opportunity or face the increasingly powerful risk of losing competitive advantage and market share.

CASE STUDIES

This section contains two short case studies of companies that are in the process of adopting SaaS as a business model. The two companies are Conchango (http://www.conchango.com/Web/Public/Content/Home.aspx) and NitroSell (http://www.nitrosell.com/). Conchango has yet to take its SaaS-based service offering to market, but has four Beta sites in operation and is almost ready to go to market. NitroSell is actively trading as a company using SaaS as the driving factor in its basic go-to-market business model.

Each of the case studies uses the same structure, addressing:

- A short description of the company's positioning
- The company's view of Web 2.0 and its associated issues and challenges
- The company's response to Web 2.0 issues and challenges
- The business model that the company will be adopting to respond to Web 2.0

Conchango Case Study

Company Status

Conchango is a midsized partner of Microsoft that acts fundamentally as a systems integrator (SI). The company is growing rapidly via:

- Its adoption and leverage of "Agile" development methodologies and, in particular, its use of the particular Agile process known as Scrum. Scrum is an iterative, incremental process for developing any product or managing any work.
- Its concentration on four primary vertical sectors — retail, finance, media and energy.
- Its investment in Internet-based technologies that are a foundation for building next-generation or Web 2.0 applications.

View of Web 2.0

For Conchango, Web 2.0 implies the following four challenges:

- The provision of a deeper, richer set of applications for internal use within an enterprise and, by extension, within smaller organisations.
- The provision of a "Web-site-based" personalised set of services for use by an individual.
- The provision of an integrated capability that works seamlessly across all an enterprise's systems, databases, channels, etc. By extension, this capability would also apply for smaller organisations.
- The provision of tools and applications that enable full interaction and collaboration by individuals using the Web as a delivery mechanism.

Conchango's corporate challenge is to develop intellectual property (IP) and services to enable the above provision, initially within its traditional target market.

Conchango Response to Web 2.0 Challenges

To respond to the above challenges, Conchango is bringing to market software-based IP that forms a Web-based layer on top of traditionally licensed Microsoft products such as Commerce Server, BizTalk and SQL Server. The IP provides "shop front-end services" by vertical industry sector, and is designed and written to respond directly to the peculiar demands of the particular sector that it is addressing.

A pleasing part of the delivery structure is that the software is structured using a service oriented architecture (SOA) methodology. Conchango can offer "slot-in" components to enable a specific service requirement by a customer. This offers a very attractive proposition to the company's traditional SI/custom development customer base rather than utilising basic SOA techniques and methodologies.

Business Model for the New IP and Services

The provision of the new IP and services will initially be targeted at Conchango's existing enterprise customer base. It will be positioned as a new facet of the company's traditional SI/developer positioning. Given the component-based nature of the offering, the new initiative also opens up the midmarket and SMBs as potential customers. In fact, the company already has four "Beta" customers — two very large retailers and two medium sized businesses (£50 million–£100 million turnover).

The new initiative is being regarded as "add-on" revenue and will be taken to market using an SaaS business model. Conchango is in a position to do this with little action being taken to mitigate the effect on the rest of its business based on the solidity of its existing, traditional business. All non-transactional costs within the company are covered by the profitability associated with this traditional business — given that staff utilisation rates can be successfully maintained. As long as the transactional costs of the new SaaS business can be kept at an appropriate level, the business is expected to be very profitable.

NitroSell Case Study

Company Status

NitroSell is a small to medium-sized partner of Microsoft that supplies ecommerce capabilities that integrate seamlessly with Microsoft's Retail Management System (RMS) software. The company was founded through the bespoke deployment of RMS in, and around, the city of Cork in Ireland. Although the company still supports its legacy customers, it no longer sells or implements the system.

NitroSell is growing rapidly based on the provision of its ecommerce (Web store) capability, supplied under a hybrid SaaS provision model. Revenues are primarily in the US (80%), but increasingly in the UK and Ireland.

View of Web 2.0

NitroSell has decided that there are two key issues with regard to Web 2.0:

- The increasing availability of a deeper, richer set of applications that enable smaller companies (SMBs) to compete effectively against their larger competitors.

- The restrictions on broadband bandwidth and the lack of very high levels of reliability for broadband connections are holding back the potential demand for SaaS.

From these two issues NitroSell has concluded that at the moment the SMB market is not yet ready for purebred SaaS as a supplier business model. However, the market is ready for a hybrid capability combining:

- A well proven software capability sold as "Software as a Product" (SaaP) with

- An SaaS-based, specialist layer of software that personalises the more generic SaaP capability

NitroSell Response to Perceived Issues

NitroSell detected a niche demand from SMB retailers for an Internet-based extension to their standard management systems that would enable an SMB to:

- Give the appearance of a more substantial enterprise with larger resources

- Display particular attributes special to that company that provide it with competitive advantage

- Thereby compete with its larger competitors with Internet-based trading

The company developed software to meet this demand using a development methodology called "Extreme Programming" (Part of the Agile set of processes) that places intense demands on the developer to be responsive to the user's requirements. (NitroSell still makes a new software release about every four weeks). The NitroSell software was developed in close conjunction with retailers spread across a number of vertical sectors to produce a capability that combined the responsiveness of an Internet-based Web store with the solidity of Microsoft's RMS package (A "black box" approach was used, with RMS being entirely transparent to the user).

Business Model for the New Software-Based Service

Responding to the perceived issues described above, NitroSell took its software to market using the hybrid model described previously, combining its specialised SMB retail software as a seamless, black box layer over Microsoft RMS. It uses the same dealer network that sells RMS and combines with the dealers to target the existing RMS customer base; i.e., the capability is sold based on the added value of having a Web channel on top of RMS.

The company keeps the capability fresh by constantly going back to its customers to learn about their needs and current priorities. To do this it has set up an automated customer feedback system that coexists with its knowledgebase, automated support system.

The Web-based part of the capability essentially acts as the "real-time" Web store part of the capability that responds to the data contained in the RMS system. It does this using a data replication facility that only replicates based on the specific requirements/directions of the customer. The Web store is run on NitroSell's own managed servers, but it uses Akamai for the delivery of its content and rich media.

This approach responds to the basic attribute of the company's target market — that running their own Web store on top of RMS is not an affordable business proposition for the vast majority of SMB retailers. Having said this, it now believes that the capability that it has developed is equally applicable to larger sized retailers. This is a market that is now under further investigation, with the Microsoft Dynamics ERP customer base being a potential target.

Another area for possible expansion is to leverage the potential of Microsoft's Office Live within the SMB community. By integrating ecommerce with Office Live, NitroSell would be in a good position to exploit the potential of the "Long Tail" market, which probably represents the largest segment of the market in terms of total value.