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Delivering SaaS: Executing on a Service-Based Business Model

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Many software vendors are already developing Software as a Service (SaaS) offerings. However, the effective execution of subscription-based technology takes more than a simple product redesign. Software providers must tackle the challenge with changes to all of the fundamental aspects of their business: strategy, people, process and technology. Such a decision is not without risk, and requires thoughtful planning and execution.

The Market Responsive Software Company

Though the SaaS concept has existed since the 1990s, increasingly open computing environments are speeding the transition from traditional licensed-based software models. In our role providing IT solutions, we talk with IT executives whose interest in SaaS is growing. For instance, an executive at a large media conglomerate told us that SaaS has the potential to create “vital business efficiencies” in his organization. The CIO of a \$1 billion financial services firm recently signed up for Oracle On Demand because he believed that “ERP was not a strategic application” for his firm, and that an on-demand model would minimize his company’s ERP spend.

Software providers engaged in an active dialogue with their customers and partners recognize that SaaS is changing their industry. Vendors responding to the growth of SaaS are creating new go-to-market strategies that build on their current offering set, customer base and market position. To effectively execute, they will have to adapt their business architectures to support the SaaS business model.

SaaS is dramatically altering the traditional license-based business architecture software companies have been built on. Steady revenue streams from subscription renewal drive profitability of the on-demand model, not upfront contractual investment from customer acquisitions. In order to support this retention-based model, software vendors need to trans-

form their business in multiple ways. Instead of focusing on the initial sale and implementation, they must create a sales model that supports development and maintenance of long-term relationships in target segments, build and establish the capacity to operate large data centers, and establish customer service functions that can consistently meet customer needs.

Successfully executing on all of these dimensions of change requires investment and an enterprise-wide commitment to change:

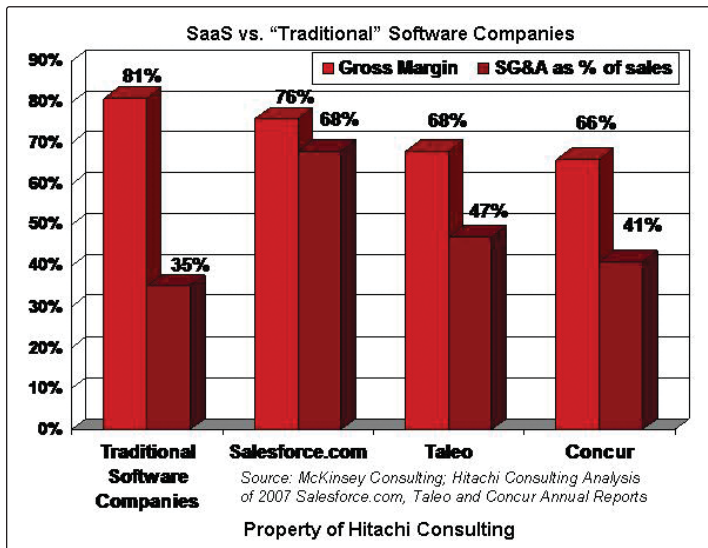
- **Marketing and Sales:** The SaaS sales team must be incented to build long-term client relationships and improve retention through the appropriate structure, metrics and tools. And because increasing SaaS adoption will not entirely eliminate the on-premise model, companies making the transition or creating a new product line will need to provide marketing and sales support for both product types.

- **Capital Expenditure:** The risk of capital expenditure is shifting from the customer to the vendor. On-premise vendors do not absorb the risk of building out big data centers to host multiple applications; their customers do, either through direct investment or contracts with outsourcers. However, SaaS players must bear the cost of hosting, on-boarding users, and managing applications and the data center. Furthermore, they are no longer able to recoup the cost of development through large upfront sales of licenses.

- **Customer Service:** Subscription-based offerings require more frequent customer interaction as vendors assume day-to-day roles in maintaining, managing and upgrading applications. Successful SaaS vendors will invest in new customer service capabilities and culture that fully meets customer expectations; generating renewals will depend on it. Such skills can be developed internally over time, or accessed through partnerships. However, either option requires investment of financial and people resources.

These significant upfront and recurring investments across the business often strain profitability of the subscription-based players, particularly in the short-term. As the chart below illustrates, pure SaaS players have thinner gross margins and oper-

ating margins than traditional software providers. When we compared Salesforce.com, Taleo (a SaaS provider of talent management solutions) and Concur, (which provides travel and expense solutions, to traditional software companies) we saw that SaaS providers were unable to achieve the same gross margin as traditional software companies. They face the challenge of driving top-line growth through high-touch customer service, riskier capital expenditure and a new sales model, all while minimizing SG&A expenses to improve profitability.



Realistic First Steps

This tight rope act of transitioning to a new business architecture, driving growth and managing to thinner margins, increases the importance of strong execution. Software companies responding to customer demand for SaaS will have to invest in the technical infrastructure to deliver their services reliably, acquire new skills in every function across the enterprise and develop new business processes to tie it all together.

There are realistic "first steps" software vendors building a SaaS offering can take to smooth the transition:

Advanced Business Planning

- Link strategy to execution by focusing on the investments that will drive the highest return in a SaaS oriented business

architecture. Rigorously evaluate results against this strategic intent through reporting and analysis of financial and sales data.

- Implement business processes and tools, such as rolling forecasts, metrics and scoreboards to improve fact-based decision-making and to carefully track spending.

Customer and Channel Solutions

- Increase scalability of customer service in order to create the ability to support complex customer inquiries.
- Capitalize on the benefits of frequent and regular customer contact. Strong customer relationships enable vendors to effectively respond to and anticipate customer needs, improving customer retention and creating more opportunities for growth.
- Revise the compensation structure to reward the sales team for subscription renewal. Make corresponding investments in training the team on customer retention and other skill sets traditionally held by account managers.

Enterprise Information Management

- Build data centers that have the staff and infrastructure required to respond to rapidly changing market conditions and demand. As customers come to expect frequent upgrades and faster iteration of SaaS solutions, data centers must be highly responsive and agile in a shorter product development cycle.

Conclusion

The software industry's migration toward SaaS is gaining momentum, driven by customer demand and adoption. The development of subscription-based technology is disruptive, and offering innovative SaaS solutions is not enough to outperform competitors. To be truly successful in meeting customer expectations profitably, vendors must continue to understand and anticipate evolving market dynamics, and translate this insight into an execution plan aligned with their strategy.

Anna Maria Anthony is a director in Hitachi Consulting's high tech practice. She has worked with clients to lead key operational initiatives, redesign key processes and their supporting organizations, and to develop and launch new products and services. Her client experience spans the technology, communications, and pharma/biotech industries.