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Converting From a Software License to a Subscription Model

Javier Rojas, Managing Director
Maximilian Bleyleben, Managing Director, London Office
Kennet Partners

The market for on-demand software pricing and delivery, also known as Software-as-a-Service (SaaS), has gone mainstream. Corporations are increasingly open to buying software in this way. As a result, revenues are growing rapidly for the right sort of application vendor in virtually every segment. Aggregate turnover for stand-alone public SaaS companies has reached nearly $750 million annually. What is more, there are significant financial incentives for entrepreneurs to shift to a SaaS model. The public equity markets are placing a high premium on SaaS vendors, with market values averaging 5x forward revenues. A company with expected revenues of $50 million in 2007 and a median growth rate may well command an IPO or trade sale valuation of $250 million or better.

As a result of this dramatic shift, private investors are focusing on promising SaaS vendors and are highly selective regarding license software companies in which they are willing to invest. In both the private and the public markets, SaaS companies are being valued at a premium because of the visibility afforded by the recurring revenue model, the low marginal cost afforded by the multi-tenancy delivery model and the reduced cost of selling on-demand solutions.

This leaves many founders of software companies asking how they can make the transition to becoming a SaaS vendor. The operational challenges of making this shift are significant, impacting every part of the company: technology, sales, services and pricing. Not least, the transition can have a dramatic impact on cash collection which, if not managed appropriately, can sink the business.

Business Model Comparison

	True SaaS	Subscription	License
Revenue Visibility	High	High	Low
Revenue Velocity[1]	Low	Low	High
New Client Acquisition Rate	High	High	Low
Cash Flow	Low	Low	High
Operational Efficiency	High	Moderate	Low
Ongoing Client Vendor Partnership	High	Moderate	Low
Ability to Upsell Services	High	Moderate	Low
Data Mining Opportunity	High	Low/Moderate	Low

In the SaaS model, the bulk of contracted revenues are deferred into the future, so the impact of increased sales is not visible in the short-term financial performance. In order to measure operational performance, new KPIs need to be measured, such as bookings per month and contracted backlog.

We have worked with a number of software vendors that have made the transition to SaaS and have found some useful lessons to insure success. In several cases we have been able to complete the shift fairly quickly, migrating to a recurring revenue model for the majority of the business in as little as two quarters. This article discusses some key lessons learned that have worked well for these companies.

Subscription Model vs. SaaS

Some vendors can't migrate to a full multi-tenancy model (multiple customers using a single instance of the software) in a single step and need to continue offering to deploy software behind the customer's firewall. Also, some products do not lend themselves to a full SaaS model because certain customers will always insist on paying for a perpetual license. But these types of exception customers are fewer in number each year.

In any case, founders can get a lot of the benefits of revenue recurrence and forward visibility by moving to a subscription model even if the product is not delivered on-demand or hosted on a multi-tenancy basis. This approach still provides the financial visibility of the on-demand model, and gives the company experience in selling subscriptions and-for hosted offerings-experience in managing a service offering. Properly designed, a dedicated-instance hosted model can also make possible an on-demand "try-before-you-buy" sales model, which can help accelerate new client acquisition. It does not provide the additional economic benefit of multi-tenancy, though this can be introduced subsequently when the appropriate technology platform has been developed.

Transition on a New Release

The change to a subscription model can be traumatic for customers accustomed to buying on a license basis (and sales people accustomed to selling this way). It is helpful to introduce the new contracting model in conjunction with a major new product release. This approach encourages existing customers to switch contracts and to accept the new pricing structure. It also helps in that the company can take advantage of the new product launch to coordinate pricing messaging, and to develop a new pitchbook for the sales team.

Use Differential Pricing to Drive Subscription Sales

The perpetual License model typically involves higher ongoing support costs than the on-demand model because of the onsite support requirements and the need to support several different versions deployed among customers. By contrast, a multi-tenancy SaaS solution has fewer implementation challenges and can be based on a single release of the software, maintained at the hosting center for much lower costs. Also, the sales costs for license software are often higher than for on-demand. This is because the customer faces a higher buying hurdle for larger upfront payments, which translates into a more difficult sale, more internal approvals and ultimately a longer and more expensive sales cycle.

For these reasons, it is important to offer customers a choice, but to ensure that the price of a perpetual onsite license is at a significant premium to the subscription pricing, so that customers are highly motivated to take up the SaaS offering. It is important that the on-demand pricing model also minimizes the loss of cash flow from the transition to subscriptions. This negative cash impact can be reduced by collecting first-year subscriptions upfront or by charging a reasonable set-up fee to offset the delayed revenues from subscriptions.

For example, in one company we priced the perpetual license and maintenance of a new release at a ratio of 1.4x to the first year of a subscription license for the same offering. Because we tied these new pricing alternatives to a significant product upgrade, we were able to increase subscription license prices by 15 percent, perpetual license prices by 25 percent and maintenance by 50 percent. As a result, subscriptions became more attractive to customers although still earning the company the equivalent cashflow at signing as the License and first year maintenance from the preceding release. In the end, cash flow from subscription sales were lower than those of the new release license sales/maintenance (about a two year breakeven) but they were equivalent to the cashflow generated from prior license sales at the time of purchase, and greater after one year.

Other Key Factors

It is important to be aware of other factors that will need to be considered:

• Contracting - One year rolling contracts with a high renewal rate are the most common type of subscription used in the US, although three-year contracts have the benefit of providing longer contract visibility, more sales focus and stronger customer buy-in. On the flipside, there is anecdotal evidence that three-year contracts have lower renewal rates, as the contract end is more likely to coincide with a natural software upgrade or change cycle at the customer.

• Focus on Bookings - Sales metrics and incentive plans need to be adjusted to incentivize operational sales velocity. Sales executives should be focused on increasing MRR (monthly recurring revenue) through monthly booking targets. The growing MRR base is the primary driver of equity value for SaaS businesses.

• Sales Model Change - The transition can be hard on sales people. They need to move from "hunting" to "farming" and not all will be able to make the transition. This can be partially addressed through compensation, but it also requires a shift in job motivation from "winning big deals" to "land and expand", which means making sure customers are happy year after year. Splitting sales (new client acquisition) from account management (existing customers) is often a key to success here.

• Sales Productivity and Incentives - Sales compensation needs to be tied to targets related to bookings, MMR, retention and useage. In the SaaS model, vendors have the ability to monitor continuous client usage of the application and can therefore diagnose a problem account often before the client realizes it. This requires vendors to motivate customer-facing reps to be aware of customer useage, and to anticipate and act on these metrics, both to ensure customer satisfaction and to exploit upsell and cross-sell opportunities.

• New Analytic Services - In some SaaS segments, it makes sense to aggregate anonymized data from customers' use of your application and turn it into an information service that can be upsold to existing customers. Customers can get significant benefits from benchmarking themselves anonymously against their peers. Such services can increase the stickiness of the SaaS application and increase the cost of customers switching to another vendor.

Be Comprehensive

When you make the transition to a recurring revenue model, try to get as many customers as possible to switch. While some clients will resist and will continue with a license model, it is important to make these exceptions and to limit it to the most important, often the largest, purchasers. In order to benefit from the valuation premium given to SaaS businesses, recurring revenues need to account for a majority of revenues. Only then will you gain the forward revenue visibility and value of cost-effectively scaling your operations. Furthermore, sales and marketing will be much more effective if focused on one model versus straddling both.

It Works

While the shift in the business model is daunting, it is achievable for most software companies. Using the above approaches, founders can minimize the obstacles and streamline the transition. Having a majority of your customers on a recurring revenue model in six months may seem like an impossible task, but we have seen it implemented successfully. With this approach, a doubling or tripling in company valuation is within reach for many software companies.

Javier Rojas is a managing director at Kennet Partners and leads its US.investment activities. He is currently on the board of Daptiv, Adviva, IntelePeer, NetPro Computing, MedeFinance, and Kapow Technologies.

Maximilian Bleyleben is managing director in the London office of Kennet Partners, where he is responsible for software, IT services and digital media investments across Europe. He is currently a director of FRS Global, Telemedicine Clinic and TradingPartners, a board observer at Adviva Media, and has been a director at Aspective (acquired by Vodafone UK).

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