The State of the Enterprise Software Market

The Transition to "Software as a Service" - The Rise of SaaS and Departmental Applications

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Market Overview

The enterprise software market, which includes a diverse set of software for different functions such as: HR, Sales, Marketing, Finance and IT is a mature market (with a range of 2% - 10% compound annual growth rate). This market is dominated by just a few global brands such as IBM, Microsoft, Oracle, and SAP. IT budget constraints and software complexity make it difficult enough for companies to support and maintain their current enterprise software let alone allow new vendors to enter the mix. As a result, IT organizations have created extensive policies to block new entrants, making it extraordinarily difficult for recent independent software vendors (ISVs) to break into the enterprise market. This, coupled with the high go-to-market cost structure of an enterprise software company has made the enterprise software market a relatively uninteresting investment area and caused innovation to stagnate in this field over the past decade. However, all of this may be poised to change due to Software as a Service (SaaS).

SaaS applications are beginning to unlock the stranglehold that enterprise application software brands have had on these companies. Contrary to traditional enterprise software, SaaS solutions are built using a modern, more open Web-based architecture – XML and SOA – with low cost tools that enable the vendor to rapidly and cost-effectively build, test and introduce new features and product capabilities. They have been built to be easily configured by the user and delivered as a service – hosted, supported and maintained by the vendor, not the customer. They typically employ a Web 2.0 user interface (UI) so they are more intuitive and require less training. Designed from the ground up to be "multi-tenant," they can support many customers concurrently using the same version of software. This means the costly, time-consuming and delayed upgrades that plague traditional enterprise software are a thing of the past and new releases are now made instantly available to every customer.

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According to a recent *Sauagatuck Technologies* survey, the primary benefits of a multi-tasking architecture are:

- Ability to upgrade the service with new features without impact to the core technology stack.
- Ability to offer opt-in features to customers (and cost-effective free trials).
- Ability to do low cost provisioning and minimize overhead costs.
- Ability to integrate with services on the other side of the firewall (within the customer's premises).
- Ability to analyze which elements of the application are being used (or not used) and provide feedback to customers based on real usage.

Due to the increased popularity of SaaS, many ISVs are trying to reinvent themselves as SaaS companies, using virtualization schemes to simulate multi-tenancy, providing them with a quick time-to-market solution. Unfortunately, this approach will only result in hundreds of virtual instances that will suffer from the same difficult upgrade problem of on-premise solutions.

The situation is reminiscent of the 1980s when companies such as Cullinet, Cincom and ADR introduced SQL/relational add-ons to their standard hierarchical/proprietary databases in response to broad interest in the new relational model. Those market leaders first ignored and then failed to re-architect themselves in time to respond to new fully relational entrants such as Oracle. Instead, the then current market leaders came up with partial "bolt-on" solutions; they positioned their traditional offerings as "transactional systems" – relational solutions at the time were not yet able to handle high transaction throughput – and they positioned their relational offerings as "reporting systems." Their offerings, however, didn't resolve the fundamental technical and business problem with CODASYL database architectures – the lack of application and infrastructure portability and flexibility and the subsequent high implementation, customization and maintenance costs.

As relational systems evolved to support transaction processing speeds equivalent to hierarchical databases, the superior flexibility of the relational system, and the application portability made it a far better solution than previous generation database technology. The incumbents found themselves unable to cannibalize their own technology. Faced with an ever-shrinking customer base and profits, all were eventually forced out of business or sold themselves to Computer Associates, which sought their maintenance revenues.

Similarly, for today's ISVs to capture the full benefits of SaaS, they must go through a complete architectural – and perhaps more importantly – a business model transformation. They must be willing to build completely new multi-tenant versions of their offerings and revamp their entire financial and compensation structures or they will suffer a similar fate as Cullinet and the other non-relational database management companies, which were at one time the “unassailable” database market leaders.

Starting with SMB and Moving Up Market

Due to their initial feature sets, of which there are typically fewer than their on-premise counterparts, SaaS applications have tended to get their initial foothold in small- and medium-size businesses. However, as SaaS providers introduce more robust features into their offerings they are finding their way into the enterprise and giving rise to “departmental applications.” Over time, these departmental applications will continue to improve and have the potential to ultimately displace traditional enterprise software solutions.

> *Robert DeSisto, research vice president at Gartner, said trends in enterprise software have certainly begun to change. However, DeSisto added SaaS is still well short of maturity and said many deployments are still focused on either individual departments or within the small to medium-size enterprise sector. DeSisto said: "No provider offers the functionality capability or process management capabilities on par with on-premise software to support end-to-end cross departmental business flows."*
>
> *But the balance of power is unquestionably shifting according to Gartner.*
>
> *Source: ZDNet*

SaaS solutions are gaining traction in the enterprise because unlike traditional enterprise software, which requires the buy-in and support from multiple divisions within a company, SaaS departmental applications can be sold directly to the line of business owner. They do not require much, if any, training, integration or involvement with IT for initial implementation and/or long-term maintenance or support, and their pricing model – monthly subscription v. perpetual license – is a variable versus a capital expense, making them even more compelling.

In departments such as marketing, the SaaS model offers a solution that traditional enterprise application software cannot. For example, marketers seldom have access to capital dollars or IT resources. SaaS uses a subscription model – a variable expense – and does not require IT resources. Therefore, the Marketing Automation market which never materialized under the traditional enterprise software model is now emerging and growing rapidly.

In other departments, such as HR and Sales, traditional on-premise software has proven to be highly unsatisfactory. For example, Sales divisions are constantly in flux (e.g. territory reassignment, sales forecasting, incentive compensation, etc). Sales applications must be highly flexible but they don't necessarily need to be highly integrated with other applications. Therefore, this is a department that is far better served by a SaaS solution; one that can be quickly and easily modified by the functional business group rather than having to rely upon the resource-constrained IT organization.

As a result of these trends, according to analysts such as Gartner Group and Deutsche Bank:

- 44% of CIOs expect to have their companies implement SaaS applications
- The SaaS market, today a $3B market, is expected to grow 10X to $30B and 50% market share by 2013
- Incumbent application software companies will find it difficult to adapt to the new SaaS technology and business model
- The markets are rewarding public SaaS companies with a median multiple of 4.0x v. 2.5x for traditional software companies

The SaaS Investment Opportunity

Software as a Service (SaaS) is providing the opportunity for software providers to introduce innovative solutions into new functional areas of business as well as into traditional areas.

Initially, they will find the SMB market and various departments within the enterprise the most receptive to their offerings but as they build in more robust capabilities and remain armed with a far more compelling business model, we believe they can and will ultimately replace traditional enterprise software.

InterWest believes the most interesting SaaS investment opportunities are the ones that have the following characteristics:

- Fragmented
- High-volume potential
- Vulnerable incumbents
- No current thought leader and/or market leader

Our initial SaaS investments are in analytics, marketing automation and sales forecasting.

Cloud9 Analytics (www.cloud9analytics.com)

Cloud9 Analytics delivers on-demand analytic applications for salesforce.com customers that accelerate sales cycles, uncover new revenue opportunities, promote team selling, and improve revenue predictability. The Cloud9 Time Machine powers Cloud9 applications by taking continuous snapshots of salesforce.com data that otherwise are being overwritten and lost. As an on-demand service fully integrated with salesforce.com, it requires no IT involvement. The Cloud9 Pipeline Accelerator application prioritizes sales opportunities, calculates pipeline coverage, “watches” for changes in the current opportunity pipeline, and connects representatives working on similar deals. The Cloud9 Messenger application sends “what’s changed” reports to mobile users to alert them to significant changes in forecast, pipeline, pipeline coverage, and closed/won deals

Marketo (www.marketo.com)

Marketo provides affordable, easy-to-use marketing automation software that helps B2B marketing professionals drive more revenue and improve marketing accountability. Marketo's solutions automate lead generation and lead nurturing processes over multiple channels, beginning with pay-per-click search marketing and landing page optimization and will eventually include a comprehensive suite of applications to turn marketing from a cost center into a revenue center.