



Software as Service — Entering the Mainstream

Software as a Service is transforming the Information Technology landscape

Conference notes by Mark Duncan, askmar

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What does it take to launch, and what are the requirements for long term success as a software as a service business?

Overview






With investors focusing on vendors providing software as a service, a new \$100 million fund investing only in Technology Enabled Services, software as a service based companies springing up everywhere, established firms such as IBM, SAP, Siebel and others joining in, and the success of the Salesforce.com IPO, many are interested in better understanding how software as a service is changing the IT landscape. The SDForum Software as a Service Conference provided the opportunity to learn and network with numerous industry experts, entrepreneurs, technologists and thought leaders who are taking software as a service into the mainstream.

The conference was a mix of panel sessions and keynote presentations, providing the audience with practical and strategic advice on developing software as a service applications, driving adoption and managing a sound business model and engineering best practices, and what to look for when investing time or money in software as a service solutions. Experts from key software as a service companies discussed their differentiators, viability, and growth prospects.

When and Where

Held on March 22, 2005 at the Network Meeting Center in Santa Clara, CA, the SDForum Software as Service conference was sold out, with over 400 people attending. Essentially everyone who was a major participant in the industry, attended the conference.

Practical Considerations

				
Rory O'Driscoll, Managing Director, BA Venture Part- ners	Halsey Minor, CEO, Grand Central	Zach Nelson, CEO, NetSuite	Tim Chou, Presi- dent, Oracle On Demand (former), author of "End of Software"	Steve Singh CEO Concor, previously General Manager, Symantec (creator of ACT)

What are the economics of Software as a Service? What are the motivations for using subscription services? What are the most important attributes when a customer evaluates a vendor? Which vendors are emerging as market leaders?

The Triumph of Hope over Experience

How did you first get involved in software as a service and why?

- At C-NET, we were putting media online. In 1997, Salesforce approached us, and back in 1999 we split the first round of funding with Larry Ellison. We saw the notion of on demand software as being very consistent with the Internet, it wasn't a big leap for us.
- Back in 1998, Zach Nelson looked at provided tools for small businesses, those with 10 to 20 people, and this was the birth of NetSuite.
- Tim Chou back in the mid-1990s had worked at Oracle. He was approached by Oracle in 1999 to return. He talked with Larry for 2 hours, argued with him, and ended up returning. His first six months of work result in spinning out a mini-EDS company. But this spinout represented a fundamental shift in how Oracle was going to do software. Today, this division represents \$200M in revenue and has been integrated into the Oracle fabric.
- In 1998, Steve Singh realized that he was using the wrong business model, that

their business model only appealed to high-end Fortune 200 companies.

The Need for the Right Architecture

Why can't you create a software as a service business by simply hosting an enterprise application and charging for access by a browser?

- You really need to design a software as a service product from the ground up. Right now, there is a period of customer confusion.
- Simply accessing software by a browser and paying monthly fees isn't sufficient, you have to have the right architecture.
- ASP will do okay for a while, but while people get focused on the reoccurring revenues, what is crucial is the leverage you get from your core architecture, which needs to be focused on a software as a service model.

Challenges

What challenges do you see?

- The challenge is to take a traditional software company into this market. At Oracle we have the scars to prove that it can be done.
- The challenge in software as a service is to provide high levels of standardization. NetSuite and Salesforce have demonstrated that it is possible to have very high levels of standardization.
- It is one thing to have generic email, but it is very unclear how you can standardize a manufacturing package.

Customizing

What can be done to provide the ability to provide customization and better integration?

- While changes cannot be done instantly, you have to upgrade everyone within a month or two. But when you do these upgrades, you have to preserve the customizations unique to each customer.
- The Yahoo website has had 10 major upgrades, but all of the user customizations have remained.
- Durability and survivability are critical when doing upgrades.
- Availability becomes increasingly important. We achieve uptimes of 99.8%.
- We are moving from standalone products to those that are integrated together. Back in 2000, Yahoo had a \$1B business in which the only thing it provided was a directory, all the other site features were integrated from others. As time goes by, there will be higher and higher levels of specialization.

New Markets

What new markets does on-demand software enable?

- There are a lot of vertical market business processes, many that venture capital

funds are making investments in, that are made possible by broadband communication services being widely available. For example, XML data is widely used in the insurance industry. You have small insurance offices with 3, 4, and 5 people, having to install software every three months. Car dealers and real estate brokers are two other examples of vertical markets like this.

- There are many horizontal and vertical industries where there is a dysfunctional supply chain. Value will come from providing inter-compatibility between companies. This in turn will raise privacy and security concerns over how the marketplace knowledge contained in a database is used.
- RFID is a huge, cross multi-enterprise opportunity.

Small and Medium Business

How does software as a service change the ability to sell into small and medium sized businesses?

- The SMB (small, medium business) market is underserved. Existing solutions for many large enterprises need to be re-deployed so that the smallest company can enjoy the power of the software used by the largest enterprises.
- The ways in which you do sales and marketing for on-demand software is different. Small and medium businesses are more profitable and provide substantial leverage. While you can use indirect channels, direct sales will win in the long term.
- On-demand software allows you to directly sell down to a 50 person company.
- An issue that needs to be addressed is how to build efficient sales channels. You cannot charge small and medium businesses the same that you did enterprise customers.

Implementation Issues

What issues do you need to think about when implementing software as a service?

- You have to think much more about usability. QuickBooks is easy to use, whereas Oracle is impossible.
- Using technology like Ajax to stretch the interactive capabilities of the browser to act more like a local application are crucial.
- With respect to security, 90% of security issues are internally directed. Inherently, software as service vendors are able to provide much better security.

New Business Models

What new business models are required by software as a service?

- You need to rethink revenue recognition, if you don't get paid, you don't have any revenue. If we don't provide service, you don't pay, we are accountable. You have to work with your customers every day.
- Software as a service is not about lower cost, rather it is about providing a better product that better meets the needs of the customer. While we charge more, it costs the customer less.
- In 2000, when we got started, we did 3 to 4 deals a year. Five years later, we do 15 deals a year to obtain the same amount of revenue.
- We need to be students of economics and rethink our costs models and structures in developing new business models in rethinking how we get paid.
- At C-NET, we compared ourselves to magazines. The magazines sold subscriptions, yet provided content that was one to two months stale. In contrast, we gave our content away for free and provided prices and product reviews that were current.

Incremental Opportunities

Does software as a service provide any opportunities for incremental revenues?

- The value of add-on services is much higher in software as service, than in a conventional software license model. Your incremental margins are amazing, when you can offer a new feature that is blasted out to 2,000 existing customers.
- At Yahoo, everyone came to them first, because everyone saw the embedded value in being associated with them.

Legacy Observations

In telecommunications, the third world is not strangled by a legacy infrastructure, with the result that countries like Korea have much more advanced communications capabilities than the United States. China has the opportunity to do things on a fresh page.

Microsoft has not yet embraced on demand software. We find companies using Webex over the web, but still using Microsoft products on their premises.





Salesforce.com

Marc Benioff, CEO of Salesforce provided the opening conference keynote address. With 227,000 subscribers and 13,900 customers, salesforce.com in 2005 was 8 times larger than its next largest on-demand customer.

The Impact of the Internet

The Internet is causing a fundamental change in the software industry, as well as in the way we live and work. It is steadily becoming more global, affordable, and pervasive. Yet we overestimate what will be achieved in a year, and underestimate what will happen after a decade.

As an example, Marc cited his ability to live and work using a virtual office. Video, voice, and email are available everywhere he travels, whether at the office, home, or on the road.

Democratization of Service

In 2004, Gartner Group observed that information management and communication are becoming commodities, and that as computing begins to be provided as an utility, there will be a democratization of small, medium, and large companies.

The Internet enables us to move from a traditional licensed software model to an on-demand, plug-in and subscribe software model.

As an example, at Salesforce we have 150 ISVs that provide on-demand integration. We have customers like ADP with 3,100 users, Polycom with 267, and Zagat with 21. We can scale to any size business.

Why Do Customers Buy?

We surveyed our customer base. We found that our intuitive features are a major selling point.

95% of our users will continue to use us, 93% would recommend us, and 76% have already recommended us. Our primary and best advertising is word of mouth.

In the 1970s, an IBM 3270 terminal, mainframe running MVS, IMS, and Cobol programs were common. In the 1990s, we moved to a client server world with browsers, Microsoft Office, Notes, Outlook, Visual Basic, and SQL running on NT and Unix operating systems. Today, software as a service is what the market is moving to.

Customer Customization

We are providing the capabilities for our product to be highly configured for a given customer. Avisforce and Yamahaforce are examples of this. First New England Mortgage and Magma Design Automation are other notable examples.


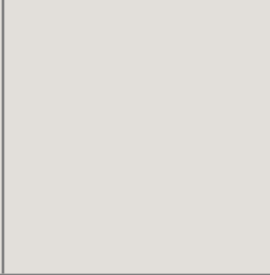

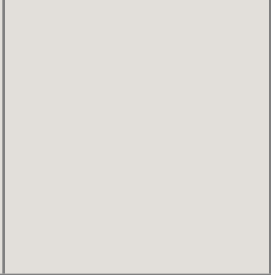

Frequent Releases

Salesforce has been able to rapidly evolve its software. Winter 2005 saw the 17th generation of our software. And each release has many new features — Summer 2004 had 100 new features.

New Types of Integration

We are finding that tools for recruiting such as candidate and resume management, can interoperate with other existing applications.

Business and Operations Issues

				
Amy Konary, Program Director Software Pricing, Licensing and Delivery, IDC	Phil Fauver, CEO, Employease	Steve Jillings, CEO, Frontbridge	Ken Rudin, VP and GM CRM OnDemand, Siebel	Treb Ryan, CEO and Co-Founder, OpSource

What are the challenges to ISVs and application developers in creating and delivering Software as a Service offerings?

Company Backgrounds

The panelists started by briefly summarizing what their companies do:

- Started in 1996, Employease targets companies having 50 to 30,000 employees.
- Frontbridge provides email security by insuring message compliance and providing disaster recovery.
- Siebel has moved from a traditional to also providing an on-demand service.
- OpSource is not a software company, rather it delivers bandwidth, infrastructure and helpdesk for software as service companies.

How Do I Get There?

Software as a service is going to be adopted, but how am I going to get there?

- Do I charge by the user or transaction?
- How do I scale the application?
- How do I deploy the application in terms of the training that is necessary?
- How do I provide the necessary availability?

Customer Requirements

A software service needs to be provided 24 hours, 7 days a week.

Software as a service means that you can get a customer up and running in weeks and months, instead of years.

We have to support 15 different languages on a 24/7 basis. When you sell worldwide, this means your support center has to have people at all times that speak all these languages.

When you deploy software, you have to design to the highest common denominator, as opposed to the lowest.

Market Changes

There has been a tremendous change in the market over the past 5 years:

	5 Years Ago	Today
Never Consider	40%	20%
Maybe consider	40%	40%
Definitely consider	20%	40%

Software Releases

At Siebel, we have been able to have 7 major releases in 14 months. A software as a service allows us to have more incremental releases.

But when changes are made, it has to occur at the higher level metalevels — customer custom fields have to be retained.

Companies that have less than 500 employees are not process driven. But in a large company, process is critical. As a result, we may have three different releases in process at one time, staggered for different customers.

Sales Cycle

The sales cycle is different with software as a service. We find that once we can get someone to try it, we have a close rate of 87%.

In selling to the Fortune 2000, we find that we spend 75% of our sales cycle in dealing with non-product issues such as security, data recovery, and other process details.

In larger companies, there is considerable anxiety over bringing in a software as service product, but this is only temporary. You have to deal with the issues of who owns the data; obviously it is the customer, but you have to articulate this.

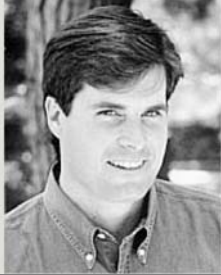



Siebel Experience

Siebel views software as a service more as a delivery vehicle, believing that on-premise software will remain. It cites that there are both technical and emotional reasons for having on-premise software. Initially it was fearful of cannibalizing its markets, but it has found that 75% of its customers are in small to medium sized businesses not previously sold to. By establishing a single salesforce where everyone sells, salespeople are indifferent to whether a customer buys software or service.

At Siebel, figuring out how to deal with cash flow and our sales force in making the transition was a major concern. What we did is to calculate a commission based on the total con-

tract value over 3 years. On the other hand, we have a predictable, recurring revenue from a customer.

Winning Formulas

				
Scott Sandell, General Partner, New Enterprise Associates	Greg Gianforte, CEO, President, Chairman and Founder, RightNow Technologies	Subrah Iyar, Chairman and CEO, Webex	Jeffrey Lunsford, CEO, WebSideStory	Michael Topolovac, CEO, Arena Solutions

What things should you know about doing a software as service business? What are the key metrics you should monitor? What are the key management considerations?

Brief Background

The panel started out with a brief description of each company:

- Greg Gianforte at RightNow Technologies was started in 1998 and went public in 2004. They provide call center operations, with their customers being 15% government and 50% middle sized businesses. They have had steadily increasing revenues and currently have 400 employees.
- Subrah Iyar started Webex in 1996. They provide a audio / video / data collaborative application service. They had \$250M in revenues in 2004 and have 11,000 customers. A prominent customer is the DOD who uses them for intelligence operations.
- Jeff Lunsford at WebSideStory provides digital marketing tools for tag based analytics of web sites. A customer provides the content, and they do all the rest. They have found that customer support and retention is critical to their business.
- Michael Topolovac at Arena Solutions has customers ranging from startups to In-

tuit. He feels that a pretty big paradigm shift is occurring in the software market.

One Thing You Ought to Know

Scott Sandell asked the panelists for one thing that people might want to know.

- You have to be selling a business value that moves the needle on the customer's meter.
- A software as a service company has a totally different cost structure from existing software companies. Think about three axis — technology, operations, how you go to market — all change. How you pitch your software and how you compensate your sales force are all different. It used to be that retail software sold for \$250 and business software was priced at \$15,000. Now you have to price on the basis the number of transactions or users.
- Before the dot com bubble burst, we gave away content, making our money on ad clicks. Today, at WebSideStory we are making \$6M/quarter on subscriptions. This has meant that we have to align our business with our cost structures. You have to get your price model right. You

also have to architect a pure on-demand architecture that allows a 4 to 6 month release cycle. You can't breath your own exhaust.

- A pure multi-tenant architecture provides huge benefits. You can't dress up and put lipstick on a pig. A software as service business model keeps you honest, your economics revolve around keeping your customers happy. The complexity of the engine necessary to do a multi-tenant architecture is non-trivial.
- There are fundamental changes in how you sell. It is the difference between drinking a couple of shots of Tequila on a Saturday night and having the entire bottle. With the shots, you'll try it next weekend, but with the bottle, you'll never go back.

Customization

How do you handle requests by customers to do customization?

- You allow customers to control when upgrades happen. When you do this, you don't have to hand hold them.
- You have to determine whether or not your code can be configured to meet their needs, or if it will require writing new code.

Key Metrics

What are the key metrics that you use for monitoring a software as service business?

- Monthly recurring revenue
- Monthly recurring revenue net gain
- Committed revenue, averages for use
- Cash flow
- Customer retention
- Customer bookings, attrition
- Increasing margins

Attrition is a key parameter. Simply going from 10% to 15% attrition can result in your overall booking growth going from 40% to 20%.

Other Comments

At our firm, we offer the option of hosting with us or the customer. Four years ago, we did 40% of the hosting. But today, we do 90% of the hosting. Often times we find that a customer intends to host the software, but is in a hurry to get the software up and running and has us host it, and than never changes.

Fundamentally, the reason why software as service is so disruptive is that it drastically reduces the technology support costs for a customer. There is no more panic when you run out of disk space.

The key management issue is to anticipate attrition before it happens, and act to stop it from happening. You need to measure the best practices for your customers. After every customer interaction, you need to query them about how they feel. If the customer screams, we're on the phone within 2 hours. Being reactive in this manner has directly driven our retention rate.



IT Market Realities

As VP Corporate Strategy for IBM, Gerry Mooney in his keynote address discussed considerations in developing a strategy for Software as a Service product offerings

Market Realities

In 2005, characteristics of the information technology (IT) market are:

- Uncertainty
- IT spending anemic
- Doing more with less
- Skepticism
- Too many vendors
- IT doesn't matter
- More alignment between business results and IT

How Do You Grow?

The question is how do you grow when the markets are not growing? Carlota Perez is an economist who cites 5 historic cycles in "Technological Revolutions and Financial Capital."

The mainframe era served the administration of a company. The client server served the person and departments of a company. But on-demand software represents new business productivity and innovation.

People forget that Darwin wasn't about survival of the fittest, but rather the survival of those who adapt. It is the companies that don't have large infrastructures to move that are the best adapted to change and survive.

In a survey of CEOs, it was found that they were focused on obtaining growth through organic means, they viewed salvation via an eco-

nomical turnaround to be less probable. Accordingly, they are focused on improving the efficiency of how their companies are run.

New Business Models

New business models that companies participating in the on-demand space include:

- Software as service (salesforce)
- Business service providers (Paychex, Paypal)
- Hubs and platforms (eBay, Amazon)
- Hosting services (IBM, Sun, aspective)
- Web service technologies (IBM, .NET, Netweaver)

There are two industry models being used by on-demand companies are:

- Process led
- Solutions led (offering driven)

Summary

It is forecast that solution based products will represent 72% of the IT market in 2007. This in turn will mean that sales cycles are longer and that pricing will be driven by value.

Software as a service is a product / solution that provides features at a fraction of the cost and complexity of traditional licensed software along with a more flexible business model.

Engineering Best Practices

				
Brian Behlendorf, Founder and CTO, CollabNet	Joe Kraus, CEO and Founder, Jotspot	Mike Myer, Vice President Product Development, RightNow Technologies	Nagi Prabhu, VP Engineering, Intacct	Jacob Taylor, VP Engineering, Sugar CRM

What technologies are enabling Software as a Service? What are the best practices for hosting and provisioning such services?

Introduction

Jotspot is a collaborative software Wiki company that was started in October 2000. It is a hosted service that makes it easy for businesses to support microvendors.

Intacct sells to small and medium sized businesses. We have 2100 customers and act as part of their financial supply chain. Our applications are coded in PHP and integrates with both Salesforce and IBM, as well as Great Plains, and Oracle Financials.

Right now we provide the Sugar CRM engine in both a host and service version. We sell to middle sized and larger divisions in companies.

Databases

How did you select a database vendor?

- MySQL has a large user base.
- We use multiple databases, but only use the lowest common denominator functions.
- We rolled our own database? 5 years ago, MySQL didn't have a transaction commit or sub-query support. When you have 300 tables, you need sub-query support!

Open Source




What is your open source strategy?

- Sugar CRM is simple, flexible, and clean. 80% of its code is open source. At the same time it is fostering an ecosystem community of related products, such as a graphics engine and Sugar Forge. It went with open source both due to the cost and the availability of very good tools.
- CBS is a bit outdated. Coleba too much to be all open source. We assigned 4 developers to creating a database with a time machine, they keeps track of sub-versions. There are 8,000 sites using this code. The alternative was having to pay \$2,000 per seat for Clearcase's product.

Other Thoughts

You have to make sure that the customer's data is open, that they aren't locked in. You need to make it easy to import and export their data and to carry on.

A Different Viewpoint: The CIO

				
Rita Khayat-Toubia, CIO, Proxim	Stephan Schambach, President and CEO, Demandware	Edward Shenderovich, CEO, Quantum Art	Axel Schultze, President and CEO, Blue Roads	Gerhard Eschelbeck, CTO, Qualys

From a Information Technology planning perspective, what are the prospects for implementing software as a service? What are the priorities that drive the decision making process to purchase software as a service?

Background

Each of the panelist was asked to describe the types of customers that they deal with, in terms of their size and location:

- At Blue Roads, we have indirect sales. We are in the government market, our users don't want to have to deal with IT departments.
- We have about 1500 customers, ranging from very small to large in the financial, insurance, and retail industries.
- Most of our customers are retailers. If they do over \$100M online, they bring it in-house. As a result, most of customers are smaller businesses.
- When we started, we hide that we were a software for service business, since it was regarded as a no-no. But in the last six months, software as a service has gotten in vogue.

Security

Security is a big question, how do you deal with it?

- We start our selling process with the business owner, and than come to the IT department

- Customers want to know how the data is secured and protected, and who has access, and how it is controlled.
- Security and the need to audit are driving factors for software as a service.

Customization

Is software as a service viewed as a commodity or a competitive advantage?

- The perception that we are not customizable is a bigger issue than security
- This gets into an issue of whether you are offering a homogenous product or one that allows unique customization. The key is to be able to do customization without having to code, to enable the customer to do the customizations, and that these customizations still work after an upgrade.

Competitive Advantages

A software as a service business model allows us to develop products 4 to 5 times faster.

In ecommerce, you have unpredictable loads. By having many customers, you spread out the load across all the resources used to serve them.

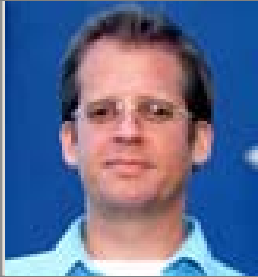




It is impossible to ask an IT department to do daily backups.

Integration

Ecommerce is a risky application for an IT department. Ecommerce can require integrating and interweaving 30 or 40 systems.

Another issue is how to do integration across SAS vendors. Are there standard APIs for web services and service orientated architectures.

Investing in Software as a Service

				
Michael Copeland, Business 2.0	Kevin Efrusy, General Partner, Accel Partners. Been in the business for 20 years.	John Hummer, General Partner, Hummer Winblad Venture Partners	Brian Jacobs, Managing Partner, Emergence Capital.	Jim Lussier, Partner, Norwest Venture Partners, currently on their 9th fund

How are traditional software companies positioning themselves to address software as a service? What does it take to launch a startup in this space, and what are the requirements for long term success?

Background

Traditionally venture capital has been focused on software as a product. Software as a service was viewed as an unattractive business that was either labor or capital intensive.

Software as a service started to become a very scalable business, yet traditional venture capitalists were not able to integrate into their portfolios.

The first software as a service companies were ADP and Paychex, but it was the success of salesforce.com in going public that made venture capitalist sit up and take notice, with the result that there has been a influx of money into this space.

Marc Benioff at salesforce.com has been very articulate about the value of his business model.

Differences

In the enterprise software market, you have a long sales cycle of 18 to 24 months. But a software as a service company can get to the market much faster.

The total capital requirements for an enterprise and software as a service company may

be the same, however a software as a service company needs less capital up front, and more later on.

The first round of funding for software as a service companies was a cruel joke on venture capital firms. People completely underestimated how slow growth would be, and how long it would take. Patience is a virtue. But what you do get is steady predictability. For example, Phil Farmer's company has had 30 straight quarters of steadily increasing revenues. So the concept has now been tested for a while.

Deal Flow

No one is doing multi-million dollar software license deals any more.

As venture capitalists in 2005, we are seeing 9 or 10 software as service deals for every enterprise software deal.

Interesting Investments

Jigsaw is a marketplace for contacts that has telesales people signing up in droves.

G2 Switchworks takes the Saber reservation system out of the loop by letting airlines deal directly with travel agents.

Opportunities

Analytics software is especially well suited to software as a service. Think about how all the hotel managers around an airport will get together to discuss their occupancy rates. A service that lets them automatically share this information on a blind basis has a lot of value.

There is the opportunity to do something new, where you have an application that shares information between companies.

Unique Characteristics

Software as a service has a different sales structure. You can think of it as the ASP sales model in sheep's clothing. You are offering low cost delivery and quick time to value, that can be easily grown.

But the downside of software as a service is that you have to ruthlessly understand your metrics, such that any slipup is immediately visible. In a teleco, you run the company by focusing on the uptime, churn, cost of new customers, and the cost to serve. A software as service company has to be much more operational orientated on a day by day basis.

You have perpetual customer accountability, you must command domain expertise, and you have to be very operations focused.

Riding Two Horses

Trying to have a hybrid model like Oracle and Siebel is the worst of all worlds. While a company like Oracle can do it, ultimately it is hard to reconcile two different business models. RightNow is making a hybrid model "work."

You have to decide which customers you are targeting. It is hard to go after both low and high-end customers.

Trying to transition from a license to a service model can be done, but it is difficult and requires a lot of dislocations.

The hardest thing is for a company to say no, but more companies have died of indigestion.

Advice and Insights

A legacy of the dot com bubble is that customers have realized that they have a lot more power. It has made it much more difficult for startups, who now have a hard slog for 5, 6 or 7 years. But at the same time, reality has set in that a \$300M IPO may be a very healthy offering.

As the customer places more and more data with the service, they become increasingly locked in. This is the model that Salesforce and Collabnet are taking.

In mobile applications, a 2% turnover per month may not seem like much. But it is 25% turnover a year, and you have to grow fast to overcome this.

You have to understand your churn. If it was because it was the wrong customer, that is okay. But if they left because of a problem that they were unhappy about, that is a major problem.

Investing

What are proof points before pulling the trigger to fund a company?

- Steadily growing revenues (Omniure)
- As many positive metrics as possible
- Repeatable sales cycle
- Short sales cycle
- How many people are using the application?
- How is the application proliferating through accounts?
- Do they have more than 2 or 3 customers?
- Do they have a diversity of customers and industries?