



Crossing the chasm:

Lessons learned in transitioning to the SaaS business model

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Overview

The last decade has seen software buyers express ever-increasing preference for purchasing software as a service (SaaS). Most new entrants in the software space have been SaaS-native, but what about the thousands of software vendors that started out with traditional licensing models? How can they transition to SaaS? Where on the transition spectrum should they aim to be?

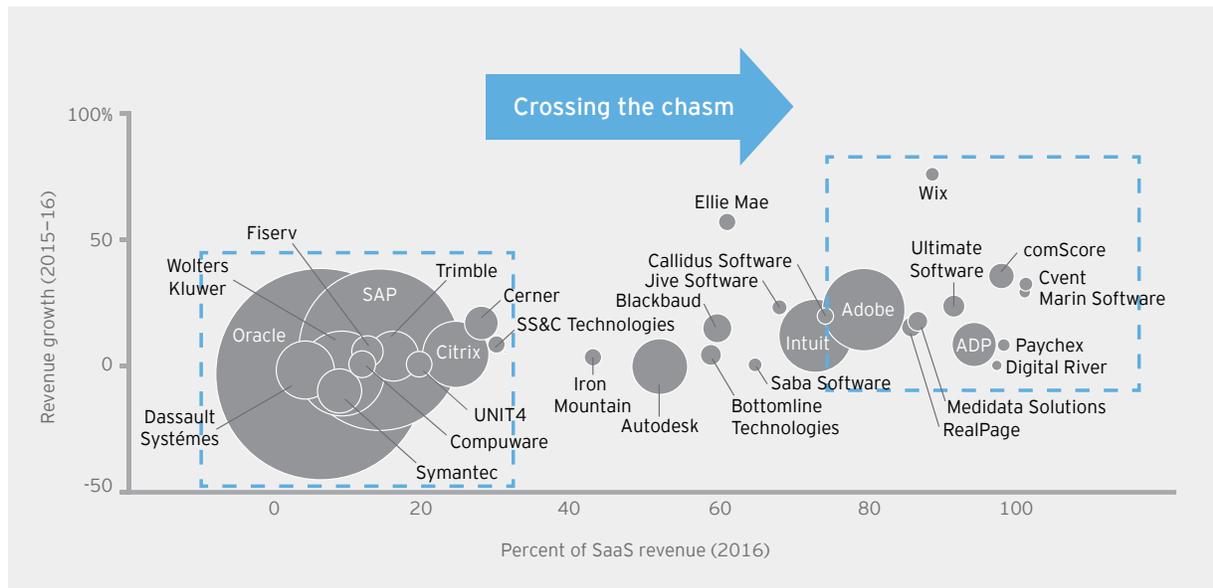
Think of the move from perpetual licensing to a SaaS business model as a wide chasm between present and future. To cross it, companies must rethink the way they do business.

Companies that have contemplated the crossing understand that there are a myriad of challenges and risks in making the transition, from operational to financial to technical. We at EY have seen a wide range of SaaS transition strategies and have found that the following principles contribute to business model transition success:

1. Set the right SaaS strategy
2. Expect more than a pricing change, expect a business transformation
3. Follow lessons learned from companies that have already begun the transformation

With the expectation of higher SaaS penetration across the entire IT ecosystem, as we highlighted in a recent article, vendors in all software stacks are planning their transitions. Successful vendors will prepare their companies to offer SaaS even if there is not yet overwhelming demand from their customers. In the diagram below, we've grouped an example set of companies by the percentage of revenues that are derived from SaaS. Note that many companies still left of the chasm are already preparing their companies for SaaS.

Figure 1: Percent of SaaS (2016) vs. revenue growth (2015-16) by total revenue, enterprise software providers

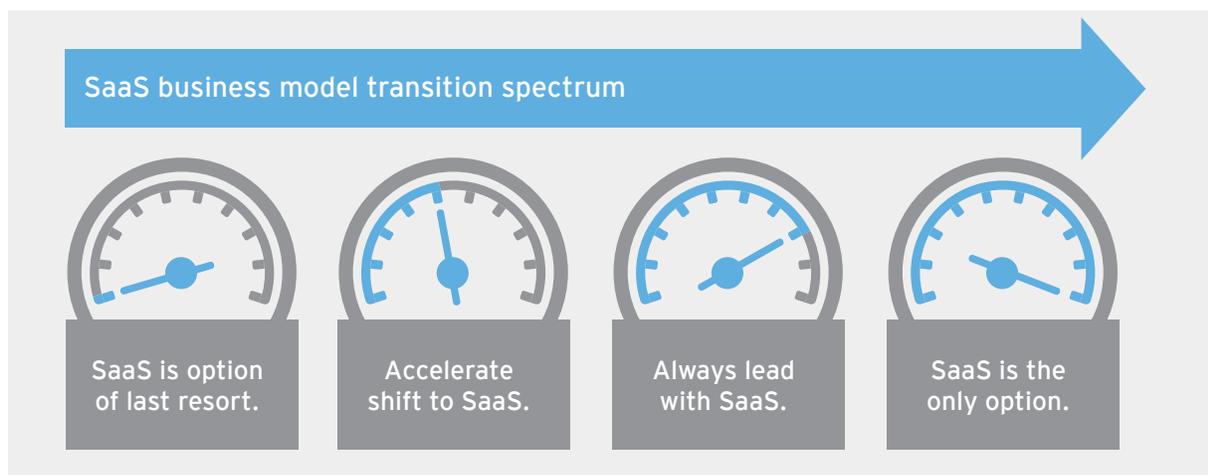


Note: Represents top public cloud companies, excluding corporations not focused on software exclusively (e.g. Apple, Amazon, HP, Hitachi, Siemens, IBM, Google, Cisco, EMC), or companies for which reliable data was not available. Sources include company annual reports and investor presentations, International Data Corporation (IDC), and two research reports: (1) Credit Suisse, 'Initiating Coverage with Neutral: INTU this Story but Not at this Valuation', 21 Apr 2016, and (2) Jefferies, 'Like The Story, Waiting For Additional Proof Points; Initiate With Hold', 29 Feb 2016.

All SaaS strategies are not created equal

In most business transformations, companies want to act as quickly as possible. With the SaaS business model transition, however, there can be valid reasons for a more measured approach. Companies evaluating SaaS transition strategies must consider the customer and competitive dynamics of their market and determine what the right speed and degree of change is for their business.

Figure 2: SaaS business model transition spectrum



On the far right end of the spectrum, companies are becoming SaaS-only businesses. This means that existing products will no longer be sold as perpetual licenses and all new products will be rolled out in SaaS forms only. This approach, taken by the likes of Adobe and Autodesk, is for companies that want to shape their market and lead customers to a SaaS-driven consumption model. It is a move with higher risks but potential for great reward. Adobe's reward, for example, came in the form of a stock price that grew at a CAGR nearly double that of the NASDAQ from 2012 to 2016.¹

On the far left end of the spectrum, companies are ready to offer SaaS but still emphasize the sale of perpetual licenses. In this approach, companies can offer customers a choice among a full range of consumption models and use pricing incentives to steer customers toward the perpetual model. Companies may choose this approach if the existing customer base is largely satisfied with the traditional licensing model and competitive conditions are not driving a rapid shift to SaaS. Companies choosing this strategy still need to "cross the chasm" as they need to be ready to accelerate the transition to SaaS on short notice if needed. Based on our experiences at EY, most companies choose one of the middle options as a starting point.

¹ Adobe's stock price grew at a CAGR of 29% from December 30, 2011, to December 30, 2016. The NASDAQ composite price increased at a CAGR of 16% during that same period. Adobe made the transition to the SaaS business model between 2011 and 2015.

Whichever SaaS road is taken, companies need to think through the details of SaaS offering that they plan to extend to their customers. When designing the SaaS strategy, vendors must ask which business challenges will be addressed given the range of benefits that customers may expect. To start, vendors should ask themselves the following questions:

- ▶ How is the SKU defined? What is the licensing unit? Does the SKU include product, maintenance and professional services?
- ▶ Is there a minimum dollar amount? Minimum time commitment? Minimum usage baseline?
- ▶ Is the customer allowed to scale up or scale down?
- ▶ Can the license be used across on-prem and off-prem/hosted deployment models?
- ▶ What is the price point? What is the crossover point in terms of years when comparing SaaS with perpetual pricing? What are the billing cycles?
- ▶ Is there an upgrade path from existing licensing models?
- ▶ How can customers be incentivized to commit to multiyear periods? To renew?
- ▶ How will volume discounts work? What options will be provided for customers who want enterprise license agreements (ELAs)?

Companies should think through the answers to these questions, and others, with the customer value proposition in mind.

Expect more than a pricing change, expect a business transformation

Some companies, like Adobe and Autodesk, have embraced the SaaS business model transition and leaped across the chasm. We have observed, however, that many remaining companies fall into one of two categories: those that underestimate the degree of business transformation required to achieve the SaaS model and those that have a full appreciation and are hesitant to dive in. In either case, the right next step is to understand the operational requirements of crossing the chasm and to assemble a team that can transform the organization. That team will need to rethink how to operate each function.

Sales and enablement

At its core, the change to a SaaS business model is a change to the way a product is sold. This will require an organization to rethink how it incents, measures and enables its salesforce.

This is particularly challenging if both traditional and SaaS licenses are made available to customers at the same time. In that situation, any commission-based salesperson would be naturally incentivized to promote the traditional license (to maximize commissions and quota retirement) over a SaaS alternative.

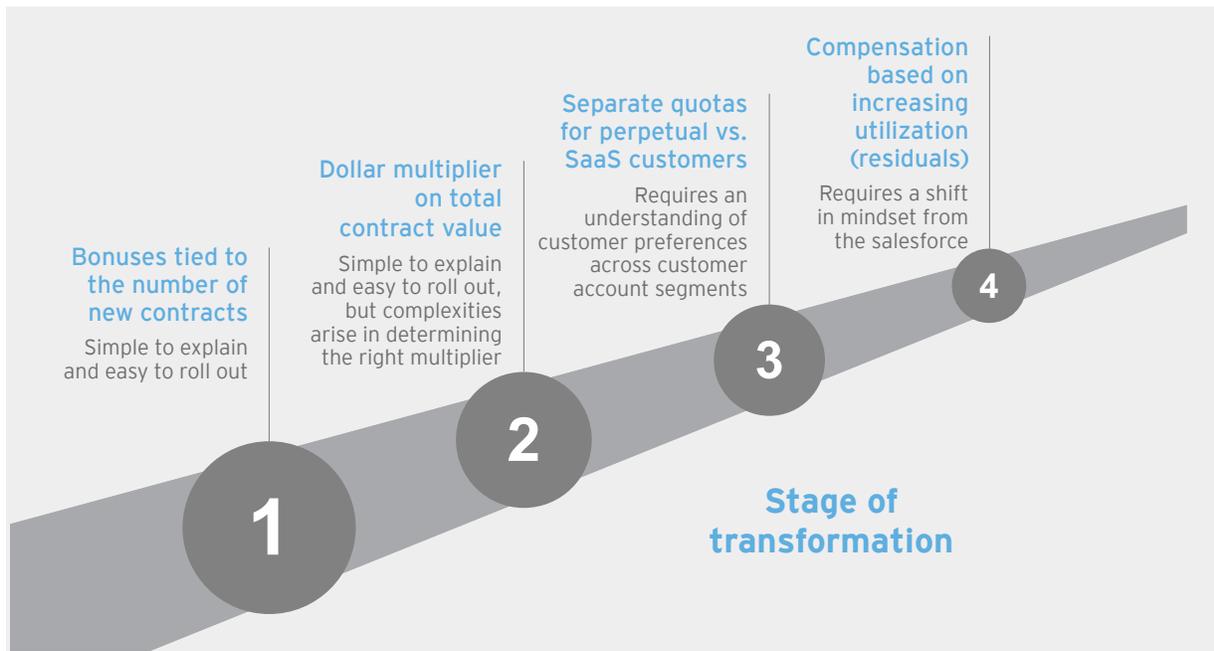
Companies need to carefully consider the implications of how quotas are attained and how commissions and bonuses are calculated to ensure that the salesforce appropriately balances the needs of the customer with the strategy of the vendor.

Changes to sales incentives are typically rolled out over time. For example, a vendor can decide to first add in bonuses tied to the number of new SaaS contracts booked. This incentive is simple for the salesforce to understand and straightforward to implement. A vendor can then decide to give credit to a salesperson based on a dollar multiplier to the total contract value (TCV). This

is also easy to understand but is highly dependent on the appropriate multiplier being chosen. This is obviously an improvement over a simple bonus per new contract, as it incentivizes the salesforce to maximize the total value of the contract (e.g., commitment to a longer duration or additional licenses). Some vendors aim to roll out separate quotes for perpetual and SaaS licenses, but this obviously requires a level of sophistication for forecasting customer demand. Most vendors eventually would like to establish a sales incentive scheme that is based on increasing utilization (e.g., residuals) across SaaS contracts. This is typically rolled out when companies are almost finished with the transition.

Equally important to setting the appropriate sales incentives is ensuring that the salesforce has been appropriately trained and is supported by the right set of tools and enablers. Enablers include updated quoting and pricing tools, updated competitive benchmarking and new total cost of ownership (TCO) calculators. Training must ensure that sales reps can explain differences in TCO across different consumption models, attributes of the SaaS offer (e.g., scale-up/down), and how SaaS offerings compare with those offered by competitors. Companies have shared with us that it can take up to a year to prepare sales reps and arm them with appropriate collateral.

Figure 3: Sales incentive transformation







Product engineering and customer support

It's not just the pricing but the product that needs to change. Successful SaaS vendors will create best-in-class user features, an intuitive web interface and a product offering that meets what customers have come to expect from SaaS offerings. Customers expect automatic updates that do not interfere with use or product customizations. Customers also expect new features and capabilities to be added often. Any time there is a disruption in service, customers expect prompt notifications and ongoing status updates.

To enable these changes, product engineering, application development and IT teams are looking for ways to automate and streamline development, testing and deployment practices. Some SaaS companies are turning to the DevOps model, in which the traditionally-distinct functions of software development, testing and IT operations are brought together. However, the transition to DevOps should be treated as a transformational initiative in and of itself.

Behind the scenes, IT needs to build multi-tenant architectures that provide performance and scalability without compromising on availability or security. This has led IT to look more toward software-defined infrastructures to complement or sometimes even replace the traditional hardware-defined models. In addition, IT organizations frequently evaluate infrastructure-as-a-service (IaaS) providers to be a part of the hosting strategy for SaaS product offerings.

Let's not forget customer support – in EY-Parthenon's 2016 Survey of CIOs we found that in return for costs associated with a SaaS product, more than 75% of CIOs expect a higher level of service from SaaS vendors.² Chasm-crossing companies will have to build a customer support infrastructure that is live 24/7 and supports the changing needs of its customer base.

Changes to the way software vendors organize product and support teams to meet the needs of the SaaS product will require both a technical and cultural shift among the engineering organization. The latter may be harder to contend with than the former.

² EY-Parthenon's 2016 Survey of CIOs.

Finance and accounting

The first change most CFOs will think about is how revenues will be impacted upon transition to the new business model. The adoption of the new revenue standard will further complicate this transition. For example, a move from up-front to ratable revenue recognition may impact revenue significantly during the transition period, while, at the same time, CFOs will have the opportunity to capitalize and amortize sales commission costs. Further, multiyear arrangements with full advance payments will require imputing interest cost and recording interest cost and additional revenue, thereby inflating EBITDA. Operationally, the finance team must be prepared to recognize revenue for the perpetual license and SaaS products simultaneously on a revenue sub-ledger, either via the existing ERP or a bolt-on application. Controllers must be prepared to manage their close processes during the transition to ensure timely, accurate and transparent external reporting.

The transition will have notable implications for internal reporting as well. P&L management will be impacted by the misalignment in timing between revenue

and expenses under the SaaS business model. The executive team will need to rethink the business metrics used to evaluate the company's (and the executives') performance, taking into account that in the SaaS universe product break-evens will be much longer, forecasts will need to be calculated differently, cost of sales will change with the sales incentive structure and transition costs may be substantial.

The finance team will also need to think differently about cash management. The payment structure will change from fewer large payments to many more small payments, some via credit card. Treasury managers will need to manage the misalignment of inflows and outflows, credit risk, cash controls, and other concerns related to liquidity.

Last but arguably most important, the finance team must be prepared to provide guidance to investors both during and after the transition around subscription adoption and achievement of SaaS milestones. Confidence will need to be built that revenue, though deferred, is coming.

Figure 4: Investor call quotes from executives in transition

"I think it is important to say that we are not seeing any change in the underlying demand for security or Symantec products in general, and we expect that this product mix shift that we talked about selling more subscriptions, more security as a service is something that will continue on in FY17 and FY18 and beyond. So we are just seeing that as a mix in terms of what shows up as in-period revenue versus deferred."

– Mike Brown, former Symantec President and CEO, Q4 2016 earnings call

"We continue to see a shift in the way our products are being delivered, evolving slowly toward a more ratable model, where unit growth will exceed revenue in the short term."

– David Henshall, Citrix COO and CFO, Q4 2016 earnings call

"We know when you are ... going more to a ratable model, whether it is due to the recurring growth revenue because of our cloud offerings or our rental offerings ... you know the effect it will have on revenue, operating margin and EPS. It has been clear in the marketplace. We will also have that effect."

– Mark Hawkins, Autodesk EVP and CFO, 2013 Autodesk Investor Day

IT

As with any other business transformation, the IT team will be responsible for enabling the new model to work. For the SaaS transition, this will mean the need for new systems or vendors to enable flexible pricing and quoting of SaaS products, along with billing tools that support recurring payments and payment by credit card. Dedicated vendors like Aria and Zoura have already emerged to serve the market for chasm-crossers in these areas.

IT will also need to enable multiple accounting and reporting changes at scale. IT will need to put automated controls in place to support the new business, and, of course, security concerns inherent in cloud services will need to be managed as well.

On top of all of this, IT will need to figure out how to budget for infrastructure, applications and support for the new business model. The level of IT investment required will impact the transformation's economics, so budgeting correctly will play an important role in modeling and selecting the right SaaS strategy.



Lessons learned to enable the transformation

The right strategy and expectations alone cannot deliver a market-winning SaaS product. Those considering the transition now can benefit from the lessons learned by those who have executed the crossing before them. Companies should leverage these leading practices to provide clarity to their customers, confidence to their investors, support to their salesforce and guidance to their employees – all the while working behind the scenes to enable the transformation. The following are some of the lessons we've observed over the past few years:

Do not expect to be revenue-neutral during the transformation.

The most common question we encounter when speaking with executives about the SaaS transition is, "How can we make this change revenue neutral?" In all likelihood, you won't. Crossing the chasm is a fundamental move from up-front to ratable revenue recognition for some or all sales. Attempts to bypass the transitional revenue impacts by phasing or altering the offering are likely to undermine the success of the transition. If employees do not believe their company is committed, the organization will not change.

What companies can do is mitigate the impacts of the transition on their stock price by providing transparency to Wall Street and allowing analysts to see the light at the end of the chasm. As Adobe CFO Mark Garrett put it to The Wall Street Journal, "Always make sure Wall Street can do a model of your business. If they can't do a model, they can't invest in your business."³

Prepare for a transformation period of more than a year.

The time from ideation to execution for SaaS transition has fallen since the trailblazers began this journey, but the depth and breadth of organizational transformation required means that effective transition will not

happen overnight. We have observed that it takes most companies at least a year from strategy commitment to SaaS product in-market. As discussed above, going for quick and easy is likely to undermine the stickiness of the business transformation.

Create a cross-functional program management office (PMO).

The SaaS PMO should determine, plan for and execute against the SaaS strategy. This team should include representation from sales, pricing, product management, R&D/engineering, IT, finance, legal and other functions, and it should be empowered with decision rights required to enact change. Staff the SaaS PMO with dedicated leaders who will evangelize the vision of the SaaS transition. The team should be accountable for meeting interim deadlines specified by the CEO.

Create a customer advisory board.

Feedback from customers on the offering structure, flexibility, features and pricing will be invaluable in the transition. Formally gathering input from a set of key customers will ensure alignment with customer needs. In addition, this customer advisory board can be used to test messaging and determine the timing and level of detail for public announcements made throughout the transition.

Communicate. Communicate. Communicate.

Though it may seem obvious to some, we cannot understate the importance of communication during this transition. A rigorous change management program including stakeholder analysis and effective communication will enable your customers, employees and investors to journey across the chasm with you. Without their support and enthusiasm, the likelihood of a successful transformation is small.

³ "Adobe Systems CFO: Managing Business Model Transformation," The Wall Street Journal, 16 January 2015.

What should the SaaS business model transition mean for M&A?

Software M&A continues to be strong, with global deals totaling \$120.9 billion last year.⁴ Further consolidation is expected in this space, as CIOs look to rationalize the number of software vendors they use.⁵ When evaluating M&A targets, buyers should carefully think through the target's relative SaaS maturity and how that will impact its stand-alone and contributory projections.

For non-SaaS buyers seeking SaaS-by-acquisition, ownership of a SaaS target will not bypass the chasm. The buyer's product and organization will still need to navigate the changes discussed above. That said,

acquiring a company with a successful SaaS model will likely enable faster adoption of the processes and systems needed to execute on the buyer's transition. This is one reason that software/SaaS witnessed more deals than any other technology subsector in 2016.⁶

For SaaS-capable buyers, targets that have not yet crossed the chasm may present an attractive opportunity. When evaluating such targets, corporate development teams should model the transitional impacts on target revenue and expenses, as well as integration costs.

In closing

What was once a trend of the future is now the reality of today. Software companies of all shapes and sizes should ask themselves if they are in the right position to compete in a SaaS-driven environment. For those peeking over the chasm, now is the time to define your SaaS strategy and begin the journey.

⁴ Global technology M&A report, Issue 34, EYGM Limited, February 2017.

⁵ EY-Parthenon's 2016 Survey of CIOs found that more than 50% of CIOs believe that their organization uses too many SaaS vendors, indicating that CIOs welcome the opportunity to consolidate among fewer vendors.

⁶ Global technology M&A report, Issue 34, EYGM Limited, February 2017.

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