SaaS: Adapt or Lose Out

What on-premise software providers need to know about transitioning to Software as a Service (SaaS).

SaaS Means Change

Life was great until the cloud came around. Your software was installed and ran on computers based at your customers' premises and was sold as a license. You got large payments up front when contracts were signed, typically followed by ongoing, high margin fees for maintenance contracts. Now with software applications moving to the cloud, your leadership team and board are likely concerned and struggling with many questions, including:

- When should you try to become a Software as a Service company? Should your legacy license model and a new SaaS model co-exist? Should you stick with the old business model that you know best?
- If you do transition to a SaaS-based business model, how do you manage the cash flow, accounting and resource transition?
- How much do you need to invest in SaaS capabilities, and what will the payback period be?
- How will you be able to provide the same customer experience on which your customers rely?

In seeking answers to these questions, know that SaaS is not a passing fad. Don't try to convince yourself that you can weather the storm and continue with only your tried-and-true perpetual license model until SaaS comes and goes. Today, 69% of businesses are using at least one cloud-based application; for instance, for customer relationship management (CRM), payroll administration or supply chain management. The trend toward cloud-based software applications is projected to continue, with global spending on SaaS expected to rise to $127 billion by 2018.[1]

At FTI Consulting, we recognize that although conversion is a complex and transformative undertaking, SaaS can create multi-dimensional opportunities for growth and long-term value creation for your organization and customers. This brief whitepaper explores the impact of a SaaS transition on legacy business models, organizational structures, core capabilities and profitability of perpetual license software providers. It also provides our thinking on best practices for moving forward with the transition.

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1 IDC report, "Worldwide SaaS and Cloud Software 2015-2019," August 2015.

SaaS Changes Software Business, Delivery and Operating Models

The public cloud is officially over Gartner's Hype Cycle.[2] Suppliers have the capability to deliver not only software as a service, but infrastructure (IaaS) and platform (PaaS) as well. With in-cloud networks, servers, storage, applications, services, buyers and end-users of technology can now get convenient, on-demand access to a shared pool of configurable computing resources for much less than it costs to buy, maintain and scale systems and software. What's more, end-users, who are increasingly mobile, do not need to be tethered to a single desktop to access their applications and can instead get them wherever and whenever.

Because in the SaaS model, buyers license software applications either as an on-demand service, through a subscription, or via "pay-as-you-go," and take delivery via the cloud, there is a very different revenue model for SaaS companies. In that model, revenues do not come in as large upfront fees when a contract is signed, but instead they trickle in as services are consumed or subscription fees collected.

EXHIBIT 1
Shifting to the Cloud

Company	Start	Goal
Adobe	Licensed Software	SaaS
Amazon	Services	IaaS
Autodesk	Licensed Software	SaaS
Computer Associates	Licensed Software	SaaS
Intuit	Licensed Software	SaaS
Microsoft	Licensed Software	SaaS
Symantec	Licensed Software	SaaS, Hardware

A look at two of the many companies shifting their product offerings to the cloud (Exhibit 1) highlights several tangible benefits of the SaaS transition. Intuit, a $4 billion company best known for its TurboTax and QuickBooks software, began shifting customers into the cloud and found that the move made it easier to cross-sell add-on solutions such as payroll and check processing. The company also determined that the customer lifetime value (CLTV) for QuickBooks online was about 40% higher than for the desktop software version.[3] Adobe, a software provider for creative professionals, stopped developing its perpetual license Creative Suite in favor of Creative Cloud, a subscription-based solution. Like Intuit, Adobe experienced increased CLTV, as well as increases in both customer retention rates and long-term revenue streams.

With its Creative Cloud, Adobe also reduced overhead costs because it could more easily control product updates and no longer needed the manpower necessary to support multiple legacy software versions across its customer base.

What Happens When You Evolve Your Business Model

For on-premise companies, converting to a SaaS revenue and delivery model requires evolving your business model to one that is subscription or transaction-based and focused on customer acquisition, retention and cross-selling. Make no mistake: this conversion is a large-scale change that requires assessing and adapting every aspect of your company's operating model, as every function is impacted in some way by the move to the cloud. However, the benefits of the change can be huge for those who try.

Here are some of the critical changes your organization will need to make:

Redefining and integrating sales and marketing. When selling perpetual licenses, the sales team was in the driver's seat negotiating and closing sales, supported by marketing for brand awareness and lead generation. In the SaaS model, marketing is in the forefront of the revenue generation equation, as focus shifts to optimizing recurring revenue growth through customer acquisition, up-selling, cross selling and retention.

With the increased focus on revenue growth, selling, general and administrative (SG&A) expense spending can ramp up considerably, driving down profitability. In fact, many companies that are in the midst of transformation are struggling to regain profitability. Your organization may need to make a choice between focusing on profitability or revenue growth. If revenue growth is the answer, your organization should be prepared with cash in-hand to fund the move to the cloud.

Another common problem is that during the transition the SaaS sales team is competing with the on-premise sales team for the same customers. Therefore the sales compensation plan must be adapted to reward collaboration among the teams while shifting emphasis to SaaS sales.

Prioritizing customer service. Under the traditional model, customer service focused around product expertise and was typically reactive in nature. It was considered a cost center. Under SaaS, the emphasis is on customer experience and offerings that are proactive. Customer service can be a profit center.

2 "Gartner's 2015 Hype Cycle for Emerging Technologies Identifies the Computing Innovations That Organizations Should Monitor," August 18, 2015.

3 The Motley Fool, "Keep Investing in the Cloud, It's Working," February 25, 2014.

Developing new performance KPIs and financial metrics. SaaS contracts are subscription or transaction-based; therefore, the SaaS revenue model requires a new set of consumption-based key performance indicators (KPIs) as shown in Exhibit 2. Traditional KPIs, such as volume of licenses sold, are replaced by customer acquisition cost (CAC), CLTV, customer retention rate (CRR) and committed monthly recurring revenue (CMRR). This transition to a new set of KPIs is not only operational but must be dealt with in terms of shareholder and stakeholder management.

Redesigning the product development process. Traditional software development historically followed the waterfall model (lately some transition to agile), which is a lengthy and sequential design process. There is often a high degree of product customization, depending on customer specifications. For SaaS, product release cycles are short. Development is done in real time with a high level of customer interactivity; however, products are standardized, with much less centralized customization. Customers serve as a very involved testing group, providing real-time feedback on product and service offerings.

EXHIBIT 2

SaaS metrics are customer-focused and consumption-based

CAC	Customer Aquisition Costs
CLTV	Customer Lifetime Value
CRR	Customer Retention Value
CMRR	Committed Monthly Recurring Revenue

Adapting talent management strategy. SaaS requires different skill sets for sales and marketing, customer support, among other areas. For example, sales representatives must have the ability to focus on customer acquisition and retention, rather than account management. Marketers, meanwhile, must be increasingly focused on enhancing the customer experience and differentiating messaging by market segments.

SaaS product development may also require a different set of research and development (R&D) staff from those who specialize in perpetual license product development. SaaS product release cycles are shorter, and developers may need to be conversant in different technologies. A significant challenge to the organization comes in managing the transition from the legacy to the SaaS R&D team.

Hiring, training or retaining talent with the necessary capabilities are other difficulties transitioning companies may face. When shifting to SaaS, your human resources team will need to create and implement a specific strategy for on boarding people with SaaS-focused skills.

Bumps in the Road

No transformational change is without difficulties. Intuit, for instance, suffered a series of outages during its migration to the cloud. These were severe enough to interfere with customers' operations and therefore impacted Intuit's reputation. Autodesk found that holders of 5-20 seats of product were reluctant to switch away from perpetual licenses. As a result, Autodesk had to dedicate additional resources to communicating the value of its offering to this market segment.

Organizational prioritization. During the transition, there will likely be competing demands between traditional and SaaS models for resources such as R&D/Product Development, sales and support.

Higher than expected costs. Moving to cloud may result in unforeseen product development, support, or sales and marketing costs, which in turn will drive up the overall cost of transforming the business model.

Lower customer adoption. As seen at several companies, some customers may be reluctant to change from traditional software to a cloud-based application. This reluctance impacts revenues and creates additional challenges for the sales and marketing teams.

Customer segmentation and pricing. Not every customer is the same, and some may prefer the existing on-premise application and/or pricing model.

Competing business models. New SaaS business can start to cannibalize existing, and profitable, businesses from the perpetual licensing model by competing against it for customers.

Conflicting systems, processes and metrics. Everything in SaaS, from revenue recognition, to back office operations, to KPIs is very different from what people are used to for traditional software business models

Channel uncertainty. Channel partners may lose confidence due to a perceived lack of structure and communication of channel strategy, programs and incentives.

Three Critical Steps—How to Begin the Transformation...

Lead with Product Integration

Choosing the right part of the organization in which to start the transition can help you deal more effectively with the challenges mentioned above. Too often, companies in a rush for profitability make a hash of the transition process by changing accounting first then products, and then figuring out what the sales team needs to do to start migrating customers. The brand, messaging and operating models are afterthoughts. Such a poorly executed strategy results in confusing messaging, lack of organizational focus and loss of customers.

It is crucial that your new cloud-based products deliver the same experience and functionality as your on-premise products, so that customers are comfortable migrating to the new offering. After product integration is determined, build your business model through marketing and brand integration, so that you are delivering integrated and cohesive messages to both the SaaS and on-premise sides of the organization and your channel partners. Only then should you transition sales, operating systems and business processes and begin to migrate customers.

Ask These Strategic Questions

Companies should have answers to a series of strategic questions to ensure that they are well prepared for a transition:

- Is SaaS a defensive move, one that is due to a disrupter in your market space, or is it an offensive play that is just outside your company's current camp?
- Who are your target SaaS customers? Will they have the same economic buyer and functionality that your legacy customers have?
- Will you need the same go-to-market assets (sales, marketing, etc.) for the target SaaS customer?
- Is your market and product positioning the same as for your licensed software, a minor variant or a completely different proposition?
- What is your product strategy? Will you try to integrate legacy and SaaS offerings or migrate all legacy users to SaaS?
- Are you going to need to manage hosted infrastructure and on-premise infrastructure?
- Are you managing for profitability or managing for growth?
- Having clarity around these questions can help your leadership team and board establish a transition plan that minimizes risk and maximizes value.

Be a Facilitator for Organizational Change

Managing the SaaS transformation is resource intensive. On-premise companies can often lack the internal capabilities or resource capacity to execute such a wide and transformational change. If you have made the decision to move to the cloud, consider whether you will execute the transformation with in-house resources, or if you need to seek external help. Additional considerations include:

- It is important to know your operating model, revenue drivers, customer preferences, and cultural barriers. For example, if your operating model requires a radical shift as part of the transformation, then leveraging an expert can help mitigate risks.
- Assimilating the lessons learned from several past implementations and SaaS transformations will help you avoid common pitfalls. If your organization does not have in-house expertise in lessons learned, a consultant with experience managing these transformations can help.
- An external consultant can provide an objective opinion on what customers respond to when migrating to a SaaS model. The consultant also can impartially negotiate internal differences of opinion. They can bring data and facts to resolve issues with SaaS-based operating models and business models.
- Change and transition can be accelerated when you have access to external benchmarks, KPIs, adoption rates, and customer and sales incentives.
- An "outside-in" view also can help align brand, channels, customer segments and the SaaS product. Such a point of view also can inform changes required to sales incentives, product development, pricing and features.

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