

Building a Recurring Revenue Business



Converting to Software as a Service

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Converting from licenses to a SaaS model can be lucrative for software vendors

Here are several tips to make a successful transition

The founders of many software companies want to 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.

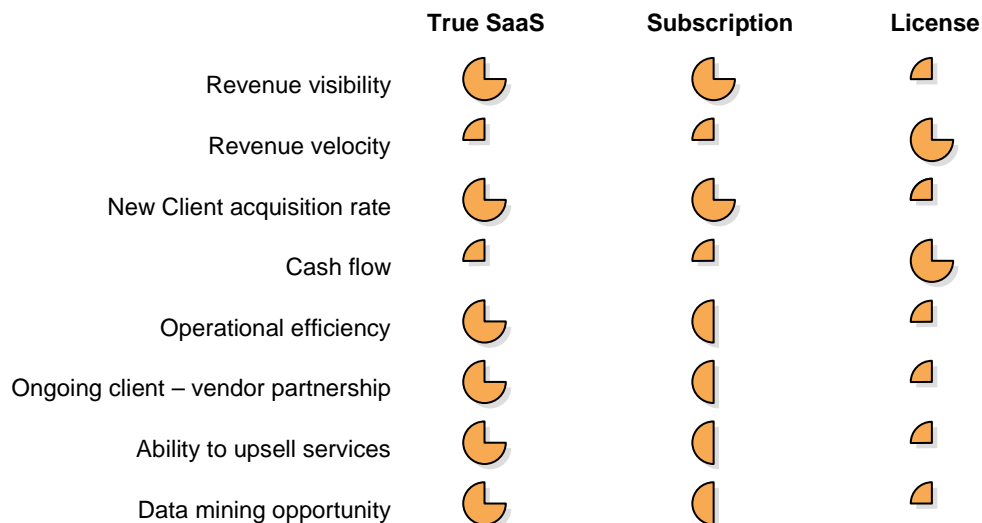
We have worked with a number of software vendors that have made the transition to SaaS and have found some useful lessons to insure success. In several cases we have been able to complete the shift fairly quickly, migrating to a recurring revenue model for the majority of the business in as little as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

The SaaS explosion

The market for on-demand software pricing and delivery (also known as Software-as-a-Service or 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.



Key lessons for a SaaS transition

Our experience working with software vendors to transition their business models to an on-demand or SaaS model has taught us several best practices.

▶ **Choosing a 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 licence 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%, perpetual license prices by 25% and maintenance by 50%. As a result, subscriptions became more attractive to customers although still earning the company the equivalent cashflow at signing as the licence 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 2 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 U.S., 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 incentivise 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 usage. 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 usage, 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 anonymised data from customers' use of your application and turn it into an information service that can be upsold to existing customers. [example?] 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 6 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.

About the authors

Javier Rojas



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

Prior to joining Kennet, he was a managing director of Broadview International and led their West Coast Software and Services practice. Javier specialized in advising high growth, early-stage companies on how to capitalize on emerging technology markets and partnering opportunities.

He invested and/or advised on a number of successful companies and high value exits including Etek, Webex, Looksmart, Blue Mountain Arts, When.com and Rightworks.

Previously, Javier was with Morgan Stanley. Earlier, he founded a software firm that developed products for capital markets interest rate and currency swap traders.

He holds an MBA degree from The Harvard Business School and a BAS degree from Georgetown University.

Max Bleyleben



Max is a contributor to investment and technology trade journals and writes an influential blog covering European venture capital, corporate governance, technology trends and entrepreneurship.

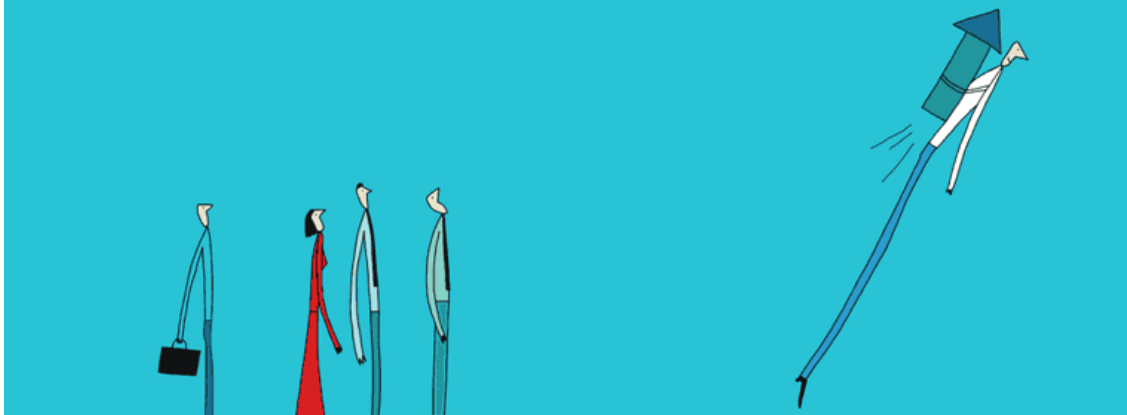
Max has led Kennet's investment in on-demand remote support software vendor NTRglobal, eSourcing managed service provider TradingPartners, teleradiology services company Telemedicine Clinic, and compliance solutions provider FRS Global. He has also contributed to investments in Clearswift, Kapow Technologies and Adviva Media.

Prior to joining Kennet in 2000, Max led the execution of M&A transactions involving software, Internet and IT services companies at investment bank Broadview International. In the 1990s he project-managed the production of economic reports on emerging markets for European and US news media. Earlier, Max worked as a production coordinator for global Spanish-language media group Televisa in Mexico City.

Max holds an MBA degree from INSEAD, France, and a BA degree from Bard College, New York. He also undertook undergraduate studies at the American University of Paris and is fluent in German, Spanish and French.

About us

Kennet invests in entrepreneurial technology businesses to help them take the next big jump in growth.



We're an experienced growth equity investor with a long track record of building global market leaders and achieving high-value exits.

Since 1997 we have invested over \$270 million in companies in Europe and the US.

As a growth equity investor, Kennet focuses on companies that have proven commercial success and are now ready for the next phase of growth.

The companies we invest in often do not need money to survive.

They have options. But the right investment from the right partner can help them keep ahead of their markets, expand internationally, ramp up their sales forces and lead to greater value for shareholders.

Visit us at www.kennet.com to learn more.

► Silicon Valley

Kennet Partners LLC
950 Tower Lane, Suite 1710
Foster City, CA 94404

tel: +1 (650) 573-8700
fax: +1 (650) 573-8712

► London

Kennet Partners Ltd
St James House
23 King Street
London, SW1Y 6QY

tel +44 (0)20 7839 8020
fax +44 (0)20 7839 848