Software as a Service: April 2008 Addendum

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White Paper

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Fast Forward/SaaS April 2008

Since we last published our strategy work on the SaaS market (Software As A Service: Ride it While it's Hot, 28 November 2007), the world has continued to change shape and evolve. Several important trends we wanted to point out include:

- **Valuations are down sharply on SaaS companies**. These are high alpha/high beta stocks that exhibit extraordinary volatility. While these stocks dramatically outperformed the market last year, and 14 of the 15 newly minted IPOs were trading above their offer price, today less than half are above their offering price and the aggregate publicly listed SaaS companies are down more than 25% year-to-date.

- **The acquirers of SaaS companies are emerging as the broader-based IT providers rather than traditional enterprise software companies.** These include the likes of Dell, EMC, and Hewlett Packard. This group seems to be in search of the sustainable, long-term profitable revenue streams offered by the SaaS model. They have sufficient size and resources to pay for these acquisitions and leverage them quite well. As we pointed out in our prior work, the channel for SaaS is likely to evolve differently over time.

- **SaaS companies are, in our opinion, shifting towards the platform sale where it is possible to raise exit barriers and establish better lock-in with customers.** Of course, what would the industry be without a growing cadre of acronyms. PaaS, which stands for "Platform as a Service" is the latest to enter our jargon-intense world. In order to emulate the extraordinary profitability found in the traditional software industry, this move makes a lot of sense. For customers, this may be a case of trading the devil they know for one they don't. We sense that CIOs are aware of these moves and consider them quite carefully. Internal costs to deploy, manage and maintain a platform are expensive. If PaaS can live up to some early promises, it could be the next secular growth area in the software sector. But, as with all new technology, we've got to get through the hype stage and the trough of disillusionment before the game really begins.

- **Customer acquisition growth is an area of increased scrutiny by Wall Street** following the rigorous questioning of "churn" by Dennis Howlett ("NetSuite's Numbers are not what they appear", February 15, 2008, ZDNet – Irregular Enterprise) and Jason Carter ("Customers are running away from NetSuite", February 15, 2008, Abridged Mind) in their respective blogs after NetSuite reported numbers. According to publicly available information, NetSuite has lost more customers than it has gained over the past 5 years.

We think that SaaS remains a secular growth opportunity over the next 10 years. Moreover, we think the PaaS concept can drive the opportunity through a long 25+ year replacement cycle not unlike the transition from mainframe to client/server. Valuations and expectations have a tendency to run in front of reality in early-stage secular-growth markets and the SaaS market is no exception. The market can move from irrational exuberance to the trough of disillusionment very rapidly. We continue to believe we are in an extraordinary time for the SaaS market and well-prepared companies should be developing their strategic plans for liquidity.

The year of the Platform; PaaS moves to the Lingua Franca

One of the primary customer advantages of the SaaS environment are low switching costs. However, with 2008 steadily on track to become the "year of the platform", those switching costs may be getting a little higher. PaaS promises to deliver compelling benefits to migrate internal applications to the SaaS model. Besides creative payment systems that dis-incentivize the consumer to look for alternative solutions, the introduction of full-fledged platform environments by many of the largest SaaS players is definitely designed to change the landscape. Phil Waineright, A highly regarded ZDNET blogger notes "There's been a veritable explosion of platform-as-a-service choices coming onto the market in the past month or two, and the pace of introductions is accelerating rather than slowing."

The latest company to rebrand its platform is NetSuite, with the launch of NetSuite Business Operating System or NS-BOS. However unlike Salesforce.com which has taken a softer approach to bundling, NetSuite bundles its platform with SuiteFlex development environment, SuiteBundler customization packager, as well as NetSuite's ERP, CRM and e-commerce suite. It will be interesting to see which approach works better with customers.

By giving customers the tools to design their own applications as well as the opportunity to partner with and integrate applications from a large group of partners, SaaS vendors hope that consumers will think twice before moving away. In the end the customer just wants the functionality of the application but, as the saying goes, if the bank has your mortgage it probably has your savings account as well. Once a customer has overcome the financial and mental hurdles to invest in a relationship, it is harder to break that bond and easier for the solution provider to up-sell to him. Customers that run the Microsoft Windows operating system are much more likely to use Microsoft Office for their business needs. In the same light, if customers are using Force.com to build many of their critical business applications then they will be less likely to switch from Salesforce.com’s CRM solution if NetSuite comes out with a lower priced higher value alternative. As SaaS matures, the theoretical appeal of lower switching costs may stick around but the realistic value will most likely resemble those in the premise-based world. With this strategy in mind, we expect larger companies with established SaaS applications to readily seek to acquire smaller companies with developed platforms that have a large customer base.

Recent active acquirers of SaaS

Dell has been in the hunt most recently in its $155m acquisition of MessageOne, a provider of hosted email management software to businesses. Dell is seeking to become stronger in the managed services arena as its hardware business continues to become commoditized. Instead of constantly championing its partners’ software with its own hardware systems, Dell is increasingly trying to create its own software alternatives that it can sell along with the hardware. The acquisition further bolsters Dell’s SaaS offering which also includes Everdream and SilverBack Technologies.

Another recently acquisitive company in the SaaS space has been EMC, which encountered the same problem Dell did about 10 years ago as storage hardware became commoditized. Since then, they have been searching for new software products to fuel growth in the business. Its recent acquisition of Mozy, a hosted enterprise backup services provider, will fit right in with EMC Fortress for high-end customers and push Mozy's offering beyond the entrenched small-to-medium sized businesses (SMB's). More recently they acquired Pi, a provider of web-based collaborative peer and enterprise file search and sharing solutions, which complements EMC's emerging cloud infrastructure strategy quite well.

These two companies are essentially following the trend that we pointed out in our earlier piece that traditional aggregators are looking at SaaS products as complementary to existing technologies, offering a great potential for growth and cross-selling opportunities. Additionally, these companies could, through some strong leadership and coordination, develop a PaaS approach to the market opportunity over time. The likes of EMC, Dell, HP and IBM don't have large, traditional enterprise application software businesses which can be cannibalized by their entrance into the SaaS market. Consequently we see them continuing their "experiment" into this business model and market opportunity.

Musings of giants

In early March 2008, Microsoft announced the expanded availability of Microsoft Online Services, originally released in September 2007 as a service for organizations with more than 5,000 employees. Essentially this initiative is an extension of SharePoint and Exchange to make the offering more inclusive for the SMB community. There are also plans to release a new PaaS product, as well as a SaaS component to Silverlight. Although many people were hoping for a big announcement from Microsoft that would bring more crucial applications into the cloud (such as Office), Microsoft is not about to abandon its business model and will seek to deliberately avoid this scenario for as long as possible. Also of interest is that Chris Lidell, the current CFO of Microsoft, views the ongoing acquisition of Yahoo! as a fundamental piece of Microsoft's SaaS strategy. Following in Microsoft's expanded Sharepoint's footsteps, IBM unveiled "Bluehouse" in late January. Currently a managed beta of a Web-delivered service, Bluehouse provides a suite of extranet collaboration services that make it easy for SMB's to securely collaborate by sharing contacts, files, project activities and interacting with chat and Web meetings. IBM is also pursuing a SaaS solution in China where it has launched eManager2 and Retail B2B which provide order management, merchandising and financial management, as well as a supply chain solution for department stores. This push in China has resulted in 3,500 new clients in the first five months. Essentially IBM is testing its new services offerings in China and can easily migrate the offering to its local customers. It also provides IBM with a huge market opportunity, where the rise of a new class of SMB's with no prior IT legacy is taking place and therefore provides a large potential market for the SaaS model to really become the dominant underpinning architecture. Meanwhile IBM will be positioned as the provider of both the service as well as the support.

SAP continues to announce news on its SaaS suite Business ByDesign (BBD) at a somewhat slow pace. Gartner has said that "SAP's ability to deliver SaaS remains unproven" citing that SAP released its CRM on-demand product in 2006, but it hasn't yet attracted a large number of customers. BBD is still however in early customer validation and SAP announced new partner wins putting the total number of global resellers that will have direct input into the new channel model at 43. Also of interest is that SAP is no longer dissuading larger customers from deploying BBD to their subsidiaries. Although they remain fearful of BBD cannibalizing their traditional offerings to these enterprise clients, they are hoping that BBD achieves account wins against their competitor's offerings.

Most recently, Oracle has rebranded the Siebel CRM on-demand as "Oracle CRM on-demand" and will use this as their primary CRM SaaS offering. The Siebel brand name will be used for the on-premise traditional solution from this unit. SAP, Microsoft and Oracle are all vying for the Saleforce.com opportunity. How the rest of 2008 plays out will remain interesting.

It was the best of times, it was the worst of times

In late December NetSuite came out at double its original intended IPO price and raised $160m in the process. However NetSuite's most recent results highlight a very important issue for SaaS companies. Churn is just as important as top line revenue growth. As Dan Howlett and Jason Minnesota both note on their respective blogs, the company has lost more customers than it has gained over the past 5 years. In a press release dated March 2003, NetSuite claimed to have surpassed the 6,000 customer mark. In their last SEC filing, however, they now claim to have "over 5,600 customers". Undoubtedly any business is prone to churn as new products come online and competitors enter the space. That being said, for SaaS companies whose profitability ultimately depends on reaching a certain customer scale this surely sends a very worrying signal. It is little wonder then that, even though NetSuite enjoyed a 62% increase in revenues YoY, its stock price is down 15% from its IPO and almost 41% YTD.

Security Name	Symbol	Return YTD	Return on IPO	One Day Return on IPO
Blackboard Inc	BBBB	-13%	142%	47%
Concur Technologies Inc	CNQR	-16%	153%	144%
Constant Contact Inc	CTCT	-31%	-10%	73%
DemandTec Inc	DMAN	-45%	-4%	-15%
Kenexa Corp	KNXA	4%	62%	0%
Kintera Inc	KNTA	-63%	-93%	29%
NetSuite Inc	N	-41%	-15%	37%
Omniture Inc	OMTR	-27%	272%	0%
RightNow Technologies Inc	RNOW	-22%	68%	0%
Salary.Com Inc	SLRY	-53%	-39%	19%
Salesforce.Com Inc	CRM	2%	457%	56%
Successfactors Inc	SFSF	-9%	0%	33%
Taleo Inc	TLEO	-32%	42%	-3%
Ultimate Software Group Inc	ULTI	-4%	203%	0%
Mean		**-25%**	**88%**	**30%**
Median		**-24%**	**52%**	**24%**

[Source: Capital IQ, As of April 01 2008]

In general, publicly traded SaaS companies have not enjoyed a banner start to 2008. While there is something to be said about the current market depressing prices across the board, the NASDAQ composite index is down only c. 11% YTD while the basket of publicly traded SaaS companies is down c. 25% on average. In fact, only two of the fourteen companies we highlighted had a positive return YTD and those that did (Kenexa & Salesforce.com) were below 5%. The recent depression in the valuations of public SaaS companies will likely lead to a market with more active buyer interest and over time more selling interest. The mantra usually espoused is that SaaS companies are better equipped to withstand recessionary pressures because they can optimize and, in most cases, reduce IT or software spending. While this may be true for the business model, in times of financial distress investors also tend to flee to safer havens. The market is volatile and exhibiting signs of confusion at the moment. The only lesson to take away from the recent movements is that secular growth alone won't sustain higher levels of value; the expectations from these companies remains high and if missed, those fleeting valuations will disappear.

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