

Investing in Companies that Deliver Software as a Service

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Software as a Service (SaaS) is a new way of creating, delivering, selling and utilizing applications. This new model provides a novel approach to solving some of the biggest challenges that plagued earlier generations of software technology: cost, complexity, time-to-market and ease of use. Application developers and end-users are embracing SaaS as they seek to lower upfront development costs, to reduce the overall risk of creating new applications and to increase the probability of success of each new application being deployed. The success of early SaaS pioneers—such as Salesforce.com, Rightnow Technologies, Kanexa, Netsuite and Qualys—coupled with the increasing user demand for software applications that are priced and delivered as a service is leading new and existing software vendors to embrace SaaS for at least part of their software business. In all, over 600 public and private companies have adopted the SaaS model as their sole route-to-market business model and delivery mechanism.

More formally, SaaS is software that is designed to leverage the web, delivered as a service, managed by the vendor and priced on a subscription basis. The initial SaaS applications addressed areas such as CRM, HR, ERP and targeted Small and Medium sized Businesses (SMB), as well as individual departments within Global 2000 corporations. Today SaaS applications are also being used to address industry-specific needs in areas such as logistics, financial services, manufacturing, etc. and their use is expanding beyond the SMB market. For example, Merrill Lynch recently adopted Salesforce.com on an enterprise-wide basis.

SaaS applications are enabled by the following technologies:

1. The ubiquity of broadband internet, which allows the worldwide delivery of feature-rich applications even in data-rich domains such as business intelligence.
2. The decreasing costs of storage and computing, which allow SaaS vendors to set up and cost-effectively operate data centers to host and run their applications.
3. Virtualization technologies that allow SaaS vendors to offer multi-tenant solutions, significantly reducing operating costs.
4. Security technologies such as identity management that provide the users of SaaS applications with “peace of mind”.
5. Web 2.0 technologies, such as Ajax, that allow SaaS vendors to offer Rich Internet Applications that are often more visually appealing and functional than their “fat client” counterparts.

The demand for SaaS applications is driven by the problems customers have experienced with on-premise software. These problems fall in four categories: deployment challenges, high costs, low utilization rates, and slow release cycles. In particular, several studies have revealed that only a fraction of on-premise software applications are deployed on schedule, with many experiencing delays of six months or more. More alarming, over 25% of purchased applications

are never fully deployed. Moreover, on-premise applications often have high associated costs. These range from the costs to deploy an application, often as high as two times the license price, to the lifetime costs of maintaining and managing an application, often as high as 10 times the license price. As IT budgets stagnate, large vendors such as IBM, Oracle, Microsoft and SAP have a seeming stranglehold on them. The IT asset inventory applications that companies started using in early 2000 revealed what everybody had suspected up to that point but had not been able to prove: only a small percentage of the software licenses purchased by a corporation are ever fully utilized. Finally, while new versions of “traditional” applications are often released every 1.5-2 years, customers are now demanding more frequent releases with new features soon after a business need arises. This fast-release cycle is akin to what consumers come to expect with Web 2.0 applications that often remain in “permanent beta release” and are refreshed on a weekly basis. In addition to addressing these four problems, customers often prefer SaaS applications because they can be quickly deployed to a distributed workforce, they convert fixed IT costs to variable costs, and they enable the corporation to focus on its core competencies and business processes.

Likewise, software vendors are also quickly embracing the SaaS model because it offers them:

1. Predictable revenue streams. Companies sign 1-3 year contracts with monthly payments based on the number of “seats” being used. These contracts are typically renewed at the end of each term. Companies can start with a small number of seats and grow their usage as necessary, lowering the barrier to an initial sale and easing incremental adoption.
2. Access to new markets. The pay-as-you-go pricing of the SaaS model (versus the high-upfront-cost perpetual license) opens access to new industries and to additional market segments within in each industry. This is particularly the case with the SMB segment which has aggressively adopted SaaS applications.
3. Lower sales costs. Delivery of software over the Internet (in conjunction with selling tools such as webinars and web conferencing) allows customers to become familiar with an application and easily “try before they buy.” This means that vendors can engage the prospect, and often complete a sale, without even having to send sales executives and sales engineers to a customer’s site.
4. Better control over engineering costs. The smaller but more frequent releases and the fact that the software does not need to be installed in diverse customer environments allow companies to achieve defined results with smaller engineering teams and to better utilize these teams.

The two major issues of SaaS applications that customers often want addressed are: the limited ability to customize such applications compared to the customizability of their on-premise counterparts and the need to improving overall application service levels. Companies, particularly those in the Global 2000, are accustomed to purchasing software and, with the aid of systems integrators, customizing the software to incorporate the specific business processes they employ (and often consider proprietary). Such customizations invariably increase the application support and maintenance costs. SaaS applications, in contrast, because they need to be supported and maintained by the vendor, offer limited abilities for customization. Instead, developers try to satisfy 70-80% of a business process such as sales management that is common to corporations of any size.

As they become more familiar with SaaS applications, customers (particularly from the Global 2000) are starting to ask for service levels that that are not often offered, such as “five 9s” uptime,

mirrored data centers for immediate disaster recovery, etc. Because the majority of the SaaS application vendors are smaller companies, they often struggle to offer and to adhere to such Service Level Agreements.

Venture investors have embraced SaaS application companies for the following reasons:

1. Ability to penetrate new markets, particularly the SMB.
2. Unique opportunity to disrupt the stranglehold of the large IT vendors in the corporate IT budget, particularly in the Global 2000
3. Capital efficiency, particularly through lower marketing and sales costs.
4. Recurring revenue model that leads to predictable revenue streams.
5. Realization that the success of the SaaS model is not limited to a single application but applies equally well to several different application areas, as well to IT infrastructure.
6. Improved rewards in the public markets, as demonstrated by the performance of companies such as Salesforce.com, Omniture and Kenexa.

Trident has been investing in SaaS companies using two investment theses:

1. Invest in companies whose industry-independent SaaS offerings address large markets across horizontal segments, such as security, business intelligence and ecommerce. We have invested in Infopia (www.infopia.com), Neohapsis (www.neohapsis.com), Qualys (www.qualys.com), Seatab (www.seatab.com) and Vidavee (www.vidavee.com) under this thesis.
2. Invest in companies that target markets that can best be addressed via SaaS offerings rather than by large on-premise applications. We have invested in Clarus (www.clarus.com), and Royaltyshare (www.royaltyshare.com) under this thesis.

Software as a Service provides for multiple types of innovation, is leading to the expansion of the total addressable software market, and will continue to enable the creation of new leaders in the software industry.