



The Benefits of a SaaS Transformation (The Obvious and Non-Obvious)

And Why All Applications Software
Companies Will Soon Be SaaS

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The General Thesis.

We spend a lot of time helping both companies and investors think through SaaS Transformations. Our general thesis is that SaaS transformations represent a significant opportunity for investors and operators alike to capitalize on the growth opportunities, efficiencies, and valuation differential experienced by SaaS companies. This thesis is comprised of the following supporting arguments:

Robust multiples. SaaS companies garner a premium multiple in the market (both private and public)

The intangible benefits. SaaS companies have many intangible benefits, most of which are well-known, such as recurring revenue, less friction in the sales cycle, and fewer issues relating to customers' IT departments

The less obvious advantages. SaaS companies also have other less obvious advantages such as streamlined R&D operations, more potential revenue models, and tighter knowledge of the customer due to online connectivity and application instrumentation

Strong growth. The revenue trough associated with converting a perpetual license on-premises software business to SaaS is often shorter in length than expected, typically lasting only 2-4 years, but providing strong growth during the transition and larger revenues and profits afterwards

Since many investors are forced to pay up for any decent software company these days, considering a SaaS transformation and capitalizing on the valuation multiple arbitrage should be a key part of an investment thesis.

Why Some Resist SaaS and Why They Won't For Long.

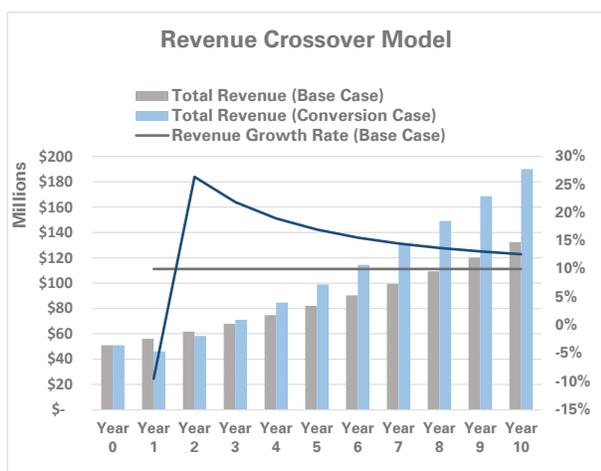
Despite the overwhelming case for SaaS Transformations, many software companies and investors are reluctant to cross the Rubicon and often choose to hedge their bets, coaching their companies to continue to offer on-premises solutions even after they have developed a feature competitive SaaS offering. We find this hesitance to be a result of two factors: (1) apprehension of the short-term revenue trough associated with a SaaS conversion, and (2) an anecdotal fear of certain high-profile large customers pushing back against a pure SaaS model. Below we tackle both objections:

To address the revenue trough, we have modeled the revenue trajectory of companies making the conversion. Our analysis indicates that for most companies, the revenue trough is both short-lived and comes with several accompanying benefits – including higher growth rates and more long term cumulative revenue. In most scenarios, companies with growth under 20%, regardless of many of the other parameters in the model, will find that revenue catches

up by year 3 and cumulative revenue by year 4. Meanwhile, in years 2 and 3, growth is significantly higher for the SaaS transformation than in the status quo. The chart below (Figure 1) is indicative of a common scenario.

The second common objection stems from the thought process amongst large enterprise CIOs regarding whether to allow certain applications to live outside of the enterprise's firewall. IT managers and executives - sometimes speaking about legitimate security concerns and sometimes speaking to protect their jobs - stand in the way of core applications moving to the cloud via a SaaS vendor. At the same time, these same decision makers have adopted Salesforce.com for CRM, and allow unencrypted email between employees and non-employees, thus calling into question the sincerity of their argument against other SaaS applications. The successful adoption of CRM in the cloud has opened the floodgates for virtually all other types of applications to move to the cloud even over the objections of certain IT managers.

Figure 1



SaaS Transformation Revenue Crossover

This model has dials for customer growth and attrition, SaaS price in proportion to perpetual license, gross margin, professional services mix, customer churn, and rate of growth (2nd derivative of revenue). As it turns out, the two most relevant factors are the first and second derivatives of customer acquisition.

The New Frontier for All Applications Software.

Towards this end, we have seen in recent years the advent of ERP (FinancialForce, Workday), Marketing Automation (Eloqua, Marketo), and Software Development or ALM (GIT and Rally Software) in the cloud. These types of applications manage information that is often considered the “crown jewels” of corporate data, and thus are the types of applications that some thought would never take root in the cloud.

These SaaS vendors are not the outliers. Enterprises surveyed by Forrester indicated a dramatic increase in SaaS interest and spending from previous years, primarily in application areas such as ERP, BI, and supply chain sectors. Forrester found spending on SaaS applications to

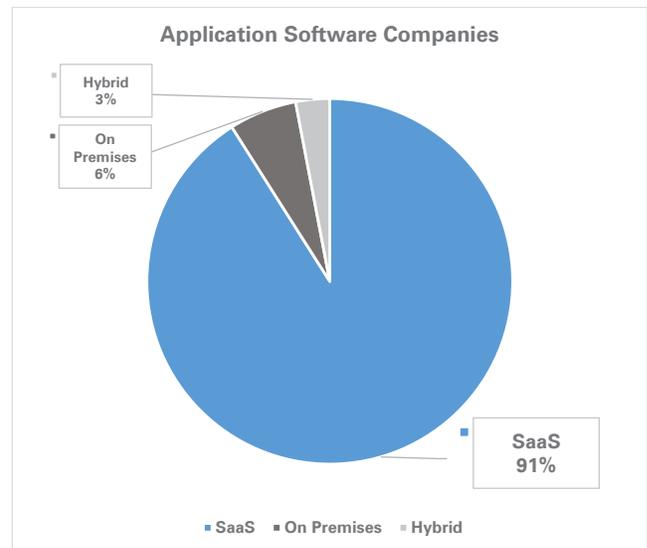
be increasing at a rate over 50% year-over-year, while spending for on-premises applications is decreasing by 16% year-over-year.¹

This overwhelming move to SaaS from the innovative start-ups that will yield the next generation’s dominant application vendors (see Figure 2) informs us that there will be a time when all applications software companies will be SaaS. Those CIOs and other enterprise executives that are clinging to on-premises applications will soon determine that in order to capitalize on the innovation in the various applications sectors, they will need to adopt SaaS solutions or risk falling behind their competitors in their ability to run their businesses effectively and competitively.

The Rates of SaaS Implementation in New Application Software Companies

In support of this position, we took a look at application software companies founded since 2011. It turns out that 91% of these companies are pure SaaS companies, 6% on-premises, and 3% a mix. This overwhelming shift in application software startups is a harbinger of the dominant future of SaaS application software companies.

Figure 2



Other Considerations.

It should be noted that we do not apply this same thinking to infrastructure software companies. We recognize that there will be technical reasons for years to come for certain infrastructure software products to be on-premises. Reasons for this include required proximity to the devices the systems software is managing for latency and bandwidth reasons, performance concerns, tight binding requirements with certain enterprise hardware or software assets, and other related concerns typically tied to cost, bandwidth and security.

Finally, we believe that a hedging strategy -

supporting both on-premises and cloud-hosted SaaS environments - is a losing proposition for most software companies. While we recognize the need to transition a customer base over time, we believe that the best companies will stop offering on-premises solutions to new customers, thus allowing their product and R&D teams to focus on "one version". With this approach, an R&D organization can often shed half of its maintenance costs or one-third of its total spend, freeing up precious resources to focus on new features and capabilities which allow it to compete more effectively in the marketplace.

Conclusion.

In summary, SaaS Transformations represent a significant opportunity for investors and operators alike to capitalize on the growth opportunities and valuation differential experienced by SaaS companies. In the application software space in particular, historical objections to SaaS models are quickly losing their currency, and we will soon find that all leading applications software companies are SaaS.

For more information

For more information on SaaS Transformations or Bulger Partners, feel free to send an e-mail to info@bulgerpartners.com. You can also follow the author of this article on Twitter @jvogel1968 or get updates from his blog at www.techmvp.net.

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References

¹ Source: Application Adoption Trends: The Rise Of SaaS by Paul D. Hamerman, May 5, 2014

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