Monetizing Software as a Service Solutions

June 12, 2008
Version 1.0

Monetizing SaaS Solutions

The research firm Gartner defines SaaS as, " hosted software based on a single set of common code and data definitions that are consumed in a one-to-many model by all contracted customers, at any time, on a pay-for-use basis, or as a subscription based on usage metrics". Gartner also predicts that SaaS will account for 25 percent of new business software by 2011, up from 5 percent in 2005. Traditional software vendors and new entrants considering SaaS offerings must assess and understand exactly how to charge their customers for the service that they provide. This paper is geared towards informing business leaders about the two phases involved in monetizing a SaaS offering, and introducing important components of a SaaS monetization platform. The paper identifies the major issues company executives and market managers need to bear in mind as they make new SaaS solutions available to customers.

Phase I. Understanding the Implications of the SaaS model

The first phase is obvious, and it is to understand the implications of the SaaS model, listed below.

- Benefits of a SaaS model to the seller and buyer
- Customer expectations from a SaaS offering
- Financial implications of the SaaS Model

Benefits of a SaaS Model

Delivering software as a service can open up new markets for software companies and help sell into existing ones. The light-weight, easy to operate nature of Software as a Service (SaaS) offerings enable companies to sell to small and mid-sized customers. Small and mid-sized businesses would have previously been priced out of on-premise offerings. For providers of SaaS, this model potentially allows for a wider range of pricing options to address more market segments and match different customer desires for payment. The SaaS model favors customers because it allows them to pay for what they need and, hopefully, avoid over-paying for shelf-ware. For both customers and providers, the benefit is allowing for an offering that fit customers' needs. SaaS customers do not need to manage the hardware infrastructure which saves them time and money. This translates to bigger investments for SaaS vendors on the hardware infrastructure and development, but also means lower support costs in the long run. Additionally, the SaaS model lends itself very well to an iterative development model.

Customer expectations from a SaaS offering

SaaS customers expect offerings to be easy to use and available all the time. They expect the offerings to be flexible enough to handle volatile and dynamic interactions. For on-premise software, a vendor would sell the customer a product and typically interact with the customer only once a year for maintenance and renewal, or when the customer reported support issues. In a SaaS delivery model, every time the user logs in to the service a potential new customer

engagement opportunity exists. The subscription or pay-as-you-go SaaS offering is volatile by nature, because a customer can switch his or her service provider at any time. The flexibility to leave at any time is often an attractive feature for customers. Customers expect packages with monthly, quarterly and annual billing options. They also expect the service to work with their existing data and infrastructure. In addition to ease of use, ease of payment and flexible billing options are other features that attract customers to SaaS offerings.

Financial implications of the SaaS model

The financial implications are huge for traditional software companies moving into the SaaS space. For buyers, SaaS is a welcome change; capital expenses are now converted to operational expenses. Traditional software companies making the shift to SaaS will see their unpredictable perpetual license revenue dry up, but with SaaS offerings their subscription revenues will grow steadily and become more predictable. All companies will find the pricing of SaaS offerings to be a challenge. Offerings must be priced such that they do not cannibalize on-premise software revenue streams. In the traditional model, a vendor's revenue is typically based on large, up-front fees for software licenses and then payments for maintenance and support. In a SaaS pay-as-you-go model, revenue is generated based on thousands – hopefully millions – of customer interactions rather than licensing the general use of the software. The SaaS delivery model often shifts a company's revenue stream from a small number of large transactions to a large number of small transactions.

Phase II. Executing on the monetization process

Once vendors have decided to offer SaaS solutions, the process of monetizing the offerings and managing the revenue begins. This phase includes the following:

- Understanding business terms and contract management
- Choosing a SaaS development / monetization platform
- Expediting business operations such as customer management, contract management, billing and accounting
- Making architectural decisions for Security model, User Interface, Metric oriented programming (MOP ™)

Understanding business terms and contract management

The SaaS model allows buyers to switch providers, and contracts usually reflect this. So rather than regarding the SaaS model as a threat – a recipe for losing customers – providers should view it as creating unique opportunities to develop a recurring and continuous relationship with the customer that transforms old delivery models into new opportunities for customer engagements.

The SaaS model allows providers to price their offerings based on value. This also means that service providers need to understand the business value of the service provided. Contracts must

reflect this notion and the pricing plan. Pricing plans are usually in flux and it is critical that they are reflected in contracts signed with customers. Pricing can be based on subscriptions, transactions or advertisements. Subscription-based models are very common today with Salesforce.com using it. Transaction-based pricing is another accepted model and in some cases the perfect fit. The ad-based revenue model has been exploited very effectively by Google. Contracts for SaaS can also include some service level agreements for availability and response time. Contracts are the basis for billing, and therefore managing and storing contracts is very important.

Choosing a monetization platform

Once a company has developed a SaaS offering and figured out the pricing approach, it is time to choose a platform to build it on. There are several choices for Platforms as a Service (PaaS), including Salesforce.com. Vendors have the option of using marketplaces such as the Salesforce.com AppExchange. The other option is to integrate with functional monetization platforms.

Whether firms are shifting to a SaaS model from a traditional packaged-software approach, or adopting a SaaS model from the outset, they will need to plan for the management of their services catalogs, customer usage metering, and, most important, billing. Planning a business operations strategy from the beginning ensures that the SaaS provider can deliver services to its customers and also properly tool itself to monetize those services to sustain the business. A robust SaaS monetization platform will allow providers to offer flexible and varied payment and contracting options – for example, a pay-as-you-go model to customers who prefer the stream of small payments with the option to leave, rather than a large up-front payment. To that end, the platform must provide access to tools and data for the proper analysis, delivery, and mediation of these varied transactions.

Vendors can build the monetization platform, but then need to carefully evaluate the build v/s buy options. While companies may be tempted to develop their SaaS business operations capabilities on their own, there can be advantages to relying on another provider for these services. Indeed, if SaaS is truly a better model for software delivery, adopting a SaaS platform for its own operations will benefit the company for all the same reasons that make its own SaaS offering beneficial. Defining and developing the best practices of a SaaS company can be daunting if these disciplines are not part of the SaaS provider's original core competencies. Selecting a platform that makes billing and subscription management easy can be a critical differentiator.

Expediting Business operations

Although SaaS is intended to simplify the *customer's* experience, maintaining good customer relations becomes critical for SaaS providers with the subscription-based sales model. A big difference between traditional, licensed software sales and the SaaS operations is the continuous metering and billing of customers in a subscription model, rather than requiring one payment at the beginning of the relationship followed by lump payments for maintenance and support.

Besides billing, providers need to carefully plan how their SaaS offering will fulfil the following:

- Set up new accounts
- Handle dynamic pricing and rates
- Meter customer usage and generate invoices
- Deliver physical or electronic bills
- Handle remittances and automated payment processing
- Handle collections and dunning
- Handle service suspensions and account activations

Best practices in business operations help a provider retain existing customers and obtain new ones, and increase the provider's margins by speeding up payment, customer management and in increasing revenue. Feed back mechanisms such as customer usage analysis and metering data in a SaaS delivery model can be used for trending and forecasting. The bottom line is that effective business operations are critical to the success of the SaaS offering. SaaS providers for whom metering, billing, and contract management are not core competencies may benefit from outsourcing these tasks to experts.

Making architectural choices for a successful SaaS offering

As described in the business operations section, SaaS offerings must satisfy a long list of requirements. Companies which offer SaaS services must factor in the requirements of a robust Security model. This is necessary because customers are of various types. A reseller of services has different needs compared to an admin user or end user. The multi-tenant model of SaaS places critical requirements on the offering. The offerings must be built with simple and easy User Interfaces from the ground up. Is there a training course for using Google search? The development organization must adopt a Metric oriented programming (MOP ™) approach which gives company executives visibility into the company's daily operations. Business metrics such as monthly recurring revenue (MRR) are affected by daily operations and therefore must be constantly monitored. A drop in number of users or usage of the service is an early indicator that revenues will drop as the renewal rates decrease. Companies must build the necessary audit capabilities and metric monitoring interfaces early in the development cycle. Patterns become more difficult to analyse in a subscription or pay-as-you-go model. Applying detailed analytics to the historical data of customer usage interactions should help better manage cash-flow expectations.

SaaS monetization platforms

The following components are a starter set for providing adequate SaaS monetization capabilities. SaaS providers should think through each of these options and consider build vs. buy options to satisfy each.

Catalog Management

From both the provider's and the customer's perspectives, the primary benefits of SaaS are the flexibility, dynamism, and responsiveness of the service. As an analogy, think of a how a

restaurant might operate. The restaurant delivery model needs to be flexible enough to handle special ordering requests on a per order basis – for example, “can I have fries with that order instead of broccoli?” In a SasS delivery model "services" become these items on a dinner menu, which are entries in a service catalog. Customers can pick and maybe even mix and match from this catalog to get their desired "dish."

The dynamic nature of a competitive SaaS offering requires flexibility in catalog pricing and bundling. Not only do services need to be clearly defined in a SaaS model, the orders need to be easily managed from a back-office perspective. Catalog items (i.e., services) need to be flexible enough to handle bundled offerings, special pricing, and custom orders.

Usage Tracking

The easier a SaaS offering makes it for customers to order, the more difficult it becomes to effectively track customer usage. A well-defined SaaS back office must include a solid tool for measuring service usage. This usage tracking and metering provides the necessary foundation for sustaining a SaaS business model: usage tracking is a source for billing, trending, and analytics. Proper back-office management of customer interactions can lead to improved revenue generation, improved billing considerations, and informed product enhancement decisions. A well-defined back-office method of usage tracking can simplify and expedite reporting – for example by providing dashboards that visualize a customer’s history of using the service.

Contract Management

An effective SaaS back office must handle the full life cycle of a customer’s contract. Dynamic service offerings need to be managed to not only ensure compliance but also optimize service monetization and customer relationships. Pay-as-you-go and usage-based pricing create an added level of complexity for managing customer contracts. Ideally, the SaaS back office-contract management will mitigate the complexity of pay-as-you-go pricing by bundling features into an integrated set of customer contract offerings, rather than requiring SaaS providers to pull this information together on their own. A solid contract management model can simplify the creation, metering, and compliance of contracts.

Billing

Billing and invoicing functions need to be delivered in accordance with customer-defined contracts. SaaS back-office billing helps automate the creation of customer invoices, removing the need to manually compile them from spreadsheets and usage histories. In a pay-as-you-go model the billing needs to be tightly integrated with a well-defined catalog management service, usage and tracking service, and contract management service.

Summary

The SaaS model brings new customer expectations and with it, new requirements on software. It brings changes to the financial model of the vendors. Software vendors planning on starting with or switching to a SaaS model for software delivery should pay careful attention to the monetization and related business operations that help maintain a sustainable SaaS offering. Patterns become more difficult to analyze in the subscription or pay-as-you-go model. Applying detailed analytics to the historical data of customer usage interactions should help better manage cash-flow expectations. So SaaS providers will need to develop or acquire tools that provide detailed information regarding a customer's usage, metering, and interactions and then tie those usage metrics back to accounting.

Even within normal service delivery models, back-office disciplines such as metering, contract management, and billing management are typically difficult. SaaS delivery models create an even more complex and rapidly changing environment for these business operations needs. The economics of the "as-a-service" model will require successful vendors to look at scaling their resources to deliver these capabilities. If in-house skills are lacking, providers should consider best-of-breed platform vendors. The bottom line is that a vendor selling any given widget as a service should do what it does best, focus its resources on the widget itself, and leave the monetization services to the experts.

Ideally, just as the SaaS vendor's customers have chosen to outsource services to experts, SaaS vendors themselves should evaluate existing platforms, rather than building systems in-house. Managing the metering, accounting, billing, and other business operations functions of SaaS offerings may be unfamiliar territory for traditional software companies. In the initial excitement and effort to release the first version of a SaaS offering, software companies may fail to adequately address the most basic of these operations requirements and result in money being left on the table.