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The SaaS Channel: A Work in Progress

by Bruce La Fetra, Rubicon Consulting



*Slow progress down the
IPO pipeline
See pages 4-5.*

According to a 2005 AMR Research study of 500 respondents representing companies of all sizes, more than 78% said they are currently using or considering SaaS. As ISVs push SaaS applications into the mainstream, ISVs and VARs need to consider likely changes to the channel economic model. One of these changes is likely to be a shift in the balance of power toward full-service VARs. While ISVs will find some of these changes hard to swallow, they need to keep in mind that this is the cost of extending the reach of their applications into additional market segments.

There has been a lot of discussion about how SaaS changes the economics for ISVs. There has been much less discussion about the changes in store for the channel. The SaaS model turns the often complex and multi-headed software licensing model into a considerably more straightforward beast. User/seat licensing may still be mind-numbing in its complexity, but the array of maintenance, upgrade, installation and services fees are streamlined or integrated into the rental payment. ISVs and VARs are going to have to re-negotiate who gets what—and because the link between time of service and time of payment is less distinct—when.

Vendors like Salesforce.com, RightNow, IBM and SAP demonstrate that SaaS is for real and is here to stay... at least until the next big thing comes along. While SaaS applications can be easier to set up and integrate, the SaaS leaders have not shown that they are more able to directly penetrate the small & medium business (SMB) market with SaaS applications than with traditional software applications. In response, the press is filled with news of big software vendors like IBM announcing sales and marketing incentives to support SaaS efforts in the channel. IBM's channel initiative for SaaS pays a 10% referral fee for partner-generated leads that IBM closes, and offers greater sales and marketing assistance to help partners close deals.

How SaaS Is Different

So what is the role of the channel with regards to SaaS offerings? Does SaaS require a new channel framework? While it definitely calls for a new compensation model and in

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**Publisher &
Managing Editor**
Merrill R. Chapman
rickchapman@softletter.com
860/663-0852

Editor
Donald K. Rosenberg
don@softletter.com
919/687-4172

Editor Emeritus
Jeffrey Tarter
jtarter@softletter.com
617/668-0028

Editorial office
Soft•letter
34 Sugar Hill Rd.
Killingworth, Conn.
06419
860/663-0552

Subscription office
United Communications
Group
11300 Rockville Pike
#1100
Rockville, Md. 20852
301/287-2718
866/313-0973
customer@softletter.com

www.softletter.com

some cases may significantly alter the ISV / channel partner balance of power, the basic framework is probably adequate, especially when considering the SMB market. The SMB market is served today by a plethora of VARs that often focus on very specific niche markets such as food service distribution or equipment leasing companies. VARs bring expertise that ISVs cannot easily develop or maintain, so don't expect them to go away merely because ISVs would like more margin.

It's also important to consider how SaaS changes the economics for customers. The SaaS "rental" model means customers pay less up-front compared to traditional licenses. Meanwhile the ISV or VAR incur development, setup and configuration costs that must be amortized over the life of the deal. As a result, there is a natural bias for SaaS to appeal most strongly to: (a) customers that are cash-constrained or, (b) vendors that can afford annuity expenses rather than front-end license payments. Due to these factors, SaaS has a built-in appeal for smaller customers and larger vendors, although the appeal certainly is not limited to these groups. The role of the channel is very traditional. Specific customer segments are served that are frequently too small or too specialized for the ISV to economically service directly. The emerging economic model, however, is different in some important aspects.

Changing Economics of SaaS

While much has been written about the appropriate way to price SaaS applications, we are concerned here with the overall economics. On the revenue side, SaaS trades a large, one-time payment for a series of smaller, on-going payments. On the cost side, SaaS has far less impact. Development and selling costs still occur up-front. The big change is that the ISV's breakeven and profitability is determined not at the time of sale, but by how long the customer continues to use the application.

On the channel side, ISVs need to first consider the role they want the channel to play in the customer relationship, then structure the partner's compensation accordingly, recognizing that channel partners may place a different value on current versus future cash flows. While the ISV may be willing to take their money over time, the channel partner may be better motivated with less money now versus more money over time.

New VAR Opportunities

Very conservative VARs that think in terms of cash-based accounting will experience a rocky ride. For other VARs, SaaS offers a number of new or expanded opportunities:

VARs have always played a big role in integrating multiple solutions. SaaS should be no different. In some cases SaaS provides VARs with the opportunity to host the integrated solution and do the billing, thus taking ownership of the relationship. ISVs won't like this aspect, but their options are limited.

"SaaS margins are an area in flux, but early research by Softletter indicates they will range considerably lower than the numbers typically seen with desktop and licensed applications. We'll know more in October when part two of the publication's SaaS survey results are released."

—Bruce La Fetra
Rubicon Consulting

"ISVs prefer referral fees for resellers, but partners are going to want a piece of the recurring revenue action."

—Bruce La Fetra
Rubicon Consulting

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If SaaS applications are viewed by ISVs as annuity streams, why should the channel not view it the same way—and participate in the annuity stream? Think about how life insurance is sold and how the agents participate in the downstream renewals. Of course, the channel is more engaged in the downstream revenue than your typical life insurance agent, so the savvy ones will probably want to be compensated accordingly.

Good News and Bad News for ISVs

Taken together, this suggests the possibility of a new generation of superVARs that integrate multiple applications into a common solution, hosting it and providing billing. They will also own a greater share of the customer relationship. Such ownership by the VAR relative to the ISV will also shift margin expectations in favor of the VAR. It is not all bad news for ISVs as the annuity aspect suggests that the margin restructure will be re-crafted to extend over the lifetime of the customer relationship. In exchange for participation in on-going downstream revenues, VARs are likely to accept a smaller payout up front, and would be wise to do so.

ISVs that cling to traditional channel models—or worse, see SaaS as a way to cut out the channel—are likely to see innovative VARs moving to isolate ISVs from the customer relationship. ISVs need to rethink the channel economics for their situation and understand how the channel can add value to their offering and extend its reach. ISVs also need to think about how they can manage the situation to maintain a relationship with the customer. This is important for the deal economics, but even more so for maintaining the insights and feedback resulting from direct customer interactions.

New ISV Opportunities

ISVs would do well to understand the additional benefits VARs can bring to their SaaS efforts. This will allow forward-looking ISVs to: (a) partner with the VARs offering the best leverage and (b) proactively drive the re-negotiation of the channel economic model. Long term customer relationships become very profitable with SaaS. VARs can be instrumental in developing and maintaining these relationships. The agent-insurance company example above is very apt.

The insurance company does not resent the agent for earning commissions on each renewal, and neither should ISVs with regards to VARs and SaaS. The ISV, however, needs to work hard to make sure that the channel compensation model works to its long-term advantage and is appropriate for the value created by the channel. ISVs must also consider multiple channel programs, keeping in mind that—at least during the near-term—not all VARs want to be paid “for the long term.”

Bruce La Fetra, senior marketing consultant, Rubicon Consulting, 101 Church St., Ste. 22, Los Gatos, Calif. 95030; 408/3953910. E-mail: bruce@corumgroup.com.

“The services model in the SaaS environment faces significant disruption. Software firms and VARs will have to reach a new equilibrium. Data integration is an area of great opportunity.”

—Bruce La Fetra
Rubicon Consulting