DIGITAL CLARITY GROUP

Insight Brief

The SaaS Channel: A Dysfunction in Need of a Fix

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SaaS Is Not As Simple As It Seems

The rush to SaaS (Software as a Service) business models — by traditional enterprise software companies and start-ups alike — has been revolutionary in both the speed of the shift and the impact it is having on technology.[1] CEM vendors are no exception to this lightning-fast trend. The initial promise to buyers has been a move toward simple monthly subscription pricing and away from complex server/seat/processor pricing with its associated costly maintenance fees. The second promise, even more appealing to some buyers, is the idea of self-provisioning software, which removes the need to involve costly and often troublesome systems integrators, consultants, and even in-house IT.

On the other side, technology vendors have been sold on the idea of regular monthly and perpetual income while passing the responsibility for getting the software to do what it should onto the buyer. However, both sides of the SaaS equation, buyers and vendors, are likely to be disappointed with what actually transpires. This report considers where the two initial promises fall short and, more importantly, what both vendors and buyers alike can do to avoid trouble and disappointment.

One thing we know for sure is that SaaS vendors need to reconsider their attitude toward building a channel of partners. Although provisioning software may be easy, getting that same software to deliver business value to buyers is much more complex and usually requires hand holding and guidance from a trusted partner.

The Problem: Building a Sustainable Business

Over the past several years, the enterprise IT industry has been buzzing about little other than "cloud"— billions of dollars have been invested in global data centers and the infrastructure required to provide cloud services. Amazon has evolved from being an online bookseller to establishing itself as a major backbone element of the cloud via its Infrastructure and Platform as a Service (IaaS and PaaS) business, Amazon Web Services.[2] Microsoft has tried hard to move its core products to the cloud (with Office365 and Azure), and even on-premises stalwart Oracle moved heavily into the cloud in 2015. Cloud proponents argue that inevitably all computing will eventually move to the cloud, and that only a Luddite would keep his software running on premises.[3] However, there is little hard evidence today to back such claims of cloud ubiquity.

Either way, cloud offers many benefits that drive increased interest in continuing the move to the cloud; however, this trend comes with a word or two of caution. Today, although many vendors claim high valuations and revenues, few are actually running profitable SaaS businesses. In fact, almost all are losing money. For example, customer experience (CX) vendors with high revenues but no profits include Marketo, NetSuite, Workday, Dropbox, Box, HubSpot, and even the mighty Salesforce.

The main pro-SaaS argument goes that SaaS firms will remain unprofitable for the first year or two of a customer's lifecycle, and then turn to profit. Indeed, that is the reason many of these loss-leading firms have high market valuations, but as of today, those firms' high estimated values have not translated to overall profitability. For some, profitability is not a priority, as some SaaS firms are focused on being acquired by larger firms as an exit route, and others are hoping for a lucrative public offering. Even so, to be long-term sustainable businesses, this situation has to change. It's in the best interests of both buyers of cloud services and the sellers of SaaS to figure things out before there are too many casualties on both sides.

SaaS Vendors Must Address Churn To Keep Making Money

Most enterprise software, and most on-premises software vendors now have at least a "cloud option." But instead of taking large up-front licensing fees, SaaS vendors essentially rent out the software and charge a much lower monthly or annual fee for access to cloud-based technology. The logic is pretty simple: the SaaS vendor must spend to attract and onboard customers, in addition to providing enterprise-grade software services to its subscribers. So in the first two to four years the SaaS vendor will most likely run at a loss to absorb those costs. However, because subscribers renew each year, the licensing is essentially "perpetual," and will start making money in subsequent years at an increasingly steep profit margin.

If that were all there was to it, then the world would be rosy, but sadly it's not that simple. Consider this: for a SaaS vendor to continue growing, it needs to keep attracting ever more (initially) loss-leading customers and, in addition, it needs to ensure that its churn rate (the rate at which it loses customers) is minimal or even net zero. It's a model that works on paper, but has proven to be highly elusive. In fact, it's a model that most technology investors believed in passionately and considered the future of enterprise software. Today many of those same investors are doubting the original wisdom of the SaaS subscription model.

The combination of these two challenges — negative cash flow for two-to-four years plus the need for more loss-leading customers — means that some SaaS vendors may never become profitable.

This problem is compounded by the fact that easy-to-provision software, subscribed to online with a monthly fee (like Box, Salesforce, or Slack) can also be easy to ditch. Anyone who has ever been involved in sales can tell you that keeping customers is a priority, and that finding new customers is hard and costly. Yet here is a business model that is predicated on continually finding more and more new customers to feed an ever more voracious machine.

For an IT sector built on the idea of simple provisioning by the customer directly and a simple monthly subscription, the idea of building a consulting arm and a channel of systems integrators and consulting firms is an anathema. Many argue that this dependency on services is the selfsame business structure that traditional on-premises software and so-called “legacy” vendors run. Surely, isn’t the outdated reliance on low margin services exactly what SaaS vendors were hoping to get away from? Well, maybe so, but smart SaaS vendors are now starting to grasp that this low margin business model coupled with extensive services is exactly what they need to embrace — and fast. This move is already happening at firms such as Salesforce and Adobe who are investing heavily in building and supporting their channel partners.

SaaS Buyers Have Complex Needs That Must Be Addressed

DThe fact is, enterprise needs are complex, and running software on somebody else’s infrastructure (aka SaaS) doesn’t change that. To be sure, the back end computing complexity and actual costs are hidden from the customer — that’s the concern of the SaaS vendor. But where the rubber hits the road, actually leveraging the technology in the business, is just as difficult and complex as ever. No two businesses are alike, nor do they want to be — that’s why it’s called competitive differentiation. In other words, every business wants, and indeed needs, to configure and use technology to meet their specific needs. Traditionally, this has been accomplished by deploying software in five distinct phases: requirements gathering, design, test, deployment, and maintenance.

Yet more buyers are accessing SaaS technology and at the same time attempting to skip these phases, often ending up with a sub-standard service and/or multiple micro deployments running virally and unconnected throughout a firm. Similarly, more buyers are dramatically underestimating the real costs (and necessity) of bringing in expert outside help to get the technology to do what it is supposed to do and, more importantly, deliver value on the investment. Often forgotten is that, with the exception of getting the software installed, the service/consulting requirements for SaaS are identical to on-premises deployments of the same software. Furthermore, the installation of software was always a very small part of the overall effort and cost.

SaaS Vendors Must Leverage the Channel

IVendors need to consider the buyers’ bigger picture — outside of SMBs, buyers’ needs are likely more complex than vendors’ software alone can service. The buyers may well be undertaking some kind of digital transformation that involves long term strategic planning and multiple systems and players. They may need to integrate now or in the future with other systems, both SaaS and on-premises, and they will likely have to migrate data and content from system to system. Vendors need to ask themselves if they are in a position to help these buyers, point them to the right partners, or ignore these the kinds of situations.

This is not to say that SaaS vendors should be building a large consulting arm to their business, rather they should be building and managing a respected, trusted and highly proficient channel of partners to do consulting work on their behalf. SaaS vendors should also consider building a small services division to support both the buyers directly and to work with the partner channel. Building a channel of service partners is difficult and involves a lot more than signing off on partnerships; it requires ongoing channel management, quality control, measuring customer satisfaction and knowing when to intervene when things go wrong.

Buyers need expert advice. It is not realistic to expect enterprises to have the specialist skills to design and manage a new software implementation or undertake a digital transformation on any scale. Choosing the right service provider is as important as choosing the right software.

Building a high quality, high value channel is a major investment of time, skills and money. But a solid channel also brings the ability to scale the business profitably as the work done by the channel deepens a buyer's relationship and reliance on the technology. This will help not only to reduce churn, but also ensure that the technology is embedded and integrated into the buyer's environment. A high-value services channel helps the buyer get the best value and use from the technology and frankly, makes it more difficult to replace on a whim.

Table 1.

Advice to SaaS vendors

Success Factors	Advice for Vendors
External advice and assistance	Build a solid and trustworthy channel of service providers.
Technology platform	Recognize that you have a responsibility to buyers to ensure your technology provides them with a quality service.
Current and future ecosystem	Consider carefully the ecosystem you live within and the challenge and opportunity of integrating easily with other technologies.
Long term partnerships	Don't assume subscribers will stay with you in the long term — without that extra love they will feel no connection. Faceless services are easy to switch off.
Services investment	Recognize that buyers are making a much larger investment than you realize to make things happen -— build solid relationships with your core channel partners.
Problem resolution	Recognize that when things go seriously wrong for a buyer, they will blame your technology, not themselves.
Selection process	Proactively manage your channel — gain insight into what they are really doing and how they are interacting with buyers.

This doesn't mean that SaaS vendors should simply go out and sign up as many partners as they can and think the job is done. Many have done this in the past and paid a high cost, and many more continue to do exactly this today, which will cost them, too. Vendors need to build high quality channels that can be measured and trusted, because working through a channel to reach a customer adds another major breakpoint in the supply chain. Customers unhappy with the service that a channel partner provides are just as likely to blame the technology as they are the partner. In fact, technology solutions frequently become scapegoats for failed or sub-standard projects, often because organizational change management was completely ignored during implementation.

If vendors build a solid channel of trusted partners, then they must also hand-hold buyers through the process of selecting the right partner for each project. Vendors may also need to educate buyers about the need to use partners in the vendor's channel rather than trying to go it alone. Again, if things go wrong, the buyer is unlikely to blame themselves — the technology will take the blame. When buyers take the SaaS route, they still need to carefully gather requirements, design a service that meets their specific requirements, and not only roll it out in a considered and managed way, but also ensure that it continues to meet the needs of the firm as needs change over time. It also benefits all concerned if SaaS vendors help in this dialogue, since too many of them prefer to maintain the illusion that with SaaS, all the buyer needs to do is pay the subscription fee and all will be well.

To be clear, for SaaS vendors to be successful and grow profitably they will have to do much more than build a good partner channel. The quality of the product, its service, and lower onboarding costs are all elements of success, but vendors and buyers both tend to underestimate the critical value of a strong partner. Yet, despite low margins and the cost of setting up and managing a channel, the rewards in terms of happier and more-invested customers will pay off handsomely for everyone involved.

Buyers Must Select the Right Technology and Services Partner

So if we agree that a good services partner complements the needs of both the technology vendor and buyer, the next important piece is how to choose or recommend the right one. The reality is that vendors seldom have good insight into their channel, as they tend to measure success in dollars, not on performance and the quality of the work. In many cases a vendor will recommend a partner based on limited criteria — whether it is a premier partner of some sort and its geographic location (are they close to you?). But buyers need to be pickier than that — and they certainly don't have to take the partner suggested by the vendor. Buyers should be proactive and ensure that the partner not only has the right technical skills to meet the business requirements, but also that they trust them and actually want to work with them. Some partners will do a poor job, drag things out and charge a fortune, others will do a much better job and honor the buyer's budget and time frame. Remember, buyers will be spending a lot of time with the partner and success or failure in the project is largely dependent upon that relationship.

Ideally, buyers should expect vendors to have much greater insight into their channel partners than most of them do today. Buyers need help assessing their prospective and current service providers' strengths and weaknesses, including their tendency to meet deadlines, provide quality of work, and their ability to build good working relationships with buyers. But that is difficult, and today few SaaS vendors really have that level of insight. It's critical to the future success of both the enterprise buyer and the SaaS firm that they work to improve upon this lack of knowledge and insight. For as the SaaS business grows over time, so too will the size of the service provider channel and in the long run, the vendors' dependency on its channel partners.

It Will Take Time for SaaS Vendors to Build a Network of Trusted Partners

Ultimately the need for quality system integrators and consultants is a shared one — buyers need them to ensure successful business outcomes, SaaS vendors need them to equally ensure that buyers are successful in their business outcomes and that, as a result, they will remain faithful, lucrative subscribers. Unfortunately, there is a long way to go before this reality is fully recognized. Many smaller SaaS vendors are only now starting to consider building a channel of trusted partners, and more established vendors are paying the price of a big channel that they have little insight into.

Realistically, all concerned need to play a part to decrease the disconnect among buyer, vendor and partners, yet progress today is slow and at best patchy. However, progress is being made; Adobe, Salesforce, Marketo, Hubspot, Box, and Dropbox, along with others, are now pro-actively looking at not just the revenue generated by their channel partners. They are also looking at how their partners operate with buyers and are working to have more insight and control over the quality of those relationships. Yet SaaS vendors, particularly start-ups that have been driven by investors to grow at a rapid pace, have still to recognize the Faustian path they have taken toward growth. When SaaS vendors eventually do recognize this reality, and in some cases it may be too late, they will realize that building a base of loyal, happy, and invested customers takes much more time and effort than providing simple billing and a cloud service.

Notes

1. The definition of Software as a Service (SaaS) is: A cloud based service that provides a buyer with subscription based on demand access to a business application such as CRM (Customer Relationship Management) or ERP (Enterprise Resource Planning).

2. The definition of Infrastructure as a Service (IaaS) is: A cloud based service that provides a buyer with subscription based on demand access to core (usually virtualized) storage, networking and processing capabilities.

   Platform as a Service (PaaS) is defined as: A cloud based service that provides a buyer with subscription based on demand access to an application development platform to design, develop and manage software applications.

3. On Premises is defined as: The traditional business model that provides application software to a buyer that in turn runs the software on their own infrastructure and platform.

About Digital Clarity Group.

Digital Clarity Group is a research-based advisory firm focused on the content, technologies, and practices that drive world-class customer experience. Global organizations depend on our insight, reports, and consulting services to help them turn digital disruption into digital advantage. As analysts, we cover the customer experience management (CEM) footprint — those organizational capabilities and competencies that impact the experience delivered to customers and prospects. In our view, the CEM footprint overlays content management, marketing automation, e-commerce, social media management, collaboration, customer relationship management, localization, business process management, analytics, and search. As consultants, we believe that education and advice leading to successful CEM is only possible by actively engaging with all participants in the CEM solutions ecosystem. In keeping with this philosophy, we work with enterprise adopters of CEM solutions, technology vendors that develop and market CEM systems and tools, and service providers who implement solutions, including systems integrators and digital agencies. For more information about DCG, visit www.digitalclaritygroup.com or email info@digitalclaritygroup.com.

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