Unparalleled industry disruption forces ISVs to shift business models

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Customer demands for flexible infrastructure choices make ISV partner choices critical to their long-term viability

The only certainty in the technology industry is the high level of uncertainty surrounding what business models will emerge once this era of unprecedented disruption quiets down. Businesses seek different evolutionary paths dictated by cloud-delivered infrastructure, fundamentally changing how IT can be consumed to deliver business outcomes. ISVs built businesses by creating software IP typically built around a specific platform stood up by customers in on-premises installations.

Customers can provision underlying infrastructure in a myriad interconnected form factors. Some continue with on-premises installations; some prefer a private cloud they manage on site; some want a managed private cloud located at a service provider's facility, and increasingly customers want some the ability to mix and match underlying infrastructures for flexible, variable cost-compute infrastructures.

Smaller ISVs will be challenged to provide solutions for each of those options on their own, as the working capital at their disposal coupled with the limited scale some of these infrastructure choices may have in their install base preclude them from being able to "go it alone" profitably. Partnering with an infrastructure technology vendor with industrialized offerings around private cloud deployment, managed services, and seamless hybrid cloud integration and support services enables ISVs to overcome the underlying infrastructure objections their customers may have when continuing to sell what they do best, which is develop software to deliver actionable business outcomes to their customers.

Small ISVs are not alone in confronting these disruptive challenges. The largest, best capitalized vendors in the technology industry face the same set of conditions with the luxury of far greater cash flow at their disposable to navigate their busienss model transformation. TBR bases its analysis on its extensive body of company-centric information and research. Profit pools dry up and disappear as rapidly as new pools emerge in the IT landscape. New disruptors challenge leading vendors and force a series of shifts reshaping the overall IT landscape. Traditional businesses are threatened by born-in-the-cloud vendors that are racing to venture-capital-funded market capitalizations in excess of $1 billion before they have turned a profit.

Consider the following events taking place in the industry:

1. License revenues are dwindling as subscription revenues make their ascent. Data from TBR's *4Q14 Infrastructure Management Software Vendor Benchmark* and *4Q14 Applications Software Vendor Benchmark* show license revenue shrinking by 3.6% and 15.7%, respectively, and subscription revenue increasing 57% and 48.2%, respectively, year-to-year. Firms from the smallest ISV to the largest tech vendors with diverse product portfolios struggle against the profit shift caused by customers opting to consume software via subscription rather than license.
2. HP and Symantec split up their businesses so each newly formed entity can align around core IP assets. The split ensures successful execution in one space will not be mitigated by potential failure in another. In short, risk gets split along with the assets for tighter alignment.

3. The pressure to improve financial performance every quarter forces firms such as Dell and Informatica to go private to address the long-term tranformational shifts necessary for their continued existence absent the short-term performance demands of the financial community.
4. Salesforce, described by many as the pioneer of the cloud-based SaaS business model, seeks financial assistance to find a suitor after becoming a take-over target in the industry.

Cloud computing is disrupting the industry, enabling new ideas to be commercialized on very small amounts of capital. Scale does not impede powerful ideas from getting to market, as the smallest business can purchase IT infrastructure on the cloud rather than be forced to build out a costly data center in advance of consumption demand. This means software businesses with customers, sound customer service and valuable IP can rapidly scale their businesses through myriad alliances, partnerships and business models. To succeed, these firms have to evaluate what they do well today and which of the many partnering opportunities makes the most sense for them to achieve what they want to do in the future. Partnership decisions also depend on where the partners have best-in-class program offerings aligning with the gaps in their operations as they start aggresively transforming how they sell and deliver their IP to customers.

Cloud IaaS: Build, buy or ally

Large ISVs struggled with deciding to build, buy or ally five to 10 years ago. Software AG CEO Karl-Heinz Streibich claims cloud shifts capex responsibilities to software vendors. First movers in the ISV community embarked on building out clouds for their customer bases as the 2008 economic downturn crippled the U.S. market. In in-depth interviews with these first movers in the past two years, many indicated they would not do it again based on the technological advancements that have been made by larger cloud service providers (CSPs) with which they can now partner. Principal advancements that have been made include better security and regulatory compliance provisions, faster and more automated onboarding and provisioning tools, and rapid price cuts on base IaaS that have the industry forecasting a time when compute cycles will “go to zero.” For example, managed storage services cost less than $0.10 per gigabyte and will soon fall below $0.05 per gigabyte. Small ISVs lacking the install base scale will be hard pressed to compete standing up their own clouds.

This economic back drop makes partnering with a flexible technology provider for base-level compute and store services a safe and logical choice in the current IT business environment. ISVs have a range of options to evaluate. The technical evaluation entails discussions with customers and cloud providers to make sure the moves the ISV makes match its customers’ concerns regarding features provided by the cloud provider. Beyond the issues of security and compliance, ISVs should evaluate cloud provider portfolios against the issues of data localization (particularly acute with multinational customers), application onboarding tools, supported connections to other popular clouds and software applications co-located with the ISV software in its customer base.

Critical to ISV success will be how easy the CSP makes it for the ISV to track consumption through metered usage statistics to bill customers accurately for their monthly IT usage. ISV partners will need to consider how much flexibility and transparency the CSP provides around customer usage patterns.

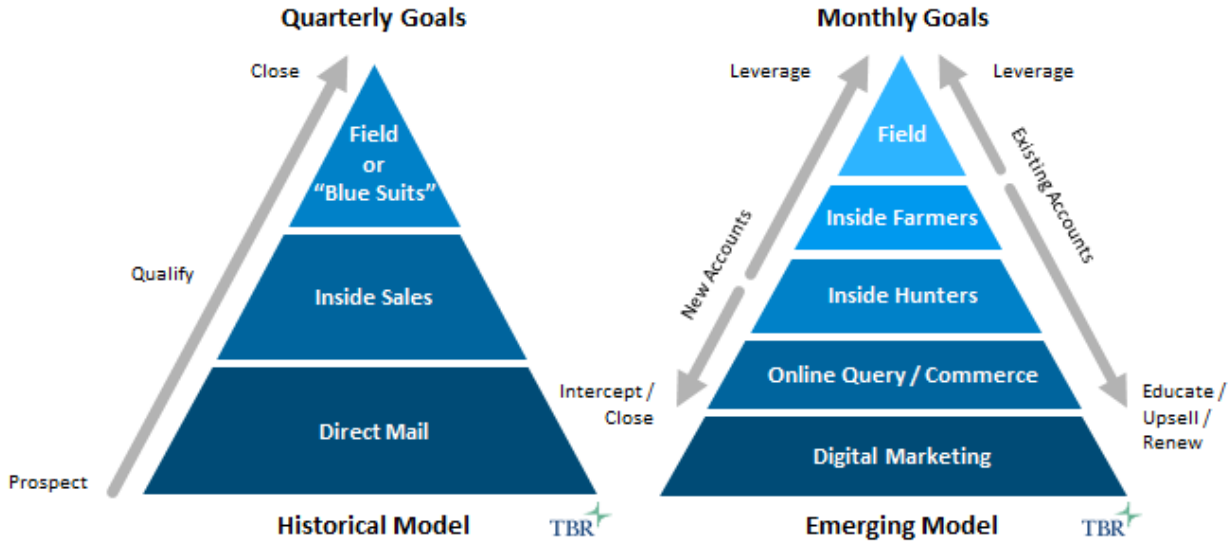
Sales engagement follows new routes to market: Travel the same path as the infrastructure provider or CSP

Just as the way the delivery of compute and store capabilities to end customers transformed radically, so too have go-to-market strategies. Old selling motions followed a typical prospecting hierarchy, depicted on the left side of Figure 1. This motion followed very simple steps:

1. Prospect by buying lists and direct mail marketing to that list;
2. Qualify leads returned from the recipients, typically with an inside sales phone follow-up;
3. Close by dispatching a high-cost direct sales representative, often times accompanied by a technical support specialist, on-site to close the deal.

Cloud selling shifts focus dramatically. First and foremost, many customers prefer to do their own research via multiple different communications channels often found through Internet searches. As depicted on the right side of Figure 1, this requires two different types of inside sales representatives that TBR defines as "Inside Hunters" and "Inside Farmers." Inside Hunters intercept Web traffic to educate prospects before they click out of a website, and Inside Farmers interact and educate customers, oftentimes pushing them down to lower-cost Web ordering tools to purchase additional product.

Figure 1



SOURCE: TBR

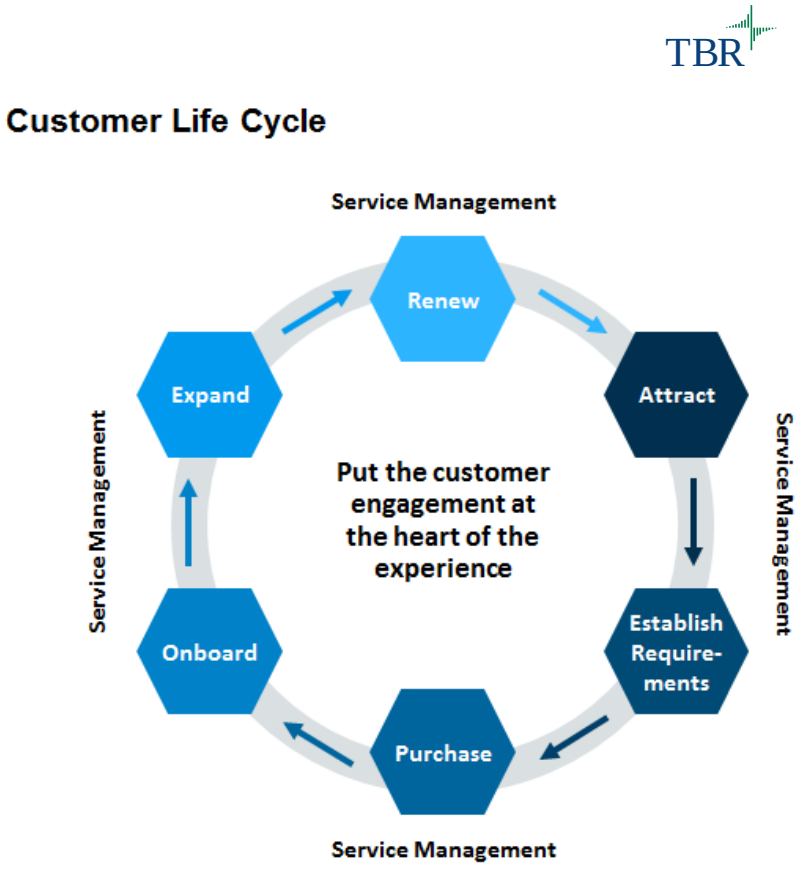
Figure 2 more appropriately depicts the new selling motion required as an ongoing circle. In many instances a freemium product entices a prospect to try the product, after which the sales motion has to educate and upsell the customer to additional software modules. This selling process requires different skills, and it requires different compensation plan metrics to manage expenses and motivate behaviors to align to this new selling process.

Where ISVs place their expensive, top-performing sales talent depends on where in this new sales cycle they believe these individuals can generate the greatest success for the company. The sales transformation cannot be considered as a stand-alone decision. Other factors to consider will be whether ISVs want to offer free trials as a way to add accounts with a freemium model, placing top sales performers further along the sales chain where converting customers to subscriptions becomes paramount.

There also needs to be consideration of shifting the traditional sales systems engineer to a model in which cloud upsells will depend on the technical features or functional benefit of adding modules to the cloud subscription. Few cloud subscriptions contain under-deployed "shelfware." Customers purchase only what they have to consume, then need encouragement to expand their activations.

ISVs have to gain unfiltered feedback on CSP selling motion road maps. From CSP partners, ISVs must determine how easy seamless migration can be. What will they do for you? What do they expect or want you to do? Do these functions align? Figure 2 illustrates the new selling model translated from Figure 1. This continuous loop between customer and IP provider means the partnership has to be solid across all phases of the sales cycle, as gaps can impact customer renewal rates integral to any successful transition to a subscription-based business model.

Figure 2



SOURCE: TBR

Support delivery shifts as single software application versions with shorter release cycles become the norm

Small firms making the shift to the cloud detailed the operational obstacles they face. Where once on-premises versions could be upgraded in staged rollouts, now releases are applied to the entire base at once. Where once small teams could rotate through the client base, now all hands must be on deck when new release cycles get pushed out over cloud to customers. Firms address these release demand spikes by shortening the time between releases, distributing smaller-scale upgrades quarterly or monthly, rather than annually or semiannually.

This disruptive challenge provides the opportunity for heightened customer engagement. Many firms, including CenturyLink, maintain active user group communities in which feature modifications can be proposed, discussed and voted on for prioritization into the CenturyLink development cycle. Based on the community prioritization, CenturyLink uses agile development methodologies to create and distribute these new features quickly through a monthly release cycle.

To succeed, ISVs must have clear insight into how their infrastructure partners address these issues as well. IP development will have to be built on top of or adjacent to other software modules through configuring IP extensions to these base-layer offerings, rather than engaging in labor-intensive customizations of the core source code. Firms that continue to rely on the old upgrade process will face incredible challenges keeping pace with the speed at which software enhancements are pushed out into the market.

Determining how to change only sets the road map; learning begins the journey

Knowing what to do cannot move the business forward without the business acquiring the new skills necessary to do it. Large IT vendors at analyst conferences universally lament the “skills gap” in the industry around new technologies such as cloud infrastructure management and monitoring, analytics/data science, mobile device management, security, and user experience technologies. Smaller firms should place more importance on the training and automated services their partners can provide than ever before.

The days of promising clients next-day response to outages will soon come to a close. Customers expect an “always on” platform. Against this backdrop, ISVs have to study the ease of use and robustness of the automated service tools their cloud service providers offer them as well as the developer tool kits and training programs provided.

Capitalizing on disruptive opportunity requires preparation; picking the right CSP partner is a critical step

Deciding how the business model should evolve and with whom to partner for cloud infrastructure has to happen simultaneously. Shifts must take place in the sales, development and delivery cycles, and therefore, realistically assessing the complementary assets of your business and the CSP has to happen dynamically. In essence, vendors must enact agile business process change, rather than waterfall business process change.

Key elements to consider include:

1. Onboarding and integration tools minimize the lift to bring applications onto the cloud.
2. Familiarize staff with the critical technologies and tools necessary to manage, monitor and maintain cloud subscriptions.
3. A broad suite of tools, APIs and frameworks simplify the labor effort associated with migrating applications to the cloud and, more importantly, integrate value-add solutions with other common components.
4. Data gravity and data volume bring security, data sovereignty and regulatory compliance to the fore of any discussion around new infrastructure deployments. Large infrastructure service providers such as CenturyLink will have the volumes necessary to invest heavily in these overarching concerns that technology evolution increasingly pushes out into the network, rather than addressing them from behind a firewall. Firms such as CenturyLink with decades of experience managing and maintaining networks have a distinct competitive advantage when building security measures into their infrastructure offerings.
5. Business model support: Numerous research firms forecast severe consolidations in the traditional reseller community based on the working capital demands associated with shifting transactional license revenue streams to ratable subscription revenue streams. As profit pools shift, small ISVs will be hard pressed to pass up any opportunity with their customer base, yet building out the necessary infrastructure options to address all choices customers may prefer is cost-prohibitive. Partnering with a well-capitalized infrastructure partner well versed in networking technologies to deliver secure, flexible infrastructure looks to be the safest bet an ISV can make in the current, ever-evolving state of the IT industry.

Surf the technology wave rather than be washed away by it

There will be consolidation in the industry, while at the same time small vendors will explode onto the scene to become the next Salesforce, Workday, Amazon, Facebook, Uber, AirBnB or Google. Cloud enables great ideas to be brought to market faster and with far less capital investment than was required in the on-premises era of the industry. ISVs have always succeeded on the virtue of their IP and are best positioned of the traditional smaller business model entities to thrive in the disruption. Deciding the transformation path and picking the right CSP to assist in the transition is one of the most important decisions left to make.

About TBR

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