Into the vortex

Software enters a new SaaS era

OC&C
Strategy consultants

uncommon sense

ABOUT THE AUTHORS

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Our software, telecoms and technology clients include some of the leading hosting, SaaS and IT service providers across Europe, US and Asia, ranging from mass-market focused brands to software, data and hosting companies focused on mid-market and enterprise customers.

We work with some of the smartest, most ambitious leaders in business – people dedicated to creating change in their industry, not just conforming to the status quo.

The most critical trend we observe today in software companies is a growing tendency for the most modern SaaS-based software 'power brands' to keep on winning. This cycle is seen in the growth rates and valuations of the major cloud-based software firms in each segment, often supported by the strong growth of software into new use cases – and the gradual erosion of the long tail of legacy software providers.

The returns to power brands' market/category leadership in software have never been higher, and the new era of SaaS is creating a powerful vortex supporting the growth of the winners
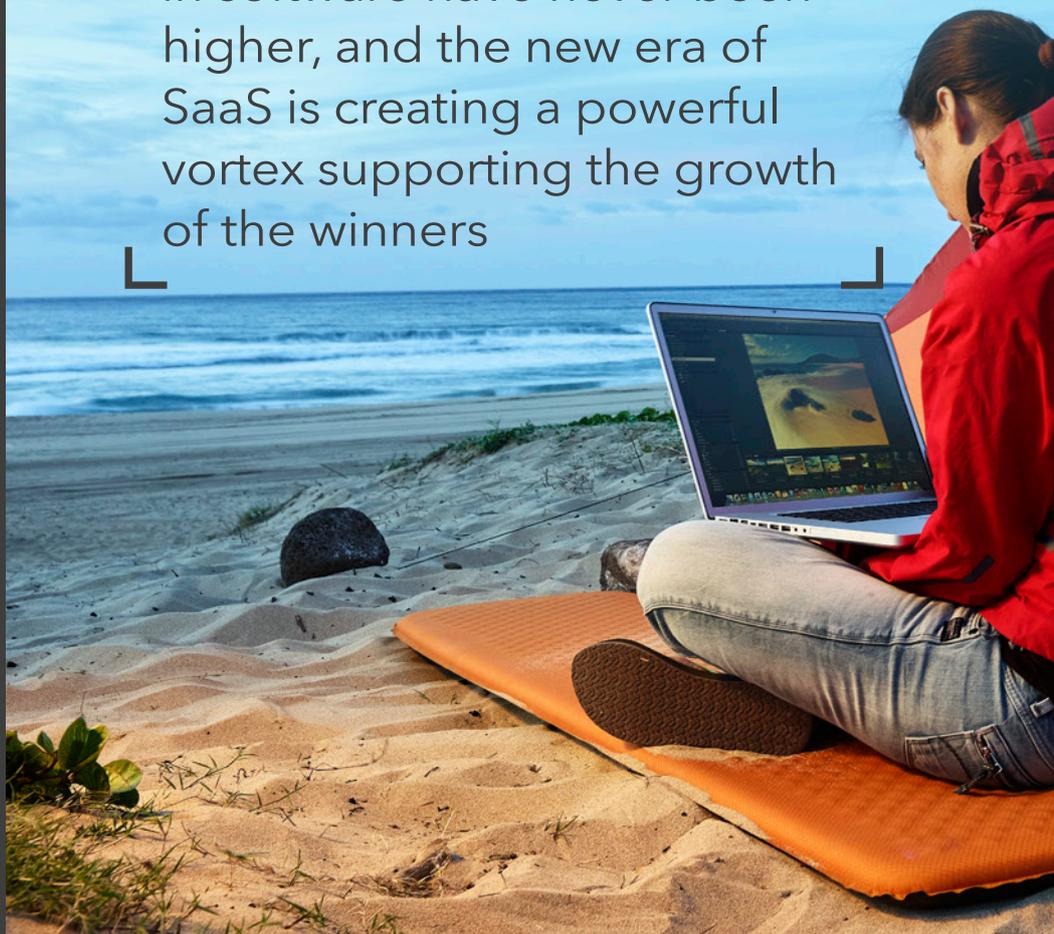
In a way this might be expected – software has always been defined by economies of scale, the largest players will have advantage – but a vortex of mutually reinforcing commercial and technological trends have accelerated this tendency far beyond its origins in the low marginal costs of software.

This is certainly not to say that we expect to see global winners – far from it. If anything, we observe a vertical and geographic fragmentation as leading software firms emerge that meet specific needs better than anyone else. Global firms will always have their field: the largest firms, the largest markets, the most universal use cases. But we see power brand winners emerging – with huge amounts of value created and captured – in more and more niche areas. Leadership can be defined at a geographic or local level (example, Visma's own e-conomic in Denmark); or it can be at a global / international category level (Bullhorn in recruiting; Twilio in APIs for voice comms).

Put simply: the returns to power brands' market/category leadership in software have never been higher, and the new era of SaaS is creating a powerful vortex supporting the growth of the winners. These returns are driven by:

- The critical importance of **brand** in being the 'safe choice' as previous unpenetrated customer segments (e.g. micro businesses, new verticals) adopt software in order to remain competitive

- The enhanced ability to **cross-sell** when you are providing a critical product (usually with 'platform' characteristics) – to be the central product onto which other products are 'bolted on', and to be trusted to meet customer needs with new solutions (which often are E2E integrated)

- An increasingly intense pace of **innovation** (e.g. around automation technologies) which sub-scale software firms struggle to keep up with

- The benefits of high **volumes of data** – e.g. for developing and training algorithms, and delivering insights at scale

- The **network effects** which these businesses increasingly incorporate via marketplaces/ecosystems

- The **channel relationships** which many businesses have developed which enable highly scalable sales, marketing & implementation and take years to build up

- Greater access to **transformative M&A opportunities**

All of which creates a vortex – these factors are self- and mutually-reinforcing over time.

What does SaaS mean?
Software, and specifically enterprise software, was for years deployed 'on-premise' meaning that each customer had their own copy of the software installed separately on their computer, or on their office's server. The emergence of cloud connected technologies changed that as software became able to be accessed remotely from 'the cloud', with software vendors initially hosting a 'copy per customer' or single-tenant version of software, but more recently shifting this towards a single cloud-hosted version of software that is accessed by multiple customers – this concept has become known as multi-tenant SaaS (Software-as-a-Service).

A new era

We see these 'vortex' trends as marking the emergence of a new era in SaaS businesses. We have had the early days of SaaS – characterised by the novelty of the delivery and economic models. Then came the democratisation of software via greenfield adoption and on-premise migration. Now we see the firms that have emerged as power brands from this second era entering a new era, defined by ever-growing returns to market/category leadership.

Evolution of SaaS businesses	**1st** Era **SaaS is born**	**2nd** Era **Greenfield adoption + On-premise migration**	**3rd** Era **Power brands**
Key characteristics	• Early days of SaaS focused on better delivery – online vs on premise – and attractive economic model – monthly subscription, low upfront costs	• Drove much wider software adoption - both greenfield and migration from on-premise – via: – Often lower cost / freemium model – Much greater usability	• Growing strength of key brands and platforms – many 'born in the cloud' • Data-driven insights and AI/automation • Customer monetisation via cross-sell • APIs and marketplaces creating network effects
Usability	• Medium/ low: Often a legacy user interface	• High: 'Consumer-grade' GUI	• GUI (if exists) is 'consumer-grade', often mobile-first • APIs can form easy-to-use 'building blocks' – often with no GUI, involving software-to-software relationships
Typical customer size	• Enterprise	• Enterprise, mid-market, SMB	• Enterprise, mid-market, SMB + anyone
Typical revenue model	• Monthly subscription per seat	• Monthly subscription per seat	• Monthly subscription per seat • Also increasingly volume-based (per API call, per transaction)
Typical time to implement	• Months	• Typically weeks / days	• Varies by solution – can be extremely rapid deployment
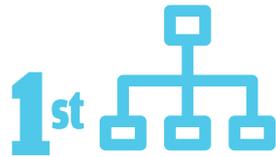
The evidence

This increasing role of power SaaS brands can be seen across a range of SaaS-based enterprise software providers:

The trend is most advanced in horizontal software with its higher rates of SaaS penetration: from Salesforce in CRM, to Hubspot in marketing, Twilio and RingCentral in cloud communications, Stripe in payments, Shopify in ecommerce, Workday in enterprise HCM, Xero, Intuit & Visma in SME accounting (and increasingly SME software more generally), the US 'Pays' (Paycom, Paylocity) in US payroll, and Coupa in procurement.

The trend is already well underway in selected more penetrated verticals: e.g. Bullhorn in recruitment in English speaking markets, Toast in US hospitality.

Our hypothesis is that these market segments are a vision of what is to come in other less SaaS-penetrated segments – whether geographic, customer size or vertical. Which has one crucial implication: the race to win in these less penetrated and fragmented segments has very high stakes indeed. Parts of the market are still wide open – but savvy founders and investors are moving quickly. Witness Silver Lake Partners' investment in Cegid (legacy French ERP software player) and Silae (fast moving French SaaS payroll pioneer)… the prize of being the horizontal SaaS software winner in France is potentially enormous.

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What about 'disruption'? In a way this story goes against the classic tech narrative of disruption – each generation exists only to be disrupted by the next. Surely a paradigm shift in AI, VR/AR, voice, or IoT etc. will be next to disrupt these cutting-edge players? We would argue (and we know we are in good company) that in fact today's large winners increasingly have major advantages that will keep them winning in a world defined by massive scale – and that these new technologies merely build on the fundamental foundations of cloud + mobile that leading firms have already mastered.

Add to this the inherent stickiness of enterprise software – which only grows with further cross-sell, data integration and ecosystem/network effects development – then you have some firms with very large 'moats' indeed.

How do **winners** win?

To bring to life how these leading software firms are deepening their scale advantages we consider three topics in further detail: Cross-sell, AI/automation, and M&A.
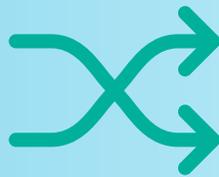
Cross-sell

Cross-sell is a major driver of value in leading SaaS businesses. These players take a large existing customer base and then increase average revenue per customer and reduce churn by selling in complementary solutions that meet customer needs. In this way their core product forms a 'platform' onto which other products are bolted on. We see a clear best practice playbook in place:

BEST PRACTICE IN CROSS-SELLING (SMB-FOCUS)

|		
'Hard' internal factors	**Customer data / intelligence**	Single, fully accessible customer database that includes thorough intelligence on customers (incl. current product portfolio) to help tailor marketing efforts and track inbound interactions across the full product-suite
	Marketing automation	An automated approach to sales and marketing efforts is crucial to reaching customers at scale. This must be tailored to customer need / type and can be achieved through in-product AI pop-ups, personalised emails via Marketo etc.
'Soft' internal factors	**Incentives**	Incentives need to reward both sales team members who originate and who convert leads regardless of the P&L ownership of the cross-sold product
	Customer 'vision'	There must be a 'vision' for both customer product journey and end-game product mix in each segment in order for effective targeting and comms by sales and marketing teams (e.g. begin with FMS, cross-sell in payroll and HCM etc.)
	Expertise	Sales teams should be specialised by vertical and product, but all sales staff must also have knowledge of potential complementary products that sit outside their area of expertise

Xero provides a strong example of this in practice:

XERO'S CROSS-SELL APPROACH

- Xero has reached high penetration in its home geography of New Zealand

- Due to this, Xero is now focused on driving revenues by increasing average revenue per customer via cross-sell and upsell

- **A major focus of cross-selling for Xero is payroll**, which can add up to 25% to ARPC
  - Payroll is characterised by strong customer loyalty given challenges of switching
  - **Once a customer is on payroll, Xero also becomes the customer's employee database, thus opening up more cross-sell opportunities…**
  - Xero Expenses & Xero Projects both run off the employee database
  - …and supporting Xero's target to become "the small business platform"
  - Accountants also have an incentive to help Xero cross-sell in payroll, as the highly automated solution increases efficiency for them

- **Data and automation are critical to driving cross-sell at scale** for Xero:
  - Xero identifies opportunities to displace 3rd parties with its in-house modules by using its extensive data on customers' use of 3rd party applications via APIs…
  - **…It then uses automated sales approaches via Marketo** to cross-sell in Xero's own solution

- Often provides a video explanation of Xero's solution, and a 6 month free trial offer

TYPICAL XERO ARPC OVER CROSS-SELL JOURNEY (INDEXED)
INDICATIVE

100	25	25	150
Accounting solution only	Payroll	Expenses	Cross-sold customer ARPC1
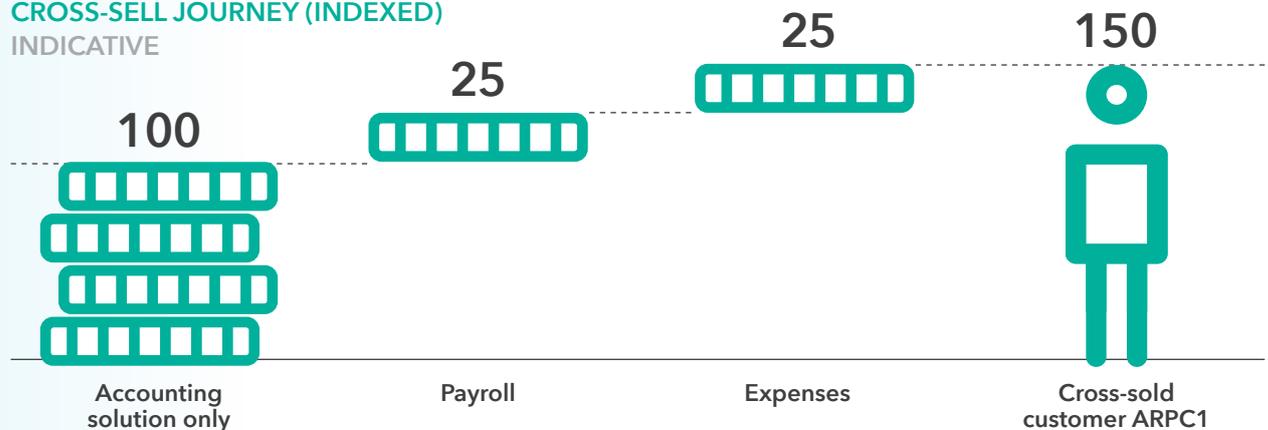
Visma is also driving similar growth around key platform FMS products like e-conomic in Denmark, Netvisor in Finland and Tripletex in Norway. SME customers often start with these brands and then cross-purchase a range of other Visma solutions to unlock more utility, including payroll, HCM software, e-invoicing and small business loans.

IN-APP SALES AND MARKETING

In an increasingly noisy marketplace it is becoming harder to reach the best customers. In Europe, GDPR also limits many of the more dynamic marketing automation techniques. In this environment in-app marketing to current users can be highly effective. Careful and not too intrusive exposure of active users to new functionality, upgrades or new features is a low cost shop-window to demonstrate highly relevant and value-added features to qualified customers. After all, cross-selling is not really what these software vendors want to achieve, but rather they want cross-purchasing, where customers reach out and buy more because the incremental functionality obviously adds value for relevant work-tasks, for customers such approaches are convenient and friction-free.

Already having a large population of active users clearly makes these in-app sales more effective for the power brands. Thus the largest players have an advantage that is hard for smaller players to match with traditional sales and marketing automation.

The critical informational advantage that SaaS gives over on-premise – visibility of **real-time data** – is being put to good use

AI/automation

Winning SaaS firms are already well advanced in incorporating intelligence into their propositions. The critical informational advantage that SaaS gives over on-premise – visibility of real-time data – is being put to good use. That said – not all AI/automation is created equal. We see a range of types being applied, with some delivering mere tables stakes and some offering a truly differentiated proposition:
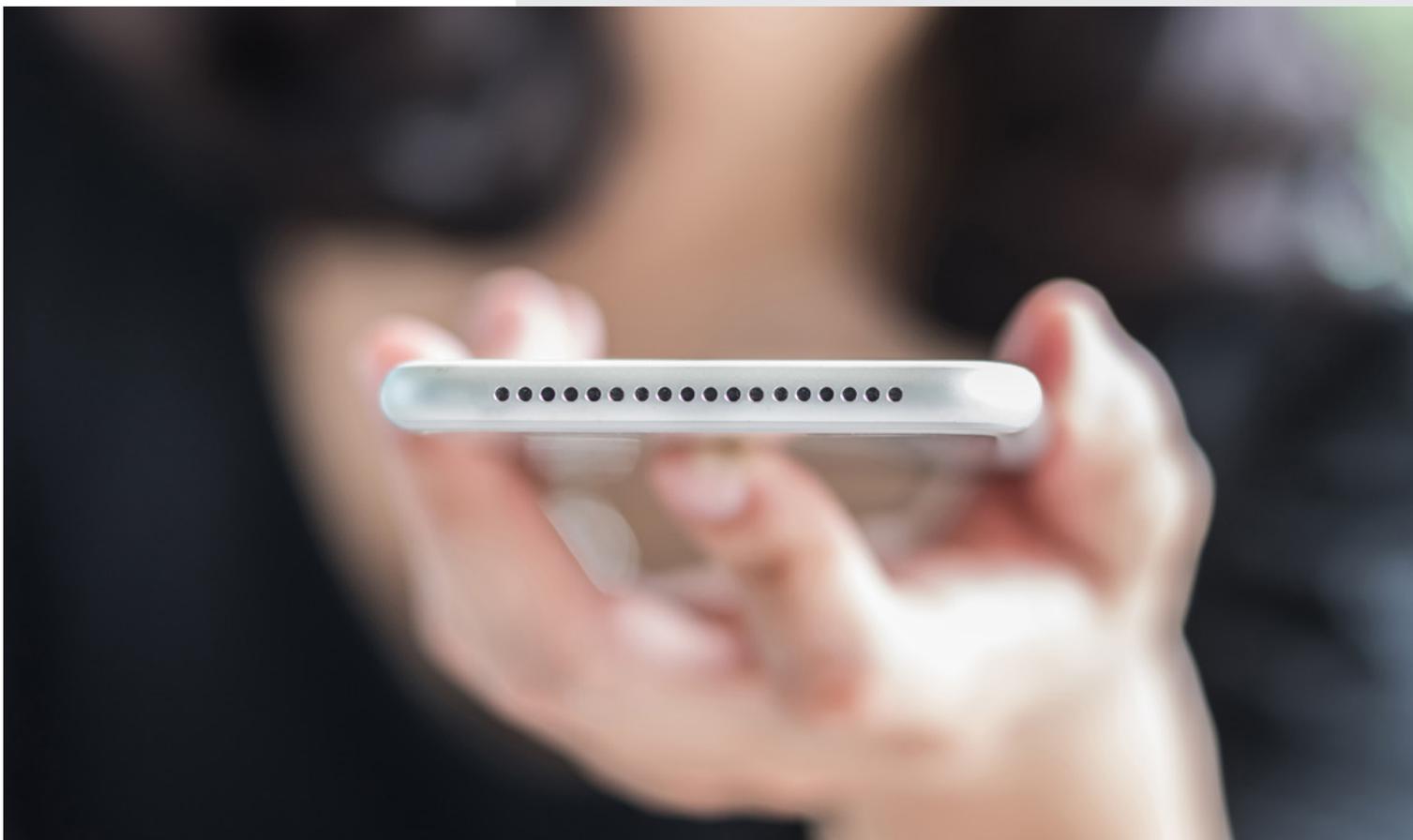
EXAMPLES OF SOFTWARE VENDOR AI AND AUTOMATION TOOLS

Many of these tools and products are developed using AI engines from 3rd parties (e.g. Amazon Alexa NLP, IBM Watson AI, botxo.ai for chatbots etc.)

	Data Classification Tools	Customer Chatbots	Invoice & Receipt Scanning	Robotic Process Automation Engines (RPA)	Process Optimisation	Customer Insights (Lead Generation /Churn Prevention)
Example vendors	xero =exact VISMA SAP ORACLE	contextor *Authorized Partner* SAP VISMA sage ORACLE	VISMA sage =exact	ORACLE VISMA SAP =exact	VISMA SAP ORACLE =exact	=exact salesforce SAP

			Table Stakes			
Functionality / customer use cases	• Automatic classification of messages, data or files by a pre-defined rule set	• Improve customer service response times • Automate responses to simple and common queries	• OCR image recognition to scan and upload receipts and invoices	• Automate a standardised manual business process of executing a task or activity	• Optimisation of simple repetitive processes	• Simple prompts for up-sell / cross-sell based on other customers
			Differentiated			
	• Custom rules and classification categories built and designed to customer specifications and trained on unique customer data	• Desktop based digital assistants designed tailored to fit each customer *(e.g. Oracle Finance Bot)*	• Automated processing of invoices etc. in accordance with local VAT and tax regulations with full traceability and audit trail	• Custom technology or engines built to interpret and manipulate data specific to an organisation or function	• Utilising knowledge of customer workflows or access to datasets to optimise planning / maintenance / production given the specific constraints that an organisation is facing	• Tailoring sales processes to specific customers depending on their activity *(e.g. Cisco identified >$1bn of new business with SAP Leonardo)* • Cash flow and financials forecasting

A question we are often asked is: how far can these developments in AI/automation actually be monetised by software firms, vs being competed away as table stakes that all customers will come to expect? The answer depends on several factors, in short – to have high monetisation potential, AI/automation solutions in software firms will have to be able to create high value for each customer, and have **characteristics that are difficult for competitors to replicate** (e.g. proprietary training data, or be based on internal knowledge and capabilities).

Strong M&A execution is a critical source of **competitive advantage**

M&A

Power brands also often deepen their winning position via highly strategic and well-executed M&A. These acquisitions serve multiple purposes - but above all mean these firms stay innovative by buying in cutting-edge new technologies and continue growing rapidly by acquiring growth. This helps these firms avoid becoming victims of their own success, unable to change fast enough due to the scale of their commitments and vested interests.

Strong M&A execution is consequently a critical source of competitive advantage. We see companies with the strongest power brands - with Salesforce, Microsoft and Visma all good examples - employing in-house M&A teams dedicated to identifying, acquiring, and integrating the best possible targets. Having a clear playbook for integration means these firms can often pay more than others for a given acquisition - as they are able to extract more value once it is acquired. Doing this without killing off the entrepreneurial spirit of acquisitions is a true art - making the acquisitions more successful, and - once a track record is established - making it more likely for founders to choose them as the acquirer.

CLOSING REFLECTIONS

This new era is a testament to the value these SaaS firms are adding to their customers. Software is being applied to more verticals and more processes within those verticals, and its ability to add value to customers in these applications is growing every month. The **growing market concentration** of SaaS software is thus in some ways an ironic side-effect of SaaS enabling **more effective competition** in industries outside software. As the frontier of competition in all industries is increasingly in the digital realm, it is increasingly these SaaS companies who enable this.

COVID-19 impact
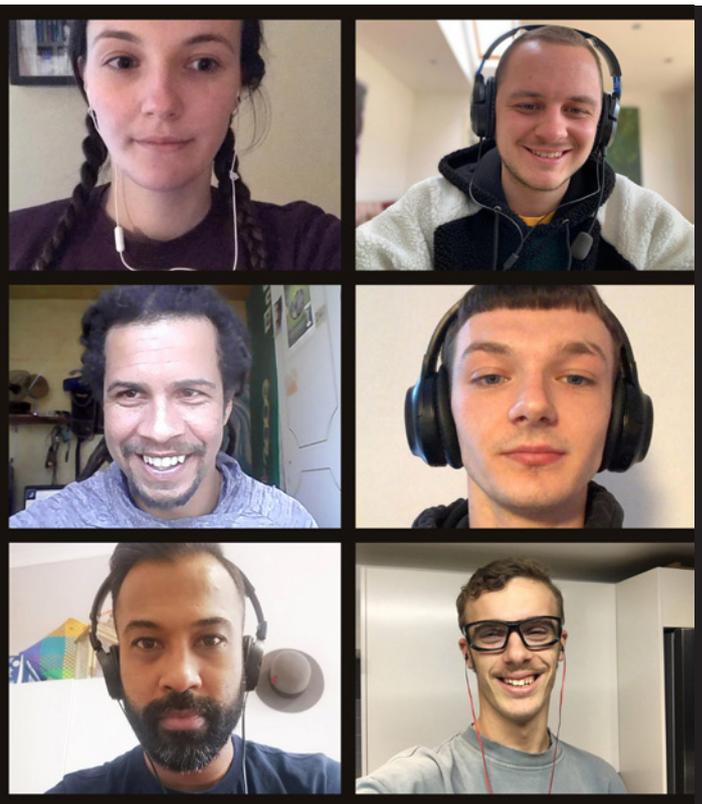
We expect the advantages of size and incumbency to be further enhanced by the impact of COVID-19. Many software users have spent months getting trained on flexible and increasingly home working. These new hybrid ways of working will likely have become the new normal, with far less commuting, more video-meetings, working from anywhere and being online from anywhere, anytime and especially, working from any device.

In such a setting, legacy desktop-based computing becomes very impractical. Software needs to be accessible from anywhere, and it needs to be secure from anywhere. Computing and security therefore must be centralised, and not depend on the resources in a local device. Thus, we expect most desktop Windows applications to be replaced by cloud computing by 2025.

We are approaching a tipping point where on-premise device installed software will become forbiddingly expensive to operate, and a hassle to use and manage. Software companies well established as cloud providers will benefit from this accelerated change; the laggards are likely to see their gap behind the winners widen even further.

Software needs to be **accessible** from anywhere, and it needs to be **secure** from anywhere

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