The New Enterprise Software Business Model

After decades of relative stability, the enterprise software business model is undergoing significant change that will position it in much the same way as other industries that rely on mass standardization throughout the supply chain.

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A new enterprise software industry business model is emerging and the changes wrought by this new paradigm will fundamentally rewrite the rules of the industry – causing new classes of software companies to emerge that will alter how software is delivered to the customer, how software is made, who makes it, and the financial underpinnings of the industry itself.

Over the last several decades, many industries have witnessed a paradigm shift caused by the split between the actual producer and the promoter or distributor of products. Manufacturing is a particularly good example – the market is replete with examples of companies that design everything from car parts to sneakers in North America or Europe but build components for final assembly in other countries.

Throughout this transformation in the rest of the economy, the software industry has remained vertically integrated with each vendor developing, marketing and selling its own versions of popular product types. This situation has enabled the development of a thriving systems integration industry whose job is to knit together disparate systems from multiple vendors so that enterprise customers could achieve a semblance of end-to-end business process automation. But this process is labor-intensive and time-consuming and rather than occurring prior to implementation – about half of the time based on our research – it is performed in line with implementation and it is a significant contributor to late delivery and cost overruns.

The solution is to develop pervasive standards for developing modularized applications rather than simply leaving each vendor to develop modular architectures that work well internally but that do not necessarily integrate well or easily with the outside world. Taken to a logical end point, once a pervasive development strategy is achieved, software houses will have every incentive to de-verticalize and form new associations in which some perform more of the traditional tasks of customer touch – i.e., marketing, sales and support – while others concentrate on applying their domain expertise to end user needs by developing and servicing applications that address new business requirements. We see this already beginning.

De-Verticalizing the Enterprise Software Industry

As with other industries that have deverticalized, the software industry will transition from one in which vertically integrated software companies perform all phases of development, sales, marketing and support to one made of a variety of specialists. Some of the major milestones in this transition are:

Publisher and Developer

The traditional enterprise software company business model will split yielding “publishing” entities and “development” entities with each new company type taking on new or expanded roles in delivering products to the market. The software publisher will emerge as an important new driving force in the industry combining the functions of sales and marketing, application hosting, venture capitalist, and technology and billing infrastructure for software developers. Most importantly, however, the publisher will become the primary aggregator of requirements from the market designing the solutions that need to be built to satisfy customer demand.

This new arrangement will drive cost reductions and improve reliability for end users, and it will provide better integration capabilities than ever before. The software publisher will offer a federated suite of applications from multiple sources that end users can use in best-of-breed solutions. The applications will be based on the publisher’s standards, tool suite, data model and Web services that all developers within the publisher’s portfolio use to craft their products. The publisher will be responsible to the customer for all aspects of quality assurance at the sub-assembly and final assembly levels.

Finally, the publisher will also provide hosting services for end users or subscribers. The software publisher will be the interface between the customer and the developer, responsible for aggregating demand and collecting subscription fees from customers and paying royalties to developers. Some publishers may also take on roles currently filled by venture capitalists to provide funding and other support to emerging software developers who can add new functionality or whole new applications to the publisher’s portfolio.

The second new class of enterprise software company, the software developer, will retain most of the research, development and domain expertise responsibilities traditionally associated with software companies. However, this new entity will have the option of outsourcing its sales, marketing and platform support issues – and the costs and overhead associated with these endeavors – to a software publisher. The software development company will be better able to focus its...
energies and talents on serving customers and deriving revenue from those services. Implementation services and ongoing service based on the developer's expertise will become a larger part of both the company's activities and its cash flow.

**Software Publisher and Ecosystem**

There are no examples of a fully articulated publisher-developer model operating today but Salesforce.com and its ecosystem come close. Salesforce.com was one of the first companies to initiate a disruptive innovation in the enterprise software industry by offering CRM as a hosted or on-demand service and it is now building a hub-and-spoke model of a developer community – the second disruptive innovation in enterprise software.

Salesforce.com's model uses its core application, storage and hosting technologies as the hub and it invites developer companies to participate as spokes by offering free access to development tools, an open API with documentation, and all the trappings of a developer community to promote interaction and cross-pollination of ideas. Currently Salesforce.com says it has more than 3,000 developers involved in the program representing more than 100 discrete companies. The development environment is hosted using the same facilities as the CRM application.

**Appforce and AppExchange**

Salesforce.com offers a complete environment (Appforce) that developers can use to build whole new applications or to customize Salesforce.com's core CRM offering and integrate that offering with other on-demand and legacy applications. Key components of Appforce include what the company refers to as an on-demand operating system (Appforce OS), which enables users to deploy and manage multiple applications. It has a data store for managing data relationships across all on-demand applications; Appforce Builder, a point-and-click development interface for technical and nontechnical users; and Appforce API, which enables companies to integrate portfolio applications with the rest of their enterprise's suite.

Most importantly, Salesforce.com has taken the next critical step in deploying the new paradigm by building the first marketplace for buying and selling compatible enterprise software. The AppExchange is an online utility that enables users of Salesforce.com to test fully compatible applications built to the same standards as the company's core system and to buy that software. Further, at any time customers can read about other users' experiences with those products or write their own reviews and provide ratings – an experience wholly similar to reading or writing a review on Amazon.com or eBay.

**Extending the Model**

For the foreseeable future, this new model will be subject to modifications. It is not clear yet that all of the contractual qualifications and guarantees are in place to give users and developers all of the assurances they need to operate in this new environment without stubbing a toe from time to time. But the technical architecture is well fleshed out, and many of the challenges, when they come, will most likely be in the form of legal and business issues.

**Challenges of Reshaping the Enterprise Software World**

Responsibilities for various aspects of software development, sales and marketing will obviously change in the new model and there will be winners and losers. But, as is frequently the case with disruptive innovations, there is plenty of time before the new model becomes dominant for forward-looking companies to insulate themselves from the worst prospects and take advantage of what should be new opportunities. There are multiple constituencies in enterprise software and each will be affected in different ways. This section examines how some of them might fare.

**Software Publishers**

The new business model is decentralized, which will cause the typical traditional software company to devolve its sales, marketing packaging and some support duties to a publishing company. Revenue sharing would probably resemble that in the publishing industry, or perhaps the deregulated utility industry, in which the publisher distributes portions of the revenue based on prior agreements. The publisher will split revenues with the developer and possibly other entities – for example, a hosting service if that function is outsourced – retaining a portion as earnings from hosting, sales and marketing activities.

The new model offers significant opportunities for improved cash flow to the publisher through economies of scale for such activities as sales and marketing. With a growing portfolio of software titles in its inventory, the publisher, as sales agent to an increasingly captive audience, will need to invest more in knowing a customer's business requirements than many of today's software companies have the time and resources to do. Finally, a bandwagon effect will be generated. As additional integrated software titles become available from a publisher, more developers will wish to become associated with that host's platform in order to sell to that channel.

**Software Developers**

Software developers – companies that elect to join a publisher's ecosystem – stand to benefit substantially from this new model. Obvious benefits, especially for new companies, include eliminating the need for some upfront investment in hardware, databases and development tools, all of which would be part of the infrastructure provided by the publisher. Also, any niche software company that has ever tried to partner with a large enterprise software company will find value in this new model. Today partnerships evolve out of negotiations between companies with existing products, and frequently most of the negotiations involve integration issues. In the new model, integration is dealt with at the beginning of the relationship before there are applications and the same is true for go-to-market strategies, billing, splits and other relationship issues.

Under the new model, developers can free themselves from the overhead of product packaging, marketing, sales and hosting, leaving them better able to concentrate on research and development as well...
as deepening their domain expertise. And because these companies focus more on their domain expertise they will be better positioned to provide consulting services to customers that need it. Under this new framework the software developer will evolve further into a business process/services expert, and it will be these additional services that fuel growth as the developer sells services and customization directly to customers subscribing to application services.

**End Consumers**

Beagle Research consistently finds that issues of customization, integration and security are the highest-ranking concerns among consumers considering hosted CRM. There has been significant progress on all fronts but especially in security as hosted vendors have implemented procedures and technologies to provide safeguards that meet or exceed those found in a corporate IT setting.

Customization and integration issues are being addressed by the new paradigm by eliminating these issues at the source. The same capabilities that are enabling the publisher-developer split are responsible for making hosted CRM applications better able to integrate with legacy applications and enabling greater customization options. The trend toward more openness and flexibility is likely to accelerate and the functionality line between hosted and on-premise applications should continue to blur as the new model takes shape giving end users more choices in how they use technology to accomplish their business objectives.

**Challenges for Systems Integrators**

Systems integrators (SIs) may be less affected by the new enterprise software business model but they will still need to make adjustments. For years systems integrators have worked with end user software consumers and software vendors by providing the expertise to knit together a company’s existing systems with new enterprise applications. While that work will continue, SIs’ domination of the space will be challenged by software developers who will also have specific domain expertise to offer to the consumer.

At the same time though, it would be naïve to suggest that requirements for integration services will cease. Companies will still require assistance integrating legacy applications, implementing systems, and training staffs, for example. Many SIs will no doubt consider forming close associations with specific publishers or possibly compiling some of the experience they have acquired through numerous engagements into specific products that fit into a publisher’s portfolio.

**Challenges for Venture Capitalists**

After years of venture capitalists funding startup software companies, the new enterprise software business model could make software innovation self-funding, leaving VCs with a diminished role. However, there are steps that VCs can take to minimize their risks and ensure they are able to play in the new environment. For example, the traditional investment role for VCs with emerging companies has been primarily financial and advisory. Some VCs may decide to become more active participants in the operations of software companies and decide to become publishers or to start publishing entities.

Alternatively, VCs that develop close relationships with publishers could tap a steady stream of new investments in companies that wish to access a publisher’s distribution channel. Those distribution channels will be larger than the installed bases of most enterprise software vendors today and they will be synchronized to a far greater extent than is currently the case. The hosted application model usually calls for a single version of an application running across the user population. Such a well-homogenized user base will make distribution and uptake of popular new modules much easier and faster than it is today and thus reduce some of the risks that new software companies experience today.

Finally, existing portfolios of software companies in various stages of maturity will need to be rationalized. Given the new model, most emerging software companies within a portfolio will be under pressure to fit into the new model as application development partners for various emerging enterprise software publishers. There will be opportunities and dangers for all concerned and each will need to be reviewed on an individual basis, which could lead to some horse trading.

After decades of relative stability, the enterprise software business model is undergoing significant change that will position it in much the same way as other industries that rely on mass standardization throughout the supply chain. This change will open up significant opportunities for customers and for new entrants in all corners of the world. Established participants in this market – venture capitalists, traditional vendors and system integrators – will need to adjust to this new mode and those who do will find ample opportunities to thrive. We believe this change is imminent and imperative. Consequently, enterprise software industry players who delay taking action or ignore the signals the market is giving off will run the risk of losing their franchises.