

Before You Begin

Dear Reader,

The cloud is radically reshaping how technology gets sold and consumed. Perhaps more importantly, it is shaking up the tech business model.

For all of its many virtues, the cloud business model has yet to emerge as a reliably profitable one. Even pure-play SaaS companies that have been in the game for a decade or more have yet to consistently deliver GAAP profits. That slows traditional tech companies from pivoting their business and opens the door for them to be disrupted by new entrants.

At TSIA, we believe that subscription-based business models like SaaS and managed services can be very profitable. And we think a blueprint for how to build a sustainably profitable technology-as-a-service (XaaS) business is emerging. And so we have written a new book, ***Technology-as-a-Service Playbook: How to Grow a Profitable Subscription Business.***

This is a chapter from the new book that we think you will find of interest and relevance to your company. We know we are treading on some controversial ground but believe that our industry must move more quickly to marry the many benefits of the cloud to a profitable business model. This book offers a framework and specific plays for how to do that.

We invite your comments and request that they be directed to:
xaas-playbook@tsia.com

Thank you for taking the time to review this material. We eagerly await your feedback.

Best regards,

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So Many Choices

This is a book about the plays a company can run as they work to establish and optimize a technology-as-a-service offer. Obviously, the offer has to have value to the user, or as it's frequently called, product-market fit. We can't help you with that. It's up to you and your team of experts to target the opportunity and establish a uniquely valuable proposition. Fortunately, the cloud and the Internet of Things (IoT) will open up thousands of chances to do just that. But believe it or not, that's just the beginning. Once you have the opportunity in sight and the core product working, an entire new set of issues begin to play out. That's where this book comes in. We want to promote discussions among your team that can accelerate your thinking and increase the chances that your great idea is a commercial success.

But where to begin? What can we learn from the cacophony of XaaS offers and activities already in the marketplace? Some of these offers lead with free trials, such as McAfee's suite of security-as-a-service offers. Customers can try the service and then determine if they want to continue paying.¹ Some XaaS offers provide all the customer requires in one simple subscription price.

Apptio property management software provides a great example of this approach. On its web page, it leads with the tag line: “No surprises. No complicated list of features that cost extra. Everything you need to run a more successful business.”² Still other XaaS offers list multiple components a customer can choose to purchase based on business requirements. Veeva Systems, which secures over 25% of its revenue from add-on services surrounding the core technology subscription, offers professional services, managed services, administrator training, environment management, and transformation consulting.³

Looking across XaaS providers, it may seem challenging to discern common patterns related to things such as offer types and pricing models. One industry article defines 12 distinct ways to price a SaaS offer.⁴ What pricing model makes sense for your XaaS offer? What should be included in the offer? One way to bring some clarity to the chaos is to use the filter of time.

Profit Horizon

As we have studied the XaaS marketplace, we believe there is one defining factor in determining XaaS offer strategy: the profit horizon, as illustrated in Figure 2.1.

Profit Horizon: The length of time targeted to achieve significant GAAP profits.

By GAAP profits, we simply mean a company is considered profitable when applying traditional, generally accepted accounting principles. This is an important distinction, because many XaaS providers are currently applying non-GAAP metrics to communicate the financial health of their businesses. The argument for non-GAAP is that non-cash items, such as employee stock option expenses or the amortization of intangible assets obtained through acquisition, should be excluded to provide a more meaningful

Profit Horizon

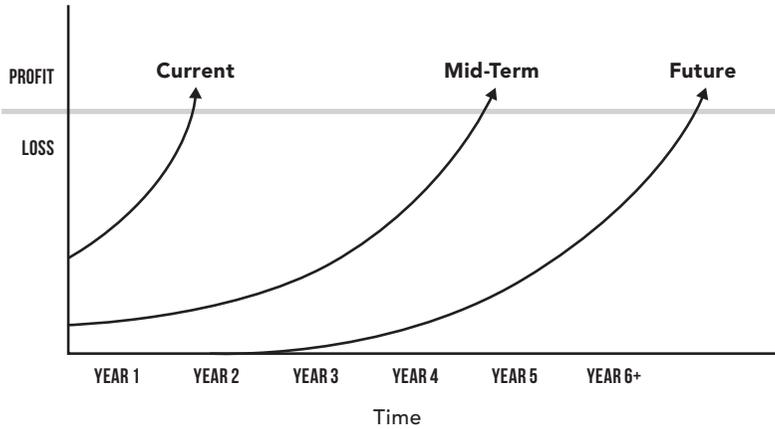


FIGURE 2.1 The Profit Horizon

view. We don't want to get into the debate about GAAP or non-GAAP, so we choose to set GAAP profits as the bar since no one will argue with you once you have achieved them!

A plethora of companies are building XaaS offers that they believe may take many years to capture significant market share, aggregate customers, and create the economies of scale needed to make GAAP profits. They may not even fully understand how those revenues will be monetized or how profits will be created. These companies have a “future” profit horizon. There are different profit horizons for companies that feel they need less time. Perhaps a company established a XaaS offer several years ago. It expects to achieve a critical mass of customers and revenue in the next few years or so. Its profit horizon is “mid term,” but not current. Finally, if you have a XaaS offer that you believe can get to a critical revenue mass and be profitable within the next year or two, then your profit horizon can be defined as “current.” You are expecting or needing the offer to generate profits for your company relatively quickly.

The 3x3 of XaaS: The First Dimension

Applying this concept of a profit horizon to XaaS offers in the marketplace, we can easily recognize three common, distinct profiles of XaaS solution providers, as seen in Figures 2.2, 2.3, and 2.4 and described below.

- 1. Future Value Aggregator (FVA).** These are XaaS providers that believe the real financial value of the offer will be realized at some date in the distant future. The method of achieving profitability may be vague or unproven, but there is an initial mass of believers (investors, customers, analysts) that has provided adequate support to get the company to believe in its direction. The critical success metric for these offers is the unit of future value. This is the item that the provider believes will be monetizable at scale. That item could be users buying subscriptions, but it could also be page views in an advertising model or transactions in a web services model. For one XaaS offer we analyzed, the unit

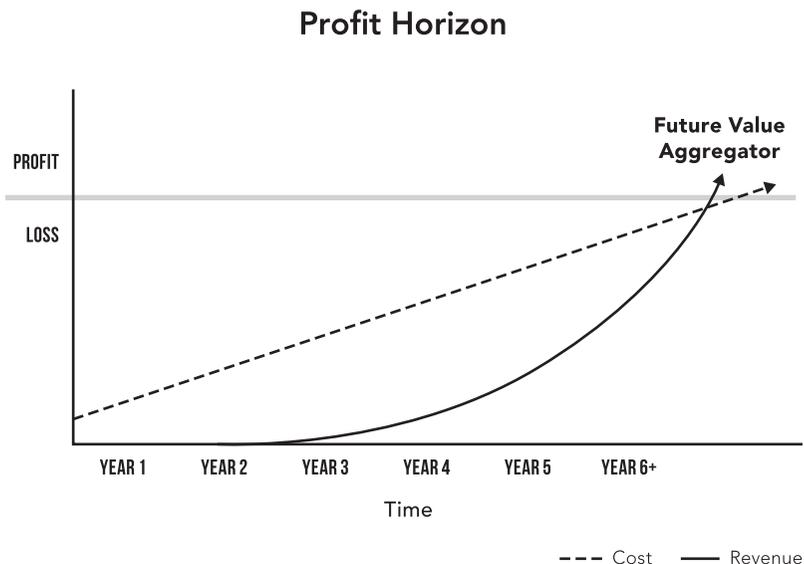


FIGURE 2.2 Profit Horizon: Future Value Aggregator

of future value was the number of project plans under management on their platform. In the early days, FVAs are likely to be experimenting with revenue models; customer spending may be erratic or even nonexistent as the company endeavors to find the levers to add visitors and translate them into reliable revenue. FVA doesn't necessarily mean that companies are not monetizing customers at all, it's that they are in an immature—and likely unprofitable—state of monetization. The per-customer unit economics are likely to be negative or sub-optimal.

2. **Mid-Term Wedge (MTW).** These are XaaS providers that expect to achieve profitability in the not-too-distant future (3 to 5 years, or so) selling their core subscription. This is the most commonly advocated SaaS business model. These companies have, or believe they will amass, enough customers on the platform in this time frame to achieve the economies of scale required to be profitable. We refer to this as the mid-term wedge profile, because these are companies that are exiting the

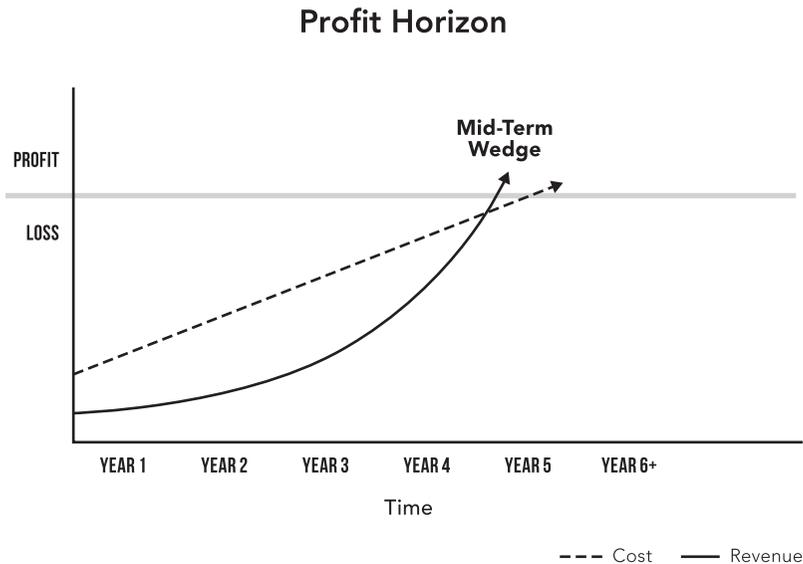


FIGURE 2.3 Profit Horizon: Mid-Term Wedge

left-hand side of the classic XaaS financial curve, where the provider is investing in the platform, and entering the right-hand side of the model, where each additional customer drives more and more revenue that brings the company one step closer to profitability. Importantly, the wedge model assumes that, at some point, costs are no longer increasing in a linear relationship to revenue. MTW is where companies start to hone in on their “balanced state.” Losses shrink and the economies of scale that are driven by positive per-customer unit economics begin to really become visible. The balanced state of growth + profits becomes clear and accurately projectable. It is the proof moment for the business model.

- 3. Current Profit Maximizer (CPM).** These are XaaS providers that are focused on maximizing the revenue and margin opportunity surrounding their XaaS offers as soon as possible. Instead of capturing market share at the expense of profitability, the companies are very focused on maximizing profitability

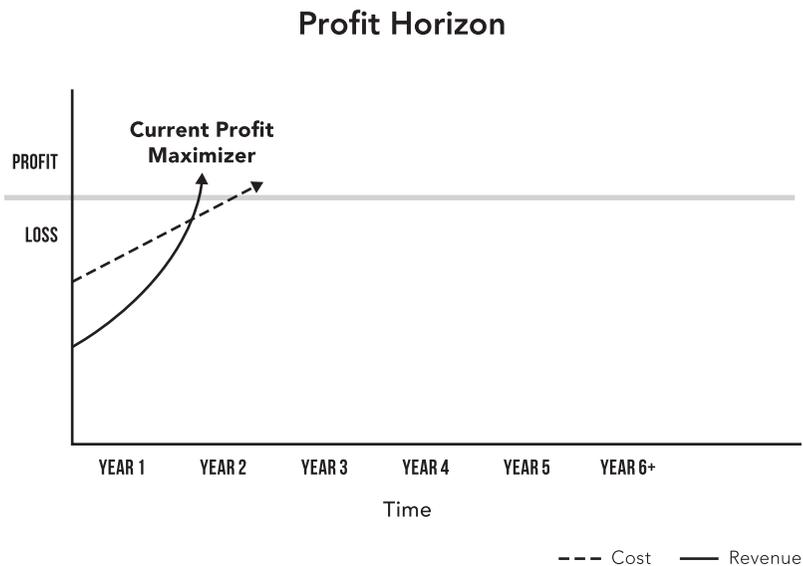


FIGURE 2.4 Profit Horizon: Current Profit Maximizer

per customer in the short term, this year or the next. Often these are large public companies with shareholders who are demanding profits now, or XaaS companies who are fairly mature and are ready to make the switch from revenue valuation multiples to profit growth valuation multiples. Most importantly, what both companies have in common is that they believe they can get their revenues to critical mass soon. Potentially this could be a new company with meteoric growth, but that usually requires a longer horizon than 1 to 3 years.

So this leads us to the three profiles of XaaS, as summarized in Figure 2.5. These profiles are the first dimension of the 3x3 of XaaS.

Shareholder Appreciation Drivers for Each Profile

What profile is applicable to your XaaS offer? There are a few key attributes you can test for:

- **Drivers for the Future Value Aggregator.** This profile is applicable when there is a significant market—that may or

The Three Profiles of XaaS

	FUTURE VALUE AGGREGATOR	MID-TERM WEDGE	CURRENT PROFIT MAXIMIZER
Unit of Consumption by Customers <i>(users, pageviews, clicks, etc.)</i>	Rapid growth <i>(usually triple-digit)</i>	Growth <i>(high double-digit+)</i>	Growth, could be slowing
Confident in Pricing/Revenue Model	Not yet	Yes	Yes, usually multiple
Revenues Growing Faster Than Expenses	No	Yes, maybe barely	Yes
Profitability Horizon	5+ years	3 to 5 years	Current to 3 years
Examples	Twitter Transitioning: → DocuSign Box	Workday Transitioning: → Salesforce.com AWS	Google, Adobe

FIGURE 2.5 The Three Profiles of XaaS

may not be well understood by the marketplace itself—to create and/or dominate. The premise is that the XaaS offer with a dominant share of this large market will be best positioned to maximize future profits. However, to assume this profile, a company needs a critical mass of investors that drink the Kool-Aid and believe in the future payoff. If investors are not excited about the potential future state, then it is hard to raise capital to support the investments required to acquire customers. Over the past few years many venture investors have been placing high valuations on unprofitable XaaS providers with the hope that over a long horizon profits will flow.

- **Drivers for the Mid-Term Wedge.** This profile is applicable when the company believes it has a 3- to 5-year line of sight to making the current offer profitable. The company believes it can manage the three attributes that kill the profitability of XaaS offers: churn, costs, and commoditization. The company can keep the majority of customers on the platform for multiple years. Economies of scale are kicking in so it costs less to serve each customer. The company will be able to fend off commoditized pricing due to hyper-competition. It knows how many customers are required to cross the line to profitability.
- **Drivers for the Current Profit Maximizer.** This profile is applicable when a company needs or expects to generate high profits in the near term to meet shareholder approval. As just mentioned, the two common classic examples would be a highly profitable, publicly traded software company that is now in the process of starting up a new XaaS offering that competes with the legacy license offering, or a mature XaaS company that is ready to show off its ability to throw off profits and cash. Occasionally there may even be a highly disruptive and high-priced entrant that is confident it can get to profitability early in its XaaS childhood. In the first case, investors are accustomed to substantial profits from the company and may not have much appetite for significant losses related to a new XaaS

offer. In the second example, investors are salivating at finally reaping the rewards of the multiyear investment to get the subscription business model to become a money-making machine.

Common Behaviors

When companies assume one of these profiles, recognizable behaviors emerge:

- **Common Behaviors of the Future Vaule Aggregator.** Companies in this profile care more about attracting new potential customers than anything else and are willing to do whatever it takes to make that happen—almost no matter what that costs. They will offer “all in,” simplified pricing models, up to and including free and freemium. They will throw in services required to enable the customer at no cost, not focus on monetizing value-added services. Sales and marketing expenses will range from 50% to over 500% of total company revenues as the company aggressively invests to acquire new customers, add units of future value, and increase market share.
- **Common Behaviors of the Mid-Term Wedge.** Companies in this profile have clear signals that their revenue model and product-market fit are valid. Subscription or transaction revenues are consistently trending up each quarter. Cost of goods sold (COGSs) as a percentage of revenue might be beginning to shrink as economies of scale kick in. Sales and marketing expenses might also be shrinking as a percentage of revenue. B2B companies in this profile are often in the early stages of monetizing premium account services around the core subscription. These services typically represent 2% to 10% of total company revenues at this stage. The company has realistic models that indicate positive cash flow, and even GAAP profits, as it passes through the wedge inflection point in the next 3 to 5 years.
- **Common Behaviors of the Current Profit Maximizer.** Companies in this profile either have, or quickly will have,

a critical mass of revenue enabling them to pass the wedge inflection point within 1 to 2 years. They are typically exhibiting slower top-line growth than the other two profiles, but are forecasting positive operating income in this fiscal year or the next. From that point forward, their models indicate strong and predictable cash flow and profit increases. If you look at their websites, you will typically see a diverse listing of multiple product and service offerings customers can purchase for additional fees. These companies may offer multiple consumption models. They may also offer to run the technology operations as a managed service.

3x3 of XaaS: The Second Dimension

Once you identify which XaaS profile you would like to pursue, you will need to answer the following three questions:

1. What is the offer portfolio and pricing model?
2. What is the customer engagement model that we will use to sell and deliver this offer?
3. What are the financial keys that will allow us to make money with this offer?

We refer to this as the iron triangle of offer definition, as seen in Figure 2.6.

A key premise of this book can now be stated: *The profit horizon of the XaaS offer should drive how a provider engineers the financial model, designs the portfolio, sets the pricing, and matures the customer engagement model for the offer.* While we will cover all three elements in later chapters, here is a bit more elaboration to help clarify the focus of our 3x3 matrix.

Portfolio and Pricing

Obviously, a company must determine exactly what it intends to take to market. The company needs to clearly define the XaaS

Iron Triangle of Offer Definition

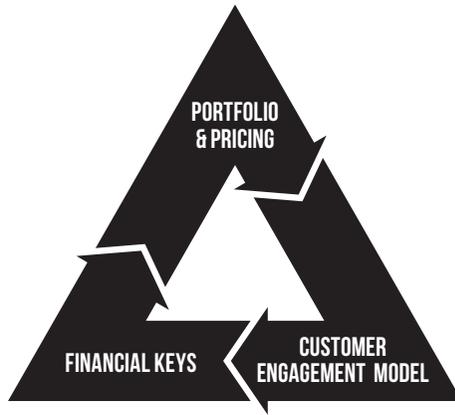


FIGURE 2.6 The Iron Triangle of Offer Definition

offer and how it should be priced. Double-clicking into this area, the company must make decisions in the following areas:

- **Technology Offer Definition.** What form will the core offer take? How will you package the high-value capabilities? What is the differentiation of these offers from competitive alternatives? Will you have a single offer or multiple, complementary offers inside a portfolio?
- **Value-Added Services Offer Definition.** Are there any additional services the customer may need in order to be successful with the technology? Services could include traditional customer or technical services as well as information/analytic-based services.
- **Offer Pricing Model.** How will the offer be priced? Will the price be based on consumption of specific features, number of users, business outcomes, or other factors? Will required services be bundled or sold separately? How will these services be priced?

As discussed in the opening chapter, the answer to these portfolio and pricing questions are wide and varied in the marketplace

today. Understanding what answers maximize success within each XaaS profile becomes key.

Customer Engagement Model

Next, a company must work through the appropriate customer engagement model for the XaaS offer. We break the customer engagement model into four distinct phases we call LAER (pronounced *layer*):

- **Land.** All the sales and marketing activities required to land the first sale of a solution to a new customer, and the initial implementation of that solution.
- **Adopt.** All the activities involved in making sure the customer is successfully adopting and expanding their use of the solution.
- **Expand.** All the activities required to cost-effectively help current customers expand their spending as usage increases, including both cross-selling and upselling.
- **Renew.** All the activities required to ensure the customer renews their contract(s).

Customer engagement models for XaaS offers are highly diverse in the industry today. There is often particular confusion and conflict around the involvement of the channel. Many traditionally channel-focused tech companies find themselves in the awkward position of bringing out new XaaS offers that allow customers to engage directly. This channel conflict is particularly hard to avoid in many cloud XaaS models because customers often can completely self-serve from the company's website. Partners, particularly those who sell to small and medium business (SMB) customers, find that some customers do not need to engage with them directly.

So far, many of the engagement models companies have deployed are poorly aligned with the profit horizon of the offer, often resulting in offer failure or financial failure due to intolerable levels of sales and marketing expense. One objective of this book is to help companies reduce the probability for these misalignments.

Financial Keys

When working through the financial keys, a provider is creating the parameters for how success will be measured for this XaaS offer. And as indicated in the 3x3 model, success is not always defined by profitability. But in any model, the main areas a company must discuss when setting the financial keys for their XaaS offer include:

- **Revenue Mix.** What percentage of total company revenue will come from the core technology subscription(s), and what percentage of revenue will come from other value-added services you intend to monetize with the customer? We often refer to this as setting the “economic engine” of the offer.
- **Margin and Profit Targets.** What are the gross margin expectations for each revenue stream we have identified? What is the profitability we expect from the overall economic engine associated with this XaaS offer?
- **Sales and Marketing Costs.** What will the cost of our LAER model be as a percentage of revenue? How do we project that these costs ratios will change over time as our profit horizon shrinks?
- **Key Performance Metrics.** What are the specific metrics we will monitor to determine if we are on track to meet our financial objectives? Some of these metrics may not be financially oriented but can predict our ability to achieve our financial objectives in the appropriate time horizon as selected in the 3x3 model.

Once again, how a company answers these questions will be very different based on the XaaS profile it is pursuing. Figure 2.7 summarizes a view of the 3x3 of XaaS that provides an outline of the critical conversations a management team must have when defining a XaaS offer.

The Basic 3x3 of XaaS

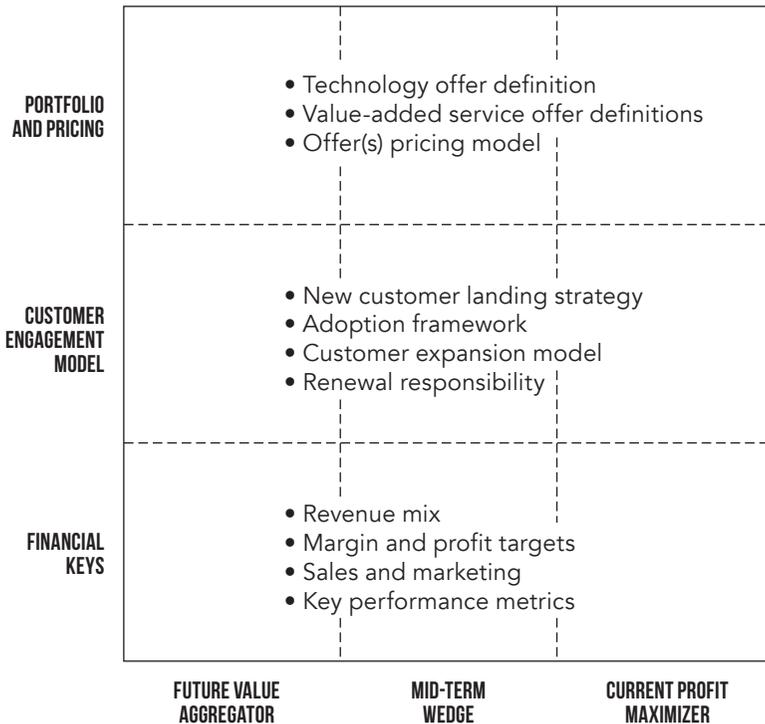


FIGURE 2.7 The Basic 3x3 of XaaS

Friction Curves

We have one final but critical thought before we continue the journey through the technology-as-a-service playbook. As you work through all the decisions associated with your XaaS offer, you will be optimizing between one of two extremes (Figure 2.8). At one extreme, you are doing everything possible to make it easy for the marketplace to acquire and adopt your core XaaS offer. On the other extreme, you are—at some point—doing everything possible to maximize the profits you extract from the offer.

On the left side of the diagram, you want to minimize any possible friction that prevents your units of future value from

Extremes



FIGURE 2.8 XaaS Offer Extremes

being acquired. That might mean free use of the product for a period, free services, and so forth. On the right side, you may be presenting concepts in your offers that add friction to the buying decisions but have the potential to increase per-customer revenue and profits. Maybe you are charging a premium price. Maybe you have a big professional services price tag to get the offer implemented correctly and you want to make money at that service. Maybe you have broken the offer into several separately priced modules that have the potential to increase total customer spend if the customer selects two or more. In any case, friction is a critical concept in the XaaS playbook. Most importantly, your friction strategy can and should change over time as your priorities, and your offer, mature. So let us introduce you to a model that TSIA calls the friction curve:

Friction Curve: *The amount of offer complexity that balances the ease of customer purchase decisions with optimal per-customer economics.*

Every parameter you set regarding your XaaS offer will move the offer up or down the friction curve, as seen in Figure 2.9.

There are friction curves related to offer definition, pricing, and so on. We will refer to the concept of friction throughout the book. Understanding your profit horizon objective helps you understand how much friction to insert into your portfolio.

The Friction Curve

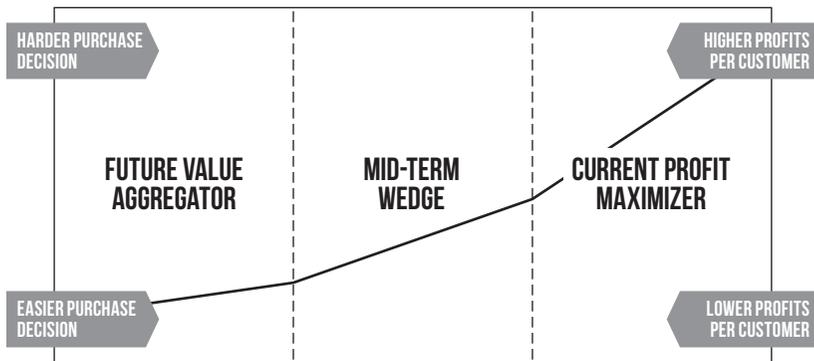


FIGURE 2.9 The Friction Curve

Now we know that there are a lot of people in the XaaS industry who might fundamentally disagree with this premise. They argue that the best way to profitability is to make it quick, easy, and fun for new customers to enjoy the offer. The idea is to get as many as you can as fast as you can. Eventually you will have enough to make money. In a perfect world you could find a highly profitable, frictionless offer model. If you can, good for you! They do exist and that could be your goal. But we think that is also the path to commoditization. Our observation is that most of the more profitable technology offers also force customers through some amount of complexity and trade-off as they choose from among multiple, sometimes premium-priced offers within a provider's portfolio of products and services. You may be faced with this reality as you make your playbook decisions. Again, we think friction is best thought of according to your profit horizon. You may start off with a low friction model when you are an FVA but intentionally place more and more expensive choices in front of your customers as you evolve into a MTW and CPM player.

So now let's put together all the elements of the 3x3 of XaaS, shown in Figure 2.10.

The 3x3 of XaaS

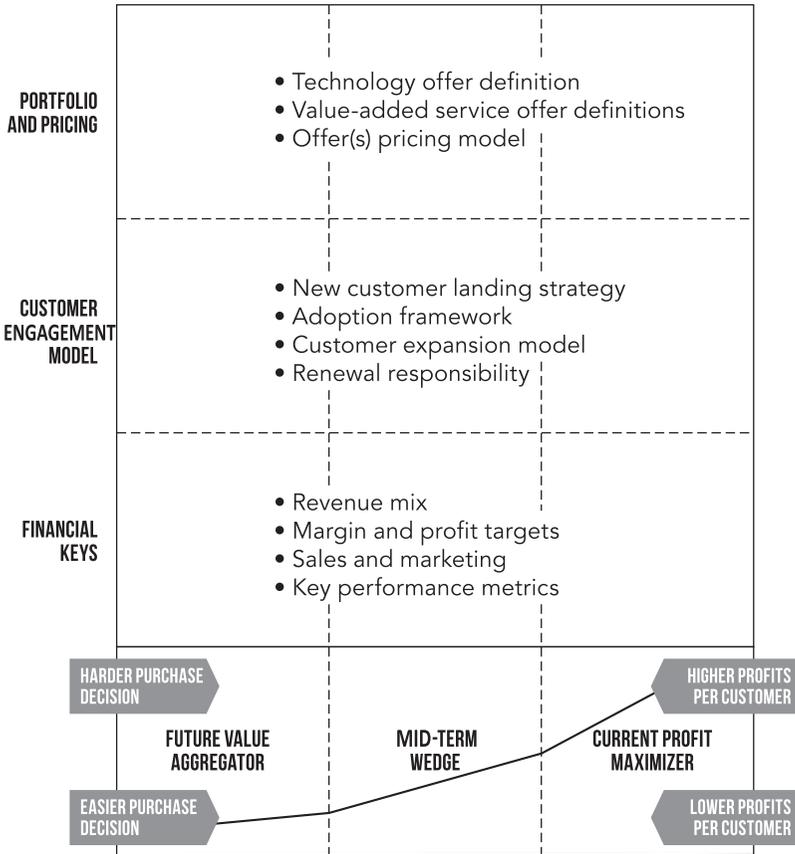


FIGURE 2.10 The 3x3 of XaaS

Upcoming Chapters

In Chapter 3, we will discuss how to create a XaaS offer that has the potential to create the highest and most sustainable profits possible by combatting the three “killer Cs” of XaaS success: customer *churn*, high *costs*, and offer *commoditization*. This is an important concept because many XaaS offers are creating a race to the bottom in terms of pricing and profitability. Chapter 4 tries to sort out how profitable XaaS businesses might eventually

organize and operate differently than traditional tech companies. Chapter 5 is targeted at all those large, legacy technology companies that are struggling to pivot from traditional technology offers to new XaaS offers. In Chapters 6 through 8 we will explore the three elements of the iron triangle of offer definition in more detail. Chapter 6 will explore the power of portfolio in XaaS. We will provide frameworks for defining your XaaS offer and setting the pricing strategy. Chapter 7 will cover the LAER customer engagement model and why the concept and science of customer adoption is the best strategy for battling the three killer Cs. Chapter 8 explores the specifics of setting target financial models and metrics for a XaaS offer. Chapter 9 looks at the special case of managed services as entrée into XaaS. Chapter 10 will explore the changing channel models—how the role and success factors of go-to-market partners can alter in XaaS marketplaces.

Playbook Summary

This book is designed to provide a set of plays you can run to move your XaaS business forward. At the end of each chapter, we will provide a summary of the plays that have been defined in the chapter. As of now, you need only make one simple decision and you will have run the first play in your XaaS playbook.

Play: Setting the Profit Horizon

Objective: Align your entire management team on what profit horizon the company is pursuing for this XaaS offer.

Benefits:

- Provides context for the wide variance in behaviors of XaaS providers in the marketplace.
- Identifies the right XaaS offers to compare yourself against and model yourself after.

- Identifies the key parameters the management team will need to set for the XaaS offer.
- Minimizes behavior schizophrenia when setting the parameters for the XaaS offer.

Players (who runs this play?): The executive management team runs this play and should include senior leadership from the areas of product development, marketing, sales, services, and finance.