



SOFTWARE AS A SERVICE: CHANGING THE PARADIGM IN THE SOFTWARE INDUSTRY

SIIA AND TRIPLETREE INDUSTRY ANALYSIS SERIES

SIIA SOFTWARE DIVISION & TRIPLETREE

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PREFACE

TripleTree, LLC and the Software & Information Industry Association (SIIA) are pleased to provide you with our report on “Software as a Service: Changing the Paradigm in the Software Industry.” As observers and proponents of the hosted software space from its earliest days, TripleTree and the SIIA have teamed up to produce this research report on the “Software as a Service market”. **“Software as a Service” is one of our mega trends in the software industry.**

In this report, we offer our perspectives on what constitutes software as a service, including the evolving business model and the core value proposition, the overall landscape including major participants and market growth, and analysis of competitive trends. The report also includes a spotlight of the on-demand CRM sector as well as a review of some of the other software categories with specific company examples and our viewpoint on the keys for success.

Several major trends are identified including:

- **Disruptive technologies** with software as a service redefining ways to deliver and sell software;
- **Growing end-user adoption** being paved by emerging, privately-held software as a service companies;
- **Endorsement becoming more mainstream** with small, mid-market, and large enterprises alike increasingly replacing license relationships in favor of hosted applications;
- **Mounting competitive tensions** with software companies taking defensive positions & maneuvers through internal development and/or acquisitions in reply to pressures posed by a new group of competitors; and
- **Shifting value drivers** with new account / subscriber growth, customer retention, deferred revenue, and cash flow analysis more suggestive of long-term value than the P&L.

We have assembled a vast body of knowledge about the companies that are beginning to re-shape the software industry. Our research and perspective encompasses years of experience in the application hosting and outsourcing sectors, to interactions with a wide range of software as a service companies in sectors such as customer relationship management, supply chain management, content management, e-commerce, security, transportation & logistics, human capital management, healthcare, back-office applications, among others. TripleTree and SIIA would like to extend special thanks to the over 25 company interviews, executive discussions with software as a service firms, and interactions with leading venture capital investors that went into assembling this report. In addition, IDC's research on the SaaS industry was a key resource for this report, as well as other analysis and research. **If you are a software as service firm or an investor with portfolio investments or interested in this topic, we would welcome a discussion.**

This is the second in a series of collaborative reports published by TripleTree and the SIIA, collectively labeled the “SIIA & TripleTree Industry Analysis Series” designed to complement SIIA's Software Division Initiatives. To learn more about our organizations and to review additional research reports and other IT-related resources (including our first Industry Analysis report on Web Services and our forthcoming report on Mobility/Wireless), please visit www.triple-tree.com and www.sii.net.

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INTRODUCTION

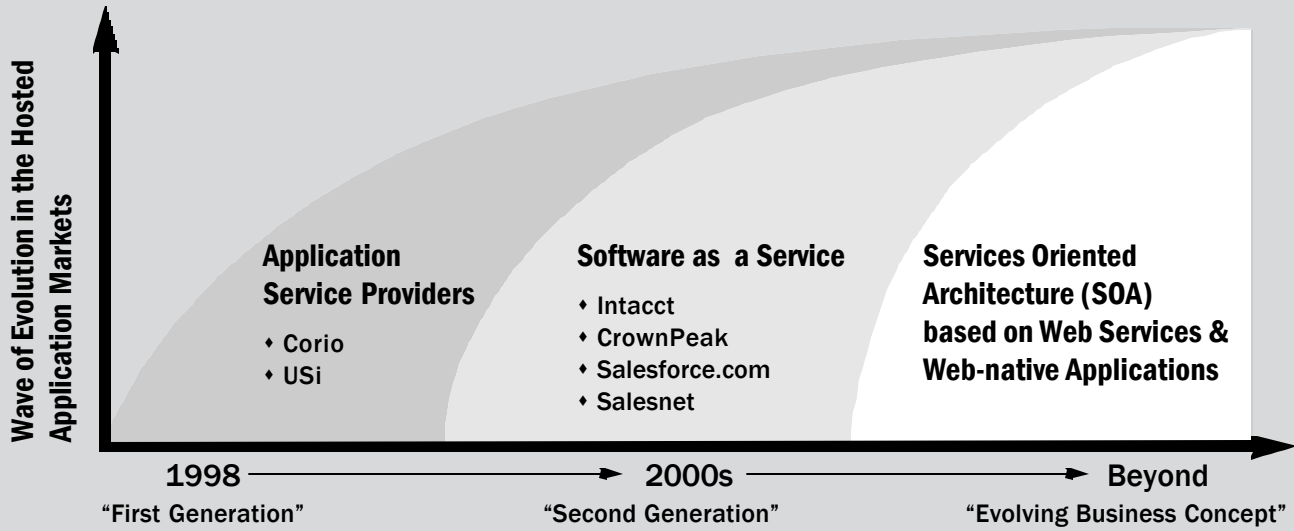
The Software as a Service (SaaS) market has experienced a number of fits and starts since it rose to prominence in the late 1990s. In the last years of the Internet boom, high-profile application service providers (ASPs) entered the marketplace with promises to revolutionize the enterprise software landscape. These firms delivered complex enterprise software packages via a hosted model, generally with little or no specialized or proprietary IP. Within several years most of these firms had exited the market, changed their business models and positioning, or scaled back operations after failing to gain sufficient momentum. However, a select group of first and second generation SaaS firms continued to execute, generally offering specialized, proprietary applications, and these firms have quietly but steadily contributed to the increasing acceptance of service-based software delivery among enterprises. In particular, the on-demand CRM space is emerging as an early “hot spot,” with companies like *Salesforce.com*, *RightNow Technologies*, and *SalesNet* paving the way in terms of market acceptance and business model validation.

Software as a service effectively redefines the software deployment model from packaged applications with up-front licensing fees and lengthy implementations to one that constitutes a dynamic, “pay-as-you-go” Internet-delivered service relationship. This shift fundamentally changes the assumptions, relationships & partnerships, and value proposition between software vendors, clients & end-users, and third-party service providers. The SaaS firm changes the dynamics and definition of a software and service provider and merges these concepts into a single source entity. This is akin to the role played in other outsourcing sectors, such as payroll processing firms like *ADP*, or the “timesharing” model that achieved prominence during the 1970s. At the same time, as software as a service firms reach critical mass and profitability, they stand to benefit from a higher level of revenue visibility and more certain & predictable cash flows than traditional software vendors.

After its early development and shakeout period, the SaaS model is poised to undergo rapid growth and to play a very meaningful role in redefining the software industry. Today, the impact of software as a service is already being felt with companies performing well and changing the dynamics in certain software sectors. Large established IT firms are expressing renewed interest in this area, due in part to defensive maneuvers needed in reply to disruptive SaaS firms. As a result, we believe the time is right for an in-depth analysis of the market and its implications on the NEW software industry.

SOFTWARE AS A SERVICE OVERVIEW

Figure 1: Wave of Evolution in the Hosted Application Market



Source: TripleTree

EVOLUTION

The software as a service market has evolved significantly over the last five-plus years, when the notion was first conceived based on early successes in business process outsourcing (BPO), application outsourcing & management, and the aforementioned timesharing model. (Figure 1).

- First Generation.** Starting in 1998 and 1999, application service providers like USinternetworking and Corio attracted a great deal of attention to the hosted software space, offering Web-based access to applications from major enterprise software vendors such as PeopleSoft, Siebel, SAP, Microsoft, Lawson, Broadvision, and Ariba on a subscription rather than licensed basis. The concept of leased and hosted software proved to be an attractive one to IT services and software firms as well as the financial community: according to John Hagel's *Out Of The Box*, this sector was the recipient of approximately \$3.6 billion in venture capital investments during 1999 and early 2000, with over 2,000 companies labeling themselves "ASPs." However a number of factors, including economic sluggish-

ness, reduced IT spending, the shakeout in the dot.com world, difficulty in achieving scale, and ASP performance issues prevented most of these firms from living up to expectations. In particular, enterprise-class applications designed for licensing in a client/server architecture have not been ideally suited to be delivered in an on-demand model, leading to a "customization trap" in attempting to exploit application efficiencies across a "one-to-many" dimension. These firms also competed against the very firms they were working with, since they were not providing new products but acting as a channel for established software vendors.

- Second Generation.** Through the ensuing shake-out period, a select group of firms continued to move the software as a service market forward by amending earlier imperfections and validating the business model with an increasingly-receptive end-user population. Most of these companies were privately held businesses operating somewhat "below the radar" of the broader market. These

¹ John Hagel III, *Out Of The Box: Strategies for Achieving Profits Today and Growth Tomorrow Through Web Services*. Harvard Business School Press, 2002, p. 45.

companies were building new, purely Web-based applications that directly addressed important business functions, provided a quantifiable return on investment and a strong value proposition, while addressing specific business functions and “pain points” like customer relationship management, HR, procurement, and messaging.

- **Evolving Business Concept.** Since the second half of 2003, there has been a definite shift in momentum and renewed interest in the software as a service model. SaaS providers are reporting increased user subscription and rapid sales growth, strong interest from both large companies and small-to-medium enterprises (SMEs) alike, and more knowledge of and confidence by end-users in hosted applications. The first generation models were predicated on 'renting' world-class enterprise software to mid-market firms, that typically could not afford the upfront, ongoing and hidden costs associated with traditional software licensing nor time to fully implement it properly. Many of these end-users also lacked the in-house resources to keep track of the changing IT landscape. Since then, market acceptance has clearly been driven by this segment of the marketplace. However, interestingly enough, a trend is emerging with large enterprise 'buy-in' across business divisions as well as at the enterprise level.

In certain market segments, software as a service companies are now emerging as serious competitors to top-tier independent software vendors (ISVs) and creating significant disruptive effects. We believe that this new generation of SaaS providers represents a crucial next step in the ongoing evolution towards a service-oriented architecture (SOA) composed of Web-native applications and XML-based Web services - providing a higher level of integration and customization than is currently available. Additionally, at this next phase, software as a service creates the possibility of offering even more functionality than its counterparts by providing end-users with much more frequent upgrades and releases with-

out facing integration complications. We will return to this discussion in the ensuing Value Proposition section of this report.

SEGMENTATION

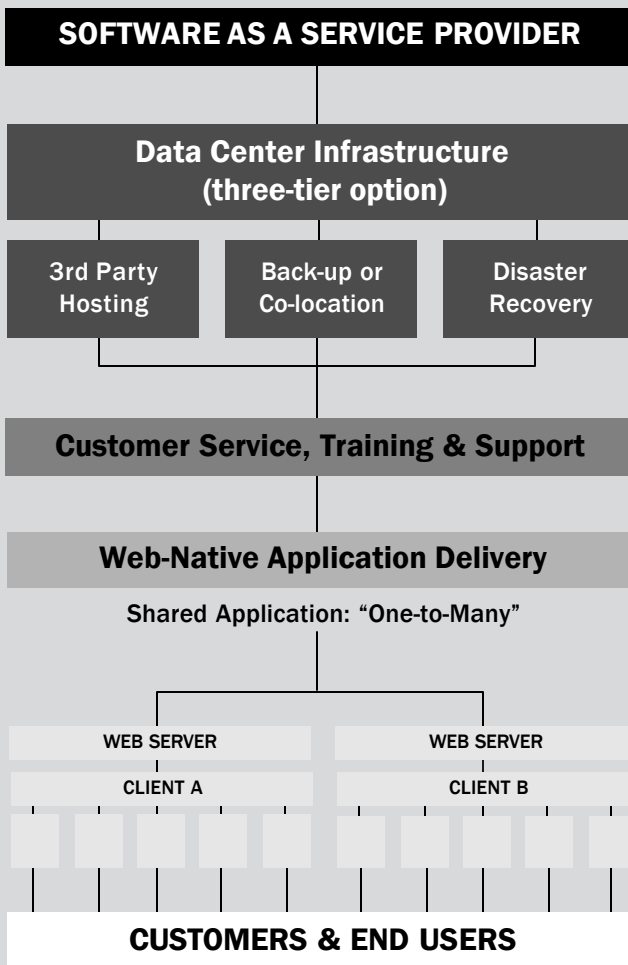
Broadly speaking, our definition of “software as a service” (SaaS) refers to any model built around delivering access to software applications via a network (public Internet or private intranets and extranets). The applications reside at an offsite data center where they are maintained by the service provider and customers access the application remotely via their Internet browsers and back-end Web servers. SaaS business models are predicated on a “one-to-many” or multi-tenant delivery model whereby the application is shared across all clients, providing a minimal level of application customization to avoid major implementation and integration costs. Figure 2 provides a simplified depiction of this arrangement, although we recognize that a number of variants exist. A key premise of this model is that the software as a service firm invests in the technology, hardware, and ongoing support services instead of the customer. In return, customers “pay-as-they-go” according to a subscription and Service Level Agreement (SLA) that ensures the customer a specified level of performance & availability, and provides the SaaS company with a long-term customer relationship.

There are several distinct types of companies within the broad software as a service sector. In further drilling down into this market, we follow IDC's segmentation² into the following categories:

- 1) **Application Service Providers (ASPs):** Probably the most widely-recognized component of this market, firms in this segment host and manage packaged software applications and provide remote access to them, with pricing generally consisting of a one-time license & set-up fee (significantly less than a standard software licensing fee) and a recurring stream of periodic subscription, hosting &

² From IDC report #31267 “U.S. Software as a Service 2004-2008 Forecast by Delivery Model,” May 2004.

Figure 2: Multi-tenant Software as a Service Delivery Model



Source: TripleTree

maintenance charges, typically on a monthly basis. These charges may be modified to reflect application usage in terms of number of users, number of “clicks,” or by some other metric. Prominent ASPs include USinternetworking, Corio, Surebridge, and NetASPx.

2) **Web-native Applications:** A growing portion of the software as a service landscape, this segment consists of proprietary applications that have been specifically architected for Internet-based deployment and delivery. Less costly and more rapidly implemented than their traditional enterprise software counterparts, Web-native applications are generally narrowly designed around a specific business function or process. Pricing generally consists of a

recurring payment stream combining licensing fees and hosting charges. The key distinction being proprietary Web-based application designed for optimization in a 'one-to-many' shared application environment.

3) **Hosted Web Services Applications:** Comprised of self-describing, Web-based software components, Web services represent a rapidly-growing sub-market within software as a service. As this sector is still developing, no single delivery model has emerged. Services can be utilized on a standalone basis or in combination with other application components, may be hosted by an external vendor or by an enterprise's IT department acting as a service provider. Likewise there is as yet no primary pricing scheme associated with Web Services, and we expect to witness an array of models tested as this market develops.

A brief note on nomenclature: we distinguish between firms hosting third-party applications and vendors delivering their own software over the Internet, using the term “proprietary software as a service” to refer to the latter (which encompasses categories 2 & 3 in our segmentation above). Because the proprietary SaaS vendors are generating a high degree of momentum in this market, we will focus most of our attention on developments among these companies and provide a number of company profiles in a later section.

Figure 3: Application Outsourcing & SaaS Business Model Comparison

SECTOR	SUB-SECTOR	STAGE OF DEVELOPMENT	BUSINESS MODEL	PRICING
Application Maintenance	Outsourcing	Growth	External service provider manages, supports, and maintains on- or off-site application development & use of internal or 3rd party applications	Typically fixed price or cost-plus contractual relationship over multi-year agreement
Software as a Service	Application Service Provider (ASP)	Growth	Customers remotely access Web-enabled versions of 3rd party enterprise applications hosted & maintained by ASP	Generally consists of upfront license fees plus monthly hosting and maintenance charges; sometimes additional per-use fees are charged
	Web-native Applications	Emerging Growth	Applications specifically developed & designed for Web-based deployment & browser-based access	Generally a recurring payment stream combining subscription and hosting fees
	Hosted Web Services	Early-Stage / Developing	Application components deployed in combination or in isolation to address particular functions; hosted by external service providers or internal IT department	Under development

Source: TripleTree

THE CHANGING RULES OF CONDUCT IN THE SOFTWARE INDUSTRY

The software as a service model is a complete retransformation of the traditional methods for selling and delivering software. This redefinition changes the scope and economic relationship between the vendor and end-users. The fundamental differences between traditional ISVs and SaaS firms can best be illustrated in three basic categories (see Figure 4):

- Revenue Model.** As stated previously, the software as a service model is quite different from the licensing model in that the large, upfront licensing fee and the resulting professional service fees and maintenance costs are replaced by periodic 'all-in-one' subscription payments - typically on a monthly or installed basis. The tradeoff being that software as a service firms have significantly smaller upfront revenue and cash flows in exchange for longer-term and more predictable cash flows that are the result of a service-based relationship. Consequently, the true measure of success or value for a software as a service firm is not necessarily tied to revenue growth or the P&L, but is

measured by metrics for new customer acquisition, rate of customer retention, predictability & visibility of cash flows, and the growth of deferred revenue on the balance sheet.

- Cost of Revenues.** Significantly different from the ISV model, software as a service firms require less investment in upfront professional services due to the rapid time to deployment and Web-based delivery. Many ISVs partner with top-tier systems integrators to provide upfront professional services and implementation, but also maintain internal resources to support these functions initially and going forward. Instead, software as a service firms invest in customer service & training, account management, and application support and management, which includes network operations, to ensure successful application delivery, virtually 100% uptime & performance, and high user adoption.
- Operating Expenses.** An area of key distinction between ISVs and software as a service firms lies in the approach for R&D and sales & marketing. The ISV typically supports multiple code bases across different technical environments

(client/server, mainframe, Web-based, etc.) and delivered in a single-tenant model that is maintained on the client's premises. Conversely, software as a service firms base their technology on a single Web-native code base that is capable of supporting numerous end-users in a multi-tenant, shared application environment. The end result is that software as a service firms are able to lower the incremental R&D costs with each new customer acquisition. Additionally, while ISVs charge for software upgrades, maintenance, and generally have new software release cycles every two to three years, software as a service firms provide free software upgrades, include maintenance & support in the service relationship, and support more frequent and seamless software releases & upgrades. In terms of the sales and marketing approaches, there are also noticeable differences. Since the ISV supports a model that is based on large upfront professional services and implementation that are often more than two times the soft-

ware license fee, major consulting and IT services firms have been natural allies and partners in developing sales alliances and indirect channels. Conversely, software as a service firms have needed to be much more creative in their sales & marketing approach, since traditional alliances & channels pose unique challenges due to the changed economic relationship for the systems integrator. Consequently, many software as a service firms have invested in multiple indirect channels to the market (vertical industry partners, infrastructure alliances, OEM, VAR, private branding relationships) as well as building direct sales channels; albeit, very cautiously and deliberately. In the end, software as a service firms are managing the tradeoff and conflict posed by **rapid growth that require significant investment in multiple sales and marketing channels as opposed to stable cash flows that require more patient growth expectations as the model and customer acquisition grows over a longer period of time.**

Figure 4: Fundamental Differences Between ISVs and SaaS

KEY MEASUREMENTS	ISVs	SOFTWARE AS A SERVICE PROVIDER
Business Model Characteristic		
Business Model	<ul style="list-style-type: none"> • Large, upfront \$ • Cashflow upfront 	<ul style="list-style-type: none"> • Periodic subscription \$ • Predictable cashflow
Pricing	<ul style="list-style-type: none"> • License pricing 	<ul style="list-style-type: none"> • Subscription service pricing
Revenue Mix	<ul style="list-style-type: none"> • 40-60% license: 20-30% maintenance: 10-40% P/S 	<ul style="list-style-type: none"> • 90% subscription: 10% P/S
Cost of Revenues		
License/Subscription	-	-
Professional Services	<ul style="list-style-type: none"> • Partnership with top-tier SIs • Large, multi-million projects (>2:1 services-to-product ratio) • 6-18 month deployment cycles 	<ul style="list-style-type: none"> • In-house services & training • Small projects, often included in recurring component • Less than 3 month deployment cycles
Customer Service and Application Support & Management	<ul style="list-style-type: none"> • Technical help desk • Cost center • Do not "own" NOCs or "manage" application system 	<ul style="list-style-type: none"> • Technical+customer service • Manage uptime, availability, performance & user adoption
Operating Expenses		
R&D and Technology Delivery	<ul style="list-style-type: none"> • Multiple code bases • "On-premises", single-tenant delivery • "Pay-for" upgrades • 2-3 year software releases / re-deployment cycles • "Pay-for" maintenance (-20% license) 	<ul style="list-style-type: none"> • Single code base - Web-native • "on-demand", multi-tenant shared application • "Free" upgrades provided seamlessly over Web • Frequent & continuous feature delivery (several times / year) • "Free" maintenance & support
Sales & Marketing	<ul style="list-style-type: none"> • Direct sales • Partnership with professional service 	<ul style="list-style-type: none"> • Multiple indirect channels to market & direct • Account management in service relationship • Difficult to partner with SIs
G&A	-	<ul style="list-style-type: none"> • Managing accounts & billing functions

Source: TripleTree

SOFTWARE AS A SERVICE VALUE PROPOSITION

As this market has developed over the last several years, the value proposition driving adoption has also evolved. In application hosting's original incarnation, the reasons for contracting with a service provider largely mirrored the motivation for any other outsourcing relationship: more predictable costs and a greater ability to focus on core competencies while leveraging the expertise of a specialist service provider. These core principles are quite similar to the software as a service value proposition where an affordable, "pay-as-you-go" relationship provides small- and mid-size organizations with a suite of enterprise applications that are similar to those available to Global 1000 organizations and a service relationship with the provider that ensures ongoing value. However, we believe revisiting a few of the key principles and the evolving trend toward a range of enhanced value drivers is important in understanding the differentiation between SaaS and licensing models. These value drivers include:

- **Lower cash outlays for enterprise-class software purchases** by replacing large, upfront cash outlays for software licenses with a smaller, subscription-based pricing model that is much more frequent but at a fraction of the cost. Such a shift in pricing moves a great deal of enterprises' expenditures from fixed costs to variable costs, increasing the flexibility of their cost structures.
- **Ease of implementation and quicker time-to-market or value** with deployments generally requiring less than three months compared to six to 18 months with traditional software. The focus of a deployment is on end-user training and acceptance, since customers do not have to install or maintain servers, networking equipment, security products, or other hardware.
- **Reduced technology investment risk and higher ROI** with lower upfront capital, resource commitment, and levels of complexity. The customer avoids the risk of additional 'hidden costs' that creep up over the application lifecycle such as

ongoing support and maintenance costs, upgrades, user acceptance risks, etc. Many on-demand providers are able to provide a breakeven point in a six months or less while licensing models require a longer payback period. In some regards, the timing for software as a service could not be any more opportune with small and large companies alike trying to maximize every dollar spent on IT and demanding a clear and measurable ROI before each investment decision is made.

- **Frees up internal resources** by reducing internal IT staff required to manage applications, keep track of upgrades, maintain performance, etc.
- **Full application lifecycle involvement**, from initial deployment through ongoing support, maintenance and upgrade, that ensures that there is a complete alignment of interests with the SaaS firm having a vested stake in the success of the application beyond initial deployment. Consequently, SaaS firms are redefining the relationships with clients by managing the application and the client relationship over the full lifecycle of use.
- **Continuous support & seamless upgrades** with new features and functionality, upgrades, customer support, and other operational services all included instead of being treated as incremental costs.
- **Shared risks and single-source accountability** with customers demanding a different vendor relationship that results in more accountability and flexibility in the actual execution of the software. Just as importantly, the SaaS firm 'shares' in the execution risk of the application, since the SaaS provider also earns their own return over the term of the relationship and consequently 'loses' in the equation when customers are dissatisfied and seek other alternatives.
- **New functionality and improved application performance** with on-demand firms receiving continual client feedback in a service-based relationship and often interacting with end-users in the appli-

Figure 5: Lower Total Cost of Ownership (TCO)

FIRST YEAR TCO	TRADITIONAL CRM	SALESFORCE.COM ENTERPRISE EDITION
Number of Users	500	500
Application License / Subscription	\$1,250,000	\$750,000
Implementation & Customization	\$6,250,000	\$187,500
Training	\$150,000	\$75,000
IT Infrastructure / Hardware	\$500,000	\$0
IT Personnel	\$500,000	\$0
Support / Upgrade Cost	\$225,000	\$0
TOTAL	\$8,875,000	\$1,012,500

Source: Salesforce.com & The Yankee Group

cation environment itself to determine priorities for new features and to fix bugs & glitches. A critical differentiator is that new product revisions are made more frequently - three to four times a year or more - compared to one new release every 12 to 18 months with traditional software. Consequently, software as a service providers are able to continually refine the product with new releases that add customer-driven functionality that can be utilized by all clients in a shared application and across a multi-tenant model. Major new product releases and application improvements can literally be made overnight or during off-hours such as weekends resulting in little service disruption for end-users.

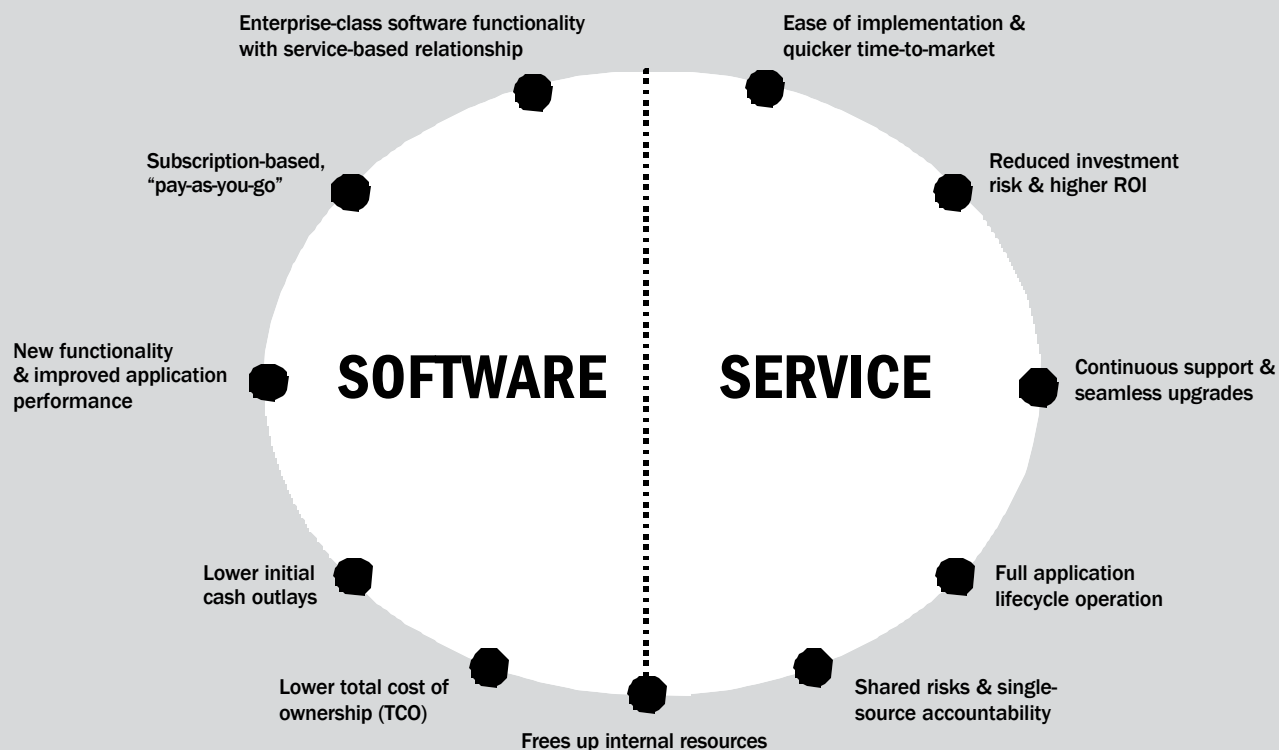
- **Lower total cost of ownership (TCO)** with licensing, implementation, customization, maintenance, upgrades, and hardware & support costs being bundled into an on-demand service relationship. The first year total cost of ownership can be five to ten times less expensive than enterprise software with the majority of savings resulting from the elimination of upfront integration and customization projects (see Figure 5). Thus, the payback period is considerably shortened. The lack of large implementation opportunities poses special challenges for SaaS firms seeking to

draw on partnerships and alliances with top-tier consulting firms that thrive on providing these types of upfront services. While harder to quantify due to 'hidden' costs, the SaaS model is also based on a longer-term value.

The application's functionality and ability to address end-users' needs remain important factors in any technology expenditure decision. That being said, the key point is that the cost and the success of the application's operation are crucial factors in evaluating hosted applications versus license. As these core tenets become commonplace, their relative value becomes somewhat less valuable over time and another set of critical success factors rises to the surface. While still early, we believe that a higher-level rationale is evolving that combines these "base case" factors already mentioned with other important business and technology issues. Such issues include access to best-of-breed vertical- and process-specific solutions, support for standards-based integration that leverages Web services protocols, new levels of customization combining unique workflow requirements, and a concern for enhanced client service and account management.

Going beyond these factors, however, the top-performing software as a service firms derive their success at

Figure 6: Convergence Between Software & Service in SaaS Value Proposition



Source: TripleTree

least in part from their ability to reconcile the tension between the two sides of their business - in other words, to transform the software purchase process into a long-term, intensive, service-based relationship. As we will discuss in subsequent sections, this ability is precisely what makes the SaaS model so disruptive to the traditional software model. Figure 6 illustrates this concept, depicting how software delivered as a service draws out “the best of both worlds” from each model and where the lines of demarcation between software and services are becoming much more blurred. It is possible the model will bifurcate at some point, with enterprise clients signing up for full-feature, process-oriented services bundled around hosted technology platforms, and SMEs adopting best-of-breed applications addressing a particular niche.

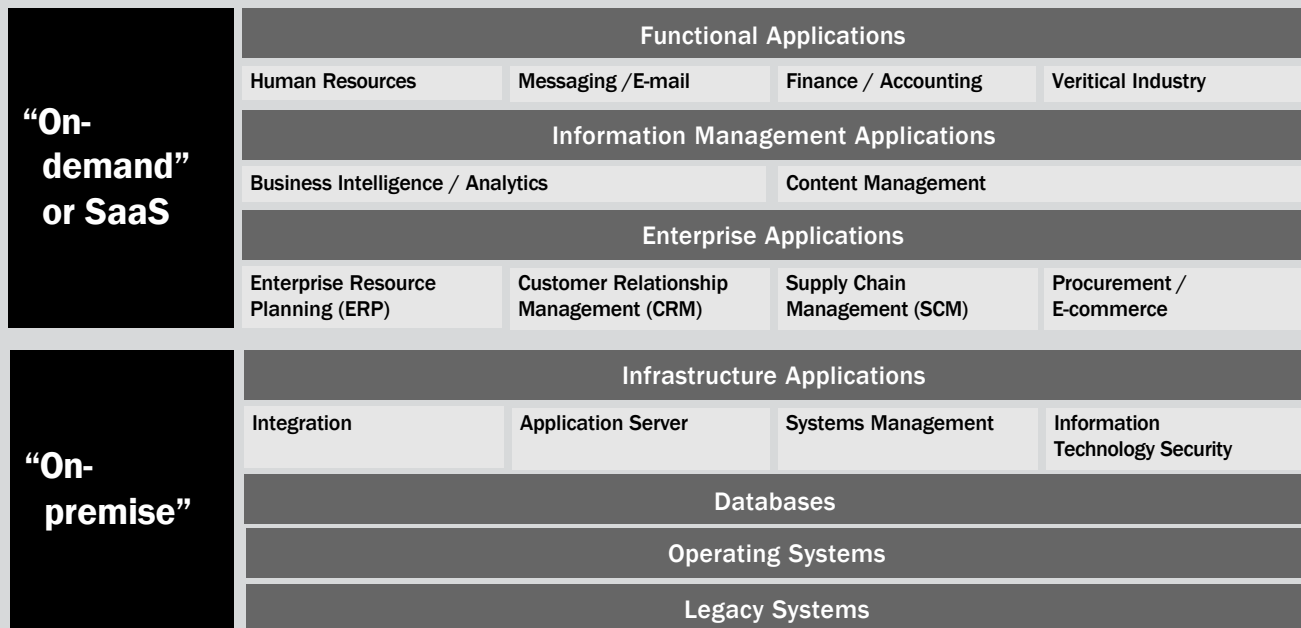
SOFTWARE AS A SERVICE DEPLOYMENT

SaaS providers have been making inroads into both large firms and SMEs across several layers of the enterprise software stack. While still too early to draw con-

clusions, SaaS firms have been most successful in penetrating the **functional application** (point-based solutions such as human resources, messaging, and vertical industry functions) and **enterprise application** markets (e.g. CRM, procurement, etc.). In addition, a number of these companies are finding success in the **information management** space, bringing the on-demand world to analytics and content management functionality (see Figure 7).

In our estimation, SaaS momentum will continue to be most prevalent in these sectors for the foreseeable future. The infrastructure software layers present a set of challenges that are still best addressed by more traditional on-premise deployments or outsourcing relationships. However we are aware of some exceptions, such as service-based offerings from Keynote Systems, Mercury Interactive, Symantec, and VeriSign, and we do expect to see this situation will change somewhat at the margins, driven by Web services-based integration and the accompanying transition to service-oriented architectures (SOAs).

Figure 7: Enterprise Software Infrastructure



Source: TripleTree

MARKET GROWTH

Throughout our research and interactions with companies, we continue to witness steadily increasing market demand for software as a service, with most of the growth driven by privately-held emerging SaaS firms. Although the ramp-up has not occurred as quickly as many commentators initially predicted, this market is on pace to become a key driver in the overall software industry within the next few years. To a large extent the same arguments and drivers advanced by the first wave of ASPs remain valid today - the service-based model facilitates lower upfront costs and total cost of ownership, faster implementation and an accelerated rapid time to value, a more rapid application upgrade cycle, and reduced ongoing application maintenance responsibilities, allowing the end-user to focus on the functionality of the application.

Among the other factors contributing to growth in this area is the well-documented slowdown in corporate technology spending. Enterprise IT spending priorities have, to some extent, split over the last couple of years to focus on integrating the major software packages deployed during the late '90s - early '00s and deploying point solutions requiring little integration to address specific business functions. Both of these trends signal a

hesitation to implement additional large-scale enterprise applications and thereby add more layers to already-complex computing infrastructures. Accompanying this hesitation is an opportunity for software as a service vendors to position their solutions as an alternative to more cumbersome enterprise software packages. Finally, we believe that the success of flagship SaaS companies like Salesforce.com is creating a “ripple effect” that is generating new interest in this market by end-users and new competitive entrants alike.

As a result of the drivers discussed above, the software as a service opportunity is projected to expand from a \$2.3 billion market as of 2003 to a \$7.2 billion market by 2008. The IDC forecast below breaks out this data by delivery model (see Figure 8).

The data in Figure 8 presents a bit of a paradox. Although the 25.6% CAGR projected for the SaaS market is impressive as a standalone metric, viewed in the context of the software industry as a whole, software as a service represents just a fraction of total spending. We think the contrast illustrates an important fact: although the SaaS market has evolved rapidly in a short amount of time, it will take years for the full disruptive impact of this new model to manifest itself. Secondly, the SaaS model is several orders of magni-

tude smaller than upfront licensing arrangements and, consequently, its full effect does not fully come into play at the outset but will be experienced over time. In other words, a \$7 billion SaaS market could translate into \$25 billion or more when compared to the traditional software licensing model. Consequently, its impact could be much more profound than the projections might initially suggest.

Nonetheless, we continue to believe that companies must move to address the on-demand opportunity sooner rather than later. We also believe the SaaS market will remain highly fragmented, with most of the established players providing application hosting and maintenance with a new breed of proprietary SaaS firms capturing the highest level of growth. This prediction is confirmed in our interactions with SaaS firms and by IDC's projected ramp for the Web-native/Web services market segment.

In addition to the quantitative data cited above, qualitative evidence continues to mount indicating the increasing momentum of the software as a service model. In part, the SaaS model may be benefiting from the trend toward utility-based models as exemplified by new initiatives from IBM and Hewlett-Packard. We believe these initiatives can only help fuel the transition from an IT environment marked by the traditional "license & install" approach to one characterized by a service-oriented architecture and an "on-demand" model. A related factor facilitating SaaS market growth is the increased buy-in from larger software vendors, which is contributing additional credibility to the service-based model. In addition, many large enterprises are still entrenched in 10-year product lifecycles due to the ramp up to Y2K. We expect that as these contracts start to end that many firms will look to the SaaS model as an alternative to installed enterprise products.

Figure 8: US Software as a Service Spending Forecast 2003-2008 (in millions)

	2003	2004	2005	2006	2007	2008	'03-'08 CAGR
SaaS Spending	\$2,296	\$3,028	\$3,879	\$4,845	\$5,972	\$7,177	25.6%

Source: IDC report # 31267: "U.S. Software as a Service 2004 - 2008 Forecast by Delivery Model," May 2004.

COMPETITIVE LANDSCAPE

During the late 1990s and early part of 2000, interest in software as a service centered around the pure-play enterprise ASPs, and their performance was perceived as indicative of the prospects for the market for outsourced software delivery as a whole. Although ASPs continue to sell into this market, the scope of firms adopting a service-based approach have broadened considerably over the last 4-5 years. Currently, competitive dynamics are driven by tensions between several sets of vendors:

ENTERPRISE APPLICATION SERVICE PROVIDERS

Companies that provide access to third-party enterprise applications from major software vendors will likely still play a role in the application hosting market despite the setbacks they experienced during the post-bubble years. Although enterprises are becoming increasingly well-educated with regard to the distinctions between various SaaS models, for many organizations ASPs are viewed as synonymous with software as a service. Thus the public perception of these companies will remain an important driver for the overall SaaS market.

Many of these companies remain formidable competitors in their own right. In addition to ASPs that went through high-profile IPOs several years ago, there are a handful of second-tier ASPs like **Surebridge** (recently acquired by **Navisite**), **BlueStar Solutions**, and **NetASPx** that continue to grow and make progress toward profitability. These firms have faced early challenges, given their lack of proprietary IP, the difficulties in delivering non-Web-native applications over the Internet, and the need to share revenue with ISV partners. However, as software companies reengineer their products for Web delivery and dedicate more resources to addressing the SaaS opportunity, these ASPs will emerge as valuable ISV partners.

INDEPENDENT SOFTWARE VENDORS (ISVs)

Although initially divided on the concept of software as a service, with some vendors moving quickly to embrace the new delivery channel while others were

more dismissive, at this point many of the major ISVs have accepted the fact that service-based software represents a significant and growing component of the software market, and are in at least the early stages of formulating their strategy. Driven by growing customer demand for an alternative to the costly and complicated software licensing and implementation model, the more proactive enterprise software vendors have moved to re-architect their products and make them available for delivery over the Web. This process has been accelerated in certain market segments wherein SaaS firms are competing (and winning) against ISVs for large enterprise accounts, forcing the incumbent vendors to respond with their own service-based offerings.

Those ISVs that have embraced the SaaS model have approached the market both through internally-managed hosted platforms and alliances with enterprise ASPs. Based on our research as well as IDC's *Worldwide Enterprise ASP Competitive Analysis*³, this section summarizes the SaaS initiatives announced by the major enterprise software vendors.

- ISV Interest.** A recent high-profile example of this was Siebel's October 2003 announcement introducing its CRM OnDemand solution. Designed for small-to-medium enterprises, CRM OnDemand is a Web-optimized version of Siebel's flagship CRM product priced on a per-user, per-month basis. As part of this initiative, Siebel announced a broad partnership with IBM under which IBM will provide hosting services as well as participating in the marketing, selling, and support of the solution.

Following the launch of CRM OnDemand, Siebel announced two relevant M&A transactions, acquiring **UpShot** (a provider of hosted CRM and sales force automation applications) and **Ineto Services** (a provider of hosted contact center solutions). Siebel's aggressiveness is noteworthy, given that the CRM giant's past experiences in the space

³ Report #29813 by Amy Konary, published July 2003.

have been regarded as less-than-successful, and sent a clear message to the industry validating the concept of software as a service. Siebel is now estimating that as much as 15% of all CRM software sales will involve hosting services within the next few years, and is positioning itself around a business model that combines both traditional and on-demand deployments.

- **Oracle.** Oracle has been steadily building its software as a service business since launching its Oracle Outsourcing initiative (since renamed Oracle on-demand) in the fourth quarter of 1999. Oracle on-demand has experienced strong growth (over 70% year-over-year) among both mid-market companies and divisions of large companies, with several hundred customers accessing Oracle's e-business applications through a services-based model. Oracle has also been active in partnering with pure-play SaaS firms, establishing relationships with companies such as **NetSuite** (co-founded by Larry Ellison) and **AppShop** to handle smaller clients.
- **SAP.** SAP's hosting initiative serves over 100 client companies, with particularly strong momentum in verticals such as financial services, manufacturing, and retail. Taking a different approach than many of its rivals, SAP has oriented its hosting-related sales efforts toward larger enterprises. The company has also entered into partnerships with Hewlett-Packard and EDS to provide the necessary infrastructure in order to better focus on the application layer.
- **PeopleSoft.** PeopleSoft has allied with Hewlett-Packard to jointly market, deliver, and support service-based access to PeopleSoft's applications. The ERP vendor is also making a concerted effort to convert existing licensed customers to hosted clients when their upgrade cycle comes around.

These leading ISVs are playing an important additional role in terms of validating the software as a service model. Among mid-tier ISVs, there have been a num-

ber of success stories, such as **Intuit's** finance & tax and small business accounting software, **WebEx's** conferencing solutions, **eCollege's** online education platform, and the aforementioned initiatives from Keynote, Stellent, and Mercury Interactive. In addition, **Concur Technologies**, a provider of corporate expense management applications, was recently singled out by Summit Strategies as "the first publicly-traded conventional software company to build a profitable software-as-services business."

OUTSOURCING COMPANIES

As a logical extension of their service offerings, business process and IT outsourcing companies are moving into the software as a service space. Within the business process outsourcing sector and particularly among HR-focused companies, technology is taking on a greater role, with BPO firms increasingly building their services offerings around software platforms. We think the end result is a deliverable that blurs the line between "software" and "services," at least from the perspective of the customer.

Platform IT outsourcing companies and managed service providers (MSPs) are also positioning themselves within the SaaS market, primarily by partnering with ISVs to host large-scale enterprise applications. In certain cases these outsourcers have also partnered with ASPs in order to take advantage of the depth of their expertise; one example of this trend is **EDS'** relationship with Microsoft Exchange hosting specialist **Mi8 Corp.** Some MSPs are also taking a more aggressive approach to building out their application hosting business, as evidenced by **Navisite's** recent acquisition of **Surebridge.**

PROPRIETARY SOFTWARE AS A SERVICE VENDORS

The proprietary SaaS category includes software companies providing their own applications via a service-based delivery model. Generally these applications are focused along a particular functional or vertical line addressing a specific business process. In addition, we also draw a distinction between pure-play vendors,

Figure 9: Competitive Landscape & Industry Players

SOFTWARE AS A SERVICE			
Enterprise Application Service Providers (ASPs)	Outsourcing Companies (BPO, Platform, MSPs)	Proprietary Software as a Service Vendors	Independent Software Vendors (ISVs)
<ul style="list-style-type: none"> ♦ Corio ♦ USinternetworking ♦ BlueStar 	<ul style="list-style-type: none"> ♦ EDS ♦ Globix ♦ Navisite ♦ Verio ♦ InfoCrossing ♦ ADP 	<ul style="list-style-type: none"> ♦ Atomz ♦ CrownPeak ♦ Intacct ♦ Ketera ♦ RightNow Technologies ♦ Salesforce.com ♦ Salesnet 	<ul style="list-style-type: none"> ♦ Siebel Systems ♦ Oracle ♦ SAP ♦ PeopleSoft ♦ Intuit ♦ eCollege

Source: TripleTree

which derive all of their revenues from their SaaS offerings, and hybrid (or transitioning) vendors, which began operations as traditional licensed software companies and have since added a hosted component to their product offering (see Figure 9).

- **Functional.** This segment includes SaaS firms offering point solutions that address specific business functions, ranging from mission-critical functions such as CRM to collaborative applications like messaging & scheduling to back-office functions such as procurement, human resources management, and travel & expense management.
- **Vertical-Focused.** Service providers within this category offer applications addressing a particular function or set of functions within a given industry (e.g. **Digital Insight's** financial services software). This degree of focus establishes the SaaS firm's credibility in terms of business process expertise, enabling them to build a referable base of clients and potentially move upstream into enterprise accounts fairly rapidly.
- **Hybrid Vendors.** The hybrid category refers to companies that have an historic go-to-market strat-

egy using a traditional software licensing model, but are currently augmenting with services-based delivery and/or subscription pricing models. Aside from the companies previously mentioned, a range of public software companies including Computer Associates, VeriSign, Symantec, Check Point Software, etc. are 'testing the waters' and announcing new offerings or pricing models. Among private companies, access control and e-commerce billing software provider **eMeta** and supply chain and e-commerce vendor **SPS Commerce** are two examples of firms employing such a model.

SPECIAL CALL OUT SECTION: ON-DEMAND CUSTOMER RELATIONSHIP MANAGEMENT (CRM)

With all eyes on Salesforce.com's initial public offering, the \$7 billion Customer Relationship Management software space is rapidly emerging as the hottest segment within the software as a service market. According to IDC, CRM remains a highly competitive and fragmented sector, with top vendors - Siebel, Oracle, SAP, and PeopleSoft - controlling only 30% of the market in 2002.

The fact that CRM is one of the earliest SaaS markets to experience this level of momentum is counterintuitive in some respects, given that enterprises have been understandably hesitant to allow their mission-critical, customer-facing applications and customer/prospect data to reside on offsite servers. In addition, early predictions suggested that SaaS market acceptance would be driven by non-mission-critical functional applications, rather than something considered as vital to an enterprise's operations as its CRM software and customer information.

Nonetheless the CRM market is leading the way forward on several key fronts and paving the way for other hosted applications.

- There is a core group of strongly performing CRM firms that are demonstrating the financial viability of software as a service to enterprises as well as to the financial community;
- CRM applications actually lend themselves to delivery over the Internet relatively easily versus a client/server environment, even given the work habits of its end-users. With sales and marketing professionals accessing information from outside the office, Internet delivery and hosted applications have provided a viable solution.
- CRM is one of the first sectors in which SaaS vendors have been able to move up-market and start winning large enterprise accounts;
- CRM is also one of the first sectors in which software as a service providers have been competing head-to-head against large enterprise vendors and winning enough deals to create a disruptive impact;
- Finally, these companies are establishing a level of trust in terms of customer data security & integrity and application performance that is essential in laying the foundation for mainstream enterprise adoption.

In determining the reasons why the CRM market has gained such momentum relative to other sectors, several factors come to mind. First, the widespread dissatisfaction and well-documented failure rates associated with large-scale ERP and CRM implementations provided insurgent SaaS firms with an opportunity to differentiate their solutions from products offered by Siebel, PeopleSoft, Oracle, and other incumbent firms. According to an AMR Research study, over 80% of CRM software deployments either fail to add value, encounter significant adoption issues among end-users, or fail outright. As a result, enterprises are increasingly unwilling to bear the risks associated with large-scale software implementations and are growing more receptive to alternative solutions.

The economic climate of the early 2000s provided both challenges and opportunities for SaaS firms. While corporate reluctance to invest in IT created a difficult sales environment for the software industry as a whole, this trend appears to have favored the SaaS providers and had a disparate impact on ISVs. To an extent, stalled license sales among the incumbent vendors gave emerging companies some "breathing room." It gave them an opportunity to ramp up sales even as the larger players stumbled, and shifted focus to ROI and an emphasis on value, which played to the strengths of software as a service. According to IDC, between 2001 - 2002 the CRM software market as a whole declined over 7%. In contrast, CRM software as a service providers prospered and grew during this same time period: Salesforce.com's revenues rose 175%, RightNow Technologies' sales increased 10%, and customer analytics provider ~~WebSideStory~~ rose 150% albeit all on a smaller revenue base than top-tier ISVs.

Another factor is the level of interest in CRM applications displayed by mid-market enterprises. Finding existing software packages too complex and costly, and the risk of a failed implementation prohibitive, many of these companies began exploring on-demand options rather than installed solutions.

Finally, Siebel's recent foray into the hosted CRM market has proven to be something of a double-

edged sword. Although the entry of such a formidable competitor is obviously of concern to on-demand CRM firms, they have also repeatedly stated that Siebel's initiative has thus far served mainly to validate the on-demand model and drive more interest in hosted solutions.

ON-DEMAND CRM COMPANY PROFILES

As stated above, a select group of private firms are responsible for much of the attention that the hosted CRM market is receiving. By examining the various strategies and tactics employed by these companies, we hope to provide other emerging vendors with actionable insights as to the keys to success in the SaaS market.

Salesforce.com

The obvious poster child for both the CRM market and the software as a service market as a whole, the strong performance exhibited by Salesforce.com has contributed a great deal toward instilling confidence in the on-demand model. With 9,500 subscribing customers and 140,000 users in 70 countries, Salesforce.com boasts one of the industry's largest user bases and has been experiencing strong growth among large, Global 2000-type companies. Generating approximately 90% of its revenues from recurring subscription and support fees (generally paid annually or quarterly), the company's contracts typically run from 12 - 24 months. The company reported fiscal 2004 revenues of \$96 million and achieved positive operating income of \$3.7 million. Salesforce.com has established itself as such an important industry player that it will be viewed not just as a benchmark for software as a service but as a bellwether for the broad IT industry.

In examining the factors behind Salesforce.com's success, several points must be made:

- **Sophistication of Hosted CRM Platform.** Initially launching as a sales force automation application, the company rapidly expanded its offering into a full-scale, Web-native CRM solu-

tion encompassing such functions as sales force automation, customer service and support, marketing automation, document management, analytics, contract management, and custom application development.

- **Enterprise Accounts.** From the outset, Salesforce.com's solution was designed to be an enterprise-class application and the company has had a great deal of success penetrating large corporate accounts such as AOL Time Warner, Dow Jones, ADP, and Honeywell.
- **Development Platform.** In addition to the depth of Salesforce.com's flagship product, the company's technology "ace in the hole" is *sforce*TM, an on-demand integration and development platform. Sforce'sTM Web services-based API enables rapid integration with existing systems, a feature that has played a vital role in the firm's ability to win business from Global 2000 firms. In addition, *sforce*TM provides a development environment that enables users to create custom data tabs (for example to add industry- or customer-specific data fields) or to customize the Salesforce.com user interface, business logic, or database. Used in conjunction with the company's Studio product, the platform also enables an enterprise's IT personnel to build and deploy J2EE- and .NET-based applications, creating further value and extendibility for Salesforce.com clients. The level of flexibility and customization provided by the *sforce*TM platform led one Aberdeen analyst to comment that "*Sforce*TM has the potential to be an even greater disruption than the subscription model."⁴
- **Aggressive Sales Channels.** It is also worth noting that just as Salesforce.com began developing an enterprise-class solution at an early stage, they also built an enterprise-class sales organization. Although initially targeting the SME mar-

⁴ Denis Pombriant, Aberdeen Group, quoted in CRM Buyer: "Salesforce.com: Weathering the CRM Storm" by Elizabeth Millard, 12/08/03.

ket, the company moved quickly to hire salespeople from industry leading firms, including SAP, Siebel, IBM, and PeopleSoft, in order to better position itself to sell into Global 2000-level companies. Salesforce.com has also been aggressive in terms of industry partnerships, establishing alliances with Borland, Sun, IBM, and BEA Systems in order to enhance the value of the *sforce*™ development environment.

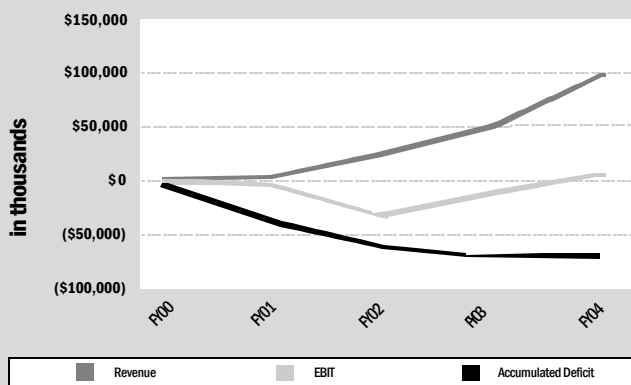
Salesforce.com serves as an example of the challenges SaaS providers face in terms of reaching critical mass, i.e. building a customer base large enough to support positive cash flow. The proprietary SaaS model is a challenging business, requiring significant investment in R&D, outlays for data center operations and shared costs, incentives for the sales team that are competitive with compensation offered by licensed software vendors, and investments in additional customer service, account management, and operations. All of these outlays must be supported by a business model that sacrifices large upfront cash inflows in favor of long-term and more predictable revenue streams & cash flow. Without meaning to overstate these challenges, we do believe it is important for new or transitioning SaaS firms to move into this market with their eyes open. Depending on how fast one desires to grow the business, the subscription business model requires a certain level of capitalization to sustain operations until positive cash flow is achieved and a highly efficient means of customer acquisition becomes possible.

To drill down into the Salesforce.com example, since its inception in 1999 the company has grown to annual revenues of \$96 million and achieved positive operating margins. In that same period of time, however, it built up an accumulated deficit in excess of \$70 million. Granted that Salesforce.com invested in sales & marketing more heavily than most of its peers and faced a more subdued economic environment, attaining breakeven profitability and positive net worth still remains a challenge and requires patient investors (see Figure 10).

Lest we appear overly pessimistic, we should stress that once positive operating margins are achieved, the picture changes considerably. The SaaS firm benefits from economies of scale as application development and infrastructure costs are shared across a growing customer base. In addition, the recurring revenue model enables these companies to effectively manage cash flow, rendering them well-positioned to address issues that still plague ISVs: revenue visibility and predictability. The large revenue backlog that SaaS firms build is highly attractive to investors and, as these firms go public, will enable them to provide more accurate guidance to analysts. However, the importance of deferred revenue as a barometer of health and viability is not yet well understood by the financial community (see Figure 11).

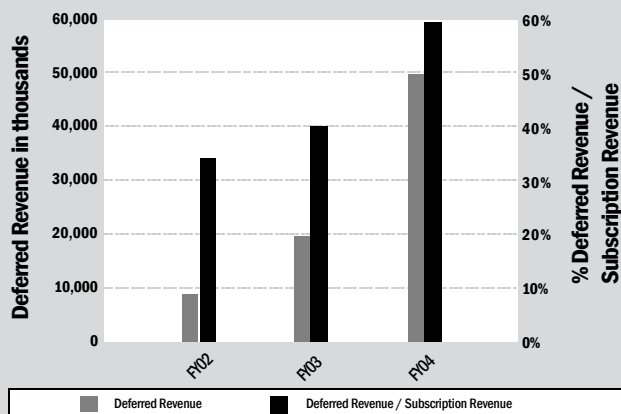
In the case of Salesforce.com, its deferred revenue on its balance sheet has increased appreciably over the past three years and also climbing as a relative comparison to its subscription revenue recognized in the given peri-

Figure 10: Salesforce.com: Reaching "Critical Mass" to Positive EBIT



Source: TripleTree & Salesforce.com company documents

Figure 11: Increased Revenue Visibility with Growth of Deferred Subscription-based Revenue



Source: TripleTree & Salesforce.com company documents

od. The end result is consistent and visible revenue & cash flow from a growing installed base going forward.

Salesnet

Privately held and venture-backed, Salesnet was one of the first wave of hosted CRM pure-plays along with Salesforce.com and Upshot.com. After launching its first product in 2000, the company has become one of the leading service providers in the hosted CRM space and has played a significant role in driving the success of this market. Focused primarily on the sales force automation and marketing automation segments of the CRM market, Salesnet's software platform provides functionality such as account management, contact management, customer/prospect segmentation, analytics & reporting, and lead management & tracking.

A number of differentiating factors have contributed to Salesnet's success. One interesting fact regarding Salesnet's product development is that prior to writing any code, the company interviewed over 200 sales professionals to ensure that their software was designed to serve rather than monitor the sales team. Although naysayers could dismiss this as marketing hype, in reality it illustrates an important principle related to customer retention - if a product is not designed around the needs of the business personnel who will actually be using it, many of its features and functions will go unused and become "shelfware," which makes it difficult for the vendor to maintain a profitable relationship with the customer in question. However, by tailoring its solution to the needs of the end-users, Salesnet ensures its client relationship is "stickier" and that retention/renewal rates remain high.

As a corollary, an important component of Salesnet's success is its product architecture. Specifically, the activity-based workflow embedded within the software is a crucial differentiating factor for the company. This workflow enables customers to leverage best practices in order to increase the effectiveness of the current sales force and quickly ramp new sales personnel up to full productivity. It also provides managers with tracking tools to link sales activities with quantifiable results and

identify weaknesses that need to be addressed. Finally, the high degree of configurability facilitated by Salesnet enables managers and sales representatives to modify existing workflows, design and build custom workflows and dashboards, build custom reports, and set user access permissions. Salesnet's product is also built to rapidly integrate with existing systems, using over 200 pre-built application adapters and connectors as well as a Web service-based API.

RightNow Technologies

Representing the other end of the CRM spectrum, RightNow Technologies has emerged as the dominant SaaS player in the customer service & support market. With 2003 revenues of just under \$36 million, the company has achieved 25 consecutive quarters of revenue growth and has been cash flow positive for eight quarters. RightNow has signed over 1,000 customers, split evenly between midmarket firms and large enterprises. The company offers both hosted and non-hosted versions of its products and reports that 90% of its new customers are opting for the service-based model, typically on a two-year basis. In May 2004, the company filed for its initial public offering.

RightNow Service™, the company's flagship product, is a contact center solution enabling customer interaction across multiple channels, including phone, fax, email, and Internet (chat & self-service). By offering a single application to manage these channels, RightNow facilitates more effective responses to customer inquiries, resulting in 10% - 30% reductions in inbound calls and 50% - 70% reductions in inquiry emails. The solution's features include intelligent Web- and voice-based self-service, inquiry tracking, service quality analytics, surveys, and SLA compliance, among others.

In many ways, RightNow's approach epitomizes the shift from a product sales model to a service-based relationship model. RightNow's product design incorporates a high degree of configurability and customization, which are highly valued particularly by enterprise customers. The company's "LifeCycle Solutions

Methodology”™ is designed to facilitate long-term client relationships by providing services related to customization/integration, optimization, and ongoing customer support. Customers are able to schedule their own upgrades, manage their applications as though they resided onsite, and customize the applications to address their specific needs. The company also provides customer activity monitoring in order to ensure that customers are benefiting from the full breadth of its products and have implemented the most recent version.

RightNow's “Tune-Up” program, recently profiled in the media, has also proven highly successful in driving strong customer relationships. Tune Ups consist of a 90-minute phone call with a RightNow consultant, who compares the client's use of RightNow's solutions to a set of best practices within the appropriate industry. The consultant then assists the company in optimizing its operations in accordance with this scorecard. RightNow has found that clients participating in this program are four times more likely to renew at the end of their contract period.

PROPRIETARY SOFTWARE AS A SERVICE LANDSCAPE

We believe developments among proprietary SaaS providers are fueling the bulk of the innovation and momentum in this space. Emerging SaaS firms are offering purely Web-architected applications designed to be deployed as services over the Internet, and offering narrow solutions that are more “on-point” in terms of addressing very specific business processes while many traditional ISVs are going to market with scaled-back versions of their current products.

Although these services generally lack the breadth of functionality offered by traditional enterprise software packages, proprietary SaaS firms are competing effectively by positioning themselves as specialists offering easily-integrated, focused applications. Given the choice between a major enterprise package that takes months to integrate versus an on-demand service that directly addresses the relevant business process and can go live in a matter of days or weeks, both SMEs and large firms are finding the SaaS value proposition compelling.

Positioning their products to address specific business functions has proven effective for software as a service companies. Since enterprise buyers are currently inclined to view major implementations with skepticism, their corresponding preference to deploy Web-based point solutions provides SaaS providers with a major opening. Many of these firms have seized on this opportunity, crafting sales strategies that emphasize both the technical advantages of software as a service as well as the lower total cost of ownership (TCO) and high return on investment (ROI) associated with these solutions.

CHALLENGES WITH THE ISV TRANSFORMATION TO SOFTWARE AS A SERVICE

While many traditional ISVs are transforming their businesses in response to software as a service models, many of their go-to-market strategies are predicated on scaled-back versions of their products. However, as prior attempts have illustrated, the transformation process for the traditional ISV is not without its own set of challenges.

- **Cultural Barriers.** As has been illustrated in earlier sections, the software as a service model is philosophically different than traditional ISVs models including a redefinition of the relationship between vendor, customer, and third-party service providers, a different value proposition, and changing roles for ongoing delivery. In fundamental contradiction to traditional ISVs, the SaaS firm becomes a service-based relationship rather than a technology enabler.
- **Technical Hurdles.** To prosper in a multi-tenant delivery model, SaaS firms utilize purely Web-native applications that are based on a single instance of an application rather than multiple instances supported across different delivery environments (client/server, mainframe, Web-based) with traditional ISV models. This is not an insurmountable undertaking by an established ISV, but requires a commitment to Web-based delivery. Additionally, technical development becomes much more adaptive, as SaaS firms provide continuous updates on a weekly, monthly, or quarterly basis rather than major upgrades every several years.
- **Sales & Partnership Conflicts.** With ISV sales teams earning commissions on large upfront licenses rather than earning over the term of the agreement, re-aligning proper sales incentives & cultures is perhaps the largest impediment that ISVs face in successfully making a quick transition. Sales teams are rewarded based on the customer's usage of the system over time rather than being based on upfront license fees.
- **Customer Service, Application Support & Management, & Network Operations.** We have already made passing reference to the implications of convergence between software and services. As this process occurs, several challenges arise. Customer service and technical engineering become intertwined as the company relies on customer feedback and user adoption trends in the

refinement of its solutions. Administrative issues surrounding customer support, account management, and application support become ongoing rather than one-time processes, and essentially become the lifeblood of the SaaS provider in building long-term client relationships. Additionally, network operations take on an additional role and are viewed as essential contributors and a hub for customer service & ongoing support.

- **Shift in Business Model and Explanation to Wall Street.** Lastly, with Wall Street demanding more revenue and cash flow predictability out of public technology companies, these types of business models are ultimately attractive, but are not without their short-term sacrifices. An ISV is forced to forgo larger software licensing deals in return for longer-term visibility. This disruption to short-term revenue growth and EPS results can be punishing to ISVs by unforgiving investors that perhaps do not fully appreciate the positive long-term impact. As a result, we believe that those ISVs that make internal commitments will do so sparingly and with gradual steps or resort to more aggressive tactics through mergers and acquisitions.

SOFTWARE AS A SERVICE SUCCESS STORIES

The on-demand model began to accelerate originally in the CRM sector and now has spread to other application sectors, including content management, e-commerce, business intelligence / analytics, supply chain management, human resources and professional services, healthcare, among other areas. In the course of compiling this report, we interacted with senior executives at over 25 SaaS firms that have continued to rationalize this market from being thought of as merely hosted applications, pushing the envelope in terms of what “software as a service” really means. As a means of providing concrete examples of the points we have been making, we thought it would be instructive to profile

several leading software as a service providers, across a range of different functional and vertical specialties.

Web Content Management

CrownPeak is a privately-held software as a service firm focused on the \$1 billion web content management market. The company's Advantage CMS™ product is an enterprise-class content management system, providing web publishing, asset management, document management, and content versioning & syndication. The company also offers modules for web site management as well as SOAP and XML-based APIs for easy integration with current systems.

Since commencing operations four years ago, CrownPeak has already completed 250 deployments and has started to make inroads against entrenched traditional vendors like Documentum (now part of EMC Corp.) and Vignette. Serving primarily mid-market firms and large enterprises, CrownPeak has experienced a strong increase in demand since the middle of 2003, with buyer attitudes more open toward IT investments in general and displaying a high degree of interest in on-demand solutions in particular.

CrownPeak differentiates itself from its competition along several distinct lines. The company places a great deal of emphasis on the flexibility and ease-of-use of its products, combining a sophisticated but user-friendly application with a flexible development environment and Web services-based connections for non-invasive installations. CrownPeak's offering is also distinguished by its focus on professional services. Reversing the logic of the traditional ASPs, which contended that application providers needed to minimize their investment in professional and support services in order to reap the necessary economies of scale, CrownPeak dedicates resources to working with end-users in order to customize and optimize the application according to their specific business needs. This approach has resulted in an extremely high customer renewal rate and strong momentum in moving up-market into larger accounts.

Commerce / Content / Search

Atomz is a privately-held software as a service firm that has been in operation for approximately five and half years. Starting from the premise that 85% of all Internet purchases involve some level of searching, Atomz's hosted offering is designed to bridge the commerce, search, content management, and marketing sectors by providing users with the ability to create templates, workflows, business rules, and digital assets to drive online shoppers to relevant products. The company targets primarily large enterprises and currently serves over 1,400 such customers, including large enterprises such as Sony, Time Warner, Verizon Wireless, GE, and CBS. The company has reported an impressive 95% customer renewal rate, which is a crucial metric as SaaS firms scale their businesses.

Atomz's 100% hosted solution offerings - Atomz Commerce™, Atomz Media & Entertainment™, and Atomz Enterprise™ - are designed to drive greater transaction activity across its clients' e-commerce systems and to facilitate higher customer retention and a greater degree of self-service and automation. The Commerce, Media & Entertainment, and Enterprise solutions are based around the following applications:

- Atomz Search™ is a search/browse application that enables online retailers to utilize keyword-based promotions to provide their customers with a “guided shopping” experience and drive incremental sales via cross-selling and up-selling.
- Atomz Publish™ is a Web content management application with an intuitive user interface that allows quick content editing and deployment at the business user, rather than website administrator level. The application also provides workflow-enabled email that facilitates easy collaboration as well as providing an audit trail.
- Atomz Promote™ is an e-marketing application that enables Atomz's clients to offer targeted promotions and content to their own customers. The application provides online retailers with the

tools to design and manage campaigns and a business rules-based means of identifying related products and cross-selling opportunities. Finally, Atomz Promote provides reporting functionality to assess the impact of a campaign.

- Atomz Connect™ enables retailers to provide targeted, opt-in email content to customers based on specified areas of interest. The application also provides these firms with the ability to design and initiate email campaigns.

Human Resources

The human resources sector is proving to be fertile ground for software as a service vendors, as enterprises have become accustomed over the last 10-20 years to farming out various HR functions to payroll processors and HR outsourcers. Now a new generation of HR-focused SaaS companies is capitalizing on this track record and experiencing strong receptivity for their solutions. One such company is **Workscape**, a privately-held provider of workforce management and benefits administration solutions. Cash flow positive and reporting consistent revenue growth, the company has experienced strong sales traction among mid-market firms and large enterprises and now counts over fifty Fortune 500 companies among its clients.

Workscape offers integrated applications and services in the following areas:

- Outsourced Benefits Administration. Workscape's solutions provide automation for all facets of benefits administration, including enrollment & eligibility, regulatory administration (e.g. HIPAA, COBRA), and employee management.
- Workforce Management. The company's workforce management offerings provide functionality related to compensation planning, employee performance evaluation, and career development.
- Employee Self-Service. A core component of Workscape's value-add is its ability to drive a higher degree of employee self-service by providing a

centralized, intuitive interface that enables employees to manage their own benefits, thereby reducing the expenses incurred by the client enterprise on administrative tasks.

Since launching in 1999, the company has established itself not only as one of the leading HR outsourcing companies, but as one of a handful of SaaS firms that have successfully executed upon a relatively aggressive acquisition strategy. Most recently, Workscope acquired **TALX Corporation's** benefits enrollment business, HR service center operator **CallConnect**, and employee performance management software vendor **Performaworks**. These and other transactions served to broaden Workscope's solutions portfolio and enabled the company to capture an increasing percentage of enterprises' HR spend.

Employeease is another SaaS provider that has established a strong position within the human resources sector. Founded in 1996 to address the "disenfranchised" small-to-medium enterprise market, privately-held Employeease currently serves over 1,000 client companies and has experienced 26 consecutive quarters of revenue growth. Although the bulk of these clients are SMEs, the company reports increasing interest from large enterprises, driven by the high degree of configurability and customization enabled by Employeease's purely Web-native applications. As a means of maintaining its edge in product development, the firm introduces three major upgrades per year in addition to minor updates every month. Offering such a high degree of product sophistication and flexibility, particularly in implementing upgrades without disrupting customer operations, is proving to be a vital ability for winning business from SMEs and large corporations alike.

Employeease's applications and outsourcing services focus on core HR and benefits functionality. The company's HR applications address performance management, vacation/leave tracking, employee self-service, and reporting functionality, while the firm's benefits solutions provide such features as administration software, employee enrollment and communication man-

agement, insurance carrier invoicing, and billing. Both sets of applications are easily integrated with other participants in the HR value chain, such as payroll systems and insurance carriers. Finally, Employeease offers BPO services including call center, enrollment, billing, and COBRA & HIPAA administration.

Procurement & Supply Chain

The procurement and supply chain sector is also developing into a strong market for on-demand solutions, attracting both pure-play SaaS firms and hybrid vendors alike. **SciQuest** is one noteworthy firm that falls within the latter category, as a publicly-traded software vendor that successfully built a significant SaaS offering within procurement and supplier relationship management. With ambitions toward launching a broad, horizontal platform, SciQuest initially targeted the life science and higher education verticals and achieved a high degree of success. The company has witnessed its on-demand revenues increase 100% year-over-year, fueled by clients such as GlaxoSmithKline, Schering-Plough, Pfizer, and a number of top-tier research universities.

SciQuest's solutions provide functionality related to supplier enablement, procurement automation, and materials management. Within supplier enablement, the company's catalog tools enable users to search for and compare products, as well as allowing managers to direct spending toward preferred suppliers. SciQuest's procurement applications provide integration between enterprise and supplier systems, reducing the time and expense associated with the ordering process. Finally, the materials management solution includes a centralized database to facilitate improved inventory management and order fulfillment.

In April 2004, SciQuest announced an agreement under which it would be acquired by Trinity Ventures for over 3.5x trailing revenue and a 50% premium over the previous day's close. This transaction was conceived primarily as a means of eliminating the distractions of being a public company and enabling the firm to focus on building out its on-demand offerings and expanding its customer base.

Finance & Accounting

Within the finance & accounting segment of the ERP market, privately-held **Intacct** is emerging as a leading SaaS provider. Founded in 1999, Intacct has raised over \$40 million in venture capital and currently serves over 2,000 clients, primarily small businesses and mid-market companies. The company has experienced strong revenue growth and is closing in on profitability.

Intacct offers three variations of its software. Eledger™ provides general ledger, cash management, and accounts payable functionality for small businesses (sub-50 employees), and add-on modules include professional services automation, retirement, and time & billing functionality. Intacct's Enterprise™ product offers a higher level of accounting functionality designed for mid-market companies, with more robust optional modules that address inventory and purchasing. Finally, the company's fastest growing solution, MEGA™ (Multi-Entity General Accounting) is designed to meet the needs of larger companies that operate multiple locations, franchises, or subsidiaries. MEGA offers high-level accounting and finance functionality for these businesses, provides consolidated financial information, enables reporting & analytics, and facilitates either centralized or distributed transaction activity. Intacct's solutions are also fully integrated with payroll systems from Intuit and ADP.

Healthcare

Marked by aging, homegrown legacy computing systems, an increasing need to improve payer and provider efficiency, and a growing focus on cost containment, the healthcare industry is proving to be fertile ground for outsourcing, and SaaS firms are benefiting from this macro-trend. **SCI Systems** and **Third Millennium Healthcare Systems** are two leading SaaS providers targeting this vertical.

SCI Systems (formerly Scheduling.com) is a SaaS firm providing access management and revenue cycle management applications to healthcare providers such as hospitals, clinics, and physicians' offices as well as to consumers. The company has over 60 current cus-

tomers, who generally sign up for contracts lasting between three and five years. SCI Systems has experienced strong revenue growth, with over 80% of revenues generated by recurring monthly fees, is cash flow positive, and has attained "critical mass" to drive significant profit margins.

SCI Systems' solutions improve efficiency within healthcare providers' scheduling and revenue cycle business processes. The company's offering includes the following applications:

- Patient Scheduling™ provides a rules-based workflow that enables hospitals and other providers to schedule patient visits and procedures and to allocate staff and resources appropriately.
- Patient Registration™ collects relevant patient and insurance data in order to facilitate a faster billing cycle.
- Access Assurance™ provides a Web-based means of gathering patient eligibility, referral, and authorization information from insurers and rendering medical necessity decisions.
- Patient Reminders™ provide multi-channel appointment notifications to consumers in order to reduce the number of "no-shows" and the accompanying misallocation of resources.
- Consumer Appointments™ enables patients to schedule medical visits online and access relevant information, such as insurance data and appointment history.
- Provider Portal™ provides physicians with a networked means of scheduling appointments & procedures and of coordinating the required resources.

To take another example, Third Millennium Healthcare Systems provides solutions more directly targeted at revenue cycle management (RCM) for healthcare providers such as hospitals and clinics. The company's core RCM offering facilitates more effective management of receivables in order to accelerate collec-

tions and improve cash flow. The application automates functions related to claims processing, billing, and the identification of problematic accounts. Other Third Millennium applications address the correction and reprocessing of denied/rejected claims, document management, and report generation.

Hybrid Models

As IT firms position themselves to respond to the threats and opportunities presented by software as a service, we expect to witness a proliferation of a number of hybrid firms. We are aware of a number of companies pursuing such a model, such as **eMeta** (profiled below), **Silver Oak Solutions**, and **SPS Commerce**, that are going to market with some combination of professional services, licensed software, and on-demand solutions.

While initially predicated on an enterprise-class software model, privately-held eMeta has been making positive inroads with a hosted, subscription-based offering that solves the challenges associated with online access control and e-commerce of digital assets and services. The company has effectively helped enable the online market and e-commerce opportunity for digital content, data and intellectual property to mature. As a result, the company has become mission-critical infrastructure in securing and commercializing the digital assets and services for some of the world's most prestigious corporations and most frequently visited web sites, including more than 100 web sites processing millions of unique visitors each day. Originally targeting and securing enterprise license relationships with the world's largest publishers and information providers such as The McGraw-Hill Companies, The New York Times, Financial Times, Thomson, Reed Elsevier, among many others, eMeta has augmented its licensed offerings with a mid-market and SME hosted solution that is based on the same feature-rich enterprise offering, but with the added benefit of a service-based relationship that ensures optimal end-user application performance and tactical execution of e-commerce initiatives.

Its technology is based on an open-standards technology platform designed in Java and developed to be inter-

operable with numerous technology platforms and client-side applications. The company's hosted and enterprise offerings consist of the following:

- **eRightsWEB™** is the hosted information access control and commerce service-based offering that allows firms to sell digital assets and services, shorten the time-to-market and reduce up-front costs for executing upon its e-commerce strategy. This hosted offering leverages the capabilities offered in eMeta's modular, enterprise software licensing products:
 - **RightAccess™** provides sophisticated access protection for digital assets and services, including rich user authentication and very granular authorization and delegated administration for both consumer and business end customers.
 - **RightCommerce™** a robust, fully integrated commerce system with numerous billing and payment options including promotions, dynamic pricing, pay-per-view, teleco, metering, rate-plan changes and progressions and full subscription lifecycle management.
 - **RightsServices™** provides authentication, authorization, metering and complete billing features for software assets delivered by Web Services.

RECOMMENDATIONS FOR SAAS FIRMS

As a result of the challenges that incumbent ISVs face, we believe that SaaS firms that are competitively positioned with successful models will make for very attractive merger and acquisition targets. While several private companies are becoming public companies at the time of this report, we believe that some of the most strategic opportunities for SaaS firms will be the result of M&A with ISVs replying to broader market conditions and competitive pressures. Throughout the course of this paper, we have made reference to the keys to success for SaaS firms to incorporate into their strategies. We thought it would be useful to briefly recap our recommendations for emerging companies looking to create long-term shareholder value in this regard:

- **Scalability and Critical Mass.** Above all else, SaaS firms must maintain their focus on building their customer base and scaling to profitability, since payment streams are considerably smaller at the outset when compared to the traditional licensing model. By comparison, while signing 20 clients in a quarter may result in \$20 million-plus in revenues for licensing firms, it is a much smaller fraction for the SaaS. Once a threshold is reached, the SaaS can enjoy the benefits of stable revenues and predictable cash flows but as we have stated, reaching critical mass can be a significant challenge and take an investment of time and patient investors. All of our other recommendations are predicated on the importance of scalability.
 - **Narrow Solutions with Quantifiable ROI that Addresses Precise Business Needs.** Due to the investment required to reach scalability, the SaaS firm cannot afford to run the risk of being 'all things to all people'. Traditional ISVs have a significant advantage in terms of R&D investment and product functionality accumulated over the years, making it difficult for SaaS firms to immediately "play catch-up" with regard to functionality. As a result, many of the successful SaaS firms have carved out niches in the market to address
- particular 'pressure points'. We believe this narrowly focused approach that quantifies a ROI for a client is an effective go-forward strategy.
- **Client Acquisition & Retention.** Strong customer acquisition and retention metrics are vital to SaaS firms, as their business model requires a rapidly growing customer base with minimal turnover. These firms must achieve contract renewal rates of at least 90%, and probably higher, in order to achieve positive operating margins. This need for high retention in turn drives SaaS firms to place a premium on effective customer service. In addition, we believe many SaaS firms will find a more lucrative customer base as they move upstream into larger enterprise accounts.
 - **Sales Channels & Partnerships.** Many SaaS firms find traditional indirect sales channels with major systems integrators somewhat restricted, since their rapid implementation cycles eliminate large sources of revenues for the service firms that usually provide valuable solution selling competencies to ISVs. As a result, effective direct sales or alternative channels to the market are important for SaaS firms, while these firms learn to take advantage of the opportunity and ROI over the traditional software model (high upfront fees, uncertain implementation timeframes, integration and support costs, etc.), as well as upgrade cycles, mergers & acquisitions, and other technology purchasing that trigger events to sell into customers. In addition to direct channels, numerous SaaS firms have sought business alliances with mid-tier consulting firms, VARs / OEM relationships, and even private labeled hosted offerings with third parties as a way to achieve more market visibility. In our eyes, this will continue to be one of the most challenging and critical factors impacting the long-term success of SaaS firms as conventional go-to-market alliances are not as readily available and require much more creative ways to drive market adoption.

- **Move Upstream into Enterprise Accounts.** In the earlier days of SaaS, the model was largely predicated on providing hosted solutions for SME and mid-market accounts. This market focus has not changed, but growing evidence suggests that larger organizations are open to considering the merit of hosted solutions. In looking to build long-term value, we believe that SaaS firms will need to continue to demonstrate their ability to migrate into the larger accounts while continuing to service the SME market. This is an important driver in terms of displacing incumbent ISVs and expanding the SaaS market

- **Educating the Market.** As we outlined earlier, current SaaS sales & marketing efforts represent a new, more “value-added” means of conveying the software as a service value proposition. Moving beyond the “base case” for software as a service, which brought the traditional arguments for IT outsourcing down to the application level, the new approach is centered upon replacing the usual software vendor relationship with a new relationship that creates value in terms of both technology and service. This new value proposition is marked by the following characteristics:
 - High degree of customer service leading to strong client relationships
 - Ongoing support and product upgrades
 - Emphasis on targeted solutions rather than broad horizontal applications
 - Support for open standards to alleviate integration complexities
 - Focus on demonstrating rapid and significant return on investment
 - Vertical and business process specific functionality

CONCLUSIONS

The enterprise software industry is undergoing a fundamental shift in how technology is being delivered and sold with new models changing the relationship between vendor, client or end-user, and third-party service provider. The trend toward software as a service represents a dramatic shift that has been brought about by an interest in lowering the total cost of application ownership, generating a faster return on technology investments, sharing in the application execution risks, and eliminating large, upfront and 'hidden' operational costs.

The on-demand model first grew into prominence in the hosted CRM space where firms like Salesforce.com, RightNow, and Salesnet have all demonstrated the attractiveness of the model and introduced it into the mainstream. Now, the software as a service model is spreading to other layers of the enterprise software infrastructure moving beyond an early-adopter phase within certain sectors like content management, e-commerce, business intelligence / analytics, human resources, supply chain management, etc. by validating the model with a growing list of satisfied clients. As a result, in several years, certain application categories will witness software as a service assuming a very meaningful role where traditional enterprise software once dominated. The success of the on-demand CRM firms as well as SaaS companies in other application categories, combined with Siebel's entry into the hosted market with its on-demand solution and recent acquisitions, are combining to validate the software as a service model.

However, due to the fundamental differences between the license and software as a service model - cultural, technical, sales incentives, customer service and operational, investor expectations, etc. - we believe that many of the large ISVs will slowly adapt or transition on their own. Going forward, we believe that software as a service will be led by emerging, private companies that have addressed these challenges from the outset by developing proprietary applications that are properly architected for Internet delivery and an infrastructure

designed to support this new delivery mechanism. As these firms gain momentum, traditional ISVs will be required to adapt or risk losing market share to a new group of competitors. These implications will be far-reaching, disrupting not only the role of traditional ISVs, but also other sectors such as consulting and IT services firms who have relied on large, upfront software license deals to secure large implementation and integration projects.

While software as a service is rapidly forcing change in some sectors, by all accounts, the model still constitutes just a small fraction of the overall software industry, a market IDC sizes at \$190 billion in spending. However, its emergence is likely to impact some software sectors much sooner than others, which will require incumbent players to quickly re-define their strategies or risk losing market share to a new breed of competition. A helpful analogy might be the consumer Internet commerce market led by the likes of eBay and Amazon, which dispelled the initial security and performance concerns and continue to gain market share against their bricks & mortar competitors. Once SaaS firms have proven themselves as worthy adversaries and conquered some of the challenges facing these models, we believe that enterprise ISVs will make strategic acquisitions to gain these competencies, acquire a new competitive advantage, and to ensure their own smooth transition to service-based delivery. Consequently, privately-held firms that have successfully mastered the software as a service delivery process, proven their business model, and overcome industry challenges are poised to prosper and build long-term shareholder value.

APPENDIX: GENERAL REFERENCES

The following resources complemented the sources cited in the report as well as our executive discussions in providing valuable background information on the SaaS market.

Aberdeen Group Research

- *Hosted CRM Gains Momentum as salesforce.com Paces the Market*, October 2003.

IDC Research

- *2004 AppSourcing Taxonomy & Research Guide* (#28743)
- *Model For Turning Information Assets into Hosted Web Services* (#29595)
- *New Foundations for Software Pricing & Licensing* (#29569)
- *Software Business Models Must Adapt to a New Era* (#29229)
- *U.S. Software as a Service Forecast by Delivery Model, 2004-2008* (#31267)
- *Worldwide Enterprise ASP Competitive Analysis, 2003* (#29813)
- *Worldwide Software as a Service Competitive Analysis, 2003: IDC's Top 10 Vendors for 2002* (#30131)
- *Worldwide and U.S. Software as a Service 2004-2008 Forecast & Analysis* (#31016)

Industry Resources

- ASPNews.com
- ASPStreet.com
- *Information Week*
- *InfoWorld*
- Outsourcing-Center.com

SEC Filings

- Salesforce.com S-1 & amendments
- RightNow Technologies S-1 & amendments
- Taleo S-1 & amendments
- WebSideStory S-1 & amendments

APPENDIX: PROPRIETARY SOFTWARE AS A SERVICE VENDORS

Business Intelligence		Healthcare	
WebSideStory	www.hitbox.com	Third Millennium Healthcare Systems	www.tmhsi.com
Content/Commerce/Search		SCI Systems	www.scisystems.com
Atomz	www.atomz.com	Human Resources	
Content Management		Employease	www.employease.com
CrownPeak	www.crownpeak.com	PeopleClick	www.peopleclick.com
Communication/Collaboration		Softscape	www.softscape.com
BlueTie	www.bluetie.com	Taleo	www.taleo.com
Intranets.com	www.intranets.com	Workscope	www.workscope.com
CRM		Meeting Management	
NetSuite	www.netsuite.com	SeeUThere	www.seeuthere.com
Motive	www.motive.com	Procurement and Supply Chain	
RightNow Technologies	www.rightnow.com	Nistevo	www.nistevo.com
Salesforce.com	www.salesforce.com	SciQuest	www.sciquest.com
SalesNet	www.salesnet.com	Professional Services Automation	
Finance / Accounting / Expense Management		OpenAir	www.openair.com
Concur	www.concur.com	Vertical Applications	
Intacct	www.intacct.com	ARC Systems	www.arcsystems.com
Ketera Technologies	www.ketera.com	Silver Oak Solutions	www.silveroaksolutions.com
Outtask	www.outtask.com	Sinex	www.sinex.com
Paycycle	www.paycycle.com		

