OPINION

Time for a New Software Model

Sales and marketing costs are dragging down the enterprise software business. Open source offers one way to resurrect it.

By Larry Augustin
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Ask a software vendor about the benefits of Open Source and you'll get a few stock answers. It's inexpensive. R&D costs are lower. Developers are plentiful.

But few vendors realize the true operational leverage that Open Source offers in sales and marketing.

The problem is that the traditional enterprise software business model is broken. A rabid search for new customers and revenue growth has caused sales and marketing costs to spiral out of control. In fact, Rick Sherlund at Goldman Sachs estimates that in 2005 software companies will spend 82 percent of new license revenue on marketing and sales efforts. That's up from 66 percent in 2000.

This quest for additional revenue has created an untenable cost structure for the industry - one that doesn't serve vendors or their customers. In essence, vendors spend a lot of money to convince customers to buy, and then charge them a lot of money for the license which covers the sales and marketing costs. We're charging the customer just to sell to them.

Enter Open Source
The Open Source model turns the marketing problem on its head. Customers can look at, evaluate and review software without contacting the company that will sell it to them. Consider companies like SugarCRM (customer relationship management), JBoss (J2EE middleware), or Pentaho (business intelligence). The customer says, "I want something like that." He locates the Open Source version of the product, downloads it and is using it before the company is involved.

The sales cycle of a traditional enterprise vendor is just too long. It takes several months to get the right sales meetings, convince the CIO, sign a deal, do a pilot - maybe the customer spends a little money at this point but not much - evaluate it, follow it with a beta phase, and then hope for a real sale. That's one and a half years to get the deal. All along, the software vendor is convincing the customer to buy.

Back at the company that deployed the Open Source solution, the CIO is happy with the software. But after using it for a while, begins to wish for documentation, a live-person to ask questions, a phone number for support, and so on. At that point, the customer calls the company saying, "I've been using your product for a year and now I need your help."

This is a great sales situation. The user already considers the product mission critical to their business. No pilot is needed. The salesperson only needs to convince the user to become a paying customer - not convince them about the value of the technology.

This allows Open Source vendors to hire a different type of salesperson. At an enterprise vendor, the cost of a good sales rep is a minimum of $250,000 per year. If he or she is responsible for a $2.5 million quota, that salary alone is 10 percent of the vendor's revenue - a hefty chunk.

On the other hand, a good telesales rep only makes half of that salary, maybe less. And even if a field salesperson is needed to close large deals, the sales cycle has been shortened from years to months. The end result is dramatically lower sales and marketing costs.

The Open Source model likely delivers at best a 50% cost advantage in R&D. Most Open Source companies gain little community leverage developing the core of their application. R&D community leverage tends to come from testing, bug fixes, and interface/integration code. On the other hand, the savings in sales & marketing could be closer to 75 percent. Without the need to pay for large up-front sales & marketing costs, the vendor doesn't have to charge a new license fee up front. No more charging the customer to sell to them - the customers have to sell themselves - but they still come to the vendor for maintenance and support. And maintenance and support is how most software vendors make their living these days anyway. At Goldman Sachs, analysts have begun using multiples on maintenance as a way to value software companies.

Spurring Market Growth

By dropping new license fees, and reducing the sales and marketing efforts to win those sales, the vendor cuts the top and bottom line by the same amount. That means the vendor can be just as profitable.

But would this shrink the market? No. Not in the long term. Lowering prices doesn't shrink the market. It makes the product available to more people. The market can grow to massive proportions if costs are lowered appropriately. Look at the success of Microsoft and the PC: the market took off because Microsoft was able to provide low cost, easy-to-use software.

An application which cost $100,000 in license fees before now only costs $15,000-$20,000 in maintenance. Although the dollars per transaction are lower, the market grows because it is selling to a customer who couldn't have afforded the product or wasn't big enough to warrant attention to begin with. The revenue stream is also recurring, creating a more stable economic environment for the vendor.

New license growth in enterprise software companies today is stagnating. By changing the revenue mix from primarily new licenses to primarily maintenance on already proven products, a typical enterprise software vendor's top line would drop by 25 to 30 percent. But the decrease in price and increase in market size will enable growth in those previously unreachable markets, creating a vibrant and growing company that will eventual pass its former revenue numbers.

Admittedly, it would be very hard for a very large, public software company to do such a radical surgery on its cost structure. This kind of change doesn't happen to a company that is profitable. But there is a huge opportunity for startups and mid-tier players to leverage the business model advantages of Open Source. And for public software companies that are struggling, Open Source could be just the lifeline they are looking for.

Coming next week from Augustin:* The Next Wave of Open Source*, why the application market is ripe for open source offerings - and which applications will gain traction the fastest.

Larry Augustin is founder and Chairman of the Board of VA Software. While at VA Software he created SourceForge.net, the world's largest Open Source software development community. He also serves on the boards of directors of JBoss, SugarCRM, Pentaho, Medsphere, and the Open Source Development Lab.