OPINION

A Hybrid Strategy for On-Demand Success

Software vendors should deploy a hybrid model in order to ensure a successful transition to on-demand pricing.

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Venture capitalists and pundits are bullish about the potential of the on-demand model; in fact, many VCs now require that a company have an on-demand model before they consider making any investment in the company. As a result, CEOs are scrambling to develop an on demand model strategy to complement their traditional license model.

A pure on-demand model can be extraordinarily taxing, particularly during the first three to four years of a software company's go-to-market phase. This is because time-to-cash is significantly longer in the on demand model, leading to higher cash burn rate issues. With the size of investment rounds from VCs getting smaller, such models become very difficult to sustain.

As a result, it is almost an imperative that software companies pursue a hybrid strategy, going to market with both on demand and license models, which provide the broader market access and appeal of the on demand model, while also delivering on the operational benefits of the license model.

After having been CEO or general manager of three on demand companies, I have learned something about what it takes to drive the hybrid strategy until a company reaches critical mass.

First, let's define and differentiate between the two models. In the on demand model.

- Customers pay for product use on a periodic subscription basis without a long-term commitment (typically 12 months or less of a contractual "rental" commitment).
- Customers may also pay a one-time set up fee.
- Each customer is on the same product version, and a tight new-product release framework ensures simultaneous migration of all customers to new product versions.
- Often a "partner ecosystem" exists, which include third-party vendors offering a composite application to provide a complete solution to a niche market, or service providers with cost-effective implementation and configuration services and/or consulting to create custom reports.
- In order to keep subscription revenue flowing, the vendor must ensure that the software is used and adds value to the business.

By contrast, in a traditional license model.

- The customer makes a contractual commitment to owning the software, typically paying all - or a large part of - the license fee upfront.

- Vendors maintain a release management framework, a substantial investment in installation and configuration tools, and substantial investment in QA to test every combination of infrastructure (hardware, database, middleware etc.) supported and a large investment in the customer support organization who can service a number of actively-supported releases on a wide range of infrastructure.
- The "partner ecosystem" consists of major or regional consulting firms, who charge hefty fees and play a significant role in package selection and implementation. These partners may also provide optional business process consulting.
- The customer takes the risk - a customer's biggest negotiating leverage is threatening to discontinue annual support and maintenance payments to the software vendor - but with the huge up-front investment already made, this is detrimental to the customer.

A variation of this is the "hosted model," which is more an adaptation of the traditional license model rather than the on-demand model.

- The customer still purchases the software, however it is hosted at a vendor site or a co-located site. Financial payments structure may involve periodic payments, but the customer pays the full license amount and owns the software.
- In addition to license fees, the vendor charges monthly or quarterly fees for hosting services.

Clearly these two models are dramatically different, and require reconciling opposing business practices. Before jumping head-first into a hybrid model, consider whether a particular market as well as your specific company is positioned well for an on demand offering.

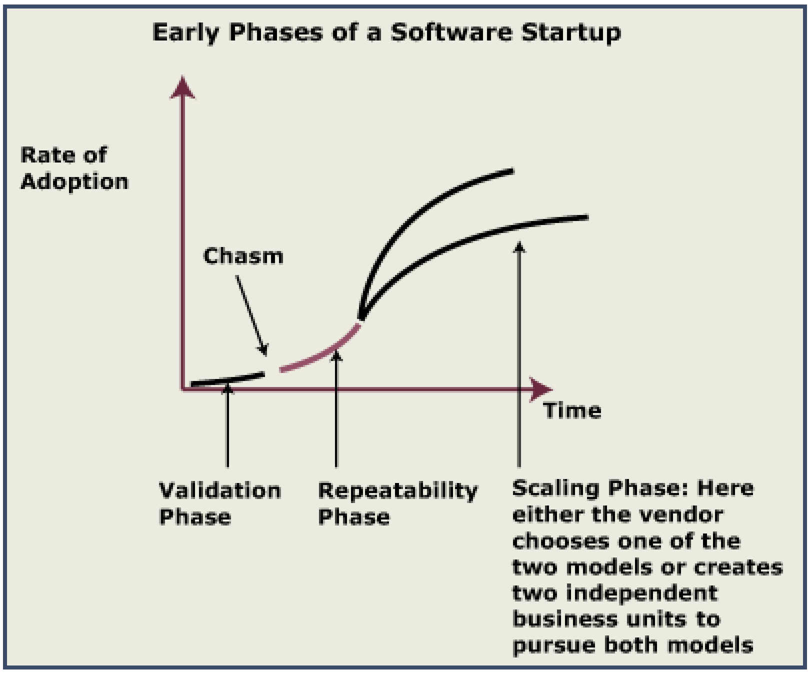
On demand models work well when the value proposition involves simple, well-defined and broadly accepted business process. Moreover, the processes supported by on demand software can function well standalone - as a result systems that automate such processes require less integration with other business systems. The sales pipeline management processes addressed by salesforce.com is an excellent example of this scenario, as are business processes such as customer service, help desk, payroll tracking, budgeting, procurement of business supplies, and expense report management.

However, trying to automate processes that are not well defined, are complex, are tightly linked to other business processes, or are not ubiquitous - typically attributes of a white space in the enterprise software market - is a greater challenge for the 'vanilla' style of on demand software solutions. As a result, sales cycles will be long as the sales and marketing teams work to convince prospects of the virtue of the company's unique approach to a business problem, and opportunities may not be plentiful in the first few quarters - a situation which earlier stage software companies with a cash-flow constrained on demand model can hardly afford.

This high upfront cost of selling, implementing, and integrating such systems may not provide the runway companies need to reach the critical customer base level that will result in zero cash burn. And even if an increased level of VC investment gives the vendor the runway to reach zero burn rate, each new customer may take too long to reach the desired profitability and revenue, making the investment not attractive enough for the VC "return horizon". Under such circumstances, the company should treat the on demand model on an add-on basis to acquire additional brand name customers who would otherwise not buy the solution, and- the company should understand it would be challenging to pursue on demand as the core contributing component of the business strategy. Software companies can indeed pursue a hybrid approach, however the business models are so radically different that this path can be successful only when the full scope of issues - including development, selling, implementation, and partner development - are recognized and reconciled.

- **Two orthogonal development approaches:** Most companies, who have a pure on-demand model and want to add a license model to their portfolio of product delivery approaches, find it challenging to offer a license model. They would have to develop a well-structured release management and QA model and develop a support framework that spans multiple releases. Hence, pure-play vendors may find themselves in difficult situations if they have to support a hybrid strategy. As a result, they cannot move as fast as their pure-play competitors.

  Since early stage companies can hardly afford to create and maintain two separate development teams and two different code lines for their product, those considering the hybrid model need to reconcile these two development approaches. A company may need to reduce the degrees of freedom in their infrastructure choices to support a hybrid model.
- **Two different selling models:** The on demand model usually requires a different selling approach - a solution-in-a-box approach or a simpler-entry-point into a company - so the cost of initial sales is not very high and the account can start yielding revenue contribution quickly. Once the customer starts using the simpler on demand solution, the scope can be expanded at a cost lower than what it may have taken to sell the entire software product or suite. Velocity and volume are of essence. As a result, the hybrid vendor would need to develop two different selling models for their two delivery models.
- **Diverse implementation requirements:** Most on demand vendors may collect the first subscription payment only after the customer is live. If it takes long to reach that milestone, customer's priorities or focus may shift in the meantime, converting this customer win into a financial loss. As a result, the implementation methodology should be geared towards "byte sized" wins, so the customer begins to start getting value from the system quickly. Such an approach may contrast with the license-based models, where the implementation schedules tend to be longer. As a result, a company seeking a hybrid approach needs to streamline its implementation approach to support both set of implementation requirements.
- **Varied partner ecosystems:** The on-demand ecosystem consists of composite application providers or small- to medium-sized services and reseller organizations. Such a partner ecosystem may be different from partners typically utilized in the traditional license model. A company using a hybrid business strategy will have to manage two very different partner ecosystems. They must rationalize the ecosystems and provide two very different sets of incentives to the two partner ecosystems to maximize value to both parties. For example, a vendor can provide sales leads to the on demand reseller organization, as well as subscription royalty revenue and all implementation revenue, in exchange for their commitment to add a certain number of subscribers every quarter through their reseller network. Under the license model, the vendor may instead agree to partner being a "prime" on all the license deals where they were involved in the selection process.
- **Getting the team on board:** The hybrid approach is challenging and creates significant complexity for a young company. The management team needs to be fully committed to the approach - knowing that there are no shortcuts to making it work. CEOs must keep their eye on every no-decision or customer loss, to ensure that any issues mentioned above can be addressed quickly and the team stays aligned. In addition the management team must review on a quarterly basis everything from selling methodologies and marketing plans to release cycles, with an express goal of ensuring that the on demand and license models are both supported according to the plan by the team.



The Hybrid Strategy is most often the right business model for an enterprise software vendor in the first three to four years of their go-to-market. For such companies, if the conflict between two models is managed well using the techniques mentioned above, it can yield solid dividends (and longer runway) in the first two phases of a vendor's lifecycle - the validation phase where the vendor is using the early customer wins to validate the technology/product/market and the repeatability phase where the vendor is trying to solve the same set of customer problems with a standard product (such that solutions implemented are not one offs).

However, once the vendor has reached 30+ customers and there is visible repeatability in the business, the business has reached a key inflection point. The vendor must significantly scale the business, and in order to accomplish this, must bet on one of the two models (license or on demand) as their primary go-to-market strategy. This decision is critical, since the complexity of a hybrid approach - driving two models with the constraints of a common code base and single sales organization yet two different implementation and support models - while scaling the company simultaneously, is a risky bet which could make many companies come apart at seams.

The choice of on demand vs. license may become obvious based on the customer traction and feedback during the earlier phases. A clear license vs. on demand go-to-market during the scaling phase will significantly improve the probability of success by freeing the management team to focus on growth-related issues and not have to deal with the conflicts of a hybrid strategy.

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