



Vertical software

A new playbook



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uncommon sense

It is time to add a new playbook to the old one: how to create supernormal returns in vertical software in the years ahead





In the past decade, a playbook for buying and growing software assets has helped smart investors and management teams make a great deal of money.

The playbook is now widely copied: seek specialised software assets that are market leaders and mission-critical to their customers; look for growing markets below the radar of global software giants; carefully but steadily raise prices; deploy high quality sales and customer success teams to drive module upselling; manage costs tightly; where possible, build a portfolio of more than one software asset in the vertical and build links between products to strengthen retention and drive cross-selling.

Further value has been created through bolt-on acquisitions that offer both p/e multiple arbitrage and some strategic and operational synergy.

We have regularly seen our PE clients generate outstanding returns from software deals - and we are proud to have helped them. An analogy on the public markets is Constellation, which has returned on average over 30% p.a. to shareholders since its IPO in 2006.

If you would like to discuss these issues, explore the challenges and opportunities for your business, or learn more about our work, we would be delighted to hear from you. Please contact the authors:

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But - there has to be a 'but' - it is getting harder to make exceptional returns using the old playbook. In many (not all!) verticals the easy improvements have been made. For example, we increasingly see annual above-inflation price increases facing more customer push back, damaging NPS, and beginning to create higher churn risk - especially in segments open to new SaaS-native competitors. Secondly, every software company must now have a good strategy for migration - probably gradual - to the cloud, where customer expectations and the rules of the competitive game are somewhat different, and an updated playbook is required. Lastly, and perhaps

most importantly, the sellers of assets are savvier about their potential value, and many more potential buyers are now chasing the same deals. The future value-adds from the old playbook are already in the price paid on day one of a new phase of ownership. New 'plays' are required to drive additional value.

It is time to add a new playbook to the old one: how to create supernormal returns in vertical software in the years ahead.





The three strategic plays to make in each vertical

We have identified three high level 'plays' every software company should be adding to their playbook in each vertical. All three are harder to achieve than the wins in the old playbook - but if they are done well they promise many more years of outstanding value growth ahead. We outline them here in order from easier to harder.



1. A more sophisticated approach to **pricing**. It is still common to see flat, above-inflation annual rises, possibly moderated by lower annual increases in exchange for multi-year contracts. Looking forward, we will see segmented approaches that better align price increases with willingness and ability to pay. Related, we will see yield-based approaches and bundles replacing modules on a price list - especially for products where the 'obvious' upsell modules are mature. Lastly, the pricing strategy must be designed to support rather than hinder the transition to the cloud, for example by pricing to encourage rather than deter broad adoption of a cloud product around a client organisation, and by adding subscription-based pricing models ahead of the transition to cloud-based products.



2. **Development of progressive SaaS propositions, and active management of a long term cloud migration strategy.** Every vertical software incumbent now faces the very real challenge of managing a medium or long term migration to cloud products. This is inevitable, and not trivial (i.e if you are not convinced it is inevitable we would be delighted to have the debate!). The art is to use smart segmentation and proposition development to navigate a multi-year transition plan that steadily repositions you as a SaaS player... but equally does not cannibalise existing profits unnecessarily. We believe the key is to define and develop a proposition explicitly targeting progressive (i.e. early mover) customers and to work with this segment, defining yourself as their champion. It may be that the characteristics of your vertical make it feasible to make the transition slowly but steadily - but it is critical, even in this case, to have a detailed and thought-through plan, as many customers will respond to the credibility of your SaaS transition roadmap even if the transition itself is not urgent.

The bad news is that this work is substantial, and can only partially be shortcut by M&A: the business will need to add and upgrade capabilities (e.g. product, tech, client service), change the product portfolio, restructure organisationally, become more customer-oriented culturally, and develop new strategies to strengthen defensibility (especially in Services, Data, and Networks, see next page).



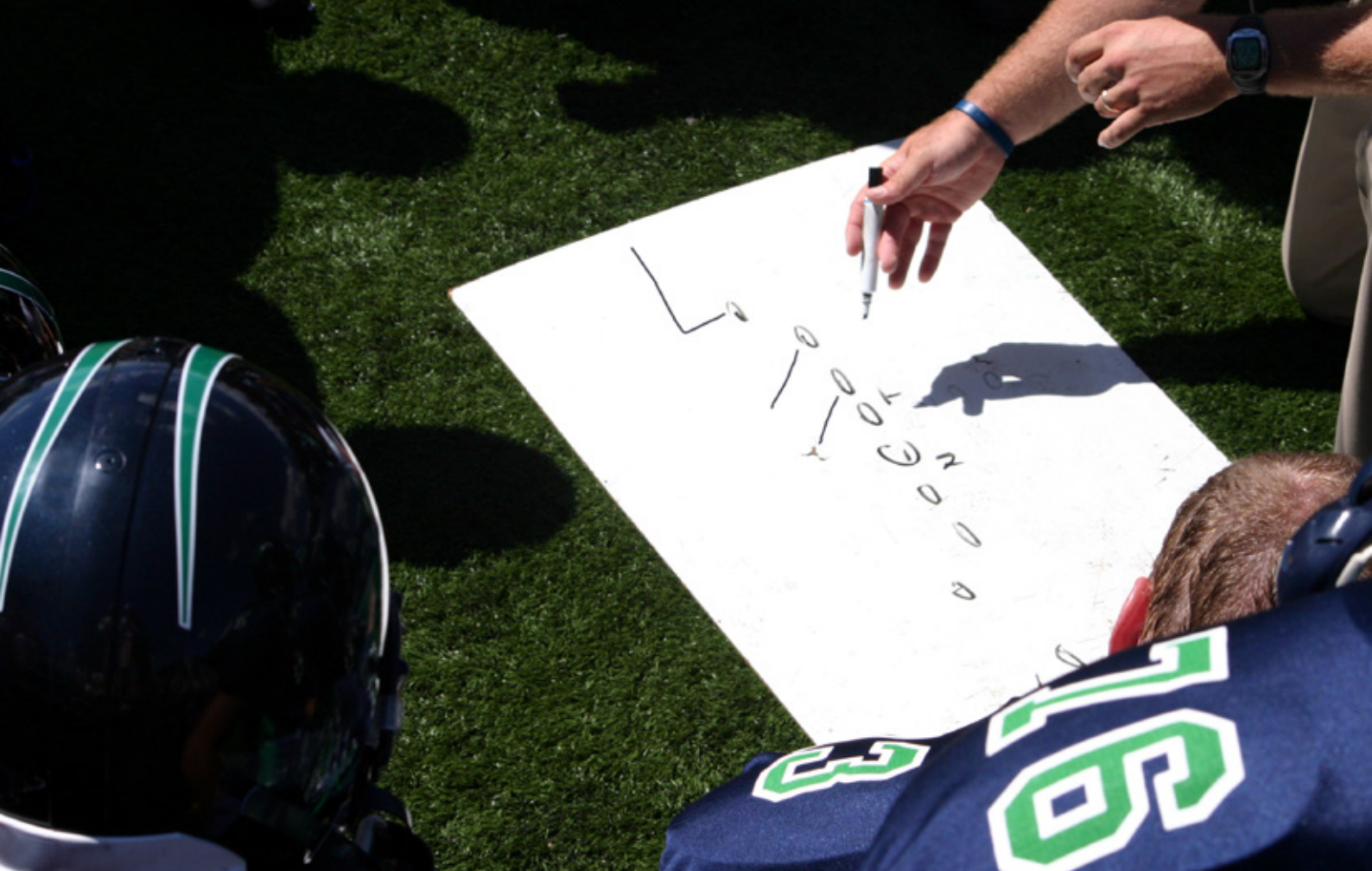
3. **Reposition for the long term: build Services, Data and Networks – the keys to long run defensibility and growth.** We believe that opportunities will exist for many players to create far more value for users and customers in the future; it will then be the job of pricing strategy to capture a good share of this new value. Beyond value-creation, our playbook focuses on adding defensibility because you can no longer rely on high on-premise switching costs and user familiarity to keep retention at 95%; your proposition needs to delight customers, improve productivity, and create new ‘good’ switching costs built on data, automation, personalisation, and network effects.
 - a. Default to **including services in your proposition**, rather than a pure software business model. Most investors instinctively prefer a pure software model without services: high margin, super-scalable, what’s not to like? We believe the burden of proof should be reversed, that services can usually help you win, and that you should ask ‘Can I really win without services?’ We see forward-looking vertical software players using professional services to bring them closer to customers and improve feedback, and to educate customers, ensuring they get the most value from the product (these tend to work better than encouraging customers to customise their implementation, which stores up problems on the software upgrade path). We also see support services bringing the software company into the client’s daily workflow and, when done well, creating a sense of team as well as some high margin revenue and stickiness. A final point on services: we often hear, especially from investors, a point of view that services are low margin – but the reality we see is that high quality services organisations have an effective monopoly with the client and frequently achieve contribution margins of 35-40%.
 - b. Start work on a **data strategy**. On a 5-10 year view, data will be a source of strategic value in many verticals. The right data strategy now will unlock a future step change in value for software businesses that are able to offer AI-driven productivity gains for customers. In some cases a wholly new and incremental business model may be available in the years to come. In verticals with data-led potential, we would recommend thinking this through sooner rather than later, as it will feed into proposition design and pricing (e.g. do not price in a way that creates a disincentive to usage and the generation of potentially valuable data).
 - c. Build in **network effects**. SaaS native software businesses like to focus on using network effects to add value for users while increasing switching costs. Network effects can be designed into the user level (e.g. collaboration tools such as Slack), the client level (e.g. data co-operatives, marketplace models), the channel level (e.g. joining ecosystems such as Salesforce). Cultivating the right network effects will likely be the single biggest driver of value to market leading vertical software businesses in the years ahead.

Reshaping and upgrading the business to get it done

The traditional software playbook called for excellence in sales, cost & cash flow management, and M&A. The best software companies are outstandingly good at all three of these. But the new playbook embraces an updated business paradigm, so a major reshaping and upgrade to many aspects of the business will be necessary.

THE TO DO LIST IS SUBSTANTIAL

1. Add and upgrade organisational capabilities. Capturing value remains key of course - but many incumbent software businesses will have to re-learn how to create more value for customers. This includes organisational upgrades such as:
 - a. Achieving a more customer-oriented organisation and culture and creating more love. You should be targeting an NPS of +50 not zero. Customer success teams are key.
 - b. More senior leadership in each vertical to make it happen. There should be a true CEO in the vertical, not a lower-level role.
 - c. Create a strong Product function as seen in all SaaS native businesses.
 - d. Upgrade the Tech team so that it is used to working with an agile Product team and is native with SaaS product development approaches and technologies.
 - e. Add a high quality in-house services organisation.
2. Tweak targets, KPIs & incentives to ensure the incentives of executives and teams are aligned with strategy, not only with current year EBITDA. Particularly important are:
 - a. Ensuring leaders and sales people work for the good of the vertical proposition as a whole, not only one product - and for long term value not current year recognised revenue.
 - b. Once a more sophisticated pricing strategy is in place, review incentive structures and revise to align with the strategic logic of pricing and proposition.



3. Clean up the brand and product portfolio to make room for innovative SaaS propositions. Many vertical software companies have a somewhat messy portfolio of propositions and brands, reflecting the history of bolt-on acquisitions and subsequent rebadging of acquired products. Each product tends to be positioned on two dimensions: first, to appeal to one or two customer sizes (Enterprise, upper mid-market, lower mid, small, micro...etc), and second, the problem the software aims to solve (is it a staffing solution, a procurement tool, a workflow product?). For the future, another dimension is necessary - we need different propositions for progressive and conservative segments. To prevent excessive complexity, now is the time for a pruning exercise to simplify the existing brand portfolio to make room for the proposition for progressive segments.
4. Rethink the product and tech stack for the long term. To ensure you have the right economics (margin, scalability) in 5 years time you are going to want to:
 - a. Update your high level technology strategy. For example: are you using a Devops approach operationally? Is your stack containerised or still using virtual machines?
 - b. Add a Data competence.
 - c. Move ahead asap with interoperability between products at a data level, to increase stickiness and strengthen the proposition of a 'family' of products... and build towards an integrated data layer in your stack.
 - d. Design a roadmap including modules of software that can be re-used across products and platforms - for example, a layer of useful microservices.
 - e. Keep the Cloud product and tech teams separate from the legacy ones until they are at scale.

This reshaping may be a two year journey or a five year one, and the level of urgency varies greatly from case to case. But the direction of travel - and the new paradigm as a destination - are clear. We believe you should get clear about your strategy for the new playbook right away - and make the speed of implementation one of the variables in your plan.



Hg are Europe's leading investor in B2B software and SaaS businesses over the last 20 years



CASE STUDY: Hg & VISMA

Elements of this approach have been applied to great effect with successive investments by Hg. Hg are Europe's leading investor in B2B software and SaaS businesses over the last 20 years having backed more than 30 "platform" investments and made over 200 bolt-on M&A software/SaaS acquisitions.

A particularly powerful example is Visma: in 2006 Hg acquired Visma, which is today the largest independent SaaS company in Europe and the leader in serving SMB's globally - with over \$500m of recurring SaaS revenues, more than 50% of the group total revenues. Since acquisition, Visma management alongside Hg (and often co-investors) have created enormous value in this business by:

- Introducing yield-based pricing by charging per employee for selected products, and generally focusing on a bundled approach over a modules-based sales approach, driving up ARPC
- Driving SaaS transition organically and through strategic acquisitions (e.g. e-economic) - such that the proportion of customers on SaaS products today is ~40% - higher than any other comparable European software business
- Thinking strategically about how to drive up share of customer wallet by addressing new parts of SME costs - e.g. offering software enabled services in ERP and Payroll, for instance: electronic invoicing, debt collection, factoring, small business loans and travel expense processing.

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