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Strategies for driving the transformation in the software industry

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Traditionally, software companies have been purely focusing on developing software and selling it to consumers or businesses. However, during the past five years, app stores and cloud computing have changed the industry logic. Software companies can no longer rely on plain software sales, as the business models have evolved to providing services and solutions.

The IT industry has had a big impact on the lives of consumers and the operations of businesses during the past twenty years. The penetration of smart devices and internet has been constantly growing and an increasing amount of services leverage the new infrastructure and ecosystem. Traditionally, software companies have been purely focusing on developing software and selling it to consumers or businesses. However, during the past five years, app stores and cloud computing have changed the industry logic. Software companies can no longer rely on plain software sales, as the business models have evolved to providing services and solutions. In this article we present how market changes have affected the B2C and B2B software markets, and describe five different strategies that software companies can adopt in this new environment.

Consumer software companies need to find new revenue streams as software becomes free

Consumer software business is in the middle of a big disruption as Internet is everywhere and consumers move from the Windows PC world to ubiquitous Android and iOS platforms. At the same time, founding a software company is easier than ever both technically and commercially. From a technical point of view, software development for the new platforms is both easier and faster than in the old Windows PC world. An even bigger change has happened on the commercial side as software distribution costs have been minimized. Physical boxes are not needed anymore when app stores and the web have become the de facto distribution channel for software. This opens up potential for small companies to reach global scale efficiently without the need to invest in retail channel development and brand building through the traditional advertising channels.

Modern startups are building their businesses by using niche-marketing in digital communities. Since startups' budgets for marketing are restricted, they look for content marketing on niche websites that their targeted user base visits most often. Often, the most difficult part in their marketing is actually figuring out whether their product/service is something that the market is really demanding. Without testing the market for a "product-market fit", many technology companies are often over-developing features of the product itself. However, testing the product-market fit requires users, and attracting users in the app market has become a very complex task that often involves a lot of resources. Therefore many companies, like Rovio, have started from selected small focus markets and expanded scope later when the product has gotten attention.

As a result of these market changes, we can see how the consumer software business is fragmenting and consolidating at the same time. Fragmentation is evident as the lower barrier to entry brings new innovations to the market. Consolidation on the other hand is driven by the American giants such as Microsoft, Google, Apple and Facebook, who continuously acquire the most promising consumer software startups and provide an increasing amount of services for free in order to lock consumers to their ecosystem. Free services are becoming more common also because many small companies choose a collision course strategy towards a giant, grow the user base with free services and make an exit by selling their user base and technology to one of the giants.

In order to survive as an independent company, software companies need to build non-software business as they grow. App co's can grow to multi-million businesses, but reaching hundreds of millions of pure software revenue is extremely difficult with the current freemium models, where conversion rates are typically only some percentage points. Consumers have already learned that software is free and are not willing to pay tens of euros for it. This new situation may not be a surprise, given that the marginal cost of software is zero. Since consumers are unwilling to pay for the software, most of the fast-growing, modern B2C software companies are already making their money from other sources. Pure software license sales have been replaced by models such as advertisement revenue or selling content, virtual goods or enhanced functionality. The trend drives software companies also towards internet-enabled wearables, drivables and scannables (Google Glass, Pandora car, Jawbone UP) since consumers are willing to pay for new hardware, and also because once a consumer "jumps in" there is an ever expanding opportunity to provide services. This means that the borderlines between software, hardware and other type of companies continue to diminish.

Transformation of B2B software business is slower but the trend towards service business is evident

B2B software companies are still able to monetize software directly, but Internet everywhere is already changing their business logic as well. While in consumer software business the hardware and content are replacing software as the source of revenues, in B2B the dedicated deployments and license sales are being replaced by software-as-a-service (SaaS), platform-as-a-service (PaaS) and infrastructure-as-a-service (IaaS) models. Although the new service models are not necessarily the cheapest options in the long-term, they have still become very popular due to their advantages such as fast deployment, flexibility, reliability, automatic upgrades and maintenance.

Being independent of location, SaaS is scalable and allows the B2B software companies to go global more easily than before. Big (local) country organizations are not needed anymore for handling deployment projects, because customers accept more standardized solutions than before and the capacity can be provided from afar. This makes the cost structure of traditional software companies less competitive, as they already have country organizations in place. Although SaaS makes the business more scalable, it also creates new requirements for software companies and increased responsibility. Previously customers were buying licenses, now they are buying uptime that software companies need to be able to ensure.

This kind of disruption provides opportunities for new entrants, who typically start their attack from the small- and mid-size business (SMB) segment. SMBs are still underserved because they could not afford the high investments that were required before the SaaS era. Companies like Salesforce.com, which offers cloud based customer relationship management solutions, have been able to start from the smaller companies and expand gradually to bigger and bigger companies. With products such as Microsoft 365 and SAP Business One, the large B2B software giants have now started their counter-attack and are putting increasing focus on SMBs.

It is easy to draw the analogy between B2C and B2B software businesses. In both cases, the software distribution costs are decreasing due to app stores in B2C and SaaS models in B2B. In B2B, software companies are still able to monetize software as the complexity is much higher, increasing the barriers to entry. However, this may not last for long. In order to succeed, they should be proactive and ensure that they emphasize the service element of their offering or develop other ways to gain revenues in the future if the software prices continue to drop.

The changes provide big opportunities for companies who go outside their comfort zones

The current trends described earlier indicate that software as a standalone business is coming to its end sooner or later. At the moment, it seems that the biggest winners in the software market are the few large giants and smaller companies that have been established during the Internet era. They have found new ways of monetizing their offering without relying solely on pure software sales. However, many traditional, mid-sized software players are facing the challenge of transforming their business and operations in order to survive.

For the traditional software players, we see five alternatives to survive:

1. Drive disruption in the current focus areas

In this case there are two alternatives to drive disruption: change the offering or change the monetization logic. The most common way to change the offering is to transform the traditional software product into a cloud solution. Cloud solutions are better for meeting the requirements in the multi-device environment. One solution can be used in multiple devices without the need of several licenses or cumbersome updating procedures. An alternative for changing the monetization logic is to change the license business towards, for example, pay-per use logic. This enables people to use the software as a service when they need it without investing large sums in the long-term software licenses. Consequently, the threshold to pay for the software is reduced even though the long term cost might stay the same. By doing this well, local software companies can go global and compensate potential revenue losses that are caused by price erosion.

2. Drive disruption in other industries by changing the software to a delivery channel

This alternative requires companies to abandon their traditional positioning as a pure software company and instead use the software as a delivery channel for more traditional goods and services. In consumer business, there are already many examples of such business models. Spotify has destroyed the business of traditional record stores by offering music as a service. Amazon is eating out the business of traditional bookstores by selling eBooks through their Kindle eBook software. Netflix is trying to replace traditional video rental shops by enabling consumers to get the films directly to their devices. In all of these examples, software offers only a platform where the traditional goods or services can be delivered more conveniently. The customer is not paying for the software but for the content or the service the software provides. In B2B software this alternative offers a lot of opportunities especially in the conservative industries that have not adopted new technologies yet. For example, public sector and construction industry are both still using a lot of paper instead of collecting, distributing and leveraging information in electronic format.

3. Build solutions that integrate software and hardware

This approach uses the combination of software and dedicated hardware to make a solution that has not existed before. The monetization takes place by selling the hardware extensions or the whole solution as a service. One example from consumer side is Sports Tracker that has been able to build a strong brand with their GPS sports application. The application itself is free, but they sell heart rate belts which help consumers get more out of the software. Monitoring solutions and handling transactions are a potential area to build B2B business with this strategy. For example ERP-integrated sensors, bar code scanners and RFID readers provide several use cases that industry focused software players can provide.

4. Build high engagement solutions and monetize the large user base

Some mobile game applications such as Rovio have been able to increase their revenues by leveraging their brand in other segments. In this approach the software is actually acting as an engaging brand advertisement that drives the demand for branded goods and experiences. Supercell has also built highly engaging games and monetizes it by selling virtual goods and enhanced functionality inside the game. Similarly, software companies in the B2B segment can build free platforms that create a strong customer lock-in. The customer base can then be monetized by selling services to them or to a third party.

5. Sell expertise

The company may have created valuable knowledge with software development but the monetization potential of the software is poor or decreasing. However, the company can monetize this knowledge by offering their expertise as for example a consulting or tailoring service. IBM is an example of a company which has made a big transformation towards selling expertise instead of selling only hardware and software. Also, some of the open source companies such as SkySQL offer the software itself for free and make the money by selling integration, deployment and support services.

Whichever of the alternatives a company chooses to go for, the path is not easy as there are often conflicts with the existing business. The conflict can be either with the current business or with the traditional distributors. Consequently, in order to survive a company should choose one or two of the alternatives and try to find a balance between them and the existing business. When launching a new disruptive business model inside a company one option is to grow them as small pilots or in-house start-ups and add resources as they get proven. A new business can initially be tested in a limited scale by piloting it in a certain region or new business area. Another option is to acquire a smaller disruptive competitor and build its business further by separating it first from the parent company and integrating it later on to reach synergies. Using a different brand in the early pilots or even throughout the lifecycle of the new business should also be considered.

Whatever the choice is, companies are finding out it is time to say goodbye to the easy days of selling pure software. Replacing an existing software business with new disruptive business requires stepping out of the comfort zone and acquiring new cross-industry and entrepreneurial competences that can build the foundation for future growth. Ultimately, some of the companies will be able to do this and win over those who did not dare to transform their operations.