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COTS Software Product Testing

Why Private Companies Need to Look at Compliance

Turning Software Into Services

SAS Institute and CEO Jim Goodnight
Racking Up 27 Straight Years
of Profitable Growth

Going Its Own Way

SAS Profile -- Going Its Own Way

I've lived a life that's full -
I've traveled each and every highway.
And much more than this,
I did it my way
 -- Lyrics from a Frank Sinatra
 Song, "My Way"

"My Way" could be the company song for SAS Institute since their success is built on defying convention. Perpetual license billing, you say; subscription billing, they

EXECUTIVE STRATEGY

Insight From Brian Turchin

SAS Institute's Revenues		Annual	Percent
Year		Revenues	Increase
1976	1	$ 138,000	
1977	2	$ 506,000	266.67%
1978	3	$ 1,227,000	142.49%
1979	4	$ 2,397,000	95.35%
1980	5	$ 5,052,000	110.76%
1981	6	$ 11,239,000	122.47%
1982	7	$ 19,646,000	74.80%
1983	8	$ 32,386,000	64.85%
1984	9	$ 52,612,000	62.45%
1985	10	$ 70,975,000	34.90%
1986	11	$ 102,427,000	44.31%
1987	12	$ 135,300,000	32.09%
1988	13	$ 170,437,000	25.97%
1989	14	$ 205,614,000	20.64%
1990	15	$ 240,243,000	16.84%
1991	16	$ 295,427,000	22.97%
1992	17	$ 365,500,000	23.72%
1993	18	$ 420,268,000	14.98%
1994	19	$ 481,954,000	14.68%
1995	20	$ 562,421,000	16.70%
1996	21	$ 652,867,000	16.08%
1997	22	$ 750,000,000	14.88%
1998	23	$ 871,400,000	16.19%
1999	24	$1,020,000,000	17.05%
2000	25	$1,071,000,000	10.10%
2001	26	$1,132,000,000	1.02%
2002	27	$1,180,000,000	4.42%

ness Intelligence to Data Mining. According to Dan Vesset, Research Manager, IDC, the Business Analytics market was about $12 billion for 2002--just for the software license and maintenance fees, no professional services included--and SAS's share about 8%. He also estimated a 6% compound market growth rate through 2007, although portions of this market, like CRM analytics, will

say. Outsource, you say; insource, they say. Have managers manage and staff do the work, you say; have managers both manage and work, they say. Care about employees and customers, you say; mean it when you say care about employees and customers, they say. Go public, you say; stay private, they say.

In this, my fifth column in a series, let's see how these unconventional strategies translate into SAS's record of long-term success.

Background

SAS is the world's largest private software company at $1.2 billion and 14th largest software company in the world with nearly 40,000 customer sites, 3.5 million users, and 10,000 employees.

Founded in 1976, SAS is the largest Business Analytics software vendor with products that span the full breadth of the category, from Data Warehousing to Busi-

grow at a much faster clip.

Jim Goodnight has always been, and continues to be, the CEO and president of SAS. What Bill Gates is to Microsoft or what Larry Ellison is to Oracle, Goodnight is to SAS. He has played a special role in the company's success, as the following story, told to me by Goodnight, illustrates:

At the end of 2000, and in the beginning of 2001, SAS was hit with a number of defections in its sales leadership. In February 2001, Marianni Suciu, head of sales in the Americas, resigned. Goodnight "decided it might be good to take over sales for a while." When asked why he didn't put someone else in the job, he answered, "Just wanted to do it," and then he added, somewhat tongue-in-cheek, "I was empowered to make the necessary decisions." How so?

SAS has only two shareholders: John Sall, co-founder, who owns one-third of SAS, and Goodnight who owns the other two-thirds. That's it. Two shareholders. And

John Sall, taking a much lower profile, has been happy to have Goodnight run the show. So for 27 years, Goodnight has done exactly that.

Choosing to run sales for a while is just one of those "things" he wanted to do. During this time, he changed the sales compensation plan to make it more aggressive and initiated action to double his sales force over a two-year period. And oh, by the way, Jim Davis, Sr. V.P and CMO, told me that this year through October 31, 2003, they are up over-all 14% with U.S. Sales up 35%.

In short, Goodnight has been the force behind SAS, shaping its culture, its business model and the vision of its future.

Success

What has Goodnight and SAS wrought?
* **26 Years Consistent Revenue Growth** - a truly remarkable record of rev-

enue growth for each year the company has been in existence, a rare feat. (Even rarer, SAS also claims these have all been profitable years. Once you understand their business, this is a reasonable claim. But since they have never published any profit numbers, and since they are not public, I can't independently verify their statements.)

◆ **Strong Customer Loyalty** - SAS has an unbelievably high 98% renewal rate. They don't lose customers.

◆ **Stable And Predictable Revenue Base** - Fully 80% of its revenue comes from existing customers.

◆ **High Revenue Profit Margin** - 90% to 95% of its revenue comes from annual license subscription fees, which provide the highest margin of any revenue line in a software company.

◆ **Very Loyal Employees** - It has an extremely low turnover rate that averages between 3-5% while the industry as a whole averages 20%.

◆ **Recognition In The Press As One Of Best Places To Work On The Planet**

-- On the Oprah Winfrey show entitled, "Only The Best," SAS was highlighted as the "Best Place To Work."

-- On "60 Minutes,, Morley Safer opened his segment on SAS, "The Royal Treatment," with the declaration "Take a look and eat your heart out," and then said later, "If there is a heaven on earth on the job, it is at SAS Insitute."

-- SAS has been on Forbes's list of "100 Best Places to Work" for 6 consecutive years.

So how does SAS do it? The following five strategies unlock some of the mystery.

1. What's Old Is New: Use Subscription Pricing To Achieve Consistent And Stable Revenue Growth

While 99% of other software companies sell a perpetual software license, SAS sells an annual software subscription and has been doing so since its founding in 1976. In a touch of irony, while SAS was the odd-man out in terms of pricing model for so many years, today there is a strong trend to move towards the subscription model-- precisely for the reasons that SAS has stuck with it over 27 years.

Just to review, in the perpetual licensing model, we charge our customer a high up-front fee; say $200,000. This permits the customer to use the software in perpetuity. In addition, we charge our customer an annual maintenance and support fee which usually runs 15% to 20% of the software license fee, which in our example is $30,000. Upgrades are usually included in the annual maintenance charge, while new versions are charged with another upfront license fee.

In contrast, with an annual software subscription model, our customer pays in our example $120,000, a much smaller upfront fee than with a perpetual license. This gives the customer the right to use the software only for a specified period, usually a year (although ASPs today, who have once again popularized this pricing model, charge by the month). To renew the subscription, we charge something in the range of 50% of the first year fee, say $60,000 as in our example, which is higher than the annual maintenance fee in the perpetual pricing model. And, very significantly for many, the customer is not only entitled to any upgrades but to all new software versions for free.

Ok, so what's the impact of using one pricing model over another? There are two key differences pitting faster growth against a more predictable revenue stream. First, because of the higher up-front fees, revenue grows much faster for the perpetual model than for the subscription model. Second, although the perpetual model provides a faster revenue growth, it is also much more volatile, while the subscription model, provides a revenue stream that is more consistent and stable. To see this, we need to work our way through a simplified example.

(Using the pricing in the prior example, these projections assume 100 new customers for 2004, and 1,000 customers from 2003.)

In the subscription model, 83% of revenue is from renewals, putting at risk only 17% of projected revenues. But for the perpetual model, only 60% is bankable, while the company is at risk for a whopping 40% of its revenue. The perpetual pricing model inherently has more risk than the subscription model.

Here's a real-world example. In 2002, Siebel, which uses the perpetual pricing model, had a revenue drop of 21%, losing $413 million, ending the year at $1.6 billion. Compare this to SAS. In 2002, although the economic downturn hit SAS as well, it still managed to grow by 4.4% to $1.2 billion. And since it already receives 80% of its revenue from existing customers, its revenue can't drop by 21%-- unless some major catastrophe occurred.

Ordinarily, pricing is thought of as something tactical, not strategic. For example, if your strategy is to dominate your market, then a tactic is to price low. But, for SAS, its choice of a pricing model has had a profound impact on its business. Clearly,

PROJECTED 2004 REVENUE - PRICING EXAMPLE

PERPETUAL PRICING			SUBSCRIPTION PRICING		
NEW SALES	$20 M	40%	**NEW SALES**	$12 M	17%
ANNUAL MAINTENANCE	$30 M	60%	**RENEWAL**	$60 M	83%
TOTAL	$50 M	100%	**TOTAL**	$72 M	100%

PRICING EXAMPLE

	First Year	Subsequent Years
Perpetual Licensing	**Upfront License Fee**	**Annual Maintenance And Support Fee:**
	$200,000	$30,000
Annual Subscription Fee	**First Year Fee** $120,000	**Renewal Fee** $60,000

Jim Goodnight

as a result of subscription pricing, retaining customers is central to its success. And because of subscription pricing, there is less of a need to drive new sales, so it can spend less on Marketing and Sales. And because it spends less, it can spend more on R&D, spending an unusually high 25-30% of its budget, while 10 to 18% is more the industry norm. And because it spends a disproportionately high amount on R&D, it can provide customers with better software. And circling back, better software creates greater customer loyalty.

For SAS, an annual subscription model provides a more stable and predictable revenue flow and focuses its business strongly on customer retention. More about that later.

2. Outsource, shmart-source! Hire Your Own To Drive Down Cost And Improve Quality

For years, business gurus have written about the virtues of outsourcing those parts of your company that do not confer strategic advantage. You let others, whose business it is to do these things, handle customer service or payroll process or even your entire IT infrastructure. It's cheaper, and it allows you to concentrate on what you are good at. And more recently, for software companies, the tide towards off-shore outsourcing, shifting your software development to other countries like India and Russia, is turning into a tidal wave.

Outsourcing doesn't compute in Goodnight's world. Period. When you walk around the Cary, N.C. campus, all of the people working there are SAS employees: the guy cutting the lawn as you pass by; the cafeteria worker who serves you lunch; the pianist in the cafeteria who serenades you while you eat; the artist who creates the paintings and sculptures that decorate the SAS hallways; the doctors who treat you on-site at the SAS medical facility; the day-care center workers who take care of your children while you work. (Yes, SAS has a pianist, artists on staff, a free medical facility, and a very low-cost day care-center as we shall discuss later on)

From Goodnight's perspective, his company continues to be profitable precisely because it is cheaper to have these folks as his employees than to pay another company that adds a profit margin for the use of their services. And, because your own employees care more, especially when you treat them as well as SAS does, their quality of work is infinitely better.

3. Administrative Managers Need Not Apply: Keep Management Hands-On

SAS acts like the largest start-up in the world. What do I mean?

According to C. Gordon Bell, a computer industry pioneer, developer of the Bell-Mason diagnostic used to evaluate start-ups, and author of *High-Tech Ventures: The Guide For Entrepreneurial Success*, the type of manager you want in a start-up is as follows:

The top-level team must also be "do"-oriented rather than "management"-oriented. Each member must be able to "play" several positions on the team that reports to him or her rather than just managing the team. This requirement implies specific kinds of competence and serves to ensure that:

◆ Members of the top-level team have an appropriate level of competence, ruling out bureaucrats who come from large companies and possess the necessary credentials on paper but often lack actual competence.

◆ The department head really knows what's going on in the department, since he or she functions as an active participant instead of just serving as the boss.

◆ The organization is lean right from the start, since it does not have the separate line(brawn) and staff(brain) components characteristic of many large companies.

The management team of SAS is chock-full of such people.

Jim Davis, Sr. V.P. and CMO, is but one example. Even though he manages about 900 marketing personnel, he is a working manager, someone who gets to exercise his marketing skills and experience as well as his management skills. Davis enjoys doing both. "I have the best of both worlds," he told me, and then said, "If I ever lost that ability to feel that way [that it was ok to both manage and do work], I would leave SAS, absolutely leave SAS."

Jim Goodnight, the CEO, is also a "doer" as well as a manager, which the following story illustrates. "More than two years ago, I woke up one morning with an idea. I had seen the amount of work it was taking to produce drill-down reports on the web, just URL after URL, which would have to be maintained. So the idea was if you are going to continuously drill-down on a table of numbers all you need is one file that has all the data on it and then a very, very simple program to read that file and display it. So we have multi-dimensional technology that I had worked on several years ago. So I pulled that back up, and once the cube was computed and sorted and written out in such a way, then at any time you clicked on a row to drill down, it knows exactly what record to start reading and reads a block of records and displays them." How many CEOs of a billion software company do you know who still write code?

Just as with a start-up, SAS's culture prides itself on the competence of its executives in their respective areas of expertise and not just their ability to organize and manage. In fact, if you were hired as an executive who was accustomed to having

hoards of employees do the work for you, according to Davis, you wouldn't last very long at SAS.

This has a direct impact on the organization. First, it breeds more respect among management and staff, especially in R&D where your technical knowledge is usually a measure of who you are. Second, it speeds up the decision-making process since employees don't have to educate their manager on the subject at hand. And third, it produces a much flatter organization because it eliminates the usual middle management administrative layers. All in all, it creates a leaner, more agile organization.

4.No One-Nighters Here: Establish Long-Term Relationships with Both Employees and Customers

Henry Ford built a "virtuous business cycle" by using an assembly line to manufacture his model T's. The use of an assembly line reduced a car's per unit cost. With lower cost, Ford lowered the price of his Model T. With a more affordable price, a greater number of consumers bought more cars, generating greater revenue. Increased revenue and a higher number of cars manufactured allowed Ford to reduce his cost even further by applying economies of scale; e.g. buying more steel in larger quantities at a lower price. And a lower cost again enlarged the potential car-buying market place. And so on. In 1908 Ford sold just 5,986 cars for a price of $850. But in 1916, when he lowered the price by almost 60%, he sold an astounding 577,036 Model T cars. Each component of the cycle feeds the other, and with this cycle, Ford created a new mass market of car buyers.

In a similar way, Goodnight built another "virtuous business cycle," which he explains simply: "If the employees are happy, they make the customers happy…If they make the customers happy, they make me happy." Goodnight's statement may sound sappy and like something with as much credence as the "fortune" inside a fortune cookie. Yet this amazingly simple formula is one of the keys to SAS's long-term success because SAS actually does pays extraordinary attention to both employees and customers.

In effect, Goodnight has created his own self-reinforcing business cycle. When employees are happy, they stay-a very low
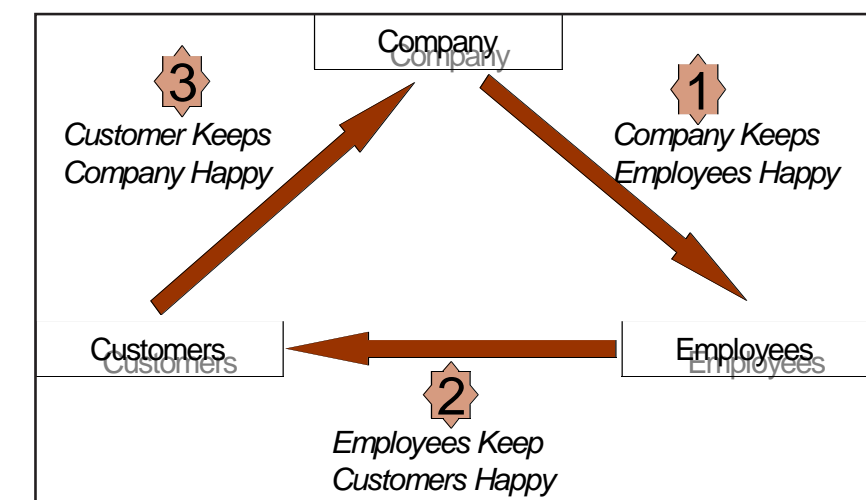
annual turnover rate of 3-5%. And when customers are happy they stay-a very high renewal rate of 98%. And when customers stay, they provide more revenue. And when the company gets more revenue, it hires more employees, in particular more sales folks. And more sales personnel win more new customers. And so on. The cycle just keeps going on and on.

The SAS cycle has a significant impact on its bottom line in two ways. First, because of its low employee attrition rate, Jeffrey Pfeffer, a Professor of Organizational Behavior at Stanford's University's Graduate School of Business, estimated that it saves more than $100 million on a base-at the time he did the study-of $800 million. Second, we know that acquiring a customer is much more expensive than retaining one. Since SAS has fully 80% of its revenue provided by existing customers, as I mentioned before, SAS spends less on sales and marketing. Put these two factors together and it helps explain why SAS's claim that it has always been profitable is a reasonable claim.

So, this little virtuous cycle keeps chugging along churning out higher and higher growth and continued profitability.

Ok. That's really neat. But how do you achieve this? Here are several ways.

For Employees

◆ **Provide Employees With The Opportunity To Have A Family Life --** The software industry is notorious for having employees work a phenomenal number of hours. In an interesting contrast, while Bill Gates created a culture at Microsoft that made it a macho point of pride to work 90 hour weeks, SAS encourages employees

to work 35 hour weeks. Why? So employees can spend time with their families. In Goodnight's opinion, "If you got a fifth-grader in his very first play, you should be there for it. We understand that."

Because SAS recognized that many of its employees were young woman who wanted to start a family, SAS set up its own on-site Montessori day-care center in 1981. This was free in the beginning, and now employees pay 1/3 of the standard rate for such services. And employees are encouraged to bring their children from day-care to the cafeteria so they may share time together during the day.

◆ **Create A More Egalitarian Culture --**Each employee has his own office. It is an article of SAS culture that whenever any building is constructed, it is designed in such a way that permits all employees to have their own offices. And all employees have the same benefits packages. The gardener has the same benefits package as the CEO

◆ **Provide A Way To Reduce Life's Normal Stresses --** Employees have an opportunity to use a 77,000 square foot fitness and recreation center-at any time of the day. They can use the services of a department called "work-life" whose purpose is "to relieve fellow employees of life's problems-from finding the right college for their kids to finding the right nursing home for their parents." They can even drop off their dry-cleaning at SAS and pick it up later.

For Customers

Professor Pfeffer commented in the San Jose Mercury News, "Most software companies have contempt for the consumer.

SAS has a very different view. Go to a SAS users' group meeting and try to say something nasty about SAS and you'll be killed. Go to an Oracle or Microsoft users' conference and say something nice about the company and everybody will think you're smoking pot."

And a writer in Forbes remarked, "Other companies talk about being responsive to the customers. At SAS it isn't an objective. It's a religion."

How does SAS do this?

SAS has baked the attitude of caring about and listening to the customer into their business processes. Here are two examples.

⬥ **Making changes to existing products** - "Goodnight has mandated that every suggestion a user makes be written down. Once a year these suggestions are sorted, ranked and then placed on a ballot that is sent out to every SAS customer. The survey results are then analyzed. The top ten suggestions are almost always implemented."

⬥ **Product Release** - In its early years, SAS released a product that had bugs. Goodnight said it was both a painful and costly process to fix this problem, resulting in increased customer support staff, calls to each customer and working with them to get the new software installed. It was a lesson learned. From that point forward, it has been critical that a product be extensively tested so that SAS employees find the bugs, and not its customers. Also, according to Davis, the "product" released isn't just the software. All of the other parts that are important to a customer must be there as well: training classes, documentation, and customer support knowledgeable about the new product or the software upgrades.

5. Being A Public Company Is Over-Rated. Stay Private.

Staying private is the bedrock foundation upon which Goodnight has built his business. Like Atlas holding up the world, this strategy sits under and supports all other strategies. Why? Because Goodnight set his own corporate agenda and didn't have one forced upon him by Wall Street.

What objectives might have gone with the wind if SAS went public?

1. A focus on the long-term. While others were laying off staff in 2001 and 2002 because of the severe market downturn, SAS was hiring. It added an additional 6% of its staff in 2001 and an additional 8.5% more in 2002. "The past two years have been a building time for us, to take advantage of the economic slowdown and bring some really good staff in," said Goodnight. If SAS went public, such a move as hiring would have been viewed as reckless, adding more fixed cost at a time of dropping demand, and the stock would have tanked.

2. A very strong focus on employee satisfaction. Do you think a board of directors for a public company would have agreed to the set of extraordinary benefits that SAS provides? No matter what SAS says about how their actions-- having medical facilities on-site, for example--reduce cost, a hard-nosed board would have to seriously question the wisdom of these employee benefits. And employees seem to know this since in a poll SAS conducted, 87% of employees said they did not want to go public.

3. A focus on slower, but steady growth. SAS has steadfastly remained with its subscription billing model. Wall Street rewards rapid growth. If SAS had

gone public, there would have been considerable pressure to change its pricing model to a more aggressive one.

All in all, SAS is a study in how a private company can create its own destiny, following the path not taken, bushwhacking its way towards long-term success.

Summary

From SAS there are some powerful lessons to be learned:

1. Choose subscription pricing to provide a more stable and predictable revenue stream.
2. Be cautious about outsourcing. It may increase cost and sacrifice quality.
3. Executives and managers should be craftsman in their jobs, not just paper-pushers, creating a leaner, more agile company
4. Make it an article of faith that you will pamper your employees and customers producing an on-going "virtuous business cycle" of growth and profitability.
5. Staying private is a way to build a large successful software business.

Brian Turchin is founder and president of Cape Horn Strategies, Inc., a five-year old advisory, research and management consulting firm to the software industry. He is currently writing a book on success strategies in the software industry, focusing especially on what strategies drive long-term profitable growth. Brian can be reached at (516) 377-4244 or bturchin@capehorn-strategies.com

This column is based, in part, on interviews with Dr. Jim Goodnight, co-founder, CEO and President; Keith Collins, Sr. V.P. and CTO; Jim Davis, Sr. V. P. and CMO; and Jeffrey Babcock, V.P. U. S. Public Sales, SAS North America.

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