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Third-party Partnerships Hold the Future in Software R&D

Sruthi Ramakrishnan

New pricing models have added to the attractiveness of partnerships with third-party vendors. Their growing maturity, ability to innovate quickly and 'go-to-market' strategy make them the answer to challenges faced by companies

The potential of third-party vendors in software R&D is still unexploited. Zinnov's study on Software R&D Globalization indicates that only 5% of R&D budgets are currently being spent on outsourced partnerships, which means about 95% of the R&D is conducted by companies in-house (HQ, Captive models).

The slow recovery from recession means that companies are still jittery to spend more; instead, they plan to optimize the investments made over the last 12 months. "There is increased R&D activity in the ISV space, but lack of venture capital (VC) spending is affecting R&D spending for startups. The challenge is that there is still lack of capital, which is especially affecting VC-backed startups, though established ISVs are starting to invest in product development activities once again," says Vishal Gauri, President & Head of Customer Solutions at Nagarro.

For many of the large sized companies that participated in the Zinnov survey, mature/ existing products account for more than 75-80% of their total revenues, and hence they have to invest heavily on maintaining and enhancing these products to suit requirements.

In keeping with their low spend strategy, companies are now focusing on new products for both the US market and the emerging markets to tap into newer opportunities and newer customer requirements. "We have seen that clients want to reduce spend on mature products in the last 3-4 years," says Amitava Roy, COO, Symphony Services. "Most software companies are looking to maximize ROI from their software products, while extending their output from their R&D teams on newer products. Over 80% of total software R&D spend goes towards activities to support the products that are in maintenance mode. Yet margins on new products are significantly higher than on maintenance contracts. This presents two major challenges to software product companies today - freeing up resources to work on new products and maintaining margins for legacy products," he says.

It is to meet these challenges that low end R&D work like QA/testing related to mature products is outsourced to offshore locations. "Outsourcing sunset products provides the bandwidth of resources to work up on new products and maintain or increase revenue streams," said Vamsee Tirukkala, Co-founder and Managing Principal, Zinnov during a recent webinar on 'Globalization Opportunities in Software Development for Enterprises and ISVs', conducted by Global Services.

Today, the majority of companies are increasing R&D spend in captive centers in emerging geographies such as India and China. Mr. G H Rao, Corporate Vice President and Head, Engineering and R&D Services, HCL Technologies says, "There have been multiple cases where players in the industry have provided high end R&D activities like architecture definition and performance tuning services from India and China. Most of the top software product companies have large R&D teams in India and these teams own complete product development and product roadmap management from India."

But captive centers, irrespective of their geographic location, have their share of challenges. "The biggest captive center challenge is the tag and the brand recognition to attract and retain people," Tirukkala said. "As a thumb rule, especially in emerging economies like India and China where career paths are more important than the prospect of just working for an MNC company, it is a significant phenomenon of captive centers not being able to contain attrition and attract the right talent."

The third party vendors are an answer to such challenges. Says Tirukkala, "A huge trend we are seeing in the industry in the last 18 months is what we call as the 'go-to-market' strategy. It is what vendor partners can bring to the table. If you are a partner in a well-known reputed company, they have the capability of taking your product to multiple markets." So the question that companies are asking is- should we develop it on our own or should we get a partner who can not only develop it for me but also help me in penetrating newer markets and support me in expanding my existing market?

Other challenges faced by companies, especially small and medium sized ones, including higher total cost of ownership, high set up cost and lower productivity are also leading them to work directly with third-party providers. "The future of product development will be working with a lot of partners to innovate and build cutting edge products very quickly," said Jacob Hsu, CEO, Symbio at the webinar.

The new pricing models (outcome based pricing, revenue share pricing and risk reward pricing) offered by vendors to clients and a higher propensity to leverage them as an antidote to the recession have added to the attractiveness of partnerships. Companies are now looking to leverage the risk-reward partnership model, where the vendors are willing to absorb a certain amount of business model risk, across the lifecycle of products. "More ISVs are starting to use their engineering vendors as their value partners," says Rao.

These trends certainly pave the way for further growth of third-party R&D vendors.