Vendor Needs and Strategies

Ultimate Software: Successfully Navigating the Transition from On-Premise to Cloud ISV as a Public Company

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IDC OPINION

In 1998, when the company went public, Ultimate Software (Nasdaq: ULTI) sold on-premise software to manage human resources (HR) and payroll. Then in 2000, the dot-com crisis changed the way many of its customers and prospects wanted to buy software because they could no longer afford to pay for it up front. So the executive team at Ultimate made the decision to flip the business model from licensed software to recurring revenue and to rewrite the software. It took four years of focus and discipline, during which Ultimate never laid off an employee or reduced compensation or benefits, until Ultimate began generating positive cash flow in 2004. Since that time, the company has never looked back and is now, in 2014, about to transition the few remaining on-premise customers to the cloud while sustaining a people-first corporate culture, meeting a commitment of 95% customer retention, and growing the company from $72 million in 2004 to $410.4 million in 2013 and on its way to top $1 billion in 2018. Key findings include:

- Ultimate Software made the successful transition from an on-premise to a SaaS provider while also fueling top-line revenue growth and achieving profitability according to generally accepted accounting principles (GAAP), a rare achievement for a pure-play SaaS company.
- Ultimate was able to meet its financial goals without losing focus on the core tenants of the business: people-first, employee-centric culture; commitment to customer retention and success; and continued investment in innovation.
- Ultimate made this transition as a publicly traded corporation.
- Starting with a core human resources and payroll offering, Ultimate leveraged the cloud to innovate its product offerings by adding time and attendance, employee onboarding, performance management, succession planning, compensation management, and recruiting modules, as well as expanding the global offerings, business intelligence, and analytics focused on people management solutions.

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IN THIS STUDY

This IDC study reviews Ultimate Software (Nasdaq: ULTI), a provider of people management solutions, and its transition from delivering exclusively on-premise solutions to SaaS as a publicly traded company. On May 22, 2014, IDC had an opportunity to meet with CFO Mitch Dauerman to talk about how Ultimate made this transition. Many independent software vendors (ISVs) have been reluctant or have struggled to make this transition because it is very hard to do when the company has a solid base in the licensed software world and the shift to recurring revenue often causes a reduction in current revenue as the company moves from recognizing revenue immediately to recognizing it monthly over a multiyear period.

SITUATION OVERVIEW

Ultimate bet its whole company on the transition from licensed software to SaaS. Many independent software vendors have been reluctant or have struggled to make this transition because it is very hard to do when the company has a solid base in the licensed software world and the shift to recurring revenue often causes a reduction in current revenue as the company moves from recognizing revenue immediately to recognizing it monthly over a multiyear period. A look at Ultimate Software's results over a 14-year period while it made this transition provides a useful example of the focus and discipline required to succeed.

Company Overview

Scott Scherr, CEO of The Ultimate Software Group, founded the company on October 1, 1990. Previously Scherr had been with ADP for 11 years, and he believed he could provide a better HR and payroll offering to the market with a licensed product rather than a service bureau offering. The initial focus for the company was an HR and payroll solution for midmarket companies.

In 1993, Ultimate launched a DOS-based version of the product and started selling it around the United States. In 1997, Ultimate launched the first 32-bit, object-oriented HCM product, and its revenue was $17 million. In June 1998, when Ultimate became a public company, the company transitioned to client/server and saw its revenue jump to $43 million. The second quarter of fiscal year 2000 was the best financial quarter in the company's history at that time, and then the dot-com crisis occurred, and it was difficult to sell licensed software. Companies no longer wanted to pay an up-front license fee but were used to paying monthly or quarterly for payroll service bureaus.

So Ultimate decided to flip the business model from licensed software to recurring revenue. The development organization estimated that it would take two years to rewrite the software in the cloud. Executive management decided that they would place the bet and continue selling on-premise software for the two years development needed. Executive management also made the decision at this time that they would not lay off any employees during this transition or make any changes in employee benefits, for which the company pays 100% of medical, dental, and vision coverage for employees and their families, and would continue to match employees' contributions to the 401(k) and give equity to all employees.

In 2002, the SaaS model, one of the first (if not the first) HCM solution in the cloud, was ready. The executive leadership put together the business plan they thought would succeed for Ultimate in a recurring revenue model:

- Grow recurring revenue 25% per year
- Exceed 95% client retention rate per year and migrate the on-premise clients base to the cloud
- Grow operating margins

At this point, Ultimate's stock price was hovering at $2–4 (the company had gone public at $10 and reached a high of $15 before the dot-com crisis), and the 2002 annual revenue was $55.1 million. But the executive leadership believed they could reach $100 million in 2006 by basing the company on the recurring revenue model. As it turned out, by the third quarter of fiscal year 2004 (September 30, 2004), Ultimate was again cash flow positive, and by the fourth quarter of fiscal year 2004, Ultimate was profitable (exclusive of stock-based compensation expense) and the company and its leadership never looked back.

Culture

Ultimate's motto and corporate culture is "people first" — which means taking care of Ultimate's employees first and the employees will take the best possible care of customers. There are no employment contracts or noncompete agreements (although if an employee leaves Ultimate to work for a competitor, he/she cannot return to Ultimate). Every employee has equity in the company. Ultimate pays 100% of employee benefits. The only change to benefits has been an increase in the 401(k) employer match from 25% to 35% (there is no cap on the match). Even during the 2008–2009 recession years when many companies laid off employees and/or cut benefits, Ultimate chose to remain true to "people first." Ultimate has repeatedly been recognized for its people-first culture, including *FORTUNE*'s "Best Companies to Work For" (2012, 2013, and 2014), and also ranked as number 4 on the inaugural list of "10 Great Workplaces for Millennials" by Great Place to Work and Great Rated!

All new hires are brought to Ultimate's headquarters in Weston, Florida, for a new hire orientation. During that two-day event, Scherr, the CEO and founder of the company, will take the time to meet everyone. He will also make it clear that everyone is there because he/she was recommended by another employee. The message is clearly "we're going to take care of you, you have to do your job, you need to be passionate about your job, you need to take care of each other, and you need to take care of your customers."

Ultimate also treats its sales team as if they were building their own franchise rather than punishing them for being successful. Quotas are raised when there is new product to sell, and Ultimate builds accelerators into their compensation plans to motivate them to grow the business. Also, while the company was making the transition from on-premise sales to SaaS, a higher quota credit was given on SaaS deals.

Finally, it's all about trust. Trust that your coworkers will be there to back you up. Trust that management will support you for doing the right thing. Trust that when things go wrong, Ultimate's team will be there to fix it.

Product/Service Offerings

Ultimate Software delivers a suite of people management solutions as follows (attach rates for products beyond the central core HR and payroll exceed 50%):

- **Core HR/Payroll** SaaS was introduced in 2002. All Ultimate customers use the core applications.
- **Time and Attendance** was introduced in 2005.
- **Employee onboarding** was introduced in 2008.
- **Performance Management** was introduced in 2007.
- **Succession Management** was introduced in 2007.
- **Compensation Management** was introduced in May 2014.
- **Recruiting** was made generally available in 2004, and a completely redesigned version was launched in May 2014.

In 2002, the original SaaS product offering from Ultimate was core human resources and payroll offered as a per-employee-per-month subscription. In 2014, the additional products and value have increased that opportunity fivefold, depending on the customer's requirements and choices of modules. It's important to note that the customer does not pay up front for the product subscription; instead, charging starts when activation is complete. In addition, standard product training is provided for free for the customer's lifetime.

Also, Ultimate is investing over 20% of annual revenue in research and development (R&D) to make the product better. In FY14, the company is estimated to spend $105 million on development (some portion of this spend is capitalized). Over 600 of Ultimate's more than 2,000 employees work in the development organization. Spending 20% of total revenue on R&D is an outstanding benchmark. Plus, all of the investment is going into Ultimate's suite of people management solutions. Other companies may say they invest more in total dollars, but the percentage spent is often more indicative of the R&D emphasis.

Financial Performance

When Ultimate first launched the re-architected multitenant solution in 2000, only 17% of revenue was recurring. During the next four years, the company went through the flip in the business model as a public company. Total revenue went down initially, but by 2004, the company could see that recurring revenue was now 54% of total revenue. It was also at this time (2004) that Ultimate returned to supporting itself with positive cash flow from operations.

Table 1 provides a look at Ultimate Software's financial performance for the period from 2007 to 2013, for which press releases and financial results are all available on the Ultimate Web site (**news.ultimatesoftware.com/news_releases/financial_releases**). Growth in total revenue, recurring revenue, and GAAP operating income is shown graphically in Figure 1. The focus on GAAP operating income here is deliberate as many SaaS-based software companies discuss operating income and profits as non-GAAP as it is often easier or faster to show profitability.

In the 12 years since 2002, Ultimate has delivered a 29% CAGR on recurring revenue (as a reference point, the worldwide $10.4 billion HCM market had growth of 9.1% in 2013 over 2012). It shows consistent, steady growth that has outpaced the market for the past 10 years, and the company delivers these results year after year. As of the first quarter of FY14, Ultimate had delivered 21 consecutive profitable quarters on a non-GAAP basis. Ultimate believes that its focus on "people first" has enabled it to build products that customers want to buy, and then the company retains those customers by partnering with them to continue to innovate on new products from concept to delivery. The financial results are an outcome of this people-first culture.

TABLE 1

Ultimate Software Financial Performance, 2007-2013 ($M)

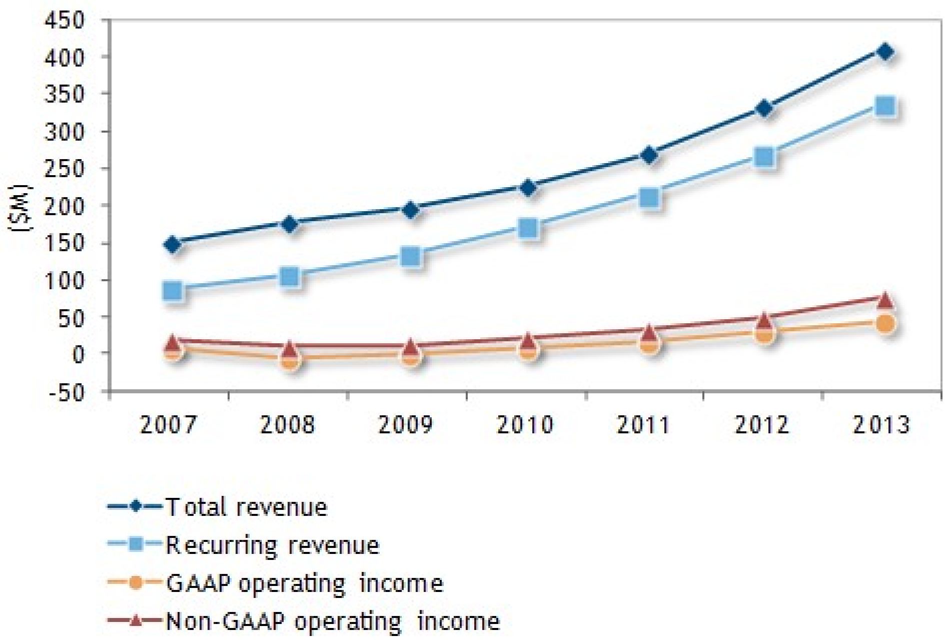
Fiscal Year	Total Revenue	YOY Growth in Total Revenue (%)	Recurring Revenue	YOY Growth in Recurring Revenue (%)	Recurring Revenue as a Percentage of Total Revenue	GAAP Operating Income	YOY Growth in GAAP Operating Income (%)	Operating Income as a Percentage of Total Revenue	Non GAAP Operating Income	YOY Growth in Non-GAAP Operating Income (%)
FY13 (year ending December 31, 2013)	410.4	23.5	334.4	25.5	81.5	43.2	48.4	10.5	76.3	54.0
FY12 (year ending December 31, 2012)	332.3	23.4	266.4	24.6	80.2	29.1	77.2	8.8	49.5	57.1
FY11 (year ending December 31, 2011)	269.2	18.2	213.8	25.1	79.4	16.4	99.3	6.1	31.5	44.8
FY10 (year ending December 31, 2010)	227.8	16.1	170.9	28.3	75.0	8.2	NM	3.6	21.8	63.8
FY09 (year ending December 31, 2009)	196.3	10.3	133.2	25.4	67.8	-0.2	NM	-0.1	13.3	20.8
FY08 (year ending December 31, 2008)	178.0	18.6	106.2	23.2	59.7	-4.2	NM	-2.4	11.0	-38.8
FY07 (year ending December 31, 2007)	150.1	31.1	86.2	35.3	57.4	8.0	NM	5.4	18.0	97.9

NM = not material

Source: IDC, 2014

FIGURE 1

Ultimate's Total Revenue, Recurring Revenue, and GAAP and Non-GAAP Operating Income, 2007–2013



Source: IDC, June 2014

Customers

Ultimate currently has over 2,700 customers in a broad range of diverse vertical industries, with more than 15 million people records in the cloud, in over 150 countries. The customer retention rate has consistently remained at 96% or higher for 10 years.

Table 2 provides information on the progress Ultimate has made moving its historically on-premise customers to the cloud. Figure 2 shows Ultimate's progress in moving the company's customers to the cloud, while Figure 3 shows the growth in people records managed in the cloud.

In early 2012, Ultimate provided notice to its customers that it intended to support only a cloud offering by the end of 2014, meaning customers had to move to Ultimate's cloud or move to another provider. Nearly all Ultimate customers have chosen to move to the Ultimate cloud. In 1Q14, a 20,000-employee hotel company and a provider of HR solutions to small and medium-sized businesses with 36,000 employees moved from Ultimate's on-premise legacy applications to the cloud.

TABLE 2

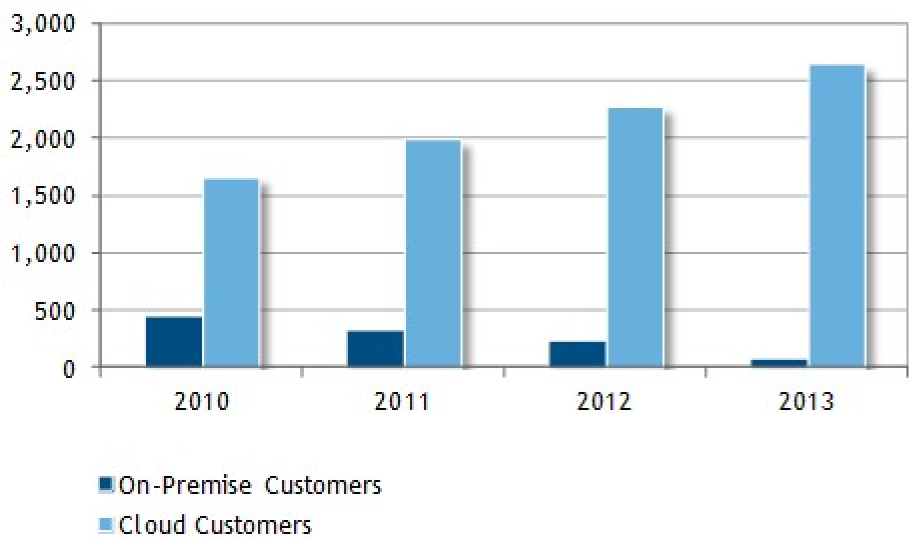
Progress in Shifting Customers from On-Premise to Cloud, 2010-2013

Fiscal Year	Total Customers	On-Premise Customers	Cloud Customers	People Records in the Cloud (M)
FY13 (year ending December 31, 2013)	2,700	70	2,630	15.0
FY12 (year ending December 31, 2012)	2,500	237	2,263	13.0
FY11 (year ending December 31, 2011)	2,300	324	1,976	10.7
FY10 (year ending December 31, 2010)	2,100	450	1,650	9.0

Source: IDC, 2014

FIGURE 2

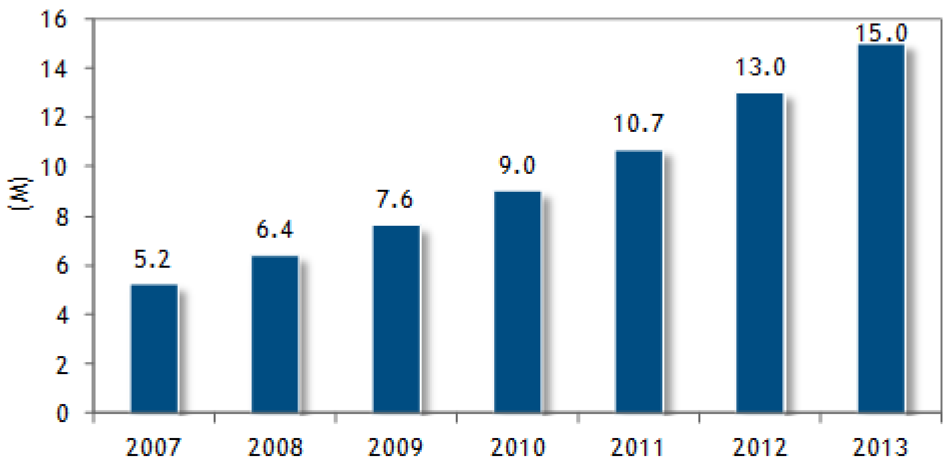
Progress in Shifting Customers from On-Premise to Cloud, 2010-2013



Source: IDC, June 2014

FIGURE 3

People Records in the Cloud, 2007-2013



Source: IDC, June 2014

Why Has Ultimate Software Been Successful

When Scherr started Ultimate in 1990, he raised about $300,000 from friends and family and believed he would need no additional investments. But the reality was that the company needed another $99.7 million, which came from friends and family along with two venture capital firms (through 1997), an IPO (in 1998), and subsequent private into public equity transactions with institutional type investors (2000–2004).

Another reason for Ultimate's success is that the company had the discipline and focus to say "no." In 2000–2002, while it was building the SaaS products, Ultimate continued to sell the on-premise solution with a perpetual license. When the company delivered the SaaS offering, it learned that it was really hard to sell both the SaaS offering and the on-premise solution. As new products were added to the mix, they were available only as a cloud offering. Finally, Ultimate had the courage to say "no" to its customers that wanted to remain with an on-premise solution.

Another important reason for Ultimate's success is the "people first" strategy and the leadership provided by CEO Scott Scherr. It really does work. The people-first culture also supports Ultimate's commitment to customer success and retention – "Customers for Life." Ultimate takes care of its employees, employees take care of customers, and customers refer other customers to Ultimate.

Finally, moving to the SaaS offering allowed Ultimate to accelerate its product innovation and expand its offering beyond the original HR and payroll to a full SaaS HCM suite of applications.

FUTURE OUTLOOK

For FY14, Ultimate has once again provided guidance for 25% recurring revenue growth and 23% total revenue growth.

Ultimate's goal is to become a $1 billion company in 2018, at which time it estimates that it will have 10% of the North America market for HR, payroll, talent, and time solutions. Given its track record and determination, there's every reason to believe that Ultimate Software will meet its goals.

ESSENTIAL GUIDANCE

For Customers and Prospects

According to the May 2014 Ultimate Software customer survey, customers that choose Ultimate Software are typically looking for the following:

- Unified people management solutions for HR, payroll, talent, and time
- Strength of functionality
- Cloud technology/SaaS
- Reporting, analytics, and business intelligence to answer questions such as predicting turnover

Generally, Ultimate's customers think strategically about human resources. Many of them have a strong focus on corporate culture, just as Ultimate does. They want to empower employees to be better performers and to get HR to be a strategic partner in the business.

Finally, talk to other Ultimate customers. Ultimate runs two customer satisfaction surveys annually, and according to the April 2014 survey, about 90% of the primary UltiPro users in its customer base are referenceable. (Note that some companies may not be referenceable because it is against corporate policy and not because they are unhappy with their solution provider.)

For Other ISVs Transitioning from a License to Recurring Revenue Business Model

ISVs looking to make a similar transition are advised to learn from Ultimate Software:

- Deliver your core product and then add additional value (e.g., products) to increase the value and the average selling price. This also gives the customer additional reasons to move to the SaaS offering beyond just updated technology.
- Set goals. Ultimate treats every sales year like a championship season and sets revenue goals of $100 million, $400 million, $1 billion, and so forth.
- Think long term. Take care of employees, and they will take care of the company and the customers.

- Understand the investment that needs to be made, make a business plan, and then execute on the plan.
- Marketing is important. Prospective customers need to know who you are.
- Focus on retaining customers while migrating them from on-premise to SaaS.

It sounds like basic blocking and tackling, but it works. Too often, ISVs get distracted by a potential opportunity, by taking on too much or not having the discipline to manage through the investment period.

For Ultimate Software

What more can be said? By continuing on the current path of "people first" and delivering 25% recurring revenue growth annually, the goal of reaching $1 billion in annual revenue in FY18 should be relatively easy.

LEARN MORE

Related Research

- *Worldwide Human Capital Management Applications 2013 Vendor Shares: Total Market, Core HR, Workforce Management, Recruiting, Learning Management, Performance Management, and Compensation Management* (IDC #248742, May 2014)
- *Person-Driven HR: Notes from Ultimate Connections 2014* (IDC #248107, April 2014)
- *Worldwide SaaS and Cloud Software 2013-2017 Forecast and 2012 Vendor Shares* (IDC #245084, December 2013)
- *Ultimate Software 2Q13 Earnings: Record Recurring Revenue Up 25% Over Previous Year* (IDC #lcUS24307313, September 2013)
- *Key Takeaway's from Ultimate Connections 2013: Global Expansion and Integration as a Service* (IDC #lcUS24034013, March 2013)
- *Ultimate Software's Q4 and 2012 Results Show There's Profit Potential When ISVs Move to the Cloud* (IDC #lcUS23956713, February 2013)

Synopsis

This IDC study reviews Ultimate Software (Nasdaq: ULTI), a provider of people management solutions, and its transition from delivering exclusively on-premise solutions to SaaS as a publicly traded company. On May 22, 2014, IDC had an opportunity to meet with CFO Mitch Dauerman to talk about how Ultimate made this transition. Many independent software vendors have been reluctant or have struggled to make this transition because it is very hard to do when the company has a solid base in the licensed software world and the shift to recurring revenue often causes a reduction in current revenue as the company moves from recognizing revenue immediately to recognizing it monthly over a multiyear period. A look at Ultimate Software's results over a 14-year period while it made this transition provides a useful example of the focus and discipline required to succeed.

"Many ISVs have struggled to make the turn from selling on-premise software, with its large up-front payments, to a SaaS model that recognizes revenue on a monthly basis. Ultimate Software has successfully made that transition in a big way, without losing focus on its core value of "people first" and as a publicly traded company. It's an inspiring story and the entire team at Ultimate is to be congratulated on their success," says Christine Dover, research director, Enterprise Applications and Digital Commerce.

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