TECHNOLOGY BUSINESS RESEARCH, INC.

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# TOP 5 PREDICTIONS FOR CLOUD & SOFTWARE IN 2023

## Cloud vendors will use predictable strategies for unprecedented times in 2023

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# VENDORS WILL FOCUS ON COST AND PARTNERSHIPS TO WEATHER 2023 UNCERTAINTY

2023 will mark the first time the mature cloud market has been tested. Cloud served as an alternative IT cost-savings measure in the wake of the 2008 financial crisis, but it is no longer a small, insignificant portion of the average customer's IT budget. While cloud spending and the overall market opportunity will continue to expand in the coming year, we expect that growth to be altered by the macroeconomic environment. In response, we believe cloud vendors will go back to basics, focusing on cost and employing the assistance of their maturing ecosystems to weather the environment. As a reflection of the uncertainty felt by customers, and the pullback and spending that will result, many cloud decisions will be based on cost savings yet again. The benefits of agility, innovation and business expansion will remain at the core of cloud purchasing decisions, but a thorough evaluation of the cost of cloud versus that of alternative solutions will play more of a role in 2023 than in the preceding years. Vendors in the cloud space may face slightly longer sales cycles, additional financial scrutiny and increased negotiation to secure deals. We also expect to see more competition and growth from vendors below the top tier of cloud providers. As more significant workloads have moved to cloud, the need for complementary solutions like data management and security has increased. Lastly, cloud partnerships will underpin the growth that will occur — albeit it at a slower rate than has been seen over the past five years. The growth of indirect cloud revenue, through systems integration engagements, cloud-based ISVs, managed service providers and resellers, will play a pivotal role in the continued expansion of the market. We expect these trends to shape the cloud market in the face of an unprecedented challenge in 2023.

# PREDICTIONS

## COST COMES BACK INTO VOGUE

**Trend:** Cost reduction or minimization will play a more prominent role in customer decision making for cloud solutions in 2023.

**Driver:** Rising inflation, a bear stock market and a pending recession will make businesses behave much more conservatively. Cloud solutions will not be immune to increased scrutiny in spending in 2023.

**Result:** Cloud will continue to grow, but sales cycles may be extended as customer teams fully evaluate the costs and alternative options. Cloud vendors will shift their value propositions to highlight the cost-effectiveness of their solutions rather than just the technological merits.

After 15 years in existence, the cloud market has been around long enough to see some trends start to repeat themselves. We expect cost to play a similar role in the evaluation of cloud purchase decisions in 2023 as it did in 2008. Challenging economic conditions, like those seen in 2008 and expected in 2023, cause businesses to err on the side of conservative spending and investment patterns. Spending slows down, gets reduced and is subject to more financial evaluation before expenses are approved. Cloud was a much smaller portion of IT spending in 2008, and adoption was accelerated in that period because it allowed organizations to shift expenses to operating expense budgets and pay only for what they needed, reducing both cost and risk.

Since then, the main drivers of cloud solutions have drifted away from cost reduction in favor of innovation, organizational agility, and the promises of returns through new business initiatives enabled by cloud. Cost is still an important consideration, but not the primary driver of most cloud implementations. While we do not believe increased cost scrutiny will have a pronounced impact on cloud growth, it will play a much more prominent role in the growth of the market in 2023.We expect cloud vendors to tweak their messaging and positioning to address customer cost concerns during the year to minimize the impact to sales cycles and continued market growth.

## THE BIG AND THE SMALL GET BIGGER

**Trend:** Dominant vendors across the cloud spectrum will continue to maintain growth momentum, but smaller pure plays will also expand their businesses.

**Driver:** The scale of cloud investment by customers of all demographics is providing ample growth opportunity. With cloud accounting for a significant portion of most IT budgets, the cloud market will grow regardless of the macroeconomic conditions in 2023.

**Result:** Some of the highest revenue growth rates will come from pure play vendors in emerging segments of the cloud market, such as cloud data warehousing, security, intelligence and automation.

Over the last couple years, a tension has developed between the major cloud platform vendors like Amazon Web Services (AWS), Microsoft and Google, and their ecosystems of ISV partners. The dynamic is not new and has existed in other technology ecosystems, since the "hub" vendor at the center could, in theory, enter many of the adjacent spaces occupied by partners. While cloud platform providers are focused on driving the consumption of their core infrastructure offerings, they have expanded into adjacent spaces offering the most sizable opportunities to support that primary goal. Kubernetes cluster management, database solutions and serverless automation are some examples of those large adjacent spaces where AWS, Microsoft and Google each offer native solutions to drive customer consumption.

Cybersecurity and data warehousing are two sizable markets with significant participation from pure play vendors that should see significant growth during 2023. Cybersecurity is a more than $150 billion market and includes a multitude of pure play vendors that are scaling quite quickly, spurred by the increase in cyber threats. The increased importance of cybersecurity led to Google's acquisition of Mandiant during 2022, but many independent vendors remain. In data warehousing, a handful of large disruptive pure play vendors are already well established, including Snowflake and Databricks. The transition of data to the cloud is still in very early days, however, and traditional vendors like Oracle, Microsoft, IBM and SAP are all facing challenges to retain existing clients against newer market entrants.

## CLOUD GROWTH IS GENERATED BY PARTNERSHIPS

**Trend:** Growth in adoption, through new customer acquisition, expansion of workloads, and addition of net-new projects, will be led by partners in 2023.

**Driver:** In addition to maintaining their existing workloads, customers require assistance in the assessment, design, implementation and operation of most projects supported by cloud services.

**Result:** Partner program structure and operations will determine which vendors succeed and fail in capturing new cloud opportunity.

In the traditional software market, the mix of indirect partner-led revenue generation ran the gamut from a low of 25% for enterprise-focused vendors like SAP to a high of 95% for a vendor like Microsoft. In the early days of cloud, the mix of indirect revenue was skewed toward the lower end, as the direct sales approach was the first logical way to establish and grow a customer base. However, partner involvement has steadily increased over the past decade, along with the importance of having a diverse ecosystem of service, reseller and ISV partners heavily involved in the cloud go-to-market model. A major factor in this shift, which will come to a head in 2023, is the type of workloads and use cases for which customers are using cloud solutions. SAP may be the best example of this trend, as partners are a requirement to implement new or updated SAP Business Suite 4 HANA solutions, whether on premises or on partner clouds. Furthermore, now that cloud represents a greater share of most customers' IT investments, they are looking for ways to consolidate purchases and leverage cloud marketplaces to procure and consume partner ISV solutions. We believe the total value of the software sold through cloud marketplaces from vendors like AWS, Microsoft, Google and Salesforce was more than $50 billion in 2022, and anticipate that figure to grow in the 25% range during the coming year. Consumption of resources and services directly from cloud vendors remains a significant portion of the market opportunity, but due to these factors we believe most of the growth in cloud consumption — in the form of new SaaS deployments, marketplace ISV title consumption, and new projects — will involve a partner's intellectual property or services.

## LOOKING TO MEET A NEW SET OF BUSINESS-LED USE CASES, HYPERSCALERS INVEST IN CLOUD-NATIVE PAAS, BUT NOT WITHOUT INFRINGING ON PARTNERS

**Trend:** Hyperscalers increasingly monetize PaaS offerings, creating competitive headwinds and opportunities for pure plays.

**Driver:** A commoditizing IaaS market makes differentiation difficult and pushes vendors up the cloud stack.

**Result:** Hyperscalers build out their cloud-native tooling, infringing on some pure play opportunities. At the same time, hyperscalers will recognize the need to partner with the smaller vendors to offer clients more flexibility and choice.

Coopetition has become standard for the cloud market, and vendors are increasingly trying to navigate how they work with partners to offer clients maximum flexibility yet compete with their own native services. Over the past few years, we have seen the leading hyperscalers supplement their IaaS offerings with platform-layer services in areas like data warehousing, analytics, IoT, Kubernetes, data management and machine learning. Naturally, as the hyperscalers' native PaaS capabilities improve, partners that market themselves as vendor-neutral and applicable across clouds, edges and data centers may feel increased pressure. Such vendors, like Informatica, Snowflake, Databricks and Red Hat, among others, still carve out a niche in the market by offering more customizable, feature-rich platforms that are popular among multicloud businesses looking to consolidate workloads. Nonetheless, with their deep pockets, the hyperscalers have proved their ability to invest alongside enterprise demand, and it would not be surprising to see the big players build out their capabilities, either organically or through acquisition, to better compete with their respective peers and maximize client wallet share.

Things to watch in 2023:

- **Will AWS go multicloud?**: While offering a broad portfolio of hybrid cloud solutions, AWS, unlike most of its peers, has yet to fully adopt a multicloud strategy. In many ways , this approach makes sense considering, as the IaaS incumbent, AWS is largely concerned with driving up consumption for its infrastructure services. Customers, however, have made their views on multicloud clear, and at some point, we expect AWS will be forced to adapt. This initiative could start in 2023, should AWS decide to make its Elastic Kubernetes service — EKS Anywhere — available truly anywhere, including on the clouds of its competitors.

AWS may not go much further toward multicloud in 2023, but down the road, the reality of multicloud should push the company to offer some additional services that integrate with other cloud providers. While offering cross-cloud solutions could come at the expense of some infrastructure revenue dollars, AWS' portfolio breadth and developer-friendly tools, not to mention its leading IaaS capabilities, may make it difficult for peers to make any kind of material dent in its customer base.

- **A large hyperscaler acquisition at the data layer cannot be ruled out**: Rather than building out their PaaS capabilities internally, some cloud leaders may choose to acquire one of the more established cloud-neutral PaaS vendors. Such a move would indicate a shift in how the leading hyperscalers are using their established positions in IaaS to expand in new areas. Google Cloud, which is often viewed as a leader in data analytics and AI use cases, and is also prioritizing revenue growth over margin expansion, could be a candidate to acquire a data management or data warehousing company. Google Cloud recently acquired Mandiant to strengthen its cybersecurity play and could take a similar approach, adding to its already leading data capabilities to differentiate from peers.

- **Macroeconomic uncertainty shifts customers to best-of-suite PaaS**: The inflationary environment is causing cloud buyers to re-evaluate certain migration decisions, and some customers may look to consolidate tools that are rolled up into their cloud bill rather than pay for multiple disparate platforms. Best-of-breed SaaS remains standard for many, but as a result of market dynamics, we could see some customers consolidate at the data layer, exploring data fabrics or similar solutions, to control the costs associated with operating multiple data silos.

Even considering these implications, it is not all upside for the major hyperscalers as the neutral PaaS vendors offer customers more choice and flexibility and address their often-primary objective of avoiding vendor lock-in. As a result, the major cloud players must protect these relationships and walk a fine line between innovating internally and delegating to partners. At the end of the day, all the hyperscalers really care about is getting the underlying compute, which partner bring them. We suspect in 2023 Google Cloud and Microsoft will stay the course, investing in cutting-edge areas while nurturing their partner networks to help customers build and manage applications on different architectures. While AWS is still committed to its broad partner network, recent investment activities in areas like security, 5G and professional services, suggest the company is more actively trying to address the market opportunity from multiple fronts and position as a one-stop-shop for cloud. Due to the sheer volume and demand for AWS services, partners will not see tangible impacts, but this does signal an overall shift in the market where AWS, Microsoft and Google Cloud, as well as some of their Tier 2 counterparts, continue to strengthen their hold on the market, even beyond traditional data hosting.

## SAAS VENDORS WILL MORE AGGRESSIVELY PURSUE SOLUTION UP- AND CROSS-SELL TO EXPAND CLIENT ARPU AND WEATHER ECONOMIC PRESSURES

**Trend:** IT budgets face greater scrutiny by executive stakeholders, resulting in additional layers of approval during the procurement process and prolonging vendor deal cycles.

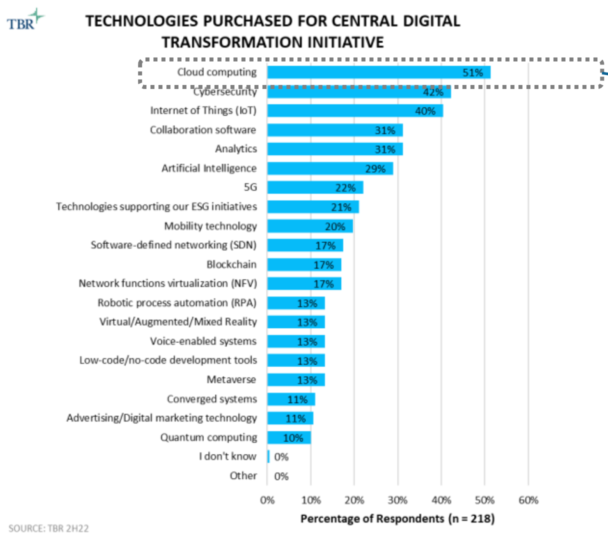
**Driver:** Persistent inflation, geopolitical tensions and fears of a global recession in 2023 have made enterprise IT buyers more risk-averse.

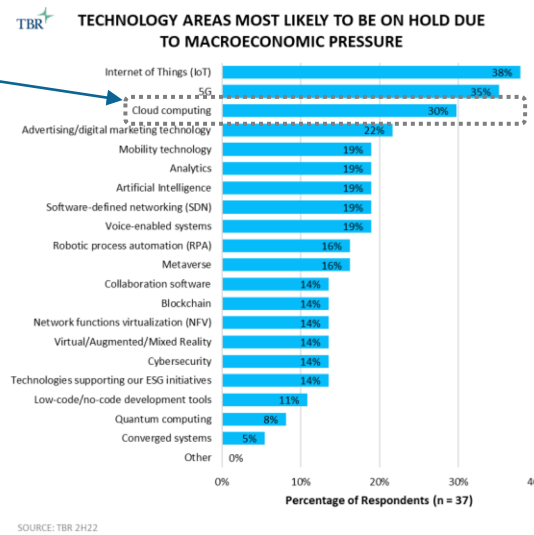
**Result:** Vendors aggressively bundle and layer value-add IP to expand client share of wallet to protect cloud margins and sustain SaaS growth amid user-seat growth slowdowns.

Vendors' quarterly performance and earnings commentary through the course of the year have painted an increasingly challenging picture of the macro economy. While challenges are broad in scope, issues related to inflation creating unfavorable foreign exchange (FX) dynamics as well as growing energy costs have been particularly challenging for cloud and application vendors, dragging down both revenue and margin performance through 2022. Microsoft, for instance, noted FX headwinds negatively impacted its Productivity and Business Processes (e.g., Dynamics 365, Office 365) segment revenue by 6 percentage points, or approximately $900 million, in 3Q22 alone. Further, the company stated FY23 data center energy costs would be $800 million higher than expected, impacting Microsoft Cloud and Azure gross margins during the quarter.

Though vendors remain optimistic, attributing revised revenue and profitability outlooks to the realities of the current economic climate, achieving these targets will require winning budget from customer organizations that are becoming increasingly risk-averse. This growing sense of unease among enterprise buyers was highlighted by both Workday and Salesforce on their latest earnings calls, with each vendor citing additional layers of required executive approval during clients' procurement processes. This dynamic resulted in prolonged deal cycles, and, more crucially, Workday elevated the importance of establishing business cases to alleviate executive concerns by proving the value of planned SaaS implementations. If clients moderate IT spend in 2023, SaaS vendors will not just be competing for smaller projects but will also need to articulate the value of new spend against the needs of the client — a dynamic that may necessitate greater involvement of IT services and consulting partners that understand how to position SaaS technologies as enablers of clients' discrete business processes. Outside of client subject-matter expertise, services entities have worked for years to gain the trust of key IT decision makers, trust which will grow ever more vital to capturing budget amid a challenging economic environment.

It goes without saying that cloud is a key enabler of enterprises' digital transformation programs. But, if macroeconomic challenges mount and IT budgets are increasingly trimmed as part of organizational cost reductions, when will IT buyers view their current cloud workloads as "good enough" for the time being? Many enterprises IT environments are far more modernized today than they were two years ago, before the pandemic necessitated the use of SaaS to support remote workforces. The opportunity that SaaS vendors were presented as a result of COVID-19 will certainly not be as strong in 2023, particularly when viewed through the lens of user-based licenses of SaaS offerings. For instance, if the looming recession fears result in global organizations trimming workforces to protect profitability, their SaaS footprints will likewise shrink, resulting in smaller revenue renewal bases for SaaS entities. This dynamic was reflected in TBR's customer survey for its upcoming *Digital Transformation: Voice of the Customer Research* report, fielded in October 2022.




It is against this backdrop that TBR feels SaaS vendors' sales and portfolio strategies will increasingly revolve around solution bundling and layering tactics in 2023. While cross- and up-sell tactics within existing install bases will reduce costs compared to net-new deal generation, they will likewise expand client average revenue per user, reducing per-client cost of services on a marginal basis. Layering capabilities like AI and natural language processing and greater client use of tools like low-code/no-code workload customization will increase SaaS vendor stickiness and the likelihood of SaaS renewals, despite growing competition between client lines of business for a contracted IT budget. Pursuing up- and cross-sell efforts within existing install bases will strengthen vendors' ability to close sales, as they already have the permission and trust of IT budget decision makers. While net-new account targeting will remain crucial, economic challenges will undoubtedly impact vendors' selling efforts. Maximizing share of wallet from existing customers provides a way for SaaS entities to augment new account deal flow and weather the challenging economic landscape in 2023.

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