

**Continuation of a Pattern: SAP Delivers
Margin Gains Despite Falling Revenues**

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SAP announced its Q3FY09 earnings on October 28, and it is a continuation of a pattern established throughout this calendar year of revenue decline but positive operating margin growth. Total revenues for q3 fell 10% over the comparable quarter of last year with software license revenues declining 31%, along with big declines in consulting and training revenues. The revenue decline in q3fy09 was accompanied, as in the previous quarter, by margin growth. This result was attained through gains in support revenue and cost reductions including headcount reductions and tax savings.

SAP's continued sound financial management has enabled it to deliver margin improvement in a difficult global business climate throughout 2009. From a geographic perspective, SAP's CFO Werner Brandt noted challenges in "emerging markets and Japan". SAP also saw significant revenue declines in its home country with a 13% revenue drop in Q3 and an 11% decline in the 9 months of 2009 to date for Germany. In the quarter, EMEA excluding Germany was the only region to see an increase in total software revenue including maintenance and support. Non-German EMEA is, in effect, SAP's largest market, twice the size of Germany and larger than the overall Americas market.

A bright spot for SAP was in the area of services margins. SAP has improved its services margin to 22.7% from 22.1% a years ago. In effect, SAP has carried on reducing capacity to maintain prices. This is reflected in the 11% cut in professional and other services headcount over the three quarters. The services costs exclude any share the €21m severance costs, which inflates the margin number, but it is still a good result in the current environment.

Q3 2009 is the first quarter which compares against a downturn quarter year over year. From that perspective, a worldwide constant currency decline in license, maintenance, and subscription revenues of 5% is somewhat disappointing. Next quarter, which will compare to a full-blown recession quarter (Q4 of 2008), will truly reveal how profoundly SAP is affected by the current economic climate.

SAP CEO Leo Apotheker noted: "we are pleased to see further progress in the evolution of our volume business as a result of smaller deals". This is a recognition of the fact that the heyday of large deals will not return, and this shortfall must be made up in a greater volume of smaller deals. IDC has previously noted that SAP's challenge is to increase the volume of deals by focusing on extensions to ERP within its existing base (especially, but not limited to large enterprises) and ERP to small-medium enterprises. (See "SAPPHIRE 2009: SAP Seeking Higher Deal Volume", June 2009, IDC #218750).

Offerings, such as the Best Run Now aimed at such upsells to the installed based are taking off, but have been insufficient to offset the decline in larger, suite deals. Rolling out Best Run Now packages, which are fixed-scope, fixed-fee packaged solutions including both software and services, to the wider partner ecosystem could cause a wider uptake of the initiative and a stronger revenue impact for SAP. Furthermore, IDC believes that new, industry-focused Best Run Now packages to complement the current horizontal packages could open a significant opportunity in the current economic climate. A higher percentage of the deals must go through direct subscription and the partner channel. Such deals are less profitable compared to direct sales due to higher discounts in the partner channel and due to lower prices for the subscription based delivery. This strategy is necessary to grow revenue, but it will make it difficult in the future to continue to grow margin.

A growing percentage of these deals will need to be subscription business, reflecting a clear buyer shift in how software is delivered and paid for. This is a trend acknowledged by SAP's CEO in the earnings call, emphasizing a commitment to increase its subscription business, calling out new milestones achieved in the long development and rollout process for BusinessByDesign. To a large degree, SAP's revenue challenges reflect its over-dependence on on-premise ERP within its software product portfolio, despite recent acquisitions in adjacent markets. In the category of on-premise ERP, SAP remains the clear worldwide revenue leader. But this is a limited way to view the market from a buyer's perspective.

To an enterprise buyer, the market is the "solve my business process problem" market. Framing a "market" in this fashion, it's apparent that buyers have alternative ways to solve their business process problems. In addition to on-premise applications, buyers can select from on demand/(software as a service), business process outsourcing (BPO), or middleware-enabled integration on a process-by-process basis. Each of these alternatives is growing much faster than on-premise ERP applications. SAP needs a play in every one of these alternatives, either via direct or indirect means, in order to maximize its total market opportunity. (See SAP's outreach to BPO providers to license SAP applications and technology as an example.) A positive sign is the recognition by SAP's senior management that alternative delivery models are here to stay and must be a growing part of SAP's future.

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