

THINK ACT

BEYOND MAINSTREAM



March 2016

Reach for the cloud

The HR software market looks to 2020

THE BIG

3



100

interviews conducted with decision makers
and experts from HR software vendors.

page 3

EURO 1.7 BN

is the expected volume of the German HR software
market by 2020.

page 4

86%

till 2020 is the predicted growth of the
strongest driver in the market: the transition
to cloud based solutions.

page 6

What is going on in the world of HR software? Do you understand the market situation well enough to make the right software purchases?

Roland Berger conducted over 100 interviews with decision makers and experts from HR software vendors and customers focusing on the four key features of the HR software market: Market size and growth, competitive environment, customer behavior and market trends. Add in a raft of primary and additional secondary research and the result is a comprehensive, quantitative market model.

This report will enable vendors to sharpen their view of the market and adjust their business model accordingly, for instance by increasing their focus on smaller customers and specific verticals. In case you are a customer, this report will dramatically improve your understanding of the current market situation and thus enable you to make the right purchase decisions for your HR software.

"Cloud will come no matter what, the question is only how long it will take the majority of companies to adopt it"

GLOBAL TRANSPORTATION PLAYER,
VP GLOBAL HR TRANSFORMATION

Seven product segments make up a German HR software market worth EUR 1.3 bn today.

The German HR software market reached EUR 1.3 bn in 2015 and will hit EUR 1.7 bn by 2020. Although growth is being achieved in all seven product segments, it is stronger in the strategic HR segments (recruiting, performance & talent management, learning & development and employee collaboration & engagement) than in the administrative HR segments (employee data administration, compensation & benefits, workforce management). Accompanying strong growth from small and medium-sized enterprises (SMEs), cloud based solutions make a significant contribution to relative growth, despite being inhibited by various factors including data security and privacy aspects. The competitive environment has proven to be rather consolidated in the administrative HR segments, while the strategic HR segments remain at a fairly low consolidation level. For the latter in particular, this is driven by many micro players developing their niches besides large players with global reach such as the industry primus SAP/SuccessFactors. To access dispersed markets such as the SME segment, system integrators provide an alternative indirect route to market. Regardless of the segment, customers are focused on product quality (in this case a mix of usability, flexibility and integration) and consider price only after their quality requirements have been fulfilled.

FOUR MAJOR TRENDS SHAPING THE MARKET

The market described above is shaped by four major trends. Increasing HR software budgets provide future potential for investments and innovation. The switch from on-premise to cloud based solutions is evidently taking off and substantially driving growth in this area. Simultaneously, this raises concerns about data security & privacy, which must be taken into consideration – especially in German companies with strong works council co-determination rights. These concerns are intensified by German companies having an emotional preference for cloud based data to be hosted in Germany, even though the entire European Union could be considered from a regulatory perspective.

For HR software customers, this implies the need to consciously assess the state of their HR software landscape. New technologies and offerings in a competitive market environment may provide less costly solutions to existing or as-yet unsolved problems. For HR software vendors, it becomes crucial to respond strategically and sustain their competitive advantages, e.g. via M&A activities. All things considered, both sides need to actively prepare to reach for the cloud.

Market sizing and growth: Administrative HR segments are larger in size but lower in growth than strategic HR segments.

The German HR software market reached a volume of about EUR 1.3 bn in 2015 and is expected to grow annually by approximately 5% to total some EUR 1.7 bn by 2020. → **A**

The market can be broken down into three administrative HR product segments, employee data administration (EDA), compensation & benefits (including payroll), and workforce management (WFM). Furthermore, there are four strategic HR product segments, namely recruiting, performance & talent management, learning & development, and employee collaboration & engagement. → **B**

The administrative HR segments have a tendency to show lower growth than the strategic segments while currently still accounting for a larger share of the market. The slower growth is primarily attributable to customers being reluctant to switch HR software vendors, thus creating product life cycles of 7-10 years. This immobility is driven by the high customization level that is required to handle the present complexity,

the interdependencies with other systems, the high sensitivity of processed data and the importance for the going concern of the company.

IMPORTANT GROWTH DRIVERS

The most common growth drivers mentioned by our interviewees include the gradual but ever more certain transition to cloud based software, the strong growth among small and medium-sized enterprises (SMEs), as well as several industry verticals experiencing elevated growth rates, including retail.

The strongest growth driver in the market is the transition from on-premise (licensed) software to cloud based solutions (or Software as a Service – SaaS). With an expected per annum growth rate of approximately 13% in 2014-2020, the segment will be worth around EUR 600 m in 2020. In contrast, the on-premise segment is expected to grow only at about 2% annually in the same time frame, reaching a total volume of some EUR 1.1 bn. → **C**

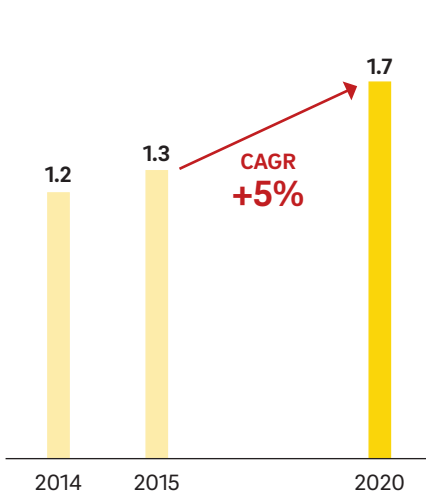
6 THINK ACT

Reach for the cloud

A

ABOVE AVERAGE GROWTH RATE TO BE EXPECTED

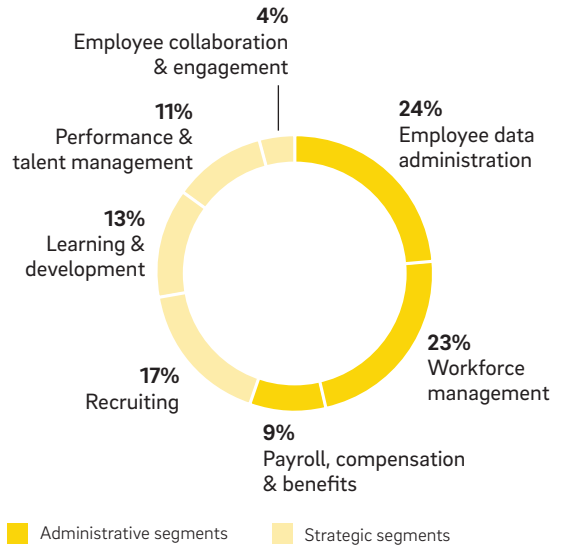
German HCM software market 2014-20 [EUR bn]



B

SEVEN SEGMENTS MAKE UP THE HR MARKET

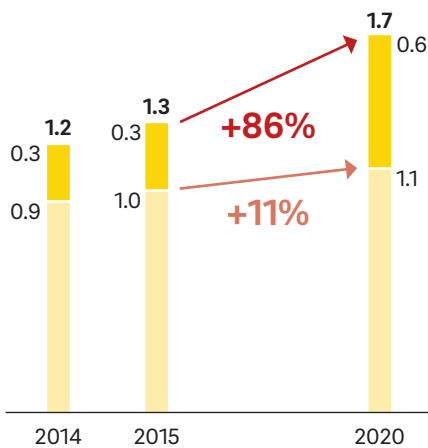
German HCM software market by product segment, 2015 [%]



C

A MAJOR GROWTH DRIVER IS CLOUD BASED HR SOFTWARE

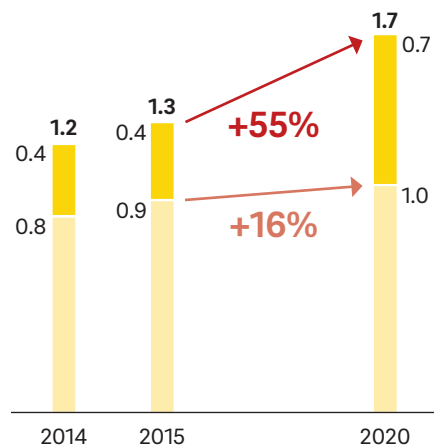
German HCM software market by deployment type, 2014-20 [EUR bn]



D

DEMAND FOR NEW SOFTWARE IS ESPECIALLY STRONG IN THE GERMAN "MITTELSTAND"

German HCM software market by customer segment, 2014-20 [EUR bn]



Currently significantly smaller, the share of cloud based solutions is driven first by the unclear legislative situation regarding data security and privacy, and second by the large market share occupied by administrative HR software, which has an inherently lower cloud adoption rate.

Lower upfront investment in IT infrastructure and more innovative technology that enables products including self-service and mobile features are furthering the growth of the cloud segment. The rather standardized cloud solutions, customizable only via parametrization, represent a good fit for SME companies with lower complexity and less need for customization. However, there are also inhibiting factors, such as the abolition of the "safe harbor" agreement. While this may change the way in which cloud based solutions are realized, it does not jeopardize the momentum of the trend.

A strong source of growth is the German SME customer segment, the fabled "Mittelstand", encompassing companies with fewer than 1,000 employees. This segment is expected to grow at about 9% per annum in the period 2014-2020, reaching a volume of approximately EUR 710 m in 2020. This stands in contrast to the large enterprise segment (LE), expected to grow by some 3% yearly to around EUR 990 m in 2020.

Even though the majority of employees in Germany work in the SME segment, its HR software market is smaller due to the lower penetration level overall and less suitable products in some areas (historic dominance of complex and highly customized on-premise solutions).

SMEs are growing faster now because they can leverage shorter and simpler decision processes as well as less complex company structures. They have a lower need for (global) IT harmonization and can thus undertake smaller projects in distinct parts of their HR software landscape. Enabled by the cloud trend, they tend to do so by choosing best-of-breed providers that ensure a balanced range of standardized and cloud based software, which simultaneously provides industry and company size specific functionality. → **D**

Industry verticals exhibit growth rates ranging between about 4-6% annually in the period 2014-2020. In manufacturing, for example, the trend toward greater specialization and Industry 4.0 creates the need for industry specific solutions to cover unique requirements.

DEEP DIVE ON PAYROLL

To illustrate the effects of the growth drivers discussed above and how they manifest themselves individually in each market segment, we looked more closely at the payroll segment.

The payroll segment in question excludes the business process outsourcing (BPO) share of the market, and is expected to grow by about 4% per annum in 2014-2020 to reach a volume of around EUR 148 m in 2020.

The cloud influence described above holds true for payroll, its cloud based software share being fairly small (approximately 7% in 2015) but growing more strongly than the on-premise segment (approximately 7% vs. 4% per annum in 2014-2020). The above-mentioned factors limiting cloud adoption can be applied to payroll as well. Complexity plays an especially important role in payroll: Dozens of updates on federal legislation concerning payroll calculations, a variety of collective and union agreements and many different employee groups contribute to system complexity. This complexity can only be met with a high level of customization, one aspect still better catered for by on-premise solutions and hence substantially limiting the influence of cloud based solutions' growth.

In terms of customer size, the SME segment is expected to grow by about 5% per annum in 2014-2020 (vs. the LE segment with approximately 3% annual growth in the same time frame). Growth can be realized by penetration gains from pen & paper as well as payroll outsourcing customers. SMEs seem to prefer best-of-breed solutions providing tailored systems with a higher standardization level, in keeping with the cloud advantages mentioned previously. The increasing scale of cloud adoption also drives a shift toward a larger share of the market realized with service and maintenance contracts.

Competitive environ- ment: Market shaped by a few large players and a variety of micro players.

The competitive environment in the administrative HR segments is perceived as being highly consolidated with a few established players and a variety of very small micro players.

Digitization took a hold in these administrative HR segments first, resulting in greater maturity than strategic HR segments, with industry leaders able to claim dominant market positions. The textbook example, SAP, has a strong presence in the LE segment and provides an all-in-one solution. It services the highest complexity levels on a global basis and is highly customizable. Despite the resulting good fit to companies' individual requirements, customization simultaneously creates a lock-in effect: Any switch of providers would render substantial previous spending wasted.

The competitive environment does, however, have to be analyzed on a segment by segment basis, since few players excel in all areas. The payroll segment, for example, has one of the highest anticipated consolidation rates; as much as 65-90% of the market is catered for by the top 10 players. The early establishment of the market, particularly long product replacement cycles, high complexity driven by the local variations in the nature of the subject, and frequent updates favor the establishment of large players. Simultaneously, this environment opens up niches in industry vertical sub-segments, which can be covered by small micro players providing schedul-

ing solutions in the workforce management segment for hospitals as part of the healthcare sector. → **E**




The perspective on strategic HR segments turns out to be inverted – consolidation seems to be rather low. Here, medium-sized and small players compete in the market with a strong technology focus, offering products with self-service and mobile features. The shorter product life cycle in combination with lower upfront investments, shorter contractual obligations, more standardized interfaces and data models reduces risk and allows for less expensive provider switches. Customers of all sizes have to deal with the consequences of demographic change and the lack of qualified labor, which serve to put more pressure on related HR software segments such as talent & performance management and recruiting. → **E**

Regardless of whether the subject in question is the administrative or the strategic segment, system integrators are essential market participants in the competitive arena. They provide an indirect alternative to the conventional direct sales channel. For HR software providers, they can thus offer an attractive way to reach the customer, which is a very interesting proposition especially in a small and fragmented customer segment. From a customer perspective, system integrators provide a neutral counterpart offering specialized expertise and able to help navigate through the market.





E

TOP MARKET PLAYERS AND CONSOLIDATION PER SEGMENT

Administrative HR segment

	EMPLOYEE DATA ADMINISTRATION	PAYROLL	WORKFORCE MANAGEMENT
Top players	SAP Oracle PeopleSoft Workday Sage	SAP P&I Datev Sage ADP	Allegion SAP ATOSS Kaba Isgus
Consolidation level			

Strategic HR segment

	RECRUITING	PERFORMANCE & TALENT MANAGEMENT	LEARNING & DEVELOPMENT	EMPLOYEE COLLABORATION & ENGAGEMENT
Top players	SAP/SuccessFactors Persis IBM Umantis Lumesse	SAP/SuccessFactors Lumesse Umantis Talentsoft Cornerstone	SAP/SuccessFactors Persis Sage Umantis NetDimensions	IBM Jive Microsoft SAP Salesforce
Consolidation level				

Source: Roland Berger assessment based on more than 100 interviews with decision makers and experts from HR software vendors and customers between November and December 2015 – enriched with a raft of primary and additional secondary research and background information.

Customer behavior: Product quality, service quality, price and ease of implementation.

Customers in the HR software market behave in a way that appears to be consistent across all industries. This can ultimately be condensed into key purchasing criteria that guide customers' buying decisions.

First, customers determine what constitutes product quality for them, what level is required to serve their purpose, before seeking out vendors able to meet these requirements. For most customers, product quality is a mix of usability ("Can my employees use it efficiently and with little or no training?"), flexibility ("Can it cover the level of complexity we need?") and integration ("Can we integrate it seamlessly via interfaces?").

As soon as the product quality criterion is fulfilled, customers proceed to the next one in line, namely service & maintenance quality ("Can I easily get in touch and how well and how fast do they resolve issues?").

Assuming the first two criteria are sufficiently well met, the price factor comes into play. Despite being ranked third, price is of the utmost importance and plays a pivotal role in strategic HR segments where many vendors compete against one another. Conversely, price becomes obsolete as a criterion as soon as companies are "locked in" by highly customized on-premise systems that simply cannot be switched, a phenomenon that occurs more often in the administrative HR segment.

The ease of initial implementation presents a final hygiene factor ("How long will implementation take, what manpower is needed on my side and what will it cost me?"). → **F**

Apart from these key purchasing criteria, it is common to establish customer loyalty via a trust based relationship. For customers to decide in favor of a HR software vendor, especially in the administrative segment, a trust based relationship is essential. Its intensity increases over the long product lifetime and consequently presents itself as an advantage if a vendor switch should be on the cards.

Such switches usually take place in specific situations, e.g. when a company has outgrown their existing systems in terms of employee numbers, when the business model has changed and introduced new requirements or when the old and new systems are no longer in harmony with one another.

The decision process customers run through is normally driven by HR, which defines its specific needs together with IT. Depending on the software segment concerned, adjacent functions may be included, e.g. the finance function in the case of payroll. As soon as a tender comes into question, the procurement office can be brought into play. The works council and data protection officer need to be involved throughout the process as well. Final decisions are usually made by an executive committee.

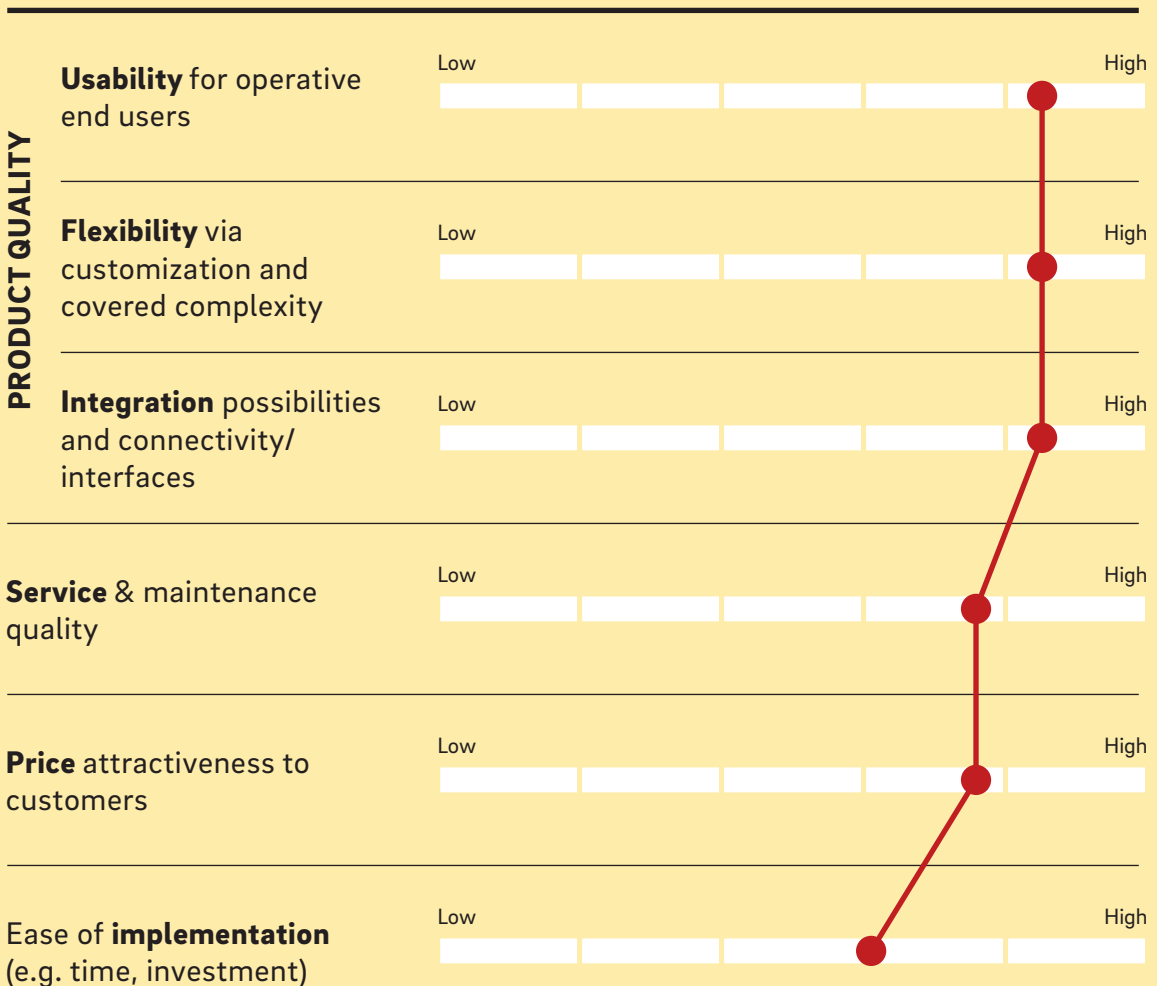
F

KEY PURCHASING CRITERIA THAT GUIDE CUSTOMERS' BUYING DECISIONS.

In the German HR software market

KEY PURCHASING CRITERIA

PERCEIVED CUSTOMER IMPORTANCE



Market trends: Increasing HR software budgets are invested in cloud solutions in the face of data security concerns.

Throughout our interview series, HR software customers and vendors indicated a variety of underlying drivers in the market. We condensed four major trends that were consistently of relevance, and which seem to have an extraordinary influence on the market environment.

HR SOFTWARE BUDGETS

The overall software budgets of German companies are expected to increase going forward, driven by trends such as digitization. Correspondingly, German HR software budgets are expected to remain stable or increase. Major motivators seem to be the aging software landscape as well as investments in the talent pipeline. HR software budgets are primarily funded by HR, though infrastructure relevant budgets from IT and corporate level may also come into play.

For the HR software market this substantiates the expected growth. Customers of HR software will have to ask themselves where to invest the resources at their

disposal, e.g. in renewing old systems or extending the scope of current applications. Vendors of HR software will need to minimize customers' reservations about making the investment, e.g. by providing a track record of successful implementations with seamless and fast implementation.

CLOUD ADOPTION

Generally, usage of cloud computing is increasing immensely across verticals and customer segments in Germany, even though the overall level still remains below that of pioneers such as the UK and the US. The same holds true for the HR software market: Cloud adoption is increasing strongly, albeit with limited absolute effect as yet due to the small basis upon which the trend is building.

As mentioned above, growth is driven by the various advantages of cloud based solutions: Lower up-front investments, lower switching costs, higher standardization with improved connectivity via interfaces/

standardized data models, and new technological features. Simultaneously, factors like the sensitive nature of HR data combined with data security and privacy issues and the limited customization via parametrization inhibit the trend's effect.

For HR software customers, this implies the need for sound decision making between on-premise and cloud based solutions in all relevant segments. For vendors of HR software, this, in turn, creates the necessity to provide cloud based HR software solutions, with or without on-premise solutions – the latter option seems feasible in the strategic HR segment, while a dual offering may suit the administrative segment better.

DATA PROTECTION

Data protection is a highly topical issue for HR in Germany and needs to be addressed appropriately when discussing HR software. Beyond HR itself, the German situation is unique owing to two institutions installed by the BDSG ("Bundesdatenschutzgesetz" or Federal Data Protection Act) and BetrVG ("Betriebsverfassungsgesetz" or Works Constitution Act):

1. Works council: Employee representation with the mandate to compensate for the uneven distribution of power between employer and employee. Every German company with more than five employees can have a works council and it is likely to have co-determination rights regarding the introduction or change of any HR software solutions.

2. Data protection officer: An internal or external officer whose purpose is to ensure adherence to the BDSG and other data protection legislation. The officer has to control and work toward the successful implementation of the BDSG and other related legislation; however, the data protection officer has information and participation rights only.

What this implies for HR software customers is the need for timely involvement of the relevant parties; as far as the works council is concerned, it involves clearly identifying motives and goals to help establish compromises. HR software vendors can help here, for instance by ensuring full software functionality even without certain critical features, providing information tailored to the works council's demands, etc.

DATA HOSTING

One aspect closely related to data protection concerns the data hosting location. In light of the general data security situation, which is fraught with distrust and legal uncertainty, German companies have a strong, rather emotional tendency to prefer data hosting in Germany. This is the case even though from a regulatory perspective, data hosting in any country of the European Union would be feasible.

Certainly in the wake of the abolition of the "safe harbor" agreement, data hosting outside of the European Union is perceived as highly undesirable and does not represent an option for most German companies. Regulation of data handling via standard EU contractual clauses or processor binding corporate rules cannot bridge this security gap and is generally perceived as insufficient.

"Data trustee" models, following the Microsoft and Deutsche Telekom example, may become a new trend: Here, companies originating from outside of Germany use a Germany based data hosting provider and voluntarily renounce all access to their own data. This prevents any third party access that could possibly be enforced by the foreign company's national government.

From the customer perspective, EU hosting locations other than Germany should also be considered. From a vendor perspective, hosting in Germany will always be perceived as an advantage against competitors with non-German hosting.

Conclusion and recommendation: Customers and vendors need to prepare to develop into the cloud.

If you are a HR software vendor, you might want to focus on developing a unique value proposition by concentrating on certain customer segments and specific verticals.

The growing market will increase competition among vendors who will try to differentiate on quality and technological levels. This will trigger innovation and may bring new software forward, solving as-yet unaddressed problems or improving existing solutions. Established HR software vendors will be challenged by new entrants with new cloud based innovative solutions. Defining clear response strategies to ensure a sustainable market position will be key. The priority has to be on ensuring a sustainable competitive advantage that creates a unique customer value proposition. Vendors can either grow organically or pursue M&A activities targeting one of the evolving small players.

Cloud providers will need to address data protection issues including the hosting location of cloud based data. This involves aspects such as the early and well prepared involvement of works councils, as well as sustainable data hosting solutions, possibly using the new "data trustee" model.

If you are a customer you might want to review your existing HR software landscape, looking for new solutions that add value and bring cost savings potential.

New features and capabilities, which were thus far out of reach or financially unattractive will provide your buyers with software solutions that will help you become more effective and cost efficient. Cloud based solutions are becoming more and more attractive for SMEs due to lower complexity and higher value from standardized products. Cloud solutions provide customers with the added flexibility that comes from a standardized process and data model. This enables you to switch providers more easily, thereby putting you as customers in a stronger buying position.

The cloud is out there. Reach for it. ♦

ABOUT US

Roland Berger, founded in 1967, is the only leading global consultancy of German heritage and European origin.

With 2,400 employees working from 36 countries, we have successful operations in all major international markets. Our 50 offices are located in the key global business hubs. The consultancy is an independent partnership owned exclusively by 220 Partners.

FURTHER READING



THINK:ACT SPECIAL: **CLLOUD ECONOMY** The path to new business models

Social networks are simply the most obvious manifestation of a trend in which ever-larger parts of our personal lives are shifting online. Business networking is also gradually making the transition to virtual reality. This transformation has a huge amount of business potential. We call it the cloud economy: an environment in which companies can use new technology to harvest huge quantities of online user data and integrate it into their business models.



THINK:ACT CONTENT **IT outsourcing involves more than IT**

IT outsourcing often feels like a lottery where you are always drawing the wrong number. While it should be a guaranteed win, more often than not you turn out to be the loser. That is why many managers making who outsource IT operations feel deceived. Often they are right. Worse still, to a large extent they only have themselves to blame. But there is a better way to make sure that firms can get what they want.

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