

PRACTICAL GUIDANCE FOR 2011

Grow Profit as a Full Service Provider
Parallels SMB Cloud Insights

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Executive Summary

Cloud computing has given small and medium businesses (SMBs) access to computing power, applications, and services that were formerly available only to large enterprises. Looking at the IT landscape at the end of 2010, we see SMBs participating in the Cloud opportunity to varying degrees—ranging from leasing a single server, to sophisticated customer relationship management systems, to complex financial packages.

Throughout 2010, Parallels studied Cloud service trends among 500 U.S. SMBs spread out across different employee sizes and verticals. Through a combination of this primary research, focus group interviews, data from our existing customers (who include the largest Cloud service providers to SMBs), and secondary research sources, we have collected extensive information about SMB use of Cloud services. This paper distills our views on SMB Cloud usage, adoption, and opportunity in the U.S. at end of 2010. Throughout 2011, we will be investing in additional research into the European and Asia-Pacific markets.

Like both the analyst community and the U.S. Census, we define an SMB as a company with under 1,000 employees. We further distinguish between a small business (SB), defined as a company with fewer than 100 employees, and a medium business (MB), defined as a company with 100 to 999 employees.

Parallels estimates the Cloud services market at the end of 2010 for U.S. SMB—including Hosted Infrastructure, Web Hosting, and Hosted Messaging and Collaboration (i.e., Business-Class Email and Hosted PBX) at \$8.6B. SBs are the foundation of this market, accounting for over 80% of the total market spending and over 95% of all U.S. SMBs. We believe that, as new SBs enter the market and existing SBs continue to convert from in-house IT solutions to Cloud services, the market will grow by an additional \$12B (\$7B in Hosted Infrastructure, \$700M in Web Hosting, \$400M in Business Class Email and \$3.9B in Hosted PBX). If you're a Cloud service provider, the good news is that there is some seriously "low-hanging fruit" in your core business, as SMBs increasingly will be buying services, not servers. But in order to capitalize on this opportunity, you need to know which segment of the SMB food chain you are targeting, offer unique and targeted sales and marketing materials, and become a full service provider—both adding value to widely adopted services, such as basic email, and branching out into new, adjacent markets, such as Hosted PBX.

This paper begins with an overview of our research methodology. It then summarizes our findings first for Cloud usage in general, and then for usage in three specific segments of Cloud services: Hosted Infrastructure, Web Hosting, and Hosted Messaging and Collaboration.

Definitions

Unlike the “as-a-service” taxonomy that market analysts use to describe the total Cloud industry (software-as-a-service, platform-as-a-service, infrastructure-as-a-service), we focused our research on the Cloud segments that matter most to SMBs: “Hosted Infrastructure,” “Web Hosting,” and “Hosted Messaging and Collaboration. We define these sub-segments as follows:

Hosted Infrastructure (also known as infrastructure-as-a-service):

This category includes dedicated servers, virtual private servers (VPS), managed hosting, and utility or elastic computing.

Web Hosting: This category includes Web hosting itself, plus blogging services, domain registration, SSL and e-commerce add-ons, and site-building tools.

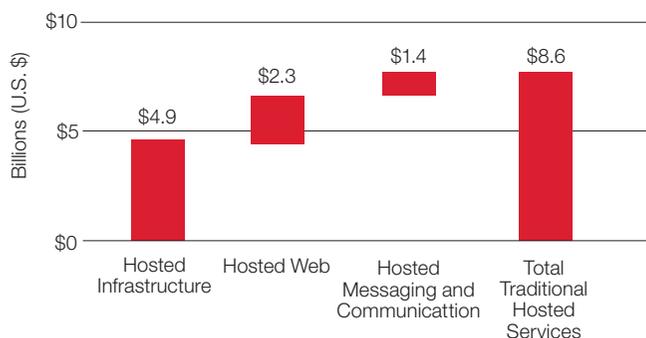
Hosted Messaging and Collaboration: This category consists of business-class email services and hosted PBX services, including email security, email archiving, mobility, and phone services via voice-over-IP (VoIP).

Based on the assumption that SMBs will choose to buy services instead of hardware in the years to come, this paper extrapolates the total market opportunity for SMB Cloud services in the U.S., as well as specific areas of incremental growth.

Key Findings in the Cloud

Our research indicates that Cloud services for SMBs in the U.S. are an \$8.6B market in 2010. As shown in Figure 1, the majority of this spending (\$4.9B) is in Hosted Infrastructure with Web Hosting and Hosted Messaging and Collaboration accounting for the remaining \$2.3B and \$1.4B, respectively.

Figure 1: Cloud Service Market for SMBs by Segment



Total market size for U.S. SMBs is \$8.6 billion.

Our findings on the degree of penetration for each of these services, however, show that there is ample future opportunity for service providers offering Cloud services to SMBs. Specifically, based on our conversations with hosting and Cloud services providers, and with their SMB customers, Parallels believes that in the coming years, SMBs will significantly increase their consumption of Cloud services, choosing to rent services rather than buy hardware. Parallels estimates the additional, untapped, incremental market opportunity for SMB Cloud services in the U.S. alone to be worth \$12B, bringing the total market opportunity to more than \$21B.

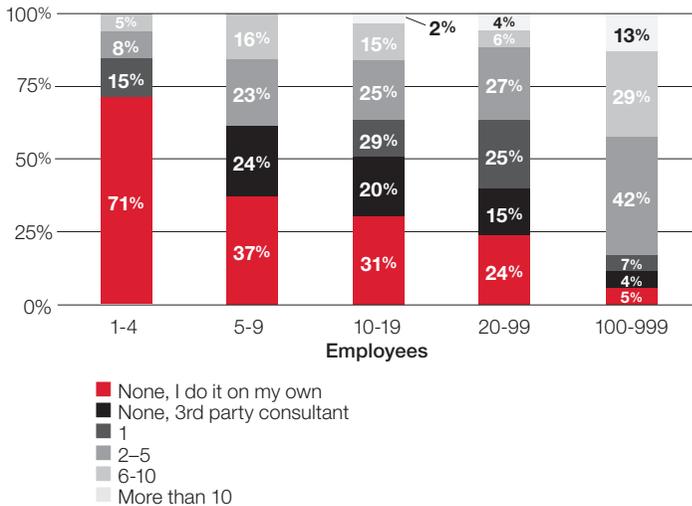
The additional opportunity falls into two categories:

- **Increasing small business use of Cloud services.** SBs currently are behind MBs in their consumption of Cloud services. Our research shows that SBs lag 19 percentage points behind MBs in their use of hosted infrastructure (17% of SBs have hosted servers vs. 36% of MBs); 33 percentage points behind in Website penetration (63% vs. 96%) and, on average, 10 percentage points behind in hosted messaging and collaboration (14% vs. 22% in paid hosted email and 7% vs. 20% in hosted PBX). As Cloud services providers continue to offer smaller and more cost-effective packages for SBs, we expect SB consumption of Cloud services to rise to match MB levels.
- **Converting in-house solutions to Cloud services.** Parallels found that a surprising number of SBs with fewer than 20 employees still use in-house solutions for services now available in the Cloud. Given the eventual end-of-life of existing hardware used for in-house solutions, and the falling costs of Cloud services, conversion to the Cloud is virtually inevitable. On average, 33% of SBs use in-house servers (averaging 2.0 in-house servers per SMB), 18% use in-house email (for a total of 6.5M in-house mailboxes) and 38% use in-house PBX (for a total of 15.6M in-house PBXs).

Parallels estimates the additional U.S. SMB Cloud opportunity at an additional \$13B.

While MBs have the perceived capacity to maintain in-house solutions, SBs with fewer than 20 employees rarely have dedicated IT personnel to manage in-house technologies. In fact, on average, less than 25% of SBs with fewer than 20 employees have any dedicated IT staff, as shown in Figure 2.

Figure 2: IT Staffing Resources by SMB size



Small businesses are the sweet spot of the SMB market today.

In summary, the distribution of spending in the Cloud services market shows the vast majority of industry spending coming from SBs. Currently, 82% of Cloud services spending (over \$7B) and 91% of the incremental opportunity comes from SBs, with only 18% coming from MBs. And with SBs constituting 97% of all U.S. SMBs, our findings confirm that SBs are the sweet spot of the Cloud services market. As Cloud services continue to reach these companies, the SB segment will become a more and more critical space for service providers' sales and marketing efforts.

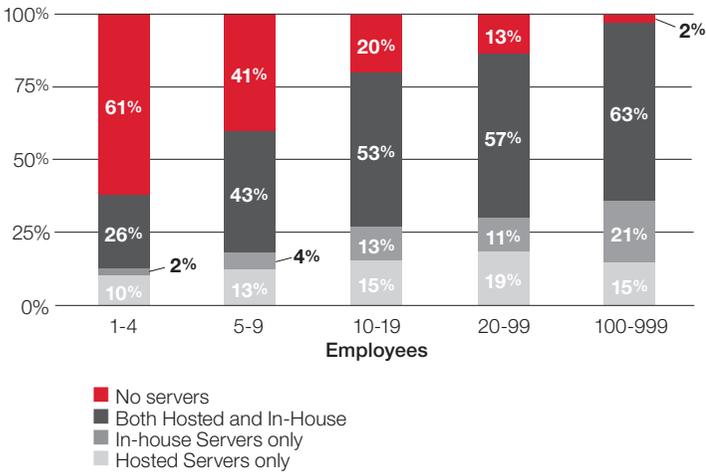
Hosted Infrastructure

Hosted Infrastructure has the lion's share of the current Cloud service market in the U.S., with a national SMB spend of approximately \$4.9B. This figure encompasses all types of hosted servers, including dedicated servers, VPS, and flexible computing (also known as utility, grid, or Cloud computing), as well as additional infrastructure services that SMBs use, such as backup. Parallels estimates the market to include 2.3M hosted servers, 500K of which are VPS. With the incremental market opportunity for hosted infrastructure estimated at \$7.1B and 4.8M servers, and hosted server penetration among SBs lagging considerably behind that of MBs, Parallels believes that marketing low-cost and easy to manage Hosted Infrastructure solutions to SBs is a great way for service providers to take advantage of this impressive growth opportunity.

As illustrated in Figure 3, SMBs' continued use of in-house servers represents a significant opportunity within the hosted infrastructure segment. Among U.S. SMBs, 55% have servers, with 82% of these companies keeping at least some servers in-house. Parallels believes the largest opportunity for conversion from in-house servers is among SBs, who could benefit the most from the reduced cost and maintenance burden of hosting servers in-house. Replacing in-house servers with hosted servers represents the single largest growth opportunity for the Cloud services market.

Hosted infrastructure has the lion's share of the current Cloud service market in the U.S., with a national spend of approximately \$4.9B among SMBs.

Figure 3: Server Penetration among SMBs

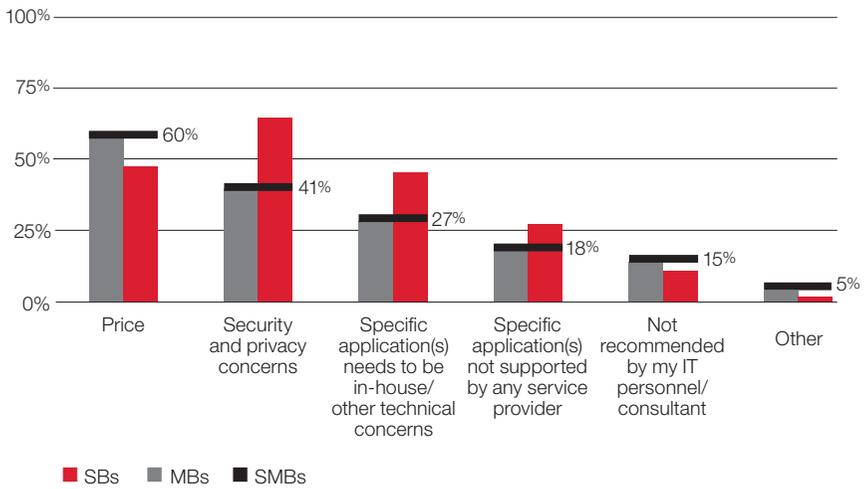


Hosted infrastructure growth is fueled by conversion from in-house servers to hosted servers.

Additionally, more SMBs who currently do not have servers will adopt hosted servers, as Cloud services continue to grow in exposure, popularity, and credibility, while simultaneously costs will be coming down. This opportunity is significant.

According to the SMBs interviewed by Parallels, price is a key reason preventing SMBs with in-house servers from shifting to hosted servers, as shown in Figure 4. Therefore, to take best advantage of this opportunity, service providers need both to educate SMBs about the total cost of ownership of in-house servers and to expand their offerings with lower price configurations. It's also noteworthy that for MBs, security and privacy concerns are an even bigger factor than price.

Figure 4: Top Reasons SMBs Keep Servers In-house



Fed by these opportunities, the hosted infrastructure market will continue to grow steadily, despite competition from new Cloud-based applications (typically called Software-as-a-Service, or SaaS), which allow SMBs to use just the needed application, without having to manage servers. While Parallels believes that the growth of SaaS will have a disruptive effect, we still see the incremental market opportunity for Hosted Infrastructure among SMBs in the U.S. as a staggering \$7.1B.

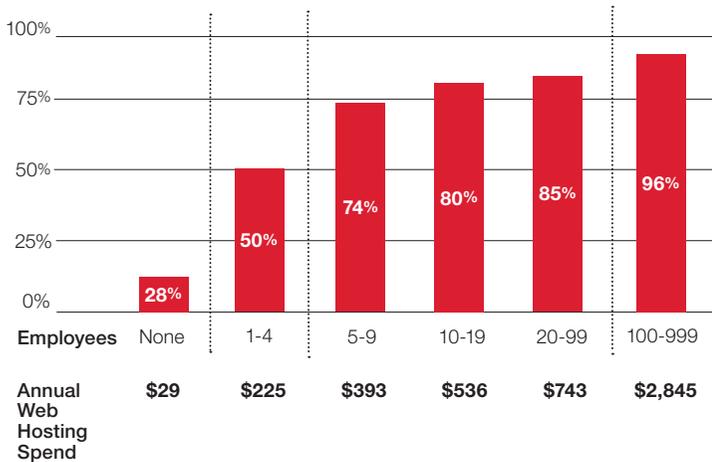
The incremental market opportunity for Hosted Infrastructure among SMBs in the U.S. is a staggering \$7.1B.

Web Hosting

Web Hosting accounts for \$2.3B of Cloud services spend among U.S. SMBs. Approximately 4.8M SMBs have hosted Websites. While this number represents 64% of all SMBs (excluding the ~17M businesses without employees), it's still far lower than hosted Website penetration among MBs, which is approaching 100%. As shown in Figure 5, future opportunity in Web hosting will be largely fueled through increasing Website penetration among SBs as well as increasing the average revenue per user (ARPU) among all SBs. When SBs (excluding the "None" category) catch up to the penetration rate of MBs at 96%, the incremental opportunity represents an incremental market of \$700M.

As few as 50% of the smallest SBs have a website. Converting this opportunity represents an incremental market of \$700M.

Figure 5: Website Penetration Employees



What Figure 5 also illustrates is that there are really four separate and distinct markets within Web Hosting:

- **One-person businesses (or personal websites).** Even though these businesses may spend only a few dollars a month on Web hosting, there is enormous volume here (~17M per the U.S. Census).
- **Very small businesses (1-4 employees).** These businesses spend roughly \$20 per month and represent the largest group of SBs that will need Websites in the coming years. However, as Figure 2 illustrated, these SBs generally do not have IT staff, so it's critical for providers to make their offerings easy to use.
- **Small businesses with 5-99 employees.** Website penetration for this group ranges from 74% to 85%. Although the average revenue per user (ARPU) increases as the firm grows in size, it averages around \$50 per month.
- **Medium businesses (100-999 employees).** These businesses spend nearly \$3,000 per year on Web Hosting but require a much higher degree of service and support than SBs do.

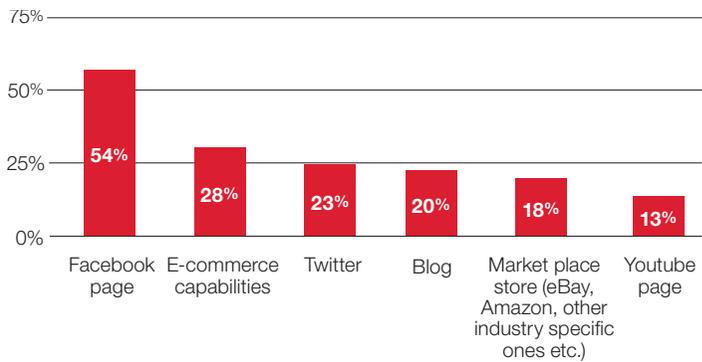
There are really four, separate and distinct markets within Web Hosting.

Ultimately, some service providers will go after each of these markets, but our research suggests that the sales and marketing tactics and messages should be unique to the market segment being addressed.

Web-savvy SMBs are clearly looking to extend their web presence by using social networking.

One of the more interesting findings of our research deals with SMBs' use of social networking. Among the 64% of SMBs that have a Website, 54% indicated they have a Facebook Page, 23% use Twitter, and 20% have a blog, as illustrated in Figure 6. Interestingly, smaller and larger SMB segments have similar rates of social network usage, a reflection of these platforms' economy and ease of use. This finding has an important implication for service providers: Web-savvy SMBs are clearly looking to extend their Web presence by using social networking. Therefore it is vital for service providers to introduce easy-to-use publishing tools to help SMBs integrate their website with their social networking activities. We predict this social networking trend will continue, and any follow-on research we do will look at the potential penetration of social networking tools among SMBs that do not yet have a Website.

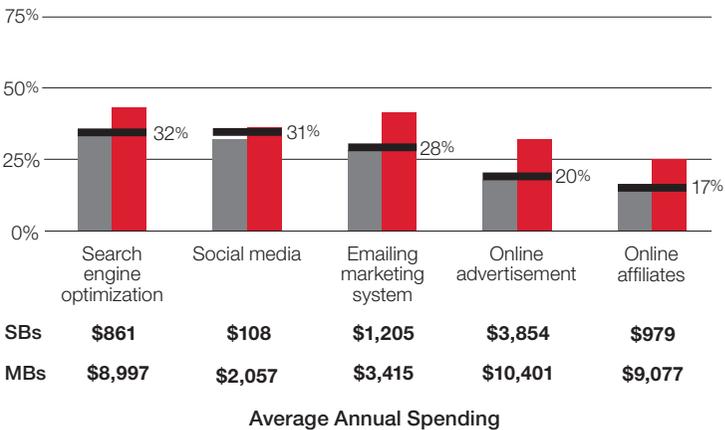
Figure 6. Social networking activity among SMBs with Websites



SMBs also have good adoption rates for some of the most common online marketing tools, such as search engine optimization (32%), social media advertising (31%), and email marketing (28%). As shown in Figure 7 below, as opposed to the case with social networking, smaller SMBs lag behind larger SMBs in penetration and—not surprisingly—spending. For example, SBs average \$861/year on search engine optimization, versus MBs who spend \$8,997/year. Parallels believes that service providers will be able to retain and expand their Web hosting customer base with holistic solutions that address not only SMBs' Website needs, but also their social networking needs and online marketing efforts. This is particularly true as prospects that used to rely on hosting directories and review sites are now leveraging social media outlets to make purchasing decisions.

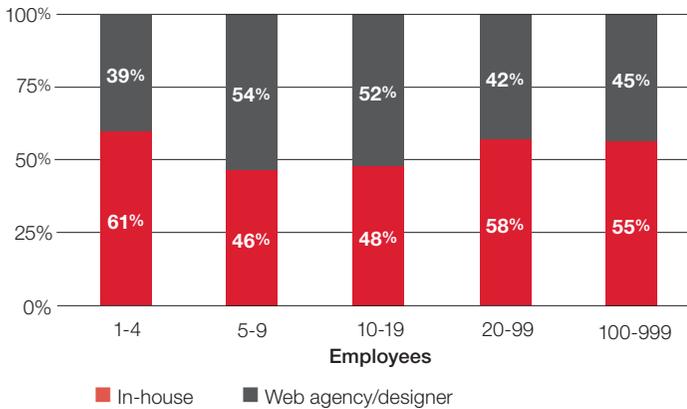
Service providers will be able to retain and expand their Web Hosting customer base with holistic solutions that address not only SMBs' Website needs, but also their social networking needs and online marketing efforts.

Figure 7. Online Marketing Activity among SMBs



The final area within the Web hosting market that our research explored is Website design itself. What we found was that using designers or agencies can be too expensive for SBs, making design costs a leading reason for lower SB Website penetration—particularly among businesses with 1-4 employees. Many SBs simply must design their Websites in-house due to budget issues. Figure 8 shows that approximately half of SMBs design and maintain their Websites in-house, with the highest rates found among the smallest SBs.

Figure 8: Website Design



Service providers should target Web designers separately with both affiliate programs and reseller.

There are two key conclusions that can be drawn from Figure 8. First, service providers targeting the smallest SBs need a really easy-to-use Website building tool. Second, service providers should target Web designers separately, with both affiliate programs and reseller packages, as these designers typically hold the proverbial “keys to the kingdom” of an SMB’s choice of Web hosting provider—and often choose to become resellers themselves.

Hosted Messaging and Collaboration

The Hosted Messaging and Collaboration category accounts for \$1.4B of the total Cloud services market among U.S. SMBs. This segment consists of two separate but related sub-segments: Business-Class Email and Hosted PBX.

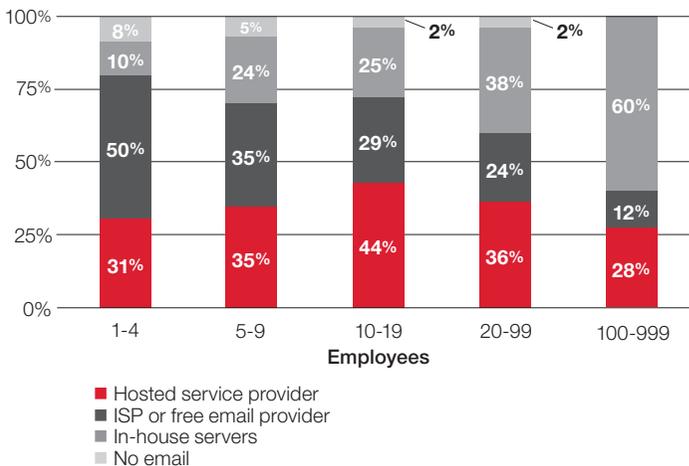
Business Class Email

For Business-Class Email (which differs from basic email in its inclusion of functionality like security, archiving, and mobility), Parallels estimates that there are 1.1M SMBs with paid hosted email accounts, for a total of 20.3M mailboxes. Our research indicates that there is an incremental market opportunity of 10.1M paid hosted mailboxes, at a value of \$400M. We found that even though 94% of U.S. SMBs use email, only 34% have their email hosted by a professional service provider, and only 14% pay for this service separately from Web Hosting.

While ISPs and other free email providers make up a significant portion of the remaining 66% of email accounts, Parallels sees the largest incremental opportunity among SMBs that currently pay to support their email in-house. The number of SMBs with email on in-house servers steadily increases with business size, as illustrated in Figure 9. Replacing these in-house email servers with hosted Business-Class Email—at a lower total cost of ownership—is where service providers will be able to find the majority of the \$400M in incremental revenue.

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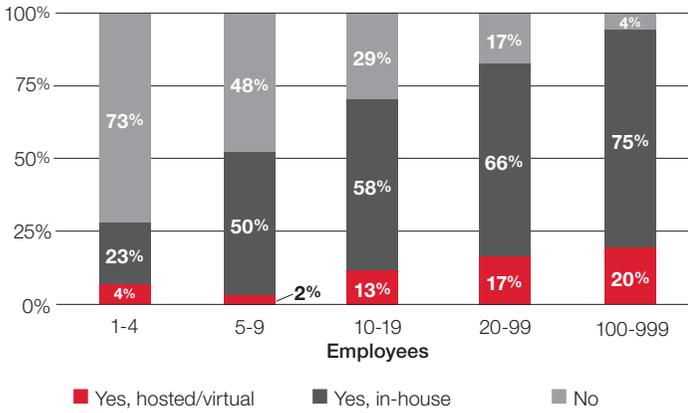
Figure 9: SMBs with Email Accounts



Hosted PBX

Our research indicates that 500K SMBs in the U.S. currently use a Hosted PBX service, representing an \$800M market. However, given our belief that the majority of the current in-house PBX systems will migrate to the Cloud over time, then the incremental market opportunity is massive: \$3.9B for Hosted PBX. As shown in Figure 10, 50% of U.S. SMBs use a PBX system, but only 7% have a hosted or virtual one. Among larger SMBs, PBX adoption is especially widespread, but the use of Hosted PBX services is still very low.

Figure 10: PBX Use



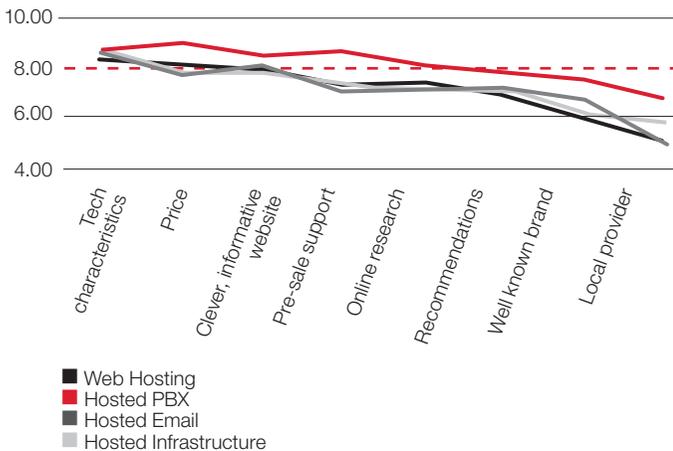
Although our research shows a significant market opportunity in Hosted PBX, so far only 19% of U.S. SMBs have ever considered using hosted or virtual PBX. Furthermore, when asked to rank the importance of various criteria for choosing a Hosted PBX provider, SMBs gave five separate criteria an importance rating greater than 8 out of 10, as shown in Figure 11. By comparison, Hosted Infrastructure, Web Hosting, and Hosted Email each have only one or two criteria with an importance rating greater than 8 out of 10. These results indicate two critical things about the Hosted PBX market:

50% of U.S. SMBs use a PBX system, but only 7% have a hosted or virtual one.

- SMBs are still unclear about how best to select a PBX provider.
- Price is not yet a gating factor. Other Cloud service markets, in contrast, are more mature and have greater adoption, and thus are subjected to more pricing pressure.

Therefore, service providers that offer the best Hosted PBX value, combined with the simplest return on investment marketing materials, will be best positioned to capture the \$3.9B in incremental market opportunity. For those providers already offering Business-Class Email, Hosted PBX is a naturally adjacent market and one worth pursuing, as all SMBs need a phone system.

Figure 11: Purchase Criteria: Importance



Conclusion

Parallels estimates the Cloud services market for U.S. SMBs—including hosted infrastructure, Web hosting, and hosted messaging and collaboration (hosted email and hosted PBX)—at \$8.6B. The foundation of this market is SBs, who account for over 80% of the total market spending and over 95% of all SMBs. Parallels believes that the incremental market opportunity is an additional \$13B (\$7B in Hosted Infrastructure, \$700MB in Web Hosting, \$400M in Business Class Email and \$3.9B in Hosted PBX). This opportunity will be realized as SBs convert from in-house IT solutions to Cloud services.

For Cloud service providers, this is great news, as SBs represent low-hanging fruit in your core business. In order to capitalize on the SB trend of increasingly buying services instead of servers, you must know which sub-segment(s) of the SMB food chain you are targeting (businesses with no employees, 1-4 employees, 5-9 employees, etc.), offer them unique sales and marketing materials addressing their specific concerns, and become a full service provider, adding value to widely adopted services such as basic email and branching out into new, adjacent markets, such as Hosted PBX.

About Parallels

Parallels enables service providers to rapidly launch and efficiently deliver the most profitable Cloud services by automating the delivery of the broadest set of solutions demanded by small businesses. Founded in 1999, Parallels is a fast-growing company with 700 employees in North America, Europe, and Asia. For more information, please visit www.parallels.com/spp.

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