CONFERENCE SUMMARY AND STRATEGIC PERSPECTIVES

ENTERPRISE 2000

McKinsey&Company

Sand Hill Group LLC

preface

We are pleased to present our third annual report on the state of the enterprise solutions industry—a summary of the Enterprise 2000 "Leaders in the New Millennium" conference. This meeting brought together 200 enterprise solutions industry leaders to share ideas, exchange opinions, and debate strategic issues of common interest.

In 1999, we explored how the Internet and e-commerce had emerged as important areas of opportunity. This year, we turned our focus to two new areas of interest: application service providers (ASPs) and business-to-business (B2B) sectors.

This report, a collaborative effort between Sand Hill Group and McKinsey & Company, summarizes the trends, challenges, and key opportunities discussed at Enterprise 2000. It also highlights the most interesting results from the Quick Tally surveys conducted at the conference.

We hope you find this an interesting and useful report as you prepare for the challenges and issues confronting your own organizations.

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This report, the Enterprise '99 report, and other conference information are available online at www.sandhill.com.

introduction

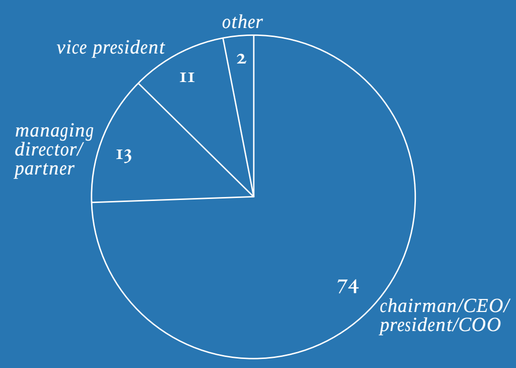
On April third and fourth of this year, senior executives and other leaders of the enterprise software industry once again gathered at the Inn at Spanish Bay in Pebble Beach, California, to attend Enterprise 2000. In a private setting, they exchanged views on the present and future of the enterprise solutions industry and spoke frankly about the issues and trends confronting their companies and clients. In addition, they explored the changes wrought by ASPs and B2B players, as technology has empowered vendors to offer solutions differently while creating an economic imperative for doing so.

This report summarizes the thought capital derived from the presentations and panel discussions of this third annual conference. In addition, it details key opportunities and specific challenges going forward. We hope it will provoke further thought and debate about these pressing issues—carrying on where the conference left off.

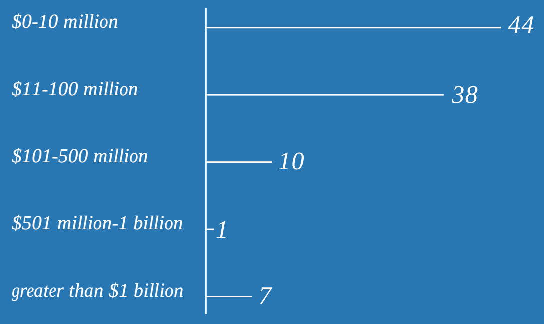
the participants

The Enterprise Conference again drew very senior executives (typically Chairmen, CEOs, COOs, and Presidents) of their companies, representing the same basic industry segments as previous years—software, services, investment banking, and venture capital.

WHAT IS YOUR TITLE/POSITION?
percent



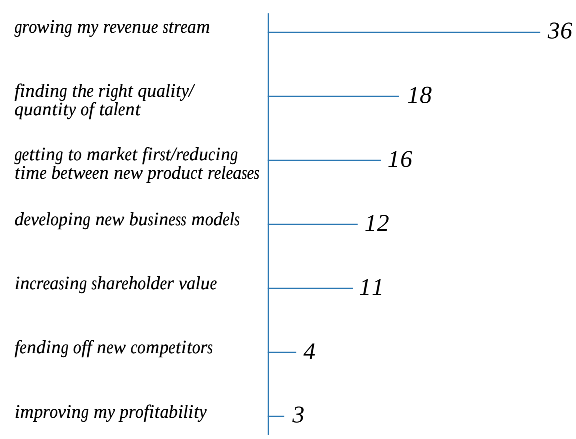
WHAT IS YOUR COMPANY'S REVENUE?
percent



Among participants, 64% represented private companies, with 26% from public companies and 11% from partnerships. However, what's dramatically different is, of the private companies represented, 60% were planning to do an initial public offering in the next 12 months—an increase from 37% in 1999 and only 25% in 1998.

With revenues factoring significantly in whether an IPO-bound company will succeed, it is no surprise that, in a Quick Tally poll, the largest share of executives chose "growing my revenue stream" as the chief concern "keeping them up at night." Of least concern were issues of profitability, shareholder value, and differentiating against competitors—which reflects executives' confidence in the current capital markets. Apparently, executives are concentrating on top-line growth as the de facto measure of potential IPO success.

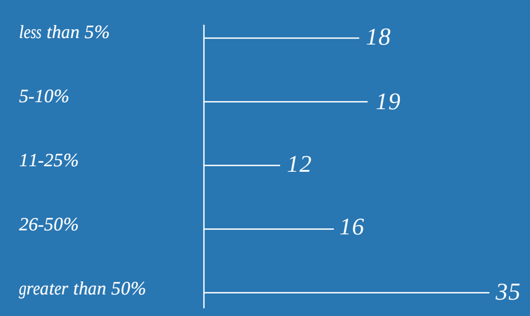
WHAT MOST KEEPS YOU UP AT NIGHT?
percent



With the emerging sophistication of the Internet and the economic pressures generated by customers and competitors, ISVs are looking to new ASP and B2B economic and technology models to fuel the enormous growth required to succeed in an IPO.

asps:
the end of software as we know it?

In the 1990s, customers were satisfied to let vendors focus on building software products—not on providing service-based solutions. Today, as Web-based technologies advance and competition increases, customers are demanding the same software solutions at dramatically lower prices, and they expect vendors to bear the risk and the heartache of difficult implementations. As one presenter described his company's response to customer problems, "Customers are hurting because of IT indigestion; the complexity and multitude of software offerings are making customers sick. Our jobs are to shield customers from this pain."



WHAT PERCENTAGE OF YOUR REVENUE WILL BE GENERATED BY THE ASP MODEL IN 2003?
percent

These new advances in technology and increases in customer expectations are driving vendors to develop ASP models. Participants hit this point home by their response to a Quick Tally poll: by 2003, a large plurality expects more than 50% of their revenue to come from ASP models. Given this trend, it seems likely that successful companies will invest in product development, channels, human resources, and the infrastructure needed to support the new ASP model. With these issues in mind, participants explored four major ASP topics at the conference: the various value propositions emerging for ASPs; the uncertainty of profitability ahead; the challenges of customization; and finally, what ISVs are doing to make their services habit-forming for their customers.

MULTIPLE VALUE PROPOSITIONS ARE EMERGING

There are multiple value propositions emerging among the vendors who were represented on the conference ASP panel. While these value propositions do not fit neatly into a two-by-two matrix (there is some overlap), a pattern does emerge based on switching costs to customers.

The first value proposition has the lowest switching costs. Under this proposition, vendors are using low switching costs as a way to gain marketshare. One example is a collaborative applications vendor which needs to create networks of product-team-based users to win in its market. Market acceptance is based on a positive feedback loop: the more users the ASP acquires, the easier it is for the ASP to attract each additional user. So, the ASP's goal is to eliminate barriers to users trying the services and to make the process of signing up for the service as simple as possible. To elaborate, customers are sometimes reticent to subscribe to a service because they don't want long-term contracts. In this model, contracts and obligations that might discourage customers from signing up are eliminated.

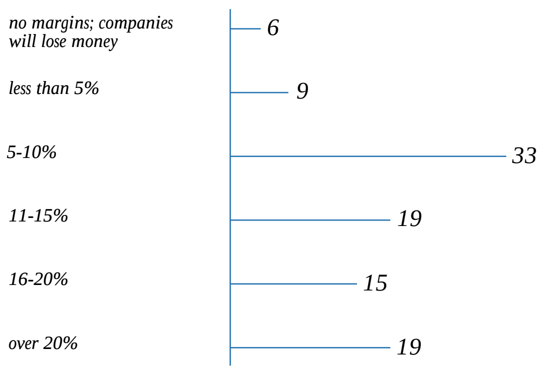
The second value proposition has medium switching costs, and offers a combination of application hosting and complexity management. It is perhaps the most encompassing and familiar of all ASP value propositions. Under this model, ASPs host standard applications from conventional ERP vendors, assuring customers that these applications will all work well together and simplify customers' processes. In essence, this is taking the IT problems from customers, allowing them to focus on their own core competencies.

The third value proposition has the highest switching costs but provides the fullest service to customers. It effectively carves out all business processes in addition to handling the software-hosting piece. For example, a customer who needs HR solutions could turn to an ASP to provide a virtual HR department in addition to application hosting. This value proposition comes with the highest switching costs because customers depend on the ASP to provide not only software, but live HR process support as well.

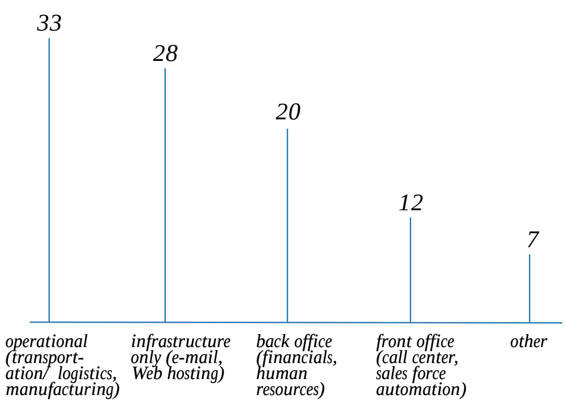
UNCERTAINTY IN PROFITABILITY

Some vendors were uncertain about the profitability of the ASP model. One reason for this may be the shifting of risk from customers to vendors as providers move from shipping products to providing services. Another may be the overall uncertainty about the costs and benefits of moving toward this new economic model.

WHAT TYPE OF MARGINS SHOULD ASP COMPANIES BE ABLE TO GENERATE BY 2003?
percent



WHICH OF THE FOLLOWING ASP TYPES WILL BE THE LEAST FINANCIALLY SUCCESSFUL IN 2003?
percent

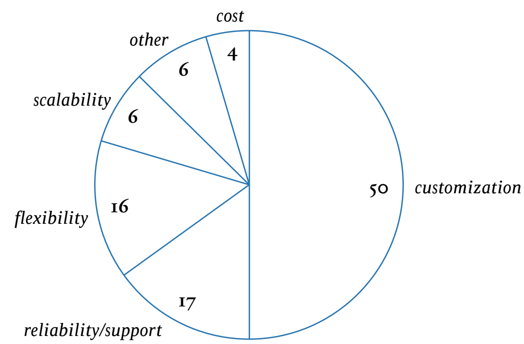


A Quick Tally poll showed that a large minority of participants think that net profit margins for the ASP market will be in the 5% to 10% range, however participants' profitability estimates were widely dispersed. In fact, one-third of respondents expect profitability to be higher than 15% (and the weighted average estimate of respondents is actually 12.3%), so predictions were by no means conclusive.

Polling also showed participants think some sectors of the ASP market may have a more difficult time financially than will others. Reasons for participants' conservative projections for ASPs providing operational solutions might be related to the amount of integration required to successfully implement solutions like these. They are often tied to back-end, legacy systems, which are often inflexible, complex, or both. The conservative financial estimates for infrastructure solutions vendors could be linked to perceptions that these services are difficult to differentiate and these markets are moving toward commoditization.

THE CUSTOMIZATION CONUNDRUM

WHAT IS THE LARGEST CHALLENGE THAT ASPs HAVE IN OBTAINING MARKET ACCEPTANCE?
percent



In Quick Tally polls, participants registered their conviction that the biggest challenge to ASPs in achieving market acceptance is the lack of customization they can offer individual customers. Customization is a real obstacle because of the inherent tension between customers' demands for unique solutions and the providers' needs to offer standard, highly replicable services to gain economies of scale. ASPs offering hosting and process management are able to offer customers the same solution at relatively lower prices because they can scale farther than customers can. They can do this for three reasons: they typically have more economic power to get better deals; they have to be world class to compete with other services; and they can offer relatively inexpensive solutions because they can leverage product development and process support efforts across a greater number of users.

Historically, innovators and early adopters have demanded more tailored solutions from software companies launching products. However the early majority and late majority have also come to expect customization. The expectation of customization is a difficult one to reverse. So, ASPs need to balance the requirements of market share objectives with the needs of customers to configure software to individual customer specifications. They can also address this issue by building automatic install and tuning wizards to simplify configurations for basic users while giving power users the ability to optimize product to their needs.

MAKING SERVICES HABIT-FORMING

Panel discussions also revealed that many ASP companies are working to make their services as habit-forming as possible. They view this as an important requisite for success. Panelists focused on ways to get customers hooked on their solutions. Four keys to doing this were identified:

- Create a service that clearly demonstrates value in terms of either dramatically increasing customers' revenues or decreasing customers' costs. It's easier to interest customers when clear returns or savings can be shown.
- Assure customers that there are no "catches" involved. Monthly commitments or try-and-buy programs encourage trials; long-term obligations do not.
- Create pricing which is incremental and fiscally manageable for customers. Low per-month charges allow customers to easily remain loyal; high up-front costs do not.
- Make it easy to register and deploy service.

To summarize the issues in the ASP space, customers are demanding the same software at lower prices and participants expressed uncertainty about ASP profitability. Successful ASPs are eliminating barriers to trials and implementing models that make habits easy to form. They are also working to manage the tension created by their customers' needs for customization and the necessity of producing standardized, volume-driven services. Companies can reduce this tension by allowing customers to self-select implementation options by automating configurations and working with integration vendors. Last, with the increasing transparency of price and the proliferation of service options, successful ASPs will rely increasingly on differentiating themselves based on the quality of their customer service.

business-to-business solutions

The Business-to-Business solutions model is another important engine vendors are using to power their growth. In addition to fueling vendor growth, this model is providing customers with improved efficiencies, more transparent prices, and a proliferation of additional value-added services. It is also pushing vendors toward more synchronized collaborations with customers, vendors, and even competitors.

The growing adoption of collaborative standards means enterprises' abilities to use software to create business value has never been greater. We are witnessing an overall restructuring of the value chains of every industry, and the latent economic value unlocked will be enormous. In fact, the economic impact of these changes could be many times over the value created thus far in the history of the software industry. In addition, B2B vendors are recognizing that transaction costs, value, and price are approaching zero. Price is also becoming more transparent and important. However, the most important implication of these new B2B trends is the notion of collaboration, which is enabling buyers and suppliers to design, build, and deliver increasingly customer-facing solutions.

PRICE OF TRANSACTIONS IS APPROACHING ZERO

The emergence of marketplaces is changing the most basic characteristics of commerce—both reducing transaction costs and building stronger ties between buyers and sellers. A number of panelists and speakers discussed the fact that one of the biggest tangible economic effects of linking B2B suppliers and vendors is the elimination of the economic inefficiencies of exchanging goods and data related to those goods. As marketplaces emerge, a clearinghouse for goods and data is born which provides sellers with demand for their goods, and buyers with a supply for their needs. And, as these markets proliferate, it is likely that super marketplaces will develop, interconnecting smaller markets in commerce webs. As the inefficiencies of conducting these transactions are eliminated and competition increases, the value of these transactions will approach zero. Transactions will become commoditized. As transactions themselves become less valuable, B2B vendors will focus on value-added services to differentiate themselves. However, one B2B panelist noted that while this commoditization was occurring, pricing models for vendors might continue to use transactions as a metric for capturing value. His argument was that because "number of transactions" is a common, simple measure, it can serve as a proxy for the value that is provided elsewhere in the B2B infrastructure.

PRICE IS BECOMING INCREASINGLY TRANSPARENT

A second tangible economic effect of B2B links mentioned by two speakers was increased transparency of price. This is true for net market users—buyers and sellers of goods—because as net markets are implemented, the importance of price in decision making is increasing. Similarly, this effect also applies to B2B software vendors and B2B net market owners to a degree. This is due to the commoditization of technology as well as users' increased abilities to see increasingly greater options among B2B technology providers. So, with the increasing importance of price, some vendors are differentiating via value-added services, as mentioned above. One presenter pointed out, "People are happy to pay more for a commodity if customer service is there."

In summary, as comparing price becomes easier to do, price as a lever in driving buying decisions becomes more important—for both users of exchanges and for exchange builders. However price is usually not the only important driver of purchasing decisions.

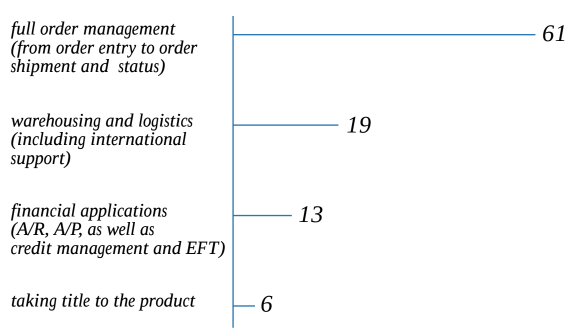
THE IMPORTANCE OF COLLABORATION

One of the most important effects of B2B technology is the collaboration between buyers, sellers, and customers up and down the supply chain—not only as regards transaction costs (discussed above), but also as regards information sharing and collaborative planning. As one speaker observed, "It's not just about purchasing and supply—it's about build-to-order [and] improving core businesses." There is enormous value unlocked when upstream suppliers gain access to downstream buyers' product plans, forecasts, and customer insights. Suppliers can begin designing their products earlier to fit with their buyers' visions for future products. They can make better decisions about capital equipment and human resource requirements if they better understand buyers' forecasts. And suppliers can incorporate customer requirements more accurately with more complete and timely access to customer data and market research. Buyers, of course, get better products with fewer defects and fewer delays. They also get better prices (as discussed in the previous section). Overall, tighter collaboration yields more customer-facing, design-build-deliver organizations, which works more synchronously and efficiently.

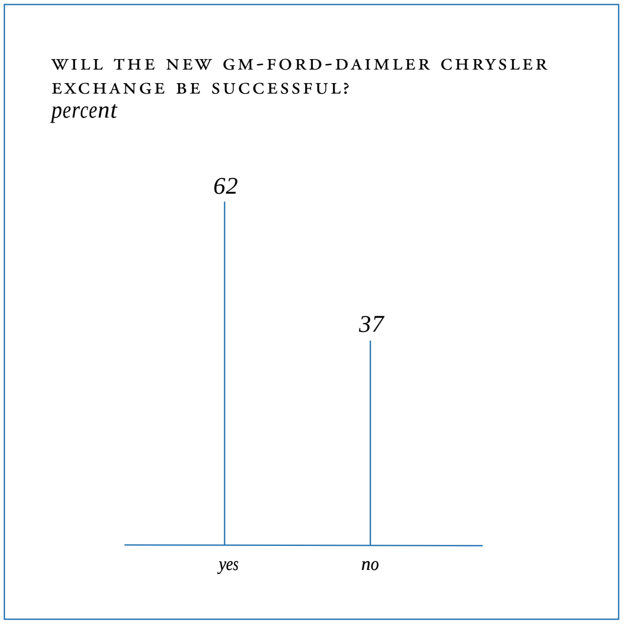
Many functions must be present to deliver on this promise of a collaborative B2B supply chain. With regard to which collaborative B2B pieces are most important early on, polls indicated participants believe that full order management will be the most critical functionality in successful exchanges or marketplaces by 2002.

In fact, participants believe this to be true by a huge margin. The basic value that exchanges provide is their ability to manage orders; it is the basic building block application on which B2B exchanges are built. While it is true that other components (warehousing, logistics, and financial applications) are also important to buying and selling goods, these can be accomplished largely through other existing applications (for example, ERP vendors' solutions), and may be perceived as ancillary modules in participants' responses.

LOOKING OUT TO 2002, WHAT ADDITIONAL FUNCTIONALITY WILL BE MANDATORY IN A TRADING EXCHANGE OR MARKETPLACE?
percent



CO-VENTURES AND CONSORTIA ARE INCREASINGLY IMPORTANT



Some presenters discussed the increasing importance of co-ventures and consortia. When polled as to whether organizations like the GM-Ford-Daimler Chrysler automotive exchange would be successful, participants responded by nearly a 2-to-1 margin that they thought the exchanges would be.

It is important to understand the value that B2B vendors provide in building successful exchanges. First, they bring innovative technologies, which represent enormous fixed-cost expenditures and the work of world-class talent. Second, they bring a history of success in implementing exchanges. And third, they bring special access to capital, technology, and industry partners.

However, it is also clear that there are sources of value that Fortune 500 companies bring in creating successful and enduring B2B networks. These sources are grounded in the corporations' domain expertise in serving vertical markets, in the supplier and customer relationships they have invested in over decades, and in the brand(s) they have built through years of research and investment. These forces are at work in the development of the GM-Ford-Daimler Chrysler B2B exchange, where significant power is concentrated in buyers' hands, and it gives those buyers a big say in who will own the exchange and who will be allowed to participate in its establishment. In the automotive industry, these few buyers exercise enormous, concentrated buying power. Because the revenue stream they currently control is so huge, they are better able to dictate terms to both suppliers and technology vendors.

For these reasons, consortia like this will continue to flourish and to wield a fair amount of power. With this in mind, successful software and solutions vendors should take aggressive action to co-venture with their customers; each providing an integral piece of the overall value proposition in building successful B2B markets and supply chains.

ONE THING NEVER CHANGES—THE CHALLENGE OF INTEGRATION

One of the biggest, enduring challenges the software industry has faced is the lack of integration between packaged applications (and also homegrown systems)—and this hasn't changed for the B2B sector. Electronic Data Interchange (EDI) is one traditional way of managing this challenge. However, because of EDI's inflexibility, companies are moving these processes online using XML. This is more complex than it sounds, though. Issues like disparate and dirty data, and reliance on legacy systems make integration between buyers and suppliers problematic. It is especially critical to understand that while XML solves the problem of getting straightforward data across the Internet "bridge" between companies, it is not a B2B integration panacea because it does not complete the bridge by getting that data in and out of back-end ERP and legacy systems. One panelist expressed the view that while the value of "XML is oversold, to see a consortium develop, like RosettaNet, is clearly a benefit." An illustration of the issue is when a B2B buyer wants to order an item from a supplier, a "create order" transaction is transmitted successfully across the Internet using XML. However, until that transaction is integrated with the supplier's and buyer's back-end systems (like inventory, accounts receivable, shipping, etc.), there is no real complete data transaction chain.

To resolve this, B2B vendors can do two things. They can participate in standards boards like RosettaNet to make sure their issues and positions are heard. And they can build strategic partnerships with Enterprise Application Integration (EAI) vendors who have momentum in their target spaces, who have compatible technology platforms, and who have a history of creating mutually beneficial, long-term, revenue-based partnerships.

To summarize the salient issues in the B2B arena, there is huge economic value being unlocked by the implementation of B2B marketplaces; and much of the value is derived from the collaboration between buyers and sellers, not just in the reduction of transaction costs. Many B2B players are moving toward a model of co-venture with customers, since each has a valuable component of building successful B2B exchanges. With regard to this collaboration, ISVs should think of their customers as partners and co-owners, not as parties to be sold to and moved away from. Vendors should also realize that XML is not a B2B panacea and that integration is going to continue to be as difficult as it has always been. The good news is that ISVs can work with standards boards and EAI players to facilitate integration and better unlock the value promised by B2B today.

conclusions

The past year saw the explosion of B2B investment and implementation, and continued acceleration in the rate of change within the software and services industry. The Global 1000 are asserting their power and demanding equity shares for the value they bring to their co-ventures with software companies.

To conclude, there is no question that the new economy is transforming the way industries do business, and software lies at the very heart of that transformation. Over the course of the next year, we will no doubt see new business models flourish and new ideas develop. Next year, the Enterprise 2001 Conference will be held at the Inn at Spanish Bay on June 8-10, so please mark your calendars. We look forward to seeing you