ENTERPRISE 2002 SUMMARY

ENTERPRISE 2002

McKinsey&Company

SAND HILL GROUP LLC

preface

We are pleased to present the fifth annual report on the state of the enterprise solutions industry. A sold-out event, Enterprise 2002 brought together an elite group of 200 enterprise software leaders to debate the state of the industry, share ideas and opinions, network with peers, and discuss issues of common interest.

While last year's conference focused on reacting to a recession then hoped to be brief, this year's event stressed the tough choices companies must make to outlast the downturn and position themselves for recovery. Much of the emphasis was on surviving the current environment, identifying means to break out, and adapting to new customer buying patterns.

The Enterprise 2002 report, a collaboration between Sand Hill Group and McKinsey & Company, summarizes the conference presentations and panel discussions in the context of both the current industry climate and the beliefs expressed at last year's conference. In addition, it details trends and challenges going forward. It is intended to provide a unique perspective on the ideas and opportunities discussed at Enterprise 2002. In keeping with the tradition of previous reports, we include highlights of the most interesting results from the Quick Tallies of participants.

Also this year, the SHG Foundation proudly presented grants to both the Field Trip Foundation and the Women's Opportunity Fund. Sand Hill Group created the SHG Foundation to pass on to charity all surpluses from the annual Enterprise Conferences. The SHG Foundation grants awards each year to non-profit organizations helping to improve the lives of low-income women and children around the world.

We hope you find this report both intriguing and practical as you plan for the challenges confronting your own organizations in the coming year.

Constantin Delivanis (cd@sandhill.com)
M. R. Rangaswami (mr@sandhill.com)
SAND HILL GROUP LLC

Greg Hughes (greg_hughes@mckinsey.com)
Mike Nevens (mike_nevens@mckinsey.com)
Bill Pade (bill_pade@mckinsey.com)
MCKINSEY & COMPANY

enterprise 2002 advisory board

The Enterprise 2002 report, and all previous Enterprise reports and conference information are available online at www.sandhill.com.

introduction

In May 2002, a select group of senior executives and other leaders of the enterprise software industry gathered at the Inn at Spanish Bay in Pebble Beach, California, to attend Enterprise 2002. In this private and intimate setting, they exchanged views on the present and future of the enterprise solutions industry, and spoke frankly about the issues and trends facing their companies and clients.

Not surprisingly, the primary topic was surviving the current downturn. Last year, when the recession was just beginning, 83% of attendees said their biggest issue was increasing revenues. This year, however, attendees were much more focused on managing profitability (58%) and revenue growth lagged well behind (32%).

Major topics of discussion included how customers are changing the nature of their software purchases, which categories of software may experience near-term growth, and what the downturn implies for industry structure. Finally, most attendees were concerned about conserving capital to remain viable in the downturn – a decided change from previous years.

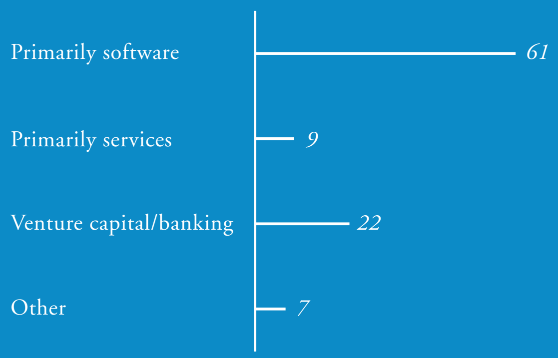
We wrote last year that the enterprise solutions industry is not immune from the effects of the business cycle. Unfortunately this cycle is proving to be longer and more painful than expected – and the tragic events of September 11 have compounded it. We believe that in this environment, software companies must confront the tough choices and consider options that may diverge from the traditional model of software success. We hope this report provokes further thought about these issues, carrying forward the discussion begun at Enterprise 2002.

ENTERPRISE 2002 *Conference Summary*

the participants

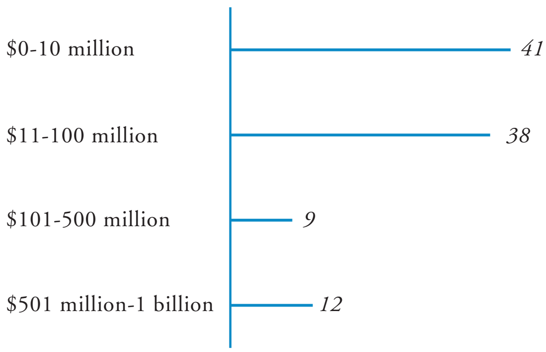
The senior executives who gathered this year came from the same basic segments as last year – software, services, investment banking, and venture capital. Of the participants, 32% represented public companies, 50% private companies, and 17% partnerships. Overall, 81% were either CEOs or managing directors of their organizations.

WHAT TYPE OF COMPANY DO YOU REPRESENT?
Percent



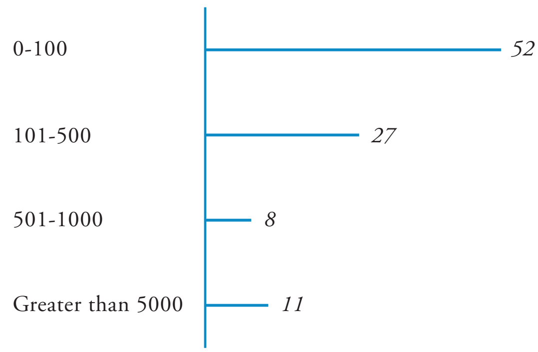
Source: Enterprise 2002 Quick Tally results

WHAT IS YOUR COMPANY'S REVENUE?
Percent



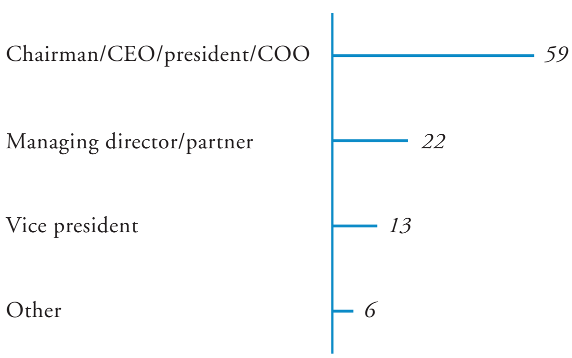
Source: Enterprise 2002 Quick Tally results

HOW MANY EMPLOYEES DOES
YOUR COMPANY HAVE?
Percent



Source: Enterprise 2002 Quick Tally results

WHAT IS YOUR TITLE/POSITION?
Percent



Source: Enterprise 2002 Quick Tally results

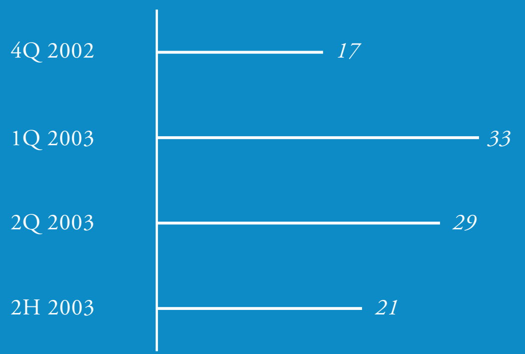
life in the downturn

ADJUSTING TO THE POST-HYPERGROWTH WORLD

The past 12 months have seen little joy for software providers. While the overall economy may be reviving from what some analysts call the "shallowest recession in history," software companies have yet to feel the effects of any upturn. Unlike last year, when the "collapse of the bubble" dominated the conference, this year saw no dramatic changes, but rather a prolongation of the bad times that began in late 2000. The terrorist attacks of September 11 exacerbated the situation, causing most IT purchasers to further restrain purchasing except in perceived mission-critical activities such as security and disaster recovery.

Few attendees foresaw recovery in the second half. The great majority placed it in 2003, and some felt it might require a new generation of technology, perhaps collaborative software.

WHEN WILL WE SEE AN INCREASE IN SPENDING ON ENTERPRISE SOFTWARE?
Percent



Source: Enterprise 2002 Quick Tally results

CUSTOMERS HAVE RETRENCHED

Customers have responded to the ongoing recession by becoming much more conservative in their IT purchasing and focusing their orders on incremental projects that simplify complex environments and help reduce costs.

Some customers discussed using the downturn to concentrate on "getting more value out of existing assets" by customizing, upgrading, or further integrating their current IT rather than buying new systems. While customers described this strategy primarily as a way to leverage both underutilized IT resources and existing "shelfware," it may also mark an opportunity for vendors who can make a convincing case that their products empower customers to "do more with less."

CUSTOMERS PERCEIVE NEW NEEDS

Customers expressed a strong desire for software that is a) sound, b) nonstop, and c) integrated. First, they want products that work out of the box, since bugs are time-consuming to fix. Stability matters more than features. In addition, they seek nonstop functionality, noting that the web has eliminated the luxury of downtime for applications and databases. Finally, they cited difficulties with inter-application integration as the greatest single cause of project time slippage and cost overruns. Customers feel a major market opportunity lies waiting for firms that improve code quality, operational continuity, and integration – and of course, rapid, tangible ROI remains a paramount need.

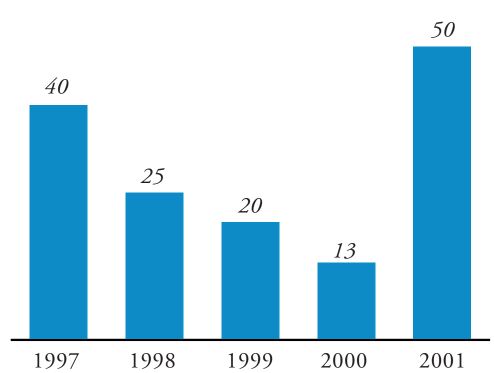
SMALL COMPANIES FACE BIG CHALLENGES

Just as we reported last year that small software companies would face tougher competition from larger players (the top 32 software companies could control up to 93% of total software spending by 2005), today small companies face even harsher challenges.

Customer conservatism will send IT buyers back to established providers, partly because they believe these companies – and their support – are more likely to survive. In addition, purchasers are more apt to categorize their vendors by type, seeking to develop relationships with a close circle of "strategic partners," making smaller point-purchases from a series of "one-time suppliers," and using sub-contractors as fungible, undifferentiated resources. In a situation where a F500 customer may work with only 5-10 strategic partners, it is critical to either become one of those partners or form strong relationships with those who are.

THE MARKET IS REQUIRING PROFITABILITY FOR IPO CANDIDATES

Percent of SW companies profitable at IPO



Source: Hoovers Online; McKinsey & Company analysis

Buyers' needs to cut costs and reduce implementation time will favor players with an easy-to-integrate suite of solutions, not smaller providers with best of breed point products. Again, emerging companies face a challenge: Either demonstrate that their products work easily with their clients' IT assets, or approach prospective customers who have strong partnerships with larger, more established vendors.

Funding opportunities are drying up, and the requirements for IPO have increased. In 2001, VC investment sank to pre-boom levels: venture capitalists invested $38B in high tech in 2001, compared with $102B in 2000. And of software companies that IPO'd in 2001, 50% were profitable at the time of IPO, compared with just 13% in 2000.

A FEW AVENUES FOR SUCCESS REMAIN

Despite the gloom, we did hear of several possible avenues for success. In the difficult B2B segment, some companies have survived through partnerships – we heard from one B2B leader that finding a single large partner with aligned interests has been crucial to its success. In the equally challenged ASP segment, we heard that focusing on a single clear value proposition with straightforward economics can lead to the same scalability and margins that we expect from licensed software. For one successful ASP a clear sign of success is having thousands of customers and tens of thousands of users all running on the same application on a single server – avoiding the customization and other variable costs that have plagued other players in this space.

Another fruitful line of discussion concerned which categories would become "systems of record" – Geoffrey Moore's term for systems like ERP that contain basic reference data that every enterprise must retain over time to function. It was argued that the path to success for companies building potential systems of record, such as CRM for customer data and perhaps PLM for product data, will be quite different from the path of companies building applications which either make use of this data or perform other functions. The key here is to know which systems will become fundamental platforms and align your company with them as they reach broad adoption.

making the tough choices

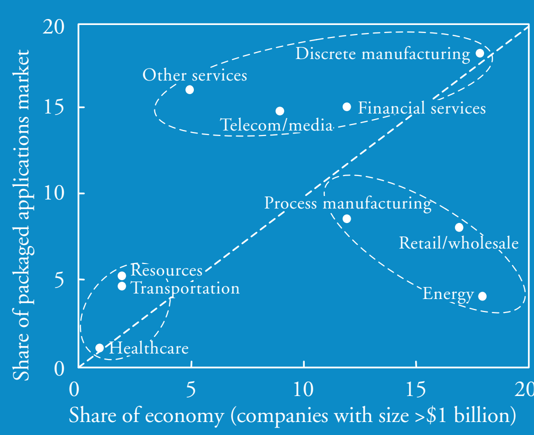
Despite these few successes, the rules have clearly changed for most software companies. Eighteen months ago, the formula for success was straightforward and had four well-known principles. Today, none of these principles necessarily applies. The formula used to be:

- **Principle 1.** Concentrate on the highest spending verticals and geographies. May not apply because: Significant opportunities are emerging in new geographies and industry sectors.
- **Principle 2.** Deploy an aggressive direct sales force to land big deals. May not apply because: More enterprises are stratifying their IT vendors and working directly only with a few, large players.
- **Principle 3.** Focus on license sales, and rely on partner SIs to provide services. May not apply because: Services revenues are growing faster than software, and SIs are exerting more control over software purchases.
- **Principle 4.** Grow revenues quickly at the expense of sustained profitability. May not apply because: Cash flow, not rapid revenue growth, is re-emerging as a value driver.

In the current environment, instead of these four magic ingredients of success, there are now four hard choices:

- **Choice 1:** Target traditional markets or focus on an underserved industry or geography?

VERTICAL OPPORTUNITIES
Percent of U.S. listed companies



Source: IDC; McKinsey & Company analysis; SIC code classifications

A high-spend vertical is one whose percentage spent on IT exceeds its percentage of the GDP. Historically, three broad segments have fallen into this category: financial services, telco, and manufacturing. However, these verticals are still recovering from their past over-investment, and the downturn has left telco and high-tech manufacturing particularly battered. At the same time, at least two sectors – retail and energy – may be prime candidates for increased future growth.

- **Choice 2:** Invest in the direct sales model, or strengthen sales channels and partnerships?

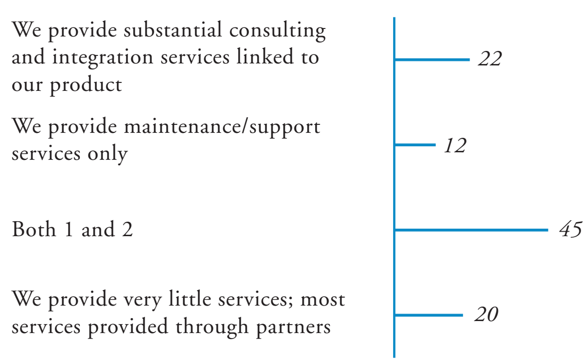
An active direct sales force was vital during the boom. However, today we are witnessing a marked rise in sales influenced by another party. From 2000 to 2005, according to IDC estimates, the percentage of software sales influenced by another product or service provider will climb from 64% to 82%. Such figures strongly suggest that CEOs should spend more time with partners and stress the management of those relationships, even at the expense of reducing their emphasis on direct sales.

Two contrasting Quick Tallies – one about the present, the other about the future – show awareness of the trend. In the first, 72% of attendees said their companies primarily use direct sales, while 10% mainly use channel partners. In the second, 56% said direct sales would be the primary means of selling the next generation of software, and 18% cited channel partners.

- **Choice 3:** Focus on distinctive product functionality, or have a joint product and service value proposition?

Firms should consider whether the addition of a few services could make a significant difference in customers' perception of value. It is worth remembering that before the boom, many successful software companies began essentially as consulting firms. They developed custom software for specific customers that only later became productized and sold into a broad customer base. This "customized first, horizontal second" approach may return to a majority of the market.

WHAT IS YOUR COMPANY'S SERVICES FOCUS?
Percent



Source: Enterprise 2002 Quick Tally results

- **Choice 4:** Grow revenues quickly through new customer acquisition, or emphasize profitability within a stable installed base?

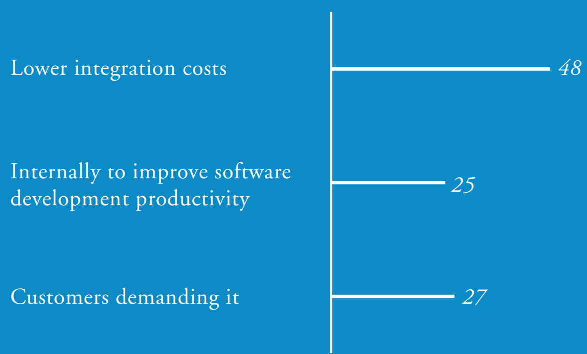
Historically, the market has rewarded revenue growth over profitability for software companies, but recent analysis indicates that expectations of increased profitability have a stronger impact on market multiples. At the same time, the difficulty of selling to new customers suggests that delivering more value to (and thereby deriving more revenue from) the installed base will be more important in the near term. These factors, along with the current lack of availability of capital, lead to a clear inference: in the near term it will be better to manage to a slow, self-sustaining growth trajectory than an aggressive path that requires substantial capital infusion. Significantly, 58% of attendees named profitability as their primary financial goal for the next year, while only 32% cited strong revenue growth.

For each of these choices, the "traditional" answer is not necessarily wrong – but companies should think hard about whether to balance one or more of these traditional success factors with its opposite.

predictions

Last year, we made six predictions: (1) the recovery would be U-shaped; (2) ecosystems would grow more important; (3) web services would present some new opportunities; (4) the enterprise solutions industry would mature overall; (5) fundamentals would again become fundamental; and (6) some disruptive changes would occur. The events of the past year have confirmed many of these predictions, although we all would have hoped to see a solid recovery by now as well as a few more disruptions that could drive new spending. Likewise, despite much talk in the press about web services, they have led to little incremental spending – although that may change in the coming year.

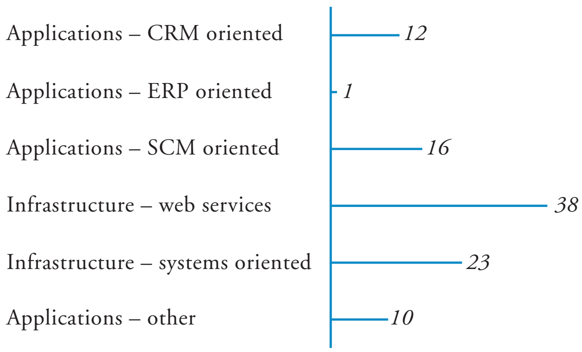
WHAT IS THE PRIMARY DRIVER TO MOVE TO A WEB SERVICES ARCHITECTURE?
Percent



Source: Enterprise 2002 Quick Tally results

Looking ahead, we believe several of these predictions will remain valid over the coming year. The enterprise solutions industry will mature further, leading to some industry rationalization and shifts towards more industry-efficient business models. Ecosystems will grow even more important as customers tier all of their IT suppliers behind a few large partners who are expected to provide a complete software and services solution. And the fundamentals of building a sound, profitable company will continue to be the prime ingredients in market success.

WHICH MARKET WILL COME BACK THE QUICKEST?
Percent



Source: Enterprise 2002 Quick Tally results

Given the transitional nature of the current environment, on balance we expect a period of continued uncertainty rather than one of dramatic new trends. However, certain developments appear significant. In particular, we think business processes outsourcing and the emergence of a more complete, global digital platform are worth noting.

BUSINESS PROCESS OUTSOURCING WILL ACCELERATE

Enterprises more and more outsource non-core functions, and the trend will increasingly affect enterprise software and service providers. The latest aspect of it, business process outsourcing (BPO), involves the wholesale divestiture of assets associated with processes, such as HR, to the management of a third party. One interesting upshot of BPO is that it shifts many IT decisions from enterprises to the outsource companies. This change in industry structure creates a whole new category of potential partners and customers – but also adds complication to already convoluted enterprise sales cycles.

THE GLOBAL DIGITAL PLATFORM WILL BECOME MORE IMPORTANT

We are moving toward a more complete, global digital platform, as wired and wireless connectivity expands inexorably, devices (PDAs, tablets, cell phones) penetrate new computing niches, and digital technology (RFid tags, sensors, appliance automation) spreads throughout business and consumer life. This platform could be the source of radical innovations, and we are just beginning to see the business process and consumer benefits it can provide. However, the majority of the rewards will go to those firms that set the standards and identify the first dominant applications. Unlike prior deployments of technology that required more central control, the development of this global platform creates the possibility for more innovation at the edge – a fact we expect to grow more important over the next year.

conclusions

In the short term, we must live with the downturn, and current customer behavior will affect what firms need to do (and can do) in the future. Customers will increasingly turn to large providers for integrated suites of solutions, and best-of-breeds will be increasingly difficult to sell.

Getting to IPO will require a difficult combination of aggressive profit focus and the continued ability to grow sales. In addition, the boom and bust cycle of recent years has demonstrated that "making it to IPO" is not enough. Many companies successfully IPO'd in 1999 and 2000, only to face severe dropoffs in profits and stock prices in 2001.

Overall, managing in the current economy will entail tough choices in the near term. The industry is likely to see significant restructuring, with major implications for the way smaller software firms bring their products and services to market. The long-term prospects, however, remain substantial, as software innovation will continue to drive business process innovation that leads to competitive advantage and value. The companies that focus on enabling this customer value should achieve long-term success.

As software companies make the hard choices over the next 18 months, new questions will likely emerge. How large must a software company be for major enterprises to view it as a potential partner? What scale across industries, geographies, and scope of functionality do they need for success? What will happen to the scores of smaller firms that cannot reach this new threshold? Will they be acquired, fade away, or survive as the suppliers to new distribution channels (such as business process outsourcers) that are only just emerging? And finally, how will BPO and the emergence of the global digital platform create new opportunities for innovation and value creation?

We hope to discuss questions such as these when we gather next year at our new location, the Ritz-Carlton Laguna-Niguel, on June 1-3, 2003. We look forward to seeing you there!