ENTERPRISE 2003 SUMMARY

ENTERPRISE 2003

This report is a collaboration of McKinsey & Company and Sand Hill Group LLC

preface

We are pleased to present the sixth annual report on the state of the enterprise software and solutions industry. Enterprise 2003 brought together an elite group of 175 enterprise software leaders to debate the state of the industry, share ideas and opinions, network with peers, and discuss issues of common interest.

Many of the themes of last year's event continued into this year, foremost among them surviving the difficult economic and business environment and adapting to new customer buying patterns. New themes this year included the implications of the continued development of the industry, the dramatic increase in offshoring, and on a more positive note, the demonstration of some examples of real and dramatic ROI from technology investments in specific industry settings.

The Enterprise 2003 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 2003. 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 "Music for Minors" (www.mfm.org) and the "World Cataract Foundation" (www.worldcataract.org). 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.

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The Enterprise 2003 report, and all previous Enterprise reports and conference information are available online at www.sandhill.com.

introduction

In May 2003, a select group of senior executives and other leaders of the enterprise software industry gathered at the Ritz Carlton in Laguna Niguel, California, to attend Enterprise 2003. 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.

The primary emphasis moved past last year's focus on the downturn. This year, attendees expressed a cautious optimism and exchanged ideas about identifying opportunities. This year 69 percent of attendees agreed that the NASDAQ has bottomed out, compared with 43 percent 2 years ago. Growth (46 percent) and innovation (29 percent) were the attendees' primary concerns.

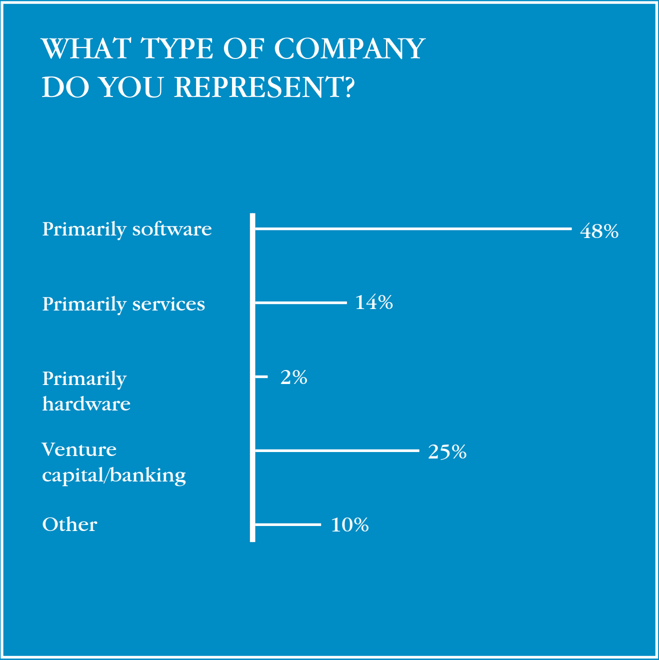
Major topics of discussion included the mainstreaming of offshoring. In an industry longing for a new killer application, enabling offshoring may have become just that. Strategies in this arena varied and customers are taking a cautious approach just the same.

Last year we talked about the fact that the enterprise solutions industry was still reeling from the tough economy combined with the tragic events of September 11. Since then companies have confronted difficult times and made hard choices. This year we also discussed the topic of Governance and the need to prepare for key changes and costs that will impact both public and private companies. We hope this report leads to further thought about these issues and helps in your planning for the coming year, carrying forward the discussion begun at Enterprise 2003.

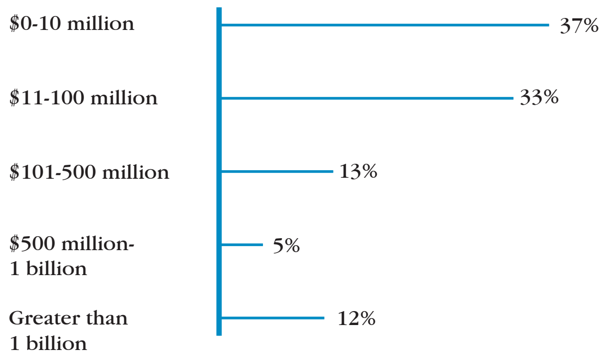
ENTERPRISE 2003 *Conference Summary*

the participants

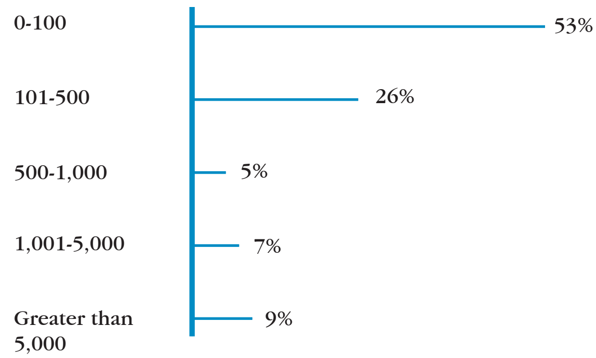
The senior executives who gathered this year came from the same basic segments as last year – software, services, investment banking, and venture capital. Overall, 81 percent were either CEOs or managing directors of their organizations.



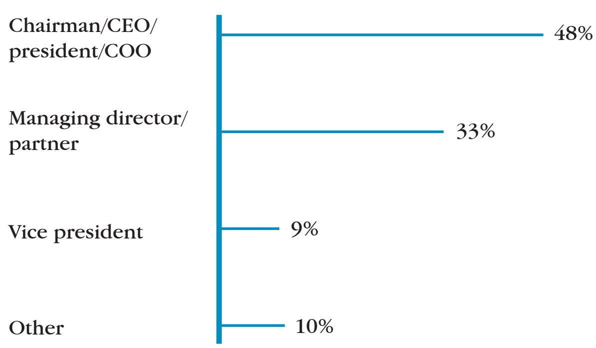
WHAT IS YOUR COMPANY'S REVENUE?



HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE?



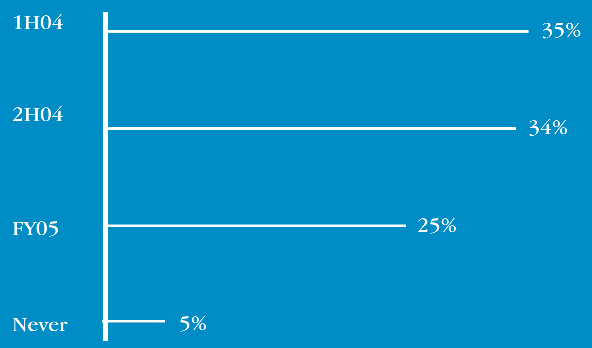
WHAT IS YOUR TITLE/POSITION?



state of the market – "cautious optimism"

Participants at this year's conference struck a note of cautious optimism. Since last year's conference it had become apparent that a return to increased enterprise spending was still some time ahead and the heady predictions of a U-shaped bounce would not play out. 65 percent of participants did not see a significant rise in spending until the second half of 2004, or later, and 86 percent believed industry growth in 2003 would be 7 percent or less.

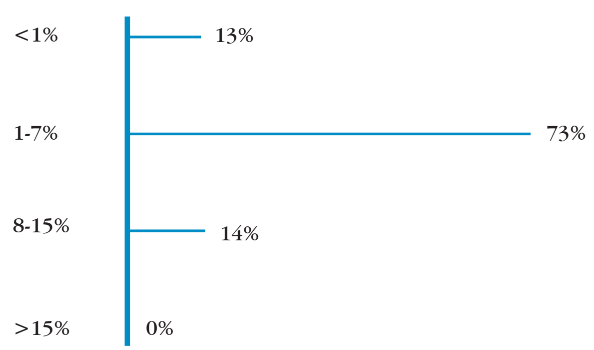
WHEN WILL WE SEE AN INCREASE IN SPENDING ON ENTERPRISE SOFTWARE?



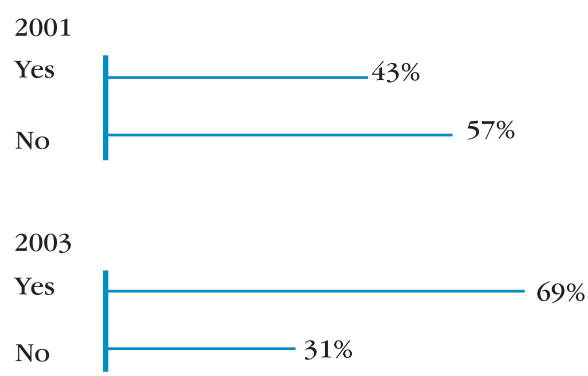
The outlook for high tech valuations was also cautiously optimistic, with an increasing share of participants from 2001's conference believing the NASDAQ to have bottomed out (69 percent in 2003 vs. 43 percent in 2001).

Overall the consensus was that the industry was not accelerating, but neither was it in a state of decline.

WHAT DO YOU BELIEVE WILL BE THE EXPECTED INDUSTRY GROWTH RATE FOR THIS YEAR?



HAS THE NASDAQ BOTTOMED OUT YET?



enterprise software as a mature industry

With constrained growth in most software sectors, the broader market appears to be entering a phase of structural change. The capital markets have also adjusted to much lower, but mostly stable valuations. Investment in software has returned to pre-boom levels with limited availability of public or private capital, and R&D spend has leveled out.

While software has become the biggest category of capital spend in the U.S., its long term growth rate is trending to the overall capital goods average, suggesting a period of stability lies ahead.

Another feature of today's market is the move to increased concentration in many of the software sectors. Customers continue to voice a preference for broader solutions from fewer vendors, and margin pressures continue to create good arguments to drive business combinations that lower aggregate S&M and R&D costs. While these pressures for increased consolidation are strong, and we expect to see more deals in the future, ongoing innovation will ensure that enterprise software does not take on all of the features of a commodity market.

In today's market, enterprise software vendors face 3 significant challenges

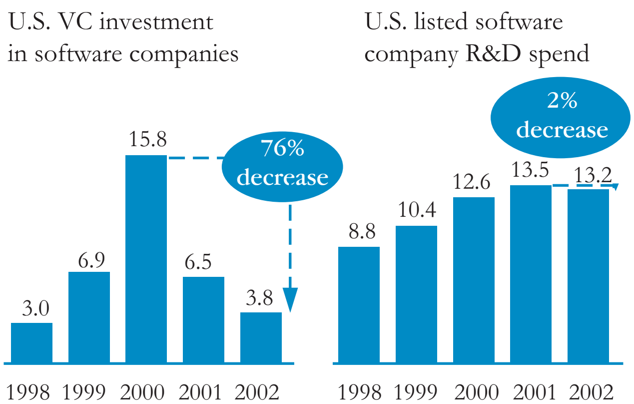
1. How to compete as concentration extends across the stack

2. How to take advantage of the globalization of supply and demand

3. How to align their business model around earnings rather than growth

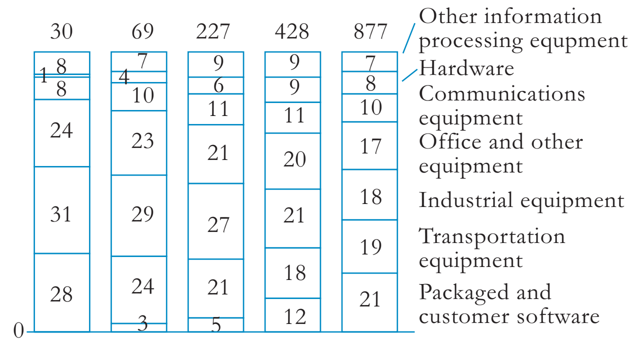
These challenges pose significant risks, but also opportunities for vendors. Companies that learn how to respond and adapt to the new reality of the marketplace, where the buyers have ever increasing power will be the most successful.

INVESTMENT IN INNOVATION IS FALLING
$ Billions



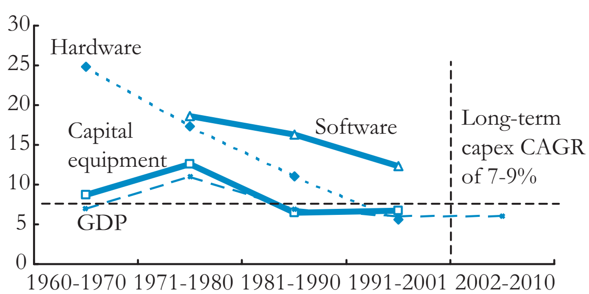
Source: Venture Xpert; Bloomberg

SOFTWARE HAS BECOME THE LARGEST CATEGORY OF U.S. CAPITAL SPEND
U.S. Capex
Percent; $ Billions



Notes: Capex is nonresidential fixed investment in equipment and software. Communications equipment includes network equipment purchased by telecom carriers
Source: BEA; McKinsey analysis

WILL AGGREGATE GROWTH RATE FOR SOFTWARE AND SERVICES CONVERGE WITH THE 7-9% LONG-TERM GROWTH RATE OF CAPEX?
Spend growth in nominal dollars
Percent

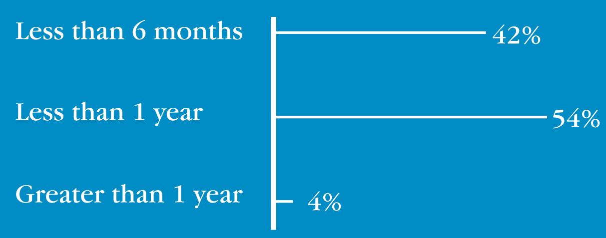


Notes: Capital equipment includes nonresidential fixed investment in equipment and software
Source: BEA

customers get more demanding

We heard of the increasing trend of customers to become more demanding of their enterprise software vendors. For the maintenance and upkeep of installed software, customers demand the same quality of service, but at reduced cost levels. For new products, customers have set a very high bar on the acceptable payback period. 96 percent of attendees told us that vendors are expected to show a payback in a year or less to make new product sales. Our CIO customer panel agreed with this outlook.

IN WHAT TIME FRAME DO CUSTOMERS EXPECT ROI TODAY?



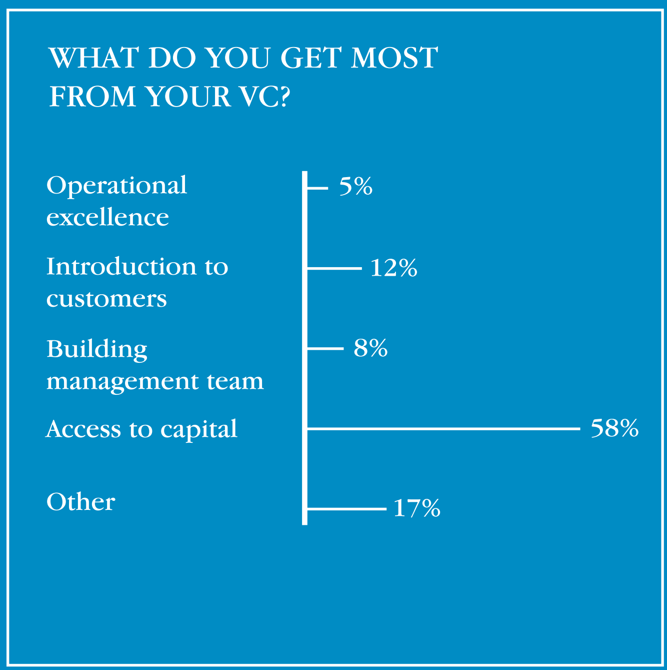
Vendor grading has become an important tool for customers to objectively evaluate their suppliers. Relationships without performance can no longer guarantee future business. We also heard how CIOs are encouraging a much greater alignment between IT staff and business users. In some cases CIO's require a business sponsor throughout the life of a project to ensure IT spend delivers business value. And IT staffs are encouraged to take a more active interest in how IT creates value. One CIO shared his objective over the next year as "getting tech people to think like business people."

We also heard that the trend of tough, demanding customers is unlikely to abate. One keynote speaker outlined a future where today's ratio of 1:8 for software spend to services will be forced to become 1:1 – reducing the available source of consulting revenue. In addition, a move to more standard platforms (a theme we discuss later) means competing software applications will become easier to swap, reducing the bargaining power of installed vendors.

investment opportunities can still be found

Despite these adverse trends for enterprise software vendors, we heard from our VC panel that attractive investment opportunities remain. There was a consensus that even with the expected consolidation, the enterprise software market will continue to support many successful companies. The market is simply too big for it to be otherwise.

Small companies are the most likely winners in vertical markets. A vendor can dominate niche verticals with $300m in sales or less, making these opportunities attractive for the investment community. It was also felt that horizontal application vendors were often not well-equipped to serve verticals, as success



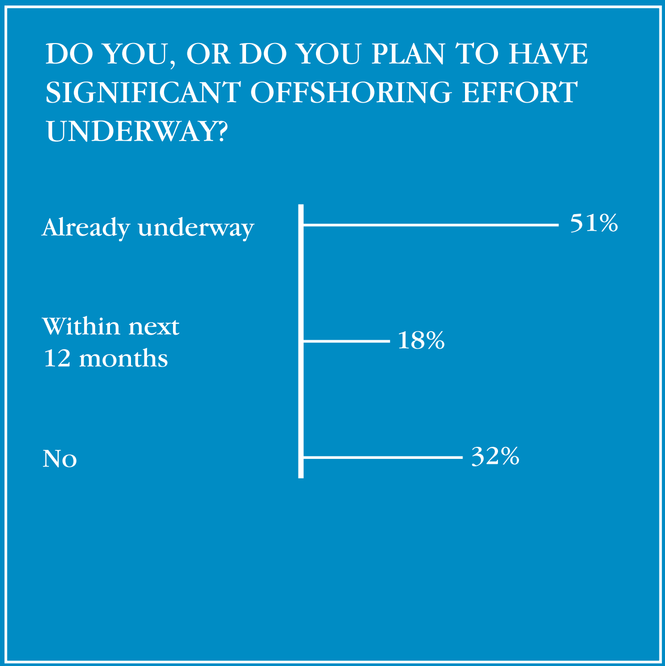
required a different value proposition and mindset. These attributes are often at odds with those needed to succeed in the horizontal markets.

Within the vertical theme, the VC panel also identified a number of fields they are closely following: Self-Service was seen is a phenomenon that has finally reached its time – with growing consumer acceptance. Straight-through processing and real time business intelligence were also viewed as attractive offerings. Security functionality in general was in growing demand – although the current fragmented market frustrated most corporate purchasers.

Despite the need for enterprise software vendors to improve operational capabilities in tough market conditions, VCs are still viewed as primarily providers of capital, not counselors on operational matters.

offshoring becomes mainstream

This year we saw a trend become mainstream – offshoring. As one panelist suggested: "We are all searching for the killer application: It is offshoring." 51 percent of our attendees already had an offshoring effort underway and another 18 percent planned one this year.

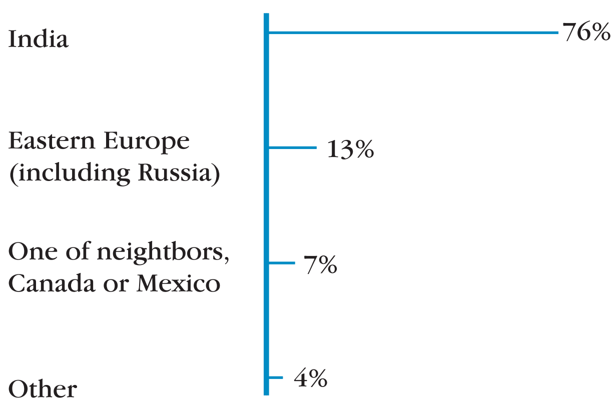


Over ¾ of our participants choose India as the destination of choice and the supply of high quality talent at reasonable cost also seems likely to continue for the foreseeable future.

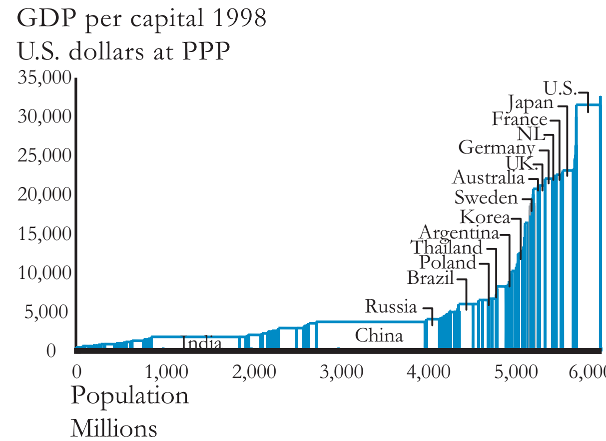
From our panel we heard that offshoring strategy varies by company size. For the largest companies with complex requirements, cost is often not the single most important driver. For some, a compatible culture is paramount and the parent's brand must always be protected. As a result, offshoring decisions are subject to extensive due diligence. We also heard that contracts are now averaging only 3-4 years. In a buyer's market, customers do not want to be committed for longer than necessary. The biggest customers are using 3-4 established offshoring vendors, diversifying their risks and ensuring competition.

For smaller companies, cutting costs and preserving capital by accessing a high quality but less expensive talent pool is the main driver. However, with due diligence and set-up costs, the savings are averaging 50 percent, still attractive, but less than typically publicized. A lack of experience in finding and negotiating with offshoring partners and "bait and switch" in the selection were highlighted as concerns for smaller customers. There was also a fear that offshore companies themselves would become mainland competitors and potentially take business away in serving the large enterprises.

OUR OFFSHORE DESTINATION WILL LIKELY BE:

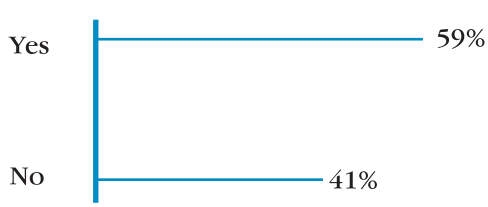


LARGE POOL OF LOW-COST TALENT IN EMERGING MARKETS PROVIDES 20- TO 30-YEAR FACTOR COST ARBITRAGE



Source: CIA World Factbook; DRI/WEFA World Economic Outlook

DO YOU EXPECT INCREASED COMPETITION FROM OFFSHORE SOFTWARE COMPANIES IN 2-3 YEARS?



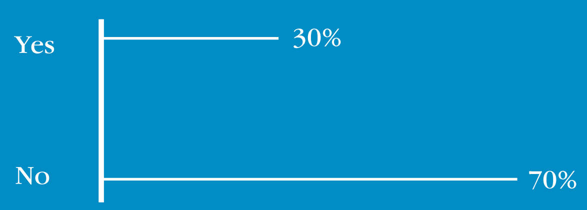
Offshoring companies felt that this market had now matured in India, with low employee turnover and wage inflation. Interestingly, the potential emergence of China as an offshoring option was identified as a benefit, not a challenge to the established Indian companies. For example, some of the major Indian vendors are experimenting with offshoring some of their work to China.

governance becomes a major issue for all

The timely topic of Governance was addressed at the conference. It was noted that only 6 percent of surveyed U.S. corporates considered themselves "completely prepared" to comply with the new requirements of Sarbanes-Oxley – this on top of a growing number of restatements, shareholder lawsuits and bankruptcies. Sarbanes-Oxley has imposed not only additional external audit & compliance costs, but new internal costs too. Most small companies face an incremental cost of $500,000 this year – a significant number for a $50m revenue software company. The time needed to effectively serve on a Board of Directors has also increased. As a result boards are getting smaller and becoming harder to fill.

Private companies also feel the impact of these changes. Those preparing to go public need to comply in advance. For some companies, this is another reason to postpone or delay an IPO.

WILL SARABANES-OXLEY AFFECT YOUR DECISIONS TO STAY PRIVATE VERSUS GOING PUBLIC?



Rather than just responding to Sarbanes-Oxley with accounting reports, our panel discussed taking advantage of the changes by instilling a "performance accountable culture." Good governance is not about producing lots of data, but about providing clarity – for shareholders, and also for management and employees to improve decision-making.

predictions

As with recent conferences, we asked our panelists and speakers to consider the major changes and developments they see in the future. The most consistent themes were around new infrastructure platforms for both hardware and software and whether new business models would take hold.

ENTERPRISE HARDWARE BECOMES A COMMODITY AND PRICES FALL CREATING NEW SOFTWARE OPPORTUNITYS

The enterprise hardware market has yet to enjoy the price performance improvements of the desktop environment – but several forces are at work to suggest the arrival of substantial improvements. The traditional market has been dominated by mainframes and Unix-based servers. Today the performance of commodity Intel and AMD architecture chips are comparable – but at a fraction of the price of traditional solutions. Intel and AMD blade servers, often equipped with a Linux-based operating system, are moving into data centers and challenging the old order. This trend should create many new opportunities for enterprise software developers. The move from a proprietary platform to a commodity, "desktop"-like environment will remove barriers to entry and reduce development costs for software companies.

NEW SOFTWARE INFRASTRUCTURE STANDARDS EMERGE BASED ON OPEN SOURCE CODING

Together with the change in the hardware market, we expect a parallel transformation in the standards for infrastructure software. We heard from one panelist how proprietary Unix solutions had become more expensive (for comparable performance) than either the mainframe or the desktop. This challenges the customary wisdom that Unix should be the solution of choice for enterprises.

Participants expected Linux to continue to grow in acceptance, particularly on Intel and AMD platforms. If Linux continues to establish itself as a broad open source solution, it should create many opportunities for enterprise software companies to port existing applications, convert legacy systems to a common platform and build new applications that make use of the new price performance trade-off. Over time, it will be essential for companies to design to this new standard and where possible gain acceptance for their solutions as part of the new standards.

NEW BUSINESS MODELS CONTINUE TO GROW

As in previous years, several new types of business models have seen increased experimentation – subscription pricing and hosting/outsourcing perhaps the two most important. There is growing evidence that at least for particular segments of the market these new models are increasing in acceptance. Many customers are looking to reduce their up-front expenditures, and to tie ongoing costs more closely to delivered value. However, despite some notable successes, it remains a challenging task to transition a software company from one business model to another. Nonetheless, we expect continued experimentation and that alternative models will continue to increase their traction in this environment.

One business model trend that will continue independent of the revenue model will be the pressure on all elements of the P&L statement to increase earnings. Boosting the effectiveness of S&M spending, driving more products with fewer R&D dollars, and continuing to clamp down on G&A costs should be a primary focus of the CEO and the management team. In an environment with greater constraints on top-line growth, identifying the means to keep healthy earnings growth will be a key driver of shareholder value.

conclusions

This conference marked a shift in perceptions on the outlook for the enterprise software industry. Participants were no longer waiting in anticipation for a rebound to the conditions of 2000. Rather there was an acceptance that the market had now entered a mature phase – where growth would be constrained and vendors needed to improve operations to generate attractive earnings. In parallel with this maturation, further consolidation could be expected. We also heard how customers were realizing their power in this buyer's market – demanding more performance from their existing investments, reduced maintenance costs and even more competition for new business.

Offshoring became mainstream in 2002-2003, with a majority of companies having already undertaken some effort. Far from a passing phase, offshoring has become a common approach to reducing IT costs, while increasing quality. At this point in time there appears to be no major impediment to further expansion, with a steady supply of new talent in several emerging economies and stable wage and turnover rates. Indeed, some would argue that the established vendors have entered a second phase, outsourcing part of their own work to countries with even more competitive rates and beginning to launch an onshore presence in the U.S.

Our predictions for this year focus on the outlook for cheaper infrastructure platforms with common hardware and software standards available for all developers. While this transformation may take several years to become the norm, in 2003-2004 we should see an irreversible foothold take place in the marketplace.

Finally we were all reminded that the ultimate success of the industry relies on delivering value to the enterprises served. One of our keynote speakers told us of a $1bn increase in revenue from CRM applications, data warehousing and networking from a $70m IT budget. We should all aim at next year's conference to share many similar examples.