

ENTERPRISE 2004 SUMMARY



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

Preface

We are pleased to present the seventh annual report on the state of the enterprise software and solutions industry. Enterprise 2004 brought together an elite group of more than 100 enterprise software leaders to debate the state of the industry, share ideas and opinions, network with peers, and discuss issues of common interest.

Last year, the key theme was surviving the difficult economic and business environment. What a difference a year makes! This year, there is lots of relatively good news for the software industry and growth is again the primary imperative for CEOs. This year's conference revolved around how to capture growth using the traditional software industry success factors of innovation and entrepreneurship. New themes this year included opensource, China, and India as next big markets, and the increasing importance of the Chief Information Security Officer (CISO).

The Enterprise 2004 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 2004. 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 BUILD (Businesses United in Investing, Lending, and Development). 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 nonprofit 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 2004 report, and all previous Enterprise reports and conference information are available online at www.sandhill.com.

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Introduction

In May 2004, a select group of senior executives and other leaders of the enterprise software industry gathered at the Ritz Carlton in Lake Las Vegas, Nevada, to attend Enterprise 2004. 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 highlight of this seventh annual conference was the return of optimism. After the collapse of the IT bubble and the economic downturn led to cost reduction and survival as the key focus areas for software companies, growth is once again the primary imperative. Almost all attendees expect a modest-to-clear recovery in the macro-technology economy this year. More than 60 percent of them were optimistic about achieving greater than 20 percent revenue growth this year.

Innovation and entrepreneurship – two fabled qualities in software history – were the two central themes of this year's conference. Major topics of discussion included successful entrepreneurship, new avenues of growth in times of industry consolidation, open source, learnings from innovation in other mature industries, the roles of the CTO and the CISO, and China and India as the next big markets.

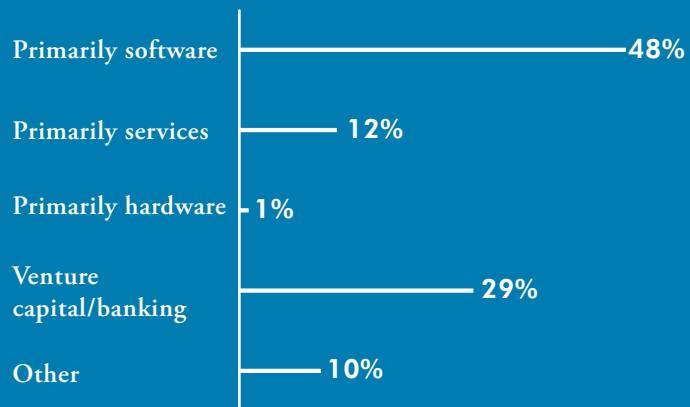
While the software industry will continue to mature and consolidate, capturing growth through such routes will be the key priority. We hope this report leads to further thought about these issues and helps plan for the coming year, carrying forward the discussion begun at Enterprise 2004.

ENTERPRISE 2004 *Conference Summary*

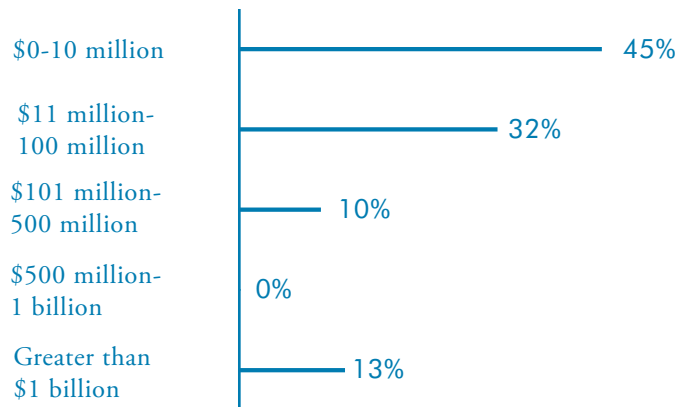
The participants

The senior executives who gathered this year came from the same basic segments as last year – software, services, investment banking, and venture capital. Overall, 90 percent were either CEOs or managing directors of their organizations.

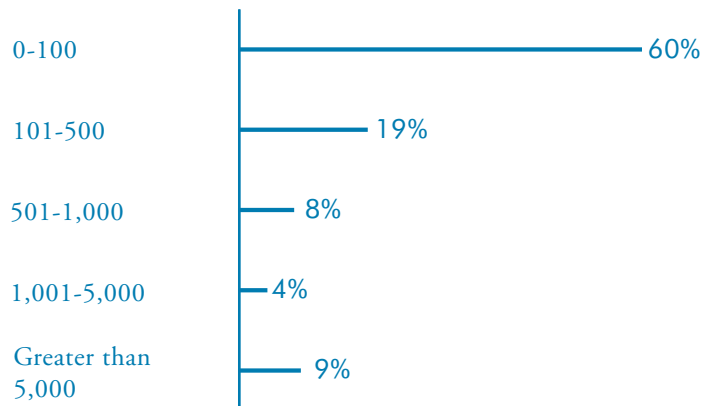
WHAT TYPE OF COMPANY DO YOU REPRESENT?



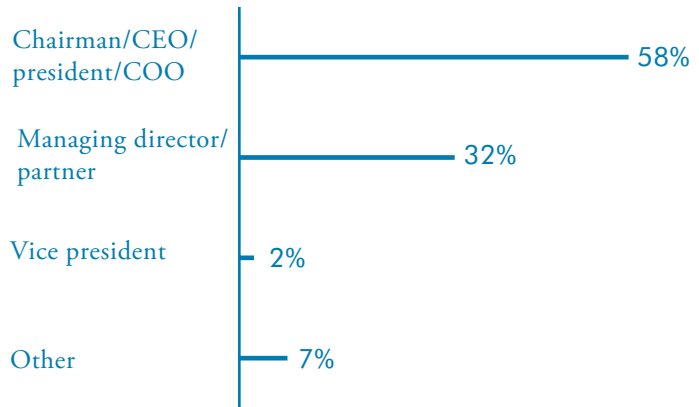
WHAT IS YOUR COMPANY'S REVENUE?



HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE?



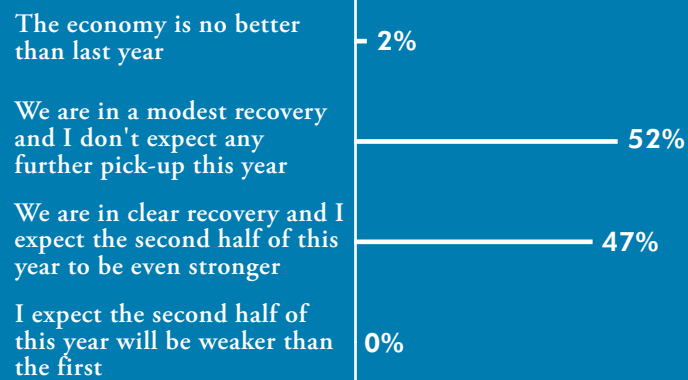
WHAT IS YOUR TITLE/POSITION?



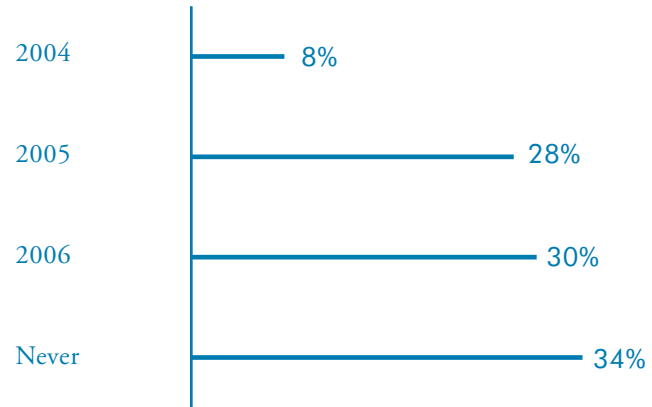
Market conditions suggest optimism

Participants at this year's conference expressed far more optimism about the software industry than in the last few years. More than 62 percent of them expected to register growth rates of more than 20 percent this year. Almost 58 percent of the attendees thought that the software industry would return to a double-digit growth rate by 2006 and more than 40 percent felt the software industry was the leading category for venture investment.

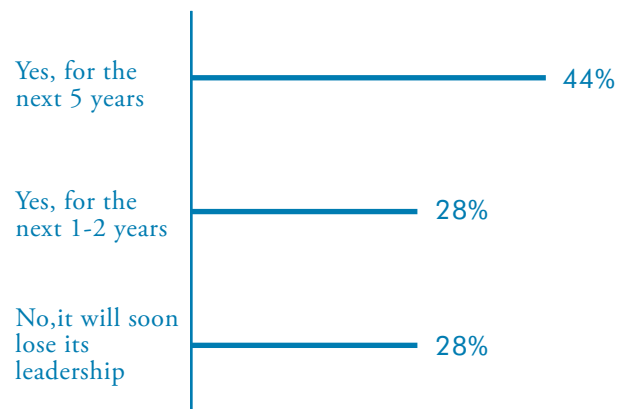
WHAT IS YOUR VIEW OF THE MACROTECHNOLOGY ECONOMY?



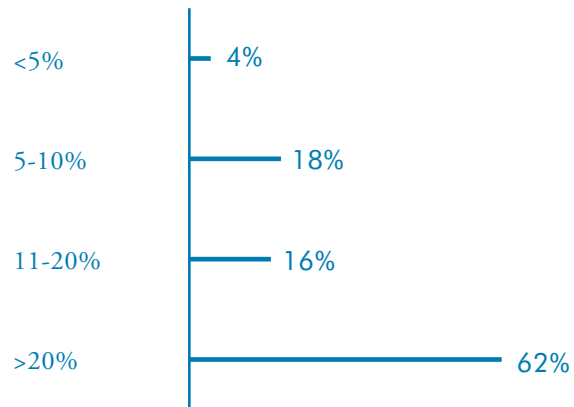
WHEN WILL THE SOFTWARE INDUSTRY RETURN TO DOUBLE-DIGIT GROWTH?



WILL SOFTWARE REMAIN THE LEADING CATEGORY OF VENTURE INVESTMENT?



HOW FAST DO YOU EXPECT TO GROW OVER THE NEXT 12 MONTHS?



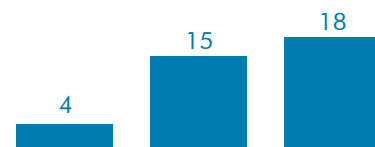
Over the past 9 months, the overall economy has also begun flexing its muscle. After more than 2 years of tepid spending and scaled-back growth expectations, the IT spending environment is once again looking attractive. The results from various CIO surveys over the last 3 months have suggested a clear improvement in overall sentiment as CIOs are increasingly optimistic on the global economy, their own firms' prospects, and the outlook for global IT spending.

The collapse of the IT bubble forced software vendors to slash costs and re-think their value propositions. Cost-cutting initiatives have paid off and market valuations are up once again. Now, growth is back on the agenda of all software companies.

THERE IS LOTS OF RELATIVELY GOOD NEWS IN THE SOFTWARE INDUSTRY

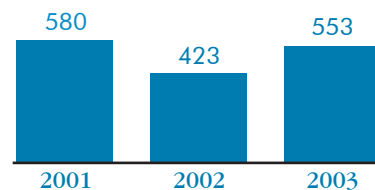
Margins

Operating margin for top 25 software companies*
Percent



Valuations

Market cap for top 25 software companies
U.S. \$ Billions

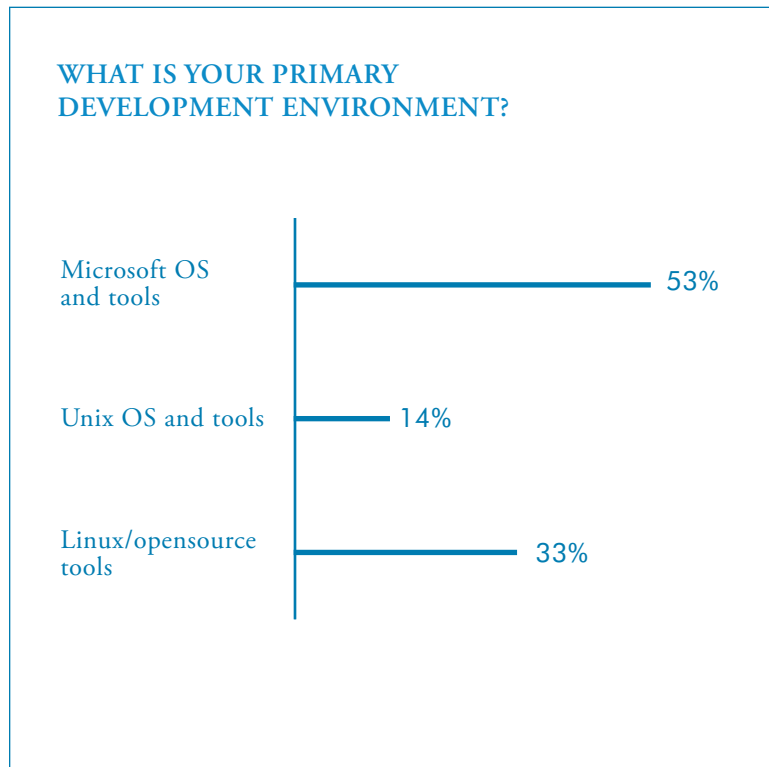


* Excludes Microsoft and Oracle
Source: Compustat; SDC; Moneytree

The growth imperative

Capturing new growth vectors has become more challenging due to the increasing dominance of incumbent software vendors, permanent changes in customer behavior, increasing arrival of innovation from outside the software industry, and the constant entry of hardware and services players to software. Hence, to achieve their goals, companies must look beyond traditional growth vectors.

Certain well-known technology shifts offer opportunities for software vendors. For instance, service-based architectures are gradually replacing monolithic architectures as the premier design principle for new business applications and could lead to disintegration of large business applications. Hardware developments are finally making the virtualization of computing, storage, and networking possible, which could lead to new classes of applications and software infrastructure needs. Open source presents a unique dilemma and challenge in most application categories. As we know, Linux is making progress towards becoming a major force in IT environments.



Servers and PCs have been the key platforms for the development of the software industry. However, with the explosive growth in consumer demand and the penetration of new computing platforms like smart phones, the most interesting new markets may lie outside the traditional realm. For instance, more than 540 million mobile phones are sold each year globally. Software is increasingly becoming crucial in traditional industries like automotive and industrial manufacturing.

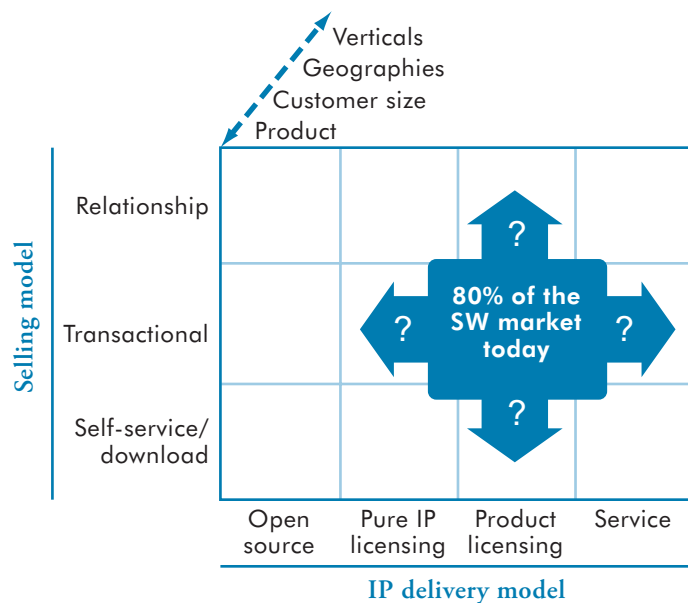
NEW PLATFORMS MAY BECOME IMPORTANT GROWTH DRIVERS

	Platform	Software content Percent	Total value (HW+SW) \$ Billions, 2003	Total SW market \$ Billions	Growth rate Percent
Traditional	Servers	65-70	164	115	5-7
	PCs	15-20	218	40	5-7
Emerging/embedded	Storage	15-20	37	6	10
	Industrial automation	15-20	58	10	10
	PDAs/mobile	10	82	8	25
	Automotive	<1	1,020	3	12

Source: VDC Corp; Salomon Smith Barney; Merrill Lynch; IDC; Gartner; McKinsey estimates

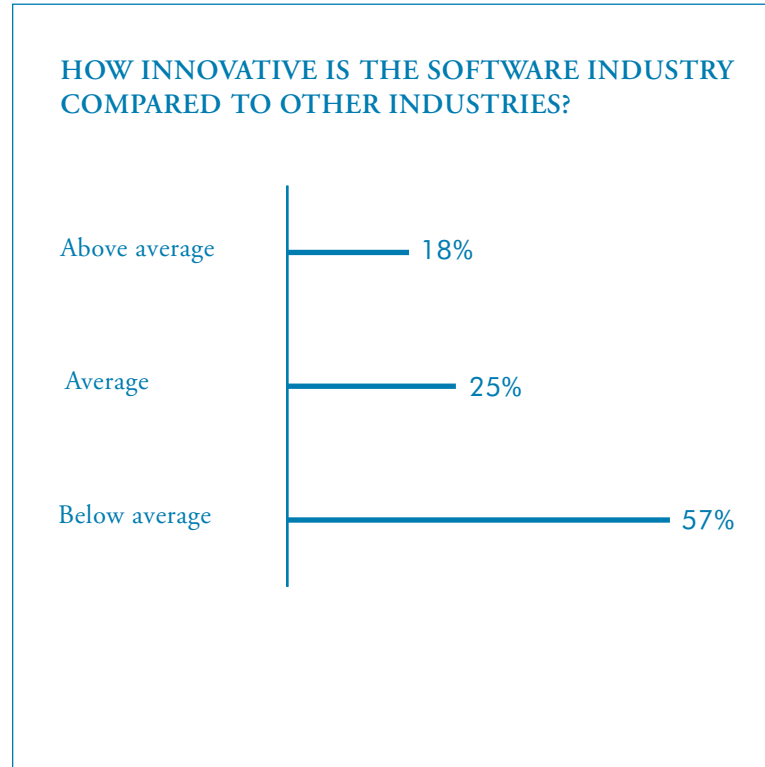
Despite the recovery and positive signs for growth, we also heard about permanent shifts in customer buying patterns – smaller deals, fewer vendors, more “pay as you go.” These trends suggest the need to rethink sales and delivery. While traditionally firms have segmented market opportunities and sales efforts by verticals and geographies, a better approach is to use the new sales models (self serve, transactional, and relationship-based) along with the IP delivery model. Our belief is that currently, more than 80 percent of sales and IP delivery is limited to transactional, product licensing arrangements.

NEW SALES AND IP DELIVERY MODELS MAY DRIVE BROADER ADOPTION

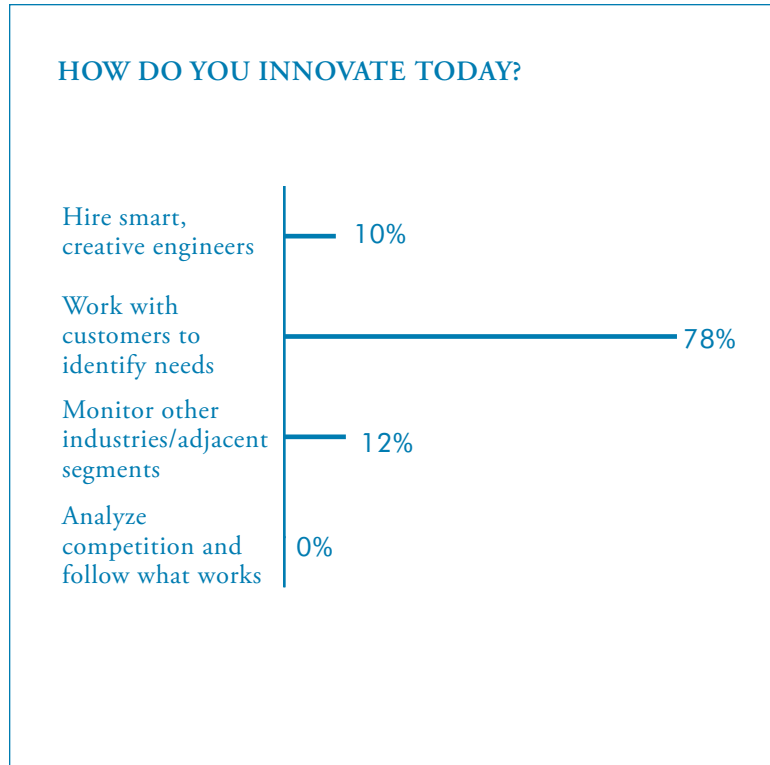


Improving management of innovation

Innovation has traditionally been the key to competitive advantage within the software industry. Throughout the history of the computing industry, major innovations like mainframes, personal computers, client-server architecture, and the Internet have led entrepreneurs to create successful companies. The software industry is still waiting for the “next big thing.” However, today the role of software in other traditional industries has become crucial and innovation in the software industry is slipping.



We heard how nontechnology companies like Nike and Disney manage innovation in a radically different way than the software industry. While the software industry primarily works with customers to identify gaps and then develops products, a more systematic innovation system including pure research and monitoring other industries/adjacent segments is required to sustain growth.



Re-building an entrepreneurial culture

In today's environment, it is necessary to re-create an entrepreneurial culture to grow through innovation. The word "entrepreneurship" seems to automatically conjure up names from enterprise software. Leaders in our industry like Bill Gates, Larry Ellison, and Tom Siebel have repeatedly shown the importance of entrepreneurial spirit.

We heard about the 3Vs of entrepreneurial success: vision, value for the customer, and a strong value system within the organization.

Vision is the foundation of any successful organization. It must be compelling, possible, and credible. It should also be long term (more than 5 years) and form the basis of a credible business strategy.

Delivering customer value is the second success factor. The value proposition must outweigh the switching costs. It must be important, urgent, and compelling for customers and differentiable from the competition.

Finally, having a strong value system within the organization, based on integrity, ethics, and honor, is essential for any company to succeed. Values are constant and form the foundation of any successful corporation.

Predictions

Last year, we made three predictions:

- (1) Enterprise hardware becomes a commodity and prices would fall, creating new software opportunities.
- (2) New software infrastructure standards emerge based on opensource coding.
- (3) New business models would continue to grow.

The events of the past year have confirmed many of these predictions. The increasing popularity of the Linux-on-Intel architecture in the low-end server market is an example of how the enterprise hardware market is being commoditized. We heard from one speaker about the growing influence of Linux in the IT environment. At the same time, more and more software vendors are offering different pricing models to enable customers to choose the one with maximum value.

We believe that all these predictions will remain valid in the coming year. Enterprise hardware will continue to commoditize and create opportunities for software vendors to exploit new architectures. Linux is starting to develop vertical scaling capabilities. Creating a strong ecosystem of applications and services would be the key factor in Linux's future growth. Due to permanent shifts in customer behavior, companies will continue to experiment with new business models to offer more options.

Certain other developments appear significant. In particular, we expect the following:

Gradual shift to service-oriented architectures

While not likely to be as rapid as the client/server or web-based transitions, multiple signs point to an overall shift towards service-oriented architectures. The continued development of standards that allow virtualization at multiple layers and drive realization of economic advantages for customers will apply inexorable pressure in this direction. Although this transition will not create compelling buying events for some time, it is likely to foster a new era of experimentation with uses of IT for competitive advantage. Enterprise application vendors will also be forced to shift emphasis from shrink-wrapped, tightly woven application stacks to suites of components that allow composite applications to be built rapidly and deployed.

More innovation from outside of the software industry

With an increasing share of many products's development cost related to software, and a corresponding increasing share of perception of value tied to software capabilities, the total amount of software research performed outside of the industry itself has increased dramatically. A natural consequence will be the likely arrival of innovation from outside the industry. Significant early drivers of innovation are already clear – telecommunications (particularly mobile devices), storage devices, and consumer electronics. But areas such as factory automation and automotive electronics are also ripe for substantial software growth – including in many cases linkages with enterprise software. Companies would be well advised to monitor activities in these industries as sources for future product ideas.

More stable, mature, and complex industry structure

Creeping standardization, steady – though not excessive – growth, and a strong customer desire for simplification and stability will likely drive a more stable, mature, yet increasingly complex industry structure over the next several years. Though not without changes (perhaps most notably, from outside players entering the software field), we anticipate a period of gradual consolidation and an increasingly mature and complex industry structure. In this environment, a focus on customer satisfaction, incremental market share gain, and profitable operation is important. Technology will no longer be the key differentiator in the software industry. Instead, human capital and operation excellence will have primary importance.

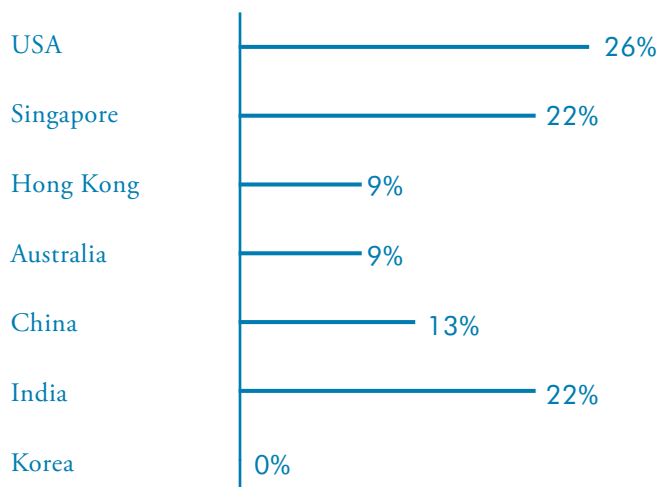
Growth and new geographies

Traditionally, we have looked at China as a sourcing base for high-tech manufacturing and India as a primary off-shore services destination. These destinations are increasingly becoming attractive markets for the software industry and are expected to grow significantly higher (>20 percent per year) than the developed markets.

Software firms will learn more and adapt from other mature industries

We heard from various speakers at the conference about the need to learn and adapt from the great companies in other mature industries like P&G or Walmart. As customer preference continues to move towards suite offerings, large and integrated players will continue to displace niche vendors. Technology will no longer be the key differentiator in the software industry – people and operational excellence are.

WHAT IS THE LOCATION OF YOUR ASIA/PACIFIC HQ?



Conclusions

This conference marked a shift in perceptions on the outlook for the enterprise software industry. The mood among attendees was optimistic and growth was back as the primary imperative for software companies. However, capitalizing on traditional and new growth opportunities will be more challenging. The software industry continues to mature and consolidate with the largest vendors increasing their size and footprint. Customers continue to dictate the engagement terms. Above all, no major buying imperatives other than compliance and security are present to drive growth.

Re-creating an entrepreneurial culture will be key to achieving growth through innovation in today's environment. During the conference, we frequently revisited the two fundamental building blocks of the software industry – entrepreneurialism and innovation.

Our predictions for this year focus on the new opportunities offered by well-known technology shifts like service-oriented architecture, open source, and virtualization. Large customers in the end-user industries will increasingly drive innovation in the software business. We should recognize that we are a maturing industry and look towards great companies in other traditional industries to learn and adapt their best practices while retaining our entrepreneurial and innovative spirit.

At the same time, even as the software industry refocuses around entrepreneurialism and innovation, we should recognize that today's environment is far more complex. Hence, success will require different and expanded forms of innovation and entrepreneurship, such as business model innovations, value chain innovations, and redefining the ecosystems.

Finally, we were reminded that success in the software industry does not rely on technology but on three simple ideas – vision, value to the customer, and a strong organizational value system – supported by great teams of people with an ability to execute and turn goals into reality.

Next year, we will be return to our roots and meet again at the Inn at Spanish Bay, on August 7 to 9, 2005 to discuss the prospect of the coming 12 months. We look forward to seeing you there!