



**Conference
Summary
and
Strategic
Perspectives**

Enterprise '99 Advisory Board

Erik Keller, Wapiti LLC

Roger McNamee, Integral Capital Partners

Mike Nevens, McKinsey & Company

Bill Pade, McKinsey & Company

Chuck Phillips, Morgan Stanley & Co.

Bruce Richardson, AMR Research

This report, the Enterprise '98 report, and other conference information are available online at www.sandhill.com.

© Copyright 1999 McKinsey & Company and Sand Hill Group LLC.

All rights reserved.

Sand Hill Group LLC

101 First Street, PMB 545

Los Altos, CA 94022

(650) 941-3702

(650) 941-1987 fax

www.sandhill.com

McKinsey & Company

630 Hansen Way

Palo Alto, CA 94304

(650) 494-6262

(650) 842-5800 fax

www.mckinsey.com



Preface

You have before you the second annual report on the state of the enterprise solutions industry. Enterprise '99 brought together 150 industry leaders to share ideas, exchange opinions, and debate strategic issues of common interest.

It has been a year of tremendous change. While Y2K and other issues distracted the industry, the Internet and e-commerce have emerged as *the* area of opportunity. This report, a collaborative effort by Sand Hill Group LLC and McKinsey & Company, seeks to summarize the trends, challenges, and opportunities discussed at Enterprise '99. It also highlights the most interesting results from the Quick Tally surveys conducted at the conference.

We hope you enjoy reading this report and find it a useful tool in the coming months, as you devise solutions to the issues confronting your own organization.

Constantin Delivanis
cd@sandhill.com

M. R. Rangaswami
mr@sandhill.com

Sand Hill Group LLC

Greg Hughes
greg_hughes@mckinsey.com

Bill Pade
bill_pade@mckinsey.com

McKinsey & Company



Introduction

In mid-May of this year, 150 leaders of the enterprise software industry gathered at Enterprise '99 to exchange views on the present and future of the enterprise space. Held at the Inn at Spanish Bay, on California's Monterey Peninsula, this second annual conference provided a private and intimate setting in which leading vendors, entrepreneurs, venture capitalists, analysts, and industry influencers could speak frankly about the issues and trends confronting the enterprise space. This report summarizes the proceedings in the context of both the current industry environment and the expectations and beliefs expressed at last year's conference. In addition, it details key opportunities and specific challenges going forward.

The prevailing theme of this year's event was that the Internet and e-commerce are changing the face of the enterprise solutions industry far more quickly than participants anticipated last year. As a result, three daunting issues are keeping executives up at night: adapting the corporate culture to meet new demands as they arise, devising new business models to meet the challenges they face, and adopting the new performance metrics required of innovative and fast-moving e-businesses. Specifically, enterprise solutions companies are considering such dramatic changes as creating completely independent businesses for the e-commerce space, experimenting with a networked applications delivery model, and learning to measure their businesses according to customer value.

We hope that this report will provoke further thought and debate about these pressing issues, carrying on where the conference left off.



The Pace of Change

Enterprise '99 Conference Summary

The Participants

The enterprise solutions companies whose senior executives gathered at Enterprise '99 last May were drawn from the same basic segments as last year—software, services, investment banking, and venture capital. And, also as last year, nine out of ten participants were CEOs or partners of their respective companies. However, this year's conference provided a slightly broader snapshot of industry perspectives, with more attendees from a wider range of companies.

This larger pool of participants had the unintended, but not unwelcome, effect of increasing the percentage of privately held companies. Of last year's 81 participating companies, 37 percent were public. This year, only 25 percent of participants identified their companies as publicly held. But where last year's public companies had a combined market capitalization of \$90 billion, this year that figure was \$350 billion (despite the fact that the companies represented last year showed a 50 percent drop in market cap).

The breakdown by segment also shifted slightly. Although the software category was down somewhat from last year, it still accounted for the lion's share of the audience, at 60 percent. Services grew to 20 percent, from 15 percent last year, while the venture capital/industry influencers segment was 5 percent less than in 1998.

Reflecting both the changed audience makeup and a radically altered business environment, Enterprise '99 participants expressed lower growth ambitions overall for the coming year. While almost three-quarters of Enterprise '98 attendees expected their revenues to grow more than 50 percent in the following 12 months, only 55 percent of this year's participants anticipated a similar growth rate for the next 12-month period (see Figure 1, next page). Nonetheless, 37 percent of this year's respondents indicated that they plan to take their companies public within the next 12 months, compared to the 25 percent of conference attendees who expected to do so last year.

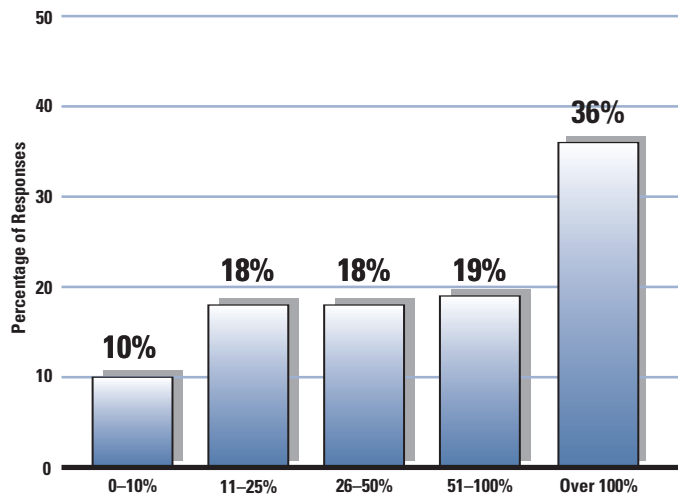


Figure 1 How Participants Project Their Companies' Growth Over Next 12 Months

The '98 Internet is not going to change the structure of the enterprise software industry.

THE FUTURE IS NOW

One of the key beliefs expressed by more than half of last year's attendees was that the Internet would not significantly alter the enterprise software industry's structure within five years, by 2003. It was assumed that for the Net to change the balance of power, it would have to become the primary vehicle for accessing enterprise software—particularly for extra-enterprise users. The vast majority (81 percent) of Enterprise '98 participants felt that this segment of the

user population would have little or no effect on the then-current licensing/pricing model, and two-thirds believed such users would contribute no more than 30 percent of enterprise software revenues over the following two years. Most also expressed the belief that browser users would penetrate the enterprise internally, through intranets, rather than externally, through extranets. Although last year's attendees acknowledged that the Net could give rise to more efficient software delivery models, their assessment of its overall impact on their businesses could be described as "wait and see."

Fast-forward to Enterprise '99: The results of the Quick Tally surveys conducted at the conference indicate that 25 percent of this year's participants believe the Internet will change the balance of power in the enterprise software industry *before* 2000. What's more, a full 99 percent think that such a shift will have occurred by 2003 (see Figure 2, next page). Add to that the following results: In ranking issues of interest and concern, a third of Enterprise '99 attendees identified "Web-ifying" solutions as being "most important," and over three-quarters of the audience indicated that enterprise software vendors would be poor stock performers unless they adopted a ".com model"—an e-commerce-oriented strategy for marketing, delivery, and support.

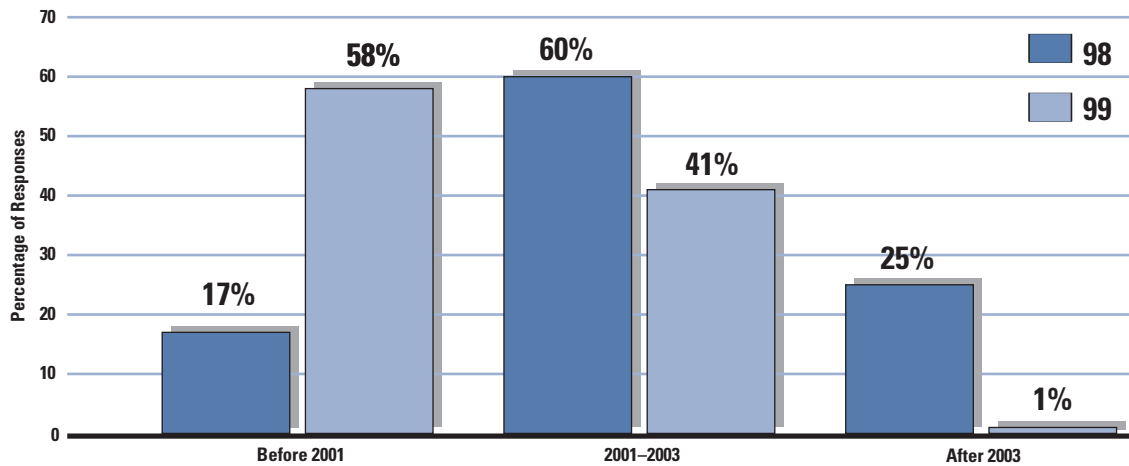


Figure 2 When Participants Thought the Internet Will Change the Balance of Power for the Industry

So for now, forget about Y2K concerns and “best-of-breed” positioning—these are back-burner issues. Today it’s all about the Internet. McKinsey’s analysis of the U.S. fiber-based communications backbone shows that capacity could increase by as much as 200 times by 2002, thanks to the new attackers building state-of-the-art fiber networks, which promise to provide service at a half to a third of the price charged by incumbents. The ensuing widespread availability of cheap and reliable data transmission makes the Internet the new IT business platform of choice—one that not only facilitates new product/service and delivery architectures but *requires* them for survival.

The '99 Internet is the new delivery model for software, support, and services.

E-COMMERCE: THE NEW IMPERATIVE

In the 21st century, the Web promises to become the Internet equivalent of today’s dial tone—always on and always ready to facilitate information flow across a multitude of devices. In this environment, barriers of time, geography, and technology disappear, firewalls retreat, and private networks become a thing of the past. Instead, there is simply one network with myriad levels of access and billions of connected devices.

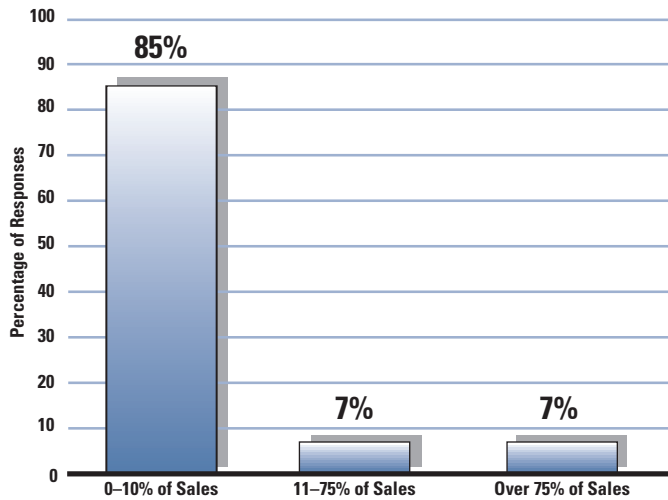


Figure 3 Percentage of Participants' Sales Derived from E-Commerce

This new landscape creates an altered playing field that enterprise software providers cannot afford to ignore. Although business-to-business electronic commerce over the Net is only four years old, it's already generated some fairly startling, if well-known, results. Cisco, the undisputed leader in e-commerce implementation, has defined its corporate strategy around an Internet-enabled supply chain. In fact, an unprecedented supply chain integration effort has enabled Cisco to cut manufacturing

costs more quickly than its products' sales prices have fallen. While sales prices fell approximately 50 percent from 1992 to 1998, during the same period manufacturing costs dropped to a mere 26 percent of 1992 levels.

Despite such issues as bandwidth, reliability, security, privacy, and trust that have yet to be fully resolved, e-commerce is creating new channels and enormous opportunities. And the pressure to respond to them is mounting. A small majority (55 percent) of Enterprise '99 attendees indicated that their companies don't currently offer Web-based applications; however, 28 percent reported that at least half of their customers have deployed such applications. And even though 85 percent of conference participants said their companies derive 10 percent or less of their sales from e-commerce, 7 percent indicated that e-commerce accounts for more than 75 percent of their sales (see Figure 3).

ADAPT OR PERISH

Enterprise software companies that want their share of what e-commerce has to offer must be ready to reevaluate much of what they know and transform them-

selves—often virtually overnight—to adopt a new corporate culture, integrate new business models, and track new metrics of success.

Changing Corporate Culture

The question of creating a “.com” culture is proving to be one of the most difficult for established enterprise solutions vendors, as well as their customers, to answer. As they focus on developing the capability to act swiftly and flexibly in the e-commerce space, executives risk cannibalizing their existing revenue streams, creating channel conflicts, losing talented employees, and sacrificing the significant percentage of revenues derived from professional services that accompany traditional software releases.

One way to manage such risk is to create a separate e-business division within the existing organization. But whether autonomous new units or more closely linked groups are charged with the effort, if companies are to survive and thrive they must create a culture that emphasizes speed and scale (those that succeed boast of getting enormous corporations online in a matter of weeks), ensures reliability (24x7 uptime with responsive customer service is essential), and decreases technological complexity.

The new corporate culture also brings e-businesses ever closer to their suppliers, vendors, and partners—sometimes even to competitors. While two-thirds of enterprise software companies still maintain an arm’s-length relationship with their service vendors, there are signs that the distance may be closing. In fact, almost half of this year’s conference attendees said they were considering some sort of partnering arrangement—deals that could take the form of traditional players or low-tech entrants joining forces with new entrants. In addition, the mergers-and-acquisitions pace in the industry has accelerated, with many currency-rich participants acquiring smaller companies for their technology and talent.

Testing New Business Models

In addition to the challenge of changing corporate culture, enterprise solutions vendors are being pushed to test new business models. New entrants have set the



Table 1 The Financial Markets Are Rewarding New Entrants

	Top Five ERP Vendors^a	Five Selected Network Application Providers^b
Total 1998 revenues	\$15.9 billion	\$297 million
Average number of customers	5800	300
Average age	21 years	3.8 years
Cumulative R&D 1995–present	\$5.38 billion	\$26 million
Combined 1998 valuation	\$77.7 billion	\$1 billion
Combined 1999 valuation	\$57.9 billion	\$11.2 billion
Change in valuation	-25.50%	+1120.00%

^a Baan, JDE, Oracle, PeopleSoft, SAP ^b Concentric, Critical Path, Exodus, USi, Verio
Note: Figures as of May 1999 Sources: Bloomberg, Compustat, Yahoo, McKinsey analysis

Winning '98
requires
new products
and a direct
sales force.

tions as a promising alternative or complement to the traditional business model. One primary reason for this shift is that networked applications help customers quickly capture value while shielding them from the solutions' complexity.

This advantage is reflected clearly in shareholder value. While the top five ERP vendors have lost \$35 billion in market cap since Enterprise '98, Wall Street has rewarded networked applications providers: In the past 12 months alone, a handful of these vendors have created a total of more than \$10 billion in shareholder value—not bad for a group of newcomers that are on average less than four years old (see Table 1).

Networked applications are being delivered in two different forms: software as a service and interaction-driven applications. The first includes hosted applications, such as those offered by Critical Path for e-mail, and hosted business processes, such as those offered by American Express to manage travel and entertainment expenses via a Web site. Interaction-driven applications include direct cross-enterprise applications (for example, Cisco's supply chain), intermediated cross-enterprise applications (e.g., Ariba's purchasing offering), and customer interaction applications (e.g., Post Communications' e-mail-based marketing support).

Since networked applications represent a departure from traditional software delivery models, they imply a new set of imperatives for enterprise software com-

stage by introducing a wide variety of new business concepts: auctions, where competitors bid to buy or sell products (such as Freemarkets.com); Net market makers (e.g., Neoforma); enabling services, in which complex business processes are managed to create new commerce networks (e.g., Bid.Com); and exchanges (e.g., National Transportation Exchange).

Likewise, enterprise solutions vendors are turning to networked applica-

pany CEOs (see Figure 4). Increasingly, vendors will need to truly understand the impact of IT on their customers' economics: how to drive greater revenue growth, how to reduce costs, and how to strengthen asset efficiency. Successful enterprise solutions companies will build their value propositions around, for example, conveying how their products and services will help customers reduce time-to-market or attract new customers.

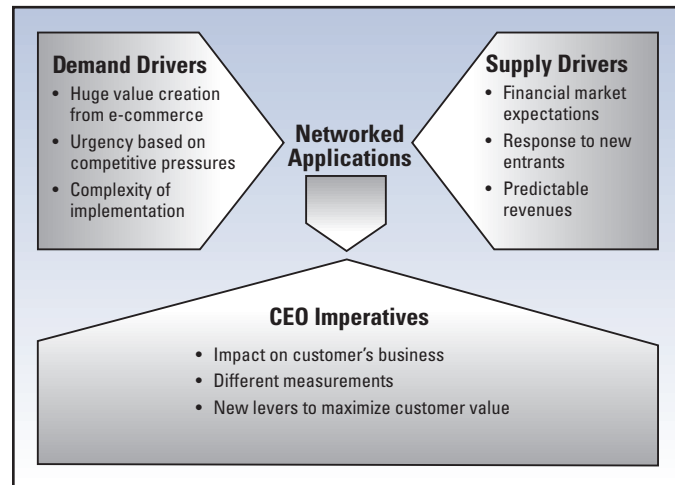


Figure 4 CEO Imperatives for New Software Delivery Model

On the cost side, vendors will have to build business cases on more efficient purchasing processes, improved inventory management costs, and so forth.

In return, enterprise solutions vendors benefit from more predictable revenue streams. Networked applications allow vendors to move away from large end-of-quarter deals, which involve selling as much product as possible in monolithic releases—and often lead to an extended and expensive deployment process that culminates in the customer exiting the market. In contrast, the new business runs on a smoother revenue model. Subscription pricing is one example, but today's enterprise software vendors are trying every pricing model possible: by seat, by application, and by amount of data. Ninety-three percent of this year's participants reported that they currently offer or are considering recurring license options. Also being explored is the possibility of renting some services, such as CPU cycles and software storage.

In the end, the traditional total-cost-of-ownership (TCO) equation is being replaced by a total-value-of-ownership (TVO) model. In this model the focus shifts from solving customers' technology problems to accelerating their overall economic performance. And ultimately, value is derived from such areas as operational problem solving, business process design, organizational change, and IT enabling. As evidence of this trend, only 21 percent of participants identified increased functionality as the most promising area where they could profitably

Success '99
is experiencing with entirely new ways of communicating and delivering value.

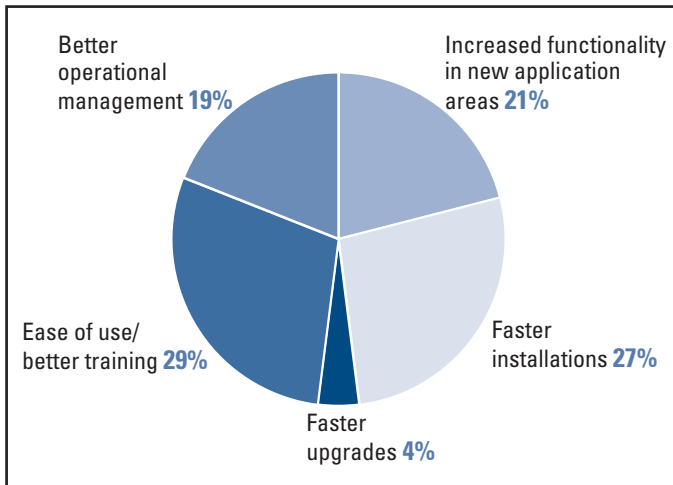


Figure 5 Where Participants Thought They Could Profitably Add Value for Customers

Is your '99 company planning to offer a recurring license option for your product?

CURRENTLY OFFER: 63%

EVALUATING: 30%

involve “churn” (customer turnover), revenues per customer, and acquisition cost per customer. These metrics differ radically from those that enterprise solutions companies have typically used in the past: revenues *per employee* and sales and marketing as a percentage of revenues. McKinsey has modeled the impact of managing these three levers for a new networked application company: Critical Path (see Figure 6, next page). The analysis shows that relatively small modifications to the levers could result in substantial increases in the capitalization of the company.

These metrics, while new to the enterprise solutions space, have been historically monitored and acted upon in a range of “traditional” industries: Magazines constantly look at their churn; retail banks try to maximize revenues per customer; and catalogue retailers are always concerned about customer acquisition costs. Enterprise vendors that follow a networked delivery model may want to learn from these “low-tech” industries.

As companies move to a TVO-oriented model, they will also need to identify the value that their solutions create for customers—through either revenue cre-

add value for their customers. In contrast, 79 percent of participants identified service areas such as faster installations, ease of use/better training, and improved operational management. (See Figure 5.)

Tracking New Metrics

Not surprisingly, new delivery models require new metrics for measuring success. In the case of networked applications, these measurements—and therefore key management levers—

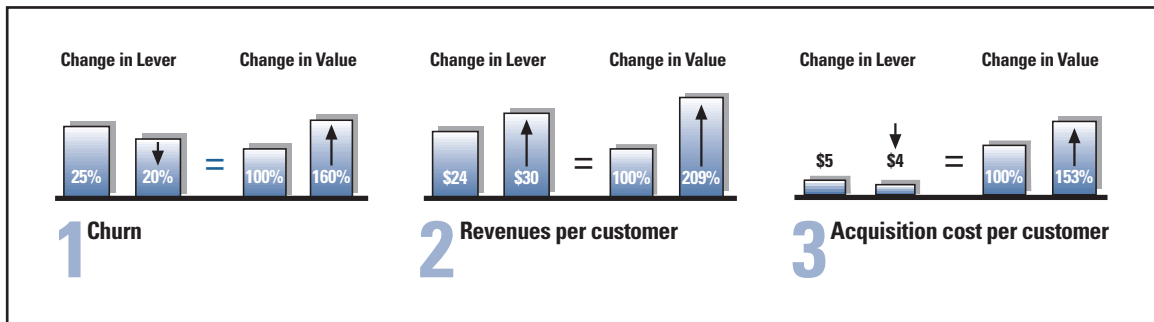


Figure 6 CEOs Will Have Three Levers to Maximize Customer Value—Critical Path Example

ation or cost savings—and set their prices accordingly. This is, of course, a radical departure for most established players, although some new entrants are already experimenting with this approach. For example, i2 Technologies links its pricing structure to the various metrics that track the value the customer realizes by way of i2's enterprise solution.

Finally, as some enterprise solutions providers' focus shifts from products to services, success will be measured by key dimensions such as revenue realization (through contract and risk management), utilization of professional service resources (by actively managing project pipelines), and the leverage ratios between project managers and consultants (through investments in training new personnel and packaging services as products).

When '99
you

**examine TCO
 for end users,
 how much is
 represented by
 application
 license fees?**

HALF OR LESS: 95%

MORE THAN HALF: 5%



Conclusion

With the distraction of the Y2K problem largely behind them—or at least well under control—enterprise software companies awoke this year to find themselves at a fork in the road. Somehow the future had arrived several years early—in the form of e-commerce and the Internet—and many were caught without a plan. The good news is that for those willing to rapidly transform their businesses, the opportunities are enormous.

While the traditional client/server leadership languishes, with each of the major players confronting threats and weaknesses, the financial markets are rewarding new entrants that demonstrate an ability to transform corporate culture, experiment with new business models, and track new metrics. In this environment, enterprise solutions companies that bring their old business practices to the Web are almost sure to fail. The e-commerce model demands a new way of doing business and requires that players address these same three issues—for example, by decreasing time-to-market on new releases, embracing the networked applications model, and focusing on the metrics of customer value. If enterprise solutions vendors move quickly and aggressively in this direction, the future promises to be exciting indeed.

In just a few months, we will have a chance to assess the effect of these new models and new ideas. Next year's program will focus on the topic "Leaders of the New Millennium." On April 2 through 4, 2000, we will gather this elite group of enterprise solutions industry executives to reflect on the leaders of the past, debate leadership strategies of those companies that dominate the market at present, and predict who will emerge as the front-runners of the next century.

We look forward to seeing you there!

**What is '99
the rank
of "increasing
shareholder value"
among the issues
enterprise companies
are facing?**

MOST IMPORTANT: 78%

**Will '99
enterprise
software vendors
be poor stock
performers unless
they adopt an e or
.com model?**

YES: 78%