ENTERPRISE 2001 SUMMARY

ENTERPRISE 2001

SAND HILL GROUP LLC

McKinsey&Company

preface

We are pleased to present the fourth annual report on the state of the enterprise solutions industry. Enterprise 2001 brought together an elite group of 165 enterprise software industry leaders to debate the state of the industry, share ideas and opinions, network with peers, and discuss issues of common interest.

Last year, we explored two developments that appeared to be changing the nature of the software industry: the rise of application service providers (ASPs) and business-to-business (B-to-B) solutions companies. What a difference a year makes! This year, the bursting of the IT bubble has led all of us to reexamine the validity of these and other new business models, and to return our attention to the fundamentals of creating, delivering, and capturing value.

The Enterprise 2001 report, a collaborative effort by Sand Hill Group and McKinsey & Company, summarizes the conference presentations and panel discussions in the context of both the current industry environment and the expectations and beliefs expressed at last year's conference. In addition, it details trends and specific challenges going forward. It is intended to provide a unique perspective on the ideas and opportunities discussed at Enterprise 2001. In keeping with the tradition of previous reports, we again include highlights of the most interesting results from the Quick Tally surveys of participants.

Also this year, the SHG Foundation proudly presented grants to a local group, the Youth Education Scholarship (YES) program, and an international group, the Children's Relief and You (CRY) organization. Sand Hill Group created the SHG Foundation to enable all surpluses from the annual Enterprise Conferences to be donated to charity. The SHG Foundation grants awards each year to US-based non-profit organizations helping to improve the lives of low-income women and children.

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

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The Enterprise 2001 report, and all previous Enterprise reports and conference information, are available online at www.sandhill.com.

introduction

In June 2001, 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 2001. 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 confronting their companies and clients.

At this fourth annual conference, it will come as no surprise that the primary focus was on managing in the current downturn. Major elements of discussion included improving core business health, identifying new opportunities for growth, and migrating to successful business models. Although increasing revenues was still the issue that 83% of attendees said keeps them awake at night (with only 3% who were more concerned about expenses), there was growing recognition that reducing expenses was necessary in the current environment, with 45% of attendees rating it either important or very important. Three other primary questions on executives' minds were how the bubble bursting affects fundamental demand for software, how to find more profitable business models as a result, and how to either cope with or take advantage of depressed investment and equity markets.

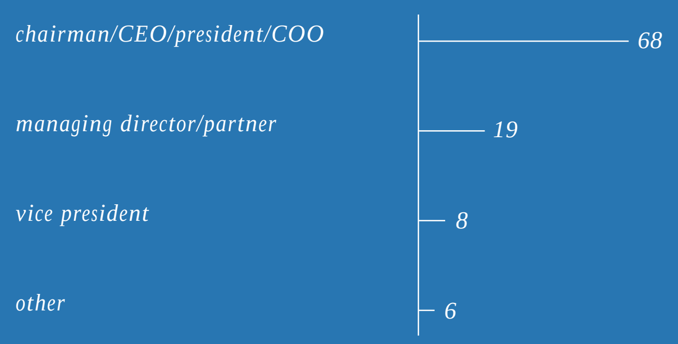
In the two conferences prior to this one, improving profitability ranked close to last among issues keeping executives up at night—quite different from the current situation. Unfortunately, we have seen conclusively that the enterprise solutions industry is not immune to the effects of the business cycle, and that managing in the presence of a downturn presents new and different challenges. This report is designed to provoke further thought and debate over these pressing issues—carrying on the discussion begun at Enterprise 2001.

ENTERPRISE 2001 *Conference Summary*

the participants

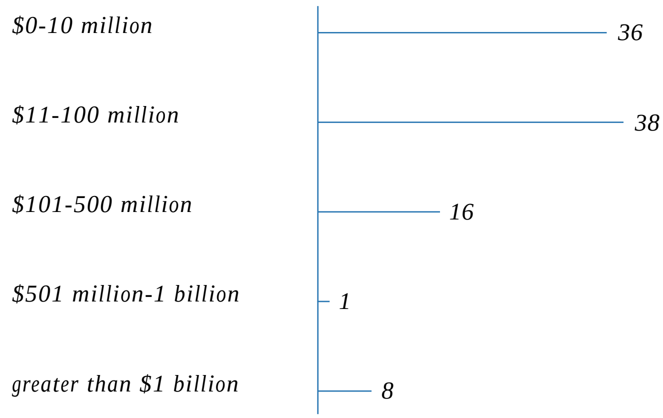
The senior executives who gathered this year were drawn from the same basic segments as last year—software, services, investment banking, and venture capital. Broadly, the constituencies represented public companies 29%, private companies 57%, and partnerships 14%. Among the group, 87% were either CEOs or managing directors of their respective companies.

WHAT IS YOUR TITLE / POSITION?
percent



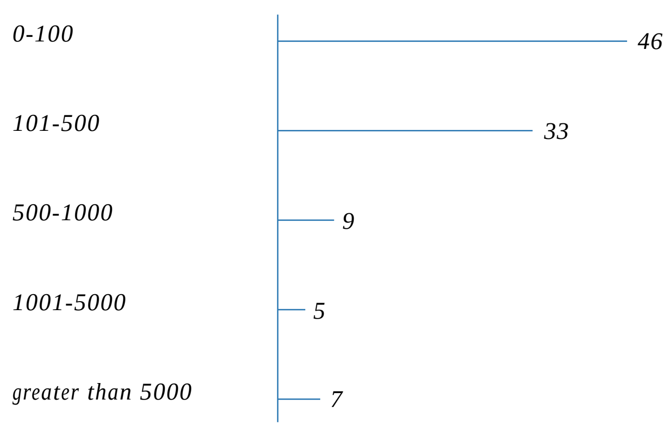
Source: Enterprise 2001 Quick Tally results

WHAT IS YOUR COMPANY'S REVENUE?
percent



Source: Enterprise 2001 Quick Tally results

HOW MANY EMPLOYEES DOES YOUR COMPANY HAVE?
percent



Source: Enterprise 2001 Quick Tally results

WHAT HAPPENED AND WHAT HAVE WE LEARNED?

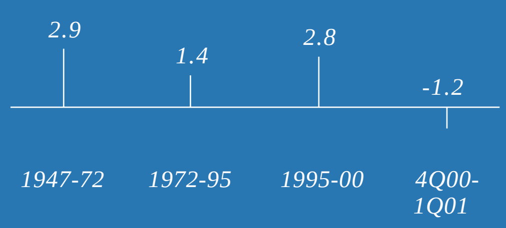
The past twelve months have seen a dramatic devaluation of the entire IT sector, with some previously high-flying software sectors particularly hard hit. While the causes for this precipitous decline were varied (collapse in demand in the telecom sector, lack of momentum in much-hyped B-to-B business models, renewed attention to overall capex budgets), the results were uniform—dramatic compression in valuations and a reduction in overall demand. In the aftermath of this sea change, many have speculated whether the dramatic run-up in IT budgets during the bubble achieved the results that IT vendors promised.

PRODUCTIVITY PARADOX RESOLVED

During most of the 1990s, the rapid increase in IT capital expenditures was justified by a combination of expected productivity benefits and imagined competitive pressures. By the mid-1990s, the lack of increased productivity was so dramatic that it prompted many, led by Robert Solow, to claim that a productivity paradox existed where the computer age could be seen everywhere "but in the productivity statistics."

A review of the situation in mid-2001 yields an improved, but still intriguing, picture. Overall economic productivity has, in fact, increased over the past several years, but these increases have been confined to a relatively small number of industry sectors. In fact, only five sectors (wholesale, retail, banking, investment, and computer manufacturing) account for virtually all of the productivity increases seen across the US economy over the past five years.

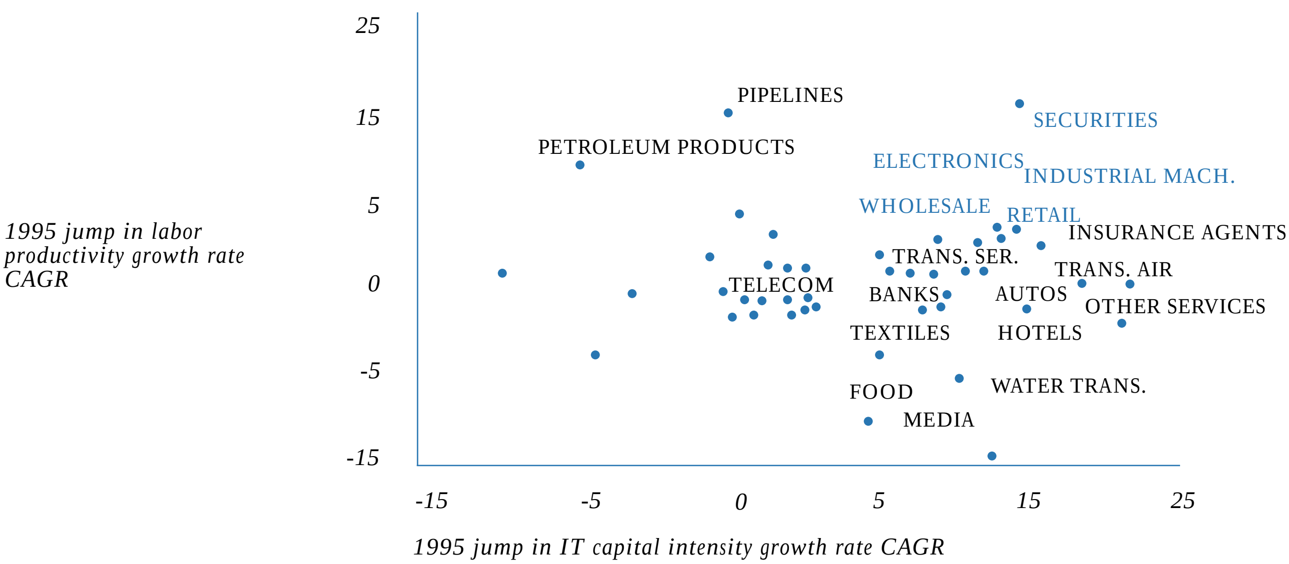
PRODUCTIVITY GROWTH OVER TIME
percent



Source: McKinsey & Company analysis

Furthermore, in the two most recent quarters for which we have data, productivity growth has slowed again. These observations raise two questions: first, what has all of this spending actually accomplished, and second, what opportunities remain for enterprise solution companies to deliver true economic benefits?

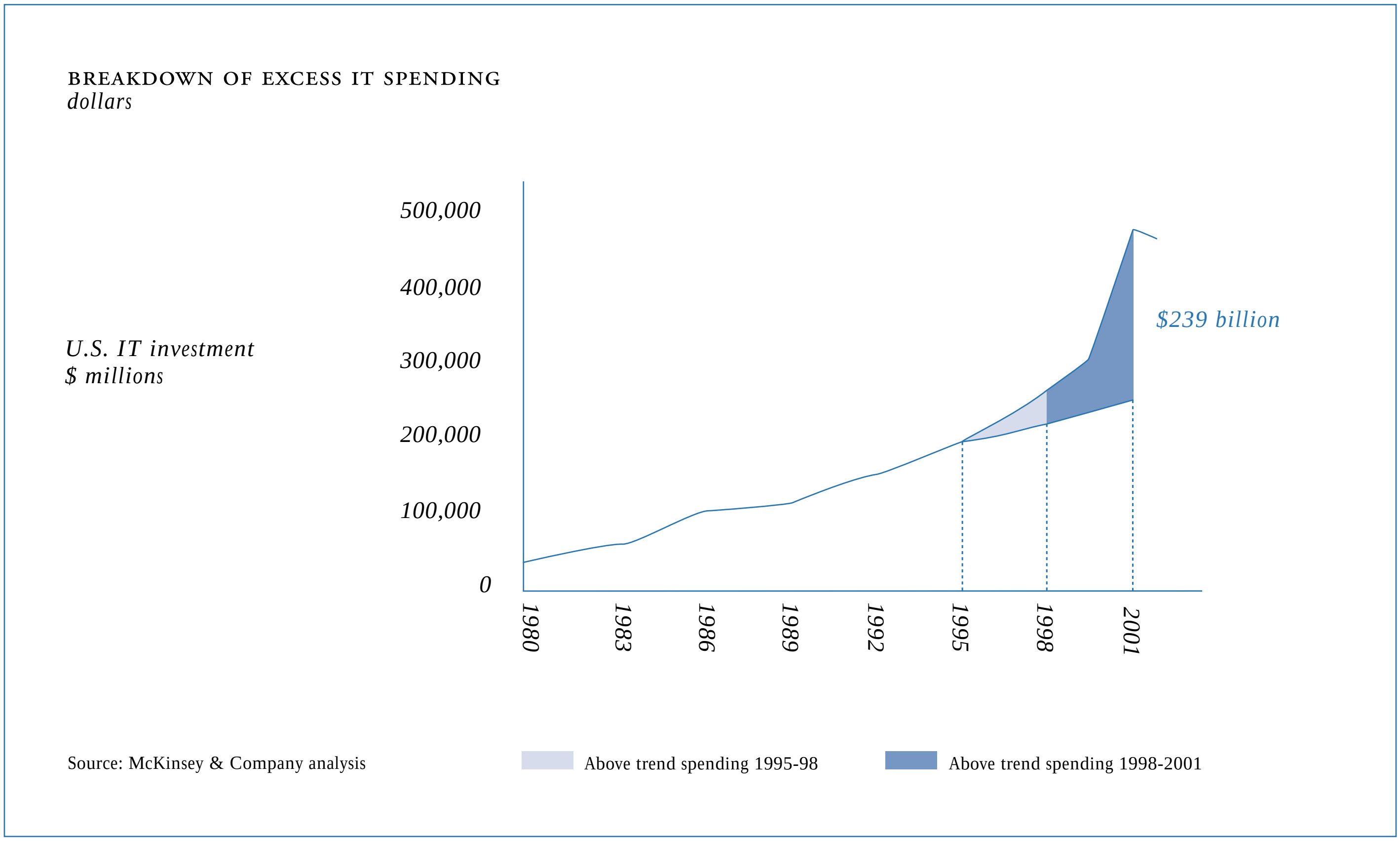
PRODUCTIVITY INCREASE BY SECTOR
percent



Major contributing sectors in blue type
Source: McKinsey & Company analysis

SPENDING IN A RACE TO STANDARDS

By most estimates, the IT bubble led to above-trend IT spending in the neighborhood of $200 billion from 1998 to 2000; almost equivalent to an entire year's spending in the years before the bubble. Two contributors to this excess have been much discussed, namely, preparations for Y2K and the rush to e-commerce. However, a third factor, and one that has a much more positive long-term impact on the enterprise solutions industry, is the increasing adoption of standards-based applications that reduce the interoperability burden. We estimate that just over the interval mentioned, roughly $100 billion was spent on simply upgrading technology stacks and installing standards. Little of this investment has directly created productivity benefits, thus far, but it provides fertile ground for the next generation of software innovation. Finding ways to leverage this large installed base of new standards will no doubt lead to many interesting enterprise solutions opportunities.



OPPORTUNITIES LEFT OPEN: LESSONS FOR THE FUTURE

Just as the race to standards has produced some plausible opportunities for additional innovation, the experimentation by many industry sectors with new software tools and business models should seed future IT investment. While almost none of the independent B-to-B marketplaces and few of the industry-based consortia have been successful in their primary mission of centralizing commerce to create efficiencies, these experiments have led many industries to look at their operations and supply chains in new ways. Many of these new entities have turned to outsourced service models and provisioning of collaborative tools to create value. Enterprise solutions providers can pursue similar opportunities. Similarly, industries, like retail, chemicals, or automotive —not the traditional deployment leaders of new technology—have been primed for future investments by the events of the past twelve months.

Enterprise solutions companies would therefore be well served to consider the wreckage of much of the B-to-B economy as useful preparation for deployment of more successful solutions, and should plan accordingly. Those companies that can successfully navigate the challenges of the next twelve months should emerge as the beneficiaries of a larger opportunity set, with fewer surviving competitors to divide up the larger pie. Managing successfully through the downturn is therefore of primary importance.

SO NOW WHAT?

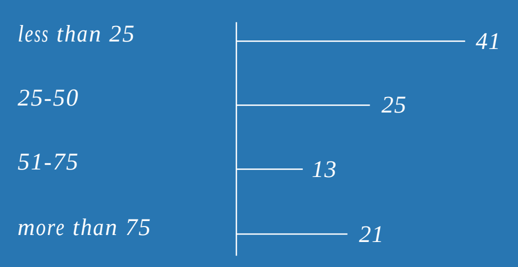
During the next year, enterprise solutions companies will be challenged to continue to grow rapidly, while preserving or reaching profitability, and to demonstrate real value to customers while expanding their business. By first assuring the health of their core business, and then strengthening their value propositions, these companies can earn the right to pursue future growth opportunities. At the same time, consolidation is inevitable. The market dynamics of the current environment should force all companies, large or small, to consider whether they will be net buyers or sellers of assets. We now turn to a brief look at each of these areas of focus.

1. ASSURE HEALTH OF THE CORE BUSINESS

Enterprise solutions companies, seeking more robust profitability in the near term, have a number of practical alternatives open to them. Improving pricing management and driving sales force effectiveness can have an immediate impact on the bottom line by increasing revenues at improved overall margins. In many cases, straightforward steps can be taken simply by using recent sales results from the field to improve customer segmentation, repricing and re-allocating resources, as appropriate.

In addition to growing the top line at improved margins, reducing costs can create some immediate wins. In fact, 59% of participants indicated they have reduced marketing budgets by 25% or more since the last fiscal year. It is unquestionably true that many enterprise solutions companies have grown so rapidly that their management of indirect costs is less aggressive than it

HOW FAR HAVE YOU REDUCED MARKETING BUDGETS FROM THE LAST FISCAL YEAR?
percent



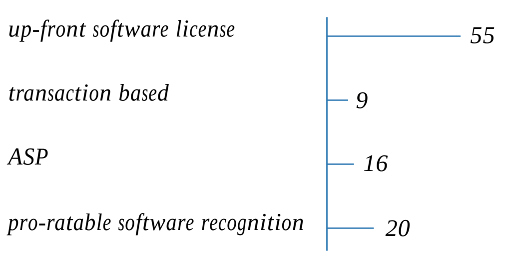
Source: Enterprise 2001 Quick Tally results

could be, and management of internal services costs (e.g., customer support) can also use some attention. In many cases, improved service operations can lower costs and improve customer satisfaction while, at the same time, increase up sell opportunities.

Another place to look to create immediate bottom line improvements, while nurturing the future health of the core business, is in rationalizing product development. Effectively prioritizing a product portfolio and assigning resources only to the highest return projects is a challenge that few companies master. In particular, most affected are those companies that have grown quickly, and moved from single to multiple products, without addressing the management complexity that multiple products create.

A final point to mention concerns the underlying revenue recognition model of your business. There may be real advantages to migrating toward a continuous revenue model, rather than the more typical up-front license fee model. While some time is necessary before one can fully evaluate the trade-offs involved here, removing some of the pressure created by the quarterly rush to close deals should certainly be a good thing.

WHAT IS YOUR PRIMARY REVENUE MODEL?
percent



Source: Enterprise 2001 Quick Tally results

Each of these suggestions, taken separately, may yield an immediate, positive impact on earnings. Taken together, they provide a firm foundation for the future health of the business—a business that can then turn its attention to identifying likely growth areas and strengthening its overall value proposition.

2. IDENTIFY OPPORTUNITIES FOR GROWTH

As mentioned previously, one of the few substantial and lasting benefits of the IT bubble is the foundation it has created for future growth. This foundation, manifested in more standardized tools and processes, is particularly important for automating processes that cross enterprises or cross functions within an enterprise. The benefits gained by integrating functional silos, and from integrating across enterprises, are substantially reduced interaction costs—the costs associated with communication, coordination, and monitoring of business activity. By McKinsey estimates, roughly 35% of all costs in the economy consist of these interaction costs, most of which can be lowered dramatically through the use of cross-enterprise functionality. These benefits also span the business system, from product or service conception and design, to sourcing and production, to sales and service.

In addition to opportunities in cross-enterprise processes, there are entire industry sectors that have increased their investments in IT, but have not yet seen the benefits. These sectors are prime targets for those with strong value propositions to profit from prior investment. And other sectors that have not yet increased their relative IT expenditures are also potential opportunities as the costs of deployment go down and the evidence of increased productivity goes up. Examples of such sectors include business services, retail banking, and utilities.

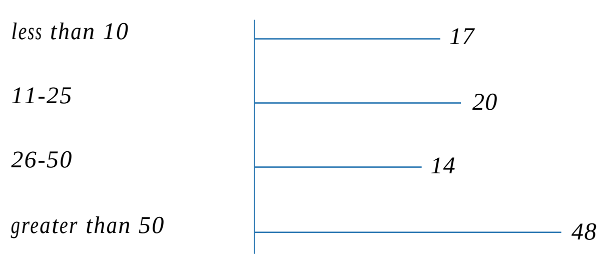
Besides cross-enterprise applications in new verticals, another category of emerging opportunities includes the real-time applications made possible by improved high-bandwidth connectivity and the rise of distributed computing. While more than 62% of attendees said that real-time appeared in their company's marketing message, in reality, the transformation from the batch mode software paradigm to the real-time paradigm represents a significant technology shift. As with any other dramatic change, this shift will create opportunities for pioneering entrants to create additional value for customers. At the same time, the likely changes required in business models (moving away from a uniform license price and toward more transaction-based structures) will require careful observation by those companies operating in this space.

ATTRACTIVE INDUSTRY SECTORS
1999, $ billions

SECTORS	REVENUES	IT INVESTMENT*
real estate	*1506*	*17*
business services	*773*	*41*
food	*490*	*2*
retail banking	*440*	*17*
utilities (electric, gas, sanitary)	*339*	*7*
legal	*161*	*3*
hotels	*129*	*1*
radio/television	*104*	*13*
apparel/textiles	*77*	*1*
furniture	*68*	*1*

Souce: Bureau of Economic Analysis
*IT investment includes computers, peripherals, software, & communications equipment.

WHAT PERCENTAGE OF YOUR ENGINEERS ARE ACTUALLY WORKING ON REAL-TIME FUNCTIONALITY?
percent



Source: Enterprise 2001 Quick Tally results

3. STRENGTHEN TOTAL VALUE PROPOSITION

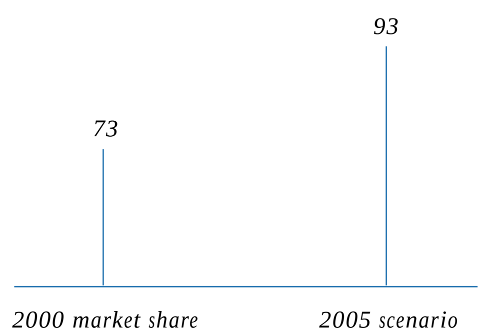
During times of consolidation, the winners are always those that articulate the strongest value proposition and reassure potential customers that this value proposition is differentiated in the long term. Today is no exception. The past few months have shown a decided shift away from experimental IT where new ideas were often hastily funded in the race to be first to deploy. Instead, we are returning back to traditional IT, where reassurance over vendor viability and continued focus on carving a sharply defined, value-based message is crucial to survival.

At the same time as this flight to quality, there is renewed recognition that software and typical IT services deliver only a small fraction of the value available from the deployment of new technologies. Reviewing and changing business processes and improving employee skills and training in the use of technology can extract much more value from the original investment. Enterprise software and solutions providers should consider adding complementary services that radically increase the total value created for their customers. Often these services also make it easier to demonstrate and measure this value, leading to more ability to capture a fair share of the value created.

4. BUY OR BE BOUGHT

Even for those solutions companies that have assured the health of their core business, strengthened their value propositions, and identified new areas for growth, the dynamics of the current environment require attention to one other matter—M&A strategy. In the past 18 months, the relative valuations of small solutions companies (less than $250 million in revenues) have dropped much more than their mid-size and large counterparts. Despite shrinking growth rates, many of these companies are now at valuations that may make acquisition attractive to their larger brethren. With a recent trend toward more market traction for broad, integrated offerings, many of these smaller companies should consider whether being bought is the best overall strategy.

PREPARING FOR CONSOLIDATION
Top 32 software company share of global 200 software spending
percent



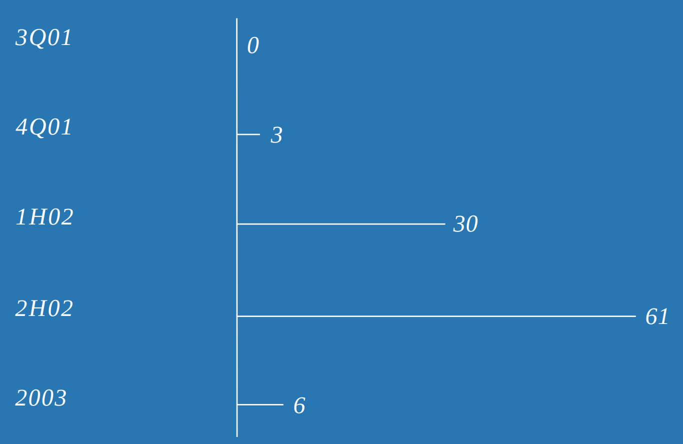
Source: McKinsey & Company analysis

Mid-size companies face a choice between trying to survive with increasingly strong larger players, and growing rapidly through acquisitions to catch up. Large companies may have a rare opportunity to purchase significant new IP or developed technology at attractive prices, and should act accordingly.

PREPARE FOR A U-SHAPED RECOVERY

Unfortunately, early hopes that the current downturn would rebound into recovery appear to have been misplaced, as recent economic figures continue to remain flat, compared to the heady growth of the past few years. In response to the Quick Tally question "Do you think the NASDAQ has hit bottom yet?" 57% of attendees did not feel that it had. Furthermore, when asked when the US economy might recover, 61% of participants said not until the second half of 2002. While there are many reasons for optimism, as noted, we expect that growth in IT spending will level out closer to the historical trend line, rather than to the bubble line of the past few years. For enterprise solutions companies, this means lower overall growth, and a particularly difficult period for the next twelve months.

WHEN WILL THE U.S. ECONOMY RECOVER?
percent



Source: Enterprise 2001 Quick Tally results

ECOSYSTEMS BECOME MORE IMPORTANT

To help steer toward recovery, it will be essential for companies to consider building long-term strategic partnerships, or to what others at the conference referred to as ecosystems or e-business networks across categories, strategic, consulting, software, platform, portfolio, content—even with competitors. Companies who succeed going forward will have to adopt the mentality that they cannot go it alone. To emerge as a true leader, they will need leverage from partners to deliver a larger value proposition to customers, products, and processes. As the influence of systems integrators begins to fade and applications, such as ERP, CRM, and SCM, become fairly standardized commodity purchases, customers will choose vendors on the strength of existing relationships and the depth of services provided.

WEB SERVICES CREATE SOME NEW OPPORTUNITIES

While it was generally agreed that there probably is no new clear enterprise wave yet on the horizon, the growth of Web services represents an important trend away from packaged software toward a world of networked devices, distributing control back from the center to the edge. Companies will need to operate in a Web-centric world with services available through a variety of vendors; each piece coupled through standards like XML to bridge and connect users to applications, devices, and services. Microsoft's .Net and other initiatives will be just some of the first forays into this brave new world of enterprise computing. We are sure that the resulting innovation and creative destruction will produce one or more killer applications that drive the distributed paradigm.

OVERALL, THE ENTERPRISE SOLUTIONS INDUSTRY MATURES

While enterprise software and services is by no means a mature industry, at least in terms of its potential for future growth, we should nonetheless expect some industry rationalization in response to the current economic environment. One by-product of the consolidation already discussed is a likely migration toward an industry structure that supports a few dominant players that control the customer channel, some infrastructure providers that exhibit large-scale effects, and remaining innovators forced more often to work with these larger players to get product to market. We expect that the days when every enterprise software startup would build much of its own platform technology and field its own direct sales force are numbered.

FUNDAMENTALS AGAIN BECOME FUNDAMENTAL

In a similar vein, up until the last twelve months, top line growth had replaced earnings as the primary corporate priority, and claiming share had been seen as more important than building a defensible base of business. It will come as no surprise that we expect the reliable, repeatable earnings growth to return to prominence for the next couple of years. Identifying a strategy that creates value for customers while building differentiation and sustainability will be the most critical success factor. Having the right business model is no guarantee of success—in fact, confining your thinking to business models rather than the usual elements of a corporate strategy is an almost certain recipe for disaster.

A FEW DISRUPTIVE CHANGES REMAIN

Despite all of the concern with the current environment and a return to fundamentals, it is important to remember that more than almost any other industry, enterprise software and services is one that is able to reinvent itself in response to disruptive changes. Several of these that are on the horizon today include the rise of peer to peer computing, the shift from desktop to wireless devices as the knowledge tool of choice, changes in IP protocols to allow virtually unlimited IP addressing and pervasive computing, etc. Each of these changes has the potential to create new that drive further increases in business productivity, and thereby creating opportunities for enterprise solutions firms to profit.

conclusions

The past year saw the carnage of too many failed business models and the first substantive decrease in software industry growth rates in over a decade. However, it also saw continued evidence of the real benefits of IT investment in certain industries. Given the contrast, a great deal of focus at the conference was placed on how to manage in the current environment. The return to fundamentals wove prominently throughout much of the discussions, with an emphasis on improving core health, identifying new opportunities for growth, and migrating to successful business models.

Managing the health of the core business, by paying attention to operational effectiveness, pricing, and organizational dynamics, is perhaps more important now than at any other time in the past decade. Maintaining a healthy bottom line is also vital in order to hold the strongest position when dealing with coming consolidation. The message is clear—focus on earnings and then use the market environment to your advantage. Just remember that the strategy and skills required to grow as rapidly as possible are different from those required to manage profitable growth in uncertain times.

Companies need to recognize where the IT spending of the past will create opportunities for the future. In doing so, they must take advantage of the spending on standards and upgrading of technology stacks that has laid the foundation for new cross-enterprise applications and other novel solutions. There are also opportunities to work in industry sectors that have invested in IT but not yet reaped the benefits—companies in these industries will be looking for solutions that create value out of their prior investments. Finally, companies focused on what truly creates value will be those with the best value propositions and quality services. Software and typical IT services are only a part of the productivity answer and customers will look for complementary services to dramatically improve overall value to their total investment.

While managing in the current economy will require different skills and approaches, the opportunities for the software and services industry are still substantial. The enterprise solutions industry can reassert itself as the engine of economic growth if we concentrate on delivering the elements of value we have discussed. Next year, we will meet again at the Inn at Spanish Bay, on May 5-7, 2002, to discuss the events of the coming year. We look forward to seeing you there!