

SOFTWARE 2004

SOFTWARE

2004

Preface

We are pleased to present our first annual report on the state of the software and solutions industry, in conjunction with Software 2004, an event that brings together more than 1,000 leaders within the software industry to debate its state, share ideas and opinions, and discuss issues of common interest.

This report, a collaboration between Sand Hill Group and McKinsey & Company, provides a guide to the issues most likely to face software executives in the coming year. Intended to provide a unique perspective on the industry, this report both summarizes the key ideas and opportunities likely to be discussed at Software 2004, and highlights emerging trends. It charts an overall agenda for software companies and suggests specific elements for each member of the CEO's team, providing each senior executive with a checklist for the coming year.

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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SOFTWARE 2004 *Summary*

The enterprise software industry is at a very interesting crossroads. While we are witnessing signs of the strongest growth in several years, the industry itself is undergoing changes both fundamental and structural. It is evolving into a customer-driven, professionalized, economics-driven industry, with a consolidated gorilla-player type landscape – all characteristics typical of a mature industry. As a result, many managerial priorities for software industry executives in 2004 have shifted. Over the coming year, these priorities should include:

- Identifying attractive growth vectors: After more than two years of tepid spending and scaled-back growth expectations, enterprises at last seem to be spending again. While overall growth is likely to be modest, growth rates will vary significantly depending on specific technologies and verticals. Also, explosive growth in consumer demand and penetration of new computing platforms such as smart phones raises the possibility that the most interesting new markets may not be enterprises at all. Finally, with shifts in both enterprise architectures (e.g., utility based computing), and delivery (e.g., increased outsourcing), all software executives must understand which growth vectors are open to their companies and which are most attractive.
- Improving overall productivity: Despite signs of the strongest growth in several years, the expectations built into most software company's stock prices still imply aggressive increases in profit margins. Productivity leaders within software companies will have to go beyond cutting expenses to driving sustainable productivity improvements that revive gross margins. Firms can increase productivity by at least three means: Optimizing the use of human capital, improving management of scope and resource allocation, and driving down indirect costs.
- Responding to permanent shifts in customer behavior: Despite positive signs for growth, all indications suggest that many new buying patterns – smaller deals, fewer vendors, more "pay as you go" – are part of a permanent shift in customer behavior. These

trends suggest the need for more "industrialized" and "professionalized" approach to customer segmentations, similar to those developed by the financial services industry during its own consolidation.

- Actively managing government actions and relations:** Software industry executives, thus far, have paid attention to the government only in the context of selling software. As the software industry has expanded in overall size and importance, government scrutiny has increased and government action is likely to increase as well. From this point forward, software executives will have to carefully examine the opportunities created by government action – and watch for potential risk.

- Continuously pursuing radical innovation:** Finally, no software executive can remain successful without keeping part of one eye on the large-scale innovations that periodically act as catalyst for the industry. Ironically, no major catalysts for innovation within the software industry have emerged recently. The increasing amount of software innovation occurring outside of the software industry also makes this a key agenda point for 2004.

The software executive's agenda for the coming year is a full one. It includes familiar topics (improving earnings, finding growth), responses to established trends (managing changing customer expectations), and special areas of focus (the role of government and identifying innovation).

As in the past, successful executives and firms will likely address each of these issues rigorously and foster ongoing debate on the senior team. Only in this way can leading software companies continue to both create substantial value and shape the direction of the industry—indeed, of the economy—as a whole. To help frame and foster this debate, the following sections identify the priorities for each member of the senior team, starting with the CEO.

With signs of growth back on the horizon and a "maturing" industry structure, CEOs need to redefine how they manage. Real and sustainable productivity improvements will be the key drivers and hence, increasing productivity should be a personal imperative for all CEOs. Professionalizing the key functions and improving relations with government at multiple levels are the other key priorities for CEOs.

- Defining and charting an attractive role in a more mature industry structure: With the software industry structure evolving towards "maturation," CEOs need to define and chart the paths for their companies. They need to look towards some of the best performers in more mature industries, such as GE, Alcoa, and Wal-Mart, who have demonstrated the competitive impact of sustainable productivity. The CEOs will need to drive towards continuous innovation in their business models and choose the dimensions in which they invest for advantage, drive periodic campaigns to upgrade business processes and infrastructure, and maintain cultures and disciplines of continuous improvement.
- Building a team that can professionalize all major functions: CEOs will need to develop management teams that can focus on developing a more "industrialized" approach to development and support, a more "professionalized" approach to sales and marketing, and a more rigorous adoption of performance metrics across the board, particularly regarding cost.
- Improving relations with government at multiple levels: Government is playing an increasingly active role within the software industry – both as a client and a regulator. CEOs will have to carefully examine the opportunities created by government action – and watch for potential risk. Hence it is crucial for CEOs to develop touch points at multiple levels within the government and focus on improving relations at every level.

Innovate the business system: The combination of substantial structural change (new entrants, blurring boundaries with other IT segments) and major behavioral change (customer interaction and partnering models) in the software industry suggests that

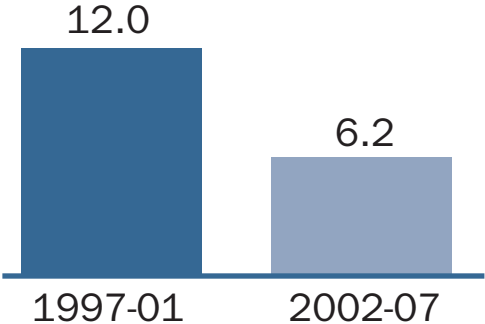
traditional business models will require readjustment, if not wholesale change. The CEO must drive constant examination of the way the business creates and captures value, and innovate to continually improve performance on both dimensions.

EXHIBIT 1

While software's share of capex will increase, growth will be more mature

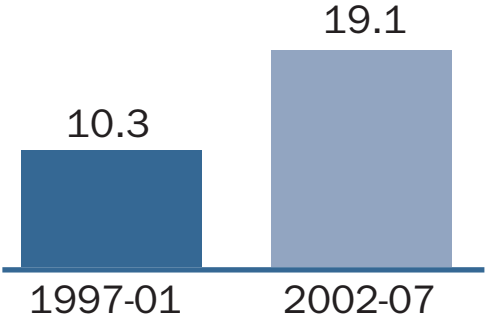
Global software spend

CAGR, Percent



Software implied share of worldwide capex

Percent



Source: IDC; Zacks; DRI; Research Insight; McKinsey analysis

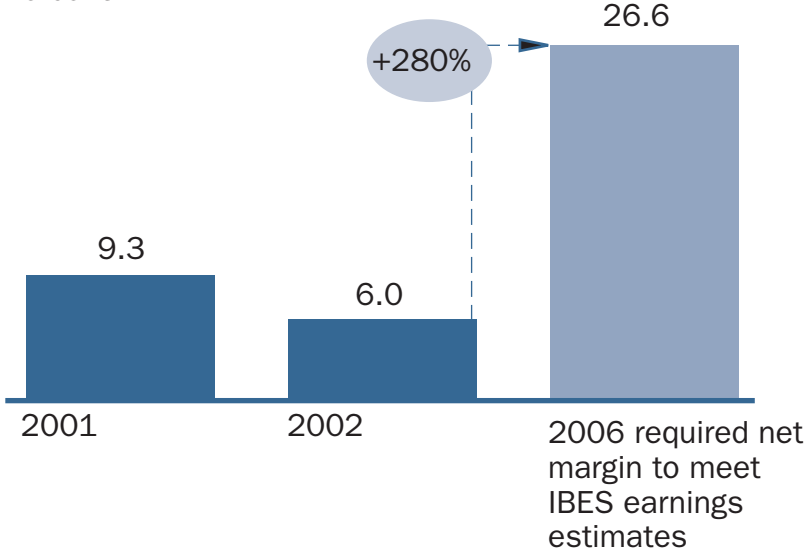
CFOs have always played a crucial role within the senior management teams of ISVs. Traditionally, CFOs have managed their responsibilities through a spectrum of approaches, from controller to strategist. However, recent environment changes (e.g. end markets, regulations) have both expanded and shifted the role of the CFO. In light of these developments, the key priorities for CFOs during 2004 are:

- Continual improvement of operating costs: Profit margin improvement has increasingly become an important source of value creation for software companies. During the last few years, with the software industry growth rates dropping, ISVs have relied on margin expansion through cost cutting initiatives to drive earnings growth. However, CFOs will also need to go beyond cutting expenses to drive sustainable productivity improvements that revive gross margins. As part of these efforts, CFOs must aggressively drive a dialog around functional efficiencies not just in traditional G&A categories but also in S&M and R&D. Part of this dialog should include a corporate process roadmap that identifies by process how to drive efficiencies through automation, outsourcing, and where appropriate, offshoring.
- Adoption of more rigorous performance management: In light of various environmental shifts impacting the software industry, CFOs must assume the mindset of a performance manager. Too often, the measures used to manage the company do not reveal, in real time, the competitiveness or effectiveness of its execution. It is also important to separate seeming productivity driven by rapid sales growth from true productivity driven by business process advantage and the innovative use of IT. CFOs need to lay out specific metrics that reach to the core drivers of performance and roll up to "no escape" results.
- Careful deployment of new pricing models: Resistance from customers towards the classic pricing model – in which firms pay a substantial license fee up front and then fork out an annual maintenance payment-has forced the ISVs to think radically about new pricing models. Customers expect an ever-decreasing price/performance ratio and steep discounting. ISVs must balance potentially complex pricing models with the need to keep pricing comprehensible for customers.

EXHIBIT 2

Operating cost improvement is crucial as expectations built into stock prices imply the need for aggressive profit margin increases

Average net margin
Percent



* For the top 50 publicly listed software companies
Source: Datastream; Bloomberg; McKinsey analysis

Customers are dissatisfied with ROI from previous software purchases and as a result are decreasing deal sizes, consolidating vendors and increasingly gating software purchases through internal business units and systems integrators. Hence ISVs need to drive a more "professionalized" customer approach. The key 2004 priorities for the Head of Sales are to:

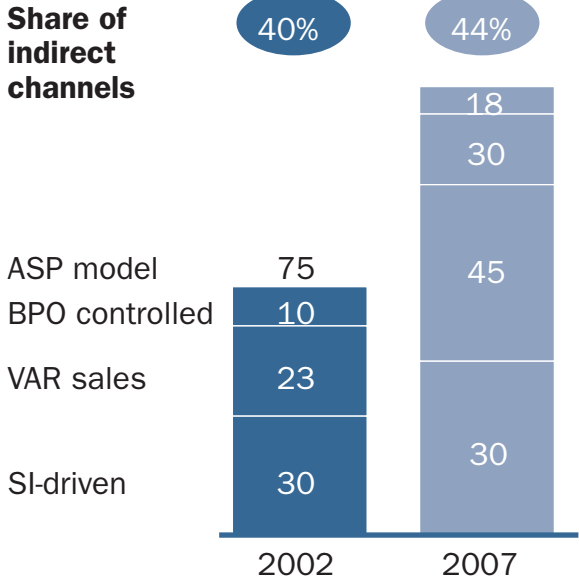
- Respond to permanent shifts in customer behavior: Customer buying behavior has changed significantly over the last few years. IT budgets have shifted emphasis towards capturing the benefits of their investments, further raising the bar for software vendors. Customers increasingly buy based on TCO models, shifting the discussion towards "hard" variables. These changes have led to some permanent shifts in customer behavior -smaller deals, fewer vendors, more "pay as you go." ISVs will need to work at understanding and meeting these new customer expectations.
- Manage increasing complexity of delivery and partner models while improving overall sales productivity: As the software industry matures, there is a natural move toward indirect channels. Growth in capabilities, increasing importance of the mid-market in several product categories, introduction of new delivery models, and the need to align with partners who have "real" access and industry value-add have been the key drivers. ISVs need to manage the increasing complexity by creating channel-ready products, with channel-ready license programs that combine flexibility with ease of understanding and acquisition, in order to make their products as easy as possible to sell. The end result here must be improved total productivity-that is, greater revenues for each dollar invested in selling.
- Respond to globalization of software supply and demand: As even mid-size companies expand their global reach and operations, the head of sales must respond to a need for tighter global coordination of sales as well as a customer expectation for global delivery. One significant challenge is responding to the rapid growth and increased influence of offshore systems integrators

EXHIBIT 3

Delivery channel complexity will increase due to more indirect channel sales

Worldwide software sales using indirect channels

USD Billions



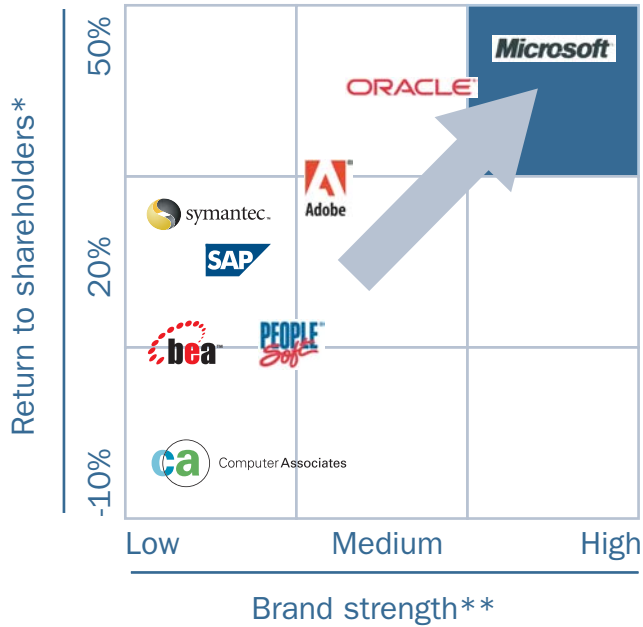
Source: Literature searches; interviews

In most industries, structural maturity drives an increased importance of brand awareness and perception. In the past, much software-related marketing spending has focused on large events and programs targeting particular new products. In the future, however, as customers concentrate their spending on a smaller number of overall solutions providers, software success will likely correlate more strongly with overall brand awareness, and marketing programs will aim at improving identification of customer segments, rather than just launching new products. In this context, chief marketing officers must:

- Develop and pursue an integrated brand strategy: With the software industry getting increasingly crowded, pursuing an integrated branding strategy is becoming increasingly important. Several trends – like maturing industry, evolution of customer needs, and "winner takes all" game-have increased the importance of branding. ISVs need to take a broad view of branding, realizing that brand influences many decision factors and all customer interactions influence brand perception. They need to develop an integrated strategy, which links branding with customer-facing business unit strategy and post-sales operations and organization, resulting in more marketing-driven value creation.
- Measure and increase effectiveness of marketing program spend: Go-to-market productivity has declined rapidly during the downturn. ISVs often take too myopic a view on marketing effectiveness and, in doing so, minimize the potential impact marketing can have on business growth and profitability. Companies need to leverage analytics and customer insights in shaping corporate strategy and priorities. The top management team must demand that market strategies are translated into the quantified performance requirements necessary to deliver the targeted bottom-line results.
- Drive market input into both sales and development: Marketing must more directly shape strategy and execution if ISVs are going to prosper in this increasingly maturing industry. ISVs have to

EXHIBIT 4

Software companies need to develop an integrated brand strategy to improve their brand strength



* For the year 2002

** As measured by CoreBrands

Source: Literature searches; interviews

2004 priorities for head of R&D

Innovation remains a key source of competitive advantage within the software industry. However, no major catalysts for innovation have recently emerged in the industry itself. At the same time, as software becomes a key part of many other industries, innovation is increasing in the end-user sphere. Given this background, the key 2004 priorities for head of R&D are:

- Building development "factories" for a majority of production: With the software industry maturing, many layers of the technology stack are becoming standardized, thereby setting the stage for industrialization of development. ISVs also need to leverage the development of low-cost locations as hubs for a majority of the software production work.
- Identifying "top 1%" performers and removing creativity and productivity barriers: Increasing software development productivity is becoming a top management agenda item. Many ISVs are forced to increase their software productivity due to pressure from clients or competitors as well as an increasing need for software renovation.

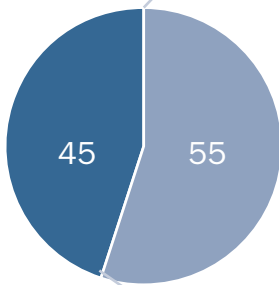
Monitoring innovation outside the software industry: Powerful technological trends are spreading software everywhere and driving industry convergence in many areas. Software is increasingly becoming important in many "non-software" industries. Innovation at the margin or outside the industry has continually bred substantial realignment of managerial priorities. Software industry executives should watch these technologies for early signs of rapid adoption and place appropriate bets.

EXHIBIT 5

More than half of investment in software innovation now occurs outside of the software industry

Total software innovation spending
Percent

100% =
USD 39 billion



Software's share of estimated development cost
Percent

Process automation system (energy)

90

Utility control equipment

60-80

Wireless telecom

60-70

Medical equipment

50-60

* Includes VC investments and R&D spend on software

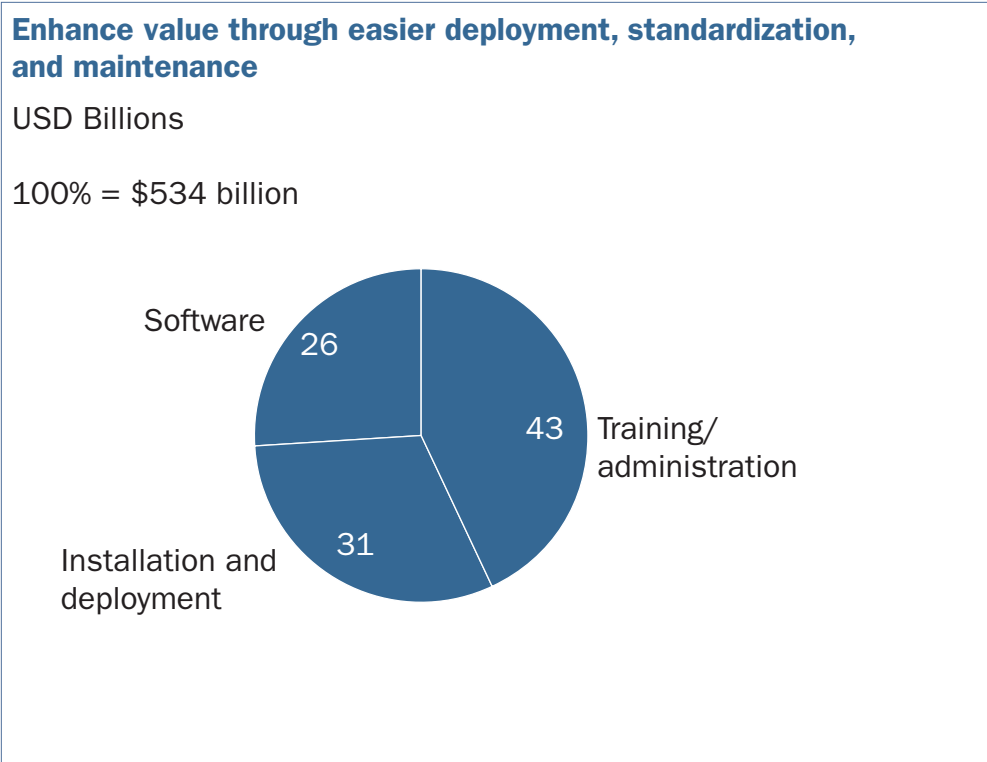
Source Giga; IDC

While most software companies still view the key to their success as driving ever-larger license revenue, the role of the head of services at a software company steadily grows in importance. Over the past several years, the ratio of software to services at most leading software companies has continued to decline as the overall revenue mix has shifted to services. While license growth will continue to be important, many software companies underestimate the benefits of more aggressive management of service growth and margin improvement. In this context, the key priorities for head of services are:

- Building a global delivery model with low-cost service factories:** More than 70% of worldwide IT spend (excluding hardware) is spent on IT training/management and deployment/support. Improving the operational effectiveness of providing services by creating an integrated global delivery model is crucial for ISVs, especially as the distinction between software providers and IT services players grows increasingly blurred.
- Managing and shaping partner relationships:** In the current economic environment where clients are interested in purchasing "solutions," ISVs need to increasingly rely on partnerships with system integrators, hardware providers, and channel partners. According to a recent IDC survey, more than 60% of all software purchased in North America was "influenced." In such a setting, it is essential to have the right set of management structures and tools for managing these relationships -that is, executive-level commitment, proper management infrastructure, performance measurement, sales and marketing support, and technology support.
- Improving customer satisfaction for post-sales services:** Too often, software executives take post-sales service for granted and give them limited attention with respect to either customer satisfaction or maintaining appropriate revenue streams. Software companies would do well to look at other industries such as financial services, where post-sales services have come to be seen as the

key to improved customer relationships and an important driver of lifetime value. Instead of neglecting them, companies should actively manage them to keep satisfaction and renewal rates high, and identify opportunities for incremental sales.

EXHIBIT 6



Themes for everyone to think about

- Competing with constant entry from new hardware and services players seeking higher margins: The economic downturn and depressed IT spending forced many high tech companies to pursue greener pastures outside their traditional domains. Hence, hardware companies looking to services for new growth and services companies coveted software's margins. Intense competition ensued, leading to "winner takes all" bids for new spending and deep discounting.
- Responding to nagging complexity, reliability, and security concerns: These issues continue to plague the software industry. Corporate and government networks have come under increasing fire from cyberspace and these attacks have led to significant productivity losses.
- Organizing to create a more unified perspective on regulation and the role of government: Several legislative issues—from compulsory security standards to enforcement of intellectual property rights, from SEC policy on revenue recognition to national legislation on offshoring—are becoming prominent and merit closer attention from industry executives. The industry needs to come together to develop a common perspective on the increasing influence of government and regulation in day-to-day operations.
- Learning from more mature industries, while retaining creativity and innovation that drives growth: The software industry is transitioning from a young, chaotic, and highly fragmented industry to a mature, professionalized, and consolidated gorilla-player arena. Software executives need to learn from experiences of managing within mature industries, while at the same time, retaining the innovative spirit that is the key driver for future growth.