

SOFTWARE 2005



BUILDING BLOCKS FOR SUCCESS

Preface

We are pleased to present our second annual report on the state of the software industry, in conjunction with Software 2005, an event that brings together more than 1,500 leaders within the software industry to debate the state of the industry, 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 be on the agendas of software executives' agendas in the coming year. Intended to provide a unique perspective on the industry, this report should both summarize the important ideas and opportunities likely to be discussed at Software 2005, as well as highlight developing themes and trends. This report suggests the building blocks for the coming year the trends, ideas, and themes that will shape the software industry in 2005.

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

Ken Berryman (ken_berryman@mckinsey.com)
James Manyika (james_manyika@mckinsey.com)
McKINSEY & COMPANY, INC.

M.R. Rangaswami (mr@sandhill.com)
SAND HILL GROUP, LLC

SOFTWARE 2005 *Summary*

Software 2005: Building Blocks for Success

From the beginning of the packaged software industry, new application categories and technologies have driven overall software spending. Looking forward, it is difficult to point to any such innovations that can catalyze substantial software growth in 2005. The good news is that software continues to experience a modest cyclical recovery. At the same time, software has started resembling “traditional non-technology” industries in its structure and conduct. Slower growth, focus on operational performance rather than technological innovation, and big consolidation deals all point to a long-term shift toward a more mature industry structure. In this changed environment, the conventional building blocks for success will no longer be valid. In the future, software companies will have to focus on a completely different set of them, including:

- **Improve total customer experience:** Customers are demanding that software vendors create more value, starting with an improved approach to their customer interaction. Software companies need to make customer value transparent and work towards more partner-like relationships with customers. The prerequisites are a deeper understanding of customer, industry and functional processes and a stronger focus on services.
- **Optimize software supply chain:** Most software companies are struggling to maintain a constant flow of innovation and incremental product improvements that customers are willing to pay for. Systematically developing a “software supply chain” that includes internal and external development, partners, and even customers across all geographies will be important to software success going forward.
- **Establish a productivity mindset:** Software companies have always focused on product innovation, and the economics of producing and selling technology in a high-demand environment enabled them to increase the value

of their output for a given amount of labor, capital, and purchased goods and services. Now they must put a similar effort into delivering the same or greater output with fewer inputs, developing innovative operational processes, and establishing a productivity-driven culture in all functions.

- **Organize for collaboration:** Many software companies face significant organization scalability issues as they grow revenues. The structure and processes required to support a \$1 billion software company differ significantly from those required for a \$100 million company. Similarly, the functional organization structures appropriate for high-growth market environments are less optimized for today's software industry, which requires agility and rapid cross-functional collaboration.
- **Manage ecosystem economics:** The software ecosystem has always been complex, with services partners capturing a large part of the total value. Recent moves by hardware and even semiconductor providers are further complicating the total distribution of value, suggesting the need for paying greater attention to managing the growth of your ecosystem – and keeping your fair share of the value.

As in the past, successful firms will likely have to address each of these building blocks directly as well as focusing on one or more areas to drive real competitive differentiation. Only in this way can they continue to create substantial value and shape the direction of the industry – indeed, of the economy – as a whole.

Improve Total Customer Experience

For too long, there has been a major disconnect between elements of the experience that customers desire and those they perceive when interacting with software vendors. While the demand upheaval from 2001-2003 has driven a paradigm shift in the selling models of most software companies, the industry still suffers from lack of focus on complete customer experience. This focus must address not just well-known issues – such as increasing software value delivered and improving software return on investment, but also on aspects of customer interaction that contribute to overall experience. For example, removing the pain from current software sales processes is a “quick win” that companies should consider. A better overall customer experience can drive not only greater satisfaction and heightened perception of value, but also real customer loyalty – the foundation of any successful long-term business. To achieve these ends, software executives should consider the following approaches:

- **Get sales basics right:** The key prerequisite for this approach is a sales organization that understands customer needs, responds reliably and completely, and strives to improve total relationships over time. If the basics of a strong sales organization are there – including the ability to listen to customers and clearly articulate basic value proposition – then it can add the capacity to demonstrate, in very specific ways, the superior value of the company’s products.
- **Demonstrate superior customer value:** Customers have often accused the software industry of over-promising and under-delivering. In the current environment, its not enough to say that purchasing software, for example, can help a company save 5 percent. Instead, the sales representative must demonstrate that she clearly understands the client’s business model and financial situation, and then articulate the exact categories where the software will save or generate money. Many vendors, for example, have

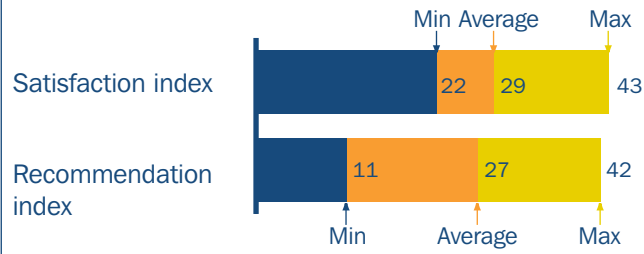
strong relationships with purchasing or IT departments, but not with business executives. Companies also need a strong follow-up to ensure that the value promised is actually delivered – especially if they rely on partners for distribution, implementation, or sales. While most software vendors attempt to assess customer satisfaction with surveys, these often target end-users, who are not typically senior executives with an understanding of real business value drivers.

- **Align company to customer experience:** A focus on improving total customer experience can eventually begin to shape the entire software company. It can structure the whole sales organization, including value-oriented training and coaching processes, and employee evaluation and incentive systems can center around it.

EXHIBIT 1

Current satisfaction level with traditional ISV model is consistently low

Percent



Note: Based on surveys for 10 enterprise application providers:
1) current implementers who definitely plan to re-implement;
2) current implementers who recommend brand
Source: Yankee, 2004

Optimize Software Supply Chain

With no new “big innovation” in sight, software companies are struggling to maintain a constant flow of innovation that can be linked to customer input and that customers will pay for. Traditionally, most innovation was technology-driven. But as the markets have matured, customers have developed strong attitudes and preferences. In fact, the share of total software spending for internal development versus packaged purchases has actually increased over the past 5 years. Future success will therefore require more active participation from customers in product development. To increase customer input, software vendors must excel in four areas:

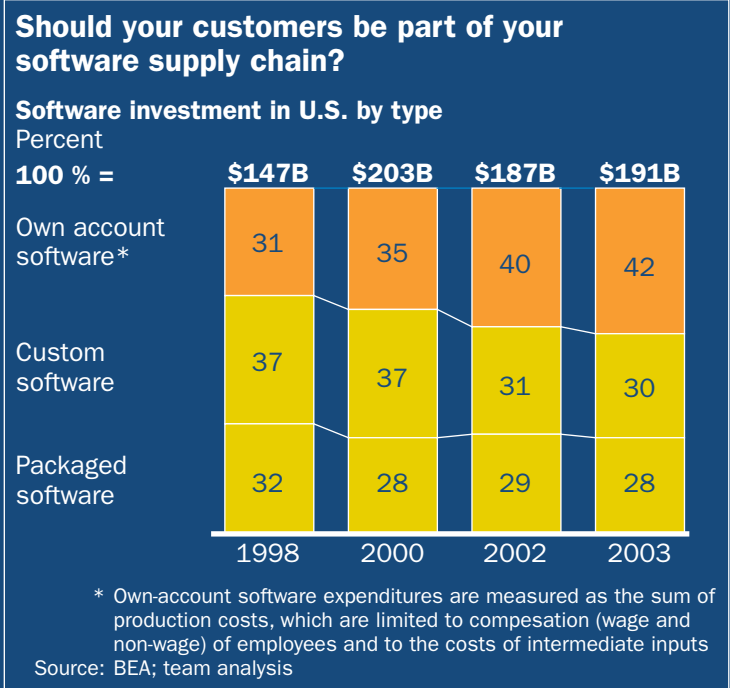
- **Capture actionable customer insights**
 - Prioritize customer segments
 - Identify key needs
 - Determine key customer benefit areas based on trends and competitive position

- **Build differentiated value propositions**
 - Build a quantitative understanding of value proposition elements, ensuring link to top customer needs and competitor alternatives
 - Highlight and pressure-test areas of differentiation with the target market
 - Map a holistic focus across company levers (e.g., products, services)
 - Develop and test value proposition message with target customers

- **Manage customer-back versus technology-forward innovation**
 - Balance innovation focus based on maturity of technology
 - Link innovation to customer needs (latent or explicit)
 - Translate innovative ideas and needs into features and platforms

- **Establish a balanced process across marketing and engineering**
 - Clear customer ownership
 - Shared marketing and engineering roles.

EXHIBIT 2



Establish a Productivity Mindset

Despite signs of the strongest growth in several years, the expectations built into most software companies' stock prices still imply aggressive increases in profit margins. The challenge goes beyond simple cost cutting. It's about changing the ratio of inputs to outputs—the value of what companies put into a production process compared with what they get out. Many other industries—automotive, retail, even pharmaceuticals—have developed specific metrics and continuous improvement processes to achieve higher levels of productivity, with the result that productivity leaders (such as Toyota and Wal-Mart) continue to outperform their industries. Software companies should adopt a similar, “production-line” attitude towards the improvement of sales productivity as well as other functions, including engineering. Boosting overall productivity in this way requires not only process innovation, but also targeted application of IT, and careful use of various outsourcing models. Driving productivity leadership will require:

- **Setting target business model(s) based on productivity capabilities:** The CEO or CFO should assess new business opportunities, investment proposals, and acquisitions through the lens of the company's core productivity skills. For example, a company such as Dell that has mastered the management of working capital may have a harder time building a services business based on intellectual property and talent. Similarly, productivity leaders know when to grow, maintain, and exit different components of their business. Dell abandoned the mobile phone and high-end storage markets when it became clear that the business model and capabilities could not deliver results in line with expectations. GE, after pioneering offshore delivery for back office processes, spun out Indian operations for greater cost flexibility.
- **Installing metrics that penetrate to the drivers of performance:** Aggregate productivity metrics that feature revenue in the denominator can be misleading if the business

is growing – or shrinking – rapidly. Financial metrics alone are not sufficient – productivity leaders use metrics that reach to the core drivers of performance and roll up to “no escape” results. For example, engineering scorecards that include the productivity impact of quality and reliability can result in improved cycle times that drive capture of market share.

- **Upgrade management systems to emphasize continuous productivity improvement:** Many software companies have managing systems defined by program management of R&D and pipeline management of sales. To compete on productivity, software leaders must take a more integrated view of execution. Companies like Intuit have followed the example of the Toyota production system and applied “lean principles” to end-to-end processes. This focus on bottom-up productivity improvement with top-down measurement will be a key factor in future software success.

EXHIBIT 3

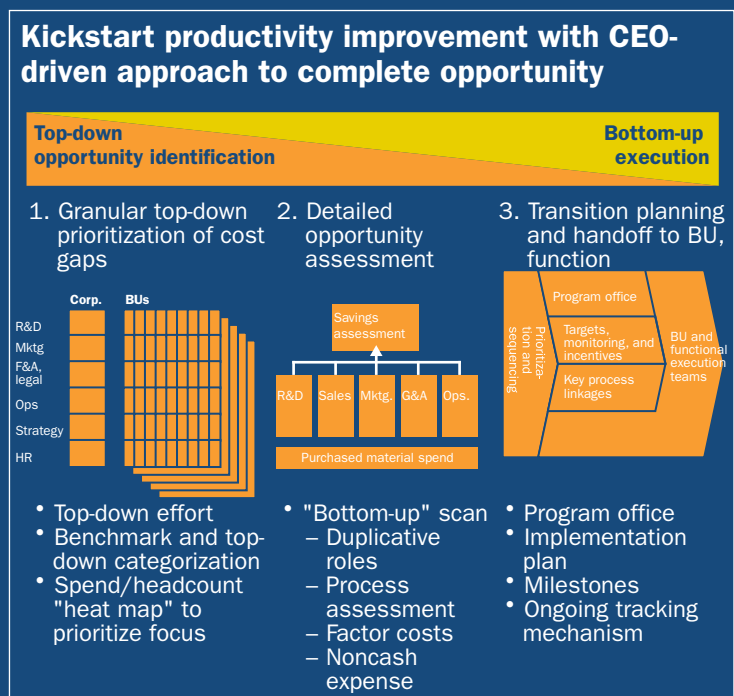
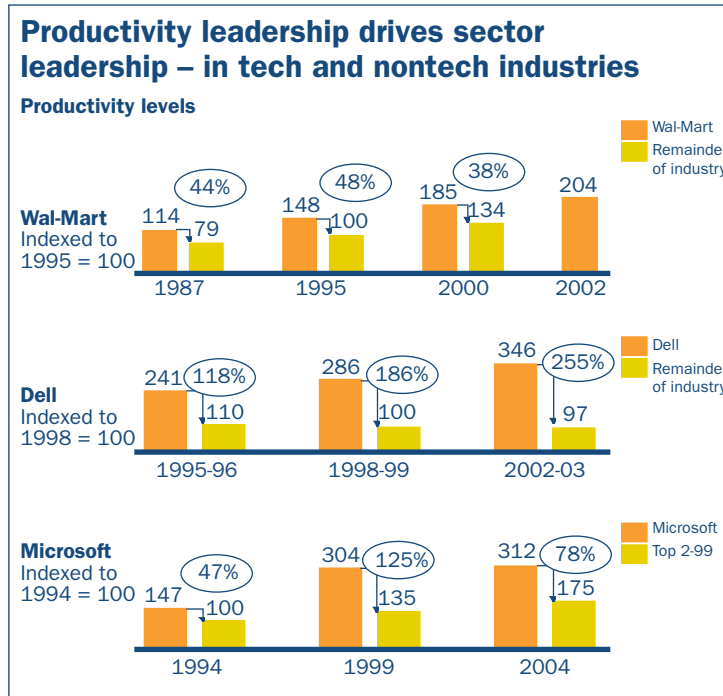


EXHIBIT 4



Organize for Collaboration

Scalability is a key challenge that software companies face as they grow. The growth of multiple forms of communication (cell phone, e-mail, instant messaging) has increased the communication burden without necessarily improving the results from collaboration. Rough estimates suggest that almost half of managers are interrupted every 10 minutes on the average – hardly the type of working environment that fosters effective collaboration and improved productivity.

Software companies should consider how to structure their informal internal networks to improve communication effectiveness, particularly across functions. Traditionally, most software companies have built functional organizations. Unfortunately, in larger companies this structure can lead to a number of issues, including: 1) lack of common processes; 2) inefficient midlevel decision making; 3) too much management by exceptions; 4) lack of cohesive planning; 5) no clear financial measurement tools; and 6) no clear targets. The cost of failing to address these issues can be severe.

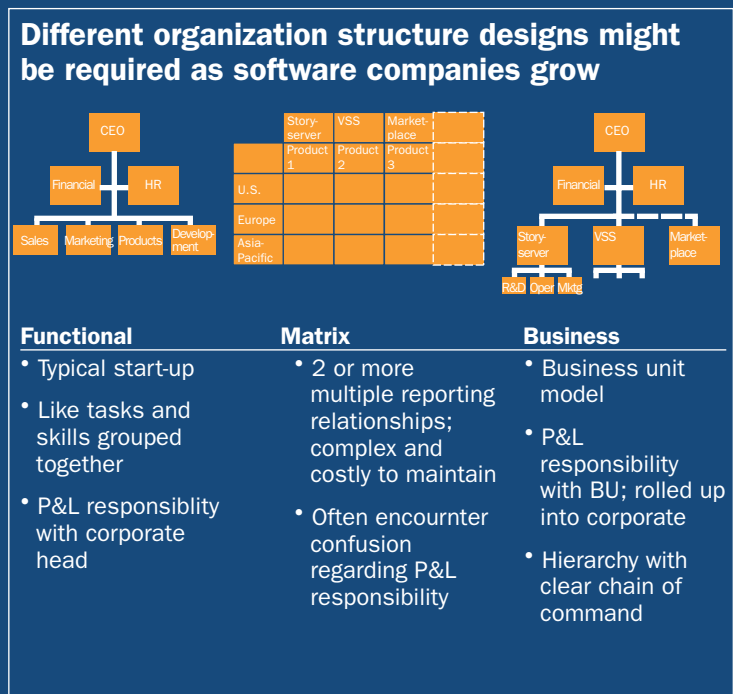
It is clear that other structures and organizational approaches should be employed by software companies in today's world. We have highlighted a few structures below and the circumstances that tend to favor them.

- **Functional**
 - Products/services are relatively similar
 - Cross-product synergies exist
 - Local operational/manufacturing needs are minimal
 - Functional specialization is key to success
 - There are clear economies of scale within functions
 - Organization is small or a startup

- **Matrix (functional/BU hybrid)**
 - Each BU cannot have its own function (e.g., manufacturing) without loss of economies of scale

- Certain functional expertise is intrinsic to the organization's core competence and competitive advantage
 - Companies have infrastructures with particular strengths (e.g., a superior network, distribution system, or technology)
- **Business-unit (product) focused**
- Economies of scope or scale exceed geographic boundaries
 - Innovation is critical and lifecycles are short
 - Consumers, customers, and competitors are, or will become, international
 - Little connection exists between product/services
 - Markets neatly segment by product
 - Firm grows through product-focused acquisitions

EXHIBIT 5



Manage Ecosystem Economics

The software industry ecosystem has always been complex, with substantial revenues accruing both to large services providers and the manufacturers of underlying hardware and equipment. The variety of channel structures (VARs, distributors, DMRs, etc.) also complicates the ecosystem. According to IDC, software sales through indirect channels are expected to account for 44 percent of worldwide sales in 2007, growing faster than direct channels. In a more mature environment, the active management of this ecosystem becomes even more important. At the same time, the growth of new hardware platforms (e.g., cell phones, telematics in automotive) is creating new ecosystems in which software companies can participate. Software executives must attend to the following areas to maximize growth and share within the ecosystems in which they participate:

- Identifying key control points and partnership opportunity areas
- Identifying required development partners (ISVs, IHVs, OEMs, NEPs) and go-to-market alliances (ISVs, SIs, VARs)
- Defining the nature of relationship with key players
- Laying out the marketing and evangelizing programs needed to develop/maintain ecosystem
- Identifying the tools and technologies necessary to drive development on platform/ecosystem (e.g., development tools, migration tools, SDKs).

EXHIBIT 6

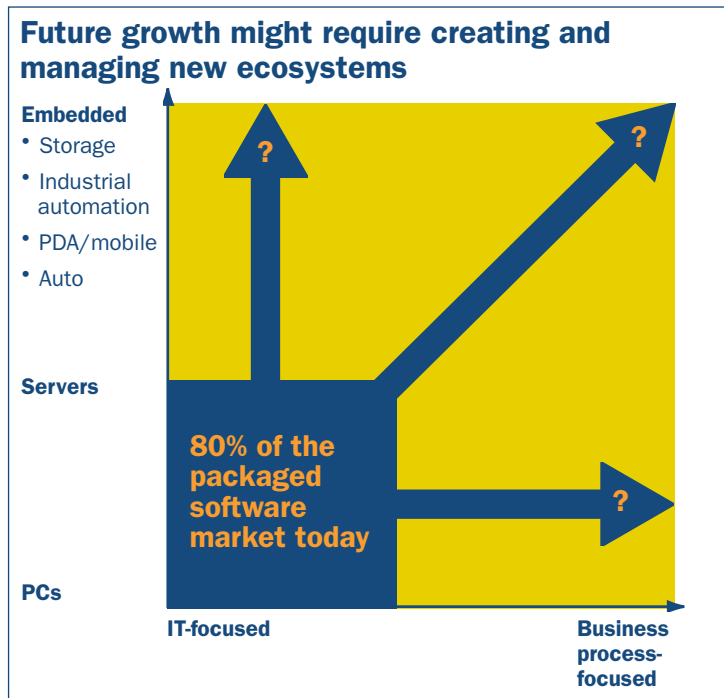
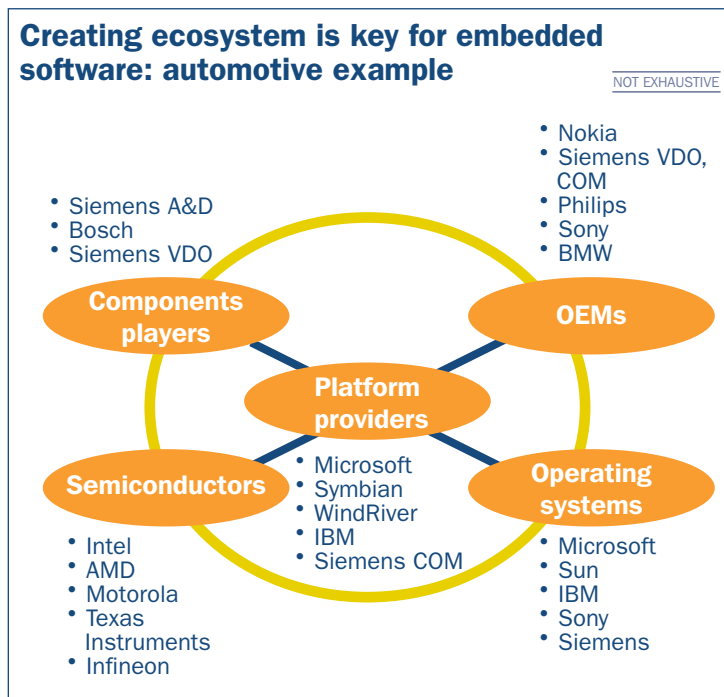


EXHIBIT 7



Monday Morning Self-Diagnostic

We believe that these five building blocks form a critical foundation for future software company success. The following questions will help indicate your status in each area. We hope that you find this “self-diagnostic” a useful tool to prioritize your own efforts to succeed in the software industry of the future.

- **Total customer experience**
 - What are your customer’s primary pain points related in the software/IT experience and are any connected to your company?
 - How much value do customers ascribe to your products, and how much “friction” do they feel in achieving this value?
 - What would you need to change to create loyal customers (e.g., proactive recommenders to other customers) as opposed to merely satisfied ones?

- **Software supply chain**
 - What fraction of your current products is developed externally? How could you increase this ratio?
 - How many different sources (such as partners and customers) do you systematically review for possible incorporation into future products?
 - Do you have a “software sourcing strategy” in place that targets continually lowering the software cost of production over time?

- **Productivity mindset**
 - How does your productivity compare with your competitors – regardless of business model and location? What does it need to be in 2 years?
 - What are the top five drivers of cost productivity in your company, besides revenue growth?
 - What “numerator” AND “denominator” initiatives do you have underway to drive ongoing improvements in productivity? Who is driving them? What are their targets?

- **Organizing for collaboration**
 - How effective is cross-functional collaboration within your company?
 - Do you have technology, business model, and productivity-innovation capabilities on your management team?
 - How aligned are your performance incentives and behaviors (such as time, mindshare, management capacity) with the new realities?

- **Managing the ecosystem**
 - How much influence do you have over partner economics?
 - Do current incentives align your interests with the broader ecosystem?
 - Do you understand the implications of likely consolidation scenarios? Are you driving changes in industry structure?
 - What additional organic and inorganic initiatives are required to achieve your growth and earnings aspirations?