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The Enterprise Software Company of the 21st Century



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By Bob Evans

You may have noticed that the enterprise software business has changed a bit in the last few years. The end of the ERP and Y2K booms of the late 1990s and the bursting of the eBubble in 2000 have left an industry that had grown 15-20 percent annually for more than three decades with growth expectations now more in the 5-10 percent range. Within the industry, the market is rapidly separating winners from losers. More than 30 formerly independent software companies disappeared last year in the flurry of over \$13 billion in M&A transactions. At least 100 venture-funded software companies closed their doors in 2003, never to be heard from again.

Investors appear to see some signs of hope within the industry with stock prices up about 40 percent, on average, during 2003 to the point that software companies are now generally trading at P/E ratios at the high end of the pre-Bubble period. Investors value two things: size and profitability, reflecting customers' desire to deal with the big guys and investor's recognition that growth has slowed.

So, if "big & profitable" are the keys to success, what are the challenges? I see five:

CUSTOMERS ARE INCREASINGLY DEMANDING, AND RIGHTLY SO

Software customers want it all today:

- ◆ 15-to-1 paybacks on their software investments
- ◆ 90-day (or less) time to payback
- ◆ Total costs of ownership 40-50 percent below past levels
- ◆ 2-month turnarounds on product fixes
- ◆ More product features ... faster
- ◆ As few software vendors as possible to deal with

And, they'll get it ... all of it. With more than 500 software companies still fighting for a slowly growing market, customers will call the shots. The only response is to be operationally brilliant around a set of truly unique software products (and services) with drop-dead value propositions.

SALES & MARKETING COST TOO MUCH AND AREN'T VERY EFFECTIVE

Not only are customers increasingly demanding, but getting new ones costs too much. Most enterprise software sales organizations were built in a world where license revenue accounted for 50-60 percent of total revenue. With gross margins on software license sales in the 95 percent-plus range, it made sense to spend heavily on sales coverage and pay those salespeople who produce results like rock stars.

Going forward, the typical enterprise software company will likely generate only 30 percent of their total revenue from license sales, with another 30 percent from maintenance and 40 percent from services. For those on a subscription model, revenue will likely be about 60 percent from subscriptions and 40 percent from services. With maintenance gross margins under intense pressure (customers have gotten smarter here too) and services margins typically in the mid-30 percent range, overall gross margins in the enterprise software business are likely to decline about 15-20 percent points from historical levels. This changes everything.

With far less gross margin available to fund sales & marketing, companies will have to completely overhaul their sales & marketing organizations, processes and cost structures.

Product Development Costs Need to Decline

Product development costs need to decline another 50 percent while simultaneously producing more products faster and at much higher levels of quality.

The last three years have not been particularly demanding on the development organizations of most enterprise software companies. True, development organizations have gotten smaller in an effort to reduce costs and getting smaller is never pleasant. But, customers' unwillingness to chase the next big thing in software has taken a lot of the pressure off development organizations to do more, faster. In short, development organizations have had to do less, with less.

That is about to change. If being "big" is part of being successful, then software companies have two paths forward. One, they can merge with other software companies. Many will likely do so, but the track record on software company mergers is pretty bleak (mainly because the mergers don't meet the customers' needs) and, with software company stock prices up 40 percent in the last year, the opportunities to "buy cheaply" have diminished.

The other way to get big is to sell more products. However, with the exception of Microsoft's and a few other's products, there are five, ten, and sometimes more sellers of just about everything today. To win, these products are going to have to be uniquely compelling and work at seven-sigma levels of quality. Unfortunately, this requires more developers. With license sales a smaller part of the revenue mix and overall gross margins likely 15-20 percent lower (see #2 above), development costs are going to have to come down, in my view, by about 50 percent. Plan on doing 50 percent more development in 2004-2006 timeframe, at 2x-3x greater levels of quality, in half the time, at about 50 percent less cost than you did in 2003.

The only way this is going to happen is if the development operations of most software companies are conducted offshore. In a survey we did last year, 95 percent of all software companies said they would be operating offshore by 2006 (47 percent are doing so today), and those companies plan to move about 70 percent of their operations offshore. And, not only is the geographic location of the work going to change, the processes by which development work is conducted are going to change as well. But, not enough space here for that story.

SERVICES WON'T SAVE THE DAY

Software companies used to think that services were something to be avoided whenever possible. Better to find implementation partners to pick up this low margin business (well, at least lower than license revenue margins) while they focused on license and maintenance sales. Today you would be hard pressed to find an enterprise software company that isn't trying to grow its services business.

However, there are two problems. First, they end up competing with their implementation partners. You can circumvent this challenge if you're able to conceive service offerings that are truly unique and which make you a desired partner to the big implementation guys in the large engagements that they sell. Second, the services organizations inside most enterprise software companies are notoriously poorly managed. Beyond the ongoing challenges of billing rates and chargeability, a new one has emerged. Your implementation partners, the Accenture's and IBM's of the world, your competitors in doing such work, are all building substantial offshore

delivery models with cost structures roughly one-fifth of yours.

Enterprise software companies will only be successful in expanding their services businesses profitably if they are able to conceive new, unique service offerings, and then manage the pricing, delivery and costs of this business at levels dramatically different from those in their pasts. Like Accenture and IBM, you're going to have to operate offshore.

NEW OPERATING MODELS MUST EMERGE

It's a math problem. As the license sales component of the revenue mix declines and downward pressure on maintenance margins intensifies, overall gross margins in the enterprise software business will likely drop 15-20 percent points. If you're going to achieve 20-25 percent operating margins (and realize the market cap valuations that reward such performance), then sales & marketing costs will have to decline 20 percent or so, and product development costs decline about 50 percent.

There are two possible responses, which aren't mutually exclusive. First, you can change your go-to-market model. I believe we will see the emergence of software companies who are terrific at conceiving, building, implementing and supporting world class software products and that these companies will go-to-market through OEM-type arrangements with the larger enterprise software companies who have huge installed customer bases. Combine great products with cost-effective go-to-market capabilities and you've got a winning model.

Second, you can change your delivery model such that you have the lowest possible costs in all areas of your business, from sales support, through development, to general & administrative functions, while still creating, building, selling and implementing more and higher quality products. Much of this will be accomplished by maxi-

mizing both the number and scope of the functions that are moved offshore. We created Symphony Services 18 months ago to meet the total offshore needs of software companies in this area. With over 1,000 people serving clients like Ascential, Autodesk, Broadvision, Manugistics, Merant, Siebel and many others, it's clear to us that this transformation is underway.

CONCLUSION

Software CEOs and CFOs have pounded on their cost structures over the last three years. Few, however, have transformed their fundamental business models. The assumption, I believe, has been that revenue (particularly license revenue) will eventually come roaring back and that their business models will generate the kind financial results they did in the late 1990s. The nice thing about the software business is that with a little cost management, you can live off your maintenance revenue stream for quite some time while waiting for revenue growth to resume. And, those software companies smart enough to issue debt in 1999 and early 2000 have even more of a cash cushion. But a closer look at many of these companies suggests that they're really self-liquidating. They are not building the products and services, or the go-to-market capabilities to compete in the software industry of the 21st century. Yes, there has been considerable change in the enterprise software business these last three years. However, most of that change was conducted inside the framework of a 20th century software company. Real change still lies ahead.

Prior to joining Symphony Services, Bob Evans was chief operating officer of i2 Technologies, Inc. and earlier was the President and COO of Aspect Development. From 1993 through 1998, Bob was the managing partner of Accenture's Supply Chain Practice in the Americas. Contact him at www.symphonysv.com.



Symphony Services Software Solutions Group

Symphony Services is a leading provider of technology-based outsourcing services. Its Software Solutions Group is changing the face of product design, development, support and professional services exclusively for commercial software companies like **Manugistics, Merant, Broadvision, GERS Retail Systems, Trigo, and VerticalNet.**

Symphony focuses on providing key benefits for each one of its clients when compared to their internal operations:

- ◆ Increased development productivity coupled with dramatically lower development costs
- ◆ Higher quality software products
- ◆ Reduced development cycles enabling faster time to market

Symphony Services is headquartered in Palo Alto, California, with operations centers in Bangalore, India, and Nashville, Tennessee.

Why Consider Outsourcing?

Outsourcing is a strategic business decision enabling software companies to reduce costs and increase their competitive differentiation. Commercial software companies are fast learning that establishing facilities overseas is key to gaining competitive advantage, profitability and ultimately survival in the market. Outsourced offshore software design and development solutions like those offered by Symphony Services through its Software Solutions Group will help today's software companies to compete, profit and survive.

Dedicated Global Operations Centers (GOCs)

By establishing dedicated, branded Global Operations Centers (GOCs) offshore, Symphony clients improve operating margins over in-house development, generally by 10 to 15 percentage points, while simultaneously improving quality and delivery time.

Symphony's executive team has real-world experience in managing leading software companies that have operated in an offshore environment. Together, Symphony and its clients institute efficient and effective product lifecycle management processes that enable commercial software companies to focus on their core competencies - defining innovative product capabilities and features to gain competitive advantage - while Symphony manages their non-core, yet strategic, product design and development efforts.

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