

The Changing Software Landscape – Pricing and Purchasing Trends

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CONTENTS

- **Overview of structural change in the software industry**
- Implications for pricing and purchasing
- Questions and options to consider

3 KEY THEMES ARE SHAPING THE SOFTWARE AND SERVICES INDUSTRY

Key themes

Structural maturity

- Slowing overall growth
- Increased industry concentration

Cost pressure

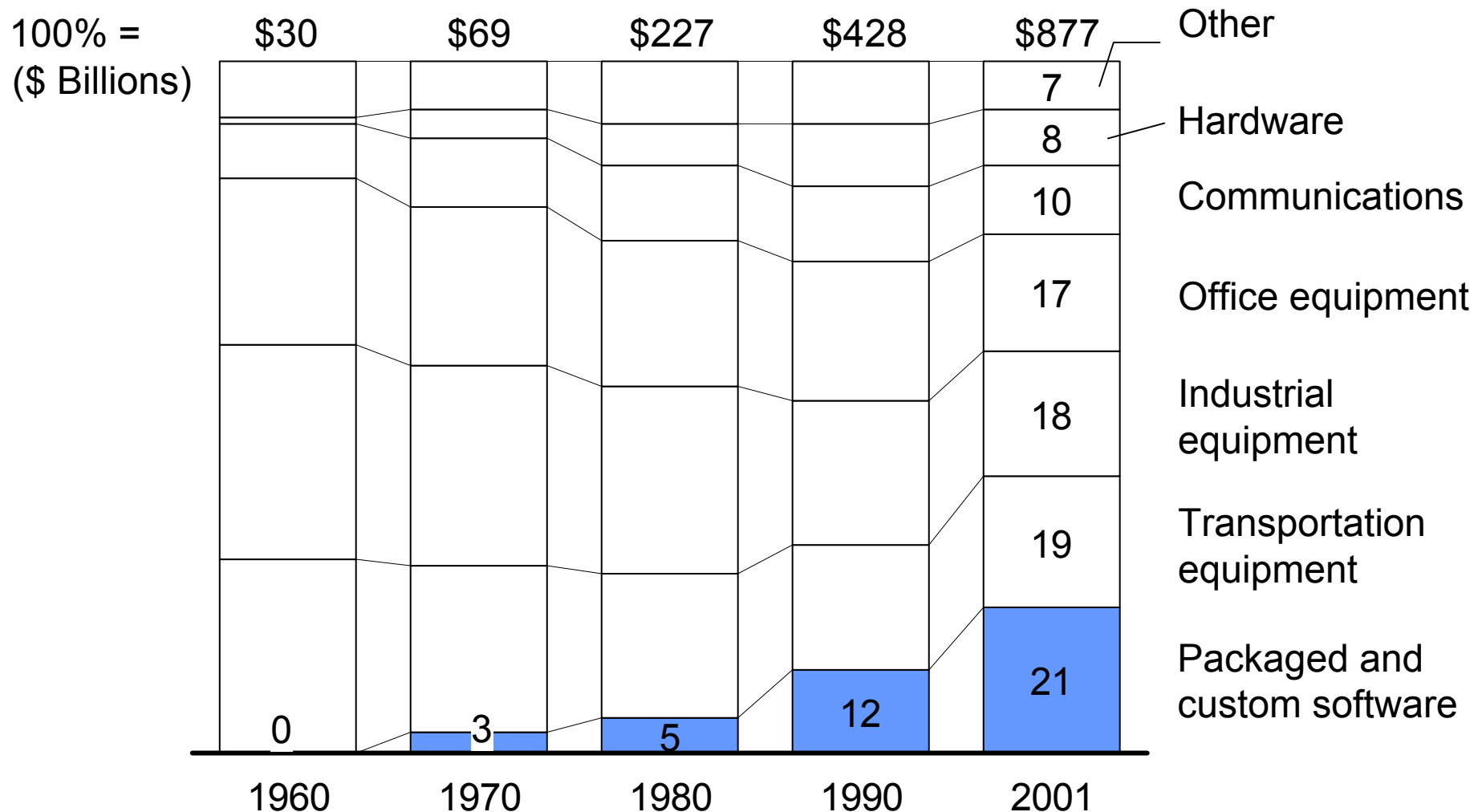
- Ongoing geographic labor arbitrage
- Increased demand for low-cost, scalable infrastructure

Emerging opportunity

- Ongoing architectural shifts (e.g., web services, on-demand/utility, devices)
- Increasing importance of software in non-software industries

SOFTWARE IS NOW THE LARGEST CATEGORY OF U.S. CAPITAL SPEND

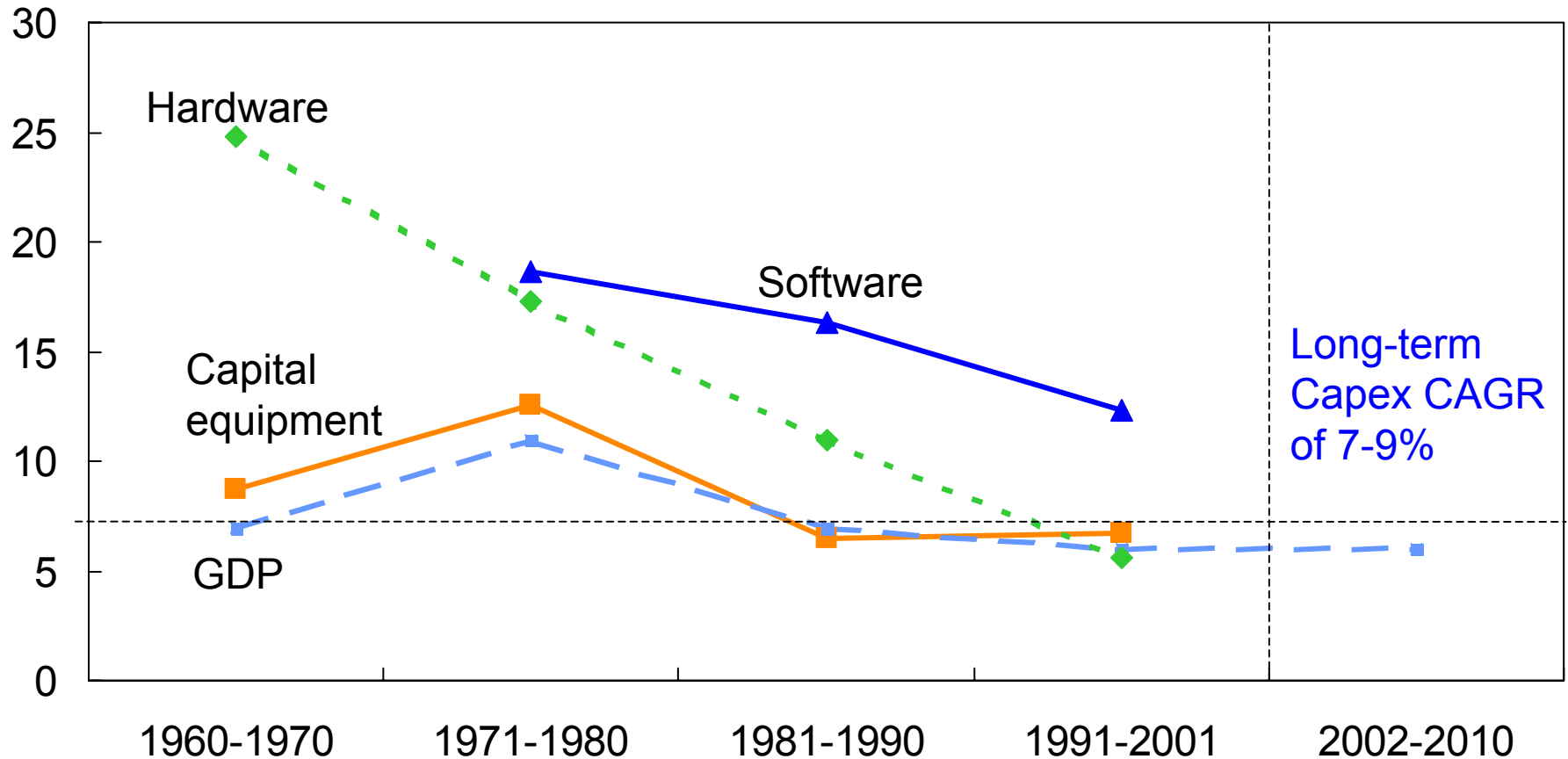
U.S. Capital spending



GROWTH RATE FOR SOFTWARE WILL LIKELY CONVERGE WITH CAPEX GROWTH

U.S. spend growth in nominal dollars

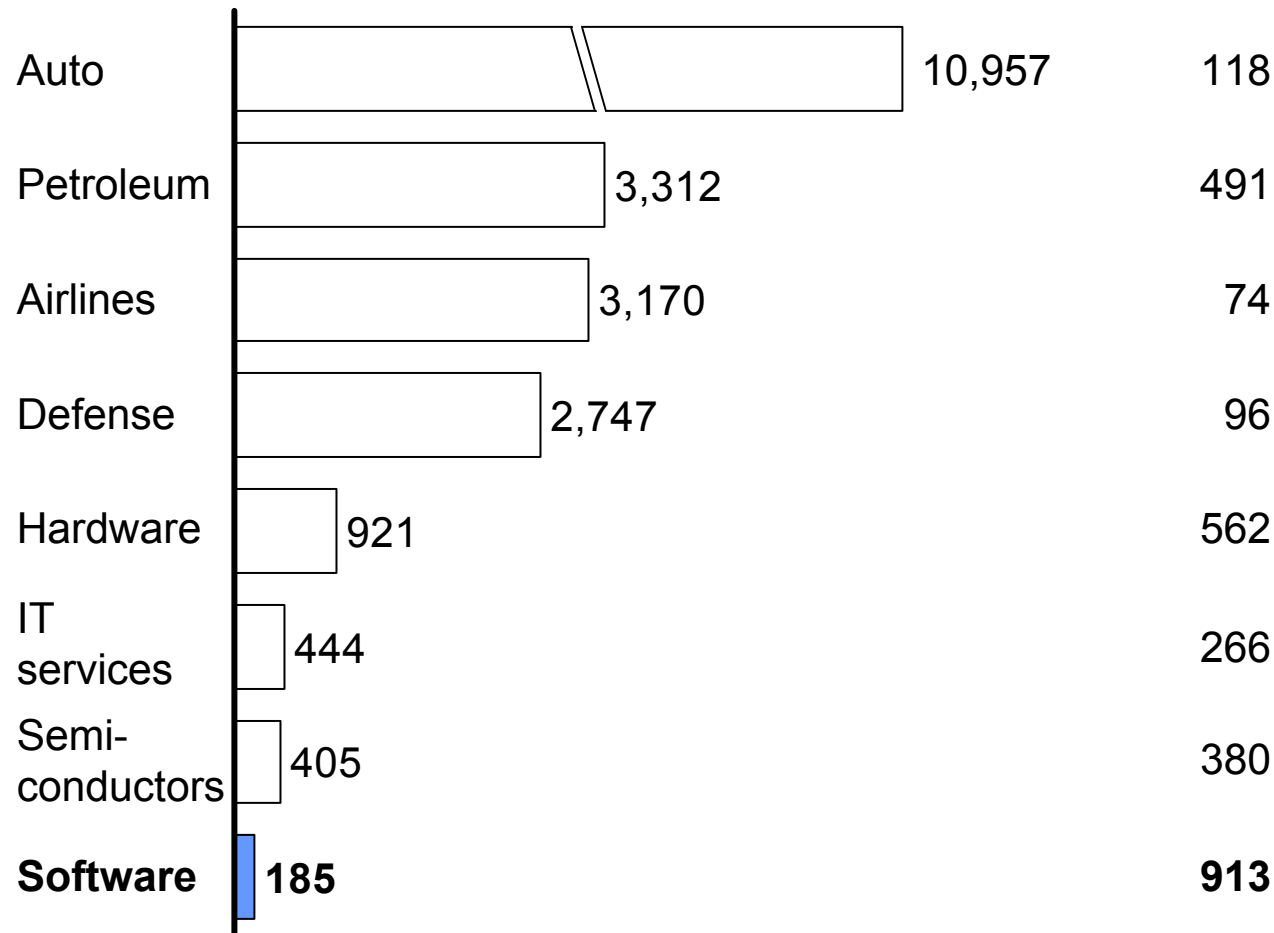
Percent



SOFTWARE REMAINS HIGHLY FRAGMENTED RELATIVE TO OTHER INDUSTRIES

**Average sales of a public
company, 2002**
U.S. \$ Millions

**Number of
public
companies**

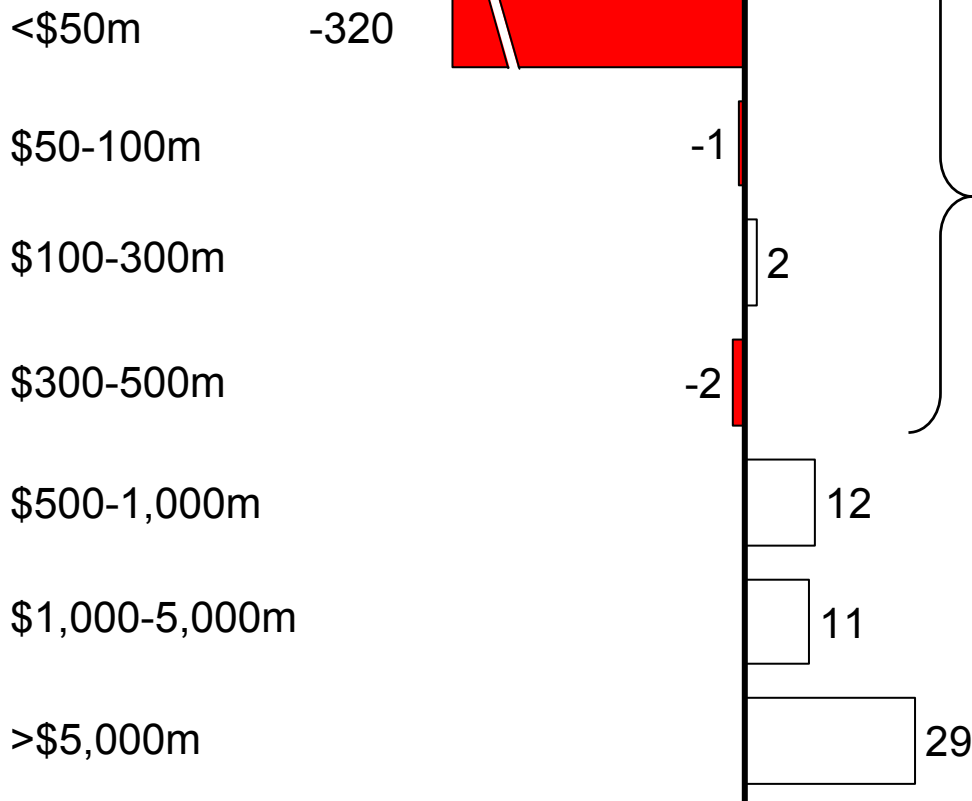


INCREASED CONCENTRATION COULD UNLOCK SUBSTANTIAL ADDITIONAL PROFIT

**Average EBIT margin of public
software companies, 2002**

Percent

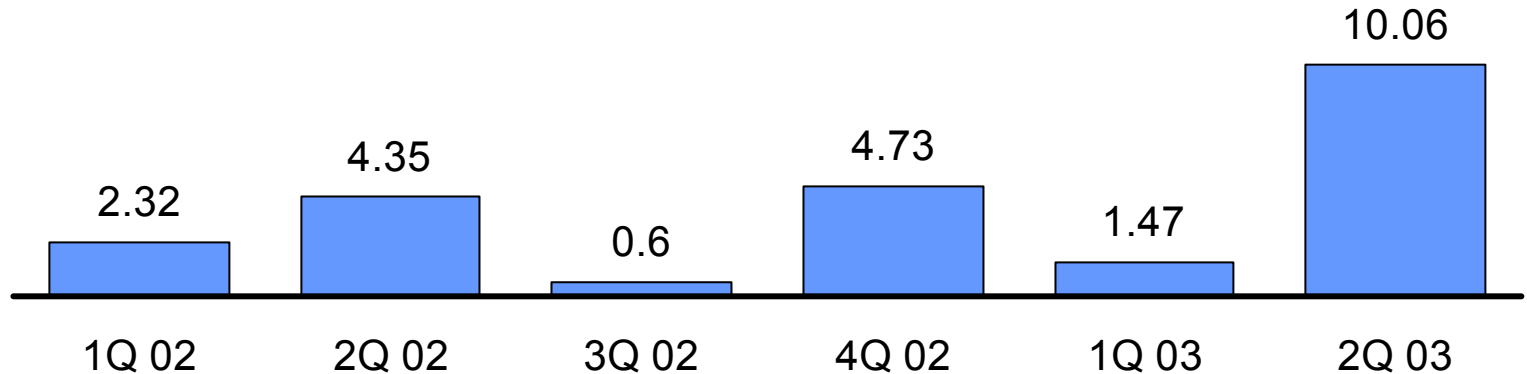
**Company
revenues**



**An estimated \$9bn annual EBIT
could be unlocked if these
companies had the profit/cost
structures of larger companies**

INCREASED M&A ACTIVITY IS LIKELY FOR SOME TIME

Value of announced software M&A deals
\$ Billions



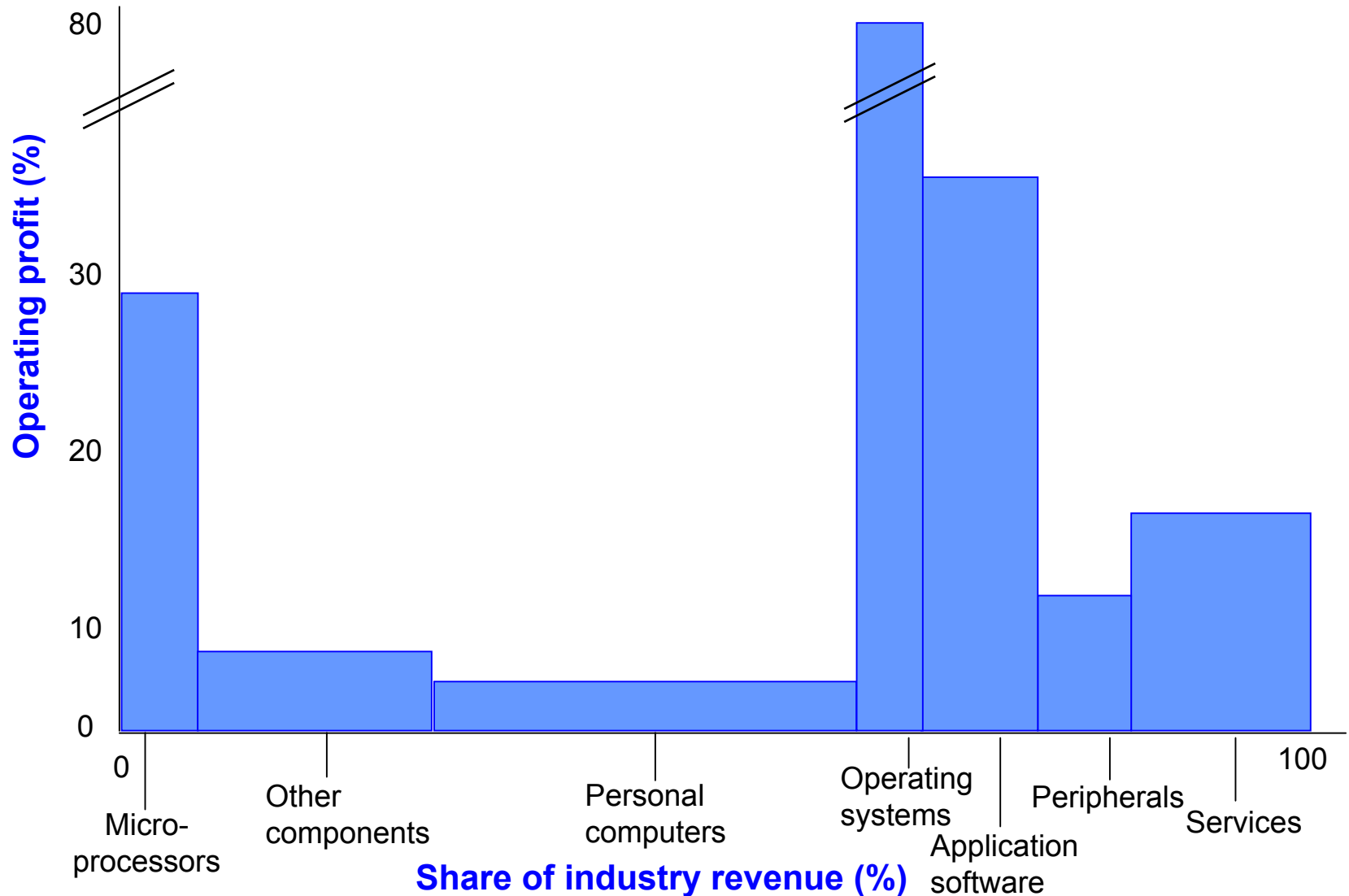
Examples

- Legato-OTG
- Microsoft-Navision
- OpenTV-ACTV
- IBM-Rational
- Synopsys-Numerical
- PeopleSoft-JD Edwards

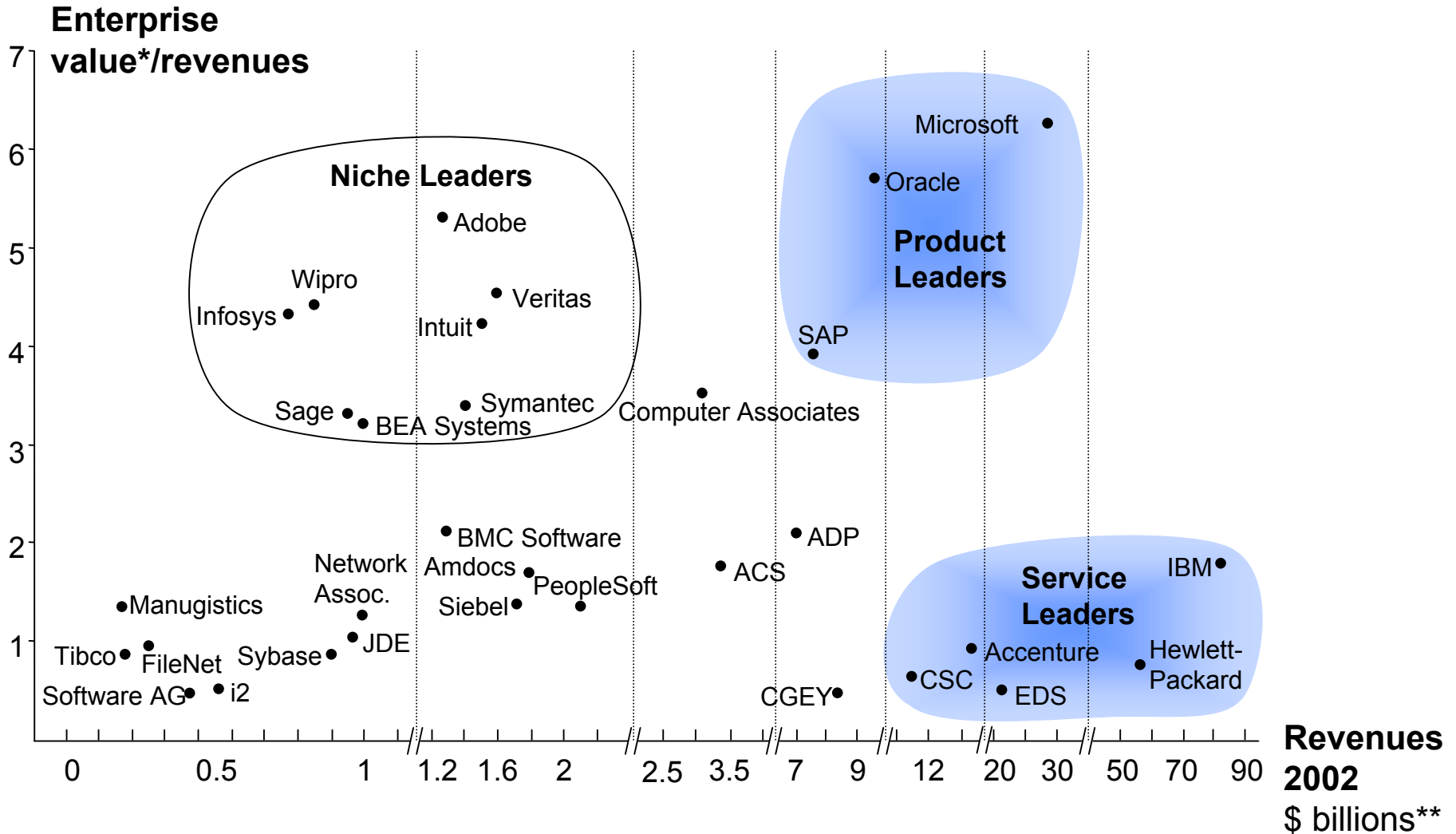
WHERE WILL VALUE SHIFT AS CONSOLIDATION OCCURS?

Estimated profit pool in desktop IT

INDICATIVE



STRATEGIC CONTROL MAP ALREADY INDICATES SOME LIKELY WINNERS



* Average enterprise value March 15 - June 16, sales 2002

Source: Datastream, Bloomberg, McKinsey

CONSOLIDATION CAN ENABLE LEADERS TO SHIFT INDUSTRY PRICING DYNAMICS

EXAMPLES

Case 1: Abitibi and Bowater (newsprint)

Starting point

- Fragmented industry
- Overcapacity/low utilization
- Weak influence over pricing

Actions

- Drove industry consolidation
- Gained ability to reduce demand/supply imbalance

Results

- \$40/ton (~10%) price increase despite historically low demand
- Several hundred \$m EBIT improvement

Case 2: Alcoa (aluminum)

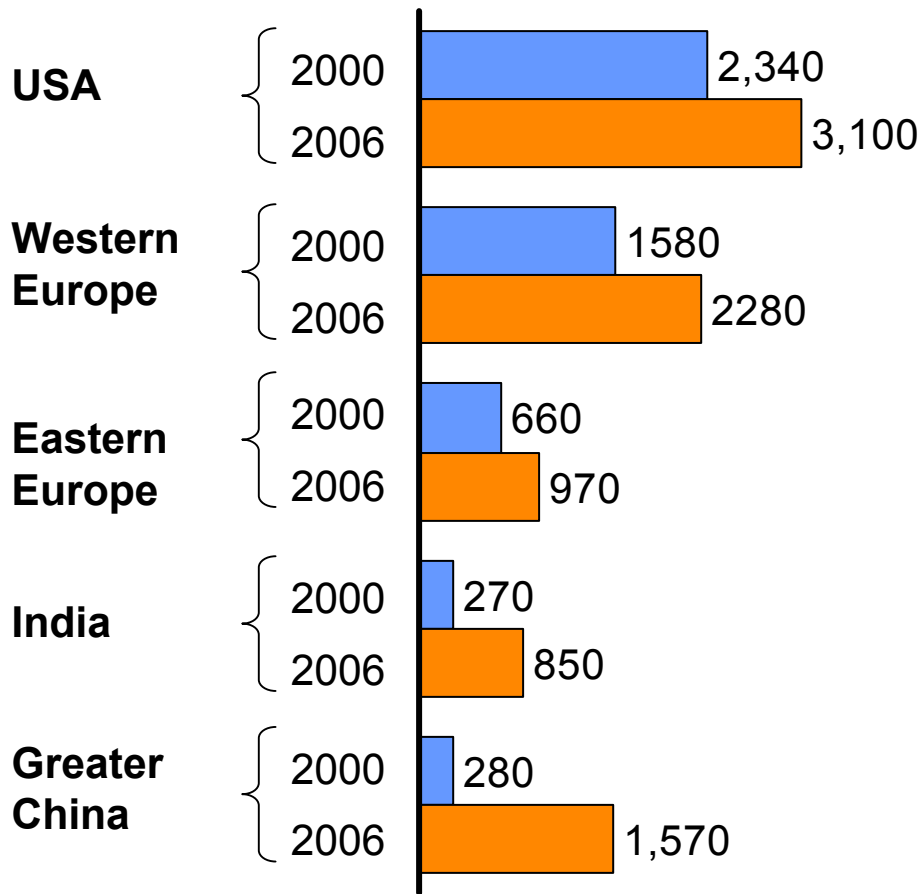
- Fragmented industry
- Profits tied to highly volatile spot pricing

- Acquired control of upstream privileged assets
- Improved downstream pricing dynamics

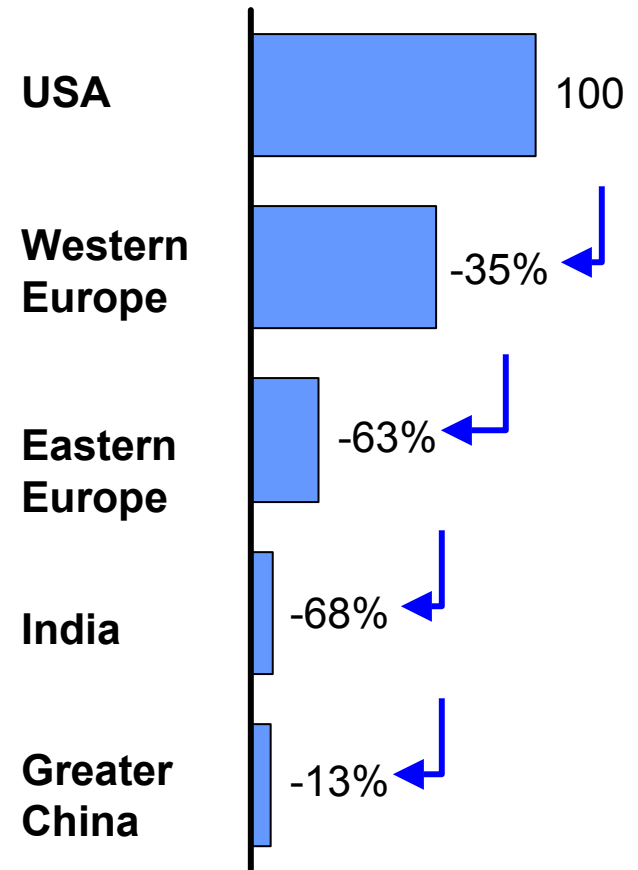
- Profit growth decoupled from spot price cycle
- 25% EPS growth vs. 10% peer average

GEOGRAPHIC SHIFTS WILL REMAIN A FACT OF LIFE

Number of professional software developers
Thousands

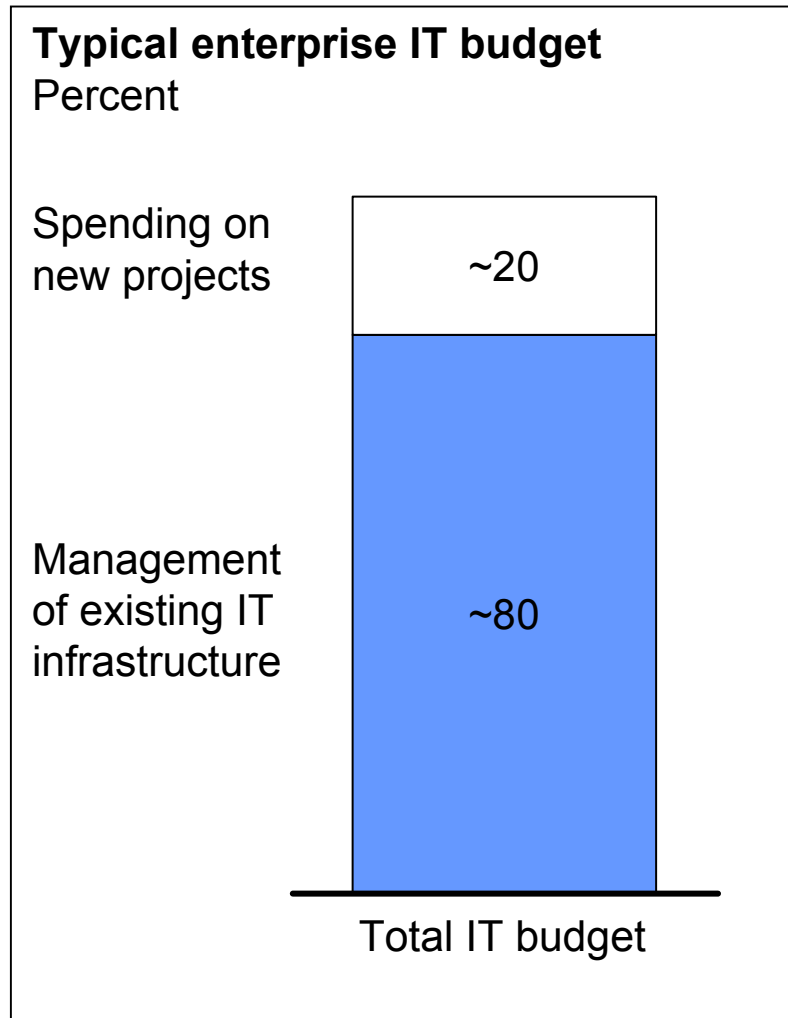


Estimated salary level, 2003
Index (U.S. = 100)

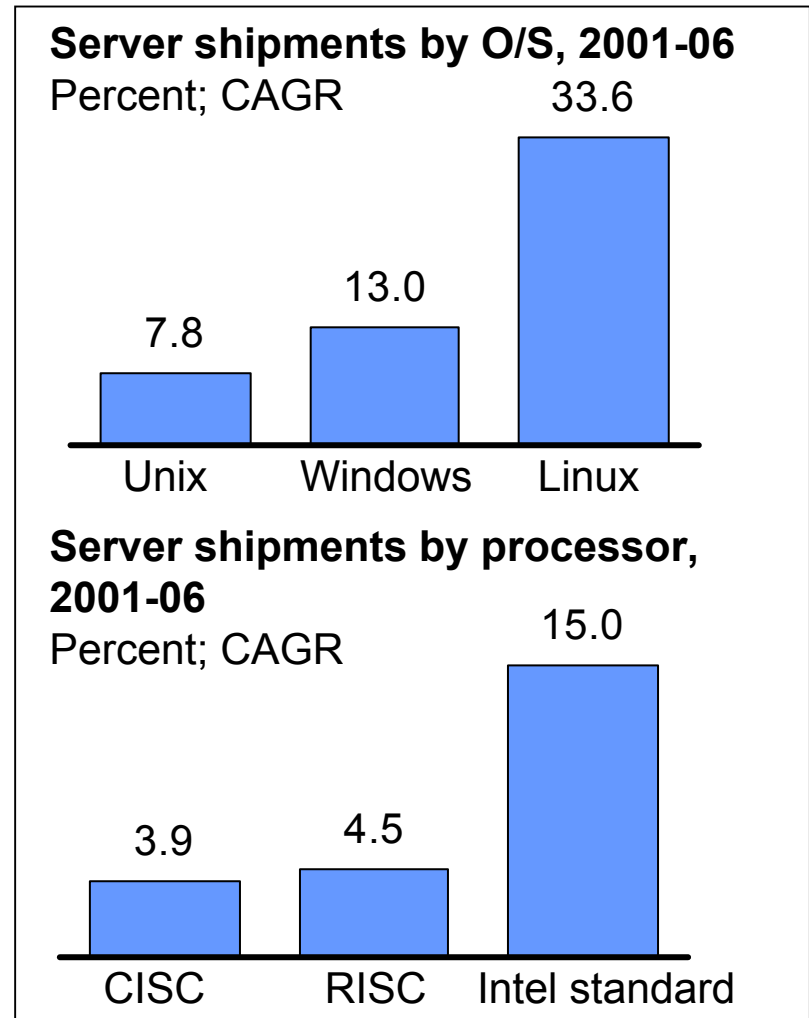


THE NEED FOR LOW-COST SOLUTIONS IS SHAPING IT INFRASTRUCTURE

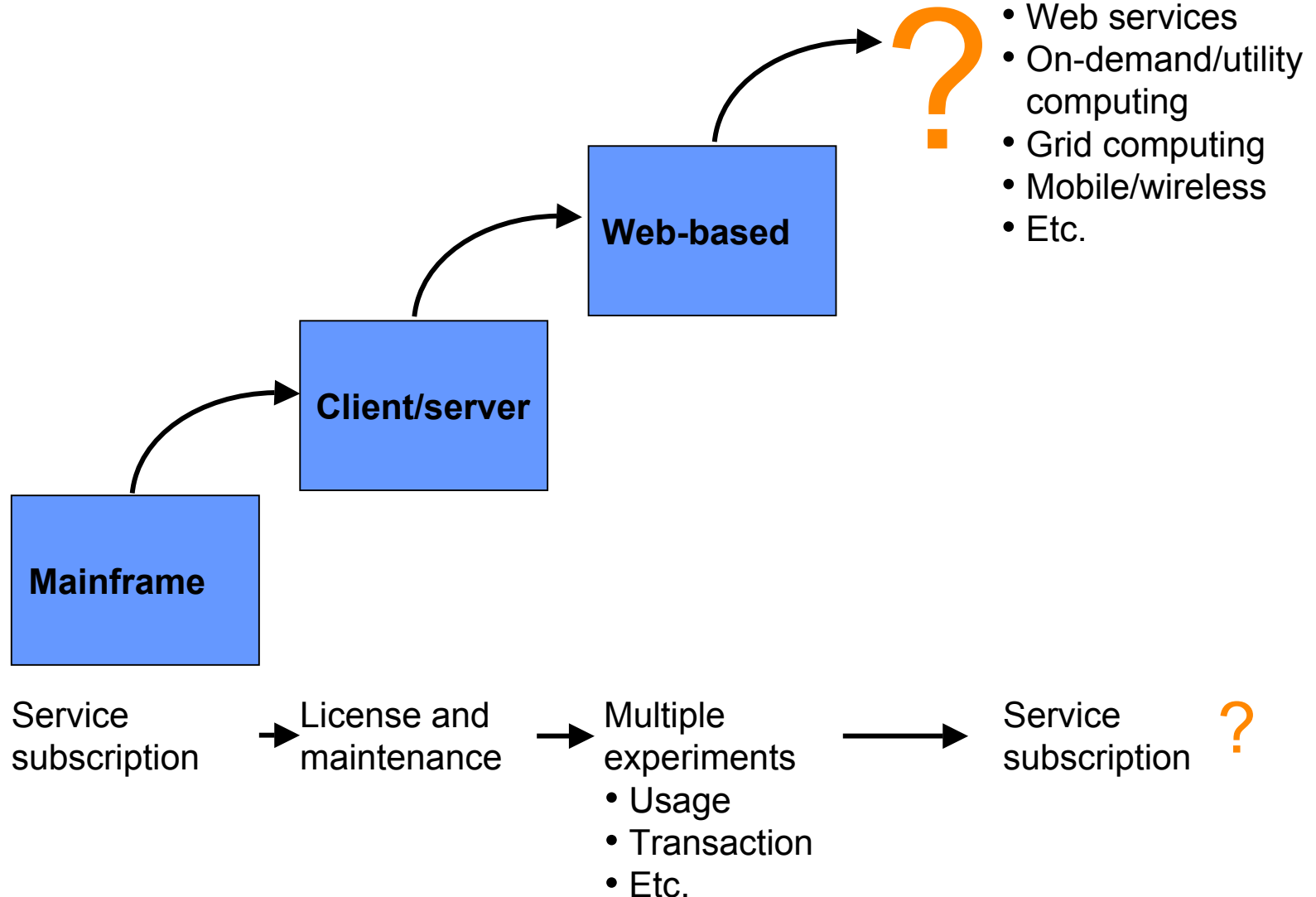
CIOs focus on reducing infrastructure costs . . .



. . . creating strong pressure for low-cost infrastructure solutions



WILL ADOPTION OF NEW PLATFORMS LEAD TO INCREASED INNOVATION?

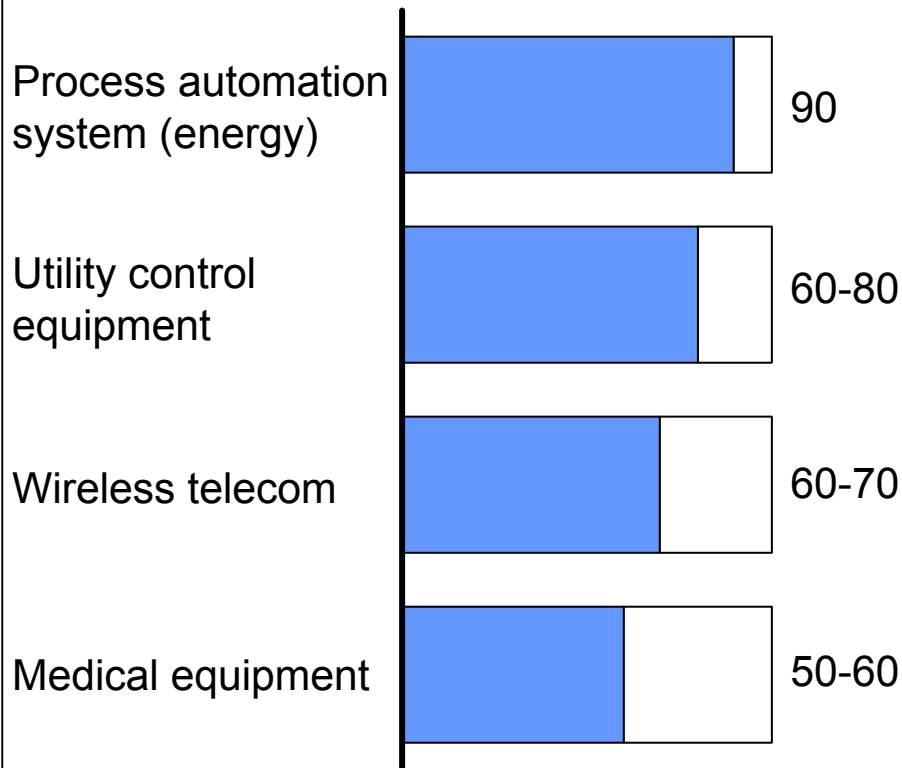


WHILE THE OVERALL INDUSTRY MAY BE MATURING, THE PERVASIVENESS OF SOFTWARE PRESENTS NEW OPPORTUNITIES

EXAMPLES

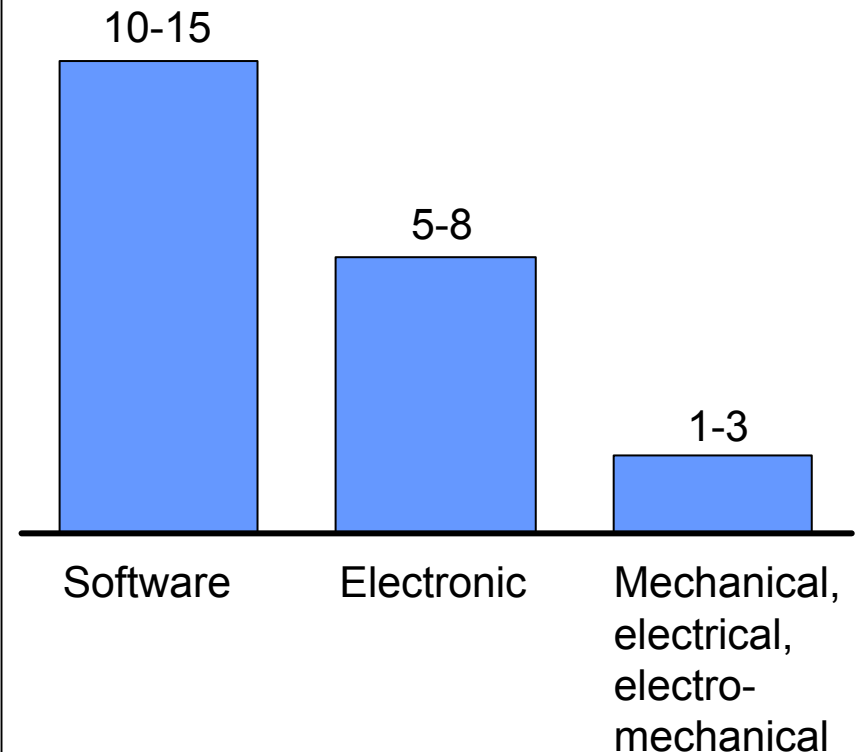
Software is already critical in many non-SW industries . . .

Software's share of estimated development cost (Percent)



. . . and its use grows rapidly

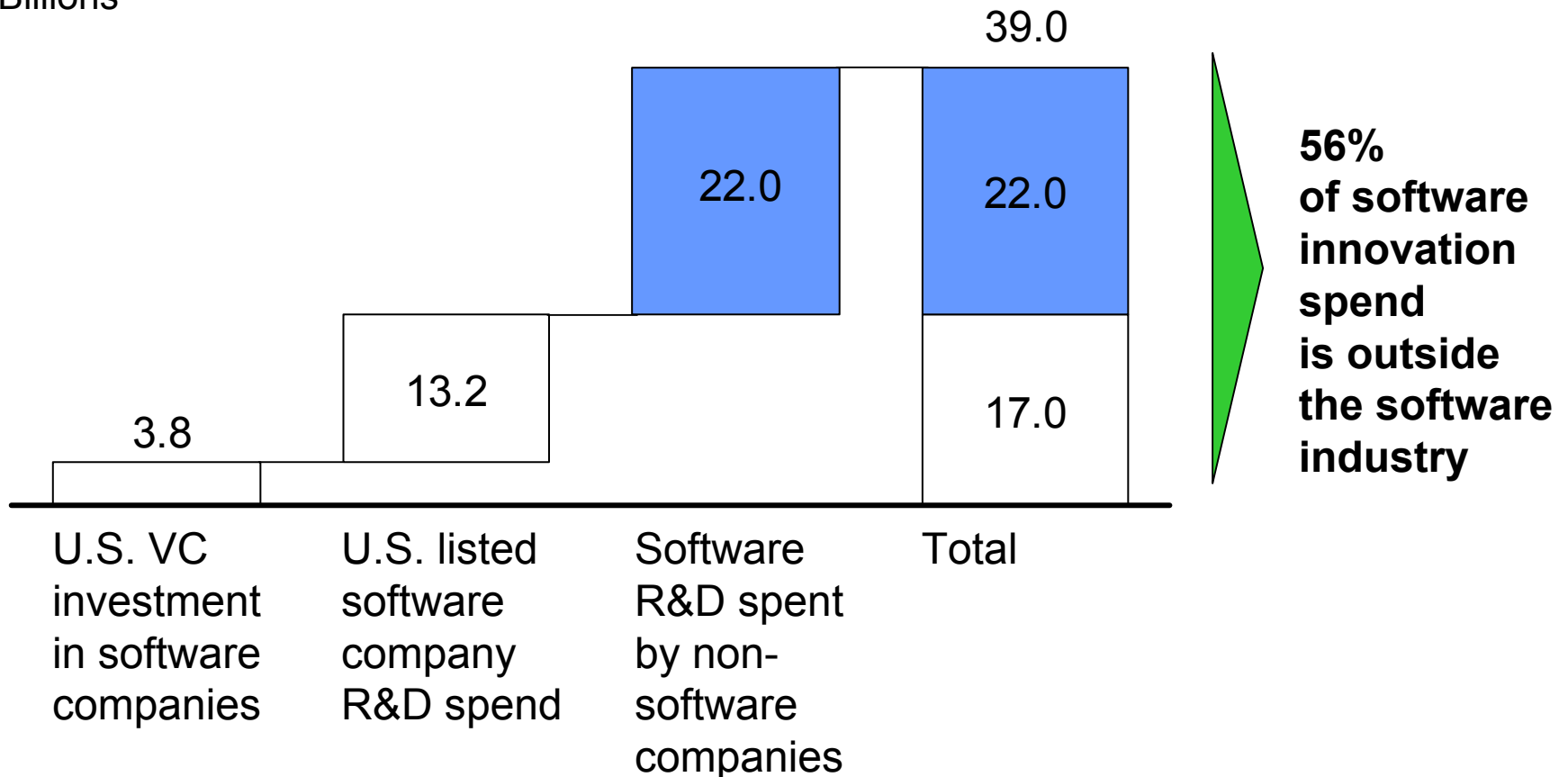
Annual growth rates in industrial control products (Percent)



ALREADY MORE THAN HALF OF SOFTWARE INNOVATION HAPPENS OUTSIDE THE TRADITIONAL BORDERS OF THE INDUSTRY

Investment in software innovation in the U.S., 2002

\$ Billions



WHAT DOES THIS ALL MEAN?

Structural maturity

- Increased standardization of offerings
- More bundling and solutions pricing
- Less “non-economic” competition

Cost pressure

- Reduction of pricing complexity
- Increased demand for transparency
- More scrutiny of TCO and ROI

Emerging opportunity

- Opportunity more tied to new platforms than to new “categories” of software
- Continued innovation in delivery models and “non-traditional” solutions

CONTENTS

- Overview of structural change in the software industry
- **Implications for pricing and purchasing**
- Questions and options to consider and services providers and buyers

WHY IS SOFTWARE PRICING UNIQUE?

Software attributes

- Intangible asset
 - No marginal cost of production
 - High volume scalability
 - Multiple distribution mechanisms, including online
- Wide range of perceived value
 - Initial perceived value based on pricing
 - Final perceived value based on experience

Software usage

- Often highly customized
- Value often tied to business process changes
- Large network effects
- Importance of de facto standards

HOW CUSTOMERS HAVE RESPONDED TO CHANGES IN ENVIRONMENT

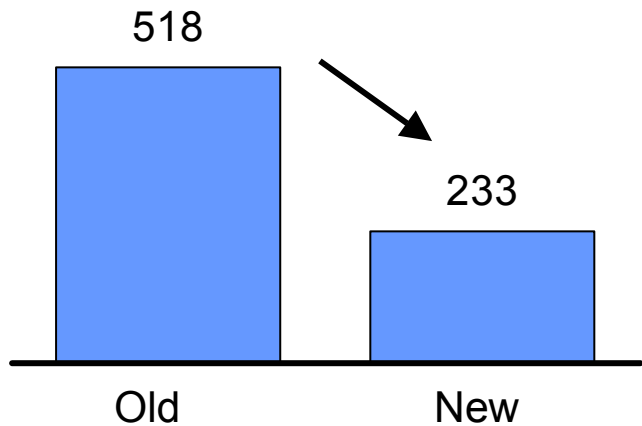
Customer actions

- Reduce number of vendors
- Aggressive negotiation of ongoing costs
- Smaller average deal sizes
- Demanding demonstrable ROI and short payback
- Increased central control of purchasing, but business owners still driving measurement

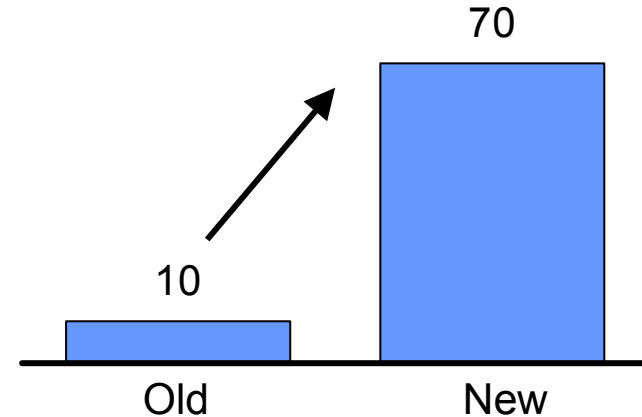
VENDOR/COMPLEXITY REDUCTION IS A STRATEGIC PRIORITY TO MANY IT CUSTOMERS . . .

CLIENT EXAMPLES

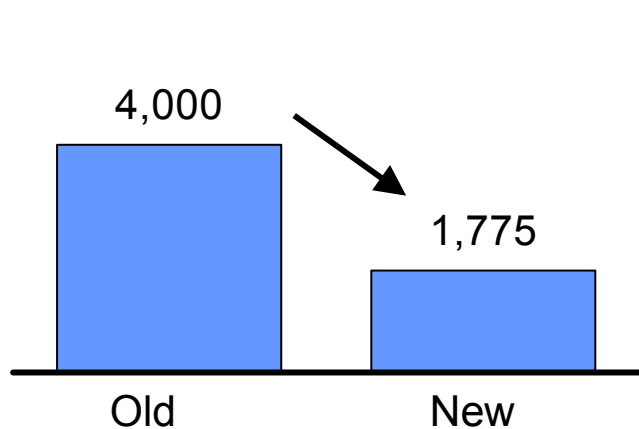
Number of servers



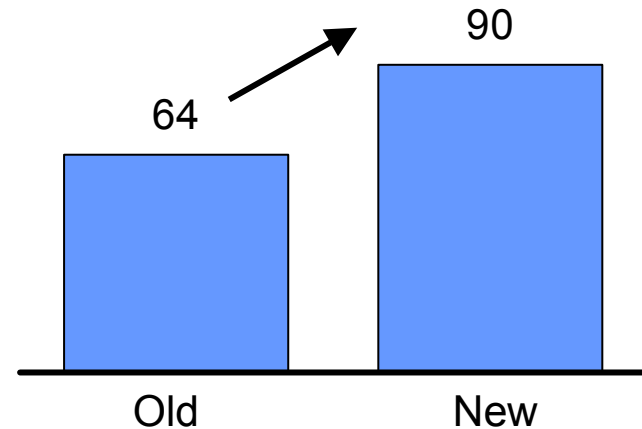
Share of preferred supplier (Software)



Number of application servers



Share of preferred supplier (Hardware)

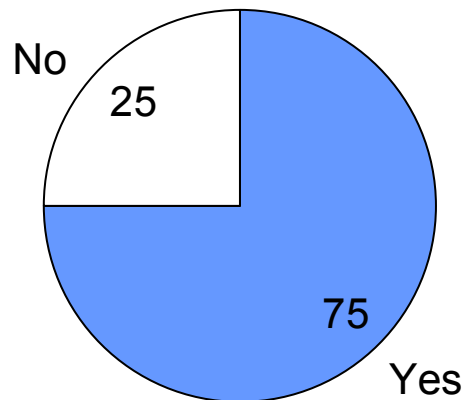


... FAVORING LARGE, PROVEN VENDORS AND PRODUCTS

Customers are less interested in cutting edge functionality. . .

Are you willing to sacrifice some point solution functionality to consolidate to fewer ISVs?

Percent



... and are becoming more risk averse

Enterprise willingness to take risks

Percent of enterprises

n = 1,001

Beginning 2001
Mid-2002

Willing to experiment with new unproven technologies

45

23

Willing to buy and roll out technology from a startup

27

16

CUSTOMERS ARE APPLYING MULTIPLE NEGOTIATION LEVERS TO REDUCE COSTS

EXAMPLES

Levers

Typical objectives

1. Capacity addition

- Negotiate volume discounts on MIPS increase to lower run rate
- Incorporate “options” for discounted capacity addition

2. Term extension

- Negotiate term extension with lower run rate
- Incorporate flexible term extension options

3. Product addition

- Leverage credible replacement threats to lower run rate by introducing competitive pricing and volume aggregation
- Incorporate flexible new product addition

4. Payment structuring

- Use contract structuring to lower run rate, e.g.
 - Term refinancing via discounted up-front capital outlay
 - Exchange maintenance for license fee in return for total run-rate reduction

5. Demand management

- Cancel unnecessary products
- Negotiate costless product cancellations

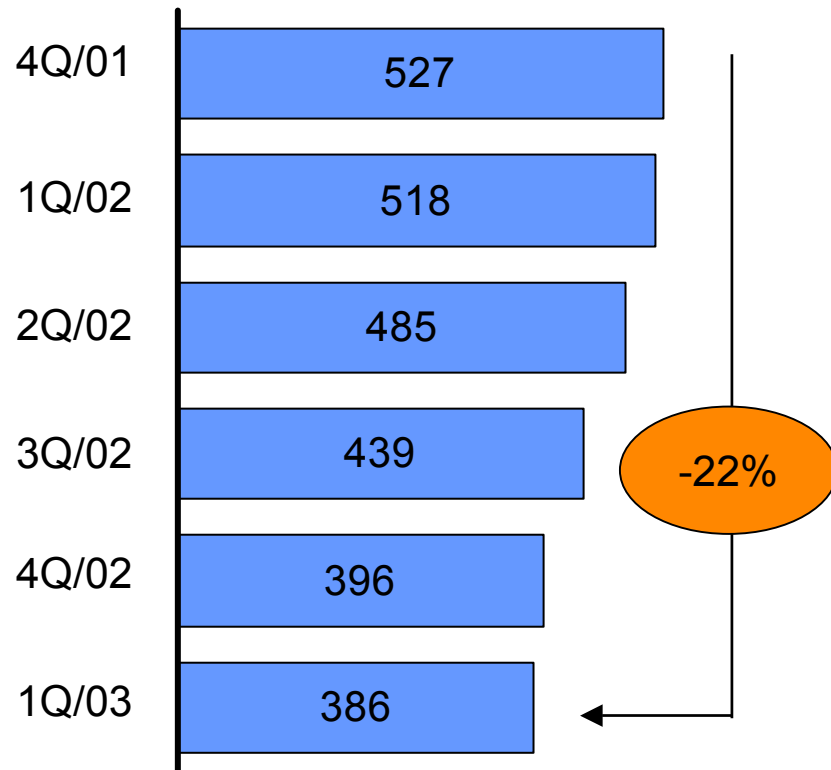
6. Purchasing channel consolidation

- Renegotiate lower aggregate spend via reseller consolidation

AVERAGE DEAL SIZE HAS DECREASED WHILE SALES CYCLES REMAIN LONG

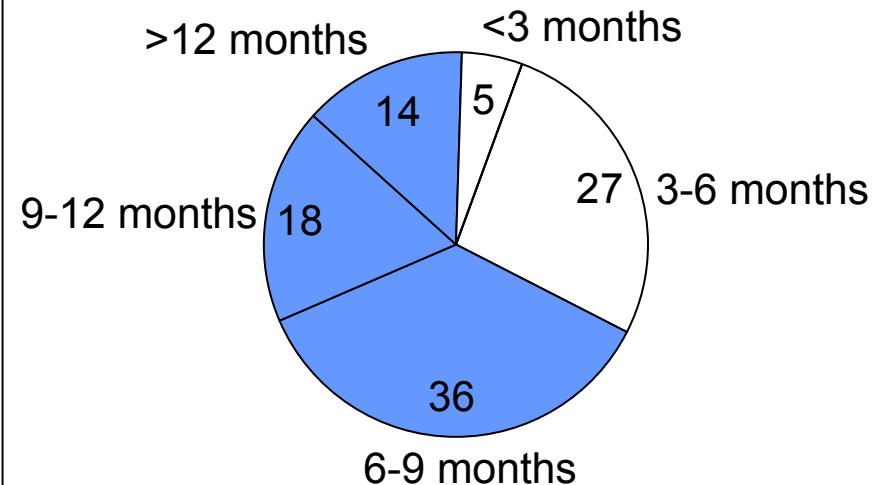
Average selling price in enterprise applications

\$ Thousands



How long is your average buying cycle for enterprise software?

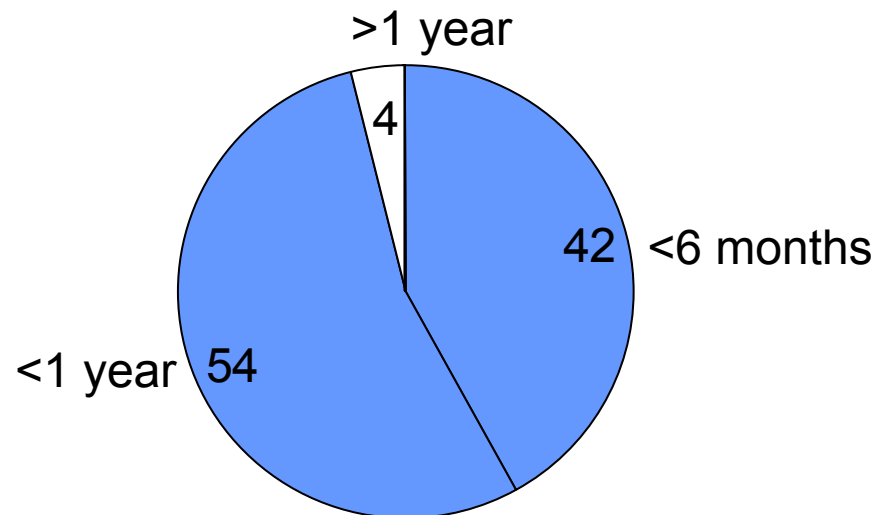
Percent of respondents



CUSTOMERS GET MORE DEMANDING ABOUT REALIZING RETURNS ON THEIR IT INVESTMENTS

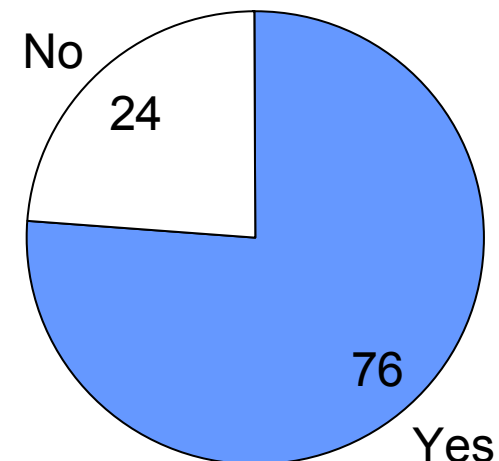
In what time frame do customers expect ROI today?

Percent of respondents



Do you track returns from IT projects?

Percent of respondents



VENDORS ARE ALSO RESPONDING TO CHANGES IN ENVIRONMENT

Customer actions

- Reduce number of vendors
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- Increased central control of purchasing, but business owners still driving measurement

Vendor responses

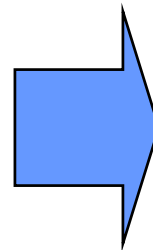
- Increased attempts to bundle
- Broader range of outsourcing and service offerings
- Alternative usage-based pricing models
- More rigorous management of customer interaction (customer segmentation, ROI studies, compliance monitoring)

ALTERNATIVE SOLUTION MODELS HAVE WORKED WELL IN OTHER INDUSTRIES



Historical pricing model

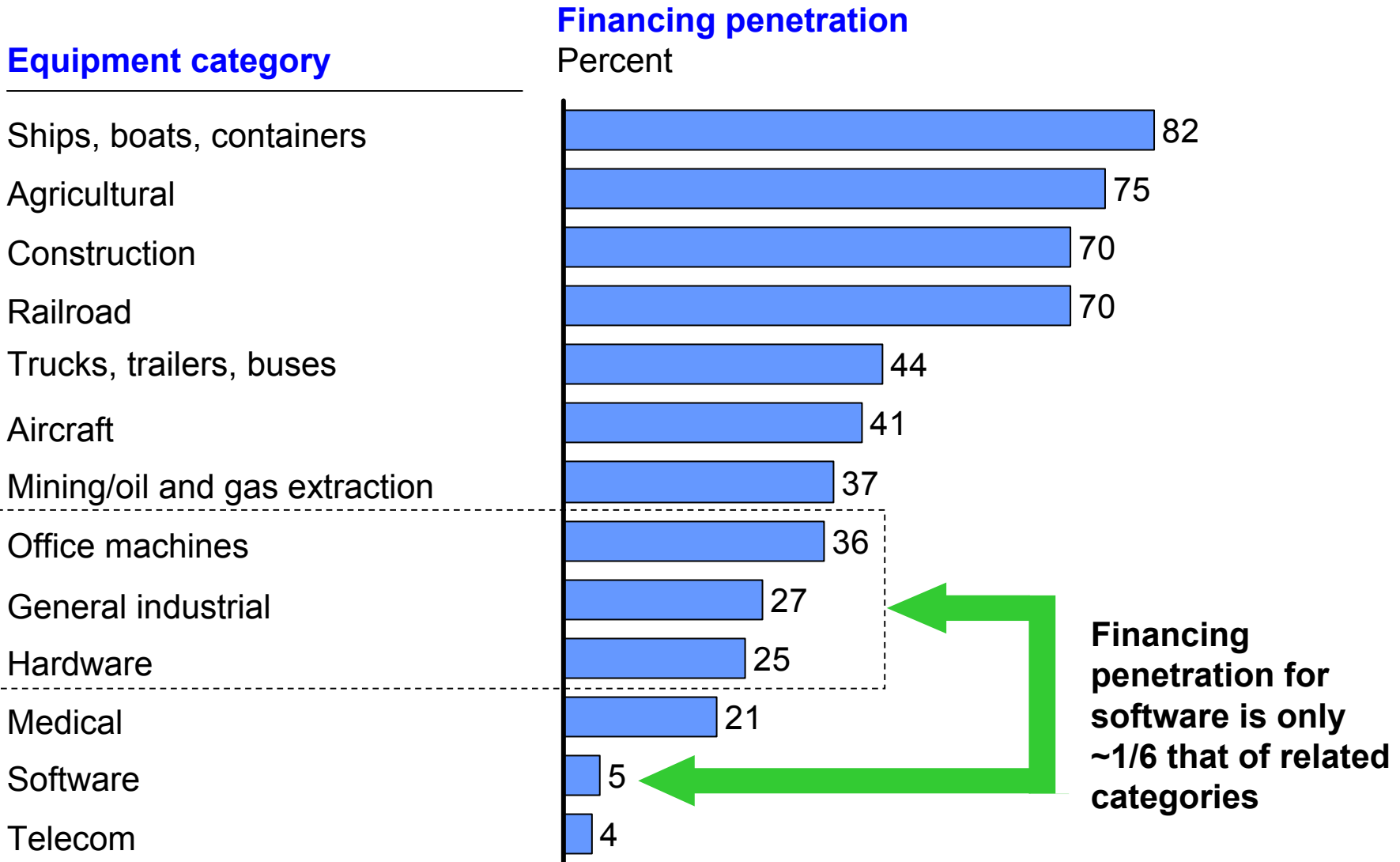
- Highly competitive space with deep price discounts; in many cases 30% below product cost
- Margin made up on spare parts and service costs; 300-500% margins
- Long-term maintenance and service cost risk and burden on airliner OEMs



Evolving model – Power By The Hour

- Gas turbine OEMs transfer and accept maintenance, service, warranty risk from airliner OEM by leasing engines on a power by the hour basis (dollars per pound of thrust per hour)
- Total solution offered to airlines
 - Engine acquisition
 - Spares replenishment and service
 - Acquiring airline service shops in some cases

CUSTOMER FINANCING IS OFTEN USED TO PROVIDE ADDED PRICING FLEXIBILITY



Note: General industrial includes manufacturing, electric power, fixtures, furniture, and material handling equipment

EARLY SIGNS INDICATE THE INCREASING VIABILITY OF UTILITY-BASED DELIVERY AND PRICING ON IT

Recent outsourcing deals with elements of on-demand IT provisioning and variable pricing

EXAMPLES

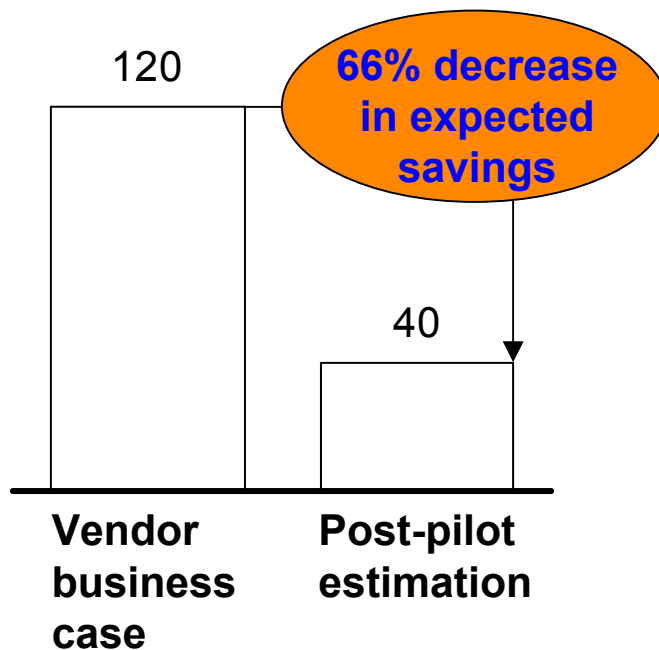
Time	Customer	Industry	Provider	Contract size \$ Billions	Contract length Years
Aug 03	Diageo	Alcoholic drinks	IBM	~0.4-0.5	7
Jun 03	Ericsson	Telecom equipment	HP	~1	5
May 03	Avista	Energy	EDS	N/a	10
May 03	P&G	Consumer goods	HP	3	10
Feb 03	AXA Group	Insurance	IBM	1	6
Dec 02	JP Morgan Chase	Financial services	IBM	5	7

MORE RIGOROUS ROI APPROACHES ARE NEED TO RESTORE ERODED VENDOR CREDIBILITY

EXAMPLES

Savings expected from markdown management system

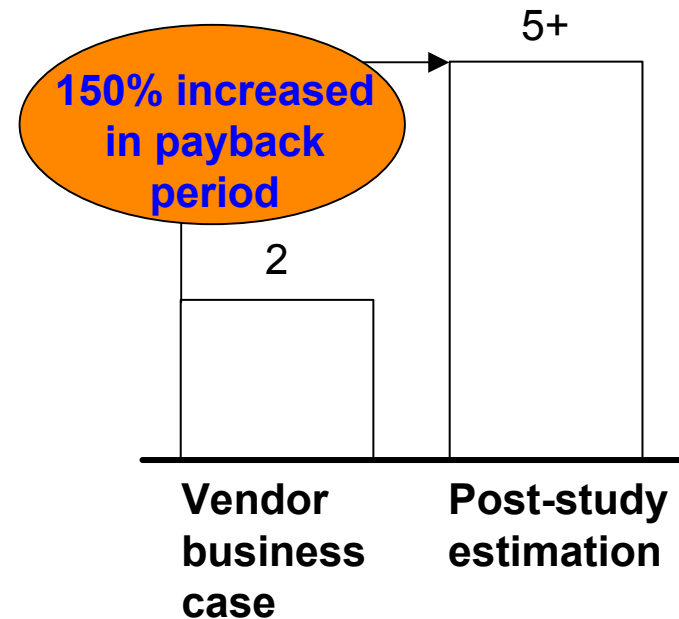
\$ Millions



(Luxury retailer)

Expected payback time for HR and payroll system implementation

Years



(Insurance company)

VENDORS SHOULD ALSO APPLY MORE RIGOR TO CUSTOMER SEGMENTATION

CLIENT EXAMPLE

Behavior/value-based segmentation for retailer credit card

Segments	Profit (\$) per account	Share (%)
Whole house lovers	400	5
Retail lovers	180	10
Revolving focused spenders	140	10
Monthly cash managers	100	15
Category spenders	100	15
Balance paydown	50	20
Holiday greats	50	10
Deal seekers	20	15

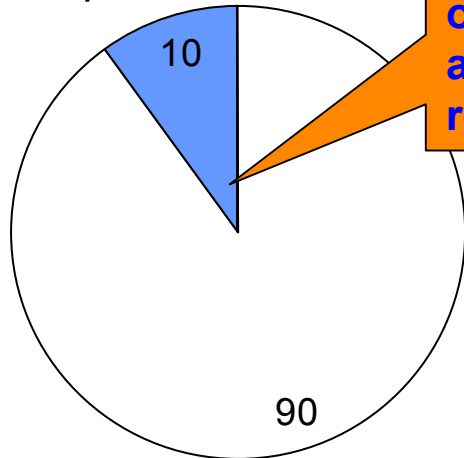
- 
- Enabled focus on the most attractive segments and design of targeted marketing programs
 - Results show a sustained 7-10% sales lift in key segments

VENDORS MAY BENEFIT FROM IMPROVED COMPLIANCE MANAGEMENT

Degree of compliance with license agreements according to end-user organizations

Percent of license usage

Noncompliant

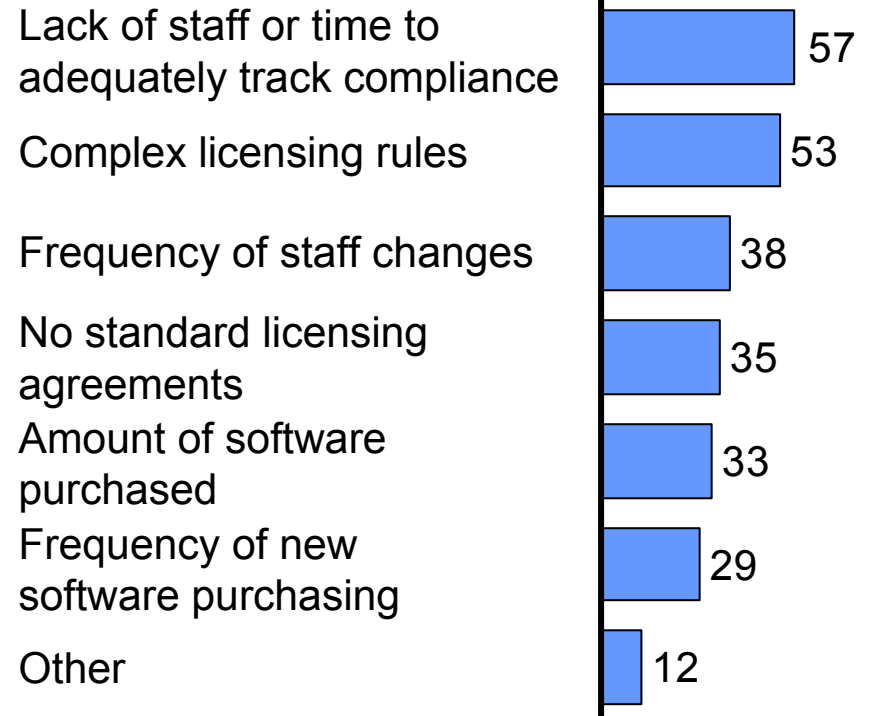


**Represents
~\$19 billion
of lost
annual
revenues**

Compliant

Barriers to software license compliance according to end-user organizations

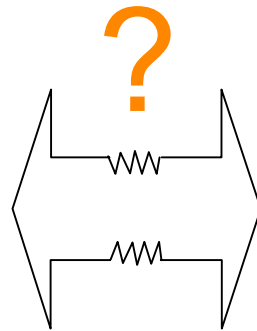
Percent of respondents



OVERALL IMPLICATION IS THE NEED FOR INCREASED ALIGNMENT OF INTERESTS

Customer actions

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Vendor responses

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- **Questions and options to consider**

SOME SCENARIOS TO PONDER

- Bundled utility pricing becomes the de facto standard for software
- Low-cost production drives overall pricing down 50%
- Modular, web services-based delivery becomes the dominant model
- Changing purchasing behavior forces massive consolidation, leaving only a handful of significant suppliers standing
- Increased open standardization and modularity erodes proprietary lock-in and pushes vendor margins down

KEY QUESTIONS FOR SOFTWARE AND SERVICES PROVIDERS

Key themes

1. Structural maturity

- What does aligning your business model around earnings rather than growth mean for pricing?
- How to respond to increasing consolidation?

2. Cost pressures

- How can you help customers address their cost efficiency needs?
- Can you improve perceived ROI?
- What about your own cost structure?

3. Emerging opportunities

- What should you do to exploit emerging go-to-market and pricing models?
- How can you leverage architectural shifts?

KEY QUESTIONS FOR BUYERS OF SOFTWARE AND SERVICES

Key themes

1. Structural maturity

- What is the right vendor strategy?
- How can you benefit from standards and consolidation?

2. Cost pressures

- How to develop and instill best practice software sourcing process and capabilities?
- Have you fully leveraged offshoring and outsourcing?

3. Emerging opportunities

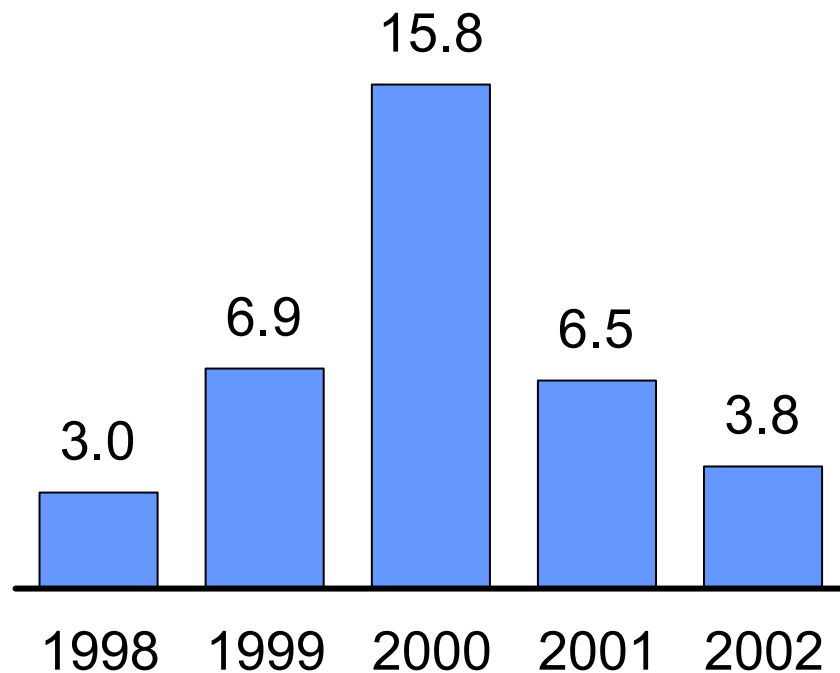
- What new IT solutions will provide competitive advantage?
- What new platforms/architectures are aligned with your business strategy?

UNUSED – BACKUP

ECONOMIC PRESSURES ARE ALSO REDUCING INVESTMENT IN INNOVATION

\$ Billions

U.S. VC investment in software companies



U.S. listed software company R&D spend

