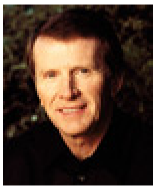
OPINION



The Innovate-Dominate Imperative

There are two paths to long-term survival for today's enterprise software companies. The problem is that very few companies are heading in the right direction.

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2006 is a year of challenge. Software companies are facing a confluence of trends which are changing the very nature of the industry. New technologies, new business models and industry consolidation are combining to create a new breed of software provider.

To their credit, few software executives are sitting on their hands, hoping things will return to the "good old days." Many are experimenting with business model changes and new offerings. But how many companies have a solid plan to deal with death-wielding market forces such as open source, megavendor offerings and offshoring? In my estimation, very few.

There is a new kind of software Darwinism going on. The harsh reality is that over the next 5 to 10 years, most of today's software providers will not fare very well. The only way for enterprise software suppliers to survive this wave of industry evolution is to innovate and/or dominate.

And 2006 is the year to get started.

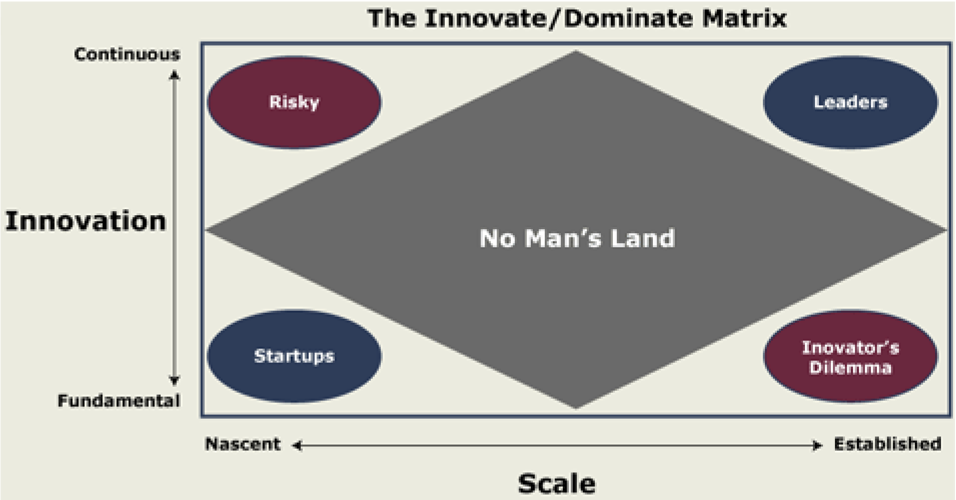
This day-late-dollar-short mentality is not new to the software industry. When other technology or market shifts have occurred, the way in which existing players respond has typically determined the new order.

When I was at Oracle in the early-1990s and client-server computing was all the rage, I had the opportunity to meet with several software industry CEOs. I was surprised that so many were still debating their strategy for moving to client-server. It was way too late! At Oracle, we had been challenged by an aggressive startup called Sybase that motivated us to move fast. Most suppliers that didn't move quickly became irrelevant, and didn't have the critical mass to take on the next technology shift - the Internet. Few are around today.

The Innovate/Dominate Matrix

The current challenges in the enterprise software market are daunting relative to the 1990s. Now, a premium must be placed on unwavering focus, and that focus must be on "innovating" and/or "dominating."

Relating the scale of companies to how they innovate (see chart) allows us to understand the bifurcation beginning in the industry. Winners will be the few that can dominate a category or execute on fundamental, paradigm-changing innovation.



The top right corner of the matrix will be held by those who dominate their sectors, or the industry overall - the Microsofts, Oracles, SAPs, Symantecs. Their vast installed base and seemingly infinite resources to "continuously" innovate - or buy innovation - will allow them to continue in business for a long time.

At the other end of the spectrum are the startups. There are as few of these as there are category leaders. Most startups are really doing "continuous" innovation but, interestingly, a well-designed startup doing fundamental innovation in this evolving market can have the same chance of survival as your average "megavendor." Why? Think of building an airplane. If you're starting out with a steam train and you need to reengineer that product into an airplane, it will take far longer than if you just set out to build an airplane from scratch. Startups can leverage the latest technologies and business models without concern for an installed base or Wall Street expectations.

The other corners of the matrix are less attractive. In the bottom right corner sits the classic, "Innovator's Dilemma." Popularized by the Clayton M. Christensen book in the late 1990s, this notion encompasses successful companies who innovated at one time and then slowed down. They now have something to protect. No one could expect this model to work in the software industry today - but it is surprising how many companies still try to make this work.

In the top left corner, there are many startups flailing about. Their innovation is essentially incremental to what leaders offer, taking advantage of time; but they rarely grow to scale because customers prefer incremental innovation from category leaders and they are willing to wait for it.

Of course the 500-pound gorilla sits smack in the center of this matrix. This "No Man's Land" will be the primary challenge for many software companies who cannot gain a dominant position in their market, or cannot innovate enough for customers to want to take a risk on them. Unfortunately, this is where many of the small and mid-sized enterprise software companies live today.

Time for Counterintuitive Thinking
This year, many software companies will be busy trying to convert their offerings from products into services. In fact, I would estimate that last year, software-as-a-service (SaaS) was the number one item on the agenda of 70 percent of software executives.

I'm here to tell you that this is a mistake.

Don't get me wrong, I'm a huge proponent of SaaS, on-demand, Web Services or whatever you choose to call this model. (In fact I wrote an **opinion piece** about its importance last year for SandHill.com.) But a service offering is not going to mask a vendor's inability to create innovative products and gain market share.

That's not to mention the tremendous, all-consuming two-year process of changing almost every

part of the business - from product architecture and pricing, to marketing and support - to a service offering (see chart). I'm not sure most companies have the DNA or the leadership to pull off such a massive transition.

Product-to-Service Transition

Area	From		To
Product Architecture	Proprietary	→	Open
Product Management	Developer	→	Customer
Release Management	Periodic	→	Continuous
Pricing Model	Per compute unit	→	Value-based
Sales Model	Push	→	Pull
Licensing Model	Perpetual	→	Subscription
Management	Product	→	Service
Customer Care	Response	→	Proactive

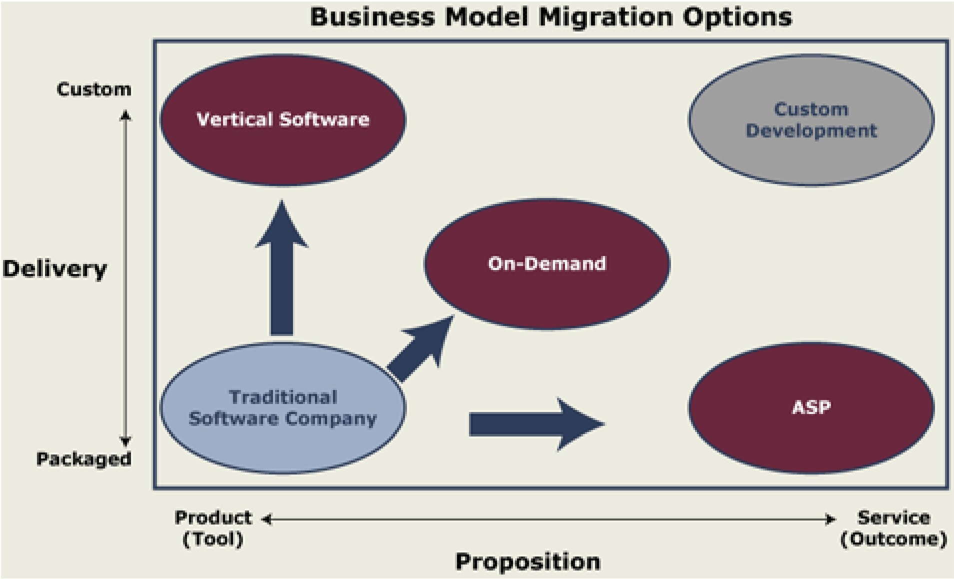
Even more importantly, customers aren't prioritizing service offerings. Sure, they'll adopt services. But I talk to CIOs of major enterprises on a regular basis. What do they say they want from software vendors? Better interoperability. Pricing that is tied to performance. Recognition of their business problems. Improved product quality.

Granted, CIOs don't want a salesperson marching in and pushing a multi-million dollar license either. Traditional enterprise vendors definitely have an image problem which needs to be addressed. Service offerings and new pricing models help address this. But these items are the proverbial icing on the cake. Vendors need to bake a better cake to begin with if they want to survive and thrive.

Paths to Innovation and Domination

Unfortunately, it is a bit late for most vendors to be Microsoft, Oracle or SAP. But it isn't too late to be the Microsoft of a specific sector, or the Google of an entirely new sector. Here are some ideas for enterprise software companies seeking to innovate and dominate in the coming years.

- **Acquire Innovation.** This is no secret, judging from the tremendous M&A activity experienced last year in the software space. I predict a dramatic slowdown in large vendors acquiring each other in 2006. But I believe vendors of all sizes will continue to acquire startup, and even mid-sized vendors with innovative products in the right sectors. Technology acquisitions to increment platforms make a lot of sense. Acquisition remains a relatively inexpensive way to adopt new technology and business models - and it can result in securing domination.
- **Move Vertically to Dominate.** A typical enterprise software vendor has many options in which they can move if they want to adopt a new business model (see chart.) One viable option for many application companies is to "verticalize" their offerings. The ability to serve an industry's needs better than any other supplier will require continuous domain innovation and will likely result in growth.



- **Go Open to Innovate.** I always ask enterprise vendors, "How many deals do you lose to open source?" The answer is invariably, "None." They don't even know about the customers who are choosing open source products every day because these rarely get into their pipeline. The fact is that most suppliers don't have a broad enough picture of their market opportunity. This narrow view prevents them from capitalizing on market growth. So if you're starting to build a new software product or reengineer an old one, build it on open source software. Why not? As long as your customers are moving in this direction (and they are), open source products will deliver an exponential advantage in future competitiveness. Take Sugar CRM. I doubt that the customers adopting their software are in Siebel's or Salesforce.com's pipeline.
- **Innovate Your Positioning.** The management team of a startup came into our offices last month to pitch me. About halfway through, I realized I wasn't going to invest in the firm. At the end, I explained why and offered the CEO some advice. "Take out the word 'enterprise' and replace it with 'Web 2.0.' And replace 'software' with 'service.'" The CEO called me recently and told me about the dramatic and positive impact these verbiage changes had on their reception. Investors and buyers are not looking backwards; they are looking to the future. Trends matter - what is the difference between "dot com" and "Web 2.0."
- **Don't Underestimate Enterprise Innovation.** Many technology investors are excited about consumer opportunities now. Indeed, there are many new gadgets and services gaining traction in the consumer market. But enterprises want innovation. And enterprises continue to spend billions on IT products year after year - without fail. There are still many unsolved problems in business computing. But both startups and established vendors have to beware of the vast "No Man's Land" of enterprise software. Business model innovation alone is not innovation. Neither is a new wrinkle on business intelligence or supply chain software. Genuine enterprise innovation involves providing a product that is not there today to solve a business problem that is a high priority for a large market. It's a difficult transformation to make when you have to start with the fact that the market for my existing product is going away.

I'm not going to abandon enterprise software. There is a lot of innovation to come in this industry and I think I understand what a supplier has to do to be successful in the enterprise. Unfortunately, the picture of that supplier is very different from what I see in the market today. The enterprise software companies that move to innovate and dominate today will be the most successful companies five years from now.

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