Future of the Enterprise Software Industry
Keys to Competitive Success

by
Mitch Rosenbleeth
rosenbleeth_mitch@bah.com

Stephen Chen
chen_stephen@bah.com

Corrie DeCamp
decamp_corrie@bah.com
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**Introduction**

In the highly competitive environment of enterprise software, catching the next technological wave used to be the way to win. Being the first to market with an innovative new technology could mean emerging as the “next new thing” instead of being folded into a larger company. Similarly, for customers, early adoption of the right emerging technology could provide the incremental boost needed to pull ahead of the competition.

Today, companies are no longer pursuing these strategies. Unfortunately for both suppliers and clients, no major innovations are expected in the enterprise software market in the next three to five years. No new concepts as significant as supply chain management (SCM) or customer relationship management (CRM) are on the near horizon—just a constant pressure to make incremental improvements. Meanwhile, virtually every company that needed to add enterprise software to its application portfolio has already done so. With no radically new technologies imminent and with most markets saturated, the enterprise software sector can expect to see the shakeout cycle typical of any maturing industry, as companies consolidate and rationalize. Oracle’s 2005 acquisition of PeopleSoft and pending acquisition of Siebel Systems illustrate a trend that most observers believe is highly likely to continue.

Driven by the need to grow, enterprise software providers that don’t merge will further encroach on one another’s territory. At the same time, customer CIOs will try to take advantage of their suppliers’ competitive vulnerabilities as they begin to rationalize their application portfolios. With fewer opportunities for growth in untapped markets, and with the scale economies of the largest players posing increasing risks to small and midsized firms, most enterprise software providers now face a harsh new environment.

How should suppliers cope with the struggle ahead, and what opportunities does that struggle create for systems integrators and clients? To answer these questions, we interviewed many of our key clients (generally larger Fortune 500 firms). We got their insights from a customer’s perspective and then analyzed the implications for the software industry. This paper was first presented to the Information Technology Association of America (ITAA) software industry board in December 2005, summarizing the key supply and demand drivers and synthesizing the major trends that are most likely to result from the current environment.
I. Supply and Demand Pressures—Underlying Drivers for Market Changes

Change happens quickly in the software industry: Bill Gates went from college dropout to richest person in the world in the space of 15 years. Even now, the evolution of the software business is continuing at high speed. In the next few years, enterprise software in particular is likely to see a number of major changes that will transform the industry and change how every provider does business.

As is the case with any industry, the shifts in the enterprise software sector will be driven by changes in supply and demand. Below are the key variables we see in flux in this market equation.

Customer CIO priorities are a demand driver for the industry. Today’s enterprise software customers face a variety of challenges. CEOs, whether they are looking for increased growth, improved cost leadership, greater information security, deeper customer loyalty, or faster corporate compliance, are turning to CIOs for help. CIOs, in turn, are asking their enterprise software suppliers to deliver quick, clear bottom-line results that fill their wish lists.

On the other hand, changes in the industry are acting as supply drivers. Enterprise software purchases as a percentage of gross domestic product are rising, an indication that companies are increasing their overall IT budgets and green-lighting more technology-focused projects. However, increased merger and acquisition activity in 2004 and 2005 indicates greater consolidation among software providers, strengthening industry observers’ belief that corporate customers increasingly value integrated solution suites over a portfolio approach (see Exhibit 1). As a result of these trends, suppliers now face:

Exhibit 1
Supply and Demand Pressures on the Enterprise Application Market

Source: Booz Allen Hamilton
Competitors with a broader reach. Larger players are addressing capability gaps and industry verticals through strategic acquisitions.

Growing emphasis on integrated solutions. Major suppliers are leveraging integrated, cross-functional offerings to captivate and expand their installed base—addressing customers’ focus on having complete solutions rather than just improving individual functional capabilities.

Competitors pushing for more standardization. Small and midsized suppliers, along with open standards groups, are pressuring the largest software suite developers to further standardize to enable vendors to better meet customer demands.

Small players focused on exploiting niches on the margins. Many smaller players now see their main opportunity in niche plays and are increasing their investment in innovation.

SOA and open source expand opportunistically. Small and midsized suppliers are betting that open source can help them overcome entry barriers by reducing reliance on the more established proprietary technologies. On the other hand, larger players hope service-oriented architecture (SOA) can help extend the value of their existing products by creating virtual connections between applications that are not well-integrated.

II. Market Changes Aggregate Around Three Key Themes

These supply and demand dynamics will lead to three major trends over the next three to five years:

Further Industry Consolidation. As corporate clients continue to look for ways to optimize their investments and integrate IT systems, large application suppliers (which are typically in control of the core back-office functions) will attempt to expand their customer base by acquiring focused software providers. The software industry will therefore be under accelerating pressure to consolidate while keeping costs of innovation down. If the newly combined giants are willing to rationalize staff and costs beyond merely cutting selling, general, and administrative expenses (SG&A), they will need to prune their combined product portfolios and reduce the number of technical leads to make the new company more efficient. Further consolidation will put mid-tier and middle-market companies at a competitive disadvantage unless they can capture an important niche quickly.

Data Centricity. The movement toward improving business rules, data portability, and standards will put a growing focus on data-centric solutions. Customers will demand interoperability in their data management architecture, seeing it as vital to the flexibility and adaptability of not just their IT environment but their entire enterprise. This requires capabilities that extend beyond what the full-suite solution providers are offering. Data will be less confined by applications and more aligned with the use to which it will actually be put. Highly robust yet fluid IT environments will be prized, particularly amid fears of being locked in by legacy providers in an ever-narrowing industry.

Complexity Management. Over the next few years, CIOs will look harder and harder for ways to overcome the growing complexity of their legacy systems. Many CIOs are actively managing their application portfolio to reduce complexity in order to rein in maintenance costs and increase the amount they can spend on new development. Most would like to configure their enterprise architecture to increase flexibility and adaptability while reducing the cost and strain of adding and decommissioning applications. The desire for such simplification will remain high even as the reach of ERPs grows, based on our client experience, since a generic ERP system is unlikely to ever serve more than 50 percent of the business applications a typical firm requires. Ubiquitous and secure delivery options are a challenge as well. Whether individual users are on a PC,
BlackBerry, or cell phone, on a hardwired network or long-distance, wireless broadband (WiMAX), they want their data to be accessible, secure, and private.

As these trends materialize, they will dramatically affect the industry’s pricing power, pricing model, customer delivery models, and competitive intensity. Here’s how:

- **Pricing Power and Models**—Eventually, if there are fewer competitors, the survivors in the industry can contemplate raising their prices. However, in the immediate future, bruising price wars are likely as competitors struggle to gain share. To survive, some competitors will shift emphasis to alternative pricing models, such as subscription service models or enterprise licenses, which smooth out their revenue streams and reduce customers’ up-front software investment costs.

- **Customer Delivery Models**—Closer relationships between suppliers and clients should be one result of fewer companies delivering more broad-based suites. With fewer opportunities for competitive advantage expected through technology, suppliers will compensate by adding new, innovative service offerings. Smaller suppliers will make it easier to buy Web-based specialty services that do not reside with the client.

- **Competitive Intensity**—The intensity of supplier competition will grow during this period of consolidation, with victory probably going in part to those firms that are best able to blur the boundaries between what was traditionally considered an application and what was considered a service.

### III. The Competitive Response

These emerging trends present different challenges to large and small enterprise application suppliers.

For the big IT firms, these changes are likely to alter the basis of competition as data portability and enterprise flexibility allow the introduction of services that extend beyond the limits of the ERP system. One major opportunity, and a growing market, is the robust enterprise-wide search engine, facilitating rapid access to a firm’s unstructured knowledge. Although searching is already a multibillion-dollar business in the online market, it has only recently made inroads into the business market.

Another promising gambit is moving into the software-as-service space. A recent Forrester report found that the hosted sales software market grew exponentially in a year when other delivery methods were flat. Market leader Salesforce.com continues to see strong demand, growing from 9,500 subscribers in 2003 to more than 13,300 in 2004, despite increasing competition. Incremental purchase is an attractive option to many cost-conscious companies, and sales executives can quickly be up and running without approval from corporate IT departments.

“Since cost is deferred over time, and we didn’t have to invest a quarter-million in one shot, the risk was lower,” explained a manager of one financial-services company quoted in the report.¹

In any case, the best strategy for a small software firm will be to begin working with edge functions and move in. Management should define a differentiation strategy, look for good niche opportunities, and then position the company for a later acquisition.

**Surviving Industry Consolidation**

As the industry consolidates, each supplier will need to place itself in one of two categories: large application suite supplier or best-of-breed provider. Booz Allen believes that the emerging customer demands will sustain companies that dwell within these markets (see Exhibit 2, page 5).

Companies that already operate in these segments should focus their efforts on solidifying their competitive positions. As consolidation occurs, large application suite suppliers will serve larger and larger installed

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¹ The Forrester Wave: Hosted Sales Force Automation, Q1 2005
bases. These companies should continue to expand their functional offerings in order to fend off potential encroachments from other major players or best-of-breed providers. They should also continue to standardize their products in order to lock in their installed base and keep their business economically sound. Their deep pockets should be used for opportunistic acquisitions, continued innovation, and greater architectural flexibility to ensure continued stability of base products from release to release. If these companies are to obtain desired savings and efficiencies, then as they acquire former competitors, they must rationalize their combined product portfolio, kill off old product lines, and encourage customers to migrate to the consolidated offering.

Best-of-breed providers must invest heavily in technology that eases the adoption of their products. Customers will avoid applications that require stand-alone technology platforms or that deviate from the rest of the enterprise architecture. Such providers should also try to develop alliances with larger suppliers for the same reason.

Mid-tier providers and suppliers in the “Crossroads” space will face a particularly challenging market. The harsh reality is that the value of integrated applications and scale will increasingly trump the value that can be offered by a smaller provider. Those firms that currently fit neither the large suite nor the best-of-breed profile should choose one camp or the other soon: Prepare to be assimilated, or develop a new business model as a niche or specialty provider.

Preparing for Data Centricity
As data centricity evolves, suppliers must prepare for the emergence of new enterprise data management solutions and data standards. Both are critical components for effectively sharing data across the enterprise. Competitors must determine how their product offerings fit into this new model. Thus strategic moves in this area are driven primarily by the company’s product type (see Exhibit 3).

Business application providers are faced with two
options: They can either promote their own proprietary standards or accept open source integration and connectivity. Larger companies are likely to gravitate toward the former since they already have significant investments in their own standards and supporting infrastructure. Other firms, however, may opt for accepting open source.

Database application suppliers have the distinct advantage in this arena because they are the driving force behind current data solutions and architectures. Thus the race is on to see which provider can bring the first viable solution to the market. Although some suppliers have proposed solutions to meet their customers’ needs today, market awareness is low and the solutions are not yet mature. In the nascent area of enterprise data management, the first mover, and the first to have embedded information security solutions, is likely to have a crucial advantage.

For infrastructure software providers, the objective should be to build strategic alliances with either database solution providers or hardware suppliers. Both options will ensure the company’s infrastructure software products remain a relevant component in the emerging field.

**Optimizing Complexity**
As IT complexity becomes more pressing on the CIO’s agenda, application suppliers should proactively realign their product and service portfolios to cater to the CIO’s need for simpler IT environments. Preemptive strategic moves to enable customers’ complexity optimization efforts should be driven by the type of functions provided by the application.

For applications that support core functions (e.g., accounts payable, accounts receivable, purchasing, requisitioning), suppliers should focus on improving integration within the extended supply chain through
such initiatives as collaborative planning, forecasting, and replenishment (CPFR) efforts, leveraging their installed base to expand into new modules and functions, and integrating any enhanced functions whose processes are becoming common.

Suppliers offering solutions that involve enhanced functions should focus on improving compatibility with core function application suites. However, these suppliers should continue to offer distinct functionalities in areas where complexity adds value (see Exhibit 4).

Specialty applications whose unique features are truly valued will remain relatively unscathed in the complexity optimization effort. They are likely to have a prime opportunity to test alternative or innovative delivery models with little or no risk. Thus, providers will benefit by locking customers in to their solution, yet remaining free to further differentiate their product—as long as they don’t increase the complexity of the client’s IT environment.

Conclusion
As the three trends emerge—continued industry consolidation, increased emphasis on data centricity, and optimization of complexity—it is critical for enterprise software suppliers to make strategic preemptive moves. Competitors should continually assess themselves by asking these five crucial questions:

- Are we providing value-added business solutions to solve customers’ problems?
- Are there any alliances we can form to create scale and control norms and standards?
- Is our enterprise positioned for further consolidation? If so, are we predator or prey? Do we need to join a pack?
- Are we designing and experimenting with innovative pricing models such as “pay for performance” and enterprise licenses/subscriptions?
• Assuming that we cannot sustain our current position (as a scale player, a niche player, or a functional expertise provider) indefinitely, are we prepared to cannibalize existing lines of business if the market begins to shift?

Clearly, the battle lines are drawn. The victors will be those who are willing to continually reassess their capabilities and competitive positioning in light of these emerging trends and proactively execute the appropriate strategy. Only then will suppliers be in a position to compete effectively in a dynamic, fiercely competitive enterprise software industry.

Also contributing to this article were Michael Grow and Kumar Krishnamurthy.
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Contact Information:

DALLAS

Mitch Rosenbleeth
Vice President
214-746-6579
rosenbleeth_mitch@bah.com

Stephen Chen
Senior Associate
214-746-6504
chen_stephen@bah.com

Corrie DeCamp
Senior Associate
214-746-6551
decamp_corrie@bah.com
Worldwide Offices

Abu Dhabi  
Charles El-Hage  
971-2-6-270882

Amsterdam  
Marc Kesteloo  
31-20-504-1900

Atlanta  
Lee Falkenstrom  
404-659-3600

Bangkok  
Tim Jackson  
66-2-653-2255

Beijing  
Edward Tse  
8610-8520-0036

Beirut  
Charles El-Hage  
961-1-336433

Berlin  
Rene Perillieux  
49-30-88705-0

Bogotá  
Jaime Maldonado  
57-1-628-5050

Boston  
John Harris  
617-428-4400

Brisbane  
Tim Jackson  
61-7-3230-6400

Buenos Aires  
Ivan De Souza  
54-1-14-131-0400

Caracas  
José Gregorio Baquero  
58-212-285-3522

Chicago  
Vinay Couto  
312-346-1900

Cleveland  
Mark Moran  
216-696-1900

Colorado Springs  
Glen Bruels  
719-597-8005

Copenhagen  
Torsten Moe  
45-33-18-70-00

Dallas  
Mitch Rosenbleeth  
214-746-6500

Denver  
Tom Kuenstner  
301-297-2100

Frankfurt  
Rainer Bernnat  
49-69-97167-0

Helsinki  
Timo Leino  
358-9-61-54-600

Hong Kong  
Edward Tse  
852-3579-8222

Houston  
Matt McKenna  
713-650-4100

Jakarta  
Tim Jackson  
622-577-0077

Johannesburg  
Charmaine Koen  
27-11-862-3110

London  
Shumeeet Banerji  
44-20-7393-3333

Los Angeles  
Tom Hansson  
310-297-2100

Madrid  
Mercedes Mostajo  
34-91-411-8450

McLean, VA  
Spiegel  
703-902-5000

Melbourne  
Tim Jackson  
61-3-9221-1900

Mexico City  
Jaime Maldonado  
52-55-9178-4200

Milan  
Enrico Strada  
390-2-72-50-91

Munich  
Jörg Krings  
49-89-54525-0

New York  
David Knott  
212-697-1900

Oslo  
Karl Haie  
47-23-11-39-00

Paris  
Bertrand Kleinmann  
33-1-44-34-3131

Philadelphia  
Molly Finn  
267-330-7900

Rio de Janeiro  
Paolo Pigorini  
55-21-2373-8400

Stockholm  
Jan-Olof Dahlén  
46-8-506-190-00

Sydney  
Tim Jackson  
61-2-9321-1900

Tampa  
Joe Garner  
813-281-4900

Tokyo  
Steve Wheeler  
81-3-3436-8631

Vienna  
Helmut Meier  
43-1-518-22-900

Warsaw  
Adrian Foster  
48-22-460-1600

Washington, DC  
Eric Spiegel  
703-902-5000

Wellington  
Jens Schädler  
41-1-20-84-05-0