

# **Under the Buzz**

## **Back to Basics in e-Business**

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*Under the Buzz* is an electronic "newsletter" authored by Philip Lay, managing director at the Chasm Group, a Silicon Valley strategy consulting firm. It is published each month, and delivered free to subscribers via email. It is also posted on the Chasm Group website at: <http://www.chasmgroup.com/underthebuzz.htm>. Back issues can be downloaded from the site at: [http://www.chasmgroup.com/underthebuzz\\_archives.htm](http://www.chasmgroup.com/underthebuzz_archives.htm).

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### **Philosophical View of Authority and Competence...**

A salutary warning for anyone attempting to exercise leadership today (this quote was brought to my attention by reader Rene Bonvanie):

*"Competence without authority is as useless as authority without competence."*

- Gustave Le Bon, French psychologist, sociologist and author (b1841-d1931):  
"La competence sans autorite est aussi impuissante que l'autorite sans competence."

### **1. Could We Be Seeing the End of Earnings Forecasts?**

*"Coca-Cola, the world's largest soft-drink maker, said Friday that it plans to stop forecasting its quarterly earnings for Wall Street and will encourage more attention to its long-term strategies rather than short-term results."*

- David A Sylvester, San Jose Mercury News, 12.14.02

Who knows, this just-announced development, involving one of this country's premier companies, just might augur the end of one of Corporate America's most counter-productive practices. Think about it and see if you disagree: the very idea that company CEOs and CFOs can be expected to see into the future in order to predict within one or two percentage points the exact revenue and earnings outcome of the next ninety days of business is preposterous; actually, it is proof to me of how ritualistic and nonsensical business practices can be when they somehow become rooted in our culture, and how seem to be so willing to ask managers to focus on the wrong priorities. Nevertheless, once it became commonplace for companies to provide this questionable 'bonus' to Wall Street analysts, it seemed hard to dispute or displace. But all it takes is for CEOs and CFOs to stop long enough to think how futile this practice is. Of course, in a constantly rising

economy (as we had in the nineties), I suppose management might not find it too much of a stretch to successfully predict, and perform to, a set earnings objectives.

But when tough times set in – such as the 2000-2002 period - any institutionalized obligation to assure investors of a given revenues/earnings performance quickly becomes a lose-lose bet for company management to take on. This is especially true for high-growth industries such as high-tech, telecom, pharma, and others, because of the extreme volatility of their growth when caution sets in inside major enterprises. But there it is, the habit of providing 'guidance' seems to have become a set part of the calvary associated with public-company management. Naturally, as any hard-working group of professionals would do, financial analysts appreciate any simplification of their jobs. Thus, the offer by company leaders to provide them with earnings targets to measure them by ends up allowing them to spend more of their time guessing how close each company will come to the forecast results than constructing their own forecasts for each company's future performance.

As we know, by the 'rules' of the earnings-guidance game, when a company misses its numbers by even a tiny percentage, analysts and investors are quick to be spooked by it, and the company's stock price can crash by 20%-50% in a matter of minutes. Despite the exaggerated theatricality of this ritual, my main concern has much less to do with the difficulty of getting the forecast just right than with how it so drastically distorts the motivations and behavior of company executives. In their desire to win over the capital markets by demonstrating skilled forecasting and performance on a consistent basis, management teams are obliged to focus enormous energy to 'manage' their earnings, which usually implies a degree of financial engineering that often ends up being unhealthy for their customers, employees, and investors.

For example, instead of spending that energy on improving the quality of their products and services for all their existing as well as new customers, companies feel compelled to adopt a hit-and-run approach to winning new customers, often relegating the requirements of existing customers to second or third place. And, instead of investing in long-term competitive advantage via, for example, R&D into new technologies, they launch repackaged products for an immediate hit, even if that same decision will quite clearly weaken their long-term prospects. When you apply this short-term mindset to high-tech businesses, we cannot be surprised to see increased volatility in their fortunes, resulting in frequent financial disasters such as those we have recently witnessed in telecoms, internet software and services, energy, and other sectors.

So what possible downside could there be if every public company from now on chooses not to provide guidance on earnings? Will this adversely affect the ability of financial analysts to predict the likely effectiveness of company management teams? Will it make the public capital markets less or more attractive to investors (and of course there are many constituencies, from the Fed to the markets themselves, who are very concerned about bringing investors back off the sidelines again)? Apart from taking some of the allure away, perhaps making the markets seem less sophisticated, my sense is that no real downside exists.

What we will see less of, quite probably, is the meteoric ups and downs of many stocks, as the markets revert to a more balanced set of metrics, looking both to short-term execution and how that execution is serving the long-term growth and market-share objectives that each management team should continue to emphasize in annual reports as well as periodic announcements. Perhaps, at a time when the brokerage houses are under fire in their research activities, more of the smaller (startup) players in each category will be covered in depth by analysts, making it seem more of a gamble to invest in them. So the markets are likely to become less 'sophisticated and less 'exciting', by which I mean less like a casino – now you see a profit in your stock investment, now you don't. But aren't we all tired of this type of excitement? And, shouldn't we recognize that stock-market investments were never intended to be such a significant focus in anyone's overall investment portfolio?

Finally, let me cite the example of what must be the most resilient and consistent growth stock among major public corporations of the past decade or so – Microsoft. Think carefully: what is Microsoft's approach to offering earnings guidance? Well, Microsoft does everything *but* offer guidance, except to almost invariably say that the outlook for the next quarter looks pretty bleak –

and then they promptly go out and blow off the hinges of the door with great earnings. You want to play the guidance game, just get into the habit of forecasting less than you *know* you can generate, or if you're not sure, don't say anything. In the short term, this can mean that your stock receives less (positive) attention from analysts and investors, but over time I would argue that investors will reward those companies that talk *down* their prospects and consistently outperform them. Of course, we can't all be like Microsoft, which has locked up one of the most powerful monopolies of recent times; in their case, Gates & Co. have the virtual luxury of deciding how much revenue and profit to declare each quarter. But I say we should just do away with guidance and let executives focus on running their businesses. It cannot be worse than what we have today, with this maniacal focus on quarter-by-quarter shenanigans. As soon as the emphasis on quarterly earnings subsides a bit, I am convinced that companies will be able to build their businesses with more than just a token eye on the future.

## **2. More Lessons Learned, by a Software-Company CEO...**

In an earlier edition (*Under the Buzz*, September 2002), I published six key lessons learned by tech-company CEOs, relative to the best approaches to running their businesses during the current tech depression. Here are four more quotes from another CEO ...

- (1) Be more frugal earlier;
- (2) Trust my gut more;
- (3) Don't do 'referral hires' for key positions without checking the people out thoroughly myself;
- (4) Be less impatient for results.

## **3. The IT Spending Outlook: What Today's Trends Mean for a High-Tech Recovery - by Tom Kippola**

*My colleague Tom Kippola writes below on his impressions with respect to the chances of a recovery in IT spending during 2003, based on the information that he has been gathering from diverse official and other sources. I want to offer one alert to tech-company management teams who are focused on getting their new technologies widely adopted by large and medium-sized enterprises, as well as government agencies; it is that the marginal percentage of IT budgets that are allocated to acquiring and implementing new technologies will continue to be 'insufficient' for some time longer. In other words, the bulk of IT budgets – 95% or so - will continue to be reserved for ongoing implementation activities, new deployments of incumbent systems, software and hardware upgrades, and maintenance contracts. Thus, it will still present a tough survival challenge for the large number of recent startups (or existing players) with new, relatively untested products, unless they can break through by proving the tangible differentiated value of their offerings to the operational effectiveness of their customers' organizations. In spite of this caveat, Tom Kippola's words about economic trends suggest that we should be encouraged to think in terms of a gradual IT spending recovery that is already underway...*

"When will businesses begin to grow their IT spending again?" continues to be one of the most frequent laments of IT vendors. While the question seems rhetorical, with no projected end in sight, there are some data points—both quantitative and qualitative—that shed some light on the current trajectory. This piece begins with a snapshot of the health of the overall US economy, then covers recent trends in tech spending, and ends with the results of a recent poll of US CIO's.

Despite all the gloom and doom in the press, the US economy appears to be well on its way towards economic recovery. After declining in the first 3 quarters of 2001, the US economy posted four straight quarters of growth and, barring a catastrophe, will end the year with the growth streak intact. For the 12 months through the end of Q3, real [inflation adjusted] GDP grew about 3.2%, which is about equal to the 30-year average of 3.1%. In addition, if the less than

stellar 1.3% growth estimates for Q4 are correct, the US will end the calendar year with about 2.9% real GDP growth, still respectable.

It still *feels* bad now because of economic indicators that normally lag a recession such as unemployment, the cumulative effect of 2 years' personal wealth decline [particularly people significantly invested in tech stocks], select troubled industries [telecom, energy, travel, airlines, etc.], corporate accounting scandals, and uncertainty around Iraq and terrorism.

### Tech Spending Comeback?

The new U.S. Dept. of Commerce numbers for business investment in information technology are also looking better: 3 straight quarters of growth. Prior to the last 3 quarters, business spending on IT equipment and software had not grown since Q4, 2000, and that was an anemic 1.6%. You have to go back to Q2, 2000 to find quarterly growth that exceeds any of the 3 most recent quarters [see figure 1 below].

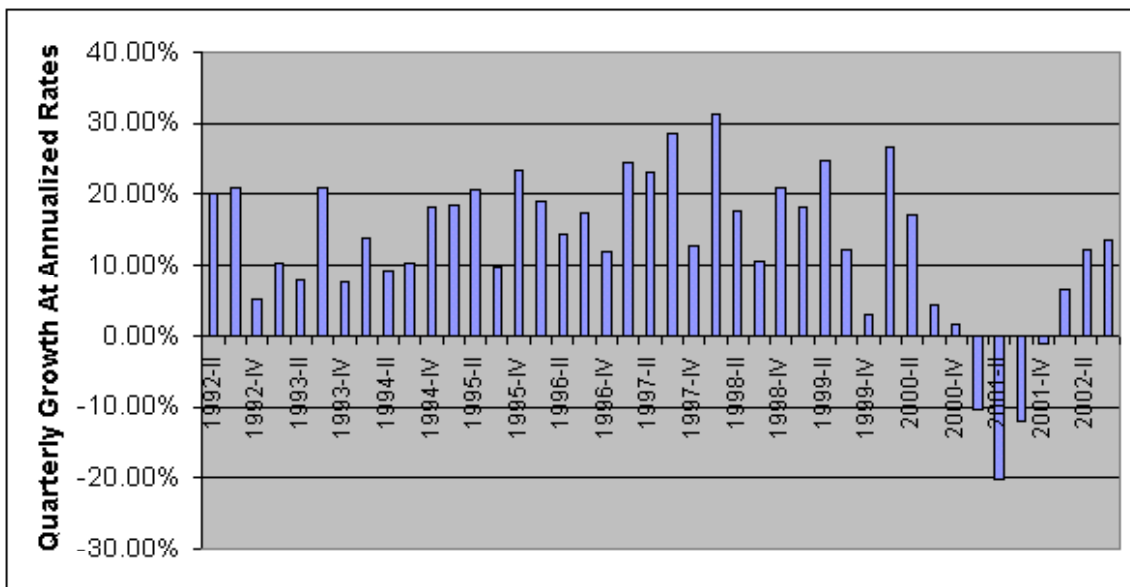


Figure 1: Change In US Business Spending On Information Technology Equipment & Software [Source: US Dept. of Commerce]

US business investment in software [a subcomponent of the overall IT spending data above] has posted 2 straight quarters of growth [see Figure 2]. Prior to that there were 6 straight quarters of either declines or near zero growth. You would have to go back to Q2 & Q3, 1999 to find a 2-quarter period that exceeds the growth rate of Q2 & Q3, 2002. [Note: these figures include *all* types of software purchased by businesses, including embedded software]. Bottom line, while we are not out of the woods yet, things are looking much brighter than a few quarters ago.

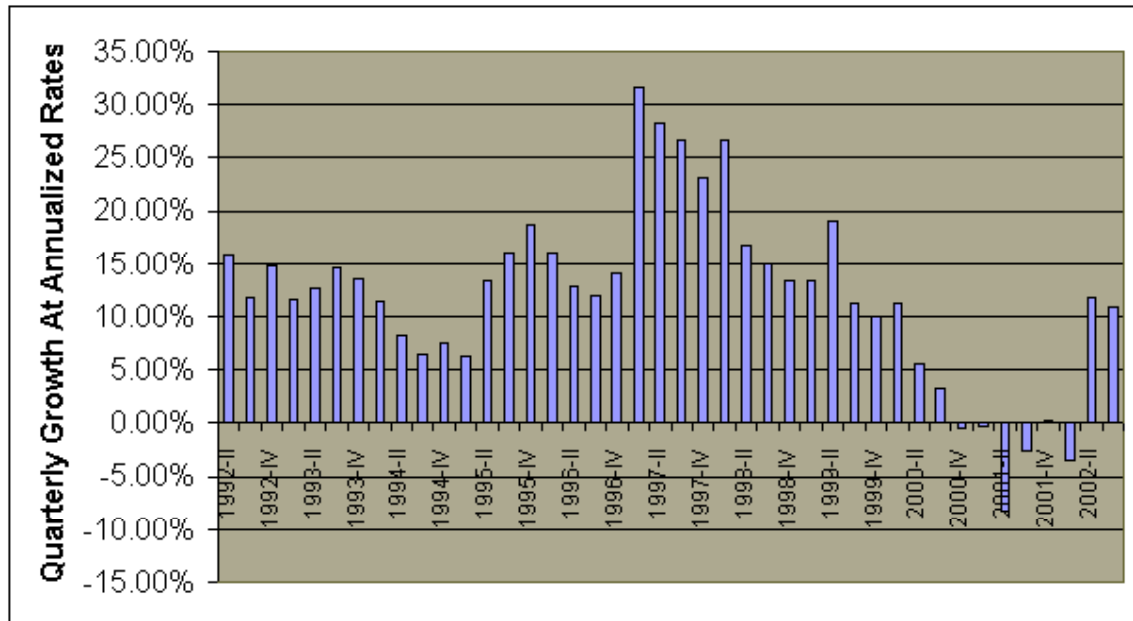


Figure 2: Change In US Business Spending On Software [Source: US Dept. of Commerce]

### Drivers Of Recent IT Spend

Several weeks ago I shared the above technology spending stats with a number of colleagues, friends and tech executives, and one person responded as follows:

*“As a category outsider, I would be interested to know who the buyers are other than the Government, and what business issues are they trying to solve with the new expenditures. From my read, they have milked the improved productivity cow fairly dry, but perhaps not. Do you have any info on what companies are buying and why they are buying?”*

My friend prompted me to reflect on my observations and anecdotal evidence in enterprise software. In my experience the recent software purchases were not nearly as focused on productivity enhancement as they had been in the late 90s. Instead, recent purchases were more often driven by two imperatives: 1) Hard dollar cost reductions: reduce excess inventory, outsource well understood processes to businesses that can run the processes at lower cost [continuing the trends described in books such as Geoffrey Moore’s *Living On The Fault Line*, in which companies are urged to look outside their organizations for ways of executing non-core activities]; 2) Insure against potential costs: fraud prevention, security enhancement [IT/data security as well as non-IT related facilities security], compensation management to prevent out-of-spec compensation packages.

One area where productivity related benefits are showing promise is in making IT integration more efficient. Companies are beginning to use new types of integration software and services to not only cut the cost of manually intensive integration efforts, but also to more quickly gain the benefits of the integrated system. An example would be an application to reduce excess inventory that must be integrated with multiple vendors’ existing products. If you can speed up the integration effort, you can speed up the time to the hard dollar cost savings benefit.

I do believe, however, that productivity enhancement benefits will begin to come back in vogue by mid-summer for some industries, provided that economic shocks such as a war with Iraq do not change the trajectory of this economic recovery. As in most economic recoveries, businesses are reluctant to hire people back quickly, causing the labor force to work harder and harder, eventually leading those businesses to either hire more people or make the existing work force more productive, or both.

### **Continued IT Spending Recovery In 2003**

A November CIO Magazine poll of 301 US CIO's revealed that companies are planning to increase their IT budgets an average of 5.1% over the next 12 months -- up from an average of 4.4% increase when the survey was conducted in October.

As 2002 draws to a close, even though not everyone who wants a job, has one, the trends are favorable: the US economy and US tech spending are both growing moderately, and, if the CIO's budgets are approved, IT promises to continue expanding into 2003. While some tech categories will continue to suffer, 2003 has the potential to be the best year for US business IT spending since the bubble burst in 2000.

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### **4. Memorable Words on the Disappointment of Not Attaining One's Goals...**

Marlon Brando's words always remind me about the predicament facing high-tech startups, in particular, regarding the statistically high mortality rate of such entrepreneurial undertakings – especially in times like these:

*“You don't understand! I could've been a contender. I could have had class and been somebody. Real class! Instead of a bum, let's face it, which is what I am.”*

- Terry (Marlon Brando) in *On the Waterfront*, screenplay by Budd Schulberg

### **5. Push vs. Pull Markets: Different Approaches to Scaling the Business**

*“In push markets you scale the organization with A players; in pull markets, you scale with numbers.”*

- John Kelley, senior enterprise-software business consultant

Despite the fact that it is still commonplace to see companies resort to scaling their businesses by the numbers, nothing in my view could be truer than the statement above, spoken by a seasoned expert in enterprise software deals and deployments during his time at Aspect Development, a successful late-90s catalog software company acquired in late 1999 by i2. Today investors and managers in high-tech all recognize that the 'instant scaling' experiment that was so expensively undertaken during the internet bubble was an aberration not to be repeated anytime soon. Nonetheless, it is not always clear to executives how best to achieve effective growth in their new business, whether they are in a startup with its first major product out in the market or in an existing company that has launched a new, disruptive technology into the marketplace. What is certain is that most managers have been brought up to think that 'scaling' a new business is as much a game of numbers as anything else. However, what Kelley is suggesting – and I am endorsing - is that nothing could be further from the truth. In fact, scaling by numbers in a market where customers are few and far between without an equal or greater focus on quality players is probably the most expensive, and potentially catastrophic, mistake that management can make.

Here's the rule of thumb recommended above by Kelley, in slightly more complete language:

- **Push markets – normally associated with emerging-to-growth product categories - scale with A players** to ensure quality and high value per business transaction
- **Pull markets – normally associated with growth-to-maturing product categories scale with numbers** to ensure coverage, with a lesser need for high-quality players

Kelley and two former colleagues, Craig Doud and Dave McLain, were business consultants at Aspect Development in the days when they helped the company to grow its business by playing critical roles in the successful closing of major software-and-services contracts with large enterprise organizations. Today all three are with different enterprise-software companies, so they are experiencing directly the contrasts between the tough-as-nails environment of 2002 and the heady days of 1997-1999. Recently, they shared with me a lengthy email conversation in which they commented extensively on the similarities and differences they see today in the challenge of closing significant deals with large customer organizations. I am grateful to them for agreeing to my request that I be able to share their observations, in paraphrased form, with *Under the Buzz* readers. Here goes:

John Kelley: *"I think the key message is that in push markets, developing value based relationships require "A" players that are willing to overcome time issues, and capable of deploying the skills needed to become a trusted advisor to an executive, developing a provocation around a business problem worth solving (leaky pipe) and a differentiated solution that is self funding or at least has a short term (3-6 months) real payback ... It's about creating value, which could be about stopping a bleeding problem or dramatically improving business margins. On the other hand, in a pull market customers will buy to stay ahead, or to catch up with their competition."*

Craig Doud: *"People are more concerned with spending money with those vendors that they have already spent money with, they want to upgrade and integrate what they have. Innovating by introducing new technology is deemed a luxury and rarely budgeted - for certain it is 80% about pain and 20% about the gain. Executives are judged by two interrelated criteria: performance, and the quality of the decisions they make. They are avoiding opportunities in IT, because let's face it, IT vendors pillaged in the late 1990s. Now many of the smart people are left in the companies. And we have to again become their trusted advisors, deliver on our promises and prove ourselves over time. Companies again will spend on IT, in a structured way, not capriciously, though this will take a few years to happen. Until then, it's one deal at a time."*

John Kelley: *"If you go back, say 4-5 years, B, C and D players couldn't get it done either, it took an A team, and it took 6,9, or 12 months plus lots of heavy lifting. Based on that you need 6-8 "A" players just to get one big pop per quarter and you better be adding 1-2 "A" player per year to scale. It will never be like 2 years ago; the excesses of 2-3 years ago are causing the hangover we are in today."*

Craig Doud: *"You are right about the B-players. One thing I found out about business consultants, is that not many of them actually did anything meaningful in these situations. They were in the room, they saw what was going on, they made comments that sounded like good ideas. But very few people can grab a pen, jointly solve a problem with a customer, document the idea, and then communicate it and the benefits it will generate."*

Dave McLain: *"One thing that has become apparent: B,C & D players are a lot more visible than they were 1.5 years ago. It is almost impossible to get a deal done with a B rep and a B business consultant."*

John Kelley: "You know I was thinking back to the Aspect days and I'm starting to realize deals really aren't much harder to do these days than they were 4-6 years ago. Five years ago, \$5m. deals were a big deal, and they took 9-12 months or longer to drag across the line. The difference is Aspect had 6 or 7 guys that could create a vision match and drive a deal structure. So if each of us did 1.5 deals a year then the company ended up with 2 big deals a quarter, and many smaller deals, we were able to make our numbers. ... The problem started 3-4 years ago: deals got easier and bigger. I think we all want to get back to the dot-com gold rush days, but they will never appear in our lifetime again. Maybe we just need to get used to \$5m.-\$10m. deals and 6-12 month deal cycles and just make sure we have enough coverage."

My sentiments, almost exactly. In fact, I can also quote a mix of comments from several other experienced enterprise software and systems executives in recent months, reflecting on how challenging it has been to get large enterprise deals closed in today's environment:

- (1) "Today CIOs have a 'veto' vote on every deal; business owners can drive the deal but not get it done on their own anymore";
- (2) "Industry analysts and CIOs all know about value based selling, so any value assessment has to cover a deep business problem to differentiate solution map, a complete solution architecture with a full cost model and, yes, a value proposition. Some boards and CEOs still think you can go in with a value prop calculator, plug in 15 numbers from the financial statement and move to closing. More importantly you have to become the trusted advisor; this takes time and requires an "A" player. This doesn't sound very different from assessments 4 years ago";
- (3) "You have to walk in to a meeting with the customer executive with a clear understanding of his business problem, a hypothesis for solving the problem and preliminary pain statement/value proposition. You have to walk in with the business problem that is bleeding the company and that the executive knows will kill the company if they don't solve it. This requires lots of poking around with the management team before presenting it as a formal proposal".
- (4) "The 'pull' market is gone, everything is missionary, there are no budget for anything new, so you have to create it or steal it from a funded project";
- (5) "The ASP (average sales price of contracts) has shrunk and sales cycles have grown; the only problem is that boards still expect large ASP and short sales cycles."

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*Under the Buzz* offers a monthly commentary on e-business. The goal is to provide provocative and accurate insights into the latest events and thinking shaping this rapidly evolving technology sector. *Under the Buzz* also provides commentary on strategies for building sustainable competitive differentiation and maximizing market valuations.

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