

Under the Buzz

Back to Basics in e-Business

May 2002 - Vol. 3, Number 5

Under the Buzz is an electronic "viewsletter" 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 e-mail. 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.

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Editor's note: The three articles in this month's edition are based on extensive quotes from three different sources. The first individual is CEO of a public enterprise software company, and despite the person's willingness to be quoted by name, I prefer to quote the CEO anonymously in the article entitled "*Stock Options, Corporate Governance, and CEO Earnings: The Other Side of the Coin*". Contributor number two is Leo Hopf, a managing director at SDG, a Bay Area based management consulting firm; in "*Life Sciences, Genomics, and So On: A New Market for Enterprise Software?*" I am citing his description of potential requirements of researchers and business managers in the life sciences industry for enterprise software applications to help them manage drug discovery more effectively. Contributor number three is John Bruno, VP of IT at Cisco Systems, whose testimony is reprinted with permission from Optimize (a magazine published by CMP Media LLC). In "*A Core-vs.-Context Approach Lets Cisco Focus on Mission-Critical Tasks*", Bruno describes how Cisco has employed a management model called "Core versus Context" to make critical decisions on outsourcing in order to focus Cisco's internal resources on priorities that differentiate Cisco against its competitors, rather than on other necessary tasks from which the Company gains no competitive advantage. In the interests of full disclosure, I should reveal that all three of these sources are connected with my day job as a strategy adviser at The Chasm Group. Hopefully, this fact does not reduce the value to readers of the ideas discussed here.

Recent quotes from the press and others on stock prices, options, and accounting problems ...

"Through the 1980s and 1990s, we constructed an architecture that emphasized reporting good news, to the point where CEOs and CFOs could not be frank with the investment community. Many of these companies needed a course correction. But the stakes in admitting problems were very high, both because the market over-valued their stock and because of executive pay."

- Anita McGahan, professor at Boston University, quoted in *BusinessWeek*, May 6 2002

"The tyranny of the daily stock price has led to borderline accounting and, in some cases, outright fraud. And why not, when every upward tick of the stock means massive gains for option-rich executives? 'Excessive pay is the mad-cow disease of American boardrooms,' says Richard Finlay, chairman of Canada's Center for Corporate & Public Governance. 'It moves from company to company, rendering directors incapable of applying common sense.'"

- *BusinessWeek* Special Report on "How to Fix Corporate Governance", May 6 2002

“You could say that, for tech investors and executives, the bad mood of the 2001 recession, which was followed by the depressed mood following 9.11, has now turned into the vengeful mood of the post Enron and Andersen period, when we see investors, politicians, and press coming after tech-company CEOs like there’s no tomorrow.”

- Heard on the Silicon Valley VC circuit, April 2002

1. Stock Options, Corporate Governance and CEO Earnings: The Other Side of the Coin

Not too surprisingly, my comments in April’s issue on the topics of stock options and corporate governance provoked strong responses from a number of readers (*“Hot Issues: From the Andersen Lynching to Expensing Stock Options”*, [Under the Buzz vol. 3, nbr. 4](#)). In light of the recent and ongoing press coverage and public debate regarding failed corporate governance, CEOs’ options-related compensation, and the increasing number of accounting-related scandals – it is time that we presented the other side of the story. In other words, how do tech-company CEOs – and in particular public-company CEOs – feel in the current heat of extreme scrutiny?

Among the strongly-worded responses I received was the one detailed below, from the chairman/CEO of a publicly traded enterprise software company, who jumped in with both feet on a number of related topics. This CEO’s reaction reminds me why, despite having thoroughly enjoyed my past experience as a software-company CEO, I would be extremely hesitant to serve in this capacity in today’s hyper-impatient capital markets environment; in particular, the position of public-company CEO has increasingly become one of the key targets for investor anxiety during the present economic downturn, whether you are talking about this past week’s press furor over the compensation of Christos Cotsakos, chairman/CEO of e-Trade, or the sudden resignation of Steve Gardner, CEO of Peregrine Software, and the company’s CFO, as a result of alleged accounting irregularities discovered by the firm’s new auditors, KPMG, who had been retained by Peregrine’s board after Andersen (not again!) was released from its duties as the firm’s auditors.

Although I have commented in a number of past articles in this journal on the poor leadership example of some tech-company CEOs – especially with regard to taking responsibility for the performance of their companies during the present downturn – I think it’s time to redress the balance by hearing one particular CEO’s point of view regarding the challenges of doing the job successfully in today’s environment. Among the comments you will see below is a portrayal of the job as relatively “undesirable” to most normal people these days, because of the intensity of the pressures surrounding their every move. While no one is suggesting that we should suddenly feel sympathy for their “plight”, what is important, I think, is to ensure that we retain a balanced view of the on-the-job challenges faced by CEOs today. So, without further ado, here are this chief executive’s self-styled “late-night ramblings”, whose straight-forwardness and authenticity I hope my readers will appreciate:

On the challenges of being a CEO:

- “Seriously, something I think missing in this whole dialogue is that CEOs have a very short life span, and it’s a brutally difficult job. They are asked to execute flawlessly and very publicly. Few people, other than professional athletes and entertainers put their job and their reputations on the line so publicly. Certainly not the nameless, faceless portfolio managers or the government bureaucrats.”

On the appeal of becoming a CEO – especially for those who have done it before:

- “Anyone who has a burning passion or need to be a CEO, hasn’t been one. Once you really understand what the job is, you may do it again, but it’s because you and your experience are needed, and because you can make a difference, not because you *want* to be a CEO.”

On the availability of talented executives for the CEO position:

- “Sort of like what has happened to elected officials in the U.S. Used to attract the best and brightest. Now it’s more difficult to attract the most talented leaders to this position.”

On CEO compensation:

- “Speaking of athletes and entertainers, if we are to use them as a compensation benchmark, (most) CEOs are grossly underpaid. ... CEOs, like coaches, get too much credit for the good times, and too much blame for the bad. The only people more underpaid in America than CEOs, are teachers, especially if we use the sports/entertainment scale.”

On CEOs and stock options:

- “As to options, humans are quite capable of killing the golden goose – it’s why we invented the term in the first place. I find it very amusing that the same people screaming for option and CEO pay "reform", are the same ones who used to scream about CEO performance needing to be tied to company performance. The whole topic is laced with hyperbole, as well. What is reported as CEO compensation is usually almost entirely made up of option gains. If the CEO had a big windfall, so did every investor, and at most tech companies, every employee to some degree or another. And unlike an investor who can bail as soon as the stock heads the wrong direction, CEO's are under all kinds of timing and volume restrictions, severely limiting their ability to bail out along with the 'investors." For every CEO who hits the papers with a big compensation number, there are hundreds of others sitting under water on their options, just like everyone else.”

On the pros and cons of expensing stock options:

- “I never have understood why options are tax deductible, but I will point out that this inadvertent business tax credit has paid huge dividends, and helped stuff government coffers. But making it a compensation charge will likely kill it as a widespread incentive, and will be limited to top execs, the very people the mob are railing against. In one way, the whole situation is laughable. The people screaming the loudest are the portfolio managers and investment bankers, who by the way usually make millions of dollars a year in compensation, far outstripping CEO pay most years. Why do they scream? In this down market, they are getting paid less and are pissed, and they need someone to deflect attention and blame to, so less attention will be paid to poor portfolio and banking income results. Let's not forget it wasn't CEO's who drove stock prices into the stratosphere -- it was the financial analysts, investment bankers and portfolio managers. And of course, the politicians and bureaucrats are happy to pile on board the bandwagon to in order to appear to be helping (or at least to be sympathetic to) their constituencies. They have always loved a good public lynching.”

On the CEO as chairman of the Board, a combined responsibility that I have criticized in past articles:

- “I would also point out that the "chairman" title is meaningless, and that most CEOs have it because no other board member wanted it. I certainly didn't ask for it.”

Despite the contrarian tone of these comments, I hope that readers can empathize with the difficulties facing CEOs in these mostly young companies. One of the increasingly regrettable developments in the technology industry during the past five years or so has been to see so many companies go public at such a precocious stage of their evolution. The result in many cases has been that they have been subjected to sudden and cruel fluctuations of an increasingly fickle market; after having been egged on by every conceivable constituency (starting with the venture capital community) to grow inorganically at a frenetic pace in the early formative stages of their development, they have then been required to adjust in unnatural ways to the new religion of cautious, controlled growth. Geoffrey Moore, my Chasm Group colleague and venture partner at

Mohr-Davidow Ventures, takes issue with a slightly different point – i.e., the prevailing “ground-rules” in the public capital markets during the 1997-2000 period:

“My biggest issue with the bubble was that there was no direct way for a CEO to call foul when he or she felt the stock was overpriced. The only intelligent thing to have done was to have used the overpriced stock to buy underpriced brick and mortar companies, which investors would have ridiculed, and which would have lowered their stock price back to where it made sense. But speaking to the issue directly was verboten, by the very people who are now out to lynch this crew.”

Undoubtedly, the companies and management teams that survive this vicious experience will be (a) in the vast minority, and (b) much stronger for the experience. However, one of the costs will undeniably be – and already has been in many situations – the accelerated burn-out of many promising leaders and managers.

2. Life Sciences, Genomics, and So On: A New Market for Enterprise Software?

What initially interested me in writing an article on this new marketplace was the critical need for a new market to form around the use of life sciences IT products and services. Make no mistake, what we are seeing is the formation of an entirely new "market structure" in which today's genomics-focused life sciences companies are beginning to require, among other products, new enterprise applications, and enterprise application integration (EAI) products and services to help them manage their drug discovery projects effectively. What I am referring to as a market structure involves helping researchers and managers in these companies to start virtually from zero to "learn" what software-based automation technologies are available to help them manage unimaginably large quantities of research data; who the main vendors and service providers are, where and how to find them, how to buy/license/rent their services, and how to set about implementing and refining their new systems, and so on.

In contrast, the general corporate market for IT products and services, which has existed now for several decades, has not only learned how to assess the need for, then buy and install, enterprise IT software, hardware and networking technologies, but now appears to have reached a temporary stagnation point. In this climate, the excessive number of enterprise software providers is being hard-pressed to define a survival path. The contrast of these two industries and markets – one new and relatively unserved by enterprise software vendors, the other more mature and now over-served by software companies – presents a fascinating prospect for new and existing market players to establish new business by intersecting the two worlds. As an example, enterprise application and integration vendors who are being severely squeezed in the increasingly commoditized enterprise world have an opportunity to redesign their business for the new genomics-based drug discovery marketplace.

Leo Hopf, managing director of consulting firm SDG and advisory board member at GeneticXchange, an EAI software firm for the life sciences industry, provides some interesting insights into the challenges facing these new players. Here is his perspective on the subject:

“As I think about the challenge these companies face of creating a new industry, a couple of thoughts pop to mind. First, is the underlying value proposition so compelling that it would be worth people changing from what they have been doing to do things the new way. Second, do the market and potential buyers understand and believe the magnitude of this value proposition?

So it seems it might be handy to have a compelling story of how, for example, an EAI software vendor can create value that can be communicated to several different audiences. After all, in creating a new industry you will need to convince many different

types of people to say yes (say the researchers using the software and the leadership of the customer organizations).

Here is my attempt at a value creation story. I will tell it on two levels -- the individual researcher and the business leader.

The Researcher

Let's start with the researcher. In the old world she spends much of her time tracking down the information she needs from many different sources. Once she has the information, she can do the real value adding part of her job, which is the creative thinking that combines all of the data into interesting ideas and powerful insights. Gathering the raw data is a necessary evil for her, and it takes a lot of time. Slogging through a wide variety of web sites and databases adds little to her job satisfaction, but right now she has no alternative. If she wants to think these great thoughts she must first do the donkey work of gathering the input she needs.

Now let's shift to the EAI proposition. What benefits does she receive, and how do these benefits create value?

- 1) Because EAI makes it easier to obtain the data, she can do the equivalent job she did before more quickly. Not only does this save her time, it enhances her job satisfaction because the ratio of creative work to donkey work is increased. With the benefits of EAI most of her time is spent doing the creative things that attracted her to research in the first place.
- 2) But will she really do the equivalent job? I think not. Since it is much easier to gather data with integrated applications, she will gather more than she would have done had she had to do everything manually. So when she brings her creativity to bear she will be armed with more input and should be able to develop deeper insights than in the old world.
- 3) But will it stop there? Perhaps there is another layer of value created by network effects. In the old world it is tedious and time consuming to get information. So the researcher pushes on through and gathers just what she needs. It is a task. With software that helps to manage the complex challenge of genomics-based drug-discovery, the gathering of information is much easier. So much so that as she gathers one piece of information ideas will pop into her head that will cause her to look up additional information not on her original list. Sort of like surfing the web where one thing leads to another and pretty soon you are in a totally different body of knowledge than you were when you started out. So by using EAI she will not only be able to do the job faster, and do it better, she may be able to make connections that enable her to redefine and improve the questions she was asking. This network effect does not show up in the old world because it is too difficult to simply branch out aimlessly in search of interesting things.

The Business Leader

What do business leaders see as a result of using these integration technologies? Better products and services are developed, since researchers can develop better questions and can access more information. These better ideas may result in being faster to market. With the patent clock ticking, this is huge. Together these things will translate into more revenue and more profit. (Costs are probably not affected because I doubt you would fire people just because you have this new tool.)

Also, because the jobs are more interesting for the researchers with this tool, it may be possible to attract and retain a higher caliber of researcher (come here and your job will be to creatively pull together ideas, not slog through computer screens searching for the

information you need.) Recruiting and severance costs go down along with turnover. Average experience level and quality of the researchers goes up which should also lead to enhanced products and services.

By only telling the researcher's side EAI could be seen as just a technical toy. By only telling the business side it may seem like a black box that magically changes the world. By telling both stories we end up with believable business improvements caused by real improvements in the way work gets done.”

By constructing scenarios like this one described by Hopf, the many systems and software vendors now entering this market can begin to identify valid ways of engaging researchers and business managers in the kind of dialogue that can lead to a productive outcome, in which one licenses products and services from the other, and slowly a market begins to form. With so many large IT vendors – IBM, HP/Compaq, Oracle, SAP and many others – announcing large marketing investments in this area, the process of learning what products and services are really needed, and how to bring them to the customer, has only just started.

3. A Core-versus-Context Approach Lets Cisco Focus on Mission-Critical Tasks

Below is an article written by John G. Bruno, then Cisco Systems' VP of IT (and now head of Technology Marketing), on the topic of outsourcing and how the recently introduced concept of 'Core-versus-Context' has helped Cisco to adopt an innovative way of outsourcing supporting tasks in order to focus its direct attention on mission-critical processes and activities. *Core-versus-Context* is one of the key concepts first introduced in *Living on the Fault Line*, the fourth book written by my colleague Geoffrey Moore, published by Harper Collins in 2000 and soon to be released in a revised and updated version. More than any single factor, I suggest that plaudits go to Cisco – and in particular John Bruno – for taking the initiative to put this conceptual model to such productive use in the company. Here follows the article uninterrupted by commentary by me:

Getting Comfortable With Outsourcing

A Core-vs.-Context approach lets Cisco's CIO focus on mission-critical tasks.
by John G. Bruno

"I've never been a fan of outsourcing, but a new take on a strategy called Core vs. Context has made me outsourcing's self-appointed champion at Cisco Systems. In July 2001, I read *Living on the Fault Line* (HarperCollins, 2000) by Geoffrey Moore, a business strategist who has become a mentor of mine. Moore described an outsourcing concept that I thought was brilliant but still didn't quite solve my ever-expanding infrastructure problems. So I asked him to amplify his Core vs. Context theory specifically for Cisco's IT department, and together we came up with a new partnership model I've used ever since.

I'm responsible for Cisco's entire IT infrastructure: the data-center operations, desktop, help desk, network, Web services – everything we use to communicate internally. I struggle with a finite number of resources to meet an infinite number of business opportunities, while cost and complexity increase by the nanosecond. Keeping up with the work is almost impossible – and that leaves little time to focus on what we do best. For us, selective outsourcing isn't just an option; it's a matter of survival.

Here's where Moore stepped in. At the most fundamental level, he says, all employees should be focused on core activities – that is, things that contribute to the company's competitive advantage and increase shareholder value. The opposite of core is context – activities that don't contribute to competitive advantage. Context activities should be outsourced. Problem is, everyone believes that all the work they do is core; among infrastructure people, outsource is a very bad, and possibly threatening, word. So Moore and I added two new categories to his core and context: mission-critical and non-mission-critical.

Mission-critical activities, if performed poorly, pose an immediate risk to the company, whereas non-mission-critical activities do not. The four categories make it easy to identify the things we want to

control, those for which we want to share responsibility, and those we want to give away entirely. On core mission-critical activities – architecture, enterprise management, integration, and Web services – my team writes the rules and does the work. Context mission-critical activities, on the other hand, are a 50-50 partnership; for ERP and systems administration, we write the rules but partner on the work. For core non-mission-critical items like new-technology deployment, we work side by side with a partner, applying best practices from both groups while developing their understanding of the next wave. We hand off non-mission-critical context activities (such as support and maintenance of PCs) to vendors.

Outsourcing allows us to focus our resources and control our head count. We hand over full responsibility within clearly defined service-management guidelines and monitor risk exposure on mission-critical performance. That's equally good for Cisco's business and the business of our partners. Our outsourcing relationship with IBM Global Services, for example, which used to center on control issues, has blossomed into a joint focus on the end customer. Complete IP multiservices integration is the future – but we need partners to get there. Moore helped us reinvent the rules, simplify the metrics, and provide distinct value to our business. It's time for IT departments to shift their values, and their partnerships. The only barrier to entry is the fear of change.”

John G. Bruno was formerly VP of IT at Cisco Systems, and now heads up Technology Marketing for the company.

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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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