

# Under the Buzz

## Back to Basics in e-Business

June 2002 - Vol. 3, Number 6

*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 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](http://www.chasmgroup.com/underthebuzz_archives.htm).

### In this month's issue:

1. **Price Discounting: If You Really Have to Do It, Make Sure There's a Quid Pro Quo!**
2. **The Worst of Times, the Best of Times**

By receiving this issue directly from Chasm Group Publications, you are already on the distribution list. To unsubscribe, send a blank e-mail to: [unsubscribebuzz@chasmgroup.com](mailto:unsubscribebuzz@chasmgroup.com)

Please feel free to send this to your colleagues and associates. They can get on the distribution list by entering their email address at <http://www.chasmgroup.com/subscribe.htm>.

*"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they recover their senses slowly, and one by one."*

- Charles McKay, "Extraordinary Popular Delusions and the Madness of Crowds" (1841), quoted in *The Consilient Observer* (05.21 edition), a CSFB newsletter

### 1. **Price Discounting: If You Really Have to Do It, Make Sure There's a Quid Pro Quo!**

*"If you're going to make your numbers in today's market, you've got to be prepared to do much deeper discounting than you ever did during the good times. I've never seen such carnage - sometimes you need to take off as much as 80%-90% of the list price, and you still may not win the deal."* This is a fair paraphrase of recent statements I have heard from three different VPs of sales, all of whom are familiar these days with the need, as they see it, to agree to significant discounts in order to have a chance of winning business. If this is true, I can only imagine how enterprise software and systems companies, anxious to reverse the current trend-line of flat or shrinking revenues, must want to find a way to avoid – or minimize – the frequency and impact of discounting in today's stingy marketplace for IT investments. To achieve this, I shall take a look at some of the real reasons that customers force the price issue (besides the obvious ones), as well as some of the options vendors should explore before concluding that they need to concede a discount in order to increase their chances of closing deals. Finally, I think it makes sense to consider if there are situations where price discounts are actually warranted – much as, frankly, I detest the very thought for a number of reasons which will become apparent as you see my arguments unfold below.

To begin with, I want to offer two potentially provocative suggestions that I would argue are nonetheless valid in all situations, *including* the current tight-budget downturn which many seasoned sales executives are saying is the worst they have seen in the past 10 to 20 years. My assertions are based on a career in systems and software sales and marketing, including being schooled in IBM. (For my money, IBM still stands head and shoulders above every other technology company as the gold standard in enterprise-level relationship and account management, especially in relation to doing business profitably). My

perspective is also based on years in software sales and marketing, including eight years as founder and operator of my own enterprise software company. Here goes:

- 1) No enterprise software or systems sales manager in their right mind should need to concede any more than a token price discount for any business proposal, unless the proposal has not been thoroughly thought through. This is particularly true with respect to emerging products, and only slightly less so concerning mature products. The only admissible exceptions are those cases where reducing the price buys you some real goodwill, either because it helps your customer to speedup the decision process by remaining within a rigid sign-off limit, or by other means. Thinking that discounts accelerate deal closure is in most cases an illusion not borne out by reality and, worse still, it usually weakens a vendor's position (see point two below).
- 2) Every time a systems or software vendor responds to a real or perceived objection from a prospect about the price of their proposed products and services by immediately making a financial concession, they are almost certainly (a) failing to understand what the customer is really saying and thus 'answering the wrong question', so to speak, besides (b) losing precious 'power' in the relationship, because (c) they are sending a signal to their customer that they lack confidence in the value of what they are proposing to deliver, or (d) there is not, in the customer's mind, a compelling reason to acquire the proposed solution. This last item is perhaps the most crucial of all: whenever pricing is in dispute, the most likely (first) cause to look for will be the lack of clarity of a 'compelling reason to buy'. If you adopt a holistic approach to these things, this the root cause that you must flush out and address before renewing the closing pitch. If, on the other hand, you take it at face value as a straight pricing objection, you are more likely to spin your wheels as you try to overcome it.

Moreover, rather than accelerating the close, the noise level generated by such reactive behavior (often abetted by management in its desperation to close quarterly quotas and/or meet earnings expectations) is likely to either delay, or actually defer indefinitely, the closing of the deal. This is because, despite all efforts to respond to the customer's concerns, price discounting – perhaps paradoxically – tends to give customers more cause for worry than for celebration.

Allow me to provide some context for these views. First, let's recognize that when a customer questions a vendor's price, beneath it all they are probably questioning the value of what is being proposed. In some cases, what they are looking for is additional information to support their case; in other cases, they are genuinely unsure about the value they will realize from the investment, or they feel that some important aspects may not be being addressed sufficiently to ensure success. Price-focused objections discussions arising out of misaligned perceptions of value should only be 'answered' with questions and arguments based on the value that is being delivered, not with an immediate lowering of the price. Thus, it follows that, if the promised value turns out not to be demonstrably there, the customer should in fact receive a discount – or, better still, a revised proposal that reflects new expectations and conditions.

Even if the customer agrees that the proposed solution will address the identified problem, and in doing so will generate eventual cost savings or additional revenues, they may still present some resistance to buy, based on the unavailability of financial resources. In this case, it is essential to discuss this resource scarcity issue in detail. If they are reluctant to do so, it may be a sign that they are at too low a level in the organization to make a decision, or that they are still worried about something else, or even that they are not acting in good faith. Having said this, customers who are being straightforward will generally be happy to share the details of their predicament.

### **Complex solutions are 'funded' out of recovered costs or discovered revenues**

When budgets are alleged to be 'tight' for product categories that have not yet firmly established themselves as 'investable' – categories such as product lifecycle management, workgroup collaboration or knowledge management are in this boat – vendors should not be surprised. This is because there may not actually be a budget for these categories, except for the one named "misc.," since corporate budgets only come into being around well-known and established categories – client/server ERP or CRM systems,

for example – two or three years after the categories have first appeared on the market as tangible applications or tools. Where there are no established budgets and if the prospect has determined that they need the solution, funds must be found from elsewhere in the organization. Possible sources may include other existing budgets, but the best source is often the anticipated cost recoveries or revenue discoveries to be realized as a result of the implementation of the proposed solution. In contrast, the budgets for acquiring established products are often set on a yearly basis, unless they are not deemed necessary at all. Unfortunately, in tough times, these are the budgets that can dry up fastest. If this happens, as with the newer categories, Product A may need to be funded out of Budget B - unless it is seen to be part of a complete solution to a high-priority problem, in which case the company should be willing and able to find the funds from somewhere else.

If all of this foraging – conducted in transparent fashion between customer and vendor - still leaves the customer short of the required funding, before the vendor considers granting any financial concessions, there are a number of options to look at, starting with alternative pricing options (such as risk-reward sharing). Beyond this option are these: hosting the application in return for monthly/annual subscription fees, leasing, bank or finance company financing, or even the practice of ‘vendor-financed sales’, which is more feasible for asset-backed systems companies to offer than asset-thin software companies. This practice has had various outings in other industries (notably in automotive, heavy equipment, and computers) during recent times, more recently (and spectacularly) in the telecom market, with companies such as Lucent, Nortel, and Cisco financing purchases by carriers and enterprise customers. The problem with this tactic is that it can rapidly get out of control and, at the first sign of a downturn, just as rapidly bite the holders of the financing paper (in this case, the tech vendors) in the posterior.

The last resort of all is discounting itself, pure and simple. Especially in such situations, vendors must extract a *legitimate* quid pro quo. This is because, as we all know, giving a product or service away for free in business is generally a bad thing, because your customer will not attribute value to it and, worse, it creates a precedent in that customer’s mind for repeating the practice in all future deals. Here is a short list of ‘mutual’ quid pro quos (‘QPQ’s) that can deliver compensatory value to the vendor in return for their readiness to be malleable in their financial dealings with the customer:

- (a) Certainty of winning the business: I am constantly amazed at the willingness of sales teams to offer discounts unconditionally. My reasoning here is that, if you are going to reluctantly offer a discount that by definition affects your company’s profitability, it can only be in exchange for a commitment from your customer that the deal is yours as a result of the concession. Any discount offered without this QPQ just makes no sense.
- (b) Accelerated payment schedule of the license, service, maintenance, and/or other fees due as part of the contract (the effect of this QPQ is to enhance the vendor’s cashflow, and even profits);
- (c) Additional resources contributed by the customer to accelerate or facilitate the implementation (the effect of this QPQ might be to reduce the vendor’s cost of implementation services, as well as accelerating the payment schedule and referenceability of the customer’s implementation);
- (d) Agreement to go above the call of duty as a spokesperson and reference site for prospects and other customers. This might mean agreeing to placing customer executives at the disposition of the vendor to make speeches at industry and user conferences, as well as to host a significant number of reference visits from neighboring companies interested in buying the vendor’s products and/or services.

There are two important caveats to consider before agreeing to these price concessions:

- 1) If you are a systems or software company with some of your own internal service resources, it is a corrosive precedent to do what so many product-driven companies tend to do, i.e., give away services for free. To begin with, service margins are almost invariably much lower than product margins. Furthermore, it is important to attribute chargeable value for the implementation consulting or support work they perform for customers, in order to ensure that commitments get resourced and delivered on.

- 2) The vendor's sales team should make sure to document what each side will concede or contribute, in an addendum to the contract. Authorized individuals on both sides who are signing up to the special conditions should be named, as they must be accountable for a set of specific results. Where appropriate, resources should be quantified, and deadlines documented. Finally, the team should make sure there is a closed loop process in which progress can be check-pointed on a periodic basis, and one person on each side should be appointed as the coordinator of each organization's commitments. Such an approach sends a signal to the customer that important commitments will not be taken lightly.

There are of course contrasting theories and practices regarding the elasticity of enterprise software pricing during tough times. Some would say that, all things being equal, there is no reason for software license fees to be reduced just because sales are harder to come by. In fact, you can argue that the savings and productivity benefits that are still the main promise of many software products have even more value during a recession – when cost reduction comes into its own – rather than during boom times when corporations turn their focus more toward increasing the top line. In any event, it is critical that vendors maintain clear and consistent practices in this area of pricing. One thing for sure: the abuses of the past several years of boom times are not a reliable guide to managing deals in today's market.

## **2. The Worst of Times, the Best of Times**

First frame of newspaper cartoon: Software salesman to Dilbert:-

*"Our new version is step backward in quality and reliability."*

Second frame: Software vendor continues his pitch:-

*"We're counting on your irrational need to have the latest version of every software product."*

Third frame: Dilbert to software salesman:-

*"I hate your weasel guts ... but I'll take one for home and one for the office."*

- Dilbert cartoon in San Jose Mercury News, June 12, 2002

*"The late 1990s for this industry was like shooting fish in a barrel. Now the fish are shooting back."*

- Heard at *Enterprise 2002* Conference, May 2002, on the change in bargaining power between software vendors (the shooters) and corporate CIOs (the fish). Reprinted from *Enterprise Critical* newsletter, June 5, 2002

After too much time – eighteen months or more already! - hoping futilely that the economy will bounce back after a short V-shaped recession, people are beginning to realize that there may be something rather different and disturbing about the current depression in enterprise markets for software products and services. In fact, I am now of the opinion that we are experiencing a watershed in the enterprise software industry, the larger consequences of which are likely to be quite dramatic for all participants, including VC firms, capital market investors, and the companies themselves. In particular, those software companies that are unable to provide significantly differentiated *solutions*, in all probability based on an increasingly different business design than is prevalent today, will almost certainly experience hard times.

Perhaps more fundamentally, the lip service that vendors paid to 'solutions' during the halcyon nineties must now be backed up by thoughtful and knowledgeable commitment to what our firm refers to as 'whole product' solutions. Whole products are defined in my firm's methodology as 'the minimum set of products and services required to solve the target customer's compelling reason to buy'. Be careful here: this definition has very little to do with the proliferating 'bundles' put together by software vendor(s), possibly in convenient alliances with one or more hardware vendors and/or systems integrators, to sell a combination of products and services that otherwise would probably remain on the shelf.

In fact, I want to go so far as to suggest that the enterprise software industry as we know it is facing a true strategic inflection point. As I see it, today's classic 35-year-old enterprise software business model has reached a stage of advanced maturity which augurs poorly for the survival of most conventional software businesses. In other words, I am arguing that between now and the end of 2005 we should anticipate a drastic winnowing of the present legions of specialized software development companies down to a much smaller number of organizations, many of them operating a different business model. Thus, in order to survive through the present crisis of confidence in the enterprise software industry, and before expecting to thrive in more prosperous times, it will not be sufficient to merely execute well. Instead of continuing to excel in one competency - i.e., software development for automating transactional tasks, as is the case of most software companies today -, my strong recommendation is that companies must gradually re-conceive and re-design themselves in more than one competency.

An example of this type of hybrid model could be *business process management and innovation* - combining both software and some type of specific process management expertise. I predict that this change will take place during the next two to four years around web services, or something like it. My sense is that the 'penalty' for failing to do this will be to have to settle for being a niche-market player with limited prospects for growth or profitability, possibly focused on geographical markets, such as less developed countries in Asia, Eastern Europe and Africa, that lag the U.S., Western Europe and Japan in enterprise-wide IT investments. Though this might present some attractive revenue growth and profit opportunities to some companies, I suspect that most venture-funded and public U.S. companies will prefer to leave these opportunities to regionally focused companies.

My line of reasoning here spans these four factors: (1) the chastened, over-cautious business environment we are experiencing as a direct result of the abuses of the booming 90s, (2) the maturity of today's enterprise software industry, exemplified by the glut of software on the shelf in enterprises customers today, (3) the diminishing 'investability' of the enterprise software business model and the increasing signs of Darwinian dynamics exerting themselves, and (4) finally, one or two ideas on what to do about it.

## **#1: The Chastened Business Environment**

We all now know about the telecom bust and the recent (and ever-more frequent) analyst conflict-of-interest and auditing scandals that are eating away at investor confidence in the capital markets. Well, let's review briefly what happened to tech in the 90s. The nineties made tech cool and mainstream. At one point late in the decade, if you didn't work in technology, you were made to feel that you were missing out badly. However, the dramatic growth dynamics that caused the 30%-plus year-over-year growth of the IT industry have begun to slow down, as the following contrasting, though related, factors indicate:

- Simultaneous and sequential spending and funding booms turning into one big bust:
  - o The Y2K-generated boom in IT spending peaked in 1998-99 and is well over now;
  - o The dotcom bubble that inflated the market between 1996-2000, also populated it with a cajillion new companies, most of which were not designed at the outset as software companies, and thus had to spend the next 2-3 years redesigning their organizations – a task that is still incomplete in most companies today;
  - o According to some sources, VC funding in the 1997-2000 period vastly exceeded the total amount of funding in the previous thirty years;
  - o Chuck Phillips, the respected Morgan Stanley enterprise software analyst, revealed recently that \$130bn. more in tech gear and software was acquired in

the mid-late nineties than was ever 'digestible' by the agencies and corporations that made those purchasing decisions.

- The 'morning-after' syndrome:
  - o To emphasize the challenge, corporations seem to have gone on strike against acquiring software from organizations whose viability seems to me more in question than at any time in the past thirty-plus years, since the independent software business started in the late 60's;
  - o There is now a glut of disparate, not necessarily workable, web infrastructure in place, acquired by every type of company during the past four or five years;
  - o There is as yet no apparent "next great thing" in the software sphere to pull the market out of its malaise, unless you count the amorphously named "web services", which if it indicates anything suggests a change in business model from "selling" perpetual usage software licenses to delivering services.

To borrow from Charles Dickens, the tech industry seems indeed to be experiencing the worst of times. Through all this, we all *hope* to return one day to the best of times. The link, as Accel venture partner Joe Schoendorf pointed out in an impressive recent conference keynote titled (along the same Dickensian lines) "The Worst of Times, The Best of Times", seems to be that the worst should eventually bring out the best in us, assuming that enough of us can be contrarian enough to turn the present sea of problems into a surge of opportunities.

On one hand, as Schoendorf pointed out, until we see "full capitulation" in the capital markets, there is no solid basis for a sustainable upturn. Until we reach that point, he argues, investors are still not reconciled to the fact that the market is indeed in a crisis because some investors are still ready to jump in and provide an artificial and temporary boost to stocks in order to achieve trading gains. The stock market being the most public forum for washing out our collective and individual business sins, the argument of 'market psychology' experts is as follows: only after all residual hope has disappeared and the market has sunk to, and remained at, a bottom (variously estimated these days to be as low as 700-1,000 on the Nasdaq index), will there be a sufficient sense of alarm capable of bringing out the entrepreneurial fire among a few enterprising individuals and companies, sufficiently to fuel new forms of prosperity.

Like other diligent students of capital market history, Schoendorf points to recent examples of how, in times of chronic pullback, great technology companies are formed, leading the charge toward new "best times". Among frequently quoted cases are IBM, that blossomed after the turmoil of World War II; Intel, Microsoft and Oracle, that rose out of the ruins of the 1980s recession; and Cisco, that appeared after the 1987 stock market crash and the 1990-91 recession.

## **#2: The Maturing Enterprise Software Industry**

On a related note, at last week's Enterprise Outlook conference in San Francisco, venture capital partners participating in panels and informal conversations were pointing out an interesting piece of information, as follows: whereas in the good old days of the eighties and nineties it used to take \$20m. or so in funding to successfully launch an enterprise software company (through, say, two to three rounds of funding), these days it is taking upwards of \$50m. to achieve the same thing. How come? Well, in addition to the reasons above, I can add my own conclusion to round out the list, namely this: in essence, the enterprise software industry itself has reached a stage of maturity equivalent to what I and my partners in the Chasm Group refer to as Main Street, in which this industry category is now regarded by corporations and other organizations as a commodity – and not always a very desirable or effective one.

Bearing this point out, competitive advantage due to technology differentiation is much weaker (i.e., thanks to non-proprietary standards for programming languages, user interfaces, and inter-

operability standards, most software products now look, feel and behave largely the same, so that customers have little reason except for high-quality service or support to stick with one versus the other). Unfortunately, most enterprise software organizations still behave immaturely in their approach to the market and in their own operational effectiveness. This is likely to make it difficult to survive in a maturing marketplace, in which customers demand a level of service and value delivery that most are unable to fulfill with any consistency.

### **#3: Diminishing 'Investability' of the Conventional Software Business - Darwinism in Action**

All this points to the need for dramatically different rules for IT companies going forward. In other words, the distinctions between vendors (software companies, hardware/systems, and IT services outsourcing companies) and specialized distribution/service channels (systems integrators, value-added resellers, manufacturers' reps, and others) may well become further blurred, in addition to the appearance of new hybrids ushered in by the web services catalyst. Examples already exist in the form of transaction services-based software companies (introduced during the internet era), as well as process outsourcing companies combining software technology and process management services.

### **#4- What to Do to Avoid Extinction**

Perhaps it's time to ask, independently of your current business design, what today's technology companies – and especially, software companies – can do to ensure their survival through the current 'nuclear winter'? I have a three-pronged strategic 'recipe' for dealing with today's set of challenges:

1. Make your own mind up about what you see going on in the industry in terms of future trends, then determine your strategy for building clear and defensible differentiation for your company based on a modified business design that takes your organization beyond being a 'pure play' software business within two to four years. Be 'contrarian' in your approach to designing your long-term value proposition. Make sure it is based on at least one of these competitive advantage strategies:
  - a. A unique technology or business-process innovation,
  - b. A unique approach to target markets,
  - c. A unique ability to construct a collaborative value chain to serve markets, or,
  - d. A unique set of differentiated offers to your customers.
2. Tighten up your market penetration strategy, and make sure that you are able to sell and deliver complete solutions to complex problems, rather than just develop, sell and support your own products.
3. Make sure you grow organically, rather than artificially (in contrast with the gravity-defying 'growth' of the 1996-2000 period); also, take advantage of the cost advantages offered by increased globalization. The best example of this today in technology is the emergence of India as a low-cost high-effectiveness software development resource pool, and the increasing importance of China and Eastern Europe as low-cost, outsourced high-tech manufacturing centers.

Of course, these points need to be fleshed out in detail and over time. But, make no mistake, the time to review the most basic assumptions about your business design is now, and the clock is already ticking.

*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.

© 2002, Philip Lay

*Disclosure: From time to time, the author and/or his firm may hold investments in, or provide advisory services to, one or more companies cited above.*