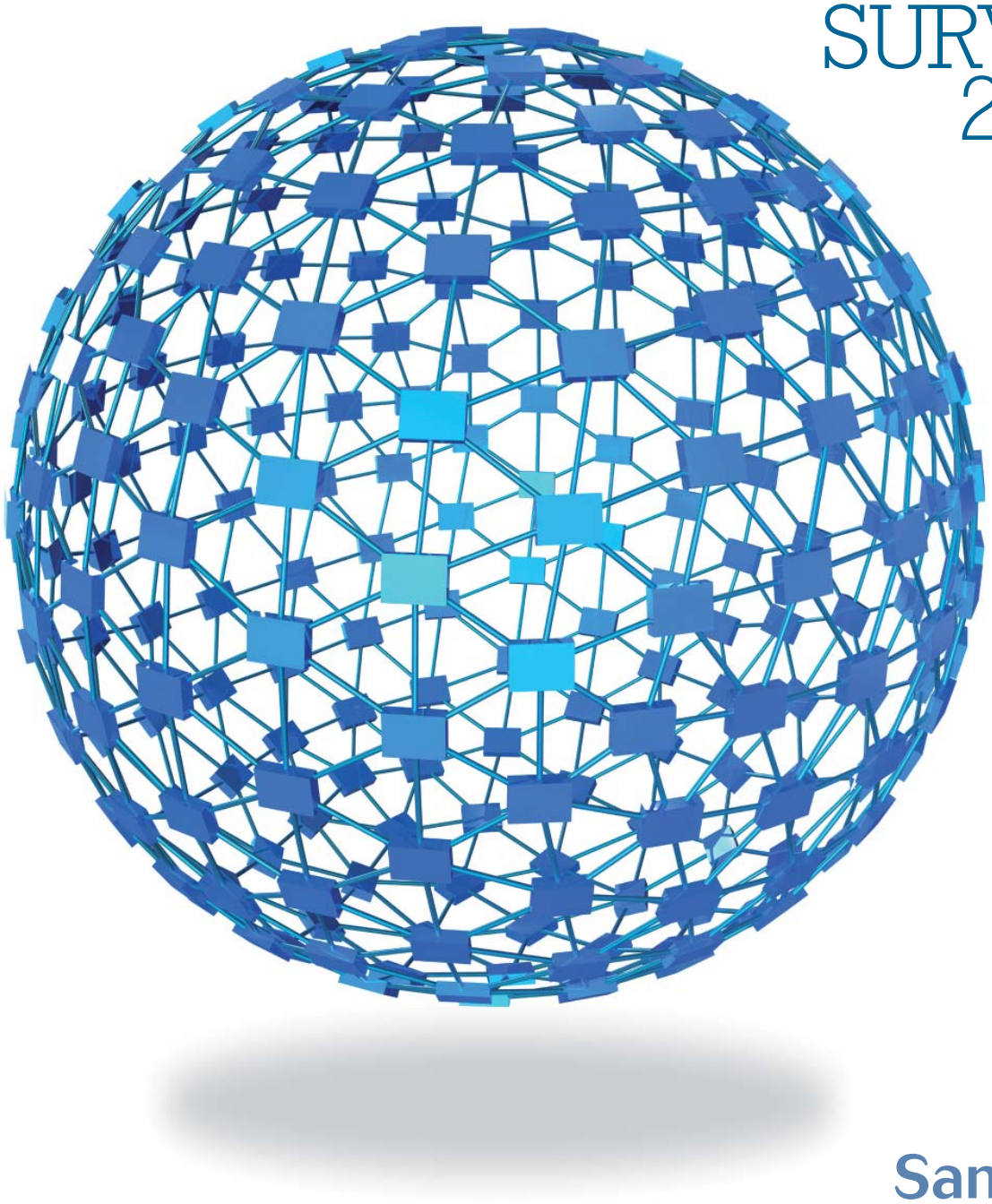
ENTERPRISE SOFTWARE CUSTOMER SURVEY 2008



Sand Hill Group

McKinsey&Company

Innovation in the software industry is on the upswing, with Software as a Service (SaaS) being a key driver. The SaaS model is becoming mainstream and this has led to the rise of a new generation of SaaS platforms (also referred to in the industry as Platform-as-a-Service – PaaS).

This year's survey of more than 850 enterprise software customers by McKinsey & Co in collaboration with the SandHill Group (www.sandhill.com) and the Software and Interop conferences showed increasing acceptance of subscription and on-demand models but more surprisingly, a high portion (74 percent) of enterprise customers favorably disposed to adopting SaaS platforms.

A battleground is emerging between traditional mega-vendors and the larger SaaS incumbents with customers almost evenly divided between the two in their preferred choice for SaaS platform provider.

The survey also found a bright spot for the software industry in the midst of consolidation and economic turmoil. Software spend as a portion of enterprise IT spend continues to increase on its way to 35 percent by 2010.

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Innovation in the software industry is on the rise. This is good news for the industry, despite the current softness in the U.S. economy. Because the majority of the activity in the software sector occurs in North America, having customers on the lookout for innovative offerings provides some assurance that, despite industry consolidation, there's growth potential ahead.

Exhibit 1: Innovation in the software industry is on the upswing

Question: *Where do you think the software industry is within the current wave of innovation?*

State of innovation in the software industry
Percent, n = 857

On the upswing
The software industry technology innovations of the past 2-3 years are nothing compared to new technologies we're about to see

At the peak
We've seen the major software technology innovations for this wave, and what we need now from software companies are the products/ services, business model innovations, and process innovations that take advantage of them

Past the peak
We've seen the major software technology innovations for this wave, and the business models and process innovations to deliver and monetize them effectively are already in place

What innovation wave?
The last few years have been business as usual

Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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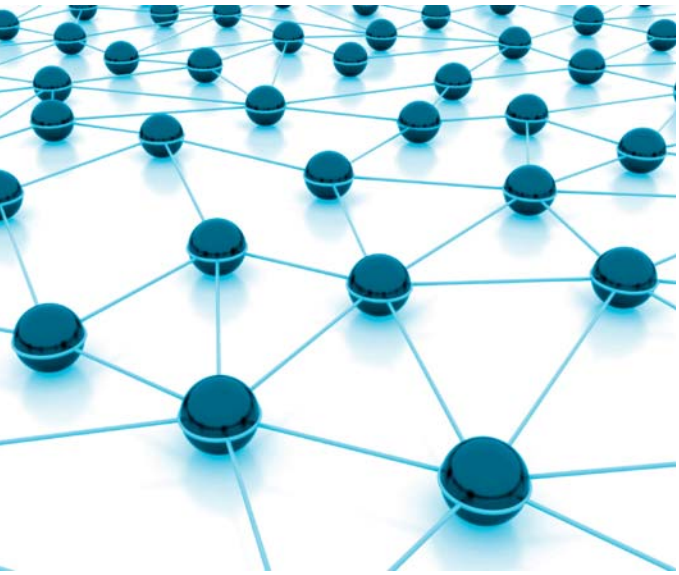


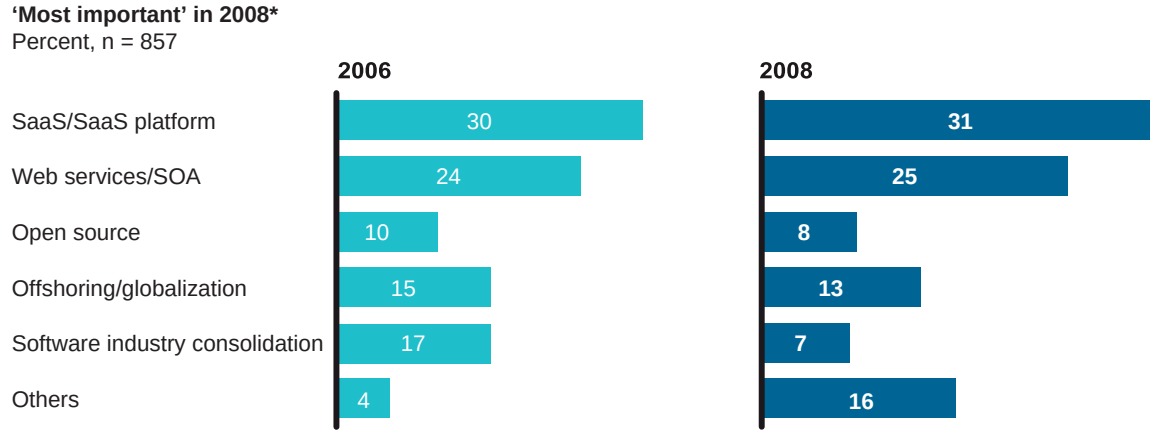
This innovation is likely driven by two major trends, SaaS and SOA (Service-Oriented Architecture), which maintain their spots atop the list of what respondents see as the most important trends in software.

While SaaS and SOA have been on parallel development paths, we expect them to converge in the future.

Another interesting trend is the decreasing importance of software industry consolidation, indicating that consolidation has reached its peak.

Exhibit 2: SaaS and SOA remain top software industry trends affecting business

Question: *Please select the most important trend impacting your business.*



* SaaS platform was not explicitly asked in 2006
Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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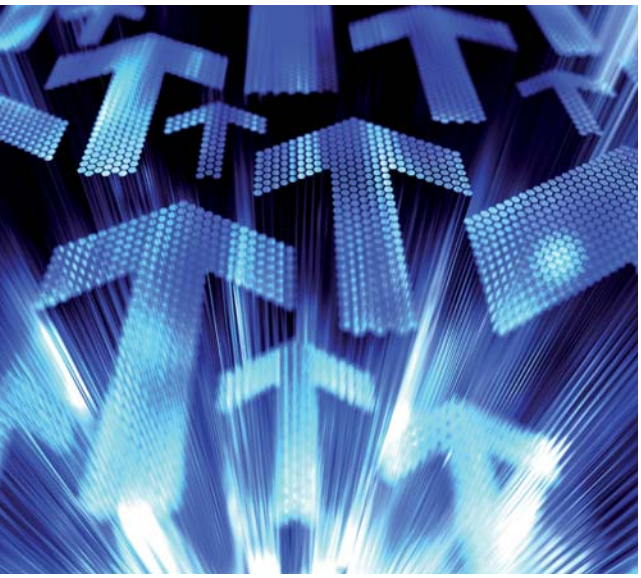
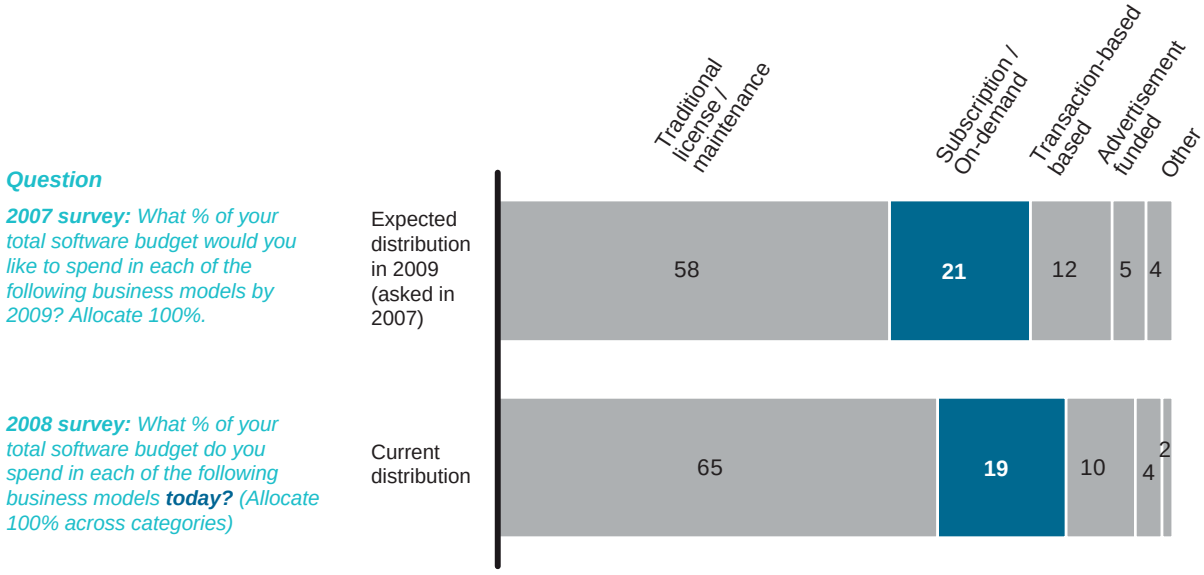


Another bright spot for the industry is the accelerated adoption of subscription and on-demand purchasing models by enterprises over the past year.

Last year's survey showed that companies expected to spend 21 percent of their software budgets by 2009 on these pricing models, long sought by the industry as an annuity stream alternative to large one-time licenses. But we see that these models already account for nearly that budget level, leading to optimism that the 21 percent level will be easily met and likely exceeded by next year. And that is not only good for the industry overall, it is especially good news for SaaS vendors who by the nature of their products sell either by subscription or on demand.

Exhibit 3: Adoption of subscription / on-demand models has accelerated over the last year relative to expectations

Software budget across various business models
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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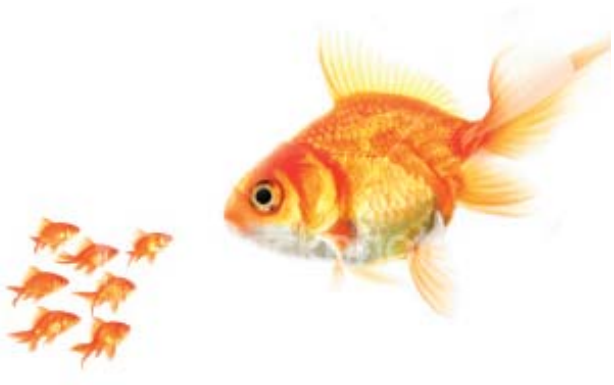
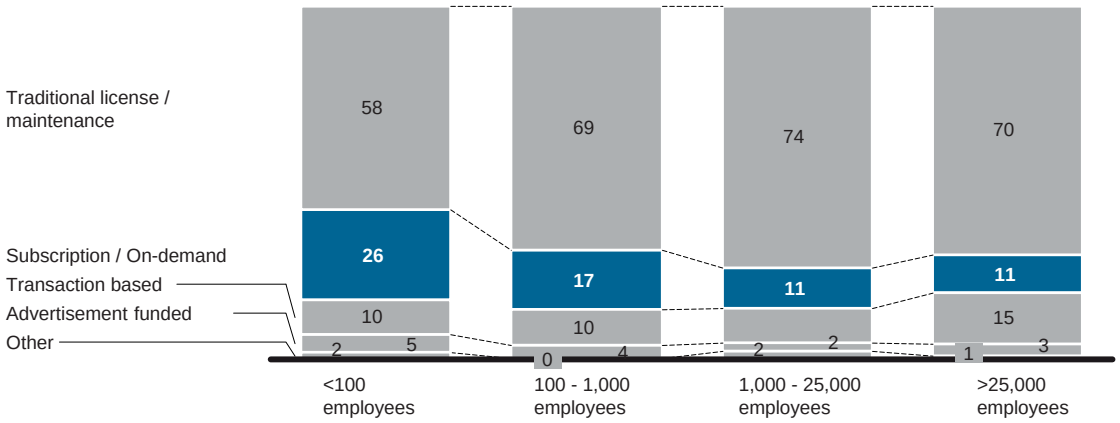


The momentum behind adoption of subscription and on-demand purchasing models is clearly being driven by SMB customers, for whom the pricing models have the greatest initial appeal. While the faster adoption in SMB is no real surprise, what is interesting is that there are some large enterprises that are converting to the models that underpin SaaS offerings. For vendors, this is a strong indication that there is a clear opportunity even at the largest prospects for those that can offer the right product in combination with the right selling strategy. Indeed, many large on-premise vendors have introduced SaaS-based offerings. But that also raises a key question for large customers in terms of how they integrate newer SaaS applications with existing on-premise applications.

Exhibit 4: Adoption of subscription / on-demand models is inversely correlated with company size

Question: *What percent of your total software budget do you spend in each of the following business models today? Allocate 100%.*

Software budget across various business models, by company size
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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The increasing adoption of SaaS is fueling the rise of a new generation of platforms to develop, integrate, deploy and host these applications. These **SaaS platforms** come in several flavors but they essentially belong to one of three "archetypes," each with different market prospects.

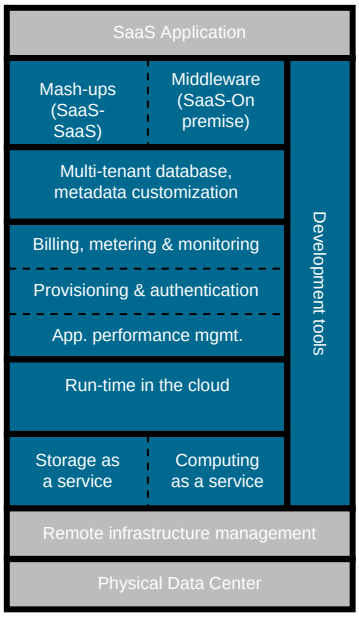
The first archetype consists of what we call delivery platforms, where the platform's competency lies in the delivery of applications. There are two major delivery platform types: (a) managed hosting and (b) cloud computing. Managed hosting, exemplified by companies such as OpSource, IBM and RackSpace, is similar to traditional hosting but tailored to SaaS. In this model, developers set up/obtain their infrastructure from a hosting provider who manages it for them. Developers can get superior service levels and support compared to doing it themselves. Cloud computing, such as offered by Amazon (EC2 and S3) is a model where a vendor provides on-demand access to infrastructure capacity over the cloud. Major advantages of cloud computing relative to managed hosting include faster provisioning of capacity and ability to scale capacity up and down as needed. On the downside, users don't get to choose or customize their infrastructure, need to be comfortable with sharing resources and may get lower service levels and support.

The second archetype is the development platform, typified by companies such as Bungee Labs and Coghead. The innovation here is around providing all or some of the integrated developer environment (IDE) tools needed for creating an application on the Web, in addition to hosting. It is a cost-effective alternative to licensing on-premise toolkits for developers, i.e., SDKs. While this is the most nascent, and hence least understood, of the three archetypes, it could create a tectonic shift in software development by opening application creation to a much wider array of developers for a modest cost and even enabling a new generation of non-developers to create SaaS applications easily.

The final archetype, Application-led platforms, is exemplified by companies like Salesforce.com, NetSuite and Cisco-Webex. These platforms rely on the initial delivery of a business application to create a customer base and establish a foundation for the platform as a separate offering. This area has the greatest marketplace traction today, in large part because of the success these vendors have in selling rapid deployment of new applications to existing customers, as well as targeting developers to write for a platform that is already popular with potential customers.

Of course, a final option for companies who are so inclined (and have the resources) is a "do it yourself" approach, which is preferred by about 19 percent of customers.

Exhibit 5: SaaS platforms broadly come in 3 archetypes – delivery, development and application led



SaaS platform components

SaaS platform options

I *Delivery platforms*

- **Managed hosting.** Contract hosting provider to host / manage infrastructure (e.g., OpSource, IBM), obtain other components separately (e.g., development tools)
- **Cloud computing.** Use on-demand cloud-based infrastructure to deploy applications (e.g. Amazon EC2, Google etc.), obtain other components separately

II *Development platforms*

- Use a cloud based development environment that provides a general purpose programming language (e.g., Bungee Labs, Coghead etc.), deploy directly on the cloud

III *Application-led platforms*

- Utilize platforms of popular SaaS applications (e.g., Force.com, Suiteflex etc.) to develop and deploy application

Other options

- **Do-it-yourself.** Purchase independent platform components and build internal "cloud"

Source: McKinsey

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The momentum toward adoption of SaaS platforms is surprising. Nearly three-quarters of the companies surveyed prefer to adopt platforms in at least one of the three archetypes we identify here.

For platform vendors, the only falloff in interest comes at the largest enterprises, those employing more than 25,000 people. In short, nearly every company – or division of a larger enterprise – is a customer or a prospect for SaaS platforms.

Exhibit 6: 74% of respondents would consider using one of these SaaS platform archetypes, though large companies are less inclined to do so

Question: *Given that SaaS platforms will take many formats in the marketplace, what model is best for your company?*

Preferred SaaS platform model
Percent, n = 857

Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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When you look further into which archetypes are preferred by customers, two things stand out: who's responding, and how mature the archetype is currently.

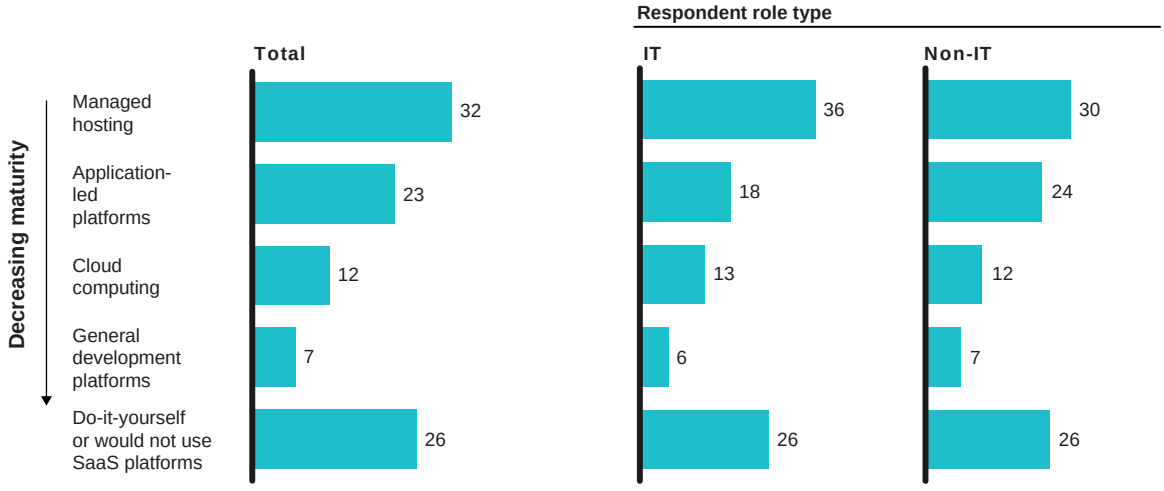
The most significant differences are in the preference for managed hosting versus application-led platforms. While managed hosting is the dominant preference of IT professionals and their non-IT counterparts, the six-point difference underscores that buyers like comfort: IT professionals like the control they get over the infrastructure with managed hosting, while front-line business decision makers like the applications they use. For vendors selling an application-led SaaS platform, the key to success is improving the value proposition for IT decision makers.

For both cloud computing and general development platforms, the issue is maturity. Especially with general development platforms, customers are still coming to terms with the value proposition, and have no significant real-world examples from which to draw. Their success will depend on time, increased familiarity, and the emergence of proven success in the marketplace.

Exhibit 7: Relatively mature and known SaaS platform archetypes are most attractive to customers

Question: *Given that SaaS platforms will take many formats in the marketplace, what model is best for your company?*

Preferred SaaS platform model by respondent type
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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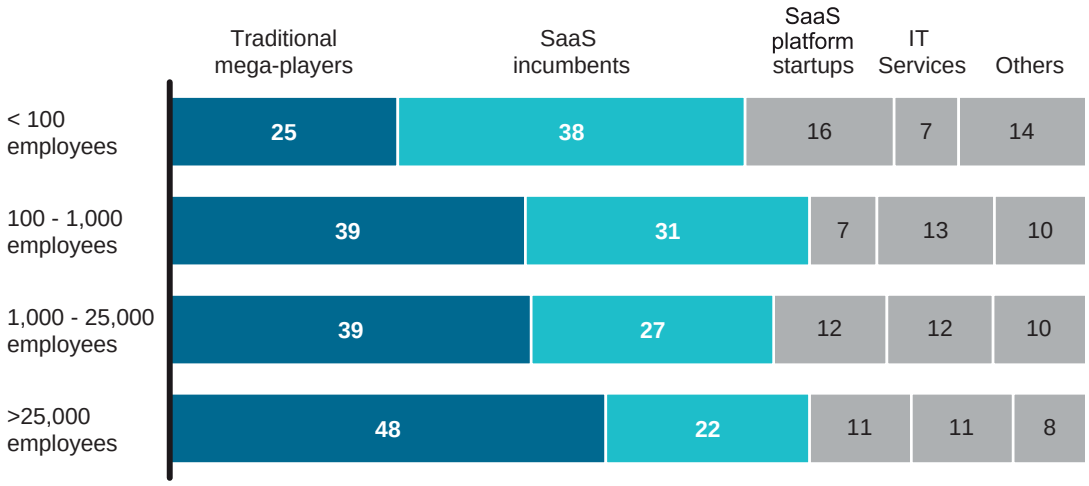
These trends – the growing acceptance of SaaS and SaaS platforms – are likely to create a tremendous battle between the largest software vendors and the newer SaaS providers. While each of these players has an advantage at one end of the spectrum (large vendors such as IBM, Oracle, SAP and Microsoft do best in large enterprises, while SaaS "incumbents" such as Salesforce, NetSuite and RightNow are more in favor with small businesses), the real battle is in the mid-market space.

For SaaS platform startups, that means trying to get into a room where there are already two elephants vying for the customer's attention. Success will mean locating a unique niche – and being prepared to have it invaded.

Exhibit 8: A battleground is emerging between traditional mega-players and established SaaS incumbents while other vendors lag far behind

Question: *Which vendor types would you prefer for SaaS platforms? {Rank 1-5}*

Vendor type ranked 1 (for those that said they would use SaaS platforms)
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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Whether a SaaS platform vendor is finding a niche or trying to maintain a market advantage, the survey underscores the vital importance of offering customers speedy deployment and a smooth path to integration with existing applications and IT infrastructure. In fact, those factors were selected as the most important twice as often as costs. This gives SaaS platform vendors a potential advantage in the marketplace, because deployment speed and integration are their hallmarks.

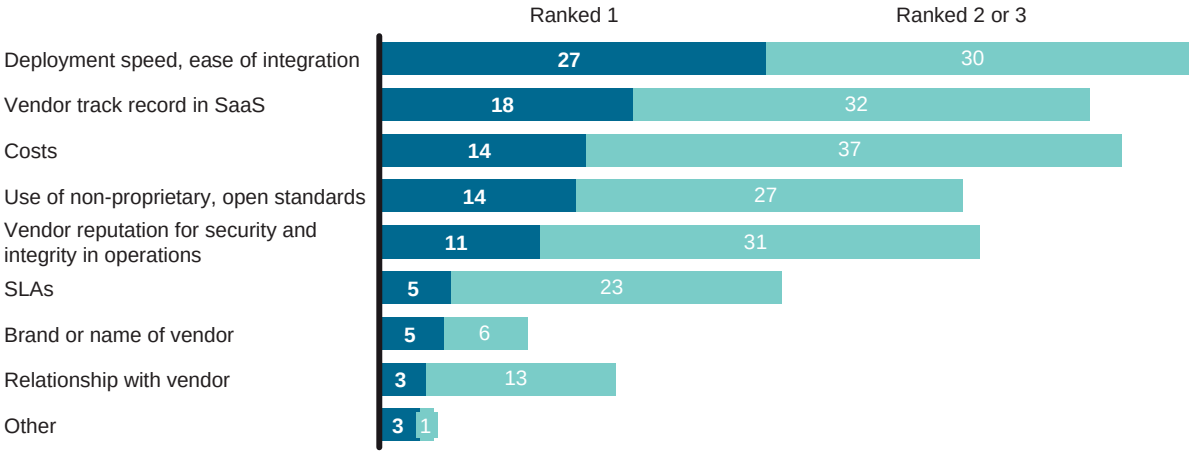
However, it is also important to customers that vendors have proven themselves in the marketplace – and costs are a crucial secondary consideration.

The good news for startups is that existing vendor relationships are very low on the priority list for most customers, indicating a willingness to switch vendors and providing an opportunity window for newer entrants.

Exhibit 9: Deployment speed & ease of integration are the most important criteria for selecting SaaS platform vendors

Question: *What are the most important criteria for selecting providers for this model? {Rank 1-7}*

Relative ranking of different criteria for SaaS Platform vendor selection
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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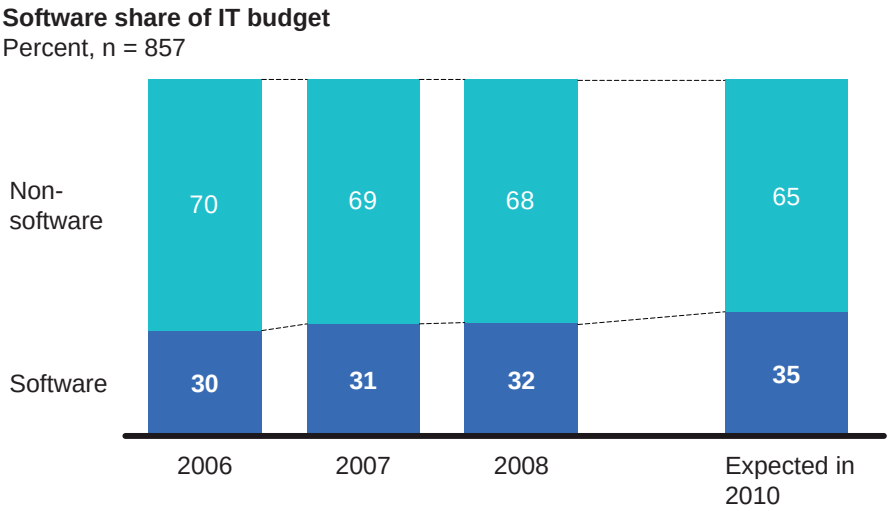
Despite the economic downturn in the US, there is slow but steady growth in software's share of the overall IT budget. In fact, survey respondents projected that this growth pace will continue for the next two years, indicating that software plays an ongoing important role in delivering business productivity gains.

Exhibit 10: Software spend as a % of total IT spend continues to rise gradually and is expected to increase to 35% by 2010

Question: *Approximately what percent of your organization's total IT budget is dedicated to software? What percent do you expect this will be in 2 years?*



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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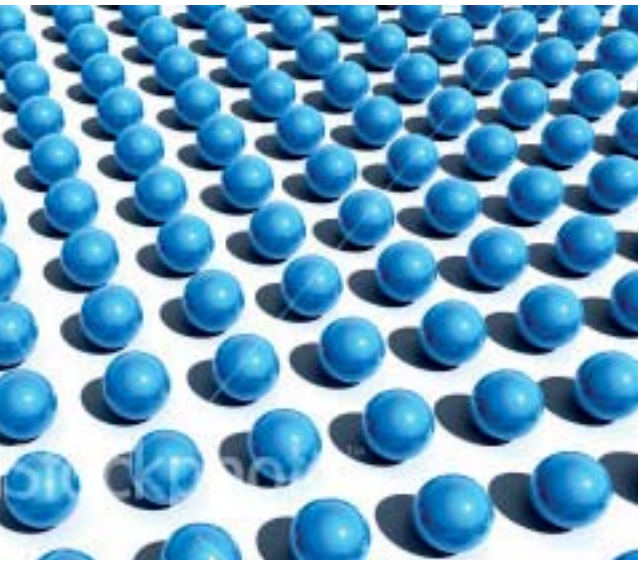
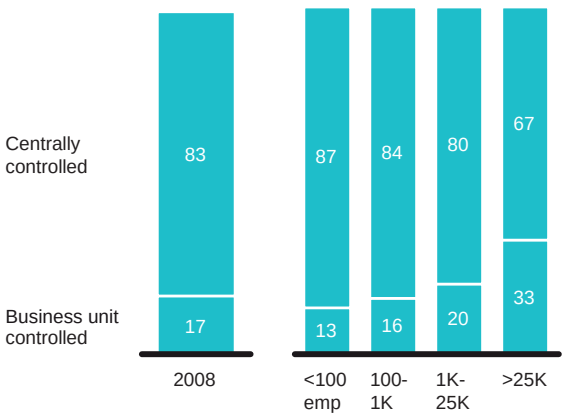


Vendors also continue to face buying decisions that are overwhelmingly centralized, with one exception. At the largest companies (those with more than 25,000 employees) the importance of the individual business unit in decision making is growing. This provides another opportunity for SaaS and SaaS platform vendors to sell into these large corporations, because it is easier to devolve the buying decisions for these platforms to more front-line functions. But, it also creates an issue for the company's CIO or IT manager who will have to deal with any problems that might be created by different business units choosing significantly different approaches to SaaS implementations.

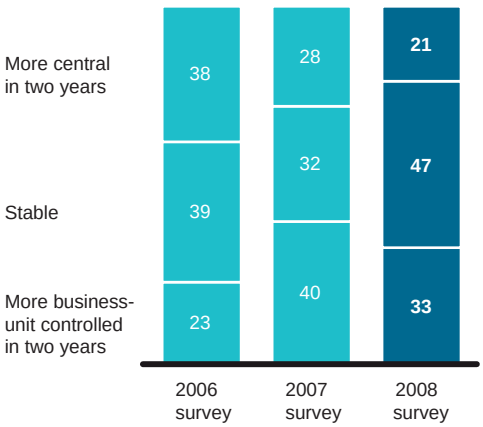
Exhibit 11: Software purchases are still predominantly centrally controlled by IT but becoming less so

Question: *Estimate what portion of final software purchase decisions (specific software brand / product selections) are centrally controlled vs. controlled by business units, today and two years from now?*

Control of software decisions
Percent, n = 857



Expected trend in control of software decisions
Percent, n = 857



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

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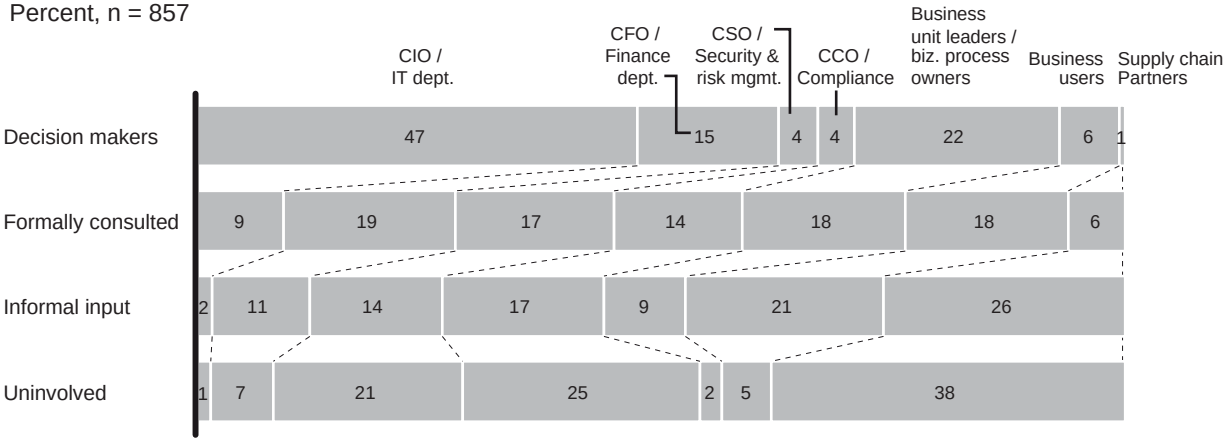
Purchasing decisions remain complicated even in enterprises that centralize IT purchases. While it's clear that the CIO and IT professionals remain the ultimate software decision makers in almost half of all enterprises, formal consultations are spread across an array of corporate and business unit functions, from finance and risk management to compliance and even users themselves. (The chief compliance officer and chief security officer functions are new to the mix this year, but have considerable influence already.) To succeed, vendors need to offer a compelling value proposition at many levels – particularly to business unit heads – in addition to the CIO in order to close the sale.

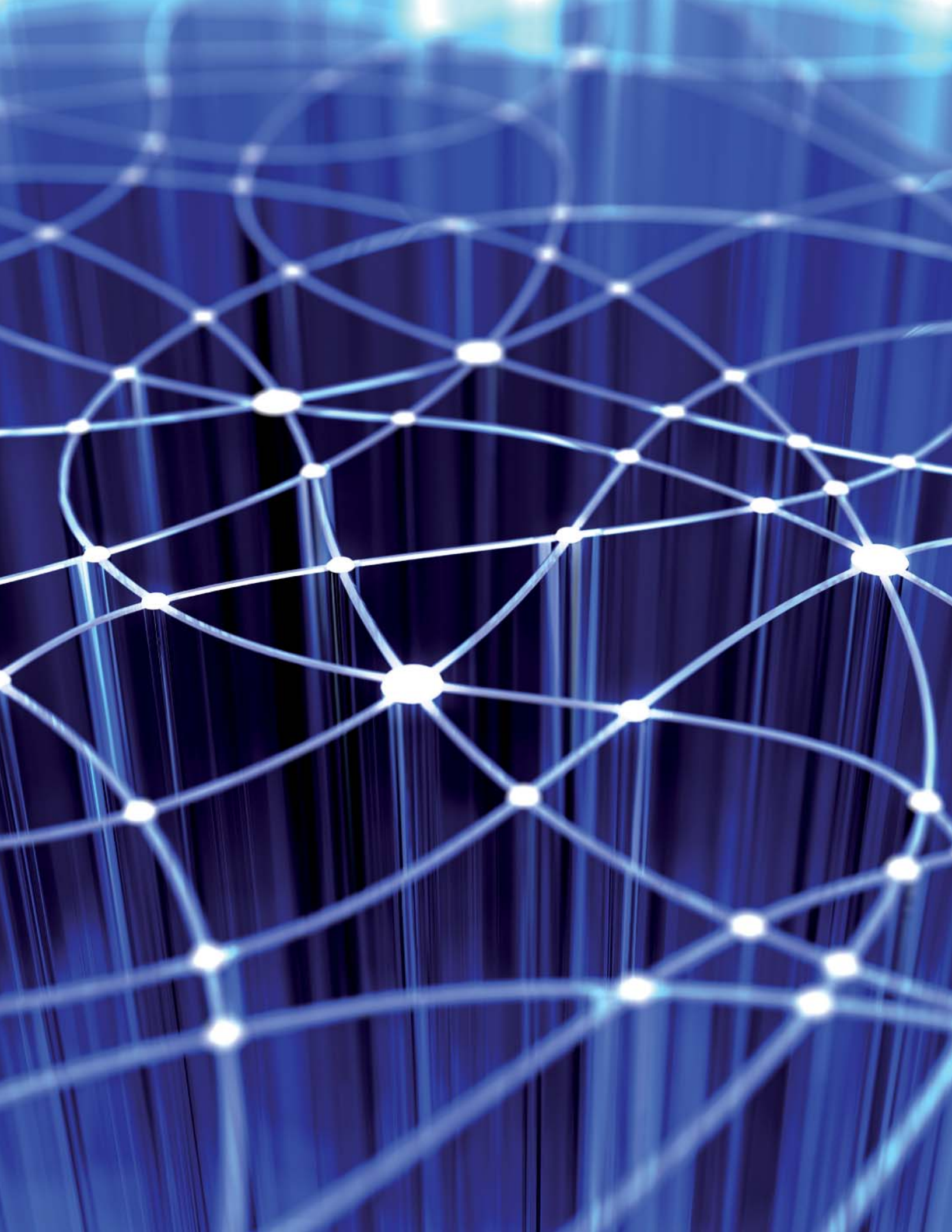
Exhibit 12: While IT is the primary decision maker in central software purchases, various stakeholders are formally consulted in the selection process

Question: *For central software purchases, how involved are each of the following in software-related spend decisions?*

Software purchase influencers
Percent, n = 857

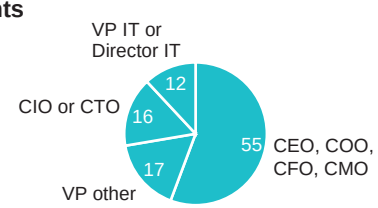


Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008

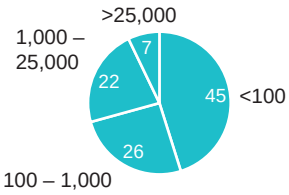


demographics

Respondents by role
Percent

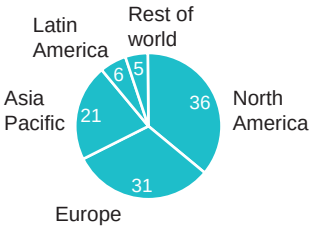


Respondents by company size
Percent

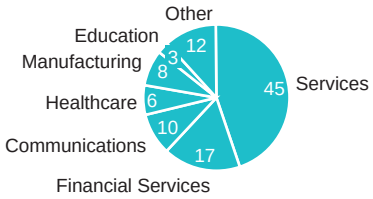


N = 857

Respondents by location
Percent



Respondents by industry
Percent



Source: McKinsey & SandHill Enterprise Software Customer Survey, 2008