



THE *JP* REPORT

ON

MARKET STRATEGY

*A bi-monthly newsletter covering the critical issues for developing great Market Strategies.
Dedicated to Strategic Thinkers everywhere.*

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VALUE MIGRATION

Introduction

In this edition of our newsletter, we introduce the concept of Value Migration and how it can be measured. We take the example of the Enterprise Software industry to make our case on how disruptive business models can have a profound effect on the structure and profitability of an industry.

The objective here is not to advise customers on their purchase decisions nor to examine in detail the specific shortcomings in the business strategies of the vendors mentioned in this article. Our goal is merely to provide a high level perspective of how the market currently views these companies as measured by money flows or more specifically the market cap in relation to its revenues. Having said that, we do intend to examine in greater detail on how the market has viewed the business models of the companies in the Enterprise Software sector over the years in the next issue of our newsletter.

What is Value Migration?

Value Migration is the process of customers shifting their purchases away from products or services generated by outmoded business models to new ones that offer superior value. Examples include value migration from 35 mm cameras to digital cameras and conventional typewriters to word processing. Anticipating value migration threats is an essential aspect of market-driven strategy. These threats could originate from disruptive technologies or an entirely new value proposition such as a new pricing model. In the Enterprise Software sector the Value Migration that is currently underway from the traditional licensing model to the software as a service and open source models is an example how high-speed broadband internet connections and super fast hardware servers have played a key role in making these new business models possible. Combine this with customer dissatisfaction of long lead times and high costs of implementation, maintenance, training and licensing fees, we have the perfect recipe for many customers itching to switch to one of the emerging business models.

How can we measure the impact of Value Migration?

A good metric for measuring the impact of Value Migration is the ratio of future earnings momentum as measured by *Market Value of the company, to the current Revenue*. This ratio can serve as a good measure of the vitality and relevance of the business model adopted by the company. Larger the ratio, greater is the expectation

Biography

Mr. Prakash has over 20 years of experience as an Executive, Management Consultant and a Business Strategist. He is the founder and President of Strategic Focus, a consulting boutique that specializes in advising Computer & Software companies on their business strategies and IT shops on their Software purchase decisions. He has an MBA & MS in Engineering –both degrees from University of California, Berkeley.

Feedback

Please let us know what you think and how we can improve this newsletter. We also invite you to share your company's experience in strategy development.

of investors for the business model to yield significant profit growth. Also, companies with high ratios will experience high value inflows in the form of new customer migration from the competition and larger profits. This migration from companies with older business models towards new propositions and business designs occur because of the latter's superiority in meeting customer priorities which in turn makes profit possible. In some cases, as in Open Source Development Tools, customers are the only beneficiaries of Value Migration because the industry's current business models have not succeeded in recapturing any of that utility in the form of revenues and profits. On the other hand business models focused on Enterprise Software on Demand have been quite successful in siphoning off both customers and profits from traditional vendors such as Oracle and SAP.

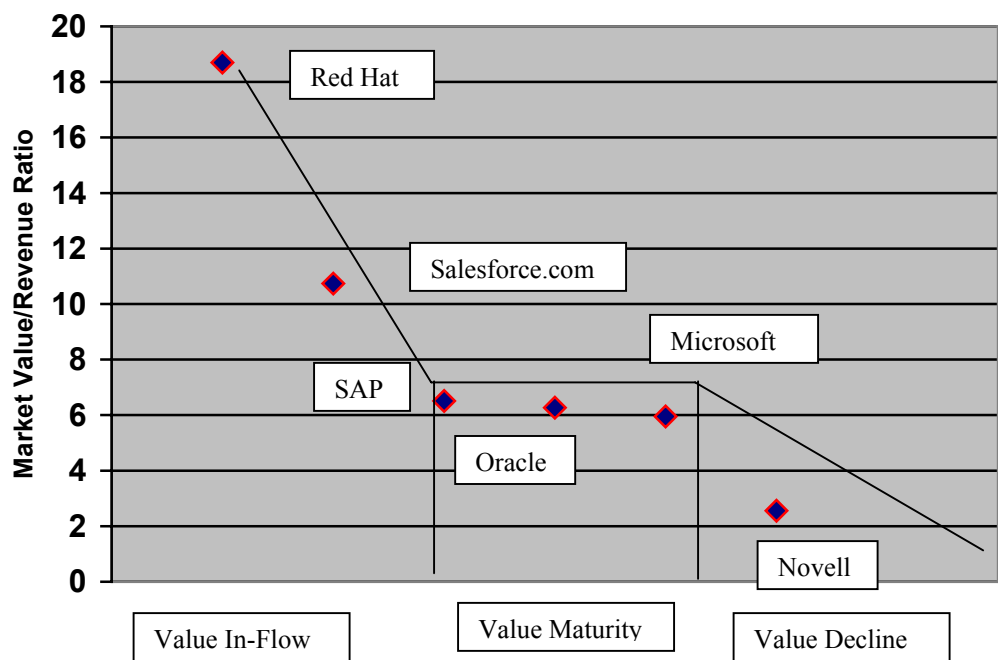
The three stages of Value Migration

There are essentially three stages through which many business models go through with respect to Value Migration.

- **Value Inflow.** In this stage, value starts flowing into the company from competitors and other parts of the industry because the business model proves superior in satisfying customer priorities. Customers and profits migrate from the competition.
- **Value Maturity.** In this stage, the company's business model is well established in the industry and customer migration from the competition has leveled off.
- **Value Decline.** In this stage of the game, the company starts losing customers to competitors with business models that better meet customer priorities.

Figure 1

The Three Stages of Value Migration



Note: Revenues are for FY 2005. Market Value is calculated based on the stock price on 5/15/2006
Source: Strategic Focus

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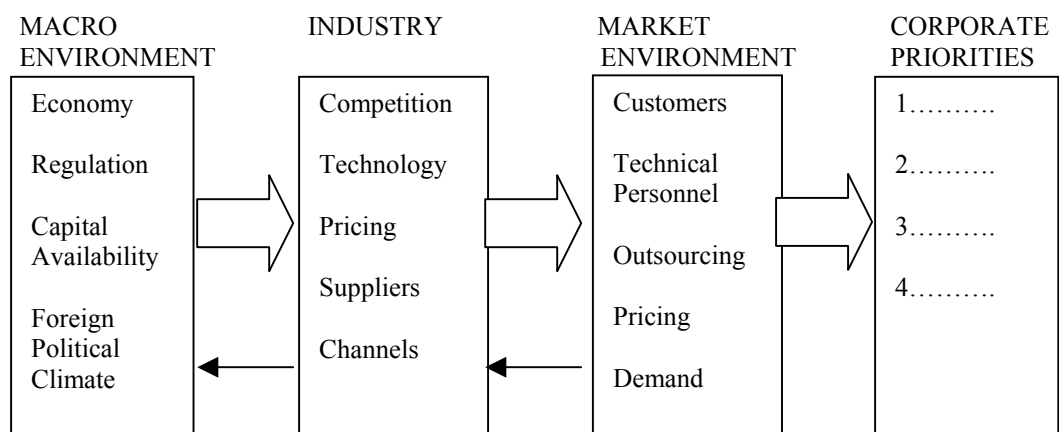
Figure 1 shows the ratio of market value to revenues for some of the major players in the Enterprise Software market. Red Hat, a company employing the Open Source model and Salesforce.com leveraging the Enterprise Software on Demand model are clearly in the Value Inflow stage of Value Migration. The two companies ratios are very high an indication of: (a) investors expectations of future earnings; (2) ability to satisfy customer priorities for reducing costs in the IT infrastructure (Red Hat) and application maintenance, licensing and implementation fees (Salesforce.com).

Microsoft, Oracle and SAP are large software companies with somewhat similar ratios. SAP whose ratio to a certain extent is dependent on the exchange rate between the dollar and the Euro could be considered to be on the cusp of the Value Inflow and Maturity stages as it continues to report healthy growth in its licensing revenues. However, these companies in general are trying to adapt and change their business models to fit the new realities of Software as a Service and Open Source business models. But it is not clear if their business redesigns are radical enough to prevent these companies from going into the Value Decline phase over the next five years. A great example of a radical business redesign is what Lou Gerstner developed at IBM in the 1990's in order to make IBM a viable company again. Digital Equipment Corporation and the current struggles of Sun Microsystems are examples of failure to recognize the need for radically new business models early enough in their life cycle. In the software sector, the strategy of Novell to offer a combination of Open Source and Commercial offerings is clearly not working as it has been in the Value decline phase for many years. Investors' expectations of the company are low and unless there is a radical makeover of its business model, we should expect a continued decline.


Developing a Strategic Understanding of the Customer

In order not to be caught unawares by the migration of customers to competitors with new business models, it is critical to develop a strategic understanding of the Customer. This understanding begins with recognizing that it is not enough to merely capture *customer needs* where most of today's market research is focused on, but developing an in-depth understanding of *customer priorities*. The customer's priorities are influenced by a number of external forces including those of the Economy, Regulations, Technology, Competing Offerings, Commoditization and other factors. These factors are processed through the customer's decision-making model as shown in the figure below.

Figure 2
The Customers Decision Making Model



Source: Strategic Focus



Building a profitable business model is challenging to say the least. If the business model is to succeed, then it is critical to understand the customer's industry and market environment, which in turn provides a better insight into its corporate priorities.