MAKING SENSE OF THE MARKET AND WHAT YOU CAN DO TO REDUCE YOUR RISK!

BY SPENCER ARNESEN AND JEFF THOMPSON

Remember the nursery rhyme, "I know an old lady who swallowed a fly...."? She swallows a spider to catch the fly, then swallows a bird to catch the spider, but, in the end, we don't know why she swallowed the fly. It seems the same thing is going on in the enterprise resource planning (ERP) market as software vendors are getting swallowed up one by one by larger and larger vendors.

The most widely publicized of these mergers has been PeopleSoft's acquisition of J.D. Edwards. This announcement rocked the ERP world. Not only were two of the JBOPS (J.D. Edwards, Baan, Oracle, PeopleSoft, SAP) merging, but Oracle CEO Larry Ellison, in a knee-jerk reaction, announced a hostile takeover bid for PeopleSoft. This created a tremendous amount of press coverage and sent more shock waves throughout the industry.

ERP Merger Mania

But it really just threw a spotlight on the merger mania that has taken hold of the whole software industry the past three or four years. In just the last few months, Epicor Software acquired ROI Systems, Best Software acquired Timberline, and the investment group that owns SSA acquired Baan. Other notable mergers the past couple of years include Great Plains' acquisition of Solomon and then their subsequent acquisition by Microsoft, Microsoft's purchase of Navision, ACCPAC's purchase of SBT, Best's acquisition of Peachtree, and Exact's acquisition of Macola.

These mergers not only impact the software vendors themselves, but, more importantly, they impact the thousands of companies and government entities that depend on this software to run their operations. ERP software is so widely used throughout the world that it has become an indispensable tool for just about every business and industry.

As unbiased software selection consultants, we've been watching these happenings with great interest. Companies both large and small have come to us with questions such as, "What is happening in the market right now?" "Should I be buying new software?" "My software vendor just got acquired. How will that impact upgrades and service and support?"

Let's cut through the marketing spin and discuss some of our observations regarding these ERP software mergers. We'll look at the reasons behind them and how they affect the software products, resellers, and customers. And we'll share what we've seen through our daily evaluation of software vendors and products and provide tips on how to mitigate the risk of buying ERP software in today's uncertain environment.

THE SOFTWARE VENDOR'S PERSPECTIVE

While some mergers seem to make sense, many appear to have no rhyme or reason, which causes great confusion. The best way to understand why these mergers happen is to look at them from the software vendor's perspective. Remember that software companies are businesses that have an obligation to be profitable and are constantly looking to grow and make money for investors. This is one of the main reasons vendors merge. Here's our list of the key drivers behind most software vendor mergers.

1. Growth. Probably the biggest reason software vendors merge is for growth. ERP software was a booming business in the 1990s, and companies grew with little effort. Executives and, more importantly, investors grew to expect astronomical growth and a rapid return on investment. With the economic downturn, software vendors weren't able to realize the growth they were once accustomed to and in many cases had to downsize. Executives realized that the quickest way to grow and satisfy investors was to acquire other vendors. This has fueled a number of mergers during the past few years.

Figure 1: ERP software vendors that have traditionally focused on large companies are moving down to the mid-market, while vendors that have traditionally focused on smaller companies are moving up to the mid-market.

2. Bargain buys. Another result of the downturn in the economy is that software company valuations have dropped significantly, creating a bargain market that stimulates acquisitions. Software vendors are seizing the opportunity to buy up competitors and increase market share at low cost before the market swings up again.

3. Mid-market initiatives. Because the Tier 1 ERP software vendors like SAP, Oracle, and PeopleSoft have saturated the *Fortune* 500 market, they have turned their attention to mid-market companies for continued growth (see Figure 1). But their success at penetrating this market has been difficult because of the total cost of ownership required by the software and because of the difficulty of implementing software that was built for large companies in small and mid-market businesses. Realizing this, many of the Tier 1 vendors are now looking to acquire mid-market software. For example, SAP recently purchased an Israeli software company and entered the U.S. mid-market under new branding called Business One. Oracle has a large stake in the Web-based accounting software NetLedger, also known as Oracle Small Business Suite. These purchases enable the Tier 1 vendors to enter the mid-market with a software package attuned to that market's needs.

On the other hand, vendors that originally focused on small companies are acquiring software products for larger companies. They, too, have had varying success moving to the next level. In 1998, SBT (before they were acquired by ACCPAC) purchased the rights to the PowerCerv product in an attempt to provide a solution for larger mid-market companies (PowerCerv was acquired by ASA International in 2002 and is now called Verticent). The net effect is that almost every software vendor has a focus on selling software to mid-market companies, and many feel their best opportunity is to enter the market through an acquisition.

4. Functional expansion. Software vendors have been increasing their functional capabilities by acquiring other products. Customer relationship management (CRM) is currently the hot functional focus for ERP software products. Although some vendors are developing their own CRM products (i.e., Microsoft CRM), the majority have acquired that functionality from stand-alone CRM software products available on the market. For example, Best Software acquired Saleslogix, Epicor acquired Clientele, J.D. Edwards acquired YOUcentric, and PeopleSoft acquired Vantive. The problem these companies have is the technical integration of the software products. Although marketing literature may say they have a completely integrated product the day after the announcement, the reality is that integration will typically take at least one to two years *if* the software is written in the same technology.

5. International expansion. Software vendors are looking beyond the borders of their home countries to expand into foreign markets. Microsoft's acquisition of Navision enabled them to gain a foothold in Europe. Sage's (U.K.) purchase of State of the Art Software (now called Best Software) enabled them to enter the U.S. market with a well-established, forward-moving company.

6. Vertical industry expansion. Some vendors acquire software that focuses on a particular industry. Best Software has an interesting strategy in this regard. Instead of purchasing software and integrating it into a core product, they have been buying vendors that are strong in a particular market, such as small companies (Peachtree), nonprofit (MIP), and construction (Timberline). Intuit has taken the same tactic through their acquisitions of Master Builder (construction) and American Fundware (nonprofit). These products are completely stand-alone and will be maintained and sold as separate products. This enables Best and Intuit to expand into vertical markets with mature software without having to integrate the products.

7. Increase user base. Some vendors acquire companies with large installed bases on old technology and then gradually phase out support for the old product to convert users to the company's flagship software. This enables the company to gain market share quickly. Great Plains used this strategy when it purchased RealWorld a few years ago. The drawback for the vendor is they have to continue supporting the old product for a few years with no guarantee that the user base will be willing to move to the new system.

8. Competitive positioning. Competition in the ERP world is fierce, with a tremendous amount of market positioning. One strategy companies use to position themselves is to acquire other vendors. They will also buy out other vendors to mitigate the risk of a hostile takeover or to lock up a particular market. Sometimes emotion drives the acquisition, and there's no logical reason or benefit gained from the merger.

9. Financial difficulty. Software vendors also merge when they are in financial hardship. When Solomon was having problems in 2000, management began looking for a buyer and approached Navision. When Great Plains learned of the discussion, it quickly acquired Solomon to increase its own market share. Another example is the Invensys purchase of Baan and its subsequent sale to SSA. When Cedar Software, a U.K.-based ERP vendor, had financial difficulty, it was acquired by investment firm Alchemy in 2002. The acquisition enabled Cedar to regain its financial footing and continue to develop and support its product.

IMPACT ON THE PRODUCT

Remember: ERP software vendor mergers are software *company* mergers, not software *product* mergers. Although there are exceptions, many software vendors

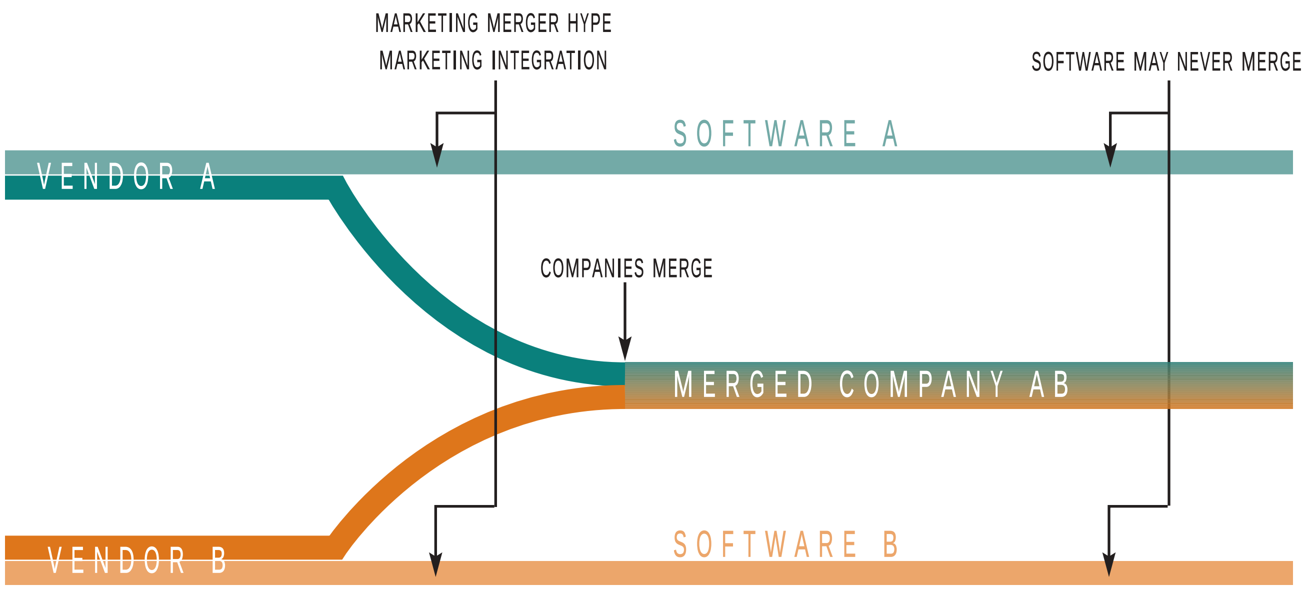

Figure 2: While software companies may merge, the software products do not always integrate (especially when the two products are based on different technologies) despite what the marketing literature may read.

merge with little or no consideration as to how they will integrate the products. It's interesting to watch mergers between vendors who have written products on completely different technologies.

For example, Epicor bought a number of products developed on different technologies than its flagship Microsoft-based solution. In fact, Epicor has never been able to integrate the manufacturing products acquired in its 1998 purchase of Dataworks because these products were based on the Ardent database (the Ardent database technology was bought by Informix and is now owned by IBM). While companies may merge fairly quickly, software products rarely do, but when they do merge, it usually takes a long time for the technical integration to be complete (see Figure 2).

This makes it difficult for software salespeople to explain mergers because they really don't know what will happen to the products they are selling. We attended a J.D. Edwards demo with one of our software selection clients the day after the merger with PeopleSoft was announced. We asked the salesperson what technical advantage the merger would bring to the J.D. Edwards software product. He said the products were a great match because both companies were customer centric. In jest, we suggested they merge with Nordstrom because they are also customer centric. The point is that, in many cases, nobody really knows the future of the acquired product, including the software vendor executives who made the merger.

A good example is Microsoft's acquisitions of Great Plains and Navision. Through these acquisitions, Microsoft became the proud owner of four of the leading mid-market software products: Great Plains, Solomon, Navision, and Axapta. These products were fierce competitors before the merger. Now Microsoft is developing a new ERP product based on the .NET architecture that's scheduled to be released over the next two to three years (see Figure 3). (The first module is Microsoft's new CRM product.) The main question has become: When will the company stop supporting the current products? The answer is that Microsoft doesn't really know what will happen to these products as their strategy is evolving, and there's no specific timeline set for their phaseout. Microsoft touts a free upgrade to the new ERP product if a company is on the maintenance program of one of the four products, but companies will still have to pay for implementation of the new software that may or may not be compatible with their business.

IMPACT ON VALUE-ADDED RESELLERS (VARS)

Many of the mid-market software vendors sell through a distributed value-added reseller (VAR) channel. These VARs sell and implement multiple software products in their local markets. Because of the mergers, the same parent company now owns many competing software products. This has forced VARs to pick up all of the products a software vendor sells in order to have the opportunity to get more sales leads from the vendor. Now, instead of

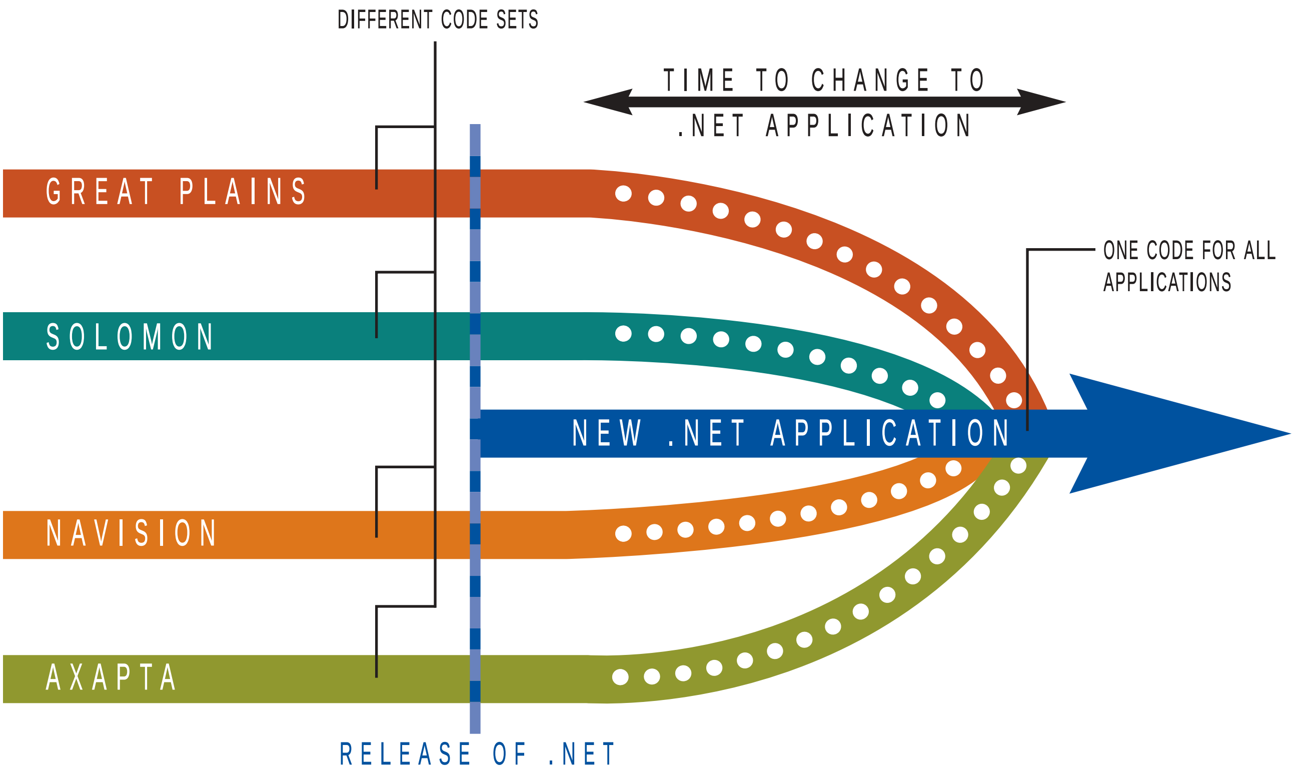

Figure 3: Microsoft's four main products are written in different technologies. The new ERP software is being built from the ground up using the new .NET technology. The question is: How long will Microsoft continue to support the current software products when the new .NET application is released?

competing only against other software products, they also find themselves competing for sales leads against other VARs who are selling the same products.

The net effect is that the VAR sales channel, once dominated by local, small five- to 15-person companies, is consolidating into larger VARs that offer multiple products and are more regional or national in size. This trend has closely followed the consolidation of the software vendors. It has had a direct impact on mid-market companies because the VAR is the first line of support for many ERP products. These changes have not only affected the sales of new software but also the support of the installed base.

HOW TO SURVIVE ERP MERGER MANIA

What impact do these mergers have on your company, and how can you protect your ERP investment? If you are using an ERP software product that is acquired, there isn't much you can do. At this point you'll just have to go along for the ride and hope for the best. In the short term (one to two years), there is typically little impact on the product. The same people will usually continue to run the software development and support of the product for the next few years. After that, it depends on how the executive strategy for the product evolves. Some products will be supported for a few years then eventually be phased out, while other products will continue to see development with upgrades and enhancements. In a worst-case scenario, you can continue to use the software without support from the vendor. Great Plains still has thousands of companies running 1980s' versions of Great Plains Accounting, which hasn't been supported for a number of years.

If you're considering new ERP software, there are some things you can do to mitigate your risk. Software mergers will continue no matter what the software market is like. Software development moves so quickly that there's a continuous flow of up-and-coming vendors entering the market. This makes it impossible to predict what will happen to the product you select over the next few years. But there are some things you can do in the software selection and contract negotiation process to swing the odds of your selected software product's stability and longevity in your favor.

1. Do your homework. As you evaluate software vendors, look at the history of the company and the moves the executives have made in the past. That will give you a good idea about how they will act in the future. Make sure you understand the history and genealogy behind the products you are considering. For example: Was the software developed in-house, or was it acquired from another company? What modules were developed in-house or acquired? Were the technologies of the acquired module compatible with the flagship product? Does the vendor offer other software products that it has integrated or not integrated with the product? A search of press releases on the company's website over the most recent few years will give you some interesting insights into the executive philosophy of that vendor.

2. Look for a large installed base. Look for software products that have a large enough installed base that if the software is sold, it would still be supported because of the maintenance revenues to the acquiring software vendor. There is strength in numbers! Yet don't rule out some of the up-and-coming software vendors with fewer installations. There may be some key functional, technical, and/or pricing advantages worth the risk that the product could be acquired.

3. Beware of old technology. Be wary of ERP software vendors with older technology that might be a takeover candidate for their installed base. The risk that the software will be acquired has to be weighed against the functional benefits of software vendors with older technology. These products are usually very mature and offer functionality that isn't available in the more modern software vendors.

4. Research the vendor's financial information. Always investigate the software vendor's financial information before making a final decision. Poor financial performance over multiple years may make them a takeover candidate. Focus on the ratio of new license sales revenue to maintenance revenue. It will give you a good indication if the company is selling a lot of new software or relying on maintenance from current installations. If the company is private, they will usually let you see their financial information if you have narrowed your field of vendors to one or two choices and their product is a strong candidate.

5. Consider third-party reporting tools. Larger companies may want to consider the use of a separate planning and analytical software package to run reports. Information from the transactional ERP system can be transferred to analysis software, such as a data warehouse or online analytical processing (OLAP) tool, and then it can be reported on. This allows you to maintain an older but functional ERP system that isn't being supported while still having modern reporting capability.

6. Negotiate the contract. Wording in the software license and maintenance contracts can be negotiated to protect you if the software is acquired. Many of our clients have been able to negotiate clauses that state that if the product gets acquired, they will get the upgrade or new software at no cost. Depending on the situation, they are also getting guarantees that the software vendor will support the product for at least five years, refunds if the software doesn't perform, and caps on software maintenance fee increases. You can also negotiate some great software pricing deals right now with the market in so much upheaval.

A BUYER'S MARKET

Just as nobody knew why the little old lady swallowed the fly, it can be difficult to understand why software companies merge. But consolidation in the ERP market that will impact software companies, resellers, and customers will continue for the foreseeable future.

Don't let the mergers and acquisitions scare you away from buying software. The current chaos has created excellent purchasing opportunities. Vendors have been aggressive in their pricing, they are more flexible in their contract terms and conditions, they are offering guarantees, and they are focused on getting referenceable clients. It's definitely an ERP software buyer's market. ■

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