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Minute Warning:

The Demise of the European Software Industry

By **Adam Hale** & **Léo Apotheker**

The differences that foster growth in the software markets, when

comparing North America and Europe, are quite marked. Most of the differences indicate a disparity in business culture and connectivity, executive role and expectation, and attitude towards funding. However, Europe does have a potential to overcome its current obstacles. The authors examine the difference between North America and Europe, and suggest that, if the role models are followed, Europe could see an increase in its number of world-class software organisations in time.

The pattern of peaks and troughs in technology spending experienced around the turn of this century has since 2003 steadied into constant growth for many areas. A fundamental part of this growth has been the shift from 'build to buy' for technology solutions. This has itself stimulated growth for software products and their organisations worldwide. However, within this overall story of growth, one inescapable fact is that North American software firms overwhelmingly dominate the global industry, while European firms have grown less quickly.

The Evidence

There are only 40 European software firms with a revenue of US\$40m+, a statistic that has remained constant since 2002. This contrasts with over 300 software organisations worldwide with revenues of US\$40m+. There are only two European businesses with revenues over US\$1bn, SAP and Misys. Counter-intuitively, Europe's software industry is the least well represented of any market sector in the *FT Global 500*, the breakdown of the world's 500 most valuable companies by market capitalisation (www.ft.com/ft500). There are 14 software and computer services businesses appearing in the list, with only one in Europe - SAP. This contrasts with the 31 banks, 12 oil and gas companies, 14 telecommunications services, five automobiles & parts and even four IT hardware firms in Europe (see Figure 1 below).

Figure 2 'Go Figure'

Only 10-15% of the world's largest software companies are European

- o 4 of the top 20 most valuable firms
- o 40 businesses with US\$40m+ revenue of 300 worldwide
- o Analysts are ignoring the sector

One-way trend of acquisition by US companies

- o Staffware, Merant, London Bridge, Eyretel, Sherwood, Suse Linux, Ixos, Tecnomatix
- o The number is reducing all the time

Large number of companies that stall at US\$15m

The world's 20 most valuable software companies

Company	HQ	Value (US\$bn)
Microsoft	US	282.03
Oracle	US	75.52
SAP	Germany	67.93
EMC	US	31.78
Adobe	US	22.50
Symantec (Veritas)	US	16.69
Computer Associates	US	14.30
Sungard	US	11.80*
Autodesk	US	9.99
Intuit	US	9.53
Fiserv	US	7.50
Citrix	US	7.20
Dassault Systèmes	France	6.15
Verisign	US	5.78
Sage	UK	6.02
Siebel Systems	US	5.61**
Cadence	US	5.11
BMC Software	US	4.66
McAfee	US	3.95
Business Objects	France	3.03

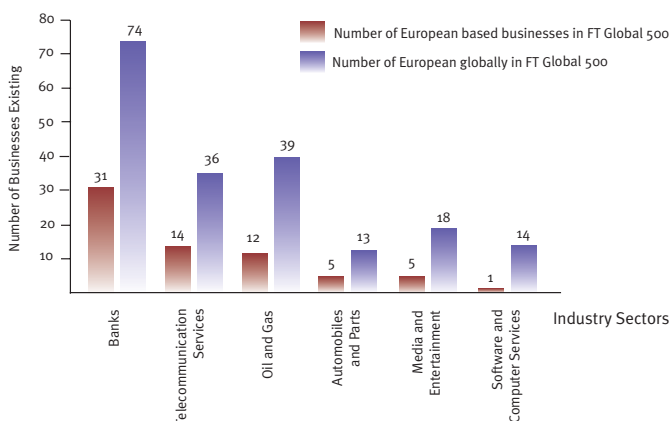
Value: Market capitalisation = number of issued shares x share price (as at 25th April 2006)

* Transition value of public to private

** Market cap on acquisition

Source: Russell Reynolds Associates

Figure 1 'The One and Only'

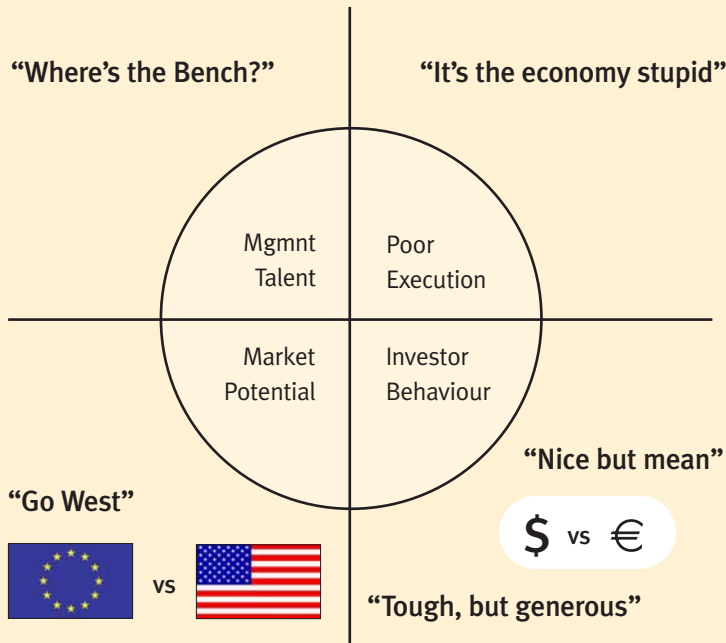


Source: *FT Global 500* 2005

You might expect that the large number of European software SMEs makes up for the lack of really large firms. However, there are only 25 European firms with a revenue of over US\$100m, led by organisations like Dassault Systèmes and Business Objects. Only four of the 20 most valuable software firms worldwide are European,



Figure 3 'Analyse this...'



and the UK sector has one FTSE 100 member, Sage. What is more, the number of medium-sized European firms is decreasing rather than increasing, through acquisition. Very few of the smaller companies are experiencing rapid growth, and really scaling revenue. For every Cramer Systems, Sophos, Trema and Cartesis there are tens of organisations that will not grow beyond US\$15m revenue (see Figure 2). Why? What has gone wrong?

The Reasons

The initial paper on this subject (March 2005) established four primary reasons. A subsequent presentation and panel discussion on the paper raised a fifth, more general issue, namely the lack of an active software community in Europe, where company executives, investors and partners can help each other to be more successful. According to Léo Apotheker, "Networking and mentoring opportunities in Europe are not adequate. The European software market has long been at a global disadvantage, due to the fact that it has been unable to develop and benefit from the same kinds of concentrated nodes of supportive infrastructure enjoyed by US counterparts. And, while the ecosystem point is certainly a valid one, the talent has not concentrated per se in the Valley

but in the USA. This needs to be viewed in conjunction with a greater mobility of skilled people (caused again by the lack of barriers such as a single language), and a culture that is more tolerant to failure in business as long as one learns from it (entrepreneurs). North America also has much better cross-fertilisation between universities and start-up businesses."

Figure 3 illustrates the initial four reasons. Interestingly, only one is the often cited reason for difference in geography and market. The other three reasons are concerned with how the companies are run and funded.

Lack of Management Talent - "Where's the Bench?"

Until 2005 each of the current top 50 software organisations in Europe had a first-time CEO; in 2005 that number reduced to 49. This is frightening and disturbing, as it shows that all but one of the CEOs are performing a role that they have not previously performed. This does not of course mean that these CEOs are not highly capable and successful, but it does indicate that they experience a steep learning curve while on the job rather than having learnt their craft from a previous one. In the USA the situation is very different, since there are a large number of CEOs who are on their second, third or even fourth assignment in that position.

Further, there seems to be a real difference in CEO personal motivation in the USA and Europe. In the USA a partially successful CEO may want to repeat the experience, "and do it better". This is not just about money but also personal ambition and peer pressure, as there are many around him who have chosen to repeat the experience and achieve greater things. In Europe, a different mentality seems to exist. Individuals aim to make themselves and their families financially comfortable, typically with a target of around US\$5 million, "so I don't have to be a CEO again". As they are unlikely to repeat the experience, this can make them less willing to hand over to a more suitable candidate for that stage of business. Europe is therefore not growing a pool of CEOs for the future, and there are too many risks facing first-time CEOs for them not to be as successful as they need.

Case study 1 Business Objects

Bernard Liautaud staked a claim in the USA very early in the company's development, obtaining venture capital from Boston-based Atlas Ventures, French venture capital firm Paribas Technologies and France Telecom's Innovacom unit. The involvement and experience of the US-based venture capitalists was an important early success factor.

Business Objects was built on the Silicon Valley entrepreneurial model, entailing stock options (then unknown in Europe), a goal-driven, fast-moving management style and a repeatable, incentive-based sales model.

When expanding to the USA, Liautaud did not just 'pick up the European operation' and move it to the USA but leveraged top engineering talent in France, and kept product development centred in Paris, where the products were written first in English for the thriving US software market. He located marketing and operations in the USA, where he had access to highly skilled software talents. Liautaud himself ran the US operation and relocated there.

Another key to US Business Objects' success was to build a stronger, more experienced management team and board. The company also hired the best external advisers (e.g. lawyers and auditors) from large, reputable international firms.

As a testament to Business Objects' US success, four short years after incorporation, Liautaud took the firm public in September 1994 on NASDAQ, the world's most famous technology market. As one of that year's most successful IPO's, it set the stage for Business Objects' continued success. Today, Business Objects is a US\$1 billion company, with sights set on becoming one of the world's top ten enterprise software companies.

Bernard Liautaud - Founder & Chairman of the Board, and Chief Strategy Officer, Business Objects

Poor Execution - "It's the Economy, Stupid!"

SAP has succeeded in running the business very effectively. As Léo Apotheker puts it, "it's all about customer centricity and focus. If you do the right thing for your customers, and become their trusted innovator, you will win in the long term. This requires building an environment for co-innovation, as no one is able to invent everything alone, and build partnerships that allow for such co-innovation. This has to be executed by a 'glocal' organisation, which demands scalable operations to expand global reach, while at the same time delivering products and services that are customised to a specific region and industry. My philosophy in this case provides global boundaries and expectations that are then managed through local, empowered leaders. At SAP, different regions are encouraged to develop different approaches to customer engagement. If they are successful, they are syndicated globally as a best-practice."

Enterprise software firms experiencing rapid growth over the past five years have used the system integrators and consultancies extremely effectively to grow business quickly. They focus on the company 'economy' including their partners' revenue rather than purely their own.

Finally, there is sales execution. As any software company leader will tell you, "new licence revenue solves most problems". Growing software companies with real ambition have the lights burning until nearly midnight on the last day of the quarter, with all the senior executives milling around hot fax machines clutching sweaty BlackBerry® devices. They have the mentality of winning, and of rewarding winners through healthy competition, incentives, and uncapped bonuses. However, customers are part of the equation. Léo Apotheker adds, "A more risk-friendly culture exists not only in start-up companies, but also from the buyers' side. US buyers are willing to take a risk when buying new technology, more so than Europeans."



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Case study 2 | SAP

In 1988, SAP formally entered the US market with an operation in Philadelphia. Just three years later, we expanded to open our first US branch in Redwood City, California. Our early years required much time and effort to be spent on adjusting our sale and distribution to the US customer base. We knew expansion in the US was critical - if we were not successful there, we would not be the global leader in our business. I believe that our success came, and still comes, from our unique capability that helped us create a SAP (US) culture, a hybrid composition of the best of America and Europe.

As we grew in the USA, we were constantly adjusting to the market. In the very early years, we brought leadership from Germany: managers knowing the product and technology to drive the region. We constantly adjusted our leadership talent in line with the then needs of the region.

We had a unique combination of European and American cultures; SAP's great product and engineering, paired with great American sales and marketing know-how, helped us create a global process and deploy it locally. We are an American company in the USA, a German company in Germany and a Japanese company in Japan, yet we are uniquely SAP everywhere.

Léo Apotheker - President Customer Solutions and Operations, SAP AG

Market Potential - "Go West"

There is no escaping the fact that the USA is a huge market. The requirements there for software solutions are also more uniform than in Europe. Breaking into different markets in Europe typically requires at least one person with native language skills for each country, and it can be a difficult and slow process. Employment laws also favour the employee, and can be the opposite of 'employment at will', meaning that mistakes in hiring can be extremely costly and time-consuming. It can cost 2-3 times annual salary to remove a manager in France or Germany.

In many ways, it can be more successful for European organisations to make the USA the second market after their home one, rather than other European countries. This means a real investment in building the US business before reaching 'critical mass' in Europe. One of Europe's best success stories in how to do this is Business Objects. From the very beginning, Bernard Lietaud had a clear vision for Business Objects to succeed in the USA.

Difference in Investor Behaviour - "Big and Seldom not, Little and Often"

In the same way that the software market in Europe is less advanced than in the USA, so is the venture capital (VC) industry. There are fewer second/third time funds, and fewer investors with large-scale operational experience. This can lead to:

- o Reduced willingness to change the founder when necessary
- o Piecemeal funding. US investors are more willing to fund a company for longer at an earlier stage, giving it time and finance to develop a major product. In Europe, the practice seems to be one of drip-feeding capital over several rounds. This practice can bring a more short term attitude to the company, forcing them into generating revenue early outside the core product

As one of the leading software investors in Europe points out, "it is the fact that we have limited confidence in the management team, the execution and the addressable market that we fund businesses in smaller tranches." This is a vicious cycle.

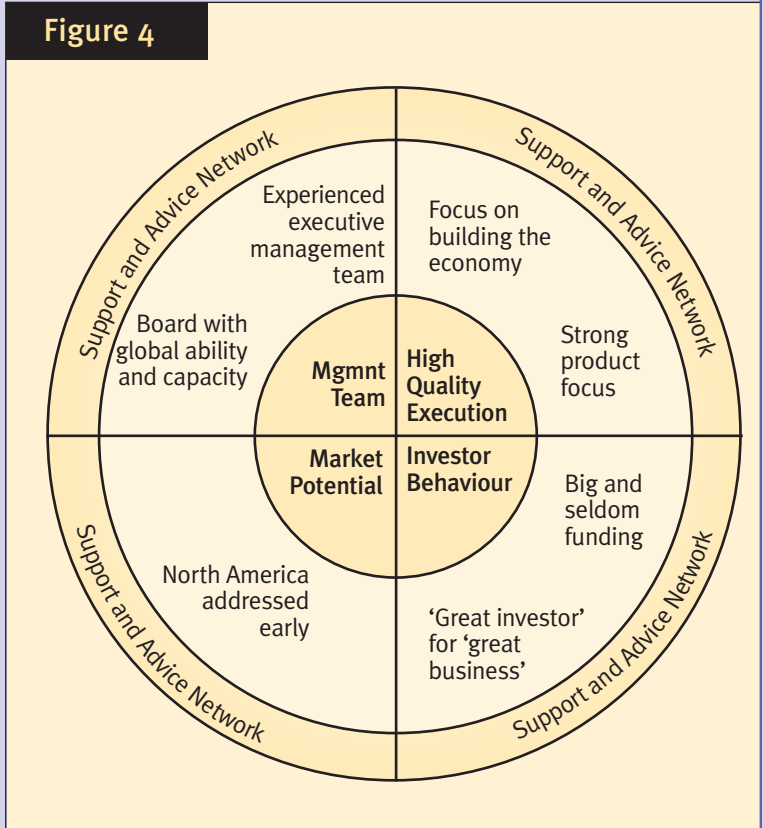
Of course, it is tricky, and happens in the minority of cases, but it is absolutely "Mission Possible". SAP, Business Objects, Dassault Systèmes, Misys, Sage have all proved that major software businesses can be built from starting in Europe

Another investor points out, from an overall perspective, that “the open question is whether European Technology Venture is an attractive asset class, as opposed to US Technology Venture or European Technology Buyouts. Historical performance of it as an asset class does not make it as attractive.”

Tricky, but Definitely - “Mission Possible”

In the light of the facts, Europe is never going to lead the global software industry. However, it can certainly play a bigger role than it currently does. With the emerging strength of new competition from Asia, particularly China, the industry will need to perform substantially better to compete globally. It is hoped that some of the issues outlined here can and will be addressed by software companies and by investors, and that perhaps 70 or 80 of the world's largest 300 software firms will be European from the 40 today.

It is absolutely possible to build a world-class software company from a European base. Successful organisations have addressed all the issues in the paper, often performing the mirror image of the models mentioned to become successful. Figure 4 shows how a small number of businesses are making this currently happen. Of course, it is tricky, and happens in the minority of cases, but it is absolutely ‘Mission Possible’. SAP, Business Objects, Dassault Systèmes, Misys and Sage have all proved that major software businesses can be built from starting in Europe. You could be building the next one.



Thoughts for this article have been accumulated over discussions with many representatives from European and North American software companies and Investors. *The Demise of the European Software Industry* was initially published in association with the Prince's Trust Technology Leadership Group in March 2005.

Léo is, as President of Global Customer Solutions and Operations and a member of the Executive Board, SAP AG, responsible for all of SAP's field organisations, including consulting, education, training, sales, marketing SMB and operations. He was appointed to his current position in 2002. Prior to that he was President of SAP EMEA. German-born and fluent in five languages, Léo holds a BA degree in International Relations and Economics from the Hebrew University in Jerusalem. Léo is also a member of the Supervisory Board for AXA, as well as a member of the Board of Enigma, Inc and the British Telecom European Advisory Board



He can be contacted at leo.apotheke@sap.com



Adam leads the European technology business for Russell Reynolds Associates (RRA) and is based in the UK. Adam has been responsible for more than 300 executive search projects for software/services companies since 1997. Prior to executive search, he spent 10 years with Accenture running large system integration projects and outsourcing arrangements. He has a BSc in Computer Science from the University of Bristol, UK.

He can be contacted at ahale@russellreynolds.com