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The Demise of the European Software Industry

“Two Minute Warning”

by Adam Hale, March 2005

Foreword and Acknowledgements

As a European working in the Global Technology industry this is an area that I feel passionately about. In my executive search role during the last eight years, I have been lucky to work with more than 200 software businesses across the world ranging from million dollar start-ups in Europe to $10bn+ global leaders. As I worked with more and more of these organisations, it started to strike me that there was a clear difference in success between the European-based industry and the North American-based industry. During the past year or so this has turned from thoughts and jottings into this paper. I am grateful to a huge number of industry leaders who have been very helpful in assisting me shape and communicate the ideas in the paper. Particular thanks go to (in alphabetical order) Steve Allen at Witness Systems, Leo Apotheker at SAP, Phil Bousfield at Portwise, Maurizio Carli at Business Objects, David Carratt at Kennet Venture Partners, Simon Clark at Fidelity Ventures, Michael Chalfen at Apax Partners, Jerry Crook, Guy Dubois at Peoplesoft/Oracle, Stephen Duckett at Favonius Ventures, Nick Discombe at Witness Systems, Chris Gale at Clearswift, Steve Garnett at Salesforce.com, Stephen Kelly at Chordiant, Nick Kingsbury at 3i, Dilip Mistry at Microsoft, Jesper Nielsen at Cazenove, John O'Connell at Tibco, Alex Ott at Cross Continental Ventures, Tim Robinson at Thales, Mike Shinya and Paul Stobart at Sage. In addition, particular thanks to Dave Embleton and all of the Cramer Systems executives and founders for being a case study. Apologies if I have left anyone out!

I am delighted to be rolling this paper out as part of the Prince's Trust and Technology Leadership Group (TLG) initiatives. This is a group who do fabulous work. I feel proud to be part of an industry and a group that has done so much to help the disadvantaged of the UK. From the TLG Richard Holway and James Bennet have given me huge assistance, Richard from his unique knowledge and viewpoint on the industry and James in terms of how to manage and run the event. Many people at the Prince's Trust have also helped; particular thanks go to Julian Barrell, Helen Parker and Cathy Brannon. It would also not have been possible to produce this paper without the support and assistance of colleagues at Russell Reynolds Associates particularly Rae Sedel, Kai Hammerich, David Mills, David Crawford, Thomas Becker, Christine van den Broeck, Neha Rajdev, Alyson Nolan and Cyndi Keane.

I hope that you find this paper interesting and thought provoking. It is deliberately written to be controversial and may exaggerate to make its points. The paper itself is not a solution to the problem, however if it can serve as a trigger and a catalyst for further industry change, then that would be a good thing.

I feel privileged to be part of a panel with such distinguished and accomplished speakers; final thanks go to Leo Apotheker of SAP, Jon Craton of Cramer Systems, Mitchell Kertzman of Hummer Winblad, Bernard Liautaud of Business Objects and Paul Walker of Sage for their participation and support of this initiative.

About the Author, Adam Hale

Thoughts for this document have been accumulated over discussions with executives of European and US software companies and Investors. Adam Hale leads the European technology sector for Russell Reynolds Associates and is based in the UK. Russell Reynolds Associates is the leading technology executive search firm in Europe. Adam has been responsible for more than 200 executive search projects for software/services companies since 1997. He is proud to be part of the Prince's Trust Technology Leadership Group (TLG), raising money from the Technology sector for deserving young individuals in the UK. 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.

The Demise of the European Software Industry

"Two Minute Warning"

Introduction

There was a huge increase in technology spending up to and including 2001, followed by a severe downturn. Growth returned in many areas in 2003/4. A fundamental part of the overall increase in technology spending has been the shift from "build to buy" for technology solutions. This has fuelled the growth of software products and their organisations. Many software firms worldwide have "scaled" very rapidly even despite the downturn. However, within this overall story of growth, one inescapable fact is that enterprise software firms based in Europe have expanded more slowly than those headquartered in the US. What are the reasons that the European software industry has failed to scale in this way? This paper examines those reasons.

The Evidence — "Go Figure"

There were only 40 European based software firms with a revenue of $40m or more in 2002. Recent figures are harder to come by as analyst organisations have stopped putting together specific analysis of the European software organisations, a depressing commentary in itself. Manual review of the Software 500 (www.softwaremag.com) suggests that the current number is closer to 30. This contrasts with over 300 software organisations worldwide with revenue of $40m+. A simple glance down the Software 500 demonstrates quickly that there are few organisations based in Europe. A quick review of the European based organisations reveals that there are only two with revenues of more than $1bn, SAP and Misys, and fewer than 20 with a revenue of over $100m. SAP is out on its own by a long way in terms of revenue, its revenue is equal to the total of around the next 15 largest European businesses combined. SAP has a market capitalisation of around $50bn, the next most valuable companies are Dassault Systemes and Sage at around $5bn. They are the only representatives of the 20 most valuable software firms worldwide. Sage is also the only software/services member of the FTSE 100. As if this were not bad enough, the number is decreasing rather than increasing. Recently Staffware, Merant, London Bridge, Eyretel, Sherwood International, Suse Linux and Ixos were all acquired by US based companies. There are also a very small number of smaller companies succeeding in growing rapidly and really scaling revenue. For every Cramer Systems, Sophos, Microfocus and Curam Software there are tens of organisations that will not grow beyond $15m revenue. This is illustrated in Exhibit A. Why is this? What has gone wrong?

Exhibit A: "Go Figure"

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

- 3 of the top 20 most valuable firms
- 30 businesses with $40m revenue of 300 worldwide
- Analysts are ignoring the sector

One way trend of acquisition by US companies

- Staffware, Merant, London Bridge, Eyretel, Sherwood, Suse Linux, Ixos
- The number is reducing all the time
- Large number of companies that stall at $15m

(Exhibit A: continued)

Company	HQ	Value ($)*
Microsoft	US	$274.6bn
Oracle	US	$66.3bn
SAP	Germany	$49.2bn
EMC	US	$30.4bn
Symantec	US	$15.7bn
Computer Associates	US	$15.7bn
Adobe	US	$15bn
Veritas	US	$10.2bn
Intuit	US	$7.5bn
Sungard	US	$7.4bn
Fiserv	US	$7.2bn
Autodesk	US	$6.7bn
Dassault Systemes	France	$5.3bn
Sage	UK	$4.9bn
Siebel Systems	US	$4.4bn
McAfee	US	$3.9bn
Citrix	US	$3.6bn
Cadence	US	$3.6bn

*Value- Market Capitalisation = Number of shares x share price in U.S. dollars. As of 23rd February 2005.

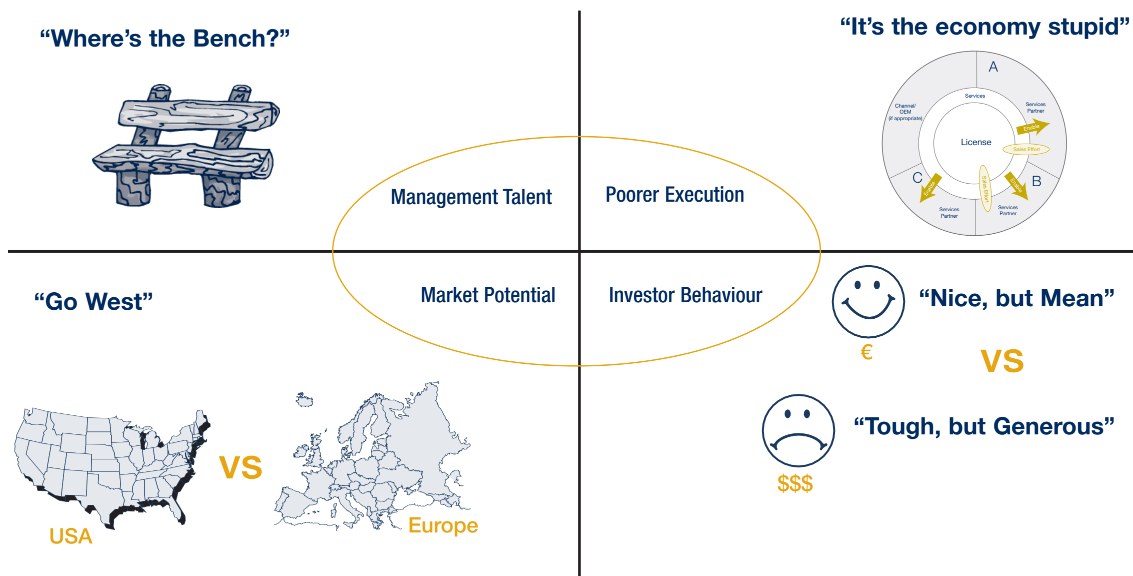
The Reasons — "Analyse This"

This paper suggests that there are four primary reasons, shown in Exhibit B. Interestingly, only one is the often cited reason of difference in geography and market. The other three reasons are concerned with how the companies are run and funded. They are………..

- **Lack of Management Talent — "Where's the Bench":** As the majority of people who work for software companies in Europe work for US based firms, there simply is not the depth of talent available to take corporate leadership roles in European companies.
- **Poorer Execution — "It's the Economy Stupid":** There is not the clarity of execution in terms of maintaining a consistent product and balancing product and services revenue. Successful companies also manage the overall "economy" around their business, taking into account the partners, alliances and distributors that they work with. There is typically also not the commitment and will to make new license sales happen. Even with a recurring or perpetual model versus the traditional initial license model, a passionate and single-minded focus on new clients and expansion is critical.
- **Market potential — "Go West":** The US is a huge, relatively homogeneous market. It is much more likely that a client solution can stretch from Tulsa to Trenton than a solution can stretch from Torino to Trondheim. Many European organisations have tried and failed to get wide-scale adoption across the European countries. Going to the US as the first market outside the home one can be more effective.
- **Difference in Investor Behaviour — "Big and Seldom not Little and Often":** US investors are also more willing to fund a company for longer initially, giving it time to develop a major product, rather than drip feeding capital as in Europe. In general, we also see more tolerance of the founder in Europe, coupled with a reduced willingness for the founder to hand over.

These reasons are examined in more depth below. Clearly there are exceptions to all of the assertions made in this paper, however in aggregate the evidence throughout the industry seems to support the assertions.

Exhibit B: “Analyse This...”

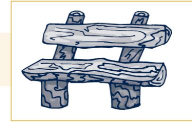


Lack of Management Talent — “Where’s the Bench?”

Every single one of the top 50 software organisations in Europe today has a first time CEO, from Henning Kagermann downwards. This is a frightening and disturbing fact. As a result, every single person leading each of the businesses is performing a role that they have not previously performed. This of course does not mean that they are not highly capable and successful CEOs. However it does mean that there is a steep learning curve and that they may learn on this job rather than learning on the previous one. This of course ripples down the organisation in that Heads of Sales, CFOs, Heads of Marketing, VP Engineering etc. are often performing a role for the first time. The situation in the US is very different - there are a large number of CEOs who are on their second, third or even fourth assignment in that position. All of the European investors are frustrated by the lack of experienced CEOs for technology businesses. The lack of experience contributes to investing behaviour, as covered later. There are a significant number of very talented executives in the software industry who have always chosen to work for US firms in leading roles and have turned down a number of CEO roles here. When I talk to them about this, the prevailing reason is that they want to work for “great companies”, and that the companies they saw in Europe were limited in their ambition, management and scale. Great people want to work for great companies and Europe needs to grow great companies more to shift this balance. I have talked to many executives, slightly tongue-in-cheek about their “duty to Europe” to run a company here. Those that have done it successfully will never go back to being Head of Europe.

Also, with CEOs there seems to be a real difference in personal motivation between the US and Europe. In the US a CEO who is partially successful may want to repeat the experience, “and do it better”. This does not just relate to money, it also relates to personal ambition and peer pressure, in that there are many people around them who have chosen to repeat the experience and achieve greater things. From a financial perspective if they have made $1 million, they want to make $5 million, if they have made $5 million, they want $10 million, $10 million, then $20 million, etc. In Europe a different mentality seems to exist. Individuals aim to make themselves and their families financially comfortable, typically with a target of around $5 million. In many cases successful CEOs are not willing to take on the effort, strain and risk of doing it again, aiming to realise enough wealth “so I don’t have to be a CEO again”. When they have done this they are more likely to continue in the role, become Chairman or seek other Non-Executive roles. 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. With unsuccessful CEOs, failure or relative failure is less tolerated and an unsuccessful CEO may not get another chance in Europe.

Exhibit C: Where’s the Bench?



There is a major talent shortfall

- First time CEOs in every major software company
- Similar situation for VP Sales, Engineering, CFO etc.
- Great people work for great companies

Huge gulf from being Head of Europe to being a CEO

- “Order of magnitude increase in decision making”

Real difference in CEO motivation

- “Do it again — better” vs. “successful enough to avoid doing it again”

There is also a huge gulf in skills between being a Head of Europe for a US software company and being a CEO. The gulf in these roles is not always understood. Many people who have made the jump describe an ‘order of magnitude increase in decision-making’ from being a Head of Europe. Decisions need to be taken in a much wider set of areas: many first time CEOs when they step back after their first role wish that they had spent more time with a long list of areas that they had not previously worried about:

- Board/ Corporate Governance
- Shareholders
- Balance Sheet/ Capital
- Product Strategy
- Product Road Map
- Finance
- Corporate Marketing
- Bringing all the functions (and executives) together successfully

They may never get another chance.

The vast majority of decision making for Heads of Europe of US companies is concerned with sales and service. It can be argued that there is not a single P&L management role in Europe for any US software firm as the product strategy and development is almost exclusively delivered in the US. Europe is not growing a pool of CEOs for the future, and there are too many risks that first-time CEOs will not be as successful as they need to be.

Poorer Execution —“It’s the Economy Stupid”

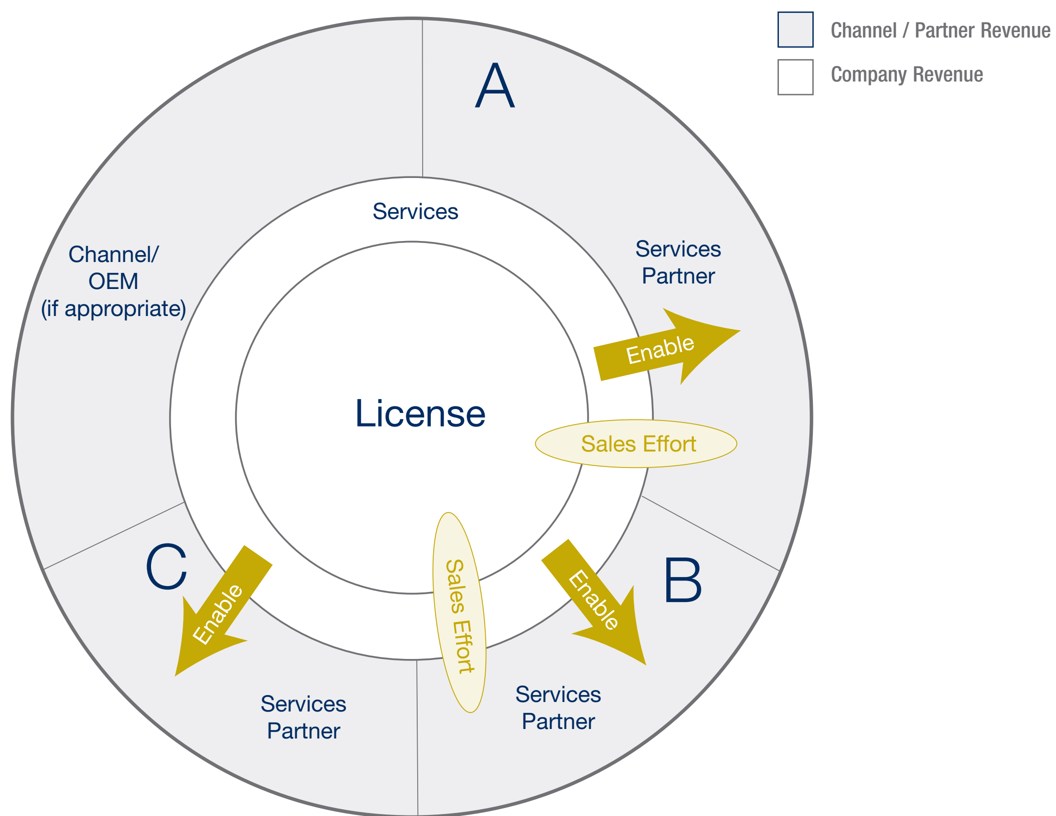
Software businesses that have scaled particularly rapidly have a very close focus on the product, partnering strategy, and sales execution. For example, it is imperative to keep the product consistent and as standard as possible without being diverted into multiple custom versions for different clients. Successful firms are disciplined with their clients, they are clear about the core version of the product, and also focus on clients upgrading to the most current version while remaining on a support contract. Multiple instances of the product can constrain growth in many ways:

- Management distraction to different client solutions
- Support burden that quickly becomes unsustainable (and unprofitable!)
- Ineffective Engineering function as they struggle to maintain multiple versions

Sometimes the most valuable function that the CEO, VP Sales, VP Engineering or Board Member can perform is to say “No” to a client request to modify, saying “yes” may have some immediate upside but could halt the company in the longer term.

Enterprise software firms that have grown rapidly over the past five years have also 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 (see Exhibit D). This means taking initial potential client opportunities to Services partners (i.e. Tier 1 players IBM Global Services, Accenture, CG ; Tier 2 players LogicaCMG, Axon, WM Data). Once the first projects have been completed, these organisations will start to build a practice of skills internally, and in time will bring opportunities back the other way. Successful organisations also aim for at least 60% of total revenue to be software license rather than any kind of services. This is not 'letting our partners take our revenue' as a major UK software company quoted unhelpfully recently, it is a way of ensuring that projects succeed and that the business can scale quickly. A good example of this is Siebel Systems, which reached $1bn in revenue faster that any other enterprise software firm, before being hit by a downturn in the CRM market. One proof point regarding the success of partnerships and alliances is the ability of software companies to charge partners merely to be part of the programme. Charges are used for practice enablement and training. We know of only one software company based in Europe that has been able to do this, against a significant number in the US.

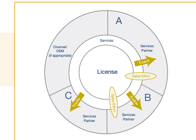
Exhibit D: The Software Company "Economy"



An entrenched culture which fits the home market can prevent "going global". One European based software CEO's view is "European companies continue to keep their leadership, culture, processes and practices right up until they reach the home market plateau stage. The transformation challenge of going global is now accompanied by a business turnaround challenge with an entrenched culture and mindset. This can be fatal".

Another European CEO notes, "European companies often focus too narrowly on their own P&L in any time period. Building the overall economy facilitates growth massively, builds credibility, can shorten and control the sales cycle and cost of sale".

Exhibit E: Poorer Execution



Successful companies maximise their "economy"

- Clear focus on their product
- Enable success of their partners

Growing product revenue should be the core business focus

- Professional sales leadership is critical
- Remember Oracle...?

Finally, sales execution. As any software company leader worth their salt will tell you "new license revenue solves most problems": Professional services, customer services and product development are all critical factors in building enduring success, but without new licenses being sold the company will not prosper. 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 a hot fax machine. They have the mentality of winning, and of rewarding winners through healthy competition, incentives, President's club. A bonus should not be capped, as it will remove the incentive to keep achieving. Too many organisations have a primarily product engineering focus, assuming that a superior product will guarantee success. When Oracle conquered the database market 10 years ago, its edge was the ambition, commitment and ability of the sales force. The edge was definitely not the fact that the product solved the management of distributed data (I'm not sure it did anyway).

Market Potential – "Go West"

There is no getting away from the fact that the US is a huge market. The requirements there for software solutions are also more uniform than in Europe. The industry is littered with examples of US software organisations that have 3-4 competitors only in the whole country, and could have 3-4 in each country in Europe. Breaking into different markets in Europe typically requires at least 1 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. Ideally when building countries the order should be "clients before operations" in a particular country, as "operations before clients" can drain cash rapidly.

In many ways, it can be more successful for European organisations to make the US 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. This can be managed from the existing HQ in Europe (e.g. SAP, Sage), or by moving the HQ to the US and keeping development in Europe (e.g. Business Objects, MicroMuse). SAP have always kept a European HQ, with senior European and American executives based in the US. With Business Objects, the CEO /Founder Bernard Liautaud relocated to California and ran the business from there. MicroMuse recruited US based CEOs, having sent over very senior executives to build the presence there. Sage have build their US business using major acquisitions as well as through organic growth. It takes a great deal perseverance, skill, understanding and partnerships to get a US operation successfully off the ground. Hard though it may be, there is no alternative if a serious company is to be built.

One danger in US expansion is building dual HQs on both sides of the Atlantic. This happens particularly where a European company brings on board a US based CEO in order to lead the expansion there. Quickly the CEO may hire a US based CFO, CMO and others and soon there are two corporate HQs, two directions and a great deal of costly confusion and bad feeling. This has led to the demise, and subsequent acquisition or liquidation of a number of promising European businesses.

Leading US staff from Europe also has its challenges. A frustration that European based CEOs of many software companies report is "the near impossibility of US employees taking direction and management from a European HQ". This can occur all the way through from product direction, marketing strategy, sales management through

to alliances and partnering. CEOs, CMOs and VP Sales from European companies regularly report that they have to “break down tasks into seriously small units” in order to manage them effectively. European companies expanding in the US have found that it is very helpful for their US staff and executives to have some ‘affinity’ with Europe, this could come from working with a European company previously, family background or travel.

Difference in Investor Behaviour – “Big and Seldom not Little and Often”

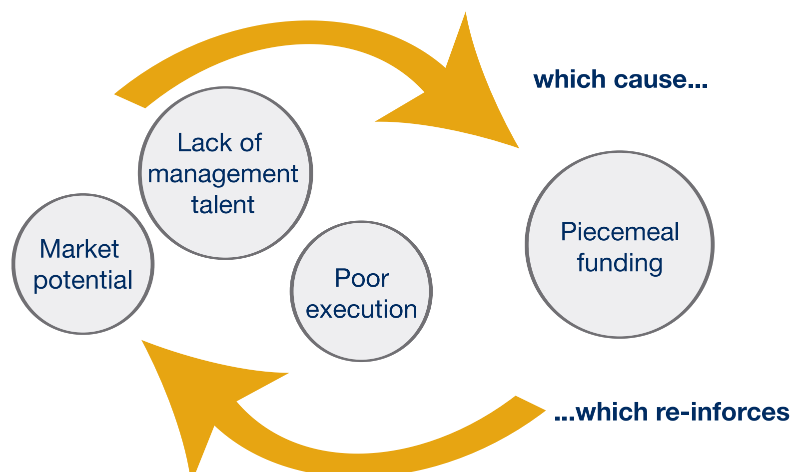
In the same way that the Software market in Europe is less advanced than the US, so is the venture capital industry. There are fewer examples of second and third time funds who have successfully helped companies to expand significantly. Several of the top level US firms have also not opened offices in Europe. Also reflecting the market, there are fewer people in VC with real experience of growing and managing software companies, whether it be as CEO, CTO or VP Sales. This leads to several outcomes which can hinder the growth of companies:

- Reduced willingness to change the founder. There are two factors here. Firstly, CEO founders are keener to stay on and to make the company “their one big shot”. As described in Lack of Management Talent, they are more unlikely to be a CEO again. Secondly, investors are less likely to force the issue of a change of CEO.
- Mixed messages. Communication to the founder CEO, even when a change of CEO is made is unclear in many situations. One founder CEO - when advised by their board and investors to bring in a CEO - was asked how he would feel working for the new CEO, his response was “I didn't think that I would report to the CEO, he would be more of a peer”. Wrong Answer. There are many examples of technical founders who constantly undermine a new CEO and are continually supported by the board in order to keep them in the organisation.
- Piecemeal funding. “Nice, but Mean” versus “Tough, but Generous” — US investors are also 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 through essentially consulting projects and implementations of “custom” products. These can be terminal inhibitors to later growth of the revenue as support of multiple versions constrains the growth.

However it is not easy to change this situation. 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, illustrated in Exhibit F.

Another investor points out the issues from an overall perspective “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”.

Exhibit F: Investment “Vicious Circle”



Changing the Situation – "It's Groundhog Day…again"

Let's face it, Europe is never going to lead the global software industry. However, it can certainly play a bigger role than it currently does. We live in the hope that some of the issues outlined here can and will be addressed by software companies and by investors, and that perhaps 50 or 60 of the world's largest 300 software firms will be European from the 30 today.

However, the story is not all doom and gloom. It is absolutely possible to build a world class software company from a European base. There are some significant success stories of European software companies that have succeeded in building and growing rapidly to become genuine global leaders of their markets. While many companies aim to be the next SAP, Sage or Business Objects, those companies are so big and successful it is difficult for earlier stage companies to relate to them.

The Cramer Systems Story

One good example of an earlier stage business is Cramer Systems (www.cramer.com), a UK based provider of large-scale enterprise software solutions to telecommunications operators. Founded in 1997, the latest year's revenue increased over 75% to be over $70m, with the majority coming from product license revenue. Revenue is growing sharply, targets are being over achieved, great people are joining the business and the economy around the business is already worth over $300m.

Cramer have addressed all four areas that normally hold companies back. Examples of what they have done as an organisation in each area are shown in Exhibit G. Clearly not everything has gone right or has worked first time, although overall there have been far more successes than failures.

Exhibit G: The Cramer Story – What's Gone Right?

Management Potential

- Ambition, mentality to hire great people
- Built professional sales leadership
- Hunger/ motivation/ ambition

Market Potential

- 20 year vision and view
- Clarity and focus
- US built, for the third time

Top Quality Execution

- Inital focus on a product
- High quality design and ability to scale
- Cramer revenue now over $70m, "economy" $300m+
- Top quality rewards for top quality people

Investor Behaviour

- Major investment tranches to fund expansion and development
- Two investing institutions, one board member in the US
- Share options for the receptionist

Management Talent

The four founders of the business (Jon CRAton, Mark FarMER, Dave Embleton and Don Gibson) always had the ambition to being great people into the company, even when it meant giving up more senior roles to those people. The business was founded on a great product and technical strength, so they focused on bringing in a CEO with very strong sales and marketing leadership skills. World class executives have also been hired to run Sales, Marketing, Finance and Alliances.

Without exception, all the managers of Cramer have the desire and ambition for the company to grow to be a very significant business in the coming years. As the company grows it will continue to add world class talent to both the executive and non-executive teams.

High Quality Execution

Cramer was founded with a focus on building a scalable product, that required significantly less maintenance and support than comparable products, due to the robust design and development techniques. This 'get it right first time' approach has enabled the business to grow rapidly, without being constrained by support and maintenance problems and resource requirements.

There is also a major Cramer economy "with a clear focus on the ecosystem", with partners such as Accenture, HP, IBM and LogicaCMG building major practices around Cramer implementations. Cramer charge accreditation fees for organisations to be partners, the charges go to training, practice building and accreditations within those partners. Relationships with other software organisations are also acknowledged as highly important, for example there is a strong partnership with SAP around telecoms solutions. All these relationships are structured as win-win arrangements, recognising that all firms need to be successful for the relationship to work.

Market Potential

Cramer have been successful at winning flagship engagements with Telcos in EMEA, Asia Pacific and North America. Their goal as a business is to have 50% of revenue in the Americas, 35% in EMEA and 15% Asia/Pacific. This will require significant expansion of the Americas, over and above the company's significant rate of growth. Cramer have addressed the North American market with some success to date, however it was not expanding as much as it needed to. The team was changed, in 2004 the company brought on board a very strong team there to build the business. Success in North America is critical to all the executives and founders of Cramer, irrespective of where they are based. Different executives use different words around the challenge in North America but the shared intent is clear:

- "significant investment is required"
- "we can't just put in 1 or 2 people and hope"
- "we are there for the long haul - where people have not succeeded before we have changed the people where we needed to"
- "our best people are on the ground; they are not our second best"
- "I spend one week in 4 there"

Investor Behaviour

Cramer has two world-class investors, Kennet Venture Partners and Broadview Capital Partners of the US. Their funding has been in major tranches, enough to take them through major product release developments and client acquisition and implementation. The lasting funding round was for more than $20m. The investors have a major, though not a majority, stake. There is also recognition that options are required for all employees for recruitment and retention.

Everyone believes in ownership of the organisation flowing down to all levels. Everyone, including the new receptionist in Bath, has share options. The CFO also worked hard early on to ensure that the options scheme was approved under a special UK scheme, meaning that holders pay tax on the gains at a quarter of the normal rate.

Summary

In many ways, Cramer have actively implemented the mirror image of the issues that face European businesses.

The good news about being a successful firm in Europe, is that success is much more noticed and visible, enabling those few organisations to attract and retain the best people.