

Predicts 2003: Gartner View for Investors

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IT spending at the end of 2002 remains in a slump as customers and vendors weather the slow economy. Investors should focus on technologies that lower costs.

ANALYSIS

Gartner has forecast that, in 2003, most segments of the IT market will remain flat, reflecting widespread enterprise cost cutting. Our research also shows that most IT vendors will continue to have flat or declining revenue streams in 2003, since it will remain difficult for them and their customers to justify spending money on non-business-related projects.

The focus of this report is to identify the IT segments that represent interesting investment opportunities. The predictions we present here are derived from some 300 predictions submitted by Gartner analysts as part of Gartner's year-end "Predicts" research effort.

We have organized our investor-related predictions into four categories:

- Software
- Security
- Web platforms
- Networking

Software

Prediction: By year-end 2004, approximately 50 percent of worldwide software product vendors from 2000 will merge, be acquired or go out of business. Acquisitions will be slower than expected, since many vendors with cash are being cautious.

Prediction: Through 2005, customer demand for innovation, as well as software vendor and venture capital investment in innovation, will continue to be dramatically reduced.

Most software vendors are struggling with new, deeply rooted challenges. Changes, including the economic downturn, have drastically reduced new sales revenue since mid-2001. Instead of larger, "do-it-all" software projects, many CIOs view enhancement of existing systems and optimization as alternatives to total replacement. Enterprises have shifted from "buying the trend" and buying the appeal of compelling software functionality to buying tools that optimize their business processes.

As IT managers continue to struggle and CFOs continue to slash IT budgets, the software industry continues to contract. As a result, most software vendors are in turmoil. The past six quarters have been tough, and there are few signs of relief at least into the middle of 2003.

Impact on Investors in 2003: Investors in smaller software companies should have an exit plan in place for a merger or acquisition. Little money is available from potential co-investors to fund new projects and startups. As margins continue to decline, all portfolio software companies will require better management and tighter planning and cost control. Sales sizes will continue to be smaller, and contract terms even tighter. Establishing the business value of the customer's spending will be mandatory.

Investors backing vendors of monolithic products should repackage and reposition them as multiple modules where feasible. Helping portfolio companies improve customer service will become even more critical.

Prediction: U.S. homeland security will drive a revenue surge in collaboration software and knowledge management tools (CSKMTs).

Federal, state and local governments in the United States have been widely criticized for a lack of information sharing relating to homeland security. In the aftermath of the Sept. 11 terrorist attacks, the U.S. government has stepped up efforts to solve this problem.

In addition to IT infrastructure upgrades, the government will need software that enables faster and better information sharing, dissemination and analysis. Despite the limited availability of tax dollars, government agencies are beginning to find ways to invest in technology to ensure compliance with homeland security initiatives. This means those agencies will be enthusiastically seeking the technology in the immediate future.

Impact on Investors in 2003: Investors in CSKMT companies must be prepared to take advantage of the need for CSKMT software as it relates to homeland security. To do so, they must strive to understand the perspective of potential public-sector customers. Preparing and presenting the value proposition to the right decision makers is critical here, so investors and their companies must identify those decision makers. If the CSKMT vendor is also able to demonstrate that it has an established or developing public-sector vertical solution, that will be a major advantage.

Gartner predicts that the ongoing demand for gathering, processing and analyzing information related to terrorist activity will create growth and revenue opportunities for CSKMT vendors, and those who fund them, beginning in 2003 and lasting through at least 2005.

Security

Prediction: Market drivers for security software are strong, but inhibitors will slow growth into 2003.

Gartner expects year-end 2002 results for security software new license revenue growth to slip to 6.7 percent, down from 10 percent in 2001. This weakening growth can be attributed to stagnant investment. Despite heightened buyer interest in improving security after Sept. 11, little panic buying has occurred among businesses or in government. Gartner does not expect a revival of general business investment in IT until late 2003, and it will take six months more for IT budgets to really loosen, in the first or second quarter of 2004, as enterprises begin to believe that revived demand for their products is permanent.

In the meantime, IT budgets will continue to be tight, and we expect IT departments to confine their spending to smaller security projects with a fast payback, low implementation overhead and staged, pay-as-you-go deployment. In addition, we expect appliances and managed service providers, on the margin, to gain share in security user spending at the expense of security software vendors. These factors will limit the security software market's revenue upside in the short term and perhaps longer.

Impact on Investors in 2003:

- Investors funding security software vendors should plan to adjust their costs to prepare for low revenue gains from these investments in 2003.
- Investors with security companies in their portfolios should push them to exploit heightened buyer interest in becoming security-certified by means of security audits that identify security holes. They should then encourage the security vendors to follow through with remediation and management products and services.
- Investors should prioritize business plans that focus on selling more small chunks of security software in a multistaged rollout, possibly by repackaging and repositioning any monolithic products as multiple modules where feasible.

- For security investments, investors should focus on vertical industries or geographies that are holding up during the current economic doldrums. The public, healthcare, housing and consumer goods sectors are countercyclical at this time. Most of the Asia/Pacific region (except Japan) is less affected by the economic downturn, and efforts to co-invest with local partners there could provide returns.

Prediction: Dominance of the top five security software best-of-breed vendors (BOBs) will erode.

Consolidation will occur in security software in 2003. But not all the largest security BOBs will be doing the consolidating. In general, network systems management (NSM) titans or "dark horses" will have a leading role. In 2006, the top five security software BOB vendors (those with the largest revenues in 2001) will collectively lose share to NSM titans, all of which are expanding their security software product lines.

Impact on Investors in 2003:

- Merger, acquisition, divestiture and demise activity will significantly intensify. Investors can anticipate that aggressive entry in the security space by NSM and other vendors attracted by relatively high revenue growth prospects will provide them with new exit opportunities for their security investments.
- Investors that can maintain security investments in several vendors are best-positioned to sustain themselves by cross-selling from their portfolios of modules to their installed base. New customers will be scarce.
- Investors funding large security vendors should encourage them to maintain their R&D and to integrate acquisitions that enable them to compete with NSM titans with a broader portfolio of offerings.

Web Platforms

Prediction: The portal market will shift to a small number of independent software vendors (ISVs).

The Internet is leading a wave of new and better-adapted computing methods and underlying technologies. Computing methods such as portals and Web services are responses to a shift in business requirements that demand that enterprises operate in real time and deliver more flexible, externally connected and resilient IT systems. At its apex in early 2000, the portal product market had about 100 vendors. At year-end 2002, about 50 vendors remain, and no single vendor owns more than 15 percent of the market. Momentum in the portal product market has been shifting to the large ISVs since 2000. As we enter 2003, large ISVs are driving the market, along with a small number of remaining pure-play and middle-tier vendors.

Impact on Investors in 2003: Prepare for acquisition, business failure or "niching" of your investments in small-size portal vendors.

Prediction: Four types of portal products will emerge.

In the portal market's most dramatic change to date, two types of integration suites have emerged that will drastically change the makeup of portal products. They are:

- The application platform suite (APS), a suite of integrated software infrastructure technologies for modern business applications containing an application server, integration suite and portal product.

- The smart enterprise suite (SES), an integrated suite containing search, classification, content management, collaboration, knowledge management and process management components.

These two suites will cause the portal product market to segment along four paths in the first half of 2003:

- APS only
- SES only
- An APS/SES combination
- Traditional products

Impact on Investors in 2003: Gartner projects that the APS/SES combination segment will become the dominant segment in the portal product market. This will drive users away from point portal products to portals embedded within suites. This should lead investors to prioritize investments in vendors offering a combination of functionalities. Only the vendors with the vision and the resources to deliver both the productivity and agility of modern user interaction styles and the quality of service of a full-scale enterprise application platform will emerge as leaders. Smaller innovators are likely to be acquired, and the niche players will probably turn to the professional services business.

Networking

Prediction: In 2003, the deployment of video over IP to the desktop will outpace the deployment of voice over IP to the desktop by a 10-to-1 margin in large user enterprises.

As we look toward 2003, the future of the networking industry does not appear much brighter than the past. Customers are looking carefully at purchases, expecting quicker returns on investments and real value. This means limited opportunity and growth for networking vendors and those who fund them.

Gartner research points to one potential growth area in this space: video over IP. Enterprises will focus on this technology as lower-risk, lower-cost and more-compelling applications appear. Unlike voice over IP, which remains largely a vendor-driven phenomenon to sell IP private branch exchanges and expensive IP phones, video over IP is a user-driven phenomenon. This is due to demand for webcasting, e-learning and other streaming-media-based applications.

There are two main reasons why we believe that video over IP will represent interesting investment opportunities:

- Low risk. Video is not mission-critical, and end users are, therefore, more tolerant of initial problems with quality and reliability. The rewards of desktop video are compelling: Video enables new applications (for example, webcasting) that allow richer communications and saving money on travel expenses.
- Lower cost. Desktop and network costs for IP telephony far exceed those for video over IP.

Impact on Investors in 2003

Investors should prioritize investments in the following segments:

- Products focusing on webcasting senior-management messages — sometimes referred to as "egocasting." These will be the main drivers behind video over IP in 2003. CEOs,

in particular, have become fond of this new medium for communicating with their employees.

- Products that enable deployments of live streaming and scheduled rebroadcasts. These products will outpace deployments of on-demand streaming by a 7-to-1 margin in 2003, because of the cost disparity in enabling the network to support live streaming vs. on-demand streaming.
- Streaming-media e-learning applications. Because most e-learning applications are designed for on-demand access, e-learning will be a distant second to internal webcasts as a driver for video in the enterprise.

Bottom Line: As difficult as it is for IT vendors to sell and for IS organizations to buy, smart enterprises are looking past the immediate gloom and planning ahead. Their buying criteria remain stringent, but they are justifying projects with clear and compelling returns on investment. That is positive news for investors and the IT companies they fund — as long as they invest in technologies that lower costs.

Gartner Predicts 2003 Spotlights

"Predicts 2003: Enterprise Networking"

"Predicts 2003: Internet Platforms and Web Services"

"Predicts 2003: Software"

Recommended Reading and Related Research

"Prediction 2003: Security Software Growth Slows" — The security software market will decline from 10 percent growth in 2002 to only 6.7 percent growth in 2003. **By Norma Schroder, Fabrizio Biscotti and Colleen Graham**

"Prediction 2003: CSKMT Market Faces Slow Growth" — Vendors will seek to prosper in the face of a changing collaboration software and knowledge management tool market. **By Burke Oppenheimer**

"Web Services Define a New Generation of Software" — Enterprises will experiment with Web services through the use of portals, and will see a shift to service-based initiatives in 2003. **By David Smith and Whit Andrews**

"Suite Approach to Portal Functionality Will Arrive in 2003" — Most enterprises, by 2004, will not buy a portal product but rather a set of functionality that includes the portal, and which will likely be bundled into a suite. **By Gene Phifer, Ray Valdes and David Gootzit**

"Predicts 2003: Video Over IP Still Outpaces Voice Over IP" — Network managers will see requests to support video over IP from senior management and business unit executives. **By Lawrence Orans**

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