Under the Buzz

Commentary on Strategy & Management Issues for
Executives & Professionals in Enterprise Systems & Software Companies

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Under the Buzz is an electronic "viewsletter" authored by Philip Lay, managing director at TCG Advisors, a Silicon Valley-based firm that helps to *catalyze* the strategy and transformation efforts of its enterprise systems and software clients. This journal is published each month and delivered free to subscribers via email. It is also posted on the TCG Advisors website at: http://www.tcg-advisors.com/Library/utb/utb.htm. Back issues are available at the same address.

In this month's issue:

1. **Larry Ellison and Scott McNealy on the State of Oracle and Sun in the World**

   In a recent extensive San Francisco Chronicle interview Larry Ellison showed why he is one of the most intriguing figures in the high-tech industry, whether or not you like what he says. The quotes selected for this article range in topic from business to political to philosophical. In a separate interview in the same paper two weeks later, Scott McNealy provided some intriguing commentary on industry issues as well as the state of Sun Microsystems, which has been fighting to recover from the double whammy of the dot-com and telecom crash.

2. **Why HP Will Continue to Lag Major Competitors, and May be Forced to Break Up**

   In another recent newspaper article Steve Milunovich, a respected Merrill Lynch stock analyst, provided his assessment of the strategic challenges that continue to cast a shadow over HP's chances for thriving in its present shape and organization. Read here why the company's stock price is likely to continue to languish in comparison with its major competitors - IBM, Dell, and others - unless some change is made to its current mix of businesses.

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1. Larry Ellison and Scott McNealy on the State of Oracle and Sun in the World

In this article I am quoting liberally from recent interviews. The first was with Larry Ellison, chairman and CEO of Oracle Corporation, and the second was with Scott McNealy, Sun's CEO and now – since Bill Joy's just announced retirement – the only remaining member of the quartet that founded the company twenty years ago. One of my reasons for reprinting such extensive excerpts is that many *Buzz* readers will not have had an opportunity to read the original interviews published by the San Francisco Chronicle, and another is quite simply the thought-provoking relevance for all high-tech executives and investors of their opinions and observations.

Interview with Larry Ellison

As everyone in the industry knows, Larry Ellison is no wilting flower. Like him or loathe him – and Ellison makes no bones about the fact that he is indifferent about which of the two you choose – the Oracle chief is one of the more colorful individuals among those occupying key positions in the high-tech industry. In this wide-ranging interview, published in the San Francisco Chronicle (9.7.03), he commented on topics such as his role at the helm of Oracle, his widely-perceived persona as a villain, the state of the software industry, his own aging process, the importance of China as a growth market, what he sees as Microsoft's soft underbelly, the magic of Japanese gardens, California's political scene and recall election, and – not surprisingly – Oracle's unsolicited bid to buy PeopleSoft.

Among other conclusions, it is easy to see that, besides being a hyper-competitive businessman, Ellison is a deep thinker who strives to interpret the changing winds that are shaping industry and society today. As such, I find him a refreshing and fascinating contrast to some of the nerdish and uni-dimensional figures who populate many of the key positions in technology companies and venture capital firms today. For those who despise or disparage Ellison as being too iconoclastic or ruthless, I believe it's well worth seeing what's behind the image, in order to avoid the danger of underestimating him. For these reasons, I am including Ellison's responses on a range of topics that goes way beyond offering a direct commentary on Oracle's business activities or challenges.

On his desire to continue running Oracle, in light of the money he has made and the impact he has had on the software industry, Ellison is candid:

"I can't help myself. If I was only more disciplined and more reasonable. It's like being caught in this book that hasn't ended yet. There's a chance for Oracle to become the most important software company in the world. Most people would say that's ridiculous – Microsoft has such a huge lead you can never catch them. I'm not so sure of that."

On the importance of China as a center of growth, the Chinese government's investment in open source Linux-based software development, and also the traditional flouting of intellectual property law in that country, Ellison claims to detect – among other things – a genuine threat to Microsoft's dominance:

"I've said for a long time that if you look at the cracks in Microsoft's monopoly, the first places you'll see them are in China and India. The real hold Microsoft has on the desktop is not Windows at all. It's Microsoft Office, and you'll see that monopoly crack first in China or India. But as far as a rude awakening, I don't think so. You're going to see an increasing respect in China for individual rights, for intellectual property rights, for the environment as China becomes a more prosperous society."

On the maturing/aging of Silicon Valley and impending consolidation in the software industry, a topic that he has commented publicly on a number of times in recent months, Ellison quotes recent and not-so-recent history in other industrial sectors:

"No industry stays in this fragmented form. The railroad industry didn't stay in the fragmented form. The automobile industry didn't stay in the fragmented form. Nor will the computer industry. It's very difficult for Silicon Valley to adjust to this notion that they won't be forever young. Let's ignore the future for a moment … I was having dinner with Michael Dell a couple of years ago and trying to remember how many PC companies there were. I said, "There had to be at least 50." And Michael said, "No there were 500." How many are there today? Four going to three?"

On his own aging process, once again he is frank about his approach to it:

"I'm probably in denial. I do a fairly good job of repression. Repression is a very necessary psychological mechanism for preserving my sanity. I spend a lot of time in the gym. I try to stay fit. I play basketball and sail competitively(*). I'm sure it's going to be difficult when it starts curtailing a bunch of my activities. But I've avoided thinking about it for as long as possible. I've said if there could be a repression foundation, I'd give a lot of my money to it."

(*) By coincidence, the competitive sporting spirit that Ellison refers to was on display during the week of September 15-20 as his America's Cup yacht, Oracle/BMW, competed against the winner of the 2003 Cup, Alinghi, in a number of daily races across San Francisco Bay. Oracle eventually prevailed against the Swiss boat in both the owner-driver and professional-driver races.

On his well-known fascination with aspects of Asian culture, Ellison offered the clearest explanation yet for what appears to be much more than a superficial appreciation for the renowned Japanese aesthetic sense:

"I've read a lot of the philosophers and poets, but I suppose it's really the aesthetics (that interest me). And it's really one specific thing – the Japanese garden – that changed my life. The first company I worked for in the Bay Area sent me to Japan, and I went to Kyoto, where I saw my first Japanese garden. And for some reason, I felt more at home in that Japanese garden than I've ever felt any place on Earth. Up until that time, my favorite place on Earth had been Yosemite Valley, which I describe as God's best work on Earth. I've never seen a painting, read a poem,

anything, as stunningly beautiful or moving as Yosemite Valley. But here I saw for the first time something that was man-made, albeit the parts came from nature – kind of collaboration between God and man. These Japanese gardens provided me with a degree of comfort and security I've never felt before, and I've spent years thinking about why this was. I have become convinced that deep inside our biology are certain sights and sounds and smells that we find reassuring. The Japanese have recaptured that evolutionary environment in their gardens in a way that I'm not sure even they understood."

On being perceived as a villain, versus just being competitive, Ellison pointed out the traps inherent with highly visible public images:

"Most public images are simplified caricatures. You're either a hero or a villain. It's just a much simpler story when you're a villain. But people are more complicated than that. I've been portrayed as a villain a lot. I don't think I'm a villain. I think I'm very competitive. I like to win. That's my job. If you're an Oracle shareholder, that's what you expect me to do. … Craig Conway has done a terrific job since leaving Oracle. I respect what they've accomplished. But they're in the same industry I'm in, and my job is to beat them in the marketplace."

On his tendency to run through leading executives at Oracle, he is justifies it in a context of doing whatever it takes to help Oracle to win:

"Most of the people I've had disagreements with have been sales people. And if you look at the long list of people who've left Oracle, some have become tremendously successful, including Craig Conway, Ray Lane, and Tom Siebel. … I've been criticized for going through a lot of players. Well, the 49ers (San Francisco's football team) traded Ronnie Lott. That might have been a mistake. But that's what you do. I try to put the best team on the field, and that means as we grow and change – as the industry changes – sometimes we have to change players."

On California's political and economic crisis, Ellison is succinct:

"Five years ago, (Governor) Gray Davis ran out of water. Two years ago, he ran out of electricity. This year, he ran out of money. Now he's running out of time. It's been a poorly run administration."

One final topic is one I have written a couple of pieces on in recent issues of Under the Buzz. The topic is Oracle's unsolicited bid for PeopleSoft. In general, I have commented against the practicality of Oracle's hard-nosed approach to the negotiation, in particular Ellison's declarations early on about discontinuing PeopleSoft's products. The comments that follow provide some additional context to explain the Oracle position regarding their uninvited bid, including observations that put Craig Conway's well-publicized refusal in a relevant context of 'owners' vs. 'renters':

"Uninvited by whom? The use of the word 'hostile' I find utterly fascinating because the question is: hostile to whom? If you're renting a house in Pacific Heights (a district in San Francisco) and I go to the owner and offer him $10 million for an $8 million house, that offer is not hostile. As a renter, I may feel that's not a welcome offer, but all we're doing is giving the owner a choice. So we want to go directly to the shareholders. The only people who consider this hostile are the renters, the managers who don't own the company, whose jobs in fact will be lost. Mr. Conway said he wouldn't sell at any price, which is fascinating by the way. It's not his choice to not sell at any price. It's the choice of the owners."

Interview with Scott McNealy of Sun Microsystems

Our next subject is often grouped with Ellison among the group most-disliked tech-company CEOs. Scott McNealy is known to have a feisty, even aggressive personality. In the Chronicle interview published on September 14, he bristled at several of the questions posed by a team of senior editors and staff writers, and provided curt and at times strongly worded answers.

On the cut and thrust of being in a competitive industry, and in particular on the 'loss of market discipline to a monopolist', McNealy makes it clear that he has thought deeply about the implications for his company as well as the entire technology industry– and for once he doesn't come off as whining about Microsoft's success:

"I believe the beauty of the Darwinian capitalist market battles is that nobody gets – I shouldn't say nobody – very few people get physically injured. Market discipline is very aggressive, very strong and very precise in whom it clobbers – those who can't perform. There's only one blemish on capitalism and that is when market discipline is lost to a monopolist. As a libertarian who has studied economics and has written an honors thesis at Harvard on antitrust, I believe there's only one major blemish besides lawlessness. It is when somebody is not operating on market discipline. Obviously, Microsoft is not operating on market discipline or they couldn't raise their prices with declining unit volumes in the face of post-bubble. They couldn't bundle the houseboat with the sport utility vehicle like they do with Windows and Office. That's the only thing we need to worry about. All the rest is simple – everybody trying to make their own case."

On the importance of sound execution, McNealy frankly admits that he and his team allowed operational controls to become lax during the heady times of non-stop growth:

"I have learned that (growing) a company at 40 percent to 60- percent a year can throw your execution gyros off. And then you pay with a hangover. We've rented too many buildings. We hired too many people."

On how he remains upbeat despite the widespread skepticism surrounding the future viability of Sun:

"We have $5.7 billion of cash in the bank. We didn't have that five years ago (during the boom). We have generated positive cash flow from operations for 35 straight quarters. We have one of the two developer communities left on the planet, .Net being the other. We've got the no. 1 64-bit computing architecture out there. We have the fastest x86 products out there. We own our entire software suite. We can do software indemnification. We don't pay any royalties."

On what's going to change in the computing environment, there's no doubt that he has a compelling vision that Sun is putting into action:

"I want to describe to you the computing environment we're moving to that will atomize large organizations in an interesting way. I give all my employees a Java card, including myself. A few of my staff members do not have offices. They share. What you do is you come in and get a good parking spot and find a good office and stick your smart card in a flat panel display. No disks, no CDs, no floppy. You stick this card in and the Java chip goes out and roams the network and finds my desktop, which is running at an instant on a server, and it downloads it in two seconds and I authenticate myself with multifactor authentication. That is now my office. Everywhere I go in North America, I stick my smart card in, there's my desktop. We save $4 million a year in energy costs alone. We have Sunrays (computer terminals) in our lunchroom. Our sales reps don't go to their offices any more. They go to the lunchroom and use the Sunrays located in our iWork cafes in our cafeteria. They put their smart cards in and there's your desktop."

On "who is going to employ all the American workers" (who are losing their jobs in the tech industry), McNealy is quick to jump on the defensive attitude implied in the journalists' questions:

"You sound like a piano player in the old days when there were 35,000 piano players playing in the front of every movie theater when they had silent movies. You're saying, "Who's going to employ all of us now that they have sound embedded in the films?" Gang, we've got brains. There'll be lots to do."

On the issue of "American companies going to countries such as India and China for cheaper labor", he turns the challenge around in an interesting way:

"What's an American company? We do half our business internationally. We've got 82 engineering sites around the world. Does that make us an international company or a U.S. company?"
Interviewer: *"A global company, I would vote."*

"Yes. So, global companies grow globally. Shouldn't India be a little upset that we have most of their software programmers here? Who's making the value judgments here? We pay more here in the U.S. of our total tax bill than we do internationally even though we do half our business internationally. That's the beauty of our market economy. You know, we could have kept all those piano players. Does anybody think that would have been a step forward? The worst think that can happen now is if we don't deploy to these new environments and new architectures."

On Michael Dell's recent comments at OracleWorld about the computer industry shifting away from proprietary systems, McNealy turns the derogatory term "proprietary' around:

"I believe R&D matters. I've spent a lot of time explaining the R&D that Sun and Oracle are doing to create systems. (The computer business today) is kind of like buying a car by buying a piston ring from a Ford dealership, a stem valve from a BMW dealership, a dashboard from another dealership. Imagine how many extra people would be working in the auto industry if Henry Ford hadn't figure out, "We'll give you any color you want, as long as it's black". That's the big change that's going on here. The computer world is moving from building your own components like a Linux blade or Sparc server or NetApps storage device, to finding the system complete, which is where we're focused and where we're spending R&D dollars. Michael Dell is the greatest spare parts distributor out there. He'll get you a piston ring or a carburetor or a crank shaft at a really low cost."

I don't know how these two 'depositions' strike you, but I must say, I find them thoroughly stimulating for the perspective they offer as well as for the specifics of how each entrepreneur intends to drive their organization forward. Above all, I am reminded by Ellison's and McNealy's words never to discount the ability of contrarians such as these two leaders to survive and thrive. McNealy, in particular, is engaged in a battle to re-invent Sun as a major systems company, and despite the widespread predictions of Sun's doom, it's hard to find fault with his reasoning or conviction that his company is poised for a turnaround. When you juxtapose their two sets of opinions and observations, it's easy to see understand that, despite the differences in their personalities, they get along famously – particularly in their quest to unseat the grim and unrelenting 'beast from Redmond'.

2. Why HP Will Continue to Lag Major Competitors, and May be Forced to Break Up

"As an investor, I'm not getting paid fully for the printer business. HP is arguably the most diversified (major) tech company. It's hard to be the best enterprise <u>and</u> consumer IT company. I'm worried about the enterprise business and I include the PC business in that. Our view is that the computing business is squeezed between Dell and IBM, and HP is going to get caught."

The quote above is from an interview with Steve Milunovich, a well-respected analyst at Merrill Lynch, on his interpretation of HP's strategic challenges following its 2001 acquisition of Compaq. Milunovich, who covers HP among a number of other major tech companies, foresees the breakup of the company, although perhaps not immediately. In his view, HP needs to get the (enterprise) computer business to be profitable before it can be in a position to spin off the printer business.

As a long-time observer of HP as well as a consultant to various groups in the company during the past six or seven years, it is hard for me not to feel perplexed by the direction the company has taken, particularly in the past three or four years. Let's take a look at the way the business is organized today, and how each one is doing: Following the Compaq acquisition, HP is organized into four different operating divisions, two of which (printers and personal systems) are targeted mainly at consumer and small-business markets - as well as departments of corporations -, and two of which (enterprise servers and consulting services) are targeted at enterprise customers. In terms of their basic business models, the printer and personal systems businesses are 'volume operations' businesses similar to Epson's and Dell's businesses, whereas the enterprise server and consulting businesses are 'complex solutions' businesses that compete head-on with firms such as IBM and EDS.

The conclusion that Milunovich has come to – as have we in our business of advising enterprise software and systems companies – is that in the tech industry these two business models (volume operations and complex systems) are like oil and water. In fact, it is perilous to manage them under one organizational roof, simply because the dominant metrics that determine the allocation of critical resources to each business will almost certainly be volume-focused or value-focused, but not both. And, the dominant one will almost certainly throttle the other. Think about it. One model deals in volume *of* units to measure its success, whereas the other deals in value *per* unit to measure its success. One deals in thousands and hundreds of thousands units sold, whereas the other deals in tends and hundreds of units sold. One model focuses on marketing, packaging and shipping, while the other focuses on selling, bundling, and installing. Logistical malfunction in assembly, distribution and inventory management can make or break volume operations companies, whereas architectural, technical, and service management issues are typically the ones that can make or break complex systems companies.

And, given the complexity of one basic type of business successfully in an increasingly competitive global marketplace, it is practically impossible for a single top management team deal with more than one dominant business model and its concomitant metrics, in guiding resource allocation. The only exceptions are conglomerates like GE, which separate their lightbulb and jet engine business as truly separate businesses, to the necessary extent of completely separate resource allocation. Thus, to all intents and purposes, the corporate entity at GE only requires that each of its 15-20 operating units respond to a *profitability* metric committed to by each BU management team on an annual basis. In contrast, and with the possible exception of IBM (which has learned its lessons over the years), tech companies such as HP tend not to allow their business units to function as truly distinct P&L's, keeping them tied to the murderous metric of *revenue* (which naturally favors high-volume businesses over high-value businesses) in order to receive funding for critical resources.

Unfortunately, when used as a dominant metric for success, plain old revenue is a deceitful thing, hiding a multitude of sins: after all, isn't there a huge difference between 'good' revenue – that results in profits based on sustainable competitive advantage and, say, the 'bad' revenue that results from profitless sales in a market where the company's offers are marginalized by the power of stronger competitors? If doing the same thing over and over, while expecting different results is one established definition of insanity, then surely HP's insistence on managing its volume-operations / complex-systems businesses using volume operations metrics and expecting the four separate businesses to be successful is a clear – and depressing – example of the same managerial insanity.

In order to try to paint the picture more vividly, our firm describes this dichotomy in terms of 'birds' (volume operations) and 'fish' (complex systems) businesses. As we all know birds fly through the air, and fish swim in the water. In-between is the waterline, or surface. One of these creatures cannot survive if it spends too long under the surface, while the other dies after a few minutes exposed to the air. We would further assert that in this world there are no surviving amphibian creatures. Pursuing this metaphor, HP is trying to be an amphibian, but it is asking its fish (enterprise computing and consulting) to fly through the air. Meanwhile, of its two real fish businesses, only one is healthy, while the other is being kept alive on a fish-respirator.

In order to avoid torturing this metaphor further, the plain reality is that HP is using the fabulous profitability of one highly successful business, printers and imaging, to pay the bills of its three other business, whose profitability - when it occurs - is fleeting, at best. Meanwhile, the personal systems business, despite being one of the two businesses favored by being part of the dominant business model, is essentially a *profitless* activity for HP, given the unrelenting and single-minded volume-operations excellence of the fastest bird in the sky – Dell Computer.

Of the two 'under-privileged' businesses, the enterprise computing group continues to under-perform, while the consulting business – managed more like a volume operations commodity business than as the complex solutions business it needs to be – continues to bring in revenues that are sometimes good revenues, but more often neutral or bad revenues, along the lines defined above. In other words, in the pursuit of revenue (at all costs), HP's consulting services organization ends up bidding for and – worse – winning far too many deals that the major players, such as IBM and EDS, either don't want to win, or prefer not to win at an unprofitable or unsustainable price.

If you contrast this picture with how HP's most significant competitors – Dell and IBM – play the game, it doesn't take long to see why they both have much higher price-to-sales valuations than HP. After banging its head against the wall trying to successfully pursue both types of business models for some years during the 1980's, IBM (a natural 'fish') eventually gave up or spun out its volume operations businesses (PCs, components, and printers), and since Gerstner refocused it as a full-time fish business, the company's market valuation has multiplied. Dell (a born 'bird') has single-mindedly avoided anything resembling a complex solutions business ever since its foundation, and has focused on perfecting its volume operations business processes to the extent where its assembly, distribution and shipping processes have set the bar for best practices throughout industry. Quite simply, HP is not in the same ballpark as Dell in running its volume operations PC business. Now Dell and others are taking aim at the one business where HP leads the entire industry – its printer franchise. Thus, by trying to defy nature and be an amphibian in a game that favors two types of specialist – birds *or* fish – HP is today, as commentators like Milunovich argue, trapped between Dell on one hand, and IBM on the other.

A corollary to this issue of mixed business models is the issue of market strategy, which I would argue is cause for further concern at HP. In the past three-four years, HP's 'market strategy' has placed the company increasingly in a position to be commoditized by its competitors, due to a hardening resolve to treat every market as a mass-market opportunity. It seems that, if the market is already formed for a specific product, in all probability with one or more competitors already entrenched, then HP somehow believes it has a right to garner its fair share of business. On the other hand, if the market is still in formation, or is not already proven by available data to be packed with competing vendors, the company does not feel attracted to establish a beachhead in order to build a dominant, powerful position. Apparently, HP fails to recognize that, in common with enterprise customers, consumer and small-business markets alike have distinct needs and wants that require vendors to adopt a niche-focused market strategies.

This refusal to enter markets thoughtfully and build its share using proven weapons such as domain expertise and carefully crafted solutions, results in an accelerated commoditization of every HP offer, pressuring revenues and profits at the same time. This approach is doing no more for HP, in my view, than to hasten the company's decline. The biggest puzzle in all of this is that, way back in HP's past is some buried institutional memory of days when HP grew profitably by attacking markets intelligently – the HP 3000 minicomputer, the laser printer, the inkjet printer, the HP 9000 Unix server, being four examples where the company excelled at building considerable – and sustained - market power.

Finally, the worst aspect I see in this alarming situation is the missed opportunity for HP in enterprise markets: Medium-sized and large companies around the world feel a strong need for a serious 'fish' alternative to IBM as their global systems vendor, but HP continues to fall short in its response to this challenge. Thus, as Milunovich affirms, HP is caught between a rock (IBM) and a hard place (Dell), and needs to make at least one of its enterprise businesses work, as a precondition for spinning out the trapped printer franchise, to allow it to flourish as the brilliant and powerful business it has become, and reward investors accordingly. If by some miracle HP can pull this off, simple math tells us that the printer business would immediately achieve a valuation well in excess of HP's poor 0.9:1 price-to-sales ratio for all four of its current businesses – in fact, I would estimate that the printer business on its own would have a price-to-sales ratio of as much as 3:1 or 4:1, resulting in a market valuation of at least twice the current $60B for all of HPQ.

Under the Buzz offers a monthly commentary on the enterprise software and systems. The goal is to provide provocative and accurate insights into the latest events and thinking shaping this critical technology sector. *Under the Buzz* also provides commentary on strategies for building sustainable competitive differentiation and maximizing market valuations.

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