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Market Strategy Report

Application Service Providers:
Market Pioneers Define
Strategies and Business Models

March 1999

"The stumbles, mistakes and maneuvers
of the Internet applications hosting market
pioneers illustrate that no company has yet
figured out the formula for succeeding—much
less dominating—in this market."

—Marty Gruhn

Capitalizing on the Power of E-Business

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Application Service Providers: Market Pioneers Define Strategies and Business Models

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THE BOTTOM LINE

Despite the unprecedented level of vendor interest in the Internet applications hosting (IAH) market, only a handful of pioneers have begun delivering real IAH solutions. Each company is learning firsthand what works and doesn't work in this emerging market. None has yet cracked the perfect combination of applications, pricing and go-to-market strategies.

In an unpredictable and rapidly changing market, these pioneers face some real barriers to success:

■ Poorly crafted channel strategies and customization pitches won't make it past any customer with a calculator and the ability to think.

■ The entry of industry giants into the hosting market, including IBM, Oracle and Arthur Andersen, will change the rules of competition during the next six months.

■ Internet portals will play an increasingly important role for smaller IAH providers targeting the small and midsize business, and small-office/home-office markets.

Application Service Providers: Market Pioneers Define Strategies and Business Models

Despite the almost unprecedented level of vendor interest in the Internet Applications Hosting (IAH) market, only a handful of pioneers have begun delivering hosted Internet applications. While many prospective application service providers (ASPs) have grand and interesting plans, most are still in the idea phase. A few of the most interesting providers that are actually delivering solutions and have had a chance to learn from their customers are USinternetworking (USi), Interliant and Pandesic:

■ *USi* is one of the strongest entrants in the emerging IAH market. The company offers its customers—primarily midsize companies—a choice of six solutions suites, each of which is based on one or more best-of-breed ISV applications designed to address key business processes. At first glance, USi appears to have all the right stuff, offering customers prepackaged solutions suites, comprehensive customer support and a state-of-the-art data center. On the other hand, USi's offerings do come at a hefty price, especially considering that the customer won't own the server or the software license. Will customers really ante up these huge prices to outsource business-critical functions, or will they decide that the cost is just too prohibitive to warrant taking the function out of house? Only time will tell how customers will react to the company's value proposition and pricing structure. Meanwhile, USi is a leading pioneer to watch as the IAH market unfolds.

■ *Interliant's* roots are in the hosted messaging and collaboration space. Recently, the company expanded its reach into the hosted-business-applications market through its AppsOnline program, a rentable applications service that offers 11 (soon to be 12) rentable software packages. AppsOnline has been an ambitious launch, and it is too early to tell how receptive users will be to this new form of computing. But, unlike competitors that have bet the ranch on one hosting strategy, Interliant offers a rich set of options to customers. This makes it one of few companies that can play both ends against the middle in the IAH marketplace—and one that can land on its feet no matter how this market evolves.

- *Pandesic*, founded and jointly owned by Intel and SAP, was established to provide a low-cost, turnkey, end-to-end e-commerce solution that incorporates and automates all the processes needed to conduct robust e-commerce on the Web. Despite a hearty e-commerce market and world-class parents, Pandesic's lofty ambitions fell short in 1998. It had a rocky first year—which resulted in dramatic changes to its channel strategy and problems with its partners. More important, it seriously underestimated the length of time it would take to implement its solutions. Undeterred, the company has spent the last year reshaping its strategy, and is attempting to rise like a Phoenix from the ashes of a flawed hosting strategy. Will Pandesic shake off the errors of its past and establish a flourishing business in the IAH space? From our perspective, Pandesic still has several strikes against it—including a questionable revenue-sharing plan and intense competition from a pack of providers that have more traditional business models.

Each of these ASP pioneers hope that its unique combination of applications and services will establish the rules of competition in the IAH market. Which brings us to the most important question: who will be smiling in six months when the IAH smoke starts to clear? With new entrants—including IBM, Oracle, and Corio—flooding into the IAH market, competition will be fierce. Our bets are on USi, Interliant and IBM, with its Business Computing Utility solution. For the rest of the roster, we invite you to place your bets and spin the wheel.

What's your opinion? E-mail the author:

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**Market
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Application Service Providers:
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Internet applications hosting (IAH) wasn't even a blip on the industry radar for most of 1998. Now, virtually every leading server vendor, most enterprise software developers, and many leading telcos, systems integrators (SIs) and Internet service providers (ISPs) are foaming at the mouth—anticipating the firestorm of opportunities IAH could create once it ignites. And as important—on a much broader scale—IAH could shift the balance of power in tomorrow's IT industry.

Despite the unprecedented level of vendor interest in this market, only a handful of pioneers have begun delivering Internet-hosted applications. While many prospective application service providers (ASPs) have grand and interesting plans, most are still in the idea phase. This report focuses primarily on providers that are actually delivering solutions and have had a chance to learn from their customers.

The most interesting of this new breed of active ASPs are USinternetworking (USi), Interliant and Pandesic. Each company brings a different heritage to this market, and is pursuing distinct strategies and business models. Each company is also learning firsthand what works and what doesn't work in this market.

This report examines the strategies and business models these three pioneers are pursuing in the IAH market, and assesses the key strengths, weaknesses and risks each company faces as the IAH marketplace evolves. It evaluates some general IAH market strategies and discusses the major factors influencing the evolution of the IAH industry.

Which IAH pioneer has the strategy most likely to win in the IAH marketplace? The answer might be surprising.

Section 1   **USinternetworking: Cadillac for Volkswagen Drivers**

Founded by former Digex Chairman and CEO Chris McCleary in January 1998, ISP USi (www.usinternetworking.com) is one of the strongest entrants in the emerging IAH industry. It boasts a management team of seasoned Internet professionals, like its founder, from companies such as UUNET, Digex, Sun Microsystems, Motorola and IBM.

Rather than refer to itself as an ASP, USi coined the term iMAP (Internet Managed Application Provider) to differentiate itself from competitors. According to the company, an iMAP offers a more robust range of services than an ASP, including guaranteed network responsiveness, high levels of security and best-of-breed, *end-to-end* applications outsourcing.

Applications and Target Markets

USi offers a choice of six iMAP "Solutions Suites," each of which is based on one or more best-of-breed ISV applications designed to address key business processes. To capitalize on the ISVs' brand names, each application carries a "powered by" tag that contains the application vendor's name. Although most Suites contain several applications, customers select only those applications in which they are interested. The Suites are:

■ *Enterprise Relationship Management (ERM)*. Consisting of USi Enterprise Sales, USi Enterprise Marketing and USi Enterprise Client Care—all powered by Siebel Systems;

■ *Human Resources (HR)*. This suite is made up of USi Human Resources, USi Benefits Administration and USi Payroll Interface—all powered by PeopleSoft;

■ *Financial Management*. Including USi Financial Management, USi Revenue Administration and USi Procurement—all powered by PeopleSoft;

■ *E-Commerce*. E-Commerce Suite applications include USi Internet Selling powered by Microsoft, and USi Internet Selling powered by BroadVision (customers choose one of the two commerce servers, depending on their requirements);

■ *Data Warehousing*. Consisting of USi Enterprise Data Mart powered by Sagent Technology; and

■ *Web Site Management*. Including services to design and operate custom Web sites.

USi is targeting these offerings toward midsize companies with annual revenues of $50 million to $1 billion—placing special emphasis on

multinational enterprises with global information requirements. The company is zeroing in on the following five vertical market segments, which are showing the most initial interest in the company's offerings:

1. Government;

2. Telecommunications;

3. Manufacturing;

4. Retail; and

5. High technology.

USi believes its best prospects within these target segments aren't the companies that want to allocate their limited IT resources to developing and maintaining enterprise-wide applications. Its best prospects are, instead, companies that want to reduce their technology risks and prefer to sidestep large IT-related capital outlays.

Strategic Partnerships

Partners are key to USi's success. To date, USi has announced several strategic relationships with software partners, including:

■   *Siebel.* Siebel provides enterprise-relationship-management software, including sales, marketing and customer-service applications. Siebel's InterActive service also gives USi clients up-to-the-minute briefings on company accounts, prospects and competitors.

■   *PeopleSoft.* PeopleSoft provides components in accounting, ERP and HR business processes.

■   *Microsoft.* Microsoft provides one of USi's e-commerce solutions. Based upon the Microsoft Commercial Internet System, it includes Microsoft Site Server, Commerce Edition and runs on Windows NT.

■   *BroadVision.* BroadVision's One-To-One Commerce program provides USi clients with an e-commerce solution that can run on either Windows NT or Unix. USi intends to expand its partnership with BroadVision to include its One-To-One Knowledge and One-To-One Financial modules in the first quarter of 1999.

■   *Sagent Technology.* Sagent provides turnkey, data-mart-based decision-support solutions.

Software partners provide much more than just product—they also lend considerable support to USi's marketing and sales efforts. In fact, according

to USi, software-partner contributions represent approximately half of USi's marketing budget. For example, Siebel and USi jointly market their offerings through advertising, tradeshows and collaboration between their Web sites.

USi's partnering strategy has another component: technology. To satisfy its hefty infrastructure requirements, USi has contracted with some leading technology vendors to provide server and networking equipment. These partners include:

- *Hewlett-Packard (HP).* USi has standardized on HP 9000 Enterprise Server as its Unix offering, using HP's Web Quality of Service (Web QoS) technologies to deliver predictable service levels to USi customers.

- *Compaq.* For Intel-based servers, USi has standardized on Compaq's ProLiant Servers running the Windows NT operating system.

- *Cisco Systems.* Cisco is the exclusive provider of network infrastructure and design engineering services for USi solutions. In fact, the USi PriorityPeering global network has earned the Cisco Powered Network designation for engineering excellence.

- *US West.* US West provides network access and direct data links among USi's data centers in Annapolis, Maryland and Milpitas, California.

USi's partners all provide the company with much-needed products and technology. But, although USi already has its own consultants and systems engineers, it also needs help in integrating and tailoring products to address specific customer needs. It is, therefore, acquiring third-party integrators: companies with revenues between $5 million and $30 million, which can accelerate USi's time to market and reduce its development learning curve.

USi's first acquisition, in September 1998, was an ERP specialist, International Information Technology (IIT), which will deliver rapid implementations of PeopleSoft's HR and financial-management applications. Its second acquisition, one month later, was Advanced Communication Resources (ACR), which specializes in developing financial-service applications in the Northeastern United States.

Pricing

USi hosts each customer's application on a dedicated server located in one of its four data centers. Hosting contracts run a minimum of 36 months, with monthly fees including rental of the application, server and network hardware, as well as ongoing operation and support of the total solution. *USi retains ownership of the server hardware and the license for the application used by the customer.*

Unlike ASPs that charge separately for applications development and hosting services, USi amortizes its front-end development costs across the entire 36-month contractual period. Because the customer begins remitting a monthly service payment only when the application actually goes online, USi has a strong incentive to deploy the system quickly and on budget. Due to its rapid deployment requirements, USi offers clients only a limited amount of applications customization, which it negotiates on a case-by-case basis. The company plans to eventually develop applications "templates" to provide greater customization while reducing development times.

USi bases its pricing upon the number of applications a customer selects and the number of users the customer plans to have use them. Monthly fees for a sales-force automation (SFA) solution, for example, range between $20,000 per month for 50 sales representatives (or roughly $400 per month, per user) to $150,000 per month for hundreds of sales representatives. USi's financial-management and HR solutions range between $50,000 and $200,000 per month, while a decision-support solution will typically cost $25,000 to $75,000 per month.

Customer Support

To address customer concerns regarding the continuous availability of these business-critical applications over the Web, USi offers a comprehensive service level agreement (SLA) that guarantees 99.9 percent application uptime and availability. This SLA goes farther than the guarantees provided by most ISPs and ASPs in this market, which simply address server performance and sidestep network congestion or bandwidth problems. Instead, USi's agreements provide guaranteed *end-to-end* access to applications, including the performance of the network between the data center and the user.

USi provides support on a 24x7 basis through its CLIENT Care services organization. This service includes dedicated 800 numbers for each account and dedicated account teams for each client. According to the company, each service representative is responsible for no more than two accounts.

The company acts as the single point of contact for all customer-support problems. It markets this "One Call Does it ALL" method as a key advantage over competitors, which make customers contact each supplier individually for support.

Technology Infrastructure

USi's four Enterprise Data Centers are located in Annapolis, Maryland; Milpitas, California; Amsterdam, the Netherlands; and Tokyo, Japan. All centers are built on the Cisco Powered Network architecture, and each uses USi's PriorityPeering architecture to bypass high-traffic, public Internet data

hubs. To provide redundant backbone carriers, USi connects each data center to the Internet through six dedicated T-1 lines from six different ISPs. The company's goal is to have 15 dedicated Internet lines from 15 ISPs in the future.

To minimize risk of downtime, the data centers are constantly monitored by local technical staff and are proactively managed using a customized version of the Tivoli Management Environment (TME). Each customer Web site is mirrored on a minimum of two servers. Storing customer data in different data centers provides expanded disaster recovery.

As noted, USi has standardized on the HP 9000 and Compaq ProLiant server platforms to host its application solutions. USi chooses the most appropriate platform for the customer, based upon the application to be hosted and the customer's anticipated scaling and reliability requirements.

Go-to-Market Strategies

USi maintains direct sales offices in Annapolis, Maryland; New York, New York; Schaumburg, Illinois; Coral Gables, Florida; San Francisco, California; Los Angeles, California; Milpitas, California; Atlanta, Georgia; Boston, Massachusetts; Dallas, Texas; and Caracas, Venezuela. The vendor has eighteen direct-sales representatives selling its services to line-of-business managers (such as vice president of human resources or vice president of sales) who have a primary role in selecting and using the applications it offers.

USi relies heavily on its software partners to train its direct-sales staff (in conjunction with the partners' own sales teams) and to generate customer leads, referrals and even sales. Partners' sales representatives, for example, will recommend USi-certified outsourcing solutions as alternatives to purchasing software licenses when appropriate, and these sales personnel are encouraged to participate in completing the sale. To minimize potential channel conflicts that may arise, USi is trying to determine the most appropriate way to incent its partner sales forces equally for selling the USi solution or the application license.

Competitive Advantages

USi believes that its most compelling competitive advantages lie in the following areas:

- *The quality of its network infrastructure.* USi claims that its network is faster and more robust than the offerings available from standard ISPs and ASPs. It backs its claim with SLAs that guarantee *end-to-end* application availability.

- *Rapid-deployment methodology.* By rolling its customization charges into the hosting contract and delaying the monthly service charges until

the customer goes online, USi has a built-in incentive to build a solution quickly and go online in minimum time. This policy is in sharp contrast to those of many SIs and applications developers, which may have incentives to stretch development times and expand project costs.

■ *World-class support services.* USi wants to take the pain out of support. The company's "One Call Does It ALL" customer-care system provides a single point of contact, through which customers solve complex problems created by integrating products from multiple vendors. Additionally, as the single point of contact, the company is able to speed resolution of support problems—striving to solve 90 percent of customer calls on the first inquiry.

■ *A comprehensive set of enterprise-class solutions.* USi's portfolio of offerings covers the gamut of best-of-breed, business-critical applications that provide Web-based user access. The company envisions integrating its solution sets into a seamless, Web-enabled set of business processes. The firm believes that the expertise it has developed so far in these solution areas will help position it as a premier enterprise-services ASP to midsize companies.

Early Results

Although USi has been in the industry limelight since early 1998, it has focused most of its activities thus far on expanding its partner roster and completing its network infrastructure and data centers. Now that it is aggressively marketing its offerings, it is finding that its outsourcing message is resonating with three types of customers:

1. Large enterprises that have tried implementing similar solutions internally and have failed;

2. Smaller companies that found the costs of purchasing, deploying and maintaining this class of software prohibitive; and

3. Companies that are currently running these solutions, but don't have the resources to effectively extend or manage these environments.

On October 5, 1998, USi announced its first customer, Legg Mason, which will use USi to host its e-commerce and public Web site. Sagent (which powers USi's data-mart solutions) quickly followed, becoming USi's second customer on October 26, 1998. Sagent will use USi's Siebel-based ERM Solutions Suite to expand its sales-contact management and market-forecasting capabilities. In late December, USi announced its third customer—and first mid-market customer—Sunburst Hospitality. Sunburst, which operates the MainStay Suites, Comfort Inn, Quality Hotel, Clarion Hotel, Sleep Inn,

Rodeway Inn and Econo Lodge hotel chains, also will outsource PeopleSoft Financials through USi during the next five years.

Current Outlook

As a pioneer in the Internet outsourcing market, USi has a lot going for it. It has partnered with powerful companies that have strong brand names in their market segments. It has developed a comprehensive customer-support framework, and it offers SLA guarantees that extend beyond the data center to incorporate the network. It has developed and built a state-of-the-art network, and now has data centers located around the globe. Finally, USi has wrapped its activities into prepackaged solution suites that make understanding its offerings and choosing solutions easy for customers.

On the other hand, USi's offerings do come at a hefty price, especially considering that the customer won't own the server or the software license. For example, the $240,000 yearly tab for a basic 50-person SFA system could easily top a million dollars a year for larger sales forces. USi's financial management, HR and decision-support systems carry even larger price tags, with "typical" prices ranging from $600,000 to $2.4 million a year.

Will customers ante up such huge prices to outsource business-critical functions, or will they decide that the cost is just too prohibitive? With only a handful of customers to date, the jury is still out. If sales don't pick up in early 1999, USi may find that it needs to offer more attractive pricing to accelerate its momentum. On the other hand, with $62 million in the bank, the company is one of few with pockets deep enough to wait the market out. Although only time will tell how customers will react to the company's proposition and pricing structure, one thing is clear: USi is a leading pioneer in the emerging IAH marketplace and is certainly worth watching during the next 12 months.

Section 2 — Interliant: Playing Both Ends Against the Middle

His desire to bring collaborative computing within reach for small and midsize businesses (SMBs) drove attorney Matthew Wolf to found Houston-based Interliant (www.interliant.com) in 1992. Interliant is an applications-hosting company that the Wolf family privately funds.

In 1996, Jim Lidestri took the helm as president and CEO of Interliant. Drawing on years of experience at IBM, Sprint and Data General, Lidestri has helped the company double in size for the third year in a row, and has brought it into international markets. Lidestri continues to build and grow Interliant, establishing it as a principal player in the IAH market and a pioneer in the emerging rentable-applications market.

Applications and Target Markets

Interliant's IAH roots are in hosting a Lotus cc:Mail messaging service, which it launched in 1993. It has since added Lotus Notes- and Domino-based messaging and collaboration applications, and a range of applications built on them, such as fax and pager services. It now hosts more than 10,000 applications, most of which were custom developed by its nearly 2,000 customers. These hosting services relieve customers of buying and implementing the hardware, infrastructure and security needed to keep these applications up and running, and Interliant provides them 24x7 monitoring and troubleshooting.

In addition to off-the-shelf and customer-developed Notes applications, Interliant also hosts rentable, prepackaged line-of-business applications through its AppsOnline program (www.appsonline.com) (see Figure 1). Currently, clients can rent 11 software packages (soon to be 12, with Interliant's recent announcement that they will add Lotus QuickPlace, an online workgroup application, to the AppsOnline catalog), including:

■ *Lotus's Instant!TEAMROOM application*, which allows users to share information, capture discussions, create and store related documents, and track a project's progress;

■ *Synergistics' Prevail Professional SFA software*, which allows sales professionals to share contact information and account histories, and access corporate information, such as sales collaterals and pricing information;

■ *TitleLink's mortgage-automation software*, which provides electronic document transfer and closing-process management for real-estate transactions;

■ *AuctionPool from iemagine.com*, a solution that allows businesses and individuals to auction products and services for a small monthly fee;

■ *Devlin Applied Design's Decision Room*, a collaboration tool that allows geographically disbursed project teams to share information;

■ *BestPractices' ProMetra*, a modular business-process-management system that allows users to assign and track business tasks, processes and procedures;

■ *UptimeOne's eCommerce Suite*, which allows midsize to large businesses to deploy an e-commerce system that manages product availability, order entry and processing, credit approval and shipping.

■ *UptimeOne's eBusiness Suite*, which provides modules for contact management, purchase requisition, expense reporting, defect tracking and document management; and

Figure 1   **Interliant's AppsOnline Offerings**

Interliant has one of the most comprehensive portfolios of hosted applications offerings available through the Web. Although it bills AppsOnline as an application-rental program, some applications are offered on a purchase-only basis.

Application	Category	Application Type	Availability	Price
Decision Room from Devlin Applied Design	Collaboration	Instant	Q199	Not announced
Instant!TEAM-ROOM from Lotus Development	Collaboration	Instant	Now	$14.95 per month for TEAMROOM owner plus $14.95 per month for each team member
Prevail Professional from Synergestics	Sales-Force Automation	Advanced	Q199	Not announced
TitleLink from TitleLink	Rea-Estate Automation	Advanced	Now	$15 set-up fee plus $45 per month
Boomerang from Momentum Business Systems	Personal Productivity (expense reporting)	Advanced	Now	Purchased application; Administrator license $5,000; $59 for each user license
ProMetra from Best Practices	E-Business	Advanced	Q199	On request only
UptimeOne eBusiness Suite from UptimeOne	E-Business	Advanced	Now	On request only
AuctionPool from iemagine.com	E-Commerce	Instant	Q199	Not announced
UptimeOne eCommerce Suite from UptimeOne	E- Commerce	Advanced	Now	Purchased application; $12-$35K depending on module
Firstuse.com from Firstuse.com	Legal Automation	Instant	Now	$4.50-$15 per transaction, depending on volume
ShareDoc/ Legal from Occam's Razor Technologies	Legal Automation	Quick	Now	$500-$5,000 certification fee plus $100 to $500 per month

Source: Summit Strategies, Inc.

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- *Boomerang from Momentum Business Systems*, a Domino-enabled expense-reporting solution that allows employees to complete and submit expense reports from any location.

Interliant's rentable applications fall into three payment and access categories:

1. *Instant Apps*. Instant Apps can be created by the user immediately after an online application subscription form has been completed and credit card information has been processed. Currently, Interliant offers Decision Room, Instant!TEAMROOM, Auction Pool and Firstuse.com's online registry service as Instant Apps.

2. *Quick Apps*. Quick Apps, which currently include ShareDoc/Legal from Occam's Razor Technologies, are created for the user by the Interliant AppsOnline staff. Applications, which cannot be ordered online, are generally rented via corporate purchase orders.

3. *Advanced Apps*. Advanced Apps are usually deployed on an enterprise-wide basis and require more configuration work and customization than an Instant or Quick App. Like Quick Apps, Advanced App subscriptions may not be ordered online, and are usually paid for with corporate purchase orders. Advanced Apps may be accessed via a private corporate intranet or extranet, in addition to the public Internet. Advanced Apps offered by Interliant include Prevail Professional, TitleLink, Boomerang, ProMetra, and UptimeOne's eBusiness and eCommerce Suites.

Although Instant Apps are not customizable, customers can get a customized version of Quick or Advanced Apps by contracting separately with Interliant to have the application modified and hosted. Interliant will also customize and host six additional applications that are not offered in the AppsOnline program:

- *Legal-automation applications*. Employees can communicate and collaborate with both internal and external colleagues on case management and litigation support through software from LIT CaseWorks, SmartCounsel collaborative networking from Tripoint Systems Development, and Interliant's Information Services reference site, with links to Lexis-Nexis and other legal-information sources.

- *Healthcare applications*. WorkFlow's ClinSync software captures data from clinical trial teams and allows participants to collaborate. Winchester Business Systems' (WBS') Protocol Manager software suite allows clinical trial teams to collaborate and share information.

- *Distance-learning applications*. Interliant offers a specialized solution for educational institutions and training companies that want to offer

distance-learning services but do not have the infrastructure necessary to launch such a service. Interliant's distributed-learning program is based upon Lotus's LearningSpace software.

Which application does the company think will be the killer application that will fuel the growth of its rentable-applications business? The company is wagering that its rentable SFA software, Prevail Professional, will be the most popular offering in its AppsOnline portfolio—particularly for large businesses with large distributed sales forces. Realizing that it can take a year or more for a company to fully implement its own SFA solution, Interliant is expecting strong customer interest in this short-term solution.

In the longer term, the company believes that any application or package that is accessed by distributed users will be a killer application for the rental model, and it is betting that the strongest interest will emerge within the pharmaceutical, legal, and manufacturing industries.

Interliant targets its offerings toward SMBs, with the goal of bringing collaborative computing within reach for smaller industry players.

Strategic Partnerships

Integral to Interliant's vision and services is its close relationship with Lotus. Interliant launched its public Notes network two years after its 1992 inception and was recognized by Lotus as a Notes Public Network Provider (this designation has been renamed, to "Lotus 'Net Service Provider, Alliance Partner") in 1996. Interliant was the first company to host Lotus Domino, and it worked closely with Lotus to co-develop Instant! Host, a Domino-based platform that is used extensively by Interliant to host collaborative, subscription-based applications.

Besides Interliant's close working relationship with Lotus, the company has also established partnerships with other applications developers to provide customized applications. For example, Interliant works closely with LIT and Tripoint Systems Development to offer customized legal-automation solutions. It has partnered with Synergistics for SFA applications, and WBS and Workflow for its pharmaceutical clinical-trial-management offerings.

Interliant is also turning to partners to capitalize on Europe's flourishing groupware market. Its European Business Partner Programme, launched in May 1998, attracts SIs, application developers and groupware consulting partners to provide the skills and materials necessary to host Notes solutions for European companies. Some Interliant European Business Partners are Riva Consulting, a Notes and Domino developer; Vanstar Europe, a network integrator; and Penfold & Redstone, an SI and Notes developer.

Pricing

Interliant offers a variety of contract terms for its applications, depending on whether the applications are customized hosted applications or off-the-shelf rental applications.

Hosted applications have a minimum one-year contract, payable monthly. For hosted Notes environments, Interliant charges $50 per month, per user. This monthly fee includes Notes mail (including the ability to send/receive mail with Internet mail users) and access to the Notes application(s) being hosted. The price goes up for customers that deploy a Notes server at their own sites and replicate databases between their systems and Interliant's hosted server. The additional fees depend on the amount of data transferred between the systems. Customers will also pay additional server fees of $2,000 to $3,000 monthly if they want their applications to reside on a *dedicated* server located in the Interliant data center.

Clients pay additional fees for customization. Interliant will customize a customer's Notes application and any hosted vertical-market business application in its portfolio. Costs can rise as high as $20,000, depending on the amount of consulting and design work needed.

AppsOnline application fees are determined on a case-by-case basis. Interliant and the application developer work together to define an appropriate price for the application based upon a number of variables, including the application's hosting requirements, the hosting-fee structure or revenue-sharing model, projected sales, and the ISV's cost and expected profits.

Unlike its hosted applications, which require a minimum contract commitment, Interliant also offers rented applications on a monthly basis. Application rental fees and structure vary. For example:

■ *Monthly fees*. Instant!TEAMROOM rents for $14.95 per month, per owner account, plus $14.95 per month, per end user.

■ *Setup plus monthly fees*. Clients pay a one-time setup fee of $15 plus $45 per user, per month for TitleLink. Prevail Professional will also have a one-time setup fee (the amount is not yet announced) in addition to a monthly per-user fee.

Customer Support

Interliant also approaches customer support differently for its standard hosting customers than for its AppsOnline customers. For its hosting customers, Interliant provides a 24x7 help desk, accessible either by e-mail or telephone, to

answer customer questions related to connectivity, mail routing, registration and database replication. Interliant limits its support to network issues and application modifications that Interliant has designed for the customer. The company does not provide any support for using, replicating or modifying Notes software and directs customers to Lotus for assistance with these issues.

Hosted customers can also assist in their own support. Interliant's OnSight support offering contains four components that allow customers to access and manage their servers and applications remotely:

1. *Interliant OnSight Manager* allows customers to control and manage their hosted Notes/Domino databases.

2. *Interliant OnSight Alerts* provide customers with e-mail and pager notifications of problems in the network.

3. *Interliant OnSight Reporter* provides usage reports to the customer, including information on traffic distribution, message size and volume users.

4. *PM for Lotus Domino*, by inter.action, is a server-reporting tool that provides weekly reports on utilization, capacity and performance.

Customer support for clients of AppsOnline rentable applications is a different story. Interliant encourages customers to call or e-mail questions to its application partners. It does, however, offer nominal self-service information through its Web site, with online support forums to assist customers in resolving problems. It also constructed a reference section on its Web site, with detailed instructions for subscribing to an application and a posting of frequently asked questions.

Technology Infrastructure

Customers can choose to have their Notes applications hosted on dedicated or shared servers. Dedicated servers are usually warranted when a company's application is accessed by a large number of users, when the load on the server will be high, or when companies are concerned about the security of their information.

While most large customers opt for dedicated machines, SMB customers typically use the lower-cost option of a shared Domino server with separate directories (called virtual servers) for each client server. Most of their Notes applications are too small to justify a dedicated server.

Notes-hosting customers may also chose between using a private network or the Internet to access their applications. Currently, most Interliant customers opt for more-secure, higher-performance private networks.

Go-to-Market Strategies

In addition to direct sales, Interliant is partnering with consultants, integrators and ISVs to sell and help deploy its hosted solutions. Through its recently announced Business Partner Program, Interliant will begin cultivating closer relationships with its channel partners, and provide them with the training, sales support and technical assistance needed to sell complete end-to-end Interliant solutions to their customers.

With the announcement of the AppsOnline program, Interliant has begun to make extensive use of its Web site to sell its rentable applications directly to customers. The company offers a catalog of rentable applications at the Web site that supplements its traditional marketing and sales efforts.

Competitive Advantages

Interliant is betting that a combination of its leadership in Notes hosting and the addition of its AppsOnline service will set the company apart from the slew of ASPs that have recently emerged. Unlike most new entrants, Interliant already has a long track record as a hosting provider for high-volume Notes and messaging applications. With 2,000 customers running 10,000 applications, Interliant has a level of credibility in hosting complex applications that its competitors can only dream of achieving.

Interliant also has a well-thought-out, two-pronged, application-rental strategy that could easily become a model for success. First, by offering applications on a month-by-month rental basis, Interliant can attract new classes of customers:

■ Customers that need short-term access to an application;

■ Customers that don't want to implement and manage an application internally; and

■ Customers that want to try an application before buying the solution.

Interliant's rental model reduces these customers' costs of entry and virtually eliminates technology risk.

The second part of Interliant's strategy is based on providing a growth path for rental customers that decide to purchase the application for broader use in their organizations. Rather than lose these rental customers, Interliant will customize most of its rental applications and host the solution on a dedicated server, on a shared server or on a co-location basis. Thus, Interliant's strategy allows the company to easily transition its rental customers into a services relationship as customer needs grow. As important, it creates a compelling

reason for ISVs to partner with Interliant to offer rented versions of their applications, because Interliant's programs encourage customers to purchase software licenses when it makes business sense for them.

Early Results

Interliant has had measurable success in the Notes-hosting market. According to the company, it owns more than half of this market, and has a number of brand-name customers, such as Amnesty International and the Salvation Army. Its relatively new service, AppsOnline, has also had some early success. The company has already signed several Instant!TEAMROOM customers.

Current Outlook

Of the pioneers profiled in this report, Interliant stands out as a company worth watching in the future. The reasons are simple. First, Interliant is one of the few companies in the industry that actually has a track record in hosting applications on the Internet and has an impressive number of paying customers. It already knows what works and, more important, what doesn't work. Second, Interliant has a well-thought-out applications-rental strategy that addresses both the short- and *long*-term needs of customers. Most important, Interliant's strategy is based on its core business competency: developing and hosting Notes-based applications. Renting these applications to users is an extension of its business strategy—not a brave new world.

What could go wrong for Interliant as it breaks new ground in this emerging market? It could find that renting applications through the Web is a bust and that users won't really adopt this form of computing. Or it could find that it has selected applications that aren't the killer applications for the rental paradigm. If this possibility turns out to be true, Interliant's momentum is likely to stop. But, unlike competitors that have bet the ranch on one hosting strategy, Interliant can fall back on its core business of hosting Notes applications. From this perspective, Interliant is one of few companies that can play both ends against the middle in the IAH marketplace—and can land on its feet no matter how this market evolves.

Section 3   Pandesic: The Perils of a Pioneer

Pandesic (www.pandesic.com) was founded in August 1997 as a limited liability company (LLC), jointly funded and owned by SAP and Intel. Its mission is to provide low-cost, turnkey, end-to-end e-commerce solutions.

SAP and Intel's partnership in creating this company made sense. First, the two companies have a long-term business relationship. SAP is a large user of Intel systems and Intel uses SAP systems to run its business processes. Second, the companies have several key business objectives in common.

SAP wanted to bring its ERP applications to the Internet and gain early experience in the e-business marketplace. Intel was betting that e-commerce market growth would be explosive and wanted to establish its platforms as the dominant standard for doing business on the Internet.

Applications and Target Markets

Pandesic hosts customized, *end-to-end* e-commerce environments that are built on SAP's R/3 Finance, Sales & Distribution, Warehouse Management and Materials Management modules, which run under Windows NT. In addition to the R/3 components, Pandesic's hosted offering integrates third-party applications and services that extend these e-commerce facilities, including applications that compute taxes instantly at the Web site, manage the shipping process, update inventory systems, manage the payment and collection processes, and capture customer data for use in the future.

Pandesic originally targeted large firms for its hosted e-commerce solutions. It believed that large companies would want to offload the immense development and operating costs associated with these Web-selling environments to a third-party expert. Today, however, it believes its sweet spot is actually in midsize companies with total revenues of $10 million to $100 million—*and* the potential to generate at least $10 million annually through Web commerce. These companies are more likely to have manual or antiquated back-end systems, and they need an easy way to automate and integrate these processes. Within these targeted customer enterprises, Pandesic's best target contacts are presidents, CEOs and vice presidents of sales/marketing. These executives must place high value on reaching Web customers in minimal time at the lowest possible costs, and have the ability to approve Pandesic's percentage-based fee structure.

Within the midsize-business world, Pandesic is targeting novice e-merchants that sell physical goods and need robust back-end processes, such as automated inventory management and balancing, catalog management and automated returns processing. The company plans to further segment its market focus into eight to 10 specific vertical segments in the future, but has yet to reveal these targets.

Strategic Partnerships

Pandesic's "one-stop solution" relies heavily on two categories of partners:

1. *Authorized Partners.* Channel partners that sell, customize and install the Pandesic solution; and

2. *Technology Alliance and Business Alliance Partners*. These partners provide the technologies and services that Pandesic integrates into its turnkey solution.

The firm depends on its channel partners to manage the sale and perform necessary application customization. Pandesic's channel partners are drawn from across the industry, from the ranks of Internet professional services firms, information SIs, network-computing-solutions implementation firms and business-solutions providers. Partners include Inacom, USWeb/CKS and US Interactive, as well as smaller firms, such as MultiVision Consulting, InfoEdge, U.S. Technomedia, Osprey Systems, IAI, Fort Point Partners, Novo/Ironlight Interactive, Free Range Media, CTR Business Systems, Onyx Interactive and Walldorf Technology Group.

Channel partners are also important to Pandesic's avowed strategy to become a global e-commerce leader. Its Japanese subsidiary, Pandesic KK, which began operations in the fourth quarter of 1998, relies on channel partners, such as Yamato Transport, Toyo Information Systems, NTT, NTT Software, and Price Waterhouse Consultants. Besides having knowledge and experience in the local market, each partner brings a unique skill set to Pandesic KK and will work cooperatively with the others to roll out the solution.

For example, Yamato Transport specializes in warehousing and distribution. Toyo Information Systems is a SI that will sell, develop and host solutions. NTT and NTT Software will focus on the SMB market by selling, supporting and hosting Pandesic solutions. Price Waterhouse will provide consultation and services to customers. Pandesic is wagering that its business model, supplemented by the complementary services offered by these Japanese partners, will be a compelling solution for Japanese businesses looking to develop e-business presence.

Technology and Business Alliance Partners are the second critical component of the Pandesic partner strategy. These partners deliver a wide range of basic technologies, enhanced applications capabilities and services. CyberCash, for example, provides Pandesic customers with secure, end-to-end, Web-based payment processing; TaxWare's tax-calculation package (the Internet Tax System) provides real-time tax calculations when products are purchased through the Web site; United Parcel Service (UPS) provides integrated package-tracking services; and Citibank offers Pandesic customers global banking services. Other strategic technology and business partners include:

- *Microsoft*. Pandesic has standardized its environment on the Windows NT operating system, Microsoft SQL Server, Microsoft Site Server 3.0 Commerce Edition, the Component Object Model (COM) and Active Server Pages.

- *Compaq*. Pandesic has standardized on Compaq's ProLiant servers, which are Intel-based.

- *McQueen*. McQueen provides global fulfillment services for Pandesic solution customers.

All of these partners are critical components of Pandesic's business model, which relies on providing end-to-end e-commerce solutions to its customers. Only through their assistance can the company provide such a comprehensive offering to its customers.

Pricing

Pandesic's pricing scheme is one of the most novel in the industry. Instead of charging for all customization services upfront, then charging an additional monthly fee for hosting, it bases its fees on a *fixed* one-time upfront installation *plus* a monthly hosting fee based on a percentage of the customer's Web-based revenues.

Installation fees, based on the number of suppliers and the number of base products being sold, are as follows:

- Companies with less than 10 virtual suppliers and less than 10,000 base products pay an installation fee of $25,000.

- Companies with an unlimited number of virtual suppliers and more than 10,000 base products pay a one-time installation fee of $100,000.

These installation fees encompass all applications software and licenses (which are owned by the customer), customization, implementation, hosting, training and ongoing customer support.

The monthly hosting fee is negotiated with each customer separately and ranges from 1 to 6 percent of Web revenues. Pandesic will charge a minimum monthly fee if a customer does not meet its monthly revenue obligation.

This revenue-sharing model necessitates a fair amount of prescreening from Pandesic to ensure that a customer will generate enough e-commerce revenue to make the relationship worthwhile. Steps in the prescreening process include reviewing a prospective customer's Web-business plan and assessing the revenue opportunity for the customer and Pandesic. Once Pandesic accepts a new customer, the minimum initial contract period is two years.

Customer Support

The core premise of the Pandesic offering is to provide customers with a customized e-commerce solution that requires little or no day-to-day technical management by the customer. To achieve this ideal, Pandesic uses its channel partners to customize and install the system, and then employs a third-party company to host the solution on a dedicated server. To further promote its "worry free" e-commerce message, all customers receive Pandesic's

Evergreen Service, which provides free product upgrades, around-the-clock service and support, monitoring, backup and system security.

Technology Infrastructure

Originally, Pandesic's business model called for the company to host its customers' sites on dedicated servers in its own data center. During 1998, however, the company realized that hosting is not a core competency and decided to outsource this function. In January 1999, Pandesic announced a strategic relationship with Digex to host client applications on dedicated Compaq servers in Digex data centers. Digex will also provide Pandesic customers with direct access to Digex's tier-one national network as well as its other public and private network offerings.

Go-to-Market Strategies

Pandesic's go-to-market strategies are an excellent example of the perils of being a pioneer. The company's original plan of selling indirectly through partners was a bust. The company quickly found that its partners weren't ready to pitch a complex and comprehensive e-commerce solution with an elongated sales cycle, and that its involvement in the sales cycle was critical to completing the sale. As important, most partners weren't willing to risk receiving fees based on customers' Web-based revenues. They were—and still are—most interested in cold, hard cash.

Today, Pandesic is pursuing a hybrid channel approach that addresses these channel realities. In the second quarter of 1998, Pandesic created its own direct-sales force, which makes joint sales calls with channel partners. Pandesic also takes a proactive role in marketing and pre-sales efforts, including sending direct mail, sponsoring advertising and participating in sales events. Once Pandesic has connected with a potential client, it usually engages a partner in the selling process.

Partners are now compensated in two ways: upfront commissions on closed business and separate pay for any customization work they provide. Some of Pandesic's original partners receive annuity revenues and the company is reviewing ways to incent new partners to share in this business model.

Competitive Advantages

Pandesic realizes competition is keen in the already over-saturated e-commerce market and differentiates its offerings from competitors in several ways, including the following:

■ It claims it has the only complete *end-to-end* solution that incorporates and automates all of the processes needed to conduct robust e-commerce

on the Web. Most competitive products and services automate only the Web-purchasing portion of the e-commerce environment.

■ It lowers the customer's risk in three ways: lowers risk of entry by charging a nominal installation fee; lowers long-term risk by basing its monthly fees on the client's Web-based revenues (assuming customers meet monthly revenue minimums); and assumes the customer's technology risk by hosting the environment, and updating the system and software when required.

The company also differentiates itself from competitors in several other ways. It competes with product vendors by integrating many state-of-the-art technologies into a seamless, end-to-end, e-commerce environment. It competes with traditional SIs by charging a nominal development fee and basing its fee on the customer's success (for example, percent of Web revenues). And Pandesic competes with ISPs that provide generic commerce solutions by integrating additional services not provided by most ISPs.

Finally, Pandesic differentiates its offering by providing the customer with a single point of contact for all hardware, software and support needs. This will be of particular value to customers with limited IT resources and those that have not done business on the Web previously.

Early Results

Pandesic got off to a rocky start. Its almost exclusive use of indirect channels was not working. And it originally focused on large companies—which didn't respond as strongly as Pandesic hoped. The result was slow sales and a much-publicized feud among Pandesic's management.

Pandesic's rocky first year resulted in a loss of valuable time and momentum. With initial business assumptions seriously off track, it was forced to switch its focus from large corporate customers to midsize companies. The company also erroneously believed that it could sell through a large network of partners, which would share annuity revenues. Finally, Pandesic underestimated the complexity of implementing systems, believing that it could customize a solution within eight to 10 weeks. This miscalculation not only lengthened the time it took to get revenues flowing, but also caused its customers to publicly criticize Pandesic's inability to integrate its own technologies.

Current Outlook

After an almost overwhelming set of false starts and missteps, the company is attempting to rise like a phoenix from the ashes of a flawed hosting strategy. It is reshaping its strategy, refocusing its target audience, and revamping its sales, channel and partner programs to address current and emerging market requirements.

Its efforts have produced some demonstrable successes. It currently has 40 customers, 21 of which are live, including DVD Express, Kosher Grocer, Cold Fusion Sports, Wild Oats Market and AllHerb.com.

Based on its new focus and momentum, Pandesic believes that its future will not be a repeat of the past. Company executives forecast that real progress will be apparent by the second quarter of 1999. It is too early to tell whether this forecast is realistic or optimistic but, from our perspective, the firm has several strikes against it.

First and foremost, customers aren't necessarily going to flock to Pandesic's revenue-sharing model, especially in a market where new competitors, like USi, offer attractive alternatives that don't require giving up profits to succeed on the Web. Pandesic must convince the customers' executives that sharing revenue is better than partnering with a fee-based Web outsourcer. This revenue-sharing approach and its customer requirements complicate and prolong Pandesic's selling process, escalate the cost of sales and make selling through partners more problematic.

Finding a customer with the need—and the ability—to buy its services is only the first step, and it is a tough task. A customer must step up to generating $10 million in annual Web revenues—using a new, largely unproven medium. To do this, the customer must have (or develop) a solid business plan for selling on the Web and demonstrate the ability to execute on it.

And then there is the question of whether Pandesic can really achieve desired profits by charging a low entry fee and covering its real costs of development and operation by taking a percent of the customers' commerce revenues. On paper, this business model looks alluring, but Pandesic has already learned that strategies that sound good on paper aren't necessarily the right bet.

Finally, the issue of competition arises. When Pandesic entered the market in late 1997, it was one of few companies targeting the applications outsourcing space. Today, it faces a pack of vendors, including IBM, USi and USWeb/CKS, which see this market as intrinsic to their future growth. Unlike Pandesic, these companies are pursuing more traditional business models, which do not require a revenue-sharing commitment. These companies can be less picky about who they select as customers, will enjoy shorter sales cycles, and will find more success selling through indirect channels.

In the final analysis, however, Pandesic does have one significant asset that can not be dismissed: brand-name parents with deep pockets and a compelling reason to succeed in this market. The question is, of course, whether SAP and Intel will give Pandesic the time it will need to find this success.

Section 4   Winning Strategies for the New Frontier

Each member of our hardy trio of IAH pioneers is approaching the industry in a different way. Each is pursuing a slightly different business model and has a different customization scheme and pricing approach. And each hopes that its unique combination of applications and services will establish the rules of IAH competition. Summit Strategies believes some of these strategies will be more successful than others. Let's examine some of the more promising ones.

Interliant, for example, has an interesting dual-strategy approach. Customers can rent a standard version of an application on a month-to-month basis. Or, customers that want a customized version can purchase the application and hire Interliant to develop and host it.

This approach gives Interliant several key advantages. First, it can target the needs of small organizations (including small businesses and branches of large enterprises)—a market that doesn't even show up on most IAH vendors' radar, despite its rapid growth. With just a handful of employees that need access to an application, small companies don't need the cost or complexity of a customized solution. Nor does the size of the problem they are trying to solve warrant a multi-year contractual relationship with a hosting provider. In short, a month-to-month relationship lets these companies date vendors—not marry them.

But Interliant's value proposition begins to really shine as these companies grow and require higher-level customization and hosting services. Then, Interliant will have a decided advantage over its competitors. After all, Interliant will have already established credibility with the customer as a hosting provider; it will have proven that it knows how to operate the application and provided a responsive hosting environment. Plus, the customer's users are already trained on a particular application, have their browsers pointed to the right Web site and have their application data loaded on an Interliant server. Why would a satisfied customer jump ship for another hosting provider?

Interliant's approach is likely to be successful for another reason also—it allows customers to test applications and the IAH waters in their own business environments before betting even an inch of the ranch on the new computing paradigm.

USi's decision to build and operate its own international server farms and worldwide network, rather than rely on partnerships with telcos or large ISPs for these capabilities, may be another winning strategy. On its face, this decision might appear foolish, especially since these centers have taken almost a year to complete and have delayed USi's entry into the IAH market. Strategically, however, this decision will likely become USi's most significant competitive advantage.

All of USi's offerings are business-critical applications that demand exceptional levels of network security, failsafe backup, and guaranteed customer access in order to be successful. By owning its own data center, USi can virtually guarantee that its hosting environments will deliver bulletproof service levels to customers. As important, competitors that use hosting and network partners may find themselves in a defensive position—proving that their consortiums can coordinate and deliver the same or a better class of service with the same levels of accountability. Although time may prove that these consortiums can deliver equal or greater benefits, for the short term, USi's strategy gives it a strong card to play with enterprise-class customers.

Another strategy for winning in the IAH market centers on customer-support programs, such as those that USi and Pandesic offer to their hosting customers. Both of these vendors take responsibility for supporting the entire hosted solution through its life cycle. Thus, their hosting customers are spared the endless rounds of vendor fingerpointing created by integrating solutions from multiple suppliers. As important, these support programs promise to handle any future incompatibilities or problems that might crop up when the hosting provider upgrades the server or the application.

USi's One-To-One support program goes one step further. It provides each hosting customer with a dedicated support team. To further enhance its promise of world-class customer support, USi also claims that its support representatives will handle no more than two customer accounts at any time.

Whether or not USi—or any other IAH pioneer—can actually deliver on its support promises as its business grows remains to be seen. But such support programs will become as important for IAH providers as having the right applications portfolio, the best or most flexible pricing schemes or competent partners that can develop customized solutions. To be truly competitive, companies will need fully staffed support organizations that understand the unique problems associated with integrating and customizing applications, and deploying them over the Internet. And, they must be able to support multiple hosting customers, each of which may have a different flavor of the solution.

Section 5   **Gaping Holes and Dead-End Strategies**

Other strategies coming from IAH pioneers look good on the surface, but fall apart under closer scrutiny. Two strategies in particular stand out as the most problematic: hybrid channel strategies and customization pitches that won't make it past any customer with a calculator and the ability to think.

First, let's look at the type of hybrid channel strategies in which some providers are trying to combine direct and indirect channels by having:

- Direct salespeople sell to target accounts and handle leads generated by the company's marketing programs; and

- Partner salespeople pass on leads and referrals, and make joint sales calls to close the business.

If a development partner generates the lead, it usually receives the contract to customize the customer's application. The ASP then hosts the application and manages the long-term customer relationship. If a software partner's salesperson refers the customer, they generally receive a commission equal to the time-discounted value associated with selling the software license, plus the value of the value-added services they provide.

On its face, this hybrid selling model looks perfect—and it works fine as long as the ASP is hosting applications on dedicated servers. But problems crop up when the ASP hosts multiple customers on a shared server. Then, each individual customer will not purchase a separate license. And, unless the software vendor and the ASP want to break the bank, paying a full sales commission won't be an option. So, the software salesperson has to decide whether they should encourage the customer to deploy the application internally, for which they receive a full sales commission, or pass the customer to a hosting partner, for which they receive a fraction of the normal commission.

And that's just the tip of the commission iceberg. Even if a full commission is paid on a license, passing the customer to the ASP will cut the software salesperson out of additional commission opportunities. For example, customers that use a hosting provider don't need to buy the application vendor's support and services contracts. (Nix two payments on the salesperson's Mercedes.) And, because most ASPs wrap application upgrades into the hosting relationship, the salesperson will lose future commissions when customer needs expand. (Nix the down payment on that little cottage in the Bahamas too.)

Finally, the discussion comes to the fundamental flaw in the assumptions being made by ASPs and their application partners. They assume that software salespeople will recommend outsourcing when they conclude that prospective customers aren't going to ante up for licenses. Unfortunately, hope springs eternal in the sales psyche. While a salesperson might be convinced that the customer isn't going to buy a license today, this doesn't mean that the customer might not buy in the future. By passing this lead to a hosting partner, the salesperson practically concedes that this customer won't purchase a license from him for the duration of the hosting contract—in most cases, a minimum of two years.

Given this reality, what kinds of leads are software salespeople likely to pass to application-hosting partners? Hard-target prospects that are unlikely to

ever buy software from the salespeople or prospects whose referrals to hosting are salespeople's last-ditch efforts to keep customers from buying from competitors. These are hardly the class of leads that hosting companies need—or want.

Section 6   No Free Lunch Here

Although the benefits delivered by an ASP can be alluring (see Summit Strategies' Capitalizing on the Power of E-Business Advisory Service report, *Internet Applications Hosting Goes to Market*, December 1998), IAH isn't always cheap, especially for companies that want to customize the applications around their specific business requirements.

Virtually every IAH vendor provides some level of application customization to address specific customer requirements. Costs can be as low as $25,000 to customize Pandesic's e-commerce solution, for example, or as high as several hundreds of thousands of dollars to modify a manufacturing solution from companies such as Oracle and SAP. Understandably, many IAH providers offer ingenious programs to make these sky-high fees more palatable. USi, for example, bundles customization fees with its hosting services and amortizes these costs over the contract period (typically 36 months). Other options being considered by some vendors, such as Oracle, are special financial programs that allow customers to stretch out the costs of upfront implementation fees.

Another way vendors are trying to obscure the total costs of these solutions is by stressing the monthly per-user fees. In many cases, these monthly fees are very attractive. For example, Interliant charges only $85 per user, per month for access to a non-customized version of Synergistic's sales-force-automation application, Prevail Professional. On the other end of the spectrum, customized sales environments can be much more pricey. For example, USi will provide a semi-customized version of Siebel's SFA software to groups of 50 users for about $400 per user, per month. Although this fee might sound reasonable when presented as a monthly cost, it translates into a total price tag of $4,800 per user, per year.

Other user-pricing scenarios are also on the drawing board, including higher monthly fees for power users who need access to all features and much lower fees for casual users (such as managers and supervisors) who will access the application only on an occasional basis.

Despite vendor efforts to cloak the impact of customization costs, these scenarios introduce a more significant problem than simple sticker shock. Because many IAH providers, such as USi, retain ownership of the application licenses, customers are actually paying these vendors to modify software they don't own. Think of it as a renter paying to renovate a house—something that

a landlord would likely embrace, but not a particularly good financial decision for the renter.

How are these vendors addressing this hole in their IAH story? Most are trying to sidestep the issue by indicating that such "details" are still under development. In reality, the solution is simple. Vendors will have to provide attractive terms that offer customers options, such as the flexibility to convert a hosted application license into a perpetual license at the end of the hosting period.

The potential impact of a vendor's customization fees on the total cost of a hosting solution won't be lost on most customers—and may well become the "make-or-break" factor for vendors eyeing the IAH market. Vendors that bet their businesses on highly complex applications that require extensive (and expensive) customization—but are used by relatively few employees—will often find their offerings too pricey to compete with internally deployed applications. Conversely, ASPs that bet their businesses on hosted solutions that require little customization—and are used by many employees in a corporation—will find that their offerings have obvious and very compelling benefits to corporations. This is especially true for ISVs and ASPs that preconfigure their applications for the needs of specialized constituencies, such as small construction firms or doctors' offices (see our February 1999 Industry Dynamics and Market Strategies Advisory Service report, *Internet Applications Hosting: Metamorphosis or Mirage?,* for a discussion of these opportunities). In the final analysis, success in the IAH marketplace may come down to a simple case of audience economics.

Section 7   **It's Getting Crowded in This Phone Booth**

That rumbling on the industry horizon is the sound of wannabe providers stampeding into the IAH marketplace. This stampede, led by a veritable who's who of the computing, telecommunications and consulting industries, will carry the IAH banner into every corner of the IT marketplace.

The following is a list of just some of the other companies planning to enter the IAH marketplace:

■   *IBM* has been testing the application-rental waters for more than two years with an IAH program called the Business Computing Utility. It is expected to launch a massive program in the U.S. market in 1999.

■   *Oracle* will launch its IAH offering, Oracle Business OnLine, in early 1999. The service, based on the Oracle8i platform, will rent Oracle's business applications and software written by selected third-party ISVs on a monthly, per-user basis.

- *SBC Communications*, a $28.8-billion telecommunications giant, partnered with Concentric Network (best known for its virtual-private-network hosting offerings) in October 1998 to develop a new business service, Online Office, which they launched in 1999. Targeted at SMBs, Online Office will provide a full range of network services *plus* access to network-hosted business applications.

- *USWeb/CKS* also plans to throw its hat into the IAH ring. Its USWeb/CKS Electronic Services program, which will host customers' customized applications and packaged software from BroadVision and Vantive, as well as provide a range of Horizontal Electronics Services, is scheduled for worldwide release in late 1999.

- *Bell Emergis,* a division of Bell Canada, recently entered the IAH market with the Business Application Rental Store located at its Web site, http://workspace.emergis.com. This site currently rents Lotus's Instant!TEAMROOM collaboration environment for $19.95 per user, per month.

- Top-five accounting firm, *Arthur Andersen,* is also targeting the IAH marketplace with a new "business-outsourcing" service that combines software from J.D. Edwards with Arthur Andersen's financial-management services.

- Tiny IAH startups are also staking their claims to portions of this emerging market. For example, *Virtualscape*, a small, fast-growing startup, develops Web-hosting tools and Web sites; *Planet Computer*, a tiny network-services company, launched its PlanetUplink applications-hosting service last September; and *Zland*, another small IAH pioneer, specializes in strategic Internet solutions for small and midsize companies.

By any standard, these new IAH entrants promise to change the rules of competition in the IAH market. For existing providers, their presence will be a sword that cuts both ways.

On one hand, these brand-name powerhouses are sure to make the application outsourcing and rental concepts much more credible for customers. Their marketing programs will generate more market awareness and, hopefully, accelerate customer demand. On the other hand, these giant vendors are sure to dwarf many smaller vendors and ISPs, which have pioneered the IAH market. Most of these giants have world-class consulting and customer-support organizations, which are intrinsic to developing these solutions and handling day-to-day operations. They have huge direct-sales forces and extensive partner networks that can reach thousands of customers. Many, such as IBM and SBC, also have worldwide networks and server

farms already in place. Most smaller vendors cannot buy, build or even begin to emulate such assets.

So will the entrance of giants, such as IBM, Oracle and SBC, sound the death knell for small companies swimming in the IAH waters? Are companies like Corio, Pandesic and Interliant—and tiny pioneers like Virtualscape, Planet Computer and Zland—on the IAH endangered-species list? Conventional wisdom would indicate yes. But things are not always as they seem.

Section 8   Place Your Bets and Spin the Wheel

Just when it looks like the mighty are going to capture the IAH market, the Internet is taking an interesting—and unplanned—turn, which might even the playing field. Power portals, which are safe havens of business for small IAH providers, have begun to emerge as the new battleground for portal vendors on the Web. In the future, Web portals will be much more than Web locations for users to get their daily news, check e-mail, chat with friends and obtain software downloads. These portals will evolve from user starting-point sites to users' permanent homes on the Web, where they will access a broad range of information and services—including IAH services. (A forthcoming Summit Strategies Capitalizing on the Power of E-Business Advisory Service report will cover the impact of power portals on the Internet industry in more detail.)

What does the development of these sites mean for IAH? Through the expansion of power portals, small IAH providers will be able to showcase their hosted offerings to millions of prospects—a market reach that not even an IBM or an Oracle can match. Small IAH providers will also achieve instant credibility from the branding provided by the portal owners. In many cases, this branding will carry more weight with Web users than the reputation of the largest IT vendor or telecommunications company.

And how will power portals affect the giants that are stomping into the IAH marketplace? To date, none of these vendors owns a major portal—and only IBM seems to be edging toward a power-portal strategy. Thus, most of the industry giants must compete on a level playing field. They will have to negotiate for portal space just like their smaller brethren—or quickly develop their own power portals to reach millions of users. But developing a power portal and generating traffic from scratch takes time and, on the Web, time is every vendor's arch enemy.

Even as power portals provide havens for smaller vendors, the IAH landscape will remain treacherous ground for the foreseeable future. The stumbles, mistakes and maneuvers of the companies we've discussed illustrate that no company has figured out the perfect formula to succeed, much less dominate,

in this market. In fact, some companies, such as Oracle, seem to have a strategy du jour, while others, such as USWeb/CKS and Corio, have cloaked their marketing messages in so much corporate jargon that they are virtually unintelligible.

However, one thing is crystal clear about the entry of industry giants into the IAH market: it will create an explosion in customers' IAH awareness and accelerate the adoption of this paradigm in companies of every size. This development means vendors that don't have bulletproof strategies, portfolios of killer applications and crisp marketing messages are running out of time.

Which brings us to the most important question: who will be smiling in six months when the IAH smoke starts to clear? Of the companies mentioned in this report, our bets are on IBM, USi and Interliant. As for the rest of the roster, Summit Strategies invites IAH market observers to place their bets and spin the wheel.

What's your opinion? E-mail the author:

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Appendix

Market Strategy Reports
1998 - Present

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