

New-World Value: **The Strategic Impact of** **Business Application Suites in** **Today's Corporate Environment**

Traditional formulas for calculating the value of integrated application suites are expanding as enterprises discover a need to better account for the upside growth potential and flexibility afforded by new technologies.

An exclusive report from **BusinessWeek Research Services**



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Executive Summary

- Traditional formulas are no longer sufficient to calculate the payback of integrated enterprise resource planning (ERP) application suites, especially given new delivery platforms such as service-oriented architecture (SOA) and new release strategies.
- Integrated enterprise application implementations provide an entrée into business process transformation, resulting in innovations that need to be entered into the return on investment (ROI) equation.
- Any ROI accounting must take into consideration modular release strategies, which provide substantial new functionality at a modest cost.
- Ability to change processes quickly and eliminate maintenance costs frames the business case for application suites.
- Enterprises are supplementing traditional measurements with a more holistic view to establish a better framework for recognizing the business value of ERP investments.
- This more holistic view maps business application investments to business goals such as growth, business transformation, customer acquisition, optimized business processes and innovation.
- Use of the total cost of ownership (TCO) metric will diminish because it ignores the opportunities afforded by increased flexibility, agility, process innovation and process reuse.

Methodology

BusinessWeek Research Services (BWRS) launched a research program in early 2008 to determine the views of C-level executives—CEOs, CFOs, COOs, CIOs—at large and midsize companies on how to calculate the value of ERP investments, especially given new technologies such as SOA, software as a service (SaaS) and modular upgrades that provide less easily measured business opportunities. Traditional formulas need to be supplemented with additional measures of value to expand the understanding of what an investment in an integrated business application suite means. These suites can be a foundation for creating new business models, serving new customers, optimizing processes and innovating both inside and outside the four walls of the enterprise. As such, it's especially important to map business goals to the promised benefits of the investment.

This report is based on interviews with C-level executives, consultants and industry analysts who are considered to be the leaders in determining the financial and strategic value that ERP makes possible. These discussions also covered the new frameworks these experts use to measure that value. In addition, various documents and other credible sources were part of the research effort.

The organizations included in the research for this report are:

- | | |
|---------------------|---------------------------------|
| ■ AMR Research Inc. | ■ Freescale Semiconductor Inc.. |
| ■ BearingPoint Inc. | ■ ICW Group |
| ■ BTM Corp. | ■ Forrester Research Inc. |
| ■ Eaton Corp. | ■ Keen Innovations |
| ■ ebizQ | ■ Red Door Spas |

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For more information about this project, please contact the associate director of Primary Research at *BusinessWeek* at marc_scheer@businessweek.com.

Introduction

When senior executives at ICW Group were examining a potential ERP investment in 2007, they considered the usual financial metrics: internal rate of return, net present value, “all the different financial plays,” says Kevin Harris, CIO at the San Diego, Calif.-based full-service insurance provider. Although important, none of those traditional measurements was able to capture the value of the opportunity ICW’s executives knew they would reap from adopting an integrated business application suite that enabled the company to run its multiple lines of business on a single platform. As COO David Hoppen noted in a recent article, it was important that the system support ICW’s business transformation strategy as well as its SOA technology strategy.

Flexibility and low-cost ways of changing processes on the fly were a big part of the decision, Harris agrees. In fact, ICW originally looked just at replacing its claims system. But as executives started digging into the process, “we realized that claims touches everything we do,” he says. “So rather than looking for a point solution, we began looking for one that would allow us to have business transformation, but in an integrated fashion.”

In the end, ICW’s business case for investing in the suite, which includes seven modules, rested largely on the fact that it provided a framework for improving the company’s operational efficiencies, reaching its customer satisfaction goals and achieving its growth expectations, according to Hoppen. “When you’re working on antiquated systems, all you can think about is, ‘Wow, this just doesn’t work,’” Harris adds. “When you take that out of the equation, you have freedom to think and innovate. We can’t measure that yet, but the ability to innovate is huge.”

By widening the lens through which ICW viewed its ERP expenditure, Harris and Hoppen have joined other executives in believing that they have a much richer understanding of how their enterprises are positioned to benefit from investments in a business application suite, rather than simply sticking with traditional formulas. In addition to using tried-and-true ROI approaches, these executives are:

- Working on ways to measure the top-line benefits that these systems enable, including business growth, customer acquisition and capabilities that enable competitive advantage.
- Considering the new modular release strategies offered by large business application suite vendors that provide their companies with new capabilities without the high costs of a complete upgrade.
- Understanding the substantial opportunities SOA offers.
- Focusing on the business process transformation that suites of enterprise applications enable and accounting for the resulting strategic innovation (see Figure 1, “ERP and Innovation Drive IT Budget,” at right).

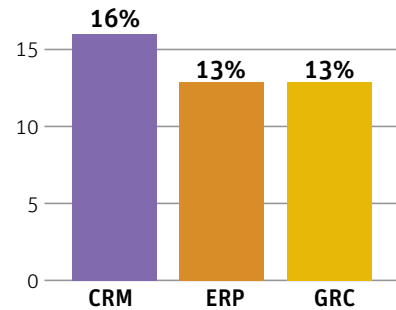
Case in point: Hoppen considers ICW’s new system a lynchpin in its comprehensive five-year growth and transformation strategy.

Figure 1

ERP and Innovation Drive IT Budget

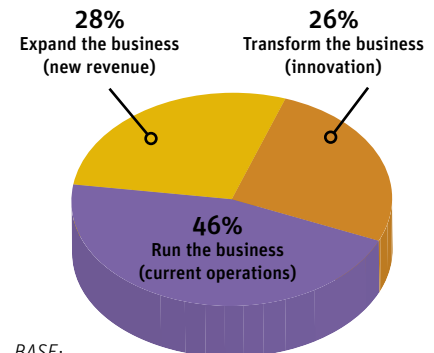
According to AMR Research’s 2008 IT spending forecast, enterprises are continuing to see ERP as a top investment, even as they look to technology organizations for innovation.

Companies named ERP and governance, risk management and compliance (GRC) as the second most strategically important investment in 2008.



BASE: 495 IT and line-of-business managers

A substantial piece of the IT budget is allocated for innovation initiatives.



BASE: 345 respondents

Source: AMR Research Inc.

Expanding Traditional Formulas

The concepts of ROI and TCO have been used for decades in enterprise evaluations of IT investments, including ERP systems (see Figure 2, “The Formulas,” below). What has changed, however, is that with the emergence of important new technological advances, executives at leading companies are now expanding these traditional formulas so they can account for new opportunities that are not reflected in a classic ROI/TCO analysis.

These executives have decided that it’s time to inject additional measures of value. Such measures expand their understanding of what an investment in a business application suite means, particularly because enterprise applications can be a foundation for building distinguishing capabilities. They have discovered new ways to measure payback, and they are using the results to reach strategic business objectives.

Progressive senior executives have been factoring into their investments the greater flexibility afforded by SOA and other new platforms for quite a while now. But it’s time for a formal, institutional recognition of this practice, especially in the context of integrated business applications. Enabling growth may entail a less concrete ROI picture. But in the long run, this type of investment can have the most dramatic ROI impact.

Not that traditional ROI analysis should get short-shrift, warns Michael Fillios, a CFO for many years and currently chief solutions officer at BTM Corp., a business technology management consulting firm in Stamford, Conn. What’s changing is the criteria and the weight placed on them: “Voodoo ROI is out, and real accounting is in,” he says.

Figure 2

The Formulas

Traditional metrics used to evaluate IT investments at a glance.

- **Return on Investment:** Also known as rate of return (ROR) or rate of profit, ROI is the ratio of money gained or lost (realized or unrealized) on an investment relative to the amount of money invested. The amount of money gained or lost may be referred to as interest, profit/loss, gain/loss or net income/loss.
- **Total Cost of Ownership:** This is a financial estimate designed to help managers assess direct and indirect costs commonly related to software or hardware. It’s a form of full-cost accounting. TCO takes into account the cost of supporting the IT asset or project as well as the initial outlay. TCO should not be used to judge bottom-line benefits, because it does not account for upside or return.
- **Payback Period:** This refers to the period of time required for the return on an investment to “repay” the sum of the original investment. Many senior executives now require payback periods of one year or less for major technology investments.
- **Net Present Value:** Defined as the total present value of a time series of cash flows, NPV is a standard method for using the time value of money to appraise long-term projects. Used for capital budgeting, NPV measures the excess or shortfall of cash flows, in present value terms, once financing charges are met. NPV is often not a good measure for technology projects, because it’s artificially low.
- **Internal Rate of Return:** This is a capital budgeting metric used by firms to decide whether they should make investments. It’s an indicator of an investment’s efficiency, as opposed to its NPV, which indicates value or magnitude.

Source: Wikipedia

“Although ROI has been the go-to metric that is most understood by CFOs and CIOs, it’s a very internally focused point of view, and that can be myopic,” Fillios says. “They need a more well-rounded analysis.”

TCO is another popular metric that should not be taken alone. “That metric is not very meaningful here,” says Beth Gold-Bernstein, chair of ebizQ, a Web portal for information on the topic of business and IT agility. “It doesn’t take into account all of the upside. SOA is all about upside, and you have to account for that somehow.”

Peter Keen, chairman of Fairfax, Va., consulting firm Keen Innovations, agrees that focusing too heavily on TCO is shortsighted; it makes IT expenditure all about cost. By concentrating on efficiency and cost reduction, the danger is that you completely overlook the capability of integrated enterprise application suites to reach business goals such as creating new business models, serving new customers, optimizing business processes and innovating both inside and outside the four walls of the enterprise.

TCO and efficiency gains are important; however, a new measurement is needed to account for scale and organizational dexterity. The question is, what are these worth to you? What would you pay to be able to change your business process flows without changing your underlying systems? To react faster? To respond to changes quicker? The new reality for business leaders is to account for these attributes when making their enterprise software decisions.

Accounting for the Intangibles

Freescale Semiconductor Inc., a \$5.7 billion maker of embedded electronics solutions based in Austin, Texas, uses a standard framework to analyze all of its potential IT investments. According to Freescale Vice President and CIO Sam Coursen, every technology project must prove that it will further business objectives, or funding is a no-go. “Everything we do has to drive more business value,” Coursen says. “If not, why would we be doing it?”

For example, Freescale is currently migrating its supply chain applications from a legacy mainframe platform to its enterprise ERP system. Coursen expects that the process improvements enabled by this project will pay off quickly, by reducing costs and improving efficiencies. “We are changing our supply chain planning processes from end to end and, at the same time, we are getting rid of those mainframe systems. That has an additional cost benefit to it,” he says. The order-to-cash process is next up for migration.

Though most of Freescale’s IT projects generate speedy positive return, not every project needs to show tangible benefits such as cost reduction or revenue generation. Intangible benefits also drive business value and can be every bit as compelling, according to Coursen. “The process of selecting the projects is not totally science; it’s art, as well,” he says.

Non-quantifiable benefits might include reducing risk, making the company more flexible and increasing customer satisfaction, Coursen says. “Unlike some companies, we don’t try to put dollar figures on those,” he adds. “But when you do that, the number doesn’t have a lot of credibility.”

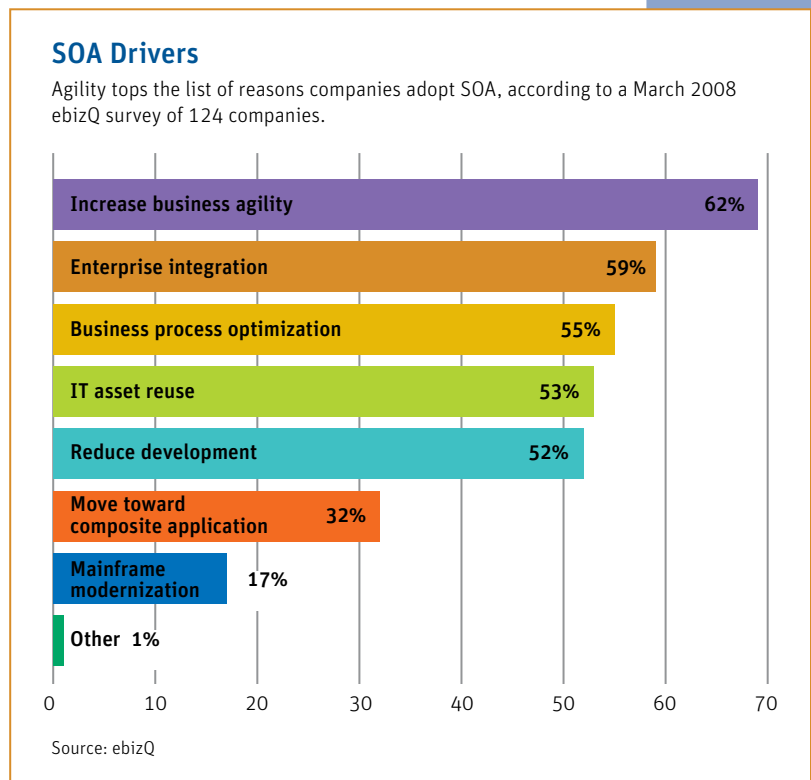
Coursen is recognized in the industry as being a leader in using technology to create value. He was recognized as one of the 100 top CIOs of 2008 in *CIO Magazine* for Freescale’s implementation of an enterprisewide business intelligence system. This system, which connects to the ERP platform, is expected this year to generate cost savings of \$1.2 million in the finance department alone.

Higher Value Releases

A development that executives would do well to consider when calculating ROI is the new release approaches offered by some large vendors of enterprise application suites that enable new functionality without the need for a monolithic upgrade. These approaches enable customers to upgrade systems gradually, “without the kind of massively expensive and disruptive projects that have traditionally characterized [ERP] releases,” says Ray Wang, principal analyst at Cambridge, Mass.-based Forrester Research, in a recent article.

According to a recent Forrester report, companies that use business application suites say that more frequent software updates, delivered in smaller doses, are increasing the value of the ERP platform. Customers can use fewer resources in terms of time and money to

Figure 3



deploy the new functionality, notes Wang, and they can get increased functionality in more frequent intervals than every two to three years.

This approach presents a big change to the ROI picture, considering that 50 percent of customers upgrade their ERP systems every three years, according to Boston-based AMR Research Inc. It poses a severe detriment to ROI, notes AMR President Tony Friscia, in a recent article. “By constantly upgrading for new functionality, they are forever adding cost and chasing an elusive ROI rainbow,” he says.

In contrast, the prebuilt integrations and vertical modules delivered around an enterprise application suite are raising value, making for a quicker return on investment.

ICW’s Harris says the option of being able to leverage modular releases in the future was a factor in his firm’s selection of an enterprise application platform. “We knew we’d have the option of utilizing [the modular releases] down the road,” he says. “The integration of those solutions into our new [ERP] backbone would be an attractive option for us.”

A SOA Vision

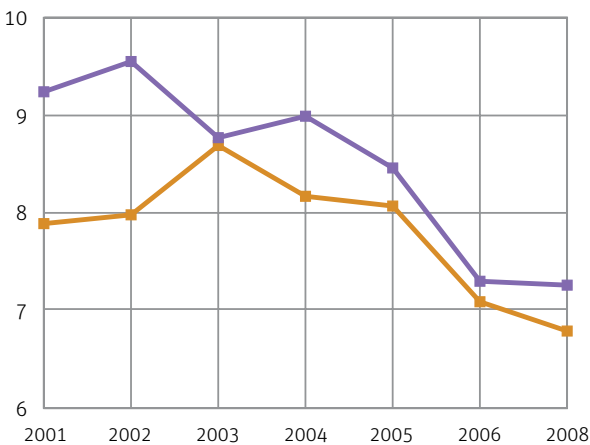
The widening lens is even apparent at companies that have a culture grounded in hard numbers and tangible benefits. At Eaton Corp., for example, traditional accounting metrics carry the day. But the \$16.5 billion Cleveland-based diversified power management company has begun its SOA journey. Eaton usually just relies on tangible cost reduction and revenue generation for all its investments, including technology, explains CIO William Blausey. Now, Eaton is taking a tiny leap of faith on the benefits of SOA.

Figure 4

IT Innovation More Important than ROI

When asked to rate, on a rising scale of 1 to 10, the relative importance of various IT goals over the next 12 months, C-level executives (the majority CEOs) consistently give a higher rating to IT innovation than ROI metrics.

- Focus on developing new ideas and applications for using technology
- Develop tangible ROI metrics for evaluating information technology initiatives



Source: BusinessWeek Research Services, 2008

“We’re developing some applications with SOA concepts, using Web services,” says Blausey, who reports to Eaton’s CFO, Richard H. Fearon. These preliminary SOA forays are not core or customer-facing applications, which are based on packaged solutions. “We depend on our software providers to deliver those applications under a SOA architecture. We believe the moves they are making to build their applications as components will benefit us down the road,” he says.

As a massively diversified corporation, Eaton stands to benefit greatly, Blausey believes, if the vision of SOA openness comes to fruition. The company currently runs more than 30 different ERP systems and versions, a result of many acquisitions in recent years. “We could plug in components from different ERPs without ever having to switch to a single platform,” he says.

Indeed, most industry analysts and a growing number of senior executives now consider SOA to be the conduit to an impressive list of business benefits (see Figure 3, “SOA Drivers,” on page 7).

Business Process Innovation

Today’s modular enterprise application platforms also carry a lower TCO than past systems. They require just one skillset to operate, no matter what module is being used. This can be a launching point for cost-effective growth.

Red Door Spa Holdings of Stamford, Conn., for example, is leveraging its business application suite to aggressively expand its retail footprint without skyrocketing headcount. In a recent report, CIO Paul Kaczmarek says technology is the driver for Red Door’s growth of about 20 percent per year. Red Door uses a retail industry-specific application built on a SOA platform.

With its previous system, Red Door would have had to add IT staff to expand, with rising personnel costs eating into growth. Not so with its current system, which is designed to allow retailers to be nimble in exploiting business processes throughout the enterprise while creating compelling customer experiences. The overall return on investment picture for this solution is, therefore, more advantageous.

Some companies are innovative in the way they evaluate ongoing investments into enterprise application suites in the context of SOA. For instance, John McMahan, managing director at BearingPoint Inc., a management consulting firm in Atlanta, endorses quantifying SOA benefits as options.

According to McMahan, some of his clients use an options pricing framework—comparable to a financial option—where they can buy or sell at a future time, when better information is available for decision-making. These companies use this approach to quantify intangible benefits, such as flexibility, around changing the business model and providing different service lines for customers. Think of these benefits as flexibility options, growth options or innovation options, he says.

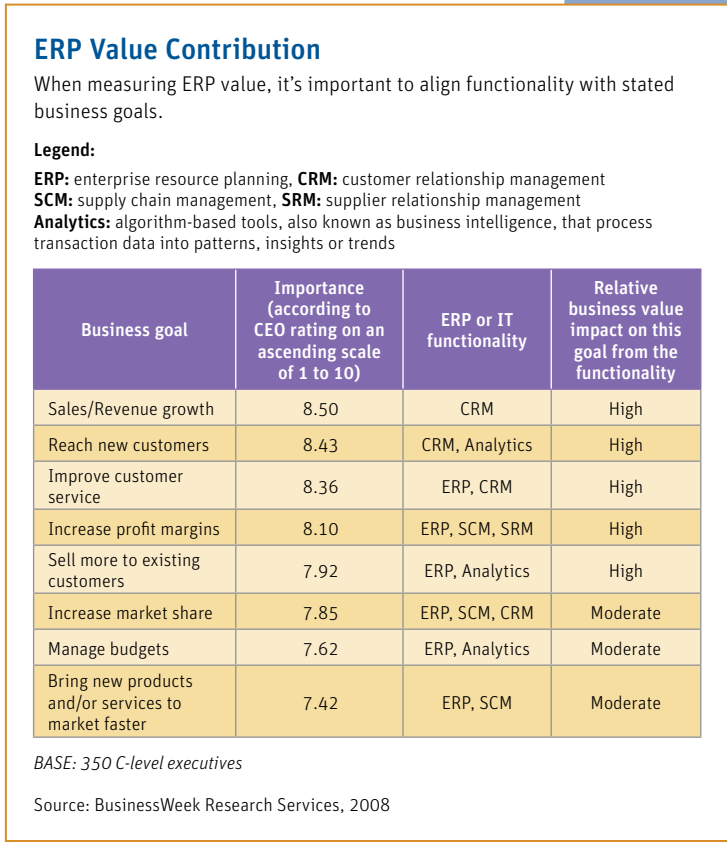
“Having the ROI/TCO number is helpful,” McMahan says, “but it has to be balanced against a more strategic view of the options that you’re creating, based on executive judgment.”

While not yet in wide usage, these additional measures of value go far toward a more holistic view of seeing business application suite investments provide a foundation for growth. Distinctive capabilities—those things that separate a company from the rest of the pack—spring from enterprise applications, now more than ever. Senior executives must learn to view their investments through this broader lens.

Extending ERP

The focus on cost reduction can be traced back to the early days of ERP, when initial investments were often cost-justified in this way. Today, however, when companies look to extend their enterprise application systems, the goal is often to improve service levels or make process changes to improve customer service, McMahan says.

Figure 5



The good news is that technologies such as SOA and new release strategies enable enterprises to extend the value delivered by their existing investments in an efficient way, says Keen of Keen Innovations.

But there's a downside: Corporate measurement and management systems have not caught up with these new technology developments, BTM's Fillios says. "Companies that want to look at the possibility for top-line growth still have measurement systems that look at costs," he says. "That creates a paradox—the measurement systems are conflicted, and the management processes don't honor that."

Because measurement systems are sometimes lacking, many companies proceed with SOA-based enterprise application suite projects without the benefit of a traditional business case. This happens simply because executives view the resulting functionality as a must-have, says Gold-Bernstein of ebizQ. "They are doing this to enable agility, or they want to enable functionality they don't have now," she says. "These are new levels of functionality and capability."

But it's important to establish the business case as part of the overall analysis, she says. Along with ROI, payback period is a critical measure. It indicates when a company can afford to reinvest in other projects that will drive more value.

The conflict between establishing a realistic business case and simultaneously recognizing potential top-line benefits can be seen in a survey of C-level executives conducted by BWRS. Respondents say they are more focused on developing new uses of technology than on developing new metrics of IT ROI (see Figure 4, "IT Innovation More Important than ROI," on page 8).

It's important to establish an agreed-upon understanding and prioritization of business goals before embarking on a framework to better recognize the business value of SOA-based business application suite investments, even when modular enhancements provide substantial new features at modest cost. Mapping business goals to benefits can indicate the largest financial opportunities.

When it comes to business objectives, C-level executives today are concerned with top-line goals, according to a January 2008 study conducted by BWRS. This is true despite the fact that a bottom-line focus on profitability and cost-cutting measures is typical during economically soft times. Over the past seven years, BWRS has polled C-level executives at large and midsize companies for their annual business goals. This year, the 350 executives surveyed are mainly concerned with increasing revenue growth, in part by attracting new customers from new and existing markets.

It's clear that adding incremental functionality that directly contributes to achieving these stated business goals in a cost-efficient manner would have the highest business value. Indeed, ERP and other IT functionalities in a SOA environment offer tremendous business value opportunities (see Figure 5, "ERP Value Contribution," on page 9).

Conclusion

Adopting this new, broader view of the value of enterprise application suite investments is an essential first step in positioning enterprise applications as a source of distinctive capabilities and business process innovations. Forward-thinking senior executives have been factoring greater flexibility and business agility into their investment decisions for quite a while now, but it's time for a formal, institutional recognition of this practice.

For ICW, the SOA-based system was a critical investment, whether the numbers were there or not. "We had underinvested over the years," Harris says. "That was making it challenging for us to be innovative and offer the same types of services that our competitors are offering. Even if we did all the analysis in the world and we were not going to make any money, we would have had to do it anyway." ■

SPONSOR'S STATEMENT

Software for Every Business, Every Process

With an objective of understanding more about how organizations are evaluating investments in enterprise applications during these tough economic times and to support its own findings and experience, SAP partnered with BusinessWeek Research Services to reexamine the role that return on investment (ROI) and total cost of ownership (TCO) play in these decisions. The findings indicate that leading companies base their decisions on how well an enterprise application can support them as they adapt new business models, create optimized processes and sustain competitive advantage during the toughest of economic times.

The overall goal for organizations today is to be able to quickly adapt to a changing business environment. It is critical that they have the flexibility to respond quickly—sometimes overnight—to business change. Increasingly, SAP's software design goals are oriented to support the customer's need to respond to business change. For example, developing solutions based around flexible frameworks such as service-oriented architecture (SOA) and enabling customers to implement business process innovation through "The Enhancement Package" rather than a wholesale software upgrade provides customers with the flexibility to adapt and innovate.

What will be some of the key characteristics of the next generation of successful companies?

- Innovation inside and outside the traditional walls of the company. Business networks will become increasingly important, in stable and turbulent times.
- Quick development of new business models and the ability to implement them effectively using software tools and technologies.
- The ability to leverage best practices through prebuilt integrations and business processes and the agility to quickly meet the needs of a changing business environment.
- Continued focus on lower TCO while increasing business continuity as a result of ongoing innovation, not big-bang upgrades.
- Use of software to embody and present distinctive capabilities to existing and new customers, business partners and, last but not least, employees, as well as the ability to retain high-performing employees.

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