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Hand-to-hand combat in enterprise software

The first quarter earnings season was at times carnage for enterprise software. Was the disruptive impact of artificial intelligence (AI) to blame?

Not entirely, no. Tougher macroeconomic conditions, with long-term interest rates back on the rise during the quarter, led to a wobble in corporate technology spending, which is still only tentatively recovering from its downturn of the past couple of years.

There are also deeper forces at work. AI needs to be viewed as a disruptive threat as much as an opportunity within the enterprise software sector, and it is starting to show.

On the face of it, the opportunity seems clear. Software companies are sitting on a goldmine of data and have the chops to integrate AI into their products and do great things for customers. Indeed, industry analyst Gartner projects AI-related revenues in enterprise software to grow from less than $50 billion today to over $1 trillion in 10 years' time, a 30%-plus compound annual growth rate.

But having spoken to enterprise software companies in Silicon Valley, our overriding impression of current conditions is not quite one of a gold rush, but rather of hand-to-hand combat.

Take one of the big beasts of the sector, Salesforce. The stock was down more than 20% the day after earnings, sending shock waves through the sector. Could Salesforce, with all its technology pedigree, scale and scores of customer data really be a loser in the AI revolution?

The late, great Clayton Christensen of Harvard Business School thought there were fundamentally two types of innovations – sustaining and disruptive.

Sustaining innovations enable incumbents to strengthen their lead by enhancing their offering to customers. Within enterprise software, think of Microsoft Teams. Over the past few years it has enabled co-workers to communicate and collaborate more easily on work in Microsoft Word, PowerPoint and Excel.

Disruptive innovations by contrast kick the door open for upstarts by enabling a much cheaper and simpler brand-new version of a product. Think of Inuit's core offering of a software package that replaces your accountant at

80-90% lower cost. These innovations are kryptonite to incumbents because adopting them simultaneously vaporises profitability and upsets existing customers accustomed to the bells and whistles.

No doubt, AI could be a sustaining innovation for Salesforce. The company has released its AI assistant, Einstein, with great fanfare and its scale with $35 billion of revenues and large customer data sets will underpin the offering. However, it is eye wateringly expensive, with Salesforce's all-in subscription including AI at $500 per seat per month.

AI is a leveller. It distributes capabilities that were once the held by the few to the ready and willing. Competitor HubSpot, for example, is currently less than 10% the size of Salesforce in revenues but growing more than twice as fast by driving down prices. HubSpot's all-in enterprise subscription with AI is $70 per seat per month, 85% cheaper than Salesforce, making Salesforce vulnerable to Christensen-type disruption.

HubSpot also has an advantage in having built its products on a single platform from day one as opposed to Salesforce's more complex platform built from many acquisitions over the past couple of decades. This means it is simpler to use for customers, and easier and cheaper for HubSpot to innovate – it has announced 200 product enhancements in the past year alone.

Salesforce faces pressure from short-term focused investors to maximise current profitability. Founder and CEO Marc Benioff will need to capitalise on the legitimacy that only founders possess to ensure that the company is adequately focused on making the right-long term decisions in the age of AI.

This will mean investing in truly game-changing innovation through AI to create great value for customers and pricing it so that it is a no-brainer for customers. This is how leading companies can escape the innovators dilemma.

In cyber security software, AI is a game changer because it is arming the bad guys. Criminal cyber-attacks, which in the good old days used to require a lot of skill, are being democratised. This means far more attacks but also faster attacks. It used to take hackers hours to do damage once they'd breached the system, now it takes minutes.

CrowdStrike was built on AI from the start and is one of the best equipped to fight AI with AI. It may have an edge over leaders such as Palo Alto and Fortinet, which were originally built on a firewall architecture to keep malware out of on-premise networks, and have had to integrate modern parts of the toolkit over time. Palo Alto has done this through serial acquisitions.

In contrast, CrowdStrike is much simpler to use, and this quarter reported a major win from Palo Alto on the basis of its customer requiring 75% less engineer time to operate.

This customer appeal is showing in CrowdStrike's growth, with revenues up phenomenally from $300 million at its IPO in 2019 to over $3 billion today. Moreover, it is growing at 30% with a 30% free cashflow (FCF) margin. Palo Alto and Fortinet will have to adequately invest to create great incremental value for customers from AI and maintain their strength.

The risk to investors from AI is clear. The winners of the last cycle will not necessarily be the winners of the next cycle.

In the short term, chief information officers are holding back on major multi-year deals as enterprise software providers deploy and refine their AI offerings, in order to judge which offering is best value for money. This is partly why Q1 was weak.

Making things even trickier, standard seat-based subscription pricing models themselves are under disruptive threat from AI, as in some cases, efficiency gains translate to fewer workers required and therefore fewer subscriptions. Consumption-based models have in the past proven far from perfect in enterprise software, but they may become a necessity.

Value-based pricing models (such as those slowly emerging within healthcare) may be the best ultimate solution, but they are difficult to achieve and there are cautionary tales. Games designer software producer Unity Software faced a big backlash from customers for asking for a cut of the upside going forward on historical projects.

Incumbents will have to get both innovation and pricing right and not leave the door open to disruptors. This means that some great companies have not just an opportunity but also a challenge on their hands in the age of AI.

James Dowey, Co-head of the Liontrust Global Innovation team

For a comprehensive list of common financial words and terms, see our glossary at:
https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

Key Risks

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May have a concentrated portfolio, i.e. hold a limited number of investments. If one of these investments falls in value this can have a greater impact on a Fund's value than if it held a larger number of investments.

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