Dealing With Small Vendors in the Elastic Enterprise

RFG believes IT executives seeking to use the most innovative technologies have little choice but to turn to smaller technology vendors. Such vendors are a primary source of significant innovation, and are usually at the forefront of the newest trends. In addition, smaller vendors often provide superior service compared to larger, more established vendors. However, smaller vendors can have trouble adequately supporting large enterprises. IT executives should seriously consider products and services from small companies, but only after adequately weighing the potential risks and rewards.

Business Imperatives:

- New and small ventures are typically the primary sources of new technologies. But the brilliance and agility of the tight-knit technical staff tends to be offset by limited capital and management expertise. However, enterprises can set up valuable relationships with smaller vendors by negotiating strong service level agreements (SLAs), by initiating strong vendor management programs, and by communicating regularly with the vendors' principals. IT executives seeking to build a competitive advantage using the leading-edge technologic innovations should earnestly consider all sources regardless of vendor size limitations.
- IT executives can partially mitigate potential risks of doing business with a small company through proper investigation into the firm's financials, investors, management team, and strategy. Forming a win-win partnership with the vendor could be the single most important critical success factor. For software products, the use of escrow for source code provides some downside protection. For hardware vendors, reviewing the vendors one year, funded technology plan is an imperative. IT executives should explore all risk mitigation possibilities when evaluating small vendors to verify if they are enterprise compliant.
- In addition to the benefits of using leading-edge technologies, doing business with startups and other small vendors can provide significant discounts and the ability to heavily influence the vendor's product direction. Typically, larger enterprises can get a small vendor's intimate attention and the best people are assigned to those important client implementations. IT executives should recognize the power of these benefits and the resulting potential affect on competitive position.

For IT, the U.S. Small Business Administration defines a small business as a software company with annual revenue less than $21 million, a hardware company with fewer than 500 employees, or an IT value added reseller with fewer than 150 employees. Of the 500 largest software companies as determined by Software Magazine in 2004, 166 qualify as small businesses under the SBA guidelines.

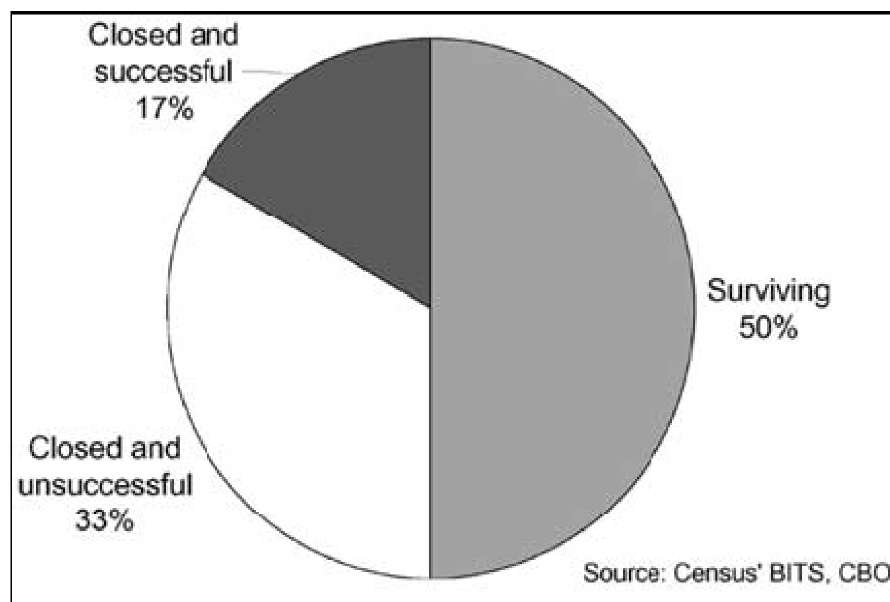
There are tens of thousands of small technology vendors. According to the SBA, small companies accounted for 39.1 percent of jobs in high technology sectors in 2001. According to Larta Institute, more than 25,000 technology companies existed in 2003 in the state of California, of course a known training ground and stronghold of new technology companies. The software industry is the largest recipient of venture capital funding with 198 companies receiving $1.1 billion in Q1 2005, according to the MoneyTree Survey by PricewaterhouseCoopers LLP, Thomson Venture Economics, and the National Venture Capital Association. The same survey showed 58 telecommunications companies captured $371 million and 40 networking firms garnered $348 million in Q1. While down from the peak in the year 2000, venture capital investment still feeds a healthy dose of investment into new and small technology firms.

These smaller vendors exist to fill market gaps left by other vendors. Each believes it has found a niche in which it can excel, providing technology and services overlooked or scoffed at by the bigger players. So it is inevitable that IT needs to eventually do business with small vendors.

Small vendors are the primary providers of some of the hottest new technologies today: healthcare automation, Internet-based applications, Linux tools and applications, security systems and tools, storage solutions, vertical market applications, voice-over-IP (VoIP) service, and wireless technologies and services. These small companies embrace a vision and commit themselves to take the big risks. Most focus first on product development and customer service. As their markets expand, these companies lure new customers. Early adapters are among the first to benefit from the competitive advantages by being on the leading edge of what could become a technology wave.

While most people assume small companies fail at high rates, U.S. Census Bureau data sources show this is not necessarily true. The Business Information Tracking Series (BITS) showed that about half of new employer firms survive beyond four years. The Characteristics of Business Owners (CBO) showed that about a third of closed businesses were considered by their owners unsuccessful at closure. (See Figure 1.) So business closings often reflect success – a buyout or merger. Also, contrary to common assumptions, prospects of survival are reasonable.

Figure 1. Business success (percent of new employer firms after four years).



Source: Census' BITS, CBO

Nevertheless, vendor failures do not typically mean the end of the technology life cycle. More financially solid companies where those technologies get employed or embedded in other products frequently acquire viable concepts, patents, and products. Those that survive sometimes do so in a big way, creating tremendous industry impact. All of today's largest technology providers were originally startups that grew, then acquired and continue to acquire small companies to bolster their product lines.

Certainly, the customers of those survivors can gain significant benefit from the relationship. IT executives should evaluate the real risks of each situation, understand their risk tolerance and consider partnerships with those new vendors that pass their criteria. In addition, as RFG has advised before, IT executives should demand contractual protections protecting them should any size vendor fail to deliver on its promises. (See the RFG Educational Asset "Vendor Management.")

Do Due Diligence

No doubt, a failed venture leaves its customers with negative consequences. Sometimes customers must take ownership of technologies to keep them operational. In other cases IT executives must abandon a failed venture and go with a replacement solution. This can affect a CIO's reputation as well as sacrificing the time and money invested in the effort. Even worse, if the customer acted as a reference for others, peer relationships may be damaged.

Therefore, it is critical that IT executives investigate the firms with which they plan to do business. While the IT department evaluates the features, ease of use, and other technical factors of a startup's product, IT executives should assess the viability of the business and the acumen of the management team. IT executives should also enter into such an association with the expectation of a partnership rather than the standard vendor-client relationship.

Understand Support Capabilities

The overarching concern of an IT executive considering doing business with a small company is the longer-term support and commitment. In other words, will support be available through the lifecycle of the product within the company? Strong partnerships between the nascent firm and established providers bolster the startup or other small company's potential and lower the risk for IT executives. However, IT executives should evaluate the partnerships to determine their financial and technical depth –partnerships that are announced but have little real commitment from the partners do nothing to mitigate risk.

IT executives should ask the startup or other small company direct questions about these alliances to determine validity. Examples of such questions include the following.

- Has training occurred?
- How much development for any product integration is complete?
- What investments has the established partner made?
- What is the exact nature of any contractual agreement?

The management team, not just technology, drives the smallest companies forward. They determine company strategy, which people are hired, what partnerships the company engages, product features, how funds are spent, where funds originate, and the philosophy of customer service. IT executives should work to understand the motivations of the management team as well as their previous experiences delivering comparable solutions for other companies. In RFG's experience, successful small companies place the highest value on customer satisfaction; during an evaluation period, IT executives can gauge responsiveness.

Get References and Review Key Personnel Résumés

After the management team and partnerships, other factors come into play. The startup should provide references. IT executives should expect that in the very early stages a startup might only be able to offer what amounts to personal references. If so, those references should be able to provide insight into the founder(s) and the ability to deliver on promises. If the startup has customers, the projects should be somewhat similar to the one in question. IT executives can ask for site visits and other communications with references to understand completely the startup's implementation.

IT executives should also determine who from the startup would work on their project. The vendor should provide résumés of important individuals illustrating their capabilities and qualifications. IT executives

should insist upon a documented implementation plan as a deliverable and in some cases, it should be part of a contractual agreement. Appropriate timelines and resource allocations should be in the plan and should reflect reality and should set proper expectations. Startups are typically short on resources. It may therefore be prudent to contract with a third party to assist.

Startups look for vocal references in their quest for clients. Clients who talk with the press, analysts, and other companies provide tremendous value to a new venture. Companies with stringent policies regarding public communications of technology activities are typically of significantly less value to a new firm. Therefore, IT executives should expect to allocate time to those communication efforts that help the startup grow.

Implant Protections that Lower Risk

Source code escrow is a protection mechanism for buyers of software. The escrow is a contractual agreement along with a physical process for placing the vendor's source code in a vault. If the new venture fails and both parties meet other turnover conditions of the contract, the source code goes to the customer. To mitigate risk, IT executives should demand source-code escrow arrangements from software vendor startups.

Financial viability matters are important but have recently been less of an issue for many small companies because of the relative availability of venture capital, angel investor money, and loans. The result is that many of the better small vendors today have sufficient funds for several years of operating capital. IT executives should understand the financial status of their vendor partners including the amounts, sources, and types of money.

Also important is a firm's exit strategy – whether it plans to be acquired or to go public via an initial public offering (IPO). IT companies are now less likely to offer an IPO. According to the Quarterly Liquidity Report from VentureOne, a unit of Dow Jones Newswires and the publisher of VentureSource, only one of eight IPOs in the first quarter 2005 was an IT firm. However, the same report shows that of the 79 mergers and acquisitions completed in the first quarter, 45 of them were in the IT industry.

Clients tell RFG that they often ask for financial information in the evaluation process yet vendors respond that they are privately held and therefore do not disclose such information. RFG recommends pressing private vendors to share financials and staffing information, perhaps under a non-disclosure agreement (NDA). It is reasonable for enterprises to ask for and receive assurances from vendors that they are financially viable and have the staffing needed to support their efforts. In addition, IT executives should meet with the company's board of directors or investors directly to get their key questions answered.

While it is understandable that vendors may not want to disclose during the early stages of investigation, if a vendor refuses to disclose under any circumstances, IT executives should not do business with that vendor. The goal of most small vendors is to grow rapidly in order to pay back investors in a reasonable time period. Large enterprise customers enable small vendors to become credible to potential clients, employees, investors, and partners. Therefore, IT executives should know the vendor's funded product development plan and use this leverage when negotiating with small vendors.

Finally, IT executives should measure the level of risk as reflected by alternatives, customization, longevity and product integration. It is critical to evaluate the negative impact of doing nothing in the area in question. IT must also determine how deeply embedded or integrated the new technology would be with existing systems. IT executives should have a clear understanding of the amount of customization required.

In addition, IT executives should estimate how long this new technology would actually be used before being replaced. IT executives can help paint a realistic picture of the risks of smaller vendor deals by evaluating these issues.

RFG believes IT executives should consider all sources of innovative technology, including new and small ventures, especially when seeking a competitive advantage from leading edge technologies. IT executives ought to understand their enterprises' tolerance for risk and take reasonable steps to mitigate those risks through the proper investigation of a small vendor before leaping into an arrangement with less established firms. However, because certain information on non-publicly held companies is more difficult to obtain, IT executives need to be aggressive in making sure they get all of the information needed to make a prudent business decision.

RFG analyst Ron Exler wrote this Research Note. Interested readers should contact Client Services to arrange further discussion or an interview with Mr. Exler.

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