

Return on IT (ROIT) is up along with spending trends

**Although it's not time to
Party Like its 1999,
there is plenty to Celebrate**

*An Alinean white paper study
by Tom Pisello, CEO and founder
and ex-Managing VP, Gartner*

Published by:

Alinean, Inc. • 201 S. Orange Ave • Suite 1210 • Orlando, FL 32801-12565

Tel: 407.382.0005 • Fax: 407.382.0906 • Email: info@alinean.com • Web: www.alinean.com

December 2006

© Copyright 2001-2006, Alinean, Inc. All rights reserved.

No part of this report may be reproduced or stored in a retrieval system or transmitted in any form or by any means, without prior written permission.
All other trademarks are the property of their respective owners

| | |
|--|----------|
| EXECUTIVE SUMMARY..... | 1 |
| Innovation is the focus, and it shows..... | 2 |
| Doing more with Less: IT Efficiency is up Sharply..... | 3 |
| IT Projects are still risky relative to other investments..... | 4 |
| IT spending not keeping pace with revenue growth..... | 4 |
| More Stakeholders are Involved in IT Spending Decisions..... | 4 |
| IT Executives Are Concerned About Value, But Progress is Slow..... | 5 |
| Frugal remains best as Top Performers under- spend both average and laggards..... | 6 |
| Modest Return on IT (ROIT) Performance Leaves Room for Improvement..... | 7 |
| CONCLUSION..... | 8 |
| The Bottom-Line | 8 |
| ABOUT ALINEAN..... | 9 |

EXECUTIVE SUMMARY

To obtain perspective on the challenges for IT executives and what it means to IT solution provider sales and marketing, it is vital to examine IT spending, opportunities for improvement and effectiveness metrics. To provide insight, each year we analyze over 21,000 companies in 37 different industry segments worldwide. , the results show that there are several significant findings to examine in relation to IT cost justification and business value selling:

1. Innovation spending is up sharply by 43% since 2003 and will likely continue to grow
2. IT efficiency has increased 10% allowing companies to do more with less
3. Yet, IT projects remain risky, with almost half of all IT projects cancelled prior to completion, or fail to meet schedule, budget or feature requirements, and only 1 in 4 launched successfully and delivering on promised benefits
4. IT spending is up, but when examined in relation to revenue growth, overall IT spending has lagged for the second year in a row declining to only 3.3% of revenue
5. More stakeholders are involved in each IT decision making it harder to gain approval and consensus
6. IT Executives prioritize proving and improving the value of IT high, but progress is slow in actually addressing slow in actually addressing the issue and quantifying value
7. Frugal remains best as top IT performers under-spend laggards and the average
8. Overall IT spending, even though lagging revenue growth, is driving superior and quantifiable corporate performance in the majority of industries, and has improved 67% from 2003.

Let us examine each of these eight trends in detail and what they will mean for 2007.

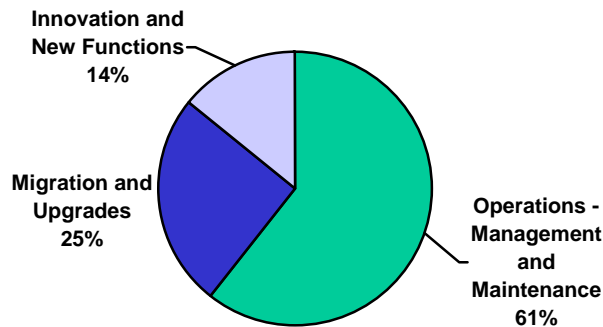
Innovation is the focus, and it shows

Even though budgets have increased, many IT organizations struggle to obtain enough funding to implement as many new applications and functions as they would like and as business units demand. Because of tight cost controls, head-count reductions and outsourcing, the trend post-bubble was massive constraint in innovation spending for new applications and IT enabled business investments.

Innovation is certainly an important focus. Gartner's 2006 survey on IT priorities indicated that "The notion of IT driving business growth has risen in priority over the last few years from number 18 to number one," according to Gartner's head of executive program research, Mark McDonald

The good news is that increasing IT budgets and corporate initiatives to reduce operating costs and reallocate budget to new initiatives have resulted in increased innovation investments, rising from a scant 10.2% of the average IT budget in 2003 to over 14.6% in 2005 – a whopping 43% three year increase. As a result of conscious efforts to address growing business needs for new process improvements, new IT enabled businesses and new applications, innovation spending increases far exceed budget increases over the past 3 years.

Keeping the lights on still consumes too much of the average budget, at around 60%, while migrations and upgrades to existing systems costs 26% of total budgets, but the rise in innovation investments is promising. And the effects are wide reaching in that innovation spending is up in 78% of all industries (29 of 37 total).

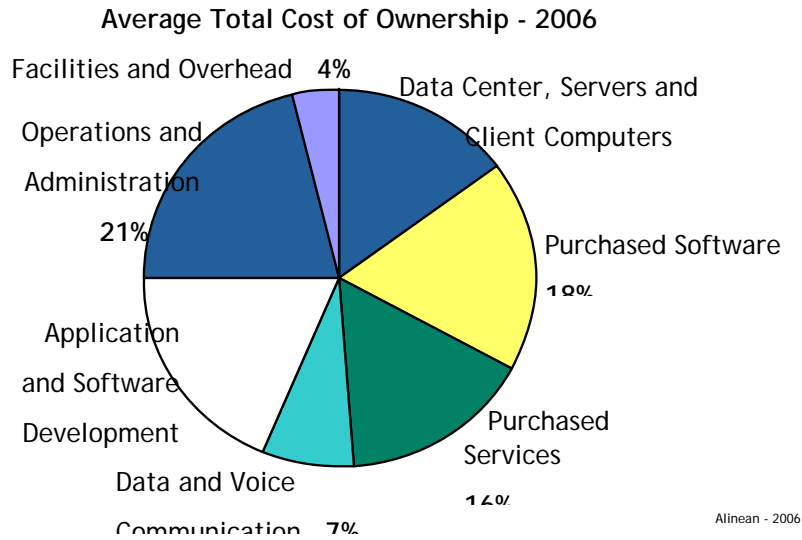


Across the 37 industries in the study group, innovation investments were up sharply in several segments including Aerospace and Defense firms, Specialty Manufacturing and Professional Services, Transportation and Utilities. Industries where increases in innovation were surprisingly low or flat included Financial Services / Banks which overall has the highest level of average innovation at 18% but with flat growth) and Insurance. Industries with drastically lower innovation rates included Telecommunications, Real Estate, Paper Manufacturing, and General Manufacturing.

With many IT departments running very lean, as projects are justified, showing how they can reduce on-going operations and allocate more towards innovation is key. Justifying projects by showing cost reductions is not longer enough. Projects need to be justified now on how they will help the business innovate more, not cut expenses.

Doing more with Less: IT Efficiency is up Sharply

Overall, IT labor or outsourced equivalents consume the majority, 56% of the average IT budget. Being able to utilize these resources to best effect, particularly being able to manage more employees and knowledge worker per staff member provides greater IT efficiency, and enabling the resources to move from mundane tasks to value added innovation is important to improving IT effectiveness.



In over 70% of industries IT efficiency increased substantially, increasing the number of knowledge workers supported per IT FTE resource. On average, 45 knowledge workers can be managed per IT FTE, while 130 employees overall can be managed per IT FTE. This represents a 10% improvement in ratios and reallocation of labor costs over 2003 spending levels. Consolidation, standardization, virtualization and management tools all contributed to the efficiency and productivity increases.

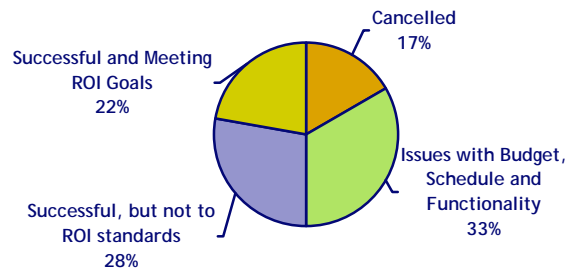
This has resulted in a reduction of overall IT costs per employee to \$4,818, while costs per knowledge worker have been reduced to \$8,685 on average worldwide.

Industries with the best increases in IT staff efficiency include Financial Services and Banks, Food and Beverages, Healthcare, Insurance, Professional Services, Real Estate, Wholesale, Government and Education. Industries that did not see improvements and have declining management efficiencies (less knowledge workers managed per IT FTE) include Automotive and Vehicle Manufacturing, Construction, Steel Manufacturing and Transportation.

The key for 2007 is further improving IT productivity and efficiency, helping to reallocate more and more budget from keeping the lights on to address the backlog of business projects, improve service levels and drive higher levels of innovation investments.

IT Projects are still risky relative to other investments

Although improving with each year since the late 1990s when we began tracking IT project success rates, still almost half of all IT projects are cancelled prior to completion, or fail to meet schedule, budget or feature requirements. Moreover, only 1 in 4 of these projects were successfully completed and delivered on promised ROI goals.



IT vendors need to realize that each IT project is reviewed in this context. Risk needs to be factored into any proposed business case, and each case made as conservatively as possible.

IT spending not keeping pace with revenue growth

IT spending has not kept pace with company's revenue growth in many industries declining for the second year in row, from a peak of 3.9% of revenue in 2004, to only 3.3% in 2006. A slight majority, 56% of industries, saw their IT spending increase relative to increases in revenue, but the database average overall still saw a decline.

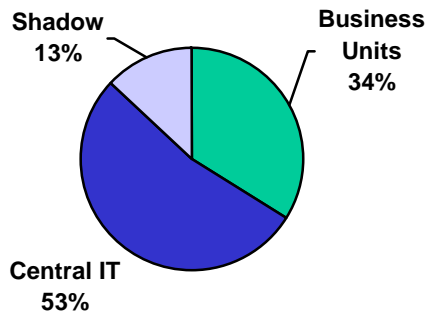
Industries with increases in IT spending relative to revenue included Financial Services and Banks, Healthcare, Insurance, Professional Services, Publishing and Printing, Telecommunications, Tobacco and Wholesale.

For 2007, CIOs need to prove the value of IT investments to the organization in order to gain a higher portion of the budget and maintain IT spending growth to drive additional business strategic advantage and revenue opportunities while improving business operating efficiency for greater bottom-line gains.

More Stakeholders are Involved in IT Spending Decisions

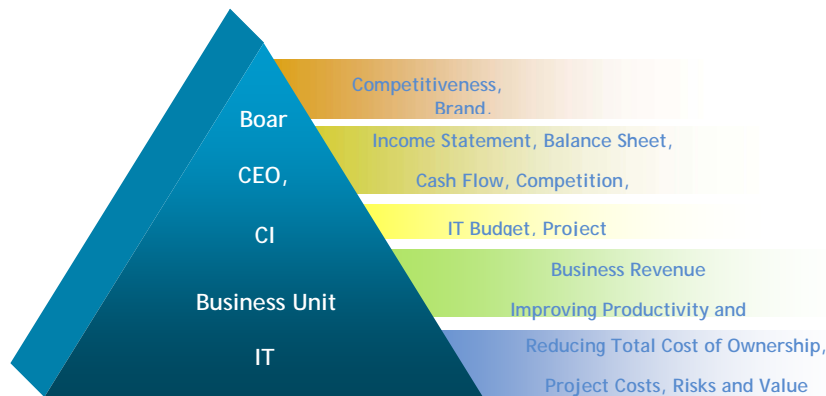
Because of decentralization and globalization of businesses, combined with a perceived failure in IT decision making centralization in the late 1990s, more and more stakeholders are now in control of making IT spending and investment decisions. Today, more than 34% of budget control is formally controlled by the business units.

Another 13% of IT spending is considered "Shadow IT", occurring in business units, but under the radar. This hidden spending causes severe IT issues later as the project is developed, launched and then needs support – often by central IT. Worse, these projects are often non-standard – outside of normal and supported architecture, platforms and quality standards. As \$4 : \$1 is the ratio of initial investment to ongoing support, unchecked shadow spending drives up IT keeping the lights on spending in outgoing years.



For the IT solution provider, this means making sure that business unit decision makers are involved in many of the due diligence and meetings. Another issue with more stakeholders being involved is that what is important to each stakeholder is different, and seemingly each must be spoken to in a different language. IT staff care about technical aspects of the solution, architecture, and total cost of ownership. They care about the impact on specific IT related KPIs like support call frequency, time per call, servers per admin and so on. Business leaders care about the impact on the business such as how it will improve productivity, streamline processes, reduce exceptions or drive additional revenue. IT executives like CIOs care more and more about business aspects of a solution, such as how a project will help the IT group do more with less, drive innovation and reduce risks.

Regardless of the particular stakeholder, business cases must include benefits for each of the stakeholders in order to get them engaged in the proposal and learn – what’s in it for them.



IT Executives Are Concerned About Value, But Progress is Slow

Each year Gartner surveys CIOs on their top IT and business priorities. In 2006 as in years past, proving and improving the value of IT ranked as one of, if not the highest priority. The good news is that there is clear focus on making sure that IT is funded adequately, and that investments are tied to tangible value and business goals. But year after year this same issue appears as a top priority. Because it is on the list every year, it shows that it is a priority, but is not getting addressed adequately.

Comparing IT departments today to those of five years ago almost everyone would agree that business savvy is on the rise. But it still lags the capability and maturity of other business groups, particularly beyond the CIO and a select few within the IT group.

If business case justification is required in order to gain project approval, the internal resources at the ready to prove the value of proposed projects, and measure the value of existing initiatives are few and far between.

The opportunity for the vendor is to help resolve this value gap and help CIOs address this concern by delivering value management services and support, or maybe even going further and offering ROI SLAs (which we will discuss later).

Frugal remains best as Top Performers under-spend both average and laggards

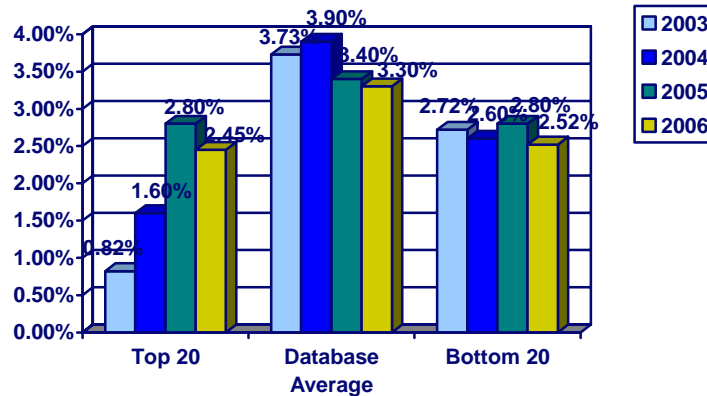
Measuring top performers based on superior EVA performance compared to the rest of the database, once again, for the fourth year in a row, the top 20 performers significantly under-spent the average IT spending as a percentage of revenue by a wide margin. Frugal in overhead, including IT spending, is certainly one consideration in maximizing profitability and driving higher EVA and it shows.

From this analysis, and examining historical trends, the top performers are most adept at scaling their spending. From 2003 to 2005, in response to market opportunities, these top performers were increasing their spending at twice the rate compared to the bottom performers, and 50% higher than the average company. This is in response to improving market conditions and proactive investments sooner and at increasing levels to capitalize early and quickly on growth opportunities. Looking back to the slowdown in the year 2001, those who saw rough times approaching were better able to scale down expenditures early. The metrics indicate that those which recognized economic recoveries early and were able to prudently scale their IT operations and investments to meet the opportunities of the next wave were the winners.

The key is to create an IT environment where fixed costs are minimized – an organization which can scale up investments in innovation when times are good to capture market opportunities and invest in the future platforms and applications needed to change the business and compete, and an organization that when times are tough can scale back overhead and spending to help the company maintain profitability, even when times are tough.

In examining the spending trends from 2005 to 2006, the recent pullback in top-performer spending is not a sharp one and to us indicates that this recent slowdown, unless radically changing the top performer IT spending profile, is merely a time-out versus a harbinger of a larger collapse.

IT Spending as a % of Revenue vs. Profitability Performance



Modest Return on IT (ROIT) Performance Leaves Room for Improvement

Measuring IT spending is only part of the equation. Although IT may be getting more efficient, is it any more effective than before – or are cost cuts taking their toll?

As Nicholas Carr's article in Harvard Business Journal stated boldly: IT Doesn't Matter. In this article's analysis on the return from IT investments, as in other studies, it was difficult to see whether IT investments were actually making an impact on corporate profits and delivering promised shareholder benefits. Carr's assertions were to lower the cost of ownership in IT at all costs since IT was not a competitive differentiator anymore – merely plumbing.

This matched earlier findings by Robert Solow, of MIT in 1987, when he made the bold statement: "We see computers everywhere except in the economic statistics". This was backed up by detailed analysis from McKinsey in 2001 which highlighted that "IT investments did NOT have an impact on productivity in 53 out of 59 economic sectors" – McKinsey Report Finding on IT Productivity – 2001

Of course these negative findings were tempered by claims from US department of labor reports and Alan Greenspan claims that information technology has provided a substantial boost to productivity, and how this impact was the main catalyst behind the biggest boom in US history.

On an individual basis, it is hard to imagine a world without the technology innovations of even the past 10 years. IT has provided us with services, products, and lifestyle advances that were unimaginable some twenty years ago. Who imagined being able to surf and order from online catalogs at a hot spot, view streaming videos of breaking news anywhere in the world, obtain stock quotes on a PDA, or manage your own stock portfolio online like a professional. As business people, we can stay connected during travel as if we were in the office; collaborate with teams worldwide using e-mail, instant messaging, and on-line conferencing; build presentations; and self-publish white papers and books. Few among us would trade our current technology enabled ability to create, connect, communicate, collaborate, and produce for the world of 10 years ago.

So the benefits from these new business enablement, productivity and process improvements should be easily measurable in the corporate bottom-line – right? Unfortunately studies continue to indicate that although individual productivity has improved, corporations seem to on average squander the gains somehow. When you run the numbers, there has been little to no correlation between investment in IT and profitability. Although some companies achieve spectacular results through use of IT systems, higher investment in IT as a percentage of revenue or per employee does not result in higher return on equity.

The good news is that times are changing, and that over the three year analysis period since 2003, 56% of the industries had increased ROIT rankings (the ratio of Economic Value Add (EVA) to IT Spending), and performance improved some 67% from 2003.

As the economy grew all ships were buoyed by the rising tide. But at the same time, organizations were being more frugal in their investing, and getting substantially more from their IT investments than prior periods. The results was an increasing ratio between the net rewards (EVA) and the investment (total IT spending)

Industries with the largest ROIT gains include Aerospace and Defense, Entertainment Services, Healthcare, Technology, Hospitality, Specialty Manufacturers, Medical and Lab Equipment, Pharmaceuticals, Oil and Gas, Mining, Publishing and Printing, Tobacco, Retail and Wholesale. Many of these large performance gainers were in industries that benefited greatly from economic conditions (such as oil and gas), and/or were well correlated with increased innovation investments.

As these ROIT metrics highlight, IT spending alone does not result automatically in value. It is not how much you spend on IT, but what you spend it on that counts. Return on IT needs to be managed. CFOs and IT executives are under pressure to cut costs, and with studies such as these and others highlighting fundamental issues with the prevailing wisdom on productivity and value from IT, it will become harder for

executives to justify continued investments without proof of returns. A company that spends wisely - even if sparsely - on IT will see its performance enhanced. A company that spends indiscriminately on IT will see its performance diminished, because IT will merely amplify its poor business practices.

Unfortunately, most IT solution providers act like arms brokers, selling the latest, greatest hardware to one country and then walking to the neighboring country and selling similar arms based on fear. With IT spending under continued scrutiny and the overall impact from investments being questioned – fear will not be a motivating factor for most CIOs as it was in the boom period.

For 2007, IT executives need to continue to align IT investments to achieve key business goals and initiatives to assure that performance improvements continue. This puts increased responsibility on the IT solution provider to assure that proposed projects are aligned with corporate goals as well.

CONCLUSION

The Bottom Line

Our research proves that overall IT spending is growing steadily, but perhaps more conservatively than expected. It is clear that overall spend levels have not kept pace with revenue growth. Focus on consolidation, standardization, virtualization and management tools has led to continued IT efficiency gains, up over 10% from prior years, which have helped organizations do more with less and freeing up IT staff for higher impact, more innovative initiatives. As a result, innovation investments are up a whopping 43% as a percentage of overall spending, helping to drive continued business improvements and growth. The yield from IT spending, ROIT continues to improve, garnering the largest year over year gains since we began tallying this metric in 2003.

The IT spending trends into 2007 will be shaped by the overall macro-economic environment and sentiment. Current predictions are that the overall economic picture is unclear. This will constrain IT spending increases until the risks of a slowdown disappear. However, with the success of prior investments, the continued efficiency improvements and shifting of budgets to more innovation will continue unabated into 2007.

For the IT vendor, these trends clearly highlight some opportunities. Customers are looking for a valued partner to help them set direction and achieve higher success, and there is a clear opportunity to help prove and improve the value of IT:

- Lower Total Cost of Ownership (TCO) to drive innovation investments
- Increase business investments vs. infrastructure spending
- Help stakeholders better collaborate and make optimal decisions
- Reduce risks and improve project success
- Help align IT investments with business strategy
- Help prove the value IT delivers to the business

ABOUT ALINEAN

Since 1994, the Alinean team has been the pioneering builder of tools to help quantify and improve the ROI and TCO of IT investments. Alinean was named for the Spanish word for “Align”, matching the Alinean mission as the leading developer of analytical tools to help IT vendors, consultants and IT executives align IT investments with business strategies.

The Alinean team has over a decade of experience in the practical development and application of ROI and TCO methodologies, models and tools to optimizing IT investment decision making. In 1994, the Alinean team formed Interpose, the original pioneers of ROI tools, developing analytical software for over 50 major IT vendors and consulting companies worldwide, and creating the industry standard TCO Manager and TCO Analyst software. Interpose was sold to Gartner in 1998, where the team continued their developments and marketing of ROI and TCO software tools. The original team reunited to form Alinean in 2001, once again becoming the leading pioneers and developers of ROI sales and analytical tools. Current customers include leading IT solution providers such as HP, IBM, Dell, Intel, Symantec, NetIQ, EMC, SAP, Oracle, SBC, and Microsoft, as well as leading consultancies and Global 1000 companies.

Additional information about Alinean and helpful ROI educational resources can be found at <http://www.alinean.com>.