

InSight

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The HSP Market: Are You Ready for the Shakeup?

It is now clear that no one player in the hosting service provider (HSP) industry has located the elusive path to profitability. With capital drying up, who can survive the current economic downturn and triumph in the aftermath where first-generation pure plays are eclipsed by the well-funded telecom establishment?

Red Sky Morning...

After five years of evolution, the hosting services market is at a crossroads. Where Exodus was once considered the industry bellwether, the sector has failed to produce a hands-down leader and an optimal business model. The investing community has turned on the hosting sector as a whole. Aggressive infrastructure build-outs, slower than expected adoption rates among enterprises, and the fallout of the dot.coms have all contributed to the inability of hosting competitors to demonstrate a timely road to profitability.

However, the strength of the HSP value proposition remains. We maintain our optimism of the market upside. The integration of Web front-ends and back-office applications will continue for years to come, albeit on a more reasonable growth curve, in the enterprise. The small and medium businesses (SMBs) — where outsourcing value propositions arguably hold the most water — will also continue their evolution into Internet-based businesses. In short, the HSP market has good reason to stand by its vision.

Nonetheless, the next 12 to 18 months will prove difficult for hosting providers. Sub-\$1 stock prices will test the confidence of existing customers, prospects, and provider management teams. Private funding will be difficult to find, leading to both a shakeout and a consolidation. Aberdeen research predicts that at the end of the day only those providers who have amassed rich coffers, loyal customers, or scalable operating processes will remain standing to satisfy the needs of both Wall Street and the customer base.

...Hosters Take Warning

Given this environment, we have tracked and analyzed 14 leading providers and now question their ability to stay atop the crowded hosting services market in an increasingly bearish economic climate. We've evaluated each competitor according to four differentiators that Aberdeen deems critical for survival over the next 18 months. The rationale behind these four factors follows:

1. *Financial strength:* The root of all HSP troubles is learning to make profits in a

time span financial backers feel comfortable with. Aberdeen tracks the significance of:

- Value of publicized funding;
- Operating cash flow; and
- Ability to satisfy debt payments.

2. *Ability to execute internally:* Services are delivered in a cost-effective manner and with constant quality if all processes and procedures are performed to a tee. Aberdeen assesses progress in the following areas:

- **Applied automation:** The systematic delivery of services eliminates human errors and speeds execution.
- **Standardized product:** Custom solutions come with high price tags. Alternatively, outsourced hosting proposes a better value. A preconfigured solution drives operating costs down and builds a robust knowledge base for support.

3. *Ability to execute in the market:* Aberdeen evaluates the market presence of competitors based on:

- **Reputation:** Bottom line, hosting is a service business, and customer care always proves to be a differentiator. In tough times, customer loyalty and “word of mouth” marketing campaigns can help providers weather the storm.
- **Focused messaging:** Aberdeen evaluates the outbound marketing efforts of HSPs for consistency, clarity, and focused positioning.

4. *Stability of existing client base:* Assuming that an influx of new customers is unlikely, the health and up-sell potential

of existing customers will prove critical in a stagnant market. Aberdeen considers:

- Quantity of customers;
- Mix of client base (i.e., large enterprises, small enterprises, dot.coms, etc.); and
- Churn rate.

Aberdeen's Verdict

Based on our market knowledge and primary research, we've determined that only a few competitors — IBM Global Services, Digex, and Qwest — are currently in a position to remain comfortably atop the market (Table 1). The rest of our HSP leaders are exposed to either financial, operational, or market challenges that may prove their downfall in the hosting market. These deficiencies should be corrected — lest we forget the sudden departure of players like PSINet and Aperiaan.

Below Aberdeen provides additional perspective by competitor segment:

- *Pure-play incumbents:* The remaining first-generation independents face a serious financial challenge over the next 18 months and will reckon with the highest likelihood for shakeout or consolidation. Exodus, today's self-described market heavyweight, is losing credibility in the industry and growing increasingly unattractive to investors due to its debt-laden assets, customer churn, and an exclusive long-term network access agreement. On the other hand, NaviSite's unaffiliated managed hosting appears a likely target for interested carriers still on the sidelines.

Table 1: Success Determinants of Leading HSPs

	Financial Strength	Internal Execution	Market Execution	Client Base	Target Market
1st Gen HSPs					
Exodus			+	+	All
NaviSite		+	+		All
2nd Gen HSPs					
Inflow	+	+	+		All
Relera	+	+	+		Tier 2 Cities
Traditional Outsourcers					
EDS	+	+		+	LE
IBM Global Services	+	+	+	+	LE
Entry Level HSPs					
Interland		+	+	+	SMB
Rackspace		+	+	+	SMB
Carriers					
AT&T	+			+	All
C&W / Digital Island	+	+		+	Financial & Entertainment
Genuity		+		+	F100
NTT / Verio	+				All
Qwest	+	+	+	+	All
WorldCom / Digex	+	+	+	+	All

Notes: LE = large enterprise; SMB = small and medium business

Source: Aberdeen Group, August 2001

- *The challengers:* Second-generation pure plays, like Relera and Inflow, should be funded long enough to prove that they have learned the lessons of first-generation HSP failures. Their funding success — each with more than \$300 million — is a testament to their sound business models. But, we postulate, how will controlled operating expenses drive market share?
- *The telecom behemoths:* It may sound like the familiar story of legacy wealth,

but several telecoms actually got smart when it came to hosting. Qwest built a legitimate competitive offering internally, while WorldCom and Cable & Wireless significantly beefed up their presence through the acquisition of two of the strongest first-generation pure plays, Digex and Digital Island. Provided their parents don't go overboard in search of "synergies" (as was the case with Verio and NTT), these offerings will gain market strength over the next 18 months.

- *Quite giants:* Traditional outsourcers have continued what they do best — managing complex IT operations for wealthy enterprises. Their expertise and stability will continue to drive success at the high end of the marketplace, crowding out HSPs that are driving up the service value chain.
- *The niche player:* HSPs offering basic, entry-level hosting services will find that the growth curve to critical mass is on a longer time horizon than originally suspected. As a result, Aberdeen's survival criteria are all the more significant. It's also important to recognize the patience exhibited by Interland and Rackspace in their business models, but widespread adoption may be too far out.

All in all, Aberdeen predicts a reordering of market leaders on the horizon. With financial concerns pressing the hosting establishment, the big telecoms and IT outsourcers will likely be the largest beneficiaries of the market downturn as customers search for stability. Well-funded second-generation pure plays, however, will emerge from the downturn with a business model and a reputation that could disrupt the landscape.

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