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Surface Tension: The Next Move For Spurned Microsoft Partners
By Martin Wolf, Global M&A Advisor

Last month, I wrote an column in which I cautioned Microsoft partners that to continue to grow revenue and enterprise value, they will need to develop new markets, new strategies and new partners.

I offered this advice in the wake of Microsoft (NSDQ:MSFT)'s late October launch of the Surface tablet and the company's decision to sell the device directly to U.S. customers through its own retail stores, cutting out what the company considers low-value intermediaries. For Microsoft as a hardware manufacturer, Surface is just the beginning.

At the same time, Microsoft is working hard to keep its partner network intact for Windows-based laptop and desktop computers into enterprises and small to medium-size businesses. This is a fine line to walk, as many of these partners would have liked an invitation to the Surface party. The tension in their current relationships with Microsoft is palatable.

Bottom line, I believe we're at the beginning of the end of the Microsoft-Intel Windows PC ecosystem, which created and sustained growth in sales, profits and value for thousands of companies for several decades.

Our just released third-quarter 2012 report on our proprietary global MW IT Index® -- which tracks the enterprise values of IT companies in key sectors and geographies -- tells part of the story. Between April 1 and Nov. 30, 2012, valuations for companies in the U.S. IT supply chain industry decreased 23.3 percent. While valuations in the space have been steadily declining for some time, this steep drop over the past eight months is unprecedented.

Now that the Wintel ecosystem is losing steam, there are those who argue we will never again see an IT ecosystem that creates so much value for so many companies over such a long period of time.

I disagree. In fact, I believe we are witnessing the birth of one right now -- and it's not Apple (NSDQ:AAPL)'s.

Certainly Apple has created a strong and valuable ecosystem in support of its products. But by far the biggest winner in the Apple ecosystem is Apple.

Instead, my money is on the ecosystem that Amazon (NSDQ:AMZN) is building around Amazon Web Services (AWS), the undisputed leader in the public cloud space.

Amazon doesn't talk much about AWS' size or financial performance, but some analysts have said AWS revenue could reach $2 billion this year and grow 45 percent or more a year for the next five-plus years. That would make AWS a $20 billion business by 2018.

In my view, nothing now or on the horizon comes close to the potential of AWS to create new opportunity for the broad range of emerging and existing cloud applications and services companies or to breathe new life into established solution providers.

And conditions are ripening for a passing of the torch from Wintel to AWS.

At the end of November, AWS held its first-ever global customer and partner cloud-focused event, re:Invent. re:Invent cemented that partners will play an even larger role going forward than they have since AWS was launched in 2006. According to Terry Wise, AWS director of Global Alliances, Ecosystem and Channel, in the last year, AWS has doubled the number of partners in its ecosystem to more than 4,000.

While in the past, many of those partners were software developers tuning their applications for AWS' Elastic Compute Cloud (EC2) Infrastructure-as-a-Service offering, a growing number are managed services providers such as Datapipe and systems integrators such as Capgemini, Wipro and Cognizant.

Equally important, despite some high-profile outages this year, AWS has aggressively tackled the reliability and security issues that were standing in the way of its enterprise readiness. Combined with its SI partners, AWS is also adding considerable strength to its enterprise go-to-market capabilities. Some estimates are that today as many as 30 percent of AWS customers are large enterprises and that most Fortune 1000 companies are running production workloads in AWS.

Now it's true that creating and nurturing an IT ecosystem where everyone wins was much simpler in the Wintel heyday: PCs were "the next big thing," the Internet was in its early days, and innovative consumer technology was a Sony Walkman. There was no cloud, no Facebook, no iPhone or Android, no mobile apps and no app stores.

But giving credit where credit is due, Microsoft (NSDQ:MSFT) and Intel (NSDQ:INTC) were masterful at partnering to provide a platform upon which hardware OEMs, software developers, mainline distributors, VARs and SIs could innovate and thrive. And there is nothing like a monopoly to sustain growth and profits.

Still, I think there are three main reasons why AWS could lead the next great IT ecosystem.
First, Amazon (NSDQ:AMZN) has already proven that it can build and manage a large and complex ecosystem that delivers value to all players. I'm talking about Amazon's retail platform that supports tens of thousands of merchants, apps developers, publishers selling digital content such as books, music, movies, TV shows and applications and its hardware business, with Kindle at the center of its plate (at least for the moment ... stay tuned).

AWS already plays an important role in this ecosystem offering low-cost storage for users' content. Amazon completes the picture with its unequaled fulfillment system, including Amazon Prime, which for $79 a year gives customers free shipping and instant streaming downloads.

Unlike Apple (NSDQ:AAPL) and now Microsoft (NSDQ:MSFT), the Amazon hardware strategy is to sell its Kindle products close to cost as a gateway to other products and services. Of course, offering low-cost hardware and enabling services to sell massive quantities of other products only works if sales volumes are huge. But so far, the strategy is working. Second, the low-cost, reliable and scalable AWS cloud platform has all the earmarks of a business platform capable of sustaining large numbers of value-added contributors at extraordinary scale over time. The decisions Amazon has made about which services to offer itself and which to leave to partners suggests that the company is sensitive to the need to return value to all participants -- not just a select few.

Furthermore, comments from Amazon executives, including Jeff Bezos at re:Invent, made it clear -- if it wasn't before -- that Amazon is pursuing a similar strategy in cloud infrastructure as in its hardware business: offer initial services at low cost and reap rewards only when customers use them. Bezos views this as the right formula for creating a long-term business based on high-value services.

Third, Amazon recognizes that cloud computing is all about the ecosystem. Back in 2011, Amazon CTO Werner Vogels said, "The successful cloud play requires an ecosystem of partners and collaboration to tie services together and make an environment work."

Of course, capitalizing on the AWS opportunity will require solution providers to reinvent their businesses and their business models to take advantage of it.

One great example is Avnet (NYSE:AVT), which introduced a new package of integrated cloud computing solutions based on AWS at re:Invent. These "cloud-in-a-box" solutions provide Avnet's channel partners -- MSPs, VARs, ISVs -- with a fast, low-cost entry into the cloud business with enterprise customers. They also buy precious time channel partners can use to sort out their own longer-term cloud positioning and value-added offerings.

While the opportunities are real, partnering with any ambitious market leader is not without its risks. And some of the moves Amazon has made in the past year -- the AWS Marketplace, for example, which is a one-stop shop for applications that can be purchased on subscription with Amazon managing the underlying infrastructure -- are signs that Amazon sees value in moving up the stack. This could certainly displace some partners in the AWS ecosystem -- in much the same way that Microsoft edged out some ISVs when it entered the applications business.

But it will be a very long time -- if ever -- before Amazon blows up its partner network like Microsoft did this year.

In the meantime, one place solution providers should look for new paths to growth is the cloud ecosystem that Amazon is building.

Marty Wolf is founder and president of martinwolf | M&A Advisors. Marty has been directly involved in the divestiture of six Fortune 500 divisions and has completed more than 115 transactions in the IT services sector. A frequent commentator and guest blogger for leading business and IT media outlets, Marty also acts as a counselor and trusted adviser to CEOs of select IT firms.