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Losing Heat -- Cloud Over Sun Microsystems: Plummeting Computer Prices; Its Long Strategy of Resisting Intel/Microsoft Standard Faces Growing Pressure; A Maverick Follows the 'Puck'

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Abstract (Article Summary)

In May 2002, Mr. [Scott McNealy] huddled with his new executive team at the clock tower of Sun's Santa Clara headquarters, the site of a former mental asylum. The sense of urgency was palpable. "Scott was quite impatient," recalls Patricia Sueltz, who had just been made head of services. "The urgency doesn't end when you're sitting with a stock price at $4."

Mr. McNealy ultimately agreed. Yet these moves didn't translate into new sales. In December 2002, Jim Melvin, chief executive of Siva Corp., a Delray Beach, Fla., firm that runs back-office systems for restaurants, wanted to invest several million dollars to build a corporate data center using Sun equipment. But when Mr. Melvin approached Sun, he found the company's restructuring was causing chaos. "Sun said call back in two months, because the guy I was talking to there didn't know if he'd still have his job," he says. Frustrated, Mr. Melvin bought IBM and Dell gear instead.

By the middle of this year, Sun's sales were still sliding. In its fiscal fourth quarter ended June 30, the company's revenue tumbled 13% from a year earlier to $2.98 billion. Product sales were even weaker, down 20% from the prior year. "People are justifiably saying 'Show me some results,' " says Mark Tolliver, Sun's head of strategy and marketing. "We can't argue with anyone on that part of the discussion."

Full Text (2180 words)

Fifteen years ago, an upstart Silicon Valley computer maker made a bold technology bet. Sun Microsystems Inc. dismissed the standard chips and software that ran most other computers in favor of its own souped-up custom designs. The switch would ultimately make its machines more powerful than its competitors' -- but also much more expensive.

The wager paid off, making Sun the dominant provider of the server computers that power Internet sites and corporate computing. But now the company is paying a big price for bucking the tech mainstream -- and scrambling to keep customers and stay afloat.

What happened? Standard chips made by Intel Corp. have caught up to Sun's specialized models in performance, turning low-priced computer makers such as Dell Inc. into Sun rivals. Likewise, relatively cheap software from Microsoft Corp. and free Linux software allow corporate users to perform tasks that once required Sun's pricier programs.

The result: The Silicon Valley legend that once boasted of putting the dot in dot-com is staring into the abyss. Sun's quarterly sales have fallen more than 40% from their peak, even as other tech companies now report stable or even increased revenue. The Santa Clara, Calif., company has lost money in seven of the past nine quarters and is expected to show another loss when it reports quarterly results today. Its stock has plunged to about $3.50 from a split-adjusted high of $64.31 in September 2000.

Scott McNealy, Sun's chief executive for the past 19 years, long resisted the standardization trend sweeping across the tech industry. But at a pivotal meeting with his top executives in May 2002, he conceded that Sun had to change. The company slashed jobs, retooled marketing and sales strategies, and began work on new chips and software. Most important, Sun decided to expand its offerings of lower-priced computers based on standard chips -- a move that risked eroding Sun's cachet even further and putting pressure on a business model built around expensive machines.

So far, Sun's financial results suggest the company's revamping operation is failing an important test: selling more computers. Many longtime customers say they don't have confidence in Sun's strategy, and some have been put off by its internal disarray as it makes itself over. Even if Sun works out the kinks, selling cheaper computers will make it harder to plow huge sums back into developing new technology, which in the past helped Sun stand out from the pack.

In the end, Sun faces a changed tech landscape that no amount of remaking may be able to fix. "The world has changed for Sun, and it's changed in a permanent way," says Andrig Miller, vice president of office-product supplier Corporate Express Inc. and a longtime Sun customer.

When the leases on Corporate Express's $2 million Sun servers expire in 2005, Mr. Miller says he may replace them with less-pricey machines from International Business Machines Corp. or Hewlett-Packard Co. Mr. Miller thinks he can save 30% to 50% by switching. "Competitors have surpassed Sun in price and performance," he says. "And people like me are finding cheaper alternatives."

Sun appears to be the latest casualty of the rising tide of tech standardization, led by Intel and Microsoft. Many companies in the history of high-tech -- Digital Equipment Corp. and Apple Computer Inc., among others -- believed they could resist standard designs and thus ultimately charge a premium for their products. In the end, a lot of these companies were either acquired or hang on in the industry as smaller players.

For his part, 48-year-old Mr. McNealy remains confident, saying Sun has defied earlier predictions of its demise. Since the tech crash, the company has come up with software and chip innovations that may yet pay off. "We're investing in where the puck is going," says the avid ice-hockey fan, "not where the puck has been."

Sun is also sitting on $5.7 billion in cash and marketable securities. And, says Mr. McNealy, Sun still has a basic advantage over its rivals: It sells integrated packages of hardware and software, as opposed to individual components. There's much to be done at Sun, he says, but "we're long on strategy. If we execute well, we'll do just fine."

Sun, founded in 1982 by a 27-year-old Mr. McNealy and a group of other young guns from Silicon Valley, began as a maker of workstations, the specialized computers used by engineers and scientists. In the late 1980s and early 1990s, Sun transformed itself into a provider of high-end servers that were powered by its own chips.

Sun developed a reputation for a highly entrepreneurial culture, where geeky engineers with new ideas could quickly rise to the top. That culture was nurtured by its brash CEO, who famously stoked the antitrust crusade against Microsoft by accusing the software giant of using "monopoly money to buy stakes in their customers."

In the 1990s, Mr. McNealy poured profits into costly research-and- development projects. That spending translated into fresh products that allowed Sun to command high prices for its servers. This model worked beautifully during the tech boom, when customers were willing to open their wallets, boosting Sun's quarterly revenue to $5 billion for much of 2000. Web start-ups, financial firms and telecommunications concerns bought Sun machines for their processing power and security and for innovations such as Java, the programming language that became ubiquitous on the Internet.

When the tech bust hit in 2001, Sun's core customers cut back on buying and began looking for less-expensive machines. At the same time, the generic chips powering cheaper servers improved, making Sun's products look even pricier. Today, a Sun v480 four-processor server costs around $35,000, while a comparable H-P Proliant DL580 is priced at around $25,000, according to market researcher Gartner Inc.

Sun compounded its problems by responding slowly to the slumping market. Even as tech spending dried up in 2001, the company increased its work force to 44,000 employees from 37,000. Other firms axed costs early, or launched big deals to remake themselves. Cisco Systems Inc. cut nearly 20% of its work force beginning in March 2001. H-P launched a controversial purchase of Compaq Computer Corp. that same year, and has since slashed $3.5 billion in annual costs.

Sun put the brakes on the hiring in the fall of 2001 and trimmed around 10% of its work force that October -- the first of several big cuts. But by mid-2001, Sun's quarterly sales had dipped to $4 billion and it began reporting net losses. Its share of world-wide server revenue fell to 13.2% in 2001 from 17% in late 2000, according to Gartner. "The appetite for change was enormous," says Jonathan Schwartz, Sun's head of software.

The opportunity for an internal makeover came in early 2002, when half a dozen veteran Sun executives, including President Ed Zander, who had effectively run the company during the boom, moved on or retired. Around that time, Mr. McNealy also resolved to reclaim operational control of Sun.

"I had spent a lot of time [in the boom] doing external stuff and had left the operational stuff to Ed," says Mr. McNealy. He wanted to get back to day-to-day control again, he says, because "it beats sitting on a plane."

In May 2002, Mr. McNealy huddled with his new executive team at the clock tower of Sun's Santa Clara headquarters, the site of a former mental asylum. The sense of urgency was palpable. "Scott was quite impatient," recalls Patricia Sueltz, who had just been made head of services. "The urgency doesn't end when you're sitting with a stock price at $4."

Mr. McNealy said he wanted Sun to better reach out to customers and grow again. But he offered no specific plan during the half-hour meeting. According to people who attended, he told the executives, "It's up to us to go and execute and lead the company through change." As an aside, Mr. McNealy added to one executive, "Don't screw it up."

Seven weeks later, after more meetings, Mr. McNealy's lieutenants emerged with three mantras: Make cheaper, simpler computers; extend its service offerings beyond repair and maintenance to consulting; broaden its offerings to mobile users with more software and strengthened security.

With those goals in mind, executives such as Ms. Sueltz began logging 1,000 miles of travel a day to meet customers and partners and mend relationships. In September 2002, Ms. Sueltz met with Sun's largest distributor, GE Access, in Westminster, Colo. She found, to her surprise, that she was the first senior Sun executive to meet the sales reps. They complained that it was taking five weeks to fulfill payments for Sun's repair and maintenance requests. Together, they ultimately reduced that backlog to around 12 days.

Other Sun executives set to work designing new products. Mr. Schwartz, the head of software, launched an overhaul aimed at reducing Sun's catalog of more than 200 software products to six. He also simplified software pricing so that corporate customers paid a fixed price per user, instead of varying amounts based on the number of processors in a computer and other factors.

But he immediately ran into resistance from Sun's 3,000 software engineers, who were accustomed to working on their own pieces of code, not cooperating on more comprehensive products. "Sun is a bottom-up culture, so when something is mandated top-down, it's not always accepted," says Mr. Schwartz. He pressed ahead by promoting his own crew of younger managers.

By late 2002, many of Sun's rivals were far along with their recovery plans. H-P, for one, had completed its Compaq acquisition and was aggressively killing off overlapping server lines. Sun, meanwhile, was still debating whether to ramp up a nascent line of cheaper servers using Intel chips. It was a wrenching decision for a company that had made its mark with its own technologies.

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The drive to make more of these cheap computers was championed by Neil Knox, who leads Sun's low-end server business. Mr. McNealy balked at first, arguing that Sun had rolled out some cheaper computers in 2001, but had found few takers. In October 2002, the two executives met for 90 minutes to choose a path. Mr. Knox argued the cheaper computers could help Sun stem defections among customers experimenting with new technology. "Customers are buying these products today and they want to be able to buy them from Sun now," Mr. Knox recalls saying.

Mr. McNealy ultimately agreed. Yet these moves didn't translate into new sales. In December 2002, Jim Melvin, chief executive of Siva Corp., a Delray Beach, Fla., firm that runs back-office systems for restaurants, wanted to invest several million dollars to build a corporate data center using Sun equipment. But when Mr. Melvin approached Sun, he found the company's restructuring was causing chaos. "Sun said call back in two months, because the guy I was talking to there didn't know if he'd still have his job," he says. Frustrated, Mr. Melvin bought IBM and Dell gear instead.

Mark Hendrix, chief information officer at energy trader Reliant Resources Inc., also found Sun distracted in this period. After buying some Sun machines in late 2002, Mr. Hendrix found himself talking with three or four different Sun employees about the installation of the machines and having to communicate the same issues over and over again. "They lost their customer focus," says Mr. Hendrix, who adds that the situation didn't improve until he complained to a top Sun executive.

A Sun spokeswoman stands behind the company's customer-service efforts but acknowledges that when a company like Sun makes big structural changes, there will be some "managed chaos."

At the end of 2002, Sun's sales were still dropping year over year, to below $3 billion a quarter. Alarmed, Sun executives intensified their remaking efforts. Marissa Peterson, Sun's chief customer advocate and head of world-wide operations, created in late 2002 an "availability battle plan" to become more responsive to customers. The plan featured 30 initiatives such as reducing server outages for clients and spurring faster response times to fixing problems.

This January, she told Mr. McNealy that Sun was still lagging. He asked her to focus full-time on the battle plan. Since then, server outages at customers have fallen to an average of one every two years, down from two a year.

Mr. Miller, the Corporate Express vice president, is happy enough with Sun's improved customer responsiveness that he bought two new Sun servers in September. But unlike the $2 million servers that he acquired from Sun in the past, the new machines cost no more than $7,000 each. He says he will continue considering Sun products in the future, but "Sun isn't a shoo-in" as his top choice.

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