



Red Hat's Szulik sees a shift toward open-source software.

Analysts doubtful as Red Hat targets Microsoft

CEO wants to grab half of server market

Frank Norton, Staff Writer

Software maker Red Hat could be within a decade of catching up with Microsoft in the business of selling server software.

That's according to CEO Matthew Szulik, who said that by 2015, his Raleigh company could gain half or more of the market for the server operating systems that businesses use.

Microsoft is far and away the leader in that market. Its Windows operating system is the standard against which others try to differentiate. But Szulik sees a global shift in business computing toward his side. More corporations and governments are adopting the open-source software model on which Red Hat's Linux business is built. The term "open-source" refers to software code that is free and open to the public. Experts worldwide collaborate on its development.

"The industry is going through an unprecedented build-out to next-generation computing systems," Szulik said during an interview at Red Hat's headquarters on NCSU's Centennial Campus.

Industry analysts agree that Red Hat is well-positioned for growth but call Szulik's projection bold, if not a stretch.

"I think it would be difficult," said James Gilman, an analyst with Soleil Securities, who has maintained a "sell" rating on Red Hat for about a year.

Microsoft's Windows has about two-thirds of the server market and Red Hat less than 20 percent. "They would have a long way to go," Gilman said.

In Red Hat's favor, the open-source movement is gaining momentum, said analyst Brendan Barnicle of Pacific Crest Securities. Red Hat not only offers a suite of services at lower cost than Windows, he said, but customers can own their data, unlike with Windows.

By 2010, at least 80 percent of all commercial software products will include elements of open-source code, according to research firm Gartner.

Red Hat is the world's largest distributor of Linux; it makes money on subscriptions and services. Beyond revenue, it champions the adoption of Linux because that chips away at Microsoft's business model: selling its proprietary Windows operating system.

Szulik said Windows and Linux are the only two relevant operating systems left in the server market. His remarks came amid a surge in Red Hat's stock last week, after it released better-than-expected quarterly results and pledged to ramp up sales in a business it acquired last year.

Still, half the server market?

"That is a very interesting statistic to put out there," Barnicle said. "A lot of people would challenge it, but Szulik could more likely be right than wrong."

One plus for Red Hat is that it appears to be outpacing competition. Subscriptions for Linux-based software are forecast to increase 17 percent a year through 2010," according to market research firm IDC. Red Hat owns about 80 percent of that Linux market, which is growing well above the 12 percent growth rate expected for Windows.

That difference could bump up Red Hat's market share a few points, but would not swing the market widely in its favor, said Al Gillen, vice president of operating system environments for IDC. Gillen said Red Hat is doing a better job than Microsoft in capturing new business as it comes up for grabs. But the company has been largely unable to steal business directly from Microsoft.

There are other obstacles.

Red Hat's recent purchase of JBoss is taking longer than expected to pay off. Red Hat bought the Atlanta company last year to gain a position in middleware, a kind of integration software that lies between basic information-technology infrastructure and desktop applications.

Szulik said JBoss is a tremendously strategic asset but requires a different kind of sales force and will take more time to bear out. "At our size, integrating technologies and rolling them out globally is not trivial," he said.

Another challenge is increased competition from rivals such as Oracle, which this year began distributing Linux software at discounted prices. "Oracle is not necessarily looking to make money on Linux right now, so they can almost give it away," said Soleil's Gilman. "That's not good for Red Hat."

But the greatest strategic threat and opportunity is virtualization, a software technology that helps computer hardware multitask and perform more flexibly across operating systems. VMware of Palo Alto, Calif., has the early lead, and that could bode poorly for Red Hat and Microsoft.

"Virtualization is key," Gilman said. "It's the new technology on the block." Though the technology is used with just 5 percent to 10 percent of server operating systems, it will expand to become a must-have feature in the near future, he said.

Barnicle said that Red Hat's technical grasp of virtualization is probably better than investors realize, "which may explain why [Red Hat] shares haven't moved more."

On a conference call last week, Szulik told analysts Red Hat would be making strides in virtualization technology and noted that the company already has developed certain advantages over VMware. That makes him bullish on the company's market value.

"Red Hat is sitting here with \$1.2 billion in the bank and an economic model that's throwing off 40-percent [growth] in sales and cash flow," Szulik said.

"If you can find another economic model throwing off that kind of cash, then buy the company."

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