

# It's AI Jim, but not as you know it!

Ian Spence, the CEO of Megabuyte, the leading technology analysts, explores how the AI that everyone is going on about isn't really AI; but it's still a game changer.

For the 25 years that I have been watching the technology sector, there has been one constant; hype. The biggest hype of recent times was obviously the dotcom boom of the late 1990s which was fuelled by the advent of the consumer Internet but, in my view, we are well on our way to the next big one, this time focussed more on enterprise technology. As Cloud and SaaS go mainstream, the new kid on the hype block is artificial intelligence, or AI. In all of the hype cycles I have experienced, the term AI is perhaps the most mis-used term yet. Why? Because the vast majority of what people call AI are just algorithms, many of which aren't really very sophisticated. Algorithms are as old as mathematics itself and have been used in the technology sector throughout its history, so, on the face of it are certainly nothing to get too excited about.

The key difference between an algorithm and AI is the 'intelligence' bit. For an algorithm to become AI, it must have the ability to learn from the results of applying the algorithm and modify the algorithm, hopefully thereby delivering a better result. An example might be in disease diagnosis where an algorithm might be used to identify cancer from scans, but artificial intelligence can then look at the resulting success rates to determine a more accurate way to diagnose. The former is difficult to do but the latter is on another level altogether. Perhaps it's no surprise then that, according to research by the Financial Times, some 40% of European AI start-ups aren't actually using any AI in their products.

So why all the negativity, I hear you say? The increasing use of sophisticated algorithms is potentially a game changer; who cares if it's not actually AI? Well, to be fair, this is a good point. Putting aside my analyst pedantry I can see that the AI trend, if that's what we must call it, is indeed a potential game changer. So, I thought I would spend the rest of



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this article giving a summary of my views on why.

## AI petri dish

To understand why the use of sophisticated algorithms is growing exponentially, we must first look at the conditions that are enabling them to grow. First, there is the explosion of data in recent years; without the use of algorithms, it would be simply impossible to get any meaningful insights from this data. Secondly, the advent of the Cloud and APIs has made accessing big data substantially easier than previously. And, last but not least, Moore's law has enabled computers to process big data, using said algorithms in acceptable timeframes.

With the conditions now right, AI applications are springing up all over the place but there seems to be three broad categories; customer

experience, product innovation and process optimisation.

## Generation gap

All of this plays into my broad theory about the future of enterprise technology; which I summarised in the previous issue of GS-insight. It has been clear for some time that we have entered into a third generation of enterprise technology; the first being mainframe, the second being client server and the third being Cloud. What has become apparent to me more recently is that there is an interesting trend developing within the third generation.

Over the last decade we have seen the growing adoption of Cloud technologies in all areas of enterprise technology, from Cloud infrastructure to IT services and, of course, to Software as a Service. In my view, Cloud technologies are now in a mass adoption phase in large parts of the economy, especially the service industries. While the focus of the third generation thus far has been largely on a shift to Cloud infrastructure, increasingly, as Cloud technology becomes pervasive, technology companies and also those involved in other sectors are now using Cloud infrastructure to do business differently, with data, collaboration and new business models at the heart of this fundamental, digital shift. AI is the glue that sticks these various elements together.

## All businesses are tech businesses

It is this digital shift, or disruption, which has led to the development of all the 'techs'; fintech, retail-tech, prop-tech, travel-tech and so on. Cloud, or perhaps 'digital' is now a better term to use, technologies are being utilised to disrupt traditional industries to a degree not seen since the dotcom boom of 10 years ago. The most high-profile examples of this are arguably in transport (Uber, Lyft, Deliveroo etc), banking and payment

(Monzo, Starling, Revolut etc al), health and wellness (BenevolentAI, Healx etc) and e-commerce (farfetch, the Hut Group etc). However, behind these well-known stories there is a broader and fundamental shift to digital business, which has all been enabled by the Cloud infrastructure developed in the last decade or so; Cloud hosting, SaaS, next generation networks, API technology etc.

There have been many column inches dedicated to these digital disruptors, as well as the potential societal impact of their rise, so I do not propose to add to those here. My main interest in this topic is what this latest phase of the third generation of enterprise computing means for those that provide software and ICT services.

On the one hand, the rapid adoption of digital technologies provides a massive structural growth opportunity for software and ICT services companies as their customers lean on them to help with the digital transformation. And we are clearly seeing this in our data on the UK market. The average organic growth rate of the companies we track in the Megabuyte service (where we can get the data from Companies House - about a third of the 2,500 companies on our database) is over 10%. And the top companies are growing at more than double that rate, whilst still generating average EBITDA margins also in the 20s. While that growth might not seem as exciting when compared to some of the unicorns references above, I think it ably demonstrates the strength of the sector when set against anaemic UK GDP growth.

There is also no doubt in my mind that this growth is driven largely by the structural demand generated by the generational shift in the use of enterprise technology. However, when we think about the consequences of the move to digital, it may not be all good news. Why? Because many of the burgeoning digital-native companies will be developing much more of their technology in-house and thereby require much less help from external suppliers. At the same time, business services companies are increasingly investing in technology to provide what are now commonly called tech-enabled services, thereby also potentially taking budget away from

pure technology companies.

Take Megabuyte for example. We are essentially a media company, but in some ways, we look more like a software company. We spend 15% of our revenue on a team of developers that are absolutely core to our strategy. Meanwhile, our external spend with software companies and infrastructure providers is very low; less than 2% of our revenue, and over half of that is with AWS. 10 years ago, we would almost certainly have used an external web agency (in fact we did) to develop and maintain our web platform.

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## ***“AI is becoming the key driver of digital transformation.”***

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I believe that this blurring of the lines of what is defined as a business services company and what is a technology company has only really just started and will play out across the industry over the medium to long term. Indeed, one might even extend this further to say a blurring of the lines between what is a company (of any kind) and what is a technology company.

So, technology companies, and especially software companies will need to adapt. And the most obvious way in which to adapt is to start providing a service on the back of your software - the clue is in the SaaS title. One obvious way to do this is with a B2B2C model but there are more direct ways to do it as well. There will of course continue to be areas where pure software remains relevant. For example, Megabuyte is a long-standing customer of Xero (and a very happy one at that) and I foresee no reason why we wouldn't continue to be so for many years to come. But, in my view, most sectors will move in the direction of tech-enabled services as the digital disruption phase of the third generational shift gathers momentum.

This will all come with another big shift in business model. Just as software companies have got used to the shift to a recurring revenue model, now they may need to embrace even

more alien models such as revenue share, pay per click, etc. There are as many business models as there are unicorns but there is one constant; they don't generate revenue from selling technology.

## **It all comes back to AI**

While you may be thinking that I've gone a bit off piste here - weren't we talking about AI? - there is method in my madness. The key point is that, as I noted above, algorithms and AI will increasingly be seen as the glue that holds many of these digital strategies together. In my view therefore, AI is becoming the key driver of digital transformation. Take Uber again as an example. At its heart, it is a collaboration and e-commerce engine bringing together multiple data inputs and outputs to bring driver and customer together, arrive at the right location in the fastest possible time and charge the right fare. But at the heart of all that are algorithms (AI) that make it all work efficiently.

Of course, I'm not the only person to spot this trend and, in the frenzy of activity to find the AI winners, investors are performing their usual trick of throwing money at any company with [insert buzzword] in its title. Also, in keeping with past hype-cycles, valuations often assume a completely unrealistic likelihood of success. Moreover, with the latest start-ups encouraged to seek world domination from the get-go, valuation excess has reached new heights.

Having looked at a significant number of companies claiming to be AI pioneers, my conclusion is that many (probably most) are simply not delivering value in their solutions. After all, a word cloud does not constitute insight. Indeed, you only need to glance at the Softbank Vision fund deck recently published by FT Alphaville to see that investor over-exuberance has reached dotcom bubble proportions in some quarters. As such, it seems likely that we are near the peak of inflated expectations for AI, to quote the Gartner hype curve, and will soon be headed down to the trough of disillusionment. But that's when the real investment opportunities will present themselves.