TimesSquare Capital Management, LLC

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AI & the Durability Debate

Enterprise Software & AI: A Balanced View for Long-Term Allocators

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"These risks are real, but overstated."

Artificial intelligence introduces meaningful uncertainty into the long-term outlook for enterprise software, particularly around competitive dynamics, pricing durability, and terminal value assumptions. While these risks warrant close monitoring, we believe the market is extrapolating worst-case outcomes that are inconsistent with historical precedent and current enterprise behavior.

The prevailing concerns can be grouped into three areas:

1. Potential for Increased DIY Development and Churn
   There is a growing perception that LLMs (large language models) will enable enterprises to develop internal software solutions or custom extensions more easily, reducing reliance on third-party vendors and increasing customer churn over time.

2. Heightened Competitive Intensity and Pricing Risk
   AI may lower development costs and blur traditional software category boundaries:

   - Startups may reach functional parity more quickly using AI-assisted development
   - Incumbents may expand into adjacent markets, increasing overlap
   - LLM providers are introducing agentic layers that sit atop existing platforms

   Taken together, these trends raise legitimate concerns around commoditization and incremental pricing pressure.

3. Structural Headwinds to Seat-Based Growth
   Many application software business models remain tied to seat count. If AI meaningfully automates white-collar workflows, seat expansion could slow or plateau in certain end markets.

Our Perspective: These Risks Are Real, but Overstated

Enterprise Behavior Favors Stability Over Experimentation

While LLMs improve internal development productivity, we believe wholesale displacement of core third-party platforms is unlikely. Over multiple technology cycles, enterprises have consistently chosen to outsource non-core software functions to specialized vendors to reduce operational, security, and execution risk.

Historical parallels — including the rise of open-source software — suggest that lower perceived development costs do not translate into mass adoption of internally maintained systems at scale. Free or internally built solutions often carry hidden costs in maintenance, security, and accountability. Importantly, CIOs and CTOs remain highly sensitive to career and business risk associated with major platform transitions, particularly for mission-critical systems.

Software is a Small Budget Line and a High ROI One

Enterprise software typically represents a modest share of overall cost structures, particularly relative to labor. In periods of cost scrutiny, enterprises have historically prioritized headcount rationalization and operational efficiency over removing core software platforms that underpin business processes. This limits the economic incentive to aggressively displace incumbent vendors.

Incumbents Are Actively Adapting to the AI Shift

Unlike prior platform transitions (e.g., client-server to cloud), AI adoption does not require a full architectural rewrite or a disruptive change to revenue recognition models. As a result, incumbent vendors have shown limited hesitation in embedding AI capabilities into existing products.

Many are developing context-aware, domain-specific agentic functionality that leverages proprietary data, workflow integration, and distribution advantages. While execution risk remains, this positioning reduces the likelihood of near-term disintermediation by horizontal LLM providers.

Pricing Models Are Likely to Evolve

Seat-based pricing may face pressure in certain use cases, particularly where automation reduces incremental user counts. However, enterprise software has historically been priced on value delivered rather than strict unit measures. We expect a gradual shift toward consumption-based or outcome-oriented pricing models, with less disruption to aggregate monetization than current market narratives imply.

Investment Implication

AI has widened the range of outcomes for enterprise software. While incumbent platforms retain structural advantages that may support long-term durability, uncertainty around terminal value and competitive dynamics is unlikely to be resolved in the near term and may continue to weigh on the sector.

From a portfolio perspective, software can appear tactically oversold at times. However, the medium-term overhang from unresolved AI-related debates remains, and downside risk is meaningfully higher than in prior cycles. This reinforces the importance of selectivity, a focus on proven platforms, and disciplined valuation rather than broad exposure.

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