Saturday, Jan. 15th, 2005
Vol. 21, No. 01

Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Software may run the world but not investor's portfolios: See pages 4-5 for the grim news over three years from our software company ***Return on Equity*** *survey. The good news is that last year saw substantial improvement in most sectors.*

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Technology for Software's Sake

In our last issue we told you we were very impressed with the hosted applications we were evaluating and pointed to some standouts (in our opinion. If you are interested in seeing what companies made it to the awards finals, you can at: http://www.siia.net/codies/2005/finalists.asp). Another entrant that stood out was a company called Surgient. The company provides software firms with the ability to mount fully functioning versions of their products online for evaluation, demonstrations, proof of concept (POC) projects, training, and Q&A. Surgient focuses heavily on providing services to SEs and its SE application is one of a very tiny number of products aimed at these key players in an enterprise sales force.

Remote evaluation of software online is not a new idea, in the late 1990s and early 2000s companies such as Runaware pioneered the concept. We have to confess we were somewhat surprised that these firms didn't meet with greater success; it is not difficult to realize a very favorable ROI from the use of online evaluation when you analyze the cost of providing software previews via CDs and the low lead rates and sales associated with this traditional approach. At the time, we thought companies would flock at the opportunity to move this aspect of their Marcom to the web; yes, the infrastructure of the time wasn't as robust as today, but most of these systems did a good job of allowing customers to try out software online even with dialup connections. However, an interesting industry phenomenon we've noted is that software companies are often no better than anyone else at recognizing and taking advantage of new technology to leverage their business processes.

That said, we decided after our stint as a Codies judge to take a closer look at Surgient and its updated take on the idea of off-loading product evaluations and demonstrations to the web. Surgient was founded in April of 2003, the result of a merger of two smaller companies. Its products are all hosted and based on an architecture that relies on the extensive use of server virtualization technology. Surgient currently employs about 80 people, is VC funded, has generated about $6M in revenues over the last 18 months and saw its best sales in the last quarter of 2004. The company's client portfolio includes such major players as Microsoft, Siebel, BEA, and Documentum. Baseline services cost approximately $25,000 and scales up per user; we estimate you should budget between $50,000 to $100,000 from your marketing budget if you decide to use Surgient. We spoke to Erik Josowitz, Surgient's VP of marketing, about the firm's services and business case.

On why remote evaluations systems are beginning to gain traction in the market: I think a number of *(continued on page three)*

The Convergence Syndrome

When one thinks high-tech, Wal-Mart is not a company that immediately comes to mind. But Wal-Mart has an interesting history in the software industry. In the late 90s a Wal-Mart executive suggested to a PC gaming company that they create a hunting title that would appeal to the discount giant's blue collar audience; thus was born Deer Hunter, a smash hit which spawned the hunting game genre.

During the Christmas season of 2004 Wal-Mart conducted another interesting experiment; selling dirt cheap PCs and laptops. The company released the first "serious" $500 dollar laptop running the Linspire (formerly Lindows) Linux distro. Wal-Mart first began experimenting with ultra-low cost PCs running Linux a year ago and seems satisfied with the results. During the Christmas rush, the $500 laptop was usually out of stock.

Wal-Mart's interest in software and high-tech is driven by the company's ability to "break categories" i.e., reverse the trend towards market segmentation by leveraging its pricing power (ask Toys-R-Us about Wal-Mart's power in this regard). This Christmas was a good one for Wal-Mart, but while people bought plenty of toys, clothes, and cheap TV and DVDs from Wal-Mart, they didn't flock to its aisles to buy PCs and other higher margin digital toys. Wal-Mart would like to change that.

So would China, Wal-Mart's largest supplier of goods (approximately $18 billion per anum). China wants to move up the high-tech food chain, as demonstrated by the Lenovo Group's recent purchase of IBM's PC business. China has obtained a hardware portfolio that includes one of the market's best know hardware brands (ThinkPad) and the IBM corporate brand on its PCs (for the next three years). No more PCs with names like "Adventia," or "Tremendia," or "Justlikeya." IBM.

China's interests now converge with Linux (and IBM's). China, like Microsoft, believes in standards and wouldn't mind owning, or at least controlling, a few. China can't hope to control Linux, at least, not yet. But Linux is split among multiple distros and is weak in (US) driver development. China, leveraging its increasing domination in mainboard manufacturing, leads the world in Linux driver work. At some of the most prominent companies, new drivers are first coded for Linux ; once complete, Windows development is done to meet marketplace requirements. What Wal-Mart, China, and "IBM" now need is to create or buy a Linux distro that sparks the coalescence of a "retail Linux"; one sufficiently standardized that third parties can develop new applications secure in the knowledge that a hardware ecosystem exists to sell into. There are several likely candidates: Linspire, TurboLinux, Red Hat, even Novell.

The end goal of these converging forces is to burn through the Microsoft/Dell duopoly. China can match Texas when it comes to manufacturing things cheaply and it now has a brand to battle with. Windows and Office OEM licenses are becoming the single largest COG item in PC manufacturing (prices range from $40 to $150), and as electronics become cheaper the numbers look even worse. Steve Ballmer may like the idea of a $99 PC, but if it comes with Windows/Office licenses it's going to cost someone about $10 to make. The Chinese are good but they're not that good, and they're not interested in turning their hardware industry into a loss leader for Microsoft.

Over the next two to three years, Microsoft and the software and hardware industry will live in interesting times.

events have converged over the past couple of years to make the time finally right for this sort of solution; enterprise software has become larger and more distributed in implementation; the rise of standard interfaces (at various levels) has meant that more solutions are really integrations between multiple, dependent products (related to the above as well); significantly more end-users today have the required high-speed internet access to make remote evaluation feasible; the dramatic drop in storage and memory prices—these solutions don't tend to be processor bound but more bound by the available memory and storage; and the emergence of server-class virtualization on Wintel hardware/OS has made the back-end side of this type of demo or evaluation centralization cost effective in a way that it wasn't before.

On why Microsoft chose to use Surgient to provide online demonstrations for the ongoing marketing of VirtualStudio.net: Remote demonstrations proved to be far more cost effective. When Microsoft rolled out VirtualStudio.net they put together a 1.1 million mailing piece to support the product. The cornerstone of the piece was a DVD with a video, sample product, marketing collateral, etc. Production costs were approximately $5 per piece, not including delivery.

Microsoft estimated that 50,000 prospects opened and installed the CD, from 4% to 5%, typical performance for a mailing of this size and production quality. Once you factored in additional overhead, including administration and delivery, the cost of acquisition became approximately $100 per lead (Editor's note: Cost of leads for higher-end desktop and retail applications typically averages between $35 to $100 per lead; costs have risen sharply over the last few years because of rising mailing costs, higher COGs, and the increased costs of creating competitive CD-based demonstrations). Another point is that their leads were delivered with no demographic or other contact information; the system we set up for them can capture name, E-mail address, and other relevant data.

In contrast, they used Surgient to create an online "Virtual Lab" where you could interact and use the actual software online. The system delivers from 12 to 15 thousand leads per month; Microsoft's cost of acquisition per lead has dropped to around $4.

On providing proof of concept projects during the sales cycle: We've found that the ability of remote evaluation system to provide a secure staging area for POC projects as part of the sales process is becoming increasingly of interest. Five years ago, at the height of the bubble, you could walk into many sales situations and almost never have to do a true demonstration or POC.

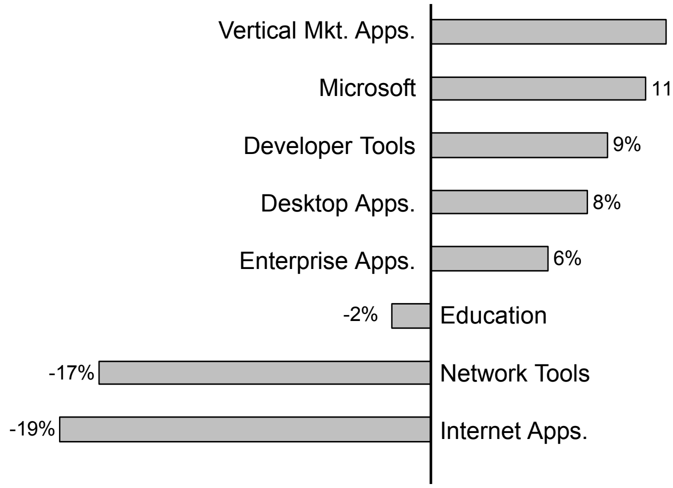
That's changed, obviously. Now customers are demanding to see working prototypes before spending their money. The problem with this is that POCs are traditionally very expensive and sales forces are trained to avoid them like the plague. Yes, yes, everyone *(continued on page six)*

"Many customers will use a web conferencing solution to display the demo to many audiences but will use remote evaluation to create customized demos and POCs. The advantage that we bring to the table is that we can provide hands-on access for multiple members of a team to an actual running product, collaboration tools that support the evaluation process, and the means of sharing and scheduling access to the resources on which the product runs."

—Erik Josowitz
Surgient

"Another point about the use of using remote demo systems is that they encourage the creation of knowledge bases for SEs, information on what type of processes to demo and the means to propagate that information back to your sales force."

—Erik Josowitz
Surgient



Asset creator or cash burner?

In the latest fiscal year, the return on equity (median) for the majority of software segments produced a positive return ranging from 6-12%. Network Tools and Internet Application companies turned out to be the cash burners.

Benchmarks: Return on Equity

Return on equity (ROE) is a measure of a company's profitability, calculated as: net income divided by shareholders equity. (Shareholders' equity is the difference between balance sheet assets and liabilities.) Shareholder equity represents the tangible assets that have been produced by the business.

ROE figures help investors distinguish between profit creators and profit burners. A high ROE percentage usually suggests a lean, mean profit machine; low or negative ROE indicates an inefficient clunker.

No single method can provide a perfect tool for measuring fundamentals. Nevertheless, ROE remains an important way of seeing if intangible assets are creating cash value. The key is knowing from where the ratio's numbers are coming.

Although ROE offers a gauge of profit-generating efficiency, the indication is not absolute. The ratio goes up whenever the value of the shareholder equity, (the denominator) goes down. Three factors that can result in an artificial increase to ROE without any improvement in the company's operations are: buy-backs, company debt, and a firm's intangible assets.

If a company buys back shares in order to increase the value of shares still available (reducing supply), this action will lower shareholders' equity proportionately more than it lowers earnings, thus increasing ROE. Furthermore, a high ROE doesn't tell you if a company has excessive debt and is raising more of its funds through borrowing rather than issuing shares. Since shareholders' equity is assets minus liabilities, the more debt a company has, the less equity it has and the higher its ROE ratio will be. In addition, for technology companies, cash is often used to create intangible assets—patents, trademarks, brand equity—which are all excluded from shareholders' equity. As a result, shareholder equity often gets understated in relation to the company's value, and, in turn, ROE goes up.

When we look at how our Benchmark 50 group of public software companies performs on ROE, we find the majority of segments produced a small positive return on equity (ranging between 6-12%) with only sixteen out of fifty companies managing to generate an average of at least a 10% return on assets over the past three years. For the industry as a whole, the three-year average was a pitiful -1% ROE, with the Education, Network tools, and Internet segments as the worst financial investments for delivering shareholder value.

The Benchmark 50: Return on Equity

	Revenues (000) 2002	2003	2004	Return on Equity 2002	2003	2004	Avg. '02-'04
Microsoft	$28,365,000	$32,187,000	$36,835,000	**10%**	**12%**	**11%**	**11%**
Desktop Applications				**-15%**	**5%**	**8%**	**-1%**
Adobe	$1,229,720	$1,164,788	$1,294,749	33%	28%	24%	29%
Intuit	$1,312,228	$1,650,743	$1,867,663	6%	17%	17%	14%
Symantec	$1,071,438	$1,406,946	$1,870,129	-2%	14%	15%	9%
Scansoft	$62,717	$106,619	$135,399	-15%	5%	-2%	-4%
Aladdin Systems	$7,627	$7,457	$8,535	-35%	-18%	7%	-16%
Macromedia	$326,498	$336,913	$369,800	-81%	0%	8%	-24%
Smith Micro	$9,489	$7,131	$7,216	-97%	-12%	-17%	-42%
Vertical Market Applications				**8%**	**8%**	**12%**	**9%**
Ansys	$84,836	$91,011	$113,535	20%	21%	17%	19%
Kronos	$295,290	$342,377	$397,355	18%	16%	17%	17%
Autodesk	$947,491	$824,945	$951,643	17%	6%	19%	14%
Dendrite	$227,362	$225,756	$321,107	-10%	10%	12%	4%
Advent	$170,215	$159,436	$137,159	8%	8%	-7%	3%
Moldflow	$35,088	$36,625	$48,673	1%	-0%	4%	2%
MapInfo	$110,034	$92,598	$106,255	-3%	-1%	4%	-0%
Enterprise Applications				**-8%**	**4%**	**6%**	**1%**
Manhattan Associates	$156,378	$175,721	$196,814	11%	14%	10%	12%
Business Objects	$415,794	$454,799	$560,825	18%	12%	2%	10%
Mercury Interactive	$361,000	$400,122	$506,473	10%	15%	6%	10%
SPSS	$174,055	$208,480	$208,367	-23%	-16%	8%	-11%
Witness Systems	$62,522	$67,686	$108,037	-8%	0%	-41%	-16%
Concur	$41,099	$45,097	$56,737	-62%	4%	7%	-17%
ServiceWare Technologies	$12,427	$10,158	$11,511	-471%	-330%	-2778%	-1193%
Internet Applications				**-37%**	**-73%**	**-19%**	**-43%**
Cryptologic	$43,550	$34,427	$44,211	30%	-5%	19%	14%
RealNetworks	$188,905	$182,679	$202,377	-16%	-11%	-6%	-11%
Interwoven	$204,633	$126,832	$111,512	-37%	-73%	-16%	-42%
Centra	$39,117	$33,400	$43,041	-32%	-74%	-33%	-46%
NetIQ	$278,239	$310,224	$261,645	-50%	-139%	-43%	-77%
Verisign	$983,564	$1,221,668	$1,054,780	-205%	-314%	-19%	-179%
Ultimate Software Group	$59,479	$55,149	$60,416	-191%	n/a	-552%	-371%
Network Tools				**-25%**	**-23%**	**-17%**	**-22%**
Citrix Systems	$591,629	$527,448	$588,625	16%	15%	18%	17%
McAfee (Network Associates)	$1,071,660	$1,043,044	$936,336	24%	17%	8%	16%
Altiris	$34,451	$62,876	$99,339	n/a	-0%	8%	4%
Novell	$1,050,796	$1,134,320	$1,105,496	-21%	-23%	-17%	-21%
NetManage	$79,284	$65,740	$50,663	-32%	-137%	-21%	-63%
Tumbleweed	$29,048	$25,525	$30,595	-265%	-96%	-28%	-130%
Tarantella	$66,662	$14,220	$14,006	-28%	-279%	-392%	-233%
Developer Tools				**-4%**	**6%**	**9%**	**4%**
Pervasive Software	$37,197	$39,205	$49,608	16%	17%	9%	14%
Progress Software	$263,584	$273,123	$309,060	10%	12%	12%	11%
BEA Systems	$975,893	$934,058	$1,012,492	-5%	10%	12%	6%
Borland Software	$221,771	$244,579	$295,236	8%	6%	-11%	1%
Sybase	$927,923	$829,861	$778,062	-4%	-16%	12%	-3%
Red Hat	$78,910	$90,926	$126,084	-43%	-2%	3%	-14%
Raining Data	$19,267	$21,006	$22,297	-174%	-34%	-14%	-74%
Education				**-8%**	**-13%**	**-2%**	**-8%**
Apollo Group	$769,474	$1,009,455	$1,339,517	23%	24%	29%	25%
Renaissance Learning	$132,354	$131,232	$130,544	22%	26%	24%	24%
Plato Learning	$70,107	$74,391	$82,192	3%	-1%	-2%	0%
American Education Corp.	$8,902	$8,483	$8,598	-8%	-13%	3%	-6%
Docent	$29,011	$27,792	$30,238	-94%	-61%	-36%	-64%
Click2Learn	$31,209	$30,477	$29,487	-66%	-148%	-33%	-83%
Saba Software	$55,648	$44,416	$34,471	-105%	-93%	-194%	-131%
All companies (median)				**-8%**	**-0%**	**4%**	**-1%**

Note: "Years" may not correspond to company fiscal years.

is taught that the customer has to be "qualified" and you have to "diagnose" the sale, and only after that do you commit to a POC but in the real world a "solution selling" song and dance routine only carries you so far.

One major system we developed was with an $8 billion dollar software company selling enterprise products that required extensive POC work. They established a server farm of 200+ plus machines staffed by four full time IT employees with an annual operating budget of $339,000; their hardware costs were an additional $2 million per year. The system was able to support 30 POC projects per year.

With our system, they reduced their IT overhead to one person, reduced their annual operating costs by 98% and lowered their hardware overhead to $1 million. In addition, their current configuration can now handle 48 POC projects yearly. More cost savings can be found in the hosted model by allowing consultants to work from their locations, lowered travel expenses, less IT overhead, etc. We believe that if a company can get the costs associated with them under control, POCs can become a competitive weapon for a sales force.

On SE field needs: Companies often don't realize the amount of overhead associated with supporting an effective SE force in the field. The typical SE supporting an enterprise sales force needs high-end laptops (preferably two of them), multiple interchangeable hard drives, backups, etc. Productivity tends to be very low since things blowup. Configurations are lost; laptops are stolen; hardware fails. Some of our customers estimate that their SEs lose 30% to 50% of their time acting as their own field-IT departments. Another issue is demo management. Our customers are software companies; they're technically astute and the industry has never suffered from a surfeit of "not invented here" thinking. Many companies build big demo servers, create VPNs, and allow their SEs to connect to it.

The primary problem facing companies using this approach is managing multiple personalized evaluations and implementation scenarios. Problems invariably arise with scheduling and data problems; multiple SEs connect to the system and demo data is loaded up and then not reset, potentially embarrassing data is left on the system, multiple people try to load demo data simultaneously, leading to lockout situations, etc.

Virtualization technology on the backend helps solve these types of problems; it's comparatively easy to automatically reset data and give someone access to a "bare metal," clean evaluation machine quickly.

On the future of desktop and client/server applications. We're in an interesting situation; we're very supportive of the ASP model (we're Salesforce.com customers) since we're ASPs ourselves. And 75% of our customers prefer to rent our products as opposed to buying licenses, though we've found this situation reverses with Q&A organizations. ISVs and IT enterprise want to keep their training, testing, and deployment within the organization and behind firewalls. But our primary focus is on companies selling desktop and client-server software.

We like to break applications into two categories: "form- vs. "object-based." Form-based applications usually interact with a database; these are natural candidates for migration to a web-based environment. Products such as Word/Outlook/Photoshop are used under different circumstances, with direct and very interactive manipulation of an object or project of some sort. We believe both classes of applications have a long life ahead of them.

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Using Strawmen in M&A Negotiations

By Linda Martin, Corum Group

"Straw Men" are issues included in agreement negotiations that you are willing to concede, if necessary. When negotiating for something as complicated as the sale of a high tech company, the axiom "win/win" should be your hallmark. Remember that everyone, especially the buyer's negotiator, whose career may be on the line, has to "look good" and feel as if they've "won" the negotiations. Properly positioned, Straw Men allow you to concede some issues early, build credibility with the other party, and enable you to obtain what you really want when discussions shift to critical issues.

There will be a number of objectives that each side will have going into the deal discussions, some of which are very important, others less so. Negotiations will run on a "points" system. If you only ask for two points and the other side feels like they've conceded both, they've taken a 100% "loss" and relationships will become rocky. Therefore, march your Straw Men into position early. For instance, if your goal is getting the escrow to a smaller number and the liability period greatly shortened, then you might want to throw in a bunch of other points such as closing date, bonuses, term of non compete, amount/timing of options, etc. as part of your requirements, knowing you will gladly sacrifice your pawns to achieve the terms you really want. Therefore, the other side will win on, say, four points and lose on two (your two). Victory in hand, they'll be motivated to sell the deal to their management.

Straw Men who can be deployed in relevant deal negotiation area include: relocation, employment agreement terms, employee bonuses, earn outs, contingent liabilities, performance metrics, etc. Keep a supply ready for sacrifice as needed.

Good negotiators always find ways to make the situation a win-win for both sides. It works in deals worth tens of millions, but is also true in everyday life for even the smallest negotiation. In a complex acquisition negotiation, it pays to have a pro guiding you. They have seen all of the Straw Men and know when and which to play.

Linda Martin, vice president, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: lmartin@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Tecnomatix Technologies (TCNO)	UGS (UGS.V)	$241,000,000	$98,700,000	**2.44**
• Software for manufacturing and process management		*Terms: Cash tender offer*		
BuzzeoPDMA	Dendrite International (DRTE)	$10,000,000	$10,000,000	**1.00**
• Outsourced compliance for the life sciences industry		*Terms: Cash*		
SMARTS, Inc.	EMC Corporation (EMC)	$260,000,000	$57,800,000	**4.5**
• Event automation/real-time network management		*Terms: Cash*		
Dralasoft	Verity(VRTY)	$8,000,000	$2,500,000	**3.20**
• Business process management software		*Terms: Cash*		

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Must Read Development Blogs

- **Dan Bricklin** (www.bricklin.com): Informative and interesting blog by the Father of VisiCalc; recent emphasis on Open Source software issues.
- **Joel on Software** (www.joelonsoftware): One of the Internet's most visited and widely quoted blogs; site recently opened a new section on the business of software.
- **Mena's Corner** (http://sixapart.com/corner/): Interesting blog by Mena Trott, co-founder and president of Six Apart, developer of one of the most succesful software blogging products, Movable Type.
- **Scobelizer:** (http://radio.weblogs.com/0001011/): Famous blog that offers the Microsoft view of things.
- **Erick Sink** (www.http://software.ericsink.com/): Very useful blog that contains a series of business lessons for software companies written by the blog's author.
- **Software Reality:** (www.softwarereality.com): Contrarian blog on Agile programming and related topics. If you're an Agile fan, guaranteed to annoy you.

FORTUNE MAGAZINE reporters David Kirkpatrick and Daniel Roth on the growing power of blogs: "The blog—short for weblog—can indeed be, as Scoble and Gates say, fabulous for relationships. But it can also be much more: a company's worst PR nightmare, its best chance to talk with new and old customers, an ideal way to send out information, and the hardest way to control it. Blogs are challenging the media and changing how people in advertising, marketing, and public relations do their jobs. A few companies like Microsoft are finding ways to work with the blogging world—even as they're getting hammered by it. So far, most others are simply ignoring it." (Quoted on Fortune.com, 01/10/2005)

DAVID BERLIND on Microsoft's pricing strategies for Office: "Anybody who thinks that Microsoft is just going to lie down and die as a result of this revolution in what $50 gets you is dreaming. If Novell, Sun, or any other company can turn a profit off of a $50 soup-to-nuts desktop offering, there's no reason Microsoft can't do it, too. It's just that the result may not be Windows and Office as we know them in their entirety. For example, Microsoft already has plans to offer a $36 Windows XP Starter Kit in India and will be offering copies of Office to certain schools at $2.50 per copy." (Quoted on ZDNet News, 12/31/2004)

DAN BRICKLIN on Open Source M&A perils: "In another case, simple, reasonable Open Source questions (like "Do you have any documentation of which Open Source code you are using and the licenses covering it?") resulted in a multi-month delay of due diligence on a lucrative deal that then lost momentum and eventually died hurting the company trying to sell badly." (Quoted on www.danbricklin.com, 12/20/2004)

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Soft•letter is published 24 times per year; ISSN: 0882-3499.

Subscription rates: $395 worldwide. Subscription office: United Communications Group, 11300 Rockville Pike, #1100, Rockville, Md. 20852-3030; tel 301/287-2718 866/313-0973 customer@softletter.com