Sunday, Jan. 15, 2006
Vol. 22, No. 01

Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

SaaS Sales Compensation Models: Another Approach, Part II of II

Welcome back from the Holidays! We continue with our look at SaaS compensation issues and models with Bob Conlin of Centive, a SaaS firm that provides an online sales compensation tracking and disbursement system. We note that Microsoft's recent "Live" announcement is a major indicator that the SaaS model has completely recovered from the 1999-2001 meltdown that almost wiped out this sector of the market.

In part one of this article we quoted you as saying you don't think the account manager approach is the best fit for sales development in a SaaS model. Why do you believe this?

This goes back to the speed of account development we're seeing in the SaaS model. Normally, when selling an application such as ours, one that impacts a critical point of a company's operations, the sales cycle is going to take between nine to 18 months, there will be many face-to-face meetings, and personal relations will be important in closing the customer. But we're finding that with SaaS sales closing more quickly, the type of skills we require are different. We need people who are good at closing on the phone and developing new business, not building annuity sales.

A corollary to this is that for experienced sales people who are used to closing larger customers on the phone, we're finding that we need to offer commission rates that range from 10% to 14% depending on the size of the sale and the length of the contract.

Over the years, services have proved to be an increasingly profitable and significant portion of the overall sale. But we're hearing from other SaaS companies that services are not as significant to them; at least as part of the initial sale. What are your experiences?

From our standpoint, we can confirm this. I think there are several reasons for this trend. One is that SaaS development is best approached from a "best practices viewpoint." With a SaaS solution; you get what you get. Don't misunderstand; our product is highly configurable and there's a lot of built-in flexibility, but there are also definitely boundaries to it. I think this is an inevitable part of the SaaS equation; you can't build a scalable and quickly deployable hosted product and offer endless customization. *(continued on page three)*

Our analysis of Q3, 2005 deals indicates VCs are serving up the largest amounts of software dollars to Open Source Software (OSS) and Software as a Service (SaaS) companies *See pages 4-5.*

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Advisory Board

Online Sales—Merchant Responsibilities

by Craig Ross, Nexternal Systems

Online merchants bear many responsibilities and face potentially expensive liabilities if they're careless in the way they handle data or fail to follow best practices for online credit processing. An E-commerce system that allows you to meet your responsibilities while limiting potential liabilities should encourage you to:

- **Not process credit cards upon receipt of order.** While some online merchants do this, it is strongly recommended that your system authorizes credit cards but not capture upon order receipt. Even with fraud detection systems in place, there is no perfect substitute for the human eye and common sense. Besides, most merchant banks require that an order be shipped within 48 hours of receipt. Auto capture imposes difficult to impossible restrictions on the merchant (example, orders received Friday night) and provides no ability to adjust orders due to out of stock items, customer upgrades, stolen credit cards, etc. Merchant banks know that orders shipped after 48 hours of capture have a much higher incidence of charge backs and will raise the merchant's discount rate or even revoke their processing abilities.

- **Not store CVV Values.** Collecting CVV information (the 3 or 4 digit code on the back of a credit card) is important for fraud prevention, but a merchant is not allowed to store this info in any format due to PCI (Payment Card Industry) regulations. The merchant's online store should pass this info directly on to their gateway provider and not store or make the CVV info available to any company personnel. Storing CVV information in violation of PCI regulations can result in a merchant losing their processing rights.

- **Limit the availability of credit card info to appropriate users.** A merchant needs to limit the availability of stored credit card information to the appropriate users. For example, a customer service rep may need to examine customer credit data to adjust an order, but an employee in the shipping department should not have the same level of access.

- **Limit data exports.** A merchant should be able to control the types of data exports from the E-commerce system and the information contained within. For your company's protection, it is not advisable to automatically export sensitive data such as credit card numbers.

- **Tightly control access to the merchant's order management software to prevent unauthorized use.** Your E-commerce system should require individual user accounts with different access levels and must require strong passwords for each user. A merchant should not tolerate the sharing of user accounts and the system should keep track of and provide an audit trail of user order and product edits.

- **Never E-mail credit card information or ask that your customers send you credit card information.** Standard E-mail is not an inherently secure medium and does not use secure protocols. Asking your customers to E-mail you new credit card information is unprofessional and can create a liability. In a pinch, fax is a more secure method of handling special-order situations.

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On the other hand, the licensed model encourages complexity; you can do anything, so the temptation is there to take advantage of this flexibility and endlessly extend and modify the software. The cost to the customer of that flexibility is the time, expertise, and resources to implement custom capabilities.

In sales of enterprise-class software service revenues (maintenance, testing, deployment, configuration, training, etc.) typically account for at least 30% of the overall deal; we've seen many scenarios where service revenues can account for 70%+ of overall dollars. On your typical sale, what percentage of revenues comes from services sales?

Services typically accounts for 15% of the sale. Testing is the most time intensive aspect of deployment, followed by discovery. I know this is low by industry standards, but it all comes back to the basic value proposition offered by SaaS. Low risk, quick deployment, best practices, reduced complexity. Commissions on service are approximately 70% of those paid for subscriptions.

What about training revenues?

These are significant, but again we come back to the issue of what makes SaaS appealing to our customers. Ease of use, best practices. We'll usually need to train the first group of 100 users of Compel, but after that, the customer is going to be in the position to train the next group. This reflects the ease of use and scalability that SaaS products offer as opposed to licensed software. I think that SaaS companies in many markets are going to have to make the decision to trade service for annuity revenues. The most important factor in building a successful SaaS model is acquiring customers and retaining them. Customer attrition is a matter of tremendous concern to many SaaS companies. *(Editor's note: SaaS attrition rates can vary widely; we've talked to companies that are suffering yearly rates as high as 40%. We will be conducting an extensive survey later this year on SaaS business practices and tactics that will query participants on this.)*

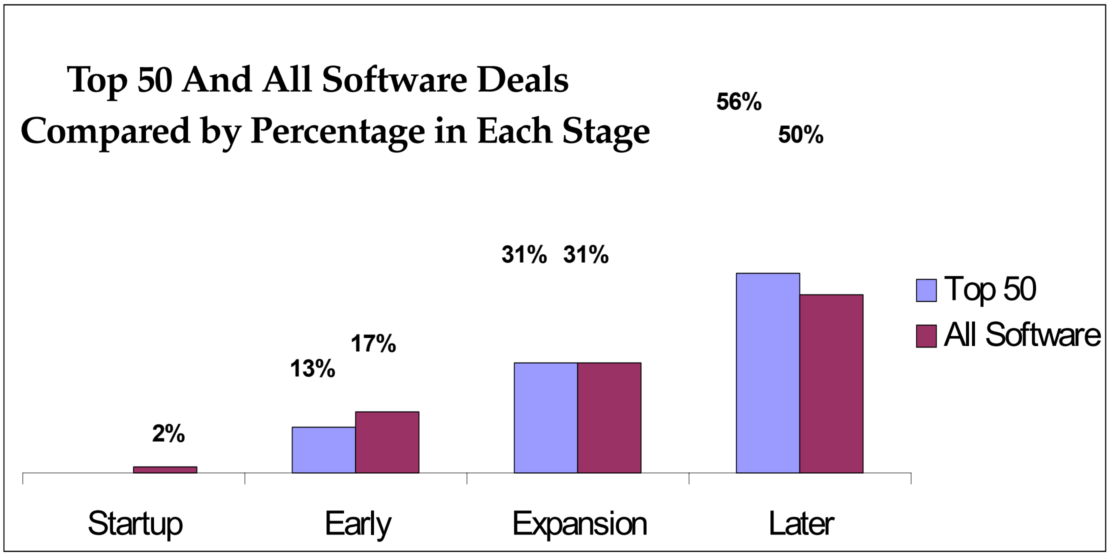
"We find that reference accounts are critical in building new business for SaaS products and services."

—Bob Conlin
Centive

How is your services group structured? What is your compensation model?

Our sales group is focused on generating new business; we want to sell additional seats via our customer services and support organization. It's a pull vs. a push model. As you noted in your earlier article on ScribeStudio, white glove customer service is absolutely critical. The SaaS model requires you take a hit on dollars upfront while growing revenue from existing customers. This goes back to the concept of trading upfront services for annuity dollars; there's no question the SaaS model often means you sacrifice big initial revenues.

Our services' team bonuses are based on speed of deployment, referenceability, and referrals. Bonuses are pooled among the group. Depending on the nature of the contract *(continued on page six)*



Benchmarks: Q3 Venture Capital Investments

Every quarter Softletter looks at cash-for-equity investments in privately-held software firms. This quarter we see again the up-and-down swinging, quarter by quarter, of both the entire VC market and the software segment as well. On the whole this shows a steady level of investment, but for software this quarter the drop was so low that it is necessary to go back to Q3 of 2003 to find a lower point: $1.035 billion in 201 deals for that quarter in 2003, and $1.038 billion in 155 deals for Q3 of 2005. And while total VC investment is slowly rising, the software segment is losing its grip as king of segments.

Software remains on top of individual segments this quarter, but with only 19.7% of all VC investments. Last quarter it was 22.2%, and a year ago it was 23.2%. Life Sciences (the combined Biotechnology and Medical Devices segments) are now 25%.

Cautious VC money is still concentrated in Later and Expansion stage deals: the investors are feeding successes and only reluctantly putting their money into Startup stage companies. Not all Later stage deals pay off, of course: Xprime, Inc. has collapsed since it received its $10m funding in Q3.

Our Top 50 Software VC Investments table shows us other interesting stories. Last quarter the median deal in the Top 50 was $12.5m; this quarter it is down to $11m. Last quarter had an outlier as number one, a deal that was twice as big as number two. And while this quarter has a similar outlier, and an even larger one than last quarter, the bottom of the Top 50 has slipped from $10m to $8m. Deal competition in software appears to be centered around Open Source Software (OSS) and Software as a Service (SaaS).

Notable press coverage from Q3 (**www.nytimes.com/2005/09/20/business/businessspecial/20rivlin.html?ex=1136350800&en=aa4526678bfeb7ce&ei=5070** and **http://seattlepi.nwsource.com/venture/241908_vc23.html**) tends to overlook the growing number of investments in SaaS companies.

The Top 50: Software Venture Capital Investments—Q3, 2005

	Company	Business Focus	Lead Investor	Investment
1	Strategic Fin. Solutions	Asset allocation/investment analysis	Insight Venture Partners	$63,000,000
2	Level 5 Networks	High-speed server interconnection	Oak Investment Partners	$30,000,000
3	Lefthand Networks	IP-based disk arrays and mgt. software	Valhalla Partners	$25,000,000
4	CaseStack	Logistics services for packaged goods	Clarity Partners	$20,000,000
5	SugarCRM	Commercial Open Source CRM software	New Enterprise Associates	$19,000,000
6	XenSource	Run concurrent OSs on a single CPU	Kleiner Perkins Caufield & Byers	$17,000,000
7	ConSentry Networks (Tidal)	Permissions-based secure networking	INVESCO Private Capital	$17,000,000
8	Alteer Corporation	Business solutions for medical practices	MedVenture Associates	$17,000,000
9	Vendavo Corporation	Provider of price management software	Mesirow Financial	$16,000,000
10	Kabira Technologies	Switching for real-time financial services	3i	$15,000,000
11	Traiana (Efidex)	TRM transaction processing software	Pitango Venture Capital	$15,000,000
12	United Devices	Software for grid computing	European syndicate	$15,000,000
13	Hillcrest Communications	Software and hardware for TV navigation	New Enterprise Associates	$15,000,000
14	PacketMotion	Enterprise network-security software	Intel Capital	$14,000,000
15	Centrify Corporation	Active Directory services integration	INVESCO Private Capital	$14,000,000
16	Kalido (Kalido Holdings)	Data warehousing & management (MDM)	Matrix Partners	$14,000,000
17	Roamware (Mobileum)	Managed roaming services	Accretive Technology Partners	$14,000,000
18	Verid	Identity verification for transactions	Fidelity Ventures/CIBC Capital Partners	$13,000,000
19	Caymas Systems	Identity-Driven Access Gateways	Levensohn Venture Partners	$13,000,000
20	Nevis Networks	LAN security systems	New Enterprise Associates	$13,000,000
21	Tizor Systems	Activity and compliance auditing	Hummer Winblad Venture Partners	$12,000,000
22	Vidient Systems	Surveillance-video pattern recognition	Canaan Partners	$12,000,000
23	Permabit	Data and document archiving and retrieval	Baker Capital Corp.	$12,000,000
24	Carefx Corporation	Open solutions for patient information	UV Partners/Appian Ventures	$12,000,000
25	NeoScale Systems	Enterprise storage security	Advanced Technology Ventures (ATV)	$11,000,000
26	Gracenote (CDDB)	Licenses digital music information DB	Bessemer Venture Partners	$11,000,000
27	Mirapoint	E-mail server, spam/anti-spam appliance	Worldview Technology Partners	$10,000,000
28	Vettro Solutions (iQenergy)	Mobile on-demand CRM and FSM	Greylock/Sigma Partners	$10,000,000
29	Sensory Networks	Network-security acceleration OEM	Individuals' Venture Fund	$10,000,000
30	Transera Communications	On-demand global IP call-center software	Storm Ventures	$10,000,000
31	MetaCarta	Location-aware geographic gntelligence	FA Technology Ventures/Hunt Ventures	$10,000,000
32	Impress Software Solutions	Integrate proj. mgt. and GIS cross-system	Key Venture Partners	$10,000,000
33	PacketHop, Inc.	Mobile mesh networking for public safety	GF Private Equity Group	$10,000,000
34	Perfect Market Technologies	General search- and shopping engine	Mayfield	$10,000,000
35	ActiveGrid	Enterprise LAMP	Worldview Technology Partners	$10,000,000
36	Xprime	Performance accelerator for SQL Server	Enterprise Partners	$10,000,000
37	CollabNet	Distributed/collaborative development	WR Hambrecht + Co	$10,000,000
38	OpTier	Transaction workload management	Carmel Ventures	$10,000,000
39	Teranode Corporation	XDA software for Life Sciences	Cargill Ventures/Trident Capital	$10,000,000
40	BitTorrent	Software for peer-to-peer (P2P) file-sharing	Doll Capital Management	$9,000,000
41	Destinator Technologies	Navigation software for mobile services	undisclosed consortium	$9,000,000
42	MetaLINCS Corporation	E-discovery for Web-based services	Arrowpath Venture Partners	$9,000,000
43	Virtual Iron Software	Software for grid computing	Intel Capital	$9,000,000
44	Wellogix (Wellbid)	Workflow and KM for oil and gas ops.	First Capital Group	$9,000,000
45	BlueNote Networks	VOIP IP PBX and SIP telephony software	First Capital Group	$8,000,000
46	CanyonBridge	Web-based access to MSFT Exchange	Wasatch Venture Fund	$8,000,000
47	Univa Corporation	OSS for grid computing and Web services	ARCH Venture Partners	$8,000,000
48	Austin Logistics	Analytics for marketing & risk mgt.	Total Technology Ventures	$8,000,000
49	InQuira	Searching and navigation of Web sites	Sutter Hill Ventures	$8,000,000
50	Orb Networks	Media access from multiple devices	OVP Venture Partners	$8,000,000

and on other factors, bonuses typically account for 15% of a service rep's compensation.

In higher-ticket license deals, sales engineers (SEs) typically play a large role in closing sales, but since many of your closes take place via the phone, what role do SEs play in the sales cycle?

In my opinion, the role of SEs will be very different in a SaaS environment. We do have SEs, but they work to support the sales group as a whole; they're not assigned to individuals as often happens in a license environment but usually to a group of sales reps. In terms of the sales cycle, SEs are usually there at the end of the sale to help close and assist in configuration. Bonuses account for approximately 20% of a SEs compensation and are pooled. Our reps are trained to do their own demos, a function that SEs usually perform in licensed sales. To assist customers to understand Compel's full functionality, we provide them "sandbox" access to the system where they can learn more about its capabilities; this helps them move faster through the decision cycle.

"In my experience, firms in markets such as CRM find that customer retention is a problem. The best way to deal with attrition is via service and integrating your product into vital company services. Because our system is part of payroll, once it's been installed customers are reluctant to switch away."

—Bob Conlin
Centive

Another point that we've been talking to software companies about is the complexity of calculating commissions under a SaaS model.

They're right, it can be very difficult to track and keep up to date. If you're going to build a home grown model, here are some of the datapoints it needs to incorporate:

- A decision about when you're going to pay commissions; at the signing of the contract, or on an ongoing basis as revenues come in. My feeling is that if you want to attract good sales reps, you'll have to pay upfront.

- If you're paying upfront, a means of tracking accrued revenue against commissions paid. In the event a contract is terminated, you'll need to decide how much of the sales rep's compensation you want to "clawback" at any pay period; I recommend no more than 20%.

- A methodology that takes into account commissions paid on different pricing structures and tiers. SaaS payment plans can differ widely and there is room for plenty of negotiation. Ideally, you'd like to be paid upfront for the entire amount of the subscription, but that adds risk to the purchase, a key selling point of SaaS. Many of our customers want to pay monthly and that's a different price structure.

You also have to account for contract length, number of seats, added seats sold after the contract has closed, changes in service terms, etc., all on an accrued basis. For a small company, you can do this manually via spreadsheets, but for an organization of any size, it's a task of dizzying complexity.

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Equities

What Is the Number One Reason Behind a Company Sale?

By Nat Burgess, Corum Group

Most software companies sell because they have identified a huge opportunity that can only be addressed with the assistance of a larger partner. Or at least, that is how they open discussions with buyers. The actual motivation behind a sale is usually more complicated. Regardless of your reason for wanting to sell your company, remember to position and plan for personnel just as you would financial readiness and technology.

For software companies with multiple owners, founder conflict is the number one reason behind a sale. In many cases, M&A provides an exit for owners who want out, and new opportunities for those who want to stay in, but there are two major challenges along the way: timing and positioning. It takes time to sell a company, and a company that waits too long may start losing people and momentum before the closing. Also, unless your intermediary understands the partner dynamics, they may present a departing founder as a key person, and then have to explain to a buyer why that person is suddenly leaving after the closing. A disgruntled founder should start moving out of a key operating role early in the process and put other, capable people on point, so that the buyer isn't surprised by the founder's departure.

Software is a complex, risky and fast-paced business and after years in the trenches, many founders are increasingly starting to look for ways to simplify their lives. We often refer to this phenomenon as founder burnout; usually there is more to it than just fatigue. Founders may want to diversify their portfolio and set themselves up for retirement, or perhaps they have a new business venture that has become their passion. One of our clients had published several novels while running his company, and decided he wanted to write professionally. Fortunately he began building out his team early, and by the time we went to market he was able to remove himself from the day-to-day management without hurting sales. Many CEO's find it difficult to delegate to a team, and are unable to both sell and exit. The best medicine for a CEO in this rut is an independent board that can push him to share control with management.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Pegasus Systems *• Vertical market solutions- hospitality*	Prides Capital Partners	$275,000,000 *Terms: All cash*	$183,100,000	**1.50**
Neon Systems (Neon) *• Database/data access*	Progress Software (PRGS)	$68,000,000 *Terms: All cash*	$20,500,00	**3.32**
Micromuse (Muse) *• Network management software*	IBM (IBM)	$865,000,000 *Terms: All cash*	$160,800,000	**5.38**
Datastream Systems (DSTM.PK) *• Asset performance management*	Info Global Solutions	$216,000,000 *Terms: All cash*	$96,800,000	**2.23**

CORUM
MERGERS & ACQUISITIONS

CardFile

Online Collaboration

- **Bad Blue Online** (www.badblue.com): Company publishes BadBlue's Excel sharing server. Program allows multiple people to view and edit Excel workbooks; sheets can be locked to the cell level. Personal Edition is free. Very cost effective.
- **GroveSite** (www.grovesite.com): System allows document sharing, organizing, discussions and project management.
- **HyperOffice** (www.hyperoffice.com): Fairly comprehensive office utility package; includes web-based E-mail, Outlook synchronization, simple project management and calendaring.
- **Writeboard** (www.writeboard.com): Free SaaS system that allows you to create shared online documents you can view, edit, and rollback to previous versions. Uses RSS for document change notification.
- **Vyew** (www.vyew.com): Whiteboarding system for collaborative meetings; system allows meeting participants to interactively markup the board during a session; offers free use for next two years to current signups.

PUBLISH COLUMNIST STEPHEN BRYANT ON SOFTWARE BETAS: "Traditionally, the beta follows the alpha release, which is tested internally at the developer's office or lab. What are the benefits of releasing a beta product?

1. Company gets early exposure
2. Product gets traffic
3. Company gets feedback on how the product works
4. Consumer gets the use, usually free, of an online service

Who gets screwed?

Of the four benefits I listed, notice how only one of them applies to the consumer. Therein lies the biggest problem. The public beta, when taken advantage of, subverts the symbiotic relationship that should exist between a company and its customer. The only true beneficiary of a public beta is the company." (Quoted on www.publish.com/article2/0,1759,1905917,00.asp)

COLUMNIST JACK KAPICA OF "THE GLOBE AND MAIL" ON COMDEX: "COMDEX was a show about technology; CES is a show about appliances and consumer stuff. Somewhere along the line the geeks, the IT departments and the programmers have been forced to take a back seat to the less-tech-minded end user.

The geek is no more king in high tech. The consumer is." (Quoted in ***The Globe and Mail*** on 01/05/2005)

GROKSTER PRESIDENT WAYNE ROSSO ON RECENT LEGAL EVENTS IN PEER-TO-PEER NETWORKING: "It's pretty clear who won. We always knew that this free trading of all this copyright material couldn't go on." (Quoted on 01/03/2006 on www.post-gazette.com/pg/06003/630364.stm)

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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

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