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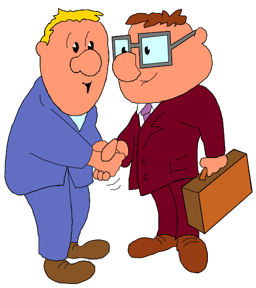
Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Open Source Business Models and Trends, Part I of II



Our OEM best practices survey uncovers a wealth of data on managing vendor/OEM relationships.
See pages 4-6.

Donald K. Rosenberg is president of Stromian Technologies, a marketing consulting firm specializing in OEM and Open Source software marketing issues. He is the author of "Open Source: The Unauthorized White Papers," one of the first books published that examined the business aspects of Open Source software.

Don has twenty years of marketing experience and has consulted and worked with companies in the U.S. and Europe on both Open Source and proprietary software licensing and marketing issues. Don frequently lectures on this topic at venues such as LinuxWorld (San Francisco, Frankfurt), Wizards of OS (Berlin), and CeBIT (Istanbul). His column, Rosenberg's Corner, deals with Open Source and business issues. We sat down with him to discuss business and legal trends in Open Source.

Don, what do you think of the current business prospects for Open Source products?

Prospects are good, but the best areas of opportunity I see are for value-add; the opportunity to get technology for free and run with it. Business evolution is coming along but it's being crafted onto an uneasy base. The Open Source community came from a no-fences environment, based on a perceived meritocracy. They don't like the concept of closed code and closed fences.

On the other hand, many businesses like fences just fine; there are companies that won't let you in the door if they know you're selling a product with Open Source in it. I've also worked with companies that have built products on Open Source but don't say it because IT wants something that works; they're not interested in playing with source.

We recently quoted a Gartner analyst who stated that Open Source is a "service," not a software, play.

That's true. Open Source software will be a service, not applications, business unless you build a proprietary superstructure on top of it.

What do you mean by proprietary superstructure?

I mean by doing what IBM does with Eclipse. At its lower levels, Eclipse is Open Source and free but as you go up the functionality ladder it becomes proprietary and you pay. *(continued on page three)*

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Advisory Board

The 504b Option

by Ted Finch

If you're a small to medium-sized software company growing successfully and generating revenue you may very well find yourself facing a cash crunch as you look to expand your business. There have been three traditional routes a company can take to raise money: VC, angel investments, and IPOs. Each offers their own advantages and disadvantages. Obtaining significant angel investment is hard, slow, and the amounts you raise vary widely. In addition, each "angel" tends to want at least 50% of your company (just to keep an eye on their money, you understand, not that they intend to run your company, though a little good advice never hurts, does it?).

VC money comes with its own set of problems. First is the issue of control. While venture expenditures have been slowly creeping up, you can still expect to hand over at least 60% of your company to the VCs once the deal in all its complexity is finalized. Also, after the dot.com bubble burst the majority of VCs retreated into the role of mezzanine bankers and only a few have resumed a "venture" role.

Traditional IPOs aimed at the NYSE, AMEX, and NASDAQ are simply out of the reach of most companies until they approach $50 million to $100 million in revenues.

In contrast to the above, a 504b offering may better fit your business goals. A 504b is a "mini" IPO that allows companies to obtain access to the public markets. The basic process consists of:

- Preparing a well-documented business plan. This is critical since this plan will be carefully scrutinized by regulatory agencies.
- Preparing what is called a "Private Placement Memorandum." This and your business plan will be examined by the NASD.
- If your plan and memorandum pass NASD muster, selling the memorandum to people and entities willing to invest in your company.

Once the memorandum has been placed, your company will then be listed on what are called The Pink Sheets, a centralized quotation service for small and lightly capitalized stocks. To avoid staying in the company of uranium mine firms for very long, you will then go through another cycle of paperwork and scrutiny with the SEC, after which you will be allowed access to the OTC-BB, a larger market with much greater capital possibilities. From here you can one day graduate to one of the larger exchanges, assuming your company's financial health stays strong.

The advantages of a 504b offering is that, depending on the type of stock offerings you develop and your company's revenue performance, you can obtain significant amounts of capital without suffering the dilution normal with angels and VCs. However, only Colorado and Texas currently allow 504b offers, so you will need to incorporate in those states and remember, regardless of the type of offering, once you are a public company the way you run your business must change dramatically.

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Sun had the same idea with NetBeans; the idea was to build a proprietary structure they could make money on around an open framework but IBM beat them to the punch. HP and Novell have the same ideas on making money on Open Source as IBM.

Other than these industry gorillas, who else is following this mixed model?

Pingtel.com is a good example. They do VOIP; they cooperate with the Open Source community via the SIP foundry and then add their proprietary technology on top. Of course, there are "pure" Open Source companies out there that are making money: JBoss, Zope, and MySQL for example.

"The ASP model is regarded as a problem by many in the Open Source movement; if you're using a hosted service, the customer never receives delivery of the software and therefore has no "right" to the source code; this violates the "spirit" of the GPL."

—Don Rosenberg
Stromian Technologies

How does this mixed model approach square with the GPL? We're aware that there are Open Source licenses that don't prevent companies from building proprietary products on top of Open Source code—the Berkeley Software Distribution (BSD) license, for instance. But the GPL and the Free Software Foundation (FSS) are Open Sources' 800lb gorillas.

This is an area of major controversy. The FSS says that if you link to an Open Source component, such as a library, you must be Open Source as well since you're creating a "derivative work." However, that's not what copyright law says. U.S. copyright law has its own definition of what's a derivative work. Copyright says that accessing a resource, in contrast to modifying it, does not create a derivative work. Let's take an Open Source library. How do you use it? You call it. What is the use of the library? It is to be called. So under copyright law, incorporating an Open Source library in your product does not put it under GPL restrictions.

"The FSS doesn't own a great deal of GPL software but they do "own" (have copyrights to) the gcc and glibc, (the Gnu compiler and library). The library is licensed under the LGPL. Anyone who wants to contribute to these components must explicitly turn over their copyrights to the FSS; this is so the foundation has legal standing in court. So much for the GPL overriding US copyright law."

—Don Rosenberg
Stromian Technologies

Are you saying a software company has the right to incorporate Open Source components such as libraries in proprietary software and not release their products under the GPL?

Yes, I think you have the right to link to it and not fall under the GPL. Technical feasibility depends on circumstances, of course. And legal experts such as Lawrence Rosen, who's spent a great deal of time working through these issues, agree.

We've read through a great deal of the FSS's and Richard Stallman's writings and rhetoric and they strongly imply that the terms of the GPL override copyright laws.

What the GPL "says" that's significant about copyright law is actually in the preamble and the commentary at the end of the license, after terms have been laid down. These don't have any force or standing in law; they're simply opinions.

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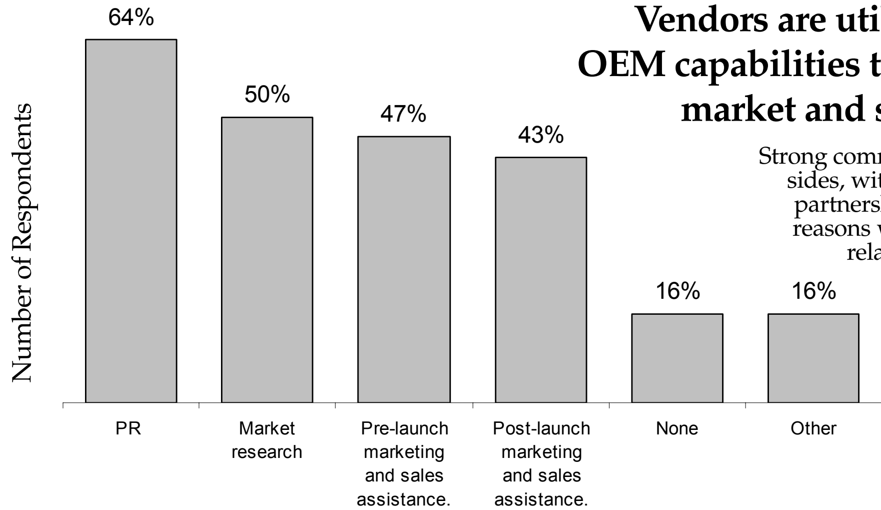

Vendors are utilizing many OEM capabilities to help them market and sell product.

Strong commitment from both sides, with emphasis on the partnership is one of many reasons why OEM/vendor relationships succeed.

Benchmarks: OEM Best Practices

We recently conducted a benchmarking survey on OEM best practices as a follow up to our OEM licensing survey in our recent 12/15/2004 issue. We collected data from 58 respondents who described key aspects of their OEM/vendor relationship. The relationship definition is that the OEM provides technology (code) that adds features and/or functionality to another vendor's software to enhance their product's functionality. Our survey looks at a variety of issues, including resources and support, source code accessibility, exclusivity, revenue verification and reasons for relationship successes or failures.

The range of revenues among the 58 firms participating in the study is quite broad, with 13% under $1 million, 20% between $1-$5 million, 20% between $5-$10 million, 30% between $10-$99 million and 17% over $100 million. Large or small, the results for a successful relationship depend on many factors including open communication, ample support, honesty, trust, and shared goals.

In our study, 78% of respondents list the top reason that vendors use a "buy" strategy ("outsourcing" a product feature from an OEM) is because it enables them to get products with needed features to market faster. Additionally, 71% state that the "purchased" feature was not the vendor's core competency and they were unwilling or unable to develop the product or feature internally. Furthermore, 53% believe they will achieve R&D savings and 43% are reacting to competitive pressures. Many respondents emphasized that outsourcing OEMs was a resource allocation advantage.

Resources were a recurring theme throughout our survey, even once product development is complete. Accordingly, 64% report that they take advantage of the OEM's PR capabilities to help market and sell their product with 50% going to market research, 47% going to pre-launch marketing and sales assistance, 43% going to post-launch marketing and sales assistance, and 16% reporting that they don't take advantage of any OEM capabilities other than development; of our respondents, 79% have underestimated the resources needed to sell a product derived from an OEM deal.

Survey participants felt that all functions in an organization (including sales, marketing, product management, tech support, R&D, finance and the executive board) need to be involved in the OEM deal when it is being formulated. After negotiations are complete, these percentages decreased for all categories except for the sales, marketing and tech support categories, which increased by 4%, 5%, and 21%, respectively. These numbers indicate the importance of these three functional areas for post-launch activities.

It is no surprise that a good vendor/OEM relationship depends on open communications, technical support, and responsiveness to customer needs. The majority of our respondents rate the effectiveness of the OEM's overall assistance as very or somewhat useful (83%), whereas a smaller percentage of our respondents (17%) rate it as not very useful or not useful at all. A strong commitment from both sides was the most common reason provided for the success of a OEM/vendor relationship. At minimum, support on the vendor side requires a person dedicated to managing the relationship. When surveyed, 54% responded that the product manager is the best person/role to manage an OEM deal after it is signed, surprisingly, even more important than an OEM account manager (32%). Far less important were VPs of marketing (9%) or heads of R&D (5%). Many survey members noted that a good OEM/vendor relationship is as important (and maybe more so) than the OEM's product/technology.

Maintaining the confidentiality of source code is usually a matter of the utmost importance to most software vendors; a company's source code is often considered its most valuable asset. We were thus a bit surprised when 26% of our respondents stated they provide OEMs access to their product's source. One possible explanation for this is access to source code is often provideded under highly structured conditions (such as inspection in a secure room).

In addition, 30% of our respondents stated they negotiated exclusive access to OEM technology in return for making a commitment to a sales minimum or paying a certain percentage in royalties. Many stated they had sought exclusivity, but found it to be "cost- prohibitive" or "the OEM had already licensed code to others." Several participants noted that depending on the situation, an agreement can be exclusive for a certain period of time and/or for a particular market segment.

A surprisingly high 13% of those surveyed have obtained OEM source code from escrow. Typically, an escrow agreement is a three-party contract that triggers, in the event of certain contingencies, such as bankruptcy or the OEM's failure to maintain the program, the escrow agent's release of the source to the vendor.

We asked respondents about what processes they put in place to verify vendor sales for the purpose of satisfying the OEM royalty or licensing agreement. In answer to this question, 56% report that the vendor's accounting firm presents a statement of sales, and 18% rely on a third party audit of vendor's books to verify vendor sales. Other answers included purchasing of serialized licenses or using keys for license control, and a surprisingly high number report using the honor system (eight of the 14 who picked "other) with a signed document or vendor's royalty statement providing sufficient proof of sales.

The top three reasons for the failure of a vendor/OEM deal were: OEM support of the vendor was not satisfactory (41%), the vendor was unable to meet its contractual sales/royalty quota(s) (33%), and the vendor decided to build the *(continued on page six)*

OEM-supplied capability internally (29%).

In the commentary portion of our survey, our respondents listed the following as primary reasons for why vendor/OEM deals fail:

- Poor technical support from the OEM.
- Poor communication and goal alignment between vendor and OEM.
- Poorly defined expectations and lack of commitment.
- Schedule slippage.
- Politics (defined as disagreement betwen members of upper management).
- The vendor's lack of knowledge regarding the OEM capability.
- Poor product and schedule definition and planning.
- Financial difficulties on the OEM's part.
- Lack of OEM quality control.
- Overly complex contracts.
- Breaches of contract regarding exclusivity or volume minimums.

Survey participants stated the following encompassed best practices when establishing and maintaining a vendor/OEM relationship:

- Resource allocation: always plan on investing more resources in an OEM integration project than originally planned.
- Improve communication and technical support from OEM to vendor.
- The need for the vendor to assign a technical liaison to the OEM to help support internal vendor communications and product training for vendor's technical support, marketing and sales staff.
- Better defined and reasonable expectations established up front.
- Agreement on delivery schedules.
- A backup plan for product relase in the event of an OEM delays.
- A long-term perspective—be sure to address plans for product upgrades and for compatibility issues.
- Strong understanding of the OEM’s core technology.
- Improved market research on the part of the vendor to ensure an OEM feature is needed and can achieve a reasonable ROI.
- Detailed but simple contracts (something of a contradiction in terms, but several respondents insisted it was possible to achieve these kinds of agreements).
- Flexible pricing schedules.
- Fair royalty models (there was a great deal of disagreement about what constitutes a “fair” royalty and we will be looking further into this topic in a future issue).

Equities

Escrow Provisions in M&A Transactions, Part II of II

By Marshall Warwaruk, Corum Group

Escrow accounts are funds that are carved out of the seller's proceeds for the benefit of buyers in order to secure indemnification obligations under M&A transactions. However, there are a couple of alternatives to fully funded escrow accounts that both parties may wish to consider.

Increasingly, buyers and sellers are turning to M&A insurance in order to provide additional protection for liability concerns, effectively transferring some or all of the risk associated with indemnification claims to a third-party insurer. Either party may pay a premium in the 3-5% range of the total limit of the liability, in order to further protect themselves from losses arising from unknown or undisclosed liabilities, including: pending or threatened litigation, environmental contingencies, tax exposures, and or specific warranty/indemnity obligations. This option does necessitate additional effort and costs for both the buyer and seller, as the insurance carrier will need to perform its own, independent due diligence prior to agreeing to any transactional insurance.

Another approach or adjunct to fully funding escrow accounts involves the use of earnouts or contingency payments. These are performance-based components of the final purchase price. In these cases, the buyer agrees to pay the seller a future amount, (i.e., a percentage of revenues or profits generated over a 2-3 year period) as a shareholder consideration subject to satisfying certain performance criteria. This scenario is more likely to occur when a privately held organization is being acquired, and while it doesn't eliminate the need for an escrow account, it can reduce the amount placed into escrow and subsequently increase payout to shareholders at closing.

Please note that while earnouts are designed to help close the gap between seller and buyer expectations, there are no assurances or guarantees that the earnout's revenue or performance goals will be reached, thus making litigation more likely.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Mapics (MAPX)	Infor Global Solutions	$320,390,000	$172,800,000	**1.85**
• ERP software for manufacturers		*Terms: All Cash*		
Corio (CRIO)	IBM (IBM)	$161,000,000	$70,200,000	**2.29**
• Application service provider		*Terms: All Cash*		
V Communications	BVRP Software	$13,500,000	$8,300,000	**1.63**
• Utilities software for the pc market		*Terms: $8.5 MM cash/shares/$5MM earnout*		
Info Systems	MTM Technologies (MTMC)	$13,200,000	$58,000,000	**0.23**
• IT reseller and IT consulting		*Terms: $6.8MM cash/$3.2MM shares/$1.7MM earnout*		

CardFile

Mail Management Tools and Services

- **AddressGrabber** (www.egrabber.com): Incredibly useful utility that allows you to grab an E-mail address from a text block and automatically insert it into a datafile.
- **Mailnet** (www.listcleanup.com): Provides a variety of merge/purge services for mailing lists.
- **Postcardmania (**www.postcardmania.com): Produces very colorful postcards in bulk for DM. Can design as well as print.
- **ShipShapes** (www.shipshapes.net): Creates self-mailers "in any shape imaginable." Shapes can include motorcycles champagne bottles, food, dartboards, software boxes, etc.
- **Spheresoft** (www.spheresoft.com): Calculates the distance between addresses stored in Microsoft Excel. Distances are calculated "as the crow flies" (not by actual driving distances) and are provided in miles. Also provides a list of zip codes that lie within a given distance of a target zip code.

ORACLE CEO LARRY ELLISON on SAP plans to provide support for PeopleSoft applications: “SAP has every right to provide support of PeopleSoft applications and Oracle products, for that matter, so as long as they don’t violate our contractual and intellectual property rights. I think that might make it awkward for them. They should be cautious.” (Quoted in InformationWeek, 01/31/2005)

REPORTERS MEL BERGSTEIN AND JOHN SIVOKLA on competitive advantages with software: “Let’s face it: It’s not in Larry Ellison’s or Bill Gates’ best interest to deliver competitive advantage to your company. It’s in their interest to get companies to buy the most standardized product or service possible so they can create leverage for their own shareholders.” (Quoted in Optimize, 01/01/2005)

EBEN MOGLEN on the ongoing SCO lawsuit: “The SCO suit shows the need to really focus early on how open-source projects are structured and managed. That case is mostly a dispute about how software is put together.” (Quoted in the New York Times, 02/01/2005)

MITCH KAPOR on Microsoft and patents as “WMD”: “Their business model no longer holds up in an era where it’s clear that open-source is simply an economically superior way to produce software. Of course they’re going to unleash the WMDs. Why would they not?” (Quoted in Computerworld, 02/02/2005)

CRAIG JAMES on the lifecycle of software “There is a natural ‘lifecycle’ to software technology, which includes both commercial periods and FOSS periods. Those who understand this pattern can work with it and thrive. Those who don’t understand the pattern, or who choose to fight it, are in for a lot of frustration.” (Quoted on http://www.moonviewscientific.com/essays/software_lifecycle.htm)

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