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BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Help! Microsoft is Targeting My Business, Part I of II

by Michael Mace, Rubicon Consulting

"Microsoft is moving into my market." Recently we've been hearing that from more and more of our clients and contacts in the industry. The companies being targeted usually assume they've been singled out for special attention from Microsoft, but when you add up all the reports, a different picture emerges. Microsoft is targeting almost every major tech company, all at once. This is a fairly new behavior for Microsoft, and it means the rules of competing with Redmond have changed as well. After the company's loss of its antitrust case and the DOJ restrictions which have been woven around the Redmond giant, many industry observers predicted the industry would be dealing with a kinder, gentler Microsoft. It doesn't seem so.

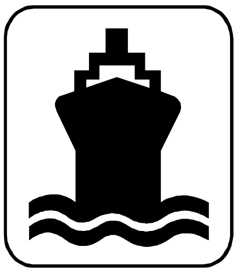
Not so many years ago, Microsoft was famous for its ability to focus on one unifying goal. The cry would go out: "Make Windows the dominant OS," or "Make Internet Explorer the dominant browser," and the company would rally around that cry. Of course, no large company ever focuses *entirely* on one thing. But more than most other companies, Microsoft had a knack for aligning its best managers and its most powerful assets against a single target.

Today, the threats to Microsoft are different. The famous "Internet Services Disruption" memo written last October by Microsoft CTO Ray Ozzie was notable because it attempted to focus the company against *an entire sector of the tech industry*, rather than against a single competitor or product.

But despite even that broad effort at focus, Microsoft is in reality pursuing even more opportunities. A quick online search for the phrase "Microsoft targets" yielded a blizzard of news articles written in the last six months, listing new and renewed initiatives Microsoft has launched to take business away from competitors. They include:

- An initiative to displace Apache/Linux from leadership in web hosting.
- Yet another effort to take over Intuit's small business accounting franchise.

(continued on page three)



Rising returns on equity are lifting most software boats (with two major exceptions)
See pages 4-5.

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What We Have Here Is a Failure to Communicate, Part I of II

by Debbie Engnell, PromoPipeline

In the IT Distribution channel, much is made of process flow, paradigms, new business initiatives and communication. Unfortunately, what these all have in common is one thing—they are all broken. Vendors continue to try to find a way to communicate product information and promotion information to both distributors and resellers. Distributors want to communicate promotions, special financing offers and new product offerings. Resellers want information when they want it, tailored to their needs, and their impression is no one is listening to them.

In a recent promotional effort, an IT vendor decided to launch a promotion for a new product. E-mails were sent to almost 1500 resellers, banner ads were put in place, a distributor included the promotion in an E-mail newsletter and significant dollars were expended. This effort didn't even make the industry numbers that tell us that E-mail campaigns typically reach: an 8 to 10% open rate and a 1 to 3 % conversion rate. And how many took advantage of the promotion? None. When resellers were asked if they had heard of the promotion or had received the E-mails announcing it, comments ranged from "I'm too busy to read most E-mail" to "I don't remember seeing it, must have hit my spam filter" as well as "After I read email, I just delete it".

As this example illustrates, E-mail has no shelf life. Further emphasizing this point is an experience a well-known security software company had when it attempted to increase their installed base. The company launched a "buy five licenses get five licenses free" promotion that E-mailed their registered reseller base that had **opted in** for E-mails. After four weeks of **no reseller** redeeming additional licenses, follow up phone calls by the software company revealed that the E-mails had been read (or at least opened), but not kept; compounding the problem was that resellers couldn't find information about this firm's promotion on their web site.

The experiences above illustrate the problems facing software companies who work with a channel. From the reseller view, the only avenues available to educate themselves about new promotional offerings are a never ending sea of E-mails or visits to the company's web site, most of which require a unique user name and password to access (a usage obstacle many resellers refuse to overcome). But for many businesses, search has become the default way of operating. When is the last time any of us opened up a phone book before first trying Google?

Of course, typing a term into Google and receiving 16,625,432 hits isn't the way to go, either. Instead, vertical search portals are increasingly being offered as an alternative to traditional approaches (current examples of successful vertical portals include the various job and travel sites). Their effectiveness lies in the fact that most resellers are interested in promotions when they are writing proposals or preparing to buy products and/or services for their customers. Their higher value is derived from their usage method; using a portal or search engine is an active, not a passive, information relay. As a result, read and click rates are at least 4x more effective than E-mail, with far more predictable and measurable ROI. But what are the key elements of a high-performing vertical portal?

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- Creation of a Microsoft-branded MP3 player to compete with Apple's iPod.
- A renewed push in corporate databases against IBM and Oracle.
- Launch of a new model of the Xbox game player, aimed at Sony's Playstation.
- A new initiative to move people off of Lotus Notes and Domino.
- The creation of a new document standard to compete with PDF.
- Sparkle, a replacement for Macromedia Flash.
- The launch of a new computer security product targeting Symantec and McAfee.
- A new push in high-performance computing.
- The creation of a new suite of graphics tools targeting Photoshop and other graphics programs.
- A push into the VOIP market.

And of course, the ongoing effort to create web services in competition with Google and Yahoo. We're pretty sure we missed a few, but you get the idea. Microsoft is pushing almost everywhere.

To understand why, you need to look at the forces affecting Microsoft. It's simply not the same company it was ten years ago, when most of the tech industry formed its image of Microsoft. In 1996, the company had revenue of $8.7 billion, and was growing 46% a year due to the upgrade cycle to Windows 95. Microsoft had two business units (platforms and applications) and about 20,000 employees.

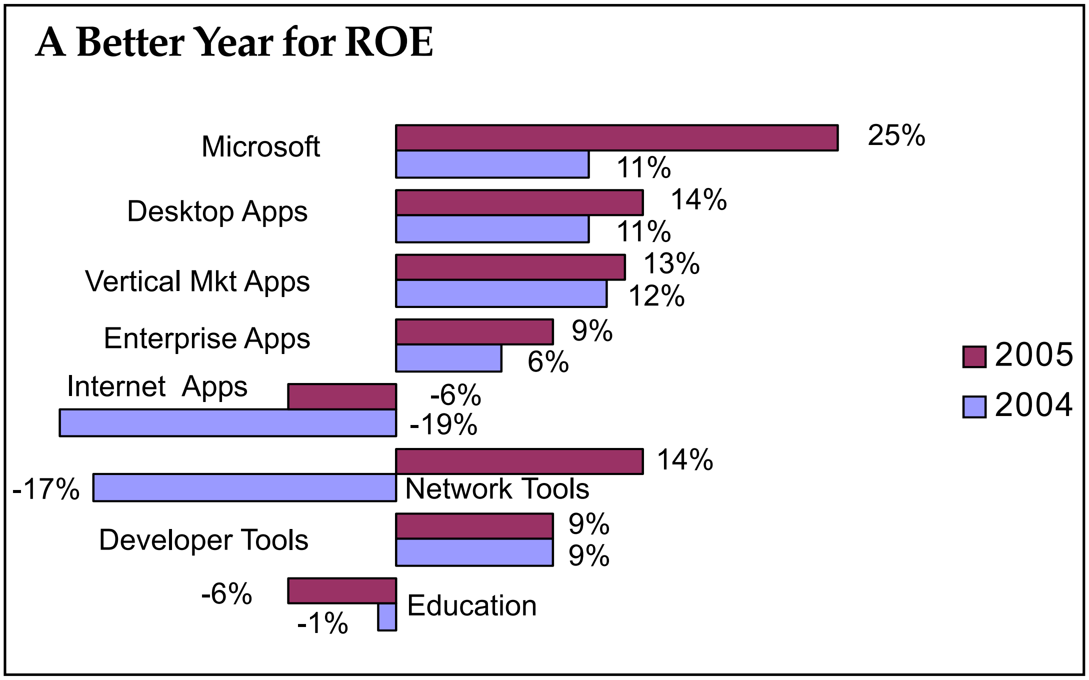
In 2006, Microsoft's revenue will be north of $40 billion. It recently consolidated from six to three formal business units, but it still has a bewildering array of businesses, from keyboards to game machines to servers to online services (plus, of course, the OS and apps that are still the core of the company). Microsoft today has about 64,000 employees.

In the most recent quarter, Microsoft's revenue grew only 9% year over year (just under its 10% goal), and its stock lagged 1% below the S&P 500 in the last 52 weeks. Although those financials would be fairly good news to most companies, they're far below the rapid growth rates that in the past allowed Microsoft to attract the brightest employees and made Wall Street swoon.

Microsoft is now so large that it's much more difficult to grow rapidly. To hit its goals, the company has to add about $4 billion in new revenue every year. That's why Microsoft's *(continued on page six)*

"Microsoft is a $40 billion company that needs to grow 10% a year to hit its financial targets. The search for $4 billion in new revenue every year is leading it to target almost every successful software franchise in the tech industry."

—Michael Mace
Rubicon Consulting



Benchmarks: Return on Equity

A rising tide lifts *most* boats.

Our Return on Equity calculations divide a company's Net Revenue by the total equity of its shareholders. The resulting figure is a rough guide to how profitable the company is in terms of its use of investment resources. While analyses always include this figure, it is not an invariable guide to performance: a company's ROE will rise if it repurchases its stock on the market, or if its share price falls. A strong brand or patent portfolio will also increase ROE. When ROE has reached its upper limit, it is a sign that no more efficiencies can be wrung out of operations, and that only more investment will generate more profits.

The real use of the figure is to compare ROE across an industry to see which companies are healthier and which are weaker. In a cyclical industry the figures are still meaningful because the companies tend to move together through the economic cycle.

Software is obviously in an up cycle, and even the suffering category Network Applications shows an improvement, if not an overall positive ROE result. One sector, however, continues to suffer hard times: Education. This category has numerous small companies competing fiercely for business in a rapidly changing field. Two of the firms we track, Click2Learn and Docent, have been merged into SumTotal Systems.

Microsoft, on the other hand, continues as leader of the Benchmark 50 in revenue, capitalization, and profitability. If you are interested in looking at your own company's performance, calculate the ROE and then compare it to the Weighted Average Cost of Capital in your company, and to the hurdle rate needed to justify new projects.

The Benchmark 50: Return on Equity

	Revenues (000) 2003	2004	2005	Return on Equity 2003	2004	2005	Avg. '03-'05
Microsoft	$32,187,000	$36,835,000	$37,788,000	**12%**	**11%**	**25%**	**16.0%**
Desktop Applications				**17%**	**11%**	**14%**	**14.4%**
Intuit	$1,797,071	$1,802,224	$2,037,703	17%	17%	23%	19.1%
Macromedia	$336,913	$369,800	$436,168	251%	7%	6%	88.1%
Adobe	$1,164,788	$1,294,749	$1,666,581	28%	24%	32%	28.1%
Symantec	$1,406,946	$1,870,129	$2,582,849	14%	15%	14%	14.6%
IMSI (Int'l Microcomputer)	$8,095	$10,017	$13,874	95%	4%	-10%	29.6%
Nuance Commo. (Scansoft)	$135,399	n/a	$232,388	-2%	n/a	-1%	-1.4%
Smith Micro	$7,131	$7,216	$13,316	-12%	-17%	31%	0.8%
Vertical Market Applications				**6%**	**12%**	**13%**	**10.2%**
Autodesk	$824,945	$951,643	$1,233,677	6%	19%	34%	19.7%
Moldflow	$36,625	$48,673	$64,418	0%	4%	8%	4.0%
Ansys	$91,011	$113,535	$134,539	21%	17%	20%	19.1%
Advent	$159,436	$137,159	$149,990	-5%	-33%	-6%	-14.7%
Dendrite	$225,756	$321,107	$399,197	10%	12%	13%	11.8%
MapInfo	$106,255	$124,673	$106,255	-1%	4%	7%	3.1%
Kronos	$397,355	$450,694	$518,658	16%	12%	16%	14.9%
Enterprise Applications				**4%**	**6%**	**9%**	**6.2%**
Concur	$56,737	$56,550	$71,831	4%	7%	17%	9.3%
Manhattan Associates	$175,721	$196,814	$214,919	14%	10%	9%	10.7%
Knova Software (ServiceWare)	$10,158	$11,511	$12,502	-330%	-2784%	-16%	-1043.2%
Mercury Interactive	$400,122	$506,473	$685,547	15%	6%	15%	11.7%
Witness Systems	$67,686	$108,037	$141,335	0%	-41%	13%	-9.5%
SPSS	$208,480	$208,367	$224,074	-16%	8%	4%	-1.4%
Business Objects	$454,799	$560,825	$925,631	12%	2%	3%	5.6%
Internet Applications				**-73%**	**-19%**	**-6%**	**-32.6%**
Cryptologic	$34,427	$44,211	$63,714	-5%	19%	19%	10.8%
RealNetworks	$182,679	$202,377	$266,719	-11%	-6%	-6%	-7.6%
NetIQ	$264,138	$217,000	$213,216	-139%	-43%	12%	-56.8%
Verisign	$1,221,668	$1,054,780	$1,166,455	-314%	-19%	11%	-107.3%
Ultimate Software Group	$55,149	$60,416	$72,028	198%	-552%	-37%	-130.5%
Centra	$33,400	$43,041	$38,064	-74%	-33%	-78%	-61.5%
Interwoven	$126,832	$111,512	$160,388	-73%	-16%	-8%	-32.3%
Network Tools				**-17%**	**-17%**	**14%**	**-6.8%**
Citrix Systems	$527,448	$588,625	$741,157	15%	18%	14%	15.8%
McAfee (Network Associates)	$1,043,044	$936,336	$910,542	17%	8%	19%	14.4%
Tarantella	$14,220	$14,006	$12,488	-279%	-392%	280%	-130.4%
Novell	$1,105,496	$1,165,917	$1,197,696	-17%	-17%	27%	-2.5%
Altiris	$62,876	$99,339	$166,565	0%	8%	8%	5.5%
Tumbleweed	$25,525	$30,595	$43,438	-96%	-28%	-12%	-45.3%
NetManage	$65,740	$50,663	$47,666	-137%	-21%	8%	-49.8%
Developer Tools				**6%**	**9%**	**9%**	**8.0%**
Raining Data	$21,006	$22,297	$21,483	-34%	-14%	-8%	-18.6%
Pervasive Software	$39,205	$49,608	$39,205	17%	9%	8%	11.5%
Progress Software	$273,123	$309,060	$362,662	12%	12%	12%	12.0%
Borland Software	$244,579	$295,236	$309,548	6%	-11%	3%	-0.7%
Sybase	$829,861	$778,062	$788,536	-16%	12%	9%	1.5%
Red Hat	$90,275	$124,737	$196,466	-2%	3%	13%	4.6%
BEA Systems	$934,058	$1,012,492	$1,080,094	10%	12%	13%	11.8%
Education				**-2%**	**-1%**	**-6%**	**-3.0%**
Renaissance Learning	$131,232	$130,544	$114,048	26%	24%	27%	25.7%
Apollo Group	$1,339,517	$1,798,423	$2,251,472	24%	29%	63%	38.7%
Saba Software	$44,416	$34,471	$42,210	-93%	-194%	-16%	-101.4%
American Education Corp.	$8,483	$8,598	$10,400	-13%	3%	-6%	-5.5%
Scientific Learning	$21,837	$29,916	$30,976	102%	-25%	9%	28.5%
Plato Learning	$82,192	$141,801	$121,804	-2%	-1%	-21%	-7.7%
SumTotalSystems	$30,477	$29,487	$55,204	-148%	-33%	-23%	-68.3%
All companies				**0%**	**4%**	**9%**	**4.3%**

Source: Company proxy statementsfor most recent fiscal years. "Years" may not correspond to company fiscal years.

targeting so many different competitors—it's looking for pools of money anywhere it can find them. The logic of growth transforms Microsoft from a focused competitor into a machine that methodically tries to suck money out of any successful corner of high tech. If you have a successful franchise and haven't been targeted yet, just wait—your turn **will** come.

"Even for a company as large as IBM, it can be difficult to fight Microsoft on your own. IBM tried in the 1990s with OS/2, and lost. That failure helped drive IBM out of the PC business, but it turns out to have been a tactical retreat."

—Michael Mace
Rubicon Consulting

Once you develop this perspective on Microsoft, you can see a fairly predictable and logical pattern to its actions. First it probes markets, looking for areas of weakness. The company can run many of these experiments in parallel, which is one reason why there were so many new initiatives reported in the last six months. Then if Microsoft gains traction in a particular market, it pours in the reinforcements and tries to take over. In the markets where Microsoft doesn't gain traction, the company generally changes management teams and redraws its plans.

This means it's very important not to let Microsoft get that first toehold in your market. It's worth sacrificing short-term profits to give them a lousy launch experience. Your goal is to convince them that the reinforcements should be aimed at a softer target. It's reminiscent of the old joke about outrunning a bear—you don't have to be faster than the bear, you just have to be faster than someone else who's running away.

Chances are you'll never completely force Microsoft out of your market. WiFi routers are about the only business we can think of that they completely exited. But it is possible to transform Microsoft into the business equivalent of a chronic disease: unpleasant, expensive to deal with, but not ultimately fatal.

Part of the mystique of Microsoft is that it eventually kills any company it targets. The folk-tale that Microsoft will get a product right by the third version feeds the belief that resistance is futile. But today that's more of a demoralizing myth than a reality. Some companies have found ways to force Microsoft through a lot more than three versions, or to dominate their markets so thoroughly that it's not clear if Microsoft will ever catch up. Some winning tactics include the use of:

- Alliances.
- Changing the rules of the competition.
- Building up a passionately loyal customer base.
- Innovating faster than Microsoft can respond.
- Using aggressive marketing to lock up a market.

In part II of this article, we look at specific examples of the use of each tactic in practice and the companies using them.

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Equities

Legal Strategies: What to Expect and Who Pays, Part I of II

By Mark S. Reed, Corum Group

Once the key business terms of a merger or acquisition have been agreed to in a Letter of Intent between buyer and seller (the topic of a prior article), attention turns to due diligence and the work of legal counsel to document the transaction. The most important legal strategy for buyer or seller is the choice of their legal counsel. Select attorneys with an established track record in mergers and acquisitions of software companies; in light of the many complex issues in software M&A—such as intellectual property and appropriate types of representations and warranties—economizing in this area is a foolish choice.

Typically, each party bears its own legal costs during the transaction process. Exceptions include situations (such as a third party code review or other study) where the beneficiary of the work is the buyer. In other cases, buyers may be willing to pay certain of the seller's transaction costs (perhaps for mutually beneficial tax reasons) provided that there is an offset made to the purchase price to compensate the buyer.

Whether the transaction is a merger, acquisition of stock or purchase of assets, the center piece of the legal work is the "definitive agreement," which is supported by numerous other legal documents. The definitive agreement has four major objectives: (1) set out the transaction structure and terms, (2) disclose all important legal and financial aspects of the seller, (3) establish the obligations of the parties, and (4) define what happens if a party does not meet its obligation or the seller's disclosure is inadequate.

It is customary for the buyer's legal counsel to create the first draft of all key documents, with substantial negotiations between legal counsels before the documents are final. A central issue is the allocation of risk between buyer and seller. Key areas of negotiation, include the representations, warranties and indemnification provisions. Sellers often are unprepared for the complexity of the issues and the difficulty of negotiating reps, warranties and indemnification. These provisions ask the seller to guaranty the product they are selling (their company) with a substantial financial commitment.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Cyclades Corporation • *Linux and network infrastructure management*	Avocent Corporation (AVCT)	$90,000,000 *Terms: All cash*	$60,000,000	**1.50**
Quote.com • *Quote.com, also known as the Lycos Finance Division*	Interactive Data Corp. (IDC)	$30,000,000 *Terms: All cash*	$12,700,000	**2.36**
Artesyn Technologies (ATSN) • *Hardware and software subsystems*	Emerson Electric (EMR)	$500,000,000 *Terms: All cash*	$432,800,000	**1.16**
Zylom Media Group BV • *European downloadable PC casual games*	Real Networks	$21,000,000 *Terms: All cash*	$7,980,000	**2.63**

CardFile

The Next Big Thing

- **Digital Center** (www.digitalcenter.org): Publishes the 2005 Digital Future Report, a very interesting look at various Internet and digital usage trends. Cost for the 2005 report is $1500; the 2004 report can be downloaded free at: http://www.digitalcenter.org/downloads/DigitalFutureReport-Year4-2004.pdf.
- **Mobile Opportunity** (http://mobileopportunity.blogspot.com) Site mentioned in this issues' quotes section. Run by Michael Mace, who's worked in competitive planning and strategy roles at Palm and Apple. Interesting takes on trends in software development and mobile systems.
- **Innovation Tools** (www.innovationtools.com): Website with a variety of articles, interviews, links to "mind management" such as MindJet software (which we like, BTW), etc.
- **Trend Watching** (www.trendwatching.com): Website that relies on "8,000 spotters, working hard to deliver inspiration and pangs of anxiety to business professionals in 120+ countries worldwide."

RUBICON PRINCIPAL MICHAEL MACE ON THE RETURN OF COMPONENT COMPUTING: "But the really transformative thing happening in software right now isn't the move to a services business model, it's the move to an atomized development model. The challenge extends far beyond Microsoft. I think most of today's software companies could survive a move to advertising, but the change in development threatens to obsolete almost everything, the same way the graphical interface wiped out most of the DOS software leaders....

...Many of the best new Internet applications and services look like integrated products, but are actually built up of components. For example, Google Maps consists of a front end that Google created, running on top of a mapping database created by a third party and exposed over the Internet as a service." (Quoted on http://mobileopportunity.blogspot.com/2005/12/software-as-service-misses-point.html, 12/11/2005)

USB GAMES ANALYST MICHAEL WALLACE ON THE MARKET FOR USED GAMES: "There is no question that the used games business is a great place to be. It's just that the publishers aren't a part of it. And the online business is also growing, but it's the non-U.S. companies that have taken advantage of it. E.A. dropped the ball, frankly, and most of the U.S. companies have not really participated in the online business." (Quoted in ***The New York Times***, 02/02/2006)

NEW YORK TIMES REPORTER TOM ZELLER JR. ON GOOGLE: "It is telling, to say the least, that the darling of so many technophiles—which promised to "do no evil"— is now on the receiving end of spontaneous boycotts, with disillusioned search-lovers looking for alternatives. These signs of lost innocence also show that the race for China may soon offer a selling point to companies that don't cooperate with repressive regimes." (Quoted in ***The New York Times***, 02/06/2006)

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