Friday, Feb. 29, 2008
Vol. 24, No. 04

Softletter's SaaS University: Selling, Marketing, Infrastructure and Finance

Five Tracks, 31 Sessions

June 18/19, Boston, MA
October 22/23, San Mateo, CA

Softletter Subscribers Save $200 on Their Attendance

Industry ROE figures are good but not great
See pages 4-5.

Publisher & Managing Editor
Merrill R. Chapman
rickchapman@softletter.com
860/663-0552

Research Editor
Lilith R. Chapman
lilith@softletter.com
860/663-0552

Editorial office
Soft•letter
34 Sugar Hill Rd.
Killingworth, Conn. 06419
Voice: 860/663-0552

Subscription office
Aegis Resources
34 Sugar Hill Rd.
Killingworth, Conn. 06419
Voice:860/663-0552
Fax: 860/663-0553
info@softletter.com

www.softletter.com

Soft•letter
BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Converting From a Licensed to a Subscription Model

by Javier Rojas, Kenet Partners

The market for SaaS has gone mainstream. Corporations are increasingly open to buying software in this way. As a result, revenues are growing rapidly for the right sort of application vendor in virtually every segment. Aggregate turnover for stand-alone public SaaS companies has reached nearly $750 million annually. What is more, there are significant financial incentives for entrepreneurs to shift to a SaaS model. The public equity markets are placing a high premium on SaaS vendors, with market values averaging 5x forward revenues. A company with expected revenues of $50 million in 2007 and a median growth rate may well command an IPO or trade sale valuation of $250 million or better.

As a result of this dramatic shift, private investors are focusing on promising SaaS vendors and are highly selective regarding license software companies in which they are willing to invest. In both the private and the public markets, SaaS companies are being valued at a premium because of the visibility afforded by the recurring revenue model, the low marginal cost afforded by the multi-tenancy delivery model, and the reduced cost of selling on-demand solutions.

Business Model Comparison

	True SaaS	Subscription	License
Revenue visibility	High	High	Low
Revenue velocity	Low	Low	High
New client acquisition rate	Low	Low	High
Cash flow	High	Moderate	Low
Operational efficiency	High	Moderate	Low
Ongoing client vendor partnership	High	Moderate	Low
Ability to upsell services	High	Moderate	Low
Data mining opportunity	High	Low/Moderate	Low

This leaves many founders of software companies asking how they can make the transition to becoming a SaaS vendor. The operational challenges of making this shift are significant, impacting every part of the company: technology *(continued on page three)*

Advisory Board

Using Robosoft to Boost MicroISV Sales

They used to be called shareware, trialware, sometimes freeware publishers, but today the preferred term is MicroISVs, small publishers, usually one or two programmer shops focusing on a niche market. Sometimes the dream is to grow big, sometimes just to make a nice living, or a bit of useful supplemental income. Regardless of their ultimate goals, all MicroISVs are faced with the challenge of getting the word out about their products while operating under "micro" marketing budgets. Ryan Smyth, a Canadian expatriate currently living in South Korea and president of MicroISV firm Renegade Minds, publisher of Guitar and Drum Trainer, a nifty program we're using as we learn how to imitate Bob Dylan, explains how his use of Robosoft has helped him build sales and search engine goodness.

Robosoft is an automatic submission utility that submits PAD (portable application description) files to a database of approximately 1200 download sites worldwide. (the product's full database is 1600, but at any one time about 25% of the database will be unavailable because of closures, domain changes, downtime, etc. For most software companies, about 600 to 800 sites will be appropriate for your product and Robosoft does a good job of categorizing its internal database. To most effectively use Robosoft, you must first create a PAD file with an editor or specialized tool, import it into Robosoft, and allow the product to scan its database, determine which sites currently list your product as available for download, and upload the PAD file. You can control which sites you upload to via Robosoft, and I urge you to not ignore international sites, particularly German, French, Russian, and Asian sites; one of the products I've promoted, ALZip, is regularly one of the top five downloaded products at several of the top German websites.

While making sure your product is widely available via download sites is very useful and the time saved not submitting your product manually to these sites valuable, the key to making the most effective use of Robosoft is writing effective PAD file descriptions and thus boosting your SERPs (search engine results page) results via the download sites. Download sites function as effective drivers of search rankings, and one dirty little secret is that some of these sites seem to be primarily no more than MFA (made for Adsense) domains (I'm not going to identify which sites fit into this category because I can't be sure which are and aren't, though I have my suspicions). Nonetheless, the "halo" effect thrown off by the download sites in the aggregate can drive your ratings for keywords and phrases you've identifed as being effective in promoting your product to top ten positions.

For example, I discovered via Google's Trends analysis tool that the phrase "free media player" was an important keyword for a product (not my own) on whose behalf I was executing this strategy. For an example of how you'd research this, type in the following phrase and study the results: http://google.com/trends?q=free+movie+player%2C+free+media+player.

My competitors for this phrase were firms such as Apple and Real Networks, but soon after my Robosoft submissions my product showed up in Google's top five rankings. An ancillary benefit of this strategy is that you should also see your "second click" results, clicks that go to another site first, then click over to you, rise dramatically.

Ryan Smyth, president, Renegade Minds, #102 Yeoksam Dong, Kangnam Gu, 651-7 Bunji, Seoul, South Korea; 82/135-913. E-mail: ryan@renegademinds.com.

sales, services and pricing. Not least, the transition can have a dramatic impact on cash collection which, if not managed appropriately, can sink the business.

We have worked with a number of software vendors that have made the transition to SaaS and have found some useful lessons to insure success. In several cases we have been able to complete the shift fairly quickly, migrating to a recurring revenue model for the majority of the business in as little as two quarters. Below are some key lessons learned that have worked well for these companies.

Subscription Model vs SaaS

Some vendors can't migrate to a full multi-tenancy model (multiple customers using a single instance of the software) in a single step and need to continue offering to deploy software behind the customer's firewall. Also, some products do not lend themselves to a full SaaS model because certain customers will always insist on paying for a perpetual license. But these types of exception customers are fewer in number each year.

In any case, founders can get a lot of the benefits of revenue recurrence and forward visibility by moving to a subscription model even if the product is not delivered on-demand or hosted on a multi-tenancy basis. This approach still provides the financial visibility of the on-demand model, and gives the company experience in selling subscriptions and—for hosted offerings—experience in managing a service offering. Properly designed, a dedicated-instance hosted model can also make possible an on-demand "try-before-you-buy" sales model, which can help accelerate new client acquisition. It does not provide the additional economic benefit of multi-tenancy, though this can be introduced subsequently when the appropriate technology platform has been developed.

Transition on a New Release

The change to a subscription model can be traumatic for licensed customers (and sales people accustomed to selling this way). It is helpful to introduce the new contracting model in conjunction with a major new product release. This approach encourages existing customers to switch contracts and to accept the new pricing structure and helps your company leverage the new product launch to coordinate pricing messaging and to develop a new sales pitchbook.

Use Differential Pricing To Drive Subscription Sales

The perpetual licence model typically involves higher ongoing support costs than the on-demand model because of the on-site support requirements and the need to support several different versions deployed among customers. By contrast, a multi-tenancy SaaS solution has fewer implementation *(continued on page six)*

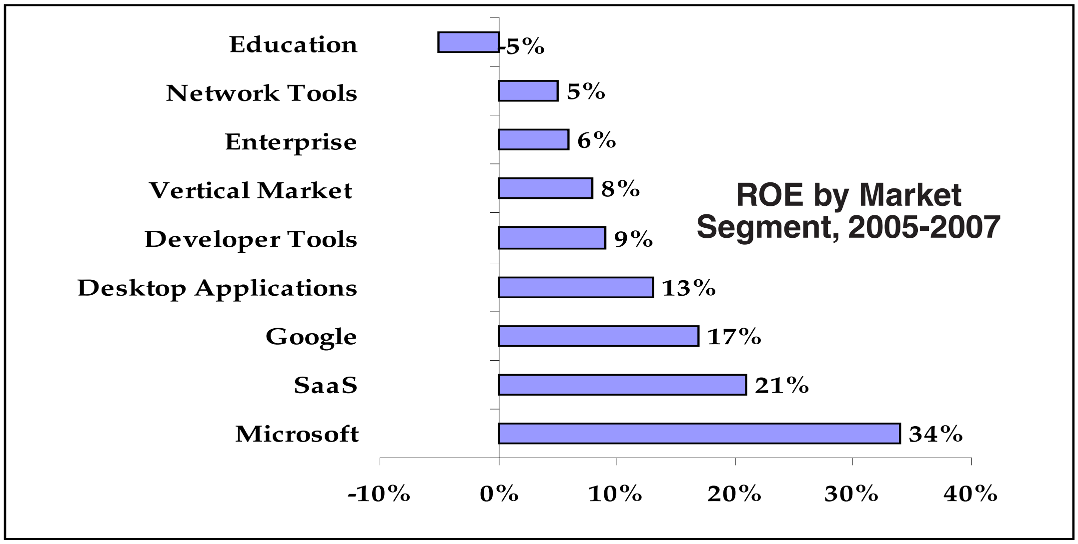
"In the SaaS model, the bulk of contracted revenues are deferred into the future, so the impact of increased sales is not visible in the short-term financial performance. In order to measure operational performance, new KPIs need to be measured, such as bookings per month and contracted backlog."

—Javier Rojas
Kennet Partners

"In some SaaS segments, it makes sense to aggregate annonymised data from customers' use of your application and turn it into an information service that can be upsold to existing clients. Customers can get significant benefits from benchmarking themselves anonymously against their peers. "

—Javier Rojas
Kennet Partners

Benchmarks



Benchmarks: Return on Equity

Return on equity (ROE) is simply a company's net income (revenues after expenses are deducted) divided by shareholder's equity in the company. ROE is considered an excellent way to judge how well management is doing on behalf of the shareholders and the firm.

The numbers for ROE this year were fairly good, a sign that the industry is resisting the downward pull of the rest of the economy, with segment medians ranging from -4% to 16%. Despite the good news, it should be noted that over the past three years, the software industry as a whole has seen steadily decreasing ROE numbers. In 2005 software ROE averaged 12%, while this year numbers fell to 9%.

Most of the sectors have dropped a just few percent from last year's numbers or just managed to held steady. The healthy numbers for Deskop Applications, which saw a major increase from 10% last year to this year's 16% are surprising to some, but remember that this market is dominated by companies who have established practical monopolies in many key markets. In such milieu's, profitability and steady revenue growth are not hard to maintain; in view of this, the lagging performance of Nuance is a bit of a puzzle. The company's performance may be impacted by the fact that in the desktop scanning and image management market, strong competitors such as ABBY are still able to compete and win sales against the market leader.

The overall poor numbers for Education are not a complete surprise as this is an increasingly brutal segment in which to compete, with the corporate learning markets under increased budgetary pressure and the frugal nature of school systems and educators constantly putting pressure on product margins and profitability.

SaaS numbers, it should be noted, dropped from 17% to 11% but the sector's performance is still notable over the last three years.

The Benchmark 50: Return on Equity

	Revenues (000) 2005	2006	2007	Return on Equity 2005	2006	2007	Avg. '05-'07
Microsoft	**$39,788,000**	**$44,282,000**	**$51,122,000**	**25%**	**31%**	**45%**	**34%**
Google	**$3,189,233**	**$6,138,560**	**$16,593,986**	**14%**	**16%**	**19%**	**17%**
Desktop Applications				**14%**	**10%**	**16%**	**13%**
Intuit	$2,037,703	$2,342,303	$2,672,947	23%	24%	22%	23%
Adobe	$1,966,321	$2,575,300	$3,157,881	32%	10%	16%	19%
Smith Micro	$13,316	$20,258	$54,469	31%	12%	7%	17%
Bitstream	$11,632	$15,653	$20,248	-13%	18%	30%	12%
Symantec	$2,582,849	$4,143,392	$5,199,366	14%	1%	3%	6%
Corel	$164,044	$177,191	$250,480	10%	-83%	91%	6%
Nuance Commo. (Scansoft)	$232,388	$388,510	$602,000	-1%	-4%	-4%	-4%
Vertical Market Applications				**11%**	**7%**	**7%**	**8%**
Autodesk	$1,233,800	$1,523,200	$1,839,800	34%	42%	26%	34%
Ansys	$134,539	$158,036	$385,340	20%	20%	13%	17%
Unica	$26,198	$35,023	$38,970	10%	1%	1%	4%
Dendrite	$399,197	$437,240	$423,958	13%	8%	-11%	3%
Advent	$149,990	$168,701	$215,303	-6%	6%	7%	2%
Moldflow	$64,418	$48,673	$55,853	8%	1%	-4%	2%
Enterprise Applications				**9%**	**6%**	**4%**	**6%**
Concur Technologies	$71,831	$97,145	$129,107	17%	29%	3%	16%
Manhattan Associates	$214,919	$246,404	$337,401	9%	9%	17%	12%
SPSS	$224,074	$236,063	$291,000	4%	10%	16%	10%
Sapient	$327,098	$421,643	$565,989	13%	1%	6%	7%
Witness Systems	$141,335	$185,371	$221,783	13%	-2%	3%	5%
Business Objects	$925,631	$1,077,151	$560,231	3%	6%	4%	4%
Pegasystems	$96,461	$102,007	$161,949	5%	3%	4%	4%
SaaS				**35%**	**17%**	**11%**	**21%**
Savvis	$616,823	$667,012	$793,833	233%	52%	165%	150%
Blackbaud	$29,978	$32,500	$37,569	51%	32%	28%	37%
WebEx Commo.	$249,133	$308,422	$380,012	19%	17%	11%	16%
Omniture	$42,804	$79,749	$143,127	58%	-9%	-3%	15%
RightNowTechnologies	$61,764	$87,148	$110,388	11%	17%	11%	13%
salesforce.com	$176,375	$309,857	$748,700	5%	15%	4%	8%
Vocus.	$28,062	$40,328	$58,076	-17%	1%	1%	-5%
Network Tools				**8%**	**10%**	**-4%**	**5%**
Citrix Systems	$741,157	$908,722	$1,391,942	14%	14%	12%	13%
McAfee (Network Associates)	$910,542	$987,299	$1,308,220	19%	10%	9%	12%
Novell	$1,165,917	$1,197,696	$932,499	6%	27%	-4%	10%
NetManage	$47,666	$43,434	$35,561	8%	21%	-11%	6%
Altiris	$166,565	$187,640	$229,434	8%	1%	6%	5%
iPass	$166,319	$169,273	$182,711	9%	6%	-4%	4%
Tumbleweed	$43,438	$50,001	$61,994	-12%	-6%	-8%	-9%
Developer Tools				**9%**	**12%**	**5%**	**9%**
Sybase	$788,536	$818,695	$1,025,530	9%	12%	16%	12%
Red Hat	$196,446	$278,330	$400,624	13%	17%	7%	12%
Progress Software	$362,662	$405,376	$493,500	11%	12%	8%	11%
BEA Systems	$1,080,094	$1,199,845	$1,402,349	13%	13%	0%	9%
Pervasive Software	$48,352	$45,580	$40,783	5%	5%	5%	5%
Borland Software	$309,548	$276,743	$268,781	3%	-10%	-11%	-6%
Raining Data	$21,483	$20,294	$18,744	-9%	-16%	-30%	-18%
Education				**-4%**	**-14%**	**3%**	**-5%**
Apollo Group	$1,798,423	$2,251,472	$2,723,793	29%	63%	64%	52%
Renaissance Learning	$111,724	$116,283	$107,932	27%	26%	13%	22%
Skillsoft	$212,300	$215,567	$225,172	-24%	11%	7%	-2%
SumTotalSystems	$55,204	$74,970	$121,924	-23%	-14%	-7%	-15%
Saba Software	$42,210	$71,147	$99,867	-16%	-13%	-17%	-15%
Plato Learning	$121,804	$90,719	$69,632	-21%	-20%	-15%	-18%
Scientific Learning	$30,976	$40,139	$46,053	9%	-305%	20%	-92%
All companies (median)				**12%**	**11%**	**9%**	**11%**

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

challenges and can be based on a single release of the software, maintained at the hosting center for much lower costs. Also, the sales costs for license software are often higher than for on-demand. This is because the customer faces a higher buying hurdle for larger upfront payments, which translates into a more difficult sale, more internal approvals and ultimately a longer and more expensive sales cycle.

Thus, it is important to offer customers a choice, but to ensure that the price of a perpetual on-site license is at a significant premium to the subscription pricing, so that customers are highly motivated to take up the SaaS offering. It is important that the on-demand pricing model also minimizes the loss of cash flow from the transition to subscriptions. This negative cash impact can be reduced by collecting first-year subscriptions upfront or by charging a reasonable set-up fee to offset the delayed revenues from subscriptions.

For example, in one company we priced the perpetual license and maintenance of a new release at a ratio of 1.4x to the first year of a subscription license for the same offering. Because we tied these new pricing alternatives to a significant product upgrade, we were able to increase subscription license prices by 15%, perpetual license prices by 25% and maintenance by 50%. As a result, subscriptions became more attractive to customers although still earning the company the equivalent cash flow at signing as the licence and first year maintenance from the preceding release. In the end, cash flow from subscription sales were lower than those of the new release license sales/maintenance (about a 2 year break even) but they were equivalent to the cash flow generated from prior license sales at the time of purchase, and greater after one year.

Other Key Factors

- **Contracting**. One year rolling contracts with a high renewal rate are the most common type of subscription used in the US, although three-year contracts have the benefit of providing longer contract visibility, more sales focus and stronger customer buy-in. There is anecdotal evidence that three-year contracts have lower renewal rates, as the contract end is more likely to coincide with a natural software upgrade or customer change cycle.

- **Focus on bookings**. Sales metrics and incentive plans need to be adjusted to focus on increasing MRR (monthly recurring revenue) through monthly booking targets. The growing MRR base is the primary driver of equity value for SaaS businesses.

Be Comprehensive

When you make the transition to a recurring revenue model, some clients will resist and continue with a license model. You'll need to make these exceptions but limit them to your most important/largest purchaser. To benefit from the valuation premium given to SaaS businesses, recurring revenues need to account for a majority of revenues. Only then will you gain the forward revenue visibility and value of cost-effectively scaling your operations. While the shift in the business model is daunting, it is achievable for most software companies. Having a majority of your customers on a recurring revenue model in six months may seem like an impossible task, but we have seen it implemented successfully. With this approach, a doubling or tripling in company valuation is within reach for many software companies.

Javier Rojas, managing director, Kennet Partners, 950 Tower Lane, Suite 1710, Foster City, Calif. 94404; 650/573-8700. E-mail: jrojas@kennet.com.

Equities

Yes, There Are Bad Deals

By Morten Lofnes, Corum

I was recently asked what was the worst deal I've seen lately and immediately a candidate sprang to mind. In August 2006, the Norwegian tape storage company Tandberg Data, acquired US-based Exabyte Corporation for $28 million. The acquisition was financed by loans. At first this looked like a good deal, as Exabyte was priced at approximately 0.5 times revenue. But, as the situation unfolded, it appeared that Tandberg bought a can of worms. Exabyte had been struggling for years in a shrinking market and had built up a lot of debt.

Tandberg's reason for acquiring Exabyte was that they wanted to grow into new markets, the two companies had complimentary products and Tandberg believed the merger would generate cost-saving synergies of as much as $10 million. When the acquisition was announced, the two companies combined were expecting to realize 2006 revenues of $215 million. Unfortunately, the "synergies" and the increased cash flow, which was supposed to fund the loans, did not materialize. As of the third quarter of 2007, the combined revenue was $144 million. The EBIT for the same period reached $8 million.

Tandberg's share price has shrunk by 75% and shareholders were quite upset (to say the least); the CEO at the time of the acquisition was forced to depart in early 2007. Tandberg is now in a very difficult financial situation. Part of the financial package put together for the acquisition needs to be renewed. Under the current circumstances, this will be a challenge.

So, what went wrong? Several factors. First, Tandberg Data has been losing money for years. The acquisition of Exabyte was a desperate attempt by the management to "do something." Unfortunately they did not have the ability to merge the two companies in an efficient way and Exabyte became an extra burden rather than an asset. The Tandberg Data management team's due diligence was flawed, with an unrealistic reliance on intangibles such as "synergies." As a result, revenue expectations were unrealistic and the result could, in worst case, end up in bankruptcy.

Morten Lofnes, Nordic regional director, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: morten.lofnes@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
ChoicePoint	Reed Elsevier	$4,100,000,000	$982,000,000	**4.18**
• Online information services		*Terms: Cash and debt*		
Enterprise Performance Systems	Eclipsys	$53,000,000	$10,000,000	**5.30**
• Performance-improvement		*Terms: Cash*		
Optio Software	Bottomline Technologies	$44,900,000	$27,200,000	**1.65**
• Document lifecycle management		*Terms: Cash*		
Compete	Taylor Nelson Sofres	$75,000,000	$14,900,000	**5.03**
• Internet data/digital intelligence		*Terms: Cash*		

CORUM
MERGERS & ACQUISITIONS

CardFile

Social Media Resources

- **Comscore** (www.comscore.com): Website that enables you to track the use of social media by a wide variety of criteria; of particular note is their tracking of the use of widgets on various sites.
- **eMetrics Summit** (www.emetrics.org): Tradeshow focusing on analytics and social media technologies and methodologies.
- **Paul Gillin's blog** (www.paulgillin.com): Must read blog for anyone interested in social networking and its impact on business. Gillin is a former editor-in-chief of ***Computerworld*** and the author ***The New Influencers***, a book analyzing the impact of blogging on markets and the forthcoming ***Secrets of Social Media Marketing*** (fall 2008).
- **Web Analytics Wednesday** (www.webanalyticsdemystified.com/wednesday/index.asp): Traveling worldwide roadshow dedicated to holding meeting discussing web analytics and social networking; anyone can sponsor a local "event."

NEW YORK TIMES REPORTER DAVID POGUE ON THE RELEASE OF THE IPHONE SDK: "I can't tell you how huge this is going to be. There will be thousands of iPhone programs, covering every possible interest. The iPhone will be valuable for far more than simple communications tasks; it will be the first widespread pocket desktop computer. You're witnessing the birth of a third major computer platform: Windows, Mac OS X, iPhone." (Quoted in ***The New York Times***, 03/13/2008)

ZDNET COLUMNISTADRIAN HUGHES ON THE RELEASE OF THE APPLE SDK: "See, while an SDK and new apps for the iPhone has generated some good press for Apple today, I can't help but notice that developers have managed to accomplish an awful lot without Apple's help. There are very active developer communities which have managed to develop and distribute applications without needing any help from Apple. Now developers can get access to an SDK and for a 30% cut can put their apps in front of millions of iPhone and iPod touch users. Is it the developers who need Apple, or is it Apple which needs the developers?" (Quoted on http://blogs.zdnet.com/hardware/?p=1441&tag=nl.e539, 03/06/2008)

GMSV COLUMNIST JOHN MURRELL ON "EDDIE": "Researchers from Rensselaer Polytechnic Institute are playing with a new Second Life resident, a boy named Eddie who behaves and thinks very much like a normal 4-year-old, except that his intelligence, his beliefs, his reasoning and his conclusions are all powered by a supercomputer. Eddie is an experiment in autonomous artificial intelligence on a path that leads directly to Star Trek's holodeck, where artificial characters, guided by a 'theory of mind,' will be able to understand, predict, and manipulate the behavior of other constructs and, in the physical world, humans." (Quoted in Good Morning Silicon Valley, 03/14/2008)

Colleagues made off with your last issue? Go to www.softletter.com. Click Subscriber Login in the upper right of the home page. To view the current issue and to search archives of hundreds of articles by keyword, topic, or issue date, log in and enjoy!

Soft•letter is published 24 times per year;
entire contents copyright © 2008 by Soft•letter. All rights reserved. Reproduction by any means, without permission of the publisher, is prohibited.
ISSN: 0882-3499.

Subscription rates: $399 worldwide. Subscription office: Aegis Resources 34 Sugar Hill Rd. Killingworth, Conn. 06419 Voice:860/663-0552 Fax: 860/663-0553 info@softletter.com