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Our operating income survey shows Google now rivals Microsoft in profitability See pages 4-5.

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Salesforce.com, AppExchange, and the Platform Wars Redux

The platform wars raged from the early 1980s with the introduction of PC/MS DOS through the mid-90s, ending with the collapse of OS/2 in the face of the Windows 3.X/95 onslaught and the demise of Novell's Netware at the hands of Windows NT/2000/XP. When the wars were over, Microsoft stood triumphant over the entire industry, with monopolies in key sectors of the software market, most notably in operating systems and the most profitable applications segments. It's a triumph that was worth well over \$100b in revenue to Microsoft, with the number growing every year.

But despite this success, Microsoft now, like IBM before it, faces an industry about to undergo significant change brought by Open Source, SaaS, and virtualization. Open Source seeks to copy and commoditize Microsoft's OS and applications businesses. SaaS seeks to make desktop software obsolete. Virtualization attempts to strip our computing environments from the bare metal most of us rely on, creating portable workspaces that move with us (and that also break the software/hardware upgrade cycle the industry has employed since the 70s).

One of the sure signs of change in software is the appearance of new development ecosystems to challenge existing institutions. Over the last three years, several SaaS-based and Open Source platforms have appeared to challenge Microsoft's dominance in software. One the most closely watched is Salesforce.com's AppExchange, an attempt by the current SaaS Golden Child to create a powerful software ecosystem around its CRM application. We sat down with Eric Rubin of DreamFactory (www.dreamfactory.com), a SaaS-based firm offering several paid and free applications, including Carousel, an impressive presentation system that allows you to visually drill down and present your CRM data. DreamFactory currently has 30 employees, has been in business since 2002, and recently received \$6M in venture funding from NEA.

Eric, why did DreamFactory decide to develop for AppExchange?

There were several reasons. One was our product architecture. Our products are "serverless" and use a rich client architecture, basically a product "player" that lives in the browser. To support that model, we needed to access a broad suite of backend services; AppExchange provides that capability.

Another factor driving the decision is time to market. Our first product, DreamTeam, *(continued on page three)*

What to Do When the Clock Strikes 11 (th Hour Sales Negotiations)

11th hour negotiations are the privilege of the customer. Yes, negotiations are, at their best, comprised of open, honest and straightforward communication based on mutual respect and mutual trust. As readers of *Softletter* know, the Prime Resource Group teaches a diagnostic sales process that is designed to remove the need for high-pressure bargaining and “arm-wrestling” in the eleventh hour.

But the reality is that no one should be surprised if, at the last minute, the person or persons with whom you’ve been working with during the sales cycle show up to a meeting with a long face or send a doleful E-mail informing you that there’s a “problem” with the terms of the deal and someone from the company needs to meet with you because “they” need “help” on a key aspect of the sale. 90% of the time, that key aspect will be the price and the odds are 60% to 70% that you’re meeting with someone from purchasing. The squeeze is on.

There are three keys to holding your ground on your pricing. The first is ensuring your sales force understands that giving up discounts is going to truly hurt the **individual** sales person’s bottom line. Many companies fail to realize that discounting pain is usually distributed disproportionately. In a \$100K sales, a 10% discount offered to a customer who needs pricing “help” represents a loss to your company of \$10K but (assuming a 5% commission), only extracts \$500 from a salesperson’s purse. Put in place a system that spreads the discounting pain to your sales group.

The second is to avoid, especially in the case of companies selling enterprise level product, being categorized as being simply a software product. Purchasing departments understand buying software and have well established policies and pricing strategies in place. But it’s hard to think of any enterprise sale that doesn’t involve the sale of a whole package of professional services. We were recently working with a software company that offers executive an sales force compensation automation system; but their true area of expertise is in fixing broken business processes that surround the use of their product. Their software is positioned simply as a tool to allow a company to create a valuable intellectual property database of best practices and information. The practical effect of this approach was to remove purchasing from a stakeholder position in the decision making process and push them into a strictly administrative role.

The third is extensive preparation and modeling of the quantifiable value your software product offers the customer. I have to say that in my experience, too few salespeople in the software industry understand the financial impact of their products. In my experience, most companies are able to quantify only 60% to 70% of their value internally and able to quantify only 50% of that value to customers. Our answer to this problem has been to encourage software companies to turn to ROI modeling simulators such as the one you can examine at www.lucidus.co.uk. It’s important to find a system that not only enables you to model your external ROI savings but also one that allows you to plug in a customer’s internal costs and business processes, thus providing them (and you) with a creditable financial argument for buying your products and services and measurable losses they’ll incur if they don’t. Properly planned and prepared for, you should be ready to fend off an 11th hour margin raid.

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went from concept to beta in six weeks; we shipped to our first customer about 90 days after that. If we'd attempted to do this by building our own server and services infrastructure, it wouldn't have been possible (well, possible but a great deal more expensive). By relying on AppExchange services, we can scale our applications quickly with minimal expense. We have no hosting costs; our smart client talks directly to the Salesforce.com server farms.

Another factor that ties into this is the current speed of SaaS development and upgrades. We're finding that, at least in our markets, our products have to have the right user experience, a blend of ease of use with steadily unveiled deeper functionality. We've integrated a customer feedback database into our applications and currently feature requests outnumber bug reports by 20 to 1. Our internal database tracks the company, number of users, revenue associated with feature development, number of requests, where it originated, and alignment with our product road map, then assigns a feature request a ranking.

Last year we introduced over 600 new capabilities into our product line; it's hard to maintain that pace of development when you're also managing a complex server infrastructure.

Hmm. What about "bloatware"?

I don't know if we can avoid bloatware in five years but right now, users are driving product development to an extent I don't think is possible with desktop or client server systems. SaaS does allow you to apply the "Wisdom of the Crowd" methodology to your products. Sometimes groups can make a smarter decision than an individual.

Another point I need to make is that by supporting the AppExchange platform you gain quick access to their 30K customer base. Of course, the corollary to that is your universe of customers, at least if you've developed only for AppExchange, is limited to how fast Salesforce.com grows.

That brings me to the question of platform commitment. Anyone who's made a commitment to Windows and the Microsoft stack understands that if Microsoft takes an interest in your market, you need to think about a buyout or getting crushed. Or just getting crushed. How do you manage this issue with Salesforce.com?

That's a danger you face with any platform. When we build a product, we're specifically trying to stay out of their way. Internally, Salesforce.com publishes what they call "white space" opportunities; market segments with problems to be solved that they don't intend to address for the next 12 to 36 months. But you need to be a part of the AppExchange program to obtain an accurate feel for where Salesforce.com is heading; being a partner opens up their sales force and internal marketing programs to you. Once you have access to these, you develop a good feel for where you need to

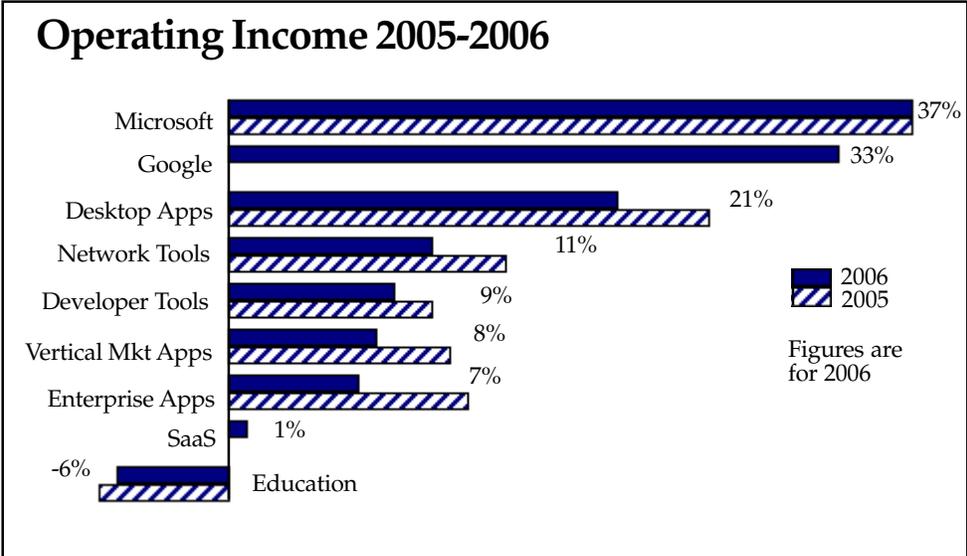
(continued on page six)

"Other development platforms we're keeping an eye on include Microsoft Dynamics, Amazon's S3, Google, and WebEx/Cisco."

*—Eric Rubin
DreamFactory*

"From a development standpoint, if you're developing for one of these platforms, protect yourself with a highly componentized, portable architecture. Web services layers make this realistic."

*—Eric Rubin
DreamFactory*



Benchmarks: Operating Income

The once hugely-profitable software industry (it was profitable even during the crash of 1999-2001) is now mature, and it is harder to make the enormous profits of old. What was once rare and difficult and therefore highly profitable has become ever more common, and software prices have been dropping since 2005. The post-Crash industry growth continues, but at a slower pace than in the old days.

The chart above shows smaller profits across the industry, but the declines in profits have more to do with individual company size than with the sectors themselves. If we look at profitability from the standpoint of company size,

Revenue	Operating Income
>\$1bn	24%
\$500-999m	15%
\$100-499m	8%
<100m	-1%

we see that every company that aspires to old-time profits must grow beyond \$500 million revenues as quickly as possible. Mere profitability needs at least \$100 million in sales. These facts may add to the other pressures on VCs to fund fewer and larger deals, as we noted in our most recent quarterly VC report. Ray Lane, formerly of Oracle and now a VC, says of enterprise software that there are over 5,000 companies, but that 85% of the revenues are received by only 15 firms, and that the top three (Microsoft, Oracle, and SAP) take 75% of the profits. And of those 75% of the profits, half go to a single firm—Microsoft.

Adopting a radical business model may be the key to upsetting the situation, though in the case of Open Source, profits remain comparatively scarce. The open question is: Can SaaS do better? Google now rivals Microsoft in profitability (33% vs. 37%) although Google sales are less than one-quarter of Microsoft's.

The Benchmark 50: Operating Income

	Revenues (000)			Services Margin			Avg. '04-'06
	2004	2005	2006	2004	2005	2006	
Microsoft	\$36,835,000	\$39,788,000	\$44,282,000	25%	37%	37%	32.8%
Google	\$3,189,233	\$6,138,560	10,604,917	20%	20%	33%	24.3%
Desktop Applications				25%	26%	21%	24.0%
Adobe	\$1,666,581	\$1,966,321	\$2,575,300	36%	37%	21%	31%
Cyberlink	\$48,966	\$65,141	\$74,926	31%	30%	31%	31%
Intuit	\$1,802,224	\$2,037,703	\$2,342,303	23%	26%	24%	24%
Smith Micro	\$7,216	\$13,316	\$20,258	-13%	26%	21%	11%
Symantec	\$1,870,129	\$2,582,849	\$4,143,392	27%	32%	7%	22%
Bitstream	\$9,726	\$11,632	\$15,653	-18%	-6%	7%	-6%
Nuance Commo. (Scansoft)	N/A	\$232,388	\$388,510	NA	1%	2%	2%
Vertical Market Applications				11%	12%	8%	10.4%
Ansys	\$113,535	\$134,539	\$158,036	27%	34%	37%	33%
Autodesk	\$951,600	\$1,233,800	\$1,523,200	11%	19%	24%	18%
Kronos	\$450,694	\$518,658	\$578,203	15%	16%	11%	14%
MapInfo	\$124,673	\$149,424	\$165,495	9%	11%	8%	9%
Dendrite	\$321,107	\$399,197	\$437,240	11%	12%	8%	10%
Advent	\$149,990	\$168,701	\$184,093	-12%	4%	0%	-3%
Moldflow	\$48,673	\$64,418	\$65,558	6%	10%	0%	6%
Enterprise Applications				3%	7%	7%	5.8%
Business Objects	\$925,631	\$1,077,151	\$1,253,760	9%	12%	9%	10%
SPSS	\$224,074	\$236,063	\$261,532	3%	12%	13%	9%
Manhattan Associates	\$214,919	\$246,404	\$288,868	15%	12%	11%	13%
Concur Technologies	\$56,550	\$71,831	\$97,145	3%	7%	7%	6%
Pegasystems	\$99,313	\$96,461	\$102,007	15%	6%	1%	7%
*Witness Systems	\$108,037	\$141,335	\$185,328	-21%	6%	-1%	-6%
Knova Software (ServiceWare)	\$11,511	\$12,502	\$23,595	-9%	-133%	-23%	-55%
SaaS				6%	11%	1%	6.2%
Digital Insight	\$154,362	\$188,891	\$213,971	11%	15%	19%	15%
WebEx Commo.	\$249,133	\$308,422	\$380,012	28%	26%	21%	25%
WebSideStory	\$22,602	\$39,452	\$64,527	7%	15%	-17%	2%
salesforce.com	\$176,375	\$309,857	\$497,098	4%	6%	-1%	3%
RightNowTechnologies	\$61,764	\$87,148	\$110,388	6%	7%	-7%	2%
Savvis	\$616,823	\$667,012	\$763,971	-16%	-1%	3%	-4%
Network Tools				7%	6%	11%	7.7%
Novell	\$1,105,496	\$1,165,917	\$1,197,696	-3%	6%	36%	13%
Citrix Systems	\$588,625	\$741,157	\$908,722	26%	21%	23%	23%
McAfee (Network Associates)	\$936,336	\$910,542	\$987,299	7%	35%	16%	19%
iPass	\$136,078	\$166,319	\$169,273	16%	17%	11%	15%
NetManage	\$50,663	\$47,666	\$43,434	-9%	3%	6%	0%
Altiris	\$166,565	\$187,640	\$229,434	15%	-2%	8%	7%
Tumbleweed	\$43,438	\$50,001	\$61,994	-18%	-10%	-10%	-13%
Developer Tools				11%	14%	9%	11.4%
BEA Systems	\$1,012,492	\$1,080,094	\$1,199,845	17%	18%	17%	17%
Red Hat	\$124,737	\$196,446	\$278,330	2%	14%	21%	12%
Sybase	\$788,536	\$818,695	\$876,163	11%	15%	15%	14%
Progress Software	\$362,662	\$405,376	\$447,063	12%	15%	9%	12%
Pervasive Software	\$49,608	\$48,352	\$45,580	16%	8%	3%	9%
Raining Data	\$22,297	\$21,483	\$20,294	-1%	1%	-3%	-1%
*Borland Software	\$309,548	\$276,743	\$304,660	6%	-13%	-17%	-8%
Education				0%	13%	-6%	2.1%
Apollo Group	\$1,339,517	\$1,798,423	\$2,251,472	29%	24%	32%	28%
Renaissance Learning	\$111,724	\$116,283	\$111,528	35%	29%	16%	27%
Scientific Learning	\$30,976	\$40,139	\$40,998	-2%	13%	-1%	3%
American Education Corp.	\$8,599	\$10,187	\$9,819	6%	13%	-6%	4%
Saba Software	\$34,471	\$42,210	\$71,147	-36%	-7%	-9%	-17%
SumTotalSystems	\$55,204	\$74,970	\$105,988	-29%	-14%	-10%	-18%
Plato Learning	\$141,801	\$121,804	\$90,719	0%	-23%	-26%	-16%
All companies (median)	\$149,990	\$188,266	\$221,703	10%	11%	8%	9.5%

Source: Company 10-K filings for most recent fiscal years. "Years" may not correspond to company fiscal years.

put your development and marketing resources.

Let's discuss the costs of developing for AppExchange.

Costs are fairly low. On the development side, minimal. We use our own resources, primarily an Ajax tool kit, and some other systems. There is a \$10K cost associated with having your application audited and certified for security. Our experience with bug resolutions and enhancement requests has been very positive and with no extra costs associated. If the customer has Salesforce, then there are no additional access costs to us or the customer. If they don't, then we OEM an AppEx user license—which is essentially a platform license that allows our applications to run stand-alone for our customers. The AppExchange User License is \$25 per month, but we embed it in our standalone offer so pricing is concealed.

“Salesforce.com is clearly a first mover platform. We want to diversify but remain focused on working with the platform.”

—Eric Rubin
DreamFactory

You mentioned the AppExchange marketing programs; let's look at them in greater detail.

They do have a menu of MDF (marketing development funds) programs you can access. For example, “their featured app” slot: that costs about \$10K per quarter and we think it's a good investment. There's their CRM Success Tour, a series of traveling mini-tradeshows that go from city to city where you can meet customers and prospects. Attendee numbers range between 100 to 500 and it will cost you from 5K to 8K per event. These can be effective. I also think their annual user conference, DreamForce, can be worthwhile. It draws about \$5K to \$6K attendees. It's going to cost from \$20K to \$75K, but we walked away from the last one with 1K high-quality leads.

We've also invested in a program that lets us put a DreamFactory representative in a cubicle at Salesforce.com HQ, not a non-trivial expense. (*Editor's note: The cost of this type of MDF program typically ranges from \$30 to \$100K.*) This allows us to develop extra face time with the company's sales personnel and that's important. They can drive sales of AppExchange products if they think you help them meet a need the Salesforce.com product portfolio doesn't meet. Along with this program comes local marketing programs such as sponsored lunches (these usually cost about \$200; evening events, \$1K), parties, etc. These aren't required expenditures but we think they make sense.

We've read that Salesforce.com is developing more aggressive revenue sharing programs tied to AppExchange.

We don't have all the details, but these programs trade more direct access to the Salesforce.com customer base for a revenue share. The system is tiered; for example, in return for qualified leads you'll pay 10% of revenue up to 45% for one-stop shopping programs where Salesforce.com does the billing. At the moment, I don't have an opinion on the value of these programs; some of the price points seem high.

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Negotiating Your Non-Compete Agreement, Part III of III

By Mark Reed, Corum Group

(We complete our three-part article on negotiating a non-competite agreement as part of an M&A process.)

Dispute Resolution and Enforcement. Disputes can be resolved in courts or through arbitration, and you may be better served by the courts. A buyer may include language whereby disputes will be resolved through mandatory binding arbitration, which generally can be enforced. Buyers will often use this as a tactic to avoid courts in states such as California which do not favor strict enforcement of non-competition agreements.

Some buyers may seek to include language to calculate the amount of damages ahead of time as a way to simplify enforcement in case of a breach. For example, the buyer may want a liquidated damages provision that stipulates a large, fixed amount. However, it will likely be to the seller's advantage to go through a process in which the amount of damage is assessed and a settlement reached.

Multiple Shareholders. When multiple shareholders sign non-competite agreements, make sure you are liable only for your own breach, not for breaches by your fellow shareholders. The Buyer may attempt to include language under which it can sue all shareholders for breach by one shareholder and, if it receives a judgment, collect the entire amount from all shareholders or from any single shareholder, as it chooses. The buyer can accomplish this through covenants not to compete coupled with joint and several indemnification in the purchase agreement or through cross-default language in separate non-competite agreements. As a seller you should qualify the indemnification language or make it "several and not joint", and eliminate cross-default language.

Attorney Fees. Consider including a prevailing party attorney fee provision. This requires the losing party to pay the winner's attorney fees if either party sues for breach of the agreement. This may cause the buyer to be more cautious before pursuing a weak lawsuit and it may permit you to more aggressively defend your case since you would be able to recover costs upon a favorable outcome. The downside is that if you lose, you'll have to pay the buyer's attorney fees as well.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
CorVu (CRVU.OB) • Business intelligence software	Rocket Software	\$19,800,000 Terms: Cash	\$14,400,000	1.38
Compel Group • IT services	2e2 Group	\$97,300,000 Terms: Cash	\$86,900,000	1.12
RelQ Software • Software testing	Electronic Data Systems (EDS)	\$40,000,000 Terms: Cash	\$22,000,000	1.82
WebEx (WEBX) • Online conferencing/instant messaging	Cisco (CSCO)	\$3,200,000,000 Terms: Cash	\$380,000,000	8.42

AppExchange Resources

- **An Introduction to Salesforce.com's AppExchange** (www.oreillynet.com/pub/a/network/2006/11/13/an-introduction-to-salesforcecoms-appexchange.html): Online three-part article that discusses AppExchange; suitable to both developers and less technical readers.
- **Apex Developer Network** (www.salesforce.com/developer): Salesforce.com sub-site dedicated to AppExchange development.
- **AppExchange Watch** (<http://appexchangewatch.blogspot.com/>): Independent blog dedicated to analyzing AppExchange; many useful links.
- **Architecting Apps for the AppExchange** (www.slideshare.net/dreamforce2006/architecting-apps-for-the-appexchange/): Online Salesforce.com-sponsored slide show on AppExchange development.
- **Where's the Upside?** (<http://foda.typepad.com/upside/>): Interesting and independent UK blog that focuses on Salesforce.com from a sales and marketing perspective; offers interesting insights into AppExchange issues.

BLOGGER MATT ASSAY ON THE MICROSOFT/NOVELL LINUX DEAL: "Novell claims to want to sell and proliferate Linux. But it has taken the exact wrong strategy to do so. Instead of protecting Linux and standing up for its integrity, Novell has slandered its reputation with its dubious Microsoft pact. However Novell may want to color it, the agreement implies that Linux is 'Unclean!'" (Quoted on http://weblog.inforworld.com/openresource/archives/2007/03/what_novell_cou.html, 03/26/2007)

NEW YORK TIMES REPORTER BRAD STONE ON THE WIDGET ECONOMY: "MySpace and its corporate parent say they want to find ways to support and exploit the growing widget economy. Last year, Fox Interactive Media introduced a service called Spring Widget. The service provides tools to help developers create widgets for use both on computer desktops and online networks like MySpace." (Quoted in *The New York Times*, 03/20/2007)

RUBICON CONSULTING ANALYST BRUCE LA FETRA ON SECOND LIFE: "Just as film revolutionized the business of performing arts and news (back in the days before they were one and the same) or vinyl records revolutionized the music industry (really the shellac versions that preceded vinyl LPs in the 1950s), Second Life offers a virtualization medium that has the potential to change the way we think, operate and do business. The change will come whether you personally participate in Second Life or not." (Quoted on <http://www.rubiconconsulting.com/thinking/newsletter/2007/04/#a000118>)

CHRIS STEPHENSON, EXECUTIVE DIRECTOR OF THE COMPUTER SCIENCE TEACHERS ASSOCIATION ON MICROSOFT'S DEVELOPER PROGRAMS: "Microsoft's willingness to create high-quality teaching and learning resources and to make them broadly available is a terrific idea." Quoted in *eWeek*, 03/22/2007)

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