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Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Gaming Your Marketing and Sales

In "The Product Marketing Handbook for Software" (www.aegis-resources.com) and in presentations we give on marketing and selling software we always extol the virtue of "war gaming," i.e., developing different scenarios based on possible promotions/pricing tactics/distribution strategies and planning for different market and competitive responses. We've always found that companies and people who take the time to "game" their markets and products find it a valuable exercise; the insights you gain into your product and business strategy are well worth the investment in time.



Pretty good news on the operating income front, but Internet companies lag behind
See pages 4-5.

While there are different online business simulators we've examined, few deal specifically with the high technology and software markets and we've not been impressed by most that we've seen. (By the way, if you are interested in experimenting with desktop business simulators, we can recommend "The Corporate Machine" from Stardock and Trevor Chan's "Capitalism" and "Capitalism 2"—all three games are out of print so we suggest a hunt on eBay. We personally recommend starting with "The Corporate Machine"; it feels somewhat like a version of Risk on steroids and specifically allows you to play as a technology company. "Capitalism" is a far more complex game, but if you have the time to master it, provides a rewarding gaming experience and deeper understanding of how a market behaves and the complexities behind starting and running a business.)

We were thus very intrigued when we heard that MindForge, a training company focusing on teaching sales and marketing skills for technology firms had licensed for online use the "Marketplace" business simulator. Normally only easily accessible to people in academia, Mindforge now makes it possible for any high-tech company to access and use what we believe is the most accurate and powerful technology business simulation tool/game in existence.

(Incidentally, we've recently taken a brief look at another company offering online business simulations: Forio (www.forio.com/simulations.htm). We can't say much about their system at this time but will be taking a closer look soon. We do think their pricing simulator is intriguing.)

We caught up with Chris Davis, president of MindForge (www.mindforge.com), and asked him some questions about how you use "Marketplace" and in what ways it can benefit your company. Chris has worked as a senior marketing and sales executive for several software and high-tech companies, including Captaris, Comsat, and Sony.

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The Developing OEM/ISV Trialware Model

by Geoff Surkamer

Standard OEM deals normally consist of a hardware manufacturer purchasing applications at a deep discount (typically between 90%+ off ESP/SRP) and including them with their hardware systems. The decision on who provides product support, documentation, and does compatibility testing are usually negotiated. While bundling is usually thought about in the context of computer purchases, the strategy extends to scanners, PDAs, digital cameras, and other hardware. OEM purchases are a very significant factor in the sales of desktop software, accounting for approximately 10% of all sales of desktop and retail-class products in 2003 (source: IDC).

The goal behind bundling is simple: manufacturers want to add value to their systems at as low a price as possible. However, the traditional model is beginning to undergo a fundamental change as the price of hardware becomes ever lower. Faced by increasing pricing and competitive pressures, hardware manufacturers are increasingly moving to replacing OEM purchases with preloads of trialware on their units and a shared revenue model when/if a customer decides to purchase a preloaded product. Over time, we expect the trialware model to account for more than 50% of total OEM sales and 90% for computers sold in the low end of the market.

The trialware model consists of ISVs providing OEMs with trial versions of their software. These products are wrapped in a licensing system that locks after X number of uses or after X period of time, reminds the user of the impending expiration of the trial, registers the product, and, depending on the options offered by the license technology provider, handles all or part of the E-commerce process when the user decides to buy. These options can include the ability to automatically disburse revenue to both the OEM and the ISV, widespread platform support, and 24/7 customer service to deal with installation and payment issues from customers.

The advantages of the trialware approach are clear from the OEMs' standpoint. They remain able to provide hardware systems loaded with software able to be used out of the box without incurring the upfront expense of an OEM purchase (though the costs of checking the software's compatibility with their hardware and loading the software onto the systems remain). In addition, depending on negotiations, the OEM can expect to share from 5% to 20% of revenues generated by trialware sales.

From the ISV's standpoint, the disadvantage of not obtaining money upfront from a software sale are somewhat offset by the fact that more OEMs will be inclined to both bundle more and a wider variety of products because their costs to do so have considerably lowered. In addition, the trialware model does allow software companies a greater opportunity to upsell registering customers and to capture contact information for future sales efforts. To maximize your sales efforts, ISVs should be prepared to coordinate compatibility testing with OEMs carefully, as download sales can often involve the transfer of remote products and components (such as ActiveX controls), plan for careful placement of your product's icons in the system's start or launch menu and on the desktop, offer a trial usage period of at least 60 days and, in many cases, send a customer a product CD after the sale (to lower post sales support costs).

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Let's get some basics out of the way. How much does it cost to play a single "game" of Marketplace?

\$125 per online game per person. To play as corporate user it costs \$100 per game per user if you purchase five "seats" in the simulator. You can play against the computer (a very tough opponent) or against each other. If you're looking to build teamwork among your employees, we do recommend that ideally five people play as a group against another team or against the system.

We also recommend that the team consist of members from different functional groups from your company: finance, sales, marketing, development, etc. I personally think the simulator is particularly good at helping sales and marketing personnel understand each other better; it's also very useful at teaching people about the financial impact their decisions can have on a company's growth. Currently, up to two thousand people can participate in a single simulation.

Can you give us some background on Marketplace?

Marketplace was developed by Dr. Ernie Cadotte, Ph.D, and a professor of marketing at the University of Tennessee. The product is now at version six and has been in development for over 12 years. Its rules engine, which simulates the impact of the business decisions you make while playing the game, is generally regarded as being the most accurate in the world. Companies such as HP, IBM, Checkfree, and Xerox use the simulator.

OK, how do you play Marketplace?

Currently, Marketplace offers one simulation on marketing strategy and that's the product we're offering to our customers. You are starting a new technology company: a personal computer firm. You start with initial seed capital and at that point need to make a series of decisions as to what markets you want to address and what customers you'll initially target. The game requires you to "purchase" market research and breaks out the different markets and segments available. Based on this, you choose how to grow. For instance, are you going to build a "Mercedes" system and target the high end of the market? Or manufacture workhorses and target broader segments?

Once you've done this, you need to move to executing the strategies and tactics that will grow your business. First, you have to make a series of choices that help to create demand, including product positioning, product design, sales channels, point-of-purchase (POP) displays (if appropriate), pricing, ad copy design, media planning, etc.

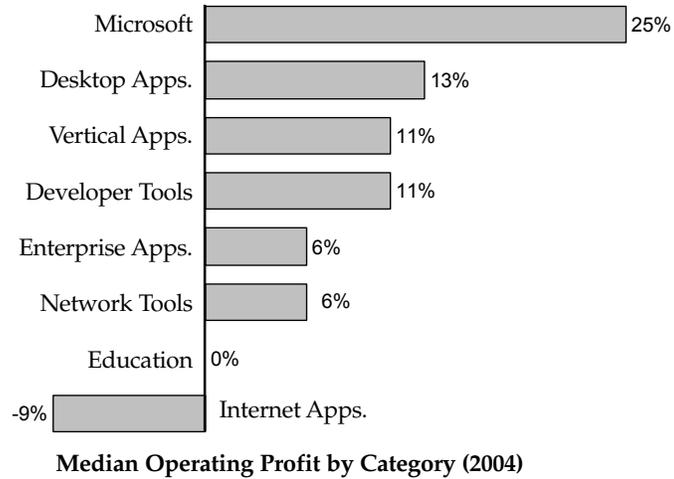
Next, you have to make manufacturing and supply chain decisions. These include things like plant location, fixed capacity, operating capacity, production scheduling, inventory control, and statistical process control, all things that directly and *(continued on page six)*

"You wouldn't board a commercial aircraft piloted by someone who hadn't tested their abilities in a flight simulator. Product and marketing managers are often given line and P&L responsibility for products and revenues without anyone testing their abilities."

*—Chris Davis
Mindforge*

Profits for 2004 are up

In most market segments, public software companies showed operating profits in 2004. Thirty-two companies in our Benchmark 50 group were profitable and the overall median for the 50 public companies rose to 6.5% from 0.3% last year.



Benchmarks: Operating Income

Operating income is a measure of a company's earning power and is often used to gauge a company's financial performance. The good news is that profit numbers are up for 2004. More companies are profitable now than they were in the last couple of years. Our Benchmark 50 group of public companies turned a median profit of 6.5%, compared to only 0.3% last year and -1.9% the year before. Thirty-two companies on the list were profitable, and five of our seven market segments (plus Microsoft) reported a profit on operations. Only Internet Applications as a category lost money on their basic business operations last year and had the lowest profitability as a category for the past three consecutive years.

Although the Desktop Applications group was profitable as a whole, they actually lost ground, with only three companies showing a profit this year versus five companies from the year before. The three companies reporting a profit in the Desktop segment are Adobe (36%), Symantec (27%) and Intuit (23%) and are the same top three companies that reported profits in 2003. An astounding six out of seven companies in the Vertical Market segment, the Enterprise Applications segment, as well as the Developer Tools segment, turned a profit in 2004, compared to only four companies in each of these segments in 2003.

Five out of seven Network Tools companies were profitable compared to three the year before. Education as a segment remained unchanged, with the same three companies remaining profitable: Renaissance Learning (30%), Apollo Group (24%) and American Education Corporation (9%). However, although profitable, each of these three companies lost money compared to the year before. In 2003, profitability for these companies was reported as 37% for Renaissance Learning, 29% for the Apollo Group and 13% for American Education Corporation.

It appears as though many software companies in every segment (except Internet Applications) have discovered new business models that actually make money. Will the Internet companies ever catch up?

The Benchmark 50: Operating Income

	Revenues (000)			Operating Income Ratio			Avg. '02-'04
	2002	2003	2004	2002	2003	2004	
Microsoft	\$28,365,000	\$32,187,000	\$36,835,000	29%	30%	25%	27.8%
Desktop Applications				-15%	8%	13%	2.4%
Adobe	\$1,164,788	\$1,294,749	\$1,666,581	25%	29%	36%	29.8%
Symantec	\$1,071,438	\$1,406,946	\$1,870,129	1%	24%	27%	17.5%
Intuit	\$1,312,228	\$1,650,743	\$1,867,663	4%	21%	23%	15.7%
Aladdin Systems	\$7,627	\$7,457	\$8,535	-15%	8%	-10%	-5.3%
Scansoft	\$62,717	\$106,619	\$135,399	-27%	6%	-5%	-8.5%
Macromedia	\$326,498	\$336,913	\$369,786	-73%	0%	13%	-19.7%
Smith Micro	\$9,489	\$7,131	\$7,216	-65%	-24%	-12%	-33.6%
Vertical Market Applications				11%	3%	11%	8.4%
Ansys	\$91,011	\$113,535	\$134,539	30%	33%	40%	34.5%
Kronos	\$342,377	\$397,355	\$450,694	21%	21%	20%	20.5%
Dendrite	\$225,756	\$321,107	\$399,197	11%	11%	12%	11.3%
Autodesk	\$947,491	\$824,945	\$951,643	10%	3%	11%	8.2%
MapInfo	\$92,598	\$106,255	\$124,673	-5%	-2%	9%	0.7%
Moldflow	\$35,088	\$36,625	\$48,673	-5%	-0%	6%	0.2%
Advent	\$170,215	\$159,436	\$137,159	24%	-10%	-29%	-4.8%
Enterprise Applications				-2%	1%	6%	1.8%
Manhattan Associates	\$175,721	\$196,814	\$214,919	21%	16%	15%	17.0%
Mercury Interactive	\$400,122	\$506,473	\$685,547	17%	10%	14%	13.4%
Business Objects	\$454,799	\$560,825	\$925,631	10%	7%	9%	8.8%
SPSS	\$208,480	\$208,367	\$224,074	-8%	0%	3%	-1.7%
Witness Systems	\$67,686	\$108,037	\$141,335	-2%	-20%	6%	-5.3%
Concur	\$45,097	\$56,737	\$56,550	-28%	1%	3%	-7.7%
ServiceWare Technologies	\$12,427	\$10,158	\$11,511	-257%	-56%	-9%	-107.1%
Internet Applications				-69%	-19%	-9%	-32.0%
Cryptologic	\$43,550	\$34,427	\$44,211	42%	-6%	21%	18.9%
RealNetworks	\$182,679	\$202,377	\$266,719	-17%	-10%	-9%	-12.1%
Ultimate Software Group	\$55,149	\$60,416	\$72,028	-26%	-15%	-7%	-16.1%
Centra	\$33,400	\$43,041	\$38,064	-69%	-19%	-30%	-39.1%
Interwoven	\$126,832	\$111,512	\$160,388	-121%	-45%	-15%	-60.3%
Verisign	\$1,221,668	\$1,054,780	\$1,166,455	-393%	-22%	11%	-134.5%
NetIQ	\$278,239	\$310,224	\$261,645	-264%	-109%	-72%	-148.2%
Network Tools				-6%	-3%	6%	-1.0%
Citrix Systems	\$527,448	\$588,625	\$741,157	20%	26%	21%	22.5%
McAfee (Network Associates)	\$1,071,660	\$1,043,044	\$936,336	14%	11%	7%	10.8%
Altiris	\$62,876	\$99,339	\$166,565	-1%	13%	15%	8.9%
Novell	\$1,134,320	\$1,105,496	\$1,165,917	-6%	-3%	6%	-1.0%
NetManage	\$65,740	\$50,663	\$47,666	-26%	-9%	3%	-10.6%
Tumbleweed	\$25,525	\$30,595	\$43,438	-78%	-32%	-18%	-42.8%
Tarantella	\$14,220	\$14,006	\$12,488	-104%	-66%	-128%	-99.3%
Developer Tools				7%	12%	11%	10.0%
Pervasive Software	\$37,197	\$39,205	\$49,608	16%	17%	16%	16.2%
Progress Software	\$273,123	\$309,060	\$362,662	10%	12%	13%	11.7%
Sybase	\$829,861	\$778,062	\$788,536	7%	13%	11%	10.5%
BEA Systems	\$975,893	\$934,058	\$1,012,492	-2%	14%	17%	9.9%
Borland Software	\$244,379	\$295,236	\$309,548	8%	-14%	6%	0.1%
Raining Data	\$19,267	\$21,006	\$22,297	-84%	-0%	-1%	-28.5%
Red Hat	\$79,503	\$90,275	\$124,737	-170%	-19%	2%	-62.1%
Education				-1%	-3%	-0%	-1.4%
Renaissance Learning	\$131,232	\$130,544	\$114,048	36%	37%	30%	34.4%
Apollo Group	\$1,009,455	\$1,339,517	\$1,798,423	25%	29%	24%	26.1%
American Education Corp.	\$9,416	\$8,598	\$10,673	1%	13%	9%	7.9%
Plato Learning	\$74,391	\$82,192	\$141,801	-1%	-3%	-0%	-1.4%
Click2Learn	\$31,209	\$30,477	\$29,487	-35%	-34%	-20%	-29.8%
Saba Software	\$55,648	\$44,416	\$34,471	-46%	-39%	-36%	-40.2%
Docent	\$29,011	\$27,792	\$30,238	-221%	-88%	-36%	-114.9%
All companies (median)				-1.9%	0.3%	6.5%	1.6%

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

indirectly affect your cost of goods, pricing, and product reliability (perceived product quality).

Finally, you have to make financial (equity versus debt) and human resource decisions (types of employees, salaries, motivational techniques, and training) that impact the firm's ability to grow and create wealth.

How does the game's interface work?

Each player fills in a "decision template" between rounds. Typically, the players will need to make 10 to 15 decisions per round. The choices are then submitted to the simulator via the template. The simulator reviews each team's or player's decisions and assigns points based upon their relevance to the market. For example, if a participant chooses a brand feature that is of limited value to a particular segment, it would receive a small number of points. If they select a feature that offers great value to that segment, it would receive substantially more points.

Then, as the business grows the simulation gradually introduces new issues that the players must master. There are help files that discuss the nature of the decisions being faced, the issues to be dealt with, linkages with other decisions, and the tradeoffs to be considered.

A typical simulation is broken into six to 10 decision rounds representing up to a two-year period. Normally, a player is going to want to take at least an hour to finish a single round, though once the game is running they can take up to a week to complete their turn. The team with the most points wins; the system uses a balanced scorecard that allows you to measure your performance across the entire business.

What do you think the benefits of this type of system are to software and high-tech companies? And who's the audience you're aiming at?

"If you ask them, upper management often doesn't believe their mid-level people really understand how their business works."

—Chris Davis
Mindforge

The technology simulation is oriented towards product and marketing managers, people in finance, and sales personnel, but I think anyone who wants to understand a technology business should play. The system is a marvelous training tool that provides your employees with the opportunity to test concepts and theories virtually before they get near your bottom line. Middle managers tend to stay in "job silos" and not develop a lateral view of how a company operates and its interdependencies. The simulator requires that they consider all aspects of the business as they develop their go-to-market strategy.

Also, the system is excellent for teaching teamwork and collaboration if you follow our suggestion and play in teams with members from different groups from your company. And just about every person who uses Marketplace ends up truly understanding the value of cash flow and finances in a company's operations. The game has a loanshark if you run out of funds and you really don't want to meet him.

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Negotiation Tactics

By Nat Burgess, Corum Group

Mike Tyson once said “Everybody’s got a plan – until he gets hit.” In negotiating a deal, you need a plan that survives the stress of the first encounter and adds value during the negotiation process. You need to counter against common ploys while moving your agenda forward aggressively.

One of the most effective negotiating tactics is serial negotiations. Issues are presented one by one and you are pushed to solve them singly before moving on to the next. In this scenario, you don’t know how many issues there are and which ones are critical. Respond to this tactic by asking for all issues to be put on the table first, enabling you to understand and study them. This allows you to shuffle and prioritize, enabling you to stage issues so that the buyer can win ones you care little about while you focus on winning points important to you. Inevitably, you will be left with a few big disagreements to hammer out, but in the meantime you’ll have minimized your upfront concessions.

Another effective ploy is “Bad News/Good News”. This begins with a negotiator outlining a doomsday scenario which kills the deal because of one “major” problem . . . and then proceeds to give you the “good news”—a compromise that involves substantial concessions (from you). In a recent example, a buyer agreed to purchase our client but then learned they were arguably infringing on a patent. The buyer opened negotiations with a worst case scenario in which the patent owner obtains a temporary restraining order and puts our client out of business. He argued it would be in our client’s interest to cut their price by 30% to compensate for the patent risk.

On closer examination, we discovered that the patent holder had recently lost an infringement case and was now being acquired by a company that had never tried to enforce its patents. Rather than cut the price, we threatened to walk away from the deal and ultimately closed at the negotiated figure.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Integrated Distribution Solutions • Provides distributors with a ERP solutions	Retalix, Ltd.	\$44,000,000 Terms: Cash,stock/earnout ¹	\$27,400,000	1.61
Concord Communications • Network management solutions	Computer Associates	\$256,790,000 Terms: All cash	\$106,190,000	2.42
IntelData • Online banking and bill payment	Corillian	\$21,600,000 Terms: \$17.1 MM stock/\$4.5 MM cash	\$50,080,000	0.43
AttentiV Systems Group • Software solutions/services for the financial services sector	TietoEnator	\$88,190,000 Terms: All cash	\$60,750,000	1.45

1. \$34.4 MM cash, \$7.0 MM in stock, \$5.0 MM earnout

Spam Filter Checkers

- **Efiltrate** (www.e-iltrate.com): Site offers a series of services and software designed to help you sheperd legitimate E-mail through the various spam filters. Site's writing is overwrought, but the services are legitimate and well thought of.
- **eNetplace** (www.enetplace.com/spam-checker.html): Site provides a free E-mail spam checker service.
- **Filterbuster** (www.filterbuster): Site offers some good practical advice on avoiding phrases and words that will trigger E-mail filters as well as a software product that scans your copy.
- **Imedia** (www.imediaconnection.com/content/3649.asp): Site offers good, up-to-date information on current spam filter practices and suggestions on how legitimate E-mails can avoid being flagged.
- **Lyris** (www.lyris.com/contentchecker/): Site incorporates SpamAssassin's rules into a form you submit your E-mail against; your E-mail is then checked for "spamminess."

JUAN-ANTONIO CARBALLO of IBM's VC group on "open hardware": "The open-source model is quickly extending from software to hardware, and it will provide a similar swell of collaborative innovation." (Quoted in InformationWeek, 04/08/2005)

MITCHELL DAVIS, CEO OF MASSIVE, on advertising in computer games: "As you move through levels and zones you'll see fresh advertising. You might see an ad for Mötley Crüe one minute and for T-Mobile the next." (Quoted in The New York Times, 04/11/2005)

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customer@softletter.com

STEVEN WEBER, director of the Institute of International Studies at UC, Berkeley, on intellectual property: "The business world today is engaged in a huge experiment in figuring out what different parts of intellectual property should be open and closed. The fate of many companies, and the strength of national economies, will depend on how the experiment turns out." (Quoted in The New York Times, 04/11/2005)

SUN EMPLOYEE TIM BRAY on web log practices: "Once again, it's all about judgment: using your weblog to trash or embarrass the company, our customers, or your co-workers, is not only dangerous but stupid. Many bloggers put a disclaimer on their front page saying who they work for, but that they're not speaking officially. This is good practice, but don't count on it to avoid trouble; it may not have much legal effect." (Quoted on www.tbray.org/ongoing/When/200x/2004/05/02/Policy)

BILL GURLEY, GENERAL PARTNER, BENCHMARK CAPITAL, on massively multiplayer online role playing games (MMORPGs): "Multiplayer online role playing games are an insanely profitable business." (Quoted on www.itconversations.com/shows/detail327.html)