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BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Wireless technologies found the most favor with VCs in our Q4 investment report
See pages 4-5.

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The New High-Tech "Bubble" (Not the Same as the Old)

In our 03/15 issue of Softletter we published an article in the M&A section that discussed the appearance of what to many seems to be a new bubble in the software industry. Signs of this bubble include a hiring crunch, soaring salaries, an M&A feeding frenzy, and an accelerating push by NASDAQ to launch a new generation of tech companies into the public market. One industry veteran we spoke to told us that "people outside the Valley don't understand how crazy things have gotten. It is like 1999 all over again."

Actually, we disagree in part with this assessment; what we're seeing is not so much a bubble but another major shift in the industry's underlying business models and assumptions. SaaS, Open Source, and the graying of the "traditional" software industry are driving significant changes in how products are being are being bought and sold. The industry has been through this before in the late 1980s, when the growth of Lotus, WordPerfect, Borland et al forced many smaller companies out of business. Then the Windows Wave destroyed the relative parity among the big software players and Microsoft became the new IBM (while for a period IBM became the new GM). There may be a couple of more Googles yet to appear on stage, but we're not going to see the speculative wave that appeared in the wake of the Netscape IPO reappear. But for some companies, the good times are back.

*We caught up with Nat Burgess of the Corum Group as he was gearing up to attend the World Financial Symposium's (www.worldfinancialsymposiums.com) fourth annua**l Growth and Exit Strategies for IT Companies** conference (Santa Clara, April 27) to discuss how high-tech's return to high spirits is impacting M&A trends.*

On the reduced number of suitors in the M&A market.

For CEOs who view M&A as their ultimate exit, the ongoing consolidation in the industry is reducing the number of potential buyers. During the Internet bubble there were multiple software companies in every market bringing competitive bids to nearly all of the deals. As an example of how much has changed, consider that in the old days you might have made calls to Siebel, Retek, Peoplesoft, JD Edwards, Vantive, Datalogix, or maybe G-Log. Today, instead of eight calls you only have to make one and if Oracle isn't buying, you may need to rethink your strategy.

With over 1,000 companies bankrupted, *(continued on page three)*

Advisory Board

Increasing QA Costs Squeeze Bottom Lines, Part II of II

by Merrill R. Chapman

(A reader of Part I of this article took me to task for using "Q&A" instead of the far more widely used "QA." When I entered the industry in 1978, Q&A was in wide use as an acronym for "quality and assurance." However, I am clearly behind the acronymal times and from now on it's a QA world around here!)

As a follow up to last issue's snap poll on current QA costs as a percentage of the overall cost of development, we asked our poll participants to project how much of their development budget will be dedicated to QA within two years. We decided to add SaaS-only firms to the mix.

Company Size	Development	Q&A
10M+	70%	30%
50M+	65%	35%
70M +	50%	50%
SaaS (10M <=)	45%	55%

Note that QA costs for larger firms are projected to rise to 50/50, while smaller companies feel the current ratios will hold (we disagree, BTW). The reason for the increased emphasis on testing on the part of SaaS firms was succinctly explained by a company that told us that "with a traditional software product, a bug can impact one company. In our environment, a serious bug can bring all of our customers, and potentially our business, to its knees. This stuff just has to work."

A logical approach to decreasing QA cost is automation, and several companies, most notably Mercury, provide script-based systems designed to flush out potential problems before they ship in your code. I've personally worked with scripting systems and while they're effective in many cases, they also tend to be expensive (a single Mercury seat can run between $10 to $12 thousand per seat) and smaller developers often can't afford them. Also, in order to be used to their full capacity, scripts require extensive programming. Another challenge is that scripts tend to run down a "single track" and aren't good at adapting to even simple changes in the underlying code base. As a result, many firms won't use test scripts till a product has become fairly stable and "scriptable." To reach this state, most firms fall back on manual testing.

On possible answer to this dilemma may lie in a new testing product we recently previewed from Aberro Software (www.aberrosoftware.com). The product is called AberroTest and from what we saw, it's worth your QA time to review. The product operates by scanning your application and inventorying its control codes. You then "hook" data to the control points and create your verification and rules tests via an editor. Most of the setup is non-programmatic and is done via drag and drop. Once complete, AberroTest drives your product via its control codes down multiple paths while logging errors; this happens at very high speed. I think the product is particularly useful for smaller companies who have tight development budgets and am somewhat surprised I haven't seen a product like it to date.

bought or out to pasture, buyers are few and sober, and the competitive dynamic has diminished. In several recent deals that should have seen Google, Yahoo and Microsoft competing, Redmond wasn't even a factor; they pulled their head under their shell and let the deals go by. In the business software market "value buyers" (bottom feeders) are calling the shots, pricing assets as though they were riddled with asbestos. Even though the tech M&A market has surged, it has a different dynamic from the bubble market, and requires different tactics. In the "old" days, we would fly in fast and hard, educating competitors on the deal while playing the buyers off one another. We would set deadlines and raise the price as the bidding went up.

"Let me tell you how I learned to love the bubble. In 1999 "old line" companies merged, young companies were bought, new companies generated massive market capital and disrupted the status quo, and smart, well-prepared CEOs took advantage of the surging market to generate unprecedented wealth for themselves and their shareholders."

— Nat Burgess
Corum Group

Now we focus more on selling individually to each buyer, stressing value proposition and earnings opportunity (yes, the current market requires that transactions contribute to earnings). Also, patience has become a virtue. With the exception of a few hot deals, buyers are currently taking their time, kicking the tires, analyzing all aspects of a transaction.

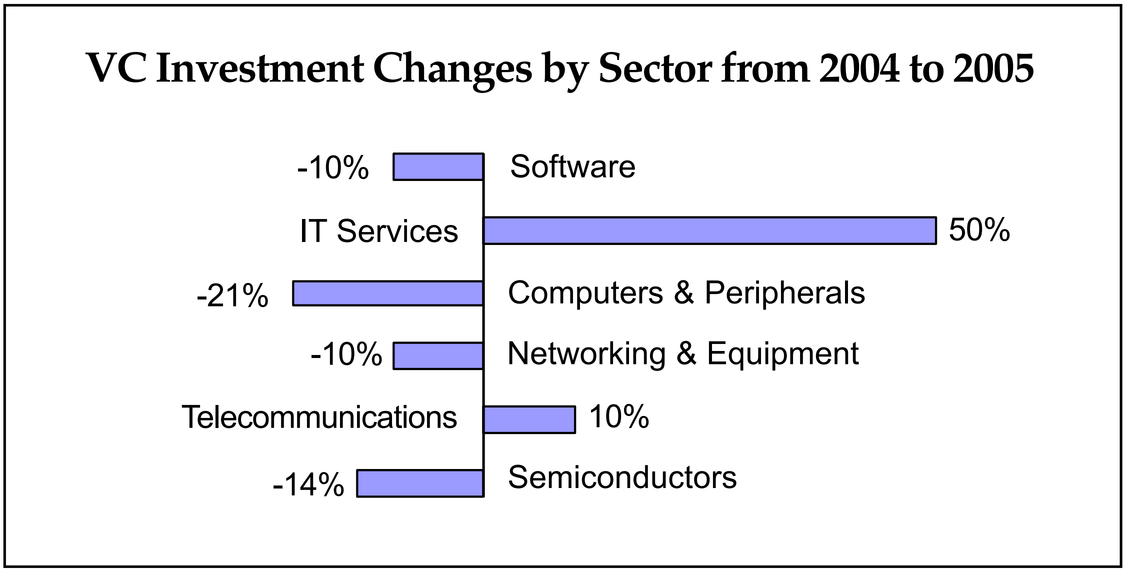
One encouraging trend in the midst of ongoing consolidation is a willingness among buyers to give their newly acquired subsidiaries a measure of autonomy in chasing deals. For example, simply because Adobe bought Macromedia, don't assume that all M&A goes through Adobe. Acquisitions that support Macromedia's product and channel strategy will continue to be championed by the Macromedia teams within Adobe, and smart sellers will parse out acquiring companies and approach multiple groups within those companies.

On Google's impact on M&A.

While the total number of publicly traded acquirers has diminished, new buyers have emerged. Google is not a trend; it is more of an event. With a bright, aggressive team of dealmakers and lawyers, buoyed by the "Google Halo," the company is arguably the most effective M&A player in the market today. I was involved in a deal recently in which three companies made offers. Two of the offers were highly contingent, had all sorts of exits built in, and anticipated a 60-day timeline to close. The third company offered a cash price and a two-week close. That company was Google and, impressively, they got it done in the promised time frame.

But as active as Google has been, they will only go after a very limited group of deals. They turn down a lot of transactions because the teams running the target companies are "not Google hires." In other words, every transaction must also be supportable as a recruiting exercise.

The other buyers stepping into the public company gap are private equity firms and their portfolio companies. J.L. Halsey, Made2Manage, and Sophos are just three examples of the many private firms out there looking for deals. These companies are harder to reach by definition; as private companies they disclose *(continued on page six)*



Benchmarks: Q4 Venture Capital Investments

Each quarter Softletter presents the fifty largest VC investments in a previous quarter. The material in this report is largely drawn from the Money Tree Survey by PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association, and generally confirmed or modified by other sources. In our research this quarter we noted the stealthiness of a few deals which were not announced until the following quarter. And the biggest deal of all that PWC reported, $41m by Insight Venture Partners to SolarWinds.net, we were unable to confirm. While the Insight Web pages list SolarWinds as an investment, no news or press releases have appeared on the deal, and SolarWinds denies on its Web site that it takes any venture funding, while maintaining on the telephone that they know nothing about the $41m deal. We were sorry not to be able to list it.

2005 saw 38% more money ($25.2b) raised by VC firms than in 2004, but total VC investments remain level. The amount of IPO money raised in 2005 ($4.5b) was 60% less than in 2004, apparently due to Sarbanes-Oxley and associated costs.

While the total amount of VC money invested in 2005 was only 0.2% less than that invested in 2004, distribution by sector changed over that period. Software remains the largest investment category, just ahead of biotechnology, but Software is down 10% from 2004 (Biotechnoogy is down 6%). Networking and Equipment is likewise down 10%, and Computers and Peripherals down 21%, but IT Services is up by 50%. Investments in SaaS companies are now 10% of Software investments, according to TripleTree Investments, who expect the SaaS category to absorb nearly $1m additional venture capital in 2007. The $460m invested in SaaS is not the only sign of changing technologies, business models, and development methods taking hold: Open Source software investments were $144m for the first three quarters of 2005, and wireless-related companies received $1.3b, an 18% increase over 2004. Wireless is now 7% of total VC funding.

Fenwick & West analyzed 118 4Q 2005 deals in the Bay Area and reported that uprounds are 67% of deals (average 81% increase in value), and >20% are downrounds (average drop of 56% in value). Most of these downrounds are in the later stages of financing. Uprounds indicate that most software companies are hitting their milestones.

The Top 50: Software Venture Capital Investments—Q4, 2005

	Company	Business Focus	Lead Investor	Investment
1	Barracuda Networks	Network firewalling for e-mail security	Sequoia and Francisco Partners	$40,000,000
2	DivXNetworks	Video compression applications	Insight Venture Partners	$17,000,000
3	Code Green Networks	Content protection solutions	Sierra Ventures	$15,000,000
4	NetContinuum	Web transaction security	Menlo Ventures	$15,000,000
5	H5 Technologies (Ejemoni)	Document review and analysis for litigators	Institutional Venture Partners(IVP)/WaldenVC	$15,000,000
6	SpikeSource	Open Source LAMP stack.	Duff Ackerman & Goodrich	$15,000,000
7	iPolicy Networks(PolicyOne)	Network firewall and security apps.	Ignite Group	$15,000,000
8	Logical Apps	Financial controls automation	Sequoia Capital, Mission Ventures	$14,000,000
9	GeoDigm Corp.	Laser-scanning for dental models	Affinity Capital Management	$14,000,000
10	Terracotta	Virtualizes JVM across multiple servers	Goldman Sachs & Co.	$14,000,000
11	INetCam	Multimedia apps. for wireless devices	Equal Elements	$12,500,000
12	Pure Networks (DynaCenter)	Home-networking software	Bessemer Venture Partners	$12,500,000
13	Demandware	On-demand e-commerce solutions	General Catalyst/North Bridge	$12,300,000
14	Antenna Software	On-demand enterprise mobility solutions	Polaris Venture Partners	$12,000,000
15	Mirage Networks	Network security on end-points	Rembrandt Ventures	$12,000,000
16	Edge Dynamics	Channel commerce management	Greylock Partners	$12,000,000
17	iBrix	Software and services for cluster computing	[undisclosed]	$11,400,000
18	Mimosa Systems	E-mail data management	JAFCO Ventures	$11,000,000
19	Intelliden (Continuum)	Network automation systems	Matrix Partners	$11,000,000
20	Kasenna	Video content, svcs. delivery via Internet	Intel Capital	$11,000,000
21	Ensenda	Outsourcing last-mile same-day delivery svcs.	Bay Partners/Alloy Ventures	$10,700,000
22	Peppercoin	Enables card-based micropayments	Wall Street Technology Partners	$10,500,000
23	ForeScout Technologies	NAC & Intrusion Prevention	Amadeus Capital Partners	$10,200,000
24	Metallect Corporation	Locates software interdependencies	Apex Venture Partners	$10,200,000
25	Agitar Software (TestAgility)	Systems to automate software testing	Globespan Capital	$10,000,000
26	Soapbox Mobile	Mobile marketing (m-commerce) solutions	Equal Elements	$10,000,000
27	SignaCert	Trust-based computing services for enterprise	DCM-Doll Capital Management	$10,000,000
28	SecureInfo Corporation	Information security programs	Insight Venture Partners	$10,000,000
29	Razorsight (Nexus)	Financial data capture, mining, auditing	Sierra Ventures	$10,000,000
30	Intransa	Data storage solutions	U.S. Venture partners	$10,000,000
31	Fortify Software	Prevents inclusion of security flaws in software	Kleiner Perkins Caufield & Byers.	$10,000,000
32	PanGo Networks	Wi-Fi-based real-time location systems (RTLS)	Investcorp's Technology Investment Group	$10,000,000
33	N8 Systems	Requirements validation for developers	Alloy Ventures/Palomar Ventures	$9,700,000
34	Axeda Corporation	Device relationship mgt. software and services	JMI Equity	$9,600,000
35	StrongMail Systems	E-mail infrastructure software	Globespan Capital Partners	$9,500,000
36	Attensa (You Software)	RSS network infrastructure software	RSS Investors	$9,000,000
37	Olive Software	XML automation technologies	Pitango Venture	$9,000,000
38	Trust Digital, LLC	Enterprise mobile security software	BCE Capital	$9,000,000
39	Game Trust	Financial mgt. for online games, contests	TWJ Capital/NJTC Venture Fund	$9,000,000
40	Simply Hired	Vertical search engines for job databases	Foundation Capital	$9,000,000
41	IMVU	Consumer Internet media sales	Menlo Ventures	$9,000,000
42	T3Ci	RFID analytics and applications for retail	Bessemer Venture Partners (BVP)	$8,750,000
43	Evil Twin Studios	Multiuser online entertainment environment	Trident Capital	$8,200,000
44	Fanfare Group, The	Automates QA functions	Matrix Partners	$8,000,000
45	Interactions Corporation	Automated interactions for call centers	Updata Partners	$8,000,000
46	Akimbi Systems	Virtual infrastructure management solutions	Mayfield Fund	$8,000,000
47	NewForma (AEC1)	Project collaboration software for architects	North Bridge Venture Partners	$8,000,000
48	IntelliVid Corporation	Automated analysis of video surveillance	Intel Capital	$8,000,000
49	BioPassword (BioNet)	Authentication via keystroke dynamics	Ignition Partners/OVP Venture Partners	$8,000,000
50	BBS Technologies (Idera)	Management tools for MSFT SQL Server	Austin Ventures	$8,000,000

little of their financials or strategies. Reaching the right company with the right message requires determined networking.

"Listen carefully to Salesforce.com and try and get a handle on how they promote their value to their customers. There is no simple SaaS formula, but there is a fundamental difference in how SaaS companies think. They sell their customers on being a long-term technology partner. They focus on ongoing business value, rather than one-time solutions."

— Nat Burgess
Corum Group

So far, not a lot of good news for mature, privately held software companies. Fewer buyers, less competition, longer times to close, highly selective new buyers (such as Google), and a challenging landscape of private firms that might be buyers, but only if you reach the right one. But one of the highest valued acquisitions of a mature software company last year involved a seller who is still on the **DOS** platform, Payroll Associates. The company established a powerful market position by acting as a backend to payroll service bureaus. Before we all get brainwashed into believing that customers buy solutions based on platform, throw up our hands and become Microsoft resellers, let's remind ourselves of one thing: software companies that carve out a defensible position in the value chain and offer ongoing value to their customers will always be attractive targets, irrespective of platform. And, if like our payroll processing company on the DOS platform, they have successfully adapted to the SaaS model, the value will go up dramatically.

The impact of SaaS on M&A and VCs.

We have a transaction currently in LOI (letter of intent) that illustrates the SaaS impact on the industry. This involved a traditional software vendor targeting the manufacturing industry that had built themselves up to about $5 million in revenue that was valued at about...$5 million. Starting in 2000 they bit the bullet and switched over to a SaaS model. Revenues plummeted, expenses skyrocketed, and the company was on the verge of bankruptcy for two years. Last month they went into the preliminary LOI with an acquirer at a valuation close to 10 times more than what they would have been worth under their old model.

"SaaS is more important than the trends that were discussed early in this article. Although the competition for deals has diminished, valuations on average have gone up about 20% in the last 12 months, and valuations for companies with strong recurring revenue models have gone even higher."

— Nat Burgess
Corum Group

As I prepare for the *WFS Growth and Exit Strategies* conference we're finding that the central, unifying theme is SaaS. Salesforce.com's John Smorjai will present on his company's acquisition strategy, but let me summarize it here: if the target doesn't support a SaaS strategy, they aren't interested. NASDAQ's William O'Brien (SVP of New Listings) will present on new tech companies coming to NASDAQ, but here is an interesting fact: currently, and for the last 18 months, software companies without a recurring revenue model need not apply. Adobe continues to dominate the desktop graphics market, but users of their new products will note that Adobe is now the front end to stock photo agencies, and is becoming more deeply embedded in its customers' ongoing businesses—laying the framework for a recurring revenue model.

I spoke at an event in New York last month that included a VC panel. One by one the panelists said "we only invest in companies that have a recurring revenue model."

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Equities

When to Dig In Your Heels During Negotiations

By Ward Cater, Corum Group

In a perfect world, a merger with a strategic buyer flies through negotiations and due diligence, closing rapidly. Unfortunately, the reality is there are many points to successfully negotiate, and many chances for negotiations to falter, or for a deal to fall apart. In order to successfully navigate this process, you need to understand your own limits on a number of key issues. Having a good feel for what will it take to get the deal done, the things you are willing to give on and what things are dear to you, will give you a foundation for successful negotiating. It will also give you the basis for deciding when you need to dig in your heals and take a firm stand.

A good example is negotiating the indemnification provisions of a purchase agreement for the sale of your business. In order for you to have a realistic perspective on when to back down, or when to push your position further, you need to know what terms are customary, and the logic behind that position. For example, if you reject any escrow provision to provide a remedy in the case of a breach of representations and warranties, you will probably find yourself in a heated debate with the buyer, who will normally expect such provisions. If you understand that an escrow is customary, and that the buyer in past deals has typically required a 20% escrow held for one year, you can negotiate from a position of knowledge. Do you push for no escrow? Well, you can always try, but better to press initially for a lower percentage, say 10% of the deal's value. You know that the buyer will probably demand more, but probably not more than "historic" numbers. Now during negotiations you know you are not being unreasonable to accept the 20% number, assuming other terms are appropriate, and that becomes the point where you can dig in your heels. You can take a tough negotiating position armed with the knowledge that you are being reasonable and prudent, not leaving dollars on the table and not taking an undue risk.

Know your limits going into M&A negotiations. Sticking points typically include indemnification provisions (and acceptance of risk), escrow terms, deal value, form of transaction consideration, tax matters, and many others. Anticipate issues in order to smooth the negotiation process and get to the goal of closing the deal.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Reality Based IT Services	SYS Technologies (SYS)	$9,500,000	$8,400,000	**1.13**
• *Network security solutions*		*Terms: Cash and stock*		
Netcentrex SA	Comverse (CMVT)	$180,000,000	$50,000,000	**3.60**
• *VoIP network communication services*		*Terms: Cash and earnout*		
Sendia	Salesforce.com (CRM)	$15,000,000	$2,000,000	**7.50**
• *Wireless application technology company*		*Terms: Cash*		
Portal Software	Oracle Corporation (ORCL)	$220,000,000	$104,700,000	**2.10**
• *Billing and revenue management*		*Terms: Cash*		

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More New and Interesting Reads

- ***The Practical Manager's Guide to Open Source*** by Maria Winslow, Open Source Migrations, 2005. This book is widely read by IT groups considering migrating or incorporating Open Source into their companies. As such, we suggest you read it in the event you are offering an Open Source product or compete with Open Source vendors in your market. Of particular interest is chapter four, where the author describes a flexible methodology for generating ROI figures for the use of Open Source. However, we suggest not spending too much time on the sections that deal with Open Source on the desktop; in our opinion, Linux will never be a significant player in this arena and the growth of SaaS moves this issue into one of fighting yesterday's battles.
- ***Cube Farm*** by Bill Blunden, Apress, 2004. A dark but entertaining look at the internal workings and politics of ERP software vendor Lawson Software in the period leading up to Y2K. If you're a student of the art of corporate infighting and empire building, a must read. Enjoy the hilarious description of how the development group stripped all comments from the main product's source code.

FORMER APPLE DIRECTOR OF FEDERAL SALES DAVID SOBOTTA ON APPLE'S ENTERPRISE VIEWPOINT: "Just remember if you buy Apple for your enterprise, you'll be on your own. The products are great, but they come from a died in the wool consumer company which more and more butters it bread with products like the iPod. Consider yourself warned." (Quoted in ***CRN***, 03/21/2006)

FORRESTER HEAD GEORGE COLONY ON BILL GATES: "Bill Gates knows how to compete with anyone who charges money for products but his head explodes whenever he has to go up against anyone who gives away products for free." (Quoted in ***The Economist***, 03/30/2006)

KLEINER PERKINS CAULFIELD VC RAY LANE ON THE STATE OF THE SOFTWARE INDUSTRY: "The industry has the largest no man's land in history. The top 25 companies are leaders with continuous innovation. There are thousands of startups, a fraction of which are doing fundamental innovation, and a couple of hundred attacking the current paradigm. That leaves 5,000 companies competing against big companies or startups." (Quoted on http://blogs.zdnet.com/BTL/?p=2816, 04/05/2006)

RUBICON CONSULTING PRINCIPAL MICHAEL MACE ON SAAS SELLING MODELS: "The selling and marketing model changes profoundly if you're trying to get an online service deployed virally in companies via end users, as opposed to selling down through IT managers. Most of today's enterprise software companies don't have a clue how to sell this way, and it makes them extremely uncomfortable. This is an area where I think Microsoft has an advantage over an Oracle or SAP, because it has a strong consumer business. We'll have to see if it can deploy that skill set to its advantage." (Quoted on http://mobileopportunity.blogspot.com/, 04/05/2006)

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