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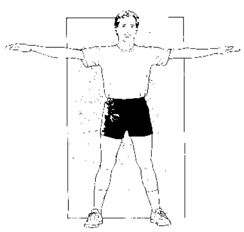

Our benchmark report reveals R&D costs are trimming down and consuming fewer corporate resources See pages 4-5.

The Micro-ISV Father Discusses the Kids

Eric Sink is the founder of SourceGear, publisher of source control system Vault, one of the industry's most popular alternatives to Microsoft's SourceSafe product. In 2002, ***Inc*** *magazine honored the company as one of the 500 fastest growing privately held firms in the US.*

Eric is also the father of Open Source AbiWord, a product which generated much buzz in the industry but no cash. The effort served as yet another example that if you want to make the big money, building the hot products of the 80s (word processors, spreadsheets, presentation products and databases) in the late 90s and today is probably not the way to go. (We must admit we laughed when we looked up the Wikipedia entry on AbiWord and read about the whining that went on over the first version's lack of tables; readers of ***In Search of Stupidity: Over 20 Years of High Tech Marketing Disasters****, which discusses the damage the lack of this feature did to WordStar, will appreciate why we found this funny.) Eric also worked on Spyglass, and led the development team that produced the browser that later grew up to be Internet Explorer.*

Eric's other main claim to fame is that he coined the term "Micro-ISV," a phrase which is increasingly being used to describe entrepreneurs who want to enter the software market with new ideas and products. He's recently had his first book published, ***Eric Sink on the Business of Software*** *(Apress, 2006). We've read it, it's an excellent book, and we strongly recommend you buy a copy. We caught up with him to discuss the Micro-ISV concept and to get his take on industry trends and developments.*

Why do you think the term Micro-ISV has become so popular?

I have to guess it's because it offers firms the implicit hope of growth; that resonates with people. The idea of a company being small is not that interesting. The idea of being a software vendor, as opposed to a shareware or freeware company, is more appealing.

Your blog, Eric.Weblog() (http://software.ericsink.com) has become very popular and you've stated it's modeled on Joel Spolsky's very successful JoelonSoftware website. For several years JoelonSoftware served as the primary marketing vehicle for his firm, FogCreek Software. Has your blog had a similar impact?

It's certainly had an impact, but it's not our primary marketing vehicle. The three marcom activities that have worked best for us are tradeshows, print advertising, and PR. *(continued on page three)*

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Harsh Shelves: The Retail Realm Becomes Grimmer, Part II of II

by Merrill R. (Rick) Chapman

To understand the continued value of retail to some software companies, we spoke with Larry Kuperman, sales head of Stardock. Stardock began its life as an OS/2 developer and survived the collapse of the operating system quite nicely. Today, Stardock is a flourishing software company with over 40 employees. On the business side, the company's primary product is its Object Desktop suite of Windows customization products; on gaming, Galactic Civilizations is a franchise.

StarDock, bucking the trend, has just released two new titles into the retail market, KeepSafe, a file protection product that automatically archives different versions of files based on your assigned criteria and Multiplicity, a very neat system that allows you to control up to seven computers from a single keyboard with the ability to cut and paste information and files between them (set it up with your laptop and desktop system and see how much more productive you can become). In our conversation with Larry, he made the following points about the continued value of maintaining a retail component in Stardock's overall sales strategy:

- **Retail presence increases the public's awareness of products across broad market segments.** "There are still portions of the market that are more comfortable with retail. Being in retail also bestows a certain legitimacy in the eyes of not only the public, but decision makers at corporations as well. And PC games absolutely require a retail presence," Kuperman states.

- **Retail influences "E-tail."** "The revenue split at StarDock between E-tail and retail is about 85%/15% in E-tail's favor. Our retails sales **are** profitable. But many people who buy online tell us they won't buy a product electronically unless they see it on retail shelves first."

- **The retail distribution system is necessary to open up the corporate channel.** "While it's fashionable to gripe about the value of the distributors, we've found that companies such as TechData and Ingram have been valuable in reaching the corporate market," Kuperman notes. "Their internal sales forces can build awareness of your products under the right circumstances. But on a more practical level, corporate purchasing groups already have these distributors in their systems, they're going to pay via a PO, and they're simply not going to add me to their payables list."

- **You don't have to be everywhere.** "At one time Galactic Civilizations was the largest selling software product in Wal-Mart and when you have that type of momentum, you should push for a wide channel. With business applications, we tend to focus on the office stores."

- **Remember that your online business should mesh with your retail sales.** "The distinction between retail and E-tail is blurring," Kuperman believes. "If someone loses or damages their CD, they can come to Stardock directly and download a replacement copy. This offers us a significant opportunity to cross sell other products and upgrades to our customers."

Larry Kuperman, sales manager, Stardock, 15090 Beck Road, Ste. 300, Plymouth, Mich. 48170; 734-927-0677. E-mail: lkuperman@stardock.com. Website: www.stardock.com.

That's interesting. These venues are routinely dismissed by pundits, but in our experience, for firms like yours, these approaches remain highly effective.

It's hard to beat tradeshows for generating quality leads. As for print advertising, while it's expensive and it's difficult to track precisely where a sales lead is coming from, the fact remains that it works. As for PR, having the press write about you for free via case studies and user stories is a lot cheaper than paying for advertising.

What about Internet advertising?

The truth is we haven't done much of it. We have experimented with Google ads with good results and high click-through rates. We've been able to obtain high keyword rankings for terms such as "source control" and "version control." But I've been managing the process and I've been too busy to stay on top of it.

in "Business" you state that you're not really a fan of hiring what you call a "sales guy" before you think a company is ready to do so. Is SourceGear ready to hire a sales force?

Yes, we are. We've just hired our first salesperson, someone who has the capacity to both sell and manage a sales force. This is a big transition for us; we're growing from 10 to 30 people and mindsets are going to have to change.

In "Business" you make the observation that good sales people are motivated strictly by money, while a development group may have very different goals and aspirations. How are you planning to manage the culture change in the company?

Well, first by acknowledging that there will be a culture change. We're putting an education process into place, one that explains the value of a sales force, what they do, and how they approach their jobs. Also, I believe it's important to reassure the developers that "your job will not change."

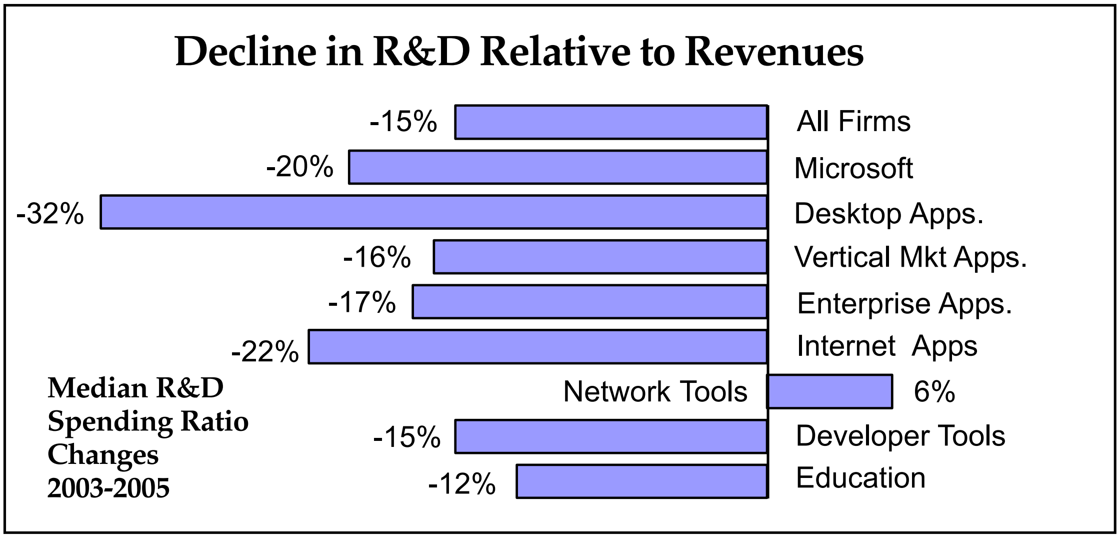
What about VC investment? How do you feel about looking for outside funding? In your book, you mention that when you were at AbiWord you signed a contract with a "weasel" who promised to put you in touch with investors but didn't deliver and charged you $40,000 to cancel the contract.

Despite that gruesome experience, I've reopened my mind on the topic of VC investment. We're not that far along the path where we're searching for an investor, but we're open to the concept and the right opportunity.

Let's talk about the impact of some major developments in the industry on your company and *(continued on page six)*

"When I think about my next startup or two, I see SaaS as very interesting. One thing you should remember is that you can't take the infrastructure costs lightly. Any Micro-ISV should be thinking about whether they're fully prepared to provide 24/7/365 access with zero downtime."

—Eric Sink
Source Gear



Benchmarks: Research and Development

R&D is consuming fewer corporate resources nowadays. The chart above shows the relative changes by software industry segment from 2003 to 2005, based on each segment's median share of revenue spent on R&D in those years.

Other looks at data collected by ***Softletter*** from 2001-2005 confirm the trend. The drop can be seen in the 2005 figures compared against 2001, but because this represents only two years of a six-year period, we present the table below which smoothes the R&D expenditures by using the averages of median segment expenditures for 2001 to 2003 and 2003 to 2005.

Average R&D Share of Revenue	**2001-2003**	**2003-2005**	**Change**
	Percentages		
Microsoft	15.7	18.3	+16.6
Desktop Applications	24	20.3	-15.4
Vertical Market Applications	18.9	17.4	- 7.9
Enterprise Applications	18.4	16.4	-10.9
Internet Applications	27	20	-25.9
Network Tools	17.1	16.7	+ 2.3
Developer Tools	19.6	19.6	no change
Education	24.5	15.5	-36.7
All companies	**20.2**	**18.8**	**- 6.9**

The change does not mean that software companies are gradually doing away with R&D and letting their technological leads melt away. This drop instead shows that software revenues are more dependent upon services elements than they formerly were. Six years ago, selling the box repaid the R&D. Nowadays, Software as a Service (SaaS) and support services (training and help desks, for instance) are bringing in a greater share of revenue, and these in turn are backed not by investments in R&D but by investments in people and equipment to provide the increased services.

Data for this analysis has been drawn from the Benchmark 50, a group of 50 public software companies whose financial results are broadly representative of trends in the software marketplace. The 50 companies are divided into seven product- and market-related segments, plus Microsoft in a category of its own.

The Benchmark 50: Research and Development

	Revenues (000)			Return on Equity			Avg.
	2003	2004	2005	2003	2004	2005	'03-'05
Microsoft	$32,187,000	$36,835,000	$39,788,000	**20%**	**19%**	**16%**	**18.3%**
Desktop Applications				**25%**	**19%**	**17%**	**20.3%**
Intuit	$1,597,071	$1,802,224	$2,037,703	16%	15%	15%	15.3%
Macromedia	$336,913	$369,800	$436,168	28%	25%	23%	25.2%
Adobe	$1,294,749	$1,666,581	$1,966,321	21%	19%	19%	19.6%
Symantec	$1,406,946	$1,870,129	$2,582,849	38%	14%	13%	21.3%
IMSI (Int'l Microcomputer)	$8,095	$10,017	$13,874	17%	20%	12%	16.5%
Nuance Commo. (Scansoft)	$135,399	NA	$232,388	25%	NA	17%	21.0%
Smith Micro	$7,216	$13,316	$20,258	35%	19%	20%	24.5%
Vertical Market Applications				**19%**	**17%**	**16%**	**17.4%**
Autodesk	$951,600	$1,233,800	$1,523,200	22%	19%	20%	20.4%
Moldflow	$36,625	$48,673	$64,418	15%	13%	12%	13.7%
Ansys	$113,535	$134,539	$158,036	21%	20%	19%	20.0%
Advent	$137,159	$149,990	$168,701	25%	22%	18%	21.7%
Dendrite	$321,107	$399,197	$437,240	4%	2%	1%	2.5%
MapInfo	$106,255	$124,673	$149,424	19%	17%	16%	17.4%
Kronos	$397,355	$450,694	$518,658	10%	10%	10%	9.7%
Enterprise Applications				**18%**	**16%**	**15%**	**16.4%**
Concur Technologies	$56,737	$56,550	$71,831	18%	16%	13%	15.6%
Manhattan Associates	$196,814	$214,919	$246,404	15%	14%	15%	14.6%
Knova Software (ServiceWare)	$11,511	$12,502	$23,595	17%	18%	24%	19.5%
Mercury Interactive	$400,122	$506,473	$685,547	11%	11%	11%	10.8%
Witness Systems	$108,037	$141,335	$185,371	24%	15%	19%	19.3%
SPSS	$208,367	$224,074	$236,063	21%	21%	19%	20.6%
Business Objects	$560,825	$925,631	$1,077,151	22%	16%	15%	17.9%
Internet Applications				**23%**	**20%**	**18%**	**20.0%**
Cryptologic	$44,211	$63,714	$86,307	NA	NA	4%	3.8%
RealNetworks	$202,377	$266,719	$325,059	24%	20%	22%	21.6%
NetIQ	$264,138	$217,000	$213,216	22%	26%	24%	23.7%
Verisign	$1,017,345	$1,118,306	$1,609,494	5%	5%	6%	5.6%
Ultimate Software Group	$60,416	$72,028	$88,603	30%	25%	23%	26.1%
WebEx Communications	$189,341	$249,133	$308,422	14%	14%	15%	14.3%
Interwoven	$111,512	$160,388	$175,037	27%	19%	18%	21.3%
Network Tools				**16%**	**17%**	**17%**	**16.7%**
Citrix Systems	$588,625	$741,157	$908,722	11%	14%	13%	12.6%
McAfee (Network Associates)	$936,336	$910,542	$987,299	20%	19%	18%	19.2%
iPass	$136,078	$166,319	$169,373	8%	9%	10%	8.9%
Novell	$1,105,496	$1,165,917	$1,197,696	16%	17%	17%	16.7%
Altiris	$99,339	$166,565	$187,640	25%	19%	23%	22.4%
Tumbleweed	$30,595	$43,438	$50,001	30%	27%	24%	27.2%
NetManage	$50,663	$47,666	$43,434	16%	15%	17%	15.9%
Developer Tools				**20%**	**21%**	**17%**	**19.6%**
Raining Data	$21,006	$22,297	$21,483	31%	34%	35%	33.2%
Pervasive Software	$39,205	$49,608	$48,352	20%	22%	23%	21.9%
Progress Software	$309,060	$362,662	$405,376	16%	17%	16%	16.1%
Borland Software	$295,236	$309,548	$276,743	25%	22%	21%	22.6%
Sybase	$778,062	$788,536	$818,695	15%	15%	17%	15.7%
Red Hat	$90,275	$124,737	$196,466	25%	21%	17%	20.9%
BEA Systems	$1,012,492	$1,080,094	$1,199,845	14%	14%	16%	14.4%
Education				**17%**	**14%**	**16%**	**15.5%**
Renaissance Learning	$127,632	$111,724	$116,283	12%	13%	15%	13.1%
Apollo Group	$1,339,517	$1,798,423	$2,251,472	NA	NA	NA	NA
Saba Software	$44,416	$34,471	$42,210	29%	29%	22%	26.9%
*American Education Corp.	$8,599	$10,187	$9,819	17%	14%	16%	15.7%
Scientific Learning	$29,916	$30,976	$40,319	12%	11%	10%	10.9%
Plato Learning	$82,192	$141,801	$121,804	3%	4%	5%	3.9%
All companies				**-0.3%**	**5.7%**	**8.9%**	**4.8%**

Note: ""Years" may not correspond to company fiscal years. In-process R&D and stock-based compensation added back where reported separately.

the Micro-ISV concept. For instance, Open Source. SourceGear competes directly with some competitors in this area: Subversion, for example, is very well known and in wide use.

Yes, we recommend Subversion to companies who don't want to pay for SourceGear. Open Source is a competitor, it has an impact on the market, but we're going to survive. Apache has not eliminated IIS. Open Office has not eliminated Microsoft Office. Adobe seems to be doing quite well despite the GIMP. Open Source products can never match the promotional budgets of "proprietary products," can never escape the issue that's there's no vendor to complain to and rely on for help. Yes, a vendor can disappear. And so can communities; take a look at all those abandoned Open Source projects on SourceForge.

As for Vista, the way they're going with the APIs, if you're a C# user, you like the product. The UI looks gorgeous and it's better. But where is the payoff for the customer? I'm not sure there's enough value here. If Microsoft wants to remain relevant over the long haul, Windows 2015 needs to be meaty. Users will want more than another face lift for Media Player. If Windows releases are going to start happening nearly a decade apart, users will be expecting things like speech recognition that works as well as it does on Star Trek."

—Eric Sink
Source Gear

What about a potential Micro-ISV looking to start out? Should they consider releasing products under the Open Source model?

I wouldn't recommend it. By nature, you're limiting yourself to a low margin business. Now, if you're going to consider the Open Source route, there are models that I think are better than others. For instance, the SleepyCat approach. Since many companies don't want to incorporate Open Source in their products, SleepyCat will sell you a proprietary license along with releasing an Open Source version of the product. But overall, this is a tough model to make money on.

What about services? Open Source advocates believe that services are where you make money on Open Source and I can tell that services are a high margin business, at least according to our surveys.

I'm going to argue that sometimes services are high margin and sometimes they're not. Larger software companies and IBM Global services can charge big customization and training fees. But a micro-ISV can't normally do this; typically they've captured a low-end customer and those big service margins just aren't there.

What about Apple?

I really would like to recommend Apple. My wife is a Mac user and it's a beautiful and elegant system. But despite all the excitement about Ipods and Itunes and I-everything, it's a small market. And it's hard to see any prospects of it growing larger. A tough call. But that brings me to Vista

Vista at this point reminds me of Liquid Robot Guy in Terminator II, slowly freezing in place. The burden of all that compatibility is just slowing down each release to the point where you have to speculate that this may be the last release of Windows. How long did it take to go from Windows 2000 to XP? Seven years? Let's be very, very generous and assume it only takes eight years to the next release. That's 2015. It's hard to imagine Windows still being so dominant by then.

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Equities

How Applications Cross the Chasm to Valuations, Part II of II

By Marshall Warwaruk

The motivations of mainstream buyers looking for acquisitions are to increase market share, enter new markets (vertical or horizontal) and increase sales performance through cross selling of products to established customers. Valuation models for privately-held companies focus heavily on historical and projected financial performance using comparable public company performance, comparable transactions and discounted cash flow as the norm for determining the value of the target company. Multiples applied to the training twelve months ("TTM") vary by industry sector and the recent financial trends of the acquired company. In today's world of M&A, you can expect to see multiples of 5x to 7x TTM sales in hot markets, tailing off to 2x to 3x TTM sales in growing market segments with as little as 1x TTM on sales for more mature segments.

Once companies enter into the later stages of the mainstream market, otherwise known as a mature market, consolidation is the driving factor. Accretive earnings and predictable revenues are key considerations, with improved productivity, increased purchasing power, and reduced operating used to help justify the transaction. For publicly traded companies you tend to see a modest premium paid, in the order of 10% to 20% over current market value, while for privately held organizations the tendency is to defend valuations of 6x to 10x times TTM EBITDA.

To some extent the relative value and valuation metric used in selling your business will depend on the stage your company is in within the lifecycle—early adoption, mainstream market or a declining market. However, there is another very important consideration, that of timing and your "window of opportunity." Assuming you have a one- to two-year window to sell, you need to be on the leading-edge of that window in order to gain maximum value for your shareholders. It stands to reason that leading companies in any active market segment are more apt to pay a premium for first-mover companies, while companies looking to acquire later in that same window are not as ready, willing or able to pay the higher values. Moreover, there will be fewer buyers as they will have either acquired one of your competitors, developed their own solution, or themselves been acquired. Timing has a lot to do with the value of your business.

Marshall Warwuruk, regional director SW, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: marshallw@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Advanced Digital Info. (ADIC) *•Storage and recovery*	Quantum (DSS)	$770,000,000 *Terms: Cash*	$462,600,000	**1.66**
Princeton eCom *• Electronics payments provide*	Online Resources (ORCC)	$180,000,000 *Terms:Cash*	$39,000,000	**4.62**
Dataradio *• Wireless software products*	CalAmp	$54,600,000 *Terms: Cash*	$32,000,000	**1.71**
Innovi Technologies *• Bluetooth technologies*	ModeLabs Group	$30,000,000 *Terms: Cash and stock*	$27,000,000	**1.11**

CORUM
MERGERS & ACQUISITIONS

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WebOS Resources

(WebOS is an attempt to introduce a universal OS for the web. Somewhat quixotic and dominated by smaller companies (though Google, Yahoo, and Amazon are jockeying to become defacto WebOS's), WebOS firms nonetheless offer a look ahead to the future of software applications.)

- **eyeOS** (www.eyeos.org): Open source desktop/WebOS environment.
- **Orca** (www.orcaa.com): WebOS application you can try today (sort of. The system is very unstable and you need Linux). Nevertheless, an interesting look at how web applications are moving towards desktop functionality and UI appearance.
- **WebOS** (www.cs.duke.edu/ari/issg/webos/): Site of the WebOS project originally started at UC Berkeley. Site has useful information and links, but this early effort failed to catch fire.
- **XIN** (www.naltabyte.se/howto.htm): Ajax-based OS for webcentric applications.
- **YouOS** (www.youos.com): WebOS that allows you to execute server-side applications with Javascript.

CARIS & COMPANY ANALYST MARK STAHLMAN ON MICROSOFT'S NEW ATTITUDE: "It's pretty clear that Bill is running the company again and they are going to remake the business. They are being much more combative and much more strategically managed." (Quoted in ***The New York Times***, 04/28/2006)

ANALYST ROB ENDERLE ON LINUX AND PC OEMS: "The PC guys live on churn, and Linux doesn't really change enough for them. That's theoretically good for IT managers, who would keep employees on the same hardware for nine years if they could, but bad for OEMs." (Quoted in ***Computerworld***, 04/26/2006)

REPORTER ERIC CHABROW ON WHY WE'RE NOT IN A TECH BOOM: "Entrepreneurs cashed out of tech startups far more quickly in 2000 than they're doing today. In 2000, the median time from initial VC investment to an exit—acquisition or IPO—was two years and eight months. Last quarter, that had grown to five years, eight months, Dow Jones/VentureOne finds." (Quoted in ***InformationWeek***, 05/01/2006)

BLOGGER TOM TOM FOREMSKI ON THE COST OF BLOGGING VS PR: "Robert Scoble, Microsoft's top blogger creates millions of dollars in good PR for his employer for the cost of an engineer's salary, about $100k. Microsoft's PR agency Waggoner Edstrom cannot compete with the ROI on Mr Scoble." (Quoted on http://blogs.zdnet.com/Foremski/?p=77&tag=nl.e539, 05/08/2006)

JUPITER RESEARCH ANALYST JOE WILCOX ON SOFTWARE PIRACY: "In emerging markets, piracy is also about gaining market share. If they weren't using a pirated copy of Office, they would be using something else, maybe OpenOffice or StarOffice. Converting pirated customers is cheaper than switching them from someone else." (Quoted on www.darkreading.com/document.asp?doc_id=93718, 04/28/2006)

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