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Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

The Way of the OEM

Selling software in the OEM markets has always been profitable, but it's also tough (and it will be getting tougher as the IT press continues to moan and whine about "craplets," free and trial packages preloaded on consumer computer systems). But to most software companies, OEM sales and marketing are usually secondary opportunities, revenue generators that play second fiddle to a retail or direct sales strategy.



Our RSS usage benchmarks indicate many software companies may be missing an easy bet See pages 4-5.

ABBYY is one software company that has traveled a different road. The firm, which is a major competitor in the very competitive desktop and high-end scanning, image management, and OCR markets achieved its success by executing a from-the-ground-up OEM and licensing strategy. ABBYY also moved into the market from an unusual direction, east. Founded by Chinese expatriate David Yang in Moscow in 1989, ABBYY is also an international software power, one that has learned how to make sales in some tough markets indeed. We spoke with ABBYY US CEO Dean Tang about the lessons the company has learned in the OEM market and the factors that have contributed to ABBYY's success.

Dean, how large is ABBYY?

Currently the company is 600 employees with four regional headquarters, including the US. Our software is bundled with approximately half of the desktop scanners currently sold and we have about 20 million OEM and retail/system integrator customers. The company's corporate HQ is located in Russia. ABBYY is currently privately held. Our primary product lines are ABBYY FineReader, our document converter utilities, and our language translation software.

Why did ABBYY pursue an OEM strategy? Why not go directly to retail?

The OEM track was driven by the company's belief that it would have to build brand awareness of its products over time. Breaking into retail channels is expensive and the company had limited resources. No one had heard of us and there were larger, more established firms in the marketplace.

Of course, it helped that we had a very good product. One of the advantages to being located in Russia was that in the aftermath of the collapse of the Soviet Union we had access to world-class programming talent; this enabled us to *(continued on page three)*

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

Editor
Donald K. Rosenberg
don@softletter.com
919/687-4172

Editor Emeritus
Jeffrey Tarter
jtarter@softletter.com
617/668-0028

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

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

www.softletter.com

Seth Grodin, Squidoo and Lenses

by Merrill R. (Rick) Chapman, Softletter

Two software companies I've talked to recently (one company is in the education market, the other provides network administration tools) report they're getting good search engine results from time spent with Squidoo (www.squidoo.com). Squidoo is a social networking site created in 2005 and is the brainchild of Seth Grodin, of "permission marketing" and "Purple Cow" fame. When first introduced, no one paid much attention to the new service, but over the last six months or so Squidoo has begun to gain some traction in the market and is now worth investigating.

The basic paradigm of the site is the "lens," a filter that functions in almost the same fashion as a blog. To use Squidoo, you first create an account on the site (this is free). You'll then give your lens a name, normally a keyword or phrase linked to your website or business. (This will appear as a subdomain under the Squidoo name; we picked www.Squidoo/softwarebusiness). You also have the ability to include three other keywords and phrases during setup. Once setup is complete, you'll be taken to a Squidoo template where you fill in information about the function of your lens and links to sites you believe are relevant to your keywords and phrases. Normally, most Squidoo lenses include a picture of the lens owner and basic bio information; we suggest you do this in most cases to give your lens a professional feel. Naturally, you will also include a link to your own site or sites. The initial setup process takes less than five minutes, but count on spending two to three hours populating your lens with relevant content.

Lens entries, which are primarily links to other sites or brief text entries, are placed on a single page. An interesting point about Squidoo is that you can create as many lenses as you want. The companies we spoke to were taking advantage of this ability and creating multiple lenses, each dedicated to specific keyword phrases they wanted to use to drive traffic to their main sites. Squidoo is one of the world's top 700 sites and as of this writing, appears to be on very good terms with Google's search algorithms. Every lens in Squidoo is ranked and to move up the ratings chart you need to receive 'stars ratings' from other lenses, generate high click-through rates, and post regular lens updates. Squidoo allows lens owners to create groups, and after analyzing the system, we believe this is one of the most effective ways to boost your lens ratings.

Another advantage of Squidoo is that the system provides built-in integration via RSS and tag and ping to the more popular social sites such as Del.icio.us and Technorati. The ultimate goal of all this social interaction is to create a "ping pong" effect of continuous interaction between your site, Squidoo lens(es), and key social sites while simultaneously keeping track of the keywords people are using to identify and visit your site. As you nourish this network effect and incorporate your keyword findings into your website, you should see a significant increase in your search engine rankings and site hits over time.

Both firms we spoke with stated that their Squidoo work had helped move their Google rankings for several keywords and phrases they were competing over into the top 10 listings. However, they also told us that to achieve this, they'd had to spend almost 12 months nurturing their lenses and monitoring their keywords. This is probably the type of work best carried out by an intern. Also, Squidoo boasts a fairly decent library of plug-in modules that can help automate the task of managing the site.

build high-quality software at a very competitive price. Once we had developed a presence in the market, we began to move into the retail Russian and European markets, then into the US. Once we'd established ourselves in the retail market, we were able to move into the market for higher end scanners and document creation systems with OEM and licensing programs. This was a long and deliberate process that took place over a period of 14 years.

There's a perception in the US that the retail market is dying, but ABBYY remains a strong player in stores such as Staples and CompUSA. What's your take on the retail market?

Retail is a declining business in the US but it's still significant. About 80% of our desktop business is now online vs. 20% retail. In Europe, we see online gaining in strength but retail is still very important. Currently, about 40% of our desktop products are now sold online, this number has grown over five years from an initial 5%. We see online numbers reaching 50% very soon, but then holding at 50% / 50% over the next five years. We think the strength of retail in Europe can be traced to the more fragmented nature of the market and a stronger reliance on traditional retail and mom and pop stores. Also, ABBYY now has a strong brand presence in key markets such as France, Germany, and the UK and stores like to feature the product on their shelves.

Let's discuss ABBYY's experiences with the realities of the OEM market. One of the accepted theories behind OEM sales is that by seeding the market with OEM products, a company can build a strong base of customers via sales of upgrades to your OEM customers. What do you think of this approach?

Based on our experiences, we think you'll be very disappointed if you have this expectation. We've found that it's very hard to convert OEM customers into paying ones. Historically, we've seen an overall OEM conversion rate of 1% to paying customer. To give your readers a feel for potential usage of their products by OEM customers, I'd like share some recent survey data we developed on the use of ABBYY FineReader, our principal OEM title. Of a 100K OEM customers surveyed, the numbers were:

- 80% of our OEM users used the software once per year.
- 30% once a month.
- 15% once a week.

A 1% conversion rate is lower than the numbers for many trial/shareware products.

Yes, it is. But that's not the whole story. While a person may not want to spend their money buying an upgrade, they may purchase the product for their office or business when the time comes (or they're not paying out of their pocket) because they've aware of the product and they found it useful. Again, above and beyond the revenue *(continued on page six)*

“When approaching a company about a potential OEM partnership, we've found that product managers are your most important initial contacts. They are the people closest to the market for their products and are always concerned about how they can make their products more competitive. They're very receptive to cutting edge technologies.”

—Dean Tang
ABBYY Software

“Another factor that impacts OEM upgrade sales is most hardware companies will not allow you to include forced registration in OEM products.”

—Dean Tang
ABBYY Software

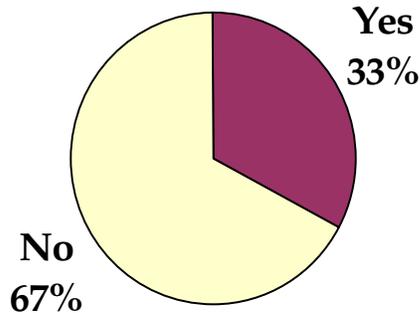
“The most successful OEM products offer ‘one click’ immediate functionality and right click integration with Windows.”

—Dean Tang
ABBYY Software

Benchmarks: Software Company Websites and RSS

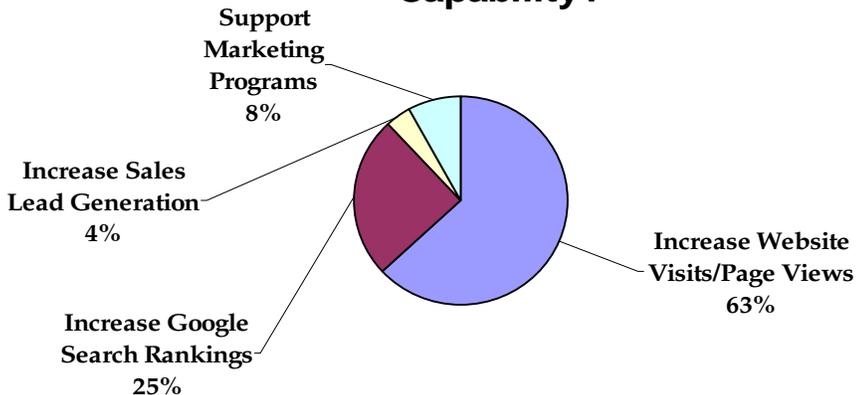
The information in these charts and tables is excerpted from the forthcoming *Softletter Marketing Effectiveness* report. The data was derived from 193 respondents reporting on their use of RSS (Really Simple Syndication) to support their ongoing marketing and sales efforts.

Have You Incorporated an RSS Ability into Your Website?



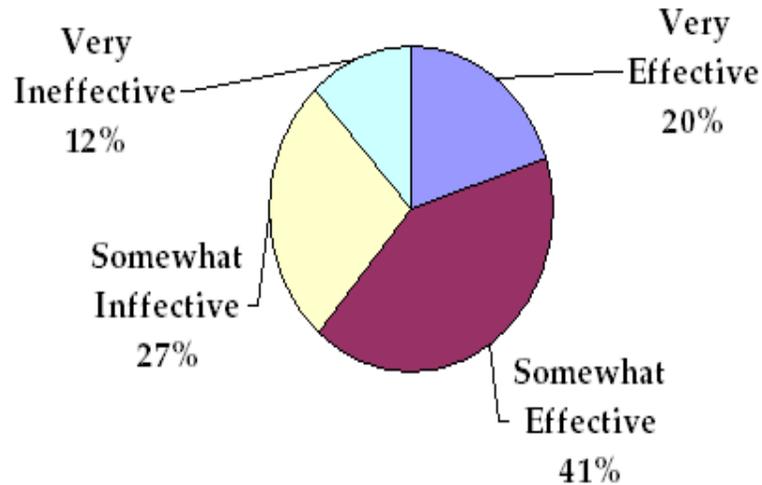
The low number of companies who have incorporated RSS capability into their websites is somewhat surprising. However, RSS, which was heralded in 2004 and 2005 as a potential replacement for E-mail, has not come close to living up to these prognostications. Nonetheless, RSS is easy to incorporate into a website and as we'll see, respondents who have made the effort are fairly happy with the results.

What is the Primary Function of Your RSS Capability?



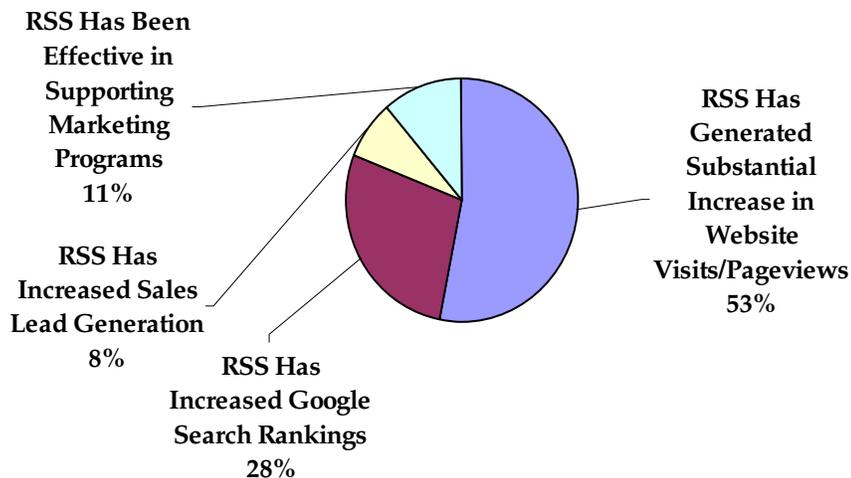
RSS, which pings an RSS reader when a website has changed its content, is primarily seen as means to increase a website's stickiness. Because of RSS network effects, it can also boost search rankings.

Is Your RSS Capability Effective in Helping You Reach Your Goals?



While RSS lacks the media mojo currently surrounding blogs, our survey respondents were much happier with the results when compared to business blogging. However, writing is not an easy skill to immediately acquire if you've not had previous experience and most blogging studies indicate you won't see much in the way of results for about six months. RSS is far more a "set it and forget it" technology.

If You Answered "Very Effective" or "Somewhat Effective," Please Indicate Why



While the figures for increasing website visits were impressive, "Substantial Increase" was defined as a rise of 5% to 10% in overall visits, not quite the same thing as a Slashdot tsunami. Nonetheless, the results achieved by RSS seem well worth the time and effort involved in adding this functionality to your website.

generated from our OEM business (and OEM hardware sales currently account for about 20% of the company's revenues), the point of a successful OEM model is to build customer awareness of your product and ensure they have an excellent experience when they use it. Upgrade sales from OEM products are a bonus, not a main source of revenue.

A point that relates to that strategy is that all our products are based on the same OCR engine. An OEM user of FineReader is using the same underlying technology as a system integrator bundling an ABBYY product into a high-speed production scanner. Flexibility and operability will differ widely, of course, but we want to provide a quality experience to users regardless of what ABBYY product they're interacting with. I don't recommend that you use "one back" or second rate technology in your OEM products. You don't want 10 million people using your product and disliking it.

Let's discuss what's involved in creating an OEM program. Is it difficult to contact hardware and software companies with OEM pitches?

Not in our experience. Hardware companies, where much of our OEM business takes place, are always looking to add value to their products. If you have a good value proposition, they'll hear you out. And major tradeshow are still a very effective way to meet potential clients.

Hardware companies are typically ranked in tiers, i.e. Dell and HP are first tier for instance. Acer and Fujitsu are examples of important second-tier firms, and there are a number of third-tier companies. Should a company new to OEM sales approach second- and third-tier firms first to build credibility with the first tier or go straight to the top tier companies?

Go straight to the top if you can. If you've got a new technology or capability you can bring to a product, it's important to try to penetrate the first tier; these deals will be far more profitable. Of course, if you can't persuade them to look at your product, or a competitor is in the space first, you'll have to work with the second and third tier. In fact, this was what ABBYY had to do when we first began our OEM programs. But one thing to be aware of is that some second tier firms, such as Acer, can have important regional impact. When we landed a deal with Acer, that established credibility with the major Taiwanese manufacturers and opened doors for us.

Another important factor in a successful OEM program is understanding how your technology can add value to products in ways that aren't immediately apparent to a hardware company. Case in point, digital cameras are now incorporating our OCR and language translation technology. Adding this ability to a camera transforms it from a picture-taking device into a portable document manager and translator. For example, someone in a foreign company can now take a picture of a map or guide in another language and have it translated into theirs.

Why are first tier deals more profitable?

Volume is an important factor, of course. And OEM discounts are high; 90% off of MSRP and go up from there. If you close a first-tier OEM sale, for the first year or two of your deal payment terms will follow a price per unit model. As your product becomes commoditized by the competition, you can expect that the manufacturer will want to move to a fixed price contract; this allows them to drive their cost per unit down. You will negotiate the terms based on an estimate of future hardware sales and previous prices, but your profits will suffer.

Dean Tang, CEO, ABBYY USA, 47221 Fremont Boulevard, Fremont, Calif. 94538; 510/ 226-6717. E-mail: dtang@abbyyusa.com

The 10 Second “What is My Company Worth?” Valuation

By Nat Burgess, Corum Group

Quick, you have 10 seconds: How much is your software company worth? Don't chuckle and tell me “a billion dollars.” That just tells me you aren't serious. Also, if you are going to rely on statistics, make sure you pick them carefully, because I can tell you definitively that software companies have been selling recently for between zero and eight times trailing revenue. The same multiple applies to headcount, and EBITDA. How helpful is that? Not very. However, there is a path to a useful answer. Let me take you down it.

First, who is asking? If it is a private equity firm, then we can step inside their constraints for a moment. Many recent private equity buyouts of profitable, growing software firms have happened at eight to 10 times trailing EBITDA. If the target has more than \$10 million in EBITDA and stable, predictable cash flow, the multiple might climb through more aggressive use of leverage. Smaller companies pose higher risks and trade at lower multiples.

If your inquiry comes from a strategic buyer, what is their price/sales multiple? Assuming you are running at a similar profitability and growth profile, discount their multiple by 25% and you have a starting point. Bringing in some additional public companies trading in the same range will help bolster your confidence in a number. Of course you will be tempted to apply their earnings multiple (“they are trading at a PE of 80 and last year I earned \$12.5 million on \$17 million in revenue, so I'm worth a billion dollars!”), but the current earnings of a small, privately held software company is an unreliable metric. Chances are you are running extremely lean, with an extremely conservative risk profile. As a subsidiary of a public company you will staff up and invest in growth. Your earnings will look very different.

What if you are simply curious? You have an asset on your personal balance sheet and every day you work to increase its value. You don't have buyer and you aren't ready to sell, but you want to know what it is worth. You can start with five times EBITDA for EBITDA generated over the next twelve months. That gives you a number that reflects the intrinsic value of the company, without the benefit of synergies.

Nat Burgess, executive vice president, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: nburgess@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Snowdrop Systems • Human resources, personnel and payroll software	Sage Group (SGGEF.PK)	\$33,500,000 Terms: Cash	\$14,800,000	2.26
eCollege.com (ECLG) • Online distance learning	Pearson(PSO)	\$477,000,000 Terms: Cash	\$52,000,000	9.17
VoiceSignal Technologies • Speech-enabled mobile device technologies	Nuance Comm. (NUAN)	\$293,000,000 Terms: Cash	\$40,000,000	7.33
Agile Software (AGIL) • Product lifecycle management	Oracle (ORCL)	\$495,000,000 Terms: Cash	\$130,000,000	3.81



SaaS Infrastructure Services

- **Bluelock** (www.bluelock.com): SAS 70-certified "Infrastructure as a Service" provider. Company's systems are pre-configured to be compliant with governmental standards and regulations, including PCI, SOX, FDA and HIPAA.
- **LeCayla Technologies** (www.lecayla.com): Firm offers series of pricing services for SaaS firms that don't want to develop this capability in house. System can handle usage, subscription, and mixed pricing models.
- **OpSource** (www.opsource.com): Company offers infrastructure as well as business consulting for SaaS companies. Pricing is "success based," i.e. you are charged a percentage of each transaction "unit."
- **rPath** (www.rpath.com): Allows software companies to package the underlying OS and their application into an application "appliance." All configuration and maintenance is handled from a browser interface. rBuilder system used to package applications is Linux-based.

NEW YORK TIMES REPORTER NOAM COHEN ON THE FINANCIAL SUCCESS OF THE MOZILLA PROJECT: "So far, no one has figured out how to balance keeping an open-source or collaborative project fully financed while remaining independent and noncommercial. Wikipedia, for example, holds occasional fund-raisers, while its leaders debate if it should take steps toward some sort of sponsorship or advertising." (Quoted in *The New York Times*, 05/21/2007)

ZDNET BLOGGER JOSHUA GREENBAUM ON THE END OF SALESFORCE.COM: "Salesforce.com is the next Siebel, the next CRM has-been, the next low-priced software buyout opportunity, unless somehow the company gets sold before its stock begins to tank or it engineers a remarkable turnaround from its current moribund strategy. It may take a couple of years, and there may be some big blockbuster announcements and a couple of good quarters in the interim, but it's gonna happen, and it's gonna be ugly." (Quoted on <http://blogs.zdnet.com/Greenbaum/?p=117&tag=nl.e539>, 05/23/2007)

DAVID MEERMAN SCOTT ON SEO MARKETING: "Search engine marketing is remarkable because, unlike almost every other form of marketing, it does not rely on the interruptive technique....Unlike non-targeted, interruption based advertising, the information that appears in search engines after you've typed a phrase is content you actually want to see." (Quoted in *The New Rules of Marketing and PR*, Wiley, 2007)

MICROSOFT LINUX LAB DIRECTOR BILL HILF ON COMMERCIAL OPEN SOURCE: "They are full-time employees, with 401K stock options. Some work for IBM or Oracle. What does that mean? It means that Linux doesn't exist any more in 2007. There is no free software movement. If someone says Linux is about Love, Peace and Harmony, I would tell them to do their research." (Quoted on http://www.bangkokpost.com/090507_Database/09May2007_data05.php)

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Subscription rates: \$395 worldwide.
Subscription office: Aegis Resources
34 Sugar Hill Rd.
Killingworth, Conn. 06419
Voice: 860/663-0552
Fax: 860/663-0553
info@softletter.com