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BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

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*Our **Services Contribution** report shows that more desktop software firms are obtaining a taste of services revenue* *See pages 4-5.*

Comeback Kid: SaaS Comes off the Canvas

In the last chapter of "In Search of Stupidity: Over 20 Years of High-Tech Marketing Disasters," I had a lot of fun with what was then called the ASP market and with good reason: from the late 1990s to 2001, more than 500 companies received over $10 billion in venture capital with no discernible ROI on all those dollars. By the end of 2001, the ASP market was in general disarray and the ASP acronym was in official disgrace.

But even while I was writing about ASP failures, I was aware that there were a handful of successes out there, companies such as Salesforce.com in the CRM space, and firms in the HR, project management, and marketing automation categories. And with Google and Amazon both turning their systems into extendable platforms via APIs, the ASP market, which is increasingly referred to as "Software as a Service," or SaaS (which we'll be using henceforth as our acronym of choice) is picking up steam, a fact confirmed by the growing number of companies who are re-engineering their products to operate with web-based interfaces and the increasing number of new SaaS applications reaching the market.

Therefore I thought it was high time I located an SaaS ISV and learned more about the impact the SaaS model is having on the business practices of software companies. The company I chose was Distance Learning, a fast-growing startup located in New York City, my hometown. The firm competes in the E-learning market with ScribeStudio, a suite of tools that integrates video, audio, images, flash, tests, polls, surveys, conferencing, and message boards into a single system for creating interactive web-based learning courses and communities. I spoke with Peter Cervieri, ScribeStudio's director of business development, on the lessons they're learning as they roll out their new SaaS offering.

Why did your company choose the SaaS model for ScribeStudio's release?

It was an organic process. Our company previously focused on developing professional E-learning tools for custom projects, web-based training, online seminars, conferencing, etc. One of our prime customers was Berlitz. We took on a project to help them transfer their CD-based language content onto the web. Once we'd done that, we then had to develop a means for them to update it; this required a web-based capability. The next step was to then provide them with the ability to create new courses based on *(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
122 Barnard Avenue
Watertown, Mass.
02472
617/668-0028

Subscription office
United Communications Group
11300 Rockville Pike
#1100
Rockville, Md. 20852
301/287-2718
866/313-0973
customer@softletter.com

www.softletter.com

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Preliminary Patent Searches for the Entrepreneur, Part I of II

by Randall Ward

The patenting process can be a daunting and expensive undertaking, especially for the entrepreneur who lacks financial backing from a large corporation or investors. You must pass through numerous mileposts to obtain a patent. If you are convinced there will be sufficient monetary reward and you have the drive and finances to finish the patenting process, you will have to jump through these "hoops".

A key principle to remember is that if your invention has been disclosed previously, you may not be able to patent your invention. A patent search must be done to find out if your invention is already known prior to application to the patent-issuing authority. There are several different kinds of patent searches, but you will most likely need a "patentability" or "freedom to operate" search.

The patentability search looks at "prior art", which is prior literature, publications, and patents, to see if the invention in hand has been disclosed. "Freedom to operate" is a search of the "landscape," so to speak, of a particular field before putting in a lot of time and resources in researching and developing inventions in that field. For instance, a search for patents in wireless software for remote transactions to see if there is an open niche (that has not been disclosed or patented) that you might exploit.

Another concept that logically follows is that the same invention may be patented in several different places or countries. The same invention may have an EP patent number, a US patent number, and a WO number. Such a group of patents is called a patent "family" and represents the same invention.

Normally, a patent will almost always be sought in one or more of the "big four" authorities of the world, the United States Patent and Trademarks Office (USPTO), World Intellectual Property Organization (WIPO), European Patent Office (EPO), and the Japanese Patent Office (JPO). The reason for this is that these organizations represent the richest parts of the world. Patents from these areas give you rights to exclude others from producing and selling your invention in the globe's most lucrative markets.

To give you an idea of the costs involved, some patent searchers may charge by the hour; these charges typically range from $70 to $150 per hour. Another possibility is a flat fee, with a "bare bones, no guarantees" search costing $500 or a little less, and more complete searches going up from there. Remember, theoretically, the person you hire is supposed to search the "universe" to find if *anything* has been published *anywhere*. In reality, the searcher, through experience, does what he or she considers "due diligence," searching until confident he has done a reasonable job and has consulted enough authoritative sources.

There are many options as far as getting a search done. A viable approach is to let your attorney recommend someone to do the search for you. This is often the most sensible course. You can contract with an independent professional searcher (and a trained professional is always involved at some point). However, even with professionals, if you hire three different searchers, often you'll get three different sets of answers.

Randall Ward, science librarian, Lee Library 2320, Brigham Young University, Provo, Utah, 84602; 801/ 422-9066. E-mail: randy_ward@byu.edu.

the existing content. Our ultimate goal became to give them, and other customers, more access to the system so that we would have to do less custom support and development. In 2004 we realized we were developing products and shifted the company's focus to that model: ScribeStudio was released at the end of 2004.

What do you perceive is the primary market for your products?

"SaaS firms must develop compensation models that aren't based on the big bang upfront."

—Peter Cervieri Distance Learning

Based on our experience, we think SaaS is currently more suitable to the SMB market. A lot of software companies are currently wrestling with the issue of cannibalization of their desktop installed bases, but we think they're going to have to accept cannibalization. The model will work something like this. You'll tell your customers 'for the SMB market, here's our SaaS product. It doesn't have all 100 of the main features of our "enterprise" products, but the five main features it does have are very useful and you can become productive immediately.' Over time, you'll add more features to your SaaS product, based on customer feedback, and the product will become more robust. Eventually, your SaaS product will eat your desktop. And our recommendation is to build your SMB product as SaaS from the ground up; your development costs will be lower and you'll avoid future migration issues.

There's been a lot of discussion in the industry about how SaaS applications will apply to distribution channels; what's your experience been?

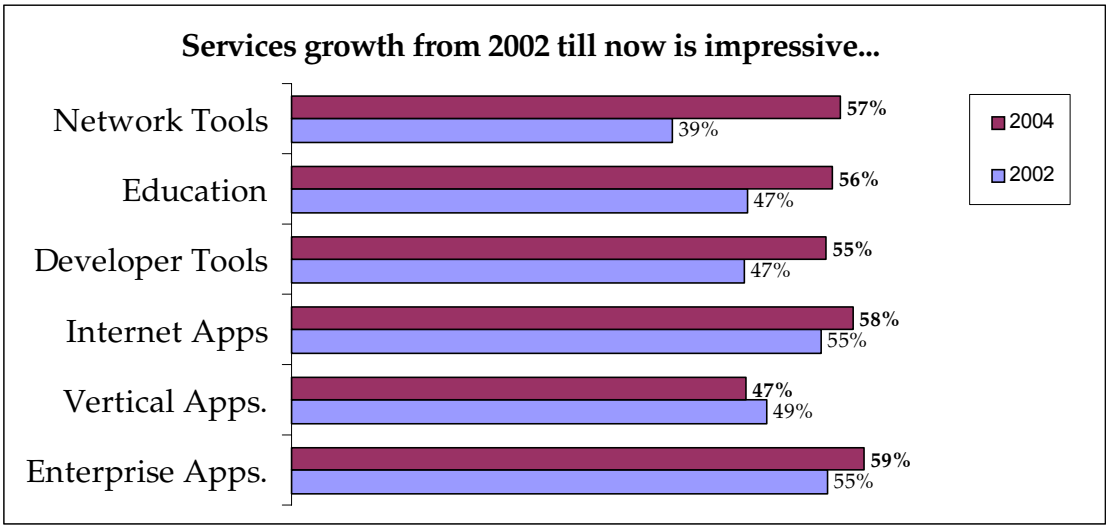
We definitely think there's an OEM channel for SaaS products; we're currently in discussions with several firms who want to build applications for very specific vertical markets using our product as a platform. For instance, one of our OEM customers is using ScribeStudio as a platform to build an application aimed at retail car salesman. They want us to develop the application based on their specs and in turn target specific customers within this market. Their model calls for them to have no development, simply sales, marketing, and customer service. We expect to make money by asking for a piece of equity in selected OEMs and by providing the infrastructure services: hosting, delivery, and some elements of customer service.

Yes, this is something I've noted; in the December 15th issue of Softletter I wrote that the SaaS model opened up new application areas. One example that struck me was a marketing application for gas stations and auto repair shops.

"Unless your pricing is highly granular, power users of your products can be your least profitable customers because of bandwidth and storage usage."

—Peter Cervieri Distance Learning

The trend you spotted is accelerating. Let me give you another example of what I mean. We're in negotiations with a small company that wants to take ScribeStudio and build an E-learning application for makeup professionals. The person with whom I'm having discussions is an eyebrow specialist—plucking, outlining, etc. Her course will be one of several contained in the system. She understands this market, can calculate how many people are likely to attend these types of courses, etc. This type of ultra specialization is *(continued on page six)*



For further discussion of Red Hat, software publishing, and services, come over to the Softletter Forums and enter the Bullpen.

Benchmarks: Services Contribution

Services continue to increase their contribution to revenue: in 2000 the median services ratio for all firms was 34%; in 2004 it stands at 56%. More ISVs than ever are reporting a services component to their revenue. This study counts consulting, maintenance, and subscription income as services, all part of the trend to treat software as a utility to be paid for regularly rather than as an occasional purchase. Although not reporting service revenue separately, Microsoft has worked hard over the past few years to bring customers over to subscription pricing.

The only sector in which ISV service revenues are still low is in Desktop Applications (though the numbers have increased since 2002), but this is not because no one buys services; customers in this category tend to buy services from third parties. In contrast to this segment's low percentage, the others ranged between medians of 55% and 59%; only Vertical Applications bucks this trend with 47%, a fall in percentage as compared to the other five categories. Network Tools and Education have shown the greatest rise in the services component over the past four years. In the Desktop segment, Scansoft's acquisition of SpeechWorks International gives them a services business for the first time, which the company estimates at 25% of total revenues. Its further acquisition of Nuance Communications now taking place will boost that contribution even more, since Nuance received 54% of its revenue from services in 2004.

If software is increasingly sold as a service, then Open Source software (OSS), in which services are the only revenue source (since licenses cannot be sold) will further accelerate this trend. Red Hat's division of its revenues into "Services" and "Subscription" indicates this 100% services model. Rather than put 100% in the chart, Red Hat's accounting was accepted (but other Benchmark 50 firms had their subscriptions counted).

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: General & Administrative

Individual firms are averages; segments are medians

	Revenues (000)			Services Ratio			Avg.
	2002	2003	2004	2002	2003	2004	'02-'04
Microsoft	$28,365,000	$32,187,000	$36,835,000	**n/a**	**n/a**	**n/a**	**n/a**
Desktop Applications				**n/a**	**n/a**	**n/a**	**n/a**
Intuit	$1,312,228	$1,650,743	$1,867,663	21%	28%	31%	26.6%
Smith Micro	$7,131	$7,216	$13,316	15%	13%	7%	11.7%
Adobe	$1,164,788	$1,294,749	$1,666,581	1%	2%	2%	1.6%
Macromedia	$336,913	$369,786	$436,168	n/a	n/a	n/a	n/a
Symantec	$1,406,946	$1,870,129	$2,582,849	n/a	n/a	n/a	n/a
IMSI (Int'l Microcomputer)	$8,484	$8,095	$11,985	n/a	n/a	n/a	n/a
Scansoft	$62,717	$106,619	$135,399	n/a	n/a	n/a	n/a
Vertical Market Applications				**49%**	**53%**	**47%**	**49.6%**
Dendrite	$225,756	$321,107	$399,197	94%	97%	n/a	95.3%
Moldflow	$35,088	$36,625	$48,673	49%	53%	46%	49.4%
Ansys	$91,011	$113,535	$134,539	47%	49%	47%	47.5%
Advent	$159,436	$137,159	$149,990	71%	79%	76%	75.3%
MapInfo	$92,598	$106,255	$124,673	29%	20%	22%	23.5%
Kronos	$342,377	$397,355	$450,694	54%	55%	56%	55.0%
Autodesk	$824,945	$951,643	$1,233,767	n/a	n/a	n/a	n/a
Enterprise Applications				**55%**	**57%**	**59%**	**57.3%**
Concur	$45,097	$56,737	$56,550	78%	85%	92%	84.8%
Manhattan Associates	$175,721	$196,814	$214,919	63%	66%	66%	64.8%
ServiceWare Technologies	$10,158	$11,511	$12,502	63%	57%	58%	59.3%
Mercury Interactive	$400,122	$506,473	$685,547	52%	60%	62%	58.0%
Witness Systems	$67,686	$108,037	$141,335	51%	57%	59%	55.7%
SPSS	$208,480	$208,367	$224,074	55%	56%	57%	56.2%
Business Objects	$454,799	$560,825	$925,631	16%	16%	19%	16.7%
Internet Applications				**55%**	**59%**	**58%**	**57.2%**
RealNetworks	$182,679	$202,377	$266,719	60%	69%	73%	67.6%
NetIQ	$278,239	$310,224	$261,645	25%	34%	46%	35.0%
Ultimate Software Group	$55,149	$60,416	$72,028	78%	87%	89%	84.7%
Centra	$33,400	$43,041	$38,064	36%	34%	42%	37.2%
Interwoven	$126,832	$111,512	$160,388	55%	59%	58%	57.2%
CryptoLogic	$34,427	$42,211	$63,714	n/a	n/a	n/a	n/a
VeriSign	$1,221,668	$1,054,780	$1,166,455	n/a	n/a	n/a	n/a
Network Tools				**39%**	**45%**	**57%**	**47.1%**
Citrix Systems	$527,448	$588,625	$741,157	28%	36%	50%	38.3%
McAfee (Network Associates)	$1,043,044	$936,336	$910,542	39%	45%	68%	50.8%
Tarantella	$14,220	$14,006	$12,488	20%	22%	35%	25.5%
Novell	$1,134,320	$1,105,496	$1,165,917	72%	76%	80%	75.8%
Spescom Software	$6,970	$7,362	$9,002	72%	72%	57%	66.9%
Tumbleweed	$25,525	$30,595	$43,438	39%	41%	50%	43.5%
NetManage	$65,740	$50,663	$47,666	52%	59%	59%	56.9%
Developer Tools				**47%**	**49%**	**55%**	**50.2%**
Raining Data	$21,006	$22,297	$21,483	53%	56%	56%	55.0%
Pervasive Software	$37,197	$39,205	$49,608	10%	10%	17%	12.5%
Progress Software	$273,123	$309,060	$362,662	66%	65%	61%	63.9%
Borland Software	$244,579	$295,236	$309,548	16%	26%	31%	24.4%
Sybase	$829,861	$778,062	$788,536	61%	65%	65%	63.5%
Red Hat	$90,275	$124,737	$196,466	47%	34%	23%	34.6%
BEA Systems	$934,058	$1,012,492	$1,080,094	45%	49%	55%	49.5%
Education				**47%**	**52%**	**56%**	**51.7%**
Renaissance Learning	$131,232	$130,544	$114,048	17%	17%	19%	17.7%
Saba Software	$55,648	$44,416	$34,471	51%	63%	71%	61.8%
Docent	$29,011	$27,792	$30,238	47%	52%	56%	51.7%
Plato Learning	$74,391	$82,192	$141,801	21%	29%	36%	28.5%
Click2Learn	$31,209	$30,477	$29,487	50%	60%	69%	59.9%
Apollo Group	$1,009,455	$1,339,517	$1,798,423	n/a	n/a	n/a	n/a
American Education Corp.	$8,483	$8,599	$10,400	n/a	n/a	n/a	n/a
All companies (median)				**49%**	**53%**	**56%**	**52.7%**

Note: "Years" may not correspond to company fiscal years. n/a = not applicable.

very difficult to achieve with desktop applications; the underlying costs of development, shipping, mailing, and support make it prohibitive. The same applies to all those informational videos and DVDs you see being peddled; that's a high risk play, normally. But our platform allows much smaller markets to be addressed at considerably lower cost and risk. The cost of supporting an application customer on the web is around $.10 on average (bandwidth use and storage can shift this up considerably). Our model is therefore based on large volumes of users in many vertical segments. Our basic price structure is built around five tiers: $29 for access to all the tools (create, organize, publish, manage, communicate), $99 for tools and 25 users, $150 for tools and 50 users, $247 for tools and 100 users, $365 for tools and 250 users (and we negotiate special deals, of course). The general rule of thumb is more users = more cost but less cost per user. For example, 1000 users would be $1,000 or $1 per user per month. Our pricing model takes into account our customers building successful products and courses off the platform.

Let me ask you another question about the SaaS model. I assume you have a sales force; how does the commission and compensation structure work?

This is going to be an area of tremendous change and difficulty for many software companies. In desktop and client-server markets, sales is king, but in SaaS you need to be prepared to offer white-glove customer service. We estimate that customer service is going to be perhaps our most significant cost center: in the 20% of revenues range. If you don't offer first-class customer service, clients can leave you quickly because you don't have the lock-in advantage of someone having paid a large chunk of money for your code and services upfront.

That may be true, but a company will still have a considerable investment in system setup, stored content, etc.

That's true. It won't be incredibly easy to switch in some cases, but the customer can apply all that money they didn't pay you in product fees to help ease the pain of leaving. As for compensation, we're learning that payment structures work completely differently from the traditional model of a base pay of $XK, a 5% sales commission, overrides and bonuses on bigger sales, etc., etc. This model has always rewarded your sales force for a "graze and move to greener monetary pastures" mentality. But with an SaaS product, we're finding this model doesn't work. With our type of sale, a salesperson doesn't rake in a big bunch of money up front. The revenue stream develops over time and is very much tied to the customer's continued success; as the customer adds learners, sales rep compensation improves. The analogy I use is it's like watching a bond grow vs. a hot stock. This in turn encourages the salesperson to stick around and makes it hard for them to leave. It also ties them to the customer in a very direct way and makes them want to ensure the customer receives first-class service. However, we are finding we still need to have a "pure" customer service group to handle ongoing technical issues, billing problems, etc.

How do you recommend structuring compensation for an SaaS sales group?

It's a work in progress. You have to provide incentives for your people to land new business while providing reasons for them to nurture existing (and presumably growing) customers. We're looking at a structure that pays 40% commissions on new accounts, then decrements over four years to around 10%. The trick is finding the right commission balance and incentives that provide strong new growth while nurturing our installed customer base.

Peter Cervieri, director of business development, Distance Learning Inc., 135 Fifth Avenue, 3rd Floor, New York, NY 10010; 212/353-0022 x23. E-mail: pcervieri@scribestudio.com

Is My Company Too Small to Sell?

By Bill Montgomery, Corum Group

If the technology is good enough, and price expectations and tolerance for risk are realistic, any company can be sold. Corum arbitrarily defines small as being $0 to $3 million in revenue, though the market you compete in can change this definition. In market categories dominated by big companies, a small competitor could have revenues of $50 million or more and still be considered "niche"; however, the reality is that most software companies don't compete in such markets.

A publicly-traded market leader typically acquires medium to large companies in any niche either because the buyer wants to grow their customer base, revenue, and sometimes profits or wants to enter a new market. Small companies are typically purchased on the strength of the potential of their technology to generate future revenue, which is much harder to quantify. And if you're shooting for a deal with an IBM or a Microsoft, you have the almost impossible task of demonstrating you possess breakthrough technology with a very high strategic value, better than the stuff the buyer probably already has under development or could acquire from a bigger company with a more established market presence.

Since it's unlikely your small company will be acquired by a really big company, it's fortunate there are many more buyers available for $5 or $10 million as opposed to $50 million deals. A target list includes "small" public companies, large and venture-backed private companies, investors, and holding companies building a portfolio or "rolling up" a market niche. But more issues will arise when dealing with these organizations. Private stock and contingent payment are much more common than with larger public companies, so negotiating the deal is harder. Also, it takes more work from you and your advisors to position offering documents for a small company since most buyers are not familiar with the firm and it's more difficult to identify logical buyers. The bottom line is that small software and technology companies are sold every day, but it takes more specialized work to achieve a deal.

Bill Montgomery, senior vice president, Corum Group, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: bmontgomery@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Extended Systems (XTND)	Sybase (SY)	$71,300,000	$32,200,000	**2.21**
• Mobile application synchronization and mobile device security		*Terms: All Cash*		
IndustryBrains, Inc.	Marchex, Inc. (MCHX)	$30,600,000	$7,000,000	**4.37**
• Web contextual advertising		*Terms: $15.6M cash/$15M stock*		
SS&C Technologies, Inc. (SSNC)	Carlyle Group	$982,000,000	$104,110,000	**9.43**
• Financial management and securities trading software		*Terms: All Cash*		
Epiphany	SSA Global (SSAG)	$329,000,000	$75,290,000	**4.37**
• Customer relationship management solution provider		*Terms: All Cash*		

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- **Japanese Patent Office** (www.ipdl.ncipi.go.jp/homepg_e.ipdl): Click on JAP when you get to the link above. Site provides for searching Japanese patents only. Not particularly English-friendly and translated sections are sometimes barely intelligible. In drawings, words are not translated.
- **Patent Information User Group** (www.piug.org): Organization of patent professionals. Site contains directories of resources, companies, and individuals.
- **World Intellectual Property Organization** (www.wipo.int/portal/index.html.en): Website for the WIPO; should be included in all serious patent searches.

SUGAR CRM BOARD MEMBER LARRY AUGUSTIN ON OPEN SOURCE ADOPTION CYCLES: "The first wave of open-source adoption was the OS, and the second wave was the infrastructure stack, but the OS and the infrastructure are commodity layers. Applications are expensive. [With open-source applications], I can undercut Siebel and get to a market that Siebel has been unable to reach." (Quoted in CRN, 08/05/2005)

COMPUTERWORLD REPORTER THOMAS HOFFMAN ON SARBANES-OXLEY AND IM SOFTWARE: " Section 302 of Sarbanes-Oxley requires CEOs and chief financial officers to certify that their companies have established internal controls and are regularly evaluating the effectiveness of the control measures. Although vendors such as FaceTime Communications Inc. and IMlogic Inc. offer tools for storing messaging traffic and protecting against malware, users like Jefferson Wells International Inc. are erring on the side of caution by simply unplugging their IM systems." (Quoted in Computerworld, 08/08/2005)

EE TIMES REPORTER PETER CLARKE ON THE MARKET FOR HANDHELD COMPUTERS: "Word that the handheld computer market is moribund, reaffirmed recently by market research company IDC, does not come as a surprise. What is surprising is that the handheld market did not implode sooner." (Quoted in InformationWeek, 07/28/2005)

OSDL CEO STUART COHEN ON "PATENT POOLS": The idea is that a pool of software licenses and software patents (issued and pending) are held in something like a virtual trust for the benefit of both developers and users of open-source software. In general, the vendors who make this pledge are promising not to litigate against people and companies whom they might otherwise sue." (Quoted on BusinessWeek Online, 08/09/2005)

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