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Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Timing Disruption, Part II of II

by Merrill R. (Rick) Chapman



Part one of our SaaS survey results reveals a host of interesting facts. Make sure to participate in part two in October See pages 4-5.

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Now, it's easy to criticize the greedy record companies, and their behavior since the digital wave swept over the industry in regards to fighting the decades-long desire of people to assemble their own custom assortments of tunes is immensely stupid. But it's impossible to see how a record company executive in 1989 can be faulted for refusing to look 10 years ahead and predict the Internet, high-speed bandwidth, a highly effective compression format for digital music that's preserves 95%+ percent of the original's sonic quality, Napster, peer-to-peer networking, the iPod, etc., and so on. And I don't think **you** can do it, because if you could, you'd be a multi-billionaire; and there's only a few of them out there, and the odds that one of them is reading this article at any particular minute is low.

But what we **can** do is analyze what factors had to be in place before a technology becomes truly disruptive, track it against a highly touted current technology, and see if whether the needed factors are in place to support a disruptive change. Let's begin with by defining what the change model must track. The key factors are:

- There must be an idea for change.
- There must be a market desire for change.
- There must be an advantage to change.
- There must be an infrastructure that supports change.
- There must be a distribution mechanism for change.
- Change must come at the right price.
- There must be an acceptable quality of experience when change occurs.

Now, it may be appropriate to add other factors to this basic model based on your particular industry or market category, but it will be a very rare situation in which you will have the luxury of not considering the above factors. Looking at the history of the software industry, it's interesting to note how often *(continued on page three)*

Aligning Sales and Marketing for Better Leads, Part II of II

by Brian Carroll, InTouch, author of "Lead Generation for the Complex Sale"

Let's now assume you've created a customer customer profile you'll use to move forward. The next step is to map this profile to your sales target. For example, one software company in the database reporting market company using my methodology was interested in increasing the average size of their sale from the \$30K to \$40K range to the \$60 to \$80K. The firm's rationale for this decision was the observation that the amount of time spent closing a sale in the lower ranges was the same as ones in the higher. The company believed that changing its sales focus would lead to an overall sales decline, but this would be more than offset by the higher volume of dollars coming from closing more highly targeted deals.

The profiling meeting between the sales and marketing group came to the following conclusions about the company's ideal customer. In addition to such obvious attributes as budget and a timeframe for its purchase, the process also uncovered that:

- The account would rely heavily on mainframe software solutions. This attribute was very important because it tended to automatically select the larger companies the software firm wanted to focus on because big firms are the principal consumers of mainframe services.
- An ideal account would have a large finance department. The reason for this was the software firm had noted these groups tended to be either purchasers or heavy influencers during the sales cycle. The reason for this tied back to the first point. While mainframe software is powerful, reporting systems tend to be monolithic and relatively inflexible. The reporting software's flexibility was thus a good fit to these prospective clients' needs.
- The ideal lead would have an IT department used to doing light internal programming and scripting work. This made sense because the finance and other groups using the reporting software would tend to rely on IT to set up the reports and automate the process of running them.

While the above information seems to fit a neat and tidy pattern, it wasn't until the sales and marketing group had shared information about the customer base that these key characteristics were uncovered in their totality.

The next step is putting in place a process for winnowing through your entire lead database and separating out enquiries and tire kicks from true leads, i.e., people who meet your lead profile and are able and willing to buy. Traditionally, many sales groups rely on cold calling and CRM systems to separate leads into different groups and then focus on the most likely candidates. I believe this is a waste of precious sales resources. Consider instead hiring a third party to qualify and separate your leads or handle the task internally. If done internally, your marketing group will be contacting customers and obtaining key information on titles, budgets, and willingness to buy. They should also be doing the initial "power maps" that define the customer's internal organizational structure. Only leads that have been put through this process can be considered "sales ready" and fit to be handed to a sales organization.

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high-tech firms gloss over or miscalculate the issues of infrastructure and distribution. For example, true hand-writing recognition requires massive amounts of computing power to operate effectively on the desktop. Apple's Newton PDA never had a prayer of working well given the state of the computing infrastructure available when the unit was released in 1993; however, this didn't stop Apple from moving ahead with the software.

Let's test out our model on the online music industry, an area that since the appearance of MP3.com and Napster has been undergoing continuous and roiling change.

There must be an idea for change	In the case of music, the idea of allowing people to quickly create their own music mixes existed for decades.
There must be a market desire for change.	As my 1989 experience demonstrated, there was.
There must be an advantage to change.	The advantage was a customized music-listening experience.
There must be an infrastructure that supports change.	In 1989, there was. It's not as sophisticated as an Internet download to an iPod, but it got the job done well enough for people who had only a painful alternative.
There must be a distribution mechanism for change.	In 1989, there wasn't. The record companies were in position to block distribution of music via their control of the means of distribution, i.e. stores, and this meant disruptive change could not occur.
Change must come at the right price.	In 1989, the price was right for the customer (though not for the record companies).
There must be an acceptable quality of experience when change occurs.	Although cassette tape systems in 1989 were not as good as today's portable MP3 systems, they were good enough.

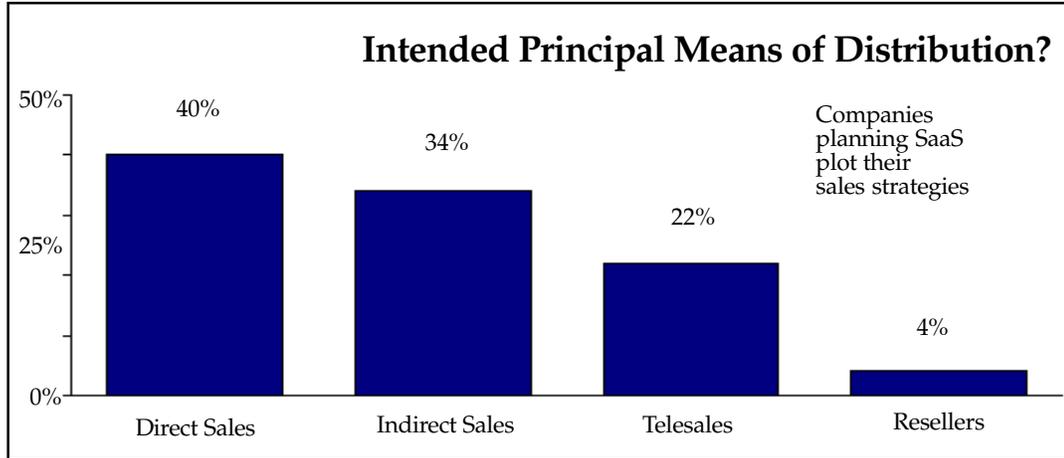
Table 1: Online music change model

As we can see, lack of a distribution mechanism in 1989 was enough to prevent the development of a potentially disruptive technology from emerging. It's also interesting to realize that while the music companies had no interest in using the Internet as a distribution vehicle, being quite happy with the existing system as it was, the very existence of this mechanism was enough to allow the market shift to occur.

Now, let's use this model to track the ASP market of 1999–2001 to understand why it failed to ignite as predicted *(continued on page six)*

“Every criteria in the basic change model must be satisfied for a fundamental market shift to occur. Voice recognition has failed to take off for over two decades because the underlying hardware infrastructure cannot support it. Once it can, this much maligned market category will come into its own.”

—Rick Chapman
Softletter



SaaS Survey Part I: Software Companies Considering SaaS

Part I of the Soft•letter SaaS survey was meant to poll software companies that are considering or planning bringing a SaaS product to market. We had 134 responses, from which we dropped those who were already in the SaaS market (a whopping 46% of those responding) and those who said they were not getting into the SaaS market (13%). The remaining 41% we dubbed the Considerers, although there are plenty of Planners among them. Our purpose was to find out what sort of companies were in this category, what they expected the technology and finances of SaaS to be, and how they assessed the market opportunities and means of reaching them. Respondents tended to answer nearly every question; the average rate of non-response per question was only 2.5%.

Who and When

We were interested to find that 76% of those thinking about or planning to bring a SaaS product to market (Considerers) are firms with less than \$25m in annual revenue; only 13% of the firms were \$100m or greater.

Fully 30% of the Considerers are not sure when their SaaS product will reach market, but 19% say in the next six months, and 44% say in the next 12-18 months. 7% figure it will take two years.

Technical and Financial

The Considerers are clearer on their technical plans than on their financial plans. 74% said they would use proprietary rather than Open Source software as the basis for their products, and 68% will base their offerings on third-party SaaS components or services. 80% said they would depend on outsourcing for the hosting of their SaaS products, with only 20% undertaking to service their SaaS customers with in-house resources.

Nevertheless, there is considerable uncertainty among the Considerers about the actual costs of being in the SaaS business. When asked **What percentage of your SaaS revenue do you expect to expend on maintaining and servicing your SaaS software?** 39% answered *Unknown*. The most common (but not by much) estimate was 16-29% of revenue (26% of Considerers), but 20% pegged the cost at a more optimistic 6-15%, while a more gloomy 13% of Considerers estimated the costs as running above 30% of revenue. 2% cheerfully estimated the cost at 5% of revenues or less. On the whole, the

Considerers do not think that SaaS is going to be a financial windfall, and 59% of them stated that they expected SaaS software would be more expensive to develop, test, roll out, deploy, and support and maintain. Admittedly, there is a 41% of Considerers who believe they will lower their product costs by going to the SaaS model.

As we mentioned, 80% expect to outsource the hosting of their SaaS products. But whether hosting is handled in house or outsourced, the actual costs are again unclear to a large number of the Considerers. Asked **What percentage of your SaaS revenue do you expect to expend on the hardware infrastructure supporting your SaaS operations?**, 46% said the cost was *Unknown*. 26% estimated it at 6-15% of revenue, and 15% estimated it at 16-29% of revenue. The optimists (7%) put it at 5% or less, and the pessimists (6%) put it at 30% or more.

Professional services operations are an important part of many software companies; only 11% of our Considerers did not have them. When asked, **If you re-deploy your current software as SaaS, will you re-deploy or downsize your professional services operation?**, those who did have professional services said they would downsize this part of the company (6%), or that they would re-deploy these personnel (25%), but fully 69% said that there would be no change in the operation. Presumably professional services will be needed to help customers integrate their back-end data bases and business processes into the SaaS product.

Despite the small company sizes of the Considerers (76% are \$25m revenue or below), it cannot be said that they are special-purpose companies formed for the purpose of selling SaaS. When asked how long it would take for their SaaS revenue to outpace their other software application revenue, only one did not give an answer. 63% of the others said that it would take "longer" than 36 months for SaaS revenue to become their largest segment, while only 17% and 13% said they expected such an event in the next 24 or 36 months, respectively. The group expecting SaaS to dominate their revenue in less than 12 months was only 7%

SaaS and the Market

The Considerers are bullish on the ability of SaaS to expand their markets. 82% believe that SaaS will enable them to move downmarket in their selling strategy (the motivation, by the way, for Oracle and SAP to enter the SaaS market), and 79% believe that SaaS will enable them to enter new markets. Microsoft's announced move of Office to SaaS is motivated not only by the desire to control the software and revenue stream more dependably, but also to make Office users of those who cannot afford to buy the current product.

Considerers are aware of the implications of SaaS for their business as seen by their customers. When asked, **What do you believe to be the primary reason your customers will choose a SaaS system?** (choose only one), 54% chose *Customers can quickly gain access to new capabilities without extensive testing, prototyping, and heavy IT involvement*. This implies increased ease of vendor switching by customers.

The other big reason, at 36%, was *SaaS applications are counted as an operating expense, not as a capital investment*. Calculations like these, on both the customer and the vendor side, show that utility computing, and not just SaaS, is waiting in the wings. The focus of vendors and customers on outsourcing everything but their special expertise is a sign of this bottom-line focus.

One final indication that the Considerers see SaaS as a corporate play is their anticipated primary means of selling their products: fully 40% expect to do so through a direct sales force. 34% expect *Indirect marketing (E-mail, direct mail, web seminars, advertising, etc.)* to be their primary means, while 22% said *Telesales group*. Only 4% chose *Reseller programs*.

So when do E-books begin to disrupt the print business? At the point when an e-book reader weighs about six ounces, has a form factor of a mid-sized paperback (though the unit will be less than an inch thick), the screen can be read in full sunlight while you're at the beach, screen resolution is comparable to the 1,500 to 3,000 dots per inch typical on a printed page, the book has between 500 gigs to 1 terabyte of integrated storage, and wireless Internet access. The price will need to be between \$250 to \$500. When will it be possible to build such a system? My estimation of the current pace of hardware development says between six to 10 years."

—Rick Chapman
Softletter

and why it is in the process of recovering under the rubric of SaaS.

Idea	There was. Providing computer applications online has been done since the 1960s.
Desire	There was. Many companies had become disillusioned with the difficulty of maintaining applications internally via large IT staffs and the complexity of licensing. For smaller and medium-sized businesses, SaaS offered the promise of access to applications they couldn't previously afford.
Advantage	1999-2001: The early ASP companies had difficulty in clearly articulating the advantage of change to many companies. They were unable, particularly in the "office" application markets, to provide a clear reason to change. Present: SaaS application developers are now focused on opening new markets by providing many companies with access to capabilities they can't obtain any other way. For example, online marketing and sales promotions software for gas stations and auto repair shops.
Infrastructure	The infrastructure of 1999–2001 was immature and had difficulty supporting certain classes of applications, but this was probably not a determining factor. Most companies had access to high-speed Internet connections in this time period, a critical infrastructure issue.
Distribution	The Internet provided such a distribution mechanism.
Experience	1999–2001: Early ASP applications were clumsy and slow. Online applications that attempted to compete with desktop applications suffered greatly by comparison in terms of power, interface, and overall usability. Present: As Ajax/Web 2.0 technology takes hold, web-based applications are starting to match their desktop counterparts in interface quality and power, though it will take time for them to match many desktop products.

Table 2: Online ASP/SaaS change model

Now, let's use this model to track the progress of a technology that received a great deal of attention in the early 2000s but has failed to catch fire: E-books. Companies such as Adobe have spent much time and energy pushing the technology with little to show for it to date. Paper books are bulky, they age and decay, and they are difficult to store. E-books offer readers potential access to an infinite number of publications that can be manipulated and accessed in ways we haven't yet even explored. For example, business books could be automatically updated on a periodic basis to ensure they are current (I've tested the technology that can do this). The corporate market is very interested replacing endless shelves of dead trees with electronic equivalents. Why haven't E-books taken off?

Because the infrastructure to support the software is inadequate and provides a quality of experience that's greatly inferior to paper. The current generation of E-book readers are too heavy, too limited in storage, and the displays are too limited in contrast and quality. Also, the price is too high. Until these points are addressed, the market will not accept this technology, despite the reality that the other criteria in our model are met by current E-book systems.

Software M&A

By Lynda Tripp, Corum Group

Halfway through the third quarter, deal volumes have not slowed. Continued confidence, rising cash reserves, private equity activity, escalating consolidation in many sectors, maturing business models, and a focus on growth and innovation all continue to create a very positive environment for buying and selling.

Companies are buying for the purpose of adding or diversifying revenue and accelerating growth; adding products to distribution channels; enhancing existing technologies; and for the strength of the investment. In terms of profit, companies are making acquisitions to increase their margins through efficiencies and synergies, and to add more revenue.

Major trends in software M&A during 2006 include:

- Convergence in markets: security, voice/video/data, and infrastructure
- Innovation and market dynamics drive buy versus build
- Escalating international expansion
- A weak (though evolving) IPO market
- Consolidation by industry players and private equity
- Evolving business models (Internet advertising)
- Continued dominance of cash in deal structures

During the first half, we were missing the blockbuster deals we saw in 2005. But during the first six weeks of the third quarter that changed with announcements by HP and its \$4.5 billion acquisition of Mercury Interactive, IBM and its \$1.6 billion play on FileNet (following a \$740 million deal with MRO Software), and SanDisk's \$1.56 billion acquisition of M-Systems.

Although we are seeing aggressive acquisition strategies by virtually all of the established software companies and private equity houses, today's buyers are very focused on accretive deals. Rather than benchmark valuations based on comparables, they tend to focus on the earnings contribution of the acquisition target. Many of the high value deals so far this year share a number of common characteristics: rapid growth, significant profitability, recurring revenue and, of course, strategic fit.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Orbital Data • WAN optimization	Citrix (CTXS)	\$50,300,000 Terms: Cash	\$4,000,000	12.58
CollaborX • Government engineering services	Teledyne Brown	\$17,500,000 Terms: Cash	\$13,600,000	1.29
Loudeye Corporation • Mobile music services	Nokia (NOK)	\$60,000,000 Terms: Cash	\$29,480,000	2.04
FileNet (FILE) • Content management	IBM (IBM)	\$1,600,000,000 Terms: Cash	\$443,170,000	3.61



Useful E-mail Marketing Tools

- **DynaSpeller** (www.dynawares.com): Free spelling utility that uses the Microsoft Word spelling engine. Utility allows you to mark text in any editor or screen, then invokes Word spelling corrector.
- **Email2DB** (www.email2db.com): Very useful tool that will scan incoming E-mail and forms and transfer them to a database.
- **Gammadyne Mailer** (www.gammadyne.com): While the product does not adhere to the standard Windows interface, this is probably the most powerful E-mail broadcasting software you can buy for the money. Supports HTML, auto-removal, conditional sending, and a host of other features.
- **SV Salespower** (www.svsalespower.com/brandmail/services.html): Service enables you to send professionally formatted E-mails with your logo automatically.
- **Word Wrap Magic** (www.wordwrapmagic.com): Nifty utility that will step through your plain text piece and make sure it adheres to a 65 character right margin. Also converts Word slant quotes to straight quotes. Cost is \$14.95.

INTERNETWEEK REPORTER LAURIE SULLIVAN ON

CYBERSQUATTING: "Before Microsoft publicly announced Zune last month there were less than 400 domain names registered that include the word "Zune," for example. Now there are between 4,000 and 5,000 domain names that include 'Zune,' and the majority Microsoft doesn't own, said Rod Rasmussen, director of operations at Internet Identity, Tacoma, Wash., which will help the Redmond, Wash. software company track ad traffic to infringing sites." (Quoted on www.internetweek.com, 08/23/2006)

ORACLE CEO LARRY ELLISON ON BUYING RED HAT:

"But what I said was that the interesting thing about open source is that the intellectual property is available to all of us. So what that means is that any company can take the Red Hat Linux and use it at no cost, so long as they're willing to support themselves." (Quoted on <http://www.forbes.com>, 07/27/2006)

BLOGGER ERIK KELLER ON OPEN SOURCE AND SAAS:

"What open source and SaaS have done, in my opinion, is make customers aware of their options. They are now starting to question the ROI of 17%-22% annual maintenance, and the vendor lock-in that is created by purchasing perpetual licenses and then spending tons of money on customizations that have to be re-written every time you upgrade to a new version." (Quoted on http://sandhill.com/opinion/daily_blog.php?id=42, 08/16/2006)

SEC FORMER CHIEF ACCOUNTANT LYNN E. TURNER ON

MERCURY SOFTWARE'S AUDIT AND COMPENSATION COMMITTEES: "If you knew those grants were being awarded on a backdated basis and you didn't say anything about it when you are sitting on the audit committee, it would be most appropriate for the S.E.C. to take you out and hang you high from the oak tree." (Quoted in the *New York Times*, 08/27/2006)

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