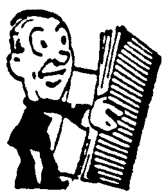
Thursday, Sept. 15, 2005
Vol. 21, No. 17

Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Don't forget to sign up for Softletter's "Marketing and Selling Open Source Software 2005" event Oct 6/7 in Burlington, MA and November 10/11 in San Jose, CA. More info at www.softletter.com!



Our Q2 VC breakdown shows average investments in software companies were slightly up
See pages 4-5.

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
860/663-0552

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

www.softletter.com

Four Ways to Stop Margin Erosion at the Point of Sale

by Jeff Thull, Prime Resource Group

What do you do when faced with a potential customer who is relentlessly insisting on a discount? Even though there's no doubt in your mind that your product or service is worth every cent you're asking, you *also* know that there is an army of competitors ready to cut their price and do whatever it takes to make the sale.

Being forced to cave in on price is frustrating, but you must admit, when faced with a customer determined to go with the lowest bidder, it's winning the sale "at whatever cost" that's most tempting. But if you play the price game, you will ultimately cut into your profits, allow commoditization of your valuable solutions and watch margins erode away. The hard truth is, if your salespeople are already cutting a few percentage points off the price to make the sale, they are failing their company and their responsibility.

To remedy discounting, an integrated, cross-functional approach to develop and deliver compelling whole solutions is required for thriving and winning in today's complex business-to-business environment. If you transition to becoming this kind of solution provider, successful value achievement will be your future, and the desperate game of low bidding becomes history. So how can you ensure that your salespeople won't cave in on price and compromise margins and profitability? What can you do to prevent margin erosion at the point of sale? Here are four key tips:

1. **Make sure your salespeople know the value of your products and services and how it links to the customer's business situation.** This is the key to creating value and is at the heart of selling with integrity and credibility. A salesperson must understand the departments that are most affected by the solution, and the financial impact of his solution on various entities within the entire company.

   If this sounds like a lot of work, well, it is. But I like to tell my clients that spectacular success is always preceded by **un**spectacular preparation. Understanding the customer's critical issues, dissatisfactions, and *(continued on page three)*

Advisory Board

RSS as a Replacement for E-mail?, Part I of II

E-mail marketing was a phenomenon in the late 1990s and through the early 2000s. E-mail is cheap, quick to deploy, and allows for fast testing and modification. Early E-mail campaigns in the software industry enjoyed response rates of 5%+, numbers that most marketers regard as signs one has entered a state of nirvana. But the flood of spam and phishing has had a heavy impact on response rates, with average figures dropping from .5% to 1.5% on average, though high-quality house files that are kept rigorously clean and are relevant to an audience perform better (2% to 3%, on average).

As the effectiveness of E-mail has declined, several technologies have been introduced in an attempt to increase its effectiveness, most notably "rich" E-mail formats that use links to servers to increase the interactivity of messages and "application-based" systems that integrate electronic messaging directly into applications (an Israeli company introduced this technology in the late 1990s and there have been several attempts to gain wider usage for this approach, most notably by Macrovison). However, the success of all these efforts has been limited to date and most companies still rely on E-mail as their primary means of electronic direct marketing.

As response rates continue to drop RSS (real simple syndication) has been heralded as a potential successor to E-mail. RSS is a reappearance of "push" technology introduced by once hot, now forgotten, PointCast. Early push products failed because of bandwidth and compatibility issues; RSS is a more lightweight approach that takes advantage of the Internet's infrastructure and XML, though there are still incompatibilities among the different RSS products.

RSS systems are comprised of two main components, an RSS reader (also called an aggregator) and an RSS feed (also referred to as a channel). Both separate readers and programs that integrate with products such as Outlook are available. An RSS reader allows a user to subscribe to an XML feed coming from a web site and notifies them when content on the web site changes. The reader allows the user to view the updated contents on the site, usually in the form of a headline or brief excerpt in a viewing panel.

An RSS feed is created by formatting a web site's content with a series of specific XML tags. This can be done via a blog, by hand with an editor, or with several more advanced tools on the market. Once implemented, most web sites indicate the presence of a "feed" via a special icon, often an orange button with XML on it. The feed can then be dragged or copied into the aggregator; feed creators have very limited control over how graphics and text will be positioned and appear as they are read. (In the event that a site does not offer a feed, there are services that allow a pseudo feed to be created from any site; this basically consists of notifying the reader when a site has been altered or changed.) Some of these services will only accept a new feed after qualifying and categorizing it; others follow an "anything goes" paradigm.

Current estimates for RSS usage among Internet users range between 2% to 4%, but a recent ***Softletter*** survey indicates that high-tech audiences are heavier users of RSS as we arrived at a figure closer to 11% (and some market categories, such as developers, seem to be trending higher). Nonetheless, RSS is at this time an ineffective direct marketing tool and it's unlikely to become one soon; we'll discuss why in the next issue of ***Softletter*** and suggest where and how RSS can bolster your marketing efforts.

frustrations, plus recognizing the business opportunities that arise from them, takes research, time, commitment, and dedicated work.

2. **Make sure your people can help the customer calculate the cost of the absence of your solution.** Before your salesperson can offer a remedy, he must be able to firmly establish the absence of your value. He must help the customer identify physical symptoms of his problem and show him that multiple departments are suffering. Let's say the CRM feature has a unique way to reduce customer attrition and the rate achieved with other users has been 6% to 9%. This issue is probably owned by the customer's sales or marketing department. Another feature might smooth the warranty tracking process, assuring that customers receive better service, and service contract renewals are increased. This is perhaps owned by the service function. The salesperson begins to build the financial case by assisting the customer in attaching real dollars to the absence of each feature. This will enable the salesperson to establish what we refer to as the "cost of the problem" which is a key factor in determining the true value of your solution. Remember, if there is no perceived lack of value—no "measurable discomfort"—there will be no sale.

"The software and technology industry is quite savvy at knowing the competition, its benefits and associated price tags. The goal here is to side step the typical comparisons and price objections and focus on the value that is achieved by your solution versus that of your competitor."

—Jeff Thull
Prime Resource Group

A client of ours provides an integrated software package for running multi-location auto dealerships. They begin their engagements by providing their prospect with a pro-forma estimate of the financial impact their software is likely to have on the dealership. We refer to this as a "Value Assumption." By looking at the size of the dealership, number of new and used cars sold, number of service technicians, salespeople, parts department employees, and a few more numbers that are readily available, they put together a ROI hypothesis and simply ask the prospect if it makes sense to take the time to prove or disprove the assumptions. This is very different from traditional claims of how much money can be saved and just let us show you how. It is inviting the customer to look at their own experiences, attach believable numbers to them, and make decisions based on solid financial information.

"You must conduct a thorough diagnosis of the customer's situation, analyzing all the critical impact points, and not take at face value what the customer claims their needs are and ultimately miss critical information from those who are affected by the solution."

—Jeff Thull
Prime Resource Group

Pain is the most basic human motivator for change. It is the natural defense mechanism that tells people that if they don't change and deal with a problem, they will face consequences. And change itself hurts and will not occur until an individual or company recognizes that the pain of change is less than the pain of staying the same.

3. **Make sure they can articulate the impact of your solution over those of your closest competitors.** We're talking specific figures here, not common and vague generalities. This is where your salesperson should be able to pre-empt all but the most irrational objections. If he can get the customer to recognize that your product will provide a specific financial impact, such as cutting the cost of a critical process or increasing desired revenues, they will surely realize that your premium pricing makes solid business sense.

It's very difficult to argue with hard numbers. When you quantify the impact of your solution, it will quickly become *(continued on page six)*

Benchmarks: Q2 Venture Capital Investments

The bad news is that VC investing has been basically flat since 2002, with quarterly bounces and falls. The Q2 total for all sectors of $5.8 billion has still not reached the pre-Bubble level of Q1 1999, $6.6 billion. The peak of the Bubble was Q1 2000, at $28.1 billion.

The good news is that the software sector still remains an attractive investment. It is still the largest single sector at $1.3 billion invested among 231 companies, or 22% of all VC investment. The biotechnology and the medical devices sectors must be combined to surpass it at $1.5 billion. One of software's attractions is that it does not take enormous amounts to fund a single company: the two life sciences sectors together funded only 154 companies. The average new investment for software is $5.5 million, $2.2 million less than the average VC investment overall. Software's Q2 is an improvement over Q1 with its $1 billion in 198 deals, but the growth is simply the quarterly bouncing mentioned above.

"VCs still consider software an attractive investment, and have increased their software deal sizes. Their involvement in Seed/Startup companies remains constant but relatively low."

In the software sector itself the average new investments were larger this quarter. For Q1 2005, the smallest deal among the Top 50 was $5.6 million; for Q2 it is $10 million. In Q1 twenty-one of the Top 50 were below $10 million in size. The median investment among all software companies in Q2 was $4 million. This shift has not affected Startup/Seed companies significantly: they were 5% of VC software investment, a figure in line with the 6% for Startup/Seed investment stage across all VC investing. The other software investment stages are generally in line with VC averages: 29% for Early (26% overall), 35% for Expansion (38% overall), and 32% for Later (30% overall).

There is one outlier in the Top 50: the $40 million investment in Omniture (formerly MyComputer.com) is twice the size of the No. 2 company (Orchestria, $21 million). Omniture is in a highly-desirable investment area, a pure Internet company (see ***Softletter*** for 31 August 2005, Mergers and Acquisitions). The fact that it is part of the SaaS comeback (see ***Softletter*** for 15 August 2005) adds to its attractiveness. The company has been providing "Web analytics and Web site statistics" for large companies for some time now, and is currently moving down into the mid-size market.

Some Open Source names pop up among the investments, notably Black Duck in the Top 50 ($12 million, Expansion). The company has proprietary software, but its niche is monitoring your developers and their code to make sure that the different Open Source and proprietary licenses are not combined in ways that infringe intellectual property restrictions. JasperSoft ($8 million, report-writer software) and Kim Polesi's SpikeSource (a LAMP stack, $4 million) fell below the Top 50 cut.

Remember that VC investment lags economic recovery. Recent improvement in the economy should eventually attract more investment; it only remains now to see how large a drag Hurricane Katrina will be.

The Top 50: Software Venture Capital Investments—Q2 2005

	Company	Business Focus	Lead Investor	Investment
1	Omniture (MyComputer.com)	Web analytics technology for online businesses	BA Venture Partners (BankAmerica)/Attractor	$40,000,000
2	Orchestria Corporation	Software solutions for communications mgt.	Paladin Capital/Goldman, Sachs	$21,000,000
3	RF Code	Hybrid RFID management	QuestMark Partners/Intel Capital	$20,000,000
4	Altura International	Develop/host e-commerce shopping solutions	Oak Investment Partners/	$20,000,000
5	Isilon Systems (Endurant)	Distrib. storage for media-rich content delivery	Atlas Venture/Focus Ventures (Charter Grwth)	$20,000,000
6	Rearden Commerce (Talais)	Automation of business services management	Charter Ventures/Foundation Capital	$19,000,000
7	DriveCam (I-Witness)	Video systems for commercial fleets	Menlo Ventures/JMI Equity Management	$18,000,000
8	OraMetrix (Orthotel)	Technology solutions for orthodontic care	Rho Ventures/Brentwood Venture Capital	$18,000,000
9	HelloSoft	Communication for converged networks	TD Capital Ventures/Entrepia Ventures	$16,000,000
10	Ingrian Networks	Secure content networking platforms	Globespan Capital Partners (JAFCO)	$15,000,000
11	Approva Corporation	Internet-based business software platform	Columbia Capital/Gold Hill	$15,000,000
12	Voltage Security (IdentiCrypt)	Security for business communications systems	Hummer Winblad/JAFCO Ventures	$15,000,000
13	Arena Solutions (bom.com)	Online product lifecycle management (PLM)	BA Venture (BankAmerica)/Arthur Rock	$15,000,000
14	Datallegro	Price/performance data-warehouse appliance	Venrock/Adams Capital Management	$15,000,000
15	Softricity	Next-generation app. deployment/management	Ameritech Capital/FA Technology	$15,000,000
16	Mindjet LLC	Software for visual mapping of information	Investor Growth Capital AB/3i (US)	$15,000,000
17	Cenzic (ClickToSecure)	Enterprise software for IT error analysis	Adv. Techn. Ventures (ATV)/Hummer Winblad	$15,000,000
18	Troika Networks	Internet area network hardware/software	Anthem Vent. Partners/Draper Fisher	$14,000,000
19	PortAuthority Techno. (Vidius)	Software to protect private and confidential data	Greylock/Lexington Ventures	$13,000,000
20	BlueLane Techno. (SecureAll)	Provides network security services	Benchmark Capital/Matrix Partners	$13,000,000
21	Global Market Insite	Integrated Internet-based market research	FT Ventures/Voyager Capital	$13,000,000
22	OneNeck IT Services Corp.	Provides ERP outsourcing services	WestView Capital Partners	$13,000,000
23	Coradiant	Managed Svc. Provider (MSP) of Internet sites	Doll Capital/GrandBanks Capital	$13,000,000
24	Tacit Networks	Appliances that cache file sharing operations	Brocade Communications/Canaan Partners	$13,000,000
25	BDNA Corporation	Develops IT management software	Newbury Ventures/Crescendo Venture Mgt.	$13,000,000
26	SWsoft	Server automation and virtualization software	Insight Venture/Bessemer Venture	$12,000,000
27	Akonix Systems	Provides e-business software applications	Menlo Ventures/Mission Ventures	$12,000,000
28	3Leaf Networks	Systems software and IC's for enterprise-sever	Enterprise Partners Venture Capital (EPVC)	$12,000,000
29	Black Duck Software	IP risk management and mitigation solutions	Fidelity Ventures/Flagship Ventures	$12,000,000
30	GTESS Corporation	Business-process outsourcing, managed-care	HLM Venture Partners/AH Ventures)	$12,000,000
31	Worksoft	Provides automated testing software solutions	Crescendo Venture Mgt./Austin Ventures	$12,000,000
32	VaST Systems Technology	Computer-aided design (CAD) services	Foundation Capital/Allen & Buckeridge	$12,000,000
33	Webify Solutions	Provides service-oriented business software	Constellation Vent. (Bear Steans)/Dali, Hook	$12,000,000
34	Arcot Systems	User authentication and digital signing solutions	Adobe Ventures/Accel	$11,000,000
35	Cloverleaf Communications	Develops storage management system	Hyperion Israel Venture Partners/BancBoston	$11,000,000
36	Dexterra	Enterprise software for mobile bus. processes	Canaan Partners/Sigma Partners	$11,000,000
37	Digital Harbor	Develops software for front-office integration	Financial Technology Ventures/Insight V.P.	$11,000,000
38	Verdasys	Enterprise-wide security platform to protect data	TD Capital Ventures	$11,000,000
39	Elemental Security	Develops enterprise security software solutions	Bessemer Venture Partners/Lehman Bros.	$11,000,000
40	Corrigo	Internet-based, integrated suite of software	Sierra Ventures/Amicus	$11,000,000
41	Fortinet	Provides network-protection systems	Doll Capital/Meritech Capital	$11,000,000
42	MedVantx (OnsiteRx)	Solutions for drug dispensing at point-of-care	ARCH Venture Partners/Advent International	$11,000,000
43	Sky MobileMedia	Platforms for wireless-handset mobile apps.	Enterprise Partners Venture Capital (EPVC)	$11,000,000
44	Altierre Corporation	Wireless business solutions for retail chains	ATA Ventures/Kinetic Ventures LLC	$10,000,000
45	Incentive Systems (Centive)	Software automation of enterprise incentives	Key Venture Partners/Polaris	$10,000,000
46	X1 Technologies	Provides desktop search solutions	U.S. Venture Partners/Idealab	$10,000,000
47	Rivermine Softw. (Telco Ex.)	Telecommunications management software	Longworth Venture/Columbia Capital	$10,000,000
48	MarketLive (Multimedia Live)	Develops/deploys e-commerce technology	Sequoia Capital/Sigma Partners	$10,000,000
49	Klocwork (Tegriant Solutions)	Static analysis for software security and quality	Mobius Venture Capital (SOFTBANK)/Cisco	$10,000,000
50	BeVocal	Provides managed call-automation solutions	ArrowPath Venture Capital (E*TRADE Group)	$10,000,000

obvious to your customer that your solution, at your price, makes for a solid business decision.

4. **Link salespeople's compensation to profit, not gross revenue.** One of the major reasons that salespeople give discounts is because it pays off for them personally. If you base your salesperson's compensation on gross revenue rather than net margins, he will see little negative impact if he gives the customer a 10% discount. That 10% discount may mean the difference between "winning a sale" and "no sale." But if that 10 percent discount causes your margin to go down by 100% . . . well, what are you really winning?

"Your salespeople must get over that burning desire to 'get the order at any price.' Not every sale is a good sale, and not every customer is right for you. Salespeople must not only be comfortable with hearing 'no,' they must actually 'go for the no' and move on to more profitable opportunities."

—Jeff Thull
Prime Resource Group

Your compensation plan should impact the salesperson's commission as much as it impacts your profits. Money talks. If your people are coasting by and digging into your profits rather than doing the due diligence it takes to sell a complex product in a complex environment, changing the way someone gets paid encourages him to rethink his approach. The game will now be about "winning big"—not just winning.

When organizations allow discounts as a way to grab sales, it often means they don't believe they can control their sales organization. Companies have established very sophisticated processes and controls in their operations, but waffle when it comes to applying the same expertise to their sales strategy. Such firms are not structured for profitable growth.

The bottom line is that when a customer says, "Your price is too high," the salesperson should regard himself as the likely problem, not the product. There are two possibilities: 1) the customer is not experiencing a significant absence of value; therefore, the price *is* too high or, 2) the absence of value is there and the customer does not recognize it. The burden of proof is on the salesperson, and he hasn't done his job.

When steps one through four are in place and the customer asks for the discount, which they have every right to do (and you can always expect that they will) the salesperson will be prepared to respond in a very professional manner. Let's look at an example recorded verbatim by one of our clients. The customer says, "This pricing is a little high, were going to need some additional consideration on this." The salesperson responds: "I realize that as a business person you need to make that request and I respect that. As a business person, and hopefully your long-term partner, when I look at this proposal, I see that we are enabling your organization to bring in an additional $122,000 in revenue per month, by the estimates of your department managers. We have offered our best price, which is $18,300 per month. It is a price that supports our ability to serve you and continue to enhance the software, and is slightly better than the four to one payback you were targeting in our initial discussions. We're comfortable that our proposal represents a solid business decision for both of us as is." The customer answers "I wouldn't be doing my job if I didn't ask. You're right; we can live with this."

Jeff Thull, president, 3655 Plymouth Blvd, Ste 110, Minneapolis, Minn. 55446; 763-473-7529. E-mail: jpthull@primresource.com.

Equities

If it Takes 8 Months to Sell, When Should I Begin Planning?

By Ward Carter, Corum Group

Proper planning for an exit requires knowledge of the process and an accurate assessment of the time required to complete the various tasks that will result in the sale of your business. In an ideal situation, a qualified and highly motivated buyer might approach you with an offer that is immediately acceptable, and then completes due diligence and document drafting in 60 days and moves straight to close. A more likely scenario will be a three to nine month search for the right buyer, and possibly weeks of negotiations to finally achieve the right deal. Anticipating this will allow you to budget your time and expectations properly.

It is never too early to start preparing for an exit. We coach our clients to begin early to assemble, maintain, and update the basic documents that will be required by any buyer as part of the deal process. Obtaining good advice on accounting methods is also critical, including not just on how to create clean and well documented accounting records, but also on how to comply with revenue recognition standards.

Once you have decided to go to market, and engaged an intermediary to assist with the task, assume that another 30 to 45 days will be needed for offering documents to be prepared and to create a targeted list of buyers. Once on the market and in front of buyers, the objective is to move qualified interested parties forward in a managed process. This includes exchange of financial and other business information leading to conference calls and face-to-face visits with the buyer. Once an offer is made and accepted, anticipate 60 days or more to close, as the buyer must complete due diligence while the definitive agreement and associated schedules are completed and details are negotiated.

All in all, six to nine months can often pass in the preparation, buyer search and negotiations phases. The process can extend even further if due diligence discloses irregularities requiring further investigation and response. In an era of Sarbanes-Oxley, don't expect a buyer to skip over any important due diligence issues. If you are properly prepared however, this process can go smoothly and quickly.

Ward Carter, executive vice president, 10500 NE Eighth St., Bellevue, Wash. 98004; 425/455-8281. E-mail: wcarter@corumgroup.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Plumtree Software (Plum)	BEA Systems (BEAS)	$200,000,000	$94,010,000	**2.13**
• *"Inward-facing" portal software*		*Terms: All cash*		
Leitch Technology Corp (LVT.TO)	Harris Corporation (HRS)	$450,000,000	$180,400,000	**2.49**
• *High-performance audio/video systems*		*Terms: All cash*		
NDCHealth Corporation (NDC)	Per-Se Technologies (PSTI)	$1,047,000,000	$387,560,000	**2.70**
• *Software for health care claims processing*		*Terms: Cash/stock*		
LinkShare Corp	Rakuten - Japan	$425,000,000	$32,000,000	**13.28**
• *Performance-based online advertising*		*Terms: All Cash*		

CardFile

RSS Resources

- **Attensa** (www.attensa.com): Currently free RSS reader for Outlook; also works with IE and FireFox. Has a simple RSS publish function that can work with a basic blog.
- **FeedBurner** (www.feedburner.com): Popular RSS syndicator system.
- **Feedster** (www.feedster.com): Site offers a comprehensive search function for many of the most popular RSS sites.
- **HitRSS** (www.hitrss.com): Site offers free RSS hosting and feeding.
- **IMM** (www.imninc.com): Offers an RSS tracking system.
- **Pluck** (www.pluck.com): Very popular free RSS reader for IE and FireFox.
- **RapidFeeds** (www.imninc.com): Offers a series of free RSS services, including publishing, updating, and tracking RSS feeds and response.
- **Syndic8** (www.syndic8.com): Very comprehensive RSS syndicator; was recently caught attempting to "game" the Google search engine.

ERIC KRISS, SECRETARY OF FINANCE FOR MASSACHUSETTS ON PROPRIETARY FILE FORMATS: "Desktop software that supports OpenDocument and PDF in the future is acceptable; Microsoft's proprietary XML formats are not." (Quoted in ***InformationWeek***, 09/06/2005)

HARVARD LAW SCHOOL PROFESSOR WILLIAM FISHER ON GOOGLE'S PLAN TO SCAN LIBRARY BOOKS FOR ITS SEARCH ENGINE: "Google would probably win a court case. Google is a profit-making venture, that counts against it, but what it is doing is a highly socially valuable activity and that counts highly in its favor." (Quoted in ***InternetWeek***, 09/06/2005)

ORACLE PRESIDENT CHARLES PHILLIPS ON LINUX APPLICATIONS GROWTH: "There was a slow trickling of ISVs a couple years ago, but now it has accelerated to the point where we offer a lot of open-source services and go-to-market products. Any time you have that sort of unit growth, it attracts the application vendors." (Quoted in ***VAR Business*** magazine, 09/05/2005)

NEW YORK TIMES REPORTER SETH SCHIESEL ON THE SUCCESS OF "WORLD OF WARCRAFT": "Since November, World of Warcraft has signed up more than four million subscribers worldwide, making for an annual revenue stream of more than $700 million. About a million of those subscribers are in the United States (with more than half a million copies sold this year) and another 1.5 million are in China, where the game was introduced just three months ago....The conventional wisdom in the industry then was that there could not possibly be more than a million people who would pay to play a massively multiplayer online game." (Quoted in ***The New York Times***, 09/06/2005)

Colleagues made off with your last issue? Go to www.softletter.com. Click Subscriber Login in the upper right of the home page. To view the current issue and to search archives of hundreds of articles by keyword, topic, or issue date, log in and enjoy!

Soft•letter is published 24 times per year;

ISSN: 0882-3499.

Subscription rates: $395 worldwide. Subscription office: United Communications Group, 11300 Rockville Pike, #1100, Rockville, Md. 20852-3030; tel 301/287-2718 866/313-0973 customer@softletter.com

www.softletter.com