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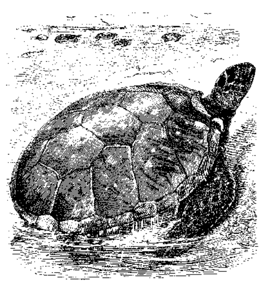
BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

The SaaS Channel: A Work in Progress

by Bruce La Fetra, Rubicon Consulting



Slow progress down the IPO pipeline
See pages 4-5.

According to a 2005 AMR Research study of 500 respondents representing companies of all sizes, more than 78% said they are currently using or considering SaaS. As ISVs push SaaS applications into the mainstream, ISVs and VARs need to consider likely changes to the channel economic model. One of these changes is likely to be a shift in the balance of power toward full-service VARs. While ISVs will find some of these changes hard to swallow, they need to keep in mind that this is the cost of extending the reach of their applications into additional market segments.

There has been a lot of discussion about how SaaS changes the economics for ISVs. There has been much less discussion about the changes in store for the channel. The SaaS model turns the often complex and multi-headed software licensing model into a considerably more straightforward beast. User/seat licensing may still be mind-numbing in its complexity, but the array of maintenance, upgrade, installation and services fees are streamlined or integrated into the rental payment. ISVs and VARs are going to have to re-negotiate who gets what—and because the link between time of service and time of payment is less distinct—when.

Vendors like Salesforce.com, RightNow, IBM and SAP demonstrate that SaaS is for real and is here to stay… at least until the next big thing comes along. While SaaS applications can be easier to set up and integrate, the SaaS leaders have not shown that they are more able to directly penetrate the small & medium business (SMB) market with SaaS applications than with traditional software applications. In response, the press is filled with news of big software vendors like IBM announcing sales and marketing incentives to support SaaS efforts in the channel. IBM's channel initiative for SaaS pays a 10% referral fee for partner-generated leads that IBM closes, and offers greater sales and marketing assistance to help partners close deals.

How SaaS Is Different

So what is the role of the channel with regards to SaaS offerings? Does SaaS require a new channel framework? While it definitely calls for a new compensation model and in *(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
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

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The Latest in Search Engine and AdWords Shenanigans, Part I of III

Over the last twelve months, Google and the other major search engines have made some of the most significant changes to their policies and alogorithims we've seen in years. This three-part series highlights the most important techniques and modifications you need to learn and take advantage of to ensure your rankings remain competitive.

Google Sitemaps

Introduced in 2005, a Google sitemap is part of Google's webmaster's toolset. A sitemap describes your site and any new content you've added or site changes. After opening a sitemap account, you can use the service to monitor pages Google can't spider and links it can't follow. **This is probably the single most important modification to your site you can make if you've not done it yet.** We've checked, and a suprisingly high number of software sites have not used sitemaps. If you haven't used the service, we recommend you do so ASAP.

Optimizing for Misspellings

Google estimates 10% of all searches are misspelled. Your site can take advantage of this by placing common misspellings into the **keyword** meta tag, placing common typos at the end of the **title** tag, and creating a "hidden" box on selected pages for common misspellings. Be careful of what words you pick to optimize for; for example, if you've developed a software product that allows you to manage commodities trading for pork bellies (bacon) there's not much point in including the keyword "porn" on your site (and you can damage your search engine rankings).

Rise of the Bots

Googlebot is an automated search routine that scours the web for new pages for indexing The Googlebot comes in two versions, Deepbot and Freshbot. Deepbot attempts to follow every web link it finds and refer the pages it finds to the Google index. It also analyzes a site's internal structure so as to provide the index with a complete site picture. Freshbot is a newer routine optimized to find fresh content. Freshbot recalls pages already stored in the Google index and looks for new, changed, or updated pages. Thus, the more often you update your website, the more often Freshbot spiders your site.

MediaBot is the Google spider for AdSense publishers. Mediabot is used to determine which ads Google should display on AdSense pages. Google recommends that you add a specific command in your robots.txt file that gives Mediabot access to the entire site. To do this, enter the following line into your robots.txt file:

User-agent: Mediapartners-Google*
Disallow:

In line with Google, the MSN and Yahoo sites have also recently undergone significant bot upgrades. The msn-bot has now been segmented into the basic search bot (msn-bot), shopping bot (msnbot-products), news bot (msnbot-news), and the image bot (msn-media). Log file analysis should now provide better information on how this site is indexing and ranking your site.

some cases may significantly alter the ISV / channel partner balance of power, the basic framework is probably adequate, especially when considering the SMB market. The SMB market is served today by a plethora of VARs that often focus on very specific niche markets such as food service distribution or equipment leasing companies. VARs bring expertise that ISVs cannot easily develop or maintain, so don't expect them to go away merely because ISVs would like more margin.

"SaaS margins are an area in flux, but early research by Softletter indicates they will range considerably lower than the numbers typically seen with desktop and licensed applications. We'll know more in October when part two of the publication's SaaS survey results are released."

—Bruce La Fetra
Rubicon Consulting

It's also important to consider how SaaS changes the economics for customers. The SaaS "rental" model means customers pay less up-front compared to traditional licenses. Meanwhile the ISV or VAR incur development, setup and configuration costs that must be amortized over the life of the deal. As a result, there is a natural bias for SaaS to appeal most strongly to: (a) customers that are cash-constrained or, (b) vendors that can afford annuity expenses rather than front-end license payments. Due to these factors, SaaS has a built-in appeal for smaller customers and larger vendors, although the appeal certainly is not limited to these groups. The role of the channel is very traditional. Specific customer segments are served that are frequently too small or too specialized for the ISV to economically service directly. The emerging economic model, however, is different in some important aspects.

Changing Economics of SaaS

While much has been written about the appropriate way to price SaaS applications, we are concerned here with the overall economics. On the revenue side, SaaS trades a large, one-time payment for a series of smaller, on-going payments. On the cost side, SaaS has far less impact. Development and selling costs still occur up-front. The big change is that the ISV's breakeven and profitability is determined not at the time of sale, but by how long the customer continues to use the application.

On the channel side, ISVs need to first consider the role they want the channel to play in the customer relationship, then structure the partner's compensation accordingly, recognizing that channel partners may place a different value on current versus future cash flows. While the ISV may be willing to take their money over time, the channel partner may be better motivated with less money now versus more money over time.

"ISVs prefer referral fees for resellers, but partners are going to want a piece of the recurring revenue action."

—Bruce La Fetra
Rubicon Consulting

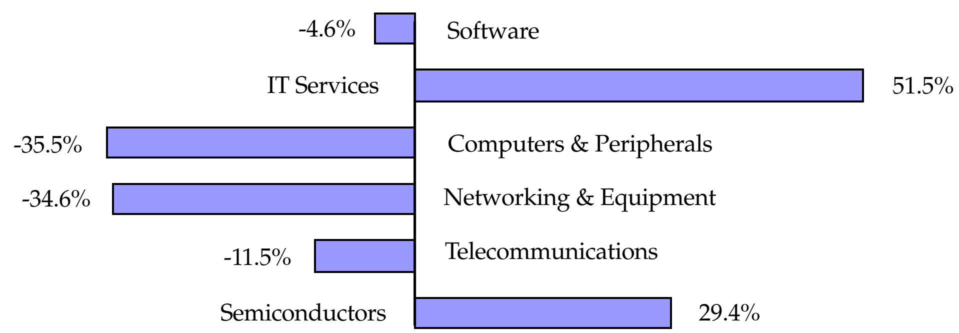
New VAR Opportunities

Very conservative VARs that think in terms of cash-based accounting will experience a rocky ride. For other VARs, SaaS offers a number of new or expanded opportunities:

VARs have always played a big role in integrating multiple solutions. SaaS should be no different. In some cases SaaS provides VARs with the opportunity to host the integrated solution and do the billing, thus taking ownership of the relationship. ISVs won't like this aspect, but their options are limited.

(continued on page six)

VC Investment Changes by Sector from 2005 to 2006



Source: PricewaterhouseCoopers MoneyTree Survey

Benchmarks: Q2 Venture Capital Investments

The good news is that there is venture money out there in greater amounts, if in smaller deals. And while it may be bad news for get-rich-quick investors, the slow progress of investments down the IPO pipeline continues.

"In the second quarter of 2006, venture capitalists invested the highest dollar amount into the most deals since Q1 2002"
—*MoneyTree*

Venture investment is slowly improving as the IPO pipeline continues to clear. Fenwick & West say that the current pace of IPOs (29 in the first two quarters) will likely be the best IPO year since 2000. This quarter saw 16 IPOs raise $1.3 billion. MoneyTree says that Q2, 2006 saw the most money put into the most deals since Q2, 2001.

As our chart indicates, the Software sector has slowed its decline. It remains the largest single sector and received 20% of total Q2 investment dollars for a total $1.26 billion. The 231 deals averaged $5.47 million, and were 27% of all investment deals. Of the sectors of greatest interest to our readers, Semiconductors and IT Services show robust growth, while Telecommunications, Networking & Equipment, and Computers & Peripherals are all down.

One hopeful sign of venture investment recovery is that Start Up and Early Stage deals are now 31% of all deals. Their increase in number, if not in total value, indicates that VCs are investing carefully as they feed the front end of the deal pipeline. First-time financings reflect this trend: they are more numerous, but smaller in size than previously. Sectors seeing the highest levels of first-time investment are Software, Energy, and Biotech.

The material in this report is largely drawn from the Money Tree Survey by PricewaterhouseCoopers, Thomson Venture Economics, and the National Venture Capital Association, and was generally confirmed or modified by other sources.

The Top 50: Software Venture Capital Investments—Q2, 2006

	Company	Business Focus	Lead Investor	Investment
1	SuccessFactors	Organization-performance management tools	Granite Global Ventures	$45,000,000
2	Global Market Insite	Integrated online market research tools	FTVentures	$35,000,000
3	BridgeCo	Digital home networking solutions	Advent Venture Partners/Wellington Partners	$23,000,000
4	Digital Chocolate	Games, entertainment for mobile devices	Bridgescale Partners	$22,500,000
5	Sourcefire	Real-time network security	Meritech Capital Partners	$20,000,000
6	ConSentry Networks (Tidal)	LAN security for the enterprise	Duff Ackerman & Goodrich (DAG) Ventures	$20,000,000
7	Kosmix Corporation	Web search engine	Accel Partners	$18,300,000
8	EnterpriseDB Corporation	Open Source database	Fidelity Ventures	$16,500,000
9	Widevine Technologies	Content security for video operators	Blueprint Ventures	$16,000,000
10	Authentium	Brandable security applications (anti-virus)	Safeguard Scientifics/Westbury Partners	$15,000,000
11	Roundbox	Mobile broadcast software	Polaris Ventures	$15,000,000
12	Roving Software	Web-based e-mail marketing service	Greylock Partners	$15,000,000
13	Dataupia Corporation	Systems for high-volume data industries	Polaris Venture Partners/Valhalla Partners	$15,000,000
14	Acsera Corporation	Performance mgt. for J2EE and SOA apps	Sierra Ventures	$14,200,000
15	Sierra Design Automation	High-performance IC implementation solutions	Artiman Ventures	$14,000,000
16	Parature (Cyracle)	On-demand customer support software	Valhalla Partners/Sierra Ventures	$13,500,000
17	Mavenir Systems	Mobile multimedia systems	Austin Ventures	$13,100,000
18	ChoiceStream	Personalization for online entertainment	Sutter Hill Ventures	$13,100,000
19	Sabrix	Sales and use tax and VAT management	GKM Ventures	$13,000,000
20	Veoh Networks	Helps users to create a virtual TV network	Spark Capital	$12,500,000
21	OATSystems	RFID software	Matrix Partners/Greylock Partners	$12,500,000
22	Applied Identity	Identity/authorization for internal networks	OVP Venture Partners	$12,000,000
23	Destineer Studios	Videogames and virtual training simulations	Exxel Group	$12,000,000
24	Maven Networks (Maven)	Broadband TV; IPTV	Prism Venture Partners	$12,000,000
25	Oakley Networks	Insider threat detection/prevention for networks	Duff Ackerman & Goodrich Ventures	$12,000,000
26	MarkMonitor	E-commerce fraud/counterfeiting protection	Cargill Ventures	$12,000,000
27	Cranite Systems	Secure enterprise connectivity from hotspots	Warburg Pincus	$11,500,000
28	Kayak.com	Search engine for travel services	Accel Partners	$11,500,000
29	Metatomix	Critical decision making software	Dunrath Capital	$11,300,000
30	41st Parameter, The	Covert fraud detection and prevention (online)	Kleiner Perkins Caufield & Byers (KPCB)	$11,200,000
31	SOA Software	SOA and Web services management/security	Draper Fisher Jurvetson (Draper Associates)	$11,000,000
32	Nextance	Contract performance management (CPM)	Eldorado Ventures	$10,100,000
33	CallMiner	Speech analytics software for the enterprise	Sigma Partners	$10,000,000
34	Integrien Corporation	System integrity management	Acartha Group	$10,000,000
35	Nangate	EDA tools for integrated circuits (ICs)	Vaekstfonden/IVS/SEED Capital	$10,000,000
36	Resilience Corporation	Ultra-high-availability security appliances	Kennet Venture Partners	$10,000,000
37	Bit9	Application control for Windows desktops	Kleiner Perkins Caufield & Byers (KPCB)	$9,800,000
38	Pyxis Technology	EDA software for IC designers and foundries	Formative Ventures	$9,200,000
39	Aequus Technologies Corp.	Aids for people with hearing/other impairments	NY State Common Retirement Fund	$9,100,000
40	Wichorus	Mobile services and applications	Accel Partners	$8,500,000
41	Palamida	Software IP management and compliance	Mitsui & Co. Venture Partners	$8,000,000
42	Verimatrix	DRM/content management for IPTV networks	Crescendo Ventures	$8,000,000
43	PatientKeeper	Healthcare information technology	Mediphase Venture Partners	$8,000,000
44	Rally Software Dev. Corp.	Agile Application Lifecycle Management tools	Vista Ventures	$8,000,000
45	Siperian	Customer data integration and management	ArrowPath Venture Capital	$8,000,000
46	Realops	Integrated operations automation	Palomar Ventures	$8,000,000
47	Pivot Solutions	AIM-certified IM for trading and research	SoftBank Capital	$8,000,000
48	Encover	Increases revenues from service contracts	Baird Venture Partners (BVP)	$8,000,000
49	Technorati	Search engine for Weblogs	Draper Fisher Jurvetson; Mobius Venture Cap.	$7,600,000
50	ServiceBench (Sideout)	Manages post-sales service and transactions	Valhalla Partners	$7,300,000

If SaaS applications are viewed by ISVs as annuity streams, why should the channel not view it the same way—and participate in the annuity stream? Think about how life insurance is sold and how the agents participate in the downstream renewals. Of course, the channel is more engaged in the downstream revenue than your typical life insurance agent, so the savvy ones will probably want to be compensated accordingly.

Good News and Bad News for ISVs

Taken together, this suggests the possibility of a new generation of superVARs that integrate multiple applications into a common solution, hosting it and providing billing. They will also own a greater share of the customer relationship. Such ownership by the VAR relative to the ISV will also shift margin expectations in favor of the VAR. It is not all bad news for ISVs as the annuity aspect suggests that the margin restructure will be re-crafted to extend over the lifetime of the customer relationship. In exchange for participation in on-going downstream revenues, VARs are likely to accept a smaller payout up front, and would be wise to do so.

"The services model in the SaaS environment faces significant disruption. Software firms and VARs will have to reach a new equilibrium. Data integration is an area of great opportunity."

—Bruce La Fetra
Rubicon Consulting

ISVs that cling to traditional channel models—or worse, see SaaS as a way to cut out the channel—are likely to see innovative VARs moving to isolate ISVs from the customer relationship. ISVs need to rethink the channel economics for their situation and understand how the channel can add value to their offering and extend its reach. ISVs also need to think about how they can manage the situation to maintain a relationship with the customer. This is important for the deal economics, but even more so for maintaining the insights and feedback resulting from direct customer interactions.

New ISV Opportunities

ISVs would do well to understand the additional benefits VARs can bring to their SaaS efforts. This will allow forward-looking ISVs to: (a) partner with the VARs offering the best leverage and (b) proactively drive the re-negotiation of the channel economic model. Long term customer relationships become very profitable with SaaS. VARs can be instrumental in developing and maintaining these relationships. The agent-insurance company example above is very apt.

The insurance company does not resent the agent for earning commissions on each renewal, and neither should ISVs with regards to VARs and SaaS. The ISV, however, needs to work hard to make sure that the channel compensation model works to its long-term advantage and is appropriate for the value created by the channel. ISVs must also consider multiple channel programs, keeping in mind that—at least during the near-term—not all VARs want to be paid "for the long term."

Bruce La Fetra, senior marketing consultant, Rubicon Consulting, 101 Church St., Ste. 22, Los Gatos, Calif. 95030; 408/3953910. E-mail: bruce@corumgroup.com.

Strategic versus Financial Buyers, Part I of II

By Ward Carter, Corum Group

A strategic buyer is a company that is positioned in the same market space as the seller, or at least in a closely adjacent space. For example, in the ERP space a large player like SAP, Oracle, or Microsoft may have a strong generalized solution and market clout, but lack the vertical market focus that smaller vendors offer. If you have a specialized vertical market solution, say in the manufacturing space, you can deliver not just technology, but also specialized domain expertise, a customer base, a sales force, and recurring revenue from maintenance or subscription services. This provides a buyer seeking to enter your space a running start instead of building a solution and market from scratch. A strategic buyer already in your market but seeking to consolidate a market category will truly understand your business and the value of what you have created.

Pros—A strategic partner can potentially offer:

1. Better brand recognition and financial strength, eliminating the objections you often face as a smaller, lesser known, financially weaker company.
2. The broad distribution you lack, and which could take years to create.
3. Access to new markets immediately, and opportunities to cross-sell your products into existing customers where the buyer already has a relationship.
4. Better opportunities for your people in the form of career advancement, benefits, financial security, etc.

Cons—Possible disadvantages to consider:

1. The market may perceive the sale of your smaller company to a larger one as indicating you could not make it on your own, and that you were forced to "sell out". You may face the same undesirable reaction from other partners, vendors, and employees.
2. There will likely be some staff attrition due to redundancies after the merger.
3. You will probably need to sell all of the equity in your company, as larger buyers are not generally interested in retaining minority shareholders.
4. The brand you have developed will disappear as your company and products are integrated into the acquirer.

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

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Intergraph (INGR) • *Spatial information management*	Private buyer	$1,300,000,000 *Terms: Cash*	$587,000,000	**2.21**
Click Commerce • *Demand chain management*	Illinois Tool Works (ITW)	$292,000,000 *Terms: Cash*	$73,900,000	**3.95**
Mobile 365 • *Mobile messaging/content delivery*	Sybase (SY)	$400,000,000 *Terms: Cash*	$90,000,000	**4.44**
Embarcadero Technologies (EMBT) • *Data management solutions*	Thoma Cressey Equity	$234,000,000 *Terms: Cash*	$59,800,000	**3.91**

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Softletter Flashback

(***Flashback** is a new feature we're introducing to Softletter as of this issue. The purpose of **Flashback** is provide up-to-date follow-up on recently published articles in Softletter*.)

In the July 31st article *Trolls and Robes: The Supreme Court Steps In,* we observed that many in the press have misrepresented the recent MercExchange vs. eBay case as a victory against "patent trolls." We made the point that though the court had made obtaining an injunction more difficult, this was likely to be counterbalanced by the judges being more financially generous to plaintiffs.

This prediction appears to coming true when you examine the z4 vs. Microsoft case, also referenced in *Trolls*. In August 2006, an exasperated district judge Leonard Davies, who had declined to issue an injunction against Microsoft after a jury found for z4, slapped the Redmond company with an extra $25M fine in addition to the $133M it ordered Microsoft and Autodesk to pay z4 after the case. Judge Davies cited an attempt by Microsoft to swamp the court by submitting 3449 exhibits while only introducing 107 during the proceedings, withholding a critical E-mail, and other annoyances. But we also believe the ruling indicates the courts will react badly to attempts by defendants to further "game" patent cases once the jury has spoken. If you loose a case but avoid an injunction, expect to pay the plaintiffs significantly more money. (The case also indicates the tolerance of the judicial system for what it perceives as improper or obfuscatory behavior from Microsoft is close to zero.)

FOGCREEK CEO JOEL SPOLSKY ON WINDOWS VISTA AND VMWARE: "If I were VMWare I'd be pretty ticked off at Microsoft right now; since Microsoft makes a competitive product, Virtual PC, it is Highly Suspicious that they come out with a major new test release of an operating system that just happens to not work on VMWare Workstation, something which is practically the de facto standard for developers testing new operating systems. Shabby and slimy, Microsoft. They're probably testing Windows Vista with tens of thousands of applications; not testing with VMWare is inexcusable." (Quoted on www.joelonsoftware.com, 09/08/2006)

INFORMATION WEEK REPORTER CHARLES BABCOCK ON PATENTS AND MODEL TRAINS: "A Berkeley physics teacher, Robert Jacobsen, loves model railroads and built the Java Model Railroad Interface as open source code for fellow hobbyists. In March, he received an invoice for $203,000 from KAM Industries saying it had a patent on digital methods of controlling a model railroad command station, and it was seeking payment for all the times Jacobsen's code had been downloaded. Jacobsen is fighting the invoice in court and asking that the KAM patent be voided." Quoted in ***InformationWeek***, 09/04/2006)

GARTNER ANALYST TOM BITTMAN ON THE FUTURE OF WINDOWS: "Is Vista the last big release of Windows? I firmly believe that it is." (Quoted in ***Optimize***, 09/06/2006)

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