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BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Channel Optimization: Are You Giving the Channel Too Much?, Part II of II

by Nilofer Merchant, Rubicon Consulting

Our extensive Open Source ISV survey reports seem to be embracing OSS; respondents split about 2:1 or 3:1 in favor of use or intended use of OSS in their own software See pages 4-6.

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Not making money selling a product is a problem for the channel, and one that you should care about as it results in less mindshare for your company. Unless the channel is providing valuable fulfillment benefits, a direct sales model always makes the most sense. Funding channel switchin is throwing money away. The big win is not from simply figuring out how to pay the channel more, but making sure the intended margins and payments reinforce desired behaviors in the channel. Increasing MDF payments for a product that will not benefit from additional advertising will only help to subsidize other products. Offering rebates without the appropriate strings turns them into handouts.

The additional payments and support should be contingent upon achieving specific results such as increasing revenue or adding new customers. You need to find another way to compensate, motivate and reward the channel if the indirect channel is to contribute to your sales model. Never offer funding without tying your dollars to specific metrics.

It is vital when planning your channel expenditures to understand how different kinds of soft dollar programs influence the various types of resellers and the departments within the channel organizations. Some specifics are:

- Each marketing champion for a vendor must bring in X% of soft dollars, and their bonuses are set by achieving this goal.
- Each VP of sales focuses on rebate dollars.
- The head of the organization, focuses on rebate targets and goals.

One of the surprises in our research was how quickly market efficiencies are leveling reseller profitability across all classes of trade and regions. This means that corporate resellers are not more profitable—as many people assume—than other classes of resellers, and therefore they do not have the resources to drive the levels of demand generation that you *(continued on page three)*

Licensing Complexity: A SaaS Driver

by Rick Chapman

I was invited to give a presentation at MacroVision's recent SoftSummit, an industry mini-conference focusing on licensing, pricing, and related marketing issues. After my session I sat through several of the presentations on licensing trends and was struck by the dizzying complexity facing a firm that wants to license software. In addition to the ongoing battle between named user, per seat, concurrent (the model Macrovision wants everyone to move to), server, and CPU-based price schedules, multi-core and virtualization technologies have now been thrown into the mix. In response, fans of per CPU pricing such as Oracle are introducing fractional core processing. In other words, when deciding how to pay for your Oracle DBMS, you now get to do something like this: *"For the purposes of counting the number of processors that require licensing, the number of cores in a multi-core chip now shall be multiplied by a factor of .75."*

Customers will probably want to avoid CPU-based license deals that deal with odd numbers if they don't want to have to subject themselves to these kinds of calculations: *"A multicore chip with 11 cores would require a 9 processor license (11 multiplied by a factor of .75 equals 8.25 which is then rounded up to the next whole number which is 9)."* (Quotes are from an Oracle license agreement.)

Of course, virtualization introduced more headaches for per CPU pricing models. Companies now must deal with copies (instances) of their software being created via hyperthreading and virtualization. In response, Microsoft has just announced a new "per instance" pricing scheme, whereby a company will only pay for each copy in use of the application spawned by the virtualization process. Microsoft likes to point out that this new model can cut costs for a company that is paying a $100 per processor for a four processor box for a total license cost of $400. Under the new license, if only two copies of the application are in use via virtualization, the company would only pay $200 for their license. Of course, Microsoft is not pointing out that if the four processor company was creating eight virtual boxes to run eight copies of an application, their license costs now jump to $800.

In response to all this, some software firms now want to try "per socket" pricing, in the belief that these mechanical connectors are unlikely to be virtualized. We suspect these companies underestimate the ingenuity of hardware engineers, who have learned to plug into system backplanes via a whole host of imaginative ways.

After my presentation, I met up with an old friend who once worked in the software industry and now holds a senior IT position with a New York-based financial services firm. His company has purchased a wide range of different software licensing, and I asked him his opinion about the developments he was learning about at the conference. He looked at me and said one word "SaaS." He then went on to tell me that he's part of a company task force looking to replace every application they can at his firm with a hosted equivalent. Only certain core business processes will be exempt. The goal of the initiative is to liberate the firm from software licensing and compliance burdens. "We've decided we can save money and resources by renting applications and using a hosted service to aggregate our billing and tracking obligations. We think it will take us about four years to clear out all the licenses and move to a 90% SaaS-based computing environment. There's not one of my peers who isn't considering the same approach."

may expect. While corporate resellers focus on selling products they know to their existing accounts, mail order/Internet resellers match them, having evolved into very sophisticated marketing machines that aggressively pursue new customers.

Thus, you need to strategically allocate funds based on a holistic view of the channel. If the channel is passing along part of their discount, then you should capture a larger share of the customer price. This directly benefits your bottom line. Improve reseller profitability—and mindshare—by providing them with a greater and more stable profit contributions.

"Your channel optimization program will need to be tuned to your situation based on market dynamics and your specific objectives. Just remember to do it with a macro lens and use all your tools effectively."

—Nilofer Merchant
Rubicon Consulting

Rebates vs. MDF

Without a valid rebate program, vendors cannot get and maintain the attention of the reseller's most senior decision maker. Because at the end of a quarter when it comes to focusing on any particular vendor, it's this executive that decides whether McAfee vs. Symantec or Palm vs. Microsoft receives the firm's sales focus.

Maximize channel motivation and responsiveness by tightly linking your rebate programs with specific and challenging goals. If rebates are needed, by all means offer them, but only to resellers that meet specific goals such as a 25% revenue increase for specific products. If rebates become a handout, they will simply be passed on to the resellers customers as additional discounts.

Your use of MDF should focus on resellers capable of doing new customer development. As already noted, our research indicates that currently the reseller segment most aggressively pursuing new markets are the mail order companies. Having undergone a bruising consolidation over the last few years, the survivors have learned to fuel their growth by selling more both to their existing customers and finding new customers. Mail order resellers, however, are only effective where indirect selling is appropriate. Since much of the rest of the channel lives off of vendor-generated demand, for products that require direct selling, the vendor will need to be involved regardless of the reseller's desire to open new markets.

Use the right tools with the right type of reseller. MDF is most effective with mail order resellers; rebates are important for corporate resellers targeting large accounts. Our analysis indicates there are two venues where MDF expenditures are most effective. First is placement in the limited number of "IT bible" catalogs. Having a presence in these publications is essential for products sold into IT. Second is money spent on seeding new product segments. Demand generation is largely the job of the vendor, so where there is risk—such as entering a new category—the vendor needs to take the lead. MDF spending is a good way to support market entry.

"Consider tieing rebates to overachievement of your company goals. If your firm's growth target is 10%, tie rebate awards to 15% growth. The channel benefits and so do you."

—Nilofer Merchant
Rubicon Consulting

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The First Softletter Open Source Software Poll, Part I

Background

Recently Softletter sent out invitations to ISVs to inform us of their use, attitudes, and plans regarding Open Source Software (OSS). We aimed for actual ISVs, rather than OSS aficionados, and managed to stay within that target group. The fact that responses were received from two OSS luminaries merely shows how pervasive their connections are in the software world.

The 70-odd respondents are admittedly self-selected, but we believe that based on company size and activity they are representative. The poll itself was kept as short as possible, and as the first in a series it was aimed at testing convention wisdom about OSS, both positive and negative, against the perceptions and practices of actual ISVs.

The ISV respondents split about 2:1 or 3:1 in favor of use or intended use of OSS in their own software, and about half the holdouts indicated they would give OSS a try if their source code could be confined to a "gated community" of their customers. This is a pretty powerful endorsement of OSS in commercial software.

We will discuss direct responses to the Poll question-by-question in this and the next issue of Softletter and will soon make available a larger version with cross-tabulated results.

Survey Results

1. What is the annual revenue of your company?

The size of companies ran the gamut from six who either put zero or refused to divulge income, to a high of $300 million. As a result the average income ran to $18.45 million. The mean income of $2.25 million is more clearly representative of the size of the companies answering. A preliminary look at the results indicates that the larger companies are more reluctant to try Open Source than are the smaller ones.

Segmented by our usual revenue ranges:

None or not divulged	**7**
Under $1m	**16**
$1m-4.99m	**22**
$5m-9.99m	**14**
$10-99.9m	**8**
$100+m	**4**

2. What type of software does your company produce?

Our software product categories were chosen to *(continued on page five)*

reflect the conventional wisdom about where OSS is strong (the back end) and where it is weak (the desktop). It was a surprise to see the wide lead of the Desktop category (26.5%) in the poll, and this topic will be revisited in subsequent polls.

In the rich category of Other (nearly half the responses), tools were the most frequently mentioned, then CRM, vertical ERP and other vertical products, and accounting. Interestingly there was no VoIP software listed, although this area is strong in Open Source.

Desktop applications	**26.5%**
VOIP	**0.0%**
Telecommunications	**7.4%**
ASP/SaaS	**7.4%**
Systems management	**5.9%**
Data warehousing	**1.5%**
Content management	**7.4%**
Other	**44.1%**

3. What is your company's principal market?

The 77 responses received indicate some overlap. Nearly half (45.7%) the companies are concentrating on enterprise software, while the others are evenly divided between vertical sectors (which can include quite large customer companies) and SMB. Obviously many of the small companies are targeting their Open Source products at the enterprise.

4. What are your major concerns about OSS and your business?

The biggest fear among the ISVs is having to operate without the advantage of proprietary code; having that code stolen is the smallest worry. Such confidence may come from a basic trust in the Open Source community to observe the licenses and copyright laws. The second-place worry is that Open Source products could undercut them in the market, but only a third of respondents picked this option.

Being undercut by OSS products	**33.9%**
Losing the competitive advantage of our proprietary code	**44.1%**
Having our proprietary code stolen	**22.0%**

5. Do you currently use any OSS in your product or in software that you distribute in connection with or packaged with your product?

This is a key question in the poll: Do they or don't they currently have Open Source in their product line? Two respondents left the choices blank, but the split among the others is a clear answer that two-thirds of the ISVs are making some use of Open Source in their software. And others are planning to do so in the next twelve months (Question 8).

6. If you currently use any OSS in your product, how do you distribute the OSS?

Some open source licenses require source code to be either distributed or made available to those receiving the binary code—and some do not. We will take up the important question of distribution channels in a later poll, but for now we were trying to get some indication of whether source code might be made available (presumably by download) instead of shipped with the product, and also whether products might simply be referring users to Open Source components that work with the product. *(continued on page six)*

As a consequence the answers are not easy to interpret (particularly since the answers are so close to each other in size), but it is significant to see that 37.3% of the respondents are using Open Source code inside their product. In the case of some licenses (notably the GNU GPL) that would mean that the entire linked code package must have its source code shipped or made available. This is a move well beyond simply bundling or referring to some Open Source components that work with their product.

Distributed with our product	**29.9%**
Made available in connection with our product	**32.8%**
Included in our product's software	**37.3%**

7. If you currently use OSS in your product, what OSS license(s) are you using?

Forty-six respondents are shipping products with OSS (Question 5), but 64 answered the License question. This response is difficult to interpret, but we do know that a dozen respondents are not shipping now, but plan to do so in the next twelve months.

The most widely used license is the GNU GPL (40.6%). One would expect commercial shippers to prefer a less-restrictive license such as the BSD, but the case is that there is more software available under the former license than under the latter. The BSD license is second (14.1%), followed closely by Mozilla (12.5%). The Other category (23.4%) showed that the Apache license was just as popular as the Sun licenses (6.3% each).

The replies under Other also indicate that there is confusion about OSS licensing (see Question 14). One respondent answered "Don't know," and two listed the Eclipse Public License, which is an IBM license (IBM and Sun have several licenses). The MIT license listed could just as well have been put under BSD; they are basically equivalent.

Cross-tabulation of the GPL shippers with other questions in the poll yield some interesting information; the answer implies that 41% of the ISVs are shipping products whose source code must be available. This would be another strong indication that the software industry is moving to a model run on services, not on code exclusivity.

BSD	**14.1%**
GNU General Public License (GPL)	**40.6%**
Mozilla	**12.5%**
IBM	**3.1%**
Sun	**6.3%**
Other	**23.4%**

8. If you are NOT using OSS in your product, do you expect to be doing so in the next twelve months?

This question identifies 17 companies that are not using OSS and have no plans to do so, or 24.2% of our sample. But 12 respondents (41.4%) intend to join the ranks of the OSS product companies in the next 12 months. The 41 who did not respond apparently correspond to the 45 who say they are currently using Open Source, and the 17 "No's" (58.6%) apparently correspond to the 22 who answered Question 11 (addressed to those who did not intend to use OSS in their products). Comparisons like these allowed us to arrive at our estimate of 25-33% of the companies not using nor intending to use OSS in their products. The resulting 66-75% for the OSS camp is a strong trend.

Equities

Due Diligence Tips for Sellers, Part I of II

By Mark Reed, Corum Group

Due diligence is a buyer's detailed investigation into the affairs of your company before they acquire it. How you prepare for and respond to the buyer's due diligence can help you receive top dollar for your company or it can destroy value and force you to live with potential liability long after the deal is closed. Following are six important tips you can use to smooth what can be a difficult process.

- First, understand the scope of due diligence and prepare to satisfy the buyer's requests for information. Buyers want to know about a seller's financial, legal, operational and technical affairs, in other words "everything". The buyer's information request will be many pages long. Sellers should prepare long before the information is requested. Get a sample "due diligence checklist". Keep thorough and orderly records and document business processes so you can gather information when required. While this will be necessary for an acquisition, it is also a valuable discipline as your company grows.

- Second, understand when to produce sensitive information. Buyers will ask for information about your customers, products, sales pipeline, financial statements, technology, personnel and other aspects of your business. You need to disclose some information to assist the buyer in a purchase decision, but expect the buyer to show commitment to the transaction commensurate with the volume and sensitivity of information they request. Don't allow the buyer to continues to ask for information without ensuring they dedicate similar efforts to completing the transaction.

- Third, remember that due diligence is about full disclosure. If your company has problems, face that fact, and plan how and when to disclose troublesome information to the buyer. Do this before a deal is negotiated. Time the delivery of bad news when you have the most leverage in negotiations. Your goal should be to ensure that the buyer has no surprises during due diligence. Undisclosed good news means you probably haven't captured full value for your company. Undisclosed bad news undermines your credibility and jeopardizes the transaction.

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

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Instinet Group (INGP) *• Electronic trading software*	NASDAQ	$1,880,000,000 *Terms: All cash*	$130,000,000	**1.66**
Apropo Technologies *• Call center software*	Syntellect	$50,000,000 *Terms: Cash and stock*	$19,100,000	**2.62**
IDX Systems (IDXC) *• Software for doctor's offices*	GE Healthcare (GE)	$1,200,000,000 *Terms: All cash*	$577,500,000	**2.08**
BindView Development (BVEW) *• Security policy compliance software*	Symantec (SYMC)	$209,000,000 *Terms: All cash*	$72,350,000	**2.89**

CORUM
MERGERS & ACQUISITIONS

CardFile

Rich Internet Development (RIA) Tools

(These tools and resources allow software companies to develop appications with interfaces that more closely approximate the power and flexibility of desktop client applications.)

- **ClearNova** (www.clearnova.com): Publishes ThinkCAP JX, an AJAX development IDE; site offers a nice collection of AJAX code samples for newcomers to the technology.
- **Droplets** (www.droplets.com): Server-based, highly componentized development system; think Java servlets on steroids. Extensive cross-platform support.
- **IntegraSP** (www.integrasp): Publishes the Altio RIA; underlying technology is built on top of the J2EE platform.
- **JackBE** (www.jackbe.com): Development suite that uses DHTML to create RIA applications.
- **OpenLaszlo** (www.openlaszlo.org): Open Sourcesuite for RIA development; product has been released under the Common Public Licences (CPL).

SAN JOSE MERCURY NEWS REPORTER ON VCS AND INTERNET FUNDING: "One thing common to new Internet companies in Silicon Valley these days is that they don't need a lot of money to get off the ground. But venture capitalists are eagerly stuffing cash anyway into the hands of some Internet entrepreneurs who have been getting buzz — and who are willing to take it." (Quoted in The Mercury News, (10/14/2005)

EE TIMES REPORTER GEORGE LEOPOLD ON PRODUCT IP LITIGATION: "While product liability remains the largest generator of lawsuits, the survey found that intellectual property disputes are an emerging problem, especially for technology companies. IP and patent lawsuits accounted for an estimated 13 percent of U.S. corporate litigation last year and 16 percent in the U.K. Only contract disputes, labor and employment, personal injury and product liability cases ranked higher than IP lawsuits." (Quoted in the EE Times, 10/12/2005)

DESKTOP PIPELINE EDITOR DAVID DEJEAN ON THE GOOGLE/SUN "ALLIANCE": "Headline writers were looking for that 'the king is dead, long live the king' moment last week in the announcement of an alliance between Google and Sun. But the reality disappointed. The alliance didn't hit with hurricane force. It didn't even manage to rain on Microsoft's parade. Maybe next time the forecasters will get it right." (Quoted in the Desktop Pipeline, 10/12/2005)

MACROVISION CEO FRED AMOROSO ON SOFTWARE LICENSING: "In August and September, the Software and Information Industry Association along with Macrovision, a supplier of software to manage software licenses, sponsored a survey of 500 SIIA members on their satisfaction with existing licensing arrangements. Two-thirds of the vendors interviewed said they had adjusted their licensing and 57% said they were satisfied with the results. Only 28% of customers said they were satisfied with their licenses." (Quoted on 10/11/2005 at SoftSummit)

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