Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Our DSO survey reveals exasperating times for desktop software companies See pages 4-5.

SaaS "Banks": The Right Solution to Funding Your SaaS Startup?

SaaS is hot and SaaS is growing and many companies are starting new SaaS companies but there's one big snake in the SaaS paradise. That snake is cash and cash flow because SaaS can also be expensive (to start). Yes, we've talked to B2C and even some B2B companies that tell us SaaS is cheap if you want to reach "sale one" quickly. You can rent infrastructure with little delay. In some highly targeted application areas, we've seen companies grab some code from here, some widgets from there, do a quick mashup and voila! Instant application. Then buy some Google keywords, run a quick E-mail campaign, and you've got customers!

But then you have to scale your business and the picture changes. To implement a multi-tenanted data infrastructure requires some real programming and a serious development team. SaaS customers require white glove support (even your small ones, who won't stand for being treated like second class citizens) and this by itself can quickly choke your financial growth (we're talking to several SaaS companies who are facing just this dilemma).

And unlike licensed software, in most cases you're not going to be able to rely on that big $1m dollar deal to bail you out; SaaS in most cases grows organically over time, but in the meantime you've got bills to pay. To discuss this dilemma in greater detail and discuss your options, we talked to Jeff Mills of SaaS Capital. Jeff launched SaaS Capital in 2007 and prior to that was a partner at Blue Chip Venture Company where he focused on investing in early stage software companies, many of them ASP/SaaS plays.

Jeff, why do SaaS companies face greater cash flow problems in contrast with software companies selling their software via a licensed model?

Because of the basic nature of the SaaS model. It's not capital issues; it's cash flow. In a perpetual model, you make your million dollar sale, come back, and go out and try to make another. With SaaS, that initial sale may be $25k. Yes, in time it's going to grow into a predictable revenue stream and investors, VCs, and Wall Street like that. The good news is that we're seeing valuations that reward the model. But you can't initially fund an organization with this amount of cash in many

Toy Trains and Open Source Lawsuits

Open Source typically has a warm and cuddly public image, but recent legal events have provided the movement with a much sterner visage. Recently, the SFLC (Software Freedom Law Center) filed lawsuits against High-Gain Antennas and XTERASYS for failing to release source code for their modifications to the BusyBox program, which was also the subject of an earlier, settled suit. The two new cases alleged the companies had violated the General Public License (GPL), which covers the use of most open-source software. (Both firms quickly settled.)

These complaints demonstrate a new, more aggressive attitude on the part of Open Source's most zealous advocates. They also show that the SFLC is very anxious to counter precedent set by the Jacobsen v. Katzer case. This suit, often called the Toy Train case, was an oddball bit of litigation that focused on a violation of the Artistic License, an Open Source license which has very few terms other than that the developer of a product that has been developed under the Artistic License include the names of the original copyright users in the software's copyright notices. In the case, the developer, Jacobsen, sued Katzer for copying, distributing, developing derivative works from, and failing to include the copyright owner's name in the derived work. (The software in question was embedded code that ran a toy train switching system.)

The crux of the case was Jacobsen's request for injunctive relief against Katzer, who was selling toy products based on Jacobsen's system. To the great surprise of Jacobsen, and many in the Open Source movement, the judge denied the request and decided that whatever violations of the license that had occurred could be considered a contract dispute.

From the viewpoint of many in the Open Source movement, the judge's refusal to grant injunctive relief weakened all Open Source licenses, including the GPL. Open Source badly wants the ability to obtain injunctions against license (particularly GPL) violators because injunctions are the nuclear bombs of litigation, bringing a defendant's business or use of a product to an abrupt halt. So-called injunctive relief is very important in copyright cases, as it's essential for plaintiffs to have some way of preventing the unauthorized use of their copyrighted work and money damages, another typical remedy, are hard to establish. What are the monetary remedies for contract violations of Open Source licenses? With proprietary commercial products, establishing monetary damages is fairly easy. If you copy 10 copies of my product and each is priced at $100 per piece, you owe me $1000. But this argument becomes fuzzy with "free" software. There are other potential points of litigation. Maybe damage to a developer's reputation within the Open Source community? Perhaps, but it's all a bit nebulous.

The initial reaction to Jacobsen v. Katzer within the Open Source community ranged from major angst to unconcern. Many observers feel that the judge in the case simply got the case wrong and eventually the injunctive power of Open Source licenses will be restored in subsequent litigation. As the SFLC is demonstrating, Open Source is actively looking for opportunities to reestablish the injunctive powers of its licenses. If you decide you'd like to blatantly violate the GPL and help establish legal precedent for the industry, now is your opportunity. Otherwise, we'd suggest respecting the GPL; violators now sport a bullseye on their chest from the standpoint of Open Source.

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cases. The SaaS model pushes a tremendous amount of cash into future years. If typical DSO (days sales outstanding) figures with perpetual licenses is 60 days, then SaaS DSOs are 600 days. That's an exaggeration, and it's not true once you've matured as a company, but that's how companies considering funding SaaS firms tend to think. Future bookings don't show up; what shows up is 30 days receivable.

Let's discuss the difference in cash requirements between a licensed and SaaS firm.

In a whitepaper we released recently in partnership with THINKStrategies, we referred to Will Price of Hummer Winblad. He's estimated that it takes 1.6X longer for SaaS companies to reach liquidity in comparison with companies based on the licensed model. He also estimated it takes between 1.75 more revenue and up to 3.65 more capital to reach profitability. I can confirm those figures since SaaS Capital works with many SaaS firms and we look at many financials.

Let's drill down a bit into the NetSuite IPO; this should be very relevant since Zach Nelson is giving the keynote at your SaaS seminar in Atlanta. The IPO filing disclosed that NetSuite generated $17.7m in revenue in 2004, $36.4m in 2005, and $67.2m 2006. But sales and marketing costs exceeded revenues in 2004 and 2005, reaching $27m in 2004 and $39.2m in 2005. It wasn't until 2006 that NetSuite spent "just" 53% of revenue on sales and marketing.

A Softletter analysis of Salesforce.com's financials in 2004 indicates these numbers can be misread if you look at their future recurring revenues.

That's a good point. Total costs of sales are not actually higher. For example, if a licensed-model software company with three sales people, each being paid $100,000 a year in base and commissions, generates $1.5m in business in Q4, the selling cost as a percent of revenue is 20% for that year. However, if a SaaS vendor has the same three sales people sell $1.5m in three-year contracts, in Q4 the selling cost would be 240% because only a small portion of the revenue is recognized. On a cash basis, the SaaS model calls for many expenses to be paid out before customer revenue comes in.

So how does a SaaS company obtain the cash it needs?

Well, VCs are the obvious source; there's no shortage of VC money flowing into SaaS, as Softletter has made clear. We looked at the last six major SaaS IPOs and about $76m in venture money was sunk. This represents a lot of founder and common shareholder dilution. Worse, if you need to come back for C, D, even E level financing (and no one wants to do that), it becomes worse.

What about the banks?

> "Because SaaS companies can require 50% to 300% more cash to build than traditional licensed software firms, financing a firm's additional cash needs with equity sources is an inefficient use of capital for the company founders, management team and the VC investors."
>
> —*Jeff Mills, SaaS Capital*

Sector	DSO
Vertical Apps	77 / 87
SaaS	56 / 61
Network Tools	65 / 74
Developer Tools	74 / 72
Education	75 / 68
Enterprise Apps	63 / 68
Desktop Apps	61 / 57
Google	46 / 41
Microsoft	77 / 66

Days Sales Outstanding
Google is a leader in this measure of financial efficiency

Grey represents 2006, white 2005

(Horizontal axis: 0, 20, 40, 60, 80, 100)
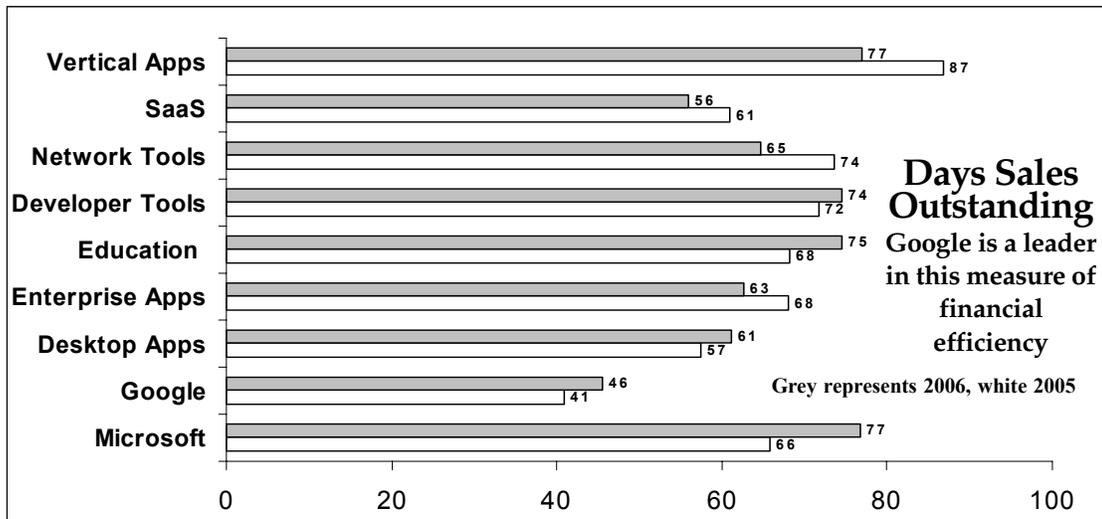
Benchmarks: Days Sales Outstanding 2004-2006

Our latest look at "days sales outstanding," also known as the ratio of receivables to total sales, shows that our Benchmark 50 public companies typically collect their money from customers a median 71.3 days after the invoice is sent, a significant though not tremendous increase from 2004's 67.7 days. Several factors contribute to this increase. Please note the very significant increase in DSO for the Developer Tools and Education sectors; these are tough markets that are characterized by low growth and heavy competition; in such markets, companies have to deal with strong competition and CFOs and purchasing departments who are not shy about attempting to use your firm as a "bank" if times are bad.

Desktop applications is another sector suffering from changing times. Retail is a harsh place to do business and unless you're a Microsoft or Adobe, software companies can regard all sales made into the channel as consignments; this accounts for DSO figures that used to hover in the 40s now moving to 60+ days. On the positive side, Enterprise Applications has seen its DSO numbers drop significantly and Vertical Applications continues its good performance.

Our new SaaS cohort also sports good DSO figures, but we're going to suspend praising this new sector until more public numbers are available. The nature of SaaS makes calculating DSO tricky, and we're currently planning to update this sector significantly and decide whether we need to adjust our metrics; we'll keep you posted.

As we've pointed out in the past, the most effective way to reduce your DSO is to calculate and chart it, (this seems obvious, but we remain surprised by the number of companies who don't do this), identifying slow-paying customers; limiting extended payment terms; rewarding early payment with upfront discounts and penalizing late payers; pursuing delinquent accounts vigorously; and identifying fast-paying customers and cross selling them additional licenses, services, and maintenance renewals, all of which have shorter payment cycles.

The Benchmark 50: Days Sales Outstanding, 2004-2006

	Revenues (000)			Median			Avg.
	2004	2005	2006	2004	2005	2006	'04-'06
Microsoft	$36,835,000	$39,788,000	$44,282,000	58	66	77	67.0
Google	$3,189,233	$6,138,560	$10,604,917	36	41	46	40.7
Desktop Applications				59	57	61	
Intuit	$1,867,663	$2,037,703	$2,342,303	18	15	14	15.7
Bitstream	$9,726	$11,632	$15,653	203	220	160	194.2
Adobe	$1,294,749	$1,966,321	$2,575,300	41	32	51	41.3
Symantec	$1,870,129	$2,582,849	$4,143,392	51	40	59	50.0
Cyberlink	$48,966	$65,141	$74,926	59	57	61	59.1
Nuance	$130,907	$232,388	$388,510	102	104	104	103.4
Smith Micro	$7,216	$13,316	$20,258	188	124	63	125.1
Vertical Applications				64	68	63	
Autodesk	$951,643	$1,233,800	$1,523,200	64	89	63	71.8
Moldflow	$48,673	$64,418	$65,558	64	76	71	70.6
Ansys	$134,539	$158,036	$263,640	5	5	14	8.1
Advent	$149,990	$168,701	$184,093	36	1	17	18.0
Dendrite	$321,107	$399,197	$437,240	81	40	16	45.6
MapInfo	$106,255	$149,424	$165,495	80	68	117	88.5
Kronos	$397,355	$518,658	$578,203	77	85	78	80.1
Enterprise Applications				86	87	77	
Concur	$56,737	$71,831	$97,145	51	63	85	66.3
Manhattan Associates	$196,814	$246,404	$288,868	76	87	77	79.8
Knova Software (ServiceWare)	$11,511	$12,502	$23,594	106	111	31	82.8
Pegasystems	$103,291	$100,209	$126,023	71	73	70	71.0
Witness Systems	$108,037	$141,335	$185,328	107	104	118	109.5
SPSS	$208,367	$236,063	$261,532	86	66	75	75.7
Business Objects	$560,825	$1,077,151	$1,253,760	122	90	97	103.2
SaaS				52	61	56	
Digital Insight	$154,362	$188,891	$213,971	52	100	87	79.4
WebEx	$249,133	$308,422	$380,012	48	61	52	53.3
Blackbaud	$138745	$166,296	$191,959	52	56	56	54.6
Salesforce.com	$1,054,780	$309,857	$497,098	9	58	56	40.9
RightNow Technologies	$60,416	$87,148	$110,388	102	107	106	105.0
Savvis	$616,823	$667,012	$763,972	28	28	21	26.0
Network Tools				77	87	74	
Citrix Systems	$588,625	$741,157	$908,722	54	70	82	68.8
McAfee (Network Associates)	$936,336	$910,542	$987,299	66	93	8	55.7
iPass	$136,078	$166,319	$169,273	64	51	66	60.6
Novell	$1,105,496	$1,165,917	$1,197,696	77	92	71	80.0
Altiris	$99,339	$187,640	$229,434	86	89	90	88.2
Tumbleweed	$30,595	$50,001	$61,994	120	66	74	86.5
NetManage	$50,663	$47,666	$43,434	92	87	86	88.1
Developer Tools				68	72	74	
Raining Data	$22,297	$21,483	$20,294	31	34	29	31.3
Pervasive Software	$49,608	$48,352	$45,580	69	56	59	61.2
Progress Software	$309,060	$405,376	$447,063	61	46	59	55.6
Borland Software	$295,236	$276,743	$304,660	68	72	74	71.4
Sybase	$778,062	$818,695	$876,163	66	75	91	77.2
Red Hat	$126,084	$196,446	$278,330	111	90	78	93.1
BEA Systems	$1,012,492	$1,080,094	$1,199,845	97	87	101	95.0
Education				69	68	75	
Renaissance Learning	$130,544	$116,283	$111,528	37	36	34	35.7
The Apollo Group	$1,339,517	$1,798,423	$2,251,472	34	35	26	31.6
Saba Software	$34,471	$42,210	$71,147	70	131	94	98.6
American Education Corp.	$8,598	$10,187	$9,819	118	83	125	108.9
Plato Learning	$82,192	$121,804	$90,719	174	68	75	105.6
SumTotalSystems	NA	$74,970	$105,988	NA	123	98	110.5
Scientific Learning	$30,976	$40,139	$40,998	67	32	32	43.5
All companies (median)				67.3	68.2	71.3	76.3

Note: "Years" may not correspond to company fiscal years. DSO = year-end accounts receivable divided by annual revenue * 365.

Your choices are limited. Most banks are uncomfortable dealing with software companies; technology loans make their teeth ache. Software Banks such as Silicon Valley and Comerica do specialize in loans to the software industry, but when they sit down with a SaaS firm, what do they see? A lack of profits and a lack of assets. Taking over your company's servers in the event your firm craters doesn't excite them. Venture debt firms are another alternative, but they tend to want to lend you money after you've already borrowed what you needed.

OK, let's discuss what your company does.

We specialize in loaning money to SaaS firms; we look at SaaS financials and where banks see lack of revenue and no assets we see future growth and predictable revenue. Our loans are not based on equity trades; we don't take a position in the companies we loan money to.

What are your criteria for making a loan?

We do a very thorough analysis of a company before making a loan. The issues we analyze include:

• Language and development methodology (we're proponents of Agile methodologies)
• Testing environment
• Location/hosting provider
• Data backup proccesses and procedures
• History of uptime
• SAS 70 and compliance (we've found this to be of increasing importance)
• Customer retention rate and individual customer usage

Individual customer usage is a particularly key metric for us. A customer who uses an application on a daily basis is a renewal; one who logs in every six months is a non-renewal waiting to happen.

Why the close analysis of a company's underlying technlogy?

We offer our customers, in the event their company goes out of business, the option of SaaS Capital taking over operation of the software and maintaining it. This is not an escrow arrangement. The application stays at its current location and stays up and running while we retire our debt. We provide help desk and maintenance assistance. We don't provide development and product updating, however. But we think there's real value in being able to offer this type of assurance to your customer base.

What are typical loan terms?

Our product is structured on lending based on the unbilled future contract value of your customer contracts. For example, let's assume you've closed a $1m contract over the 36 months; we loan you $330k (a third of the future cash flow brought forward). You repay the loan as the customer repays you. Our interest rates range from 13% to 15%. If your business consists primarily of many short term contracts, we'll provide a loan that's a three to four times multiple of your montly recurring revenue. For example, if you're bringing in $500k per month, we'll loan you $2m. We typically look for companies that are generating $3.5m in recurring revenue, though we will consider smaller startups on a case-by-case basis.

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Not All Revenue Is Created Equal, Part II of III

By Mark S. Reed, Corum Group

Maintenance: Maintenance revenue, typically billed annually as a percentage of software license value, can provide revenue stability and profitability for companies that mainly sell software licenses. Buyers value that predictability. However, when maintenance revenue is a small percentage of total annual revenue, it may reveal that few customers purchase maintenance. Alternatively, if maintenance revenue is a high percentage of annual revenue, it may be because sales have stagnated and there is little growth. Another issue facing companies transitioning to the SaaS model is that traditional maintenance revenues evaporate quickly as your business moves to a recurring revenue model.

Subscriptions: The sale of software under a subscription is increasingly common and is the business model for the sale of "software as a service" or SaaS. Valuations of companies like Salesforce.com clearly indicate that investors and acquirers highly value the predictability of this business model. The high valuations also stem from the fact that once SaaS companies reach a base of revenue that covers operating costs, the profit margin on all revenue increases is very high. Part III of this article will examine this issue in greater detail.

Long term contracts: Software companies may sell licenses under contracts that extend over several years. Future amounts are contractually assured but will not show up on historical financial statements. This contractual revenue should be highlighted as an element of a company's pipeline analysis. While a revenue multiple may not be applicable, contractual revenue can support a rationale for using the highest comparable market valuation metrics and a premium valuation.

So, be prepared for buyers to ask for an analysis of your revenues. Don't expect them to value all your revenue the same way. If your potential buyer is a public company, look to their business model, financial statements, analyst reports and market valuation to understand their perspective on valuation so that you can provide them sound rationale for the valuation that you want. As you describe your company's revenue models, help the buyer gain an accurate view of the risks in your business and recognize where they can drive future profits.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Tradus (QXL2.DU) • *Internet auction company*	Naspers (NSPN)	$1,910,000,000 *Terms: Cash*	$116,200,000	**16.44**
Visicu (EICU) • *Clinical software*	Philips Electronics (PHG)	$431,400,000 *Terms: Cash*	$36,000,000	**11.98**
Electronic Clearing House (ECHO) • *Electronic payment processing*	Intuit (INTU)	$131,000,000 *Terms: Cash*	$76,900,000	**1.70**
Document Sciences Corp (DOCX) • *Document output management*	EMC (EMC)	$85,000,000 *Terms: Cash*	$38,700,000	**2.20**

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MERGERS & ACQUISITIONS

Create Your Own Online TV Show Resources

- **Brightcove** (www.brightcove.com): Positions itself as a complete platform for producing, publishing, and monetizing online videos and TV shows. Allows video uploads from audience and a wide variety of sharing and tagging features.
- **Mogulus** (www.mogulus.com): System allows you to create your own "TV" show within a browser. Allows you to stream from a home-based webcam as well as combine video from external sources. Popular blogger Robert Scoble is a noted high-tech user. Quality of your show can vary widely based on the viewer's connection and your hardware. Supports a tag feature that enables your show to be embedded in different websites.
- **Operator11** (www.operator11.com): Browser-based system allows you to create your own TV show; ranking system calculates popularity over the last seven days. System doesn't have much focus on high-tech.
- **Vpod.tv** (http://corp.vpod.tv/index.php?option=4): Easy to use TV channel creations system; elegant interface; not much high-tech focus.

MICROSOFT FOUNDER BILL GATES AT CES: "This is my last keynote. This will be the first time since I was 17 that I won't have my full-time Microsoft job." (Quoted on http://www.sciam.com/article.cfm?id=ces-notebook-gates-gives, 01/07/2007)

BLOGGER JOHN MURRELL ON BILL GATES' FUTURE IMAGE: "When he makes that much fun of himself, you just gotta love the gawky lug. And as the memory of Gates the hardball monopolist gradually fades in favor of the image of Gates the relaxed philanthropist, the chairman's legacy-building will be right on track." (Quoted on http://svextra.com/blogs/gmsv/2008/01/bill_gates_20_--_now_harder_to_hate.html, 01/07/2007)

GOOGLE OPEN SOURCE PROGRAMS MANAGER CHRIS DIBONA ON OPEN SOURCE: "The thing about open source [is], it's kind of like it's yours. Considering that Google does an insane amount of software development, if we had to have some of the restrictions that heavily proprietary [code] would present us, we couldn't develop at the speed that we do." (Quoted in *Redmond* magazine, January 2008)

INFORMATION WEEK COLUMNIST ANDY DORNAN ON MICROSOFT'S PLANS FOR SILVERLIGHT: "Unlike previous client-side Microsoft technologies like ActiveX and Windows Media Player, Silverlight is cross-platform (supporting Macs) and cross-browser (working with Firefox, Opera, and Safari).

The intent clearly is to marginalize the browser, hoping that RIA developers will target a richer platform." (Quoted in InformationWeek, December 10th, 2007)