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Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

ASP/SaaS Pricing Models, Part I of II

Blah news from the VC front for the first quarter of 2005
See pages 4-5.

The history of business computing is the story of enterprise-level computing moving downward into smaller businesses; it began with minicomputers, continued through desktops, and continues on Treos and Blackberries. So it should not surprise us that the application service provider (ASP, now often known as software as a service) model is as old as the timesharing that made mainframes available—remotely—to smaller businesses. And software rental likewise existed in the old mainframe days; while software to some extent was given away in order to sell the machine, the leasing of a machine with particular software (a time lease, remember) could be priced differently according to the software. The resurgence in today's ASP market simply shows that the market is defined by the fact that large companies can have in-house whatever they need; small companies depend on ASPs to give them enterprise-level services.

Interest in ASPs is driven on the IT side by the outsourcing movement and on the ISV side by the search for steady revenue. And both parties hope to save money in support costs. These motives are the actual drivers, while technical advances, from increased bandwidth to increasingly complex metering software, are merely the enablers. Related issues receiving much press play include:

- Grid computing (full utilization of resources, ease of maintenance).
- Virtualization (like grid computing, it deploys local and remote assets more efficiently).
- Utility computing (under different names associated with different vendors: the idea of metered, on-demand computing power).
- Services (ASPs are cheaper than having your own or visiting technicians tweak your system).
- Outsourcing (all of the above).
- Open Source (the classic big-company stuff for little companies: get Linux or BSD instead of Solaris).

Don't confuse ASPs with "subscription pricing;" the latter is an effort by "boxed-product" publishers to smooth out the revenue stream.

In the outsourcing of current functions, customers will compare costs with their present technologies. *(continued on page three)*

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Introduction and Hello from Don Rosenberg

(Editor's note: Gail Wertheimer has resigned as editor of Softletter and Software Success newsletter because she is expecting her second child. We join all of our readers in wishing her the very best with her new arrival!)

Rick Chapman has asked me to join Softletter as editor, and I am very pleased to do so. I will continue to run Stromian Technologies (www.stromian.com), where I do consulting on software licensing and strategy in two flavors: OEM and Open Source. Readers will be interested to hear that the Open Source part of the business is growing. Not only are more proprietary companies writing for Linux (McAfee just entered this market, and Macromedia just announced their intent to do a multimedia tool for the Open Source platform Eclipse), but more companies are interested in looking at the ticklish question of how close you can get proprietary code to code under the GNU General Public License (GPL) before the alarm bells go off. I wrote a piece for LinuxWorld Magazine that goes into this question in depth (www.stromian.com/Corner/Feb2005.html). This topic will only become more relevant to software companies as the next version of the GPL inches towards the light of day. Early analyses indicate that not only do free software advocates seek to overturn the existing copyright system, they have their eyes on patent and IP laws in general.

Rick and I share a passionate interest in the software industry and I am looking forward to providing you with timely analyses on recent developments. In this issue I take up the reviving interest in ASPs (though it looks like the ASP appellation is being supplanted by a new acronym, software as a service (SaaS)) as a business model for ISVs, and look particularly at the pricing issues surrounding this approach.

My own involvement in software marketing began in the heady days of Windows 3.1, when a friend at a startup (Q+E) asked me to come and manage the OEM end of things. There were a few contracts already in place when I arrived, and by the time we were acquired less than 18 months later, there were over 50 partners. Some, like IBM, Microsoft, and Computer Associates, are still around, but most of the rest passed into consolidation or oblivion. I very much enjoyed the ferment and variety of desktop computing in those days, watching the cowboys and the rise of their *Accidental Empires*. Having come out of the international end of a heavy construction and mining company, I had seen similar types in that industry as well.

I believe that those turbulent (and interesting) times are coming again. Since 1996 I have been passionately interested in the progress of what has come to be called Open Source. I began by giving a talk on commercial software marketing to the FREENIX track at USENIX, and as an Open Source market emerged started giving talks on it. Eventually I wrote the first book on business and Open Source, *Open Source: The Unauthorized White Papers*, in order to show business audiences what was coming down the rails, and how it all worked.

But enough about the past. Rick and I believe that Softletter can do more things for its ISV audience, and we are in the midst of starting to provide them. The seminar on Open Source this fall is just the start. This should be a lot of fun for all of us.

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It doesn't matter whether the vendor thinks these comparisons make sense or not. Imagine selling Oracle servers to a company full of file cabinets and file clerks. Low labor and storage costs will be compared with the higher equipment, personnel and training costs for Oracle, along with changes in work practices. The vendor must persuade the customer that the new solution is far better than the old one, especially when the customer may not understand it the way the vendor does.

The customer will always do own-vs.-rent calculations. If the ASP pricing is transaction- or bandwidth-based, the larger the company the more attractive "own" looks, provided there is a fixed infrastructure like a factory or hospital; pure service organizations (such as law firms) won't care; they worry only about month-to-month costs. And just as larger companies have CFOs who make cost-of-capital decisions (are funds better raised through debt or equity?), smaller companies have CFOs (and CIOs) who decide whether it is better to carry certain computing burdens as capital costs (own) or current expenses (rent).

And there is one important consideration the customer may not be aware of, and which works to the vendor's advantage: Real savings are achieved only if the customer shuts down his in-house alternatives, the predecessors to the ASP product. For optimum efficiency, the customer must work to eliminate the vendor's in-house competition.

"We use the term ISV instead of vendor here because the vendor may well be someone in the channel, and it is the responsibility of the ISV to set pricing for sales both direct and indirect."

—Don Rosenberg
Stromian

PRICING

While software pricing for large corporations has always been customized, granular (to aid custom pricing), and negotiated—often amounting to software rental—smaller businesses have had to take or leave what they were offered. These standard offerings went through a development and sales cycle that is still with us.

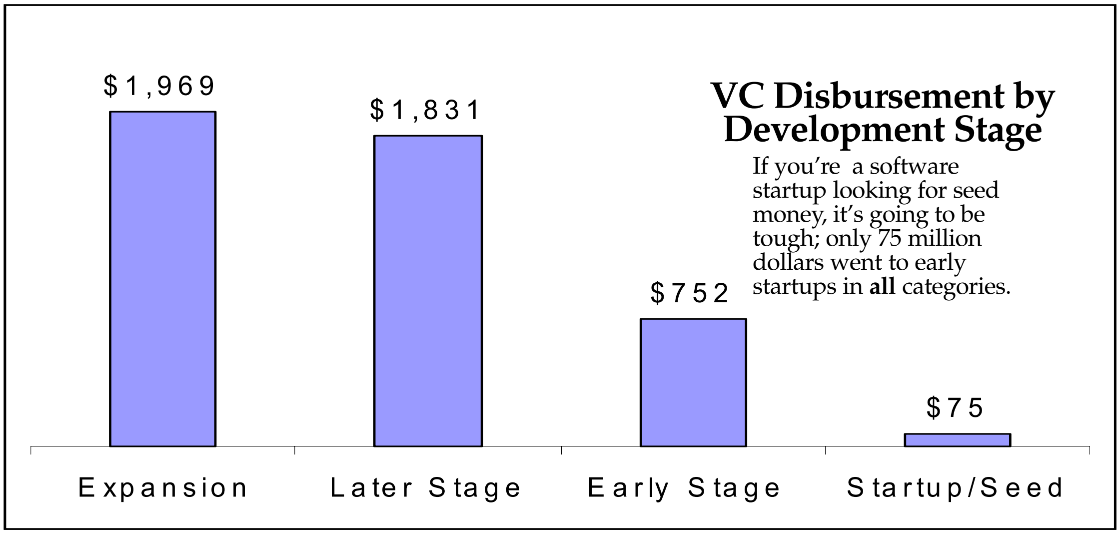
OLD MODEL VS. NEW PRICING MODELS

Old model: Upfront investment for development and marketing/sales, then a windfall of revenues from sales followed by the revenues and burdens of support while collecting funds for another development push; repeat while solvent. To boost revenue, customers are offered discounts and new features to upgrade and pushed to upgrade by dropping support for older versions.

The software industry is feeling its way toward a new business model to deal with the SMB market:

New model: Subscription pricing for OS, servers, and applications to supply a steadier revenue stream. ASPs as software rental services.

For software that runs on the customer's site, the chief difficulty of subscription pricing is whether the ISV can afford the usual upfront investment for development and marketing/sales, without receiving a large lump of immediate sales revenue. Can the ISV front the customer while waiting for the steadier revenue *(continued on page six)*



Benchmarks: Q1 Venture Capital Investments

Our analysis of the first quarter's VC numbers reveal a stagnant current in the flow of VC investment to the market. According to PricewaterhouseCoopers MoneyTree Survey, total Q1 investment numbers came in at $4.6 billion as opposed to $502 billion in 2004's Q1 numbers. Of this year's totals, software held onto to its traditional number one slot with 198 companies gathering in approximately $1.01 billion of VC funding or 23% of all deals; these numbers are down slightly from 2004's Q1 totals, $1.3 billion and 201 companies, respectively.

There have been a spate of recent reports in the press about how VC firms are renewing their search for new and innovative business models but the numbers don't reflect this. First time financings were very low, with only $75 million, or 1.62%, of VC money directed towards firms seeking seed capital. We don't believe the problem lies in the ability of companies to innovate or move into new markets. In software, the continued growth of broadband, the rebirth of the ASP model, and the convergence of mobile platforms such as PDAs and phones is driving innovation, with new application categories appearing almost weekly. We believe that the VC community is still waiting for its financial toes to heal from the multiple shots to its collective foot inflicted on itself during the dot.com bubble. But if you're a small firm looking for seed funding, your chances are grim.

The particular outlier in this report is the $108 million handed over to Webroot, a company developing anti-spyware products. (We're particularly impressed by this number since Microsoft is currently giving away a very competitive product for free in this market.) The company's flagship desktop product, Spy Sweeper, has received consistent kudos from the press and in January, 2005 received *PC Magazine's* Editor's Choice award for the third time. In our experience, software companies, particularly those with desktop products, fail to realize the significant impact excellent press can have on your financial health; the lofty numbers for Webroot reflect in part this multiplier effect.

The Top 50: Software Venture Capital Investments—Q1 2005

	Company	Business Focus	Lead Investor	Investment
1	Webroot Software	Anti-spyware software	Accel Partners;Mayfield Fund	$108,750,000
2	Cadent Holdings	3D digital software	Apax Partners;J.P. Morgan Partners	$25,000,100
3	Bitfone Corporation	Mobile phones software	Qualcomm Ventures	$22,000,000
4	Incipient	Management software for storage	Globespan Capital Partners	$20,150,100
5	Level 5 Networks	Semiconductor software	Accel Partners;Amadeus Capital	$18,000,000
6	Teneros	Mission critical support	New Enterprise Associates/Sevin Rosen	$17,499,900
7	Ardence	Embedded applications	Capital Resource Partners	$14,000,000
8	ExaGrid Systems	Data protection and storage software.	Highland Capital Partners;Sigma Partners	$13,500,000
9	VIEO	Software for high-speed input/output networks	INVESCO Private Capital	$13,000,000
10	Procuri	Supply management software.	Advent International;Insight Venture Partners	$12,500,000
11	Network Intelligence	Internet software	Ascent Venture Partners;Bain Capital	$12,100,000
12	Teros	Security software for web applications	CMEA Ventures;ChevronTexaco	$12,000,100
13	NeoScale Systems	Data storage security	Advanced Technology Ventures;Bay Partners	$12,000,000
14	SpikeSource	Open Source code management	Fidelity Ventures;Kleiner Perkins	$12,000,000
15	Zilliant	Pricing management software	Austin Ventures;Cardinal Venture Capital	$12,000,000
16	Active Reasoning	Operations resource management software.	ArrowPath Venture Capital	$11,500,000
17	Code Green Networks	Networking software	Bay Partners	$11,220,000
18	Fieldglass	Web-based workforce management	BlueStream Ventures;Grotech Capital Group	$11,065,000
19	StreamBase Systems	Streaming data software	Accel Partners;Bessemer Venture Partners	$11,000,000
20	Aarohi Communications, Inc.	Storage software	JumpStartUp Advisors;TeleSoft Partners	$11,000,000
21	Zenprise	Exchange management software	Bay Partners;Mayfield Fund	$10,999,900
22	Telcontar	Geo mapping software	Cardinal Venture Capital;Ford Motor Company	$10,600,000
23	FirstRain	Web-infrastructure software	Ampersand Ventures/Diamondhead Ventures	$10,197,000
24	DataPower Technology	XML middleware	Atlas Venture;Mobius Venture Capital	$10,000,000
25	Entopia	Knowledge management platform	Global Catalyst Partners;Invus Group	$10,000,000
26	Siperian	Data integration and BI software	Anthem Venture Partners;ArrowPath	$10,000,000
27	Padcom	Wireless remote access systems	Liberty Partners	$10,000,000
28	Vontu	Surveillance software	Benchmark Capital;U.S. Venture Partners	$10,000,000
29	Movaris	Financial control management	Granite Ventures;Mohr Davidow Ventures	$9,999,900
30	Voxify	Voice-base customer service	El Dorado Ventures;Palomar Ventures	$9,999,900
31	DivXNetworks	Video compression technology	Draper Atlantic; Samsung Venture	$9,876,100
32	sentitO Networks	Communication infrastructure	Core Capital Partners;Kodiak Venture Partners	$9,500,000
33	Secure Software	Security auditing services	Charles River Ventures	$9,250,000
34	RLX Technologies	Server management software	Austin Ventures;Ignition	$9,100,200
35	Integrated Healthcare Syst.	Hospital and pharmacy management	AIG Global Investment Group	$9,000,000
36	VhaYu Technologies	Business intelligence	DB Capital Partners;Menlo Ventures	$9,000,000
37	InnerWorkings	Learning tools for software developers.	Benchmark Capital;Mohr Davidow Ventures	$8,800,000
38	Groundwork Open Source	Software assets monitoring system	Canaan PartnersMayfield Fund	$8,500,000
39	SuccessFactors	Performance management software	Canaan Partners;Cardinal Venture Capital	$8,499,900
40	Valchemy	Software to track M&A activities	Discovery Ventures;Lightspeed Venture	$8,020,000
41	Anystream	Streaming media encoding software	SCP Private Equity Partners;Softbank	$8,000,100
42	Avinti	Anti-virus software	Sequel Venture Partners	$7,660,900
43	NGOA	Vertical solutions for various industries	Norwest Venture Partners;Trident Capital	$7,500,000
44	Kryptiq	BPM platforms for automating healthcare	BCM Technologies;Shelter Capital Partners	$7,100,000
45	ChoiceStream	Personalization solutions for online consumers	General Catalyst Partners	$7,000,000
46	Duck Creek Technologies	Product life-cycle management for insurers	Pequot Capital Management	$7,000,000
47	Ortiva Wireless	Wireless communications	Artiman Ventures;Avalon Ventures	$7,000,000
48	Silicon Valley	Performance management systems	Shasta Ventures Management;U.S. Venture	$6,725,000
49	CounterStorm	Security software	Metropolitan Venture Partners;Novak Biddle	$6,651,000
50	Invoke Solutions	Marketing research systems	BRM Capital;Bain Capital	$6,500,000

stream to cover initial investment?

In the case of ASPs, the ISV not only has these problems of funding development and marketing/sales, but the additional one of supplying investment for the servers and infrastructure to run the ASP products/services. The customer may be persuaded to shift this burden to the ASP, but can the ASP afford to take it on?

To compensate for these increased costs, the ISV hopes to take advantage of the ease and lower costs of supporting his own software in his own environment, and servicing customer sites remotely. The customer can be warned of coming upgrades; the intention is that all customers will be using the same version.

Besides the new model influences listed above, ASP pricing will be influenced by other factors, the chief of which is the customer's scale. In a simple form, scale means that large customers will look for pricing in terms familiar to large customers, including negotiation, and expect to pay higher prices than small firms are willing to pay (mostly to cover the increased costs of selling to a large corporation). Most important, scale is the key to helping the customer make sense of ASP pricing.

"Because ISVs are bringing a large-company software sales model to SMBs, it follows that a large-company complex pricing structure can follow, provided it meets the sales objections typical of SMBs. This is best done by metering usage with specialized software: just as desktop spreadsheets drove modern business financial computations into more complex forms, so billing software drives more complex pricing models for ASPs."

—Don Rosenberg
Stromian

If the ASP model provides large-firm technology advantages to small firms that cannot afford to bring the technology in-house, it stands to reason that economies of scale will generally make ASPs a wasteful expense for a large company. A study of digital imaging (MRI, X-ray, etc.) in hospitals (http://www.imagingeconomics.com/library/200011-16.asp) has tables and charts that demonstrate that the customers for an ASP version of this technology exist at the small and medium hospital level, not the large. The SMBs are not really paying a higher cost-per-image than the large hospitals if we consider that the SMBs could not afford the capital to bring the operation in house, and even at supposedly high ASP rates they believe that the outlay is more than repaid by the technology advantage. There is no make-or-buy decision for the SMBs, there is only rent. The ISV need only demonstrate to the market that the price is more than repaid by the resulting increased revenue.

Pricing itself can go from the simple to the complex, and if we are to follow the market, it will be complex. Accounting software from Intacct Corporation (www.intacct.com) was originally flat-rate; over time they have turned the package into a wealth of individually-priced choices so the customer knows exactly what he is getting. There are many possibilities for pricing structure in addition to function:

- Monthly fee or annual fee.
- Seat count and/or transaction count.
- Bandwidth use.
- Initial fees.
- Annual minimums.
- Discounts for peak use levels to encourage usage and spread out loads.

These options can be used alone or in combination with each other.

Equities

Getting a Deal Done: Spousal Approval

By Ward Carter, Corum Group

With 20 years of software M&A deal experience under our belts, we've managed hundreds of client engagements. Many of those were privately held companies, often originally backed by friends and family, and still owned by the original founders. Not surprisingly, owners of small companies may not plan properly for eventual exit strategies as they face the daily challenges of meeting payroll and managing an often remote workforce in a highly competitive environment.

When faced with the decision on an M&A exit, the difficulty is directly proportional to the complexity of ownership. For a sole proprietor, it may only be necessary to obtain spousal approval. In terms of business, managing marital affairs is probably easier than meeting the diverse needs of a broad base of partners, co-founders or investors but you need to obtain early agreement on your goals in any case. If no agreement is in place prior to going to market, the probability rises that a deal may fall apart as the pressure of negotiations forces decisions and creates fractures in a relationship that may not be prepared to deal with financial stress.

We have seen several deals fall apart because "dueling spouses" could not agree over what constituted a reasonable value. In one circumstance, greed kicked in and before we could gain consensus the market turned downward and the opportunity was lost, never to return. In another case, one partner was very interested in selling and had received offers at a very reasonable value and structure. The deal eventually fell apart as the other spouse, who was not motivated by money, was more concerned about losing control of the company and the "corporate family" they had created.

Our advice is to take time early on to understand the dynamics of ownership and your marriage to avoid issues like this later, especially if both partners have different views. It is very difficult to get a buyer back to the table after they have dedicated substantial resources to working on a deal only to have it fall apart due to a messy personal situation.

Ward Carter, executive vice 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
NetScaler	Citrix (CTXS)	$300,000,000	$20,000,000	**15.00**
• High performance application networking		*Terms: 45% cash and 55% stock*		
Vintela	Quest Software (QSFT)	$56,500,000	$12,500,000	**4.52**
• Platform integration		*Terms: All cash*		
Shopping.com (SHOP)	Ebay (EBAY	$480,000,000	$106,830,000	**4.49**
• Online comparison shopping and consumer reviews		*Terms: All cash*		
StorageTek (STK)	Sun (SUNW)	$3,001,000,000	$2,210,000,000	**1.36**
• Enterprise storage management		*Terms: All cash*		

CardFile

Sales Lead Resources

- **B2BOnline.com** (http://netb2b.com): Site offers a wide variety of B2B resources, including E-zines and resource directories.
- **BizTalk** (http://b2b.biztalk.com): Site allows you to search through a database of RFPs.
- **GoLeads** (www.goleads.com): GWeb-based lead service that provides access to a 12 million record database for $9.95(US) per month. Records can be searched by size, geographical location, SIC codes, sales, etc. Cost is $9.95 per month.
- **Jigsaw** (www.jigsaw.com): Online networking system aimed at building business contact information. Site allows you to buy, trade, and sell contacts. Cost is $25 per month or free if you provide 25 new contacts monthly.
- **Lead411** (www.lead411.com): Lead411 is a web-based application that allows you to search news articles, PR releases, and public information on hiring, management shifts, etc. Site tracks approximately 50 thousand executives; cost is $29.95 per month.

JENNIFER MARKEY OF CONSULTING FIRM SEMICONDUCTOR INSIGHTS on patent "trolls": "The controversy that's out there right now is the definition of the term patent troll. No one wants to be known as a troll." (Quoted in The Globe and Mail, 06/02/2005)

ANNONYMOUS SOURCE FROM MICROSOFT ON OPEN OFFICE: "I recommend to my friends that they always keep a copy of Open Office on their systems in the event that MS Office's activation system locks up the software when they're not expecting it and they can't reach a phone or the Internet to reactivate it. Interoperability is excellent and you can usually get something done. It's good protection against our copy protection."

BILL GATES ON GOOGLE: "Google is still perfect, the bubble is floating, and they can do everything." (Quoted in CRN, 05/30/2005)

JESÚS VILLASANTE OF THE EC'S INFORMATION SOCIETY on whether large companies are using the Open Source community as subcontractors: "IBM says to a customer, 'Do you want proprietary or open software?' Then [if they want open source] they say 'OK, you want IBM open source.' Companies are using the potential of communities as subcontractors—the open source community today [is a] subcontractor of American multinationals." (Quoted on http://www.zdnet.com.au/news/software/,2000061733,39194786,00.htm, 06/01/2005)

RED HAT VICE PRESIDENT OF OPEN SOURCE AFFAIRS MICHAEL TIEMANN on a proposed meeting with Microsoft: "Microsoft reached out to me as president of the OSI, and they basically said they wanted to begin a productive conversation, and we agreed to take that at face value." (Quoted on www.LinuxLinks.com, 06/03/2005)

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