Wednesday, Jan. 15, 2003
Vol. 19, No. 4

Soft•letter

BUSINESS INSIGHTS FOR SOFTWARE DEVELOPERS & PUBLISHERS

Six Rules for Sustained Success

"Software is a business that has always produced great overnight success stories," says management consultant Brian Turchin. "But surprisingly few software companies ever achieve *consistent* growth and profitability. Most of the time, companies are hot for several years, then they just flame out."

A dozen software companies went public in 2002. Here's the scorecard. *See pages 4-5.*

In fact, says Turchin, out of a universe of 223 public software companies, he's found only 15 that have a track record of sustained growth and profitability for five years or more (see page 3). "That's especially scary, when you consider that public companies are supposed to be the top role models for success," he adds.

Turchin has been working on a book about what keeps these top 15 companies (and other long-term winners) on a steady track. Recently he gave us a sneak preview of six "rules for sustained success" that he's found:

★ **Decide to be profitable:** "Being profitable doesn't happen by accident," Turchin points out. "It's almost always a deliberate goal, inspired by founders who see profitability as a survival tactic. In fact, ten of the 15 companies with solid growth and profitability records were started with bootstrap financing—they didn't have venture capital to fall back on if they ran in the red."

When companies are consistently profitable, Turchin adds, top management has usually set a dramatic example of "being cheap" even in small things. "Rather than spend money on hotel rooms, Mike Marvin and two other co-founders of MapInfo took a tent to their company's first trade show and slept in a park near the convention center ," Turchin says. "As the company grew, Marvin drove budget responsibility lower and lower into the management chain, giving more people first-hand experience with forecasting and managing expenses—in effect, teaching them the value of a dollar in a very tangible way."

★ **Learn to spot real pain issues:** Software is a business where it pays to listen *very* carefully for clues about what customers need, Turchin notes. "For instance, many companies have focused on solving the generic problem of cutting warehouse costs. But Manhattan Associates—which now has 12 consecutive *(continued on page 3)*

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Gorillas, Chimps, and Monkeys

When Geoff Moore wrote his now-famous *Crossing the Chasm* more than a decade ago, he introduced a model of technology adoption that has profoundly influenced the way software marketers move from early adopters to mainstream buyers. But for all its power, Moore says, the chasm model often didn't answer basic questions that arose when marketers tried to apply it to real-life problems. "Far from being as simple and elegant as specified," he admits, "things were in actual fact a mess."

In particular, Moore realized that a company's *market share* also played a vital role in determining what tactics it could—and could not—use most successfully, especially as markets matured. The result was a new model that divided competitors into three groups: market-leading gorillas, also-ran chimps, and lowly monkeys. Each has a role in the competitive jungle, Moore says, and it's important for companies to pick strategies that reflect their place in the primate pecking order.

By the time he wrote *The Gorilla Game,* however, Moore had become more focused on helping investors pick the next Wall Street favorites (who tended to be gorillas-in-waiting). Marketers who wanted specific tactical advice had to wait until Paul Wiefels, Moore's first consulting partner at the Chasm Group, wrote *The Chasm Companion,* a "fieldbook" to the practical lessons that Moore and his partners have learned.

Wiefels tells us, for example, that gorillas don't just generate more sales than their rivals—more importantly, they have the ability to define infrastructure standards and "control the architecture" of their market segment. Smart gorillas, says Wiefels, often "encourage and facilitate other vendors in the value chain to integrate their products with the gorilla's product to forge a complete solution—a whole product—for the target market." Gorillas also tend to have higher margins than their rivals, both because they can better control costs and because customers will usually pay a premium for a "gorilla brand." But keeping prices high isn't necessarily a smart tactic for gorillas who are still struggling with monkey-level discounters, Wiefels argues. In fact, "gorilla power is advanced when the gorilla can compete effectively on price with the monkey, thereby forcing the monkey to be even more price competitive, possibly driving it into the land of negative margins."

Chimps face a different set of competitive options, says Wiefels: They shouldn't get into head-to-head standards fights with gorillas, because customers have already "voted with their feet" to adopt the gorilla's market architecture. However, successful chimps still have a few good options, he notes. They can "target specific customer segments that are not well served by the gorilla," they can emphasize technology leadership and higher levels of service and convenience, and they can knock off other chimps. "For a chimp, being number two is better than being number three."

For monkeys, finally, "the best way forward is becoming the low-cost provider, delivering commodity products with minimal overhead, perhaps using differentiated or novel business models." Forget technology leadership, Wiefels adds; the monkey's natural customer is usually a price-sensitive buyer. "If your product now falls under the aegis of a purchasing department, you become quite attractive, particularly if no other competitor responds," he says.

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THE HONOR ROLL

Public software companies with five or more years of continuous growth and profitability (as of 10/02)

	Revenues	Years
Microsoft	$28,300,000,000	**17**
Kronos	$292,900,000	**16**
SAP	$7,100,000,000	**14**
MapInfo	$110,000,000	**13**
Manhattan Associates	$151,300,000	**12**
Business Objects	$416,000,000	**9**
Citrix	$591,600,000	**8**
Siebel Systems	$2,000,000,000	**7**
CheckPoint	$527,600,000	**7**
THQ	$379,000,000	**7**
Mercury Interactive	$361,000,000	**6**
Ansys	$88,500,000	**6**
Trend Micro	$255,600,000	**5**
Advent Software	$170,200,000	**5**
Cryptologic	$43,600,000	**5**

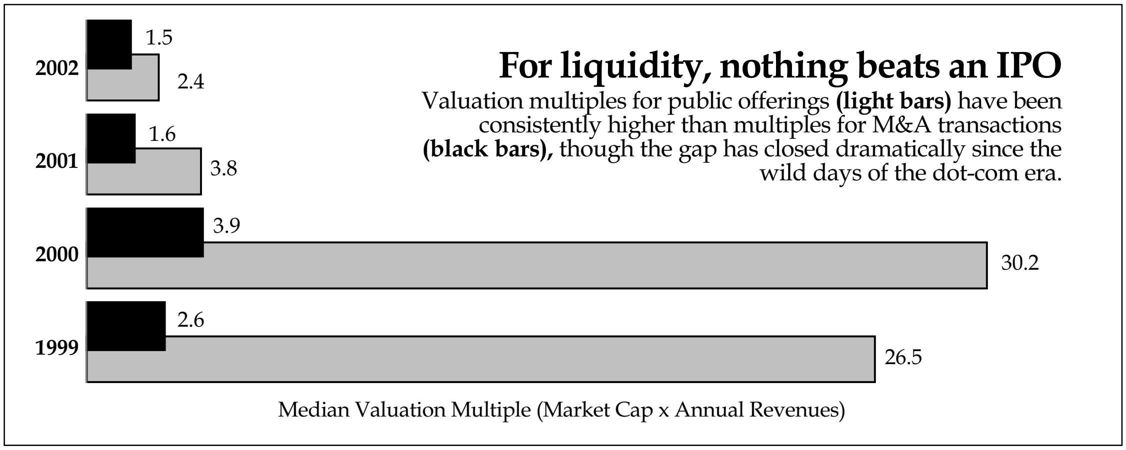
"At the other end of the spectrum, I found that fully 30% of the top public companies have been unprofitable for five years or more."

years of growth and profitability—zeroed in on the specific warehouse cost-management problems of consumer product manufacturers. By talking to manufacturers in this segment, company founder Alan Dabbiere discovered that retailers routinely deducted 5% to 25% from invoices for orders that didn't meet exacting shipping rules. And the problem was getting worse because retailers were adopting more complicated just-in-time ordering procedures. By focusing on the compliance problems of a single market segment, consumer goods manufacturers, Dabbiere's company gained a tremendous competitive advantage over competitors who were still trying to shave a few points of cost off everyone's warehouse operations."

"The usual response when products aren't selling is to test a lower price. But many buyers want the assurance that they're getting the top-of-the-market product. In Japan, Cheyenne pushed the price of a slow-moving product up to $5,000 and produced a significant spike in sales."

★ **Lock in your customers:** Developing a must-have product is only part of the success equation, says Turchin. "You should also look for ways to *keep* customers—to encourage them to become loyal fans and lock them into a long-term relationship." Ansys, a developer of engineering design simulation tools, has done an especially good job of hanging on to its users, he adds. "They start by seeding the schools where new engineers are trained, which is like a baby chick imprinting on a mother hen. Then Ansys keeps adding features and new modules that help users solve increasingly broad, higher-level problems. The result is an amazing 65% recurring revenue stream and six years of consecutive growth and profitability."

★ **Use price as a strategic weapon:** "Long-term winners don't just set prices in response to the competition—instead, they regularly try to outflank their rivals with gutsy price moves," says Turchin. "One of the best examples here is Cheyenne Software, which produced a six-year run of non-stop growth before the company was sold *(continued on page 6)*



For liquidity, nothing beats an IPO

Valuation multiples for public offerings **(light bars)** have been consistently higher than multiples for M&A transactions **(black bars),** though the gap has closed dramatically since the wild days of the dot-com era.

Benchmarks: IPO Valuation Trends—2002

Despite last year's stagnant economy, software public offerings are beginning to make a comeback. According to Bruce Hadley of SoftwareCEO, whose Web site has historical data on nearly 600 software M&A deals and IPOs, "the resurgence began in the last two months of 2001, when five companies went public after a dry spell of only one IPO in ten months. In 2002 we saw a steady stream of IPOs, with a total of 12 software and software services companies choosing the Wall Street route. That's slow compared to 1999 and 2000, when we logged 57 and 21 software IPOs, respectively—but it's at least a return to normalcy."

There are several "striking metrics" about the 2002 IPOs, Hadley adds:

- **Declining multiples:** "Valuations slumped to 2.4 times revenues at the median," says Hadley, "a 37% drop over 2001's 3.8 multiple. While this year's multiple pales compared to the 26.5 and 320.2 multiples we saw in 1999 and 2000, it represents a return to realism on the part of investors. And 2.4x is still half-again better than entrepreneurs have been getting when they take the M&A route, where the overall median for 190 deals we've tracked in 2002 hovers around 1.5."

- **Tougher standards:** "Not many software companies are candidates for IPOs, and 2002 offered a sobering reminder that Wall Street likes a sure thing," Hadley points out. "This year's typical software IPO company had revenues of $111.9 million, compared to a median of just $23.6 million in 2001. And that's just the median: The top 25% were $329.1 million or larger. By way of contrast, in the nutty valuation years of 1999 and 2000, the median revenues for software IPOs were just $9.4 million and $11.6 million," Hadley adds. One area where current IPO standards are less strict, he points out, is profitability: Median net income among all IPO companies this year was a $3.1 million loss, compared to a negative $0.7 million in 2001.

- **More cash:** "In the downward spiral of 2001, initial share prices averaged just $9.50, companies gave up 25% of their shares outstanding,

Software IPOs—2002

Date	Company	Revenue (000,000)	Income (000,000)	%Sold at IPO	Rev. mult.	---Market Cap (000,000)--- At IPO	1/3/03
2/7	**ManTech Intl. (MANT)** *IT services for defense clients*	$378.8	$1.7	28%	1.1	$408.5	$510.9
3/11	**Anteon Intl. (ANT)** *IT services for defense & federal clients*	$715.0	($0.1)	37%	0.8	$604.8	$853.5
3/15	**Verint Systems (VRNT)** *data mining and business intelligence*	$131.2	($4.6)	19%	2.9	$374.3	$515.3
5/20	**Computer P&S (CPSI)** *healthcare information solutions*	$59.7	$8.7	29%	2.9	$173.1	$258.0
5/22	**Altiris (ATRS)** *IT systems management software*	$34.5	($10.2)	25%	5.7	$198.0	$271.0
5/23	**SRA International (SRX)** *security services & software*	$312.5	$7.4	47%	0.6	$192.9	$307.0
6/3	**Plumtree Software (PLUM)** *Web portal development tools*	$81.5	($7.8)	17%	3.1	$248.5	$76.9
6/4	**Veridian (VNX)** *national defense & security solutions*	$690.2	($29.7)	43%	0.7	$495.3	$614.5
6/17	**Printcafe Software (PCAF)** *printing industry supply chain software*	$41.9	($80.5)	35%	2.5	$106.0	$13.2
6/27	**MTC Technologies (MTCT)** *systems engineering for defense clients*	$92.6	$7.8	40%	2.3	$210.6	$299.8
11/11	**SI International (SINT)** *IT technology provider for federal government*	$146.6	($2.8)	52%	0.8	$118.2	$100.2
11/19	**IMPAC Medical (IMPC)** *healthcare software*	$45.7	($3.4)	24%	3.0	$137.8	$171.8
	Median	$111.9	($3.1)	32%	2.4	$204.3	$285.4

and raised $48.5 million in their IPOs. In the somewhat resurgent market of 2002, the average share price at IPO was $16, companies sold a 32% slice, and raised a median $66.5 million—a 37% jump."

- **Services are sexy, software is not:** "This year's IPOs offer more evidence that successful software companies are transforming themselves into services firms," Hadley notes. "Seven of the 12 companies choosing the public path this year earn the majority of their revenues from IT services rather than software licenses. Of the remainder, four are what we consider 'pure' software companies, and one—portal builder Plumtree Software—has centered its business around the Web. Moreover, software-focused companies have seen their post-IPO market cap decline by a median 13.2%. The services firms, on the other hand, have enjoyed a median 45.8% increase in their market cap since going public."

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"Making the transition to a coaching style of management is an incredibly hard thing for most CEOs to do, because it so often runs counter to the instincts and management habits that made them successful as entrepreneurs. That's why very few actually make the transition successfully."

to Computer Associates. At a time when competitors were selling LAN backup products for a few hundred dollars, Cheyenne pegged the price of its entry in this market at $1,995. The $1,995 price sent a clear selling message that Cheyenne provided more value than its competitors, and this strategy helped the company carve out upwards of 70% of the market," Turchin says.

★ **Learn to manage like a head coach:** "The classic style for founders is to run their companies like a ship's captain, retaining full decision-making power and control over the smallest details," says Turchin. "But as companies grow into larger enterprises with hundreds of employees and multiple product lines, the CEO's role obviously has to evolve as well. What's interesting about this transition, however, is that the CEOs of so many top-15 companies have all developed a similar 'coaching' style of management (or they replace themselves with new CEOs who've adopted this style). At least in the software industry, the coaching model seems to be a success factor by itself."

CEOs who see themselves as coaches, Turchin adds, tend to delegate substantial control and power to others. "Like a football coach who lets his quarterback decide on which plays to run, the CEOs of consistently-successful companies give their subordinates a great deal of freedom to run their parts of the business. The coach gives advice and has the right to send a player to the bench occasionally, but his players aren't just following orders—they're playing to win."

★ **Keep the odd ducks in the coop:** As companies grow, it isn't just the CEO's job that changes, Turchin points out. An often unnoticed consequence of growth is that many of the company's original "odd-duck employees" gradually drift away, frustrated by bureaucracy and narrowed job responsibilities. "Odd ducks are the creative, egotistical, obnoxious types who drive the exploration of new technologies and dream up new product ideas," says Turchin. "They are absolutely essential for companies that hope to keep renewing themselves and keep coming up with new products. If the original odd ducks have flown the coop, it's very hard for a big company to recruit the same kind of talent."

How do consistently-successful companies hang on to their odd ducks? "It's a tough challenge," Turchin admits. "Several of the companies I've looked at have dual career tracks, so that technical and creative types can get promoted without having to become managers. I've also seen companies with special R&D groups that just focus on new technology. And it helps to have an incentive system in place that conspicuously rewards people who come up with new product ideas and push to get them accepted by the rest of the company. When top management doesn't do *something* to hang on to their odd ducks, even the most successful companies will eventually run out of steam."

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Behind the Scenes

By Software Equity Group, L.L.C.

- **Rational:** IBM bulks up its software group and improves its positioning against Microsoft by adding Rational, the crown jewel of the software development tools sector. With Rational, IBM seeks to foster its e-business-on-demand strategy, enabling disparate enterprise applications to automatically integrate without writing new code. IBM also gains access to Rational's extensive customer base which includes 98% of the Fortune 100. This is an all cash deal in which Rational shareholders receive a 29% premium for their shares. Adding back Rational's $500 million of debt and subtracting its $1 billion of cash, IBM paid 2.4 times Rational's LTM revenue.

- **Marshal:** NetIQ, which has evolved from a provider of Windows infrastructure management solutions to a cross-platform provider of systems management, security management, and Web analytics, picks up privately held Marshal Software of Auckland, New Zealand. Marshal strengthens NetIQ's enterprise content security offering and anti-spam solutions for messaging environments, currently a source of pain for many NetIQ customers. This transaction follows on the heels of NetIQ's recent acquisition of security management provider PentaSafe Security Technologies.

- **Precise:** A leader in storage management, Veritas is aggressively pursuing additional market opportunities and positioning to be a leading IT infrastructure management provider. Veritas will acquire Precise, a next-generation application performance management provider, and Jareva Technologies, a market leader in server automation. From Precise, Veritas also picks up a complementary low-end SAN product. Precise shareholders will receive a 37% premium for their shares. Veritas will pay $63 million in cash for Jareva. Jareva's revenue was not disclosed.

- **Financial Engineering Associates:** Barra, a leader in risk-management technology for investment professionals, strengthens its product offering by acquiring privately held FEA, a market leader in option valuation models and risk analytics software with more than 700 institutional clients. Highly-profitable Barra (39% EBITDA) paid all cash for FEA.

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Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Rational Software (RATL)*	IBM (IBM)	$1,600,000,000[EV]	$657,300,000	2.43
• *developer tools*		*Terms:* Cash		
Marshal Software	NetIQ (NTIQ)	$23,000,000	$6,000,000**	3.83
• *enterprise security*		*Terms: Cash*		
Precise Software Solutions (PRSE)*	Veritas Software (VRTS)	$400,000,000[EV]	$71,800,000	5.57
• *application performance management*		*Terms: Cash & stock*		
Financial Engineering Associates	Barra (BARZ)	$21,500,000	$8,000,000	2.69
• *financial investment software*		*Terms: Cash*		
CTX Corp.	ManTech Intl. (MANT)	$34,000,000	$35,000,000	.97
• *IT and software services provider*		*Terms:* Cash		

* This deal has not closed yet. Terms may change. ** SEG estimate. (EV) Enterprise Value = purchase price plus debt minus cash & equivalents.

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- **HRIT** (www.hrit.com)—Employee handbook templates; $49+; consulting, $95/hr.
- **HRN Management Group** (www.hrnonline.com)—Web-hosted customized manuals, $195+.
- **Employee Handbooks Corp.** (www.employeehandbooks911)—Employee handbook customizable by state; $200; legal review, $550.
- **Literary Technologies** (www.literarytechnologies.com)—Custom handbook development, $795.

ORACLE chief security officer Mary Ann Davidson on the likelihood that new laws will force software companies to address the problem of poor network security: "It's been the dirty little secret—or not so secret—of the industry for a long time. Now, the government really means it this time, I think." (Quoted in eWeek, 1/6/03)

AMR RESEARCH senior vice president Jim Shepherd on the increased use of standardized components in software development: "We're moving from a craft environment to a production environment." (Quoted in Infoworld, 12/16/02)

INTUIT founder Scott Cook on his company's highly successful CEO, Stephen Bennett: "To say he's the best new CEO in technology damns him with faint praise." (Quoted in Business Week, 10/28/02)

GREAT PLAINS SOFTWARE founder Doug Burgum on his company's traditional Christmas party, where employees roast senior management: "It's all part of that keep-us-humble approach. It's good to laugh at your own missteps." (Quoted in Forbes, 10/28/02)

SUN MICROSYSTEMS chief executive Scott McNealy on his company's huge financial reserves: "We have more cash than most of our customers do." (Quoted in The Wall Street Journal, 12/27/02)

EDWARD JONES analyst Arthur Russell on Wall Street's problems with financial reporting by Computer Associates: "We're not saying they're cooking the books, but there's ample evidence to wonder if everything is on the up-and-up." (Quoted in Business Week, 9/30/02)

LINKSYS sales chief Glen McLaughlin on his company's strategy for staying ahead of competitors like Microsoft: "We launch a new product a week. By the time our competitors realize what's going on, we're already working on the next one." (Quoted in Business 2.0, 2/03)

Soft•letter is published 24 times per year;

ISSN: 0882-3499.

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

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