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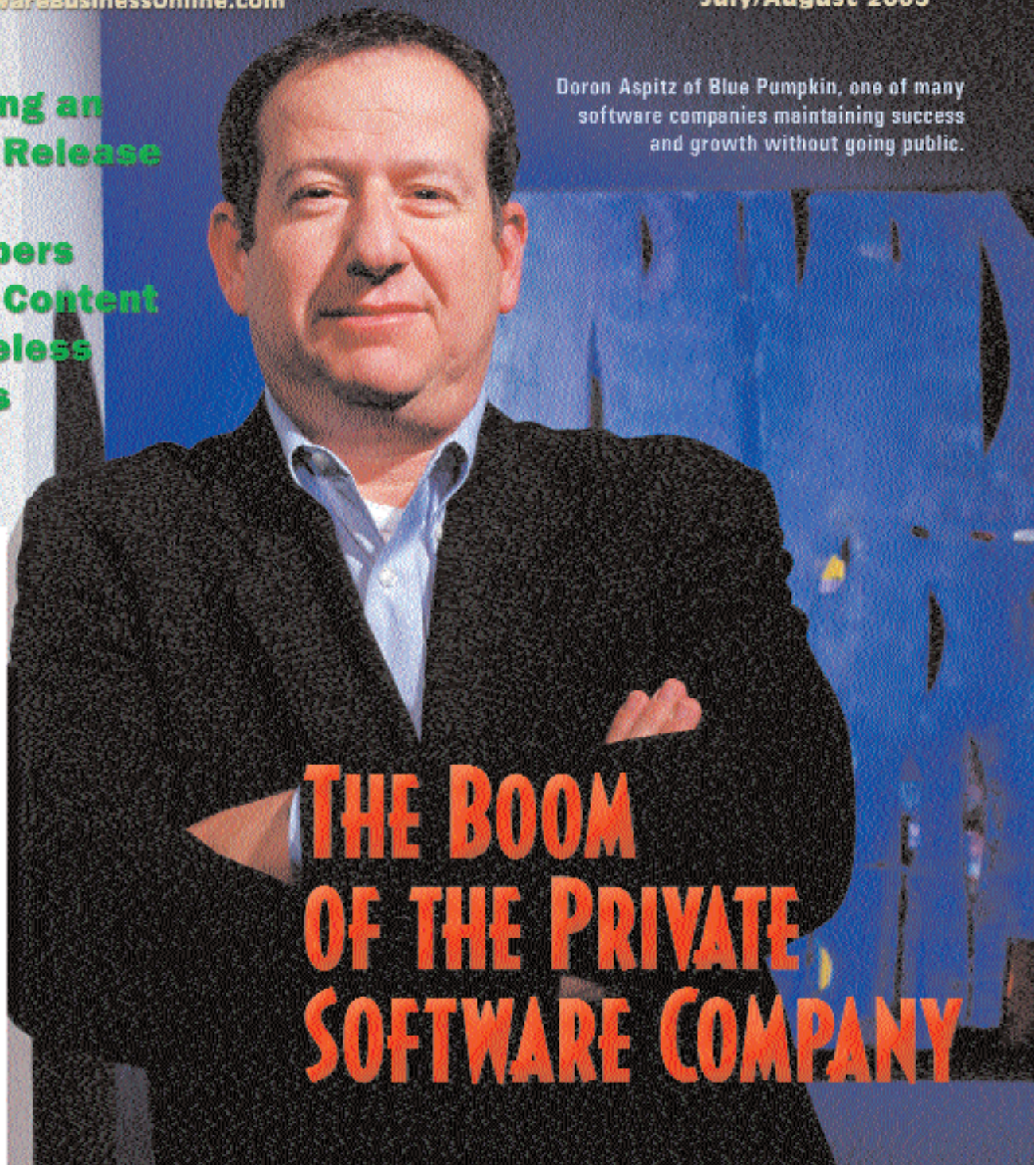

Doron Aspitz of Blue Pumpkin, one of many software companies maintaining success and growth without going public.

THE BOOM OF THE PRIVATE SOFTWARE COMPANY

Long-Term Success Isn't Mercurial At Mercury Interactive

Programmers would rather stick pins into their flesh than test software they wrote. After all, who likes doing a tedious, routine task that, in the end, just shows you how you screwed up. No, testing is not the sexy part of software development. Yet Mercury Interactive, a company that has built its fortune on selling testing software, produces financial results that make Wall Streeters drool.

Drool so much, in fact, that they have rewarded it with an impressive market capitalization, at the time of this writing, of $3.2 billion. Not bad when you consider that high-flying Peoplesoft with revenue of $1.9 billion, more than four times that of Mercury at $400.1 million, has a market capitalization of just $4.7 billion, only about one-half more than Mercury.

So what has Wall Street so excited? Three reasons, at least.

First, Mercury is one of the very, very few software companies that currently have a seven-year record of sustained growth and profitability from 1996 to 2002 (see table below). And Mercury's year-to-year growth record is even longer at 11 years, 1992 to 2002.

Executive Strategy

Insight From Brian Turchin

> "At the end of the day, building a business is all about creating and leveraging assets."

Second, since Amnon Landan became CEO in January 1997, revenues have risen a very healthy eightfold, from $54.6 in 1996 million to $400.1 million in 2002, an annual average growth rate of 41 percent, while net income has seen an astonishing rise of 1,300 percent from $4.6 million to $65.2 million, an annual average net income of 16 percent.

And third, even though growth slowed in 2001 and 2002 from the company's previous torrid pace, compare Mercury to two of its major competitors. Compuware didn't negotiate this downturn very well, having a precipitous drop in revenue from $2 billion in 2000 to $1.7 billion in 2001 and then to $1.3 billion in 2002, for a total drop in revenue of an astounding $700 million. And Segue Software went from $58.2 million in 2000 to a dismal $29.7 million in 2002, a drop of 49 percent. (Segue Software's CEO resigned as of May 5, 2003).

How did Mercury achieve this record? In an interview, Amnon Landan shared four of his success strategies.

Build Your Future During Boom Times

Landan observed, "At the end of the day, building a business is all about creating and leveraging assets." So in the middle of the dot.com bubble in 1998, he saw an opportunity to invest in growth by building a new product line. "It was the easiest time to invest $100 million to make something new." In fact, he was amazed that, "Very few other companies bothered to make this investment, and create the next leg of their story."

Besides having cash to invest, Landan believed his company had the right critical mass: a solid base of customers, an experienced management team, a mature set of technologies and an excellent market positioning. So, in the next several years he siphoned off something in the range of $100 to $150 million and devoted 60 percent to 70 percent of his R&D staff to building a new line of business, his "Application Performance Management" product line.

And Landan was certainly glad he did. This new product line, which didn't exist in 1998, fueled his growth in 2001 and 2002, and when I spoke to him, had a run rate of $100 million, providing about one-fourth of

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Mercury Interactive's Revenue And Profit 1992 to 2002

Year	Revenue (Millions)	Growth Rate	Net Income	Net Profit Margin
1992	$4.3		-3.3	-76.7%
1993	$13	202.3%	$1.0	10.8%
1994	$24	80.8%	$5.0	21.3%
1995	$39.5	68.1%	-$5.3	-13.4%
1996	$54.6	38.2%	$4.6	8.4%
1997	$76.7	40.5%	$5.7	7.4%
1998	$121.0	57.8%	$19.5	16.1%
1999	$187.7	55.1%	$33.1	17.6%
2000	$307.0	63.6%	$64.7	21.1%
2001	$361.0	17.6%	$54.3	15.0%
2002	$400.1	10.8%	$65.2	16.3%

(Source: Hoovers' Online and corporate 10-ks)

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his new business revenue.

Have R&D Personnel Discover Customer Needs First-Hand

IDC analyst Richard V. Heiman, who has been following Mercury Interactive for ten years, said, "Mercury's success in the marketplace is due to its uncanny ability to anticipate needs in the ASQ (Automated Software Quality) space and be among the first to fulfill them." Perhaps a practice of Landan's helps provide some insight into how Mercury developed its uncanny ability.

Landan believes that in most software companies R&D personnel are too disconnected from the market. The results? The development of the wrong products, and a Sales Division and R&D division that fight like the Hatfields and McCoys.

Landan reasons, "Usually R&D personnel have the highest average IQ in the organization and this leads them to have a certain type of logic they apply to product decisions. But this logic isn't the customer's logic, which is why R&D delivers the wrong product and bumps heads with Sales."

So what do you do? "The only way to change R&D management and engineers is to convince them there is a different logic, said Landon. "Once they buy into this notion, then it is pretty easy from this point on. And the only way they buy into this notion is to put them in the field and sit them in front of customers. This works like magic. For example, a customer wants some type of new report but the engineer think this doesn't improve the product much. But put this engineer in front of several customers who want this report and he now understands the need, and then, if he hears other customer examples like this one, he now understands conceptually what the market wants. At Mercury, I believe, R& D is spending more time in the field than probably any other company, and it is intentional."

How well does this work? Landan concluded, "The Sales organization worships R&D which certainly isn't a common thing. We just had our annual sales kick-off meeting attended by over 800 sales employees. I always have R&D personnel attend as well; this time about thirty people. As I normally do, when giving my speech, I mentioned how the product is the starting point for everything we do and asked the R&D guys to stand up. As I did so, without asking, the audience started clapping and only stopped when I asked them to three minutes later."

Landon's practice not only deepened R&D's understanding of the customer but it also built much stronger relations between Sales and R&D.

Match Your Business Strategy To Your Stage of Growth

Like a lobster that must shed its shell to grow or else face death, software companies must also adjust as they grew in size or they too will die. The strategies that worked in the past may cause failure now.

In 1995 Mercury ran into the proverbial wall, growth slowed and for the first time in its history staff was laid off. What was the problem? Landan, upon becoming President in 1995 realized he had to change a business strategy left over from their start-up days.

Landan said, "We were a small company so we brought in revenue anyway we could which meant we were doing too many small projects in R&D and servicing markets that didn't have long term prospects. So we cut R&D by 20 percent, and, toughest of all, we had to turn away customers. Two reasons why: one was strategic. It was clear that we didn't put the wood behind the right arrow. And the other one was financial. We were on the verge of not making money."

> "Let as many people as possible own something. Ownership is the key word."

In effect, Landan executed a fundamental shift in strategy from being a sales-driven organization to a market-driven organization, where the company consciously chooses its markets and customers.

Ownership and Risk Key To Retaining Creative Odd-Ducks

Creative odd-ducks are those employees who flock to start-ups because they love the adrenaline rush of solving new problems and creating order from chaos. They tend to be very smart, arrogant and, at times, downright obnoxious. However they also play a huge role in a start-up's success. One problem exists, though. As a company matures, they tend to fly the coop because there is too much order and too few big problems for them to solve. And when this happens, it mortgages your company's future when time comes time to dream up and build new products.

Landan, understanding this problem, has a fundamental answer, "Let as many people as possible own something. Ownership is the key word." By ownership he means delegate decision making along with responsibility and let that person decide how to achieve the goal you set. This way they own the results of their efforts. A good management practice for all but even more important with odd-ducks who crave doing things their way and getting credit for it.

In addition to believing that ownership is key, Landan revealed in our interview a way of thinking that encourages risk-taking. He said he went into the effort in 1998 to build a new product line with these beliefs: (1) he accepted the fact that he would encounter serious issues, (2) he was committed to working his way through them and (3) had the confidence, no matter what the problem, that he and his team would solve it.

At the core of his beliefs is the notion that risk and mistakes are to be expected. Innovation, in fact, requires it. Since the CEO sets the tone for a company, Landan is directly encouraging an entrepreneurial set of attitudes, like there is in a start-up making the odd-ducks feel right at home.

So, Landan directly by motivating through ownership, and indirectly, by encouraging risk-taking and learning, serves up the right ingredients for the odd-ducks to remain in the coop.

How do you create long-term success? From Landan we learn several important lessons: (1) When experiencing rapid growth, even in boom times, be aggressive about financially investing into your next leg of growth, assuming of course that you are profitable. (2) Ensure that computer software engineers truly understand customers needs by in-face customer meetings. (3) At some time in a company's growth, it will reach a low-point, a wall. At that time, adjust your fundamental business strategy to do what it takes to generate your next growth cycle. And lastly, 4) create an inviting environment for your odd-ducks that allows them to own the results of their work, and to experience the risk and learning that come with a start-up.

❖ *Brian Turchin is founder and president of Cape Horn Strategies, Inc., a five-year old advisory, research and management consulting firm to the software industry. He is currently writing a book on success strategies in the software industry, focusing especially on what strategies drive long-term profitable growth. Brian can be reached at (516) 377-4244 or bturchin@capehornstrategies.com*