SOFTWARE SUCCESS

Increasing Profits for Software Entrepreneurs

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The Growth Imperative

Twenty years ago, a tiny startup called Osborne Computer began shipping its first product, a 23-lb. portable computer. Less than a year later, the company had zoomed to $10 million a *month* in sales, and the press was beginning to talk about a new phenomenon called "hypergrowth." Osborne crashed and burned two years later, but by then near-exponential growth rates had become a fundamental expectation for the whole technology industry. If a company couldn't grow by at least 50%-100% a year, year after year, it was arguably a loser.

And it wasn't just economic illiterates who became obsessed with hypergrowth. As technology companies blossomed, financial analysts began developing valuation models that were—and still are—largely based on highly-leveraged forecasts of future revenues and cash flow. Thus, a modest failure to meet growth projections can have a disastrous impact on valuations, even for well-established software companies. Microsoft's stock price was barely nicked by the massive Justice Department anti-trust trial, for example, but the price collapsed as soon as the company's historic 30% growth rate dropped into a 10%-12% range.

There's nothing inherently wrong with focusing on growth as a yardstick of success, of course. Trouble is, it's becoming increasingly hard for software companies to deliver on traditional hypergrowth expectations these days—or to grow at all. Dozens of public companies are now frantically spending IPO war chests on futile efforts to grow fast enough to prop up depressed stock prices. And there are perhaps another thousand venture-backed firms that are burning through startup funds with the same hope. When the money finally runs out, the vast majority of these companies will almost certainly vanish. Many *could* be viable businesses, but the rules for technology companies are relentless: Grow fast or become a writeoff.

Moreover, the growth imperative has an impact that often extends far beyond the inner circle of public and venture-backed companies. Increasingly, private firms find themselves facing competitors with deep pockets who are willing to burn through several dollars of working capital to generate every dollar of revenue gains. Kamikazi sales tactics tend to trash everyone's margins, but the hypergrowth wannabees do extra damage in emerging *(continued on page 3)*

Overhead costs gobble up a significant percentage of software company revenues, especially in smaller firms. *See pages 4-5.*

Editor
Jeffrey Tarter
jtarter@ucgtech.com
617/668-0028

Publisher
Carol Crowell
carolc@ucgtech.com
781/751-8653,
888/400-4768 x253

Editorial office
Software Success
122 Barnard Avenue
Watertown, Mass. 02472
617/668-0028

Subscription office
United Communications Group
11300 Rockville Pike #1100
Rockville, Md. 20852
301/287-2718
866/313-0973
customer@softwaresuccess.com

www.softwaresuccess.com

The Hidden Cost of Capital

Rusty Luhring is a veteran software entrepreneur whose company was once so cash-poor that it was "running on fumes," barely able to meet payroll and constantly juggling creditors. In fact, Luhring's business card lists his title as "survivor in chief," and his flagship financial forecasting product is called SurvivalWare. Having survived tough times, Luhring says he's learned an important lesson: Calculating the true cost of money always involves a lot more work than just comparing interest rates.

Especially for smaller companies, Luhring adds, the hidden costs of acquiring working capital typically include everything from nickel-and-dime bank fees to near-total loss of control over the business. Many of these costs are intangible, but they typically fall into five categories:

- **The time it takes to arrange for the capital in the first place:** "For a bank loan, you may have to factor in preparation time, meetings, filling out applications, and the fact that you may get several rejections before finding someone willing to lend you money," says Luhring. "If you have nothing better to do, that's not so bad. If your time is tight, and you could be doing more customer work, then you had better factor this into the cost equation." One reason that credit cards and equipment leases are so popular as sources of capital, Luhring adds, is that they take so little time to arrange—even though the actual interest rate is usually steep.

- **Interest and fees:** "The interest is pretty obvious," Luhring notes. "But any fees required to secure a loan should be part of the equation. This might be an upfront servicing fee for a computer lease, annual membership for a credit card, an appraisal fee for a second mortgage, or the penalty from the IRS if you decide to take your time remitting payroll withholding taxes."

- **The time it takes to "service" the capital provider:** "If you've convinced an investor to put up some money, you might have regular meetings and phone calls to keep him up to date. Or time with your lawyer to defend a lawsuit. This is where credit cards get more expensive: I know of a friend who once spent four hours a month making payments on 35 different accounts."

- **Higher prices from vendors willing to extend credit:** Small businesses almost always rely on vendor credit as a source of financing, Luhring points out—but the hidden cost of that credit can be extraordinarily high. "I ran into a stark example of this with a printing supplier in another state who was willing to print brochures for me for a third of what my downstairs print shop was offering. The only hitch was that they wanted cash in advance. Clearly, there was a huge cost of doing business with the corner printshop guy based on getting credit terms."

- **Loss of control:** "Some control issues are obvious—'I invest $100,000 in your business and you give me 51% of the stock,'" says Luhring. "Others are gray areas: You convince Uncle Fred you've got the next Microsoft, and hire your cousin Fred Jr. as a condition of the investment. It's something you have to consider: Most of us are entrepreneurs because we want to be our own bosses. Loss of control is a big, big deal."

Rusty Luhring, chief executive officer, Luhring SurvivalWare, 8403 Porter Lane, Alexandria, Vir. 22308; 703/780-2044. E-mail: rusty@ferox.com.

markets, by wrecking the kind of early ROI that companies expect from expensive technology investments.

Moreover, there's growing evidence that hypergrowth isn't quite the success indicator that we once thought it was. Cyrus Ramezani, a finance professor at California Polytechnic State University, recently co-authored a scholarly analysis of 2,156 public companies, looking for a relationship between growth and "wealth creation" (measured by corporate profitability and shareholder value between 1990 and 2000). Ramezani's surprise conclusion: The fastest-growing quartile, which had average sales growth of 167% during this period, showed significantly *worse* performance on most value indicators than the slower-growing third quartile (average growth, 26%).

"Corporate managers need to abandon the habit of blindly increasing company size and investors need to carefully consider the drawbacks of diseconomies of scale."

– Cyrus Ramezani, California Polytechnic State University

"The investment industry demands that managers maximize sales and earnings growth over time," Ramezani says. "Our empirical results indicate that maximizing growth does not maximize corporate profitability or shareholder value. On the contrary, companies with moderate growth in sales or earnings show the highest rates of return and value creation for their owners."

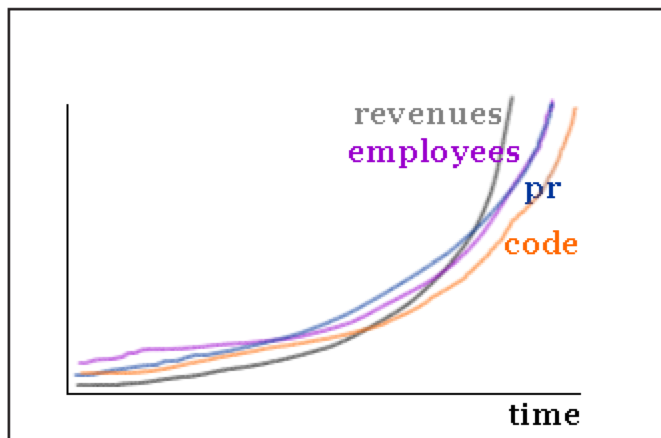
In other words, the VCs once again screwed up: They threw money at hypergrowth candidates and missed a whole universe of companies that, in the long run, were more likely to be real winners. Oops.

"Great companies are often not the ones that spend all their time begging for investments... It's bizarre that so many VCs are willing to ignore these companies simply because they aren't playing the traditional get-funded game."

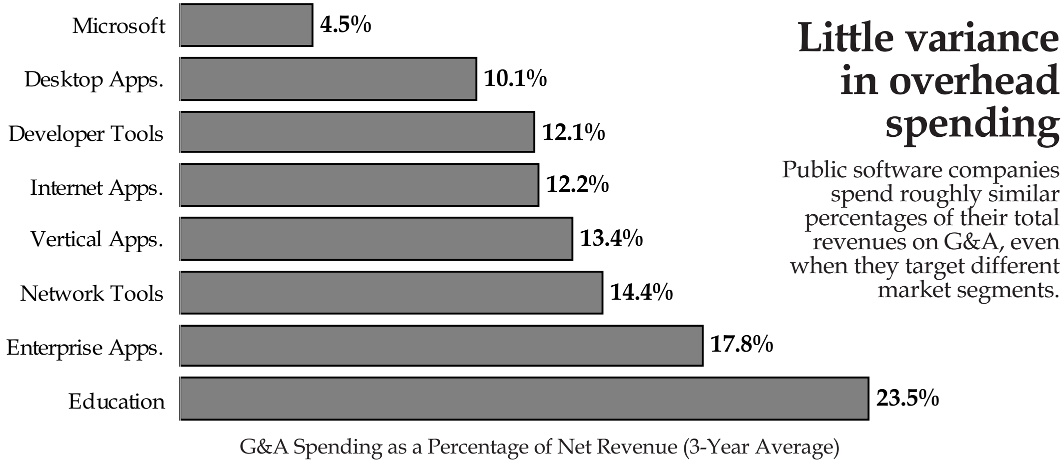
– Joel Spolsky, Joel on Software

Ramezani doesn't try to explain why the growth imperative yields such poor results, but software entrepreneur Joel Spolsky—who refuses to let venture investors anywhere near his company—argues persuasively that it's all a question of growth curves. In a "small company growing at a natural pace," says Spolsky, the growth rate in revenues is generally in sync with growth in headcount, reputation, and product development. Well-run companies usually manage to keep these growth curves in balance, he adds, and the result is profitability.

"But VCs don't like the flat part of the curve at the beginning," Spolsky notes. "VCs try to speed things up by spending *(continued on page 6)*



Synchronized growth: Ideally, a company should ramp up key growth areas at roughly the same rate, says Joel Spolsky.



G&A Spending as a Percentage of Net Revenue (3-Year Average)

Benchmarks: General & Administrative Costs

When revenues and profits are falling, corporate overhead is usually an attractive target for cost cutting. In actual practice, however, "general and administrative" expenses can be surprisingly hard to shrink. Many G&A costs represent long-term commitments (notably rent) or are outside the company's direct control (insurance, legal, and accounting fees). And in most cases, the G&A category includes pay and support costs for the CEO, COO, and CFO—hardly the most likely group to see serious belt-tightening.

Thus, average G&A spending for our Benchmark 50 group of public companies has remained relatively stable over the past three years at 13.8% of total revenues. Moreover, year-to-year changes for individual companies have tended to be minimal, despite substantial growth or decline in sales. Compared to more volatile cost categories like sales and marketing or R&D, overhead expenses are a rock of stability.

Moreover, there is remarkably little difference in G&A spending across market segments: The three-year G&A ratio for five of our eight segments falls between 10.1% and 14.4% of revenues; only Microsoft (4.5%) and the perennial high-cost enterprise (17.8%) and education (23.5%) segments vary much from this narrow range of ratios.

Not surprisingly, however, we do see relatively big differences in G&A spending that reflect economies of scale. The 22 Benchmark 50 companies with current revenues over $100 million spent only 10.8% (median) on G&A, while the 17 companies with revenues of less than $50 million spent 18.7%. Since G&A spending rarely contributes directly to product development or marketing, this is one area where small companies suffer a distinct competitive disadvantage.

Data for this analysis has been drawn from the Benchmark 50, a group of 50 public software companies whose financial results are broadly representative of trends in the software marketplace. The 50 companies are divided into seven product- and market-related segments, plus Microsoft in a category of its own.

The Benchmark 50: General & Administrative

	Revenues (000) 2000	2001	2002	G&A Ratio 2000	2001	2002	Avg. '00-'02
Microsoft	$22,956,000	$25,296,000	$28,365,000	**5%**	**3%**	**5%**	**4.5%**
Desktop Applications				**9%**	**10%**	**11%**	**10.1%**
Symantec	$745,725	$853,554	$1,071,438	6%	5%	5%	5.3%
Intuit	$1,037,300	$1,148,405	$1,358,348	7%	8%	8%	7.9%
Adobe	$1,266,378	$1,229,720	$1,164,788	9%	9%	9%	9.3%
Macromedia	$264,159	$389,600	$324,794	9%	10%	13%	10.9%
Aladdin Systems	$10,169	$7,627	$7,457	16%	15%	14%	14.7%
Corel	$157,487	$134,320	$126,701	42%	25%	27%	31.3%
Scansoft*	$49,055	$63,855	$78,184	n/a	n/a	n/a	n/a
Vertical Market Applications				**13%**	**14%**	**13%**	**13.4%**
Kronos	$271,195	$295,290	$342,377	7%	6%	6%	6.3%
Advent	$134,931	$170,215	$159,436	9%	9%	13%	10.2%
Timberline	$53,406	$59,942	$61,855	12%	12%	13%	12.4%
MapInfo	$96,160	$110,034	$92,598	13%	15%	14%	14.0%
Ansys	$74,467	$84,836	$91,011	15%	15%	11%	14.0%
Autodesk	$848,051	$936,324	$947,491	16%	14%	14%	14.6%
Moldflow	$27,369	$39,943	$35,088	18%	15%	19%	17.5%
Enterprise Applications				**20%**	**19%**	**15%**	**17.8%**
Mercury Interactive	$307,000	$361,000	$400,122	6%	6%	7%	6.5%
SPSS	$186,114	$176,556	$209,301	8%	8%	8%	7.8%
Manhattan Associates	$138,619	$156,378	$175,721	11%	12%	12%	11.6%
Witness Systems	$44,742	$62,522	$67,686	20%	19%	16%	18.1%
ServiceWare Technologies	$17,136	$11,933	$10,158	20%	30%	29%	26.6%
Concur	$35,704	$41,099	$45,097	41%	26%	15%	27.5%
Net Perceptions	$37,429	$10,514	$5,244	30%	59%	54%	47.5%
Internet Applications				**12%**	**11%**	**14%**	**12.2%**
NetIQ	$47,920	$166,937	$278,239	10%	8%	7%	8.2%
RealNetworks	$241,538	$188,905	$182,679	12%	11%	11%	11.1%
Cryptologic	$34,390	$43,550	$34,427	9%	9%	17%	11.6%
Interwoven	$133,603	$204,633	$126,832	10%	11%	14%	11.8%
Ultimate Software Group	$61,954	$59,479	$55,149	12%	17%	12%	13.8%
Centra	$22,973	$39,117	$33,400	22%	19%	23%	21.4%
Virage	$5,561	$11,401	$16,745	48%	46%	30%	41.3%
Network Tools				**14%**	**13%**	**15%**	**14.4%**
Novell	$1,161,735	$1,050,796	$1,134,320	8%	11%	11%	10.0%
Network Associates	$610,984	$697,742	$810,974	14%	12%	14%	13.2%
Altiris	$10,030	$34,451	$62,876	15%	14%	11%	13.3%
Citrix Systems	$470,446	$591,629	$527,448	12%	14%	17%	14.6%
NetManage	$102,653	$79,249	$65,689	17%	13%	19%	16.1%
Tumbleweed	$37,338	$29,048	$25,525	32%	32%	18%	27.4%
Tarantella*	$148,923	$66,662	$14,716	n/a	n/a	n/a	n/a
Developer Tools				**11%**	**12%**	**13%**	**12.1%**
Rational Software	$572,190	$814,935	$689,797	8%	6%	8%	7.3%
Sybase	$963,163	$927,923	$829,861	7%	8%	10%	8.5%
Rogue Wave	$54,442	$57,653	$43,299	10%	10%	12%	10.9%
Pervasive Software	$52,078	$42,158	$37,197	11%	14%	14%	13.3%
Red Hat	$42,427	$80,832	$78,910	22%	23%	17%	20.7%
Raining Data	$6,210	$9,319	$20,045	60%	45%	35%	46.6%
Borland Software*	$191,067	$221,771	$244,579	n/a	n/a	n/a	n/a
Education				**34%**	**20%**	**17%**	**23.5%**
DigitalThink	$10,815	$38,658	$43,356	22%	16%	17%	18.1%
Saba Software	$18,755	$54,955	$55,648	34%	18%	12%	21.3%
Click2Learn	$25,495	$31,209	$30,477	24%	21%	22%	22.0%
Lightspan	$16,916	$99,074	$57,532	39%	10%	20%	23.1%
Riverdeep	$8,312	$51,884	$169,251	51%	20%	12%	27.6%
American Education Corp.	$10,741	$8,902	$8,483	28%	37%	36%	33.4%
Skillsoft	$4,191	$19,297	$44,271	104%	30%	16%	50.2%
All companies				**13.4%**	**14.0%**	**13.9%**	**13.8%**

Note: "Years" may not correspond to company fiscal years. *Tarantella, Borland, and ScanSoft report combined G&A and S&M costs.

"When companies get on the treadmill beating the drum for more earnings growth, it's very tempting to invest too much capital in unrewarding, mature, or risky businesses."

– Bennett Stewart, Stern Stewart

more money. They spend it on public relations, and you get a problem (PR grows faster than code). They spend it on employees, and then you get other problems (too many cooks and a high burn rate). They hire HR people, marketing people, business development people. They spend money on advertising. And the problem is, they spend all this money before anyone has had a chance to learn what the best way to spend money *is*."

But is this learning and synchronization problem any different than it was, say, during Osborne Computer's frenzied ramp up? In fact, it is. The hypergrowth model first emerged in what was essentially a simple, homogeneous consumer market. Early adopters bought what they liked and spread the word to their friends, with little to get in the way of brushfires of demand. (It's no accident that most of the big Internet home runs, such as Netscape, Amazon, and eBay, grew through rapid consumer adoption.) But hypergrowth becomes far more difficult to achieve in mature markets. Distribution channels are complex, customers tend to be locked into competing solutions, and adoption decisions usually involve committees and long-term budget cycles. Even if demand is strong, rapid growth in a mature corporate market is likely to be just wishful thinking.

Of course, growth won't suddenly vanish as a yardstick for measuring the performance of software companies—or their managers. Growth simply *feels* like a good metric. Fast-growing companies do sometimes turn into stars, and the press likes to showcase these companies (as the annual Inc. 500 rankings bear witness). All other things being equal, getting to be a big company means greater market influence, greater stability, fatter budgets.

Nevertheless, focusing on growth metrics is almost certainly a dead-end strategy for most software companies these days. Sooner or later, investors will tweak their valuation models to reflect the insights we're hearing from people like Joel Spolsky and Cyrus Ramezani. Sales reps may start to hear that they should "only bring home profitable deals." Slower rampups—perhaps emphasizing smaller recurring subscription sales instead of big license deals—are likely to become more popular. Market share, customer loyalty, and profitability may gradually define what we think contributes to genuine "success" in the software business.

And the entrepreneurs who understand these new metrics may very well find that they're running the next generation of star performers.

"Growth, Corporate Profitability, and Value Creation," by Cyrus Ramezani, Luc Soenen, and Alan Jung, *Financial Analysts Journal,* Nov.-Dec. 2002.

"Fixing Venture Capital," by Joel Spolsky, chief executive officer, Fog Creek Software, 217 E. 31st St., New York, N.Y. 10016; 646/424-1712. E-mail: spolsky@panix.com. Web: www.joelonsoftware.com.

Equities

Behind the Scenes

By Software Equity Group, L.L.C.

- **Divine:** Fallout from the Divine debacle continues with the U.S. Bankruptcy Court's approved sale of Divine's managed services unit to Saratoga Partners, a New York private equity firm. Saratoga is one of the few private equity firms that saw opportunity in the current market and jumped headlong into the fray. This is Saratoga's third acquisition since February and follows on the heels of its recent sale of Datavantage to Micros Systems. The managed services unit was built through Divine's acquisition of Data Return, Intira, and Host One.

- **Interliant:** NaviSite, a provider of application management and hosting services, acquires Interliant, a bankrupt competitor focused on corporate messaging and e-mail outsourcing. Its fourth acquisition of a hosting business in recent months, NaviSite is taking advantage of depressed valuations and others' misfortunes. While the market reacted favorably to the acquisition, driving NaviSite's stock price upward 67%, we're a little less enthusiastic. NaviSite has significant debt, a dwindling cash balance and negative operating income.

- **Nexland:** Symantec continues to reposition itself as a security software provider by acquiring Nexland, a small public company whose patent-pending security applications and appliances enable secure virtual private networking between corporate and remote offices. Here's another example of a strategic partnership evolving into an acquisition with a decent multiple. After backing out Nexland's cash and adding debt, Symantec paid $20.1 million. Nexland's compound annual revenue growth rate exceeded 129% over the last two years.

- **TeamShare:** Serena, a provider of software solutions used to manage enterprise application code and Web content changes, picks up TeamShare, a Softletter 100 provider of developer-oriented collaboration and workflow management tools. TeamShare's product, which is already integrated with Serena's, provides a highly complementary product extension for Serena. Revenue is estimated to be $12.5 million.

Allen Cinzori, Software Equity Group, 12220 El Camino Real, San Diego, Calif. 92130; 858/509-2800. E-mail: acinzori@softwareequity.com. Web: www.softwareequity.com.

Company/Description	Acquired by	Price/Terms	Revenues	Multiple
Divine's Managed Services Unit • *managed services/hosting*	Saratoga Partners	$28,000,000 *Terms: Cash*	$60,000,000	0.47
Interliant (INIT) • *managed services/hosting*	NaviSite (NAVI)	$7,000,000 *Terms: Cash*	$44,600,000	0.16
Nexland (XLND)* • *Internet security*	Symantec Corp. (SYMC)	$20,100,000 EV *Terms: Cash*	$7,740,000	2.60
TeamShare • *collaboration and workflow*	Serena Software (SRNA)	$18,000,000 *Terms: Cash*	$12,500,000**	1.44
APAP Infotech* • *custom software development*	Ness Technologies	$78,000,000 *Terms: Stock*	$60,000,000	1.30

* 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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Loyalty Marketing

- **Colloquy** (www.colloquy.com)—Web portal with extensive research, articles, news, resources on loyalty marketing; free quarterly magazine.
- ***The Loyalty Effect,*** by Frederick Reicheld—Classic book on the economic value of loyal customers; $24.95.
- **The Griffin Group** (www.loyaltysolutions.com)—Loyalty expert Jill Griffin's consulting and research firm.
- **Reid Smith Associates** (www.reidsmith.com)—Customer retention consultant for Web businesses.
- **Drilling Down** (www.jimnovo.com)—Modeling techniques and tools for customer scoring and lifecycle management.
- **Client Shepherd** (www.megaputer.com)—Data mining software for graphical analysis of "customer migration" trends.

DIRECTV chief financial officer on his company's investment in superior customer service: "We have to spend around $550 to acquire a new customer. It only costs us about $50 to keep an old one. Spending a few extra dollars in the call center is better than shelling out the big money all over again." (Quoted in Business 2.0, 6/03)

"CULTS IN OUR MIDST" author Dr. Margaret Singer on the intense loyalty that people feel toward businesses that try to provide a more personal experience: "Many adults today are overwhelmed by the confusion and apparent coldness of our society. Many mature adults are finding less and less to hold onto in today's techno culture." (Quoted in ClickZ Today, 3/21/03)

FEDERAL EXPRESS chief information officer Rob Carter on why he was "stunned" by a Harvard Business Review article arguing that information technology is now so pervasive that it "doesn't matter": "Everything strategic in [our] company has IT inputs into it. I always annoy my team by telling them, 'It's the software, stupid.'" (Quoted in Fortune, 6/9/03)

GENERAL MOTORS chief technology officer Tony Scott on Microsoft's response to the growth of Linux: "They understand that it's a real threat and are beginning to take it seriously. You can see a strategy starting to emerge, but it's not at the level yet that guarantees they will win." (Quoted in The Wall Street Journal, 5/19/03)

NOVELL vice chairman Chris Stone on what happens when his company tries to negotiate with strong corporate customers: "We get squashed." (Quoted in Business Week, 5/26/03)

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11300 Rockville Pike, #1100
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301/287-2718
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customer@softwaresuccess.com