OPINION

Software VC Outlook: A Flight to Quality

An analysis of the latest statistics finds new economics, new technologies and newfound restraint will drive software venture investing in 2006.
By Matt Miller, Walden VC
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Ask any venture capitalist to rank their favorite investment sectors and you'd be pressed to find any lists with "enterprise software" at the top.

The mood among VCs remains hesitant about enterprise software startups. Competing against today's megavendors is tough. The last investment "bubble" funded plenty of strong small and mid-sized vendors who are still waiting to be acquired with many stagnating. Perpetual license models are a slowly dying business model, but the much-hyped Software as a Service (SaaS) model is still more conjecture than reality in the core software sectors.

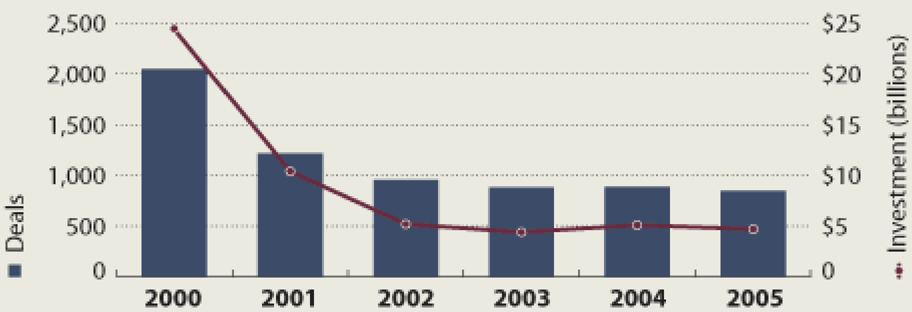
Yet software companies received $4.7 billion in venture capital investment during 2006. That's more than biotech, alternative energy, or any other sector.

Sure, you hear about some software VCs moving on to clean energy, digital media or consumer plays. But most remain committed to software. Why? Because even in today's rapidly evolving industry, software startups offer backers high margins and high growth rates - a combination that few VCs can ignore. Moreover, the sector has become more capital-efficient in the last 10 years. (More on that to follow.)

Of course, certain software sectors are more promising than others. An in-depth look at the latest statistics on financing trends shows software venture capital is on solid ground with several "hot" sectors, lots of interesting startups and a stable of active investors.

No Bubble in Sight
Despite media buzz about a resurgence in VC investment, software funding slipped 8 percent in 2005 (see Software VC Trend chart). To me, that's great news. We may be regaining some balance after the excesses of the 2000 period. Enterprise software is not getting left behind: The data show investment is healthy and stable.

U.S. Software VC Investment Trend

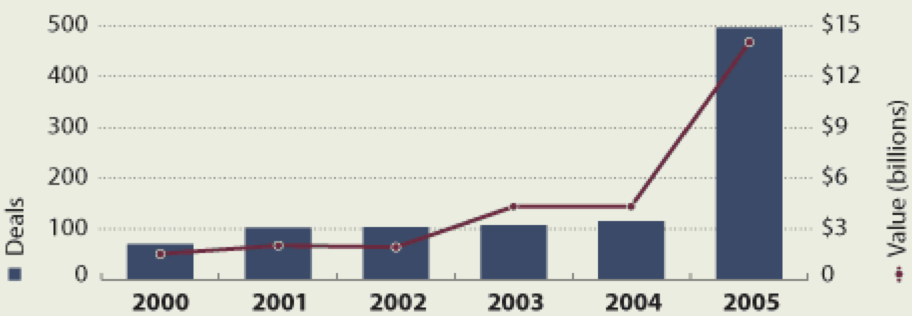


	2000	2001	2002	2003	2004	2005
Deals	2,047	1,215	954	880	887	849
Investment (billions)	$24.4	$10.4	$5.2	$4.4	$5.1	$4.7
Deal average (millions)	$11.9	$8.6	$5.4	$5.0	$5.8	$5.6

Source: PricewaterhouseCoopers/Thomson Venture Economics/National Venture Capital Association MoneyTree Survey

As venture-backed M&A skyrocketed in 2005 and the possibility of a lucrative exit becomes a reality again, there has been a worry in the venture community that another speculative bubble would emerge, similar to the one during 1998-2000 (see Software VC-Backed M&A Trend chart). While not truly overheated, there continues to be far too much VC money out there chasing deals.

U.S. Venture-Backed Software M&A Trend



	2000	2001	2002	2003	2004	2005
Deals	69	102	103	107	114	495
Value (billions)	$1.5	$2.0	$1.9	$4.3	$4.3	$14.0
Avg. value	$53.1	$37.5	$44.6	$77.1	$79.7	$60.0
Avg. financing received (millions)	$30.0	$37.6	$32.3	$27.5	$36.9	$33.1

Source: Thomson Venture Economics / NVCA

2006 looks like it will be a solid year for software investment for two reasons. One, we aren't yet seeing a bubble that is funding a lot of unworthy companies. And two, we aren't yet overfunding hot categories.

Venture capitalists tend think as a group today. This seems much different than when I first worked in the Silicon Valley in the late 1980s. At that time, if there was a really hot market segment - take visual tools for databases, for example - there would be a small number of startups funded in the area - maybe five, or so.

As the market grew, a couple of those startups would fail, a couple would emerge as strong players and maybe one or two would go public. It was a good balance which allowed all of the companies and investors to make a fine return.

But today, when a sector gets popular, you might see VCs fund fifteen companies in that segment. Each of these will blow lots of marketing money to secure a few big customers, and none will gain critical mass. Right now, both the social networking and Business Intelligence areas are getting a bit crowded. That makes it harder for companies to have a good shot at getting beyond the noise, reaching customers and becoming successful. Still, the VC demand seems healthy because we haven't yet seen crazy excesses in valuations.

New Software VC Economics at Work

But a look at the average funding level for software companies shows a decline over the past few years. It's possible that VCs may be investing less because they have become a bit more conservative after being burned by "bubble" deals.

But a more likely explanation is that software companies have become more "capital efficient." It used to cost $7 - $10 million to build a product. You started with a blank slate and built it all - the tools, the middleware, the databases - with languages and no pre-built components.

Today, software companies can leverage open source components and offshore development to decrease development budgets significantly. A decent piece of enterprise software can be built for $5 million or even less.

On the marketing side, significant cost-effective methods have also emerged. During the Dotcom Era, a software company would spend 10%-15% of its gross revenues on "big-blast," brand marketing aimed at building awareness through advertising. That would be coupled with a big-budget, BMW-driving salesforce.

Today, software companies have fewer highly-paid salespeople. And when was the last time you saw a software ad on TV? Software companies "pay per click" for qualified leads from Web ads. They are leveraging online, "viral" methods such as marketing through developers, word-of-mouth and pass along - especially true for open source companies who can simply give the product away for free.

Is it working? I can't be sure. But you certainly aren't seeing young software startups spending as much on marketing anymore, which decreases the amount of money VCs need to invest.

A Flight to Quality

Within enterprise software, certain sectors are "hotter" than others. Business intelligence is still going strong. Security has been and may always be a mainstay investment for VCs. New threats are always emerging. There continues to be quite a bit of security M&A activity by good acquirers, for good money.

Open source financings have exploded over the past year. A look at the the biggest software VC deals of 2005 finds open source players such as, SpikeSource and Code Green at or near the top of the list (see Top Software VC Deals.)

Top Software VC Deals of 2005

Rank	Company	Investment (millions)
1	Webroot Software	$108.8
2	Strategic Financial Solutions	$63.0
3	Level 5 Networks	$48.0
4	SolarWinds.Net	$41.0
5	Barracuda Networks	$40.0
6	Omniture	$40.0
7	SpikeSource	$30.8
8	DivXNetworks	$26.9
9	Code Green Networks	$26.2
10	Integrated Solutions	$26.0
11	Cadent Holdings	$25.0
12	Lefthand Networks	$25.0
13	Rearden Commerce	$25.0
14	XenSource	$23.4
15	Bitfone	$22.0
16	Orchestria	$21.0
17	Pipeline Trading Systems	$20.7
18	Incipient	$20.2
19	RF Code	$20.0
20	Digital Fuel Technologies	$20.0
21	Kabira Technologies	$20.0
22	CaseStack	$20.0
23	Isilon Systems	$20.0
24	Comergent Technologies	$18.8
25	SugarCRM	$18.8

Source: PricewaterhouseCoopers/Thomson Venture Economics/ National Venture Capital Association MoneyTree Survey

But open source is tricky. The barriers to entry are quite low - you and I could start an open source software company this afternoon if we wanted to. That means the scale needed to have a successful open source company is dramatic.

In the "old days," we could close five large sales deals and be in good shape. An open source startup might need 100,000s or millions of users to generate meaningful revenue on maintenance. Few open source companies can quickly achieve the scale needed to be successful.

What is the hardest part of running a young software company today?

"The hardest part of running a small fast growing company in the technology industry is managing through the constant changes you will encounter as you grow from stage to stage, all of the time working to ensure alignment, innovation and client satisfaction. Managing change requires constant focus and attention. The need for consistent and open communication is paramount to managing through this growth. Changes will inevitably be made to a company's business strategy, business model priorities, team members, products and services in response to external market and competitive conditions, all happening as a company drives through the start up phase to an early stage company to an emerging company and finally to a mature one. Managing change to drive growth is the hardest part of running a young company, but also perhaps the most satisfying as a company continually grows and matures, employees grow, cultures emerge, and value is provided to its clients." - Bill Portelli, CollabNet

"Moving the company from a posture of a few people easily communicating and nimbly moving forward on key tasks to a company with 30 to 50 people that clearly understands the objectives and plans of the company yet retains the small company passion and efficiency. As you grow and blend on-shore and off-shore resources needed to optimize the use of capital, it becomes increasingly critical to formalize plans and work hard to ensure that a growing and distributed team is pulling together towards company objectives. One of the greatest challenges faced by a growing company is the ability to continue to build momentum while retaining the energy, spirit and nimbleness of a start-up." - Joe Salesky, ClairMail

"If you are an enterprise software company, the selling model is the hardest part today. The idea of organically growing a direct sales force and reaching profitability in a reasonable time doesn't work anymore. The sales cycle leverage is on the side of the enterprise. The enterprise buys less, takes longer and works vendors harder on price then ever before. And, most of these enterprises have a stated goal to reduce the number of vendors they buy software from. Figuring out a sustainable, profitable, predictable selling model is the biggest challenge." - John M. Jack, Fortify Software

"When we started the company, the leadership team's focus was to get the job done, whether it was sales or product development or customer implementations. Now that we've grown beyond the 100-person mark, those same hard driving individuals have to step back and focus their efforts on empowering our people to succeed. It's a difficult transition for any entrepreneur." - Srikant Vasan, StorePerform

What lessons would you would share with other executives running young software companies today?

"Figure out how you are going to bring a product to market as part of the design process. In order to be successful today, you need products that cover the entire range of delivery options: enterprise sales, channel sales, distributors, resellers, and so on. Build a company that works in a multi-channel, multi-product world." - John M. Jack, Fortify Software

"Stay focused on satisfying your customers and everything else will fall into place." - Srikant Vasan, StorePerform

"The one lesson I would share is to focus on the shortest path to value. Building on this, find a way to prove that value in the shortest time without having to 'build it all.' Also, I cannot emphasize enough the importance of getting the product into people's hands. Find a customer as you start to build, and do whatever it takes to make sure that those customers help you prioritize your earliest capabilities and prove they will use the product and value it. Make sure that your bridge funding gets you to three customers and validates your solution." - Joe Salesky, ClairMail

"It might sound trivial, but make sure your team has a single-minded focus, and is completely aligned for the mission of your company. Make that mission is something the employees can be passionate about because that passion and your focus will carry you through the inevitable highs and lows of building a great company. Ensure your team is completely aligned around your vision and mission, and articulate your corresponding set of core values to guide your daily decisions. Make sure your entire team understands your strategic imperatives and strategic objectives to achieve that mission, and honestly measure your progress against a stated set of metrics. Surround yourself with a team made up of individuals better than you are, lead them, help them, and then get out of their way." - Bill Portelli, CollabNet

*Maryann Jones Thompson is editor of **SandHill.com.** Hear more from these and other CEOs of fast-growth software companies at the **Software Showcase** during **Software 2006.***