William Blair & Company®

Equity Research

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Software as a Service

An Update on the Evolution of Software as a Service

The technology team at William Blair & Company has been covering the software-as-a-service (SaaS) space since its emergence in 2000, consistent with our mission to identify important new investment opportunities for our clients. While we still expect to find successful investments in traditional software models, we believe companies using a SaaS model will represent the primary source of attractive new investment ideas over the next several years, as they have been over the last few.

This marks our third report covering the SaaS industry. We published the first report in September 2004 and the second in March 2006. There have been a number of material changes in the market since our last update. Chief among them is the movement away from perpetual licenses to pure subscription models as customers have become more accustomed to buying software as a service. Another major change is the adoption of SaaS by even the largest companies and commensurately a material increase in deal sizes—the age of widespread adoption has begun. We have also seen a lengthening of contract terms as customers try to lock in existing pricing to better understand their costs going forward. These trends in combination should lead to SaaS market growth of 20% to 25% over our five-year forecast period, well in excess of the midsingle-digit growth we project for traditional enterprise software and the 9%-12% we forecast for the majority of transaction processors (which can be viewed as the early SaaS companies).

This year we expect a flood of new SaaS companies coming to the public market. In this report we attempt to help investors differentiate between those SaaS companies likely to succeed and those that might run into difficulties. We will also update investors on how the large traditional software companies are responding to the SaaS model, and our handicapping of their likely success. We also update our list of public companies in the SaaS market (not intended to be all inclusive).

Figure 1
Public SaaS Participants

Source: Companies' Web sites

Laura Lederman, CFA
312.364.8223
llederman@williamblair.com

Franco Turrinelli, CFA
312.364.8166
fturrinelli@williamblair.com

Jeffrey Houston, CFA
312.364.8586
jhouston@williamblair.com

John Weidemoyer
312.364.8154
jweidemoyer@williamblair.com

William Blair & Company, L.L.C.
222 West Adams Street
Chicago, Illinois 60606
312.236.1600
www.williamblair.com

Please consult pages 50-51 of this report for all disclosures.

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Executive Summary

The emergence of the SaaS model—also referred to as on-demand software—has, in our opinion, revitalized innovation and entrepreneurialism in the software industry and created new opportunities for investors. The SaaS names as a whole also have provided investors attractive returns, outperforming by a wide margin traditional software companies. As a result of the stock performance and the increase in new offerings entering the space, investor interest is strong and growing. Even those who did not believe in the SaaS business model or market after its initial emergence generally agree now that things have changed for the better in the software space. We expect SaaS vendors, new and established, will continue to set the pace of growth and innovation in the software market and will continue to be the area most interesting to technology investors.

We also believe that as the market and companies in it mature, the appropriate approach for investors is to own multiple companies that operate a SaaS model, and that this selection should increasingly be on the companies' individual merits rather than as a part of a "movement." In our opinion, the trend toward SaaS is sufficiently important, the companies sufficiently diverse, and the returns on investments we believe will be strong enough to merit owning a number of SaaS names. In some cases, we have heard investors comment that they own one of the early, successful on-demand companies and that that was enough exposure. In our view, that is like owning a single software company or a single semiconductor company. SaaS is a broad trend that will lead to a host of successful public companies.

The main reason for the success and adoption of SaaS is customer value and benefit. We outline all of the benefits in detail later in this update report, but the one we most frequently hear from SaaS users is low up-front cost: because the software is leased and the vendor runs the product, the user does not have to buy the underlying infrastructure or pay for a large up-front software license fee. The next two most common benefits we hear about are the decrease in risk of deploying SaaS-based solutions versus traditional software and the rapid time to user benefit. From our research, we conclude that even those companies that have not already adopted a solution that is based on a SaaS model are at least familiar with the model and more open to using a remotely hosted subscription-based solution, as a result of the success of, and publicity afforded, a number of SaaS vendors such as salesforce.com, Vocus, RightNow, Ultimate Software, Concur, Kenexa, and WebEx. This is enabling SaaS vendors increasingly to be considered for new projects and included in request-for-proposal lists.

Customer acceptance has been paralleled by increasing awareness, understanding, and appreciation among technology investors. We no longer have to explain the model and its intricacies when we speak with investors: a key point of this report is that SaaS acceptance (stock and customer) has reached the mainstream.

SaaS Market Overview and Developments

What We Mean by SaaS

Before we go any further, it might make sense to differentiate SaaS from other business models. As we define SaaS, the vendor rents software to users on a subscription basis and also hosts it.

This definition differentiates SaaS from several other business models: software sold on a subscription basis to customers, who then operate it in-house; application service providers that host customer software; and business process outsourcers that take over the entire business process from the customer. The SaaS model of renting and hosting allows SaaS vendors to differentiate through technology innovation and customer service, and leads to a steady steam of revenue and unusual visibility compared with the traditional model of offering perpetual licenses (where license revenue is recognized all in the quarter when signed) and customers' running the software on their own premises. As we discuss later in this report, it is important to note that many "SaaS vendors" also offer or operate part of their business using other more-traditional models. Ultimate Software is an example.

In this report we introduce one additional criterion for an application to qualify as SaaS. In our opinion, the software should be intended to enable or support users' activities as part of regular business operations, through a user interface. We introduce this criterion to differentiate SaaS from transaction processing models, such as those operated by merchant acquirers such as First Data. While transaction processing applications architecturally are precursors of the SaaS model and share many similar characteristics, we consider them separate and believe this differentiation is useful.

Market Acceptance—SaaS Is Mainstream

The SaaS sector is no longer a fledgling market. In addition to the evident success in both the software and financial markets of several companies operating a SaaS model, the vocal support of the major software companies such as Microsoft and SAP over the last year has brought additional credibility to the market.

But even more important than the support of the software stalwarts are the increasingly proven benefits to the customer. SaaS offers compelling benefits, some of which we already have mentioned, including the ability to get up-and-running much more quickly than when the software must be installed and managed at the user's site. Software-as-a-service also decreases the up-front risk of failure and cost since the software is only purchased for a period of time and the vendor, not the user's organization, absorbs the costs of the infrastructure.

The model also increasingly appeals to companies of all size. Even large organizations like the idea of not having to build out IT resources to support new applications, and many, in our opinion correctly, conclude that the SaaS vendor can run the software more effectively than they can internally. Why should health care, financial services, or retail companies become experts in running software when the SaaS model allows them to retain control over applications while outsourcing the non-value-added activities of managing the IT infrastructure and maintaining software?

Market Size and Growth

The SaaS market has grown beyond its first points of strength (customer resource management and "webinar" hosting) into a multitude of applications. These applications include pricing and revenue optimization, spam filtering and security, storage management, human resource management, corporate communications, pre-employment screening, expense and travel, compensation, marketing automation, compliance, and business intelligence. While long, this list is far from comprehensive, in our view, and the SaaS model has been

applied in only a relatively small portion of the potential end-markets for which we believe it will ultimately prove applicable. The increasing application of SaaS concepts for consumer software, for example, is an interesting trend that we plan to revisit in future research.

Another important evolution is that SaaS is now a global market, with most of the companies we cover, and many that we do not, broadening to reach overseas. This is despite the inherently greater complexity of having to establish global processing infrastructure capabilities to target foreign markets, rather than simply needing sales and distribution as is the case for a traditional software company. As noted, SaaS also appeals to companies of all size, from small to large—an important factor contributing to the globalization of the market.

As a result of the expansion of SaaS into new segments and new geographies, one year after the publication of our last update, the market pundits have revised upwards their expectations yet again for the size and the growth of the market. It also seems that every market researcher has a forecast for SaaS growth—another clear indication of the mainstreaming of SaaS.

A number of recent surveys also show the increasing shift to buying software under a SaaS arrangement:

- AMR Research estimates SaaS revenue was $2 billion in 2006, up from $1.5 billion the previous year. Although SaaS represents less than 10% of the overall software market, it is growing at more than 20%, compared with traditional software's single-digit growth.

- Gartner Group expects the multitenant SaaS market to be $19.3 billion by 2010; the number grows to $55 billion including services and hosted applications.

- Gartner also forecasts that as much as 25% of new business software will be delivered as a service by 2011, up from just 5% in 2005.

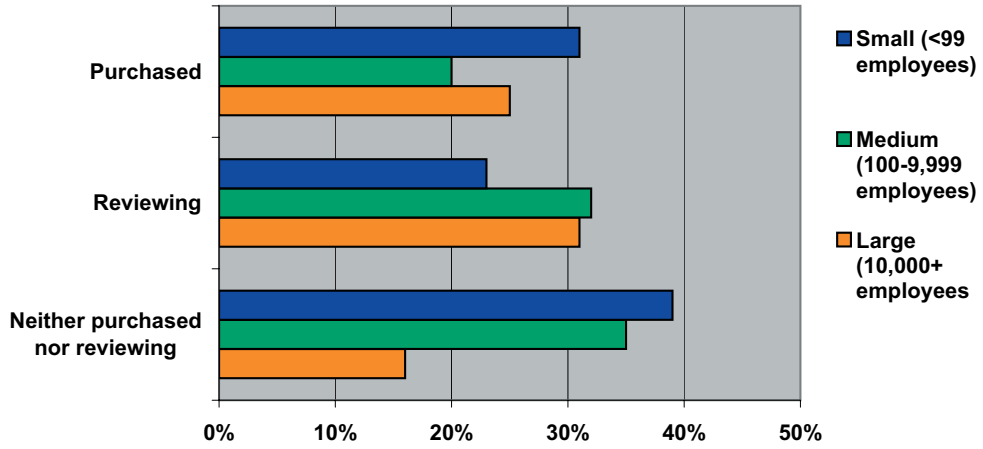
- Aberdeen Group finds that 70% of 631 companies surveyed are looking at or planning to use SaaS.

- Nucleus Research observed that 64% of 198 respondents to a Web survey said they plan to consider implementing a new SaaS solution in the next 12 months; 51% of these same companies said they already use SaaS solutions.

- International Data Corporation's (IDC) survey results on software buying intentions are shown in figure 2, on the following page. This research shows that the majority of companies surveyed have already purchased SaaS or plan to do so.

- In an IDC survey of 201 companies using or reviewing SaaS, the most common SaaS functional areas were customer service and conferencing (both just above 20%). The remaining categories were financial (17%), content/document management (13%), recruiting (12%), compliance (8%), and authoring (6%). While the sample size was relatively small, it shows that SaaS is not just for customer relationship management (CRM).

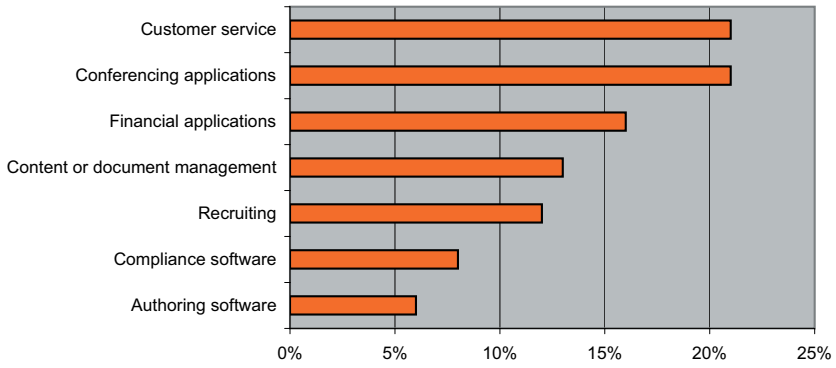
Figure 2
SaaS Demand
(% of respondents)



Source: IDC and InfoWorld Software on Demand Adoption Survey: 2006; Unweighted n=238

Figure 3
SaaS Categories
(% of respondents)

Q: Please select the category or categories that best describe(s) the type of software-on-demand offerings that your company uses or is reviewing.



Source: IDC and InfoWorld Software on Demand Adoption Survey, 2006; Unweighted n=201

Expanding the Total Available Market

One difference between SaaS and traditional software companies is the size of the total available market they address. We have addressed this point in prior updates, but it is important enough to return to here.

With the advent of the SaaS delivery model, enterprise software is no longer just for large enterprises. Before the SaaS companies came to market, enterprise software was typically bought by large enterprises that could afford to purchase the software licenses, the requisite hardware, and the costly installation and customization services required to get the software up and running and applicable to the company's operations. Smaller companies were limited to solutions with less functionality, or simply went without. Few software companies' products could span the gamut of small companies to the largest multinational enterprises. The market remained segmented and underserved.

With SaaS, the cost of starting with the software is relatively low and, crucially, is proportional to the scale of the implementation. The same application can be offered to small and large customers. SaaS-based systems can even be deployed by small companies that lack IT staffs. Our surveying of SaaS customers has included golf courses, graveyards, and spa operators—not traditional enterprise software customers.

We estimate that 60% of the addressable software market is companies in the small and midsize business (SMB) market—a sector that SaaS companies can better penetrate, in our opinion.

Moving Up and Down Market

There is movement up- and down-market in the SaaS space, and no single strategy appears to be the "right" one.

- Some early entrants targeted small companies and later expanded to the enterprise. An excellent example is salesforce.com, which first appealed to small and midsize companies (typical contracts averaged five to 15 users) and it was only with time that large companies became comfortable with and therefore interested in its services. To achieve this market expansion, salesforce.com added a direct sales team to target large enterprises. Another example is Postini, which at first sold to midsize organizations, but as SaaS has become more mainstream, large companies increasingly have turned to the company to outsource their hosted e-mail/antispam needs. Ultimate Software initially experienced success with midmarket companies, but its average customer has been gradually becoming larger.

- Other vendors initially targeted large companies, which had the most money to spend and the most complicated problems to solve, and have more recently been moving down-market. For example, Concur's first customers were enterprises with large numbers of expense statements and complex integration challenges (e.g., trying to tie expense data to payroll). The company's outsourced solution provided a pain-free, seamless solution given it had already built the interfaces between disparate systems, alleviating the need for customers to do it themselves. Once systems and architecture had been built, Concur was able to leverage its SaaS model into the middle market by offering a lower price point. One could argue that it was imperative for Concur to move down-market to maintain growth, which tends to slow once the large enterprise market has been penetrated. Talent management vendor Kenexa's solutions also first made sense for corporations with large employee bases.

- RightNow is somewhere in the middle. The company started in divisions of large and midsize companies, and decided to focus more of its sales effort on large companies. In RightNow's view, it is easier to sell one $5 million deal than a multitude of $100,000 ones.

These examples show that there is ample opportunity at both ends of the market, and starting in one segment does not preclude a company from entering any other. This is in direct contrast to traditional software, where companies that start in the low end of the market have difficulty selling to large organizations because of limited functionality and scalability. Along the same lines, enterprise software vendors have difficulty scaling down functionality to suit smaller organizations. In both cases, the vendors' reputations tend to precede them; they are viewed as appropriate for only companies in the segment that the vendor initially targeted.

Horizontal and Vertical Market Focus

As previously noted, the first SaaS companies targeted broad horizontal markets such as salesforce automation (salesforce.com), customer service (RightNow), and payroll (Ultimate Software). As the broad horizontal areas become covered, we have found that newer companies have started to target vertical segments, such as software for financial companies or retailers. Our sense is that the target markets SaaS companies serve will become more narrow—and hence likely smaller—over time.

As a general rule, we still believe companies with large horizontal markets will have greater opportunity for growth, and hence for returns to investors. That said, a few of the companies William Blair & Company covers in the SaaS space address relatively narrow markets—horizontal or vertical. The key, though, is that the size of these vertical markets is substantial. For example, Vocus sells a hosted corporate communications solution, and DealerTrack is focused on a very large vertical market, serving the needs of automotive dealerships.

One factor that in our opinion increases the appeal of niche markets for investors is that they are often less competitive. A huge market such as customer relationship management will attract myriad players, whereas hosted corporate communications applications are less likely to do so. Case in point, when we asked what other competitors Vocus customers looked at, many replied that there were no other firms that offered as broad of a solution as Vocus—and in our estimation, the market is not large enough to attract many more entrants. DealerTrack similarly has no competitor with an equally broad offering or presence in the market—we believe competitive entry in DealerTrack's target market would now be very difficult.

Our summary thought is that the total available market a company targets does not have to be huge to make a good public investment. But our point should not be construed to mean that all small target markets will make good investments. There already are examples of SaaS company failures as a result of the combination of too small of an end-market and poor execution.

The Positives and Negatives of Adjacent Expansion

Some of the SaaS companies we cover have worked to expand their total available market by expanding outside their core market into adjacent areas. Sometimes this strategy makes sense, but it also creates more risk and in our opinion the risks can sometimes outweigh the advantages.

An excellent example of an adjacent acquisition that made sense to us was Vocus's purchase of PRWeb, which increased its total available market (by adding a new product that would appeal to existing users and allow it to sell down-market) and added to corporate margins (PRWeb has an operating margin of 30%, while Vocus's was in the single digits). The most significant negative in our view was that the acquired business did not have a subscription model and Vocus will have to work over time to shift the business to ratable revenue recognition.

We also like Kenexa's acquisition of BrassRing since it brings the company a more competitive recruiting system than the product Kenexa had. But this acquisition in our opinion carries with it more risk than Vocus's purchase for two reasons. First: Kenexa has been more acquisitive and we believe there is therefore greater execution risk to integrating the various elements. Second, the recruiting market is more competitive than other spaces in which Kenexa operates, in our view. As a whole, with respect to Kenexa's acquisition of BrassRing, we believe that the benefits outweigh the risks but would prefer that Kenexa not make another large acquisition in the near term and instead digest what it has already bought.

Not all acquisitions will be obviously synergistic; witness Intuit's purchase of SaaS vendor Digital Insight. This acquisition does not have immediate or logical synergies from either a market or a cost perspective. The acquisition does, however, bring a third leg to Intuit's growth (in addition to tax and small-business accounting). Intuit management believes that together, the two companies can better serve the more than 20 million small businesses looking for a solution to invoice and manage cash flow. On the conference call discussing the deal, management referred to a "killer application" that would include functionality from Intuit's QuickBooks, Quicken, and Payroll business as well as Digital Insight's online banking and bill pay services, creating an all-encompassing solution.

The Internationalization of SaaS

As noted above, we believe 2006 was an important year for an increasingly global view of the market by established SaaS companies. The North American market was the first to embrace the SaaS model, a typical trend in technology adoption. We tend to see this pattern because the United States has the world's largest technology end-user market. Also, most of the new corporate technologies are developed and sold by U.S.-based companies.

Toward the end of 2006, we detected an increased interest in and adoption of hosted software in Europe. In the financial services space, we have seen several large SaaS deals, including salesforce.com's wins at ABN Amro and Barclays Bank. We have also seen vendors like Kenexa make acquisitions to speed their market entry overseas; the BrassRing acquisition brought not only international functionality, but also a field organization. Ultimate Software is introducing a Canadian version of its payroll software, and is redesigning its solution to facilitate language, currency, and payroll rules localization to support expansion into other markets.

Many of the next-generation software companies are only starting to build their international presences. Growing in Europe, the Middle East, and Africa (EMEA) and Asia-Pacific requires time to add the right personnel as well as to customize the software for local markets. It is in our opinion an expensive venture that is quite different from gaining share in the United States.

Also, many of the smaller SaaS companies are still focused entirely on the domestic market, which should carry their growth for the near future. But it is important to start to build an overseas presence before it is needed to support growth since it can take years.

Turning to mature traditional software companies, such as Oracle and Microsoft, for a glimpse into the potential for international growth, they receive roughly half of their revenue from overseas markets.

What Makes a Good SaaS Market?

Having commented on the wide potential applicability of the SaaS model, and companies' ability to approach the market in different ways than is possible for traditional software applications, it may be appropriate to comment on what we believe makes a "good" market rather than one that is simply available.

We first addressed the issue of what makes a good SaaS market in our last SaaS report. But, one year later, we believe that our answer at the time was too narrow. We now believe that the SaaS model should be applicable to almost all markets. In addition, and as we stated in previous research, the traditional wisdom that SaaS is only for front-end applications is not correct, in our view.

Also, we believe that even markets that are relatively mature/slow-growth can have successful SaaS vendors. Indeed, some of these markets may be the most ripe for a disruptive approach that can kick-start both more widespread adoption and a significant upgrade/replacement cycle in otherwise stagnant markets. An example is the payroll processing market, where Ultimate Software has been able to grow rapidly by offering a brand-new solution (the first in the market for many years, if not decades). Ultimate Software's solution takes advantage of all the latest technological thinking to offer a functionally richer, better-integrated solution that the employer can still retain control over instead of having to cede operational control to traditional outsourcers such as ADP or Ceridian, or go through the expense of implementing payroll software solutions from Oracle or SAP.

It is increasingly apparent that it is *not* necessarily easier to outsource a newly computerized application than one that has been running internally for some time. Especially if the existing system is not working, is too expensive to maintain, or is not being used, it is ripe

for replacement. But even if the existing system *has* been working successfully, the appeal of lower total cost of ownership, the availability of enhanced functionality, and/or the greater functional integration that is often being offered by SaaS vendors can be a cause to switch—in part because of the lower cost and risk of doing so, as we have already discussed.

We still believe, but to a lesser degree, that mission-critical applications might have fewer successful SaaS players. As much as we like to think that human resource management or customer relationship management software is critical, if the system becomes unavailable temporarily, it would not lead to major problems at most corporations. Also, it is easier for customers to give up control over this data than something mission-critical, or sensitive, such as financial data. We forecast that, as a percentage, fewer organizations will choose SaaS for their financial systems than for salesforce automation—especially large organizations.

Another point that in our opinion has become clear is that departments that have power to choose their own solutions—in some cases even over the objections of the IT department—are also the best segments to target, and offer a large total available market for SaaS vendors. For example, most sales organizations are powerful enough to veto what IT says, since they drive the revenue for most organizations.

Issues and Developments in SaaS Operations

Key Operating and Financial Characteristics of SaaS Companies

In this section and the one that follows—"Economics of SaaS Companies"—we focus on key operational and financial characteristics of SaaS companies. The characteristics that we address are those that we believe are undergoing particular change, or that we believe are especially important in differentiating between companies that will be successful in the marketplace and attractive for investors.

We present in table 1 data regarding these characteristics for several SaaS companies that are public—and for most of which we provide research coverage. For example, we list in table 1 how these companies bill their customers, how their solutions are built, and what is their mix of subscription versus perpetual license fee revenue.

We believe this table provides an interesting overview of current practices in the SaaS market, and provides additional context for comparison and evaluation.

Table 1
Public SaaS Companies: Comparable Metrics

Company Name	Ticker	Sector	% Subscription/ % Perpetual	% Hosted/ % On-premise	Commissions Expense and Cash Flow Recognition	Average Contract Length (years)	Billing Cycle	Pricing	Architecture	Hosting Provided by	% Uptime, Excluding Maintenance Windows
Blackboard	BBBB	E-learning	100% subscription	13% hosted; 87% on-premise	Up-front expense and CF	1.0	Annually up front	Total enrollment: 70%; enrollment that use it: 30%	Dedicated	AboveNet, but self-managed	99.997%
Concur	CNQR	Expense & Travel	95% subscription; 5% perpetual	95% hosted; 5% on-premise	Pro rata expense over contract; up-front CF	3-4: enterprises; "evergreen": SMB	Monthly	By transaction with a minimum commitment	Multitenant	3rd-party vendors, but self-managed	99.995%
salesforce.com	CRM	CRM-SFA	100% subscription	100% hosted	Pro rata expense; quarterly CF	1.0: small firms; 2-4: rest	Quarterly: small firms; annually: rest	Per user	Multitenant/ Nodes	Self	99.9% trust.salesforce.com
Digital River	DRIV	Web Stores	Receives a % of product sales price up front	100% hosted	Pro rata expense and CF	1.0	NA	Client sets pricing	Multitenant	Self	NA
Kintera	KNTA	Nonprofit	Some of both	Some of both	NA	1-3	Quarterly and annually, mostly	Per transaction, record, and user	Multitenant	Self	99.99%
Kenexa	KNXA	Talent Mgmt	100% subscription	100% hosted	Pro rata expense; up-front CF	2.0	Quarterly: mostly; monthly: BrassRing	Total employees	Multitenant	Self, but moving to Quest and will manage self	99.97%
LivePerson	LPSN	Web Support	100% subscription	100% hosted	Pro rata monthly expenses and CF	1.0	Monthly	By seat plus overage	Multitenant	Verio, but exploring hosting self	99.92% last 3 years
Omniture	OMTR	Web Analytics	100% subscription	100% hosted	Up-front expense and CF	1.7	Monthly, quarterly, and annually	Per transaction	Multitenant	Equinix, Savvis, and Verio	99.99%
RightNow	RNOW	CRM-Service	86% subscription; 14% perpetual	90% hosted; 10% on-premise	Pro rata expense; up-front CF	2.0	Up-front: 75%-80%; monthly: 20%-25%	Per user: mostly; per bandwidth capacity: Web-self-service	Multitenant	AT&T, IBM, and Savvis, but self-managed	99.99%
Salary.com	SLRY	Talent Mgmt	100% subscription	100% hosted	Pro rata expense over the next 12 months; CF NA	2.0	Annual: 90%; Quarterly/Simi-Annual: 10%	Tiered by employee count	Multitenant	AT&T, but manages self	99%-plus
Smart Online	SOLN	E-business	86% subscription; 14% perpetual	100% hosted	Pro rata expense and CF over contract life	2.0 initially; 1.0 auto-renewal	Monthly	Per user	Multitenant	Hosted Solutions, Rackspace, and Data Return, but manages self	99.92%
Taleo	TLEO	Talent Mgmt	100% subscription	100% hosted	Pro rata expense over contract life; Pro rata CF over the next 12 months	3-4: enterprises; 1.0: SMB	Monthly: SMB; quarterly/annually: enterprises	Per user: SMB; "complex": enterprises	Multitenant	Internap Network Services and Equinix	99.9X%
DealerTrack	TRAK	Auto Dealer Technology Services	100% subscription	~100% hosted	Up-front expense and CF	~2.0	Monthly (trans: end of mo.; subs: beg. of mo.)	Per transaction and per location for subscriptions	Multitenant	Savvis Communications	NA
Ultimate Software	ULTI	Payroll	70% subscription; 30% perpetual	70% hosted; 30% on-premise	Pro rata expense; up-front CF	2.0: initially; 1.0: renewals	Quarterly	Per active employee	Multitenant	BellSouth and AT&T for facilities; access/bandwidth/ connectivity by IBM; rest by self	99.8%
Vocus	VOCS	Corp. Comm.	85% subscription; 15% transactions	100% hosted	Up-front expense and CF	1.0: 90%; 3.0: 10%	Annually: 98%	Per concurrent seat: 85%; per transaction: 15%	Multitenant	Quest, but fully manages self	99.998%
WebEx	WEBX	Web Meetings	100% subscription	100% hosted	Up-front expense and CF	1-2	Monthly	Per user	Multitenant	Self	99.999%
WebSideStory	WSSI	Web Analytics	94% subscription; 6% perpetual	94% hosted; 6% on-premise	Pro rata expense; 50% up-front CF & 50% over time CF	1.4	Monthly, quarterly, and annually	Event-based pricing (e.g., downloads)	Multitenant (SCS and HBX); Dedicated (VS)	Level 3 and Equinix	NA
Workstream	WSTM	Talent Mgmt	NA	NA	Up-front expense; pro rata CF as milestones are met	3.0: mostly; 4.0 and 7.0: some	Monthly, quarterly, and annually	Per employee	Multitenant: mostly; dedicated: some	BellCanada/ FusePoint, but manage self and own equipment	99.90%

Sources: Companies' management

Table 1 (cont.)
Public SaaS Companies: Comparable Metrics

Company Name	Ticker	TTM Recurring/ Subscription Revenue	TTM Perpetual/ License Revenue	TTM Services/ Other Revenue	TTM Total Revenue (Millions)	TTM YOY Rev. Growth	TTM GAAP Operating Margin	TTM Non-GAAP Operating Margin	Customer Retention Rate (TTM)	No. of Customers	Average Revenue per Customer	No. of Subscribers	Average Annual Subscription Rev. per Subscriber	TTM Price to Revenue Multiple	TTM Price to Free Cash Flow Multiple
Blackboard	BBBB	70%-75%	0%	25%-30%	$183.1	64%	-6%	8%	90%	3,462	$52,877	20,000,000	$7	5.4x	77.9x
Concur	CNQR	83%	1%	16%	$107.1	49%	8%	41%	98%: enterprises; 92%: SMB	4,000	$26,780	NA	NA	6.0x	120.7x
salesforce.com	CRM	81%	0%	9%	$497.1	60%	-1%	8%	~90%	29,800	$16,681	646,000	$623	10.0x	55.9x
Digital River	DRIV	NA	NA	100%	$307.6	40%	22%	30%	NA	50,000	$6,153	NA	NA	7.3x	22.2x
Kintera	KNTA	NA	NA	NA	$44.3	8%	-81%	-66%	NA	15,000	$2,951	NA	NA	1.4x	NM
Kenexa	KNXA	81%	0%	19%	$112.1	71%	17%	20%	90%+	2,600	$43,119	NA	NA	7.3x	56.8x
Liveperson	LPSN	95%	0%	5%	$29.5	32%	5%	14%	~100%	5,000	$5,898	NA	NA	10.4x	92.1x
Omniture	OMTR	93%	0%	7%	$79.8	86%	-10%	-4%	95%	2,000	$39,875	NA	NA	11.2x	NM
RightNow	RNOW	57%	21%	22%	$110.4	27%	-7%	-1%	90%	1,800	$61,328	NA	NA	5.0x	28.8x
Salary.com	SLRY	86%	0%	14% advertising	$19.2	59%	-20%	-12%	94%	1,800 enterprise; 3,400 SMB	$3,692	NA	NA	8.5x	149.1x
Smart Online	SOLN	59%	10%	24% services/other; 7% maintenance	$4.6	287%	-349%	-336%	NA	NA	NA	NA	NA	9.3x	NM
Taleo	TLEO	82%	0%	19%	$91.6	17%	-5%	-1%	90%+	850	$107,720	800,000	$93	4.6x	NM
DealerTrack	TRAK	31% subscription; 65% transaction	0%	4%	$173.3	44%	12%	25%	70%-90%, varies by product	>325 lenders; ~22,000 active dealers	$7,761	~10,600 dealers	$5,067	7.0x	34.9x
Ultimate Software	ULTI	56%	11%	34%	$114.8	30%	2%	8%	99%+: subs.; 97%: overall	>1,400	$82,007	500,000-600,000	$117	5.9x	74.1x
Vocus	VOCS	80% (subscription); 15% (transactions)	0%	5%	$40.3	44%	-3%	7%	85%+	1,727	$23,353	NA	NA	8.3x	34.7x
WebEx	WEBX	100%	0%	0%	$380.0	23%	21%	28%	99%	28,000	$13,572	2,200,000	$173	7.5x	34.0x
WebSideStory	WSSI	86%	6%	8%	$57.9	47%	-12%	11%	90%+	1,540	$37,586	NA	NA	4.5x	36.9x
Workstream	WSTM	NA	NA	NA	$29.5	10%	-35%	-35%	~90%	250 software customers	$65,556	NA	NA	2.2x	NM
Group median					**$99.3**	**43.93%**	**-4%**	**8%**			**$26,780**		**$145**	**7.2x**	**55.9x**
Group average					**$132.3**	**55.42%**	**-25%**	**-14%**			**$35,112**		**$1,013**	**6.8x**	**62.9x**

Sources: Companies' management

Table 1 (cont.)
Public SaaS Companies: Comparable Metrics

Company Name	Ticker	Customizability	Average Implementation Time	Forced Upgrades?	Upgrades Cost Extra?
Blackboard	BBBB	Limited/ configurable; open architecture, but not open source	Same day: stand-alone; 1-2 months: back-office integration	No, but only support so far back	Yes
Concur	CNQR	Limited/ configurable	3-9 months	Yes/No—enhanced features are forced without losing customization; new services are optional	No
salesforce.com	CRM	Extensive	Immediately: stand-alone; varies: back-office integration	Yes, customization not lost, changes are optional	No
Digital River	DRIV	Limited/ configurable	Days or weeks depending on complexity	Yes	No
Kintera	KNTA	Extensive	Varies depending on project scope	Automatically available	Free update, but new features may cost extra
Kenexa	KNXA	Limited/ configurable	6-8 weeks	No (mostly), but yes for BrassRing	No
LivePerson	LPSN	Limited/ configurable	A few hours: small; 14-21 days: medium; ~60 days: enterprises	No	No
Omniture	OMTR		One week to months depending on size and complexity	No	No
RightNow	RNOW	Extensive	50 days	No, but only support one version back	No
Salary.com	SLRY	Extensive	30 days	Yes	No
Smart Online	SOLN	Limited/ configurable	160 work hours	Enhancements are not forced; security and regulations are	No
Taleo	TLEO	Limited/ configurable	Less than 1 week: SMB; 8 weeks: enterprises	Yes, automatically for SMB, gradually for enterprises	No
DealerTrack	TRAK	Limited/ configurable	Days to weeks, varies by product (including training)	Yes	Yes, only upon renewal
Ultimate Software	ULTI	Highly configurable	60-69 work days; 6 months: calendar days	Yes	No
Vocus	VOCS	Limited/ configurable	3-5 days: medium firms; 1-2 weeks: enterprises	Yes	No
WebEx	WEBX	Extensive	Days	Yes	No
WebSideStory	WSSI	Some are extensive and some are limited/configurable	Within one month	Yes (HBX); Optional (VS)	No, but perpetual license clients must be current with maintenance
Workstream	WSTM	Limited/ configurable	2-6 months	No, but only support back so far	Only for really old versions

Sources: Companies' management

SaaS Platforms

In addition to providing hosted applications, several of the SaaS companies have expanded their offerings in such a way as to create application development platforms that third parties can use to build and run their own software. These platforms we believe allow SaaS companies to sell more seats and create or expand a vendor's ecosystem of partners and resellers. EBay has proved the importance and power of a Web ecosystem, and Apple has done the same in the consumer electronics space with the iPod, which is now supported and made more valuable by the plethora of accessories specifically designed for it.

The following are three examples of companies trying to leverage the power of these application development platforms:

- Approximately one year ago, salesforce.com announced AppExchange, the culmination of a strategic vision—salesforce.com becoming the "iTunes" of application code—that has been in the works for several years. The goal is to create a central marketplace for software where customers use salesforce.com's services to build applications while others turn to the AppExchange to find/use the software they need. The exchange also provides a context or platform for various SaaS solutions to interconnect. Today, the AppExchange directory contains more than 500 applications and brings salesforce.com into markets it likely could not have reached solely with its own resources.

- Hosted suite vendor NetSuite's SuiteFlex initiative is aimed at delivering a new generation of vertical applications. SuiteFlex is built on the company's on-demand programming language, SuiteScript. The language allows for the creation of complex programmatic applications hosted in a SaaS application. Both platforms (NetSuite's and salesforce.com's) allow applications to be customized and new ones to be built.

- Another vendor looking to participate in the platform space is WebEx with its Connect service. Connect allows third-party-application vendors (ISVs) to run their applications over WebEx's proprietary network. There is a long list of ISVs wanting to take advantage of this offering, we believe. Connect also allows companies to create tight integration between multiple applications and gives on-demand applications access to the more than 2 million WebEx users.

We believe the emergence of the platform is an important development and those vendors that are able to attract significant third-party participation—and, by definition, collaboration and contribution—in these application environments stand to benefit significantly. These benefits will be both direct in terms of additional customers and revenue opportunities, but also indirect. The availability of additional applications not developed by the platform "sponsor" but nevertheless integrated with and complementary to the sponsor's SaaS solution will we believe enhance the value of that solution and indirectly result in greater sales, higher renewal rates, and potentially higher pricing. For example, salesforce.com recently added a financial bundle that included third-party applications and costs $500 per user per month, which represents a significant potential increase in revenue opportunity.

Market Consolidation and the Movement to Suites

Another trend that gained momentum in 2006 was the movement to offer complete solution suites, and industry consolidation to achieve this capability.

Suite building and attendant consolidation were particularly heavy in the human capital management space:

- Kenexa acquired to broaden the company's offerings, announcing the acquisition of BrassRing.

- Kronos, the leader in employee timekeeping, acquired Unicru to add the recruiting and management of hourly employees to its list of services.

- ADP, the largest of the payroll processors, made two acquisitions: VirtualEdge (an on-demand provider of enterprise talent management solutions covering everything from hiring to firing) and Employease (on-demand outsourcer of employee benefits).

Why are some of the SaaS spaces consolidating? We believe that it is a natural progression of markets to consolidate. In technology, when a new space emerges—such as talent management—the scope of the functionality associated with the need is often only vaguely defined. As many separate efforts occur to serve the needs of customers, the scope and structure of the applications and their functionality progressively become clearer. In the meantime, each software effort has gone a slightly different way, creating new solutions, new functionality, and new approaches to the same problems. As these early efforts mature, the relationship and points of commonality between these separate efforts become more apparent, and the overall "suite" of functionality that is needed for, as an example, talent management, becomes more evident—and the process to form complete suites begins. Customer preference also drives the movement to suites, we believe. Most companies would prefer to deal with fewer vendors to reduce complexity, and also because they believe they can extract a more attractive price for the overall solution than by having to source it from separate vendors. We believe customers also place significant value on not having to integrate the various solutions of several vendors themselves, and typically assume that a suite vendor has already addressed and solved any integration needs between the various pieces of functionality.

The scope of relatively mature software suites such as enterprise resource planning (ERP) we believe was defined in this way: The advent of ERP suites proved that companies wanted to buy accounting, supply chain, and human resource transactional back-end software as a suite. As another example, at one point users bought spreadsheets, word processors, and e-mail solutions separately; today they are purchased as a suite in both the corporate and the consumer markets.

The process of building the suite of solutions is complex, however, and in fast-evolving markets speed may be of the essence to maintain competitiveness. Acquisitions allow vendors to broaden their offerings quickly, although long-term problems of integration and platform commonality may be created. We expect further consolidation in both the human resource management systems space and for other SaaS markets to follow a similar pattern.

The Impact of Outages

Early last year, salesforce.com experienced a small number of outages, which received a great deal of attention and were the source of new concern regarding SaaS business models.

To understand the impact on the company and the broader SaaS space, we formally surveyed 100 salesforce.com users on what happened, the impact on their businesses, and if they would continue to use the system. Only two of the 100 clients we contacted said that they might stop using the service. Overwhelmingly, user organizations seemed to understand that IT systems have downtime and that SaaS solutions would not be immune. The outages caused material problems at a few of the companies we surveyed, but even they seemed to be willing to see if things improved, and they did. A key factor in our opinion is that salesforce.com communicated proactively with customers that there was a problem and what the company was doing to address it.

As for the broader market impact, salesforce.com's issues seem to have had little or no impact on momentum in the space. We believe that if the problems had continued, it might have stalled the market. But, at this point in time, we believe that SaaS market acceptance is broad enough and carries enough momentum that an outage at a single vendor would not materially affect adoption.

Architecture

SaaS vendors have taken different architectural approaches, which can affect performance and reliability:

- Some have a true multitenant model, running most customers' applications effectively on a single system, database, and hardware platform.

- Others have broken the user base into smaller groups (pods) that share a single server and IT infrastructure. While this latter model is more expensive, as it does not take advantage of scale economies to the same extent, it can lead to higher availability and performance.

- SAP offers "isolated tenancy" where customers effectively have their own hardware and software stack. The profit margins for a company running a hosted software model through isolated tenancy will be not nearly as high as if it were running customers on a shared infrastructure, we believe.

A true multitenant system spreads the cost of computing over a large group of users so that each bears a smaller portion of the overall cost. Thus, there is a trade-off between cost savings for clients and potential performance issues. We believe that the pod approach will ultimately prove necessary and desirable for most SaaS companies. Even salesforce.com, a staunch proponent of scaled multitenancy, has moved to this model using more and smaller servers, and groups of users.

Who Should Host?

Another debate in the vendor community is who should provide the hosting. All else equal, we believe companies that are involved in the running of their own products carry lower risk and greater opportunity, and therefore are preferable from an investment perspective.

One benefit of the SaaS vendor's running the software is that it learns a lot about its products and can therefore more readily adapt and evolve them. Also, if a third party is doing the hosting, the speed of getting customers up and running can at least partly depend on the hosting company and its book of business and conversion backlog, not the SaaS company.

For smaller start-up companies, however, outsourcing the running of the software can make sense. One benefit of using a third party (like IBM) is that it can lend instant credibility and lower the perceived risk, especially when the SaaS vendor is small.

Hosting vendors provide other benefits (for example, best practices and expertise learned by working with a host of customers). Hosting vendors also generally have multiple sites that can provide redundancy, failover, and disaster-recovery capabilities that would be expensive and difficult for SaaS vendors (especially at the outset) to provide and maintain. A cottage industry has been forming around providing hosting services for SaaS companies—in many cases these companies represent the resurrection of ASP companies, such as USi. IBM in particular has built an attractive business by hosting for the SaaS community. Pure-play vendors like Opsource and NaviSite have also benefited.

We believe that the customer in the end will not care too much as long as the service works and has a high level of uptime. That said, we believe that a SaaS vendor should be intricately involved in the running of its software services. We expect that as small SaaS companies grow, they may choose to take more control over their own destiny and become more involved in the hosting process if not fully take it over themselves.

We believe that SAP's and Microsoft's initial decision to have third parties host their software was a mistake. It requires additional work on the part of the customer to choose a hosting provider, and both SAP and Microsoft are large enough and trustworthy enough that customers would not require or want a third party to host if the vendor made hosting available. Both companies appear to have decided to run the service internally in the next iteration of their products.

Customization

The first on-demand companies offered relatively little ability to modify the application. But, as the model has evolved, we have seen companies providing platforms that allow more customization, such as salesforce's Apex, NetSuite's SuiteScript, and Connect from WebEx, as discussed above. With these platforms, there will be more work for third-party integrators—which have on the margin been hurt by the movement to SaaS—since the platforms allow for a new layer of integration and customization services.

Also, as previously discussed, we have found that large companies make more-extensive changes and create more integration with existing applications than do small ones.

The overarching consideration is that certain applications require less customization and can be used with little modification. A large number of SaaS applications do not need significant customization—salesforce automation, most HR management applications, and many payment applications are examples.

While on-demand software companies are facilitating more customization, the industry as a whole continues to move away from heavy customization. In the late 1990s, companies purchasing software hired third-party consulting firms such as Andersen Consulting (now Accenture) to implement and customize the software to fit their businesses, frequently spending 4 to 5 times the initial cost of the software to customize it. The heavily customized code has proved too costly and difficult to maintain. As a result, with the current generation of applications, hosted and on-premise, companies are customizing less and the software is designed to *need* less customization but be able to support the customer's specific requirements through configuration instead.

Usability

One major difference between SaaS applications and traditional software solutions, especially those targeted at the enterprise and the middle market, is the much greater focus from the SaaS companies on ease-of-use.

Traditional enterprise software was frequently used by only a few people, typically subject-matter experts such as accounting or production staff who had received extensive training in using the software (and likely had been involved in designing or at least rolling out the system). In contrast, newer SaaS applications are touched by a much broader audience and often *support* a user's main activity rather than being the essential tool of an individual's job. With respect to the user interface, faced with a nonexpert user community, SaaS companies have leveraged the look and feel of the Internet, which is instantly familiar to a large base of users.

This focus on ease-of-use is in contrast to that of traditional software vendors, which have been developing applications for specialized, highly trained users for decades. These vendors still are focused on further enhancements to functionality and not to the same extent on user needs and usability. This development paradigm is a hard habit to break and represents an important competitive obstacle for traditional software vendors, in our opinion.

Economics of SaaS Companies

The Move From Perpetuals

Over the last year we have observed a further movement from perpetual licenses to subscriptions. One of the most visible examples of this trend is the change in RightNow's license mix. During 2006, the perpetual content of the business fell precipitously from 21% of bookings to 15% as customers became more comfortable with buying software as a service. Ultimate Software's subscriptions have increased from 60% of sales in fourth quarter 2004 to 72% in 2005 and 80% in 2006. Kenexa has also experienced a move away from perpetuals.

To some extent, companies get used to buying in a certain way and it takes time for SaaS vendors to shift customers to a new way of doing things. Given that the SaaS space is now approximately six years old, it appears that shift is occurring and many companies are now becoming accustomed to buying on a subscription basis.

Technology goes through cycles, swinging from one end of the spectrum to the other (outsourcing then deciding to in-source and then once again to outsource). This truism in technology makes us wonder if someday the market might move in the other direction. Could customers over time become frustrated with paying for the same service over and over again and decide to own it outright instead of leasing?

We believe the SaaS pendulum will not swing back for several reasons. Maybe most important is that with the SaaS model the customer not only leases the software, but also has the vendor run the software—so it is truly an outsourced service, not simply a way of purchasing software. Our expectation is that having the vendor run the software makes it less likely that the contract mechanism will revert back to perpetual licenses since the customer is getting much more than the use of the software and would have to make a significant investment to bring the IT infrastructure as well as the process back in-house.

Incremental Buying

A constant among SaaS companies across horizontal and vertical markets is that customers buy incrementally instead of purchasing all the subscribers they need up front. One of the benefits of the SaaS model is that you can pay as you go for what you need and there is less incentive to buy everything at once. This is particularly attractive to small companies that in most cases can pay for only a limited number of users until the solution proves itself valuable to the overall organization or the organization grows.

This approach also significantly lowers the risk of software implementations (making it appeal to a broader audience), as the application can be rolled out to small groups of users at low initial cost and with lower implementation effort and disruption. In contrast, traditional software implementations do not naturally lend themselves to a "partial purchase" or a partial implementation.

Where it is possible to do so, most of the SaaS deals we have watched start with a small number of users and grow as users and departments are added. For example, almost all of salesforce.com's large deals started out quite small, with 50 seats in time becoming several thousand. Very few are similar to its deal with Dell, which was announced with 15,000 seats.

As a result, many of the companies in our SaaS coverage have very high up-sell rates—the equivalent of "same-store sales." For example, the amount that Vocus customers pay typically grows 20% to 26% each year, comprising a 5%-6% annual price increase and new sales of 15%-20% (modules and users).

This buying pattern is not universal. For example, in applications such as payroll (e.g., Ultimate Software) or payments (e.g., CyberSource), a complete switchover to the new system is still required for all functionality and for all potential users. Nevertheless, these companies also benefit from growth in the existing customer base as additional employees are hired and additional transactions processed.

Renewal Rates

Renewal rates seemed to trend higher in 2006. We see more companies with renewal rates above 90%, up from an average of closer to 85% a few years ago.

We believe several factors have contributed to the increase:

- ***Customer size.*** Larger customers are now a greater percentage of the revenue mix of many SaaS players (salesforce.com, RightNow, Postini, and Ultimate Software, to name a few). Large customers tend to have high renewal rates for two reasons. First, because of the scope of the implementation and the number of users involved, switching costs are higher (though still significantly lower than for a traditional software implementation). Second, knowing that switching costs are higher and they therefore are less likely to want to make a change, large customers often trade longer contract term for lower price, and this mathematically leads to higher renewal rates as measured by number of customers. In addition, large companies tend to integrate the service into their existing infrastructure—and in some cases customize the service—and this investment makes the service "stickier."

- ***Age of customer base.*** Another factor is time as a customer: the longer a company has subscribed to an on-demand service, the more likely it is to renew, we find. Many of the SaaS companies we cover see the highest churn in first-year customers, and churn thereafter drops significantly. As a result, as a larger portion of the customer base is from existing clients (rather than new ones), the renewal rates improve.

- ***Comfort with SaaS as a delivery model.*** We also believe that increased comfort with the model has improved renewal rates. The SaaS model is no longer a novelty that is being tried out by users; instead, for many companies it has become an accepted way of doing business.

While the aforementioned factors have increased industry renewal rates, company-specific rates will depend first and foremost on the value of the functionality provided, in our opinion. If the service has a high level of utility, customers are likely to continue using it. Another key that will vary between vendors is customer care—if a vendor supports its subscribers well, they are much more likely to renew.

One factor that has proved somewhat less important than we had thought is product differentiation. Yes, the more differentiated the product, and the fewer competitive alternatives, the higher the renewal rate is likely to be. But, in general, customers appear to prefer to stay with a vendor if it is suiting its needs and if support is good. It seems that switching vendors is still a painful process. Why switch just for price when something is working well?

Approaches to Billing

The SaaS market is beginning to see more companies with transaction-based business models in addition to, in combination with, or instead of long-term subscriptions. Concur, the leader in SaaS for expense management, has long-term contacts based on a minimum level of expected expense statements. Similarly, HireRight, in the pre-employment screening space, charges by employees screened.

In these cases, billing generally needs to be periodic—typically monthly—rather than for the whole contract life. Although we have seen some instances of up-front billing based on projected levels of activity with "truing up" of fees based on actual activity, we expect this approach to remain relatively rare. One note on activity-based billing is that it can introduce some volatility, particularly due to seasonality of activity in the end-market. Two examples of this are CyberSource (fourth-quarter holiday-related retail e-commerce sales generate stronger volume) and DealerTrack (car sales are typically highest in the third quarter).

There is also variety on payment/billing terms among companies that focus on subscriptions. Although many SaaS vendors have long-term contracts, billing is often on a monthly or quarterly basis.

What is interesting is that billing cycles tend to vary by industry. In the human capital management space, Kenexa has been trying to bill for longer periods, but the competition keeps management from being able to implement a change. Longer bill periods are, in our opinion, preferable from an investor's perspective—a vendor, if it can, should get the cash up front, leading to better cash-flow metrics and visibility. Turning to the expense management area, Concur expects bill periods to lengthen. Historically, its customers have preferred monthly billing, but over the last year it has tested less frequent billing and has seen some success. Concur's management believes that there are economic benefits for both the vendor and the customer to move to less frequent cycles. Further, it believes that large companies will move in this direction for economic reasons (it is less expensive and easier to pay less frequently).

Another trend that we continue to observe is lengthening contract durations. Our sense is that when existing customers become comfortable with a service, they are willing to sign longer-term contracts to receive a discount on the out-years, instead of re-signing each year. We have also noticed that once a vendor becomes more established, contract terms lengthen—consistent with the view that companies are unwilling to make a long-term commitment to vendors whose viability may not be assured or whose quality of service is unknown. When salesforce.com first started to sell its service, customers wanted monthly subscriptions, but once salesforce.com became a factor in the market, it was able to move its growing base to longer contracts.

We expect a continued proliferation of pricing methods as more SaaS companies come to market.

Expense Recognition

The biggest change in expense recognition in 2006 (and early 2007) was at RightNow. The company shifted from using term licenses to subscriptions. The change allows RightNow to defer recognition of sales commissions to match revenue recognition instead of recognizing commissions in quarter. RightNow, in our estimation, had the most volatile earnings given that it paid sales commissions up front and recognized the expenses in the quarter incurred and at the same time had perpetual licenses and subscriptions, which also caused variability in revenue and earnings.

Expense recognition still varies across the SaaS space. Some recognize sales commissions at the time of the sale and other organizations defer expense recognition to match revenue recognition over the life of the contract. Vocus conservatively expenses commissions in the quarter that they are incurred; salesforce.com and RightNow defer them to match revenue.

SaaS and the Public Markets

Current Leaders

As noted in the opening of this report, the technology team at William Blair & Company has been covering the SaaS space since its emergence in 2000. We believe our coverage includes the significant majority of successful SaaS companies. Recently, ASPnews.com, an online source of news and analysis focused on the application service provider (ASP) and SaaS industry, updated its list of Top 25 providers, shown in table 2. ASPnews.com has been following the space since 1998.

While we believe there are some significant omissions from this list—including, Ambiron, Constant Contact, ExactTarget, Intralinks, Perimeter Internetworking, Postini, Previsor, Salary.com, Silkroad, SuccessFactors, TrustWave, and Workscape—as well as some questionable inclusions, we nevertheless believe this list is interesting for various reasons:

- The list confirms our contention that it is still very early in the evolution of SaaS-based companies. Thirteen of the companies listed were private at the time of writing this report.

- The list is dominated by human resources and customer relationship management/salesforce management solutions. As previously noted, this is clearly the space where SaaS has to date seen the most success and uptake, but we believe the list of providers is likely to become much more diversified by end-market.

- Three of the listed companies are application outsourcing vendors, or hosting companies. While this in our opinion reflects the roots of ASPnews, it also illustrates that the growth of SaaS models is creating an attractive opportunity—and a second life in some cases—for these established application service provider business.

- Last, the William Blair & Company research team covers all but three of the public companies.

We expect this list, and others like it, to show significant change over the next few years, but we also see some constants. We believe established leaders such as salesforce.com, Vocus, Ultimate Software, and WebEx will continue to set the pace of development and innovation in the industry, and for these and many of the other companies we cover to retain their leadership positions.

Table 2
ASPnews.com's Top 25 SaaS Providers

Company	Ticker	Market Cap. (millions)	Public	Private	William Blair Coverage	Primary Business Model	Application Outsourcer	Software-as-a-Service Provider	Application Software Vendor	Business Service Provider	Service-Oriented Architecture	Location	Notes
Aspective				✓	-	Application Outsourcer	✓					Staines, England	
Clickability				✓	-	Software-as-a-Service Provider		✓				San Francisco, Calif.	
Concur Technologies	CNQR	$ 643.00	✓		✓	Software-as-a-Service Provider		✓	✓			Redmond, Wash.	Recently acquired Outtask
CrownPeak				✓	-	Software-as-a-Service Provider		✓				Los Angeles, Calif.	
EmailLabs				✓	-	Software-as-a-Service Provider				✓		Redwood City, Calif.	
Employease				✓	-	Software-as-a-Service Provider		✓		✓		Atlanta, Ga.	Recently acquired by ADP
Everest Software				✓	-	Application Software Vendor		✓	✓			Dulles, Va.	
ExactTarget				✓	-	Application Software Vendor		✓	✓			Indianapolis, IN	
Intacct				✓	-	Software-as-a-Service Provider		✓				Los Gatos, Calif.	
Kintera	KNTA	$ 62.00	✓		see notes	Software-as-a-Service Provider		✓				San Diego, Calif.	Covered by William Blair until February 2006
LivePerson	LPSN	$ 306.00	✓		x	Software-as-a-Service Provider		✓				New York, N.Y.	Not covered by William Blair
NetSuite				✓	-	Software-as-a-Service Provider		✓				San Mateo, Calif.	
Omniture	OMTR	$ 891.00	✓		x	Software-as-a-Service Provider		✓				Orem, Utah	Not covered by William Blair
OpenAir				✓	-	Software-as-a-Service Provider		✓				Boston, Mass.	
QuickArrow				✓	-	Application Software Vendor		✓	✓			Austin, Texas	
RightNow	RNOW	$ 555.00	✓		✓	Software-as-a-Service Provider		✓	✓			Bozeman, Mont.	Recently acquired Salesnet
Sage Software				✓	-	Software-as-a-Service Provider		✓	✓			St. Petersburg, Fl.	
Salesforce.com	CRM	$ 4,979.00	✓		✓	Software-as-a-Service Provider		✓				San Francisco, Calif.	
SOA Software				✓	-	Service-oriented Architecture					✓	Los Angeles, Calif.	Recently acquired Blue Titan
Ultimate Software	ULTI	$ 672.00	✓		✓	Software-as-a-Service Provider	✓	✓				Weston, Fla.	
USi					-	Application Outsourcer	✓					Annapolis, Md.	Acquired by AT&T in October 2006
Web.com	WWWW	$ 70.00	✓		x	Software-as-a-Service Provider	✓	✓				Atlanta, Ga.	Not covered by William Blair; Formerly Interland; Recently acquired WebSource Media
WebEx	WEBX	$ 2,850.00	✓		✓	Software-as-a-Service Provider		✓				San Jose, Calif.	Recently acquired Intranets.com
WebSideStory	WSSI	$ 262.00	✓		✓	Software-as-a-Service Provider		✓				San Diego, Calif	Recently acquired Atomz

Source: ASPnews.com

Laura Lederman 312.364.8223

The Coming Flood

One way of looking at the success of SaaS companies in the public market to date is to look at the number and combined market capitalization of the companies we believe qualify as "SaaS companies." Table 3 shows the growth in the number of companies, from six in 2000 to 20 at the time of writing this report.

Equally impressive is the change in market capitalization: from approximately $1 billion in 2000 (of which WebEx represented 75%) to approximately $18 billion today (and with greater diversification). This change represents a CAGR of more than 60%. While this growth has not always been smooth (2002 for example), it has become more so as the list has become more diversified and the companies have proved out their business models.

The composition, and the totals, of this list are likely to undergo significant change. We believe that 2007 is likely to see more initial public offerings from companies positioned as SaaS vendors than the past five years combined.

Most of the SaaS companies that we believe are planning to go public have between $20 million and $80 million in revenue, and in our experience range widely in profitability: some are profitable, others close to breakeven, and others are a long way from profitability on a GAAP basis.

One of the issues with SaaS companies is that they can look expensive on a price-to-earnings ratio. This is primarily because while in some cases companies bill up front for their services, the revenue recognition is "spread" over many periods. However, the organization needs to be scaled to support all customers, and in some cases expenses such as sales commissions are expensed up front. This poses a challenge for comparison of companies and for valuation, and we suggest that investors look at cash earnings per share and other metrics in addition to the reported GAAP numbers.

In previous reports, and again earlier in this update, we have expressed the concern that some companies may be brought to market using a SaaS tag to obtain a good reception and attractive valuation, and that some of these companies may not in fact represent attractive investments. However, our experience to date is that most of the SaaS companies that we have spent time with are of high quality and will merit investors' attention if and when they reach the public markets. We continue to be concerned that quality may lessen in the next few years.

Table 3

SaaS Market Capitalization

($ Millions)

SaaS Companies	Tickers	2000	2001	2002	2003	2004	2005	2006	3/26/2007
Blackboard	BBBB	NA	NA	NA	NA	NA	787	843	997
Concur	CNQR	28	48	84	314	296	430	581	643
salesforce.com	CRM	NA	NA	NA	NA	1,747	3,471	4,137	4,979
Digital River	DRIV	54	407	325	690	1,373	1,047	2,242	2,256
NIC	EGOV	85	179	82	469	301	372	306	334
Kintera	KNTA	NA	NA	NA	283	258	108	45	62
Kenexa	KNXA	NA	NA	NA	NA	NA	368	686	820
LivePerson	LPSN	36	11	32	178	118	211	217	306
Omniture	OMTR	NA	NA	NA	NA	NA	NA	NA	891
Phase Forward	PFWD	NA	NA	NA	NA	264	326	528	457
RightNow	RNOW	NA	NA	NA	NA	468	586	562	555
Salary.com	SLRY	NA	NA	NA	NA	NA	NA	NA	164
Smart Online	SOLN.U	NA	NA	NA	NA	NA	140	37	43
Taleo	TLEO	NA	NA	NA	NA	NA	290	298	422
DealerTrack	TRAK	NA	NA	NA	NA	NA	710	1,152	1,219
Ultimate Software	ULTI	38	62	57	180	284	446	560	672
Vocus	VOCS	NA	NA	NA	NA	NA	154	267	334
WebEx	WEBX	754	977	611	861	1,063	1,002	1,707	2,850
WebSideStory	WSSI	NA	NA	NA	NA	194	283	251	262
Workstream	WSTM	NA	79	29	39	140	81	58	64
Web.com	WWWW	NA	NA	NA	NA	NA	NA	NA	70
Total Market Capitalization		**995**	**1,762**	**1,220**	**3,014**	**6,506**	**10,810**	**14,478**	**18,400**
Market Capitalization Growth			*77%*	*-31%*	*147%*	*116%*	*66%*	*34%*	*27%*
Number of Public Companies		6	7	7	8	12	18	18	20

Sources: Reuters and Thomson

Jumping on the Bandwagon

We spend quite a bit of time visiting private companies in the software space and have noticed that the vast majority of software companies have adopted the SaaS model. Some of the companies built their offerings to follow the SaaS model from inception, and others are trying to shift business models to subscriptions and hosting.

In general, those that have shifted, or still are in the process of shifting, in our opinion imply greater risk than those that have made the transition. There are three key considerations:

- First, companies that have not from the get-go designed and built their product to be offered in a SaaS model face a complex—one might argue near-insurmountable—challenge in adapting their solution. The different approaches and mindsets required for developing traditional software and SaaS solutions mean that while a traditional software product can be "made to work" under SaaS principles, we believe that as the customer base builds in scale, new functionality is developed, and performance demands increase, eventually the limitations of a solution not designed for SaaS will become apparent.

- Second, the transition is difficult and confusing, both internally to the organization and for its target customers. Salespeople used to targeting capital budgets and overcoming objections to large up-front payment, but who also receive large commission based on large software license fees, in our experience find it hard to make the switch to leading with a SaaS offering. This is even harder if the company continues to support both software license fee sales and SaaS implementations. Ultimate Software, for example, has found that it needs to make SaaS sales *significantly* more attractive to the salesperson (from a commission perspective) to drive SaaS sales.

- Third, as we have seen in covering Mercury Interactive and RightNow, mixed business models are more difficult to forecast. It is often challenging to project what the mix will look like in any given quarter, leading to variability in revenue and earnings and offsetting some of the operational and financial-market advantages of the SaaS model.

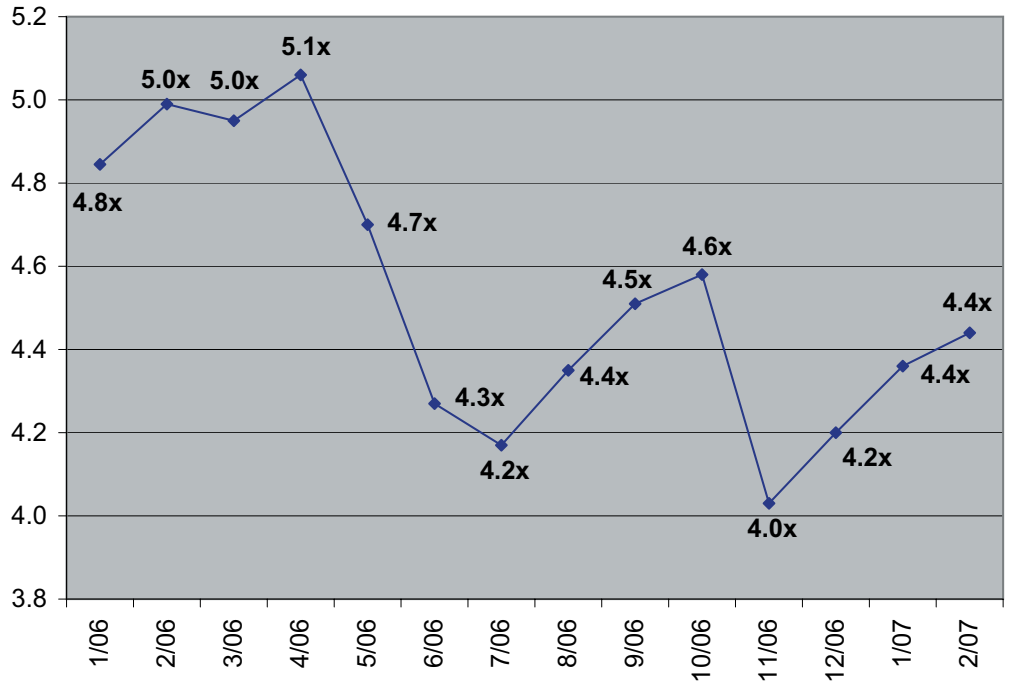
While we prefer the SaaS model over traditional software companies, this approach to building and selling software may also be becoming overemphasized, and the lumping together of highly diverse companies operating SaaS business into a single category overlooks the important difference of end-market and company quality of each. The venture community has been flocking to invest in SaaS companies for a number of years, and we worry that some subsegments may become overcapitalized and too many SaaS companies might come to the public market relying only on the SaaS tag for public-market access and attractive valuation.

SaaS Valuations

Valuations of SaaS companies have been volatile, as shown in figures 4 and 5, and the stocks have traded as a group despite the differences between the various companies. The group has a high beta, leading to material swings (up and down) when the overall market moves.

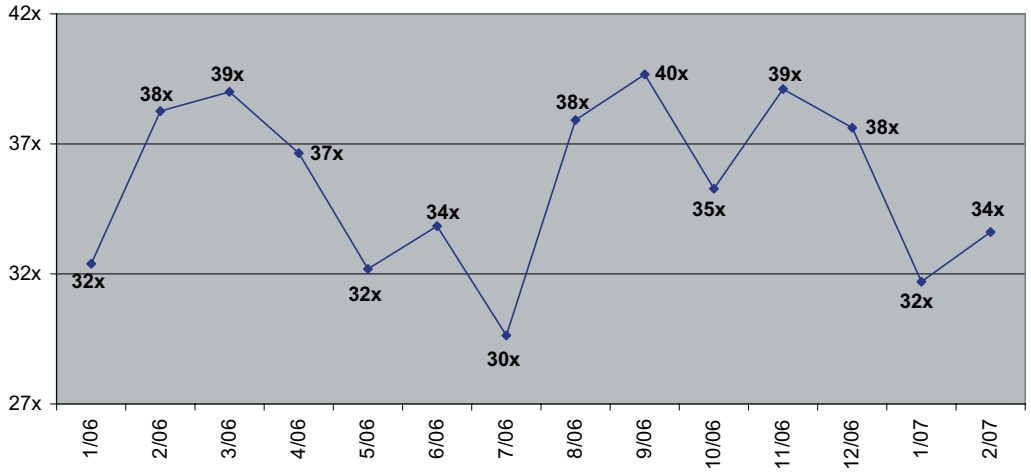
Last summer was particularly difficult for the SaaS group. Technology tends to be weak May through August based on industry sales seasonality (which does not necessarily apply to the SaaS group); but when valuations compress, SaaS as a group is likely to compress more given their relatively high betas and valuations. Last summer SaaS also suffered from the problems at salesforce.com when investor confidence was shaken by the outages earlier in the year and the slowdown in the addition of subscribers. Given that the SaaS names traded largely as a group, almost all SaaS companies saw a material decline in value.

Figure 4
Historical SaaS Price to Forward Revenue



Source: FactSet data for the median price to forward revenue for BBBB, CNQR, CRM, DRIV, KNTA, KNXA, LPSN, RNOW, TLEO, TRAK, ULTI, VOCS, WEBX, WSSI, and WSTM

Figure 5
Historical Price to Forward Earnings

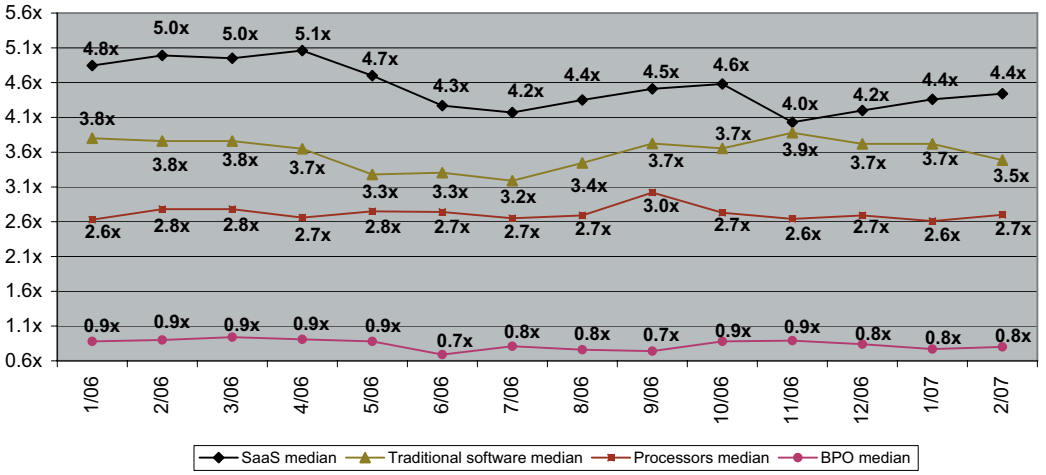


Source: FactSet data for the median price to forward earnings for BBBB, CNQR, CRM, EGOV, IPAS, KNXA, LPSN, RNOW, TLEO, TRAK, ULTI, VOCS, WEBX, and WSSI

The SaaS space sells at a premium to traditional software as a result of the revenue and earnings visibility that these companies afford and their faster growth. Even taking out the relatively higher valuation of one or two stocks, SaaS companies still sell at a premium.

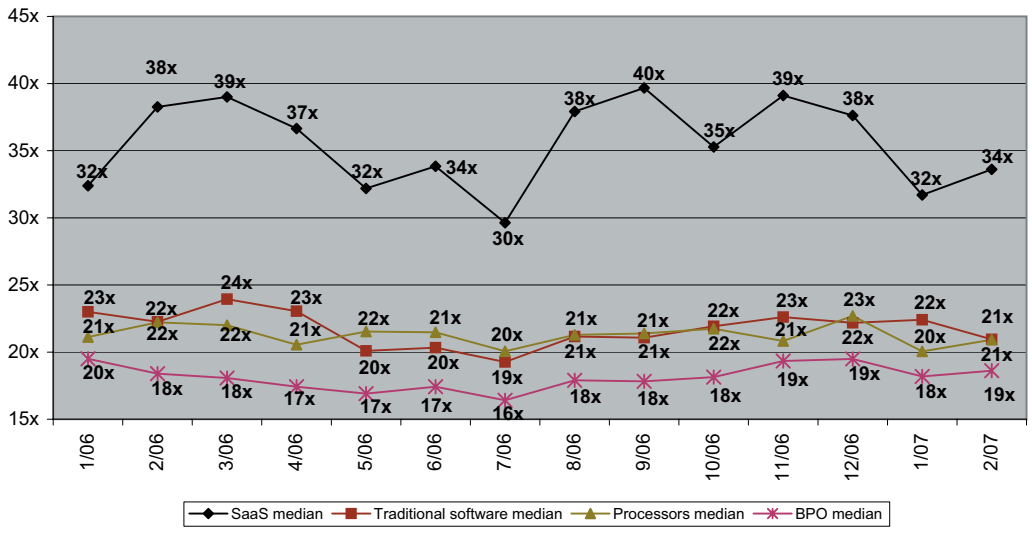
But as mentioned earlier, we expect a large number of SaaS companies to come to the public market. With more SaaS names covering disparate areas, in time investors are more likely to look at the names not as a single group, but in discrete categories (talent management, retail, CRM, etc.). Also, with time companies are likely to develop independent identities and valuations reflecting specific growth rates, renewal rates, margins, and total available market. We are starting to see this, with Vocus shares selling at a premium given the company's consistency and RightNow's valuation last year having been hurt by the difficulty in forecasting that firm's results due to its mixed business model.

Figure 6
Comparative Forward Price to Revenue



Source: * SaaS median includes FactSet data for BBBB, CNQR, CRM, DRIV, KNTA, KNXA, LPSN, RNOW, TLEO, TRAK, ULTI, VOCS, WEBX, WSSI, and WSTM
* Traditional software median includes FactSet data for ADBE, BEAS, BMC, COGN, CA, INTU, MSFT, ORCL, QSFT, SYMC, TIBX, and VSRN
* Processors median includes FactSet data for FDC, TSS, FISV, ADP, CEN, PAYX, and GPN
* BPO median includes FactSet data for ACN, ACS, CACI, HEW, EDS, CSC, CVG, and DRCO

Figure 7
Comparative Forward Price to Earnings



Source: * SaaS median includes FactSet data for BBBB, CNQR, CRM, EGOV, IPAS, KNXA, LPSN, RNOW, TLEO, TRAK, ULTI, VOCS, WEBX, and WSSI
* Traditional software median includes FactSet data for ADBE, BEAS, BMC, COGN, CA, INTU, MSFT, ORCL, QSFT, SYMC, TIBX, and VSRN
* Processors median includes FactSet data for FDC, TSS, FISV, ADP, CEN, PAYX, and GPN
* BPO median includes FactSet data for ACN, ACS, CACI, HEW, EDS, CSC, CVG, and DRCO

Changing Valuation Metrics

Twenty years ago when we first started covering software companies at William Blair, the standard methods to value companies were discounted cash flow, and comparative analysis using price-to-earnings ratios and multiples of revenue .

The emergence of the SaaS model has necessitated some changes in how we look at valuation. Because many companies defer revenue but recognize expenses as incurred, enterprise value or market value to free cash flow is a metric that many investors use.

We have also begun to adjust enterprise value to free cash flow metrics to reflect varying billing cycles. Some vendors have long contract lengths, but bill customers only on a monthly or quarterly basis, which leads to less cash being taken in up front and a higher enterprise-value-to-free-cash-flow metric.

Transaction processing companies, whose business models have many of the same characteristics although growth is likely to be lower, have historically been valued on price-to-earnings and P/E-to-growth, and we believe the latter remains an appropriate metric.

We believe that having SaaS companies valued as a single group leads to higher valuations for some SaaS companies that probably do not deserve a premium valuation and thus implies more risk for the second tier names that are not at the same level of quality.

Table 4
Current Valuation Multiples

Company	Ticker	PEG		Price/Sales		Price/Earnings		EV/FCF		Adjusted EV/FCF	
	3/23/07	CY07	CY08	CY07	CY08	CY07	CY08	CY07	CY08	CY07	CY08
Blackboard	BBBB	3.6x	2.0x	4.5x	3.9x	91.2x	49.6x	22.3x	19.3x		
Concur Techn.	CNQR	2.0x	1.4x	4.6x	3.7x	56.3x	39.7x	58.6x	54.7x	35.2x	32.8x
Digital River	DRIV	1.0x	0.8x	6.7x	5.4x	25.2x	19.9x	NA	NA		
Kenexa	KNXA	1.0x	0.8x	4.1x	3.5x	24.9x	20.7x	36.3x	30.6x	27.3x	22.9x
LivePerson	LPSN	1.0x	0.8x	6.6x	5.0x	33.1x	25.4x	30.8x	30.3x		
Omniture	OMTR	NM	1.4x	6.9x	4.6x	NM	52.1x	NM	NM		
Red Hat	RHT	1.5x	1.2x	10.6x	8.2x	37.0x	31.1x	NA	NA		
salesforce.com	CRM	NM	1.7x	7.5x	5.2x	NM	82.7x	38.9x	25.3x		
Taleo	TLEO	2.5x	1.5x	3.7x	3.1x	49.6x	29.0x	38.1x	26.0x		
DealerTrack	TRAK	1.3x	1.0x	5.5x	4.6x	29.2x	23.6x	18.9x	15.0x		
Ultimate Software	ULTI	1.8x	1.7x	4.9x	4.0x	37.5x	33.7x	29.2x	21.6x		
WebEx Comm.	WEBX	1.8x	1.5x	6.5x	5.5x	33.8x	28.0x	36.1x	32.3x		
WebSideStory	WSSI	0.5x	0.4x	3.1x	2.5x	18.2x	13.3x	13.3x	12.2x		
Mean*		1.7x	1.3x	5.8x	4.6x	40.7x	35.3x	33.0x	27.8x	31.2x	27.9x
Median*		1.6x	1.4x	6.0x	4.6x	35.4x	30.1x	36.1x	26.0x	31.2x	27.9x

Sources: Reuters, Thomson, and William Blair & Company estimates for CNQR, CRM, KNXA, and RNOW
*Includes valuation multiples for VOCS based on William Blair & Company estimates

Recent Trends in CRM and Talent Management

Customer Relationship Management (CRM)
The hosted CRM market had new entrants in 2006 and a shifting of competitors' positions. SAP introduced a hosted CRM offering in February, but it had little impact on the market. We believe one reason is that SAP turned to third parties to host. Also, our sense is that the product is being used only in accounts where SAP dominates. At the high end of the CRM market, Siebel seemed to lose market share in both the on-premise and the hosting space—at least the salesforce.com salespeople we spoke with during the year saw the vendor less. In the CRM middle market, we are seeing less of Pivotal, Onyx, and Saleslogix (Sage) and more of Microsoft (probably due to the falloff of the aforementioned smaller vendors).

Looking to 2007, Microsoft by year-end expects to deliver a new version of its Dynamics CRM product and this time plans to host it. Also this year, SAP will launch a new midmarket product, code-named A1S, that should include basic ERP and CRM functionality.

In our opinion, the CRM space can support a relatively large number of players given the size of the market. For example, in salesforce automation, any company with one or more salespeople anywhere in the world can use a hosted CRM product, representing a huge market. We project the CRM SaaS market will grow at 30%-plus over the next five years.

Talent Management System (TMS)
Merger-and-acquisition activity picked up materially in 2006 with TMS vendors acquiring to broaden their product offerings and the payroll processing and labor management (time-and-attendance) vendors acquiring TMS SaaS companies. Not only is the market moving to suites through acquisitions, but also the point-solution vendors are building products with a more complete offering. For example, performance-management vendor SuccessFactors has introduced an applicant tracking system and Salary.com brought to market a performance

management system, both of which were internally developed rather than acquired. We expect the TMS space to continue to consolidate given that in our opinion there are too many players in each segment and over time weaker players will be bought or marginalized.

While the vendors are moving to offer suites, most customers are still looking to buy point solutions. A client will start where it has a problem, such as the need for an applicant tracking system or a survey tool to try to get employee buy-in to corporate strategies. But, while customers are still buying point solutions, they are starting to require in requests for proposals (RFPs) that the vendor offer a broader suite in case there is a need for additional purchases over time. Hence, the ability to offer a suite of products may be a necessary competitive strategy even if companies are not currently experiencing sales of multiple products within the suite—and for vendors not currently able to meet this requirement, acquisition is likely the only way to rapidly regain this competitive ground.

Most segments of the TMS market are still growing in excess of 20%. Increasing competition for employees has prompted firms to focus more on talent management and the tools required to support this activity. With companies placing higher importance on their employee bases, paper-based and rudimentary, homegrown applications are no longer sufficient. Companies are seeking new solutions that help hire and retain qualified employees.

Today, the talent management market can be divided into three main submarkets: talent acquisition, employee management, and employee process outsourcing. IDC projects a 15% compound annual growth rate (CAGR) through 2009 for the e-recruiting and performance management software markets (the two segments into which IDC subdivides the market).

- ***Talent acquisition and e-recruiting***. Talent acquisition software can help companies better measure candidate skills, improve interview consistency, identify high-potential candidates, and expand the pool of qualified applicants. Major players include Authoria, BrassRing (recently acquired by Kenexa), Deploy Solutions, HireRight, Kenexa, PeopleClick, SilkRoad, Taleo, Unicru (recently acquired by Kronos), Vurv (formerly Recruitmax), and Workstream.

  This is the more crowded TMS space with a host of vendors targeting the enterprise and middle markets. We believe there is a risk that pricing will continue to deteriorate in the space given the increasing number of vendors, especially if market growth slows, leaving too many vendors chasing too few customers. Also, our sense is that the functionality difference among the vendors' ATSs (applicant tracking systems) continues to narrow, which could cause pricing pressure.

  Skills and behavioral assessments are also included in the talent acquisition space. In this subsegment, Kenexa and Previsor appear to have the most traction and the largest skills libraries. This market segment has a large number of very small players that the bigger participants are likely to acquire.

- ***Performance management.*** Once employees have been hired, performance management software helps companies retain the right employees. Specifically, the system automates the performance review process by tracking and monitoring the progress of an individual employee, a group, and the entire organization. In addition to performance reviews, the performance management space entails employee surveying.

  The competitive landscape includes a number of the players that are also in the talent acquisition space, including Kenexa, Vurv, and Softscape. SuccessFactors and Halogen Software are pure plays in performance management.

At the writing of this update report, SuccessFactors seems to have the most momentum in the performance review market, in our opinion, while Kenexa seems to be gaining share in employee surveying. We believe that given its domain knowledge in the human resources space, Kenexa can better advise its clients on what the data means and what actions should be taken as a result than general survey organizations that are not focused on the HR market.

We believe that the competitive landscape in this industry may look markedly different in the future. ERP providers (SAP and Oracle) and HRO vendors (such as Affiliated Computer Services and Hewitt Associates) may decide to develop or enhance their offerings to become stronger players. On its last conference call, Hewitt management commented that it is likely to make acquisitions to expand its presence in the consulting and benefiting outsourcing space. Payroll vendor ADP has already made two acquisitions in the HMS space.

An Update on What the Traditional Software Companies Are Doing

Oracle. For about eight years, Oracle has offered hosting for its customers. It runs its software for both its applications and database customers. It also has a product that was built to be hosted (the Siebel on-demand product), which currently has less than 100,000 subscribers—not a terribly high number given that last quarter salesforce.com added 95,000 subscribers in a single period.

While Oracle will host, it still does not offer subscriptions, which in our opinion is a key component of the SaaS model that dramatically decreases the up-front cost of application software. Also, Oracle management told us that the company is not interested in the low end of the market, or companies with less than about $30 million in revenue, a large portion of the SaaS market.

Oracle's strategy is focused on two areas:

- Bringing out its next-generation Fusion products.

- Building suites and market presence in vertical markets.

The SaaS market is not an area of strategic focus for Oracle. Oracle is targeting vertical industries by purchasing industry-specific solution providers (e.g., acquiring Retek for retail, i-flex for banking, and SPL for utilities). According to Oracle's president, Charles Phillips, the vertical applications are driving much of the growth in Oracle's applications business. Why is it faster growth? These markets tend to be less penetrated than the ERP space. Also, many vertical applications in use today are old, developed in outdated languages where programmer skills are difficult to find, which is leading to their replacement. The primary competition in Oracle's vertical solution markets is internally built applications, making it unlikely, in our opinion, that Oracle would move these vertical businesses to the SaaS model.

Another factor keeping Oracle from focusing on SaaS is its efforts to bring to market the new version of its ERP suite—Fusion. Given that Fusion uses a lot of the code from Oracle's current E-Business Suite and its data model and messaging engine, we do not believe that the new suite will natively support multitenant hosting.

As much as we respect the collective raw intellect at Oracle, we believe the company has too much on its plate with Fusion and vertical-focused solutions to truly make a dent in the SaaS space.

SAP. In February 2006, SAP made a foray into the SaaS business. Its on-demand solution is a hybrid system that extends SAP's current mySAP CRM into a hosted environment. With A1N and A1S products, SAP will provide hosting, new products, and a broader suite, not just CRM.

We continue to believe that SAP is likely to meet with success only in the stalwart SAP shops. Our belief is based on several factors, including SAP's reputation as being more appropriate for large companies since market perceptions are slow to change. Also, SAP will need to build out a new distribution channel of value-added resellers (VARs) to help sell and install the product. To compete effectively, SAP will also have to market aggressively—something it has not excelled at, in our view. Also, we wonder if the next iteration of the product will be easy enough to use.

Microsoft. In November 2005, Microsoft announced its entrance into the SaaS market with "Microsoft Live." The company announced Windows Live and Office Live, Internet-based versions of its Windows and Office products. During the Microsoft Live event, Chairman Bill Gates said that Microsoft plans to offer all its software as a service at some point. Since that time, we have seen or heard little of the new products. While Microsoft has been slow to adopt and gain share in the SaaS market, many in the press believe that the current version of Windows Vista that just shipped will be the last packaged product. Potentially hinting at the future of Microsoft's live products, Microsoft and Verizon signed an agreement last year whereby Verizon will resell Windows Live in 2007.

In a separate effort, Microsoft plans to bring a new version of its CRM Dynamics product to market. We believe that Microsoft is more likely to meet with success with its new hosted product than SAP and Oracle given its broad customer base in the middle and low end of the market. Also working in Microsoft's favor, the product is supposedly truly multitenant. Once it is available (it is due out at calendar year-end), we will have a better sense if it will be more competitive.

The Problem With Changing Business Models

SAP, Oracle, and Microsoft are traditional software companies that are evolving to address the SaaS market. All three vendors (but SAP and Oracle in particular) share the issue of trying to add hosted and subscription customers without cannibalizing existing license sales. If subscription revenue grows too quickly and perpetual-license sales falter, it could lead to declining overall revenue and earnings.

In addition, we believe *selling* a SaaS offering will also present a challenge. The existing sales teams of all three companies are more familiar with, and generate more income from, selling licenses. Shifting the behavior of a salesforce is difficult, in our experience. A separate channel can be created to sell SaaS, but that could potentially confuse customers and lead to channel conflict.

In conclusion, we believe the large, traditional software companies face challenges in developing a meaningful and credible SaaS offering, and we expect them to have limited actual impact in the market in the near term.

SaaS Model Versus the Traditional Software Model

Much has been written about how SaaS differs from the traditional software model. Our goal is to once again present a summary view of these differences.

Customer Benefits

Lower initial cost. With vendor-supported hosting, clients do not need to buy the underlying hardware infrastructure—they rent what the vendor has built. In addition, with SaaS companies, customers typically buy subscriptions and thus pay for use over time. As a result, the initial costs can be far less than buying traditional enterprise software.

Not only are start-up costs lower under the subscription model, but costs in general are also predictable. Clients typically pay the monthly or yearly subscription fee and do not need to worry as much about escalating implementation/customization costs. We believe this is one reason for the increase we have seen in contract terms; customers want to lock in current pricing years into the future.

Reduced risk. Given decades of application failures and cost overruns, it is not surprising the traditional software model would be challenged by a new one. The traditional model of running the software on site and purchasing perpetual licenses led to huge up-front costs and thus a high level of risk. It can take years (if ever) before a company achieves a return on investment. With the newer SaaS model, the up-front costs and risks are reduced substantially, and customers can receive near-term benefits and ROI from their efforts.

Quick implementations. Traditional software implementations are expensive and time consuming. With SaaS, limited customization and the use of existing infrastructure significantly reduce initial implementation work. As a result, the software can be deployed in weeks instead of months or years for purchased-packaged software.

Minimal IT support. When we first started surveying the users of SaaS applications in 2000-2001, most of the user organizations were small companies and the No. 1 reason they gave for choosing SaaS was that they lacked internal IT resources. Because SaaS companies manage the technology, their services require little IT support from user organizations' internal IT departments.

Circumventing IT. We believe that one of the reasons for the success of SaaS is the ability to circumvent the internal IT department. With software offered as a service, departments (such as sales or HR) can buy the software and use it without the help of the IT department. Along the same lines, it can shift power from IT to the user organizations. When we survey salesforce automation customers, we frequently hear that the sales organization chose a SaaS product over the objections of IT—but sales departments have enough power to trump the desires of IT (since they are responsible for a company's top-line growth).

More-frequent functionality improvements and built-in upgrades. With SaaS, one version (the newest release) typically is used for all subscribers. As a result, customers have access to the most up-to-date software. In addition, with the hosted model, the customer automatically has the new version of the software without having to implement and customize it. Because the vendor automatically upgrades software for all customers, no decision about whether to upgrade (often at considerable cost) is necessary. Over the last year or two there has been a subtle change to this model; some companies are maintaining older versions of the product so as not to force the customers to migrate on the vendor's timetable. Even salesforce.com, which once strictly forced all users to upgrade to the new version, now supports more than one version.

Customer care. Another benefit of the SaaS model is heightened customer care. In a subscription model, vendors are more dependent on the current base of customers and therefore have a far greater incentive to provide high levels of service and support and to keep their software at the forefront of the industry—or risk losing customers. Because the economics of SaaS depend on high levels of customer retention, service is a critical component of success. Unfortunately, sales personnel at traditional software companies often quickly move on to the next customer after making a sale so that they can meet their quota targets (since outright license sales typically are not followed by additional product purchases) and the incentives to support existing customers are weaker.

Security. We now frequently hear from SaaS users that the security provided by the vendor is better than what the client could duplicate at its own site. We believe this is true despite the introduction of an additional point of potential security problems, which is the external network. SaaS applications are designed for high levels of security, and SaaS companies monitor security aggressively. We expect security to become an increasingly important criterion in selecting SaaS vendors.

Understanding the user. When software is offered as a service, the vendor can watch how the user community works with the software—what is being used, what is not, and where problems lie. We believe this allows for a much tighter and faster feedback loop from the user base to the developer. As a result, product enhancements appear to be more relevant and to occur more frequently. The product evolves more quickly and its utility is higher.

Vendor Benefits

Better visibility. The SaaS model corrects the two biggest deficiencies of the traditional software model: back-end load and the lack of revenue and earnings visibility.

By selling subscriptions instead of perpetual licenses, SaaS companies have much better earnings and revenue foresight. Instead of deriving 50% or more of revenue in the last few days of the quarter (and dealing with the inherent pricing pressure that causes), SaaS companies have 75% to 95% revenue visibility entering any given quarter. This allows companies to undertake much better planning and budgeting, with significant advantages for corporate strategy and profitability, in our opinion.

It is important to point out that better revenue and earnings visibility does not necessarily lead to a less volatile stock. The SaaS stocks can experience rather violent reversals on perceived growth, or the lack thereof, in bookings. Salesforce.com has seen wide swings in stock price on a quarterly basis based on its subscriber metric.

Lower cost of development. Companies that host software typically develop to a single-technology stack, which is considerably less expensive than developing all the permutations (of databases, operating systems, applications servers, etc.) needed by customers who want to run the software on their own premises. Since SaaS vendors do not have to support multiple versions of an application environment, all resources can be spent on new functionality instead of creating multiple versions of the same code. In addition, since there is only one version of the application being maintained, upgrades are typically more frequent as noted above and code complexity can be reduced. SaaS vendors spend from 5% to 10% of revenues on research and development, well below the 10% to 22% at more traditional software companies.

Longer corporate life. William Blair has covered the software market for more than 15 years, and in this time numerous software companies have grown rapidly only to all but disappear in a few years. With the perpetual model, customers have the right to use software in perpetuity, and if all the needed modules are purchased up front, it is possible that

the customer would never need to make an additional purchase from the software vendor. Given that we prefer to make clients money, and to cover companies for a long period of time, we prefer SaaS companies.

With SaaS, users typically buy only the required seats and purchase additional users and modules when needed. And because the model is subscription-based, customers who want to continue to use the service must continue to pay for it. In addition, the SaaS business model usually defers the recognition of revenue to match the life of the service. These factors in combination should lead to a longer corporate life.

We view the potential longer-life factor as one of the major benefits of the SaaS model. We have seen too many perpetual license software companies quickly penetrate their markets, leading to rapidly rising stock prices. But after the market is penetrated, which in some cases can occur in only a few years, license revenue growth disappears and the stock collapses. We much prefer the SaaS model with its long tail of recurring revenue since we believe it reduces the risk for investors and rewards long-term investing.

Better expense visibility. Because revenue is more predictable, SaaS vendors are also able to better plan expenses since they have a good sense of what revenue will look like for six months to a year.

Shareholder Benefits

Less volatile earnings. SaaS offers increased predictability over that of license models. Because SaaS models have a base of recurring revenue, the next sale is incremental. The tradition model essentially requires rebuilding a revenue base each quarter. This high level of predictability comes at a modest cost, in our opinion. Although SaaS companies generally are not as dependent on large deals, the stocks will still move on bookings, which can be inferred from changes in the deferred revenue account—so they are subject to quarterly changes. This model is still much better than deriving 50% to 75% of revenue in the last few weeks of the quarter, as is the case at most traditional software companies.

Longer public life. Having a longer corporate life benefits the investor as much as it benefits the vendor. Most investors believe, and rightly so, that software companies do not have sustainable franchises (with a few notable exceptions like Microsoft, SAP, and Oracle). We believe that SaaS companies might make better investments for a longer period since they are less likely to quickly penetrate their underlying markets. And even once they have penetrated (which is many years from now), they will continue to derive annual revenue (like payroll processors).

Larger target markets. We previously have noted that we believe the SaaS model allows companies to expand the addressable market and to target more of that market. In addition, companies able to retain customers for long periods will experience higher net present value opportunity from those customers. In the aggregate, we believe the SaaS model creates significantly larger, as well as longer-lived, growth opportunities.

Customer Disadvantages

Higher total cost. Evidence suggests that subscription models can—over the lifetime of the project—result in higher software costs compared with purchasing the application outright, if the time horizon during which the software is in use is long enough. But we believe these software costs are more than offset by lower associated costs, such that total cost of ownership is nevertheless lower.

Loss of control. SaaS customers are letting someone else (the vendor) run their software, which means that they have less control over the application than running it internally.

Potential performance issues. Most SaaS products run over the Internet, which can at times run into performance problems. Also, the service itself could also encounter performance problems, as we detailed earlier in this update.

Less customization. SaaS applications are not, as a rule, as customizable as software that is run on premise.

Vendor Disadvantages

Slower growth. SaaS companies typically grow more slowly than their perpetual competitors since revenue is recognized pro rata over the life of the contract, instead of all up front. Since revenue is deferred and most costs recognized up front, profitability is also delayed.

A more complicated business. Instead of only developing and selling software, SaaS companies also host the product, which is a different and additional skill. Running the software effectively for clients is not easy, as evidenced by the outages at salesforce.com.

Potentially smaller total available market. In theory, if vendors do not offer perpetual licenses and the option for customer to host in-house, it could limit market opportunity. There are likely to be some customers (e.g., the U.S. government, which is the world's largest buyer of technology) that might not embrace the SaaS model. The total available market impact of strict SaaS adherence is likely to vary by market. For example, in accounting, our sense is that many customers will continue to want to run their financials internally.

Investor Disadvantages

High valuation. Most SaaS companies carry a higher valuation than their traditional model competitors. This valuation premium presents a risk: if the vendor falters, there could be more downside to the stock.

The wheat from the chaff. Most of the private software companies we have visited over the past five years are SaaS companies. We expect more and more to come to the public market, and not all, or not even most, will be good companies. Now that investors have bought into the SaaS model, they need to understand the unique value to customers and investors that each company provides. Furthermore, the multiples of the public companies tend to be correlated, so one company's misstep could have a ripple effect on the group.

Additional information is available upon request.

This report is available in electronic form to registered users via R*Docs™ at www.rdocs.com or www.williamblair.com.

DJIA:	12481.01
S&P 500:	1436.11
NASDAQ:	2456.18

Appendix: Public SaaS Companies

Blackboard Inc.
(www.blackboard.com)
Ticker: BBBB Price: $35.26

Management

Co-founder and Chairman:	Matthew Pittinsky
Chief Executive Officer:	Michael Chasen
Chief Financial Officer:	Michael Beach

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$183	$235	YTD Price Performance:	17.4%
Year-over-year growth:	64%	28%	Shares Outstanding:	28 million
EPS**:	-$0.39	$0.39	Market Capitalization:	$991 million
Price-to-earnings:	NM	90.4x	Fiscal Year End:	December

* Thomson One Analytics estimates

** Includes FAS 123R option expenses

Description

Based in Washington, D.C., Blackboard offers software and related services to the education industry. The company's products include five software applications bundled into two suites: Blackboard Academic Suite and Blackboard Commerce Suite. The Blackboard Academic Suite provides a platform for delivering education online through a Web portal to augment a classroom-based program or distance learning. The Blackboard Commerce Suite can be used for, among other things, online e-commerce, meal plan administration, and student and staff identification. Today, Blackboard has about 3,500 clients using its applications.

Concur Technologies, Inc.
(www.concur.com)
Ticker: CNQR Price: $17.72

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman and Chief Executive Officer:	Steve Singh
President and Chief Operating Officer:	Rajeev Singh
Chief Financial Officer:	John Adair

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$97	$125	YTD Price Performance:	10.5%
Year-over-year growth:	35%	29%	Shares Outstanding:	40 million
EPS**:	$0.30	$0.29	Market Capitalization:	$642 million
Price to earnings:	59.1x	61.1x	Fiscal Year End:	September

* William Blair & Company estimates

** Excludes FAS 123R option expenses

Description

With its strong brand recognition and solid reputation, Concur is the leader in the corporate expense management market. The company's strategy is to be the global leader in expense management, similar to what ADP is to payroll. Concur's services include expense reporting, corporate travel booking and processing, corporate spend management, business intelligence, and regulatory compliance. The company's solutions enable clients to manage their indirect costs, increase employee productivity, reduce discretionary expenditures, and meet regulatory compliance for corporate expenses. It now employs more than 500 people and has about 3,600 customers.

DealerTrack Holdings, Inc.
(www.dealertrack.com)
Ticker: TRAK Price: $30.81

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman and Chief Executive Officer:	Mark O'Neil
Senior Vice President and Chief Financial Officer:	Robert Cox III

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$173	$219	YTD Price Performance:	4.7%
Year-over-year growth:	44%	27%	Shares Outstanding:	39 million
EPS:	$0.85	$1.03	Market Capitalization:	$1.2 billion
Price to earnings:	36.2x	29.9x	Fiscal Year End:	December

* William Blair & Company estimates

Description

DealerTrack provides several remotely hosted technology services that increase auto dealerships' success in making sales, as well as the profitability of those sales. The company's primary offering supports the electronic submission of financing applications from approximately 22,000 dealerships to more than 325 financing providers, a service for which it is compensated on a per-application basis from the lenders. DealerTrack has expanded its offering to include several subscription-based services to dealerships that address each stage of the sales process, greatly increasing the company's market and growth opportunity.

Digital River, Inc.
(www.digitalriver.com)
Ticker: DRIV Price: $55.75

Management

Founder, Chairman, and Chief Executive Officer:	Joel Ronning
Chief Financial Officer:	Thomas Donnelly

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$308	$382	YTD Price Performance:	-0.07%
Year-over-year growth:	40%	24%	Shares Outstanding:	40 million
EPS*:	$1.79	$2.17	Market Capitalization:	$2.2 billion
Price-to-earnings:	31.1x	25.7x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description

Based in Minneapolis and founded in 1994, Digital River builds and manages online businesses for more than 40,000 software publishers, manufacturers, distributors, and online retailers. Today, with its multichannel e-commerce solution, Digital River is able to support both direct and indirect sales, as well as help companies maximize their online revenues, while at the same time reducing the risk and cost of running their own e-commerce sites. Digital River offers a wide array of solutions depending on the clients' needs, from site development and hosting to site management, order management, product fulfillment, customer service, and e-mail marketing.

iPass Inc.
(www.ipass.com)
Ticker: IPAS Price: $5.11

Management

Chairman and Chief Executive Officer:	Ken Denman
Vice President and Chief Financial Officer:	Frank Verdecanna

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$183	$196	YTD Price Performance:	-13.1%
Year-over-year growth:	8%	7%	Shares Outstanding:	65 million
EPS:	$0.06	$0.09	Market Capitalization:	$343 million
Price-to-earnings:	85.2x	56.8x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description

Founded in 1996 and based in Redwood Shores, California, iPass helps its customers unify the management of remote and mobile connectivity and devices. With iPass software and services, customers can create easy-to-use broadband solutions for their mobile workers, home offices, and branch and retail locations, complete with device management, security validation, and unified billing. The company's offerings are powered by its leading global virtual network, on-demand management platform, and award-winning client software. The iPass global virtual network unifies hundreds of wireless, broadband, and dial-up providers in more than 160 countries, with offices throughout North America, Europe, and Asia. Customers include General Motors, Nokia, and Reuters.

Kenexa Corporation
(www.kenexa.com)
Ticker: KNXA Price: $32.48

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman and Chief Executive Officer:	Nooruddin (Rudy) Karsan
President and Chief Operating Officer:	Troy Kanter
Chief Financial Officer:	Donald Volk

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$112	$187	YTD Price Performance:	-2.4%
Year-over-year growth:	71%	67%	Shares Outstanding:	25 million
EPS**:	$0.96	$1.21	Market Capitalization:	$813 million
Price-to-earnings:	33.8x	26.8x	Fiscal Year End:	December

* William Blair & Company estimates

** Excludes FAS 123R option expenses

Description

Kenexa Corporation is a leading provider of talent management solutions. The company's broad suite of services (comprising applicant-tracking software, more than 1,000 skills tests, 100-plus behavioral tests, structured interview questionnaires, performance management applications, employee engagement surveys, and outsourcing services) allow organizations to recruit and retain employees more effectively. None of Kenexa's competitors provides a solution that targets all of Kenexa's underlying market segments. Therefore, the company's broad product suite along with its strong domain knowledge allows Kenexa to significantly differentiate itself from its competitors. Kenexa made two acquisitions in the last year, BrassRing and PSL. BrassRing strengthened Kenexa's applicant-tracking market position, while PSL improved Kenexa's already-dominant assessment product and brought it overseas; therefore, the newly combined entity provides a more complete and robust product suite.

Kintera, Inc.
(www.kintera.org)
Ticker: KNTA Price: $1.70

Management

President and Chief Executive Officer:	Richard LaBarbera
Vice Chairman and Executive Vice President:	Dennis Berman
Chief Financial Officer:	Richard Davidson

Key Statistics	***2006E****	***2007E****	***Valuation***	
Revenue (mil):	$47	$52	YTD Price Performance:	36.0%
Year-over-year growth:	14%	11%	Shares Outstanding:	40 million
EPS:	-$0.83	-$0.44	Market Capitalization:	$63 million
Price-to-earnings:	NM	NM	Fiscal Year End:	December

* Thomson One Analytics estimates

Description

Founded in February 2000 by a team of successful entrepreneurs, Kintera is a pioneer and early leader in providing software as a service to nonprofit organizations. Kintera's Web-based products enable nonprofit organizations to use the Internet to increase donations, reduce fundraising and administration costs, and build awareness and affinity. The company's flagship product, Kintera Sphere, sits at the nexus between nonprofit organizations' employees, volunteers, and donors. Kintera Sphere offers content and contact management, communication tools, reporting, and commerce capabilities. All these integrated applications are aimed at the specific needs and workflow demands of nonprofit organizations and are accessed through a simple Web browser.

LivePerson, Inc.
(www.liveperson.com)
Ticker: LPSN Price: $7.38

Management

Chairman and Chief Executive Officer: Robert LoCascio
President and Chief Financial Officer: Tim Bixby

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$34	$49	YTD Price Performance:	41.1%
Year-over-year growth:	50%	47%	Shares Outstanding:	41 million
EPS:	$0.13	$0.22	Market Capitalization:	$306 million
Price-to-earnings:	56.8x	33.5x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description

LivePerson is a leading provider of online sales, marketing, and customer service solutions. LivePerson's live chat, e-mail, and knowledge-based technologies have enabled more than 5,000 customers to increase revenue and productivity, answer customer questions, build relationships, and deliver results. LivePerson enables sales and customer service teams to interact with customers online, in a secure, real-time environment, at critical moments during their visits. Its solutions offer Web sites a timely and cost-effective solution to reach the right customer at the right time, helping increase revenue and the productivity of sales and customer service agents. Combining the interactive nature of the Internet with the dependability of traditional customer service, LivePerson helps build strong, long-lasting consumer relationships, convert browsers into buyers, and turn one-time visitors into loyal customers.

Motive, Inc.
(www.motive.com)
Ticker: MOTV.PK Price $3.56

Management

Chairman and Chief Executive Officer:	Alfred Mockett
Chief Operating Officer:	Richard Hanna
Chief Financial Officer:	Mike Fitzpatrick

Description

Motive provides service management software for broadband and mobile data services. Its software is helping wireline, wireless, cable, and satellite operators deliver a new generation of IP-based services that seamlessly integrate voice, video, and data into a single, connected experience. With Motive, operators can leverage one service management platform to automate and remotely manage key customer touch points throughout the service life cycle, across multiple services, networks, and devices. Since 1997, the company's solutions have been used in connection with more than 45 million endpoints, including products and services from market leaders such as AT&T, Bell Canada, Deutsche Telekom, and Verizon. Neither Thomson One Analytics nor William Blair provides estimates for the company.

NIC Inc.
(www.nicusa.com)
Ticker: EGOV Price: $5.41

Management

Founder, Chairman, and CEO:	Jeffery Fraser
President:	Harry Herington
Chief Financial Officer:	Eric Bur

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$71	$80	YTD Price Performance:	8.9%
Year-over-year growth:	20%	13%	Shares Outstanding:	62 million
EPS:	$0.17	$0.14	Market Capitalization:	$337 million
Price-to-earnings:	31.8x	38.6x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description

NIC Inc. helps governments use technology to increase efficiencies, improve how user services are delivered, and reduce costs. In 1991, NIC created the first electronic government Web site for the state of Kansas, and since then the company has been building and managing online solutions for state and local government agencies. Today, the company has long-term e-government outsourcing contracts with 19 states and hundreds of local governments in the United States.

Omniture, Inc.
(www.omniture.com)
Ticker: OMTR Price $18.45

Management

Co-founder and Chief Executive Officer:	Josh James
Executive Vice President and Chief Financial Officer:	Mike Herring

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$80	$133	YTD Price Performance:	31.0%
Year-over-year growth:	86%	67%	Shares Outstanding:	48 million
EPS:	-$0.08	$0.06	Market Capitalization:	$889 million
Price-to-earnings:	NM	307.5x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description
Omniture is a leading provider of on-demand Web analytics, supplying the essential capabilities companies need to conduct business online successfully. The company has helped more than 600 customers fully leverage their Internet channels by successfully attracting visitors and turning them into loyal customers. Omniture offers a range of professional services that complement its online services, including implementation, best practices, consulting, customer support, and user training provided through Omniture University. Omniture's customers include eBay, AOL, Wal-Mart, Gannett, Microsoft, Oracle, General Motors, and Hewlett-Packard.

Phase Forward Incorporated
(www.phaseforward.com)
Ticker: PFWD Price: $12.96

PHASE•FORWARD

Management

President and Chief Executive Officer:	Robert Weiler
Chairman and Founder:	Paul Bleicher, M.D., Ph.D.
Senior Vice President and CFO:	Rodger Weismann

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$107	$127	YTD Price Performance:	-13.5%
Year-over-year growth:	22%	19%	Shares Outstanding:	35 million
EPS:	$0.45	$0.51	Market Capitalization:	$465 million
Price-to-earnings:	28.8x	25.4x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description
Phase Forward is a leading provider of integrated data collection and data management solutions for clinical trials and drug safety. Its services are designed to enable life sciences companies to automate and integrate the management of their clinical development processes, from study initiation and FDA submission through postmarketing studies. Phase Forward's solutions have been used in more than 10,000 clinical trials involving more than 1,000,000 trial study participants at 260-plus life sciences companies, medical device firms, regulatory agencies, and public health organizations.

RightNow Technologies, Inc.
(www.rightnow.com)
Ticker: RNOW Price: $16.89

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Founder and Chief Executive Officer:	Greg Gianforte
Vice President of Finance and Administration and CFO:	Susan Carstensen

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$110	$118	YTD Price Performance:	-1.9%
Year-over-year growth:	27%	7%	Shares Outstanding:	33 million
EPS**:	-$0.01	-$0.40	Market Capitalization:	$549 million
Price-to-earnings:	NM	NM	Fiscal Year End:	December

* William Blair & Company estimates

** Excludes FAS 123R option expenses

Description

Founded in 1997, RightNow Technologies is on its way to becoming one of the leading providers of customer service and support solutions. The company's on-demand service module improves the effectiveness of service and support operations through easy-to-implement technology and replicable best practices. Specific features in this module include complete multichannel customer service, live-chat personal service, and customer-satisfaction measurement. These features help reduce call center costs and improve and automate customer-satisfaction rates. In addition to its core customer service module, RightNow sells two newer CRM modules: sales and marketing.

Salary.com
(www.salary.com)
Ticker: SLRY Price: $11.43

Management

Founder and Chief Executive Officer:	Kent Plunkett
Executive Vice President and Chief Operating Officer:	Yong Zhang
Senior Vice President and Chief Financial Officer:	Ken Goldman

Description

Salary.com's on-demand software strives to simplify the connections between people, pay, and performance. Its solutions empower customers to make the best decisions about pay and performance and help attract, motivate, reward, and retain top performers. Salary.com has developed four unique market offerings: on-demand talent management software, on-demand compensation data and software, premium content and research services, and targeted online advertising. Neither Thomson One Analytics nor William Blair provides estimates for the company, which had its initial public offering on February 22, 2007.

salesforce.com, inc.
(www.salesforce.com)
Ticker: CRM Price: $43.30

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman and Chief Executive Officer:	Marc Benioff
Chief Financial Officer:	Steve Cakebread

Key Statistics	***2007***	***2008E****
Revenue (mil):	$497	$716
Year-over-year growth:	60%	44%
EPS**:	$0.23	$0.42
Price-to-earnings:	188.3x	103.1x

Valuation	
YTD Price Performance:	18.8%
Shares Outstanding:	121 million
Market Capitalization:	$5.0 billion
Fiscal Year End:	January

* William Blair & Company estimates
** Excludes FAS 123R option expenses

Description
Salesforce.com is the leading provider of on-demand CRM services to the enterprise market. With its services, businesses can streamline customer interactions and improve productivity. The company's solutions are delivered over the Internet and can be accessed anywhere at any time through a standard Web browser. Customers subscribe to use salesforce.com's services. From the introduction of its service in February 2000, the company's customer base has grown to approximately 29,800 subscribing organizations, representing 646,000 users worldwide. Its services include salesforce automation, customer service (call center), marketing automation, as well as application development and applications hosting for third-party applications. Salesforce.com services a huge market: any company with sales, marketing, or customer support people. Further, AppExchange, Apex, and the new App-Store could change the way applications are developed and sold, just as the company has changed the way CRM software is developed, sold, and delivered.

Smart Online, Inc.
(www.smartonline.com)
Ticker: SOLN.OB Price: $2.80

Management

President and Chief Executive Officer:	Michael Nouri
Chief Financial Officer:	Nicholas Sinigaglia
Executive Vice President:	Henry Nouri

Description
Founded in 1993, Smart Online develops and markets Internet-delivered business software applications and data resources critical to small businesses. Smart Online's applications include Smart Attorney, Smart Business Plan, Smart Market Research, and Smart Family Law. The company's wide range of about two dozen useful applications and information resources provide small businesses with a comprehensive suite of offerings for their business needs. Smart Online trades very thinly over the counter; neither Thomson One Analytics nor William Blair provides estimates for the company.

Taleo Corporation
(www.taleo.com)
Ticker: TLEO Price: $16.82

Management

President and Chief Executive Officer:	Michael Gregoire
Executive Vice President and Chief Financial Officer:	Katy Murray

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$97	$119	YTD Price Performance:	23.0%
Year-over-year growth:	24%	23%	Shares Outstanding:	24 million
EPS:	$0.13	$0.32	Market Capitalization:	$414 million
Price-to-earnings:	129.4x	52.6x	Fiscal Year End:	December

* Thomson One Analytics estimates

Description
Taleo delivers talent management solutions that allow customers to manage their workforce more efficiently and effectively. Taleo's software manages the employee acquisition process for many different types of workers, including professional, hourly, or contingent. The company views the contingent workforce as an untapped market with the potential to be as large as its core (professional and hourly) recruiting market. Taleo's 575 employees help support its 850 customers and 800,000 users.

The Ultimate Software Group, Inc.
(www.ultimatesoftware.com)
Ticker: ULTI Price: $26.78

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman, President, and Chief Executive Officer:	Scott Scherr
Vice Chairman and Chief Operating Officer:	Marc Scherr
Executive Vice President and Chief Financial Officer:	Mitchell Dauerman

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$115	$149	YTD Price Performance:	15.1%
Year-over-year growth:	30%	30%	Shares Outstanding:	24 million
EPS:	$0.38	$0.70	Market Capitalization:	$667 million
Price-to-earnings:	70.5x	38.3x	Fiscal Year End:	December

* William Blair & Company estimates

Description
The Ultimate Software Group is a leading provider of payroll and human resources solutions to midsize and large firms. Initially, the company sold its award-winning UltiPro product via the traditional license model, but in 2002 it began offering the same product in a hosted form, which it terms Intersourcing. Since the introduction of its hosted model, the contribution of recurring revenues has grown from 35.1% of overall revenues in 2002 to 55.7% in 2006, and recurring revenue posted year-over-year growth of 27.2% in 2006. The hosted solution accounted for approximately 70% of new deals in 2006 and has provided for a more predictable and stable set of revenues. Ultimate enjoys industry-leading client retention (97%), driven by its strong customer service, award-winning product, and industry-leading implementation times.

Vocus, Inc
(www.vocus.com)
Ticker: VOCS Price: $20.82

Management

Co-founder, President, and Chief Executive Officer:	Rick Rudman
Chief Financial Officer:	Steve Vintz

Description

Vocus is targeting a relatively new and underpenetrated market—software as a service (SaaS) for corporate communications. The company is benefiting from the movement of old paper-based public relations operations to Internet software, processes, and digitized media. The opportunity for recently acquired PRWeb is along the same lines; the company has reinvented the press release market via the Internet. Traditional newswire businesses target the traditional media (newspapers, etc.) and do not as effectively reach the Internet-based news sources, which is exactly what PRWeb is built to do. Companies of all sizes and verticals need to communicate with their constituencies. This universal need creates a market opportunity of $2 billion in the United States alone and $3 billion to $4 billion on a worldwide basis. Vocus believes its potential client base is more than 200,000, yet it has fewer than 2,000 existing customers.

WebEx Communications, Inc.
(www.webex.com)
Ticker: WEBX Price: $56.99

William Blair & Company Rating:	Market Perform
Company Profile:	Aggressive Growth

Management

Co-Founder, Chairman, and Chief Executive Officer:	Subrah S. Iyar
Chief Financial Officer:	Michael T. Everett

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$380	$459	YTD Price Performance:	63.3%
Year-over-year growth:	23%	21%	Shares Outstanding:	49 million
EPS:	$1.43	$1.74	Market Capitalization:	$2.8 billion
Price-to-earnings:	39.9x	32.8x	Fiscal Year End:	December

* William Blair & Company estimates

Description

WebEx Communications, Inc. is the leading provider of on-demand collaborative applications and services. WebEx applications are used across the enterprise in sales, support, training, marketing, engineering, and product design. WebEx delivers its suite of collaborative applications over the WebEx MediaTone Network, a global network specifically designed for highly secure delivery of real-time on-demand applications. WebEx also hosts third-party on-demand application capabilities through its WebConnect platform. WebConnect allows customers to seamlessly integrate collaborative, workflow, and business applications within a secure, reliable common delivery platform. WebEx sells its collaborative services on a subscription basis and offers third-party applications on a revenue share basis. Third-party applications can be married with existing in-house applications on the WebConnect platform to allow for real-time collaboration with partners. On March 15, 2007, Cisco announced a definitive agreement to acquire WebEx for $57 in cash per share, a more than 23% premium to the prior day's close. The transaction is valued at $3.2 billion, or $2.9 billion netting

out WebEx's healthy cash balance. Cisco is looking to combine WebEx within its vision of network-based solutions for unified communications and collaboration, leveraging WebEx's position in the SMB market and Cisco's enterprise scale and international reach. Over the past few years, the company has made other acquisitions in the space.

WebSideStory, Inc.
(www.websidestory.com)
Ticker: WSSI Price: $12.94

William Blair & Company Rating:	Outperform
Company Profile:	Aggressive Growth

Management

Chairman and CEO:	Jim MacIntyre
Chief Financial Officer:	Claire Long

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$69.4	$89.8	YTD Price Performance:	2.2%
Year-over-year growth:	76%	29%	Shares Outstanding:	20 million
Pro Forma EPS:	$0.55	$0.71	Market Capitalization:	$266 million
Price-to-earnings:	23.5x	18.2x	Fiscal Year End:	December

* William Blair & Company estimates

Description

WebSideStory provides on-demand Web site analytics. Its solutions gather information from Web browsers, process it, and make the data available online for clients in the form of customized standard reports. Recent acquisitions and investments have positioned the company in adjacent markets, including site search, Web site content management, bid management, and customized enterprise analytics solutions. About 1,540 enterprise customers take advantage of WebSideStory's services, enabling them to better understand how Internet users respond to a Web site design, content changes, online marketing campaigns, and e-commerce offerings. These clients then use this information to make better marketing decisions as well as changes to merchandising, sales, and site design.

SaaS acquisition. WebSideStory acquired Visual Sciences in February 2006. In addition to site analytics (Visual Site), Visual Sciences offers three key products (Visual Call, Visual Mail, and Visual Document) that management estimates will expand the market opportunity from about $1.4 billion to $2.4 billion. Total consideration of the deal was $57 million, representing a price-to-revenue multiple of about 5 times. The VS solutions will be integrated into the HBX platform through the existing stream integration process that has proved successful in allowing an effective interface between third-party software providers and HBX. The company has a strong presence in the government, e-commerce, technology, financial services, and travel sectors, which should complement WebSideStory's strong position in e-commerce, financial services, media, technology, and health care. The company's average customer size is $200,000, and the company has about 40 customers and 40 employees. Jim MacIntyre, cofounder and CEO of Visual Sciences, has replaced Jeff Lunsford as the CEO of WebSideStory.

Workstream Inc.
(www.workstreaminc.com)
Ticker: WSTM Price: $1.25

Management

Chief Executive Officer:	Deepak Gupta
Chief Financial Officer:	Stephen Lerch

Key Statistics	***2006***	***2007E****	***Valuation***	
Revenue (mil):	$28	$31	YTD Price Performance:	9.7%
Year-over-year growth:	56%	8%	Shares Outstanding:	51 million
EPS:	-$0.12	-$0.22	Market Capitalization:	$62 million
Price-to-earnings:	NM	NM	Fiscal Year End:	May

* Thomson One Analytics estimates

Description
Workstream offers human capital management (HCM) solutions and services. The firm's products and services help companies attract and retain their most important asset—their employees. Firms use Workstream's software to manage the entire employee life cycle. The company operates in two distinct units, Enterprise Workforce Services and Career Networks. The Enterprise Workforce Services segment offers a complete suite of HCM software solutions, which includes recruitment, benefits administration and enrollment, performance management, succession planning, compensation management, and employee awards and discount programs. The Career Networks segment offers recruitment research, resume management, and outplacement services.

Web.com, Inc.
(www.web.com)
Ticker: WWWW Price: $4.20

Management

President and Chief Executive Officer:	Jeffrey Stibel
Executive Vice President and Chief Financial Officer:	Gonzalo Troncoso

Key Statistics	***2006E****	***2007E****	***Valuation***	
Revenue (mil):	$49	$55	YTD Price Performance:	0.24%
Year-over-year growth:	NM	12%	Shares Outstanding:	17 million
EPS:	-$0.76	$0.05	Market Capitalization:	$70 million
Price-to-earnings:	NM	84.0x	Fiscal Year End:	August

* Thomson One Analytics estimates

Description
Web.com, Inc. is a leading destination for Web sites and Web services. The company offers do-it-yourself and professional Web site design, Web site hosting, e-commerce, Web marketing, and e-mail. Since 1995, Web.com has been helping individuals and small businesses leverage the power of the Internet to build a Web presence. More than 4 million Web sites have been built using Web.com's tools and services.

The prices of the common stock of other public companies mentioned in this report follow:

ABN Amro	$43.24
Accenture	$36.40
Automatic Data Processing	$50.76
Affiliated Computer Services	$59.34
Barclays	$59.43
Ceridian	$32.88
Dell	$22.83
First Data	$26.22
Gartner Group	$23.52
Hewitt Associates	$29.48
IBM	$95.03
Intuit	$27.39
Kronos	$53.11
Microsoft	$28.02
Oracle	$18.24
SAP	$45.57
Verizon	$38.12

Current Ratings Distribution (as of 2/28/07)

Coverage Universe	Percent	Inv. Banking Relationships*	Percent
Outperform (Buy)	56%	Outperform (Buy)	13%
Market Perform (Hold)	43%	Market Perform (Hold)	5%
Underperform (Sell)	1%	Underperform (Sell)	1%

* Percentage of companies in each rating category that are investment banking clients, defined as companies for which William Blair has received compensation for investment banking services within the past 12 months.

Laura Lederman and Franco Turrinelli attest that 1) all of the views expressed in this research report accurately reflect their personal views about any and all of the securities and companies covered by this report, and 2) no part of their compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed by them in this report.

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Corey Tobin 312.364.5362
Specialty Software and Systems, Health Care IT

Franco Turrinelli, CFA, Principal 312.364.8166
Technology Services, Payments Infrastructure

EDITORIAL

Steve Goldsmith, Head Editor 312.364.8540
Beth Pekol +44 20 7868 4516
Lisa Zurcher 312.364.8437

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William Blair & Company, L.L.C. 222 West Adams Street Chicago, Illinois 60606 312.236.1600 www.williamblair.com

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