

CRM: Waiting for the Consolidation Ball to Begin

Those focused on the enterprise software industry and the Customer Relationship Management (CRM) software space have been left waiting for what everyone has been expecting all along—consolidation. This inevitable dance has been postponed for the better part of three years with the exception of select deals here and there. Why do we view consolidation as inevitable and why has it been delayed so long? These are some of the questions that we will address in this CRM Spotlight.

Mirus' Software Group predicts that New Year's Day 2002 will mark the official beginning of meaningful consolidation in the crowded CRM space. We believe that by the end of 2002 the group of 24 public CRM companies we follow will number only 5-7 meaningful independent vendors.

Why is consolidation in software and among CRM vendors inevitable?

Customers' desire to deal with fewer vendors.

One trend affecting the CRM software group is the desire of customers to deal with fewer, more stable vendors. This debate has gone on for decades in software and now the pendulum has swung back towards suites as opposed to best of breed, point solutions. This trend is prevalent across the entire enterprise software industry but exacerbated in the CRM space by the sheer number of public (and private) vendors that hit the market from late 1998 to the middle of 2000, each focused on a particular aspect of a broad addressable CRM market. In these troubled economic times, enterprise software contracts are being approved by the customer's chief financial officer. These CFOs oftentimes push to centralize supplier relationships around several stable vendors to simplify the procurement process when faced with scores of potential vendors. CFOs also take a hard look at the balance sheet of any vendor, particularly point solution vendors that may be more likely to go out of business before the term of the maintenance agreement is complete. All these factors make it harder for the point solution vendors to close new deals and survive long-term.

Early mergers and acquisitions around the move to suites trend can be best highlighted by KANA Software

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which is the result of the following mergers over the last several years: Broadbase, ServiceSoft (Balisoft/ Internet Business Advantage), Silknet (Insite Marketing Technology), Panop, Aperio, Decisionism and Rubric. In the face of immense challenges, KANA has done a good job of handling the technology, culture and marketing integration to enable the company to offer a variety of solutions across customer service and marketing initiatives.

Difficult operating environment and resulting balance sheet weakness.

While customer demand for fewer vendors is an important consideration, the main driver of consolidation is the difficult operating environment and the resulting weaker balance sheets.

We recently analyzed the business performance and balance sheet strength for public companies within and across enterprise software segments on which the Mirus Software Group focuses our efforts: Platform Value Chain (Adobe, Borland, Interwoven, BEA, Akamai, etc.); CRM (Seibel, PeopleSoft, E.piphany, Kana, etc.); Design Collaboration (PTC, Agile, etc.) Business Process Collaboration (Manugistics, i2, Ariba, etc.), eLearning (Saba, Digital Think, etc.), and Vertical Market Applications (Retek, JDA, etc.). The aggregated results support our theory that the CRM space will be one of the first enterprise software areas to consolidate (See Table 1).

CRM vendors tend to be the least developed from a revenue critical mass standpoint as evidenced by the average revenue over the last few quarters of \$15-18 million versus an overall average of \$66-\$73 million. CRM vendors also had the greatest percentage of revenue contraction over the last two quarters (17% versus the overall average of 10%). While not quite as bad as the Business Process Collaboration vendors in the last quarter, CRM is using \$8.7 million of cash to cover operating losses versus \$2.4 million for the broader Group. Finally, the average cash balance for a CRM vendor is \$69 million versus an overall average of \$162 million. The relatively stable cash position for CRM vendors (\$69 million to cover the recent quarter's \$8.7 million operating cash deficit) belies two factors: (1) the average hides many companies with less cash and greater operating losses and, (2) the sequential contraction in top-line revenue of 17% in the most recent quarters points to further losses or cost cutting

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Table 1: Mirus Software Segments Aggregated Operating and Balance Sheet Analysis

Company	Revenue			Operating CF		Cash
	Q2	Q3	Q/Q	Q2	Q3	ST. Inv.
	\$s	\$s	%	\$s	\$s	\$MM
<i>Mirus Select Enterprise Software Segments</i>						
eLearning	\$22.9	\$23.0	-2%	(\$1.3)	(\$3.5)	\$50
Vertical Market Apps	\$41.7	\$41.7	-2%	\$3.0	\$4.4	\$77
Design Automation	\$112.6	\$107.9	-8%	\$2.3	(\$2.3)	\$241
Platform Value Chain	\$71.1	\$66.4	-11%	\$3.9	\$2.0	\$220
Business Collaboration	\$88.2	\$66.0	-13%	(\$2.4)	(\$15.6)	\$266
CRM	\$18.1	\$15.1	-17%	(\$11.2)	(\$8.7)	\$69
<i>Aggregate</i>	\$73.1	\$65.7	-10%	(\$2.4)	(\$2.4)	\$162

1. These numbers are based upon the mean excluding the maximum and minimum values from each group.
2. CRM metrics exclude outlier values from Siebel, PeopleSoft, SAP and Oracle although all four have CRM product offerings.
3. Information based on actual company filings.

of infrastructure below the level of a sustainable public company.

Table 2 provides a detailed analysis of the specific CRM vendors' revenue, cash flow and balance sheet metrics aggregated in Table 1 (with the caveat that SAP, PeopleSoft, Siebel and Oracle were omitted from the averages in Table 1 given their broader software focus and "outlier" size).

The first issue to note is that this is hardly a "comparable company" analysis when looking at how little Oracle, PeopleSoft, SAP and Siebel have to do with the rest of the group from a financial perspective. That being said, all of these major vendors are actively pushing existing (Siebel) and more recently launched (Oracle, PeopleSoft, SAP) CRM product suites. Beyond these major companies, it is clearly a mixed bag of situations with an overriding negative tone across the group (Chordiant being an exception with 11% sequential growth).

High cost of capital

Even companies that are relatively well positioned from a breadth of product standpoint have faced financial challenges. For example, KANA's revenues declined 21% sequentially and cash flow from operations was a \$27.6 million deficit coupled with a cash balance at the

end of the quarter of \$52 million. The company addressed these balance sheet challenges recently by securing up to \$55 million through a straight equity private placement as well as a convertible note provided by Technology Crossover Ventures (TCV). The TCV convertible note is illustrative of the "cost of capital" for many small to mid-cap software companies with many features in the financing (liquidation preferences, warrant coverage, etc.) crossing over from private company financings.

Other public company boards and management teams should take pause from the KANA financing given that KANA has a fairly robust product offering (as noted) and is generally considered a higher quality CRM vendor relative to the broader CRM group. KANA shares have traded recently around \$15.00 (on a 10 for 1 split adjusted basis). Given the terms of the financing (source: KANA Software 8-K, November 2001), if KANA were to be acquired the acquisition price per share would have to be \$50.00 or above to keep the TCV liquidation preference from activating and reducing the transaction value available to common shareholders.

Other public CRM vendors requiring capital may face even tougher terms when exploring PIPE alternatives. If so, the management team and board of these vendors will have to exercise prudence in their fiduciary responsibilities to the common shareholders who only

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Table 2: CRM Comparable Company Operating and Balance Sheet Analysis

Company	Revenue			Operating CF		Cash
	Q2	Q3	Q/Q	Q2	Q3	ST. Inv.
	\$s	\$s	%	\$s	\$s	\$MM
<i>CRM</i>						
Oracle Corporation	\$3,264	\$2,242	-31%	\$1,436.2	\$1,263.6	\$6,051
SAP	\$1,498.0	\$1,421	-5%	NA	NA	\$1,048
PeopleSoft, Inc.	\$532.7	\$509.4	-4%	\$152.3	\$122.5	\$1,421
Siebel Systems, Inc.	\$549.7	\$428.5	-22%	\$156.7	\$79.3	\$1,548
Peregrine Systems Inc.	\$172.0	\$175.0	2%	(\$38.5)	(\$30.6)	\$220
DoubleClick, Inc.	\$101.9	\$92.7	-9%	(\$9.0)	(\$10.2)	\$565
E.piphany, Inc.	\$31.1	\$28.5	-8%	(\$18.2)	(\$10.3)	\$338
Onyx Software Corp.	\$28.9	\$20.7	-28%	(\$5.3)	(\$7.0)	\$18
Chordiant Software, Inc.	\$18.5	\$20.5	11%	(\$13.4)	(\$6.3)	\$56
KANA Software, Inc.	\$22.1	\$17.4	-21%	(\$35.0)	(\$27.6)	\$52
Pivotal Corporation	\$22.1	\$16.0	-28%	(\$3.2)	(\$9.5)	\$58
Blue Martini Software, Inc.	\$15.6	\$11.3	-28%	(\$12.6)	(\$10.9)	\$105
Selectica, Inc.	\$14.1	\$9.7	-32%	(\$5.0)	(\$3.5)	\$106
Exchange Applications	\$10.8	\$9.1	-16%	(\$7.4)	(\$11.6)	\$14
FirePond, Inc.	\$10.1	\$9.1	-10%	(\$16.7)	NA	\$50
Engage Technologies, Inc.	\$12.6	\$9.1	-28%	(\$19.6)	\$27.1	\$33
eGain Communications	\$14.3	\$8.0	-44%	(\$13.4)	(\$11.8)	\$30
Primus Knowledge Solutions	\$6.5	\$4.7	-27%	(\$3.5)	(\$7.0)	\$23
Delano Technology Corp.	\$3.0	\$4.0	30%	(\$14.8)	(\$8.1)	\$12
Accrue Software, Inc.	\$3.6	\$3.8	5%	(\$2.6)	(\$5.1)	\$7
Net Genesis Corporation	\$4.3	\$3.0	-30%	(\$6.1)	(\$7.1)	\$31
Net Perceptions, Inc.	\$2.4	\$2.2	-9%	(\$6.0)	(\$5.0)	\$76
Serviceware Technologies	\$3.3	\$2.1	-36%	(\$8.8)	(\$5.3)	\$4
LivePerson, Inc.	\$1.9	\$1.7	-9%	(\$3.2)	(\$1.9)	\$12
Total without Oracle, PeopleSoft, SAP and Siebel:						
Mean:	\$25.0	\$22.4	-16%	(\$12.1)	(\$8.0)	\$91
Median:	\$13.4	\$9.1	-19%	(\$8.9)	(\$7.1)	\$42
Mean excl. Max & Min.:	\$18	\$15	-17%	(\$11.2)	(\$8.7)	\$69
<i>NOTE: Information based on actual company filings.</i>						

ask, "Will I be better or worse off on a per share basis?" The board and management team will have to exercise their judgment when thinking through the probability that the future common share price will exceed the liquidation preference after a potential financing, particularly if there are logical merger partners that could offer the common shareholders an immediate premium and potentially stronger share appreciation should the shareholder choose not to sell after the deal is announced and/or closed.

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Lack of institutional investor interest

A rule of thumb for institutional portfolio managers ("PM's") is that they typically hold 100 positions in a given fund. PM's may follow another 100-300 companies to either keep up with competitive issues relative to their portfolio companies or identify new investment opportunities. As smart and hard working as PM's may be, it is not easy to

Table 3: CRM Comparable Company Analysis

Company	14-DEC									
	14-Dec	Avg. Daily	52 Week		Shares	Market	Revenue (E)		Market Cap./Rev.	
	Close	Liquidity	High	Low	Out.	Cap.	2001E	2002E	2001E	2002E
	\$s	\$K	\$s	\$s	MM	\$MM	\$MM	\$MM	X	x
<i>CRM</i>										
Oracle Corporation	\$14.57	\$318,945	\$35.0	\$10.2	5,560	\$81,009	\$12,000	\$13,600	6.8	6.0
SAP AG	\$32.30	\$16,429	\$49.1	\$21.3	1,260	\$40,698	NA	NA	NA	NA
PeopleSoft, Inc.	\$38.50	\$181,727	\$53.9	\$15.8	303	\$11,662	\$2,100	\$2,400	5.6	4.9
Siebel Systems, Inc.	\$24.51	\$203,496	\$104.3	\$12.2	462	\$11,333	\$2,400	\$3,100	4.7	3.7
Peregrine Systems	\$15.92	\$36,586	\$33.6	\$11.3	191	\$3,047	\$794	\$1,100	3.8	2.8
DoubleClick, Inc.	\$11.43	\$12,722	\$18.3	\$5.2	134	\$1,529	\$444	\$537	3.4	2.8
E.piphany, Inc.	\$8.68	\$4,141	\$65.3	\$3.4	71	\$613	\$166	\$266	3.7	2.3
Kana Software, Inc.	\$14.10	\$21,312	\$18.4	\$0.4	18	\$257	\$155	\$206	1.7	1.2
Chordiant Software	\$6.20	\$1,320	\$5.4	\$1.5	53	\$329	\$75	\$104	4.4	3.2
Onyx Software Corp.	\$3.45	\$380	\$17.3	\$1.5	43	\$149	\$128	\$175	1.2	0.9
Selectica, Inc.	\$4.95	\$368	\$25.8	\$2.0	35	\$173	\$66	\$97	2.6	1.8
Blue Martini Software	\$2.20	\$395	\$29.3	\$0.7	68	\$150	\$83	\$158	1.8	1.0
Pivotal Corporation	\$5.20	\$306	\$51.0	\$2.4	24	\$125	\$154	\$205	0.8	0.6
eGain Comm.	\$1.52	\$61	\$6.5	\$0.9	36	\$55	NA	NA	NA	NA
Engage Technologies	\$0.47	\$105	\$3.5	\$0.2	197	\$92	\$102	NA	0.9	NA
Net Genesis Corp.	\$1.68	\$73	\$4.3	\$0.3	24	\$40	\$19	\$29	2.1	1.4
Net Perceptions, Inc.	\$1.70	\$104	\$3.8	\$0.9	27	\$46	\$14	NA	3.3	NA
FirePond, Inc.	\$0.80	\$52	\$10.1	\$0.4	39	\$31	\$78	NA	0.4	NA
Delano Technology	\$0.93	\$112	\$10.0	\$0.1	38	\$35	NA	NA	NA	NA
Primus Knowledge	\$0.84	\$33	\$10.0	\$0.6	19	\$16	\$52	\$63	0.3	0.3
LivePerson, Inc.	\$0.30	\$27	\$1.8	\$0.1	34	\$10	\$9	\$15	1.1	0.7
Accrue Software, Inc.	\$0.41	\$24	\$3.1	\$0.1	30	\$12	NA	NA	NA	NA
Exchange Apps.	\$0.24	\$22	\$4.5	\$0.1	34	\$8	\$68	\$91	0.1	0.1
Serviceware Tech.	\$0.29	\$4	\$4.9	\$0.1	25	\$7	NA	NA	NA	NA

Average Daily Liquidity = the closing price * the 90 day average trading volumes in shares

Notes:	Mean:	\$6,309	\$995	\$1,384	2.6	2.1
LTM - Latest 12 months	Med.:	\$137	\$102	\$190	2.1	1.6
CY - Calendar Year	Mean exc. Max & Min.:	\$3,201	\$406	\$609	2.5	2.0

NA - Not Available

NMF - Not Meaningful

Company information based on actual company filings. Revenue estimates are based on First Call Consensus Estimates.
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on 100 names and keep up with an equal or greater number of other stocks. In addition, once the PM has put in the work to pull the trigger on buying a stock, the PM will want to be sure that they can take a meaningful position in that stock to affect the overall portfolio performance. The definition of "meaningful position" has changed with the rapid growth of 401k plans and other capital feeding into the institutional money management system, but \$10 million could be used for sake of argument with growth oriented funds. Eleven of the 24 companies in our CRM control group have market capitalizations under \$100 million. A \$10 million investment by a PM would represent over 10% equity ownership in that company leading to regulatory issues/filings that some money management firms are hesitant to trigger. More importantly, PM's are restricted in their ability to invest in small and micro-cap stocks because of the lack of trading liquidity for the stock (as measured by the average daily number of shares traded in a given stock multiplied by the share price of the stock). As seen in Table 3, many CRM stocks trade at or below \$1.00 with average daily volumes around 300,000 shares which means that on average about \$300,000 worth of stock trades on a daily basis. A PM with limited bandwidth would find it close to impossible to take a meaningful position in a CRM stock at this point because the PM would end up driving up the price of that stock because of the lack of trading liquidity. These bandwidth and liquidity issues are on top of the fact that many PM's are still smarting from their initial CRM positions collapsing over the last two years. All these factors add up to make it extremely difficult for stocks trading under \$10.00 and especially under \$1.00 to recover in the market.

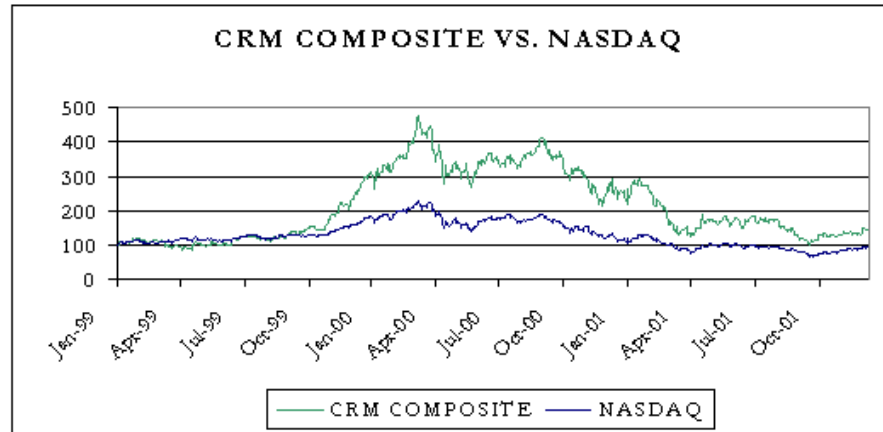
Why has the dance been delayed so long?

Capital market and operating volatility.

So if it is so readily apparent that the CRM space (and even the broader enterprise software group) is ripe for consolidation how come we have not read about a wave of mergers in the space? Mergers represent many opportunities for corporate development but also many risks: political, economic, industry, financial, technological, and cultural risks of integration. Signing a definitive merger agreement requires the explicit

approval of a majority of the board of directors (oftentimes, including senior management) as well as the sponsorship of the senior management team. For sake of argument, ten to fifteen board members/senior managers *from both companies* have to sign-off, explicitly or implicitly, for a deal to be consummated.

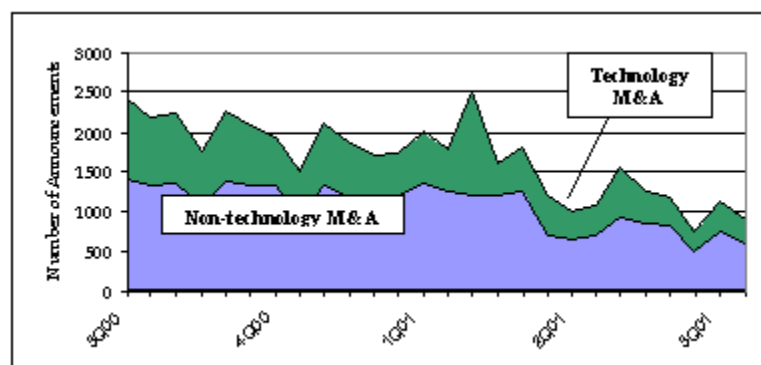
Chart 1: Jan 99 to Date CRM Composite versus NASDAQ



This means that 15-30 individuals have to agree that the potential benefits of the merger outweigh the combined above-referenced risks of integrating the two companies. It was far easier to come to that kind of consensus in 1998 and 1999 when the world was safer, the economy was booming, software license revenue growth was unprecedented and stock prices were soaring. The higher stock currency resulted in the ability to pay up for acquisitions, which made the acquisition target's board, senior management team and shareholders all pretty happy.

Turn the page to 2000 and 2001 and the world is not as safe as it used to be, the economy is in a recession, software revenues are contracting sequentially and share prices are at 5-15% of their highs. While the NASDAQ has experienced an unprecedented boom and bust, it is overshadowed by the boom and bust of CRM

Chart 2: (Merger stat) overall M&A transactions



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stocks as seen in Chart 1.

Even worse, all these issues have been in a constant state of flux since March 2000. The number one hindrance to rational consolidation activity is volatility. We have been in one of the longest periods of economic, technological and capital market volatility over the last 20 years and the lack of acquisition activity reflects it.

Table 4: CRM Precedent Transactions to Date

Target Name	Acquirer Name	Date Announced	Transaction Value		
Target LTM Revenue	Transaction Value/LTM Revenue				
Torrent Systems, Inc.	Ascential Software Corporation	11/28/01	\$46	NA	NA
NetGenesis Corporation	SPSS, Inc.	10/29/01	\$45	\$20	2.3
Brightware, Inc.	FirePond, Inc.	01/30/01	\$18	\$9	1.9
OnLink Technologies, Inc.	Siebel Systems, Inc.	08/07/00	\$609	\$6	101.5
Interface Systems, Inc.	Tumbleweed Communications Corp.	06/29/00	\$62	\$14	4.4
MediaBridge Technologies, Inc.	Engage Technologies, Inc.	06/12/00	\$268	\$18	14.9
Baan Company, N.V.	Invensys, Plc.	05/31/00	\$708	\$565	1.3
Simba Digital Conversations	Pivotal Corporation	05/31/00	\$12	NA	NA
Simpli.com, Inc.	NetZero, Inc.	05/25/00	\$23	NA	NA
Inference Corporation	eGain Communications Corp.	03/16/00	\$79	\$23	3.4
Exactis.com, Inc.	24/7 Media, Inc.	02/29/00	\$490	\$11	44.5
Mustang.com, Inc.	Quintus Corporation	02/28/00	\$290	\$4	72.5
Silknet Software, Inc.	Kana Communications, Inc.	02/07/00	\$4,200	\$22	190.9
Clarify, Inc.	Nortel Networks Corporation	10/18/99	\$2,100	\$200	10.5
Vantive Corporation	PeopleSoft, Inc.	10/11/99	\$433	\$184	2.4
Genesys Telecom Lab, Inc.	Alcatel Alsthom S.A.	09/28/99	\$1,500	\$156	9.6
WebLine Communications	Cisco Systems, Inc.	09/22/99	\$325	\$5	65.0
Acuity Corporation	Quintus Corporation	09/13/99	\$73	\$4	18.3
Periphonics Corporation	Nortel Networks Corporation	08/24/99	\$436	\$142	3.1
Forte Software, Inc.	Sun Microsystems, Inc.	08/23/99	\$540	\$84	6.4
IEX Corporation	TEKELEC	04/20/99	\$163	\$49	3.3
GeoTel Communications	Cisco Systems, Inc.	04/13/99	\$2,000	\$55	36.4
Mosaix, Inc.	Lucent Technologies, Inc.	04/05/99	\$145	\$112	1.3
Advanced Solutions, Inc.	Keane, Inc.	03/03/99	NA	NA	NA
Scopus Technology, Inc.	Siebel Systems, Inc.	03/02/98	\$460	\$93	4.9

Notes:

LTM - Latest Twelve Months	Mean:	\$626	\$85	28.5
NA - Not Available	Median:	\$308	\$23	6.4
NMF - Not Meaningful	Mean Excl. Min. & Max:	\$491	\$64	21.4

TV = Transaction Value

LTM Revenues are NA for all those companies that were private upon being acquired.

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So in the face of this volatility and uncertainty attacking the necessary consensus among the 15-30 people on both sides that have to sign off on an M&A transaction why do we believe that consolidation in enterprise software and the CRM segment is imminent? In the end, we believe that the continued operating difficulties coupled with weakening balance sheets will create increasing pressures on directors and management teams when faced with extremely painful financing options. The trigger, however, will be one of the major vendors acquiring a mid-tier but quality vendor (E.piphany, KANA, Selectica, etc.), thereby creating pressure on everyone else to find a partner before all the quality companies are gone. Again, we believe there will only be 5-7 meaningful CRM vendors in the space at the end of 2002 and CRM is likely to be just one of the applications on which those 5-7 vendors focus.

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