

THE VALUATION CLOCK IS TICKING DOWN FOR SMALLER SOFTWARE COMPANIES

OEM Capital believes that the longer term profit outlook for smaller software companies is negative as a result of a 'good enough' attitude among end users, too many alternative solutions and Microsoft's very serious strategic thrust to provide 'solutions out of the box' to selected vertical markets reminiscent of their highly successful Office marketing campaign. We would like to expand on the reasons for our view of the industry outlook as well as to urge smaller software companies that wish to maximize shareholder value to execute sooner rather than later an exit strategy.

In a recent *New York Times* article assessing 2004 prospects for the software industry, the newspaper categorically stated that the trend in the software industry is towards consolidation. Software companies are buying technology and customers for the same reasons more traditional media publishers have always been buying customer lists and creative staff, all the while eliminating overhead to grow profits.

Small software companies have been particularly active on the merger front, a trend that is expected to continue. The newspaper reported that in 2003, the software

industry averaged 250 transactions per quarter, with half of those worth under US\$13 million. This is up 25% from the previous year. A big driver behind the merger activity is the hesitancy of customers to buy software from small firms because so many have gone out of business in the past three years. Furthermore, smaller firms cannot satisfy the growing need of end users for support covering multiple office locations in different parts of the country or the world.

In November 2002, *Forbes* magazine was one of the first to put out very discouraging news for software companies. In an article titled "The Undead", the magazine stated that two years into the biggest bust in high technology history, an estimated 10,000 public and private software firms were still doing business, with approximately 5% of these public companies. And, half of these public companies were unprofitable, but sitting on a pile of cash raised in initial public offerings during the boom years that could fund their cash eating operations for years.

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COMMENTARY

If the venture capital funding of US\$47 billion into software startups during the boom years were not enough to cause an over supply, we also have Microsoft Corporation moving to become a 'solutions out of a box' supplier. It will now be competing head on with many software firms that have stressed vertical markets, particularly as related to financial and supply chain software. Such a strategy was first signaled in Microsoft's purchase of Great Plains Software in the US and Navision in Europe a couple of years ago.

With these ominous trends, what can a smaller software company do to extract maximum shareholder value? For a short answer, *don't wait too long to sell*. We are currently in a valuation upturn due to recent stock market advances. *Take advantage of it*. US currency depreciation relative to many foreign currencies has been severe. For instance, since the fourth quarter of 2002, the euro has moved from parity with the US dollar to a 25% premium. *Take advantage of it*. The consequences of waiting could be disastrous. Imagine a situation where your firm's most likely acquirers have already been acquired and your firm is too small to attract the remaining companies to pay anything resembling a premium price.

Aside from a need to move quickly to secure a sale or merger partner, it is important to remember that your firm is most valuable to a larger company that does not offer similar products, is comfortable servicing your client base and is enticed by the recurring subscription revenues from your installed customer base. *This means that acquirers must be carefully identified, sought out and sold on acquiring your firm*.

Selling a software company is very different from selling most other types of companies. Value is not intrinsic to the cash flow of the business itself, but has a much higher value to the acquirer. Therefore, finding 'the hand that fits the glove' is a carefully nurtured process and is not done by discretely posting a 'for sale' sign and conducting discussions

among those parties where some interest has been solicited. Most importantly, potential acquirers need to be approached on a global basis by knowledgeable professionals.



Ronald J. Klammer is a managing director and president of OEM Capital Corp. (DE). In 1985 he co-founded its predecessor firm, a New York partnership, where he led its technology practice. He has over 35 years of experience in all aspects of the electronics industry.

Previously, Mr. Klammer was a corporate vice president of Gulton Industries, Inc., a diversified NYSE electronics company, where he was responsible for initiating and closing the acquisition and divestiture of six businesses and returning four divisions to profitable growth. Prior to this, Mr. Klammer was vice president of Cross River Products, Inc., a venture-capital-backed manufacturer of consumer products. Earlier, he held various management and technical positions with General Electric's Missile and Space Business Group with a specialty in communication, control and computer systems.

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OEM Capital specializes in the sale or divestiture of electronics, communications and computer related companies. The firm also helps to secure capital to complete an acquisition or to refinance a company with minimum dilution to existing shareholders.

Since 1985, the firm has initiated and completed numerous transactions for New York Stock Exchange listed, American Stock Exchange listed, NASDAQ listed, and a variety of over-the-counter and privately held companies located throughout the United States. Typically, the companies, subsidiaries or divisions we are asked to help have annual revenues between US\$10 and 50 million. Where we have been financial advisors in the sale of a division or subsidiary, some of our clients have had annual revenues in excess of US\$2 billion.

The firm has been able to realize exceptional results because its senior staff is comprised of professionals who have had extensive prior experience as operating executives in the industry and continue to maintain extensive contacts throughout the world.

Our clients have included companies engaged in a wide variety of areas including software publishing and services, computers and peripherals, microwave and rf components, communication equipment, instrumentation, defense electronics, electronic materials, entertainment electronics, electronic and electromechanical components, electrical motors, power supplies, and product distribution and servicing.

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