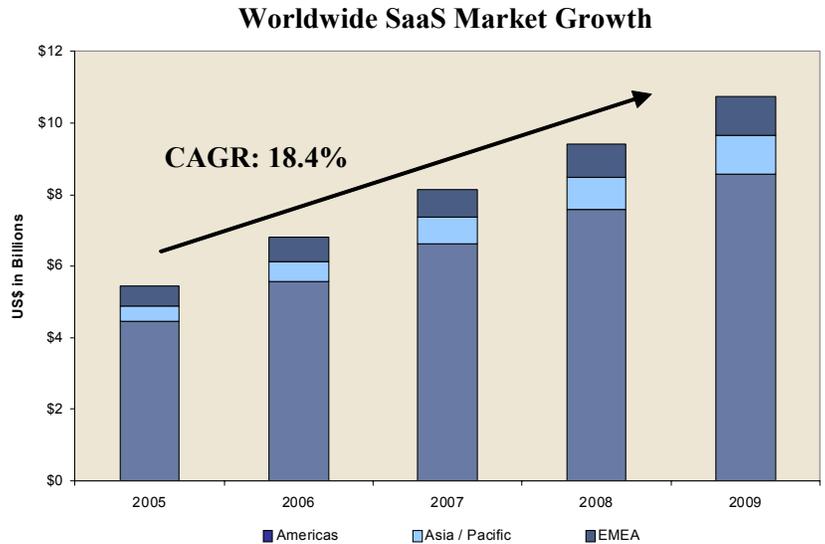




Software as a Service: Putting the Desktop Under Siege

The software-as-a-service (“SaaS”) delivery model is a revolutionary application of technology with the potential to drive change throughout the entire software world. The market for these hosted or “on demand” solutions is growing at an amazing rate - IDC estimates that spending on SaaS applications will grow at a CAGR of 18.4% over the next four years, from \$5.5 billion in spending in 2005 to \$10.7 billion in 2009 (see chart). The reason that this growth trend is particularly exciting is the broad-reaching impact of the technology – not only does SaaS offer an enticing ROI to customers and a differentiated offering for innovative vendors, but it is also creating unique opportunities for partner firms, both in complementary software development and in consulting services. Furthermore, on demand solutions are threatening to erode the market positions of the leading enterprise software giants that are struggling with the transition to a radical new sales and delivery model. The SaaS model is a truly disruptive utilization of technology that will touch upon nearly every facet of the information technology industry over the next few years.



Industry Professionals Interviewed in the Creation of this Piece:

Sean Rollings, Director of Product Marketing – NetSuite
 David Havlek, Vice President, Investor Relations – salesforce.com
 Mark Flessel, Vice President of Business Development – SugarCRM
 Chris Harrick, Senior Manager of Product Marketing – SugarCRM

Growth in the SaaS market is being driven by several factors. Initially, market acceptance was driven by a combination of the customers’ need to address specific business process pain points with a software solution that provided a low total cost of ownership; vendor desire for a differentiated offering and predictable revenue streams; and enabling improvements in technology infrastructure (as depicted on the following page). These are the factors that the industry has traditionally accepted as the genesis of the SaaS model. More recently, however, SaaS has started to gain real traction as a result of vendors’ ability to confidently address the major obstacles that reluctant

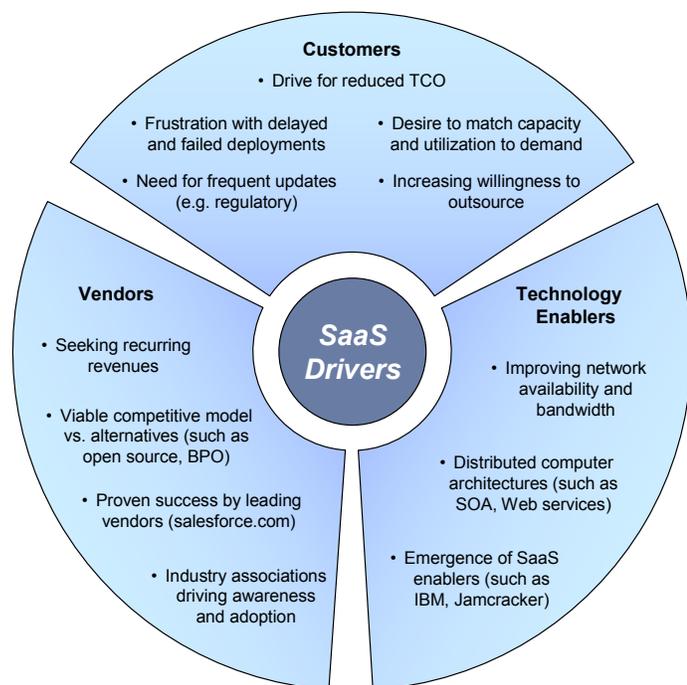
Also in this edition of the Industry Spotlight: A Dynamic Opportunity for Strategic Partners

The potential to capitalize on the proliferation of the SaaS delivery model is not limited to innovative software vendors. Agile services providers are differentiating themselves through shared software development efforts and well-developed deployment methodologies... *continued on page eight*

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potential customers have encountered in evaluating on demand software solutions. Leading SaaS vendors have convinced customers that their hosted solutions provide levels of security, availability, integration and customization that will meet or exceed the needs of end users (see inset box on following page).

SaaS Market Drivers



While the overall market has gradually grown to overcome these hurdles and accept the viability of SaaS, there are certain customer groups that are unlikely to be persuaded to utilize the on demand delivery model. For potential customers that require an incredibly high level of control over their systems, such as companies strictly adhering to Six Sigma process guidelines, outsourced services and solutions are a difficult sales proposition. Certain federal government departments are also unlikely customers due to security requirements that rule out hosted data sources. We believe that the majority of business customers, however, have the potential to utilize SaaS solutions throughout various aspects of their organizations.

It is also interesting to note that different vendors have found different ways to help customers overcome their adoption issues. SugarCRM is of the belief that after a certain threshold, CRM deployments are best satisfied with on premise software implementations. The Company deploys its software in a Web-native,

multi-tenant basis for small customers, but installs the software in a traditional on premise manner for mid-sized customers in order to best meet integration, customization and corporate policy needs. Salesforce.com, on the other hand, greatly values and emphasizes the flexibility of its on demand offering. Through its own templates and through opening up shared development opportunities with customers and partners, the company has successfully met the needs of all customers, including large enterprises, with its hosted application.

As these concerns have been addressed, spending on SaaS solutions has grown by leaps and bounds, beginning to penetrate a market that offers plenty of room for additional growth moving forward. In the applications where SaaS has gained the most traction to date, CRM and sales force automation, the pool of potential customers is vastly under-penetrated. Research firms estimate that only 50% to 75% of the addressable market in the U.S. is currently using true CRM solutions and that many potential customers have been unable to come to terms with the technology's cost and complexity. Vendors and systems integrators have found that in the SMB market, new on demand CRM deployments are often replacing Goldmine, ACT or nothing at all. On demand CRM has been a missionary sale to these small and mid-sized businesses that once were not ready to handle an enterprise software purchase but can come to terms with the low upfront costs and easy-to-manage nature of an on demand solution.

continued on page four



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Acceptance of the SaaS Delivery Model, with Regard to:

Security and Availability

Initial Reluctance- Traditionally, customers have been very sensitive to data security and availability concerns – particularly with CRM solutions, which have been one of the most popular on demand application genres. Reluctant purchasers have felt that they would prefer to keep their customer data in-house due to their need to closely control this information. Customers also have minimal tolerance for downtime, given the potential impact on revenue generation.

Creating Acceptance- In reality, the hosted application model lends itself to very high levels of security and availability. SaaS vendors have created incredibly strong IT infrastructures that individual customers cannot afford to build and maintain on their own. As a provider of multi-tenant solutions, SaaS vendors can operate one strong and secure IT infrastructure much more efficiently than, for example, ten separate potential customers could allocate resources to build and maintain ten separate IT infrastructures. Accordingly, established SaaS vendors have security and uptime dependability that even large enterprises cannot match. Many customers have toured the facilities of leading solution providers like salesforce.com, reviewed the security measures in place and left fully assured that their sensitive customer data is in safe hands. To reinforce this, salesforce.com has never had a security breach, and NetSuite has never violated its service agreement of providing 99.5% uptime.

Integration

Initial Reluctance- On demand solutions are typically adopted to address specific points of pain for a customer. Even if a hosted solution can successfully cater to a particular customer need better than other available options, it must be able to exchange data seamlessly with a customer's other in-house legacy systems in order to be effective. Customers see complexity in asking a single multi-tenant application to integrate with the varied in-house systems of hundreds of different customers.

Creating Acceptance- Over the last few years, SaaS vendors have gotten better and better at integrating their hosted applications with customer systems. Currently available hosted applications have been designed to speak easily with SAP, Oracle, Microsoft and other leading enterprise platforms. This has been facilitated by shared development efforts with vendors like salesforce.com and SugarCRM. For example, salesforce.com has created AppExchange, a shared development community through which customers and partners have developed integration tools for common customer needs. SugarCRM also promotes shared development with customers and partners by writing 80% of its application in open source. By providing both partners and customers with the ability to augment available solutions and sharing development efforts, integration concerns can be conquered soon after they are recognized.

Customization

Initial Reluctance- Traditionally, leading enterprise software packages have been developed either horizontally or with a broad vertical focus that does not reach the needs of a particular industry niche directly out of the box (i.e. developed for financial services, but not specifically for wealth management or investment banking). These solutions are then customized to meet the needs of a particular customer. Given the nature of their structure, multi-tenant applications cannot open themselves completely to customers who want to deeply change aspects of an application.

Creating Acceptance- SaaS solutions have become increasingly customizable over the last few years via the development of user interfaces and templates that allow for customers to view and manipulate information in any manner they wish. These tools act as an additional level between the customer and the multi-tenant application, allowing end users to feel as though they are using their own personalized or branded solution. Additionally, these templates are maintained from version to version as on demand solutions are upgraded, removing the need for customization efforts to be duplicated.

Member of



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Growth is not limited to the small and mid-sized business market. SaaS solutions are beginning to gain traction with large enterprise customers, as well. Many enterprises have attempted to deploy Siebel or other leading enterprise solutions in the past, but have failed to generate adequate ROI from these investments and are interested in evaluating alternative options. The growth of SaaS in this market has been an educational process, both for customers and vendors alike. For enterprise customers, even more so than small and mid-sized businesses, the security, availability, integration and customization concerns that are detailed above are critical factors in a purchase decision. The enterprise customer also needs an educated services provider in order to successfully deploy these solutions, an issue that is described in greater detail later in this piece. Also, vendors have come to understand that it takes a different sales model to reach these enterprise customers. Salesforce.com has successfully begun to penetrate large clients by selling to business users at the department level, addressing particular points of pain in a company's CRM or sales force automation initiatives. Once the technology has been deployed successfully, other departments then have the opportunity to see the application work and the solution can grow via a "land and expand" strategy from business unit to business unit. As success is demonstrated throughout the organization, a vendor then has the potential to book larger sales at the CIO level.

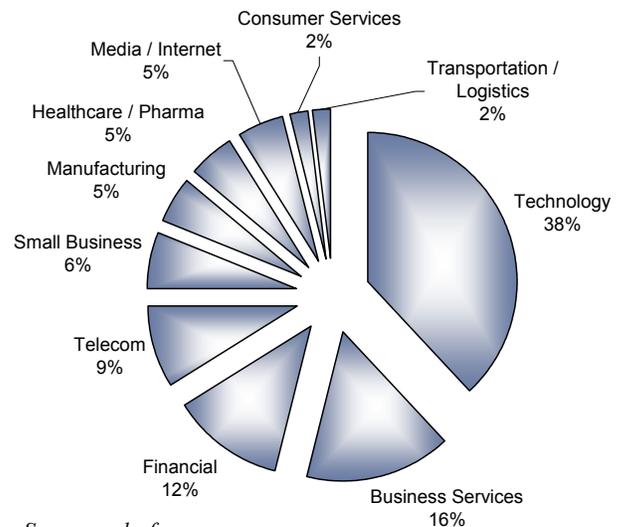
Salesforce.com has been the SaaS leader in penetrating the enterprise market. Recent wins with ADP, Cisco Systems, Merrill Lynch and Sprint (each with over 5,000 subscribers) have proven the viability of the SaaS model with large enterprises. Despite this success, the company understands that the small and mid-sized business is still the heart of its customer base. Salesforce.com's target business mix is 1/3 small businesses, 1/3 mid-sized and 1/3 enterprise, and the company has recently reorganized its sales leadership to reflect each size of customer. The company's customer base is also representative of the vertical markets which are conducive to using its hosted solutions (as depicted in the following chart).

Other leading vendors are not as focused on climbing the ladder to larger enterprise customers. NetSuite's sweet spot consists of deployments of 500 end users or smaller. For any larger customer wins that the company has found opportunistically, the company's solution becomes a hybrid of NetSuite tied to other systems. RightNow Technologies has a similar focus on small and mid-size customers. SugarCRM has found the majority of its success in the small business market with its innovative open-source solution.

The SaaS market will also be driven by the expansion of on demand solutions to include new applications and functionality. To date, on demand solutions have been the most popular in applications for CRM, sales force automation, supply chain automation and human capital management. Numerous other applications, however, are drawing a significant number of vendors that are competing for market share (as depicted on the following page).

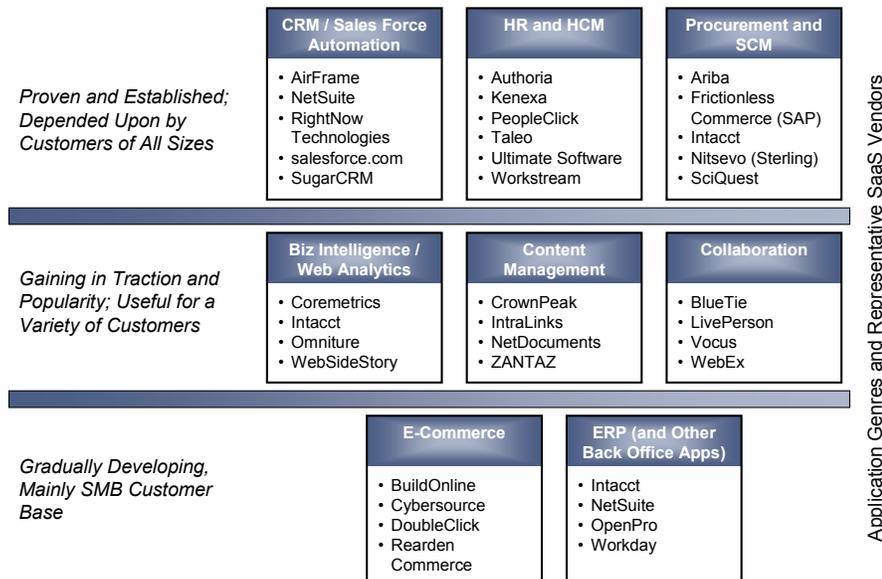
The SaaS model has the potential to touch upon nearly every solution within a business' application infrastructure. An increasing number of vendors have emerged in the SaaS landscape, providing solutions for business intelligence

salesforce.com Revenue Breakdown by Industry



Source: salesforce.com

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Source: BCF research

and analytics, content management, collaboration tools and niche applications for specific vertical markets. One area in particular that we believe is ripe for growth and development is on demand data services. Given the amount of customer data that is now hosted within the scope of on demand CRM solutions, applying on demand data management, data cleansing and complementary analytics and reporting to this data is a natural next step for application vendors to pursue. Vendors beginning to provide solutions in this area include Business Objects and Informatica.

NetSuite is unique to the SaaS model in its desire to host the entirety of a customer’s enterprise data and applications. The company is attempting to meet all of a customer’s software needs with a single suite of end-to-end on demand solutions. The scope of the company’s on demand offering is broad, capable of acting as the foundation ERP platform of a mid-sized business. NetSuite has spent a significant amount of time creating its Web-native application that is capable of handling all of the responsibilities of back-office ERP programs, and the result is a flexible and modular hosted enterprise solution that it easily scalable due to the company’s ability to host the majority of a customer’s IT infrastructure and leverage a single data repository. This business model has limited potential to penetrate enterprise customers, however, due to the number of deeply embedded in-house systems that would need to be replaced.

Salesforce.com has plans to expand into new areas of functionality, which brings to light the real growth opportunity of the previously mentioned shared development platform, AppExchange. The company currently has over 400 applications available on its shared development platform. Utilizing AppExchange, customers and partners have realized needs for solutions to complement their existing salesforce.com deployment. They have created recruiting tools, project management tools and other applications that leverage salesforce.com’s existing application infrastructure. Furthermore, the company is developing an on demand programming language called “Apex”, a code that runs natively on the AppExchange server for maximum efficiency in creating on demand solutions. Salesforce.com has set the long-term goal of becoming an on demand “application hub”. The company is striving to make itself the “go-to” destination for on-demand software, just as Amazon.com is the go-to internet shopping experience.

SugarCRM has also positioned itself to benefit from the development efforts of its partner network. The company has provided 80% of its programming in open source and as it releases more and more of its functionality in open source, as described to us via interview, “the more the phone rings”. Accordingly, SugarCRM assuages the integration and customization concerns that a potential customer may have by allowing users to more tightly

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integrate with the product's programming. SugarCRM also claims that via its open source foundation, partner firms are more highly incentivized to tailor the company's solutions. While salesforce.com AppExchange partners are forced to develop new tools and templates within the context of the proprietary salesforce.com application infrastructure, the nature of SugarCRM's open source structure allows partners to build tools that could be utilized on a much wider basis and provide significantly more revenue-generating potential.

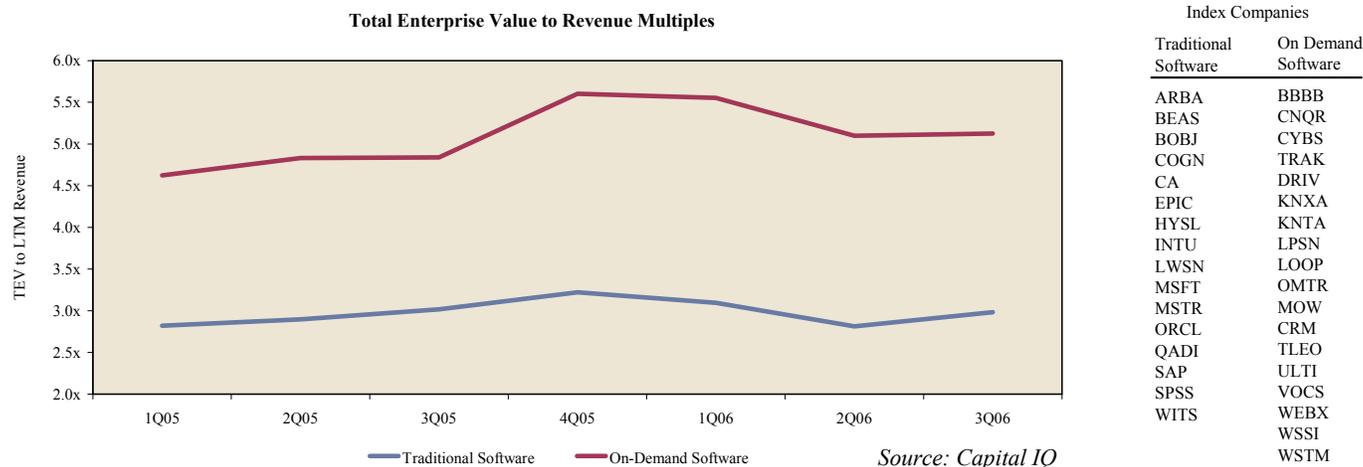
Despite these growth drivers, the leading enterprise software vendors are conspicuously absent from the SaaS competitive landscape. Most of these vendors have recently begun to release "hosted solutions", but they are vastly different from the multi-tenant, Web-native applications that leading SaaS vendors have created. The majority of systems sold by SAP, Oracle (Siebel) and Microsoft are single-tenant applications – essentially, these vendors will simply host their traditional enterprise software packages on their own server, off of the customer's premises. This delivery model does not provide many of the benefits of the SaaS model. From the customer's point of view, frequent version updates are not available and pricing is not likely to reflect the cost efficiencies of the multi-tenant model. From the vendor's point of view, the economies of scale of multi-tenancy are lost. The vendor is responsible for hosting and maintaining multiple versions of its own software, maintaining databases in dual locations, etc. These solutions are not yet truly competitive for customers evaluating SaaS, but their presence serves as validation that on demand solutions are a growing trend that needs to be addressed by all software vendors.

Additionally, it is not going to be easy for the traditional enterprise software leaders to successfully enter this market. As described by salesforce.com, "it is not a technology problem; it is a transition problem". First, these vendors do not have Web-native applications that lend themselves to multi-tenant usage. Trying to retrofit traditional applications to a hosted software model is a difficult task because existing offerings do not provide the same capability, flexibility and cost-efficiency via on demand delivery that Web-native, multi-tenant solutions provide. In an on demand environment, they lack the integration and customization capabilities necessary to create an advantageous solution for customers. Secondly, on demand solutions require a complete transformation away from a traditional software vendor's existing business model. These vendors are not ready to tell investors that the license revenues that were projected for this year will now be deferred across the course of multiple years going forward. They are also not ready to reinvent themselves to a Web-native model and abandon the desktop applications they have built their foundations on in years past – a desktop that salesforce.com claims is now "under siege".

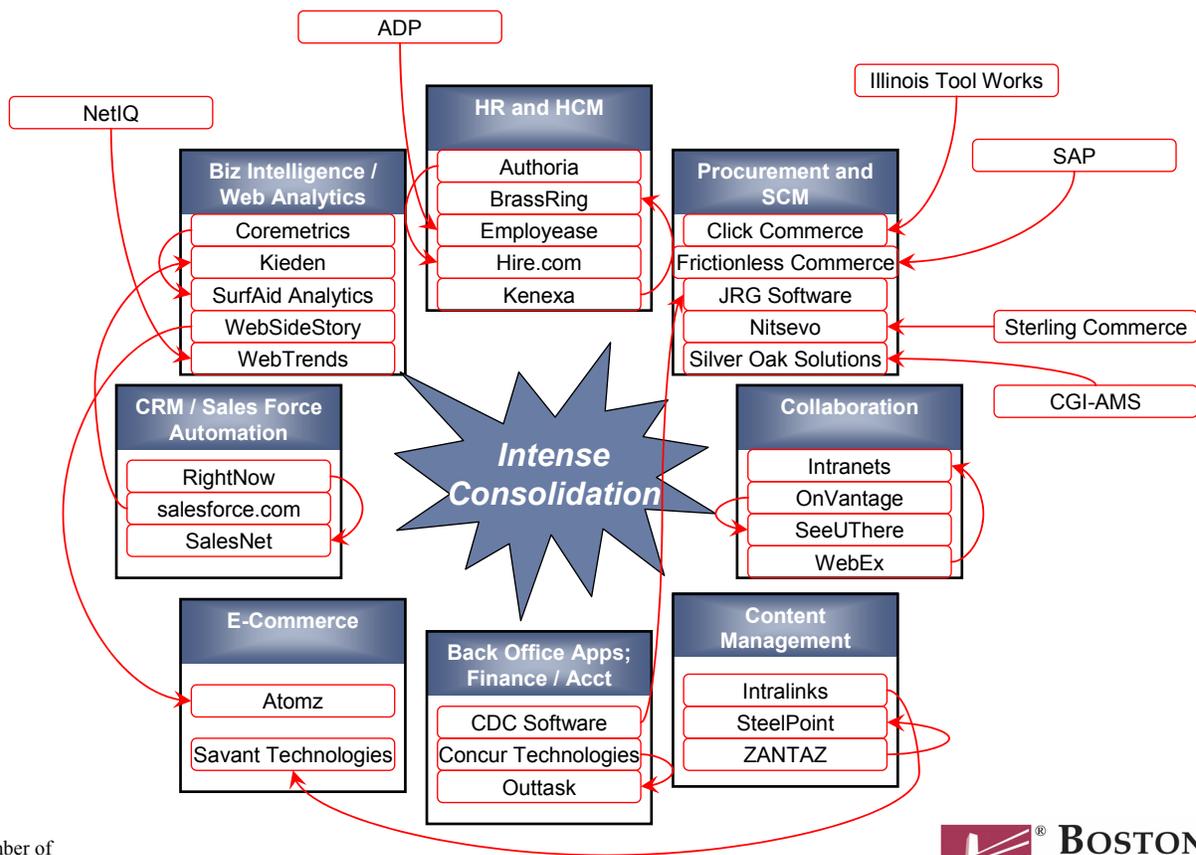
The previously identified growth factors, combined with the software industry leaders' relatively slow reaction to the SaaS movement, have created a strong value proposition for providers of on demand solutions. Public SaaS solution providers currently trade at multiples that vastly exceed those of traditional enterprise software providers, as portrayed in the chart below. The BCF Index of On Demand Software Providers currently trades at an average of more than 5x LTM revenue (as depicted on next page).

“It is not going to be easy for the traditional enterprise software leaders to successfully enter this market... it is not a technology problem; it is a transition problem”

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Furthermore, these SaaS vendors have become extremely attractive acquisition targets. We have observed an incredible amount of M&A activity among on demand solution providers within the last two years. This activity represents the desire of acquirors to take advantage of the vast growth and earnings potential of these innovative SaaS vendors, as well as the desire to round out existing on demand capabilities with more complete solution sets. Since the majority of on demand solutions were developed to address particular points of pain within a customer organization, most vendors are niche-focused and growth by acquisition represents an excellent way to add complementary functionality to existing applications.





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A Dynamic Opportunity for Strategic Partners

The growth in the SaaS market is also creating exciting opportunities for the strategic partners of these vendors. As already described, many of the leading SaaS vendors have created immense opportunities for partner firms to share in software development efforts. The need for integration and customization of on demand solutions is extremely important, and accordingly the tools being developed for plugging into necessary in-house systems and the templates being developed for different groups of end users both serve to improve the on demand offering as a whole while also creating revenue opportunities for development partners. Over 150 independent software vendors currently have applications listed on salesforce.com's AppExchange. SugarCRM also maintains relationships with over 150 development partners.

Another notable opportunity that has been created by the proliferation of SaaS is the need for knowledgeable services partners. "Ease of deployment" is a major component of the SaaS sales pitch, but successful user adoption of an on demand solution is by no means a given assumption. Although hosted multi-tenant solutions are available for use almost immediately after purchase and do not require the traditional six to nine months of planning that on premise software requires, a successful solution must meet the particular business needs of each individual customer and must be introduced in a manner that encourages end users to adopt the application as intended. This requires not only knowledge of the relevant on demand solution being provided, but also intimate knowledge of the customer's vertical market and the relevant business processes that are utilized in an organization. The integration of data from existing in-house systems to the hosted application platform is also crucial to an on demand solution's success, and services providers that are familiar with this process are extremely valuable. Especially within the enterprise market, a savvy services partner is required in order to complete a successful deployment. Without a team of consultants to adequately address business process needs, integrate data, train end users and facilitate acceptance, it is extremely challenging for an on demand solution to meet its ROI generation potential.

Only recently has the necessity of strong services partners become apparent to the SaaS marketplace. Of the on demand vendors we interviewed in making this piece, most admit that large system integrators have a learning curve to climb in order to properly assist with the deployment of SaaS applications. To date, the most successful services providers have been smaller, innovative, open-minded services companies with established vertical market focus areas. We believe that the large SIs who recognize the growing market opportunity for SaaS consulting and deployments will likely enter this market through acquisition, purchasing the technology expertise and vertical skill sets they need to compete.

In conclusion, we are very bullish on the prospects of the SaaS sector. We expect vendors to meet or exceed the aggressive expectations that have been set by the leading research analyst firms. The growth of this sector is going to drive significant change throughout the software industry, particularly with leading enterprise software players that will be forced to undergo some dramatic transformations in order to catch up to the growing capabilities and market share of SaaS competitors. We expect the M&A market to remain strong as consolidators gain scale and new skill sets via the acquisition of growing SaaS vendors, innovative development partners and uniquely skilled services partners. During the next few years, the actions of the players willing to take leadership positions in the SaaS market will shape the entire software industry landscape going forward.

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