2009 Outlook for Software Maintenance Revenues

MGI Analytical Team

The current downturn has given rise to numerous pieces of fundamentally good analysis on software company valuations that use software maintenance payments as a basis for valuing a business. Comments like "this company sells at only 2X or 3X its maintenance revenue stream" have popped up in numerous conversations with tech investors and sell side analysts. In fact, in better times, comments like these would send most investors to the trading desk. Software maintenance are the fees that software users pay to enterprise software providers to keep their products current, get enhancements, bug fixes and obtain all kinds of support. That is the theory.

In the real world, the actual maintenance arrangements are typically a lot more complex and involve numerous terms and conditions, price increase clauses and caps, differentiation between renewable and perpetual contracts and many more highly-legalese terms designed in some cases to protect the users and in others to insure that the enterprise software vendors do not go out of business. Part of the reality is also that many software vendors treat maintenance as a right to collect 15-20% of the current list price of their product every year and in advance but in return forget to actually provide many enhancements or quality support, but in good economic times users tend not to bother with this issue too much. Thus, most investors tend to feel that the maintenance payments are a safe bet, sort of

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The MGI Index ("Margin Growth Indicator" or "MGI-X") is a quantitative benchmark that identifies companies that are the most and least efficient managers of growth and profitability. Companies with bloated cost structures and inefficient business models tend to have low and declining MGI scores, while those that are constantly trimming the corporate "fat" and increasing their efficiency tend to have high and rising MGI scores.

The MGI Index answers the following key questions:

- How do companies compare vs. their peers?
- Which management team is the most or least efficient?
- How well do executives manage costs in both up and down cycles?
- Is management taking concrete steps to improve results?

MGI Index measures management's effectiveness across key operating areas of the business. MGI uses up to eight years of publicly available financial information derived from SEC filings and management reports. MGI Index models a company's performance and synthesizes short-term, mid-term and long-term operating results into an objective, uniform measure of corporate efficiency. MGI Index takes into account changes in key budget allocation areas such as research and development, sales, marketing, capital spending, general and administrative. The result is a single number – the MGI Index, a measure of corporate operating fitness.

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a high-margin economic “sacred cow” in technology.

Make no mistake, as analysts we are big fans of those fat recurring maintenance payments that users have little choice but to pay - especially for software products that benefit from a high degree of integration into the customer’s environment and are nearly impossible to replace without considerable business disruption.

The experience of the 2001-2002 tech downturn taught many lessons. One of the most important ones is that sacred cows like software maintenance can become hamburger meat if users feel enough of budget pressure. We believe that a similar scenario may unfold in the current economic cycle, especially if the recession lasts longer than the end of 2009. Thus, a valuation based on a multiple of software maintenance, particularly during the times of low or no growth needs to take a more conservative view towards software maintenance renewal rates. The data does not yet show that we have yet entered an environment in which IT users are aggressively slashing budgets with a chain saw – so far it has mostly been a “freeze for now and use a scalpel later” environment. However, the longer the recessionary mood, the more likely it is that maintenance payments will be slashed, re-negotiated, cancelled, re-negotiated again and otherwise reduced. Companies with perpetual software licensing models are particularly vulnerable to this risk factor. During 2002 we saw numerous examples of users calling vendors’ bluffs on maintenance and dropping support – which they claim was not worth much anyway. Some of the companies affected by such aggressive user negotiating are no longer with us, e.g. Manugistics. This can happen again and on a bigger scale, and smaller companies with low MGI Index (MGI-X) values are most likely to feel the pain first. SaaS companies are definitely less vulnerable to this specific risk factor for they tend to charge a monthly per seat fee. But they have their own issue: How do you grow the seat base when the client company is laying off 10% of its workforce. Reduced per seat pricing with advanced payment options covering 2-3 years was often the solution of choice to this dilemma in the past, but given the credit crunch it seems very unlikely as a way forward.

Companies Most Likely to Experience Downward Pressure on Maintenance Fees

Software vendors that have grown acquisitively during the past five years have a higher risk for

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maintenance fees coming under pressure. Top of the list are Oracle, IBM, and Sybase, among others. Many of the software vendors owned by private equity firms (i.e., Infor, JDA Software, Ventyx, and Lawson) have increased maintenance rates while cutting/offshoring customer support staff and investments. Software as a Service (SaaS) vendors and products dependent on headcount (e.g., HR tools like Callidus, and CRM products) will no doubt see maintenance renewal rates drop as companies cut headcount to bring expenses in line with falling revenues. Even software giant Microsoft is not immune. With volume licensing contracts renewable on a three-year cycle, fully one-third of the Microsoft installed base comes up for renegotiation every year. Given the number of companies choosing to not upgrade to Vista, it is conceivable that many corporate buyers will opt-out of paying the “Microsoft tax” for maintenance and support that goes unused, in the end.

Bottom Line: There are no sacred cows in technology. Users should be scrutinizing their maintenance and support costs, and aggressively stopping or renegotiating their maintenance bills. Vendors should prepare for this, and take pro-active steps to increase the value delivered to their installed base customers. Investors should be wary of software companies when maintenance renewal rates below 90% - a likely event for some software companies, and a clear warning sign of deteriorating corporate health.

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