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To: Forethought Directors

From: Bob Gaskins

Subject: **Forethought Future Business Strategy Considerations**

Choices of Strategy

In June of 1984—almost precisely three years ago—Forethought began its restart plan. This plan was in outline very simple:

(1) Immediately acquire marketing rights to software products developed by others, and use these products to build Forethought marketing, sales, and operations into a delivery vehicle for software, even though not immediately profitable;

(2) Meanwhile, and in parallel, begin to develop our own first product (PowerPoint) internally, consciously designing it for high profitability.

If everything worked out, we would, at the completion of the restart plan, have both a great product with the potential for high revenue and high profits, and also the delivery mechanism necessary to turn that product into actual sales, receipts, and earnings.

A fuller account of the restart plan and of how we executed it is found in a companion memorandum. For our purposes here, all that is important is that, although we suffered myriad problems along the way, we have now—finally— delivered what we said we would deliver under the restart plan of 1984. We have finished it.

What we did *not* have, in any detail, was a plan for what to do after that. Now, having reached the successful end of that plan, we must decide what our strategy is to be in the future.

About the only constraint we have is an effect of our long financing history. The restart has consumed about $4,000,000 and nearly 3 years. In addition, we have full responsibility for the first $2,000,000 and 18 months which were lost following Forethought's founding. We need a business plan now which is appropriate to an investment of about $6 million, over a period of 4 1/2 years. We owe to our shareholders a strategy which goes for maximum company value and liquidity in a minimum period of time.

I can think of two basic strategies which we might follow from here.

Choice One: Become a Second-Tier General Software Company

A first strategy would be to try to become a general software company, on the model of Microsoft, Lotus, or Ashton-Tate. This means we would try to have a stable of multiple products in different major applications categories (say, four to ten) with some degree of compatibility, which we would sell to general business customers.

(If we had any assumptions in the past, it was probably that we would eventually try to become this sort of company, if only because this was the goal of all software companies back in 1983. Since then many of these have gone out of business—Peachtree, Sorcim/IUS, et al.—but the aspiration lingers on.)

I say "second-tier" in this choice, because it is quite likely that there will not be another Microsoft, Lotus, or Ashton-Tate. Based on 1986 revenues, those three companies are all in the range of $200 million to $300 million. Well below them—at roughly one-tenth their size—are Micropro ($35 million), Electronic Arts ($30 million), Digital Research ($29 million), Activision ($26 million), Software Publishing ($25 million), Brøderbund ($25 million), and Epyx ($20 million). And even of these, at least as many are on the way down (start with MicroPro, Digital Research, and Activision) as are on the way up.

Closing that order of magnitude gap is very likely impossible. With the barely-possible exception of Apple's new software spinoff, no one else is likely to join the ranks of the largest general software companies.

There are formidible product development and marketing difficulties facing a second-tier general software company. To properly develop, support, and market four to ten major products is expensive. And to underline the difficulty, current companies of this sort have had a very difficult time making a profit.

The underlying difficulty with this strategy, I judge, is that there are, really, no benefits to customers from having a single publisher for multiple products. Where once we thought that a single vendor's line would provide uniformity of user interface and data exchange, we now see that those benefits will instead come from the environment standards (Macintosh, OS/2) so that products from multiple vendors will be uniformly compatible.

If each of those products comes from a vendor which has lavished full attention on it, then each of the competitors is apt to be better than the corresponding offering of the general software company. There would have to be dramatic economies from sharing technology or from sales and distribution efficiency, resulting in greater profitability, to offset the competitive limitations of a 'full-line' general software company strategy.

The story of Software Publishing Corp. in the last three years stands as a warning of just how difficult this course can be. It appeared that no one could have been better positioned than they were, even licensing some products to IBM for its Assistant series. Revenues were spread over a range of categories and machines (Apple][and IBM-PC). But as that whole generation of products became obsolescent, it seemed too difficult for SPC to be timely in updating it. SPC entirely missed the Macintosh, doubtless because it seemed wiser to maintain focus on moving all their products forward on IBM. Meanwhile, against each of their products, single competitors appeared who nibbled at their markets. In competing against all these, they were slow to develop products themselves in new categories. They acquired products in new categories developed by smaller competitiors (project management, desktop publishing), but these gained no particular advantage from being gathered under the SPC umbrella. Without a miracle of strategy, SPC will be going the way of MicroPro, with an aging product line and no distinctive competitive advantages.

For Forethought, a choice to follow this strategy would have some additional problems. Right now we have only one real product in our stable, PowerPoint. To become a second-tier general software company, we would need to develop or acquire at least three more.

FileMaker Plus, which we have sold under a publishing agreement, does not contribute to this strategy, because (a) we have such limited rights to it, and (b) what minor rights we have are accompanied by crippling royalty payments. There is no justification for continuing to invest in FileMaker Plus when its rate of return is so vastly inferior to any other opportunity. The only way to improve this situation would be to purchase all rights to the product from Nashoba, and to gain the services of its development team as employees on a continuing basis, relocated to California. Apart from the fact that these developments are unlikely, they would also be expensive. (See Appendix for a full discussion of FileMaker.)

It is sometimes suggested that a general software company could be formed to pursue only "new-generation" categories—by which is meant desktop publishing, presentations, and other categories of products which have emerged along with graphics. For Forethought, this restriction goes without saying—it is our fundamental premise. But this was presumed above, and does nothing to change the argument. These are precisely the categories which the top-tier and second-tier general software companies are now pursuing as well.

So I conclude that the attempt to build a general software company is not a desirable strategy. Recent history suggests that more leverage is available by focusing all our creativity and our management attention sharply on control of a single category—which brings us to the other alternative.

Choice Two: Become a Presentation Company

There is a second choice, and that is to focus on a single category of software and become the pre-eminent competitor in that category. For Forethought, obviously, our only present choice would be the category of Presentations—a new category which we have already shown to be a vast market, without entrenched competitors.

This has been the strategy of several successful companies, and in fact has created larger companies than the strategy of second-tier general software. Examples would be AutoDesk ($52 million) and WordPerfect (also $52 million), both of whom are twice as large as the secon-tier general application companies, and substantially more profitable. Other examples would include Adobe ($16 million), MicroRim ($15 million), and Aldus ($11 million). Note that these companies are by and large more recently-formed, and are on the upward path at the moment.

The case of Aldus is particularly interesting as a counterpoint to Software Publishing. With a single sharp focus Aldus was a leader in pushing its category onto multiple hardware bases, and growing with the category. It was timely in getting to Macintosh, then very agressive in setting standards and pioreering in the move to Microsoft Windows, which led to deals with H-P, DEC, Wang, and IBM. Althought its revenue for all last year was just $11 million, its revenue this year is running at $8 million for the first quarter. Its present public offering will value the company at a minimum of $120 million pre-IPO (maybe much more), and raise a minimum additional $30 million. Resources on that scale, combined with smart management, should retain Aldus's pre-eminent position in desktop publishing.

While Aldus has been turning a relatively small investment into a great deal of value for shareholders, Software Publishing has not. With a much larger investment over a much longer time, Software Publishing is currently valued at $116 million, or slightly less than Aldus. (This is a high-point for Software Publishing—in the last year its value has been down to one quarter of what it is now.) Software Publishing has been showing profits of about 12% of revenue, where Aldus has been doing more than twice that percentage profitability.

If Forethought were to adopt a similar strategy to Aldus's, then we would focus on Presentations alone. We would move heaven and earth to be the solution of choice on IBM's new machines. We would perhaps be more eager to move PowerPoint to other environments (Real-mode Windows, Sun, Apple IIgs, _). We would pursue arrangements with computer manufacturers and with AV presentation device manufacturers (like Aldus's deals with the computer manufacturers). We would flesh out a line of products, moving aggressively into higher-end 35mm and video, perhaps into more-professional high-end systems. We might even sell presentation-related hardware.

We could perhaps later identify adjacent categories, which would share base technology and share customers, and in which our first success would make us plausible contenders. (For example, Aldus could now plausibly target Presentations, based on its reputation in desktop publishing, although its customers would be more likely the professional producers of presentation materials than our content-originators.)

We would not kill FileMaker Plus outright, but we would restrict our future investment in it to the absolute minimum possible. Now that it has started to pay off our long investment in it, we would let its revenue smooth out our initial PowerPoint revenue pattern. Within a year we would have divested ourselves of it, and it would be history. In the meantime, we would be sure not to confuse our crisp PR message that Forethought is a presentations company with references to FileMaker. We would let FileMaker persist on its own strength. We would try to find some way to sell our limited marketing rights to someone more interested in FileMaker than we are.

Conclusion

My own conclusion, today, is that it is not a good idea for us to try to become a second-tier general software company, like Software Publishing or Digital Research. It would take years, and many tens of millions of dollars. Even if we had the resources to make the attempt, I do not believe that it would be a wise investment. The day of the general software company as a strategy has come and gone.

Everything we see today would encourage us to be a Presentation company specializing in the solution to a sharply-focused horizontal category, like Aldus or AutoDesk or WordPerfect. This is something we can feasibly accomplish over the next couple of years, with no more than the amount of money ($5 to $10 million) that we could raise, from an IPO or privately. This is the strategy which will give us the largest value relative to investment, in the shortest period of time. We have made a strong entry as the first product in the category. The initial sales and reaction to our PowerPoint show us that we have a strong contender in the category, and there is no reason why it cannot be the leading product with proper marketing and development effort applied to it. We can raise ourselves to sales of $50 million (a valuation of more than $100 million) by this strategy, and then consider our next step. To make our move, we must act now.

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Appendix: Why FileMaker Plus Cannot be in Any Strategy

In order to get a Nashoba renewal in March 1986, and in order to conserve cash, we had to agree to extreme terms in our agreement covering FileMaker. We have no ownership of the name FileMaker. We have no rights to any future versions of the product for Macintosh. We have no rights to any future versions for other machines, including IBM. We have exceedingly onerous reporting requirements, which involve disclosing almost all of our financial information to the developer. We have very limited control over the evolution of the product. We have virtually no ability to transfer our limited right to sell FileMaker to others. And—sufficient all by itself—we pay royalties under a complicated formula which works out to about four times the going rate! In our FY1987 just completed, including all the introduction costs of FileMaker Plus, we paid 26% of revenue as royalties to Nashoba. On a multi-year basis, we estimate that 30% or more of FileMaker revenue will be paid to Nashoba.

By agreeing to these terms, we in effect guaranteed that the effort invested in FileMaker Plus would not increase the asset value of Forethought. We had no ownership of the product, and we had assured that our marketing rights would—because of the royalties—be vastly inferior to any other investment opportunity open to us, and quite probably would be permanently unprofitable.

It is instructive to look at a table of what happens to each dollar of revenue received, for FileMaker Plus and for PowerPoint.

	FileMaker Plus	*PowerPoint*
Revenue	100%	100%
COGS	15%	9%
Royalty	30%	0%
Gross Margin	55%	91%
Sls & Mktg	33%	33%
Prod Dev	3%	9%
G&A	14%	14%
Total Expenses	50%	56%
Operating Net	5%	35%

This is all straightforward. Cost of Goods Sold is higher for FileMaker than for PowerPoint as a percentage, because of its lower price. Other figures are comparable, except for the higher cost of development for PowerPoint and the cost of royalties for FileMaker Plus.

The result, of course, is totally unacceptable. A net profit of 5% is far below what is required, and there is no way to remedy this situation short of cutting the royalty to half of its present level or less (a situation which Nashoba would find unacceptable). All of our hard work in building a market for FileMaker Plus is being invested in a product which can never return us more than marginal profit. This means that our hard work is being wasted, and should be re-directed toward projects which do have the potential to build the value of Forethought.

FileMaker Plus was part of a strategy to generate revenue without profits until PowerPoint arrived. Once we have any alternative, it is a mistake to continue to pour effort into a dead-end situation. There is nothing here that we can turn around: whatever our own lean expenses, there is always a 30%-of-revenue penalty in FileMaker.

Here is a worked-out example with numbers close to our present forecasts for April 1987 through March 1988:

	FileMaker Plus	*PowerPoint*
	18,181 units/year (1,515 units/mo) @ $132/unit	40,449 units/year (3,370 units/mo) @ $178/unit
Revenue	$ 2,400 K	$ 7,200 K
COGS	360 K	648 K
Royalty	720 K	0 K
Gross Margin	1,320 K	6,552 K
Sls & Mktg	792 K	2,376 K
Prod Dev	72 K	648 K
G&A	336 K	1,008 K
Total Expenses	1,200 K	4,032 K
Operating Net	$ 120 K	$ 2,520 K

Hence, for the next fiscal year, we could expect to earn net profits of only $120,000 from FileMaker Plus, versus $2,520,000 from PowerPoint.

We expect to do roughly 2 times the number of units in PowerPoint over FileMaker Plus, but to do roughly 20 times the amount of profit.

If we were to sell an additional 168 units of PowerPoint per month—or about 5% more in sales—we would add more than $120K to our net profits, hence making a bigger contribution than all the activity of FileMaker Plus.

The old (present Forethought) business plan really amounts to running two separate businesses under the Forethought umbrella, with entirely different economics. The PowerPoint business is highly profitable on an on-going basis, and also continues to build the value of the company's only real asset.

By contrast, the FileMaker business is just busy work. And think of the huge amount of wasted effort! The salespeople frantically trying to make a monthly FileMaker target of 1500 units, 12 times in a year; the constant attention to manufacturing, entering orders, fulfillment, answering inquiries about why FileMaker has not arrived; the expense and creative effort of trying to revamp all the advertising and collateral material; the late-night sessions trying to get the highly-detailed Nashoba statement out of accounting every month for 12 months; the customer support reps trying to answer detailed technical questions from customers all day every day; all the work of specifying a new version of the product, trying to influence development without much success, and all the expense and attention required during documentation and testing; and so on, and so on. All wasted. At the end of the year we will have virtually no profit left to show for all our work. Since we own nothing in the product, we have only increased the value of an asset of Nashoba's.

It is for this reason that FileMaker cannot play a long-term role in our strategy. Whether as a presentation company or as a general software company, Forethought will have to find products to replace FileMaker which have an acceptable level of return.