

# Open Source Business Program

## **VC's and Open Source - some history and lessons learnt to guide today's fund raising**

Helsinki, 19th of September 2007

Mikko Puhakka

## Goals for the presentation:

1. Understanding of how we got here - some highlights of OS financing from 90's to today
2. Open Source company as an investment target-some views
3. Some ideas when approaching investors

# Venture funding to Open Source 1999

- <http://www.youtube.com/watch?v=Oy7EeZOBDKQ>

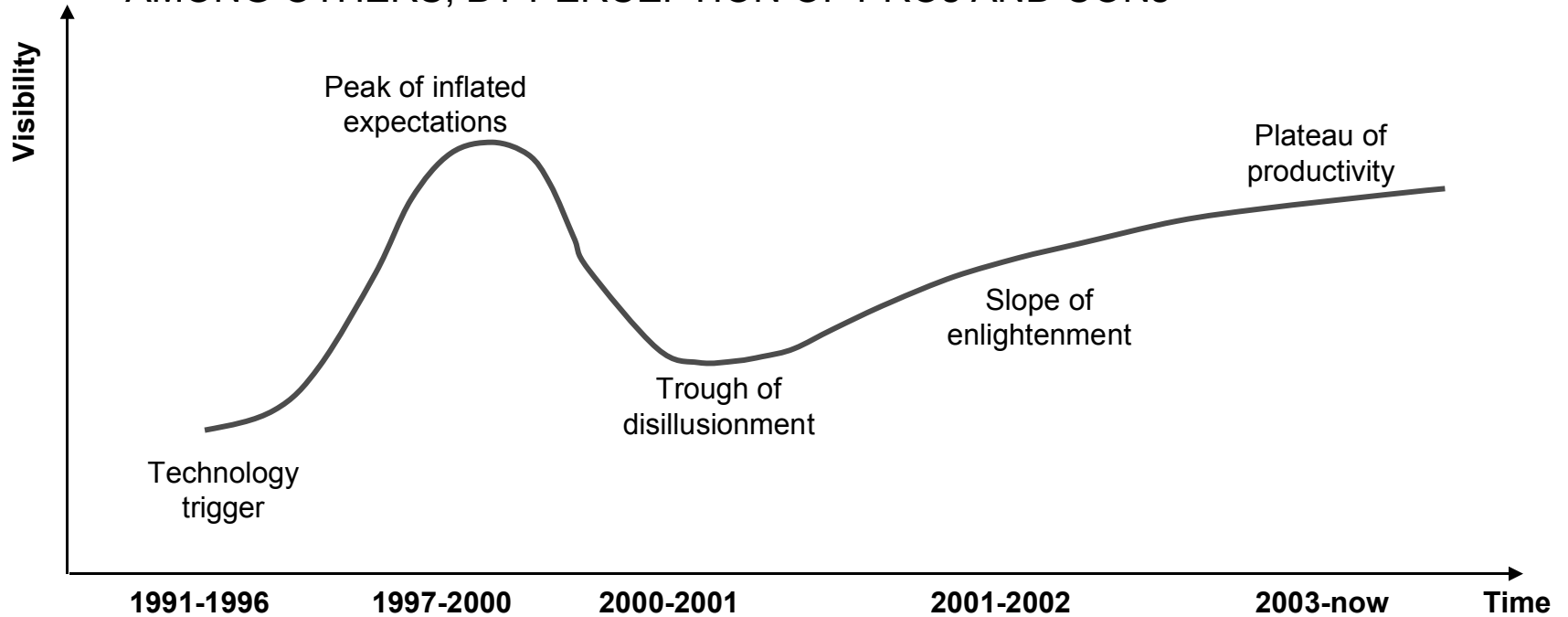
# Financing Reflections

So far the OS experience has not been a happy one for venture capitalists. According to research firm VentureOne some \$714 million was invested in 71 Open Source companies in 1999-2000, and most of those projects collapsed or were run down.

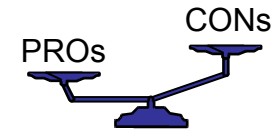
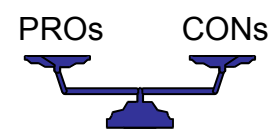
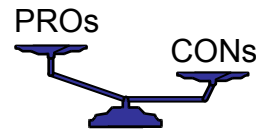
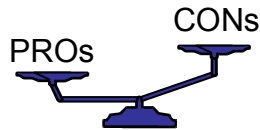
One of the biggest successes of those experiences is Red Hat which went public in 1999 and makes money by selling enhancements and maintenance services to corporations using Linux open-source operating system. Still that is relatively mild success as it still has some \$200 million in revenues with capitalization of 2 billion. So this is certainly no Google or EBay that aggressive venture capitalists often use as a reference as companies they want to fund as the 'Next Big Thing'.

Source: Ripos Project/TKK

LINUX(OSS) HYPE CYCLE HAS BEEN GUIDED,  
AMONG OTHERS, BY PERCEPTION OF PROs AND CONs



PROs &  
CONs in  
the press



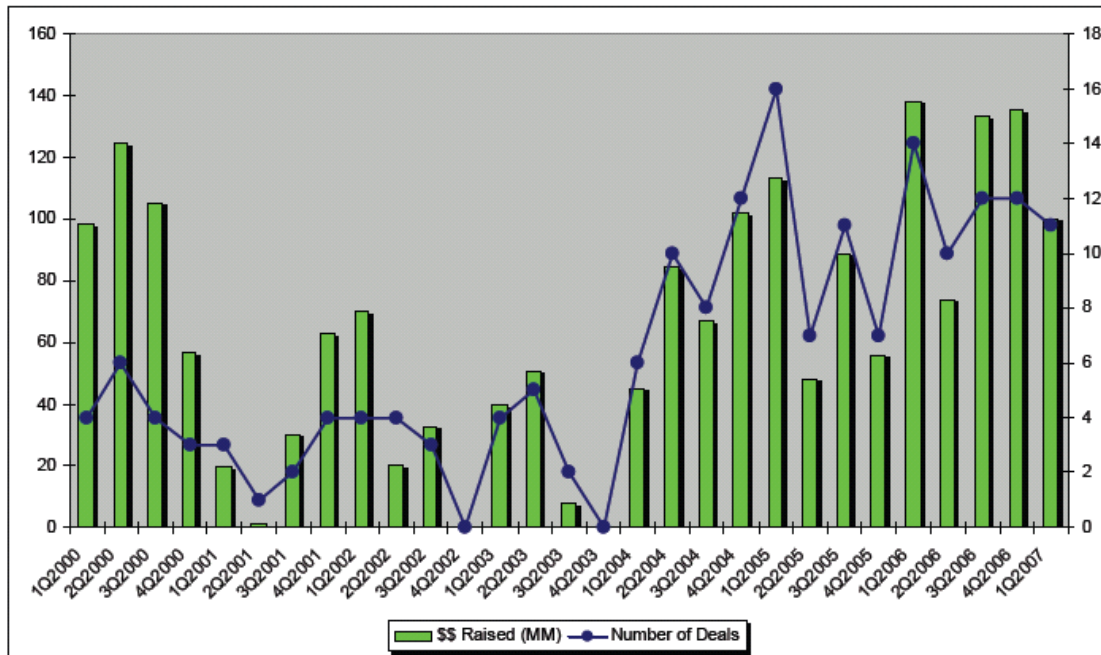
# OSS is Mainstream



© Scott Adams, Inc./Dist. by UFS, Inc.

# Venture funding to Open Source

- Almost \$ ~1,9 billion raised by Open Source startup since year 2000 and growing!



Still no real  
Open Source  
Funds in place!

SUSE exit in 2003 the  
turning point!

# Venture funding to Open Source

- 
- 2004: \$149MM, 20 open source startups—
- 2005: \$294MM, 41 open source startups—
- 2006: \$475MM, 48 open source startups—
- \$1.89B raised by open source startups since 2000—
- 1Q2007: \$86.3MM SourceFireIPO, \$100MM, 11 deals

# Venture funding to Open Source 2006

The future is going to be open source. According to figures collated by CBR, VCs invested \$475.2m in Linux and open source-related vendors in 2006, up 61.6% from \$294.0m in 2005.

Matthew Aslett

# Venture funding to Open Source 2006

While the amount invested in open source vendors is tiny compared to the market as whole, it is clearly one of the areas of growth. The total amount invested in vendors tracked by CBR was \$13.66bn in 2006, up just 13.2% from \$12.08bn the previous year.

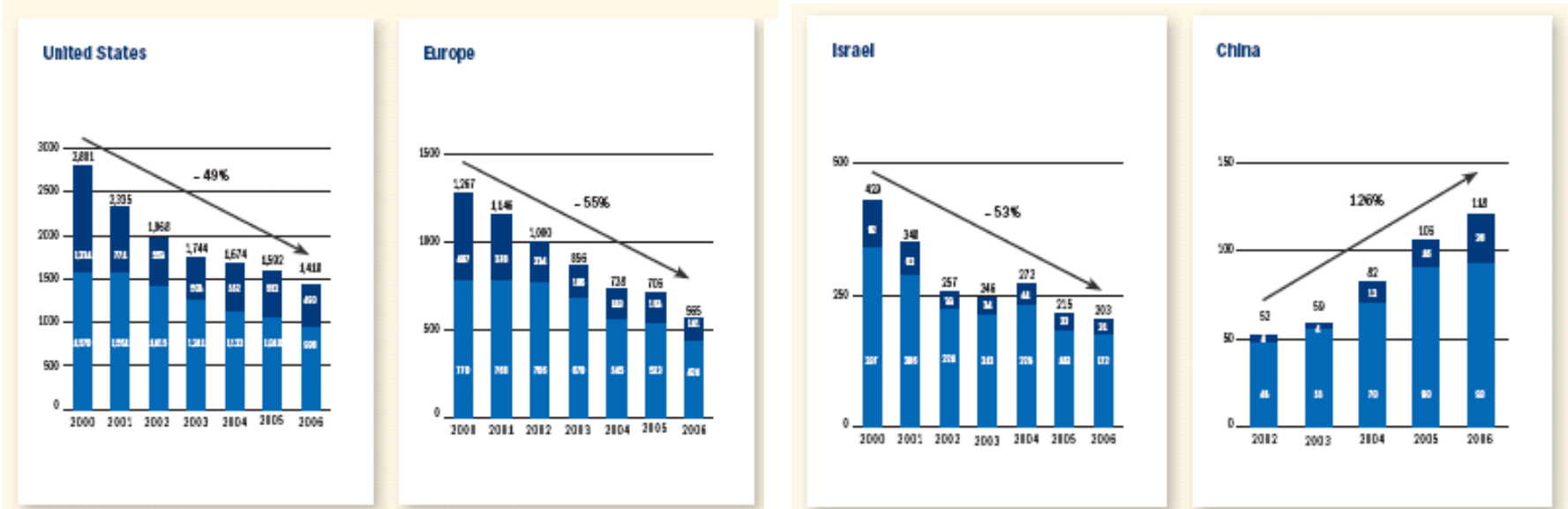
Matthew Aslett

# VC money is focusing on growth and talent markets

**Figure 1: Number of Active Firms**

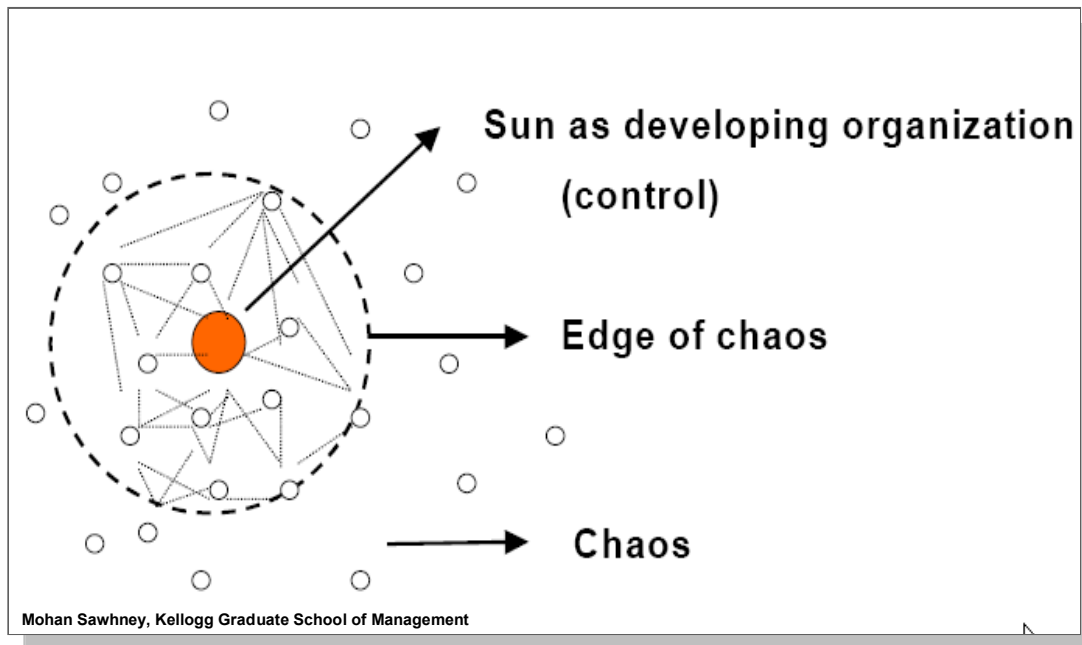
- Number Firms: Four or more deals in a year
- Number Firms: Less than four deals in a year

*Inclusion in Investor Pool: Made at least one round of equity financing in a VC-backed company in the given year.*  
 Source: Dow Jones VentureOne



\* Ernst & Young: Global Venture Capital Insight Report 2007

# Sun's Community Source Licensing: Innovating at the “edge of chaos” \*



- Similar models have been adopted e.g. by IBM, Microsoft, Google, Apple and Nokia
- Reasoning is very pragmatic:
  - Quality
  - Cost
  - Diversity of resources



Still no Open Source  
Funds in place!

# Venture funding to Open Source 2007

”Is there money in Open Source investments”?

”How can you make money with software that you just give away”?

”How can you scale and protect a business when you have not protected (patented) the key assets”?

Comments by Finnish VCs in the fall  
of 2007

--> Out of the financing ecosystem in Finland, only TEKES is active in  
Open Source space

# Challenge: Conservative Valuation Methods

(Lockett, Wright, Sapienza & Pruthi 2002)

- Liquidation value asset based methods
- Discounted cash flow based methods
- Options based valuation methods
- Rule of thumb valuation methods (comparator valuations)

Puhakka & Jungman(2005)

# Aggressive Valuation Methods - Bad Track-Record

- In the nineties it was argued that revenues and earnings were not sufficient nor relevant ways of putting value to emerging e-businesses or 'dotcoms' which had no revenues and actually no existing mechanisms of extracting payments from customers
- Life-time value of a customer
- A price-to-eyeball multiple

Puhakka & Jungman(2005)

# Valuing OSS Companies

- Open Source companies face a similar challenge as part of their business (and value) rely on Open Source communities where people contribute voluntarily their time and knowledge into projects
- Contributions are real but take place without formal contracts or incentive mechanisms and people can easily abandon the community

Puhakka & Jungman(2005)

# Some messages

- Money is available for OS ventures, but no special value is put to companies
- Transparent valuation methods lacking not only from OS companies, but all venture capital investments
- Results are indicative, larger sample would be needed

Puhakka & Jungman(2005)

# Exit Markets - Industry seems to know more than VCs

- Zimbra - \$350 million (on ~\$3 million of trailing revenues) - September 2007
- XenSource - \$500 million (on \$1 million in trailing revenues) - August 2007
- JBoss - \$350 million (on \$27 million in 2006 revenues) - June 2006
- Sleepycat - \$35-50 million (on ~\$7 million in trailing revenues, is my best guess) - February 2006
- Gluecode - \$10 million (on very little in trailing revenues, less than \$1 million, I believe) - May 2005
- SUSE - \$210 million (can't remember revenues - I think \$30-40 million) - November 2003
- Ximian - ~\$50 million (I can't remember - on \$1 million or so in trailing revenues) - August 2003

Source: Matt Asay

+ Trolltech & Sourcefire IPOs

# Build on Our Heritage - You need a good story

- In coming 5 to 10 years **Open Source based innovation and service is one of the largest business transitions** in software driven industries.
  - IDC Research; Worldwide revenue from standalone Open Source Software will grow 26%(CAGR) to reach \$5.8 Billion by 2011.
  - IBM is investing hundreds of millions on Open Source based software development.
  - Several countries (e.g. China) has made decision to favor OSS based architectures.
- **Finland has cultural heritage** and track record in developing open source based innovations into businesses.
  - Linux –we all know it so far, but there is more to come!
  - MySQL – the worlds leading open source database company with over 100million cumulative downloads
  - Star Wrek Studios –with €15 000 production over 5 million downloads in the net!

# Open Source evolution -from process innovation to value creation!

- In its early days open source was rather improving existing than innovating new
  - Value creation and preservation are the key. The software value is preserved by sharing it. The more people using it, the more value it creates. People should not mix the value of "IP protection" (i.e. a legal tool to protect intellectual assets) to the business, with the value of the asset itself.
- Today there are clear evidences of business innovations
  - Proprietary software world talked about subscription models for years, but it was companies with open source related products that developed real innovation here. Likewise, with SaaS vendors that are invariably hosted on infrastructures of open source software and able to be more inventive in their business models because their margin calculations scale differently.
- Phenomena is still moving on
  - Open software, open data, open innovation...



There is an great opportunity to further accelerate  
OSS transition towards  
value creation!

# Maybe we should change terminology?

Maybe we should start talking about software driven businesses instead of Open Source businesses.

After all Open Source is way of producing and distributing software, not a businessmodel.

...and the biggest successes in 2000's have been software (OSS) driven businesses such as Google, Amazon, Ebay, Sulake Labs.

# Key Lessons

- OSS investments do not have great track-record with investors
- Especially in the US, big bets are being made again
- All the pieces for successful OSS investing are in place - European (especially Finnish) VCs have not realized this yet
- You have to understand the history and VC way of thinking to approach the convincingly - they want to make money, not necessarily build great lasting companies

**Thank You!**

[mikko.puhakka@gmail.com](mailto:mikko.puhakka@gmail.com)

<http://blogit.digitoday.fi/opensource/>