



## NetSuite's IPO: How Sweet It Is

**The offering may validate the on-demand software model -- and make another \$1 billion for Oracle CEO Larry Ellison**

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Oracle Chief Executive Larry Ellison is facing another huge payday. His software venture NetSuite could see a first-day stock surge on Dec. 20, giving its principal owner, the billionaire Ellison, another \$1 billion and yet another lever to shape the direction of the software industry.

NetSuite expects to sell 6.2 million shares -- about 10% of the company -- in a Dutch auction-style initial public offering [BusinessWeek.com, 7/2/07] that could raise nearly \$161 million. That would give NetSuite a market value of more than \$1.5 billion and make Ellison's stake worth more than \$1 billion. Ellison owns the majority of NetSuite shares and will continue to exert control after the IPO.

The offering could also further boost the recovering IPO market, even as investors begin their holiday vacations and Wall Street looks to the new year for clearer signals about the stock market's direction. NetSuite, which has been flirting with an IPO for years, set a target price of \$26 for its shares late on Dec. 19. Earlier that day the company had raised its price range for the second time in as many days, from \$19 to \$22 per share. On Dec. 5, the company had set an initial range of \$13 to \$16 per share.

## Subscription Model

Investors' enthusiasm about Internet-related stocks and a strong environment for tech earnings could lead to even higher prices on the first day of trading. "The very structure of this auction will cause a pop on the first day, because [investors] will be looking at it speculatively," says Eric Gebaide, a managing director at investment bank Innovation Advisors. Now, money-losing NetSuite needs to show that it can parlay its unorthodox way of selling business software into a profitable enterprise that can garner investors' long-term interest. And it will need to do so in an environment in which uncertainty about credit markets and the strength of corporate technology spending in 2008 could dampen enthusiasm for new issues.

NetSuite makes accounting software for midsize companies, delivering it to users over the Web. Customers pay via renewable subscriptions, vs. the traditional way of selling business software, in which customers pay hefty up-front fees and regular support charges and install programs on their own servers. NetSuite's model is similar to one used by customer management software maker Salesforce.com (CRM), which continues to post solid results [BusinessWeek.com, 12/4/07]. One question among analysts: Will software that works in sales departments deliver the same results for bookkeepers?

## Venture Plays

"What everybody's waiting to see is whether this is going to fly in the ERP [enterprise resource planning] space," says Jim Shepherd, an analyst and senior vice-president, research, at tech industry consultancy AMR Research. AMR says such "on-demand" software accounts for just 1% of sales in the market for ERP applications, which companies use to track their financial performance, plan budgets, and forecast sales. The worldwide market for enterprise applications could reach \$35.8 billion in 2008, according to AMR.

Yet a disproportionate number of companies say they want to license enterprise software through subscriptions. According to an AMR survey of 204 business software buyers in September, 39% said they would prefer to purchase enterprise applications through on-demand licenses. "While no one in the investment community is fully convinced about the business model -- what it takes to make money and when -- they're certainly intrigued by it," says Shepherd. "They see it as a new opportunity in the software space."

Strong demand for software and other information technology helped the IPO market continue to thaw in 2007. Through Dec. 12, 74 venture-backed companies went public, compared with 57 in 2006,

according to data from the National Venture Capital Assn. and Thomson Financial (TOC). In August, software company VMware (VMW) held a blockbuster IPO that raised nearly \$1 billion [BusinessWeek.com. 8/14/07].

### Tangled Connections

But NetSuite's IPO isn't without risks. The company, founded in 1998, hasn't yet managed to turn a profit. It pared its loss for the first nine months of the year to \$20.6 million, compared with \$27.6 million in 2006. Revenues grew 63%, to \$76.8 million. Selling software through on-demand licenses can be challenging for vendors, since they book less revenue at the beginning of contracts compared with traditional licensing arrangements and need to reckon that many of their small customers will go out of business each year. Deborah Farrington, a general partner at StarVest Partners in New York, which invests in NetSuite, says investors have become more confident buying shares of on-demand software suppliers, but that such companies are "often expensive to build."

NetSuite also faces stiff competition. German software powerhouse SAP (SAP) has begun selling a suite of Web-delivered business applications [BusinessWeek.com, 9/19/07], called Business By Design, for midmarket companies. Microsoft (MSFT) and Oracle (ORCL) also are developing software that can run in that fashion, and Salesforce is eyeing expansion into adjacent markets, which could include NetSuite's.

And then there is the larger-than-life Ellison, standing near the center of the software industry's transition to this new style of sales. He was also an early investor in Salesforce.com, and NetSuite's IPO will further spotlight the company's deep relationship with Ellison. NetSuite plans to use part of its IPO proceeds to pay down an \$8 million loan from Ellison's investment firm. Ellison and his family will own two-thirds of the company's shares after the offering.

### Happy New Year?

Making matters more complex, Oracle is considered a potential competitor to NetSuite, as well as a possible future acquirer. To reduce concerns about a conflict of interest, Ellison has transferred his 32 million NetSuite shares into a limited liability company "lockbox," which removed his voting rights for the company's directors. But Ellison still has voting power over a sale of the company. "There's a lot of logic" to Oracle one day buying NetSuite, says banker Gebaide. Because of regulations in the Sarbanes-Oxley Act of 2002, Ellison would need to recuse himself from setting the

company's purchase or sale price, he says.

There are other ties between the two companies: NetSuite co-founder and Chairman Evan Goldberg spent eight years at Oracle as a high-ranking software engineer, and Chief Executive Zach Nelson was a former marketing executive there. In May, NetSuite bought \$5.6 million worth of Oracle software. NetSuite's stock will trade on the New York Stock Exchange (NYSE) under the ticker symbol "N." Credit Suisse (CS) and W.R. Hambrecht are underwriting the offering.

If NetSuite's share price is as buoyant as demand for the stock, companies will have fresh evidence that on-demand software has decent prospects. And for tech investors, the IPO could represent a warm welcome to 2008.

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