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IncrediMail
Accelerating growth in a rapidly changing environment

Introduction

IncrediMail Xe, an email client that permits user control and personalization of messages with graphics such as backgrounds, emoticons and animations as well as sounds, allows email communication to become a tool for personal expression. Available for download through the internet since September 2000, the product virtually marketed itself as those receiving the email messages used a built in link to download it themselves. By 2010 there had been over 146 million registered downloads of the free product in more than 100 countries. The income model was initially based on the Freemium concept—the basic product was downloaded for free and a variety of upgrades such as a wider graphic library and a strong spam filter were offered for a charge, ranging from $10 to $60. This model allowed the company to reach profitability in 2002, in contrast to many internet companies at that time, yet growth was slow. After its successful IPO in 2006, the company expanded its business model in 2007 and became a partner with Google, as well as other search providers, which opened the way for better monetization of the user base. While the company's income and revenue grew as a result of the agreement with Google, it has become very dependent on this one client for its income: by 2010, around 70% of revenues were from the Google search agreement. Considering this dependence, the constant changing of business models in the internet environment and the need for fast growth the company needs to consider new or additional business models, to replace or enhance the current mode of operation.

Realizing this IncrediMail has been shifting focus from maximizing search revenue to better serving the user base, which consists mainly of people aged 35 and above seeking computer products that are simple, safe and easy to use. Setting its objective as becoming a leading provider of consumer software for these users, IncrediMail's goal is to reach revenue of $100 million by the end of 2014.

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Background

For thousands of years human communication has been evolving in richness, formats and scope. Spoken language evolved from animal like sounds that allowed very basic communication to a wide variety of languages, each rich enough to allow very complex expression. Written communication has evolved in three major stages. First was the creation of written communication through pictographs, from very basic drawings to hieroglyphs, most of which were made on stone and were therefore not transportable. As new writing material, such as papyrus, clay, wax and paper, came into use written communication became mobile. Common alphabets were introduced and allowed uniformity of languages across large distances. Yet only in the 15th century, with the invention of the Gutenberg printing press, did written communication become widespread through books and later newspapers. As technology progressed written communication also became faster through means such as the telegraph wire. Technology also allowed audio communication to overcome the distance barrier first with recordings and then with real time communication through radio and the telephone. Video came next and followed the same path, first with recordings such as film and then with recordings in real time in mediums such as television. And so communication continues to expand in scope and variety.

The Personal Communication Revolution (Exhibits 1-6)

In the last two decades human communication has gone from the privacy and intimacy of face to face conversation and hand written letters, where self expression is inherent, to an almost endless choice of communication mediums and venues, oftentimes losing some levels of self expression along the way. Hand writing, design control, and graphics control have been diminished or eliminated in the digital communication age. Emails, cellular communication, and social networks are changing the way people communicate.

The emergence of the internet, in 1990, impacted all communication formats, starting with written communication. Internet added the ability to communicate instantly not only on a one to one basis but also on the basis of one to many and many to many, with literally no regard for geographical location, time zones and other restrictions, all at a relatively low cost. The major tools at that time were the web sites, where the owner created text for visitors to read, and the electronic mail (a.k.a. email), where any person with minimum necessary infrastructure, such as internet connection and an email address, could send and receive written messages. These messages could be sent to multiple recipients and could be forwarded. Easy and affordable, the internet expanded quickly both in its reach, growing to about two billion users world wide by the end of 2010 with 107 trillion email messages sent in 2010 alone, and in the growing amounts of information, with just the amount of blogs reaching around 200 million in 2010. While web site design and capabilities have greatly evolved during this time, email capabilities have stayed pretty much static, focusing on sending and receiving texts and file attachments with limited user control over other attributes such as design, look and feel and so on.

To help users reach the information they needed or wanted search engines and portals were created. Portals consisted of web site lists, grouped by subject, and included those by companies like AOL or Yahoo. Search engines, on the other hand, stored information regarding web sites and allowed the users to define what interests them through Boolean search to create a list of relevant web sites. As search algorithms created better and better results portal popularity declined.

As the internet penetration deepened, companies and developers started to expand its usability and offer new ways to create value for users. One of these expansions was the use of

the internet to create real time, instantaneous communication, very similar to a phone conversation yet with its own added value of user flexibility and added data. This became known as instant messaging. ICQ, which was launched in 1996, was the first instant text messaging tool and was followed by many other applications that allowed instant text communication through the web. Later this was expanded by Voice Over IP (VOIP) tools such as Skype. These tools reduce the need people have for other communication tools and also condition users to expect an immediate reaction, by giving them an indication of the availability of other users.

Following the launch of Facebook in 2004, social networks began flourishing, with Facebook claiming 630 million users in 2010. With some focusing on business networking and others on connecting with friends and family, these web sites became people's focal point on the web and a platform that supplies all other needs (such as communication, gaming and more) for its users. Many of these platforms offer members the ability to send messages to one another, and some also offer internal real time text messaging capabilities, making the external applications such as email and instant messaging seem redundant.

YouTube, a video sharing site that started operating in 2005, has also had a major impact on internet users. Allowing any user to upload short video clips and share them, in a one to many mode, with friends or with the entire internet community, its popularity has grown very fast and it was one of the most popular web sites in 2010, with an average of two billion videos watched each day. In comparison, Facebook, which also allows video uploading and sharing, has about two billion videos watched each month.

At the same time other communication technologies have also been progressing. While mobile car phones had been demonstrated and used earlier, the first hand held mobile phone, nowadays called a cellular phone, was demonstrated in 1973 and was commercially available in 1983. World wide cellular phone usage grew from 12.4 million users in 1990 to over 4.6 billion users in 2010, penetrating the developing economies and reaching the bottom of the economic pyramid. For regions where communication infrastructure is still lacking, cellular communication offers a shortcut into the highly complex communication infrastructure available in the developed world.

Starting in 2001, the automated cellular networks, in which the cellular phones operate, matured into their 3rd generation (3G), and they are now offering more and more capabilities on top of the basic mobile audio communication. Some of these capabilities are in text, as all cellular phones now offer SMS and the "smart" phones also offer the possibility of becoming another email outlet. Smart phones also offer photographic abilities, video streaming and internet connectivity, allowing users to stay constantly connected, even on the go. This gives users the ability to communicate all traditional infrastructures (mail, social network, video clips, and search engines) in one device.

The Web Business Arena

Background

The internet has become an integral part of people's life in the last few decades. It supports communication, knowledge and data transfer, collaboration, searching, shopping, gaming and much more. While the internet may have started out as merely a communication tool, a platform for the exchange of knowledge, information and opinions, it has expanded to become much more. Still used to communicate, the internet has become a major business platform and it has changed basic assumptions and common practices in the process. Now it is easier for customers to act based on knowledge, it is easier for small and specialized

producers or marketers to reach their client base and so on. The basic rules of business may have stayed the same but their application has changed in many ways.

The move into the internet as a business arena was not trivial. The shift from local to global reach, the ability to make even the esoteric profitable, and the need to stand out from the crowd, when the amount of data available is growing exponentially, are just some of the factors that contribute to the complexity. All this makes the process of transforming different business rules and paradigms from the physical world to the cyber world hard and complicated.

In 1995 internet user growth started accelerating markedly, leading companies to view these users as potential customers. This led to the creation of numerous internet start-ups (named dot-com companies) in the mid to late 1990s. Most dot-com companies engaged in a policy of growth over profit, assuming that if they built up their customer base, their profits would rise as well somehow; moreover, many companies built their business model without any consideration for financial measurements such as revenues or profits at all, based mainly on external capital flow from investors,. Some well-known examples include Flooz.com, Kozmo.com, Pets.com and Webvan.com. Investors, for their part, responded to daring business practices with money, lots of it. The American stock market rose dramatically during the dot-com bubble, with hundreds of companies being founded weekly, especially in tech hot spots like Silicon Valley near San Francisco.

This phenomenon proved to be illusory. The first signs of trouble came from numerous high profile court cases targeted at tech companies for unscrupulous business practices, including borderline monopolies. The issues of the dot-com bubble were also compounded by outside factors, like a rise in outsourcing which led to widespread unemployment among computer developers and programmers. The market also took a major downturn in the wake of the 9/11 terrorist attacks in 2001. Another major blow came from a series of government investigations into companies that had engaged in shoddy or questionable bookkeeping. The loss of consumer faith in the tech industry also depressed earnings for dot-coms. A decline in business spending combined with the market correction to deal a serious financial blow to many dot-coms, and tech companies began to fold one by one because they had acted without a long range strategic viewpoint and a real business model.

Major value destruction was the ultimate result. The NASDAQ index, which represents the technology stocks, demonstrates this phenomenon: it made a quantum leap from 1741 points on 10/03/1998 to 5060 points on 10/03/2000 and then crashed to 2001 points on 12/03/2001, and dropped sharply to 1295 points on 10/03/2003.

Following this market correction, internet companies found it harder to raise the necessary capital. Investors were no longer satisfied with “business models” aiming at market dominance or eyeballs and now required new ventures to showcase a monetizing business model. This means that getting the traffic was no longer enough; companies needed to figure out how to make revenues and profits from the traffic they generate.

Business models (Exhibit 7)

The crash of many dot-com companies without sustainable business models forced companies to develop a coherent business model based on traditional methods: revenues and profits. This led to a plethora of business models, such as banner and ad sales, Pay Per Click (PPC), Pay Per Lead (PPL), Search Engine Optimization (SEO), software sales and Software as a Service (SaaS), affiliate marketing and many others. Some of these models direct their value and retrieve their income from the same source; they are used by companies that sell goods, such as software, data, online games and so on, to customers who pay for them. The

majority of the other models are based on a split between the target of the value and the source of income, mostly directing value at the internet user and gaining income from advertisers, directly or through intermediaries. For example in a free gaming site that gets paid by advertisers when internet users click on ads appearing on the site, this payment can be done directly to the site operator or to an intermediary such as an agency that pays the site. A lot of combination models exist—sites offering free value with paid advertisements included or paid for value with no ads, partial value available free and paid upgrades, time limited free value and so on.

Since the internet allows tracking of all activities, advertisers can pay for real results such as how many times an advertisement has moved surfers to click it (PPC) or to perform a necessary action such as filling a contact form (PPL). This payment is shared between the advertising platform (the search engine, for example) and the traffic provider through a revenue-sharing agreement.

A lot of the traffic generated to different web sites stems from the internet's extremely viral word of mouth type of communication. The term viral refers to the way popularity of different sites spreads much like a viral epidemic, with each infected user infecting several others. Virality can be manifested in several ways. Most viral content is communicated at the users' will through the different communication options of the internet (email, instant messaging, social networks, forums and such). In these cases users take an active role in creating or forwarding a message containing the viral content or a link to such content (a web site, a video and so on). Very few applications have managed to create inherent virality, meaning that the users' will is not relevant and that simply using the application creates the viral impact. This happens when the viral message is built in to the application and infrastructure is not needed on the receiving end, so the viral message appears without need for user action.

With the power of the viral effect supporting the need to create traffic and in order to mitigate the perceived risk inherent in employing new software, especially through a new distribution channel such as the internet, software suppliers have had to change the way they handle their business and many have moved to offering their software for free, all of it or a basic version of it. As this practice has become more common, users have started expecting the software to be free and their willingness to pay has eroded to some extent. A number of business models have emerged out of this situation. The basic model is the trial period model, where users can download the software and use it for free for a limited time, after which they are required to pay in order to continue using it. The "Freemium" model offers a basic package free of charge and premium usage at a certain fee, usually not very high. Conversion rates from free user to premium user are very low, at about 1-3%. Another model is SaaS where users are not required to purchase the software at all and pay a fee (such as a monthly fee) for usage through the web.

The widespread use of the internet and its ease of use, achieved through the work of specialized companies, have made the internet accessible to a wide range of activities and users. The internet bridges distances, languages and cultures and allows small and large businesses alike to use it advantageously. Since the internet environment is extremely dynamic, finding a durable business model, one that allows the creation of ongoing revenues and profits, is not an easy task. Most of the companies active in this arena are subject to very high variability in their business activity.

Conducting an internet-based business is inherently highly complicated since this is an ever-changing environment, where one change has not yet matured and another one is already in full force, like the latest impacts coming from the social networks and twitter, and the emergence of smart phones. All these present new possibilities but there is still a need for profitable business models especially for small growing companies.

The email arena

Over the years email has become one of the leading forms of electronic communication worldwide, with 480 million new users and 107 trillion mail messages sent in 2010. Spam, also known as junk mail, is on the rise, and it is speculated that 89% of mail messages sent are spam. Any new email software product should provide an effective and secure product that satisfies users' concerns regarding spam, as well as safety and security issues. The email market may be divided into two segments: the consumer or home users are about 75% of the market and the business or corporate users are the remaining 25%. Both private and corporate markets are serviced by many of the same popular email software applications (each user had to install software on the computer being used in order to have access to emails) such as Microsoft Outlook and by web-based email services (a solution not requiring the user to install software) such as Hotmail™ and Gmail™. Security is a critical concern for the consumer market as viruses, worms and identity theft all continue to grow. While there are advantages and disadvantages to each method and system and the markets for each of them remain large, most web professionals speculate that the market for web-based email systems is growing at the expense of downloadable email clients.

There are some competitors in the downloadable email clients market, such as: WikMail, Arcsoft Multimedia Email™ 3 and Mind Spark Products™, as well as competition from general email software programs offered to the private market by large internet and software companies, such as AOL9 by America Online, Inc., Eudora® by QUALCOMM Incorporated (NASDAQ: QCOM), and Thunderbird® by Mozilla Corporation, some of which may also incorporate certain special features that provide a personalized email experience, some of them offering creative graphic backgrounds. Many of the large internet and software companies offer their email software programs free of charge.

The web-based email market is characterized by significant competition, changing technologies and evolving product and service enhancements. Google, Yahoo! and Microsoft are each offering a web-based email service in addition to the many other services they provide, such as desktop search, local search, instant messaging, photos, maps, video sharing, mobile applications, and so on.

Many of the competitors in both segments have established brands and products as well as customer relationships and loyalty, which could inhibit market penetration efforts by new entrants, even for those offering a solution that is of higher value to the user, such as being simple to use, or providing customized and entertaining email experience. This can result from consumers choosing to receive an extensive package of internet and email services from a dominant and recognized company, such as Microsoft Corporation (Outlook Express) or America Online, Inc. (AOL®) or from the high switching costs that customers perceive (such as the need to move all the data collected in the old email to the new email, the need to learn how to use the new email and the need to move all future communication to the new email address).

The search arena (Exhibits 8-9)

While search engines were available before Google, Google's breakthrough created a new business category, the search engines category, since it basically created a model for monetizing search results. A search engine is an algorithm-based software product which allows users to look for web pages and web sites using key words and phrases relevant to their needs or interests.

With 313 million distinct web sites making up the World Wide Web, search engines work by scanning as many documents (web sites) as possible and creating an index based on the words contained in each document. Each search engine uses a proprietary algorithm to create its indices such that, ideally, only meaningful results are returned for each query. In the search process the search engine's software quickly sorts through millions of pages in its database, finds matches to the query and ranks these matches in order of relevancy. Search directories are another type of search engine; they index content chosen by human editors.

Search engines have created a full eco-system in the internet world. In order to be profitable a search engine must be popular enough with the web surfers. This popularity can then be leveraged to convince marketers to pay for promoting their ware on the search engine. Since achieving such popularity can be far too time consuming, many search engines have moved to buying bulk amounts of users from other web sites that have a large user base that they can move over to their own site in several ways such as offering the search service from their site or by impacting the users' home page. Once a search engine can provide enough activity through its user base it can start attracting paying advertisers.

There are many small players in this category and a limited number of big players, such as Microsoft's Bing or Yahoo, but it is irrevocably dominated by Google. Established in 1998, Google employed over 26,000 people, had over $29 billion in revenues and $8.5 billion profits in 2010 and with a global market share of over 85% is definitely the most dominant player.

Traditional advertising models were based on using different advertising media and trying to capture the target market's attention by the use of creative advertisements. Advertisers paid the ad agency for the production of advertisements and then paid the different media according to expected exposure. More advanced models created some connection between the payment and the campaign results, but they were mostly used for sales promotions. The business models presented by search engines are totally different. These models, based on the technology powering the search algorithms, allow the advertisers to focus in on the target markets they wish to reach. Advertisers select the key words and search terms of interest themselves and pay the search engine operators only when clients select (click) their ad, using PPC or PPL models.

On top of this, the algorithm allows the collection of a lot of information about customers and thus creates the ability to present them with unique offers that fit their profile. The ability to receive a lot of high value marketing information with varied correlations allows advertisers to offer better and more targeted value propositions to their target markets.

This unique model created a totally new market for the search engine category players, a market based solely on results that allowed millions of businesses around the globe to market their wares using this new advertizing option without being required to commit to high investments in media and production costs.

In order to increase their exposure options, the three major companies in the market have created cooperation agreements with small or niche web sites that direct search questions to their search engine. In return the search engine companies share part of the revenue these searches generated with the referring site. Using this model, many small companies have been given access to a large revenue source with very high profit margins. In order to maintain success in such a model the small companies must maintain as large a customer base as possible, since their distinct advantage and value proposition to the search engine companies stem from their customer base. These companies are almost completely dependant upon a single customer, and in Google's case, the uncertainty is much increased, as Google will only sign short-term contracts of one to two years and the small companies have no way of knowing, beforehand what their expected level of income from this venue is going to be.

IncrediMail (Exhibits 10-18)

IncrediMail is an internet content and media company that designs and markets a suite of downloadable consumer products that are simple, safe and useful and bring a new level of fun, personality and convenience to email, desktop and screen saver applications. The main product offered is a free downloadable local email client that allows the user to create emails rich in content such as backgrounds, graphics and animation. The content is embedded into the email so it can be seen by all those who receive it, regardless of the email client they are using and without any effort by them. The product suite also includes a graphic add-on to instant messaging software, wallpaper and screensaver software and software for presenting digital personal photos. IncrediMail products are currently available in ten languages in addition to English. Prices and license fees for premium products range between $10 and $60, varying depending on market, length of license period and whether products are offered as a bundle. All of the products may be downloaded over the internet through a personal computer running on a Microsoft Windows operating system only.

The company believes that the user experience they have created has been successful in attracting a unique underserved demographic that is seeking software applications that make their life a little simpler and time effective. The company focuses on addressing a demographic market of non-early adopters.

The company was incorporated in November 1999, started operations in 2000 and went public in the US stock market in February 2006 (Symbol: MAIL). The company's revenues have grown from the 2006 level of $10.9 million to $29.5 million in 2010, though 2010 showed a decline in growth rate. Net profit follows the same trend, growing from $2.5 million in 2006 to $8.4 million in 2010, with a declining growth rate in 2010 as well.

Located in Tel Aviv since the day it was founded, IncrediMail ended 2010 with 107 employees on its payroll, in comparison to its 111 employees in 2009 and 119 employees in 2008. The R&D department with 54 employees is charged with research and development efforts that are focused on the development of upgraded software, new features and the enhancement of the existing product suite.

At the end of 2010 a new CEO, Mr. Josef Mandelbaum, was hired in order to take the company to its next level. The founders, cousins Ofer and Yaron Adler, stepped down and are no longer active in the day to day management of the company.

Since the beginning of operations, IncrediMail has recorded over 146 million registered downloads of their free products in more than 100 countries, reaching an average of 1.8 million registered downloads each month in 2009 and an average of 1.5 million registered downloads each month in 2010. At the end of 2009 there were approximately 11 million active users sending more than 350 million mail messages each month. At the end of 2010 there were approximately 10.7 million active users, sending more than 280 million emails each month. Users typically use the products for up to six years. The user base is primarily the result of the viral effect as recipients of IncrediMail emails click on a link that appears at the bottom of every email sent through an IncrediMail powered email client and download the product, as well as through word of mouth.

IncrediMail's email client can be used as a stand alone email client where all email traffic is downloaded into the user's computer and saved there (like MS Outlook). It can also be used as an interface with web mail systems such as Gmail, adding a rich interface to the user's local computer, but not hindering mobility and the ability to access data from many outlets in any way. Additional products include graphic content for instant messaging and personalized desktop graphics. The products are offered as free downloads in a Freemium model with

additional graphic capabilities as well as add-ons, such as anti-spam capabilities, available for purchase.

In the last few years, revenues from advertising has been the primary source of income, including primarily generating searches and sharing in the revenues with the provider of the search engine. Another source of revenue is selling premium software products. Since it began operating IncrediMail has sold more than two million products and content licenses to its registered users.

IncrediMail's activity today can be divided into three distinct periods: the start-up phase, between 2000 and 2007, characterized by desktop products with income based on premium purchases from the end users and customers; the second phase, between 2007 and 2010, characterized by the establishment of search-based revenues, especially from Google; and the third phase, starting in 2010, characterized by creating a product and service road map, based on the understanding of user needs, essentially blending the two earlier phases. Despite the distinct differences between the three phases, the main growth feature throughout the years has been the high quality, wide and loyal customer base the company has created for its products.

Phase one, 2000-2007: Desktop products

In 1999 personalization was the major buzz word. Cellular phone covers and replaceable panels were all the rage. In this environment the cousins Ofer and Yaron Adler decided to offer a new email client that would have an enhanced user experience.

The main product the company developed was IncrediMail Xe, which is still the company's flagship product and is available over the internet free of charge. It offers a variety of features that the user can apply to email messages including: pre-prepared backgrounds and letterheads; animated notifiers (animated indications that mail has been received); emoticons (animations that are intended to convey emotions); 3D effects; handwritten signatures; a web gallery with additional animations, notifiers and email backgrounds; sound effects; and virtual e-cards.

Following the success of the email client IncrediMail Xe, which was rich in graphic content and provided the ability to personalize the email experience, the company developed and marketed more products emphasizing graphic content. Consistent with this strategy, it developed the Magentic and HiYo products, both of which are rich in graphic content. However, neither of these products has been successful in generating substantial revenues.

The original plan was to use the "eyeball" model in which the company gets the users and the monetization follows. Yet as the company started operating, investors' requirements were changing, in reaction to the burst of the "dot com" bubble. Demanding that companies show a monetizing business model, the plan was no longer viable and IncrediMail had to look for a different venue. Changing to a Freemium business model, it began offering content packages and premium accounts on top of the basic product, which remained free. This model proved viable and the company created an income stream from its inception, becoming profitable in 2002, in contrast to most internet companies at the time.

Phase two, 2007-2010: Search-oriented company

In 2007 the company, while profitable, was still creating limited value from its products and ever-growing user base. At the same time, search engines were starting to gain revenues

from paid search results. This created an opportunity for IncrediMail with its large customer base and high rate of new customer recruitment, since the companies behind the search engines were looking for ways to create traffic for their search engines and capitalize on the paid searches. Companies such as Google were willing to share the revenues they were creating through paid search in order to create the traffic needed for that revenue generation. IncrediMail grasped the opportunity and signed its first contract with Google. The revenues created through this channel were significantly larger than those created by selling content packages and premium accounts.

The significant growth in the popularity of search engines increased IncrediMail's revenues dramatically. However the company became very dependant on the revenues derived through search, primarily the Google AdSense program, which pays IncrediMail a portion of the amount advertisers pay Google for the activity performed by those downloading IncrediMail's applications and opting for the MyStart homepage in the install process. The dependency continued to grow, to the point of creating 70% of 2010 revenues through the Google venue, with the growth trend expected to continue. IncrediMail has a two-year contract with Google, effective January 1, 2011. While Google is the main source of search revenue for IncrediMail, it is not the sole source. The company was able to limit Google's exclusivity to the IncrediMail product and is therefore free to sign contracts with other search providers for other products.

As a result, over 77% of the revenues for the year ended December 31, 2010 were generated from the acceptance and subsequent retention of search properties by the users of the IncrediMail software products.

A significant and growing portion of IncrediMail's revenues is obtained from searches made through the home page (MyStart) set up in the user's computer during an IncrediMail application, as well as offering other search properties. Therefore, the focus during this period has been on constantly looking for ways to convince users to make MyStart their homepage and accept the other search properties offered.

In August 2009, the company released a substantially new version of its main product: IncrediMail2. In addition to providing all of the above features with a fresh look and current graphics, the new version has greatly enhanced search capabilities as well as other attractive functions.

Phase three, 2010-2011: Customer-oriented company

As the slowdown in growth of revenue and profit, felt throughout 2010, as well as the decline in all products other than mail signaled the possibility of a problem, IncrediMail shifted focus towards its users. Up to this point in time, IncrediMail had little knowledge of its customers and most of their insights were the result of products' success or failure. Now it began to understand that user satisfaction is imperative for lasting success. Even though most of the revenue is not derived directly from the product's users, without user value, the company's ability to generate revenue through search will diminish as the products will not be installed on new computers and therefore the search capabilities will not be created. With this realization IncrediMail set out to collect the missing data and create the knowledge needed, and conducted its first consumer research.

The consumer research led to the understanding that the IncrediMail email software holds value for a unique demographic segment, people over 35 years old: on average 95% of the users were 35 years or older, and 78% were 45 or older. In addition, these users tended to adopt technology later in its life cycle, rather than earlier. While the graphic content was

critical, the main attraction of the product was that it was simple, safe and useful, and assisted users in better utilizing their time.

IncrediMail seems to be one of the few hi-tech companies that target this substantial and underserved demographic segment, rather than offering the latest technology to younger audiences, that adopt technology faster but are much more fickle. It is, therefore, actively seeking to enrich the product suite to include other consumer products that bear similar characteristics appealing to this particular demographic segment, such as tools in the areas of personal productivity, language, PC optimization, and more. All marketing and development efforts have been shifted to support a better understanding of this target segment and its particular needs. This should support the effort to create the best possible products to answer these needs.

The next step

IncrediMail is entering 2011 with a strong base of consumers who are interested in a customized and entertaining email or instant messaging experience. However, its revenue stream is based on one major product, supported on a single platform and device type and one major revenue stream. In the constantly changing and rapidly evolving environment of the internet and electronic communication industries, the company fears this is not a sustainable situation for the coming future.

The search arena, which creates almost 80% of the company's revenues, is affected by the general trends and metrics of the search revenue market. One of the most significant metrics is the cost per click (CPC) rate. In an economic downturn, the amount advertisers are willing to pay naturally declines, reducing the CPC rate and subsequently the company's revenues. The CPC rate fluctuated dramatically over the last months of 2010 and it is difficult to predict a specific trend in this important metric going forward.

There has been a growing usage of portable platforms bridging between the mobile phone and the PC, enabling users to enjoy a more graphic and creative experience, while not requiring a PC. This trend is most notable in the iPhoneTM and other similar "smart phone" products as well as the iPadTM and similar products. In addition, and partially as a result of these successes, the popularity of the Apple-Mac platform has increased as well.

Another major trend that has been apparent is the inclination of market leaders in different areas to incorporate services from areas outside their product's main focus. An example of this has been the social network leader Facebook with its increasing penetration first into instant messaging and then into email. This trend has caused IncrediMail to focus efforts on accommodating the Facebook platform, and transforming its email client from a software managing emails to a communication client capable of incorporating other methods of communication, such as social networks, instant messaging, etc.

Yet another complication in the email market is the direct competition between web-based software and downloaded software, and while email software programs and services currently enjoy a large market, the development and consumer acceptance of other means of electronic communication, such as text messaging over phone networks, chat boards, blogs and web-based social networks, could result in a substantial decrease in the size of this market. Other threats include the faster growth of web-based email software in comparison to client side email software and the growing trend of internet-based companies to provide services for free, including email clients and anti-spam software and services, reducing the demand for paid premium products, such as those sold by IncrediMail.

All this has led the company to realize it must find new ways for its core business to grow, focusing on consumers and their needs. However the main question remains what are the strategic actions the company must pursue in order to achieve its ambitious goal to create $100 million in revenues by 2014 in such an ever-changing environment.

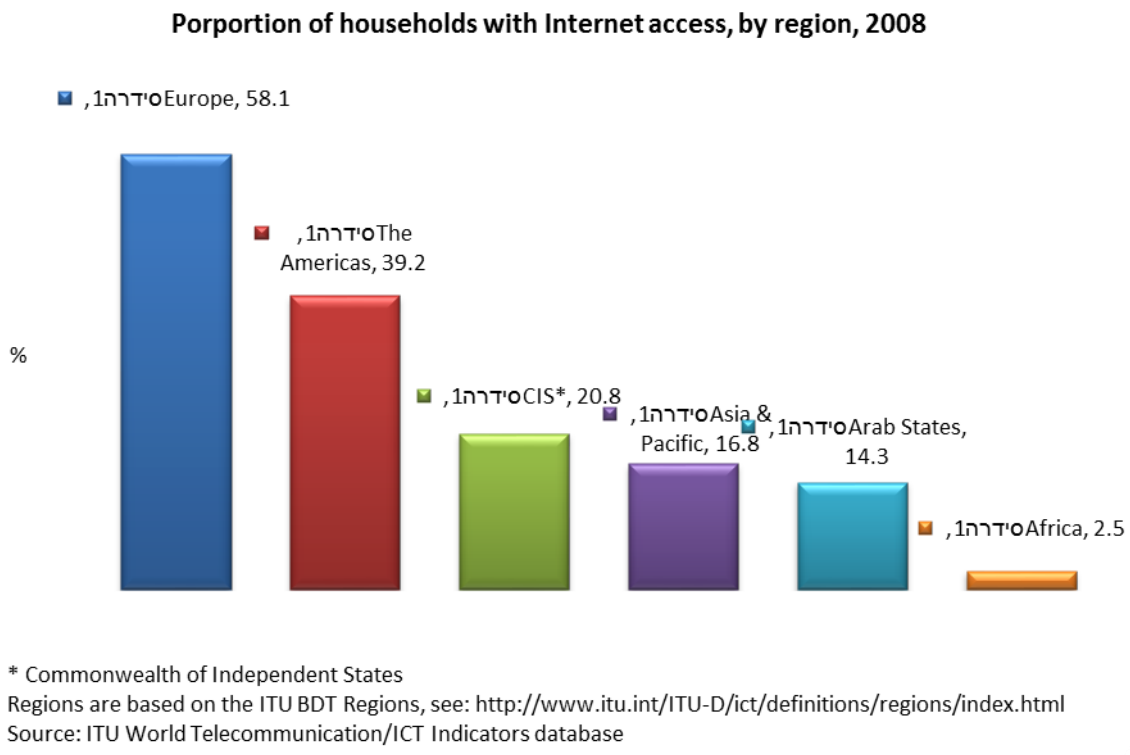
Appendices

Exhibit 1: World Internet Penetration by Geographic Regions, 2010

Region	Penetration Rates	Users (m)
North America	77.4%	266.2
Oceania/ Australia	61.3%	21.3
Europe	58.4%	475.1
Latin America/ Caribbean	34.5%	204.7
Middle East	29.8%	63.2
Asia	21.5%	825.1
Africa	10.9%	110.7

Source: Internet World Stats

Exhibit 2: Proportion of Households with Internet Access, by Region, 2008



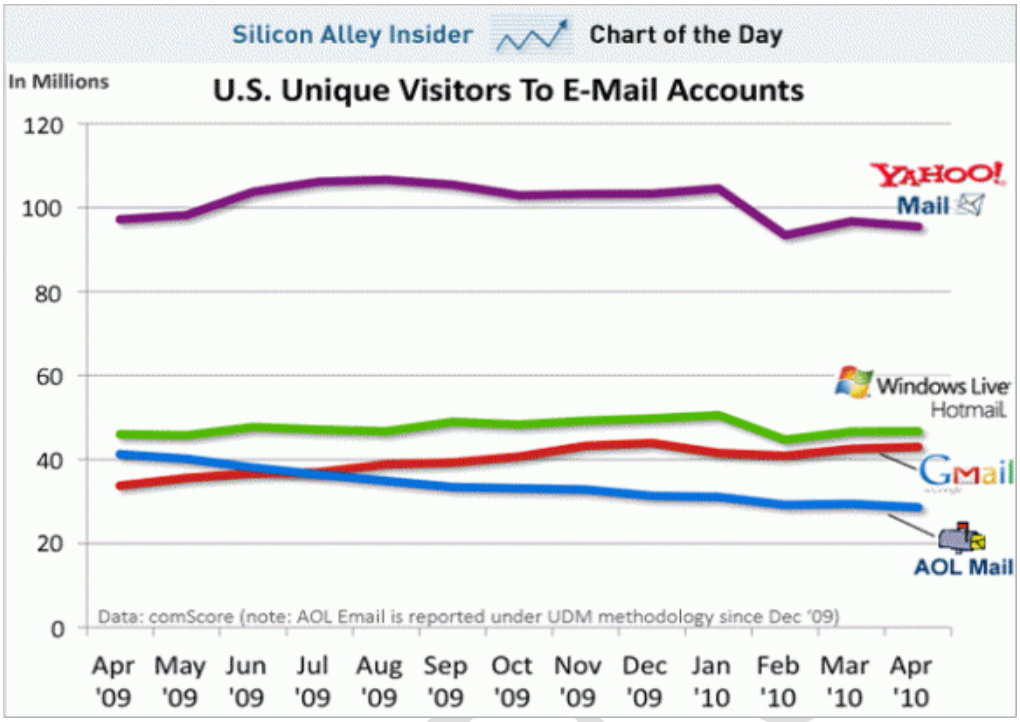
Source: ITU world communications

Exhibit 3: Top 20 Countries with Highest Number of Internet Users

Country or Region	Population, 2010 Est. 1,000	Users Latest Data 1, 000	% Population Penetration	Growth 2000-2010	% of World Users
China	1,330,141	420,000	31.6 %	1,766 %	21.4 %
United States	310,233	239,894	77.3 %	151 %	12.2 %
Japan	126,804	99,144	78,2 %	110 %	5.0 %
India	1,173,108	81,000	6.9 %	1,520 %	4.1 %
Brazil	201,103	75,944	37.8 %	1,418 %	3.9 %
Germany	82,283	65,124	79.1 %	171 %	3.3 %
Russia	139,390	59,700	42.8 %	1,825 %	3.0 %
United Kingdom	62,348	51,442	82.5 %	234 %	2.6 %
France	64,768	44,625	68.9 %	425 %	2.3 %
Nigeria	152,217	43,982	28.9 %	21,891 %	2.2 %
Korea South	48,636	39,440	81.1 %	107 %	2.0 %
Turkey	77,804	35,000	45.0 %	1,650 %	1.8 %
Iran	76,923	33,200	43.2 %	13,180 %	1.7 %
Mexico	112,468	30,600	27.2 %	1,028 %	1.6 %
Italy	58,091	30,026	51.7 %	127%	1.5 %
Indonesia	242,968	30,000	12.3 %	1,400 %	1.5 %
Philippines	99,900	29,700	29.7 %	1,385 %	1.5 %
Spain	46,506	29,094	62.6 %	440 %	1.5 %
Argentina	41,343	26,615	64.4 %	964 %	1.4 %
Canada	33,760	26,225	77.7 %	106 %	1.3 %

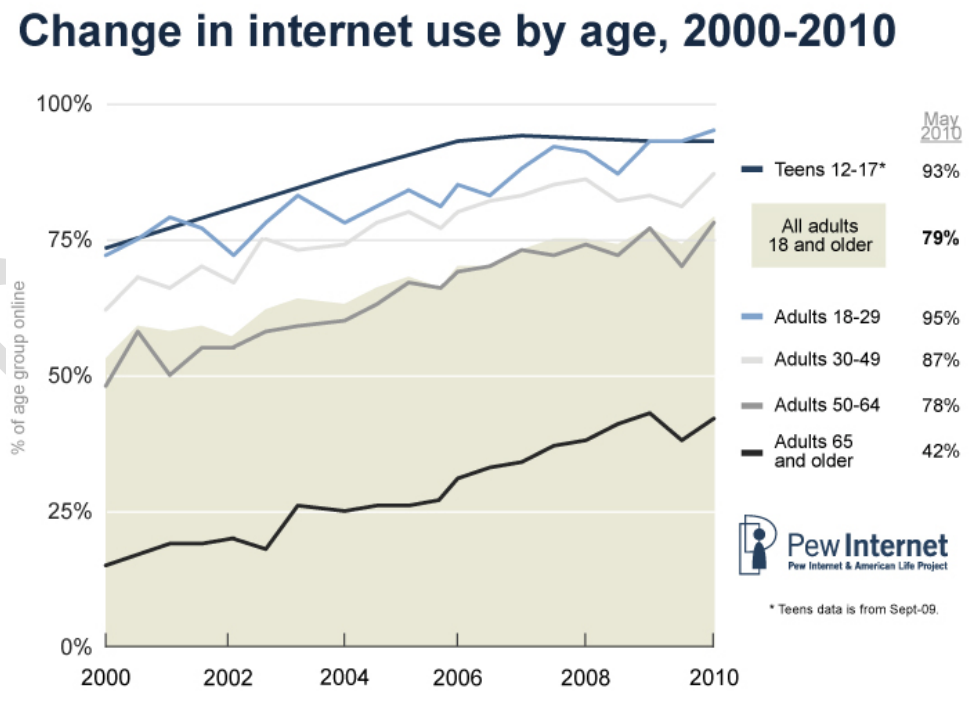
Source: Miniwatts Marketing Group

Exhibit 4: Internet US Accounts



Source: ComSource

Exhibit 5: Change in Internet Use by Age, 2000-2010



Source: Pew Research Center

Exhibit 6: Searches—Comparison, 2009 vs. 2008

Top 10 Countries by Number of Searches Conducted* December 2009 vs. December 2008 Total Worldwide, Age 15+ - Home & Work Locations Source: comScore qSearch			
	Searches (MM)		
	Dec-2008	Dec-2009	Percent Change
Worldwide	*89,708*	*131,354*	*46%*
United States	18,688	22,741	22%
China	11,778	13,278	13%
Japan	6,213	9,170	48%
United Kingdom	4,623	6,245	35%
Germany	4,079	5,609	38%
France	3,362	5,425	61%
South Korea	2,796	4,039	44%
Brazil	2,454	3,763	53%
Canada	2,900	3,710	28%
Russian Federation	1,735	3,333	92%

Exhibit 7: Internet Business Models

Brokerage Model

Brokers are market-makers: they bring buyers and sellers together and facilitate transactions. Brokers frequently play a role in business-to-business (B2B), business-to-consumer (B2C), or consumer-to-consumer (C2C) markets. Usually a broker charges a fee or commission for each transaction it enables. The formula for fees can vary. Main brokerage models include :

Marketplace Exchange—offers a full range of services covering the transaction process, from market assessment to negotiation and fulfillment (Orbitz, ChemConnect).

Buy/Sell Fulfillment—takes customer orders to buy or sell a product or service, including terms like price and delivery (CarsDirect, Respond.com).

Demand Collection System—the patented "name-your-price" model pioneered by Priceline.com. Prospective buyer makes a final (binding) bid for a specified good or service, and the broker arranges fulfillment.

Auction Broker—conducts auctions for sellers (individuals or merchants). The broker charges the seller a listing fee and commission scaled with the value of the transaction. Auctions vary widely in terms of the offering and bidding rules (eBay).

Transaction Broker—provides a third-party payment mechanism for buyers and sellers to settle a transaction (PayPal, Escrow.com).

Distributor—is a catalog operation that connects a large number of product manufacturers with volume and retail buyers. A broker facilitates business transactions between franchised distributors and their trading partners.

Search Agent—a software agent or "robot" used to search out the price and availability for a good or service specified by the buyer, or to locate hard to find information.

Virtual Marketplace (or virtual mall)—a hosting service for online merchants that charges setup, monthly listing, and/or transaction fees. It may also provide automated transaction and relationship marketing services (zShops and Merchant Services at Amazon.com).

Advertising Model

The web advertising model is an extension of the traditional media broadcast model. The broadcaster, in this case, a web site, provides content (usually, but not necessarily, for free) and services (like email, IM, blogs) mixed with advertising messages in the form of banner ads. The banner ads may be the major or sole source of revenue for the broadcaster. The broadcaster may be a content creator or a distributor of content created elsewhere. The advertising model works best when the volume of viewer traffic is large or highly specialized. Main advertising models include:

Portal—usually a search engine that may include various content or services. A high volume of user traffic makes advertising profitable and permits further diversification of site services. A personalized portal allows customization of the interface and content to the user. A niche portal cultivates a well-defined user demographic (Yahoo!).

Classifieds—list items for sale or wanted for purchase. Listing fees are common, but there also may be a membership fee (Monster.com, Craigslist).

User Registration—content-based sites that are free to access but require users to register and provide demographic data. Registration allows inter-session tracking of user surfing habits and thereby generates data of potential value in targeted advertising campaigns (NYTimes).

Query-based Paid Placement—sells favorable link positioning (i.e., sponsored links) or advertising keyed to particular search terms in a user query, such as Overture's trademark "pay-for-performance" model (Google, Overture).

Contextual Advertising / Behavioral Marketing—freeware developers who bundle adware with their product. It may be, for example, a browser extension that automates authentication and form fill-ins, and also delivers advertising links or pop-ups as the user surfs the web. Contextual advertisers can sell targeted advertising based on an individual user's surfing activity.

Content-Targeted Advertising—pioneered by Google, it extends the precision of search advertising to the rest of the web. Google identifies the meaning of a web page and then automatically delivers relevant ads when a user visits that page (Google).

Intromercials—animated full-screen ads placed at the entry of a site before a user reaches the intended content (CBS MarketWatch).

Infomediary Model

Data about consumers and their consumption habits are valuable, especially when the information is carefully analyzed and used to target marketing campaigns. Independently collected data about producers and their products are useful to consumers when considering a purchase. Some firms function as infomediaries (information intermediaries) helping buyers and/or sellers to understand a given market. The following models are in this field:

Advertising Networks—feed banner ads to a network of member sites, thereby enabling advertisers to deploy large marketing campaigns. Ad networks collect data about web users that can be used to analyze marketing effectiveness (DoubleClick).

Audience Measurement Services—online audience market research agencies (Nielsen).

Incentive Marketing—a customer loyalty program that provides incentives to customers such as redeemable points or coupons for making purchases from associated retailers. Data collected about users is sold for targeted advertising (Coolsavings).

Metamediary—facilitates transactions between buyers and sellers by providing comprehensive information and ancillary services, without being involved in the actual exchange of goods or services between the parties (Edmunds).

Merchant Model

These may be wholesalers and retailers of goods and services. Sales may be made based on list prices or through auction, and several models of operation exist:

Virtual Merchant (or e-tailer) is a retail merchant that operates solely over the web (Amazon.com).

Catalog Merchant is a mail-order business with a web-based catalog. It combines mail, telephone and online ordering (Lands' End).

Click and Mortar is a traditional brick-and-mortar retail establishment with a web storefront (Barnes & Noble).

Bit Vendor is a merchant that deals strictly in digital products and services and, in its purest form, conducts both sales and distribution over the web (Apple iTunes Music Store).

Manufacturer Direct Model

The manufacturer or "direct model" is predicated on the power of the web to allow a manufacturer (i.e., a company that creates a product or service) to reach buyers directly and thereby compress the distribution channel. The manufacturer model can be based on efficiency, improved customer service, and a better understanding of customer preferences (Dell Computers). Additional business models include Purchase, Lease, License and Brand integrated content.

Purchase—the sale of a product in which the right of ownership is transferred to the buyer.

Lease—in exchange for a rental fee, the buyer receives the right to use the product under a "terms of use" agreement. The product is returned to the seller upon expiration or default of the lease agreement. One type of agreement may include a right of purchase upon expiration of the lease.

License—the sale of a product that involves only the transfer of usage rights to the buyer, in accordance with a "terms of use" agreement. Ownership rights remain with the manufacturer (e.g., with software licensing).

Brand-Integrated Content—in contrast to the sponsored-content approach (i.e., the advertising model), brand-integrated content is created by the manufacturer itself as the sole basis of product placement

Affiliate Model

In contrast to the generalized portal, which seeks to drive a high volume of traffic to one site, the affiliate model provides purchase opportunities wherever people may be surfing. It does this by offering financial incentives (in the form of a percentage of revenue) to affiliated partner sites. The affiliates provide purchase-point click-through to the merchant. It is a pay-for-performance model—if an affiliate does not generate sales, it represents no cost to the merchant. The affiliate model is inherently well-suited to the web, which explains its popularity. Variations include banner exchange, pay-per-click, and revenue-sharing programs (Barnes & Noble, Amazon.com). Several other variants of the model include:

Banner Exchange—trades banner placement among a network of affiliated sites.

Pay-per-click—site that pays affiliates for a user click-through.

Revenue Sharing—offers a percent-of-sale commission based on a user click-through in which the user subsequently purchases a product.

Community Model

The viability of the community model is based on user loyalty. Users have a high investment in both time and emotion. Revenue can be based on the sale of ancillary products and services or voluntary contributions; or revenue may be tied to contextual advertising and subscriptions for premium services. The internet is inherently well suited to community business models and today this is one of the more fertile areas of development, as can be seen in the rise of social networking.

Open Source—software developed collaboratively by a global community of programmers who share code openly. Instead of licensing code for a fee, open source relies on revenue generated from related services like systems integration, product support, tutorials and user documentation (Red Hat).

Open Content—openly accessible content developed collaboratively by a global community of contributors who work voluntarily (Wikipedia).

Public Broadcasting—a user-supported model used by not-for-profit radio and television broadcasting extended to the web. A community of users supports the site through voluntary donations (WCPE.org).

Social Networking Services—sites that provide individuals with the ability to connect to other individuals along a defined common interest (professional, hobby, romance). Social networking services can provide opportunities for contextual advertising and subscriptions for premium services (Flickr, Friendster, Orkut).

Subscription Model

Users are charged a periodic—daily, monthly or annual—fee to subscribe to a service. It is not uncommon for sites to combine free content with "premium" (i.e., subscriber- or member-only) content. Subscription fees are incurred irrespective of actual usage rates. Subscription and advertising models are frequently combined.

Content Services—provide text, audio, or video content to users who subscribe for a fee to gain access to the service (Listen.com, Netflix).

Person-to-Person Networking Services—are conduits for the distribution of user-submitted information, such as individuals searching for former schoolmates (Classmates).

Trust Services—come in the form of membership associations that abide by an explicit code of conduct, and in which members pay a subscription fee (Truste).

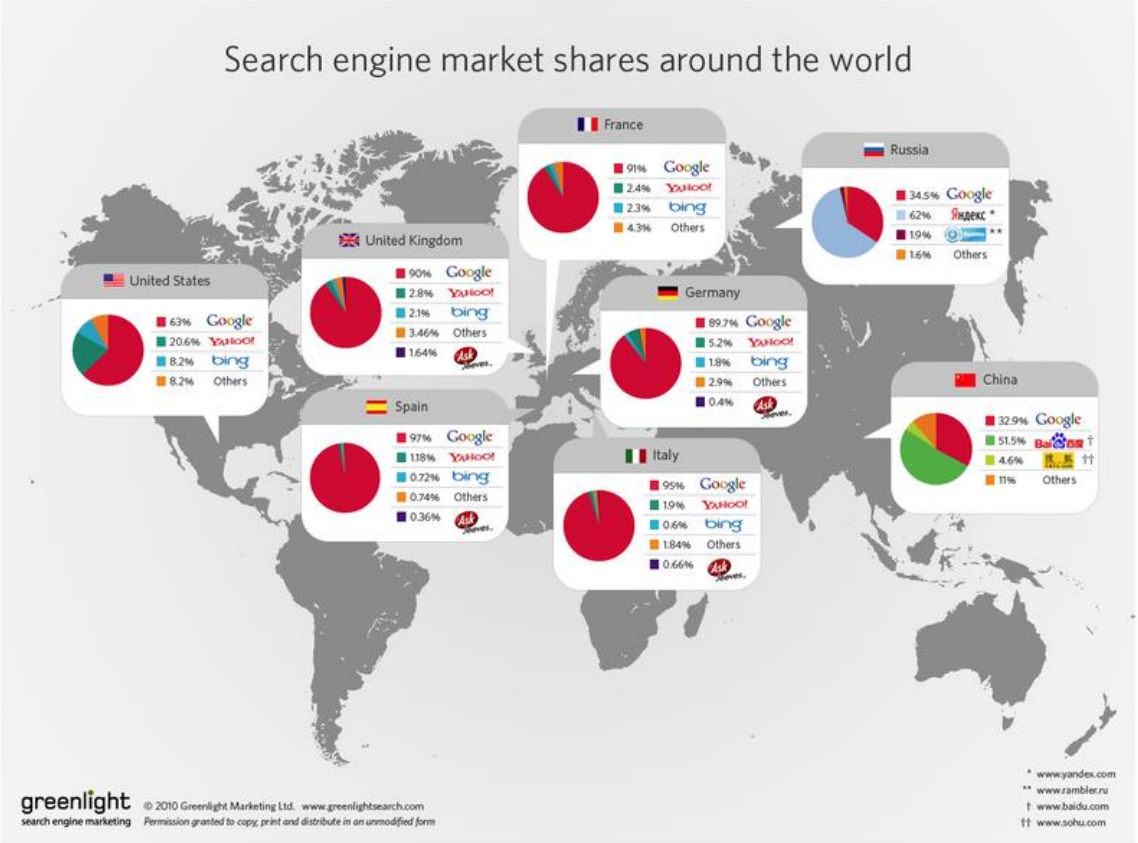
Internet Services Providers—offer network connectivity and related services on a monthly subscription (America Online).

Utility Model

The utility or "on-demand" model is based on metering usage, or a "pay as you go" approach. Unlike subscriber services, metered services are based on actual usage rates. Traditionally, metering has been used for essential services (e.g., electricity water, long-distance telephone services). Internet service providers (ISPs) in some parts of the world operate as utilities, charging customers for connection minutes, as opposed to the subscriber model common in the US. The business model varies between metered usage (measures and bills users based on actual usage of a service) and metered subscriptions (which allows subscribers to purchase access to content in metered portions, e.g., numbers of pages viewed).

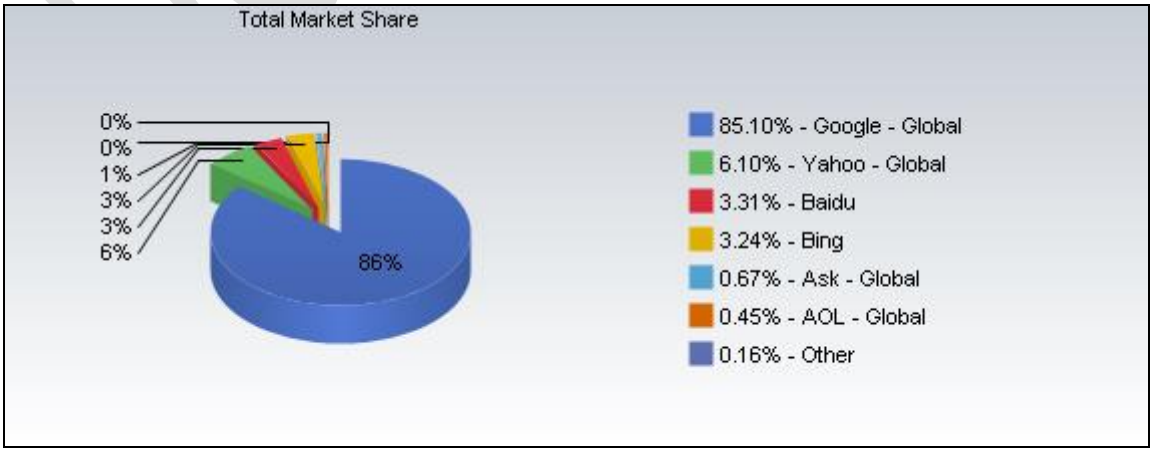
Source: http://digitalenterprise.org, Prof. Michael Rappa, Department of Computer Science at North Carolina State University

Exhibit 8: Search Engine Market Shares around the World 2010



Source: www.greenlightsearch.com

Exhibit 9: Search Engine Market Shares, 2010



Source: www.netmarketshare reports statistics for internet technologies

Exhibit 10: IncrediMail Competitors

Web-based email

The web-based email market is characterized by significant competition, changing technologies and evolving product and service enhancements. Leading competitors include email software providers such as Google (Gmail), Yahoo (mail) and Microsoft (Hotmail). Each of these large companies offers a web-based email service in addition to the many other services they provide, such as desktop search, local search, instant messaging, photos, maps, video sharing, mobile applications etc.

Downloaded email clients

Some competition also comes from competitors offering programs bearing some resemblance to the IncrediMail software. Using the software also requires the download of an email client. Main competitors in this field include: Wikmail, Arcsoft (Multimedia email 3) and Maid Spark products.

General email software

Additional competition also comes from the general email software offered to the private market by large internet and software companies such as America Online Inc. (AOL9), Qualcom Inc. (Eudora), Mozilla Cooperation (Thunderbird) and Microsoft (Outlook Express). Most of these programs are offered by the companies to their clients free of charge. Some also incorporate certain special features that provide a personalized email experience, and some offer creative graphic backgrounds such as Yahoo Mail.

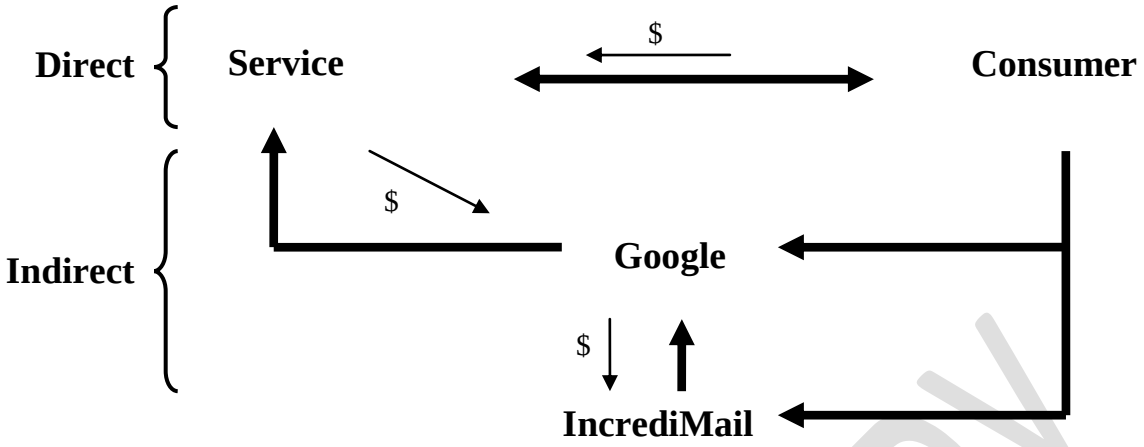
Wall paper, screen savers and digital photo management

The main competitors for Incredimail's Magnetic and PhotoJoy products in the area of wall paper, screen savers and digital photo providers include Picasa, webshots.com screensavers.com, which offer wallpapers and screensavers for free and premium products for a fee.

Creative instant message tools

The HiYo instant message upgrade tool has several competitors, including SweetIM, Bandoo, Imminent and Smiley Central (by Inter Active Corp.), which offer end-user solutions similar to those of IncrediMail's product.

Exhibit 11: IncrediMail Business Model



Source: Authors' analysis

Exhibit 12: IncrediMail Products

IncrediMail Xe

The company's flagship product is available free of charge. It offers email, background and letterheads; animated notifiers (indications that email has been received); emotions (animations that are intended to convey emotions); 3D effects; handwritten signatures; sound effects and virtual e-cards.

In August 2009 the company released a new version of the product, Incredimail2, which had a fresh look, current graphics and enhanced capabilities, including enhanced search capabilities. The product is currently available in ten languages in addition to English.

Incredimail Premium

Incredimail Premium is an enhanced version of the free software with the following features: no advertising banners; the ability to change the product's appearance through the use of software skins; a voice message recorder; no promotional link at the bottom of outgoing emails; a web gallery with additional animations; notifiers and email backgrounds; advance account access and email-based user support. The advanced access feature allows the user to delete unwanted mails for the server without downloading them to the computer.

Magnetic

Magnetic software is free offering its users a huge selection of thousands of amazing screensavers; new collections are constantly being added, including a feature enabling users to add personal screensavers and wallpapers from their own photos.

PhotoJoy

Free software designed to reveal on the user's desktop all chosen photos saved on the user's computer. Features include desktop wallpaper collages (display photos inside beautiful scenery and illustrations); PhotoToy (displays photos in fresh and fun ways); and 3D screensavers (displays photos in 3D dynamic screensavers). In addition the software allows users to take photos from photo hosting web sites (such as Flickr and Picasa) and continue viewing new photos once uploaded to these sites directly on PhotoJoy as well.

HiYo

HiYo is a free add-on for upgrading the instant messaging experience that takes it to a whole new level of fun by adding many amazing Emoticons, Winks, SuperWinks, Animations, Nudges, Smileys and Sounds .The program is compatible with Windows Live Messenger (MSN), AIM and Yahoo! Instant Messenger.

Exhibit 13: IncrediMail Revenue Breakdown, by Line of Business, $ m

Source	2008	2009	2010
Search	11.7 (53%)	20 (74%)	22.8 (77%)
Software license	3.6 (16%)	2.4 (9%)	1.8 (6%)
Anti-spam and content database subscription	5.5 (25%)	4.3 (16%)	3.6 (12%)
Advertising, collaboration and other	1.0 (5%)	0.5 (2%)	1.3 (4%)
Total revenues	**21.9**	**27.2**	**29.5**

Source: Company data

Exhibit 14: IncrediMail Sales and Distribution by Region, 2010

Region	Registrations	Search Generated Revenues	Product Revenues
United States, Canada, United Kingdom & Australia	20%	41%	53%
France, Germany, Netherlands, Italy, Belgium & Switzerland	36%	42%	32%
Other	44%	17%	15%
Total	**100%**	**100%**	**100%**

Source: Company data

Exhibit 15: IncrediMail Users, Downloads, Usage and ARPU, per Year

Year	*Active Users, (end of year) 1,000,000	*Average Monthly Program Downloads 1,000,000	*Average Monthly IncrediMail emails Sent 1,000,000	**Average Yearly Revenue per User US$
2006	10.2	1.2	330	1.1
2007	10.0	1.2	330	1.9
2008	11.0	1.7	350	2.0
2009	11.0	1.8	350	2.5
2010	10.7	1.5	280	2.8

Source: *Company data
** Authors' calculations

Exhibit 16: IncrediMail Employees *

	2008	2009	2010
Management and administration	16	12	21
Support	16	16	14
Research and Development	69	64	54
Selling and Marketing	18	19	18
Total Employees	**119**	**111**	**107**

* At the beginning of 2011, some changes were made, following outsourcing of part of the R&D to the Far East and recruitment in the areas for marketing and management.

Source: Company data

Exhibit 17: IncrediMail Consolidated Statement of Income, US$ 1,000

	31/12/2006	31/12/2007	31/12/2008	31/12/2009	31/12/2010
Revenues:					
Advertising and other services	n/a	n/a	12,748	20,478	24,093
Products	n/a	n/a	9,158	6,717	5,404
Total revenues	**10,851**	**18,675**	**21,906**	**27,195**	**29,497**
Cost of revenues	**858**	**1,740**	**1,687**	**1,505**	**1,606**
Gross profit	**9,993**	**16,935**	**20,219**	**25,690**	**27,891**
Operating expenses					
Research and development	3,251	6,125	7,838	6,254	6,607
Selling and marketing	1,767	4,682	7,202	4,616	5,244
General and administrative	2,717	3,693	3,806	3,334	4,741
Goodwill impairment and restructuring		163	1,153		
Total operating expenses	**7,735**	**14,663**	**19,999**	**14,204**	**16,592**
Operating income	**2,258**	**2,272**	**220**	**11,486**	**11,299**
Financial income, net	984	(3,641)	4,494	72	322
Income before taxes on income	3,242	(1,369)	4,714	11,558	11,621
Taxes on income	765	1,393	289	3,545	3,232
Net income	**2,477**	**(2,762)**	**4,425**	**8,013**	**8,389**

Exhibit 18: IncrediMail Balance Sheets, US$ 1,000

	Item/ Year	31/12/2006	31/12/2007	31/12/2008	31/12/2009	31/12/2010
Current assets	Cash and cash equivalents	8,366	4,611	7,835	24,368	16,055
	Short-term bank deposit		1,000			
	Marketable securities	17,381	17,811	18,790	5,225	14,973
	Trade receivables	1,828	1,993	2,194	2,320	2,795
	Deferred taxes, net	418	368	362		
	Other receivables and Pre-paid expenses	611	2,017	4,941	4,819	4,485
	Total current assets	**28,604**	**27,800**	**34,122**	**36,732**	**38,308**
Long-term assets	Severance pay fund	589	1,037	955	1,104	877
	Deferred taxes, net	221	92	328	63	102
	Long-term deposits	412	482			
	Restricted cash	92	158			
	Long-term investment		100			
	Other long-term assets			619	495	478
	Property and equipment, net	877	1,808	1,478	1,366	1,381
	Other intangible assets, net	341	164	149	134	202
	Goodwill	288	125			
	Total long-term assets	**2,820**	**3,966**	**3,529**	**3162**	**3,040**
Total assets		**31,424**	**31,766**	**37,651**	**39,894**	**41,348**
Current liabilities	Trade payables	464	1,546	1,948	1,039	1,831
	Deferred revenues	3,703	3,254	2,605	2,270	2,204
	Accrued expenses and other	2,876	3,244	4,426	6,577	6,206
	Total current liabilities	**7,043**	**8,044**	**8,979**	**9,886**	**10,241**
Long-term liabilities	Deferred revenues	951	1,559	1,743	1,616	1,576
	Accrued severance pay	853	1,392	1,385		
	Obligation under capital lease				1,390	1,379
	Total long-term liabilities	**1,804**	**2,951**	**3,128**	**3,006**	**2,955**
Shareholders' equity	Ordinary shares	20	20	21	21	22
	Additional paid-in capital	20,993	22,029	23,358	22,390	23,734
	Accumulated other comprehensive income	109	112	12	207	100
	Retained earnings	1,455	(1,390)	3,035	5,386	5,298
	Treasury stock			(882)	(1,002)	(1,002)
	Total shareholders' equity	**22,577**	**20,771**	**25,544**	**27,002**	**28,152**
Total liabilities and shareholders' equity		**31,424**	**31,766**	**37,651**	**39,894**	**41,348**