

4 KEYS TO A STICKY SERVICES SUBSCRIPTION BUSINESS MODEL

A WHITE PAPER BY ERIC MERSCH

EXECUTIVE SUMMARY

The managed services sector has been slow to adopt subscription business models despite the success of product companies in doing so. The main concern seems to be the need to change behavior of consumer, which includes both individuals and enterprises. I've drawn upon my experience to identify several key success factors common to managed services providers using the subscription model.

Barriers to Subscription Model Adoption

Subscription-based business models provide higher value to both the vendor and customer. For the vendor, recurring revenue is more predictable and, hence, more valuable than revenue derived from on-demand purchases. Providing monthly services also enables stronger customer relationships since the providers work with the customer throughout the month. The customer enjoys convenience and better product or service fit.

Why then do managed service providers hesitate to offer subscriptions? Foremost, is a concern over the need to change customer behavior. The traditional financial transaction is on-demand, pay-as-you-go. So, selling services requires consumers – both individuals and businesses – to buy into a completely new way of acquiring services. For example, consider a company with a need for some specialized type of technology development. If the company's processes require a consistent workload, provided by easily recruited talent, served by available technology, and managed with a high degree of control then it will develop internal capability. A vendor wishing to provide subscription services to this customer must offer a higher value proposition in one or more of these requirements by an order of magnitude – a daunting challenge to be sure.

A second customer concern relates to the consistency of their needs, both short-term and long-term. In the short term, the services need may vary significantly or may be infrequent. For the vendor, this is a market fit issue. The service will only fit the need if the vendor can convince customers to change the way in which the function works. And while this is certainly possible, vendors must ensure that the probability of doing so is high enough to justify the effort.

In the long term, customers may plan to internalize the outsourced function and seeks to use outsourced services in the interim. For the vendor, the challenge is to perform so strongly as to convince the customer to maintain the outsourced contract.

A third issue relating to subscription adoption relates to enterprise customers that have internal organizational hurdle. Such customers purchase software with capital funds allocated through a disciplined budget process. Most do not have a process to evaluate and approve the use of operational funds for subscription purchases. Departments within the enterprise use their operational budgets to purchase point solutions. However, enterprise-wide solutions require reallocation of capital funds and this makes subscription sales much more difficult.

Given these barriers, how can a managed services provider run a successful subscription business? Product companies pioneered subscriptions and educated individuals and companies on the benefits. This clearly created momentum for subscription adoption. However, managed service providers need to understand key success factors unique to their businesses.

Keys to a Sticky Services Subscription Business Model

1. Gain an understanding of the customer's true internal costs

All companies considering outsourcing a function run the numbers on outsourced versus internal costs. It is important for vendors to understand the actual internal costs so that they can market their subscription service properly. This is true for any outsourcing business but is far more important in the subscription model because managed service providers seek a long term relationship.

True internal costs include far more than the cost per service hour calculated as the annual salary divided by working days per year. Other internal costs, sometimes referred to as hidden costs, include employee management, labor overhead, and operational expenses. Building an internal team consumes resources for recruiting, onboarding and low-productivity ramp-time of new hires. A blog post by well-known recruiter, Jörgen Sundberg, estimates the cost of onboarding an employee at \$240,000. Cultural fit is a challenge with expensive consequences. According to the U.S. Department of Labor, the price of a bad hire is at least 30 percent of the employee's first-year earnings. And termination can bring severance costs and disruption as the team reorganizes to cover for the departed employee.

Other employee-related costs are more straightforward. Payroll taxes, health and insurance benefits, 401k plan, earned PTO, stock-based compensation combined can reach 30% of an employee's base salary. Bonuses can add another 3% to 20% on base. To complete the picture, you should estimate per-employee overhead expense such as travel & entertainment, rent, maintenance and utilities, IT support, dues & subscriptions and office benefits such as food service if significant.

Once you have this knowledge, use it to educate potential customers through all traditional marketing channels as well as through direct and indirect sales. Set your subscription rate to be competitive with an internal team.

2. Provide an alternative to building an internal core competency

Another major consideration in the outsource vs internal decision, is the customer's reliance on the function to support its core competency. Core competencies directly contribute to the competitiveness of a company's business and is based upon the combination of knowledge and technology.

Not all functions need to be a core competency. Therein lies the opportunity for the outsourced businesses. Again, this exercise takes on more importance in the subscription model due to the longer term relationship.

To evaluate a potential customer's function as a core competency, understand the following three questions.

Does that function significantly enhance the customer's ability to serve the largest possible addressable market?

Does that function make a significant contribution to the customer's value proposition?

Does that function make the customer's product or service difficult to imitate by competitors?

Any function that does not meet all three criteria is available to be outsourced. By completing this analysis, the managed services provider can determine the target customers for its service offering. Having this knowledge will allow for customer education and conversion to the subscription offering.

3. Understand the nature of the customer's needs

Selling subscription services requires a unique evaluation of the customer resource needs. You need to gain a deep understanding of the consistency of demand on a month to month basis. In general, the greater the consistency, the better the fit. The goal is to fully replace a customer's internal function, which should result in a consistent workload. The need to evaluate demand is obviously key to any outsourcer, but is more important in the subscription model since any supply / demand imbalance will create friction both internally and externally.

Of course, there will be volatility in the workload. You will need to decide an acceptable variance that both you and the customer find suitable. The contract must address usage above and below the subscription level. Customer usage above the subscription level should be addressed with overage charges. Make sure that you track customer usage during the subscription period and alert the customer before the end of the period. Consistent usage above the subscription level should be leveraged to upsell the customer's subscription. You could invoice for overage charges, but this defeats the purpose of a subscription model, leading to higher revenue volatility.

Customer usage below the subscription level should trigger customer alerts to the availability of services. Customer Success teams should convey this message and then help customers maximize their use of resources. To be sure, customers are paying for availability of services. But, consistent underutilization will eventually lead to churn. You could offer a discount on the monthly invoice, but it dilutes the advantages of the subscription as described above.

Monitoring the customer usage will also demonstrate your success in on-boarding the right customers. If your customer base begins to diverge from your Ideal Customer Profile, then you should evaluate the marketing message and sales efficiency.

4. Establish the organization necessary to support the subscription model

The amount of work required depends upon your starting point. Assuming you are just starting the process, there are several steps I suggest you take.

1. You need to ensure that the entire company understands subscription model theory because its importance touches every aspect of the business. It's a traditional organizational challenge - all employees must believe in the subscription model strategy.

2. Develop proprietary technology to provide specific functionality to your services. The strategy is to enable your labor force with technology, allowing for increase productivity and service delivery excellence. In practice, I've seen technology platforms that increase labor productivity, automate more mundane tasks and provide customers with data analytics and visualization. Following this strategy will allow price increases or, at least, prevent price reductions.
3. Organize a team to actively manage your labor force to ensure resource availability and cost flexibility. Add community elements to build a sense of cohesion. Introduce technology-driven gamification and non-compensation-based incentives. This is especially important with a distributed labor force.
4. Establish Customer Success and Operations organizations that work collaboratively to deliver the right amount of resources to customers. These departments need to provide feedback to Sales & Marketing to refine the Ideal Customer Profile and to Product Engineering to influence the product roadmap.
5. Track operational metrics on an intra-day basis. Tailor your KPIs to your service, but at a minimum you should track the following metrics,
 - Customer Engagement
 - Hours Utilized per Customer
 - Revenue per Hour
 - Labor Cost per Hour
 - Labor force Utilization
 - Operations Utilization
6. Create an automated system for monthly invoicing. This should be easy unless you offer variable fee structure to include overage charges and/or discounts. As mentioned above, this is not advisable. Not only does it negatively impact the purpose for implementing a subscription model, but it will also add significant complexity to invoicing.
7. Establish systems to track profitability by customer. This is particularly important if you offer services requiring different degrees of knowledge and skills and, hence, differing wages.

FOOTNOTES:

- i. Forbes <https://www.forbes.com/sites/falonfatemi/2016/09/28/the-true-cost-of-a-bad-hire-its-more-than-you-think/#cd791504aa41>
- ii. Prahalad, C.K. and Hamel, G. (1990) "The core competence of the corporation", Harvard Business Review (v. 68, no. 3) pp. 79-91.
- iii. 1.Topo <http://blog.topohq.com/framework-ideal-customer-profile-icp-development/>

ABOUT THE AUTHOR

Eric Mersch works as an On Demand CFO at Burkland Associates. He has 15 years of corporate finance experience including two public company CFO roles and an operational finance role at a Fortune 500 company. Most recently, he served as CFO, CAO and VP, HR for ZipRealty, Inc., a public real estate technology services company. Eric and the Zip team sold the company to Realogy at a 122% premium to market capitalization. He has provided financial and strategic advice to small and large organizations in the telemedicine, mobile phone, logistics, and data center virtualization and industries.

Eric holds an MBA from Harvard Business School, a master's in Nuclear Power Engineering from the US Navy's elite Nuclear Program, and a Bachelor of Science in Economics from the U.S. Naval Academy.