

Transitioning to Subscription-Based Business Models

What Solution Providers Need to Know

Channel experts are urging solution providers to adopt subscription-based business models or risk losing ground to competitors. Gartner, for example, says that “to capture future growth and be positioned on the right side of the fast-shifting IT services marketplace, IT service providers of every type need to bridge their legacy offerings and new delivery paradigms.”ⁱ

But actually making that transition can be challenging, particularly if the current approach appears to be working. This paper takes a deeper look at some fundamental changes in the market that make business model change essential to solution provider survival. It will also explore what solution providers need to know to keep evolving their businesses, including a maturity curve designed to help spur additional progress no matter where they are in the transition.

Why change?

In the day-to-day minutia of running a solution provider business, it can be hard to see the bigger picture. But the fact is, the SMB IT marketplace is shifting in some fundamental ways that will impact how current and future customers will want to buy their IT.

Customers Are Changing. As older business owners retire and new entrepreneurs launch their own businesses, the number of tech-savvy SMBs increases. These owners are more accustomed to buying tech as a service. SMBs will spend an average 11% of their IT budgets on managed services and 14% on hosted/ cloud-based services in 2014, according to IT community Spiceworks.ⁱⁱ

A subscription model for IT better fits the way today’s SMBs want to buy: predictable monthly costs, eliminating tasks and investments outside their core competency and enabling business units to purchase solutions directly instead of through IT staff.

Tiffini Bova, VP, distinguished analyst at Gartner, says today’s IT customers are “far more interested in tagging together IT and business processes. . . It’s forced the channel to look at their business model and say what’s worked for me in the past is not necessarily what will work for me in the future.”ⁱⁱⁱ

Competition is closing in. IT solution providers are not the only ones to notice this shift. Lots of companies are moving into services—telcos, managed print providers, internet service providers, and generalized IT distributors such as CDW. There is a land grab for foundational services such as VoIP, print and IT. Companies with large marketing budgets and scalable delivery models are targeting customers currently served by IT solution providers.

Growth potential is limited. The classic break/fix business model creates highly volatile cash flow. This type of business is difficult to grow because it’s reactionary: Sales only occur if a business chooses to invest, or if something breaks.

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Channel analyst firm Service Leadership says product-centric solution providers comprise 22% of the North American partner population, and predict they will decline to about 18% by the end of 2015. Managed services businesses account for 41% of the partner population, a percentage that's increasing. From 2008 to 2012 median profits at the best-run managed services firms were nearly 20%, compared with about 13% for the top product-centric firms. ^{iv}

The market that has supported solution provider growth in the past is rapidly moving toward new ways to acquire technology. Solution providers need to shift along with them or risk losing those customers to competitors.

Maturity Curve In Selling Managed Services

But a recurring revenue-based business model represents a significant change for both providers and their clientele. Some solution providers have yet to begin the transformation, while many others have stalled somewhere along the road. While it's true that sometimes a few customers are better kept in break/fix relationships, the biggest benefits come when the solution provider can shift a majority of its services, and its customer base, to a recurring revenue model.

The most successful transitions allow the solution provider and its customers to migrate gradually. This maturity model illustrates what the business looks like at each stage of the transformation:

Level 1: Remote monitoring. In this model, the solution provider deploys software that allows techs to remotely monitor hardware, software and network performance for a client. The solution provider becomes aware of issues as soon as they occur and can contact the client to take action.

- **Value for the client** — This approach decreases the mean time to resolution; tech calls the client instead of waiting for the client to notice and call. Since the issue is resolved faster, the client enjoys better uptime. As part of the monthly fee, clients get a discount on needed services. However, the client may need to actively participate in remote problem resolution.
- **Value for the solution provider** — Less diagnostic time, since the problem is already known. Some predictable monthly revenue, though most often clients pay month to month.
- **Alignment with customer** — In this model, the solution provider still makes money—by selling repair services—when client is not making money, because their systems aren't working.

Level 2: Proactive Monitoring. In this model, techs use remote monitoring software to anticipate and prevent problems according to the terms of a service-level agreement. The contract may also include scheduled maintenance and remote support, such as blocks of time to cover mitigation/repairs. Tech support receives alerts as a client's environment is trending toward failure, so the issue can be mitigated before it happens.

- **Value for the client** — Proactive monitoring extends the life of systems and reduces downtime. The client gains somewhat predictable monthly IT costs—a set fee plus the cost of any on-site repairs or replacements/upgrades. Remote tasks can be performed without client involvement.
- **Value for the solution provider** — Predictable recurring revenue, with contracts typically covering 12 months. Opportunity to spot additional revenue potential in upgrades/replacements.
- **Alignment with customer** — In this model, there is a closer balance in solution provider/client interests; both benefit from well-maintained IT environments.

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Level 3: Fixed-Fee Services. This model has several variations, but generally the solution provider maintains the client's complete environment for a flat monthly fee, according to the terms of a comprehensive service-level agreement. The agreement typically covers everything except replacement hardware or projects, which are available at discounted rates. This model requires that solution providers have a firm grasp of their costs to serve and use tools to maximize the productivity of support staff.

- **Value for the client** — Client gains a de facto IT department and a predictable monthly IT cost, with low downtime rates. This model requires the least oversight and involvement for the client's staff.
- **Value for the solution provider** — Predictable recurring revenue, with higher margins than the previous models. Contracts are longer, often 36 months, which increases the market value of the solution provider's business.
- **Alignment with customer** — This model closely aligns customer and solution provider interests – both benefit the most when everything is working well, and lose money when it's not working.

The more mature the model, the more value the solution provider is delivering to the customer. Higher value equates to better customer retention. The most mature model also reaps the highest margins.

How To Get There

Just as with break/fix, it's easy to get stalled somewhere along this path. To reap the maximum potential from subscription-based models, solution provider leadership needs to craft a plan to begin or reinvigorate the transition toward a more mature model.

Talk to customers. The best way to start is to talk to customers and identify those services they truly need. The more mature the service, the more business value the solution provider should add to the service offering.

Develop a sales process. Selling recurring revenue services is entirely different than selling break/fix services. Progressing through the maturity curve is a good way to learn how service-based selling works.

A critical step is to ensure the right profile for sales talent. For many solution providers, this means replacing existing staff. Gartner's Bova says only about 30% of salespeople will be able to make the transition from traditional IT sales to the consultative style required for selling recurring revenue solutions and services.^v

Many have found that, when it comes to salespeople, experience in selling recurring revenue services, such as time-shares or advertising, is more valuable than technical sales experience.

Another key to a successful sales process is to compensate and motivate sales staff appropriately. Be prepared to pro actively coach sales staff through daily contact and feedback. Also:

- Establish attainable quotas
- Offer a percentage of the first month's contract
- Use trailers, a percentage (typically 2% to 5 %) of the monthly contract that is added to the salesperson's monthly commissions on an ongoing basis. The more contracts sold, the larger their compensation.
- Clearly define engagement goals, such as introducing the subscription model to existing customers.

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Create a pricing model. The IT industry tends to use these three approaches to pricing services:

- Based on number of devices — When presented with this model, SMBs tend to try to exclude devices. Because of this, the next two models tend to work better.
- Per user-pricing — SMBs are less likely to try to exclude people than devices. If they do, note that everyone really needs coverage since they access e-mail and the network.
- Holistic pricing — Includes an array of services at a flat rate. Solution providers often offer distinct levels of coverage, such as bronze, silver and gold.

Solution providers should choose the model they feel would best resonate with their clientele.

Manage change. A recurring revenue model impacts every part of the business, and clients as well. The first step is to let go of any past failures with similar business models. Then, make a clear case for the benefits and a plan for implementing the change with each affected department. Strong executive advocacy is the number one success factor in any business initiative.

Then develop a process for communicating to existing customers. Start with segmenting customers into logical groups according to their business needs or buying habits. For example, research firm AMI Partners found that SMBs with at least one full-time IT employee are much more likely to deploy advanced IT solutions, and account for 40% of SMB cloud spending, compared with 10% by SMBs with unmanaged IT environments.^{vi} These sophisticated buyers represent the best opportunity for managed services sales.

Another segment may include unlikely buyers, because a subscription-based model doesn't work for every customer. Prepare presentations and materials that make the most sense for customers in each group.

Business model transformation doesn't just happen. Solution providers need to create a clearly defined strategy that includes assessing the customer base, building a sales model, creating a pricing structure and managing the considerable change this means for both internal staff and customers.

Embrace Today's New SMB Buyer

The IT marketplace is undergoing rapid change. A more tech-savvy customer increasingly expects to buy IT as a service, and is finding a lot of choices from companies now moving into the IT services space. Solution providers still serving these customers with costly, break/fix delivery models put their businesses at risk.

While many solution providers have adopted a few managed services, it's common for them to get stalled at some point in the transformation. Those not evolving toward a more mature business model are missing out higher margins and increased customer service value. A maturity curve for subscription-based revenue starts with remote monitoring, then evolves to proactive services and finally to fixed-fee services.

Driving a solution provider business along this path requires deliberate steps to assess the customer base and create sales, marketing and change management strategies to get there. The more mature the business model, the more value the solution provider is delivering to the customer — and the more likelihood that both will thrive.

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About AVG Technologies (NYSE: AVG)

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