WHITEPAPER

Strategies for Creating Recurring Revenue Businesses

Executive Summary

In this whitepaper developed by the enterprise transformation experts at Aria and our partners at Navint, you'll learn how companies can increase shareholder value by digitizing their products and service offerings. We'll also look at how to fend off nimbler competitive upstarts, and the potholes companies may encounter along the way. We'll discuss the underlying market forces at play with regard to digitization and recurring revenue models, and provide both a conceptual framework for moving towards a recurring revenue business model, as well as a set of practical functional considerations that must be carefully evaluated in order to maximize chances for success.

Established companies feel the daily pressure to digitize, innovate, hire fresh young talent and just plain get cool. After all, rapidly growing startup-like businesses get high valuation multiples, while the less hip but steadily growing legacy enterprises are trading for single digit price/earnings ratios.

The Journey to Recurring Revenue Success

Judging by how the press fawns over flashy startups, one might get the impression that the Fortune 2000 is on the verge of extinction. CEOs are being exhorted to "digitize or die", and all sorts of startups with innovative business models are attacking incumbent Fortune 500-size companies. The now-familiar talking points highlight the cool businesses—such as the largest hotel group that doesn't own a single room (Airbnb), the fastest growing transportation provider that doesn't own a single vehicle (Uber), and on and on.

A common characteristic amongst all these companies is that they are based on recurring revenue models. Subscription- and usage-based businesses are capitalizing on the shift from buying products to buying experiences, and in the process, generating a massive amount of continual value from each customer, a mile, an hour, or a day at a time.

It can cost up to five times more to acquire a customer than it does to retain one, making subscription-based businesses extremely attractive. From software to shaving, the availability of subscription services is growing quickly, and for good reason. The customer gets a low cost of entry, no commitment, more choices and more flexibility, and the companies that deliver the services get a more reliable revenue stream and more attention from Wall Street.

As established businesses attempt to capitalize on these recurring revenue models, there are some key questions that must be answered:

- What does a journey to a successful recurring revenue look like?
- How can mature companies experiment and succeed in this space while avoiding false prophets, expensive acquisitions and high customer churn?
- What are the major markers on the road to durable and defensible sources of subscription revenue with a sustainable growth?
- How should companies, particularly those that already have a proven, profitable (albeit slow-growing) business adopt new monetization strategies and platforms?

Market Forces – The Customer is in Control

Many of the technological challenges companies face result from the shift of power to the customer. Before the digital revolution, companies focused on the product and production. Marketing, communications, and sales supported the product specs and the production timeline. Customers just took it as-is.

Now, consumers across all industries are controlling the conversation and the sales process. They are seeking increased transparency, alignment of price-to-value, and greater sense of control of a largely self-service buying process.

In this era of authentic, viral marketing vying to start a conversation with hyper-connected customers, buyers are flocking to products and services that are more open and transparent—transparent about the source of raw materials, transparent about their labor policies, and transparent about their pricing models and their billing.

In particular, price and billing clarity engenders greater trust and stronger brand affiliation. B2B industries are embracing transparency and clarity with increasing speed. Corporate CFOs have embraced the shift from CAPEX to OPEX spending in many industries. Sophisticated pricing and billing engines are now affordable and accessible to even the smallest startups. A/B price testing is no longer an expensive science project—it's become table stakes as market demand flows to the most attractive models.

Another tool that gives customers a greater sense of control is self-administration, the ability for a customer to purchase a goods and services online, on any device, and adjust levels of service without the hassle of dealing with a sales or customer service representative. Underlying all three of these market demands is convenience—we all desire a frictionless customer experience. The bonus? Providing this experience often less expensive, because it utilizes less human capital.

Market Forces – Customers Demand Choice

There was a time when you could have any Ford, as long as it was a black Model T. There was a time when you could get any song you wanted, as long as you bought the album. And there was a time when the only way to get a phone was to lease it from Ma Bell. Those days are long gone. Consumers have (and continue to demand) much more choice now, but they still often have to buy the way sellers dictate. But those walls are falling down too. There's a power shift in the marketplace and customers are now calling the shots.

We're in the midst of a revolution where customers now define the purchasing and consumption experience they want, paying only how and when they want. Many companies are now enabling customers to choose their product, packaging, consumption, and payment options. There are fewer barriers to switching and customers are flocking to sellers that let them choose how to buy.

For these reasons, the market is moving to recurring revenue models focused on subscriptions and usage-based models with flexible payment options and timing. Though, the struggle to provide multi-dimensional customer choice has stalled sellers across many industries. They want, and they need, a better way to serve customers who demand multi-dimensional choice on *their* terms.

Market Forces – Business Model Innovators

Constant change is synonymous with modern business. What is striking about the change taking place today is how quickly a newly introduced business model can capture the imagination and share of the market, and expose the holes in existing business platforms. One of the areas where this trend is most prevalent is within subscription business models. Netflix—the pioneer in in B2C subscription services—not only turned the whole video rental business upside down, but took the idea of subscription services into the mainstream.

Soon to follow were services like Zipcar, Amazon Prime memberships, and subscription "box services" for everything from clothes to groceries—pretty soon consumers were demanding everything-as-a-service.

Adobe's switch from a one-time sale of perpetual software licenses to a subscription-only model is instructive. In 2012, Adobe announced that it would change its popular desktop design suite, Adobe Creative Suite, to a cloud-based subscription service called Creative Cloud. Initially, users and market analysts were apoplectic. People thought it was absurd that they would have to pay a monthly fee for something that they don't even *own*! But Adobe had to do something to prevent sales from stalling and to stop an eminent crash. The issue was that Adobe's products were actually very, very good, while the price of entry was prohibitively high. Once a consumer paid thousands of dollars for the desktop design suite, there was very little motivation to hand over more money to upgrade when the latest version arrived. Why pay hundreds more when the version you *own* works just fine?

As it turns out, Adobe's move to subscription was predictive of the market to come. It was also very successful. After an initial cough where sales declined in a mini-customer revolt, people started to catch on. You no longer had to plunk down a grand to use Photoshop, in comparison, paying $9 a month is downright reasonable, and it's only around $50 a month for the whole Creative Cloud suite. Plus, customers could use it on more than one machine, so they were no longer tied to the desktop. The subscription model worked, and sales rebounded strongly. Adobe posted record revenue of $1.46 billion in Q3 of 2016, with approximately 80% of the company's revenue coming from recurring sources. This gives investors a clearer picture of Adobe's stability, and this is reflected in its stock price—it has increased about 275% since November 2011.

Today, subscription cloud-based software (now often referred to as SaaS) is widely accepted in both B2B and B2C markets.

Adopting a Recurring Revenue Business Model

Management teams that successfully introduce and/or transition to recurring revenue models (RRMs) start by mapping out key drivers, opportunities and risk factors, i.e. modeling the physics of the opportunity and risk. Four major forces shape the speed and trajectory of a recurring revenue-based business journey:

1. Customer-Driven
2. Competitive
3. Strategic
4. Pursuit of Business Agility

One of the most important elements of assessing strategic and competitive opportunities and risks is an evaluation of the risk of doing nothing. What are the likely business scenarios with status quo? And what is the impact on incumbent lines of business under either go-forward or hold-back scenarios? A realistic, honest inventory and analysis of likely outcomes is the most important first step that businesses can take toward RRM.

Customer-driven: Customers often force the RRM decisions onto suppliers as the client base begins to seek a subscription or usage- based economic relationship. In this pursuit, customers seek to improve speed, convenience, transparency in dealing with suppliers; align payment with value received; and gain greater capability to self-administer the economic relationship with vendors. While much of the customer-generated shift to subscription is being driven in B2C environments, B2B relationships are moving in the same direction rapidly. Disruptive competitors are another major force that can force the RRM decision as a response to a competitive offering priced via a subscription and/or a usage-based model.

Competitive: It would be a mistake though to think of a shift to a subscription model or other consumption-oriented monetization models as purely driven by customer preferences or competitive pressures. Competitive pressures are a major driver for subscription-based business models. You don’t want to be playing catch-up when the competition or your customers are moving away from your older CAPEX-intensive business model to an OPEX-oriented approach.

Strategic: There are rational strategic business reasons for businesses to look at recurring revenue-based models as means to increase revenue predictability, improve margins, drive gains in market share, increase customer satisfaction and retention, and ultimately become meaningful drivers for improved valuation multiples. It also provides businesses with a new field of potential customers who previously may have been excluded because of high entry costs. The software field is just one of many real-world markets where the transition to subscription has generated value for both buyers and sellers. A whole new class of companies has become potential customers for product that were previously prohibitively expensive.

Sellers and their financial backers have benefited tremendously as capital markets reward businesses that generate recurring revenue with higher valuations and lower cost of capital. While many technology companies were the first to experiment with subscription- and usage-based pricing, more traditional sectors from industries as diverse as industrial machinery, car rentals, and insurance among others, have now entered the fray.

Agility: Companies that opt to wait or do nothing in shifting to RRM are more likely to fall behind their peers in market share, as well as in desirability for doing business, and are more likely to stay with older calcified business processes and outdated technology portfolios. These companies tend to lag behind their peers in basic business agility. Moving to an RRM affords an organization a chance to critically review their toolsets and perform major house cleaning. In this context, the move to subscription is a catalyst for optimizing the business and gaining agility. It is an opportunity to gain speed and push the organization into a more rapid time-to-revenue.

Managing Recurring Revenue Business – The Practical Impact

On the surface, a journey to a recurring revenue-based business may seem simple: develop a monthly subscription price, re-package the product or service, get a software tool to invoice customers at regular intervals and process payments, then sit back and collect the cash coming in. The reality however, even for businesses of modest complexity, is quite different. Reinforcing this is an MGI Research report that projects that between 2016 and 2020, businesses globally will spend over $100 Billion on monetization tools. Specifically, within this time period, almost $66.3 Billion will be spent on monetization tools by organizations whose businesses will experience Huge, Meaningful or even Moderate impact from a move to a subscription business. Significant investments are being made to assure the success of new recurring revenue models.

The difference between companies that succeeded in RRM vs. those that failed is in having a deep understanding of the impact that a move to an RRM can have on the entire business and financial infrastructure of an organization. In their journey, companies will find themselves needing to re-invent their core processes, metrics and then acquire both the vocabulary and the hands-on skills in finance, technology, sales and marketing specific to recurring revenue business models. Specific functional areas affected by these business models cut a wide path across the organization and include:

- Sales Management
- Customer Service
- Order Management
- Financial Reporting and Analysis
- Marketing
- Incentive Compensation
- Recruiting
- Revenue Recognition and Disclosure
- Payment Management
- Billing and Invoicing
- Collections
- Core Finance Systems
- Taxation

The Bottom Line

Strategically, success in moving to a recurring revenue-based business model hinges on an honest assessment of opportunities and market objectives, risks of going in, and risks of doing nothing. Yet, a well thought out RRM business strategy is a necessary but by itself not a sufficient condition for success.

Companies also require expertise in RRMs in their management ranks, in technology organizations, in finance, product management, sales and marketing groups as well as modern technology tools and business practices. Bringing in experienced outside resources – fresh executive talent, experienced practitioners and outside advisors can reduce both the cost and risk of the journey to a subscription business.

About Aria Systems

Aria Systems' cloud-based monetization platform is the consensus analyst choice, top ranked by leading research firms. Innovative enterprises like Adobe, Philips, and Zipcar depend on Aria to accelerate time to market and increase flexibility, enabling them to maximize customer value and grow recurring revenue through subscription and usage-based offerings.
For more information, visit ariasystems.com.

USA Office
575 Market Street, Floor 32
San Francisco, CA, 94105, USA
Phone: 1.415.852.7250
Fax: 1.415.852.7251
Sales: 1.877.755.2370 (Toll Free)

EMEA Office
59-60 Thames Street
Windsor
Berkshire SL4 1TX
UK
Phone: 44.1753.272024

About Navint

Navint Partners is a different kind of management consulting firm, blending unique industry experience and innovative thinking to address clients' business challenges in imaginative ways. Navint is the right partner for organizations facing a journey to efficient and scalable recurring revenue streams. We help our clients with all aspects of the Subscription Business Model journey, from strategy development and rationalization to realization of the strategy through effective team, process, and technology design. To learn more about Navint's Subscription service offerings, visit http://www.navint.com/subscriptionservices.

For more information go to www.ariasystems.com
or contact Aria at info@ariasystems.com or 1-877-755-2370.