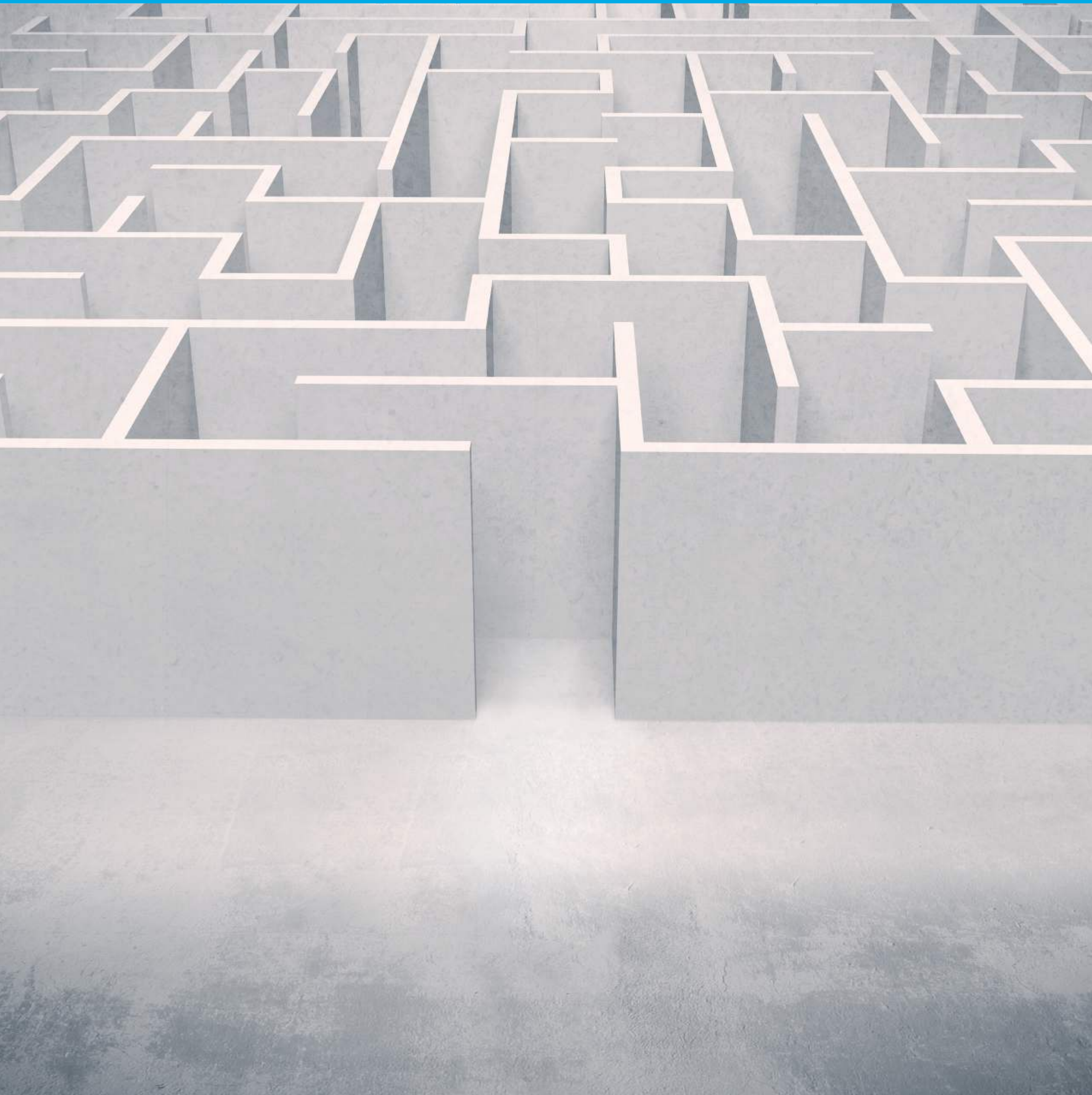
WHITEPAPER

Recurring Revenue Fallacies & Truths



Recurring Revenue – Fallacies & Truths

By Brendan O'Brien

The desire for businesses to adjust their go-to-market strategies in order to offer products in some form of recurring revenue model has now graduated from a collection of vanguard recurring offerings (e.g. Netflix, Uber, Amazon Web Services) to an urgent imperative that spans virtually all industries. It is arguably a truism that has become unavoidable: regardless of what you sell, some or all of your customer base will expect a way to pay for it that spans time, mitigates or avoids the hurdle of up-front capital expenditure, and more directly reflects the long-term way in which people consume products in the digital age. Customers are embracing recurring revenue models, businesses have fallen in love with the revenue predictability offered by them, and investors are rewarding those who do it right and punishing those who don't.

However, for business that are exploring the movement to recurring revenue models for the first time, there are social and technical challenges that are overlooked at their peril. This article endeavors to point out, at a high enough level to be as broadly applicable as possible, some of the false assumptions (i.e. fallacies) often made by new entrants to these models, what the general sources of those assumptions are, and to offer alternative ways of thinking that are far more likely to yield a successful market position.

Fallacy #1 - Recurring Revenue is merely a repetitive Quote-to-Cash motion

The truth is, The Quote-to-Cash (Q2C) paradigm was designed and adopted to serve businesses that sell in a one-time sale model. Applying it to recurring revenue propagates a "transaction-centric" world view, and ignores the key imperative universal to all recurring revenue models.

All one-time sale models, memorialized by Q2C processes and spanning everything from the purchase of shrink-wrapped software to airplanes to sweaters, have a common goal: first acquire a customer, get their money, then work to re-acquire that customer again in the future. The initial focus is in converting a prospect to customer (i.e. acquisition), the secondary focus is to try and sell them something else in the future (i.e. re-acquisition).

Recurring Revenue is fundamentally different. While initial customer acquisition remains the critical starting point, the temporally secondary function is not re-acquisition, but rather, retention. While a healthy recurring revenue business will also want to keep an eye out for upsell and cross-sell opportunities going forward, the primary goal after acquisition must be in keeping that customer in perpetuity.

Customer retention is maximized when customer satisfaction is elevated. Elevating customer satisfaction is contingent upon maintaining a permanent 360-degree view of exactly how your customers utilize the goods or services you provide, which is to say, all of the things that occur "between the bills". How and how often did they access my offering? What are their consumption habits? How many times have they called customer service? Have they upgraded or downgraded their service? For these and many other similar questions, the successful recurring business not only asks the question, but seeks to react to its answer in a way that continually demonstrates value to the customer. The end point "Cash" in "Quote-to-Cash" is a transaction. Albeit critical to your business success, it does not "see" (much less address) the myriad (and potentially actionable) touchpoints that are, from the customer's perspective, the real events that define their lifecycle and the opportunities afforded your business to either delight, disappoint, or ignore them. While it may seem paradoxical on the surface, recurring revenue success is far more likely when focused and proactive action are placed on these events, versus merely the "mile marker" financial transactions which frame them.

Fallacy #2 - Business success is measured only by margin achieved at initial sale

The truth is, Recurring Revenue models demand more nuanced KPIs than simplistic margin calculation can provide.

For “born digital” recurring revenue services like Netflix, margin calculation has little or no applicability at an individual customer level, as there is no individually crafted or provisioned “thing” being offered to each new customer in a true sense. But for businesses who make physical goods that seek to launch a recurring revenue offering, the continued application of margin calculation as primary KPI poses two challenges. For those positioning a “goods as a service” model, where a consumer pays over time (via operational expenditure) for that which was only acquirable via up-front capital expenditure, margin will likely be achieved at a future date well after initial customer acquisition. This poses a risk/reward model not imposed by a one-time sale model. The risk is that a customer departs before hitting the future date at which they have cumulatively paid for the Cost-Of-Goods-Sold, and reward is realized only if they are retained past that point. The upside reward can, however, be far greater than what a one-time-sale can yield if the customer is retained in perpetuity. The risk can be mitigated by enforcing either contractual commitments and/or creative incentives to the customer to stay on board, such as perpetual equipment upgrades. Customers pay more over the long haul, but get latest-and-greatest offering the entire time, while older equipment can potentially be reclaimed by the provider even refurbished/recycled/resold to achieve a secondary upside (not dissimilar from the model via which car rental companies have always operated).

For manufacturers of physical devices which have an up-front cost to the consumer but subsequently “unlock” access to a subscription-style service (e.g. a home security system with an associated active monitoring service), attempting to achieve margin at the initial device sale can be a road to ruin. Instead, viewing these enabling devices as “barriers to entry” for consumers is the far wiser approach, long demonstrated by the mobile phone industry. Be prepared to take a loss on an enabling device as necessary (possibly to the point of giving it away!) in order to guide consumers toward a perpetual service that delivers ongoing profit, and learn to measure the success of your business with KPIs like churn rates, adoption rates, and retention rates rather than merely traditional COGs/margin.

Fallacy #3 - Recurring Revenue is a synonym for subscription

The truth is, while subscription is a perfectly valid and attractive business model, it is actually the simplest and least technically demanding sub-set of business models available under the broader Recurring Revenue umbrella.

Recurring Revenue encompasses multiple pricing models, and is defined as such not by a given specific pricing structure so much as by the “perpetually tethered” relationships between consumers and providers it engenders. While the simplistic Netflix subscription model, a non-variable and rhythmic (monthly) transaction, is most certainly categorized as “recurring revenue”, it is equally true that Apple’s traditional iTunes model is as well. While iTunes is variable and arrhythmic (customers are billed for what they consume, only if and when they consume something), the “tethering” of iTunes consumer to provider Apple by virtue of the consumer’s relationship with the iPhone device and iOS and the iTunes app requires the same amount of attention to perpetual customer retention as the Netflix model requires. Such “pay-per-drink” models as iTunes can also be re-crafted into true arrears-based consumption models (how we pay for utilities, for example), which are variable in amount but predictably rhythmic like subscriptions, or hybrid subscription/consumption models such as the typical mobile phone bill which incorporates subscription fees with consumption fees and one-time/ad-hoc fees as well. All of these pricing structures should be considered versions of recurring revenue.

Fallacy #4 - Consumption-based pricing models will never pertain to my business

The truth is, your customer's demands can (and will) change at any time. Assuming usage-based models can't apply to your business limits customer choice and is counter to any effort to future-proof against unforeseen market shifts.

Since the initial love affair began with simple subscription models, the trend over the last few years across virtually all industries has been in favor of more sophisticated "pay as you go" (i.e. usage or consumption) pricing models. This is most obviously evidenced by the wide adoption of cloud infrastructure technologies, which provide the benefit to consumers of only paying for exactly what they use, avoiding unnecessary investment in potential capability that lies fallow and represents unnecessary expenditure. It is critical to note, however, that the business should not presume their go-to-market strategy should be limited to either simple subscription's promise of an "all you can eat buffet" versus "pay per drink" – many forward-thinking businesses realize that providing the choice of a combination of models broadens their addressable market, which in turn requires up-front investment in back office systems that can support both simplistic subscription billing AND the far more sophisticated demands of consumption-based billing.

Additionally, it is critical to understand that consumer consumption data provides immeasurable value to the business even when it is not directly reflected in how consumers pay for the service. Using Netflix as an example once again, while their customers pay for the service in a straightforward flat subscription, the thorough metering of exactly what those customers watch affords massive benefit to Netflix on both a micro level (e.g. providing targeted content recommendations to individuals) as well as on a macro level (e.g. informing Netflix's decisions as to which new types of content to produce and offer).

Fallacy #5 - Cloud-based billing technologies can directly replace any legacy on-premises billing system

The truth is, legacy billing systems were designed as downstream systems that are merely adjunct to other critically related back office needs (like product management and customer entitlement and customer care) rather than an integral component of those functions.

Additionally, these systems were designed to "flex" via deployment of engineering resources rather than line-of-business resources. Modern recurring revenue platforms like Aria are designed to be far more tightly coupled with the definition of product/service offerings, the process of selling those offerings, the entitlement and provisioning (and disentitlement and de-provisioning) of services, and the ongoing needs to care for customers in a perpetual fashion. This fundamentally different and more integrated approach to billing and all of the functions that inform or are informed by it naturally positions a modern "billing system" in a different location in the ecosystem, far more like a hub in a hub-and-spoke model than the downstream "black box" position typically occupied by legacy systems. Perhaps even more importantly, legacy systems were designed not only to be on premise, but to be made to adjust to a given business' proprietary needs by coding one's way out of every problem. This presents two very expensive problems to the business. First, the deployment of engineering resources every time a change is needed is typically expensive to do, expensive to maintain, and slows time to market in an age where premiums are placed on all businesses for speed and agility. Second, customization-via-coding has the costly effect of often deviating so far from the original code line of the system that one is no longer eligible for upgrades to the original system, at least not without a massively costly retrofit effort. Modern cloud-based platforms, by comparison, put the "power to change" in the hands of less expensive and more nimble business users via configuration tools, dramatically decreasing time to market, and offer a constant stream of upgrades to which all existing customers are always eligible.

In Closing

If your enterprise is new to the Recurring Revenue world, success begins with an institutional admission that mere tweaks to the way you've operated historically isn't sufficient to get you to the promised land. A renewed and early focus on the importance of elevating customer satisfaction, combined with the adoption of new processes and systems that are singularly pointed toward that goal (rather than merely figuring out how to generate bills in repetitive fashion) is what distinguishes winners from losers in Recurring Revenue. The primary benefit of Recurring Revenue is that it allows you to know (in a way that non-recurring revenue models simply can't) who your customers ARE rather than merely who they WERE. Just like one can't necessarily apply the same strategy to winning a second date with someone versus keeping an existing marriage happy and healthy, "keeping" demands a richer and fuller understanding than "getting" ever will.

About Aria Systems

Aria Systems cloud-based monetization platform is the consensus analyst choice, top ranked by leading research firms. Innovative enterprises like Verizon, Adobe, and Audi 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.

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