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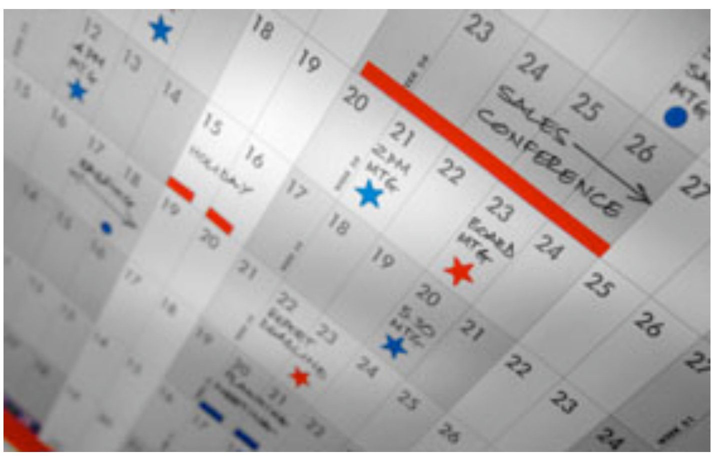
Technology Management Resource for Business Leaders

A Unique Business Opportunity to Create Annuity Revenue

By Sam Klaidman and Dennis Gershowitz \\ March 2010

In a world full of continuing business uncertainty, what would you give for a predictable, growing revenue stream that creates loyal customers and helps sell product? Read on to find out about the importance of value added services.

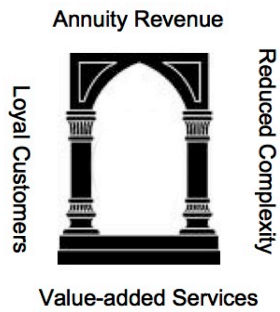


Let's begin with the graphic below. This reflects what we think, and have demonstrated to people we work with. This is creating Annuity Revenue.

We will proceed to show you how to achieve this financial success by:

- Reducing the complexity of your product to enhance the usability of its features.
- Providing your customers with value added services, including professional services, to enjoy the features built into your product.
- Building customer loyalty strong enough to engage your customer.

In the end, these actions lead to developing a repeatable and predictable revenue and profit stream.



If you manage a high tech business, you are always looking for ways to create a continuously growing revenue and profit stream (we refer to this as annuity revenue) while creating loyal and engaged customers. The key take-away of the TSIA October 2009 World Conference was that the era of product sale pulling service revenue is drawing to an end...service revenue is already beginning to pull product and the buyer buys based upon features and usability.

Also, at the same conference, HP was quoted as saying, “Service will be challenged to reduce product complexity and accelerate the realization of product value.” Gary Budzinsky, SVP and GM of HP Enterprise Business Technology Services pointed out the following in his presentation “HP Technology Services Transformation and Futures”. Among the primary influencers of the client experiences are:

- Services led selling: Go-to market with technology consulting.
- Technical Support drives product sales by accelerating time to value and the consumption of value.
- Mission Critical intellectual property.

Gary also points out that Service keeps the technology running and consulting is the ‘Expertise’ connection with the customer. We suggest you think about this as we continue.

What is annuity revenue?

Annuity revenue is a predictable stream of revenue and profits derived from a wide variety of sources. They are a part of the company backlog, are generated from an increase in customer satisfaction and loyalty, and in many cases they differentiate one company's products and services from the pack. To compare discrete product with annuity revenue, we first take a 30,000-foot look at both sources of revenue (and profits):

1. Discrete product or service – a stand-alone sale to either new or repeat customers (even if purchased under a blanket order) and unlikely to repeat for a number of years.
2. Annuity revenue – a predictable revenue stream from new or existing customers who buy products and services associated with new or previously purchased products. Many times this term is used in conjunction with value added services.

Comparing both sources of revenue; we have been able to demonstrate to companies we work with that annuity sales have a number of significant advantages:

1. Some annuity services can be included with the initial purchase:
   - Solution selling makes the overall sale easier.
   - Financing may make the sale possible.
   - Value added services can become a competitive lockout differentiator.

2. Lower selling costs, since the prospect is already your customer, or will soon become one – no need to begin establishing a relationship.

3. Your total revenue stream will be more predictable or consistent. For years, Xerox has reported over 70% of its annual revenue as annuity revenue.

4. You have moved your customer relationship to a higher level and are therefore enjoying the benefits of increased recommendations, repeat purchases and higher margins.

Is generating an annuity stream a new concept?

Absolutely not! This is a strategy that has been around for a long time.

- In 1904, Boston-based inventor King Camp Gillette received a patent for an improved safety razor with a disposable blade. He realized that profits lay in selling the razor for less than it cost to make and the disposable blades for more. His revolutionary idea has come to be known as the "Razor and Blades," or "loss leader," business model.
- Kodachrome was invented in the early 1930s and first sold in 1935. Cameras were relatively inexpensive and Kodak and others made most of their profits from film sales.

You get the idea. Products using disposables have been generating annuity revenue for at least a century. However, the idea of selling value added services (VAS) as annuity revenue is much newer.

In the product space, is this concept applicable to both hardware and software products?

Absolutely! Here are a few examples of value added services (as compared to availability services) commonly associated with both types of product:

Hardware products:

- Software updates
- Scheduled preventative maintenance
- User training
- Remote monitoring
- Consulting

Software products:

- SaaS
- Access to an enhanced Support web site
- User forums and User Group meetings
- Customization
- On-going training
- Consulting

With many products, there are unique opportunities for a stable revenue stream.

Some examples are:

- If you develop tax preparation software, you know that the codes and rules change annually requiring an annual update.
- If you develop anti-virus software, you know new viruses are created almost daily requiring continuing updates.

But so far we have described lists of common revenue streams that are probably familiar to all high tech executives. What are some less common areas to consider?

- Medical products frequently require disposables such as chemicals and reagents, needles, tubing, etc. All are usage based. The size of each monthly shipment is based upon testing volume established at the time of the sale.
- Servers use virtualization software, which gets updated periodically.
- Jet engines and other flight hardware require frequent, scheduled inspections and overhauls based upon usage, which the manufacturers closely monitor.
- Copier and printer users need paper and toner (or ink) and many prefer buying from the original manufacturer since they can tie deliveries into usage as monitored by the machine and reported back to the OEM.

Perhaps the first widely used VAS was equipment financing. Capital equipment suppliers like GE had access to large amounts of money at relatively low interest rates. They used this money to finance major purchases. This is how GE Capital began; they financed locomotive, jet engine, medical equipment and appliance purchases. Other manufacturers without such capital availability, but still looking to help their prospective clients and customers purchase more, became lease brokers. They put lenders in touch with the purchaser. Then, they were able to complete the sale and earn a referral fee. This is an example of a VAS, but not with a predictable revenue flow.

Another area for good margin business for high tech companies is consulting. Within the past two years the following acquisitions were announced or completed by well known high tech companies:

Acquirer	Target	Date	Objective
HP	EDS	May 2008	Enterprise information consulting business complements data center products. Double HP revenue from Services.
Xerox	ACS	Sept. 2009	Business process management yielding annuity revenue ~80%
Dell	Perot Systems	Sept. 2009	From Dell: "A single company that leverages Perot Systems' enterprise services across a broad customer base and significantly expands the range of Dell's commercial IT solutions" An $8B combined service company.

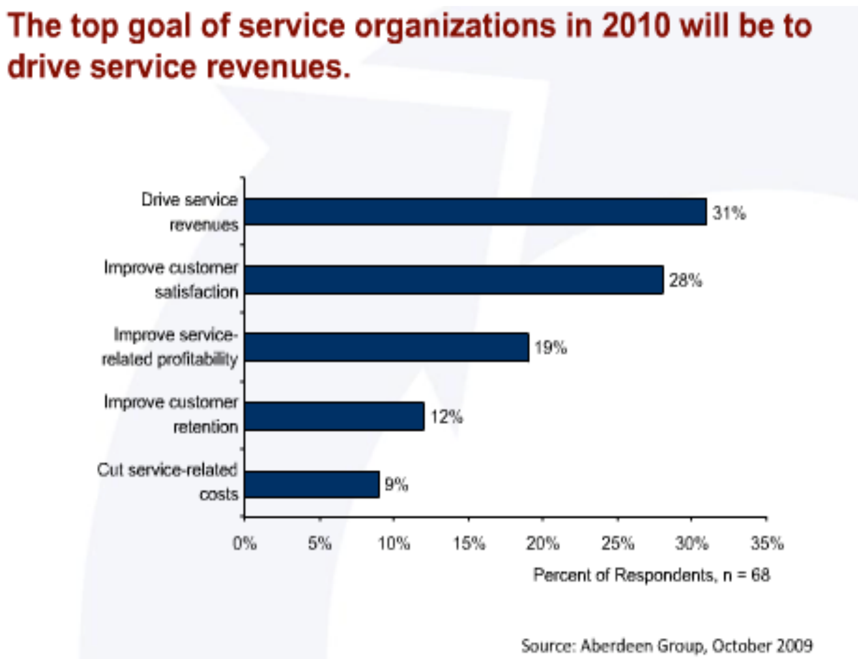
In 2009, The Association of Support Professionals published "Maintenance & Services Ratios". They examined 100 public software companies and looked at their Maintenance and Services revenue and profit contribution. Here is an abstract of that publication:

Name	Total Revenue	Service % Revenue	Service Margin
PTC	$941,279,000	68.5%	57.4%
Pegasystems	$161,949,000	68.5%	41.2%
Oracle	$22,430,000,000	66.5%	66.6%
SAP	$14,957,000,000	64.0%	68.2%
Progress Software	$493,500,000	62.1%	77.6%
Median	***$93,108,000***	***54.4%***	***56.7%***

We can see that some of the top public software players are generating over 60%

of their revenue from Services (typically annuity) and earning margins that exceed typical product margins.

Recently, the Aberdeen Group surveyed a group of senior executives regarding high priority goals for their service groups going into 2010. Aberdeen reported that the number one priority is revenue. This is reflected in Aberdeen's summary of that query in the chart that follows. Think about how annuity revenue contributes to revenue growth.



How about other examples:

Intacct is a creative use of annuity sharing. Intacct is an accounting and finance SaaS provider. They have rolled out a new channel program designed to build channel loyalty through an annuity revenue plan that boosts margins. Jerry Jalaba, the company's vice president of channel sales, said under Intacct's new business solution partner program "a partner can share in the revenue stream of every one of their customer wins."

The program includes intensive product training and certification, along with advanced web training. The financial management applications are pre-integrated with some leading applications such as salesforce.com and feature an open interface for additional integration. Jalaba said Intacct has established strong alliances with complimentary providers such as CompuPay, Boomi and Adaptive Planning.

Is the predictable revenue stream the only reason to go down this path?

There are two other major reasons to make sure your strategy includes value added services:

1. Decrease customer time-to-value and time-to-value-consumption.
2. Increase customer loyalty because of an enhanced overall experience with your company.

In his recent book Complexity Avalanche; Overcoming the Threat to Technology Adoption, J.B. Wood discusses the significant issues associated with the increasing complexity of high tech products:

- Only a small percentage of features are ever used.
- The full value is never achieved resulting in a sub-optimal number of actual users. Fewer software licenses are sold per installation than could be achieved.

The end result of both situations is that over time your ability to sell enhancement upgrades or the "next new thing" will be limited. Why? Because now they are not generating an ROI sufficient to pay back their investment and so they will not bother to invest in your new product. For example:

- This article was written on Word 2004 for Mac. A 2008 version of Word is available but why bother buying the new version; this version totally fulfills all needs.
- In a recent discussion with an executive at one of the world's largest medical imaging companies, we learned that "most customers use less than 30% of the device's capabilities". Good luck in trying to sell a next generation MRI or CT scanner to existing customers!

So, how do you go about generating this renewable revenue stream?

We have learned that the only practical solution is to extend your interaction with your new customers through VAS. As we have seen with our more successful clients, their strategy and processes takes them beyond the Integration phase and into the Deployment and Value Realization phases of the product lifecycle. Of course, these services all generate revenue and keep you in close contact with your customers.

This kind of long-term, tight coupling with your customers results in many significant benefits:

1. Annuity revenue.
2. Continuous feedback concerning usefulness of product features and benefits and an understanding of the gaps and challenges in maximizing the product’s capabilities.
3. Loyalty, will ultimately lead to a fully engaged customer. When the customer is engaged with your business, they are involved with you in a very positive and proactive way. They refer you. They take part in your success. They look to buy more from you. The loyalty factor is based upon your customer realizing very high value for investment of their purchase and in developing a partnership relationship with your employees and your business. In the long run, they trust you.
4. As a side benefit, your customer facing employees will quickly feel better about working for a company that fosters meaningful relationships with the customer. Also, engaged employees are another significant driver of customer loyalty. You benefit from building a strong commitment from employees which aligns them with the organization’s goals.

In summary, annuity revenue from value added services generates a sustainable, predictable revenue and profit flow. It helps your customers realize increased value from their purchase and can easily accelerate the time to repurchase. It

increases customer loyalty and it energizes your employees. In the end, it is a win for you and your customer.
Sounds to us like a must do opportunity for your business.

About the Authors

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