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Annuity Revenue, Complexity, and Loyalty: A Unique Opportunity

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In a world full of uncertainty, what would you give for peace of mind?

If you manage a high-tech hardware or software business, you are always looking for ways to create a continuously growing revenue and profit stream while creating loyal and engaged customers. If you attended TSIA's Technology Services World (TSW) 2009 in Las Vegas this past October, you likely heard that the days are numbered on the trend of *product sales "pulling through" services revenues*. Services revenues will begin to pull the product, and the buyer will buy based upon features and usability.

In addition, HP said at TSW: "Service will be challenged to reduce product complexity and accelerate the realization of product value." Gary Budzinsky, senior vice president and general manager of HP Enterprise Business Technology Services, pointed out the following in his presentation titled "HP Technology Services Transformation and Futures":
Among the primary influencers of the client experiences are:

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

Gary further pointed out that service keeps the technology running, and that consulting is the "expertise connection" with the customer.

Think about these concepts as you read this article.

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

- **Discrete product:** Standalone sales to either new or repeat customers (even if purchased under a blanket order) and unlikely to repeat for a number of years.
- **Annuity revenue:** Predictable revenue stream from new or existing customers who buy products and services associated with new or previously purchased products. Many times, but not always, this term is used in conjunction with value-added services.

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

- 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.

- It lowers selling costs. Since the prospect is already your customer, or will soon become one, there is no need to begin establishing a relationship.
- Your total revenue stream will be more predictable or consistent. For years, Xerox has reported over 70 percent of its annual revenue as annuity.
- 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? Certainly not! This is a strategy that has been around for a long time, as the below examples illustrate:

- In 1904, Boston-based American businessman and 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 manufacture, 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.
- How often do professional craftsmen and machinists replace their bits and saws, and how often their cutting tools?
- Analytical and clinical instrument manufacturers focus on placing the capital equipment to benefit from ongoing revenue stream of reagents and disposables based upon numbers of tests performed.

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.

What Is a Value-Added Service?
This term appears to have originated in the telecommunications industry. According to Wikipedia, in the telecommunication industry, on a conceptual level, value-added services *add value* to the standard service offering, spurring the subscriber to use their phone more and allowing the operator to drive up their average revenue per user (ARPU).[1]

In the product space, is this concept applicable to both hardware and software products? Absolutely! Below are a few examples of value-added services (as compared to availability services) commonly associated with both types of product:

Hardware Products:

- Support Plans
- Software Updates
- Scheduled Preventive Maintenance
- User Training
- Calibration and/or Certification
- Remote Monitoring
- Consulting

Software Products:

- Support Plans
- SaaS
- Access to an Enhanced Support Web Site
- User Forums
- User Group Meetings
- Customization
- Ongoing Training
- Consulting

With many products, there are some unique opportunities for a stable revenue stream. Some examples are:

- If you make tax preparation software, you know that the codes and rules change annually. This requires an updated version.
- If you make antivirus software, you know new viruses are created almost daily. This requires continuing new releases.
- If you make medical products, you know they frequently require disposables such as chemicals and reagents, needles, tubing, etc. All are usage-based.

Perhaps the first widely used VAS came from the financial industry. 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.

Even more opportunities presented themselves. For example, 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 book 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 year the following acquisitions were announced or completed by well-known (predominately) hardware companies:

Acquirer	Target	Date	Objective
HP	EDS	May 2008	Enterprise information consulting business complements data center products. Double HP revenue from services.
Xerox	ACS	September 2009	Business process management yielding annuity revenue ~80%.
Dell	Perot Systems	September 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.

Another example?

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 that Intacct has established strong alliances with complementary 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*,[2] TSIA president and CEO 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. This means that 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 constrained by existing customers (either yours or your competitors). Why? Because now they are 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 percent of the device's capabilities." Good luck in trying to introduce 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 process takes them beyond the Integration phase and into the Deployment and Value Realization phases of the product life cycle. 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, and this is where your renewable revenue stream gets more of their purchasing dollar. The loyalty factor is based upon your customer realizing real 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 and will become more energized and engaged about working for you. 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 you.

Endnotes

1. Wikipedia. http://en.wikipedia.org/wiki/Value_added_service.
2. Wood, J.B. 2009. Complexity Avalanche: Overcoming the Threat to Technology Adoption. http://www.complexityavalanche.com.

About the Authors…

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