What to know when adopting subscription or consumption business models

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The transition away from traditional licenses to a subscription or consumption delivery model requires fundamental structural changes along with adopting an entirely new perspective on customer relationships. For those who are ready for transformation, now is the time to put in the building blocks of success.

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Authors

Ken Englund
EY Americas Technology Sector Leader

Dave Padmos
EY Americas TMT Leader

Contributors

Raghav Mani
EY Americas TMT Strategy and Operations Leader

Richard Golik
EY Global TMT Senior Analyst

Introduction

The growing preference for companies to use third-party cloud-based software services is having a profound impact on the enterprise technology market. For software providers, the subscription business model is becoming the dominant one. Worldwide, perpetually licensed software revenues will shrink by a compound annual growth rate (CAGR) of 6.1% between 2020 and 2024, while software subscription revenues will grow by a CAGR of 16.6%.[1]

New software-as-a-service (SaaS) entrants were "born in the cloud," but numerous hardware and software companies started out with traditional on-premises licensing models. Those companies want to add a subscription element to their business. Eventually, many companies may also offer their products on a pure consumption or "by-the-drink" basis, although this model is still in its early days.

While there are certainly risks involved in transitioning away from the traditional on-premises licensing model, there are also great rewards. Valuations of enterprise technology companies that adopt subscription models with new value metrics like annual recurring revenue (ARR) and net revenue retention (NRR) are higher than those that generate most of their revenues from perpetual licenses. The higher valuations occur because subscription earnings are more predictable and companies that offer them can generate more revenue over the long haul. A recent CIBC World Markets study found that, on an annual basis, SaaS stocks outperformed the mature software names, with an average stock price return of 83% vs. an average year-to-date mature software return of 22%.[2]

Subscriptions don't necessarily generate big up-front fees like traditional licenses do, but the lifetime value of each customer is often greater, as long as enterprise technology companies effectively manage churn and are successful at selling additional services to their clients. Subscription models are tremendously scalable, so providers can grab a bigger slice of an expanding pie. Using a land-and-expand strategy, enterprise technology companies can sign customers up to small deals and expand their footprint to more products and services over time. This also applies to by-the-drink consumption models, where customers can try new products for a very low cost (or even free) and expand usage as their needs grow.

But this transition is neither simple nor rapid, particularly for those enterprise technology companies that offer traditional products and services. EY professionals interviewed subject-matter resources in the enterprise technology industry to identify the key operational, financial and strategic challenges companies face as they consider making the transition. These discussions uncovered several key learnings and leading practices, but the pace of change varies; some companies are rapidly adjusting, while others are struggling to work out which steps to take, how and when. Often, the determining factors are based on the nature and complexity of their product offerings and the need to maintain certain legacy businesses.

The transition away from traditional licenses doesn't happen by flipping a switch. Respondents are typically taking five to seven years. Regardless of where enterprise technology companies are in their transition, our research shows that moving to a subscription model requires an extensive enterprise transformation, not just technology re-platforming. Our interviews uncovered several transition challenges, but they largely encompassed four main areas:

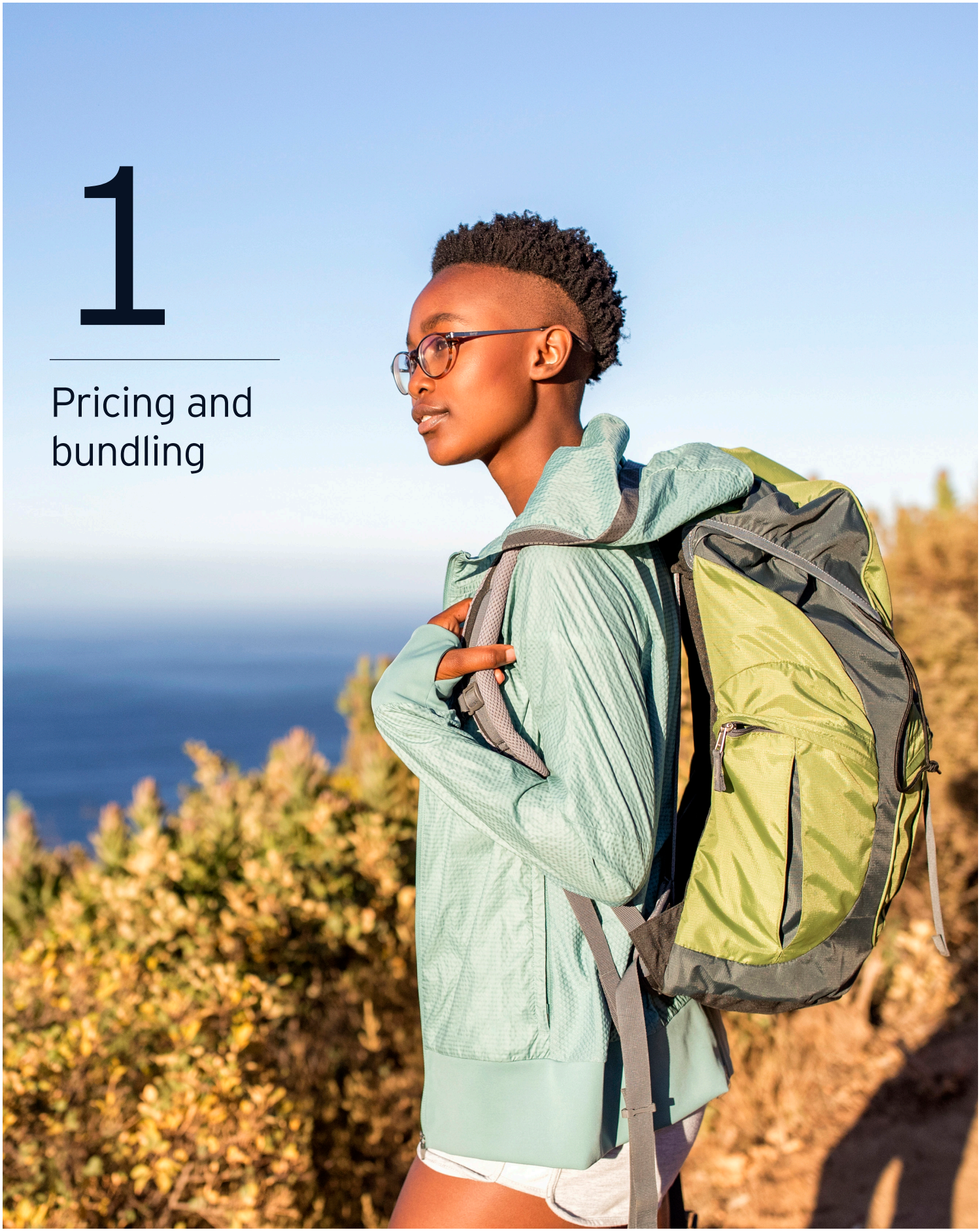
1. Pricing and bundling
2. Sales transformation and customer incentives
3. Operating model change
4. Key performance indicators (KPIs), accounting and revenue management

[1] "Worldwide Software License, Maintenance, and Subscription Revenue, 2018–2024," IDC, July 2020.

[2] Stephanie Price and Scott Fletcher, "Software Valuation Month, November 2020," CIBC World Markets, 2 November 2020.

1

Pricing and bundling



Pricing and bundling new offerings to meet changing customer requirements and increase profitability

At its core, the change to a subscription model fundamentally transforms the way products are developed and delivered. As a result, enterprise technology companies must create highly customized offerings and price them to be attractive to customers but not "leave money on the table." Yet our discussions revealed that many enterprise technology companies still don't have formal programs, strategies or methods in place to profitably price and measure their offerings.

Many of these companies have customers that are happy with the way they buy IT products and services. Enterprise technology companies must offer a compelling value proposition to persuade their customers to switch as well as provide a simple and straightforward path to do so. Certainly, the key to success is the ability to effectively move away from product-based pricing toward new value-based pricing schemes.

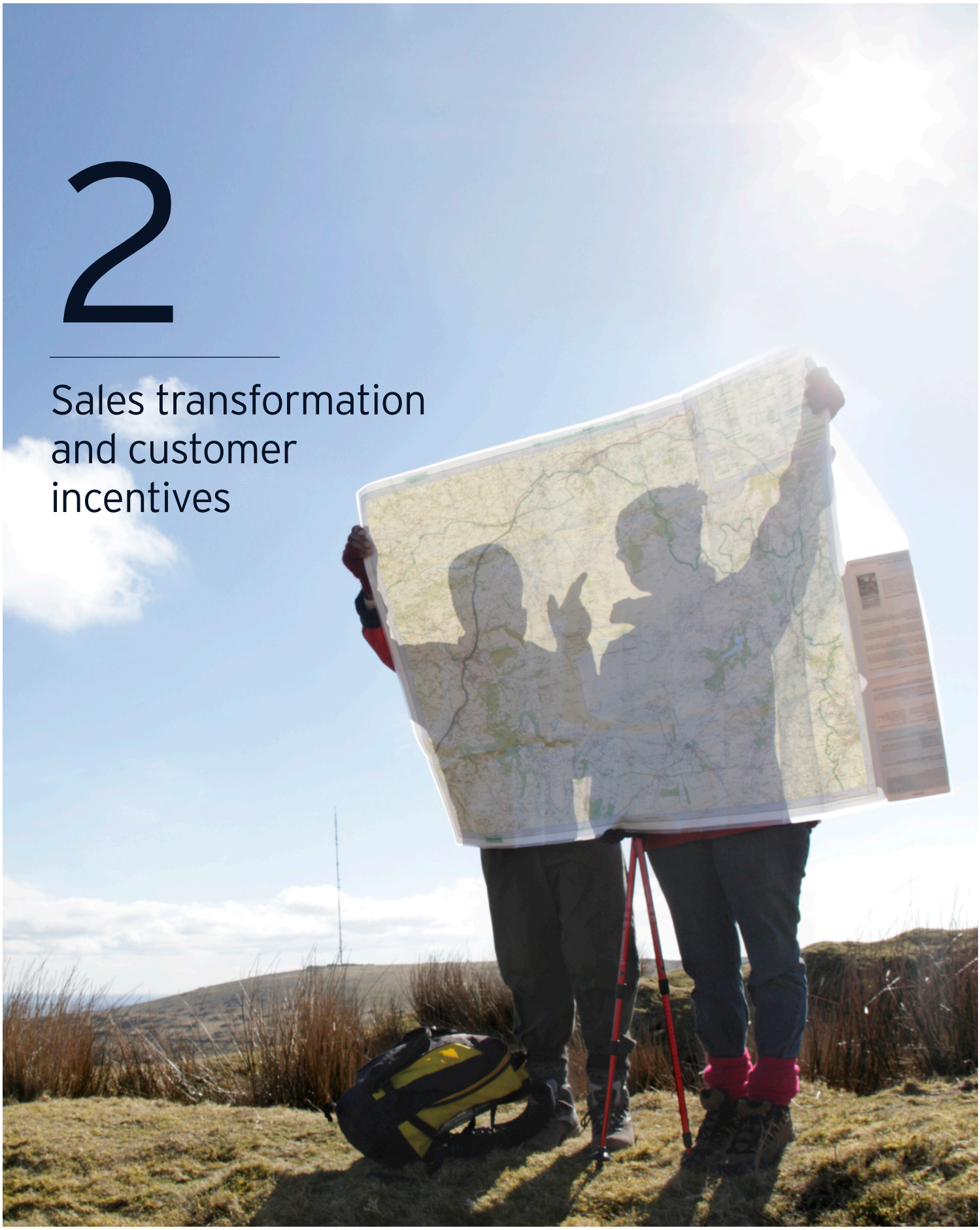
As products and delivery methods evolve, enterprise technology companies must also choose what markets to serve. Our research shows that many enterprise technology companies have not done a proper customer segmentation analysis to determine which markets they can operate profitably in or what capabilities they need to serve them. We found that successful enterprise technology companies incorporate data-driven customer segmentation early on as they develop their strategic road maps.

Key questions

1. Do you have a structured method to price your offerings so that they are attractive to customers and don't leave money on the table?
2. Have you done a customer segmentation analysis to identify the markets in which you can operate profitably?
3. How have you performed price segmentation to support pricing decisions?

2

Sales transformation and customer incentives



Reimagining the sales organization and customer incentives to meet several needs at once

Sales incentives can be a particularly challenging area. The move toward subscription requires enterprise technology companies to completely rethink how they incentivize, measure and equip their salesforce and third-party sellers. This is particularly difficult if they offer a mix of both traditional and subscription options.

Wrestling with how to calculate compensation, including commissions and bonuses, in a way that appropriately balances the needs of the salesforce, customers and the larger enterprise goals is key. Sales training is equally important, since most salespeople are still accustomed to selling licenses. Training must be accompanied by an effective set of quoting and pricing tools, updated competitive benchmarking and new total cost of ownership (TCO) calculators to explain TCO across different consumption models, and new solution-based value propositions.

While specific leading practices are still emerging around sales compensation, most enterprise technology companies recognize the need to move away from a "sell things" mindset to one that's more focused on nurturing long-term relationships. This is critical, because it can take up to two years to cover the cost of sales and begin to turn a profit.

Companies are also finding that establishing a customer success organization — one that monitors and reacts to the needs of customers along their journey — is a powerful tool to help enhance and maintain that critical relationship. Companies with well-developed customer success organizations use sophisticated data tools to understand customer behaviors.

These behavior trends can be shared with clients to help them maximize the services they buy, creating a powerful upsell tool. These tools can also be used to proactively identify and address potential issues.

Companies also are grappling with how and when to use customer incentives. Many of our clients' customers don't understand how new models will benefit them. This requires being prepared to demonstrate the costs and delivery benefits of subscription models. Some enterprise technology companies are creating value metrics that their salespeople take to market. Others phase discounts out over time or sunset their legacy products, in effect forcing customers to move away from licenses to subscriptions.

Key questions

1. Do you understand the sales compensation implications of moving from a transaction orientation to one more focused on long-term customer relationships?
2. Do you have the capabilities to train your salesforce to sell subscription-based services?
3. Do quoting and/or pricing tools need to be updated? Do you have dedicated resources to training on these tools?

3

Operating model change

Transforming operational capabilities to support a new delivery model

Many enterprise technology companies are unprepared for the move or are unsure about their organizational readiness. They do not have an integrated operating model capable of supporting a combination of new and existing offerings across the enterprise. Areas that are often overlooked are back-end supporting processes, such as product entitlements and provisioning, customer support, and billing and invoicing.

The lack of well-developed product usage and adoption metrics also surfaced as a challenge for many enterprise technology companies. A lack of these metrics creates a significant blind spot for gauging the success of current products and limits visibility into upsell opportunities. It also leaves enterprise technology companies unable to adjust quickly to market shifts and hampers their decision-making around long-term investment priorities.

Key questions

1. Do you have an end-to-end integrated operating model to support a combination of new and existing offerings?
2. Have you developed customer usage metrics for your products and/or services to improve internal performance, drive product sales and marketing, and establish long-term investment priorities?
3. Can your billing systems and processes support the transition to a subscription model? With a new and complex product suite, is there a need to utilize third-party vendors?

4

KPIs, accounting and revenue management

Developing a growth and transformation narrative to gain stakeholder buy-in

We found that there is critical importance being placed on developing relevant KPIs (ARR being just one), since traditional operational and financial measures do not accurately reflect the changing levers of business value. However, developing these KPIs is difficult. First, many enterprise technology companies are still unsure of which measures matter in a subscription model. Once these KPIs are defined, the data to support them is often scattered in different systems and business units, and many haven't deployed advanced analytics tools to interpret the data that does exist.

We found that enterprise technology companies that are further along in their KPI journey include competitor KPIs and value propositions into their own KPI calculations. Some road test new KPIs for several quarters to make sure they are accurate and actionable.

Once the relevant KPIs are developed, enterprise technology companies must use relevant KPIs to explain to external stakeholders how the transition will impact their near- and long-term performance. This includes creating a narrative around the long-term benefits of shifting to a subscription model, since it is likely that the change will not be revenue neutral — at least in the short term.

For enterprise technology companies to mitigate any possible negative share price impact, full transparency is essential regarding what the end state is and how the enterprise technology company plans to get there. A necessary first step is meeting regularly with investors to explain how the new KPIs demonstrate enterprise value, along with clarifying the accounting and revenue implications of moving to a subscription model. One leading practice we observed is teaching CEOs, CFOs and communications staff how to speak subscription and consumption language with investors. Finally, the transition from on-premises to subscription fundamentally alters how, when and where revenues are generated, which has significant impacts on finance and accounting processes that CFOs must address.

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