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Journey to a Subscription Business Model

EXECUTIVE SUMMARY

As companies work to increase shareholder value by digitizing their products and service offerings and fend off nimbler competitive upstarts, many are finding potholes along the way. This whitepaper discusses the underlying market forces at play with regard to digitization and subscription revenue models, and provides both a conceptual framework for moving towards a Subscription-Oriented Business Model, as well as a set of practical functional considerations that must be carefully evaluated in order to maximize chances for success.

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Customers of all types are demanding closer alignment of the price model to the perceived value.

Established companies feel the daily pressure to digitize, innovate, hire fresh young talent and just plain get "cool". After all, rapidly growing "cool" businesses get high valuation multiples while steadily growing legacy enterprises are trading for single digit Price/Earnings ratios despite the fact that the Fortune 500 companies generated 71.9% of US GDP in 2014 (up from 58.4% in 1994).

Judging by the business press fawning over digital businesses, one might get the impression that the Fortune 2000 is on the verge of extinction. CEO's are being exhorted to "digitize or die", and all sorts of start-ups 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.

Amongst the characteristics of these companies, a subscription-based business model figures prominently. Anything and everything – from yogurt, juice cleanses, shaving blades and toilet paper to legal services, heavy industrial equipment and enterprise software is now sold by subscription. Yet as established businesses look to capitalize on these subscription revenue models, many are left with key questions in the transformation:

- What does a journey to a successful subscription business 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 (and often slow-growing) business adopt new monetization strategies and platforms?

The concept of a subscription business model is not new. What is new is how a whole new class of technologies is enabling start-ups with a limited capital base to move quickly to attack subscription revenue opportunities in both established and new markets. Many corporate leaders clearly see how upstarts equipped with fresh new technology tools have an advantage over existing businesses saddled with legacy technology platforms. In fact, 72% of Fortune 500 CEOs consider the rapid change of technology innovation as one of their three or four greatest challenges according to a recent survey. A tight link between new business models and modern technologies that enable companies to create and deploy subscription revenue businesses is a key to success.

Market Forces - What Do Customers Want?

Aside from technological gaps that companies are facing, consumers across all industries are seeking increasing transparency, alignment of price to value and greater sense of control through self-administration. In the era of authentic brand marketing and hip, ironic conversations with millennials, consumers 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 bills. In particular, price and billing clarity engenders greater trust and stronger brand affiliation. B2B industries are embracing transparency and clarity with increasing speed. Customers of all types are demanding closer alignment of the price model to the perceived value. Corporate CFOs have embraced the shift from Capex to Opex spending in many, but not all industries. Sophisticated pricing and billing engines are now affordable and accessible to even the smallest start-ups. A/B price testing is no longer an expensive science project – it's become table stakes and 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 good/service on-line, on any device, and dial the service up or down 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.

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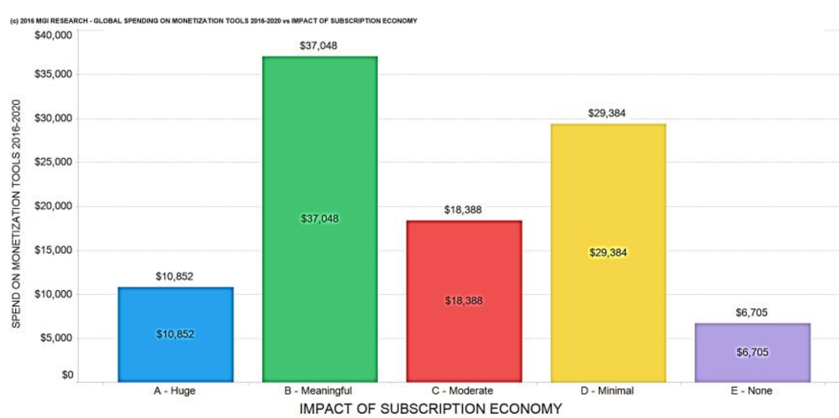
Market Forces – Business Model Innovators

Constant change is synonymous with 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. The subscription economy that has gained traction in business-to-consumer (B2C) industries – e.g., Netflix, car-sharing schemes, Amazon's Subscribe and Save within its Prime membership – is a metaphor for the "as a service" and other business models that are gaining increasing traction in business-to-business (B2B) industries. Organizations across all industries are embracing pricing models that more closely align price with perceived value delivered.

Unilever's reported $1 billion acquisition of Dollar Shave Club (DSC) is instructive. In an industry that typically ac-quires companies based on conservative discounted cash flow estimates, Unilever is believed to be paying more than four times projected revenues for a business that is barely running at cash flow break-even. Why? Founded five years ago, Dollar Shave Club (DSC) aimed to disrupt the category with a direct-to-consumer, subscription business model and targeted men's shaving products in the US – a market dominated by Gillette (Procter & Gamble) and Schick (Edgewell). DSC innovated in three inter-related areas. First, by going direct to consumer and using modern media outreach (e.g., distinctive, viral YouTube videos), the company established a connection with its customers – a connection the customers didn't share with their previous shaving kit suppliers. Second, DSC attacked the juicy profit margins of the razor and razor blade business with its direct to consumer, subscription revenue model. DSC created a seamless buying experience for a disposable product that needs to be replaced on a regular basis. By subscribing to DSC, customers eliminated the hassle of dealing with an increasingly negative buying experience of having to go to the store. Beyond the strategic imperative of eliminating a competitor, Unilever acquired DSC's predictable revenue stream – a key benefit of a subscription business model. Like many large companies with a complex patch-work of business applications, Unilever's sophisticated ERP environment is built for delivering high volume consumer packaged goods at fixed prices with great efficiency. But in a world where companies want greater agility – the ability to monitor customer trends and quickly translate demand sensing into product and pricing innovations, Unilever's tightly coupled IT systems are too rigid and constrain innovation. Undoubtedly, part of the strategic premium paid for DSC was its unique and highly flexible monetization platform optimized for a subscription business model.

MGI Research, an independent tech industry analyst firm 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 Economy.



Adopting a Subscription-Oriented Business Model

Management teams that successfully introduced and/or transitioned to Subscription Business Models (SBMs) typically start by mapping out key drivers, opportunities and risk factors, i.e. "model the physics of the opportunity and risk". Four major forces shape the speed and trajectory of a subscription business journey:

A. Customer-Driven
B. Competitive
C. Strategic
D. 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 SBM.

Customer-driven: Customers often force the SBM 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; shift Capex to Opex; 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 an-other major force that can force the SBM 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 subscription-based models as means to increase revenue predictability, improve margins, drive gains in market share, 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 rewarded subscription-oriented businesses 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 going digital 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 their peers in basic business agility. Moving to an SBM 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.

Getting to SBM - The Practical Impact

On the surface, a journey to a subscription 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. The difference between companies that succeeded in SBM vs. those that failed is in having a deep understanding of the impact that a move to an SBM can have on the entire business and financial infrastructure of an organization. In their journey to a subscription based business, companies will find themselves needing to re-invent their core business metrics and acquire both the vocabulary and the hands-on skills in finance, technology, sales and marketing specific to subscription-based business models. Specific functional areas affected by subscription-based business models include among others:

- 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

Bottom Line

Strategically, a success in moving to a subscription 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 subscription business strategy is a necessary but not a sufficient condition for success. Companies also require expertise in subscription business models 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.

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About Us

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, please visit us at http://www.navint.com/subscriptionservices or contact jwissink@navint.com or tflanagan@navint.com.