
The Enterprise Services Imperative for Technology Companies

Industry Whitepaper
by Waterstone
Management Group

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The Enterprise Services Imperative – The Importance of Services to the Health of Technology Firms

What is top of mind for executives running technology companies today? Most often, at least for our clients, it is imperatives such as addressing cloud and “xxx as a Service” in their technology architectures and business models, leveraging “Big Data” and business analytics in their product suites, and determining the role of Social Media in product and marketing strategies. Seldom will “Enterprise Services” hit the priority list.

We believe that ignoring Enterprise Services is a mistake. In this paper, we will attempt to provide several reasons why paying attention to Enterprise Services is critical to a tech firm’s growth, customer satisfaction, profitability and valuation.

First, let’s define Enterprise Services. Traditionally software, hardware and other technology providers have classified their services as customer support or maintenance services, professional services, and managed or outsourced services. While there are certainly distinctions between these service categories, an increasing number of successful technology companies are finding power in the blending and interplay across services. We will refer to this entire group of services as “Enterprise Services” throughout this paper.

There are many technology companies – across various hardware and software industry segments – who pay lip service to their Enterprise Services (ES). Their strategies, execution and results indicate that they believe Enterprise Services are not critically important to their future. Their ES revenue as a percent of total firm revenue lags their competitors. Their ES profitability is lackluster or, worse yet, they do not know their ES profitability. Those companies view their services as an afterthought, instead of a critical component to implementing technology solutions and helping their customers achieve business results and generating economic value.

In this paper we focus our discussion on the professional services and managed services (PS/MS) portions of Enterprise Services, with less focus on pure customer support, or maintenance, services. We will present three reasons why technology executives should pay attention to their PS/MS business: 1) profit growth and increased economic value, 2) increased customer satisfaction, and 3) enhanced sales opportunities leading to higher enterprise growth. And these core benefits of PS/MS are as true today in the cloud-enabled, big data and analytics world of technology providers as ever before ... perhaps to an even greater degree.

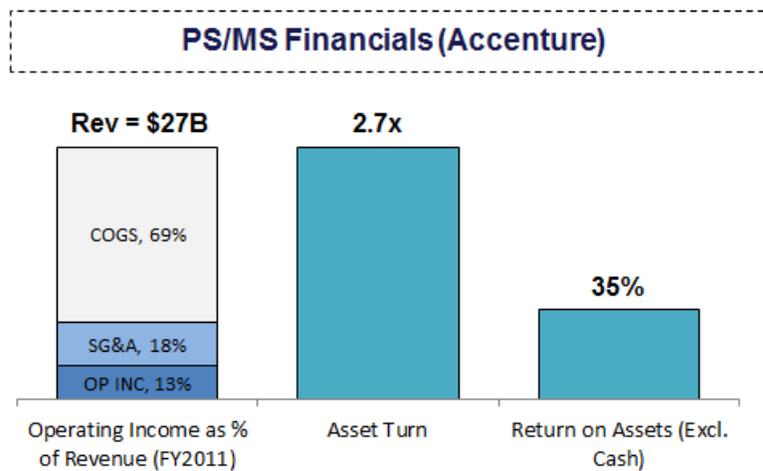
Reason 1: Profit Growth and Increased Economic Value

Creating a set of strong PS/MS offerings can enhance a technology firm’s business model by providing an additional source of profit growth and economic value creation.

We often encounter technology executives who label PS/MS as a low return business compared to the higher margin software license business. Often they fail to recognize the good aspects of the fundamentally different economic models inherent in PS/MS businesses. PS/MS businesses, which generally have lower gross margins than software and other technology product businesses, also typically enjoy lower SG&A and R&D costs. Furthermore, PS/MS businesses turn assets at a much greater rate than most technology product businesses.

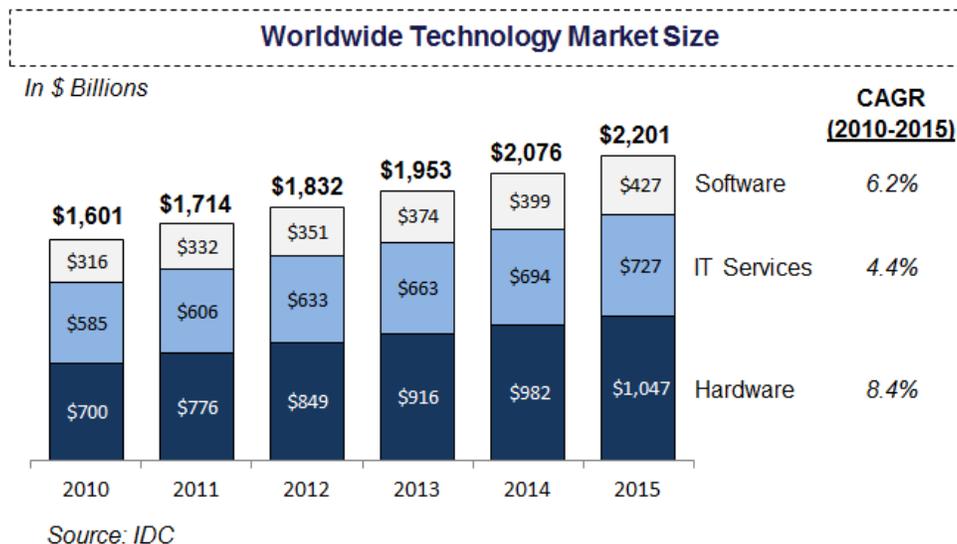
A brief comparison of the financial performance of Accenture (as an example of a PS/MS company) with that of Oracle and SAP (representing Enterprise Software companies) helps to illustrate these points. The operating margin of Enterprise Software is nearly triple that of PS/MS (34% operating margin of Enterprise Software vs. 13% for PS/MS). However, PS/MS businesses require a considerably lower level of assets than Enterprise Software businesses. PS/MS businesses' lower asset requirement translates into a higher asset turnover, which is nearly quadruple that of Enterprise Software firms (2.7x for Enterprise Services vs. 0.7x for PS/MS), as well as a return on assets that is almost 50% greater (35% for PS/MS vs. 24% for Enterprise Software).

Figure 1



Once it is accepted that the two business models' economics are different and that both offer enticing profit opportunities, the global IT services market appears quite attractive due to its large size. At \$606B in 2011, the IT services market is of equal size to the technology hardware market and double that of software according to IDC, a technology market research firm. (see Figure 2)

Figure 2



Moreover, because of the lower asset intensiveness of PS/MS, technology firms do not need to tie up substantial amounts of capital to tap into the large IT services market. Accenture, for example, has an asset-to-revenue ratio of 37% in 2011, whereas Oracle and SAP have ratios of 97% and 125% respectively (ratio calculated using assets less cash). That ratio means that, in the best case, a technology firm can generate \$100 of PS/MS revenue by tying up only \$33 of its capital, compared with up to \$125 for software.

Determining the right mix of PS/MS within a technology company, i.e., the percentage of overall revenue that is derived from PS/MS, is an important element of business strategy and planning. While each company's situation is unique, our experience and research indicates that a mix of PS/MS at 20%-30% of total revenues is a good starting guideline. A ratio below 20% suggests that money may be left on the table or that the firm is not providing enough support to its customers. Conversely, a ratio above 30% suggests that there may be an over-reliance on PS/MS, perhaps because the company's core products are lagging the competition. While these guidelines are a helpful starting point, it is important to determine the right proportion for a technology business based on its own unique situation.

Using the above ratios, technology companies can do the math and roughly size the potential profit from growing their PS/MS. For example, a \$1 billion revenue company with \$100M of Enterprise services could potentially add an additional \$125-285M in PS/MS revenue. This revenue could generate an incremental \$15-35M or greater operating income with modest investment in capital and assets.

Reason 2: Increased Customer Satisfaction

PS/MS can enhance customers' experience with their technology investment by helping them realize their return on investment (ROI) goals for the IT project. Handing over a high quality hardware or software product to a business customer is simply not enough. Purchasers of technology generate value by using the technology to improve existing business processes and enable new ones. And, of course, in order to drive this process improvement, customers must successfully implement the technology. If problems are encountered either with the process improvements or the technology implementation, the project's ROI is at risk. If the project ROI is not achieved, customer satisfaction and, with it, the customer relationship are at risk.

Three real world problems that plague technology customers and hamper the realization of ROI in IT projects are:¹

- a.) **The Consumption Gap** exists when purchased technology is underused or altogether unused. It suggests either an over-purchase on the part of the customer's IT department, which results in wasted investment, or an underutilization of the technology, which results in unrealized benefits from the project. A 2007 study by AMR Research indicates that nearly one in four ERP software licenses purchased by U.S. companies go unused. And while selling unneeded products may bolster a technology vendor's quarterly numbers, it will lead to dissatisfied customers in the long run.
- b.) **The Delivery Gap** exists when projects are not delivered or implemented on time. A 2010 Panorama Consulting study of companies using ERP systems indicates that 35% of ERP projects are not completed on schedule. In addition to affecting the project ROI, delayed delivery pushes

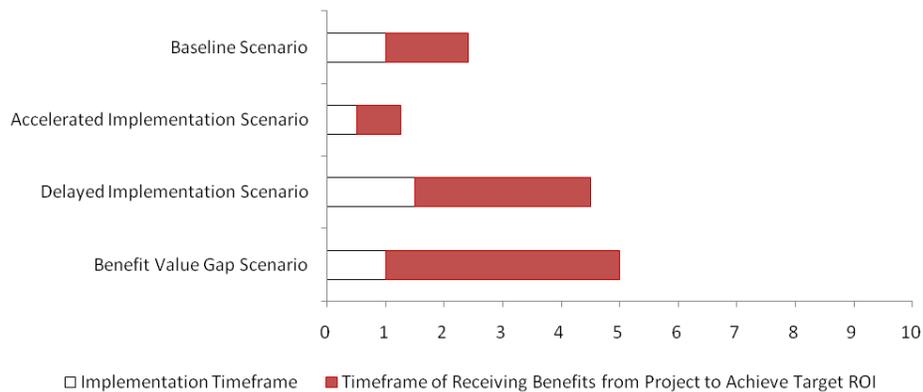
¹ Adapted from: J.D. Wood, *Complexity Avalanche: Overcoming the Threat to Technology Adoption*, 2009

back customers' purchases of additional technology products, thus lengthening the sales cycle for existing customers.

- c.) **The Business Value Gap** exists when projects fail to deliver their expected benefits. The Panorama Consulting study indicates that 67% of companies fail to achieve even 50% of the project's expected benefits. Failing to realize 50% of a project's expected benefits means that its target ROI requires over twice as long to achieve (see Figure 3).

A Waterstone analysis (in Figure 3, below) depicts the impact of these three problems on IT project ROI. IT project ROI is extremely sensitive to several factors: implementation time, implementation cost and benefits realized as a result of the project. The analysis's baseline scenario, in which a software implementation project is completed on-schedule in 1 year and delivers its expected benefits, requires 2.5 years from the initial investment date to achieve the target ROI (set at 35% IRR in the analysis). In the "Delayed Implementation Scenario" illustrating the Delivery Gap, where the implementation completion is delayed by 6 months, the project requires 4.5 years from the initial investment date to achieve target ROI. Conversely, in the "Accelerated Implementation Scenario" where the implementation period is shortened to 6 months, target ROI is achieved in less than 1.5 years from the initial investment date. In the "Benefit Value Gap Scenario" depicting the Consumption Gap and Business Value Gap, where only 50% of the IT project's expected benefits are delivered, the project requires 5 years from the initial investment date to achieve target ROI.

Figure 3



Technology companies can create PS/MS offerings to address all three gaps and help customers achieve their business objectives and project ROIs. They can minimize the consumption gap by providing consulting services to assist customers in project planning and purchasing decisions. To minimize the delivery gap, technology companies can offer project management assistance along with rigorous and consistent software implementation services (e.g., configuration, integration, training) to ensure that the project is delivered on-time. The business value gap can be bridged by offering consulting services to ensure that expectations for the project's value are realistic and that the required process and organizational changes that are critical to the project success are implemented in parallel with the technology.

Addressing all three of these gaps not only translates into greater service revenue and profits, but also creates more opportunities to sell additional technology hardware and software. Stated simply, technology firms can sell more hardware and software once their customers see the value from their prior technology investment.

Reason 3: Enhanced Sales Opportunities

In addition to helping customers better execute technology projects, possessing a robust PS/MS capability provides technology companies with the ability to deepen both their sales efforts and product offerings. On the sales and customer relationship side, PS/MS give technology companies the ability to build deeper relationships at all levels within customers' companies and provide more opportunities to engage customers in discussions about additional technology and service offerings. On the offerings side, PS/MS are the key enabler for technology companies to develop and sell solutions.

Enterprise services personnel work with many members of the customer's organization beyond those whom the sales force engages, allowing for deeper and stronger working relationships and trust to be built at many levels of the customer's organization. These additional relationships can strengthen the technology company's name recognition and reputation within the customer's organization. The stronger reputation can make the technology company a favored option when customers are identifying vendors for future technology projects. In the best case, building this reputation helps a technology company to move away from competing primarily on price. However, these engagements place a greater share of the accountability for the IT project's success on the technology company. Reaping these benefits depends on flawless execution of service engagements. Engagements that do not deliver the promised results can just as easily create a bad reputation for the technology company within the client and hamper future business development efforts.

The greater access that service personnel have to a customer's organization, in terms of working relationships and organizational knowledge, provide the technology company with additional opportunities to engage customers beyond what the sales force can do. Working relationships pave the way for informal conversations about the technology company's other offerings to be held in a wide range of situations outside of formal sales calls. A deep knowledge of the customer's organization allows for identification of opportunities where the technology company's offerings can provide value. This greater access to the customer extends the sales force and enhances its reach, allowing the technology company to achieve a greater customer wallet share.

Beyond enhancing sales, having a robust PS/MS capability is critical in enabling technology companies to engage in solutions selling: the practice of combining products and services to create a compelling offering that addresses a client business issue or opportunity. Solutions can create value beyond that of merely cross-selling products and services. Done effectively, solutions allow technology companies to sell based on customer business value, often resulting in higher prices and margins than selling the individual product and service on an a la carte basis. However, technology companies should be very cautious when deciding to engage in solutions selling, making sure they understand what investments and organizational changes are required to succeed.

Conclusion

Our work with leading companies in many technology sectors – including application software, telecommunications equipment, measurement instruments, and information services – has convinced us of the vitally important role that PS/MS play in the overall success of technology enterprises. In this white paper we have discussed three broad benefits to an effective PS/MS capability: profit growth and increased corporate economic value, increased customer satisfaction, and enhanced sales opportunities.

To learn more about how Waterstone Management Group can help your company improve its Professional Services and Managed Services practices to grow new revenue streams or improve current business performance, please contact:

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Mark is the founder of Waterstone Management Group LLC. He has extensive market and operating experience in Business Services and Technology for both public and private companies on a global basis. Prior to founding Waterstone in late 2003, he was CEO of Cap Gemini Ernst & Young Americas and served on the Global Management Committee of the multibillion dollar provider of Consulting, System Integration, and Outsourcing Services. Mark holds a Bachelor of Science degree from Marquette University and a MBA from Case Western Reserve's Weatherhead School of Management with a concentration in Finance.

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Eric brings extensive experience in both managing large services businesses and consulting with clients on their growth and operating strategies. Prior to joining Waterstone, Eric was VP and Global Leader of the Strategy and Change service line for IBM Global Business Services, managing one of the world's largest strategy consulting practices. Other prior roles include Senior VP for Mainspring and Partner and Managing Director of Strategic Advisory Services for Ernst & Young Consulting. Eric holds a MBA from Harvard University and a BBA from the College of William and Mary.

For more information, please visit www.waterstonegroup.com