



Examples of IT Solutions Companies Transitioning to Successful Business Models

Service Leadership Associates understanding of the most successful, long-term profitable, IT Solutions business models comes from three sources:

1. Building, running and turning around IT Solutions companies ranging from \$5mm to \$1.7bb, since the late 1970's.
2. Valuing and combining IT Solutions companies by doing mergers, acquisitions and then integration of the merged companies, since the late 1980's.
3. Management consulting and benchmarking of IT Solutions companies for the past 5 years, leading to the development of a benchmarking database with over 500 IT Solutions companies analyzed.

From these, we can provide several examples of successful transitions to long-term profitable business models.

Local IT Solutions Provider

This company served small and medium businesses (ranging from 30 to 900 users) in a major metro area.

Prior to Transition: The company had revenue of \$6.1mm, with about 57% coming from product resale and the balance from project-based services. True pre-tax profit (leaving the owners' market-rate salary in company expenses) was 4.6% although this varied significantly month-to-month.

Other than low profits, there were several challenges. First, billable utilization varied because of the project-based nature of the service business. This led to poor actual gross margins on the services business, variable morale among the services people, and frustration among sales reps with the difficulty of scheduling consultants who were at times easily available and other times completely unavailable.

Second, the company had strong *repeat* business but poor *recurring* business. That is, happy customers were to doing their next project with the company, so they had a pipeline of repeat but unpredictable project business. While this spoke well of their service capability and customer satisfaction, it made worse the problems caused by variable utilization.



Third, once a project was completed, the company left the customer's site. This meant that the customer returned to a status where the primary contact was a company sales rep calling on them periodically to try to learn when the next project would come up.

Goals of Transition: Stabilize and improve profitability, smooth out the billable utilization curve, make the project-based business more predictable, and reduce the cost and unpredictability of selling new projects to existing customers.

Transition Methods: Several strategic and tactical changes were made to address the challenges and reach the goals:

1. A small, formal remote support center (including network monitoring and help desk services) was built.
2. Sales and implementation processes and tools for both the project and new support center services were built. Sales, consulting and operations staff were trained on their use.
3. Sales compensation plans were re-aligned to emphasize sales of recurring and project-based services and de-emphasize product sales. The new plan also recognized sales of add-on services into existing customers.
4. Consultant compensation plans were re-aligned to emphasize both customer satisfaction and personal and team utilization.

Operational Results: The new support center services were pivotal in transitioning the organization.

First, they created a recurring revenue stream, which made staffing requirements easier to predict. This improved billable utilization (gross margin), consultant morale (due to being more consistently busy and better able to anticipate their individual schedules), as well as sales rep satisfaction (due to more reliable consultant scheduling).

Second, statistics tracked by the support center enabled the consultant team to better predict when customers needed new projects.

Third, because customers of the support center were constantly visited in person or by phone by the consultants, the sales reps had no problem getting a meeting with the customers to discuss new business.

Financial Results: Over the next 24 months, four of the top ten customers signed up for the new support center services. In addition, the new support center services attracted 3 entirely new customers. Revenue grew 32% to \$8.1mm.



More importantly, services grew 82%, now making up 59% of the business. Better utilization improved the gross margin on services from 32% to 46%. Combined gross margin (services and products) increased from 22% to 33%. Although SG&A increased by 3 points due to the additional overhead needed for the services business, net income improved by 254%, from 4.6% to 12.3% (\$280k vs. \$994k).

Regional IT Solutions Provider

This company served medium and medium-large businesses (ranging from 500 to 6,000 users) across six states.

Prior to Transition: Founded in the early 1980's, the company peaked in the mid-1990's at about \$28mm in revenue with about 30% of revenue coming from services, and a net income of 7.6%. By 1997, market pressures had created a strong negative trend in the company's business. Margin pressure on the product business came from Dell's entrance to the marketplace, as well as increased competition in major account by larger IT Solutions providers. In 1997, the company had \$20.5mm in revenue (of which 31% was services) and a net income of 6.3%, with prospects for 1998 and beyond looking poor.

Goals of Transition: Strategically re-position the company as a services provider to offset margin pressure on product sales, and to create a barrier to entry against larger IT Solutions providers who could not yet provide advanced services.

Transition Methods: Several strategic and tactical changes were made to reach the goals:

1. To facilitate a rapid entry into the recurring services business, the company pursued and won on-site help desk and desktop support services contracts with several existing large customers.
2. Project-based services were re-purposed from informal, product-implementation-oriented services to stand alone, value added services.
3. Sales and implementation processes and tools for both the project and new on-site services were built. Sales, consulting and operations staff were trained on their use.
4. Sales compensation plans were re-aligned to emphasize sales of recurring and project-based services and de-emphasize product sales. The new plan also recognized sales of add-on services into existing customers.



5. Consultant compensation plans were re-aligned to emphasize both customer satisfaction and personal and team utilization.
6. The P&L reporting structure was modified from a unified P&L to a matrixed P&L which measured profitability at each branch office across all lines of services business, as well as within each line of services business. P&L accountability was driven down to the local/business unit contribution level.

Operational Results: As these changes were being made, several market shocks impacted the company which, had the transition to a more profitable model not been tackled, the company would likely not have survived.

First, in 1998 and 1999, two large product revenue accounts were lost to larger competitors because of product pricing. In 2000, the economy went into recession and all accounts delivered much lower results. In 2001, a third large product and services account was lost, also due to pricing.

Despite these unfortunate events, the transition was successful in enabling the company to survive and even improve its profit performance.

The focus on services protected most of the profitable services accounts from the attrition to larger competitors that plagued the product-sales accounts.

During the recession, although most customers terminated capital IT projects, which would have been most also continued to require IT support services (albeit at a slower pace). Thus, the catastrophic drop in product revenue that put many product-centric IT Solutions providers out of business during this time was "merely" a difficult but survivable period for the transitioned company.

The on-site recurring services customers the company had initially won later required (and effectively funded) the building of an off-site, centralized support center by the company. In the past two years, this support center offering has been enhanced to appeal to an additional customer base (the SMB market) not previously accessible to the company. This SMB offering is expected to be the primary growth segment for the company in 2005.

Financial Results: The transition enabled the company to survive major market pressure and the economic recession. By 2002, the transition from the operational and cultural points of view was largely complete.

By the end of 2004, the company's revenue had dropped 56% from its 1997 to \$8.95mm. Given that a great many product-centric IT Solutions companies had gone out of business or shrunk even more dramatically during this time, this must be seen as a success in itself.



Product-resale gross margin, subject to unrelenting pressure for all players, dropped from 19.5% in 1997 to 11% in 2004.

However, the company's improved processes for project-based services and strong initiative in recurring services had the desired results. Gross margin on services improved from 34% in 1997 to 43% in 2004. Significantly, the percentage of revenue coming from services had increased from 31% in 1997 to 82% in 2004. As result, despite a 56% drop in revenue from 1997 to 2004, the company delivered a 2% increase in net income dollars during the same period.

The transitioned business model is also considerably more robust and attractive to lenders and investors. Net income is now 14.7% compared to 6.3% in 1997. About 62% of the company's revenue is now derived from contracted recurring revenue services. The top ten customers now deliver about 22% of the revenue, compared to 67% of the business in 1997.

Critical to the future, the company has been able to reinvest in additional lines of service which give it more opportunities to further secure its relationship with existing customers and to attract new customers.

National IT Solutions Provider

This company served medium-large and large businesses (ranging from 1000 to 30,000 users) nationally.

Prior to Transition: Founded in the early 1980's, the company's revenue grew rapidly from its initial formation (from a consolidation of three regional providers) with \$100mm of revenue at breakeven.

By the end of the 1980's, the company had about \$300mm in revenue, of which only about 5% was services. These services were primarily manufacturer-required warranty maintenance services which were operated at about break-even. The Enterprise Value (EV) of the company was about \$38mm.

By the early 1990's, management had identified several market trends which caused concern. Gross margin on resold product had been dropping consistently since the company's founding, following an industry-wide trend. With Dell's IPO in 1989, that trend promised to accelerate.

The company took aggressive action to sustain acceptable product resale gross margins, the most prominent of which was to dramatically grow top line revenue. Nonetheless, by the early 1990's, product gross margins had dropped from the



28% range to about 11%, and already several large national competitors had gone out of business.

At the same time, the company's customers were struggling with the challenge of installing and supporting their ever-growing population of desktop computers and, later, local and wide area networks. Traditional computer services providers such as IBM and EDS were slow to recognize a need in this area. This left an opportunity for the company – if it could transition to delivering more services, more profitably – to add value to their customers, drive its own bottom line and secure better prospects for the future.

Goals of Transition: The goals of the transition were very similar to the local and regional companies in the preceding examples. They were to strategically re-position the company as a services provider to offset margin pressure on product sales, and to create a barrier to entry against larger IT Solutions providers.

Transition Methods: Several strategic and tactical changes were made to reach the goals:

1. At a national level, a handful of services “principals” were promoted from within to act as high-level pre-sales resources for key services opportunities and to lead the development of profitable services offerings.
2. To facilitate a rapid entry into the recurring services business, the company pursued and won on-site help desk and desktop support services contracts with several existing large customers.
3. Project-based services were re-purposed from informal, product-implementation-oriented services to stand alone, value added services.
4. To demonstrate internally that growing the services business was both possible and profitable, the company began publishing internally a set of key financial metrics, each month ranking all 22 branch offices by their services growth and bottom line profitability.
5. Branch budgets were adjusted to accommodate the addition of key resources to support the sales and delivery of the chosen services.
6. In a half-dozen key markets, small acquisitions were made of local IT Solutions providers who were themselves services-centric. Although these did not add much in terms of services revenue or profit, they provided an immediate and credible source of services resources.
7. Sales and implementation processes and tools for both the project and on-site services were built. Sales, consulting and operations staff were trained on their use.



8. Sales compensation plans were re-aligned to emphasize sales of recurring and project-based services and de-emphasize product sales. The new plan also recognized sales of add-on services into existing customers.
9. Consultant compensation plans were re-aligned to emphasize both customer satisfaction and personal and team utilization.
10. The P&L reporting structure was modified from a unified P&L to a matrixed P&L which measured profitability at each branch office across all lines of services business, as well as within each line of services business. P&L accountability was driven down to the local/business unit contribution level.

Financial Results: As these changes were being made, product sales continued to grow dramatically but, paradoxically, the gross margin contribution of product resales was not increasing at the same pace. By 1996, product revenue had grown to almost \$1.7bb from \$295mm in 1990, an increase of 472%. However, during the same period, gross margin dollar contribution from product resales had only grown by 38%.

The strategic transition to a services-centric model had, however, done its job. Services revenue had grown over 6000% to just over \$300mm, of which about 52% was recurring services. More importantly, the gross margin dollar contribution of the services operation had increased by over 8100%, in 1996 yielding \$124mm in gross margin dollars. This was about 20% more than the gross margin contribution of the product resales operation during the same year.

As a result, the net profit of the company still increased by 84% from 1990 to 1996, despite the dramatic drop in gross margins on the company's previously core product resales business.

Critical to the shareholders, the Enterprise Value of the company had increased significantly: in 1990 the EV was about \$37mm, but in 1996 the EV was about \$636mm. This represented an improvement of 17 times in shareholder value over seven years.