Why Channel Partners Are Out Performing Their Vendors

Although IT Solution Providers (channel partners) had flat revenue dollar growth in 2015, they still managed to drive a 3.9% Year-Over-Year increase in Earnings Before Interest Taxes and Depreciation dollars (EBITDA), according to the just released, *Service Leadership Index® 2016 Annual Solution Provider Industry Profitability Report©*.

The Service Leadership Index® is the largest scale, longest running and most accurate, direct benchmark of Solution Provider financial performance worldwide.

Solution Provider Performance Compared to Their Vendors

In doing this, privately-held Solution Providers (SPs) maintained in 2015 an average estimated stock value at the same peak level of 2014 for a second straight year. This is a strong achievement when contrasted with the IT vendor and distributor community who fared less well.

As Figure 1 shows, IT Technology & Equipment companies (IT vendors) had tepid growth with shrinking profitability. Those which are the leading suppliers to the SP community saw even sharper EBITDA dollar declines. Without the strong performance by HP Inc., these leading vendors would have seen even sharper declines in both average revenue and average EBITDA.

	Solution Providers (SPs)	Public IT Technology & Equip. companies[1]	Core Hardware & Equip. OEMs for SPs[2]	Core Hardware & Equip. OEMs for SPs w/out HP Inc. [2]	Public Software Co's[3]	Core OEMs of Software to SPs[4]	Largest IT Distributors[5]
Revenue Growth YOY	**-0.5%**	**2%**	**3%**	**-8.6%**	**3.5%**	**-6.2%**	**-4.7%**
EBITDA ($) Growth YOY	**3.9%**	**-3.3%**	**-4.3%**	**-5.8**	**.6%**	**-14.4%**	**-1.8%**

Figure 1: Year-Over-Year Revenue and EBITDA Growth Last 4 (TTM Basis)

[1] Source Capital IQ from S&P: Public, North American IT Hardware and Equipment, Last 4 quarters over prior 4 quarters
[2] Source Capital IQ from S&P: Public, North American IT Hardware and Equipment, Apple, Cisco, EMC, HPE, HPI, and NetApp, Last 4 quarters over prior 4 quarters
[3] Source Capital IQ from S&P: Public, North American IT Software and Services, Last 4 quarters over prior 4 quarters
[4] Source Capital IQ from S&P: Public, North American IT Software and Services, Symantec, Intuit, VMWare, CA, Oracle, IBM, and Microsoft, Last 4 quarters over prior 4 quarters
[5] Source Capital IQ from S&P: Public, North American IT Hardware and Equipment, Arrow, Avnet, Ingram Micro, Synnex, and Tech Data, Last 4 quarters over prior 4 quarters

We see the same pattern with the public software companies, whose revenues grew faster than the U.S. economy with a slight increase in EBITDA dollars Year-Over-Year (YOY). But those IT software companies who are the leading suppliers to the SP community saw their YOY revenues and EBITDA $ shrink significantly.

Not surprisingly, the largest IT distributors also saw their revenues and EBITDA $ decline.

The following factors explain the average SP's ability to outperform their key suppliers:

- The SP has the closest relationships with customers' business and IT decision-makers, as compared to the vendor, and certainly to the distributor.
    - Proximity to customers' decision-makers is a key competitive advantage of the SP, more now than ever with an increasingly complex IT landscape. The earlier in the customer's IT needs evaluation that one engages with their decision-makers, the more profit one can make.
- Most SPs provide at least some services which have less or no reliance on the vendors' success at selling equipment or software.
    - While an SP's services related to installing IT products do depend on the sale of those products, even among Product-Centric partners (or VARs) this so-called Professional Services revenue only equates on average to 5.1% of their total revenue. VARs made up only 9.6% of the SP population in 2015.
    - Fully 36% of SPs in 2015 were objectively (by revenue mix) Managed Services Providers (MSPs), the single most common SP business model. In the average MSP, services related to installing products made up 8.9% of revenue, but services related to operating and supporting the customers' environment generated some 59% of their revenue.

As Gartner Group has repeatedly demonstrated, of the end customer's Total Cost of Ownership of equipment and software over five years, some 80% is related to operating and supporting it (operating expenses) versus 20% to buying and installing it (capital expense). This very fact means as SPs continue their march towards delivering support (whether via Managed Services or Cloud Services), their dependence on the IT vendors becomes less and less.

Indeed, the remaining 9.6% of SPs who are Product-Centric convey about 69% of the hardware and software bought by end customers each year, while the 80.4% of SPs who are Services-Centric sell the remaining 31% of products.

Because of this, while most vendors are aware partners in general want to sell more of their own services, most do not realize the majority of their sales rely on a very small minority of partners. That is, few vendors realize they are standing on a burning platform.

Of those that do, few have been able to become credibly important to Services-Centric partners. This is because virtually all of the vendor-provided services which a partner might resell, compete with the partner's own services, which have both a higher upside and a higher downside to the partner.

Differences in SP Business Model Impact Profit Performance

The difference in influence over the end customer's IT buying decisions is clear even within the SP community. For example, we can see this in the difference in profit potential between:

- The Product-Centric SPs (VARs, i.e. those with less than 40% of their total revenue coming from services they deliver), who typically engage late in the customer's decision process. Top (Best-in-Class) financial performance for them in 2015 was 10.1%.
- The Infrastructure-services-centric SPs, who engaged earlier with the customers' decision-makers to help them decide what product to buy. Top (Best-in-Class) financial performance for them in 2015 was 17.9%.

This highlights the danger of aggregate-only looks at the SP community, which mask critical differences in performance by Predominate Business Model© (PBM©) and Operational Maturity Level© (OML©), which is why Service Leadership segments the SP community by these important business model and management method differences.

For example, in 2015, the closer the SP's PBM was to Product-Centric, the more their performance reflected that of the vendors.

	Core Hardware & Equip. OEMs for SPs	Core Hardware & Equip. OEMs for SPs w/out HP Inc.	Core OEMs of Software to SPs	**Product Centric SPs All**	**Infrastructure Technical Svcs SPs All**
Revenue Growth YOY	3%	-8.6%	-6.2%	**3.4%**	**-2.4%**
EBITDA ($) Growth YOY	-4.3%	-5.8%	-14.4%	**-14.1%**	**-43.3%**
CY 15 % Of Rev Which is Recurring				**5.8%**	**12.9%**

Figure 2: Year-Over-Year Revenue and EBITDA Growth – SPs on a Calendar Basis

As Figure 2 details, Product-Centric SP revenues mirrored that of core Hardware & Equipment OEMs, but their EBITDA fell even more sharply than their OEMs. Infrastructure-Technical Services (aka break fix) revenue declined 2% and absolute EBITDA dollars declined a sharp 41%.

	All Solution Providers	Core Hardware & Equip. OEMs for SPs w/out HP Inc.	Core OEMs of Software to SPs	Infrastructure Project Services SPs All	Infrastructure Managed Services All	Infrastructure Shared Services All
Revenue Growth YOY	-0.5%	-8.6%	-6.2%	**5.2%**	**6.5%**	**9.6%**
EBITDA ($) Growth YOY	3.9%	-5.8%	-14.4%	**14.6%**	**16.1%**	**60%**
CY 15 % Of Rev Which is Recurring	28.5%			**18.3%**	**47.7%**	**50.2%**

Figure 3: Year-Over-Year Revenue and EBITDA Growth – SPs on a Calendar Basis

In stark contrast, as Figure 3 details, SPs in the PBMs of Infrastructure-Professional Services, Infrastructure-Managed Services (MSPs) and Infrastructure-Shared Services (CSPs) all grew strongly – top and bottom line, since they were services- not product-led, and were able to leverage their stronger bases of recurring revenue.

Differences in Operational Maturity Level© Impact Profit Performance and Ability to Deliver Vendors' Higher Value Offers

The Best-In-Class (Top quartile adjusted EBITDA % in their PBM) SPs have the highest Operational Maturity Levels and consistently deliver about 3x the financial performance of the Median-performing SPs in the same PBM.

Sequential improvement in OML results in SPs who go to market with their own brand solutions designed to effectively meet the business objectives of a tightly-defined Target Customer Profile (TCP) or size range in number of end users.

These higher OML SPs (i.e., OML >3.5 out of a possible 5.0) target strategic buyers of IT within their chosen TCP, with more compelling solutions and are better able to value-price, which drives Gross Margins in both services and product.

For example, the Best-in-Class Product-Centric have higher Services Gross Margins (42.2%) vs their Median (30.6%) and Bottom ¼ (24.7%) colleagues in the same PBM. These Top (Best-in-Class) performing Product-Centric firms have learned how to sell and deliver services at margins higher than the Median Infrastructure-services-centric SPs.

How do these higher OML partners accomplish this? By strict adherence to their chosen TCP and by providing significant solution value over and above the resale of product, which together earn them higher trust, and higher service and product Gross Margins.

It's important for vendors who themselves seek to bring a higher value to end customers through the partner channel, to understand this difference in their partners' abilities to convey a higher value. Put another way, vendors who know their partners' Operational Maturity Levels, can better predict the degree to which a given partner is likely to be able to sell meaningful quantities of higher value offerings in a usefully short period of time.

Cloud's Surprising Impact on Solution Providers

What about the purported demise of the Solution Provider due to the cloud? This conclusion, while popular "wisdom," is not substantiated by the empirical data.

For example, the Best-in-Class MSPs know that the more the client goes to the cloud, the more (not less) complex their actual IT operating environment (more vendors, more connectivity, more dispersed data and apps). Thus the more work they will have to do, and the more value they are adding. They are successfully raising their fees as their customers adopt cloud more.

Measuring, as Service Leadership does, at the actual, normalized income statement level, cloud resale was only 3.3% of overall SP revenues in 2015. While this is up from 2.7% in 2014, it is far from the "disruptive take-over" touted by the cloud vendors. Even more telling, this small share of SP revenue comes as cloud vendors large and small have belatedly realized they cannot disintermediate the SPs and are increasingly selling through them.

How can cloud vendors report fast revenue growth when it doesn't show up as a larger share of revenue in their channel partner's income statements? There are three reasons:

- The least reason is that a small proportion of SPs' cloud resale is rewarded on a commission rather than outright resale basis.
- A larger reason is that the cloud vendors' total revenue still makes up only a very small portion of the overall IT economy.
- The largest reason, however, is overlooked by senior decision-makers, software developers, cloud vendors and others not familiar with how IT infrastructure operates; applications appear to be the iceberg.

  In fact, applications are the tip of the iceberg, resting and reliant on a large base of infrastructure. Cloud is supposed to remove a good deal of that infrastructure, but this is an illusion: the app moves, but the infrastructure gets more complex, and thus the support workload gets higher. Meanwhile cloud apps and data proliferate, adding more work.

Even as cloud adds momentum to the need for infrastructure work, the Internet of Things (IoT), accelerates it even further:

- IoT is enabled by IPv6, the internet addressing scheme which increases the number of available endpoints bearing on that infrastructure by literally 28 orders of magnitude (the math of which is in *Service Leadership Index® 2016 Annual Solution Provider Industry Profitability Report©*).

- All this new infrastructure, and indeed most of these new endpoints, need to be managed for the customer to gain the benefit of IoT-based business processes.

All of these factors speak to increasing opportunity for Infrastructure services SPs, not decreasing.

Yes, cloud is rapidly accelerating the amount of data being created, and increasing the number of apps being used, all of which increases the opportunity for capable applications services firms to do more work.

But for Infrastructure SPs, the correct conclusion is that the need for infrastructure services will continue to grow rapidly, giving them great opportunity as they become more operationally mature and focus on getting to Best-in-Class.

Key Take-Aways

So what should IT vendors take away from the *Service Leadership Index® 2016 Annual Solution Provider Industry Profitability Report©*?

- The Infrastructure Services SP community overall fared significantly better in 2015 than the leading IT vendors and distributors who work most closely with the SP community.
- These SPs have greater account control and trust by virtue of their services positioning and local proximity, and are generally able to use their customer positioning to drive Gross Margins and with it EBITDA performance.
- Higher OML Product-Centric SPs did better than the Median Product-Centric SPs; not by having more services per se, but by leading with Services properly, which, as with their compatriots in Infrastructure Services, positioned them more strongly with business and IT decision-makers.
- And finally the oft-predicted demise due to the cloud is mistaken. The cloud is actually an opportunity for the higher performing SPs to make more profit. IoT follows closely behind as a business driver for Infrastructure-services-centric.

Conclusions for IT Vendors from This Year's Report?

- Your partners who are most compelling to Business and IT decision-makers, become so by getting involved early in the buying process which means they are, by design, speaking to meeting business objectives with solutions – not by selling specific products or vendors.
- You have little ability to sway Infrastructure Services SPs, despite contributing between 18.6% (Median Services SP) and 8.8% of EBITDA (Best-in-Class Services SP) in the form of Commissions, Rebates, MDF and Agency fees.
- There's a huge delta (in OML and in financial results and valuation), between lower OML SPs and those higher OML SPs. This is especially true of your primary channel partners, the Product-Centric ones. Of these, the higher OML are successfully Services-led.

- Yes, the Median Product Centric SPs derive nearly 50% of their EBITDA from Commission and Agency Fees, so you do hold sway here; but the Best-in-Class Product Centric SPs only get 16.7% of their EBITDA from Vendor Commission and Agency Fees; significant, but not overly so.
- So what does this report provide you? It allows you to understand how to target the right SPs based on PBM and OML and begin to design programmatic approaches to your SP channel that will be more effective.

And the distributors?

- Today you're seemingly between a rock and a hard place – between shrinking vendor profits which impact you and diminishing relevance with an increasing portion of the SP community.
- That said, as with the vendors, the *Service Leadership Index® 2016 Annual Solution Provider Industry Profitability Report©* allows you to understand how to target the right SPs based on PBM and OML and begin to design programmatic approaches that will be more effective in securing greater share of wallet with those SPs.

For vendors and distributors, the winds are against you with fewer SPs whose primary business model is the resale of product. Even with Product-Centric SPs, the most mature have positioned product in the context of Services and solutions, to drive both product and Service Gross Margins which erodes the vendors' leverage with these SPs.

Next Steps

To truly understand your channel partners and how to be most relevant to them, purchase the full *Service Leadership Index® 2016 Annual Solution Provider Industry Profitability Report©*. The report includes:

- Current valuations for partners in each Predominate Business Model© (PBM©),
- How Solution Providers have performed since 2008,
- How the Top (Best-in-Class) Solution Providers attain their results and do so with consistency, and
- Why the profitability of some PBMs are more volatile than others,
- Gross margins by line of business; and by sales, marketing, and general and administrative costs in Top, Median and Bottom quartile profitability firms by PBM.

The 2016 report also features enhanced analysis on Cloud Services Growth and Profitability, as well as Myth Busting of the five commonly-held myths that lead SP executives away from growth and profit.

Service Leadership's unique business model – as consultants passionate about helping Solution Provider owners grow revenue, profit and shareholder value through best practices proven effective for their specific Predominant Business Model© – provides the insight required to help Vendors work with the right partners and design a program for success in a shorter period of time with less risk and greater return. Contact us for more information or to discuss how we can address your specific needs.

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Service Leadership offers advanced peer groups for Solution Providers of all sizes and business models, and individual management consulting engagements for Solution Providers from US$15mm to US$3bb in size worldwide. In addition, Service Leadership provides global IT vendors with advanced partner enablement assets, partner ROI models, management consulting and advanced peer groups, as well as executive and industry best practices education and speaking. Please visit www.service-leadership.com for more information.