



SMB Channel Services Transformation

A Special Report by Channelnomics, Pax8, Acronis, Dropsuite, IBM Security, Microsoft, & Novacoast

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Services Transformation: A Continuing Journey

Services are endemic to the channel – particularly on the small-business level. The average SMB-oriented solution provider earns as much as 60% of its gross revenue from managed or professional services. Cloud computing – infrastructure and application services – make up another 15% of the revenue mix. And the balance comes from a mix of traditional hardware and software products.

The dominance of services in solution provider portfolios reflects the continuing evolution of partners' business models and operations. For much of the past two decades, vendors and distributors told partners to evolve their models and adopt services as a means of staving off the declining profitability of commoditized hardware and software products. The evidence is clear they took the advice.

Services Lead the Way

75% of solution provider revenue comes from professional, managed, or cloud services.

Services Margins

Professional Services: Up to	60%
Managed Services: Up to	50%
Cloud Services: Up to	20%

From a fiscal perspective, services are good for solution providers. Gross margins on managed services range from 40% to 50%. Professional services – pre-sales consultation and post-sales implementation and integration support – carry margins up to 60%. While cloud services aren't as lucrative for solution providers, they still generate as much as 20% profit. Even if these services were less profitable, their recurring installments produce compounding income with fewer resources and costs.

Services in the SMB channel are widespread. According to our study, the SMB Channel Services Transformation, small solution providers are the conduit that brings and increases service volume to the small-business segment. As small businesses increasingly transition from on-premises technologies to remotely delivered and cloud-based systems, they're turning to their traditional solution providers for guidance in selecting, acquiring, and migrating their organizations to more modern systems.

While solution providers continue to see strong growth potential in services, most don't focus on making the right investments to maximize their returns. Like their counterparts from the old product-focused channel, solution providers see growth as a riddle solved with more offerings added to their portfolios and line cards. Their actual growth remains stymied by a lack of investments in capabilities that improve repeatable go-to-market processes and customer experience.

In this first "SMB Channel Services Transformation" report, we'll detail the strengths and shortcomings of SMB solution providers in services and where they can improve their competitive standings, growth, and profitability.

About This Report

The SMB Channel Services Transformation report is a collaborative effort of Channelnomics (formerly The 2112 Group), Pax8, Acronis, Dropsuite, IBM, Microsoft, and Novacoast. The project's objective is to provide solution providers in the Pax8 community with insights into service adoption and transformation of capabilities in the channel.

For the study behind this report, Channelnomics reached out to more than 16,200 solution providers in the Pax8 network. More than 400 qualified solution providers participated in the study, giving the data a margin of error of +/- 5% with a 95% confidence level. Channelnomics believes the results reflect the Pax8 solution provider network's current state.

The study's sample is almost entirely composed of SMB-oriented solution providers that are themselves small businesses (see *FIGURE 1: Annual Revenue of Survey Participants*). Among the participants, 81% generate less than \$5 million a year in gross revenue; 75% self-identify as managed service providers, with the balance made up of IT consultants, value-added resellers, and other channel companies. Most of the solution providers in the sample are seasoned organizations that have been in business for 11 years or more (see *FIGURE 2: Age of Surveyed Businesses*).

FIGURE 1: Annual Revenue of Survey Participants

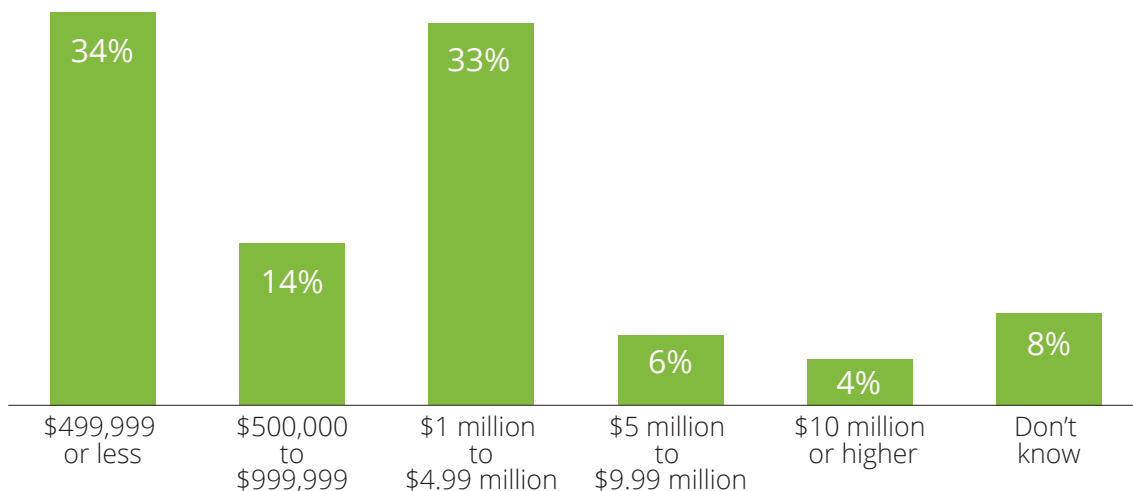
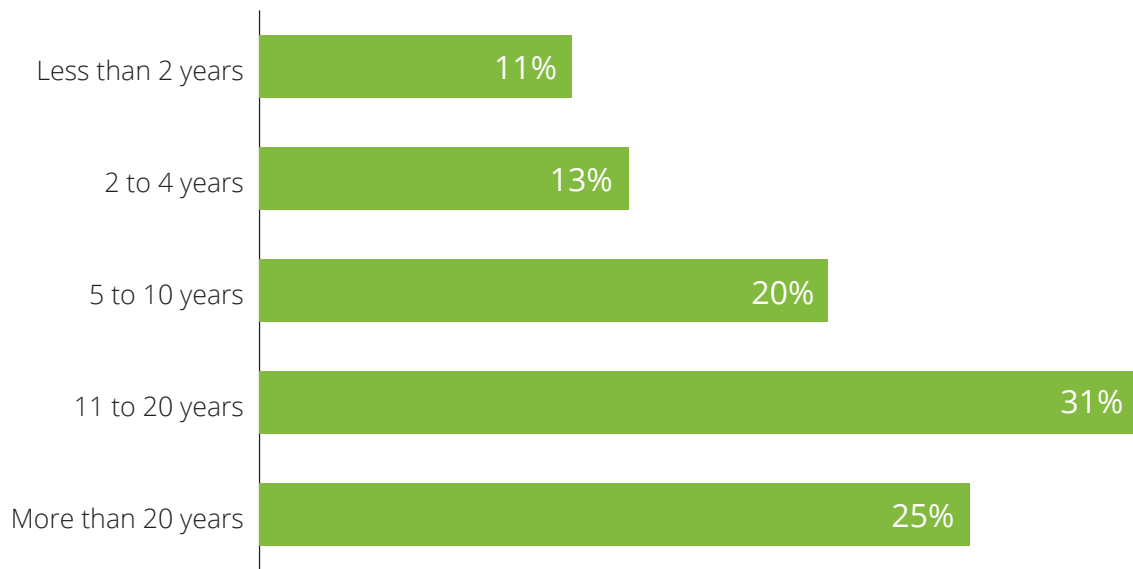


FIGURE 2: Age of Surveyed Businesses



SMB Solution Providers Bring Services to SMB Customers

Small businesses – companies with 250 employees or fewer – are typically resource-constrained. Most SMBs don't have in-house IT staff and resources to select, manage, and maintain increasingly complex IT systems. Simultaneously, SMBs are getting more dependent on IT – particularly cloud-based applications and resources – to operate effectively. The imbalance in resources puts SMBs at risk.

The strategy most SMBs take to address their IT needs with limited budget and know-how is working with knowledgeable solution providers. By outsourcing their IT needs to solution providers with managed and professional service capabilities, SMBs get the support and technologies they need within a predictable budget.

Small solution providers are the source of most services consumed by SMBs. In the SMB Channel Services Transformation study, 90% of the solution provider participants reported having 25 employees or fewer (see *FIGURE 3: Number of Full-Time Employees of Surveyed Companies*). In that group, 95% support small-business customers, and one in four of that 95% works with companies of nearly equal size (see *FIGURE 4: Size of Solution Providers' Average Customer*).



FIGURE 3: Number of Full-Time Employees of Surveyed Companies

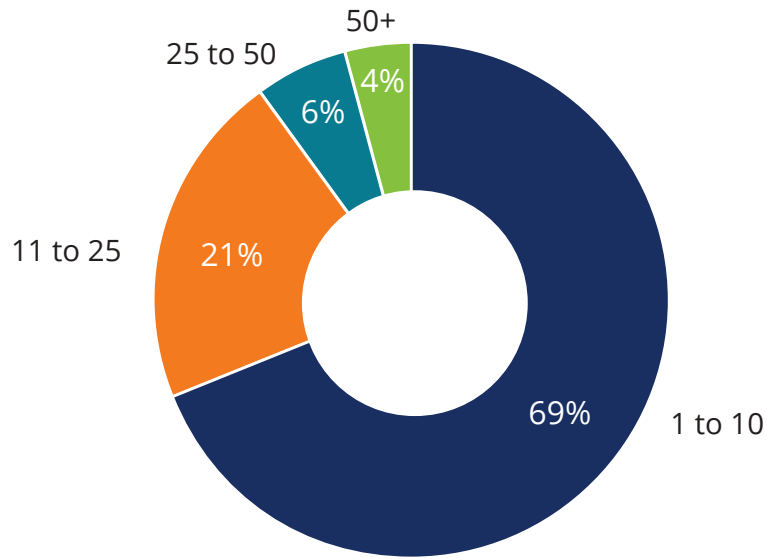
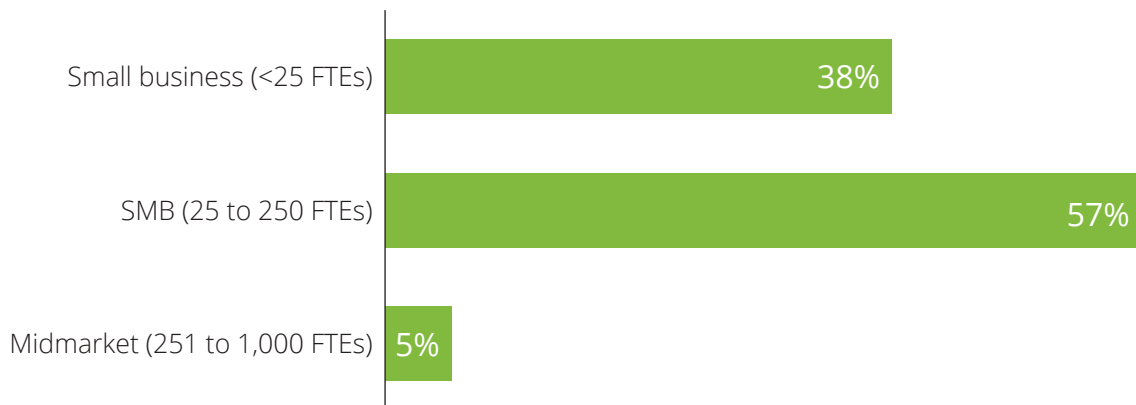


FIGURE 4: Size of Solution Providers' Average Customer



The correlation of size is significant as it reveals two opportunities:

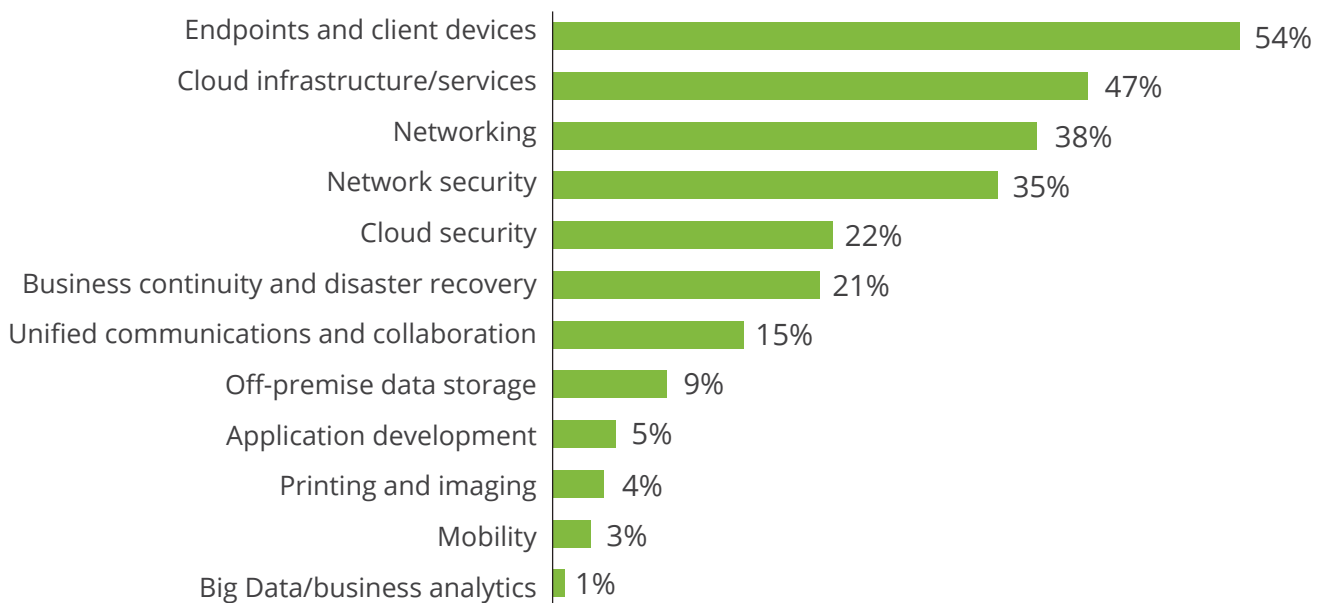
- Solution providers seeking growth in services should target companies that look like them in size and composition.
- Solution providers have an opportunity to grow their business beyond the small-business segment, as only 5% of participants support midmarket companies (251 to 1,000 employees), and none work with enterprise accounts.

Growth in Services Over Products

Even as the channel and its customers transition more of their IT to service-based offerings, traditional hardware and software products remain foundational to all businesses. The expansion of services isn't the result of share shift – or money previously spent on one offering converting to a new offering with no appreciable growth. Traditional hardware and software sales are a services growth catalyst.

Traditional products and services continue to dominate the portfolios of solution providers in the SMB Channel Services Transformation study. More than one-half of solution providers (54%) report selling and supporting endpoint devices such as PCs and tablets. Another 38% sell and support networking equipment such as switches and routers. And 35% offer network-level security products such as firewalls and intrusion detection appliances (see *FIGURE 5: Products and Services Offered by Solution Providers*).

FIGURE 5: Products and Services Offered by Solution Providers



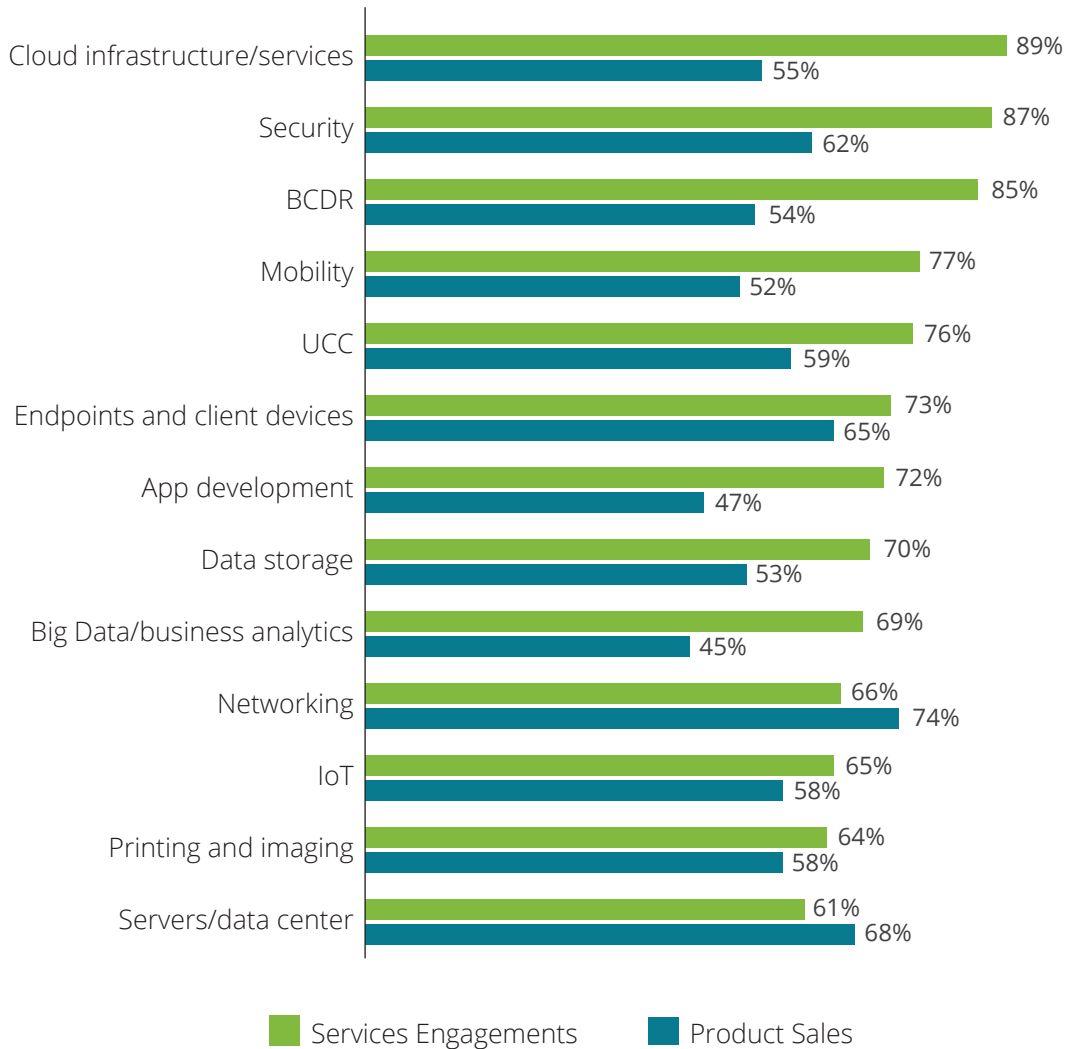
The presence of traditional hardware and software products on solution providers' line cards tells only part of the story of their economic model and transition to services. Most of the traditional products are a means to an end, as most have attached services. The sale of network and security equipment is often a part of managed services. Endpoint devices often come with configuration and deployment services. And all hardware sales have some level of backup and cloud services attached.

Among the surveyed solution providers, 64% generate revenue through primary and secondary service sales. In other words, if they're not selling a service as the primary offering, the traditional hardware and software will often drag a managed or professional service with it.

When it comes to growth, solution providers are bullish on services – mainly services that support traditional products (see *FIGURE 6: Technologies With Highest Growth Potential*). Solution providers see strong growth potential across most common technology categories – both traditional and service-based equivalents. Only

two categories – product-based Big Data and business analytics, as well as application development – aren't seen as having growth potential by at least 50% of solution providers.

FIGURE 6: Technologies With Highest Growth Potential



What's interesting is the growth perceptions around different products and services. More than 80% of solution providers see growth opportunities in cloud infrastructure, security services, and cloud-based backup and disaster recovery. More than two-thirds of solution providers see potential in services around mobility, unified communications and collaboration, endpoint device management, storage services, and business analytics.

The standout data point is that only two traditional product categories – networking equipment and data center servers – have higher growth potential for solution providers. The inverse means that services are overwhelmingly seen as more advantageous to solution providers in terms of growth and success going forward. Among respondents, 72% said they plan to increase their service offerings in the next 12 months.

72% of solution providers plan to increase their service offerings in the next 12 months.

Challenges Hindering Growth

No business is worry-free, and that holds true for the solution providers participating in the SMB Channel Services Transformation study. While the economic damage and lingering uncertainty caused by the COVID-19 pandemic are palpable, the most significant challenges are rooted in attracting customers and generating revenue.

Among the solution providers surveyed, 43% said closing sales is a challenge for them. One-third said marketing is a challenge. A substantial number of them are grappling with price and margin contraction pressures and managing cash flow (see FIGURE 7: Challenges Facing Solution Providers).

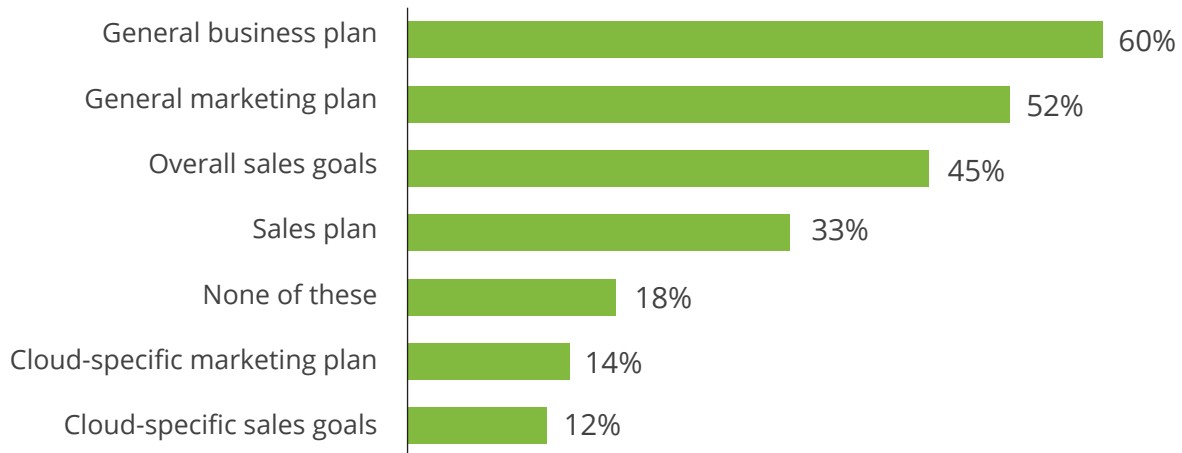
FIGURE 7: Challenges Facing Solution Providers



Sales and marketing challenges are a long-standing issue among solution providers. Perennial studies often find solution providers conceding that their lack of marketing and sales capabilities stymie their revenue creation and stability. The chronic sales challenge is why 60% of solution providers are adopting more services to build and sustain recurring revenue. With more recurring revenue from accounts under contract, solution providers are under less pressure to generate net-new sales.

The lack of sales and marketing success among solution providers isn't surprising given the absence of planning (see *FIGURE 8: Business Instruments Used by Solution Providers*). Only 33% of solution providers have a sales plan, and 55% don't have established sales goals. For a cohort that's focused on growing services, solution providers aren't planning for success. Only 12% have sales goals for their cloud services.

FIGURE 8: Business Instruments Used by Solution Providers



Most solution providers plan to add more services – particularly around the cloud – in the next year, but only 14% have plans for marketing their cloud offerings and capabilities. On top of that, 48% of solution providers don't have a general marketing plan.

Just 60% of solution providers have a general business plan that defines and governs their business operations. That lack of planning contributes to other operational pressures. More than one-quarter say they're challenged by the lack of time and resources to do their jobs effectively. Others face difficulty keeping current with new technologies and emerging skills, retaining customers, and staving off competition.

The research shows that the lack of planning doesn't hinder the current revenue and profitability performance of solution providers, as market momentum carries them forward. However, the lack of sales and marketing planning does contribute to general uneasiness among solution providers, which saps their confidence and challenges their ability to forecast future growth accurately.

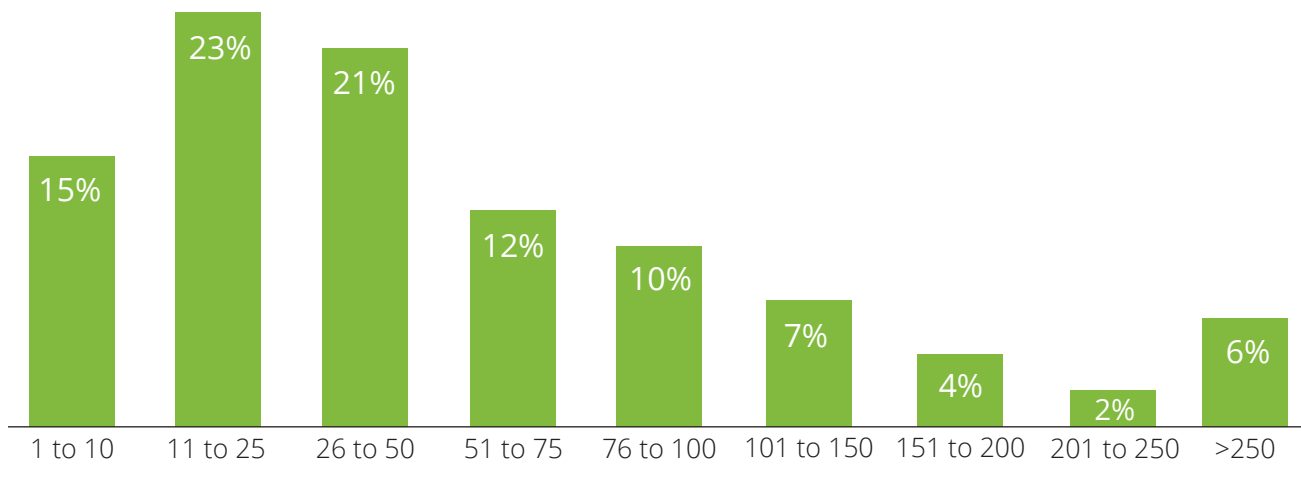
48% of solution providers don't have a general marketing plan.

60% of solution providers have a general business plan that defines and governs their business operations.

Unpredictable Revenue and Account Retention Problems

SMB solution providers are generally supporting SMB customers, as noted previously. The average solution provider in the SMB Channel Services Transformation study supports less than 50 accounts, with 37% reporting having 25 or fewer accounts with service contracts (see *FIGURE 9: Number of Active Services Customers of Solution Providers*).

FIGURE 9: Number of Active Services Customers of Solution Providers



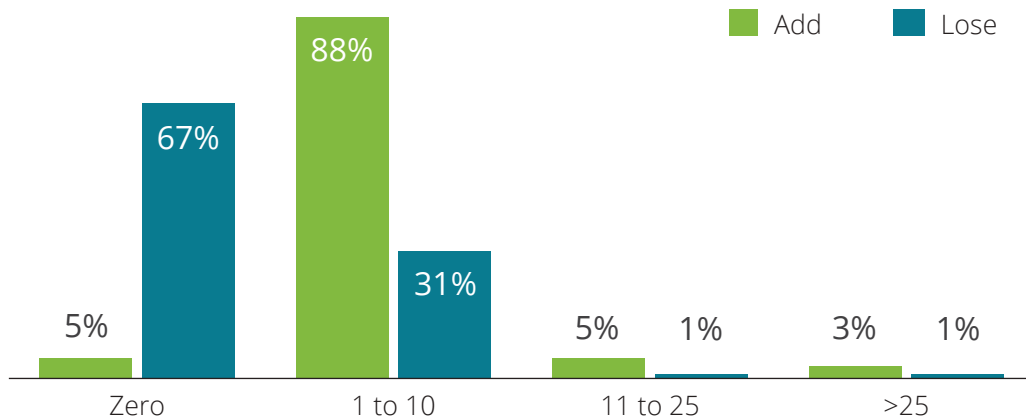
The sales and marketing challenges are acutely noticeable in the account acquisition and retention data provided by solution providers.

Most solution providers say they're building services to develop and sustain recurring revenue. When flowing smoothly, the recurring revenue paradigm can deliver predictable income and profits. With more predictable revenue, solution providers will mitigate the pressure they feel from their sales and marketing challenges.

Two things make the recurring-revenue model work: account acquisition and account retention. Revenue compounds as more customers are brought under contract and expand their service consumption. What makes recurring revenue predictable, though, is account retention. Customer renewal means that every new account is compounding new revenue on top of the existing base. If account retention is low – or, conversely, account attrition is high – the recurring-revenue model is unstable because the revenue stream isn't predictable.

The account acquisition-to-attrition ratio is moderate among solution providers participating in the SMB Channel Services Transformation study (see *FIGURE 10: Service Account Acquisition-Loss Ratio*). While 88% report adding one to 10 new accounts per month, 31% report losing the same amount. At the same time, 67% of solution providers report losing no customers each month. For all the partners in the study, these numbers add up to a 2.5-to-1 ratio of new accounts to lost accounts each month.

FIGURE 10: Service Account Acquisition-Loss Ratio (per-month basis)



The acquisition-attribution issue is seen when comparing specific add-loss ratios. One-third of solution providers add no new accounts while losing as many as 10 accounts per month. Nearly one-third are losing as many accounts as they're gaining. And slightly more than two-thirds report losing one account for every 2.5 they add.

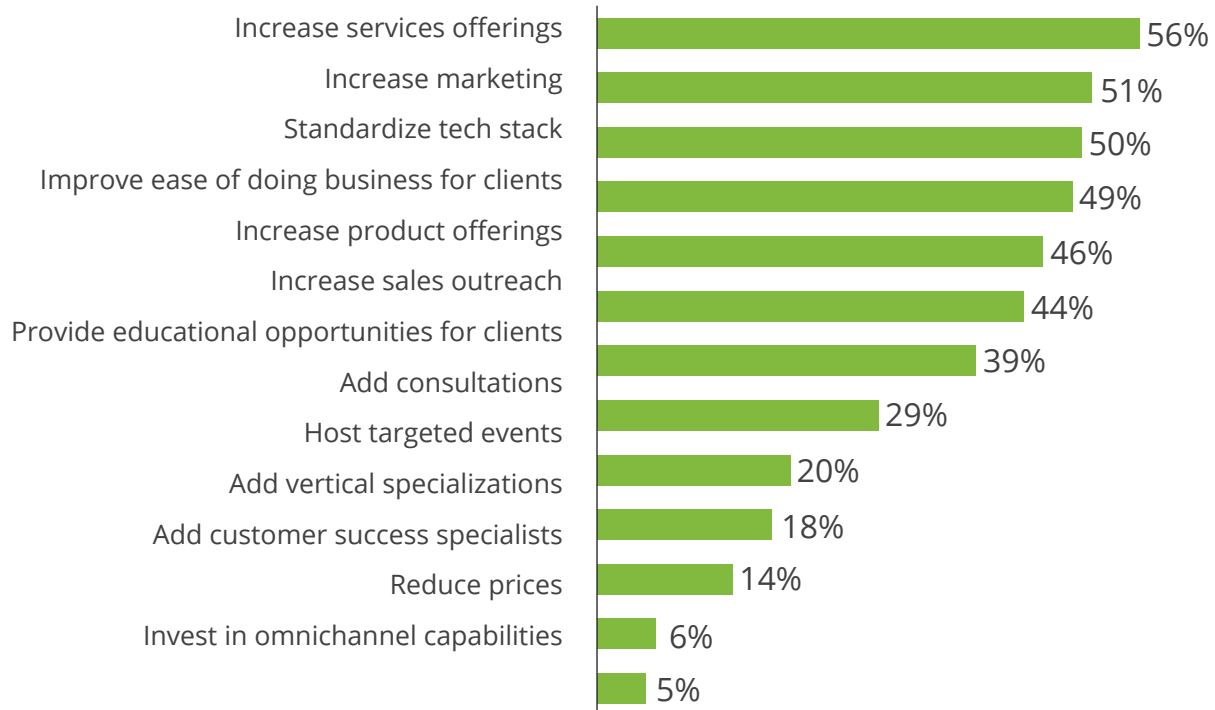
Solution providers readily admit they have sales and marketing problems, but they're more blasé about their account retention issues. Only 9% say they're challenged by account retention, and only 7% say they're vexed by business churn (when customers downgrade or drop certain services).

The lack of concern about account attrition doesn't go unnoticed by solution providers, but those polled in the SMB Channel Services Transformation study see the problem as a product portfolio issue, not an operational issue. More than one-half plan to increase their service offerings to attract and retain customers; 50% plan to standardize their technology stack to simplify offerings to customers; and 46% anticipate that they'll add more products to their portfolio to attract and retain customers (see FIGURE 11: Investment Plans for Increasing and Retaining Services Customers).

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- ➔ 9% say they're challenged by account retention.
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FIGURE 11: Investment Plans for Increasing and Retaining Services Customers



While 51% of solution providers plan to increase marketing efforts to keep customers in the fold, less than one-half plan to focus on operational issues and customer experience. Just shy of one-half plan to improve their ease of doing business, but only 14% plan to add customer success specialists to ensure customers have successful engagements.



Reinvestment Lacking

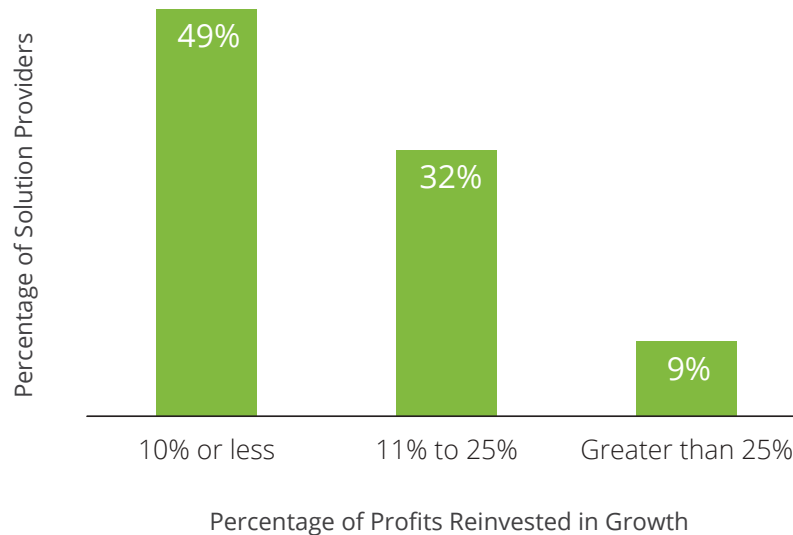
Whether right or wrong, solution providers see their future success in services entirely through the lens of expanding their offerings. Today, the average solution provider works with 11 service and cloud vendors, includes six vendors in its sales to accounts, and includes about seven service products in each sale.

As noted in the growth plans, expanding services and attracting customers through expanded marketing require investment in capabilities and capacities. Solution providers need talented people to support go-to-market initiatives and service customers brought under contract. Each new service added to the portfolio requires infrastructure and training. All these cost money.

In 2019, the average net profit of the solution providers participating in the SMB Channel Services Transformation study was between 16% and 20%. Only 8% reported no profits or a loss for the year. And just 20% reported profits of 31% or higher. Average solution provider profitability is consistent with the rest of the technology market, meaning they're relatively healthy.

As a best practice, a business should reinvest at least 10% of its net profits in business development. Nearly one-half of solution providers say they're reinvesting 10% or less in their service development. Another one-third is investing 11% to 25% in the growth of their services. And 9% are investing more than 25% of their profits in service expansion (see *FIGURE 12: Solution Provider Reinvestment Growth Plans*).

FIGURE 12: Solution Provider Reinvestment Growth Plans



Context matters when it comes to investment in growth. While these reinvestment percentages sound impressive, the actual numbers are typically not sufficient to make a material impact on a business. By revenue, the largest segment of solution providers in the study generates less than \$1 million a year in gross revenue. If profit for these businesses is 20%, their actual net is \$200,000. If they reinvest even double the best practice – 20% of net profits – they're only earmarking \$40,000 for their growth.

To put the reinvestment challenge differently, that \$40,000 – a liberal estimate based on the known variables – must cover the increased expenses of adding services, training, and marketing. Given that many of these businesses don't have sales and marketing plans, the base on which new investment is added is likely small.

Funding growth to align with appropriately ambitious investment strategies requires more than the minimum investment. Businesses under \$2 million in revenue should consider allocating as much as 25% or more of net profits to growth investments. Only after the \$5 million gross revenue threshold can reinvestment revert to best-practice levels.

Service Transformation: A Work in Progress

The common theme in the SMB Channel Services Transformation study is that small solution providers are the primary conduit of technology, managed, and cloud services to the SMB market segment. Solution providers play a vital role in ensuring SMB customers get access to the services they need and the support they require to maximize the return on the associated expenses.

The motivation for solution providers is getting off the roller coaster of unpredictable transactional sales. Solution providers are clear that they want more recurring revenue to bring stability to their businesses and minimize the risk of disruption – such as what many experienced during the 2020 pandemic.

While solution providers see growth opportunities in services, they continue to treat the growth equation from a transactional model that includes legacy hardware and software products. They see adding “more” services – professional, managed, and cloud – as the means for facilitating growth, but they're making precious little investment in business planning aimed at realizing their growth aspirations.

Despite a decade of solution providers migrating to service-based portfolios and revenue models, the SMB Channel Services Transformation study reveals that most SMB solution providers need to pay more attention to their soft skills and organizational efficiencies rather than continue to focus on products and vendor brands.

The good news for solution providers is that they have a cushion on which to buffer their maturation. The service market will continue to grow at a substantially higher rate than the rest of the market for at least the next five years. Demand for services endemic to solution providers' capabilities – endpoint management, essential security and backup, and cloud-based storage – will remain high as SMBs continue their digital transformation investments. In the meantime, vendors and distributors – Pax8, among them – can provide resources to offset gaps and support development efforts.

SMB solution providers in the Pax8 network have the right elements and foundations for service success. Any gaps in current capabilities are only slowing success, not making it unattainable. Based on the SMB Channel Services Transformation study findings, solution providers will compete and excel in services with planning, investment, and effort.

About the Report Supporters

The SMB Channel Services Transformation study and report are a result of a collaborative effort from these companies.



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