

## Creating Annuity Revenue through Value-Added Services

By Dennis Gershowitz, Principal, DG Associates, and Sam Klaidman, Principal Advisor, Middlesex Consulting Group

*In a world full of continuing business uncertainty and tough economic challenges, what would you give for a predictable, growing revenue stream that creates loyal customers and helps sell product? Read on to discover the difference of value-added services.*

If you manage a high-tech business, let's face it—you are always expected to be looking for ways to create a continuously growing revenue and profit stream (we refer to this as "annuity revenue") while creating or maintaining loyal and engaged customers. In this article, we will proceed to show you how to achieve this level of financial success by:

- Reducing the complexity of your product to enhance the usability of its features.
- Providing your customers with value-added services, including professional services, so they can enjoy the features built into your product.
- Building customer loyalty strong enough to engage your customer.

### What is annuity revenue?

Annuity revenue is a predictable stream of revenue and profits derived from a wide variety of sources. They are a part of the company backlog, are generated from an increase in customer satisfaction and loyalty, and in many cases they differentiate one company's products and services from the pack. To compare discrete product revenue with annuity revenue, let's first take a high-level look at both sources of revenue (and profits):

1. Discrete product or service – a standalone sale to either new or repeat customers (even if purchased under a blanket order) and unlikely to repeat for a number of years.
2. Annuity revenue – a predictable revenue stream from new or existing customers who buy products and services associated with new or previously purchased products. Many times this term is used in conjunction with value-added services.

Comparing both sources of revenue, we find that we have been successful in demonstrating to companies that annuity sales have a number of significant advantages:

1. Some annuity services can be included with the initial purchase:
  - Solution selling makes the overall sale easier.
  - Financing may make the sale possible.
  - Value-added services can become a competitive lockout differentiator.
2. Lower selling costs, since the prospect is already your customer, or will soon become one. There's no need to begin establishing a relationship and incurring the related costs.
3. Your total revenue stream will be more predictable or consistent. For years, Xerox has reported over 70 percent of its annual revenue as annuity revenue.
4. You have moved your customer relationship to a higher level and are therefore enjoying the benefits of increased recommendations, repeat purchases, and higher margins.

### Is generating an annuity stream a new concept?

Absolutely not! This is a strategy that has been around for a long time.

- In 1904, Boston-based inventor King Camp Gillette received a patent for an improved safety razor with a disposable blade. He realized that profits lay in selling the razor for less than it cost to make, and selling the disposable blades for more. His revolutionary idea has come to be known as the "razor and blades" (or "loss leader") business model.
- Kodachrome was invented in the early 1930s and first sold in 1935. Cameras were relatively inexpensive;

Kodak and others made most of their profits from film sales.

You get the idea. Products using disposables have been generating annuity revenue for at least a century. However, the idea of selling value-added services as annuity revenue is a much newer concept.

### **In the product space, is this concept applicable to both hardware and software products?**

Absolutely! Here are a few examples of value-added services (as compared to availability services) commonly associated with both types of product:

Hardware products:

- Software updates.
- Scheduled preventive maintenance.
- Continuous product upgrades.
- User training.
- Remote monitoring.
- Consulting.

Software products:

- SaaS.
- Access to an enhanced support website.
- User forums and user group meetings.
- Customization.
- Ongoing training.
- Consulting.

With many products, there are inherent opportunities for a stable revenue stream. Some examples are:

- If you develop tax preparation software, you know that the codes and rules change annually, requiring an annual update.
- If you develop antivirus software, you know new viruses are created almost daily, requiring continuing updates.
- If you offer mapping software, you know this gets updated annually.

But so far we have described lists of common revenue streams that are probably familiar to all high-tech executives. What are some less common areas to consider?

- Medical products frequently require disposables such as chemicals and reagents, needles, and tubing. All are usage-based. The size of each monthly shipment is based on testing volume established at the time of the sale.
- Jet engines and other flight hardware require frequent, scheduled inspections and overhauls based on usage, which the manufacturers closely monitor.
- Copier and printer users need paper and toner (or ink), and many prefer buying from the original manufacturer since they can tie deliveries into usage as monitored by the machine and reported back to the OEM.

Perhaps the first widely used value-added services was equipment financing. Capital equipment suppliers like GE had access to large sums of money at relatively low interest rates. They recognized that they could use this money to finance major purchases. This is how GE Capital began; they financed locomotive, jet engine, medical equipment, and appliance purchases. Other manufacturers without such capital availability, but still looking to help their prospective clients and customers purchase more, became lease brokers. They put lenders in touch with the purchaser. Then they were able to complete the transaction and earn a referral fee. This is an example of a value-added service, but not with a predictable revenue flow.

### **Is the predictable revenue stream the only reason to go down this path?**

There are two other major reasons to make sure your strategy includes value-added services:

1. Decrease customer time-to-value and time-to-value-consumption.
2. Increase customer loyalty because of an enhanced overall experience with your company.

In his first book *Complexity Avalanche: Overcoming the Threat to Technology Adoption*, author J.B. Wood discusses the significant issues associated with the increasing complexity of high-tech products:

- Only a small percentage of features are ever used.
- The full value is never achieved, resulting in a suboptimal number of actual users. Fewer software licenses

are sold per installation than could be achieved.

The end result of both situations is that over time, your ability to sell enhancements, upgrades, or the “next new thing” will be limited. Why? Because they are not generating an ROI sufficient to pay back their investment, and so they will not bother to invest in your new product. For example:

- This article was written on Word 2004 for Mac. A 2011 version of Word is available, but why purchase the new version? This version totally fulfills all needs.
- In a recent discussion with an executive from one of the world's largest medical imaging companies, we learned that “most customers use less than 30 percent of the device's capabilities.” Good luck in trying to sell a next-generation MRI or CT scanner to existing customers!

### **So, how do you go about generating this renewable revenue stream?**

We have learned that the only practical solution is to extend your interaction with your new customers through value-added services. As we have seen with our more successful clients, their strategy and processes take them beyond the *integration* phase and into the *deployment* and *value realization* phases of the product life cycle. Of course, these services all generate revenue and keep you in close contact with your customers. They also go a long way in keeping the customer engaged and continuing their loyalty.

This kind of long-term, tight coupling with your customers results in many significant benefits:

1. Annuity revenue.
2. Continuous feedback concerning usefulness of product features and benefits and an understanding of the gaps and challenges in maximizing the product's capabilities.
3. Loyalty will ultimately lead to a fully engaged customer. When the customer is engaged with your business, they are involved with you in a very positive and proactive way. They refer you. They take part in your success. They look to buy more from you. The loyalty factor is based on your customer realizing very high value for investment of their purchase and in developing a partnership relationship with your employees and your business. In the long run, they trust you.
4. As a side benefit, your customer-facing employees will quickly feel better about working for a company that fosters meaningful relationships with the customer. Also, engaged employees are another significant driver of customer loyalty. You benefit from building a strong commitment from employees, which aligns them with the organization's goals.

In summary, annuity revenue from value-added services generates a sustainable, predictable revenue and profit flow. It helps your customers realize increased value from their purchase and can easily accelerate the time to repurchase. It increases customer loyalty and it energizes your employees. In the end, it is a win for you and your customer. Sounds to us like a must-do opportunity for your business!

#### **About the Authors...**

*Dennis Gershowitz is principal of DG Associates. An accomplished senior executive, he is recognized for leadership in aligning business and development strategy to achieve best-in-class business success. He has served on various boards for AFSMI (now merged with SSPA and TPSA to form TSIA) and is a member of the AFSMI President's Club. He may be reached at [dennisg@dgassociates.net](mailto:dennisg@dgassociates.net). [www.dgassociates.net](http://www.dgassociates.net)*

*Sam Klaidman is the principal adviser at Middlesex Consulting Group, where he helps clients grow their service revenue and profits by migrating services from free to fee, helping businesses transition from product focused to a balance of product-and-service focused, and developing, pricing, and commercializing new value-added services. Sam may be reached at [sam@middlesexconsulting.com](mailto:sam@middlesexconsulting.com). [www.middlesexconsulting.com](http://www.middlesexconsulting.com)*

*Don't miss Dennis' Professional Development Course at [Technology Services World Las Vegas](#) on October 24, titled “Transform Your Organization DNA to Include Customer Centricity,” to be co-presented with Bill Moore, director of DG Associates.*