The ConnectWise Difference

For Product-Centric ITSPs – The Business Case for Adding Managed Services

This brief lays out the business case for VARs (IT Service/Solution Providers who are product centric) to consider adding managed services. Recognizing that the product-centric model is highly successful, no attempt is made, here, to dissuade anyone from that model. Rather, the purpose of this piece is to provide some of the reasons why a VAR should consider adding a managed service practice if they haven't done so already.

The case for adding Managed Services runs along these lines:

- It can enhance your **corporate profitability**

- It can make a significant difference in the **exit value** of your company

- It can help you get on a **more predictable path for growth**

- For certain kinds of services and technologies– **cybersecurity** for example – it is the delivery mode that will be most successful in achieving positive outcomes for end-customers

Enhancing Corporate Profitability

A majority of product centric ITSPs – and if you generate more than 60% of your revenues from product sales, for our purposes here, you are product centric – have a business model that features high levels of revenue with relatively thin profit margins. According to the Service Leadership Index®, in Q2-2021, median product centric ITSP profitability Adjusted EBITDA was 4.1% while best-in-class (top quartile) was 14.7%. Further, for the average product-centric firm in 2020, vendor rebates comprised 89.4% of their profit dollars for the year. So, delivering profitability is a challenging game for many product centric ITSPs, between the relatively thin gross margins they must accept to continue to win product business, and the on-going stress put on the ITSP sales team to deliver against its volume targets to meet the thresholds of performance for vendor rebates.

Managed Services effectively counterbalances the product resale profit model. Looked at in isolation, the bottom line of the Median Managed Services practice in Q2-21 was 8.1% and the top quartile was 18.5%. Both of these help offset the lower profitability of the product business. The revenue pattern also counterbalances product resale: it's steady and recurring and attractive to investors that can see that the revenue stream doesn't have to be continually "re-invented". What's more, this steady profit stream helps offset the risk of missing specific vendor volume targets and thus not getting a given rebate. Generally, the revenue and profitability of a managed services account is more easily forecastable from the start of the engagement.

So how does the profitability picture improve for a product-centric who adds Managed Services? Let's look at the results of the Service Leadership Index quarterly benchmarking service used by ITSPs around the world, for Product-Centric companies in 2020.

Type	Product GM%	Services GM%	Blended GM%	EBITDA%
Traditional Product-Centric ITSP	18.5%	30.7%	22.7%	5.8%
Services-Led Product-Centric ITSP*	24.4%	42.7%	31.3%	15.4%

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*This is the product centric ITSP who is moving in the direction of adding managed services and leading their marketing and sales efforts with their services story. One beneficial aspect of this is, as you can see, clients in Managed Services relationships tend to pay higher margins for products. They also tend to produce project work more consistently, which helps the profitability of your Professional Services practice.

Managed Services Can Make a Significant Difference in the Exit Value of your Company

According to Service Leadership, you can expect these approximate outcomes between your different lines of business and your corporate valuation:

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Your Product Resale Revenue. In 2020, for every $1 of product business, you could expect your business valuation to be about 13 cents. Viewed another way, a $10M Product-only VAR, might be worth about $1.3M

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Your Professional Services Revenue. Every $1 of project services revenue might be worth about 63 cents.

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Your Managed Services Revenue. In 2020, managed services contributed about $1.43 of corporate valuation for every $1 of MSP revenue. So, adding $1M in managed services, which produces $1.43M in valuation, would more than double the value of that $10M VAR revenue referenced above.

In addition to creating stickier and more predictable customer relationships with higher profit margins, building a moderately-sized Managed Services business unit can more than double the value of a Product-centric firm.

It Can Help You Get on a More Predictable Growth Path

Product-centric ITSPs take on the stress of having to "reinvent" their revenue stream on a regular basis. Many do a great job with this, but it is still a stressor on the business. Managed Services are a form of recurring revenue and, assuming the customer is satisfied with your service delivery, every year becomes a layer in the "cake" of revenue that builds on top of the previous layer.   So, this is revenue that has some stickiness allowing you to focus your energies on incremental business that drive growth as opposed to incremental business that replaces completed projects.

Of course, ITSPs must ensure customer satisfaction with the service to maintain the revenue continuity. In this way the game shifts somewhat from sales to customer success and customer service kinds of roles, and product centric ITSPs need to be prepared to consider what this means for their organization.

"As a Service" Fits Selected Services/Technologies Very Well

While almost anything can be delivered as a managed service these days, certain kinds of offerings fit better into the managed service delivery model, than do others. Cybersecurity is certainly one of these. Bad actors are continually re-imagining their attacks to stay ahead of defenses. Timing, targets, attack vectors, and level of sophistication are all variables that cybersecurity criminals can manipulate to achieve their goals. So as threats are continually evolving, so too must our cybersecurity defenses. Cybersecurity, like personal fitness, is a commitment that has no finish line. Just like you can't just eat a salad one-time or jog one-time to achieve fitness, so cybersecurity requires the on-going application of monitoring, expertise, and adjustment to optimize protection.

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ITSPs looking to enter or expand into the cybersecurity space should consider the Managed Services model. It is a way to organize your technology, resources, and attentions in a manner that is consistent with the ever-changing demands of the threat landscape, allowing you to best support your end-customer. What's more, there are vendors who specialize in partnering with you, who can provide the staffing, expertise, technology, and active threat research to enable you to gain critical mass in Cybersecurity, delivered as a Managed Service.

Note that, in general, managed services tend to be the optimal delivery model where the specific need for the service changes frequently, where problems or interruptions can occur at odd times, and where point technology solutions have a high rate of obsolescence relative to their efficacy against threats.

Wrap Up

We covered the business benefits to a product centric ITSP of adding managed services, which includes improving profit margins, overall business valuation, establishing new areas of business growth that are less hardware/software vendor dependent, and for those ITSPs evolving in their approach to cybersecurity, matching the needs of clients to the optimal model for service delivery to meet those needs.