Realities on the Ground 2017
The Evolving Microsoft Partner Cloudscape

A Proprietary Study

conducted by:
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Executive Summary

Last year, CloudSpeed produced its first *Realities on the Ground Study*. It chronicled the operational and financial impacts of the Cloud among frontrunners in the Microsoft Partner ecosystem.

The study was well received and widely read, and since many Partners requested it, the study was repeated.

This year, 26 Partners stepped forward to share their experiences, opinions, and perspectives. All were located in Europe or North America, where Cloud adoption has been strongest. As with last year, study participants were owners, founders, or CEOs. No compensation was received either by CloudSpeed or Partners for producing this study.

The shift to the Cloud is well underway, and its impact on Partner business valuations is massive.

The focus of this year's study is shareholder value creation – how leading Partners are leveraging the Cloud to build the value of their business. It details shifts in their revenue composition, margin structure, and overall growth rates, as well as the core strategies being used to monetize the Cloud opportunity. In short, this *Realities on the Ground Study* dives deeper into the numbers.

Key findings of this survey include:

- The shift to the Cloud is well underway, and its impact on Partner business valuations is massive. Early movers are now creating strong gains in shareholder value, while the valuation gap between them and later adopters widens. For many who have not yet begun, there seems very little time remaining to monetize the Cloud opportunity.
- The key to shareholder value creation in the Cloud lies in shifting revenue composition. A focus on selling Cloud subscriptions containing Partner-generated IP and/or supplemented by ongoing managed services yields the best results.
- Operationally, study contributors have significantly bolstered their technical capabilities in the Cloud. That said, revenue composition still lags technical and operational readiness by a wide margin. Many would suggest that in terms of truly monetizing the Cloud opportunity, they have only completed perhaps 20-30% of their journey. And it must also be pointed out that the broader ecosystem likely has an even further distance to travel, overall.
- Sourcing capital is now arguably the biggest constraint a Partner faces to securing strong future valuations. Whether pursuing a strategy of market position consolidation, or aggressive market share gain, capital access is now mission-critical for many.

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[1] see Study Participants

Study Format

As with last year, the overall study approach followed a planned interview format in which the following core topics were covered:

This year's study chronicled shifts in Partner revenue composition, margin structure, and growth rates across various Partner types.

- What a Partner's revenue composition was like, how fast individual revenue streams were growing (or shrinking), and what gross margin levels were being achieved for each revenue stream. The CloudSpeed Business Valuation Model[2] was used to gather and tabulate this data, as well as drive out expected valuation ranges.
- What growth strategies Partners were pursuing in their efforts to drive revenue increases and superior operating margins.
- What obstacles Partners were facing in the execution of their strategies, and what they saw as the key momentum blockers hindering their acceleration and adaptation to a Cloud-first world

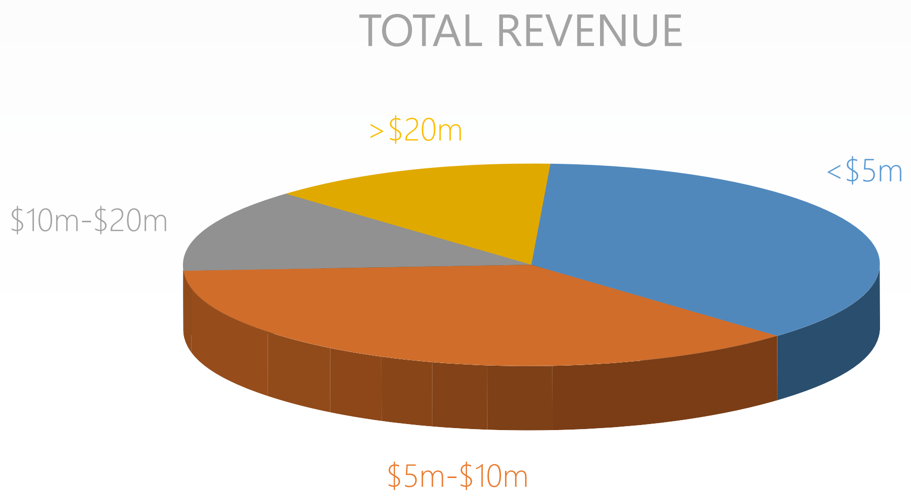
Several Partner types participated in the *Realities on the Ground Study*, falling into these categories:

- Independent Software Vendors (ISVs) – predominantly offering vertically-specific Dynamics or SharePoint-based solutions.
- Systems Integrators (SIs) – predominantly working with Azure, Office 365, and SharePoint.
- Managed Services Providers (MSPs) – predominantly acting as outsourced IT providers for small and medium sized businesses.
- Value Added Resellers (VARs) – predominantly working with Dynamics ERP solutions.
- Others – representing a mixture of Application Services Providers, Hosters, and Peer Networks.

[2] for a copy of the Model, contact the author

Partner Size Breakdown

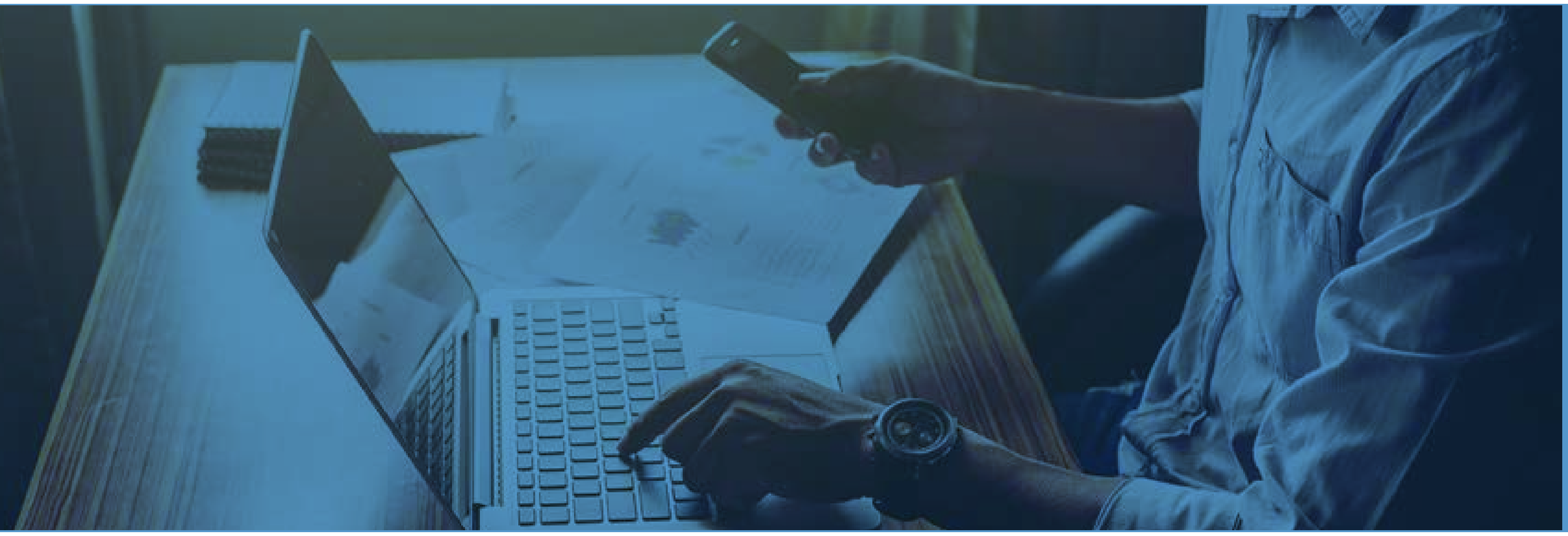
Partners of varying size contributed to this study, with roughly 2/3 having under US$10m in annual revenue. Overall, the distribution of Partner size is illustrated below.



In terms of core business focus, ISVs comprised nearly half of the study participants. They ranged in maturity from those who had more recently adopted a product-oriented focus, to those who had long been selling their own software, leveraging the Microsoft platform.

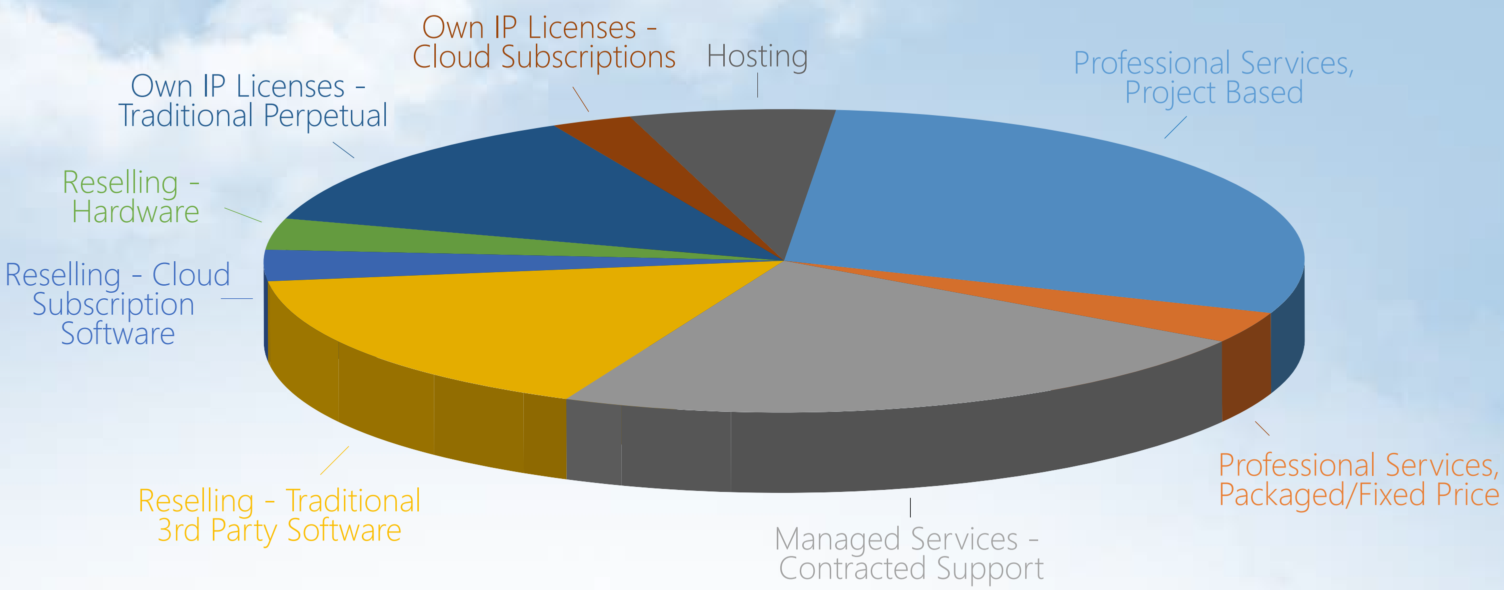
VARs were the second largest group of study contributors, many of whom centered on Dynamics. System Integrators rounded out the mix, along with MSPs and ASPs.

Geographically, study participants were located either in Europe or North America, the dominant Cloud markets.



Group Renenue Composition

Combined, group revenue was just over US$450m and was distributed as shown below.



Professional services still form the mainstay of Partners' collective revenue composition (nearly half), but as will be later detailed are declining in terms of overall magnitude on the Partner P&L. Reselling as an activity accounts for nearly 17% of total revenue composition, with Cloud subscriptions far outstripping "traditional" software and hardware in growth. Because several study contributors were ISVs, Own IP licenses accounted for just over 17% of total revenue composition, whether perpetual or subscription-based. Managed services were just under 10% of total revenue makeup.

Overall, "pure" Cloud-related revenue is still no more than 20-25% of total revenue in most cases.

Overall, "pure" Cloud-related revenue was still no more than 20-25% of total revenue in most cases, although the overall Partner P&L was migrating towards Cloud-based revenue streams for all study participants. Some were more aggressively pursuing the Cloud as a core business focus than others, but all were being strongly pulled in that direction by market forces.

Partner Growth Strategies

In the main, Partner strategies fell into three broad categories.

Market Position Consolidation

For some, the goal is to expand their market footprint and customer base by way of merger or acquisition. The growing consensus is that success in the Cloud will require greater scale economies and market reach, for those not more specifically focussed on niches.

Smaller players in most cases do not have the cash reserves or cash flow needed to reach "minimum efficient scale", and are generally challenged with raising external funding. They often do not have the appetite for navigating the operational and organizational complexities of the business model transition either. So, they typically look to merge with others, or divest their interest outright. Those looking to exit, however, often find themselves faced with a "buyer's market" that is simply unwilling to meet their expectations of company value. Consequently, many potential transactions simply do not conclude.

Partner strategies fell into 3 broad categories – consolidating market position, aggressive market share pursuit, or "riding" organic momentum.

Larger players look to leverage their stronger existing market footprints to achieve a critical mass in terms of Cloud market awareness, by way of strategic acquisitions or mergers. As a group, they are far less capital constrained. Their core challenge often centers around extracting the shareholder value gains on which the acquisitions or mergers were predicated. Frequently, cost rationalization and revenue gains take longer to materialize than anticipated, as the new entities formed adapt to the operational and organizational complexities of larger scale ***before*** realizing enhanced efficiencies and economies.

What is not yet known is what the "minimum efficient scale" in fact will be in a Cloud-first world. In other words, what size is enough/optimal in terms of operating efficiency? What is far clearer, though, is that the existing operational "middle ground" occupied by many in today's ecosystem will become far less viable. Implicitly, a strategy of market position consolidation is based on the premise that a critical mass in terms of market presence will result in competitors' customers also migrating to bigger players, because of their broader capabilities and better scale economies. In this context, accessing the capital needed to achieve scale quickly becomes very important.

The growing consensus is that success in the Cloud will require greater scale economies and market reach, for those not specifically focussed on niches.

No matter what the current operating scale, this backdrop of consolidation often restrains Partners from making investments in things like automation or offering development. They fear they will only find they have replicated what several others have already done, and thereby derive little in the way of lasting differentiation or competitive advantage.

There is also some movement towards consortiums forming which would certainly combine complementary Cloud capabilities, but leave individual ownership structures intact. This can seem to represent a way to superior scale with lower risk, and in fact has some precedent in the ecosystem. Its long-term viability as a strategy, however, is far from proven.

Aggressive Market Share Pursuit

Particularly for Partners relying heavily on monetizing their Own IP in the Cloud, rapid expansion of their customer base and market share is the dominant goal. However, this strategy is largely reliant on product readiness. Some find themselves first needing to effectively re-engineer their offerings for the Cloud, which requires both time and investment.

It is here that capital access is arguably the greatest constraint, especially for smaller or early-stage ISVs. They are simply not as known by potential investors, and often have trouble making a convincing business case, particularly in the face of a potential investor's fear of disintermediation by Microsoft itself. Absent a clear idea of the role of the "new" ISV in the Microsoft ecosystem, many potential sources of capital will in fact view Microsoft partnership as a negative.

Compounding this is a focus on EBIT-based multiples among "traditional" investors. In a time when operating profitability is depressed or even negative (owing to material Partner investments in offering development, customer acquisition, or broader business model transition) profitability-based valuation measures
are almost meaningless. What matters is "core" margin structure, revenue trajectory, and revenue durability. This inevitably requires a forward-looking valuation approach, based on revenue rather than profitability.

In a time when operating profitability is depressed because of Partner investments in Cloud transition, profitability-based valuation measures are almost meaningless.

Organic Momentum

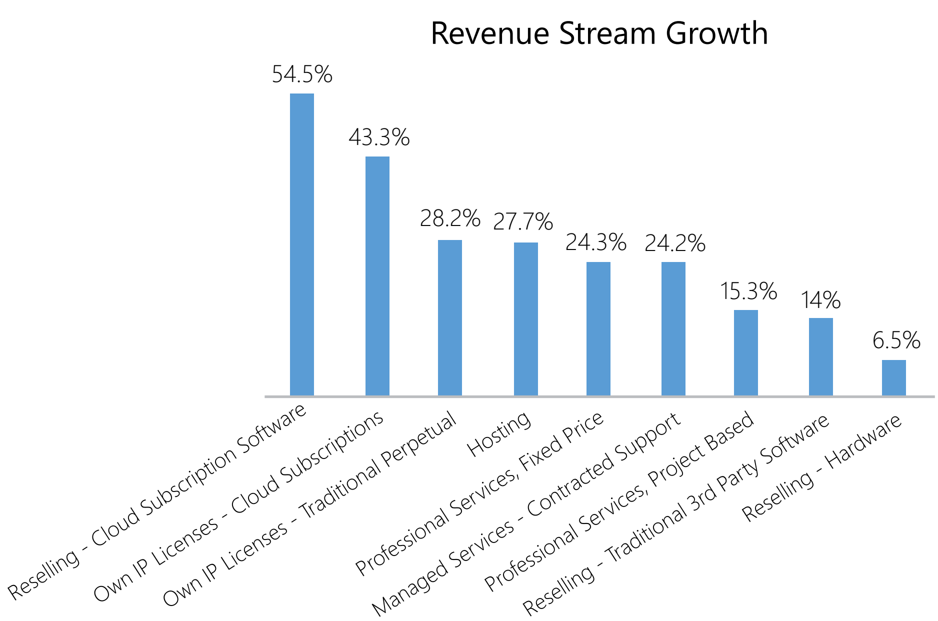
Where a Partner has both strong revenue growth and margin levels, the tendency is to simply continue riding the wave. In the main, the focus is on vertical or functional niches, where a market presence can be relatively quickly and cost-effectively established. Shareholder value can be built largely without the need for external funding.

It must be said, however, that this strategy depends on having strong offerings and market presences in defensible niches. Often, these players have significantly pivoted their businesses from a service to a product orientation, and have survived the initial transition period. This invariably involves a "shedding" of the existing business model, and a period of significantly reduced revenue. It always requires a viable product concept, which in practice is most often co-developed with an anchor customer or two, who also materially funds the required R&D along with an owner's capital injection, as well as credentials the solution, allowing a user base to be assembled at a relatively low cost of customer acquisition.

Certainly, the business model pivot from service to product is something few attempt. Even though there is an emerging "playbook[3]" for cost-effective IP development, most owners still perceive it as too high-risk. Nonetheless, a move towards greater "productization" may well prove key to survival for many Partners in a Cloud-first world.

Revenue Stream Growth

Individual revenue stream growth showed wide differences, as depicted below.



[3] for more detail, contact the author

Not surprisingly, the fastest growing revenue stream was Cloud subscriptions. Several Partners were experiencing explosive growth in Office 365 subscriptions in particular, but those selling ERP or CRM subscriptions were also seeing high growth rates, in several cases doubling year-over-year.

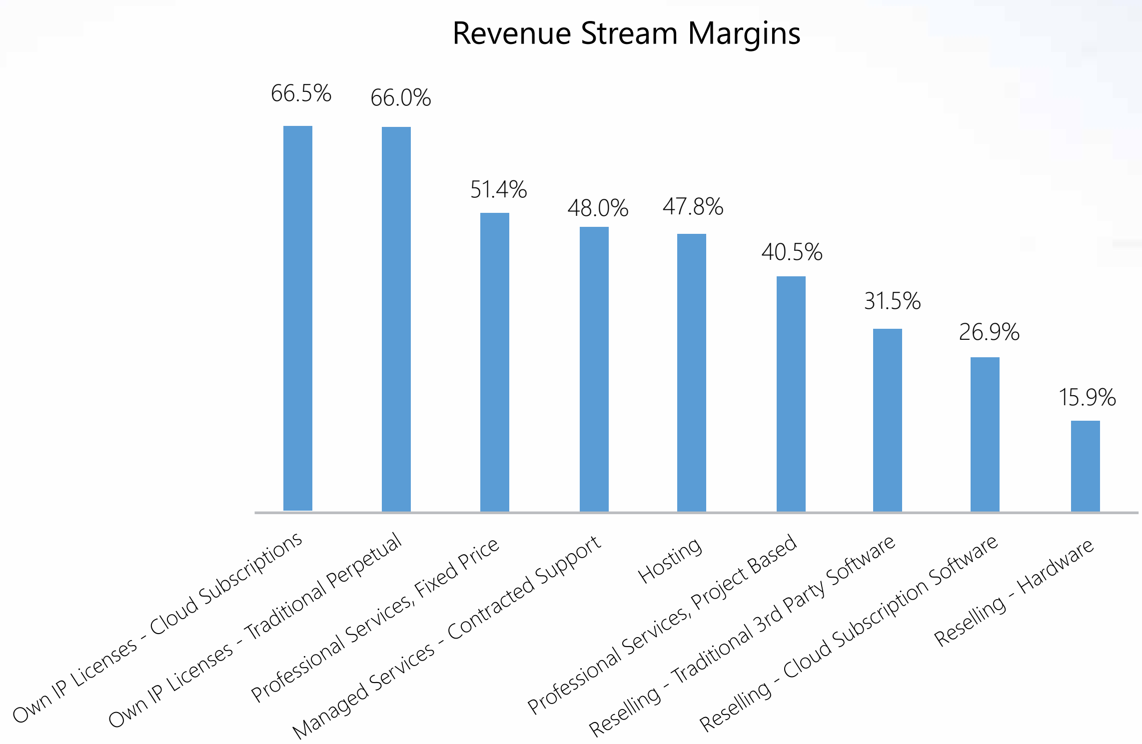
Those monetizing their Own IP also typically saw strong revenue growth, especially if they had subscription offerings as well as traditional perpetual licenses. Hosting and managed services offerings posted strong gains as well.

On the services side, there was some movement towards packaged or fixed price offerings which were gaining strong market acceptance.

The reselling of "traditional" software and hardware products were the slowest growing revenue streams.

Revenue Stream Margins

Margin levels achieved on individual revenue streams also showed wide divergences, as illustrated in the following graph.



The highest margins being earned were by those monetizing their Own IP[4], whether in perpetual license or subscription form. This is consistent no matter whether a Partner is an early-stage ISV, or more mature. Early-stage ISVs have typically migrated from the traditional services business model, and while they have invariably experienced a short-term decline in revenue and operating margin as they made investments in product development, customer acquisition, and business model transition, they are generally now posting both strong revenue growth and high margins. Mature ISVs have often revamped their offerings for the Cloud (although not necessarily fully), and while they continue to sell traditional offerings as well, their Cloud products are often posting the strongest growth rates too, although this is not universally the case.

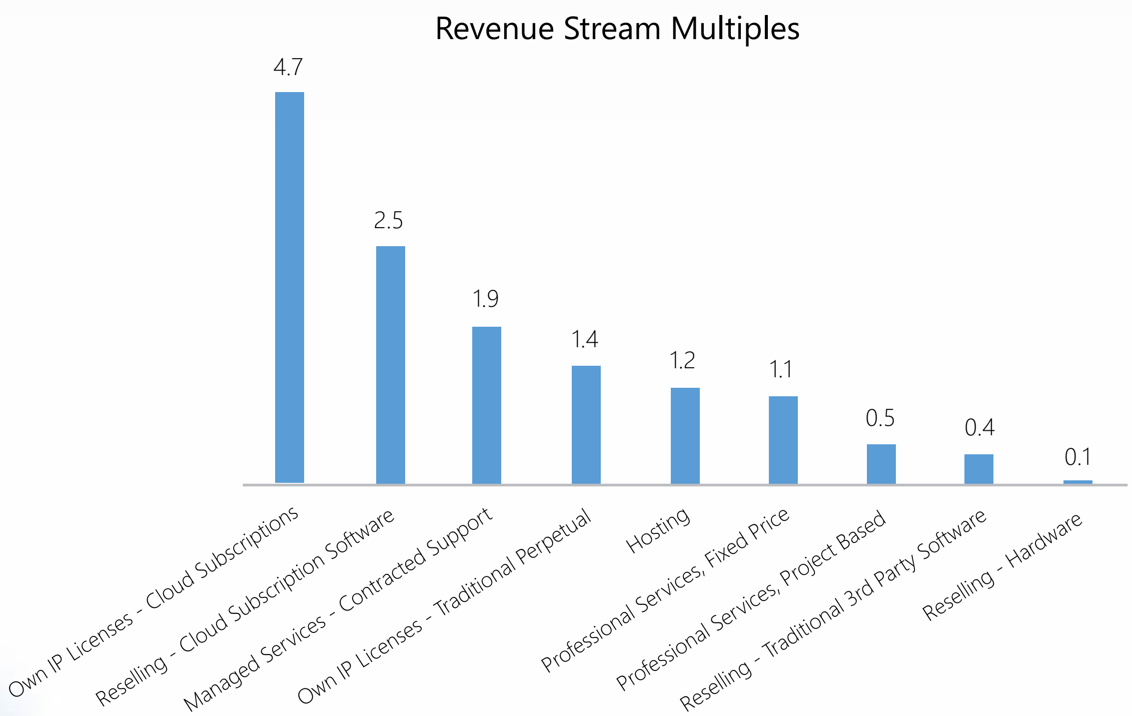
For those who were especially early adopters of the Cloud and have hosting as a major revenue stream, margin continues to be strong because of previous infrastructure investments, but most are migrating to larger scale platforms on a go-forward basis.

On the services side, managed services and fixed-price offerings deliver the strongest margins. Reselling and project-based services are lower, and generally under the most ongoing downward pressure.

[4] Own IP margins stated are exclusive of hosting costs.

Revenue Stream Multiples

The value of an individual revenue stream is a function of its expected duration, margin level, and anticipated future growth. Revenue streams that have high margins, are recurring, and those streams that are growing strongly obviously have the highest value. Their relative multiples, as derived by the CloudSpeed Business Valuation Model[5] , are listed below.



It is important to understand that any individual Partner will have ***some combination*** of these revenue streams. In other words, none of the study contributors were solely reliant on any individual source of revenue. It is their relative proportions that made up the overall business model, and drove overall company valuations which are discussed in the next section.

Those Own IP subscriptions that were sold as Cloud subscriptions carried the highest multiple. This is because as previous graphs indicated, they delivered the highest possible margins, strong growth, and were typically "attached" or embedded in a Microsoft subscription, often Office 365.

[5] for a copy of the Model, contact the author

> *Few Partners will float a business model on the act of reselling Cloud subscriptions alone - but it can form the base on which Partner-generated revenue streams are monetized.*

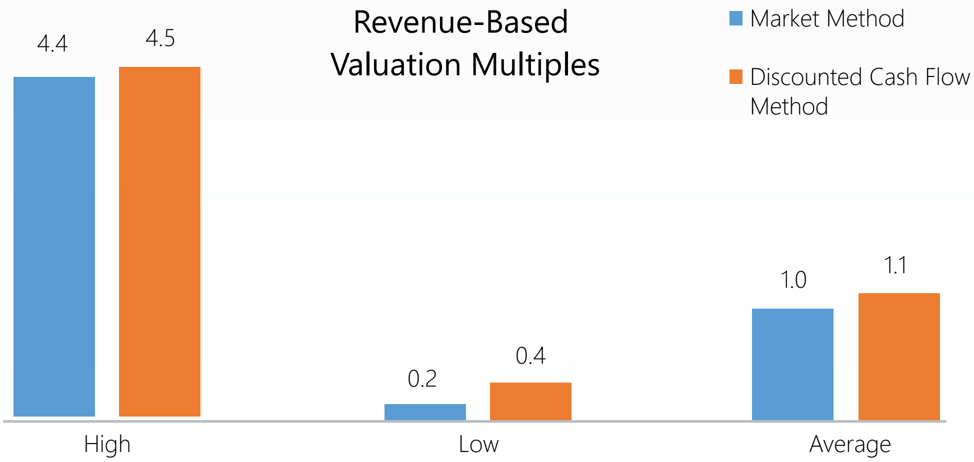
Reselling Cloud subscription software carried a slightly lower, but still significant multiple. Although the available margin was lower, the average growth was the highest reported. The dominant driver of this was the stellar growth of Office 365. For several Partners, these subscriptions were doubling each year. It is important to note, however, that this multiple will very likely decline in time, for 2 reasons. Firstly, at some point Office 365 will become very broadly diffused, and therefore its growth will decline. Secondly, margins reported were inclusive of short-term incentives and rebates, which will also decline in time. In practice, this revenue stream often “anchors” a Partner’s ability to monetize other revenue streams, whether managed services, professional services, or Own IP. Few if any Partners will float a business model on the act of reselling Cloud subscriptions alone – but it can form the base on which other Partner-generated revenue streams are monetized.

Managed services delivered the 3rd highest individual revenue multiple, again based on its margin level and growth rates. Although the nature of support offered in the Cloud is very different from the on-prem world, it seems still a very strong requirement for the customer.

Non-recurring revenue streams delivered the lowest revenue multiples, because they are inherently less predictable, and often carried lower margins as well. Several Partners were also experiencing negative growth in “traditional” product and services revenue, a trend that has in fact been in place for some time now, although to varying degrees across different markets.

Overall Company Valuation Ranges

In the end, building strong shareholder value in the Cloud requires obtaining higher company valuations. It is here that the greatest divergence is most readily observed, and true impact of different strategies can be assessed.



Each study contributor populated the CloudSpeed Business Valuation Model[6] with their data, and it was added to the CloudSpeed Valuation Benchmarking Database[7]. The Model considers:

- revenue composition
- margin structure
- growth rates

The model is calibrated based on actual market transactions, and drives out two separate calculations.

1. The market method is derived from a statistical analysis of publicly available market data weighted based on Partner liquidity, leadership transitionability, market growth potential, and offering maturity.
2. The cash flow method discounts anticipated future cash flows, and is risk-weighted.

Partners with high concentrations of their own IP, monetized as subscriptions, had the highest valuations. Those with significant lower-margin, services-heavy revenue streams had the lowest.

Overall, the average Partner company valuation is in the 1-1.2x revenue range, but can be as low as half that, or as high as quadruple, depending on the precise Partner revenue composition. Those Partners with high concentrations of their Own IP, monetized in subscription form, received the highest overall multiples, a result validated by the direct experience of those actually raising capital. Business models with high concentrations of lower-margin, low growth, services-heavy revenue streams received the lowest valuations. In general, the presence of subscription-based revenue streams, anchored in some form of reselling but heavily supplemented with either managed services and/or Own IP lifted the overall company valuations.

[6] for a copy of the Model, contact the author
[7] currently comprised of 49 Partners, concentrated in Europe and North America

A final point is that although the valuation multiples are expressed as a function of revenue, they are calculated based on operating margins and growth rates. As earlier stated, in a time when operating profitability is depressed or even negative owing to material Partner investments in offering development, customer acquisition, or broader business model transition, profitability-based valuation measures are almost meaningless. What counts is "core" margin structure, revenue trajectory, and revenue durability. This inevitably requires a forward-looking valuation approach, based on revenue rather than profitability.

Momentum Blockers

When asked what core obstacles Partners saw to successfully implementing their strategies, the following key themes emerged:

- *Access to capital is difficult for many.* All Partners were looking to accelerate their pursuit of the Cloud opportunity, but relatively few saw themselves able to achieve that based on organic growth alone. Inevitably, this led to consideration of some form of transaction that required external capital to complete. Larger players are the most likely to be approached by private equity and/or venture capital, as well as the most capable of seeking out potential investors. But the process of sourcing equity capital is both time consuming and haphazard for them. Those with strong balance sheets are more able to access traditional debt financing, but often this is insufficient to fully execute their growth strategies, and the availability of traditional bank financing varies significantly from market to market. In some cases, mezzanine financing is tapped to swing the deal, but it is generally avoided due to its high relative cost. For all these reasons, earn-outs are often favored to limit the cash requirements needed to close a transaction. But this deal structure is of course less attractive to a seller, and often hinders transaction speed. There simply is no mechanism in place to bring sources and uses of capital together, and in the opinion of many this stalls the speed with which the ecosystem adapts to and monetizes the Cloud opportunity. Related to this is the fact that identifying suitable acquisition targets is often problematic for those following a strategy of market position consolidation.

The process of sourcing capital is both time consuming and haphazard for many Partners, often stalling Cloud transition and shareholder value creation.

- *Assessing speed of Cloud adoption is tricky.* Not all customer segments move at the same speed; some are more concerned with security than others. Similarly, some markets are faster moving than others. A Partner who moves in advance of market demand risks not generating sufficient revenue and experiencing cash flow shortfalls. A Partner who moves too late risks being pre-empted by competitors. In the opinion of several, customers are reluctant to commit to the Cloud absent some form of technology roadmap, which often cannot be provided. They do not feel comfortable taking such long-term technology decisions on faith alone.

- *Surviving the cash flow trough is challenging.* Particularly for those who were in the earlier stages of their business model transition, the owners were usually the sole source of readily available working capital. This limits the speed with which they can adapt to Cloud demand. This is especially critical for those who sought to "productize" their Cloud offerings with significant amounts of their Own IP, shifting away from a traditional services focus.

- *Building market awareness is expensive.* Those with productized Cloud offerings often saw market awareness as their biggest constraint. Particularly if these offerings were more horizontal in nature, quickly building market share is considered critical to long term success, and this requires a material investment in sales and marketing infrastructure.

- *Sourcing talent remains tricky.* This is especially true for Partners operating in smaller markets, and needing expertise in Azure and BI related work.

- *Product stability is better, but still in need of improvement.* Many felt that although the Cloud has generally been positioned as plug-and-play to the end customer, it has not yet met that promise. Those looking to build and field solutions in hybrid environments and leveraging open architecture felt impacted, but so did those working with simpler solutions in lower market segments.

- *Implementation needs further automation.* ISVs often faced low-cost implementation of their solutions as a barrier to growth. Their traditional channels are generally not evolving fast enough to meet Cloud demand, and stepping into solution implementation can be costly. Beyond the ISV community, many are also feeling the need to develop and fold packaged implementation into their Cloud offerings.

  Automated migration tools like BitTitan and SkyKick have made a significant difference with respect to Office 365 adoption, but are not yet available in the Dynamics sphere for instance. Standardizing the remaining labor-based elements of Cloud solution implementation and streamlining service delivery by using platforms like BitTitan MSPComplete could be especially useful in this regard.

  Automating Cloud solution implementation is especially key to rapidly building Cloud market share.

- *Cloud pricing is becoming commoditized.* For those monetizing their Own IP, the low price of Office 365 and Dynamics 365 was often seen as damaging to their overall business case for the Cloud. Although this pricing makes for more rapid market adoption, it extends the time it takes for a Partner to fully monetize a subscriber base, and therefore requires a far greater level of capitalization, or simple patience. This was seen as especially acute in the Dynamics sphere. That said, Partners also recognize the need for pricing to be competitive.

  Commoditization of Cloud pricing extends the time a Partner needs to monetize a subscriber base, and requires a greater level of capitalization.

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Conclusion

The shift to the Cloud is well underway, and its impact on Partner business valuations is massive. Early movers are now creating strong gains in shareholder value, while the valuation gap between them and later adopters widens. For many, there is very little time remaining to monetize the Cloud opportunity.

The key to shareholder value creation in the Cloud lies in shifting revenue composition. A focus on selling Cloud subscriptions containing Partner-generated IP and/or supplemented by ongoing managed services yields the best results.

Selling Cloud subscriptions containing Partner-generated IP and/or supplemented by ongoing managed services yields the best results.

Sourcing capital is now arguably the biggest constraint a Partner faces to securing strong valuations, whether pursuing a strategy of market position consolidation, or aggressive market share gain. While some Partners will build strong shareholder value through organic growth, they will likely remain a minority.

Operationally, study contributors have significantly bolstered their technical capabilities in the Cloud, but still look to streamline and automate wherever possible, to lower delivery costs and remain competitive. However, revenue composition still lags technical and operational readiness by a wide margin.

Building market awareness and cost-effectively acquiring customers remains a challenge for several Partners, especially those not pursuing acquisition-based growth strategies.

Study Participants

The following is a list of participants in the CloudSpeed Study:

Partner	Website	Partner Type	Location	Study Contributor	Position
Socius	www.socius1.com	VAR	USA	Jeff Geisler	CEO
InfoWAN	www.infowan.de	SI	Germany	Lars Riehn	CEO
Qorus	www.qorusdocs.com	ISV	South Africa	Ray Meiring	CEO
IA Cubed	www.iacubed.com	VAR	UK	Margaret Totten	Director
Collabware	www.collabware.com	ISV	Canada	Graham Sibley	CEO
Rose ASP	www.roseasp.com	ASP	USA	Linda Rose	CEO
EMIT	www.emitsolutions.ie	MSP	Ireland	Eamon Moore	Founder
Printvis	www.printvis.com	ISV	Denmark	Kasper Tomshoj	Owner
EasyStep2lean	www.easystep2lean.nl	VAR	Netherlands	Rick Blom	Owner
Encore Business Solutions	www.encorebusiness.com	VAR	Canada	Ken Chartrand	COO
Infoma	www.infoma.de	ISV	Germany	Oliver Couvigny	Managing Director
Proserve IT	www.proserveit.com	SI	Canada	Eric Sugar	CEO
Wortell	http://www.wortell.nl/	SI	Netherlands	Danny Burlage	CTO
Heartland Technology Group	www.htgpeergroups.com	MSP Peer Network	USA	Arlin Sorenson	CEO
Bestborn	http://bestborn.com/	ISV	USA	Martin Kerr	CEO
Wise Fish	www.wisefish.com	ISV	Iceland	Hrannar Erlingsson	Managing Director
AKA	www.akaes.com	VAR	USA	Benjamin Holtz	CFO
Isatech	http://www.isatech.fr	VAR	France	Farnck LeStrat	Group General Manager
Forceworks	https://forceworks.com	ISV	USA	Steve Mordue	CEO
Continia	http://continia.com	ISV	Denmark	Torben Kragelund	General Manager
Ciall	www.ciall.com	VAR	Ireland	Michael Horgan	Managing Director
Websan	http://websan.com/	VAR	Canada	Andrew King	Owner
ADNET Technologies	https://thinkadnet.com/	MSP	USA	Edward Laprade	CEO
Agiles IT	http://en.agiles.com/	ISV	Germany	Christian Sega	Owner
Axon IT	http://axon-it.com/	VAR	UK	Tim Mears	Managing Director
Javelin Technologies	www.javelin-tech.com	VAR	USA	John Carlan	Co-owner

About the Author

As founder of CloudSpeed, Dana Willmer has been a driving force behind Cloud adoption in the Microsoft ecosystem over the last 8 years.

In that time, he has provided strategic advice to scores of Microsoft software resellers, independent software vendors, managed services providers, hosters, and systems integrators on four continents. He is also the author of numerous assets, publications and financial models for Microsoft, which help Microsoft Partners ensure they get "the right things right" in their critical business model transition. His work has been consistently regarded as best in class by Microsoft Executives, Partners, and industry analysts alike.

More recently, his proprietary research among early movers in the Cloud has chronicled the "best practices" that have been proven to accelerate Partner business model transition, reduce the attendant risk, and build shareholder value.

Highlights of his work over the last 10 years include:

- Originator and curator of the Partner Benchmarking Database
- Author of numerous Microsoft Cloud SureStep assets and materials
- Anchor author for Dynamics Cloud Partner Profitability Guides (2 editions)
- Co-author of Cloud Curriculum for Dynamics Partner Academy
- Author of several Cloud Profitability Models designed for VAR's, ISV's, Managed Services Providers, and Systems Integrators
- Facilitator of the above content on 4 continents
- Active consultant to Microsoft Partners on 4 continents

Dana can be reached at dana@cloudspeed.co. His full professional bio and client recommendations can be found online here.