The Growth of Recurring Revenue Business Models

THE CFO SERIES:
CHALLENGES IN ADAPTING TO RECURRING REVENUE BUSINESS MODELS

Recurring-revenue business models, also known as subscription or usage-based models, are creating new opportunities across all industries—even in sectors where they haven't traditionally appeared before. Advances in social media, mobile devices, cloud computing, artificial intelligence, robotics, and the Internet of Things (IoT) are now enabling businesses to leverage these new models to generate entirely new revenue streams.

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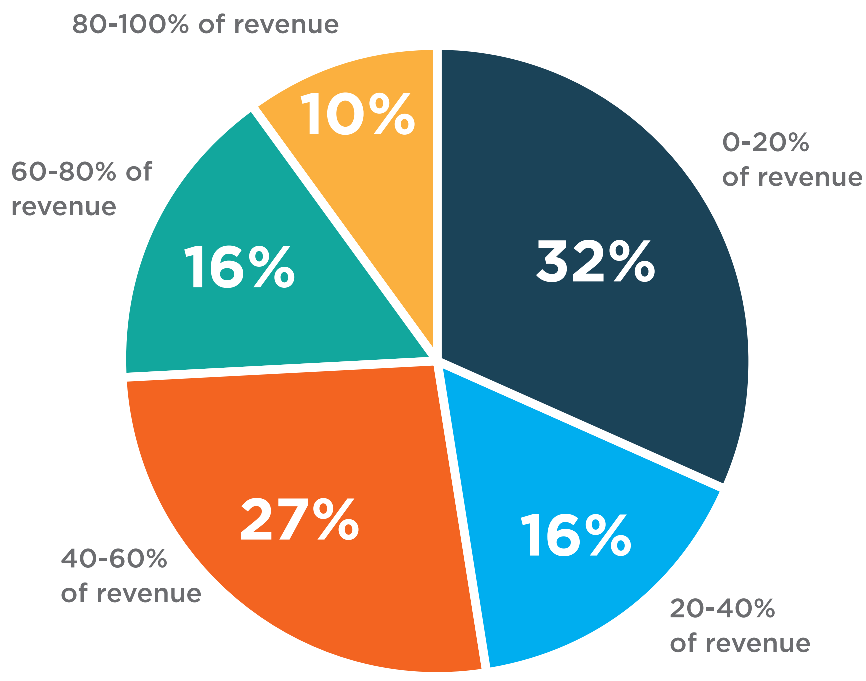
A recent online survey of senior finance executives by CFO Research and Salesforce shows that recurring-revenue models are well-established and growing. And the business case for the recurring-revenue model is strong: It focuses on the customer relationship, aligning the success of the customer with that of the business, which opens new growth opportunities. Additionally, companies gain smoother and more predictable revenues and higher valuations from investors. Key findings from the study include:

- **More than half** of surveyed finance executives report that at least 40% of their current revenues are recurring, and even more of them expect to reach the 40% level in five years. Trends were remarkably consistent for respondents from companies in a wide variety of industries—the growth of IoT and cloud-delivered services is clearly enabling adoption in non-traditional industries such as manufacturing.
- Recurring-revenue/subscription models improve customer relationships and generate more sales and marketing opportunities than traditional transaction-based business models. In turn, smoother revenue streams from recurring-revenue models enable CFOs and their companies to improve planning and forecasting. And lastly, investors value improvement in business results as well as the predictability of those results, both driven by recurring-revenue business models.

Established and Growing

More than half (52%) of the CFO Research/Salesforce survey respondents have companies where at least 40% of revenues are recurring, i.e., from subscription or usage-based business models. See Figure 1. This reflects the trend of companies in a broadening set of industries adopting the model. Software-as-a-service, health and nutritional supplements, media streaming, telecommunications and cable TV, utilities, digital

FIGURE 1
The percentage of my company's revenue that is currently recurring (e.g., subscription or usage-based)



Percentages do not add to 100 due to rounding.

publishing, and big-data companies have widely adopted recurring-revenue/subscription models. But the model has also taken root with companies in industrial sectors, like heavy equipment makers, and in sectors like medical devices. More companies will adopt recurring-revenue models as technologies like IoT devices are incorporated into business lines.

The survey of finance executives shows that trend toward future expansion, with **55% of respondents** estimating that in five years over 40% of their companies' revenue will be from recurring sources.

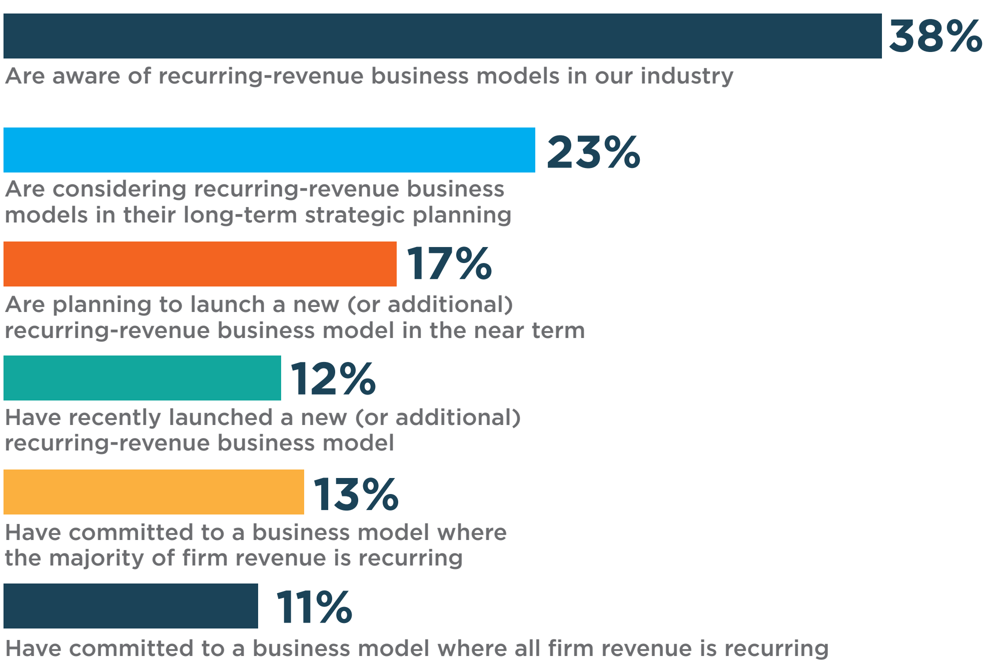
Other members of the C-suite, as well as company board members, are becoming increasingly aware of recurring-revenue business models and are committed to developing them, the CFO Research/Salesforce survey shows. According to the survey, **23% of C-suites and boards** at respondents' companies are incorporating recurring-revenue business models in their strategic planning. Also, 17% of C-suites and boards at respondents' companies are planning to launch a new or additional recurring-revenue business model in the near term. See Figure 2.

Why Recurring Revenue

Companies are turning to recurring-revenue/subscription business models for several reasons. For some companies, transitioning to recurring revenue is a natural change as the economy shifts to a service economy, and these revenue streams present a path into new markets. For others, the competitive landscape is driving their business model change. IoT connectivity and cloud-delivered services are also setting up more companies for recurring-revenue/subscription models, along with business lines related to social media, mobile devices, and even market opportunities involving

FIGURE 2

"My C-suite and Board …."



Multiple responses allowed.

robotics and artificial intelligence concepts. Companies may transition to recurring-revenue models because they seek the benefits of establishing long-term relationships with their customers, or to better meet the expectations of today's customer bases that prefer a relationship-based model. Most companies aren't transitioning from traditional transaction-based business models to recurring-revenue/subscription models all at once, or abandoning their current business models, but rather are leveraging these models to expand into new markets, making the change over time instead.

The Advantages

There are also several clear advantages to adopting a recurring-revenue model. The recurring-revenue/subscription model produces a more predictable revenue stream that is smoother and easier to model, so business forecasts are more accurate. Recurring-revenue/subscription models also lower the long-term costs of sales, because customer relationships are no longer one-time sales transactions. After the relationship is created, the model establishes a renewal event, which creates cross and upsell opportunities, further strengthening and developing the relationship. The ongoing relationship can also help the company penetrate new markets in other business lines.

In a recurring-revenue model, the first sale is seen as the starting point for growing revenue with each customer, which is a shift from the traditional transaction-based business model. Under a recurring-revenue/subscription model, sales and marketing can target at least five types of transactions: the initial sale, a subscription renewal or extension, an upgrade to a higher level of services, an add-on of more services, and the potential salvaging of service just prior to cancelation.

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From a finance perspective, CFOs enjoy several benefits from recurring-revenue business models. Finance gains more financial controls, and better controls, and compliance is improved under recurring-revenue/subscription-based models. Also, the quality and speed of decision-making for the company improves because more real-time data is available, and the data is more frequent and more accurate. With smoother revenues—a series of payments over a product or service's lifetime instead of a single upfront payment—revenues are more predictable and less likely to drop off suddenly, which makes planning by finance easier. The predictability of revenues is also a boon for investors, who value companies with recurring-revenue models as much as **eight times greater** than comparable companies with transaction-based business models.[1]

NEXT IN THE SERIES:

The recurring-revenue challenges that finance faces.

1 Jeff Wissink, Managing Director of Navint Partners, *Gearing Up for New Revenue Models,* CFO Publishing, September 2018.

CONCLUSION

There's a lot for CFOs to like about recurring-revenue/ subscription-based business models, i.e., benefitting both their companies and investors. Those benefits are key drivers for companies adopting recurring revenue, including smoother revenue streams, stronger customer relationships, and greater sales opportunities with those customers. CFOs also enjoy more accurate and quickly available financial data for improving their forecasting and decision-making capabilities. There is a clear growth opportunity in recurring-revenue businesses. Company Boards and C-suite executives across all industries[2] are taking note and taking steps to launch and grow their recurring businesses.

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2 The industries most frequently represented by survey respondents were: financial services/real estate; auto/industrial/manufacturing; education; insurance; business/professional services; health care; transportation/warehousing; wholesale/retail trade; construction; and energy/utilities.