



The Power of Recurring Revenue: Building a Better Business Model

By: Jim Schleckser, Inc. CEO Project

There's an inconvenient truth in business that most CEOs and entrepreneurs alike tend to overlook: not all revenue is created equal. Sure, a dollar in sales is a dollar in sales. But the more predictable that dollar is, as in the more likely that you will receive that dollar from your customer every month, the more valuable it becomes. When you begin to multiply that dollar by adding new customers and creating an annuity of cash flow, you begin reaping the benefits of what is known as a recurring revenue stream.

What makes recurring revenue so valuable is that you can spend more of your energy growing your business rather than on trying to acquire enough new or repeat business just to hit the same revenue level you did the year before. Let's say you run a business with \$10 million in sales, 90 percent of which is recurring. Since you can already bank on receiving \$9 million as you kick off your next fiscal year, you need to find just an additional \$1 million to match your prior year's result. Anything you add beyond that is all growth. Compare this to a business built with no recurring revenue. You might earn \$10 million in a single year. But, every subsequent year you begin again at \$0 – something that makes it difficult to sustain growth.

The beauty of recurring revenue is that because you can predict what you're going to earn, you face less risk – something that investors love (one private equity firm even hands out bumper stickers that say: "I heart recurring revenue"). In fact, the more recurring revenue a company has, the higher the valuation it will receive from prospective investors and buyers. That's why recurring revenue has become the gold standard of business models and something that every CEO should be working towards building into their own business.

You only need to compare the fate of Blockbuster with that of Netflix to see the power of this idea. While both firms rent DVD based movies to consumers, Netflix has essentially 100 percent recurring revenue and Blockbuster had almost none. What is left of Blockbuster has a market capitalization of under \$20 million, while the market values Netflix in excess of \$7 billion. For context, consider that the market is valuing every dollar of Netflix revenue at \$4.45 to arrive at that market capitalization. That's compelling evidence of the power of recurring revenue.

Along those same lines, let's consider the example of GE, which conducted a company-wide drive a few years ago to add service and financial service offers around all of their product-based businesses, even at its jet engine manufacturing division. Sales had been growing due to global demand, but

once a customer in, say, China, bought new jet engines for an airliner, they might not need more for a while – a classic example of a non-recurring revenue stream. But, by adding service contracts, spare parts supply, overhaul service and financing services around the sale of the power plant, GE created several recurring revenue streams that were far more profitable and valuable than the sale of the engine itself.

There are actually several kinds of recurring revenue and you can arrange them in a value pyramid consisting of five levels where the higher your business model falls on the scale, the more valuable it is. And the key to value in this case is the ability of your business to create barriers to entry for competitors while also making it undesirable for your customers to switch their business. Let's expand on this.

At what we'll call Level One of the pyramid is a business model based on *Repeat Customers*; say something like a grocery store. Having folks around the neighborhood stop by every few days to pick up their staples like milk and eggs is a great thing. By providing solid customer service, you can hope to attract those same customers on a weekly basis for years. The rub is that there is really nothing stopping your customers from stopping by a new store that opens on other side of town. Other than the possible cost of fuel, there are no switching costs for that customer. So, while having repeat customers is far better than not having them, your revenue stream remains risky because you can't count on your customers sticking with you. Many firms in this mode have build affinity programs, like frequent flyer cards to create stronger brand preference and make their offers stickier.

That leads us to Level Two of the pyramid, which we call *Recurring Revenue*, where you find businesses such as insurance agencies or your cable company, businesses which benefit from a basic level of recurring revenue. Think about when you sign up for your auto insurance policy. You agree to pay a certain amount of money every month for a year, which makes for a fine source of recurring revenue. But, as with the grocery store example, your customers are under no contractual obligation to renew their policy with you or even to stick with you for the life of that policy. A customer can simply shop around and, if they find a cheaper rate, instantly switch over their policy and robbing you of what you thought was bankable income. Some businesses have worked to combat this by adding automatic credit card or bank account billing, which can be effective at changing the consumer's decision to stop or continue the service each month.

The next level up is *Level Three: Recurring Revenue with a Contract*. Think about the contract you signed when you got your new cell phone. Not only did you agree to pay a certain amount of money each month depending on the plan you selected, you also agreed to keep paying for something like two years. Sure, you can change your phone provider, but this time it will cost you, say, a \$75 or higher switching fee. That makes changing a little more painful for you as a customer, which, in turn, makes for a better business model. The phone company also runs promotions where it offers you a discounted new phone every year or so. Of course, there's a catch: You need to sign a new two-year contract to take advantage of the offer. Again, this is an appealing model because you can predict with a higher level of certainty what your recurring revenues will be both in the short-term, as well as over the longer term.

A related example is the business model employed by Salesforce.com, the online sales tracking platform. Customers of Salesforce.com don't have to sign a long-term contract as they pay a fee per user, per month. At first, you might think this is simply an example from Level Two of the pyramid.

What's to stop customers from switching to a competing website, after all? Well, in this case, there is actually a convenience cost to switching. Consider that the more you use Salesforce.com to track your contacts and appointments, the more data you accumulate. And since that data is stored on a database hosted by Salesforce.com, you will have to jump through some technical hoops to transfer that data to a competing service, making it far more likely that you'll just stay put. The lesson here is that the more complex you can make it for your customer to switch their service, the less risky your recurring revenue, and the future of your business, becomes. Just ask anyone who has tried to terminate his or her cable service to find out how complex it can be these days.

Level Four of the pyramid is called *Sequential Revenue*. The idea behind this approach is to create recurring income by encouraging your customers to consistently upgrade to new product and service offerings. Look no further than billion-dollar companies like Microsoft and Oracle to see how this model works. Take, for example, Microsoft's flagship software product, Microsoft Office. Initially you as a customer might purchase Office 2003. Then, a few years later, Office 2007 comes out complete with several fancy new features to tempt you to upgrade to the new product. If that's not enough to convince you, the company may also issue an alert that it will stop supporting earlier versions of the software. Either way, the company has found a way to keep collecting money from you.

Oracle takes a more component-driven approach where they encourage their customers to constantly upgrade by adding new features. They might begin, for instance, by selling you an Enterprise Resource Planning (ERP) system. Then, in time, they will try to entice you into adding additional components to your system such as a Customer Relations Management (CRM) or Human Resource Management (HRM) system – each time adding new levels of service and charges. This concept was the driver behind their acquisitions of JDE, Siebel and PeopleSoft over the years.

Another example is a company like Constant Contact, which starts customers out on a basic plan that costs \$10 month. As you begin to use the system more, you can then upgrade if you like, spending an additional \$5 a month to get unlimited image storage or the ability to input a larger number of contacts. In other words, the more you use the system, and the more valuable it becomes to you, the more you're willing to pay. This model also works where companies may offer a free service as a way to attract new customers. The company also offers a premium service where customers can access advanced features. Even if the company can convert just a fraction of its customers over to the premium service, it can create an extremely valuable recurring revenue stream.

The fifth and highest level of the pyramid is called *Repeat Revenue with a Network Effect*. What this means is that the more someone uses the company's product or service, the more each individual customer gets out of the experience – something that we call the network effect – which creates a barrier to that customer leaving. Consider the appeal of a company like eBay. Regardless of whether you are a buyer or a seller, the more people that participate in the company's online auctions, the more valuable it becomes for you to the point that you wouldn't even consider switching to a competing offering. Can you even name a viable competitor to eBay these days? An example of a more recent startup using this model would be Groupon, which offers a deal of the day to the members of its social network. The model is premised on the notion that deals, such as a discount to a restaurant or tickets to a show, become viable only if a certain number of people sign up for it. On-line dating services like e-Harmony have a similar model, the more people participate, the more potential soul-mates are available and the higher probability you find yours. Again, the

more people participate, the more valuable the service becomes, which means customers and advertisers are less likely to leave since they risk losing the benefits of remaining in the community.

The key point then is whether you're the CEO of a company or an entrepreneur hammering out your first business plan, you need to be thinking of how you can drive a higher percentage of these flavors of recurring revenue through your company. Even if you can move from 0 percent to 15 percent recurring revenue, you have done wonders for the value of your company. Ideally, as a culture, we'd never see another business started that didn't have recurring revenue woven into its core. The point is that if you're not thinking along these lines, you're putting the future of your business in jeopardy.

Jim Schleckser a principal the Inc. CEO Project, LLC, an organization that operates peer groups for growth CEOs of middle market companies in a wide variety of industries from \$25 million to over \$1 billion in revenue. He can be reached at jimschleckser@ceoproject.com. The website is: www.IncCEOproject.com