

WHITE PAPER



CompTIA Partner500 Advisory Council
MARGIN RETENTION THROUGH OPERATIONAL EFFICIENCY

December 2011

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INTRODUCTION

The business of being an IT solution provider has evolved significantly over the past 10 years—from the technology they sell to the business models they operate. Unfortunately, one trend that continues is the steady decline of basic operating margins available in the process of selling and supporting technology products.

In fact, research published by CompTIA shows that average margin levels for solution providers have declined by a factor of 4 in virtually every technology category. In 2001, the “typical” gross margins a solution provider could earn by selling hardware or software products would range from 25–45 percent, depending on the category or complexity of the product. Today, solution providers report product resale margins in the range of 5–15 percent.

This troubling trend begs a number of questions:

- Why are IT solution provider margins declining?
- Are all IT solution providers affected equally?
- What specific steps can IT solution providers take to improve margin results?

The information presented in this paper is the result of a concerted effort by CompTIA and the CompTIA Partner500 Advisory Council to answer these questions—and to identify practical, short-term steps solution providers can take to improve their fortunes.

To identify the most accurate trends and relevant solutions, CompTIA and Morris Management Partners interviewed executives from 15 IT solution providers located throughout the United States. Participants in the 60-minute in-depth interviews represent companies that range from less than \$2 million in annual revenue to more than \$150 million, and operate a mix of business models including traditional product resale, systems integration, managed services and even cloud-based subscription sales.

Our objective in the research project was to address three specific management questions:

- First, what are the most common “margin leaks” that IT solution providers struggle with, and how can those leaks be addressed?
- Second, how can IT solution providers assess their own business operation to determine whether they are experiencing margin leaks?
- Third, what strategic changes will IT solution providers need to make over the coming years to remain financially viable?

CORE FINDINGS

In general, participants in this study reported struggles with a number of operational challenges that resulted in significantly reduced profit performance relative to past years, as well as compared to the “optimal” levels of performance that leading IT solution providers report. Further, solution providers reported that the most effective fixes to these challenges were “tactical” adjustments to improve basic operational efficiency rather than significant structural or strategic changes.

As one interview participant said, “There is no secret to improving margins—it’s about basic business operational best practices. Know your business, track your performance, measure your results.”

At a point when the IT industry is undergoing dramatic changes in technology platforms, virtualization, mobile solutions, and core financial models, this observation seems almost too simple to be effective. While competitors are rushing to adapt their basic business models and adopt emerging delivery platforms in the cloud, is it wise to focus on tactics before strategy? Basics before cutting-edge solutions?

The short answer, based on study participants, is yes. The consensus reports that improving margin results correlates directly to the business operations of individual companies. While external factors must eventually be addressed, if a business is not operating effectively in its current model, for its current customers, on its current solutions, then the odds that business will survive a fundamental transition of the business model are extremely low.

A summary of the most significant findings from our research into best practices for managing margins include:

- Margin results have been consistently declining for the average solution provider in virtually every product or solution category (servers, storage, security, applications, etc.) for at least 5 years, meaning the source of the decline pre-dates the recession of 2008.
- Average margin performance has been declining in this period for solution providers in virtually every business model category (product resale, project-based services, managed services, etc.), in spite of some temporary bubbles for newer models.
- Margin results show a surprisingly consistent trend across “size” factors as well—spanning solution providers who are small (less than \$5 million annual revenue), medium (\$5–15 million) and large (more than \$15 million), as well as those who sell to SMB-, midmarket- and enterprise-sized customers.
- Despite the general trends toward reduced margins, every category (technology, business model, and customer target) also contains a significant portion of solution providers who are outperforming their peers, actually increasing margins and reporting positive trends.
- Solution provider participation in vendor channel programs designed to increase margins (rebates, incentives, specializations, etc.) have declined across the board as solution providers report increasing complexity and resource requirements to participate in and manage those programs. Solution providers who do participate indicate that incentive programs have mixed results: some improve margins by directly reducing product costs, while others ironically reduce margins as sales or administrative costs are increased. This trend and other are also borne out in the data from CompTIA’s recent “State of IT Channel Programs” study (www.comptia.org/members/research/allreports/State_of_IT_Channel_Programs.aspx).
- While not every solution provider has been able to improve overall margins through direct management efforts, study participants indicate that certain tactical adjustments to sales, service, and back office operations have produced consistent cost savings and revenue capture. Focusing on these specific operational improvements can provide short-term margin results as well as long-term sustainable changes if supported by top-level leaders.

NEGATIVE MARGIN DRIVERS IN THE CHANNEL

While the specific combination and difficulty of margin challenges vary significantly from solution provider to solution provider, a number of consistent themes emerged from the study process. The following factors were identified as leading threats to solution provider profitability:

- Declining product margins due to “commoditization” of IT functionality, even in complex product categories caused by improvements in vendor offerings, over-distribution among larger numbers of solution providers, and easy access to product information via online sources.
- Pricing pressure from customers due to expanded alternatives, economic challenges, and improved negotiating strength as vendors and solution providers have surrendered pricing control.
- Inefficient sales processes that drive up sales costs due to complexity of configuring solutions, getting pre-sales support from vendors, navigating vendor channel program requirements, gaining access to financial decision makers, and advancing opportunities toward a successful close.
- Inefficient service delivery operations due to inaccurate scoping of product delivery requirements, unscheduled time for billable resources, project management and scope control, high levels of manual labor processes, and lack of repeatable processes.
- Ineffective management control of financial performance due to lack of accurate data on business activities, lack of meaningful metrics on process effectiveness, infrequent changes to operating processes, and low levels of organizational control across critical business functions.

POSITIVE MARGIN DRIVERS IN THE CHANNEL

Beyond the obvious answers of “undoing” the negative drivers addressed above, there are a number of direct actions that management teams can take to quickly and significantly improve their margin performance. As noted earlier, there is a notable portion of the solution provider community bucking the trend of declining margins in spite of external pressures (the economy, competitive threats, product-related factors, etc.). These companies are operating in the same conditions, selling similar products, and targeting similar customers—yet somehow manage to increase margins while peers suffer consistent declines. Study participants reported particularly positive results when the following conditions were in place:

- Integrated solution sales comprised of multiple products/technologies to address a measurable customer business requirement, including the need to scope and/or integrate the technologies into a single functioning unit.
- Presence of professional/management level staff who are responsible for discrete business functions and have access to performance data at regular intervals plus the authority to make direct changes to business activities.
- Leverage of specific, documented, repeatable processes across multiple business functions that are tuned for the size/complexity of the partner operation and the availability of particular resources (people, automation/tools, outside partners, etc.).

- Active participation in and management of vendor channel programs to ensure the solution provider captures every available dollar for aligned sales, plus minimizes the complexity of participating in programs, submitting paperwork, tracking compensation, etc.
- Institutional control of the financial model and compensation factors for revenue, incentives, rebates, etc., to prevent misaligned priorities among sales teams/company objectives. Specifically, preventing the use of vendor incentives to “pad” the margin structure or exacerbate the discounting process in customer negotiations.
- Emphasis on high-priority solutions that align with customer urgencies as well as capture the proper mix of products and services based on the structure/capabilities of the solution provider’s current business model
- Investments in “professional” sales resources that are both qualified to negotiate effective pricing deals with customers and motivated to preserve company margins, such as hiring qualified sales consultants, providing training in sales and negotiation tactics, variable compensation plans that emphasize profit performance, and availability of support resources that allow sales reps to focus on sales-specific activities.

CORE RECOMMENDATIONS

In the context of current financial conditions, solution providers who participated in the study were adamant about focusing on internal factors that could be directly affected rather than simply waiting for market conditions to improve or macro-customer factors to shift in favor of more inherently profitable business models.

One primary objective of this research study was to identify specific things that solution providers can do to improve margin performance now—in the market conditions we’re experiencing, in the business model they operate. In that spirit, we asked for details of current initiatives that study participants were implementing in their own businesses, as well as best practices they had observed in peers or competitors.

Most solution providers will find one or more items on this list that they are already doing, and can already point to as a source of financial performance improvement. However, even study participants were unanimous that they found at least one item on the list they were not currently focusing on, and would be able to use for even more improvement in financial conditions.

For best results, solution providers should consider these recommendations in the context of “realism-then-significance.” In other words, rather than trying to implement all of these best practices at once, changes should be prioritized to emphasize facts that can be addressed quickly, as well those which will produce the largest financial improvements. Obviously this approach will produce a list of actions that may take an extended period of time—which directly aligns with the advice of study participants.

To quote a CEO of a large-size solution provider with operations throughout the US: “Margin improvement isn’t something that happens all at once, and it’s not something that will ever be finished. In fact, waiting for a big one-time solution to dramatically improve margins is one of the biggest reasons why operations have been allowed to slip and inefficiencies have eroded margins. Start where you are, do what you can, make incremental improvements, and you’ll find it all adds up.”

A round up of specific recommendations from study participants includes the following items:

Control the “Controllable” Factors in Operations

Some business operations are inherently complex and expensive, and no amount of management effort will eliminate the cost or associated effort. Rather than wishing for dramatic cost savings, managers should focus on the elements of operating processes that are directly controllable. Specifically, identify the exact activities that employees are doing, why they’re doing them, and consider whether those actions could be improved, consolidated, automated, or eliminated. As one study participant said, “Don’t take anything for granted. Don’t assume that just because you’ve always done it that way means you can’t do it differently.” The key is to focus on things you and your people do, not things that people outside of your business do.

- **Keys to Operational Effectiveness**

- **Defined Process**—A step-by-step description of exactly how you do the things you do. From sales process to accounts receivable process to payroll process—everything you do represents cost that could be controlled. Begin with the most important processes in your business, because even small improvements in critical activities can yield significant margin returns.
- **Functional Capability**—Do your people possess the skills to perform their tasks effectively? Whether you have people covering multiple roles, or people who are assigned tasks they aren’t specifically trained to do, most businesses have “less than experts” doing important things. Every person in every role should have the benefit of professional training to improve their skills—but the immediate focus should be on covering tasks that are currently being done by people who don’t have the skills to perform effectively.
- **Core Metrics**—Track the results of business operations that matter most—metrics that indicate whether your business is operating within acceptable cost ranges, or whether you’re spending too much on certain items. As explained by a study participant, there are literally hundreds of metrics you could track, but many are either incomplete measurements of a larger process, or are disconnected from direct actions that your people take. Instead, choose a very few, very specific metrics that are specifically attached to financial health (details below).

- **Target Principal Margin Leaks**

Beyond the measurements of your financial results, pay attention to the specific actions which can impact those results—and develop official policies/procedures for managing the most important and impactful actions. Once effective policies have been designed, communicate the standards to all employees—not just those who are directly responsible for the actions—and track compliance with the policies to ensure consistent application of best practices. To quote a study participant, “Don’t just assume that everyone knows the right way to handle financial decisions. Set a policy, teach the policy, and track the policy.”

- **Primary Financial Leaks**

- **Product Discount/Price Control:** Selling products and services at discounted prices has a direct and significantly negative impact on margins and profitability. Not only will profit metrics be reduced, but also you will need to engage more customers, more often just to get the same level of revenue. Determine who in your business is authorized to approve discounts, what levels of discount are acceptable, what conditions must be met to approve a discount, and how the discount will be documented/tracked.

- **Solution Urgency/Distinctiveness:** Selling high-value products and services will naturally improve margin performance. Yet sales cycles and complexity factors can be more challenging for those products—leading many sales teams to sell lower-value products by default. Define standards for the mix of products that sales teams sell, and align their motivation by setting metrics in their compensation plans to emphasize high-value products.
- **Rebate/Incentive Programs:** Failing to participate in incentive programs or capture rebates for products you are already selling is simply leaving “free” money behind—UNLESS the program you’re participating in actually costs more to manage than the incentive income that’s available. Establish clear procedures for joining, tracking, and collecting from incentive programs, and communicate those processes to vendor partners to ensure your approach complies with program requirements.
- **Service Operations:** Low utilization percentages for billable service personnel is the single biggest factor for diminished margins, if your service people are on staff and collect a fixed salary. Maximize utilization by emphasizing the sales of services, planning project calendars, tracking specific activities and deliverables, and setting service prices based on the value of the activity as well as the cost of the resource.
- **Marketing/Sales Operations:** Inefficient marketing programs produce fewer leads that yield lower revenue; inefficient sales programs yield slower sales cycles and lower winning percentages. When budgets are allocated for people (salaries, resources, etc.) and for programs (campaigns, media, etc.), always establish a target “rate of return” or a multiple of the budget that is produced in revenue to ensure efficient operations. Control campaign costs, provide incentives for lower sales expenses, capture vendor MDF investments, etc.
- **Back Office/Financial Management:** Beyond the revenue from sales and the cost of operations, your business must also track and measure its ability to capture revenue from customer receivables (minimize the percentage of “bad debt”) and the speed with which you collect those receivables (minimize the number of “days sales out” in cash flow). Slow receivables must be financed with loans from banks or other sources, which causes your company to incur higher “cost of money” in the form of interest charges. Similar metrics can be established and tracked in the opposite direction: managing payables.
- **Keep Score on Real Performance**

“If you don’t keep score, you can’t know if you’re winning. And tracking your margins at the end of each quarter isn’t nearly enough to allow management to do something about it.” Study participants were unanimous in their recommendation of tracking key financial metrics, and emphasized the frequency of measurements as well as the detail of data tracked. It is too common that solution providers are focused too much on revenue numbers and “absolute” cost factors (measured in dollars vs. as a percentage of related revenue). While “cutting costs” is a noble objective, it’s not precise enough to simply spend fewer dollars. The key is to establish acceptable benchmarks for each metric, then track performance based on those financial calculations as often as your systems allow.

- **Most Valuable Financial Metrics**

- **Gross Margin on Product Sales:** A direct measurement of the company's ability to sell product based on value without resorting to discounts. Define carefully which costs are included in the GM calculation; for example, are pre-sales costs included in product margins, or are they accounted for in the cost of sales?
- **Gross Margin on Service Sales:** A direct measurement of the company's ability to sell services at a value-oriented price, as well as your ability to operate service deliverables efficiently. Service margins should be tracked by type of service, type of technology, type of customer, and type of customer engagement.
- **Selling Expense as a Percentage of Gross Margin:** A comparison of how much it costs to generate the margin for products and services. In other words, are sales reps using resources wisely, winning a high percentage of their opportunities, and closing deals quickly—without resorting to discounts.
- **Percentage Mix of Revenue from Products and Services:** A measurement of the company's ability to attach service engagements to product deliverables, as well as the focus on building self-standing service deliverables. Assuming margins on services are higher than margins on products, the goal is to drive a higher percentage of revenue from services. **IMPORTANT NOTE:** Your mix of services should be modeled to match the budget expenses of your target audience. If your model is artificially designed to include more service revenue than customers are spending, your result will be leaving product revenue on the table and introducing competitors into your accounts.
- **General and Administrative Expense (G&A) as a Percentage of Revenue:** A combined measurement of how efficiently your back office expenses are managed compared to the total revenue of the organization. Identify areas where you are spending too much (unnecessary or unaffordable management personnel, inefficient processes, expensive resources, etc.) as well as those where you are spending too little (absence of critical management personnel, lack of resources to support operations, etc.).
- **Back-End Rebate Income as a Percentage of Revenue:** Measured separately from product sales margin, this is a calculation of the amount of incentives/rewards you capture from vendors for hitting specific revenue targets, selling specific products, participating in channel programs, etc. Not all solution providers participate in these programs, and many who do report complexity and costs associated with managing them, but as a whole, the incentives are an important source of additional margin. **IMPORTANT NOTE:** This percentage **MUST** be tracked separately from margins, or the additional margin points are likely to be lost in the selling process and used to “pad” the impact of discounts.

A DIAGNOSTIC APPROACH TO OPERATIONAL EFFECTIVENESS

How does your business perform in the critical operational factors described in this paper? Are your margins high enough—or could they be higher? The practical application of the best practices outlined here will produce varying levels of improvement based on the current condition of your business—as well as the effectiveness of your management action to address inefficiencies.

To determine how much improvement you can realistically achieve, you'll need to carefully examine the current effectiveness of your business in detail, and compare your capabilities with the performance of peers, both inside the IT solution provider industry, and outside in relevant “solution provider-style” business models. In many cases, you'll find that your business is already performing effectively in key areas—but it's never safe to assume your processes are operating up to standards without performing a detailed assessment.

In order to prioritize the changes you make or investments in resources, begin with a basic inventory of your operating processes. What does your business actually do? And specifically, how are you doing those things? While some improvements may be obvious and immediate based on the description of best practices in this whitepaper, others will be more nuanced depending on the complexity of your operations.

What determines whether a process is healthy? Management best practices taught by Morris Management Partners outline a three-part evaluation model to “score” the status of your business processes. The model looks at three dimensions:

- **Core Competency:** What is your level of skill/expertise in a specific business function? This can be an absolute measurement (functional capability) and a relative metric (how you compare to peers/competitors). It is possible to be highly skilled in a function, yet still be less capable than a competitor. *(Score this factor on a scale of 1–5, where 1 = very low competency, and 5 = very high competency)*
- **Repeatability:** What is your ability to execute a business function the same way time after time? This can be significantly improved by defining specific processes for key functions, but will naturally be affected by the number of people involved in a specific function. The more people who do a particular task, the more likely you will have variations in time, quality and cost. *(Score this factor on a scale of 1–5, where 1 = very low repeatability, and 5 = very high repeatability)*
- **Financial Leverage:** How much do you pay to complete a particular function ... and how much value does the task create? Some tasks are very expensive to complete, yet are justified by the high level of revenue you receive in return. The key is to ensure your resources are focused on tasks that matter, and costs are recovered from low-value activities. *(Score this factor on a scale of 1–5, where 1 = very low financial leverage, and 5 = very high financial leverage)*

To make this model a “countable” scorecard for operating effectiveness, consider each process according to all 3 dimensions, enter a score in the table below, and add up the 3 scores for each process. Then compare the process scores to the following scale:

- **Score = 11+** — Excellent process effectiveness; monitor performance to ensure consistency
- **Score = 6–10** — Marginal process effectiveness; if it's a central process, plan for changes
- **Score = ≤ 5** — Weak process performance; determine process importance immediately

Business Process	Competency	Repeatability	Leverage	Process Score
DEMAND-SIDE FUNCTIONS				
Market Research/Alignment				
Portfolio Management/ Development				
Marketing/Demand Generation				
Sales Process				
Customer Engagement				
Account Management				
DEMAND-SIDE FUNCTIONS—TOTAL SCORE				
DELIVERY-SIDE FUNCTIONS				
Product Configuration/Delivery				
Billable Service Operations				
Technical Support/Help Desk				
Delivery Process Design/ Improvement				
Inventory Management/Utilization				
Resource Development/Training				
Account Management				
DELIVERY-SIDE FUNCTIONS—TOTAL SCORE				
SUPPLY-SIDE FUNCTIONS				
Product Evaluation/Proof-of- Concept				
Vendor Relationship Management				
Channel Program Participation				
Human Resources Management				
Financial Management				
Facilities/Tools/Support				
SUPPLY-SIDE FUNCTIONS—TOTAL SCORE				

ABOUT MORRIS MANAGEMENT PARTNERS

Morris Management Partners, Inc. is a consulting and business development firm serving IT channel companies. Our services are delivered in a flexible format based on client requirements, including private consulting projects, ongoing coaching services, private or public training events and speaking at conferences.

Our point of view on how to build a business that thrives in the technology channel has been refined over decades of combined experience in the technology industry. Having worked with, for, and around small and large technology solution providers, IT distributors, and vendor companies ranging from the most established Fortune 500 companies to spunky new start-ups, it's our position that the business dynamics of the channel have changed substantially over the past few years—and these changes require channel companies to adapt, or disappear.

The new conditions in the IT market represent a rare and lucrative opportunity for new players to establish a position of competitive advantage—or for established companies to reinvent themselves and leap ahead into a new period of sustained growth. The only option that's not available is standing still. Yesterday's best practices simply won't win any longer.

And that's why this firm exists. To apply years of experience and unparalleled perspective about how to build a technology business through indirect channels to market.

ABOUT CompTIA

CompTIA is the voice of the world's information technology (IT) industry.

As a non-profit trade association advancing the global interests of IT professionals and companies, we focus our programs on four main areas: education, certification, advocacy and philanthropy. We:

- **Educate the IT channel:** Our educational resources, comprising instructor-led courses, online guides, webinars, market research, business mentoring, open forums and networking events, help our members advance their level of professionalism and grow their businesses.
- **Certify the IT workforce:** We are the leading provider of technology-neutral and vendor-neutral IT certifications, with more than 1.4 million certification holders worldwide.
- **Advocate on behalf of the IT industry:** In Washington, D.C., we bring the power of small- and medium-sized IT businesses to bear as a united voice and help our members navigate regulations that may affect their businesses.
- **Give back through philanthropy:** Our foundation enables disadvantaged populations to gain the skills they need for employment in the IT industry.

Our vision of the IT landscape is informed by more than 25 years of global perspective and more than 2,800 members and 1,000 business partners that span the entire IT channel. We are driven by our members and led by an elected board of industry professionals. All proceeds are directly reinvested in programs that benefit our valued members and the industry as a whole. Headquartered outside of Chicago, we have offices across the United States and in Australia, Canada, China, Germany, India, Japan, South Africa and the United Kingdom. For more information, visit www.comptia.org.



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