The rule of 78 – how the cloud adds up

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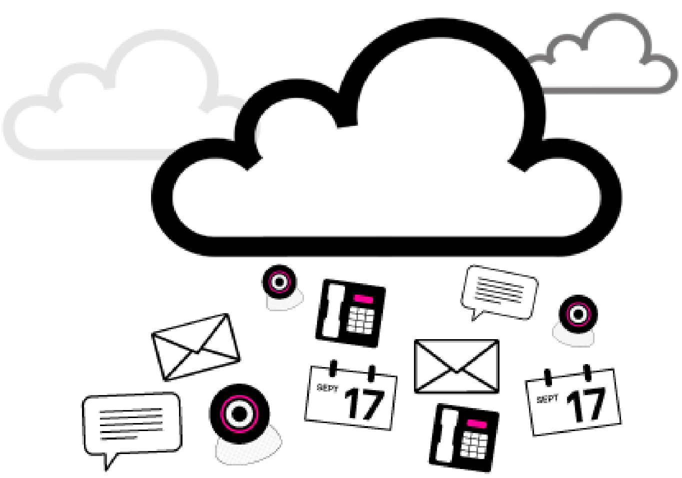

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THE CLOUD EXPERTS

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HOW THE CLOUD ADDS UP

Cloud economics – a beginner's guide

The cloud, whilst the 'next new thing', is not based on a new principle. The cloud is about economies of scale and its success can be traced back to the industrial revolution and earlier. The same principles explained in Adam Smith's Wealth of Nations, where the separation of activities enabled specialisation and improved efficiency in the manufacturing of pins, can apply to cloud.

By moving individual on-premise IT deployments, including the supporting services and infrastructure, to a larger, centralised and therefore more efficient service enables the cloud to leverage economies of scale in many areas, from the bulk purchasing of infrastructure and electricity, to the ability to justify a highly-skilled/specialised workforce.

The maths

One of the biggest challenges for organisations moving to selling cloud is the change in commercials from a traditional post-event view of accounting – "last quarters numbers were…", to a forward-looking model 12, 24 or 36 month secured revenue stream. Many organisations see a smaller monthly income from cloud and wonder how they will make it pay. By borrowing a lesson from banking, we can visualise the impact of the cloud and start to understand the long-term opportunities it presents.

Rule of 78 – every cloud has a silver lining

The Rule of 78 (Wikipedia, accessed 29.08.2013)

*Also known as the sum-of-the-digits method, the **Rule of 78** is a term used in lending that refers to a method of yearly interest calculation. The name comes from the total number of months' interest that is being calculated in a year (the first month is one month's interest, whereas the second month contains two months' interest, etc.).*

The same model applies to the cloud and looks like this:

When looking at cloud revenues in the future, consider a sales person signing one deal a month at £1,000 per month revenue. At the end of a 12 month period this would equate to £78,000 of revenue.

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	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£12,000
		£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£11,000
			£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£10,000
				£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£9,000
					£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£8,000
						£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£7,000
							£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£6,000
								£1,000	£1,000	£1,000	£1,000	£1,000	£5,000
									£1,000	£1,000	£1,000	£1,000	£4,000
										£1,000	£1,000	£1,000	£3,000
											£1,000	£1,000	£2,000
												£1,000	£1,000
Comulative Billing	£1,000	£3,000	£6,000	£10,000	£15,000	£21,000	£28,000	£36,000	£45,000	£55,000	£66,000	£78,000	£78,000
Billing per month	£1,000	£2,000	£3,000	£4,000	£5,000	£6,000	£7,000	£8,000	£9,000	£10,000	£11,000	£12,000	

When you look into your first coffee of the year in year two, you already have the comfort of a £12,000 a month contribution. At the end of year two that would become £211,200 revenue, with an on-going contribution of £21,368 a month (even applying a 7.5% churn to keep it real).

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£11,100	£133,200
	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£12,000
		£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£11,000
			£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£10,000
				£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£9,000
					£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£8,000
						£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£7,000
							£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£6,000
								£1,000	£1,000	£1,000	£1,000	£1,000	£5,000
									£1,000	£1,000	£1,000	£1,000	£4,000
										£1,000	£1,000	£1,000	£3,000
											£1,000	£1,000	£2,000
												£1,000	£1,000
Comulative Billing	£12,100	£25,200	£39,300	£54,400	£70,500	£87,600	£105,700	£124,800	£144,900	£166,000	£188,100	£211,200	£211,200
Billing per month	£12,100	£13,100	£14,100	£15,100	£16,100	£17,100	£18,100	£19,100	£20,100	£21,100	£22,100	£23,100	

Looking further ahead into year three, that same £1,000 a month becomes £322,410.

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Total
	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£21,368	£256,410
		£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£11,000
			£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£10,000
				£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£9,000
					£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£8,000
						£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£7,000
							£1,000	£1,000	£1,000	£1,000	£1,000	£1,000	£6,000
								£1,000	£1,000	£1,000	£1,000	£1,000	£5,000
									£1,000	£1,000	£1,000	£1,000	£4,000
										£1,000	£1,000	£1,000	£3,000
											£1,000	£1,000	£2,000
												£1,000	£1,000
Comulative Billing	£21,368	£43,735	£67,103	£91,470	£116,838	£143,205	£170,573	£198,940	£228,308	£258,675	£290,043	£322,410	£322,410
Billing per month	£21,368	£22,368	£23,368	£24,368	£25,368	£26,368	£27,368	£28,368	£29,368	£30,368	£31,368	£32,368	

The cloud can therefore be likened to a pension plan – the sooner you start paying in, even if only small amounts, it pays dividends in the future.

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The exit strategy

As businesses grow and develop, the owners/directors, all have an eye on the big plan, the long-term strategy and the point at which they consider themselves successful. The success criteria might be to sell up and retire, to hand over the business to partners/children, to be acquired or to float on a stock exchange. In all circumstances the valuation of the business is a key consideration and this is where the cloud and recurring revenues play a trump card.

When running the numbers, cloud creates a powerful argument for focusing on recurring revenue. As the screen shot below illustrates, a relatively modest £5,000 a month net new cloud revenue creates a business conservatively valued at £3.2 million after three years.

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Cloud Economics Rule of 78

Cloud

					Revenue	Margin			
	year 1	£5,000		year 1	£390,000	£78,000	churn %	7.5	per annum
NET NEW REVENUE	year 2	£5,000	Total	year 2	£1,056,000	£211,200	EBIT multi	10	
(per month)	year 3	£5,000		year 3	£1,612,050	£211,200	Margin	20%	
			Total		£3,058,050	£500,400	Total Margin	£500,400	
							Business Valuation	£3,224,100	

On Premise

					Revenue	Margin			
	year 1	£150,000		year 1	£1,800,000	£180,000	churn %	0	per annum
NET NEW REVENUE	year 2	£150,000	Total	year 2	£1,800,000	£180,000	EBIT multi	4	
(per month)	year 3	£150,000		year 3	£1,800,000	£180,000	Margin	10%	
			Total		£5,400,000	£540,000	Total Margin	£540,000	
							Business Valuation	£720,000	

The calculation even takes into account a degree of churn and fairly conservative EBIT (Earnings Before Interest and Tax) multipliers. What is especially noticeable is the difference in business valuation even when compared to a £150,000 net new deal **EVERY** month on the old on-premise model.

Setting out on the cloud journey is not a straightforward rush for gold but Outsourcery can provide advice on the correct plan, thinking and company structure.

Commissions

In the hunt for cloud success, experience has taught that one crucial element is often overlooked. In a partner's organisation, who sells and who gains long-term from the cloud often isn't aligned. The sales team, account managers and Directors regularly have differing motivations and compensation.

However, for it to be a success there is one group whose motivation is clearly defined and for cloud to be a success their motivation has to be aligned to the common goal of growing recurring revenues. The Sales team is key to cloud success and ultimately this all comes down to a sticky conversation around sales commissions.

Never forget, sales people, as a general rule, will work towards commission, not necessarily corporate goals. Remember, the first job of a sales person is to hit their target. The 'best' sales people will do this in the most efficient and effective way. Sales people are also the initial prospect-facing element of the business and their key role is to influence the prospect to buy services. Don't be surprised if they include what compensates them the best as part of that influencing process.

However, cloud is all about building recurring revenue and not upfront cash, so how do you change a commission scheme based on up-front deal signing and cash, without further jeopardising cash flow? Furthermore, an upfront Gross Profit (GP) based target, common across many partners, will not promote cloud revenues, as the relatively small (compared to upfront) monthly payments won't come close to a traditional GP based model.

To make the maths easy;

Cloud-based deal – £1,000 a month
Cloud Deal GP per month – £400 (40% GP)

On-premise deal – £12,000 upfront
Cloud Deal GP month one – £4,800 (40% GP)

With sales leaders often looking for an average of £30,000 a month GP (£60,000 to £100,000 a month turnover), a traditional commission model is never going to promote cloud and therefore sales people are highly unlikely to push it to clients. It becomes that last chance saloon of deal approaches.

In three years however, the above deals (new £1,000 a month cloud revenue each month for a year or new £12,000 one off on-premise deals each month) have a very different value. The traditional on-premise is worthless from a business sale and on-going revenue position. However a years' worth of £1,000 revenues (even now it is 36 months old) is still worth £123,000 of revenue a year and the business stream could be conservatively valued at close to £250,000.

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Cloud Economics Rule of 78

Cloud

					Revenue	Margin			
	year 1	£1,000		year 1	£78,000	£15,600	churn %	7.5	per annum
NET NEW REVENUE	year 2	£0	Total	year 2	£133,200	£26,640	EBIT multi	10	
(per month)	year 3	£0		year 3	£123,210	£26,640	Margin	20%	
			Total		£334,410	£68,880	Total Margin	£68,880	
							Business Valuation	£246,420	

On Premise

					Revenue	Margin			
	year 1	£12,000		year 1	£144,000	£14,400	churn %	0	per annum
NET NEW REVENUE	year 2	£0	Total	year 2	£0	£0	EBIT multi	4	
(per month)	year 3	£0		year 3	£0	£0	Margin	10%	
			Total		£144,000	£14,400	Total Margin	£14,400	
							Business Valuation	£0	

So this creates a number of problems, including funding that switch of revenues in the short-term, but also to incentivise cloud promotion by the sales team. So in line with a cloud model, there needs to be a significant shift in the way numbers are discussed, represented and paid out in an organisation. The £100,000 deal becomes a £3,000 a month deal, a commission target becomes £2,000 a month GP (rather than £30,000 a month GP). Feel free to adjust the numbers but hopefully you get the idea.

As well as commission, this leads to an interesting issue with scale and plaudits. The £100,000 deal, banded around the office and channel, is no longer capped or even a relevant way of quantifying a deal. Potentially its value, based on £3,000 a month, could be extrapolated over three years (including 7% churn) to £100,000, but is still paying £30,000 a year out (including churn) after year three, so it becomes a question of time. In five years it is going to be a £150,000 deal.

That said a £3,000 a month deal doesn't sound quite as good as a £100,000 (or even a £150,000) deal and sales people tend to be vain.

A recurring revenue commission model allows you to tie staff in and make them less likely to leave (with the associated costs of recruiting and getting new starts running) as it will enable them to get over lean periods as they will have a back stop of recurring revenues paying their wages but will also take the hit out of big deals as they will be paid out over a longer-term. By paying commissions more gradually, rather than the boom to bust that a traditional on-premise model tends to develop, these factors can make cloud a more stabilising, long-term plan for an organisation. It just needs a different view and perception of the numbers.

ABOUT OUTSOURCERY

Outsourcery is one of the UK's leading providers of cloud-based IT and Communications (ITC) business solutions, and has been delivering cloud services to partners of all sizes since 2007.

It is Outsourcery's aim to provide cloud solutions that integrate with existing infrastructure or completely remove the need for companies to have a 'comms room' and their own ITC infrastructure, allowing them to switch their IT payment model from Capex to Opex. For that reason, the company has invested heavily in its cloud platform, O-Cloud, which has been built using the latest technologies from best-of-breed partners Microsoft and HP, to ensure high availability and resilience for ITC solutions.

Outsourcery enables partners to move into the cloud by preparing them with the skills to adopt new technologies, enter new markets and help them to remain competitive. Partners can gain access to an integrated, secure suite of cloud services on which to build and deliver high value, compelling solutions to customers.

After less than three years in the sector, Outsourcery was named as Microsoft's 'Hosting Solutions Partner of the Year' 2010, and in 2011 as Finalist 'Dynamics CRM Partner of the Year'. Outsourcery is a Microsoft Certified Partner with a total of six competencies including three gold and three silver. Outsourcery is a founder member of the Cloud Industry Forum (CIF) and has achieved ISO 9001, 14001 and 27001 certifications which are internationally recognised standards for information security, quality and environmental impact, assuring customers that their data is in safe hands.

For more information, please visit our web site: www.outsourcery.co.uk