ScienceLogic

White Paper

Seven Ways to Up Your Enterprise Value

Enhance the value of your managed services

Service providers face significant challenges to improving their Company Market Value, more often termed Enterprise Value. By maximizing operational leverage, relying on metrics, opportunistically re-packaging existing tools, and wisely spending for the future, service providers can effectively meet these challenges. With these seven steps, service providers can realize new revenue streams, increase customer satisfaction, convert new prospects, and execute expert future planning, thereby — and simultaneously — improving their Enterprise Value.

The service provider industry by its nature cannot remain static for any length of time, due to advancement of technology. Since information technology is continually transforming, service providers are in a constant scramble to keep up with customers' demands for the latest and greatest new products, tools, and services. This steady, never-ending reinvention has caused service providers, more than most in the high-tech sector, to have difficulty in trying to keep up with technology while improving their companies' valuations.

When service providers ride the crests of technological waves, they acquire the operational leverage that can generate new revenue before their competitors can figure out how to use the latest advances to their advantage. Adding value back into the organization is a matter of making the business more efficient and cost effective by looking internally for ways to cause everyday operations to affect valuation in a positive way. This paper takes an in-depth look at how service providers can do just that while improving customer satisfaction, retention, and acquisition.

Start by Assessing Your Enterprise Value

The biggest concern for stakeholders in any business is whether or not they are improving the valuation of their company. IT and managed service providers (MSPs), especially, are always looking for ways to add value back to the business by keeping customers happy, attracting prospects, and leveraging IT resources for greater operational efficiencies and unique value-added offerings — all while figuring out how to make their daily work life easier. When they work out well, these day-to-day, nuanced activities can easily culminate in an upward trajectory in value for any company.

To assess how well all these efforts are working in a company, most analysts look at the "valuation multiple," an indicator of a company's worth derived by dividing the Enterprise Valuation by EBITDA (Earnings Before Interest, Taxes, Depreciation, and Amoritization). The numbers used are the current run-rates for up-to-the-minute assessments. At the recent Hosting & Cloud Transformation Summit in Las Vegas, one of the pre-eminent investment bankers in the industry, DH Capital, cited valuation multiples for the three primary data center service provider businesses, namely, colocation providers, REITs (Real Estate Investment Trusts), and hosting providers. In the data center colocation segment, Equinix reportedly has a multiple of around 14 times, and companies like Interxion around 21 times.

Within the REIT segment, behemoth Digital Realty Trust (DRT) is said to be at 18 times, while in managed hosting/cloud, Rackspace is cited at 21.3 times annualized trailing EBITDA to revenue run-rate, prior to its recent anomalous price softening.

Calculating your own company's valuation multiple now, and on an ongoing basis, is a good baseline to reference as you progress with your initiatives.

Examine Your Company in the Correct Service Provider Space

The multiples discussed in the previous section may seem high to you. That's because they are. We are at an all time high, and although the above names are leading the pack, a slew of public and private service providers are not too far behind in Enterprise Value and valuation multiples. Why? Because the fundamentals are solid in the service provider industry, proven by the relatively consistent growth of approximately 5%, quarter over quarter, in top line earnings — not to mention the promise of far more growth in the managed services industry yet to come as enterprises begin their collective journeys into the clouds.

Perhaps by now you've called your finance and accounting team in and calculated your valuation multiple and whistled through your teeth because you seem to be in a different ball park.

Well, perhaps you are. The service provider industry has different business models that yield different operating expenses which contribute to different valuation multiples. Take, for example, the astonishing growth in EBITDA numbers for the service provider industry. Having a market is one thing, but reducing your operating expenses is quite another, especially while simultaneously earning more money per square foot, per KW, per server, and per service. Rackspace has such an incredibly high multiple because it has recently grown EBITDA by 10%, quarter over quarter. Why, then, with 45% and 60% EBITDA margins, are Equinix and DRT not far better businesses to be in than the managed services space?

The answer lies in looking at the top line earnings. Looking at a typical 25 square feet of data center space in all three models, Equinix, with its multitude of cross connects and racks, weighs in at a decent $2,000 per rack. By contrast, a data center service provider like DRT comes in around $770 per rack; an unfair measure since they don't offer racks, but rather the wholesale facility cage or room, with low overheads to boot. In the managed hosting space where the fully managed hosting services often create 50% of the revenue from a mere 10% of the footprint within a facility, the cost rises astronomically to $15,000 per rack equivalent for Rackspace, with other public companies such as Savvis and Verizon showing similar ratios.

The lowest EBITDA multiple suddenly looks very different to stakeholders, since it is not the percentage, but rather the overall margin that is taken to the bank. No wonder, then, that these companies are so eager to move to a higher plane of managed services.

Focus on Improving Your Operational Leverage

Net income margins for the most successful managed service companies are often in the single digits, despite extremely high EBITDA margins. The biggest drop in the income statement can be found in three core areas: capital investments, labor, and operational expenditures. Capital investments these days are often reduced considerably by involvement with large software and cloud providers. Labor costs are also being offset by automation and cloud-era technologies that have obviated the labor-intensive manual tasks of IT management. The greatest variability among the three resides in operational expenditures. The skill by which cost reductions are achieved in this area lie expressly with the individual provider and how the company manages its business practices. IT tools — and the talent for selecting and applying them in the most effective ways — are key.

Investment in tools consolidation has never been higher, given the increasing fluidity and complexity associated with virtual sprawl in the data center. Unfortunately, the cost of integrating the numerous rolled-up technology modules, modern and legacy varieties, found in many large and complex organizations can have negative consequences on operational leverage. Fewer code bases, few tools, and greater extensibility to the tools (read: well documented and supported API structure) is an acknowledgement that an operational tools vendor understands the need to future-proof service providers from a rapidly changing set of infrastructure technologies.

For example, the popular convergence of infrastructure leading to vBLOCK, UCS, Flexpod, and other pre-integrated technologies, as well as the reduction in support for WMI and vCenter going forward, requires a constant modification in tools and licensing.

The ability for service providers to illustrate low levels of lock-in and dependency on expensive vendors is an area that has had many large public organizations and service providers wanting to compete in the long-tail of cloud computing. Service providers are searching for flexible and extensible tools that will at once lower constrictions, improve operational leverage, and lead to new service revenues. Bottom line: do your homework first in order to select the right tools for your business that will improve your operational leverage.

Seven Steps to Take Toward Improved Profitability

The following seven steps, derived from a careful market analysis of the state of the service provider industry, will help you improve your Enterprise Valuation. They are aimed mostly at MSPs, but other entities in the service provider sector can benefit as well. Not all steps will apply equally to all businesses, and not all steps will be suitable at every point in a company's business plan. But for certain, even a single step that may apply to you will help.

Seven surefire ways you can improve your MSP profitability:

1. *Calculate & Grow Your EBITDA*

Cash flow and EBITDA margins are the major arbiters of valuations. While Rackspace presently leads multiples for MSPs at 21.3 times annualized trailing EBITDA run-rate, a more typical and sustainable multiple is 12-14 times. Trends around last month's or last quarter's annualized revenue are highly reflective of your value, and far more so than looking at all of last year's numbers. For private companies in particular, you should check your adjusted EBITDA for line items related to their owners that are not recurring expenses; these need to be normalized.

Use the following steps and processes to work toward increasing your EBITDA in order to improve your valuation multiple. Since the market is at an all-time high for multiples, ask yourself what you should be thinking about to improve yours.

2. *Use Metrics for Everything*

You have to count to determine true worth. Numbers tell the tale for everything in IT; and for MSPs, keeping an eye on the numerical values is essential for success. From tracking historical trends of revenues — per rack, per EBITDA margin, per employee, per customer, per service, etc. — to those of expenditures, monitoring numerical progress of your business can tell you what you are doing right and where you are off the intended mark.

"Monitoring and management technologies allow MSPs to apply cost chargebacks to their customers in a fair and revenue-generating fashion."

Metrics are the key to differentiated service, application performance, cloud monitoring, usage-based billing, multi-tenancy, time-savings from automation — just about anything happening in your business. One of the wisest investments you can make is in tools that give you insightful metrics, such as those detailed by ScienceLogic's solutions, that lead directly to accurate performance measurement, ease of troubleshooting, customer satisfaction, and increased revenue opportunities.

3. Reduce Capital Expenditures

An alternative to data center and server investment for MSPs that is gaining popularity lies in utilizing large software and cloud providers as a means of reducing capital expenditures. SaaS offerings through channel partners, Microsoft-hosted applications, and IaaS players like Amazon Web Services (AWS) are now being viewed in a new light. Rather than seeing AWS as the hosting industry killer, many service providers have begun using the behemoth in obvious ways: either reselling AWS services — completely or partially — with their own managed services, or covertly employing them on the back end via storage gateways for short term disk/volume requirements.

Contrary to many concerns, MSPs accrue no apparent valuation penalties by taking this route, and can actually be a positive in the reduction of capital outlay risk. New technologies, such as those offered by ScienceLogic to monitor and manage the numerous service and product offerings, allow MSPs to apply cost chargebacks from these cloud platforms to their customers in a fair and revenue-generating fashion.

4. Retain Customers through Efficiencies

All service providers keep a close eye on churn, but most are ineffective at controlling it. The root of all churn is dissatisfaction: with costs, with customer service, with offerings, and with quality. MSPs can reduce churn through a checklist of efficiencies: by making sure your contracts are not transferrable (legal efficiencies); by showing your customers that your service offerings are unique (customer interface efficiencies); and by keeping your infrastructure as fresh and modernized as possible to stay ahead of the pack (quality efficiencies). In short, you need to give your customers every reason to choose you and no one else.

Introducing new and demonstrable value-added services will help keep your existing customers as well as attract new ones, as we'll show below. But you need to make sure what you currently offer is top shelf in efficiencies. Besides influencing your true Enterprise Valuation by costing your operation time and money, your everyday practices have a direct impact on customer satisfaction and, ultimately, retention.

Ask yourself these questions to assess your internal efficiencies:

- Is my infrastructure fresh and modernized enough to stay ahead of my competition?
- Am I employing predictive intelligence proactively for both customer and market insight, including operational business intelligence?
- Have I maximized automation in processes and workflows to minimize headcount and other costs associated with onboarding new customers?
- Are the tools needed for IT management fully consolidated, both legacy and modern, to eliminate duplication and overlap — and possible contrary performance?
- Have I reduced average remediation time, costs, and resources to speed up onboarding of customers and drive greater value?
- While exploiting unified platforms, have I ensured that my operations remain future-proofed?
- Most critically, do I leverage my IT tools to create new value-added services that are monetizable?

This last point about monetizing investments in IT tools is easily missed by MSPs in their focus on ensuring that their entire instrumentation and orchestration of IT assets contribute to the entire service. Overlooking this additional revenue opportunity can be the MSP's greatest inefficiency. The zero sum game of sunken investments in yesteryear's tools necessary for service operations has been usurped by the need to evaluate the tools' ability to be additive or synergistic to top line revenue.

5. Gain Customers with New Services

The rule in technology is that the newest ideas are the ones that get the most attention. To attract new customers in the managed services market, new offerings are the key — and, practically, this is the case even if they are old offerings in new packaging. Using an intuitive client interface, differentiate the value you provide clearly by presenting what you do for your customers in unique ways that show the additional value. Make these distinctions clear to your resellers as well as to prospects because any attrition of resellers or channels loses both customers and prospects. If you build an ecosystem of adjacent technologies and services, with services elevated above the infrastructure layer, you will be able to position your offerings as solution-oriented and, importantly, you will be able to make new offerings on a regular basis.

One way to offer new services — and raise your Enterprise Valuation in the process — is to leverage your operational tools by turning them from necessary evils (from a cost perspective) to service creators and revenue generators. Investment in tools consolidation has never been higher, given the increasing fluidity and complexity associated with virtual sprawl in the data center. Thanks to tools consolidation, MSPs have seen a reduction in customer onboarding costs, a lowering of remediation times, and a general reduction in headcount attributable per new customer. Offering modern tools to your operations teams becomes critical to creating greater efficiency — of both time and money. Those tools can pay you back doubly by creating new value-added services for your customers that can be meaningful revenue generators.

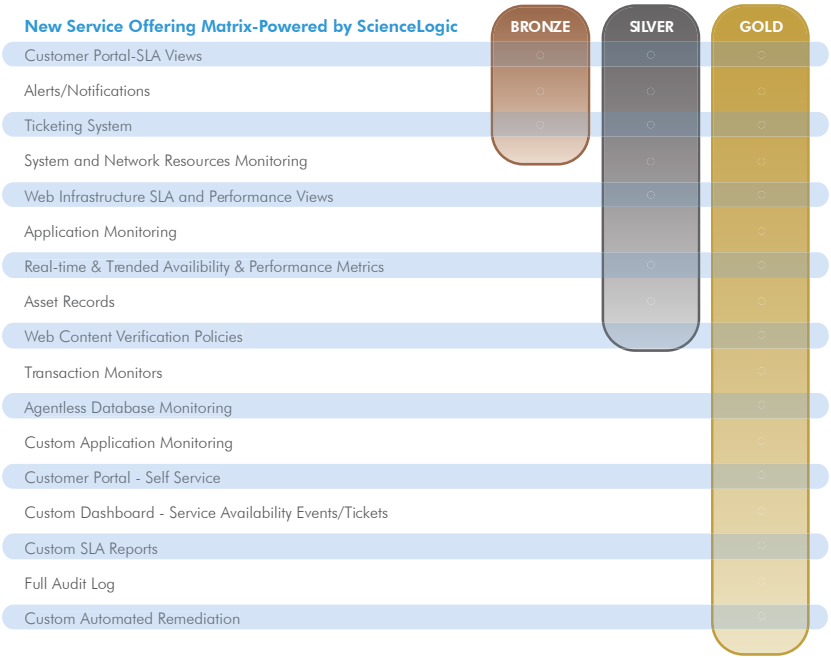

Figure 1: Differentiated services created by leveraging operational tools can generate new revenues and keep your offering portfolio fresh and varied.

Figure 1 shows a model commonly used by managed hosting providers to create differentiated monitoring and management services for their customers. Providers have also begun offering differentiated Cloud Infrastructure as a Service (IaaS) in silver, gold, and platinum levels with differentiated monitoring (levels of granularity, volume of devices, component mapping, ITSM service views, etc.), security, management level, and storage, among others. Additional revenue opportunities in the Cloud IaaS market can be gained by highlighting support once prospects become customers.

The trick is to keep your offerings fresh by adding new capabilities and services regularly so the buzz about the latest technology will also highlight your business because you, unlike your competitors, already have it available in your portfolio of offerings.

6. *Recognize Synergies in This Era of Consolidation*

Acquisitions, mergers, and consolidations are happening every day in every sector. However, the true values of many acquisition and merger transactions are not actually rising currently. So before you get involved in an acquisition, make sure you know what synergistic value you can bring to the table. Look for places to cut costs and streamline operations. Ask whether there are operational leases that can be closed out by either or both sides, and what the EBITDA contribution is to the buyer.

Lastly, listen to the market. What may be opportune for your business may not be a good time to buy or sell. Instead, put money away and keep taking advantage of the business and industry while you wait for a more favorable time to make your move.

7. *Spend Wisely for the Future*

Today's expenditures will have a major impact on how well or poorly MSPs fare in the future. Keeping audited financials makes it easier to raise capital or to sell, and helps you keep your investors informed ahead of time when you need a new facility or more infrastructure. You should know your financial health — down to the available capacity residual for the next customer, what your expectations are two years out, and how you will use capital.

For today, you should pursue options for reducing capital expenditures at every opportunity. Not surprisingly, the difference in capital expenditure to operational expenditure between different types of service providers is immense. Facility-centric providers are currently converting an average $.40 of capex into $1 of revenue, while managed hosting providers, like Rackspace, convert every $.69 into $1 of revenue. Conversely, not facing the same risks of overbuilding capacity, MSPs are growing faster than facilities providers because cloud and fully managed solutions continue to grab larger market share. Hence, the challenge for data center and managed hosting providers that are attempting to introduce new cloud services to market is to do so while containing their operational costs as much as possible.

In valuation parlance, the term "highly leveraged" is often thrown around to describe the ability to create high margins off high volume sales, with each new sale contributing less to fixed costs and much more to profitability.

More specific to the valuation of interest to a service provider in the cloud era, is the ability to assign a higher proportion of expenditures to fixed costs and a lower proportion to variable costs.

The injection of automation into manual workflows — now being found everywhere from the automating and provisioning of IT asset monitoring to Autoscaler and billing technologies — all have long-run operating expenditure consequences that will differentiate the winners and losers of tomorrow, as reflected increasingly in service provider valuations.

Improving Operational Leverage with ScienceLogic

What is the single thing you can do that will quickly and effectively put you on the path to achieving all seven steps? Since they are all interrelated, the seven steps rely on a set of IT tools that are powerful enough to raise your EBITDA, retain your customers and gain new ones, give you the metrics needed to turn those tools into new service offerings, and position you well to buy, sell, or plan wisely for the future.

EBITDA margins in the service provider space ought to be in the 7-10 times range for any healthy and growing managed service company. Above that, and you're in the range of leaders as previously discussed. Below that, and it's time to take a look at your EBITDA margins. The following simple example shows how ScienceLogic's tools can help improve your operational leverage and, thereby, your EBITDA.

PRODUCT OR SERVICE	PER MONTH FEE	PER MONTH FEE	EBITDA MULTIPLE
Managed Server (with Intel Xeon 3200 Processor, 40GB storage, 300 GB of data transfer, 4GB of RAM)	$150	$150	
Management/Support Services	$30	$30	
Subtotal Price of Managed Server	$180	$180	
Fully loaded cost of Business	$165	$165	
Pro rata EBITDA Margins	9%	9%	3 - 7x
Advanced Monitoring Margin (using numbers from actual ScienceLogic customers)	$20	$30	
Total Price of Managed Server	$200	$210	
Increased Top Line Revenue with Advanced Service	11%	17%	
Cost of ScienceLogic Software License (theoretical per device cost that varies with volume, etc.)	$12	$12	
New Fully Loaded Cost of Business	$177	$177	
New EBITDA Margins	13%	19%	7 - 10x
Realized Margin on ScienceLogic Software	67%	150%	

Table 1: Effects on managed services costs with and without performance management and monitoring tools from ScienceLogic.

Suppose you are a low-cost managed hosting provider offering managed hosting services with the operational costs shown in Table 1 (subtotal) and a starting EBITDA of 9%.

In this example, the addition of ScienceLogic's IT management and monitoring tools (at a cost of $20/month price for an advanced monitoring service and $12 per ScienceLogic license) improves the managed hosting provider's margins from 9% to 13% EBITDA at the low end, to potentially 19% at the high end. Simultaneously, the provider's marginal revenue moves from $180/month/device to $200-$210/month/device on average.

PRODUCT OR SERVICE	PER MONTH FEE	PER MONTH FEE	EBITDA MULTIPLE
Price of Managed Server with 5 vm's per 4-core server (price per vm)	$114	$114	
Management/Support Services	$69	$79	
Subtotal price of managed VM	$183	$193	
Pro rata Fully loaded cost of Business per vm	$156	$160	
Pro rata EBITDA Margins	18%	20%	7 - 10x
Advanced Monitoring Price (using numbers from actual ScienceLogic customers)	$20	$30	
Total Price of Managed Server	$203	$223	
Increased Top Line Revenue with Advanced Service	11%	17%	
Cost of ScienceLogic software license (theoretical per device cost that varies with volume, etc.)	$12	$12	
New Fully Loaded Cost of Business per vm	$168	$172	
New EBITDA Margins	21%	30%	10 - 14x

Table 2: Effects on Public Cloud Service with monitoring tools from ScienceLogic.

If the service provider customer has limited additional support fees, the advanced tool set allows for the introduction of a deeper SLA and increased revenue associated with premium support service offerings. At the high end, with an average virtualized environment of five VMs per server, advanced monitoring charged on a per virtual instance moves EBITDA margins from 18% to 21%, or even 30% at the high end, with marginally higher cost and price points (since hardware was further amortized into the cost component of the offering, but it has been mitigated by the costs of possible OS licenses, power, and/or support staff).

ScienceLogic's Resources Are Ready to Assist You

For more information on how ScienceLogic can help you bolster your MSP profitability by improving your operational leverage, expanding your service offerings, improving your customer retention and acquisition, and streamlining your overall performance management — all with the goal of increasing your Enterprise Valuation — please contact us at www.sciencelogic.com. You can also visit the Service Provider Activation Resource Center (SPARC) on our site to download free white papers, technical documents, presentation templates, and other descriptions for packaging up new services, and explore our go-to-market strategies and techniques for adding or expanding new cloud services.

ScienceLogic delivers the next generation IT monitoring platform for the network of everything. Over 15,000 global Service Providers, enterprises, and government organizations rely on ScienceLogic every day to significantly enhance their IT operations. With over 1,000 dynamic management Apps included in the platform, our customers are able to intelligently maximize efficiency, optimize operations, and ensure business continuity. We deliver the scale, security, automation, and resiliency necessary to simplify the ever-expanding task of managing resources, services, and applications that are in constant motion.

ScienceLogic won InfoWorld's 2013 Technology of the Year award, Red Herring's Global 100 Award, Deloitte's Technology Fast 500™, and MSPmentor 250, among other worldwide recognitions of excellence. For more information, visit www.sciencelogic.com.

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