PROFITABILITY

Pay It Forward

It's the old chicken and the, well, golden egg conundrum--does growth come before profits or vice versa? And more importantly, how do you attain both?

By **Heather Clancy** *CRN*
3:00 PM EDT Fri. Oct. 28, 2005
From the October 31, 2005 *CRN*

Which comes first, growth or profits?

Yes, this is a trick question that parallels the age-old chicken-or-egg query. But perhaps a better question would be: How do you achieve both?

Because the answer is that growth takes investment. And profitable growth takes disciplined investment. It forces ongoing attention to the types of vendor relationships a solution provider has forged. It requires a methodical approach to top-to-bottom business processes, and it lives and dies by the right hiring decisions.

If you re growing, this will affect your bottom line. Growth costs money. & Once you have profits, you have two choices you can invest in growth, or you can invest in the balance sheet, said Michael Fong, CEO of Calence, a Cisco Systems partner based in Tempe, Ariz.

You can t solve your profitability problems by growing revenue, echoed Paul Dippell, partner in Service Leadership, a consulting organization in Plano, Texas, that works with solution providers on strategic planning. Fix the model first, get into the profitability ranges, and then grow the business.

>> GROWTH COSTS MONEY. & ONCE YOU HAVE PROFITS, YOU HAVE TWO CHOICES YOU CAN INVEST IN GROWTH, OR YOU CAN INVEST IN THE BALANCE SHEET. --Michael Fong, CEO, Calence

Through its benchmarking research of approximately 650 solution provider organizations, Service Leadership has identified three primary models by which VARs, resellers and IT services organizations can be categorized, Dippell said.

The first, dubbed Product Resale, describes a company that relies mainly on product sales for 60 percent to 85 percent of its revenue. These companies tend to have higher annual sales and can yield from 0 percent to 5 percent earnings before interest, taxes, depreciation and amortization (EBITDA). Dippell said this is by far the most typical model today, with 50 percent to 60 percent of solution providers meeting this description.

The second model, called Project Services, refers to solution provider organizations that drive revenue through a series of definable projects that combine product sales and services engagements. Approximately 40 percent to 50 percent of revenue is tied to these projects, and EBITDA runs 5 percent to 15 percent. At this point, to get that much services, you are really selling your own brand name, your own quality, Dippell said.

The final structure, Recurring Services, is for companies that have tied at least 40 percent to 60 percent of their revenue to service offerings with a predictable, ongoing payment stream. You are not riding a wave of projects up and down. You have reason to call on that customer all the time. You know their systems and their politics, and you are more likely to snag the project business as a result, Dippell said. Recurring Services companies can yield 7 percent to 18 percent EBITDA.

Net profits often range from 1 percent to 2 percent on the Product Resale structure today and up to an average of 20 percent for the other two models, the Service Leadership research shows.

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Innovative Technology Solutions (aka IT Solutions) is one of the few companies founded with its feet planted firmly in the third model, Dippell said. The Princeton, N.J., company generates annual revenue of approximately $10 million. Over time, its project business has grown to about 20 percent of its run rate because the services team has been able to pinpoint specific problems during the course of its routine engagements, said IT Solutions President Dan Glazier. We report weekly on what we re doing for the client. We re able to answer the question, What have you done for me lately? We make it very visible to them, he said.

Glazier attributes his company s profitable growth directly to an internally developed project management system. We have a proven process that we can employ in different situations, he said. If our competitor or internal personnel could do it with 10 people, we can fix it with six.

Likewise, World Wide Technology, a network and systems integration company in St. Louis with close to $1.8 billion in annual revenue, has invested heavily in its IT and ERP infrastructure. Calence, meanwhile, has built out its knowledge, CRM and customer portal tools.

World Wide Technology CEO Jim Kavanaugh said his company s internal systems have led to the creation of a series of supply chain services for large telecommunications companies, enabling it to support large-scale buildouts on their behalf. Over time, this capability has been extended to support customers who aren t necessarily handling IT rollouts. During the next 12 to 15 months, the company will spend another $10 million to extend these systems, Kavanaugh said.

>> WE REPORT WEEKLY ON WHAT WE ARE DOING FOR THE CLIENT. & WE RE ABLE TO ANSWER THE QUESTION, WHAT HAVE YOU DONE FOR ME LATELY? --Dan Glazier, president, IT Solutions

The ability to manage our business on those types of programmatic and structural pieces of business helps us to level out and manage and focus the business, he said. The solution provider has seen its bottom line grow by an average of 40 percent and its top line grow by an average of 25 percent over the past five years, he said.

Pat Grillo, president and CEO of Atrion Communications Resources, a security solution provider in Branchburg, N.J., said his company is in the midst of its own model transition. Currently, about 75 percent of the $18 million that ACR generates annually is tied to hardware sales, but Grillo would like to see that shrink to about 50 percent. To do so, Grillo said he was forced to hire sales personnel who could create more cohesive messaging around its services lines. That decision is already paying off: ACR just reported its best month for services sales. And Grillo is continuing to invest. If I wanted to be shortsighted, I could be more profitable today and be out of business tomorrow, he said.

Don Eckrod, president of AAA Networks and executive vice president of its parent company Convergence Technologies, White Plains, N.Y., said one way his company has addressed profitability is by declining to break up solution proposals into pieces that can be bid out by price. Eckrod has ensured higher hardware margins for his network infrastructure offerings about 60 percent of AAA s sales are from products in the process. Part of the problem is that high-tech solution providers have conditioned customer prospects to believe that their architectural and process advice come for free, which has undervalued some fundamental IT services. You can blame our industry for not fighting for what is truly theirs, he said.

The good news is, the times they are a-changin . How can you resist the challenge to alter that perception, becoming more profitable in the process?

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