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THE PS BUSINESS MODEL

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OVERVIEW

TPSA, the Technology Professional Services Association (TPSA), was founded in September, 2005. TPSA is the industry's first association focused exclusively on the management needs of technology professional services providers. TPSA provides unique insights, models and best practices that address the industry's most complex and pressing business challenges, as well as venues that foster peer-to-peer networking and accelerated innovation.

In its first year, TPSA will be launching a perpetual industry benchmark study. This study will collect critical baseline data on all six disciplines of the PS organization: Services Strategy, Services Operations, Services Delivery, Services Sales, Services Engineering, and Services Marketing. The most critical portion of the benchmark study relates to PS business model data. To date, service executives have been extremely handicapped in their ability to acquire and analyze the financial data of technology professional services organizations. The TPSA Benchmark Study asks a series of business model questions designed to better define actual and sustainable business models for TPS organizations.

This document provides an overview of the importance of defining a financial business model for the PS organization. This document also details how TPSA will define the specific line items of the PS business model for benchmarking purposes.

DEFINITIONS

Corporate and Business Strategy

Before we can clearly define the term "business model," we must clarify the often misused term of strategy. A business model is the product of a specific business strategy, not the other way around. Also, a specific business strategy is driven by the overall corporate strategy of a company. These concepts and core linkages are often lost in business literature.

For the sake of productive dialogue on the concept of business model, it is important that TPSA use clear and concise terminology. To that end, we reference the work of Robert M. Grant in *Contemporary Strategy Analysis*. In this work, Mr. Grant clearly defines the two critical terms we are discussing:

- **Corporate strategy:** This is the result of a management team having determined what markets the company will pursue to make money. The process of setting corporate strategy is often referred to as "domain selection."
- **Business strategy:** This is the result of the management team having determined how the company will effectively compete in those chosen target markets. The process of setting business strategy is often referred to as "domain navigation."

Corporate strategy is set first. Where can the company make money? From there, the management team moves to business strategy. How do we need to operate to support our corporate strategy? **Figure 1** diagrams this universal model.

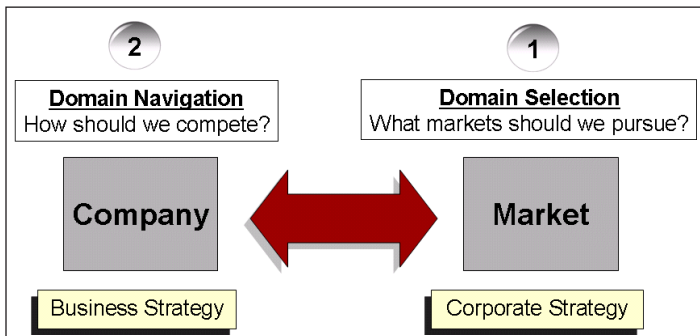


Figure 1: Corporate and Business Strategy

In terms of professional services strategies, both corporate and business strategies need to be considered. To define corporate strategy, a management team must answer the following questions:

- What markets do we want PS to pursue?
- What do we want PS to achieve in those target markets?
- What services do those markets need?
- How do those markets like to purchase professional services?

To define business strategy, the management team must answer the following questions:

- What is the financial business model for the services business unit?
- What financial objectives make sense?
- How will we differentiate our services offerings?
- What skills and positions will be core to the PS organization?
- What partners will we use?
- How will we scale delivery capability?

Business Model

When people think of the term “business model,” several concepts come to mind:

- Target markets
- Target customers
- Product and services offerings
- Distribution channels and sales strategies
- Margins
- Profits

A sound business model considers all of these items. In essence, a business model reflects and supports the business strategy of the company. The business model demonstrates how a company will manage all of these elements to grow and make money on a sustainable basis.

As a component of a business strategy, a business model defines the costs, investments, and profits required for the business. A successful model allocates the appropriate amount of investment in sales, research, and administration to achieve the corporate strategy, achieve market success, and hit target profitability. The business model should be realistic and sustainable.

Business models are not simply financial reports. A financial report summarizes anticipated revenues and expenses to show profitability. You could have extremely accurate financial reporting and still have no idea what your target business model should be.

For the purpose of creating meaningful benchmark data, it is important for companies to agree on the definition of each business model line item. The specific line items for a technology professional services business are documented in **Table 1: PS Business Model Definitions**.

Category	Common Abbreviation	Definition	Calculation
Revenue		Total revenues achieved by the professional services organization.	= Billed hours from direct staff + Billed hours from subcontractors + Third party product revenues recognized by PS
Cost of Services Sold	COS	Cost of materials and human resources that are required to deliver the services to the customer	= Cost of direct staff + cost of subcontractors + cost of third party products
Project Gross Margin	PGM	Difference between what customers pay for the services and what it costs the company to deliver those services	= Revenue – COS
Field Gross Margin	FGM	Gross margin achieved on services after the local overhead costs are subtracted.	= PGM – Field Costs <i>Field Costs = Indirect expenses of any administrative staff directly related to managing and supporting the service delivery function in that geography.</i>
Sales Costs	Sales	Total cost of all selling efforts— includes salaries and expense accounts and commissions for sales management, sales people, and sales support	= Services Sales staff salaries + expense accounts + commissions paid on service sales
Research & Development Costs	R&D	Investments made to improve services methodologies and delivery tools. Includes knowledge management infrastructure.	= Services Engineering staff salaries + Services Engineering program expense
Marketing		Investments made to market the services portfolio and services capabilities. Includes market research, marketing materials, trade show attendance, general advertising, and demand generation campaigns.	= Services Marketing staff salaries + Services Marketing program expenses
General & Administration Costs	G&A	General expenses not captured in COS, Field Costs, Sales, Marketing, or R&D.	= General management salaries + Services Operations salaries + remaining cost items not previously accounted for.
Operating Profit	OI	Profit generated by services. Also known as the operating margin or operating income.	= Revenue – (COS – Field Costs – Sales Costs – R&D – Marketing – G&A)

Table 1: PS Business Model Definitions

TPSA acknowledges that many services organizations may not classify their services expenses as defined in Table 1. However, if the industry is going to assemble meaningful benchmark data, it is imperative that data be normalized into consistent categories. Otherwise, it will be difficult for companies to compare their performance in any meaningful way.

THE 40/20 MYTH

Senior management teams often have a common assumption regarding technology professional services: PS is a fat business. How fat? Executives consistently seek gross margins of around 40% and operating profits of around 20%. What are these expectations based on? It is unclear. The answers provided by many companies to the following questions do not help unravel the mystery:

- Do you currently achieve 40% gross margins and 20% operating profits with your PS business? No.
- Have you ever achieved 40/20 from your PS business? No.

- Do you have hard data that other companies are sustaining 40/20 from their PS business? No.

Based on these answers, where do the expectations for a 40/20 business come from?

Industry Results

TPSA believes this 40/20 myth is a byproduct of how companies report their services revenues. In The Service 50, TPSA captures the publicly reported financial data for 50 of the largest providers of technology services. The average gross margin on services reported by these 50 companies in the October 2005 snapshot was 42%. This 42% average is driven by support services as well as professional services. However, the only reported number is a blended number that substantiates this 40/20 myth.

Mix Matters

In reality, a mature services revenue mix with more revenue coming from professional services (including managed services and outsourcing services) actually drives down the gross margin on services reported by a company. To prove the point, **Figure 2** documents the revenue mix reported in Novell's 10-Q dated 9/8/2005. As shown, the mix is heavily weighted in support services. This helps Novell report a healthy overall services gross margin of 58%. However, the PS portion of Novell's service mix (Celerant Consulting, a product of the Cambridge Technology Partners acquisition) reports an operating income of only 4.6%.

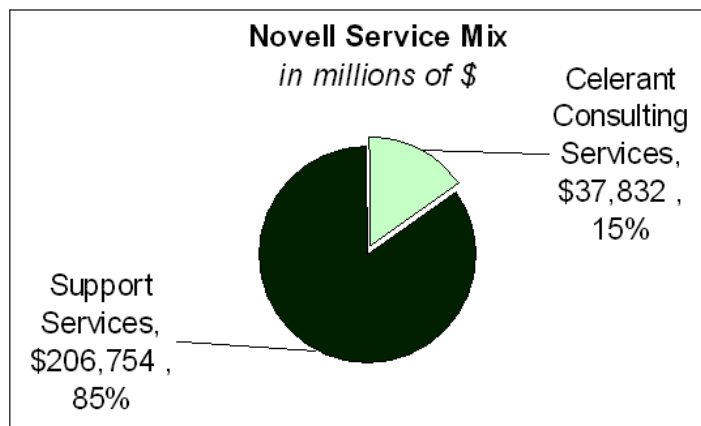


Figure 2: Novell Service Mix

As another example, Unisys has a very mature services revenue mix which includes integration, outsourcing, and managed (“Infrastructure”) services, as shown in **Figure 3**. Support services only represents 10% of total services revenues. This reality drives the blended services gross margins for Unisys down to 14%.

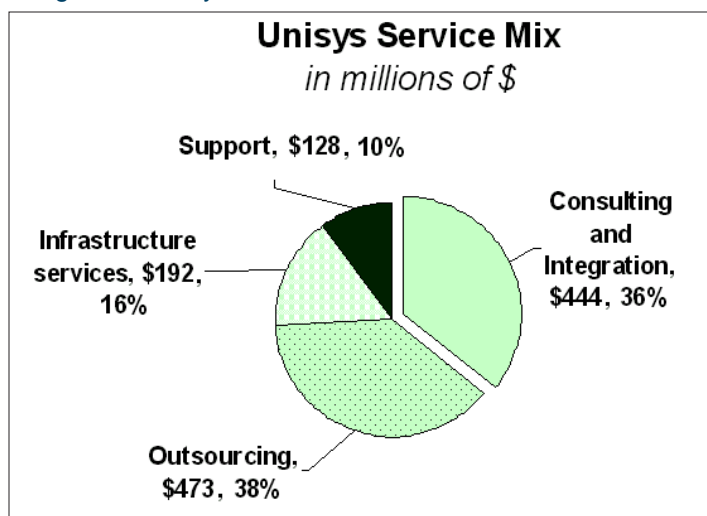


Figure 3: Unisys Service Mix

In summary, Professional Services activities appear to drag down total services gross margins. All this data substantiates the premise that PS is typically not a 40/20 business when it is part of a product company. But what does the business model look like?

SAMPLE BUSINESS MODELS

Example Business Models for Service Organizations

We now have a common understanding of the line items that make up a service business model. We have also defined the specific line items for the professional services business model.

Before attempting to define a viable financial business model for your technology professional services business, it would be helpful to understand what models already exist in the marketplace. Let’s begin this review by looking at Accenture, a global consulting firm with over 75,000 employees in 47 countries. Accenture performs the type of high-end technology and business consulting that many technology companies wish they could deliver. **Table 2** shows the financial results for Accenture in 2002 and 2005.

	Accenture 2005 (in millions)		Accenture 2002 (in millions)		Sample Business Model
	Revenue	Margin	Revenue	Margin	
Revenue	\$17,094	100%	\$13,105	100%	100%
COS	\$12,002	70%	\$8,428	64%	68%
Gross Margin		30%		36%	32%
Sales & Marketing	\$1,558	9%	\$1,566	12%	10%
R&D					2%
G&A	\$1,512	9%	\$1,616	12%	8%
Operating Income	\$2,111	12%	\$1,385	11%	12%

Table 2: Accenture Financial Results

In the far right column, we have reverse engineered a financial business model Accenture could be using. Accenture targets services that will bring in decent gross margins but it needs to invest heavily in sales and marketing to maintain its brand and secure large engagements. We make the assumption that some of Accenture’s G&A expenditures are actually R&D dollars invested in delivery methodologies.

A second model to review is that of IBM, the poster child of PS at product companies. **Table 3** shows IBM’s results for 2003 and 2004. What is interesting is how significantly different the IBM services business model is from Accenture’s. IBM’s services business brings in an average of 25% in gross margin. IBM does not report the allocation of G&A and Sales costs to the services business based on the percentage of total revenues services represented.

	IBM 2004 (in millions)		IBM 2003 (in millions)		Sample Business Model
	Revenue	Margin	Revenue	Margin	
Service Revenues	\$46,213	100%	\$42,635	100%	100%
COS	\$34,660	75%	\$31,903	75%	75%
GM		25%		25%	25%
Selling, G&A					10%
R&D					3%
Marketing					4%
Operating Income		8%		10%	8%

Table 3: IBM Global Services Results

Even with gross assumptions, the sample business model reverse-engineered in the far right column of Table 3 is significantly different from the one Accenture is probably operating under.

Next, consider the point most product companies start from: a support services financial model. A traditional support services business often commands healthy margins with minimal investment in sales and marketing. This is due to the fact that support services are a natural attachment to the product sales cycle. **Table 4** summarizes the target financial business model for a traditional support services business within a hardware product company.

	Support Services at a Hardware Product Company
Service Revenues	100%
COGs	60%
GM	40%
G&A	5%
Selling	5%
R&D	2%
Marketing	2%
Operating Income	26%

Table 4: Support Services Business Model

Three sample business models for three different services organizations: the variations are wide, with gross margins ranging from 40% to 25% and operating profits ranging from 8% to 26%. What is the right answer for a technology professional services organization?

Setting the Boundaries

We have reviewed example business models for services organizations and we have argued that Professional Services in a technology company is not the 40/20 business many executives feel it should be. Now, for the million-dollar question: What does a sustainable business model look like for professional services?

First, we should discuss the individual line items of the financial business model. **Table 5** provides target boundaries for each line item. The table also provides rationale for the boundaries.

Category	Common Abbreviation	Definition
Field Gross Margin	15% < Target < 40%	If less than 15%, PS can't sustain itself (no money left to invest). Difficult to consistently exceed 40% when asked to pull products or invest in critical company accounts.
G&A	5% < Target < 8%	If less than 5%, required infrastructure for PS is not created and maintained. Greater than 8% is a sign critical operational processes are not defined or are not being followed.
Sales	5% < Target < 8%	If less than 5%, services capabilities are not aggressively being sold to customers and channels.
R & D (Engineering)	2% < Target < 5%	If less than 2%, intellectual property is not being documented and leveraged to improve profitability.
Marketing	2% < Target < 5%	If less than 2%, services portfolio is not being positioned to the marketplace. Sales reps are forced to perform general awareness and generate initial demand.
Operating Profit	5% < Target < 12%	Within this range, PS is being asked to carry its own water. However, the organization is not being tasked to sustain unachievable profits.

Table 5: PS Line Items

Below the Line

If the business model does not account for ongoing investments, the PS function will not effectively manage the intellectual capital and human capital required to generate healthy margins. The question becomes "how much investment is required?" How much money should PS plan to invest in marketing, services development, sales, and infrastructure? Because companies do not typically report publicly these investments regarding their services business, it is very difficult to create a broad-based data set that helps bound this question. The TPSA Benchmark Study will specifically ask what percentage of services revenues companies are investing in services marketing, services engineering, etc.

In the twentieth century, product companies optimized business models that allowed them to produce capital goods and scale production capabilities to obscene levels. Companies that could scale product production cost effectively, won. In the twenty-first century, companies must apply the same level of discipline and enthusiasm to scaling specialized human resources. It is the technology companies that optimize their business model to scale services capabilities effectively that *will win*.