Introduction to Managed Services

A Publication of the CA Nimsoft MSP Center of Excellence
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Today, the managed services business model presents a huge opportunity, one that enables value-added resellers (VARs) and system integrators to offset shrinking margins on product sales, and to address increased customer demand for outsourced IT services. However, end-user anxiety, reseller uncertainty and lack of experience, and the tepid economic recovery are preventing solutions providers from taking full advantage of the opportunity. Further, as technologies continue to evolve with increasing rapidity, it can grow even more difficult for organizations to capitalize on the managed services opportunity.

What are managed services?
At the most basic level, a managed service provider (MSP) monitors and maintains a customer’s IT system on a regular basis and charges a monthly fee for the service.

The primary benefit MSPs provide to the customer is third-party monitoring and maintenance, which is designed to prevent unexpected interruptions in system availability. This increases system uptime, which ultimately increases employee productivity and therefore company profitability. The value to the MSP is the predictability of income and the consistent utilization of technicians, who are expected to forestall problems or discover them early, rather than relying on the customer to report an emergency. When the customer has a problem, the MSP is available to solve the problem, as part of the monthly fee.

Following are some of the common characteristics of managed services:

- In general, the customer owns or leases the system. Customers may run equipment on their premises or have it hosted off site, whether at the MSP’s data center or at another service provider’s or hosting provider’s facilities.
- The MSP may go to the customer’s site to perform services, but more frequently monitoring and maintenance are performed remotely.
- Services range from basic monitoring and maintenance to more extensive packages, which may include security, data storage and/ or disaster recovery, software and technology updates, document management, help desk response, firewall monitoring, intrusion detection and restoration of operations.
- With the introduction of the cloud, hardware is quickly becoming an afterthought. The MSP becomes a strategic IT advisor, averting problems and making recommendations regarding future technology needs.
A key difference between a VAR and an MSP is that the VAR’s emphasis is on selling the system; the MSP’s emphasis is on selling the service needed to keep the system running once it is installed.

The story gets more complicated

The definition of managed services has gotten more complicated. One reason is that customers are demanding more sophisticated services. As technology has become increasingly embedded with business functions (for example, electronic medical records (EMR)), the MSP’s functions have also become more intrinsic to the customer’s business. The MSP isn’t just keeping the system up and running for the business; the MSP may be running the EMR application.

The second complicating factor is how fast the modes of delivering IT services are evolving. The evolution from hardware to virtualized servers to cloud-based services is happening so quickly that watching the changes is almost like watching clouds—right before your eyes, they change shapes, move across the sky, morph from a shape that looks like a ship to one that looks like a rocket. Many companies are blending multiple modes of delivery into their service offerings.

Nonetheless, the MSP should start with the basic definition in mind: The customer’s system, managed and maintained on a regular basis for a monthly fee.
Managed services grow despite anxiety and uncertainty

Most managed services agreements fall somewhere between the most basic and the more extensive ends of the spectrum. Because the managed services model is only about 10 years old, parties on both sides of the agreement are still experiencing anxiety.

Customers are wary about entrusting critical operations to a third party, especially since it’s difficult to vet a service provider’s quality. The possibility of security lapses worry them—even though the majority say that alleviating security concerns is a major reason they are considering outsourcing. That hesitation is weighed against actual costs of maintaining an independent, in-house IT department and the lost opportunity costs associated with diverting IT staff from core business functions to system maintenance.

Resellers may be uncertain about how to add managed services to their offering, especially if it means sacrificing big-ticket equipment deals and emergencies that require hours of billable technician time to resolve. These individuals face the realities of shrinking margins on equipment and must weigh the need for consistent income versus the expense of developing the new competencies needed to meet managed services demands.

Despite those obstacles, industry research overwhelmingly supports the idea that outsourced IT service agreements are bound to become almost as ubiquitous as the public water systems that have largely replaced household wells. Following are just a few statistics that underscore this point:

- Sixty-two percent of the organizations surveyed for the report, “CompTIA: Trends in Managed Services, 2011”, reported plans to increase their spending on managed IT services in the next two years.
- In 2011, the technology research group ISG registered a record number of outsourced IT service contracts worth $25 million or more, with a collective value of $95.4 billion.
- IDC predicts the global IT outsourcing market will reach $133 billion in 2015.

The success of service arrangements, CompTIA found, was the specificity of the service level agreements (SLAs) in place. The most critical SLA elements are response times, 24/7 support, and data and systems security.

Why do companies need managed services?

Remember DOS, punch-tape back-ups, dumb desk-top terminals connected to a room-size mainframe, and IT services departments that consisted of a technician or two who scolded individual users for taking up too much memory by failing to empty their files frequently enough? Distant as they might seem, those days are only a few decades—not eons—in the past.

Comparing today’s computing power, storage capacity and software sophistication to those early days is like comparing cosmonaut Yuri Gagarin’s 108-minute orbit of Earth to the creation of the International Space Station. Goals, technology, funding, policies and politics have all changed so much,
it’s almost impossible to comprehend that one event led eventually to the other. Just as the world of space exploration has evolved from an individual rocket carrying one man into space for less than two hours, the world of technology has developed into a universe of its own, demanding fleets of experts to not only maintain the systems but to exploit them to full advantage. That’s why companies need managed services.

The following sections outline a few trends that are fueling increased demand for managed services.

**Business complexity**

The days when technology could be compartmentalized as a distinct function or department within a business are over. Technology is a foundational layer of operations, regardless of the type of business. Every business function—whether billing, record-keeping, payroll or resource management—is dependent on technology. Those are just the support systems. Revenue-generating activities are also tied into technology. Most industries rely on increasingly complex dashboards, tracking a matrix of business elements, such as manufacturing, inventory, shipping and sales. Productivity depends on real-time capability to maintain precise reporting and coordination between those functions. Even a minimal disruption in service results in operating losses.

**Erosion**

As technology evolves, technological relevance erodes. The half-life of today’s new technology is ever-shrinking. In other words, the IT system installed today loses value almost as quickly as a new car driven off the sales lot. Technology morphs so quickly that corporate IT departments are hard-pressed to keep up with the latest permutations, even as the technologies grow more indispensable to daily business. This has become one of the many drivers for cloud services.

**Accessibility**

At the same time that technology and business functions have become ever more enmeshed, modes of access are rapidly evolving. Technology is no longer tethered to a desk—or even a computer. Analyst firm Gartner predicts that, by 2016, at least half of enterprise email users will rely primarily on browser, tablet or mobile clients, rather than their desktops. At the same time, application development projects for smartphones and tablets will outnumber PC projects by a ratio of four to one. Mobility increases the demand for 24/7, worldwide accessibility and support services.

Look around the next time you exit an airplane. How many fellow passengers have pulled out their smartphones to check their emails, respond to text messages—or merely check the time, because they no longer wear a wristwatch? How many are uploading files created during their five-hour cross-country journey? In fact, with wireless Internet available on many airlines, how many were online and collaborating with their peers while flying?

As always, youth is a leading indicator. Check with any university student. Most no longer use email, barely know how to connect by telephone, and generally live by their smartphones—using them for morning alarms, directions to the hot band in town, downloading research, updating their Facebook status, tweeting their locations and posting video to YouTube. They make a dozen phone calls in a billing period, but rack up thousands of text messages or data downloads each month. This is not
merely a comment on youthful habits. Executives are only slightly less dependent on mobile applications than today’s adolescents and, on a larger scale, so are the companies that employ them.

**Regulatory compliance**

Even Vanna White, the letter-flipping star of TV’s Wheel of Fortune, would shrink from the onslaught of alphabet-and-acronyms soup that characterizes today’s regulatory compliance atmosphere. HIPPA, GLBA, PCI-DSS, SOX and the SEC, FOIA and FISMA—it makes an IT staff just want to go AWOL.

When President George W. Bush signed the Sarbanes-Oxley (SOX) Act in 2002, he called it “the most far-reaching reform of American business practices since the time of Franklin D. Roosevelt.” SOX regulates corporate governance, financial disclosure and public accounting practices, with hundreds of highly specific rules covering every aspect of business that could possibly generate a transaction or a record.

SOX is an IT nightmare. And SOX is just the king of the “Gang of Three”, a troika of laws requiring stringent corporate record-keeping and reporting procedures. The other two are HIPAA (Health Insurance Portability and Accountability Act), passed by Congress in 1996, and GLBA (Gramm-Leach-Bliley Act), passed in 1999. There are dozens of other laws governing the creation, storage and reporting of computerized records. Research and drug development in the pharmaceutical industry, is regulated by the FDA. The records of financial transactions in the credit card industry are governed by the Payment Card Industry (PCI).

The regulatory requirements are so sweeping, SMBs need sweeping solutions, including network, data and device security; and protection from intrusion, theft or disclosure. These electronic records all need to be analyzed, archived and made available for audit on an annual basis. Most companies do not have the IT staff, tools or training to meet the data storage and security responsibilities these regulations impose. Even if they could develop the expertise and hire appropriate staff, the costs are prohibitive—and disproportionately higher for small to medium businesses.

However, according to CompTIA, while many organizations need security solutions, fear of turning over sensitive information to an outside entity makes many decision makers hesitant to outsource security and reporting functions.

**Financial considerations**

Saving money is the number one reason customers turn to managed services, according to CompTIA’s 2011 report, “Trends in Managed Services”. The next three reasons all relate to costs: freeing up staff to focus on revenue-generating activities, gaining access to the newest technologies and improving security. Hardware, maintenance, continual certification of staff for new technologies and compliance mandates make keeping up with technological change incredibly expensive. These are all areas in which a managed service contract can reduce the customer’s cost of doing business.

If you tie in those factors with the benefits of cloud computing, which transforms technology from a capital expenditure (CapEx) to an operating expense (OpEx), the benefits are even larger. Computing capacity is expanded, allowing the in-house IT department to concentrate on strategic projects. Support functions are scaled as necessary through the MSP. The combination creates a perfect storm of financial benefits.
The City of Asheville, N.C., for example, took bids on a document management program that saves $100,000 over the cost of replacing its own, hardware-based system with something similar. The outsourced program accommodates twice as many users and provides more than double the storage capacity of the city-owned system. It will cost $12,000 a year more than maintenance of the existing system—but it would take almost nine years for that expense to eat up the $100,000 in capital savings.

Half the respondents in CompTIA’s 2011 survey reported saving between 1 and 24 percent in IT costs annually with managed services; more than a third saved between 25 and 49 percent, and another 13 percent cut their IT costs by more than half. Ironically, one of the biggest obstacles keeping companies from using managed services more heavily is confusion about how service agreements are priced. Creating clear and detailed service agreements is one of the key challenges facing MSPs today.

Why you need to offer managed services

Hardware and location matter less and less at the user level of technology. Just as individuals can roam on the wings of the Internet, technology is no longer tethered to the physical location of the end user. At the same time, that end user—whether it’s an individual at a small company, large enterprise, university or government agency—is dependent on ever more sophisticated software functions. Those users need their mobile devices to connect smoothly with one another from a variety of locations, and run that software flawlessly. When that doesn’t happen, they want immediate assistance.

This trend is accelerating. Mobile knowledge workers account for 70 percent of the American workforce, according to InfoTrends. Three out of four workers use more than one mobile device on the job, and approximately one third use three devices. A quarter of employees believe they are more productive when working at home, and more than two-thirds think regular attendance at an office isn’t necessary.

The U.S. government is moving from CapEx to an OpEx model. Federal agencies are required to purchase cloud-based IT services whenever that option is secure, reliable and cost-effective. One-fourth of the $80 billion federal IT budget is designated for “cloud first” systems, consolidating more than 1,000 data centers. The CIO Council, the CAO Council and the Federal Cloud Compliance Committee recently released “Best Practices for Acquiring IT as a Service.”

The first rule of business is to offer a product or service the market wants, one that you can supply at a reasonable cost and in a way that differentiates you from your competition. You need to offer managed services because, if you don’t, you may find you are selling the equivalent of an electric typewriter and a regular supply of ribbons.

Higher profit margins, increased stability

Beyond the market trends outline above, there are solid short and long-term financial considerations for increasing the percentage of services in your product offerings:
• In the short and mid-term, a mix richer in services yields net profits that average 15 percent, rather than the 6 percent typical of a reseller with a 90 percent hardware/10 percent services mix.
• Financing is easier to obtain for companies that can demonstrate recurring revenues.
• Labor costs for MSPs are lower, as are long-term inventory costs.
• Growth is more profitable for MSPs, whose net income increases with growth, than it is for resellers, whose net percentage is eroded by higher operating costs.

The average net income for a typical hardware focused reseller is 6 percent. Typically, that reseller relies on big hardware sales plus installations—which are sporadic. There are two problems with this model: The profit margin on hardware is low and the expertise needed for installation is high, meaning the reseller pays for technicians with multiple certifications who may be idle in the intervals between installations.

Compare that scenario to this one: The MSP with contracts that include monitoring, maintenance, security, telephony, email hosting and help desk response is receiving regular monthly checks. It costs less to deliver services than it costs to deliver equipment. Most of those services are not labor-intensive, nor do they require highly skilled technicians. The MSP’s net income average is 15 percent.

The monthly sums may be relatively low at first, but they arrive on the first of the month. Bankers love recurring income. MSPs have less need for outside financing (which eats into profits) but when financing is necessary, it’s easier to obtain. Plus, it’s hard to put a numeric value on the reduced stress level that comes from financial stability.

The MSP also has the advantage of continual interaction with the customer. When a problem comes up, “Who ya gonna call?” Not the reseller who stops in every three to five years to sell a new system. No, the customer is going to call Jane at MSP, Inc., who they talk to on a regular basis as part of their ongoing service relationship. Even if the problem isn’t Jane’s problem, she’s going to know how to solve it—or will call someone who can. When it’s time to upgrade, Jane has the customer’s ear.

Time to sell or retire?
As a well-run MSP, your company will be more attractive to potential buyers or merger partners. That’s particularly true if you have a strong portfolio of recurring services contracts.

Private equity firms want to invest in companies with at least 6 percent net income and annual growth of between 15 to 20 percent. MSPs are likely to have a higher net income and can afford the expenses that go along with that growth rate. A hardware-centric business struggles with that growth rate, because—unlike a services business—expenses rise when a reseller grows. In fact, growth often erodes the reseller’s net income percentage.

Investors use a formula to determine a company’s value. Taking into account various factors, they come up with a multiplier based on the company’s earnings before interest, taxes, depreciation and amortization (EBITDA). That EBITDA multiplier is applied to the company’s net income to determine its value. A strong services company benefits on both sides of the formula: first, it’s likely to have a higher net income. And if it has a significant amount of recurring contracts—income that’s locked in for two to three years, for example—the EBITDA factor will be higher.
Here’s a simplified example: Two companies have annual gross revenues of $5 million. The hardware reseller nets $300,000 (6 percent). The MSP has a net of $750,000 (15 percent). The investor multiplies the reseller’s income by a EBITDA factor of 4 (which is typical) and values the company at $1.2 million. Because the MSP has a portfolio of recurring service contracts—which means lower operating costs and higher profit—the investor bumps the EBITDA factor up to 6. The value of the company is $4.5 million—more than triple the value of the reseller.

**Figure B.**

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<th>Net Profit Averages</th>
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<td>Hardware</td>
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*He who hesitates is ... ?*

What’s stopping you?

The business reasons for developing a managed services offering are sound. The market is, by all accounts, robust. Still, CompTIA reports a mix of factors preventing VARs and systems integrators from taking advantage of the managed services opportunity.

Volatility is one factor. Cloud computing is taking shape like a thunderstorm over the Midwestern plains. A lot of resellers—35 percent of those surveyed—are waiting to see if it develops into a nurturing downpour or a twister that upends the MSP business model.

Some just say they are focused on other competencies, but uncertainty of one kind or another is also evident in reasons given for holding back. Lack of in-house expertise or skills is an obstacle for 17 percent of those surveyed, and the same percentage are unsure of the potential return on investment.

Twelve percent aren’t sure of how to enter the market, with a small group who aren’t clear on what the MSP model entails. Another 12 percent just don’t see the demand. Lack of support by vendor partners is the obstacle for 9 percent of those surveyed.
Conclusion

The ever-changing computing climate is both creating demand for managed services, as well as anxiety for both resellers and their customers.

Factors influencing customers’ desire for managed services include:

- Increased complexity of the technology universe, including rapid development of new mobile devices and applications that quickly erode the relevance of their current technology.
- The desire to save money by transforming capital expenditures (CapEX) into operating expenses (OpEx), which also provides more flexibility for nimble system upgrades.
- Federal laws and regulations with stringent record keeping and reporting requirements, which are beyond the capacity of most in-house IT staff.
- Concern over security from theft, intrusion or exposure of sensitive data, especially when so many devices used to access the information are mobile.
- A preference for putting in-house IT experts to work on revenue-producing functions, rather than business-supporting functions.

Benefits of the managed services model for resellers include:

- The ability to compete in a market in which hardware is becoming less relevant than software applications.
- The ability to offer a product and services mix that sets them apart from the competition.
- Higher profit margins and increased revenues, due to a richer mix of services and products. Lower costs related to growth.
- Easier availability of financing; bankers love recurring services contracts.
- The potential for higher value when it’s time to sell the company or merge.
- Predictability and consistency of revenues, as well as better utilization of technicians’ time.

Factors holding back customers and/or resellers from creating managed services contracts include:

- Fear of security breaches on the part of end users.
- A wait-and-see attitude by both parties regarding developments, especially in cloud computing, that might positively or negatively affect managed services agreements.
- Anxiety or uncertainty by resellers about what the managed service business model is, what it might cost to implement and whether they have the skills necessary to carry it off successfully.

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