



Cloud PBX Strategy

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Today's successful Cloud PBX service provider with annual sales in the upper quartile can do so with services revenue of under \$100 million; host fewer than a half-million seats; and have under 50 thousand customers. Any start-up in the cloud PBX market, whether an incumbent or challenger SP, has or will have ample opportunity to build a half billion dollar business over a five year period and can do so with fewer than 100 thousand customers.

Without any doubt the cloud PBX market is growing rapidly worldwide. At a point in the foreseeable future the cloud PBX industry, including public and private cloud, may exceed one-quarter of all PBX lines sold. This will equate to more than 11.5 million new lines sold annually, which is a substantial increase from today. Eastern Management has researched and analyzed the drivers underpinning this growth. The key forces are PBX obsolescence (i.e., businesses need a new PBX every 7-10 years); opex versus capex as the global economy mends; and customer interest in employee productivity improvement enabled by unified communications features such as mobility, collaboration, presence.

Many service providers (SP) are in the cloud PBX market. They have built track records, experienced successes and failures, and established certain best practices for others to follow.

When assessing the cloud PBX market it's useful to classify the SPs as either incumbents or challengers. Frequently companies of one classification have common traits or practices which may be adopted by their peers.

Incumbents for example already have an existing customer base, network, NOC, data center, practices, brand identity, OSS/BSS, and public policy expertise. Eastern Management Group classifies incumbent service providers by size as Tier 1, 2, or 3 companies. Thousands of incumbents exist worldwide including such well known carriers as AT&T, BT, Verizon, and Telus. Challengers are everyone else in the hosted PBX business and that includes companies such as 8x8, Comcast, and EarthLink. Challengers in the hosted PBX business include PBX vendors such as ShoreTel and Mitel.

Challengers have their own set of advantages. There are no allocated costs such as those which incumbents allot to all services, which can contribute to high prices and reduced margins. Challengers can create new practices quickly; launch new services quickly, and establish partnerships quickly. Challengers may face less bureaucracy and accelerate marketing practices with less friction than incumbents.

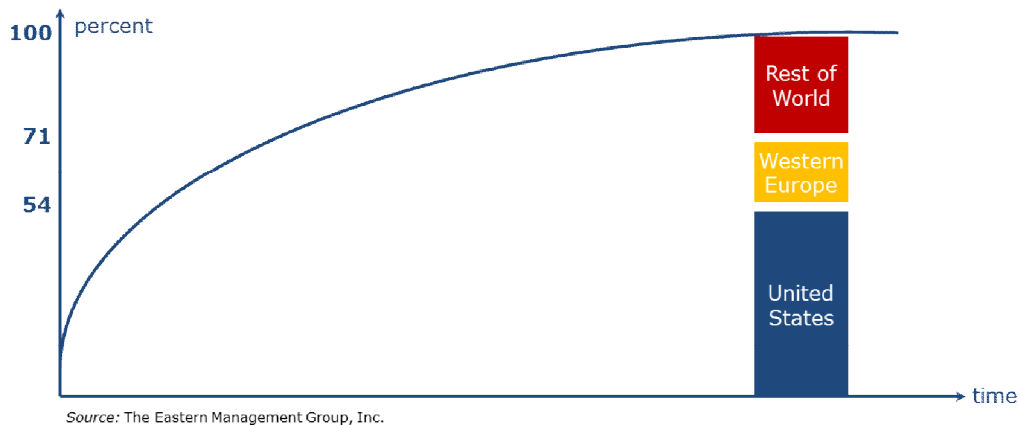
There are several reasons why cloud PBX is an attractive business for SPs. In the traditional premises PBX world there is a strong likelihood that once a customer buys a premises PBX, they will buy again from the same vendor since allegiance runs high. That leaves only a small opportunity for PBX vendors to dislodge competitors and grow market share, or for newcomers to establish a meaningful business from scratch, which is tantamount to a near impossibility. Cloud PBX, particularly hosted on the other hand is a greenfield opportunity for competitors. Comparatively few businesses have a hosted PBX today meaning that the market is almost wide open for service providers.

It is possible to build a large going concern with thousands of cloud customers, recurring monthly revenue, manageable churn, and no significant cash outlay if that's what the SP's business strategy calls for. The hosted PBX business is a flywheel capable of generating significant cash flow.

Cloud margins can be substantially better than what is possible in the premises PBX business. PBX equipment margins can be half that of hosted PBX. Hosted PBX applications delivered in the cloud also make the customer sticky, not just for PBX applications, but transport as well, which is a large problem for SPs facing intractable POTS line erosion.

The cloud PBX market is worldwide. North America accounts for more than half of what is sold globally, however over time we expect North America to cede share to the other world regions and settle at around 40% of global cloud sales.

Hosted PBX by World Region



Hosted PBX SPs may have differences from one to another although at times show considerable similarity. For example the number of seats sold to a new hosted PBX customer is fairly uniform across SPs and averages considerably fewer than 25 seats for the initial transaction. This contrasts to 75 stations which is the average for new premises PBXs, and is more in line with traditional key systems.

Features sold to customers on the first hosted PBX sale are fairly consistent from one service provider to the next. For businesses with fewer than 100 employees, SPs generally bundle similar sets of features.

Pricing models are fairly standard across SPs. Although on occasion seat prices can vary up to 100 percent for systems offering a similar feature set.

Where vendors differ from one to another may be dramatic and shows up in the differences in network, platform, OSS, BSS, response time, QoS and go-to-market strategy.

SP Cloud PBX Strategy Toolkit

Eastern Management Group uses a strategic review protocol for assignments where we advise service providers on cloud solutions. Below we will identify four major areas which typically require strategic analysis within the SP, call attention to what is entailed, and use examples from our service provider

consulting practice to make some key points. The four areas covered are Marketing, Technology, Go-to-market, and Finance.

Marketing – The cloud PBX business is not a new phenomenon. It began its wide deployment in 1961 using a central office technology branded as Centrex by the telephone companies. It may be said that today's cloud PBX is part of the evolution. Millions of customers have used Centrex (many still do) and after more than 50 years the idea of a cloud PBX, particularly hosted, is proven, durable, and not going away.

More than 100 service providers have established hosted PBX businesses today. That's a small number when considering the business opportunity. Today's successful hosted PBX service provider with annual sales in the upper quartile can attain such status with cloud services revenue of under \$100 million; host fewer than a half-million seats; and have under 50 thousand customers. Any start-up in the hosted PBX market, whether an incumbent or challenger SP, has or will have ample opportunity to build a half billion dollar business over a five year period and do so with fewer than 100 thousand customers.

Putting together a marketing analysis requires knowledge and understanding of the following:

- Total addressable market size
- Number of prospective customers
- Customer demand
- Marketing forecast
- Market opportunity for services, products, pull-through business
- Expected customer size
- Location
- Vertical markets
- Value proposition
- Customer willingness to pay
- Competition - (who are the peer competitors, product-service portfolio, territory, customers, pricing, market share, value, go-to-market, SWOT, competitive advantages, sales, CSAT, support, service terms)

You can't ignore the variety of approaches to the cloud PBX business that other SPs use. While some invest heavily in back office software (a large capex investment) so they will be well positioned to scale and reap higher gross margins per seat, others may forego the significant infrastructure investment and use another company's platform. Some SPs will have a field sales force and support staff while others depend strictly on inbound marketing tools and a call center. There are many different approaches to using partners, contracts, SLAs, outsourcing, NOCs and data centers; so knowledge of your peer competitors (not every competitor) is an important consideration. In our experience studying up to 10 competitors may be a worthwhile effort.

Technology – There are distinct approaches to technology. Here are several examples:

Some SPs want to sell a cloud PBX to large enterprises with multiple branches, and the SP may acquire a cloud platform, including equipment, software, and licenses for the data center. Some of these private cloud solutions support an end user's existing PBX investment without the need for fork-lift upgrades as branches are added to the service over several years. An example of a platform provider would be Cisco Systems.

Other SPs choose a different infrastructure route and deploy a hosted PBX solution platform from a specialty software provider. Many of these software approaches are suited to SPs targeting the SMB market. An example would be Broadsoft.

Some SPs invest in more than one platform types to meet the requirements of both large and small customers. This is not uncommon at Tier 1 SPs where one might find for example both Cisco and Broadsoft deployed.

Some SPs develop their own unique platform and may make this technology approach a key aspect of the value proposition. The end product may be better suited to the needs of the SPs customers.

White label is and will grow in popularity and although not a distinct platform technology, it represents a choice for SPs. An attraction to this approach is the build, operate, and transfer option.

Putting together a technology analysis entails addressing the following:

- System architecture
- Platform and suppliers
- Network and suppliers
- NOC
- Data center
- Practices (e.g., order entry, provisioning, service, maintenance)
- BSS
- OSS
- Product portfolio
- Ecosystem partners
- Warranty
- R&D

Technology requires considerable forethought and long term commitment to a strategy that is influenced if not completely driven by a commitment to a particular target market such as SMB or enterprise. A tier 1 service provider the size of an AT&T may want very small businesses, medium size businesses, and large enterprises for their cloud PBX service and recognizing the implications of different technologies for different markets make a commitment to a different platform for each.

We have seen companies in our practice that have found themselves hamstrung by earlier technology decisions. Consider the following example: SMBs often buy hosted PBX on price. This is particularly true of those with fewer than 10 employees which today are a large part of the hosted PBX customer base. While it is routine for an SP to want this business, being successful may require a distinct architecture to be competitive. But the infrastructure that enables an SP to profitably sell a service at \$10 per month per seat may be wholly inadequate or perceived as such when competing to win business from companies with 500 or 5,000 employees that expect more of a semi-custom and less of a shrink-wrapped cloud solution.

Go-to-Market – The issue of choosing people-over-software or software-over-people is evident in the go-to-market strategies of cloud PBX SPs.

Each of these extremes exists in abundance. It is expected that large enterprises prefer a high touch experience particularly for sales, customer service, network management, maintenance and repair. But they may not want such high touch for adds, moves and changes. High touch may be valuable when MPLS networks are involved, a mix of PBX and hosted PBX locations must be connected, multiple needs like CRM or ecosystems need to be implemented, and systems integration requirements exist.

SMB's requirements, expectations and willingness-to-pay may be different than enterprises. Some SMBs may be willing to accept self-provisioning or something close to shrink-wrapped, take mail delivery on telephone sets and self-install, and use a web portal for reporting trouble. Other SMBs prefer a person to work with and more hands-on involvement of the SP.

Putting together a go-to-market analysis entails decisions regarding the following:

- Channel
- Direct and indirect sales
- Channel partner, resellers, agents, distributors
- Dealer support
- Customer support (e.g., help desk)
- Maintenance and repair
- Contracts
- Vertical markets
- National Accounts
- Dealer support
- Discounts, commissions
- Programmatic tools
 - Front and back-end rebates
 - Deal registration
 - MDF & co-op dollars
 - Training
 - Certification
- Inbound marketing
- Branding
- Advertising
- Financing

A problem that some Tier 1, 2 and 3 incumbent telcos experience is the challenge to maximize sales of cloud PBXs in a competitive market. It is particularly evident at the enterprise level. Competition comes from formidable PBX manufacturers (and their channel partners) such as Avaya, Cisco, NEC and others; and hosted PBX vendors that may be already established in the enterprise market such as EarthLink, WestIP, or a Tier 2 SP. The principal business of numerous incumbent SPs is selling network services (e.g., NGN) and/or cellular; and not cloud PBX. The enterprise cloud PBX sales force may face budget issues in staffing and training. Channel partners which may be good selling equipment such as PBXs can pose their own set of issues to SPs who use them as partners, resellers and agents. They may be more inclined to sell PBX equipment (hardware/"boxes") with up front discounts and rebates instead of hosted PBXs where the incentives may be paid out over time.

Finance – Several of our clients, particularly incumbent SPs, have at times experienced difficulty getting their finance organization to make requested investments or follow-on investments in the cloud PBX business. We've observed more than one instance where a hosted PBX business case may project a ROI of say 25% only to find the SP chose an alternative use of capital offering perhaps a 26% return. Start-ups, public and privately held challengers may face different finance issues.

Putting together a financial analysis entails decisions regarding the following:

- Revenue forecast
- Customer forecast
- Pricing
- Churn
- Capex and opex
- Staffing and resources
- Financing and capitalization
- ROC
- ROI
- Budget
- Balance sheet
- Income Statement
- Regulatory matters
- Risk analysis

SPs should revisit their cloud PBX finance strategy annually to reassess both options and opportunities. While cloud is a small percent of the overall PBX market, we foresee the number as capable of moving to 25%. One implication is that such a large market projection attracts competition and ups or accelerates the forecast. However on the plus side opportunities will continue to surface for pull-through products and services; more large enterprises will move to cloud pbx; more SPs will probably consolidate; and investment will grow.

About Eastern Management Group Service Provider Consulting

We'd be glad to assist your company maximize its cloud PBX business potential. Eastern Management Group has worked with more than a hundred service providers on cloud projects, ranging from Tier 1 SPs in North America, Europe and Asia to others of various sizes on all continents. All staff members on our service provider consulting team have had SP careers, strengthening Eastern Management's ability to support your requirements. For more information on how Eastern Management Group may assist you contact John Malone at jmalone@easternmanagement.com at +1 212 738 9402 ext. 2201 or visit us at www.easternmanagement.com

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