ABSTRACT

The subscription economy is growing at a fast pace. The Nordic markets are at the forefront of this phenomenon and consumers in these markets are adopting subscription-based products and services faster than the rest of Europe. While subscription business seems to be about retaining subscribers, it is managed by different performance metrics from those used in traditional business models. Even within the subscription economy, nuances exist in terms of application of churn rate mitigation techniques, use of analytics etc.

This paper, first of a two-part series, looks at the subscription economy from the point of view of businesses operating in the industry and strategies being used by incumbents to succeed in it. Part two will look at subscription economy from the consumer's point of view

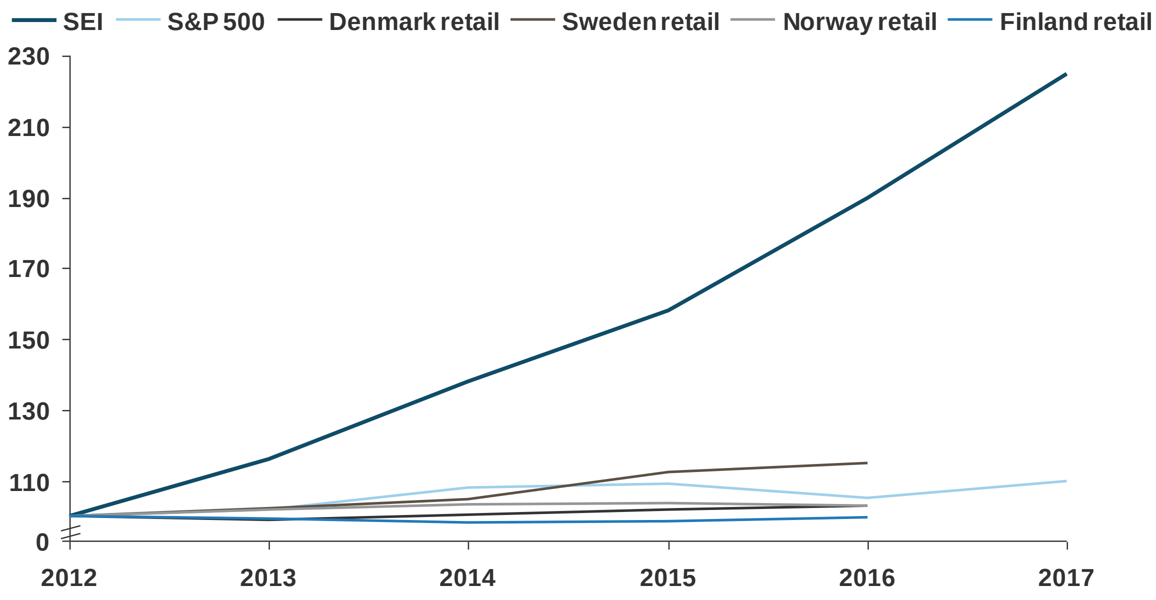
INTRODUCTION

Subscription is defined as an advance payment made to receive or participate in something. Simply stated, businesses in the subscription economy enable their customers, or subscribers, to pre-book a product, service, experience, or access a platform. Subscribers typically access this product or service on a regular basis and pay much less than what they would have paid, if the product or service had been purchased piece-meal.

Fig. 1: Growth of Subscription Model

REVENUE GROWTH INDEX OF SUBSCRIPTION VS. RETAIL[i]

The subscription business model has grown exponentially in recent years. Globally, the total number of companies offering a service based on subscription is estimated to be around 28,000. As shown in Fig. 1 below, in the past five years, revenue growth for subscription companies has outstripped that of the retail indices of the Nordics and global S&P 500 sales index. During Jan 2012 and Sep 2017, the SEI registered an annual average growth rate of 17.6% as compared to the S&P 500 which grew at merely 2.2% during the same time.



Source: Subscription Economy Index 2017, Zuora; Eurostat; MEC+ analysis

This global expansion of subscription companies and fast-paced growth is both a cause for and effect of the investments made into this sector. Over EUR 93 billion has been invested in companies in the subscription economy since 2011, because of which, there are currently 14 diverse product categories for which subscription services are available. Fintech, analytics, and marketing companies within the subscription business model have garnered the highest proportion of the total investment.

However, there are signs that the market is now slowing down; after consistent and robust growth from

2011 to 2015, investments into the sector declined during 2016 and stayed the same in 2017. This slowdown is attributable to four strategic challenges:

1. Market Saturation: Markets are getting flooded with several alternatives and many consumers have already taken up subscription services in popular categories such as media streaming and beauty products, making it difficult for new entrants
2. High Cost of Differentiation: Subscription businesses need to invest continuously and increasingly to retain a diverse customer base
3. Subsidisation: Due to high competition, it is increasingly imperative for businesses to subsidise prices, which impacts returns
4. High Consumer Expectations: Consumers expect subscription service to sustain their ability to offer variety or discounts over a sustained period.

SIZE & COMPOSITION

Out of the 28,000 companies, almost 3,100 offer subscriptions in the Nordics; but only slightly over 1,000 are based locally, i.e. over two-thirds of the subscription services operating in the Nordics are coming from global suppliers expanding to new geographies.

Subscription model-based companies serve both B2B and B2C markets. With over 65% of the total number of subscription companies based in the Nordics serving the B2B market, it is the dominant customer segment in the subscription economy. ~25% serve the B2C market and the remaining serve both B2B and B2C.

Subscription companies can be categorised into three types based on their offerings:

1. Physical goods; includes providing ownership or consumption of a physical good, e.g. a grocery subscription
2. Access-dependent; includes offering access to a service or platform (usually online/ digital), e.g. a video subscription
3. Person-dependent; an offering in which a service/product is tailored to the requirements of an individual and is non-transferrable, e.g. a fitness service

Among the companies based in the Nordics, most (92%) are access-dependent, followed by person-dependent (6%) and physical goods subscription companies (2%).

The second way to categorise companies is based on how they earn money. Digitisation has reduced the distribution, marketing and personalisation costs for businesses. As a result, companies are enabled to conduct data-driven customer targeting and pass on the benefits of cost savings to customers. While a combination of technologies and billing procedures are used, six broad categories of subscription companies emerge[1]. Fig. 2 below depicts the categories in which companies can be classified based on how subscribers are billed.

Fig. 2: Types of Subscription Companies by Billing Models

Model	Definition
Flat-rate Unlimited Usage	Product/services are provided at a fixed rate with no capping on the volume of usage by the customer
Flat-rate Limited Offering	Product/services are provided at a fixed rate with a certain cap on the volume of usage by the customer
Tiered Pricing Model	Services are offered with varied allowed usage volume or extent of services or both, usually in 3-4 different packages based on the type of target customers
Usage-based Billing Model	Customers are enrolled for a basic token fee and then charged for the products/services based on their usage volume
Freemium	Product/service is provided free of charge, but money (premium) is charged for additional features or services
Hybrid	Flat-rate or tiered pricing models are clubbed with usage-based billing, i.e. providing a certain extent or volume of services at a given rate and then charging over and above for any extra usage of the services

Source: MEC+ analysis

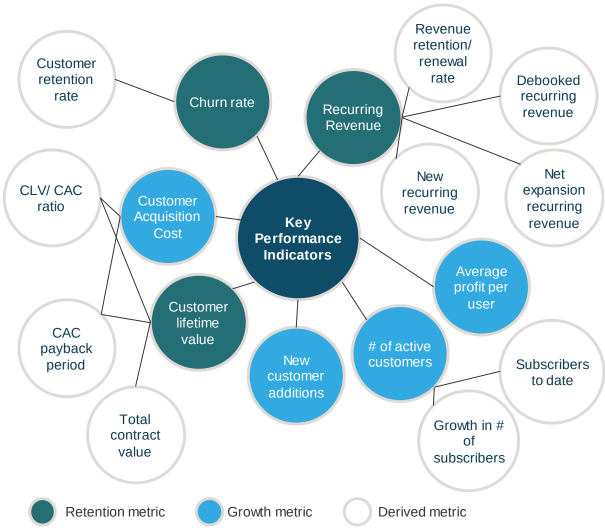
[1] Based on the analysis of billing models of 100 companies

METRICS

The fundamental difference between retail and subscription models is that while the former is based on ad-hoc purchasing and total revenues, the latter relies on pre-planned purchasing and recurring revenues. As a result, metrics that are used for measuring and increasing growth in subscription business are based on retention of customers. Hence, rate of churn, rate of customer acquisition, and cost of customer addition are popular metrics used by subscription businesses. Fig. 3 outlines the key performance indicators used to measure retention and growth of businesses in the subscription economy.

Although balanced performance on all parameters is essential for ensuring success in a subscription business, some are more critical than others. As shown in Fig. 4 below, the top-four success parameters observed across sources are customer churn, monthly recurring revenue, customer lifetime value, and customer acquisition cost.

Fig. 3: KPIs for Measuring Performance of Subscription Business



Source: MEC+ analysis

Fig. 4: KPIs and Success Parameters

Category and KPI		Description and Perceived Importance in Determining Success	
Universal	Churn rate	% subscribers leaving every month. Should ideally be less than customer acquisition rate	60%
Universal	Monthly recurring revenue	Sum of revenues from recurring product plans, excluding all one-time, non-recurring payments such as setup costs and/or professional fees	50%
Fiscal	Customer lifetime value	A prediction of the value a business will receive from an on-going customer relationship over a defined period of time	50%
Fiscal	Customer acquisition cost	Total cost of sales and marketing spent to acquire a single customer	45%
Fiscal	Average profit/ user	Average percentage of profit that remains after deducting costs for the product/service from revenue	40%
Customer Growth	# of monthly new users	Number of new subscribers added per month	15%
Customer Growth	# of active users	Running sum of net subscriber count (# of subscribers acquired minus # of subscribers churned) during a given period	35%

Source: Case studies; Investor reports; Primary Interview; MEC+ analysis

Furthermore, the specific nature of customer engagement or business model being followed can increase or decrease the relevance of a metric. For instance, customer lifetime value or customer acquisition assume a higher relevance for businesses following unlimited usage models at flat rates such as music subscriptions, video on demand, etc.; while monthly recurring revenue is of higher relevance for businesses with major initial investments, such as SaaS.

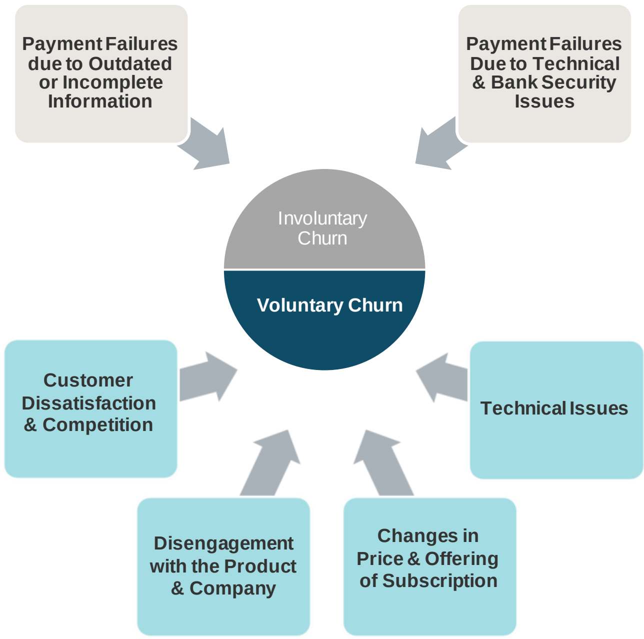
Nevertheless, churn rate is the most important metric for subscription companies.

CHURN: TYPES & MITIGATION

Churn rate is defined as the proportion of customers that a subscription business loses on a regular interval: monthly, quarterly, annually. As shown in Fig. 5, churn rate comprises two distinct parts; voluntary churn and involuntary churn.

Voluntary churn is attributed to low customer satisfaction, disengagement with service, pricing issues, and/or aggressive competition. Involuntary churn occurs without the customer taking a conscious call to move away from the business. Payment failure – due to various reasons such as outdated information, network issues etc. – is a common cause for involuntary churn.

Fig. 5: Types of Churn and Its Drivers



Source: News articles and press releases; Market reports; Zuora; Technology companies; Primary Interview; MEC+ analysis

Companies focus on variations of three broad strategies to reduce voluntary churn: communication and engagement, offering more features, offering more discounts. Substantial effort goes into identifying the optimal level of discounts, communications, and features that drive retention for a business for a specific customer segment. A three-step approach is taken to ascertain the best-fit solution for mitigating voluntary churn:

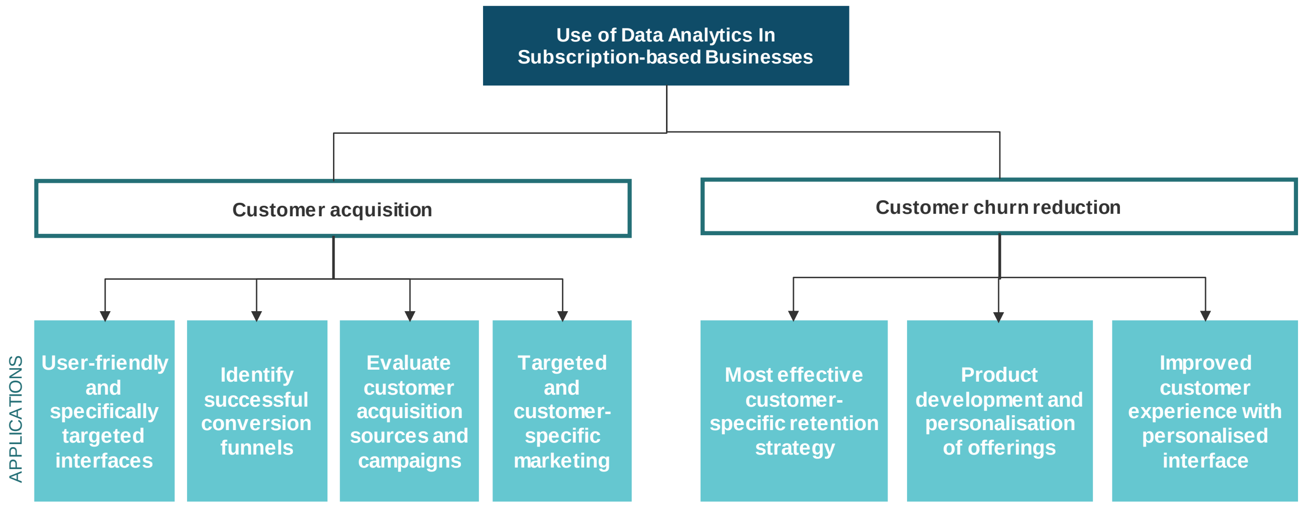
1. Analysing churn data in the context of customer feedback to create a hypothesis on root cause and mitigation
2. Sequentially offering mitigation mechanisms to identify real cause
3. Using personalisation and data analytics to ensure that the solution can be pre-empted for remaining customers

Comparatively, involuntary churn is usually mitigated through the automation of billing, updates, and communication with customer.

USING DATA ANALYTICS & PERSONALISATION

Businesses in the subscription economy are extensively using data analytics and personalisation to acquire new subscribers and mitigate churn. Data analytics involves collation, categorisation, and analysis of data pertaining to customers' interaction with the subscription service. Its application areas include identification of successful subscriber conversion funnels by focusing on targeted marketing, enhancing customer experience, and driving automation. Personalisation enhances subscribers' experience on the platforms by customising the interface of the platform and/or the offering.

Fig. 6: Data Analytics in Subscription-based Businesses



Source: News articles and press releases; Analytics companies; Primary Interview; MEC+ analysis

Analytics and personalisation are getting increasingly accurate as more consumers sign up to services.

The current focus of analytics companies catering to subscription businesses is to automatically generate mitigation offerings and to build deeper insight into consumer behaviour by knowing the context in which the consumer is using the service.

THE ROLE OF PAYMENTS

A subscription business' payment requirements are significantly different compared to those of a retail business.

For a payment solution to be effective in a subscription business, it should be:

1. Flexible enough to support recurring and pro-rated billing, adjust mid-cycle changes etc.
2. Able to offer subscribers a choice by supporting multiple currencies and payment modes
3. Secure and easily integrated into the business' platform

Thus, when it comes to subscription businesses, a payments solution is much more than a simple platform for monetary exchange. By being flexible and diverse, it can prevent voluntary churn. On the other hand, a secure and easy-to-integrate solution prevents payment failures and thus, involuntary churn. On the flip-side, a poorly chosen payment solution can hamper growth despite a well-crafted product and pricing strategy.

CONCLUSION

The subscription economy is as complex as it is vast. An appreciation of the nuances of the subscription business model, both external and internal, is essential to success. Subscriber retention, the silver bullet for ensuring success in the subscription economy, is not a singular strategy. Rather, it is a high-level goal for which companies need to identify specific interventions relevant for their subscriber base.

The next paper in the series outlines subscriber insights; what does the subscriber base look like, what do subscribers want, how does a Nordic subscriber compare with others etc.

[i] All indices take a base value of 100 on January 1st, 2012 and grow in proportion to the quarterly increase in the one year trailing total sales that they measure; SEI includes subscription business sales of companies that use Zuora services (Billing and finance platform).