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# Subscription Based Services

# The rise of subscription-based businesses

Subscription-based services have been around for a while—for more than a century, in fact. They are an integral part of consumer spending. Most of us are used to paying a yearly flat fee or a monthly fee to get something in return, from magazines to cable television.

An overall consumer desire to simplify life has led more people to pay for the convenience subscription-based services offer. This trend has been an economic boon for existing and startup businesses that are early adopters of selling goods and services through subscriptions. In 2014, Zuora, a subscription-based billing company, estimated that 15 million companies in the United States and Europe were already using or “could embrace” the business model.<sup>1</sup>

This Blue Paper® will explore the history of subscription-based services, why the business model has gained popularity, the pros and cons of adopting the model, and how to start a subscription-based business.

## Centuries of subscribers

The first of what we now know as subscription-based services made their debut in the 1700s with wealthy people gaining status into clubs or organizations.<sup>2</sup> Today, these clubs, such as country clubs or yacht clubs, still exist. We think of the dues as membership fees, but in essence, their members “subscribe” to be included on the roster in return for a service or access. In 1881, a more tangible service, the Theatrophone, was introduced to wealthy people who were willing to pay to listen to five minutes of an opera performance via a telephone line.<sup>3</sup>

As time went on, more subscription-based services were born, from magazines to everyday staples, like coal, milk or ice, all delivered to homes on a regular basis. Today, a significant portion of the population is entertained by subscription cable television or music streamed from a mobile device. In addition, more and more products—as opposed to just services—are being purchased through a



<sup>1</sup> Hutzler, Kyle. “The Rise of the Subscription Economy.” *The Huffington Post*. *TheHuffingtonPost.com*, 10 Mar. 2014. Web. 31 July 2015.

[http://www.huffingtonpost.com/kyle-hutzler/rise-of-the-subscription-economy\\_b\\_4548866.html](http://www.huffingtonpost.com/kyle-hutzler/rise-of-the-subscription-economy_b_4548866.html).

<sup>2</sup> Burkhart, Dan. “Understanding the New Boom in Subscriptions.” *AllThingsD*. N.p., 27 Mar. 2013. Web. 03 Aug. 2015. <http://allthingsd.com/20130327/understanding-the-new-boom-in-subscriptions/#>.

<sup>3</sup> *Ibid*

subscription. According to a May 2015 report, 18 percent of consumers buy products by subscription.<sup>4</sup>

Here are just a few companies, along with their core product, that have experienced phenomenal growth using the subscription-based model:<sup>5</sup>

- Trunk Club® (men's clothing): Started in 2009 and was purchased by Nordstrom in 2014 for \$350 million.
- Birchbox® (beauty products): Had 1 million subscribers at the end of its first five years in business in 2015.
- Dollar Shave Club® (men's razors): Launched in 2011 and reached 1.7 million subscribers by 2015.
- The Honest Company® (natural baby and home products): Valued at \$1 billion in 2015 after just three years in business.

## What's to like about the model

Consumers are buying into subscription-based services and products for two primary reasons: saving time and money.

In the daily juggling that is life, consumers who sign up for a subscription service or product like the fact that they don't have to think about continuous repurchases.<sup>6</sup> The product comes to the door, oftentimes before it is needed and without any extra effort.

Customers also like the convenience for monthly budgeting, as subscriptions are purchased at a flat rate. Customers enjoy even more value because many subscriptions are bundled, saving consumers more than buying services or products à la carte.<sup>7</sup>

Finally, customers like the control they have over subscriptions—they can upgrade or change their preferences, either for the subscription itself or for the company, at any time. Or, they can cancel the service all together.<sup>8</sup>

The fact that this control is not always practiced by consumers is the primary reason businesses like adopting a subscription-based model—it offers predictability, especially in sales and revenue. Subscription-based businesses also

<sup>4</sup> Super Subscribers: Disrupting the Subscription Services Model. Rep. Lewisville, TX: Blackhawk Engagement Solutions, 2015. Print.

<sup>5</sup> Speisman, Hal. "Subscription-based Companies Find Success." BBB Consumer News and Opinion Blog. N.p., 9 July 2015. Web. 03 Aug. 2015. <<http://www.bbb.org/blog/2015/07/subscription-based-companies-find-success/>>.

<sup>6</sup> Longanecker, Chuck. "Why You Should Use a Subscription Business Model." Entrepreneur. N.p., 19 Mar. 2015. Web. 31 July 2015. <<http://www.entrepreneur.com/article/243573>>.

<sup>7</sup> Ibid

<sup>8</sup> Burkhardt, Dan. "Understanding the New Boom in Subscriptions." AllThingsD. N.p., 27 Mar. 2013. Web. 03 Aug. 2015. <<http://allthingsd.com/20130327/understanding-the-new-boom-in-subscriptions/#>>.



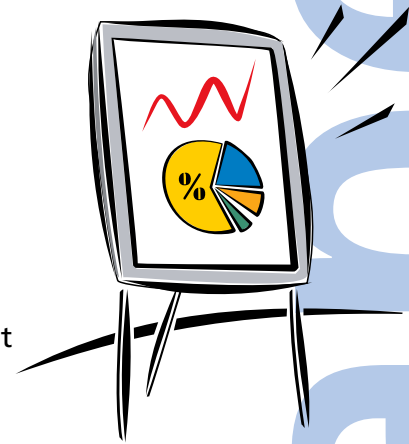
have more ability than other business models to calculate the lifetime value of a customer, manage inventory and offer uncomplicated pricing options.<sup>9</sup>

## Entering the market: The good and the bad

The ability to forecast revenue is just one benefit of adopting a subscription-based model. Not only is recurring revenue a benefit for business forecasting, it's also a benefit to business valuation. A business with a high percentage of recurring revenue will be valued up to eight times that of comparable businesses with little or no recurring revenue.<sup>10</sup>

Other pros include:<sup>11, 12</sup>

- **Saving money on retaining customers.** While retention is less expensive than recruitment, this obvious benefit cannot be overlooked.
- **Forming long-lasting customer relationships.** A consistent customer base allows a business to better understand the wants, needs, likes and dislikes of its customers. This makes for better products and services. In addition, customers who hear from you often—like when a product arrives monthly—are more apt to speak highly of you in social circles, both face-to-face or over social media. In fact, the exclusive feeling subscribers get—that “being part of the club” feeling—makes them more likely to rave about the business’ products or services.<sup>13</sup>
- **Testing new products.** Distributing a box of products each month allows businesses to add samples of new products or up-and-coming products from vendors. Selling more products naturally leads to bigger profit margins.



Of course, every business model has its drawbacks. Entrepreneurs or existing businesses considering a subscription-based model may find entry into the market has challenges:<sup>14</sup>

- **Not all consumers like contracts.** Signing up for a free subscription trial is easy, but remembering to cancel it when it's no longer wanted is not. Therefore, many people avoid the scenario, making customer

<sup>9</sup> Longanecker, Chuck. “Why You Should Use a Subscription Business Model.” *Entrepreneur*. N.p., 19 Mar. 2015. Web. 31 July 2015. <<http://www.entrepreneur.com/article/243573>>.

<sup>10</sup> Burlingham, Bo. “Subscription Services: The Perfect Business Model?” *Inc.com*. N.p., 22 May 2014. Web. 31 July 2015. <<http://www.inc.com/bo-burlingham/why-john-warrillow-is-all-about-subscription-services.html>>.

<sup>11</sup> Burkhart, Dan. “Understanding the New Boom in Subscriptions.” *AllThingsD*. N.p., 27 Mar. 2013. Web. 03 Aug. 2015. <<http://allthingsd.com/20130327/understanding-the-new-boom-in-subscriptions/#>>.

<sup>12</sup> Ludin, Josh. “The Pros and Cons of Running a Subscription Service - Bplans Blog.” *Bplans Blog* N.p., 01 July 2014. Web. 03 Aug. 2015. <<http://articles.bplans.com/the-pros-and-cons-of-running-a-subscription-service/>>.

<sup>13</sup> Speisman, Hal. “Subscription-based Companies Find Success.” *BBB Consumer News and Opinion Blog*. N.p., 9 July 2015. Web. 03 Aug. 2015. <<http://www.bbb.org/blog/2015/07/subscription-based-companies-find-success/>>.

<sup>14</sup> Ludin, Josh. “The Pros and Cons of Running a Subscription Service - Bplans Blog.” *Bplans Blog* N.p., 01 July 2014. Web. 03 Aug. 2015. <<http://articles.bplans.com/the-pros-and-cons-of-running-a-subscription-service/>>.

recruitment difficult at times.

- **Businesses must maintain value.** This is true of all businesses, but subscription-based businesses have the added burden of appealing to the same customers month after month.
- **Competition is growing. Fast.** Because the entry into the market is low (more on that next), businesses are jumping on the bandwagon, leading to oversaturation in some markets.

## Why growth? Why now?

Businesses and consumers have met at an intersection where businesses are moving toward creating a predictable revenue stream and consumers are looking for more choices.

At the same time, the ability to buy and sell products and services online has catapulted the recent boom of subscription-based businesses. From newspapers to cloud-based software to application-based services, businesses have taken advantage of ongoing—and less expensive—digital trends. After all, it is cheaper to start and sustain a digital business than it is to produce physical products or maintain a store front.

Consider what has changed in just the past 10 years:<sup>15</sup>

- There has been a 100-time reduction in the cost of software infrastructure. What would have cost a startup business \$100,000 per month 10 years ago can now be purchased for \$1,000 per month.
- File storage costs are 16 times less.
- The cost of Internet bandwidth “transit” has gone down 75 times.
- Free, open-source software has replaced costly licenses.

## Developing a model

You’ve decided you’d like to know more about starting a subscription-based business, or maybe you want to add the model to your company offerings. Even though the field is filling fast, opportunities are plenty. Your business may fit into one or more of these models:<sup>16</sup>

- **Membership website:** Providing insider information via the Web works best in niche markets where members can learn and interact with one another.



<sup>15</sup> Burkhart, Dan. “Understanding the New Boom in Subscriptions.” *AllThingsD*. N.p., 27 Mar. 2013. Web. 03 Aug. 2015. <<http://allthingsd.com/20130327/understanding-the-new-boom-in-subscriptions/#>>.

<sup>16</sup> Zwilling, Marty. “Subscription Business Models Are Startup Favorites.” *The Huffington Post*. *TheHuffingtonPost.com*, 1 Mar. 2015. Web. 03 Aug. 2015.

<[http://www.huffingtonpost.com/marty-zwilling/subscription-business-mod\\_b\\_6779336.html](http://www.huffingtonpost.com/marty-zwilling/subscription-business-mod_b_6779336.html)>.

- **All-you-can-eat content:** Much like Netflix® or Hulu®, access to regular content retains subscribers.
- **Private club:** If you have a service or experience with limited supply, consider making it a subscription for those seeing status offerings. The challenge is to sell customers on its rarity.
- **Front-of-the-line:** This model is for customers who will spend money not to wait in line. This model can work for business IT services as well as hotels.
- **Consumables:** If you have a product that naturally runs out, like diapers or beauty aids, a subscription-based business may be right for you.
- **Surprise box:** If you have multiple varieties of a food product, customers may be willing to subscribe for the delivery of monthly varieties.
- **Simplifier:** Business owners and home owners alike are looking for ways to simplify their lives. How about signing them up for regular services in cleaning or maintenance?
- **Network:** Do you have an idea in which the benefits increase as more people join? It works for dating and car-sharing services.
- **Peace-of-mind:** These services alert people when there is an issue. They exist to tell you if your child walks out of a “safe zone” or if your website is down.

Stephen Rapoport, founder of subscription-based Pact Coffee, says customers are more apt to buy if they are able to pull the product toward them rather than having it pushed at them.<sup>17</sup> To get customers to pull, Rapoport suggests your subscription product act like a vitamin or a painkiller—improve lives or solve problems.



## What about professional services?

Chuck Longanecker, a San Francisco Bay-area entrepreneur, suggests that now is the time for professional service providers, like Web designers, marketers and financial advisors, to get into the subscription-based market. He did so with his user experience firm, Digital Telepathy, where subscribers pay a flat rate rather than fees for individual services or projects.<sup>18</sup> The result? A 300 percent increase in revenue.

Longanecker says a primary benefit to professional services is much like the

<sup>17</sup> Rapoport, Stephen. “How to Launch a Subscription Based Start-up - Virgin.com.” *Virgin.com*. N.p., 25 Feb. 2015. Web. 03 Aug. 2015.

<<http://www.virgin.com/entrepreneur/how-to-launch-a-subscription-based-start-up>>.

<sup>18</sup> Longanecker, Chuck. “Why You Should Use a Subscription Business Model.” *Entrepreneur*. N.p., 19 Mar. 2015. Web. 31 July 2015. <<http://www.entrepreneur.com/article/243573>>.

benefit of any other model—you can forecast revenue and needed resources. For the provider, it's also less work in the long run. No longer is there a need for scope changes or writing up recurring contracts. Subscribers feel secure in knowing resources will be available even though their needs may change. This all results in a better relationship between provider and client because the goal is no longer a deliverable—it's an objective.

## How to get started

You have an idea you are sure will succeed with a subscription-based model. Now what? While the new model may be worth it, getting there won't be easy, especially if you are an established business.

Adobe® realized a few years ago that it had to transform its software business to a subscription model in order to stay alive.<sup>19</sup> Through the process, its leaders learned they had to “rethink virtually every aspect of the business,” from packaging to culture.

According to those who have studied or developed the business model, several initial steps await those who want to get into the business:<sup>20, 21</sup>

- Step 1: Imagine the business or model already exists. Who are your ideal customers? What would they buy? For how long of a time would they buy it? Ideal may not necessarily equal large. Instead, consider profit margins and ease of delivery.
- Step 2: Track the reasons customers contact you. This list should span the past three to five years. Then, imagine how you would respond to these inquiries under the subscription model.
- Step 3: Model the model. In other words, develop a concept of what you would offer, when you would offer it and to whom. Base your assumptions on what you determine from the first two steps.
- Step 4: Do some fine tuning. Now that you have a concept, does your model include too many elements so that you won't attract enough customers? Eliminate them. Could you add tiers—or varying levels—of service to make it attractive to more customers? Include them.
- Step 5: Set a price. The easiest way to start is to add up how much a customer would pay à la carte for all of the services included in each tier of the model, then provide a discount. It may feel uncomfortable to discount



<sup>19</sup> Horwitz, Lauren. “Subscription Models Are Upending Business as Usual.” *SearchCRM*. N.p., 22 Sept. 2014. Web. 03 Aug. 2015.

<sup>20</sup> Warrillow, John. “How To Start a Subscription Business.” *Inc.com*. N.p., 25 Mar. 2015. Web. 03 Aug. 2015. <<http://www.inc.com/john-warrillow/how-to-start-a-subscription-business.html>>.

<sup>21</sup> Zuora Content Team. “9 Keys to Building a Successful Subscription Business.” *Academy*. N.p., n.d. Web. 31 July 2015. <<https://www.zuora.com/academy/guides/nine-keys-building-successful-subscription-business/>>.



your services, but remember that you are making up the difference by no longer having to market to existing customers. Another strategy is to determine an ideal price point and set tiers above and below it. As time passes, learn from your customers and adjust as needed.

- Step 6: Skip your A and B customers. Don't roll out the model to your best customers, or even your second best customers. Instead, propose the model to your C-level customers. Fine tune the product until they buy, and then move up the customer ladder.
- Step 7: Use multiple sales channels. Customers expect to sign up for a subscription on their own time, their own way. Make sure sales can happen whether a customer wants to use a desktop computer or a mobile device, or wants to talk with someone directly.
- Step 8: Make it the only option. Once you have A- and B-level customers on board, consider turning off the à la carte option in favor of exclusively providing subscription-based services.

## Accounting: A cautionary tale

A minimum of nine models from which to choose. Low entry costs. Consumers hungry for convenience. Even entrepreneurs with the least appetite for risk may be thinking that starting a subscription-based business is a no-brainer. And then accounting comes along to raise a flag.

On the surface, it may seem that billing for recurring products or services should not be difficult. But, what about the "what ifs?" What if customers change their subscription preferences in the middle of a billing cycle and you are left to prorate? What if the credit card "on file" fails? What if you are unsure of the tax rate on your product or service? What if you are unable to track products' churn rates?<sup>22</sup>

The following accounting challenges face entrepreneurs implementing a subscription-based model:<sup>23</sup>

- **Recognizing revenue.** Subscription-based businesses have been around long enough to be addressed by Generally Accepted Accounting Principles (GAAP). However, not all revenue recognition situations are clear, and some may require judgment as to the correct revenue recognition.
- **Taxes.** Will you be able to keep up with changes in tax code and state tax rules? Are you able to determine what is taxable (products are taxable, services generally are not) or where it is taxable (if you are crossing state lines)? Selling internationally magnifies these issues.

<sup>22</sup> Vodnik, Craig. "Top 6 Challenges with a Subscription model." *VentureBeat*. N.p., 4 Nov. 2014. Web. 03 Aug. 2015. <<http://venturebeat.com/2013/11/04/subscription-model-challenges/>>.

<sup>23</sup> Ibid

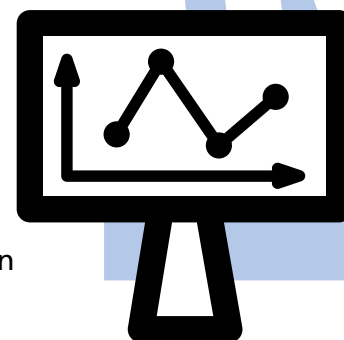




- **Credit cards.** You will need a plan should customers pay with prepaid cards that run out or credit cards that fail.
- **Compliance.** And, speaking of credit cards, if you keep payment details for renewal billing, you are subject to Payment Card Industry (PCI) regulations. You can eliminate this issue by outsourcing your payment process, although setting up payments for international customers can be more difficult and costly. Setting up recurring payments and keeping card information on file is especially tricky for subscription-based businesses because some customers may not initially understand they are going to be billed routinely and because you are on the hook to capture customer consent if you need to change billing amount or frequency.

It may be logical to think that once customers buy subscriptions, they stick with the product or service as it was sold to them during the life of the contract. In reality, subscriptions change over the lifetime, causing ripples in a business' accounting system, according to Zuora.<sup>24</sup> Tracking these changes and generating monthly financial statements can be difficult, so businesses owners need to determine how to streamline accounting before they end up piecing reports together by hand.

Zuora also suggests that business owners set up a dashboard of key performance indicators specific to subscription-based businesses. These include annual recurring revenue, customer retention rate, recurring profit margin and growth efficiency index, which is defined as the cost to get \$1 in additional annual recurring revenue.



## Patience is a virtue

You've chosen your model and set a price. You've crossed your t's and dotted your i's with accounting. The final step of the startup process is to be patient. If you are already in business, keep in mind that this is a change—you are asking your customers to form a new habit. And that's just what buying a subscription becomes—a habit.

Once established, habits are hard to break. But, have you thought about the last time you tried to make a habit of something? It's difficult, isn't it? As a subscription-based business owner, your job will be to help customers build a new routine. And, Rapoport says you can't do it without a product or service being so valuable, customers can't live without it.

<sup>24</sup> Zuora Content Team. "9 Keys to Building a Successful Subscription Business." Academy. N.p., n.d. Web. 31 July 2015. <<https://www.zuora.com/academy/guides/nine-keys-building-successful-subscription-business/>>.

“A good subscription is one where, if you removed that subscription aspect, your customers would actually be irritated—they’d be disappointed, and they’d call for it to be brought back, not collectively breathe a sigh of relief,” he said. “To achieve this, you have to listen really intensely to what your customers want, and go and build it for them.”



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