EXECUTIVE SUMMARY

Service Leadership Index® 2022 Annual IT Solution Provider Industry Profitability Report™

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Introduction

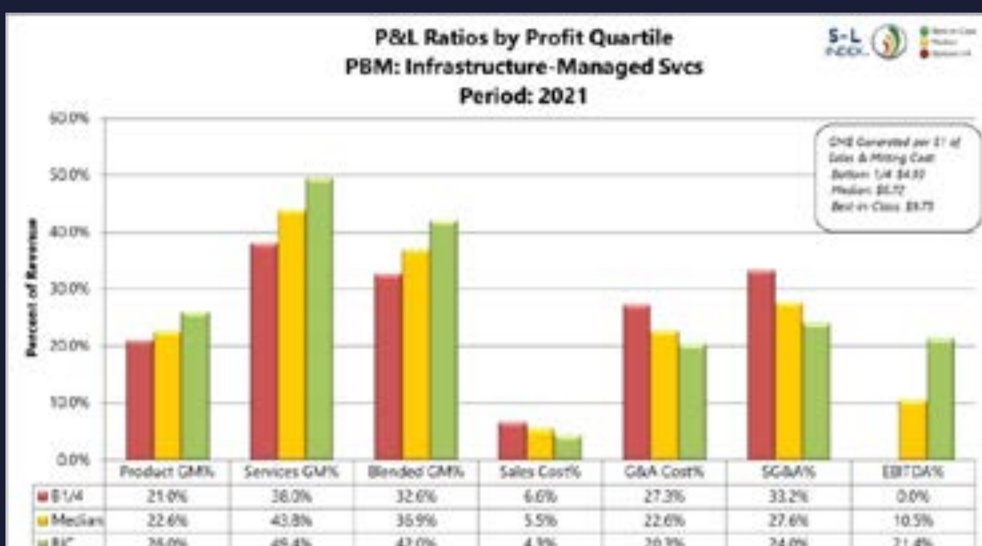
The Service Leadership Index® 2022 Annual IT Solution Provider Industry Profitability Report™ is recognized worldwide as the "IT solution provider industry encyclopedia of performance." This report provides a wealth of information about the health and viability of the IT solution provider (TSP) industry, by Predominant Business Model™ (PBMs™ also known as business models such as managed service provider (MSP), Product-Centric also called value-added reseller (VAR), etc.).

This executive summary is based on the Service Leadership Index 2022 Annual IT Solution Provider Industry Profitability Report.

In this executive summary, we will be referring to TSPs as having the financial performance of Best-in-Class (BIC), Median and Bottom Quartile (Bottom ¼), which mirrors what is in the report.

- BIC is defined as having profitability in the top 25% most profitable TSPs.
- Median profitability is the level for the 50% of TSPs in the middle, between BIC and Bottom ¼.
- Bottom ¼ or B¼ profitability is the performance level at which 75% of TSPs are more profitable.

Here is an example of a chart in the report showing the three quartiles.



To get the full report, click **here**.

About the Service Leadership Index®

Since 2005, the Service Leadership Index has been the largest, most detailed and most accurate TSP benchmark in the IT industry worldwide. This year (2022) marks the 17th year of benchmarking to objectively identify best practices and "set the bar" for TSP owners and executives, including in 102 countries.

17 Years

Service Leadership Index benchmarked TSP owners and executives

MSPs in 102 countries benchmarked with the Service Leadership Index

State of the TSP Industry

31% of TSPs founded 30+ years ago

50% founded 25+ years ago

Private equity-funded TSPs have further accelerated the growth in average size of TSPs, particularly MSPs.

82% TSPs under $10mm in revenue

69% TSPs under $5mm in revenue

For TSPs, 2021 was an impressive year financially as they continued to rise to the challenge of enabling their clients to continue to work from home and increasing security while navigating the same challenges in their own businesses.

Across all PBMs, BIC EBITDA was 21.1%, a slight decrease from the record-setting 21.4% in 2020. Median and Bottom ¼ TSPs finished at 9.7% and -.6% EBITDA, respectively. Both are the strongest on record (while clearly still underperforming).

In addition to working from home in 2021, TSPs had to deal with severe supply chain and employee staffing challenges while COVID government relief programs ended.

Last year (2021) was also a record-setting year for TSP mergers and acquisitions (M&A), driven significantly by TSP owners advancing in age and looking at an exit strategy. As of 2021, 31% of TSPs were founded 30 or more years ago, while about 50% were founded 25 years ago or more.

Thus, many "first generation" IT company owners are in their late 50s to 70s and are actively planning the succession of leadership and ownership needed to extract the required value for the next phase of their lives.

The advent of private equity-funded TSPs also impacted M&A in 2021 and accelerated the growth in the average size of TSPs, particularly MSPs. However, while the average MSP has increased in size, the industry is still dominated by smaller companies—82% of TSPs are under $10 million in revenue, and about 69% are under $5 million.

State of the TSP Industry (continued)

Revenue Growth

For all PBMs, 2021 was a year of profitability growth, even exceeding strong revenue growth. Revenue grew 8.8% from 2020 while Adjusted EBITDA grew 13.5%. Not surprisingly, BIC firms grew the fastest.

For MSPs specifically, overall revenue growth was a remarkable 16% with a 15.5% growth in EBITDA. This provides further evidence that high growth does not need to mean low profitability, quite the opposite for the BIC.

It is important to note that MSP top-line revenue growth would have been higher for the BIC had they not also been terminating low-profit clients. Carefully terminating low-profit customers while winning new higher-profit ones is a sign of high operational maturity.

For VARs, they have only experienced revenue growth of 0.7% over the last two years. However, while a small fraction of total revenue, cloud resale for VARs grew an astonishing 453.4% in 2021, which is a testament to the rapid and sustained move to work from home.

All PBMs

8.8% revenue growth

13.5% Adjusted EBITDA growth

BIC firms grew revenue the fastest proving that growth does not need to mean low profits.

State of the TSP Industry (continued)

Impact of COVID-19

When the world went into pandemic lockdowns in March 2020 due to COVID-19, TSPs worked around the clock to rapidly and securely transform their customers' IT infrastructures to support employees suddenly working from home.

To help TSPs survive, various government financial aid programs were created. Most significantly in the U.S. was the Paycheck Protection Program (PPP). Interestingly, these financial aid programs made only a minor contribution to 2021 TSP profitability. (The PPP loans were provided in 2020 and loan forgiveness happened in 2021 for most TSPs; this moved PPP funds from the balance sheet to the income statement in 2021.) Most profitability was not because of aid programs, instead it was due to:

- Significant cost control measures taken by many TSPs in mid-2020. It's interesting how much cost can be cut from a TSP business without the much-feared "inability to take advantage of a rebound." No one could have conducted a cleaner test case.
- An astonishingly sharp rebound of the economy that continued through 2021.
- Continued work-from-home and security issues that fueled increased demand for IT outsourcing.

It is important to note that while our results showed many TSPs ultimately didn't need the aid programs to survive, many of their customers did. TSPs only experienced customer downsizing or temporarily suspending purchases, and not a large number of customers going out of business. The TSPs themselves were able to survive the dramatic contraction and expansion.

MSPs

Of the 21.4% adjusted EBITDA earned by the top quartile in 2021, only about 1.6% was attributable to government aid programs.

VARs

Of the 15.9% adjusted EBITDA earned by the top quartile in 2021, only about 0.7% was attributable to government aid programs.

State of the TSP Industry (continued)

Impact of Supply Chain Issues

Like most industries, the IT industry has felt the impact of supply chain issues. In 2021, many TSPs were left with approved orders from clients yet could not fulfill the procurement. This particularly impacted many VARs and Project-Centric firms because they were left with idle resources when their project engineer team had fewer products to install and fewer projects to complete.

For VARs, 2021 was a roller coaster ride. In Q1, they had a slow performance due to supply chain difficulty. In Q2, there was a significant increase in revenue due to sold product arriving; however, the second half of the year saw another drop due to continuous supply chain constraints. While impossible to quantify, undoubtedly, this constraint slowed revenue growth rates and negatively impacted profits.

MSPs had their share of problems but not to the degree of VARs. However, like VARs, they would have had even bigger revenue growth rates and profits if it were not for supply chain issues.

For TSPs, especially VARs, results were impacted by extreme supply chain issues

Roller coaster ride for VARs

Q1: Slow performance due to difficulty getting products from vendors

Q2: Significant increase in revenue due to sold product arriving

Q3 & Q4: Drop due to continuous supply chain constraints

Valuations in 2021

2021: Highest company approximate valuations on record

29% ↑ from 2020 indicates strong health of the industry

A primary motivation behind any TSP owner going into business is to create value—for their customers, vendors, employees, and ultimately for themselves. High-performing TSPs tend to have a clear value creation strategy regardless of whether their exit date is three or 30 years; lower-performing ones tend to have no value creation strategy.

Unsurprisingly, 2021 saw the highest company approximate valuations on record, showing a 29% increase from 2020. This indicates strong results for the industry as a whole.

The average TSP's approximate stock value (based on Service Leadership's Solution Provider Value Creation Planner™) grew from about $3.2 million to about $7.1 million from 2017–2021, a CAGR of 22.0%. This is attributable to higher revenue, higher EBITDA dollars, a larger percentage of recurring revenue dollars, and increasing valuation multiples in the market.

MSP and VAR Trends

Budget Trends

The Annual Profitability Report shows that the MSP community is extremely optimistic in its projections for 2022. After budgeting 12% revenue growth and achieving it with 12.4% revenue growth in 2021, MSPs are budgeting 19% revenue growth in 2022, a 64% increase over 2021. Additionally, they are budgeting around a 40% growth in their overall net operating income. This optimism should be tempered because in 2021 they had budgeted 27.7% net operating income growth while achieving only 12.6%.

On the other hand, the average VAR is budgeting 2022 to attain 68.2% more net income dollars.

They plan to do this by increasing revenue growth of 12.2%, and increasing sales, general, and admin spending by only 7.7%, thus increasing gross margin dollars (GM$) production by 15.8%.

MSPs Optimistic About 2022

19% average MSP budgeting for revenue growth

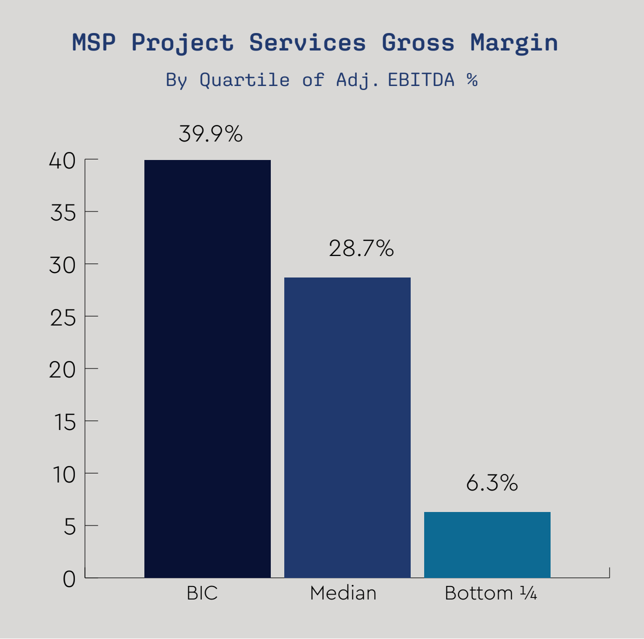
↑ 64% over 2021 budgets

Budgeting best practice: Set the budget prior to the start of the year and do not change it regardless of the magnitude of subsequent micro- or -macro economic challenges.

MSP Gross Margin Trends

The blended (product and service) gross margin for BIC MSPs was 42% compared to 36.9% for the Median and 32.6% for the Bottom ¼. Part of the reason for this difference was that the BIC sell services for a 5.6% higher gross margin and a 3.4% higher gross margin than the Median.

Upon a closer review, another reason lies in how MSPs generate project services gross margin. One of the most dramatic contrasts between BIC and Bottom ¼ in 2021, was in project services gross margin. BIC is at 39.9% compared to the Median and Bottom ¼ at 28.7% and only 6.3%, respectively.



This is due to the BIC firms effectively using quarterly business reviews (QBRs) to harvest projects from their managed services client base, thus keeping their project team(s) [the majority of the cost of goods sold (COGS)] busy. In contrast, the Median and Bottom ¼ firms are struggling to produce a great gross margin percent (GM%). To fix this, they should:

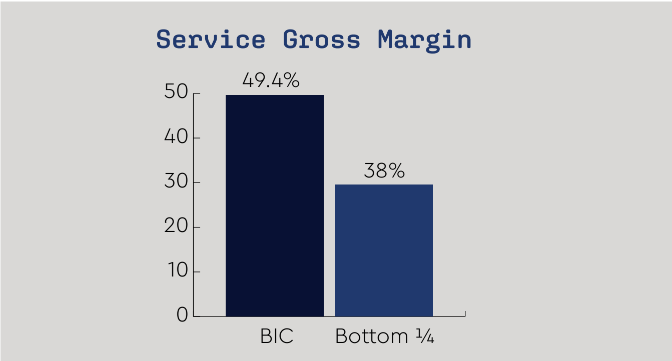
- First, drive up operational maturity in the predominant line of business to benefit the practice's profitability.
- Second, apply basic best practices, such as raising prices, reducing discounts, driving standards, condensing geography, changing compensation plans, and so on, to drive profitability and growth.

MSP and VAR Trends (continued)

Service Gross Margin Trends

For most TSPs, service gross margin is their most important metric to drive profitability. This is especially true for MSPs, as most of their gross margin comes from the service side of the business.

BIC MSPs had 49.4% service gross margin versus 38% for the Bottom ¼. Put another way, for every $1 of service revenue, the BIC kept around an additional 11 cents of profitability versus the Bottom ¼ because of their overallefficiency in service delivery.



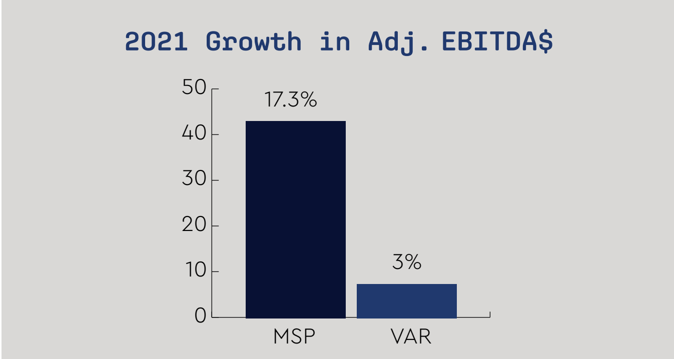
For every $1 of service revenue, BIC kept around an additional 11 cents vs. the Bottom ¼ quartile

Profitability Trends

A best practice to improve profitability is to grow sales and marketing and general and administration spending at half the pace of gross margin growth. Unfortunately, neither MSPs nor VARs were able to do this in 2021. However, both managed to restrain selling, general, and administrative (SG&A) growth to slightly less than gross margin growth (Figure 1).

	MSP	VAR
Sales & Marketing $	12.1%	4.4%
General & Admin $	16.2%	4.5%
Total Expenses $	15.1%	4.5%
Gross Margin $	16.4%	6.3%

Figure 1



For MSPs, the overall net result of growing gross margin at a higher pace of 16.4% then the pace of SG&A growth of 15.1% contributed to the 17.3% growth in Adj. EBITDA$ in 2021 over 2020. For VARs, the net result of 4.5% SG&A growth and 6.3% GM$ growth was 3.0% growth in Adj. EBITDA$.

Impact of Sales Structure and Productivity on Overall Profitability

You must assess the overall sales and marketing operation when evaluating how BIC TSPs structure their sales team to produce higher productivity. In short, the results show that the BIC sales teams are selling on value and not price.

BIC sales teams selling on value, not price

Sales Productivity

Gross Margin Dollars Spent on Sales

The BIC MSPs sold almost twice as much gross margin per dollar spent on sales ($9.75) as Bottom ¼ ($4.93) and almost 1.5 times as much as Median performers ($6.72).

For VARs, the BIC generate $6.94 of gross margin for every dollar of sales cost. Both the Median and Bottom ¼ have much lower GM$, only $3.71 and $3.05, respectively.

Part of the higher result of the BIC is from more efficient selling, richer offerings, higher prices, and delivering at lower cost.

BIC MSPs and VARs sold almost 2x GM per dollar spent on sales as Bottom ¼ in 2021

Building Sales and Marketing Teams

Part of the higher result is also from how the BIC structure their sales and marketing teams. The most common model among the lower-performing MSPs (which leads to the lower sales per dollar spent described above as well as slower growth and customer satisfaction) is to have hybrid "hunter/farmers" roles. Having the salesperson "keep" the accounts they win seems "fairer" to them and "preferred" by the client. But once the sales rep has enough accounts to make the living they want, they rarely have the time or motivation to do much hunting, which leads to revenue growth stagnation.

In contrast, top-performing MSPs drive revenue by leveraging more costly, skilled hunters (who solely hunt), and lower-cost farmers to later optimize the account relationship. The BIC have 26.4% of the sales and marketing team as hunters and 23.4% as farmers versus the Bottom ¼ with only 15.9% as hunters and 20.4% as farmers.

These results are even more jarring in VARs, where the BIC has only 17.7% in the hybrid hunter/farmer role, 16.6% in the farmer role, and 17.2% in the hunter role. By comparison, the Bottom ¼ has the largest percentage of the sales and marketing team in the hybrid role, 37.6%, followed by 7.3% and only 10.6% for farmers and hunters, respectively.

BIC MSPs and VARs use almost twice as many hunters as a percentage of their sales and marketing team as the Bottom ¼

Impact of Sales Structure and Productivity on Overall Profitability (continued)

Sales Productivity (continued)

Focus More on Marketing Individuals, Less on Sales Administrative Staff

BIC performers also have a slightly higher number of marketing full-time employees (FTEs) and are less reliant on sales administrative staff. BIC performers' marketing staff make up 13.2% of their sales and marketing teams, while sales admins make up 10.4%, compared to the Bottom ¼, which are 11.6% and 16.3%, respectively. The BIC performers have clearly recognized and invested in the shift in lead generation towards more marketing efforts, including a defined process and automation, and have reduced their reliance on sales administrative positions.

Sales & marketing teams:

BIC have higher % of marketing FTEs and lower % of sales admins.

Bottom 1/4 have 60% more sales admins as a % of their sales & marketing teams than BIC.

End Customer Size vs. Managed Service Fee

Among SMB MSPs it is a common but false assumption that as the user count goes up, the fee/user/month should go down "due to scale."

Those who have successfully served larger customers know the opposite to be true. This is because your people must be more skilled (and compensated as such), your tools must be more capable, and your processes must be more granular and complex on both the sales and service side of the business. All of this adds substantial cost.

The average fee/user/month for "full meal" managed services, charged by Median profitability TSPs is shown in Figure 2. Those in the Bottom ¼ of profitability charge materially less for the same described (but generally not well-delivered) set of services, and the BIC (top quartile) generally charge 20% to 50% more and do a materially better job of service delivery delivering.

Target Customer Profile (TCP)	Median MSP (Fee/User/Month)
1) 5–25 Users	$114
2) 26–100 Users	$148
3) 101–500 Users	$183
4) 501–1000 Users	$244
5) 1001–3000 Users	$284
6) 3001–10,000 Users	$355
7) 10,000+ Users	$401

Figure 2

Target Customer Profile (TCP)

BIC TSPs do not focus on more than one TCP; this narrowness of focus is key to their higher growth and profitability. Most BICs don't ever strategically "switch" or jump TCPs. If they do, they immediately cease adding customers fitting the old TCP. Again, regardless of size or business model, no TSP can sell and serve multiple TCPs with profit and quality.

TSP Profitability Over Time

To look at long-term profitability, we have to go back to Q1 2008, which was the start of the "Great Recession." From Q1–08 through Q4–21, the BIC TSPs had 2.6 times higher EBITDA% on average than the Median TSPs. This has allowed the BIC firms to increase their value creation at a dramatically faster rate and have more money to invest back in the business during this time.

It also means that once you control for your specific business model, regardless of geography or client segment, every market has BIC serving the same clients and doing the same things as the Median. Bottom line: It's not where you are, which client segments you serve, what you do, or how big or small you are; it's how you do it. Management skill makes the biggest difference in financial performance, and it is a learnable skill.

When looking across the last 14 years of results across all PBMs, the BIC consistently achieved anywhere on average 17% to 22% EBITDA compared to the Median of 4% to 10%. The Bottom ¼ always lost money, which continued in 2021, -10% to -1%. The Bottom ¼ do not have a sustainable business model, and this group is the most transitory, with members either improving to Median performance, being acquired at a discount, or ceasing operations.

Looking at specific PBMs, we found:

MSPs: The BIC had a slight decrease in EBITDA from 21.6% to 21.4% from 2020 to 2021. These results are still over 20%, which hadn't been achieved in consecutive years since 2008. Also, the Bottom ¼ and Median increased their overall EBITDA from 2020, which is a good indicator for the MSP industry as a whole.

VARs: Remarkably, 2021 was the fifth consecutive year the performance of the BIC VARs improved, with 15.9% EBITDA. They almost reached their last record of 16.5% set in 2009. Happily, the Bottom ¼ also showed improved results.

Infra-Technical Services firms: These firms have their predominant line of business, hourly ad hoc support (aka "break/fix"), and staff augmentation. In 2021, these firms saw a slight decrease in BIC EBITDA % from 25.3% to 24.0% due to rising G&A costs. They continue to experience an exodus of firms to the MSP business model.

Project-Centric firms: These firms are among those dependent on capital spending. They install systems the client often procures elsewhere, often from VARs. In 2019, they continued the downward trend at BIC EBITDA % of 15.0%. This was surprising given the volume of projects in 2019 to update Microsoft-based systems reaching end-of-life. Fortunately, 2020 and 2021 provided a welcome reversal at 19.3% and 18.4%. The largest factor was that many clients invested in retooling to enable work from home and increased security. If not for supply chain issues causing stagnated product sales and project team ability to complete additional projects, they likely would have experienced record results in 2021. Also significant, for the first time since 2008, the BIC, Median, and Bottom ¼ were all profitable.

2008–2021

BIC TSPs average 2.6x higher EBITDA% than Median TSPs

Management skill makes the biggest difference in financial performance, and it is a learnable skill.

EBITDA by PBM from 2020 to 2021

MSPs: Down slightly to
21.4%

VARs: Increased slightly to
15.9%

Infra-Technical Services firms: Down slightly to
24.0%

Project-Centric firms: Down slightly to
18.4%

Impact of Product and Cloud Resale Margins on TSP Profitability

In 2021, gross margin on product resale rose significantly across all PBMs to 25% from 22.6% in 2017.

VARs attained their highest GM% in the five-year span at 22.7%, up dramatically from 18.1% in 2020. An average of about 80% of their revenue from product resale greatly helps GM$ and, ultimately, EBITDA. For these firms, product GM% is critical. With VAR BIC SG&A of 18.5%, average product GM% of 18.1% cannot be long withstood, especially if services GM% is low.

In 2021, most other PBMs had higher product resale GM% than in 2020, spurred by the economic rebound, better pricing discipline, and the lack of ability to get product to sell, creating scarcity.

Product resale gross margin for all TSPs continued 5-year improvement trend, finishing at 25%

Dependence on Product Resale for GM$

In 2017, VARs relied on product resale for 70.9% of their GM$; by 2021 this decreased to a still-high 68.4%. The high proportion of GM$ coming from product resale for the VARs explains the attention they pay to vendors' volume discount programs.

For MSPs, they went from 12.1% in 2017 to about 23% of their GM$ from product resale in 2021. This percentage has almost doubled over the last five years, primarily due to the increase of cloud resale and to a lesser degree, traditional product resale as a portion of total revenue.

For MSPs this is dangerous. It's important to remember that all managed services are MRR, but not all MRR is managed services. The increased dependency on GM$ from cloud resale can drag the MSP business model back towards becoming "recurring revenue" VARs. The dependence on resale for gross margin ultimately leads to co-dependence on the vendor's business model, which further degrades the TSP's service model. Additionally, this gives vendors who can further dictate the gross margins the control. While this MRR can be enticing, MSPs should be careful to avoid moving toward the VAR business model at a time that most VARs are trying to move to a more services-driven model.

GM$ from product resale over last 5 years

	2017	2021
MSPs	12.1%	23%
VARs	70.9%	68.4%

Cloud Resale for MSPs

In 2021, BIC, Median, and Bottom ¼ all experienced a decrease in the GM% of overall cloud resale. For MSPs, it dipped in the last two years from 30.1% in 2019 to 26.9% in 2021. To reduce this impact, the BIC continued to resell cloud solutions while concentrating on appropriately pricing and adding services and management fees to the cloud solutions over which they do have pricing control.

↓ in GM% of overall cloud resale from 30.1% in 2019 to 26.9% in 2021

Importance of Managed Security Revenue for MSPs

The BIC MSPs ended 2021 with a much higher share of their total revenue coming from managed security than the Median and Bottom ¼ (11.9% versus only 5.8% and 4%, respectively).

BIC MSPs are more effective at cross-selling by making sure every customer buys every one of their offerings, including security. This allows them to grow faster, earn a greater profit, and become more successful with each new offering (in this case, managed security) than MSPs who are less successful at cross-selling.

The top performers have also made managed security offering a part of their managed service offering without letting the client make the decision. This is due to the importance of consistently managing every client's environment as well as the benefits to both client and MSP of layering in security solutions. They avoid offering this as optional, or an a la carte service, which many low performers do.

BIC MSPs

3x as high of a % of total revenue coming from managed security for BIC MSPs.

Mandates managed security offering as part of their managed service offering—client does not make the decision.

Conclusion

There are as many ways to run a TSP business as there are proverbial snowflakes, but the top financial performers manage their businesses with a common set of operational best practices. The Service Leadership Index 2022 Annual IT Solution Provider Industry Profitability Report gives you the ability to drill down into the metrics and trends in your specific business model and to see how the Best-in-Class are really doing.

To get the full report, click **here**.