INSIGHT

Renaissance of the Subscription Model in a Digital Era

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In today's cloud and streaming based world, the subscription model has attracted ever more attention over the past few years, from both consumers as well as businesses.

The subscription model is far from new. It dates back to the emergence of a more organized and formal diffusion of journals and books in Europe during the 18th century. It occurs, and has been found, in many different examples of analogue and print publications – newspapers and journals, but also concert series, health clubs, razors, pet food, and many more. Not to mention book clubs that were so popular a few decades ago.

Digital subscriptions

As a result of the digitalization and the Covid-19 pandemic, the demand for digital subscriptions has almost exploded, and it is the digital subscription model that we are focusing on here. This is where the service that is subscribed to is also delivered digitally. The background to the rapid growth is, of course, technological progress,with increased bandwidth, faster transmission speeds, new devices such as smartphones and tablets, and storage moving to the cloud.

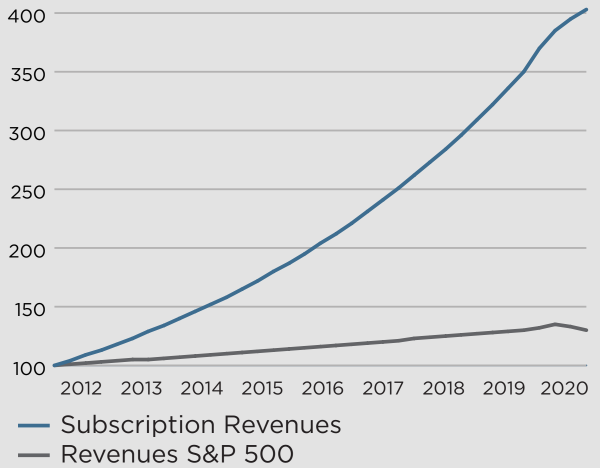
Added to this is the Covid-19 pandemic which has led to many people spending more time at home, while social and physical distancing requirements have also meant that they have opted for more individual activities.

According to DataReportal, 16 to 64 year-olds in a large number of countries around the world that they surveyed, 57% said they had spent more time watching films and other material via streaming services, and 39% said they listened more to streamed music and podcasts between March and April when the pandemic accelerated, compared to before. This benefitted services based on the subscription model.

It is not difficult to see why companies and investors are attracted by subscription-based models. Their repetitive, predictive, and typically stable pre-paid cash flows are a source of significant value, and result in higher margins. Zoura, a software company, has shown that earnings for US companies with a subscription-based business grew five times faster than the S&P 500 index companies between 2012 and 2019 (see figure 1). In turn, European subscription companies grew twice as fast as their American peers, according to Zoura.

Furthermore, an advantage of the subscription model is that it also leads to stronger customer loyalty over time, and thus brand-building. It allows for the collection of long time series customer data and it also provides opportunities to understand consumers' needs and behaviour which, among other things, can be used for personalisation and more targeted marketing purposes. (There is, however, an integrity aspect here that can be discussed.)

Figure 1: Subscription Company Earnings Grow Faster



Source: Zuora as of Sep. 2020

Customer Acqusition Cost (CAC) in today's digitally driven market becomes ever higher against the backdrop of intense competition, low barriers to entry, increasing transparency, and last, but not least, the 'freemium model', i.e. where a form of free subscription is offered initially, with the aim of converting it into a paid subscription over time. Therefore, it becomes even more important to look at the value of a customer relation over time (Customer Lifetime Value (CLV)). Long-term engagement and loyalty thus become critical to the success of a subscription-based business model. The subscription economy is growing fast. In the US, the market increased more than 100 percent annually between 2013 and 2018 according to McKinsey, and the share of the US population having at least one streaming-based subscription was 46% 2018. There is no reason this figure should be lower in, say, Scandinavia; in fact, rather the opposite.

The main reasons for a consumer to sign up for a new, paid subscription seems to be that the customer typically experiences value in buying something at a discount (as compared to buying single units) combined with a curiosity and willingness to try something new.

The primary motive to continue with a subscription according to McKinsey is not financial, however, but personalized customer experience, i.e. being able to tailor the service to one's own needs and desires, receive recommendations based on taste and interest, ability to share profiles with others e.g. in social media, special offers based on user history, etc.

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Subscription-based services

What types of subscription-based services are there available? Simply put: two. On the one hand, streaming-based services which provide content – Spotify, Netflix, Storytel and so on – where the rights belong to either the provider ('Originals') or the originator. This type is mainly directed towards consumers. The pandemic has, as stated above, strengthened this trend further.

On the other, software companies providing infrastructure, operations and maintenance, and business-critical applications but where the client provides content – ERP systems, CRM systems, software of various kinds (Software as a Service (SaaS), and similar cloud-based services and acronyms). A company such as Lime Technologies, to name but one example, provides sophisticated subscription-based CRM systems but ultimately it is the clients themselves that own and control the data. This type of service, naturally, is targeted towards businesses.

The big challenge for both types of service is to overcome the potential hurdle after initial subscription. The so-called churn rate, i.e. loss of customers, is very high in the early stages of a subscription-based customer relation. The customer is more aware and open to critical scrutiny of the service or product after signing up for a new subscription, and to terminate it is often just one click away. According to McKinsey, more than a third of all new subscriptions are cancelled within the first three months, and more than half within the first six months.

Adding to that is the payment. Obsolete or inaccurate credit card details can endanger not only a single transaction but an entire customer relation. Payment industry resource PYMNTS estimates that approximately 7% of a subscriber base is, on average, at risk every month due to payment issues.

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The good news? The longer the relationship keeps running, the lesser the likelihood of the customer cancelling his or her subscription. This is part due to force of habit - and also partly due to the fact that a customer typically becomes more satisfied with a product or service over time, when he/she has learnt how to get the most out of it – but also, when people simply forget that they have signed up to automatically renew subscriptions.

At C WorldWide, we are monitoring companies with subscription-based models closely and with great interest. There are several examples of businesses benefitting from the increasing importance of the model. One example is audible book company Storytel. Another example could be Amazon, which has benefitted from lower customer churn by signing up consumers to its Amazon Prime subscription service. Software companies such as SAP and Microsoft have increased the stickiness of its offerings by switching its customers to pure subscription services – and the market has rewarded the increased stability of cashflows by assigning them higher valuation multiples.

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