

Todd McElhatton:

By 2025 we expect the subscription economy to be a 1.5 trillion dollar market and it's going to be growing at about 18 percent.

Jason Lopez:

That's Todd McElhatton quoting a projection from UBS on the expected growth of the subscription economy. Todd is the Chief Financial Officer of Zuora, a company that offers tools to help other companies manage subscriptions to customers. The idea behind buying a subscription rather than a product is more than just a different way of billing. It's about purchasing an outcome rather than a product that enables the outcome. As an example, we dug up a podcast with Ray Wang of Constellation Research who gave an energetic talk about subscription models

Ray Wang:

For 10 cents a month, for the next eight years, I'm going to give you toast as a service.

Jason Lopez:

If you were in the audience that day, you realized that Ray's example of toast was pitch perfect. You don't buy a toaster to be the proud owner of a metal box that cooks bread. As Ray points out, you're buying toasted bread. In his fictional sales pitch, he'll send you the toaster.

Ray Wang:

Connect it to the internet. If it ever breaks, I'll replace it. If it goes down. We'll get you a new one. Doesn't matter where you go. Even if you move, we'll take those with us and actually change it for you. So what did we just do here? I've now built a subscription revenue stream.

Jason Lopez:

The cloud is moving the world from products to subscriptions. So we started the interview off with Todd McElhatton by asking him to give an overview of the subscription economy, especially in how the pandemic affected it.

Todd McElhatton:

So it's been interesting. And I think I would look at our experience here at Zuora and we've seen companies fall into three areas about 50% of our customers accelerated their growth. People sat there and said, wow here's something that I need. And I'm really interested in consuming that on a subscription basis. So zoom went from doing 10 million sessions a month to 300 million. We saw some companies that actually stayed relatively flat. And maybe an example of this is clear. So if you think about clear their business had primarily been as you go to the airport, helping people clear and check into their flights without having to stand in line or having some of the same levels of screening because of the pre background checks they did. And I know at the beginning of COVID, they were really super worried about, oh my goodness. You know, our business is based on travel is you saw airlines and hotels. You know, they watched their demand shrink by 90%, but we saw actually with clear is they actually went public this last year. What was much to their, maybe not surprised, but you know, it turned out much better than they thought, because what people said was, look, I know I'm going to come back and travel and I'm going to just go ahead and keep the relationship going. Maybe some people pause, but then they resumed as they saw the pandemic was easing up. So I think that was a

great example of the resiliency of the subscription economy. And then of course there were some people and that's about 25% of the business where you saw they absolutely were impacted and they did see their business shrink. But overall, even through the really challenging times of COVID subscription economy in general grew, it didn't grow as fast as it did, but compared to the rest of the economy that shrunk, it continued to ex. So I think that showed the real resiliency of the business model. And quite frankly, why you're seeing so many companies have an interest in how do I have this ratable revenue model?

Jason Lopez:

Well, I wonder if you could go a little deeper into this idea that some businesses did not experience this ripple effect of these negative effects that were predicted because of the pandemic.

Todd McElhatton:

So I think you absolutely hit it correctly there. I think we went through some phases. So at the very beginning of the lockdown, I think companies in general, everybody had this hunker down mentality and most people weren't sure what was going to happen. Some of the professional services firms got really nervous and laid off big chunks of their people. And as they've looked back said, wow, that it was really a big mistake because now they're short on people as these implementations of big systems are continuing to go on and people have gone out and found something else. So could we actually operate from home? And I mean we saw millions of people who had been coming to the offices every day. All of a sudden people scattered back to their home offices and basements and living room couch and corners of their kids' room and started to go about their daily Workday. What we found is there's a lot of things that we don't need to be in the office to do. And technology played a huge role in that companies that had more of a technology or enterprise type flavor, we're able to kind of get back to businesses normal. Now I think where we're going to come from there is how do we move that on to the next version? Because I think what we're going to find is we're not going to go back to where we were, but I think we're also going to find what we did in the pandemic. Probably isn't sustainable long term. And we're going to have somewhere in the middle that we meet

Jason Lopez:

And an interesting effect of the pandemic in terms of the kinds of technologies that were rolled out in order for people to work from home is this idea of the offerings from hospitals, for example, in telehealth or universities and public school systems offering remote learning. There were technologies that allowed this before the pandemic, but those were add-ons. Those were things that were for people who absolutely could not come into the clinic or could not come into the classroom. But now going forward, these are going to be standard offerings. This is a changed world we're in now where remote learning, telehealth, these sorts of things, are now going to be standard issue going forward. And I'm wondering how this has affected suddenly the idea of a subscription model, not only for telehealth and for remote learning, but in all aspects of the way people use software.

Todd McElhatton:

So I think a couple things, one of the things that you're seeing with subscription models is companies in particular that were selling the product, loved it because they loved the durability of the model. As you know, I gave my, the example of clear is here is a business that was highly dependent upon travel. And when the floor fell out of the travel industry, their business did all right, they actually saw, Hey, this was a great buffer. People were willing to maintain those subscriptions because they believed that they were

going to travel again on the consumption side of it on subscriptions. It was helpful for a lot of companies where they were able to say, all of a sudden, maybe I don't have certain needs. There are areas where we're dialing back, where we were using services. And those subs subscriptions gave them the ability to pause. So it gave them that level of flexibility. So it turned out, I think, a win-win for people both on the buy and sell side.

Jason Lopez:

Todd, what would you say to the perception that subscription models lead to vendor lock in? What are you seeing in subscription businesses right now?

Todd McElhatton:

I think what you really see subscription businesses is it's really helping democratize how people consume and use services. And we see some people are paying for a flat monthly rate. We're seeing other people are paying based upon consumption. One of the things that we know, and we have almost 1400 different customers. So we've got some tremendous data. What we know is the companies that are most successful, have a few characteristics. One of the characteristics is they have is not only a flat fee, but they have ability to allow people to have a fee, but then you have a consumption component of that. So it allows them to modulate based upon their using tend to be more successful than those with just a flat fee. The other thing that we know is that companies that have multiple interactions with their customers or changes to those subscriptions over the year are also more successful. And so you start thinking about those changes. Those may be changes where I want to pause my subscription for some period of time, because something's happened to me. I want to upgrade because I want to take advantage of a new service. I see there's services that I'm not using and I want to downgrade. So I think in general, what you see is a subscription business does allow consumers to really tailor how they consume products to what their needs are.

Jason Lopez:

Right. And on that tech, we did an interview with one of the leading security people at BAE systems who talked about subscription models in terms of stoking competition in the industry three and you know, being able to seamlessly move to the services and the products that you wanted on the basis of, of subscriptions. Are you sort of saying the same thing here?

Todd McElhatton:

I believe I am. And I believe at the end of the day, there's some outlier where something maybe is a monopoly or a near monopoly, and it's just hard to get off of, but if you've seen the pace of innovation and how things change, if you take a look at the companies that were on the S&P 500 20 years ago, and how many of them are still there, five of the top 10 most valuable companies... some of them weren't even around 25 years ago, and now are the leading companies in the world from value. So I think you've seen with technology a real ability to very quickly innovate and meet customer needs. And you're going to find if you're trying to force somebody to consume something that they don't want to, or it's not upon the terms that the consumer wants, ultimately they're going to go and they're going to find another. So there'll be somebody out there to meet that need.

Jason Lopez:

Gotcha. Gotcha. Now let's take it down the rabbit hole, just a, a couple feet deeper. And that is the idea of subscription models disrupting the marketplace. I wonder if you could describe that phenomenon.

Todd McElhatton:

So as I start thinking about that, what one of the big changes that you have is now all of a sudden, instead of having as a company purchasing, it really helps you do two things. First of all you can significantly reduce your CapEx. So instead of having to make these long term decisions on things that maybe you are committed to for 3, 5, 10 years, you're able to buy those on a consumption basis. So that certainly helps your CapEx model. If you take a look at startup companies out here in Silicon valley, if you went back 20 years ago, funding requirements for getting companies off the ground were huge, right? You had to build a data center, you had to have all that computer capacity. Now someone just pulls out their credit card and starts charging it with an AWS or a Microsoft Azure.

Todd McElhatton:

So that's certainly changed on how companies innovate and how they're able to start, but you also start to see the companies on the buying side are able to modulate what they buy. We talked a little about COVID earlier. So now all of a sudden, maybe I have 20% less employees while I can. A lot of times cut my call us by 20%. If I'm buying on a seat basis, I've seen some studies that 30 to 40% of it budgets are wasted by having people buy things on a subscription or consumption basis. You again, can get much better at how you're modulating, what purchases you're making and making sure those are actually aligned to what your needs are. And I think that's been very different from in the past where you've had to make kind of an upfront commitment, and you're stuck with that commitment for a much longer period of time.

Jason Lopez:

And of course, with any new thing that's been put out into the marketplace, whether it's a new product or a service, there sometimes can be a little bit of confusion around what what's being offered or what it means. And I'm wondering when it comes to subs subscription services, especially for someone leading an it shop or something along those lines, what have you seen out there that tells you that the market really understands what's going on with the subscription models that are being offered.

Todd McElhatton:

So I think for it leaders, it's certainly caused a big change from a standpoint of, they had typically been very CapEx focused. You would see maybe businesses at the end of the year saying, wow, I've got this huge budget. You know, I don't want to lose my CapEx. And so you have a lot of purchasing done at end a quarter or end of business, where that's no longer relevant in a subscription business where it becomes moves from CapEx to OPEX. So you're certainly seeing people have to be more thoughtful on the difference between CapEx planning and OPEX. And I think that's probably been one of the biggest changes that we've seen, but I think one of the positives has happened is you're able to go in and try things. You don't have to jump in and have some of the major commitments that you've had. You can experiment. And as things work out, you can kind of consume more over time. Or if it doesn't work out, you can kind of turn the, stick it off. And so I think that's one of the real advantages that you've seen.

Jason Lopez:

And one of the areas that I've heard that subscription models could really have a big effect on is the area of environmental, social and governments, ESG, where are you seeing impacts along those lines?

Todd McElhatton:

ESG is absolutely front and center for people. You know, how do we get more efficient use of resources? Think about cars in general. Cars are really underutilized and building a cars. There's a lot of waste in that, or a lot of impact to the environment. So if you can sit there instead of having a car with a really low utilization, move it up to much higher utilization, that's going to be a huge environmental impact. Think about products that we were shipping out, whether it be CDs or DVDs and all the environmental impact of the shipping, and then what happened when the product didn't get needed. Well, now all of a sudden you're able to stream that. Uh, I think those are all things that are going to be super important to people as we move forward into the future.

Jason Lopez:

You had mentioned earlier that your company, they generates a lot of valuable data from customer behavior. What are you seeing in terms of the adoption of subscription models?

Todd McElhatton:

So I think our subscribe strategy group does a lot of work. And I think what we've seen is subscription businesses are growing at a multiple of what non subscription businesses are. And if you look in the it space in particular or software business, Nutanix is a great example. Today is 90% of the business is subscription based. And what you've seen is most of these companies either have transitioned or on the middle of transitioning to a subscription model. And I think the reasons are like we've talked a about, first of all, if you're offering the product, the good thing is that you've got a customer base. We've got that recurring revenue where I think we talked about it in the past, that it's great to know you start the quarter and you've already got 95% of your revenue in the bank. And so you've got that level of consistency. You're able to be much smarter about how you're allocating resources. You don't have, have to be pulling budgets or back and forth based upon the whims of individual transactions. So I think that's been really beneficial for folks, but I think more importantly, as we take a look at what's happened as we've moved to these businesses, is it also allows on the flip side, the companies that are buying to be more thoughtful about how they procure and do a better job of metering their purchases with their needs.

Jason Lopez:

And having worked in tech for so long and having worked at large tech companies now your experience seems to include a wider range of companies than ever before. What are you seeing out there what's, what's exciting for you out there in the marketplace and, and changes that you're seeing right now?

Todd McElhatton:

You know, I think a couple things that are really exciting, one is you're seeing where people, where they offer something as a service where typically it would've been a huge upfront cost is able to be much more affordable now. So you're able to open up the doors of consumption to people that weren't able to do it in the past, but you're also seeing a lot of old buying manufacturing companies reinventing themselves. And yes, they're still selling product, but they're seeing their subscription where they're taking I OT services and monetizing that, and that's actually giving them a better outcome to their end customers. So it's a way that now do they have their product new, but they're also got a subscription line of revenue. And even some of those companies are taking it the next step and saying maybe instead of selling a big piece of equipment, I'm going to sell an outcome. And there's a lot of efficiencies to that. So I think it's been a really interesting time here in the subscription business. And it's been interesting to see that what started off maybe as a SaaS phenomenon or in the software in industry has certainly

taken hold in how we consume media, how industrial companies are, you're seeing healthcare, financial services. So it's been really interesting to watch how a lot of these companies are evolving and all the changes that have to happen to their companies as they change their business models.

Jason Lopez:

So we started the interview off with your sound bite that the subscription economy is expected to be 1.5 trillion by 2025. Can you go into a little deeper what that actually means?

Todd McElhatton:

I think that 18% growth where you start thinking about that's going to attract all kinds of new capital. It's going to attract all kinds of new goods and services, and it's going to allow people to consume things and maybe utilize things if they weren't able to utilize in the past and in the whole stream of it, it's going to allow us to do it in a way that's better for the company providing the service. It's better for the people that are consuming the service and probably environmentally it's a whole lot better for us from an ESG perspective, because we're getting much better, much more efficient utilization of resources.

Jason Lopez:

Todd McElhatton is the Chief Financial Officer of Zoura. This is the Tech Barometer Podcast. I'm Jason Lopez. We invite you to check out more stories about technology as well as interviews with people in tech, at the forecastbynutianix.com.