



# SMB and Mid-Market Channel Partners Geared Up for Growth

## Executive Summary

SMB and mid-market channel partners have a favorable but cautious outlook on the economy. Interviews with these partners show that many are excited about growing their business and less worried about survival (see Exhibit 1).

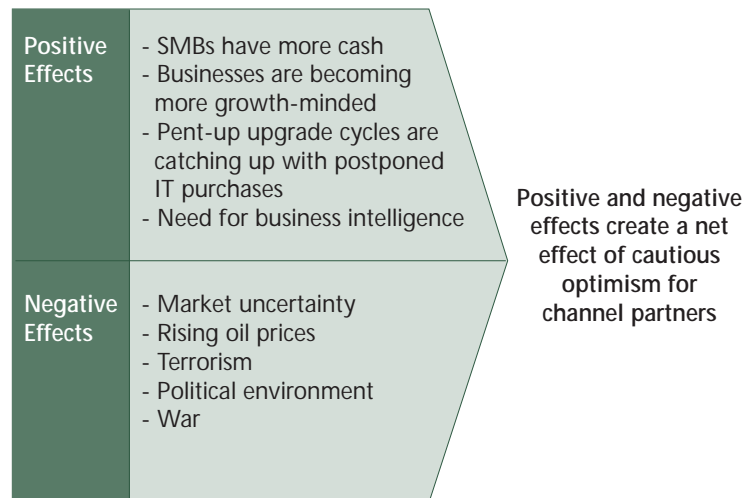
These are the positive trends that reinforce the general market optimism:

- SMBs and mid-market firms have more cash in the bank.
- A pent-up upgrade cycle is inducing more drastic spending on technology. The SMB and mid-market economy is growth-minded. The channel is continuing its transition to a service-based model. Achieving this requires major transformation in the business—and not all partners will make it. This report presents best practices and identifies new metrics for partners to consider for success in an evolving market environment.

### Exhibit 1.

#### Market Outlook Among Channel Partners Is Mainly on the Upside

Source: The Yankee Group, 2004



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## I. Introduction

Certain SMB and mid-market vendors succeed because they offer product and service solutions appropriate for this target market (offered at the right price) and they employ suitable routes to market. The wrong channel strategy can break a vendor's chances in this space. Even for enterprise-minded vendors, the pursuit of a direct sales model is too costly. However, the SMB and mid-market market opportunity is real and many vendors seek to dominate this space. To do so, vendors need to engage partners effectively to gain critical mass and broad sales coverage. Channel partners sit at the critical cross-section between SMB and mid-market business customers and vendors. They sit at the juncture where technology product and solutions are bought and sold and where information is actively exchanged formally and informally.

This report analyzes trends in the channel, the SMB and mid-market buying climate, and key challenges encountered. In addition, we discuss best practices for partners to succeed in the long term. Our purpose is to provide insights for vendors interested in strengthening channel programs and for channel partners that are transforming their businesses and are interested in benchmarking against peers. This research is an update of the September 2003 Yankee Group Small & Medium Business Strategies report, *SMB and Mid-Market Channel Partners Face Challenging Market Dynamics*.

## Methodology

Similar to last year, the Yankee Group conducted interviews with multiple vendor-channel program executives and channel partners that service the SMB and mid-market. Partners that we spoke with mainly specialized in business applications and foundation infrastructure technology solutions aimed at the SMB and mid-market. Business applications include accounting, ERP, HR/payroll, CRM, e-commerce and IP telephony. Foundation technologies include servers, networking, security and storage. This report doesn't include conversations with distributors, system builders and pure ISVs, although the findings may be relevant. We use the terms *solution provider*, *channel partner*, *VAR* and *reseller* interchangeably.

## II. Market Outlook

Like last year, there is further consolidation in the channel and in the number of application vendors in this space. The soft economic climate of recent years forced many surviving VARs to become very lean, which positions them well in a growth phase. The partners that we interviewed generally were optimistic about their business prospects.

The majority believes that the market is on a cautious upswing. Businesses have more cash in their wallets and are more willing to spend on technology purchases. The dot-com burst combined with the effects of 9/11 forced many SMBs and mid-market firms to focus solely on survival. Money was tight and technology upgrades were postponed indefinitely. With the market picking up slightly, businesses have more money to spend. The pent-up upgrade cycle forces businesses to spend more on massive upgrades to bring their networks and infrastructure up to date with their current requirements. Had business end users made upgrades incrementally, the cost of upgrading wouldn't be as high.

Macro-related factors businesses can't control (and fear) temper the positive trends in the market. Market uncertainties, the threat of terrorism, the war, the political climate and the rising cost of oil contribute to fears of a potentially shaky business environment.

The geography also affects the SMB and mid-market end-user business climate. For example, checks into the channel suggest that businesses in Ohio and New York State are more risk-averse than businesses in Houston, Las Vegas and on the West Coast.

### III. SMB and Mid-Market Purchase Drivers

During the past few years, SMBs and mid-market businesses needed to weather the storm and make difficult business decisions. Companies needed to reorganize and lay off valued employees to survive. Many businesses simply had no money to spend on technology upgrades. The improving market environment and a delayed replacement cycle are spurring purchases. In addition, some firms are seeing the maintenance costs of supporting outdated technology going through the roof—another reason to upgrade.

Companies are willing to spend to better optimize existing assets, resources and people. Midsize firms running multiple products and systems want to optimize and simplify. They will spend money to integrate disparate applications and consolidate servers.

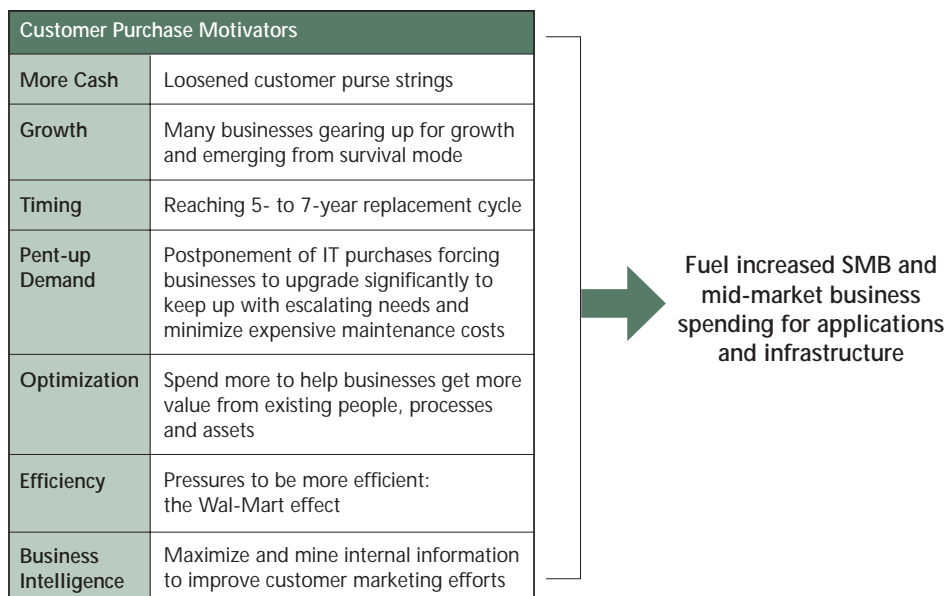
The focus on business growth is also pushing customers to spend on technology solutions that help them mine internal information to understand their business, mine customer information, and deliver better customer service and targeted marketing. Small companies are buying new applications such as Act! and SMBs are more interested in using CRM to learn how they can understand the behavior and needs of their customers.

Exhibit 2 shows key SMB and mid-market purchase drivers.

**Exhibit 2.**

**SMB Mid-Market Buying Motivations as Heard from the Street**

*Source: The Yankee Group, 2004*



## IV. A Transitioning, Evolving Business Model

The shift to a services-based business model is inevitable and some partners are adjusting better than others. The transition from a product- to a service-based model requires the partner to fundamentally change its business approach (see Exhibit 3). The benefits can be dramatic because services yield higher profits, more income and predictable revenue.

### Business Discipline

Most partners will need to transition from a product-centric to a service-centric business. This transformation is significant. In this model, the trite phrase “time is money” is the cornerstone of the strategy. A partner needs to view employees, resources and assets as profit centers, rather than cost centers. Each employee, resource or asset should be attached to billable revenue. Our conversations with partners pegged a minimum billing utilization at 65% for an organization to be healthy. Partners need to be very disciplined and must track time as diligently as a lawyer or CPA.

Margins are less important than figuring out the breakeven point on the company’s resources, assets and employees. Partners need to follow a consultative model that values a vastly different set of business operating metrics (see Exhibit 3):

Companies should move accounting to a revenue deferral model that recognizes revenue when services are delivered—not when they are purchased.

#### Exhibit 3.

#### New Business Values: A New Set of Operating Metrics

Source: *The Yankee Group, 2004*

Outdated Metrics: Product-Oriented	New Metrics for Success: Service-Oriented
Cost of goods sold (COGS)	Hourly cost by resource and employee skills
Sales price	Billing utilization rates
Items	Projects
Margins	Cost basis: know breakeven point for resources
Collection	Identifying out-of-scope requests
Revenue recognition when purchased	Deferred revenue: recognize revenue when delivered
Products-based compensation	Services- and products-based compensation

## Project-Based Approach

A service-based model requires a different sales approach and a shift in the perception of the customer as a long-time client (see Exhibit 4). Similar to our findings from last year, partners must ask the right questions that probe into customer pain points. Partners are selling solutions that wrap services, expertise, best practices, products, project management and advice—more than just a software license or a piece of hardware.

Project management is an essential skill in a services-driven organization. It is critical to have a project manager who defines the project phases and deliverable deadlines, manages the processes and resources that support the project, adheres to a rigid project schedule, and serves as the main point of client contact for every project. Applying this discipline is instrumental to figuring out the billing utilization rate and standard pricing, managing customer expectations with detailed proposed project deliverable deadlines, and identifying out-of-scope requests that may lead to additional revenue opportunities.

In this paradigm, partners need to think of their customers as long-term clients that are serviced and managed by an account executive.

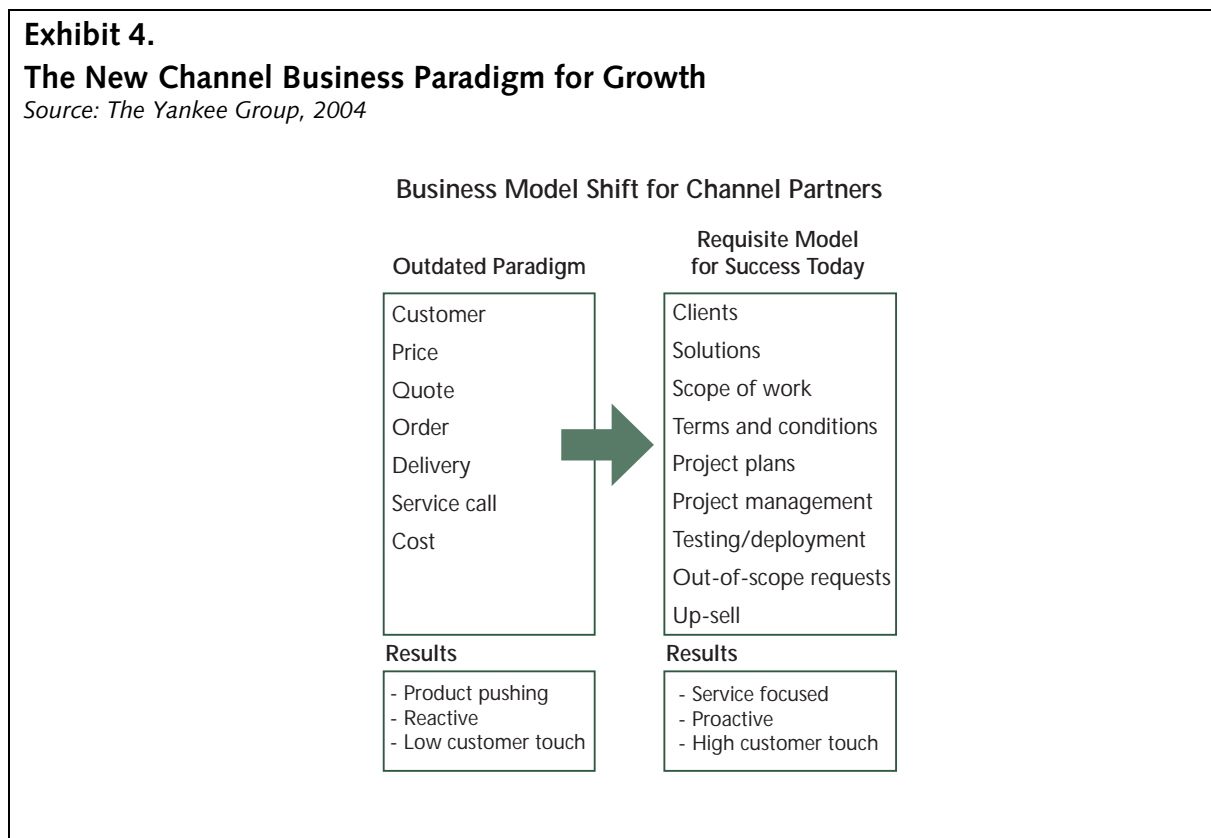
## Healthy Customer Attrition

Not all customers are good customers. Partners should optimize resources and employees and be realistic about the opportunity costs of servicing an unprofitable, long-time customer at the expense of not servicing profitable customers. Partners need to analyze their customer base and determine the cost basis of supporting each one.

### Exhibit 4.

#### The New Channel Business Paradigm for Growth

Source: The Yankee Group, 2004



Fred Johnson, president of Ross-Tek, a Microsoft-certified partner based in Cleveland, Ohio, created a customer segmentation model based on a few simple but important principles:

- **For a short-term opportunity:** Who's a good customer today, but a bad one tomorrow?
- **For a long-term opportunity:** Who's good today and good tomorrow?
- **For future potential:** Who's bad today, but good tomorrow?
- **Waste of time:** Who's bad today and bad tomorrow?

Johnson's segmentation model can be an emotional exercise, but the danger of servicing an unhealthy base of customers can break a business.

## V. Channel Partners Share Key Challenges

A channel partner today is confronted with many challenges because of the changes occurring in and around its business.

### Managing a Successful Business

Because most channel partners are SMBs, they contend with challenges that reflect the overall SMB market (see Exhibit 5).

#### Exhibit 5.

#### SMB and Mid-Market Channel Partners Are Uniquely Challenged

Source: *The Yankee Group, 2004*

Biggest Challenges Facing a Partner	Biggest Challenges in Serving the SMB/Mid-Market
<p><b>Sales:</b> Value proposition to an SMB/ mid-market client leads with business value unique to the client, not features.</p> <p><b>HR:</b> Hire quality sales consultants with domain expertise and experience in building a business case and managing the purchase cycle.</p> <p><b>K:</b> Access to capital to manage growth judiciously, build knowledge base, and market, hire and train staff.</p> <p><b>Grow customer base:</b> Will need to steal customers from other partners. Must market and brand company based on experience, expertise and examples.</p> <p><b>Competitive edge:</b> Stay one step ahead and always look out for what more can be done for your customers.</p> <p><b>Services:</b> Price erosion on product margins: Need to focus on services to make sure the dollar stays with the firm.</p>	<p><b>A numbers game:</b> Success in the SMB market is driven by volume. Need to touch a lot of SMBs to get the bottom line you need.</p> <p><b>Focus:</b> Success will require persistence and patience. Cannot be disheartened by small transactions and SMBs' reluctance to spend.</p> <p><b>Balancing breadth and depth of knowledge:</b> Know enough to service a broad SMB client base while balancing the opportunity cost of learning too much about a topic.</p> <p><b>Sell efficiently:</b> Must minimize business expenses to achieve profitability without crimping margins. The up-sell opportunity to SMBs may not be sizable.</p> <p><b>Be creative:</b> Think of new ways to apply technology that solves clients' issues without breaking the bank.</p>

There are three major challenges that partners contend with in today's environment:

- **Access to capital:** Where do partners get the financial capital to fund investments they need to grow? Building domain expertise, hiring and training the right people, investing in channel partnerships with vendors, and marketing all require cash.
- **Managing growth judiciously:** In a growth environment, companies need to be very strategic about how they plan to grow their business. Finding good people continues to be a major challenge. In addition, timing is also very important when it comes to having the right and appropriate resource at the right time, both from a financial and an HR point of view. More knowledge about billing utilization and a deeper understanding of the firm's breakeven rate can help partners make adjustments and forecast requirements more intelligently.
- **Keeping up with technology:** Clients expect partners to be up-to-date with technology. In fact, that is the first selection criterion when it comes to partner selection. It's important for partners to be students of the industry.

### Distinct Challenges in Serving the SMB and Mid-Market

SMBs and mid-market companies can be difficult to serve. Serving such a diverse, broad and distinct group of end-user needs requires that the partner stay focused and committed to serving this market.

Here are some major challenges specific to serving this market:

- **Establishing an efficient sales process:** A partner must know when to walk away from a customer prospect. When selling to SMBs and mid-market businesses, it's important to qualify the lead at the very beginning. Depending on the prospect's potential value to the partner, the business expense and resources used to close the sale may exceed the revenue gained throughout the client's lifecycle.
- **Thinking creatively to apply technology in new ways:** These businesses have pain points but don't know how to leverage technology to solve those business challenges.
- **Asking the right questions to uncover revenue opportunities:** Mid-market firms have a much stronger understanding of their requirements than SMBs. However, a partner must probe to uncover those opportunities because requirements can be outdated and may not take into account the current and future needs of the organization.

## VI. Critical Success Factors

We have highlighted many recommended best practices and critical success factors for channel partners throughout this research. In addition to applying strong business discipline, such as in-depth analysis of the customer base and new business operating metrics, the partner also needs to aggressively market itself in order for the business to grow (see Exhibit 6).

**Exhibit 6.****Improved Productivity Motivates Many Software Purchase and Upgrades***Source: The Yankee Group, 2004*

A partner needs to focus on marketing, creating new services and adapting the business model and culture to succeed in the SMB/mid-market	
Marketing	<b>Brand your organization and focus on lead generation.</b> A strong brand will raise the customer perception of your firm's track record, value proposition and expertise.
Customer Lifetime Value	<b>Know your customers and optimize your opportunities.</b> Identify unprofitable customers where the cost of servicing them exceeds the revenue gained. Also, assess your customers' needs accurately to provide a solution appropriate for their needs.
Sales Efficiency and Discipline	<b>Optimize your sales process.</b> Time is money. Although turning away a lead can be the same as burning money, not knowing when to walk away can be disastrous. Minimize sales cost, optimize margins and be mindful of the client's lifetime value (up-sell opportunity).
Service-Based Business Model	<b>Don't wait for business to come to you.</b> Hire experienced sales executives to uncover customer pain points to build more solutions for customers while generating new revenue opportunities for your firm.
Profit Center Mentality	<b>Optimize resource utilization rates.</b> Every employee, resource and asset must be attached to billable revenue. Operate your services businesses as a profit center, rather than a cost center. Employees must be disciplined and track billable hours diligently.

In positioning their business for growth, partners are focusing on marketing and increasing their visibility—a long neglected area for partners in general. Channel programs from Microsoft, Best Software and Cisco have helped tremendously.

## VII. Conclusions and Recommendations

The channel has been experiencing a general market upswing during the past 12 months. Loosened purse strings combined with a pent-up upgrade cycle are driving end-user businesses to spend on technology. However, partners will have to transform their business drastically to adapt to a new service-centric model to satisfy the changing requirements of SMB and mid-market clients. Vendors also will have to continue improving and updating their channel programs to ensure they are satisfying the evolving needs of channel partners. Here are some actionable recommendations to consider:

### Recommendations for Vendors

- **Educate partners on achieving an efficient selling process.** Microsoft and Best Software serve partners very well. In the past year, the two readily provided case studies, scripts, industry-specific templates and co-branded collateral to help partners brand and market their businesses. Vendors can go a layer deeper and provide guidelines to partners to better qualify leads and efficiently pursue prospects.

- **Provide best practices to partners on how to manage growth.** Learning how to grow judiciously is a major struggle for partners. Tips on how to hire the right people and even providing monetary and operational support to partners can go a long way in helping partners succeed. Best Software is a standout in this area.
- **Help partners understand how to analyze their customer base.** Many partners assign equal value to each client they serve. However, the profitability of each client varies widely. Vendors can provide ideas on how partners should assess the long-term lifecycle value of each customer.
- **Provide partners access to capital and key operating metrics important for a service-based business.** Switching business models can be a major risk for partners. Vendors can assist partners by providing them access to capital during this transition process. It's critical to help partners rethink which metrics are central to measuring their business performance.

## Recommendations for Channel Partners

- **Know your limitations and focus.** Clients expect you to know everything. Robert Spaulding, an MCSE-certified partner based in Colorado who sells Microsoft Small Business Server, says, "There's a million gotchas, and it's important to admit to the client 'I don't know this, but I can find answers for you.'" Focus and develop a deep and broad knowledge in the specialization you choose.
- **Underscore your experience.** Impress your clients with your expertise, objectivity, proven track record and commitment to serving them for the long term. Although competitors can lower prices, you can score points by exposing your experience during the sales process to help clients understand that your expertise will translate into shorter deployment cycles and predictable outcomes—which means no hidden or unexpected costs later.
- **Align clients with the right products.** Partners need to accurately scope the needs of customers. Walk away from deals when you're forcing a client to adopt an application or solution that doesn't match its needs. This will save you from long-term headaches and dealing with an unhappy client, which could drain your resources.

## Recommendations for SMB and Mid-Market End Users

- **Be careful when selecting partners based on price alone.** Hourly rate is only one selection criterion for selecting a channel partner. Have an open discussion about your needs and ascertain whether the potential partner understands your precise needs. Lack of expertise and capabilities will lead to additional costs because of longer project cycles and unanticipated glitches.
- **Value project management skills.** A partner's disciplined project management approach will usually mean the project scope is accurately defined at the beginning, client expectations are properly aligned, and costs will come out as expected. Don't underestimate the importance of this ability when choosing a partner.
- **Use good judgment when choosing the solution that your partner recommends.** Bias may set in if partners recommend solutions to clients that they can deliver but that unfortunately misaligns with the needs of the client. Choose an objective partner.

## VIII. Further Reading

### **Yankee Group Small & Medium Business Strategies Reports**

*To Win in the SMB Market, Go Beyond the Basics*, September 2004

*Vendors That Help SMBs Upgrade and Integrate Their Applications Are on the Right Track*, June 2004

*SMB and Mid-Market Channel Partners Face Challenging Market Dynamics*, September 2003.

### **Yankee Group Small & Medium Business Strategies Research Notes**

*While Linux Is No Threat to Microsoft Today in the SMBs' Desktop, the Threat Is Mounting Gradually*, August 2004

*Solution Selling 101: Understand the Underlying SMB Business Challenges*, April 2004.

*SMB Survey Uncovers Views About Microsoft, Outsourcing, and Sales Cycles*, February 2004

### **Yankee Group Small & Medium Business Strategies Audio Conference**

*Infrastructure and Applications: SMB Demand Assessment*, February 2004

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