

The background of the entire page is a nighttime photograph of a city skyline across a body of water. A prominent bridge with a red-painted structure spans the water. In the foreground, a multi-level highway interchange is visible, with light trails from cars creating streaks of white and red. The sky is a deep blue with some clouds. The overall scene is illuminated by city lights and the bridge's own lighting.

The State of Managed Services 2022

The Rise of Digital Managed Services

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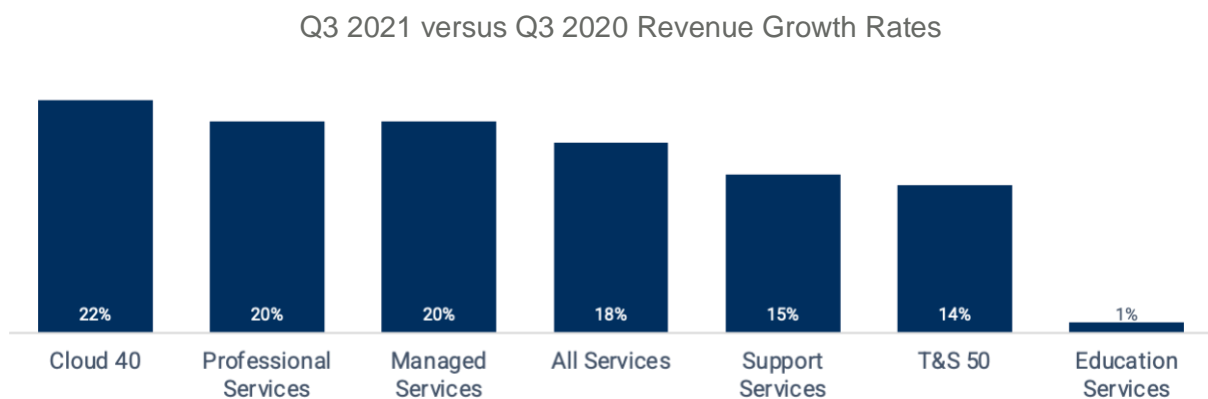
The Rise of Digital Managed Services

By George Humphrey

Introduction

For the past 24 months, managed services has been one of the fastest growing revenue engines of the technology industry. The most recent year-over-year data show managed services continuing to grow at a healthy 20%, as seen in *Figure 1*. This includes both subscription and traditional revenue streams tracked through TSIA’s Cloud 40 Index, TSIA’s Technology & Services 50 Index, and TSIA’s benchmark database. The benchmark data for revenue streams include hardware, software, and such services as professional services, support services, education services, customer success, and others.

Figure 1: Revenue Growth Rates, Q3 2021 versus Q3 2020



Source: TSIA Technology & Services 50 Index, TSIA Cloud 40 Index, TSIA Benchmark Gold Standard.

There can be little doubt that COVID-19 has been an accelerator for companies moving to subscription offerings, such as cloud and managed services. Coincidentally (or not), TSIA is also seeing a rapid acceleration of digital transformation across our entire membership community. This is creating the perfect storm for managed services providers. Companies are quickly learning how crucial it is to digitize all processes across the business. Managed services providers are no exception. Managed services providers that have overly complex and custom solutions have created self-inflicted wounds, inhibiting scale. Lack of scale ultimately inhibits growth and profitability.

At TSIA, we are seeing a rapid separation of managed service providers into two classes, which we call 1.0 MSPs and 2.0 MSPs. A 1.0 MSP has highly customized solutions and employs a resource-intensive delivery model. A 2.0 MSP focuses on standardized offers, standard delivery operations models, and employs software-driven, *digital* delivery capabilities. If you're a 1.0 MSP, what do you need to do to become a 2.0 MSP? That's exactly what we'll be focusing on in this year's "State of Managed Services" paper.

Note: This paper includes multiple data-driven insights. All data, unless otherwise noted, comes from TSIA's Benchmark Gold Standard.

Top Challenges for MSPs

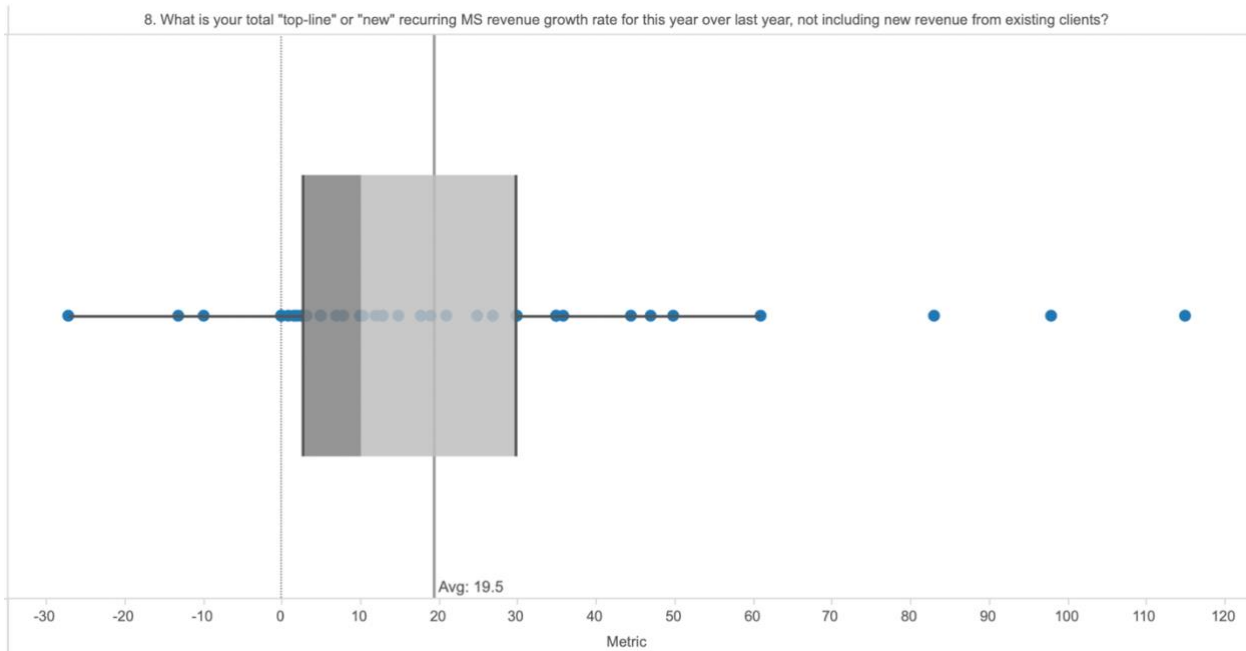
As a research and advisory firm, we focus on helping our members become the most profitable, fastest-growing technology and service providers they can be. In other words, we want them to be healthy and thriving. To do that, we must diagnose where they are, understand where they could or should be, and what they need to do to get where they want to be. It all starts with performing a diagnosis. Part of the diagnosis process is understanding what their biggest challenges are within their businesses. The first place that challenges show up is in the core performance metrics of the business. Although there are dozens of metrics that TSIA tracks, it really boils down to the three questions every MS executive should be asking themselves every day:

1. Is our business growing?
2. Are we keeping as much of that recurring revenue as possible?
3. Is it profitable?

Challenge #1 - Growth

As mentioned earlier, the data from the most recent TSIA Benchmark Gold Standard for Managed Services indicates that the average growth rate for new managed services agreements is 20%. However, as with all average metrics, there is a range, as shown in *Figure 2*. The data tells us that the growth rates for MSPs have a range of -27% all the way to 115%! The majority of companies in the benchmark database are performing well under the average of 20%. While 20% average growth rate sounds great, most MSPs are not experiencing that kind of growth—but they can.

Figure 2: Managed Services Growth Rates



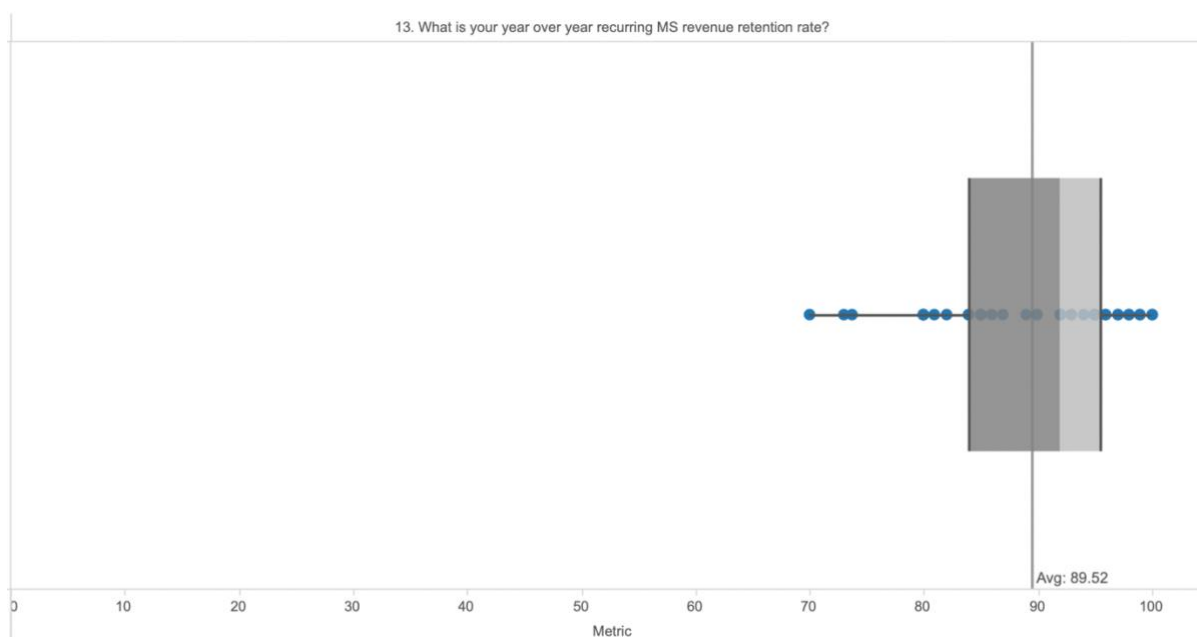
Source: TSIA Research.

Challenge #2 - Retention

Managed services is a recurring revenue stream. For executives who have learned the power of recurring revenue (thank you, cloud services), they understand that it creates a dependable, predictable revenue model for the company. Managed services follow Newton's first law of motion: An object that is in motion will stay in motion if there is no other force acting on that object. The object, in this case, is a managed services agreement. We once had a managed services executive say it like this, "We've generated a ton of inertia with our managed services revenue that we've built up over the past three years; we just have to not screw it up and it will be unstoppable." This is why companies that have made the pivot to recurring revenue streams have substantially higher valuations than those that still focus on product-centric, transactional businesses.

In fact, a previous prediction from The World Economic Forum is that "all products will have become services"¹ by 2030. If this is true, then **shouldn't the retention of the recurring revenue from services be one of the absolute top priorities for a managed services executive?** The data tells us that the average recurring revenue retention rate for managed services is 90%. Yet more than half of the members in the benchmark database have average retention rates below 90%, with an overall range of 70% to 100%, as seen in *Figure 3*.

Figure 3: Managed Services Retention Rates



Source: TSIA Research.

Challenge #3 - Profitability

There are two core profitability metrics that are commonly used in the technology industry to understand profitability of revenue: gross margin (GM) and operating income (OI). Gross margin is often the go-to metric for tech execs. You'll often hear, "what's the gross margin of this business or that business?" Rarely do you hear the better question, "what is the operating income of the managed services business?" However, between the two, OI is a far superior metric to understand relative to whether or not a services business is profitable, for a number of reasons. From the over 140 managed services organizations that TSIA has benchmarked, no two calculate gross margin in exactly the same way. There is a constant debate over what costs are "above-the-line" or "below-the-line." Every finance team has its preferred way of calculating gross margin for managed services. Some companies even have different gross margin calculations for different product and service lines. In other words, you'll never get a true apples-to-apples comparison with your peers in the industry. Operating income, on the other hand, is simply all revenue minus all direct and indirect costs. With GM, you never really know if a business is truly profitable at a bottom-line level. With OI, you always know.

According to TSIA research, once again there is no surprise that there is a wide range in performance of OI across the MSPs in the benchmark database. The average is at 10%, the lowest OI is at -17%, and the highest is at an outstanding level of 31%, as shown in *Figure 4*.

Figure 4: Managed Services Operating Income



Source: TSIA Research.

There are reasons companies are performing below the average of these three metrics. There are also reasons why companies are substantially outperforming the average. If you are underperforming on any of these metrics, or would like to achieve pacesetter status, the next section will identify trending practices and capabilities that you can develop or enhance to improve your performance.

What Are Digital Managed Services?

To understand what digital managed services are, it is helpful to understand what digital managed services are not. Managed services are not new to the technology industry. Many believe these services were introduced in the 1990s, along with the application service provider (ASP) model. Some would argue that managed services evolved out of IBM Global Services through its Data Processing Support Services (DPSS) that go back as far as the 1970s. Though it is debatable when the first managed services offers were introduced, one thing is abundantly clear, it has been decades. Since the start of managed services, all the way through 2010, these services have been resource-intensive and highly custom in nature. Custom is the enemy of scale. The enemy of scale is the enemy of profit. Digital managed services are not custom, resource-intensive managed services.

Digital managed services are highly scalable, highly standardized offerings that not only reduce cost and risk in technology operations, they also provide deep business insights to the customer that they themselves are not able to understand on their own. Digital managed services require a strong bridge between the service offer portfolio and delivery operations. For examples of companies leaning into digital managed services, and the incredible value these offers bring to their customers, check out the TSIA research report “Your Mess for More.”²

So, let’s talk about the three most important organizational capabilities required to build your foundation for your digital managed services business. Two of these are emerging and one has reached main-stream adoption. All three of these are required, not optional. Think of them as the legs of a stool. Any stool with fewer than three legs will not stand.

The three critical capabilities for digital managed services are:

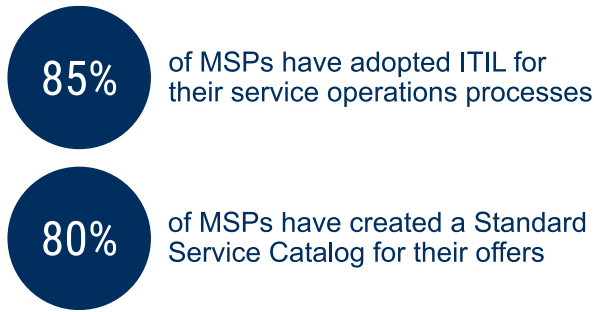
- Standard Service Catalog
- Digital Delivery Platform
- Formal Service R&D Investment

#1 - Standard Service Catalog

As mentioned earlier, most managed services providers come from a history of custom, complex managed services. This is especially true for managed services providers that target enterprise customers and vertical industries, such as government, finance, and healthcare. There is a perception that every customer is unique and has its own special requirements. Therefore, many MSPs believe a custom scope of work (SOW) must be developed for every customer. We can dispel that myth. Technology operations are not new. There is nothing in technology operations that has not been seen before. The ITIL framework was created in the 1980s as a library of the operational processes required to ensure technology is operating as intended so that companies would benefit from the value of their technology solutions promised by their suppliers. ITIL v4 is now the current standard and has been in place since February 2019.

As of July 2021, 85% of managed services providers have adopted ITIL for their service operations processes and procedures (*Figure 5*).

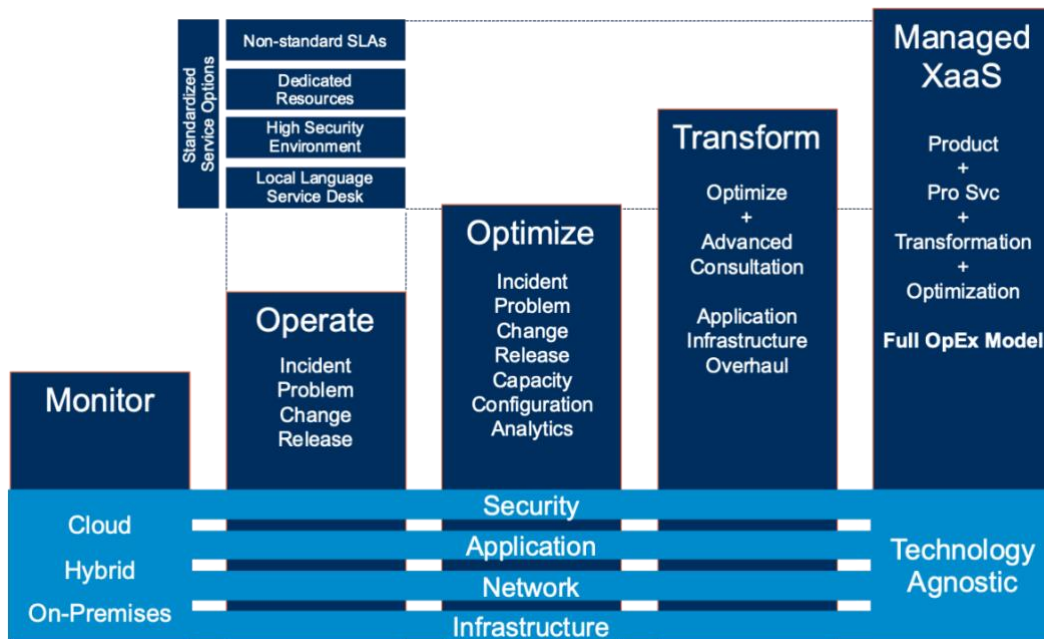
Figure 5: ITIL Adoption Among MS Providers



Source: TSIA Research.

Aligning to ITIL is Step 1 of starting to standardize and digitize your managed services offer portfolio. It's not just a general alignment, it's understanding the elements in the ITIL catalog and how they are logically grouped together in a minimum viable product (MVP) to create a managed services offer. It's also important to standardize any options you may apply to a standard managed services offer. Examples of standard options may include service desk language options (English is the international standard), high-security configurations, advanced reporting, consumption analytics, non-standard SLAs, etc. *Figure 6* illustrates a framework TSIA uses to help members understand a logical MVP framing of a managed services portfolio.

Figure 6: Minimum Viable Product Framework

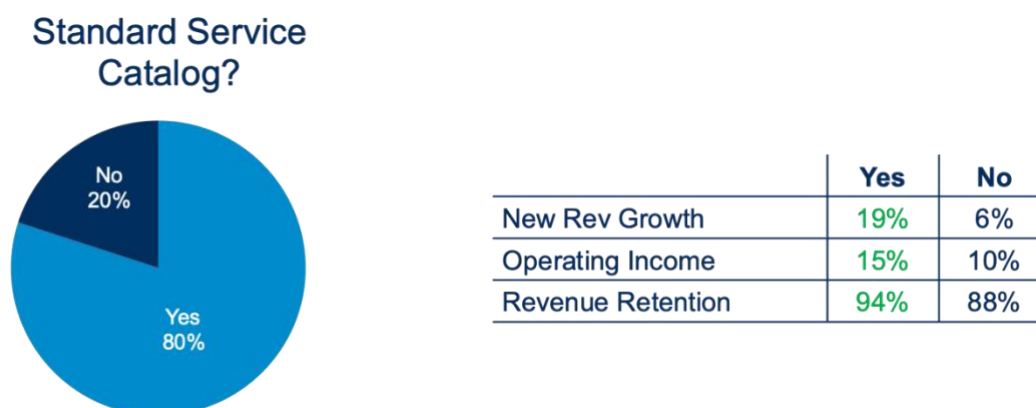


Source: TSIA Research.

The TSIA research report “Defining Managed Services”³ includes detailed descriptions of each of these offers and why they are important to customers.

TSIA’s benchmark data for managed services indicates that companies that have a standard service catalog experience higher growth, higher revenue retention, and higher profitability, as seen in *Figure 7*.

Figure 7: Effects of Having a Standard Service Catalog



Source: TSIA Research.

#2 - The Digital Delivery Platform

The heart of any service offer is the delivery of the offer. The key to the profitability of a service offer is scalable delivery operations, and the only path to scalable delivery is through a digital delivery platform. At TSIA we used to say “software eats hardware” and “services eats software.” Now we add to that that “software eats services.” What this means is that delivery processes must be turned into software. Sounds simple enough; but, in reality, it’s way harder than it sounds. It’s almost impossible to do for custom managed services.

Once the service catalog has been standardized, the delivery organization must standardize and document all of the operations processes required to deliver the promise of the offer. As with the offer, these delivery processes are categorized into logical groups of functions:

- Service Management (IT and customer service management)
- Performance Monitoring (application, infrastructure, device, network, service)
- Analytics (data collection, correlation, orchestration, reporting)
- Provisioning
- Business Operations Support Systems (BOSS) Integrations
- User Interface

The Service Management module contains the heart of the platform—the configuration management database (CMDB). The contractually obligated service levels are also governed from the Service Management module. The Service Management module automates service operations and guides the activities of the engineers through the ITIL processes within the offer. This typically includes core ITIL processes, such as incident management, problem management, change management, release management, capacity management, configuration management, and so on.

The Performance Monitoring module of the digital delivery platform includes software agents and applications that will have two core functions: discovery and ongoing monitoring. These agents will automatically identify devices, network topologies, applications, and transactions. Often, discovery tools are used by professional services organizations to empower more insightful consulting engagements. Unfortunately, there is often a lack of consistency between the professional services and managed services organizations with regard to which tools are used and what happens with the data that is collected. TSIA recommends that any discovery data is captured, stored, and leveraged to auto-populate a CMDB. Many discovery tools can also be used to perform ongoing monitoring of the health of the customer environment. There are two different fundamental types of monitoring: reactive and proactive. Reactive means you're monitoring for events as they happen and then collecting data on the event. Proactive means you're monitoring things like application or network performance in order to predict and prevent bad things from happening. Both are crucially important.

The Analytics module is the most exciting and emerging area for managed services providers. The foundation of the Analytics module is the data collection system where all discovery and monitoring data is stored and structured to be analyzed for patterns. With correlation and orchestration, incidents and problems can be resolved more quickly. Next-generation digital MSPs are heavily investing in machine learning and advanced artificial intelligence to identify patterns not obvious to human engineers. These systems are starting to predict future impacts, capacity requirements, and even future opportunities to improve the customer's business.

TSIA recently authored a paper on many of these capabilities called, "The Rise of AIOps"⁴ and will be writing extensively about these capabilities in the upcoming book *Digital Hesitation*,⁵ to be released at TSIA World Interact 2022.

The Provisioning module contains all the tools and applications used for configuring, administering, and maintaining the applications, infrastructure, and devices under the managed services contract.

The digital delivery platform also must interface into all of the other corporate systems, such as finance, human resources, salesforce automation, offer catalogs, billing systems, etc. This requires a combination of open and private APIs to ensure machine-to-machine (M2M) communication.

The final core module is the User Interface module (customer, engineer, and partner). This is often called the "portal," as it is a window or a "single pane of glass" that allows a simplified view into the

capabilities of the platform. The user interface should also control security authentication and roles-based authorization for access to specific views, tools, reports, etc.

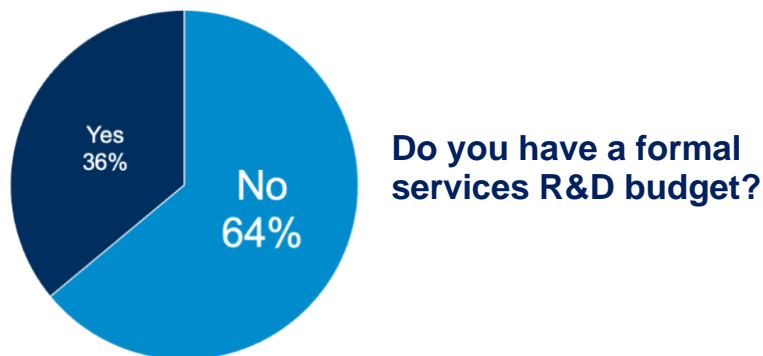
At the end of this document, we provide a full-page blueprint of the managed services digital delivery platform.

#3 - Formal Service R&D Investment

If software is going to eat service operations, who will create the software?

Most services organizations are not new to creating software. However, according to a recent survey by TSIA, almost two-thirds of services organizations do not even have a formal R&D budget, as seen in *Figure 8*.

Figure 8: Services Organization with a Formal R7D Budget

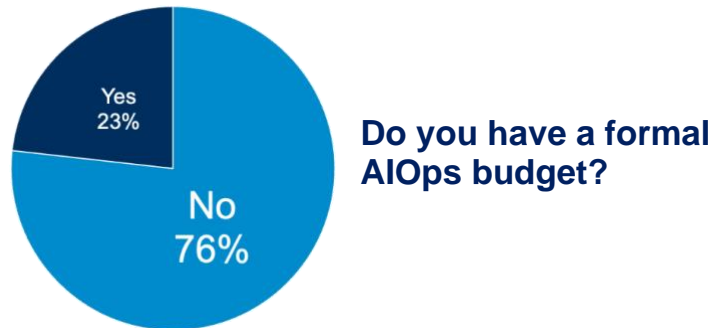


Source: TSIA Research.

As discussed in the Digital Delivery Platform section, companies are starting to lean into data analytics and AIOps. This will be the “secret sauce” and intellectual property of the future for many services organizations. It will set them apart from the resource-intensive operations of the past. The delivery software of the future will be the key to scale, and scale is the key to growth and profitability.

Also of concern is that the data tells us that only 23% of MSPs have a formal budget for AIOps, as documented in *Figure 9*.

Figure 9: MSPs with a Formal AIOps Budget

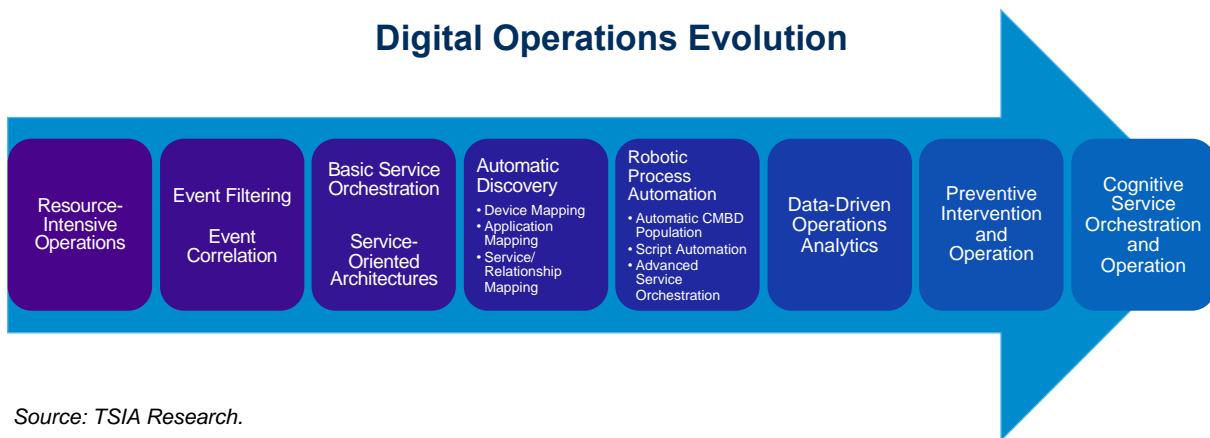


Source: TSIA Research.

TSIA has a strong assertion that companies must create a formal services R&D budget and that a significant portion of that budget must be allocated to the development of AIOps and automation capabilities. A formal plan, backed by a formal budget, is the only way for companies to accelerate the digital transformation of their managed services business.

In 2017, in the TSIA blog “Managed Services Is an Orchestra,”⁶ we outline the fact that all aspects of operations in managed services need to be conducted in synchronization with each other. If the tools, processes, and people required for managed services are the instruments of the orchestra, software is the conductor. Connecting the right technologies with the right APIs to deliver the intended outcome of the offer at scale with a compelling digital experience has the potential to be a major competitive differentiator. This is why one of the biggest trends we’re seeing in managed services is the digital operations evolution shown in Figure 10.

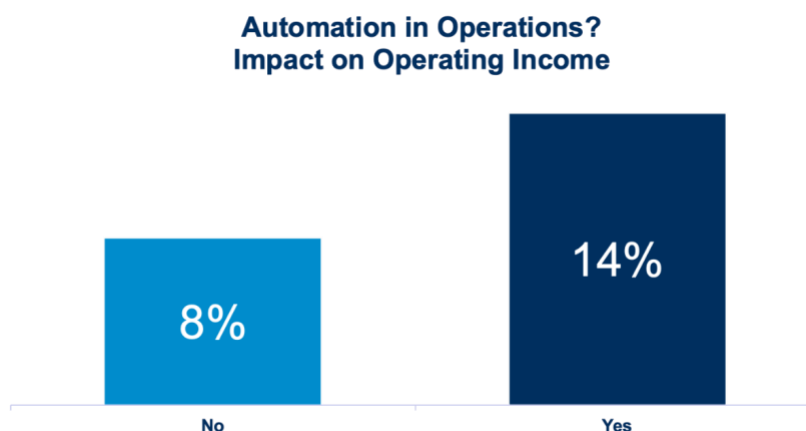
Figure 10: Digital Operations Evolution



Source: TSIA Research.

A digital operations evolution starts when a delivery team starts to embrace technology to replace many of the day-to-day functions historically completed by an operations engineer. With over 75% of the headcount in a managed services organization coming from delivery resources, it's no surprise that using software to eat away at manual operations delivered such a strong improvement to profitability in the organization. Even with basic levels of automation in delivery operations, companies are seeing a 75% increase in profitability, as *Figure 11* demonstrates.

Figure 11: The Impact of Automation on Operating Income



Source: TSIA Research.

Summary

While there are dozens upon dozens of challenges facing today's managed services organizations, we've intentionally focused on the three that are most basic and most important. Every executive should be asking: "Am I growing MS revenue? Is it profitable? Am I keeping as much of it as possible?" As managed services continue to grow as a proportion of overall company revenues, leaders across the industry are focusing on three specific capabilities to answer yes to those questions.

- They are building standard services catalogs supported by standardized delivery operations.
- They are making substantial investments in a digital delivery platform focused on scaling operations.
- They are focusing on a formal services R&D budget to invest heavily in next-generation service automation capabilities.

A 1.0 MSP embraces complexity and offers predominantly customized solutions. These engagements are supported by labor-intensive, manual operations. A 2.0 MSP embraces simple, standard, and scalable offers. They seek out and destroy complex, manual operations with advanced, scalable digital operations resulting in faster growth, higher profitability, and greater recurring revenue retention.

Which model will you choose?

Would you like to know how you compare to your peers and the industry overall in your managed services evolution from a resource-intensive classic MSP to a software-oriented digital MSP? Would you like to learn more about the keys to successfully creating, growing, and scaling a highly profitable managed services business? If so, reach out to TSIA to learn more!

Endnotes

¹ Parker, Ceri. November 12, 2016. "8 predictions for the world in 2030." World Economic Forum.

<https://www.weforum.org/agenda/2016/11/8-predictions-for-the-world-in-2030/>.

² Lah, Thomas, George Humphrey, and Vele Galovski. February 2021. "Your Mess for More: The Future of On-Premise Technology Providers." TSIA. <https://www.tsia.com/resources/your-mess-for-more>.

³ Humphrey, George and Jeff Connolly. May 2021. Defining Managed Services. TSIA.

<https://www.tsia.com/resources/defining-managed-services>.

⁴ Humphrey, George. May 2020. "The Rise of AIOps: Seven Emerging Managed Service and XaaS Delivery Capabilities You Must Invest in Right Now." TSIA. <https://www.tsia.com/resources/the-rise-of-aiops>.

⁵ Wood, J.B., Thomas Lah, and the TSIA Executive Research Team. 2022. *Digital Hesitation: Why B2B Companies Are Falling Behind*. San Diego, CA: Point B, Inc.

⁶ Connolly, Jeff. October 3, 2017. "Managed Services Is an Orchestra." TSIA Blog.

<https://www.tsia.com/blog/managed-services-is-an-orchestra>.



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