



HEAD IN THE CLOUDS

A large, fluffy white cloud against a blue sky with smaller wispy clouds.

MAXIMISING OPPORTUNITIES
IN CLOUD SERVICES



AT A GLANCE

- The cloud services market presents an opportunity for service providers to profitably serve customers in both the private and public cloud.
- Service providers will need to be aware that revenue and margin economics differ between private and public cloud estates.
- As there is a lower margin opportunity in reselling public cloud infrastructure, service providers are altering their commercial models to increase margin on managed or value added services.
- Service providers can also benefit from additional revenue opportunities and efficiency savings provided by public cloud. This can lead to an absolute increase in gross profit.
- We have identified four characteristics that prime cloud service providers for growth, and have seen buy & build used to turbocharge this.

A MOVE TOWARDS THE CLOUD

The growing cloud services market presents an opportunity for managed service providers to profitably serve customers in both the private and public cloud.

Organisations require an increasing amount of computing resources (or workloads) to operate and compete effectively. This growth is not solely linked to an expanding number of devices, associated applications and internet users. Instead, advances in technology, such as artificial intelligence and the internet of things, mean that these workloads are now created and manipulated in new ways.

An organisation's ability to collect, store and manage these workloads is essential for harnessing the resultant data to drive insight and business performance in a competitive marketplace. Advances in technology, such as pooling data into data lakes and automating workflows, make this easier for businesses to achieve.

Businesses are migrating towards cloud solutions to meet two key needs:

- **Technological:** organisations are seeking to benefit from the flexibility and scalability cloud solutions offer, as well as allowing for more efficient remote working.
- **Strategic:** leadership teams are looking to collect and analyse business information more effectively, facilitating more data-driven decision-making.

In 2017, businesses were allocating an average of ~24% of IT hosting spend on cloud solutions versus on-premise and / or colocated infrastructure. This significantly increased to ~65% in 2021. As cloud adoption grows, so too does the need for cloud services providers to harness its potential.

This report explores CIL's research into the relative economics of the public and private cloud, and how providers can benefit from the additional opportunities the public cloud offers, while navigating a shift in their commercial model.

GROWTH IN CLOUD ADOPTION

Moving to the cloud essentially outsources the hosting infrastructure, and typically the management and maintenance of the hosting environment. Broadly, there are two types of cloud solution: private and public. Most organisations adopt a 'hybrid' approach.

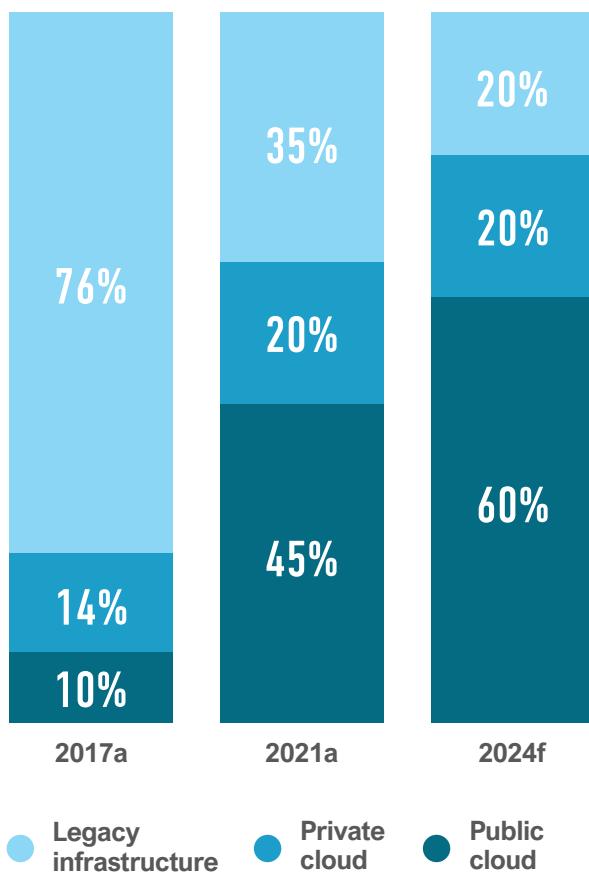
Private cloud providers tend to own or specifically lease the hosting infrastructure and charge the customer on a recurring basis. The infrastructure can either be a dedicated stack (isolated servers for individual customers) or multi-tenanted (where servers are not segmented by organisation).

Public cloud infrastructure is provided by hyperscalers, such as AWS, Azure and Google Cloud, and rented to organisations on a flexible, pay-as-you-go basis.

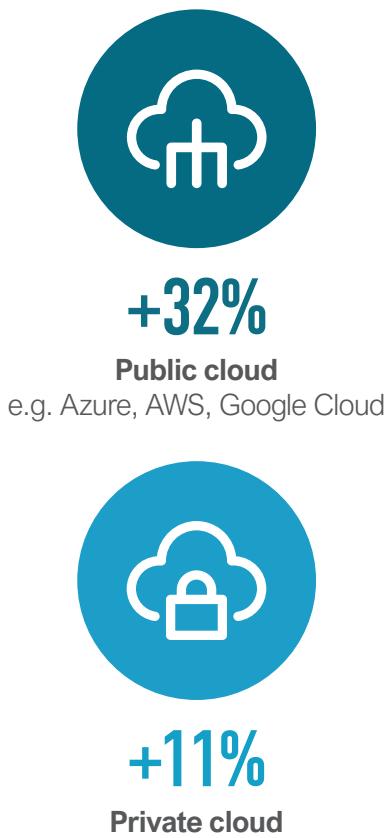
Both private and public cloud solutions are in growth. Public cloud in particular is taking a high share of new workloads, as well as benefiting from the migration of those that have been historically stored on-premise or on colocated infrastructure.

However, wholesale data centre providers / colocation providers are also positioned to scale as they can host end customer, service provider and hyperscaler estates.

Average allocation of IT hosting spend
Global 2017-24f



Percentage growth of enterprise application workloads and compute instances
Global, 2016-21 CAGR



A SHIFT IN THE COMMERCIAL MODEL

Service providers will need to be aware that revenue and margin economics differ between private and public cloud estates.

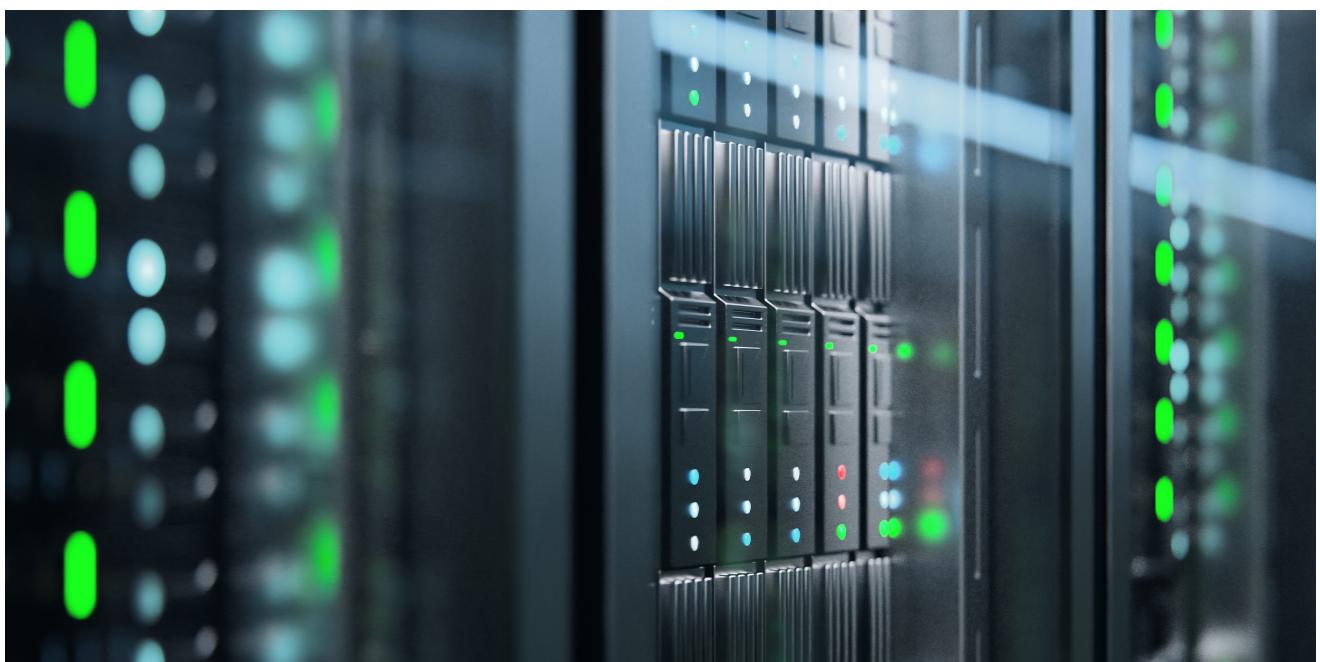
Service provider revenue composition

Typically, cloud service providers' commercial models break down into three broad revenue segments:

Infrastructure: providers own or resell access to storage infrastructure and software licences. In return, they receive hosting fees that are often recurring. These fees vary based on the level of involvement service providers have in a customer's technology stack. The greater the involvement, the greater the fee.

Managed services: providers actively offer ongoing maintenance, monitoring and management of a customer's hosting environment, as well as back-up and disaster recovery services. This can include providing reactive support by fixing assets, making required changes, and implementing updates to both hardware and software.

Value-add services: providers can offer customers other wraparound services that are complementary to providing hosting infrastructure and managed services. One example is hosted workspace, where end-user devices (e.g. laptops, tablets) access data virtually on a server rather than it being stored on the machine, enabling collaboration and hybrid working. Cyber security and application modernisation are also examples.



The shift

The most significant shift in the commercial model is associated with infrastructure.

There is typically a 10-20% gross margin opportunity for reselling hyperscaler storage infrastructure, compared to 50-70% for private cloud environments.

Private cloud providers can sell storage at a higher margin given they directly own or lease the infrastructure. However, this also requires greater CAPEX and management costs. Once this is considered, there is less of a difference in absolute profitability between serving private and public cloud customers.

Growth in public cloud adoption and the tendency for potential customers to make price comparisons means service providers are changing the composition of their commercial models. We increasingly see providers including more margin in managed and value-add services versus infrastructure.

Furthermore, any reductions in infrastructure revenue and margin can be offset through additional revenue opportunities and efficiency initiatives, which can lead to an absolute increase in gross profit. These include:

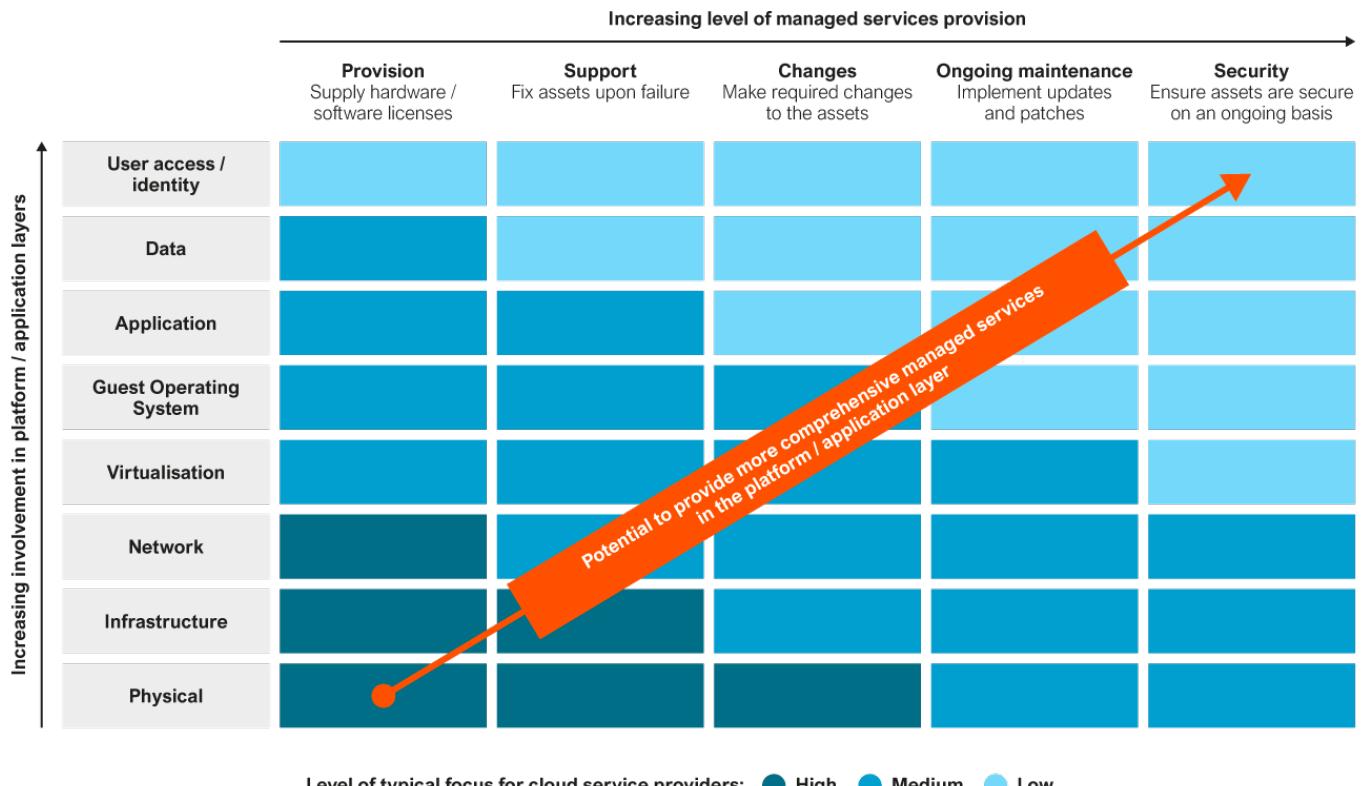
Professional services to support cloud migration: this can include transferring data and files from on-premise to a cloud environment and application modernisation, where legacy on-premise applications are ‘containerised’ and remodelled to sit on cloud infrastructure.

More comprehensive **managed services**: as service providers become more embedded and responsible for a customer’s wider hosting environment (particularly in the platform / application layer of the infrastructure), both the revenue opportunity and customer stickiness increase.

Wraparound **value-add services**: service providers gain the ability to cross-sell additional value-add services and expand further up a customer’s application stack.

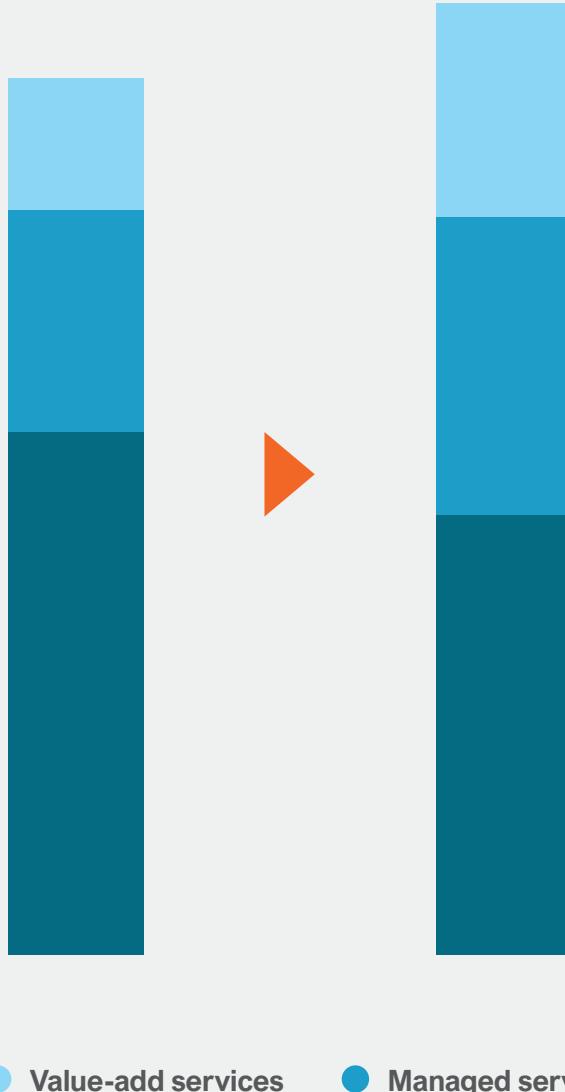
Investment in **automation**: service providers can gradually improve the efficiency of their cloud offering through automation or developing a technology platform to administer it. Efficiencies lead to lower costs.

Further **cost reductions**: public cloud hosting allows service providers to reduce their CAPEX (e.g. servers) and OPEX (e.g. NetOps staff).



The impact of a shift towards public cloud on cloud service providers' revenue composition

Increased revenue upsides from managed and wraparound services should offset any infrastructure revenue reduction. In reality, many customers will continue to operate hybrid cloud estates so the shift in commercial model will be gradual.



Revenue upside

The ability to offer additional services such as cyber security provides a significant cross-sell opportunity.

Revenue upside

There is greater complexity in managing a hybrid estate, plus opportunity to sell more cloud products / additional services.

Potential revenue decline

Public cloud infrastructure costs can be cheaper than private cloud on a storage-only basis.

● Value-add services

● Managed services

● Infrastructure

A WINNING FORMULA

We believe there are four characteristics that prime cloud service providers for growth. M&A can be used to turbocharge this.

1 Cloud agnosticism

Cloud service providers that can support both private and public cloud workloads and have as much responsibility as possible across a customer's entire IT environment, are likely to be the most successful. The exception to this is where focus is on one cloud vendor, or customer type differentiates.

2 Effective sales and marketing

Investing in sales and marketing capabilities helps generate new business leads, while establishing proven initiatives that drive cross-sell will boost revenue opportunities with new and existing customers. Where it is difficult to economically serve an end customer directly, service providers can work with partners that can absorb customer acquisition and service costs.

3 Broad service proposition

Private and public cloud customers are likely to also purchase adjacent services, such as back-up and disaster recovery, cyber security, application modernisation and containerisation, and broader digital transformation.

4 Strong technology platform

Automating platforms and workflows will help to deliver managed services more efficiently and cost-effectively, and therefore more profitably. This will require initial and some ongoing investment, however once established, it will continue to bring benefits.

Opportunities for buy & build

A cost-effective way of broadening a service proposition and achieving cloud agnosticism is to acquire providers with different cloud capabilities and managed service offerings.

M&A also creates several synergies, such as greater purchasing power for the service provider when it comes to software / vendor licences and cost savings in central functions, such as finance, HR and IT. Buy & build can generate lower customer acquisition costs versus direct sales efforts and acquiring the target's customer base provides significant cross-sell opportunities.

OUR EXPERIENCE

At CIL, we have significant experience working with businesses in cloud services, IT managed services and cyber security.



Acora provides managed services, Microsoft-centric business software and cloud solutions to mid-market organisations.



AllCloud provides application modernisation and public cloud migration services alongside Salesforce consultancy to international clients.



Appsbroker is a Google Cloud-only partner offering digital transformation and managed services.



CTS provides cloud and managed IT services for law firms and the wider legal sector.



Cybit provides end-to-end IT solutions including the design, development and delivery of flexible managed IT services, cloud migration, data and analytics and cyber security solutions.



Just After Midnight is a provider of managed cloud, 24/7 infrastructure and application support & DevOps services. It is part of Ultima.



Solvinity offers IT and managed cloud solutions, including private cloud, Azure and AWS, to international enterprise and public sector organisations.



Aker Systems designs, builds and operates ultra-secure public cloud data environments for large private and public sector clients.



ANS provides digital transformation services including public & private cloud, managed hosting, security solutions, applications, DevOps & data services.



Content+Cloud is a Microsoft-focused cloud, digital transformation and managed services provider.



Cyberfort provides ultra-secure hosting and managed IT services to mid-market companies.



Ekco is a managed cloud services provider, supporting private and public cloud estates with wraparound cyber security services.



Littlefish provides managed services, cyber security and cloud services to UK enterprises and large public sector organisations



Xperience provides managed cloud and IT services, cyber security and ERP and CRM services to SMEs.

GET IN TOUCH

CIL provides growth strategy and due diligence support to management teams and investors. We are rigorous in our approach, confident in our conclusions and expert at what we do.

To discuss any of the points raised in this piece, please get in touch.



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