Dr. Titus Kehrmann

CONNECTED VALUE

ARTICLE · CFO 4.0

How CFOs are driving value creation in the digital age

How CFOs are driving value creation in the digital age

The most valuable companies are built around a subscription business model

A decade ago, traditional corporations were dominating the league tables by market capitalization. Today, 5 out of the top 6 companies are in technology or media. While the primacy of digital technology has become commonplace in every company's strategy, it is often overlooked that the value leaders have re-invented pricing and business models. They are offering their customers *"low upfront investments, easy to get started"* subscription models: Microsoft has replaced its licensing model with a SaaS and Cloud-as-a-Service offering, Apple has announced it is no longer going to report equipment sales as the strategic focus is on customer-centric service offerings, Amazon takes a fee on its merchant transaction value (besides its Prime subscription, AWS …), Google and Facebook are charging per click.

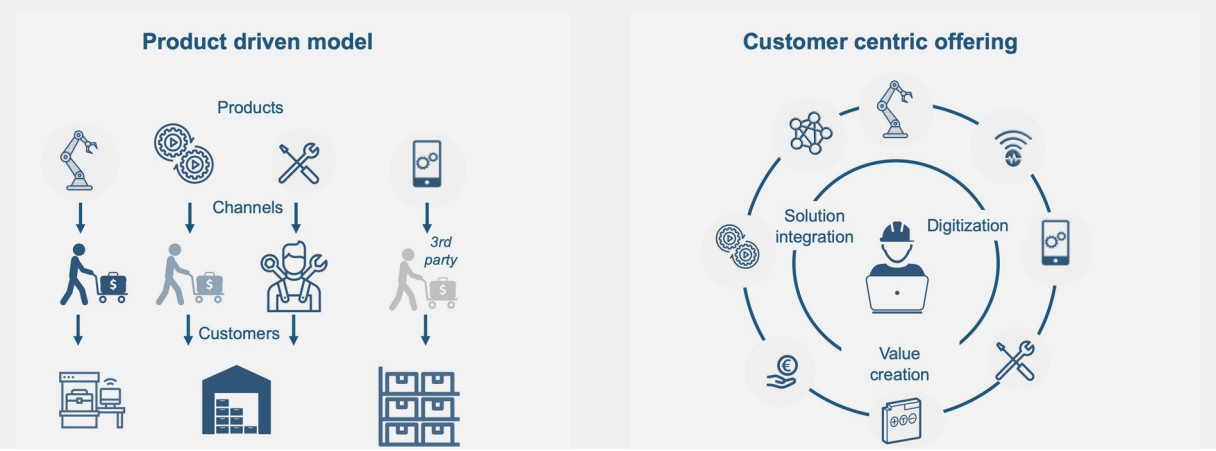


Exhibit 1 – A switch in business models

Investments in digital must be balanced with customer value creation and with taking a fair share of the value created

Traditional industrial companies have invested in digital products and services, too often without the expected boost in market success. As companies and their customers are managing the downturn, it is now time to catch up on the pricing and business model side and to balance customer value creation with the monetization of the value created.

By connecting equipment, software, and users, the foundation to measure and price based on usage and/or value creation has been established. However, there are a couple of challenges in the servitization journey:

- As we have seen in the technology sector, customers expect a real choice among a few pre-bundled solutions with a clear value delivery and transparent pricing. These solution bundles integrate hardware and software to solve a specific customer issue holistically.
- Since value-based pricing typically transfers revenues into the future, an (external) refinancing structure must be in place that allows to realize a “true sale” and mitigates some of the flexibility provided to the customer.
- Finally, the accounting and reporting solution must translate the (nonlinear) usage and output parameters into invoicing as well as investor reporting.

Handling these issues requires not only to view the digital twin as an instrument to integrate equipment and services horizontally and vertically into the value chain, but also to measure, evaluate, price and refinance value creation. In other words, to add a financial layer to the digital twin. This is the additional role of the CFO in the digital age. What are the new tasks?

- Develop and implement new KPIs, e.g., to measure customer value added (CVA) and monetization, leveraging the machine and usage data.
- Allocate capital to digital initiatives and evaluate their success both by financial KPIs as well as milestones.
- Support the business units in developing pricing and monetization schemes based on value sharing and evaluate the business cases.
- Adjust the financial reporting to capture recurring revenue models and build the abilities to invoice flexible pricing schemes based on usage data.
- Advance the risk management to identify and mitigate new types of technological, operational, and financial risks leveraging the available new data.
- Organize refinancing and risk transfer options (including off-balance sheet) to allow for scaling the as-a-Service offerings and to realize a true sale with immediate revenue recognition.

- Evaluate options to shift to variable sourcing models on the purchasing side to implement the as-a-Service model end-to-end.

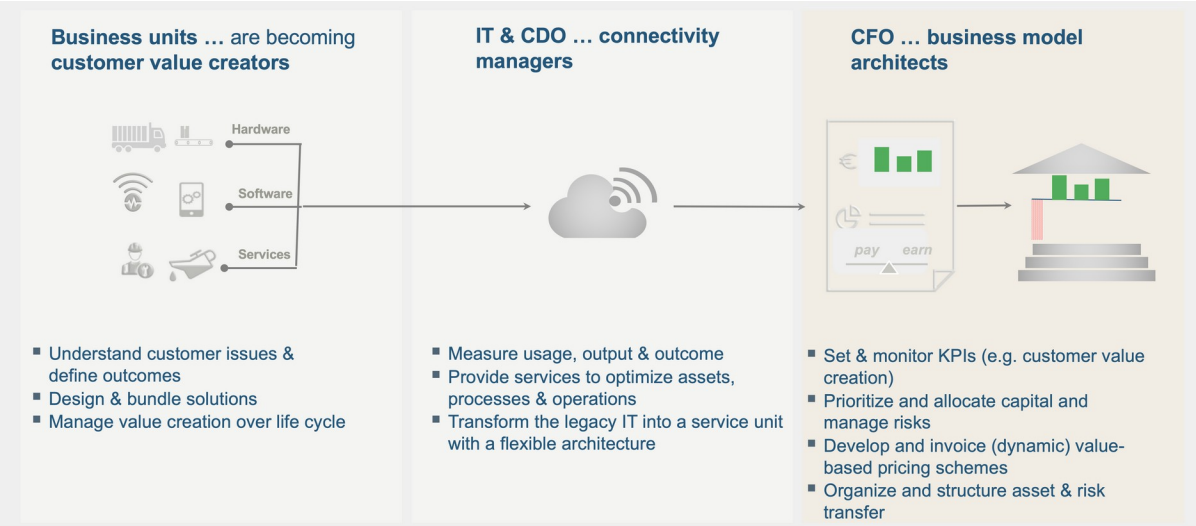


Exhibit 2 – New roles in the digital age

How to start – Use case vs. holistic approach to develop the new CFO role

Two fundamentally different transformation paths can be adopted to drive the change in the finance function:

- A "concept-driven" approach, following the "target image, gap analysis, concept, implementation" principle. In this case the methodological framework, tools and KPIs are developed and then implemented.
- A "use case" approach, based on an agile "design, learn & transfer" logic. Use cases are rapidly developed and piloted according to the strategic priorities. Typically, 3–4 specific solutions or specific business units are selected. After a short conceptual phase to set the direction, the instruments are developed and implemented for these specific use cases. Based on the results of the pilots, use cases are transferred to other customer segments and product areas and the next wave of solution offerings.

Most companies prefer the pragmatic step-by-step "use case" approach because it allows for testing market success, the customer response as well as the "right" configuration. This provides comfort before investing into larger scale implementation with infrastructure build out and changes of organizational structures. Implementation and market risks will be managed, and misallocation of resources avoided. CFOs should support their companies in their journey to turn data into value … and value into business in three areas: customer-facing solutions, sourcing on a flexible basis, and transforming internal services.

Customer-facing business units – Beyond the asset transfer model

As manufacturers are starting to offer data and software-based solutions such as equipment automation or predictive maintenance, they find the traditional asset transfer (or licensing) models are not adequate: The cost+ logic does not work, since variable costs are low and do not reflect the value creation potential of the services. Based on a segmentation of offerings and customers, value-based pricing models allow revenues to be adjusted over time as the solutions mature and customers are upgrading to higher degrees of automation. Some companies are building ecosystems of third-party applications around their IoT platforms in order to benefit from positive effects on their core products following the success of app stores in the consumer space. However, unlike in the consumer world, most corporate customers have stringent purchasing processes in place. To reduce onboarding costs, the individual purchasing

processes must be bundled for the industrial users by the platform, ideally without the platform acting as a reseller of the products.
The next step is to include the equipment and the "physical services" into the "pay-for-what-you-get" commercialization package. This is advantageous in mature markets if there are strong technical and/or economic interdependencies between the software/service solutions and the equipment as well as a need to increase the share in the aftermarket.
Additional pull towards value-based business models comes with new technologies such as electrical drives & engines, automation, capacity management or autonomous machines and vehicles. Why? Because there are significant hurdles on the customer side (upfront investments and unclear value); with autonomy, the responsibility for operations shifts to the manufacturer; and often the products can be optimized over time, given that software development cycles are faster (e.g., in automation).

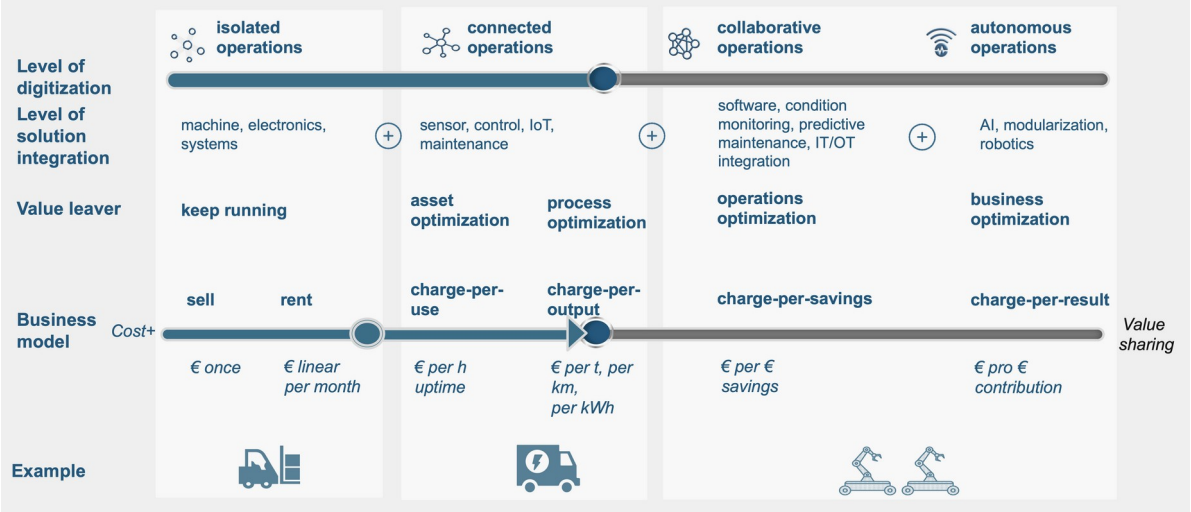


Exhibit 3 – As digitization increases and value levers … business models have to change

Purchasing side – stabilizing cash flows and strengthening the ecosystem

The same principles can be applied to the purchasing side. From an industrial user perspective, sourcing on as-a-Service terms relieves the balance sheet and (contrary to leasing and renting) also stabilizes cash flows, as usage, risks, revenues and costs are aligned. By adopting an "easy to get started, low upfront investment" subscription scheme structured around usage or outcome, suppliers and operators are aligned to optimize performance over time. This is especially important as development and deployment cycles are much faster in the digital age.
Sourcing on an as-a-Service basis requires a good segmentation into internal demand clusters and defining the functional requirements for the solutions as well as the expected outcomes.
Purchasing on an as-a-Service basis is a value lever in cyclical industries and efficiency gains through automation should be realized in an "asset light 4.0" logic without burdening the balance sheet or increasing the volatility of the cash flow.
Finally, in some industries aggregators such as mobility providers (e.g., bus companies) and forwarders are starting to transfer their purchasing and refinancing advantages to smaller sub-providers to maintain the ecosystem and increase their attractiveness in the competition for operators.

Internal functions – from cost centers to service units

Large companies have started to reorganize their internal functions and split up governance tasks and internal services. Typically, internal service units have started to assemble catalogues of products including e.g., in the case of an IT function, often hundreds or even thousands of items and ex-post charging based on price lists. However, this transparency

leaves the internal customers with the question which services to choose and how to optimize spending. As with solutions for external customers, as-a-Service requires the packaging of services and flexible pricing models, targeted to specific internal demand clusters. This requires a refined demand management process, pre-defined service catalogues with prices, a pre-calculation model to transform the resources and costs into a pricing model, and transparent reporting to the business units including quantities of usage and service levels. Ultimately, the service unit could be run as a profit center; this, however, would require offering fixed prices (instead of ex-post cost allocation). The service unit IT in turn bears opportunities & risks.

***

If you want to monetize the digital transformation of your company, the CFO needs to assume the role of a transmission belt, linking investments in digital, value creation and value distribution (including invoicing and refinancing) across the business units, functions and throughout the supply chain. The finance unit can bring in the holistic and independent perspective, the specific analytical and financial skills as well as the knowledge of the invoicing, reporting, and refinancing infrastructure and processes.

CONNECTEDVALUE

ConnectedValue is the specialist for industrial Equipment-as-a-Service. Together with our clients, we develop and implement capital- and carbon-light business models, their invoicing, the management and transfer of risks, and their (off-balance-sheet) financing as an integrated whole. In more than 50 projects with leading industrial users and manufacturers, we have built up this unique combination of competencies.

The Author



Dr. Titus Kehrmann is the Co-Founder of ConnectedValue. He has 30 years of experience in consulting top executives in finance, payments and manufacturing (e.g., as a Partner and co-head of the payments practice with The Boston Consulting Group and Stern Stewart & Co.) as well as in senior management roles in a leading German banking and insurance company and in professional service firms. He applies his know-how in digital transformation, finance and pricing to help industrial companies develop, price, and refinance digitally enabled products and solutions.