THEMATICS
asset management

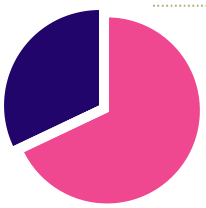
SUBSCRIPTION ECONOMY : THE FUTURE OF CONSUMPTION

Have you recently taken a long, hard look at your credit card statement? It's increasingly likely that you'll find a few monthly or perhaps even annual subscriptions to a range of services that you use regularly. You most likely recognize that you are paying for a video or music streaming service but you can be pretty certain that these are not your only subscriptions.

Over the last decade, we have seen a constant and steady increase in the number of industries and companies that use subscription services to monetize their offering and, in more cases than not, this has been a success.

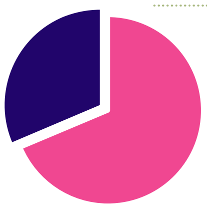
The business model is quite easy to understand. Instead of creating a hit product that will be 'sold once', you offer ongoing value such as new content, more personalization, or perhaps access to updates which customers pay for via a monthly or annual subscription. Companies end up building stronger relationships with their customers and successful companies enjoy high renewal rates. And this matters a lot. In our next white paper we will explore this further, but high renewal rates essentially lead to better revenue visibility (if every consumer renews at the same price, revenue will be *at least* as high as in the previous year) which in turn means that the company can commit capital to research and development spending with more confidence, offering additional and better services to the customer. This is the virtuous circle that both companies and customers benefit from.

Subscribing to a service means you don't actually own the product. Recent surveys suggest that 68% of adults no longer value ownership and don't necessarily think that ownership defines what or who they are[1]. However, what we *do* value is the 'usership' and the experience. But what does this actually mean? To use a simple example that most of us can relate to, we don't particularly care about owning a DVD, but we *do* value the experience of watching the movie. There is absolutely no need to buy a DVD if you can simply watch it on a video streaming service. Furthermore, 70% of adults say that the maintenance and costs associated with ownership of material possessions is burdensome and that they would rather subscribe to a service that takes care of these items.



68%

of adults believe that a person's status is no longer defined by what they own



70%

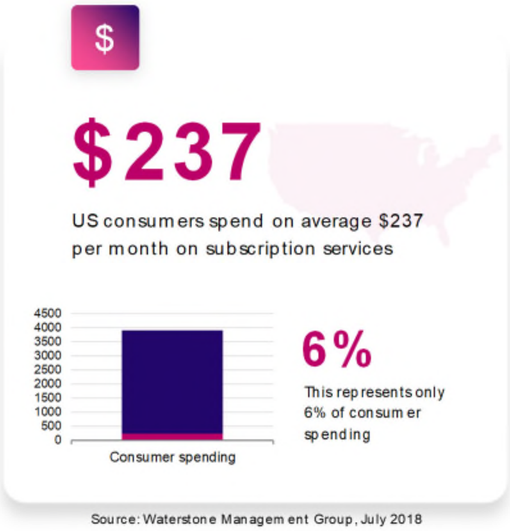
of adults agree that subscribing to a service frees from the burden of ownership

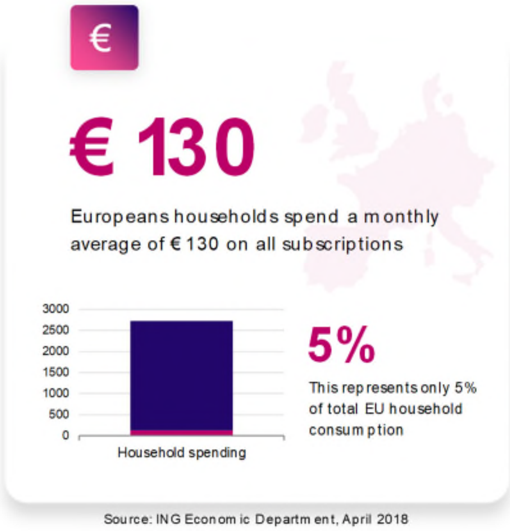
A LARGE MARKET GROWING FAST

It is estimated that US consumers already spend $237 a month subscribing to different services[2]. Looking at the evolution of our consumption habits, it is very obvious that this number has been on an upward trajectory over the last decade. The Economics Department

[1] Zuora, November 2018
[2] Waterstone Management Group, July 2018

of ING estimates that Europeans spend an average of EUR 130 per month on subscription services. Therefore, the European subscription market is estimated to be around EUR 350bn.





Subscription penetration in developed markets remains low

Zuora is a software company that provides financial accounting solutions for companies with a business model based upon subscription services. Looking at its customers, the Company estimates that revenue from companies operating with a subscription model have grown at an 18.1% compounded annual growth rate (CAGR) over the last 6 years. This is 5 times faster than US retail sales (3.1% CAGR over the same period) and not even comparable to revenue generated by MSCI All Country constituent companies (0.5% CAGR over that period). Zuora has assembled these clients into what it calls its Subscription Economy Index, which it updates quarterly.

Are those $237 or EUR 130 representative of 'peak' subscription spending? Surveys would appear to indicate that this is very much not the case. 74% of adults expect to subscribe to more services in the future than they do today[3]. This bodes well for the subscription economy. In addition, with many of these services first offered in the US and Europe, we suspect other countries to be substantially less well penetrated, with consumers likely spending substantially less on subscriptions, representing a large global opportunity.

SUPPORTED BY SECULAR GROWTH DRIVERS

Today, a series of so-called 'Primary Forces' are shaping the way that the world is evolving and are creating secular growth drivers that underpin many very long-term themes, such as the subscription economy. We consider there to be four of these Primary Forces, namely demographics, globalization, innovation and resource scarcity.

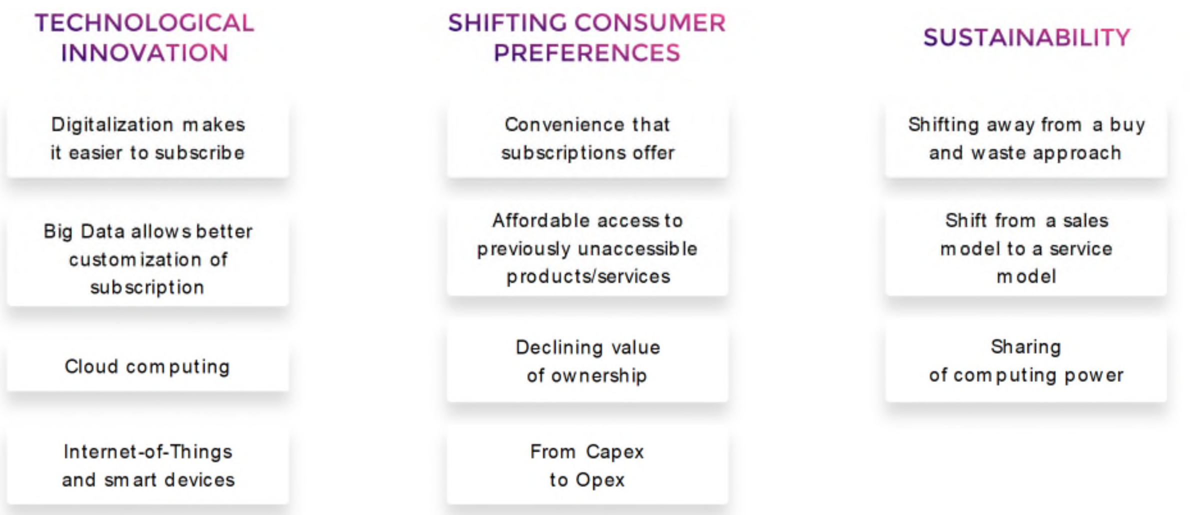
[3] Zuora, November 2018

In the case of the usage of subscriptions, we identify three secular growth drivers that underpin its growth horizon. We start with shifting consumer preferences that are derived from demographic changes. Consumers want to be able to consume anything at any time, have access to the latest content without asking themselves whether it would be more sensible to purchase that product or service. This phenomenon also captures the idea that consumers don't buy things for the rest of their lives anymore, preferring instead to return old products in exchange for more recent versions. Subscription-based services facilitate consumption but also offer affordable access to previously inaccessible products because of large upfront prices.

Consumers also now realize that many business models that are supposed to be free, actually rely on data and the monetization of private data through targeted advertising. Increasing privacy concerns are leading consumers towards other sorts of services. Many consumers for example prefer to spend $5 a month to read high quality content in The Economist rather than general content on a media website that interrupts the experience with sometimes excessive 'pop-up' advertising. The increased usage of 'ad blockers' is a testament to this trend.

Corporates also have an increased preference for different business models, especially those where costs are predictable and can be paid with a regular or predictable frequency. This is exactly what subscriptions provide, allowing more costs to be recognized as operating expenses ('Opex') rather than capital expenses ('Capex'), and facilitating often improved cashflow characteristics.

Innovation, of course, is a big driver of growth for the subscription economy. Implementation of such services has been facilitated by digitalization. If a consumer goes to a company website, signs up for a service, enters their personal and credit card details, they are a *de facto* subscriber. It is that simple. In addition, companies can offer personalized content to subscribers. Spotify, for example, will automatically create customized music playlists based on previous usage and your musical tastes. Elsewhere, Netflix uses the success (or failure) of existing TV and movie content to create new programming which should improve its chances of future success.



The Subscription Economy underpinned by three major secular drivers

Finally, the subscription economy has a positive impact on resource scarcity by increasing the efficiency of existing resources. In the case of cloud computing, some servers are shared and used by many companies. Subscriptions are also a pillar of the circular economy or a shift away from the 'buy and waste' approach. For example, if you sell a washing machine based on a subscription contract, there is little incentive for the vendor to make it obsolete and a large incentive to reuse as many parts as possible.

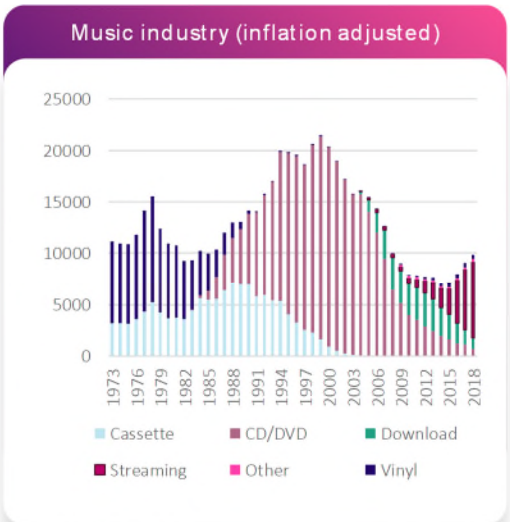
MANY INDUSTRIES ARE TURNING TO SUBSCRIPTIONS

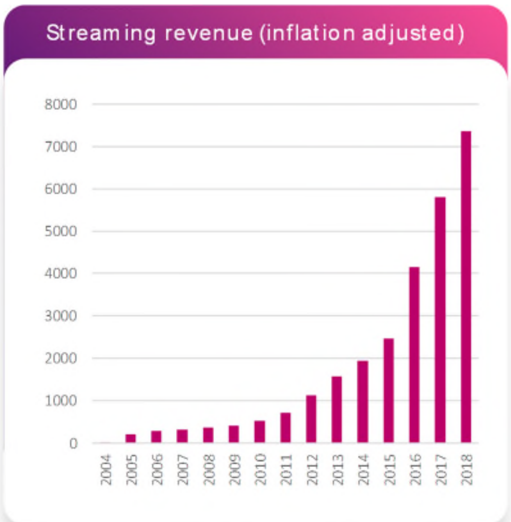
Some industries were born comprised of subscription service businesses. Telecommunication companies for example have been heavy users of that monetization model for decades. It is interesting, however, to see that telecom companies have increased usage of subscriptions over time. You possibly remember when you used to pay 30 cents per minute (or a similar equivalent amount depending on where you live) for domestic calls? Packages including unlimited calls, messages and even data have become the standard. This is a simpler model to put in place for telecom companies, while consumers benefit from an 'all-you-can-eat' subscription without specifically worrying about the costs of phone usage.

Purchase	Item	Amount	Debit	Credit
17.03.2019	**Office software** Card 4901 1111 2222 3333	USD 9.50	USD 9.50	
21.03.2019	**News app** Card 4901 1111 2222 3333	USD 5.50	USD 5.50	
22.03.2019	**Video/ Music streaming** Card 7208 1111 2222 3333	USD 9.75	USD 9.75	
22.03.2019	**Gym membership** Card 4901 1111 2222 3333	USD 45.00	USD 45.00	
25.03.2019	**Razor blades** Card 7208 1111 2222 3333	USD 15.99	USD 15.99	
25.03.2019	**Ride-sharing app** Card 7208 1111 2222 3333	USD 12.75	USD 12.75	
25.03.2019	**Utility bill** Card 4901 1111 2222 3333	USD 9.75	USD 9.75	
30.03.2019	**Wifi provider** Card 4901 1111 2222 3333	USD 38.50	USD 38.50	
30.03.2019	**Security service provider** Card 4901 1111 2222 3333	USD 25.00	USD 25.00	
30.03.2019	**Console subscription** Card 4901 1111 2222 3333	USD 9.99	USD 9.99	
30.03.2019	**Telecommunication** Card 4901 1111 2222 3333	USD 55.50	USD 55.50	
	Total		**USD 236.98**	**USD 0.00**

How many subscription services are you paying for?

The Media industry has been quick to move to subscription-based business. Spotify and Netflix mentioned above have revolutionized the way that we consume video and music. Music industry revenue peaked in 1999 before entering a secular decline for 15 years due to piracy and record labels that would only sell complete albums for comparatively high prices; the consumer would have to pay their hard-earned money for several tracks they didn't want and didn't necessarily like. Thanks to the rise of music streaming, and the strong demand for such services, music industry revenue has been on the rise again in the past 3 years. News outlets also benefited from the shift to subscriptions. News applications from well-known publishers are growing in popularity. The New York Times for example now has more than 4 million digital subscribers to its 'app'. Content digitalization also allows that publisher to target subscribers outside of the US. Interestingly, most subscribers today are between 20 and 40 years old. Who said the news media was dead?





Source: RIAA, August 2019

It took the music industry more than a decade to find its right business model

Retail is also testing components of subscription services. While Amazon is seen as a global disruptor of retail, most of it relies on Amazon Prime, a subscription service. This brings highly recurring revenue to Amazon and an opportunity to bring more personalized services. Elsewhere, the Dollar Shave Club has seen instant success with its subscription-based delivery of razorblades. In fact, it proved so successful that Unilever bought the company. Zalando, Amazon and Stitch Fix have all launched personal stylist services; on a regular timeframe, the companies will send you new clothes selected by an AI algorithm. In addition, other large retailers such as CostCo are using memberships to grant access to their stores. This brings a solid base of recurring revenue and allows the Company to provide products at lower prices to its customers. For CostCo, the highest margin is made on the membership subscription, not on the products sold in stores. More recently, Nike launched the Nike Adventure Club, a footwear subscription service for children that lets kids regularly select Nike and Converse shoes as their feet – and tastes – evolve.

Nike has launched its first subscription shoe service for kids

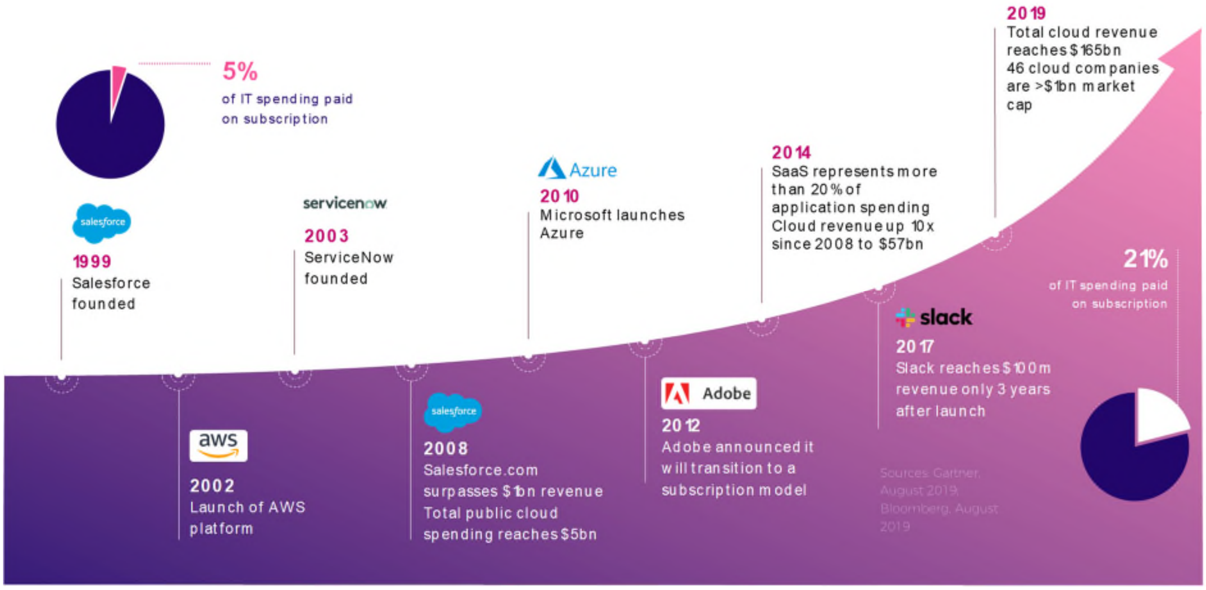
Furthermore, other consumer-related industries offer services based on subscriptions. Think about your gym membership, your home security/alarm or guarding subscription or potentially your utilities that offer contractual fixed prices.

While many consumer services are now available in the form of subscriptions, this is also the case for 'B2B' services. Cloud computing has been the primary driver of this shift. Previously, CTOs bought software licenses and installed them on their own servers. Every company had an iteration of its relevant operating software, but there was no consistent, uniform version across all clients – which, of course, made servicing those clients very complicated for software developers.

And then came the cloud. Instead of selling 'a version' of the relevant software, developers would host the software on their own servers and give access to the software through the web, on a subscription basis. Every customer would consequently be using the same version, all benefitting from updates as soon as they are deployed and all paying exactly the same amount per user of the software. In addition, software spending shifted from Capex to Opex, which is often preferable for corporations.

Subscriptions have grown from 5% of total IT spending to more than 21% last year. This impacts general software such as HR, CRM or ERP but also software dedicated to specific industries such as healthcare, architecture or education. Despite the strong growth witnessed since early 2000, penetration remains low.

A myriad of information providers also uses subscriptions to grant clients access to their database. For example, users of Bloomberg or Factset in the financial industry are well aware of this.



Software-as-a-Service has transformed how corporates consume IT

VENDORS ALSO BENEFIT FROM THE MODEL

While we have seen that both consumer and corporate buyers see subscriptions as a better fit to their consumption habits, vendors also benefit from the model. When a customer signs up for a new subscription, the vendor enjoys recurring revenues that are highly predictable, and usually seen as 'high-quality'. With more confidence on the revenue side, expenses can be budgeted more precisely with R&D in particular a big beneficiary. With lower upfront costs, corporates are also able to extend their target market to customers for whom the cost was too high in a 'standard' model. In a subscription model, you also create stronger relationships with your clients, eventually

Adobe is one of the best illustrations of how a move to subscription can be successful. By the beginning of the decade, the developer of Photoshop had slowing revenue growth due to declining innovation. In 2012, it decided to move to subscriptions, gradually suppressing licenses and offering subscriptions instead. While the move negatively impacted the company financial performance initially, the Company rapidly saw its market expanding and is now growing revenue at over 20% - to levels that have doubled those observed in 2012. Today, Adobe is seen as a textbook case for conversion to subscription by many companies that try to replicate it.

With the right supporting demographic, technological and sustainability drivers in place, the subscription economy is poised to see further, accelerating growth. Consumers and corporates increasingly see it as a model that is a better fit with their consumption patterns. At the same time, vendors also benefit from the model in several ways and are keen to offer more of their services under subscription. We are convinced that subscriptions will be applied to more services in the future while their utilization will also increase.

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