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That Sucking Sound is a SaaS

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Remember when you used to save up to buy something which you could then call yours: films, cassettes, CDs, LPs, computer software and games for example. In return for an upfront fee, you got the product and no further questions asked.

As you will know times have moved on. Almost all forms of entertainment, software (business and personal) and consumables (even ink for your domestic printer and coffee for your morning brew) are now in that slightly uncontrollable box called a SaaS or "Software as a Service" or, perhaps, more accurately, service as a subscription.

It is a powerful business model particularly with respect to entertainment and software where the marginal costs of distributing product via the internet is close to zero and therefore marginal profit is close to 100%. At the same time, network effects are colossal in a borderless online world.

A recent price increase to subscribe to Microsoft's business software added $5 billion to the company's operating income as the "costs of providing the services were already factored into its operations:" in other words the revenue increase went straight to the bottom line.

Network effects coupled to a near monopoly of basic but essential business software lies behind the $198 bn and $83 bn of revenue and operating income that Microsoft earns mostly secured by the steady drumbeat of endlessly renewed SaaS contracts, mostly paid by direct debit which consumers rarely review.

It is a business model that generates mixed feelings; as a shareholder, that level of pricing power is excellent news; as a consumer, why am I paying for the same thing year after year?

A recent survey noted that consumers tend to cancel subscriptions when their credit cards expire only to see them build-up again as the new card arrives. That level of consumer inertia is gold dust to companies and shareholders alike and reflects the idea of the "moat" talked about by Warren Buffett.

Increasingly the subscription model is found in the commercial world where activities such as accounting, payroll, software, legal and compliance are farmed out to third parties in return for an annually renewable price.

From a shareholder perspective it is worth noting that once many of these "partnerships" are in place they are extremely hard to change. No CFO changes his accounting software on an annual basis following the annual cost review; it is simply too much trouble. A "Saas" agreement is as close to a business annuity as it is possible to get. Consequently, successful firms in this space are highly valued.

That said, there is a striking exception to the success of this model: the telecommunications sector.

Virtually all of us subscribe, one way or another, to a combination of land and mobile comms networks. Life without access to the phone and the internet is unthinkable in the western developed economies.

Growth in network traffic has risen from 20 exabytes per month in 2010 to 150 exabytes per month in 2020. (An exabyte is one billion gigabytes). The "internet of things" and the impact of AI is driving this growth still higher.

As an investor, one might have thought that here was an infinitely growing resource that could and should be monetised. (Full disclosure, this investor did!). Yet, despite the exponential growth in traffic the telecoms companies remain relentlessly unprofitable, burdened with the debt loads imposed by spectrum auctions and capital expenditure on building (and maintaining) key infrastructure.

Still, one can't help thinking there is a mismatch in the realised economic rewards between the users of, and the operators of, this critical 21st century communications infrastructure.

Nevertheless, the combination of near-monopoly, entrenched network effects and supra-national consumer markets have handed the SaaS titans unprecedented economic power where even small price increases generate revenues equivalent to 1p on the UK income tax rate.

As the festive season approaches, keep an eye on those Xbox, Spotify, Netflix subscriptions. You're almost certainly spending more than you think.