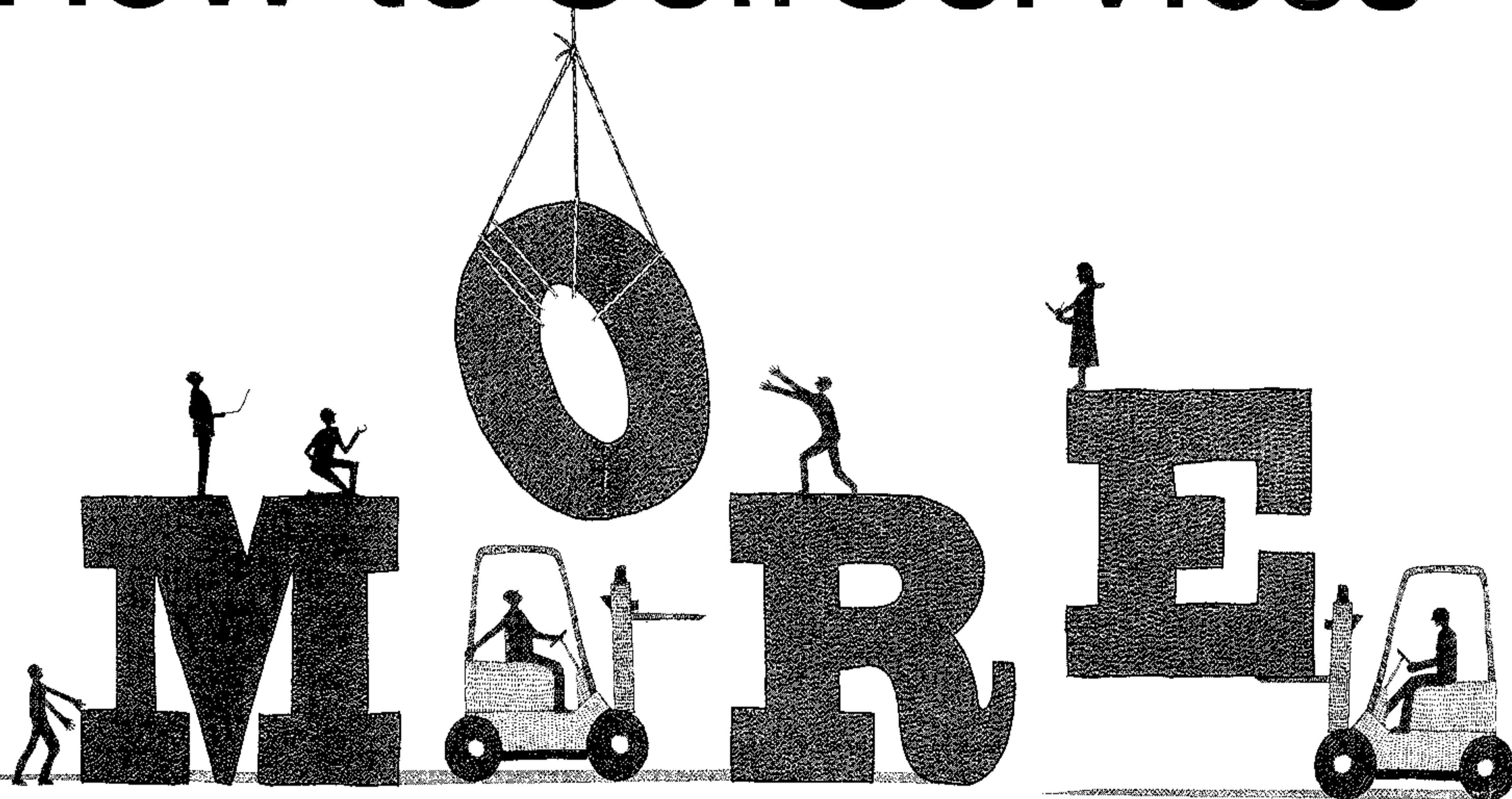
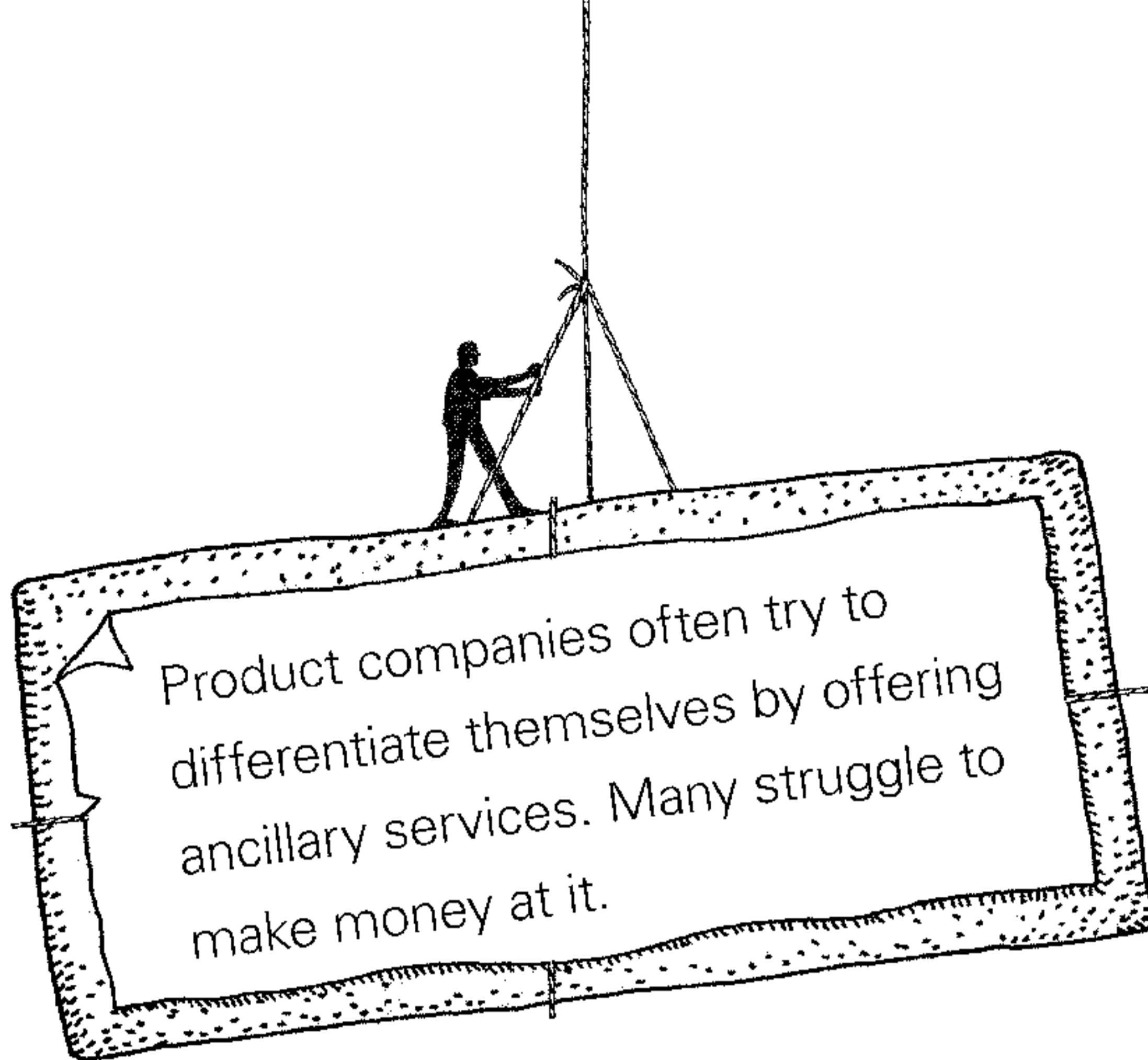


How to Sell Services



Profitably



MANUFACTURERS FREQUENTLY believe that adding value in the form of services will provide a competitive advantage after their products start to become commodities. When the strategy works, the payoffs are impressive, and a company may even discover that its new service business makes more money than its products. But for every success story, at least five cautionary tales remind us that manufacturing companies will most likely struggle to turn a profit from their service businesses.

Even the best stumble. Consider one large technology firm we studied – a world leader in medical equipment, IT, automotive equipment, and transportation systems. Back in 2003 the company's €5 billion IT business unit realized that the limited product-related services it offered, such as installation and training, generated twice the 3% to 4% net margins it earned on its increasingly commoditized product offerings. The unit decided, therefore, to invest heavily in developing its service capabilities for large clients. Managers estimated that such customized services would soon generate margins of 15%.

by **Werner Reinartz and Wolfgang Ulaga**

The estimate proved very wide of the mark, and the unit recorded a negative net profit margin of more than 10% in 2005. The venture was a serious loss-maker, costing the group around €260 million in 2005 alone. The losses stemmed from several distinct causes: First, the company found that the back-office production of complex services was much more difficult than expected. Each client's requirements were highly customized, which meant that little learning and knowledge could be leveraged across cases. Second, the salespeople were used to selling products with basic service contracts attached, and their traditional contacts at target firms were too low in the hierarchy to make decisions about multimillion-euro solutions contracts. Third, much of the knowledge around the service production had to be sourced externally – which proved time- and resource-intensive. The board member responsible for services was frank about the mistakes: “We wanted too much too soon, and we simply weren't ready for it.”

Over the past three years we have investigated how manufacturers in business markets can develop profitable services. We conducted in-depth studies of 20 industrial companies operating in a broad variety of product markets, including adhesives, automotive coatings and glass, bearings, cables and cabling systems, energy generation and distribution, on-board electronics for civilian and military aircraft, printing presses, and specialty chemicals. Every firm was among the top three in its industry, and the managers we interviewed were all key decision makers, frequently executive board members. Throughout the process we interviewed multiple people in different business units and country organizations. We went on to have discussions with more than 500 B2B managers in a series of executive workshops; these complemented the insights from our interviews.

As our research process unfolded, we uncovered a wide variation in revenues and profits from service offerings. One group of companies derived up to half of their sales from services, and margins up to eight times those on product sales. A second group reported a very different experience: Although those companies had made significant investments in the development of services, customers proved unwilling to pay, revenues were low, and the companies barely broke even. Comparing the two groups, we were able to identify clear differences in the ways they had developed their service businesses.

Like the technology company in our example (which has since turned itself around in this respect), companies unsuccessful at developing service businesses have tried to transform themselves too quickly. Successful firms begin slowly, identifying and charging for simple services they already perform and using

those to build enthusiasm for adding more-complex ones. They then standardize their delivery processes to be as efficient as their manufacturing ones. As their services become more complex, they ensure that their sales force capabilities keep pace. Finally, management switches its focus from the company's processes and structures to the nature of customers' problems, the opportunities that customers' processes afford for inserting new services, and the new capabilities needed to deliver those services. (See the exhibit “The Path to Profits in Industrial Services.”) Let's take a closer look at those four steps.

1 Recognize That You Are Already a Service Company

Many product companies are in the business of delivering services; they just haven't realized it yet. These companies are missing out on the revenues they could generate simply by charging for what they already do. The first step in expanding a service capability is to make both the company's managers and its customers aware of the value provided by existing services.

Take the pharmaceuticals giant Merck. In one of the company's product categories, its French subsidiary had a long-standing tradition of including delivery in its product price for customers. Because specialty chemicals are high in value but low in volume, Merck had never questioned its responsibility to assume transportation and insurance costs, which represent a tiny fraction of the amount invoiced. And because no shipping costs were itemized, customers were unaware of the value Merck provided. A few years ago the company put this tradition to a test: Managers randomly selected 100 customers and changed the terms of delivery from “shipping and insurance paid” to “ex works,” though the bottom line barely changed. Ninety percent of those customers readily paid the additional charges, seemingly without noticing. Of the 10% that recognized the change, only half insisted on returning to the prior terms of payment. Merck re-established the original terms for those customers – but it had succeeded in managing the transition from “free to fee” for the other 95%. Once the new billing terms had been rolled out to the entire customer base in France, Merck's profitability in this product category improved significantly, even though the cost to customers was minor.

Switching services from free to fee clarifies the value of the assets involved for both managers and customers. The French gas provider Air Liquide also took this tack. The company had traditionally purchased millions of cylinders in which to transport small quantities of gas to industrial customers. It charged customers only for the gas delivered, supplying the

Many product companies are already delivering services; they just haven't realized it yet.

cylinders free. Consequently, customers took no special notice of how many cylinders they had accumulated, and the company was stuck with considerable floating inventory. Starting in the mid-1990s, however, Air Liquide charged a small rental fee of €5 to €7 per cylinder per month. Not only did this turn a profit drain into a profit engine, generating several hundred million euros a year in fees, but it created customer awareness. Once the gas cylinders had a price tag, customers wanted to optimize their inventories. As a result, Air Liquide was able to sharply reduce its floating inventory, transferring cylinders from customers that didn't need them to customers that did.

Large companies can uncover profitable existing service offerings simply by comparing billing practices across their operating units. We found that at Nexans, the world's leading cable manufacturer, subsidiaries in some countries were charging customers a fee for cable drums, whereas in other countries they were not. Nexans holds large inventories of high-voltage cable in order to ensure rapid delivery; applying the fee across the whole company represented a significant opportunity to recoup its investment in working capital.

Smart companies will put a senior executive in charge of looking at practices in other business lines to uncover hidden services. He or she can then start crafting a forward-looking strategy for services on the backs of early wins. By giving the process an owner early on, companies can ensure that their service initiatives are not just opportunistic ideas developed by individual business units but part of a strategy to capture best practices and roll them out across the organization. Schneider Electric, a French electrical-equipment company, chose this route. Early in its move toward services it created a strategic deployment and services division whose executive vice president was charged with auditing existing services

The Path to Profits in Industrial Services

Each step on the path to service profitability requires that companies focus on particular questions and goals. Our research suggests that they should be sure they've achieved each goal before proceeding to the next step.



	1 Recognize That You Are Already a Service Company	2 Increase the Bottom Line	3 Create Service-Oriented Sales Cycles	4 Focus on Customers' Processes
Key Questions	<p>How do we currently sell services across business units and countries?</p> <p>What are the best practices inside our organization?</p> <p>Which services can be moved from free to fee?</p>	<p>Which services are profit drains or moneymakers?</p> <p>How can we ensure cost-efficient service processes?</p> <p>How can we tailor services to customers' needs?</p>	<p>Is our sales force ready to promote services along with products?</p> <p>Can we explain the benefits of our services to customers?</p> <p>Are we willing to move to longer sales cycles?</p>	<p>Are our offerings aligned with our customers' goals and processes?</p> <p>Can we address their problems holistically?</p> <p>What further expertise do we need?</p>
Key Goals	<p>A list of services we currently provide to customers</p> <p>Revenue from easily chargeable services</p> <p>A senior executive who oversees the development of service capabilities</p>	<p>Standardized service processes and control mechanisms</p> <p>Service platforms flexible enough to fit individual customer contexts</p>	<p>Service-selling know-how or separate sales forces</p> <p>Incentive systems that promote service sales</p> <p>Tools for documenting value and communicating it to customers</p>	<p>Detailed descriptions of core customer concerns and operating processes</p> <p>A shift from activity-based to outcome-oriented performance indicators</p> <p>A checklist of capabilities needed to compete in new service spaces</p>

across the organization and then creating a coherent strategy for offering new services. An executive board member with 20 years of experience in the company was named to the post.

2

Industrialize the Back Office

Manufacturers are accustomed to stable and controllable production processes. But when they venture into value-added services, they may find front-office service customization turning into a delivery-costs nightmare. Unless they can prevent this, their service margins will suffer. One of the managers we interviewed explained, "To earn money in services, you need to industrialize the back office. Companies like GE and IBM really are process freaks."

The German printing-equipment maker Heidelberg Druckmaschinen (Heidelberg) has experienced a back-office dynamic that can occur when manufacturing companies move into services. In France its customers currently choose one of two ways to maintain their printing equipment: pay-as-you-go, in which case Heidelberg sends an invoice for parts and labor each time a field technician responds to a customer's call; or a full-service contract, in which case customers have access to a help desk, remote monitoring, and preventive maintenance. The trouble is that full-service customers call for assistance twice as often as pay-as-you-go customers. And because those customers have no reason to monitor costs, Heidelberg's field technicians replace spare parts on their printing presses much more readily, make on-site visits to them much more frequently, and are likelier to schedule those visits poorly or to forget essential equipment, necessitating yet more visits. (The technicians, for their part, tend to assume that all costs are covered by the hefty full-service fee.) All this erodes Heidelberg's margins on the full-service contracts, making them less profitable than pay-as-you-go.

There are three ways companies can prevent delivery costs from eating up their service-offering margins. First, they can build flexible service platforms that meet customers' varying needs while relying on common delivery processes, much as good manufacturers create distinct product models based on standard product platforms. One of our interviewees explained, "We offer six different types of maintenance contracts. Eighty percent of customers fit into one of these boxes. The customer can look at these offers and see which of them best matches his situation."

Second, the successful firms in our study continually monitored the costs of their processes to identify profit drains. Air Liquide appointed an executive

with specific responsibility for trying to standardize services in the organization. Backed by top management and supported by an internal task force, this executive taught managers and frontline employees in operational units how to systematically take costs out of service production and delivery processes while making sure that customers still got what they expected. For example, Air Liquide regularly mailed gas-consumption reports to its customers. But when the standardization team reviewed this practice, they found that some customers made no use of the information. By discontinuing that part of the service package for those customers, Air Liquide was able to reduce its costs to serve selected customers while maintaining the perceived value of the service provided.

Third, successful companies are quick to exploit process innovations made possible by new technologies. The Swedish bearings manufacturer SKF helps customers extend the service life of their equipment by enabling off-site access to an electronic monitoring tool via a secure internet browser. Vibration-analysis data, for instance, can alert a customer early about potential machine failure. Such smart services allow the company to perform first-level maintenance without deploying field technicians for on-site visits.

3

Create a Service-Savvy Sales Force

As long as a company considers services to be an add-on to existing products, its sales force – with some training, of course – will probably be able to handle both product and service sales. But if companies are to move away from straightforward product-related services into more complex customer solutions, managers must take a new look at sales management strategies. Services require longer sales cycles, and the sales process is often more complex and strategic, meaning that decisions are made high up in the customer's hierarchy.

Failure to recognize this challenge got Heidelberg into trouble. In the early 2000s the company started offering its customers remote monitoring of their printing presses – to be sold as an add-on, because the service could save customers many hours of expensive machine downtime. On average, one hour of downtime in a print shop can cost several hundred euros; given that the lead time for delivering spare parts to a customer's site is typically 24 hours, a single breakdown may cost thousands. Heidelberg priced its new offering significantly below this amount, but customers did not bite. The problem was that although the company's sales force and field technicians were well equipped to promote standard

Value-added services can turn front-office service customization into a delivery-costs nightmare.

service contracts, they weren't up to explaining more complex customer solutions – largely because they were accustomed to discussing terms with people in procurement (who tend to focus on cost per part or per service) or people in charge of in-house maintenance (who might view a service offering as a threat to their jobs). What Heidelberg needed was a sales force that felt comfortable talking to production managers – people who would see the implications of the new service for the total cost picture.

Product salespeople are often actively inimical to change, as Air Liquide quickly discovered when it started offering services. Top salespeople argued that margins from the firm's traditional product business were already high enough and that the company still had room for growth in its existing product markets. Services were labor-intensive, would tie up considerable financial resources, and could harm product sales if the company failed to deliver on its promises.

The successful manufacturers we studied all took pains to retrain their sales forces. In a major overhaul of its sales organization, Schneider Electric switched the focus of its salespeople from cost-plus pricing to value-based pricing when promoting its services. This involved educating them about how their customers' managers justified decisions internally, so that the salespeople could help the managers they dealt with take more responsibility for shaping decisions. But even after extensive training, companies may find that they have little choice but to fire and hire; a few in our study replaced 80% of their existing sales forces. Even those that managed to retain a significant proportion of their people still needed some specialized newcomers. Air Liquide hired several agri-food engineers to develop sales expertise for services in food-processing industries across Europe. The French forklift manufacturer Fenwick recruited specialists at the corporate level and in each of its regional sales offices to promote services attached to tri-directional forklift trucks. A good place to find this talent internally is among service-support staff members.

Most of the successful companies we studied made some kind of distinction between product and service salespeople. At GE Medical Services, for example, product salespeople are "hunters," expected to go out and get orders for new equipment. Service salespeople are called "farmers"; GE expects them to grow their relationships with customers and sell services over time. Splitting the sales force is not always a perfect solution, however. Xerox has been very successful in establishing a solutions business in which the focus is not on providing office equipment but, rather, on helping clients manage their document flow. The organization nevertheless continues to do considerable business the old way, by selling printers and copiers and slapping simple service contracts on them. The two units end up competing for midsize customers: Whichever unit is first to get a lead pursues the opportunity vigorously, not wanting the other to get involved – even if it might be more suitable from a companywide perspective.

It almost goes without saying that a move to services will

fail unless salespeople are financially motivated to promote them instead of focusing solely on product sales. Such a shift is difficult when product revenues are much higher than service revenues. For example, if Air Liquide supplies €500,000 worth of gas to an individual customer, the related services may be invoiced at only a few thousand euros. If objectives for service and product sales are not properly coordinated, their sales forces may even compete. When Air Liquide started to promote inventory management services to assist customers in optimizing the number of gas cylinders they had on hand, the company's product sales force resisted out of fear of losing its traditional revenues. Management had to explain that although the new offering would indeed enable customers to reduce their on-site inventories, it would also help to lock in customers over the long run and to grow Air Liquide's share of their purchasing overall. To reduce conflict between the two sales forces, Air Liquide created a double credit system: For each closed deal, product and service salespeople would get the same commission.

Why Services?

Product-centered companies are pursuing service strategies for a number of reasons. Of particular interest among them are three drivers of growth in B2B services:

Outsourcing trends. In recent years asset optimization has been a source of growing concern to many business customers. With higher returns on assets expected, production units becoming more flexible, and technology steadily advancing, customers are focusing more on their core businesses and are more willing to outsource nonstrategic processes.

Saturation of an installed base. Equipment manufacturers find it increasingly difficult to grow an installed base. For example, in 2005 Otis, with global revenues of \$9.6 billion, sold approximately 100,000 new elevators and escalators while servicing an installed base of more than 1.5 million worldwide. To maintain growth, companies like this have little choice but to make major acquisitions or develop services.

Commoditization in product markets. Product price erosions are exacerbated by a growing trend toward commoditization. Most suppliers, even in emerging economies, can satisfy required product standards – so manufacturers turn to services to set themselves apart from the competition.

Finally, selling services requires that companies develop tools to document and communicate the value those services create for customers. These tools range from customer case studies and white papers to sophisticated simulation software. A good example is Documented Solutions, a tool developed by SKF over the past 15 years. Conceived by the company's U.S. subsidiary, it helps SKF salespeople worldwide to identify and explain to customers how much they can save by using the company's services. The tool is linked to a database that compares the best practices of SKF customers around the globe. It also allows customers to calculate their return on investment.

4

Focus on Customers' Processes

Once manufacturers have learned how to sell and deliver services in a cost-efficient way, they can move toward addressing customers' problems and processes holistically. This means shifting focus from their own processes, incentives, and structures to those of the customer.

Fenwick found a good way to do this: It installed data-collecting sensors and radio-frequency identification technology in its forklifts, to amass valuable information about how customers used its equipment. This knowledge became the basis for developing new service offerings, including access control and remote monitoring, asset management, a customer-specific intranet – Fenwick Online – and even a school for forklift drivers. Today 50% of the company's €500 million in revenues comes from services developed over the past 15 years.

When manufacturers move beyond ancillary product-related services to complex offerings, they need to revisit the basis for their pricing and the way they measure success. Product-oriented companies typically focus on input-based indicators – hours of equipment use and numbers of units sold. As long as their services are discrete and productlike and performance risk is limited, that focus is entirely appropriate. In such cases, services are viewed as products in both the back and front offices – meaning that their input costs take center stage. But above that level they require companies to focus on problem solving from the customer's perspective. When a company commits to solving a customer's problem, it assumes a much higher risk: The goal is to achieve a certain output, and the degree to which it is achieved is the basis for compensation. This was true for all the successful companies we studied. Clearly, pricing then becomes much more complex. The French jet-engine maintenance company Snecma


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Services, for example, writes service contracts that guarantee air carriers a certain number of flight hours for their jet engines, however much servicing time that requires. Similarly, Hilti, headquartered in Liechtenstein, promotes an "all-round hassle-free" service package for the power tools it leases to the construction industry. The company's customers don't have to

buy, say, a drill for their operations; they "pay by the hole" and are guaranteed a drill on the construction site.

Once executives have redefined the value proposition around solving customers' problems, they may quickly discover a lack of the expertise required to tackle the processes involved. The Pittsburgh-based industrial-coatings specialist PPG offered to take over the paint shop in Fiat's Torino automotive plant. Under the new deal, Fiat would pay PPG according to the number of cars flawlessly painted rather than the amount of industrial paint bought. PPG had to learn how painting robots function in order to control the outcome of its painting processes. Similarly, when SKF started developing services around its core product – bearings – the company studied how bearings might break down in its customers' equipment and then acquired the know-how to help manage such breakdowns. Through internal development and acquisition over the past decade, SKF has become a world leader in condition monitoring, industrial sealing, lubrication systems, and vibration analysis.

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Services can be a powerful way to lock in customers and increase their switching costs. As one manager at Air Liquide put it, "The more we enter into a customer's business, the more the customer forgets how things are done." At the same time, services represent an excellent route for acquiring new product business. Fenwick managers told us, "Whenever we can't directly break into a customer account with a product, we'll offer to provide services on a competitor's product." Finally, the relationship developed by providing services positions manufacturers to anticipate future business. But these considerable benefits can't be achieved overnight. The four steps we've outlined will help to speed the process and boost companies' profits. 

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