

## **101 - SERVITIZATION OF PRODUCT COMPANIES**

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The increased importance of the service sector in industrialized economies is undeniable. Services account for a higher percentage of GDP in virtually every country – be it developed or developing - than say 20 years ago. The list of Fortune 500 companies contains more service companies and fewer manufacturers than ever before.

And even manufacturers themselves increase the service share of their traditional product based business. Almost without exception, manufacturers offer basic 'break-fix' services to convince customers to buy their products. In many industries, over time more value added service propositions like training, system integration and consulting have been added. And some are starting to deliver managed services / outsourced services. They no longer sell products. Products go 'under water' and are means to sell services.

Services are being discovered as profitable and stable revenue streams that protect against the effects of commoditization of products.

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## 1. PROPOSITION - WHAT IS IT ?

Servitization is the widely applied - yet limited understood - transformation process, where companies embrace a customer orientation and focus more on services the aim is to: (i) satisfy customer's needs, (ii) enhance the firm's performance and / or (iii) achieve competitive advantages.

Frank Marks and Leon Ramselaar<sup>1</sup> led a research study<sup>2</sup> to explore and frame the phenomenon of 'Servitization of product companies'. Key take-aways:

- ❖ *Servitization is real* for product companies - It is driven by external drivers (customers demanding more service) as well as internal drivers (shareholders demanding new growth and profit streams).
- ❖ *Servitization is difficult* - Many product company struggles with defining the 'how to' roadmap.
- ❖ *Servitization pays off* - Services offer new, relative stable, relative high margin revenue streams, especially in mature markets / economic downturns.
- ❖ *Servitization is not restricted to the service domain* - It is a state of mind and requires a company-wide transformation towards more customer focus.

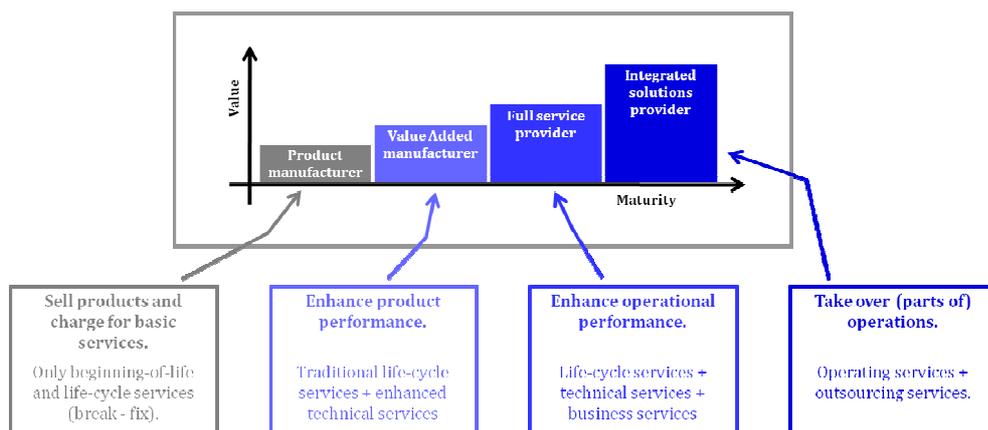


Figure 1 - Servitization maturity Model 2.0.

- ❖ *Servitization is predictable* - The Servitization Maturity Model (see figure 1), with four distinct stages, can help to structure, plan and accelerate the transformation.

<sup>1</sup> Frank Marks and Leon Ramselaar are partners at [Praetimus](http://www.praetimus.com), a Dutch Strategy & Operations boutique.

<sup>2</sup> Source: Marks, Ramselaar et al - White paper Servitization in Product Companies - Feb. 2011.



## 2. **COMMERCE** - *WHY IS IT IMPORTANT TO YOUR CUSTOMERS ?*

Traditionally, services played only a qualifier role in the customers' initial purchase decision. No or bad after sales services, meant no deal. Increasingly, the customer experience demands for value added services. Consumers as well as business customers. The goal is to improve the productivity for their assets. And as they focus on their core activities, there is ample room to deliver value / reduce risk for customers. Manufacturing firms start to bundle product with value added services in one deal.

Ultimately, when customers outsource the management of their assets or even (part of) their operations, services become an integral part of the proposition. In fact it is virtually impossible to distinguish products from services. The supplier becomes part of the customers primary delivery system.

This has a profound impact on the relationship and the associated sales process. The process to sell integrated product-service propositions is considerably longer and is dominated by new success factors. Total Cost of ownership, improved value generation potential, shared risks and rewards become paramount for the customer. As risks are transferred from the buyer to the seller, so are rewards. Pricing and revenue models have to be reinvented. This requires that insights into how the customer (or even better the customer's customer) will use the product or service (in such a way that it increases the value of the proposition) will become the basis for the marketing and sales programs.

Service firms will have to focus on a limited no. of market segments or even customers to truly understand demand and develop associated vertical solutions. Customer centric (as opposed to product centric) culture, key account management (starting with the customer's interest in mind) and service innovation, become distinctive competences.

## 3. **OPERATIONS** - *HOW DOES IT WORK ?*

At more mature lifecycle stages, product businesses increasingly commoditize. Services provide an opportunity to create differentiation vis a vis the competition. Five basic organizational design elements need to be addressed to take the necessary organizational transformation step by step in order to control the performance of the organization:

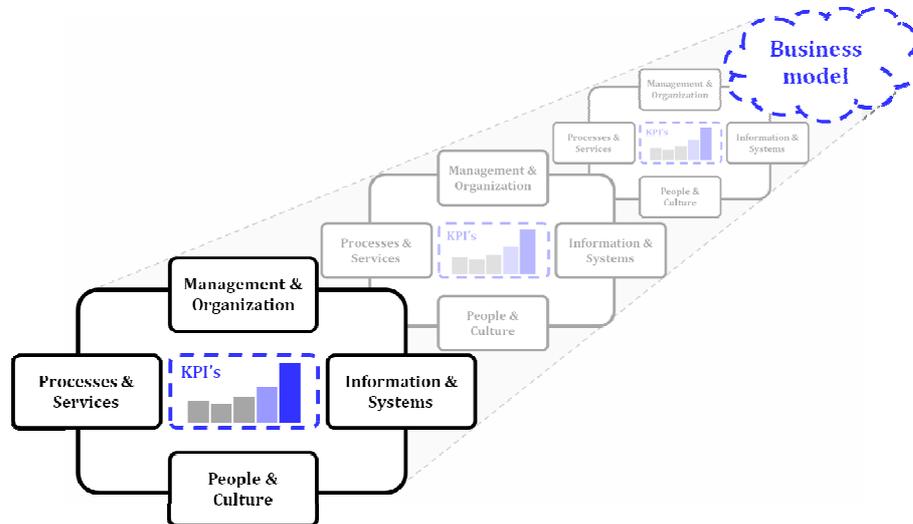


Figure 2 - Clover leaf & Plateau planning.

- ❖ **Performance metrics or KPIs** – Control metrics must focus on Customer Intimacy, rather than Product Leadership.
- ❖ **Management & Organization** – Organize around customers, rather than around products.
- ❖ **Processes** – to (i) develop, (ii) sell, (iii) deliver and (iv) control the primary business.
- ❖ **People & Culture** – The mindset must shift from product-out, to customer-in with different associated skills (soft skills, next to product skills).
- ❖ **Information & Systems** - off course IT applications to support the processes; but information becomes value in itself as information becomes part of new services.

A detailed maturity model describes how to transform each of these dimensions in a balanced way, as the company evolves over the various stages (see figure 1): from 'product manufacturer' (stage 1) via 'added value manufacturer' (stage 2) to 'full service provider' (stage 3) and ultimately an 'integrated solutions provider' (stage 4).

Research reveals that that the more mature a manufacturer is, the more difficult change becomes. The transition from stage 1 to 2 ('value added manufacturer') is relatively easy. The transition from stage 2 to 3 ('service provider') is more difficult. Only a very limited number of companies have made the step from stage 3 to 4 ('integrated solutions provider'). An indication that this step is virtually impossible to make without completely reinventing the company.

#### 4. FINANCE – HOW DOES IT CREATE VALUE FOR YOU ?

It is widely recognized that services are potentially more profitable than products. This is especially the case in product firms that exploit their product installed base. A large study among a broad range of German equipment manufacturers revealed that on average 'services' are 4x as profitable as 'products'<sup>3</sup>.

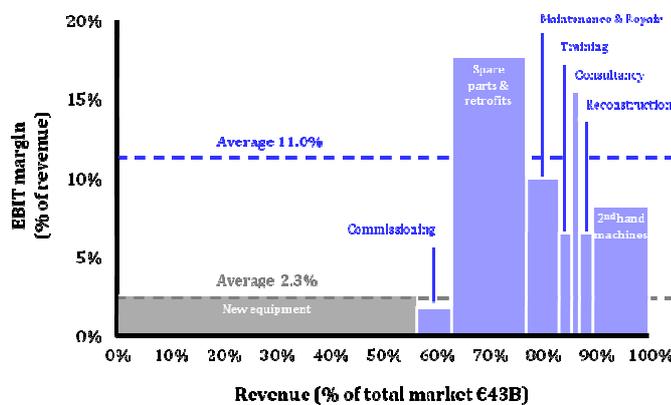


Figure 3 - Revenue contribution and profit margin of products and various services.

Paradoxically the financial rewards of servitization are not certain. An analysis of over 10,000 companies in 25 countries shows that servitized companies at the aggregate level generate lower profits as a % of sales. These findings are moderated by firm size. In smaller firms servitization appears to pay off while in larger firms it proves more problematic. The rationale is that economies of scale in services seem more difficult to realize. Moreover statistical evidence shows that the number of bankruptcies among servitizing companies seems to be much higher than in non servitized firms.

In order to capitalize on the full potential servitization offers the business model has to be reviewed fundamentally and the organization has to be transformed to develop and deliver these services to benefit from this new business. If the transformation is not executed in a fundamental way, than servitization could prove a risky endeavor, which ultimately might endanger the continuity of the firm.

<sup>3</sup> Source: German equipment industry VDA, 2009