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How to Survive the Next Crisis: Execute on Service-driven Business Strategies to Make Your Firm Robust

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by Paul Artur Glenn, Friedrich Bandulet

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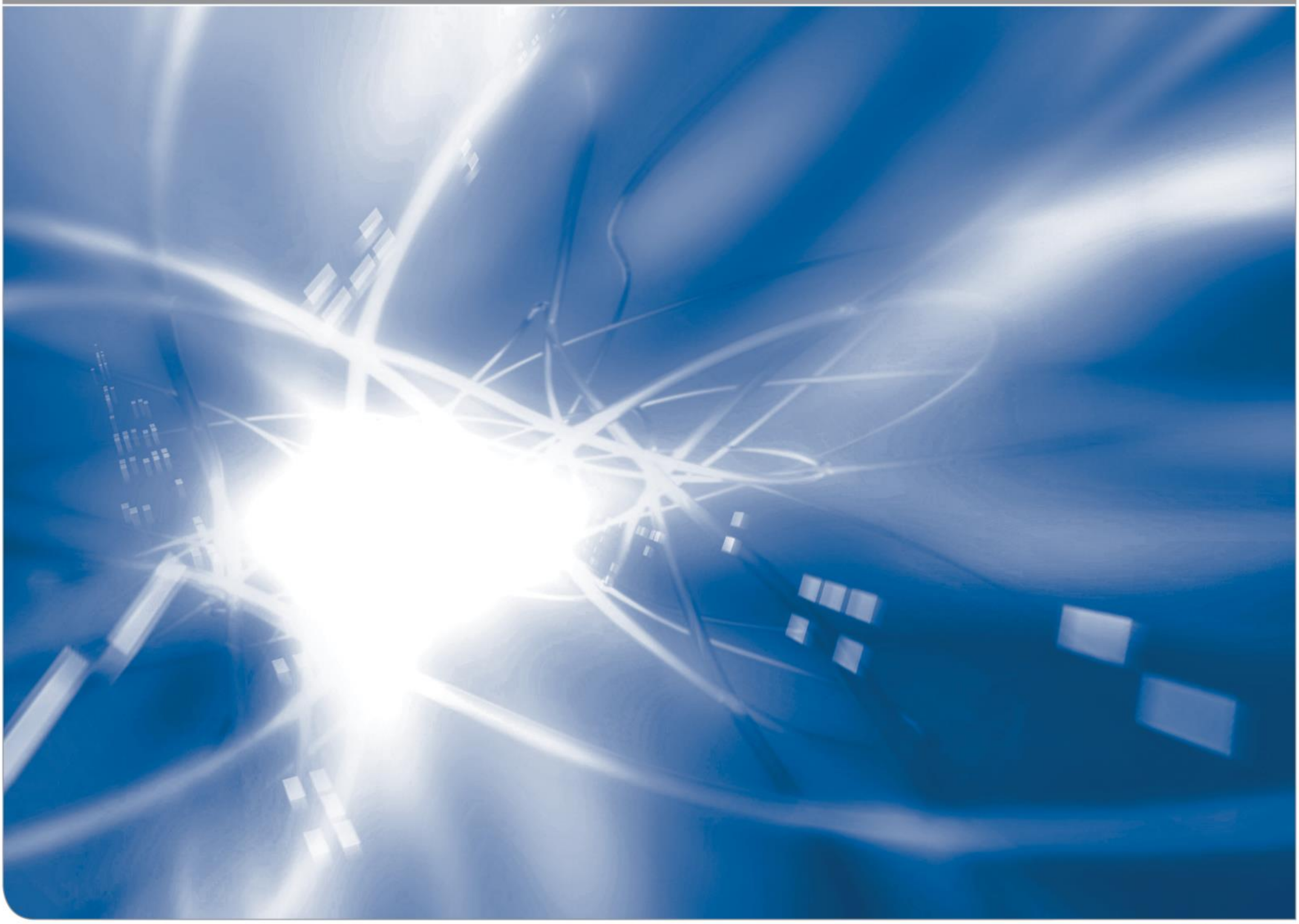

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Introduction

Firms can improve their robustness towards external shocks by developing a strong service business. A strong service business is necessary to decrease risks of fluctuating income streams from product business. Start focusing on robustness when the economy is growing. Focusing on robustness with services is in good times something that seems counterintuitive and requires a high discipline because services are typically not considered part of firms' core business. We recommend focusing on robustness that can be incorporated into the overall business. A strong service business can achieve both revenue and margin stability in times of crises.

In most manufacturing and IT firms that are sensitive to recessions, service business tends to show a lower share in overall revenue. At high-tech companies it follows product or system sales and a higher share of service business is sometimes viewed as a sign of a maturing industry. Inexperienced financial analysts question the vitality and future proof of such businesses because they lack "next generation" product revenue and the hype of a "sexy new technology or business model". Even worse, analysts tend to overvalue growth prospects per se without factoring in the often times high volatility of promising product businesses.

Assess your company's business robustness

Assess your company's businesses according to their robustness contribution for the entire firm. Doing so, most companies realize that service is much more robust than core-product business regarding external fluctuations. Examples are continuous and predictable software maintenance fees of enterprise software companies or regular and high-margin spare parts and services income at machine manufacturing companies.

For all firms it is important to evaluate by which extent service business is influencing robustness. Robustness in this article is defined as the company's ability to resist unexpected changes in market conditions. This is not going as far as Taleb's "Antifragility" definition, which is an antithesis to fragility and requires a business to actually benefit from high-impact events or shocks and not just resist by staying unaffected.[1] While we show in which situation service business actually can contribute to businesses antifragility, we focus on robustness because it can be more easily assessed and established.

Increasing a company's robustness is something that should be worked on in all corporate functions. Looking at daily management practices, mainly CFOs are concerned with robustness by managing such vital areas like a company's cash situation or its need and timing for external financing. In the best case, service business keeps on generating stable or even growing, antifragile returns in adverse situation. Generally, service incomes from after-sales services are more stable and predictable than services delivered in conjunction with product sales (e.g. installation). The latter ones should be considered with caution regarding robustness, because they can turn out to be "false friends" if their success correlates with product sales.

A brief example helps to illustrate the impact of services on robustness. Let's take the deep recession in 2009 as an example and have a look at the situation of two German industrial equipment manufacturers. On average, the German manufacturing industry suffered from an order intake decrease of 55% from the very top at beginning of year 2008 to bottom in year 2009.[2] Based on the analysis of Glenn, service market size in the German equipment manufacturing industry decreased by only 20% from top to bottom in the same time period.[3] Let's assume a product-oriented company (A) has a split of 70% product and 30% service revenue. Service-oriented company (B) shows the opposite revenue distribution of 30% product and 70% service. Applying above numbers leads to a total revenue loss of 44.5% for company A, but only 30.5% for company B. This difference of 14% can be decisive for a company's sheer survival.

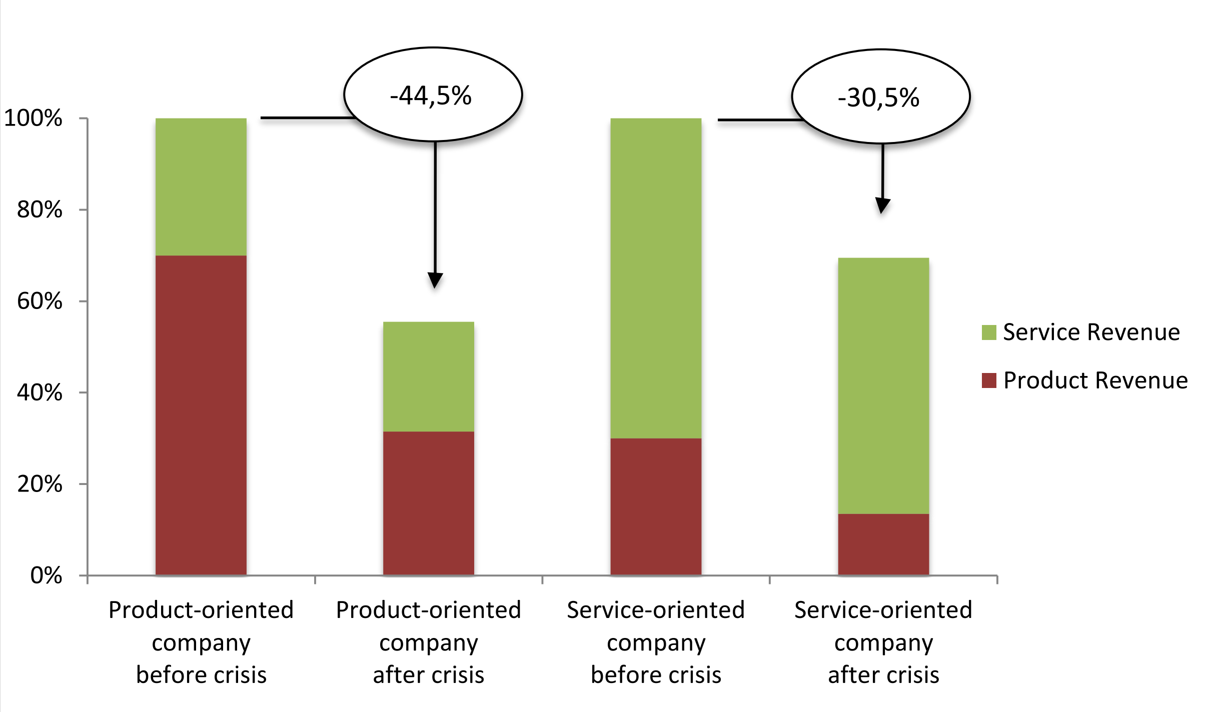

Figure 1: Example decrease of product and service revenue during crisis

Services also create often a higher margin than products[4], the gap between company A and B will become even wider in terms of overall robustness, because the difference becomes even stronger with regards to profitability. This is valid especially for companies active in B2B markets, where an economic downturn leads very quickly to a halt in investment spending of customers. Even worse: the few deals closed suffer from increased pressure on their profitability because competition is desperate in times of under-absorption and full warehouses. Maintenance services, repair and spare parts are a necessity for keeping up business and are therefore much less affected – especially if the service revenue is ensured via long-term service contracts.

Even better, there are services that are in higher demand during recession than during boom times. Such a service is business process outsourcing which enterprises typically request when they have to cut costs quickly. Therefore, in the past outsourcing business used to get a boost when the economy went bust. Such a service business can extend a product company's robustness considerably by serving as an antifragile business unit. This is in spite of the fact that outsourcing business margins might be lower than those contributed by a company's product business. After you have identified promising business areas for robustness contribution, you should go the next step and develop them to be prepared for the next crisis.

Develop robust service business

Service business development consists of several interrelated tasks that need to be considered and established to create the long-term basis for future robust income streams: strategy, organization, portfolio, pricing, sales, and endurance.

Define your service strategy and business-model starting with customer preferences

Establish a service strategy including a transformation roadmap to grow from a product-driven to a service-driven business model design. Start your strategy from customers' point of view. Which services do your customers really need? Think about todays and future needs. Take a long-term focus at your strategy. There may be potential services that customers don't need today but may expect in the future and will be willing to pay for. Focus on value-add for customers, avoid waste. Only for value-adding services customers will be willing to pay for. Rethink your entire business model. Do you want to position yourself as a multi-product company, selling a lot of different products and product-accompanying services, or as a solution provider? Depending on your business model, your company's strategy will look differently. Following a service-dominant logic[5] requires a completely different approach to processes, product structure, pricing, and selling. If you position your company as a solution provider, your customers will expect to get solutions for their problems instead of a variety of different products and services from different business areas.

IBM is one of the most prominent examples of an incumbent regaining strength by focusing on services for surviving in a severe crisis. Before Louis V. Gerstner took over in the early nineties as IBM CEO, revenues and margins were rapidly declining above all because the dominant mainframe business deteriorated quickly. According to Gerstner (2003), the only part of IBM still growing was services based.[6] However, this part of IBM's business was rather small in size and not very profitable. When the turnaround was accomplished, Gerstner pointed to the importance of services in this and even more acknowledged that the future of IBM would be driven by services and much less so by software or hardware products. Focusing on services also helped IBM re-orient the enterprise towards the customer with the mainframe system business being revitalized as the center of gravity for IBM.

Transform your organization by focusing on your future business structure

Design an organization matching new requirements instead of applying rules of engagement of a product-driven business. Position your service business as a profit center to place the right incentive for the management to generate profits. Organization does not simply mean line-organization, but more important the right service-oriented process-organization (instead of a purely product-oriented organization) that supports your strategy and effectively fulfills customer needs. This does not only mean moving boxes in org-charts but – more important – consistent and customer-oriented business processes. Also consider your geographical reach: if you're part of a global organization you need to take a global focus with local execution. This implies globally consistent and efficient processes.

The company Heidelberger Druckmaschinen AG ("Heidelberg") started early to develop its service business. After very successful decades of equipment sales, the company began to face hard times in the recent years. Especially after 2008, Heidelberg was confronted with overcapacities in its equipment business in some markets and very cyclical offset-printing equipment demand in a mature industry. The revenues from its services business helped the company to partially stabilize its income in the very volatile heavy equipment industry and to survive the last crisis. Compared to Heidelberg, its main competitor manroland struggled and went into insolvency.

A good organization also requires fueling the service venture with the right talents. Consider proper hiring and capability development to fuel your organization with service-oriented talents. Think about talent development as investment into the future of your service business. This is particularly important because companies and universities tend to overemphasize product-related talent development. Thinking in services requires a different mindset than products. Service champions are very much focused to deliver a good service and contribute to customer success. They're customer focused instead of deal focused. This is because they spend a good portion of their time with the customer onsite and are the ones to master the problems with the product originally sold. Service champions are also strong in active cross- and up-selling additional products or services in the context of the customer contacts they have. Product and service departments need to have a good collaboration and to understand the roles of each others well. This can be facilitated via job rotation and by asking the product developers to take over the initial service. Vice versa, service experts should continuously provide input to development in order to make sure that the serviceability is already incorporated into the product design.

Establish a structured portfolio by targeting value-add services

Companies that want to develop their service business have to establish a structured service portfolio. "Structure" means how services are going to be managed and marketed. The company has to ask itself, which services are already available within the organization and which have to be developed. Existing services need to be examined with regards to their fit into the company's strategy and in how far they contribute or may contribute to future profits. We recommend to take a customer-oriented service engineering approach and to focus on robustness early on in the service definition phase. The right services need to be offered and these services have to be managed in the right way. Right services in terms of robustness contribution are services that are independent from product revenues due their content, contractual design, pricing, and the way they are delivered. Multi-year contracts contribute to business robustness if the pricing is set in a way that the customers have little incentive to terminate running contracts. This can be achieved by establishing a pricing that keeps customers better off by continuing their contracts instead of dropping out and in. For example, customers terminating enterprise maintenance contracts have to repay service fees that would have been due if they had not terminated the contract earlier on.

Special caution should be put on service business that is highly correlated with product sales. An example for such a business is the implementation of enterprise application software. Such implementation and system integration work is a highly important part of the solution that enterprise providers like SAP AG provide to customers. While these services can both generate significant revenue and profits in boom times, they can also contribute losses in times of crisis. This is mainly because such services are immediately linked to product business and a lack of product sales results in under-utilization of personnel capacity. Creating an ecosystem of system integration partners helps to manage such cycle risk, because it can then be partially allocated to specialized and flexible partners knowing how to deal with it.

As general guiding thought, it helps to imagine your service portfolio as a well-kept garden that you have to constantly work on. If you don't, it may turn out to either become a jungle of unmanageable services or a deserted landscape with non-performing, loss-making services. The authors recommend being particularly aware about three frequently observed challenges in daily service portfolio management as outlined in the table below:

Key Challenges	Aspects
Manage the service portfolio holistically	■ Comprehensive service management considering dependencies between services, e.g. robustness of software support services depends upon quality of previous implementation service ■ All-encompassing service controlling & accounting including incremental product revenue, e.g. triggered by free of charge (pre-sales) services
Control the service delivery on a global level	■ Global service management defining standards for service localization and for optimal service capacity utilization across markets ■ Service delivery handled by local companies to ensure local responsiveness and flexibility on operational level
Manage the services along the complete lifecycle	■ Standardized retirement process for loss-making services or those in low demand ■ Dedicated service business development team following a standardized process for growing new services

Table 1: Key Challenges in managing a service portfolio

SAP AG is a good example for a company that systematically has grown its service business and therefore achieved a high degree of overall robustness. Like the whole industry, the company had suffered from a significant decrease in software license and consulting sales during the severe financial crisis in 2008/2009. As quick reaction, the board rapidly implemented a profound cost reduction program which limited the negative impact of the revenue growth decrease on SAP's overall margin. But what was actually much more important, was the fact that more than 50% of SAP's revenue came from software-related services like maintenance and support. Customer demand for such services is hardly dependent upon the overall business cycle they are in. This situation led to an only limited revenue decrease from euro 11.6bn in 2008 to 10.7bn for SAP AG in 2009. The decrease in operating profit even turned out to be negligible with euro 2.6bn net profit in 2009 compared to 2.7bn in 2008 (IFRS reporting) – a less than 5% decrease in times when many companies hardly managed to create a profit at all.[7]

Develop pricing to a core capability in your organization

Pricing is a very strong profit lever and supports overall company's robustness when managed properly. Take an active approach to pricing and develop pricing to a core competence! Instead of simple cost-plus, set prices strategically and value-based. Simple cost-plus leads either to too high or too low prices. Even worse, in many cases the underlying service costs are wrongly calculated due to bad data. In most cases cost-plus is suboptimal. Especially during crises, cost-plus pricing will lead to counterproductive prices. The reason is increasing full-costs due to declining volume. A robust pricing strategy is multisided and considers several factors like value, capacity, costs, and competitive prices (for products and services). Multisided pricing strategies achieve better and considerably more robust results than one-sided pricing approaches that focus e.g. only on a single factor or a sub-sample of factors.

Transform your pricing to a mainly value-based approach with a multisided pricing strategy. How much are customers willing to pay for your services? Take an outside-in perspective from your customer point of view. While it is always advisable to screen competitors' prices, many companies forget to differentiate their products and prices and don't know the price-premium they can charge. Money is left on the table. Value-based pricing will ultimately lead to a situation with different services in your portfolio having very different margins, depending on the grade of differentiation, exclusivity, and customer-willingness-to-pay. Basic services may be used as door openers and attractively priced. Advanced and premium services with high value-add for customers, high willingness-to-pay, and high exclusivity should be priced at the higher end. Differentiate your pricing to target different customers preferences and market segments.

Take a global approach to pricing. Develop a global pricing policy and a professional (global) price-management in your company. Professional price-management covers the entire pricing-process from pricing-strategy, price-setting, price-enforcement (e.g. discount policies), implementation, to monitoring. Developing a good pricing-strategy and setting prices with a differentiated price structure is only one half of the way. The other half is being able to communicate prices to customers, training the sales force, enforcing price discipline and price quality in the organization, implementing discount policies on global, regional and local level as well as monitoring of net-prices, discounts, sales, profits and market-shares and taking appropriate decisions. This is especially important during crises when companies with low pricing capabilities only react on changing market conditions instead of actively securing sales and margins. Discount policies support securing margins in bad times and during price wars. Companies with a high pricing capability, discipline, and global price-management are far better able to earn high returns for their services and act actively to secure margins instead of reactively on changing market conditions.

Take an active approach to service selling

Historically, many product companies offered services because of legal regulations (e.g. guarantee services or old fashioned customer support) or because customers requested them. They offered services reactively. Times changed. Today many companies more and more realize the revenue and profit potential of service offerings. For any reason, still many offer their services reactively.

Take an active approach to service selling! Do not simply offer services when customers demand them, but offer services pro-actively. For an active-selling approach your company needs the following information, skills, and methods:

1. Know your service market size (the size of the market you want to target),
2. Utilize existing or develop new sales channels for selling services,
3. Train your sales in service offerings,
4. Implement a proper incentive program for service selling,
5. Set challenging but realistic sales targets for your sales force,
6. Monitor sales development,
7. Act early if targets cannot be achieved.[8]

In good times your sales force will most likely focus on product sales if bonuses are higher for products compared to services. Therefore it’s helpful to put the right incentives to sales reps for service sales and include service sales targets in balanced-scorecards of managers. Push services actively in good times to secure your company’s margins for the next crisis, when product sales will considerably drop.

Possess long-term endurance while focusing on profitable growth early on

Success requires a firm long-term commitment to service and a company-wide belief that service business is vital for overall success – even in times of soaring product revenues. Such belief can be solidified by following a planning approach that enables a quick path to profitability and a long-term focus on service business. Unfortunately this can be a truly delicate task – especially for the corporate executive who needs to fulfill (short-term) capital market expectations. It does not help to deny the fact that the current fiscal quarter is always the most important quarter. But rejecting the importance of a long-term planning approach would also inhibit sustainable business creation.

Therefore, an approach is required which divides the venture in tangible targets and milestones for quarterly and yearly execution. Tangible means defining concrete quantitative objectives. Fulfilling revenue and profitability objectives is most suited to indicate service success. In early lifecycle stages with comparably little revenue contributed by services, it can however be smarter to focus on KPIs like customer satisfaction, e.g. captured by conducting quantitative research surveys. Only by showing quantitative results, it will be possible to convince key stakeholders like the board, investment analysts and strategic partners of continuing to invest in the service business. Missing such quarterly and yearly objectives helps create a burning platform for reviewing and adapting the chosen service strategy. Executives will then have to reengineer or even eliminate loss-making services. A solid status assessment based on quantitative research is key to make stakeholders understand that such change is required. Deciding when and how it makes sense to adapt a chosen service strategy is a critical element of success. Looking at companies with failed service business it however seems much more risky to completely abandon a chosen service strategy instead of sticking to it. It is very tempting for executives to propose new initiatives in each fiscal year. Re-affirming an already entered path with endurance and tenacity can be interpreted as lack of adaptability. But exactly this is often a crucial prerequisite for creating a sustainable business with services.

A prominent example for illustrating this challenge is Kodak whose executives were very early on aware of the disruptive shift from analog to digital photography. When Kodak was still market leader in the U.S. photo-finishing market in the early 1990s[9], the new Kodak CEO M.C. Fisher initiated a multitude of global product and technology projects[10]. These ranged from development of groundbreaking digital sensor chips to new scan and photo storage solutions. With 27% share in the U.S. digital camera market in 1999, Kodak even achieved to establish itself as second largest vendor. However at the same time, Kodak failed to defend its minilabs-based service and replenishment business against Fuji in North America. For Fuji, the steady and robust revenue stream from minilabs business generated in total over 15% profit margin still in 2000. Also today, Fuji continues to invest in its minilabs photofinishing production lines and in associated services. High-value added service offerings like “Photobook” even enabled an increase in net sales for Fuji’s Photo Imaging business unit in fiscal year 2012.[11]

Conclusion: Hedge your product business by investing in services

In times of prosperity, it is smart to stay alert and raise the question how to make the company more robust. This can be done by developing service business e.g. around as-is technology platforms and product portfolios or developing your company to a true solution provider. For doing so, think about how you can complement your current product business by offering services showing little positive or even negative correlation with it. Start to develop your service business in good times, in order to benefit from additional robustness in bad times. This article provides a structured guideline for managers how to do so. It can serve as a blueprint for an action plan towards more robust income streams to better survive the next crisis – which certainly will come.

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[2] Statistisches Bundesamt (2010). Auftragseingang im Maschinenbau, Volumenindex Inland. Wiesbaden.

[3] Glenn, P.A. (2011). Strategisches Management industrieller Dienstleistungen aus system-dynamischer Sicht. Göttingen: Sierke Verlag, 236.

[4] For profitability in industrial services see: Schuh, G. et al. (2004). Fit for Service: Industrie als Dienstleister. München, Wien: Hanser Verlag, 11. Kaerner, H. et al. (2004). After-Sales. Frankfurt a.M.: Frankfurter Allgemeine Buch, 14. For profitability in IT services shown with software-as-a-service see: Bandulet, F. et al. (2010). Software-as-a-Service as Disruptive Innovation in the Enterprise Application Market. Software-as-a-Service. Wiesbaden: Gabler Verlag, 15-30.

[5] For a description of the service-dominant logic see Lusch, R.F. & Vargo, S.L. (2006). Service-dominant Logic of Marketing. Armonk NY: M.E. Sharpe.

[6] Gerstner, L. (2003). Who says Elephants can't dance? London: HarperCollins Publishers, 53.

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[8] For further advices how to develop an active service sales approach see Glenn, P. & Kummert, S. Wie Zusatzleistungen richtig vermarktet werden. IO New Management 75(5), 40-43.

[9] Hill, C. & Jones, G. (2008). Strategic Management. 8th edition. Boston, Mass.: Houghton Mifflin, 485.

[10] The following Kodak example is based on Gavetti, G. et al. (2004). Kodak and the Digital Revolution. Boston, Mass.: Harvard Business School Case 9705-448 2004, 4-15.

[11] Fujifilm (2012). Annual Report 2012. Tokyo: Fujifilm Holdings Corporation 30, 31, 45.

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