The Road to Service Excellence

Ten Ways Industrial Goods Companies Can Win in Services
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Ten Ways Industrial Goods Companies Can Win in Services

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Many industrial-goods manufacturers think of services only in terms of supplying spare parts. Service champions, however, know that there is a wide variety of services they can provide to customers, such as installation, training, retrofits, upgrades, and outsourcing—all of which can be quite profitable.

**HIGH-RETURN LEVERS TO PULL**

BCG has helped industrial goods companies rethink their approach to services. In this report, we focus on ten high-return levers—such as employing value-based pricing and building a service factory—that can enhance service revenues and profitability.

**BUILDING THE CAPABILITIES**

Expanding service operations can often be done incrementally with modest resources, but achieving true service excellence requires companies to excel across all elements of the service value chain. It’s essential to gain a deeper understanding of customers’ priorities and then to reconfigure offerings to address their most pressing needs. This requires a sales force with the right structure and incentives, the systematic pricing of services, and a rigorous performance-monitoring process.
The strategy of wrapping services around the sale of a product has been pursued for several decades by industrial goods manufacturers. Yet, surprisingly, few companies are fully exploiting their service opportunities. Many are leaving substantial value on the table.

Consider manufacturers of water treatment equipment. For their industrial customers such as microelectronic companies, water treatment is critical to the production process but accounts for less than 2 percent of total plant-operating costs. The treated water must meet certain quality standards, but exceeding those standards offers no competitive advantage. Hence, from the customer’s perspective, there’s no benefit to developing an expertise in water treatment.

Many water companies, however, have not considered the customer’s point of view and, therefore, have not perceived the opportunity to offer a solution. Instead, they have focused on selling new products and viewed services in terms of spare parts, sold opportunistically. They have seen no need for dedicated service departments, which has resulted in their service activities being underresourced and undermanaged. Using this business model, companies’ earnings before interest, taxes, depreciation, and amortization (EBITDA) have on average shown lower single-digit margins.

A supplier that we will call WaterFlow adopted a different approach. It offered solutions rather than only equipment. These solutions typically took the form of “build, own, operate” contracts. That is, WaterFlow would provide its customers with a loan to purchase its water treatment equipment, then the company would run and maintain the equipment on-site on behalf of its customers. These water-by-the-hour deals allowed WaterFlow’s employees to keep in close contact with customers, advising them on retrofits, upgrades, and how to effectively treat water and wastewater in order to improve their sustainability record.

WaterFlow also professionalized its service business by making it a discrete unit and setting ambitious revenue and margin targets for the head of service. This helped to align the entire organization with the solutions strategy, and it encouraged employees to look for other service opportunities to grow the business, such as maintaining the equipment of WaterFlow’s competitors. WaterFlow’s ambitious service program resulted in the company outperforming its peers in both EBITDA-margin and market-share gains.

This divergence in approaches holds a key lesson: industrial goods companies should broaden their view of service operations. When managers think about
services, they should avoid focusing on only spare parts. Rather, after-sale services comprise a wide variety of activities—traditional technical services (such as basic installation and training), enhanced technical services (such as retrofits and upgrades), and business services (such as consulting, financial services, and outsourcing)—all of which can be quite profitable because they provide high value to customers. (See Exhibit 1.)

![Exhibit 1 | The Universe of Service Opportunities](image)

Source: BCG analysis.

**Committing to Service Excellence**

Industrial goods companies that understand the opportunity at hand have turned their service operation into a competitive advantage, and some are achieving a level of true service excellence. They have moved from only manufacturing products to offering solutions, and as a result, they are outperforming their peers in terms of service revenues and profitability.

The Boston Consulting Group conducted a benchmarking study of 50 manufacturers of industrial machinery that confirmed the attractiveness of establishing a service business. On average, services accounted for 30 percent of companies’ revenues—and contributed up to 50 percent of total operating profits at a profit margin of 24 percent. (See Exhibit 2.) However, for the service champions in this sample, the service business contributed an average of 47 percent of revenues and had profit margins of 36 percent.
Obviously, these data vary significantly by industry, but they do suggest ample room to expand service operations in many industrial-goods companies—even if they already generate healthy service revenues and profits.

Thus, we believe that the time is ripe for companies to start the journey toward service excellence. Since the financial crisis, business customers have been trading down in many markets, keeping their products for longer periods, and seeking out used rather than new products. In addition, the increasing number of environmental regulations along with the growing interest in sustainability have created opportunities to promote retrofit and upgrade services.

Moreover, it takes years to reach a level of service excellence, and we often see companies struggling in their effort. Part of the challenge is cultural: industrial managers typically view products as central—and the associated services as tangential—to the company’s identity. As a consequence, service businesses tend to be undermanaged, understaffed, and underresourced. Additionally, companies encounter operational challenges related to standardizing delivery processes, establishing systematic pricing, and instilling an active service culture. However, none of these problems are insurmountable.

**Ten Ways to Capitalize on the Service Opportunity**

In the course of our work with industrial goods companies, we have identified a set of levers that have proved quite useful in building strong service businesses. Here, we discuss these ten high-return levers that companies can pull to enhance service revenues and profitability. (See Exhibit 3.)
Typically, a company that wants to increase service revenue must focus on levers that are different from those it would emphasize to boost profitability. A manufacturer whose service lines account for about one-tenth of total revenues but more than one-third of its margin should probably focus first on steps that will raise sales, whereas a company in the reverse situation should do the opposite. In either case, achieving true service excellence generally requires a command of all ten levers. Let’s review each in turn.

**DEFINE THE SERVICE BUSINESS MODEL**

The very act of recognizing service activities as belonging to a different business model is a critical first step in defining a service business model. The next step is creating a new value proposition (including determining the customers to serve, the services to offer, and the price to charge) and supporting it with a distinct operating model (how to profitably deliver the new offering).

A global truck manufacturer experienced substantial margin pressure on its product sales in light of new competition from truck-leasing companies. As a consequence, after looking anew at customers' needs and priorities, the company started offering fleet financing to its longest-standing customers and expanded into fleet management. The latter included not only maintenance but also insurance, gas, and even driving services—all offered at a fixed price per mile driven, which provided customers full cost transparency. Furthermore, the truck manufacturer created a new organizational unit with its own P&L responsibility to manage this...
new solution-type offering so as to ensure that the effort would be sustained.

To define a service business model, executives need to make purposeful choices along several dimensions, including service philosophy, financial aspirations, service offering, associated risk exposure, target customer segments, and organization structure. If the service business is treated simply as an add-on to or byproduct of the manufacturing business, it will forever be stuck in low gear.

**Adopt Design-to-Service Principles**

In recent years, manufacturers have focused on reducing complexity in their new product offerings. Automakers, for instance, have developed global vehicle platforms, because by standardizing parts, they can produce lower-cost vehicles. The mantra has been “design to cost.”

But cost is only part of the profitability equation, and adopting a “design to service” approach can help maximize the total profit possible from a particular product or customer relationship. In our experience, captive original-equipment-manufacturer (OEM) services generate double or triple the margins of licensed or third-party-fulfilled services for industrial goods companies. To generate these healthy margins, manufacturers must inject a service perspective into R&D.

A design-to-service approach also increases the number of customer touch points, as it requires customers to contact the OEM for certain parts and service tasks throughout the life span of a piece of equipment. Done well, this approach raises customer satisfaction and cements customer loyalty to the brand. Done poorly—through overpriced spare parts or unreliable service—this strategy has the potential to jeopardize long-standing customer relationships.

On the cost side, a thoughtful design-to-service approach can also help raise productivity. A manufacturer made a machine that required a service engineer to use special tools to open the cover to access the interior. After recognizing that this slowed the servicing of the machine, the manufacturer changed the cover design so an engineer could open it easily and quickly.

Another major new trend in many manufacturing industries is enabling the remote monitoring of a product through software that’s included in the original design. Remote monitoring sets up the possibility of a number of downstream repair and maintenance services by triggering “smart maintenance visits.” A service technician can arrive at the right time, and with the right replacement parts, to repair a machine that is critical to the manufacturing process and prevent an otherwise expensive breakdown.

**Defend and Develop the Entire Installed Base**

The installed base constitutes one of a manufacturer’s strongest assets, yet most companies don’t tap its full potential. In most cases, there is considerable room to enhance the quantity and quality of after-sale services offered to existing customers. At the same time, many companies don’t have a central, comprehensive view of their installed base. New equipment might be marketed to customers through third-party representatives, and used products might be resold several times over...
their life span. Some companies simply have not kept track of their installed base—especially if they have grown rapidly through acquisitions and never integrated their various customer lists. Scrubbing these databases and actively reconnecting with customers can be an easy and quick way to advance the service cause.

A major machinery company offered a line of presses, and after years of selling through value-added resellers, the manufacturer had lost track of where its products were installed. That made it difficult to offer retrofits and upgrades, and the company had become reactive in servicing older equipment—it only offered to service a press when a customer managed to locate the company headquarters and called with a problem. In addition, although the general technician dispatched to a customer’s site might be able to diagnose the problem, a dedicated engineer for the particular piece of equipment and another visit were often required before the issue could be resolved.

By conducting a telemarketing campaign, the company was able to compile detailed data about its installed base. Technicians then paid a visit to most of the operators of its presses, affixing to the equipment a sticker with a service phone number and having low-key conversations with the customers. Service calls started to roll in, and the company was ready with a redesigned set of integrated services as well as with related pitches for upgrades.

**SERVICE THIRD-PARTY PRODUCTS**

In our conversations with manufacturers, we often see a reluctance or outright resistance to providing services to competitors’ installed bases. As a result, this service business is picked up by competing manufacturers or by independent service providers found in sectors such as construction technology, machinery packaging, and engine manufacturing. Yet servicing third-party products can offer a way to spread competencies to new markets and generate additional revenues.

Consider the case of a building equipment manufacturer that also installs and services its equipment. The company saw a drop in new orders and installations when new construction slowed, so it decided to pursue servicing competitors’ products installed in commercial properties, such as department stores, hospitals, and office buildings. The company built an internal competence center to develop methods for servicing competitors’ products and trained technicians and a secondary sales force.

The regular presence of service representatives at these sites allowed the company to develop strong relationships with these customers. In addition, company representatives were able to gain insights into competitors’ installed equipment, giving them more ammunition to promote equipment upgrades and new services, such as remote monitoring and fault diagnostics. The representatives were also able to have conversations with customers about installing their own products when customers needed major upgrades. As a result, the company generated service revenues and upgrade revenues that were higher by nearly 30 percent.

To be sure, manufacturers that aspire to service third-party products will have to make a series of investments. After they do so, however, they can secure a steady
stream of revenue, and they raise the odds of retrofitting the next piece of equipment or selling that customer a new product.

**SELL PROACTIVELY**
Successful service providers do not wait for customers to call. Instead, they initiate contact with their customers throughout the life cycle of the product. Our benchmarking study revealed that selling proactively manages to raise revenues often by more than 20 percent and boost profitability by more than 30 percent.

For example, a leading industrial-membrane maker revamped its sales strategy after experiencing low implementation rates for new service offers. Its revised sales approach—supplemented by a new incentive structure for the sales force—started by identifying prospective customers that were over- or underservicing their equipment or were concerned about complying with regulations. The company customized service plans for those customers, benchmarked their operations, and made recommendations for capital expenditures. This highly targeted approach caused service and new-product revenues to grow substantially.

Proactive selling raises performance regardless of where a company stands in its service evolution. For a company that’s starting to expand its service business, it may make sense to train existing product-sales representatives or continue to rely on third-party service representatives or both. As the service business matures, or if it branches into more complex services, it may be appropriate to hire dedicated service representatives. At some point, a separate sales organization focused on services could be created. But regardless of how the effort is organized, the respective service-sales force will need the appropriate knowledge and tailored incentives. Service-sales managers should determine which customers to treat as key accounts and set targets for service sales for individual accounts.

**EMPLOY VALUE-BASED PRICING**
In a service business with profit margins as high as 60 percent or 70 percent, the upside potential of value-based pricing may seem limited. However, by shifting from traditional pricing paradigms (such as cost-plus) to advanced value-based pricing, companies can actually increase both sales volume and margins.

In this case, it is critical to strike the right balance between pricing and customer retention. High markups for crucial parts that can be obtained only from the manufacturer may undermine future customer relationships—unless the price can be justified by a level of service that the customer values considerably, such as same-day repairs. For example, when a broken conveyor belt shuts down the entire manufacturing process, the price of a spare part often takes a back seat to a speedy solution. Value-based pricing accounts for such tradeoffs.

A U.S. OEM took these principles to heart and introduced an advanced pricing model that categorized spare parts according to the three main contributors to its customers’ price sensitivity: competitive intensity, price elasticity, and product life cycle. Setting appropriate markups for each spare-part category on the basis of these factors helped the company offset a double-digit sales decline in the wake of the recent financial crisis.
**Build a Service Factory**

Many industrial-service leaders aim to establish a “service factory” by standardizing their offering and their delivery of services. The service-factory approach emphasizes consistent processes, best-practice sharing, and continuous improvement.

Global hotel chains illustrate the benefits of a standardized approach. Travelers can count on finding the same quality and customer experience at every property in the chain, regardless of location. This uniformity rests on consistently deploying the same booking, housekeeping, and room-service processes worldwide. Although an establishment run by a leading hotel chain is not necessarily better than an independent hotel, the chain’s business model is scalable and allows for sharing of best practices and systematic improvement.

The same rigor should apply to standardizing industrial-service offerings. Too often we find that services provided by OEMs depend on the activities of the local head of service rather than on defined, standardized processes. Of the companies in the BCG benchmarking study, only about one-third had optimized their service networks through shared expertise to offer a consistent level of quality.

A company that sells many uncoordinated variations of a service contract will find it more difficult to train service employees, to coherently explain the contract to customers, and to execute services in a way that optimizes profit. Multinational customers, in particular, put a high value on receiving the same service and quality wherever they operate. Moreover, for every product-based service bundle, there should be a catalog or blueprint that describes in detail each included service and its intended outcome.

To keep standardized offerings humming along, companies should strive to standardize their delivery processes and tools as well. Field-service personnel, for instance, could be equipped with mobile devices that provide technical information on all equipment types, details regarding past visits to a site, a spare-part ordering system, a GPS that tracks the location of personnel, and a list of tasks that specifies the order and time period in which they need to be done.

**Establish Clear Performance Metrics**

Achieving true service excellence requires fact-based decisions, which in turn call for KPIs that are different from those used to monitor a new-product business. Service-related KPIs encompass not only financial indicators, such as service share of revenues and service profitability, but also operational performance indicators, such as on-time delivery ratios, the time it takes to issue a quote, and stockout ratios. The information derived from service-specific KPI dashboards can then be used internally and externally to compare the performance of the service organization across locations as well as with peers and recognized service leaders in other industries.

An engineered-products provider faced the challenge of higher service demands and low customer satisfaction. In response, it defined the key maintenance tasks and the associated processes in detail, such as taking the initial call, ordering the materials, notifying the customer, and dispatching the service technician. Perfor-
mance grades were based on key ratios, such as first-time fix rates, the number of visits per technician per day, and on-time delivery rates. After using pilot programs to fine-tune the process steps, the company implemented a tool to track, continuously revisit, and lift the service KPIs in an intelligent fashion.

The result: a step change in terms of productivity improvement paired with a continuous-feedback loop. Such rigor is standard for chief operating officers when it comes to manufacturing products, but few companies apply the same discipline to their service businesses.

**EMPOWER THE SERVICE ORGANIZATION**

Service businesses within industrial goods companies usually get scant management attention. For one thing, most companies focus first on new products, with services being an afterthought. For another, services tend to be highly profitable, and executives are often satisfied with their current performance level, not believing that there is much more room to grow.

In many cases, though, companies could earn even greater returns by treating their service business as a separate entity that has profit and growth responsibilities. Virtually none of the service champions that we have worked with treat their service business as a cost center or bury it within the new-product organization.

In fact, in our benchmarking study, companies with separate service businesses earned service revenues that were 15 percent higher than those with integrated businesses. A separate business sharpens both the focus and accountability of the service organization. It also encourages more sophisticated processes, interfaces, and roles (all of which need to be deliberately designed) and raises awareness of the value of the service business throughout the company.

At the same time, it’s important not to oversteer and focus exclusively on services; companies must strike a balance between manufacturing new products and servicing them. Over the course of our work in this area, we have encountered several companies that jeopardized their product business by making the service organization too prominent, which in turn impeded new-product innovations.

**INSTILL A SERVICE CULTURE**

Service leaders also are characterized by a strong service culture. They view services not simply as a lever to sell more products but as a key differentiator relative to competitors. This attitude permeates the entire organization, from senior executives to line managers and frontline employees. The cultural change required to get to this point takes time and substantial management effort to accomplish. Nonetheless, it’s quintessential to ensure the other service excellence levers can be sustained over time.

It helps to break up the challenging task of changing the culture of an organization into small, tactical steps. For instance, service executives should have veto rights, or at least strongly considered viewpoints, across the chain of product development and manufacturing. The same applies to the compensation of service employees, which should be on par with their new-product counterparts.
As industrial goods manufacturers face pricing pressure on the product side and tight spending by customers, well-run service operations provide a renewed source of profitable growth. Intelligent investments in service businesses can yield high and sustainable returns—and the initial investments may not need to be large. Executives should determine how their company is positioned for growth and where it needs to build capabilities by asking a series of pointed questions. (See the sidebar “Questions for Executives.”)

By striving for excellence across all areas of their service business, industrial goods companies can reap significant financial rewards and improve their relationships with their customers, killing two birds with one stone.
Executives who want to diagnose their current level of service and assess which capabilities will need to be augmented in order to perform at a high level should start by answering the following questions, which are related to the elements of the service value chain. (See the exhibit below.)

- **Service Strategy.** Do we set clear revenue and margin targets for our service business?

- **Product Design.** Do we apply design-to-service principles when developing new products?

- **Service Portfolio.** Do we offer services that address the most pressing customer needs?

- **Customer Segments and Insights.** Do we have a comprehensive, integrated view of our installed base, including, for example, the type of equipment and its exact location?

- **Go-to-Market Approach.** Do we have specific sales targets for services and the right incentives?

- **Pricing.** Do we apply a value-based pricing approach to our service offering?

- **Delivery Processes and Tools.** Do we enforce standard operating procedures for servicing customers’ equipment?

- **Operational Excellence and Metrics.** Do we monitor our service performance using tailored KPIs?

- **Service Organization.** Do we have a dedicated service department with clear accountabilities?

- **Service Culture.** Do our employees understand the importance of our service business?

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**The Service Value Chain**

![The Service Value Chain Diagram](source: BCG analysis.)
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