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The right **service strategies** for product companies

As products evolve into commodities, services become more important. But companies that play this new game must understand its rules.

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As relative newcomers to the service economy, many product companies have yet to make money there. Until recently, brisk sales growth, buoyed by a rising tide of demand for services, kept trouble from view. But as the estimated \$500 billion “embedded” service sector (Exhibit 1, on the next spread) becomes more competitive, too many companies find themselves grappling with strategic questions they should have resolved when first entering the market: are they offering embedded services for offensive or defensive purposes? Are they playing a skill- or a scale-based game? Confusion about fundamental issues of strategic intent and the source of competitive advantage now seriously hampers the profitable pricing and delivery of embedded services and the effective management and governance of product and service organizations alike.

That strategy must precede structure has been a tenet of good management since Alfred Chandler published his seminal studies in the field of business history, in 1962.¹ But product companies in the embedded service sector lack the strategic clarity needed to make sensible decisions about how to design businesses. Some view internal service businesses as a growth platform but structure and run them as an adjunct to product businesses. Others stumble by pursuing scale-based business strategies in skill-based

¹ Alfred D. Chandler Jr., *Strategy and Structure: Chapters in the History of Industrial Enterprise*, Cambridge, MA: MIT Press, 1962.

Article at a glance

Profits from service businesses have disappointed many companies that launched them to protect or enhance products. This embedded service sector has grown rapidly, but the businesses are often barely profitable.

One reason for the mixed returns is that companies aren't always clear about whether services are intended to grow in their own right or to protect products.

Although executives often say they want service businesses to expand independently, they keep services captive within the structure of product businesses.

Understanding the direction of the business and the source of competitive advantage is essential to determining the right structure for an embedded service unit.

service markets or vice versa. This kind of confusion leads to organizational conflict, misguided pricing and service delivery, and misunderstandings about costs and the capabilities and resources needed to succeed in different competitive environments.

To make existing service groups profitable—or to succeed in launching a new embedded service business—executives of product companies must decide whether the primary focus of service units should be to support existing product businesses or to grow as a new and independent platform. These executives must also discern the source of competitive advantage in the service markets in which

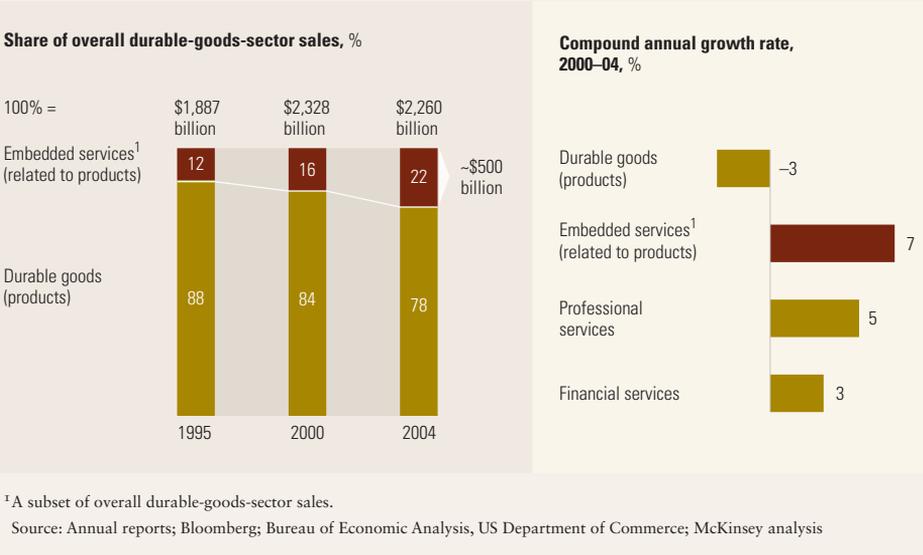
they choose to compete. Only with these questions answered can executives properly design an embedded service business. Getting the fundamental strategic questions right may not guarantee success, but getting them wrong is a sure route to failure.

Common mistakes

Of course, some companies fully understand the strategic intent of their own embedded services. EMC, for example, entered the skill-based business of storage-related maintenance and professional services in order to enhance a leading position in storage equipment. Johnson Controls saw the scale-based business of managing integrated facilities as a growth platform that would be more robust than its climate-control-equipment and -components business. But other companies fall prey to one or more common traps:

- They strive for growth in services with a business model designed to protect or enhance a core product position, thus setting up a conflict between the product and service businesses—a conflict the product side usually wins. Services are often underpriced in a bundle or promised at service levels that companies can't deliver profitably.
- They inadvertently undermine the health of the product business while promoting a growth-oriented service business. During a big push to expand a service business, one company bundled and priced service

EXHIBIT I

Growing fast

contracts with products at levels that made solutions more attractive than stand-alone products. In effect, the company failed to prevent the commoditization of its product business and implicitly underpriced its services, a situation that took two to three years to rectify.

- They pursue scale in a skill-based business and expand to compete for customers whose needs are not well suited to their standard offerings or most distinctive capabilities. What follows is a self-defeating cycle of underpricing and underdelivery of services, dissatisfied customers, ad hoc customization, higher costs, and sustained operating losses.
- They rely on specialized skills in a business that rewards economies of scale, thus leaving themselves vulnerable to lower-cost attackers that have standardized competitive offerings and operate over a larger customer base.

Strategic intent and source of advantage

To avoid these mistakes, executives must clearly define their markets and goals. They must also be certain whether they will achieve competitive advantage through high-margin skills or through large volumes of more scalable services (Exhibit 2, on the next page).

Defend or grow

Most product companies offer services to protect or enhance the value of their product businesses. Cisco, for instance, built its installation, maintenance, and network-design service business to ensure high-quality

EXHIBIT 2

Where you're going, how you're getting there

Source of competitive advantage	Economies of scale	<ul style="list-style-type: none"> • Apple's iPod music download and transaction-management service (iTunes) • Otis Elevator's remote-monitoring and -diagnostics services • General Motors' OnStar auto remote-diagnostics service • Symantec's virus protection and data security services 	<ul style="list-style-type: none"> • Cardinal Healthcare's hospital inventory-management services • Cincinnati Bell's billing services (now part of Convergys) • IBM's data-center-outsourcing services • Johnson Controls' integrated facilities-management services
	Economies of skill	<ul style="list-style-type: none"> • Cisco's network integration and maintenance services • EMC's storage-management and -maintenance services • SAP Systems' integration services • UTC's utilities field support services 	<ul style="list-style-type: none"> • Cincinnati Bell's call-center-management services (now part of Convergys) • General Electric's aircraft-engine-maintenance services • GE Healthcare's hospital equipment—support and diagnostics services for hospital equipment • IBM's systems integration services
		Protect or enhance product	Expand independent service
Strategic intent			

product support and to strengthen relationships with enterprise and telco customers. Otis Elevator's services focus on improving customer satisfaction, retention, and market share by increasing the reliability of the elevators. A company may also find itself drawn into services when it realizes that competitors use its products to offer services of value. If it does nothing, it risks not only the commoditization of its own products—something that is occurring in most product markets, irrespective of the services on offer—but also the loss of customer relationships.

Yet once companies establish a defensive rationale for market entry, too many succumb to a dangerous temptation: viewing the service business as a growth platform. After all, service margins can be attractive as compared with those of most product companies, and there have been some famous success stories. General Electric, for example, has pursued embedded services in all of its business segments as a way of expanding its addressable market in aircraft engines, medical products, and industrial equipment. Cincinnati Bell spun off, as Convergys, its successful call-center-management and billing unit.

But treating embedded services as an independent growth business is a challenging proposition requiring a distinct strategy, tactics, and organizational structure. Instead of competing for revenues adjacent to products, where strong customer relationships deliver a decisive advantage, a growth business faces a larger market and more competitors. For many years, Arrow Electronics, a leading distributor of electronic and industrial equipment,

offered bundled logistics services to its customers. When it ventured into supply-chain- and inventory-management services, in 2001, it found itself in competition with not only transportation companies, third-party logistics firms, and contract manufacturers but also its own customers' internal operations groups. The move also increased the management complexity of every aspect of Arrow's service business and raised difficult issues of integration and separation between product sales in the company's core distribution business and sales of value-added services. Trying to compete simultaneously on a defensive and an offensive basis is a recipe for confusion and conflict between the product and service businesses. Often the result is that the latter loses money and justifies its difficulties by pointing to a "product pull-through effect"—that is, the ability of a service to create incremental sales for the product. Of course, those involved in the product business fiercely deny the existence of such an effect.

Scale or skill

While product companies choose to enter service markets for varied reasons, success requires achieving competitive advantage from either economies of scale or economies of skill—depending on the structure of the specific service market. Economies of scale call for high volumes, low variable costs, and the high utilization of fixed assets. Automated transaction processing, for example, scales almost infinitely when standardized, thereby helping that service industry's big players—such as Automatic Data Processing (ADP) and First Data—to achieve low unit costs and high margins. Businesses with economies of scale also benefit from positive network effects, so they depend on globally dispersed assets, such as distribution centers (for supply chain services), data centers (for IT outsourcers), or payment platforms and protocols (such as Apple's iTunes music download service).

By contrast, businesses that rely on economies of skill create value mainly by identifying, deploying, and replicating scarce capabilities or developing process innovations. Sometimes the skill is a detailed knowledge of a product—not necessarily one from the company offering the service—as well as the experience and tools to fix problems and reduce the customer's total cost of ownership. Other high-value skills help generate additional revenue or speed time to market, as they do in outsourced design services for semiconductors or mobile phones. Such service businesses depend on the systematic application of genuine and scarce expertise, with only modest advantages from higher scale.

Confusing the main source of competitive advantage is dangerous, because it leads companies to target customer segments or to offer services that don't provide differentiated value. A company relying on skills in a scale-based market, for example, will have trouble achieving attractive

margins against high-scale competitors, because customers won't pay for customized offerings.

On the other side of the ledger, many companies have tried to run high-scale field service businesses by pursuing global field support deals and hiring thousands of technicians. But most such businesses rely on skills: familiarity with equipment and software problems tends to matter far more than the number of clients served. Boosting the volume of service contracts rather than focusing on managing processes and knowledge is a recipe for losing money.

IBM has combined skill and scale successfully. When the company entered the data-center-outsourcing market in the late 1980s and early 1990s, it leveraged its deep knowledge of mainframe computers as the basis for its skills. But IBM also invested in scale—enlarging its sales force, increasing its global presence, and scaling its services across many large customers—to compete against Electronic Data Services (EDS), the market leader at the time.

Optimizing design

A company hoping to succeed in embedded services has to make business design choices that accurately reflect both its strategic intent and its source of advantage (Exhibit 3). Although one or the other axis may determine the company's individual functional choices, creating a coherent integrated business system depends on getting both axes right. When companies are unclear about their strategic intent, for example, they tend to stumble in pricing and sales—thereby crippling the profitability and growth of the business in ways that the delivery of services, no matter how excellent, could never overcome. By contrast, if companies misunderstand the source of their competitive advantage, they more typically fail in delivering the service, in deciding how much to customize their offerings, or in instituting performance-management metrics and processes to motivate the right investments and frontline activities.

Balanced pricing

The structure and level of pricing is perhaps the most crucial design choice in embedded services. To get pricing right, a company needs a clear grasp of its strategic intent and its sources of competitive advantage and must often make trade-offs between product penetration and the growth and margins of its service business.

A company's strategic intent largely determines the appropriate extent of product-service bundling and the value attributed to services in such bundles. Companies that focus on enhancing or protecting core products should price their services to improve their product penetration. The

EXHIBIT 3

Different strokes		
Source of competitive advantage	Economies of scale	<p>Pricing: Bundled products and services; volume-based pricing; price level of services set to optimize product penetration and life cycle profit</p> <p>Sales: Single product/service sales force; sales support to sell standard add-on service packages</p> <p>Delivery: Embed services into hardware/software where possible; consolidate service delivery assets</p> <p>Organization: Single business unit; specialized development of service offering; measure life cycle profits, 'attach rates,' and unit delivery costs</p>
	Economies of skill	<p>Pricing: Bundled or separate; menu-based pricing to reflect customer value of solution and to optimize life cycle profits of product line</p> <p>Sales: Single sales force with service specialists; sell integrated solutions to reduce total cost of ownership for products</p> <p>Delivery: Design products to be serviced; enhance productivity of skilled delivery force via knowledge management, standard processes</p> <p>Organization: Single business unit; measure life cycle profits, revenues, and productivity per service delivery employee</p>
		<p>Protect or enhance product</p> <p>Expand independent services</p>
Strategic intent		

pricing strategy to achieve such product pull-through varies according to customer purchasing decisions. Companies can raise the value of the product in use and increase its pull-through by bundling products and services into a higher-value solution. If the entry price is a key factor, service contracts can be priced higher, which allows for lower product pricing—the practice in many software businesses. In some cases, companies can raise the price of maintenance service contracts to accelerate the rate of product upgrades. The strategic goal of product pull-through also means that sales and field agents should have some flexibility and authority in the pricing of services. However, companies must still actively manage pricing discipline by ensuring that these salespeople are accountable for the total profitability of the bundles they sell.

By contrast, companies aiming to create an independent, growth-oriented service business should price their offerings to achieve profitable growth and set pricing targets as close to the services' value to customers as competitive alternatives permit. These companies should set pricing guidelines and

delegate authority centrally, with relatively limited freedom for sales and field personnel and clear rules for discounting. Bundling prices for services and products is usually a bad idea for a growth platform in services, since within any given customer's organization, the person who buys the service might not be the one who buys the product. It is also difficult to bundle prices while holding both product and service business units accountable for their independent sales and margin targets.

The source of competitive advantage—scale or skill—mainly affects pricing structures. If economies of scale drive a business, its pricing should be based on standard units (such as terabytes of storage managed) and it should offer volume discounts to encourage growth in usage. Such companies ought to make the price of any customized variation from their standard service offerings extremely high, since these exceptions push up costs throughout the business.

By contrast, if a service business relies mostly on special skills, it should base its prices on the costs its customers avoid by using its services or on the cost of the next-best alternative. Such value-based pricing requires a sophisticated analysis of a customer segment's total cost of ownership and a deep understanding of the cost structure of the service business. Competitive benchmarks and the cost of deploying the skills should determine the respective upper and lower bounds for these price levels. In the best case, companies can package this intelligence into pricing tools that allow sales and field agents to estimate customer value more accurately and thus improve field-level pricing decisions. As Exhibit 3 shows, these factors create four very different guidelines for pricing embedded services, according to a company's intent, its source of advantage, and combinations of the two.

Focused sales

The sales force can make or break an embedded service business. Companies should start by basing the structure of their sales teams for embedded services largely on their strategic intent. If a company aims to protect or enhance a product, integrating sales of products and services makes the most sense, and the sales force should have the tools and sales support to communicate the benefits of the integrated solution.

By contrast, a company focused on building and enlarging an independent service business must give it a separate sales force that can gain credibility as a trusted adviser to customers. If the purchaser of the product and the service is the same, a company taking the independent approach should build an "overlay" sales force for services and design aligned incentives and business processes to allow the two sales forces to coexist within those client accounts.

The chief influences on a company's efforts to gain competitive advantage by managing its sales force are the complexity, variety, and degree of customization that characterize its service offerings. The more complex and variable they are, the more skilled and actively managed a sales force must be, because sales are more differentiated from customer to customer and the risk is high that an unintended variation could make a sale unprofitable. To realize the advantages of a scale-based service business, a company should sell the most standard feasible solution to its largest customers and streamline sales to smaller ones in order to bring them as close as possible to self-service.

Companies in skill-based businesses, such as applications development or software and equipment maintenance, should keep sales and delivery well coordinated: skilled service specialists often identify specific customer needs on site, and salespeople will often need to have nearly as much technical credibility as service delivery specialists. Companies can strengthen such a sales force by developing deep knowledge-management databases of best practices and by providing semistandard solutions and experienced service delivery people to address the most common customer requirements.

Exhibit 3 shows how these factors create four different approaches to sales forces across the four design quadrants for embedded service businesses—depending, again, on the unique combination of strategic intent and the source of advantage.

Measured delivery

When a company chooses a business design for delivering embedded services to customers, it should remember that its strategic intent affects which elements of the delivery life cycle are most important. If the aim is to protect or enhance the value of a product, the company should integrate the system for delivering it and the associated services in order to promote the development of product designs that simplify the task of service (for example, by using fewer subsystems or integrating diagnostic software). This approach involves minimizing the footprint of service delivery and incorporating support into the product whenever possible. If the company wants the service business to be an independent growth platform, however, it should focus most of its delivery efforts on constantly reducing unit costs and making the services more productive.

But the best way to achieve (or accelerate) this kind of continual improvement depends on the nature of a company's competitive advantage, for scale- and skill-based service businesses have very different delivery requirements. In businesses where economies of scale are essential, the effort must focus on standardizing processes and platforms for service delivery. Since the

temptation to customize services is always great, companies must incorporate standards into the work flow of frontline employees by giving them shared tools and processes. If at all possible, companies should also realize the benefits of scale by consolidating service delivery assets, such as data centers, help desks, and payment platforms.

When economies of skill are the differentiator, delivery should focus on enhancing the company's knowledge and on best practices. Knowledge-management tools are therefore essential to competitive success, as a skill-based service company must bring the most appropriate resource to bear on any problem by providing access to the most up-to-date information on everything from product specifications to diagnostic work flows.

Companies that don't understand their intent and competitive advantage can emphasize the wrong performance metrics or make bad decisions about the range of services they offer. If executives think that they are competing in a skill-based business when the real differentiator is scale, for example, they could offer too many service delivery variations that call for expensive expertise while their competitors profit from a limited menu of low-margin options. Exhibit 3 presents the four broad approaches to the delivery of services that result from these differences in strategic intent and in the source of competitive advantage.

Organizational design and performance management

Although a company's strategic intent should determine the organizational structure for an embedded service business, the right performance-management systems and metrics for running it depend equally on the source of competitive advantage.

When a company uses services to enhance a product business, it must consider which elements of the two to unite and which to separate. If the core product and services are best sold as a bundle (as in software or hardware maintenance packages), the company should combine the leadership of the sales and business units and give services a specialized role in the offering's development and fulfillment. If the services have a value distinct from that of the product or demand very different sales skills, a separate leadership for each sales force typically makes more sense, with care taken to create incentives for collaboration between the two.

By contrast, when a company pursues embedded services as an independent growth platform, both a separate business unit and a separate sales force are usually required, since the service business must fully control the targeting of customers and the development, pricing, and delivery of offerings.

Few product businesses can focus sufficiently on services or understand their unique requirements.

But organizational design is only one piece of the service-management puzzle. The most successful embedded service businesses use performance metrics that reflect both their strategic intent and their main source of competitive advantage. If the strategic objective is to defend or enhance a product business, metrics and financial systems should take into account integrated sales, costs, and profits over the life cycle of the customer's interaction with the product and its associated services. When scale is uppermost for services that enhance a product, the key metrics are the rate at which the company sells its product together with a service contract (the "attach rate" for services) and the unit cost of service delivery. In a skill-based product-enhancement business, a product's life cycle sales, costs, and profits matter, but revenue and productivity metrics for frontline service employees should complement them.

Even in the case of an integrated offering, companies should independently measure the forces that drive the costs of developing and manufacturing products and of servicing them. That information yields important insights about the trade-offs between profits from products and from services. Cutting quality-testing costs during product development, for example, may raise service costs down the line, and metrics that focus only on one step in the value chain often result in misguided investments.

Product companies should want to succeed with embedded services: as competitive pressures increasingly commoditize product markets, services will become the main differentiator of value creation in coming years. However, companies will need a clearer understanding of the strategic rules of this new game—and will have to integrate the rules into their operations—to realize the promise of these fast-growing businesses. **Q**

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