
Servitized business models: organizing for success

Increasingly, manufacturers and distributors are seeking to create value beyond their products by building service-based business models. This whitepaper explores this trend and elaborates on the various development stages you need to undergo on such a journey.

See what counts.

Introduction

In the business-to-business (B2B) market, in many cases customer¹ needs are evolving away from traditional concepts of equipment ownership towards a more fluid model, where businesses have 'just-in-time' access to equipment at the moment it's required.

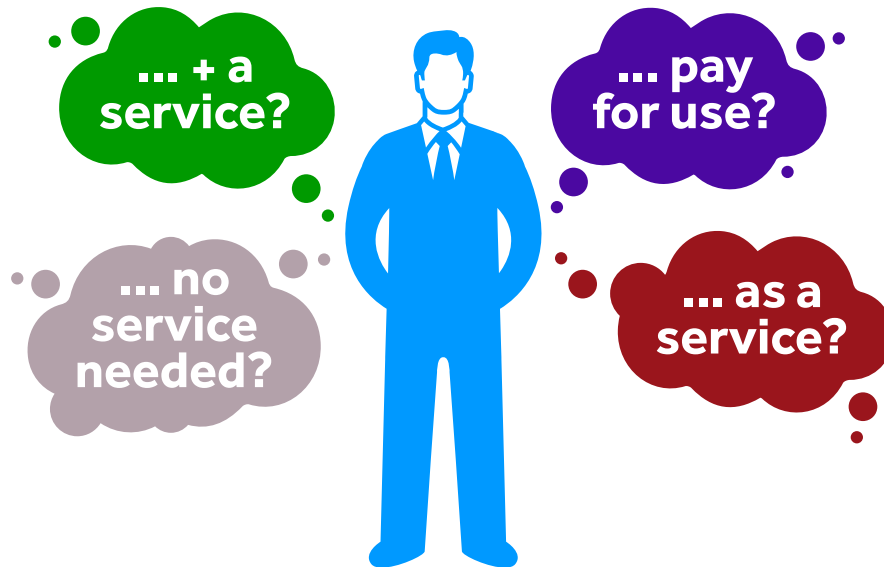


Figure 1: Servitized propositions are numerous

The shift is towards a model that focuses on the benefits of equipment usage without carrying any of the related burdens and responsibilities of ownership. As a result, there is an increase in companies developing usage- and performance-based business models where manufacturers, dealers and resellers move from selling a product to selling a 'comprehensive service' which, in addition to the product itself, also includes a variety of services. This trend is referred to as 'servitization'.

Servitization is neither radical nor new. The term was first introduced in 1988² and has become widely understood to mean the process of creating value by adding services to manufactured products. Its advocates see an increasingly important role for services within a product offering, not least because virtually every product today has a service component to it. These can range from basic services such as installation, maintenance, telemetry and extended warranty through to advanced services such as training, performance guarantees, life cycle and fleet management.

1. In this white paper, customers are also referred to as 'equipment users' and/or 'operators'.
2. Vandermerwe and Rada - Servitization of Business: Adding Value by Adding Services – European Management Journal (1988).
3. Praetimus - Servitization in product companies - Published via Atos Consulting (2011).

Academics and businesses alike are increasingly interested in the 'how' of servitization: how exactly does one go about building a usage- or service-based business model? Because although it sounds straightforward in theory, in practice the numerous offerings available, from simple over-the-counter service products to customized one-off managed service contracts, mean that it can be difficult for a company to know the best option for its circumstances (Fig. 1).

From a supplier perspective servitization is a way of increasing sales revenues. While from a customer perspective, it offers a way to reduce risk, and decrease maintenance costs.

In this paper, we (i) explore the servitization trend, (ii) share lessons learned from companies that have undergone this journey, (iii) look at the Servitization Maturity Model (as introduced by Marks, Ramselaar et al³) and (iv) conclude with a checklist designed to help servitizing companies learn from their forerunners.

Servitization from a customer perspective

Key when one servitizes a business model is to understand how your customer will be using your service offering.

Theory defines three categories of 'servitized offerings' (Fig. 2). The way the customer approaches these propositions differs substantially. And understanding the different mindsets involved is essential when determining the needs and expectations of the end-user.

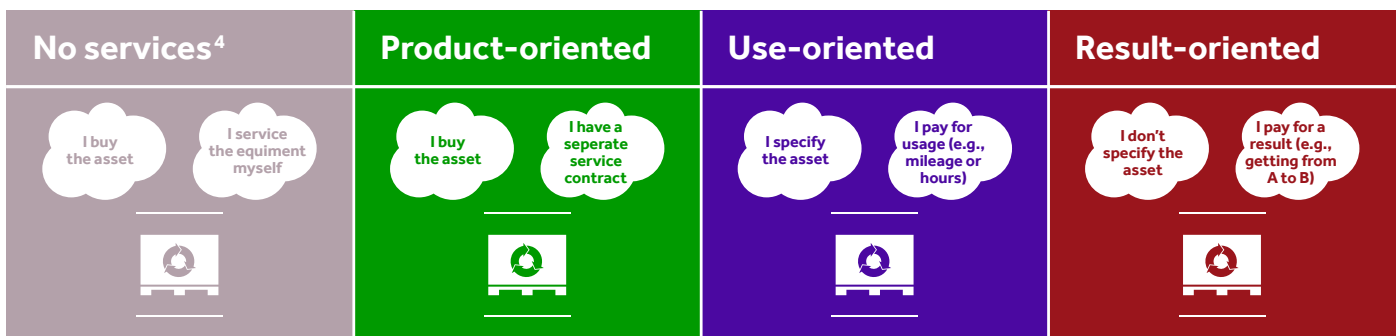


Figure 2: Different customer mindsets

Product-oriented offering

In a product-oriented service offering, the customer buys the equipment with the option to add a (sometimes separate) service package for an additional fee. These services mostly include installation, after-sales, maintenance and/or repurchase agreements. The customer specifies the equipment according to their needs. In most business models, a customer obtains legal and economic ownership of the product, and assumes all risks and rewards. The separate service contract enables manufacturers to gain additional revenue and often increases customer retention.

Use-oriented offering

In a use-oriented offering, the customer uses the equipment for a specific amount of time or 'usage period' (e.g. hours, prints, scans, mileage). A variety of services are included to ensure 'hassle-free' usage. The pricing of the services is bundled together with the product, making it easier for the customer to obtain the product and have predictable costs of usage. In these offerings, the equipment is specified as per the customer's needs. However, in most cases the supplier retains legal and economic ownership of the product. All related risks and rewards are with the lessor or manufacturer.

Result-oriented offering

In a result-oriented offering, the customer is invoiced based on a specific result or output. In addition to the tangible services mentioned above, more intangible services such as consultancy, performance guarantees and life cycle management are included. These offerings are commonly referred to as 'Full Service Solutions' or 'Managed Services'.

Suppliers combine products and services into a seamless offering that addresses a specific customer requirement that they are willing to outsource. The main difference with a use-oriented agreement is that the product and configuration are not specified by the customer. The supplier retains legal and economic ownership, as well as all product- and service-related performance risks and rewards.

Every product-service system has its pros and cons. Depending on the requirements of the customer, and their willingness to outsource specific activities, a particular product-service combination can be more or less relevant.

4. A supplier is by law required to deliver warranty at the minimum.

Drivers towards Servitization

There could be a wide variety of drivers leading a company to servitize its business model. Here we explore four of the most common reasons.

1. Satisfying customer needs

In doing business, it is customary that the highest value comes from satisfying customer needs. Yet, before suppliers can deliver on customer needs, it is essential to understand them.

As servitization requires a shift in the business model from transaction- to relationship-based, there is ample opportunity to grow the understanding of true, i.e. operational and financial, customer needs. Moreover servitization, especially in more mature stages, helps to align supplier and customer interests via new business models: e.g. via performance-based or output-based contracts.

Thus, servitization matches the ongoing trend to outsource services – move from CAPEX to OPEX and make costs variable, make use of the economy-of-scale of the supplier and to focus on the own core business, – with the need for more value adding services.

2. Enhancing a firm's performance

In spite of all the difficulties related to cost and profit allocation in service-based business models, it is widely accepted that the margins on service in many industries are larger than those for the stand-alone product sale (Fig. 3). This is further corroborated by studies of Oliver Wyman⁵ (2004) and Roland Berger Consulting⁶ (2009).

The financial drivers lie in the ability to sell products at a higher profit margin when the total cost of usage/service is competitive. It can help a company increase its turnover without creating a direct need to sell more assets. Statistical analysis reveals that the market size of services for many industrial products during the total lifetime of the product can be up to 5 to (sometimes) over 20 times higher than that of the initial product sale. In addition, also the EBIT margin on services is 3 to 7 times higher⁷.

Over the long term, this enables manufacturers and dealers to shift from a volatile transactional-based business model towards a fee-based, contracted services one. Thereby increasing the stability and predictability of their revenue streams.



5. Oliver Wyman – The profit zone is downstream in equipment (2004).
6. Roland Berger – Downturn in production systems (2009).
7. Wise and Baumgartner, (1999); Ren and Gregory, (2007).

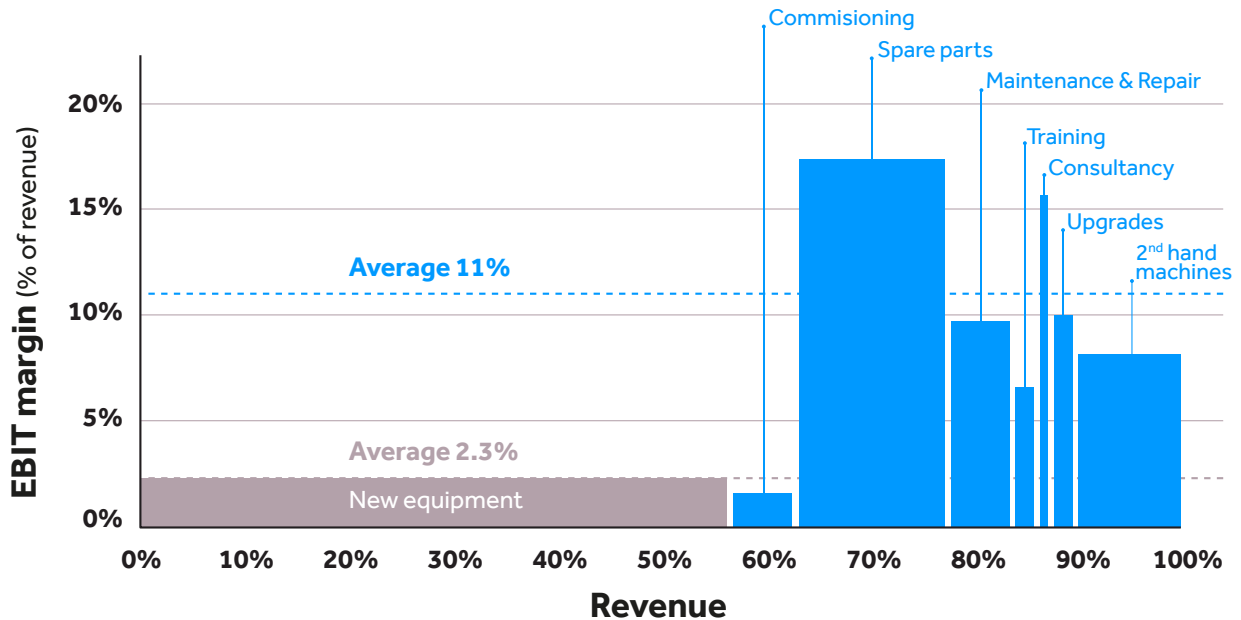


Figure 3: Margins on service-based propositions⁸

3. Achieving competitive advantage

Servitization can help firms gain competitive advantage in a mature marketplace. When products commoditize, margins on equipment sales deteriorate, leading many manufacturers to seek business models that will allow them to move away from price competition.

For them, the development of services and solutions is a lifeline, and a basis for growth⁹. However, a company would need an extensive and mature network to deliver on the service commitment, something that cannot easily be emulated.

Servitization enables companies to provide a one-stop shop and showcase the operational value of their products by selling:

- Total Cost of Ownership.
- Total Cost of Usage (Costs of ownership incl. hardware related service and maintenance).
- Total Cost of Service (Costs of usage incl. fleet management disposables and operating services).

This way of promoting and selling assets lowers adoption hurdles for customers to obtain more expensive equipment in mature industries.

4. Technology

In all industries, there is an ongoing trend where software is replacing hardware. Meaning that hardware is becoming more compact and less complex and ultimately replaced by software.

The greater connectivity of equipment to existing computers and sensors, in combination with the Internet of Things¹⁰, is enabling companies to provide real-time, information-based services that in the past would not have been economically viable or technologically feasible. As such technology has the potential to greatly enrich the perceived value for the end-customer, and in many industries enabling only-pay-for-what-you-need-or-use business models.

8. Praetimus (2011) – Based on Oliver Wyman (2004) and Roland Berger (2009).

9. Slepniov, Waehrens and Johansen (2010).

10. More information: DLL bluepaper “Tapping into the potential of the Internet of Things” (April 2017)

How to servitize an organization?

Next to a business model innovation process, servitization is also a transformation journey. Companies need to develop the required capabilities to deliver services and solutions that can supplement their traditional product offering. In this paper we are focusing on the the 'Design' and 'Validate' phase of the journey.



Figure 4: The DLL product development process

The adoption of a servitization strategy brings with it significant cultural and corporate challenges. As they servitize, companies are confronted with a new set of dynamics in their relationship with their customers. Research by several universities¹² reveals that, in order to be successful, an organization must not only adapt its proposition from product-centric to a product-service system, it also needs to redesign its organization.

During interviews with executives, service managers and innovation leaders from various companies active in different industries around the globe, both DLL and Praetimus learned that nearly all of them struggle to harvest the benefits that they envision from their own servitization journeys and how to organize servitization within their organization.

They attribute this to organizational misalignment with their commercial business models. There are huge differences between a traditional manufacturing firm that develops, sell, manufactures and (reactively) supports its installed base products and a firm that operates their equipment and sells performance.

The latter has to develop new customer facing processes, has a different customer relation, needs a different (more customer centric) culture, needs to understand that maintenance no longer is a source for income but a cost that needs to be limited, uses more and different information generated by the systems in the field, and so on. Such a process can be visualized in the stages of a typical product development funnel (Fig. 4).

11. More information: DLL whitepaper "Professionalizing service contracts to minimize dispute risk" (November 2017)

12. Slepniov, Waehrens and Johansen (2010) and Baines et al. (2009).

Servitization from a supplier perspective

An integrated servitization maturity model, which integrates business model and organizational elements, would be of significant value to practitioners that want to successfully implement new servitized propositions.

For this reason, we use the Praetimus' Servitization Maturity Model (Fig. 5). The basic thinking behind this model is that the switch from product-centric to a product-service system can't be accomplished in one go, as any transformation requires orchestrated change on multiple domains:

- Developing new service propositions
- Defining new KPIs
- Adapting management & organization
- Redesigning processes
- Adapting your business culture
- Re-aligning IT

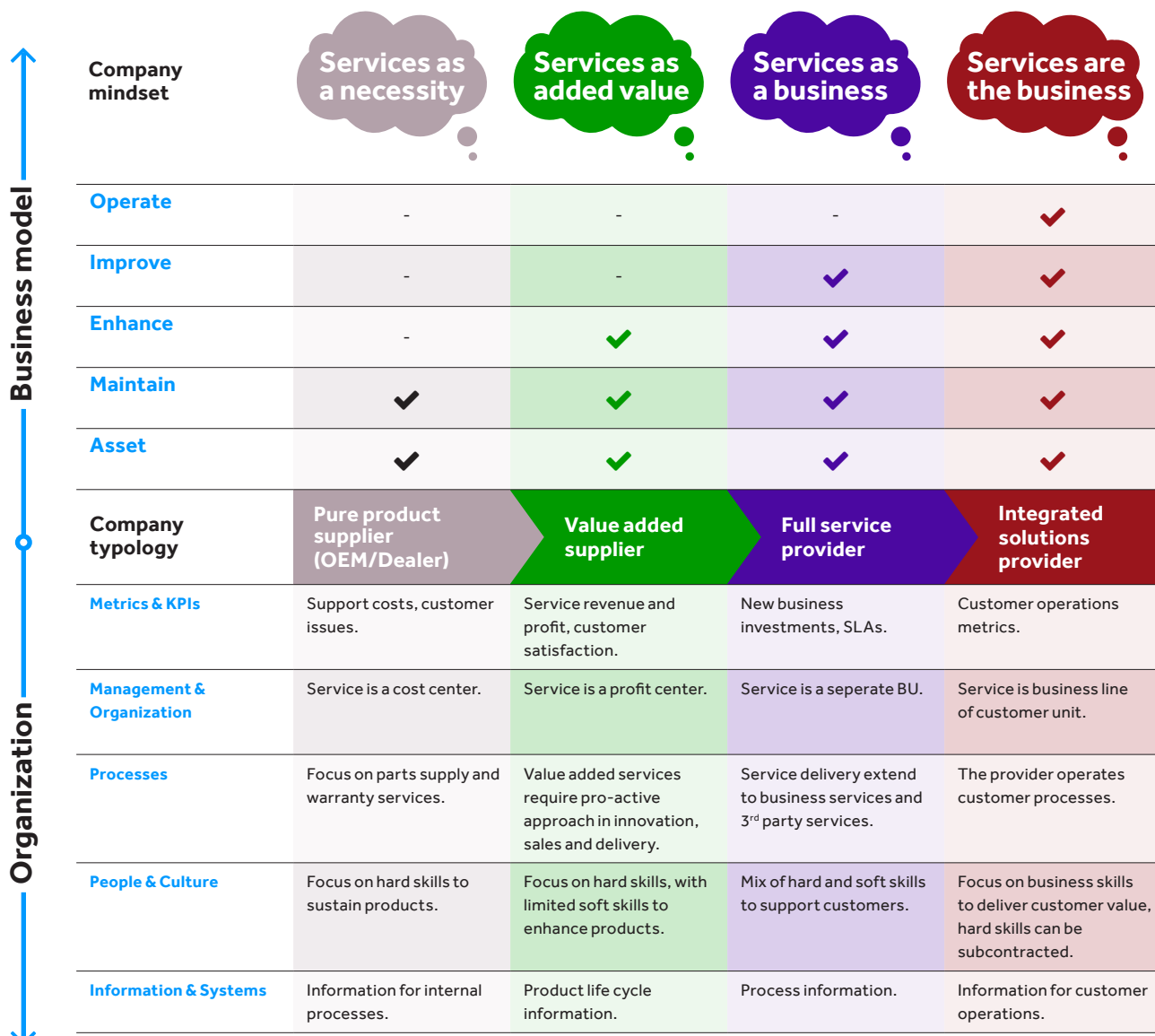


Figure 5: The Praetimus Servitization Maturity Model

Servitization: **the good, the bad and the ugly**

The 'good' consists of the added value of offering services for customers and the resulting revenue and profit potential for equipment suppliers. The 'bad' consists of the organizational change that is required and which can be managed via the maturity model as described in chapter 4. Unfortunately, there is also the 'ugly', the servitization paradox. There is early evidence¹³ that servitization – if not managed structurally – generates business risks.

Economies of scale

"A statistical analysis of over 10,000 companies in 25 countries shows that while the share of product companies that has been servitized is larger than traditional manufacturing firms in terms of sales revenues, at the aggregate level they also 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."¹⁴

Service relatedness¹⁵

Service relatedness indicates the extent to which a manufacturer's service business links to its core product business. In certain service extensions, such as integrated solutions that bundle services around a product (e.g., maintenance of aircraft engines), product and service offerings are related operationally to each other, and the knowledge requirements overlap. In contrast, other service extensions have little overlap or commonality between the product and service offering, such as manufacturing high-tech electronic components and offering financial services.

When the service offering is more closely related to a firm's core manufacturing business, the knowledge developed and resources used in manufacturing can be more easily leveraged to the service area, which results in greater knowledge and resource spillover.

For example, an engine manufacturer can leverage its knowledge in engineering and manufacturing when its service extension is engine maintenance rather than financial services.

The customers' perceptions of "product fit," or the extent to which customers perceive the product and service offerings as compatible or complementary, can also play a significant role in how they respond to the product and service bundle, their attitude toward the supplier, and eventually their level of firm loyalty. Therefore, when customers perceive a higher level of relatedness between a firm's product and service offerings, they sense lower evaluation and performance risks and display higher loyalty towards the seller.

Finally, when services are related to the firm's core product business, there is less danger of a loss of strategic focus. Because service-focused tasks relate better to ongoing product-focused tasks, fewer incremental or dedicated resources are required.

13. University of Cambridge (Benedittini, Neely & Swink) – *Why do servitized firms fail?* (2015).

14. University of Cambridge (Neely & Benedittini) – *The challenges of successful servitization* (2010).

15. Journal of Marketing – *Effect of service transition strategies on firm value* (2008).



To conclude:

While servitization is an attractive option for product companies, it also raises significant challenges or - when not addressed adequately - severe risks. The following pitfalls when servitizing, are further elaborated upon.

A company can fail to bring the proposition to market, despite investing time and effort due to:

- Targeting a customer base which is unwilling to buy the services offered.
- Insufficient knowledge of what such customer really wants (e.g. services fail to have a distinctive added value).
- No (financial) service risks are taken away from the customer.
- Servitization driven primarily at an operational level from the service department (rather than strategically at a business level).
- The fact they are not being part of a services network (service-based business models often involve services that are provided by partners and external parties).
- The company being too late in servitizing. Crucial services are already supplied / dominated by Independent service suppliers or competition.
- Competition from outside the usual domain (e.g. independent rental companies, their own suppliers, distributors and maybe key customers).

A company fails to make money when selling servitized solutions due to:

- Selling a service proposition before the organization is ready to deliver it in an economical way.
- Not selling a standardized package, which results in additional costs of complexity.
- With the focus on winning a crucial equipment deal, responding to a customer request/demand (e.g. via tendering), which a vendor then provides without really having a proper service organization.
- Servitized solutions are priced opportunistically, with too much (financial) risk taken.
- Services are delivered (free of charge) by a sales organization, by overemphasizing the "strategic importance of the relationship" with a customer.
- A focus is on "selling at a margin" the equipment, without securing enough margin in the services offering.
- Insufficient engagement in the sales process of non-sales disciplines (e.g. Marketing, Services and Finance).

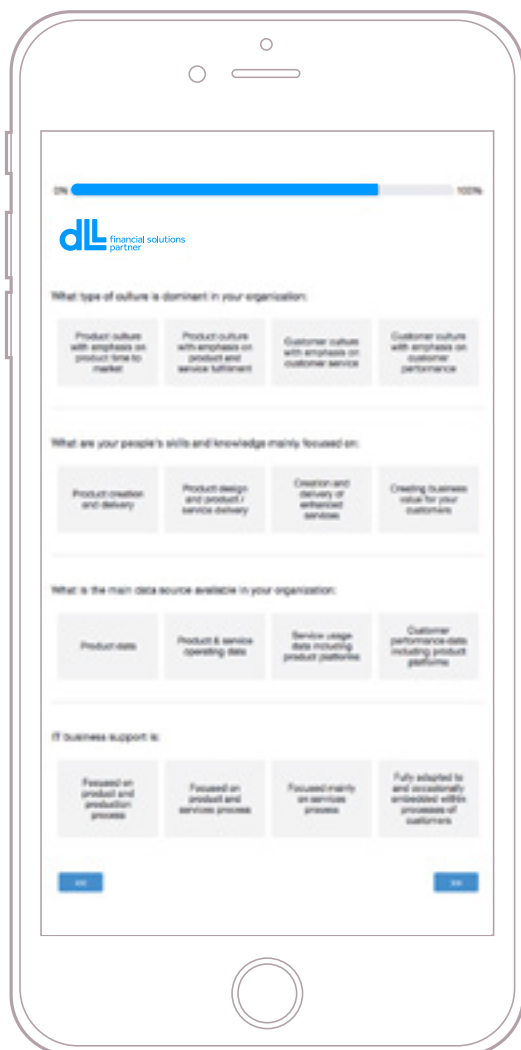
Carrying out a self-assessment

Both DLL and Praetimus believe that being aware of any upcoming challenges at an early stage, is the key to success. Any company, stepping into the servitization journey, should be particularly aware of any gaps between the envisioned business model and current organizational capabilities.

To help companies identify where exactly these gaps lie, DLL and Praetimus have developed a Servitization self-assessment tool designed to provide servitizing organizations with a set of questions that generate a clear insight into the different maturity levels for each of the organizational areas defined earlier.

Access to this tool and its output can be requested via your Praetimus or DLL contact person.

Input Servitization self-assessment tool



Output Servitization self-assessment tool

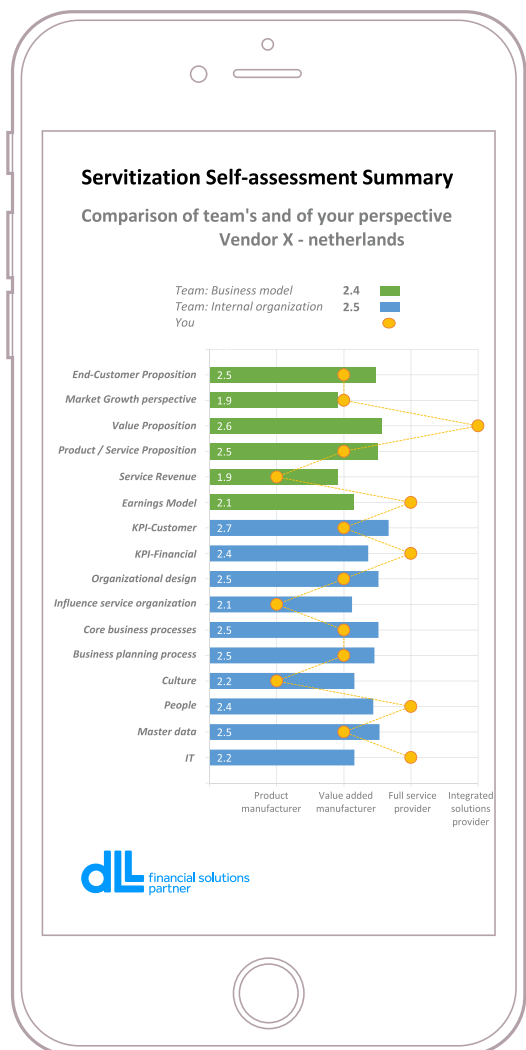


Figure 6: An example of the dashboard showing the output of the Servitization self-assessment tool

Checklist when Servitizing



Strategy

- Develop a service ambition, vision and mindset.
- On-board all stakeholders internally and externally (customers and suppliers).
- Translate this ambition into a business model.
- Align your service strategy versus your current product sales strategy.



Customer focused propositions

- Develop a service offering based on customer needs (pain relievers and gain creators).
- Create clear and standardized service propositions.
- Breakdown your overall service proposition into separate service elements.
- Live your end-customer's journey.
- Maintain a close feedback loop with early-adopter customers and then implement the lessons learnt.



Build the relevant skillset

- Conduct a self-assessment across your organization.
- Benchmark your service skills against your current (new) sales proposition.
- Determine your gaps and define organizational gap-closing plans and the required skillset.
- Develop an organizational change plan to develop the required skills set.
- Define effective metrics to measure the success of your servitized business model.

Closing note

About DLL

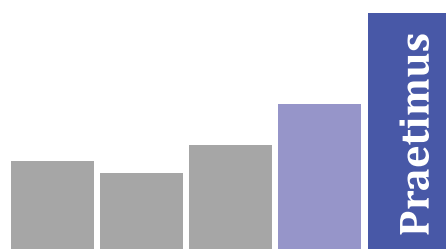
DLL is a global vendor finance company with more than EUR 30 billion in assets. Founded in 1969 and headquartered in Eindhoven, The Netherlands, we provide asset-based financial solutions in the Agriculture, Food, Healthcare, Clean technology, Construction, Transportation, Industrial and Office technology industries. We partner with equipment manufacturers, dealers and distributors in more than 30 countries to support their distribution channels and help grow their businesses. We combine customer focus with deep industry knowledge to deliver sustainable solutions for the complete asset life cycle, including retail finance, commercial finance and used equipment finance. DLL is a wholly owned subsidiary of Rabobank Group.

DLL's servitization solutions include repair, maintenance and many other services provided by our manufacturer partners. This enables manufacturers, dealers, end users and DLL themselves to extract more value out of an asset's specifications. End-customers are supplied with value-added services that enable them to outsource those activities that are less core to their business, or too complex to manage individually.

At DLL, we are passionate about finding original, integrated solutions that help resolve real-world challenges. We are constantly thinking about how we can collaborate with our partners to rethink how we use our assets to get the most out of them together.

About Praetimus

Praetimus is a partner-owned consulting firm serving customers in the manufacturing, trade and service industries. Our partners all have 25+ years of relevant experience: in leadership positions in industrial companies and as consultants advising company Boards. Praetimus is Latin for 'we will create value'. The company specializes in (i) business model innovation, (ii) servitization and (iii) optimizing commercial, manufacturing, logistics and service operations. Praetimus supports customers throughout the entire servitization journey: strategy, road mapping and execution. In addition, we create management awareness and develop employee competences via a suite of servitization master classes. At Praetimus we are passionate about value and committed to results.



The Value Engineers

Whitepaper range

This is just one of a series of whitepapers that DLL has released. The others can be found at the DLL Group company website.

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