

think:act CONTENT

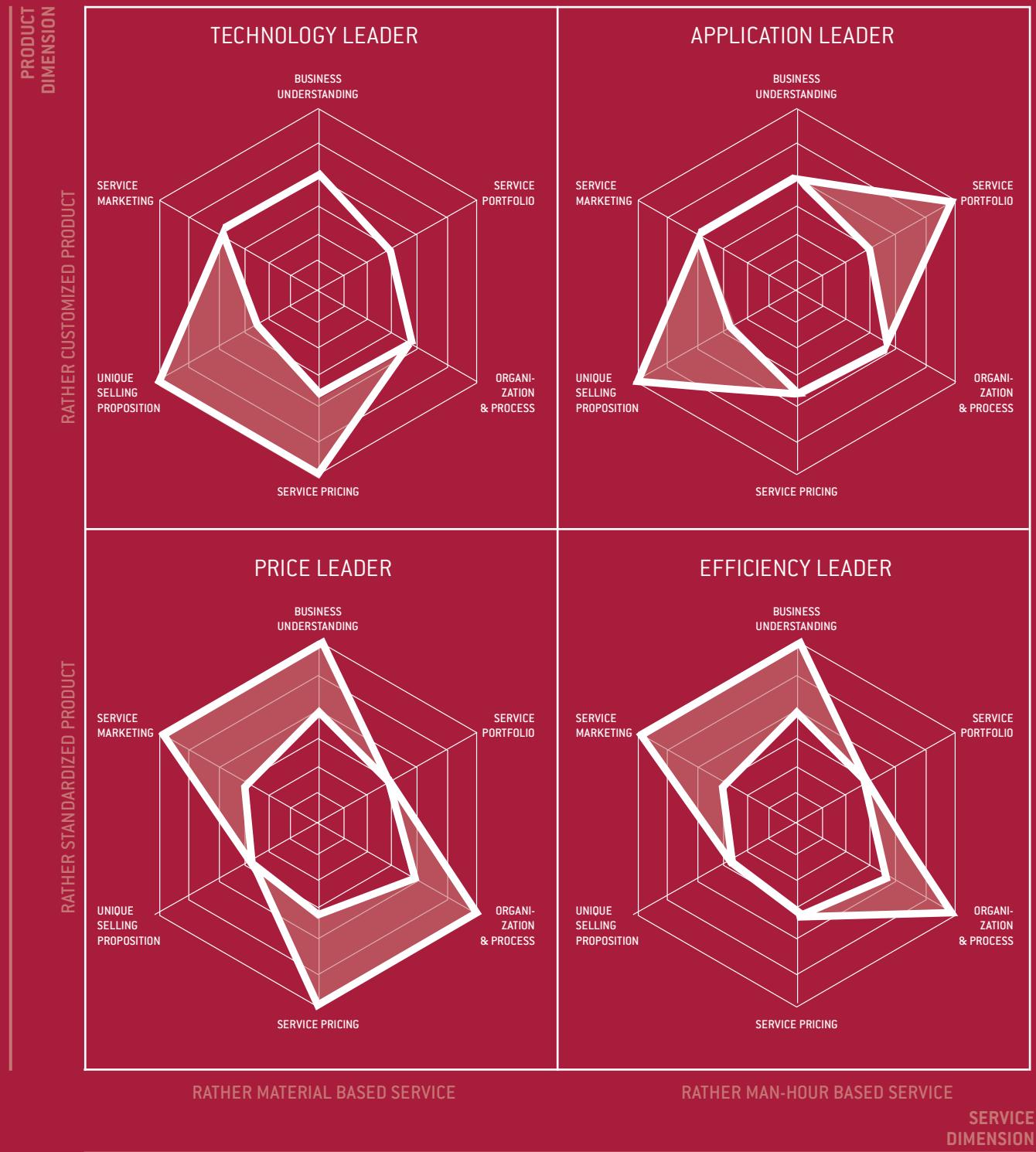
Fresh thinking for decision makers

Evolution of service |

The engineered products industry depends on the service business | But traditional pillars of the business are gradually crumbling | How can firms capture the value pockets that still remain?

ROLAND BERGER HAS IDENTIFIED FOUR DIFFERENT TYPES OF STRATEGIC SERVICE PROFILES

These four models serve as a basis for examining the dynamics of the service business for different companies and identifying the correct strategic focus for developing their service business



CAPTURING VALUE POCKETS IN THE SERVICE BUSINESS

It's no secret that services represent a large chunk of profits for the engineered products industry. As markets become increasingly saturated, services offer new revenues and a chance to leverage the installed base. Not only that, the service business can help smooth out the ups and downs of economic cycles, at the same time as binding customers into a close relationship with the supplier. But spare parts – which along with maintenance traditionally form the main pillars of the service business – are declining in both revenue and profit terms. This places companies in a dilemma: How can they compensate for their shrinking business? What should they be doing to exploit the upside potential that still exists? How can they develop more sophisticated offers, including services such as consulting and performance increase, say? And in terms of organization, should they structure their service business as a separate business unit or integrate it into the new machine business?

To find answers to these pressing questions, Roland Berger carried out an extensive study of services in the machinery and production systems industry in German-speaking countries. We spoke to senior executives at 30 companies, both big and small, to find out what they were doing and where they felt services were heading. On the basis of our discussions, we identified four types of companies, each employing a distinct business model in the area of services. For each type of company we developed key strategies – strategies that can help them prepare for the challenges of the future.

AT LEAST 30% OF REVENUES

The importance of the service business in the machinery and production systems industry has grown rapidly in recent years. As customers go global, they are placing increasingly rigorous demands on production efficiency. Services are key to meeting these demands. As a result, the service business now makes a major contribution to OEMs' sales and profits.

Our survey of 30 companies in the machinery and production systems industry in Germany, Austria and Switzerland revealed a clear correlation between service revenue and EBIT margins at a company level. Firms where services accounted for more than 30% of revenues enjoyed particularly high EBIT margins of well over 10%. This was true for both big and small companies. Yet many companies still fall below the magic 30% figure. By failing to focus sufficiently on services, they are squandering some of their potential to raise profits. Indeed, almost 40% of the companies that we spoke to said that they had not yet reached their envisaged share of revenue for services – and were planning to do something about it in the near future.

A FUTURE-PROOF SERVICE PORTFOLIO

At the same time, the nature of the service portfolio is changing for many companies. Spare parts and maintenance traditionally formed the main pillars of the service business in the machinery industry, the cornerstone upon which the business was built. When it came to replacing a broken part, the OEM was the obvious first port of call for customers. That is no longer the case. Increasing standardization means that customers are just as likely to look elsewhere for replacement parts, sourcing them themselves or turning to third parties.

SERVICE HAS SIGNIFICANT IMPACT ON A COMPANY'S OVERALL PROFITABILITY

Profit contribution by service; companies per category in %

65%
ABOVE COMPANY PROFIT

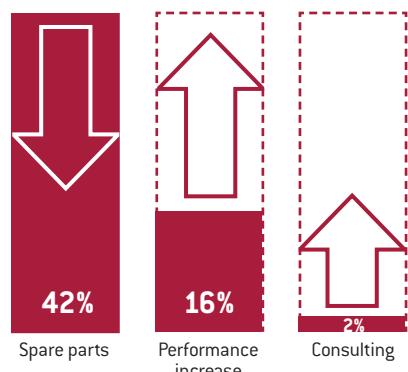
20%
EQUAL COMPANY PROFIT

15%
BELOW COMPANY PROFIT

Source: Service study Roland Berger 2013

SPARE PARTS STILL CONTRIBUTE THE MOST TO REVENUES BUT MARGINS ARE UNDER PRESSURE

Performance increase and consulting offer more potential



Source: Service study Roland Berger 2013

These new players come in two types. On the one hand, we see suppliers entering OEMs' traditional territory and providing machine owners directly with spare parts. On the other, we have companies offering copies of unpatented spare parts and occasionally pirated versions of patented parts. Both types of supplier are skimming the market and rapidly pushing down OEMs' margins. The key question facing companies in the machinery industry today is thus: How can I make my service portfolio future-proof? Which pockets of value remain, and what should I be doing to capture them? This was one of the main things we set out to discover in our survey.

Our conclusion? Today's machinery companies generally already offer a broad portfolio of services. While spare parts and maintenance make up over 65% of revenues, the firms we spoke to are not expecting to see revenue growth in this area. Much more promising areas exist, such as performance increase (upgrades, updates, performance audits) and consulting services (technical assessment, due diligence, dimensioning, factory planning, etc.). Right now these are smaller parts of the service portfolio – "nice to haves" rather than "must haves". Yet both areas are expected to show an upward trend in the coming years. With effective pricing models, they can deliver significant earnings: directly in the case of performance increase, and more often indirectly in the case of consulting services as a driver for sales of new machines. Other areas, such as operation, installation and training, are less significant in terms of revenues but are expected to remain stable in the period to 2017.

Of course, areas such as performance increase and consulting present challenges of their own. Both require a high degree of customer knowledge and understanding, plus expertise in specific applications and manufacturing processes. But there are great benefits to be reaped – not just in terms of burgeoning revenues but also in the strengthening of the customer relationship. Our survey revealed that, more often than not, companies' service portfolios have been fashioned historically in reaction to the specific needs of customers. To take their service portfolios to the next level, companies must now become proactive rather than reactive. "Active portfolio management" is the buzzword here. Companies that pick up and run with this concept are quick to spot new areas where they can expand their relationship with clients and maximize their service revenues.

LEVERAGING THE INSTALLED BASE

Servicing the installed base is an area of major – and growing – importance for companies. When it comes to servicing their own machines, OEMs are at a distinct advantage: They already have access to the client and they possess the necessary expertise, giving them a natural edge over their competitors.

In many cases, however, companies are failing to exploit this potential to the full. Frequently, they lack transparency about the installed base – transparency that is essential if they hope to increase their penetration. In some cases, they even lack transparency about who their clients are, for example where machines have been sold on by distributors rather than directly. As production capacity shifts overseas, emerging countries are growing in importance. OEMs must adjust their structures and processes accordingly. Medium-sized, family-owned companies face a particular challenge as they

often lack the necessary resources to build service structures and guarantee top quality and fast reaction times around the globe. Our survey revealed that most companies focus strongly on servicing their installed base, at least in theory. The majority have made a clear strategic decision not to service third-party machines as this requires special expertise and involves a complexity that can be expensive to deal with. Yet even when it comes to their own machines, many companies are underperforming: On average, the firms in our survey serviced just 55% of their installed base. The other 45%? Lost to the competition.

REMOTE MONITORING – THE WAY FORWARD?

For many companies a game-changing solution exists, if they can only find a way to implement it. Remote monitoring – using wireless sensing devices to monitor installed machines – can act as a powerful growth driver. Used properly, it has the potential to form the basis for profitable new business models. At present, machines are generally only connected to wireless sensing devices if the client is expecting problems to occur. Companies have to grant specific permission to allow continuous, active access to their machines. Many are unwilling to do so. The problem does not lie with the technology, which is already advanced enough to allow such solutions – it lies with the clients' reservations and lack of trust.

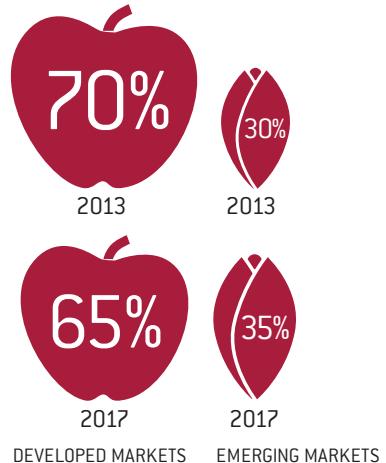
OEMs have their work cut out here. Guaranteeing that confidential data will not fall into the wrong hands is not enough in itself. Clients must also be able to see that allowing their machines to be monitored remotely has some real benefit for them, some added value, such as enabling OEMs to take preventive action or carry out "condition monitoring". For OEMs, gaining remote access to their customers' machine data can be highly advantageous. Ongoing evaluation and analysis of the data gathered in this fashion allows them to improve their products and services. It also creates the basis for new business models – models that have proven highly effective in other industries (see below). The flipside is that new market entrants, given sufficient scale, could also potentially exploit the new technology to enter the field and steal market share from OEMs.

Our survey revealed that over 80% of companies currently receive some form of data from their installed base. Yet much of this information is acquired reactively, when responding to a specific problem at the client's. Systematic, continuous data collection is rare, and feedback is patchy. Respondents recognize remote monitoring as a key opportunity as long as they can answer clients' concerns and guarantee data security. They also see a need to develop their ability to capture the "right" data to allow for effective analysis.

Companies are still working out concrete business models for converting the data gathered through remote monitoring into revenue streams. Here, they can look to other industries for guidance. "Analytics services" are already effectively monetized in industries such as civil aviation, energy and power generation, oil and gas, nuclear and defense. Often, companies specializing in data management and analysis act as intermediaries between the machine owners and the OEMs – although there is nothing to stop the OEM owning the intermediary, as in the case of Rolls-Royce Group subsidiary OSyS. Such intermediaries collect raw data from the installed equipment. They then transform this data into actionable information, enabling maintenance management, operations optimization,

EMERGING MARKETS ARE GAINING IMPORTANCE

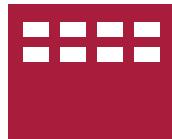
Geographical split of installed base [% of total]



Source: Service study Roland Berger 2013

IN MOST COMPANIES, SERVICE ORGANIZATIONS HAVE BECOME FULLY-FLEDGED BUSINESS UNITS

But is this the way forward?



Service unit

CONTINUE WITH SERVICE AS A SEPARATE BUSINESS



Service unit

AIM FOR REINTEGRATION

compliance with regulations, preventive health management, and so on. Data management solutions like these reduce the cost of ownership and mitigate risk for the client. They also maximize the performance of the client's essential business assets. The data itself can be sold on to the OEM or, after interpreting and evaluating it, back to the machine owner. The range of services offered by intermediaries is broad. They include, for example, producing tailored reports for clients, comparisons of machines or sites, early warning systems, operation scheduling, remote supervision and real-time machine park management. Revenue streams are established through service agreements with clients, selling access to particular datasets, or producing and selling reports. In each case, the basis for ensuring continued access to data – and the ability to monetize it – is building trust and adding real value.

(RE)STRUCTURE YOUR SERVICE ORGANIZATION

Another fundamental question investigated in the survey was how firms should structure their service business. Should it be a separate unit within the company or integrated into the new machine business?

Many companies in the machine industry have already established their service organizations as fully-fledged business units or are well on the way to doing so. On the face of it, separating the service business from the new business function makes eminent sense: It creates transparency, improves management and stimulates entrepreneurship. But it can also lead to friction at the interfaces between production, logistics and R&D, say. Competition over resources can also be an issue. To avoid such friction, a number of things must be guaranteed. Independent service organizations need their own resources in neighboring functions – sharing capacity and technicians with production, for instance. They need special support processes in areas such as logistics to avoid having to compromise on operations. They must be properly integrated into R&D initiatives to ensure access to third-level support. Companies must clarify who exactly is responsible for data management: the service organization or the customer relationship management (CRM) function? Clear allocation of responsibilities is essential when it comes to installation: Should responsibility lie with new business or the service business? Independent service organizations should also be able to set their own service prices, thereby avoiding the tendency for new machine business to "give away" or undersell service.

IDENTIFY YOUR BUSINESS MODEL

Based on the results of the survey, we identified four different types of strategic service profiles, each employing a different business model with regard to services. Each type of profile occupies a different field in a matrix with two dimensions: the product dimension (standardized vs. customized) and the service dimension (material-heavy vs. man-hour heavy):

→ **Technology leaders** benefit from niche product positioning and proprietary design and access. This effectively keeps other players out of their territory. Their products are subject to a high level of material erosion or consumption, creating strong demand for wear parts and consumables

→ **Price leaders** face strong competition, as they have no proprietary design or access. Like technology leaders, their products are subject to a high level of material erosion or frequently require replacement parts, but their standard components can be freely purchased on the market and have less value add

→ **Application leaders** focus on building machines of a "prototype" nature. Servicing them requires experts with specialized know-how in specific application areas

→ **Efficiency leaders**, like price leaders, have no proprietary design or access and so face strong competition. Their services can be bought on the market and have limited value add. However, unlike price leaders, service revenues are based on service hours by technicians who do not require a high degree of specialized know-how

These four models serve as a useful basis for examining the dynamics of the service business for different companies and identifying the correct strategic focus for developing their service business. The key strategic focus for technology leaders should be leveraging their niche position and maximizing their profits by finding optimal price points. It is important that these companies avoid any lack of transparency over internal costs. Price leaders should leverage their strong cost position. However, they need to find ways to escape the "commodity trap" by turning their services into branded products. This will help build customer intimacy and allow them to command a price premium.

The strategic priority for application leaders is to leverage their close relationship with customers through frequent performance increases and upgrades. They should include services relating to sub-components in their product solutions, and follow their customers if they relocate production. At the same time, they must make sure that their application skills are always at the cutting edge.

Finally, efficiency leaders should focus on leveraging their service network and extensive resources in terms of service manpower. These firms need an optimal service footprint and coverage, so as to minimize unproductive time and enable best-in-class reaction times and costs. It is particularly important for efficiency leaders to roll out remote services, improving ease of access to second- or third-level support and ensuring knowledge transfer and high-quality local services.

CONCLUSION

As we have seen, OEMs need to move away from simply selling parts and services toward providing performance and asset management. In a nutshell, they must shift their focus from products to outcomes. Unless they adapt their service portfolios, they risk seeing the installed base taken over by lower-cost third-party service providers, or by competitors who are better than them at generating revenue on the back of data analytics. Smaller OEMs should consider collaborative models that allow them to share costs and resources. Additional value pockets exist in the service business, of that there can be no doubt. It is up to companies of all types to find effective strategies for capturing them, putting themselves in a strong position to face tomorrow's challenges.

THE CORRECT STRATEGIC FOCUS IS DIFFERENT FOR EACH MODEL



TECHNOLOGY
LEADER



APPLICATION
LEADER



PRICE
LEADER



EFFICIENCY
LEADER

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