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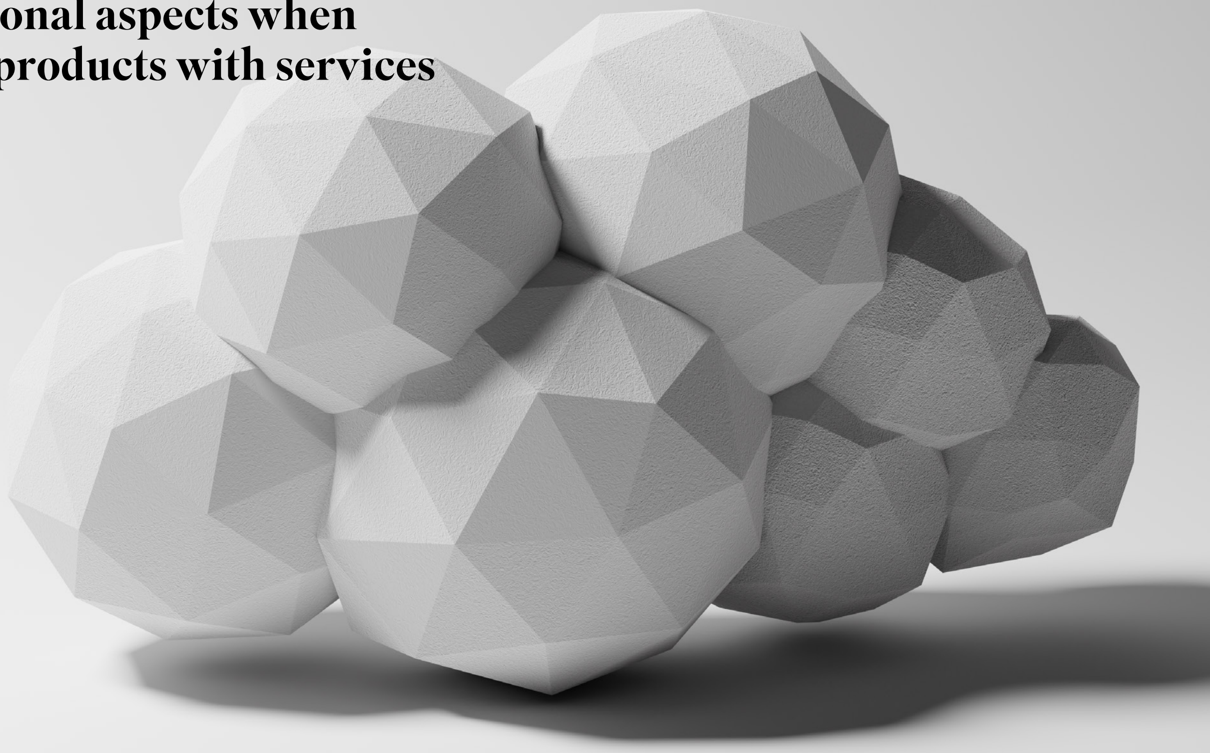
— Management and organizational aspects when replacing products with services



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Servitization – not for all product companies

— Management and organizational aspects when replacing products with services

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A popular trend among product companies is to build competitive advantage by shifting from products to services in the form of performance. However, the Servitization Journey is not easy for a product company. Indeed, there are critical management and organizational challenges to consider. This article highlights some of the challenges and suggests a course of action to overcome them.

One idea behind servitization is that manufacturers offer product performance to customers as a service, rather than selling and supporting traditional products. Performance via services is expected to increase in various industries due to digitalization and the ability to measure and monitor asset usage. The idea of selling performance rather than products is hailed as a smart strategic move, and studies show that those who succeed with it do well - Rolls Royce's "Power-by-the-Hour" and Hilti's "Fleet Management" are considered holy grails for many companies. However, there is little clarity on how a product-based company can make this shift. How does this change affect the managerial and organizational processes in a product company? These were the questions that sparked research interest.

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To better understand the process of transitioning from a product-based business model to a service-based business model, we conducted a research study to examine Ericsson's strategy in shifting from selling telecommunications networks to selling network capacity through performance-based contracts. The case spans a ten-year period in three different geographic markets and consists of many attempts to find a suitable service-based business model.

Major challenges

The research identified three major challenges - the impact on organizational structure, the impact on processes and systems, and the ability to continuously adapt.

As is often the case, the identification of, and the decision to pursue, a service-based business model was the result of a discussion between Ericsson's top management and one of its customers. However, the operational implementation was carried out by managers at different work levels, which led to problems as the restructuring was initially carried out in the local, established organizations that also operated the traditional business model for other customers. It was not possible to develop and integrate the required capabilities within the existing organization. It became clear that creating a separate organization was the only way to properly implement the service-based business model.

The study also shows that existing processes and internal systems were inadequate for the service-based business. There was no support from existing accounting and financial systems in recognizing revenue from the sale of networks as a service. This resulted in unclear revenue recognition between the different business units and uncertainty about the profitability of the business as such.

Finally, the research also shows that the service-based business model was modified over time based on the experience gained during operation, mainly due to unforeseen effects and changing external contextual factors. These results show us that business model development and operation occur simultaneously and that a company aiming for a service-based business model must have the ability to continuously adapt the business model.

The results provide several valuable insights for managers involved in the development of service-based business models. So how should leaders prepare for a new way of doing business, and how should they act while the business is up and running? A recommended approach to prepare for the new business model is a pre-launch evaluation, followed by a post-launch evaluation.

Pre-launch evaluation

The prelaunch evaluation of the changed business models considers three aspects of the transformation. A qualitative assessment of the overall impact on the existing business model, an extended risk assessment, and a financial modeling.

Assess the impact on the existing business model - In the planning phase, it is important to identify the critical areas of redesign by looking at the business model holistically and consider all elements of the business model. Use the Business Model Canvas as a template. Start by evaluating the value proposition and associated revenue streams - does the value proposition meet the customer's goals/needs? Are you capturing a relevant portion of the value with the pricing parameters used? Once the value proposition and revenue streams are defined, the next step is to review the impact on all other elements of the business model. Here it is advisable to involve a cross-functional team to ensure that aspects from different areas of expertise are captured.

Extended risk assessment - The second aspect aims at capturing the dependencies of the business environment on the business model when moving from selling products to selling performance as a service. Risk assessment in the product-based business model focuses on a clearly defined scope of delivery and the risk assessment is based on the fulfillment of this scope. Moving to a service-based business model means that the risk analysis must be expanded. The focus must capture the full interdependencies of the business environment on which the model is built and identify the internal and external factors that influence the new business model. Typical questions that need to be answered are: Who owns the assets in the business model? How much dependence will there be on future market developments? Will there be new definitions for acceptance of solutions? Can the business model provide economies-of-scale benefits? How well does the model align with regulatory and financial requirements? Are there challenges in industrializing the business model or in the need to adapt existing systems and/or develop new systems to support the business?

”The transformation challenges should not be underestimated. To be successful product companies must be well prepared”

Financial Modeling – The purpose of the third aspect is to gain a better understanding of the commercial dynamics and financial consequences of the service-based business model. In product sales models, costs and revenues are closely linked because when a product or service is delivered, costs are incurred, and through terms and conditions we know how much and when payment will be made. In a service-based model, costs and revenues are typically not completely linked. For example, revenue may be tied to the capacity used, while the full cost of the corresponding capabilities and capacity is incurred when delivered to the customer. Therefore, it is advisable to analyze the impact of different market and solution development scenarios over time and understand the sensitivities of the revenue model.

The results of the three assessments in the pre-launch phase highlight the most critical transformational aspects of the service-based model and provide a good foundation for implementing the service-based model. The results will help the company create the initial contract for the service-based business, build a dedicated organization with the additional competencies identified in the assessment above, and establish new processes and support systems for operating and financially tracking the new model.

Post-launch evaluation

Regardless of how well the pre-launch evaluation was conducted, many decisions and activities are still unknown and need to be adjusted. This requires post-launch evaluation activities during the operation of the service-based model. For example, workflows between the provider and the customer must be established, and personnel from both parties must become familiar with how the service-based model works. Over time, external factors such as new technologies and new regulations might affect the service-based business model and require adjustments.

Digitization opens the opportunity for product companies to sell performance as a service and puts it high on the agenda for many product companies. The study shows that the transformation challenges should not be underestimated, as it has a significant impact on the business model. To be successful, product companies must be well prepared, and a structured pre- and post-launch evaluation supports a successful transformation.

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Mats is industry PhD-student at House of Innovation, Stockholm School of Economics and Principal Researcher Business Models at Ericsson Research. Mats' research is about business model innovation in manufacturing companies. Digitalization and servitization offer both opportunities and challenges. Integrating products and services, and thereby delivering added value, leads to increased competitiveness. However, for this to be possible, the company's business model needs to be transformed. How are the company's management, organization and processes affected by this transformation?