

# Products or Services: Should Product Manufacturers Increase Their Investment in Services?



Services are an important way for product companies to boost their profit margins and grow revenue, particularly in a tough economy. Yet many companies are having trouble finding the right balance between products and services. Many others are struggling to overcome their traditional product-centric mindset in order to effectively execute their services strategy.

Here's a look at some of the major issues companies are wrestling with, along with some practical thoughts on ways to tackle the problem.

	Point	Counterpoint
<b>Focus on products</b>  <i>"Continue to focus primarily on products. Invest in services as needed."</i>	It's how you've always made money.	Products used to be the center of the business universe. But not anymore. Like it or not, services are now a permanent part of the business landscape. Companies that ignore this fundamental shift could leave a lot of money on the table.
	Customers see you as a product company, and seem satisfied with that.	Ultimately, customers are looking for solutions that enable them to get things done. Products provide the foundation, but services complete the solution and make it fit the customer's needs. Why not use your strong brand image to help sell services?
	It's comfortable. You know how to do it. Also, you already have the processes and infrastructure to support a product-focused strategy.	Things that worked well in the past can become an anchor that drags you down in the future. Many manufacturers are finding that the infrastructure they spent decades building is now a dead weight that limits their flexibility.
	Most of your revenue and profits come from products, not services.	In some cases, that's true. In other cases, it's a lie perpetrated by inadequate accounting systems or business practices that misallocate costs and revenue. The reality is services tend to be much more profitable than products, and in many cases are the key to making a sale.
	Your gross margins for products are very high, and providing services might dilute them.	Gross margins don't tell the whole story because they don't reflect the high cost of R&D. Services generally have lower development costs than products, so their fully loaded operating margins tend to be higher.
	There are a growing number of situations where products are being replaced by services. Your services might cannibalize some of your products.	If it's possible to replace some of your products with services, you can bet there are other companies looking to do just that. A great way to protect your business from disruptive change is to make it happen yourself.

	Point	Counterpoint
<p><b>Increase the focus on services</b></p> <p><i>“Treat services as equal to products. In some cases, services might even be more important.”</i></p>	Services can be developed faster and cheaper than products, which makes it easier to meet the needs of a rapidly changing market.	That’s only true after your service capabilities are well established. In the beginning, significant time and investment is required to build the necessary organization and infrastructure. You may also need to hire different kinds of workers that will need to be integrated into your culture.
	Services provide a new source of revenue and help drive significant product pull-through. They also tend to deliver higher margins, particularly in sectors where products have become a commodity.	Services are not a magic source of eternally high margins and revenue growth. Sustained success requires constant improvement and innovation.
	Services make products more appealing by enabling complete solutions tailored to the needs of a particular sector or customer.	Developing complete solutions requires a coordinated effort between your product and service groups. You can’t just create a service organization and expect everything to work itself out. Crippling turf battles are all too common — especially for businesses with a long and proud tradition as product companies.
	Services improve customer loyalty. Unlike products, services naturally involve frequent and ongoing contact after the sale, which helps build customer relationships. This is particularly important in a down economy, when many companies close their doors to sales people.	The downside of increased customer contact is the need to deliver excellent service all the time, which is not an easy task. Factories routinely produce a steady stream of identical high-quality products. But service experiences tend to be created on the fly, and are highly dependent on the individuals who deliver them. Consistent excellence requires effective processes, systems, management, and training.
	You already provide basic services such as warranty and call center support. Why not go further?	Lack of experience with broader services can increase your risk and produce unintended consequences.



## My take

**John Namovic**  
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The amount of emphasis your strategy places on services is entirely up to you. However, it’s important to make a conscious decision on the degree of value driven by your services strategy, rather than letting your services strategy evolve ad hoc. Too many businesses miss out on major service value creation opportunities because they still think of themselves as product companies and never stop to consider the larger role that services could play. Sure, companies develop or deploy services here and there — but usually in the context of supporting the product business. More often than not, firm leadership doesn’t develop an explicit services strategy; nor do they establish an operating model and infrastructure that enables their services business to flourish. Here are some things to consider as you contemplate your services strategy:

**Focus on enterprise value.** Ultimately, the decision about services should be based on whatever creates the most value for your enterprise — not on internal politics or resistance to change. Take a close look at changing market trends and customer requirements, and then make an objective decision about the role products and services should play in the current and future business environment.

**Be open to disruption.** Many product companies shy away from services because they are afraid of disrupting the market and cannibalizing their own product sales by equivalent service offers. But, avoiding such problems doesn't make them go away. If services are truly a viable alternative to products, it's only a matter of time before the market will be disrupted. In some instances to protect your business, you may need to take the lead on making the disruption happen. A proactive approach can better position you to challenge existing competitors, stop emerging competitors in their tracks, and dominate in the new environment. Remember, if you don't do it, someone else will.

**Choose the right operating model.** Once you decide on a services strategy, it's important to choose an operating model that fits both products and services. Companies that opt to maintain a product focus might be well served by a model that continues to put services in a supporting role. However, companies that elect to increase their focus on services are likely to adopt a model where services operate as a distinct business with its own P&L, performance metrics, governance, organization, and infrastructure. Some forward-thinking companies are going even further by establishing an adaptive model that focuses on providing ever-changing combinations of products and services to meet specific customer needs, rather than fixed product and service offers.

Focusing more attention and investment on services is a very effective way for a product company to boost its revenue and margins — particularly in sectors where products are becoming a commodity. But simply throwing more time and money at the problem is not enough. Success requires a clear strategy, along with the right operating model and supporting infrastructure recognizing the interplay between products and services.

## A view from the Aerospace & Defense sector

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Performance-based Logistics (PBL) for the service supply chain has quickly become the Defense Department's preferred model for support and sustainment. Unlike the traditional approach of providing maintenance parts and services on a cost-plus pay-as-you-go basis, PBL is a service that guarantees a specific level of performance for a fixed price. Fundamentally, PBL as a service shifts the value proposition of the hardware providers to focus on the actual need of their customers as having higher equipment up-time. This services model shifts risk to the hardware providers while giving them an opportunity to significantly increase their profit margins.

Success in a PBL environment requires new capabilities and a new way of thinking. Companies that don't make a strong and committed effort to improve their PBL capabilities are likely to find themselves falling behind the pack — or locked into bad contracts that might never be profitable.

There are a wide range of effective practices that can help companies make the shift to PBL. However, our experience and research reveals five activities that are particularly critical:

**PBL capability assessment.** PBL requires changes and improvements throughout the business. A capability assessment and diagnostic can help a company objectively evaluate the maturity of its existing capabilities and develop a roadmap for improvement.

**PBL pricing and risk analysis.** Pricing PBL service contracts is much harder than pricing a traditional cost-plus parts contract. It is also much more critical to long-term profitability and success. If the price is too high, the provider will lose the bid. But if the price is too low, the provider will get stuck with an unprofitable contract. Determining the right price requires a sophisticated, risk-based analysis that reflects all of the costs necessary to profitably deliver the specified level of service.

**PBL culture shift.** Changing from a cost-plus, product-oriented culture to a performance-based service culture is often the single biggest obstacle to PBL success. We've found that a behavior-based approach is a very effective way to tackle the problem. This approach centers around "business-critical events" — a small set of activities that have the biggest impact on PBL success. Changing employee behavior around critical events can produce a large and immediate impact on performance. Moreover, it tends to create a ripple effect that helps transform the entire workforce and culture.

**Spare parts network optimization.** With PBL, it's critical to have the right part at the right place at the right time. There are severe penalties for missing performance targets, and every inefficiency eats into margins. To meet their availability objectives, PBL providers need the right tools and capabilities. Also, the same tool should be used to price the contract and manage its execution to more effectively manage risk and improve efficiency.

**PBL contract management and overall portfolio management.** PBL requires an intense focus on financial performance — especially contract profitability and the correlation between execution cost and contract results. This is an area that is still maturing. Companies need a high-level portfolio view that helps executives make strategic decisions, as well as a drill-down view that allows individual teams to manage their detailed budgets. Companies also need data to facilitate various trade-off analyses, such as: should we invest in engineering to make the product more reliable, or should we buy more spares to keep the system available and meet our contract commitments?

Focusing extra attention on these five areas — particularly in the early stages of PBL transformation — can help position a product company for long-term service success.

## A view from the Technology sector

**Eric Openshaw**

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A recent global survey of more than 200 companies by Deloitte and the Economist Intelligence Unit (EIU) on Services strategy showed that online support services and complete customer solutions will become much more important over the next three years. Also, in our discussions with C-suite executives, Software as a Service (SaaS) has become an increasingly frequent topic of discussion — particularly in light of the current downturn.

We believe this shift to services and the maturation of services as a key driver of profitability are not just passing fads but are here to stay. Customers want to avoid large capital expenditures and maximize flexibility. They also want the ability to resolve product issues on their own using online self service. At the same time, more and more companies are looking to collaborate on end-to-end solutions. These market forces will require technology companies to develop new and innovative ways to engage their customers.

**Be willing to unbundle.** Instead of combining products into increasingly complicated offerings, be willing to offer fewer products for less money, and then augment your offerings with related services. Develop service capabilities that address the real issues your customers are facing, and be willing to collaborate with them and others to find the right combination of products and services. Don't ask yourself, "What product is the customer looking to buy?" Ask yourself, "What problem is the customer trying to solve?"

**Use services knowledge to build loyalty.** According to our survey, technology organizations can use services to enhance customer loyalty and strengthen their brand. Provide your services organization with the capabilities and latitude to have broad-based discussions with customers. Capitalize on your intellectual property and company know-how. Let customers resolve their own product problems by giving them access to your services operations' knowledge networks.

**Modify your services.** If your services business is facing tighter margins and slower growth, reevaluate its operating model, and identify characteristics that can drive higher value. Review your service offerings and determine which ones truly differentiate you from the competition. Understand the relationship between products and services, and introduce variable offerings that can be tailored to fit a customer's exact needs.

For more information, please visit: [www.deloitte.com/us/debates/productsorservices](http://www.deloitte.com/us/debates/productsorservices).

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