New research can help product manufacturers effectively shift to service-centric business strategies

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According to research conducted at the University of Washington, manufacturing firms can increase shareholder value by transitioning to services, but there are some important caveats.

"First, company leaders need to recognize that firm value isn't positively affected until the level of service sales reaches a critical mass," said Robert Palmatier, assistant professor of marketing at the University of Washington's Foster School of Business. "And, the effects of service sales are highly contingent on the service chosen and the industry."

In an era of increased product commoditization and global competition, academics and industry experts have both promoted the benefits of shifting from a product-centric to a service-centric business model as a strategy for generating shareholder value. The success of companies such as IBM and General Electric highlights the attractiveness of this strategy. Yet there has been little research to show when and how such strategies work.

"If you look at the current U.S. economy, over 80 percent of all jobs and a similar percentage of our gross national product are based on services rather than products. Go back to the early 1900's and that number was about half of today's levels. But when does shifting to a service strategy really work to increase firm value?" asked Palmatier.

To answer that question, Palmatier and two colleagues evaluated data from 477 publicly traded manufacturing firms during the period from 1990 to 2005. One of the first studies to examine the impact of service transition strategies on firm value, the research provided insights to three questions: do service transition strategies pay off; what level of service intensity is required for transition strategies to be effective; and, which factors enhance the effectiveness of service transition strategies?

According to Palmatier, the question of service intensity may be the most important for managers. "We discovered that building a critical mass in service sales--between 20 and 30 percent-- is the tipping point for positive effect on the firm's value," he said. "Decision makers need to recognize that a limited approach often has negative results."

So what can managers do to reach critical mass? According to the authors, one solution for quick growth is to acquire an existing service business. Another option is to hire experienced outsiders to decrease the number of poorly informed decisions and accelerate the transition process.

The study also shows that firms should stick to what they know when transitioning to services or the shift will have little or no effect on firm value. Without some synergy between the product line and the service offering, product-centric firms often find themselves struggling for sales against more focused, service-only competitors.

Service transition strategies also depend heavily on the characteristics of the firm's core product industry. Adding services to a core product offering is most effective for firms in slow-growth and turbulent industries. But in other conditions, service transition strategies may decrease firm value even at high levels of service sales.

John Deere and Texas Instruments are two firms used to highlight this

point in the study, cases where success was dependent on contextual factors. From 1995 to 2005, John Deere's value increased 76 percent as the company transitioned from 17 to 36 percent service-based sales. During the same period, Texas Instruments' value decreased by 3 percent as it increased services from 14 to 33 percent of sales. Although both firms launched services related to their core business, Texas Instruments' core industry was growing rapidly, whereas John Deere's was shrinking in the face of high levels of industry competition and turbulence. Although both firms made similar progress in shifting to services, the strategy was much more effective for John Deere, which leveraged its brand and loyal customer base; in contrast, the benefits of shifting to services for Texas Instruments could not overcome the loss of strategic focus on its valuable and fast-growing core business.

Published in the September 2008 *Journal of Marketing*, the study was authored by Palmatier and colleagues Eric (Er) Fang of the University of Illinois at Urbana-Champaign and Jan-Benedict E.M. Steenkamp of the University of North Carolina at Chapel Hill.

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