Marketing ROI

Is service transition a silver bullet for B2B firms?

In the B2B sector, expanding from products into services is often seen as a surefire way to improve firm performance—particularly when commoditization drives down prices. Managers want to follow the successful example of former manufacturers like IBM, who transformed themselves into service providers. With pressure to enter services, or expand them, however, comes an even more critical imperative: Understanding how these changes—which require significant resource investments—affect overall performance.

Gaining that insight depends on untangling a number of financial processes. In "Dynamic Effects of Service Transition Strategies on B2B Firm Value," Mehdi Nezami, University of Illinois, Stefan Worm, BI Norwegian Business School, and Robert Palmatier, University of Washington, examine how a firm's service ratio (the percentage of its revenues generated from selling services) affects product sales growth, profitability, and cash flow volatility. The study also explores how those effects are influenced by industry maturity, the scope of a firm's offerings, and turbulence within the industry.

"This is a hot topic for B2B managers," comments Worm. "Yet there was significant uncertainty around how successful services can be as a strategy, with managers reporting divergent results. We wanted to have a clearer picture of whether moving into services works, when it works, and why."

Using a data set from 1997 to 2015 of 237 B2B manufacturers, Worm and his coauthors gathered information from annual reports to determine a firm's service ratio and other financial measures. (Firms represented a range of industries, including chemicals, industrial and commercial machinery, metals, and computer and transportation equipment.)

Their findings show a direct positive effect between services and sales growth, with a higher service ratio resulting in a corresponding boost in product sales. "When firms sell bundles of products and services together, it can make it more difficult for customers to switch

Issue theme

Causality and complexity

The working papers featured in this issue of *Insights* take up the first of MSI's 2016–18 research priorities: "Quantitative models to understand causality, levers, and influence in a complex world."

Today, there are huge opportunities for firms to better-understand the effect and value of their marketing actions—and equally big uncertainties. How can marketers effectively detect the signals in the noise of big data, identify critical paths to purchase, and understand the individual-level effects of new technologies?

New smartphone technologies enable advertisers to capture a richer set of targeting details than ever before. "Anticipating customers' next steps" describes research by Anindya Ghose, Beibei Li, and Siyuan Liu that shows how this fine-grained data can be combined with sophisticated data analytics to improve mobile campaign results. By tracking shoppers' pathways (with their permission), marketers can infer preferences and purchase intentions far more accurately.

As commoditization drives down prices in the B2B sector, expanding from products into services is often seen as a surefire way to improve firm performance—but is it? Our second article describes research by Mehdi Nezami, Stefan Worm, and Robert Palmatier to understand the impact of firms' service investments on product sales growth, profitability, and cash flow volatility. Their findings will help managers justify the necessary investment of resources and manage expectations of when firms will reap the benefits.

As reported in "Optimizing TV ad buy via brand search response," Rex Du, Linli Xu, and Kenneth Wilbur link offline (TV) spending to online (search) outcomes. Their work provides marketers with important causal evidence and new analytic tools to help them optimize their advertising spending.

Our final article describes work by Hannes Datta, George Knox, and Bart Bronnenberg to address the individual-level effects of online streaming. Does it yield a winner-take-all market, or does it level the playing field—the question reverberates for other industries, as streaming becomes a predominant technology for many entertainment and published goods. Managers can take heart: streaming offers benefits to consumers and firms alike.

Full versions of all reports can be downloaded at www.msi.org
—SUSAN KEANE

to another supplier, in addition to differentiating the product from the competition," Worm explains. "A service contract for maintenance and repair also offers opportunities for on-site sales that didn't exist earlier."

The effect of services on profitability, however, varies. Worm notes that expanding into services requires significant investments in staff and training; as a result, it isn't until firms reach a service ratio of 45% (i.e., 45% of revenues deriving from services) that a positive effect on profit is seen. Up until that point, costs outweigh the financial gains due to the investment that services require.

At the payoff stage—when firms derive 45% of revenues from services—overall firm value increased by 26%.

At the 45% service ratio, firms also enjoy reduced cash flow volatility thanks to what Worm describes as the "lock-in effect" of multi-year service contracts, with a recurring, guaranteed cash flow that is unaffected by economic downturns and aggressive competitors.

"From a managerial standpoint, it is important to note that these three mechanisms of product sales, profitability, and cash flow volatility have different effects among themselves, depending on the firm's service ratio," says Worm. For example, at service ratios of 20% and less, a 10% increase in the service ratio changed the firm's value through product sales growth, profitability, and cash flow volatility, by 2%, -18%, and 6%, respectively, resulting in a net effect of -10% on firm value. However, at service ratios between 20% and 45%, benefits begin to be felt, with a 10% increase in the service ratio resulting in changes of 6%, -8%, and 4%, respectively, for a net increase of 2% on firm value. At the payoff stage cited above, those figures increase to 16% and 12% for product sales and profitability, with cash flow volatility (-2%) being the only detriment to an overall firm value increase of 26%.

"Firms that reach a service ratio of 45% or more can reap the benefits of their earlier investments into services," explains Worm. "They can finally capitalize on their newly acquired skills and also enjoy product sales growth."

The study also considers how industry and firm characteristics further determine the strength of these effects. Worm and his coauthors found that when businesses are competing in a mature industry, for example, services can have an even greater positive effect on revenue growth and profit. "When firms offer services alongside commoditizing products, they see a competitive advantage from differentiation," he says. "In a growth industry, however, the effect isn't as strong, and there are options for investment beyond services, such as developing new product features."

Business scope adds complexity

On a firm level, Worm and his coauthors found that an organization's business scope—the number of separate industries that the manufacturing company is selling in—negatively impacts the effect of service ratio on profitability. "We already know there is a strong, significant negative effect on profits when a firm starts expanding into services. Imagine the added layer of complexity involved with a business operating in a large number of product markets. A negative impact on profitability is prolonged and intensified if a company is heavily diversified." Such a company might find it unattractive to expand into services; if it did so, Worm suggests, managers might elect to focus the service transition on isolated segments of product activity in order to avoid prohibitive upfront costs.

A third context variable considered by Worm and his coauthors is industry turbulence—an environment characterized by an unstable economic climate, changing customer needs, and technological change. In this case, findings show that services have an especially beneficial, stabilizing effect on cash flow volatility at all service transition levels. "If you're operating in an industry where technical standards are changing rapidly, new competitors are entering, and revenues are at risk in any single quarter, it's even more attractive to have the lock-in effect of a long-term customer relationship," he says.

In all cases, Worm notes, managers with a clearer understanding of when the presumed "silver bullet" of services makes sense for their firm will be in a better position to justify the necessary investment of resources and manage expectations among investors and supervisory boards of when to see results. "If a manager is facing the need to do something about profits in the short run, it's clear that services are not the right strategy," Worm explains. So services can and do pay off—but managers who appreciate the nuance of when and why they make sense for a firm will most likely see the greatest rewards.

BY JULIA HANNA

From "Dynamic Effects of Service Transition Strategies on B2B Firm Value: Tradeoffs in Sales, Profits, and Cash Flows" by Mehdi Nezami, Stefan Worm, and Robert Palmatier (MSI Report No. 16-108)