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Article

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CASE: Managing Customer Relationship Gaps at SKF

Fredrik Nordin · Danilo Brozovic · Christian Kowalkowski · Mats Vilgon

Mr. Torvik, SKF's Business Development Manager in the Service Division Area Northern Europe, had a difficult problem to resolve. He had to find a way to handle the sudden loss of a large customer relationship in Finland. One of the major customers had decided to discard SKF to a cheaper provider. Since many years back, SKF had been successful by delivering industry-leading, high value products, services and knowledge-engineered solutions to its customers. The new situation made him ponder about whether they would have to rethink their old strategy. The loss of the customer, a large paper mill, meant that a significant portion of SKF's revenues were lost. Mr. Torvik was well aware that there had been a decline in the economy and that many of SKF's customers had been hard hit by this. At the same time, he was convinced that the existing strategy and the focus on value and high-quality solutions was the best for the customers, at least in the long run. He had to think thoroughly about this and if there was any way to regain the customer, preferably without abandoning the strategy that he really believed in.

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Company Background¹

SKF is a leading global supplier of products, solutions, and services within rolling bearings, seals, mechatronics, services, and lubrication systems. Services include technical support, maintenance services, condition monitoring, and customer training. SKF was founded in Gothenburg, Sweden, in 1907 on Sven Wingqvist's patent of the world's first self-aligning ball bearing. At the close of the first year, SKF had 15 employees and produced 2,200 bearings. Even if this was a modest beginning, the groundwork was completed, and in the following year, 45,000 bearings were produced. By 1912, SKF had twelve factories, sales representatives in 100 countries, and 12,000 employees. By 2010, the company had net sales of €6 billion (US\$9 billion) and approximately 40,000 employees worldwide. SKF technology can be found in very diverse applications, ranging from energy wind farms, offshore oil rigs, aircraft flight control systems, steel and paper mills, and high-speed trains to washing machines, cars, trucks, and motorcycles. The SKF business was organized into three divisions: Industrial (industrial original equipment manufacturers, OEMs), Automotive (automotive OEMs), and Service.

Although SKF is the global leader in bearings, it does not want to be perceived as a product-centric manufacturing firm. Instead, the company puts great emphasis on a customer-centric approach aimed at delivering superior customer value through its offerings, which is increasing through services and integrated solutions. Mr. Torvik, who has long been convinced of the potential of services for the company and its customers, says:

“Servitization’ is here to stay. We have seen in many industries how manufacturing companies, proactively or reactively, extend their product offerings with services. This service infusion phenomenon is clearly evident in our business as well. Commoditization and competition from low-cost countries decrease our margins for traditional product sales. However, servitization also provides a key opportunity to leverage our knowledge engineering expertise through services and solutions to work more strategically with our clients, helping them to become more profitable by delivering superior customer value. Thereby, we can strengthen our competitiveness and increase our margins. It is a win-win arrangement.”

The market for services typically counteracts the cyclicity of manufacturing operations. This became evident in the repercussions of the global financial crisis of 2008, which led to a global recession. During these turbulent times, SKF's Service

¹ The information in this case has been obtained from SKF and public sources. It was made possible through the generous co-operation of SKF. The case is intended as a basis for class discussion rather than to illustrate either effective or ineffective handling of management situations. No part of this publication may be copied, stored, transmitted, reproduced or distributed in any form or medium whatsoever without the permission of the copyright owners. All names and some numbers have been disguised to protect anonymity and company information.

Division performed significantly better than the two product divisions, with its operating margin basically unchanged.

SKF puts major emphasis on training its sales personnel on how to sell value for the customer rather than the technical product. As Mrs. Hultsson, a Business Process Developer at SKF responsible for sales processes, explains, selling services is challenging:

“A new kind of salesperson is needed. The ones we have are often too narrow-minded and product oriented. In particular, the sales representatives at our resellers are typically very reactive. We are trying to educate them, but it is not easy.”

To drive the transition towards services, SKF has developed several success stories of value selling and examples of failure with traditional technical selling to get the attention of the sales personnel. During the internal sales training, Mrs. Hultsson may show a real-world case in which the salesperson lost the business based on price despite executing correct technical selling. Furthermore, SKF’s “area value champions” spend a week with individual salespeople, conducting joint sales calls and customer visits, and building personal relationships. Together, the two will use SKF’s Documented Solutions Program (DSP), which is web-based software that calculates the expected value of a solution. The DSP allows the customer, sitting down with his/her SKF account manager, to see how SKF’s offerings—bearings and units, lubrication systems, linear motion and actuation systems, power transmissions, and services—can deliver value. The customer can quantify the value by using SKF offerings, calculating return on investment, cash flow break-even analysis, expected and actual rate of return, net present value, among others. Furthermore, as part of the partner relationship with SKF, the customer has access to the software and can view cost reductions in over 250 areas, including energy, inventory, warranty costs, manpower, machine life, reliability, and quality.

The company is working systematically to understand and communicate the value of their offerings to customers. Since the company has made a systematic and methodical effort to document the actual savings and increased productivity from over 19,000 cases worldwide, it has become knowledgeable about how its offerings deliver superior value to customers and how the value delivered varies across different customer segments. This means that SKF has a core capability in its ability to accurately predict customer value through DSP thanks to its large customer case database. SKF leverages the knowledge it gains from its DSP tool to bundle different value attributes to each customer segment (or large customer) and offer customized solutions and contractual innovations. Furthermore, SKF offers various performance-based contracts, which may be arranged as risk-sharing, gain-sharing agreements for which the company is paid for documented results in meeting mutually defined key performance indexes.

“The market power is indeed in the services”, thought Mr. Torvik, flying home from Finland after a promising meeting with Empower, a young and vigorous company that described itself as a multinational service group delivering construction, maintenance,

and professional services within energy, telecom, and industry sectors. He was thinking of initiating a sort of cooperation with Empower in the Finnish market, characterized by heavy outsourcing². He liked the company's slogan, sustainable agility, which is precisely in line with SKF's philosophy of long-term benefits for clients and flexible modular solutions. He was satisfied with the meeting. But now it was time to continue working on other solutions. Mr. Torvik was constantly thinking of improvements within SKF's Solution Factory³, but he had to switch off his laptop because the flight captain started the landing procedure. Finland was only an hour away by plane, but in market terms, it was a completely different world.

Management concerns

Mr. Torvik's next workday started busy as usual. As a business development manager, he was answering emails and telephone calls from the early morning. However, the email he read that morning had made him worried; Mr. Arinen, the Managing Director of SKF in Finland, asked Mr. Torvik to call him the very moment he reached the office and started his computer. The email was rather short, but Mr. Torvik thought he knew what it was about. Something was wrong in their Finnish market.

He remembered the long conversations he and Mr. Arinen had had regarding the changing situation in Finland. The Finnish subsidiary of SKF has approximately 150 employees. Its customers are primarily from the process industry, such as paper and pulp companies, and OEMs. The 2009 turnover was €30 million. Although the situation on the Finnish market has been relatively stable over the years, more recently, it has become more turbulent. In fact, gross domestic product (GDP) plunged by a staggering 7.5 percent in 2009. While SKF's customers were generally highly reliant on export markets, these proved little comfort as most other markets were contracting too.

Mr. Torvik arrived at the main SKF office, an imposing brick building from the mid-sixties located closely to the center of Gothenburg. He had not stopped thinking about the email he had received from Mr. Arinen during the trip. SKF's Finnish market had for some time been characterized by stability although the general trend in Finland had been the heavy level of outsourcing. Industrial companies were increasingly transferring activities, such as production, operation, and maintenance, to specialized actors providing acceptable solutions at a lower cost. SKF had managed to build up a solid customer base and successfully competed with its philosophy of delivering superior customer value and long-term productivity improvements as opposed to mere products and services of low cost, but the situation was changing. The financial crisis had struck hard against many client firms in Finland. The long-term values of SKF had no meaning unless the short-term savings could keep the clients floating. The short-term survival preceded the long-term benefits.

² http://www.economist.com/node/13059821?story_id=13059821

³ <http://www.skf.com/group/knowledge-centre/media-library>

“Hello, Antti, it’s me,” said Mr. Torvik.

“Tomas, we have a problem,” said Mr. Arinen without greeting his colleague. He then explained that the problem was that its largest Finnish client in the pulp and paper segment had decided to outsource all its service activities and service employees to a provider of a broad range of inexpensive services⁴⁵. The outsourcing agreement was of a fixed-price type and would last for 3 years, and the contract was as good as signed. Throughout the world, SKF’s bearings were integral parts of the machines used for producing paper, and the company had been working with different kinds of services and solutions for the pulp and paper industry almost since its founding. The new outsourcing agreement meant that SKF had just lost a significant share of its Finnish market within the segment as an indirect result of the crisis.

“Antti, it is crucial that we meet with the client and explain to him the benefits of SKF’s solutions,” said Mr. Torvik.

“Tomas,” replied his Finnish colleague, “we have tried the method you are suggesting. The client is fully aware of the advantages that our products and accompanying solutions bring in the long-term, but as they have already said, there is no long-term if they do not survive the short-term. The crisis has struck pretty hard.”

“But,” said Mr. Arinen, “I am sending you an Excel worksheet⁶ with an idea we have come up with.”

Mr. Torvik opened the sheet, which represented for him very well-known calculations based on the DSP, Documented Solutions Program. SKF Finland’s sales personnel had been using the calculations when dealing with their major customers, to illustrate how much they would save in the long-term in comparison with the inexpensive—in the short-term—competition.

“Where’s the catch?” asked Mr. Torvik.

“Mrs. Hultsson, our key account manager, and I have devised a possible solution to the problem. If you open the worksheet titled “Solution,” you can read about our proposition. The contract we intend to offer to the customer is based on the three cycles of three years, where we basically strip the initial solution in the first three-year cycle, and this is the proposition that you can read in the file. We unbundle the offer to be able to compete by matching the competitor’s price, and later as the crisis flattens, we progressively add accompanying services such as our advanced services, and reach the initial contract in the last three-year cycle. What do you think?”

“Well...”

Mr. Arinen interrupted him and said, “Think about it, but please, Tomas, reply at the very latest by this afternoon. The key account manager visits the customer tomorrow, and we must have your blessing.”

Mr. Torvik nodded, but he quickly replied verbally as well, realizing that his colleague could not see him. “You will have my answer by the end of the day.”

⁴ <http://www.tappi.org/content/events/09papercon/papers/Pousette.pdf>

⁵ <http://www.abb.com/cawp/seitp202/0fb85e5ef0e859e5c12574eb001d241f.aspx>

⁶ See separate tables in Exhibit 1.

Mr. Torvik sighed. Just as he had suspected, the news from Finland had not been good. He scratched his head, took a sip of coffee and checked the watch he had on his desk. He felt it was going to be a long day. He had been receiving reports about smaller clients opting for outsourcing companies offering cost savings, despite the lower quality of both products and services. He was also very aware how this client was coping with severe financial problems caused by the present crisis. He had not expected, though, that SKF would lose this important client. He had been convinced that the philosophy of long-term and customer value would prevail, that the clients would understand how SKF saves costs in the long-run even if one must bear higher costs in the short-run. Figures do not lie; SKF is better than the competition in suppressing clients' downtime by minimizing the frequency of failures. Yet clients pressed by the crisis currently only view one category in the spreadsheet: costs. That made him realize that a third of the customers in the segment obviously had decided to change their attitude and philosophy of work. Mr. Torvik understood the clients completely; replacing SKF's performance-based contracts with outsourcing companies' cost-based contracts provided significant savings in the short-run, which could be crucial for surviving the crisis. However, the understanding of the clients' position and the concerns regarding the sales proposition were not so helpful to Mr. Torvik in solving SKF's situation. For the Finnish subsidiary of SKF, these changes would imply dramatic consequences. He wondered though if there really was any point in meeting the client again and if they were not reacting in desperation.

The severity of the financial problems had made the focus on costs inevitable and eliminated the interest for more advanced services. The outsourcing also meant that the previous strategically important interface between senior-level executives and the customer would be transferred to the more cost-oriented outsourcing companies. SKF would become a subcontractor to these companies. This would not be a desirable position for SKF.

The proposition devised by Mrs. Hultsson, Mr. Arinen, and the Key Account Manager for the runaway Finnish customer was clever, and Mr. Torvik was very much able to see its benefits. Conversely, he was also able to see its drawbacks. The proposition clearly stated that the customer was not obliged to continue dealing with SKF after the first three-year-cycle. What would happen if the customer did not want to prolong the contract? Would SKF then be perceived as a low cost company that delivers short-term cost savings, just as the competitor? What effects would that have on their reputation as a provider of customer value? Would the rest of the market eventually equalize SKF's seals and bearings with cheap copies of inferior quality produced elsewhere? Mr. Torvik was not quite certain if he was willing to take such a risk. Also, would the customer be willing to retain their own costly workforce when the cheap competitor can perform the same labor, but cheaper? Probably not; it was reasonable to assume that the cooperation between the competitor and the client would extend beyond this contract. However, the option of cheaper, but competent outsourced labor propelled his thoughts into a new direction: the possible alternative of aligning with a partner to better address customers' situation without risking drawbacks, such as a deteriorating reputation. Would a company such as Empower, for instance, be interested in joining forces with SKF to address the new situation?

They were a much smaller and a very flexible specialized service company that perhaps could supplement SKF by handling lower margin business deals. Partnering with them would most likely work since they already had good experiences from collaborating, on a smaller scale, however. Mr. Torvik was a very well respected SKF employee and had not been given his good position in the company for nothing. Among other things, he had a remarkable ability to figure out possible solutions to most problems. He understood that this problem was by no means resolved yet. What alternative solutions existed and which one of the options at hand was most appropriate? What should he tell Mr. Arinen?

EXHIBIT 1

Key financial figures⁷

The following tables summarize three alternative offerings and their respective costs of repair, including component costs and labor costs connected to system failure. They are fictitious and do not in any way correspond to actual figures of SKF. Nonetheless, they have been designed with the purpose to mimic actual company figures and to provide additional ground for reasoning around possible solutions.

The initial offer (Tab. 1) is the initial fixed price contract with SKF and means that the customer handles repairs with their own labor and that SKF provides advanced services aimed at improving system reliability, thus reducing the number of failures and the total repair costs. SKF advanced services means that SKF guarantees the reliability of the system, provided that it is monitored by SKF's consultants and maintained accordingly.

Tab. 1: Initial offer by SKF Finland

Number of systems (in units)	2,078
Failures per 9 years (A system fails three times in 9 years)	6,234
Component costs: bearings, seals, lubrication, etc. (18,226 EUR x 6,234)	113,620,884
Client labor cost (4 staff x 9 hrs. per unit x EUR 130 per hr. x 6,234)	29,175,120
SKF advanced services, 9 years	25,000,000
Total cost	167,796,004
Cost per year	18,644,000

The offer by the low-cost competitor (Tab. 2) implies a shorter contract time and that repair work is taken over by the supplier, but does not guarantee reliability of the system in the same way as the initial offer by SKF. On the other hand, it means lower costs for components and labor costs (since in this case it is the competitor that handles repairs), which results in lower annual costs. Lowering the costs is at the moment the customer's primary concern.

⁷ All figures in EUR, unless stated otherwise.

Tab. 2: Offer by the low-cost competitor

Number of systems (in units)	2,078
Failures per 4 years (A system fails two times in four years)	4,156
Component costs: bearings, seals, lubrication, etc. (12,017 EUR x 4,156)	49,942,652
Competitor labor costs (3 staff x 7 hrs. per unit x EUR 100 per hr. x 4,156)	8,727,600
Total cost	58,670,252
Cost per year	14,667,563
Competitor offer (fixed cost)	60,000,000
Competitor offer per year	15,000,000

Table 3 contains a summary of a new solution proposed by the team of SKF Finland, which in terms of cost matches the offer by the low-cost competitor. It means a shortened time of the contract, but the guarantee of failure frequency remains at the same level as in the initial contract. Components (bearings, seals, lubrication, etc.) are still slightly more expensive than the competitor's (explained by being of higher quality), yet the team of SKF Finland is willing to offer them at a cheaper price than compared to the initial contract (Tab. 1). The team of SKF Finland also decided to remove SKF advanced services from the offer, making the proposed calculation even cheaper, with the intention of offering and including SKF advanced services to the contract in the later contractual cycles (see the conversation of Mr. Torvik and Mr. Arinen). Although it may be expected that customer's systems would fail more frequently than in the initial solution due to lower costs of labor and lack of advanced services, SKF is in this solution ready to vouch that this would not happen, in hope that the customer would later prolong the contract for next three years.

Tab. 3: Revised offer by SKF Finland

Number of systems (in units)	2,078
Failures per 3 years (A system fails once in three years)	2,078
Component costs: bearings, seals, lubrication, etc. (16,951 EUR x 2,078)	35,224,960
Client labor cost (4 staff x 9 hrs. per unit x EUR 130 per hr. x 2,078)	9,725,040
Total cost	45,000,000
Cost per year	15,000,000