

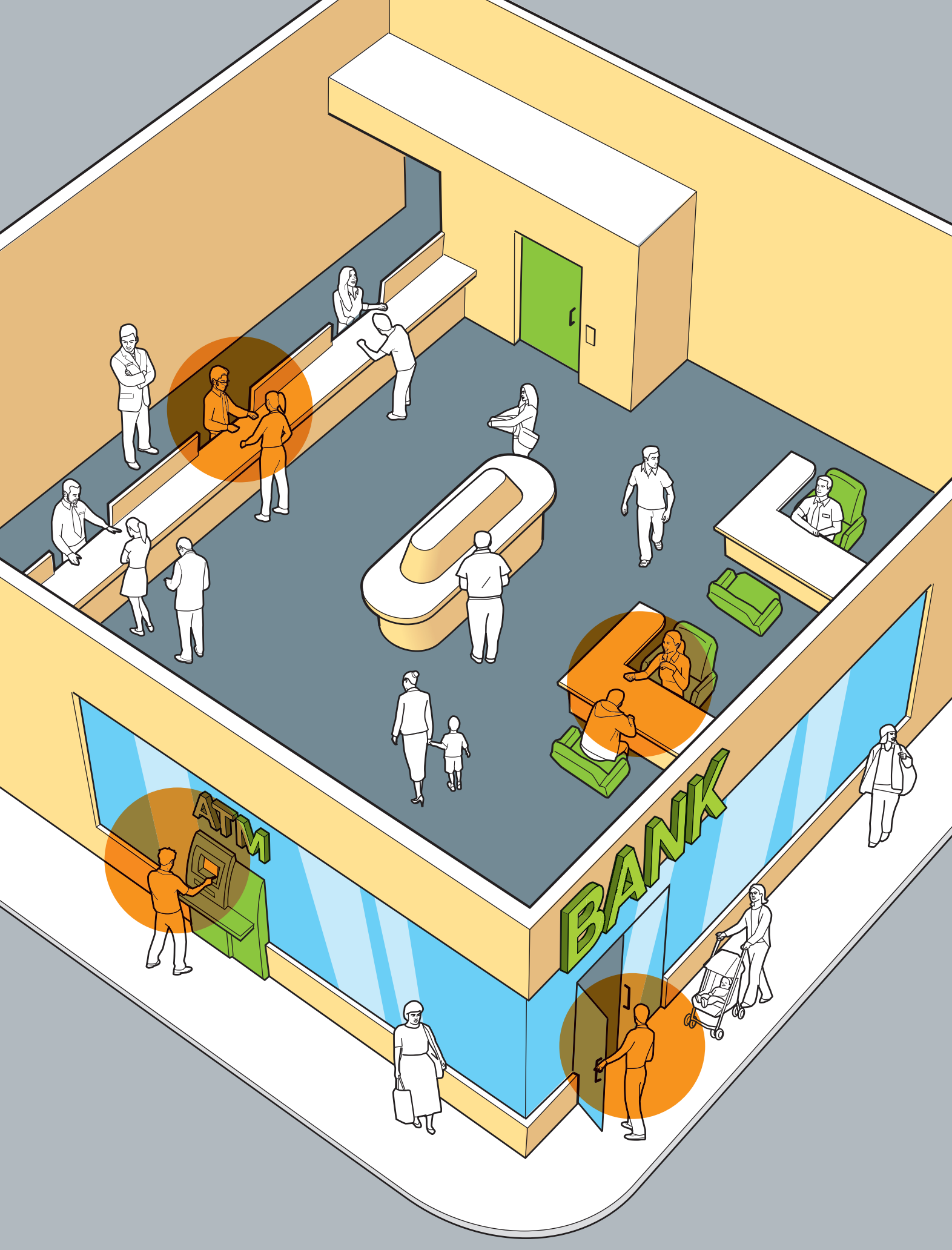
Extensive study  
of the world's  
best service  
companies reveals  
the principles on  
which they're built.

# The Four Things a Service Business Must Get Right

by **Frances X. Frei**

AS THE WORLD'S MAJOR ECONOMIES have matured, they have become dominated by service-focused businesses. But many of the management tools and techniques that service managers use were designed to tackle the challenges of product companies. Are these sufficient, or do we need new ones?

Let me submit that some new tools are necessary. When a business takes a product to market, whether it's a basic commodity like corn or a highly engineered offering like a digital camera, the company must make the product itself compelling and also field a workforce capable of producing it at an



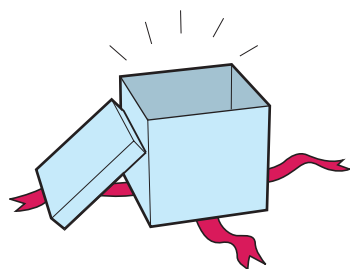
attractive price. To be sure, neither job is easy to do well; enormous amounts of management attention and academic research have been devoted to these challenges. But delivering a service entails something else as well: the management of customers, who are not simply consumers of the service but can also be integral to its production. And because customers' involvement as producers can wreak havoc on costs, service companies must also develop creative ways to fund their distinctive advantages.

Any of these four elements – the offering or its funding mechanism, the employee management system or the customer management system – can be the undoing of a service business. This is amply demonstrated by my analysis of service companies that have struggled over the past decade. What is just as clear, however, is that there is no “right” way to combine the elements. The appropriate design of any one of them depends upon the other three. When we look at service businesses that have grown and prospered – companies like Wal-Mart in retail, Commerce Bank in banking, and the Cleveland Clinic in health care – it is their effective integration of the elements that stands out more than the cleverness of any element in isolation.

This article outlines an approach for crafting a profitable service business based on these four critical elements (collectively called the “service model”). Developed as a core teaching module at Harvard Business School, this approach recognizes the differences between service businesses and product businesses. Students in my course learn to think about those differences and their implications for management practice. Above all, they learn that to build a great service business, managers must get the core elements of service design pulling together or else risk pulling the business apart.

## 1) The Offering

The challenge of service-business management begins with design. As with product companies, a service business can't last long if the offering itself is fatally flawed. It must effectively meet the needs and desires of an attractive group of customers. In thinking about the design of a service, however, managers must undergo an important shift in perspective: Whereas product designers focus on the characteristics buyers will value, service designers do better to focus on the experiences customers want to have. For example, customers



may attribute convenience or friendly interaction to your service brand. They may compare your offering favorably with competitors' because of extended hours, closer proximity, greater scope, or lower prices. Your management team must be absolutely clear about which attributes of service the business will compete on.

Strategy is often defined as what a business chooses not to do. Similarly, service excellence can be defined as what a business chooses not to do *well*. If this sounds odd, it should. Rarely do we advise that the path to excellence is through inferior performance. But since service businesses usually don't have the luxury of simply failing to deliver some aspects of their service – every physical store must have employees on-site, for example, even if they're not particularly skilled or plentiful – most successful companies choose to deliver a

**Service excellence can be defined as what a business chooses not to do well.**

subset of that package poorly. They don't make this choice casually. Instead, my research has shown, they perform badly at some things in order to excel at others. This can be considered a hard-coded trade-off. Think about the company that can afford to stay open for longer hours because it charges more than the competition. This business is excelling on convenience and has relatively inferior performance on price. The price dimension fuels the service dimension.

To create a successful service offering, managers need to determine which attributes to target for excellence and which to target for inferior performance. These choices should be heavily informed by the needs of customers. Managers should discover the relative importance customers place on attributes and then match the investment in excellence with those priorities. At Wal-Mart, for example, ambience and sales help are least valued by its customers, low prices and wide selection are most valued, and several other attributes rank at points in between. (See the exhibit “Wal-Mart's Value Proposition” in David J. Collis and Michael G. Rukstad's article “Can You Say What Your Strategy Is?” in this issue.) The trade-offs Wal-Mart makes are deliberately informed by these preferences. The company optimizes specific aspects of its service offering to cater to its customers'

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priorities, and it refuses to overinvest in underappreciated attributes. The fact that it takes a drubbing from competitors on things its customers care less about drives its overall performance.

The phenomenon, of course, has a circular aspect. Shoppers whose preferences match Wal-Mart's strengths self-select into its customer base. Meanwhile, those who don't prefer Wal-Mart's attributes buy elsewhere. It is important therefore to identify customer segments in terms of attribute preferences – or as some marketers prefer, in terms of customer needs. Identifying what might be called *customer operating segments* is not the same exercise as traditional psychographic segmentation. Rather than stressing differences that enable increasingly targeted and potent messaging, this type of segmentation aims to find populations of customers who share a notion of what constitutes excellent service.

Once an attractive customer operating segment is found, the mission is clear: Management should design a new offering or tweak an existing one to line up with that segment's preferences. Look, for example, at the fit achieved by Commerce Bank, which has been able to grow its retail customer base dramatically even though its rates are among the worst in its markets and it has made limited acquisitions. Commerce Bank focuses on the set of customers who care about the experience of visiting a physical branch. These customers come in all shapes and sizes – from young, first-time banking clients to time-strapped urban professionals to elderly retirees. As an operating segment, however, they all believe that convenience is a bank's most important attribute and choose Commerce Bank because of its evening and weekend hours. Second most important to them is the friendliness of interactions with employees, and so the promise of a cheerful, familiar teller has become part of the bank's core offering. Commerce has added to its branch ambience with interior elements both lovely (high ceilings and natural light) and fun (an amusing contraption for redeeming loose change). When it comes to attributes less important to the bank's customers – price and product range – management is willing to cede the battle to competitors.

It is tempting to think, "If I'm a really good manager, then I don't have to cede anything to the competition." This well-intentioned logic can lead, ironically, to not excelling at anything. The only organizations I have seen that are superior at most service attributes demand a price premium of 50% over their competitors. Most industries don't support this type of premium, and so trade-offs are necessary. I like to tell managers that they are choosing between excellence paired with inferior performance on one hand and mediocrity across all dimensions on the other. When managers understand that inferior performance in one dimension fuels superior performance in another, the design of excellent service is not far behind.

## 2 The Funding Mechanism

All managers, and even most customers, agree that there is no such thing as a free lunch. Excellence comes at a cost, and the cost must ultimately be covered.

With a tangible product, a company's mechanism for funding superior performance is usually relatively simple: the price tag. Only the customers who forfeit the extra cash can avail themselves of the premium offering. In a service business, developing a way to fund excellence can be more complicated. Many times, pricing is not transaction based but involves the bundling of various elements of value or entails some kind of subscription, such as a monthly fee. In these cases, buyers can extract uneven amounts of value for their money. Indeed, even nonbuyers may derive value in certain service environments. For example, a shopper might spend time learning from a knowledgeable salesperson, only to leave the store empty-handed.

In a service business, therefore, management must give careful thought to how excellence will be paid for. There must be a funding mechanism in place to allow the company to outshine competitors in the attributes it has chosen. In my study of successful service businesses, I've seen the funding mechanism take four basic forms. Two are ways of having the customer pay, and two cover the cost of excellence with operational savings.

**Charge the customer in a palatable way.** The classic approach to funding something of value is simply to have the customer pay for it, but often it is possible to make the form that payment takes less objectionable to customers. Rarely is that done with à la carte pricing for the niceties. A large part of Starbucks's appeal is that a customer can linger almost indefinitely in a coffeehouse setting. It's unthinkable that Starbucks would place meters next to its overstuffed chairs; a better way to fund the atmosphere is to charge more for the coffee. Commerce Bank is open late and on weekends – earning it high marks on extended hours – and it pays for that service by giving a half percentage point less in interest on deposits. Could it fund the extra labor hours by charging for evening and weekend visits? Perhaps, but a slightly lower interest rate is more palatable. Management in any setting would do well to creatively consider what feels fair to its customers. Often, the least creative solution is to charge more for the particular service feature you are funding.

**Create a win-win between operational savings and value-added services.** Very clever management teams discover ways to enhance the customer experience even while spending less (finding, in other words, that there *can* be such a thing as a free lunch). Many of these innovations provide



only a temporary competitive advantage, as they are quickly recognized and copied. Some are surprisingly durable, however. An example is the immediate-response service provided by Progressive Casualty Insurance. When someone insured by Progressive is involved in an auto accident, the company immediately sends out a van to assist that person and to assess the damage on the spot – often arriving on the scene before the police or tow trucks. Customers love this level of responsiveness and give the company high marks for service. But in anticipation of such a need someday, would they pay more in insurance premiums? Unfortunately, no. People are pathologically price sensitive about car insurance and almost never select anything but the rock-bottom quote. The key to Progressive's ability to fund this service is the cost savings it ultimately yields. Normally insurance providers are subject to fraud, with criminals making claims for accidents that were staged or never happened. Because of these and other types of disputed claims, firms also incur high legal fees – which, combined with the other costs of fraud, add up to some \$15 out of every \$100 in insurance premiums across the industry. Since deploying its vans, Progressive has seen costs in both categories plummet. Sending a company representative to the scene pays for itself.

Progressive offers another customer convenience that many competitors have so far shied away from: giving quotes from other providers alongside its own when a potential buyer inquires about the cost of insurance. It's not that Progressive is determined to go one better than rivals to win the business. In fact, Progressive's is the lowest quote only about half the time. What Progressive does believe is that its quote is the right one given the probability of that person's getting into an accident – a probability that the insurer is best in class at determining. If indeed its quote is spot-on, then allowing a competitor to insure the customer at a lower rate is doubly effective: It frees Progressive from a money-losing proposition while burdening its competitor with the unprofitable account. Thus a level of service that looks downright altruistic to the customer actually benefits the company. This is an example of leveraging operations into a value-added service.

How can your management team find win-win solutions of its own? When I pose this question to managers, their impulse is to imagine what new value could be created for customers and then to ponder how that could be funded through cost savings. I suggest beginning instead by asking, "Where are our biggest cost buckets?" With these in mind, managers can then simultaneously determine how to reduce costs and create a value-added service. A good first place to look? Anywhere that time is a large component of cost.

Removing time is often fruitful, since it can directly improve service even as it cuts costs.

**Spend now to save later.** Often it is possible, if somewhat painful, to make operational investments that will pay off eventually by reducing customers' needs for auxiliary service in the future. A classic example is Intuit's decision to provide free customer support, in defiance of the software industry norm. Call centers are expensive to staff because of the combination of technical knowledge and sociability

**If a self-service option is truly preferable, customers should be willing to take on the work for nothing or even pay for the privilege.**

required to field inquiries effectively. Customers meanwhile are extremely uneven in their neediness vis-à-vis information technology. For most software makers this adds up to the obvious conclusion that customers should be charged for support.

Intuit founder Scott Cook sees the matter differently. Those needy calls, he believes, are a useful form of input to continued product development – the engine of future revenues – and that justifies an even greater expense outlay. Intuit has its higher salaried product-development people, not solely customer service people, fielding calls so that subsequent versions of its offerings will be informed by direct knowledge of what users are trying to accomplish and how they are being frustrated. This is part of a broader commitment to feedback-driven improvement that Cook refers to as "DIRST" – for "do it right the second time." The investment has paid off in better software, which means a lower call volume. "Our competition thinks we're crazy," Cook says, and he understands why. "If we got as many calls as they do, we'd be out of business."

**Have the customer do the work.** One other type of funding mechanism for enhanced service puts the cost back in the customer's court, but in the form of labor. Offering self-service, from pump-your-own gas to self-managed brokerage accounts, is a well-established way to keep costs low. If the goal is service excellence, though, you must create a situation in which the customer will prefer the do-it-yourself capability over a readily available full-service alternative. Airlines have achieved this, at last, with flight check-in kiosks, although the value proposition they initially presented was dubious. At first, passengers felt compelled to use the relatively unappealing kiosks only because carriers had allowed the lines in front of manned desks to become intolerable.

Today, however, frequent fliers prefer the kiosks because they provide readier access to useful tools like seat maps. Businesses looking to achieve service excellence in other settings should not take such an indirect route. They should set themselves the challenge of creating self-service capabilities that customers will welcome. Indeed, if a self-service option is truly preferable, customers should be willing to take on the work for nothing or even pay for the privilege. When managers designing self-service solutions are not permitted to add the inducement of price discounts, they are forced to focus on improving the customer experience.

Whatever funding mechanism is used to cover the costs of excellence, it is best thought out as thoroughly as possible prior to the launch of a new service, rather than amended in light of experience afterward. When a service that's been perceived as free suddenly has fees associated with it, customers tend to react with disproportionate displeasure. And since companies cannot thrive by offering service gratis, it is vital that they not set expectations that can't be sustained. With careful analysis and design, a company can offer and fund a better service experience than its customers would enjoy elsewhere.

### 3 The Employee Management System

Companies often live or die on the quality of their workforces, but because service businesses are typically people intensive, a relative advantage in employee management has all the more impact there. Top management must give careful attention to recruiting and selection processes, training, job design, performance management, and other components

that make up the employee management system. More to the point, the decisions made in these areas should reflect the service attributes the company aims to be known for.

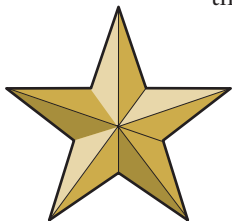
To design a well-integrated employee management system, start with two simple diagnostic questions. First: What makes our employees reasonably *able* to achieve excellence? And then: What makes our employees reasonably *motivated* to achieve excellence? Thoughtfully considered, the answers will translate into company-specific policies and programs. Companies that neglect to connect the dots between their employee management approaches and customers' service preferences will find it very hard to honor their service promises.

At one large international retail bank I studied, a senior manager had come to a depressing realization. "Our service stinks," she told me. Under her guidance the bank took various measures, mainly centering on incentives and training, but the problem persisted. Customer experience in the branch did not improve. Perplexed but determined,

the executive decided to become a frontline employee herself for a month. She thought it would take that much time to experience a typical range of service interactions and see the roots of the problem. In fact, it took one day. "From the time the doors opened, customers were yelling at me," she reported. "By the end of the day, I was yelling back." What became clear was that employees were set up to fail. Recent cross-selling initiatives had created a set of customers with more complex needs and higher expectations for their relationship with the bank, but employees had not been equipped to respond. As a result of decisions made by the management team (all individually sensible), the typical employee did not have a reasonable chance of succeeding. The bank's employee management system was broken.

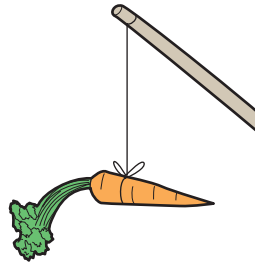
If your business requires heroism of your employees to keep customers happy, then you have bad service by design. Employee self-sacrifice is rarely a sustainable resource. Instead, design a system that allows the average employee to thrive. This is part of Commerce Bank's competitive formula. Recall that the bank chooses to compete on extended hours and friendly interactions and not on low price and product breadth. Now think how that strategy could inform employee management; the implications are not hard to imagine. For instance, Commerce concluded that it didn't require straight-A students to master its limited product set; it could hire for attitude and train for service. In job interviews, its managers could use simple weed-out criteria – like "Does this person smile in a resting state?" – rather than trying to maximize across a wide range of positive characteristics. The bank's current employees could be deployed as talent scouts, on the principle that it takes one to know one. (When people from Commerce see someone providing great service in another setting, whether at a restaurant or at a gas station, they hand out a card printed with a compliment and a suggestion to consider working for Commerce.)

It's a simple reality that employees who are above average in both attitude and aptitude are expensive to employ. They are not only attractive to you but also attractive to your competitors, which drives up wages. A business that wants to maintain a competitive cost structure will probably need to compromise on one quality or the other (or, if it insists on having both, find a way to fund that luxury). If, as Commerce Bank does, you choose to hire for attitude, then you must engineer things so that even lower-aptitude employees will reliably deliver great service. Like managers who don't want to admit that their service is designed to be inferior on some attributes, many people are reluctant to acknowledge a trade-off between aptitude and attitude. But failure to accommodate this economic reality in the design of the employee management system is a common culprit in flawed service.



## 4) The Customer Management System

In a service environment, employees aren't the only people affecting the cost and quality of service delivered. The customers themselves can be involved in operational processes, sometimes to a very large extent, and their input influences their experiences (and often other customers' too). For example, an architectural firm's client may explain the purpose of a new facility well or poorly, and that will affect the efficiency of the design process and the quality of the end product. A customer who dithers at a fast-food counter makes the service less fast for everyone behind him.



Customer involvement in operations has profound implications for management because it alters the traditional role of the business in value creation. The classic product-based business buys materials and adds value to them in some way. The enhanced-value product is then delivered to customers, who pay to receive it. In a service business, however, employees and customers are both part of the value-creation process. A main benefit is that customer labor can be far less expensive than employee labor. It can also lead to better service experiences. When students participate more in a classroom environment, for example, they learn more. But there are challenges, as well. Designing a system that explicitly manages these challenges is essential to service success.

Consider the issue of customer selection. Service designs may call for customers to perform important tasks, but for the most part customers have no interview, no background check, and no personality profile. As a former senior executive from Nestlé now working in financial services put it, "I could control who was in my factory at Nestlé; I have no such control over the customers in my bank's branches."

In addition, despite many organizations' best efforts, customers are not as easy to train as employees. There are usually many times more customers than employees, and creating effective training materials for such a large, dispersed, unpaid, and often irrelevantly skilled workforce is difficult. When this holds true, firms must accommodate the limited training in the design of the service experience. If tasks are shifted from employees to customers – from higher-skilled to lower-skilled people – then they must be adjusted accordingly. Airlines seem to get this right. Recall (if you can) the last time you checked in with an agent at the full-service counter. Chances are you witnessed the agent complete a dizzying sequence of keystrokes. It would not seem reasonable to expect customers to perform these same steps, and so when the check-in role was transferred to customers, it was

dramatically simplified. By contrast, think of the self-service supermarket checkout. Here customers are asked not only to do what trained employees have done previously but also to shoulder the additional responsibility of fraud prevention through a complicated process of weighing bags. Asking customers to perform more-complicated tasks than higher-skilled employees contributes to the disarray and anxiety that surrounds these checkout lines.

Customers also have a great deal of discretion in their operational activities, usually far more than employees. When a company introduces a new process that it wants employees to use, it can simply issue a mandate. When customers are involved, transitions like this can be significantly more complicated. Look at Zipcar, the popular car-sharing service. To keep costs low, its service model depends on customers to clean, refuel, and return cars in time for the next user. Motivating employees to perform these tasks would be routine; motivating customer-operators has required a complex, evolving mix of rewards and penalties.

In managing customers in your operations, then, you'll need to address a few key questions: Which customers are you focusing on? Which behaviors do you want? And which techniques will most effectively influence behavior? For example, a company whose business model depends on customers' timeliness – whether it's a dental office packing its appointment calendar or a video store circulating hit films – may use more- or less-heavy-handed tactics to ensure compliance. In a previous article for *Harvard Business Review* ("Breaking the Trade-Off Between Efficiency and Service," November 2006), I related lessons from several companies that have used a range of techniques to modify customer behavior. These techniques can be divided into two basic categories: instrumental (the carrots and sticks we commonly see play out as discounts and late fees) and normative (the use of shame, blame, and pride to motivate us to return shopping carts and pick up trash even when no one is looking). The important thing is to manage customers in a way that is consistent with the service attributes you've chosen to emphasize overall.

### Integrating the Elements

Successful service companies have a working plan that incorporates all four elements of service design. Within each of those areas, however, it is hard to spot any best practice. This is because the whole business depends more on the interconnection of the four than on any one element.

A standout example of effective overall integration is the Cleveland Clinic, which is consistently ranked among America's most eminent hospitals and has been a leader in pioneering cardiac care for decades. It's hard to put a finger on the source of that advantage. The fact that the clinic has specialty centers focusing on diabetes, for example, or cardiac care is not exceptional in itself. Its refusal to attach

## Diagnosing Service Design

**THE SUCCESS OR FAILURE** of a service business comes down to whether it gets four things right or wrong – and whether it balances them effectively. Here are some questions that will sharpen managers' thinking along each dimension and help companies gauge how well their service models are integrated.

### 1 The Offering

Which service attributes (convenience? friendliness?) does the firm target for excellence?

Which ones does it compromise in order to achieve excellence in other areas?

How do its service attributes match up with targeted customers' priorities?

### 2 The Funding Mechanism

Are customers paying as palatably as possible?

Can operational benefits be reaped from service features?

Are there longer-term benefits to current service features?

Are customers happily choosing to perform work (without the lure of a discount) or just trying to avoid more-miserable alternatives?

### 3 The Employee Management System

What makes employees reasonably able to produce excellence?

What makes them reasonably motivated to produce excellence?

Have jobs been designed realistically, given employee selection, training, and motivation challenges?

### 4 The Customer Management System

Which customers are you incorporating into your operations?

What is their job design?

What have you done to ensure they have the skills to do the job?

What have you done to ensure they *want* to do the job?

How will you manage any gaps in their performance?

### The Whole Service Model

Are the decisions you make in one dimension supported by those you've made in the others?

Does the service model create long-term value for customers, employees, and shareholders?

How well do extensions to your core business fit with your existing service model?

Are you trying to be all things to all people – or specific things to specific people?

financial rewards to doctors' productivity is unusual but might not be effective elsewhere. Step back from the details, however, and the bigger picture emerges. Attracting the highest-severity patients means that doctors will always face a challenging environment in need of innovative solutions. Organizing into disease centers rather than narrower, more traditional lines of specialization (such as kidneys or blood) sets the stage for cross-disciplinary collaboration – and thus for novel perspectives – within those centers. Removing productivity incentives gives doctors license to spend time on innovation, which is enhanced by their close work with specialists from other fields. The particular choices made on methods, processes, and personnel are the right ones for the Cleveland Clinic because they complement one another and come together in a smoothly operating system.

Any service company, no matter how long established, can benefit from a review of its operations using the framework laid out in this article. Bringing the four elements of service design into tighter alignment can be an ongoing process of small tweaks and experiments in change, inspired by the kinds of questions included in the sidebar "Diagnosing Service Design." A management team planning to launch a new service will find the framework particularly helpful. It flags the decisions that should be made early and in tandem so that they don't clash down the road. And at the highest level, it underscores two very important principles of service design. First, there is no such thing as a good idea in isolation; there is only a good idea in the context of a specific service model. Second, it is folly to attempt to be all things to all customers.

The first point notes the importance of fit, mentioned earlier as a key strength of the Cleveland Clinic. At the clinic, management knows that extensions to its core business must be examined closely for their fit with its existing service model. The organization recently abandoned the concept of a high-end wellness and spa offering because it didn't build on the hospital's core operational strengths. In some ways this seems like an obvious point, but managers often stray into areas of relative weakness, particularly when they see a firm they consider to be a direct competitor succeeding with a service they don't yet offer. Progressive made this mistake when it decided to venture into the home insurance market. No question, there is money to be made in home insurance, as innumerable firms have shown. But Progressive failed in its attempt because the challenges of that business did not match up with the company's competitive strengths. Recall that Progressive is justifiably proud of its analytics advantage, which enables it to effectively size up the risk that a given policyholder will file a claim. Unfortunately, that kind of actuarial prowess is not as central to making a profit on insuring homes. Home insurers rise or fall on the management of their investment portfolios – and that is a relative weakness of Progressive. (Firms typically lose money on the



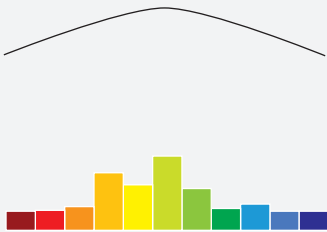
**HIGHLY FOCUSED FIRMS** are the bane of big, established companies. Because they laser-target certain customer segments, they are able to optimize their service models. The service quality they provide, using specialized employees and a customized product set, is potent. By contrast, incumbent firms typically attract a mix of customers, hire and develop a variety of employees, and – as a result of excellent, well-intentioned suggestions from both groups – are rampant product proliferators.

**Are Focused Competitors Nipping at Your Flanks?**

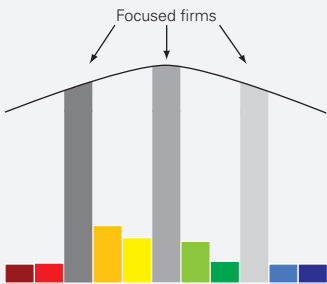
insurance but make money investing pre-paid premiums.) The fit, in retrospect, was a bad one. It should have been seen that way early on.

Just as common a failing is the misguided desire to be all things to all people. In today's service economy, it is nearly impossible to design a service model to cover a huge range of customers and remain competitive across them. Instead, firms should design their service models for more targeted excellence by being specific things to specific people.

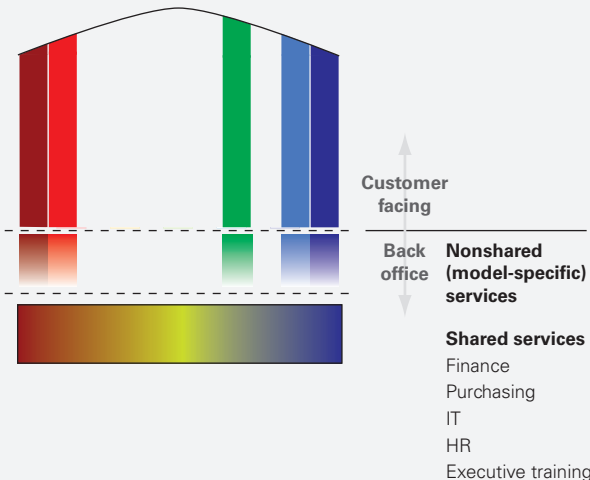
**A** Covering the waterfront like this can dilute your excellence in every area. Companies that try to do it all...



**B** ...are vulnerable to attacks by highly focused entrants, who pick off niche businesses.



**C** Your best defense is to concentrate on multiple niches, shoring them up with the economies gained through internal shared services.



Great service companies are, almost without exception, very clever about selecting their customers. We saw this in Progressive's highly informed choice of whom to do business with. Commerce Bank, from its beginnings in 1973, knew it should stake out its own claim on the market. "The world," its founder Vernon Hill said, "did not need another 'me-too' bank. I had no capital, no brand name, and I had to search for a way to differentiate from the other players." Shouldice Hospital, a Canadian specialist in hernia operations, is highly selective about its customer base. Not only does it serve just patients experiencing a certain type of ailment, it has the luxury of operating on otherwise healthy people. It has skimmed the cream of the market.

**Becoming a Multifocused Firm**

Inevitably, companies that attempt to be all things to all people begin to struggle when upstart competitors like Shouldice start picking off profitable niches. Often, the decline is not taken seriously until it's too late. (See the sidebar "Coming to Terms with the Threat.")

However, some incumbents have managed to compete effectively with their more-focused rivals, and there is much to learn from their experience. The common thread in their competitive responses to upstarts is the capacity to become "multifocused." In other words, they stopped trying to cover the entire waterfront with a single service model. Instead they pursued multiple niches with optimized service models – each designed to achieve excellence on some dimensions at the expense of inferior performance on others. The secret to success in a multifocused firm is the ability to benefit from having various service models under one house umbrella. This benefit often comes in the form of shared services (that is, internal service providers), which enable a firm to generate economies of scale and economies of experience across its service models. Effectiveness at utilizing shared services to the advantage of the individual service models can determine the success of a multifocused firm. (See the exhibit "Are Focused Competitors Nipping at Your Flanks?")

The shared services architecture can be seen in multifocused corporations across industries – from Yum Brands, a collection of five fast-food companies, to Omnicom, which consists of hundreds of companies in the interactive-marketing space, to GE, which seems to have no limit on the markets it can enter. Each corporation has created distinct service models for distinct customer operating segments and gauges the overall benefit of the models by assessing how much they gain from one another. What determines whether a company has assembled the right portfolio of service models? It comes down to a critical test: Is each of the firm’s distinct service models better off as a result of the others? If the answer is no, it signals that performance is about to decline or that the company may want to spin off some service models. If the answer is yes, it’s almost always thanks to superior management of shared services, and the incumbent thrives.

The services shared in multifocused companies typically include business functions like finance, purchasing, information technology, human resources, and executive training. The scale advantages they provide are straightforward and include pooled purchasing, preferred access to credit, and other cost-related benefits. Economies of experience are more difficult to realize but can also be more valuable. Here, the challenge is to use knowledge gained in one service model to strengthen the performance of the others. To a limited extent, this kind of knowledge transfer occurs informally; this has always been the hope and promise of diversified companies. The important difference in successful multifocused firms is that they formalize the process, designing very explicit ways of leveraging experience across service models. Knowledge transfer is facilitated by deliberate investments in such programs as formal best-practice sharing; centralized, dynamic employee training; and the rotation of managers among models.

My research convinces me that the best means of sustaining growth in a service business is to employ the multifocused model, yet it is also evident that this model requires concentrated effort to defend. Leaders of individual service models constantly assert that dedicated, rather than shared,

#### HOW DO INCUMBENTS REACT

when a focused entrant appears on the scene? The usual response seems to follow four distinct stages of “strategic grief.”

**Dismissal.** The incumbent perceives the entrant as a non-threat. It is a deceptively easy assessment to make, given that the focused firm has optimized its service model to be deliberately good – and bad – at certain aspects of the incumbent’s business.

**Sadness.** Next comes a sense of loss as profitable customers start to defect. They are willing, if not eager, to make the trade-offs inherent in the entrant’s service model.

**Relief.** Sadness is replaced by relief as the realization dawns that only one of the incumbent’s customer segments is being targeted by the focused entrant. The new competitor may win on a few dimensions of value and take certain customers away, but there are still many other segments to serve!

**Dread.** Finally, the larger threat reveals itself. The problem is not this single entrant; it’s the inevitable attack of focused firms on other fronts.

Spotted in time, the threat of focused competitors can be met effectively. Is there a troubling area of competitive activity on your radar screen? If so, don’t be lulled by its small scale and isolation. Move quickly to understand what’s going on there. In particular, focus on the entrant’s rate of improvement along critical measures like market share, share of wallet, and service quality. Benchmarks of absolute difference can fool managers into believing that the threat is not imminent. But when a new competitor improves faster than you do, the gap soon closes.

Once you learn the threat is real, explore your potential advantages. Can you compete effectively as a “multifocused” firm (one that targets multiple niches rather than trying to tackle everything)? The threat needs to be addressed with humility. The temptation will be great to believe that “our way” remains the better way. If anything, overstate the fact that it is not, and proceed from that assumption to craft a competitive response.

## Coming to Terms with the Threat

resources would do more to strengthen their own businesses. Operations managers, meanwhile, raise a chorus of complaint that shared services require more-vigilant control “below the line” if they are to deliver the necessary economies of scope and experience. Given the perpetual assault on the model, it may not be surprising that another common characteristic of successful multifocused firms is directive (even autocratic) leadership. This leadership style accommodates different personalities, but it always relies on senior managers who are able and willing to exert strong influence on subordinates. They must be, in order to balance the competitive autonomy of individual service models with the collective value of shared services. Without strong, centralized leadership, revenue-generating line managers typically overrule shared-services

managers, particularly in moments of strategic distress. Indeed, companies often stack the deck by placing stronger leaders in the service models than in the shared services, effectively undermining the performance of the system.

### The Management-Practice Frontier

Management scholars, and not a few practitioners, have taken up an interesting debate in recent years: Is the discipline of management fundamentally different in service businesses than in product businesses? The way in which management is studied and taught in graduate business schools was forged in the context of the industrial economy. Are the approaches that worked for manufacturing companies equally applicable to services?

As service businesses continue to innovate, succeed, and be studied, the answers are becoming clearer. The framework presented here suggests why the traditional techniques have proved as durable as they have and why they still leave sophisticated managers wanting more. Much of what determines the health of a product business – the soundness of its offering and the management of its people – is just as indispensable in a service business and can be addressed with a similar tool kit. But whole new areas involving the roles of customers have opened up, and their tool kits are only now being assembled. ▢

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"I'm here to defrag the Magic 8 Ball."

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