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VALUE SELLING AT SKF SERVICE (A)

Tough Buyer Confronts Strategy

Research Associate Aimee DuBrule prepared this case under the supervision of Professor Kamran Kashani as a basis for class discussion rather than to illustrate either effective or ineffective handling of a business situation. Some names have been disguised for confidentiality.

Professor Marco Bertini of London Business School provided material support in collecting company information for this case.

Phil Knights, president of SKF Service division, had a dilemma to resolve. He had to decide whether SKF should accept an invitation from Steelcorp – a large US buyer of its products – to participate in a reverse auction in which the lowest-priced bidder would win the order. Competing exclusively on price ran counter to the value strategy that Phil and his team were pursuing at SKF Service. Selling was increasingly focused on demonstrating tangible customer benefits. To that end, a recent tool, called the Documented Solutions Program, had been developed to quantify customer benefits and returns from investing in SKF's more expensive, but also superior quality, products and related services.

Steelcorp's invitation to the reverse auction had sparked off a big debate. Some argued that participating in the auction would seriously undermine value selling at SKF Service. They proposed that the company should simply refuse the invitation. Others feared that the company's refusal would lead to an annual loss of $4 million of orders to a lower-priced competitor. They suggested a one-off exception to the general strategy by participating in the reverse auction.

A couple of factors complicated Phil's decision. One was the fact that Steelcorp and the SKF distributor serving it, Industrial Technology Corporation (ITC), were among the division's largest customers. A refusal to participate in the reverse auction could have serious long-term ramifications for SKF's relations with both. The other factor was a downturn in economic activities which was beginning to negatively impact division sales. Steelcorp's orders were going to be even more important in a recessionary market condition.

Company Background

SKF was the world's largest producer of bearings. Founded in 1907 in Göteborg, Sweden, the company invented the first self-aligning ball bearing. Over 100 years later, SKF had net sales of SEK 63.4 billion ($8.2 billion)[1] and a leading global market share approaching 20%.

[1] SEK 1 = €0.091 / $0.129.

The primary function of bearings was to reduce friction between the moving parts of an engine, a motor or a wheel (*refer to **Exhibit 1** for images of bearings*). Well-functioning bearings prevented product failure, improved efficiency and reduced energy consumption and maintenance costs. SKF's products could be found in myriads of applications, including airplane engines, gas turbines, pumps, washing machines and roller skates.[2]

SKF had 110 manufacturing sites across the globe and sales companies in 70 countries. It served an estimated two million customers worldwide in diverse industries such as oil and gas, aerospace, pulp and paper machinery, medical instruments, construction equipment, automobiles, food and home appliances.

Since its inception, SKF had focused on developing technically superior bearings that were durable and reliable, two dimensions critical to the sound performance of products that incorporated them. Prices for the wide range of bearings produced by the company varied from $1 for bearings used in bar stools, to hundreds of thousands of dollars for those used in power generating turbines. Historically, SKF-branded bearings commanded significant price premiums which could vary from 10% to 50% depending on the criticality of the customer's application. Premiums were at the top end of the range for highly engineered bearings used in mission critical applications such as jet engines and gas turbines, where malfunction could potentially lead to catastrophic failures. Phil explained:

> Bearings are at the heart of big machines. If they fail, the entire operation comes to a standstill – a very expensive possibility when an hour of downtime costs thousands of dollars in lost production.

The SKF Group was organized into three business divisions: Industrial, Automotive and Service. Each global division served specific customer groups.

Industrial division sold its products to OEM[3] customers in approximately 30 different industry segments such as machine tools, power generation, oil and gas, and mining. Industrial customers included Caterpillar, John Deere, Metso, Vestas and Siemens. This division accounted for 32% of company sales.

Automotive division sold to OEMs of cars and trucks and served the vehicle repair and maintenance aftermarket. The division also sold to manufacturers of home appliances and power tools. Customers included General Motors, Ford, Scania, Toyota, Ferrari, Bosch and Black & Decker. Automotive division accounted for 35% of SKF's sales.

Service division, which accounted for one-third of SKF's sales, provided industrial end users – typically factories – with replacement bearings and aftermarket services. The profitable services, which had grown to 18% of division sales, included predictive and preventive systems that gave plant engineers early warnings of potential problems with bearings or mechanical parts before costly failures occurred. Among SKF's end users were British Petroleum, International Paper, Arcelor Mittal and Nestlé.

SKF Service served its industrial end users both directly (20%) and through its 7,000 distributors worldwide (80%). Channel partners, as the company called its independent distributors, provided the division with "feet on the street" and services such as carrying

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[2] Bearings were ever-present though often invisible. For example, it was estimated that a car had on average 87 bearings in it, while a house contained between 60 and 80 bearings.

[3] Original equipment manufacturer.

local inventories for rapid order fulfillment, selling to end users, delivery, customer credit and collection. Trained and certified distributors were also authorized to sell SKF services to end users.

Pricing for industrial aftermarket products and services was a local decision often made in coordination with distributors, many of whom carried competing brands. In the US, all industrial aftermarket bearing sales were made exclusively through SKF's 1,200 distributor branches which, in turn, served close to 50,000 end users. The Service division's 60-person US sales force was geographically organized and supported by teams of 12 industry specialists. It sold to the company's vast distribution network, and supported the distributors in selling to end user customers.

(*Refer to **Exhibit 2** for SKF's partial organization charts*.)

Global Markets and Competition

The global bearings market was estimated to be $40 billion and changing in pace with growth in world GDP and business cycles. The aftermarket repair and replacement sales represented about 30% of overall demand. Asia accounted for 40% of global demand, followed by Europe (30%) and North America (21%). SKF's presence was strongest in Western Europe, which accounted for 51% of its total sales, followed by Asia (19%), North America (17%) and Latin America (5%).

SKF competed with more than a dozen makers of bearings worldwide. Strongest among them were Germany's Schaeffler with an estimated 16–18% global market share, Timken with approximately 9–11% and Japan's NSK with around 10%. SKF was facing new international competitors from low-cost producers in emerging markets, most significantly from Eastern Europe and China. None of SKF's rivals matched the company's vast array of products and services.

In the highly competitive US market, SKF's most important rival was Timken, a native American producer and market leader in North America. Timken was considered an aggressive competitor fiercely protecting its estimated 30% domestic share, compared to SKF's 12–13% share. Other important competitors in the US were: Schaeffler (8–10%) and NSK (5–7%). SKF Service sold close to $275 million in the US last year.

Selling to a Changing Market

Several trends were changing the global market for industrial aftermarket (repair and replacement) bearings. One was a growing concentration of distributors and end users. Mergers and acquisitions were creating larger entities, resulting in increased concentration of sales among a declining number of customers. Another trend was taking place inside end-user organizations: Maintenance engineers, who had traditionally understood and appreciated SKF's product and technical superiority, were losing their influence in favor of those in purchasing and finance who shopped for "good enough" quality at the lowest prices. One SKF sales person observed:

> Purchasing is now attracting aggressive managers whose salaries have outpaced those of other functions because of their direct impact on profitability.

End users were also consolidating their purchases among a reduced number of suppliers to extract lower prices. It was not uncommon for large end users to demand a flat, across-the-board discount on unit prices. One US sales executive recalled:

> Everything is being commoditized. A few years ago some purchasing people in the competitive paper making industry went to their distributors and said, "You've got to give us 5% off all our purchases," and most distributors and their suppliers complied. That's how "Five-off" became a norm for the industry. For some bearings that meant a loss of 50% in producer margins. But while such discounts are a win for purchasing, and a loss to us and our distributors, they are not sustainable year after year.

Increasingly, distributors were becoming the purchasing arms of their customers, who were buying a growing and wide range of products from a smaller number of them. In the US, leading "big box" distributors were now supplying end users with everything from buckets and brooms to pneumatic machinery, and from power transmission products to bearings. At the same time, distributors had seen their gross margins drop due to rising competition from other distributors. More recently, large end users were trying to bypass distributors altogether and place unbundled "naked" orders directly with manufacturers. By policy, and in line with industry practice, SKF abstained from conducting commercial negotiations directly with end users in the US.

SKF's brand reputation for quality and engineering excellence was still considered an important factor in purchasing decisions, albeit a declining one for price-sensitive accounts. Historically, the brand had allowed SKF access to good distributors and important end users.

A member of SKF management highlighted the challenges of selling premium quality in a price-oriented market:

> While quality is hidden in our product's performance and becomes apparent only over time, price is visible and measurable right away.

As a general rule, SKF did not seek business from customers whose only decision-making criteria was price.

In an increasingly competitive market, SKF Service was giving high priority to strengthening customer relationships. Effective salespeople were viewed as good "farmers" (as opposed to "hunters") for their skills in building and nurturing close relationships with their distributor accounts for long-term results. Steve Benedetto, SKF's corporate account VP responsible exclusively for ITC, explained what was important in his job:

> I see it as my business to understand ITC's business, to know its costs, its products, the competing bearings it carries, and its people from shop floor to the top. It's equally important to let them know and trust me. It's all about building and maintaining trust.

The SKF US sales force was compensated with a fixed salary and variable bonuses based on individual as well as team performance. The 80% fixed portion of the sales force's total compensation was considered high compared to other companies.

DSP: "Show Me The Money!"

SKF Service had recently deployed a computer-based sales tool, Documented Solutions Program (DSP), for quantifying and measuring end-user value from using SKF's bearings and related services. Phil explained:

> For years we struggled to convince end users of the savings from our aftermarket products and services. What we told them made intuitive sense, but we lacked factual arguments. When we finally began to quantify and measure the savings on total cost of ownership we were amazed: What made intuitive sense showed exponential benefits to customers. It's a fantastic tool.

DSP, which started on the "back of a napkin" and had an initial budget of $5,000, contained several hundred case studies of SKF products in use, where end user benefits and investments were identified, quantified, measured and tracked. Each case study, which featured information methodically collected by members of SKF's sales or service force, outlined a bearing's application, as well as the following variables:

- Customer **benefits**: reduced failure rate, longer life, less frequent replacement, savings in labor, material, inventory, etc.

- Customer **investments**: premium paid for SKF bearings, additional tools, add-on services, such as condition monitoring, end-user training, etc.

Powered by the database and proprietary software, DSP was thus able to calculate for any given bearing application what an end user could expect from SKF products and related services in terms of total savings and return on investment. Condition monitoring was one such service – a package of hardware and software that allowed factory maintenance engineers to assess a rotating machine's temperature, oil, speed, bearing condition, noise and vibration, and thus take preventive measures to avoid costly breakdowns.

Exhibit 3 shows a sample DSP case study from the petrochemical industry illustrating how a customer investment of $2.29 million in SKF's high-performance bearings and related services was able to generate a return of nearly 500% in 54 months from savings in total cost related to reduced pump failures and reductions in components and labor.

DSP's Logic

Phil remembered how DSP was developed despite initial skepticism:

> Some questioned DSP's logic. I had to convince our people that DSP would eventually allow us to sell more bearings by converting our technical knowledge into customer benefits. It forced us to think in ways we didn't do before, like thinking about our customers' profitability as well as our own.

One of the architects of DSP was Todd Snelgrove, Global Manager for Customer Value, responsible for the tool's international deployment. Formerly SKF account manager for a large Canadian distributor, he saw DSP helping SKF Service to make the shift from "talking" about customer value to "measuring" and "delivering" it:

> For years, when we talked about value we were accused by customers of using "soft dollar b----t" to sell expensive products and unnecessary services. Today we have to document value to get paid for it. What DSP has allowed us to do is to offer measurable end-user benefits in ways hard-nosed buyers understand. We document savings in total cost of ownership, which we can then translate into performance guarantees.

At the outset, putting a financial number on customer value was a novel idea in a company historically dedicated to technical excellence. Todd recalled:

> I used to get a blank face when I asked our people, "Do we have a value proposition?" My definition of value is in customer benefits: "Are we selling a bearing? No, we're selling pump output." Otherwise, why should anyone buy from SKF? Our old sales pitch, "Buy from us because we make great Swedish bearings" doesn't sell anymore.

Phil thought that while historically the company enjoyed proven core competencies in bearing technology, it lacked an equally deep knowledge of user requirements. Todd agreed:

> It's a big problem getting engineers to think in commercial terms when the customer says, "Show me the money." For example, when engineers say a certain bearing requires reduced lubrication, that technical point has to be put in total savings in labor and material for the commercial people to see it. One way to force the issue was to keep asking engineers, "*So what*?" for every technical argument they came up with till they translated it into tangible customer benefits.[4]

Using DSP

Due to DSP's proprietary nature, distributors did not have direct access to it. Instead, SKF used the tool in close collaboration with its channel partners for large end users. Once a distributor was on board, the SKF account manager and a representative of the distributor would arrange a joint meeting with the customer's purchasing manager and, where possible, participants from finance, engineering and operations. At the meeting, SKF used a diagnostic tool called Customer Needs Analysis (CNA) to build a tailored study with data that was provided by the end user, such as materials, downtime, labor, energy, inventory, lubrication and replacement costs. When customer data was unavailable, SKF used a database case study from a similar industry and application as a guide. The DSP software then calculated estimated savings and returns for the customer on a package of SKF products and related services.

Following an initial DSP assessment, SKF would typically draft a customer guarantee specifying a minimum ROI from projected savings. The agreement included a clause that obliged SKF to extend a product credit equal to any shortfall in the guaranteed minimum savings. In Todd's experience, the risks associated with such performance guarantees were minimal, "What we promise is on the safe side; actual customer savings are almost always higher."

After initial reluctance to support DSP, distributors learned that the tool could actually stimulate demand for SKF products and educate buyers about the total cost of ownership. However, not all distributors were on board. ITC, for example, had not yet agreed to use DSP with its major customers.

Currently, less than 15% of SKF end users had been introduced to DSP. Priority accounts were defined along two criteria: STRATT: "STRength", as measured by potential volume, and "ATTractiveness", as defined by orientation toward "value" as opposed to price.

The Service division was spreading the use of DSP by training its 1,000-strong sales force around the world. Training experienced sales people to make a business case for

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4 Todd Snelgrove's e-mails ended with the following automatic signature message: "Price Does Not Equal Cost: True Cost Reduction does not come by using cheaper parts. It comes from not having to replace them in the first place. Partner with SKF for the lowest total cost."

ordering from SKF was a challenge. Going "back-to-school," as Phil saw it, was initially hard for some. But through experience, many had come to see DSP's value. In the words of one recently trained SKF salesperson, "DSP is our last defense in a commoditizing market."

Steelcorp

With annual global sales of over $30 billion, Steelcorp was the world's third-largest producer of raw steel and steel-based products used in the automotive, household appliance, construction, and oil and gas industries. Based in Pittsburgh, US, the company employed 97,000 people in 44 countries. Last year, Steelcorp experienced a sharp decline in sales and profitability as a result of the recent economic downturn. The company announced that it would cut its global workforce by 13% in anticipation of another 18% drop in output for the current year. There were also reports that Steelcorp would be searching for low-cost suppliers that could meet its target of 20% savings for total purchases.

Steelcorp was a key account for ITC. With 400 branches in the US and additional locations in Canada, Mexico and Puerto Rico, ITC was a "multi-brand" distributor that also carried bearings from Timken, Schaeffler, NTN, SNR and a handful of smaller suppliers. As ITC's second-largest supplier in the US, SKF accounted for approximately 8% of ITC's $2.1 billion in annual sales.

Steelcorp bought a wide range of products from ITC, including pulleys, pneumatic and hydraulic hoses, roller chain and sprockets and power transmission components. Prices paid followed a negotiated cost-plus formula: ITC was allowed a fixed 10% margin on prices it paid to producers.

Bearings were a large purchase item for Steelcorp since they were critical to the smooth operation of machinery in steel mills. Last year, it bought close to $12 million in bearings from ITC, nearly 50% of its total purchases from the distributor. SKF believed that ITC was Steelcorp's almost exclusive "one-stop-shop" supplier of bearings in North America.

SKF accounted for one-third of ITC's sales of bearings to Steelcorp; the remainder went to Timken and several smaller brands. Theoretically, any major producer could provide for Steelcorp's total bearings needs.

While SKF was occasionally in contact with end users on matters related to product performance, it had never dealt directly with Steelcorp, a situation preferred by ITC, which exercised complete autonomy in conducting all commercial dealings with this key account. In fact, Steve had even declined a direct sales opportunity with Steelcorp when approached by the company soon after arriving at SKF a few years earlier.

Invitation to Reverse Auction

A week earlier, Steve had received an e-mail from Brad Carson, ITC's key account manager for Steelcorp, inviting SKF to participate in the reverse auction to be hosted by Steelcorp in two week's time. According to Brad, Steelcorp's new VP of purchasing, John Elliot, had signaled that all future procurements of bearings in the US would be conducted through reverse auction, where producers would compete with each other online for Steelcorp's annual requirements. John had asked ITC to invite all of its bearings producers, including SKF, to the auction. This decision came as a surprise to both ITC and SKF. It reflected a new procurement policy at Steelcorp.

Web-based reverse auctions were gaining popularity in the industrial sector as a quick and effective means of reducing unit prices. Typically, a buyer initiated the auction by putting a potential contract up for bid while sellers competed online to win the business by bidding each other down. Potential sellers were pre-qualified and selected according to standardized criteria determined by the buyer. This allowed the buyer to distinguish between bids based on a single factor – price. The benefits of reverse auction for the buyer were numerous: reduced transaction costs, overall reduction in unit price for large purchases and lower investment in sourcing and securing potential suppliers.

During the auction, bidders' identities were hidden from one another. Sellers followed the event online, watching the bidding in real time. The process could be frenetic, stressful and fast. Bidders had to have a clear strategy to avoid making irreversible mistakes. After the auction, the buyer would select its preferred bidder, or bidders, often based on the lowest unit price(s).

Under John's leadership, Steelcorp's procurement was undertaking a radical housecleaning. The company aimed to reduce inventories by standardizing SKUs and centralizing all Steelcorp's previously local decisions. This "Convergence Project" also aimed to reduce the number of producers in all categories. According to Brad's e-mail, Steelcorp had already successfully employed reverse auction to procure other products.

The invitation triggered immediate concern at SKF. The company had never before participated in reverse auction, which many felt undermined the value proposition of SKF-branded products and services. Todd was strongly opposed to what he called "the ultimate commoditization tool." For him, this policy was a bad idea, even for the customer:

> RA [reverse auction] ignores the total cost of ownership, which is only partially related to the original price of the product. It's completely short-sighted.

Soon after receiving the invitation, Steve called Brad. He learned in confidence that ITC had tried to dissuade John from the auction but had caved in under pressure. Apparently several manufacturers, including leading US producers, had indicated they would take part. According to Brad, ITC's management strongly urged SKF to participate given its general reputation for product superiority. At any rate, ITC would continue to serve almost all of Steelcorp's bearing needs under its previously negotiated cost-plus agreement.

Steve was concerned about the long-term implications of Steelcorp's new policy and its impact on SKF's relationship with ITC. He feared that reverse auction might be leading the way of the future for the entire industry, "What if it takes off? What if end users and our major distributors find it attractive?"

He could see the possibility of losing out to more aggressive competitors – not only Steelcorp's $4 million annual orders but also a part of the substantial business SKF conducted through ITC. He was worried.

Debate

Steelcorp's announcement was the focus of a big debate. Todd was adamant that by participating in the reverse auction, SKF was falling into a commodity trap that was in no one's interest. He strongly felt that SKF should refuse to participate:

> The enemy of value selling is this evil internet reverse auction because it completely undermines a strategy we're following with many customers.

On the opposite side of the debate was the ITC management who, according to Brad, was certain that if the company failed to participate the distributor would not only lose its profitable sales of SKF products but also damage its own relationship with Steelcorp. For Brad, keeping this customer happy was paramount. He told Steve:

> Times are tough and Elliot has directives from the top to cut costs. He was chosen for this job because of his reputation as one hell of a tough negotiator. I am not happy with his RA policy but as long as Steelcorp buys from me, we're in business. I need SKF in the game.

Brad was also concerned about ITC's build-up of inventory – a result of the economic downturn. With its operating costs at 23% of sales, the distributor needed the margins from SKF's higher prices.

Siding with ITC's management was Steve, who saw an opportunity to increase SKF's share of Steelcorp's total bearings business, but also feared a loss of volume and the historically good relationship with ITC if SKF didn't participate in the auction:

> We have to keep an eye on this new process, the reverse auction. We can't disregard what Steelcorp wants because it might just have the potential of undermining our business in a big way and for a long time.

Decision Point

Based in Brussels, Belgium, Phil heard the news about Steelcorp's reverse auction during a teleconference with regional presidents for SKF Service, a monthly discipline called Quick Market Intelligence (QMI) where customer and competitive information from around the world was shared among the key executives. The question of whether to participate was escalated to him by the head of North America due to policy implications that went beyond Steelcorp. A 20-year veteran of the company, Phil had participated in transforming SKF from simply a manufacturer of bearings to a value-oriented provider of solutions that, in his words, "helped customers get the most out of their machinery investments." Steelcorp's reverse auction initiative was putting Phil at a crossroads.

Should the company, as some argued, comply with Steelcorp's demand as a "one-off exception" to its value-driven strategy? Or, as Todd and others advocated, should it refuse to do so and bear the consequences, including the likely damage to its relationship with ITC and Steelcorp? He was keenly aware of the general slowdown of division sales due to the recession. Projections put the current year's sales at 5% below the previous year's.

Phil glanced at his calendar and noted that there were only five working days left before the date set by Steelcorp for the reverse auction. The clock was ticking and many inside SKF and outside were awaiting his decision.

Exhibit 1
SKF Bearings

Ball Bearing

Sealed Ball Bearings

Polymer Ball Bearings

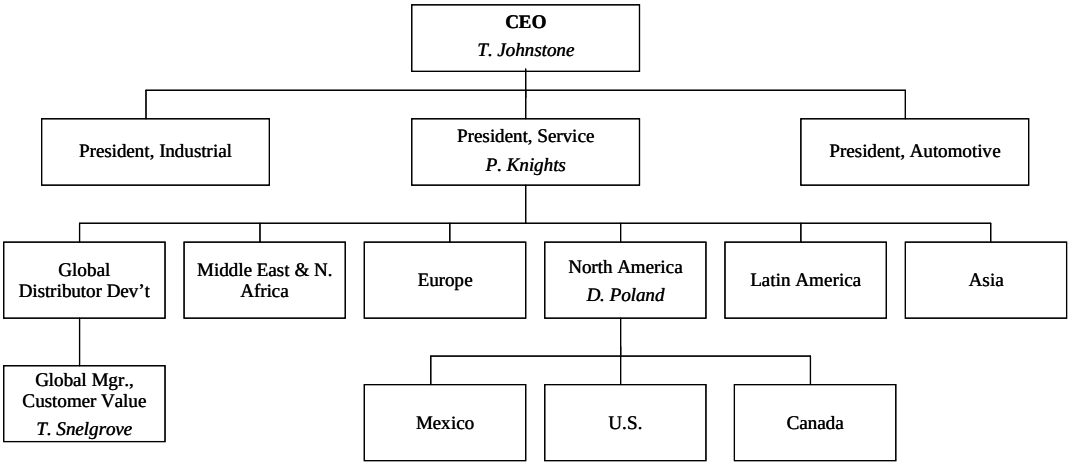
Tapered Bearing Unit for Trucks

Spherical Roller Bearing for Steel

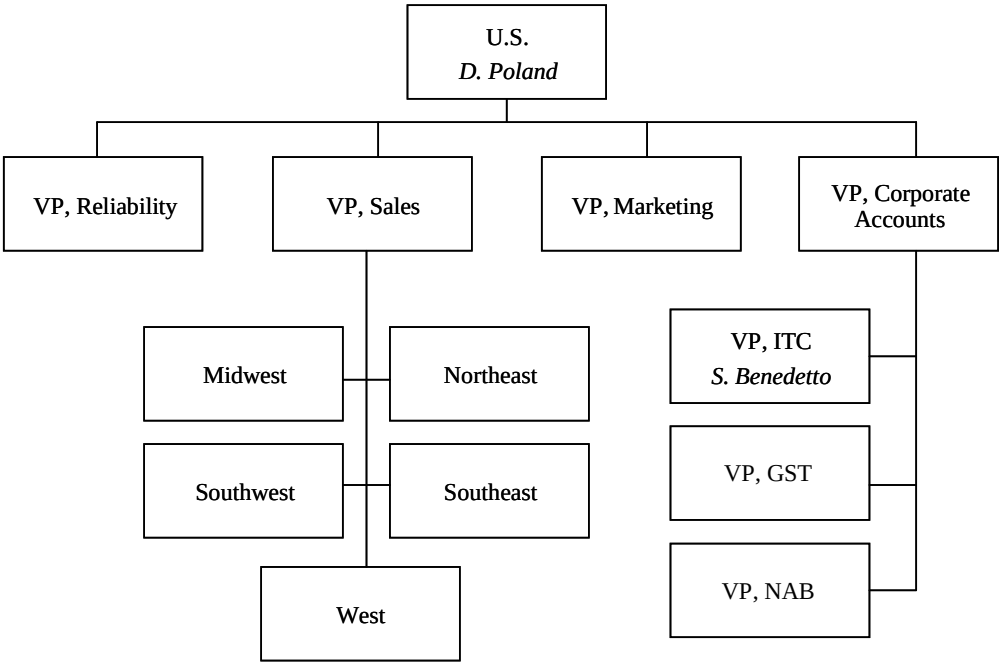
Source: Company information

Exhibit 2
SKF Partial Organization Charts*

SKF Group



SKF Service North America



*These charts are a partial representation of SKF Group, only featuring units discussed in the case.

Source: Company information

Exhibit 3
DSP Case Study

RETURN ON INVESTMENT (ROI) SUMMARY

Pump population (in units) **523**

Reduction in pump failures
(increased MTBF* from 18 to 54 months) ..... (fewer failures) **1,046**

Cost of failure:
Components
($11,916.60 per pump x 1,046) **$12,464,764**

Labor
(4 staff x 7.5 hours per pump x $38.00 hours x 1,046 ..... **$1,192,440**

Total cost **$13,657,204**

SKF solution investment (price differential on bearings,
alignment tools, condition monitoring, training) **$2,287,677**

Net benefit **$11,369,527**

SKF solution ROI over 54 months
(net benefit/SKF investment) **497%**

**MTBF = Mean time between failure*

Source: Company information