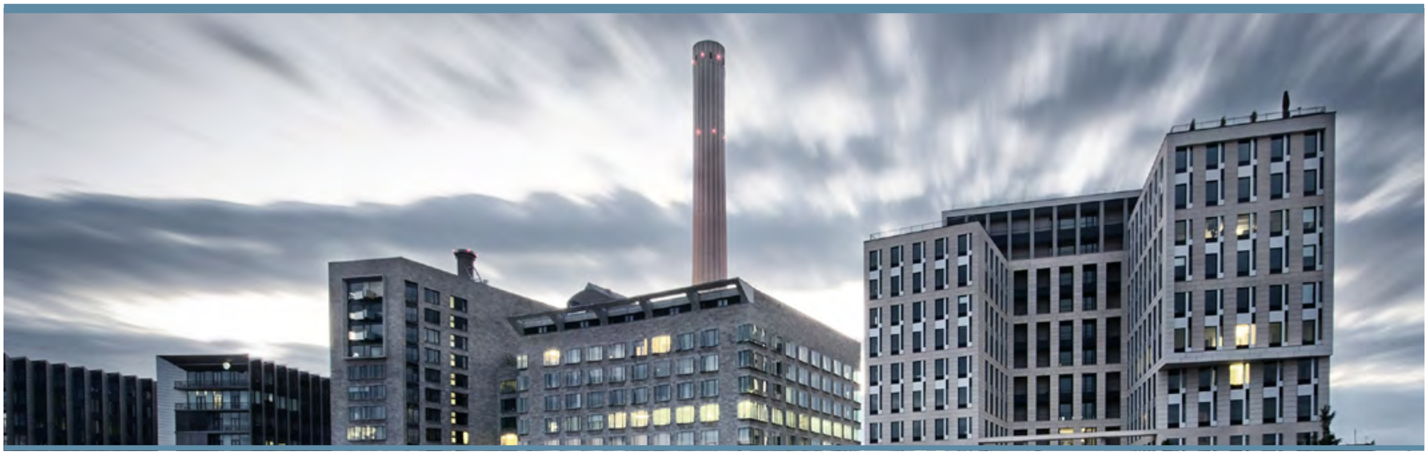

Executive Insights

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Developing Your Industrial Edge

One common theme that we hear as we speak to executives at industrial companies is the enormous challenge they face in achieving growth. Perhaps they are exposed to the depressed oil & gas or agriculture sector, or perhaps they are facing the export headwinds associated with a strong dollar. Most commonly, they see that the general industrial economy has experienced only very modest growth overall during the past five years.

In response to this core market growth challenge, many companies are turning to adjacent markets as a source of growth. However, this growth path presents a host of challenges. By definition, adjacent market opportunities involve moving into new product categories, channels or geographies that are unfamiliar. With each step taken farther from their core market, companies face new risks and aggressive incumbents that will not cede share easily.

An alternative path exists that involves far less risk and potentially far greater return. This alternative involves exploiting opportunities that lie at the edge of your current market offering, opportunities to capture incremental profits with the customers you have already won and assets you have already developed.

We encounter these "edge opportunities" in our daily lives. Recall the last time you purchased an electronic device and were asked if you wanted to sign up for the protection plan, or when you sat down to eat a prepared meal in the café section of your local supermarket. As in these examples, there are many opportunities within industrial companies to create incremental profits by presenting customers with additional offers that surround the core product or service that defines your business.

We call this an Edge Strategy® mindset. Unlike other, more familiar strategies, an Edge Strategy approach focuses on gains that are easily within a company's grasp. It shines a new light on the latent leverage that companies have, but of which too few take advantage. Looking around for new bets, companies tend to overlook the fact that a significant, untapped source of profit exists in the near field — on the edge of the core — through the sale of ancillary goods and services that make existing customers' interaction with the business more complete.

We call this a *mindset* because often the information that inspires an edge opportunity is familiar to us. Our traditional organizational model and incentive structures tend to steer us in a familiar direction: drive revenue. Many edge opportunities are inspired by observing how some customers have needs not fully met, or certain goals beyond how our current offer supports them.

Most industrial companies are organized to win core business, drive sales volume, and protect and grow prices. We incentivize

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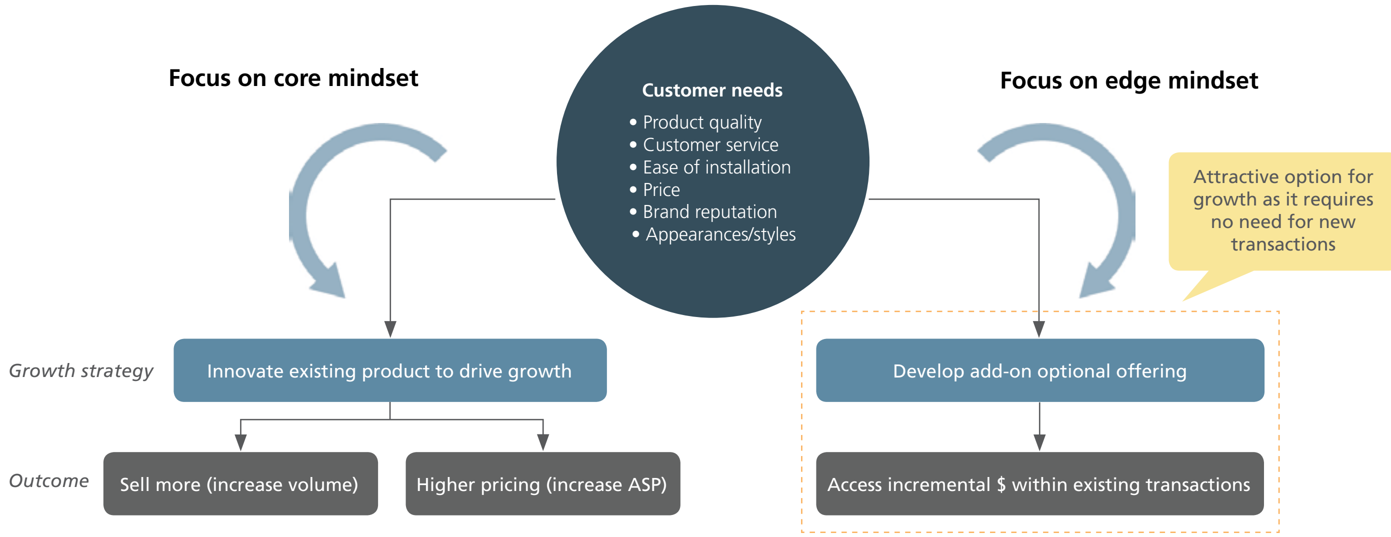
Figure 1
Advantages of focusing on an edge mindset



Source: L.E.K. research and analysis

our managers to do this. So when companies see unmet needs, they figure out how this can be used to address the core goal … drive volume and price. An edge mindset requires the practitioner to interrupt this reflex and instead ask, What incremental options could I offer that my customers would pay for over and above the core sale? (See Figure 1.)

The Edge Strategy concept is extremely relevant for industrial companies; those confronting enormous challenges — like commoditization — in achieving acceptable growth are tempted to move increasingly far afield in that pursuit. Too often this pursuit focuses on ways to make big top-line impacts, ignoring the bottom line. An Edge Strategy approach is both a path to bottom-line growth and a weapon that helps companies fight commoditization.

Three Edge Strategy approaches

Industrial companies seeking edge opportunities can often find them in the following categories:

Edge-based customization. If you have ever purchased any bespoke product (a suit, a custom home, etc.), you have experienced the value and paid the price that come with customization. However, the problem with a fully custom business model is that there are fewer scale efficiencies, and there is often a need for more skilled (and more expensive) workers. Edge-based customization offers a way for companies to customize product or service offerings without disrupting the core business model.

For example, take Masonite, a $2 billion manufacturer of residential and commercial door slabs. It had the insight that some builders and general contractors increasingly wanted more diverse sizes and shapes of doors. Rather than expanding its product line in an effort to meet this need, Masonite developed an online door configuration platform whereby a customer can pay a premium to configure doors to the desired specification (style, width, height). By offering an easy-to-use, customizable door upsell offering, Masonite is able to achieve incremental profit in meeting this growing need of its customers. In addition, Masonite's strategy establishes a direct relationship with the end customer, thereby enabling the company to capture more of the profit pool, given that the majority of the door components (such as the frame and the slab) are manufactured by Masonite. By combining this strategy with additional local support for end customers (for example, by opening fabrication centers), Masonite is able to successfully extend downstream to capture more value — including value traditionally captured by the channel — while limiting downside associated with inventory risk. Through edge-based customization, Masonite has captured not only incremental profits but also overall market share.

Edge-based solutions. Solution selling focuses the customer value proposition on completed outcomes, rather than feature sets. Focusing on feature sets often leads to haggling over the price of features and benefits that are often easily lost to the competition. One of the key value drivers of solution selling is that it migrates the customer from a transactional mentality to a broader customer-mission mindset. This is especially powerful in markets that are prone to commoditization pressures. It allows the company to utilize a service element to pull through more core products while serving a customer's higher-order need — one that involves accomplishing the company's core mission.

Fastenal — a $4 billion industrial distributor with 2,500 stores and 400-plus on-site locations — provides a great illustration of an edge-based solution, one provided through their accredited calibration and lab testing service. Traditionally, Fastenal competed on the breadth of its fastener product offerings, but the company was primarily focused on selling product. As Fastenal built its catalog, it also built an asset base of equipment to test the quality of Fastenal products (measuring such factors as fastener strength under various use cases, surface hardness and corrosion performance). The testing equipment was highly underutilized. Fastenal recognized an opportunity and opened an in-house accredited calibration and testing lab for customers — providing them with complete mechanical and chemical fastener analysis. Using the service provides customers the assurance they need that the fastener meets or exceeds the requirements for the particular job. By utilizing an asset that was already required for its core business, and offering to sell customers "peace of mind" on the outcome, Fastenal was able to create a high-value customer service profit stream at very low cost and with limited risk.

Edge-based bundling. A variety of industries generate enormous value by offering ancillary products and services on the edge of their core offering. Think of movie houses that sell popcorn or concession stands at the ballpark. Businesses approach how they sell such products and services in different ways. Some choose to bundle ancillary offerings — for instance, resorts sell VIP packages that include ground transport, spa treatments and premium beverages in a single purchase. Others offer a la carte edge options — for example, rental car companies offer customers a menu of discrete add-ons that include rental insurance, prepaid fuel, GPS, child seats and more. Both pricing approaches can be successful. When should a company look to pursue an edge strategy bundle? We recommend considering it when the following three characteristics hold: 1) the bundle's complexion and value proposition are complementary and instantly clear to the customer group being targeted, 2) the bundle is profitable and contains some selling synergy or amortizes a fixed cost required for the core offer, and 3) the core purchase decision is a major discrete sale and the bundle can help reduce complexity.

Vestas — a €10 billion manufacturer of wind turbines — offers a clear example of edge-based bundling through its fleet optimization service platform. This program offers customers the option to add additional features to the base wind turbine platform to drive incremental efficiency. Vestas charges extra for these additional features, which drives an increase in revenue per customer. For example, the TurbinePlus™ offering provides customers the option of adding upgrades around efficiency (e.g., automatic lubrication of the yaw ring), protection (e.g., blade surface, leading edge, fire and lightning) and/or compliance (e.g., bat mitigation system, shadow detection). Additionally, Vestas offers its PowerPlus™ service that delivers site-optimization/tuning to drive up to 5% more power through software algorithms. These services can be provided at the time of purchase but also serve to diversify the company's revenue stream with aftermarket sales. Including Vestas' other service offerings, service revenues now total more than €1.3 billion, or more than 13% of total company revenues, and deliver meaningful profit margin.

Unlocking value from existing resources

Beyond these core edge strategies, another edge trend that companies are pursuing is to leverage their proprietary data. This can be data that was already being captured as part of their core services or, with the advent of low-cost sensors and cheap data storage, new data created by adding sensors or other data-capture devices to their products. Before, they might have viewed this data as just a byproduct of the core business. But leading companies are now finding ways to leverage this wealth of information — both to develop an ancillary service offering or revenue stream and to develop differentiated capabilities that help them achieve stronger and stickier relationships with customers. Take Caterpillar, the global industrial equipment company. Today, if you buy a vehicle from the company, chances are that hidden inside are dozens of sensors. For an ongoing service fee, Cat will unlock the stream of operating data these sensors provide for its customers. This not only accesses new revenue but, more interestingly, also totally changes the nature of the company's relationship with its customers, moving from transactional to product lifetime engagement.

Teletech is a global business process outsourcing company. The business operates call centers and other outsourced business services in 14 countries across various industries. The company had always captured data on the end customers and contacts who had dialed in to its call centers. In 2010, however, the company acquired a majority stake in Peppers & Rogers Group, a customer experience, thought leadership and consulting firm. Drawing on the combination of this experience and capabilities, Teletech began offering a range of consulting services along with its outsourced model. In one case study, Peppers & Rogers helped an entertainment/technology retailer develop an online self-service platform to reduce call numbers and improve customer service. The company leveraged the data it had captured as a result of managing the client's technical customer-service calls to identify the most frequently asked questions and issues. Teletech was then able to create a platform with sophisticated Q&A matching technology that used natural query language, which allowed customers to self-service online. This led to a reduction in managed calls. Under the new system, 87% of questions could be addressed by the online platform.

Steelcase is one of the largest office furniture manufacturers in the world. As part of its product development and innovation work, the company conducts a number of experiments in its own offices to try to understand how people prefer to use and interact with their office furniture and office spaces. With the advent of the Internet of Things (IoT), that innovation work now includes adding low-cost IR and movement sensors and data capture devices to products. Tying this new sensor data with calendar appointment data generates greater understanding about which room and product configurations are preferred.

After first using these data capture and analytic techniques internally, Steelcase, like Caterpillar, now offers ongoing services to customers. These workplace advisor services collect and analyze client-generated data to provide organizations with meaningful insights about how their people work and how their workplaces can be redesigned to support worker preferences. For companies that are moving or are developing new office space, Steelcase can arrive before the transition and install sensors on furniture, equipment and office spaces. The information is incorporated into the development of the new space. The company also offers longer-term data analytics and tracking, where companies permanently install sensors in their office space to help ensure they are using their equipment and resources efficiently, and are able to adapt their spaces to best meet their employees' needs.

Conclusion

To exploit your company's industrial edge, take these three steps:

1. **Edge Strategy development.** The first step involves addressing a variety of key questions about your customers and your operations. These include:

    - Are there customer segments that would be willing to pay a premium for a broader product or service offering?
    - What unmet needs do customers have? For example:
        - o Extended warranty
        - o Guaranteed delivery timing
        - o Installation services
    - Is there a premier solution or offering that larger customers can access to improve margins or minimize switching to the competition?
    - Do you have underutilized physical assets?
    - Does your production process create byproducts that you are not fully monetizing?
    - Do you have or could you easily create scalable assets, such as expertise or data that could be leveraged to offer a new service solution?

    Answering these and other questions enables companies to probe for and develop unique offerings around the edge of their operations.

2. **Edge Strategy planning.** The second step is to develop a business plan to implement the identified edge strategy. The advantage here is that because, by definition, this opportunity is close to current operations, the actions needed to implement this should be reasonably familiar.

3. **Edge Strategy activation.** In order to realize the value of an edge strategy, careful attention must be paid at the implementation stage. This is because, unlike many growth investments in manufacturing or new product development, Edge Strategy approaches tend to touch many different parts of an organization. It may need to involve finance, IT, manufacturing, etc., but none may end up being wholly accountable for the final result. Therefore, this approach often requires forming a special-purpose team to drive success. Sometimes, while the bottom-line impact is big, the top-line change may be modest; this can result in bias in the organization that must be overcome, as some may seek to deprioritize the edge move.

For companies in industries hard-pressed to maintain growth, Edge Strategy is the smart choice. It addresses the risk of slow growth and commoditization while avoiding the other extreme — the risk of lost time and lost capital that can result from pursuing adjacencies that are too far afield from the core business and where it is too hard to displace incumbents. Edge Strategy enables industrial companies to create new value and realize new growth by building on the things they already do well, and satisfying the customers they already serve.

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