

## Money for Nothing

I confess to sometimes listening to oldies stations on the satellite radio in my car. Last week, a gem popped up: Dire Straits' 1985 Grammy-winning chart-topper, *Money For Nothing*. The song is written from the point of view of a working-class guy unloading boxes in the TV department of an appliance store. As the verses go by, it becomes clear that he is watching an MTV video of some over-the-top heavy metal band – rumored to be Mötley Crüe – and growling his disapproval:

*Look at them yo-yo's that's the way you do it  
You play the guitar on the MTV  
That ain't workin' that's the way you do it  
Money for nothin' . . .*

The song's title came back to me recently when I was thinking about a company called Home Service USA, a subsidiary of the U.K.-based HomeServe plc. You might well have never heard of this Miami-based enterprise or its U.K. parent. In fact, you've probably never even heard of HomeServe's rarely-discussed industry: the home-warranty business.

Basically, companies like HomeServe sell warranties to homeowners on one or more systems in their homes. HomeServe has grown aggressively in recent years by buying up a range of existing home-warranty companies, and steering those acquired companies into its highly profitable niches. While it has competitors, HomeServe is unique in part because

– unlike competitors who rely on real estate firms, banks, and other companies to reach new customers – it markets *only* through large utilities.

An example of one of the more creative offerings from HomeServe is insuring the external wires that connect your home to the electric grid. They market to the customers of third-party utility partners, using mostly letters (and sometimes inserts in your utility bill) that are co-branded by both HomeServe and the utility. When a wire fails or is damaged and needs repair or replacement, HomeServe commits to engage a local contractor to fix the problem. True, individual consumers pay only a few dollars a month for such a warranty, but when the customer base gets up into the hundred of thousands, or millions, that revenue stream gets to be quite lucrative. For example: this past April, HomeServe signed a long-term marketing agreement with National Grid, giving it marketing access to that utility giant's five million customers. Once a customer has signed up for one of HomeServe's basic services, they can try to sell on additional products that often end up multiplying the per-customer revenues.

But what's really clever about some of HomeServe's offerings is that the company almost never has to pay out. Most people are aware that power lines get hit every so often by falling trees, or suffer other kinds of storm-related damage. But a homeowner is only responsible for the power line between the meter and

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*Money for Nothing* was written by **Stuart Jackson**, Vice President of L.E.K. Consulting and author of *Where Value Hides: A New Way to Uncover Profitable Growth for Your Business* (Wiley 2007). This article is © Emerald Group Publishing Limited and first appeared in the *Journal of Business Strategy*.

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the edge of the property. The chances of that line being damaged at any given house are extremely low. And even in the unlikely situation that something does go wrong, your electric company is not going to want to let an unsafe situation go unfixed, and it certainly doesn't want to lose income as a result of you being unconnected. Most likely, they'll fix the problem in a hurry, and they probably will not charge you for it.

So, arguably, revenues derived from warranties on home exterior electric lines really are "money for nothing." Nice business when you can get it, but what are the possible lessons for other companies?

For one thing, it is always worth looking for goods and services where there is a large disconnect between the perceived value by customers and the cost to supply. Insurance products and service contracts frequently fall into this category, because there is often a large asymmetry in information and risk perception for suppliers and customers. This can be true whether you're selling guaranteed service and repair of homeowner electric lines for \$5 per month, or guaranteed service and repair of aircraft turbine engines for \$5000 per hour of use. Companies as disparate as GE (capital equipment) and Best Buy (consumer electronics) often make more of their profits from selling service contracts than they do from selling the equipment itself.

Of course, selling service contracts has to be about more than persuading customers to buy something they don't need. One of the things I like about service contracts is that they can start to lock-in customers to your organization, allowing you to build scale and efficiencies that competitors find hard to match. With its well-designed service contracts for capital goods such as power plants, aircraft engines, and medical equipment, GE effectively shuts out independent repair and service organizations. This allows the company to build more scale efficiencies in service operations, more information on failures and how to manage them, and a better overall value proposition for its new equipment sales.

Other good things happen, too. For example: as you sign up new accounts, you are both building a valuable data base of customers and creating a reason to keep in touch with them. Depending on the nature of your business, there may well

be adjacent business offerings into which you can lead your existing customers. With some kinds of service contracts, the customer can build up a reserve, which will fund a replacement when the equipment becomes worn out or obsolete. When that time comes, who better to supply the new equipment than the company that helped plan for and fund the replacement?

Here are a few rules of thumb for getting into, and succeeding in, the warranty and service plan business:

- **Create awareness of potential losses.** Are you sure that there are no termites gnawing away at those wooden timbers that hold up your house? [Insert appalling photo in your mailer:] *Just look at what a determined colony of carpenter ants did to this poor fellow's home!* Do you have any idea what it costs to refurbish an NMR imaging machine? *Just think what that would do to your departmental budget over-run (and your prospects for promotion)!*
- **Lower the barriers to sign-up.** Try to keep the cost below the customer's pain threshold, if necessary by making it a monthly amount instead of a lump sum. Work with other marketing partners. If you can turn yourself into a check-off box on a mailing from a vendor that your prospective customer trusts, the commission may prove to be a small price to pay.
- **Make it an easy add-on.** This pertains mainly to capital goods – that washing machine at Sears, or that TV at Best Buy – but it also has broader implications. At the time and point of purchase, the customer is shelling out big bucks, and probably feeling some anxiety about that. This is a good time to offer some (inexpensive) reassurance! For higher cost items such as business equipment or even a Sub-Zero refrigerator, a monthly plan may make sense.
- **Take good care of the front-line troops.** If there's a sales force involved, make sure that they are fully motivated to sell *your* service, as well as the washing machine. Retailers already understand these economics very well. Of every dollar of extended warranty that gets sold in the appliance department, fully *fifty cents* go to the retailer. Twenty cents go to the repair network. The rest is gross margin for the service plan administrator.

- **Make it self-renewing.** Another very attractive aspect of warranty and service plans – again depending on the specific circumstances – is that they can be structured as an ongoing commitment. In other words, you can make continuation of the policy the default mode. When the consumer has to actively *opt out* of a commitment, that commitment is likely to be a durable one.
- **Trade on your good name.** If you're a company with a strong reputation for quality and straight-shooting, why not get a tangible return on that good will? Industrial distributor W.W. Grainger offers a three-year extended warranty on everything it sells. This generates more good will and – no doubt – a welcome revenue stream. Maybe I'm overly sensitized to this topic, but I just got a catalogue from The Sharper Image, and I'm wondering why they *aren't* making me this kind of offer.

Who can participate in these warranty and service opportunities? I think there's almost unlimited potential out there. I'm wondering why my cash-starved municipality isn't offering revenue-generating warranties on those new lead-free water lines they're installing all over town, and why the local black-top guy isn't offering revenue-generating warranties on his driveways. True, not everyone is going to want these service plans, but for those that do, why not offer them the opportunity?

When you fail to pursue an opportunity to provide a service to your customers that they value – and on which you can make great money – then maybe you really are turning your back on *"money for nothing."*

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