A Practical Guide to Combining Products and Services

by Venkatesh Shankar, Leonard L. Berry, and Thomas Dotzel

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The Idea in Brief

• In tough economic times, companies need new ways to innovate and drive revenues. By combining a product with a service, or vice versa, firms can improve their bottom and top lines. However, if a hybrid offering is to be successful, managers need to understand which of four potential combinations is most appropriate.

• A “flexible” product-and-service combination allows buyers to customize their purchase. A “peace-of-mind” bundle offers the best of breed in both the product and the service. A “multibenefit” bundle offers customers an increasing number of add-on features or benefits. A “one-stop” bundle focuses on convenience shopping.

• Four rules help managers discover which hybrid combination is most likely to be successful for their firm.
A Practical Guide to Combining Products and Services

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Here’s a cautionary tale: In 2004, when online video provider Akimbo decided to combine a set-top box with a movie-downloading service, it seemed like the perfect offering. The product and service were inextricably linked—one was worthless without the other. Sales of the DVR would drive a steady revenue stream from subscription fees, and customers wanting the convenience of downloading videos would have to invest in the hardware. But the company stumbled when it priced the less-valued component of the bundle, the set-top box, at a high $199, without understanding that the real profit potential was in the downloading service. Things went awry when the company charged users for its movie service. The shows were not top quality, and customers resented having to pay for them on top of what they’d already paid for the high-priced box. The offering failed, and the company went out of business in 2008.

These days, many firms are trying to mix products with services in an effort to boost revenue and balance cash flows. Hybrid solutions—products and services combined into innovative offerings—can help companies attract new customers and increase demand among existing ones by providing superior value. Such offerings are commonplace—think Apple (the iPod product combined with the iTunes service) and Xerox (copiers and printers bundled with maintenance or customer support services). For these and many other companies, hybrid solutions have spurred growth or helped reverse market-share or profit decline.

While the promise of combined offerings is great, it’s easy to get them wrong. The problem is that too many companies, expecting to catch the brass ring, don’t think through exactly how to structure, market, and sell their combined offerings. Over the past three years, we have analyzed more than 100 winning hybrid solutions from a variety of business-to-business and business-to-consumer companies. Our research shows that most of them stumble in one or more of four ways: failure to differentiate; failure to scale; failure to
assess markets and prices appropriately; and failure to invest in the brand.

Before we look at these factors, let’s consider the common types of hybrid offerings.

**Common Hybrid Offerings**

Two underlying characteristics determine how customers will value and use an offering. The first is complementarity, or the degree to which the value to the customer increases when the product and the service are used together. The iPod and iTunes, for instance, are highly complementary. The other is independence. Some goods and services are highly dependent (a customer cannot derive any value from an XM Satellite radio without subscribing to the XM Satellite communication service) and therefore must be bundled together. Other products and services are relatively independent: A copier will function whether the customer purchases a service contract or not. Products and services that are highly independent are traditionally sold separately.

When products and services are examined through the lens of complementarity and independence, the following types of hybrid offerings emerge.

**Flexible bundle.** This type is best suited to complex products and services that address thorny customer problems. The products and services themselves are highly independent (customers could easily buy them separately), but they are also highly complementary (their value can be significantly enhanced by combining them in flexible ways). Take Oracle on Demand. Known primarily for its packaged database software products, Oracle also offers a consulting and management service for customization of the product that allows companies to get the most value out of their Oracle investments. The hybrid has boosted Oracle’s growth: Revenues from the service component of Oracle on Demand grew by 75% from 2006 to 2008, and services now account for about 20% of Oracle’s total revenues.

**Peace-of-mind bundle.** This type appeals to customers looking for the assurance that they are getting a complete, best-of-breed offering. Despite the low complementarity and high independence between the product and the service, companies can leverage a strong product brand to attract customers to an otherwise undifferentiated service, or vice versa.

Take elevators. Typically, a building owner or contractor purchases an elevator from one company and then hires a service firm to do the maintenance. By combining high-quality elevator equipment with a premium service, Otis has powerfully differentiated itself from its competitors, which are typically strong in one area or the other, but not both. Customers that are familiar with Otis as a leader in elevator manufacturing feel comfortable in the hands of its service organization. Otis attributes 90% of its more than $1 billion in annual operating profits from 2002 to 2008 to the addition of the service component.

**Multibenefit bundle.** Here, the products and services are often inseparable. Because the hybrid is already highly complementary and dependent, the benefit to the customer, and to the company’s bottom line, comes from offerings added to the basic one. For example, TiVo’s product (the digital video recorder) is useless without its service. TiVo differentiates its offering and makes its money through add-on services that let users stream from YouTube, record in high definition, download music, view on-demand movies, and so on. At least a dozen competitors have introduced DVR-subscription hybrids; thus far, TiVo has maintained its position by offering a more attractive slate of services. For the fiscal year ending in 2008, about 83% of TiVo’s $273 million in revenue came from services.

**One-stop bundle.** This combination does not provide additional value in itself; rather, customers are attracted by reliability of service and shopping convenience. Although the products and services are minimally complementary and independent, companies increase their share of wallet simply by making products or services available at the point of sale. Regis Corporation, a $2.6 billion hair care company, owns more than 13,000 salons worldwide, including Sassoon, Supercuts, and Mastercuts, where it sells hair care and beauty products. Customers’ service experience may not be greatly improved by buying these products, but customers value the convenience and the recommendations of their stylists.

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**Developing Your Offering**

Developing hybrid solutions can be tricky because various combinations may have potential. A hybrid offering is most likely to yield sustainable returns if the dependence

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If you have a trusted product brand, the untried service component will benefit from the “halo effect.”

between the product and the service can be increased and if the offering is scalable. In evaluating options, companies should keep in mind four rules related to differentiation, scalability, pricing, and branding.

**Rule 1: Look for points of differentiation in product and service markets.** The first step in thinking about a hybrid offering is to carefully examine the barriers to entry in your target market. Consider the following questions:

*What is the degree of commoditization?* If your product is highly commoditized, look for a way to enhance its value through the addition of a high-quality service, or vice versa. (This is particularly relevant for flexible and peace-of-mind bundles.) Xerox, for example, found that competing on equipment alone was becoming harder as competitors such as Canon and Ricoh began making comparable copiers and printers at much lower costs. Leveraging its deep knowledge in solving customers’ document-related problems, Xerox launched a consulting service in 2007 that helps customers publish documents, manage documentation budgets, and secure important information.

*Is the customer’s problem complex?* Hybrid solutions that address difficult problems are likely to create sustainable advantage, not only because they are hard for competitors to imitate but also because they increase switching costs. If the problem your customer faces is complex, consider a flexible bundle that offers a customized solution. Although companies such as EMC, HP, and Dell offer powerful storage devices, IBM has carved out a niche with its customized Storage Area Network (SAN) service, which allows customers to connect to local networks of data warehouses.

*Can the quality of the service be improved?* While performance of a product may not vary much, human service can be highly uneven. Try pairing a commoditized product with reliable, consistent, and quality service to better differentiate your offering. If you have a trusted product brand, the untried service component will benefit from the “halo effect.” Companies like Apple, Xerox, and IBM have leveraged—and improved—brand credibility by pairing highly trained service teams with product offerings.

**Rule 2: Scope the service and scale the product.** A hybrid solution will improve market share and profitability only if it is scalable. When Gillette comes out with a new razor, it achieves scale through mass production and distribution. But razors are straightforward products; more complex customer solutions require blended services that are difficult to scale. Smart companies find ways to build economies of scope—for instance, different services can be performed at the same location at low overall cost. Regis has successfully scaled and scoped both its products and its services. By offering services including haircuts, facials, and head and neck massages at its locations, it has spread its fixed costs of service delivery and customer acquisition. At the same time, it achieves economies of scale for products through centralized purchasing and production. Regis’s average gross margin on hair and beauty products (about 49%) exceeds that for services (about 42%). In 2007, about 30% of Regis’s profits came from goods, up from 25% in the previous year.

In thinking about scale and scope, ask yourself the following questions:

*What can be centralized?* People-intensive services have to be very productive if you are to make money. Think about how to put various services in one location. You can also scope service delivery by providing centrally administered remote or online services (sales, maintenance, installation, and technical support, for example). If services cannot be delivered from a central location, consider offering employees a variable compensation plan that rewards them according to sales volume.

*Can the service be digitized?* To enhance scalability, look at options for putting components online to lower the total unit cost of the offering. Use the internet to reinforce the linkage between the goods and the service. GE Healthcare, for example, pairs its low-cost AssetPlus web-based software with its expensive diagnostic-imaging equipment and biomedical devices. AssetPlus allows the customer (typically a hospital) to track and manage inventories of GE medical equipment and devices, schedule servicing, and follow regulatory requirements online. GE uses it to access customer data and offer technical support, thus shortening service response times and increasing efficiency. Once customers start using and benefiting from the service, their switching costs for the equipment rise. Today, the service component constitutes roughly 37% of GE Healthcare’s revenues.
Rule 3: Assess the revenue and profit potentials of various hybrids. Once you have explored different combinations of goods and services, carefully analyze the markets for each. Consider the following questions:

Which half of the offering has the most profit potential? The relative market and profit potential can be quite different for goods and services, depending on the context. One way to create a winning hybrid offering is to identify which product or service has the highest profit potential and combine it with the most commonly purchased product or service. For example, the market for digital music or MP3 players (products) is huge, but that for music downloading (services) is even bigger. By marketing the iTunes store together with iPod, Apple has substantially expanded its revenue stream. However, the profit margin for digital music is smaller than that for the player, so Apple makes most of its profits through the iPod.

How often do customers repurchase either goods or services? Typically, products have longer purchase cycles than services do; a consumer may buy an MP3 player every three years but buy movies and music far more frequently. If you balance the timing and magnitude of cash flows from the product and the service, you can improve the success rate of hybrid offerings. Apple balances its cash flows from customers by selling new and frequent services through iTunes (some of which are designed for the next generation of iPods), thus accelerating their next iPod purchase. Cell phone providers also use hybrids to balance cash flow. By offering a hybrid that combines unlimited text messaging with a high-end handset, cellular phone service providers can front-load cash flows with one high payment for the product and back-load with periodic small payments for the service. Hybrid offerings, especially multiple-benefit combinations, have a better chance of success if you hedge between the product and service purchase cycles.

Which should lead the customer purchase, the product or the service? Especially for a one-stop bundle, it’s often best to lead with the product or service that customers choose first. Many cell phone providers, for example, offer their telecommunications services and a choice of different brands of handsets, including their own. In the U.S., customers typically choose the brand of service first and then pick the handset brand. Because their reputations are built on service, successful hybrid providers like AT&T and Sprint exploit this order of choice to more effectively sell their own branded handsets.

Rule 4: Invest in the brand. Once you have identified a viable hybrid offering, consider branding or subbranding it to leverage the halo effect. Be prepared to invest in branding activity that promotes the link between the product and the service and enhances the company’s credibility. Brand investment is particularly important for hybrid offerings with a high degree of independence. For example, IBM’s sustained investment in brand building has enabled it to successfully enter the computer storage market. Although IBM is not the leader in storage technology, it is a global powerhouse in IT services. By buttressing its hybrid solution with the IBM brand, the company has been able to transfer the positive attributes of reliability, quality, and competence from the service to the server product and make its $400 million investment in this innovation pay off.

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For a hybrid offering to be successful, firms must decipher which products and services work best together and present the most upside. If commoditization of the product or service is low and the customer problem is complex, a flexible bundle may be the ideal hybrid offering. If commoditization is high but the product or service is scalable, go for a peace-of-mind bundle. If revenue potential for the product or service is high but the purchase cycles of the product and service are far apart, you may want to opt for a multibenefit bundle. But if revenue potential is low and you know which components customers choose first, lead with those in a one-stop bundle.

As companies look to the future, they will need to pay more attention to hybrid offerings if they want to increase their top and bottom lines. Hybrid offerings attract new customers and improve demand among existing ones by providing superior value. They enable firms to boost their revenue and profit streams and improve liquidity at low risk. The rules above can help you identify successful hybrid offerings.

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