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Service innovation in a digital world

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New digital upstarts are threatening the bottom lines, growth prospects, and even business models of traditional service providers. It's time for incumbents to innovate—or be left behind.

A growing number of companies are finding their service businesses under threat. The culprits are members of a new wave of digital upstarts that capitalize on changes in technology, customer behavior, and the availability of data to create innovative, customer-friendly alternatives to the services incumbents offer. Indeed, the sorts of digital disruptions that began in retailing with the likes of Amazon, two decades ago, are fast coming to an industry near you—if they haven't already. Examples include Uber and Zipcar in transportation, Airbnb in hotels and hospitality, AngelList in venture capital, and Castlight Health and Healthgrades in healthcare. Attackers such as these may be small now, but they represent a growing challenge to traditional companies.

The attackers also highlight an uncomfortable truth: large companies rarely put as much sustained effort and management attention into transforming services as they do with products. Imagine the reaction of a time traveler from 50 or even 20 years ago upon visiting a contemporary hospital. The medical devices, tools, and products available to physicians would be largely unrecognizable, but the service experience, in many cases, would be largely the same. The service inertia big companies often suffer is understandably hard to shake. Change is difficult with a large base of legacy assets optimized for a certain way of working, as well as a large, distributed workforce steeped in the status quo. The incremental approach many companies take to improving services doesn't help; processes that grind out small, steady cost reductions rarely deliver breakthroughs.

Nonetheless, some incumbents are fighting back successfully. These companies are learning from the attackers while mobilizing their own strengths—including scale, superior resources, and access to customers—to redefine service offerings, harness digital technology, and improve the customer experience. Some are lowering their costs as well. While few organizations have mastered the new environment, we can already see that winning approaches will combine three elements:

1. a focus on service innovation matching the intensity and attention that product companies bring to R&D

2. the ability to personalize the customer experience and to help customers do things themselves

3. the will to simplify (and in some cases automate) the way services are delivered

To pull all this off, companies must find more collaborative ways of working to ensure that they remain focused on their customers, not their own internal processes. A closer look at how the environment is changing and what leading companies are doing about it should stir the imaginations of a wide range of organizations struggling to adapt to a more digital and competitive world.

The new service landscape

The nature of services and the pace of change have shifted dramatically in recent years, and mastering the traditional aspects of service delivery will no longer be enough. To seize the opportunities, companies must learn to tap the potential for service innovation made possible by four evolving trends.[1]

[1] In addition, artificial intelligence and robotics represent intriguing developments that appear poised to make their way from manufacturing to services. For more, see "Robots mean business: A conversation with Rodney Brooks," on mckinsey.com.

Higher customer expectations. More than ever, consumers demand greater involvement, customization, personalization, and mobility from services—with immediate results. When they see cutting-edge service innovations in one industry, they expect to find them in others as well; witness the spread of self-service kiosks from airline check-ins to the retailing and hospitality industries. As industry boundaries increasingly blur for customers, companies must look for new ideas beyond their immediate rivals.

The rise of the mobile Internet. About 1.5 billion smartphones are currently in use worldwide and more than 100 billion apps were downloaded in 2013, up from 64 billion in 2012.[2] The resulting mobile and self-service possibilities are transforming service delivery. Uber's disruption of the taxi business is just one prominent example. Advances in digital payments are increasingly spurring mobile commerce, with far-reaching implications in financial services and retailing. Remote access and monitoring in healthcare are also potential game changers made possible by increased connectivity. The proliferation of smart devices unlocks growth opportunities, reduces the cost to develop services, and dramatically lowers barriers to entry.

Big data and advanced analytics. Companies such as Amazon and Harrah's are known for using customer data to personalize and tailor their services. Continued advances in analytic capabilities allow companies to draw insights from massive, previously untapped sources, leading to new service possibilities. SATMAP, for example, is a software solution that uses advanced analytics to improve service in call centers. It helps companies match callers to service agents with appropriate personalities, resulting in higher rates of customer satisfaction and service-to-sales conversion.

The Internet of Things. Pervasive machine-to-machine (M2M) connectivity[3] is already facilitating real-time service delivery in a number of B2B applications, such as the sensors GE uses in aircraft engines to monitor performance and improve the efficiency of maintenance. In the B2C space, Nest (recently acquired by Google) uses M2M connectivity to link its smart thermostats to other home

[2] For more, see *Forecast: Mobile App Stores, Worldwide, 2013 Update*, Gartner, September 2013, gartner.com.

[3] Embedding sensors and actuators in machines and other physical objects to bring them into the connected world.

devices, including washing machines and personal-fitness bands, thus positioning the company as the network hub in a digitally connected home. The prevalence of connected devices opens up possibilities for proactive, even “touchless” service, as well as new commercial models quite unlike the traditional fee-for-service one.

Three imperatives

The benefits of mastering these shifts will be significant. Services, which currently represent about 65 percent of global GDP, are expected to account for about three-quarters of global growth over the coming decade. Companies that evolve quickly will better position themselves to capture this growth, while those clinging to traditional models will face growing pressure from digital attackers. To meet the challenges, forward-looking incumbents are pursuing three imperatives.

1. Institutionalize service innovation

Services, like products, have a shelf life. After all, customer demand evolves, service expectations change, and technological advances constantly bring new possibilities. Services, therefore, should be periodically examined and refreshed, just as products are. Many companies think of R&D as exclusively for product development.[4] Yet when they dedicate resources and management attention to developing and refining their service offerings systematically, they can make significant improvements.

For example, a large retailer facing pressure from online attackers and incumbents created a cross-functional R&D lab that focuses on overhauling the retailer’s in-store customer experience and improving employee satisfaction. The lab takes an end-to-end approach, looking at every aspect of store operations, from customer checkout to storage-room processes. One of the lab’s early efforts involved using advanced analytics to optimize the tasks of employees and thus to help stores improve their services and efficiency.

[4] To be sure, some companies have long understood the importance of an institutionalized approach to service innovation. In the McDonald’s innovation center, for example, the company develops prototypes and simulates new service procedures in fully functioning mock restaurants housed in a suburban Chicago warehouse. For more, see “Innovation with a side of fries,” *Crain’s Chicago Business*, June 12, 2006, chicagobusiness.com.

The lab brings its cross-functional experience to tailor the rollout of new ideas so that they are more likely to stick—for example, by releasing them to stores in small batches that are easier for store managers to handle. These and other innovations significantly raised customer satisfaction, while helping the retailer to enhance store operations and refresh store formats much more quickly than it had before. The moves also generated significant labor savings and increased employee satisfaction.

Similarly, a large provider of commercial and residential services was struggling in the face of increasing customer expectations, customer dissatisfaction, and churn rates. To respond, company executives created a permanent in-house innovation team staffed with colleagues from different parts of the business, including customer care, scheduling and dispatch, finance, and marketing.

The team works its way through the service offerings of the company's different business units on a three-month rotating cycle, troubleshooting problems and working with the businesses to spot opportunities. The rotations ensure that every business process can be examined regularly. To bring in fresh thinking and maintain momentum, team members are rotated periodically. By sending them back to their former jobs, the company solicits and spreads new service thinking throughout the organization.

This approach has led to practical and powerful ideas. For example, when the team examined the relationship between customer satisfaction and the scheduling of field services, it discovered that many customers were less concerned with the actual date of service than with getting a date rapidly. This insight allowed the company to optimize its scheduling for maximum efficiency, often by scheduling the service calls for a few days *later* than it might have otherwise. Nonetheless, customer-satisfaction scores have improved markedly because the uncertainty—and anxiety—around the scheduling process has been removed.

More recently, the team has been testing a mobile workflow app to help field technicians in densely populated urban areas balance their workloads in real time. The app acts as a sort of clearinghouse for service calls: when technicians realize that they may be late for the next visit, they can trade it to a nearby technician who has just finished a job early. While still in the pilot stage, this approach is intriguing because it promises to improve customer satisfaction further still, while requiring no additional centralized resources—the service techs manage the process themselves.

2. Personalize the customer experience

Companies have always sought to understand customers better to tailor services to their needs. Traditionally, this has meant focusing on customer segments or groups. While that wisdom still holds, the advent of massive new datasets and the spread of mobile devices mean that services can now be personalized cost effectively to a much higher degree.

A large credit-card provider, for example, partners with retailers to create personalized, real-time discounts for products and services through a mobile app. The app generates offers by matching customers' locations (determined from their smartphones) to products and services that should appeal to them given their purchasing habits and preferences. The credit-card company also works with social-media players to draw on the preferences of participating customers, using "likes" and other markers to refine its offers. The initiative helps the company to strengthen its relationships with merchants and serve them better, while also staying relevant to younger, digitally savvy customers.

Some incumbents go further by giving consumers even more control over services (see "Redefining service innovation at Starwood," on mckinsey.com). Disney recently implemented a new service that uses wristbands with radio-frequency identification (RFID) chips to give patrons more control over their visits to the company's theme parks and resorts. These MagicBands act as hotel-room keys, allow visitors to enter the park and purchase merchandise, and enable guests to schedule reservations for rides. When customers volunteer additional information, the experience can be personalized further. For example, the bands help costumed Disney characters to greet guests by name when encountering them or to extend personal birthday greetings.[5]

[5] For more, see Sarah Sekula, "Disney gets personal with new MyMagic+ system," *USA Today*, February 25, 2014, usatoday.com.

3. Simplify service delivery

Digital attackers tend to thrive on simplicity. Many adeptly combine new technology with process improvements to make services straightforward and more pleasing. Meanwhile, big incumbents, burdened by legacy IT systems and entrenched processes that have evolved over time, often struggle to keep things simple. Still, incumbents can bring more simplicity to their service operations by looking at the world the way their customers do.

Consider the experience of the healthcare distributor that faced increased pressure on margins and rising customer expectations. On closer examination, executives realized that unnecessary complexity was a factor. For example, each of the internal groups involved in providing the service used its own metric to gauge success. By optimizing their own contribution, they inadvertently overlooked the downstream effect on other internal groups and thus the overall effect on customers.

In response, the company dramatically simplified the metrics it used to measure success, choosing error-free orders as a target ensuring that it would stay focused on customers and not its own internal workings.[6] The company also gave the front line additional decision-making authority, which helped employees resolve—and prevent—more customer-service problems. Together, these moves helped increase the proportion of error-free orders by nearly one-third.

Meanwhile, the company's call centers began serving as the single point of contact for customer problems. (Previously, salespeople had played this role, believing that solving problems themselves strengthened relationships.) While the change represented a mindset shift for the salespeople, it was one they were willing to make, since it boosted sales.

A large European bank combined technology with an effort to simplify its services, to improve the mortgage-application process. The company formed a team of project managers, mortgage specialists, and software developers who redesigned the process

[6] For more about optimizing services from the customer's point of view, see Alex Rawson, Ewan Duncan, and Conor Jones, "The truth about customer experience," *Harvard Business Review*, September 2013, hbr.org.

from end to end, eliminating unnecessary handoffs and simplifying the customer experience—all while keeping the process compatible with the company's legacy IT systems. The resulting web solution has proved popular with customers, reducing approval times to 15 minutes, from several days. Moreover, the bank's analysis suggests that the quality of loan decisions has improved—even as costs associated with the process have been reduced, on average, by 75 percent per mortgage.

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The new services landscape is unlocking innovation opportunities in nearly every industry. Yet for many companies, managing day-to-day operations is all-consuming. Even the most forward-looking incumbents find that implementing an innovation mind-set can be daunting. Institutionalizing service innovation, for example, requires more than setting up a new R&D lab; the lab's efforts must be hardwired into the company's services strategy, investment cycles, sales, and operations. Similarly, personalizing the customer experience is about not only mining data and applying the latest analytic techniques but also marrying those capabilities with insights from service representatives, third parties, and customers.

And the quest for simplicity is rarely simple—especially as the pace of innovation and customization continues to grow. Companies that excel on these dimensions, while keeping the customer at the center of everything they do, will be best positioned to survive the mounting pressure from attackers and master the new services environment.

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