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SKF BEARINGS SERIES: MARKET ORIENTATION THROUGH SERVICES (A): RESTRUCTURING THE BEFORE AND AFTER MARKET

This case was prepared by Professor Sandra Vandermerwe and Dr. Marika Taishoff as a basis for class discussion, rather than to illustrate either effective or ineffective handling of a management situation.

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In the spring of 1987 Mauritz Sahlin, CEO of SKF, the world's largest bearing company, took a bold step. The time had come to do whatever was necessary to improve profitability and return on assets. He knew that his plan would require a complex reorganization of SKF with far-reaching consequences, but he had no other options.

Production had already been rationalized and was fully automated, leaving little room for real savings. The company could not pull back on R&D expenditures as they were essential to having technological prowess and quality standards. Cutting back on staff would upset the unions and provoke costly work stoppages.

He was convinced that the only viable long-term solution was to change the strategic orientation of SKF from the production line to the market. Amidst great uncertainty and speculation, he called together the senior bearing managers from around the world to Saltsjobaden, Sweden, to announce his intention to split the company into three new areas.

> It is essential, he said, that we optimize by structuring around our market relationships instead of our manufacturing capacity. If we want to remain the industry leader in bearings, we must be prepared to give customers what they want rather than merely sell them what we make

He knew that the traditional sluggish culture of the company had to be altered. Questions would have to be answered which were not yet part of the existing SKF vocabulary. He expected criticism, resistance and conflict among the divisions. Even confusion for awhile. He was prepared to take the risks.

The Beginnings and Background

As in many industrial success stories, the formation of SKF happened by chance. At the turn of the century Sven Wingquist, a young Swedish maintenance engineer, was fed up with the poor quality of bearings, with frequent stoppages and replacements that were not only expensive but took weeks for suppliers to deliver. The frustrated Wingquist got his employer's blessing to begin work on a new bearing in 1905 and soon perfected a product that was more effective and longer lasting than competitors' models. By 1907 Svenska Kullager Fabriken (SKF), the new company set up to produce and market the technological innovation, was in business.

The ball bearing, a device which allows rotation around a shaft or axle with minimal friction, is an essential part of any motion dependent product, be it car, machine, truck, or train. As a result, high quality bearings soon became an indispensable item for all major industrial sectors, ranging from electrical and heavy industries to transportation. Over the next six decades, SKF grew in tandem with industrial growth and became the world leader in bearing technology and applications.

Up through the mid-'60s, SKF was highly centralized; all aspects of the business such as logistics, global sales, application engineering and public relations were handled by the parent company in Göteborg. Five European plants produced a wide range of products geared to their own large local customer base. These regional units concentrated exclusively on the manufacturing process, particularly on maintaining cost effectiveness. Countries did not export to each other or operate internationally except rarely--when the initiative came from Göteborg.

The company's underlying drive was mass production and having high quality standards. In the words of one executive, "Big was beautiful." The plants were given significant capital budget allocations. Large economies of scale meant that huge quantities of bearings could be sold at competitive prices on the world market. Operations were integrated as much as possible both horizontally and vertically. A tools division was acquired in order to expand into the manufacture of engineering products and machine tools. Manufacturing machinery was designed in-house so that material flow systems and production techniques could be perfected and capacity increased.

R&D contributed greatly to SKF's strength. Since most bearings had an average life of five years, there was a continuous need to develop new products. About 200 people in the Netherlands were involved in product development and in improving the engineering and performance standards for the product lines. Input was received from the various plants where R&D had a close relationship. As a general rule, SKF preferred to overdesign its products to ensure that the needs and specifications of the plant managers were met.

The '70s and '80s: Japanese and European Competition

In the early '70s the Japanese, already strong in Asia, entered the European bearings market. As a result, SKF management was forced to cut costs further "by whatever means" as well as begin exporting outside their traditional markets. To reach this goal while developing scale economies, production facilities were rationalized along the lines of the Japanese model, i.e., each factory became responsible for making and exporting a specific bearing type for world consumption.

The rise in oil prices in the early '80s, causing a drop in real wealth and in demand for capital goods and consumer durables, put additional pressure on margins. "Production Concept 80", aimed at stimulating effective production, at cutting staff and underscoring the manufacturing process in company investment policy, was SKF's response to economic conditions as well as to competitive threats.

This concept, along with the continued emphasis on top quality standards, allowed SKF to remain the number one bearings producer. By the late '80s the company had 20% of the world bearings market share, nearly twice that of its closest competitor, Nippon Seiko of Japan. Another Japanese bearings producer, NTN, had 10%, followed by Germany's F.A.G. and Timken of the US with 8.5% each, and the Japanese firm Koyo with 6% of the world market.

Bearings producers were not the only competitors on the world scene. Automobile manufacturers, including Ford, Honda and Mercedes, through their spare parts divisions, were both competitors to and customers of SKF. This was also the case for some specific manufacturers of automobile parts, such as the UK's Quinton Hazel, which would typically purchase SKF bearings and sell them under its own brand name to distributors, thereby cutting into a segment of SKF's traditional customer base.

SKF's position had always been strongest in Europe and Latin America, with 35% and 30% of these markets respectively. In the US, SKF was in third position, with 12%. On average, Europe accounted for almost 60% of SKF's business, North America for 20%, Sweden 5% and the rest of the world 15%. Despite this comparatively strong market share, worldwide economic and industrial conditions continued to squeeze margins during the first half of the decade. This situation came to a head in 1985 when SKF's volume in the US, susceptible to economic changes and often indicative of what could happen in other regions, plunged 15%. The company was obliged to embark on a substantial restructuring program in the US.

1986: A Financial Ebb

By 1986, SKF had 48 factories in 13 countries operating at near or full capacity to produce two million bearings a day. SKF vigorously promoted its products through 35,000 local dealer and distributor (d/d) outlets worldwide, as well as a direct sales force of 600 throughout 130 countries. Dealers and distributors carried

large stocks of limited range high turnover bearings for SKF, along with competitive bearings and complementary materials and tools.

When Sahlin took the helm as CEO in 1985, SKF was operating at the crest of what amounted to a roller bearing boom. Nevertheless, economic conditions and competitive pressure made it a buyers' market. Bottomline results began to turn flat at SKF that year, when sales slackened and margins narrowed. *(The financial profile for the years 1982 through 1986 are shown in **Exhibit 1**.)*

Segmenting the Bearings Market

With increasing competition, SKF found it more and more difficult to differentiate its product from the others. It had always applied one strategy and organization for all bearing customers. High quality products were sold in large quantities at competitive prices. Sahlin questioned this approach and, late in 1986, commissioned research to examine the bearings market in detail. He wanted to establish whether the market could be segmented along any natural split amongst the product lines according to specific customer needs.

Consumers were grouped into three categories:

1) ***Automotive OEM*** (cars, trucks, electrical), with 32% of SKF bearings sales in Skr.

2) ***Machinery OEM*** (heavy industry, railway, general machinery), with 27% of SKF bearings sales in Skr.

3) ***Aftermarket*** (vehicles and industrial), with 41% of SKF bearings sales in Skr.

Whereas bearings were regarded as vital components in the OEM market, in the aftermarket they were seen merely as spare parts. Large OEM sales were handled directly by the company's global sales arm. Contracts were substantial and steady. "Large orders were signed and executed in a routine way."

The aftermarket sales were made to distributors and dealers, who in turn served end users. Relationships were entirely different for these markets, as were the services demanded. Delivery requirements, lead times and quantities, along with type and range of bearings needed, also varied considerably.

There were more than twice as many OEM than aftermarket customers, although fewer in the vehicle business than in machinery. Automotive OEM customers were large and tended to operate centrally on a European, if not global scale. By contrast, machinery OEM users were smaller; their particular strengths tended to be in specific industries and geographic locations. Large OEM customers made up roughly 40% of the total SKF bearings sales in kronor. Lead times were stable and predictable, making forecasting straightforward. Profit margins were low in the OEM sector. The larger OEM customers, who often set their own prices on substantial, long-term contracts, were particularly cost conscious since "every

cent saved was money in the bank." SKF was thus under constant competitive pressure to keep price increases at or below the inflation rate.

OEM customers were considered the glamorous end of the business, always given priority by the SKF factories. High volume production and sales standards set for the large OEM customers were applied throughout the rest of the organization. OEMs were not only allocated most of the new product funding, but also attracted SKF's best talent. Some of the reasons for this situation were:

- OEMs would typically deal with big name customers like Volkswagen or Ford, and would be involved in negotiations at a senior managerial level.

- Technical developments for OEMs were more challenging than for the aftermarket because they tended to be more complex and state-of-the-art.

- Orders for the OEM were larger, steady and more consistent, with lead times that made well-defined production schedules possible.

By contrast, the aftermarket tended to concentrate on single sale deals for motor dealers and factories. Although price was important, these clients, for whom speed, availability and assistance were essential, were prepared to pay more than the OEM customers. In fact, the higher prices in the aftermarket enabled SKF to do OEM business that otherwise may not have been justified. It had long been suspected that, despite being largely limited to single sales, the aftermarket was the most profitable part of the business. However, since operating results for all the markets were consolidated, this impression was never really confirmed.

The aftermarket was subdivided into two separate categories:

1) ***The Industrial Aftermarket*** (factory owners and plant managers), with 66% of SKF aftermarket sales in Skr.

2) ***The Vehicle Aftermarket*** (fleet owners and repair shops), with 34% of SKF aftermarket sales in Skr.

In their industrial aftermarket business, which contributed two-thirds to the overall aftermarket sales, SKF had concentrated mainly on steel and paper mills. Mines and railways were also a part of this business. These customers had the same basic needs wherever they were geographically situated. The distributor network accounted for 80% of the sales.

For industrial users, the cost of the bearing was "peanuts compared to the cost of standstill." They sought to minimize downtime and maximize the recovery speed. Customers spent 75% of downtime locating the proper equipment and people, and only 25% on actually repairing the machine.

The lifetime of a bearing played a fundamental role in the success of the customer's production activities. Longevity was affected by: 1) the quality of the product, 2) how it was installed, 3) protecting the bearing from the environment,

and 4) the quality of maintenance management at the factory. The last three factors depended on the users. Most bearings failed because of incorrect installation, inadequate or improper lubrication or environmental contamination.

The vehicle aftermarket accounted for one-third of total aftermarket sales. Despite the fact that the automobile and truck sectors contributed 24% of SKF's OEM sales, the aftermarket had been relatively ignored. This neglect stemmed from the basic principle, "if we made it, we sold it." And since SKF made only a limited range of bearings compared to the great variety of autos, the aftermarket had never been considered a priority.

Dealers for automotive OEMs and independent distributors channeled spare parts through to the car and truck market. Because of the better service they were receiving, garage and fleet owners were increasingly shifting their business to the independents. Bearings comprised only 3-4% of distributor and retailer sales, compared to between 30% and 70% in the industrial aftermarket. The distance from the bearing manufacturer to the final user was much longer in the vehicle aftermarket, with the channel consisting of wholesalers, large retailers, and garages. Since cross referencing of bearing components was not consistent in the industry, it was difficult to ascertain which manufacturer's part was being replaced.

Vehicle dealers and repair shops wanted a bearing quickly because car owners expected vehicles back within a couple of hours. They also needed the right bearing for that particular vehicle. Replacing a bearing presented three problems for the bearing installer: 1) where to find the correct bearing, 2) how to mount and install it, and 3) how to obtain the various accessories to get the job done.

SKF had always regarded distributors as customers rather than as part of the channel to the end user. Bearings were sold *to* them instead of *through* them. Relationships with end users were left in the distributors' hands. Sales people loaded up the distributors' shelves and devised all sorts of deals to gain volume, even if items had to be taken back unsold. The distributor network gave Bearing Services the necessary local presence and coverage, and it was often more cost effective than using a direct salesforce to get the bearings to the customer. There was, however, no guaranteed preference for the SKF brand.

Splitting the Organization

Research showed that the market for bearings was far from homogeneous. This information confirmed Sahlin's instincts that different target segments had to have their own market strategies and organizations.

No one knew what to expect when Sahlin convened an urgent meeting in Saltsjobaden. As one manager described it, "Phone calls had been made back and forth to try to find out what was going on and who had been invited. Most of us only found out the next day when it made *The Financial Times*." At the meeting, Sahlin announced that, as of September 1, the bearings group would be officially reorganized into three new areas.

1) ***Bearing Industries*** would include all the manufacturing plants producing "standard" bearings for OEM, both machinery and automotive. The selling would be done by its own salesforce in countries where SKF had factories, such as Germany, France, the UK, the US, Sweden, Brazil, Argentina, Mexico and Italy. In other countries such as Switzerland, Belgium and Holland, Bearing Services would do the selling.

2) ***Bearing Services***, carved out of the global sales organization, would handle the entire vehicle and industrial aftermarket as well as some of the smaller OEM clients with whom the aftermarket distributors did business.

3) ***Specialty Bearings*** would handle products outside the standard line which needed highly specialized skills. This division would have its own factories and would utilize Bearing Industries' and Bearing Services' salesforce in most countries. Customers included the aerospace industry, medical equipment suppliers, large machine tool producers, and satellite manufacturers which required custom-designed products for highly specialized applications.

Each business area would have its own CEO and separate worldwide profit responsibility. Efforts would be made to keep these autonomous, thus minimizing the need for coordination. Sahlin believed the new structure would allow each business unit to be more flexible, to target and get close to its own customers, thereby commanding better margins. *(For the old and new group organization structures, see* ***Exhibit 2.)***

The research confirmed Sahlin's earlier instincts that the aftermarket was indeed the profitable end of the business. He had long believed that this market had not been given enough attention but nothing had been done because it was not clear what to do and the financial significance of the aftermarket had never been established. Sahlin was convinced that the key to future profits and customer loyalty was in offering the aftermarket SKF knowhow and expertise. Bearing Services, he decided, would be a major focus for the company in the future.

The sales management teams which had been dealing with the aftermarket had previously reported to the manufacturing companies. Now, in the newly formed Bearing Services, they were elevated to the same status as that of their former bosses. Sales and marketing directors in various countries became managing directors (MDs).

Transforming the Change Process

Previously, all changes at SKF had been very structured. Typically, before any decision could be made, numerous studies were undertaken and proposals scrutinized in order to minimize risk. A kind of "bible" was then written stating exactly how the change would take place--what had to be done, by when and by

whom. As little as possible was left to chance. Sales budgets, production budgets and action plans were put in place before the new process began.

It was clear to Sahlin that SKF not only had to become a market focussed company, but the process of change itself had to be transformed. Although the ultimate goal of improving profits was straightforward, exactly how it would evolve was not 100% clear. The company would have to learn by doing, by feeling out the market and being as flexible as possible.

One thing was obvious: the entire culture of the company needed a jolt. The manufacturing functions had always had the clout, but they would have to give up some of that power. The financial approach to the market would have to change as well. Marketing could no longer be considered an expense or cost center, but would have to be handled like any other capital investment.

Sahlin knew it would be impossible to move the whole company at once. He expected Bearing Services to be a springboard to a new SKF market culture. Once they began making positive inroads into the market, he was convinced that the rest of the organization would follow. The goal was not to push for sudden and monumental changes but, rather, to let things take shape as they moved along. Small positive steps had to be taken to influence people and convince them about the new SKF way. He drafted a rough outline of how the organization would look and some guidelines for implementation. He wanted the company's technical expertise be used to serve customers more fully, thus giving SKF a significant competitive edge. A new CEO would be appointed to each of the three areas and left to formulate his own plan.

Göran Malm, a sales and marketing specialist with a financial background, had been the European marketing and sales manager for SKF. He had been Singapore area manager for less than a year when Sahlin called and asked him to head Bearing Services. Malm, who had been pushing for change at SKF for some time, had initiated and set up maintenance support centers in Sweden to provide services for the aftermarket there. He was, Sahlin believed, the ideal candidate for the job. At first Malm was reluctant: he'd only just begun to develop a network in Singapore. Sahlin remained adamant: "I decide on the priorities, Goran," came his voice late one night. "I need you back here. You understand the aftermarket and what the customers want. Let me have your decision soon, Goran."

Malm had smiled as he put down the phone. He knew the job would be tough, but he also knew he couldn't resist the offer to lead Bearing Services.

Some Reactions to the Restructuring

* Most aftermarket sales people liked the idea of the split; they would finally be elevated from the second class status to which they felt they had been relegated. As one marketing director expressed it. "Suddenly we felt that we were as important as the guys in manufacturing. It was incredible. We knew then that Sahlin was serious about becoming customer oriented. There had been lots of jokes about the d/d club or, as some called it, the dinner/dance club. That's the

way those of us in the aftermarket were seen--wining and dining customers without doing any real work. We were happy that at last someone was listening to us and we could concentrate on customers' needs."

* Some of the more traditional administration, engineering and financial executives lacked enthusiasm. They couldn't quite see the point. "It will simply add extra costs we don't want or need in our business" was the typical remark.

* Another reservation was whether or not to take the restructuring seriously. "This is just another reorganization. We've had so many, how long will this one last?" was the refrain.

* Some thought that too many questions had been left unanswered and that the ultimate objectives were still too vague. It wasn't that they necessarily disagreed with the overall plan: they wanted more data and details so they could "proceed in an orderly SKF fashion."

* Others felt that such a novel approach would simply not be feasible in an institution as bureaucratic as SKF. The stringent reporting requirements to head office and rigid structural barriers were just some of the many obstacles which would have to be overcome. These executives were not convinced that the new structure could fit the managerial techniques and tools that they knew worked.

* The MDs who had previously controlled both sales and aftermarket did not all react positively when they heard Sahlin's reorganization plan. Some resented the sudden change in status of the people who had previously been working for them and who would be taking away a chunk of their business and their profits. "Some executives tried to get around it by saying 'yes', but then delayed implementation."

When challenged about these concerns, Sahlin stated repeatedly that he understood the difficulties ahead, but was prepared to take whatever risks were necessary.

SKF Bearings (A)

Exhibit 1
Financial Profile for 1982-1986

In Skr (bn)

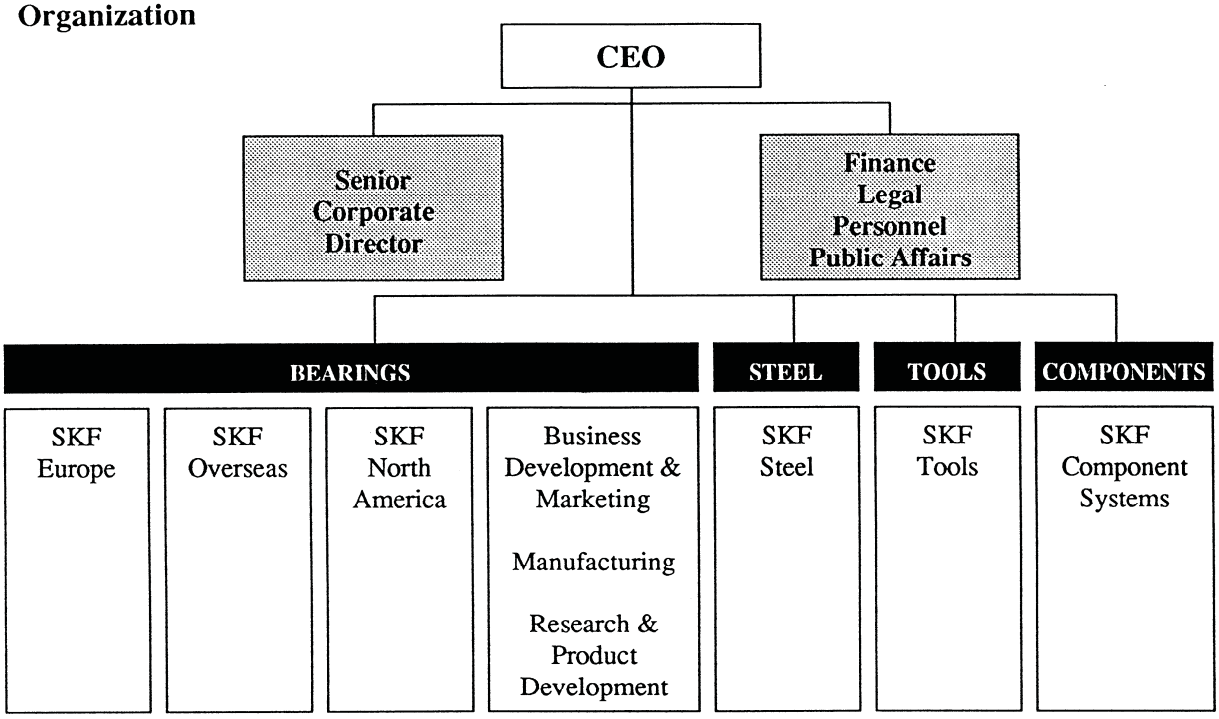
Consolidated	1982	1983	1984	1985	1986
Net Sales	14.4	16.2	17.8	20.0	20.1
Operating Expenses	13.0	14.9	15.9	17.9	18.0
Income after Financial Income and Expense	.657	.604	1.3	1.4	1.5
Total Assets	18.8	18.6	21.8	22.0	22.8
Shareholder Equity	5.4	5.2	6.8	6.7	7.3
Return on Total Assets	8.0	7.4	9.8	9.5	9.3
Price per Share	29.2	42.0	43.0	75.0	84.0
Bearings:					
as % of Total Sales	80	82	80	76	77
as % of Total Profits	90	95	80	78	75

Source: Annual reports

SKF Bearings (A)

Exhibit 2
Old and New Organizational Structure

Old Group Organization



New Group Organization