

# Why Companies Sell Service Contracts and Why People Buy Them

Mr. Klaidman is Principal Advisor, Middlesex Consulting Group, 1 Gina Cir., Framingham, MA 01701, U.S.A.; tel.: 508-877-1924; e-mail: sam@middlesexconsulting.com.

If you are a laboratory manager, you were probably offered an opportunity to purchase an extended warranty or service contract at the time you ordered a new piece of laboratory equipment. If you initially declined the offer, you were probably given another opportunity to purchase a service contract about nine months after equipment acceptance.

This article explains why the manufacturer is offering you the contract and the motivations for laboratory managers to purchase them. The intent is to prepare you to make an informed decision the next chance you get to make a contract purchase and to be able to articulate your expectations to the company's contract sales rep.

## What is the difference between an extended warranty and a service contract?

Before we can begin to understand why service contracts (sometimes called service agreements or service plans) are sold and purchased, it is useful to understand the difference between service contracts and extended warranties.

A warranty on most laboratory equipment has a one-year duration. The manufacturer promises to correct defects in manufacture or design. An extended warranty generally covers hardware failures and software fixes for an agreed-upon period after the initial manufacturer's warranty ends. On the other hand, in addition to repairing failed hardware, a service contract can include any number of value-added services. Some of these services include:

- Software updates
- Scheduled preventative maintenance
- User training
- Loaner equipment
- Advanced exchange (you receive a replacement unit and then return the defective one)
- Calibration
- Certification
- Priority response, both on-site and on the telephone
- Consigned inventory
- Additional discounts.

This article talks about a service contract, but understand it can be merely an extended warranty.

## Why do companies sell service contracts?

First, remember that companies sell a portfolio of products, including:

- Equipment
- Consumables (e.g., columns, reagents, pipet tips)
- Services (yes, services are products, too).

In companies that have been around for a number of years, the salesperson, your account manager, probably sells the whole portfolio. If the company is very big, the salesperson may sell only a subset of the product line. However, in many cases this person will offer to include a service contract with the initial order; in other cases someone in service sells the contract near the end of the warranty period.

There are a number of reasons why companies want you to buy a contract:

- Profit: If the manufacturer is serious about selling service contracts, then it generally does a good job of understanding its potential costs and its value to you, and usually establishes a fair price for each service offered. While these companies do not have an actuarial team that is as extensive as a life insurance company, they do a very good job monitoring costs and profitability.
- Revenue, profit, and cash flow predictability: Companies like predictability when they budget and report financial results. Since product sales, and many expense categories (e.g., holiday and vacation pay, travel, overtime), can be lumpy, the companies like the inherent predictability of a significant and growing contract revenue base. In accounting terms, the revenue from a service con-

**Table 1 Study of customer loyalty**

| Type of coverage           | % Reported likely to repurchase |
|----------------------------|---------------------------------|
| Contract with manufacturer | 85%                             |
| Contract with third party  | 82%                             |
| No contract (T&M)          | 60–65%                          |

tract is spread evenly over the life of the contract, so there is no seasonality or buying pattern impacts to their orders and profit.

- Customer loyalty: A study of customer loyalty conducted by Hahn Consulting (Beaverton, OR) (Table 1) showed that customers are most likely to repurchase from the manufacturer if they have a service contract. The logic is that laboratory managers and equipment users are more likely to call technical support for information, get minor problems fixed, and report problems when they have a contract than those not under contract because they want to get their money's worth. However, they become very satisfied with the equipment because it appears reliable (minimum downtime) and easy to use (they take training during the preventative maintenance, or PM, visit), and they generally form a strong bond with their service engineer. If they are satisfied with their engineer, why would they purchase equipment from another company and risk getting someone inferior to their favorite engineer?
- Reinvestment in service: Service executives want to continue to expand their capabilities. Financial executives want to invest in assets that will grow the top and bottom lines. A record of strong and growing service revenue frequently allows the service executive to convince the rest of the management team to let service do what it needs to in order to support a growing customer base.

In summary, a strong contract sales program benefits both the equipment manufacturer and the end user.

## Why do people buy service contracts?

Some equipment buyers work in a company that has a policy of buying service contracts. That takes the decision out of the buyer's hands. However, most laboratory managers have to initiate the budget request for the contract. Why do they do it? There are four reasons:

1. Reduce hassle: In larger companies (and sometimes even smaller ones), before ordering service you must get an estimate, prepare a P.O. request, get it approved by your manager, send it to purchasing, follow up to make sure a P.O. is cut, and then begin to arrange the repair with your vendor. With a contract, you just call or e-mail the vendor and schedule the fix.
2. Uptime: While you are dealing with the P.O., processing your lab equipment is nonoperational. With a contract, not only can you place a service call as soon as you determine the need, but contract customers generally receive dispatch priority. This means that your call moves high up, or to the top, of the dispatch list. Also, many contracts include at least one annual PM, so there is a good chance that potential failures can be identified and corrected before they become critical.
3. Expense predictability: Managers are measured based on their actual expenses compared to budget. With a full service contract, you budget exactly what you are going to pay; there are no variances. If maintenance is a significant portion of your budget, then having service contracts on important pieces of equipment will help you control your costs.
4. Peace of mind: When critical or very important equipment fails, it is usually at the most inopportune time (Murphy's law always works!). Important testing, on a project's critical path, needs to be done. The eyes of high-level management are on the laboratory. The last thing the project engineer or laboratory manager needs to worry about is when the equipment will get fixed, how much it will cost, and whether he or she will be blamed for the project's delay. With a service contract these worries are minimized because he or she can stand tall and say, "I bought the best equipment from the best vendor and then purchased their best support plan." There is very little room to find fault in this scenario.

## Conclusion

If an equipment supplier develops a range of service contracts that offer different value-added services at fair prices and customers buy the right contract to satisfy their needs, then we have a "win-win" situation and both parties feel satisfied. Profits and loyalty are maximized, and the people who make purchasing decisions can feel confident that this overall experience will be positive.

## ***About Middlesex Consulting Group and Sam Klaidman***

**Middlesex Consulting Group specializes in:**

- Service Strategy**
- Services Marketing**
- Identifying and commercializing value-added services**
- Go to market assessments**
- Creating and retaining customers**
- Operational improvements**

**Sam Klaidman is the Principal Adviser at the Middlesex Consulting Group. A thought leader in service excellence, Sam is an experienced executive with a deep and varied background that spans nearly 45 years. During that time, Sam led several world-class service delivery organizations and has more than 20 years of service and support experience. He is an accomplished speaker on Service Strategy and Marketing and has published numerous articles on Services Marketing and Services revenue.**

**For a no obligation discussion about how we may help your business grow revenue, profit and customer loyalty please contact us;**

**[Sam@middlesexconsulting.com](mailto:Sam@middlesexconsulting.com)**