SUPPLIES, FUNDING AND OUTSOURCING SERVICES

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Abstract: *Outsourcing has become a strategic issue although many managers are still unprepared to do so. A new era of outsourcing various capabilities shall cause organizational redesign and the development of a new set of managerial skills. Due to rapidly changing global economy, any company must be able to anticipate changes in the economy and the dynamics of outsourcing. Not long ago the biggest companies had their own warehouses and distribution system and the logisticians had no management expertise or skills. Today, however, vendors are competing to offer full service in terms of logistics networks and even large companies outsource storage, distribution and other activities.*

Keywords: outsourcing, vendors, management, organization

For years, “sourcing” has been just another word for procurement - a financially material, but strategically peripheral, corporate function. Now, globalization, aided by rapid technology innovation, is changing the basis of competition. It’s no longer a company’s ownership of capabilities that matters but rather its ability to control and make the most of critical capabilities, whether or not they reside on the company’s balance sheet. Outsourcing is becoming so sophisticated that even core functions like engineering, R&D, manufacturing, and marketing can - and often should - be moved outside. And that, in turn, is changing the way firms think about their organizations, their value chains, and their competitive positions.

Forward-thinking companies are making their value chains more elastic and their organizations more flexible. And with the decline of the vertically integrated business model, sourcing is evolving into a strategic process for organizing and fine-tuning the value chain. The question is no longer whether to outsource a capability or activity but rather how to source every single activity in the value chain. This is the new discipline of "capability sourcing."

Perhaps the best window on the new sourcing landscape is a handful of vanguard companies that are transforming what used to be purely internal corporate functions into entirely new industries. Firms like United Parcel Service in logistics management, Solectron in contract manufacturing and Hewitt Associates in human resource management have created new business models by concentrating scale and skill within a single function. As these and other function-based companies grow, so does the potential value of outsourcing to all companies. It's not always obvious which functions have the most potential for developing scale and skill.

Migrating from a vertically integrated company to a specialized provider of a single function is not a winning strategy for everyone. But all companies need to rigorously assess each of their functions to determine in which they have sufficient scale and differentiated skills and in which they don't. Greater focus on capability sourcing can improve a company's strategic position by reducing costs, streamlining the organization, and improving quality. Finding more-qualified partners to provide critical functions usually allows companies to enhance the core capabilities that drive competitive advantage in their industries. [1]

Yet despite the enormous opportunities available through capability sourcing, specialized re-search indicates that many executives remain unprepared for this transformation. A recent Bain survey of large and medium-sized companies reports that 82% of large firms in Europe, Asia, and North America have outsourcing arrangements of some kind, and 51% use offshore outsourcers. But almost half say their outsourcing programs fall short of expectations, only 10% are highly satisfied with the costs they're saving, and a mere 6% are highly satisfied with their offshore outsourcing overall. [2]

The reason these efforts often fail to measure up to expectations, even purely in terms of cost savings, is that most companies continue to make sourcing decisions on a piece-meal basis. They have not put hard numbers against the potential value of capability sourcing, and they've been slow to develop a comprehensive sourcing strategy that will keep them competitive in a global economy. [3] To realize the full potential of sourcing, companies must forget the old peripheral and tactical view and make it a core strategic function.

The Changing Basis of Competitive Advantage

For over a century, companies competed on the basis of the assets they owned. AT&T, with its direct control of the American telephone network; Bethlehem Steel, with its large-scale manufacturing plants; and Exxon, with its vast oil reserves, each dominated its respective industry. But in the 1980s, the basis of competition began to shift from hard assets to intangible capabilities. Microsoft, for example, became the de facto standard in the computing industry through its skill in writing and software. Wal-Mart transformed retailing through its proprietary approach to supply chain management and its information-rich relationships with customers and suppliers. [4]

A similar shift occurred in the worldwide auto industry. When U.S. automakers began losing market share to Japanese companies, they were forced to confront a growing gap in both cost and quality. Recognizing that upstream component quality was critical to their end product and seeing the success of the Japanese keiretsu model of networked suppliers, the Big Three began to move design, engineering, and manufacturing work to specialized partners. They hammered out strategic sourcing relationships for complex subassemblies such as seats, steering columns, and braking systems. [5] To win a significant share of their business, chosen suppliers had to meet tough cost and quality specifications. More important, to ensure the long-term success of a partnership, both parties had to open their books, sharing detailed information that became the basis for continual quality and cost improvements over many years. Both parties shared in the savings generated from improved efficiency, which provided ongoing incentives to identify and remove unnecessary costs.

This new approach to sourcing had profound effects on the automakers' operations and management. For example, Chrysler established what it called "value-managed relationships," in which it consolidated component purchases with the few suppliers it believed could sustain competitive costs, high quality, and efficient delivery. The carmaker and its key suppliers set a common goal of achieving the lowest total systems cost. Before it could reach this goal, however, Chrysler had to refocus its entire procurement function so that it could manage the new, highly collaborative sourcing relationships. That required the company to train and promote a different kind of manager who was capable of understanding system economics, not just one who knew how to nickel-and-dime the supplier base [6].

The same dynamics were also at work in the credit card industry, which restructured in response to a dramatic change in the basis of competition fueled by technological innovation. In the 1970s, most banks that issued credit cards also processed their own transactions in a very labor-intensive manner. But as computers automated transaction processing, the economies of scale grew significantly, and individual issuers started to pool their transactions to drive down costs. The industry began to separate into those companies that issued cards and managed customers, on the one hand, and those that processed transactions, on the other, as transaction-processing underwent rapid commoditization.

If globalization and technology transform more industries, all companies will eventually have to let go of that comfortable but simplistic guideline. A series of geopolitical, macroeconomic, and technological trends has opened the world's markets, made business capabilities much more portable, and produced a level of discontinuity that has no precedent in modern economic history. These events include the fall of the Berlin wall, China's embrace of capitalism, the advent of worldwide tariff reduction agreements, and the spread of cheap, accessible telecommunications infrastructure. In the new era of capability sourcing, companies' value chain decisions will increasingly shape their organizations and determine the kinds of managerial skills they need to acquire and develop in order to survive amid increasingly fluid industry boundaries. [7]

Outsourcing Opportunities

Using a sourcing opportunities map, we can determine which functions have the highest outsourcing potential and which should remain under a company's control. The vertical axis measures how proprietary a capability is for a company.

The horizontal axis plots how common the capability is within or outside an industry. The less proprietary and the more common a function is, the stronger a candidate it is for outsourcing [8].

The vertical axis of the map measures how proprietary a process or function is; the horizontal dimension assesses the degree of commonality, both within and outside an industry. Capabilities that fall in the upper right portion of the map are strong candidates for outsourcing. Those that appear in the lower left section are potential prospects for captive sourcing. Such capabilities may even be candidates for "in-sourcing" - that is, if can determine that a company is really the best at a given function, and may have an opportunity to perform this function for other companies.

Opportunities that fall in the middle of the sourcing opportunities map generally require more detailed analysis of both a company and an industry. We will need also to consider such factors as regulation, standards, and alternative products to figure out what will happen to those capabilities in the future. To provide a quick sense of the relative financial stakes involved, and highlight the biggest opportunities, the sourcing opportunities map should be populated with bubbles scaled to represent the cost dollars at stake for each capability. Once we've discovered which capabilities promise high potential for alternative sourcing, the next question is: How should we source them? We need to figure out how ours capabilities stack up to what's required. Do we meet, exceed, or fall short of cost and quality requirements? A capability assessment map like the one in the exhibit “How Strong Are Ours Capabilities?” plots each capability according to its cost and quality relative to top-performing competitors or suppliers. This map will help we determine which key capability gaps our company needs to fill. Perhaps equally important, it will identify any current activities that we could perform with less rigor without incurring any strategic penalty.

Where capabilities fall on this grid establishes appropriate goals for an outsourcing relationship. Functions that fall, for instance, in the upper left (relatively high-cost functions).

Not proprietary			High Strong candidates	Priority outsourcing
Data are proprietary		Medium Priority:		
Business process is Proprietary		Outsourcing on industry and dynamics	opportunities company	Dependent
Profit model is Proprietary	Low Priority: Captive Candidates	sourcing		

Unique to self — Common across industries

Uniqueness of business process or function

Table 1. Proprietary nature of process or function [9]

Company’s ability to perform function

Once we have determined which capabilities offer the highest potential value from outsourcing, we need to see how well, and how efficiently, a company currently performs each one of them. This exercise may surprise: If the cost per transaction is low enough and quality high enough, should be thinking of selling that function as a new business in itself.

Better than it needs to be	Source to sacrifice necessary	reduce cost; capability if	Consider creating
	Source to	reduce cost	a new business (if adjacent to core business)
Not good enough	Source to increase capability at lower cost Above industry median	Source to capability even if necessary Alt industry median	Increase at higher cost Below industry median

Cost per transaction

Table 2. Company's ability to perform function [10]

Given the rapidly shifting contours of the global economy, companies need to be able to anticipate changes in the economics and geography of outsourcing. It wasn't long ago, for example, that most big companies had to own their own warehouses and operate their own distribution systems. Logistics specialists had neither the skill nor the scale to handle those functions. But today, suppliers are competing fiercely to offer full-service logistics networks, and even the largest companies can now outsource warehousing, distribution, and related activities. Such trends will only accelerate in the future, and those companies that have recognized and prepared for them will be the first to capitalize on them.

So, to ensure that it doesn't quickly be-come obsolete, a sourcing strategy needs to consider not only present circumstances but also future alternative scenarios. What trends will influence the sourcing options available for each key capability? Is the supplier base growing rapidly, and are innovative new outsourcers emerging? Are different regions of the world investing heavily in particular capabilities - like contract manufacturing or customer service - and will they offer greater cost or quality advantages in the future. The answers to such questions may encourage a company to pursue certain sourcing opportunities that might not be highly attractive based on current numbers but could offer dramatic benefits in the coming months and years [11]. Or they may lead a company to negotiate short-term sourcing contracts to keep options open, rather than enter into long-term relationships. Ultimately, a company's skill in quickly remolding its sourcing arrangements in response to market conditions and rivals' moves may be its strongest competitive advantage.

Instead of conclusions

Functions that are situated in the upper (costly functions whose quality levels exceed requirements) should be outsourced to low-cost providers - even if it means a reduction in quality. Capabilities that fall in the lower left (high-cost functions performed relatively poorly) require outsourcing partners that can both reduce costs and improve quality. The capability assessment map also gives another way to identify in-sourcing opportunities. Capabilities that fall in the upper right (low-cost, high-quality functions) could become the basis for attractive new businesses.

Following the first two steps of our framework can help you determine what type of control we need over each of your capabilities. The third step is a kind of reality check in which we determine whether a capability that is a strong candidate for strategic sourcing can be carried out at a distance without any loss of quality.

The issue of physical proximity may not seem very strategic, but globalization and advances in technology ensure that it's a constantly moving target. For many functions, including transaction processing, design, engineering, and customer service, the Internet and an increasingly sophisticated telephone infrastructure have made physical proximity much less relevant, at least from a cost perspective. The necessary information and outputs can be transferred electronically at high speed and low cost. For tangible products that must be shipped, however, proximity plays a large role in both cost and timeliness considerations; it may not be feasible to manage the movement of such products from afar. There may also be customer service constraints. Certain product development, sales, and service tasks, for example, may require local interactions. Capabilities that do not require physical proximity are good candidates for off shoring, whether through a traditional outsourcing arrangement or, for proprietary capabilities, through a captive operation.

If to go through this three-step analysis, a company should have the outline of a comprehensive capability sourcing strategy. To know which capabilities need to own and protect, which can be best performed by what kind of partners, and how to structure a productive relationship. Formulating the strategy is, of course, only the first stage of a sourcing effort: Partners then have to be chosen, contracts negotiated, and management structures established and monitored. The success of the strategy often hinges on the creativity with which partner-ships are organized and managed. But only by first taking a broad, strategic view of capability sourcing can a company make the most of its sourcing choices.

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