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HRG Insight:
Making Successful Sourcing Decisions

Harvard Research Group recommends that organizations include sourcing decision-making as part of their ongoing strategic planning. While cost and technology are important factors, there are usually more strategic considerations. HRG interviewed C-level executives at Fortune 2000 companies to learn how they make successful sourcing decisions. We learned the following:

- When strategic sourcing involves entire functions, capabilities, or business processes, cost is not usually a primary decision-making factor. However, for well-defined tactical sourcing decisions, cost is typically a key decision-making factor.
- For sourcing decisions involving organizational, cultural, and human resource changes to succeed, C-level executives need to be involved.

Interviewees tell us that cost is not the predominant factor in the majority of these decisions. However, business expansion, revenue generation, streamlining business processes, and risk mitigation are more often key factors.

HRG recommends that organizations work with and seek the advice of an experienced independent third-party throughout the strategic sourcing decision-making and implementation process. Organizations today are starting to examine sourcing core capabilities or functions, but at this time few are actually doing it. IBM is one of the top professional services firms with the required levels of experience and expertise necessary to act as a long-term strategic sourcing partner.

IBM commissioned this paper and underlying study.

Harvard Research Group, Inc.
PO Box 297
Harvard, MA 01451-0297 USA

Tel. (978) 263-3399
Tel (978) 456-3939
hrg@hrgresearch.com

Why source?

There is no one, simple "one-size-fits-all" answer. Every organization is unique and quite often, complex sourcing decisions are a function of interrelated factors with one or two being key. The drivers behind many sourcing decisions are described in the following table, ranging from simple to complex.

Simple → Complex

Cost-Related Metrics	Tactical Business Initiatives	Strategic Initiatives	External or Longer-Term Challenges
✓ Cost metrics ✓ ROI metrics ✓ Return-on-capital metrics	✓ Increase top-line revenues ✓ Improve business processes ✓ Enhance responsiveness	✓ Risk mitigation ✓ Major business expansion ✓ New business creation ✓ Regulatory requirements	✓ Response to major industry or external changes ✓ Response to significant internal change ✓ Response to major competitive challenges

The people we interviewed told us that complex business considerations are most important when organizational or industry changes drive sourcing decisions. Two examples follow:

A mid-size retailer - Three years ago a mid-size retailer with more than 150 stores on two continents decided to expand into global markets, which led them to examine sourcing as a way to meet new and evolving IT requirements. They decided to use their reputation as a high-end retailer and unique core competency in franchising to drive their global expansion. They needed to double their IT capability almost immediately. When we talked with the retailer's CIO, we learned that cost was not a primary sourcing decision factor. The CIO told HRG that they decided to source with IBM because of their global reach, technical bench strength, on-time delivery capability, on-demand flexibility, deep experience and well-established partnerships.

A large utility - During the 1990s this utility grew into a sprawling highly diversified company with an internal culture of risk-taking, and little centralized control. Recent major industry events forced the company to reexamine its strategic direction and to take on a dramatic business transformation. They examined all aspects of the company - IT as well as business processes and functions – and made a significant sourcing decision around optimizing profit while aggressively cutting costs. As the situation progressed, they realized it was unreasonable to maintain multiple internal divisional IT organizations. They needed a vendor with deep experience and expertise in choreographing business transformations involving both people and technology issues. Their decision to source to an outside vendor, particularly one with the brand recognition of an IBM, had the effect of facilitating and accelerating the desired cultural changes.

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What to source?

What is sourced depends on specific business goals that can range from the very simple tactical aspects of a business to sourcing an entire business function such as human resources or accounting. Even when sourcing decisions are based on solid business and strategic considerations, deciding what to source is not trivial.

Tactical | Strategic

Discrete Activities and Commodities	IT Services and Infrastructure	Business Processes and Applications	Entire Functions and Businesses
✓ Office equipment ✓ Capital equipment ✓ Bounded, single IT applications	✓ Hardware, software, network infrastructure ✓ Business infrastructure (printing, copying, data input)	✓ Business applications within overall business function (payroll, market research) ✓ Web-based or hosted biz processes	✓ All or most processes within a function (HR, accounting, procurement)

A recent Harvard Business Review article points out that, "It is no longer a company's ownership of capabilities that matter, but rather its ability to control and make the most of critical capabilities whether or not they reside on the company's balance sheet." [1] Adopting and applying this view allows an organization to examine more carefully what is really core about their business, including the possibility of sourcing such sacred cows as research and development, engineering, and marketing.

- Several companies included in this study are starting to test-source selected core capabilities outside their organizations.
- Most have started to identify and define their core capabilities, but are not taking a planned and strategically integrated approach.
- A small number are looking into sourcing core functions, but expressed concern over possible conflict between business divisions and corporate headquarters when it comes to defining which core capabilities to source.
- Increasingly, organizations are recognizing that control of resources does not require traditional ownership, thereby opening the door for the sourcing of core business functions.

IBM's Component Business Model (CBM) offers a good road map for helping to decide which business elements to source. The CBM provides a clear methodology that can be used when deconstructing organizations into their essential functional and logical components. By leveraging this methodology, specific business processes can be segmented into discrete activities such as design specification, coding, implementation, operational management and support. The result is that sourcing decisions can then be well articulated and implemented for the entire function (process) or one of its components.

As sourcing becomes more complex and broad-reaching, cost becomes less important – as these decisions are more likely to be driven by strategic business concerns. If based only on tactical cost considerations and not integrated into an overall organizational strategy, companies are prone to overlook significant opportunities for business improvement. As Ravi Aron, Wharton School of Business professor says, "Sometimes, executives tell me they're making a strategic decision with the goal of achieving lower costs. But that's a contradiction in terms. If it's a strategic decision, it should be about more than lowering costs.

[1] "Strategic Sourcing: From Periphery to the Core," Mark Gottfredson, Rudy Puryear, Stephen Phillips, Bain & Co., Harvard Business Review, February 2005

"Unlike IT outsourcing and software-maintenance services, the main reasons for the right-sourcing of business processes—finding the optimal location for their production and execution—have to do with strategic, as opposed to tactical and operational, gains."[2]

The organizations HRG studied clearly understand the implications of strategic sourcing decision-making, and most have integrated this approach into their business strategy planning and execution.

When to make sourcing decisions?

Determining when to make a sourcing decision depends on a range of factors, some of which are listed in the table below.

Orderly			Least Structured
Planned, Orderly Budget Reviews	**Major IT Architectural Issues**	**Division-Level Disruptions**	**Company-Wide disruptions**
✓ Specific IT program or project benchmarks ✓ Part of annual or long-range business plan review	✓ Change in IT architecture or platform ✓ Major change in IT strategy	✓ Change in business strategy (key expansion or contraction) ✓ Inter-divisional organization changes in management or function	✓ Potential merger and acquisition activity ✓ External industry or national events ✓ Potential spin-offs

Each of these events can provide a convenient opportunity for making sourcing decisions. Sourcing decisions made in a logical and orderly manner – as components of planned budget or business strategy reviews – on an annual or quarterly basis are more controllable, better managed, and the results are usually more predictable. Sourcing decisions should be part of an ongoing strategic review process. The more complex the sourcing decision, the more closely it should be tied to strategic business objectives.

How is the decision made? What is the process and who are the players?
Whether sourcing decisions are part of a strategic plan (a key element of an organizational value chain) or are simply tactical "make/buy" procurement decisions, the process of making these decisions is critical. HRG recommends that companies ask themselves the following questions:

1. Is there a logical, well-considered, step-by-step process that is used to arrive at a sourcing decision?
2. Is there an independent thirdparty either managing the process or providing due diligence? This broker function was critical for most of the organizations studied.
3. Who is on the decision-making team? CXOs? Business unit managers? Technology influencers? Procurement specialists?
4. How much CXO involvement is required? This is important if the decision is linked to organizational change and will impact employees and other stakeholders.

[2] "Sourcing in the Right Light" by Ravi Aron, Optimize Magazine June 2003 Issue 22

Delivery of sourced capabilities

Delivery options for sourced capabilities vary in the degree of direct control of the sourced function. One option is to continue to perform the service or function in-house. Another option is either total or partial outsourcing of the capability. For example, a large multinational company can continue to in-source by providing the function at one of its offshore facilities – and still realize the benefits of reduced labor and resource costs.

Ultimately, the delivery question will be answered in the context of the specific business drivers and strategic direction behind the sourcing decision. Implementation questions should include:

- Should the element, application or function stay in-house? What is at risk beyond just cost? For example if proprietary or secure data is required to be managed "locally," outsourcing may not be an option.
- Can the element, application or function be outsourced to a third party? What will the nature of this relationship be? Joint venture? Trusted partnership? Hosted? Web-based? Performance-based service level agreement contract with a third-party provider?
- What geographic considerations are involved in the implementation? Offshore within the organization? Offshore within the third-party provider? Centralized/ De-centralized?

Most of the organizations included in this study made sourcing decisions that resulted in sourcing to third parties. For example, a health services company (and an outsource provider themselves) had to remain aware that the primary business drivers for its clients (health insurers) were operational costs – with mitigation of risk as the end goal.

All respondents said they feel strongly that a vendor needs to act as a true partner. This can take several forms:

- For the smaller and medium-sized organizations, particularly those with specific business expansion plans, doing demonstrable joint marketing was very important. The image of the company benefited from showcasing the sourcing partnership. Sometimes the partnership can provide a competitive advantage in expanding a medium-sized business in regions or countries where it is not well known.
- Flexibility and risk-sharing are important components of the partnership. A small service-based organization of member clients and a large, sprawling manufacturing company both appreciated their vendors' flexibility in negotiations and in handling the resulting relationship. In particular, the vendors were willing to rework terms and conditions during negotiations and demonstrate on-site examples of the future services. Small favors count – as does a vendor's willingness to share the risk of both pain and profit.
- Access to additional, less strategic partners can be a major advantage of the relationship. The retail company mentioned earlier indicated that having the opportunity to work with their vendor's other partners was important from both technical and tactical perspectives, while it also demonstrated a long-term strategic advantage.

Conclusions and recommendations

Most strategic sourcing decisions are complex, critical to an organization's long-term success, and go well beyond traditional cost and technology considerations. The interviews conducted for this study clearly point out that the following issues must be considered as part of most sourcing decisions:

1. Consider business drivers beyond cost and technology – such as business expansion, risk mitigation, quality of delivery and improved competitiveness.
2. Link the decision directly to the longer-term strategic vision of the company.
3. Clearly identify and define what is being sourced – commodities, discrete activities, processes, or entire functions.
4. Use a proven methodology – such as IBM's Component Business Model – to help identify and define what is to be sourced.
5. Clearly identify and define your core and non-core capabilities and functional business elements. Core activities do not always need to be under direct control of the company.
6. Make sure that senior management is aware of and involved in the decision, paying close attention to the people issues involved.
7. Finally, choose a sourcing partner with the required flexibility, strategic industry relationships, proven expertise and bench strength necessary to ensure success.

Harvard Research Group is an information technology market research and consulting company. The company provides highly focused market research and consulting services to vendors and users of computer hardware, software, and services. For more information please contact Harvard Research Group:

Harvard Research Group™
PO Box 297
Harvard, MA 01451 USA

Tel. (978) 456-3939
Tel. (978) 263-3399

e-mail: hrg@hrgresearch.com

http://www.hrgresearch.com