Strategic Sourcing for Business Results

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Strategic sourcing can do so much more than just cut business costs: it can be the key to achieving profitable business growth. Robert Gandossy and Jennifer Tower report.

All too often, business leaders fall into the trap of trying to do it all. In some instances, it stems from their early days, often operating a small business in which they may have served as purchasing officer, sales manager, book-keeper and proverbial 'chief bottle washer', all in an attempt to stay in the black.

Once they achieve the kind of success they have been seeking, they sometimes find it difficult to let go and delegate such duties to others, believing that they must play a hands-on role in every aspect of the business.

The most effective CEOs avoid this kind of scenario, however. They understand that leading a company means focusing on core competencies – the things they do at best-in-class levels – and leaving the squeegees to the window washers.

CORE COMPETENCIES

Expanding this line of thinking to the entire organisation, companies would be well advised to invest their resources in the areas where they are best in class, while forging external partnerships to deliver on the non-core activities.

Companies simply cannot deliver excellence in all aspects of their value chain. In fact, most organisations find they can only be best in class at two or three things. The solution lies in strategic sourcing – that is, tapping into the deep knowledge base of a network of suppliers who themselves are best in class in their particular area of expertise. For an organisation such as Amazon, for example, that means outsourcing almost everything, with the exception of its core competency: developing easy-to-use websites.

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The theory that winning in today's service-based economy requires a disciplined approach to exploiting core competencies and strategically sourcing all non-core activities lies at the heart of James Brian Quinn's landmark book, *Intelligent Enterprise*. He holds that moving the playing field from the realm of products to the realm of ideas has made it increasingly important for business leaders to focus their investments and their best people on the activities that will drive competitive advantage.

THE DELL EXAMPLE

Take Dell Computer, for example. Few Dell customers realise that their computer was not actually manufactured by Dell. Recognising that its core competency is understanding customer needs rather than making computers, Dell makes strategic sourcing the foundation of its business model. When the company works with suppliers, it opens up both the design and the production processes, providing them with the targets they need to hit for cost, timing and quality. By doing so, they eliminate the burden of hiring employees, managing them and paying their benefits, all the while ensuring that they are getting parts and labour from best-in-class suppliers.

Seeking to understand how companies such as Dell not only make decisions about outsourcing but also ensure that those decisions produce business results, Hewitt Associates collaborated with *CFO Magazine* to study the sourcing strategies of more than 4,000 of its subscribers. Then, working with Michael Treacy, author of *Double-Digit Growth: How Great Companies Achieve It – No Matter What*, they focused on more than 70 Double-Digit Growth (DDG) companies that had sustained at least 10% profitable growth over the past five years. This group was compared with Single-Digit Growth (SDG) companies that achieved 0% – 9% growth over the period.

The findings were noteworthy. For starters, most DDG companies believe that strategic sourcing increases shareholder value. This is apparent in the fact that they outsource more non-core activities than SDG companies, particularly in the areas of IT and HR.

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The logic behind the action is simple: IT and HR share two common 'pain points' that make them prime candidates for outsourcing: the high cost of upgrading applications and the high volumes of low-value transactional activities.

When it comes to strategic sourcing, DDG companies are nearly twice as likely as SDG companies to have a formal strategy (65%, compared with 37%). Clearly, there's a payoff in doing so. Nearly two-thirds of DDG companies with sourcing strategies in place report better cost management, as measured by total operating costs as a percentage of sales. And fully two-thirds of DDG companies with sourcing strategies demonstrate greater total shareholder returns than SDG companies. DDG companies also generate a higher ROI from outsourcing, an average of 19.3% versus 17.6% for SDG companies.

SETTING BALANCED OBJECTIVES

Still more compelling than the amount of outsourcing being done by DDG companies, or even the amount of money they are saving, is their approach. DDG companies have woven the concept of core competencies into their business strategies. Thus, they are more likely to have a strategic perspective on outsourcing, viewing their provider relationships as part of a holistic business strategy.

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Consequently, they are more likely to stick with it, even when times are bad. In fact, 58% of DDG companies say they are more likely to pursue outsourcing when there is a 'soft economy', compared with 25% of SDG companies.

Outsourcing just for cost savings is not a winning strategy, however. While cost reduction, improved processes, better return on capital, lower risks, increased flexibility and enhanced responsiveness to customer needs are all desirable outcomes of strategic sourcing, the overriding objective should be to sharpen the focus of employees at all levels of the company on the kinds of activities that will drive competitive advantage.

Clearly, DDG companies understand this philosophy. Three-quarters of DDG companies that outsource their HR function say the number one reason for doing so is to concentrate resources on the core business, compared with 61% of SDG companies.

Leaders at DDG companies set outsourcing objectives that are consistent with broader business goals and then work relentlessly towards meeting them. Asked by *Business Week* to outline his company's strategy, A G Lafley, CEO of Procter & Gamble, replied: 'We're in the business of creating and building brands.' In line with that strategy, Lafley has made P&G less internally focused, partnering with outside firms whenever the company identifies an opportunity to save money, improve quality and sharpen strategic focus.

Consequently, P&G has entered into agreements with outsourcing providers to accelerate new product development and to manage all of the company's IT infrastructure, data centre operations, end-use support, and applications development and maintenance. P&G expects to save billions of dollars through such initiatives.

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MANAGING THE RELATIONSHIP

Companies that are truly strategic about outsourcing build partnerships with their providers. Rather than telling a supplier how to do the work, they describe their need. That's not to suggest that these organisations merely hand over a critical function, such as IT. On the contrary, the best outsourcing partnerships are based on mutual self-interest, with both parties working together to come up with the best solutions.

Central coordination is the name of the game among DDG companies, with 75% dedicating one person or department to managing the strategic sourcing programme. As vendor management is a strategic, rather than administrative, activity, senior leaders should play an active role in managing relationships.

Some 81% of DDG company respondents report that their CFO participates in selecting outsourcing vendors, compared with just 8% at SDG companies. In addition, CFOs at DDG companies apply greater discipline to measuring the returns from outsourcing. Tracking cost savings is important for a variety of reasons, most notably because it helps clarify upfront the expected benefits from the outsourcing arrangement and it provides an important framework for discussing current and expected service levels with vendors.

KEY TO GROWTH

Cost pressure is leading a growing number of companies to consider outsourcing as a means of reducing operating expenses. As we've seen, however, strategic sourcing does far more than contribute to bottom-line savings, it also helps organisations improve processes, gain and sustain competitive advantage and produce impressive business results. Specifically, it can contribute to an organisation's ability to produce DDG.

Granted, strategic sourcing is just one of many factors that contribute to a company's ability to achieve and sustain profitable growth. However, it makes sense to be the best in one's area of core competency and to look to outside providers for low-cost and effective delivery of non-core services.