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Thinking business technology

Sourcing versus subscription

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Today, companies have many sourcing options from "insourcing" to newly emerging subscription based sourcing. In the middle lie the outsourcing and offshoring options. As the business climate changes, the most common sourcing practices of today may not be the most appropriate sourcing strategy for successful companies of tomorrow. Smart CEOs will look at the entire spectrum of sourcing options from a strategic standpoint, literally reinventing their companies by drawing together the right capabilities from the right sources at the right time using a subscription based model to eliminate risks and to increase flexibility. Find out how this new subscription based model of sourcing will result not only in greater productivity, but also in a flexible, agile sourcing method that can be changed quickly by companies to respond to changing market demands.

Sourcing is a process designed to allow companies to procure the products and services for the best value. Using this approach, the buying company analyses what it's buying, what the market conditions are, and who can provide those goods or services. Historically, the buying company then uses that information together with innovative contracting techniques to find the best prices available in the marketplace.

Today, companies have many sourcing options. On one end of the spectrum are "insourcing" alternatives. A company can, for example, make a particular capability in a traditional business unit, or it can source it from a separate part of its business. It can also establish a captive offshore operation (such as HSBC's processing centres in India). In all these cases, the company owns and operates the source. At the middle of the spectrum are joint ventures. A company can draw on managed-services programmes for capabilities it needs, tapping an external service provider to take over an internal function, or it can partner with other companies to create a mutual capability. In each of these cases, ownership and operations are shared. Towards the other end of the spectrum lie offshore outsourcing options. A company can use domestic service providers to provide a capability. It can call on a business process outsourcer to change the way some part of its business works, or it can outsource one or more business functions to an offshore outsourcer. All of these options carry a degree of risk. For example, "in-sourcing" option is often seen as the lowest risk whereas offshore outsourcing option carries the highest risk to a company (see Figure 1).

Sourcing Options

Variety of Risk	Insourcing	Managed Services	Captive Shared Services	Outsourcing	Offshore Outsourcing	Subscription based sourcing
Operational risk	Low	Low	Low	Medium	High	Low
Security risk	Medium	Medium	Medium	Medium	High	Medium
Market risk	Low	Low	Low	Medium	Medium	Low
Volume risk	Low	Low	Low	Medium	Medium	Low
Credit risk	Low	Low	Low	Medium	Medium	Low
Environmental risk	Low	Low	Low	Low	High	Low
Reputational risk	Low	Medium	Low	Medium	High	Low
Regulatory risk	Low	Low	Low	Low	Medium	Low

Figure 1: Risk is relative but higher risk do not translate into high returns

Between 1940 and 1980, the basis of competition was determined largely by the assets a company owned, whether factories, infrastructures, raw materials, or bank branches. But during the last decade, successful companies moved their focus from owning assets to owning capabilities—think of Tesco's supply-chain management skills of recent years.

Now, we're entering a third phase of competition, in which companies will compete based on how skillfully they can exploit capabilities owned not just by themselves but by others as well on a subscription based method. The way a company manages its sourcing network under the subscription based framework lies at the very core of this new mode of competition. In the years to come, subscription based sourcing strategy will be increasingly indistinguishable from competitive strategy.

Flawed sourcing practices destroy value

Today, businesses grow and build market share by being better than their competitors. But because business leaders crave certainty and because shareholders prefer steady and predictable performance, it is understandable that companies tend to stick to existing ways of sourcing. If the sourcing model is not broken, there should be no need to fix it. But even as senior executives congratulate themselves on getting a grip on the business in uncertain times by sticking to existing ways of sourcing, they may be creating bigger problems for the future.

For example, senior executives thinking which parts of their IT or business function should be outsourced and which should be in-sourced usually ask themselves: Does the specific IT or business function provide a strategic advantage or is it a non differentiating activity from the competitors? If the function is a core activity, they keep it within the company, otherwise it is a candidate for outsourcing. Unfortunately, the decision making process is not that simple. Over the last 3 years, we studied 50 European and US companies that had grappled with the issue of sourcing IT and/or business functions, and we found that in most cases traditional outsourcing methods led to below par performance and disappointment among executives.

To understand the failure of this approach, consider its underlying assumption: that executives can place big bets about their markets, future technologies, and suppliers' capabilities and motives with great deal of certainty. The truth is that they simply cannot. Today's business world is global, complex, unpredictable, and too turbulent. In spite of this, we have seen time and again senior executives sign five to ten year outsourcing contracts without considering that they often cannot predict, with confidence, how business conditions will change even in two years – let alone what technologies will be available then. They turn to external sourcing to gain access to the latest technology and low-cost labour with service level agreements (SLAs) without taking into account how an external service provider's need to maximise its profits will impact the outcome. For those reasons, the issue of whether an IT or business function is core or a commodity is secondary. A company's primary objective should be to maximise flexibility, choice, and control so that it can pursue different options as it learns more or as its circumstances change. And a subscription based sourcing method precisely does that. Subscription based sourcing also helps to maximise competition – because a company can see and compare the service bundle and its price offered by one provider with another provider, just like a customer can compare an item on a restaurant menu between two restaurants. For this reason, senior executives should not make a decision whether to insource or outsource. Instead, they should create an environment in which potential suppliers – both external companies as well as internal departments, such as IT – are consistently competing to provide IT or business services on subscription based method making services and associated charges completely transparent (see Figure 2).

Our research found that companies that neglect the subscription-based pricing model and prefer traditional sourcing (both insourcing and outsourcing) based on conventional SLAs or similar techniques perform poorly. This is because companies are encouraged to institutionalise best practices, freeze them into place, focus on execution, stick to their knitting, increase predictability and get processes under control. These approaches establish stability as the key to performance. As a result, companies are built to support stable strategies and bureaucratic structures, not to change. Unfortunately, customers do change. They want new and different services and products, and they want to be able to get hold of them in new and different ways. So, sourcing methods have to change. But companies often find it hard to register and respond quickly to this.

From our research over the last three years, we found that most companies struggle to transform their sourcing methods. They typically enter a fast or slow death spiral and eventually performance suffers and sometimes they go out of business. Before they know it, they become a legacy business, a sitting target for fast-moving new entrants. They have failed to adapt to changed circumstances. There is clearly not just a first-mover advantage when disruptive changes are involved; there is a new competitive advantage.

What are the warning signs that companies may be falling into the legacy sourcing trap? First, companies get out of synch with their customers. Paying very close attention to customers sounds blindingly obvious. But, it remains necessary because it is so rarely acted upon. Another sign of a losing battle with legacy sourcing practice is the sheer frustration and anxiety that will be felt by senior executives to change – because changing sourcing practice is about hands-on action, and rational analysis of the current customers demand and no enjoyment.

Today, companies must be built around sourcing practices that encourage change, not those that hinder it. Change is difficult because people are rewarded for stability. But sticking to an outdated yet stable sourcing practice, company in a complex and rapidly changing business environment is following a recipe for failure.

Lack of enthusiasm among traditional service providers doesn't help

Large IT and traditional service providers are, understandably, not keen on subscription based pricing models for their services. This is because most of these companies are either products sellers and/or large-scale body-shops, and their business models are either based on economies of scale or volume of products they can flog to customers regardless of their customers' need.

FACTOR	TRADITIONAL SOURCING METHODS	SUBSCRIPTION BASED SOURCING METHOD
Nature of demand	Capable of handling predictable and forecast demands	Capable of handling predictable, forecast as well as unpredictable and sporadic demands
Required response	Slow and standard but can be adjusted by changing contractual terms and paying more	Standard, ad-hoc by mixing and matching menu-based offerings
Product/service portfolio	Mainly homogenous and rigid	Both homogenous and heterogeneous; configuring new services are simple
Delivery channel	Depends on nature of services sourced or contracted; multiple delivery channels necessary	Uniform delivery channel, capable of delivering different products and/or services at speed
Aim of inventory management	Maximise product and resource utilisation	Pre-position resources to provide services requested
Reverse logistics	Not capable of handling easily	Handles returns, repair, and disposal of failed parts of the services effortlessly
Performance metric	Charges based on Service Level Agreements (SLAs); higher charges for changing demands	Based on menu-based transparent pricing and known charges

Figure 2: Traditional sourcing versus subscription based sourcing – benefits are self-evident

Our analysis revealed that continuous quest for lowest cost sourcing and doing business primarily with large IT suppliers did not allow companies gaining a substantial advantage over their competitors. In fact, performance of those large IT suppliers steadily deteriorated. So, why haven't traditional IT suppliers been able to deliver the flexible services that match the expectation of these companies? We found several reasons. For example, large traditional IT suppliers are unable to respond to unexpected changes in companies demand. All most all large scale IT suppliers have centralised their production and servicing facilities in low-cost locations (such as India, China, Philippines) to generate economies of scale, and they are capable of only delivering lots of standard processes to companies to minimise service delivery costs. When demand for a particular service raises unexpectedly, these large scale IT suppliers are unable to react. Even when these IT suppliers respond, the costs of services climb exponentially (see Figure 3).

Many CIOs are faced with legacy IT suppliers or incumbent IT suppliers of the 20th century, who were selected based on their size and panoply of product offerings, and outdated sourcing practices. These IT suppliers continue to use shotgun approach and promise to supply all kinds of products and services that instantly solve all kinds of customers' problems. But, these IT suppliers are not keen on providing transparent pricing and short-term contracts.

Yet, companies continue to source from large IT suppliers using the traditional sourcing approach, but unable to get return of their technology investments. Large IT suppliers, continue to hold companies hostage with their proprietary technologies, fixed set of productised services, and long-term contracts. But, it doesn't have to be like that – and there is a better way.

Subscription based sourcing – model of the 21st century

Subscription based pricing models provide win-win solutions for both the service providers and companies. As China's manufacturing prowess and India's low-cost call centres have grown in the past decade, IT and services companies in the high-cost regions of Western Europe, North America and Japan need to find ways to gain a competitive advantage on lower-cost rivals there – or risk being driven out of business. In this competitive battle, western companies have adopted a number of strategies. Many European and US companies joined their Chinese or Indian cousins and set-up business there recruiting vast number of low-cost employees to compete with the local rivals. Some other western companies have concentrated on narrow product niches that few others can match, or have invested in highly productive automated machinery that reduces the disadvantages of high labour costs. Others have added a "service" component to their product, tethering supplier to customer through an intangible benefit that a rival company of Chinese or Indian origin would find difficult to reproduce. But, service providers of developed countries can make their business "China-India proof" with their higher quality labour and subscription based pricing.

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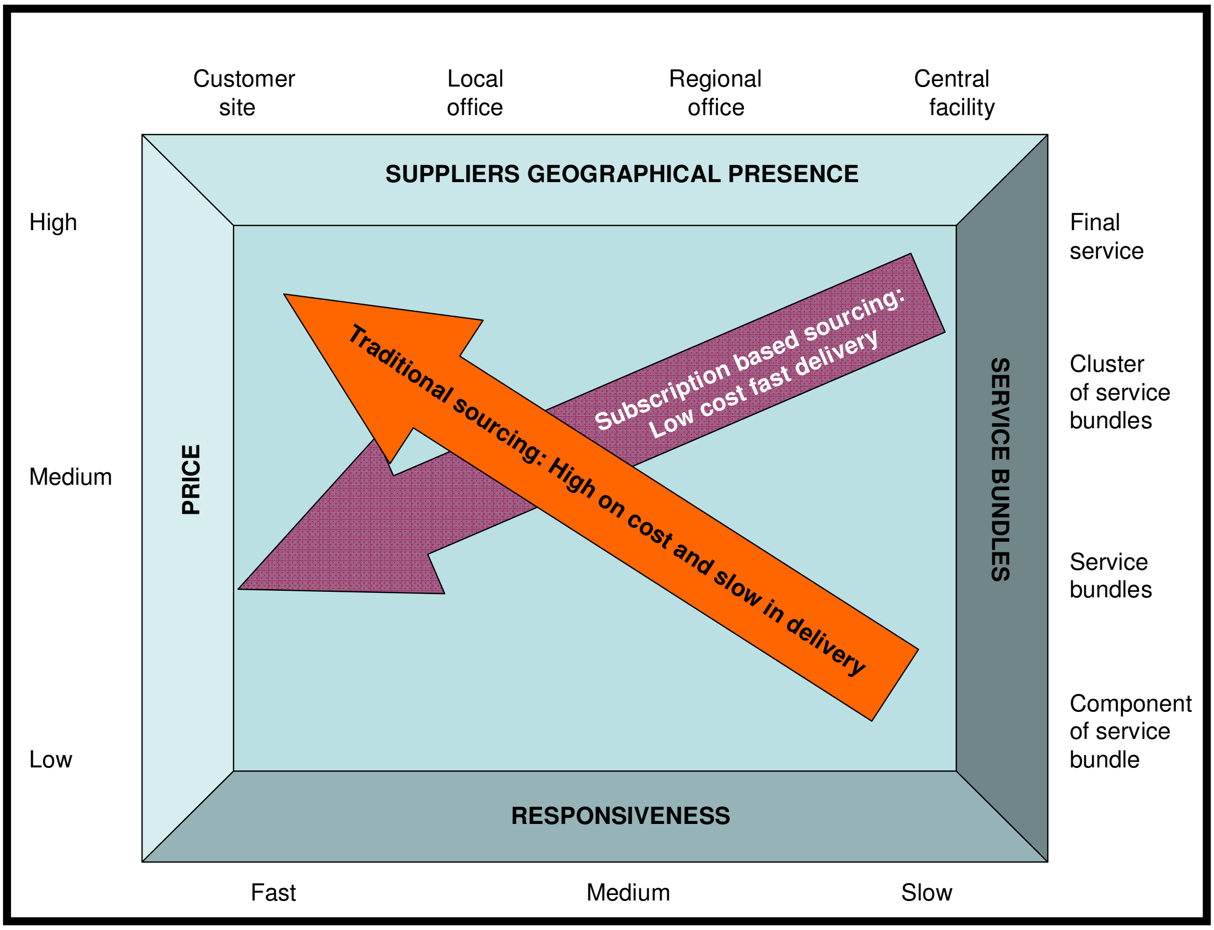

Figure 3: Traditional sourcing do not give competitive advantage anymore

What does all this mean?

However, smart CEOs don't approach sourcing decisions on a piecemeal basis. Rather, they look at the entire spectrum of options from a strategic standpoint, literally reinventing their companies by drawing together the right capabilities from the right sources at the right time. That results not only in greater effectiveness, but also in flexible, agile sourcing methods that can be changed quickly to respond to changing market demands.

About the authors

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