

Capability Sourcing

Cost and flexibility opportunities in the new global arena

By Richard Lynch and Ralph Loftin

Should your company be looking to alternative sourcing of business capabilities in the coming years? To be competitive and excel at strategic execution, odds are you should be. Yet few companies are taking full advantage of the cost and flexibility opportunities in the new global arena. This paper first describes the context for sourcing, proposes a capability centered framework for decision making, and then provides best practices from 4 case studies.

The Outsourcing Wave

Thomas Friedman, bestselling author of *The World is Flat*, describes ten change forces that have reshaped the competitive landscape. These “flatteners” as he calls them have created a global, level playing field. Events like 11/9/89 (when the Berlin Wall came down and opened up the global economy), 8/9/95 (when Netscape went public and created a surge in IT infrastructure investment), and the boom of workflow software changed forever the way businesses and people communicate and collaborate. Other flatteners opened the doors to new business platforms. These models are based on unprecedented forms of collaboration and teamwork. They include open sourcing, outsourcing, offshoring, supply chaining and insourcing.

Outsourcing of jobs has skyrocketed 472% since 2000 and is expected to grow another 171% over the next five years. As Table 1 suggests this is not just about IT jobs: management, life sciences, architecture, legal, art design, sales jobs and many others are also in play...as many as 3-6 million jobs by 2015!¹

Table 1: Outsourcing Trends by Job

Job category	2000	2005	00 to 05	2010	05 to 10	2015
Management	0	37,477		117,835	214%	288,281
Business	10,787	61,252	468%	161,722	164%	348,028
Computer	27,171	108,991	301%	276,954	154%	472,632
Architecture	3,498	32,302	823%	83,237	158%	184,347
Life sciences	0	3,677		14,478	294%	36,770
Legal	1,793	14,220	693%	34,673	144%	74,642
Art design	818	5,576	582%	13,846	148%	29,639
Sales	4,619	29,064	529%	97,321	235%	226,564
Office	53,987	295,034	446%	791,034	168%	1,659,310
Total	102,674	587,592	472%	1,591,101	171%	3,320,213

SOURCE: U.S. Department of Labor and Forrester Research, Inc. All numbers have been rounded.

¹ Estimates from Forrester Research and Goldman Sachs

Before diving in and looking for cost savings, companies need to:

- Define for their own business how they create competitive advantage, and identify key capabilities they need to be world class;
- Sort through the complex set of issues required for the right sourcing decisions;
- Determine the optimal work location and delivery approach for in-house work (e.g., Corporate, Region, Country, Center of Excellence, Shared Service Center, etc.);
- Determine the right sourcing option to meet the outsourcing strategic objectives and structure optimal outsourcing decisions;
- Determine optimal outsourcing location: onshore, nearshore, offshore.

Table 2 provides a brief description and pros and cons of the various outsourcing options:

Table 2: Outsourcing Options

Option	Definition	Examples	Pros	Cons
Out-tasking	Contracting for a specific, narrowly defined service	<ul style="list-style-type: none"> • Unix server administration; • Cabling 	<ul style="list-style-type: none"> • Straightforward contract • Low buyer overhead • Well-defined services • Performance easy to measure • Short lead time (few months) 	<ul style="list-style-type: none"> • Tendency to neglect relationship
Outsourcing	Contracting for a complete function	<ul style="list-style-type: none"> • Deutsche Bank and HCL; Wipro and Ericsson; • Infosys and American Express; Infosys and Telstra 	<ul style="list-style-type: none"> • Same as above 	<ul style="list-style-type: none"> • Same as above
Consortium	A cooperative, mutually beneficial arrangement among companies (co-opetition)	<ul style="list-style-type: none"> • Credit Unions (CUNA); • Industry associations; • Ariba 	<ul style="list-style-type: none"> • Straightforward contract • Well defined services • Low customer overhead • Short lead time (weeks to months) 	<ul style="list-style-type: none"> • Limited range of services available • Limited customization available
Alliance	A close association of companies or groups, formed to advance common interests or causes	<ul style="list-style-type: none"> • Banc One (AT&T and IBM) 	<ul style="list-style-type: none"> • Services can be tailored • Wide range of services can be provided 	<ul style="list-style-type: none"> • Success is critically dependent on the relationship between alliance partners (limited control by buyer) • Complex contractual issues • Difficult to change vendors • Long lead time

Option	Definition	Examples	Pros	Cons
Joint Venture	A legal entity formed to share risk or expertise. Characteristics: Customer can have name on door, Vendor operates, Joint management, Negotiated sharing of investment, risk and rewards	<ul style="list-style-type: none"> • Call centers; • Facility management; • Business Process Outsourcing (BPO) 	<ul style="list-style-type: none"> • Services can be tailored • Wide range of services can be provided • Customer can exert significant control • Can provide asset management benefits • Can shield both parties from certain liabilities • Can resolve local approval issues 	<ul style="list-style-type: none"> • Complex contract; requires establishing separate legal entity • Significant customer overhead (support, relationship management) • Long lead time • Difficult and costly to extricate • Customer must commit resources
Partnership	A legal contract entered into by two or more organizations in which each agrees to furnish a part of the resources for a business enterprise, and by which each shares a fixed proportion of the benefits.	<ul style="list-style-type: none"> • Staples and UPS • Stop & Shop and Citizen's Bank 	<ul style="list-style-type: none"> • Services can be tailored • Wide range of services can be provided 	<ul style="list-style-type: none"> • Complex contract • Significant customer overhead (relationship management) • Long lead time • Difficult and costly to extricate

For many, “outsourcing” is the term applied to any situation where services are provided by a third party.

However the choice of option influences every phase of the sourcing effort:

- The option must fit the strategic context for the sourcing decision;
- Vendor requirements are different for each option, and vendors are evaluated differently;
- The form and content of the contract are different for each option;
- The operational relationship is different and is managed at a different level in the client organization;
- The pricing structure is different;
- The incentives and measurements are different, both for the client and for the vendor.
- Recognizing the differences in these options and selecting the right option for each situation is essential to a successful sourcing transaction and relationship.

Building the sourcing strategy

Leaders often mistake the course of action and pursue a wrong path — diverting attention from the intended strategy. A root cause is often that strategic intent and objectives are not articulated in clear operating language for better execution.

To ensure rapid and aligned strategy execution, companies must:

- Identify desired relationships among lines of business or profit centers that pinpoint areas for efficiency and leverage;
- Identify how the business creates competitive advantage;
- Identify the organization’s dominant and secondary business strength;
- Identify the organization’s dominant and secondary customer value proposition;
- Clarify critical capabilities needed to execute the strategy, and those that can be shed.

Capabilities – what the company needs to do to execute its business strategy, stated in measurable and actionable terms – are the key to alignment and successful execution. Having a strategy does not ensure strategic action. A framework is required to bridge this gap to provide:

- Operating executives with a clear set of business capabilities that are necessary to win;
- CFOs with a method for aligning investments to the capabilities that will execute one game plan and eliminate waste in the organization;
- **IT leaders with a focus to allocate precious resources by first defining desired capabilities that create competitive advantage and then building enabling systems and supporting infrastructure.**

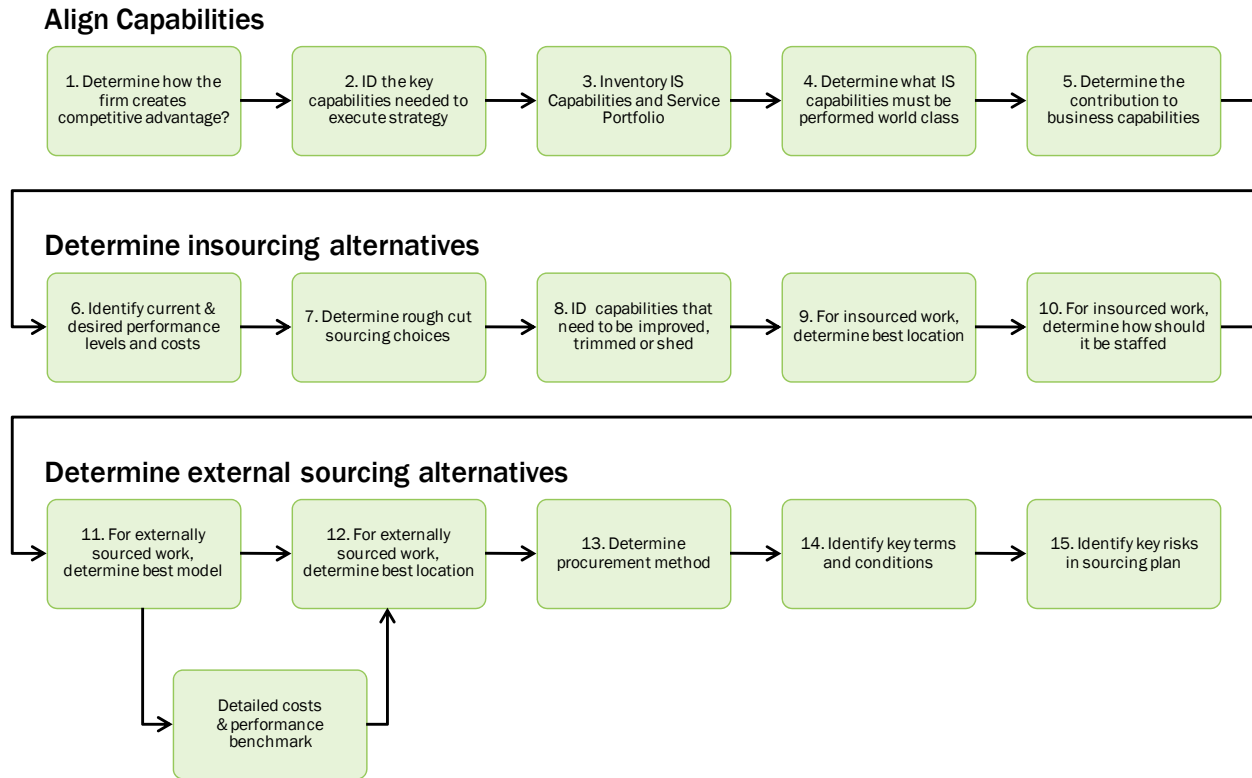
Being clear about the strategic relevance of a capability helps a business allocate the right level of time and resources towards strengthening the appropriate capabilities. We suggest three levels: **Advantage** (the capabilities that create competitive advantage and need to be performed near world-class levels), **Strategic Support** (the work that enables competitive advantage) and **Business Necessity** (those capabilities that need to be performed only at industry parity and at low-cost).

Strategic relevance is not the same as traditional *value added analysis*. It is a filter above it. Determining the strategic relevance helps focus resources on creating value and identifies where to take aim at costs either through rigorous process improvement or outsourcing.

The sourcing strategy is developed at the level of the major organizational units or functions. The following sections trace the development of the sourcing strategy for IT, and offer IT case examples, but the approach is the same for any other function (Finance, Marketing, Manufacturing, etc.).

Once the business capabilities are identified and their strategic contribution assessed, a set of IT (or other function) capabilities can be developed, and cross-referenced with the business capabilities. Each functional capability can then be evaluated in terms of whether it delivers, enables or supports the business capabilities. After the functional capabilities are aligned and contributions determined, internal and external sourcing decisions can be addressed as illustrated in Figure 1, using IT as the example:

Figure 1. IT Sourcing Flowchart



CIO challenges

Research by LSU’s Rudy Hirschheim² suggests four daunting challenges to CIOs and other IT executives:

1. IT governance – how to manage the increasingly complex set of relationships and vendors who provide IT products and services – domestic and offshore vendors, SBU IT units, corporate IT units, contractors, and customer desires?
2. IT alignment – how to align IT strategy with business strategy?
3. Process outsourcing – which processes to outsource - commodity vs. strategic processes?

IT succession – where does the next generation of IT leaders come from when most of IT is outsourced?

² “Outsourcing / Offshoring: What Do We Really Know?” Rudy Hirschheim, E.J. Ourso College of Business Louisiana State University. Paper delivered at Bentley College, December 2, 2005

Lessons from the front line

IT GOVERNANCE: MANAGING A COMPLEX SET OF RELATIONSHIPS ³

On 1 October 2002, the parent company of Six Continents proposed separation of the group's hotels and soft drinks businesses from the retail business, and the return of £700 million of capital to shareholders. The hotels group had more than 3,400 hotels and 530,000 guest rooms across nearly 100 countries and territories

At the time of the announcement, the company was being openly challenged by analysts and shareholders as to whether the company's leadership 'had what it takes' to run and grow a profitable hospitality company. The company struggled with several unique challenges:

- Integrate several brands, three regions and geographically dispersed operations.
- Finish the work left undone in several recent acquisitions.
- Complete the de-merger in less than six month in the midst of the outbreak of the Iraqi war and the SARs outbreak in Asia where many of the company's marquee hotels were located.

In order to sort out the complex set of global relationships across the business units and vendors who provide IT products and services, the company wrestled with its corporate strategy: what were the desired relationships among the businesses? Regions had traditionally controlled IT spending and decision making since they were closer to their customers. That coupled with a long history of leaders acting autonomously under the holding company model (former parent Bass and then current parent Six Continent operated breweries, soft drink businesses, pubs and hotels business) developed and ingrained behaviors based on the operating characteristics illustrated in the last column in Table 3:

Table 3. Corporate Strategy Implications on Governance

Corporate Strategy Component	Integrated (McDonalds)	Allied (Gillette)	Holding (Tyco International)
Business Strategy	One	Many	Many
Customers	Same	Shared	Many
Corporate Role	Resource Allocations	Define Protocols	Financial Roll-ups and Analysis
Human Capital	Common	Some Shared	Independent
Systems	Common	Common	Different
Enabling Processes	Centralized	Centralized	Decentralized

³ Adapted from: "Reinventing a Hotel Company: BPM as a driver for restructuring" with James W. Larson (*BPM Connections* Oct/Nov 2004) and "Succession Planning: How to Build Talents Pools for Future Leadership" with James W. Larson (*Linkage*, October 2003) ...

While the holding company model allows independence and can promote faster decision making, it is the most expensive model to operate. The new hotel company had to show investors efficiencies (over \$100 million in savings was promised and delivered) and leverage of its capabilities. Key to success was strategically refocusing the organization from a holding company to an integrated company (the least costly model) with multiple divisions.

The new global organization could only be effective with a new set of governance standards and rules. The leadership team spent an intensive six week period clarifying key components:

Table 4: Corporate Strategy Implications

Factor	Implication for Governance
Business strategy	For all regions/brands: <ul style="list-style-type: none"> • Single Business Focus (what we want to do): • Distribution/Production Capacity which means getting as many of our hotels as possible into each market using as little capital as possible, with the right brands on each, and then optimize the yield on the rooms stock • Single Customer Value Proposition (how we want to do it): Quality which means delivering the highest quality hotel experience to guests whilst ensuring that we have the best ROI trade-off of brand standards, fees and services for the hotel owner (whether ourselves or a third party).
Customers	Recognition of need to share customer data (Priority Club Rewards)
Resource Allocation	Centralized asset management function to allocated resources
Human Capital	Some common HR systems needed for vertical and global mobility
Systems	Efficiency from corporate standards for centralized shared services The reorganization and staffing of IT around central shared services.

The company then established business rules and governance policies to ensure that the changes would stick, and the methods used to redesign the organization were continually used to guide growth. The company specifically created Global Governance Boards for IT, Central Shared Services and Global Brand Services. The Governance Model, based on Sarbanes-Oxley and The Higgs Report, created a set of pragmatic guidelines for how decisions should be made about a few critical areas including:

- Investment in properties, talent development, business capabilities, information technology and key leadership positions;
- Standards for firm brand, leadership brand and hotel brand hallmarks;
- Performance measures for customer satisfaction, service quality and financial performance;
- Interoperation of business regions and supporting functional departments;
- Utilization of shared services across regions and functions.

Governance was not seen and would not be accepted as a separate controlling entity; rather it was embedded within the organization design and implemented as an enabler of the business through Service Level Agreements across the enterprise.

This corporate strategy shift allowed significant cost savings, mostly from IT: reduced development costs, use and maintenance of common systems, reduction in number of IT vendors and transaction efficiencies from central shared services. Some of these savings were reinvested in building capabilities that contributed directly to their strategy: “designing ROI savvy brand standards,” “delivering services in hotels” and “obtaining new distribution channels.”

IT-Business alignment

The CIO of a global risk management company needed to develop a cost model that would illustrate how IT was supporting the company. The problem was that line leaders had different assumptions about the business and different priorities. Without a mechanism to create alignment, all projects made sense and IT was in the unenviable position of trying to support all requests. As costs kept spiraling upward, the CEO was demanding more efficiency and chartered the CIO to look at more outsourcing.

The CIO knew that her function was overextended. She also knew that outsourcing might disrupt delivery of essential services that give the firm its competitive advantage. The crux of the problem was getting agreement on business priorities. To do that she first derived the set of business capabilities from published company strategy documents: a few examples are shown below:

Client solution determination:

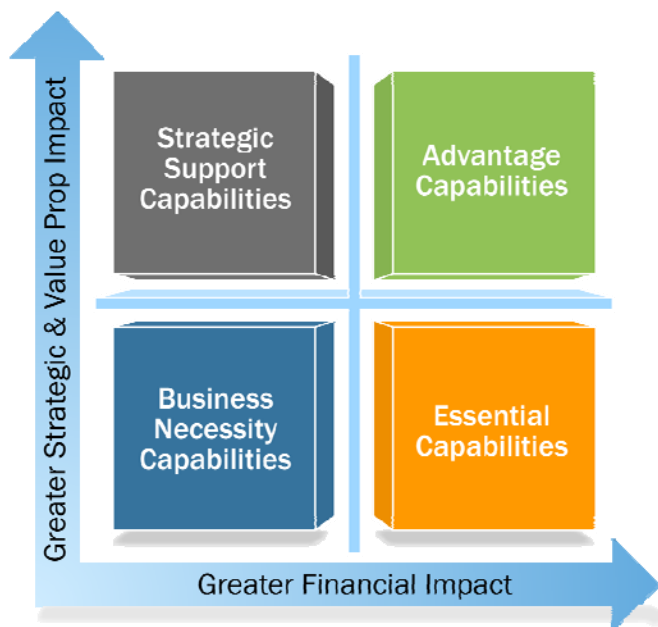
- Superior risk management services to multinational customers
- Delivery of country specific and industry insurance information
- Superior leverage of financial capacity in marketplace

Property/Hazard Exposure Identification:

- Provide convenient, easy access to loss prevention assets and loss prevention experts
- Superior knowledge about specific industries (types of risks)
- Understand and manage aggregate exposure to natural hazards that impact more than one location

Next she determined how each capability contributed to the company's strategy and classified them as Advantage, Strategic Support, Business Essential or Business Necessity. The big "ah-hah" here was to recognize that different service level requirements should be assigned to different business capabilities based on strategic contribution.

Figure 2. Strategic Contribution



Next, she related each business capability to one or more business organizations. She was then able to build a cross-reference matrix that showed how IT spending was related to business capabilities. A section of this matrix is shown in Table 5.

Table 5. IS to Business Capability Mapping

		Global Risk Mgmt, Inc.					
		Loss Management					
		Specific Business Capability	Identify losses and record loss information	Rapid, accurate measurement, assessment and migration of loss severity and causation	Recognition of the amount to be recovered through reinsurance	Recover losses through salvage, subrogation and litigation	Utilize information to analyze and understand nature of losses
IS Capability	TOW→	S.S.	ADV	B.N.	B.N.	S.S.	
Acquire solutions (applications, data, information appliances)							
Acquire resources from external sources (contracting/procurement)							
Deliver solution services (application availability, network connectivity)		Enable	Support	None	None	Deliver	
Provide the computing infrastructure							

IS capabilities were assigned a role in Business Capabilities by answering the question, “What would be the impact on the Business Capability if the IS Capability did not perform?” Four roles were defined, ranging from “Deliver” to “None.” For example, the IS capability “Deliver solution services...” was judged to “Enable” the Strategic Support Business Capability, “Identify losses and record loss information,” while playing other roles for other Business Capabilities.

By considering the role each IS capability plays in the Business Capabilities, the strategic significance of the IS capability can be clarified. In the example above, because this IS capability delivers a Strategic Support Business Capability, it is also a Strategic Support capability.

A series of discussions with senior executives served to clarify the business capabilities and build a rationale for altering IT spending priorities for better strategic leverage.

For example, in choosing between IS projects, each project was evaluated for its impact on key business capabilities as well as cost. Spending was sharply curtailed for projects having minimum strategic impact. In addition, the “spread” of spending for IS between business capabilities was rebalanced to provide more support to high-impact areas.

As a result of this exercise, the business capability model was adopted as a framework for planning and budgeting throughout the company.

Process outsourcing: Which processes to outsource?

The Director of global infrastructure for a major office supply retailer was being pressured to keep reducing IT costs, including the continued use of outsourcing alternatives.

Like many companies, most decisions were made piecemeal, based on differing sets of assumptions about the business. After developing a set of business capabilities derived from interviews and published company strategy documents, the Director and his team made an assessment on the strategic contribution of each capability. Next they examined IT capabilities that delivered or enabled strategic business capabilities and identified those that were foundation work – still important but needed to be performed at low cost. Finally the team assessed whether the knowledge to do the work was generic or proprietary.

These analyses provided the decision criteria to make a first cut at process sourcing (the first pass assumption was that advantage work gets done in-house unless the performance gap is too wide and the time to close the gap too short).

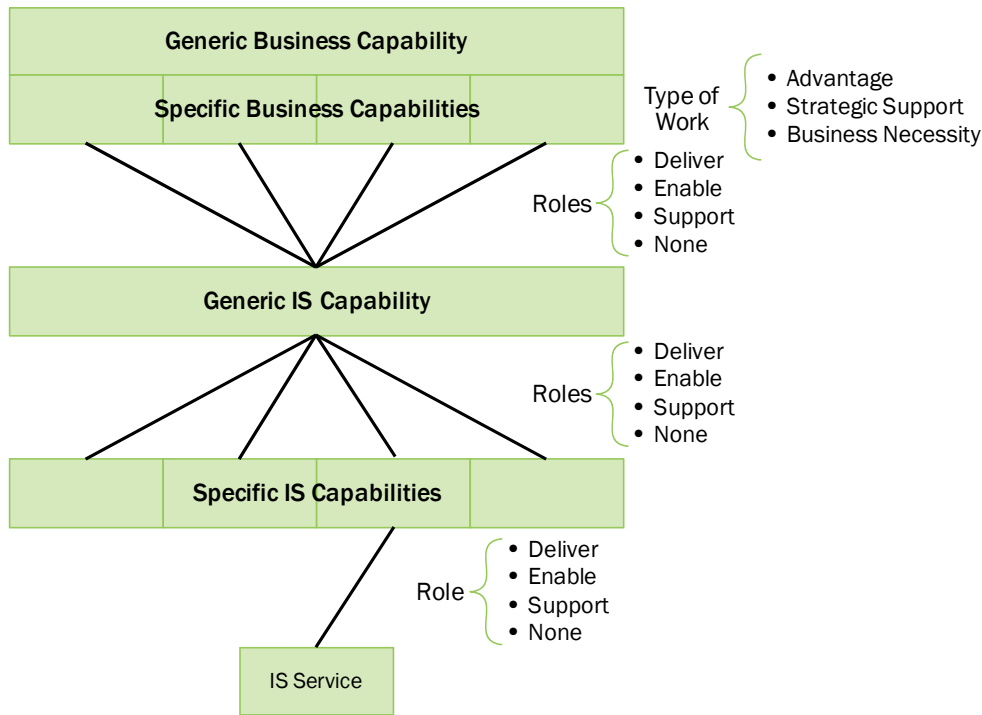
Figure 3. Sourcing Alternatives

		Unique Knowledge	
		Proprietary	Generic
Strategic Relevance	Strategic Support	<p>Provision Develop/build the best internal capability possible</p>	<p>Broker Develop ongoing, long term partnerships with the best capability available</p>
	Business Necessity (Foundation)	<p>Maintain Manage internal capability to meet cost and quality standards</p>	<p>Contract Out Access the most efficient external vendor, monitor to ensure compliance with specs</p>

Next the team further evaluated capabilities for their current and desired/future performance requirements.

With these answers, the team then connected an IS service (e.g., asset management, cabling, etc.) to specific IS capabilities and eventually to business capabilities. In this way the strategic contribution of every IS service can be determined and a sourcing decision can be made. (see Figure 4)

Figure 4. Business Alignment



Both business and IS capabilities have performance requirements based on their strategic contribution. Where performance gaps exist, projects can be launched to close those gaps, or sourcing decisions can account for the size of the gap and the urgency to close it. Thus all projects (IS and otherwise) can be evaluated based on how completely and how quickly they will close a capability gap. Obviously projects that close significant gaps in the performance of an Advantage capability will be seen as more urgent than those that address gaps in Business Necessity capabilities.

IT succession & organization structure – where does the next generation of IT leaders come from when more of IT is outsourced?

The CIO of a major consumer electronics company wanted to modify the structure of the IT organization to provide better service to the business and ensure adequate succession of IT leadership as more work was outsourced.

Asking the right questions was critical in the organization design. (See Table 6)

Table 6: Setting the Organization Design Context

Context	Answers the questions	Design Implications
Mission	What does this organization do, for whom, where and to what extent?	Set boundaries for products, customers, geographic presence and competitive focus.
Vision	Where the company will be (an ideal state) at some future date (when), intimating how the company will look, feel and be?	Challenge the organization to stretch its capabilities; watch for valued opportunities.
Corporate Strategy	What are relationships among businesses in the corporate portfolio and the process by which investments will be determined among them?	Identifies the number of unique businesses, need for common or shared systems and whether enabling processes should be centralized or decentralized.
Business Strategy	Of all of the ways that we could accomplish our mission, what courses of action have we chosen?	Establish what is most important about how the organization will compete.
Growth Strategy	How we will grow the top line?	Geographic, product or market share drives design.
Business Capabilities	What specific capabilities are needed to deliver on the strategy and how big is the gap from where we are today from our strategic intent?	Zero in on the capabilities needed to win and the processes that deliver competitive advantage.
Type of Work	What work do we need to excel at and what work needs to be done at industry parity?	How to set goals and priorities.
IS Capabilities	How does IS contribute to strategy?	Align IS capabilities to business capabilities.
Sourcing Decisions	What work should we own, broker or outsource?	Optimizes scarce internal resources. Where work should be located: Corporate, Regions, County, etc. Delivery model: Centers of Excellence, Shared Services, etc. Explicit outsourcing models.

Based on answers to these questions the CIO assessed six models including: Functional, Customer Centric, Competency Based, Process Based, Service Based and Retained/Outsourced.

A much flatter organization structure was developed with each of the CIO's direct reports having responsibility for a well-defined portfolio of IT capabilities (processes) that supported the strategic business capabilities.

Finally, a schedule was established to rotate the direct reports so that each gained experience in every part of the organization including managing projects composed of internal and external partners around the globe.

Conclusions

CIOs are required to make better use of IT assets — both people and infrastructure. To accomplish this successful CIOs are:

- Documenting how IT contributes to the work of the company — both strategy execution and business operations — clearly articulating the business value of IT;
- Keeping the focus on business capabilities to remove ambiguity from solution requirements and ultimately lead to better IT choices;
- Determining whether IT delivers or supports strategic business capabilities. Highlight quick fixes to shore up immediately needed business capabilities. Grow long-term strengths to enhance business capabilities required in the future;
- Adjusting the IT project portfolio with a precision that maximizes the business capabilities' return on investment;
- Identifying and prioritizing capabilities as strategic or routine and assessing performance gaps;
- Aligning capabilities for profitable growth;
- Structuring optimal in-source and outsource decisions (e.g., model, location, vendor and risk).

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