

The strategic rationale for outsourcing decisions



By reviewing the relative and risks of “ making or buying”, firms can persuade their expertise and resources for improved profitability. Combining two strategic approaches accurately permit managers to coordinate their companies’ skills and resources efficiently beyond levels obtainable with other strategies.

1- Concentrate company’s possessed resources on its “ core competencies” through which the company can achieve definable incomparability and offer “ unique value” for customers. (Quinn, and Doorley, 1990)

2- Outsourcing strategically other activities of the companies – consisting of many conventionally believed primary to a company – which are neither special capabilities the firm nor affect critical strategic requirements. (Quinn, 1992)

Substantial gains can be achieved from effective combining of the two approaches. Directors leverage their firm’s resources in four manners.

First, they expand returns on in-house resources by focusing investments and energies on the enterprise’s best jobs. Secondly, if core competencies are well-developed a company can supply astounding barriers for present and forthcoming competitors that look for entering into the company’s areas of interest, thus assisting and shielding the strategic advantages of “ market share”. Third, conceivably the utmost leverage of all is the full deployment of external contractors, investments, innovations, and specialized professional capabilities that would be unaffordable or even not possible to replicate internally Fourth, in rapidly shifting marketplaces and technological circumstances, this cooperative strategy reduces risks, shortens discovery

and manufacturing cycle times, decrease investments, and generates better responsiveness to customer needs. (Quinn and Hillmer 1995)

Earning sustainable competitive advantage through Outsourcing

Managers can combine core competency concepts and strategic outsourcing for maximum effectiveness. Managers can analytically select and develop the core competencies that will provide the firm's uniqueness, competitive advantage, and basis of value creation for the future.

Core competency strategies

The basic ideas behind core competencies and strategic outsourcing have been well supported by research extending over a twenty-year period.[4] In 1974, Rumelt noted that neither of the then-favored strategies – unrelated diversification or vertical integration – yielded consistently high returns.[5] Since then, other carefully structured research has indicated the effectiveness of disaggregation strategies in many industries.[6] Noting the failures of many conglomerates in the 1960s and 1970s, both financial theorists and investors began to support more focused company concepts. Generally this meant “ sticking to your knitting” by cutting back to fewer product lines. Unfortunately, this also meant a concomitant increase in the systematic risk these narrower markets represented.

However, some analysts noticed that many highly successful Japanese and American companies had very wide product lines, yet were neither conglomerates nor truly vertically integrated.[7] Japanese companies, like Sony, Mitsubishi, Matsushita, or Yamaha, had extremely diverse product

offerings, as did 3M or Hewlett-Packard in the United States. Yet they were not conglomerates in the normal sense. They were termed “ related conglomerates,” redeploying certain key skills from market to market.[8]

At the same time, these companies also contracted out significant support activities. Although frequently considered vertically integrated, the Japanese auto Industry, for example, was structured around “ mother companies” that primarily performed design and assembly, with a number of Independent suppliers and alliance partners - without ownership bonds to the mother companies - feeding into them.[9] Many other Japanese hi-tech companies, particularly the more Innovative ones like Sony and Honda, used comparable strategies leveraging a few core skills against multiple markets through extensive outsourcing.

The term “ core competency strategies” was later used to describe these and other less diversified strategies developed around a central set of corporate skills.[10] However, there has been little theory or consistency in the literature about what “ core” really means. Consequently, many executives have been understandably confused about the topic. They need not be if they think in terms of the specific skills the company has or must have to create unique value for customers. However, their analyses must go well beyond looking at traditional product or functional strategies to the fundamentals of what the company can do better than anyone else.[11]

For example, after some difficult times, it was easy enough for a beer company like Foster’s to decide that it should not be in the finance, forest products, and pastoral businesses into which it had diversified. It has now

divested these peripheral businesses and is concentrating on beer. However, even within this concept, Foster's true competencies are in brewing and marketing beer. Many of its distribution, transportation, and can production activities, for example, might actually be more effectively contracted out. Within individual functions like production, Foster's could further extend its competitive advantage by outsourcing selected activities - such as maintenance or computing - where it has no unique capabilities.

The essence of core competencies

What then is really "core"? And why? The concept requires that managers think much more carefully about which of the firm's activities really do - or could - create unique value and which activities managers could more effectively buy externally. Careful study of both successful and unsuccessful corporate examples suggests that effective core competencies are:

1. Skill or knowledge sets, not products or functions. Executives need to look beyond the company's products to the intellectual skills or management systems that actually create a maintainable competitive edge. Products, even those with valuable legal protection, can be too easily back-engineered, duplicated, or replaced by substitutes. Nor is a competency typically one of the traditional functions such as production, engineering sales, or finance, around which organizations were formed in the past. Instead, competencies tend to be sets of skills that cut across traditional functions.

This interaction allows the organization consistently to perform an activity better than functional competitors and continually to improve on the activity as markets, technology, and competition evolve. Competencies thus involve

<https://assignbuster.com/the-strategic-rationale-for-outsourcing-decisions/>

activities such as product or service design, technology creation, customer service, or logistics that tend to be based on knowledge rather than on ownership of assets or intellectual property per se. Knowledge-based activities generate most of the value in services and manufacturing.

In services, which account for 79 percent of all jobs and 76 percent of all value-added in the United States, intellectual inputs create virtually all of the value-added. Banking, financial services, advertising, consulting, accounting, retailing, wholesaling, education, entertainment, communications, and health care are clear examples. In manufacturing, knowledge-based activities - like R&D, product design, process design, logistics, marketing research, marketing, advertising, distribution, and customer service @ also dominate the value-added chain of most companies (see Exhibit 1).

2. Flexible, long-term platforms - capable of adaptation or evolution. Too many companies try to focus on the narrow areas where they currently excel, usually on some product-oriented skills. The real challenge is to consciously build dominating skills in areas that the customer will continue to value over time, as Motorola is doing with its focus on "superior quality, portable communications." The uniqueness of Toys "R" Us lies in its powerful information and distribution systems for toys, and that of State Street Boston in its advanced information and management systems for large custodial accounts.

Problems occur when managers choose to concentrate too narrowly on products (as computer companies did on hardware) or too inflexibly on formats and skills that no longer match customer needs (as FotoMat and

numerous department stores did). Flexible skill sets and constant, conscious reassessment of trends are hallmarks of successful core competency strategies.

3. Limited in number. Most companies target two or three (not one and rarely more than five) activities in the value chain most critical to future success. For example, 3M concentrates on four critical technologies in great depth and supports these with a peerless innovation system. As work becomes more complex, and the opportunities to excel in many detailed activities proliferate, managers find they cannot be best at every activity in the value chain. As they go beyond three to five activities or skill sets, they are unable to match the performance of their more focused competitors or suppliers.

Each skill set requires intensity and management dedication that cannot tolerate dilution. It is hard to imagine Microsoft's top managers taking their enthusiasm and skills in software into, say, chip design or even large-scale training in software usage. And if they did, what would be the cost of their loss of attention on software development?

4. Unique sources of leverage in the value chain. Effective strategies seek out places where there are market imperfections or knowledge gaps that the company is uniquely qualified to fill and where investments in intellectual resources can be highly leveraged. Raychem and Intel concentrate on depth in design and on highly specialized test-feedback systems supporting carefully selected knowledge-based products - not on volume production of standardized products - to jump over the experience curve advantages of

their larger competitors. Morgan Stanley, through its TAPS system, and Bear Stearns, through its integrated bond-trading programs, have developed in-depth knowledge bases creating unique intellectual advantages and profitability in their highly competitive markets.

5. Areas where the company can dominate. Companies consistently make more money than their competitors only if they can perform some activities – which are important to customers – more effectively than anyone else. True focus in strategy means the capacity to bring more power to bear on a selected sector than any competitor can. Once, this meant owning and managing all the elements in the value chain supporting a specific product or service in a selected market position. Today, however, some outside supplier, by specializing in the specific skills and technologies underlying a single element in the value chain, can become more proficient at that activity than virtually any company spreading its efforts over the whole value chain.

In essence, each company is in competition with all potential suppliers of each activity in its value chain. Hence, it must benchmark its selected core competencies against all other potential suppliers of that activity and continue to build these core capabilities until it is demonstrably best. Thus the basic nature of strategic analysis changes from an industry analysis perspective to a horizontal analysis of capabilities across all potential providers of an activity, regardless of which industry the provider might be in (see Exhibit 1).

6. Elements important to customers in the long run. At least one of the firm's core competencies should normally relate directly to understanding and serving its customers - that is, the right half of the value chain in Exhibit 1. Hi-tech companies with the world's best state-of-the-art technology often fail when they ignore this caveat. On the other hand, Merck matches its superb basic research with a prescription drug marketing knowhow that is equally outstanding.

By aggressively analyzing its customers, value chains, a company can often identify where it can specialize and provide an activity at lower cost or more effectively to the customer. Such analyses have created whole new Industries, like the specialized mortgage broker, syndication, secondary market, transaction-processing, escrow, title search, and insurance businesses that have now taken over these risks and functions for banks and have disaggregated the entire mortgage industry.

7. Embedded in the organizations systems. Maintainable competencies cannot depend on one or two talented stars - such as Steven Jobs and Stephen Wozniak at Apple or Herbert Boyer and Arthur D. Riggs at Genentech - whose departure could destroy a company's success. Instead, the firm must convert these competencies into a corporate reputation or culture that outlives the stars. Especially when a strategy is heavily dependent on creativity, personal dedication, and initiative or on attracting top-flight professionals, core competencies must be captured within the company's systems - broadly defined to include its values, organization structures, and management systems.

Such competencies might include recruiting (McKinsey, Goldman Sachs), training (McDonald's, Disney), marketing (Procter Gamble, Hallmark), innovation (Sony, 3M), motivation systems (ServiceMaster), or control of remote and diverse operating sites within a common framework and philosophy (Exxon, CRA, Inc.). These systems are often at the heart of consistent superior performance; in many cases, a firm's systems become its core competencies.(12)

Preeminence: The key strategic barrier

For its selected core competencies, the company must ensure that it maintains absolute preeminence. It may also need to surround these core competencies with defensive positions, both upstream and downstream. In some cases, it may have to perform some activities where it is not best-in-world, just to keep existing or potential competitors from learning, taking over, eroding, or bypassing elements of its special competencies. In fact, managers should consciously develop these core competencies to block competitors strategically and avoid outsourcing them or giving suppliers access to the critical knowledge bases or skills that underpin them.

Honda, for example, does all its engine R&D in-house and makes all the critical parts for its small motor design core competency in closely controlled facilities in Japan. It will consider outsourcing any other noncritical elements in its products, but builds a careful strategic block around this most essential element for all its businesses.(13) Most important, as a company's preeminence in selected fields grows, its knowledge-based core competencies become ever harder to overtake. Knowledge bases tend to

grow exponentially in value with Investment and experience. Intellectual leadership tends to attract the most talented people, who then work on and solve the most interesting problems. The combination in turn creates higher returns and attracts the next round of outstanding talent. In addition to the examples we have already cited, organizations as diverse as Bechtel, AT&T Bell Labs, Microsoft, Boeing, Intel, Merck, Genentech, McKinsey, Arthur Andersen, Sony, Nike, Nintendo, Bankers Trust, and Mayo Clinic have found this to be true.

Some executives regard core activities as those the company is continuously engaged in, while peripheral activities are those that are intermittent and therefore can be outsourced. From a strategic outsourcing viewpoint, however, core competencies are the activities that offer long-term competitive advantage and thus must be rigidly controlled and protected. Peripheral activities are those not critical to the company's competitive edge.

Strategic outsourcing

If supplier markets were totally reliable and efficient, rational companies would outsource everything except those special activities in which they could achieve a unique competitive edge, that is, their core competencies. Unfortunately, most supplier markets are, imperfect and do entails some risks for both buyer and seller with respect to price, quality, time, or other key dimensions. Moreover, outsourcing entails unique transaction costs - searching, contracting, controlling, and recontracting - that at times may

exceed the transaction costs of having the activity directly under management's in-house control.

To address these difficulties, managers must answer three key questions about any activity considered for outsourcing. First, what is the potential for obtaining competitive advantage in this activity, taking account of transaction costs? Second, what is the potential vulnerability that could arise from market failure if the activity is outsourced? Conceptually, these two factors can be arrayed in a simple matrix (see Exhibit 2). Third, what can we do to alleviate our vulnerability by structuring arrangements with suppliers to afford appropriate controls yet provide for necessary flexibilities in demand?

The two extremes in exhibit 2 are relatively straightforward. When the potential for both competitive edge and strategic vulnerability is high, the company needs a high degree of control, usually entailing production internally or through joint ownership arrangements or tight long-term contracts (explicit or implicit).

Marks & Spencer, for example, is famous for its network of tied suppliers, which create the unique brands and styles that underpin the retailer's value reputation. Spot suppliers would be too unreliable and unlikely to meet the demanding standards that are Marks & Spencer's unique consumer franchise. Hence, close control of product quality, design, technology, and equipment through contracts and even financial support is essential.

The opposite case is perhaps office cleaning, where little competitive edge is usually possible and there is an active and deep market of supplier firms. In <https://assignbuster.com/the-strategic-rationale-for-outsourcing-decisions/>

between, there is a continuous range of activities requiring different degrees of control and strategic flexibility.

At each Intervening point, the question is not just whether to make or buy, but how to implement a desired balance between independence and incentives for the supplier versus control and security for the buyer. Most companies will benefit by extending outsourcing first in less critical areas, or in parts of activities, like payroll, rather than all of accounting. As they gain experience, they may increase profit opportunities greatly by outsourcing more critical activities to noncompeting firms that can perform them more effectively independence and incentl, v

In a few cases, more complex alliances with competitors may be essential to garner specialized skills that cannot be obtained in other ways. At each level, the company must isolate and rigorously control strategically critical relationships between its suppliers and its customers.

Competitive edge

The key strategic issue in insourcing versus outsourcing is whether a company can achieve a maintainable competitive edge by performing an activity internally - usually cheaper, better, in a more timely fashion, or with some unique capability - on a continuing basis. If one or more of these dimensions is critical to the customer and if the company can perform that function uniquely well, the activity should be kept in-house. Many companies unfortunately assume that because they have historically performed an activity internally, or because it seems integral to their business, the activity should be insourced. However, on closer investigation and with careful

benchmarking, a company's internal capabilities may turn out to be significantly below those of best-in-world suppliers.

Ford Motor Company, for example, found that many of its Internal suppliers' quality practices and costs were nowhere near those of external suppliers when it began its famous "best in class" worldwide benchmarking studies on 400 subassemblies for the new Taurus-Sable line. A New York bank with extensive worldwide operations Investigated why its Federal Express costs were soaring and found that its Internal mail department took two days more than Federal Express to get a letter or package from the third floor to the fortieth floor of Its building.

In interviews about benchmarking with top operating managers in both service and manufacturing companies, we frequently encountered some paraphrase of " We thought we were the best in the world at many activities. But when we benchmarked against the best external suppliers, we found we were not even up to the worst of the benchmarking cases."

Transaction costs

In all calculations, analysts must include internal transaction costs as well as those associated with external sourcing. If the company is to produce the item or service internally on a long-term basis, it must back up its decision with continuing R&D, personnel development, and infrastructure investments that at least match those of the best external supplier; otherwise, it will lose its competitive edge over time. Managers often tend to overlook such backup costs, as well as the losses from laggard innovation and

unresponsiveness of internal groups that know they have a guaranteed market.

Finally, there are the headquarters and support costs of constantly managing the insourced activity. One of the great gains of outsourcing is the decrease in executive time spent managing peripheral activities - freeing top management to focus more on the core of its business.

Various studies have shown that when these internal transaction costs are thoroughly analyzed, they can be extremely high.⁽¹⁴⁾ Since it is easier to identify the explicit transaction costs of dealing with external suppliers, these generally tend to be included in analyses. Harder-to-identify internal transaction costs, however, are often not included, thus biasing results.

Vulnerability

When there are many suppliers with adequate but not dominating scale) and mature market standards and terms, a potential buyer is unlikely to be more efficient than the best available supplier. If, on the other hand, there is not sufficient depth in the market, overly powerful suppliers can hold the company ransom. Conversely, if the number of suppliers is limited or individual suppliers are too weak, they may be unable to supply innovative products or services as well as a much larger buyer could by performing the activity in-house. While the activity or product might not be one of its core competencies, the company might nevertheless benefit by producing internally rather than undertaking the training, investment, and codesign expenses necessary to bring weak suppliers up to needed performance levels.

Another form of vulnerability is the lack of information available in the marketplace or from individual suppliers., for example, a supplier may secretly expect labor disruptions or raw material problems, but hide these concerns until it is too late for the customer to go elsewhere. A related problem occurs when a supplier has unique information capabilities: for example, large wholesalers or retailers, market research firms, software companies, or legal specialists may have information or fact-gathering systems that would be impossible for the buyer or any other single supplier to reproduce efficiently. Such suppliers may be able to charge what are essentially monopoly prices, but purchasing from them could still be less costly than reproducing the service Internally. In other cases, there may be many capable suppliers (for example, in R&D or software), but the costs of adequately monitoring progress on the suppliers, premises might make outsourcing prohibitive.

Sometimes the whole structure of information in an industry will militate for or against outsourcing. Computing, for example, was largely kept in-house in its early years because the information available to a buyer of computing services and its ability to make judgments about such services were very different for the buying company (which knew very little) than for the supplier (which had excellent information). Many buyers lacked the competency either to assess or to monitor sellers, and feared loss of vital information. A company can outsource computing more easily today, in part because buyers, computer, technical management, and software knowhow are sufficient to make informed judgments about external suppliers.

In addition to information anomalies, Stuckey and White note three types of “asset specificity” that commonly create market imperfections, calling for controlled sourcing solutions rather than relying on efficient markets.(15)

These are: (1) site specificity, where sellers have located costly fixed assets in close proximity to the buyer, thus minimizing transport and inventory costs for a single supplier; (2) technical specificity, where one or both parties must invest in equipment that can be used only by the parties in conjunction with each other and has low value, in alternative uses; and (3) human capital specificity, where employees must develop in-depth skills that are specific to a particular buyer or customer relationship.

Stuckey and White explain the outsourcing implications of information and specificity problems in the case of a bauxite mine and an alumina refiner. Refineries are usually located close to mines because of the high cost of transporting bauxite, relative to its value. Refineries in turn are tuned to process the narrow set of physical properties associated with the particular mine’s bauxite.

Different and highly specialized skills and assets are needed for refining versus mining. Access to Information further compounds problems., if an independent mine expects a strike, it is unlikely to share that information with its customers, unless there are strong incentives. As a result, the aluminum industry has moved toward vertical integration or strong bilateral joint ventures, as opposed to open outsourcing of bauxite supplies – despite the apparent presence of a commodity product and many suppliers and sellers. In this case, issues of both competitive advantage and potential market failure dictate a higher degree of sourcing control.

<https://assignbuster.com/the-strategic-rationale-for-outsourcing-decisions/>

Degree of source control

In deciding on a sourcing strategy for a particular segment of their business, managers have a wide range of control options (the Exhibits 3 and 4 for the most basic). Where there is high potential both for vulnerability and for competitive edge, tight control is indicated (as in the bauxite case). At the opposite end is, say, office cleaning. Between these extremes are opportunities for developing special incentives or more complex oversight contracts to balance intermediate levels of vulnerability against more moderate prospects for competitive edge. Nike's multi-tier strategy offers an interesting example (see boxed insert on page 62).

The practice and law of strategic alliances are rapidly developing new ways to deal with common control issues - by establishing specified procedures that permit direct involvement in limited stages of a partner's activities, without incurring either ownership arrangements or the loss of control inherent in arm's-length transactions.

Flexibility versus control

Within this framework, there is a constant tradeoff between flexibility and control. One of the main purposes of outsourcing is to have the supplier assume certain classes of investment and risk, such as demand variability. To optimize costs, the buying company may want to maintain its internal capacity at relatively constant levels despite highly fluctuating sales demands. Under these circumstances, it needs a surge strategy.

McDonald's, for example, with \$8 billion in sales and 10.1 percent growth per year, needs to call in part-time and casual workers to handle extensive daily variations yet also be able to select its future permanent or managerial personnel from these people. IBM has had the opposite problem, since its core demand has been declining, the company has had to lay off employees. Yet it needs surge capacity for: (1) quick access to some former employees, basic skills; (2) available production capacity without the costs of supporting facilities full time; and (3) the ability to exploit strong outside parties' specialized capabilities through temporary consortia - for example, in applications software, microprocessors, network development, or factory automation.

Strategically, McDonald's has created a pool of people available on "call options," while IBM - through spinouts of factories with baseload commitments to IBM, guaranteed consulting employment for key people, flexible joint ventures, and strategic alliances - has created "put options" to handle surge needs as it downsizes and tries to turn around its business. There is a full spectrum of outsourcing arrangements, depending on the company's control and flexibility needs (see Exhibit 4). The issue is less whether to make or buy an activity than it is how to structure internal versus external sourcing on an optimal basis. Companies are outsourcing much more of what used to be considered either integral elements of their value chains or necessary staff activities. Because of greater complexity, higher specialization, and new technological capabilities, outside suppliers can now perform many such activities at lower cost and with higher value-added than a fully integrated company can.

In some cases, new production technologies have moved manufacturing economies of scale toward the supplier. In others, service technologies have lowered transaction costs substantially, making it possible to specify, transport, store, and coordinate inputs from external sources so inexpensively that the balance of benefits has shifted from insourcing to outsourcing. In certain specialized niches, outside companies have grown to such size and sophistication that they have developed economies of scale, scope, and knowledge intensity so formidable that neither smaller nor more integrated producers can effectively compete with them (for example, ADP Services in payroll, and ServiceMaster in maintenance). To the extent that knowledge of a specific activity is more important than knowledge of the end product itself, specialized suppliers can often produce higher value-added at lower cost for that activity than almost any integrated company.

Strategic benefits versus risks

Too often companies look at outsourcing as a means to lower only short-term direct costs. However, through strategic outsourcing, companies can lower their long-term capital investments and leverage their key competencies significantly, as Apple and Nike have done. They can also force many types of risk and unwanted management problems onto suppliers.

Gallo, the largest producer and distributor of wines in the United States, outsources most of its grapes, pushing the risks of weather, land prices, and labor problems onto its suppliers.

Argyle Diamonds, one of the world's largest diamond producers, outsources virtually all aspects of its operation except the crucial steps of separation

<https://assignbuster.com/the-strategic-rationale-for-outsourcing-decisions/>

and sorting of diamonds. It contracts all its huge earth-moving operations (to avoid capital and labor risks), its housing and food services for workers (to avoid confrontations on nonoperating issues), and much of its distribution (to De Beers to protect prices, to finance inventories, and to avoid the complications of worldwide distribution). By outsourcing to best-in-class suppliers in each case, it further ensures the quality and image of its operations.

Important strategic benefits

Strategically, outsourcing can provide the buyer with greater flexibility, especially in the purchase of rapidly developing new technologies, fashion goods, or the myriad components of complex systems. It reduces the company's design-cycle t