GETTING TO VESTED: CHANGING THE RULES

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Late in 2012, the Zurich Insurance Group re-issued a survey on supply chain risks. This report, which canvasses senior supply chain leaders across the globe, stressed that outsourcing failure is now a significant cause of supply chain disruption.

Compared to its last report, service issues from outsourcing failures had increased from 17 per cent to 35 per cent, moving the issue into third place on the list of disruption causes. Outsourcing has also been in the news with the outsourcing of security for the London Olympics ending in a major fail. Closer to home, the trend for companies to consider 'insourcing' elements of their supply chain from 3PL service providers because of dissatisfaction with results is on the rise. Australian governments have also contributed to this insourcing trend, with projects such as the 'eHealth IT initiative' brought back in-house.

Does this mean that outsourcing is a failed business model versus doing it yourself? Not necessarily - it is more probable that the customer actually got what it asked for rather than what it wanted! What is at play here is a failure of process rather than a failure in execution of the outsourcing contract. After all, what service provider would actively show up to tank their customer?

So here's the basic question: is there a better way? The good news is that over the past ten years or so, many thought-leading companies have challenged conventional outsourcing models. The result? The 'next-generation' outsourcing model we call vested outsourcing, or vested.

Over several years, a group of researchers participated in a University of Tennessee research program funded by the United States Air Force to formally study companies that were employing performance-based approaches to outsourcing. The best of the best didn't just buy a black box with a green scorecard – but rather, adopted mutual symbiotic performance partnerships that truly unlocked win-win solutions. Simply put, they were vested in each other's success, because neither could be successful without the other.

But you might be saying – I am just a logistics provider. Stop there! Rethink your approach! Your job is to get your customer's product to

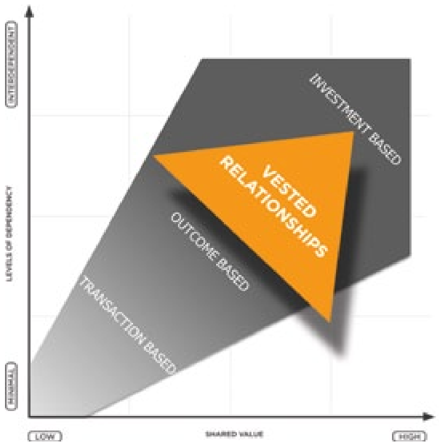

Figure 1.

their customer at the right place at the right time with the right packaging and labels as cheaply as possible without it getting damaged. If you are a customer, you may think that the only important criteria are to get the lowest price. Again, stop there! Don't your own customers want your goods to arrive at the right place, at the right time and undamaged? Would they value reliable service if it were offered? Service providers and customers can indeed learn from the University of Tennessee's groundbreaking research in the area of outcome-based outsourcing and how companies and their service providers are striving to get in synch to raise the level of performance.

A better approach: the rise of vested partnerships

While many believe win-win is a simple buzzword that is theoretical, feel-good public relations in nature, our research has uncovered there is indeed a set of rules companies can use to develop performance partnerships where both parties have a stake in maintaining the relationship. These companies work together to create a performance partnership that takes both the company outsourcing and the supplier to new levels of cost, service and profitability not realised before.

How is this done? A good starting point is to understand the type of transaction that's involved. Companies looking to outsource should understand the various types of sourcing business models, and those best suited to the business at hand. A business model mapping analysis and a compatibility and trust assessment will help the parties make a decision about the suitability of using a vested approach. The tools provide insight on whether the cultures and the relationship are a good fit for a vested agreement. In addition, they set a foundation for deriving the most mutually advantageous agreement for the parties, while helping service providers consider how to offer added value that is more closely related to the parties' desired outcomes. This means that everyone has an outcome-based focus, compared to transaction-based thinking.

We'll look briefly at each sourcing business model type. Figure 1. illustrates four types of sourcing business models. There are three commonly-used business models: transaction-based, outcome-based, and investment-based; these are contrasted with a fourth, the vested business model.

Transaction-based model

Most companies use transaction-based business models for all of their commercial agreements when a 'buy' decision is made.

Conventional approaches to transaction-based models keep service providers at arm's length. Three types of transaction-based sourcing relationships have evolved as businesses wrestle with how to create service provider relationships that are suited for more complex business requirements. Those are simple transaction providers, approved providers, and preferred providers.

Outcome-based business model

Rolls-Royce PLC was the first organisation to explore outcome-based approaches in the 1960s. However, outcome-based business models did not gain much traction until around 2000, and their use still remains limited. An outcome-based business model pays a service provider for the realisation of a defined set of business outcomes, business results, or achievement of agreed-upon key performance indicators. A good example is when an airline pays its outsourced ground crew for achieving a 20-minute turnaround time after the plane has been parked at the gate.

Basically, in this model service providers do not get paid if they do not deliver results. An outcome-based business model typically shifts risk for achieving the outcome to the service provider. A well-structured agreement compensates a service provider's higher risk with a higher reward. Outcome-based approaches are widely used in the aerospace and defence industries. They are often referred to as performance-based logistics because they couple maintenance and support to the procurement of a product.

Investment-based model

Companies struggling to meet complex business requirements by using conventional transaction-based or outcome-based approaches typically adopt an investment-based business model as the solution. Under this model, the company returns to a single balance sheet entity, essentially a merged in-source solution. These equity partnerships can take different legal forms, from buying a service provider, to becoming a subsidiary, to equity-sharing joint ventures. Equity-based partnerships often are born out of a company's need to acquire mission-critical goods and services. Also, these partnerships often require the strategic integration of infrastructure and heavy co-investment.

Equity partnerships, by default, bring costs in-house and create a fixed cost burden. As a result, equity partnerships often conflict with the desires of many organisations to create more variable and flexible cost structures on their balance sheets.

Vested outsourcing: a new hybrid business model

As shown in the above figure, vested partnerships are a new relationship model positioned between performance-based arrangements and equity partnerships. The relationship is more focused than an equity partnership and does not require as much operational infrastructure.

Many progressive companies today are striving to achieve the benefit of an investment-based model, but without investments, by leveraging the vested hybrid business model that enables success in an outsourcing environment, while still allowing a company to remain a separate entity through outsourcing. These companies achieve mutual advantage and gain by working in an integrated and mutually beneficial manner. The parties are aligned for mutual success.

The vested business model is a hybrid of outcome-based and shared-value principles. It is best used when a company wants to move beyond having a service provider perform a strict set of directed tasks and wants to develop a solution based on mutual advantage to achieve the company's desired outcomes. Vested requires the parties to build a solid, cooperative foundation for sharing value. Highly integrated outcome-based business models use value incentives to maintain mutual advantage. In the purest cases, a service provider is paid only when it is successful in achieving the mutually agreed upon desired outcomes.

No two vested partnerships are alike, but the good ones achieve a new level of success based on optimising three key goals - what we call the performance pyramid:

- Innovation and improved service
- Reducing cost to the company outsourcing.
- Improving profits to the service provider (see Figure 2.).

Conventional wisdom says that there is typically a trade-off among these three goals. For example, achieving higher service levels often costs more money. Allowing the service provider to double its profit margin may raise the cost for the company that is outsourcing.

Progressive companies are reinventing their outsourcing practices. They work together with their service providers to develop perfor-

Figure 2.

Figure 3.

mance-based solutions, where both parties' interests are aligned so that they both receive tangible benefits. The heart of a vested contract is an agreement based on desired outcomes that explicitly states the results on which the companies will base the outsource contract. A desired outcome is a measurable objective that focuses on what will be accomplished as a result of the work performed. To be effective, desired outcomes must have supporting metrics that objectively indicate whether the outcome has been accomplished or not.

A commitment to deliver against projected value for the company outsourcing (such as a commitment to reduce costs, or improve service, or both) shifts risk to the outsource provider. In exchange, the company outsourcing commits to allow the outsource provider earn additional profit (above and beyond industry average profits for their service area) for achieving this incremental value. The result is a win-win vested partnership - a true trading partner paradigm shift.

WIIFWe vs.WIIFMe

While many organisations contend they have 'partnerships', experience and research shows that most organisations have really want to optimise their self-interests. This is often known as a WIIFMe approach (what's-in-it-for-me). How could they not, when we are ingrained with 'winning' from early childhood, and most business schools and law schools focus on 'winning.'

The word 'partner' implies that there are two sides. The progression towards a vested agreement should focus on creating a culture where parties are working together to ensure the ultimate success of each other. The mentality should shift from an 'us vs. them' to a 'we' philosophy, or a what's-in-it-for-we (WIIFWe) philosophy.

A vested agreement is like symbiotic relationship. Only by working together can the companies succeed. The goal of a vested partnership is to focus on first identifying and then aligning the interests of the parties. The relationship becomes more collaborative and expands beyond simply meeting requirements.

Developing a WIIFWe relationship is easier to describe than it is to do. Evolving from a culture of oversight and control to mutual respect is not an easy transition for most companies that outsource. Adversarial relationships often persist, and getting to a true win-win relationship will likely take practice.

Follow the rules

For many companies a win-win approach is a learned behaviour, and they have to unlearn their conventional approaches and ways of thinking. In a vested relationship the organisations must work together upon a foundation of trust where there is mutual accountability for achieving the destined outcomes.

Five key rules set the stage of a sound outsourcing partnership (Figure 3.):

1. The business model is established based on outcomes versus defining transactions.
2. The company outsourcing needs to feel comfortable describing the 'what' and delegating the 'how' to the outsourcing provider, and the provider must be comfortable signing up to take the risk to deliver the 'how.' Each organisation must constantly seek to overcome roadblocks in the processes, infrastructure, technology and people that prevent mutual success.
3. Carefully aligned, clear and measurable performance objectives are used to monitor the desired outcomes.
4. A balanced pricing model that includes mutual incentives and rewards, optimised for cost-versus-service trade-off.
5. The relationship is based on insight versus oversight governance that empowers the parties to pursue improvements that will deliver better performance, higher profits, and lower total ownership cost. The five key rules of a sound outsourcing partnership set the stage for companies to take their outsourcing relationships to the next level – a true vested performance partnership.

Most companies that use vested as an approach for outsourcing do not spend much time talking about how it gives their outsourcing providers the opportunity to make more money. Rather, they focus on how it delivers better value or better outcomes at the same or lower total cost. Nevertheless, service providers who work under vested partnerships often focus on the higher profit potential of vested, and point to the fact that such successfully designed partnerships create happier clients. Because the organisations are working together to achieve their goals, vVested works as a true win-win relationship, which is what a partnership is all about.

The organisations that challenge the WIIFMe mentality are able to achieve true vested relationships that deliver outstanding results. In our opinion, adopting anything less that WIIFWe philosophy will result in less than optimal business relationships.

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