How companies can realize the full potential of outsourcing and offshoring to leapfrog the competition

Seizing the strategic high ground in capability sourcing

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Wage inflation in traditional offshoring destinations, evolving government regulations and recent high-profile instances of back sourcing have led some companies to question the value and sustainability of capability sourcing—getting the right capabilities from the right partners at the right price from the right location. Others, however, see it as even more critical than ever.

Many companies are not satisfied with their current capability sourcing efforts, which include outsourcing and offshoring. Bain & Company's global Management Tools and Trends 2009 survey of 1,430 executives showed that 63 percent of respondents used outsourcing as a business tool, but they ranked it in the lower third of 25 business tools in terms of satisfaction.

Despite widespread dissatisfaction, many companies are expanding their use of capability sourcing. Why? Are these companies misguidedly buying into the hype surrounding outsourcing and offshoring, or are they on to something that others have yet to grasp?

What many companies are realizing is that capability sourcing can be used for more than just cost cutting. When done right, capability sourcing can help companies achieve strategic objectives.

Companies that successfully create and sustain value over time are rare. A recent Bain study of more than 2,000 companies across 10 years revealed that, while many companies aspire to outgrow their market, only 1 in 10 companies achieve sustained, profitable growth. Not surprising, these Sustained Value Creators often make use of capability sourcing in more innovative ways. We found that 85 percent of these highest-performing companies use capability sourcing to fix either broad structural cost or quality disadvantages, or for strategic purposes such as accelerating time to market or breaking into new markets. Another 10 percent transformed their business models through capability sourcing. Only 5 percent used outsourcing and offshoring less strategically, for purely opportunistic reasons or tactical cost reduction (see Figure 1).

How winners win

Our experience with hundreds of clients has helped us identify five key ways in which winners capture the strategic high ground by using capability sourcing. Let's look at each of the five opportunities.

1. Tap global talent pool

The war for top talent has become intense. To win the war, companies must tap into sources of talent more broadly. Historically, companies have pursued offshoring as a means to access low-cost resources to substitute for more expensive onshore talent. In doing so, companies focused on lower-skilled work that could be safely performed from remote locations. In the past, few companies used offshoring to recruit top talent or develop innovation outside their home countries.

Companies that seize the strategic high ground do exactly that: frame the war for talent in global terms and rely on offshoring and outsourcing to access the best global talent. For example, Texas Instruments offshores not only to tap new sources of talent, but also to broaden the climate for innovation in new global locations.

Figure 1: Fundamental shifts are taking place in capability sourcing

Early 2000s	2010
Periphery of business	Core of business
Tactical cost reduction	Enabling competitive advantage
China and India	Global
Signing deals	Maximizing value
Traditional vendor management	Managing complex ecosystems

In 1985, Texas Instruments became one of the first global technology companies to establish a research and development center in India. The world's largest maker of chips for mobile phones looked to India for more than cost savings and has nurtured a rich Indian talent pool over the course of two decades. Texas Instruments India developed the first digital signal processor designed in India for control applications in 1996 and supported the development of LoCosto, the semiconductor industry's first single-chip solution for low-cost handsets. Today, Texas Instruments India has the highest number of US patents granted to any organization in India.

2. Build ecosystems

The stakes in capability sourcing are getting higher. As the sourcing market has matured, companies have become more comfortable increasing the scale and scope of what they outsource and offshore. Rather than focusing on a single location, they have expanded their sourcing network to include multiple countries—and often multiple locations within a country. While companies historically outsourced and offshored low-risk activities, today they are increasingly outsourcing and offshoring more mission-critical activities, such as final assembly and product development, adding complexity to their supply chains.

The trouble is, while sourcing risks have increased over time, most companies continue to manage their sourcing relationships in much the same way they did when they first started—as arm's-length vendor interactions overseen by the procurement department. Offshore captive centers are often managed as independent delivery units of a particular function, such as IT or finance.

The result of companies failing to keep pace with the changing requirements of relationship management can be painful. This was

nowhere more apparent than during the toy industry's lead paint crisis in 2007. Toy companies with more sophisticated systems and processes for managing their partners were relatively unscathed by the lead paint controversy. To maintain control, companies like toy manufacturer Hasbro view their external relationships as strategic partners, part of a broader ecosystem tightly integrated with their domestic operations. That's a major reason why Hasbro was largely unaffected by the toy industry's lead paint recall. The toy manufacturer prequalifies and continually monitors its overseas factories to ensure quality-management systems are in place. The risks of a quality issue arising can't be totally eliminated, of course, with more complex webs of suppliers spread across multiple regions. The key is to limit the number of potential problems and to act quickly when a problem does occur to prevent it from happening over and over.

3. Seize new market opportunities

Strategic companies outsource and offshore to tap into local market opportunities and build presence in new markets.

AstraZeneca's experience in China is an example of offshoring more strategically to penetrate a fast-growing emerging market. It did not simply build a local factory offshore to serve the Chinese market. AstraZeneca made large-scale, multiyear investments in research and development, manufacturing and sales, and partnered with local universities, government organizations and domestic companies. AstraZeneca increased its market share by focusing on largely underserved rural hospitals and physicians. By 2008, the Anglo-Swedish pharmaceutical giant became the largest pharmaceutical multinational in the Chinese prescription drugs market, with leading market share across eleven drug brands.

4. Accelerate and innovate

Leading companies use capability sourcing to accelerate time to market and develop new sources of innovation. Traditionally, while the promise of cost savings and improved service quality from capability sourcing was appealing, many companies became disillusioned with the time it took to start realizing those benefits, often many years. However, companies are now reaping benefits faster by sourcing capabilities in more targeted ways.

Consider Procter & Gamble's innovation networks. The world's largest consumer products maker turned the innovation paradigm on its head a decade ago by developing strategic alliances and partnerships. Realizing its internal capacity for innovation was flagging and its competitors were gaining ground, P&G created the Connect + Develop℠ strategy that welcomed outside innovation through open networks. That was revolutionary for an industry in which R&D was considered a core competitive competency.

By outsourcing elements of R&D, especially for accessing technology, Procter & Gamble boosted innovation productivity by 60 percent and generated more than $10 billion in revenue from over 400 new products. Today, about half of P&G's innovation is the result of external collaboration. Other companies are following P&G's example. Bain's Management Tools and Trends 2009 survey showed that nearly six in 10 managers believe their companies could dramatically boost innovation by collaborating outside with other companies.

5. Disrupt the industry business model

In some instances, capability sourcing can help companies to leapfrog the competition. It can fundamentally disrupt an industry's economics by changing the traditional basis of competition;

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however, only a few companies have achieved that objective.

Taiwan-based personal computer maker Acer is one rare success story. Starting with the spin off of its contract manufacturing operations in 2000, Acer sought to focus exclusively on branding and marketing. Its virtual model allows Acer to maintain a strikingly lean and flexible operation. Its nearly 6,800 employees represent a workforce less than one-tenth the size of its largest competitor. Capability sourcing played a critical role in helping Acer to neutralize the historical cost advantage of the PC direct model and become the world's second-largest PC manufacturer (see Figure 2).

Using experience as a guide

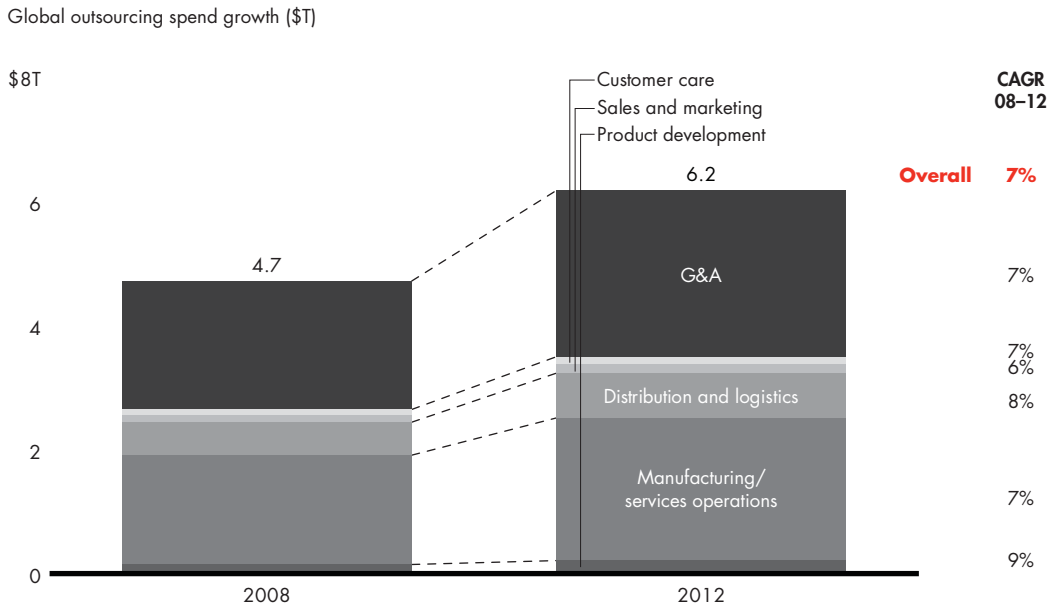
As more companies seek to replicate the success of leaders in capability sourcing, they first need to consider their capability sourcing experience when drawing up a game plan. Their strategy will depend on whether they are first-time users, testing the waters or experienced practitioners. Let's look at each category.

First-time users: Learn from others' mistakes—and successes

1. Establish a clear mission with strong executive support

Strong corporate sponsorship and on-site leadership are critical to successful offshoring programs. Many companies fall into the trap of using offshore locations as body shops: Most innovation occurs onshore and then work is handed off to the offshore center for lower-value activities. This makes it difficult to attract and retain the best talent offshore as well as to scale a company's offshore capability over time. Developing a local team offshore with an independent charter and autonomy improves the long-term odds of success.

Figure 2: Continued healthy growth expected for outsourcing market



Source: IDC; Gartner; Frost & Sullivan; Datamonitor; analyst reports; literature search; expert interviews; Bain analysis

General Electric has successfully done this over its long history of offshoring. One example is how GE has used offshoring to develop a multi-disciplinary R&D hub in India that supports the company globally and, in the process, has built up a large and deep Indian talent pool and strong onsite leadership. The John F. Welch Technology Center in Bangalore is the largest, integrated multi-disciplinary R&D center for GE, and is the first located outside the US.

2. Develop a comprehensive capability sourcing blueprint

Companies can achieve full potential value from their capability sourcing efforts by developing and then implementing a sourcing blueprint. The starting point is a comprehensive assessment of a company's activities across the value chain to determine what should be kept in house, what should be outsourced and what should be offshored. No area should be off limits in this assessment phase. Then, every company should develop a multiyear roadmap of both short- and long-term actions, linked to financial and service quality improvement metrics, to track progress over time. This blueprint should be drafted in collaboration with the corporate center, with the CEO's involvement if possible.

3. Consider emerging capability sourcing models

Not surprising, most first-time users pick up the playbooks used by companies already outsourcing and offshoring. They assume that, given their experience, those companies must be model examples. However, that's rarely the case. As we saw in our tools and trends survey, satisfaction with outsourcing was less than the overall average of the 25 tools studied. Most companies are not achieving their expected return on investment: That's why first-time users should be very careful about assessing the lessons they learn from other companies.

New capability sourcing models such as equity investments and managed captives are emerging to help companies avoid the mistakes made by other companies or to address the specific strategic, operational or change management challenges that have historically prevented companies from outsourcing or offshoring (see Figure 3).

The pharmaceutical industry, for example, has historically been slow to adopt outsourcing and offshoring. However, with escalating costs and longer cycle times in drug discovery, development and launch, pharmaceutical companies are increasingly turning to outsourcing and offshoring. While traditional forms of outsourcing and offshoring like active pharmaceutical ingredients (API) and dosage-form manufacturing still dominate, some large pharmas are experimenting with new models. Alternative drug development models such as Chorus, an autonomous early phase drug development division within Eli Lilly that operates a fully outsourced model, is one example.

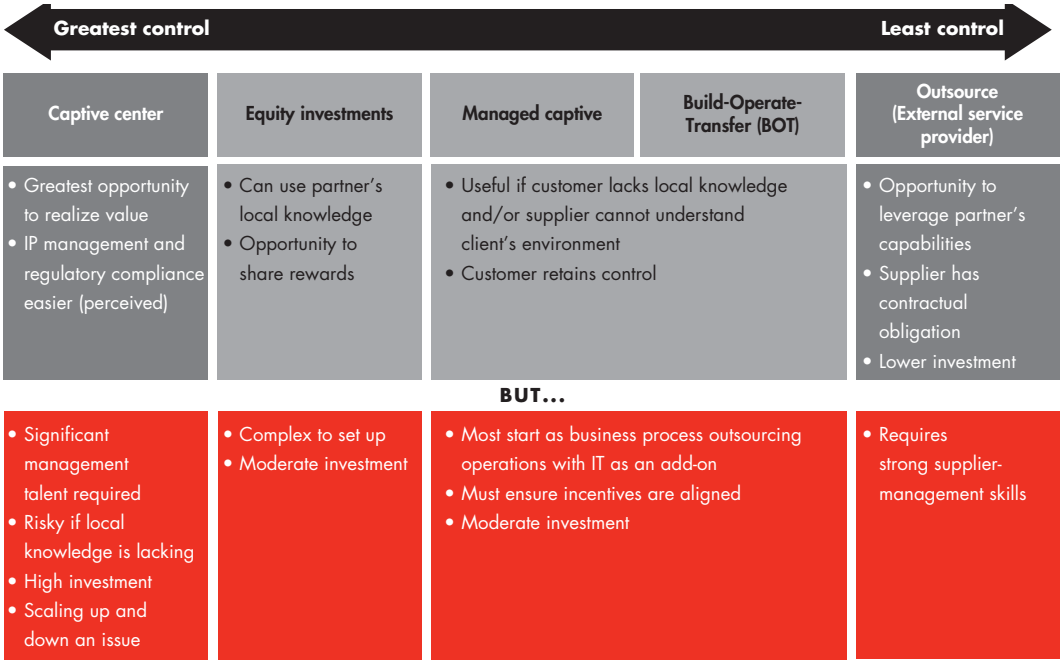
Testing the waters: Achieve full potential from existing efforts and take a stand

1. Maximize return on investment from existing sourcing programs

Rather than achieving full value from existing capability sourcing programs, companies often move on to the next outsourcing or offshoring project. Our client experience suggests that companies should be getting at least 25 percent return on investment on their sourcing programs. If companies are not on a path to achieve that level of return, they should carefully review, and if needed, fix their current programs before moving on to new projects.

New capability sourcing models are emerging to help companies avoid the mistakes made by other companies.

Figure 3: New capability sourcing models are emerging



Companies often underestimate the value that can still be unlocked from their current sourcing programs.

2. Build a repeatable formula

As companies outsource and offshore more complex activities, it is critical for them to apply what they have learned. One way of doing that is to build an internal organization with capability sourcing experience to manage partner relationships and transfer experience from one project to the next. Another way is to institute a systematic approach to partner evaluation and selection.

One company that continuously applies what it learns from its capability sourcing programs is Cisco Systems. The global leader in IP-based networking equipment aggressively turned to outsourcing production in the early 1990s to manage its rapid growth. Despite supply chain challenges in the early 2000s recession, Cisco recovered. Today, Cisco may face more complexity and change than ever before. The pace of technology change remains relentless, but Cisco continues to expand globally and diversify its product and services portfolio. Due in part to its ability to carry out supply chain innovation, Cisco continues to apply successfully its outsourcing model to new products and services with remarkable efficiency and effectiveness.

3. Take a stand on the role of capability sourcing

Companies rarely understand the implications of starting down the path of capability sourcing. Though outsourcing can fundamentally change a company's operations and economics, many companies testing the waters approach it as a series of one-time, contractual events where responsibilities are often delegated to functional leaders or to the procurement department. The inevitable result is often a disparate collection

of outsourcing contracts. Since these various contracts are not part of an integrated effort, they often fail to achieve the promised benefits.

Companies testing the waters need to decide quickly on the strategic role of capability sourcing in their operations and take a stand on which programs to keep and which to unwind; which to expand or which to shrink; which new areas to outsource or keep in house; and which to keep onshore and which to offshore (see Figure 4).

Experienced practitioners: Avoid complacency and look to change the game

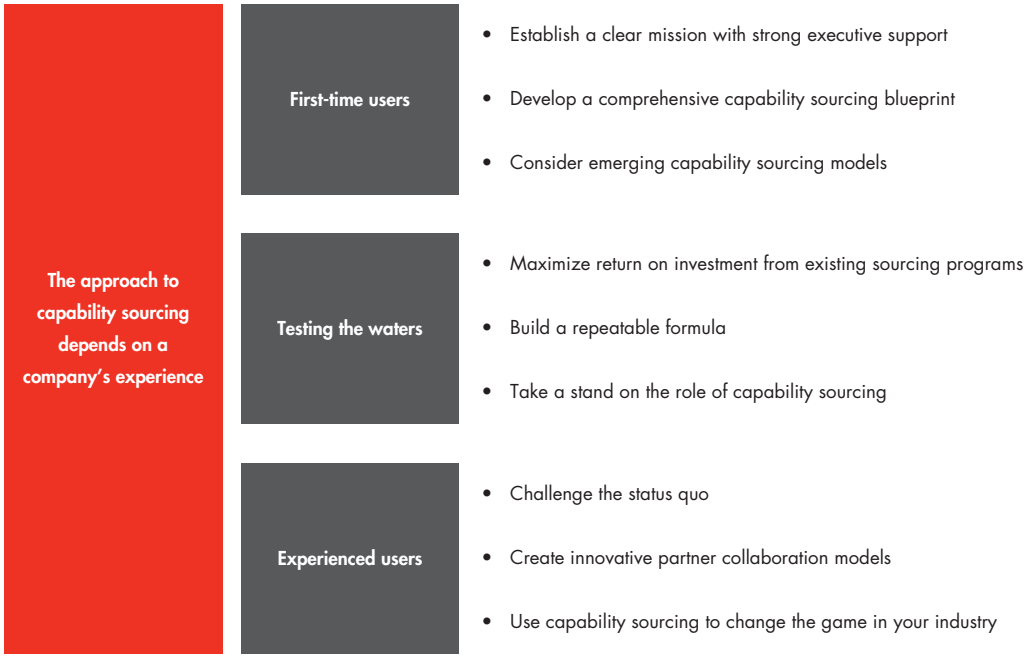
1. Challenge the status quo

Just as first-time users should not on faith pick up the playbook of experienced practitioners to execute their plans, experienced practitioners should avoid becoming complacent about even their most successful sourcing programs. Similar to companies testing the waters, many experienced practitioners fail to achieve full value from their sourcing programs.

Experienced practitioners should regularly undertake a comprehensive review of their capability sourcing programs. For example, while an offshore captive may have been the best approach years ago, conditions may have changed and outsourcing may now be the more attractive solution. Experienced practitioners should continuously evaluate their capability sourcing strategy and operational approach. They may want to consider changes including modifying scope, converting captive operations into independent profit centers, diversifying or changing their low-cost country footprint or rationalizing and changing outsourcing partners.

The recent meltdown in financial services, an industry with some of the longest and deepest experience in capability sourcing, has caused many companies in the industry to reevaluate

Figure 4: Using experience as a guide



Outsourcing and offshoring can free up scarce resources that allow companies to invest in more sustainable areas of differentiation.

their outsourcing and offshoring programs. In the new economic climate, the relative benefits of owning and operating captive offshore centers has declined, even for pioneering financial services firms such as Citibank and American Express. That has led to a wave of activity aimed at extracting more value from existing captive operations, which, in some cases, includes selling them. Citibank sold its offshore captive to Tata Consultancy Services at the end of 2008, and American Express divested its offshore travel center to Nasdaq-listed Indian company ExlService in November 2009.

2. Create innovative collaboration models with partners

Companies that seize the strategic high ground by building partner ecosystems rather than managing their outsourced vendors at arm's-length invest in developing innovative approaches to collaboration. Experienced practitioners are often best positioned to make such investments. Collaboration can take several forms and extend across the entire value chain.

Cisco is pioneering innovative collaboration models with its Electronic Manufacturing Services (EMS) partners. After the recession of the early 2000s, the company focused on fewer partners to enable more collaborative relationships, and aggressively invested in new approaches. The company and its partners jointly develop technology roadmaps in Commodity Councils and rely on a collaborative network that captures real-time data from partner facilities. This network provides Cisco a unified view of its entire production network. The company also developed and expanded standards-based partner interfaces in ordering, logistics and transportation that require shared goals and processes.

3. Use capability sourcing to change the game in your industry

Outsourcing and offshoring can change the game, freeing up scarce resources that allow companies to invest successfully in new and more sustainable areas of differentiation.

The semiconductor industry was disrupted by the change that outsourcing brings. With the industry's birth in the 1960s, semiconductor manufacturers felt the need to be highly integrated, given the complexity of the manufacturing process. In the 1980s, however, outsourced foundry manufacturing changed the game. Companies that outsourced production to low-cost Asian foundries took off, as they were free to focus on research and development rather than investing in fabrication and its associated operating costs. Fabless companies like Qualcomm and graphics-chip maker NVIDIA quickly gained market share. Today, outsourced semiconductor foundries make up close to 25 percent of total semiconductor manufacturing capacity.

Capability sourcing creates real value, but companies will need to adapt to the shifts taking place. High-performing companies are moving from using capability sourcing narrowly and tactically to using it more broadly and strategically. The results will depend on whether a company is just getting started, testing the waters or is an experienced practitioner. In today's uncertain business climate, a strategic view of capability sourcing isn't an option, it's an imperative.

Undergo a capability sourcing health check

A company looking to understand whether it is achieving full potential from its current outsourcing and offshoring programs should undergo a health check.

Answering the following questions will help a company understand the opportunities to improve the efficiency and effectiveness of its capability sourcing programs.

- Is your sourcing strategy aligned with shifts taking place in your industry?
  - Is outsourcing and offshoring on the CEO's agenda?
  - Has capability sourcing improved competitive differentiation—in cost, service quality, time to market and flexibility?
  - How is the competition approaching outsourcing and offshoring, and could your competitors' actions potentially affect your position?

- Are you implementing sourcing programs effectively?
  - Have past transitions to outsourcing or offshoring been on time, on budget and without disruption to your organization?
  - Do you have a repeatable formula for implementing outsourcing and offshoring programs?

- Are you achieving the benefits you were expecting?
  - Are you achieving at least 25 percent return on investment?
  - Are you achieving the non-financial benefits you were expecting?

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