The **Evolution** of the Vested Business Model

From research to a methodology to a movement: These five rules for outsourcing are helping companies develop strategic supplier relationships.

BY KATE VITASEK

Inside Supply Management® *published an article about Vested outsourcing in its January 2011 issue, which profiled the University of Tennessee's (UT) research that shared five rules for developing successful outsourcing agreements. This article explores how the Vested sourcing business model has evolved, and how large and small organizations are reflecting on their approach to strategic supplier relationships.*

Many companies say "strategic" supplier. In fact, they often use category management classifications that carefully segment suppliers into buckets, commonly using some version of the Kraljic matrix. Introduced in Peter Kraljic's 1983 *Harvard Business Review* article, the Kraljic matrix gave companies a framework for segmenting supplier spend in a way that enables them to highlight and prioritize spend categories to achieve the biggest impact.

The Kraljic matrix classified suppliers into four segments: non-critical, leverage, strategic and bottleneck. Kraljic's premise was an instant hit among procurement executives, and it soon became the global standard.

Unfortunately, while there might be intent to have a strategic supplier relationship, the execution can fall short. A case in point is an analysis of a facilities management contract for a large telecom company. A review by UT researchers showed many contradictions between the buyer's "intent" and his or her actions. For example:

- The buyer wanted "innovation" — yet the contract had an 800-page SOW with exacting detail on how the supplier should perform each of the activities in scope.
- The buyer wanted "outcomes" — yet the contract spelled out more than 550 service level agreement (SLA) metrics.
- The buyer outsourced to the expert and wanted more "insight" — yet the buyer retained a large staff to provide "oversight" for managing the supplier.
- The buyer wanted the supplier to have "productivity improvements" — yet its transactional pricing scheme inherently incentivized the supplier to have more transactions. For example, if paid hourly for custodians, what supplier wouldn't want more custodians?
- The buyer wanted a "partner" — yet the contract had a 60-day "termination for convenience" clause.

These are just a few of the inherent structural flaws UT researchers found as part of a research project funded by the U.S. Air Force. The research led to the book *Vested Outsourcing: Five Rules that Will Transform Outsourcing*, first published in 2010.

By 2016, UT researchers had compiled six books from their pioneering work studying successful outsourcing relationships at such companies as McDonald's, Procter & Gamble and Microsoft. Figure 1 on page 34 shows how the five rules fit together.

FROM RESEARCH TO REALITY: VESTED IN ACTION

When the UT research first came out, many thought it was an intriguing theory, but difficult to put into practice. The critique led to the UT researchers teaming with the International Association for Contract and Commercial Management (IACCM) to write a second book on Vested — *The Vested Outsourcing Manual* — which provides a step-by-step guidebook for how to turn the five rules into a contract.

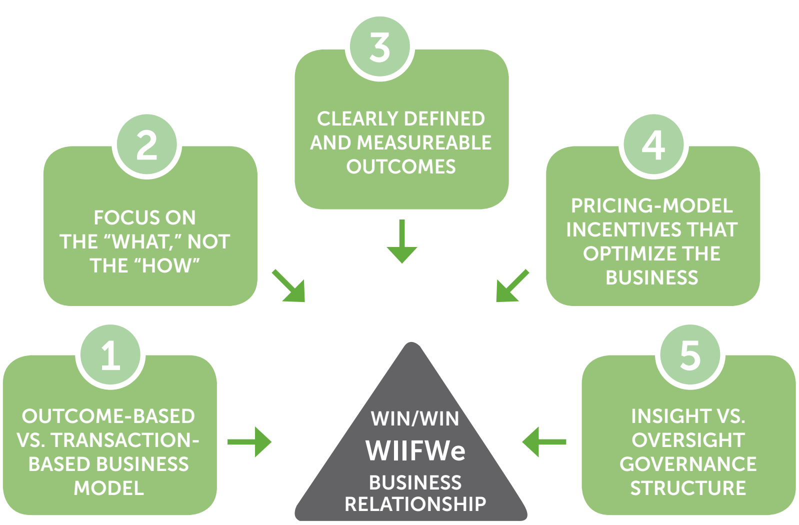
CASE STUDY 1: DELL/GENCO

Dell was one of the first companies to pilot the Vested methodology. The company and its strategic partner GENCO, a reverse logistics provider that is now part of FedEx, followed the rules with great success.

The relationship was strategic, but the structure of the agreement was transactional in nature. The contract was a typical transaction-based contract in which FedEx assumed the risk of meeting a set "price per activity" while maintaining service levels. The agreement worked reasonably well for a time, but Dell's leaders continued to face cost pressures, insisting on an "every dollar, every year" procurement principle — despite FedEx assuming much of the risk under the contract terms.

The seeds for a difficult endgame were sown, unless both companies could transform their relationship through trust and collaboration. A new partnership could drive innovation and get the parties unstuck

Figure 1: Vested Methodology



At the heart of the Vested methodology is what researchers call a "what's in it for *we*" (WIIFWe) business relationship. Buyers and suppliers structure contracts to follow these five rules, designing an agreement with mutually desired outcomes, clearly defined measurements, an incentive-based pricing model and a transparent governance structure.

from the conventional buyer-supplier scenario of sitting across a table negotiating tradeoffs and contract concessions. Dell and FedEx succeeded by structuring a win-win strategic commercial agreement that embedded Vested's "what's in it for *we*" mind-set and followed the Vested five rules.

Rule 1: Focus on outcomes, not transactions. Instead of buying transactions, Dell and FedEx created a joint shared vision and six desired outcomes to set the relationship focus. This helped the parties avoid the "activity trap" in which suppliers are paid for performing a task or activity — regardless of whether it is needed. Applying this rule enabled the parties to not only talk about a strategic partnership, but craft a deal around true business outcomes.

Rule 2: Focus on the "what," not the "how." A conventional buyer-supplier relationship has a detailed SOW that dictates how the supplier should perform the work. Dell and FedEx replaced their detailed SOW with a taxonomy and workload allocation that clearly showed how the parties would work together to achieve their shared vision and desired outcomes.

Rule 3: Agree on clearly defined and measurable outcomes. Traditional outsourcing agreements have detailed SLAs. In a Vested agreement, metrics are clearly aligned to desired outcomes. For Dell and FedEx, this meant reducing the number of metrics from more than 100 to 20 clearly defined metrics that aligned to six desired outcomes.

Rule 4: Pricing-model incentives that optimize the business. The Vested business model does not guarantee higher profits for suppliers. Rather, suppliers take a calculated risk to link profitability to achievement of mutually agreed desired outcomes. Dell's agreement incentivized FedEx to make strategic investments in processes that would help reach such outcomes. Using a pricing model with incentives enabled the parties to "grow the pie and share the pie" when value was created. The more effective FedEx was at achieving the desired outcomes, the more incentives (or profits) it earned. A true win-win economic model.

Rule 5: Governance structure that provides insight, not oversight. Dell and FedEx established a flexible and credible governance framework that enabled the rules to work in sync. The focus shifted from managing the supplier to managing the business — with the supplier. Together, the parties built a governance structure based on transparency about how operations are developing and improving.

The results were nothing short of transformational. Dell reduced the cost structure for its repair and returns business by 32 percent in less than two years. And service and quality did not suffer at the expense of costs. In fact, they increased. Quality levels (measured in defective parts per million) reached record highs, and the parties reduced the scrap level of old and damaged hardware by 62 percent. FedEx also benefited with a tripling of its margins.

John Coleman, FedEx's general manager of operations for Dell's reverse logistics business, explained the power of a collaborative win-win approach. Says Coleman, "It's like we broke open a new innovation piñata. (FedEx) employees now know that we will share in the reward for good ideas."

CASE STUDY 2: NOVARTIS/JLL

Companies like Novartis are also starting to make the shift to more strategic supplier relationships. Often, however, the path is not a straight line.

When Novartis International AG, a multinational pharmaceutical company based in Basel, Switzerland, started its outsourcing initiative, facilities management operations were decentralized across each of the company's seven business divisions. Each division had its own objectives, budgets and needs. There were more than 5,000 suppliers managing their facilities, which were ultimately reduced to four strategic suppliers.

The first step to a more strategic supplier relationship began when Novartis shifted to an integrated facilities management (IFM) agreement for its U.S. operations. Integrating maintenance and repair, site operations and workplace services under a single service provider contract enabled Novartis to drive efficiencies through scale. A key objective of the IFM initiative was to reduce Novartis' facilities management cost structure. Leveraging Novartis' purchasing power across fewer suppliers gave it significant negotiating power during the bid process.

Jones Lang LaSalle (JLL) was selected as the supplier, with Novartis shifting from 5,000 transactional contracts to a single performance-based agreement with JLL in 2010. The contract shifted risk for performance to JLL. The supplier agreed to a guaranteed savings glide path with penalties if it missed performance SLAs.

The relationship worked well, and Novartis and JLL met aggressive cost-reduction targets. However, as the relationship matured, Novartis knew it would be difficult, if not impossible, to seek further improved performance and cost-structure reductions without innovation. And innovation would require investment from JLL.

In 2013, Novartis began to explore shifting to a Vested framework to renew the original agreement. Moving to a Vested agreement would allow Novartis and JLL to shift to an outcome-based framework and incentivize JLL to invest in innovation — essential if Novartis was going to sustain year-over-year cost savings and continued value-add services. A Vested model would also provide Novartis with more flexibility because it uses a pricing model versus a "price" approach.

Novartis and JLL began their Vested journey with a formal review of their existing deal. The review identified gaps in the contract that would need to be addressed and closed under a Vested relationship. For example, their performance-based agreement used output-based SLAs and not outcome-based measures.

With a road map in hand from the deal review, Novartis-JLL worked through the five rules to create a contract that would fully align the 10 contractual elements. On January 1, 2016, the parties signed a fully Vested agreement that covers nearly three dozen facilities spanning North America and South America. The agreement is structured as a flexible framework and allows Novartis an option to add other regions as conditions require.

THE EVOLUTION CONTINUES

The appetite for shifting to a Vested model has increased dramatically since the 2011 article in *Inside Supply Management*®. What started out as a research project has turned into a methodology.

Today, the Vested methodology is fast becoming a movement, with more than 50 organizations applying it to such spend categories as facilities management, reverse logistics, third-party logistics, environmental services, fiber optic network management and labor services. And companies are beginning to apply Vested in strategic direct spend categories; for example, Danfoss, a Nordborg, Denmark-based manufacturer of heating and cooling products, created a Vested agreement with NuTech, a manufacturer of high-precision compressor housings and related machined parts.

The UT research library dedicated to Vested includes six books, 16 white papers and 13 public case studies that document the success stories of such organizations as Intel (third-party logistics), Dell (reverse logistics), Vancouver Coastal Health (environmental services), Novartis (facilities management) and Discovery Health (insurance claims management). The research materials are available at www.vestedway.com/vested-library.

The Vested approach's theme is simple: It is easier to win when you have a win-win deal. **ISM**

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