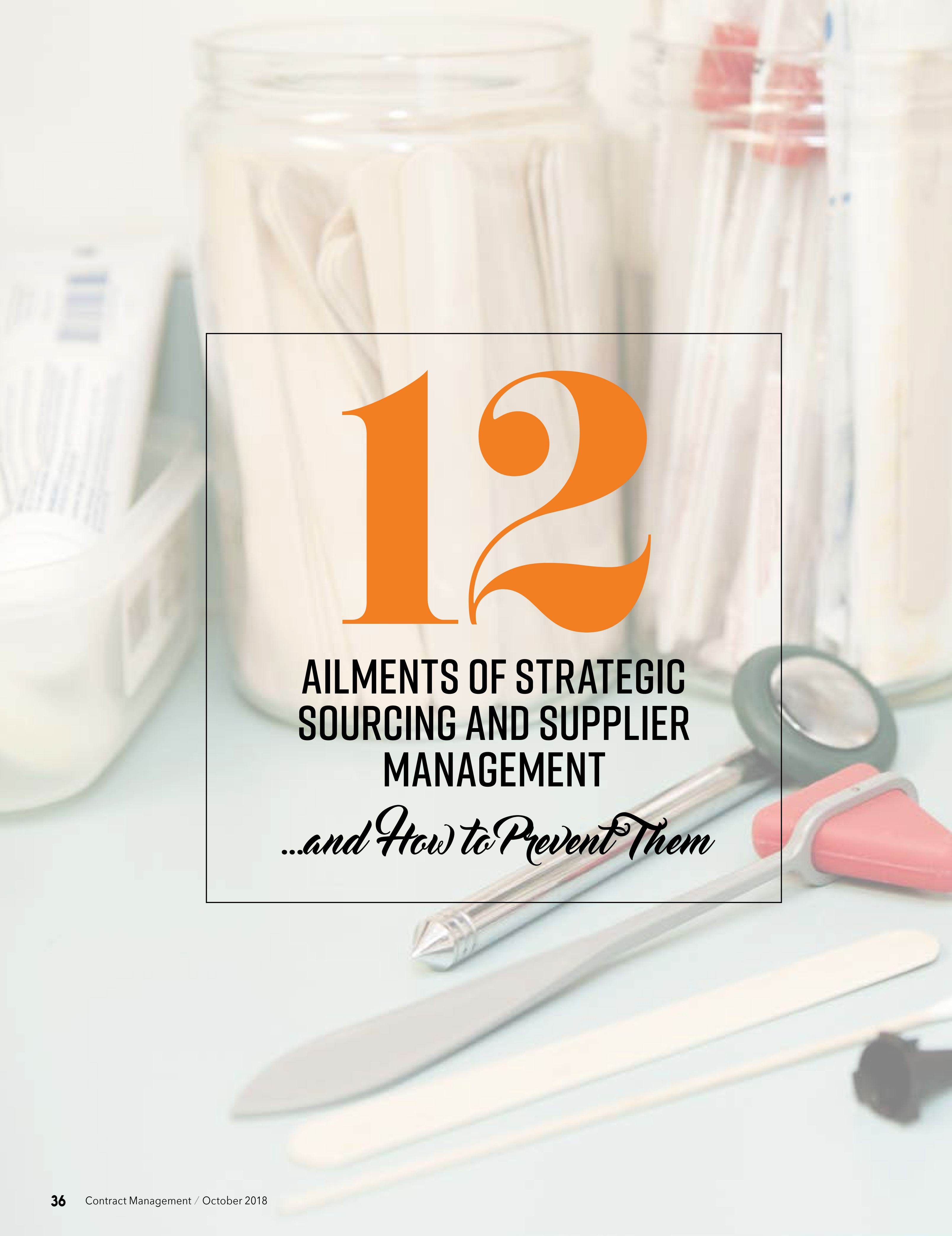
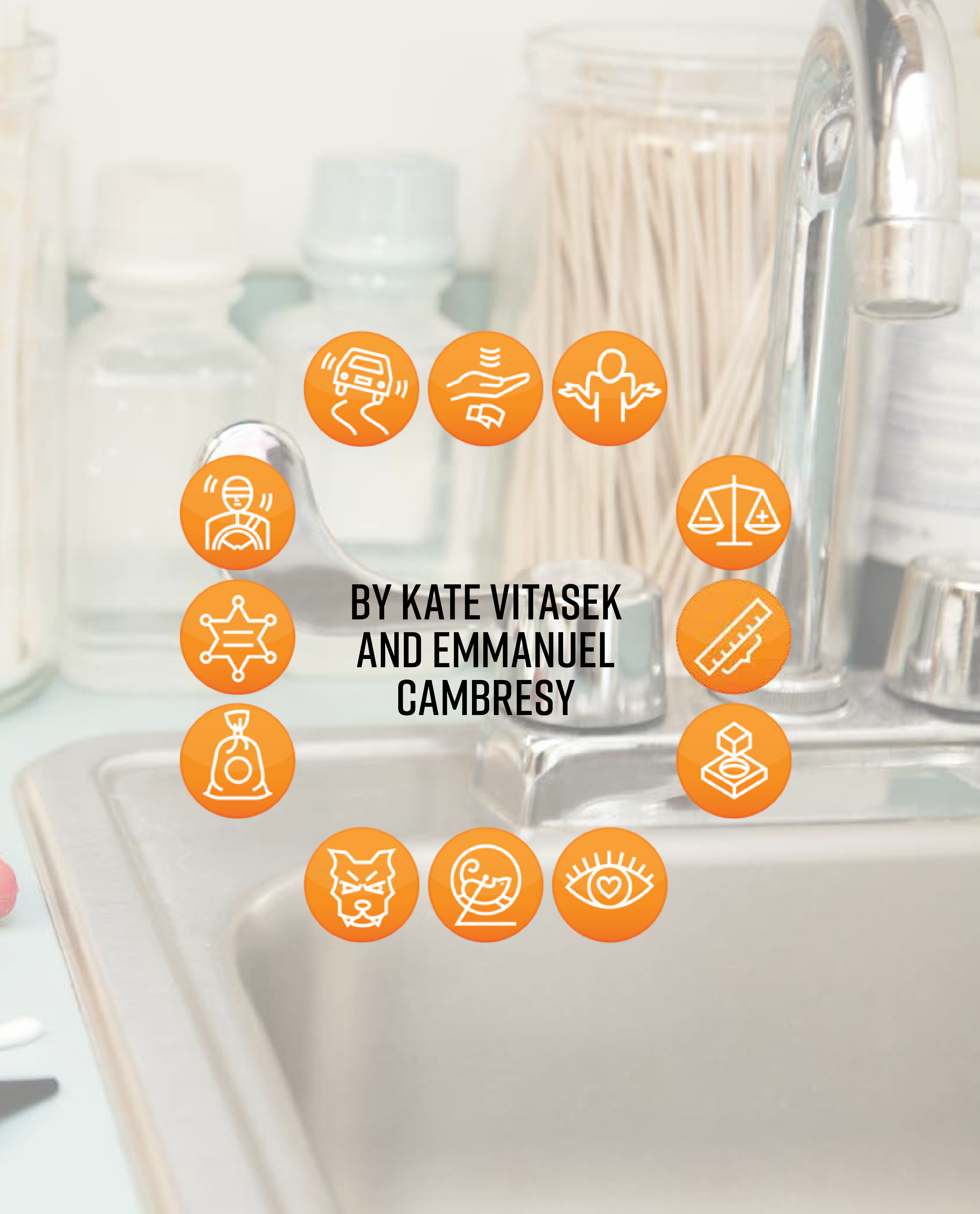


12 Ailments of Strategic Sourcing and Supplier Management

...and How to Prevent Them



BY KATE VITASEK AND EMMANUEL CAMBRESY

TODAY'S CONTRACT MANAGEMENT PROFESSIONALS FACE MORE GLOBAL, COMPLEX, AND OUTSOURCED SUPPLIER RELATIONSHIPS THAN EVER BEFORE.

The result? Organizations are finding themselves with a new set of challenges—many created by gaps between the intent of the relationship and the actual contract. And these gaps are especially wide for services (outsourcing) contracts, where what is procured is less tangible than a "good" or a "commodity." These gaps are what University of Tennessee (UT) researchers call the "Outsourcing Ailments."[1]

UT researchers first began uncovering the Outsourcing Ailments as part of a research contract funded by the U.S. Air Force to study performance-based and public-private partnership contracts where there was an intent to outsource key functions to strategic suppliers. Specifically, why were some contracts so successful while others fell well short of the promise of their "strategic" nature?

The findings were clear: Often, there is a disconnect in the intent of a "strategic" deal and how it is procured, contracted for, and ultimately managed. When this happens, there is often friction that can disrupt, derail, or even destroy the best-intentioned strategic supplier relationship.

A key to eliminating the Ailments is first to identify they exist and understand how they can make your strategic supplier relationships unhealthy. This article summarizes each of the 12 most common Ailments and guidance on how to overcome each Ailment in your strategic supplier relationships.

Ailment 1
"PENNY WISE AND POUND FOOLISH"

In case you are unaware of the adage, "penny wise and pound foolish," it refers to when one is particularly cautious and economical with small matters, but careless, wasteful, or extravagant with larger ones. Well, this doesn't just apply to individuals—it happens with large organizations too.

Specifically, this Ailment crops up when a company sources based purely on costs. Many procurement professionals (and even some organizational policies) operate in the Dark Ages. You don't have to look far to find organizations professing to have contracted with a strategic supplier intending to create value or drive innovation, but behind the scenes, they focused solely on "beating up" the supplier to get the lowest possible price. This state of mind is deeply rooted in the way procurement organizations are incentivized. The narrower their approach to "value" is, the less they get rewarded for achieving "value beyond savings," which increases the likelihood of developing a sole focus on price. In short, they get what they pay for.

This myopic focus might pay off in the short term, but time and time again it has been proven that it does not pay over the long run because of unintended, disadvantageous consequences. These consequences include such things as the following:

- The best suppliers refuse to bid on your work because they always lose on price.
- Even those that play the game become tired of getting "squeezed" on price. Eventually, they will reallocate their customer relationship management teams to accounts that offer better chances for sustainable revenue and long-term rewards. Ultimately, their "C" team will replace the "A" team on your account.
- When making significant progress in R&D, suppliers will typically restrict access to their latest innovations to clients that understand the importance of their creative capabilities and the end-to-end value of their solutions. As much as sourcing professionals learn to segment their "preferred suppliers," service providers equally know how to spot a "customer of choice."
- What might look like a recurring price benchmark exercise will end up making suppliers reluctant to share information about their cost structures due to lack of trust regarding how such data will be used.
- Suppliers that play the "bid low" game to win the work will seek to "get even" (i.e., to increase their margins) by locking their client into what is informally called "change order hell."
- Worst of all is the supplier that cuts corners on quality because its profits are pressured. This becomes a lose-lose situation for both the buyer and supplier.

HOW TO PREVENT:

Resolve to move to a more sustainable approach for driving business value by using three quick tips:

1 | Move beyond the costs and prices—and understand the total cost of ownership (TCO).

2 | Once TCO (along with associated hidden risks) is understood, determine the best value for the goods or services bought and used.

3 | Finally, shift your thinking from focusing on price to creating a holistic compensation model that seeks to understand the true cost drivers.

Ailment 2
"THE OUTSOURCING PARADOX"

The "Outsourcing Paradox" happens when an organization hires a supplier as the "expert" and then tells it (with excruciating and often annoying precision) exactly how to do the work. The organization develops a "perfect" set of tasks, frequencies, and measures, but paradoxically gets no input from the supplier it has hired as the expert. Thus, the "perfect" statement of work (SOW) then contractually obligates the supplier to perform as told—effectively locking the buying organization into status quo. In such a context, the deal acts like a cage that restrains suppliers' innovative capabilities to the boundaries of an overly prescriptive SOW.

The Outsourcing Paradox often occurs when the decision to engage into a business relationship is made for the first time, when the fear to lose control is peaking, while faith in a supplier's true capabilities is still low. The Outsourcing Paradox is especially rampant within agreements for complex outsourced services.

HOW TO PREVENT:

If you are working with a "strategic supplier" (i.e., the kind you hire for their expertise and best practices), resist the urge to "handcuff" the supplier with a SOW that is too detailed and prescriptive. Instead, shift to what UT researchers call a "statement of objectives" (SOO), which provides the supplier with your *objectives* for the work, but still allows flexibility to make those changes/innovations that will drive efficiencies and improvements in how the work is done. In addition, a clear and proactive workload allocation will help both parties understand who is in charge of what activities. This is essential for complex supplier relationships where there is a lot of integration.

Ailment 3
"THE ACTIVITY TRAP"

The "Activity Trap" is especially rampant in services contracts where the buying organizations pay per hour, per day, per shipment, per order, per mile, per call, etc. Transaction-based pricing promotes an inherent perverse incentive where the supplier is paid for every transaction—whether it is needed or not. Therefore, there is no incentive for the supplier to reduce the number of non-value-added transactions because doing so would lead to lower revenue.

Consider the following scenarios. A logistics supplier stores marketing and promotional materials for its client, including calendars—of which there are a large number of obsolete calendars dating back several years because the client never thought to scrap them. Or, consider a transportation provider that gets paid per mile. Why bother to optimize transportation if you are getting paid by the mile? The more miles, the better revenue for the transportation provider.

The more inefficient the entire support process is, the more money the service provider can make and the less interest it has to share the conclusions of its expert observations with its customer.

HOW TO PREVENT:

Shift your more strategic transaction-based contracts to performance-based or a Vested[2] sourcing business model that contracts for business outcomes. A Vested model is ideal when trying to motivate a supplier to drive innovation and transformation.

Ailment 4
"THE JUNKYARD DOG FACTOR"

The "Junkyard Dog Factor" is especially prevalent when procuring outsourced services. Often, there are many great reasons behind the decision to outsource, including a desire to focus on core functions, such as business process outsourcing or facilities management. However, when a decision to outsource is made, it can sometimes mean jobs are lost or transferred from the buying entity to the supplier. Employees often will go to great lengths to hunker down and draw a line in the sand, claiming that certain processes simply "must" stay in-house.

The result: misalignment and a potentially ruinous disconnection between the organization and its supplier. In addition, the Junkyard Dog Factor almost always leads to duplication of effort as the organization keeps people to manage—or, more appropriately, *micro*manage—the supplier.

HOW TO PREVENT:

Identify potential misalignment and duplication of effort by creating a workload allocation—what UT researchers refer to as a "taxonomy." Unlike a traditional SOW, which is one-way and outlines the supplier's work, a "taxonomy" is an end-to-end inventory of the work to be done by both the organization and the supplier. The parties create a "T-Chart" to allocate who does what. This simple exercise is a wonderful way of rooting out duplication of effort and mitigating the Junkyard Dog Factor. Also, make sure that people that stay in-house shift their focus and skills to govern the supplier relationship/performance—and that they don't fall into the trap of micromanaging the supplier just because they once held the job before the role was outsourced.

Ailment 5

"THE HONEYMOON EFFECT"

All new supplier relationships go through a "honeymoon" stage. The research firm Gartner, Inc., studied the "Honeymoon Effect" experienced between several buyers and suppliers and found that overall attitudes tend to be positive at the outset of a new relationship, but satisfaction levels drop over time.[3] Suppliers often jump through hoops as they ramp up and collect revenue from their new clients, but over time, the excitement wears off and the "A" team that sold the deal has moved on to sell the next deal, leaving the "B" team or even the "C" team behind to keep the relationship going. Meanwhile, buyers in charge of the sourcing process have left the business relationship to their stakeholders, who now must deal with the unexpected consequences of a contract not designed to deliver against business expectations.

HOW TO PREVENT:

The Honeymoon Effect may be prevented in two ways:

1 | Consider shifting from a transactional contract to a performance-based agreement or a Vested model, where supplier payments are linked to maintaining high performance, therefore "keeping the vibe alive"; and make sure you have a well-thought-out governance structure as part of your contract, including a "key personnel" clause that ensures the "A" team remains involved for a minimum amount of time (i.e., ideally 18 months to three years).

2 | Also, identify and document processes for continuity of resources—especially how key personnel will be replaced and newcomers onboarded—as part of the contract. Key personnel clauses should ideally be bilateral, enabling the buyer and supplier to become "two-in-a-box" partners with a common goal to maintain a healthy relationship.

Ailment 6

"SANDBAGGING"

To prevent the Honeymoon Effect, some companies have adopted approaches to encourage suppliers to perform better over time by establishing bonus payments or other incentives for them to achieve certain levels of performance. Incentives can and do work, but all too often they create the Ailment known as "Sandbagging"—i.e., the act of purposely withholding value at the other party's expense. This is common in a performance-based contract.

Incentives and penalties can be applied to performance targets (e.g., "you will pay a penalty if you fail to meet the service level agreement") or to cost savings targets (e.g., "if you save me $1, you can keep 25¢"). However, consider the case of the world-class Ukrainian pole-vaulter Sergey Bubka. He earned $50,000 every time he set a new world record—and from 1983 to 1998, he broke the world record for men's pole vault 35 times…but never by more than one centimeter!

HOW TO PREVENT:

Structure the relationship so it prevents the urge to sandbag. Do this by aligning your intentions with your metrics and incentives. Also, consider shifting to a model that promotes transparency of economics and is designed as a "win-win" contract. This helps prevent the supplier (or the buyer!) from playing games of one-upmanship. Ultimately, your contract should be designed so it flexibly allows you to regularly adjust your performance framework to realistic expectations.

Ailment 7

"THE ZERO-SUM GAME"

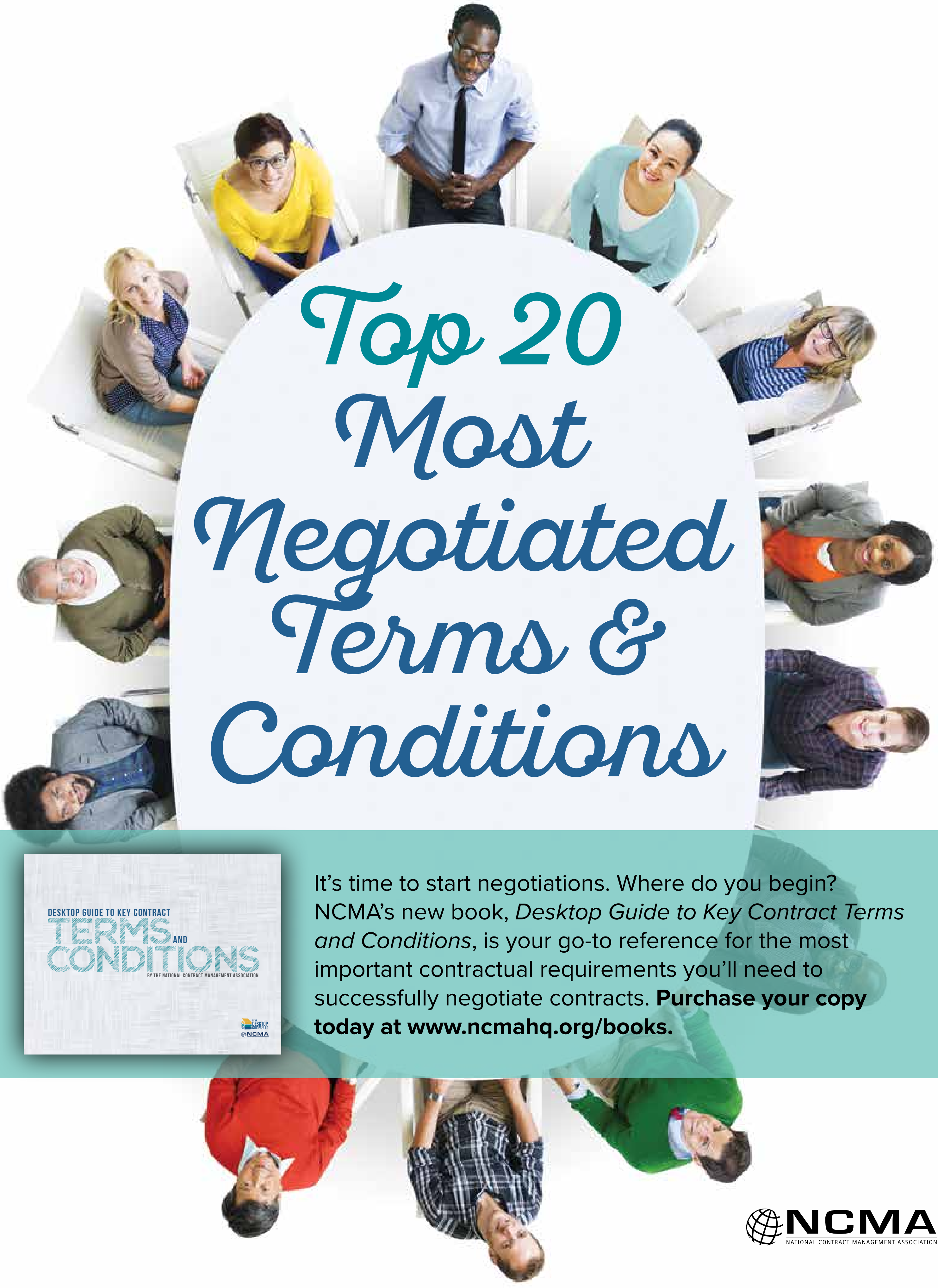
Contracting parties play the "Zero-Sum Game" when they believe, mistakenly, that if something is good for the supplier, then it is automatically bad for the buyer—and *vice versa*. Players on each side often do not understand that the sum of the parts *can* be better when combined effectively. It's called the power of trust and collaboration: When individuals or organizations work together to solve a problem, the results are *always* better than if they had worked separately or at cross-purposes.

Zero-sum thinking boils down to this: "when *I* win, *you* lose." Or, as once mentioned by a procurement executive, "'win-win' is when I get to win twice."

Win-win economics has been studied since the pioneering, Nobel Prize-winning research of John Nash laid the foundation for his "Nash Equilibrium." Other academics have built on the concept of win-win—further proving that when individuals or organizations play a game together and work together to solve a problem, the results are always better than if they work separately or play against each other.

HOW TO PREVENT:

Play nice—together—by adopting a "what's in it for we?" philosophy and understanding that the sum of the parts can be better when combined effectively. This can be achieved by implementing a robust platform for collaboration where individuals from both organizations are jointly accountable for the delivery of successful outcomes. Needless to say, joint rewards and incentives can act as significant enablers for collaboration.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Ailment 8
"DRIVING BLIND DISEASE"

You might suffer from "Driving Blind Disease" if you lack a formal governance process to monitor overall relationship performance. When we started working with companies more than 20 years ago, most supplier arrangements fell into this trap. They would rush to strike a deal, but not outline how they would measure its success. Typically, companies would focus on tracking costs but not measure essential aspects of performance. As a result, supplier agreements often failed because of an unclear definition of success and a lack of proper alignment.

The good news is that most organizations are addressing this Ailment head-on with supplier scorecards or dashboards. Sadly, however, many organizations find they are still suffering from a "watermelon" scorecard because the supplier may be achieving a "green" scorecard on the surface (from a strictly operational standpoint), but business leaders see "red," or savings leakage, below the surface (from a relational or transformational perspective).

HOW TO PREVENT:
Avoid a "watermelon" scorecard by agreeing on mutually defined desired outcomes based on business needs instead of focusing on transactions, headcounts, and detailed service level agreements (SLAs). In short: Measure the business, not just the activities the supplier is doing. But beware! This means that your scorecard will be bilateral in nature—measuring both the buying organization and the supplier. Why? Rarely can a supplier impact the overall business outcomes without the required support from its client. Ideally, scorecards should demonstrate how effectively the buying organization *and* its supplier work together to achieve success against their mutually agreed business outcomes.

Ailment 9
"MEASUREMENT MINUTIAE"

The hallmark of the "Measurement Minutiae" Ailment is trying to measure *everything*. As the saying goes, too much of a good thing can be bad for you. This applies to binging on Halloween candy as well as to the exhaustive measurement of your supplier's performance.

The minutiae that some organizations find necessary to track are remarkable. It is not uncommon to find spreadsheets with 50 to 100 metrics on them.

In one real-world case, a scorecard for a facilities management outsourcing deal weighed in with a whopping 550 metrics… tracked monthly! The supplier relationship manager for the buying organization was embarrassed to reveal the total number of person-hours required to create the spreadsheets.

Tracking metrics is not necessarily a wasted effort if the buying organization is getting positive results based on the improvements made by doing so. Unfortunately, experience has shown that few companies have the diligence to manage the metrics they have created actively. As an Ailment derived from the Outsourcing Paradox, Measurement Minutiae reflects the need to maintain absolute control through the illusion of safety.

Our research (and others) has shown that Measurement Minutiae results from a lack of discernment regarding the importance of success measures. When critical success factors for any business are fully understood, the ideal number of metrics rarely exceed 5–10 key performance indicators. Paring down the number of metrics allows you and the supplier to focus on what matters—not simply what *can* be measured.

HOW TO PREVENT:
Mutually agree on clearly defined and measurable outcomes, not dozens of detailed SLAs that are micromanaged by "Junkyard Dogs." Then, take the time to establish definitions and calculations for exactly how relationship success will be measured. A good performance framework should not be designed as a flat library of exhaustive metrics, but as a multilayered hierarchy that converges toward the achievement of business success.

Ailment 10
"THE POWER OF NOT DOING"

The "Power of Not Doing" is perhaps the saddest of all the Ailments. Many companies fall into the trap of investing heavily in fancy software and scorecards, but then fail to follow through and actually use them to manage the business. The adage, "You can't manage what you don't measure" holds true, but if the metrics compiled are not used to initiate corrective actions to adjust and improve performance, then don't expect positive results.

Many buying organizations establish measures simply for the sake of having them in place. They don't think through how the data will manage the business relationship. In one real-world case, a supplier relationship manager was very proud to show us the organization's automated dashboard for collecting and measuring supplier performance, but when asked what one of the metrics meant and how the data was being used, she simply stated, "Gosh, I'm not sure."

HOW TO PREVENT:

Jointly measure the things that are most vital to managing the business relationship successfully by leveraging the supplier's expertise to build the most appropriate and relevant performance framework. One way is to do what Dell and FedEx Services did when restructuring their reverse logistics contract: They "mapped" their existing 100+ metrics against the business outcomes. Their findings? Over 80 metrics were not being used and did not contribute to a positive business outcome in any meaningful way.

Ailment 11

"NEW SHERIFF IN TOWN SYNDROME"

You're probably familiar with this scenario. The new "sheriff" rides into town, wanting to clean things up and make a name for himself. In the movies, this individual is usually the "good guy," and by the time the credits roll, the "bad guys" are all dead, littering the dusty road of the now peaceful town. Happy ending. The "good guy" won; the "bad guys" lost. The "sheriff" rides into the sunset. Fade to black.

Unfortunately, in the business world, the reverse is often the case. The "New Sheriff in Town" can be a gun-slinging, power-hungry executive looking to enhance his or her name and image; along the way throwing good-standing partners/suppliers under the bus for the name of "lower costs" or "a new strategic direction."

The New Sheriff seeks short-term gains to make himself or herself feel good and is often gone in a flash to the next company to repeat the situation. Sometimes, the New Sheriff comes from the supply side and brings knowledge that can be used against the supplier–such as their margins.

The result? Once-loyal suppliers no longer trust their customer.

HOW TO PREVENT:

Recognize the dynamics and potential derailers of a New Sheriff. Make sure that any New Sheriffs are adequately onboarded with the "why," "what," and "how" your supplier works and what makes it effective. Demonstrate the value achieved so far and to which extent it has contributed to the delivery of business outcomes. Of course, if you don't have an effective and high-performing supplier relationship, you should be trying something new, and that may be what the New Sheriff is recommending!

Ailment 12

"STRATEGIC DRIFT"

Even the seemingly most well-crafted contracts and business relationships can suffer from a common but dangerous Ailment: "Strategic Drift." This Ailment occurs when buyers and suppliers don't work to maintain their relationship or put in the work needed to keep abreast and update their strategic priorities as business happens. In short, what once may have been a high-performing relationship has drifted to a place that is no longer desirable—or at least not living up to its potential. With the end of the Honeymoon Effect, Strategic Drift opens a new era that some call "relationship neglect." In this phase, priorities shift, earlier promises fade into limbo, and prior commitments revert to wishful thoughts.

Strategic Drift typically occurs after a first-generation outsourcing deal has operated successfully, perhaps after a certain amount of complacency sets in as quarterly business reviews slip—or "drift"—to biannual or even annual events. When this happens, a vicious circle often results: Suppliers can lose sight of priorities and can become less proactive in driving solutions to problems or connecting the dots to arrive at new solutions for new priorities.

The buying company then thinks the supplier is not proactive enough and looks for new suppliers—when, in reality, it already has a good supplier right in front of it. The parties just haven't done enough work and communication to stay on the same page with each other.

HOW TO PREVENT:

A properly architected governance structure can help prevent strategic drift.[4] Six practices are used to align organizations and avoid strategic drift:

1 | A tiered management structure establishes an organizational framework that ensures vertical alignment between the executives and the employees in the organizations tasked with getting the work done.

2 | Ensure your governance structure promotes and drives transformational efforts. This is best achieved with a governance organization supported by four separate governance roles:

- Service delivery management,
- Transformation management,
- Agreement compliance, and
- Relationship management.

3 | Establish peer-to-peer communications protocols by "mapping" the individuals into the structure using a peer-to-peer alignment approach commonly known as "reverse bow tie" or "two-in-a-box."

4 | Develop a regular communications cadence or rhythm utilizing formal and regular reporting and measurement processes (which should include metrics that align performance to strategy). A minimum larger or more strategic relationship should have a formal quarterly business review and monthly operational reviews.

5 | Develop a process to maintain continuity of people and resources.

6 | Create a formal performance management program.

Once you have created a governance structure using these guidelines, resolve to put your governance structure into practice, embracing the dynamic nature of business and adjusting to changes as they happen. This will prevent buyer-seller frustration and eliminate the potential for strategic drift.

CONCLUSION

Do these Ailments set off some loud and uncomfortable alarms? Even one might endanger the future of your relationship. Fortunately, diagnosing the illness is the first step to curing it!

Want to discover how bad you might be suffering from these Ailments? The University of Tennessee offers a free "Ailments" self-assessment that will provide you with a quick and easy litmus test to gauge how healthy your supplier relationship is. Check it out at www.vestedway.com/self-assessment/. CM

ENDNOTES

1. These Ailments are described in detail in *Vested Outsourcing: Five Rules That Will Transform Outsourcing* (see Kate Vitasek, Mike Ledyard, and Karl Manrodt; *Vested Outsourcing: Five Rules That Will Transform Outsourcing*; second ed. (New York: Palgrave Macmillan, 2013): Chapter 3). For more information, visit www.vestedway.com/vested-outsourcing/.
2. For more information on the Vested sourcing business model, visit www.vestedway.com.
3. *See* http://searchcio.techtarget.com/news/1173176/Gartner-Outsourcing-deals-based-on-price-alone-are-likely-doomed.
4. This is the focus of UT's "Vested Certified Deal Architect" program. (*See* www.vestedway.com/vested-certified-deal-architects/.)

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