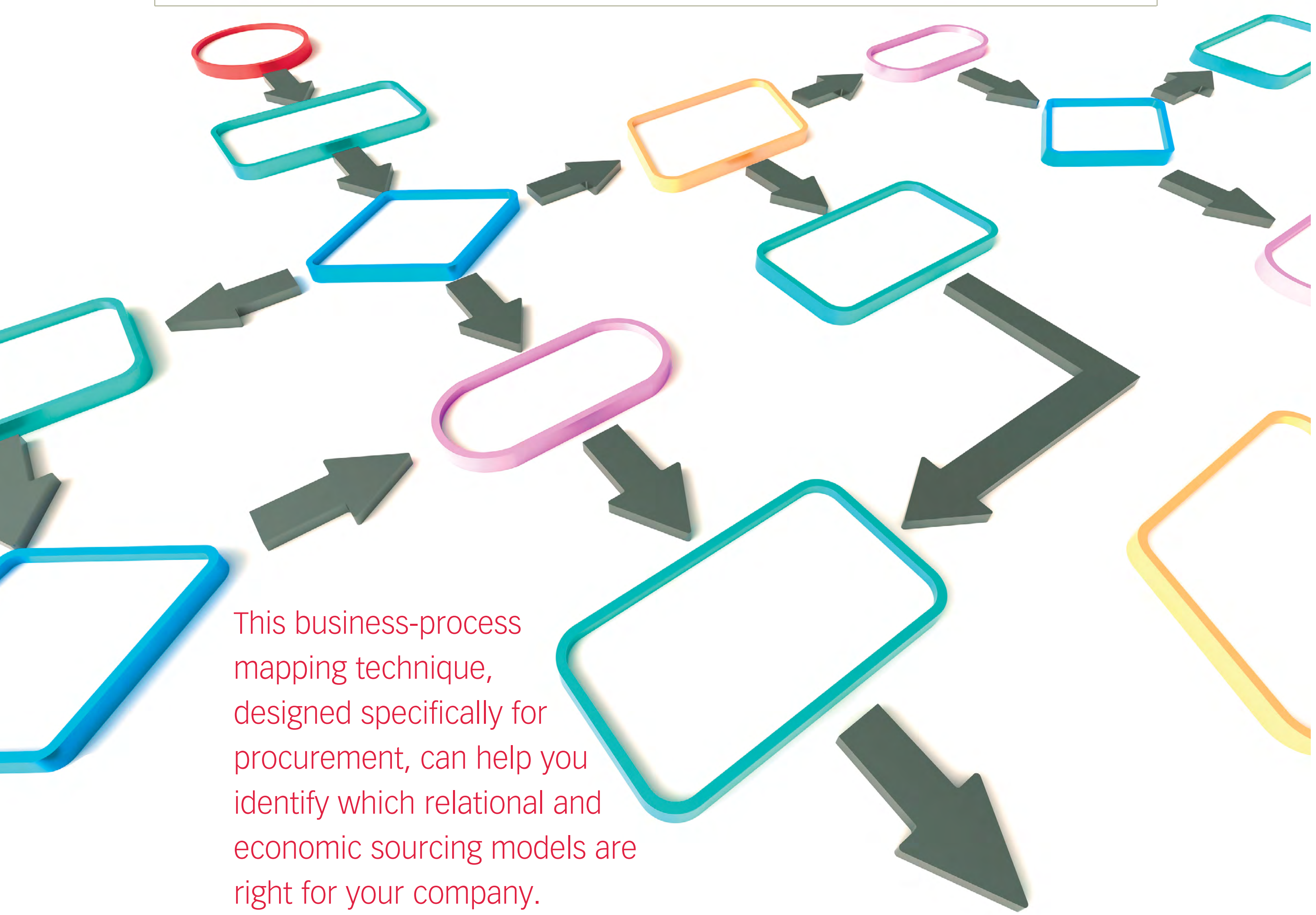

This business-process mapping technique, designed specifically for procurement, can help you identify which relational and economic sourcing models are right for your company.

Map your way to an effective sourcing strategy

[BY KATE VITASEK]

PROCUREMENT PROFESSIONALS have wrestled with "make vs. buy" decisions for decades. Today, however, organizations are "buying" far more than they are "making." Many experts agree that typical organizations spend 40–80 percent of revenue with suppliers that help them develop, manufacture, sell, and service their goods and/or services.[1] Indeed, the automobile industry spends 70 percent of its revenue with suppliers.[2]

A big reason for this increase is the rapid rise in the amount of indirect spend—that is, the procurement of goods and services that are not directly incorporated into a manufactured product. In particular, the procurement of outsourced services has experienced significant growth. For example, the technology giant Dell made the shift to outsourcing much of its North American supply chain operations in 2001.[3] While statistics vary based on the source, the growth in outsourcing is undeniable. According to Statistica, an aggregator and provider of global statistical information, the global market size of outsourced services grew from US $45.6 billion in 2000 to $104.6 billion in 2014.[4]

Today's procurement professionals must maneuver in a complicated, evolving environment that is more dynamic than ever; they must embrace change as business needs change. This means balancing what seem to be insurmountable, conflicting goals of reducing cost structures while driving innovation and mitigating risks.

Unfortunately, the approach to buying goods and services today's procurement professionals learned may not be up to the task. Virtually all textbooks teach that the "gold standard" for a sourcing strategy is the Kraljic Matrix. Introduced in Peter Kraljic's 1983 *Harvard Business Review* article, the Kraljic Matrix gave companies a framework for segmenting their supplier spend in a way that enables them to prioritize the spend categories that could provide the biggest impact for the firm. The Kraljic Matrix classified suppliers into four groupings: Non-critical, Leverage, Strategic, and Bottleneck.[5] Kraljic's premise was an instant hit among procurement executives, and it soon became the standard taught all over the world.

The problem with the Kraljic Matrix is that it bases its logic primarily on a company's purchasing power—that is, by teaching organizations how to leverage their power and position in the marketplace to their advantage. While power-based approaches can work well with less-complex goods and services, they fall short when dealing with a dynamic environment that demands a high degree of collaboration, especially with outsourced service providers.

So is there a better way? The answer is "absolutely." But there is no single approach that works best for every situation. Instead, there is a continuum of strategic sourcing models companies can choose from based on a number of tangible and intangible factors. This article will outline the basic characteristics of those models and offer a framework for determining which is most appropriate for a particular organization. It also includes a case study on how this process is being applied in the pharmaceutical industry. This information as well as all of the figures in this article have been adapted from *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement*, one of six books resulting from a research project conducted by the University of Tennessee and funded by the United States Air Force, and the white paper "Unpacking Sourcing Business Models, 21st Century Solutions for Sourcing Services."

Strategic sourcing as a continuum

The vast majority of organizations that buy goods or services use a traditional transaction-based contract that pays a supplier per unit, per hour, per mile, and so forth. The buyer provides the specifications and typically uses a highly competitive bidding process to pick the best supplier. Transaction-based contracts are by far the dominant commercial contracting method. Research by the International Association for Contract and Commercial Management (IACCM) shows that most organizations operate under conventional transaction-based models that are constrained by a formal, legally oriented, risk-averse, and liability-based culture.[6]

But contemporary thinking is challenging tradition, instead thinking about sourcing along a continuum that leads to a path of value creation—not just exchanging value through transactions. Oliver E. Williamson, professor of economics at the University of California, Berkeley, has challenged the "make vs. buy" concept with his work in transaction cost economics (TCE). Williamson received the 2009 Nobel Prize in economic sciences for his work in this area. One of his key lessons was that organizations should view sourcing as a *continuum* rather than as a simple, market-based make vs. buy decision.[7] Williamson suggests that organizations should use a "hybrid" approach for complex contracts.[8]

University of Tennessee researchers reviewed the various approaches procurement professionals were using and plotted them into the three categories spanning Williamson's make vs. buy continuum. Two market-based "buy" models were classified as transactional in nature, and two "make" models were classified as investment models. The researchers identified three models that were more "hybrid" in nature, which they reference as "relational" contracts due to the longer-term and more strategic nature of the supplier relationships.

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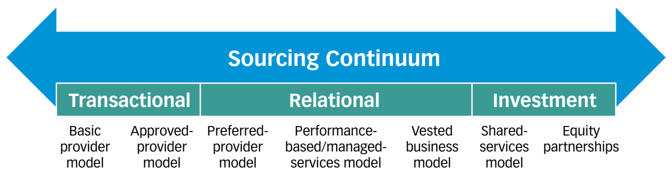
Figure 1 illustrates how the seven models relate to each other along the continuum.

[FIGURE 1] THE SEVEN SOURCING BUSINESS MODELS



The seven sourcing business models[9] are outlined as follows:

1. Basic provider model. The basic provider model is a transaction-based economic model. Typically there is a set price for individual products and services for which there are a wide range of readily available, standard market options, with little differentiation among what is offered. This model is best suited when there are low-cost, standardized goods and services in a market with many suppliers. Buyers typically use frequent competitive bidding (often with pre-established e-auction calendar events), and there is little or no impact to the business when switching suppliers.

2. Approved-provider model. An approved-provider model is also a transaction-based approach, with goods and services purchased from suppliers that meet a predefined set of qualification characteristics, such as quality standards, previous proven performance, or other selection criteria. Frequently organizations have a limited number of preapproved suppliers for various categories from which buyers or business units can choose. In these transactions risks and costs are known or are relatively low. Multiple suppliers mean costs are competitive, and one supplier can easily be replaced with another if it fails to meet performance standards.

3. Preferred-provider model. A key difference between the preferred-provider and other transaction-based models is that the buyer has chosen to move to a more strategic, relational approach. Buying companies seek to do business with a preferred provider to streamline their buying process and build longer-term relationships with key suppliers. They often enter into multiyear contracts using a master agreement that allows them to conduct repeat business efficiently. The preferred-provider model is still transactional, but the way the parties work together and the efficiencies achieved go beyond the simple purchase order.

4. Performance-based model. A performance-based model is generally a longer-term, formal supplier agreement that combines a relational contracting approach with an output-based economic model, based on a supplier's ability to achieve predefined performance parameters or savings targets.[10] Performance-based agreements shift thinking away from activities to predefined outputs or events. A good example of an output is a supplier's ability to achieve the objectives set out in predefined service-level agreements (SLAs). Some companies call the results "outcomes," but in performance-based agreements the term "outcome" is defined as the achievement of an event or deliverable that is typically finite in nature and is therefore easily understood and controllable by the supplier.

5. Vested business model. A Vested business model is a highly collaborative sourcing business model where the buyer and supplier have an economic, or vested, interest in each other's success.[11] A Vested sourcing business model combines an outcome-based economic model with the Nobel Prize-winning concepts of behavioral economics and the principles of shared value. Using these concepts, companies enter into highly collaborative arrangements designed to create value for the buyer and supplier above and beyond the conventional buy-sell economics of a transaction-based agreement. A Vested business model is best used when a company has transformational or innovation objectives that it cannot achieve by itself or by using transactional sourcing business models or a performance-based agreement.

6. Shared-services model. A shared-services model is an investment-based model where a company typically has set up a centralized or center-led, internal organization that provides services to internal customers. The shared-services organization acts as a supplier to the company's various business units or functional groups, charging them for the services used. Organizations use this model for a variety of functional services, such as human resources, finance operations, and administrative services (for example, claims processing in health care).

7. Equity partnerships. If an organization does not have adequate internal capabilities to acquire mission-critical goods and services, but it does not want to outsource or invest in a shared-services organization, it may opt to develop an equity partnership. Equity partnerships create a legally binding entity and take a number of different legal forms, from acquisition of a supplier or creation of a subsidiary to an equity-sharing joint venture.

Finding the appropriate sourcing model

Which sourcing business model should you use? No single model is preferable over another. Rather, most organizations probably should use multiple models. Moreover, sourcing models can evolve over time as the business changes and events occur. An organization might start out with an approved-provider model and shift along the sourcing continuum to a preferred-provider or, later on, even a performance-based relationship model.

University of Tennessee researchers worked with participating organizations to develop a resource to help buyers and sellers answer this question. The result is the Business Model Mapping Toolkit, which organizations can use to "map" their various spend categories. Completing the following four steps outlined in the toolkit can help them determine the most appropriate sourcing business model for a particular buyer-supplier situation.

Step 1: Select the defined spend category/categories you are sourcing or potentially sourcing. This includes products and/or services that will be needed in the "make or buy" decision, including those that are currently insourced, currently outsourced, or may be launched in the future.

Next, identify each associated spend category that is part of the sourcing initiative. For example, an organization thinking about outsourcing facilities management might have six different services they are considering: repair and maintenance, custodial/cleaning, grounds maintenance, dining, security, and employee moves.

Conventional procurement approaches teach buyers to unbundle and commoditize the various services, as commoditization will help them leverage their buying power. However, sourcing-business-model theory teaches organizations to consider bundling as a way to drive potential supplier efficiencies. When completing a business-model map, then, it is helpful to map the spend category both as a bundled and an unbundled service to see if it will make a difference in how you think about the category from a more strategic perspective. For example, Procter & Gamble chose to bundle its real estate and facilities management into one globally integrated agreement that ultimately used a Vested sourcing business model with the goal of achieving strategic desired outcomes and driving innovation. The P&G case study is profiled in the book *Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships*.[12]

Step 2: Use the business-model mapping template to determine the best *relationship* model for what you are sourcing. This will help answer questions about the business environment, such as the overall level of dependency, the risk "comfort zone," and the strategic impact of each spend category. For example, one of the attributes to map is the level of supplier integration/interface. The possible responses (in Figure 2) range from "none" to "critical."

Step 3: Use the business-model mapping template to determine the best *economic* model for what is being sourced. As previously noted, the most widely used economic model in businesses is a transaction-based model. They are the easiest to administer, as typically the supplier is paid per activity. However, as companies move along the sourcing continuum they will want to shift to more of an output- or outcome-based economic model because it gives the supplier greater degrees of freedom to provide solutions that will create value and drive innovation. Figure 3 illustrates one of the business-model mapping attributes—potential efficiency gains—typically used when determining the best economic model.

[FIGURE 2]

Attributes (to determine the best relationship model)	Transactional Contract		Relational Contract			Investment
Sourcing model	**Basic**	**Approved**	**Preferred**	**Performance-based**	**Vested**	**Shared-services and Equity**
Level of supplier integration/interface required (systems, support processes)	None	None	Medium	High	Very high	Critical

[FIGURE 3]

Attributes (to determine the best economic model)	Transaction-Based Economic Model			Output-Based Economic Model	Outcome-Based Economic Model	
Potential efficiency gains	None	Low	Medium	High	Very high	Significant

Step 4: Use the business-model mapping matrix (shown in Figure 4) to develop a consensus view of the sourcing business model that is right for your situation. The best sourcing model will be a combination of the relationship model and the economic model chosen. For example, if your map indicates you should

[FIGURE 4] BUSINESS-MODEL MAPPING MATRIX

Economic Model	Relationship/Contract Model: Transactional Contract (Market)	Relationship/Contract Model: Relational Contract (Hybrid)	Relationship/Contract Model: Investment (Vertical integration/hierarchy)
Outcome-based Economics tied to boundary-spanning/business outcomes	Mismatch—not a viable strategy	Vested	Equity partner Vested shared services
Output-based (Performance-based/Managed services) Economics tied to supplier output	Mismatch—not a viable strategy	Performance-based (Managed-services agreement)	Equity partner Shared services
Transaction-based Economics tied to activities drives behavior	Basic provider Approved provider	Preferred provider	Equity partner Shared services

use a relational contract model and an output-based economic model, then the matrix will indicate that a performance-based agreement is the most appropriate model for your situation.

Business mapping in action

Pharmaceutical organizations have increasingly turned to outsourcing as a way to increase speed-to-market and reduce the costs of drug development. One popular spend category that is growing rapidly in the pharmaceutical sector is contract research outsourcing (CRO), a strategy pharmaceutical companies use to speed the innovation of new drugs by outsourcing clinical research. CRO is a complex outsourcing initiative and could be a good candidate to shift up the sourcing continuum.

Earlier this year, the biotech company Roche funded a white paper to study the applicability of a Vested sourcing business model for the CRO spend category (Step 1 above). University of Tennessee researchers then worked with Roche and other pharmaceutical experts to map the key business attributes of CRO using the business-model mapping template. The goal was to answer the question: "Which sourcing business model is most appropriate for CRO?"

The business-model mapping toolkit helps companies identify which sourcing business model is most appropriate for their situation. A key part of the mapping exercise involves completing the map for 25 business attributes. The 25 attributes fall within the following broader considerations:

- What level of dependency exists between the buyer's and supplier's organizations?
- What is the overall availability of the service/product in the marketplace?
- To what extent is what you are outsourcing a "core competency"?
- To what extent is there business risk in what you are outsourcing?
- How much potential is there to create mutual advantage?
- What is the nature/characteristics of the work-scope?
- How critical is that work?
- What are your risk-tolerance preferences?

The UT researchers explored each of the 25 attributes within the contexts of the considerations noted above. This created a "map" of each attribute on the sourcing continuum, which, when taken together, indicated where CRO falls on that continuum. The following overview of some of the analyses in Step 2 of the business-model mapping process for CRO explains both how this was done and the results. The shaded blocks indicate the responses deemed applicable to CRO as practiced in the pharmaceutical industry.

Supplier dependency. The pharmaceutical industry scores high in the area of supplier dependency. For example, the relatively high level of skilled personnel and the fairly high level of asset-specific equipment engineered specifically for the unique needs of the pharma companies make the cost to switch suppliers steep. In addition, time-to-market pressures as well as the pharmaceutical companies' data needs meant it was important for the supplier's systems and support processes to be integrated into the buyer's operations. Accordingly, the business-model map (shown in Figure 5) indicated pharmaceutical companies would be best served with a relational contracting model.

[FIGURE 5]

Attributes (to determine the best relationship model)	Transactional Contract		Relational Contract			Investment
Dependency						
Sourcing model	**Basic**	**Approved**	**Preferred**	**Performance-based**	**Vested**	**Shared-services and Equity**
Overall cost to switch suppliers	Low	Low	Medium	Medium to High	Medium to High	High
Physical-asset specificity (location, machinery, processes)	Low	Low	Medium	Medium to High	Medium to High	High
Skill level needed for predominant personnel	Unskilled	Semi-skilled	Skilled	Professional	Professional	Expert
Level of supplier Integration/interface required (systems, support processes)	None	Low	Medium	High	Very high	Critical

Availability of service/product in the marketplace. The next category mapped was "availability of service/product in the marketplace." While there is wide-to-moderate availability of CRO suppliers, the market needs more sophisticated suppliers than simple transactional models can offer. As seen in Figure 6, this results in the need for a relational contracting model.

[FIGURE 6]

Attributes (to determine the best relationship model)	Transactional Contract		Relational Contract			Investment
Sourcing model	**Basic**	**Approved**	**Preferred**	**Performance-based**	**Vested**	**Shared-services and Equity**
Overall availability of service/product in marketplace	Widely available	Widely available	Wide to moderate availability	Limited number of capable suppliers	Limited number of capable suppliers	Scarcely available
Availability of human resources	High	High	Medium	Low	Low	Low
Availability of required technology	Universal	Limited	Restricted	Restricted to Scarce	Scarce	Unique
Access to buyer's critical systems and processes	None	Low	Medium	High	Very High	Critical

Extent that service is a core competency. Based on interviews, researchers scored the pharmaceutical industry's CRO spend sector as having "some" or a "critical" level of strategic impact. Innovation is key to success, with CRO suppliers playing a critical role in a company's ability to bring new products to market. While pharma companies could insource CRO work (by moving to an investment-based model), it is likely they will continue using suppliers to support them. For this reason, a relational contract is most appropriate. (See Figure 7.)

[FIGURE 7]

Attributes (to determine the best relationship model)	Transactional Contract		Relational Contract			Investment
Sourcing model	**Basic**	**Approved**	**Preferred**	**Performance-based**	**Vested**	**Shared-services and Equity**
Strategic impact/core competency for buyer	No	No	No	Maybe	Maybe	Yes

Potential to create value/mutual advantage. CRO services have significant potential to create value, and therefore they have a high potential to increase a pharmaceutical company's revenue and drive innovation. As shown in Figure 8, an outcome-based economic model is best suited for CRO outsourcing.

[FIGURE 8]

Attributes (to determine the best economic model)	Transaction-Based Economic Model			Output-Based Economic Model	Outcome-Based Economic Model	
Potential to create value/mutual advantage						
Potential efficiency gains	None	Low	Medium	High	Very high	Significant
Potential for revenue increase	None	Low	Medium	High	Very high	Constant
Potential for innovation	None	Low	Medium	High	Very high	Critical
Investments required to achieve outcomes (buyer or supplier)	Low	Medium	High	High to invest	High	High

Nature of the workscope. The nature of CRO workscope aligns best with an output- and outcome-based economic model. (See Figure 9.) Due to the type of work CRO suppliers perform, most have a degree of control over the outcome, even though there is considerable shared risk. Because of the strategic nature of the CRO services, companies should be looking to more strategic key performance indicators (KPIs) or business-outcome metrics rather than the transactional metrics they tend to rely upon now.

[FIGURE 9]

Attributes (to determine the best economic model)	Transaction-Based Economic Model			Output-Based Economic Model	Outcome-Based Economic Model	
Nature of workscope/tasks						
Degree of supplier control over outcome	Low	Low	Low	High	Medium to High	N/A
Type of success measure desired/required	Trans-actional activity metrics	Trans-actional activity metrics	Trans-actional activity metrics	Output service-level agreement metrics	Strategic KPI or business outcomes	Strategic KPI or business outcomes
Ease with which task/workscope can be specified	High	High	Medium	Medium	Can vary	Very difficult or impossible

Risk-tolerance preferences. The scoring for risk tolerance indicated that pharmaceutical companies desired shared risk. In discussions with CRO suppliers, we learned that some suppliers are exploring outcome-based shared-risk/reward economic models. Thus, as noted in Figure 10, an outcome-based economic model is suitable—at least with some suppliers.

[FIGURE 10]

Attributes (to determine the best economic model)	Transaction-Based Economic Model			Output-Based Economic Model	Outcome-Based Economic Model	
Risk-tolerance Preferences						
Financial risk tolerance for buyer	High risk	High risk	Medium risk	Medium to Low risk	Shared risk	N/A
Financial risk tolerance for supplier	Low risk	Low risk	Low risk	Medium risk	Shared risk	N/A

The last step in the business-model mapping exercise is to determine which sourcing business model is most appropriate. Step 2 has shown that a relational contract was the most appropriate contract model,

[FIGURE 11] BUSINESS-MODEL MAPPING MATRIX FOR CONTRACT RESEARCH OUTSOURCING

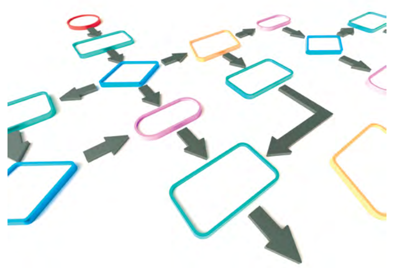
		Relationship/Contract Model		
		Transactional Contract (Market)	**Relational Contract (Hybrid)**	**Investment (Vertical integration/hierarchy)**
Economic Model	**Outcome-based** Economics tied to boundary-spanning/business outcomes	Mismatch—not a viable strategy	**Vested**	Equity partner Vested shared services
	Output-based (Performance-based/Managed services) Economics tied to supplier output	Mismatch—not a viable strategy	Performance-based (Managed-services agreement)	Equity partner Shared services
	Transaction-based Economics tied to activities drives behavior	Basic provider Approved provider	Preferred provider	Equity partner Shared services

while Step 3 showed that an outcome-based economic model was most appropriate.

When in Step 4 we plot these against the business-model mapping matrix (Figure 11), it is clear that a Vested sourcing business model is the most appropriate choice for the CRO spend category.

Explore alternative models

Today's procurement professionals need more modern approaches that help them leverage the power *of* their suppliers, and not simply leverage their power *over* the supplier. This requires going beyond conventional "make vs. buy" decisions and tapping into alternative sourcing business models designed to enable supplier collaboration and innovation.



The good news is that the 21st century is ushering in progressive, new approaches such as sourcing-business-model theory to help organizations shift along the sourcing continuum. As procurement professionals are confronted with sourcing initiatives that are more complex, risky, or demanding of innovation, resources like the business-model mapping toolkit can help them explore the potential benefits of using alternative models.

It is important to note that no single sourcing model is "better" than another. The key is to let the business-model mapping process help guide you to the most appropriate model. It might be tempting to think that a performance-based or a Vested sourcing business model sounds good because it motivates a supplier to invest in innovation and transformation. But if you choose one of those options even though the mapping exercise indicates, for example, a preferred-provider model is more appropriate for a particular business or outsourcing relationship, you will end up overthinking and most likely overengineering how you work with that supplier.

The bottom line? It *is* the bottom line. Savvy organizations are making the shift along the sourcing continuum to tap their strategic suppliers and help drive transformation and innovation for their organizations.

Editor's note: Readers can download the Business Model Mapping Toolkit at no charge at http://www.vestedway.com/tools/. The book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models for Modern Procurement,* on which this article was based, is available on Amazon.com. △

Notes:

1. Gerard Chick and Robert Handfield estimate up to 80 percent in *The Procurement Value Proposition* (London: Kogan Page, 2012). Cees J. Gelderman and Arjan J. van Weele estimate 60 to 80 percent in "Purchasing and Supply Chain Management," *European Journal of Purchasing & Supply Management* 2, no. 4 (1996): 153–160.

2. John W. Henke, Jr., Thomas T. Stallkamp, and Sengun Yeniyurt, "Lost supplier trust … how Chrysler missed out on $24 billion in profits over the past twelve years," *Supply Chain Management Review* (May/June 2014), accessible at: http://www.ppi1.com/uploads/wri-profit/scmr-lost-trust.pdf.

3. Kate Vitasek, Mike Ledyard, and Karl Manrodt, *Vested Outsourcing: Five Rules That Will Transform Outsourcing;* second edition (New York: Palgrave Macmillan, 2013), Chapter 12.

4. From Statistica: https://www.statista.com/statistics/189788/global-outsourcing-market-size/.

5. Peter Kraljic, "Purchasing Must Become Supply Management," *Harvard Business Review* (September 1983) https://hbr.org/1983/09/purchasing-must-become-supply-management.

6. "Contract Negotiations Continue to Undermine Value," International Association of Contracting and Commercial Management, "Ninth Annual Top Terms in Negotiation Report," April 2010.

7. Oliver E. Williamson, "Outsourcing: Transaction Cost Management and Supply Chain Management," *Journal of Supply Chain Management* (2008) 44 (2), 5–16.

8. Ibid.

9. Content for this article is primarily based on ideas and research by the University of Tennessee in the book by Bonnie Keith, Kate Vitasek, Karl Manrodt, and Jeanne Kling, *Strategic Sourcing in the New Economy* (New York: Palgrave Macmillan, 2014). Additional content is based on the Vested White Paper, "Unpacking Sourcing Business Models, 21st Century Solutions for Sourcing Services," available at http://www.vestedway.com/vested-library/.

10. Performance-based models are often referred to by several other names. These include "managed services" agreements (information technology or business-process outsourcing), performance-based contracts (often used in the government sector), performance-based logistics (used to describe performance-based contracts for military weapon systems), and gross maximum price (facilities management and construction projects). Regardless of the term used, the nature of a performance-based model is that the supplier is accountable for "managing" a portfolio of services on behalf of the buyer, and its compensation is tied to its performance.

11. "Vested" in a sourcing or outsourcing context is a registered business term (http://www.vestedway.com/what-is-vested/).

12. Kate Vitasek and Karl Manrodt, with Jeanne Kling, *Vested: How P&G, McDonald's, and Microsoft are Redefining Winning in Business Relationships* (New York: Palgrave Macmillan, 2012).