IBM **Center for Applied Insights**

Why partnering strategies matter

How sourcing of business and IT services impacts financial performance

Outsourcing motivations have changed, so should sourcing strategies. Why? Those who have made the shift are also outperforming – racking up twice the revenue growth and five times the gross profit growth of their peers.

Sourcing's hierarchy of needs

At its inception, outsourcing revolved around cost reduction – turning processes, particularly ones that offered little differentiation, over to a provider who could deliver those services better and cheaper. But sourcing motivations have evolved. Cost savings are still expected; however, organizations today are sourcing services to meet more complex needs.

Executives are increasingly turning to external providers for critical capabilities they need to innovate and succeed. Not only are more CEOs now partnering externally – 53 percent are doing so to drive innovation.[2] Among CMOs, 92 percent are increasing use of external partners for customer and data analytics.[3] And two-thirds of growth-focused CIOs are partnering extensively to change the mix of skills, expertise and capabilities in their organizations.[4]

As technology shifts continue to accelerate, so do C-suite leaders' ambitions. During their careers, these executives have witnessed technology's impact firsthand – how it has enabled new channels, new business models and even brand-new industries. Now, as social, mobile, cloud computing and big data converge, these leaders recognize the signs of another, bigger groundswell of change. And they want to be there early, capitalizing on opportunities to innovate. At the same time, though, leaders are realizing their organizations may lack key capabilities.

This shift in mindset – bringing strategic capabilities in, versus sending work out – is one reason enterprises are balking at the word "outsourcing" to describe these sourcing relationships. A recent survey by analyst firm HfS Research indicates 63 percent of business and IT services buyers would like to drop the term "outsourcing" entirely.[5]

While the "why" behind sourcing has evolved considerably, the "how" still lags. Even when organizations engage service providers to help drive business outcomes, the way they select partners, structure contracts and manage those relationships does not always reflect those higher-order motivations.

About the study

To understand the shifts underway in the business and IT services industry – specifically, why and how organizations are sourcing – we needed a sample of significant size and diversity. We've achieved that objective, with 1,351 sourcing decision makers from around the world participating.

Nearly 40 percent of the respondents are C-level executives; the rest are senior executives who directly influence services sourcing decisions. Roughly one-third of the respondents are business executives; the other two-thirds are IT leaders. In terms of organization size, 35 percent have more than 10,000 employees, and 65 percent have between 1,000 and 9,999 employees. These decision makers sit in 18 different industries and 12 countries (30 percent from growth markets and 70 percent from mature markets).[1]

As part of our analysis, we also examined business performance for the subset of enterprises with publicly available financial information. To control for firmographic factors that could also influence financial results, multivariate analysis was used.

So does partnering strategy really matter? As it turns out, it appears to have significant financial implications. Decision makers who source more broadly – and are doing so to drive innovation – are also outperforming their peers in terms of revenue growth, gross profit growth and a host of other financial measures. Equally important, they are architecting and managing those services relationships quite differently – tying metrics to business outcomes, scoping to transform and integrating governance.

Partnering strategy matters

To better understand the changing dynamics in business and IT services sourcing, we surveyed more than 1,300 sourcing decision makers from around the world. Our findings confirm that sourcing motivations are evolving beyond cost savings to higher-order outcomes like process effectiveness, competitive advantage and business innovation. In fact, less than 7 percent of surveyed decision makers said cost reduction and efficiency were the sole reasons they outsourced IT infrastructure, applications and business processes. Many had a mix of motivations, with 39 percent sourcing primarily for innovation in at least one business or IT service area.

When we examined both the extent of outsourcing and the motivations behind it, four partnering strategies emerged (see Figure 1):[6]

- *Enterprise Innovators* are outsourcing more areas of their business. And across IT infrastructure, applications or business processes, they're sourcing services to drive innovation – changing how they operate, their role in the value chain, how they monetize value or even the way their entire industry works.
- *Enterprise Optimizers* outsource a similarly broad set of business and IT functions, but their aim is primarily to drive greater efficiency and effectiveness.
- *Focused Innovators* outsource in a narrower manner. They engage service providers to innovate particular areas of their business.
- *Focused Optimizers* have a more traditional outsourcing strategy. They're tapping providers to improve efficiency and effectiveness in targeted areas.

Four partnering strategies emerge from looking at both sourcing motivations and extent of outsourcing

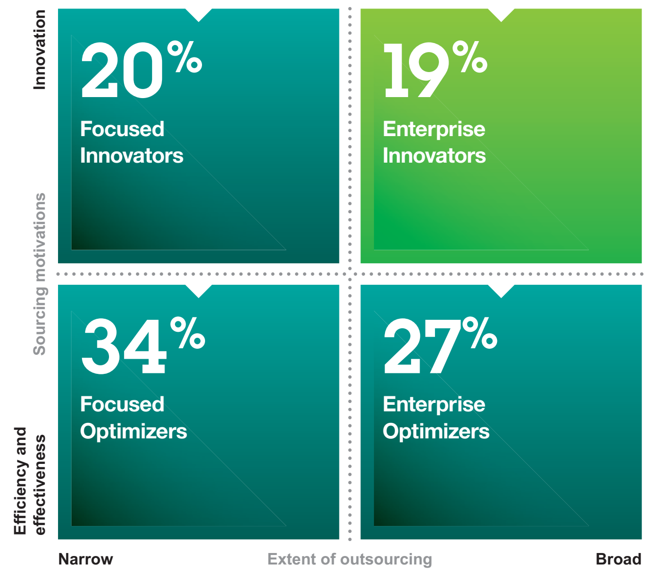


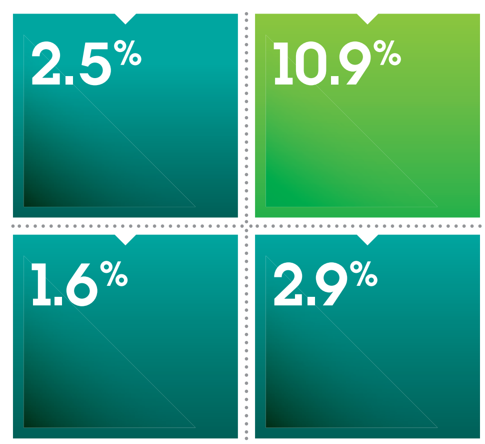
Figure 1. Enterprise Innovators sit on the front edges of this trend, sourcing broadly to drive innovation.

All of these are valid strategies. However in comparing them, what stood out most was Enterprise Innovators' financial performance. An initial look at average revenue growth and gross profit growth suggested a potential correlation between partnering strategy and business performance. To test the strength of this linkage, an in-depth analysis was conducted, controlling for other firmographic influences such as geography, company size and industry.[7]

The results? Across every financial measure tested, Enterprise Innovators outperformed those using other partnering strategies (see Figure 2). Their businesses show healthy growth and continued investment. So, what's behind this powerful performance? Partnering is likely a contributing factor. By virtue of the segmentation, we know that these organizations are pursuing more business-oriented, innovation-driven outcomes from their sourcing relationships. But which business priorities are driving them to partner? What capabilities are they seeking in providers? Is there something inherently different about how they partner?

Revenue growth by partnering strategy
3 Year CAGR %: FY 2011

Gross profit growth by partnering strategy
3 Year CAGR %: FY 2011



Propensity analysis: Link to financial performance
3 Year CAGR %: FY 2011

	Revenue	Gross profit	EBITDA	Net income	Earnings cont ops	Diluted EPS	Cash from ops	Levered free cash flow	Cap ex
Enterprise Innovators	9%	11%	15%	18%	24%	22%	15%	22%	10%
Other partnering strategies	4%	2%	5%	6%	3%	2%	7%	2%	-3%

Figure 2. Enterprise Innovators are outperforming financially, with more than twice the revenue growth and over five times the gross profit growth of their peers.

Higher expectations…

Across partnering strategies, sourcing decision makers share some common business objectives. Lowering cost is the top business priority globally and across every segment. Other common objectives include increasing revenue among existing customers and attracting new ones, maintaining high technical skills and improving data quality and analysis.

But where priorities differ most is in the areas of agility and market responsiveness. Enterprise Innovators place a higher priority on business objectives that put them in position to innovate rapidly and capitalize on growth opportunities. This, in turn, causes them to seek different capabilities from service providers (see Figure 3). Their ambition to innovate causes Enterprise Innovators to be more selective. They have a different bar – a different way of assessing potential providers and the value they bring.

While the majority of services buyers expect high-quality support, security expertise, tailored business knowledge, customized services and the "best price", Enterprise Innovators expect more.

Agility is a higher priority for Enterprise Innovators. Their geographic expansion plans depend on how quickly they can transform to serve those new markets. As a result, they're looking for providers that can help them wherever they want to go, with proven infrastructure and on-the-ground experience. To enter new markets and deliver new products, Enterprise Innovators need more agile supply chains – and services providers that understand their particular industry and can help improve supply chain integration, visibility and compliance. Enterprise Innovators are also more likely to be experimenting with new business models, so they want a provider with business strategy experience across a variety of industries that can help them design and execute necessary changes.

Differences in business priorities		Differences in capabilities sought	
Agility		**Agility**	
Expand into new regions	▲2.2x	Extensive global infrastructure	▲1.7x
Expand/integrate supply chain	▲2.2x	Leader in driving industry standards and proactively implementing compliance shifts	▲1.5x
Enable new business models	▲1.7x	Business strategy and transformation experience	▲1.2x
Responsiveness		**Responsiveness**	
Anticipate/respond to technology and market shifts	▲1.8x	Drives and capitalizes on technology innovations	▲1.4x
		Robust cloud capabilities	▲1.4x
Culture of innovation	▲1.5x	Responsive organizational change management	▲1.3x
Enable predictive modeling	▲1.4x	Strong business analytics capability	▲1.3x

▲ Enterprise Innovators vs. Focused Optimizers

Figure 3. Compared to Focused Optimizers, Enterprise Innovators are more focused on agility and responsiveness – which changes the mix of capabilities sought in providers.

Enterprise Innovators are also more focused on anticipating market and technology shifts – and responding faster than competitors. So they're seeking providers that have a proven track record of capitalizing on disruptive technologies like mobile, social and analytics – this is where strong R&D capabilities may come into play. They also want providers that can design, launch and scale those innovations quickly via cloud. To respond faster, Enterprise Innovators put more emphasis on predictive modeling and knowing in advance what will happen next. This means they're looking for providers that bring advanced analytics capabilities and can help them discover new insights and opportunities. For Enterprise Innovators, innovation is not a short-term priority – they're more intent on developing a pervasive culture of innovation. To accomplish that goal, they're enlisting providers capable of designing and implementing collaborative environments, incentives and other organizational changes that help transform the culture.

"This agreement allows us to offer better services to our clients and obtain competitive advantages in a sector in which innovation and new technologies are key to realizing growth."[8]

—Juan Maria Nin, General Manager, La Caixa

Teaming for growth

La Caixa – one of Spain's leading banks – has responded to the ongoing European financial crisis with a bold plan for strategic growth, through mergers and acquisitions across Spain and internationally, as well. But with no IT support outside of its home country, the bank needed a services provider with extensive experience operating in other regions to help integrate new acquisitions rapidly.[9]

Long recognized for its pioneering use of new technologies, the bank also wanted a provider with strong research and innovation capabilities that could help extend that advantage. Prospective providers had to bring deep social, mobile, cloud and analytics capabilities to help the bank dramatically improve clients' banking experiences.

With those business priorities guiding its sourcing decisions, the bank entered a 10-year sourcing agreement for IT services. As part of the alliance, the long-term provider will open its research and development centers to La Caixa, sharing access to the latest technologies, research capabilities and advances in banking business processes. The bank plans to reinvest some of its expected savings – EUR400 million over the term of the agreement – to further innovate and grow.

Through teaming with an innovative global provider, the bank is not only improving IT proficiency; it is also enabling its ambitious growth strategy and the culture of innovation it needs to lead the industry.

…Achieved differently

Not only are Enterprise Innovators seeking a different kind of provider, they're also establishing an inherently different type of relationship. To accomplish their business objectives, they recognize the need to alter the way they structure and manage their long-term alliances (see Figure 4).

The greatest differences among partnering strategies largely revolved around: business-oriented metrics aimed at strategic outcomes, contract scope designed to drive transformation and an integrated approach to governance that provides the coordinated decision making necessary to achieve targeted results.

	Focused Optimizers	Focused Innovators	Enterprise Optimizers	Enterprise Innovators	Enterprise Innovators vs. Focused Optimizers
Metrics tied to outcomes					
Metrics tied to business outcomes				✔	▲1.5x
Services aligned with business objectives		✓	✔	✔	▲1.3x
Transformational scope					
Transform roles of in-house personnel				✔	▲1.7x
Broad range of delivery models		✔	✔	✔	▲1.4x
Partner influences strategy			✔	✔	▲1.7x
Vertically integrated contracts		✔	✓	✔	▲2.1x
Integrated governance					
Services integration across providers		✔	✔	✔	▲1.5x
Enterprise-wide governance		✓	✔	✔	▲1.4x

✔ Higher frequency relative to peers ✓ Moderate frequency relative to peers

Figure 4. Enterprise Innovators are more likely to tie metrics to business outcomes, scope contracts for transformation and integrate governance.

Metrics tied to outcomes

Historically, service level agreements have focused on operational or cost-centric measures like system availability or cost per service desk call. But Enterprise Innovators are leading the charge toward more business-oriented measures. They're aligning provider metrics with bigger, more strategic business objectives.

In the financial services sector, that might mean driving uptake in mobile banking; in the telco industry, it might be lowering subscriber acquisition cost or increasing up- and cross-sell rates; or for a retailer, it might involve meeting an aggressive roll-out schedule for expansion into a new market. This shift in thinking gives rise to new vendor valuation models – ones that can help assess a provider's contribution to broader business objectives beyond cost reduction.

Enterprise Innovators are also aligning the services they source with these broader business objectives. This means looking end to end across all the processes involved in achieving the desired business outcome when determining which services to source. They recognize that providers can only agree to put profit at risk and link financial incentives to business outcomes when they can influence enough of the business process vertically to effect substantive change.

Transformational scope

Enterprise Innovators are sourcing to get capabilities they need to innovate on a broad scale. So there's a transformative bent to their sourcing relationships. For instance, their contracts are more likely to be vertically integrated – inclusive of business process, applications and technology infrastructure – to enable more holistic change. Innovation and broad-scale change are also likely to require a mix of service delivery models.

Enterprise Innovators are more likely to enlist providers with the industry and functional expertise required to help transform the roles of their employees. For example, if their aim is marketing innovation and they're sourcing analytics capabilities, they don't just want a piece of software or reports. They want their partner to help reshape how the marketing function works – to drive beyond understanding customer segments to understanding individual customers, from describing what's happening to predicting what's next.

Because Enterprise Innovators often tap providers with knowledge and experience they lack, they're more inclined to leverage that partner's insight when developing strategies. If they're expanding into a new geographic market, for instance, they'll consider input and advice from providers who are already active there.

Integrated governance

Enterprise Innovators are pushing faster toward enterprise-wide governance. Because they're focused on achieving business outcomes, they recognize the need for input and collaboration across business units. For example, if the goal is accelerating the launch of new products and services, then marketing, manufacturing, distribution and sales may all need a voice in related services sourcing decisions.

Achieving broad business goals often requires the involvement of multiple service providers, too, elevating the need for integration. Even Focused Innovators face this challenge. Whether the innovation target is narrow or broad, it typically impacts business process, applications and technology infrastructure–and often requires working with multiple vendors. The steady uptick in cloud computing can also cause a proliferation of vendors, which may be yet another reason Enterprise Innovators are more focused on services integration.

"Through this agreement, we reinforce our commitment to transform into an increasingly flexible, agile and competitive global company."

—Fernando Gonzalez, Executive Vice-President Finance and Administration, CEMEX

Hardwiring innovation into a contract

CEMEX is one of the world's leading suppliers of cement, ready-mix concrete and aggregates. Like others in the construction and building materials industry, the company has faced some tough economic times during the global financial crisis. To emerge stronger as the industry recovers, CEMEX realized it needed to accelerate its transformation to gain competitive advantage and build the agility to respond rapidly as new opportunities emerged.

This global building materials company decided to engage a strategic sourcing provider that would not only help cut costs and improve productivity but would also deliver transformative innovation, increasing its agility and competitive position in the marketplace. Spanning a vertically integrated set of business and IT services, the contract scope was commensurate with the degree of transformation sought.

Knowing how critical innovation was to its future success, CEMEX designed its sourcing arrangement to reflect that priority. The provider is contractually bound to invest annually in innovative projects that help CEMEX achieve desired business outcomes, that will deliver substantial incremental savings beyond the US$1 billion in the base contract. However, to foster collaborative behavior, the investment model also included a gain-share mechanism, allowing the provider to earn back its investment if it meets business result targets.

CEMEX also put in place a cross-organizational governance team responsible for selecting innovation projects based on transformative potential, business need and anticipated return on investment. Through integrated, enterprise-wide governance, the manufacturer and its services provider are weaving the strategic imperatives of the business into the delivery of services across the company.

Moving up the hierarchy

As partnering has become a more prevalent business strategy, sourcing motivations have evolved. C-suite executives are moving up the sourcing hierarchy of needs, seeking higher-order business outcomes like innovation. Cost reduction, while still important, has become a means to a different end – a way to fund innovation and growth.

Yet, a much smaller percentage of organizations have revamped their sourcing behaviors to match their business objectives. And it's this elite group of Enterprise Innovators that is outperforming financially. Their formula? Metrics tied to business outcomes, transformational scope and integrated governance. Their business strategies are pushing them to take a more expansive view of where partners can contribute. And their sourcing strategies are designed accordingly – with a broader, more integrated approach that offers room to achieve targeted business objectives.

If you have not recently thought through why you're outsourcing and what business outcomes you seek, that's the place to start. If you already have clear aspirations for your sourcing relationships, the next, more complex question is: does *how* you're sourcing align with *why*? The considerations outlined in Figure 5 can help guide your thought process.

Many firms are sourcing business and IT services to obtain needed capabilities. Far fewer will achieve the business outcomes they seek. Enterprise Innovators provide valuable insights on how to attain those aspirations.

Questions to consider

Metrics tied to outcomes	• What business outcomes do you hope to achieve? • What capabilities do you need to deliver desired outcomes? • How should your vendor evaluation criteria evolve? • What will SLAs need to look like?
Transformational scope	• Is cloud part of your delivery mix? • Are your strategic sourcing contracts structured vertically? • Are you sourcing generic or customized services? • Are your long-term sourcing partners influencing your strategy?
Integrated governance	• How will you structure your governance model – contract-by-contract, centralized, enterprise-wide – and who needs to participate? • What are the essential control points? • How will the CIO's role need to change? • Will you manage and coordinate services across providers or use a service integrator?

Figure 5. As motivations evolve, sourcing decision makers need to rethink how they structure and manage sourcing relationships.

Acknowledgments

About the authors

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About the IBM Center for Applied Insights

The IBM Center for Applied Insights (**ibm.com/**ibmcai) introduces new ways of thinking, working and leading. Through evidence-based research, the Center arms leaders with pragmatic guidance and the case for change.

Notes and references

[1] The growth markets studied include Australia, Brazil, China, India, Russia and Singapore. Mature market countries studied include Canada, France, Germany, Japan, the United Kingdom and the United States. To smooth possible geographic distortions, responses were weighted based on IBM assessment of each country's total IT spend.

[2] *Leading Through Connections: Insights from the Global Chief Executive Officer Study.* IBM Institute for Business Value. May 2012. http://www.ibm.com/ceostudy

[3] *From Stretched to Strengthened: Insights from the Global Chief Marketing Officer Study.* IBM Institute for Business Value. October 2011. http://www.ibm.com/cmostudy

[4] *The Essential CIO: Insights from the Global Chief Information Officer Study.* IBM Institute for Business Value. May 2011. http://www.ibm.com/ciostudy

[5] *It's official: the outsourcing industry has voted out its name.* HfS Research Ltd. September 5, 2012. http://www.horsesforsources.com/outsourcing-voted-out_090512

[6] On the x axis, the dividing point is based on the number of IT functions, applications and business processes outsourced – those to the left are outsourcing fewer than the trimmed mean of the sample, and those to the right are outsourcing at or above that level. On the y axis, those above the mid-point selected innovation as their primary motivation for outsourcing IT infrastructure, applications or business processes. Those below the mid-point did not select innovation, choosing other motivations instead, such as staff augmentation, cost reduction, process efficiencies and effectiveness.

[7] In collaboration with IBM, National Analysts Worldwide conducted Propensity Score analytical modeling to help rule out firmographic characteristics as the primary reason for Enterprise Innovators' outperformance. Against a slate of financial measures, each based on 3-year 2011 compound annual growth rates, Enterprise Innovators trended higher than the average of the other segments combined. This overall pattern is statistically significant. However, since this sourcing study is observational, we could not definitively conclude that Enterprise Innovators' approach to sourcing causes better financial performance based on this correlation. To help make that case, we used an analytical technique called Propensity Score Modeling. Propensity score analysis matches Enterprise Innovators with other organizations in the sample that have similar firmographic characteristics, such as industry, company size and geography. In this case, we calculated propensity scores using 68 Dun & Bradstreet variables – those which showed a significant difference between Enterprise Innovators and the other segments. After finalizing the propensity score calculations, we used algorithms to create subsets of Enterprise Innovators and other businesses that have minimal differences on the propensity score. We used algorithms to create these subsets of "matches" since it is not feasible to determine optimal matching manually. After creating matched groups, the next step was to test whether Enterprise Innovators still outperformed. Enterprise Innovators still scored higher than other businesses on all financial measures even after propensity score matching, increasing the likelihood that their approach to sourcing – i.e., sourcing broadly to drive innovation – was a contributing factor to this higher performance.

[8] *La Caixa saves EUR400 million by sourcing IT operations to IBM.* IBM Global Services. January 2013. http://public.dhe.ibm.com/common/ssi/ecm/en/soc03017usen/SOC03017USEN.PDF

[9] Ibid.

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