Sirius & Company

How to select suppliers to mitigate risks?

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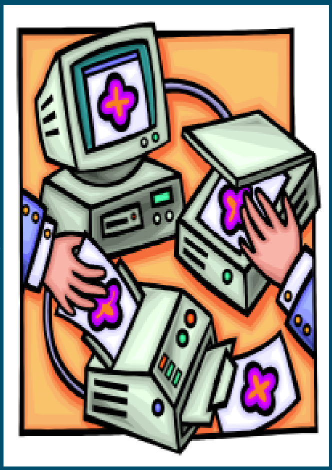
Companies spend a huge amount of money on large and old suppliers because of their size and believing them to be safe. This principle may have worked in the past, but its validity in the 21st century is doubtful. Senior executives need a new understanding of what it means to manage business operations in the 21st century. In the past "business operations" mostly referred to functions and processes inside a company and had little to do with suppliers ability to reduce waste and help to capture value. Then, selecting a supplier, for example, was mostly about size and panoply of offerings. Today, smart companies select suppliers who are independent, innovative, small, agile, adaptable, and whose interests are aligned to companies' objectives. Find out how companies can upgrade their existing practices for selecting suppliers and create mutually profitable relationships with them to capture value and reduce risks.



Few companies in the developed countries need to be convinced that in today's technology-intensive global economy, selection of suppliers are crucially important. Companies in the developed countries buy more products and services from suppliers than they have done in the past. The issue is not whether companies should change their existing relationships with large and old suppliers into close partnerships, but fundamentally if the existing practices of doing business primarily with large suppliers is a valid one. Historically, companies unsuccessfully tried to build value-based relationships with large suppliers, and found their expenditures soar without getting adequate returns of their investment. As a part of the quality movement, many companies fashionably adopted the Japanese partnering model – reduced the number of small suppliers they did business with, awarded the large suppliers long-term contracts, and in some instances, encouraged these large and old suppliers to manage the small suppliers, who managed to escape the brutal pruning. Despite this fashionable trend, it was not long before companies and their chosen large suppliers were fighting bitterly over price reductions. So, what went wrong despite the best intentions of these companies? More importantly, what lessons can be learnt from this non-profitable relationship with large suppliers and how can companies make changes to their existing practices.

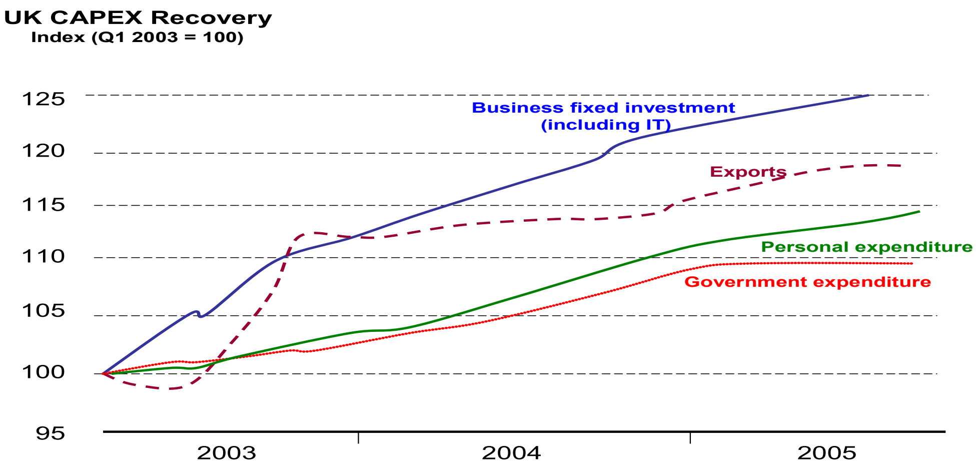


Figure 1: *Rising CAPEX in IT increases pressure on return on investment (Source: Bureau of Economic Analysis)*

The holy grails of companies purchasing organisations

The holy grails of most large companies' purchasing organisations are still cost reduction, scale and size of the suppliers. Companies believed that doing business with large suppliers will help to reduce cost, therefore optimise capital expenditure (CAPEX). Our analysis of CAPEX in the UK since 2003 shows that the reserve is true. Since the UK CAPEX bottomed in early 2003, growth in business fixed investment (including IT) has outstripped that of exports, government expenditures, and personal consumption (see Figure 1).

While the increase in expenditure may not be in the same scale of 1999, it looks poised to grow further in 2006. Some spending will go into mergers and acquisitions, which is good for growing companies, while continued offshoring is a further brake on domestic IT investment. After the bursting of the technology bubble in 2000, there is pent-up demand for CAPEX in IT, which many large companies can afford to satisfy. According to Morgan Stanley's recent survey, CAPEX in IT is likely to grow further in 2006, which in turn might lead to stronger than expected gross domestic product (GDP) growth [1]. Pressure on returns from IT investment from slowing earnings growth will only be exacerbated by rising CAPEX.

Our analysis of how companies purchased their IT services, for example, since 2000 revealed that the continuous quest for lowest cost and large suppliers did not allow companies to gain a substantial advantage over their competitors. In fact, performance of those large IT suppliers steadily deteriorated. So, why haven't large and old IT suppliers been able to deliver the required services that match the expectation of these companies? We found several reasons. For example, large IT suppliers are unable to respond to unexpected changes in companies demand. Almost all large scale IT suppliers have centralised their production and servicing facilities in low-cost locations (such as India, China, Philippines) to generate economies of scale, and they are capable of only delivering lots of standard processes to companies to minimise service delivery costs. When demand for a particular service raises unexpectedly, these large scale suppliers are unable to react. Even when these suppliers respond, the costs of services climb exponentially. Purchasing organisations' obsession with lowest costs can also cause services from large suppliers to break down during the launch of, say, new products and services.

New set of criteria for selecting suppliers are a necessity and not a luxury

The end-to-end and top-to-bottom transformation of the 21st century supplier selection is shaping the agenda of senior executives (such as CEOs, CIOs, and CFOs) today, and will continue to do so for years to come. Great companies' select suppliers, who are independent, bring economies of skills, innovation, agility, adaptability, and align the interests with their clients (see Figure 2).

Five star criteria for selecting IT suppliers

	Independence	Economies of skills	Agility	Adaptability	Alignment
Objectives	• Explain choices and implications. • Declare interests and future intentions explicitly. • Integrity is the foundation of every action.	• Explicitly states the depth and breadth of skill that would make the difference. • Brings innovative and practical problem solving ability as opposed to "bleeding edge technology".	• Respond to short-term changes in demand quickly. • Handle external disruptions smoothly.	• Adjust processes and practices to meet structural shift in markets. • Change delivery processes to new strategies, products, services, and technologies	• Create incentives for superior performance. • Set out to exceed mutually agreed and explicitly stated expectations. • Honour commitments.
Methods	• Act in the best interests of the client. • Unafraid of explaining the truth. • Bring trust and integrity in each and every action. • Unwilling to compromise on integrity. • Act as an educator to the senior client executives.	• Bring relevant expertise and skills to solve client's problems. • Invest in the highest level quality as opposed to quantity. • Builds new capabilities in client's organisation that last. • Identify productivity leavers in client's organisation. • Improves client's productivity.	• Promote flow of information both ways. • Develop collaborative relationship with clients and suppliers. • Prepare to accept postponement. • Posses sufficient human capital. • Have dependable delivery method. • Draw up fall-back plans and practices.	• Monitor economies globally to identify new IT suppliers and markets. • Evaluates needs of ultimate clients. • Create flexible designs for products and services. • Determine where clients' products and services stand in terms of technology cycles and product and services cycles.	• Exchange knowledge and information freely between suppliers and clients. • Lay down roles, responsibilities, tasks, accountabilities for suppliers and clients. • Equitable share risks, costs, and savings of improvement initiatives.

Figure 2: *Criteria for selecting suppliers in the 21st century*

Select suppliers for maximising return from investments

From our work with Fortune 500 companies, we identified four practices that distinguish the companies that are most successful in selecting right IT suppliers and subsequently develop enduring relationships. *First,* these successful companies target their IT investments at the productivity levers that are important for their industries and themselves and look for IT suppliers' who understand these productivity levers as opposed to market their hyped up products, scale, size, and seemingly lower labour costs. Second, these companies took a sceptical view of large scale technology and service providers who consistently behaved in ways that reduced companies' financial benefits from IT. *Third,* companies create two-tier systems for their selected IT suppliers – tier one comprises suppliers who are truly independent and posses in-depth advisory skills required by these companies; and tier two consist of suppliers who provide required hardware, software, applications, and associated services. *Fourth,* these successful companies did not pursue cost reduction or CAPEX in IT in isolation, instead they developed business innovations with independent advise in parallel with IT innovations (see *Whose business is IT?* by Pal).

Companies also mistakenly believe that these large and old IT suppliers are unlikely to be acquired by other large suppliers or go out of business, therefore they are a safe bet – but in today's business environment, this assumption is rather fragile. Just look at what happened to once mighty Digital Equipment, MCI, Compaq, PwC Consulting and EDS. Moreover, many large IT vendors – especially in the hardware sector – have become outsourcers, whose primary aim is to carve out technology and back-office functions from companies, lock them into long-term contracts, and subsequently make them pay over the odds when their business changes (see *Offshoring: Saviour or Value Destroyer?* by Pal). Many companies have failed to recognise this new risk.

Right IT suppliers are a pre-requisite for successful partnerships

Often CIOs are faced with legacy IT suppliers or incumbent IT suppliers of the 20th century, who were selected based on their size and panoply of offerings. These IT suppliers used shotgun approach and promised to supply all kinds of products and services that instantly solve all kinds of customers' problems. Later, some of these IT suppliers also started to call themselves "management consultants", claiming to provide "impartial advice" and deliver "high performance" to companies' management. Subsequently, the market became over-crowded with suppliers who claimed to be experts in nearly every thing, from strategy formulation to management consultancy, and software suppliers to outsource service providers (see Figure 3).

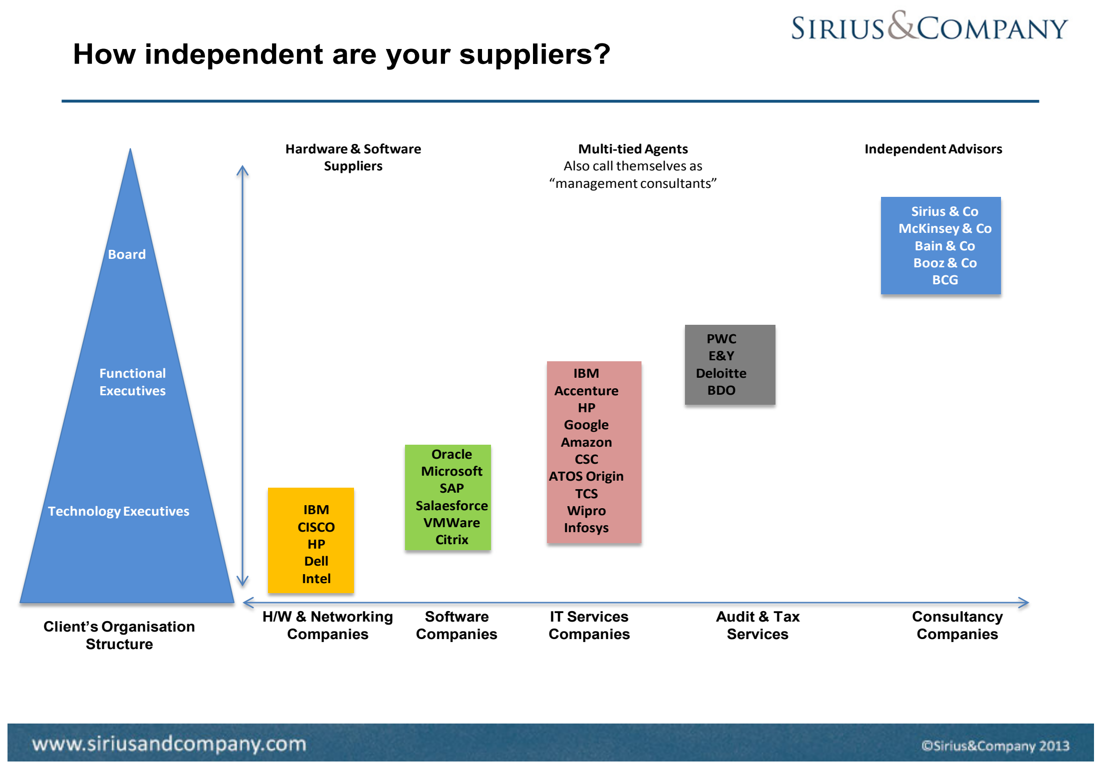


Figure 3: *It is not hard to identify truly independent and trusted advisors from others in a crowded field*

H/W & Software Companies | Independent Consultancies

IT Services Companies | Audit &Tax Services

Capabilities & positioning	Commodity	Routine procedure	Experience	Expertise
Client Problems	Common and simple problems	Choosing among several alternatives; implementing a complex project	Defining on a major, poorly defined issues on which the client has little experience	Addressing a unique and difficult problem with major impact on the client
Selling Proposition	Efficiency in delivery	Systematic and step-by-step approach; process-centric knowledge management	Past experience with similar problems ("grey hair"); experience-centric knowledge management with rigorous empirical analysis	Analytical ability to solve difficult problems ("rocket science")
Organisational Capabilities	Efficient delivery processes	Methodologies	Learning from experience	State-of-the-art theory
Professional Skills	Delivering against specific requirements	Following routine procedures rigorously and exhaustively	Highly talented, in-death skills and applying learning from experience to specific circumstances	Applying theoretical and empirical tools to solve problems at hand
Profit Drivers	Utilisation ← / Rates → / Leverage ←			

Figure 4: *Capabilities and positioning spectrum (source: HBS [3] and Sirius & Company analysis)*

Many CIOs are unclear about where to get real independent advice from. It should not come as a surprise that most companies in today's "management consultancy" sector offering IT advice are multi-tied agents, implementation partners, or resellers, behind the scene, for one or more software, hardware, or network companies - with it comes the added risk. The problem is that it is not always easy to know how objective these "management consultants" actually are. Just look at the partner networks of Microsoft, IBM, Oracle, SAP, and it will be immediately clear that most of today's "management consultancy" companies are in those networks, meaning they are multi-tied agents with down-stream agendas. However, in some cases this is not that obvious, because they use an associated company with a different name to market their preferred technology offerings. There is a danger for CIOs that "management consultants" like this will seek to fit a company's problems to their pre-packaged solutions. Most "management consultants" in this situation will claim to offer advice that is in the best interest of the client. The decision on whether this claim is credible or not is the CIOs to make.

The trick most old and large IT services companies play is to present themselves as credible suppliers to CIOs in both commodities and experience spectrum, when in practice this is an impossible mode to operate (see Figure 4) because the organisational capabilities, skills and profit drivers are very different. Yet, we see time and again many CIOs fall in this trap of large and old IT services companies.

Balancing co-operation and competition and IT supplier relationship

Commitment to a co-operative relationship	Low commitment to competitive pricing	High commitment to competitive pricing
High	**Trust-based Relationship** • May not provide clear incentives to drive improvements. • Can create fear of upsetting the IT supplier. • Likely to allow supplier to capture all value creations.	**Profitable Relationship** • Fully leveraged IT supplier capabilities. • Drives improvement at both company and IT supplier. • Require significant company capabilities.
Low	**Unleveraged Purchasing** • Typifies the clerical purchasing or supply chain mentality of traditional purchasing. • Focus on price rather than total value over the life-time. • Leaves a lot of money on the table.	**Darwinian Rivalry** • Requires significant purchasing clout. • Eliminates IT suppliers lethargy may instil resentment. • Does not drive synergetic improvements.

Commitment to competitive pricing

Source: Sirius & Company Analysis

Figure 5: *Results depends on type of relationships*

By contrast, independent advisors are central to the CIOs learning process, because when the choices are explained, CIOs recognise the value of independent advice. The key to engaging an independent consultancy company is to recognise the value of time and the price of mistakes. The crucial benefit is that independent consultancy companies have seen the problem before and know the quickest path to the results. Truly independent consultants are the CIOs trusted advisers.

Responsibility for creating profitable relationship lies with both parties

Recently, a well known DIY retailer has turned the screw on its suppliers — almost doubling the number of days they will have to wait for payment [2]. In November 2005, Travis Perkins blamed a price war between this retailer and its direct competitors for falling profits. Currently this retailer pays its suppliers within 49 days of receiving goods, but over the next 12 months that will almost double to 90 days. However, the industry average is 45 days. These changes mean making payments to suppliers when goods are sold, rather than when they are delivered to their store. Undoubtedly these changes will affect suppliers' cash-flow. This retailer's suppliers include a number of prominent IT suppliers. It is safe to conclude that most of these suppliers are not going to be entirely pleased about these changes (see Figure 5).

This ground breaking work was completed by the independent consultancy company in less than 12 weeks. But, the insurance company's central technology organisation and its purchasing department had other ideas – and they stipulated that doing business with a small independent consultancy company posses risks to the insurer. To mitigate this "manufactured risk", the insurance company asked the small independent consultancy company to handover their own processes and tools that created the infrastructure technology platform to an incumbent large and old IT supplier. Understandably, when the small independent consultancy company declined to handover their intellectual property to the insurer nominated large and old IT supplier, the insurance company ended a fruitful and mutually profitable relationship with the small independent consultancy company. Subsequently, the insurer asked its newly appointed large IT supplier to re-create the technology infrastructure platform. But, the large IT supplier spent more than 18 months trying to emulate what the small independent consultancy company achieved in less than 12 weeks, but without success.

So, who lost out in this case? The insurer, its centralised technology organisation and the purchasing department. The winner is, of course, the large and old IT supplier, who promised the earth to the insurer but delivered very little. So, what do these types of flawed decision making mean to the companies and their suppliers? Companies continue to spend hundreds of millions on large and old suppliers, yet they are unable to get return from their technology investments. Large IT suppliers, continue to hold companies hostage with their proprietary technologies and long-term contracts. But, it doesn't have to be like that – there is a better way.

	Hardware/Software suppliers & large IT services companies	**Independent consultancy companies**
Management components for partnership	**Operational partnership**	**Strategic partnership**
Planning • Style	• On ad-hoc basis	• Systematic: both pre-planned and ad-hoc
• Level	• Focus on project or process	• Focus is on relationship
• Content	• Sharing of existing plans and eliminating conflicts	• Performed jointly and at multiple levels; each participated in other's business planning
Joint operations • Measurement	• Measures are jointly developed, and focus is on individual performance	• Measures are jointly developed and shared; focus is on joint performance
Communication Periodic	• Limited, usually at the process or project level	• Planned as a part of the relationship; occurs at all levels; speaks the same language
Daily • Organisation	• Conducted on ad-hoc basis, between individuals	• Systematised method of communication and communication systems are linked
• Balance	• Primarily one-way	• Balanced 2-way communication flow
Reward sharing • Loss tolerance	• Low tolerance for loss	• High tolerance for short-term loss
• Gain commitment	• Limited willingness to help the other gain	• Desire to help other party gain
• Commitment to fairness	• Fairness is evaluated by transaction	• Fairness is measured over life of relationship

Figure 6: *Management components for profitable partnerships*

Creating partnerships that last and capture value for both parties

Like the word "commitment" in a marriage, "partnership" is often interpreted differently by the parties involved. In partnership between companies and their suppliers, companies need two levels of partnership with their suppliers: strategic partnership and operational partnership. Both levels entail varying degrees of management complexity and resource use (see Figure 6).

In operational partnership, both the company and its IT suppliers co-ordinate activities and planning on a limited basis. Building operational partnerships is a two-way road and the actions of IT suppliers are important. Those that are open about software product issues build trust and provide insights that can guide the purchasing decisions of clients; sharing information about a forthcoming product can, for example, help clients better plan their own IT road map. In strategic partnership, companies and selected independent providers share a significant level of integration, with each party viewing the other party as an extension of itself.

Our experience shows that although a majority of CIOs want to have strategic partnerships with some of the selected IT suppliers, their purchasing orgainastions often act in ways that undermine that goal. Many companies' purchasing organisations lose out on the potential benefit of a profitable partnership by engaging in value-destroying behaviour by too much emphasis on costs and size of suppliers. Developing a profitable partnership that lasts is not a simple task. More importantly, it is not a task of companies' purchasing organisations. And, the two-level partnership model described above is not designed to be a supplier section tool. Once a company has selected its suppliers using our five start selection model, it can then use the partnership model to create value. It shouldn't come as a surprise that partnerships are costly to implement since they need additional communication, collaboration, risk and reward sharing. They are economically justified only if they stand to yield substantially better results than the companies and suppliers could achieve without them.

What does all this mean?

Most successful companies look for suppliers who understand their specific operational and technology environments, offer ongoing independent advice, help them manage aggressive software upgrade cycles, and provide solutions for their most pressing business problems. As one of our senior client executives explained before appointing us, "We're looking for a supplier that can bring real insight to our business without any down-stream agenda, know what my peers are doing, and helping me make better IT decisions that reduce cost, bring agility, and help my business to grow."

Successful companies need to select suppliers who can respond to sudden changes in markets – and the monolithic size and scale of old and large IT suppliers and their outdated practices are often prohibitive to achieve this objective. Agility is critical because in most industries, as both demand and supply fluctuates rapidly. Large suppliers try to hide their lack of agility by playing up on their size, but independent and agile suppliers respond both quickly and cost-effectively. Smart companies also select suppliers who are capable of adapting to changes in their strategies. Long term contracts and software lock-in by large IT suppliers are a hindrance to companies' achieving their strategic objectives. Companies in the 21st century align their interests with that of the suppliers, but this is not easy. Because, large IT suppliers are concerned solely with their own interest by selling new versions of software and large pool of people to companies, regardless of the companies need.

Companies must not assume that the five start suppliers section model described earlier requires more technology (e.g., large and expensive enterprise resource planning software), a room full of purchasing experts with all the external benchmarking information at their finger tip, and massive capital expenditure. Nothing could be further from the truth. Most companies have the infrastructure in place to develop the five star supplier selection model and a two-tier partnership model. What they will need instead is a fresh attitude and new culture across the company to get their five star suppliers selection model deliver five star performance.

In the 21st century, companies must give up their obsession with lowest-cost and large suppliers, which has proved counter-productive time and again. Successful companies must be prepared to change the traditional large supplier networks. Instead of looking out for their interest alone and putting more money into large suppliers' pockets, companies must take responsibility for the entire supply chain recognising that independent advice from small independent consultancy companies reduced the price of mistakes and helps to capture value from their technology investments. To get more from IT investments, companies must understand the types of partnerships they need from their IT suppliers, decide which suppliers can offer those partnerships, and then act on building the right level of partnership. By avoiding value-destroying behaviour, companies and their selected suppliers can build a foundation of trust. These can be challenging for many companies because there are no technologies and traditional purchasing tricks that can do those things – only senior executives with forward looking mind-set can make them happen.

NOTES

1. “Bullish on Capex”, Richard Berner, Morgan Stanley Global Economic Forum, 23 January 2006.
2. The Financial Times, 30 January 2006.
3. “Strategy and Positioning in Professional Service Firms”, Professor Ashish Nanda, Harvard Business School, HBS Case No: 9-904-060, 7 May 2004.

About the authors

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