

SOUTH
CENTRAL

SOURCING BUSINESS MODELS

Seven Sourcing Business Models to Create Value and Manage Risk

Presented by:

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Faculty, University of Tennessee



FORUM2016



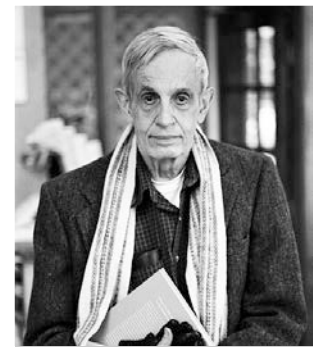
Overview

- ***Modern Research Supporting Business Model Frameworks***
- Introduction to Sourcing Business Models
- The Seven Sourcing Business Models
- Sourcing Business Model Selection
- A Word About Relational Business Models

Research: Collaboration Generates Value/Reduces Risk

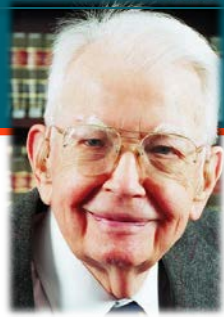


Robert Axelrod



John Nash

Grow the Pie Don't Fight over it



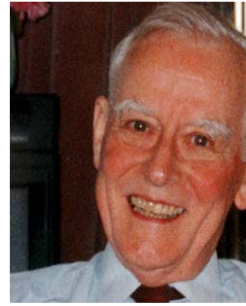
Ronald Coase
Nobel Prize

Total Cost Not Price



Robert Solow
Nobel Prize

Innovation = Growth



Ian R. MacNeil

Flexible Relational Contracts



Kathleen Eisenhardt
Stanford

Transaction or Outcome Models



Oliver Williamson
University of California, Berkeley

Sourcing is a Continuum not purely Make or Buy

Large playground in the middle of "hybrid" models

In the Words of Oliver Williamson

“All complex contracts will be incomplete – there will be gaps, errors, omissions and the like.”

“Muscular buyers not only use their suppliers, but they often ‘use up’ their suppliers and discard them.”

“The muscular approach to outsourcing of goods and services is myopic and inefficient.”

Example: A Profile of GM's Procurement Practices

- “Adversarial and arms length supplier relationships dating back to the 1950’s”
- 1990 Dr. Ignacio Lopez promoted to director of General Motors Worldwide Purchasing operations
 - “I do not want to hear any more that prices are already down too far and you are making no profits.”
 - Saved a whopping US \$ 1.1 billion in 1991 and US \$ 2.4 billion in 1992



Dr. Ignacio Lopez
Former Director
General Motors
Worldwide
Purchasing
Operations

The Lopez Effect Still Haunts GM

- Worst automaker by U.S. suppliers
- Tier 1 suppliers rate GM as their least favorite big customer
- Low marks for key measures such as overall trustworthiness, communication and protection of intellectual property
- 55% of suppliers rated their relationship with GM as poor to very poor

Source: Reuters Business News, May 12, 2014



The screenshot shows a Reuters news article from May 12, 2014. The headline is "GM ranked worst automaker by U.S. suppliers: survey" by James B. Kelleher. The article features a photo of the GM logo on a blue sign. A sidebar on the right lists trending news items, including "Shares rally on China stimulus hopes, strong European data" and "U.S. dentist who killed Zimbabwean lion Cecil returns to work".

2014 Reuters report cites GM

Service Provider Trust Study - Automaker Relationships

- General Motors was the least trusted automaker and Toyota the most trusted
- General Motors incurred six times higher transaction costs (procurement costs) than Toyota



Jeffery Dyer
Brigham Young University
Marriott School

A Muscular Approach has Limited GM's Profits

A Clear Message is Emerging

- This century's business battlefield will be based on **harnessing the power of your suppliers not just lowest cost or best value**
- Today's highly collaborative supplier relationships are helping drive transformation and innovation
- **Tomorrow's winners will:**
 - **Abandon win-at-all costs game with their key suppliers**
 - **Surpass lip service "saying" strategic supplier but**

If organizations are going to compete 'supply chain to supply chain,' shouldn't supply chain partners work together?

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The Evolution of Sourcing Business Model Theory

Concept first introduced in the book *Vested Outsourcing: Five Rules That Will Transform Outsourcing*

Built on in *The Vested Outsourcing Manual: Creating Successful Business and Outsourcing Agreement*

Expanded on in a white paper published by the University of Tennessee, SIG, CORE, and IACCM

Refined in the book *Strategic Sourcing in the New Economy: Harnessing the Potential of Sourcing Business Models in Modern Procurement*

Sourcing Business Model Basics

STRATEGIC SOURCING IN THE NEW ECONOMY

Harnessing the Potential of Sourcing
Business Models for Modern Procurement



Bonnie Keith • Kate Vitasek • Karl Manrodt • Jeanne Kling

Sourcing Business Model theory suggests sourcing should be thought of as a business model between a two parties with the goal to **optimize the exchange**.

Sourcing Business Models are based on two factors: **relationship models** and **economic models**.

What is a Sourcing Business Model?

There are **seven Sourcing Business Models**, each serving to optimize for 25 key business attributes

An organization should consciously select the Sourcing Business Model that is most appropriate for their sourcing situation in order to optimize for their business environment

Relationship Model and the Economic Model

	Relationship Model	Economic Model
What is It?	A relationship model determines how you will formally control or influence your supply source	An economic model determines how you will manage the economics of the relationship
What are your decisions	<p>Three relationship models:</p> <ul style="list-style-type: none"> • Transactional Contract (Market) • Relational Contract (Hybrid) • Investment / Vertical Integration (Hierarchy) 	<p>Three economic models:</p> <ul style="list-style-type: none"> • Transaction-Based <ul style="list-style-type: none"> • <i>Activities drive behavior, e.g pay per Unit, Hour, Activity)</i> • Output-Based <ul style="list-style-type: none"> • <i>Pay for supplier output such as SLAs or Guaranteed savings glidepath</i> • Outcome-Based <ul style="list-style-type: none"> • <i>Boundary Spanning / Business Outcomes with shared risk or shared reward</i>

Sourcing Business Models

A Sourcing Business Model is a combination of an organization's Relationship Model and its Economic Model.

Relationship Models	Sourcing Business Models	Economic Models
Transactional Contract (Market)	Basic Provider Model	Transaction-Based
	Approved Provider Model	
Relational Contract (Hybrid)	Preferred Provider Model	
	Performance Based/Managed Services Model	Output-Based
Investment / Vertical Integration (Hierarchy)	Vested Business Model	Outcome-Based
	Shared Services Model	
	Equity Partnerships	

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The Seven Sourcing Business Models

1. Basic Transaction Provider
2. Approved Provider
3. Preferred Provider
4. Performance –Based Agreement
5. Vested Business Model
6. Shared Services
7. Equity Partnerships

Basic Provider Model

Primary purpose: gain access to goods or services at the lowest cost

Transaction-based economic model and a **transactional relationship** model (price per unit, per activity, per hour)

Competitive mind-set

Generic or standards with broad supply options

A basic transaction provider is a supplier that operates under a simple buy–sell arrangement where buyers typically pay a set “transaction” price for products or services

Approved Provider Model

Primary purpose: leverage volumes, gain pricing discounts and reduced administrative costs with fewer proven suppliers

Transaction-based economic model and a transactional relationship model

Master Agreements

Reduced Competition

An approved provider is a supplier that meets a predefined set of qualification characteristics, quality standards, prior proven performance or other selection criteria

Preferred Provider Model

Primary purpose: to gain access to value-added capabilities at best value or volume discounts through a longer-term contract

Transaction-based economic model and a relational contract model

streamline buying processes and allow for **easy repeat business**

may have an exclusive arrangement, but competitors exist

A preferred provider model uses a transaction-based approach, but the buyer chooses a more strategic relational model with specifically chosen supplier(s)

Performance-Based Model

Primary purpose: drive efficiencies and ensure predefined service levels with provider expertise

Transaction-based with output performance incentives and penalties economic model and a relational contract model
longer-term contract with the intent that the **supplier invests in improvements** to meet predefined service-levels and/or savings targets

shifts risk to the supplier -Also known as “pay for

A performance-based model combines a relational contracting model with an output-based economic model

Vested Business Model

Primary purpose: co-developed, co-managed collaborative solution with expert to generate and optimize value not individually gained

A Vested model combines an outcome-based economic model with a relational contracting model (WIIFWE Mindset)

Creates a **longer-term relationship** (5-15 yrs.) to develop solutions that achieve boundary spanning business outcomes

Ideal for **managing risk**

creates a highly **collaborative** environment that drives innovation

A Vested business model creates highly collaborative win-win relationships in which both buyers and suppliers are equally committed in each other's success

Vested Business Model

Developed by University of Tennessee researchers studying the world's most successful buyer-supplier partnerships

- Turned lessons learned into a systematic model following the Nobel Prize-winning concept of behavioral economics and the principle of shared value

Key differentiator is a “What’s in it for We” mindset

- The more efficient and effective the business outcomes, the more profit the supplier makes
- Suppliers are rewarded for reducing cost structures (not prices) if work scope stays the same
- Agreements follow **5 Rules**: Business Model, Scope of Work, Performance Management, Pricing Model, Governance

Shared Services Model

Primary purpose: Create **internal functional business unit** or stand-alone entity that **provides goods or services** to an overall broader organization

processes typically are centralized into organization that **charges business units** and users for the services they use

An **SSO consolidates services** across an organization and places them into a distinct entity designed to be **competitive with “buy” solutions**

A shared services model is like an entity that creates its own internal

A shared services model is one of two investment-based categories and is constructed as an internal organization based on an arm's length outsourcing arrangement

Shared Services Model



Equity Partnerships

Primary purpose: legally bind potential business partners through formal structures to effectively meet business objectives

Organizations creating equity partnerships **make a direct investment** in building capabilities with a formalized entity

Typically **asset-based** with a formal and **comprehensive governance framework**

Setting one up can be a **costly and complicated** process

Equity partnerships are the second category of investment-based models along the sourcing continuum

Equity Partnerships

If an organization decides to invest in an equity partnership, they can take different legal forms:

**Equity Solutions
are typically
created by a
senior executive
team which may
can include
Sourcing**

Acquisitions

Joint Ventures

Subsidiaries

Purchasing
Cooperatives

Architecting Equity Partnerships

Because of this variety of investment-based models, there is **no one right way to structure** such a model

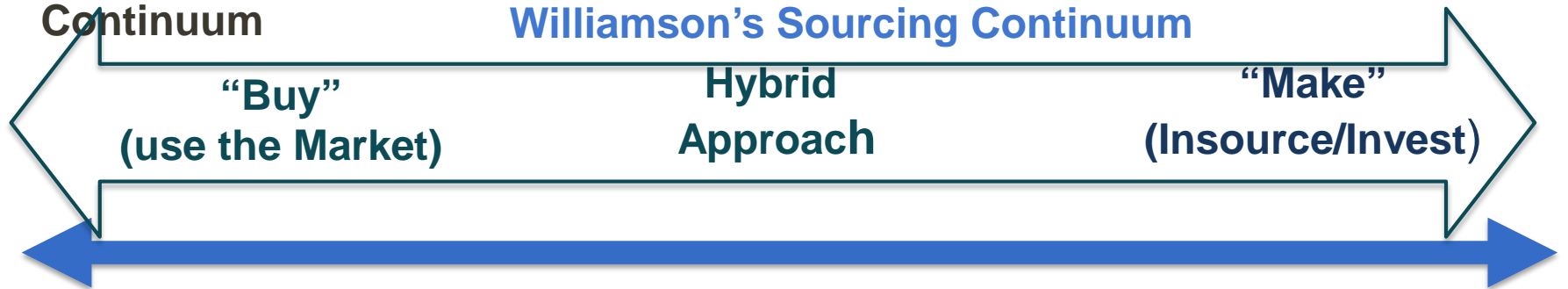
Investment-based models can **use any of the three economic models**: transactional, output or outcome based

Due to organization financial nature, the **stakes typically are high**, therefore most investment-based models benefit when following a highly collaborative what's-in-it-for-we (WIIFWe) approach with an outcome-based economic model **Every situation is different!**

Seven Sourcing Business Models

- As goods and services become more strategic and the business environment more unpredictable, risk increases and organizations should shift to more sophisticated Sourcing Business Models.
- The seven Sourcing Business Models are “mapped” to Williamson’s Sourcing Continuum

Williamson’s Sourcing Continuum



TRANSACTIONAL

RELATIONAL

INVESTMENT

Basic Provider Model	Approved Provider Model	Preferred Provider Model	Performance Based/ Managed Services Model	Vested Business Model	Shared Services Model	Equity Partnership
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Source: STRATEGIC SOURCING IN THE NEW ECONOMY: HARNESSING THE POTENTIAL OF SOURCING BUSINESS MODELS FOR MODERN PROCUREMENT, Keith, Vitasek Manrodt & Kling, Palgrave 2015

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Sourcing Business Model Selection

Determining which Sourcing Business Model is best for your situation is easy when you complete a Sourcing Business Model Mapping exercise!

A Sourcing Business Model Mapping exercise where you assess your category against **25 key attributes** will help you answer two key questions

- What relationship model should you use?
- What economic model should you use?

Based on your answers, you will then “map” your answers to the Business Model Map Matrix

The Sourcing Business Model you pick greatly depends on your level of dependency/risk and your potential to create value



Sourcing Business Model Selection: Exercise

Select a Category/Commodity you manage or influence.

Using the Template provided:

- Start with Relationship Attributes and select the box(es) that you feel best fits your business needs
- Then with Economical Attributes select the box(es) that you feel best fits your business needs

Example: Economic Model Mapping Template

1) Review each attribute and score based on the rankings to the right

3) Select the best Economic Model

2) Scores determine the economic model

Open Source Sourcing Business Model Toolkit
Economic Model Mapping Template
(refer to definitions on 13 if you have questions about what an attribute means)

Attributes to Determine the Best Economic Model	Transaction - Based		Output -Based	Outcome Based		
	1	2	3	4	5	
Potential to Create Value / Mutual Advantage*						
Potential Efficiency Gains ^{1,2}	None	Low	Medium	High	Very High	Significant
Potential for Revenue Increase ^{1,3}	None	Low	Medium	High	Very High	Constant
Potential for Innovation ^{1,3}	None	Low	Medium	High	Very High	Critical
Size of investments needed in to achieve outcomes (buyer or supplier)*	Low	Medium	High	High to Invest	Invest	Invest
Nature of Workscope/Tasks²						
Degree of Supplier Control Over Outcome ²	Low	Low	Low	High	Medium-High	N/A
Type of Success Measure Desired/Required ^{2,4}	Transactional Task Metrics	Transactional Task Metrics	Transactional Task Metrics	Output SLA Metrics	Strategic KPI or Business Outcomes	Strategic KPI or Business Outcomes
Ease at Which Task/Workscope can be Specified ²	High	High	Medium	Medium	Can Vary	Very difficult or Impossible
Criticality of the Work⁴						
Risk related to operational safety ⁴	Minimal	Low	Medium	High	High	Critical
Risk related to operational reliability ^{1,3}	Minimal	Low	Medium	High	High	Critical
Commercial Preferences						
Financial Risk Tolerance for Client ²	High Risk	High Risk	Medium Risk	Medium-Low Risk	Shared Risk	N/A
Financial Risk Tolerance for Service Provider ²	Low Risk	Low Risk	Low Risk	Medium Risk	Shared Risk	N/A

Source Key of Research Supporting the Attribute: ¹Williamson, ²Eisenhart, ³Prahalad and Hamel, ⁴University of Tennessee, ⁵Kraljic

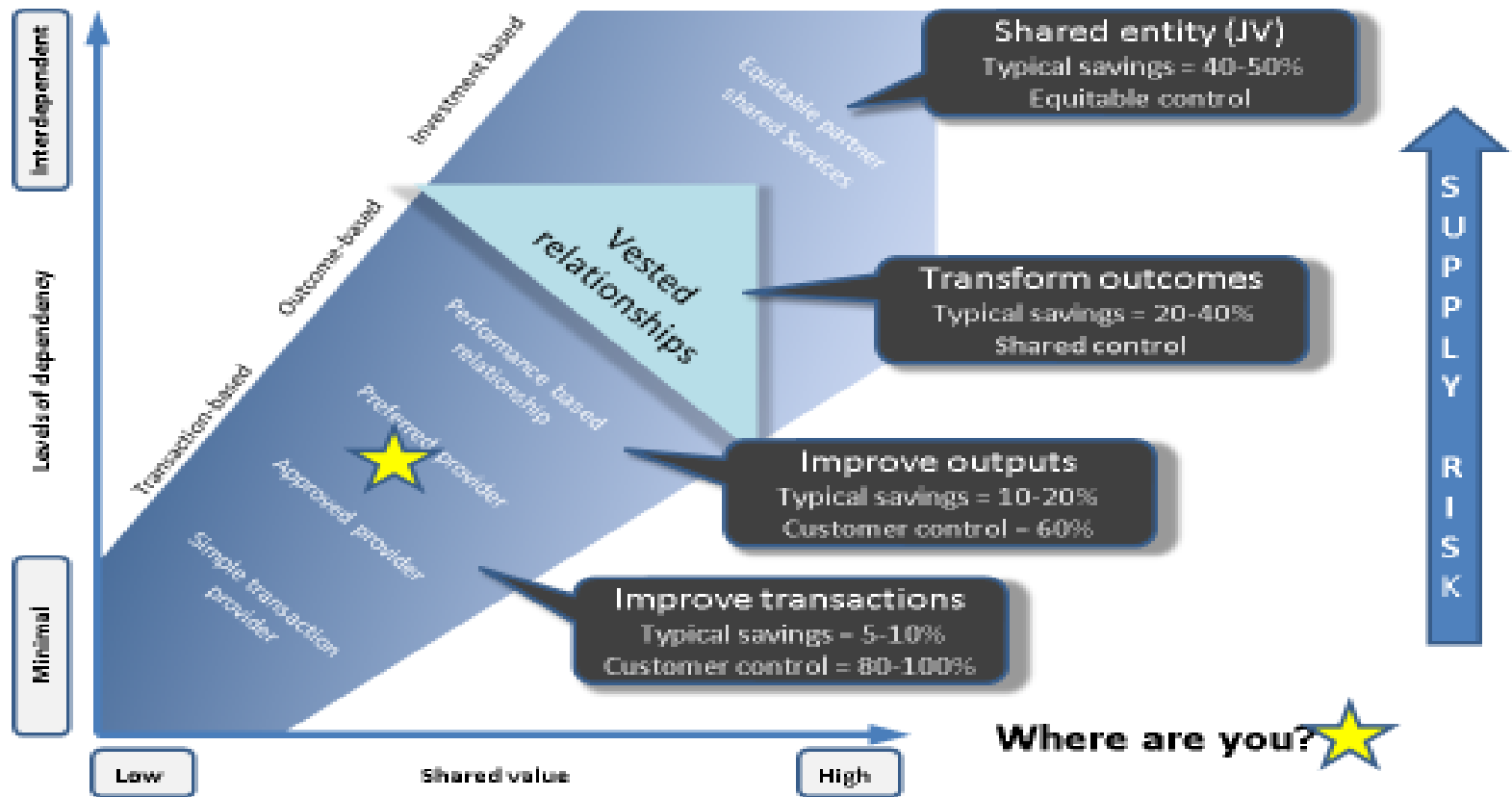
*these attributes are used to determine both the relationship and economic model

VESTED **HASLAM**
COLLEGE OF BUSINESS
THE UNIVERSITY OF TENNESSEE, KNOXVILLE

Source: STRATEGIC SOURCING IN THE NEW ECONOMY: HARNESSING THE POTENTIAL OF SOURCING BUSINESS MODELS FOR MODERN PROCUREMENT, Keith, Vitasek Manrodt & Kling, Palgrave 2015

Sourcing Business Model Value

What is the most beneficial model?



Comparison of Relationship Models Risk

Transactional Contract (Market)	Relational Contract (Hybrid)	Investment Vertical Integration (Hierarchy)
Creates arms-length relationship	Creates “partnership” relationship without a legal entity	Creates “partnership” with a legal entity
Focus on the “deal” as one big transaction	Focus on the relationship, within which the “deal” can change	Focus on organizing transactions within a hierarchical organization.”
Focus on opposing interests “I want to win – regardless of if you lose”	Focus on the creation of continuously aligned interests “we must both win to be successful”	Inherently aligned interests due to nature of a single entity; “we inherently win and lose together”
The contract clauses should cover every little present and future aspect of the relationship	Since all contracts will be incomplete, the contract is a flexible framework	Full vertical integration: transactions management through employment contracts; JV: JV managed through JV contract
Social norms ¹ affecting behavior play no role	Social norms should be embedded in the contract to increase behavior alignment	Social norms must be embraced and embedded into the hierarchical organization for the most success
Power based	Trust based	Combination of power and trust through a single entity

¹Research identifies six universally accepted social norms: Loyalty, equity, reciprocity, autonomy, honesty and Integrity

Comparison of Economic Models Risk

Transaction -Based	Output-Based	Outcome-Based
Economics tied to activities drive behavior, e.g. per unit, per hour	Economics tied to Supplier Output	Economics tied to Boundary Spanning/Business Outcomes
Well suited when the focus is on performance of activities or tasks	Well suited when the buyer wants to hold a supplier accountable for supplier controllable outputs or the supplier	Well suited when want to focus on transformation
Well suited when the focus on the “base” book of work	Well suited when the focus is on Service Levels on the base book of work	Well suited when the focus is on transformation or innovation
Customer carries the main risk if transactions does not create value	Supplier carries main risk if Service Levels are not met. Customer carries the main risk if the achieved service levels does not create commercial value.	Shared risk and reward if the transactions does not create value
Runs the risk of creating opposing interests between customer and supplier	Creates alignment of interest regarding the service levels for the defined scope of work	Creates long term alignment of interests regarding strategic business outcomes

Risk Management by Model

Business Model RISK	Risk Assessment	Risk Management	Stakeholder Involvement
Basic Provider	No action. Risk low. Large supply option of standards to meet corp./compliance	No action. Typically low value. Can easily switch suppliers.	None
Approved Provider	Conduct risk assessment of part of supplier qual., complete formal risk assessment incl. capacity, capability, supply mgmt. processes, compliance	Can switch suppliers with supplier pre-qual. alternates	Some with pre-qualification process
Preferred Provider	Conduct risk assessment as part of the supplier qual., complete formal risk assessment with stakeholders, compliance	Document risk mgmt. expectancies from the supplier; ID alternate suppliers, value comparison matrix. Supplier change contingency plan	Moderate with pre-qual., contingency planning, value assessment

Risk Management by Model

Business Model Risk	Risk Assessment	Risk Management	Stakeholder Involvement
Performance Based Provider	Conduct full risk assessment due to higher supplier dependency; draft contract clauses to transfer risk to suppliers with supplier contingency plans. Complete full risk assessment and develop risk mitigation plan with input from suppliers and formal transition plan for transfer of work	Document risk mgmt. expectations from the supplier and get supplier risk mgmt. contingency plan. Develop Risk Metrics, document risk penalties, includes supplier adherence to compliance and capability guarantees	Substantial inclusion to build out contract inclusions and monitor performance
Vested Provider	Comprehensive risk assessment completed by both parties	Contract includes shared risk, shared reward. Jointly develop risk management plans, formal onboarding process developed	High - Joint stakeholder Team
Shared Services Equity	Participate in assessment/contingency planning with periodic reporting	Prepare formal risk mitigation and management plans	Some-mostly Exec decision

Supply Business Model Selection

When selecting a supply **business model** for the category you are managing, it is important to understand that a **single model will not work** for every requirement

Understanding how the **requirement supports** and is **viewed by your business** as well as the **internal and external** influences will impact your model choice

The **level of effort** you apply in your **sourcing and ongoing** management approach will vary

This is true for both Sellers and Buyers

Which Sourcing Business Model is Best? It Depends

What is the right Relationship Model?

What is the right Economic Model?

Relationship Models	Sourcing Business Models	Economic Models
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	Performance Based/Managed Services Model	Output-Based
	Vested Business Model	
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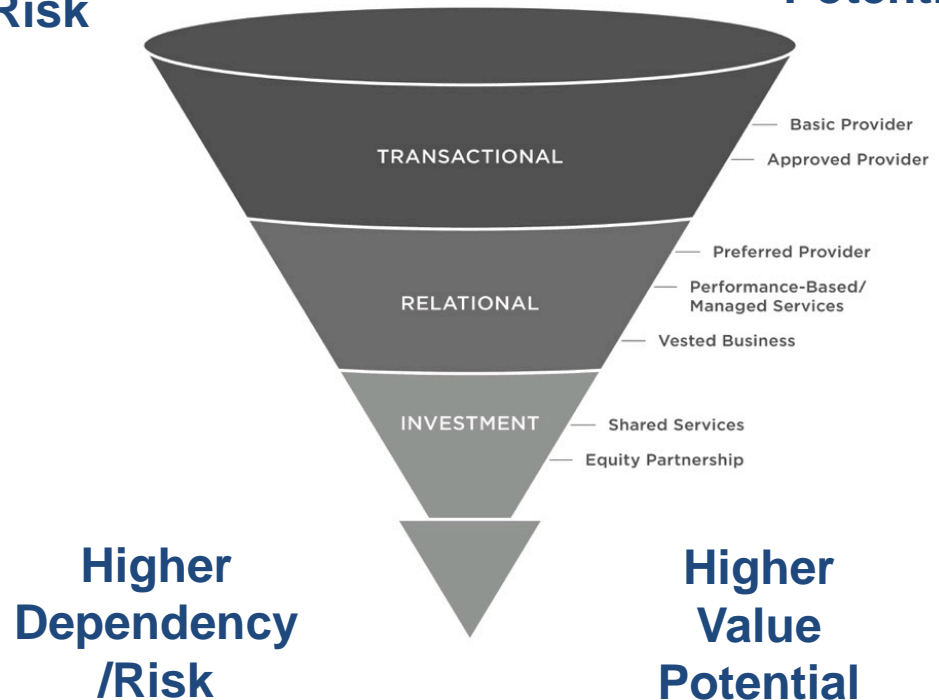
Results in the best Sourcing Business Model

Sourcing Business Models in Context

- As you map your sourcing situations across the 25 attributes, you will likely find the results somewhat like a funnel
- From a Buyer's perspective, the majority of your sourcing situations will likely need transactional sourcing business models
- Likewise you will likely find there are very few situations that call for an investment based model

Lower
Dependency
/Risk

Lower Value
Potential



* the complete Business Model Mapping template contains 25 attributes

The Dependency-Value Linkage

		Relationship/Contract Model		
		Transactional Contract (Market)	Relational Contract (Hybrid)	Investment (Vertical Integration / Hierarchy)
Economic Model	Outcome-Based <i>Economics tied to Boundary Spanning/ Business Outcomes</i>	Mismatch – Not a Viable Strategy	Vested	Equitable Partner Vested Shared Services
	Output-Based (Performance-Based / Managed Services) <i>Economics tied to Supplier Output</i>	Mismatch – Not a Viable Strategy	Performance-Based (Managed Services) Agreement	Equitable Partner Shared Services
	Transaction-Based <i>Economics tied to activities drive behavior</i>	Basic Provider Approved Provider	Preferred Provider	Equity Partner Shared Services

If the business attributes are present for value creation, an organization can create the most value through the use of relational and investment-based relationship models combined with output of outcome-based economic models.

Organizations that do not have the capabilities or are not willing to take on investment risk should consider Vested or Performance-Based Agreements as ways to create the most value with supplier relationships.

Caution: Supply Business Model

Many companies are not using the right **Supply Business Model** for their environment

There are several conditions that could cause an inappropriate

- Business **cultural behavior** may cloud the best solution
- Category management is **relatively immature**, so it limits ability to move to a more advanced model
- Stakeholder **misalignment** creates ambiguity in how supplier relationships should be managed
- The Sourcing organization **does not truly “own” the supplier interface**, and therefore is not able to impact the nature of

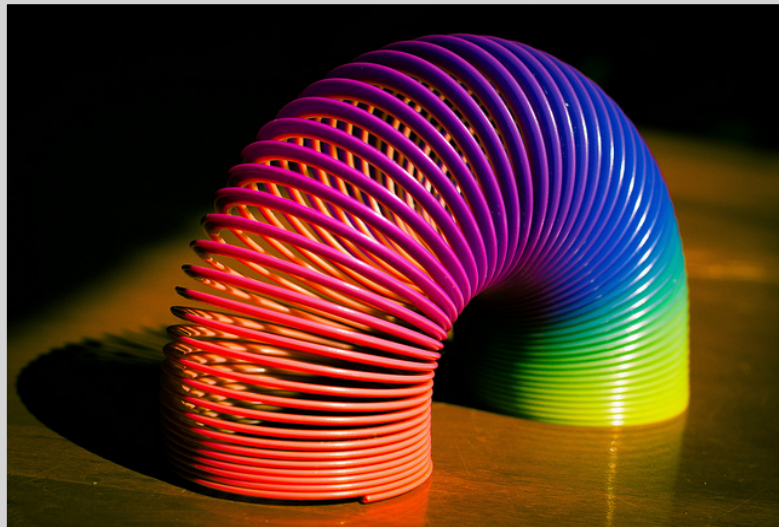


relationship

Using the right **Supply Business Model** will allow your company to optimize overall business execution, result in **lower costs, high service levels, overall organizational performance and improved shareholder value**

Systems Thinking Is Key

The purpose or function of a well structured system is to perpetuate or replicate a chosen result.



Slinky image by Lucho Molina via Flickr CC

- A system is an interconnected set of elements, sub-elements and components that are coherently structured in a way that achieves a defined purpose
- This interconnectivity between the elements forms a feedback loop in which information is derived

Architecting a supplier agreement using the Sourcing Business Model rules creates the most appropriate “system” for your situation

“Cherry Picking” the Rules Creates Chaos



Audi 2014 Super Bowl Commercial - "Doberhuahua" by Tony Mack is available on YouTube. Photo is a screen shot from publically available YouTube video.
<https://www.youtube.com/watch?v=2nrbF21Ybo0>

- Mix and matching “best practices” without understanding the system implications creates a Business Model mismatch
- It is like creating a Doberhuahua; it sounds good but doesn’t work well
- Instead architect the “best fit” solution for your solution using a well structured agreement following the Sourcing Business Model rules

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Relational Sourcing Business Models - A review

Relational deals are dynamic.

Transaction deals are static.

A static deal in a dynamic or risky environment is a set up for failure.

"87% of economic growth results from technical change,' which is driven by improvements in business process or technical improvements in products."

- Robert Solow

A word of caution...

- A more progressive Sourcing Business Model approach may not be the right choice given your environment or organizational constraints.
- Your organization may lack the mindset or skills to lay the foundation for a more collaborative relational contract.

Maintaining fair and balanced value exchange takes effort and a focus on mutual benefits

Stakeholder Involvement Along the Continuum Reduces Risk

SOURCING CONTINUUM



LOW Procurement Involvement **Stakeholder Involvement** **HIGH**

From Transactional Buyers **To Value Architects**

Business Stakeholder Involvement

From Operations Managers **To Transformation Leaders**

Supplier Involvement

From Vendors **To Solution Providers**

TACTICAL

STRATEGIC

Relational Sourcing Business Models are Different

Relational Sourcing Business Models are different:

- They are about negotiating the intent and behaviors of the relationship.
- They create a repetitive relationship with a supplier aimed at creating value.
- They lay a strong foundation where parties can fluidly adjust to business needs and risks as they arise.
- By agreeing to the foundational nature of the relationship itself, the organizations can get to a fair and balanced deal.

Relational Models and the Sourcing Continuum

As you move along the sourcing continuum each Sourcing Business Model brings higher levels of co-dependency.

- A Preferred Provider Model – is still a relationship and needs structure.
- Performance-Based and Vested agreements require laying a strong WIIFWe foundation.

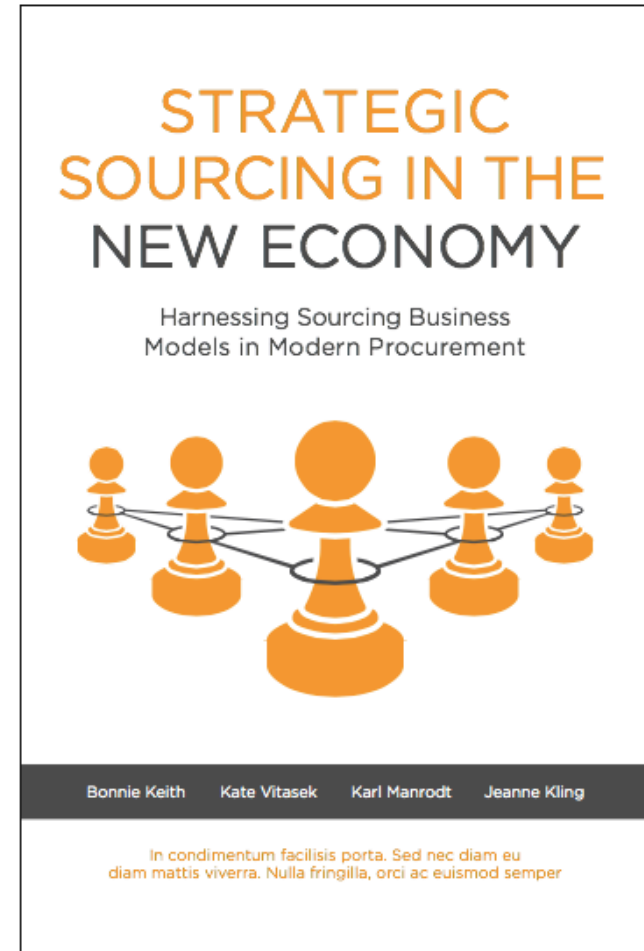
Incorporate Modern Thinking into your Procurement Practices

How do you incorporate more modern thinking into your procurement and selling practices?

Rethink your strategic sourcing processes to actively promote more modern approaches.

Use a multi-step process, to incorporate the best thinking of leading economist and strategic thinkers.

Source: STRATEGIC SOURCING IN THE NEW ECONOMY: HARNESSING THE POTENTIAL OF SOURCING BUSINESS MODELS FOR MODERN PROCUREMENT, Keith, Vitasek, Manrodt & Kling, Palgrave 2015



Contact Me with Questions!



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Why

What

How

When

Negotiate the relationship

Tells the real stories of...

