Outsourcing VENTURE

Vendor or Partner?

Know the difference and manage accordingly.

Ben Gomes-Casseres ***Outsourcing Venture Magazine***, Quarter 3, 2006

"Peace, commerce and honest friendship with all nations; entangling alliances with none," was President Thomas Jefferson's goal in his first inaugural address in 1801. This seems to be the ideal for many companies today that outsource their operations, manufacturing, or services to third parties. But can they avoid entangling alliances? Should they?

The very term "outsourcing" implies a certain detachment and distancing of the activity – ripping it out of our own company and leaving it for another to do. This is usually justified by the argument that the outside party can get the job done more effectively, more cheaply, or more quickly than we can. That may well be true – but will they do it on their own, just because they have signed a contract to do so? Or will we have to hold hands, coach them along the way, and from time to time even do some of the work ourselves?

In short, can our outsourcing be based on the isolationist principle of "peace, commerce, and honest friendship," or is it based on the more interventionist model of "entangling alliances?"

Another way to put the choice is this: Is the outside party our vendor or our partner? Here the typical answer often is "our partner, of course!" Because this answer often *sounds* better and more forthcoming, it is frequently part of a sales pitch. No one wants to be a vendor, and no one wants "just a vendor" to take over their work. But the distinction is usually not well understood, and confusion about this very point can lead to conflict and business failure.

An Outsourcing Dilemma

Take the case some years ago of a large US telecom service provider that needed software for a new billing system for international markets. A quick review at the time showed that the company did not have internal expertise to develop the software itself, and that a suitable system was not available off-the-shelf from existing vendors.

Though it had little experience with complex third-party relationships at the time, the telecom company decided to outsource the project through a "true partnership" with a small software firm. The intent was explicitly to have the outside company develop something new and distinctive, even though neither company knew at the start precisely what its features would be. The first order of business for the partnership, in fact, was to develop a winning set of product specs.

That is where the trouble began. The partners pushed and pulled at each other regarding product features, IP ownership, timing, and cost – all aspects that had been poorly defined up front. The telecom company had banked that "trust" between the "partners" would help the companies resolve such contentious issues smoothly. Perhaps that might have been possible, but only with substantial involvement by high-level executives and serious relationship management, neither of which was forthcoming.

The partnership failed in all respects: the software was late, lacking critical features, and even the small company did not get much of a boost from the job. And what's worse, the telecom company had no back-up plan – it had outsourced the task expecting it to get done.

What should they have done instead? First, recognize the critical difference between a partner and a vendor. Second, select the right model for the task at hand. Third, manage the deal for what it is – manage partner as partner and vendor as vendor and never mix the two.

The telecom company failed in all respects, but especially in the third: They embarked on a partnership, but managed it like it was a vendor relationship. In this they are unfortunately not alone. Partnerships and alliances of all sorts frequently devolve into confrontational vendor-like transactions just when they most need the extra forbearance implicit in the partnership model.

Lessons from Alliance Strategy

We will borrow ideas from the field of alliance strategy to understand better what a "true partnership" is and how to manage it. The consensus among leading thinkers and practitioners in alliance strategy is that vendor deals and partnerships lie on a spectrum from short-term contracts with standardized and explicit terms, to longer-term relationships that are relatively open ended. The key is to choose the right structure for the task at hand, and then to manage it accordingly.

Spectrum of Relationships. Some transactions involve clear-cut deliverables and tasks that can be defined up-front. An example might be the supply of a standard component for a product or the performance of routine services, such as payroll processing. This type of agreement can be managed as a straightforward and well-defined contract.

At the other end of the relationship spectrum are tasks that involve a great deal of uncertainty around technologies, markets, timing, cost, and other features. This type of task lends itself to a more open-ended relationship that is more difficult to manage. Examples would be development of a new technology or provision of complex services, such as human resource planning and development.

In these latter situations, you need to create a governance structure that allows you the flexibility to go with the new information that you will gather over time. A flexible structure allows you to deal with things later that you cannot foresee now. This means also that partners meet more often to coordinate and make joint decisions; autonomous action by each party is bound to lead to waste or conflicts. Outsourcing relationships with these features can be classified as partnerships, though that does not guarantee that they will be managed as such. The telecom example cited above is a case in point: The goal called for a partnership, but management did not follow suit.

It is important to realize that the open-endedness of the relationship is not something you choose -- it is imposed on you by the task or goal at hand. If the task is not open-ended, you can define the requirements, timetable, milestones, payment and penalties clearly at the start of the project. If the task at hand is not well defined, then it is by nature open-ended and needs to be managed as such.

Between these two extremes there are numerous shades of gray along the spectrum. One project might have some amount of certainty, but there will be uncertainty around some aspect of the project such as usage, cost, or materials design, so that those particular aspects might need to be left open. This implies a governance structure that is characteristic of complex alliances. Some elements are nailed down clearly and others are left to be decided, but all of these are part of an over-arching "relational contract" that evolves to address new problems and opportunities over time.

Managing Partnerships. Not surprisingly, open-ended tasks require a great deal more relationship management than simpler contracts. You need to set, in the agreement, the way you will relate to each other, in addition to the things you expect each other to do. For example, firms with good alliance management have personnel assigned to monitor and coach each relationship, aside from business leaders responsible for results. They have systems for resolving potential conflicts with partners and encourage sufficient people-to-people contact to help in managing the flexible parts of the relationship.

Managing the relationship with the outside party is only one part of the equation; the other part is managing the outsourcing process *within* your own firm. This is critical as there is often an internal unit that may consider itself an alternative to the outside party, or even whose job is being replaced by outsourcing. Sometimes the internal unit is transferred lock-stock-and barrel to the outside party, as IBM did when it outsourced parts of its HR process to Fidelity. But at other times, internal interests have to be accommodated and involved for the outsourcing to succeed.

Successful firms recognize that it takes personnel, time, and investment to manage partnerships well. In a sense you have gotten rid of one management task, only to create a new one. In that sense, "outsourcing" can be a misleading term, making it sound like the task will be done on somebody else's watch. On the contrary, outsourcing of complex processes or project components typically requires a lot of management for it to work well, and to ensure that it is properly integrated into what the firm's operations.

Measuring Results. A frequent concern in relatively open-ended arrangements is that measuring results may be difficult. That is true, but again, it is in the nature of the task rather than a result of the governance choice.

Tasks that can be well-defined in advance usually produce results that are clearly measurable according to metrics that can likewise be defined in advance. Such tasks lend themselves to vendor-like outsourcing; an open-ended, partnership arrangement is not needed and, indeed, may be counterproductive.

In the 1990s, Chrysler had changed its supplier-relationship model from vendor to partnerships – increasing contract length, reducing numbers of suppliers, committing to joint management of engineering, and so on. This move yielded important benefits in product development as the suppliers now had greater incentives to contribute new ideas to Chrysler. For commodity components, on the other hand, this new model led to higher costs without commensurate gains in performance. After the merger with Daimler, this partnership program was scaled down substantially to save costs on standardized components.

But tasks that cannot be well-defined in advance often are indeed harder to measure. The purpose of measuring progress in these kinds of relationship is then twofold. First, the performance needs to be measured much as you would measure performance of an open-ended task within your organization, that is, with a flexible and adjustable measuring stick.

Second, the success of the relationship itself needs to be measured, or at least monitored. This helps reduce avoidable frictions between the partners. It is unavoidable that a partnership creates new uncertainties, in part because you can't fully control your partner's behavior. Good partnership management tries to lower the relationship risk, so that you can engage outsiders in tasks and projects that in themselves carry some technical or market risk.

By definition, partnerships cannot be maintained through the usual command and control structures that executives – and corporate lawyers -- frequently prefer. If you are not comfortable with this approach, then stick to narrower vendor-type relationships. But you will not get out of vendors what you might get out of a well-managed outsourcing partnership. Select the right tool for the job and learn to use it.

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