Resources for Growth

Today's world is a modular one, where joint ventures, alliances, pooling, shared services, offshoring and outsourcing are common tactics. Growth no longer requires optimally managing a firm's resources — it requires having access to competitive resources, internal or external, exclusive or shared.

DURING A DISCUSSION ABOUT OFFSHORING and outsourcing, one banking executive told us, "Look, my goal is not to shift the work to India. My goal is not to have the work at all." This simple but overlooked insight hints at the solution that will provide a select few of today's companies with the resources they need to grow and succeed. Traditional business optimization—finding a cheaper way to do the work—is not enough. Today's leaders must combine business optimization with strategic thinking to maximize a wide range of opportunities for every piece of a company's value chain.

In the case of the banking executive, he could have offshored his heaping pile of transactional work related to legacy applications, duplication as a result of acquisitions, and difficulty implementing new products and services on multiple systems. But he suspected bigger savings would come from transforming his business processes and applications to eliminate much of that work. Of course, this transformation could still involve sourcing from a low-cost country. But where to start and how? His dilemma represents a simple form of the new types of choices facing many companies—and the subject of this article.

The goal of every company is to boost growth and financial performance through better price, products or service. But two things have changed. First, the playing field for business optimization has expanded massively. If you do not consider optimization step changes—scaling up individual processes, relocating them, and fundamentally reengineering the configuration in which they operate—you are denying your company competitive advantage. Second, if you do not shop for such competitive resources directly, you are withholding your company from real freedom for strategy deployment.

A company's growth strategy must align with a resource strategy to fuel that growth. What are your competitive resources? Which ones belong on a resource shopping list? Which ones offer opportunities to grow into adjacent or new markets? In a modular world, the first step is to outline the required contributions of each part of the company's value chain.

The New Pastime of Resource Shopping

If you were starting a new company today, would you create something vertically integrated? Or would you seek to control only the most important parts of your value chain, complementing them with competitive external resources?

Even established companies regularly outsource support functions, including IT infrastructure, call centers and administrative processes. Now this practice is gaining momentum beyond supporting processes—driven from the perspective of business value. Do you want to distribute your product in a new geographic region? Then get a well-established joint-venture partner so you don't have to develop your own distribution capability. Need faster innovation? Get other companies to complement your R&D capabilities. Need to ramp up a new product? Get somebody else to produce it for you so you don't have to invest in additional capacity.

For example, one food manufacturer used the knowledge and expertise from a flavor supplier to rationalize its ingredient base into flavor and additive "modules" that provide specific tastes or textures. The result: savings for the manufacturer, additional sales for the supplier and, perhaps most important, faster time to market. Similarly, more than 35 percent of Procter & Gamble's new products contain

YOU CAN NO LONGER SIMPLY ASK how well your internal resources perform, **YOU MUST ASK IF OTHER FIRMS WOULD SELECT THEM** as complementary parts of their own value chains.

contributions from suppliers and third parties, representing billions in turnover. As P&G executives explained in a recent article, the key was to change philosophies from "Not Invented Here" to "Profoundly Found Elsewhere." And the reason to do so was that today's business environment requires more innovative power and speed than can be found within even P&G's company boundaries.[1]

What exactly is a competitive resource? Consider Amazon.com's state-of-the-art online presence. Over the years Amazon has invested an industry-leading amount of money to offer a wide product assortment to allow consumers to order, pay for, track, and have their goods delivered or downloaded—and to gain market intelligence from these transactions. The only thing left to improve was volume and scale. So Amazon offers its services to retailers and consumer goods manufacturers such as Nordstrom, Target, Polo Ralph Lauren, OshKosh B'Gosh and others. These companies rent space on Amazon's online shopping mall and gain access to huge numbers of online shoppers and efficient customer-facing operations. Similarly, Borders.com in the United States and Waterstone's in the United Kingdom have their own online presence, but they are "powered by Amazon.com"—they let Amazon handle inventory, fulfillment and customer service. Amazon gains by turning its unique strength into a new source of revenue and growth.

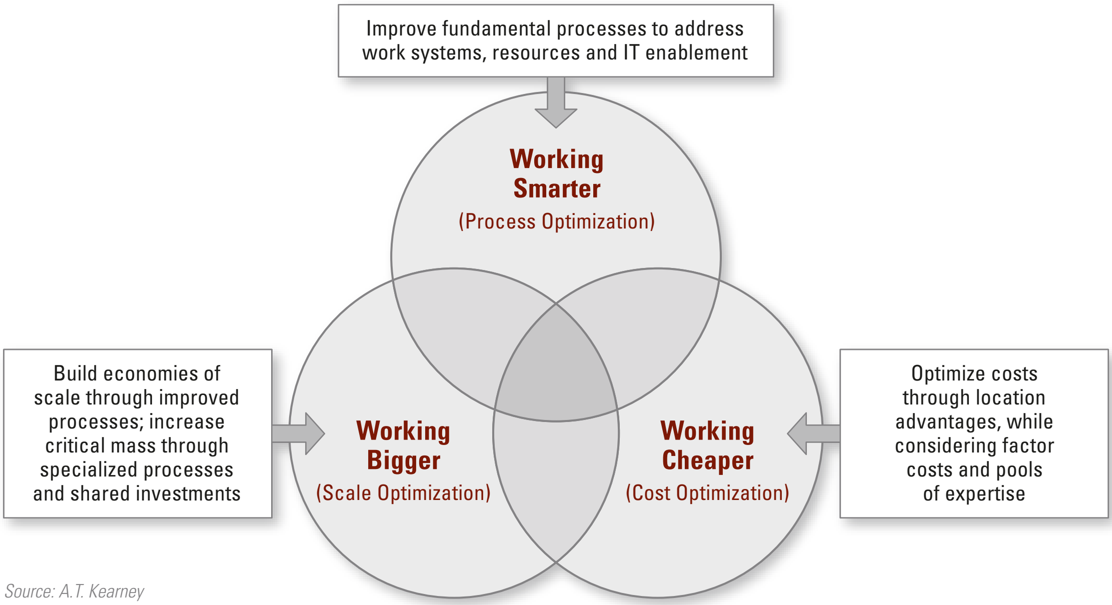
In other words, shopping for competitive resources doesn't just lower costs, it can also create business value. To take another example, consider Nike's partnership with Apple to create the Nike + iPod Sport Kit. The kit includes a computer chip that fits into the heel of certain Nike running shoes and a small wireless receiver that connects to Apple's iPod Nano. The Nano then tracks the time, distance and speed of each run and then sends it to a personalized page at Nike.com. By tapping into Apple's iPod technology, Nike has created the next must-have item for every runner, from the weekend warrior to the serious marathoner. Could Nike have created such a powerful offering in house? Perhaps, but certainly not with such speed or brand strength. The faster, more profitable route was to team up with Apple.

These are just two examples in a virtually endless list with implications not only for a company's growth strategy but also for how companies look at business improvement.

[1] *Larry Huston and Nabil Sakkab, "Connect and Develop: Inside Procter & Gamble's New Model for Innovation,"* Harvard Business Review, *Vol. 84, No. 3, March 2006.*

FIGURE 1

Three dimensions to business improvement



Source: A.T. Kearney

When you evaluate internal resources, you can no longer simply ask how well they perform as part of a vertically integrated value chain. You must ask if other firms would select them as complementary parts of their own value chains, which are in need of such resources. In short, you must ask how well they perform against what is ultimately possible for that resource. To answer that question, let's look at what can be done with individual pieces of the value chain.

Three Ways to Optimize Resources

Most companies know about the fundamental tactics to improve parts of value chains: business process redesign and automation, increased scale, and relocation. But as today's companies shake free from the vertical integration straightjacket, they must consider these tactics in more detail—and then prioritize them.

Recall the banker mentioned at the beginning of this article. He could offshore functions such as application maintenance, application design or basic transactional processes. He could offshore and then outsource them. Or he could redesign his business processes. Which form best suits his needs? As this question suggests, we can distinguish among three major dimensions of business optimization *(see figure 1).*

1. Working smarter. Business process transformation, as our banker suspected, can offer huge potential, due to technological advances, market changes, or acquisitions that have caused fragmented and inefficient processes. If you merely relocate or rescale such work without first addressing process inefficiencies, you may gain short-term savings but encounter a longer-term strategic blockage.

Companies require **SCANDAL-FREE EFFECTIVE ACCOUNTING,** but double scandal-free would have little influence on share price. **SO ACCOUNTING AND PAYROLL PROCESSING CAN GET OUTSOURCED.**

2. **Working cheaper.** Optimizing costs seeks to reduce labor expenses usually by relocating to lower-cost countries (LCCs). Labor costs here are not just limited to physical labor. For example, India matriculates more engineers every year than the total number of engineers employed in Silicon Valley in the United States and, as everyone knows, engineers in India work for a fraction of the cost.

3. **Working bigger.** Scale optimization can diffuse fixed costs across a larger base to achieve huge efficiencies and offer relief from one-size-fits-all processes by providing enough volume to accommodate different specialized processes. This final point requires further discussion—first, because it is important to analyze the scale sensitivity of different parts of the value chain, and second, because scale can be achieved in two ways:

Internally. Consolidation and integration (organic growth or mergers and acquisitions followed by properly integrating processes) can increase scale in strategically crucial processes, or those difficult to disentangle from the rest of the value chain. Wal-Mart in North America is a great example of gaining scale benefits through organic growth (leveraging fixed costs, increasing purchasing power and flexibility, and affording more specialization). As Wal-Mart's competitors seek similar scale benefits through M&As, they must first integrate the disparate processes of their acquired companies.

Externally. Outsourcing can create *non-proprietary* scale across multiple businesses. Outsourcing is the most appropriate strategy for processes that can be decoupled from the value chain relatively risk-free as well as for processes that are sufficiently generic to be standardized across multiple businesses. (Note that the scale benefits result from this standardization, not from having a third party operate your specialized process.)

Mix, Choose, Prioritize

To understand better how these business-improvement tactics interact, consider a company that manufactures plastic components and assembles them into its products. Nifty features of the plastic components allow the pieces to be snapped together in assembly, saving on labor costs, and allowing several component variations for each plastic injection mold. Because of these features, though, the molds are complex and expensive, so the company insists on high-quality, long-lasting molds to recoup its fixed costs. On the other hand, it means the company cannot easily change product designs or make smaller batches.

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Because manufacturing the molds is labor-intensive, the company could explore sourcing the molds from China or Eastern Europe. Lower-quality molds would be even more cost-effective and reduce the need for large batches. *But wait,* say the naysayers, *we need the high-quality complex molds.* Well, why? To save labor costs during assembly at high-cost locations. However, if the company shifts its assembly to a lower-wage country, the components can be screwed together rather than snapped together, eliminating the need for the complex, expensive molds. The result: lower labor costs and lower fixed costs, as well as higher transportation costs (a tradeoff we'll assume proves worthwhile). Without the expensive, complex, long-lasting molds, the company has flexibility to change its product designs over time, and has thus gained not just a cost advantage, but a strategic advantage.

Although opportunities like these abound, the difficult task is prioritizing them. Many executive boards are already tackling strategic questions from many directions: the IT director wants to outsource various processes; the R&D director has lined up co-development agreements for next-generation technologies; the manufacturing director wants to offshore processes to China. The supply chain director wants to pool the flow of goods with other companies to improve service levels. The sales director wants to sign distribution agreements for new markets. And, the head of strategy wants to leverage parts of the company's value chain in adjacent business segments with complementary partners.

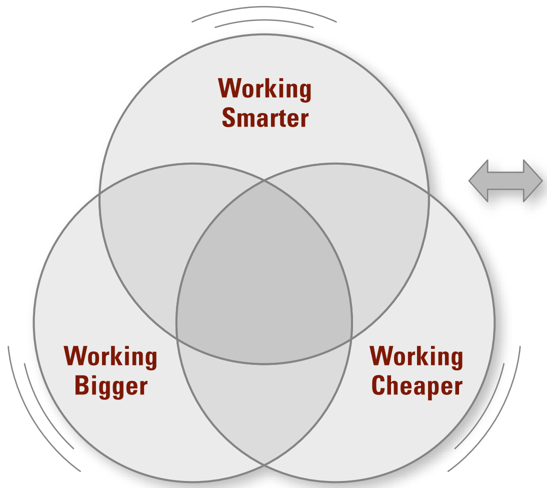
The board of directors is more than capable of evaluating these opportunities on a case-by-case basis. However, identifying all the relevant opportunities from a broader strategic perspective and then prioritizing them based on their likely value and ease of implementation requires a more structured approach.

A New Style for Your Business Optimization Agenda

Done it, seen it, tried it, you may be saying—and you're right. These individual business-optimization tactics are well tried and tested. What's new is scope: Each tactic can be executed with opportunities across all parts of the value chain, and so everything becomes relevant simultaneously. Since you can't address everything at once, there is increasing pressure to figure out what, how and when. This is where you need a new agenda for business optimization.

FIGURE 2

Three insights must come together for strategic business improvement



Resource Perspective

Determine relative importance of processes and activities (for example, whether scale can be pursued through outsourcing, insourcing, joint ventures or acquisitions)

Industry Perspective

Determine conditions under which optimization can be pursued

Company Strategy Perspective

Determine strategic choices with specific implications for the different parts of the value chain

Source: A.T. Kearney

In our experience, this requires insights in three interrelated areas—resources, industry characteristics and company strategy—to come together *(see figure 2)*.

The resource perspective. A resource analysis identifies those value chain parts with improvement potential and areas that can enhance competitiveness and growth. It should then explore if other businesses might be interested in those pieces of the value chain. So even the first step of the business optimization agenda can identify direct growth opportunities.

However, this analysis will probably identify more opportunities for business optimization and growth than can be handled simultaneously. This means prioritization is in order. Traditional prioritization filters—savings potential, size of the growth opportunity, expected ease of execution, and potential business risks—will no longer work. Because many of the contemporary business optimization opportunities are *strategic*—after all, they cut across business units and even company boundaries, changing the business configuration in the process—you will need more strategic filters. For example, you'll have to take into account industry and company perspectives to prioritize the opportunities and to create the right context to deploy the opportunities (in terms of organization, governance, control and performance management).

The industry perspective. Some parts of your value chain have more value than others. If you are in a commodity business you'd better have excellent feedstock sourcing and manufacturing capabilities. If you are in branded fast-moving consumer goods, you'd better have great brand equity, strong innovation capabilities and excellent trade leverage. In other words, your business determines the relative importance of your value chain parts. For example, Coca-Cola Corporation's value creation centers on brand equity. Thus Coke pays particular attention to merchandising the brand for things such as T-shirts. On the other hand, payroll processing and accounting play a much smaller role in Coke's value creation. Coke requires scandal-free effective accounting, but double scandal-free would have little influence on share price. So accounting and payroll processing can get outsourced.

While hardly rocket science, this sort of value-chain prioritization is a necessary process from which a company's leaders and managers can gain a shared vision of important resources and a comfort level to make decisions. This is especially true when the decisions shun short-term savings so to focus on longer-term investments. After all, despite the proven value of outsourcing non-crucial business capabilities, the efforts are not worthwhile if they distract management from more-crucial parts of the value chain. If outsourcing payroll processing distracted Coke from a major brand merchandizing opportunity, the company's potential value would suffer.

Interrelationships mean that many parts of a company's value chain cannot be optimized in isolation. Yet sometimes such interrelationships are used as an elaborate excuse for not wholeheartedly exploring internal and external opportunities—the lure of vertical integration is just too great. It helps systematically to identify and describe all the relevant interrelationships among all the different value chain parts. Although this will highlight numerous material interdependencies, the articulation can help define measures to accommodate such interdependencies or make them manageable in a (risk-) controlled manner.

These interdependencies, and the freedom to optimize individual parts of value chains, are influenced by the specifics of a company's winning recipe, which brings us to the next perspective.

The company strategy perspective. Brand equity is crucial to most companies in fast-moving consumer goods. But one company may build brand equity by bringing innovations to market ahead of the competition, while another might bring superior product quality, or the most fashionably packaged products. These are strategic choices, with specific implications for each part of the value chain. For example, an innovation strategy requires seamless interaction among development, production and marketing—most likely at the expense of competitive costs.

Pinpointing these requirements provides a clear set of criteria against which all business improvement efforts and growth opportunities can be evaluated. The requirements that have the greatest impact on the crucial parts of the value chain should immediately jump to the front of the line in terms of importance.

Integrating the Perspectives

Rethinking value chain configurations is part art, part science. Identifying broad improvement opportunities will come from the insights gained from assessing each individual piece of the value chain.

Consider the apparel industry. For decades, apparel companies have sourced both fabric and garment manufacturing from low-cost countries. Today, many large apparel companies also continually optimize their entire network of fabric mills and garment manufacturers to ensure a competitive offering. A typical company first designs or decides on the ranges for a specific season, decides on quantities and sizes, and then sources these products from manufacturers. It's not easy. Because this cycle takes three months, apparel companies must get their planning absolutely right. Underestimates lead to lost sales opportu-

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nities and dissatisfied consumers. (Consumers will not necessarily switch to another style of clothing just because the one they fancy most has sold out.) Overestimates lead to surpluses that must be discounted at the end of the season.

Spain-based Zara Clothing chose an alternative value-chain configuration to support its unique strategy of "Fast Fashion." Acknowledging that the planning challenge is mainly brought about by the long delivery cycle, Zara set out to create a configuration with a much shorter cycle. Its goal: to optimize the mix of garments sourced and manufactured during the season, thus eliminating inventory and surplus costs, and allowing it to respond quickly to the latest trends. Small production runs also assure shoppers that they won't be seeing mirror images of their outfits around every street corner.

This competitive strategy had huge implications for Zara's value-chain configuration and, thus, its business-optimization opportunities. The short delivery cycles require fabrics to be kept in stock close to Zara's main markets in Europe. Short cycles also require access to garment manufacturing capacity in Spain (again, to be close to its markets in Europe). In addition, smooth and integrated management of the supply chain from fabric sourcing to the shelf is the business capability that drives Zara's value potential.

The Real Challenge

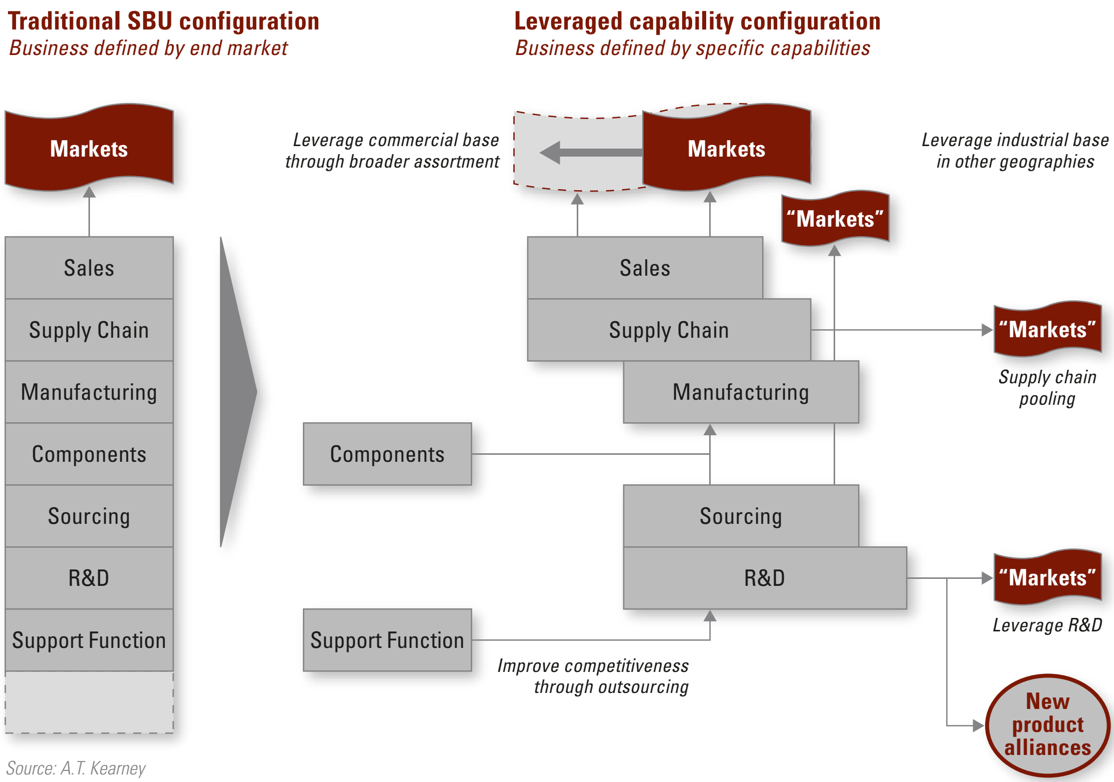
Perhaps the biggest challenge of this new style of business optimization is that it requires a different perspective: considering not only the resource at hand but also a bigger strategic picture, and considering not only an optimization tactic but also the optimal mix of tactics.

To bring about such sea changes, there's nothing like a bit of economic adversity, as the airline industry demonstrates. Since the 2001 downturn, most airlines have been obsessed with cutting costs, with aircraft maintenance a big target cost-reduction area. Since 2001, a substantial part of aircraft maintenance has been outsourced and offshored (or nearshored) to tap into lower labor costs—until recently. Aircraft maintenance plants at both United Airlines and American Airlines in the United States are now insourcing from other airlines.

For both airlines, the eve of another round of outsourcing and relocation prompted a realization: If there's anything airlines like more than cost reduction, it's having aircraft in the air. After all, planes can serve as resources for growth only when they're flying. Surely airlines would put a premium on shorter maintenance

FIGURE 3

Transformation from vertical integration to resources for growth



Source: A.T. Kearney

turn times—a premium that could compensate for the higher labor costs of sourcing maintenance operations in the higher-cost countries where most of the planes fly. So what if maintenance focused not on cost reduction but on shorter turn times?

American and United discovered strategic value. The maintenance units at both companies substantially cut turnaround times by finding smarter ways to do their jobs. They have been so successful—cutting days or weeks from the time required for certain activities—that they freed up capacity to sell externally, charging 30 percent more than offshore competitors to compensate for higher labor costs. United, for example, saw its external maintenance revenues grow from $100 million in 2004, to $180 million in 2005, to an expected $257 million in 2006.[2] While keeping the total number of employees the same, this represents an attractive cost reduction in itself.

Where Does This Leave Us?

This all sounds a bit farfetched, you may be saying, and I think I'll just wait to see

[2] *James W. Ramsey, "United Airlines: Reinventing Support Services,"* Aviation Today, *1 November, 2005; Kevin Allison, "Tulsa teaches U.S. how to fly — American Airlines has rewritten the book on aircraft maintenance,"* Financial Times, *7 September 2005.*

what happens. After all, today's predominant organizational structure—the strategic business unit—provides a very comfortable home. But we believe that wait-and-see is a poor recipe for success because both the opportunity and the freedom for business optimization have never been greater. You will have to address them sooner or later. Yet because the new style of business optimization will take time and effort, you need to plan for it in advance, so to focus on genuine opportunities rather than irrelevant tangents. If you must wait and see, we ask that you at least view the business world with the right business optimization glasses so that you see the right picture.

We'll leave you with one final example: small domestic appliances. Although most firms in this industry have been very vertically integrated, organized by business unit, this is no longer the case. Today these companies are being transformed to pursue new business optimization opportunities throughout their value chains. Consider some of their favored tactics:

- Leveraging strong brand and distribution power by selling products made by third parties (often players in other geographic regions)
- Leveraging high-fixed-cost industrial set-ups by producing appliances to be sold by others (again, often players in other geographic regions)
- Sharing component-manufacturing operations, even through joint-venture factories
- Optimizing distribution by pooling with companies that make products other than small appliances, but have similar routing needs
- Employing outside designers such as Alessi, Pininfarina and Porsche Design to get more brand support from existing R&D resources

This new firm is a very different animal to manage, drawing heavily on new organizational and entrepreneurial concepts *(see figure 3)*. What is clear is that this transformation will take time, which is all the more reason to have a solid plan for where and how to begin turning your company's optimization potential into bite-sized, prioritized and value-creating initiatives. ea

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