Outsourcing has become strategic—yet many executives remain unprepared. A new era of capability sourcing will trigger organizational redesign and require a new set of managerial skills.

**Strategic Sourcing**
**From Periphery to the Core**
by Mark Gottfredson, Rudy Puryear, and Stephen Phillips

For years, "sourcing" has been just another word for procurement—a financially material, but strategically peripheral, corporate function. Now, globalization, aided by rapid technology innovation, is changing the basis of competition. It's no longer a company's ownership of capabilities that matters but rather its ability to control and make the most of critical capabilities, whether or not they reside on the company's balance sheet. Outsourcing is becoming so sophisticated that even core functions like engineering, R&D, manufacturing, and marketing can—and often should—be moved outside. And that, in turn, is changing the way firms think about their organizations, their value chains, and their competitive positions.

Forward-thinking companies are making their value chains more elastic and their organizations more flexible. And with the decline of the vertically integrated business model, sourcing is evolving into a strategic process for organizing and fine-tuning the value chain. The question is no longer whether to outsource a capability or activity but rather how to source every single activity in the value chain. This is the new discipline of "capability sourcing."

Perhaps the best window on the new sourcing landscape is a handful of vanguard companies that are transforming what used to be purely internal corporate functions into entirely new industries. Firms like United Parcel Service in logistics management, Solectron in contract manufacturing, and Hewitt Associates in human resource management have created new business models by concentrating scale and skill within a single function. As these and other function-based companies grow, so does the potential value of outsourcing to all companies.
It's not always obvious which functions have the most potential for developing scale and skill. Virgin, for instance, has successfully extended its brand management capabilities from planes and trains to music, mobile phones, personal finance, and even bridal wear. And you might still think of Nike as a sneaker and sportswear company. But as it lends its brand and merchandising expertise to an increasing array of products—from golf instruction centers to MP3 players to eyewear—it's evolving into a focused provider of marketing services to other companies.

Migrating from a vertically integrated company to a specialized provider of a single function is not a winning strategy for everyone. But all companies need to rigorously assess each of their functions to determine in which they have sufficient scale and differentiated skills and in which they don't. Greater focus on capability sourcing can improve a company's strategic position by reducing costs, streamlining the organization, and improving quality. Finding more-qualified partners to provide critical functions usually allows companies to enhance the core capabilities that drive competitive advantage in their industries.

Yet despite the enormous opportunities available through capability sourcing, our research indicates that many executives remain unprepared for this transformation. A recent Bain survey of large and medium-sized companies reports that 82% of large firms in Europe, Asia, and North America have outsourcing arrangements of some kind, and 51% use offshore outsourcers. But almost half say their outsourcing programs fall short of expectations, only 10% are highly satisfied with the costs they're saving, and a mere 6% are highly satisfied with their offshore outsourcing overall.

The reason these efforts often fail to measure up to expectations, even purely in terms of cost savings, is that most companies continue to make sourcing decisions on a piecemeal basis. They have not put hard numbers against the potential value of capability sourcing, and they've been slow to develop a comprehensive sourcing strategy that will keep them competitive in a global economy. To realize the full potential of sourcing, companies must forget the old peripheral and tactical view and make it a core strategic function.

In this article, we'll describe how and why the role of sourcing is changing in the twenty-first-century economy and lay out a practical strategic framework to guide companies through the transition.

The Changing Basis of Competitive Advantage

For over a century, companies competed on the basis of the assets they owned. AT&T, with its direct control of the American telephone network; Bethlehem Steel, with its large-scale manufacturing plants; and Exxon, with its vast oil reserves, each dominated its respective industry. But in the 1980s, the basis of competition began to shift from hard assets to intangible capabilities. Microsoft, for example, became the de facto standard in the computing industry through its skill in writing and marketing software. Wal-Mart transformed retailing through its proprietary approach to supply chain management and its information-rich relationships with customers and suppliers.
A similar shift occurred in the worldwide auto industry. When U.S. automakers began losing market share to Japanese companies, they were forced to confront a growing gap in both cost and quality. Recognizing that upstream component quality was critical to their end product and seeing the success of the Japanese keiretsu model of networked suppliers, the Big Three began to move design, engineering, and manufacturing work to specialized partners. They hammered out strategic sourcing relationships for complex subassemblies.

It’s no longer ownership of capabilities that matters but rather a company’s ability to control and make the most of critical capabilities.

But as computers automated transaction processing, the economies of scale grew significantly, and individual issuers started to pool their transactions to drive down costs. The industry began to separate into those companies that issued cards and managed customers, on the one hand, and those that processed transactions, on the other, as transaction-processing underwent rapid commoditization.

For example, despite having enviable scale in its own transaction-processing operations, American Express, in a prescient strategic move, spun off its transaction-processing business in 1992. Then the company negotiated a long-term service contract with the newly independent entity, First Data. Although Amex executives considered transaction processing a strategic capability—without reliable and efficient processing, it was very difficult to make money in the credit card business—they also saw that commoditization was eliminating any proprietary advantage. As a spin-off, First Data could aggregate Amex’s volume with that of other companies (issuing banks would have been reluctant to outsource processing to Amex as a competitor). In that way, American Express could gain additional scale advantages while ensuring long-term cost effectiveness. Going forward, Amex was able to focus on the issuing side of the credit card business and enhance its core capabilities in marketing and risk management.

The decisions Chrysler and American Express made required them to challenge one of the basic tenets of business strategy: that you should always keep strategic capabilities within your walls. As globalization and technology transform more industries, all companies will eventually have to let go of that comfortable but simplistic guideline. A series of geopolitical, macroeconomic, and technological trends has opened the world’s markets, made business capabilities much more portable, and produced a level of discontinuity that has no precedent in modern economic history. These events include the fall of the Berlin wall, China’s embrace of capitalism, the advent of worldwide tariff reduction agreements, and the spread of cheap, accessible telecommunications infrastructure. In the new era of capability sourcing, companies’ value chain decisions will increasingly shape their organizations and determine the kinds of managerial skills they need to acquire and develop in order to survive amid increasingly fluid industry boundaries.

**Capability Sourcing at 7-Eleven**

To illustrate the power of capability sourcing, let’s take a detailed look at one dramatically successful practitioner, which began as a most traditional, vertically integrated company.

Back in 1991, when 7-Eleven’s current CEO Jim Keyes was named vice president of planning and chairman of the executive committee, the retailer was losing both money and market share. As the major oil companies added mini-marts to more and more of their gas stations, the convenience store industry was becoming crowded and cutthroat, putting both revenue and margins under intense pressure. To attract...
more customers, 7-Eleven needed to cut its operating costs substantially, expand the range of its products and services, and increase the freshness of food items.

Keyes launched a business review aimed at tightening operations, rebuilding competitive advantage, and perhaps divesting a few noncore businesses. The deeper he and his team got, however, the more apparent it became that 7-Eleven was trying to do too many things and was not good enough at any of them. The core of the business, Keyes believed, was merchandising skill—the pricing, positioning, and promotion of gasoline, ready-to-eat food, and sundries for consumers driving cars. But 7-Eleven had always been vertically integrated, controlling most of the activities in its value chain. The company operated its own distribution network, delivered its own gasoline, made its own candy and ice. It even owned the cows that produced the milk it sold. Managers were required to do lots of things other than merchandising—store maintenance, credit card processing, payroll, and IT systems management. Keyes found it hard to believe that the company could be best-in-class in every one of those functions.

As part of his initial assessment, Keyes studied the company’s highly successful Japanese unit, whose keiretsu model of tight partnerships with suppliers was unique within 7-Eleven. By relying on an extensive and carefully managed web of suppliers to carry out many day-to-day functions, the Japanese stores were able to reduce their costs and enhance the quality of their operations, spurring rapid growth and strong profits. After considering many options, Keyes concluded that the best way to save the U.S. company was to adopt the Japanese model. The goal he set was to “outsource everything not mission critical.” This marked an abrupt and deliberate break with the company’s vertically integrated past.

All activities were on the table. Keyes’s team even evaluated strategic functions such as product distribution, advertising, and procurement, attempting to identify outside partners with greater expertise and scale. Simply put, if a partner could provide a capability more effectively than 7-Eleven could itself, then that capability became a candidate for outsourcing. Over time, the company relinquished direct ownership of many parts of its business, including HR, finance, IT management, logistics, distribution, product development, and packaging. Yet despite moving at a rapid pace, Keyes remained cautious about losing control and avoided the temptation to take a one-size-fits-all approach to outsourcing.

The way 7-Eleven has structured each partnership depends on how important each function is to the company’s competitive distinctiveness. For routine capabilities like benefits administration and accounts payable, 7-Eleven picks providers that can consistently fulfill cost and quality requirements. More strategic capabilities require more complex arrangements. Gasoline retailing, for example, represents an important source of revenue for many 7-Elevens, as gas is often the reason customers come to the stores. So while the firm outsources gasoline distribution to Citgo, it maintains proprietary control over gas pricing and promotion—activities that could differentiate its stores if done well.

The company has paid similarly close attention to its relationship with Frito-Lay, since snack foods are one of the most important product lines for convenience stores. By allowing Frito-Lay to distribute its products directly to the stores, 7-Eleven has been able to take advantage of the chip maker’s vast warehousing and transport system. But unlike other convenience store companies,

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**The Endgame: Dynamic Sourcing**

GIVEN THE RAPIDLY SHIFTING CONTOURS of the global economy, companies need to be able to anticipate changes in the economics and geography of outsourcing. It wasn’t long ago, for example, that most big companies had to own their own warehouses and operate their own distribution systems. Third-party logistics specialists had neither the skill nor the scale to handle those functions. But today, suppliers like UPS and FedEx are competing fiercely to offer full-service logistics networks, and even the largest companies can now outsource warehousing, distribution, and related activities. Such trends will only accelerate in the future, and those companies that have recognized and prepared for them will be the first to capitalize on them.

So, to ensure that it doesn’t quickly become obsolete, a sourcing strategy needs to consider not only present circumstances but also future alternative scenarios. What trends will influence the sourcing options available for each key capability? Is the supplier base growing rapidly, and are innovative new outsourcers emerging? Are different regions of the world investing heavily in particular capabilities—like contract manufacturing or customer service—and will they offer greater cost or quality advantages in the future? The answers to such questions may encourage a company to pursue certain sourcing opportunities that might not be highly attractive based on current numbers but could offer dramatic benefits in the coming months and years. Or they may lead a company to negotiate short-term sourcing contracts to keep options open, rather than enter into long-term relationships. Ultimately, a company’s skill in quickly remolding its sourcing arrangements in response to market conditions and rivals’ moves may be its strongest competitive advantage.
7-Eleven doesn’t allow Frito-Lay to make critical decisions about order quantities or shelf placement. Instead, the retailer mines its extensive data on local customer purchasing patterns to make those decisions on a store-by-store basis.

The choice 7-Eleven has made to maintain control over product selection and stocking illustrates a critical issue in strategic sourcing partnerships: when to keep vital data confidential and when to share them with a partner. Similarly key was 7-Eleven’s decision to rely on an outside vendor, IRI, to maintain and format detailed customer purchasing behavior data while keeping the data themselves proprietary. This gives 7-Eleven a picture of the mix of products its customers want in different locations without relying on outside decision makers like Frito-Lay for such information. In this way, 7-Eleven is able to structure its supplier relationships to gain a capability without relinquishing control over decisions that could make or break its business.

For a few targeted product segments, 7-Eleven has identified opportunities that call for an even deeper level of collaboration. Company executives figured out that their traditional, do-it-yourself approach to creating branded products was cutting the company off from the superior scale, resources, and creativity of major food suppliers. So they began sharing information with a select group of manufacturers, allowing them to create custom products for 7-Eleven stores. For example, 7-Eleven worked with Hershey to develop an edible straw based on the candy maker’s popular Twizzler treat. In return, Hershey gave 7-Eleven the exclusive right to sell the straw for its first 90 days on the market. To further promote the unique product, 7-Eleven joined with its syrup supplier, Coca-Cola, to come up with a Twizzler-flavored version of its proprietary Slurpee drink. Such exclusive arrangements reduce the strategic risk of sharing customer information while greatly expanding the set of unique products 7-Eleven can offer.

Likewise, when the data on beer sales showed that certain packaging options were more successful than others, 7-Eleven forged a tight partnership with Anheuser-Busch to build sales in those categories. Anheuser-Busch helped 7-Eleven develop a product assortment and establish merchandising standards for a new display. The beer giant also agreed to give 7-Eleven first-look opportunities at new products. In return, 7-Eleven shares its customer information so together the two companies can develop innovative marketing programs, such as a cobranded NASCAR promotion targeting 7-Eleven’s core customers and a Major League Baseball promotion campaign. Anheuser-Busch is also using 7-Eleven store data, provided daily by IRI, to test a new ordering forecasting system that would link the retailer’s orders more tightly with deliveries from the brewer’s wholesalers.

In addition to restructuring and enhancing existing activities, 7-Eleven has used creative sourcing partnerships to pioneer entirely new capabilities. It realized, for example, that by being a one-stop source for a broad range of products and services, it could gain a leg up on more narrowly focused competitors. So it has set up a consortium to provide multipurpose kiosks in its stores. American Express supplies ATM functions, Western Union handles money wires, and CashWorks furnishes check-cashing capabilities, while EDS integrates the technical functions of the kiosks. Here too, 7-Eleven maintains control over the data—in this case, information on how customers use the kiosks—which it views as critical to its competitive edge.

Some of 7-Eleven’s outsourcing relationships tie suppliers’ financial interests to its own. The company took an equity stake in Affiliated Computer Services, for instance, one of its major IT outsourcers. 7-Eleven also agreed to share productivity gains from a services agreement with Hewlett-Packard. In an even deeper collaboration, the company created a joint venture with prepared-foods distributor E.A. Sween: Combined Distribution Centers (CDC) is a direct-store delivery operation that supplies 7-Elevens with sandwiches and other fresh goods. By drawing on the skills and scale of a specialist, 7-Eleven was able to

The Measure of Success

For 7-Eleven, strategic sourcing has translated into industry dominance. In the past two years, the mini-mart retailer has led all major rivals in same-store merchandise growth, inventory turn rate, and revenue per employee.

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<tr>
<th>Same-Store Merchandise Sales Growth</th>
<th>Merchandise Inventory Turns</th>
<th>Merchandise Sales Per Employee</th>
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<tr>
<td>6.6%</td>
<td>38.3</td>
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<td>3.5%</td>
<td>22.2</td>
<td>$95K</td>
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Sources: Annual and quarterly SEC filings

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cut its distribution costs from more than 15% of revenues to 10% and eventually hopes to cut that figure in half again. But cost reduction is only a secondary benefit. The real gains have come in service. When it owned its own distribution network, 7-Eleven delivered fresh goods to its stores only a couple of times a week. CDC now makes deliveries to stores once, and soon twice, a day. More frequent deliveries mean fresher products, which draw more customers into the stores.

By almost any measure, 7-Eleven's sourcing strategy has transformed the company. In narrowing its focus to a small, strategically vital set of capabilities—in-store merchandising, pricing, ordering, and customer data analysis—the company has reduced its capital assets and overhead while streamlining its organization. It reduced head count 28% from 43,000 in 1991 to 31,000 in 2003 and flattened its organizational structure, cutting managerial levels in half from 12 to six.

Today, 7-Eleven consistently outperforms competitors. Same-store sales have grown in four out of the last five years. In the past two years, it has dominated the industry's vital statistics, with same-store merchandise growth at almost twice the industry average, revenue per employee at just about two-and-a-half times higher, and inventory turns at 72% more than the industry average. (See the exhibit "The Measure of Success"). Furthermore, after its acquisition of two regional U.S. chains (Christy's Markets in the Northeast and Red D Mart in the Midwest), the firm's new business model helped grow sales by more than 30% and increase gross profit margins by 2%. 7-Eleven's stock appreciation over the past five years has outpaced all major competitors, including Casey's General Stores, the Pantry, and Uni-Mart.

Should you always keep strategic capabilities within your walls? As globalization and technology transform more industries, all companies will eventually have to let go of that comfortable but simplistic guideline.

A Framework for Capability Sourcing

As companies like Chrysler, American Express, and 7-Eleven have discovered, a strategic approach to sourcing can dramatically improve your company's competitive position. So how do you make something that's always been tactical more strategic? You need to stop focusing on incremental cost improvement targets, step back, and reevaluate your strategy and your capabilities. In working through this process with clients, we've found that three steps can ensure that decisions are made objectively and are based on facts.

The first step is to identify the components of your business that represent the core of the core. These are the activities that your company does better and cheaper than its rivals. For 7-Eleven, the core of the core is in-store merchandising and product ordering. For drug maker Pfizer, it's developing and marketing pharmaceutical compounds. For American Express, it's identifying customer segments and creating card offerings tailored to them. Everything else exists to support the core of the core.

In deciding what to outsource and what to keep inside, 7-Eleven considered two factors: whether a capability was proprietary and whether it was common enough that outside suppliers could achieve scale or other advantages by supplying it to multiple companies. To determine proprietary value, executives asked themselves two questions: Did 7-Eleven carry out the capability in a way that generated measurably more value than its competitors could deliver? And would the company suffer a high degree of strategic damage if rivals could imitate that capability? To deter-
What Should You Outsource?

Using this sourcing opportunities map, you can determine which functions have the highest outsourcing potential and which should remain under your company’s control. The vertical axis measures how proprietary a capability is for your company. The horizontal axis plots how common the capability is within or outside your industry. The less proprietary and the more common a function is, the stronger a candidate it is for outsourcing.

How Strong Are Your Capabilities?

Once you’ve determined which capabilities offer the highest potential value from outsourcing, you need to see how well, and how efficiently, your company currently performs each one of them. This exercise may surprise you: If your cost per transaction is low enough and your quality high enough, you should be thinking of selling that function as a new business in itself.
mine commonality, they had to look outside their company—even outside their industry. They tried to identify capabilities in which outside suppliers were building scale across their industry, or across several industries, because these common business processes or capabilities could pose an immediate or future threat to 7-Eleven’s cost position.

By plotting each of your required capabilities on a sourcing opportunities map like the one in the exhibit “What Should You Outsource?” you can judge the relative merits of your company’s outsourcing possibilities. The vertical axis of the map measures how proprietary a process or function is; the horizontal dimension assesses the degree of commonality, both within and outside your industry. Capabilities that fall in the upper right portion of the map are strong candidates for outsourcing. Those that appear in the lower left section are potential prospects for captive sourcing. Such capabilities may even be candidates for “insourcing”—that is, if you determine that your company is really the best at a given function, you may have an opportunity to perform this function for other companies. One example of successful insourcing is FedEx, which plans and manages inbound transportation for more than 1,500 product suppliers into 26 General Motors power train facilities. This capability puts FedEx at the leading edge of the $225 billion logistics-outsourcing industry.

Opportunities that fall in the middle of the sourcing opportunities map generally require more detailed analysis of both your company and your industry. You will need to consider such factors as regulation, standards, and alternative products to figure out what will happen to those capabilities in the future. To provide a quick sense of the relative financial stakes involved, and highlight the biggest opportunities, the sourcing opportunities map should be populated with bubbles scaled to represent the cost dollars at stake for each capability.

Once you’ve discovered which capabilities promise high potential for alternative sourcing, the next question is: How should you source them? You need to figure out how your capabilities stack up to what’s required. Do you meet, exceed, or fall short of cost and quality requirements? A capability assessment map like the one in the exhibit “How Strong Are Your Capabilities?” plots each capability according to its cost and quality relative to top-performing competitors or suppliers. This map will help you determine which key capability gaps your company needs to fill. Perhaps equally important, it will identify any current activities that you could perform with less rigor without incurring any strategic penalty.

7-Eleven had always been a vertically integrated company, delivering its own gasoline, making its own candy and ice. It even owned the cows that produced the milk it sold.

Where capabilities fall on this grid establishes appropriate goals for an outsourcing relationship. Functions that fall, for instance, in the upper left (relatively high-cost functions whose quality levels exceed requirements) should be outsourced to low-cost providers—even if it means a reduction in quality. Capabilities that fall in the lower left (high-cost functions performed relatively poorly) require outsourcing partners that can both reduce costs and improve quality. The capability assessment map also gives you another way to identify insourcing opportunities. Capabilities that fall in the upper right (low-cost, high-quality functions) could become the basis for attractive new businesses. Following the first two steps of our framework can help you determine what type of control you need over each of your capabilities. The third step is a kind of reality check in which you determine whether a capability that is a strong candidate for strategic sourcing can be carried out at a distance without any loss of quality.

The issue of physical proximity may not seem very strategic, but globalization and advances in technology ensure that it’s a constantly moving target. For many functions, including transaction processing, design, engineering, and customer service, the Internet and an increasingly sophisticated telephone infrastructure have made physical proximity much less relevant, at least from a cost perspective. The necessary information and outputs can be transferred electronically at high speed and low cost. For tangible products that must be shipped, however, proximity plays a large role in both cost and timeliness considerations; it may not be feasible to manage the movement of such products from afar. There may also be customer service constraints. Certain product development, sales, and service tasks, for example, may require local interactions. Capabilities that do not require physical proximity are good candidates for offshore, whether through a traditional outsourcing arrangement or, for proprietary capabilities, through a captive operation.

If you go through this three-step analysis, your company should have the outline of a comprehensive capability sourcing strategy. You will know which capabilities you need to own and protect, which can be best performed by what kind of partners, and how to structure a productive relationship. Formulating the strategy is, of course, only the first stage of a sourcing effort: Partners then have to be chosen, contracts negotiated, and management structures established and monitored. As 7-Eleven found, the success of the strategy often hinges on the creativity with which partnerships are organized and managed. But only by first taking a broad, strategic view of capability sourcing can your company make the most of its sourcing choices.

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