

THE WHY STRATEGY: INCENTIVES ALIGNMENT

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SC CONTRACTS FOR COORDINATION

- ▶ Wholesale price contract
- ▶ Buy-back contracts
- ▶ Quantity discounts
- ▶ Option contracts
- ▶ Revenue-sharing contracts

SUPPLIER-SIDE: ALTERNATIVE SOURCING STRATEGIES

- ▶ Make (Vertical Integration)
 - ▶ Produce inputs in-house
 - ▶ A captive production facility
 - ▶ Examples: Oil Refineries with dedicated oil fields; Pit-head Thermal Power Plants

- ▶ Buy from Spot Market (Short Term Contracts)
 - ▶ Source product from a spot market.
 - ▶ Compare, evaluate and select between alternate suppliers on a continual basis.
 - ▶ E-procurement, Procurement Auctions, Spot market purchases
 - ▶ Internet enabled price discovery mechanisms have made this much more common
 - ▶ Common in US Manufacturing

- ▶ Buy (Long term relationships)
 - ▶ Designate a supplier. Source from the same supplier again and again.
 - ▶ Contract terms may vary with time.
 - ▶ Relationship specific investments are often made.
 - ▶ Cross ownerships, integrated ERP systems, embedded employees.
 - ▶ Common in Japanese Manufacturing.

WHAT ARE THE PROS/CONS OF SHORT-TERM RELATIONSHIPS?



"I LIKE A MAN OF FEW WORDS.
'I DO' WOULD BE ENOUGH FOR ME."

AN INSIGHT FROM GAME THEORY – PRISONER'S DILEMMA

Two members of a criminal gang are arrested and imprisoned. Each prisoner is in solitary confinement with no means of communicating with the other. The prosecutors lack sufficient evidence to convict the pair on the principal charge, but they have enough to convict both on a lesser charge. Simultaneously, the prosecutors offer each prisoner a bargain. Each prisoner is given the opportunity either to *betray* the other by testifying that the other committed the crime, or to *cooperate* with the other by remaining silent.

The offer is:

- If A and B each betray the other, each of them serves two years in prison
- If A betrays B but B remains silent, A will be set free and B will serve three years in prison (and vice versa)
- If A and B both remain silent, both of them will only serve one year in prison (on the lesser charge).

**Prisoner's dilemma payoff
matrix**

A \ B	B	
	B stays silent	B betrays
A stays silent	-1, -1	0, -3
A betrays	0, -3	-2, -2

WHEN DO LONG TERM RELATIONSHIPS WORK?

- ▶ These contracts can achieve the best of both worlds! But there are certain conditions to make this all work.
- ▶ Long Term Relationship if executed correctly, can get all the benefits of buying and mitigate most of the downsides.

When the benefits of a relationship will only be realized in the long-run, make your relationships also have the same time horizon (duration)

ALIGNING INCENTIVES

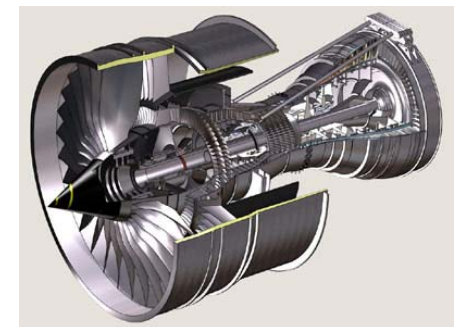
ALIGNING TIME HORIZONS

ALIGNING PAYMENT STRUCTURES

ROLLS ROYCE : POWER BY THE HOUR



- ▶ A typical relationship: Time & Materials Contract (pay per repair)
- ▶ Incentive problems:
 - ▶ The supplier (Rolls Royce) wants more repairs.
 - ▶ The customer (airline) faces all the risks associated with engine breakdowns and wants fewer repairs.
 - ▶ The customer's costs are unpredictable.
 - ▶ The customer is forced to buy spare parts while what it wants is the working engine.
- ▶ The alternative: Power-By-The-Hour contract
 - ▶ Pay per flying hour.
 - ▶ Ensure predictable costs.
 - ▶ Both parties have the same incentives.
 - ▶ Rolls-Royce takes over the risk of break-downs but it is better positioned to handle it!



SERVICIZATION



THE INNOVATION

- ▶ Rather than sell the product, Sell the service that the customer cares about...
- ▶ Offer “Power by the hour” Style contracts; lease instead of sale
- ▶ Increases Revenues and Increases Risk Exposure, Risk is borne by Party that can best manage it.

WORKS BEST WHEN

- ▶ Customers do not want to own assets, but only want service
- ▶ Customers don't want to bear risk of asset productivity.
- ▶ You can bear the risk better– Risk Pooling, Private Information, Aligned Incentives

THE COMMON THREAD?



WHY DECISIONS

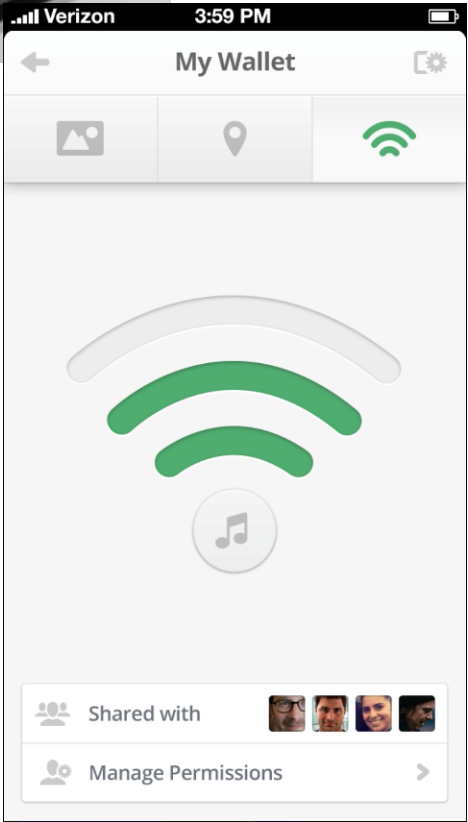
THE INCENTIVES

*Change
Revenue streams
Align Time Horizons*



CHANGING WHY DECISIONS ARE MADE

WHY INNOVATION IN ACTION

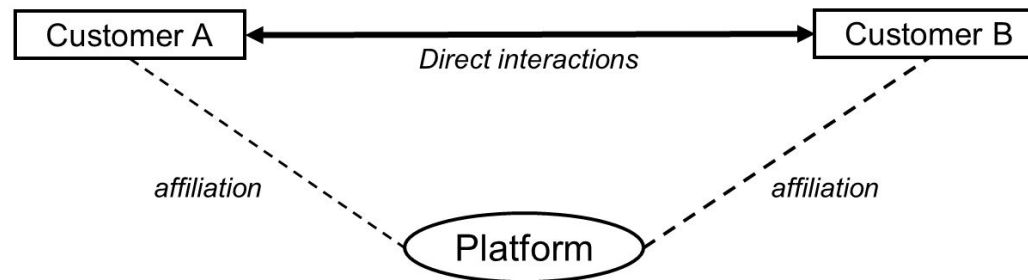


KEY LESSONS

- ▶ *WHY: Align the incentives!*
 - ▶ *Change the revenue model (e.g. auctions vs. contracts)*
 - ▶ *Align decision horizons (short-term or long-term?)*
 - ▶ *Centralize decision-making*
- ▶ *Wholesale, revenue-sharing, risk-sharing contracts*

WHY!

PLATFORM OPERATIONS



DISINTERMEDIATION - WHY DO INTERMEDIARIES EXIST?



THE INNOVATION

- ▶ Cut out sales channel— Sell Direct or through alternate channel
- ▶ Increase Revenues and Reduce Risk Exposure to others' actions

WORKS BEST WHEN

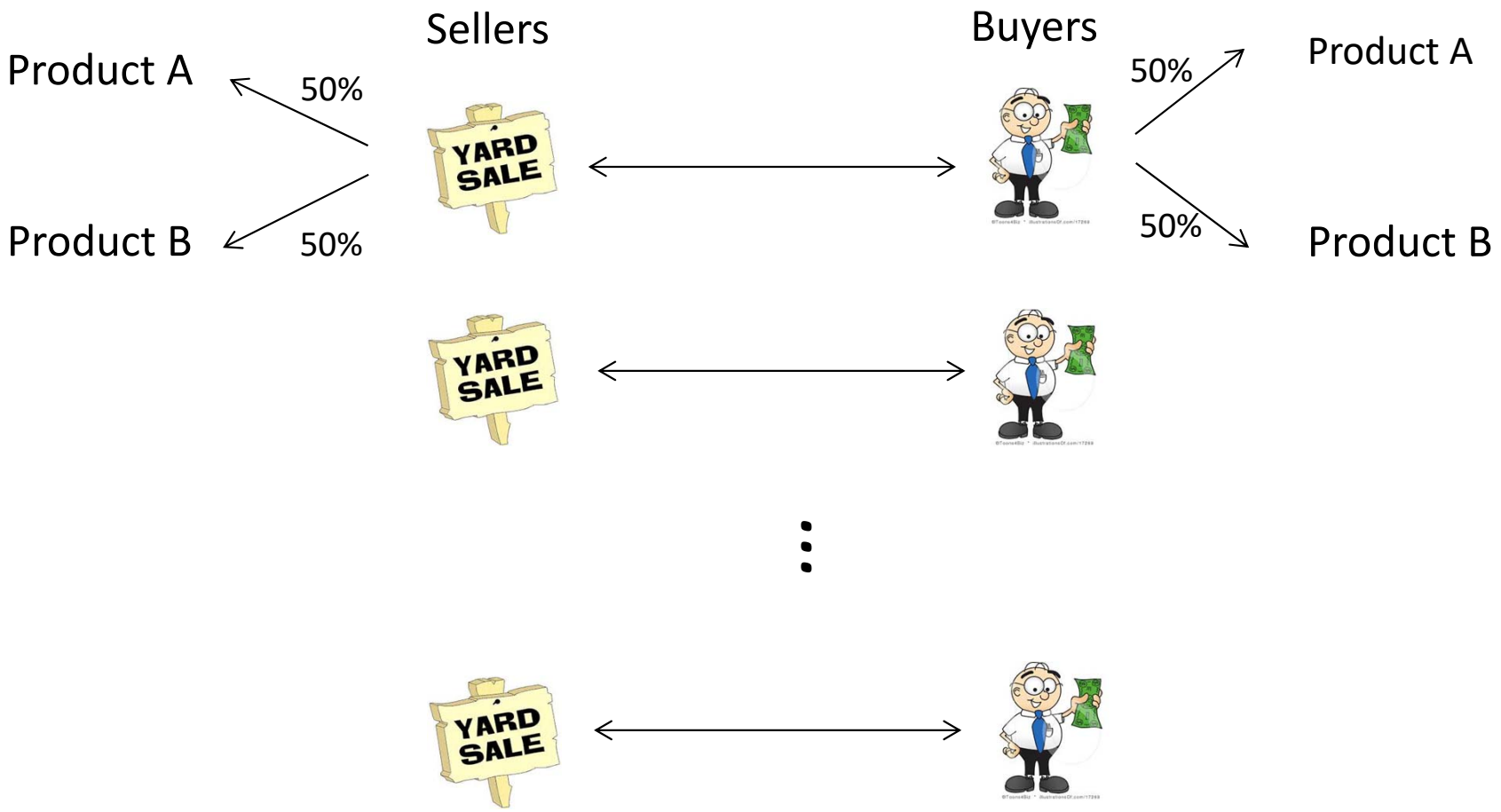
- ▶ Channel Profits and incentive misalignment are high
- ▶ Services provided by channel are small—
 - ▶ Search and Distribution
 - ▶ Physical Inventories, Delivery
 - ▶ Customization
- ▶ Products can be sold online

THE MARKETPLACE THAT STARTED IT ALL

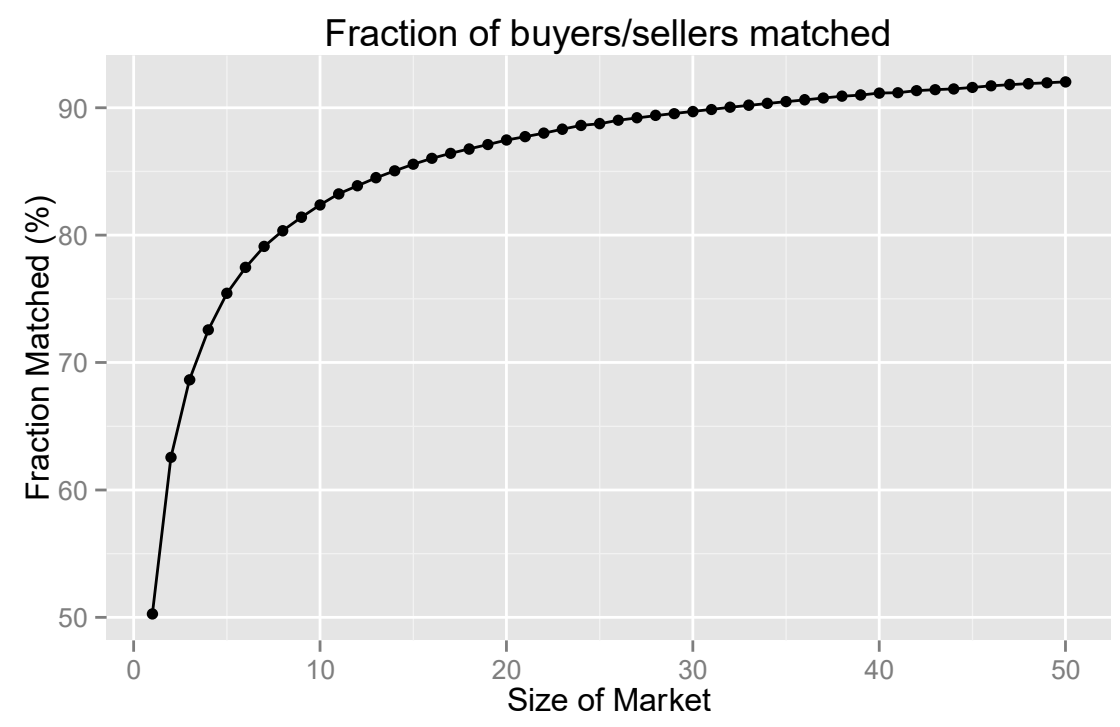


SEARCH, PRICE DISCOVERY

TRADITIONAL WAY TO DO BUSINESS



STATISTICAL POOLING



ALIBABA

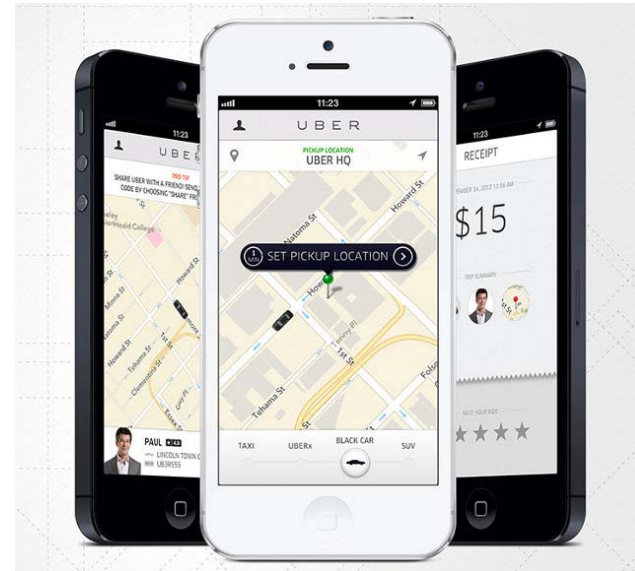


Alibaba.comTM

淘宝网
Taobao.com

天猫 TMALL.COM

UBER!



Platform to Match Supply with Demand

THE UBER BUSINESS MODEL



Surge Pricing



*No Physical Assets
Intermediation*



*A Free Frictionless
Market of "Employees"*



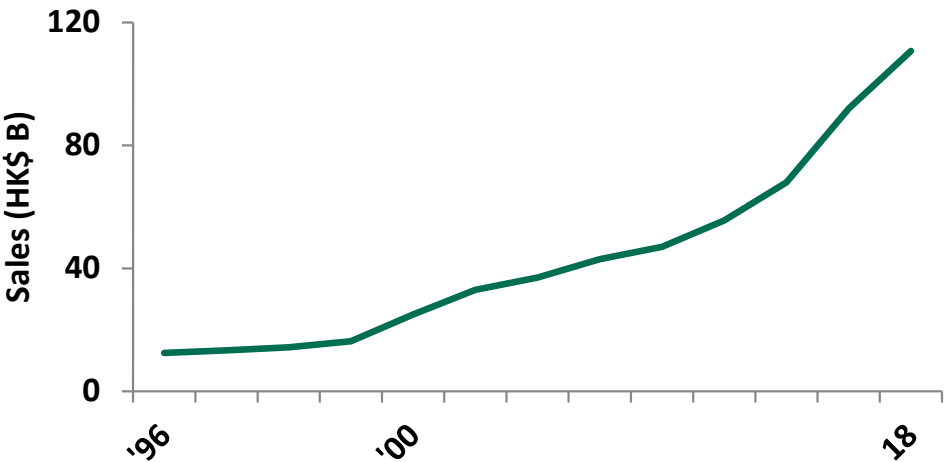
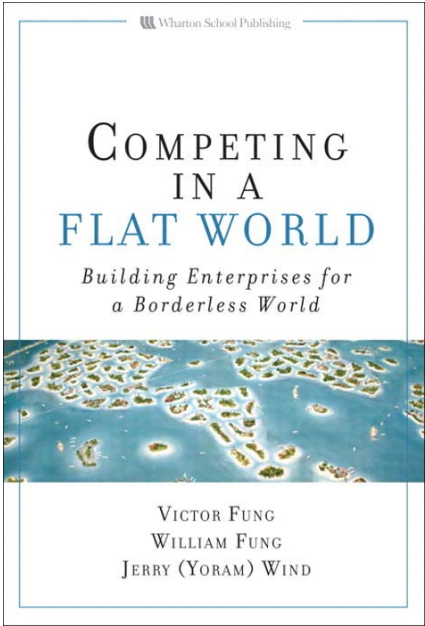
SPATIAL!

Disruption in Risk Profile

ON-DEMAND SERVICES



BUSINESS MODEL INNOVATION: LI & FUNG LIMITED

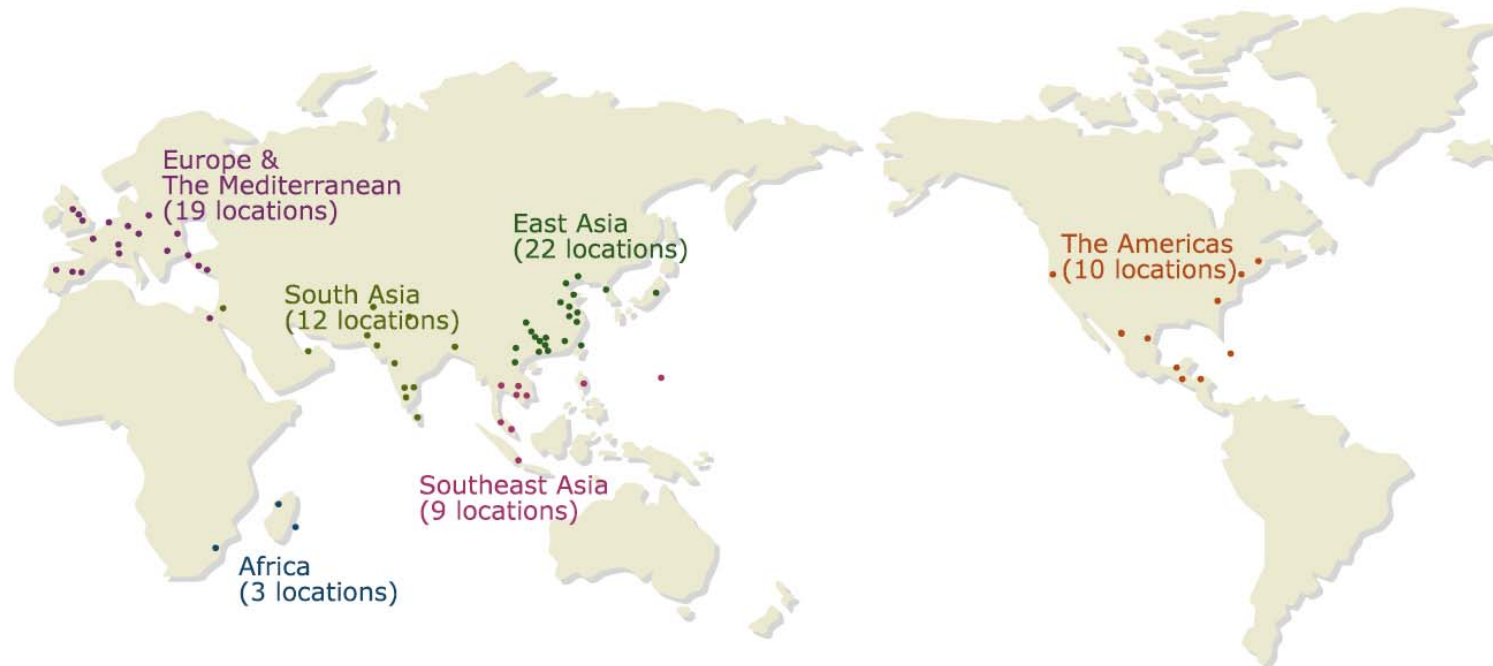


LI & FUNG LIMITED: WHAT DOES IT DO?



- ✓ *Buyers outsource sourcing to Li & Fung*
- ✓ *Has a global platform of suppliers*
- ✓ *Finds suppliers to source from*
- ✓ *Ensures good behavior*
(Quality, information, etc.)

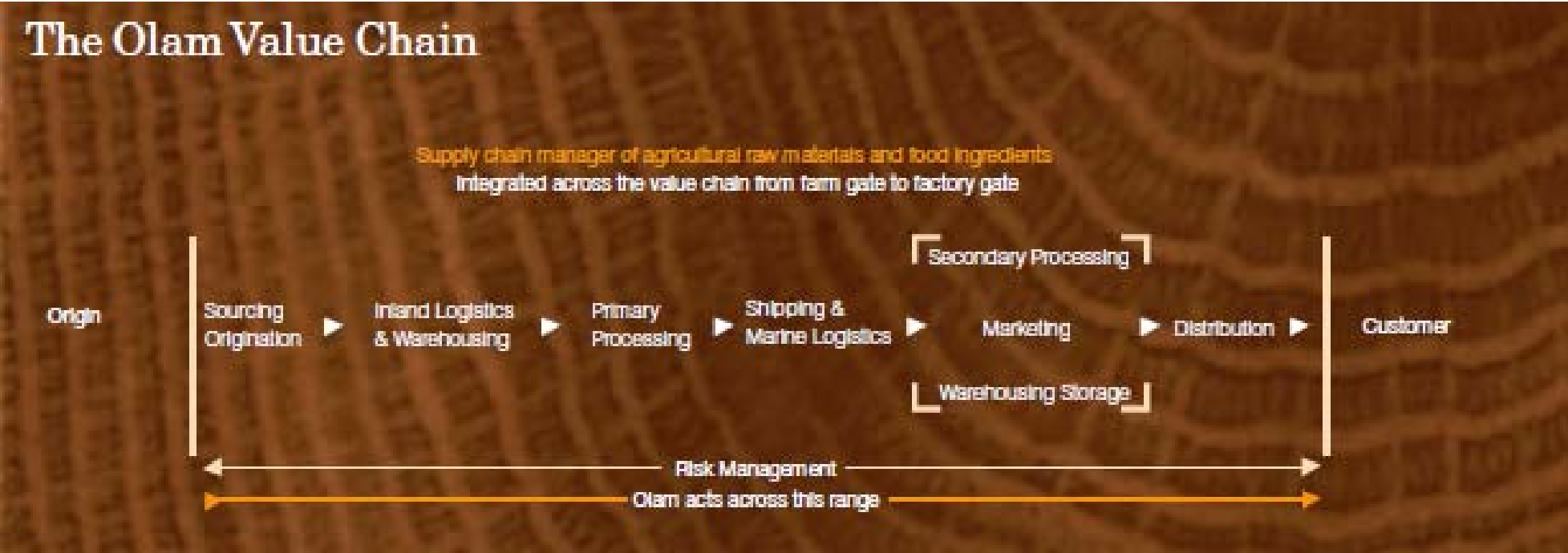
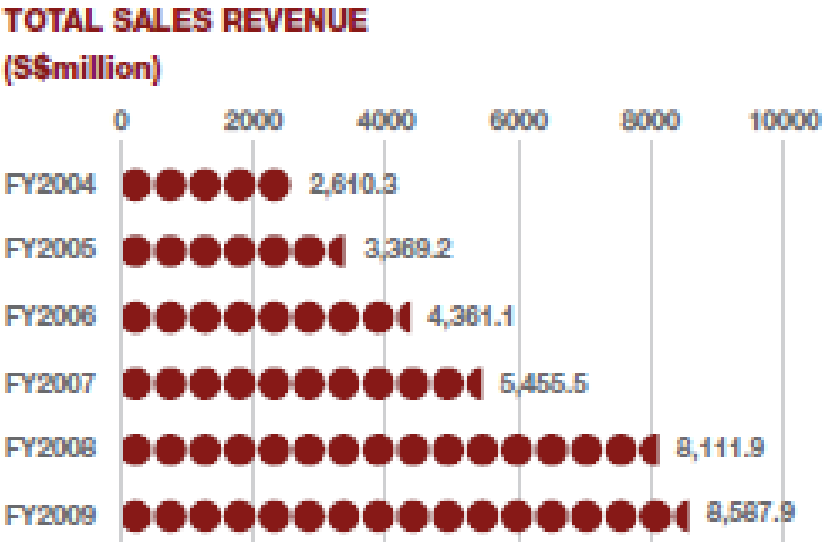
Global Platform of Suppliers



FOOD PRODUCTS: OLAM INTERNATIONAL

Our Global Business

We have grown over the last 20 years by taking advantage of adjacent opportunities in businesses, which share geographies, channels, costs, suppliers and customers, and acquiring new businesses and competencies. We have repeated this formula to evolve from a one-product and one-country business to a global business in integrated supply chain management of 20 agricultural products across more than 60 countries.

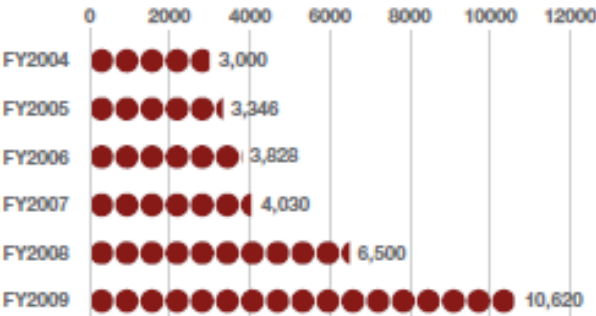


D. E. Bell and M. Shelman. Olam International. HBS Case 509002, Harvard Business School, Boston. 2009.

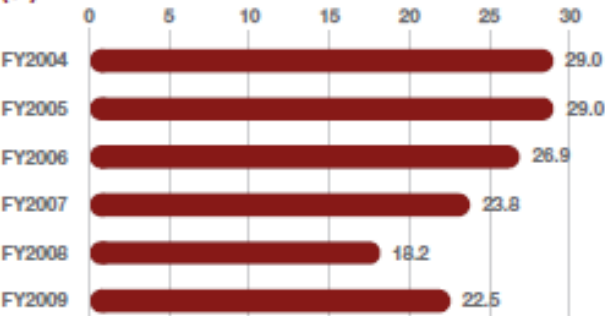
FOOD PRODUCTS: OLAM INTERNATIONAL



NUMBER OF CUSTOMERS



TOP 25 CUSTOMERS' SHARE OF TOTAL SALES REVENUE (%)



Additional Tier in the Supply Chain



Wal-Mart, Li & Fung Sign Sourcing Deal

What can Li and Fung do that Wal-Mart can't?

- ▶ Wal-Mart has scale (US\$ 350 B v/s US\$ 20 B)
- ▶ Wal-Mart has local knowledge (189 stores in China, 50K local employees)
- ▶ Wal-Mart is a long-term partner (solid, highly profitable business)



Is there something more to it?

“ Suppliers need to be reliable... deliver on time... reserve capacity... be socially responsible”

“ Supplier compliance is a major business and reputation risk”

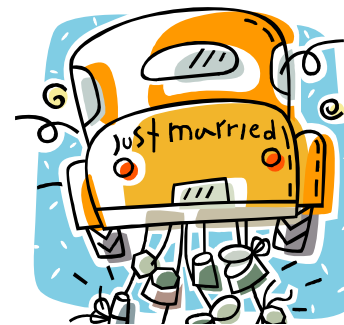
“ Li and Fung ensures better Supplier Behavior”

What are the advantages of sourcing through Intermediaries?

A HARD CHOICE: FLEXIBILITY VERSUS COMMITMENT



DATING



MARRIAGE

HOW TO BREAK THE TRADE-OFF?



Intermediaries relieve the trade-off by dynamically allowing for flexibility by limiting opportunism

PLATFORMS FOR MATCHING AND LIMITING OPPORTUNISM



THE INNOVATION

- ▶ Match two distinct customer segments
- ▶ Create Reputation Systems, and Long-Term relationships with both segments
- ▶ Create Value by reducing Search costs and Limiting Opportunism Risks
- ▶ Reduce Costs, Risk of not finding a partner, Exposure to Opportunism Risks

WORKS BEST WHEN

- ▶ Disaggregated Buyers, Sellers; Buyer and Sellers with long-term perspective
- ▶ High Search Costs
- ▶ High Potential for Opportunism

MARKETPLACES

Level I	<p>Reduce search costs: match supply with demand (pooling)</p> <p>More secure transactions: provide insurance, trust and credibility</p> <p>Regulate prices</p> <p>Reduce transaction costs: frictionless commerce</p>
Level II	<p>Reduce opportunism risks</p>

Marketplaces can disrupt every industry in the world today