The Long Tail Strategy of IT Outsourcing:
Building a Supplier Portfolio for Disruption

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Today's rapid pace of technological change has fundamentally transformed global IT outsourcing. Traditionally viewed as a measure of cost saving, outsourcing is increasingly leveraged as a strategic tool for acquiring cutting-edge innovation. Many companies are expanding their portfolios of IT suppliers to include smaller, highly innovative companies. This pursuit of emerging technologies and capabilities, however, has elevated the complexity of managing supplier portfolios. The outsourcing practices that companies have been maturing in the past decade are under a new level of duress. Today organizations need to reimagine IT outsourcing strategies in increasingly turbulent business environments.

The Utopian Portfolio

Traditionally, companies are advised to optimize their portfolios of IT service providers by relying on several major partners with extensive technology and industry experience[1], while limiting the number of ad-hoc suppliers. To mitigate significant lock-in risk associated with such a portfolio, companies are advised to use shorter-term contracts with well-designed incentives. Collectively, this limited set of partners could offer a comprehensive and complementary set of capabilities, while the competition among partners could motivate them to invest time and resources in the client. By centrally managing this "optimized" portfolio, a company could achieve the economies of scale necessary for low cost and high efficiency.

Although this approach to outsourcing was designed to ensure economies of scale and gain efficiency[2], companies also hoped that their outsourcing partners would introduce innovative technologies and associated services[3]. Few business and IT leaders, however, are satisfied with the level of innovation introduced by their suppliers[4]. Yet today, more than ever, as rapid technological changes disrupt industries, established companies need access to fresh ideas, new technologies, and cutting-edge expertise. These capabilities are often found among smaller, more agile suppliers[5]. This is not surprising as the very idea behind disruptive innovation is in that many established players tend to ignore disruptive changes to their business until newer firms replace their products and services by providing better value to the customers [6]. In response, savvy business leaders are devising far more proactive outsourcing practices, and not just relying on a stable, limited set of partners, for identifying and introducing innovations.

These proactive practices, however, contradict many companies' aspirations for consolidating their supplier portfolios. Having encountered the pain of managing multiple suppliers in the past, many companies, especially those with a well-established sourcing management office, have created policies that mandate contracting only with the small group of strategic partners. Yet, even in such firms, business unit leaders tend to circumvent policies and engage the services of niche, value-adding suppliers to keep up with technological changes critical to their units' competitiveness. This often results in a large set of shadow suppliers working on smaller, fragmented projects, oftentimes under the radar of sourcing management offices and enterprise architects. Absent systematic orchestration and proper incentives, companies will miss the opportunity to integrate the local innovations of these diverse suppliers into the organization.

The Long Tail Strategy

In this research we introduce the "long tail" strategy of IT outsourcing as an alternative to the dominant practice of concentrating on a few key partners. Representing a dynamic, diversified, and yet disciplined approach towards outsourcing, the long tail strategy embraces and even fosters a flow of new suppliers, continually bringing in new capabilities that can enable the company to prosper in turbulent business environments. This strategy requires a carefully-designed governance framework which rewards best-performing suppliers by increasing the client's commitment while specifying a set of policies and architectural requirements for partners. The small set of partners assists the client in operating core technologies and business processes, while integrating the local, temporary, or experimental capabilities of long-tail suppliers into the firm's architecture. If orchestrated effectively, this strategy turns into a reality the seemingly unattainable goal of introducing innovation while ensuring cost and efficiency.

Global Bank: Leveraging the Long Tail for Technology Leadership

Global Bank is one of the largest global financial services companies and has been ranked amongst the world's most innovative investment banks multiple times by financial industry associations. Global Bank had a history of pioneering cutting-edge technologies in financial services. For decades, IT outsourcing had been considered a strategic tool by the company. As an early adopter of global sourcing, the bank embarked on its global sourcing journey in the 1980s. In the decade that followed, Global Bank partnered with a small set of major IT service firms in both onshore and offshore locations. These suppliers provided IT support and maintenance for the bank's worldwide business. The bank's corporate policies focused on promoting these key relationships so as to achieve efficiency in operations.

In the 2000s, however, with the rapid maturation of offshore IT service markets, the bank started adding new outsourcing relationships to include suppliers from new regions as well as smaller local suppliers offering new capabilities. In addition, through multiple M&As, the bank acquired divisions with their own supplier relationships. This diverse portfolio, often including hundreds of suppliers within the same service category, allowed the bank to tap into new sources of value and access "best of breed" skills and talent across the globe. At the same time, much redundancy existed among the suppliers and significant value was left on the table due to the unrealized economies of scale, scope, and expertise. The collective cost of managing transactions with this diversified portfolio of suppliers was also very high.

As the global supply market matured, the costs of such fragmentation and redundancy became increasingly noticeable. This resulted in the decision to strengthen the bank's global sourcing governance. By mid 2000s, the bank started to consolidate smaller contracts into larger partnerships with multinational IT firms. However, business unit leaders continued to enter into small-scale contracts with new suppliers, justifying their actions by the need for skills and innovation. Instead of banning these practices or looking the other way, Global Bank's sourcing management office started implementing policies that allowed local business unit managers to discover and experiment with new suppliers. In this process, two issues had to be addressed. The first was how to avoid adding suppliers that did not bring unique capabilities, but were rather added to the mix because of the local manager's personal preferences. The second issue was how to motivate new suppliers to invest in relationships with Global Bank when they viewed the bank as committed to its existing partners.

What ensued was the creation of a "long tail" sourcing strategy that leveraged carefully-designed organizational practices to combine advantages of accessing the innovative capabilities of niche players with the efficiencies offered by major partnerships. To implement this strategy, Global Bank mobilized distributed, bottom-up decision-making among its large number of "program managers," – middle-level managers responsible for creating and maintaining IT systems serving particular business functions – while using multi-leveled, top-down governance to continually evaluate and consolidate the supplier portfolio. Specifically, several initiatives were taken across the organization.

First, the bank gave its program managers from diverse business units a high level of autonomy in supplier selection for smaller projects. In search of capability and cost advantage, these program managers experimented with hundreds of different niche players:

> "*We let people make relationships with whomever they wanted; do small projects offshore so that people see that it works and then encourage them to do bigger projects.*"

Second, the bank incentivized the program managers to develop their own "best-of-breed" suppliers by helping suppliers acquire valuable knowledge of financial industry, facilitating suppliers' market competitiveness and likelihood of winning further business from Global Bank. These "groomed" suppliers viewed Global Bank as a strategic client and were willing to invest in the relationship without being promised a long-term commitment. Such mutual investment had created strategic value for both Global Bank and its suppliers.

For example, in one business unit, managers spent significant time educating their new suppliers about the bank's workflows in risk management. Such teaching enabled the supplier to rapidly create a series of highly successful software applications supporting this business function. Both the program managers and the supplier recognized that these new applications could be offered to other clients in financial services industry as they automated standard industry processes. Legal agreements were negotiated on how the supplier could sell these new software "assets" and related services while rewarding Global Bank' for their intellectual property (IP).

In a similar mode, an award-winning Customer Relationship Management system was developed in partnership with another supplier, although Global Bank decided to keep IP rights. One of the supplier's senior managers explained the bank's mode of working with new suppliers:

> "*[At Global Bank] there is willingness to experiment with new types of partnerships… They have also shown us a significant commitment. They have shown us tremendous*

willingness to educate us about how a bank works… We have shown a lot of commitment to [Global Bank] in terms of making investment in people and time."

The final piece of this new approach was that program managers evangelized their success stories across the organization, promoting "their" successful suppliers among other business units. Through this distributed decision-making process, a portfolio of preferred suppliers emerged. The portfolio was regularly evaluated by the bank's sourcing management office, which identified the top-performing suppliers across the firm. The top suppliers were then shortlisted in subsequent contracts. Over the years, some of these "new" suppliers were promoted to the list of key strategic partners. This set of strategic partners still accounted for the majority of Global Bank's IT outsourcing activities.

This distributed internal "championing" process enabled Global Bank to foster and proactively manage an influx of diverse suppliers with unique value propositions. Instead of seeking a static portfolio with an "optimal" number of limited suppliers, the long tail of suppliers continually brought in disruptive capabilities and technologies. The diversified portfolio also helped hedge the risk of lock-in with strategic partners. The long tail strategy, however, incurred significant total cost of coordinating a large set of suppliers[7, 8]. This cost was somewhat mitigated by the multilevel decision-making process, in which the sourcing management office not only managed the core group of strategic partnerships, but also provided support for contracting with new suppliers.

As a result of the long tail strategy, Global Bank was able to rapidly tap into nascent supply markets in the early 2000s, obtaining a first mover advantage in the global race for capability and talent. As digital disruption became the key concern in the last decade, the long tail strategy enabled Global Bank to proactively scan and experiment with new technology offerings from smaller agile suppliers, allowing it to emerge as an industry leader of digital innovations such as enterprise social media, cloud computing, mobile technologies, and crowdsourcing. Today, Global Bank continues relying on the long tail strategy to stay at the cutting edge of global technological innovation.

Toyota North America: Leveraging the Long Tail for Rapid Innovation

The long tail strategy can help multinationals tap into the latest technologies, but in order to do so more rapidly than the competition, this strategy requires strong technology architectural capability. Toyota North America has outsourced 80% of its IT workforce, which has enabled the company to cut information systems support costs[9]. Several strategic partnerships are critical for maintaining commodity technologies and implementing incremental improvements. However, Toyota's management recognized that, while their core partners consistently provided efficient infrastructure services and legacy systems support, the company also wanted to leverage emerging technologies — often based in the public cloud — to offer new dealer and consumer services. Thus, management looked to smaller, more agile suppliers to address their pressing need for innovation, especially in customer-facings areas. The Consumer Portal Delivery (CPD) group at Toyota was responsible for the consumer-facing web portal — a "big ecosystem" accommodating the entire consumer experience of users with diverse digital devices. CPD's unique technology requirements led to new kinds of supplier arrangements for Toyota, namely, working on one-off projects with nascent start-ups instead of long-term engagements with major partners:

> “*[CPD] needs vendors that can build very quickly, and then tear it down the next day. And we are dealing with smaller shops. When you were first able to spin a car graphic, there were only a couple of shops that could do it, and most of those guys were working out of their garage.*” – Zack Hicks, Chief Information Officer

Such sourcing arrangements have demanded new governance approaches, because integrating the services of these small suppliers into a seamless customer experience requires access to enterprise data. Toyota created an architecture team that defined key business capabilities, and both technology and data standards. By adhering to architecture standards, smaller suppliers can now build new functions and applications that are integrated with Toyota’s core infrastructure and data. The shared technology and data platforms not only offer a wider range of partnerships, they also accelerate CPD’s time to market.

> “*I have invested in supporting [the CPD web portal]’s team. In the past their sites used to replicate customer and vehicle data, but now [CPD] uses the same services, back-end systems, and customer database*.” – Jayadev Gopinath, Head of the IT architecture group

Toyota is part of a complex ecosystem that includes numerous dealerships ranging from small, rural, family-owned locations, to major metropolitan, multi-location, mega-dealerships. Management feels it is important to enable dealerships to create their own applications and websites suited to their local needs and budgetary constraints. To facilitate this local flexibility, Toyota’s IT organization has worked with the National Dealership Council to vet and finalize a list of 19 web development providers from which individual dealerships can choose. All 19 providers take advantage of Toyota’s standardized access portal to its centralized customer database when developing websites and applications for local dealerships.

Like Global Bank, Toyota North America leverages the long tail strategy to ensure efficiency while facilitating localized innovations. The core partners deliver reliable services and constitute the majority of Toyota’s IT outsourcing spend. In contrast, the smaller innovative niche players allow Toyota to experiment with new technology trends, and, more importantly, to accommodate the diverse local needs of its dealership network. These smaller suppliers leverage the technology and data platforms that core providers build and manage. In most cases, they do not aspire to become big strategic partners. Rather, the long-term payback is often in the ability to generate new relationships with similar companies. Toyota’s two types of supplier must work together, but they bring different strengths to the table, which, combined, make Toyota more efficient, reliable, and agile.

Leveraging the Long Tail

As evidenced in the experience of Global Bank and Toyota North America, deriving strategic value from the supplier portfolio requires a methodical approach for managing the diverse and dynamic set of outsourcing relationships. With each strategic partner in the portfolio, the client should continue investing time and resources in order to reach long-term goals of these relationships. The close tie between the client firm and its key partners enables and motivates these partners to develop knowledge and processes specific to the client so as to deliver greater value. Meanwhile, the client also should foster some healthy competition among key partners by engaging suppliers with both complementary and substitutable capabilities. The long tail part of the portfolio, in contrast, has a different objective. It enables the client to acquire emerging technologies and capabilities in an agile fashion. In order to identify new suppliers as well as manage the complexity and costs associated with the long tail, companies need to build a special set of sourcing practices that institutionalizes both centralized and decentralized decision making when it comes to discovering, nurturing, incentivizing, controlling, and integrating relationships with multiple suppliers. Through interviews with 150 managers from 30 major multinational corporations, we have identified five such best practices for leveraging the long tail approach to IT outsourcing.

Distribute responsibility for technology scanning. The design and evolution of the portfolio, to a large extent, relies on an emergent, bottom-up process. This process is driven by the distributed decision-making of middle and senior managers who have the best understanding of their business and technological needs. These managers should therefore take on an entrepreneurial role, proactively scanning for new technologies and leaving the door open for suppliers, both existing and new, to pitch innovative solutions to them These local managers are in the best position to tell apart latest fads from potentially valuable innovations. Based on their analysis of promising technologies, they can start identifying who is in the best position to help them further probe new opportunities through experimentation – internal IT, incumbent partners, or new suppliers? The sourcing management office should introduce informal and formal communication channels so that managers across diverse business units can recommend new technologies and suppliers to their peers.

For example, a major European insurance company historically relied on about a dozen major IT services suppliers worldwide. Even with this relatively large number of partners, it still had to venture into proactive search and engagement with newer niche suppliers to keep up with the digital disruption. The sourcing director explained how the company was always prepared to open up its portfolio:

> "*We have a very, very close look at what's on the market and how the market reacts… The whole notion of having big vendors in big rooms can be turned upside down… We had a parallel [internal] development, which now we are discussing to stop because [the niche new supplier] is on the highway on the left lane and just bypassing us… They are just moving much faster than we can. So why don't we jump on their train?*"

Nurture relationships at the tail-end. One pitfall of the long tail strategy is that it demotivates new suppliers from investing in client relationships. Indeed, each supplier in the long tail may feel that their role is temporary and focus their best efforts on other clients willing to make long-term commitments. It is thus important that both business unit managers and the sourcing management office incentivize suppliers to invest in the relationship. Top-down incentives are clear: if experimental projects show positive results, the supplier will get internal referrals and potentially make its way into the mix of strategic partners. This was the case, for example, with cloud computing providers, who often started as niche players, but have moved into the partnership roles as cloud technologies became more prominent. The bottom-up nurturing requires more creativity and relationship management skills. Business unit managers cannot always promise long-term commitment, but can design more creative incentives such as invitations to work on innovative projects, strategic learning opportunities about the client's industry, willingness to serve as a reference, and even financial investments in the suppliers. It is important for managers to realize that the viability of outsourcing relationships often lies in the alignment between the client's IT sourcing strategies and the supplier's long-term growth strategies.

A large U.S. financial services company, for example, had been relying on a concentrated portfolio of a handful of strategic partners. Yet, over the years it also developed several relationships with other suppliers mostly for cost saving reasons. Gradually, the client discovered the significant potential of some of these suppliers and allowed them to work on more innovative projects. Leveraging these projects as incentives, the company achieved significant success in outsourcing:

> *"You always want to be… a customer of choice. And to be the customer of choice, you want to have the kind of partnership where you are making your supplier work on some of your most innovative activity. And if you do that consistently and honestly, the suppliers will give the most talented resources."*

Encourage sales pitches from your suppliers. Capitalizing on the suppliers' investment in the outsourcing relationships, the client's program managers should encourage the suppliers to actively propose innovative services. Suppliers' technology capabilities, coupled with knowledge acquired from the clients, can become a driver of value creation. Yet clients often express disappointment with their existing suppliers' innovativeness[4]. A key idea of the long tail strategy is to stimulate innovation by inviting both existing and new suppliers to propose new services and win new business. While client's managers sometimes institute policies precluding proactive sales pitches from current suppliers, inviting these proposals is an effective way of learning about innovative technologies and service offerings.

As an example, the global technology company EMC successfully leveraged suppliers to introduce innovations, ranging from new business processes to emerging technologies. During supplier evaluation and contract renewal, the firm emphasized innovative capacity as an important differentiator.

> "*They (suppliers) have got to demonstrate that they are bringing something different to the table that is strategic to EMC. I always say to them, they've got to make me a hero… So they came to the table, and they actually proactively suggested ways to change the process, and some changes to the technology platform, and then we have a mobile app.*"

Govern your entire outsourcing portfolio. The portfolio of suppliers emerging from the distributed decision process needs to be effectively orchestrated at the enterprise level. The critical role of governance is to distinguish between the company's core processes, which long-term strategic partners can manage for efficiency, security, and scale, from temporary, experimental, local processes that local business or IT managers can outsource to niche suppliers. This distinction will clarify accountability for sourcing decisions.

Governance must also specify standard, repeatable processes for due diligence, contracting, and performance measurement. In addition, governance is needed to periodically rationalize the portfolio to increase the client's commitment to the top-performing players while ensuring competition. This rationalization requires a deep understanding of value drivers of different types of outsourcing services[7]. It requires asking questions like: Does this service benefit more from scale and scope economies or best of breed approaches? Would using a one-off niche supplier for this service create significant risk of lock-in without proper control mechanisms? Is this a business critical process that requires significant redundancy with at least two suppliers that can substitute for each other?

Large corporations with complex outsourcing portfolios will need a dedicated outsourcing governance office that works together with business unit managers to understand value drivers for each service, institute proper controls, and support specific relationships. For example, a multinational financial services company has been recognized as one of the best private banks in the world. The bank invested in establishing a centralized governance organization responsible for designing the company's overall outsourcing model, supervising a small number of major partnerships, and collaborating with business units to coordinate relationships with diverse long-tail suppliers. Under the management of the governance office, local business units still had the flexibility to select best-fitting capabilities:

> "*The choices about who the strategic vendors are and where they have a right to play as well as what top-down targets we'd like to see over time, about how much of a footprint is done with these vendors, those decisions are pretty centralized. The selection and the execution of individual deals is pretty decentralized within that framework.*"

Architect for integration. With diverse suppliers delivering specialized services, the long tail strategy places significant emphasis on the client's integration capability. At the core of this capability are investments made into a strong technical architecture, shared data sources, and common standards, which enables the client to develop a holistic and detailed view of different processes within the organization. This in turn should allow the local business unit managers, the centralized IT staff, and the sourcing management office to make better decisions about when to allow for a local niche solution and when to demand a top-down engagement. Architectural investments that build capabilities for integration are expensive, but they save time and money when a company attempts to extend its capabilities with a new technology.

As an example, an Asia-Pacific-based multinational financial services company increasingly embraced the long tail strategy. Through effective outsourcing, the company reduced costs, improved service levels, and invested in collaborative innovation with suppliers. In recent years, the bank received a number of global financial industry awards for their technological innovation, and emerged as an industry leader in technology. The bank emphasized the importance of retaining and investing in architectural capability as it moved toward a more diversified and dynamic outsourcing environment:

> *"[The bank] retains the architectural oversight. [The bank] has a keen interest in insuring that we have broad design authority... We took (the business) up into a multi-source environment... We retain the high level engineering capability and the service integration role. And that's quite deliberate.*"

Changing the Outsourcing Culture

The above five practices are key to the success of leveraging the long tail strategy for managing IT supplier portfolios. While outsourcing researchers and advisors have pointed out the pitfalls of using only "megadeals" and the need for expanding to some form of "multisourcing," we propose that in the time of rapid technological change, relying on a limited number of suppliers, no matter how diversified, is insufficient. Meanwhile, everything business leaders have learned about the risks of too many suppliers is still relevant.

The very nature of disruptive innovation is such that new players replace incumbent firms. IT service suppliers are no exception. Some of the forward thinking suppliers are themselves proactively engaging niche technology players in open innovation projects to boost their firm's innovativeness[11], but it often takes a long time for their customers to see the results of such open innovation strategies. Meanwhile, their clients can derive great value from establishing a more dynamic, diversified, yet still disciplined approach to creating and managing external relationships. By synergistically combining bottom-up portfolio design with top-down portfolio governance, the long-tail strategy should allow companies to maintain their focus on cost and efficiency while still discovering new sources of value and innovation in today's turbulent business environment[12].

The implementation of this strategy is not easy and will be particularly uncomfortable for firms that are used to centralized governance of their IT resources. It requires continuously nurturing key partner relationships while still facilitating the emergence of new value-adding relationships that may eventually disrupt some of the key partnerships. Meanwhile, it requires significant investment into shared practices and architectural capabilities so as to provide proper incentives to a diverse set of players, reduce coordination and contracting costs, and enable integration of services. Thus, implementing this strategy requires three changes in companies' outsourcing culture: from reactive problem-solving thinking to proactive, entrepreneurial thinking; from focus on cost to focus on value created through external innovative capabilities; and from a stable set of partnerships to a dynamic set of relationships. If well executed, the long tail strategy can transform IT outsourcing into a driver of innovation and value creation in the age of digital disruption.

About the Research

We have been studying portfolio strategies for IT outsourcing since 2005. The main objective of the research program is to understand the changing nature of IT services in today's increasingly digitized and globalized business environment. We have conducted 150 interviews with 30 companies, including 15 clients, mostly Fortune Global 500 companies, and 15 major suppliers. The 30 companies are based in North America, Europe, Australia, New Zealand, Latin America, Russia, Japan, India, and China, and spanning financial services, business services, technology, manufacturing, and energy sectors. The financial services industry, as a pioneer of global IT outsourcing, represents a main context of the study.

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