Rebalancing your sourcing strategy

Offshoring is alive and well, but it's no longer the only answer.

Conradin Merk, Jonathan Silver, and Fabio D. Torrisi

After years of large-scale outsourcing and offshoring, a number of onshoring initiatives in both the manufacturing and service industries have left many executives wondering if a major trend reversal is occurring.

The answer, according to our analysis, is simply that many leading companies now have a broader set of options when they source. To do that optimally, they define bundles of activities that should be sourced consistently and select the best option for each bundle: offshoring, nearshoring (locations in neighboring countries), farmshoring (lower-cost locations in the company's home country), or onshoring. Today, sourcing strategy focuses increasingly on value-creating factors that go beyond labor costs, which was the primary driver of sourcing in the past.

Diversified sourcing modes

Our review of major onshoring initiatives reported by media in the past two years highlights diverging sourcing trends for manufacturing and for IT and business processes. The vast majority of onshoring initiatives were in manufacturing. This development is primarily due to a rebound in domestic demand for goods such as machinery and automobiles that are typically assembled close to final demand. In addition, a two-thirds decline in the US price of natural gas since 2008 is attracting some manufacturing industries that use gas as direct fuel or feedstock.[1]

In contrast, only about 20 percent of onshoring concerned IT and business processes. Corporate sourcing leaders that we interviewed said they find that strategic offshoring of IT and business processes retains the promise of reducing costs, hedging production risk, and increasing access to talent by employing a network of offshoring locations.

Manfred Immitzer, CIO of Nokia Solutions and Networks (NSN), said his organization

[1] Katy George, Sree Ramaswamy, and Lou Rassey, "Next-shoring: A CEO's guide," *McKinsey Quarterly*, January 2014, mckinsey.com.

Takeaways

There's a shift in how many leading companies think about sourcing strategy, driven by factors that go beyond labor costs.

In addition to traditional outsourcing and offshoring, companies are tapping into nearshoring, farmshoring, and onshoring to maximize value.

By bundling activities to optimize their network of locations and sourcing approaches, executives can help shape their operations' cost, risk, and talent structures.

remains heavily outsourced. Moreover, its sourcing partners in turn offshore resources to a high degree. This provides flexibility for NSN by avoiding fixed costs and having short lead times to add or reduce resources. A financial-services executive estimated that his industry's shared-services centers are increasing their offshoring ratio to have at least a third of business-process staff offshore.

Overall, we conclude that what's happening is not a major trend reversal but rather a rebalancing of sourcing modes focused on factors other than cost. In the case of offshoring, these factors are access to a global talent pool, increased flexibility, and the ability to establish a global network, which naturally hedges against multiple operational risks such as currency fluctuations, regulatory changes, and natural disasters.

Nearshoring and farmshoring, on the other hand, offer advantages such as access to workers with language skills that are essential for sourcing effective frontline sales. One global insurer, American International Group (AIG), is moving ahead with the creation of nearshore centers in multiple regions, according to its global shared-services executive, Peter Robertson. AIG expects to locate an increasing percentage of its staff in scaled centers, as nearshoring also allows movement of activities that require language skills other than English, enabling relocation of activities higher up the value chain. Clearly, nearshore and farmshore servicing will become more important as companies revise their sourcing strategies.

Thinking about bundles

Making the right choices in an evolving sourcing market, in which new economics and technologies enable new synergies and a wider range of options, requires a new way of thinking.

Many companies are discovering that sourcing decisions cannot simply be made based on the notion that "noncore" business activities can be offshored. First, what is core or noncore is subjective. For instance, the finance function might consider sales a core activity because it generates revenues and view operations as noncore. Those in marketing and sales might consider call centers core because they are visible to customers and view R&D as noncore.

Second, if top managers agree, for example, that IT project management is core and should be kept in-house, while software development is noncore and can be outsourced, they must weigh the potentially damaging side effects of separating the two activities. In this case, one complication could be a lack of good in-house project

Many companies are discovering that sourcing decisions cannot simply be made based on the notion that 'noncore' business activities can be offshored.

As companies move away from the core and noncore logic and bundle their activities, they find themselves in a better position to optimize their sourcing strategy.

managers in the future, because the career path to an IT project-leadership role often includes deep software experience.

That's one additional reason companies need to articulate the building blocks of a sourcing strategy according to a bundling logic that results from a systematic analysis of the business processes in scope (ideally covering the entire enterprise). This analysis should identify interdependencies among activities, uncover proximity requirements, and reveal language requirements; based on this information, companies can define bundles of activities that should be sourced consistently, by using the same ownership model and the same location.

Such a strategy could be useful, for instance, in manufacturing. In a March 2012 *Harvard Business Review* article, GE CEO Jeffrey R. Immelt argued that by bundling R&D and production into one unit at Appliance Park in Louisville, Kentucky, he could reduce waste and cost and increase productivity to achieve a 68 percent reduction in time to produce.

At NSN, Manfred Immitzer structured three big enterprise IT bundles. The first included the enterprise applications that run customer operations and supply-chain activities. The second was IT for R&D, which he described as a pivotal function in a technology company like NSN. The third bundle was the common IT infrastructure serving all of NSN. These bundles have been sourced with three different vendors, each with different mixes of onshore and offshore resources.

As companies move away from the core and noncore logic and bundle their activities, they find themselves in a better position to optimize their sourcing strategy. This process usually results in a network of locations and sourcing approaches, which hedges against geopolitical, currency, and other risks, while increasing access to a diverse pool of talent. Our analysis shows that rather than increasing the size of their existing offshore locations, companies prefer to complement their network with additional farmshore and nearshore centers.

As the complexity of their network increases, executives need to focus on effective sourcing governance and ensure that they make the most of value-creation levers such as centralization, scale advantages, process standardization, automation, and labor arbitrage.

• • •

Sourcing is coming of age, and many executives must revise their sourcing strategy to maximize value for their enterprises. Those who get it right can shape the cost, risk, and talent structures of their operations.

The authors wish to thank Tor Jakob Ramsøy for his contributions to this article.

Conradin Merk (Conradin_Merk@McKinsey.com) and **Fabio Torrisi** (Fabio_Torrisi@McKinsey.com) are associate principals in McKinsey's Zurich office, and **Jonathan Silver** (Jonathan_Silver@McKinsey.com) is a principal in the New York office.