

# **New Scenarios in Sourcing Innovation**



# The **Strategic** Logic of **Connect & Develop**

*For Firms embarking on strategies to source innovation through partnering it is vital to develop scenarios for thinking about, and dealing with the strategic opportunities—and uncertainties*

## *An innovative sourcing scenario*

Shortly after he was appointed CEO of the consumer products company Procter and Gamble, Alan Lafley saw that P&G couldn't meet its growth objectives by spending greater and greater amounts on R&D for smaller and smaller payoffs. So he dispensed with the company's age-old "invent it ourselves" approach to innovation and instead embraced a "connect and develop" or C&D model.

In the March 2006 *Harvard Business Review*, Huston and Sakkab (2006) explain that under the C&D model, the company collaborates with suppliers, competitors, scientists, entrepreneurs, and others (that's the connect part), systematically scouring the world for proven technologies, and products that P&G can take to market (in other words, develop).

When people first hear about connect and develop, they often think it's the same as outsourcing innovation—contracting with outsiders to develop innovations for P&G. But it's not. Outsourcing strategies typically just transfer work to lower-cost providers. Connect and develop, by contrast, is about finding good ideas and bringing them in to enhance and capitalize on internal capabilities.

By identifying promising ideas throughout the world and applying its own capabilities to them, P&G realized it could create better and cheaper products, faster. Procter & Gamble's radical strategy of open innovation involving the sourcing of new product ideas now produces more than 35% of the company's innovations and billions of dollars in revenue.

*Understanding the strategic opportunities and uncertainties is critical*

The strategic logic of open innovation and inter-Firm collaborative partnerships is compelling:

- Critical types of innovation simply will not take place within traditional corporate structures. Inter-Firm cooperation— in the exploration of new technologies, new market opportunities, and product and process innovation — can be a vital source of value creation
- Additional value may be created through new flexibility in bringing products and services to market. This is consistent with a “real options” approach (Miller and Waller, 2003); when there is greater volatility associated with the future market and technological environment, a firm is better off to enter into more flexible contracts with its suppliers / customers.

However, against these benefits, there are new risks in “using the market” rather than “doing it in-house”. A purchasing agent can easily write a request for proposal for paper clips or motor vehicles that is detailed enough for suppliers to submit a bid. However in knowledge-intensive sourcing initiatives, the real requirements are often incomplete at the time of negotiation. The hazards of strategic sourcing present new challenges for most organizations. These hazards are to do with:

- The complexity of the deal — protection of intellectual property, scope of services, and so on
- The specialized investments supporting the new initiative; these may be both tangible assets (e.g., specialised facilities and equipment), and intangible assets (e.g., new skills and capabilities)
- The challenges in measuring the real outcomes, and
- Coping with unanticipated change in the business environment.

## SCENARIO PLANNING AS THE FOUNDATION FOR NEW SOURCING STRATEGIES

The classic approach to Sourcing Strategy starts with a presumption: armed with sufficient business rigour, companies can predict their future needs, anticipate suppliers’ or customers’ strategies, and design a “water-tight” sourcing solution. In effect, planners “assume away” most of the uncertainties.

In many inter-Firm initiatives however, uncertainty about the future business environment is the critical issue. More than ever, these initiatives have to be designed and delivered in an environment of disruptive change — driven by shifting customer, competitive and regulatory imperatives, new technologies and global sourcing opportunities. With such uncertainty, one cannot predict events. Instead Management’s role must be to explore how things might pan out, and so scenarios are an essential way of understanding the possible future states of the world (Schwartz, 1991).

*Case study in ignoring critical scenarios: the collapse of the General Motors–Fiat alliance*

The collapse of the General Motors-Fiat alliance in 2005 had its origins in GM’s inattention to the critical scenarios as to how the future of Fiat might unfold. General Motors and Fiat SpA parted company after GM paid \$2 billion to Fiat to exit the joint venture.

Five years after the alliance formation, GM’s European arm and Fiat had racked up huge losses. After investing billions, GM refused to put any more money into the Fiat joint venture. The assessment according to Mario Ross, a former Fiat executive was that “GM did a classic financial due diligence, when in reality, the situation was much more complicated. It required understanding the strategic, political and social situation of the company.” GM never grasped the complexity of Fiat Auto, and the tactics it used to prop up sales according to Mr Rosso. (Asian Wall Street Journal, 2005).

*Role of scenarios*

Scenarios help in the construction and testing of sourcing strategies in three ways:

- Scenarios provide a solid foundation for developing a new sourcing strategy where there is change, opportunity and uncertainty ahead
- By educating decision makers about the alternative ways in which the future might unfold, it can help them to design more robust sourcing arrangements - and better prepare the organization
- An explicit use of scenarios helps the executive team to adjust course in the light of events. The better the scenarios, the less frequent these surprises will be and the better the sourcing strategy.

*The scenario planning process*

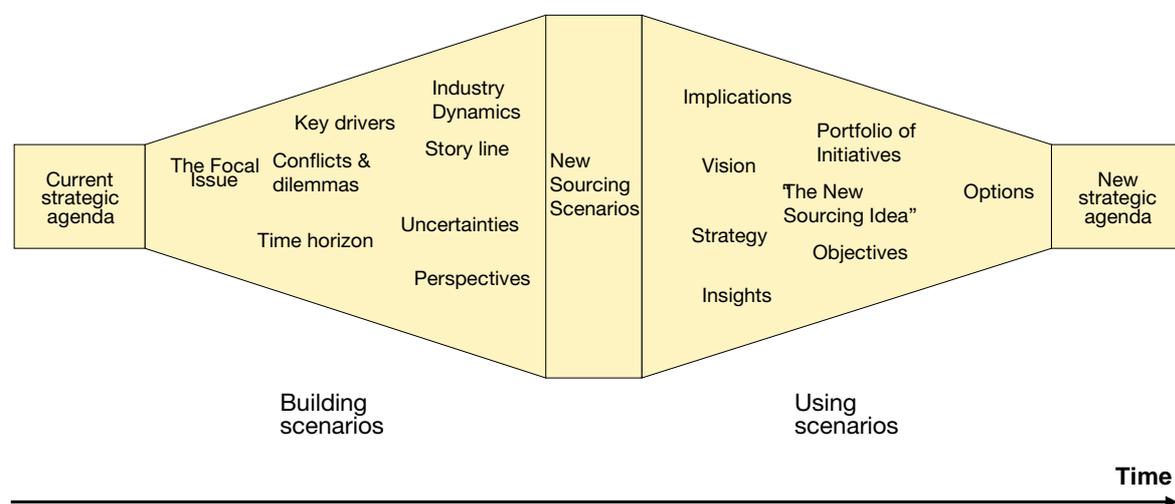
The process of scenario planning covers the following major activities:

- Deciding on the major sourcing issues and decisions facing the organization
- Preparing the groundwork including interviews with key participants both internal and external to the organization
- Planning and delivering the scenario planning workshops
- Developing and reviewing scenarios, and exploring implications.

As the Exhibit below shows, there are two main phases to get to the new strategic agenda: building scenarios and using scenarios. The process of producing and using scenarios is as important as the scenario narratives themselves.

The process is intended to widen our perspectives, helping us to understand issues and events as significant that we might otherwise dismiss as unimportant, or just not see at all. The process of building scenarios will create a shared understanding through which stakeholders can exchange perspectives and explore new sourcing options.

Exhibit – Building and Using Scenarios



When developing scenarios, we begin with a specific decision or issue that management will need to think hard about, for example:

- How can new sourcing arrangements help the business deal with the future competitive forces?
- How can we augment and leverage our innovation through our partners?
- Which capabilities or competencies should we be developing?

The work of developing and using scenarios is centred on two major workshops. These involve a dozen or more selected participants both internal and external to the company. The selection of participants is vital to success. The key is to gather together people who are challenging thinkers and represent a variety of disciplines, as well as different perspectives.

**Workshop 1 – Developing the scenarios**

The task of developing a set of skeleton scenarios is the work of the first two-day workshop. The scenarios are based on the key factors and driving forces, and the critical uncertainties driving the longer-term future of the industry. After that initial workshop, the core team performs the task of turning a set of scenario outlines into narratives.

For example, the scenarios might address new and complex developments such as:

- The unrelenting pressure to increase the rate of innovation and reduce cost simultaneously
- The trend towards more knowledge-intensive contracts with suppliers and customers
- The rise of business process outsourcing in R&D and business analytics
- Changing market needs.

The next step is to identify the most uncertain forces and factors. For example:

- The emergence of new global competitors, the convergence of technologies, and the increasing speed and cost of technological platforms suggest an increasingly uncertain environment for firms
- The risks and opportunities of offshoring in the enterprise sourcing portfolio; the new risks of business process interdependencies, labour unions, market reaction and service integration
- The ability of the company to make the necessary organisational changes
- Events that might transpire to put the sourcing relationship at risk
- The ability of suppliers to deliver on their strategy
- The industry business cycle.

The task of drafting good scenarios demands background research. One of the outcomes of the initial workshop is to identify where further information and expert input is required. So it will take weeks, if not months before the core team can come back to the Scenario team with a set of well-written, well-researched narratives.

## **Workshop 2**

### **Exploring the implications: from scenarios to the strategic sourcing roadmap**

Once the scenarios have been drafted, the objective of the second workshop is to assess the findings and explore the implications, addressing the following questions:

- What should sourcing arrangements make sense under each scenario?
- What is common for sourcing under all scenarios – the “no regrets” strategy?
- What sourcing strategy works under one scenario, but is very risky under another scenario?

The tests of a good scenario are as follows:

- It is neither right nor wrong, but it leads to better decisions
- It is both plausible and surprising, and so it has the power to break old stereotypes
- It anticipates key moments of change and identifies major leverage points.

### **From Scenarios to the Portfolio of Sourcing Initiatives**

A major use of the scenarios is to design the portfolio of sourcing initiatives such as the following:

- Formation of new kinds of sourcing arrangements and partnerships. For example, joint ventures provide firms with access to new knowledge. Alliances in particular facilitate the creation of new, often unexpected, opportunities for value creation.
- New capabilities which are needed, and traditional capabilities which need to be updated
  - For example, corporate expertise in open-innovation relationship management
  - Changes in the nature of the dialogue between key stakeholders – customers, suppliers, distributors, regulators, and so on
- Initiatives to increase speed of innovation and internal flexibility, and foster organizational cultural change
- Initiatives to lower costs, such as shared innovation platforms for companies to use.

### *Governance and contract design needs to address strategic risks*

Flexibility to adapt to changing market conditions is a key criterion for deciding on governance and contractual arrangements. By using a scenario-based analysis of alternatives, the Parties to the deal can craft governance arrangements that increase return and reduce risk.

For example, a key task of the scenario analysis is to address the question: should we be aiming for a tightly structured arrangement, or would a more flexible arrangement be appropriate? Faced with greater business uncertainty, firms may want to avoid long entanglements that could prove to be wrong later and will instead favour more flexible, less binding relationships. Moreover, firms that are flexibly contracted have the edge to respond to changing market conditions.

In contrast, more highly-specified contracts can provide greater guidance and certainty throughout the duration of the contract. However, they are more costly to design up-front and to adjust “down the track”. If future conditions change in ways which are not anticipated in the contract, the inability to adjust the contractual arrangements will increase costs.

## CONCLUSION

In conclusion, through a scenario-based approach, innovation is fostered and new sourcing options can be developed with confidence. Companies can benefit in the following ways:

- The critical scenarios are identified describing possible futures within which new sourcing and alliance arrangements must operate, including the critical hazards
- The structured and rigorous approach ensures the confidence and support of top management. Key success factors are uncovered, leading to an enhanced ability to manage change
- Scenario-based analysis will ensure the strategic decisions are evaluated comprehensively
- The process guides the views of participants and effectively draws on their wide-ranging ideas
- A forum for ongoing strategic discussion across the organisation is created.

Understanding the ways in which open sourcing arrangements can best deal with uncertainty is crucial to success. The role of scenarios is to stimulate “out of the box” thinking, helping people to imagine the unexpected and overcome outmoded viewpoints.

For generations, Procter & Gamble generated most of its phenomenal growth by innovating from within-building global research facilities and hiring the best talent in the world. Back when companies were smaller and the world was less competitive, that model worked just fine.

Now the company has dispensed with the age-old “invent it ourselves” approach to innovation and instead embraced a “connect and develop” model. Huston and Sakkab (2006) explain that this connect-and-develop approach has helped increase R&D productivity at Procter & Gamble by nearly 60%. In the past two years, P&G launched more than 100 new products for which some aspect of development came from outside the company. Welcome to the new scenario of sourcing innovation.

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#### **About the Author**

Jay Horton, Founder of Strategis Partners, is recognised as a leading adviser to companies and Governments on a wide range of strategic business issues, including scenario planning, innovation, value chain strategy and organization.

During his twenty year management consulting career, he has worked with clients in Australia, Canada, Japan, Hong Kong, Indonesia, New Zealand and Singapore.

Jay has played a range of leadership roles:

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