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Knowledge@Wharton-Wipro Future of Industry Series: Risk-Reward Models

Clients and Vendors Find Big Gains in Linking Rewards to Risks, Revenues and Outcomes

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A tougher economy, increased competition and constrained budgets are forcing businesses to gravitate towards innovative contracting models. Across industry groups, companies and their third party vendors are showing increasing preference for risk-reward contracts over traditional time-and-materials contracts. Experienced service providers are displaying a bigger appetite for riskier projects that bring more rewards. Trust and maturity on both sides are the key prerequisites for risk-reward models to be mutually beneficial, says Malay Verma, vice president and global head of the Cisco business unit at Wipro Technologies and Ravi Aron, senior fellow at Wharton's Mack Center for Technological Innovation. Verma and Aron share insights on how these models are evolving in this "Future of Industry" series white paper produced by Knowledge@Wharton and sponsored by Wipro Technologies.

Many companies these days have fewer discretionary funds available to invest in new products, including creating prototypes and proof-of-concept studies. At the same time, competition is forcing them to be more efficient and improve customer experiences. "This is driving companies to look for innovative models," says Malay Verma, vice president and global head of the Cisco business unit at Wipro Technologies. According to Verma, risk reward contract models could be a good alternative.

Risk-reward models have been around but not commonly used for a decade now. "Now, they are on a faster growth path," says Verma. "Both vendors and their clients have a greater need for these models," he says. "There is consolidation within industries and companies want to be ahead of the curve. Vendors also want to go up the value chain and are willing to take higher risks." For example, he says the networking products and services industry has become more competitive as compared to what is was a few years ago. Competition is intense with numerous players including Cisco, Huawei, Juniper, Alcatel and Ericsson, he adds.

Risk-reward contracts allow client companies to overcome three types of risks they encounter in the traditional time-and-materials model, according to Ravi Aron, senior fellow at Wharton's Mack Center for Technological Innovation. One is "operational risk," where a project underperforms because the vendor has insufficient competence or if the project specifications change frequently. The second is "strategic risk," where a project may fail if a vendor under invests in testing or quality control, or if the client changes contract terms. "Composite risk" is the third type of vulnerability some companies face, especially when they may have lost key capabilities over time or whose vendors have limited flexibility.

Revenue- or gain-sharing models lower strategic and operational risks for a client when payments to service providers are tied to a set of business metrics, says Aron. In outcome-based contracts, vendors use two benchmarks to mutual gain: "operational benchmarks" such as those on error rates, costs and turnaround times; and "strategic benchmarks" such as with customer attrition rates, he adds.

MORE SKIN IN THE GAME

"With a risk-reward or revenue-share model, there has to be lot more skin in the game for both parties," says Verma. He describes the formats in vogue:

- In a pure play revenue-sharing model, a service provider develops or maintains a product for a client for a share of the revenues it generates from cost of goods sold.
- In a performance-oriented model, the service provider agrees to help achieve savings in a specified activity for the client and gets a percentage share of the actual savings.
- In outcome-based contracts, a service provider earns rewards if it meets pre-defined criteria or risks penalties if it does not meet them.

Product manufacturers, especially those in high technology or consumer electronics, have a higher adoption of risk-reward models, says Verma. They have such models with their supply chain vendors and are comfortable with extending them to their outsourced services providers, he explains. Outcome-based compensation is the preferred format with non-product companies, who may have specific targets like migrating their systems to a new platform by a certain date.

However, risk-reward contracting is less common in BPO contracts because determining outcomes is difficult, says Verma. While revenues are usually public information, client companies tend not to share information on savings, and they are prone to errors.

Verma offers an example of how risk-reward models can be mutually beneficial. Company A has a product that has served it well for many years but is now reaching the end of its life cycle with declining revenues. The company still has accountability to support its customers and provide enhancements, etc. It may have a bunch of engineers that continue to work on such end-of-life products. A third party partner offers to take up that work, and the company's engineers can focus on newer products.

In addition to risk sharing in such models, vendors help their client companies expand capacity for innovation. Vendors have a greater incentive to drive operational innovations such as using reusable components and tools or spreading resources across multiple projects to cut costs.

MAKING RISK-REWARD CONTRACTS WORK

Verma and Aron list a few must-haves for risk-reward contracts to be successful. To begin with, both client companies and their third party vendors must bring a high degree of trust and maturity to the relationship, or else they are doomed from the beginning. For instance, for a new product development project, a vendor's compensation may depend on the client's product marketing efforts. "If they don't have the trust and the maturity it is very easy to do finger-pointing," Verma says. The credibility and integrity of vendors is also critical because sensitive intellectual property information may be shared.

Vendors must ensure they have the right qualifications, such as the financial stability to assume capital risks. They must also have an in-depth business understanding to ensure they agree with the client on revenue forecasts.

Most of all, vendors must possess the requisite technological expertise. A failed project may mean losing a few million dollars for a vendor, but the complete loss of a market opportunity for the client.

For successful implementation, flexibility is important, according Verma and Aron. For example, if one part of a supply chain fails, they must have a second option to proceed. Alternatively, in a revenue-share contract, if a client falls short of sales forecast on a consistent basis (where the vendor is not at fault), they must find ways to compensate the vendor, such as a higher revenue share in subsequent quarters or compensation generated from other projects.

Further, appropriate governance structures must be in place. A high degree of mutual engagement is critical. In addition to formal quarterly or six-monthly meets or conference calls for project reviews, "each party must feel they can pick up the phone and reach out to the other person if they see any concern or need any help," says Verma. Governance standards must define accountability at multiple stages and involve executives at both ends that can make financial and investment changes. In contracts involving multiple vendors, the role demarcations of each party must be clearly specified to avoid buck-passing.

EVOLUTION OF RISK-REWARD MODELS

Verma explains how risk-reward models have evolved. In the initial phase of outsourced IT services, the key driver was labor arbitrage between developed countries such as the U.S. and relatively cheaper locations like India. That evolved into what he calls "process-led selling," where service providers offered to align client processes to create higher efficiencies. "Business-led selling" was the next stage. Here, for example, instead of selling a client data center services, service providers offered to improve end-customer experiences by not just managing the data centers but undertaking to educate customers on managing their accounts, complete with online and mobile apps.

Service providers have now moved further up the value chain in a partnership model where they are willing to invest along with their client in developing new products or services and marketing them jointly. Their new motto: "I am joined at the hip with you – I lose or win with you," says Verma. Select service providers that are financially sound and have gained experience, expertise, maturity and their clients' trust over time now have increased appetite to share risks with clients, he adds.

Do risk-reward models work well only in economic downturns? Not so, says Verma, explaining that clients and vendors that have seen how these models help share risk, cut costs, bring expertise and drive innovation, will stick with them. "Once a lion has tasted blood, it is very difficult for it to change."

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