NPS-AM-07-007

EXCERPT FROM THE

PROCEEDINGS

OF THE

FOURTH ANNUAL ACQUISITION RESEARCH SYMPOSIUM WEDNESDAY SESSIONS

Strategic Sourcing—Is There a Role for Midsize Companies in the Industrial Base Supporting the Federal Government Market Space?

Published: 30 April 2007

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4th Annual Acquisition Research Symposium of the Naval Postgraduate School:

Acquisition Research: Creating Synergy for Informed Change

May 16-17, 2007

Approved for public release, distribution unlimited.

Prepared for: Naval Postgraduate School, Monterey, California 93943

Acquisition Research program
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The research presented at the symposium was supported by the Acquisition Chair of the Graduate School of Business & Public Policy at the Naval Postgraduate School.

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Introduction

Strategic Sourcing has become the focus of buying organizations both in government and the private sector. In the federal government, the Office of Federal Procurement Policy (OFPP) began an initiative in 2004 through its Chief Acquisition Officer Council (CAOC) to provide for Strategic Sourcing on a government-wide basis. Similarly, State and Local governments have initiated strategic sourcing initiatives to varying degrees across the United States. In support of this initiative, the National Institute of Governmental Purchasing (NIGP)

[1] The opinions expressed herein are solely those of the author. They do not reflect the opinion of the US General Services Administration or the US government.

adopted a resolution in 2006 supporting the use of Strategic Sourcing at levels of government. In the private sector Strategic Sourcing has been a way of life now for over a decade.

For the uninitiated, Strategic Sourcing has become synonymous with the process of identifying certain commodities, or commoditizable [sic] services, aggregating those commodities, and then driving a price point that reflects the leveraged buying power of a particular buying organization. While this certainly reflects an aspect of Strategic Sourcing, Strategic Sourcing is much broader and encompasses not only the actual sourcing decisions, in terms of aggregation of requirements and supplier/supply-chain management, but also the analysis of all requirements, the capabilities of the supplier base to meet those requirements, and the appropriate method to satisfy requirements through the supplier base, among other considerations. In some cases, managing the supplier base/supply chain requires the identification of the optimum size of the supplier base/chain and the mix of companies (read capabilities) necessary to meet the demands of the buyer. On occasion, the management of the supplier base/chain includes, or should include, efforts to expand or contract the base, or the mixture within the base, in order to control value and the total cost of ownership to the buyer. The ability of a buyer to shape the base is dependent on the buyer's buying power and, in the case of governmental buyers, other policy considerations associated with the functions of a sovereign. It is from this latter perspective that we approach the question of this paper of whether there is a role for midsize companies in the base/market that supports government acquisition at the federal, state and local levels.

Market Shares of Smalls, Midsize and Large Companies

At the moment, the absence of an accepted definition for midsize companies makes it impossible, with any precision or general acceptance, to define the market share for midsize companies. In fact, the current statutory and regulatory schema divides markets into two groups, small companies and other than small companies. Small companies are defined by statute and regulation in the federal market and in most state and local markets. Even where small companies are defined by statute and regulation, there is room for inaccuracy precisely because of the way in which the definitions are drafted and as result of evolution in the markets themselves. For example, the size status of a company in the US federal market is determined by the North American Industrial Classification System (NAICS), which establishes size status based on the code selected. The various codes use one of two, or a combination thereof, measurements to determine the size of a company: sales or the number of employees. Because the federal contracting officer determines the NAICS code to employ in a particular acquisition, in some acquisitions a company may be small and in others, other than small. In addition, in the federal market, there are process rules that allow a company to remain small for reporting requirements for the duration of a contract, even though after submission of their original offer an event occurred that caused the company to become other than small.

It has often been argued that there is a strong strategic and economic benefit in encouraging small business in America. The Small Business Administration (SBA) anticipates that small businesses will be responsible for the nation's economic growth during the coming decades, however, at great risk to the companies themselves. The key role of small enterprises in the federal market space has further been codified through the *Small Business Act* established by Congress. The purpose of the *Act* is to provide assistance to these ventures through set-aside programs, sole-source contracting opportunities, interest-free loans and a variety of government funding and support activities.

In the information technology (IT) arena, the welfare of small and midsized companies is critical to the US economy in that the birthplace of innovation generally is found in small to midsized businesses, and the new technologies will open avenues for future investment, growth and employment opportunities for the future. While it may be true that large companies have an innovative advantage in sectors that are capital-intensive, highly unionized and specialized, small businesses have the innovation advantage when skilled labor comes into play (Acs & Audretsch, 1987). Secondly, in order to remain competitive in the global marketplace, the US needs to constantly feed and foster new product development.

By most reports, the federal government's SBA is serving its constituents well. Marked growth in some industries, especially those whose market sector has expanded into global commerce via the Internet, has catapulted the previously categorized small business into the midsize sector. The IT market has especially fallen prey to this phenomenon since the late 1990s. What would appear to be a boon for these corporations often becomes detrimental to their existence. The intended protectionism provided by the *Small Business Act*, one that allowed for a gradual, steady growth of a business, one under which experience can be gained and expansion revenue generated, is then lost by the sudden influx of economic success without the insight and wisdom of years of business-management knowledge.

Once the threshold of success has been crossed for a company that has morphed from small to midsize, a series of events occur. This maturation of the enterprise ends the exemption provided to small business in such areas as cost accounting reporting and governmental contracting compliance standards. These emerging enterprises have a greater need for capital for expansion, and most often the small business has been reliant on the credit of an individual such as the owner for ready cash. As the small business market grows into midsize success stories, the risks associated with achievement are exponentially multiplied though regulatory requirements, technology exposures and environmental threats. A great deal of companies report that they are having difficulties getting financial software systems that will meet the growing needs of their enterprise at a price that is affordable to the midsize market. This exemplifies the challenge of finding something stronger than Quicken but smaller than SAP (large-corporation ERP system) for their finances. Unfortunately the dummied-down versions are not available in the mid-market size. This begs the question of just who are small, midsize and large businesses.

Defining Small, Midsize and Large Businesses

In the market generally, small businesses are viewed by the public as those companies that have less than 100 employees and no more than $500K in annual sales (Peterson, Albaum, & Kozmetsky, 1986). This general interpretation by the average citizen differs from that of the Small Business Administration's standards of a maximum of 500-1,500 employees based on industry type, and average annual sales as high as $17 million (Small Business Administration, 2006).

In the management accounting software realm, the middle market segment is defined as companies who have $1 million to $250 million in annual sales—the number of employees is not mentioned as the regulations and accountability of such revenue dictates the level of sophistication needed in product development and application.

What is a Midsize Company?

As noted earlier, while there are definitions for small businesses in the federal market and in most state and local markets, there is no generally accepted schema for identifying midsize companies. There clearly is no agreement on how a company's size should be measured, e.g., number of employees or sales (gross or net). Further, there is an even greater divergence of opinion at what point a company other than small becomes a large business in terms of number of employees or sales (gross or net). For the purposes of this discussion, we would like to posit that the definition should be tied to the gross sales of the company as opposed to the number of employees.

We suggest the use of gross sales as a measure for midsize companies. We do so in no small part as a reaction to how the markets have evolved over the past several decades. At one point in time, companies integrated their functions horizontally—performing most of the work they sold within their own employees. Over the past decades, companies in both the manufacturing and service sectors have, to a great extent, outsourced non-core functions of their business, keeping as members of their in-house workforce only those employees key to the core functions, and relying on outside sources to "ramp" up to meet business engagements. Using the number of employees a company has in this environment grossly under appreciates the share of the market a company may actually control, whereas gross sales really tell the story of a company's dominance in a particular market sector.

In terms of what threshold should be used to determine the size of a company other than small, the suggested numbers are all over the map. The US General Services Administration (GSA), in preparing a Request for Proposal (RFP) for its next generation Government-wide Acquisition Contract (GWAC) (named Alliant), issued a Request for Information (RFI) from the IT industry (hardware, software and services) asking for feedback from the industry on what the cutoff should be in terms of sales for a midsize company in that market. GSA received a significant amount of feedback from companies with recommendations ranging from $500 million dollars in sales and up; Yet, the majority of those responding proposed $500 million in sales as the threshold.

For purposes of this paper, we recommend that the definition be set at $500 million in gross sales. Over time, in keeping with sound Strategic Sourcing practices, this threshold should be reviewed and adjusted as the nature of the market changes. It may also prove necessary, as the SBA found for small businesses, to adjust this threshold market by market based on specific market conditions. Clearly, this would prove a significant effort to undertake; yet, its continual maintenance is essential to achieve sound market management to meet government buyer requirements.

The Importance of Midsize Companies to a Healthy Government Market—Size Really Does Matter

What happens when a business outgrows its competitors and is forced to compete with the "big dogs" for the first time—when they are too big to be small and too small to be big? A company in this transitional phase of moving from small to large is considered to be in "no-man's land." It is here that they have maximized the ability of their founders to further add capacity to the business, while at the same time burning cash in order to keep up with the market. Additionally, when a new midsize business loses a major client it had been serving during its evolution, the impact of such a loss can devastate or perhaps destroy the company entirely (Lafayette, 1992).

Most small business owners sacrifice themselves for the betterment of the business, putting in long hours and taking little pay for their efforts. Often, they rely on the skills of the founder, and when capacity dictates additional support, they find that they must pay a prevailing wage for the work, thus taking in lower profits.

Along with the additional resources needed to keep up with demand comes the burden of growing customer expectations. What a small business did to cater to its customers (from personalized service, friendly conversations and lunch meetings) will not only be expected to continue as the firm grows, but increasing levels of service will be anticipated: “Now that the business has all that money from expansion, well surely they could have house-calls, and free replacements, etc.”

At the crux of this explosion of opportunity will be the requirement for the owner to give up his control of the company. A CEO, CFO or COO will be needed, and this is not a small investment to be had. You can’t manage a larger company without a high-level manager; but as a midsize business, you may not be able to afford their services. Thus the term “no-man’s land.”

Cold Hard Cash

As the personal net worth of the founder becomes tied to the company’s balance sheet, the credit of the company becomes risky. There appears to be a reluctance to borrow money, as repayment causes lower profit margins—already very tight due to the competitiveness of the marketplace (*Journal of Commerce*, 1999, January). When money is needed and funds are hard to come by, this is when the decision to seek venture capital comes into play. Control of the corporation by these investors often leads to the separation of the founder from the business he/she founded. Further, it may be that the successful midsize business is just the perfect complement to the large corporation seeking to acquire a greater market share and lock-in or -out its competition. In the end, most midsize companies vanish into either a subdivision of a larger entity or disappear completely through dissolution.

Better, not Bigger

Some companies, when faced with the challenge of expansion, have discovered that perhaps the growth opportunity is not worth the investment, thus choosing to be better and not bigger. These companies look at the market sector in which they operate and choose to perfect their niche—moving from good to great and staying in control of their own destiny. In situations such as these, the most important motivators for the company are found not in profit generation, but in relationships that have been built, ties that have been created in a community and the personal rewards that have generated from the worthwhile work they perform (Burlingham, 2006).

Challenges for the Midsize

In order to be successful, midsized companies must be able to foresee the requirements of their clients and find innovative methods with which to meet these needs. A constant stream of investment must always be made in which cutting-edge thoughts and actions are encouraged

(Violino, 2006). Companies that fail to take action in these areas tend to fail, and the failure to keep up with the impact of IT innovations can really play a critical role in the downfall of a successful company. The Internet has had a profound impact on companies that found a manner in which to incorporate the opportunity of increased exposure, high demand and customer service. Those businesses that chose to ignore the digital revolution are now awakening to a business model that fails to meet the new consumer set of expectations.

Risk Tolerance

The amount of risk tolerated by companies is often dictated by their size and market position. Large companies tend to be as bureaucratic and risk averse as governmental organizations. Even where they are inclined to take risk, their internal processes to identify the risk, quantify the risk and get approval to assume it are lengthy and expensive. Clearly, when a large company decides to assume risk, they price for it in an attempt to shift as large a portion as possible to the buyer. Conversely, small companies generally lack the bureaucracy associated with making risk-assumption in large businesses; but when they face the “bet the company” type of risk issues, their inability to shift the risk through pricing or to bet the company’s fate on a single acquisition may cause them to pass on acquisition. Midsize companies are particularly situated in this risk-tolerance arena to take on the risk without having to bet the company or the ability to fully shift the risk to the buyer through pricing. The buyer clearly benefits in this environment.

Integration

Another arena where midsize companies provide an advantage is integration. More and more today government buyers find themselves in situations in which they lack the expertise to serve as integrator for solutions they require, but feel uncomfortable buying the products and services and integration function from a single provider. Small companies will frequently lack expertise in integrating these complex requirements, although they are more than capable of providing the products or services or both. Large companies are capable of providing a fully integrated solution, but experience has shown that it may be to the buyer’s advantage to separate the integration function from the parts to be integrated to create a tension in the supply chain that ensures that decisions are made that ultimately benefit the buyer while focusing on performance and cost-benefit trade-offs.

Overhead Costs

Clearly, an advantage that midsize companies offer (whether in fixed-priced or cost-type acquisitions) is lower overhead rates. Small businesses offer similar advantages in this area as well. Lower overhead costs benefit the buyer in both fixed-price and cost-type contracts.

Flexibility/Responsiveness

The advantages in flexibilities and responsiveness, at least from an organizational perspective, are clear to any observer when dealing with midsize companies. With large companies, try calling the President or CEO of the company as a government buyer and getting them on the phone; our personal experience has been that even when calling to discuss potential suspension or debarment (the equivalent of the death penalty in government contracting), getting through to a Large company’s senior executives to talk is difficult at best.

However, at the midsize level, the very nature of the organization allows/promotes effective communication with the company's senior executives.

Similarly, when problems arise, even the best contracts with the best companies of all sizes have problems; midsize companies seem to demonstrate greater flexibility. Whether this flexibility stems from the lack of a significant internal bureaucracy, greater risk tolerance, relative position in the market or some other reasons, is irrelevant. For the government, it means access to senior management and more timely, effective dispute resolution.

Boom and Bust Cycle

Finally, there is a boom and bust cycle in government marketplaces. Government at all levels promotes the development of small businesses and supports their growth through programs designed to help them grow in size and gain experience in performing work. However, once they graduate to "other than small" in the US market, the government support network disappears completely, leaving most of these companies in the situation where they lack the government support programs to sustain their continued growth and, as noted above, the capital to compete with large companies. Thus, many either find themselves selling their company or going out of business. This is an incredibly wasteful process in which the company that the government invested in when it was small because it was the strongest part of the engine of our economy both in terms of producing jobs and in terms of technology development, patent submissions, etc., simply goes away—and along with it, often the jobs it created, the innovation it promoted and the experience acquired during the time it enjoyed the protections of the various small business programs. By identifying a mid-tier in the market and managing that tier so companies do not have to sell or go out of business, waste is eliminated and an overall stronger economy results—one better capable of surviving market shifts.

Conclusion

There is unquestionably a dearth of empirical data to support the suggestions in this paper. The dearth exists not because the data isn't available but because government markets have not focused on it to date. Intuition informs many that there is an important role for midsize companies in meeting the requirements of the government market, particularly in the challenging times facing government buyers today both domestically and internationally.

Midsize companies offer lower cost solutions, greater risk tolerance and more responsiveness than large companies; combine that with greater experience than small companies have had the opportunity to garner, and it is clear that there is a value to the government buyer in having midsize companies in the government market place… Government buyers, however, lack the empirical data they need to utilize existing procurement flexibilities to manage government markets to ensure that a sufficient number of midsize companies remain available to meet government requirements.

What is needed at this point is greater study of the markets, empirical demonstration of the value of midsize companies to those markets and then the development of an effective program designed to ensure that a sufficient mix of companies exist to meet the government's requirements in a timely manner and at best value.

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