The Long-Tail Strategy for IT Outsourcing

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BY NING SU, NATALIA LEVINA, AND JEANNE W. ROSS

TODAY’S RAPID PACE of technological change has fundamentally transformed global IT outsourcing. Traditionally viewed as a cost-saving measure, IT 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 Downside to Traditional Outsourcing

In the past, companies have been advised to optimize their portfolios of IT service providers by relying on several major partners with extensive technology and industry experience while limiting the number of ad hoc suppliers. To mitigate the significant lock-in risk associated with such a portfolio, companies have been 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 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, companies also hoped that their outsourcing partners would introduce innovative technologies and associated services. Few
business and IT leaders, however, are satisfied with the level of innovation introduced by their suppliers. Yet today, more than ever, as rapid technological changes disrupt industries, established companies need access to fresh ideas, new technologies, and cutting-edge expertise. In IT, these capabilities are often found among smaller, more agile suppliers. This is not surprising, as the very idea behind disruptive innovation is that many established players tend to ignore disruptive changes to their business until newer companies replace their products and services by providing better value to customers. In response, savvy business leaders are devising far more proactive outsourcing practices and are not just relying on a stable, limited set of technology partners to identify and introduce innovations.

These proactive practices, however, conflict with many companies’ aspirations for consolidating their IT 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 a small group of strategic partners. Yet even in such companies, 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, often 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 article, we introduce a “long-tail” strategy for IT outsourcing. This innovative IT-outsourcing model combines a few key partnerships with a dynamically changing and unrestricted number of smaller contracts with other suppliers to deliver specific value propositions beyond the capabilities of the key partners. Representing a dynamic, diversified, and yet disciplined approach toward outsourcing, the long-tail strategy embraces and even fosters a flow of new suppliers offering new capabilities that can enable the company to prosper in turbulent business environments. This strategy requires a carefully designed governance framework that 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 key 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 company’s architecture. If orchestrated effectively, this strategy can turn into a reality the seemingly unattainable twin goals of introducing innovation while ensuring cost and efficiency.

Leveraging the Long Tail for Technology Leadership

Global Bank (not its real name) is one of the largest global financial services companies and has been ranked among the world’s most innovative investment banks multiple times by financial industry associations. Global Bank has a history of pioneering cutting-edge technologies in financial services. For decades, IT outsourcing was considered a strategic tool by the company. An early adopter of global sourcing, the bank began pursuing a global sourcing strategy in the 1980s. In the decade that followed, Global Bank partnered with a small set of major IT service companies 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 mergers and acquisitions, the bank acquired organizations that had 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 to 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 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 a decision to strengthen the bank’s global sourcing governance. By the mid-2000s, the bank started to consolidate smaller contracts into larger partnerships with multinational IT companies. 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 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 the 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 multilevel, 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. As one of the leaders in the bank’s global sourcing office explained:

> 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 about the financial industry, facilitating the suppliers’ market competitiveness and their 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 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 work flows in risk management. Such teaching enabled one 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 the financial services industry, since they automated standard industry processes. Legal agreements were negotiated as to how the supplier could sell these new software “assets” and related services while rewarding Global Bank for its intellectual property.

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 described the bank’s mode of working with new suppliers:

> At [Global Bank] there is a willingness to experiment with new types of partnerships. The bank has also shown us a significant commitment. They have shown a tremendous willingness to educate us about how a bank...

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 buyers of IT-outourcing services, mostly Fortune Global 500 companies, and 15 major technology-services suppliers. The 30 companies are based in North America, Europe, Australia, New Zealand, Latin America, Russia, Japan, India, and China, and span the financial services, business services, technology, manufacturing, and energy sectors. The financial services industry, as a pioneer of global IT outsourcing, represented a main context of the study.
works. We have shown a lot of commitment to [Global Bank] in terms of making investment[s] 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 company. 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 that offered unique value propositions. Instead of seeking a static portfolio with an “optimal” number of limited suppliers, the long tail of suppliers continually brought in new capabilities and technologies. The diversified portfolio also helped hedge the risk of lock-in with strategic partners. The long-tail strategy, however, incurred a significant total cost to coordinate a large set of suppliers. This cost was somewhat mitigated by the fact that 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 mid-2000s, obtaining a first-mover advantage in the global race for capability and talent. As digital disruption became a key concern in the last decade, the long-tail strategy enabled Global Bank to proactively scan and experiment with new technology offerings from smaller, more 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.

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 design and architecture capabilities. Toyota Motor North America Inc. has outsourced 80% of its IT workforce, which has enabled the company to cut information-systems support costs. Several strategic partnerships are critical for maintaining the organization’s commodity technologies and implementing incremental improvements. However, Toyota Motor North America’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 services to dealers and consumers. Thus, management looked to smaller, more agile suppliers to address their pressing need for innovation, especially in customer-facing areas.

The consumer portal delivery (CPD) group at Toyota Motor North America was responsible for the consumer-facing Web portal — a “big ecosystem” accommodating users with diverse digital devices. CPD’s unique technology requirements led to new kinds of supplier arrangements for Toyota — in particular, working on one-off projects with nascent startups instead of long-term engagements with major partners. As Zack Hicks, chief information officer and group vice president of Toyota Motor North America, said:

> 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.

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. In the past, developers supporting Toyota Motor North America’s consumer portal delivery group tended to create multiple new databases for the applications they created locally. In the new
governance model, Toyota created an architecture team that defined key business capabilities, as well as both technology and data standards. By adhering to architectural 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 offer a wider range of partnerships and accelerate the CPD group’s time to market.

Toyota Motor North America is part of a complex ecosystem that includes numerous dealerships, ranging from small, rural, family-owned locations to major metropolitan, multilocation 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 Toyota National Dealer Advisory 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 Motor 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 expenditures. 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 suppliers must work together, but they bring different strengths to the table. Combined, they make Toyota more efficient, reliable, and agile.

**Deriving Value From the Long Tail**

As evidenced by the experiences of Global Bank and Toyota Motor North America, deriving strategic value from the supplier portfolio requires a methodical approach to managing a diverse and dynamic set of outsourcing relationships. Prior research has documented the need for as few as three strategic partners to minimize management overhead and ensure the value of global IT outsourcing. Companies’ experiences with the long-tail approach corroborate the wisdom of a small number of strategic partners. But companies that manage their strategic partnerships effectively and institute architectural practices that preserve enterprise platforms can have a much higher number of small niche partnerships. In fact, companies and their strategic partners can institute practices that lead to a growing set of both one-off and ongoing targeted supplier arrangements that generate a constant flow of innovative technologies and approaches.

With each strategic partner in the portfolio, the client should continue investing time and resources in order to reach the long-term goals of these relationships. The close ties between the client company and its key partners enable and motivate these partners to develop knowledge and processes specific to the client so as to deliver greater value. Meanwhile, the client company should also foster 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. Strategic partners will help to identify and integrate the services of these niche providers.

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\(^\text{10}\) 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.

1. **Distribute responsibility for scanning for new technologies.** 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 a proactive role, 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 distinguish the latest fads from potentially valuable innovations. Based on their analysis of promising technologies, they can start identifying who can most effectively 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 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 we are now thinking of stopping because the new niche supplier is bypassing us. They are just moving much faster than we can. So why don’t we jump on their train?

2. **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 its role is temporary and focus its best efforts on other clients that are 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 should be 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, which often started as niche players but have moved into partnership roles as cloud technologies became more prominent.

Bottom-up nurturing requires more creativity and relationship-management skills. Business-unit managers cannot always promise long-term commitment, but they 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

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several relationships with other suppliers, mostly for cost-saving reasons. The company gradually 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. As one senior procurement executive said:

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 [your organization] the most talented resources [it has].

3. 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’ capacity for innovation. 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 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 Corp., headquartered in Hopkinton, Massachusetts, successfully leveraged suppliers to introduce innovations ranging from new business processes to emerging technologies. During supplier evaluation and contract renewal, EMC emphasized innovative capacity as an important differentiator. A former senior vice president and IT chief operating officer explained:

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 proactively suggested ways to change the process and the technology platform, and then we have a mobile app.

4. Govern your entire outsourcing portfolio. The portfolio of suppliers emerging from the distributed decision-making 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 — and 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 outsourced services. It requires asking questions such as the following:

- 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?

The portfolio’s precise breadth and depth can vary significantly depending on a company’s industry and strategy, as well as external supply markets. To evaluate the performance of the portfolio, a company should look into its unit costs for IT services. Continually decreasing costs with sustained or improving service levels are indications of effective, strategic partnerships. A company should also be able to calculate the increasing revenues from technology innovations as a measurement of the success of the long tail. Overall, a company should closely monitor the evolution of its portfolio, ensuring the company’s survival and competitiveness in an ever-changing technology landscape.

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
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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. As one senior IT executive at the bank said:

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, are pretty centralized decisions.

5. Design 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 enable 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 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, a multinational financial services company based in the Asia-Pacific region increasingly embraced the long-tail IT-outsourcing 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 financial industry awards for its 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. As a senior executive of technology and operation explained:

The bank retains the architectural oversight. The bank has a keen interest in ensuring that we have broad design authority. We took the business up into a multisourcing 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 successfully 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 this time of rapid technological change, relying on a limited number of suppliers, no matter how diversified, is insufficient. The focus of the long-tail strategy is not managing a particular number of suppliers so much as managing an architecture that permits varied numbers of suppliers by regulating key standards and placing limits on where variability of suppliers is acceptable and where it is not. Based on the architecture, managers should take a close look at the supplier portfolio, carefully assessing and cultivating different outsourcing arrangements for different types of functions.

This long-tail model allows organizations to more effectively adapt to today’s technology disruptions. The very nature of disruptive innovation is such that new players replace incumbent companies. IT-service suppliers are no exception. Some forward-thinking suppliers are themselves proactively engaging niche technology players in open innovation projects to boost their company’s
capacity for innovation,\textsuperscript{14} 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.\textsuperscript{15}

The implementation of this strategy is not easy and will be particularly uncomfortable for companies that are used to centralized governance of their IT resources. It requires continuous nurturing of key partner relationships while facilitating the emergence of new value-adding relationships that may eventually disrupt some of the incumbent 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. 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 globalization and digital disruption.

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