Value Creation in IT Outsourcing

Management guru CK Prahalad's concept of "core competency" is one of the factors behind the outsourcing revolution, which is leading to an evolution from vertically aligned enterprises to lean enterprises. The benefits could be strategic or tactical.

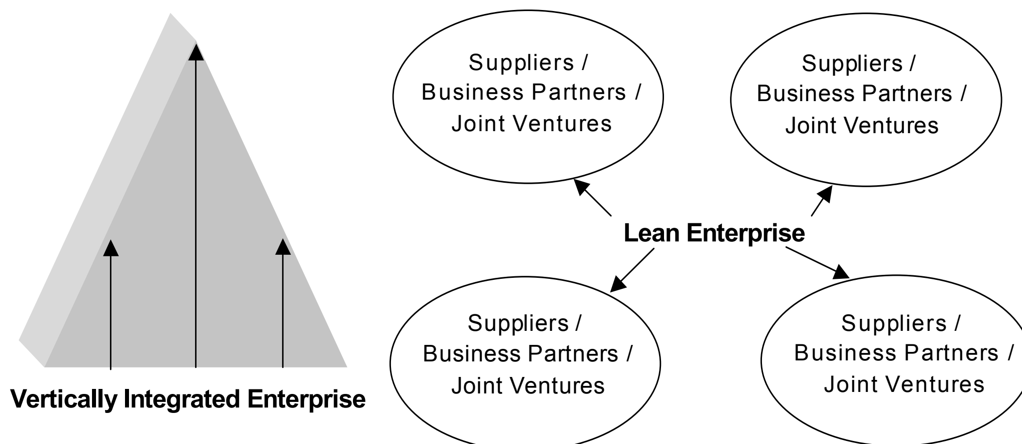
A comprehensive approach to IT outsourcing would cover all aspects of infrastructure and software – and extend to complete processes or activities themselves. This raises issues, both for the client and vendor. The chances of success can be enhanced through well-structured outsourcing relationships, backed by realistic outsourcing contracts.

The intention behind an outsourcing relationship, like marriage, is that it will continue for a long time. But any relationship can fail. Exit clauses in the outsourcing agreement could be a legal safeguard. A good knowledge management culture and system will help both parties cope with a separation.

We are operating in a new era of frequent and radical changes in the competitive landscape. Speed has therefore become an imperative on all fronts. Another paradigm shift is in the pace of change of technology – and the resulting increase in the time, efforts and investment required to be on the right side of the technology curve.

On account of these developments, one of the most influential management thoughts of the twentieth century, CK Prahalad's concept of "core competency", continues to reverberate in the twenty-first century.

The *principle of core competency* is that organizations should handle inhouse only the core businesses, activities or processes that they are competent to handle - leaving the rest to others who are experts in their respective fields. This is one of the factors behind the outsourcing revolution, which is leading to evolution of organisations as follows –



* Focussed on many issues
* Large overhead staff
* Less agile organisation
* "Invent it here" approach

* Focus on core competencies
* Small overhead staff
* Nimble organisation
* Access "best in breed" resources/capabilities

Why Outsource?

Organisational discussions on outsourcing normally meet their first speed-breaker in fears of loss of control. Inhouse execution is perceived to assure better control. Why should organizations outsource?

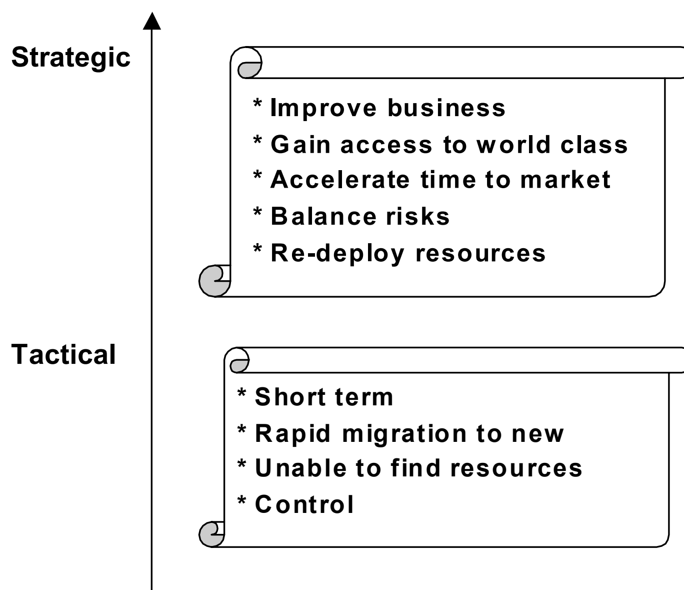
Outsourcing would be worthwhile, if –

- It releases management time that can be applied to the core of the business.
- It releases capital that can be applied to the core of the business. Even if the released capital is not required in the business, the cut back would improve return on capital employed.
- Further, the conversion of fixed costs (investment and employment related) into variable costs (payable to the vendor) would bring down the breakeven point, thus reducing business risk.
- The vendor providing the outsourced service can set higher performance standards through specialization and economies of scale.
- The cost economics of the vendor (wage rate, economies of scale etc.) could make the service cheaper.

Outsourcing across time zones opens up the opportunity of lengthening the work day and reducing cycle times. Anca Metiu and Bruce Kogut[1] provide a good example from the world of software development. Trintech, an Irish software company, provides credit card swiping equipment software. The company's Dublin engineers send the software code to Princeton and San Jose at the end of the Irish work day. The code is debugged at these centers and sent back to Dublin before the Irish staff arrive the next day. Thus, they are able to devote 16 hours in the day to the task – effectively halving the number of calendar days for the development.

At times outsourcing is the only option, because the client either cannot afford to have a dedicated inhouse execution capability, or is not in a position to organize it, or the requirement is temporary.

Thus, some benefits are strategic, while others are tactical.



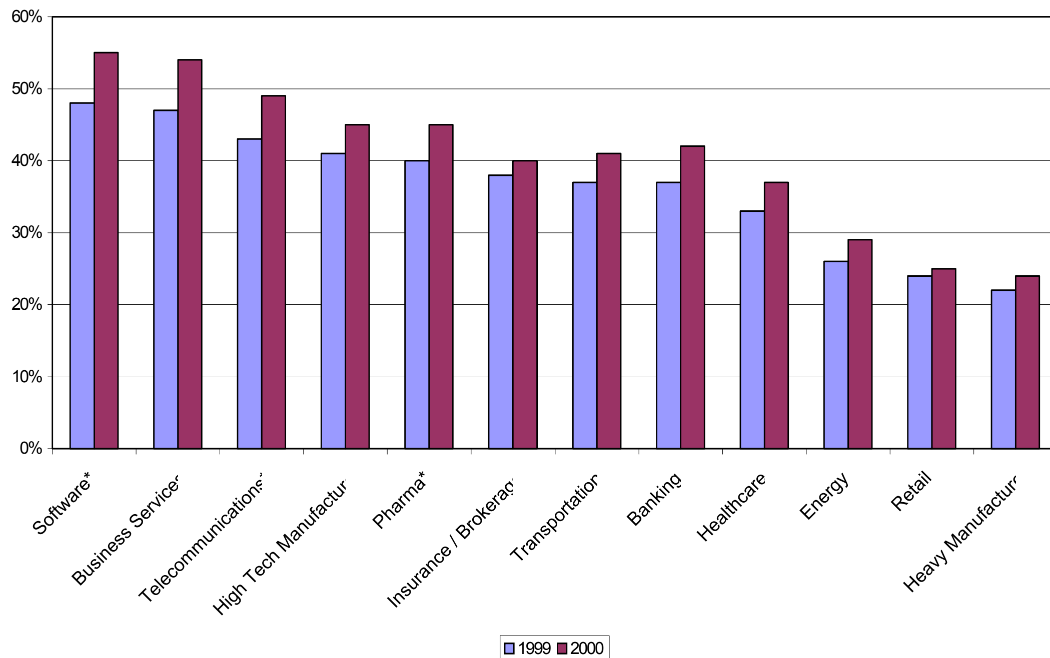
The Outsourcing Institute conducted a review in 2001, where respondents were asked to list the top 3 reasons why they would choose outsourcing as an option. The results were –

Reduce and control operating costs	48%
Improve company focus	40%
Resources not available internally	35%
Free resources for other purposes	31%
Access to world-class capabilities	27%

Stern Steward Research[2] shows that IT outsourcing has a discernible impact on share prices. A study of 27 companies that undertook large IT outsourcing initiatives (contract size above $325mn) indicated an average gain in shareholder value of 5.7 per cent over and above the market trend.

The Outsourcing Market

Given the benefits, the share of outsourcing in business activities is increasing.



Total Sample Size = 200

* Indicates Sample size of 5 or less

Source: The Outsourcing Research Council

Bullishness about the future potential is therefore not surprising.

The Outsourcing Dilemma

Once organizations are convinced on the benefits of outsourcing, the dilemma is what to outsource. David Flint[3] categorises business processes as follows –

- Critical processes contribute directly to the company's ability to generate revenue, or add to its intangible assets (brands, patents and copyrights, or particular knowledge and skills). These could be *core* i.e. processes that keep you in business and ahead of your competitors, or *non-core* i.e. other critical processes.
- Background processes don't make money, but are essential. They include paying staff expenses and drawing up budgets. These processes are important hygiene factors. If they are not handled properly, the organization will become unhealthy and vulnerable to low morale, staff churn, and fraud.
- Mandatory processes are required by law. They include audits and various reports on business activities, covering areas such as equal opportunities and environmental impact.
- Folklore processes are neither valuable nor mandatory, though they can persist for years. They are continued on the basis of oral tradition, rather than analysis. They waste resources and distract attention from the real work that needs to be done. Whenever they are identified, these processes should be stopped immediately.

The value provided by each, and the suggested approach is as follows –

Critical– Core	Competitive Differentiation (Leadership)	Handle in house
Critical– Non-core	Competitive Sustenance (Success)	Consider outsourcing
Background	Cost Control (Well-being)	Definitely outsource
Mandatory	Continuity of legal operation (Sustenance)	Definitely outsource
Folklore	None	Eliminate

Source: GartnerG2

Technology companies are in the business of delivering technology to their clients. Thus, technology is a core offering that they had better perform inhouse. For other companies, technology is only an enabler – a tool for delivering a business value proposition to their clients.

Technology itself has two elements –
- Software, which is people driven (e.g. software development, audit, maintenance, disaster recovery) and
- Hardware, which is infrastructure driven (e.g. data centers, application hosting, voice and data networks).

It is quite conceivable that a software oriented company chooses to outsource the infrastructure component of the technology. The software itself being *core-critical* would be handled inhouse – unless its role is that of an aggregator of several disparate software elements (the Linux business model, for instance) – in which case the software elements could come from different parties.

In 1993, Equifax, the Atlanta credit reporting company, sold its computer assets to IBM and contracted service rates where the projected cost reduction was 10 per cent. The 10-year $700mn outsourcing contract was criticized because “it was outsourcing the heart of the business. But the management realized that Equifax’s competencies are in software, not hardware. And the software remains proprietary”[4].

Thus, depending on the nature of the industry, technology would be *critical core* (for a technology company) or *critical non-core* (telecom, where every service provider seeks to deliver the services that competitors offer) or *background* (food, where the business can be handled, albeit sub-optimally, without technology) or *mandatory* (banking, where technology is essential for effective participation in the clearing operations).

As can be seen from the following Resources – Accountability matrix, the preferred outsourcing zone lies between contract hiring (where accountability is retained by the client) and projects (where accountability is fully assumed by the vendor). The resources could be provided by the vendor or could be shared. The sharing arrangement has to be properly understood by both the vendor and the client, so that nothing falls between the stools.

R - A Matrix

RESOURCING \ ACCOUNTABILITY	Client	Shared	Vendor
Client	Own Team		
Shared		Preferred Outsourcing Zone	(Rare) Projects
Vendor	Contract Hiring	Preferred Outsourcing Zone	Projects

ACCOUNTABILITY

Client Perspective

The Outsourcing Institute study discussed earlier mentions cost as the most significant factor in outsourcing. This is perhaps because many outsourcing relationships starting out with infrastructure, where the parameters can be easily reviewed in cost-equivalent terms. A similar study today could see non-cost factors as a key driver.

A comprehensive approach to IT outsourcing would cover all aspects of infrastructure and software – and extend to complete processes or activities themselves. This would increase the strategic value of the IT outsourcing relationship. Implications of such a deeper relationship are –

- The client starts viewing the relationship more in terms of strategic benefits such as reduction in cycle times, faster new product launches, stickiness in association with customers etc. The trade-offs made by the client would be more value-oriented than cost-driven.
- The outsourcing relationship would be influenced by the cycles and dynamics of the client's product market. A rigid definition of role expectations and deliverables in the outsourcing contract would therefore not be advisable. Where deliverables cannot be clearly set out, mutual understanding and chemistry between the client and vendor becomes most important.
- The vendor would have greater access to the business strategies of the client. This would necessitate mechanisms to ensure client confidentiality ("Chinese walls", non-compete etc). Further, greater business orientation would be expected from the vendor. In many ways, the vendor would be a partner in the success or failure of the client.
- The technology cell within the client organization would focus more on the value delivery to its customers. The technology updation aspect would be managed through vendor relationship/s.
- While the relationships would be forged with a long term view, the consequences of a failed outsourcing relationship can be disastrous to the client. Therefore, clients need the flexibility to smoothly transition between vendors.

Vendor Perspective

Apart from the business orientation and client confidentiality expectations outlined earlier, the critical vendor related issues are –

- Appropriate protection for relation-specific investments and various longer term initiatives, against the background of exposure to the client's business cycles and dynamics, loosely defined role expectations and deliverables, and client expectations of easy transition between vendors.
- The more customized the service for a client, the lower would be the scope for economies of scale.
- The more strategic the role for a client, the more difficult would be the scope for easy replication of processes between clients.

The vendor would seek protection against these risks and economic imperatives in the outsourcing agreement.

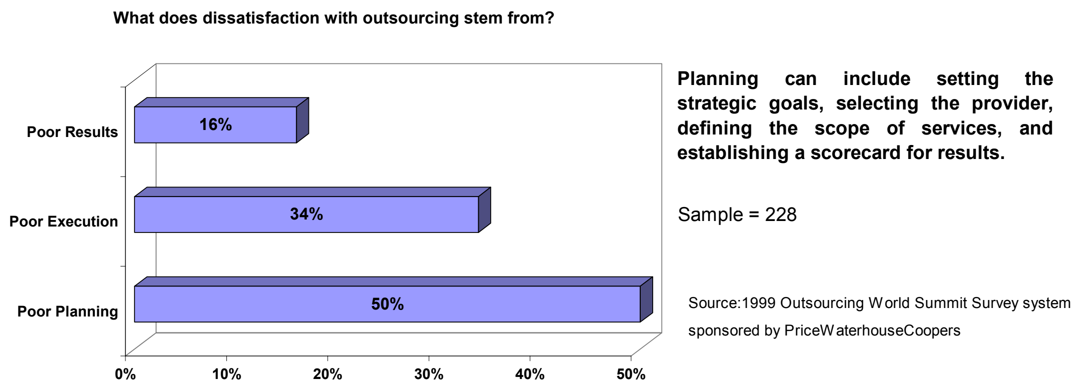
The approach of the vendor to the business obviously determines its positioning and profitability. Byron G. Auguste, Yvonne Hao, Marc Singer, and Michael Wiegand[5] provide an interest contrast between two call center providers - Sitel and Convergys.

Sitel still fails to achieve scale economies greater than those of the big call centers (with 300 or more employees) maintained by many large companies. Other third-party call-center aggregators have achieved similar scale, and as competition among them intensified during the past two years Sitel's service became a commodity.

Convergys, by contrast, offers services that go beyond routine call-center functions. For large telecom companies, to give one example, it can tally the minutes that end users spend on the telephone and generate bills accordingly. Convergys has a volume of business sufficient to give it the resources needed to deploy the highly sophisticated computer applications that do the job, and its mastery of those applications in turn attracts leading clients.

Failure of Outsourcing Relationships

A PriceWaterhouseCoopers study provides useful insights on possible causes for failure of outsourcing relationships.



The chances of success can be enhanced through well-structured outsourcing relationships, backed by realistic outsourcing contracts.

Legal Structure for the relationship

Broadly, the options are –

- *Outsourcing to an independent vendor* – This would be a pure market transaction, with the client's control limited to the delivery aspects of the business outsourced. This approach would work only where the deliverables can be clearly defined in the outsourcing contract.
- *Forging a joint venture with the vendor* – This partnership approach provides a win-win framework. The vendor would be more willing to commit resources to the venture, since the client has a stake in its success. Equity stake in the venture would provide some degree of control for the client. Cost, though important, becomes less of a deal breaker, because the stake would provide an element of upside to the client, which identifies itelf with the venture.

  This structure would be ideal in situations where the outsourcing relationship is strategy oriented, with consequent ambiguities in roles and deliverables. The assured business should however not make the joint venture complacent. The client needs to be cautious about this aspect.

  Any joint venture model imposes management overheads – both in time and cost. It is therefore advisable to leave management to the management team. The vendor could control the venture through an equity stake that is higher than that of the client.

  This was the approach pursued by Japan's Sumitomo Metal Industries (SMI), when it forged an over $600mn outsourcing deal with IBM. A new company was formed, where the existing infrastructure and people of SMI were transferred. IBM had a majority stake in the new company.

The Outsourcing Contract

Once the outsourcing relationship has been thought through, and legal and soft structure finalized, the service level agreement (i.e. the outsourcing contract) is to be executed.

The contract lays out who is responsible for what resources (infrastructure and people) and where accountability would lie, on the lines discussed so far. An important element of the contract is the fee structure. It could be –

- <u>Cost-Plus</u> – in which case the vendor would have no interest in cutting cost.
- <u>Profit Sharing</u> – which becomes cumbersome to implement, unless backed by an independent joint venture structure.
- <u>Fixed Fee</u> – in which case the client does not benefit from scale economies, improvement in vendor processes and reduction in technology costs.

No single approach would be effective in all situations. The terms and the arrangement is to be worked out depending on the criticality of the activities outsourced, availability of alternatives, ease of switching between alternatives, comfort between the parties and any special vendor issues. For instance-

- Where the balance of power is very clearly with the client, he can get away with a cost-plus structure.
- Where the outsourced activity is too small a component of the activities of the vendor, then he may not like the head aches and levels of transparency required to measure profit share.
- Fixed fee may be workable if the infrastructure is owned by the client and the role of process economies is low.

The Soft Issues

As the role of outsourcing, both technology and otherwise, increases in any organization, several vendors would offer various specialized services. Maintaining relationships with these vendors would become a critical factor driving business success. This role would typically be played by a Chief Resources Officer (CRO).

According to Frank J. Casale, CEO of The Outsourcing Institute[6], a CRO would need to possess skills in managing different businesses, managing costs, project management, contract negotiations, political and cultural consciousness, an open mind and flexibility.

In organizations where outsourcing is driven by strategic considerations, the CRO would report to the CEO. The reporting would be to the CFO where cost considerations are paramount.

Reward structures, both between the client and vendor, and within the vendor organization, should factor the need to promote a partnership spirit and camaraderie. This Is easier when a separate joint venture is in place, because there is an organization with which every one identifies. Replicating it in a relationship is a challenge, but not impossible.

"Siemens Business Services recommends compensating the IT professionals managing the outsourcing partner with a package that includes base, percent bonus on company success, and per cent bonus on partner success … Along with goal aligned compensation, both the internal IT professional and the outsourcing partner must be able to reap the rewards for responding effectively to change."[7]

According to Howard Lackow[8] of The Outsourcing Institute, governance of an outsourcing relationship, at a minimum, equates to a series of events, critical to the ongoing relationship between the buyer and service provider(s) including:

- Daily operations meetings.
- Monthly status meetings to review performance and monitor costs.
- Quarterly strategic meetings to discuss new directions or services.
- Annual meetings to refresh services, service performance levels and assess costs.

The operation of the relationship should involve multi-level contact at both the client and vendor organisations. At the outset itself, there should be an understanding on the people (positions) in both organizations who would be part of the discussions to re-focus the direction, re-set the performance measures and review performance.

This becomes even more important where the outsourcing relationship is strategic, and the roles and deliverables are ambiguous. "Today's essential values may be irrelevant six months from now, replaced by some critical new issue. Mechanisms are needed that allow the service relationship to adapt as technology and business needs evolve"[9]. The role of the CRO is critical, because it balances the emotional issues that come up in both sides during execution.

Exit strategies when the IT function returns inhouse

If Michael Douglas and Catherine Zeta-Jones can have a pre-nuptial agreement on how a possible divorce would be settled in future, why not exit clauses for the vendor and client in an outsourcing relationship?! The intention behind an outsourcing relationship, like marriage, is that it will continue for a long time. But any relationship can fail.

Exit clauses in the outsourcing agreement ensure that the consequences of a termination of the relationship are clear to both parties. This saves the time, cost and uncertainties of legal processes. The important clauses typically covered are –

- *Who would own the data and algorithms?* Logically, the client. The onus would be on the vendor, on the instruction of the client, to transfer the files and ensure a smooth transition to the new vendor. The old vendor will be compensated for the service as per agreed fee schedule.

- *Who would own the infrastructure?* Generally, relation-specific infrastructure reverts to the client as per agreed valuation formula. Services from shared infrastructure could be made available for a limited time period, until the party losing control of the infrastructure can make alternate arrangements.

- *What about the employees?* This can be a ticklish issue. Apart from assuring service until alternate arrangements can be made by the party losing an employee, a non-poaching agreement for a limited period is not unusual.

- *Will the expertise go to my competitor?* There could be a provision barring the vendor from taking competing business for a limited period – particularly when the outsourcing arrangement provides access to strategic information. The client could pay a time-bound non-compete fee to the vendor.

While these are the legal safeguards, a good knowledge management culture and system will help both parties cope with a separation.

Conclusion

The gains are there for businesses that adopt outsourcing as a strategic option, and have the competencies to make the outsourcing relationship work.

Larry A Olson, a national columnist for Information Week magazine has an interesting thought – "As I look out my window to a warm beautiful Spring day and my mind drifts to how technology could impact us in future, I start to dream about the day when an ESP (Environment Service Provider) can deliver Spring virtually to me year round ….. now that's an outsourcing strategy that will really have an impact on my bottom line.

Footnotes

[1] "Distributed Knowledge and the Global Organisation of Software Development", Feb 2001
[2] Stern Stewart & Co., "IT Outsourcing and Strategic Value", EVAluation, August 2000
[3]David Flint,**"**Sourcing Business Processes:The Key to a Focused Strategy",GartnerG2, 2002
[4] Stern Stewart & Co., "IT Outsourcing and Strategic Value", EVAluation, August 2000
[5] Byron G. Auguste, Yvonne Hao, Marc Singer, and Michael Wiegand "The Other Side of Outsourcing", The McKinsey Quarterly, 2002 Number 1
[6] Michelle Gabrielle, "Outsourcing's Marriage Counselor", CFO.com, 2001
[7] Bill McNamara, "Enabling Long-Term Value in Your Outsourcing Relationship", The Outsourcing Institute
[8] "People Wise: Managing Outsourcing Contracts", The Outsourcing Institute
[9] Bill McNamara, "Enabling Long-Term Value in Your Outsourcing Relationship", The Outsourcing Institute