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Outsourced, But Not Out of Mind

Turning contractors into strategic partners

By David Bovet and Andrew Chadwick-Jones

Outsourcing services to a third party is typically done to reduce costs. But it also holds many hidden risks. Our best-practice research shows how managers can address these risks and move beyond a cost focus to create value that delights customers.

The external sourcing of services traditionally performed internally as a matter of course constitutes a major trend across a range of industries, with a projected \$143 billion of service outsourcing by 2005. Information technology providers such as EDS and IBM, third-party logistics providers such as Exel and UPS Logistics, back-office banking providers such as State Street, and major Indian outsourcers including Wipro and Infosys have pioneered new service sectors, dramatically transforming business practices along the way.

While domestic IT providers have formed part of the business landscape for years, there are two major trends that change the face of outsourcing: the rapid emergence of capable offshore contractors accessible via the Internet and the externalization of a broad range of business processes once assumed to be untouchable. The result is the creation of new service capabilities around the globe—and a round of soul-searching by major and mid-sized companies wondering how they can benefit from these new capabilities.

Outsourcing can provide significant benefits, notably the ability to leverage suppliers' scale, expertise, and systems; access suppliers' lower labor and capital costs; provide higher-quality and more stable processes; and enable management to focus on the core business.

But while considerable effort goes into deciding what to outsource in order to capture such benefits, most managers find it more difficult to arrive at an optimal model for managing their resulting partner and supplier relationships. The risks of flawed provider selection and management are considerable, especially for critical or large activities:

- *Loss of strategic control.* JPMorgan Chase recently announced it would bring back in house a major set of IT activities it had outsourced to IBM in a seven-year, \$5 billion deal. The bank now feels it is critical to manage and control IT directly to gain competitive advantage. Some 4,000 IBM employees will be transferred back to JPMorgan just two years after the contract was announced.
- *Hidden costs.* Companies often find that hoped-for benefits do not materialize. A recent AMR Research survey showed that 80% of outsourcing deals did not meet targeted ROI. Another study by Gartner found that one-sixth of companies outsourcing IT activities did not save any money at all; for half of these cases, costs went up. Moreover, certain contingent liabilities linked to outsourced providers may not surface until years later.

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- *Service quality problems.* Call center activities transferred to Indian vendors have run into trouble and have been repatriated in several well-publicized cases. Lehman Brothers, Conesco, Capital One, and Dell have all experienced customer service disappointments and terminated outsourced arrangements in India.
- *Regulatory compliance exposure.* Companies remain responsible for ensuring that all their operations are in compliance with national regulations, even when they have shifted activities from in-house to outsourced. Proliferating requirements (e.g., Sarbanes-Oxley, Basel II, EU Data Protection Directive) raise the risk when outsourcing.

Given these risks, how can a company maximize the value actually delivered from outsourcing? What's the best way to select a strategic partner? How can one ensure top performance by an external party over a period of years and minimize the risks associated with giving up direct control?

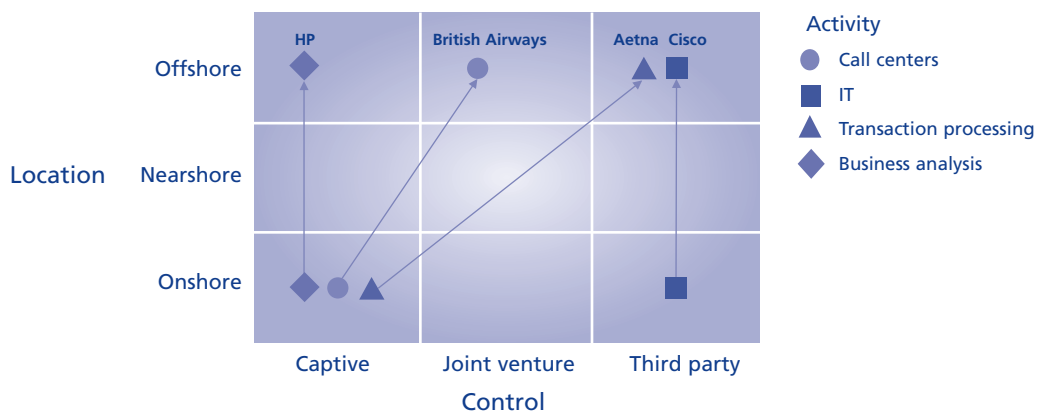
Definitions

Outsourcing means using a third-party provider to perform certain business activities on behalf of a company. A company may also choose to establish a joint venture arrangement with an external provider. The largest multinationals, including GE, American Express, and Tesco have set up their own operations in low-cost locations, forming "captives." One alternative that retains activities in-house is the creation of shared services organizations, consolidating volume across business units.

Activities can include almost any service process. Historically, IT services formed a major part of outsourced activity, first domestically to specialized U.S. providers such as Paychex and ADP. More recently, business processes ranging from call centers to insurance claims processing have been handed over to suppliers in Asia. Business process outsourcing is growing at a faster rate than IT outsourcing and is expanding at over 50% annually in India.

As for the *locational* dimension, outsourcing mentioned most in the news these days is that being sent *offshore* to India and other far-flung locations (see exhibit). Another option is to move the work to a *nearshore* destination such as Canada or Eastern Europe. Then there's the traditional *onshore* location shift of back-office activities, such as the Salt Lake City cluster of technical support. ❖

Exhibit **Dimensions of outsourcing**



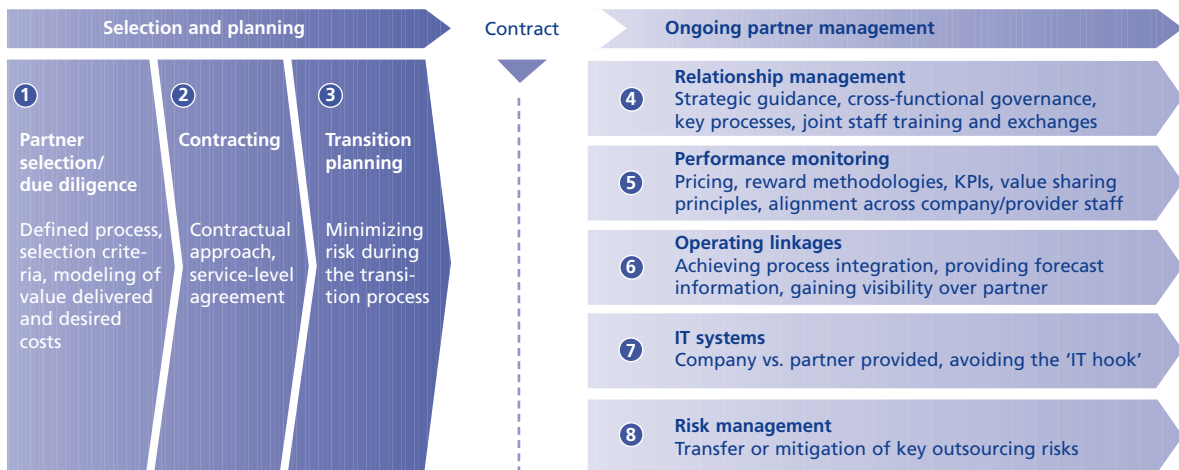
Secrets of strategic partner management

Research by Mercer Management Consulting has identified best practices that can help managers avoid pitfalls in planning and managing major outsourced activities and advance to strategic partner management. We designed and conducted this research to support an innovative transportation company that had outsourced many individual functional areas to outside providers but lacked a coherent service delivery model. Issues arising with a large existing provider and the need to extend outsourcing because of a planned fleet expansion triggered the charge to develop a robust delivery model based on best practices worldwide.

Mercer interviewed both customers and providers of outsourced services, including U.S. and European executives in banking, retailing, telecommunications, electric power, transportation, high technology, and manufacturing. Our key findings were that successful strategic partner management demands a substantial planning and selection process and then a level of attention to governance and alignment of interests that goes well beyond the usual procurement approach.

Our resulting model consists of eight components split into two major phases. The first phase entails selecting a partner, reaching a formal agreement, and planning for the transition. The second phase involves developing the right relationship structure and measurements to ensure strong performance over time (Exhibit 1).

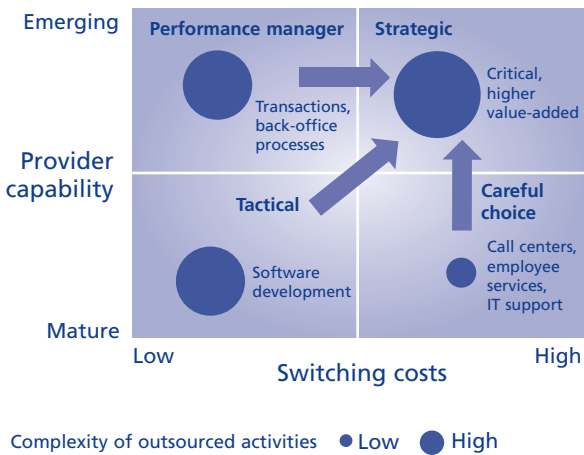
Exhibit 1 The components of outsourcing service delivery



In both phases, three factors influence the extent of effort and specific arrangements required: supplier market capability, complexity of the activities outsourced, and switching costs (Exhibit 2). Depending on the industry and the specific activity involved, a preferred delivery model may feature:

- A tactical approach, where supply bases are very competitive and switching costs are low (e.g., small call centers and software projects)
- A *performance manager* approach, when switching costs are low but suppliers are not particularly well developed (e.g., transactional but less common processes)

Exhibit 2 Strategic risks are rising



- A *careful choice* focus, if switching costs are high but processes are simple and well mapped (e.g., employee services, IT support)
- Finally, a *strategic* outsourcing approach is required when the supply base is generally immature, competition is limited, and the concept of outsourcing has emerged only recently. Business activities are mission-critical, making switching both costly and risky. And activities can be complex, involving multi-party interactions, non-standard processes, and high skill levels. These factors drive the need for a sophisticated approach to selection, partner management, and linkages among different systems or processes.

Getting the most from partners

This process-oriented view of strategic partner management provides a strong framework for summarizing the practices used by the best outsourcing customers and providers in the following eight components. The relevance for any given company will, of course, vary by industry and the activities outsourced. But the common thread is the level of rigor and effort spent to ensure that value is created.

1. Partner selection and due diligence. This is “the most important part of the whole approach,” according to one fund manager who outsourced back-office transaction processing. Best practices include articulating the outsourcing vision, strategy, and target results, which in turn help define the selection process and criteria. It is also useful to take the time to explore the opportunity for innovative solutions; new or unconventional players may offer more desirable and competitive capabilities. In any case, managers should focus on value delivery, not on cost alone. The best outsourcing yields process and service improvements that drive customer satisfaction as well as profits.

Moreover, the critical nature of strategic services requires a deep understanding of the supplier’s internal processes, and how the services will resolve problems and add value. Value creation, not just costs, should be modeled to determine feasible targets and to compare proposed solutions with current performance.

2. Contracting. Negotiations can be conducted based on the detailed understanding of value drivers and processes developed in the first step. The contract should be developed in partnership with the supplier, with incentives that motivate the supplier to improve service and to innovate. Penalties are generally not useful here; as one financial services company told us, “If it ever came to the fine print, we knew the relationship was over.” A well-crafted service level agreement is the heart of the contractual relationship.

3. Transition planning. Whether activities are being shifted from an internal unit or from an existing provider, these moves require backup plans in case of customer dissatisfaction linked to service issues. To limit the risks, it pays to transfer activities in phases, starting with simpler tasks or limited geographies.

Another critical step is to conduct training with the new provider at the existing location or onsite at the new location. While this step may require more time and effort than anticipated, it can be streamlined with the right approach.

One online retailer we interviewed brings new providers up to speed through a small team whose sole role is to integrate new service suppliers, whether call centers or logistics hubs, into the firm's business processes. Only when the vendor is fully ready does the team hand off to the functional executive involved.

4. Relationship management. Many companies don't anticipate the complexities of managing large outsourced relationships. When services are outsourced on an *ad hoc* basis, responsibility for performance diffuses throughout the organization. As a result, the company lacks coherent policies and conditions and cannot leverage the benefits of significant outsourcing volume.

Instead, managers should think of strategic suppliers as true partners and develop formal partner management principles, processes, and governance. A cross-functional relationship team can be set up to manage the multiple aspects of performance and ensure close linkage with relevant parts of the organization. Formal customer/supplier meetings that involve senior management from both sides ensure prompt resolution of problems and ongoing alignment of business objectives.

It's critical to retain strategic direction and control of the activities. This may require creating a small high-caliber team under a senior executive to manage large outsourced relationships. Alternatively, functional vice presidents can exercise responsibility for both in-house and outsourced work. The best relationships exist where both the customer and the provider continually explore opportunities for improvement. Otherwise, the outsourced activity risks focusing solely on "getting out the wash," effectively freezing processes in place.

Imprinting the outsourcing company's culture on suppliers also helps as a means of instilling the company's values and promoting efficiency, communication, and trust. This can be accomplished by training key partner staff at the company, encouraging staff exchanges between company and partner, and co-locating supplier and company staff where possible.

5. Performance monitoring. Key performance indicators (KPIs) should be selected based on performance relevance (e.g., quality of service delivery to the customer, total lifecycle costs) and should match areas where the provider has a high degree of influence. These measures should speak to value delivered to the company, whether the metric is number of successful transactions, average customer order size, equipment availability hours, or on-time delivery percentage.

Baseline and stretch targets for provider payment should directly link to these service levels. Supplier staff bonuses at every level should align with the contract incentives to strengthen the link between a supplier's stated goals and the behavior of its staff. Finally, the performance management process should be formally codified through the use of scorecards, monthly or quarterly reviews, and follow-through on commitments.

6. Operating linkages. “You can never interact too much,” said a manager we interviewed at a call center provider. This is especially true when there are numerous touchpoints across the customer and provider organizations. Interfaces for joint operating processes must be clearly defined and fully integrated. Where feasible, automated Web-based linkages can help improve responsiveness and efficiency. From the supplier side, accurate and timely demand information (including actual vs. planned demand) is essential; from the outsourcer’s side, visibility into the supplier’s activities can best be achieved through frequent, detailed review of KPIs and in-person discussion, rather than duplicative or intrusive management activities.

7. IT systems. IT systems play a central role in many outsourced operations. So it pays to draw a clear technology roadmap that communicates the company’s system architecture plan to the provider. Systems functionality and interfaces must be defined and tested, and the customer company must ensure that it has permanent access to critical data.

One key decision will be whether applications will reside with the customer or the provider. Many activities are outsourced in part to gain access to a provider’s superior systems capability. The challenge here is to avoid the “hook” and ensure portability of key systems and data to another provider at some future point. One financial services provider we interviewed noted the importance of clients having “an exit strategy”; thus, the provider uses an industry-standard data warehouse to facilitate its clients’ business operations in case a client should ever decide to shift the business.

8. Risk management. Outsourcing of strategic services carries risks, particularly if the provider is located offshore. As one bank executive put it, “Moving IT across the street was a disaster. How could we ever contemplate offshoring?” Effectively dealing with risks, some less obvious than others, is a critical part of deal design, transition, and ongoing management (see “Considering the risks” on next page).

Anxiety that the risks will outweigh the benefits slows many outsourcing initiatives. The most effective response is to conduct a thorough assessment of risks, address them through detailed business planning and risk transfer vehicles, and implement processes and metrics that allow for ongoing monitoring of each major risk.

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Strategic services outsourcing is all about adding value—through direction setting, intelligent analysis, committed management, innovation, and measurement. Developing and following a robust framework for partner selection and management, based on the best-practice experiences cited here, provides the best assurance that outsourcing will be rewarding to both outsourcing companies and their partners.❖

■ Considering the risks

Outsourcing, or moving activities offshore, raises a host of risks. Here are the most important:

- *Flawed direction.* Considerable exit costs and damage to customer and employee relations can place a high penalty on a flawed relationship, as illustrated by the JPMorgan/IBM reversal. One option that can be overlooked is moving to an in-house, shared-service model. For companies organized into autonomous divisions or built through acquisition, the advantages of centralizing may outweigh the benefits of moving to an outsourced model.
- *Loss of control.* After outsourcing an activity, some companies devote little attention to it. Staff and knowledgeable managers are fired or depart for greener pastures, and no one keeps up with IT advances in the functional area. An office equipment manufacturer, for example, was forced to undertake a major new outsourcing initiative only two years after it had put most of its logistics activities out to a third-party provider. Initial savings were offset by lower service levels to such an extent that innovative supply chain solutions were impossible.
- *Brand damage.* Just as garment manufacturers like Nike have been tarred with the “bad practices” brush due to their choice of product suppliers in China and Central America, so too can banks and other service businesses (e.g., Wal-Mart) be attacked for their outsourcing partners’ reputations. With the explosion of service providers in distant countries and the political nature of outsourcing issues in developed economies, due diligence is more important than ever.
- *Poor service performance.* This problem can defeat the most attractive cost advantage. Capital One cancelled a contract with Spectramind, India’s largest call center provider, after instances of workers tempting credit card customers with unauthorized free gifts. Poorly integrated processes, heavily accented English, or contextual unfamiliarity also can threaten customer service. To minimize service risks, one online retailer maintains a small team to integrate new service providers into its ongoing operations, viewing the skills for ramping up new vendors as replicable across functions.
- *Weak governance.* At a leading high-tech company, a major operating function had been outsourced to the same provider independently by three different divisions via eight contracts worth \$100 million annually. Only when one of the divisions expressed dissatisfaction with the supplier’s responsiveness did managers connect the dots. Not surprisingly, the provider then resisted attempts to centralize control over its activities.
- *Staff resistance.* Outsourcing can profoundly disrupt staff and cause lower morale, lower productivity, higher turnover, and reduced service delivery. Employees should be actively involved in the project, with retention plans, role changes, reassignments, job shadowing, severance programs, and interviewing by the provider all part of the plan.
- *Arrested evolution.* Business requirements inevitably change, and an outsourcing solution defined from a short-term static perspective cannot respond adequately to rapid growth or new challenges. Companies thus may face a costly reassessment and complex transition of providers. This can materialize as an inability to serve new needs, to scale up, or to innovate. Dell recently faced this problem with its Indian call center, which was unable to adapt to increased call volume resulting from expanded product lines.
- *Unforeseen costs.* The costs of evaluating vendors, managing major contracts, traveling to offshore sites, enhancing security, and paying severance for laid-off workers are not always foreseen in the first flush of enthusiasm. Realizing too late that packaged standardized services will not meet the real needs of the business is a classic problem. Customized solutions by the vendor will likely cost 15% to 30% more than standard, and a company can find itself captive to a multi-year agreement. Exit costs are another hidden risk, as ending an arrangement prematurely exposes both buyer and provider to litigation. Careful cost modeling and scenario planning that include good benchmark information and a solid understanding of current activity-based performance and costing are essential.

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- *Insurable and uninsurable liabilities.* Insurable outsourcing risks are often spread across so many types of policies that it is difficult to form a comprehensive view about whether all relevant failures have been insured. In addition, certain contingent liabilities are not currently insurable (e.g., customer service level declines, revenue loss due to brand impairment). For these risks, mitigation is the best medicine, through a robust process of risk assessment and careful development of alternatives and contingency plans.
 - *Regulations.* Restrictions on outsourcing motivated by protectionist instincts are appearing on state and local ballots in the U.S. and might be debated in Congress. Even without dramatic change, however, companies remain responsible for regulatory compliance. Sarbanes-Oxley, Basel II, and HIPAA compliance are now, or soon will be, required of financial services and other firms. Yet not all outsourcers can assure customers that they are fully compliant, so due diligence and monitoring of regulatory change is essential. ❖