Navigating the Minefield:

How to make your Outsourcing Initiative a Success

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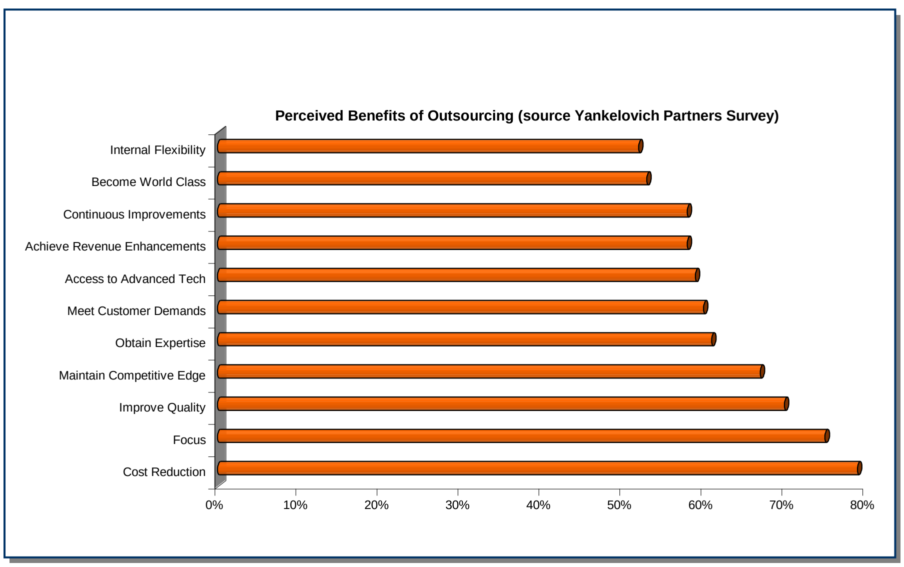
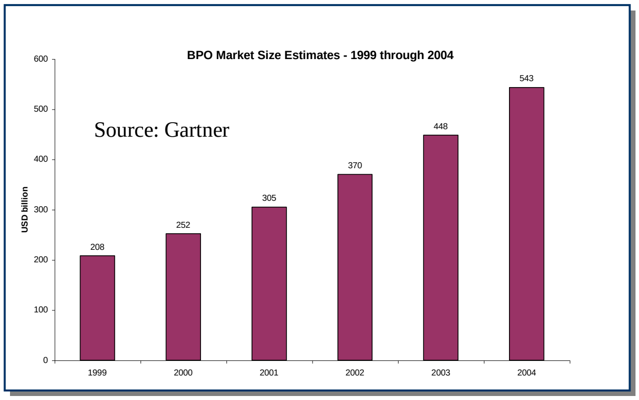
Should You Outsource?

Companies have traditionally performed a large range of functions in-house, regardless of internal capability, or criticality to the business. This was driven by the absence of dependable service providers to outsource to and partially because of insecurity. Most companies pursued vertical integration to control the value chain[1]. The 90s challenged this mindset when Hamel and Prahlad's theory of core competence captured the imagination of CEOs worldwide. Core competence theory seemed to urge businesses to stay focused only on functions and processes that were core to the organization. A lot of companies realized that they could safely outsource their non-core processes to external service providers who were specialists in that function or process. This would free up their time to focus on strategic activities core to their organisations. Further, market pressures in the 90s put Managers under relentless pressure to achieve the dual objective of improving the bottomline and growing the topline. Outsourcing was the mantra chanted to help achieve these objectives. - Business Process Outsourcing (a.k.a BPO), the management of one or more business functions with the support of information technology is being heralded as a means to revitalize organisations and make them more competitive. While there are many business drivers for outsourcing, cost reduction and improving company focus on the core business are the most important.



A Gartner report says the worldwide BPO market stood at USD 208 billion in 1999 and is expected to touch USD 543 billion by 2004. Also, amongst all functions being outsourced, Information Technology leads as the most active area of outsourcing.

[1] Charles L Gay, James Essinger, "Inside Outsourcing"



Source: Gartner

The outsourcing of business processes began with small, relatively low-grade jobs like storage of records externally. The front-runners in Outsourcing were largely US based companies. As their confidence grew, these companies started outsourcing more valuable functions like payroll, accounting etc. BP-Amoco is a good example. It first started outsourcing accounting functions in its North Sea office in 1991 and is now one of the world's premier outsourcers. PricewaterhouseCoopers and Accenture manage its accounts and finance functions, while Exult manages its HR. These outsourcing contracts run for around 5 years and save BP Amoco at least 10-20% annually on costs[2]. The following table illustrates some of the outsourcing deals that have been done worldwide:

Company	*Outsourcing Partner*	*Service*	*Contract Duration*	*Value in USD*
BP-Amoco	PwC	Finance & Accouting, IT applications	10 years	1.1 billion
Ryder Systems	Accenture	Operations	10 years	1.4 billion
BP-Amoco	Exult	HR	5 years	600 million
Cable & Wireless	Accenture	Accounts Receivable, HR	5 years	115 million
Nortel	PwC	ERP & Accounting	10 years	1.1billion
Unisys	Lloyds TSB	Cheque Processing	10 years	700 million
Bank of America	Exult	HR	10 years	1.1 billion

Source: Business World, January 14, 2002

Until now, adoption of BPO was largely a "western" phenomenon. While Indian Companies have tremendous strengths in providing outsourcing services to their US and

[2] "The BPO Boom", BusinessWorld, 14 January, 2002

European clients, Indian corporates have just woken up to BPO. Outsourcing is not new in India, though. There are a number of companies who have outsourced their payroll processing, housekeeping, fleet management and use registrars for managing activities related to transfers, dematerialisation etc of shares. Another widely outsourced area is recruitment where corporates are increasingly using the services of executive search firms to source their candidates. BPO, however, in its truest sense is just beginning to be explored by Indian corporates. We believe that in the future, intense competitive pressures will force Indian companies, both large and medium sized, to explore BPO as a strategic tool to remain competitive. Indian businesses will need to relook at their value chain to see where it is possible to improve quality, reduce cost and improve overall effectiveness with the use of BPO. For India, being a latecomer on the BPO bandwagon has an advantage – learning from the mistakes of others.

Why Outsourcing Fails!

A study conducted by Oxford University and University of Missouri analysed 29 of the biggest outsourcing deals in the last decade. The researchers concluded that more than 35% of the deals had failed. In 1998, a study published by KPMG Consulting found that 75% of the 123 organisations responding to a survey were dissatisfied with at least one important part of their outsourcing service provider, though 90 percent reported they were satisfied with the general level of service they received[3]. The reasons include the following:

1. Stated cost reduction is not achieved
2. Deterioration of service quality
3. Violation of SLAs (Service Level Agreements)
4. Deterioration in the relationship between the Outsourcer and the Service Provider
5. Strain in employee-employer relationship in the outsourcing company.

This leads to non-achievement of the greatest benefit sought from outsourcing – the opportunity for the outsourcer to focus on their core strengths and achieve a competitive edge.

Outsourcing deals begin with a lot of excitement and gung-ho optimism. After some time, however, the partnership between the outsourcer and the service provider sours when expected benefits are not seen. By the time the outsourcing deal is called off, careers are destroyed, morale is down, time, money and effort is wasted. The service provider also loses reputation, which significantly impacts ability to win future deals.

Our research indicates that there are several key reasons why outsourcing deals go wrong.

Absence of Strategic Perspective: A number of organisations commit the cardinal sin of treating an outsourcing decision as just another purchase decision. These organisations approach outsourcing with a cost-benefit and a make or buy mindset. Key issues like why they should outsource, legalities involved, human resource concerns, and slack SLAs, are often ignored or unplanned. The decision to outsource is sometimes spearheaded by the CFOs office only – the absence of a cross-functional perspective in making the outsourcing decision often contributes to the failure. Often CEOs push the outsourcing agenda with very unrealistic time frames, which leaves very little time for

[3] "Inside Outsourcing" by Charles L Gay & James Essinger

planning anything other than just undertaking a cost benefit analysis. Lack of a strategic perspective results in the wrong deal being made.

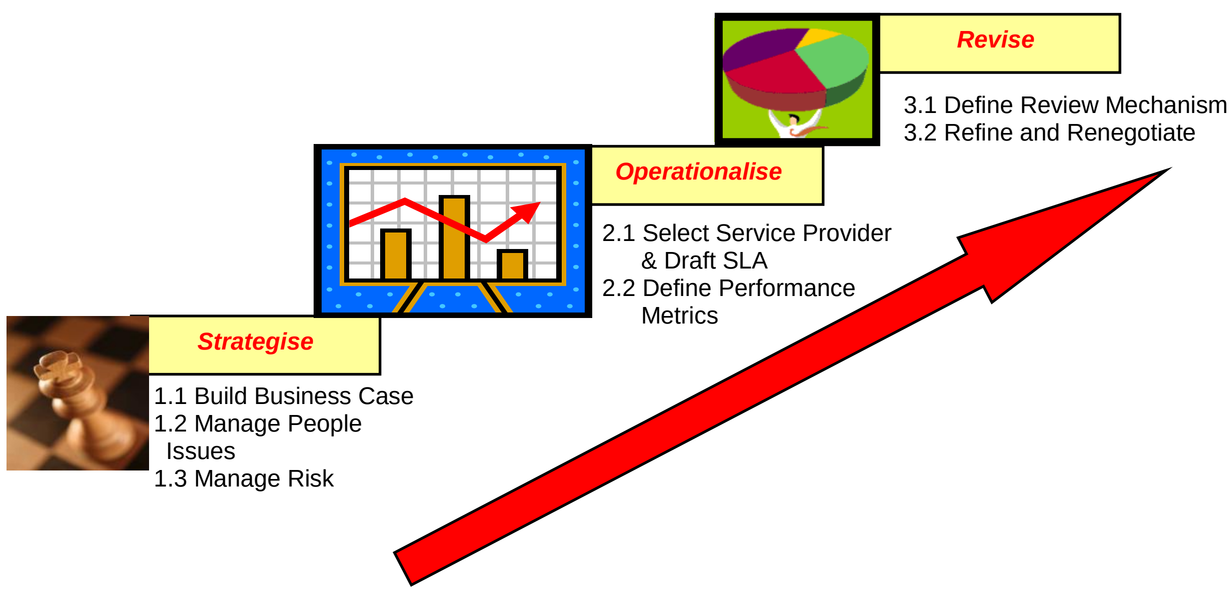
Unclear and Conflicting Objectives: Outsourcers set targets for cost reduction and enhancement of quality and value as well. This enhancement of value and improved quality requires investment on the part of the service provider. The service provides in their eagerness to close the deal, do not point out the impracticality of the objectives. The end result is an outsourcing deal, which is doomed to fail at the outset

Poor Vendor Selection and Management: The singular focus on cost reduction, above all else, impacts the selection of the service provider. Often, the lowest-cost provider is selected for executing the outsourcing deal, with very little consideration for other parameters like quality of service, expertise, past experience etc. The service provider is treated as a vendor rather than a partner in creating long lasting value for the outsourcer. This lack of a partner relationship is evident in the way the SLA documents are prepared. Outsourcers request the prospective service provider to draft the agreement, as opposed to preparing the SLAs themselves, to set expectations. SLAs are thus not clear in terms of quality of service and performance expectations. Sometimes, outsourcers commit inadequate resources to the project.

How Should You Outsource?

Our research has yielded several insights to make outsourcing work, set out in the "Outsourcing Value Creation Approach". Adhering to this simple, yet effective approach will help potential Outsourcers to minimise the probability of failure.

Outsourcing Value Creation Approach



Phase 1 - Strategise

1.1 Build Business Case: Your outsourcing agenda begins with the definition of the "Case for Outsourcing". This starts with an understanding of which function or process is being outsourced and the scope to be outsourced. We recommend that a cross functional team involving people from the function which is being outsourced, representatives from other functions that are impacted and the CFOs office, be setup at the outset. If customer interfacing processes are being outsourced, one could include a number of customer representatives as a part of the extended team. The team should begin by establishing the relevance of the initiative to the overall strategic direction of the business. Once the strategic relevance has been established, the team needs to outline the objectives of outsourcing – whether it be in terms of reduced cost, increase in efficiency or overall improvement in the quality of the process. Having defined the objectives, the team needs to organise a data gathering effort to understand the current situation with respect to objectives – for e.g. if the objective of outsourcing is to reduce cost, it is important to understand current cost levels and therefore data regarding all components of current cost, needs to be gathered. Conducting a benchmarking exercise at this stage would also be important – for e.g. if current costs are on par with other players in the industry, or if current process efficiencies are on par with other players in the industry, the team might want to question the need to outsource. Drawing parallels from outsourcing of similar functions in other industries might also be relevant. At this juncture the team should also build a perspective in terms of what benefits can be expected.

The next step is for the team to look at alternative approaches to outsourcing – for e.g. "contracting-out" vs "outsourcing the service" vs "insourcing" vs "co-sourcing", and arriving at an appropriate approach. The team would also have to evaluate risks and develop a risk mitigation plan. Once the strategic relevance, objectives and estimated benefits are clear, the team can put forth an initial "Case for Outsourcing".

1.2 Manage People Issues[4]***:*** Once the "Case for Outsourcing" is approved, Top Management needs to focus on addressing people issues related to the outsourcing initiative. This step is extremely critical as HR issues often derail an outsourcing initiative. Wherever outsourcing is proposed, there is a great fear about downsizing or layoffs. If the function being outsourced involves unionised personnel, the whole issue becomes even more sensitive. In the event layoffs are inevitable, Top Management needs to evaluate options, which could range from transfers to other departments, transfer to the outsourcing service provider or an amicable separation. Resistance also comes from people who aren't dislocated or laid off – these people clearly fear for the future, feel that they have lost control over their careers and worry whether they really have the skills to work in a new environment.

At this stage Top Management needs to put in place a communication plan to address concerns. This plan should clearly outline key messages and media to be used to communicate the same. The positioning of the outsourcing arrangement is also important – successful outsourcers are honest in communicating to everybody the benefits of outsourcing and emphasize the partnership nature of the deal with the outsourcing service provider. Any step in this issue needs to be thoroughly verified for legalities – regarding people related actions and messages being communicated. This is not an area that can be delegated. Seniority is valued and respected and hence this aspect needs to be driven by Top Management alone. It is important to understand that at this juncture only a plan to manage people issues is put in place – the actual communication would begin after selecting the service provider and setting the outsourcing ball rolling.

[4] "Inside Outsourcing" by Charles L Gay and James Essinger

1.3 Manage Risk: Identifying risks, anticipating changes and managing them is an extremely important step in any outsourcing initiative. Performance risk i.e. risk of non-achievement of stated objectives is the most significant risk any outsourcer should consider. Performance risk is largely influenced by other risk factors like a change in management, a merger or sale of the business, a change in operating procedures that could completely turn the logic of outsourcing on its head and technology risks especially that of technology obsolescence. Consider this example: A large retail house outsourced its entire information systems to a highly reputed outsourcing services provider for a very large sum. The ten year outsourcing deal was ended within a couple of years when the Board decided to decentralise and leave operations to the individual units. Identifying these risks, their impact on outsourcing and the probability of their occurrence is a step no business should overlook while considering an outsourcing initiative.

Phase 2 - Operationalise

2.1 Select Service Provider and Draft SLA: Despite advances in selection procedures, organisations often quote "wrong service provider" as reason for a failed outsourcing initiative. Organisations need to realise that there are good service providers and bad service providers; they also need to realise that it takes two to tango - organisations are equally responsible for a failed outsourcing deal. Selecting the right service provider is likely when organisations shift their mindset to viewing the potential service provider as a strategic partner, as opposed to a commodity vendor. The first step would be for organisations to document the nature of relationship that they would like to pursue with a service provider; some would prefer a partnership approach while others would prefer an upper hand over the service provider. The service level agreement (SLA), drives the nature of the relationship as they specify who does what, service levels, pricing, termination clauses, penalties etc. Organisations need to understand that nobody understands their needs better – however well meaning and reputed the service provider may be. It is important that clients take charge of this process. Clients have to watch out for the "yes-men" – in their pursuit of winning the deal, service providers often over-promise and, in the final outcome, under deliver. Culture fit is extremely important; an outsourcing deal is doomed for disaster if there is a cultural misfit between the organisation and the service provider. In addition to cultural fit it is important to evaluate the provider in terms of other parameters like geographical spread, technical expertise and past experience. Once the SLA is drafted and the service provider shortlisted, Outsourcers should legally verify the SLA. Some of the key sections that would require a close verification include liabilities, termination clauses, and accommodation of unforeseen circumstances, invoicing payment terms, leases and terms for renegotiations

2.2 Define Performance Metrics: Defining performance metrics is an important tool to manage the outsourcing service provider on an on-going basis. Some organisations use a balanced scorecard approach to managing the service provider. Whatever tool is used, it is important to list metrics derived from the overall objectives and also assign targets. Metrics should be balanced and should not contradict each other – for e.g. if the overall objective of an outsourcing initiative is to reduce cost, targets for new technology implementations should be balanced or given a significantly lower weightage. Balanced metrics will provide a realistic picture of the overall success of an outsourcing initiative and will also point out areas of performance where improvements might be required.

Phase 3 - Revise

3.1 Define Review Mechanism: Defining a review mechanism is critical to ensuring the success of any outsourcing deal. We recommend that the frequency of review be highest during the initial stages of any deal and reduces with the passage of time and increase in comfort levels of all concerned – for e.g. reviews could be held once every two weeks during the initial phases of outsourcing. The performance metrics could form the prime agenda for the review meetings, as this would help gauge whether the project is on track and whether any course correction measures need to be administered. A potential pitfall to be avoided here is the tendency to use review meetings as a platform for playing the blame game. Clients and service providers often quote that meetings are extremely

stressful with each side brandishing a sword at the other – both parties need to realise the necessity for constructive feedback and a "forward looking" attitude.

3.2 Refine and Renegotiate: A properly executed review mechanism also provides a platform for refinement, or renegotiations on objectives and target performance metrics. The review mechanism, more than anything else, is an excellent platform for strengthening relationships, which is the most critical factor in ensuring a successful outsourcing deal.

Summary:

Outsourcing has been labeled as one of the most important management ideas of the last five to seven decades. Organisations have been outsourcing activities, however, for many years. Indian companies are just waking up to Outsourcing. Carefully navigating the potential minefield that presents itself in every outsourcing relationship, will help your company to make your outsourcing initiative a success.

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