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Outsourcing Relationships: Why Are They Difficult to Manage?

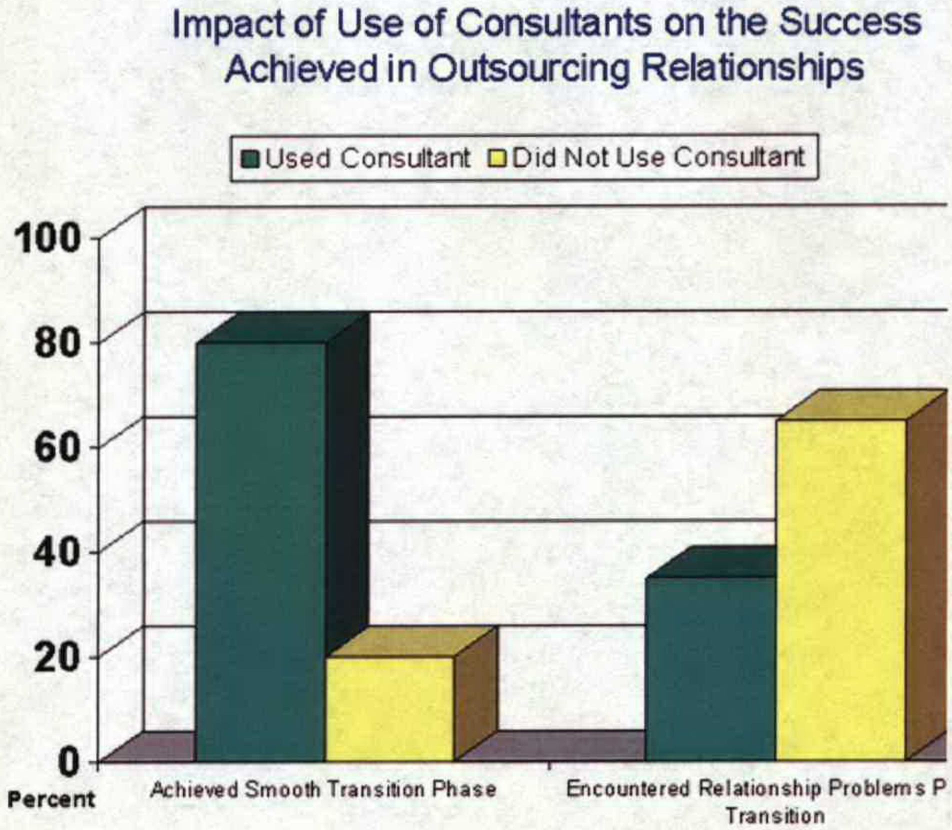
Cost vs. Value of Using an Outsourcing Consultant

By Kathleen Goolsby, Senior Writer

Today's cost-cutting environment pits some ex against the cost of retaining a consultant for ad structuring an outsourcing agreement. Often pe be a high-cost item or an action that essentially the time before the buyer can realize financial l from the outsourcing initiative, outsourcing adv services frequently end up on the chopping blo

Such thinking results from the traditional menta the pencil at the lowest cost." That is an ill-fate approach, since an outsourcing arrangement c advice and deep insight as well as cost reduction.

"If I had it to do over again, I would change the way we..." is the lament of many e who structure their outsourcing arrangements without an advisory firm's assistanc figure below illustrates the results from 78 relationships we studied within Outsour Center's 2003 Editor's Choice Awards (now Outsourcing Excellence Award) proce



Clearly, there is a direct correlation between the success achieved in an outsourci relationship and having used consultants.

We spoke with six of the 78 buyer executives in the study to determine the benefit results of their having used consultants to structure their outsourcing relationships

Outsourcing Center: What did your outsourcing consultant do that you coul done as well in house?

Mr. A. Lou Whitley, manager, HR Service Center, Edison International: "The wor passes you by about every three months in this field of outsourcing, and you need someone who is current with it to help you. I used to go through trial and error witl pieces of HR functions before. But now that I've done a deal using a consulting fir again would I do this without expert help - even on a renewal. From a cost standp were invaluable to me for the Request for Proposal (RFP), the implementation det the negotiation of the contract."

Ms. Anne Lloyd Davies, CIO, Simon & Schuster, Inc.: "Our consulting firm helpe out how to state the requirements for the RFP. It was a difficult RFP to put togethe we were in a shared services environment at the time. So it was a gigantic effort t everything. We had to identify all the applications in the RFP. It turned out that we applications running; we had to figure out what they all were and whether we ever of them and then put it together into an RFP that made sense. We also had to sco data center, help desk, desktop, and network requirements as well. We worked or about six months with the consulting firm, and it would have taken far longer withc

Mr. Jake Farkas, director, Trinity Industries, Inc.: "The consulting firm helped us v provider selection. They have a very robust process to identify BPO providers and know the marketplace. We did not have the requisite resources within our compar this. They did a really good job of understanding our requirements and were able t preliminary selection for us to identify the right providers to consider for the initial c They also made us very much aware that we were going into a long-term relations how important it was to make sure we had the right partner."

Outsourcing Center: How did the consultant assist you in your go/no-go dec outsourcing?

Ms. Jennifer Heffernan, CIO, Bank of Queensland: "We formed a project team o but we used the consultants' particular methodology and process for the analysis to outsource. The firm was selected for its expertise and experience in the numbe had done in the financial services industry."

Ms. Kathy Honda, manager, Business Development & Planning, The Queen's Me Center: "We made an internal assessment about whether to outsource our IT area consulting firm helped us determine the feasibility of that. We did not go through a process because we had pretty much decided on a provider, based on prior recommendations. But we used the consulting firm to help us validate that the pro the right choice for us. They were extremely knowledgeable in assisting us throug process."

Mr. Farkas: "It's very important, if you haven't outsourced before, to have a third p shepherd you through the process. There is no way we would have achieved succ without our consultants' help. They put a process in place to help us do the feasibi objectively. They helped us determine the risks associated with what we were plai they introduced us to the concept of business process outsourcing.

Outsourcing Center: Besides help with the RFP and provider selection, in wl ways did you benefit from using a consultant?

Mr. Jim Landry, executive director - Technology Lifecycle Management, Anthem Companies, Inc.: "They also helped design and negotiate the contract that govern relationship. That was a key success factor, and that governance structure is the r reason our relationship and contract have stood the test of time."

Ms. Honda: "I agree. It's very important to make sure you have a good governanc good service level metrics, and a good account manager."

Ms. Davies: "Our consulting firm was with us through the contract negotiations. Tl experts and knew exactly what to ask for in the negotiations. They were very deta thorough; the benefit of that is that it let our staff focus on larger issues, and the ni details were tidied up without my having to be immersed in them. Then we were a through the bids with the consultants' eyes seeing the providers' weaknesses; we have done that ourselves or, at least, it would have taken a lot longer. The other tl they advised us to use a law firm that had a specialty practice in outsourcing. The chose has been on both sides of the fence, doing contracts for providers as well a They knew the kind of contract to put together, depending on which provider we cl

Mr. Farkas: "A key to our success in the transition was due to our consultants' ad pertaining to communications. They helped us understand the importance of comr with our employees throughout the entire process; so we communicated from day we started the feasibility study about whether it made sense to outsource or not. V signed the outsourcing agreement, the communication became a lot broader and actually communicated with the entire enterprise as we went through this process consultants had explained that it was important for all of our people to understand initiative and set the right expectations for what was going on."

Ms. Heffernan: "Our consultants are helping us determine how to measure return investment. In the first year, that measurement was against our budget, which wa: regard to having decided to outsource that year. Now, we will measure those bene forward, with the budget taking into account that the outsourcing agreement and improvements are in place. We are also looking to the consultants to determine h measure the overall success of the relationship."

Bottom Line

What is the value of advice? If an outsourcing consultant warns of danger zones a steps into uncharted territory, the advice is invaluable. If the advice ties up danglir ends, gathers and analyzes relevant input from the right sources, and prevents co mistakes, the value is easy to measure. If the consultant provides a systematic wa making things predictable and understanding implications of decisions, the value (far more than its price.

Lessons from the Outsourcing Journal

- An outsourcing advisory firm's value includes crucial expertise in designing effective RFP, service levels, pricing components, and other contractual ele
- An advisory firm has daily insight into the marketplace and can provide valu advice on strategic and cultural fit of potential providers.
- An advisory firm knows the pitfalls of outsourcing relationships and can cor implementation/transition phase that comes in on time and on budget.

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Building a Case for BPO - Part 2

For Buyers' Eyes Only

By Damon Rosenhan, Everest Group

In Part One, published in the July issue of the BPO Journal, I touched on core versus non-core functions and gave a few examples of each. To summarize: A function that is core to your business is one that distinguishes your company from your competitors; a non-core function is one that may be critical, but does not directly contribute to shareholder value and the ability to distinctively compete in the marketplace.

Unfortunately, many organizations struggle with deciphering critical versus core, making it difficult to adopt a BPO strategy. The reality is that core versus non-core is still difficult to determine for most organizations. For example, recently I spoke with a chief financial officer (CFO) who was convinced that processing accounts payable and accounts receivable was core to his company's business. I told him while I agree that both of these processes (and the information they provide) are critical to any business, the ability to process better and faster than the next guy simply is not core. It does not differentiate his company from the competition.

How Do We Find Value in BPO?

The most important thing to identify as a buyer of BPO services is the benefits or value you plan to gain from outsourcing. In our work with clients, we strive to help buyers focus outsourcing efforts on the true value they can receive by outsourcing a function. In many cases the outsourcing initiative is driven solely by a desire to reduce operating costs, when, in fact, there are several other business issues that an outsourced solution can address.

If the only value you plan to obtain is cost reduction, I would challenge you to look deeper into your organization to discover what other business and strategic value you could obtain through outsourcing. Some examples include increased speed, better flexibility, improved financial insight, access to capital, etc. As we learned from the history of IT outsourcing, relationships that focus strictly on cost and have no partnering qualities often fail before they begin.

Buying BPO

Now that we have reviewed the fundamentals about core versus non-core, we can talk about spending money wisely (we all like to spend, but nobody likes to waste). Here are the four most common questions we hear from buyers:

1. What do I need to keep in mind as I go about the process?
2. How do I select a service provider?
3. How should I structure a win-win BPO deal?
4. Where can I go shopping? Who are the key players?

1. What do I need to keep in mind as I go about the process?

The best way to procure BPO and maintain a focus on adding value is to drive the transaction from a strategic level and facilitate an interactive process with the potential service providers. It is critical to keep the focus on the value and the outcomes, not the cost. Otherwise, the aspects of success will be hard to maintain.

This often requires a different procurement process than most of us are used to. There are two things to keep in mind. First, you must define your outsourcing objectives using the criteria important to your organization. Then, you must formulate your buying criteria. Your executives can do this by assessing which non-core processes could help meet your company's strategic objectives and what outcomes a service provider would need to deliver through better operation of those the non-core processes.

Second, in order to achieve the desired strategic and business outcomes of BPO, it is critical to treat the potential service providers you are working with as partners. Engaging a service provider early on in the "strategy" development phase will allow you to understand its capabilities and incorporate its thinking into your solution. Developing a concise set of specifications and desired outcomes will help you and the service providers concentrate on the best solution.

2. How do I select a service provider?

Due to the complexity of BPO, it will be difficult to attempt the selection process if you begin with more than a few service providers. It is critical to understand the service providers' various skills in order to invite the right ones to the "dance." In order to find the most appropriate service providers, you can research them yourself, rely on third-party information, or hire a consultant who has worked with the service providers before and understands their strengths and weaknesses.

In identifying the requirements, most companies we work with decide to pursue a Request for Proposal (RFP) process. However, sole sourcing approaches are common in cases where there is a long standing relationship in place, particularly for more complicated BPO transactions that require a very strong buyer-service provider relationship due to the lack of competition.

The RFP process is somewhat like a trip to the dentist for both the buyer and the service provider. For BPO initiatives, it often becomes difficult to compare the service providers' responses because their solutions vary based upon their competitive strengths. The challenge becomes comparing apples to oranges. In these situations, the evaluation must focus on the potential value provided by the solution.

3. How do I structure a win-win BPO deal?

The goal in structuring a successful BPO deal is to achieve the desired results while building and maintaining a strong relationship. We often refer to outsourcing as a marriage for a couple of reasons:

1. You are committing a significant amount of resources to the relationship.
2. No one wants this relationship to end before "death do us part" (or the period of the contract.)

The most critical aspect of structuring the deal is to align the pricing and incentives with the desired outcomes. Since recent trends have been towards driving greater business and strategic value through BPO, pricing has shifted to reflect this new emphasis. We're finding value-based pricing is becoming increasingly common. Value-based transactions are structured around strategic outcomes and business profitability. In many cases, performance incentives and gain sharing are put in place if these objectives are met or exceeded. This changes the pricing method to one of investment and expected return based on actual business results.

4. Where can I go shopping? Who are the key players?

The BPO landscape is changing rapidly. The most notable recent change was the July announcement by IBM that it plans to acquire PwC Consulting (which includes its BPO group) to complement its technology expertise with business process expertise.

The landscape of BPO service providers consists primarily of three distinct groups:

1. Big 5 players or spin-offs (e.g., Accenture, Deloitte Consulting, OPI/KPMG spin-off, Cap Gemini Ernst & Young);
2. Venture capital-funded niche players (e.g., Exult, SourceNet, Equitant, Creditek); and
3. Traditional outsourcers (e.g., ACS, EDS, IBM, CSC)

The Big 5 players build upon traditional consulting strengths to enter the BPO marketplace. In addition, strong executive level relationships and market permission derived from their business consulting and process reengineering backgrounds have given them traction in this space. In addition, many have "purchased" capacity in order to gain quick acceptance and critical mass.

The strategy for the VC-funded niche players is to use capital infusions and technology to gain a foothold in a single area (e.g., accounts payable, HR) for which they have a strong value proposition but initially have limited delivery capability (often requiring them to "acquire" a cornerstone client). After successfully establishing a foothold, the players may begin moving into adjacent processes.

The traditional outsourcing firms are taking advantage of market opportunities to acquire struggling BPO and finance and accounting (F&A) organizations. These companies leverage their IT infrastructure capabilities along with strong client relationships in large companies.

Across the three groups of competitors, there are no clear winners yet. Based on our experience and market knowledge, we believe there will be further consolidation as well as new entrants into the space.

Lessons from the Outsourcing Journal:

- Invest in understanding how to apply core versus non-core concepts to your organization.
- Strive to discover the business and strategic impact of BPO and structure a relationship around creating and capturing that value.
- Buying BPO services is a more complicated process than traditional IT services (e.g., desktop, data center) and requires a process that focuses on and allows service providers to create value for your organization.

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Building a Case for BPO - Part 3
From the Service Providers' Perspective

By Damon Rosenhan, Everest Group

In earlier issues we've discussed business processes outsourcing (BPO) in great detail. We've discussed how to assess core functions and differentiate from non-core. We've discussed the issues that BPO buyers face in developing a strategy, determining their goals, defining the specifications and ultimately selecting the service provider that they are going to 'marry' for the next five to 10 years. This segment looks at outsourcing from a service providers' viewpoint. The goal: to have both parties in an outsourcing relationship focus on creating a win-win situation.

Due to the complexity of BPO, it is in the best interest of buyers and service providers to focus on the true value that outsourcing can create, and the service providers' needs in order to deliver on the promise of value creation.

Value Creation

As the BPO marketplace becomes increasingly competitive, BPO is in danger of suffering a similar fate to that of ITO: commoditization. Service providers ought to look deeply into their organizations and discover new ways to create value for their clients and structure relationships accordingly. In addition, the necessity to continue to innovate and revolutionize the industry is critical to the success of outsourcing as we know it. However, buyers must also realize that in order to have a successful outsourcing arrangement, the service provider needs to make money on the deal.

Many view the term 'value creation' as "consultantese," but the ability to differentiate your services from that of the competition is what drives value creation. Furthermore, as BPO increases in popularity, it will be increasingly important to offer services and structure deals that will not fall into the bucket of commoditization. From a service provider's perspective, creating value means bringing a solution to the buyer that will meet or exceed his business needs at a price that will make his wallet smile. Given the current economic conditions, companies are trying to reduce costs as much as possible while meeting or increasing the quality of the service they receive from their current operations.

As service providers strive to increase the value of their relationships, it is critical for buyers to structure their specifications and Requests for Proposal (RFP) in a way that will challenge the service provider to search for business value.

Understanding the Service Providers' Needs

Although most buyers envision their service providers as the enemy, in truth, their intentions are generally good. At Everest we have had the opportunity to work with just about every service provider in the BPO marketplace on at least one transaction. Most service providers we've worked with have the desire to bring a meaningful solution to their buyers that will have true business impact on their organizations for years to come.

Recently, we've actually seen service providers begin to back away from deals that they know will not be viable or add value to the client in the future. Deals that are not structured around business value - deals that have a valid approach for achieving cost reduction and increased efficiency -- are destined to fail from Day One. The service providers know this. All the major service players are accountable to their shareholders; the only way to increase revenues and provide healthy profits is to sell and structure deals that work for both the buyer and the provider.

Just because the service provider has to make a profit doesn't mean the opportunity to significantly reduce costs through outsourcing doesn't exist, because it does. What is does mean is this: In their efforts to get the best deal, buyers must recognize the service provider has to make money for the relationship to work. Buyers must add this perspective to their negotiating strategy.

For example, I recently purchased a new car, and despite my negotiating skills (or lack thereof), the dealer wasn't willing to sell the car for less than invoice. He actually wanted (and needed) to make money.

The bottom line is that service providers must share the rewards in order to continue to fund the innovation, training, and improvements they will use to decrease the buyers' costs over time and add strategic value to the relationship. Shared learning and leverage are what give outsourcing its power in the marketplace.

Lessons from the Outsourcing Journal:

- Service providers need to be in a position to make money or the relationship will deteriorate.
- The service provider's ability to participate in rewards helps the buyer by funding the innovations, training and improvements it needs to gain value from outsourcing.
- Buyers must structure their RFPs and contracts to motivate service providers deliver and create additional value.
- Service providers today will not bid on an outsourcing deal if they can see it will not add value and be viable in the future.

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Outsourcing in 2003: How Offshoring Is Changing the Industry

By Peter Bendor-Samuel, CEO, Everest Group

The biggest event in outsourcing last year -- and the biggest event since outsourcing's inception -- was the growing use of offshoring. Both buyers and suppliers realized the profound power of labor arbitrage.

The move to offshore work to take advantage of low cost labor is affecting every area of outsourcing. In the IT space, offshoring is making major inroads in the applications development and management area. The offshore service providers have made this area extremely competitive. I predict every company needing applications will have to outsource or create its own offshore captive if it is going to have the work done cost effectively. This year the same will probably be true for IT infrastructure.

Offshoring also enabled a big push into BPO, the second major trend of 2003. Offshoring allowed suppliers to outsource many business processes they couldn't touch before because they couldn't drive down cost. Last year the universal mantra for buyers was: cut our costs. Offshoring finally allowed suppliers to do that.

For that reason, BPO suppliers expanded their capabilities last year, moving higher up the value chain.

The combination of these two trends has significant consequences for the future of the outsourcing industry.

Trend 1: Offshore Suppliers Come Into Their Own

Last year offshore labor arbitrage finally got some respect, as Rodney Dangerfield used to say. Offshore firms created a new credibility in IT applications work and data center operation. On a recent trip to India I visited a number of suppliers who could support substantial data centers in India while leaving the assets in North America or Europe. This is a very interesting development with serious implications for the IT market; it allows buyers to retain their assets and still drive out cost.

Last year offshore service providers moved from project work to true outsourcing. Now that they have earned the respect of their buyers, the offshore suppliers are entering into long-term outsourcing relationships. I expect to see substantial migration of work to India, the Philippines, and Eastern Europe.

Moving work offshore presents different risks. How do you think about governance when the supplier is eight times zones away? Buyers had to revamp their governance models to deal with a different set of challenges.

Trend 2: The HRO Transaction Model Gained Traction

Transaction engines rule in human resources outsourcing (HRO). Transaction engines are rules-based outsourcing where a supplier uses technology, people, and a new process to automate routine and recurring transactions like payroll and benefits administration. Offshoring is a key part of the transaction engine success story. 2003 was the year that proved they work.

This is good news for both buyers and suppliers because the engines allow for more value capture. For buyers, they reduce cost and improve the service; for suppliers, they can spread their investment over a lot of clients.

Trend 3: The BPO Market is Dividing

We see the BPO market dividing in two: some buyers just want to outsource transactions, while others want to achieve a bigger business impact. For example, an Everest survey released in December 2003 found the finance and accounting outsourcing (FAO) market segmented almost equally into two distinct pieces - full service and transaction-based. The study found 44 percent of the last 85 FAO transactions signed were full-service in scope.

Trend 4: Niche Outsourcing Is Thriving

Various industries are enjoying big wins thanks to outsourcing. One of the big winners is the insurance industry. Outsourcing third-party administration and claims processing produces both cost reduction and high business impact. Outsourcing can dramatically reduce the cost per claim while improving customer service and retention.

Banking is benefiting from outsourcing clearing functions. Healthcare is outsourcing its revenue cycle for greater profit, to name a few.

Trend 5: American ITO Slowed Down

There was also a slowdown in the American IT infrastructure and applications development outsourcing market. Historically, companies outsourced their IT infrastructure to save money. Today, sending that work offshore to take advantage of the labor arbitrage is becoming the best way to cut costs. Companies unwilling to deal with suppliers that use offshore labor are not receiving the value they expect from outsourcing these processes. This led to last year's slowdown.

What's Ahead in 2004

This year offshoring will gain even more traction. We expect more and more companies to focus on the benefits labor arbitrage can bring. At the same time, we believe service providers will take their successful offshore models in established processes like HR and finance and accounting and apply them to other business processes. We expect a rapid adoption across all BPO processes.

How long will the offshore providers be able to provide an economic advantage through low cost labor? That debate began last year and will continue this year. We predict the offshore providers can maintain this advantage for at least 15 years and maybe considerably more.

We also expect one of this year's high impact areas will be in the order to cash space. Outsourcing this payment and fulfillment process will result in substantial wins for buyers by reducing their required working capital. Automating this process allows the outsourcer to move buyers from simple cost reduction to business impact, creating more value.

This year we expect the transaction engine process will expand to three other processes. One will be indirect purchasing. It's too early to determine who the winning suppliers will be. It may be the firms specializing in logistics. But it may be the big finance and accounting providers like Accenture, ACS, IBM, or EDS. All are assembling compelling offerings in this space. For example, if you combine the offerings of A.T. Kearney, an aggressive sourcing company, with EDS, together they can create a very strong value proposition.

Another candidate for transaction engines is customer relationship management (CRM) for use at the call center. A third possibility is commercial real estate (CRE), an extension of the traditional outsourcing offering.

We don't expect the indirect purchasing transaction engine to be fully validated this year, but it will make great strides. We predict by year's end it will have evolved to where F&A outsourcing is today.

Predictions for 2004:

- Offshoring will grow faster and gain more traction in 2004.
- Offshoring will spread to other BPO processes.
- Order to cash, customer relationship management, and commercial real estate may become prominent outsourced processes using a transaction engine this year.