A Whole New World of Outsourcing

Norris Overton

Maxelerate Systems Ltd.

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Outsourcing IT Services—it's no longer a Gordian Knot, on the other hand, there are still risks for the unwary.

Fifteen years ago outsourcing corporate IT services was quite literally a foreign concept. Today it's not so foreign but it's still risky. Moving such a critical function offshore used to be risky; it was tedious; and time consuming. Today it's easier to do the deal but selecting the right supplier presents its own set of risks and challenges.

Fueled by technological advancements and the trend toward globalization — as well as cost savings ranging between 30 and 50 percent when compared to doing the same work in-house — outsourcing has become an accepted way of doing business. However, it hasn't been a walk in the park. An American Management Association survey reports that 35 percent of outsourcing deals were terminated for cause. Perhaps more telling are the results of a Dun & Bradstreet survey that reports more than 60 percent of respondents expressed dissatisfaction with some aspect of a an outsourcing deal.

But outsourcing isn't predestined for failure. Prudent executives are capitalizing on the lessons of the past to structure deals that deliver bottom-line results while avoiding the pitfalls that have created problems previously. These managers are identifying methods to cope with the changing cost structure of offshore outsourcing and many new issues, often helped by skilled consultants .

While the Law of Supply and Demand has narrowed the wage gap (especially between the U.S. and India) that made early offshore outsourcing deals so attractive, new sources of less expensive labor have been found in Eastern Europe, China and the Philippines. Other issues being addressed include data security, cultural compatibility, language problems, taxes and legal implications as well as political and environmental considerations.

Although outsourcing is no longer as complicated as the Gordian Knot, the solution is not as simple as Alexander the Great's sword, either.

"You're going to do what!"

The executive vice president was literally aghast when I first suggested (in 1992) outsourcing the data center operations of a $2 billion nationwide transportation company with some 23,000 employees. The thought of transferring a significant number of employees in the corporate technology department, along with ownership of our data center, to an outsider was viewed as an unthinkable management action.

In the early '90s outsourcing was in its infancy. Business leaders were slowly and cautiously beginning to consider using this tool—principally in the information technology area—although there were several reasons to justify this dramatic action. They included:

Gaining access to world-class technological capabilities,

Transferring a difficult-to-manage function to an outside, "expert," service provider,

Reducing the requirements for capital investment in a back office function and freeing up resources to focus on the organization's core functions.

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In addition, outsourcing could provide an infusion of cash from the sale of fixed assets. In our case it was an existing data center and the computer mainframe.

"Due diligence" 12 years ago took nearly two years

It took several more conversations and several more weeks but, eventually, the executive vice president reluctantly agreed to authorize a budget and the resources needed to develop a business case. The necessary "due diligence" required almost two years and included participation in outsourcing seminars and visits to organizations that had already outsourced an IT function. An experienced outsourcing consultant was hired to advise and guide our efforts.

Although the business case identified a reduction in operating cost as a justification for outsourcing, the consultant cautioned against using this explanation for taking such a wrenching action. In retrospect it was pretty good advice. The complexities of determining the real costs of something so unusual, and thus the "savings," would have been a formidable task. When the RFP to outsource the company's Data Center and Telecommunication function went to the Board of Directors it was justified by emphasizing:

- Access to world-class technical capabilities
- Economies of scale
- Infusions of cash from the sale of fixed assets
- Reducing the need for future capital investments.

Globalization provides a whole new world of outsourcing

That deal would be easier and less time-consuming to put together today. Globalization is providing a whole new world of outsourcing for today's business leaders. These opportunities have emerged in a climate of growth and expansion fueled by technological advancements, international standardization in information technology and inexpensive communication cost. Coupled with the capabilities of the Internet, these factors now make it possible to efficiently move mass amounts of data and information around a world that is rapidly becoming (technologically) borderless.

One consequence of these changes is an upward trend in use of cost savings to justify outsourcing. Immediate cost savings are now more easily quantified, up front, on many contracts such as: call center operations, warranty management, insurance policy management, accounts receivable management, financial transaction accounting and a score of other back office functions. The primary reason this has been possible is the spread between wages for skilled workers in the U.S. and Third World countries. For example, India currently stands at the center of the almost explosive expansion in outsourcing back office operations because a programmer there can be put on a payroll for about half of the cost for the same work in the United States ($80,000 a year, plus benefits). Because India has a very highly educated and talented workforce clamoring for employment opportunities, U.S. companies have reported cost savings ranging between 30 and 50 percent.

But offshore outsourcing is not a magic bullet. Executives can no longer simply pick a vendor in India and whistle their way to the bank. First the wage-gap is narrowing. As the highly skilled and well-educated workers in India have become more productive, they are have begun seeking higher wages. And, given the increases in productivity, if they're unable to get higher levels of compensation, they will change employers. The turnover rate in India has recently been estimated at 30 percent and includes systems engineers who are following the opportunities for higher earnings.

Risks and concerns of offshore outsourcing

As a result, India's technical workforce could become significantly more expensive in the future. However, China, Russia and the Philippines are beginning to offer more attractive labor costs and, for the foreseeable future, offshore outsourcing will be able to take advantage of lower labor rates. But this doesn't suggest that offshore outsourcing is without risks and other significant concerns including:

- Data security,
- Cultural compatibility,
- Language problems,
- Taxes and legal implications, and
- Political and environmental considerations.

Fortunately sorting through and evaluating these concerns today is less difficult than it was a decade ago. Not only are there dozens of qualified vendors anxious for your business, there are experienced consultants, such as Maxelerate, available to share their experience in this complex business arena. We can help you learn from the past experiences of others. This knowledge bank may be more important than in earlier years as outsourcing has expanded from the traditional back office functions to entire business processes. And it matters little whether the outsourcing transaction is onshore or offshore, in too many instances buyers leave themselves open to chance and unnecessary risk. All too often, the same old mistakes are being made.

Vendor evaluation, which always has been a critical step in the outsourcing process, takes on a more significant role in the new era of offshore outsourcing. Previously, the vendor's reputation, experience, treatment of transitioned employees and financial stability as well as its ability to meet goals for outsourcing and transition planning had top priority. Today it has become critical to add cultural compatibility to the evaluation.

Your responsibilities when evaluating potential vendors

Recognize that potential vendors understand why you're outsourcing a function and will tailor their sales pitch accordingly. It is your responsibility to determine the real value of any "free services" they may offer. Look that gift horse in the mouth before saying yes. Equally important, determine if the vendor plans to subcontract any portion of the work they contract to an offshore facility. If so, insist on your right to participate in the subcontractor selection process. In addition, require the vendor to provide alternatives and remedies should communication and/or cultural differences become a problem during the term of the outsourcing relationship.

Your internal and external customer satisfaction should be a major component in the vendor evaluation process. We know of a computer manufacturer that outsourced its technical support help-desk to India. Within a relatively short period of time, external customers began complaining of communication difficulties in resolving technical problems with their desktop hardware and/or software. These customer complaints reached a level that caused the company to reverse its decision and cancel the contract. Customer satisfaction was viewed as more important than a 45 percent reduction in labor cost achieved by offshore outsourcing.

We believe that many avoidable mistakes are being made as the result of hasty, uncritical vendor selection. For example, clients succumb to a vendor’s marketing pitch that the client and vendor become "partners" in the project. Keep in mind that your goals and those of the vendor may not be congruent. They may actually be diametrically opposed. For example, your goal may be to decrease operating costs while the vendor’s goal may be to maximize the revenue stream from the outsourcing relationship.

The most important message in this article

If you take away only one message from this article remember that the relationship between your company and the vendor is contractual. The marketing staff you work with prior to signing an agreement will move on to other assignments. Get your conversations into writing! Once the project begins you will find yourself dealing with a new team. We know of a client who, expecting an onsite crew of individuals wearing the vests and buttoned-down collars that were the trademark of the vendor who won the contract, opened the local newspaper and found a want ad seeking employees to work on their account.

Here’s a checklist to help you benefit from others lessons:

- Never forget that the relationship is contractual, no matter how often the potential vendor describes it as a "partnership"
- When outsourcing deals go bad, the underlying cause often can be traced to the contract
- Allocate sufficient resources to manage the process
- Insist upon unbundled pricing
- Avoid ambiguities; identify specific contractual deliverables
- Employ a structured procurement process that provides discipline and gives adequate consideration to cultural compatibly

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- Specify that termination assistance required from the vendor include intellectual property rights
- Document immediately and advise the vendor of any failure to meet contract terms
- Make sure that your intellectual property is legally and physically protected in the country of outsourcing
- Provide a well-defined and contractual dispute resolution process
- Manage expectations of an immediate improvement in performance
- Control changes in the scope of the agreement
- Exercise "due diligence" in all phases of the contracting process
- Most importantly, employ a structured vendor candidate evaluation process prior to signing any outsourcing agreement
- Do not place too much weight on the lowest price
- Use benchmarking prior to entering into an outsourcing contract and within a year after the contract take effect
- Rate the vendor on his experience in your industry
- Consider the location of vendor service centers
- Retain the right for vendor flexibility

Notwithstanding these concerns, outsourcing has emerged as a growth enabler and we expect offshore outsourcing will continue to grow at approximately 20 percent a year for the immediate future. Outsourcing back office functions often makes internal resources available to focus on the core business processes and there is a strong potential that outsourcing to a world-class service provider will result in reduced cost resulting from the economies of scale.

If you take the time, up front, to develop an appreciation for and learn from the mistakes of others — and select a consultant able to share that experience — you and your company can benefit from the new world of outsourcing.

Maxelerate's goal is to help Sourcing, Procurement, Purchasing, Engineering, IT and other professionals in all industries and government agencies to get better deals from suppliers. We accomplish this by providing Consulting, Training, Seminars and Leadership Implementation.

To get more information about us and find out how you can get better results contact us at:

MAXELERATE
Maxelerate Systems Ltd.

PO Box 940, Prospect Heights IL 60070
Phone Toll Free: (866) 855-5335
Phone Direct: (847) 483-5014
Fax: (847) 483-5015
e-mail: BusDev@maxelerate.com