Outsourcing: Moving from Tactics to Strategy

Everyone knows what IT outsourcing is. You assign the technical call center to India. Right?

Not any more. Outsourcing traditionally has been about reducing costs and part of that is outsourcing high overhead procedures to less expensive third party contractors, often located in foreign countries. But outsourcing – or in its more modern incarnation, "sourcing" – can cover outsourcing, nearsourcing and insourcing. It can also mean sourcing tasks and processes ranging from simple and repetitive tasks to the most complex systems architecture and support. In fact, the only thing a company probably should not source is its critical core competencies. Otherwise it's all fair game.

Why? Although cost reduction continues to be a strong value lever for IT outsourcing, the strategic value of sourcing can be many times higher. In fact, merely offloading procedures just to save money does not yield the type of savings that third party outsourcing vendors say it does. Procurement and management costs eat up the widely advertised 60% in savings, putting the true savings total closer to 15%. And outsourcing vendors of this type often engender complaints among customers.

These factors and others based on strategic value are not replacing cost reduction whole cloth, but putting it in perspective of a much more meaningful business case. This modern business case is founded on the *transformative value of strategic outsourcing based on technology*. This approach includes cost reduction as a value lever, but folds in many other strategic levers as well to greatly increase the value of outsourcing to a company's competitive advantage.

Outsourcing select IT functions has a long history in sourcing. The most valuable procedures focus on long-term needs of the business and on strengthening competitive advantage. IT functions sourced range from high overhead processes such as customer support to entire infrastructure support or database management.

Value creation never comes from cost-cutting alone, and strategic sourcing is far more than typical outsourcing.

The ABCs of IT Sourcing

A company can use different sourcing strategies to fulfill strategic objectives, but there are two tenets to successful sourcing: technology is key and sourcing is driven by multiple value drivers.

- *Technology is key to strategic sourcing.* Explanation.
- *Multiple value drivers, not just cost reduction.* Explanation.

The Matrix: Three-Dimensional Outsourcing

There are three dimensions of resource-related sourcing strategies where IT is concerned: personnel, IT objectives, and technologies. ("Resource related" means that you source IT activities depending on your resources: the skill sets you have available to you, the objectives of your IT organization, and on the technologies that you are using.)

- *Personnel: Using outsourced personnel as IT resources.* Personnel resource management in IT doesn't just mean managing and compensating your own employees, but can also mean outsourcing IT functions and activities to third party vendors. It is important to align vendor offerings to your own internal IT skill sets, activities, and objectives.

- *IT activities: Outsourcing elements of your infrastructure.* Managing your own infrastructure includes a large range of activities: hardware, software, operating systems, databases, networks, communications, and so on. Many companies benefit from outsourcing parts of infrastructure management to third party vendors. IT activities also include outsourcing business applications support and databases.
- *Technologies: Outsourcing enterprise technologies.* Enterprise technologies such as ERP applications are often administered in-house. But these technologies can require such a high level of specialized skill sets that in-house administrator can suck up personnel resources. Companies are successfully entering long-term contracts with third-party vendors who specialize in administrating these challenging enterprise applications.

First Dimension: Personnel

This dimension has been dismissively referred to as "body shopping." This notion thinks of outsourcing as the process of offloading support help lines and other front-line services to barely trained warm bodies. But this is not the value of sourcing, which can and should be a rich well of strategic advantage. So-called body shopping serves no one well.

Strategic IT sourcing can certainly include using third party vendors to provide skilled manpower. The two most common types of usage are hiring temporary IT employees from a staffing agency, and hiring companies that provide IT services regardless of personnel. A third area of sourcing is "insourcing," where your own people can bring long-term skill sets to specific project areas.

The structure can differ, ranging from temporary employees working in-house to directing calls and activities to outsourcing vendor sites. You must still match outsourced personnel skill sets to outsourced IT activities. Companies can realize value in several ways from this arrangement. For example, you can certainly achieve cost savings because you will not pay fringe benefits to outsourced personnel. But you can also realize value by shifting high overhead activities like Fibre Channel network administration to a highly specialized vendor, which allows your internal personnel to concentrate on internal IT initiatives. Whatever model you choose, your outsourced personnel should be aligned with your IT objectives, technology and activities.

Second Dimension: IT Activities

Always consider your IT activities and value to the organization when choosing outsourced personnel and services. Outsourcing IT activities requires analyzing IT and its activities. For example, IT operations may include supporting an IP network, a Fibre Channel SAN, and a new InfiniBand network with gateways to the IP and Fibre Channel networks. In addition, IT could handle multiple databases and enterprise systems such as an ERP or CRM. The question arises: which activities should internal IT keep in order to best serve competitive advantage, and which can they strategically outsource? The decision might happen on several levels, including in-house expertise and headcount, levels of automation, critical nature of applications and systems, expertise of outside vendors, and ease of outsourcing management.

For example, network provisioning is fundamental to running a successful network, but it does not require high levels of customized development and support. In many cases, turning this activity over to a trusted specialty outsourcer such as IBM or EDS would return value. These vendors and others have proven methodologies and services which allow them to economically administrate network provisioning. Another advantage is that companies like this have track records with newer approaches such as utility computing, which the company may decide to adopt for further strategic advantage.

Business applications are in a different world from services such as network provisioning and infrastructure management, and require their own IT sourcing strategies. For example, designing and programming can be outsourced to development specialists, or a company can develop its own database but outsources its database management to a vendor. In all of these cases, third party employees can work at the client's place of business or can work remotely.

(Vendors such as) such as IBM or EDS. IBM in particular can provide elements of utility computing to its infrastructure and provisioning clients, which can add value to the process of outsourcing infrastructure activities.

It's common to outsource infrastructure activities, but less common to outsource critical applications and support like database management. Outsourcing applications generally falls into two categories: support and management of the company database, and outsourcing the business application. The most common element to outsource is database management, where the company owns the database but outsources database service and structure management. Moving up the value chain is business application outsourcing, where the outsourcing vendor provides the database application along with managing and supporting it.

BPO (business process outsourcing) is closely related to IT activities and is a method to reduce costs and fine tune IT activities within the organization. Examples of outsourced transactional processes like accounting and payroll.

Another prime area for outsourcing is "transformational outsourcing," which seeks to meet strategic goals by outsourcing core business functions and processes. It is primarily pitched by large vendors with the size and track record to successfully manage it. Transformational outsourcing differs from vendor to vendor; EDS for example has a primarily technology approach while IBM and Accenture tend to take a more holistic approach. In transformational outsourcing, the client company's CEO signs a long-term contract with the outsourcing vendor. The vendor performs core part of the business by transforming its business processes and technology. At the end of the time period the transformed core processes are to be returned to the organization.

Third Dimension: Technologies

In the second dimension, IT activities are outsourced. These activities might include solution research, planning, building the infrastructure, development, operations, and so on. But in the third dimension, the client company outsources specific technologies such as SAP to expert consultants. Often the contract concerns the company and the vendor, but can also include an external support organization. Sometimes multiple technologies are combined and outsourced to an integrated vendor who is expert in all of them, while other companies choose to contract with different expert consultants for different technologies. For example, a company may choose to outsource SAP and Microsoft Dynamics Great Plains to the same consultant, or to two different ones with specific expertise in the individual application.

In our SAP example, the company could outsource SAP configuration and development to one consultant and entrust daily administration either in-house or to a second consultant.

The Holistic Approach

These three major outsourcing choices – personnel, IT activities and technologies – should not be rigidly separated from one another, but rather combined into an integrated matrix. This type of multiple sourcing strategy is flexible and highly advantageous for the organization. Based on the three-dimensional model, companies may decide to outsource to a single vendor to provide multiple services, or to select multiple vendors for specialized services. Within that structure also lies the decision of outsourcing personnel, IT activities and/or technologies.

Value and Cost Levers in IT and Process Sourcing Activities

"Value" can be a nebulous term, and is one of those wide-ranging concepts that everyone knows but few can agree on. In terms of sourcing, we can define value as those measurable benefits that the company derives from trusting given operations to third party providers. Assessing value in sourcing was traditionally based on cost reduction alone. As we have already discussed, cost reduction can generate value but cannot be the sole driver for sourcing. Indeed, too much of an emphasis on cost reduction can rob a company of the investment it must make in its own long-term health. Other factors are as important or more so to value creation, such as increasing revenues as well as decreasing costs, shrinking expensive headcount, and improving decision making through real-time, meaningful metrics.

"Value levers" are the actions and processes that increase value, and allow you to relate actions to measurable value. By assigning value to strategies, you will be able to review sourcing initiatives and state the benefits of cost, change management, cultural changes, and so on. This grants a much deeper approach to value and cost levers linked to the stated strategies and the concepts. By detailing and selecting the right value levers for your company's sourcing activities, you can generate the value you need.

Traditional vs. Transformational Outsourcing

Traditional outsourcing refers to assigning personnel, IT activities or technologies to an external organization which operated either operate on-site or off, and sometimes both. (Off-site could mean anything from just down the street or across the world.) The primary driver for traditional outsourcing is cost savings. Many companies did realize some level of reduced costs, but not nearly as much as outsourcing vendors were fond of quoting. And traditional outsourcing – especially in commoditized areas such as technical support – actually aggravated already unhappy customers and led to massive amounts of bad publicity for the outsourcing company.

Many companies also find that managing traditional outsourcing services is time consuming and distracts from pursuing core competencies. For example, Texas' House of Representatives budget writers furiously protested a state contract with a major outsourcer. The contract was plagued by cost overruns and howling errors. And another large outsourcer is being prosecuted in Florida for badly mismanaging an IT security system.

In contrast to the narrow cost savings and management headaches of traditional outsourcing, transformational outsourcing takes a process or function and engineers it to improve performance and decrease cost. The organization has not merely shifted a cost center to another cost center, but can now use the reengineered process as a core company benefit. Transformational outsourcing is less common than traditional and requires skilled consultants rather than the traditional body-shifting approach. But it holds tremendous promise for outsourcing companies.

Managing Outsourcing Contracts

Successfully managing outsourcing contracts is the key to success in a long-term relationship between the organization and the service provider. The foundation of the contract must include not only price, but also methodology and technology. And the successful long-term contract will include basic strategies such as effective processes, transparent expectations of both vendor and client, and putting mechanisms in place that allow both parties to feel comfortable with the relationship throughout the contract.

Gartner reports that IT departments often lack the governance and management structures needed to manage outsourcing contracts.

Gartner analyst Christopher Ambrose wrote "Successful IT Outsourcing: Strategies, Tactics and Management Approaches for Strategic Sourcing." He reports that poor management of IT contracts can cripple returns on the outsourcing investment. Reengineering IT process management and governance structures is crucial for managing outsourced personnel, activities and technology. This approach includes finding and quantifying lost value due to poorly managed outsourcing programs (especially when sourcing to multiple vendors), identify internal management gaps, bring the executive council on board and develop a management structure for vendor relationships. Relationship management is key to the process, and is in the best interests of both the organization and the service provider. Depending on the nature and complexity of the contract, relationship management can be relatively straightforward or very involved. For example, if the service vendor is managing a call center and if the corporation regularly tracks key metrics, then the relationship can be maintained with regular attention to service levels. On the other hand, if a vendor is carrying out a transformational outsourcing project with the organization's core activities, then both companies must stay in constant communication with each other. The IT department from the contracting company must have a structure in place to maintain communications and relationship, and the vendor must be set up to manage and encourage communication equally well. Compensation will likely change too. Traditional outsourcing arrangements might be founded on outright fee structures, while transformative outsourcing may involve revenue or market share growth as well.

Off-Shoring: Is That All There Is?

Off-shoring, where a company outsources to another continent in order to save costs is common in the United States. Traditionally U.S. companies have outsourced to India and Eastern Europe. However, there are distinct advantages to near-shoring for U.S. companies. Near-shoring is a subset of off-shoring, and means outsourcing to a different country in or close to the organization's time zone. For the U.S., Latin and South America are geographically closer. There are still language and some time zone issues, depending on where the company and the vendor are located. But it's a much shorter trip for executives to Mexico City then New Delhi or Budapest.

Senior Management and the Art of Outsourcing

Senior management is (or should be) heavily involved in larger outsourcing projects. No senior VP will care that IT brought in a tech for a week to configure a hundred new laptops, but they will certainly care about outsourcing infrastructure management, SAP development, and the entire IT help desk. What is the right approach to advising and involving senior executives in significant outsourcing projects?

Whatever you do, don't take potshots in the dark. Involving senior management in outsourcing decisions involves a process of diagnostics, process mapping, linkages, value and cost levers, and integration with the business strategy. The process ultimately yields the benefits the company will achieve in the business language that the executives understand.

The Role of Vendors in the Outsourcing Industry

The outsourcing industry is profitable and growing, but as with everything in business nothing stays the same. For example, a common area of traditional outsourcing has been shifting call centers and help lines to India. But the most experienced Indian outsourcing vendors are starting to reject these contracts since they no longer pay well due to client cost-cutting demands, frustrated and abusive support callers, and the dearth of highly trained personnel who will work for lower wages. Instead these companies are pushing contracts around higher paying IT activities and technology.

Outsourcing Providers Today – and Tomorrow

The role of outsourcing vendors today is primarily traditional, with cost reduction and savings their primary offering. These vendors concentrate on providing commoditized services at a cut rate; often because their national workforce offers many educated English speakers who can work for far less than what companies pay their U.S. workers. However, this outsourcing approach suffers from commoditization, an aggressive drive by client companies to cut costs, and rising workforce salaries. What then is the future of the industry, not only in financial terms but also in ethical terms? Should outsourcing vendors largely exist so U.S. companies can lay off workers?

Instead of existing as a method of slashing payroll, outsourcing vendors will adopt a transformational model where they become partners with organizations seeking to meet their strategic objectives.

Outsourcing is one of those terms inherently tied to globalization. Essentially, companies go the outsourcing route as a way to reduce costs, but often they spend too little time considering its strategic value, often over stated by many outsourcing providers.

The truth is one of outsourcing's main values is to relieve IT staff of time-intensive duties, and create opportunities for them to take on truly strategic initiatives.

It's widely known that companies pursue outsourcing with the cost reduction factor in mind. Some also look for outsourcing to improve service levels or to create budget flexibility.

To fulfill the cost reduction promise that most businesses expect from outsourcing, many outsourcing firms have responded by becoming more efficient and seeking out cost-effective resources in the global marketplace.