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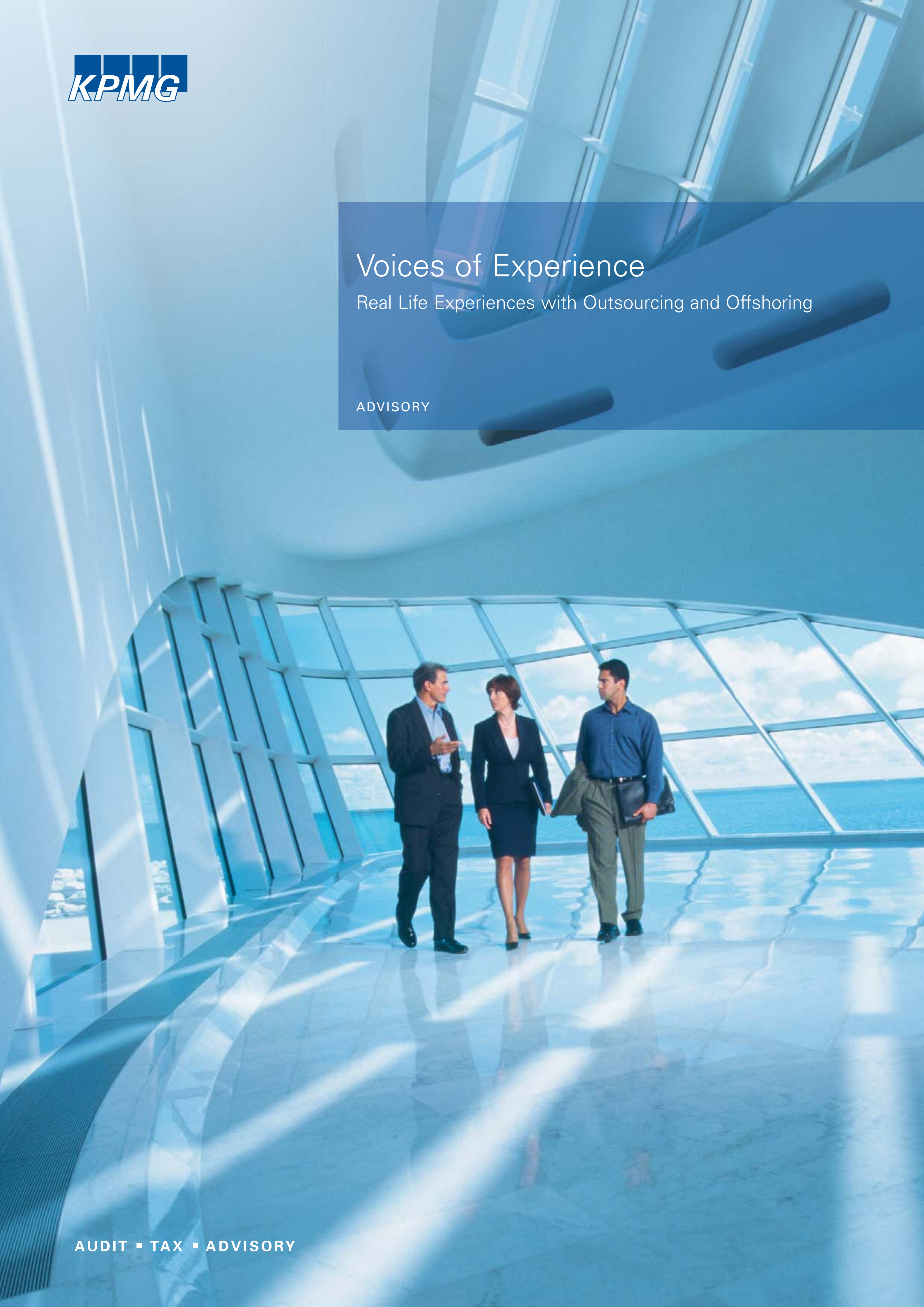

Voices of Experience

Real Life Experiences with Outsourcing and Offshoring

ADVISORY

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Foreword

Alan Buckle, Partner, KPMG LLP (UK)

Outsourcing is not a new phenomenon and has been an accepted practice for lower-value functions. It is only relatively recently that outsourcing has been considered a viable option for core and critical activities – the activities that have an impact on company performance, productivity and, potentially, shareholder value.

Initially, outsourcing focused on the lower-value IT functions. This has and is rapidly changing, and outsourcing now encompasses large, complex and strategic activities, including broader business as well as technology. It is even evolving to include key business processes under the name "business process outsourcing". Together these functions can account for between 20 percent and 40 percent[1] of the cost base of an organisation.

And to add an extra degree of complexity, these activities are being sourced globally as well as locally. This publication considers the 'real life' outsourcing experiences in three different areas: the experiences of an outsourcing lawyer, how outsourcing can help a rapidly growing new business and the potential role of offshore outsourcing.

I would like to thank David Barrett, outsourcing specialist of law firm Simmons and Simmons; Marco Trecoce, business transformation manager of Opodo and Robin Barrett (no relation), the ex-CIO of American Express for giving their time to help with the case studies. Each of these have performed some quite remarkable feats in sourcing, as this publication will explain.

Source: [1] Nelson Hall, 2003

Introduction

Alex Blues, Director, KPMG LLP (UK)

You could describe today as a crossroads for outsourcing. Today, many organisations have outsourced functions, or at least considered the idea. And as more groups have attempted the process, more has been learned about the best ways to make it work.

This means that the approach today is changing. Eight years ago, the majority of organisations looked only at outsourcing elements of their business that were outside a very strictly defined idea of 'core competency'. And the functions were outsourced to local organisations.

But today a far wider range of options is in common use. Outsourcing is only one alternative when you can also offshore specific functions, or create a shared service centre onshore or offshore, or take on new ideas to adjust the balance of inhouse and sourced activity.

Different executives now manage the process as well. In the past, sourcing was led at a departmental level, usually by procurement or IT. Now the strategy is usually articulated and sponsored by the CEO or CFO, and multi-disciplinary teams review and implement a sourcing programme. From often being a purely technical play, now sourcing draws on expertise from performance improvement, financial management, change management and compliance.

This publication looks at the personal experience of three executives at the sharp end of sourcing. It is focused particularly on outsourcing and offshoring, but even that relatively narrow focus offers a set of consistent themes:

Strategy
Outsourcing can work if you can clearly articulate business reasons for it. Cost may be a key driver but it is far from the only potential reason (in fact, a pure cost-based approach can actually be counterproductive). But what are broader reasons to take on sourcing? It can help transform processes, increase productivity, reduce time to market or help enable a business to buy and sell companies more easily and profitably.

Measurement
Strong performance indicators are just as critical as well-articulated goals for a sourcing programme. You have to be clear how the sourcing relationship will be measured.

Culture

In the past, sourcing partners may have been selected for the best balance of technical competence and pricing. Today, a range of additional factors is understood to be just as important. Many of them are cultural – the style with which a relationship will be managed as well as the cultural fit required from it and the management skills available from the sourcing agency.

Relationship

This realisation that culture is critical has also driven a focus on the sourcing relationship. Early outsourcing agreements focused greatest attention on writing and signing an ideal contract. Today, a great deal more attention is focused on ensuring that the long-term relationship delivers the value anticipated.

Ongoing

In addition, two needs of the sourcing process are particularly critical, and sometimes ignored. The first is ensuring that, once a contract is live, skill sets are already in place to manage and communicate with the sourcing agency, and to evaluate and prioritise demand from the customer. The second closely related need is ensuring that key stakeholders stay involved, by making sure that influential business users are kept close to the sourcing process.

But that is not all that the personal experience of Simmons and Simmons, Opodo and American Express has shown. Hopefully, these three case studies will give you ideas for managing your own sourcing ambitions.

The big picture

David Barrett, Partner, Simmons and Simmons

Silos are almost unavoidable in the modern organisation, and different functions never work together quite as sensibly as you might like. But outsourcing requires a holistic approach, said David Barrett, a partner at law firm Simmons and Simmons. If you let the silos define the way an outsourcing agreement is set up, the cracks will soon start to show...

David Barrett has an unusually broad view of outsourcing. He is a lawyer at UK firm Simmons and Simmons and a specialist in outsourcing agreements. He is also the person that Simmons and Simmons has asked to run its own outsourcing programme. That dual role has given him insight into the pitfalls that must be avoided when outsourcing and also an understanding of what causes organisations to fall into those traps.

In Barrett's view, the first trap is that many organisations outsource for the wrong reasons. "They see IT as a problem and they say, 'Let's just get rid of it.' But outsourcing isn't just pushing IT under the carpet. It's a long-term transfer of risk. In a meaningful agreement you're not just getting someone else to do some work, knocked off cheap in the short term. You need to transfer risk so you have at least as much control over external work as you do internal."

It is better to work towards effective transformation than simply getting rid of IT, Barrett said. "You can always get a contract delivered word for word. But in a situation where that's all you expect, problems will occur. Everything will be hunky dory for two or three months, then executives will become uneasy. They'll say, 'The service we get now is no better and the costs not much better – what's the point?'"

Questions to ask:

- Are you outsourcing for the right reasons?
- Is your strategy holistic?
- What's the long-term gain?
- Are some administration functions you are outsourcing more critical than you realise?

Poor outsourcing deals could be said to follow a surprisingly predictable progression. "First, the top executives decide they want to outsource a particular function. They want to improve price and performance – whatever it is that's being done, it has to be cheaper and better. But that message gets diffused through the contract-writing process. Rather than getting transformation, you end up doing 'what's done today'. In the meantime, your staff are transferred to the outsourcer. So you not only get what's done today, the way it's done today – but it ends up being done by the same people as well. There's not much transformation in that."

It is not easy for Barrett, as a lawyer, if a contract is set up to deliver only 'what's done today' rather than something more ambitious. "If the owners are not happy with it, it is difficult to deliver the message that a contract is going according to plan. Or that now the outsourcer says they can deliver transformation – but there will be an arm and a leg in extra costs. That's why I put so much focus on building agreements that allow you to drive change. And also why I believe it's important not to try to achieve everything at once. You can't get all the transformation you need the first time round, so it is important to structure your needs with realistic expectations."

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But that's a rare approach, he said, adding that many organisations expect a 'silver bullet'. "It's a common approach: 'If I give this contract to X, things will immediately get better.' But an outsourcer is not a silver bullet. If you hand over IT without considering how relationships need to change, you'll get a fundamental mismatch in your contract. There's no costing for change – and beyond that you've not even considered how your business needs to transform."

The solution, he said, is to have a holistic view of the ambitions of your business – which is obviously easier said than done. Most businesses are arranged as silos, and this causes problems, Barrett said. "Each silo has its own mission, its own desires – effectively, each might as well be its own business. That's why it's a problem if you assume that you can create a new outsourcing agreement by cutting and pasting a shopping list of similar contracts for similar services. Risk falls between the contractual cracks."

Outsourcing seems even more difficult when you consider that few companies do it regularly. "When the average medium-ranked executive starts an outsourcing process, it's likely they will not have done it before. It's not that helpful to have procurement experience either. In outsourcing, you've got to work at getting a long-term relationship right with one partner, where procurement can work as a set of one-off deals with different organisations. And most big companies are overconfident, which makes the process even more difficult. They always assume they can outsource quickly – that no internal barriers exist, and that they're not constrained by existing labour or management. That's rarely the case."

Barrett's experience extends back 15 years, which has given him interesting insight into the outsourcing process that Simmons and Simmons is undergoing at the moment. "I was advising on outsourcing well before it was a sexy subject. Now we're doing it ourselves. And the funny thing is that I see us doing all the same wrong things I would see clients doing. I'm not sure déjà vu is the right word. Our outsourcing is relatively small. Even the biggest law firm is a small organisation but Simmons and Simmons still face the same challenges as larger organisations.

"Outsourcing is more important than you think... You're handing over delivery, what makes you tick."

"Outsourcing is more important than you think," Barrett said. "You're handing over delivery, what makes you tick. In our case, an example is billing. On the surface, that looks like an administrative function. But actually it's how we make our money: if we can't charge, we won't get paid. By that measure it's the most critical element of our business. Currently we're not planning to outsource that function. But if we did, it would be one of the most difficult decisions we could make."

Lessons learned

Barrett has seen some disasters in his time. Few had a holistic strategy in place but there is another, additional problem that also tends to trip up outsourcing – a lack of management commitment. That's because outsourcing can be perceived as empire building rather than a genuine attempt to improve a business, Barrett explained. "In most organisations users have very little idea what is going on inside support departments. It's typical for organisations to fail to invest in support, then support is unfairly blamed for problems it doesn't have the resources to resolve – and then the function will be outsourced. But an outsourcing programme that attempts to take over several support departments will meet resistance because support staff know that they are being sidelined for the wrong reasons."

Management itself can also be an issue if the head of a function is outsourcing the function that they manage. "Consider your own skills," said Barrett. "If you're a head of function that's going to be outsourced, your motivation for making a contract work is different. The skill base that makes you successful as a head of that function won't help you negotiate a good agreement."

But do not be discouraged, Barrett says. "Outsourcing is not a business-as-usual situation. Even in the case of a law firm that advises on outsourcing, we still need to think through the issues carefully and make sure we listen to our own advice. But you can get outsourcing right. People do."

Demanding radical change

Marco Trecroce, Chief Operating Officer, Opodo

Marco Trecroce transformed Thomas Cook's business through outsourcing and a commitment to fast, radical improvement. Now he's attempting the same feat for Opodo. What are his hints and tips for getting big change right?

Slow change does not work, according to Marco Trecroce, Chief Operating Officer of pan-European online travel retailer Opodo. He believes that radical change is the only way a business can truly inject rigour, high performance and speed into ailing or complacent companies.

And he has success on his side. Where some advocates of radical change have never risen to the challenge of making their ideas work, Trecroce is the opposite, having proved his approach can work by turning around the fortunes of once-ailing UK travel retailer Thomas Cook. Sourcing was critical to that success, and Trecroce says it will be critical to growing Opodo as well.

Questions to ask:

- Are you creating radical change or 'business as usual'?
- Is your relationship with your outsourcer at the right level with the right small group of partners?
- Do you see software development as a process of risk mitigation?
- Are personal performance indicators and outsourcer performance indicators tied to the same goals?

Sourcing is critical because you won't ever have all the skills or time you need in internal teams, he said. "Opodo employees are busy. The company has almost €1billion gross sales but only 830 employees, and it's only four years old. So to grow, we need two or three key partners."

Having only started at Opodo in April 2005, Trecroce had made the selection of outsourcing partners a high-priority task for his first months in office. (This interview took place in October 2005.) "When you first move into a new business, the process is always the same," he said. "Two to three months of assessment, then two to four months business casing to determine the need for substantial return. We've just finished what was called 'plan 60' – our assessment period, a large part of which is time spent selling new ideas to Opodo executives and employees. Now we have established the work that must be done, I'm going through the partner-selection process."

It's a similar process to that which he pioneered with Thomas Cook. "Thomas Cook was a successful large-scale transformation story," he says. "Opodo needs to go through a similar process. I'm looking to inject pace, to continue to push limits. The question is this: 'How do you take a young company and inject high performance, rigour and speed – but not bureaucracy?' It helps that Opodo is a relatively new young company, and keen to learn. Many of the employees are under 30 – and very high-quality, energetic people."

Even the most energetic people can't do good work if they don't have the right process, he said. "A lot of companies struggle with the basic concept of how to deliver projects and how to measure whether they are successful. Technology is an area that is executed particularly badly. It's well understood there is no point delivering technology if it will not produce business results. Most companies will struggle to deliver projects on time, to budget and see financial improvements to the bottom line."

"Consider your network of partners...How many do you have? Who is valuable?"

The solution is to aim for a step change rather than gradual improvement. In Trecroce's view, "The traditional approach to project budgeting and execution just doesn't work. Once a year, you've got finance asking for project budget estimations. Everyone panics and throws a budget together because they usually don't have this information readily available. By the time all those separate budgets are approved, it turns out the costs are wrong, or the idea has been forgotten or momentum is lost. When projects are finally launched they are often done sequentially and deliver sporadically throughout the year. This makes it more difficult to correlate a programme of work that delivers a financial step change to the business."

That's why Trecroce drives all projects to run simultaneously, and for most to finish at the same time. But that is an approach that can only work if much of the execution is farmed out to trusted partners. "It's a higher-risk approach," he explained, "but it returns greater benefits. At present, we're in the middle of a first wave of projects at Opodo, all timed to finish June 2006. But I'll be planning the second big wave of work in February and March. It will start in July 2006."

That high-speed approach had been proved to succeed, he added, but simplicity is key. "At Thomas Cook, we had 129 projects that were winnowed down to 19. They were all critical, and all delivered on time. But that does not mean it was easy – in fact, I think people underestimate how difficult it is to do this successfully." In contrast to Thomas Cook, Trecroce has to deliver much more custom developed software versus third party package software.

In Trecroce's view, the process of software development should be focused around mitigation of risk. "The development cycle can't really be compressed when you are writing custom software. You'll always have to think about business needs, translate that into requirements, and write, test and release the software. That's why, where possible, Opodo is moving towards implementing third-party systems. Because you're not redoing what has been done before, you can get to market faster. But it's a huge move to integrated third party packages with custom software if you're used to writing systems from scratch."

The right partners

As Trecroce explained, the high-risk, single-deadline approach to delivery works if you partner with the right outsourcing groups. So he has thought deeply about how to establish the most effective network. "Consider your network of partners," he said. "How many do you have? Who is valuable? Could you cut that number down to a handpicked group? And when you do, how much time can you spend working directly with your partners?"

However, he is dismissive of traditional ideas of partnership. "'Partner' is an overused word," he said. "It is often just paying lip service to the idea of working together. What really counts is the executive time you are given by, and give to, your outsourcing partners. It may cost significant management time to spend time with the executives of an outsourcer. But that effort is the only way you can add 'delivery partner' to the range of tools you have as an executive."

For this to work, however, you and your counterpart executive at the outsourcer must have equivalent decision-making power. "You must have the ability to take decisions for your company for this arrangement to work," he said. "And where you can change the priorities of your organisation, as the customer, the outsourcer executive must also have the power to make the same type of decisions for the supplier."

Trecroce asks supplier executives to become colleagues in his personal team – and said that suppliers are rarely used to that level of executive contact. "Our partners sit in our team, as decision makers within our programme. Not every partner is 'internal' – some are offshore. But the key people sit around the same virtual table making decisions as a single team."

But he agreed that this is not the standard outsourcing arrangement. "Some people look at outsourcing simply as a way of cutting costs. I wouldn't stop anyone getting involved for that reason but if you want more than that, you need a different approach. I could offshore right now to cut salaries. But the problems it would create are just not worth the headache."

Instead, Trecroce's plans for outsourcing will create more significant change within Opodo. "It usually takes 15 months to fix a business," he said. "That applies whether you are trying to improve a solid business, like Opodo, or turn around a business in bad shape."

The plan 60 initiative was the first step in that work. Each functional area of the business were asked what Opodo needed to do to be successful? "From that," Trecroce explained, "we created the Opodo programme plan. It also included an organisational review and the identification of key value drivers for the business. The value drivers help us measure revenue as well as cost. We even reset the personal objectives of the senior managers and the executive team to align with this newly created plan, because project delivery is so crucial to our financial success.'"

"You've got to be clear on how you will improve costs."

Lessons learned

Trecroce argues that outsourcing creates progress only if four guidelines are followed. "First, you've got to be clear about what's required. Second, you've got to agree what will be provided over and above the standard service-level agreement. Third, you should pay an outsourcer only on their ability to improve the service. Some outsourcers are happy with that and some struggle. But if your outsourcer doesn't have a results orientation ingrained in its culture, they will not do good work."

And finally, he said, "You've got to be clear on how you will improve costs. One way is to commit to a specific unit cost, with the outsourcer taking the difference between that cost and the actual as a supplement to their fee, a risk/reward arrangement. So if they can drive down the actual cost, they get the financial benefit. But at the same time you can't gouge your suppliers. If you set them up to fail financially, you won't even get incremental improvement."

These four guidelines, Trecroce says, have pointed Opodo in the right direction for success. "Today's projects have the right resources and shareholder support," he said. "I'm pretty confident Opodo next year will look very different to Opodo today."

Making a moral commitment

Robin Barrett, ex-CIO of American Express
and now Director, Orbys Consulting

Offshoring can reduce staff costs, says Robin Barrett, ex-CIO of American Express and now director of Orbys Consulting, but that should not be the primary goal. It is better instead to make a moral commitment to keep jobs. If that commitment is made correctly, it can cut costs, improve staff motivation, and make slow-moving teams flexible and successful.

Questions to ask:

1. Do you need to improve the capability of your own people to outsource successfully?
2. How do you protect the livelihood of your own people?
3. Is the most obvious offshore location actually the best?
4. What stays inhouse and what can be externalised?

Robin Barrett first became involved in outsourcing working for American Express in 1998. And even then the organisation was at the very cutting edge of outsourcing and offshoring. "Then," Barrett said, "few companies had even considered the issue. But we had to. Our IT function was growing 37 percent a year. There just weren't enough people available to do the work. I found myself hiring people who were 'just good enough'. We were just filling seats, not finding the right people."

Barrett has now retired from American Express. But in his nine years with the company, one of his biggest accomplishments was to resolve, once and for all, his organisation's resource crisis. And he didn't just eliminate the short-term problem caused when the organisation needed to increase or reduce the size of teams. His aim, always, was to create a long-term solution that allowed for what he describes as American Express's 'moral commitment' to its workforce.

"It's morally wrong to hire when the business cycle is up if you plan to jettison those same people as the cycle turns down," he said. "That's one principle that we stuck to in creating our outsourcing strategy. American Express had 7000 IT employees who had made a commitment to the company. So any changes we made to work practices should not affect employee livelihoods."

Working within that commitment, Barrett had three goals. "First, I wanted to make resources more flexible. We had 2500 contractors who had not made the same level of commitment to American Express, so how could we use conventional offshoring and outsourcing to free up those roles? Second, how could we make resources scalable without 'bad cost' – without affecting our commitment to our own workers? And third, how could we ensure that, whatever its final shape, our IT function remained a meritocracy?"

To Barrett, an outsourced IT programme must be managed as a "weighted portfolio of risk" – that is, with the risk of outsourcing each element balanced against the savings made and flexibility gained when it is outsourced. "Even if you don't care about staff, you can't just throw every job overseas," he explained. "You've got to balance risk and cost. The riskiest roles and functions should stay within your own company. Then near-shore contractors can be used for work that's not highest risk – but then it won't be lowest cost either. After that, very high-cost, low-risk contractor work can be moved to, say, India – somewhere that has a base of outsourcing organisations that can take the strain if you need to flex your resource requirements up or down."

However, American Express considered a wider range of options than just India, the traditional destination for outsourcing. The company also built a near-shore insource development centre in Canada and is exploring the feasibility of joint ventures in China. "That is quite a risk in itself," he said. "If you start new ventures that you own, you must make a similar long-term commitment to staff in those countries."

China and Canada will each bring different benefits to American Express. "India and China are obvious choices for offshoring but Canada shouldn't be ignored. For the same job, a Canadian staffer with the usual benefits will cost roughly US$15 per hour less than the United States – although it is also US$15 more than China. Also, I personally believe there is at least 15 years of surplus IT talent in Toronto, left over from a time when Canada had a strongly protectionist software industry. Once borders were opened, a lot of hugely qualified talent became available."

"You've got to balance risk and cost. The riskiest roles and functions should stay within your own company."

China, on the other hand, is often seen as a more traditional outsourcing market, similar to India. But actually Barrett believes it to be a better long-term bet. "In 1998, we estimated China would overtake India as the offshore location of choice – on a purely financial basis – within five years. In 2003, it did. So while we still invested US$200 million a year in India, we decided not to build our own facility there. We didn't feel we could commit to a country with 17-24 percent wage inflation, even though the depth of skills was excellent. We would have had to hire 2000 people, but then what would we do with them when China became a more financially sensible location?"

Spreading out

Barrett believes, however, that there is more to offshoring than simply picking the right locations. A spread of skills is also critical. "You've got to look carefully at what you keep inhouse and what you farm out. Most companies ask, 'What's our core competency?' then assume that question defines which skills should best remain internal. But I don't agree. A better question is, 'What roles are best performed by our employees?' Why keep coding inhouse, for instance? It's a commodity. There's no value in doing it yourself."

In American Express's case, the company elected to keep roughly 80 percent of relationship managers, business analysts, project managers, integrators and architects inhouse. "They're the people who've got to make it all fit together," Barrett explained. "But you can't still keep 100 percent of that skill base internal – that would put employee livelihood at risk. At some point you'll need to flex staff levels 20 percent up or down. You can't do that if all the relevant people are in your internal teams. You need, also, to keep the good coders for your team. While programming does not need to be a core competency in most businesses, you need to retain some residual expertise to maintain a technical skill pipeline. In our case, 15 percent to 20 percent of coding remained inhouse."

And Barrett said he was surprised at how exposure to external coders led to his internal team needing to improve its own skills. "Our first experience with outsourcing code was not what we expected," he said. "The outsourcer kept coming back with questions on our specification, which was a surprise. We expected the process to run a little more smoothly. But when we did an analysis of the outsourcer's competency versus our own, we discovered that actually we were the problem. Our outsourcer, whose core competency is system development, was actually so efficient that our specifications weren't quite at the level of quality to which it was used. You can get away with that when your coding is inhouse. But if you're outsourcing, it is an issue to consider: will you need to improve the quality of your own retained organisation? Putting development on the other side of the world exposes problems with competency."

"Most companies ask, 'What's our core competency?'... A better question is... 'What roles are best performed by our employees?'"

Lessons learned

No process runs completely smoothly. So Barrett acknowledges that if he had to outsource again, there are elements of the process he would handle differently. The first is communication. "We invested a lot in redeployment and communication. I was happy with those results – through the entire outsourcing process only 30 employees of 7000 lost jobs, 22 of whom were early retirement. It helped that we were very clear about the culture and skills we wanted in the organisation. We gave staff a roadmap of skills we'd need in the business so they were comfortable that they had a clear path for progression in future."

But more can always be done. "I'd like to have made an even more concerted effort to allay fears. Outside the management team, we probably weren't clear enough in describing our central principle that livelihoods would not be put at risk. You've always got to tell staff what you know, when you know it. If you're closing an office or relocating, be upfront – never let information trickle out."

And finally, it is critical to safeguard your company culture. "The way people work is what differentiates one company from another. Culture is the aggregation of all behaviours. To outsource, you've got to understand what I call the 'culture vector'. It's not enough to measure and define culture today – you also need to know where your organisation is going, its point of arrival. If your outsourcers are in tune with your own leaders, and culture is in tune, you'll be travelling in compatible directions. And that gives you a lot of lift."

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