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A **dba**DIRECT White Paper

**EXCELLENCE IN OUTSOURCING  
CONFRONTING THE COST OF COST  
AND THE VALUE OF VALUE**

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### Executive Brief

*A cynic is a man who knows the price of everything and the value of nothing.*  
--Oscar Wilde

The initial waves of outsourcing have hit the world of business technology, leaving both significant benefits and significant disappointments in their wake. Now, we are preparing for the next wave of outsourcing. The question is whether we will fully capitalize on its promise of continual improvement – and even transformational advancements – in business performance.

The challenge we now confront is outsourcing's legacy as merely a source of cost-cutting and low-cost labor. When executives only see outsourcing as a means of reducing costs, they miss the opportunities for business improvement and transformation that lie ahead. Worse, their outsourcing decisions tend to revolve around cost criteria and ignore other key elements that complete the larger value equation. If companies fail to fully consider the hidden risks associated with their price-driven decisions, they are vulnerable to the kinds of outsourcing disappointments that still plague the IT sector.



## 1.0 The Cost of Cost

In the fall of 2004, JP Morgan Chase cancelled a \$2 billion IT outsourcing contract with IBM. "We believe that managing our own technology is best for the long-term growth and success of our company," said the company's CIO in a statement.

Then, in the late spring of 2005, Sears announced that it was canceling a \$1.6 billion contract with CSC and claimed that the firm failed to perform certain obligations. Whatever the case (CSC shot back that the decision was related to the Sears acquisition of K-Mart), it's clear that the outsourcing world had suffered another blow.

The bad news, however, didn't end there. Deloitte Consulting LLP released a study in 2005 arguing that "outsourcing is not delivering its expected value to large organizations." One of its key findings was that 70% of participants have had "significant negative experiences with outsourcing projects and are now exercising greater caution in approaching outsourcing."

More recently, Stamford, Conn.-based research firm Gartner Inc. released a study concluding that overall satisfaction with outsourcing tends to be positive at the outset of deals, but typically diminishes as projects progress and key objectives aren't met. One reason may be their overarching focus on cost containment. "The truth of the matter is that cost focus alone is not going to be satisfying over the long term," contends Allie Young, research vice president for Gartner's Sourcing Group.

Young asserts that CIOs expect business improvement and innovation from outsourcing deals, but their own organizations don't have the skill and capabilities to build outsourcing relationships that will deliver such results. As she sees it, they engage in reactive outsourcing instead of developing a disciplined multi-sourcing strategy. Moreover, IT organizations end up negotiating and procuring outsourcing solutions strictly on price.

"They want [the outsourcing provider] to act like a partner, but they want to drive the cost focus to the point where the providers are not making a profit," Young argues. "And that's only a bad thing for the client."

Those views are echoed by Forrester Research analyst Bill Martorelli who claims deals "are underperforming due to contract rigidity." He also believes that disappointment is significant and widely shared. "Declining payback for suppliers and buyers offsets growth," as he explains.

At the same time, there is a growing recognition that the sole-sourcing of large outsourcing contracts has led to negative outcomes. While a sole-source relationship theoretically represents lower costs, greater simplicity, standardized methods and a single point of accountability, the reality appears to be one of diminished sourcing capability and an unhealthy dependence on a single, powerful, outsourcing vendor.

Recognizing some of these problems, there is now a backlash against sole-sourcing and a movement toward something Gartner calls "strategic multi-sourcing" and Forrester calls "selective sourcing." What this trend suggests is that companies increasingly are asserting their independence from large and dominant outsourcing providers as they seek a more dynamic and agile set of outsourcing relationships.

Procter and Gamble is one party in the vanguard of this movement. Under the leadership of CEO A.G. Lafley, the company has outsourced an array of business processes: IT to Hewlett Packard, human resources, accounting and purchasing to IBM, and data infrastructure management to dbaDIRECT. Lafley's objective is holistic – to derive as much as 50% of the company's invention from external sources, up from 20% four years ago and nearly 35% today. It's a strategy known to P&G as "connect and develop." The approach mandates that the company actively look outward for all sorts of process and product expertise.



General Motors is another recognized proponent of selective sourcing. It recently signed deals with multiple outsourcing vendors of varying sizes and specialties in order to meet its strategic objectives. Altogether, GM is outsourcing \$15 billion worth of outsourcing contracts. Ralph Szygenda, group VP and CIO at GM, said the deals are a “significant milestone” for GM and its IT organization, promising to provide greater flexibility and performance. “Of critical importance is the focus we have had on driving innovation and supporting future globalization and digitization of the company,” stated Szygenda.

The bottom line is that CIOs are now rethinking the approaches that have led to disappointment in the past. While vigorous negotiations based on price may have seemed smart by procurement standards, they appear to have contributed to a situation in which mistrust, misalignment and “contract rigidity” are all too common. The casualty of a single-minded, cost-focus seems to have been the trust and collaboration necessary to drive expected gains and improvements. And while sole-sourcing relationships may have promised greater cost efficiencies and economies of scale, they appear to have undermined the ability of organizations to smartly source and govern the IT capabilities that are vital to their future competitiveness.

## 2.0 The Value of Value

As the next wave of outsourcing gathers momentum, CIOs and other CXOs are rightly exploring what it means to go beyond cost-focused outsourcing. While cost reduction often is a valuable component to an outsourcing relationship, there are wider gains in performance, productivity and growth that can be seized if companies take a value-driven approach to outsourcing.

Jeffrey Immelt, CEO of General Electric, has been asking himself and his colleagues in recent years which of the company’s activities are core, differentiating competencies and which ones are merely peripheral. How, he wanted to know, can GE capitalize on its core strengths?

He concludes that, “At GE, 60 percent of our resources are in the ‘front room’ – customer-facing, growth-driving, manufacturing, selling, and controllership. The other 40 percent of our resources are in the ‘back room’ – supporting as well as compiling and passing information. This will change. Digitized companies in the 21<sup>st</sup> century will have significantly smaller back rooms with more resources committed to growth and customer success.”

Financial services giant Wachovia Corp. recently signed a \$1.1 billion contract to outsource finance, accounting and human resources activities. It’s “what we need to do to become a great customer-relationship company,” says Peter J. Sidebottom, director of corporate development. Wachovia intends to reinvest as much as 40% of the \$1 billion it hopes to save over three years into channels and personnel to enhance the performance of its core business.

Such perspectives show that executives are thinking beyond the cost reduction elements of their outsourcing initiatives to the value-creating opportunities they generate. Gartner recognizes three key reasons to outsource IT. One is *efficiency* or the reduction of costs. Another is *enhancement* – the incremental improvement of business operations. And, finally, there is *transformation* – changing how a company competes or creates value to drive gains in business performance. All are valid reasons. The key is to ensure all executives agree on the objectives and that those objectives are clearly understood by the outsourcing provider.

Transformational outsourcing represents the next wave. Companies are seeking outsourcing partners that can help them elevate performance, further differentiate themselves and generate new levels of growth. To accomplish these objectives, however, they will need to collaborate effectively and take into account the wider array of benefits that can emerge in a dynamic outsourcing relationship. Among them:



### **2.1 Building organizational capability –**

One of the key elements of the new outsourcing value proposition is the opportunity to create or enhance key capabilities within the enterprise.

Specialization affords the outsourcing provider the ability to build deeper strengths, assets and talents in its chosen field of endeavor. The more deeply it provides its services, the more powerful, focused and skilled its capabilities become. Through effective collaboration, companies can gain access to these capabilities from their outsourcers. This may enable them to divest back office operations and refocus their resources on truly differentiated activities – or even to incorporate these capabilities into their front-office, core offerings and take them to market.

**2.2 Infusing best practices –** Outsourcers have access to the best practices (and knowledge of the worst practices) in the field. Through hard-earned experience, they have learned how to most effectively provide a capability or deliver a service. Their clients realize the benefit of this knowledge and skill by working with them. It is far easier to operate at the top levels of one's profession when one's offering is a core capability or competency. That is one of the chief benefits of IT outsourcing. Few companies differentiate themselves on the basis of their underlying IT capabilities (though quite a few incorporate them into the core offerings). But IT outsourcers do. They bring them and even transfer them to their clients. These best practices enable IT organizations to operate at the top of their game.

**2.3 Driving continual improvement –** In a well constructed and managed outsourcing relationship, IT organizations will continue to improve and deliver incrementally higher performance throughout the enterprise.

Processes will be more effectively designed, monitored and enhanced. The outsourcer can provide the leadership and impetus to drive these performance improvements – and ensure they are delivered. Indeed, these improvements should be recognized as a core element of a service level agreement.

**2.4 Delivering value assurance –** IT organizations face a great many risks in terms of their ability to keep up with constant changes in technology and talent.

Outsourcers can help their clients mitigate risk by managing the resources necessary to deliver a vital capability. They take responsibility for procuring and implementing leading technologies, while hiring, training and developing core talent. As the pace of technological change intensifies and the talent necessary to capitalize on new opportunities gets more specialized, outsourcers provide assurances that these core capabilities will be available.

**2.5 Ensuring operational excellence –** Hyper-competitive markets are unforgiving markets. Enterprises increasingly must be able to demonstrate operational excellence in all areas of business. If those areas are not core, differentiated strengths, then the strengths must be procured elsewhere. One of the key value propositions of outsourcing is the ability of the outsourcer to ensure that top levels of quality are provided and maintained.

Ultimately, the value equation that outsourcers bring to a potential business relationship must be explored and enshrined as a working agreement. Apart from one's outsourcing objectives (whether they are focused on efficiency, improvement or transformation), one must negotiate this initial agreement with a larger sense of business value and impact in mind.

Companies that surrender the sourcing process to procurement managers that care only about price plant the seeds of their eventual disappointment. The trouble with many centralized procurement organizations is that they have no clear sense of the business objectives and processes that outsourcing is designed to address. Procurement managers are typically incentivized to cut price down to the bone. However, the outsourcer will be hampered and hindered at the outset of the relationship if price is the guiding criterion for the decision and the various elements of business value are not factored into the final agreement.



The business benefits listed above can and should be valued in the final deal. The ability of an outsourcer to infuse best practices and generate continual improvements should be recognized, valued and encouraged.

However, if these elements of value are given short-shrift and the outsourcer is incapable of making money, then both parties will ultimately fail. Flexible agreements that encourage the sharing of risk and reward – the extension of business value – are essential to mutual success.

### **3.0 Maximizing the Value of Outsourcing**

In order to thrive on the next wave of outsourcing, senior IT executives have several strategic moves they can and must make. By embracing these strategic perspectives and then acting on them, they have an opportunity to avoid the disappointments that have befallen outsourcing in past years. Further, they have an opportunity to realize the value-driven and even the transformational potential that outsourcing represents.

So what must they do? Here are some of the core principles that will guide the strategies and actions that will, in the coming years, come to symbolize outsourcing excellence:

#### **3.1 Assess the Total Value Equation –**

One of the chief mistakes that companies make in regards to an outsourcing decision is to simply judge possible vendors on the basis of a list of capabilities and features. The mistake relates to an insufficient evaluation of the business problems they are trying to address. Through an extensive analysis of their key problems and the associated costs, they could learn which outsourcer is best suited to address them. Presentations loaded with lists of service capabilities and apparent differentiators tend to sound the same. The mere practice of lining up vendors for “bake-offs” leads to a situation where price is the only enduring differentiator.

Instead, companies should encourage outsourcing vendors to engage in a thorough diagnosis, assessing key business objectives, defining the scope and cost of the problems being addressed, and presenting the business value they can deliver in relation to these objectives and problems. Such exercises are the true foundation of a strong, collaborative outsourcing relationship.

**3.2 Optimize Agility and Flexibility –** With market-making companies such as P&G and GE in the lead, there’s a movement toward “multi-sourcing” and “selective sourcing” that promises to widen the portfolio of outsourcers companies will manage. This is good news. It can be expected to enhance the sourcing governance capabilities of companies that would otherwise become unwisely dependent on a single outsourcer. Strategic sourcing is a practice and capability that every company must build and continually refine. Companies accomplish this objective by managing a diversified portfolio of outsourcers just as any investor should manage a diversified portfolio of stocks. Anything less is a monopolistic relationship – an unhealthy one that is wide open to abuse and subject to poor performance.

In a recent study of outsourcing, MIT's Center for Information Systems Research (CISR) found that “transaction relationships” – which are clearly defined in terms of the processes they cover and enhance – lead to greater customer satisfaction than any other types of outsourcing relationship. Such relationships depend on an active sourcing team, the clear delineation of business processes and the capacity to manage the outsourcer in a disciplined fashion. The collaborative relationships that emerge can be expected to be more agile and flexible than the relatively static and rigid arrangements that have emerged through sole-sourcing.



**3.3 Provide Committed Executive Leadership** – There’s a false dichotomy often expressed in business circles suggesting that companies must either take a short-term perspective or a long-term one. However, the strategic leaders of outsourcing’s next era will abandon these unhelpful assumptions. World-class outsourcing relationships, as we are seeing, are instead guided by the assumption that they must deliver results in the near term and over time. Their planning efforts incorporate ambitious commitments and milestones to follow, determining upfront how business value can be measured, managed and delivered in a continuous fashion.

Behind the ongoing commitment to management of business value is committed executive leadership. While outsourcing contracts are based on service level agreements, it is common for companies to invest the bare minimum in quality business outcomes at the outset and for outsourcers to deliver the bare minimum relative to these agreements. It takes strong leadership – such as that demonstrated by people like GE’s Jeff Immelt, P&G’s Lafely or GM’s Ralph Szygenda – to articulate the vision and ensure these outsourcing relationships deliver the business performance gains they promise.

#### **4.0 The Transformational Promise**

Outsourcing excellence requires that we build on the successes of the past and learn from the mistakes. Companies have indeed leveraged outsourcing to shed activities that were non-core and reinvested their resources for competitive advantage. In many cases, this has delivered extensive gains in shareholder value, revenue growth and cost reduction. But many companies and careers have also drowned in past waves of outsourcing. The mistakes – and unmet promises – are there to be studied. Hopefully, they will be addressed in the next wave.

The promise that some are now beginning to articulate is one of “disaggregated corporations” – rigorously focused on their differentiated, core capabilities and depending on outsourcers to actively manage the roles and responsibilities that are non-core, yet nevertheless critical. But they also see “transformational” opportunities in outsourcing relationships. There is the potential to draw on outsourced capabilities to further differentiate themselves, elevate their people, and transfer and infuse best practices into their organizations. The transformational promise revolves around dynamic and continuous collaboration in the identification, creation and delivery of business value.

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