Trends in the Outsourcing Industry and Common Problems with Outsourcing Deals

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John Nicholson

John.Nicholson@ShawPittman.com

What are we going to talk about?

- **Outsourcing Basics**

- **Trends in the Outsourcing Industry**

- **Common Problems in Outsourcing Deals and How to Avoid Them**

- **Your Questions and Comments**

Part I

Outsourcing Basics

What is Outsourcing?

Outsourcing is the long term contracting of an information system or business process to an external service provider to achieve strategic business results

- What is not outsourcing?

  - Services never intended to be performed internally such as hardware maintenance

  - Project-based services such as systems integration

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Who are the Players?

- **Tier 1 Providers: IBM, CSC, EDS and ACS.**

- **Tier 2 Providers: Perot Systems, Accenture, CGI, Unisys, Lockheed Martin, Siemens.**

- **Other Consulting Firms**

- **Hardware Providers moving into Services**

- **Offshore Providers**

- **IBM is the dominant player in the global market.**

  - More because of problems at the others (new leadership, accounting issues, etc.).

  - "Nobody ever got fired for buying IBM."

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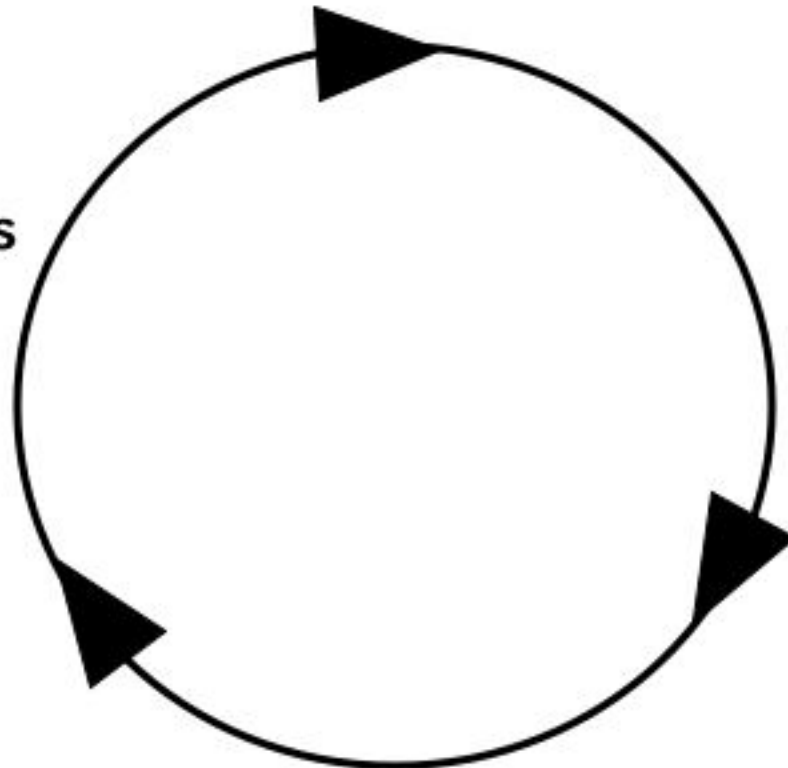
Trends in the Outsourcing Industry

Trend 1 - Changing Focus

- **Large US companies are already signed up (market saturation)**

- **US economy has been slow.**

- **Vendors are courting international customers and US middle market.**

Trend 1 - Changing Focus (cont.)

Large US
Customers

Large Intl.
Customers

Mid-Size US
Customers

Average Deals
5 - 7 Years

- **Approach to mid-market companies may result in partnerships between large, traditional outsourcing vendors and companies that traditionally serve middle market.**

- **In the beginning, there was ITO - "Information Technology Outsourcing"**

  - Now fairly mature.

  - Deals are common and services are well understood.

- **Next came BPO - "Business Process Outsourcing"**

- **Now people are starting to talk about BTO - "Business Transformation Outsourcing"**

- **BPO is less mature than ITO.**

- **Deals are still relatively unique and customized, and require a lot of attention.**

  – Understanding customer's internal costs (and the vendor's price) is more difficult because BPO focuses on outputs.

  – Services provided by BPO vendors may be less fungible across customers, increasing variability and decreasing economies of scale.

  – Need to focus on clear SOW, appropriate SLAs and meaningful pricing structures.

- **ITO model does provide guidance for implementing BPOs, but BPO services are 5 - 10 years behind ITO in terms of maturity.**

- **US vendors are pursuing "anchor" accounts that will define their BPO offerings.**

- **BPO will not mature until one or more vendors acquires a "shared services" facility/function from a customer and uses that as the basis for its BPO offering.**

- **BTO - "Takin' Care of Business"**

- **The concept behind BTO is almost, but not quite, a joint venture.**

  - Supposed to encourage the vendor to initiate technology-based business transformations.

  - Focus on "win-win" relationships and gain-sharing

- **JV-like relationships have been tried many times in the outsourcing arena and have not succeeded often.**

- **Too early to tell whether BTO is a viable concept (and somehow different from a BPO or a JV) or simply marketing hype.**

  – Challenging to measure success.

  – No clear benchmarks.

  – Difficult to motivate in-house leaders who are left with a skeleton staff.

  – IP/Competition Issues

Trend 3 – Offshore

- **Offshore outsourcing is very attractive**
  - **Cost of labor in other countries is much lower**
  - **Offshore vendors compete based on quality - CMM**
  - **Educated, frequently English-speaking labor force**
  - **Historically very low turnover compared to US (but this is changing in India)**

- **Weak dollar is making offshore temporarily more expensive (but still cheaper than US)**

  – But, know what your own internal costs are, otherwise, how can you evaluate your savings?

- **Hidden costs of offshore outsourcing**

  – Coordination/project management costs

  – Estimate soft costs (e.g., dealing with cultural issues)

  – Ask peers/vendor references about hidden/unexpected costs

  – Cost of transition

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- **Cultural differences**

  – **What does "Yes" actually mean?**

- **Increasing labor costs in India driving business to other "next generation" countries -**

  – **Philippines, China, Malaysia, Russia, Brazil**

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- **Telecom infrastructure not ready in "next generation" countries**

- **Concerns about confidential/proprietary information**

  - Indian companies recognize this and are willing to agree to audit/enforcement provisions in contract.

  - Medical transcription case.

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Trend 4 – Shareholder Influence

- **Wall Street is watching the outsourcing vendors.**

  - Friday, June 28, 2002: EDS stock closes at $37.15

  - Monday, July 1, 2002: EDS announces it has terminated discussions with P&G regarding an outsourcing deal.

  - EDS stock drops to $30.45.

- **Many outsourcing vendors have become public companies.**

  - What used to be the consulting arms of the "Big Five" have all morphed in some way and, with the exception of Braxton, are all publicly held companies:

    - Andersen Consulting ⟹ Accenture
    - PwC ⟹ IBM
    - KPMG ⟹ Bearing Point
    - Deloitte Consulting ⟹ Braxton
    - Ernst & Young ⟹ Cap Gemini Ernst & Young

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Why is this important?

1. Hardware and software companies are already driven by monthly, quarterly and annual results. Outsourcing vendors are trying to get deals signed in time to be reported.

2. Analysts are concerned about the slowing growth rate in the industry.

3. Outsourcing vendors use stock as compensation - when the stock goes down, it's harder to get/retain talent.

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- **Customers who signed long term agreements are renegotiating these deals.**

- **More than 50% of customers seek to renegotiate deals within first 3 years. (Gartner)**

- **Customers with strong, clear rights to terminate for convenience have the leverage to renegotiate.**

- **Vendors do not want to lose business in a down economy.**

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Trend 6 - Piecemeal Deals

- **Customers trying to expedite deals by breaking up required scope and negotiating several deals.**

- **Wrong approach**

  - Decreases customer leverage.

  - Less efficient.

  - Draws out outsourcing and can cause morale issues.

  - Gives vendor opportunity to renegotiate agreements from previous deals.

  - Can lead to "blame game" if vendors must interact.

Trend 6 – Piecemeal Deals (cont.)

However…

- **Ongoing threat of competition can keep vendors prices in line.**

- **Outsourcing agreements should include the ability to give work to third parties.**

Trend 7 – Changing Nature of IT Departments

IT personnel are being called on to be relationship managers in addition to providing technical skill.

- Maintain relationships with users

- Understand business needs

- Build relationships with vendor personnel

- Manage/evaluate vendor performance

Common Problems in Outsourcing Deals

and

How to Avoid Them

- **You're an executive who is under pressure to do "SOMETHING" and to do it with a lower budget.**

- **A salesperson from a well-known services provider tells you that his company can provide the services that your IT group provides:**

  - As well or better than you do it yourself

  - Using "global best practices"

  - At a lower cost.

- **Wouldn't you say yes?**

Why is this a problem?

- **Timing.**

  - Salesperson wants the deal done quickly (by month end, quarter end or year end).

  - Executive wants the deal done quickly so that she can book the savings promised by the salesperson.

- **Leads to:**

  - Poorly defined scope.

  - Loss of negotiating leverage.

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- **Customer perspective:**

  The vendor should perform the services in the same way that the in-house personnel would have. That means staying late, doing extra work, etc. without additional cost.

- **Vendor perspective:**

  The vendor has priced a fixed scope of work. Additional work should result in a change order.

- **IT culture is to do whatever it takes to solve the problem. As long as resources are a fixed cost, that isn't a problem.**

- **Customers may decide to scale back "extra" services provided to end users to save cost on outsourcing.**

- **Customers may not accurately communicate the decreased services to end users - resulting in end user dissatisfaction with the vendor.**

Rushed negotiations/SOW development

+

Differing expectations

+

Poor communication with end users

$\Downarrow$

An unhappy relationship

Avoiding/Minimizing Problems

Treat an outsourcing deal like buying a used car.

- **Recognize that doing a deal properly takes time -**

  - For outsourcing deals frequently as much as 6-9 months.

- **Compete the deal.**

  - Talk to multiple vendors. Don't do things that undercut your negotiating leverage.

- **Know what you want.**

  - **Clearly document scope, service levels.**

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- **Know what it will cost.**
  - Clearly specify pricing before signing the deal.

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- ## Know what it will cost (cont.)

  - Vendor due diligence must be complete before the deal is signed.

  - Avoid "Assumptions" and "Dependencies."

- ## Use an independent deal consultant.

  - A mechanic knows how to look for and evaluate problems that you might not see.

- ## Communicate, communicate, communicate.

Summary - Avoid Buying a "Lemon"

- Take the time.

- Maximize your leverage by competing the deal.

- Clearly understand what you want and what it costs you now.

- Clearly understand and document what you are getting.

- Clearly understand the price and how it might change.

- Recognize your limitations.

- Communicate.

Questions and Comments?

Thank you for listening!