

Why do companies consider outsourcing?

Most companies consider outsourcing because management believes that the cost of the operation in question is too high and the service levels are not acceptable. Sometimes it is one or the other, but both factors are usually present. Companies look at their costs and service levels compared to others in their industry and see they are at a competitive disadvantage. With continuing pressure to reduce operating expenses, senior executives are enticed (or coerced) to evaluate outsourcing a portion of their operation to reduce their expenses or fix persistent performance problems.

In many cases, when service levels are perceived to be poor it is because the operations lack consistent, reliable metrics which accurately measure their efficacy. This lack of data leads management to rely upon anecdotal information and complaints from clients to shape its opinion on the overall effectiveness of their operations.

Another factor which contributes to a decision to outsource is modernization of the infrastructure and technology that supports the operation in question. If the current support infrastructure (i.e., servers, network, applications, etc.) or business processes are outdated and require significant investment to upgrade, a company may look to an external supplier to modernize the operation by way of outsourcing.

What causes these problems?***Internal Politics***

A common source of problems is the competitive nature of the business units within a company. The natural political environment and competing needs of the business units may drive them away from company standards, shared services and common architecture and infrastructure. Each business unit within the company tries to drive revenue and maximize profits for its products and services. This drive creates competing priorities and needs which are often unique to the particular business unit. For example, a business unit may perceive that its needs for technology architecture, software, infrastructure and operations are unique and potentially incompatible with the needs of other business units. To demonstrate this concept, just consider the portfolio of ad-hoc reporting tools in use today in your company. This type of competition creates several problems. First, it increases the complexity and cost of the underlying infrastructure and operations. Second, it dilutes already limited talent pool within the company. Third, the underlying infrastructure and operations become difficult to maintain and tends to spiral further away from the remaining portion of the infrastructure over time.

Acquisition

Many companies have grown through acquisition. As a result of these acquisitions, companies often retain a large portion of the acquired legacy systems and infrastructure. Unless the company invests considerably to bring the acquired company into the operations and technology fold, the complexity of managing operations and its supporting systems will increase over time.

Complex Metrics

Most internal departments are measured by the achievement of their budget. Therefore, the driving measurements are those that help them achieve their revenue goals, their cost objectives and their quality objectives—often in that order. Common measurements to ensure attainment of cost budgets are headcount, controllable expenses and third party expenses. In the case of an information technology or client service operation (a cost center), the typical goal is to ensure that changes to departments (or budget commitments) are equal to costs.

In order to know if the price of a service will allow them to meet their profit objective, business unit leaders must understand the cost of the service. Typically, there are four variables in the cost of the service; hard costs, such as hardware or software, environmental costs, such as rent, utilities and security, overhead and labor costs. Often the biggest variance between costs for internal and external providers of service is the labor cost.

How can an outsourcer help?

Why do companies look to outsourcers to solve these problems? First of all, the services that outsourcers provide are their core business. This is what they do and in order to be competitive and make money they must do it cost effectively with high quality and scalability. Because it is their core business, they can attract top talent. A top notch professional in a services firm benefits from a consistent flow of challenging work assignments. In addition, this professional is provided a career path that provides him/her continuous growth and advancement. Many companies suffer from bloated payrolls and outsourcers are skilled at taking over the bloat and managing the pay scales to a more reasonable level over the first couple of years of the agreement. The challenge lies in the fact that many companies use salary increases as a means to retain key employees, but may not necessarily offer the work challenges that should accompany pay raises.

Outsourcers are better suited than a company to optimize tasks (i.e., perform them cheaper with better quality) because:

They have performed similar tasks in many places.

Outsourcers train their employees on technologies, processes and systems because they must do so in order to perform. It is cost effective to do so because the training is leveraged again and again. For example, a company may forgo huge capital expenditures and tremendous risk by outsourcing the operations (and supporting infrastructure) to a provider that already has invested in the required infrastructure, has executed upgrades of similar size and scope and benefits from the economies of sharing that infrastructure with many other clients.

They have invested in and deployed toolsets that automate the work.

Most outsourcers have already developed and deployed software and tools and there is little or no incremental cost to reuse them as additional clients are integrated into the overall operation. For outsourcers that also manufacture hardware or develop commercial software, such as IBM or HP, this extends further to operating systems, hardware and other software products such as databases and middleware. By bundling the hardware and software into the service delivery price, outsourcers can build their market share while still meeting the cost containment objectives of its clients.

They know how to measure productivity.

There are two major drivers of labor efficiency; automation and productivity. Therefore, every major outsourcer puts in place key metrics which will allow them to measure the productivity and quality of each service. The amount of time it takes to perform each step of the service is measured, the personnel are stack ranked and one client environment is compared to others. These processes drive shorter cycle times and therefore lower costs. Experience across a broad range of clients is entered into a context sensitive model and those under performing use the methods that have been successful elsewhere to bring the operation to the desired productivity levels.

They know how to cut costs.

A key ingredient to an outsourcer's cost saving recipe is the advantageous cost base when running an operation within service delivery centers. For the most part, service delivery centers are not located within major, high-cost urban centers. Instead, they are located in or near tier 2 and tier 3 cities where there is a strong labor pool with lower labor and facilities costs. This allows the outsourcer to hire and train employees at a lower cost than its client base. In addition, this promotes lower employee turnover, again reducing training costs and leading to higher productivity. Furthermore, the outsourcer's investments in training can be reused across a broad client base operating within a given delivery center.

They consolidate resources.

Another advantage that outsourcers have is economy of shared operations and facilities. Outsourcers can gain tremendous efficiencies by consolidating operations for many clients into a given service delivery center. This allows outsourcers to leverage facilities, equipment and resources across a wide base of client operations. It also allows the outsourcer to leverage its personnel with greater efficiency as utilization increases and dependencies on rare talent diminish. In addition, it serves the added benefit of providing redundancy, business continuity and disaster recovery solutions more cost effectively than any one client could realize.

They have profit in mind.

Lastly, outsourcers have a profit motive. If an outsourcer does not make the contract work, they cannot make money. Project Executives (the individual responsible for the outsourcing operations, P&L, service levels and client satisfaction) are provided incentives to meet plan objectives and these objectives are passed down to subordinates in the forms of tight operating plans, performance measures and accountability.

What about controlling your own destiny?

Opponents of outsourcing will say that you lose control and flexibility when you transfer operational responsibility to an outsourcer. Companies that choose to retain and optimize operations (as opposed to outsourcing) argue that they can retain control of their business and benefit from the savings that normally would be retained by the outsourcer. While there is merit to this argument, companies need to carefully take stock and analyze whether they have the expertise required to affect the changes required, evaluate their team's ability to reach those goals, and determine if they possess the necessary infrastructure to sustain those changes. In addition, a company must be able to answer the key question; ***if we can do this ourselves, how come we have not done it yet?***

Summary

It is very important to keep in mind that very few companies can be world class in everything they do. While firms may be excellent in their core business, they may lack the top talent and expertise in information technology or other non-core business processes. For more information on outsourcing, please contact Nathanson and Company @ 203.227.1816 or info@nathansonandcompany.com.