2 In-House IT Service Providers – Exploiting Efficiency Potentials

In the 1990ies, many companies integrated their internal IT functions, spinning off IT service providers as separate corporate entities. There was a regular wave of start-ups across all industries, seizing manufacturing companies, energy suppliers, airlines, and banks alike. While this trend has subsided over the past years, there is still a great number of companies facing the decision whether or not to spin off their internal service units.

Key motives for spinning off internal IT service providers are cost reductions and quality increases in IT performance:

- *Cost reductions:* The company wishes to reduce IT costs by integrating IT departments and staff under one management and exploiting economies of scale (for example, by consolidating applications and computing centers – see chapter 1 of this section, 'IT Optimization'). In particular when companies have several similar divisions, each with its own IT department, there are usually considerable synergy potentials in the different areas of IT. The same is true for companies which have passed through phases of strong external growth: They can usually exploit substantial cost and market synergies by spinning off internal IT service units. The objective must be to procure IT services at market prices, which are usually lower than internal transfer prices.
- *Quality improvements:* The integration of IT systems and staff helps consolidate the existing know-how and thus to improve IT performance. Service levels can be raised, simply due to 'more mass', IT solutions can be transferred between business units, launch times can be reduced if more people are involved, and many more optimization measures can be taken. Transforming the in-house IT unit into an independent IT service provider leads to a clear distinction between the role of the client – played by the company – and that of the contractor, which is the IT provider's part. It should result in a constructive service mentality in the provider's organization, while enhancing transparency on the IT services purchased and the related costs. Finally, companies might seek quality improvements by establishing an external IT service provider if they face substantial IT investments which, contrary to historical practice, will be introduced and used across the organization.

In the second half of the 1990s, when qualified IT resources were scarce and sought-after in the market, many companies also hoped that spinning off their internal IT service units would help them market their IT services to external customers. A positive side-effect of establishing an internal IT service provider is the support for the company's IT governance: If, for instance, the IT provider becomes aware that several uncoordinated orders for identical IT requirements or system solutions are placed by the business units or subsidiaries, and if the company's IT governance calls for integrated IT solutions, the provider can bundle these requests and implement standardized IT systems – based, for example, on template solutions – which incur much lower costs for implementation, operation, and maintenance than would customized solutions for individual business units or subsidiaries.

The question that remains is: Why should a company go through the trouble of spinning off an internal IT service unit, instead of simply outsourcing IT services from an established external provider? The answer is that in many companies, outsourcing is unacceptable for one or several of the following reasons:

- The company has critical know-how in IT systems and business processes, which may not under any circumstances be passed on to third parties (example: merchandise management in trade).
- The company is highly specialized or innovative, or present in exotic locations, or it requires very specific IT services which external service providers can only deliver as 'special customer requests' at excessive extra cost (example: market launch of data communication products in telecommunication).
- The company faces major change with substantial consequences for IT, and therefore wants to retain IT in its own control.
- Corporate tradition or explicit agreements with the employees' representatives prevent outsourcing.

Prior to the spin-off of an internal IT service provider, the company should be clear about its objectives, taking them into account when deciding on the service provider's design configuration. Similar to the outsourcing of IT services to external IT service providers (see chapter 3 of this section, 'IT outsourcing and offshoring'), working with internal IT service providers requires strategic lifecycle management – spanning from the spin-off itself to professional cooperation to an exit strategy that works for both parties.

Strategically aligning and spinning-off the IT provider

With regard to technical and commercial details, the cooperation between the internal IT provider and its customers – the divisions of the parent company – is set up in the same way as is customary between third-party providers and their clients. Mutual service relations are based on a service level agreement, with service levels tied to prices and a system of incentives (bonuses/maluses), and the cooperation is continually adjusted to the changing requirements of the company or the potential for technological innovation in the provider's operations.

However, since IT providers are created from the centralization and spin-off of existing IT departments, there is a certain risk that previous inefficiencies and shortcomings will live on. Therefore, a series of stipulations is required covering everything from the IT provider's organization structure, to staff competencies and responsibilities, to the re-design of business processes. The aim must be to ensure the transition form a mere organizational unit to an independent corporate entity.

This is where spinning off an internal IT provider differs from IT outsourcing. Determining the configuration of the internal IT provider and defining the rules for cooperation will involve opportunities and new challenges for the company. Even prior to the spin-off, the company must be aware of the goals it is pursuing with this move, and integrate them in the design effort.

The first question in this context is: What parts of IT should be spun-off at all? There are three basic answers which, in practice, will vary in several ways:

- *Everything:* The entire IT including all systems, computing center locations, and IT executives and staff will be transferred to the internal IT provider. Only demand management will remain in the company, to be taken care of by a CIO Office.
- *Only central IT systems and staff:* In this case, the CIO Office and decentralized IT remain in the company
- *Only shared IT systems and staff:* In addition to the CIO Office, division-specific IT systems and staff remain in the company

Other varieties include spinning off the entire IT (with the exception of the CIO Office) and leaving certain IT components in individual divisions. To simplify matters, we will base the following on the assumption that a company's entire IT is spun off, while the CIO Office controls IT demand and determines the IT governance rules relevant to the cooperation with the internal IT provider.

Determining 'strategic parameters' for the IT provider

For a successful later cooperation it is crucial to determine the 'strategic parameters' of the IT provider's business model from the very start (figure 3.5): Should it operate only from the company's primary locations, or should it be present internationally to support the company's growth strategy? Should its focus rather be on service quality or competitive prices? The clearer the answers, the easier it will be for the IT provider to support the company's goals.

Strategic parameters	Design options		
Regional presence	Focus on primary locations	↔	International presence
Service portfolio	Focused	↔	Broad
Service strategy	Cost-driven	↔	Performance-driven
Financial targets	Profit center	↔	Cost center
Focus of orders	Individual customer	↔	Cross-divisional
Sales activities	Key Account Management	↔	"Real" sales operations
Vertical integration	100 %	↔	An optimized 50 to 70 %
External market	Yes (5 to 10 %)	↔	No

Figure 3.5: Strategic parameters for the business model of the IT provider (examples)

The IT provider's position in each parameter will determine its further actions, development, and cooperation with the company. Some of them enhance, some constrain the entity's growth potential or its ability to meet the company's cost and performance requirements. Most important from the company's point of view are those parameters concerning the interface between both parties, as well as those affecting the IT provider's technical and financial performance.

- *Regional presence:* After existing IT functions are spun off, the new IT provider will immediately be present at all company locations. What should be clarified in addition is whether the IT provider will focus on supporting the primary locations of the company, or cover all existing and future locations. The latter may require establishing new international operations, for instance if the company intends to go to China. If the international focus of the IT provider is to be expanded, it will be crucial to ensure that executives and employees are gradually introduced to working on intercultural teams, and that they build the necessary language skills (most importantly in English).

- *Breadth of service offering:* As far as this parameter is concerned, less is more: Due its specialization, the industry and company-specific know-how, and the physical proximity to its customers, the internal IT provider is likely to be better positioned than external providers when it comes to application development and maintenance, on-site support in small, dispersed locations, and the management of infrastructure projects. On the other hand, where standard services like the operation of computing centers or help-desks are concerned an internal entity will usually not be able to compete with the prices of external providers which, due to their size and the standardization and centralization of their services, will benefit from fixed-cost degression and other economies of scale. The internal IT provider should therefore focus on those services where it can offer the company a price, performance, and quality level superior to that of external vendors. Likewise, it should give up those services where it cannot be competitive in the medium or long term, seeking alliances with external providers which are able to render these services at better terms.

- *Service strategy:* The service offerings and qualities requested by the parent company will differ from one division to the other: Some attach more importance to quality, others emphasize costs. Particularly large differences exist between the United States, Europe, and Asia: The high labor costs in Europe and the U.S. have resulted in higher penetration rates for automation and IT, which in turn calls for higher quality standards in user support and application development. The homogeneity of languages between the U.S. and U.K. facilitates the bundling of telephonic user support, as would be provided by a user help desk. The high qualification level found in some Asian regions, along with comparatively low labor costs, provide an excellent basis for location and language-independent services delivered on a worldwide scale. They include server and network management and certain parts of application development (cf. chapter 3 of this section, 'IT outsourcing and offshoring'). The company should therefore consider carefully whether the internal IT provider should offer high-quality services based on a broad presence in all corporate locations, or cut down on local presence and transfer some of its IT operations to other countries, thus benefiting from factor cost advantages which it can pass on to the company.

- *Financial targets:* If an internal IT provider is set up as a profit center with fixed financial targets in terms of ROCE or EBIT, conflicts of interest with the divisions are virtually unavoidable, which can seriously hamper an effective cooperation. Divisions will argue that the provider's profits result from a simple transfer of their own profits, rather than representing 'real' business results. This accusation seems justified in those cases where the IT provider – at least in the divisions' perception – does not charge market prices but cost-covering internal transfer prices which are above market level. Corporate divisions will therefore often demand that the IT provider be operated as a cost center. This, of course, contradicts the intended market orientation and other strategic goals which have been set for the IT provider. The provider's prices should be such that it can achieve an adequate profitability level while preventing the divisions from outsourcing to external providers for cost reasons. In short, it is imperative to use sound judgment in setting financial targets.

- *Focus of orders:* The IT provider can either work by order of each individual customer (i.e., division) or it can be given the mandate to seek cross-divisional synergy potentials, for instance by transferring IT solutions. In the latter case it will bundle similar requests from individual customers and strive for joint, cost-optimized and benefit-increasing IT solutions, using parameterized IT systems and template models.

- *Sales activities:* The need of the IT provider to build up own sales activities will depend on whether it will be closely involved in the parent company's IT planning processes – or treated as a third party, competing for bids with external IT service providers. In the former case, all the IT provider will need is a key account management staffed with knowledgeable IT specialists with problem-solving skills, and closely cooperating with IT users and CIOs at the divisions and subsidiaries. This solution is optimal in terms of costs because it provides planning certainty; it requires, however, the divisions' confidence in the quality and price competitiveness of the IT provider. If such confidence is lacking, a sales team must be set up at the IT provider at considerable extra cost, since the staff from the company's previous IT departments will usually not include any sales professionals.

- *Degree of vertical integration:* Many IT providers, particularly at the beginning, tend to cover most of their value creation in-house. From the perspective of the parent company, this only makes sense it the IT service rendered is crucial to competitiveness and cannot be outsourced. In most other cases companies will demand their IT providers to focus on core activities at competitive prices. This means for providers that they must outsource certain parts of the value chain to external vendors, and assume a management and integration function for these parts. Services suitable for (partial) outsourcing usually include those related to infrastructure, an area where specialized or large external IT providers enjoy scale advantages. A similar, project-based strategy suggests itself in application development. Outsourcing these types of services will enable internal IT providers to counterbalance the high volatility in staff utilization; in addition, it offers opportunities to selectively buy in innovative know-how which they expect to become critical in the future, and which they can then develop, step by step, in-house.

- *External market:* Many companies count on external sales potentials when spinning off internal IT providers. In individual cases, they can contribute up to 50 percent to the provider's overall sales. This, however, is another point which – just like the setting of financial targets – requires a good deal of discretion: The new IT provider will initially suffer from considerable competitive disadvantages against established providers, which can be eliminated only through substantial and ongoing investments on the company's part. In addition, the high quality demands of most external customer will force the IT provider to assign its 'best people' to external projects, which means that these experts will not be available for services to the parent company. In this scenario, unrealistic sales targets for the IT provider can easily fall back on the company. At least in the starting phase, companies should therefore expect their IT providers to achieve a maximum of five to ten percent of their sales in the external market.

In order to fulfill the strategic parameters of its parent company, the IT provider will have to develop corresponding capabilities: At the beginning of its existence, it will be nothing more nor less than the sum of the IT departments it was formed from, with all the strengths which the company has built and fostered over the years, and all the weaknesses it has been tolerating. This will include the usual, industry-specific compromises in HR policies (for example, where regulations for the protection against unfair dismissal must be observed) which, in the case of an external IT provider, would result in the cancellation of orders.

The quality of human resources is a key success factor for an IT provider. Consequently, the staff of the former IT departments will need to shift their focus from IT technology to customer orientation and service-mindedness. While they are usually highly motivated at the time of the spin-off, they will probably need some time to really adopt and live a true service culture. Suitable measures in HR leadership and management systems, as well as organization changes (such as introducing key account management or establishing cross-functional 'solution teams') can help accelerate this cultural change. Supporting tools like project evaluations, performance evaluations, performance-related compensation systems, trainings, and organizational transparency between the IT provider's individual departments will provide the necessary incentives.

In many countries the need to be fluent in English can be a major issue. And it goes without saying that employees of an independent IT provider will additionally need brilliant IT expertise, broad business management knowledge, excellent problem-solving skills, and long-standing experience from numerous projects. The new IT provider's staff will need to build and develop these capabilities and skills over time – 'from zero to hero' in no time will always be an exception.

Nevertheless, in many cases the divisions of the parent company – now customers of the new IT provider – will immediately tend to apply the same standards they use when dealing with other providers. If the parent company (which will have to cover the new entity's losses, just as it will benefit from its profits) now exerted too much pressure, demanding immediate competitiveness on the external market or setting excessively high targets, the failure of the IT provider would be inevitable. It is therefore imperative to determine clear rules for the starting phase.

Allowing for a start-up phase to set up and professionalize the IT provider

During the first two years after the spin-off, the newly established IT provider will need to get organized as an independent entity, and develop professional structures and processes. The transition must be made from the sum of IT systems, IT executives and staff, computing centers, etc. that were spun off, to a high-performing organization. During this period mutual tolerance is a top priority, along with swift advances in professionalizing the cooperation – on both sides.

During the start-up phase there is much to be done. Existing staff must be trained, new personnel may have to hired to build the customer interface, and this very interface must be set up depending on the desired type of customer relations – either as an IT-driven key account management (operating ‘closer’ to the customer) or as a sales organization (keeping a greater distance from customers). The core processes of IT service provision must be built up, efficiency potentials exploited.

In one case example, several computing centers were transferred to the newly established IT provider, which immediately consolidated them from formerly over 10 to only three centers in optimal locations, thus achieving a substantial cost reduction. The IT provider’s own value creation must be contrasted with market-level performance and cost data, and its structure must be effectively aligned – in particular by outsourcing IT services which in the long run cannot be rendered at market-level quality or prices. Simultaneously, as performance increases are achieved in IT core processes, administrative services with respective commercial processes must be set up, in particular order processing with concurrent cost/revenue accounting and calculation, as well as bookkeeping, controlling, procurement, and HR.

While management will be busy initiating the transformation of the company, customers will expect continuity in IT operations. At the same time, the services rendered will not be on a competitive level – nor will the cost structure, and thus the prices for these services. Therefore some temporary relieving arrangements should be made to give the new IT provider a decent starting chance.

- *Cost allocation guarantee:* Up to a predefined point in time, which should be no later than in two years, the IT provider charges its actual costs to its customers – just like the IT departments did prior to the spin-off. To ensure that the divisions – the provider’s customers – register some positive development before that point, efficiency gains achieved should be passed on to the customers in the form of across-the-board cost reductions, such as ‘3 to 5 percent IT cost reduction per year’. At the same time, the services rendered should be recorded, a cost/price calculation should be set up and the prices should be determined based on criteria customary in the market. Cost allocations should gradually be replaced by service level agreements, thus building up a price mechanism which will be valid for all services no later than in two years’ time

- *Order placement guarantee:* The newly established IT provider could hardly survive intense competition with long established external providers; after all, the previous IT departments of the company did not have to compete in the market. Therefore, it makes sense to guarantee order placement for the duration of the start-up period. Whether this guarantee will be maintained or gradually redrawn, remains to be clarified in the context of the subsequent strategic rules of cooperation (see following subchapter, 'Defining the strategic rules of cooperation').

- *Gratuitous use of infrastructure:* The offices and infrastructure of the newly established IT provider will be on the premises of the parent company, at the locations of the previous IT departments – which means that they will draw benefits from the parent. These are usually provided at no cost, at least in the beginning, then sometimes charged to the provider (e.g., as rental fees). In that case the IT provider will need to consider these costs in its cost calculations and prices.

Granting the new provider a start-up phase has shown to be useful in particular with regard to fulfilling two strategic parameters – financial targets and sales targets for the external market:

- For meeting *financial targets* a gradual transition has proven effective. On principle, the IT provider will be managed as a profit center. Profitability targets for the first two years will be based on market prices, plus an overhead charge to compensate for an initial lack in competitiveness, or for any cost-intensive internal agreements with employee representatives that may not be customary among competitors (for example, if the IT provider has originated from the collective labor agreement of a manufacturing company). In these cases, profitability targets need to be introduced successively, oriented by the profitability targets of other divisions. This must be done with substantial discretion, as in many cases the parent company's profitability figures will not 'fit' the IT provider – for instance if the parent runs an equipment-intensive manufacturing business where profitability targets must reflect the high capital lockup – which is usually not the case with IT providers.
- If the parent company wants the IT provider to work the *external market*, a low-key start might be an interesting option – for instance, by winning a few associated or friendly companies as customers before actually entering the external market. As the IT provider continues to build critical capabilities, sales targets can gradually be increased.

Even if the management, executives, and staff of the newly established IT provider do everything possible and necessary for a speedy professionalization of their organization, according to all experience there will be complaints from the customers – the divisions – during the start-up phase. Previously internal IT departments are turning into a legally independent service provider: a change like this is bound to affect the relationship between users and IT and often causes multiple grievances. Severe disturbances in the relationship, however, will manifest themselves in very concrete ways:

- IT orders from the parent company's divisions or subsidiaries will increasingly be placed with external vendors, without checking back with the internal IT provider, thereby dodging the order placement guarantee.
- Divisions will gradually (and in part secretly) build up in-house resources, stating reasons such as higher quality, lower costs, and better controllability.
- The IT provider's internal customers will demand that, for quality reasons, certain projects or user support be given to subcontractors they have selected.

Unless the causes for such disturbances are identified, analyzed objectively, and resolved in a constructive manner, a downward spiral will set in which has led to the failure of many IT providers. A suitable tool for this cause analysis is a customer survey, in particular one focusing on strengths and weaknesses: It helps identify the areas to be addressed most urgently, also in comparison to external providers. Such surveys should generally be conducted by 'neutral' institutions (such as consultants or market research firms) to prevent accusations of instrumentalizing it for political purposes. In many cases, such surveys reveal a need for action in the following areas:

- Enhance customer orientation in key account management or sales, as applicable (typical complaints: 'order generation takes too long', 'contact persons keep changing' 'incompetent contacts').
- Improve coordination and cooperation between sales and delivery (typical complaints: 'if customers don't keep calling back about their orders, nothing will get done', 'sales people sell services which are impossible to deliver').
- Improve delivery quality (typical complaints: 'project got out of control', 'service levels were not maintained').
- Improve administrative support processes, in particular invoicing and knowledge management (typical complaints: 'external providers accomplish more', 'invoices are intransparent' 'the left hand doesn't know what the right hand is doing').

In almost every case, the internal provider's 'market share' in the parent company's IT budget will gradually decrease and external providers will take over. This development threatens the IT provider's existence in two ways: First, the decrease of critical mass in sales will resulting in an increasing fixed-cost share (as resource utilization goes down); secondly, there will be a lack of projects on innovative topics to safeguard the future of the business. This is why disturbances in the cooperation, particularly during the start-up phase, require top management attention and possibly a change management program, in order to enable the IT provider to take proactive measures. Apart from serving the provider's own interests, this will also help the parent company to meet the original goals of the spin-off.

Stipulating strategic rules for cooperation

Soon the start-up phase will be over. In almost all cases the customers of the IT provider – the parent company's divisions and subsidiaries – will now demand that full competition with established external providers be opened. At the same time, the parent company will increasingly expect the IT provider to form an 'IT bracket' around divisions and subsidiaries, actively contributing to IT cost reduction at consistent – or even improved – IT performance quality by developing shared solutions. On top of that, the IT provider will be expected to be highly innovative, providing the parent company with current know-how and latest-generation IT systems to strengthen its competitive position and optimize its costs, thereby rendering a clear contribution to corporate value increase. In short: The IT provider will be caught between conflicting goals.

To increase the benefits from IT and from the in-house provider, and to reduce overall IT costs, the company will need to determine strategic rules for the cooperation between the provider and the divisions. In practice there are three variants, each with its own specific consequences:

- *'Arms Length' – full competition, no involvement:* In this scenario, the IT provider is in full competition with established external IT providers, and is not given any guarantees in terms of order placement. The only way for it to obtain an order is by winning the parent company's bidding process through superior prices, services, or delivery quality. Rather than being involved in the planning processes of the parent and its divisions, it receives the same information as any other IT provider.

  This approach is only advisable if the IT provider's performance has reached market level and if a sufficient share of its business (30 to 50 percent) comes from the external market, enabling it to buffer fluctuations in demand. Another essential prerequisite is that divisions and subsidiaries maintain a neutral relationship with the IT provider, neither discriminating against it nor giving it preferential treatment.

  In reality these criteria are impossible to fulfill: Almost all IT providers start by achieving only limited sales and experiencing losses. Usually there is no or only very little external business and it cannot be expended quickly, least of all with 'real' customers which are not associated with and independent from the parent company. Moreover, customer relationships are mostly burdened, as all the 'sins of the past' – when the provider was still an IT department at the customers' organization – will come back into play. Full competition will, in all probability, result in a rapid sales decline and high losses, which the parent company's divisions and subsidiaries will ultimately have to compensate for. Therefore this option is not advisable. Rather than establishing an internal IT provider, the company should look into outsourcing its IT services or – if the internal provider has already been established – selling it to an external provider.

- *'Preferred supplier' – some competition, some involvement:* In this scenario, the IT provider is involved somewhat in the company's IT planning processes, enabling it to better prepare for its customers' short, medium, and long-term requirements. While the divisions may invite external bids, the internal IT provider can be sure to win the bid if terms are at least comparable. This, in turn, enables the IT provider to invest in building innovative IT know-how, helping the company to achieve higher increases in corporate value. This approach is quite common in practice: It combines competitive elements (bid invitation) with corporate control and planning mechanisms, which in the long run will be beneficial to both, the company and the IT provider, while divisions can be sure to obtain market-level prices and services.

- *General provider – no competition, tight involvement:* This approach entails a very tight, possibly even full involvement of the IT provider in the company's IT-related planning and decision processes. There is no competition with other IT providers in the external market; instead, there is an IT monopoly with an obligation for the provider to submit proposals, and an obligation for divisions and subsidiaries to accept them. The result is a tight and stable relationship with full mutual transparency on the customers' IT needs and the IT provider's cost and services structure.

  This scenario guarantees long-term survival for the IT provider, but not necessarily optimal or even market-level IT services and prices for the company. In fact, this type of involvement does not even correspond to the idea of an independently managed IT provider – rather to that of a Shared Services center with an IT focus, in particular because it lacks the element of entrepreneurial risk that would legitimate the profits obtained. All in all, this option is only advisable if, due to special circumstances or very specific requirements, there is no alternative offering in the market (a conceivable scenario for instance in the defense sector or in highly specialized or very low-revenue industries) or if the performance of the internal IT provider is so far below market level that even in the longer run – that is, after the start-up phase – it is not likely to become competitive. This is another case where the company should consider IT outsourcing, or selling the internal IT provider to an external vendor to restore its competitiveness.

In any case, a monopoly situation with purchase obligations for the divisions will not be sustainable long-term – in particular if these divisions operate in very competitive industries: Their willingness to tolerate non-competitive services and prices will quickly subside since, after all, they are evaluated based on their own results, not their merits in subsidizing a sister company.

For all these reasons, it will be advisable after the start-up phase to strive for a 'Preferred Supplier' solution: It requires the IT provider to keep its costs and services at or above market level – permanently and structurally. If not explicitly demanded by management, this is usually fostered by customers' demands for more transparency on IT costs and services, including comparisons with external IT providers. Benchmarking its own services and prices against the market will help the IT provider to identify levers for improvement. In practice they usually include the following:

- *Extensive consolidation:* For standard services – in particular infrastructure services – consolidation across locations or regions can help achieve substantial cost reductions (see chapter 1 of this section, ‘IT optimization’). Examples are provided by external IT providers following an outsourcing effort (consolidation of computing centers and help-desks, integration of service teams for user/PC support, centralization of central functions like sourcing, sales, and others).
- *Optimization of the product portfolio and of vertical integration:* IT services or individual components of IT services, which the IT provider cannot offer at market-level terms due to insufficient volumes, are outsourced to external subcontractors.
- *Optimization of key and cross-divisional functions:* In case of shortcomings in bid preparation and invoicing, external providers’ best practice can be used as a reference in optimizing the efficiency of service delivery processes, and adjusting service quality to market standard.
- *Aligning qualification, leadership, and management systems* of the internal IT provider with customer requirements: Common approaches include intensive staff training with particular emphasis on service-mindedness, introduction of customer-oriented performance evaluation and incentive systems, adjustment of tariff structures and career paths, and finally systematic recruiting of lateral hires from external IT providers and IT consultants for leadership positions.

Choosing a suitable business model for the internal IT provider and striving to professionalize the cooperation are both crucial to reaching the original goals of the spin-off. They are also key factors for the success of the company’s exit strategy.

Spin-off and professionalization of an internal IT provider at a manufacturing group

A group of companies in the manufacturing sector had completed several large-scale mergers, and was now looking for synergies. Management’s attention was drawn to the regionally dispersed and hardly consolidated IT organization, which had largely remained the same as before. An agreement was reached to consolidate all IT activities in one IT service company, in order to exploit synergies in IT costs and improve the allocation of resources (for example, by increasing utilization rates in application development) with corresponding advances in professionalization.

After a twelve-month start-up phase the organization structure was complete. After another twelve months, key IT cost synergies had been realized. There was, however, a series of strategic and quality-related factors raising doubts in the sustainable success of the new entity: With roughly 1,000 employees, the IT provider covered almost the entire service portfolio of the group, with a particular focus on Europe and smaller marginal activities in the U.S. and Asia. The group's divisions placed their orders directly with the IT provider, with very limited central coordination.

After approximately three years, there were increasing signs of problems in the cooperation:

- The IT provider's market share in the group was declining
- External providers won numerous bids for new application projects
- The IT provider was perceived by its internal customers as being bureaucratic, expensive, inflexible, and not in line with corporate strategic goals
- The IT provider had made only small entries into the external market
- A newly established IT sales organization met with limited acceptance.

These problems went all the way back to the start-up phase: The substructure of a classical IT department had been left unchanged, and transferred to the organization of the new IT provider. Employees did not perceive themselves to be service providers, and the entity's regional presence did not match the requirements of a group operating on a global level.

The IT provider started a quality initiative in delivery: The status quo was verified through internal customer surveys, and compared against the parent company's requirements. Likewise, the group compared the IT provider's services and costs with the experiences gained with external providers on similar projects, and derived strategic guidelines for the IT provider's future positioning. Resulting measures were detailed in business plans and a change management process was set up to eliminate the deficits in the cooperation. In addition, standard services were outsourced to external, lower-cost providers; for selected regions, a strategic alliance was established with an external IT provider present in those regions.

These measures helped to turn the cooperation between the group and its IT provider into a win-win situation: The IT provider's position within the group was secured long-term by means of permanent benchmarking with external providers, continuous customer surveys, and concentration on its particular strengths. This way the group ensured that critical know-how would remain in the company, safeguarding its strategic independence from external IT providers. At the same time, the IT provider was able to reduce the costs of IT operations by 15 percent in the first two years, increasing the bundling of specific IT functions (such as computing centers and call centers), with additional structural cost reduction potentials in the entity's further development.

Expanding, insourcing, or divesting the IT provider

Despite all efforts made by management, executives, and employees, long-term prospects for corporate IT providers tend to be poor – the wave of consolidation is rolling. Even very successful spin-offs are divested by their parent companies. A prominent example is debis Systemhaus: Despite its rapid and profitable growth, a large share of third-market business, and an excellent market position, DaimlerCrysler decided to divest – another indicator that groups are increasingly focusing on their core business again. The exit happens even sooner if the original goals of the spin-off are not fulfilled, or if the parent company's need for cash has increased. In this case the IT provider is sold, most likely to one of the leading international providers.

'Survivors' have so far included those IT providers which have enjoyed a stable order intake, due to very tight links with the parent company, and which have used external benchmarks to continually optimize their processes and structures. By contrast, those IT providers that emerged during the 'New Economy' boom specializing on Internet, e-business, and CRM services have mostly failed or been taken over by a large-scale IT provider. Those hat remained include mainly IT providers offering a broad service portfolio and focusing on a customer segment so far neglected by large providers (such as small and medium-sized companies).

The generally weak IT market of recent years has even affected IT providers with an established position in the market and highly competitive services. Price competition and the resulting pressure on margins, to be compensated only through increasing scale effects, require globally active service providers with large computing centers, consistent standards, and high service quality. Regional providers face increasing pressure, as customer tends to prefer providers that operate on the same global level. Corporate providers are at a disadvantage her because the majority of them is only present in the group's primary locations.

The competitive situation of IT providers is additionally influenced by changes in demand. Rather than purchasing their entire IT from an external provider, more and more companies start to outsource only services unrelated to their core competences. Almost all customers keep process and application-related, strategic, and controlling services in-house. What remains is basically services standardized to such an extent that they can be outsourced to several providers, thus intensifying price competition among them.

Together, these factors have led to a profound, and still ongoing, consolidation in the IT market. Large, international IT providers take over smaller corporate IT providers, mostly after five to ten years of existence when it has become apparent that the possibilities for internal growth are limited. Figure 3.6 illustrates some of the important changes in the IT market.

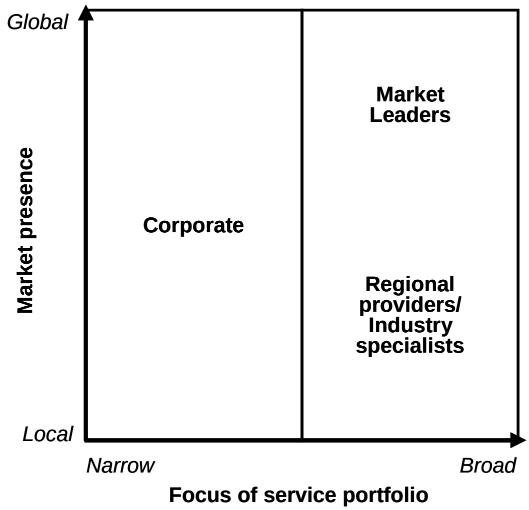

Figure 3.6: Consolidation of IT providers in the market

Many companies have realized that they will not be able to exploit the cost and in particular benefit potentials they have hoped for when spinning off an external IT provider – despite all efforts to professionalize the cooperation. They have come to a crossroads where they must choose between two options: divesting the IT provider, or separating its services into strategically relevant ones to be returned into the company (insourced) and non-critical services to be outsourced to external providers.

The first option, disinvestment, will be relevant for companies which, in the long run, do not consider IT a core competence and which, faced with a make-or-buy decision, would rather opt for outsourcing. The decisive factor is the IT provider's critical size: If it is not able to offer professional processes (from new-business acquisition to project management and invoicing) at fair prices, it will be a candidate for sale, as small and medium-sized IT providers have survival chances only in certain market niches – based either on industry-specific know-how, or on strongly segmented IT services such as SAP development.

Once the company has decided to divest, potential buyers must be identified. Main motives for them to take over a corporate IT provider will usually include non-organic sales growth, procurement of industry specific IT know-how from the parent-company's industry, or simply access as Preferred Supplier to the IT provider's previous customers, the parent company's divisions. Depending on the competences of the internal IT provider, several potential buyer groups may come into question:

- Software firms for IT providers which have developed marketable and competitive software products
- IT consultancies for IT providers which have built up strong development and consulting skills
- IT outsourcers wishing to enter into existing contracts of the internal IT provider.

The price achievable will depend on the existing (industry) competence of the IT provider, as well as its future sales potential with its previous parent company. In individual cases, restructuring the IT provider might further enhance its attractiveness to potential buyers. This may include dividing it up in several segments, each of which may be even more attractive to the target groups mentioned than their combination would. The result may be partial insourcing, or negotiations with several target groups. If no buyer can be found, the only remaining option is to outsource the services so far rendered by the IT provider, and close down its operations step by step.

Insourcing can be an interesting option if the IT services have strategic relevance for the parent company. It can be accomplished either by closing down the internal IT provider, transferring its operations to the parent company, or by integrating it with the parent company and focusing on in-house production (de-facto insourcing). Based on the parent company's strategic requirements, it will be necessary to professionalize the IT provider, build up market-oriented activities, eliminate redundant administrative functions, and reduce the product portfolio to what is needed by the group. In this case the IT provider, together with the corporate CIO organization, will assume responsibility for a strategy-conform, market-oriented and efficient IT supply. Regions and IT services where there are internal know-how deficits, or lack of critical mass, can be developed based on alliances or selective outsourcing.

Even if the spin-off of internal IT providers, as a general rule, will not be a long-standing solution but mostly a more or less temporary state of affairs, cost and benefit increases in the context of the spin-off can contribute to IT optimization, and to exploiting the savings potentials of IT outsourcing and offshoring.

Checklist: Does your company's cooperation with its internal IT provider rest on a solid basis?

	Yes
■ Have appropriate targets been defined for the IT provider in terms of sales, cost reductions, quality improvements, and financial results (ROCE, EBIT)?	❑
■ Has the design of the IT provider been guided by the structures and business processes of external IT providers, and have services and prices been aligned with the market?	❑
■ Are executives and staff being developed with regard to customer and service orientation?	❑
■ Have the scope and depth of the IT service portfolio for individual regions and customers been derived from a business case, ensuring that only economical activities will remain with the IT provider?	❑
■ Have the parent company's divisions and the internal IT provider established formal, market-oriented service level agreements in line with technological state of the art?	❑
■ Have temporary arrangements been made for a transitional period of about two years, allowing the previously internal IT departments to grow into one professional IT provider?	❑