3 IT Outsourcing and IT Offshoring – Cost Advantages from Contracting Out Services

If you want to drive a car, do you have to be able to build and repair it? If you need electricity, do you have to operate your own wind, water or coal-fired power plant? Well, for most people the answer will be No. Cars can be bought or leased from a variety of manufacturers, electricity comes 'out of the wall' – as long as you have a power supply contract and regularly pay the bills.

The principle of division of labor implies that companies specialize in certain products and services which they can deliver better and cheaper than other companies, so that ultimately they will become suppliers to others. From the perspective of the overall economy, this is a very positive phenomenon as it generates jobs at the specialist and prevents a waste of resources at the non-specialist. The same applies for IT: Information technology is complex and subject to continuous change. The management of IT, therefore, binds precious corporate resources: highly qualified staff, capital for hardware and software investments, office space, and others. Most companies, however, are 'only' users of IT: Yes, they need the performance – but why should they obtain or retain an 'IT production'?

As early as in the 1960s, innovative entrepreneurs in the U.S. started specializing in 'IT production – either as IT service provider, without their own hard- and software, or as a value chain extension of hard- and software producers. Today, the first approach is pursued by globalized companies like CapGemini Ernest & Young, EDS, SBS, or T-Systems. Outstanding examples of the second approach include IBM, Hewlett Packard, and more recently also SAP.

IT outsourcers are plenty today. The IT outsourcing sector has become an established industry with numerous professional suppliers. In every industry there are prominent examples of extensive outsourcing relationships – including areas where IT sourcing had previously been considered to be difficult or even impossible: Nowadays, even banks, telecom suppliers, and governments outsource large parts of their IT to external vendors. In other sectors which are less IT-driven – such as manufacturing – IT outsourcing has long prevailed. This raises a question for every company still retaining an in-house 'IT production': What do we need this for? Is it a real necessity or a luxury?

The advantages consisting in a sharper business focus, obtained through IT outsourcing, can be further expanded through IT offshoring – a rather young approach which is currently finding its way into European business practice. Pioneers in this field include the global automotive industry and the financial sector, where the share of IT is particularly high and the prevailing proprietary systems are hard to replace with standard software.

The positive experiences they have gained with IT offshoring provide excellent learning examples for other industries.

Reducing vertical integration with IT outsourcing

The motive for outsourcing is the same in most cases: Companies want to cut IT costs. Reduction targets are defined, specifying a 20, 30, or even 40 percent cut in IT production cost. Other crucial factors can be higher performance requirements with regard to IT service availability or shorter project durations.

A highly successful mechanical engineering company, for example, which so far had its main focus of operations in Germany and Western Europe, expanded into the U.S. market by acquiring a local company. As a result, its IT was now expected to run global systems, establish transcontinental networks, consolidate a number of locations, and introduce a standardized IT landscape. Moreover, support to U.S. users would require the computing center to go from a two-shift to a three-shift operation. A critical self-evaluation led the company to realize that all those IT activities could not reasonably be in the focus of an engineering company. A powerful outsourcing partner was identified and the IT outsourced. The new partner's competences, capabilities, and local presence enabled the engineering company to obtain the improved and broader IT qualities required, quickly and at moderate cost, without having to make any major investments.

Such situations mostly happen in companies where IT performance and the speed in implementing innovative IT products are critical to competitiveness. For instance, at banks and insurances, telecom providers, and airlines, value creation massively relies on IT (in telecommunications, for example, on rating and billing systems and on data communication products for GPRS/UMTS; in airlines, on reservation and check-in systems). Above all, they seek outsourcing partners helping them enhance their IT capabilities, for instance by bringing in the additional know-how needed to meet specific market challenges, or by providing the critical mass and capabilities required to carry out large-scale projects or manage the technical complexity of global IT operations.

In many cases, the company will expect its IT outsourcer to bring additional business into the cooperation, for instance by actively offering the company's services to the outsourcer's other customers or by integrating its services into its own portfolio. Let us take, for example, a cooperation between an IT outsourcer and a telecom provider: The IT outsourcer will need telecom services to globally network the 'IT productions' it is running for other companies, so it can either use the telecom provider's services or recommend them to other corporate customers. Another example would be an IT outsourcer assisting in the establishment of a new financial services provider by adapting an existing IT platform to the new company's needs. The financial services provider could pay

back this service by granting the IT outsourcer a fixed percentage of its sales, which it could not have achieved at the same extent and speed without the IT outsourcer's help.

One way or another, IT outsourcing offers economic benefit potential to companies of all industries:

■ *Reduction of complexity:* For many companies, certain services provided by their in-house 'IT production' (such as the operation of the infrastructure) have become an essential part of their IT which, however, does not belong to their core competences and therefore adds little to their competitive differentiation. For these companies, IT outsourcing will have the advantage of reducing the scope of services rendered in-house – known as 'vertical integration' – and focusing their 'IT production' on strategically relevant, value-added IT activities.

■ *Consolidation:* For companies running several IT landscapes in their different divisions, outsourcing is often the only way to break through particular interests, enforce the consolidation of the IT landscape from an integrated point of view, and speed up necessary restructuring efforts. By setting ambitious cost-saving and service improvement targets, the IT outsourcer can be encouraged to follow a tough consolidation course, and will usually have the experience needed for a complete redesign of the IT landscape. In many cases the outsourcer will be prepared to make the necessary initial investments, in return for a fixed share in the savings obtained by the company (depending on the duration and terms of contract).

■ *Fixed-cost variabilization:* Once the IT landscape has been consolidated – usually after the so-called transfer phase – the IT outsourcer can jointly run several customers' IT. These economies of scale will enable the outsourcer to offer flexible pricing models and to charge for IT services based on the quantities delivered (pay-per-use) – for instance, per MIPS (Million Instructions Per Second, a measuring unit for processor capacity or storage space in a computing center), per workstation, or even per business transaction. This way, the previously fixed resource IT becomes a variable that can be adjusted to changes in the business activity.

■ *Improvements in reliability and innovation:* IT is highly complex and volatile. Companies are forced to continuously follow the latest technological trends, while maintaining a standardized environment that will guarantee high availability. This is only possible with high-level IT staff specialization – which, in turn, requires substantial critical mass. Benefiting from the specialization and innovativeness of an IT outsourcer is often the better alternative.

■ *Reduction of staff levels and achieving of cash effects:* Outsourcing, as a general rule, involves a transfer of IT assets (computing centers, all hardware licenses, possibly some software licenses) which means that previously fixed assets turn into current assets. For the company in question this can be a means to improve its short-term

cash position, as the IT outsourcer will purchase its IT assets at market prices – often based on their residual book value – so that the company will obtain corresponding sales revenue. The outsourcer, however, will need to earn back this purchase price in the course of the service contract in order to be profitable, and will therefore integrate it in the service prices to that customer. Consequently, it will not be advisable for most companies to maximize the sales price for their IT assets.

Initially, the value-creation potential of IT outsourcing will lead to increasing IT costs (figure 3.7): In many cases the reason is that companies, instead of systematically optimizing their IT, hope that IT outsourcing will 'automatically' lead to optimization effects. Winners will be those who have positioned their IT as a value driver, separated demand management from supply management in the context of IT governance and continually pursued optimization measures, such as standardizing PC workplaces or switching off outdated or redundant IT applications. Even in those cases, however, the transfer of IT to the outsourcer's business system will initially cost money. This temporary cost increase, typically for a period of one or two years, will affect both parties involved.
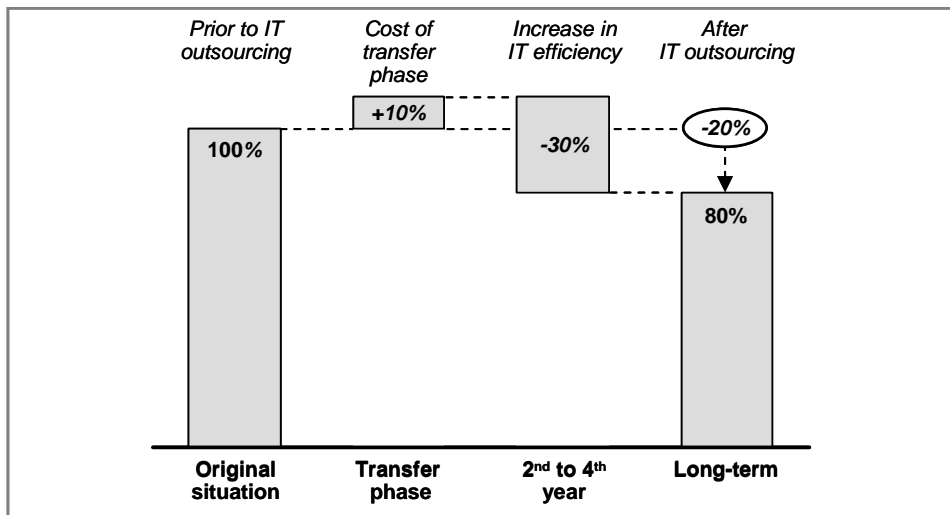

Figure 3.7:   Typical results curve of IT outsourcing; Source: A.T. Kearney

For the company, IT costs will temporarily increase due to the transfer of the previously in-house 'IT production' to the IT outsourcer, as well as the resulting need to set up a CIO function for demand management (unless it already exists) and to make any 'hidden' IT costs visible.

■ *Costs for setting up demand management:* The IT outsourcer will need a competent contact person in the client company to prepare IT-related decisions and carry them through. The company will need a person in charge of managing the IT provider.

Both requirements can be met by a CIO Office: In addition to managing and monitorring the IT provider, its task will be to manage the interface with the business departments and IT users, jointly identifying innovative IT topics that might contribute to the value increase of the company. Consequently, the CIO Office will bundle demand vis-à-vis the IT outsourcer, and strive to prevent any increases in IT costs as would result from uncoordinated IT requests.

- *Transfer costs:* The IT outsourcer receives the company's IT technology (hardware systems, communication networks, software systems, computing center locations, and others) and IT staff. In order to be able to achieve the targeted cost reductions and performance improvements, the IT outsourcer will integrate the IT technology and staff into its own business system (for example, by connecting the computing center to a central control station, or by ensuring better utilization of the IT staff, dedicating their spare capacities to projects for other customers). In many cases, the outsourcer will also obtain better purchase terms for PCs, notebooks, and printers, as well as software licenses. To be integrated into the business system, the IT usually needs to be 'rebuilt' and optimized – which requires IT investments. The extent of the integration into the outsourcer's business system will be ruled in the outsourcing contract. Likewise, the contract should stipulate who will bear the one-off costs for rebuilding the IT, and the possible severance payments for, and/or training of, the IT staff.

- *Making 'hidden' IT costs visible:* In the course of the transfer of IT technology and staff to the IT outsourcer, the actual extent of IT services rendered will become transparent for the first time: While the IT staff will continue to deliver extensive services to the divisions and other IT users at the company, these services will now be recorded and billed.

The costs of establishing a demand management function at the CIO Office, as well as transfer costs and the new visibility of the previously 'hidden' IT costs will add up to a temporary increase in IT costs by roughly 10 percent (possibly more in individual cases, depending on the expenditure for 'IT consolidation'). 'Temporary' here means one to two years at maximum. From the second year, a steady state of affairs should have been reached, including performance improvements and 30 percent cost savings – which, in absolute terms, will translate into a total improvement of 20 percent. It is due to the expenditure and time required to reach the targeted improvements, that such outsourcing contracts are usually laid out for several years. At present five- to seven-year contracts are common, with optional extensions – but also the possibility of a premature cancellation, if mutual expectations are not fulfilled.

It is up to the company to strive for value increases through IT outsourcing at any time – including options to insource certain parts of IT, or outsource additional processes. And even if the company opts for insourcing at some later point, this does not necessarily

mean that its original decision was wrong – rather, that either the corporate strategy, or the market, or the significance of IT to the company have changed.

To exploit the value increase potential targeted, companies should consider the entire life-cycle of an outsourcing effort from the beginning, so they can set the right course at any stage (table 3.1). From entering into an outsourcing partnership, to actively developing it, to the decision to outsource further activities or insource certain parts of IT, the company will need to resolve crucial issues at every life-cycle stage.

Table 3.1: Important issues in the outsourcing life-cycle

Life-cycle stage	Issues
Make-or-buy decision	Do we want to outsource IT? If yes: What are the IT services we want to outsource?
Entering into an outsourcing partnership	Which partner will be a good strategic and cultural match for our company, and can offer the best service, greatest flexibility, and lowest prices in the long run? How can we motivate the partner to continually support our goals? How can we motivate our divisions to cooperate and deal with IT in a cost-efficient manner? How can we manage the cooperation?
Active development of the partnership and renewed make-or-buy decision	How can we, as a company, stay in control? What will we do if service problems occur? What will we do if costs rise? What will we do if there is a lack of innovativeness? What are the incentives for renegotiating the partnership? Do we want to continue or expand outsourcing, change the IT provider, or insource?

There are plenty of good reasons for outsourcing. The decisive factor will be that ambitious expectations are fulfilled. Companies must be prepared to take massive consequences, including the transfer of staff, changed roles between IT and the business departments, as well as new leadership and control mechanisms. Not surprisingly, a study by Dun & Bradstreet in 2000 revealed that 20 to 25 of all outsourcing efforts fail within the first two years; after five years the failure rate exceeds 50 percent. Outsourcing, then, offers exciting opportunities but also involves high risks. Minimizing these risks while exploiting the opportunities – that is the art of IT outsourcing.

Defining the objectives of IT outsourcing and identifying suitable IT services

Many of the causes for the later failure of outsourcing partnerships can be prevented if the company is clear on its motives. It will make a great difference, for instance, whether the goal is simply cost-cutting, or achieving an optimal economic benefit for the company. If the company aims for IT cost reduction, a sensible measure may be to transfer the existing IT staff to other parts of the company and give them other tasks (or let them go) and to outsource only the IT task itself, expecting the outsourcer to cover it with own resources (for example, desk-top support). While resulting in the lowest annual fee for the IT outsourcer's services, this option will increase the costs to the company during the transfer phase, due to the retraining of or severance payments to the previous IT staff. In addition, the interface between the company and the outsourcer will be quite anonymous since the previous staff, which are familiar with the company's requirements and peculiarities, will not be available for the outsourcer's task.

When determining the objectives of an outsourcing partnership, it will be important to consider the company's strategic, economic, and personnel-related goals:

■ The *strategic goals* of the company are usually focused somewhere between cost reduction and performance improvement. They provide the basis for considering whether the IT staff should be transferred to the outsourcer, what part of IT should remain in the company (and why), and how the company's demand for IT services will be managed in the future. Another crucial factor is how IT outsourcing will affect the company's long-term strategic coals, such as focusing on core competences or external growth via mergers and acquisitions. These and many other questions must be clarified beforehand, even if they can partly be adjusted or detailed in the course of the outsourcing partnership.

■ *Economic goals* comprise both, the costs and quality of the IT services required. Necessary decisions include what service level will be required at what price, and what the scope will be for possible later price negotiations with the potential outsourcing partner. This includes the option to pay higher prices in the initial phase, which is more capital-intensive for the outsourcer, and to pay less in the later, steady-state phases – or vice versa, depending on the company's financial state (and opportunities for optimization through financial engineering). An important question in this context is how business units will be involved in the bidding process and the outsourcing contract negotiations, as well as the later fulfillment of the contract.

■ *Personnel-related goals* are particularly important if the company intends to transfer staff to the IT outsourcer. For many employees, outsourcing – when considered from a neutral perspective – will be an attractive opportunity since they will proceed from a company's marginal activity to the IT outsourcer's core business. In addition to at-

tractive career and compensation prospects, this will also involve higher-level performance standards. By contrast, what the IT staff really feels in most cases is that they are unwanted and therefore 'pushed out'. However, as the previous IT staff will be required to run the company's IT business from the outsourcer's organization, early and clear communication will be imperative to help people explore the opportunities involved in the outsourcing move – and, of course, to ensure that these opportunities really exist.

Along with the company's objectives, its current situation will have to be considered as well: It will make a lot of difference, for instance, whether the company has already taken measures for IT optimization, and exploited cost savings potentials in IT, or whether 'clearing out' is an essential motive for outsourcing.

A European company in the service sector had already outsourced large parts of its IT. When the question came up whether country organizations should do the same, analysis revealed that cost savings would only range between 15 and 20 percent – a disappointing figure in view of the fact that the majority of divisions delivered the same service products and business processes were largely identical. Based on harmonized business processes and standardized IT systems, cost savings through outsourcing could have reached an estimated 60 percent. In cases like this, it will be worth the effort first to explore efficiency potentials by clearing out the IT landscape, thus achieving 60 percent cost savings, and to reduce the remaining cost base by another 20 percent, benefiting from an outsourcer's economies of scale – in other words, to save 70 percent on IT costs and while achieving simultaneous IT performance improvements.

Tips for selecting IT services suitable for outsourcing:

- *Do not outsource 'problems':* While internal shortcomings such as insufficient IT performance or unsatisfactory service levels can be eliminated through outsourcing, the resulting cost savings will be close to zero. Rather, internal potentials should be exploited and the company should be prepared for the outsourcing effort before it is actually taken into consideration.

- *Do not outsource all IT services to one IT provider:* In accepting a company's IT, the outsourcer will strive for profitability and growth. Profitability is achievable through appropriate prices and a fast integration of the company's IT landscape into the outsourcer's business system. Growth potentials, however, mainly result from the chance to be award further parts of the company's IT. The outsourcer will reach both objectives through good performance and fair prices, leading to a high degree of customer satisfaction. Retaining some IT parts or distributing the services outsourced over several IT providers will constitute permanent incentives for the IT outsourcer's good conduct.

Not all of the IT services that could potentially be outsourced are really suitable for that. In addition to company specifics, mainly strategic and economic factors will have to be considered in evaluating the outsourcing potential.

Strategic IT services contributing to company's competitive differentiation had better be retained in-house. Examples include billing systems at telecom providers: The continuos change of products, processes, and tariffs calls for proprietary development, as these systems need to be tightly linked to the corporate strategy.

Another lesson learnt from practice is that, while outsourcers are usually capable of eliminating operational inefficiencies, they often have difficulties coping with the rapid change and strategic development of IT systems. Above all, strategic IT systems in industries with strong competitive or regulatory dynamics will require permanent, speedy development with a careful eye on the competition and/or regulation.

In less dynamic industries even strategic systems can be outsourced. Banks, for instance, are very dependent on their IT systems; nevertheless, the stability of the industry makes it possible to outsource even strategic IT, as external IT providers are likely to be able to develop these systems in a tightly managed process.

As for the question whether non-strategic IT systems and 'basic IT supply' services should be outsourced, the answer is a clear Yes. These are mostly commodities and therefore highly standardized, and their prices in the IT outsourcing market will be transparent. In general they include infrastructural services like computing centers, networks (LAN and WAN), personal computers (desktop and laptop) and back-office applications (such as SAP/ERP in financial accounting). Just like electricity or gas, such commodities are usually highly suitable for outsourcing.

In practice we will find the following design options for IT outsourcing – each of which will require a CIO function for managing both, internal demand and the external provider:

■ Outsourcing of the entire IT

■ Partial outsourcing
  – only of computing centers
  – only of application development
  – only of end-user computing (PCs, LANs, user help-desks)

■ Outsourcing of parts of IT tasks ('outtasking')

The greatest opportunities exist in complete outsourcing to only one IT provider. At the same time, this will require the strongest control: The transfer of all IT tasks will enable the outsourcer to optimize the company's entire IT landscape with regard to both, costs and benefits. However, this option also requires a maximum of control since, for the du-

ration of the contract, the company will be dependent on one monopoly supplier. In most cases it will therefore be preferable to opt for partial outsourcing (see box on page 183).

An economic factor of great significance for any decision on IT outsourcing is the pricing of IT tasks. Companies will need to objectively analyze their 'in-house production costs' in comparison to the IT outsourcer's prices. This comparison needs to be based on the 'total costs of ownership' – which, beyond the actual costs of the central IT department, also include the local IT costs in the divisions, the 'hidden' IT costs, the IT costs of local IT departments, and opportunity costs in the business departments (for example, for losses in HR capacity due to insufficient system availability, or for the manual reworking required due to missing interfaces between IT systems). Other factors to be considered include the capital tied up in the corporate IT, and the labor costs for internal IT specialists. Only if all relevant IT costs of the company are considered, taking into account the organizational allocation to divisions or departments, the result will be a 'true' cost comparison sustainable long-term.

Weighting the relevant strategic, economic, and company-specific factors against corporate goals will provide management with a sound basis for decision. The ultimate make-or-buy decision for IT tasks should always be made by top management, for IT outsourcing involves a long-term, structural linkage to an outsourcing partner who will make an important value-added contribution to the company's economic success – and who cannot easily be changed for another if the partnership runs into rough waters.

Outsourcing IT by selling an internal IT provider (disinvestment)

A large German group had established an internal IT provider to consolidate its in-house IT and place industry software and IT services on the external market. After a few successful years, the IT subsidiary started making losses and prices started getting out of control; in addition, the expected international expansion could not be achieved in parallel with the parent company. The group therefore decided to give up on the 'IT adventure' and refocus on its core competences.

The plan was to sell the internal IT provider to an international IT outsourcer who would be able to ensure the group's IT supply at lower costs. De facto, this would involve two contracts between the outsourcer and the group: one ruling the sale of the internal IT provider, and one ruling the group's outsourcing of IT services.

In this constellation of outsourcing and disinvestment, the outsourcing contract between the external IT provider and the group constituted an essential share of the IT subsidiary's corporate value: The higher the savings expected from the outsourcing contract, the lower the value at which the outsourcer would assess the subsidiary. The company thus had to find and negotiate an optimal balance between the selling price and the service costs, which turned out to be a particularly challenge.

This special situation was pointed out clearly in the bidding process, to be taken into explicit account by the bidders. The selection of the future IT outsourcing partner was based primarily on the usual key criteria which would influence the cooperation in the coming years (such as scope of services, references, international presence, market prices, cultural fit). Maximizing the selling price only ranked second, as the company was aware that it constituted a pleasant financial one-off effect that would not be sustainable; nevertheless it was an important topic in the negotiations.

At the end of the day, the IT subsidiary was sold to the IT outsourcer at an attractive price, while the prices set for the future IT services were considered appropriate by the company. All staff were transferred to the IT outsourcer, and the majority of them was still there after three years. Today, the relationship between the group and the IT outsourcer is stable, the contract is 'lived' in mutual respect, service levels are maintained. In addition, the group has achieved 15 percent in annual cost savings. An evaluation of the outsourcing strategy after three years has led the group to consider the outsourcing of further IT tasks.

Developing the outsourcing partnership

The foundation for a successful outsourcing partnership is laid by selecting a suitable IT outsourcer and actively developing the cooperation with that provider. In view of the strategic importance and duration of this contractual relationship (typically, five to seven years) there will obviously be changes in the course of time – either because the company's requirements to the outsourcer change or because technological or market developments on the outsourcer's part call for adjustments to the relationship. Such milestones, which are decisive for an active management of the partnership, need to be considered in the design of the partnership in order to prevent later conflicts and ensure that the economic potentials from outsourcing are fully exploited. To facilitate straightforward decisions the company should make sure that, in addition to top management, key executives are involved as well:

- IT managers and staff, because they are immediately affected

- Business departments / business units, because they are the outsourcer's future customers and will depend on its services

- Purchasing, legal department, and HR, because they will be involved in the selection of, and transactions with, the outsourcer

- PR, because they will need to be able to defend the 'logic' of outsourcing vis-à-vis external stakeholders, such as customers or suppliers.

An early involvement of representatives of these areas of responsibility will ensure that all corporate interests and perspectives on outsourcing are considered in the process. A

frequent mistake, for instance, is the late involvement of functions perceived to be 'only supporting', such as purchasing, legal, and HR: Companies often realize too late that essential legal requirements in the transfer of staff or important agreements with employee representatives have been 'overlooked'. Mistakes like these can cause the bidding process to be prolonged or even called off. Therefore, all the individuals listed above should get together at the very start of an outsourcing effort and jointly set up a permanent team to manage the bidding process.

Selecting a suitable outsourcing partner

The selection of a suitable IT outsourcing partner is a complex process for which companies need to make sufficient time (in simpler cases three to six months, for global outsourcing contracts even six to twelve months). After the objectives of outsourcing have been clarified, there will be a bidding process comprising several phases, in the course of which the long-list of potential outsourcers is gradually cut down to a short list, from which the company finally selects a favorite and an alternative candidate (figure 3.8).

Bid phase 1		Bid phase 2		
Request for Information	**Evaluation of first bidder contacts**	**Request for Proposal**	**Evaluation of bidders and bids**	**Transfer phase**
Define objectives of bidding process Develop communication plan Draw up long-list of IT providers Request confidentiality agreement, references, and confirmation of interest	Evaluate IT providers and references based on strategic fit Draw up short-list of qualified IT providers Send out RfP with detailed information on IT tasks	Receive detailed bids Make reference visits to bidders' customers Invite bidders to present bids Receive revised bids based on discussion during presentations	Evaluate detailed bids and reach agreement on preferred IT provider Negotiate Letter of Intent for service contract with future IT provider	Negotiate contracts with future IT provider Transfer IT tasks to future IT provider

Figure 3.8:   Bidding procedure for IT outsourcing

The first task for the outsourcing team will be to draw up a *reasonable long-list* of all IT outsourcers capable of delivering the services required. For instance, if a global company wishes to outsource its IT, the long-list should only comprise IT outsourcers which are also present on a global scale.

The market for outsourcers can roughly be structured into the following segments (names are only examples, lists are not exhaustive):

- Global providers with a broad presence and portfolio, such as Accenture, CapGemini Ernest & Young, CSC, EDS, HP, IBM, and others

- Predominantly European providers present in several EU states and with a comprehensive range of services, such as Atos Origin, Siemens SBS, T-Systems, and others

- Predominantly national providers including Datev, HVB Info, is:energy, ITERGO, its.on, Lufthansa Systems, RWE Systems, Triaton, and many others

- Local providers.

To identify the 'right' outsourcer, the first step of the bidding procedure will be to obtain information on services and prices from potentially interesting providers. For this purpose, a *first Request for Proposal* (RfP 1) is drawn up. It should be detailed enough to allow IT providers to write a qualified proposal. In comprehensive bids, the RfP 1 may well comprise several hundred pages. On the one hand, its clarity and quality will facilitate discussions in the company, helping to synchronize the different user interests; on the other hand, the document will signal to providers that the company is seriously interested, and allows them to draw up meaningful and robust first proposals.

Tips for bid phase 1:

- *Give prior notice of RfP:* It has been proven practice to call the management of the providers selected in the long-list, informing them about the intended dispatch of the RfP, and asking them to confirm their interest in writing to speed up the bidding process

- *Communicate frequently:* It will be advisable early on to point out the advantages of outsourcing to the relevant constituencies, such as the works council / union representatives, the board of directors or other boards and committees, and – last but not least – the employees concerned, in order to prevent rumor mill effects, calm down fears, and motivate staff for the changes to come.

The IT providers' replies to the RfP are then compared and evaluated. Based on this evaluation, the company will be able to make a realistic estimate as to whether its outsourcing objectives (IT services and costs, personnel transfer, and others) can be fulfilled; in addition, the number of bidders can be cut down to a short-list of interesting candidates.

The responses of the different outsourcers will permit first conclusions on their interest and commitment: Bids submitted with substantial delay or in poor quality (for instance, containing a standard proposal rather than addressing the company's specific concerns) should lead to the immediate exclusion of the bidder.

In bid phase 2 the company will intensify its contacts with providers on the short-list. A *second Request for Proposal (RfP 2)* is drawn up, informing bidders in detail on the IT services required. In addition, selected providers are invited to present and discuss

their bids, permitting the company to obtain a detailed picture of the respective outsourcing concept (in particular with regard to staff transfer), outsourcing services and costs, and other terms of the proposed cooperation.

The company will want (and have) to 'live' with its IT outsourcing partner for many years. It is therefore imperative to establish through thorough discussions whether potential partners will really be a good match for the company in the long run. This also includes 'soft factors' like management philosophy, employee conduct, communication style, and many others which could turn out to be serious obstacles to the cooperation.

Reference visits to customers of the IT provider will help to round off the 'familiarization phase'. Many things can be made to appear in a positive light in the context of a proposal; companies should therefore take the opportunity to pay visits to existing customers of the IT outsourcer's – both, visits arranged by the outsourcer itself and visits arranged directly with the respective customer (and without prior notice to the provider). Following discussion with the company, IT outsourcing providers will further detail their proposals, possibly revising the services and prices offered.

The detailed and revised proposals are finally evaluated in the second round. At this point in time, the company's specific concerns have been clarified in several discussions and presentations with the remaining bidders, so that the services and costs specified in the updated bids will be clear and comparable. While in this phase economic criteria will usually be given highest priority, the company should make sure to take proper account of its strategic requirements as well, to ensure that the future outsourcing partnership will provide optimal and long-term support. If, for instance, an expansion to China is intended in the near future, the IT outsourcer should be present there or, at least, be able to present a conclusive concept.

On this basis, the company will select a preferred IT provider from the remaining candidates. Both parties then sign a *Letter of Intent (LoI)*, thus initiating a limited Due Diligence and negotiation phase.

Tips for the internal evaluation of final proposals:

■ *Evaluate in several dimensions:* The final evaluation of outsourcing proposals should always be carried out by the entire team in charge of the bid procedure. In particular HR, the legal department, and purchasing should play a major role.

■ *Ensure neutrality of IT staff:* In the majority of cases, the company's current IT staff will be transferred to the IT outsourcer. In the course of the process there will be increasingly frequent contacts between IT staff and the provider, and it is only natural that IT people will think about which of the providers they would prefer to be their future employer. In order to keep control over the different options, management should make sure that IT staff remain neutral.

Since it will be in the company's interest to keep control of the negotiation progress, the results of each negotiation round should be recorded in-house. Likewise, the company should insist on drawing up the outsourcing contract and scheduling the negotiation dates, and refuse to give up the helm at any time.

At the end of the second bid phase the company will have selected its preferred IT provider. However, as long as a contract has not been concluded it will be advisable to keep the second-priority candidate 'on the back-burner' – and to let the preferred candidate know about it. This will strengthen the company's negotiation position, and offer a realistic alternative in the event that, contrary to expectations, negotiations with the preferred supplier fail

Using the outsourcing contract to constitute a long-term partnership

In the course of the contract negotiations, the course will be set for either a long-term partnership or a dead end. There is a series of typical causes for later failure, all due to contracts negotiated insufficiently:

- *Tasks have not been defined clearly enough:* Often, the company's targets and respective service levels are not clearly defined at the beginning of the partnership. As a result, the services rendered by the IT provider either do not meet the company's needs or are not duly acknowledged by the company. To provide a sound basis for resolving such conflicts, the contract should stipulate in detail the reporting procedures for services rendered.

- *The outsourcing partnership is too rigid:* Companies change; outsourcing partnerships must be adjustable. For instance, the number of IT systems and desktop workstations may increase due to mergers and acquisitions, or decrease due to restructuring. In these cases, corporate reality will soon no longer match the outsourcing contract. Even if the company 'only' grows organically, consequences for the planning data must be clarified in the course of negotiations, or discussed early in the cooperation, in order to be taken account of in the design and development of the outsourcing partnership.

- *Prices are considered too high by payers:* In large groups, outsourcing contracts are often concluded centrally, while the costs incurred by the respective services are allocated to the divisions and must be borne by them (or gained through their economic performance). Not surprisingly, costs are often closely monitored in these cases. Allocation ratios which have not been made sufficiently clear, or prices that were originally considered appropriate but have not been adjusted to recent economic trends (such as overcapacities and resulting price drops) will then be a constant source of annoyance. To avoid such nuisances, prices can either be tied to economic indexes, or regularly (every one or two years) benchmarked by external experts.

A European service company facing illiquidity sold a number of assets, including several IT subsidiaries. The acquirer was chosen based on its price offer, which by far exceeded the usual level. While this helped the company temporarily to overcome its cash short-age, the IT provider was forced to earn back the purchase price, and consequently set the prices for its IT services – to be paid by the divisions – well above market level. From the very start, the outsourcing relationships suffered from the fact that all advantages from the high selling price remained at headquarters, while the divisions, which were engaged in fierce brand competition, had to pay excessive IT prices. Since they were also the ones to deal with the IT outsourcer in day-to-day business, the relationship was programmed for permanent conflict – which soon led to the renegotiation of the out-sourcing contract, as this was the only way to 'rescue' the partnership.

In order to place the outsourcing partnership on a sound basis from the beginning, the company and its IT provider need to agree on a series of details in negotiating both, the master agreement and the individual Service Level Agreements (SLAs).
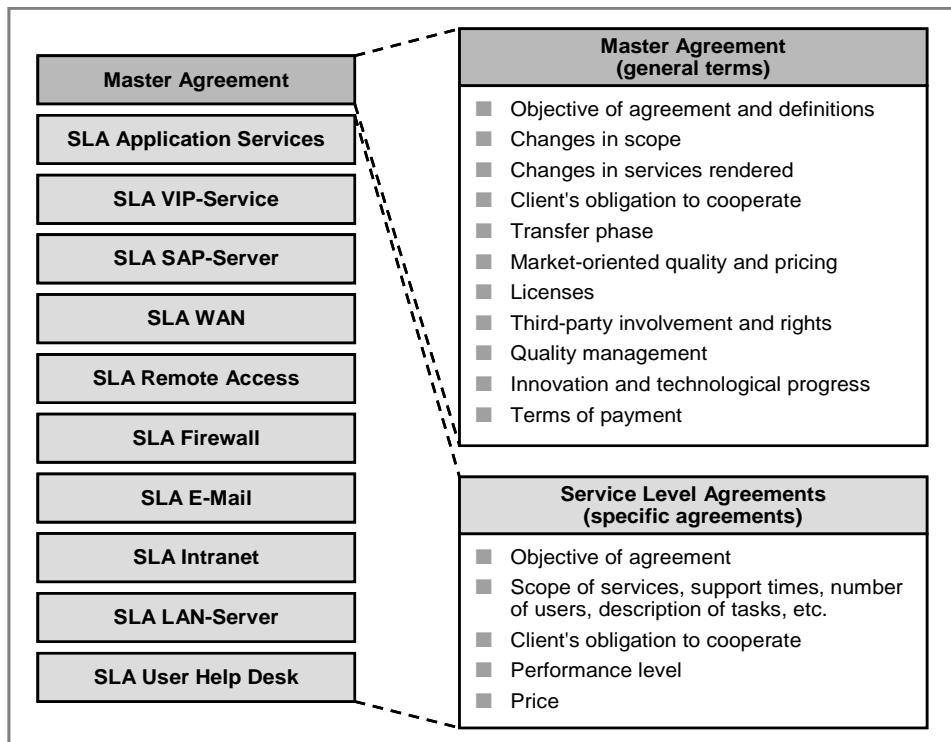

Figure 3.9:   Master Agreement and SLAs; Source: A.T. Kearney

The Master Agreement will contain all general stipulations regarding the duration and scope of the contract, price conditions, rights of cancellation, property rights, and others (figure 3.9). Further stipulations will concern compliance monitoring and the continual adjustment of the contract to possible changes in requirements – for instance, how to deal with changes in the types of services rendered, and how they will affect prices. In addition – similar to the spin-off of an internal IT provider – arrangements must be made for a six- to nine-month transitional phase during which all IT tasks are transferred from the status quo to the future operations model. Last but not least, the company should ensure that the IT provider will treat all information obtained confidentially, strictly adhering to data protection laws and industry-specific regulations.

If the company decides to outsource its entire IT, the congruence of interests should be safeguarded by corresponding incentives incorporated in the payment model, as well as cancellation clauses in the contract. In one case, the outsourcer's compensation was not based on service prices stipulated in the SLAs but simply on the changes in certain items on the client company's balance sheet, which were highly influenceable through IT. This constituted a clear incentive for the outsourcer to contribute to balance sheet improvements and align all IT optimization and upgrading efforts to this single goal. Such incentive and compensation systems are possible; however, they require mathematic precision to be set up prior to the signing of the contract: Both, the client company and the IT outsourcer will be required to understand the cause-and-effect relationships between IT systems, business processes, and balance sheet figures, and to agree on a corresponding calculation formula – which also needs to cover the simulation of possible scenarios in the company's development (such as market share gains or losses) as well as possible effects on IT and balance sheet figure.

Even during contract negotiation, the company should also think about the time after its expiration. To maintain flexibility, arrangements should be made with regard to a possible insourcing of IT, or outsourcing to another IT provider, covering aspects like the obligation to cooperate, periods to be observed, and the coverage of costs. For if the company really decides not to renew the contract, this will usually be preceded by a period of conflict between both parties, resulting in a very unfavorable basis for further discussion if no arrangements have been made beforehand.

While the Master Agreement will contain the general terms valid for all SLAs, the latter will rule the details on individual services to be delivered, such as scope and availability, unit prices, obligations of the client to cooperate in the provision of services, and others. In negotiating the SLAs, the company should be sure to define its requirements very clearly so that the outsourcer's services can objectively be measured against them. In particular, this will include the definition of parameters, times, and responsibilities for measuring, as well as of a mathematic formula to point out the correlation with bonus/ malus components of the IT provider's compensation.

Table 3.2: Typical measuring parameters for the service level stipulated in an SLA

Requirements of the company	Measuring parameters for service level
Services must be available (hardware must be functional; software must be usable, etc.)	Average availability (may be between 95 and 99.9 percent, with clear price discounts for every percentage point)
The IT provider should deal with emerging questions according to priority, and within an acceptable period of time	Response rate (generally, 80 to 90 percent of replies should be received within a given time frame)
The IT provider should solve emerging problems according to priority, and within an acceptable period of time	Problem-solving rate (generally, 70 to 80 percent of problems should be solved within a given time frame)
System performance (speed) should be acceptable	System response times (generally, 80 to 90 percent of responses should be given within less than a second)

At first glance, drawing up detailed service level agreements may seem like avoidable extra work. Nevertheless they are highly recommendable, for without them there will be ambiguities with regard to services and prices which, in the course of outsourcing relationships, have often been the cause of complaints on both sides.

Actively managing the outsourcing partnership

An active management of the outsourcing partnership – including how changes are dealt with – is the most important and difficult tasks in the outsourcing process. There is a risk of immense losses if the partnership fails, while both the company and its IT provider can benefit from a harmonious and productive cooperation.

Both partners should be aware that an IT outsourcing partnership designed to last several years will hardly ever remain unchanged for the duration of the contract. Time and again there will be modifications – mostly initiated by the client company, but sometimes also from the provider. The company, for instance, might wish to include new requirements to locations, services, or other factors, or 'readjust' individual SLAs, typically including details such as user help-desk service times. On the IT provider's part, innovation leaps in IT might trigger a rapid upgrading of the IT infrastructure or application landscape which, subject to agreement, can be passed on to the company in the form of effectiveness and efficiency increases (examples: Computing on Demand/Grid Computing). A new topic for both parties is the transfer of labor-intensive tasks to low-cost countries in Eastern Europe or to India. Due to the resulting structural changes in the IT outsourcer's

performance, companies and provides should evaluate the risks and opportunities of off-shoring jointly.

Whatever the cause of changes in the outsourcing partnership, the fact of the matter is that they are likely to happen. The challenge lies in recognizing them early on and managing them in a professional manner. Throughout the lifetime of an outsourcing partnership there will be early signals of an emerging need for change. In most cases, alarming signals will prevail and should be taken very seriously. Typically, everything will start with users in the divisions complaining about the IT provider's staff, which they perceive to be lacking in customer friendliness, too expensive, and too slow in their response times. Subsequent discussions with the IT provider will reveal that there are also causes for complaint, for example because the client company's requirements are not specified clearly enough, communicated too late, and targets are in part unrealistic.

According to analyses of failed outsourcing partnerships, the failure is hardly ever the fault of one partner only; rather, complaints on both sides tend to add up to a severe lack of mutual understanding, finally culminating in a total communication breakdown. Both partners are dissatisfied with how the outsourcing partnership has turned out, or fail to reach their individual objectives. Since contractual sums are usually substantial – in comprehensive outsourcing situations, several hundred million or even several billion Euros are not uncommon – these disagreements often end up in court. This, however, represents a worst-case scenario, for an outsourcing partnership is not that easy to dissolve.

It has been a proven practice to take precautions right at the beginning of the partnership ensuring that necessary changes will not cause the partnership to fail. An important prerequisite is continuous communication between the company's IT organization and the IT provider. It is institutionalized at three levels:

- At the highest level, members of a *Review Board* – representatives of top management and the corporate CIO as well as of the IT provider's management board and key account management – meet once or twice per year to determine the long-term strategic direction of the cooperation – such as, what areas will need new IT systems or how technology leaps can be used to the mutual benefit of both partners

- The *Steering Board* – comprising the corporate CIO and representatives of business departments/divisions, as well as key account managers and industry/functional specialists from the IT provider – meet three or four times a year to take important single-case decisions on new developments in the context of the strategic overall plan, or major changes in SLAs (services and prices).

- At the operating level, a *Service Management Board* – consisting of corporate CIO and one person specializing in the management of the outsourcing contract, as well as key account managers and service specialists from the IT provider – meet once a

month to decide on details of the cooperation, as well as smaller adjustments to SLAs, and to generate current reports on the cooperation.

On the company's part, important change requests will usually refer to the IT services agreed upon – which the company will want to expand or reduce – or the prices of existing services. While changes in the services outsourced are usually uncritical, demands for price changes often lead to disagreements, possibly even to the premature termination of the partnership. It has therefore proven useful in practice to define a set of mechanisms which will prevent the company's expectations and the IT provider's services and prices from drifting apart.

Quality monitoring carried out at regular intervals will help to measure service quality and customer satisfaction in day-to-day cooperation. In addition to quality analyses and customer surveys, some IT providers have begun to establish online quality data bases where appointed representatives of the company (such as the CIO and major users in the divisions) are free to give current evaluations of the IT provider's services at any time they please, for instance by entering them in a 'traffic light' system with additional room for feedback. Such procedures are very useful to quickly recognize, diagnose, and eliminate emerging problems. At the same time they improve the IT provider's negotiation position when it comes to bidding for further outsourcing services, since the – hopefully high – service quality it has been delivering can now be measured objectively.

An institutionalized *improvement program* helps to continually adapt the partnership to both parties' changing requirements throughout its lifetime (figure 3.10). This is necessary because it will only be after the transfer of IT staff to the IT provider, and the subsequent implementation of the partnership, that the company starts gaining concrete experiences with what the SALs actually mean in day-to-day business. This is often the point where the user helpdesks's contractual service and/or response times turn out to be insufficient, or prices for the services rendered are perceived as being too high compared to the situation pre-outsourcing.

When closing the contract with its IT provider, a manufacturing company had agreed to user help-desk service hours from 6 a.m. to 8 p.m. The IT provider had established two service shifts which were billed to the client company. When this service level was evaluated in the context of a continuous improvement program, it turned out that far more than 90 percent of staff were present between 9 a.m. and 5 p.m., so that one shift at the user help-desk would be sufficient. By adjusting this service level to actual demand, the company was able to achieve substantial cost savings without any noticeable negative consequences for users.

Like the changes in services, demands for price changes are usually foreseeable: Customers are entitled to expect prices to decrease in the course of an outsourcing partnership, as the outsourcer will also keep optimizing its internal prices. Additional factors giving

cause for price adjustments will include changes in the market. During the e-business/IT hype in the late 1990ies, for example, prices for IT services were very high due to a lack of qualified specialists. These times have changed since the stock market crashed. If a company has concluded one or several outsourcing contracts during the high-price phase, it stands to reason that it will be able to obtain much better financial terms by adjusting or renegotiating them.
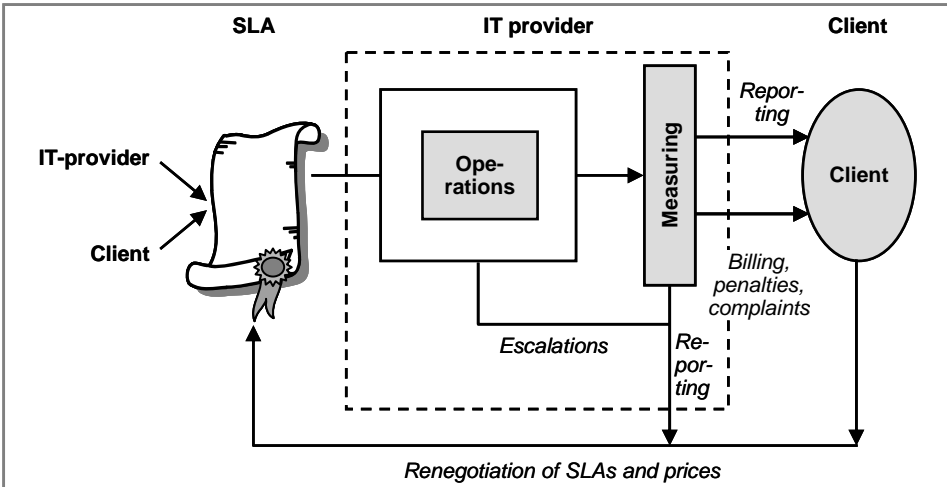

Figure 3.10: Continuous improvement program

Another important mechanism is the *systematic cost management* of IT operations, in the context of which both parties should – ideally jointly – continue evaluating and actively managing the ratio of IT performance and prices. This implies, however, that a regular evaluation and adjustment of IT services and prices, based on transparent costs, has been included in the outsourcing contract. In practice, a systematic cost management will rarely have been agreed upon at the very beginning of a partnership; therefore the company should at least attempt to introduce annual performance and price benchmarking after one or two years, in order to obtain an objective and broad basis for negotiating any adjustments that may become necessary at a later point.

For other sourcing categories, purchasing would simply set up a bid procedure and use the results as a basis for negotiation. For IT outsourcing this is not feasible: First of all, the very subject matter is so complex that it would take too much time and effort to issue a new bid invitation. In addition, all other IT providers would be aware that the company has been having contractual ties with one outsourcer for several years. And in view of the fact that it takes plenty of time and resources to seriously deal with an outsourcing request, requests clearly meant to serve as a benchmarking tool would promptly be sorted out. It is therefore preferable to use a benchmarking firm to be selected jointly by

the company and the IT provider, commissioning it to conduct a comparison of market prices at least for key services. If market prices are within a predefined corridor (such as +/- 5 percent) adjustments will be made automatically. If price benchmarks are outside the agreed corridor, the *Steering Board* will have to find a solution, which in many cases will be renegotiation. If the outsourcing contract covers a very large scope of services, it may be advisable also to reevaluate the company's IT demand, providing management with a clear view on the IT outsourcing partnership and its goals.

Price negotiations – whether they refer to adjustments within a given contract or complete renegotiations – need to be prepared thoroughly. Just like the initial bid invitation and conclusion of the outsourcing contract, they require a negotiation team consisting of the corporate CIO, representatives of IT controlling, the legal and purchasing departments, and IT users. It goes without saying that the IT provider will be less interested in renegotiating than the company, in particular since the client company is bound to the contract and, for its duration, will hardly have a legal handle to enforce any changes (temporary monopoly). Canceling the contract, on the other hand, will be very difficult due to the complexity of IT, the negative effects on business resulting from temporary non-availability of the IT services outsourced, and the – often very drastic – contractual penalties.

The IT provider's willingness to adjust prices will depend on the answers to a series of questions, which the company can influence in part:

- *What is the balance of power in the outsourcing partnership?* If it is a large-scale outsourcing contract with a leading company, the IT provider will hardly be in a position to risk losing the contract. Rather, the provider will be interested in a solution avoiding negative publicity, in particular as it is likely to be in negotiations for further contracts in the same industry.

- *What are the incentives?* The company's negotiation position will be best if it has not entirely outsourced its IT. Additional potential for the IT provider will be a powerful incentive for demonstrating flexibility

- *How great is the price difference compared to market prices?* The provider will, of course, be aware of the margins obtained with the client company. More than 10 percent above market price are not feasible in the long run.

A company and an IT provider had concluded a 10-year outsourcing contract amounting to nearly two million Euros. When prices where compared for selected services it turned out that they were clearly above market level, leading the company to assume that this was also true for the remaining services. A detailed benchmarking was conducted, revealing substantial opportunities for cost reduction in the computing center as well as in end-user computing (desktops and software, LAN/WAN, user help-desk). Renegotiating the existing contract enabled the company to reduce its annual costs by 20 percent; in

addition, contractual penalties for purchase quantities below agreed levels (the company's demand was declining) were 'negotiated out'.

In some cases, the need to renegotiate and modify the outsourcing contract will be recognized not only by the company but also by the IT provider. Under some contracts, for instance, the IT provider is responsible for managing and developing the IT while the company retains the right to choose the software or select a hardware supplier. Stipulations like these limit the outsourcer's possibilities to bundle quantities and negotiate better prices with suppliers. If IT infrastructure technologies are concerned, they can also make it difficult, if not impossible; to integrate the company's IT into the outsourcer's business system. To give an example: The IT outsourcer might want to connect the company's computing center to a central control station to ensure cost efficient operations at night, on weekends, and on holidays. This will, however, be impossible if the company insists on using incompatible software. In such a case the outsourcer will be justified in demanding modifications to the contract, to be able to better achieve the efficiency targets specified for the partnership.

Even if a company has originally had good reasons to opt for outsourcing, this does not necessarily mean they will remain valid forever. Therefore, the make-or-buy decision should be revised periodically in the context of strategic planning. Changes in the market, a realignment of the company, new IT developments, or changes in the IT provider's operations can be a cause for either expanding or reducing the scope of the outsourcing relationship. In any case, the company should decide no later than twelve months prior to expiration, whether to renew the contract or look for another outsourcing partner. A new bid invitation will take at least six months, and so will usually the transfer to a new outsourcer and/or the (partial) insourcing of IT.

Checklist: Is your company ready for outsourcing?

Yes

■ Have the objectives of outsourcing been clearly defined? ❑

■ Is the company prepared to go through the necessary change process – including both, the IT staff to be transferred and the IT users who will have to deal with new contacts? ❑

■ Has the 'right' outsourcing partner been selected – taking into account both, economic and long-term strategic and cultural aspects? ❑

■ Have contractual conditions been clearly agreed on between both parties, taking into account possible future changes in the company? ❑

■ Have possible scenarios for 'the time after' been discussed, prior to the conclusion of the contract, and corresponding stipulations been included? ❑

Using factor cost advantages by IT offshoring

When, in view of the Y2K threat, Indian software firms started taking over programming tasks at low prices, a new market had emerged: IT offshoring. Meanwhile, a series of other countries have positioned themselves as offshoring suppliers – from China, Malaysia and the Philippines, Australia and New Zealand, to Russia, Mexico and Brazil, Canada, Ireland, and finally Eastern European countries like the Czech Republic and Hungary. The outsourcing of IT services to geographically distant regions is now considered a growth market with exciting future potential (figure 3.11).
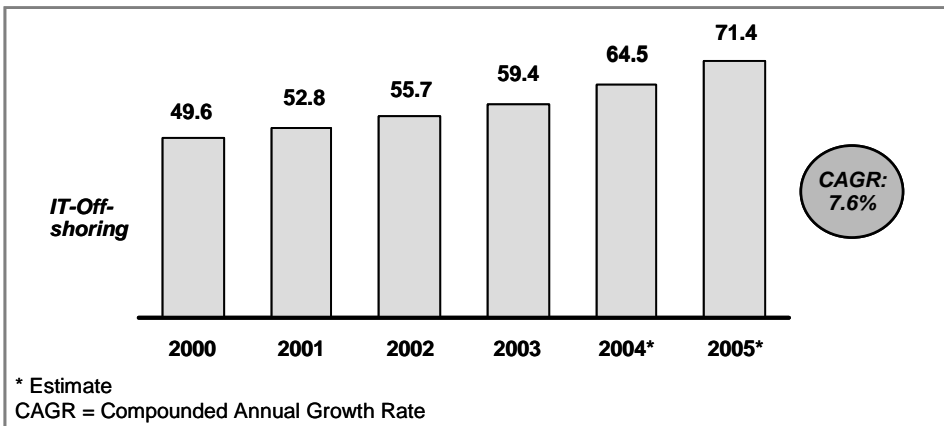

Figure 3.11: Growth of the IT offshoring market; Source: A.T. Kearney

At first glance, IT offshoring does not seem very different from IT outsourcing. Consequently, recommendations will be similar with regard to the selecting and maintaining of provider relationships. There are, however, essential differences in the services suitable for IT offshoring, and the cost advantages to be obtained. At the same time, IT offshoring requires different risks to be evaluated than would apply for most globalized IT outsourcers. Companies looking into IT offshoring should start by identifying the services which, according to their IT strategy, are suitable for offshoring – then choose an IT offshoring model, and lay out the life-cylce of the offshoring relationship as they would in the case of IT outsourcing.

Developing a corporate IT offshoring strategy

IT offshoring is interesting for both, client companies and IT providers. Companies relying on the strategic sourcing of IT will be able to exploit factor cost advantages and/or reduce the degree of vertical integration. IT providers can use IT offshoring as a means

to reduce IT costs and improve competitiveness. Offshoring, then, adds to the selection process in the context of companies' sourcing decisions; at the same time, it plays a vital role in the decision for a certain IT provider: Providers using offshoring to reduce their own costs will be able to pass on the resulting cost advantages to their customers.
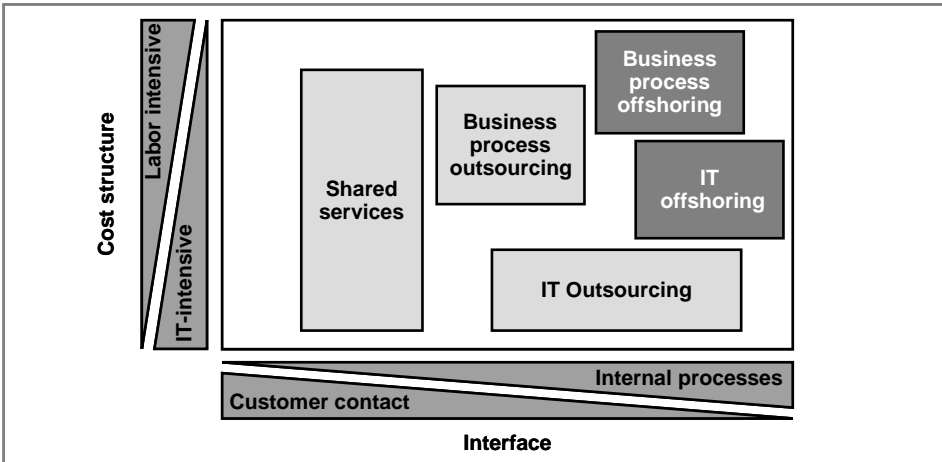

Figure 3.12: Optimization strategies for business processes; Source: A.T. Kearney

IT offshoring fills a gap in the previous approaches for business process optimization (figure 3.12):

- *Shared services* – The internal bundling of business processes – are used primarily for labor-intensive processes with customer contacts (for example, call centers). Companies can achieve substantial cost advantages through the shared use of certain tasks; however, since these processes can comprise critical internal know-how in some industries, the pros and cons of outsourcing them must be carefully evaluated with regard to the risk of a know-how loss.

- *Business process outsourcing* – Subcontracting business processes to an external provider in one's home market – is possible for internal processes, including those with customer contact (such as call centers and user help-desks).

- *Business process offshoring* – Transferring business processes to lower-cost locations – is suitable in particular for labor-intensive internal processes which are highly standardized and not very critical in terms of corporate know-how (such as HR administration, accounting, transportation). Cost reductions will mainly result from factor-cost advantages.

- *IT outsourcing* – Transferring (predominantly) IT infrastructural services to external providers in one's home market – is suitable primarily for standardized processes,

such as the operation of computing centers or communication networks, with cost advantages resulting primarily from the IT processes

- *IT offshoring* – Transferring labor-intensive IT services to lower-cost locations – has established itself for standardized, clearly definable processes requiring limited coordination but a substantial degree of project work (such as software development and maintenance, as well as user help-desks). Topics less suitable for IT offshoring include those requiring proximity to the market or customer, such as CRM applications or customer portals providing access to corporate information and processes, as well as IT consulting, developing professional concepts, and training. Cost advantages will result, above all, from lower labor costs at offshore locations.

The 'new' concept meets with lively interest in the U.S. and Europe, particularly in industries with a substantial share of highly standardized, labor-intensive processes with limited strategic relevance to the respective company (such as banks and insurances). An A.T. Kearney survey of 120 financial service providers in the U.S. and Europe in 2003 revealed that so far, companies' experiences with offshoring (mainly IT offshoring, only in some cases also business process offshoring) have been positive: Almost every second company has achieved over 30 percent savings, 17 percent of companies even more than 50 percent. Among other things, this also reflects the high degree of professionalism which offshore suppliers have managed to built in the past years – although at different degrees of maturity. While business process offshoring is currently still in its infancy, IT offshoring has already reached a medium to high level of maturity:

- The initial service offerings have reached an advanced stage of maturity. They include (Y2K) debugging, the development and maintenance of mainframe systems, migration and upgrading of application systems, release changes as well as code conversion.

- A lesser degree of maturity applies for IT services in the context of the introduction and modification of standard software (such as ERP systems) as well as upgrades programmed in-house.

- The new development of application systems has reached a medium stage of maturity

- Offerings on EAI (Enterprise Application Integration) or business intelligence (such as data warehousing) are still at an early stage of development

- Service offerings like help-desk, call centers, business process outsourcing are at the beginning of their market development. They are, however, gaining importance for offshoring, and some offshore suppliers have already gained experience with these services.

Companies opting for offshoring their IT services should take account of these conditions, and compare them to their strategic goals to arrive at a sound offshoring strategy.

IT services that could be essential to competitive differentiation in the medium or long term should definitely be excluded. By contrast, the offshoring of standardized IT services can help free up substantial financial and personnel resources for value-added IT projects.

Even more than IT outsourcing, IT offshoring strategies need to take account of the company's current situation: Companies which still have deficits in IT optimization should eliminate them before thinking about outsourcing to offshore IT providers. Likewise, transparency on the IT costs and tasks – company-wide – will be an essential prerequisite for evaluating the risks and opportunities involved.

Uncoordinated IT offshoring projects in individual division involve a major risk, in that the value gained through IT offshoring

Tips for selecting services suitable for offshoring:

- *Develop migration strategy:* Make sure that local IT staff are involved early in your offshoring plans, and prepare them for deployment at offshore providers

- *Optimize first, then go offshore:* Consolidate your IT processes in shared-service organizations or internal IT providers before outsourcing them to an offshore IT supplier

- *Go for early wins:* Begin by selecting IT services for offshoring, which can reach a steady state in less than six months. Make sure you select closed processes only.

could be destroyed by enormous migration costs. When the offshoring potential is evaluated from an integrated point of view, it will be advisable to involve all stakeholders on both, the IT and the users' part, in order to make transparent the benefits of IT offshoring for the company and eliminate fears and uncertainty in the IT staff.

Systematic development of an offshoring strategy for a U.S. based group

In a U.S. based group, several divisions had initiated offshoring to test out the possibilities it offered. These individual efforts were now to be integrated in a corporate offshoring strategy, in order to limit the number of offshore suppliers and reduce the amount of time and effort required for all those individual decisions.

A key factor for success of the offshoring effort was its systematic preparation: First, the objectives of offshoring and the restrictions following from the corporate strategy were determined, and the future requirements to IT derived. On this basis, suitable topics for offshoring were identified organization-wide, and a value proposition developed. Totals costs were determined for each application system and IT service, compared to the costs at different offshore locations, and prioritized. As a result, the user help-desk and the development of individual application systems emerged as priority themes. Next, suitable locations and offshore suppliers were selected. For

the help-desk, Canada turned out to be a slightly better location than India; in the field of application development it was vice versa.

Once this was established, a corporate offshoring strategy was developed, including the requirements to the offshore suppliers (type of suppliers, global, company-wide contracts and service levels). This strategy was broken down to division level, and the detailed offshoring issues and time frames for implementation were agreed on with the departments concerned. A key element for success was the integrated implementation plan, based on agreed sub-plans per division, which was carried out successively.

Evaluating risks and opportunities of a location

Whether companies will be able to fulfill their cost and benefit expectations, and whether they will build a successful and long-standing cooperation with their IT provider, largely depends on their selection from the numerous offshoring locations available. The systematic selection of a suitable IT offshoring location should be based on three key criteria: resources, location factors, and the offshore country's cost position. A.T. Kearney has evaluated key outsourcing countries against these three criteria, based on our project experience, market surveys, and expert interviews (figure 3.13). This evaluation confirmed India's dominant role: The country received best values in both, costs and HR resources.
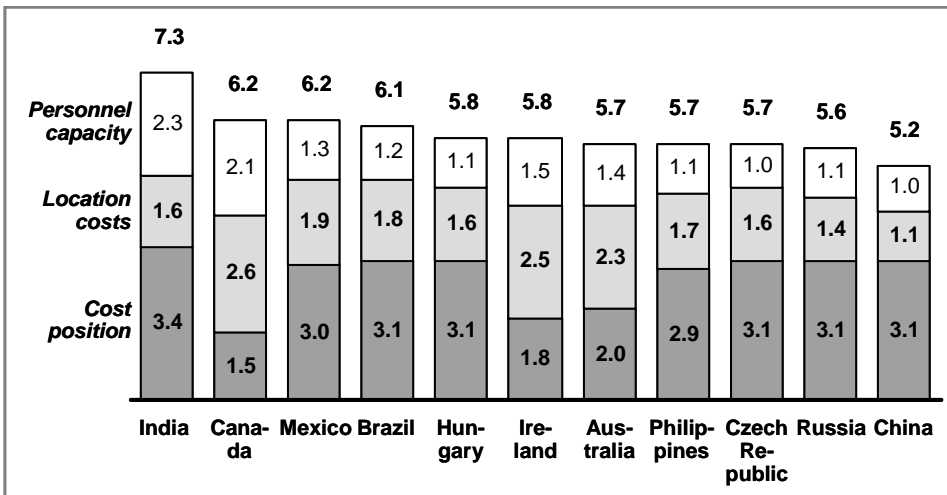

Figure 3.13: Evaluation of offshore locations; Source: A.T. Kearney

An essential criterion for the success of an IT offshoring initiative, frequently emphasized by companies, is the availability of qualified local personnel. Many companies fos-

ter staff rotation between onshore and offshore, which is not easy to do on a large scale with IT providers in faraway countries. Time changes are another factor that makes the management of the IT partnership highly challenging. In view of twelve hours' difference between India and the U.S., and six hours between Europe and the Philippines, office times in the regionally dispersed project teams will have only minor overlaps. Moreover, complex matters and business processes will be harder to communicate long-distance, in particular if the business environment in the countries concerned is very different from one's own. Last but not least, the protection of intellectual property, such as program codes, and the observance of licensing laws must be ascertained – for instance, through respective regulatory measures in the suppliers' countries.

Cultural differences are another crucial factor for the offshore provider's ability to fulfill the customer's requirements: If two people speak to each other in English this does not necessarily mean they understand one another. German companies accustomed to working with qualified IT experts have often experienced that their specifications, which are in part highly complex, are perceived to be imprecise by the IT offshore supplier, and fail to be fulfilled in a satisfactory manner. In an IT offshoring partnership there is no sense in expecting that the provider will understand the context of one's request and align its execution with the user's goals, possibly even make own suggestions for its execution. U.S. based companies, used to issuing clearly structured and precise instructions without any 'irritating' contextual comments frequently get better results.

It is mainly due to culture and language factors that companies in the U.S. and central Europe differ in their choice of IT offshoring locations: In the U.S., 90 percent of all companies prefer India (figure 3.14), with China at Philippines following at some distance (20 percent each).

Quite different were the results of an A.T. Kearney survey among companies in German-speaking countries: Only 50 percent quoted India as their preferred location. Again, the reasons are obvious: Even in the globalization age, language barriers vis-à-vis India is still higher for a German company than they are for a U.S. company. And while it is true that there are also language barriers vis-à-vis Eastern European countries, they are much 'closer' to Germany not only geographically, but also politically and culturally – in particular after the European Union's recent expansion to the East. In addition, the higher degree of vertical integration in German companies is also reflected in a higher share of in-house IT. It comes as no surprise, then, that IT offshoring has long been popular in the U.S., whereas in Europe (with the exception of the U.K.) it is still in its beginnings.

All of the countries listed have made considerable efforts over the past years to build a stable infrastructure and extensive data networks, and they offer highly qualified, English-speaking It specialists. Their long-term success in the offshoring market, however, depends not only on economic factors but also on political trends and global influences.
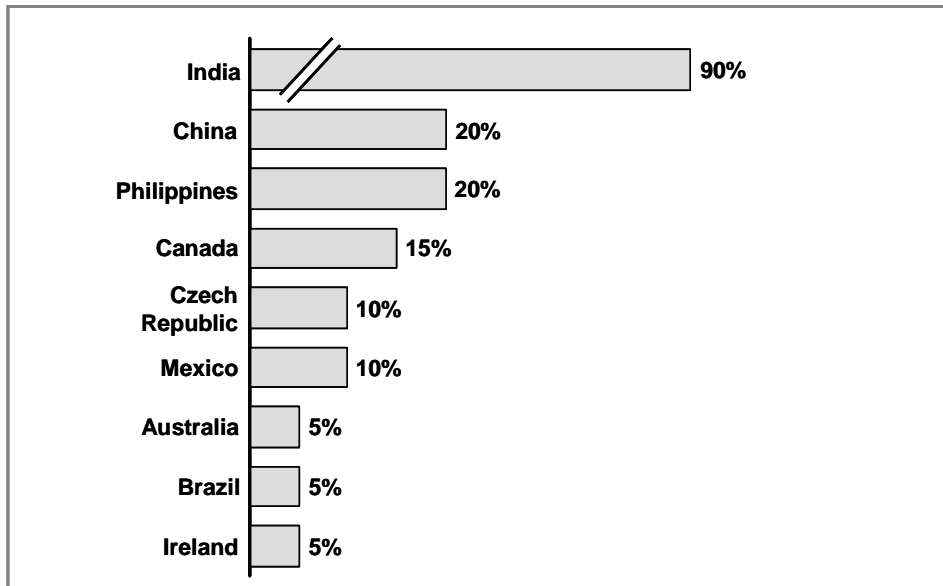
India 90%
China 20%
Philippines 20%
Canada 15%
Czech Republic 10%
Mexico 10%
Australia 5%
Brazil 5%
Ireland 5%

Figure 3.14: Offshore locations preferred by U.S. companies; Source: A.T. Kearney

Above all, these include terrorism and military conflicts: They can prevent companies from transferring their business processes to the regions concerned, such as the Middle East, China, Taiwan, or Corea. In addition, there are risk factors for traveling, such as diseases or epidemics: In the case of SARS, for instance, the IT offshoring regions Asia and Canada were affected the most. Another risk for the development of the IT offshoring market consists in (hacker) attacks on data networks: AS IT offshoring depends on the possibility to exchange data across long distances using a variety of networks, any attack on these data transmissions would have disastrous effects on the IT offshoring market. Finally, protectionist measures taken by the customer countries can play a major role, if they are used with the aim of preventing the migration of jobs to 'low-income countries'. The supplier countries, on the other hand, must be able to offer not only a qualified workforce, but also adequate incentives to prevent a migration of these specialists, who will be sought after in the international labor market. According to our surveys, leading companies do no longer rely on one IT offshoring location only, but pursue multi-country strategies. This way, should there be a natural disaster in, say, New Delhi, they can use Manila as a back-up.

In the past years, the attractiveness of IT offshoring was mainly based on the cost savings potentials which, depending on the location, could be anywhere between 10 and 70 percent. Cost advantages from IT offshoring mainly result from the lower labor cost level in offshore countries. This is a major issue for the customer countries where labor costs are high: After deduction of hardware and software costs (40 to 45 percent on av-

erage) the remaining 55 to 60 percent of TI costs go to internal labor or external providers. This cost block can be considerably reduced with offshore locations (figure 3.15).
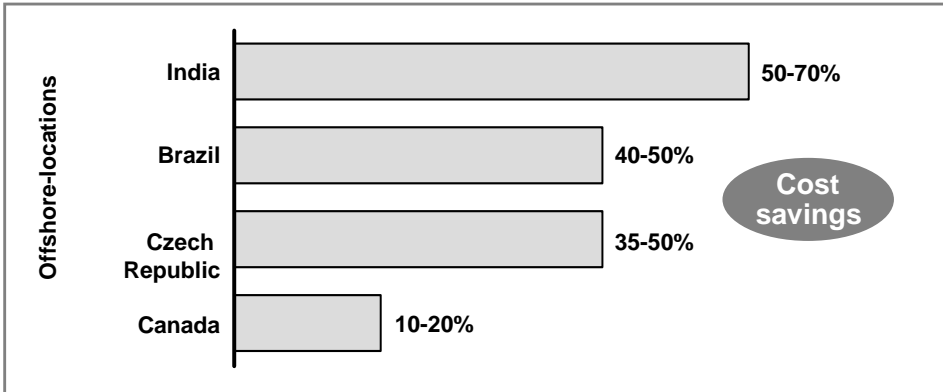

Figure 3.15: Total cost savings (labor costs, infrastructure, taxes) compared to the U.S.; Source: A.T. Kearney

Labor costs strongly depend on the cost of living in the particular country, the wage level, and the educational level of employees. Costs of IT programmers, for instance, are 60 to 70 percent lower in India than they are in the U.S. While labor costs are currently rising in India – partly at a faster rate than in the industrialized countries – they are not expected to reach comparable levels any time soon. This may, however, change along with the increasing consolidation of IT offshore suppliers: Even today, the Indian offshoring market is dominated by five suppliers which have made first efforts to expand to other offshoring countries and Europe. 'Globalization' of the industry, however, will inevitably lead to 'globalization' of labor cost.

The situation is similar in the locations preferred by European companies. At present there are still considerable differences in labor costs, making 'nearshoring' to Eastern European countries very attractive: While average labor costs in the 'old' EU (prior to expansion) amounted to 22.7 Euros per hour, it is only 2.9 Euros per hour in countries like Poland, the Czech Republic, Hungary, and the Slovak Republic. However, wage levels will clearly rise in those countries in the process of their integration into the EU: In Hungary, for example, wage levels are expected to double between 2000 and 2006 according to corresponding analyses.

For all these reasons, the cost issue should be considered with great caution – as in the case of IT outsourcing: Current labor cost advantages are partly offset by higher transaction costs, additional expenses for documentation (due to the geographic distance and time differences) as well as travel costs. Experiences in the U.S. and U.K. – where the outsourcing of complete services and partnering with other companies are common prac-

tice – have shown, however, that economic benefits to companies from offshoring go far beyond the cost savings expected:

- *Higher productivity:* As IT offshore suppliers annually improve their internal processes by 10 to 15 percent, their productivity is often superior to that of European competitors

- *Better service quality:* A major share of IT offshore suppliers has achieved a very high level of international certification, such as SEI CMM Level 5 (the highest level) while most IT providers only fulfill CMM levels 2 or 3. This involves considerable quality advantages, such as lower error rates

- *Flexible resource quantities and capacities:* IT offshoring was begun in 1999, at a time of scarce IT resources. Meanwhile, in particular India has established itself as a new and, above all, flexible labor market (comprising more than 400,000 IT specialists).

- *7x24 capacities:* Internationally leading IT providers with corresponding capacities in all continents and, as a result, regionally dispersed project teams, are able to guarantee 7x24-hour capacities. (Upon closer scrutiny, these theoretical 7x24 hours will be cut down to a very short time period, as on a typical 8- to 12-hour day within a given time zone, around 10 to 15 percent of labor will be spent on documentation and handing over tasks to other parts of the worldwide project team. In view of labor cost advantages, the 7x24 benefits should be weighed against alternative solutions, such as two-shift models in another offshore location.)

For each individual IT task, the strengths and weaknesses of each offshore location, as well as the opportunities and risks in three dimensions – cost position, location factors, and resources – should be analyzed in detail.

The IT task itself should be evaluated against two criteria: its potential value to the company (number of IT staff, and costs per IT staff member) and the possible savings. Only if IT tasks involve substantial value to the company while incurring limited migration cost – for instance, if existing IT staff can be put in charge of managing the IT offshore supplier – will the company draw maximum benefits from this optimization process.

Selecting a suitable offshoring model

Once an adequate offshoring location has been chosen, a suitable IT provider must be selected. IT offshoring services can either be delivered in-house, or outsourced to an offshoring partner or an external provider (figure 3.16). In either case, the division of tasks between the company and the provider needs to be clarified.
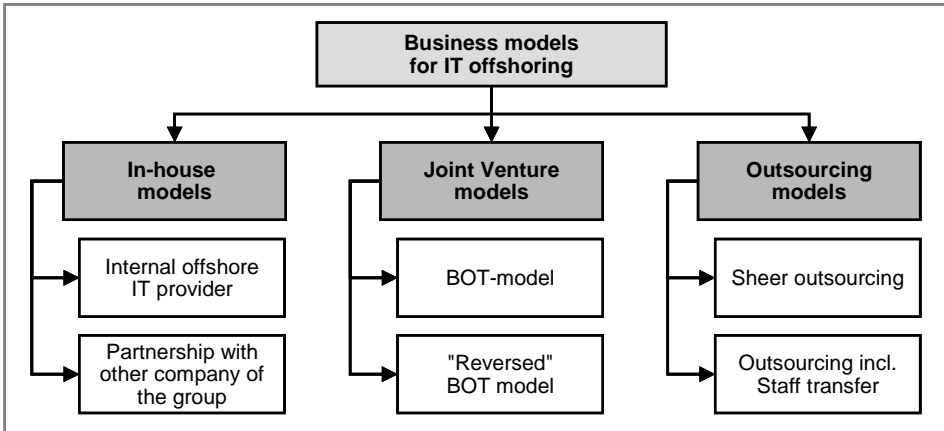
Figure 3.16: Variants of IT offshoring; Source: A.T. Kearney

In-house models imply that the company establishes its own location in an offshore country. This will be an option only for large groups present worldwide, which consider IT a core competence while involving IT offshoring providers to exploit labor cost advantages. These companies will retain control of the entire project, which will require them to have the necessary capabilities and experiences. Examples of companies which have opted for this solution early on include General Electric, with 15,000 employees in eight offshore locations, as well as HSBC with 2,000, and American Express, also with 2,000 employees in India. Intel, Boeing, and Motorola have established locations in Russia.

This option is suited in particular for longer-term tasks, such as IT processes in IT operations, or large-scale application development projects where IT resources are scarce and there is a substantial need for resources to meet project milestones. It is also chosen by most global IT providers who improve their cost structures (and prices) by transferring tasks to offshore countries.

Outsourcing models represent the other extreme: Companies outsource IT services to an IT offshoring partner who will execute the entire project or service offshore. This solution is suited for simple, clearly defined tasks, and is often chosen for the operation of application systems and hardware, user support, and self-explanatory mass processes like data consolidation. Possible outsourcing partners for the 'sheer outsourcing' model are the large IT offshoring providers, such as TCS, Infosys, Wipro, Satyam, HCL Technologies, and Cognizant. The disadvantage of this solution, which involves no exchange of resources between the company and the provider, is the considerable management and control effort required from the company. Some companies resolve this by sending individual members of their IT staff to the offshore location to manage the provider relationships at least during the initial phase, and facilitate the know-how transfer. Outsourcing

cum staff transfer is also used in the cooperation with smaller offshoring providers which do not have sufficient resources to build an international presence and operate from the company's local premises.

For many companies which have included offshoring in their longer-term strategy, the best solution will be joint venture models with an IT offshoring partner. The provider's staffs, together with the company's IT staff, carry out the design phase on the company's premises while the later implementation will happen off-shore. This way, there will be no 'start-up' phase for hiring suitable candidates, and for selecting and leasing suitable infrastructure. Likewise, the company will not have to go through the initial, often painful learning phase. In particular companies with little outsourcing experience, or with reservations against offshoring, will find this option attractive since it permits them to manage the know-how transfer while the IT offshoring provider will monitor the off-shore activities. Language or cultural differences will be mitigated as the regional distance is overcome.

In joint venture models, the BOT approach can be used when the IT offshore supplier returns the IT tasks to the company after a predefined period of time. In this case the staff of the offshore supplier will be deployed both, on-site and off-shore. On-site topics will be strategic issues, architecture, design, implementation, while off-shore activities will include development and maintenance/upgrading: It is obvious that this model will be particular suitable for complex projects. An example is the joint venture between British Telecom and the Indian IT-offshoring provider Mahindra. The BOT model can also be reversed, in that the IT offshoring provider initially focuses on implementation support, successively taking over the location as predefined milestones are reached. This model has been chosen by the insurance company AIG with Polaris, as well as British Airways with WNS.

The future will show which of these models will ultimately turn out to be the dominating one. It is, however, becoming more and more apparent that in the case of IT offshoring – as opposed to IT outsourcing – the geographic and cultural distances speak for a very fine definition of service relationships. IT offshoring is therefore ideally suited for covering the 'basic IT needs' of a company in terms of IT commodities (such as the operation of computing centers and user help-desks), helping them to quickly achieve sustainable cost savings of 20 to 40 percent. By contrast, company-specific and differentiating IT tasks will be kept in-house. As a result, the role of the IT department will change, and with it the IT staff's qualification profile: Instead of application programmers with extensive IT-system know-how, solution oriented business shapers will drive value-added IT contents with competitive relevance and a clear business focus.

Checklist: Is your offshoring strategy promising?

Yes

- ■ Have the objectives of your IT offshoring strategy been defined clearly and with a careful eye on corporate strategy (for example, growth targets)? ❑

- ■ Have all stakeholders been involved in your offshoring plans? ❑

- ■ Have IT processes been optimized prior to transfer to an offshore supplier? ❑

- ■ Have conclusive IT services been chosen for offshoring – labor-intensive, with limited customer contact and non-critical to competitiveness? ❑

- ■ Have the opportunities and risks of IT locations been evaluated with regard to your long-term goals – not only cost aspects? ❑

- ■ Does your offshoring partner maintain the key capabilities you will require? In case of doubt, did you engage several offshoring providers to spread the risk? ❑