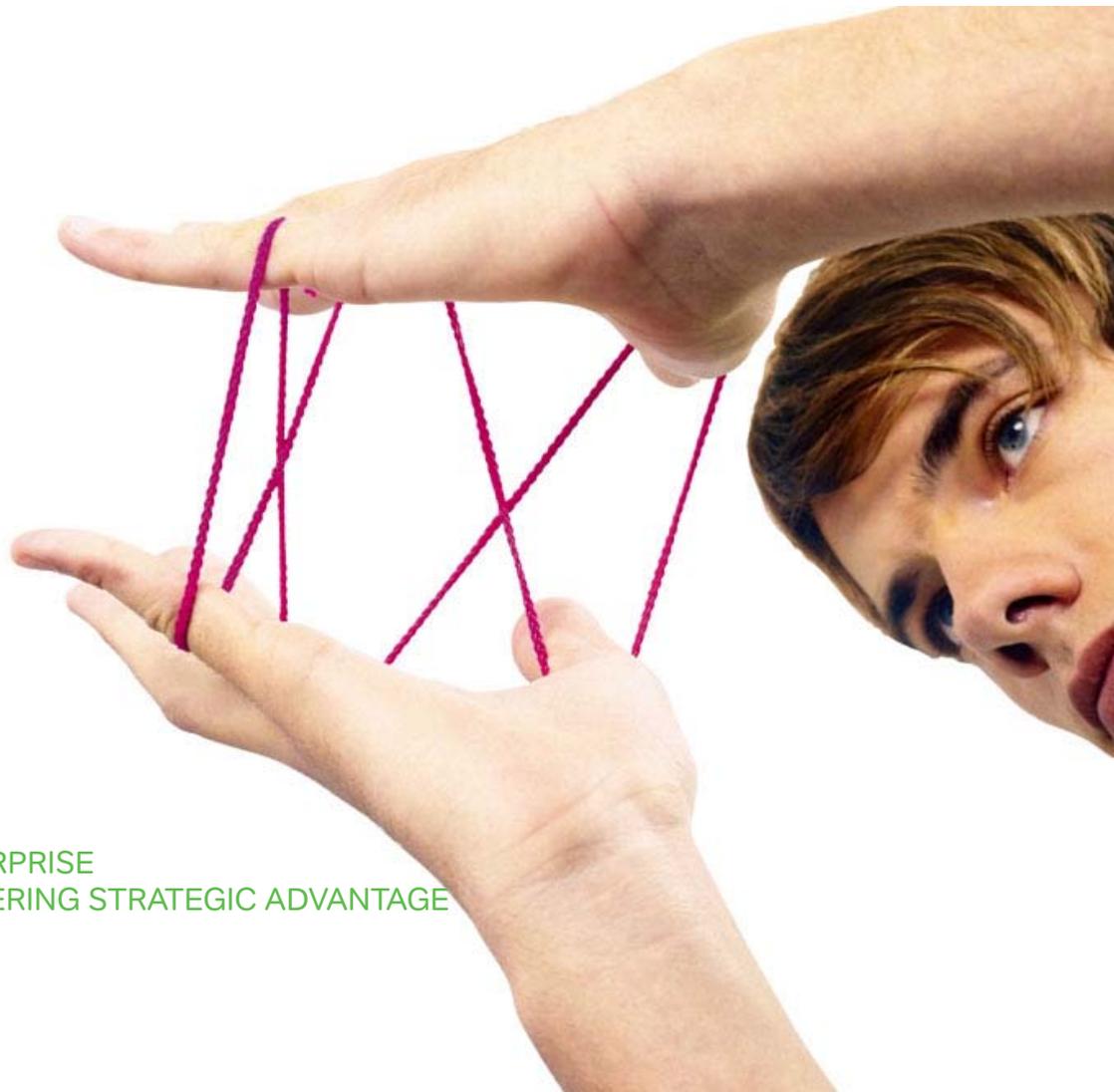




In association with the
London School of Economics
Information Systems and Innovation Group

There is a recommended
path and a flawed path.
The difference between
the two is management.



THE OUTSOURCING ENTERPRISE
THE CEO'S ROLE IN DELIVERING STRATEGIC ADVANTAGE
Leslie P. Willcocks, Sara Cullen

Six key lessons from The Outsourcing Enterprise

Through analysis of our research base, which represents 15 years of combined research into over 1200 organisation, we see six key lessons emerge.

- 1 Organisations fail because they outsource problems, messes, and things they do not understand. The lower risk option is to outsource well understood activities for which it is possible to write detailed contracts and monitor. Partnering arrangements are for mature clients to undertake.
- 2 Outsourcing disappoints where the CEO and senior management see it as about spending a little as possible on an activity or function, and about stepping aside from management. In fact, outsourcing is still about managing but in a different way, with different skill sets, if the organisation is to retain control of its own destiny.
- 3 Signing long-term outsourcing contracts for short-term reasons has been, and will continue to be, a regular source of serious disappointment.
- 4 Vendors still tend to be better at selling their services than clients are at buying them. This Outsourcing Enterprise series is dedicated to developing better customers.
- 5 Client organisations, and their CEOs, still expect too much from ITO/BPO vendors, and not enough from themselves. So what should clients be able to do?
 - Formulate and monitor sourcing strategy that fits with dynamically changing strategic and operational business needs for the next five years
 - Understand, in detail, the external services market, vendor strategies and capabilities, where vendors are coming from, and what a good deal with this vendor looks like
 - Put in place a process for the management of all outsourcing arrangements across the life cycle
 - Arrive at a contract that delivers what is expected and needed without sustaining high hidden or switching costs over 3-5 years
 - Put in place and sustain a post-contract, in-house management capability that keeps control of the IT/business function destiny and leverages supplier capabilities and performance to mutual advantage
- 6 There is a recommended path and a flawed path. The difference between the two is management, which will initially cost money.



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Introduction

Recently, information technology outsourcing (ITO), business process outsourcing (BPO) (and their offshoring variants), have received massive press and media attention.

Outsourcing is not a fad, but a substantial part of corporate and government expenditure, needing top team oversight and management.

But in fact the ITO/BPO services market has been dynamically expanding its revenues, capabilities and associated rhetoric, in equal measure, for over a decade. This is set to continue apace. Outsourcing is not a fad, but a substantial part of corporate and government expenditure, needing top team oversight and management.

Despite the accumulated experience, learning has been painfully slow; there has been very mixed success, and all too much conflicting advice. Moreover, getting large-scale outsourcing wrong can seriously disable the business. On the up side, the potential payoffs from outsourcing are not just operational and cost-related. Indeed, the accumulated evidence demonstrates that outsourcing, properly planned for, resourced and accomplished, can deliver significant strategic advantage to firms and government agencies in every sector. However, this is the case only where the CEO and senior executives take key actions and ensure specific management and core capabilities are in place.

This paper, the first in The Outsourcing Enterprise series sponsored by Logica, is derived from rigorous and independent, internationally-acclaimed case and survey research in over 1200 organisations conducted in Europe, USA, and Asia Pacific over the last 15 years. In the course of that research and related advisory work, we have been able to achieve in-depth understanding of what makes for success, what does not work, why some organisations are effective users of outsourcing, and have achieved strategic advantage, while others have very mixed experiences. A critical factor in outsourcing success is CEO engagement. Why do successful CEOs care about outsourcing? What do they care about? What key developments in the outsourcing phenomenon need to shape CEO and top team thinking over the next five years?



Why effective CEOs care

Why should hard-pressed CEOs devote attention to outsourcing?

Because a substantial and rapidly rising amount of most large organisations' cost base is already with outsourcing service providers; because getting large-scale outsourcing wrong can seriously damage the business; because from now on, outsourcing is part of any future strategy.

OUTSOURCING IMPACTS ON MARKET VALUE

Share price is a fundamental barometer of corporate performance. Our own case histories show a frequent, significant, positive stock market reaction to firms outsourcing their IT infrastructure or back offices. Investors view outsourcing as a sign of active investment and management in a firm and consider movement toward outsourcing as an important, usually favourable variable when assessing a firm's worth. In our experience, the announcement of a large-scale outsourcing deal regularly has a positive effect on share price that can last between three and ten months. The danger for the CEO is being swayed by short-term share price concerns and signing a large, long-term deal in order to try to shift the share price substantially upwards or perhaps to buy time rather than focusing on the fundamental business logic of the outsourcing deal. Longterm outsourcing contracts signed for short-term reasons invariably bring about major disappointments for CEOs and their organisations.

OUTSOURCING IS PERVASIVE AND GROWING: THE SPENDING ALONE DEMANDS ATTENTION

The outsourcing of IT and business processes is likely to move from a 2005 average of 12 per cent to 20 per cent of organisational costs by 2008. As these figures indicate, outsourcing makes up a substantial and rapidly rising part of expenditure in corporations and government agencies alike. Organisations are choosing to outsource more frequently for a variety of reasons: to get to market more quickly; to cut internal costs; or to leverage the increasing capabilities of external services providers. For many organisations, outsourcing has become a major item of expenditure. However, much of this is happening incrementally, as a response to immediate market conditions and specific opportunities to cut costs, rather than on the basis of long-term strategic thinking. CEOs, if they have not already done so, need to put such large spending on to a much more strategic footing.

OUTSOURCING BEARS MANY RISKS: IT CAN ENABLE OR DISABLE BUSINESS STRATEGY

The outsourcing highway is littered with casualties. We have seen even experienced organisations repeatedly running into massive problems, suffering from slow organisational learning, and working in a reactive rather than an anticipatory mode.¹ In a recent example, UK retailer J Sainsbury signed a seven-year US\$3.25 billion deal with Accenture to outsource its IT operations in 2000. By late

¹ For evidence see Cullen, S. and Willcocks, L., *Intelligent IT Outsourcing*, Butterworth Heinemann, Oxford, 2003; Kern, T. and Willcocks, L., *The Relationship Advantage: Information Technology, Outsourcing and Management*, Oxford University Press, Oxford, 2001; Kern, T., Willcocks, L. and Van Heck, E., 'The Winner's Curse in IT Outsourcing: How to Avoid Relational Trauma,' *California Management Review*, 44, 2, 47-69; Lacity, M., and Willcocks, L., 'Information Technology Sourcing Reflections,' *Wirtschaftsinformatik*, Special Issue on Outsourcing, Vol. 45, 2, 2003, pp. 115-125.

2004, the deal had been renegotiated twice, and J Sainsbury had announced a 2004/5 write-off of US\$254 million of IT assets, and a further US\$218 million write-off of automated depot and supply chain IT. The way forward was to reduce costs and simplify systems.²

While it appears that clients have a history of outsourcing experiences to draw upon, the problem is change. First generation outsourcing clients often change what they outsource and how they outsource the second and third time around. Each time, they find themselves in a relatively new situation, having to learn anew.

Why do CEOs get involved? Because, in outsourcing, strategic risk mitigation is fundamental. Furthermore, pursuing an operational, cost reducing outsourcing approach can drive costs down but often at the expense of other expected benefits; strategic, and even operational, inflexibilities can result³. As one example, while the Xerox-EDS 1994- 2004 IT outsourcing deal achieved cost reductions, at one point it incapacitated the ability of Xerox to cope with a major change in market structure. In late 1999, Xerox lost control of its billing and sales commission systems, and this had major consequences for profitability. By the following year, Xerox's market share value had dropped significantly⁴.

OUTSOURCING CAN PLAY A POSITIVE STRATEGIC ROLE

The CEO must also care because, as the examples above show, strategic decisions to merge, acquire, or enter new markets can incur substantial unforeseen damage, delay and costs, where existing outsourcing arrangements need to be refocused.

We are increasingly seeing leading organisations utilise forms of outsourcing and partnering to: penetrate new markets more quickly; operate in new geographies (for instance, Boeing sourcing IT in Malaysia to sell core products there, Dell looking to sell into China); achieve strategic agility (for instance, adjusting volumes in response to business cycles, or to provide business continuity in times of crisis); achieve strategic sourcing (for instance, offshoring; using offshore competition to get better prices and service; best-of-breed sourcing); and enhance strategic capabilities by partnering with a complementary supplier.

We have also seen CEOs use outsourcing for financial restructuring; to strengthen core competences; as a technology or business process catalyst; and as a means of business transition or innovation.

2 Reported in Rohde, L. 'Sainsbury, Accenture To Redo Outsourcing Pact', Computer Weekly October 25th 2004.

3 Lacity, M. and Willcocks, L. (2001). Global IT Outsourcing: In Search Of Business Advantage. (Wiley, Chichester).

4 Kern, T. and Willcocks, L. (2001) The Relationship Advantage (OUP, Oxford).

What effective CEOs need to do

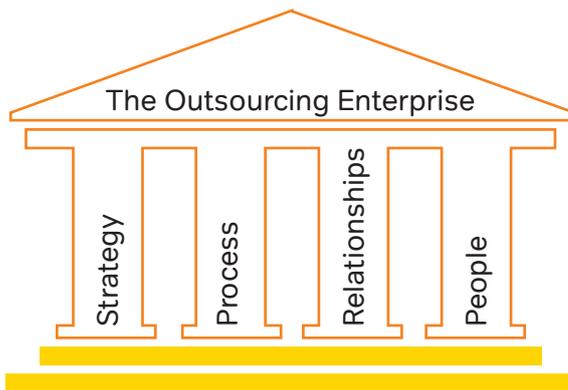
The evidence from our research shows clearly that outsourcing - properly planned, resourced and managed - can deliver significant competitive advantage to companies and organisations in all sectors.

However, this is only when the CEO plays a key role - taking crucial strategic decisions, creating vital capabilities, putting in place integrated management processes and applying effective monitoring and evaluating mechanisms.

The CEO needs to shift from a tactical approach to outsourcing, to a strategic and much more personally involved one. In particular, the CEO must take responsibility for founding the four pillars of the successful outsourcing enterprise, namely strategy, process, relationships and people.

THE FOUR PILLARS

The CEO's role is to build these four pillars to ensure that strategic advantage is the outcome, not organisational damage, disappointment and discontinuity.



STRATEGY

The CEO can be hands on in two key strategy areas: sourcing and configuration. Strategic sourcing means finding sourcing solutions that are sustainable for five or more years without incurring substantial switching costs. Configuration is the sum of the highlevel choices that an organisation makes in crafting its outsourcing portfolio and the individual deals contained in it.

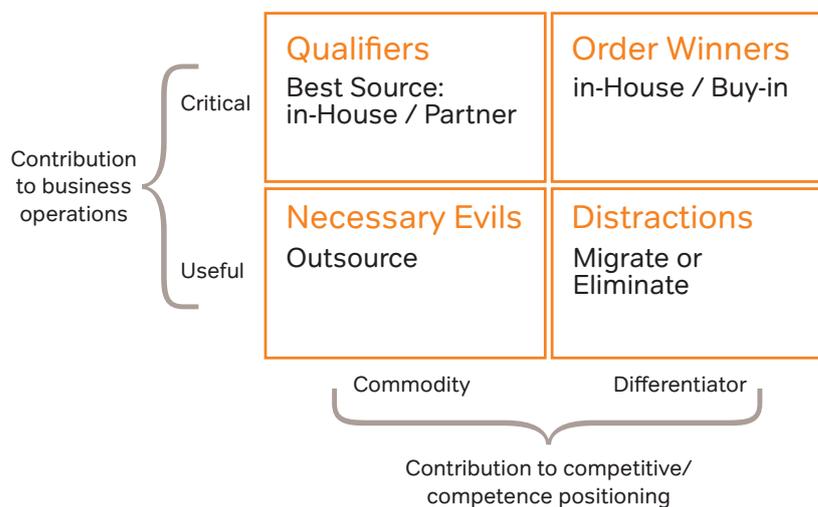
STRATEGIC SOURCING: BUSINESS ACTIVITY

There are two ways of classifying business activities: contribution to business positioning; contribution to business operations. Some activities are often seen as commodities - for example payroll and mainframe processing in IT or administration in HR. These need to be done, but do not differentiate the organisation competitively. In this figure, the vertical axis allows us to assess whether a business activity critically supports strategic direction and its delivery, or merely makes incremental contributions to the bottom line. The horizontal axis allows us to assess whether a business activity is a differentiator in strategic positioning or a commodity.

High-rise prices building up low-carbon cities of the future

As energy prices continue to rise, maximising the benefit gained from the use of energy and resources is a huge priority for governments and regulators alike. Most European governments have plans – or have started – to build carbon neutral homes and even new low-carbon cities.

Strategic sourcing by business activity



'Order winners' are the business activities that critically and advantageously differentiate a firm from its competitors. 'Qualifiers' are business activities that fulfil minimum entry requirement to compete in a specific sector. 'Necessary evils' are tasks that have to be done but yield no strategic advantage from their fulfilment; these are the 'non-core' activities ideal for external sourcing. 'Distractions' are failed or failing attempts to differentiate the organisation from its competitors. The goal with distractions must be to eliminate the activity, or shift it into another quadrant.

STRATEGIC SOURCING: MARKET COMPARISON

It is not enough, however, to identify a potential role for service providers and business allies from an internal organisational standpoint. The sourcing market itself requires detailed analysis. Where the market is cheaper and better, outsourcing is the obvious decision, but only for 'Qualifiers' and 'Necessary evils'. In-house sourcing is the best alternative when the market offers inferior cost and capability. Where the market offers a better cost deal, this should be taken - but only for non-key activities, i.e. the 'Necessary evils'. Where the market offers superior capability, but at a price above the in-house cost, there still may be valid reasons to buy in expertise or enter into partnership with the third party, not least to benefit from their knowledge and apply it to 'qualifying' and 'Order winning' activities.

STRATEGIC CONFIGURATION

'Configuration' - again an activity in which CEOs need to be closely involved - is the second key factor in outsourcing decisions. Configuration is the sum of the high-level choices that an organisation makes in crafting its outsourcing portfolio and the individual deals contained in it. The various attributes involved in configuration cover the range of choices available to management in arriving at deals that will work for them. The resulting portfolio of sourcing decisions in fact makes each organisation's approach to outsourcing very different. This is one reason why management consultancy templates for outsourcing often run into problems.

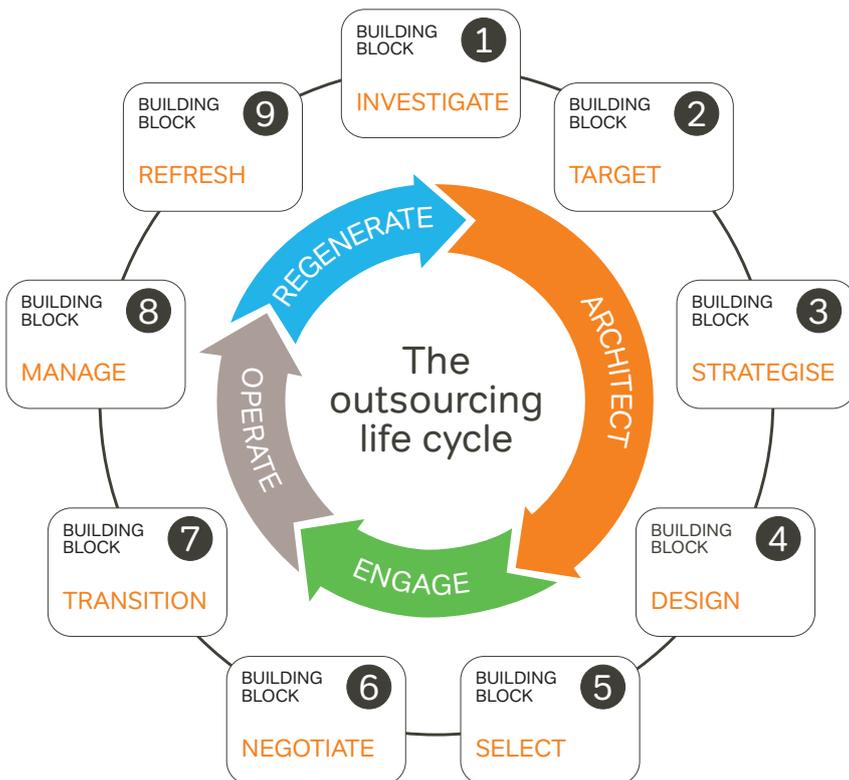
The three attributes at portfolio level are service scoping, supplier selection strategy and financial scale. The four attributes at the level of individual deals are pricing, duration, resource ownership and commercial relationship. Each organisation must design, and often redesign, the configuration that will work best for it and the CEO has a key role in making sure this happens.

PROCESS

The second pillar of the successful outsourcing enterprise is Process. Here the CEO needs to ensure that a process is in place to deliver strategic priorities.

Outsourcing initiatives are usually conducted in a disjointed manner, with different individuals or teams independently carrying out, what are in fact, interrelated activities. The CEO may determine the services to be outsourced, the legal team prepare the contract, an operational team prepare the SLAs, a separate team select the service provider, and a different team altogether formed to manage the service provider, and so on. The outputs of the various teams overlap and at worst contradict one other. Only a CEO-determined strategy can remedy this. The CEO needs to ensure that a management process is in place that will deliver strategic priorities. We identify from case studies an integrated four-phase outsourcing life cycle framework that is a structured means to make decisions, prepare for and manage outsourcing from precontract to contract end. In the life cycle, each phase, and the building blocks therein, prepares the way for the following phases and building blocks. The life cycle framework is proven to optimise the business benefits of and work through the strategic steps necessary to keep the outsourcing arrangement on track and deliver targets effectively while minimising risks and hidden costs.

The outsourcing life cycle



The CEO will be involved in the Architect phase, and must ensure that the Engage and Operate phases are properly set up and resourced. If this is the case, then the CEO will monitor outcomes but become hands on again only at the Regenerate phase when the sourcing options need to be debated against changing requirements and service market developments.

RELATIONSHIPS

Everyone associated with outsourcing points to the criticality of getting the relationship dimension right. But how can this be done, and what is the CEO's role in this? The CEO will be active in top team relationships across the parties. The CEO must also ensure sufficient resourcing and an enabling structure for commercial relationships to exist to optimise and translate deals into business results. It is critical for the CEO to understand the different types of relationships and how they can be leveraged, the roles of power and trust, together with common stereotypes in key jobs and how they combine with beneficial or adverse affects.

PEOPLE

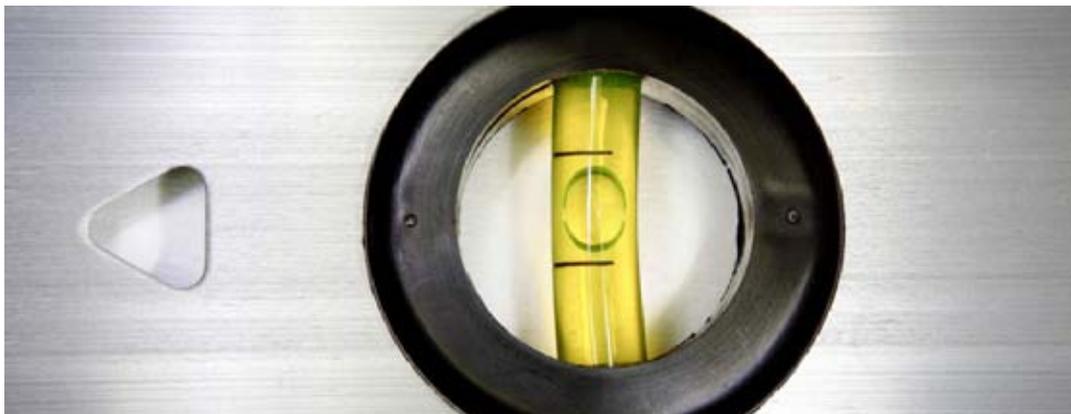
The CEO must also be active in ensuring that people resources are in place as a basis for capabilities that convert into competencies. Benchmarking outsourcing providers in terms of their delivery, transformation, and relationship competencies is a means of doing so. However, there are core tasks and people-based capabilities that the CEO must also ensure are maintained in-house by the organisation if outsourcing is to be successful. Our research consistently shows that where these capabilities are absent, significant problems arise - however good the strategic thinking was, and however strong the contract was drawn up. Moreover, few executives really think through what happens to knowledge when they outsource.

The Relationships and People pillars will be discussed further in future papers in The Outsourcing Enterprise series.

Finally, outsourcing is not a goal in itself but a management technique to achieve a wide range of business goals. Whether outsourcing is achieving these goals needs to be firmly monitored and kept on track.

To assess whether an outsourcing deal is 'successful' we regularly find organisations pursuing five or six separate objectives - and sometimes as many as seventeen! As an alternative, and to get a more rounded view, our research has identified a range of balanced scorecards that can help achieve this. Our contract scorecard evaluates outsourcing success through the following four dimensions: service quality; financial; relationship; strategy. Service quality covers measures of all aspects of service delivery. Financial includes the monetary measures to compare costs at different fiscal points. Relationship includes measures of how the parties see and behave towards one another. Strategy involves higher-level issues that go beyond the letter of the agreement, e.g. innovation and business contribution.

Evaluating outsourcing success through these four dimensions provides a more holistic analysis than simply conforming to key performance indicators and reducing costs. Our scorecard treats outsourcing as a phenomenon that has dimensions beyond the purely financial and seeks to encourage organisations to think more strategically about their outsourcing deals. As such, we believe that it equips CEOs and senior executives with a valuable integrated set of measures to regulate the ongoing success or failure of the deal.



Logica's top ten outsourcing predictions for 2005-2010

SELECTIVE SOURCING WITH MULTIPLE SUPPLIERS WILL REMAIN THE DOMINANT TREND; SPENDING WILL CONTINUE TO RISE

ITO global revenues will exceed US\$200 billion by the end of 2005. After, and indeed partly because of, the slowdown between 2001-2004 this figure will rise by at least 7 per cent per annum for the next five years. Of this, offshoring (US\$7 billion in 2004) will probably rise to over US\$20 billion by 2010.

BPO, OVERSHADOWING AND INCORPORATING ITO, WILL BECOME THE DOMINANT MARKET PLAY

Mainstream BPO expenditure is likely to grow worldwide by 10 per cent a year from US\$140 billion in 2005 to over US\$220 billion by 2010. IT provides major underpinning for, and payoff from reformed business processes.

BACK-SOURCING WILL BE MINIMAL, OUTSOURCING IS HERE TO STAY

The most popular course of action at the end of a contract will continue to be to extend it with revisions, a quarter will be re-tendered, and a tenth back-sourced.

OUTSOURCING WILL HELP INSOURCING - MARKET DISCIPLINES WILL HELP INHOUSE SERVICE PROVISION

In-house operations are facing real competition in nearly every area and can no longer assume they will retain their monopoly status with the organisation. In-house operations are adopting the techniques of the market.

THERE REMAINS SIGNIFICANT GROWTH IN TRADITIONAL ITO. EXPECT INNOVATIVE NEW VALUE PROPOSITIONS FROM THE MARKET

Suppliers as a whole will need to become increasingly creative in their search for profitable business models.

CLIENTS ARE TAKING CONTROL - DRIVING AND DESIGNING DEALS

This trend was reinforced in the 2001-4 semi-recession, but is irreversible and set to continue.

CLIENTS WILL INVEST MUCH MORE IN CONTRACT MANAGEMENT

On our figures, the cost of getting to contract is between 0.4 per cent and 2.5 per cent of the contract value. On-going management costs fall between 3 per cent and 8 per cent of contract value. These costs will increase. After some painful experiences, clients will adopt more readily a spend-to-save philosophy for outsourcing.

FAILURES AND DISAPPOINTMENTS WILL CONTINUE TO OCCUR

Some 70 per cent of selective sourcing, multiple supplier deals will be considered relatively successful in this period. A third of large-scale deals, those involving complex processes and 80 per cent of the outsourcing budget, could fail - with a further third having mixed outcomes.

KNOWLEDGE MANAGEMENT WILL STILL NOT FEATURE ON THE RADAR SCREEN

The hidden business value in knowledge leverage is all too often left behind on the bargaining table - by both parties. The issues may be too soft for hard-boiled commercial bargainers.

CLIENTS WILL TRANSCEND 'HYPE AND FEAR' AND MIGRATE TO MATURITY

We expect to see from 2005 to 2010 a slow but rising tide of improvement in clients' ability to manage ITO, BPO and offshore outsourcing arrangements. The final CEO and senior management imperative is to make sure this happens.

The first research base consists of 112 sourcing case histories (mainly in the area of IT) studied longitudinally from 1990 to 2001. These are described in Lacity, M. and Willcocks, L. (2001) *Global IT Outsourcing: In Search Of Business Advantage* (Wiley). The second is a study of relationships through seven case histories. This appears in Kern, T. and Willcocks, L. (2001) *The Relationship Advantage* (OUP, Oxford). The third is a 2001-2005 longitudinal study of business process outsourcing practices, with a particular focus on four cases in aerospace and insurance.

We also draw upon a fourth research stream consisting of ten cases of application service provision, published in Kern, T, Lacity, M. and Willcocks, L. (2002) *Netsourcing* (Prentice Hall, New York). Additionally there are two published studies of offshoring arrangements we draw upon. These are by Kumar, K., and Willcocks, L. ((1997) *Offshore Outsourcing: A Country Too Far?* in ECIS Conference Proceedings, Lisbon. In addition, Rotman, J., and Lacity, M. (2004) *Twenty Practices For Offshore Sourcing*, MISQE, 117–130.

A further research stream analysed vendor capabilities and is represented in Feeny, D., Lacity, M. and Willcocks, L. (2005) *Taking the Measure of Outsourcing Providers*. *Sloan Management Review* 46, 3. We also draw upon five outsourcing surveys carried out in USA, Europe, and Australasia in 1993, 1997 2000, 2001 and 2002 covering multiple sectors and over 900 organisations.

A final research stream, by Sara Cullen, assessed 100 ITO/BPO initiatives of a variety of business functions during the decade from 1994 to 2003 to determine what worked and what did not work, what drove the various degrees of success and failure, and the emerging lessons. The research is represented in Cullen, S. and Willcocks, L. (2004) *Intelligent IT Outsourcing* (Butterworth) and Cullen, S., Seddon, P. and Willcocks, L. (2005). *Managing Outsourcing: The Lifecycle Imperative* MISQE, 4, 1.

Combined, this work forms a 450 case research base held by the researchers at Warwick, Melbourne, Missouri and St. Louis Universities. The research base covers all major economic and government sectors, including financial services, energy and utilities, defence and aerospace, retail, telecoms and IT, oil, transportation, central, state and local government, health care, industrial products and chemicals, and is drawn from medium, large and multinational organisations based in Europe, USA and Asia Pacific.



About the authors



Leslie Willcocks has an international reputation for his work in outsourcing, IT and change. He is Professor of Information Management and E-business at Warwick Business School, UK. He is also Associate Fellow at Templeton College, Oxford, Visiting Professor at Melbourne and Erasmus Universities and is Editor-in-Chief of the Journal of Information Technology.

He is co-author of 25 books and over 150 papers in journals such as Harvard Business Review, Sloan Management Review, California Management Review, MIS Quarterly, MISQ Executive, and Journal of Management Studies.

In February 2001, he won the PriceWaterhouseCoopers/Michael Corbett Associates World Outsourcing Achievement Award for his contribution to this field. He is a regular keynote speaker at international practitioner and academic conferences, has extensive consulting experience, and is regularly retained as adviser by major corporations and government institutions.



Sara Cullen is a former national partner at Deloitte Touche Tohmatsu (Australia). She has consulted to 85 private and public sector clients in 110 projects with contract values up to US\$1.5 billion per annum.

She is a widely published, internationally recognised author having written 19 publications, conducted 7 reviews for government, featured in 40+ articles and presented in 100+ major conferences.

Her publications include, with Leslie Willcocks, Intelligent IT Outsourcing (Butterworth). She has been featured numerous times in such publications as ABIE Source, Australian Financial Review, Business Review Weekly, the Bulletin, Computerworld, Directions in Government, New Accountant, Strategic Asset Management, Information Technology Report, MIS, and MISQ Executive.

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