

The Snowball Effect:

Characteristics of Outstanding Outsourcing Relationships

Introduction

Outsourcing is complex and strategic, and executives need a breadth of skills and a depth of knowledge to do it successfully.

Although the adage, “If at first you don’t succeed, try again,” is a great motivator, it is not an effective approach to achieving goals in outsourcing. Negative situations can spin out of control. Absorbed in the details, the parties find themselves facing an ever-growing snowball of dissatisfaction. Failure to achieve the desired end results can lead to the cost-prohibitive process of terminating an unsuccessful relationship and finding another service provider.

Success comes with being able to join the beginning goals with the end results. While there is not universal agreement on all the elements that ensure success in an outsourcing arrangement, studies show that success is directly related to the mechanisms that are in place up-front to control the parties’ interactions throughout their relationship.

Outsourcing success is also the result of choosing a service provider with the solutions that will make the most strategic impact on the buyer’s business at an enterprise-wide level.

Like a snowball that keeps growing, the effect of rolling together strategic value and relationship governance “tools” creates a force that rolls on through obstacles in the path. As with snowballs, growing in size and impact, success begets more success. In

that manner, the day-to-day successes of handling both expected and unanticipated challenges has caused each of the outstanding relationships studied in this research project to grow ever stronger and more valuable to both parties.

What works in creating success? What doesn't? We researched the core characteristics and strategies to create value in the world's most acclaimed outsourcing relationships during 2001 (which were nominated for the Outsourcing Journal's 2002 Editor's Choice Awards). The findings of that research are presented in this paper.

We must learn from our mistakes, but it is more important to learn from our successes.

Norman Vincent Peale

How the Study Was Conducted

Each of the 121 relationships nominated for the 2002 Outsourcing Journal Editor's Choice Awards was considered eligible for this study. For each nomination, we first examined written material received from the service providers.

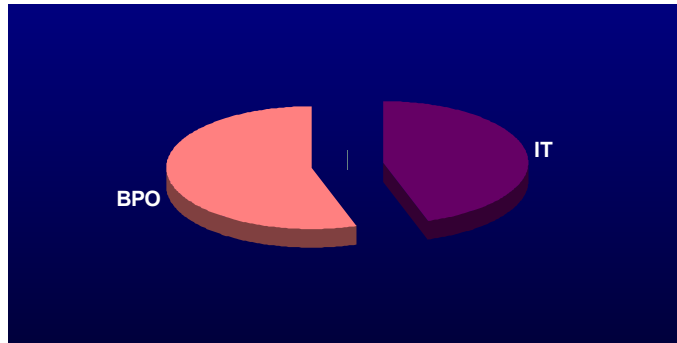
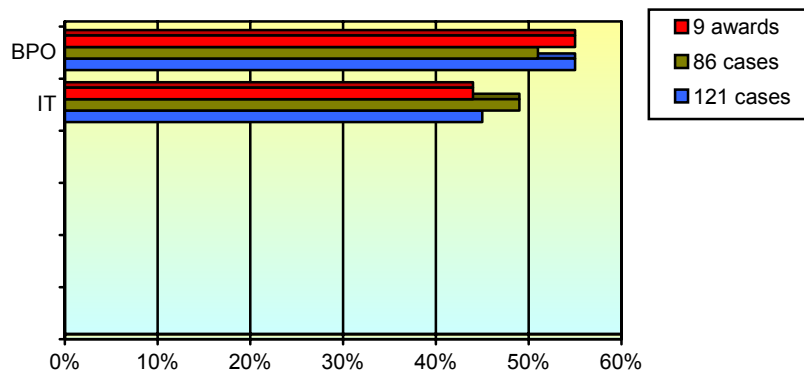
From that information, we eliminated 35 relationships that did not meet the criteria of flexibility and teamwork from *both* parties on an ongoing basis. While it is certainly a fact that some valuable outsourcing relationships are structured on a utility model (requiring very little interaction between the parties and encountering few or no challenges once implementation and transition have been achieved), for the purpose of this study we eliminated those relationships.

Of the remaining 86 nominations, we conducted interviews of representatives from the buyer organizations. The persons interviewed from the buyer organizations were usually the CEO, CIO, CTO, CFO or, in some cases, the most senior person with responsibility for the day-to-day relationship with the service provider. Each was asked the same questions.

Demographics

The graphics that follow illustrate various aspects of the 121 relationships nominated for the 2002 Outsourcing Journal Editor’s Choice Awards, compared to 86 of those cases studied in this research (nine of which were selected by the judges as the 2002 award winners).

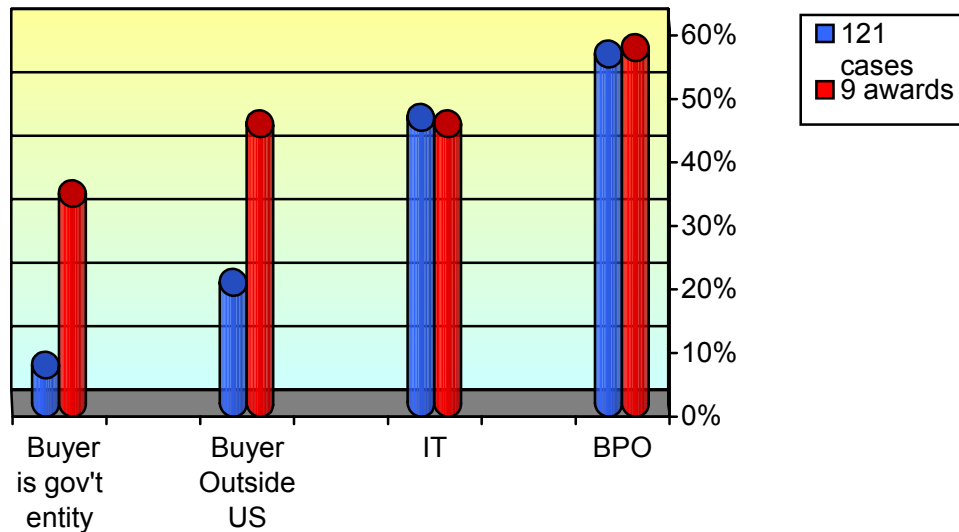
Types of Outsourcing



Note:

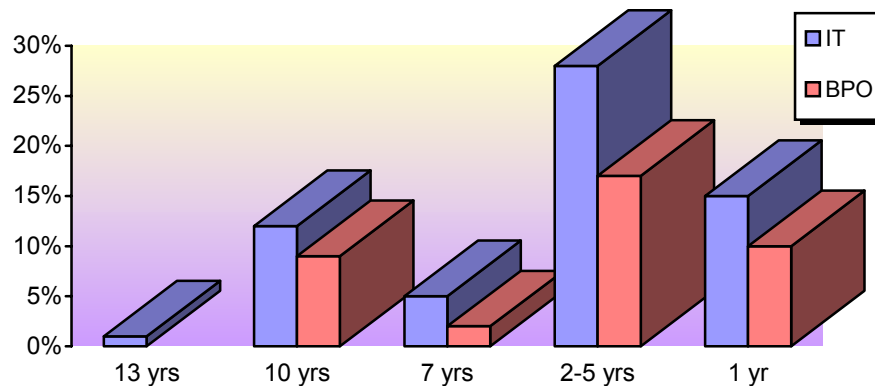
“BPO” includes the people and information technology for an entire function or functions in the following processes: human resources, payroll, finance and accounting, billing, collections, Web-enabled banking functions, logistics, supply chain management, purchasing, customer relationship management, eFulfillment, telesales, call centers, email, data warehousing, data mining, document imaging, packaging, sales force automation, insurance claims processing and administration, facilities management, risk management.

Categories of Award Winners

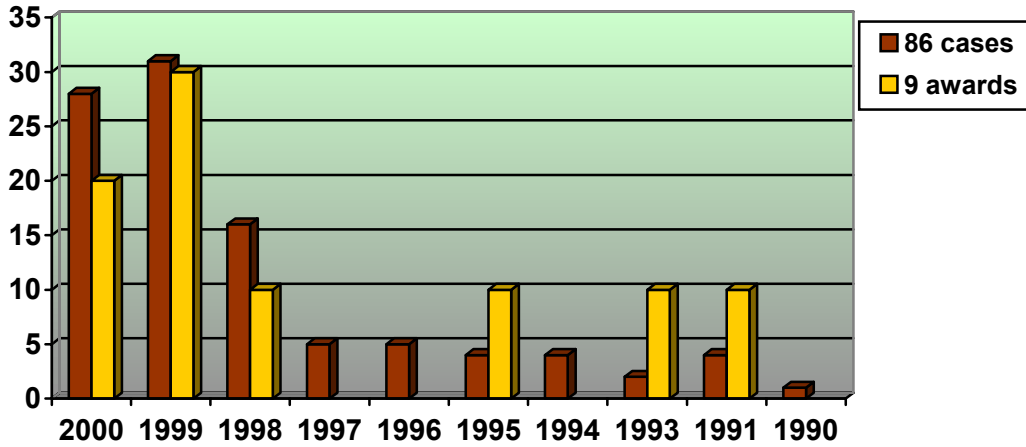


Historically, government outsourcing relationships have been considered less effective than those of private-sector buyers, and agreements outside the U.S. have been considered several years behind the most innovative U.S. deals. As this graph points out, a significant number of the award-winning relationships involved buyers that are government entities or that are headquartered outside the U.S.

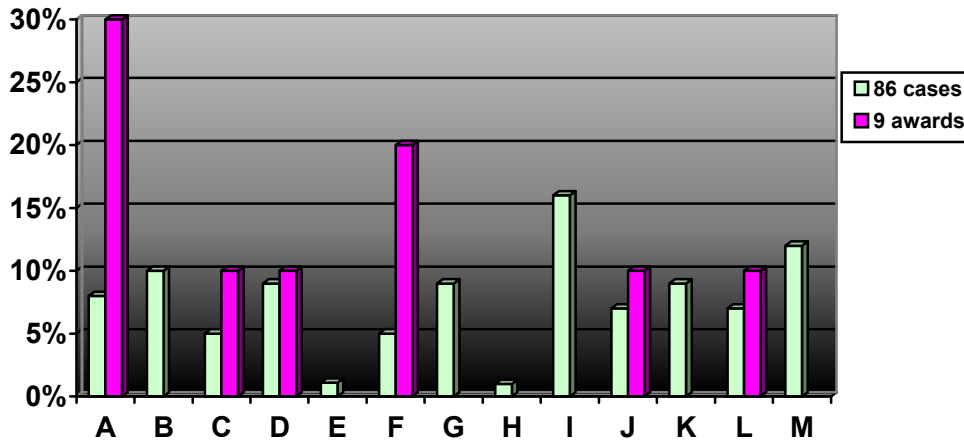
Initial Contract Term Length



Year of Origin for Relationships at Time of this Study



Industries of Buyer Organizations



Legend:

A = Government; B = Healthcare; C = Insurance; D = Finance & Accounting; E = Logistics/Supply Chain; F = Chemical, oil/gas; G = Energy/Utilities; H = Engineering/Construction; I = Manufacturing; J = Software manufacturing; K = Telecom or It infrastructure service provider; L = Retail; M = Miscellaneous.

Study Findings

The study found four primary differentiators shared by the most outstanding outsourcing relationships.

A significant factor is the use of outsourcing to achieve an enterprise-wide strategic impact on the buyer's organization. Rather than outsourcing to accomplish lower operating costs or higher process efficiencies, the most outstanding relationships use outsourcing more strategically to accomplish a new business objective that cannot be accomplished by the buyer organization without leveraging the strong points of the service provider's organization.

A second characteristic shared by the best relationships is the use of penalties and incentives to motivate performance. Many are using innovative risk-reward schemes to ensure specific goals are achieved.

Dwarfing all else, this study found that Award winners and nominees are differentiated not by the challenges that face them but, rather, by the way they face challenges. Winners are not immune from unanticipated problems, but they handle them differently. Both parties work together to formulate joint goals and achieve joint outcomes. For long-term success, one must be willing to stop looking for a solution and, instead, seek to *be* the solution.

“What’s very important is to have those upfront discussions with your service provider about shared goals and key success factors.

Every step you take should be bumped against those and, if it doesn’t jive with those, then you have to look at your goals and success factors or modify the steps you’re trying to take.

At Verizon, we can’t afford to have a kink in our relationship or to get off track. The shared objectives and key success factors have a lot to do with keeping us on track.”

Sara Mellinger
Executive Director - Benefits Delivery,
Verizon

That approach, and structuring the deal so that it achieves maximum value, requires upfront planning. This is the fourth characteristic of the most outstanding relationships. Unlike a current trend to sign a contract or letter of intent and then work out the relationship details later, the details of the most outstanding, successful outsourcing relationships were structured for effectiveness before the contracts were inked.

“You must ensure that the service provider you want to work with has the ability and track record to do what you want. Make sure the organization is one that really can deliver.

Then understand each other and be willing to work together to get where you want to go.

It takes time to do that. I can frame it up in three words: research, commit, and partner.”

David Kepler, CIO and Corporate Vice President, eBusiness, Dow Chemical

This paper looks at the details in each of the three aspects of shaping a successful relationship.

1. Culling Out Incompatibilities

Success is a big leap for both parties fresh out of the gate at contract signing. Each side has corporate chieftains who are accustomed to having the last word and, undoubtedly, their separate corporate cultures have caused them to focus on different values and make decisions in different manners.

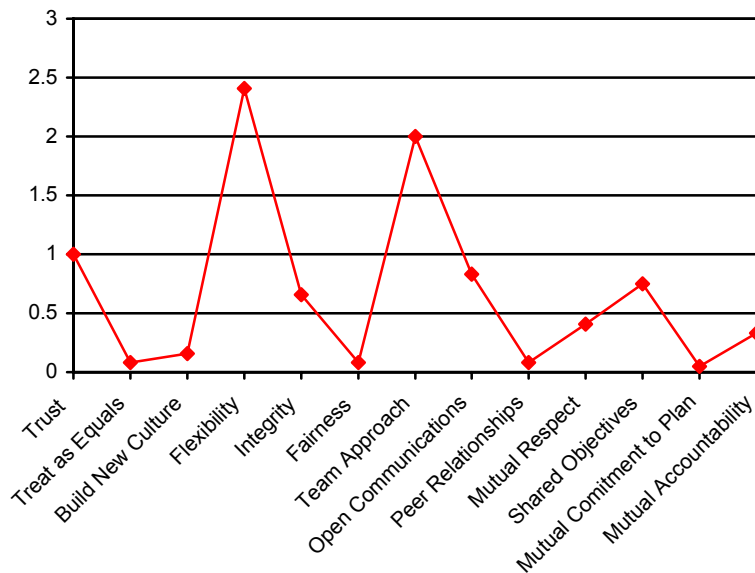
Now they must work together, or they will fail. It's more complex than simply making allowances for the other party from time to time. And it's not as simple as counting to 10 before a face-off. It requires a new approach. In actuality, people are not all that different from computers when it comes to reactions. Both react according to their internal programming.

In the 86 relationships studied in this research, the buyer organizations were asked their opinions as to the most outstanding characteristics that make their relationships so successful. Each was encouraged to list as many characteristics as were pertinent. In each case, their responses included a statement that these winning characteristics were

built in from the outset. While it is true that these characteristics grow in strength as time goes by, these attitudes must be “programmed” into the parties’ principles for interaction before they begin working together.

The graphics below illustrate the study’s findings as to the most important attitudes and characteristics for success.

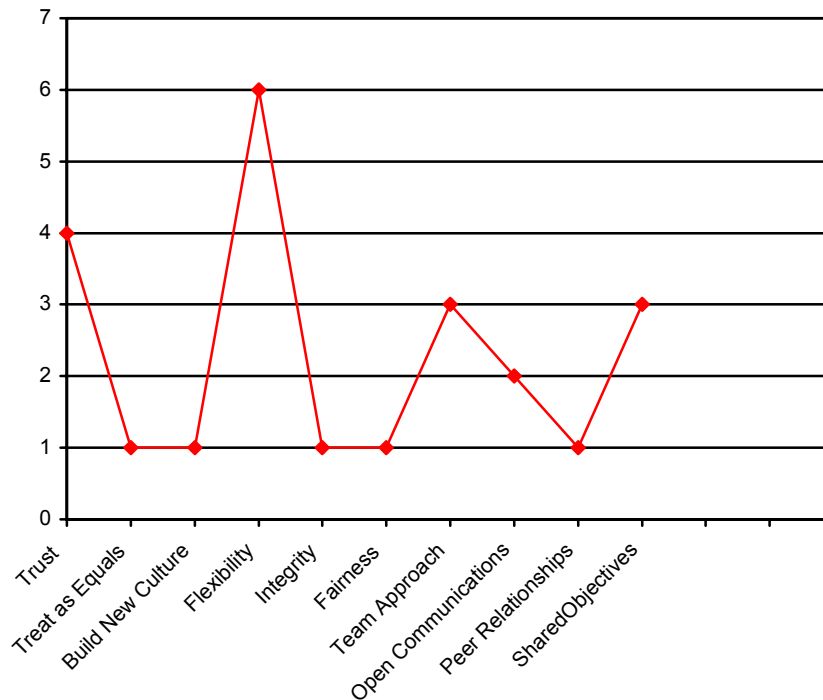
The Most Important Relationship Characteristics Listed Among the 86 Cases Studied



It is significant to note that, while some might argue that “mutual respect,” “mutual accountability,” “open communications,” and “fairness” when considered together comprise many elements that build “trust,” the parties in the 86 cases differentiate these characteristics. Mutual accountability, open communications and fairness were most often cited by buyer organizations comparing a nominated relationship to other (or previous) outsourcing relationships the buyer has experienced.

The chart below indicates that the top four characteristics in the previous chart (flexibility, team approach, trust and shared objectives) are also the most highly rated characteristics among the award winners.

The Most Important Relationship Characteristics Listed by the 9 Relationship Award Winners



The true impact of the importance of building into an outsourcing relationship the 10 characteristics cited by the award winners in the chart above is evidenced by the next two primary success factors in outsourcing relationships. These 10 characteristics are the principles that allow the parties a strong enough foundation to risk achieving more value by implementing risk/reward pricing structures and strategies to make an enterprise-wide impact on the buyer organization.

Each buyer organization in this study was asked to provide advice for companies considering outsourcing for the first time. Nearly all of them focused on one of the three primary aspects presented in this paper. Highlights of their advice include the following.

Javier Lopez, Digital Manager, BP Columbia:

“Be open with information and with expectations. If you know what you have in terms of cost and people and assets and you are open to the vendor with that information, they will be in a better position to give you a right answer. Trust the vendor. Otherwise, it is just like a marriage where the wife or husband is checking over their shoulder every day when their spouse goes away, or they follow the spouse around, trying to catch them in something. It doesn’t make any sense.”

Al Nazzaro, Senior Operations Manager, Rational Software:

“Do a lot of due diligence on the front end. Really understand your own business and the cost of doing business – not only today but also where you are going to be four or five years down the road. Understand if the supplier is a good fit. Go in with an open mind, not the attitude of ‘this is the way we’ve always done things.’”

Richard Bagby, VP for Informatics and CIO, Pinnacle Health System:

“Develop a win-win relationship.”

Gregg Baugh, IS Director, Pinnacle Health System:

“I would say that truly you need to remember that your success or your failure is completely tied together. So you want to go in this as a partnership. If you go into it as ‘this is my vendor and I am going to scrutinize everything that they do and check up on them, your attitude won’t support outsourcing, and you will set yourself up for failure’.”

Monica Lavin, Director of Electronic Services, Thomas Publishing:

“There must be a good working relationship, and the two companies need to share similar relationship values. The cultures need to mesh so that you can work closely together and be focused on the same end result.”

David Guzman, Sr. Vice President and CIO, Owens & Minor:

“You really have to look at the culture of your company and the culture of the outsourcer’s company. And then ask how it meshes with yours. For example, if the buyer

is very formal and ritualistic in the way they work, and there always has to be metrics and return on investment, and everybody has to sign off on everything they do; but the outsourcer is extremely flexible, that may not mesh. Or vice versa. It's like a marriage. You are going to live together for a long, long time."

Jim Bowman, Director, NCR University Operations:

You need to find a supplier that not only can meet the requirements of what you need to have done, but you also need to have compatibility and be sure their strategies are in tune with your strategies. You need to set up a partnership situation, where there is mutual value between the two companies."

2. Banking on Incentives

The fact is, incentive-based pricing structures pay significant dividends. The greater the risk, the greater the reward. The reward is not paid to the service provider unless the service provider meets the specified desired result of the buyer organization. Incentive-based pricing, or risk-reward structures are highly effective strategies to motivate a service provider to achieve a challenging goal that will greatly impact the buyer organization's ability to compete. When the service provider delivers on that goal, the added value it has brought to the buyer organization is demonstrated by the reward.

In the 86 cases we studied, 27 are not using penalties associated with unsatisfactory service level performance. These 27 cases also are not using incentives. The two reasons most often cited for not using service level penalties were (1) a trusting prior relationship with the service provider, and (2) a belief that penalties are a negative approach to a relationship.

Of the remaining cases, all but eight have put in place Service Level Agreements that include monetary penalties if a service provider does not meet the required service level. In one case, the buyer has tied an incentive to the penalties; if the service provider

incurs a penalty, it will be rewarded if it then improves services above the level of required service.

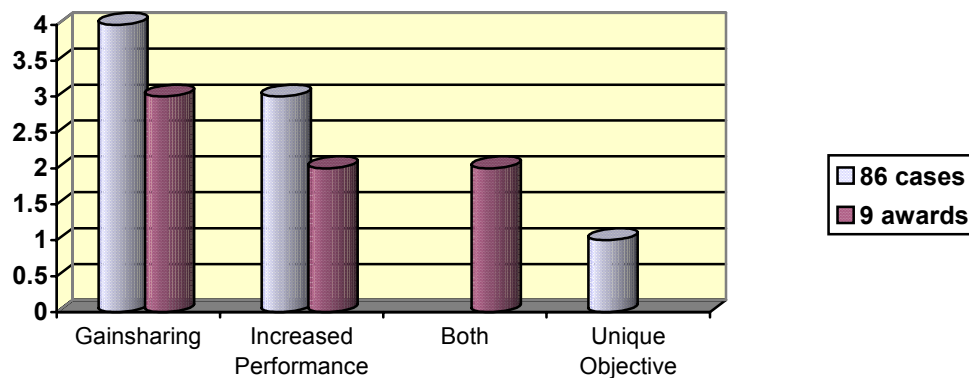
Of the remaining eight exceptions that have not put penalties in place, one is a government entity that does not permit the use of penalties. The remaining eight are cases where the outsourced process was a one-time implementation or a one-time software development project, rather than an ongoing process.

Of the nine award winners, only two do not employ penalties and/or incentives with required service levels. One of these is a government entity that does not permit the use of incentive rewards.

Fifteen of the 86 relationships are using risk-reward pricing structures. Seven of the 15 are for award-winning relationships.

The risk-reward structures in place in these 15 relationships fall into four main categories: (1) gain-sharing on the savings achieved in operational costs; (2) a reward for improved performance; (3) a combination of 1 and 2; and (4) a reward for achieving a particular, unique objective. The chart below illustrates the number of relationships for each category.

Use of Various Types of Risk-Reward Pricing Structures



3. Earmarked for Optimal Impact

The third primary factor in outstanding outsourcing relationships researched in this study is structuring the solution so that it makes the greatest impact on the buyer's organization.

Many buyers fail to achieve significant returns on those information technology investments. The greatest return on investment (ROI) is a solution that enhances the capability of the buyer to compete. It is something more valuable than investing in software tools or infrastructure that increases productivity or reduces direct costs.

The true value of an investment cannot be measured in dollars of investment alone. As the investment contributes to the buyer organization's strategic imperatives, its total value becomes far greater than the original investment.

While all of the 86 cases studied have employed outsourcing strategies to make a significant business impact, the nine award-winning relationships and four of the seven runner-up finalists all achieve greater total value by using outsourcing to make strategic impacts on the buyer's enterprise.

Business impact initiatives reduce the cost of service or improve the utilization of resources. Examples of business impact from the 86 relationships include the following:

Business Impact

BPO Deals	IT Deals
Frees up time to focus on core processes	Frees up time to focus on core processes
Increased accuracy of internal charge backs	System availability
Automation of manual processes	Rapid deployment of new applications
Web-enabled process	Eliminate need to purchase hardware
Scalability for corporate growth	Scalability for corporate growth
Eliminates need to recruit IT staff with particular skills	Eliminates need to recruit IT staff with particular skills
Standardization of services to buyer's external customers	Upgraded system to meet regulatory requirements
Process efficiencies	Process efficiencies
Reduced operating costs from streamlining process and leveraging supplier's economies of scale	Reduced operating costs from streamlining process and leveraging supplier's economies of scale
Centralization of process (moved from multiple locations)	Centralization of process (moved from multiple locations)
Reduced headcount	Asset management
Flexibility in peak periods	Disaster recovery process
Faster time to market	More reliable infrastructure; replaced legacy equipment
Increased accuracy of data	More frequent technology refresh
Increased quality of service	Increased quality of service
Access to supplier's best practices and industry expertise	Access to supplier's best practices and industry expertise
Assures variable resources in case of merger, acquisition or divestiture	Assures variable resources in case of merger, acquisition or divestiture

Examples of the strategic impact accomplished by the award-winning relationships and runner-up finalists include:

Buyer/Supplier	Strategic Impact
<p>Glasgow City Council & Mitel Networks</p> <p>Award: BEST FIRST STEPS IN IT</p>	<ul style="list-style-type: none"> * Because of access to support and maintenance services, teachers can now focus on core business instead of IT. * Gained network and new PCs. * Continual refresh of current software. * Access to new developments in telephony. * Incentive plan ensures improvement in teaching and learning process. * Pilot use of handheld devices. * Access to other vendors and consultants.
<p>Bank of America & Exult</p> <p>Award: BEST FIRST STEPS IN BPO</p>	<ul style="list-style-type: none"> * Focus on core business. * Bank has equity stake in Exult; as a result, Exult will encourage its clients to use the Bank's services.
<p>Sears & GENCO Distribution System</p> <p>Award: MOST INNOVATIVE</p>	<ul style="list-style-type: none"> * Strategic use of logistics infrastructure to recycle and provide asset value and also to comply with regulatory issues regarding discarding certain materials. * Leverage infrastructure to integrate processes and systems for seamless operation among different-named Sears entities.
<p>BP Colombia & Getronics Colombia</p> <p>Award: MOST EFFECTIVE</p>	<ul style="list-style-type: none"> * Increased bandwidth performance. * Incentive plan assures continued annual decrease in costs with no loss of quality in service.

Buyer/Supplier	Strategic Impact
<p>Commonwealth of Pennsylvania & Unisys</p> <p>Award: MOST STRATEGIC</p>	<ul style="list-style-type: none"> * Consolidation of data centers freed up 180 people and capital resources to work on new innovative IT initiatives. * Speed to market and reacting to change. * Speed of hardware/software installation and upgrades is unheard of in government circles. * Smaller agencies now have leading-edge technologies that usually only the larger agencies could afford. * Disaster recovery for mission-critical applications. * Spin-off services for eGovernment initiatives.
<p>Rational Software Corporation & Compaq Computer Corporation</p> <p>Award: MOST IMPROVED PROCESS</p>	<ul style="list-style-type: none"> * Focus on core business. * Globalization capabilities. * Proactive ideas on how to improve process. * Entry into eCommerce with no buyer liability for the site. * I-Query tool to check order status. * Web-based solution for next product release.
<p>Australian Taxation Office & EDS</p> <p>Award: MOST FLEXIBLE</p>	<ul style="list-style-type: none"> * Ability to change telecom services (because market is undergoing enormous competitive adjustments). * Flexibility to accommodate new business requirements because of newly developing tax reform. * Achieves government-mandated objective of developing Australian industry.

Buyer/Supplier	Strategic Impact
<p>BP & Accenture</p> <p>Award: BEST PARTNERSHIP</p>	<ul style="list-style-type: none"> * Catalyst for radical transformation of organization's ability to focus on core. * Flexibility for overnight corporate growth, mergers/acquisitions. * Catalyst to achieve a new corporate culture by bringing in people from other backgrounds and experiences. * Strategy to unbundle upstream and downstream accounting processes. * Reduced risk by using two suppliers. * Risk/reward scheme (annual cost targets). * Gained further economies of scale and price reductions by helping supplier gain new clients. * Agreement for supplier to provide (at no charge) a number of consulting days for innovative planning.
<p>DS Barkley Insurance Management & Results International Systems</p> <p>Award: OUTSTANDING APPLICATIONS OUTSOURCING</p>	<ul style="list-style-type: none"> * Obtained custom application that collects insurance data and generates custom reports from any number of aspects/views/sorting of the data; this program is used to develop or change rates and underwriting criteria. Provides buyer with better data extraction and data availability reporting than 75% of U.S. insurance companies. The program also reduces underwriting risks. • Obtained custom Web-based application that enables independent agents to issue policies in their offices. This program reduced customer service phone calls by 2/3 and reduced cycle time in ability to bill customer, thus increasing revenue and decreasing policy cancellations. Also enables buyer to do business in different time zones.
<p>(runner-up finalist)</p>	<ul style="list-style-type: none"> * Time to market. (Buyer had time

Buyer/Supplier	Strategic Impact
	<p>constraints because of preparation for deregulation and entry into European Union).</p> <ul style="list-style-type: none"> * Consolidation of systems from 13 companies to one. * Integration of processes and applications from 13 companies to one.
(runner-up finalist)	<ul style="list-style-type: none"> * Access to new market (New business model [Internet sales] was not possible without a virtual warehouse). * Allows retailers and vendors to expand their product assortments through the virtual warehouse. * Cross-marketing between TV and Internet sales channels increases customer spend. * Gained upfront awareness in supply chain or logistics problems before customers complain. * Improved level of customer service. * Provides new avenues to promote buyers' (and its clients') merchandise to customers.
(runner-up finalist)	<ul style="list-style-type: none"> * Facilitates addition of benefits options. * Facilitates unbundling of dental and vision plans from medical plan.
(runner-up finalist)	<ul style="list-style-type: none"> * Access to global capabilities (50% of existing business is outside U.S.). * Access to expertise and increased intellectual capabilities.

Summary

Outstanding success in outsourcing occurs when the buyer selects a service provider that ensures the greatest impact on the buyer's business imperatives, when a risk-reward pricing structure is used as an incentive for the service provider, and when the parties determine before contract signing how they will manage the relationship and interact with each other.

"Go beyond making sure your outsourcer is an expert in the business that they are functioning within. Make sure you are dealing with someone who will also have a working relationship that is just as important as the contractual relationship you have on specific services. Then structure your agreement in such a way that the agreement itself drives the desired behaviors. It must encourage the right behaviors from both parties."

Clay Valstead
Director - Reverse Logistics
Sears

For More Information

For information on how Everest Group can assist your organization in achieving success in outsourcing and capturing more value through this business strategy, please contact Marc Liebman, Vice President of Business Development, at mliebman@everestgrp.com or at 972-980-0013.