

Risky Business, High Payoffs

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As markets develop and competitive pressures escalate, outsourcing continues to be businesses' preferred method of reducing costs and accessing specialist expertise. But companies are increasingly moving away from older models, where cost-cutting was often the only driver, where services outsourced were clearly "non-core" and a long-term relationship with a sole supplier was preferred, toward a strategic outsourcing model that is more value-driven, more integrated with the business' main operations and thus more flexible.

Many companies are now quite familiar with outsourcing back-office services to save money, but have been disappointed with a lack of service quality or promised innovation that has failed to materialize. They are now driving harder bargains with their vendors and exploring different ways to ensure that they not only reap cost savings but also increased innovation, quality and business value.

These "next generation" models often involve forming relationships with multiple suppliers, frequently across diverse geographical locations, or forming closer, risk-sharing partnerships with a single supplier. Accordingly, outsourcing is evolving into a strategic tool

for change, with customers outsourcing not only their back-office functions--such as the management of information technology infrastructure and data operations--but also their intellectually based functions such as research, product development, human resources, marketing, accounting and legal services.

A key component of many next-generation outsourcing models involves companies looking to hand over different elements of the service to some of the "best of breed" players in that space, which are usually specialized service providers who can address specific client needs. As a result, outsourcing deals that, at one time, would have been handed off to a major vendor such as IBM or Accenture are now finding their way to a range of providers--including some of the main offshore vendors such as Wipro , TCS and Infosys, which were all started in India.

Two recent multi-vendor deals that highlight the way a deal can be structured are the Kimberly Clark and ABN Amro deals, which both involved global and Indian companies. The first part of the ABN Amro deal, which was worth about \$1.8 billion, went to EDS, a firm known for information technology outsourcing. The second part, of almost a similar size, went to IBM, TCS, Infosys, Accenture and the Indian company Patni. So although IBM got the major piece of the work, TCS and Infosys also got a reasonable share, along with Accenture and Patni. With Kimberly Clark, we saw a slightly different type of outsourcing, where the appointment of specialist providers was key. Cognizant won the applications management part of the deal, Genpact was awarded the finance and accounting piece, TCS the infrastructure services and Accenture the HR outsourcing component.

Both deals are typical because they reveal that businesses are starting to think more strategically about how they slice up their

outsourcing structures. Companies are increasingly looking to break up their existing arrangements to ensure they are getting the right vendor for the right level of service, while simultaneously reducing the risk associated with single provider dependency.

Closer partnering between the corporate headquarters of a business and the outsourcing provider is another feature of these next generation models. The company Xchanging has used an "enterprise partnership" model, which offers a new approach to providing routine business process services that involves the creation of a third business entity that is jointly owned by the customer and service provider. The take-home message is that the next-generation service provider can not only take the customer's services and perform them more cheaply, but can also add value to the customer's main business.

Outsourcing has always been a risky move. These risks are often not properly identified or understood when the decision to outsource is made, or are simply off-loaded onto the service provider without due consideration as to whether this is an appropriate and cost-effective way to allocate risk. Given the greater complexity of these new outsourcing models, these risks grow ever greater--in both frequency and severity, particularly where companies have greater integration with and dependency on the service provider or multiple partners in different countries.

The shift away from major single vendor, long-term outsourcing deals, towards a more segmented, multi-vendor approach--coupled with closer collaboration between the parties--adds new complexities to the arrangement. The multi-vendor structure, for example, may be less attractive than it first appears when faced with the increased costs of due diligence and ongoing management resource commitment. The due diligence and risk assessment

process will routinely involve background research, site visits, management interviews and a range of analysis and investigative work by appropriately qualified auditors.

In addition, such a relationship will need a strong governance structure that is equally respected and supported by all parties. It is common for parties establishing a relationship founded on next-generation principles to spend almost as much time developing a system that will enable the parties to communicate and resolve issues as partners as they will negotiating the specific terms and conditions of the deal itself.

Finally, once the relationship has come to an end, companies will need to ensure that the outsourcing agreement provides a framework for a seamless handover of services to avoid being faced with service continuity issues or a situation in which the company has no choice but to renew the outsourcing agreement at the end of its term.

To be sure, next generation outsourcing offers concrete benefits: enhanced flexibility in responses to market demand fluctuations, closer collaboration and integration of strategy and operations, and shared risk and reward incentives. But the challenges of working so closely with one or more vendors can be extremely demanding, and although the benefits can be significant, so can the management time that needs to be devoted to making it work. Such outsourcing models are not for everyone, and a business should carefully consider the risks of next-generation outsourcing instead of blindly embracing its methods.

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