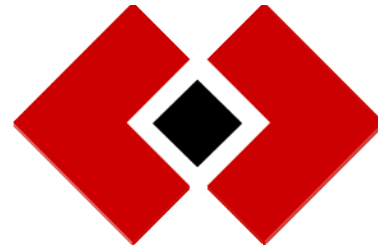
How to Engage in a
Strategic OutSourcing Relationship

A Practicioners Guide



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How to Engage in a Strategic Out-Sourcing Relationship: A Practitioners Guide

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This Guide was conceived and written by members of The Warren Company network of consultants. These individuals, members of the Strategic Sourcing Practice of The Warren Company, would like to acknowledge and thank the following parties for their important contributions: Robert Porter Lynch, founder of The Warren Company, whose ground-breaking work regarding the "*architecture of cooperation*" is the foundation for this Guide; Principal contributors as writers and editors were:

- Les Blumberg, Project Leader
- Brian Monbouquette
- Howard Oliver

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The methodology and opinions expressed in the *Practitioners Guide* are solely those of The Warren Company. Andersen Consulting and G2R specifically take no responsibility for application of the ideas and recommended actions included in this Guide, other than those specifically attributed therein to G2R.

Please contact Robert Porter Lynch at 401-640-1166 or RobertLynch@warrenco.com with any questions regarding these matters, or to obtain assistance with a strategic sourcing relationship. The Warren Company is a consulting organization that specializes in the development, management and revitalization of strategic alliances, joint ventures and other collaborative relationships, including strategic sourcing arrangements. Through our network of consultants in the United States and Canada, we apply a variety of proprietary processes to help increase the success of collaborative ventures. Our professionals provide consulting, training, benchmarking and best practices research, negotiations coaching, and diagnostic assessments to both large multinational and middle market companies.

The Principles, Processes, and Practices in this Practicioners Guide have been used extensively in companies such as Cisco Systems, Eli Lilly, Procter & Gamble, and Dupont, among numerous others to produce extraordinary results, streams of innovation, new products, and increased revenues.

We sincerely hope you will experience similar results.

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Introduction

In business today, one fact has become clear: The ability to forge, manage and sustain strategic sourcing relationships is increasingly critical to competitive success.

Such relationships, however, are often handled in an ad hoc, trial-and-error manner. The Warren Company believes that companies can, and must, take a more planned approach.

As a result, The Warren Company has drawn on its research and experience to develop a Strategic Sourcing Architecture--a systematic set of practices and frameworks for creating strategic outsourcing arrangements. This architecture, or process, is designed to help companies forge relationships that will not only cut costs, but also allow them to join forces with a strategic sourcing partner in order to find broader, breakthrough benefits in terms of revenue growth, market-share gains and customer service improvements--in short, to become a more powerful competitor.

This guide is intended to help senior executives understand and use this process to establish strategic outsourcing arrangements for their organizations. The first chapter explores strategic sourcing concepts; it is followed by six chapters, each of which explores one of the six phases of the strategic sourcing process:

- Strategy
- Analytics and Selection
- Co-Creation
- Operational Planning
- Structuring
- Management

In each of these six chapters, you will find a discussion of action steps associated with the phase being discussed, and a number of charts, tips and checklists designed to provide more detailed help and guidance in shaping a relationship.

Finally, an appendix provided by the research firm G2R provides examples of how various outsourcing arrangements might be measured.

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The precise nature of the strategic sourcing process will vary depending on the companies and business processes involved. The guide is intended to be a starting point, and to provide insight that can help executives find their way forward. Ultimately, the guide is designed to help make the building of strategic relationships more than a stand-alone or one-time effort. It is designed to provide executives with concepts and a common language that can help them embed strategic sourcing into corporate strategies and plans, and develop a set of relationship-building skills that will give the organization a powerful competitive weapon.

About The Warren Company

The Warren Company is a consulting organization that specializes in the development, management and revitalization of strategic alliances, joint ventures and other collaborative relationships, including strategic sourcing arrangements. Through our network of consultants in the United States and Canada, we apply a variety of proprietary processes to help increase the success of collaborative ventures. Our professionals provide consulting, training, benchmarking and best practices research, facilitation of the development process, and diagnostic assessments to both large multinational and middle-market companies.

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Chapter One Strategic Sourcing Concepts

Outsourcing has been a part of corporate life for decades--but today, we are seeing a fundamental shift in the way outsourcing is used.

The Warren Company's research shows that for many organizations, outsourcing is becoming an increasingly strategic tool. These organizations are beginning to look outside for more than cost cutting and basic efficiency. They are looking to tap into the core competencies of partners not only to reduce costs, but also to:

- Enhance an organization's focus on core competencies and key differentiators.
- Share risk and reduce the need for capital investment.
- Provide access to a sourcing partner's high-caliber skills, tools and competencies in a given process.
- Enhance corporate flexibility, responsiveness and speed.
- Support corporate regeneration.

As companies embrace the strategic use of outsourcing--or strategic sourcing--they are finding that it calls for a new kind of relationship between the corporation and its outsourcer. Unlike traditional outsourcing arrangements, which tend to limit their focus to increased efficiency in the outsourced process, strategic sourcing arrangements rely on the resources of both partners to drive improvements in quality, speed and innovation that generate *enterprisewide* benefits. As a result, strategic sourcing requires non-adversarial, collaborative relationships that are focused on long-term goals. Increasingly, strategic sourcing relationships also involve multiple organizations. When the business process in question is both large and critical, and therefore demands a deep well of resources, this multiple-partner approach allows several sourcing partners to pool their resources and expertise.

Strategic sourcing vs. outsourcing

The Warren Company defines *outsourcing* and *strategic outsourcing* as follows:

- *Outsourcing*--the contracting of a business process or processes to an external organization for operation and management of these activities. Outsourcing also encompasses the transfer of assets and employees to the outsourcing provider.

- *Strategic OutSourcing*--a tightly coordinated outsourcing arrangement with an external supplier for the operation and management of either core/critical or non-core business processes. The goal of such arrangements is not only increased efficiency, but also broader, breakthrough gains in terms of revenue, market-share, innovation and customer service.

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Differences in transactional and strategic outsourcing

Strategic sourcing differs from traditional, transaction-based outsourcing in several dimensions.

Transactional Outsourcing	Strategic Sourcing
Non-core functions only	All functions can be considered
Fix immediate problem	Position for the future
Cost reduction	Profit improvement
Asset elimination	Co-governance in key strategic areas
Contractual relationship	Enhanced relationship without over-reliance on contracts
No vested interest in each other's success	Incentive systems require co-investment, productivity improvement, innovation, and profit sharing

The Warren Company's research shows that there is in fact a broad spectrum of sourcing relationships emerging in business today. These range from the traditional vendor-supplier relationship to increasingly strategic arrangements, such as alliances and joint ventures. We plot this range of relationships on a "strategic sourcing spectrum" in five stages:

- *Stage 1: Independent Vendor.* This relationship is characterized by clearly defined contractual activities being performed for a fee. This is usually a tactical arrangement: The choice of vendors is based primarily on price, and the organization typically hopes to reduce costs or relieve management of a distraction that is necessary but that adds little value to the organization.

- *Stage 2: Teaming.* An organization and its outsourcer begin to collaborate and integrate their activities in some areas. The organization continues to maintain sole responsibility for strategic control over the activities in question, but relies more heavily on the provider's resources.

- *Stage 3: Strategic Partnering.* The two organizations work toward common goals. Their activities are integrated to a high degree, and they share risks and rewards. The reasons for selecting a vendor shift from an emphasis on price to an emphasis on achieving broader value, such as speed, quality and innovation.

- *Stage 4: Entrepreneurial Networking.* This relationship features a high degree of shared planning and operational integration, with the two organizations sharing each other's core functions as they reengineer the value chain.

- *Stage 5: Entrepreneurial Venturing/Hybrid Spin-off.* These arrangements create hybrid alliances that combine the different capabilities of two organizations to create new capabilities and market new products and services. The two organizations function as equals, rather than as superior and subordinate. While they are bound by legal contracts, it is a shared vision, strategy and sense of trust that actually govern the relationship. Often, these relationships lead to the formation of a spin-off organization.

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As sourcing arrangements move up this spectrum, the goals and benefits become increasingly strategic, encompassing such areas as improved customer service and the reengineering of the value chain. These more collaborative forms of outsourcing are in essence strategic alliances; they involve sharing and integrating competencies with a sourcing partner.

At the far end of this evolutionary spectrum, the relationships between companies become so strategic and close that an essentially new kind of organization is created--the Networked Enterprise. This type of company uses strategic sourcing to "mix and match" the capabilities of several partners in order to enter new markets with tremendous speed--and therefore promises to be an increasingly powerful force in business.

Although higher-level relationships tend to bring greater benefits, a company should not necessarily evolve *all* its outsourcing relationships to the higher levels of the Strategic Sourcing Spectrum. The relationship that's most appropriate depends on the types of benefits the organization is seeking. Thus, for companies wanting to simply cut costs, the basic vendor relationship may be the best fit. On the other hand, if a company wants to improve customer service or reengineer the value chain, the higher-stage relationships are probably most appropriate. However, even if a company sets out to develop a basic vendor relationship, The Warren Company recommends that senior managers begin by giving serious consideration to the higher-level relationships. Often, such an examination will reveal that a seemingly basic relationship can be transformed into a more strategic arrangement that can take the organization beyond cost cutting, and open the door to growth in revenue and market share.

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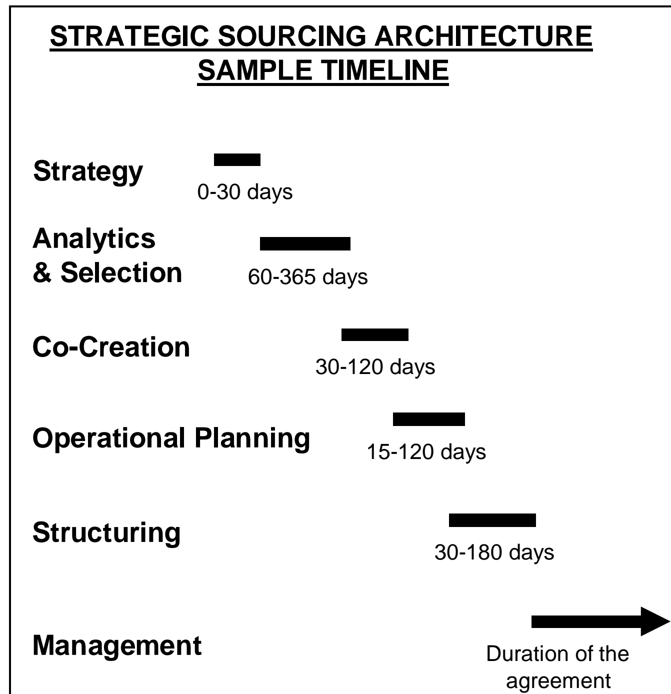

A process for developing strategic sourcing relationships

To help organizations take a planned, methodical approach to developing strategic sourcing relationships, The Warren Company has developed a Strategic Sourcing Architecture - essentially, a six-phase process that proceeds from the creation of an outsourcing strategy through the ongoing management of the strategic sourcing relationship. These phases are:

- Strategy
- Analytics & Selection
- Co-Creation
- Operational Planning
- Structuring & Governance
- Management & Innovation

These phases are not necessarily performed in a linear sequence, and every portion of every phase may not be required in some relationships. However, all the phases should be at least considered in order to determine whether they apply to an organization's specific situation.

This process - the subject of this guide - replaces traditional, hard-edged negotiation with an iterative, mutual exploration of corporate strategy and capabilities. It ensures that both the client and the outsourcing provider have the internal structures and skills needed to work together - and it lays the groundwork for a successful long-term relationship in which both parties can share goals and contribute to innovation and growth.

Before initiating this relationship-building process, executives must make a preliminary assessment of the potential value that strategic sourcing relationships hold for their organization. That is, executives should ask fundamental questions such as those posed by authors James Brian Quinn and Frederick G. Hilmer in their *Sloan Management Review* (Summer 1994) article, "Strategic Sourcing":

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- What's the potential for obtaining competitive advantage in this activity, taking account of transaction costs?
- What is the potential vulnerability that could arise from market failure if the activity is outsourced?
- What can we do to alleviate our vulnerability by structuring arrangements with suppliers to provide appropriate controls, yet provide for necessary flexibility in demand?

If the preliminary assessment process leads to a decision to proceed with the strategic sourcing process, two success factors are critical from the outset:

1. Assembling the right teams at the right time.
2. Focusing on the right performance measures.

Assembling the right teams

Senior management begins by selecting a champion--an executive who is charged with making the strategic relationship take shape and become a reality.

The champion builds a cross-functional/multidisciplinary core alliance development team that will execute the relationship-building process--analyzing needs and potential partners and ultimately creating an operational team that will oversee the sourcing relationship over the long term. As the process proceeds, the core alliance development team grows and draws on the expertise of people from throughout the organization to create sub-teams to handle specific tasks.

The nature of the core team and sub-teams varies as the organization moves through the six phases of the strategic sourcing process; the precise makeup of the team depends on the task at hand at any given time, on the nature of the business process being considered for outsourcing and on the organization’s specific structure and needs.

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The various teams involved in the strategic sourcing process are essentially temporary. They are assembled to perform specific tasks and then dissolved when the tasks are complete (with the exception of the operational team, which is created to manage the outsourced process on an ongoing basis). As a result, executives must ensure that team members are familiar with the strategic sourcing concepts and processes and have enough time to devote to the effort. Typically, that means relieving individuals of some of their normal workload so that they can focus on the sourcing process.

Team roles and definitions

Strategy Phase

The Strategy team is an executive-level group that concerns itself with corporate strategic sourcing questions. This team is responsible for appointing a champion for the strategic sourcing arrangement, assembling a core alliance development team, and providing strategic sourcing input into the overall corporate plan.

The Strategy team handles six action steps:

1. Identify the process(es) to be considered for outsourcing.
2. Tentatively determine which type of sourcing relationship is appropriate.
3. Assess organizational readiness.
4. Develop and document a preliminary *Outsourcing Mission, Strategy and Goals* (OMSAG) statement.
5. Identify and train champions and the core alliance development team.
6. Reach a team consensus on and gain management approval of the final OMSAG statement and outsourcing development plan.

Analytics and Selection Phase

This team identifies, screens and initiates contact with prospective sourcing providers. Team members should be individuals who have excellent business skills and an understanding of the corporate strategic plan, who are knowledgeable in the business process that is to be outsourced and who can evaluate the financial health, technical capabilities and operational skills of the potential partners.

The team essentially establishes the boundaries of the proposed agreement that will be the basis for later Co-Creation and Structuring meetings between the organizations.

The Analytics and Selection team handles 11 action steps:

1. Outline tentative performance goals for the business process that is to be outsourced.
2. Establish preliminary requirements and measures.
3. Gather internal and external benchmarking data.
4. Develop a summary of specific performance objectives, operating requirements and measurement criteria to be used in the outsourced process.
5. Develop an ideal-partner profile.
6. Create an initial list of candidates.
7. Establish and communicate the partner-selection procedure.
8. Check the references of candidates.
9. Conduct interviews with candidates.
10. Perform due diligence.
11. Pick the provider(s).

Co-Creation Phase
The Co-Creation team - a small, focused group formed at the beginning of the Co-Creation phase - works closely with the sourcing provider to develop a memorandum of understanding that describes the broad goals and nature of the relationship.

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Because this effort requires excellent communication and business skills, the members need to be experienced professionals. They also should have demonstrated skills in the business process that is to be outsourced and have been involved previously in other alliance or strategic sourcing relationships.

The Co-Creation team handles three action steps:

1. Plan the Co-Creation approach.
2. Conduct joint exploration and design of the venture.
3. Create a memorandum of understanding.

Operational Planning Phase

In the Operational Planning phase, the partner organizations develop detailed plans for implementing and maintaining the outsourced business process. The core alliance development team creates an operational team, drawing on people with the functional expertise needed to complement the vendor's capabilities and strengths. This operational team creates an operational plan describing how the services outlined in the memorandum of understanding will be provided. Some members of the operational team then remain in place during the launch and ongoing operation of the outsourced process in order to provide the in-house expertise needed to manage the relationship over time.

The Operational Planning team handles two action steps:

1. Create an operational plan.
2. Develop an operational launch plan.

Structuring & Governance Phase

In the Structuring phase, the legal and organizational frameworks of the upcoming relationship are created - frameworks that allow both parties to share fairly in risks and rewards. Therefore, in this phase the alliance team should include individuals with financial, administrative and legal expertise, as well as people with communication skills and the relationship-building and management experience needed to create a win-win arrangement.

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The team must also involve senior managers, such as the alliance manager and the champion, to ensure a focus on strategic goals and collaboration in developing a contract.

The Structuring & Governance team handles eight action steps:

1. Prepare an organizational structure chart.

2. Prepare a summary of the governance structure and control mechanisms.

3. Agree on performance objectives and operating measures.

4. Agree on financial, legal and ownership matters.

5. Evaluate all structural elements for balance and a win-win approach.

6. Draft the contract.

7. Obtain final senior management approvals.

8. Sign the contract.

Management & Innovation Phase

The Management & Innovation phase encompasses the implementation of the plans created in the Operational Phase. In this phase, all parties work to ensure a smooth transition to the new outsourcing arrangement, and to ensure that the relationship continues to grow and evolve in order to provide benefits as the business environment changes.

The members of the operational team with ongoing responsibility for managing the relationship work with a joint governance board to ensure that issues are handled in a timely manner. Therefore, this team must have a clear understanding of the business process in question and of the nature and expected benefits of the relationship.

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At the same time, team members should have strong communication and problem-solving skills that will allow the partner organizations to work together to find new approaches and breakthroughs beyond those spelled out in the original agreement.

Who's on the team?

The following table shows which executives and functional areas are involved in the core team and various sub-teams in each of the six phases of the strategic sourcing process.

Phase	Core Alliance Development Team Members	Members as Required
Strategy	CEO/Executive VP VP Business Development VP Finance VP Human Resources VP Administration	Chief Information Officer Chief Technologist Staff Support
Analytics and Selection	Champion/Initiator Business Analyst Marketing Human Resources Contract Management	Technical Legal Manufacturing Business Process Analyst IT Operational Management
Co-Creation	Champion Alliance Manager Operational Support Marketing Human Resources	Legal Procurement Administration Manufacturing Technical
Operational Planning	Business Process Experts Human Resources Alliance Manager	Administration Logistics Technical Support Service Support

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Phase	Core Alliance Development Team Members	Members as Required
Structuring & Governance	Champion Alliance Manager Legal/Contract Management Administration	Finance Marketing Technical
Management & Innovation	Alliance Manager Operational Functions Administration	Human Resources Technical Legal

Continuity of the team is critical; excessive turnover - especially in key management positions - will slow progress and even prevent the success of the relationship. Finally, the team should include, or at least have access to, senior executives, so that the partner organizations can move swiftly to solve problems and exploit new opportunities.

The Management/Operational team handles nine action steps:

1. Hold initial implementation meeting.
2. Maintain continuity of personnel.
3. Monitor performance.
4. Exploit short-term opportunities.
5. Review service levels.
6. Resolve problems.
7. Maintain top-management support.
8. Maintain motivation of alliance managers.
9. Renew the alliance.

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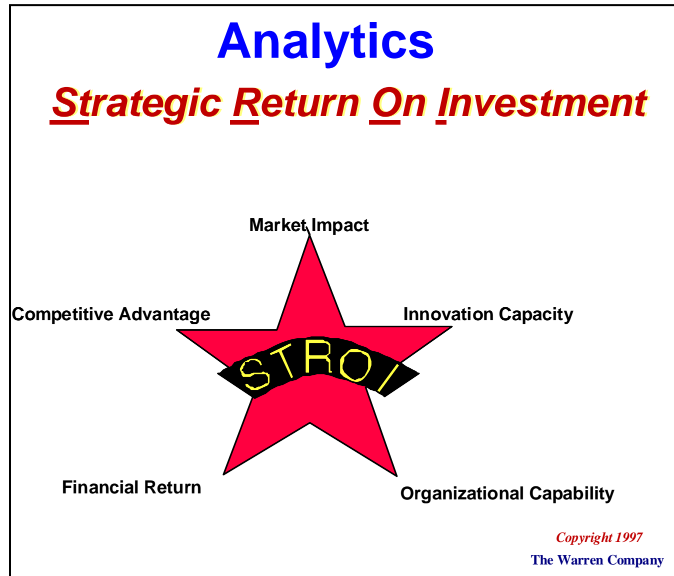

Measurement plays an important role the Strategic Sourcing Architecture. It is the key to accurately setting goals and then tracking progress toward those goals. The Warren Company uses a proprietary set of measurements, called Strategic Return On Investment (STROI). STROI takes a broad view of operations that extends beyond traditional financial indicators; it encompasses a range of business results in five categories:

Market impact

- Penetration into new market niches
- Expansion of market share
- Broadening of product line
- Access to best lines of distribution
- Faster response to customer needs
- Increased customer satisfaction
- Greater sales-closing rate and shorter sales-cycle time
- Development of strong brand recognition

Organizational capability

- Higher productivity and shorter product-development cycles
- Lower absenteeism
- Broadened and deeper knowledge
- Capacity to convert ideas into new product
- Faster and more accurate decision making
- Higher levels of cooperation and synergy between business units
- Increased teamwork
- Improved service delivery capacity

Innovation capacity

- New and broader technical capacity
- Better manufacturing processes
- Financial innovations (e.g., new financial tools or mechanisms)
- New product innovations and continuous improvement
- Integration of systems

Competitive advantage

- Becoming "best-in-class" competitor
- Creation of new barriers to entry and exit
- Positioned as highest-quality, lowest-cost producer
- Enlargement of market to maximize production efficiencies

Financial return

- Decrease in overhead costs
- Improved return on sales, equity or assets
- Lowered production costs
- Increased gross profit margins
- Decreased marketing costs on a per-unit basis
- Matching and improving industry cost and price structure
- Prevention of ruinous or cutthroat competition

Considering this broad range of measures will help you understand what to expect from the outsourced process and what to look for in a partner, and better gauge the benefits that the relationship is creating.

Ultimately, by understanding and using these measures and the other techniques that make up the Strategic Sourcing Architecture, executives can help their organizations build long-lasting, effective relationships that will enhance competitiveness for years to come.

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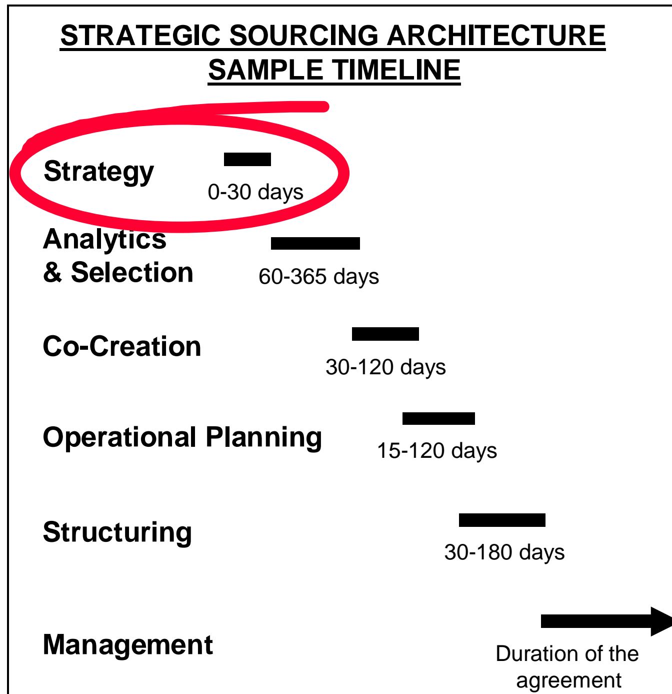
Chapter Two Strategy



The Strategy phase involves identifying sourcing opportunities and determining the type of sourcing relationship that best fits those opportunities. The phase begins once senior management has authorized an executive, or a strategic sourcing practitioner, to conduct a full evaluation of strategic sourcing opportunities in a given function or process.

An outsourcing strategy should be an outgrowth of your company's overall strategic plan and should be directly aligned with the company's directions and goals. It is important that the managers who are responsible for implementing the outsourcing plan have a clear understanding of that overall strategy, and outsourcing's place in it. Just as important, those managers should play an integral role in shaping the implementation plan for outsourcing.

In the early steps of this phase, work is done by a small group of executives. Within a short time, however, this group appoints a champion for the strategic sourcing arrangement, and assembles an alliance-building team that develops - and "buys into" - the strategic sourcing strategy.

The action steps of the Strategy phase are:

1. Identify the process(es) to be considered for outsourcing.
2. Tentatively determine which type of sourcing relationship is appropriate.
3. Assess organizational readiness.
4. Develop and document a preliminary *Outsourcing Mission, Strategy and Goals* (OMSAG) statement.
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Strategy

ACTION STEPS

1. Identify the process(es) to be considered for outsourcing.

Traditionally, outsourcing decisions have focused on questions of "core" versus "non-core" processes, with the latter being candidates for outsourcing. But we believe that model to be too simplistic, and recommend taking a broad view of which processes might be outsourced. Indeed, The Warren Company's research has found many companies that have successfully outsourced activities vital to the operation of their core functions.

For example, Barnett Bank outsourced its credit-card processing to Household Credit Services. Credit cards are a high-growth business for Barnett and one in which Barnett's distribution channels and marketing savvy are strong. But state-of-the-art technology and competitive prices are also critical, and Barnett now has access to those capabilities through the sourcing alliance with Household, the sixth-largest credit-card processor in the United States. Similarly, telecommunications giant GTE has outsourced a major portion of its international telemarketing to SITEL Corporation. Both companies recognize the importance of those functions to GTE's revenue growth and customer satisfaction, and they have established closely aligned operations.

We believe that in addition to the more traditional core and non-core distinctions, companies should consider two emerging types of relationships:

- "Sharing core," in which a company conducts activities that are vital to the operation of its core processes in a highly integrated relationship with an outsourcing partner.
- "Expanded core," which involves the creation of new competencies and capabilities through a partnership or joint venture.

These types of relationships almost always require tightly integrated operations and a truly strategic, long-term partnership between the companies involved. Often, companies have concerns about protecting and maintaining their core competencies in such arrangements.

Do your homework

Before deciding which processes to outsource, develop a thorough understanding of your own strengths and weaknesses. For example, be sure to:

- *Identify core competencies and evaluate the potential for enhancement.* Every business needs to identify its core competencies in order to clarify how it can bring added value to the marketplace. Opportunities to expand or share core competencies through outsourcing should be an integral part of the strategic planning process.
- *Identify non-core functions and evaluate the potential for enhancement.* It is important to identify the support activities that can be outsourced in order to reap the traditional benefits of cost control and the ability to re-focus management energy on competitive, rather than internal, issues. But these processes should be viewed with a more strategic eye, as well. For example, could a more collaborative relationship lead to operational or cultural transformation, new capabilities or enhanced organizational learning?
- *Be clear about which functions are truly strategic.* A process or activity may be business critical, but not strategic--that is, it may be important but not something that differentiates your company from its competitors. Such business-critical processes may be the best candidates for highly collaborative outsourcing. Strategic functions can also be outsourced, but doing so naturally increases the importance of trust and confidentiality.

That is an important issue, but remember that a number of legal protections are available to minimize such vulnerability, including patents, copyrights, and nondisclosure and non-compete agreements. Such formal documents are only part of the solution, however. Our studies show that fears about loss of control are most effectively overcome by developing a sourcing relationship based on trust, mutual benefit and the clear alignment of interests.

What to outsource

The chart below shows the business processes that are typically outsourced today. Most of these processes are non-core functions and represent the traditional base of outsourcing activity. Some, however, are more strategic, reflecting the growing variety of outsourcing arrangements.

Finance and Administration	Operations	Sales and Marketing
Administration	**Manufacturing**	**Sales**
Internal Audit	Contract Manufacturing	Inbound call center
Tax compliance and planning	Quality control/testing	Outbound call center
Payroll	R&D/product development	Sales-force support
Claims Administration	Materials management	Telesales
Asset management		
Shareholder service		
Finance	**Logistics Management**	**Marketing**
Customer Billing	Distribution	Telemarketing
Collections and cash applications	Inventory control	Database marketing and mining
Accounts payable	Warehouse management	Market/Customer analysis
Travel and expenses	Fleet management	
Payroll accounting		
Cost and inventory accounting		

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Finance and Administration	Operations	Sales and Marketing
Finance (cont.)	**Customer Care**	
Fixed asset and capital	Customer service	
Accounting	Operator service	
Cash management	Inbound call center	
Purchasing		
Human Resources	**Payment Services**	
Benefit/Claims administration	ATM transactions	
Compensation	Credit-card processing	
Regulatory compliance	Credit authorization	
Expatriate administration	Electronic benefits transfer	
Employee financial planning		

2. Tentatively determine which type of relationship is appropriate.

In this step, executives determine how closely integrated the operations of the two companies should be - that is, the type of relationship they want to develop in terms of the Sourcing Spectrum.

It is important to remember that there is no standard "right" or "wrong" relationship in this spectrum. The type of relationship that your company decides to pursue should be based on the goals it hopes to reach. If, for example, executives are looking only for ways to cut costs or fix an immediate problem in a non-core area, a traditional vendor relationship is probably most appropriate. However, if they are targeting a new market or reengineering customer service, the more strategic, integrated relationships, such as those in Stage 3 or Stage 4 on the Spectrum, will be in order.

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What kind of relationship?

Outsourcing relationships can and do vary widely. Which type is right for your company depends on your motives for outsourcing. The chart below shows how various motives relate to the types of relationships described in the Strategic Sourcing Spectrum.

Major Stage Differentiators

	Transaction-Based		Relationship-Based		
	Stage 1: Transaction Oriented Outsourcing	**Stage 2: Co-sourcing Partner Relationships**	**Stage 3: Strategic Sourcing Strategic Relationships**	**Stage 4: Value-Chain Networking Shared Asset Relationships**	**Stage 5: Entrepreneurial Venturing/ Hybrid Spin-off relationships**
Motive for Outsourcing	Fix immediate problem	Leverage resources, technology	Positioning vehicle for the future	Co-creating future value, focus on asset influence/ pooling	Capture of specific breakthrough bypass business opportunity
Provider Selection	Vendor procurement based	Negotiated partner selection	Strategic Alliance Architecture–based	Strategic Alliance Architecture–based	Strategic Alliance Architecture–based
Measures	Better, cheaper, faster	Productivity Leverage Best-in-class Value-added projects	STROI/ balanced measures System Integration Trust measures	STROI/balanced measures System Integration Trust measures	STROI/ balanced measures System Integration Trust measures
Strategic Orientation	Short-term	Medium- to long-term	Long-term	Long-term, open ended	Long-term, open-ended
Structure	Transactional	Hybrid of transactional/ relational	Relational	Completely relationship based	Primarily relational leading to stand-alone entity

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	Transaction-Based		Relationship-Based		
	Stage 1: Transaction Oriented Outsourcing	**Stage 2: Co-sourcing Partner Relationships**	**Stage 3: Strategic Sourcing Strategic Relationships**	**Stage 4: Value-Chain Networking Shared Asset Relationships**	**Stage 5: Entrepreneurial Venturing/ Hybrid Spin-off relationships**
Pricing Framework	Low-bidder	Cost-cognizant but not dominant Sometimes shared risk/reward	Win-win, shared risk/reward	Win-win, shared risk/reward	Win-win, shared risk/reward
Strategic Planning	Little or none	Significant resources for decision	Extensive planning and due diligence	Intimately linked to corporate vision	Driven from distinct new venture plan
Formal Control	High	Low level collaborative mechanisms	Based on shared outcomes/ objectives	Control exercised through collaboration	Medium to low
Integration Level	Very little or none	Loose integration	Very substantial	Very high	Very high
Trust	Low	Based on partnering	High levels of mutual trust	Highest degree of mutual trust based on performance	Highest degree of mutual trust based on performance Joint expansion of opportunity

Although this handbook is focused on strategic sourcing relationships, there's no doubt that traditional vendor-style outsourcing arrangements are here to stay. The costs in terms of analytical effort and relationship building simply will not be justified for certain low-value-added processes. The key is to make sure that you do not *automatically* move to a traditional arrangement, and thereby miss opportunities or underestimate the potential of the more collaborative types of relationships.

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Regardless of the type of relationship selected, we believe that it is important to see each arrangement as part of a portfolio of relationships that contribute to the development of the "extended enterprise." That is, each relationship should be a step on the road to building a collection of collaborative relationships that allows your company to exploit market opportunities that it couldn't address on its own.

At this point in the relationship-building process, companies should also begin to consider how many partners the sourcing arrangement will involve. (The final determination is not made until the next phase, Analytics and Selection.) When the business process in question is both large and critical, and therefore demands a deep well of resources, executives may want to consider working with several sourcing partners that can pool their resources and expertise.

This kind of approach is increasingly common. In some cases, companies using two vendors try to maintain a degree of competitiveness in the arrangement by giving each vendor a portion of the work, with the remainder being left open for either vendor. For example, two vendors might be given 40% of the work each, leaving the remaining 20% to be shifted annually to the vendor who has shown the greatest cost and productivity improvements. This "competing vendor" approach keeps the participants on their toes, but it has its limitations: The vendors are not truly working together in the best interest of the company, and their focus is on cost - on "beating the other guy" - rather than on transformation or innovation. In addition, this kind of arrangement steers the competing organizations away from the sharing of best practices.

Another trend is to split a process in order to give each portion to the vendor with the most appropriate skills. For example, one member of an alliance may provide you with application-development expertise, while another member might be responsible for ongoing systems support. This emphasis on tightly aligned, complementary services allows you to use the core competencies of two or more specialized organizations, and it creates a situation in which the two vendor organizations cooperate, yet implicitly "keep an eye on each other."

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Generally, these kinds of arrangements require more effort in terms of making sure the various partners are in alignment and that the overall arrangement is managed well on an ongoing basis.

3. Assess organizational readiness.

Although a lot of attention is typically given to a potential sourcing partner's capabilities, it is important to understand your own organization's suitability as a partner. Organizational readiness has a number of components, including:

- ***The ability to build relationships.*** It is vital that your organization has a process for architecting successful relationships, such as the process described in this guide. Your company also must have the organizational ability to use that process - meaning that the managers responsible for implementing a new outsourcing relationship must understand the key factors for success in an alliance. Look for people who have experience in managing outsourcing and strategic sourcing relationships, especially those who understand the spectrum of relationships that are possible and best practices for implementing a strong strategic sourcing relationship.

- ***Management support.*** Top-rank support for an expansive investigation of outsourcing's potential is crucial. Senior managers need to set clear strategic direction, but they also need to provide a supportive atmosphere that encourages innovation and allays fears about trying new approaches. Don't begin an outsourcing evaluation without support from the top.

- ***A plan for overcoming roadblocks.*** An effort to outsource often will run into cynics, skeptics and protectors of "turf." It is critical to identify and understand such internal political and cultural resistance early in the process, and to quickly design plans for overcoming it.

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Characteristics of a well-structured alliance

- ❑ **Strategic synergy.** Can the two (or more) organizations together achieve a high level of benefits?
- ❑ **Growth opportunity.** Can the relationship--and its benefits--be expanded?
- ❑ **Less risk.** Does the relationship reduce the level of risk for your organization?
- ❑ **Excellent chemistry.** Is there a good "fit" between your organization and the provider(s) organization?
- ❑ **Clarity of purpose.** Are the goals and benefits explicit and clear?
- ❑ **Win-win.** Does each party benefit fairly from the relationship?

4. Develop and document a preliminary Outsourcing Mission, Strategy and Goals (OMSAG) statement.

An Outsourcing Mission, Strategy and Goals (OMSAG) statement is a document that sums up the organization's outsourcing intentions and the strategic rationale for outsourcing. The OMSAG statement should describe the:

- Processes to be outsourced and the broad objectives for outsourcing.
- Relationship of outsourcing to the overall corporate strategy.
- Links between the outsourced process and your company's core competencies.
- Strategic forces that are driving your organization into a relationship.
- Expected positioning of the relationship on the Strategic Sourcing Spectrum.
- Scope of coverage (international, across business lines and so forth).
- Critical risks involved.
- Expected duration of the relationship.

The OMSAG statement should include a value proposition that focuses on the expected value that the outsourcing arrangement will bring to the customers of the process - both internal and external.

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This proposition is at the heart of the OMSAG, because its helps executives understand why they want to outsource the process in question, and because it helps executives understand why they want to outsource the process in question, and because it helps ensure that the outsourcer will remain focused on giving the organization what it needs.

The value proposition

In drawing up a value proposition:

- Consider how specific target customers (internal or external) are affected - how the relationship's product or service makes the customer more:
  - Successful?
  - Profitable?
  - Competitive?
  - Efficient?
  - Effective?
  - Productive
  - Satisfied?
- Seek validation from target customers.
- Describe explicit, quantified benefits.
- Fix the date when measurable success is expected.
- Assess the feasibility of reaching goals.
- Consider the advantage of an alliance versus other approaches.
- Strive for simplicity and elegance. For example, a value proposition might state that "by FY2003, the sourcing alliance will reduce the cost of our travel by 35%, increase productivity of our personnel on travel assignments by 15%, and establish a performance-metrics system that allows us to measure both of these goals."

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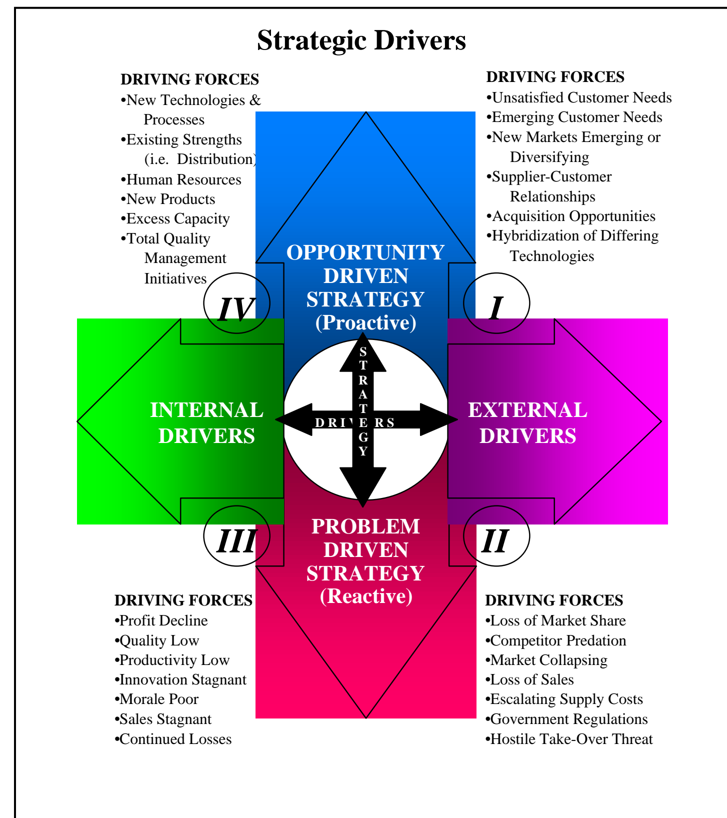
Understand the driving forces

"Driving forces" put pressure on strategic sourcing partners to come together and stay together. An understanding of these forces will help you create a relationship that will endure over time.

When determining whether it makes sense to establish an alliance, examine the driving forces for both companies. Are they sufficient to hold the structure together? What is the expected duration of these forces? Are you aware of the forces that affect your prospective ally? Is that organization aware of the forces affecting you? Are these forces truly strategic, or are they more tactical and operational? The forces can be many, or they can be few. In a successful relationship, they are powerful, strategic and relatively permanent.



- **Quadrant I: Customer Drivers.** These are typically *opportunities* that exist externally, such as new customer demands and emerging markets. Sometimes these opportunities are highly visible and recognized by the customer, but often the customer does not even have knowledge of the opportunity, especially if it is a new technology, product or service that can emerge from the supplier's capacity to innovate.
- **Quadrant II: Competitive Drivers.** These are often *threats* to a company, such as markets collapsing and new predatory competitors. The presence of a strong competitor is often a good motivating force because it provides a *threat* if it is better than your company's alliance, and it provides a *benchmark* for excellence.

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- **Quadrant III: Capability and Capacity Drivers.** No company has all the resources and capabilities to accomplish anything and everything. The lack of capability or capacity is always a fundamental driving force behind an alliance, because it is a combination of *strengths* and *weaknesses* that propels an alliance. However, beware of weaknesses that may eventually undermine the venture--particularly situations in which the prospective ally is looking for someone to *offset its incompetence*, not simply supply what's missing.
- **Quadrant IV: Core Competencies.** The best alliance partners, whether large or small companies, have a set of core competencies that add significantly to the competitive advantage of the alliance. Both companies should have core competencies to contribute, and together, the two companies' strengths should enable innovation, spark customer excitement and sustain competitive advantage. Keep in mind that these core competencies must be distinct and complementary for the alliance to realize its full potential. Such core competencies are seldom found on a company's balance sheet: Be sure that the alliance includes access to the partner's key personnel, and that a means of leveraging the organization's abilities is established.

Selecting a champion

In designating a sourcing relationship champion, look for an individual who:

- Believes intensely in the future of the alliance.
- Has the unequivocal confidence of and access to the top management of your organization and that of the sourcing provider(s).
- Has a vision for the future of the alliance.
- Has clear access to and the confidence of your CEO.

5. Identify and train champions and the core alliance development team.

Without an internal "champion," strategic sourcing relationships rarely succeed. The champion - usually a well-regarded executive - should play the role of coach and supporter to both your company and the sourcing candidate(s). Incentives should encourage the champion to share information, smooth difficulties and ensure that the strategic sourcing option is presented in its best light. The role of the champion is not the same as that of the "sponsor" of the sourcing relationship. The sponsor's role is to make the *right* decision; the sponsor should be incented equally to decide "for" or "against" moving forward with strategic sourcing.

Create a core alliance development team to handle the strategic sourcing process and create the strategic sourcing relationship. Don't make the mistake of handing the relationship-building process to your corporate development staff in an effort to keep the process "objective"; doing so may only shift the focus to costs and traditional vendor-style relationships, and cause you to miss the opportunities for innovation and breakthroughs that strategic sourcing can bring.

In addition to the champion, the core alliance development team should include representatives from relevant functions. For example, if the team is exploring the possibility of having another company manufacture a product for your company, the team should have members with expertise in technology, marketing, manufacturing and procurement. (See "Team roles and definitions" in Chapter 1).

To foster communication, create a list of team members that includes information about their organizations, titles, phone numbers and e-mail addresses. This should be distributed to all parties interested in the potential relationship.

Finally, if necessary, team members should be given training in strategic sourcing development skills and in team building. All team members should be familiar with and embrace the fundamentals of successful collaboration. In particular, they should understand the processes and behaviors, such as those outlined in this guide, that will help ensure the development of a successful sourcing relationship. And be sure that you've obtained buy-in from the team regarding the approach to be employed - some may not be familiar with the concepts or techniques of building strategic business relationships.

The role of the core alliance development team

The core alliance development team, which is established in the Strategy phase, plays a leading role throughout the alliance-building process. This team:

- Validates the need or opportunity that points to outsourcing.
- Collects and analyzes data to validate assumptions and support outsourcing decisions.
- Selects the best approach to strategic sourcing.
- Evaluates the capabilities of potential outsourcing providers, and selects a provider or providers..
- Identifies what is needed to make the arrangement succeed.
- Identifies areas for potential breakthroughs.
- Determines how the alliance can most effectively migrate capabilities during the transition.

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6. Reach a team consensus on and gain management approval of the OMSAG statement and outsourcing development plan.

Hold a teamwide session to finalize the OMSAG statement. Agreement and buy-in from the team are essential. Remember: People support what they help create. The team should also agree on the key process steps and planned timing for developing and implementing the relationship. Once a team consensus is reached, ensure that the appropriate levels of management have been briefed on the OMSAG statement and development plans, and that those executives have approved them. Remember that the strategic plan for outsourcing should be tied to the organization's overall strategic goals. Be sure that the linkage is complete - that the plan reflects senior management's most current strategic thinking and that senior management's support is in place.

The strategic sourcing development plan

In determining how to proceed with the creation of a strategic sourcing relationship, the core alliance development team should consider questions such as:

- ❑ Will the team use the process steps outlined in this guide, or some other set of specific process steps, to ensure that all team members have a common expectation of future development activities?
- ❑ What is the timeline for each of the remaining process steps--will the timing of implementation satisfy strategic goals?
- ❑ Do public or internal communications regarding the outsourcing plan call for special planning, for reasons of competitive advantage or human resources sensitivities ?
- ❑ Are there elements of the upcoming process steps that may be time-consuming or troublesome, and require additional resources or increased attention? For example, if strategic sourcing is not well-ingrained in the strategic planning process or as fully accepted by senior management, further work might be necessary before the development process continues.
- ❑ Will human, financial and other resources be adequate to complete the development process? Will key managers and champions be available during and after the roll-out of the relationship?

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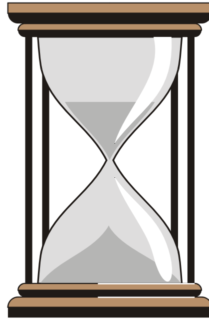
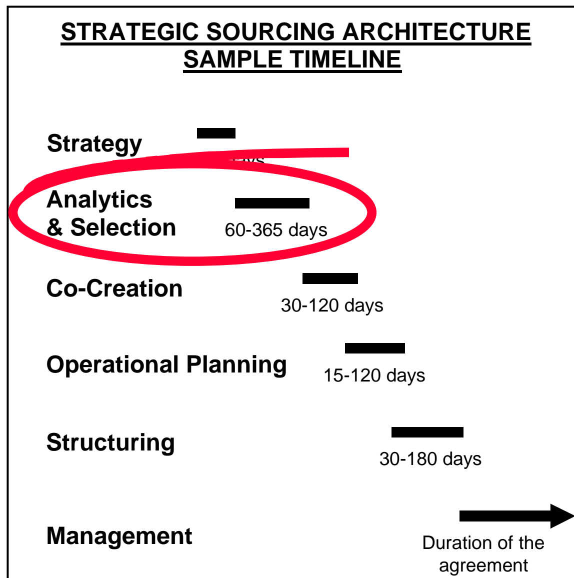


When am I done?

The Strategy phase is complete when senior management approves the Outsourcing Mission Strategy and Goals statement and when the core alliance development team is prepared to explore the potential of new strategic sourcing opportunities. As the phase ends, the organization has identified the business process that is to be outsourced, and is ready to begin searching for specific partners.

Chapter Three Analytics and Selection



As its name suggests, the Analytics and Selection phase is dual in nature.

In the first part of this phase (Analytics), performance goals for the outsourcing relationship are established. Those goals are used to determine the broad operational capabilities that will be required, and the targeted operational results that will be used to measure performance once the relationship is in place.

In the second part of this phase (Selection), those performance goals are used as criteria to identify and evaluate potential outsourcing providers. The selection process begins, and the list of candidates is narrowed to a short list of finalists.

The Analytics and Selection phase begins after the core alliance development team has had an opportunity to develop a broad understanding of what the organization can achieve through strategic sourcing, and how it plans to proceed with establishing a strategic sourcing relationship. The team's work should be based on a clearly documented charter from senior management.

In this phase, the core alliance development team creates a number of sub-teams to explore specific aspects of the business process in question and the potential sourcing provider organizations. This phase may require people with expertise in a variety of functions. Precisely which function to involve will depend on the business process being outsourced. For example, an IT process would require expertise in information technology, while a financial administration process would require finance expertise.

The action steps of the **Analytics** portion of this phase are:

1. Outline tentative performance goals for the business process that is to be outsourced.
2. Establish preliminary requirements and measures.
3. Gather internal and external benchmarking data.
4. Develop a summary of specific performance objectives, operating requirements and measurement criteria to be used in the outsourced process.

The action steps of the **Selection** portion of this phase are:

1. Develop an ideal-partner profile.
2. Create an initial list of candidates.
3. Establish and communicate the partner-selection procedure.
4. Check the references of candidates.
5. Conduct interviews with candidates.
6. Perform due diligence.
7. Pick the provider(s).

Analytics and Selection
ACTION STEPS

Analytics

1. Outline tentative performance goals for the business process that is to be outsourced.

Using data developed in the Strategy phase, identify the preliminary *quantitative* goals (e.g., cost reductions, improved cycle times) and preliminary *qualitative* goals (technology that will be developed, improved image in the marketplace) for the outsourcing relationship. This information will provide a basis for assessing providers in the Selection portion of this phase (e.g., Will the provider be able to improve productivity 20% or to cut cycle times by one-third?)

2. Establish preliminary requirements and measures.

Identify all the resources and capabilities that will be needed to meet your desired goals, such as equipment, personnel, support services, geographical scope and funding.

In addition, identify the tentative metrics that will be used to measure the performance of the outsourced activity. Traditional measurements, such as costs and revenues, can be used as performance-measurement criteria, but balanced measurements, such as The Warren Company's Strategic Return on Investment (STROI) tool, should also be used. STROI is a proprietary set of measurements that addresses the key factors for success in collaborative relationships (see "Focusing on the right performance measures" in Chapter 1).

Most financial measures are historical and only "look backward." They therefore tend to ignore where the organization wants to go - the crucial strategic objectives related to such issues as technological innovation, market power and competitive position. STROI, on the other hand, includes nonfinancial factors such as:

- Market impact.
- Organizational capability.
- Innovation capacity.
- Competitive advantage.

These factors examine an organization's ability to succeed in the future. That is, they provide an early indicator of whether future financial goals are likely *to be* met, as opposed to whether they *have been* met.

One drawback: Competitive benchmarking data and historical internal data often do not include such nonfinancial measures. However, once nonfinancial benchmarks are developed, they can be used later in the strategic relationship-building process to jointly develop operational goals. Ultimately, these measures also provide a basis for establishing the partnership's risk-and-reward sharing formula.

3. Gather internal and external benchmarking data.

Gather data that will help the organization clearly understand the baseline historical performance of the process in question, as well as the best-in-class performance of similar processes at other companies. Then, use this understanding to further develop the preliminary performance objectives established in Step 2, and to set ambitious stretch

Get a good baseline

"A mess should not be outsourced," one executive told The Warren Company. "You should get a process into reasonable order before handing it over to someone else to run, so that you can quantify looked-for and actual improvements. We already had a very good accounts receivable performance, near 98%. If that hadn't been the case--if we'd started with say, 60%--it would have been hard to know if the outsourcing company's performance was truly good, or just better than our poor performance. In general, outsourcing is only a good idea if you can measure it and know that you're getting value for money."

goals for the relationship. It is important that team members with expertise in finance be involved in this step.

Historical internal costs/baseline

Establishing a baseline of internal costs is a key step in this phase. The baseline provides a foundation for gauging future performance and levels of improvement. Even if the activity or process in question is later cut back or significantly reengineered, this baseline can still provide some sense of the level of improvement created by the changes to the activity.

A baseline should include not only direct costs, but also the indirect costs that are necessary to the functioning of the organization. Often, an organization will choose to use only direct costs in assessing the cost structure of an operation - an approach that can lead to problems when proposals are solicited from potential partners. If you look only at direct costs, such proposals will often seem out of line with what you believe are the costs of running your activity or process. That's because the potential partner is including the often-overlooked indirect costs of recruiting, training, management time, outside purchases, human resources support and so forth.

The collection of internal data should encompass three steps:

1. **Collection of hard data,** including all budgeted direct costs.
2. **Collection of indirect and hidden costs,** including recruiting, training, personnel skills, processes used, technology used, development environment and office space and support (when the process will be moved to a new or different facility). Add to these costs management involvement and other indirect overhead charges that may not be included in the budgeted costs.
3. **Aggregation and analysis of data.** This should include qualitative assessments of your technology versus the technology that currently exists in the marketplace, and the cost of capital and time required to bring new equipment onboard and upgrade to the skills needed to use the new technology.

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If there is a question about the ability of your organization to develop an accurate assessment of productivity, there are outside organizations that can perform this service for you. These organizations will take information from one of your last projects and evaluate it against a database of companies performing similar activities.

Benchmarking
External benchmark data is becoming increasingly available from a variety of sources, such as the U.S. Census Bureau, and companies such as G2R, Dun and Bradstreet, and the Gartner Group. Often, the real challenge is to capture accurate historical internal data and new data from reengineered operations that can be accurately compared on an "apples to apples" basis with external information.

Be sure to verify the reasonableness of internal and external benchmarking data**.** Check with industry sources and outside consultants to see if their information confirms the accuracy of the data you've gathered, as well as the feasibility of the preliminary goals established in the first step of this phase.

Sample measurements: IT outsourcing

The following table outlines high-level metrics and sample measurements that might be used to gauge the impact that an IT outsourcing arrangement has on a company's IT environment and business. The individual metrics and measurements required will vary by company, IT service outsourced, industry and the nature of the engagement (duration, risks, cost versus value and so forth).

4. Develop a summary of specific performance objectives, operating requirements and measurement criteria to be used in the outsourced process.

Develop a consensus among the core alliance development team members about the final performance objectives, and document those objectives and the operational requirements and measurement criteria to be used in the selection process.

In general, cost objectives should be weighed against other parameters, such as productivity improvements, responsiveness and customer satisfaction. Develop a set of boundary conditions, or acceptable ranges, for such parameters. It may be that your partner can provide desirable improvements in some areas at an additional cost, or that a desired improvement in one area will reduce performance in another. An agreement about the relative importance of these factors, and the changes in costs/performance that are acceptable, is important to the later development of a memorandum of understanding with the sourcing partner.

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Expected Average Values Achieved

Vendors and End Users Expect Outsourcing to Achieve the Following Benefits

Metric	Benefit
Cost Savings	10%-20% savings
Availability	Increase 5%-10%
Response Times	Reduced
Worker Productivity	Increased 10%-15%
Internal Customer Satisfaction	Increased 10%-20%
MIS Staff Morale	Increased
MIS Staff Turnover	Initial increase, then decrease (stabilize)

Vendors expect to deliver these benefits after the first contract year, while end users expect to receive them upon contract initiation. Thus vendors must set expectations during the sales process about the benefits they will deliver and when they will deliver them.

Selection

Selection is the second part of the Analytics and Selection phase.

1. Develop an ideal-partner profile.

Create a checklist of the attributes that a successful outsourcing provider would need to have in order to deliver the performance objectives and operating requirements developed in the previous Analytics steps. Determine the relative importance of these attributes. For example, you may be looking for both IT responsiveness and manufacturing expertise - but of the two, IT responsiveness may be more important. Such distinctions will be helpful in comparing providers later in this phase.

It is also important to assess the "three-dimensional fit" of candidate organizations. Look for a good fit in the following areas:

- **Strategic Fit:** Can the potential sourcing partner provide the complementary or breakthrough capabilities that you seek? Does the organization understand the technology required and the trends in your industry?
- **Operational Fit:** Is the organizational structure of the potential sourcing partner compatible with yours? Is its style legalistic and contractual? Collaborative and flexible? Commanding and directive? Is its management approach formal, coordinated or hierarchical?
- **Chemistry/Culture Fit:** Is the potential sourcing partner flexible enough to embrace change as new conditions arise? Is there a sense of trust between your organization and the sourcing provider? Is there a sense of respect for each other's cultures? The "soft stuff" of being able to get along well is probably one of the most important elements in a relationship.

A sample ideal-partner profile

Assess potential relationships in a number of areas. (Not every potential relationship will require expertise or strengths in all of the following areas.)

Management style. Is the potential provider compatible with your organization in terms of:

- Structure, philosophy, work ethic and operating style?
- Strategic planning, culture and long-term view?
- Responsiveness to opportunities and threats?

Marketing aspects. Does your potential partner have:

- Depth of experience?
- A competitive advantage?
- A customer- and market-driven orientation?
- A record of innovation?
- An understanding of brand management and market mix?
- A proven new-product success?
- A track record of putting strategic thinking into action?

(continued)

A sample ideal partner profile
(continued)

Manufacturing strengths. Does the provider have:
- A consistent record of efficiency and quality?
- Sufficient production capabilities?
- The necessary technical and R&D expertise?
- A willingness to invest in production?
- High-quality, long-term suppliers?

Financial aspects. What is the provider's:
- Financial strength?
- Long-term outlook?
- Expectation for financial rewards from the relationship?

Trade aspects. Does the provider have:
- Strong trade relationships?
- Global distribution capability?

Relationships. Does your potential partner:
- Have successful joint-venture experience?
- Show enthusiasm for working with your company?
- View your company as a high-priority partner?

What is *chemistry?*

Chemistry may be the most difficult aspect of a relationship to evaluate objectively. Chemistry is *not* tangible or visible, nor can it be created, codified, legalized or contracted. However, in interviews with executives, The Warren Company has identified the following characteristics that make up "good chemistry" in a sourcing relationship:

- ❑ Trust in the other partner
- ❑ Faith that the partner will do the right things--strategically and operationally
- ❑ Belief that the other party will live up to the unwritten terms of the agreement
- ❑ Unfailing commitment to a win-win arrangement
- ❑ Cherishing a reputation as a hard but fair dealer
- ❑ Respecting integrity
- ❑ Doing what you say you will do
- ❑ Predictability under pressure
- ❑ Creativity in the face of adversity

These qualitative parameters should be added to your selection checklists and evaluated as objectively as possible. Chemistry between senior managers is particularly crucial, because an inability to develop high-level joint trust almost always leads to failure of the relationship. Interpersonal chemistry at key operating interfaces and broad organizational chemistry emanating from culture and values are other important areas of focus.

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2. Create an initial list of candidates.

Identify a list of candidates based on current relationships, industry data or other knowledge, and temporarily rank these candidates on a numerical scale.

Note that the outsourcing industry is expanding and growing increasingly sophisticated. Often, there will be several companies actively marketing their capabilities in the process you are considering for outsourcing. There will usually be a spectrum of capabilities available, ranging from large, diversified, integrated service firms with outsourcing experience in a variety of functions to true niche players with capabilities that are narrowly focused in a specialty.

Many companies allow incumbent in-house functions to compete in the partner-selection process. In assessing the in-house capability, be sure to collect the same type of information and apply the same criteria that you use to evaluate sourcing providers.

3. Establish and communicate the partner-selection procedure.

Use your knowledge of your requirements and the capabilities of the available candidates to determine how many candidates should receive detailed scrutiny.

If one trusted partner already has a sound relationship with your company, you may want to start by exploring its capabilities. If no such relationship exists, then you may want to consider three or four candidates. There is no "right" number of partners to engage in evaluation discussions or any "right" order for dealing with them. A thorough analysis may require an internal review of multiple companies followed by direct contacts with a few. Or, if an existing relationship looks promising, more time may be devoted to ensuring that other promising partners have not been overlooked.

In any case, we do not recommend a traditional RFP (Request for Proposal) process. RFPs too often focus only on the needs and requirements of the company to be serviced; they seldom create a two-way dialogue about how the organizations should work together to maximize the return of both service provider and customer. The process of identifying the best partner will work most effectively if you encourage each partner to share its strategic goals, its profit objectives and other important aspects of what will make the relationship a "win" for both sides.

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This win-win approach is a fundamental aspect of success in strategic sourcing relationships. Throughout the alliance-building process, keep your partner's needs in mind. Effective integration of operations and cooperative activity requires that concern for mutual benefit be a primary concern. The traditional vendor-customer, zero-sum-game mentality seldom leads to a relationship that brings significant breakthrough benefits.

We suggest using dialogue and discovery to see that the full potential of partner candidates is addressed. That is, ask potential partners to submit information about themselves based on your vision and goals for a strategic sourcing arrangement. Then, meet with each potential partner to discuss and evaluate their abilities and ideas.

Time constraints may make it necessary to hold discussions with several candidates at once. However, simultaneously engaging multiple partner candidates in outsourcing discussions can inhibit frankness and the growth of the relationship, unless those activities are clearly disclosed to all parties involved. A lack of candor about the competitive environment a candidate faces can make it difficult to establish trust down the road.

4. Check the references of candidates.

Investigate references supplied by the candidates, as well as information available from industry sources.

Find current references in your industry, and make sure that those references are mature accounts that are not still in the "honeymoon" stage. This will help you determine how responsive the outsourcer has been to changes and conflicts in the relationship. Ask open-ended questions that get at core issues: How has the vendor delivered on its promises?

How have your people fared in the new environment? Now that you've gone through the outsourcing process once, what would you do differently? Look beyond formal references. "There's almost an underground network of CIOs who are willing to talk about their outsourcing suppliers," notes one outsourcing attorney.

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5. Conduct interviews with candidates.

Conduct an exploratory session with each candidate. Use the ideal-partner profile checklist (described in Step 1 of this phase) and "Fit/Gap" mapping to create a quantified ranking of tentative finalists.

Fit/Gap Analysis

Company A	Differentiation dimension	Company B
Quick/Punctual	**Time orientation** Ill-defined	
Individual	**Individualism**	Team
Direct	**Communication**	Diplomatic
Certain	**Information**	Ambiguous
Hierarchical	**Organizational** structure and culture	Collaborative
Harmonious	**Labor relations**	Conflictive
Familiar	**Technology**	Unfamiliar
Finance	**Management style**	Engineering
Adversarial	**Business/gov't relations**	Harmonized
Rapid	**Environmental rate of change**	Slow

Affects Negotiating Environment

- Negotiating style
- Pace
- Decision making
- Personal relations

- Legal and administrative issues
- Emotions
- Critical decisions
- Trust

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Listen to the candidates

In discussions with potential partners, remember that they are not likely to bring up their motivations and fears unless clearly asked. As one executive said to us: "I viewed this issue differently when I came over to the other side of the table and thought about it from the supplier's perspective. In fact, suppliers don't want 100% of their business tied up in alliances. In some instances an alliance, while it's good for a supplier in a downturn situation because it shelters some of the prices, is bad for a supplier in a heated industry situation because it takes away some of the premium that they could achieve on their product. Many of the companies that we have had sub-alliances with don't want any more than about 40% of their total business in an alliance-based structure--because some of the gravy that they get in a heated industry can offset some of the things they are giving up on pricing with the alliance structure."

Compare information from these meetings with the previously prepared partner profile checklists that describe your specific performance objectives and operating requirements. Note, however, that the due diligence process often will turn up new and unexpected partner capabilities and operational potential. Be sure to stay open to these possibilities, and give yourself the flexibility to include these "other" benefits in your comparative rankings. In addition, as you explore providers' capabilities, keep in mind the possibility of using multiple partners to handle the business process in question.

A Fit/Gap analysis should be conducted on the Strategic and Operational dimensions. This analysis will help you determine how well potential partners complement your company - or how a number of providers complement each other - and what capabilities need to be added. Various other diagnostic tools - such as surveys and direct observation - can also be used to help assess each partner candidate on these dimensions.

Using a skilled facilitator in preliminary discussions can help set the right tone for interviews and the relationship as a whole. A good facilitator can help establish a sense of openness and trust that enables a faster evaluation of each organization's objectives and a more effective exchange of ideas.

Finally, your interviews and analyses will naturally be more complex as the number of geographical locations and organizational and management contact points involved increases, and if the relationship requires high levels of operational integration. The potential for problems expands exponentially as this complexity increases, so it is important to have an analysis of the organizational fit that’s as comprehensive as possible.

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6. Perform due diligence.

Examine in more detail the tentative finalists determined in Step 5 to ensure that each is a valid candidate. A full evaluation of the risks presented by each provider is warranted because the downside potential of a relationship may outweigh its potential benefits, particularly if your assessment of capabilities and potential benefits turns out to be wrong. The result of this step is a short list of potential providers.

Checking them out

In checking the background of a potential outsourcing provider, consider a range of aspects, including:

- Financial statements, to ensure capacity to meet financial commitments.
- Relations with vendors (do bills get paid on time?) and relations with customers.
- Court filings: Is the provider always involved in legal hassles?
- Industry reputation: Is it "quality"?
- Quality of top managers: Do they have a good track record? Is there high turnover?
- Critical strategic decisions in the past: Do they have a record of sound judgment?
- Board of directors: Does the board support the decision to form an alliance? Will it support or undermine the CEO?
- Core organizational values: Do you like the organization's:
  - Teamwork?
  - Tough-mindedness?
  - Loyalty?
  - Discipline?
  - Adherence to commitments?
  - Integrity?
  - Human resources?

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Selection alternatives

As in many endeavors, ingenuity has its value in partner selection. Faced with winnowing down a list of six potential partners, and believing that no one firm could satisfy all its diverse IT needs, a UK energy company allowed the winners to "select themselves." The company instructed the candidates to form any alliance they chose among the finalist group, as long as the alliance had more than one partner and fewer than five.
The contestants then submitted proposals responding to strict cost and performance criteria. As a result, a three-way alliance, self-designed and complete with its own approach to cooperation among the partners, has operated effectively for several years. The vendors provide combined services at each of the energy company's sites, with one of the vendors acting as principal contractor and service coordinator.

Known quantities

The Warren Company's research indicates that most companies have succeeded in building a high-level strategic sourcing relationship only after a long prior relationship. Working together over a long period allows the necessary trust to be established. Don't underestimate the value of a deep institutional relationship or a set of personal relationships that will allow the parties to move more boldly forward.

7. Pick the provider(s).

Identify the candidate(s) that best fits your needs, review the choice with senior management and let the provider(s) know of your decision.

Selecting the provider

In most cases, the completion of the due diligence step will leave you with several candidates with slightly differing capabilities. Therefore, it is important to develop selection criteria and a weighting methodology that will let you identify the provider or providers that best fit with your organization. If your company is considering an in-house function to handle the business process, the internal organization should be assessed with the same criteria used for the external providers.

Each provider should be assigned a rating for each capability (1 - 5, with five indicating the highest level of capability), based on the alliance development team's due diligence assessment. In addition, each capability should be given a "weighting multiplier" (i.e., 1 - 5, with five being the most important), based on the prioritization performed in the "Develop an ideal-partner profile" step at the beginning of the Selection portion of the Analytics and Selection phase.

Once the providers are rated, their scores for each capability are multiplied by the associated weighting factor, and then added to produce a single-number score. Comparing scores can help the alliance development team make its selection.

The following table shows a sample of a completed weighting and selection chart.

Criteria	Weighting* Ranking Legend (1 = low to 5 = high)		Internal/External organization ABC Co.	Internal/External organization XYZ Co.
Technical skills	3	x	3	2
History of success	5	x	3	2
Human resources program	2	x	5	2
Responsiveness	3	x	2	3
Financial strength	3	x	4	4
Competency	4	x	3	4
Step gap fit	5	x	4	2
How interested is the third party?	5	x	3	5
Total Score			99	92

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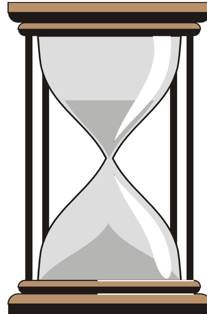
It is possible that the weighting technique will not clearly differentiate between the providers. In that case, use the “three-dimensional fit” concepts, such as chemistry, strategy and operations, to help make the selection.

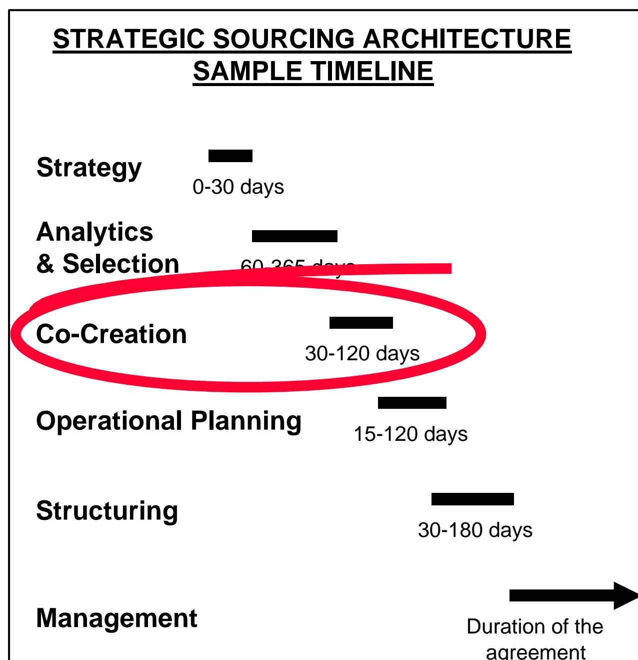


When am I done?

The Analytics and Selection phase is complete when a detailed set of operational requirements and performance objectives has been established, and one candidate or a short list of candidates has been chosen. Your company should know what it wants to accomplish and have a good idea of with whom it will happen.

To illustrate how strategic sourcing structures and the Analytics and Selection phase might differ depending on the specific processes to be outsourced, we have included descriptions of several sample outsourcing possibilities in Appendix A. These descriptions were developed by the G2R research firm and are included in this guide with G2R's permission.

Chapter Four Co-Creation



Why a Co-Creation team?

There are several reasons for using a team, rather than a sole deal maker, in Co-Creation. The team approach:

- Helps ensure that all the details, contingencies and opportunities are thought through.
- Allows middle managers to get involved, ensuring that operational views are included.
- Provides an opportunity to gain full understanding and commitment among all those who will be involved in structuring and maintaining the relationship. Provides opportunities for experts within the organization to examine the alliance its opportunities for success.
- Builds the foundation for future teamwork.

The Co-Creation phase marks a key departure from the typical head-to-head negotiations of traditional outsourcing. Instead of behaving as adversaries, potential sourcing partners work to understand each other's requirements and find approaches that will benefit both parties. The output of the Co-Creation phase is a memorandum of understanding that describes the broad goals and nature of the relationship.

In the Co-Creation phase, work is done primarily by a small Co-Creation team that is formed at the beginning of the phase. Co-Creation team members should have excellent communication and business skills, as well as skills in the business process that is to be outsourced. If possible, the team should also include members who have been involved previously in other alliance or strategic sourcing relationships.

Finally, it's important to note that although Co-Creation is treated here as a separate phase of the strategic sourcing process, it should actually overlap several other phases. From the initial meetings with a potential partner through the signing of a contract and ongoing operations, the two organizations should be working to understand each other's needs and to find ways to combine their competencies to create new opportunities.

The action steps of the Co-Creation phase are:

1. Plan the Co-Creation approach.
2. Conduct joint exploration and design of the venture.
3. Create a memorandum of understanding.

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Who should be part of the Co-Creation team?

Unlike the traditional merger process, which separates deal makers from those who will ultimately work in the trenches, Co-Creation involves the people who will eventually be responsible for managing the operation of the relationship.

The Co-Creation team can be small--perhaps 4-10 people. It should include:

- One or more senior executives who have a clear grasp of the strategic direction of your company and an appreciation of how strategic outsourcing fits with that direction.
- External people from consulting and outsourcing companies who have managed and delivered large outsourcing relationships.
- People with skills in negotiating and project management.
- Managers who will eventually "run" the relationship.
- The alliance champion.

Co-Creation
ACTION STEPS

1. Plan the Co-Creation approach.

This initial step sets a direction for developing the relationship with a sourcing partner. That is, develops a framework for how the two organizations will work together to understand each other's needs and explore a wide range of opportunities that they can pursue together.

The effort begins with the creation of a small Co-Creation team -- consisting of 4 to 10 people -- that has the authority to hold discussions and make decisions about the outsourcing relationship. The team members should possess skills in contract creation, program administration and the process that is being outsourced.

The Co-Creation team will handle discussions with the sourcing provider through the Co-Creation phase and into the next phase, Structuring. In addition to the alliance champion, the team should include a relationship manager who will eventually be responsible for day-to-day operations (the champion and the alliance manager can be the same person). It is important to identify this individual early in the Co-Creation phase so that he or she can influence discussions and develop a sense of ownership toward the relationship. The team also should include the operational managers who will be involved in the relationship on an ongoing basis. Hold preparatory sessions to familiarize the team with the tools and concepts of Co-Creation.

Consider using outside facilitators throughout this phase to keep discussions moving forward and to help identify and overcome personal and cultural differences. Make sure the facilitators understand the concept of strategic sourcing and have experience in creating higher-level relationships. Spend time with the facilitators before Co-Creation discussions begin so that they understand your strategic intent and the concept of Co-Creation.

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The role of the facilitator

"We did have a professional facilitator work with us," says an executive at a large energy company. "He was there to make sure we stayed on the right path. In the formative stages, we benefited from the facilitator not being totally immersed in the process--with the ability to stand back objectively and mentor the participants. This person has to have an intimate understanding of the end state you wish to achieve."

Tactics for success

To help ensure a successful Co-Creation phase:

- **Plan the Co-Creation discussions carefully.**
  - Build your internal team.
  - Create a clear Co-Creation strategy.
  - Expand the range of options to be considered.
- **Work to build a relationship.**
  - Understand the type of relationship that both sides want.
  - Focus on building an atmosphere of trust.
  - Act with integrity.
- **Emphasize areas of agreement.**
  - Clarify the needs and goals of both parties.
  - Ask questions about the outsourcing provider's needs and perspectives.
  - Be flexible.
  - Resolve differences by seeking creative solutions and new opportunities.
- **Work to maintain agreement.**
  - Stay committed to a cooperative approach with frequent interaction.
  - Use a non-adversarial approach for dispute resolution.
  - Continue to build trust and integrity.

2. Conduct joint exploration and design of the venture.

Hold meetings and conduct visits that bring together people from both sides of the relationship, allowing them to develop the trust, chemistry and personal contacts needed to work together effectively. In addition, orient your sourcing partner to the Co-Creation process and offer training if necessary -- and be sure that your partner understands the importance you place on Co-Creation and is willing to move beyond traditional negotiating approaches.

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Co-Creation versus traditional deal making

In traditional outsourcing, deal making involves a short-term view, a tactical orientation, and pressure to close the deal. The focus is on negotiations, not the implementation and operation that follows.

Co-Creation, on the other hand, is focused on building a strategic relationship with a long-term focus. In Co-Creation, seek to:

- Create a powerful vision and value proposition.
- Forge strategic relationships.
- Avoid tactical-transactional-legalistic arm wrestling.

Take the time

To help develop the relationship between organizations, hold informal off-site gatherings as well as formal meetings. Giving teams from each party the time to "eat and drink" together will help build rapport and trust.

In meetings with your partner, outline the requirements and expectations that both parties have for the relationship. In addition, explore the cultural viewpoints that will affect Co-Creation and the nature of the arrangement. For example, look at:

- **Style.** Will the shop be a casual-dress office or a formal-business-attire operation? How do people communicate - i.e., using e-mail or voice mail? Is decision making handled in a hierarchical or consensus fashion?

- **Management.** Will the sourcing partner manage its outsourcing teams remotely, or does it keep its management staff on-site? Communication is vital in an outsourcing relationship, and it can make a big difference if vendor managers are easily accessible.

- **Problem solving.** How will conflicts be handled? (The way that the companies interact during his phase may foreshadow the dynamics of the ongoing relationship.)

Conduct formal facilitated meetings to establish a breakthrough value proposition--that is, a cooperatively developed revision to the original value proposition created in the Strategy phase. In addition, these meetings should produce a detailed outline of operating parameters, including overall strategic sourcing objectives, financial models, technical proposals, staff transition approach, a communication plan and time lines.

In describing the breakthroughs, use the broad, balanced STROI metrics, such as organizational capability, market impact and innovation capacity, described in Chapter 1. These metrics will allow you to capture the entire range of value that you envision, rather than just the traditional financial measures.

The result of this step is a Co-Creation Information Document that provides an initial view of the shape of the relationship, including the targeted internal and external customers, scope, objectives and value that is expected. This document provides a foundation for later documents that will describe the relationship in more detail.

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The Co-Creation Information Document

The Co-Creation Information Document should describe:

- 5-10 opportunities for improvements within the outsourced process (new markets, products, technologies, systems).
- Internal and external customer groups.
- Commercial objectives for each party.
- Strategic drivers of the relationship.
- Detailed cost models.
- Risk-and-reward sharing alternatives.
- Affected locations.
- Service levels.

Willing to work together?

When a major financial services firm was holding discussions with potential outsourcing partners, the company's head of corporate technology met with the candidates to discuss the scope of the work--and assess their willingness to pursue Co-Creation in a multiple-vendor arrangement. "When you get into this discussion, you'll find areas people will fight over," he says. "If they argue for solutions to benefit all parties in the relationship, that's a good sign; if they are aggressively territorial, look out."

Is your partner ready?

Early in Co-Creation, determine your sourcing partner's willingness to participate in a mutual exploration of possibilities. Ask the partner questions such as:

- How did you approach your last outsourcing negotiations?
- Who was on the negotiating team? What were their roles?
- How did you manage issues of control and power in the negotiations?
- Do you think, in retrospect, that the team's approach was effective?
- What were you prepared to give up in order to sign an agreement? What was new?
- Did you seek an "open book" approach through the negotiation process?
- Was the chief negotiator aware of the "win" for the other party?
- What did you consider a "win" for your company? Were you able to achieve that win?
- What was the role of legal counsel in the negotiations? What advice do you have regarding use of lawyers?
- What type of bidding process was used for outsourcing? How effective was the process?
- Do you have any history of outsourcing relationships that have fallen apart in negotiation?
- Did you negotiate an exit and transition clause? How will you regain control if the relationship goes wrong?
- What consideration was given to operational issues during the negotiations? Were operational managers consulted or involved?

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When to announce

The question of when to tell employees about the decision to outsource is often a difficult one for executives. If the announcement is made too early, there may be a lack of hard information about the future, and employees will have a long time to "stew" and imagine the worst scenarios. If the announcement is made just before the new relationship takes effect, employees will be shocked, and it may be difficult to maintain productivity.

The Warren Company usually recommends that companies tell employees about outsourcing plans when the list of vendors has been narrowed down to two or three candidates. This approach gives the company a chance to explain the business reasons for the move, and gives time to present employees with an accurate, and reassuring, view of the future.

The announcement should be a proactive communications effort: "When we publicly announced the decision to outsource, we brought in 60 managers who in turn cascaded the discussion out to their reports," says a CIO at a major U.S. transportation company.

What to cover

In joint exploration and design sessions, you should:

- ❑ Review the business case.
- ❑ Discuss each party's objectives.
- ❑ Evaluate benchmark information.
- ❑ Examine objectives and possible concerns of partners.
- ❑ Look for opportunities to combine companywide requirements to gain leverage.
- ❑ Assess how critical the arrangement is to both sides.
- ❑ Analyze pricing and financial considerations.
- ❑ Define positions regarding contract terms and conditions, schedules, deliverables, support, maintenance, distribution and logistics.
- ❑ Agree on the role of team members.
- ❑ Consider potential volume commitments.
- ❑ Discuss the positions, biases and styles of both organizations.

Overall, be sure to address four difficult issues that are key to the sourcing relationship:

- ❑ *Who gets transferred and how?* This is often an uncomfortable point: Heightened sensitivity to the feelings of the staff being transferred is vital.
- ❑ *How will measurements be established?* Instead of writing key performance measures up front, consider defining a process for the mutual setting, measuring and reporting of objectives as you go along.
- ❑ *Where will savings come from?* Work together to understand the process's cost profile before the sourcing partner takes over, so that you can quantify looked-for and actual improvements.
- ❑ *Compensation for performance.* Will the sourcing partner's compensation be based to some extent on the new value that is created?

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When to bring in legal help

Use lawyers and contract experts experienced in sourcing relationships, but keep them in the background. This helps keep discussions from getting mired in detail, while allowing these experts to make sure you are not getting into something you should avoid. Legal experts become more involved at the end of the Co-Creation phase, after the intent of the relationship has been spelled out in business terms and is ready to be put into legal terms.

Keep it moving

Co-Creation discussions should not get bogged down in detail and minor issues. To maintain momentum through the entire phase:

- Aim high; target breakthrough opportunities.
- Use the diversity of partners' perspectives to break old paradigms, traditions and assumptions.
- Use stretch goals and creative problem-solving techniques.
- Focus on shared risks and rewards, mutual commitment and effective management--not on legal or financial controls.
- Balance your need for reduced costs with the profit motive of your partner.

3. Create a memorandum of understanding.

The results of the Co-Creation discussions should be refined into a jointly developed memorandum of understanding. This nonlegal document outlines the broad principles and spirit of the relationship -- what each party will do and what the relationship should achieve. The memorandum of understanding acts as a high-level guide for those who later work through the legal issues.

The memorandum of understanding: 10 critical points

A memorandum of understanding should be written in "plain business language," be 2-5 pages long and cover 10 critical points:

1. Purpose: Why is the alliance being formed and what is its perceived mission?

2. Spirit of the venture: What commitments to the future are both companies seeking? What values and vision will engender communications and trust?

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3. Key objectives and responsibilities: What products, services or other specific projects will be included and excluded from the venture? Identify target markets (i.e., regions, user groups and so forth) and any excluded markets that will remain the domain of the individual partners. Clarify and specify objectives and targets to be achieved by the alliance, when these objectives will be met, any major obstacles anticipated and the point at which the alliance will be terminated (if any). Each participant should designate a project manager who will be responsible for his or her company's day-to-day involvement in the alliance.

4. Method for decision making: Who will have the authority to make what types of decisions, and under what circumstances? Who reports to whom?

5. Resource commitments: What specific financial resources--such as cash, equity, stage payments and loan guarantees--are needed for the achievement of your goals? Other "soft" resources may be in the form of licenses, knowledge, R&D, a sales force, contacts, production facilities, inventory, raw materials, engineering drawings, management staff, access to capital and the allocation of specific personnel for a certain percentage of their time.

6. Financial philosophy: What are the "soft" resources worth? Soft resources should be quantified with a financial figure so that a monetary value can be applied to them and considered along with cash commitments. The manner of handling cost overruns should be agreed on.

7. Sharing of risks and rewards: What are the expected rewards (new product, new market, cash flow or technology)? How will the profits be divided?

8. Project-specific issues: Who has the right to products and inventions? Who has the right to distribute the products, services, technologies and so forth? Who gets licensing rights? If confidentiality and non-compete agreements have not yet been developed, they should be addressed in basic form here. How will agents and distributors be handled?

9. Anticipated structure: This section should describe the intended structure (written contract, corporation, partnership or equity investment).

10. Transformation: How do the partners foresee the growth, evolution or unwinding of the alliance? Any termination provisions should be identified.

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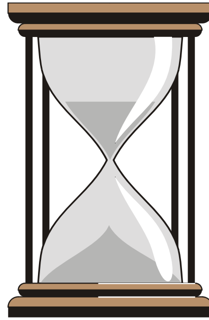

When am I done?

The Co-Creation phase is formally complete with the approval of the memorandum of understanding. The discussions in this phase will have strengthened the relationship and helped build a foundation of trust that will be valuable in the next phase, Operational Planning, and in the ongoing management of the relationship.

Again, it is important to remember that although the Co-Creation phase is complete, the parties should continue to jointly look for breakthrough opportunities throughout the life of the strategic sourcing relationship.

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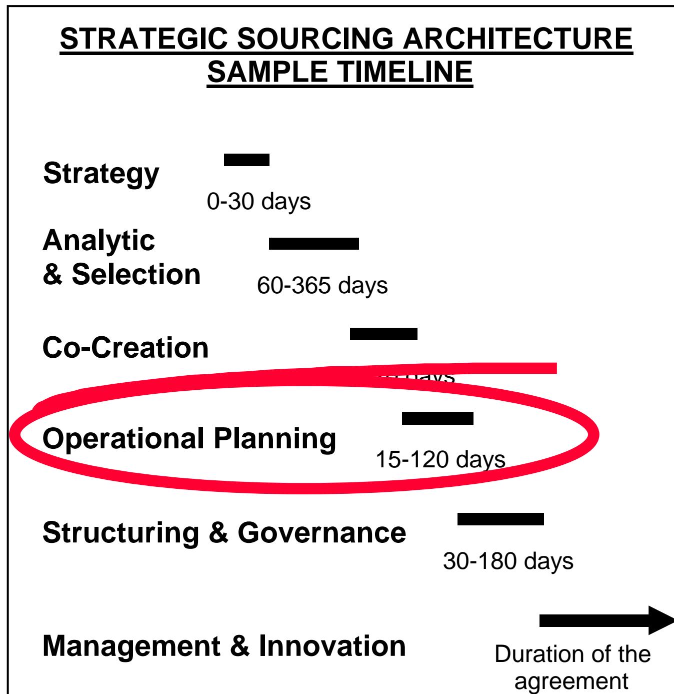
Chapter Five Operational Planning



In the Operational Planning phase, the organization and its sourcing partner or partners jointly establish day-to-day operational plans. They create a detailed manual that describes how the business process will operate, and they establish preliminary designs for control systems, reporting systems and the interfaces that link customers and the providers of the outsourced business process. The creation of these plans should be viewed as a pilot project that provides a "reality check" on the assumptions and projections made during the Co-Creation phase.

The Operational Planning phase essentially translates the memorandum of understanding into reality, adding in the "nuts and bolts" detail that will operationalize the memorandum's broad vision.

In the Operational Planning phase, the core alliance development team creates an operational team, drawing on people with the functional expertise needed to complement the vendor's capabilities and strengths. This operational team creates an operational plan describing how the services outlined in the memorandum of understanding will be provided. Some members of the team then remain in place during the launch and ongoing operation of the outsourced process in order to provide the in-house expertise needed to manage the relationship over time.

The action steps of the Operational Planning phase are:

1. Identify and form an operational team.
2. Create an operational plan.
3. Develop an operational launch plan.

Operational Planning
ACTION STEPS

1. Identify and form an operational team.

Drawing on the organization at large, the core alliance development team should select an operational team of 8-10 people. This team will take on most of the responsibility of creating an operational plan, managing relationship-building activities and eventually managing the relationship after it is launched.

Once members of the operational team have been selected, responsibility charts should be created to describe who will be responsible for what in overseeing and guiding the outsourced process. These charts provide a foundation for creating the operational plan, and they help identify ambiguities and gaps in roles and responsibilities.

In the chart, broad responsibilities are divided between organizations. These charts can then be further refined into specific activities that can be assigned to certain individuals. If you assign more than one person to a task, be very clear about who is accountable for what, or you may find that each person assumes the other is responsible for a given task, and the task will not get done.

The Operational Planning team

The precise makeup of an Operational Planning team will depend on the business process that is being taken over by the strategic sourcing partner. For example, if financial administration is being outsourced, then higher levels of financial expertise will be needed on the team. In general, you will want to consider people who can provide:

- **Technical support.**
  - Product planners
  - Chief engineers
  - Technical program managers
  - Specialists
  - Manufacturing staff

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- **Marketing support.**
  - Product managers
  - Industry segment managers
  - Marketing managers
- **Legal expertise.**
  - Corporate legal counsel
- **Logistics and customer service.**
  - Operating unit staff
  - Service and distribution
  - Materials management and procurement
- **Finance.**
  - Financial services
  - Operating unit controllers
  - Division controllers

2. Create an operational plan.

Work jointly to write an operational plan, and capture the plan in an operations manual. The operational plan turns broad plans into day-to-day activities; it translates the goals outlined in the memorandum of understanding into a detailed, workable view of how the business process will operate, the measurement and control systems that will be used to manage the process, and the responsibilities of the various parties. The creation of the plan involves three basic activities:

- Establish distinct, measurable, time-phased goals using a broad base of measures, such as the Strategic Return on Investment (STROI) measures described in Chapter 1, which take into account factors such as penetration into new markets and increased capacity for innovation, as well as financial results.
- Develop a detailed project plan.
- Assign detailed roles and responsibilities, and update the responsibility charts created in Step 1 of the Operational Planning phase.

The communication plan

Strategic sourcing usually entails significant change--and in times of change, communication that is open, consistent and accurate fosters trust and helps ensure a strong relationship. Effective communication helps employees understand what the sourcing relationship is designed to achieve, and their roles in the sourcing relationship's future success. Thus, it is important to develop a communication plan that describes how and when the organization will discuss and explain the outsourcing-related changes to employees.

As one executive points out, "Looking back over the process, you can't communicate enough to combat rumors, control communication and manage expectations. It is important that staff understand what is going to happen to them, how it will effect them and what form the outsourced services will take."

In general, the organization should establish a formal communication program that:

- encourages two-way interaction between management and employees.
- ensures that messages are delivered consistently to all audiences.
- encompasses everything from group meetings and newsletters to one-on-one meetings.
- includes feedback mechanisms that allow executives to track results.

Human resources experts should be heavily involved in the Operational Planning phase to help assess the compatibility of benefits programs, career paths and compensation, and to help determine how the organization will handle communications and the transition period - that is, the period when the business process and people are transferred to the sourcing partner. Indeed, proper human resources planning can make the difference between a successful transition and a troubled one, and it can help ensure that transferred employees do not harbor ill will toward their new "customer," their former employer. In addition, the involvement of human resources experts from both sides of the relationship can help in the formation of teams and foster an open understanding of cultural differences.

A detailed, thorough operational plan provides a sound base for managing the alliance, helps ensure that the right levels of service are provided to the process's customers, and highlights gaps and overlaps in responsibilities, skills and capabilities. It also tests the validity of the alliance, helping determine whether the "gears will mesh," whether the strategy is operationally feasible and whether the sourcing relationship can produce the results you want.

The plan also provides a foundation for the Structuring phase that follows. By defining the operational functions, the plan helps identify any structuring issues - such as organizational shape, legal form and tax issues - that may arise.

Finally, the process of creating the plan provides insight into the chemistry - or lack thereof - within and between the middle ranks of the two organizations. It gives the staff a chance to test ideas and form working relationships, so that they can "hit the ground running" when the relationship is launched.

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Performance objectives

It is important to establish operational performance objectives that are measurable and specific. Objectives should establish minimum acceptable levels, desired levels and "overkill" levels. Multiple objectives will most likely be required to capture performance from many viewpoints. Examples of performance objectives to consider are:

- Uptime/Downtime.
  - By period
  - By shift
  - By application
  - Mean time between downtimes
- Output.
  - Definition
  - Method of delivery
  - Response time
  - Resource capacity
  - Priorities
  - Variance from schedule
  - Remedies for missed performance

The operational plan

The operational plan should encompass:

- Key objectives and milestones.
- Financial forecasts.
- Critical success and risk factors.
- Expected performance levels.
- Service support.
- Competitive analysis.
- Management procedures.
- Manufacturing/Production/Engineering plan
- Technology architecture.
- Staff transfer.
- Functional and task analysis.
- Communication plan.
- Implementation schedule.
- Contingency plans.
- Operational and administrative responsibilities.
- Fees and charges.
- Scheduling.

The compensation task force

Establish a task force within the human resources group to evaluate compensation systems on both sides of the relationship. This evaluation will help identify compensation and benefit programs that will require special attention as people are transferred. The compensation team should examine:

- Overall compensation philosophy.
- Compensation administration.
- Annual compensation (benchmark salaries, if appropriate).
- Incentive-plan design and participation levels.
- Incentive awards.
- Outstanding compensation obligations, such as unexercised stock options and uninvested restricted stock.

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Writing the plan

In creating the operations plan, consider putting operational managers from both organizations in a room together--for meetings spanning one to three days--and asking them to hammer out details of the plan. This not only focuses the group on developing the plan, it also helps you assess the group's ability to solve problems. If the appointed operational managers cannot work jointly to develop a plan, then they have slim hopes of managing the venture together. This team approach enables operational managers to troubleshoot the plan, check "chemistry" and trust, smoke out unforeseen personnel problems and determine if the "not invented here" syndrome will smother innovation. In short, it gives these managers a chance to quickly forge a working relationship.

Management Issues in Operational Planning

There are a number of management issues to consider in developing the operational plan:

Operational management

- Have operational managers from both partners been identified?
- Do the operational managers understand and believe in the value of the alliance?
- Have operational team members been identified?
- Is the writing of the operational plan being conducted in joint meetings?

Policies and values

- Has the value proposition been agreed upon?
- Have policies and values been agreed upon?
- Have all of management's requirements been captured, measured and reported?
- Have service levels been established?

Contingency planning

Has a broad plan been outlined to cover events such as:

- a large increase in service demand beyond the forecast?
- a drop in service demand?
- a radical shift caused by the introduction of new technology?

Finance

- Are payments keyed to satisfactory performance?
- Are risk-sharing mechanisms in place?
- Are methods for operational improvement in place?

Customers

- Has the relationship's impact on all affected internal and external groups been measured? Is it being measured on a continuous basis?

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Operational reporting systems

The operational plan should establish the reporting systems that will be used to manage the outsourced process. Consider systems that will track:

- ❑ Milestones.
- ❑ Critical issues and deadlines.
- ❑ Monthly and year-to-date financials versus plan.
- ❑ Executive council members' activities on the relationship's behalf.
- ❑ Service levels and forecasts.
- ❑ Customer activity, especially target customers.
- ❑ Cost and price issues.
- ❑ Quality reviews.
- ❑ Shipment, delivery and completion reviews.
- ❑ Technical, manufacturing or production problems.
- ❑ Coordination and teamwork issues.
- ❑ Next month's expectations.

3. Develop an operational launch plan.

It is important to create a launch plan that describes how the transition -- the first 90-120 days of the new relationship -- will be handled. This period, and the way it is managed, will have a powerful impact on the ultimate success of the relationship.

The launch plan should identify the resources that will be required to get the operation started off properly and the short-term goals that will help build a sense of success and progress in the early stages of relationship. The plan is important to ensuring:

- A seamless transition for customer groups.
- A well-thought-out and humane transfer of staff.
- Minimal conflict between the partners.
- A clear agreement and alignment of activities.

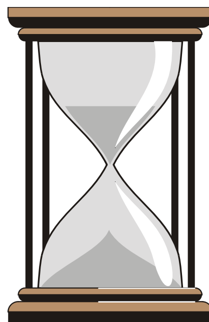
The launch plan should be written collaboratively by the core alliance development team and the operational managers and staff who will be responsible for the performance of the business process. Remember: People support what they help create. Also, it is often helpful to establish task forces to perform specific functions during the launch - i.e., a Service and Support Team, a Technical Team, a Systems Integration Team and so forth.

In writing the launch plan, do not attempt to take shortcuts or to have one organization write the plan independently and then seek the approval of the other partner later. If you do, important details will probably be overlooked, and the integration of the two operational cultures will be hampered. The result will be conflict and confusion -- especially in the critical early period when people are transferred and service levels are under intense scrutiny.

The launch plan

The launch plan should spell out what will happen during the first months of the sourcing relationship. It should encompass factors such as:

- Essential goals, objectives and results.
- Roles and responsibilities for specific individuals.
- Most important tasks.
- Resource requirements.
- Time lines.
- Interfaces between organizations.
- Key success factors.



When am I done?

At the end of the Operational Planning phase, you will have formed an operational team, and that team will have created a detailed operational plan and a launch plan for the early stages of the relationship. In addition, the process of creating these plans will have provided a detailed test of the "fit" of the two organizations in terms of strategy, chemistry and operations. Finally, senior management will have signed off on these two plans.

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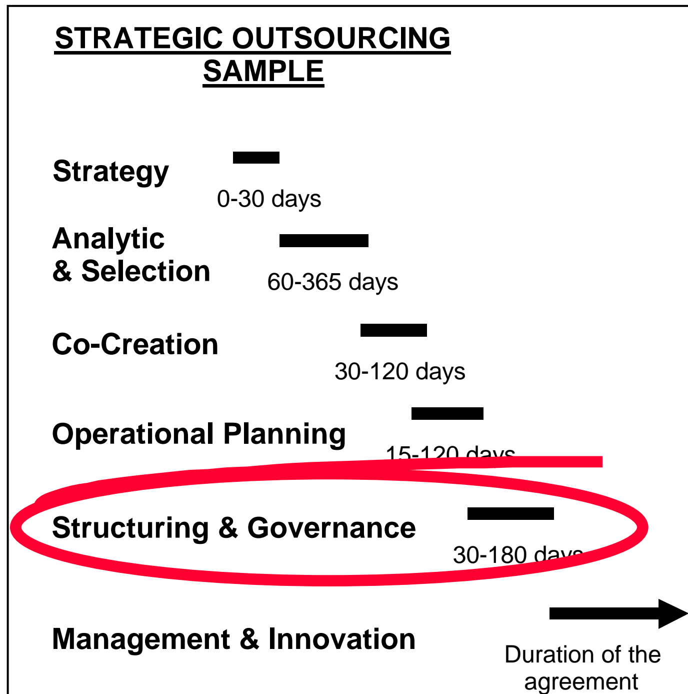
Chapter Six Structuring & Governance



The Structuring & Governance phase focuses on creating legal and organizational frameworks for the strategic sourcing relationship - on finalizing operational plans, ensuring that leaders and key managers are in place, and establishing a risk-and-reward formula that motivates both parties to make the relationship succeed. Structuring culminates in the signing of a contract.

A mistake that companies often make in developing strategic sourcing relationships is trying to finalize a contract too soon. The Warren Company's approach is based on the concept "form follows function." That is, the contract should be a tool for formalizing what has already been discussed and agreed to, rather than a focal point of negotiations. An important rule of thumb: Spend 80% of your time on structuring operations and 20% on structuring the deal. Detailed terms and conditions and accounting considerations should not overshadow the more important drivers of strategic intent and operational performance.

The Structuring phase builds on the broad goals described in the memorandum of understanding (created in the Co-Creation phase) and the detailed view of the operational plan (created in the Operational Planning phase) to create a framework that reflects the collaborative spirit of those two documents. Therefore, in this phase the alliance team should include individuals with financial, administrative and legal expertise, as well as people with communication skills and the relationship-building and management experience needed to create a win-win arrangement. The team must also involve senior managers, such as the alliance manager and the champion, to ensure a focus on strategic goals and collaboration in developing a contract.

The action steps of the Structuring phase are:

1. Prepare an organizational structure chart.
2. Prepare a summary of the governance structure and control mechanisms.
3. Agree on performance objectives and operating measures.
4. Agree on financial, legal and ownership matters.
5. Evaluate all structural elements for balance and a win-win approach.
6. Draft the contract.
7. Obtain final senior management approvals.
8. Sign the contract.

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Structuring & Governance
ACTION STEPS

1. Prepare an organizational structure chart.

Create an organizational "map" and define the functions, team leaders and other personnel for each organizational unit. The most important role is that of the alliance manager -- the individual who will be responsible for the overall success of the relationship. The alliance manager should be a person who is well-respected and who has access to decision makers at all levels of his or her organization. The alliance manager should also be able to relate well to the sourcing partner's organization, because a critical aspect of strategic sourcing is the chemistry between the two organizations. Over the long term, the alliance manager plays an essential role in solving problems, addressing conflicts that arise, and helping to keep the relationship on track when a shift in business conditions takes place.

Once the organizational structure chart is complete, review it carefully to be sure it truly supports the operational plan.

Train for success

Strategic sourcing relationships often require people to have new abilities and skills. It is important to consider the use of training for key individuals. For example:

- Alliance managers should be trained in successful leadership and management techniques.
- Teams should cross-train with their counterparts in the other organization, particularly in the areas where sales, technology development and service delivery must be highly integrated.
- Key managers should be "seconded"--that is, given short- to medium-term assignments in the partner company to learn how things work at that organization.

The organizational structure chart

The typical strategic sourcing organizational structure chart will include:

- ❑ Alliance managers.
- ❑ Champions.
- ❑ Content specialists.
- ❑ Special task force(s).
- ❑ Delivery teams.
- ❑ Support teams.
- ❑ Other teams, such as R&D, purchasing, production or logistics, as required.

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Content specialists

In creating an organizational structure chart, "content specialists" bear special consideration. These specialists are people with experience in the outsourced process who are retained by the organization, rather than transferred to the sourcing partner. Keeping these content specialists on staff helps ensure that the organization continues to have the expertise needed to monitor the outsourced process and manage the strategic sourcing relationship. These specialists do not need to be involved in the day-to-day oversight of the relationship, and they will normally have other duties within the parent organization. But they are nevertheless important to the relationship because they provide a vital "institutional memory."

The organizational structure chart, *continued.*

For each of these groups, it is necessary to define the:
- ❑ Functions the group will handle.
- ❑ Individual personnel assignments.
- ❑ Team leader(s).

Be sure to balance the teams by including personnel from each of the organizations, taking into consideration the capabilities and responsibilities of each organization. Consider using a "matrix evaluation chart" (similar to the responsibility chart used in Chapter 5 for allocating operational responsibilities) in order to gauge how well your selections balance capabilities and responsibilities.

Finally, you should designate a key individual to act as a "learning liaison." This person should be responsible for identifying and gathering the knowledge and learning that is gained from the alliance and for disseminating it throughout the parent company.

2. Prepare a summary of the governance structure and control mechanisms.

A strategic sourcing relationship requires more ongoing management oversight than does a traditional outsourcing arrangement. At the highest level, the relationship should have a joint governance board or steering committee that includes senior executives from your company and your provider(s). This body should guide policy, review the relationship's performance regularly, and generally be responsible for keeping the relationship "healthy" and focused on continued improvement.

The joint governance board

An effective joint governance board or steering committee will have five fundamental responsibilities:
- Policy guidance: Maintaining strategic and operational direction.
- Performance review: Controlling the alliance by measuring progress or missed milestones.
- Pressure: Motivating and empowering the alliance to encourage innovation and improvement.
- Problem solving: Overcoming difficulties in operations.

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- Partnership relations: Maintaining a win-win approach and keeping communications open.

Generally, the governance board will have five to seven members, including:

- Champions (in some cases, the champion and the alliance manager may be the same person).
- Alliance manager or managers who oversee the day-to-day operations of the relationship.
- Key delivery team leaders.
- Special task force leaders (if any).

In general, the board should meet:

- Immediately after the relationship is finalized.
- At least monthly for the first six months, to ensure that the new relationship gets off to a good start.
- As needed after the first six months, but never less than quarterly.

Nearly every outsourcing relationship incorporates meetings between the participating organizations, but enthusiasm often falls off over time, and meetings occur less frequently or on a lower and lower level, and thus become less effective. The continuation of regular meetings, even when they may not seem absolutely necessary, will help the relationship succeed.

Although the legal agreement for the relationship may call for a formal governance-board voting procedure, successful boards *never* rule by voting, but by unanimous consensus.

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Staying in control

Overseeing a strategic sourcing relationship requires an approach to management control that is new to many executives. In a strategic sourcing relationship, control tends to be an *empowering* process, instead of the traditional *limiting* process, and tends to be exercised in the following ways:

- **Control systems:** Establish an effective reporting system that lets your organization know if specific goals are being met and that lets both partners know when corrective action is needed. Monitor performance against STROI goals, such as innovation capacity, organizational capability and competitive advantage, in order to have a forward-looking control mechanism that focuses on the key strategic objectives of the venture.
- **Conception:** Gain mutual agreement at the top and middle ranks of both organizations so that all key players have a "common vision." This empowers people to act as a team and ensures alignment of activities. An operational plan that clarifies expectations keeps everyone marching toward the same destination.
- **Coordination:** Use project management techniques that break down the tasks of the alliance into discrete process steps.
- **Communication:** Communicate extensively, using technology to augment face-to-face communications. Many companies are now linked to each other via Electronic Data Interchange (EDI), videoconferencing and computer networks, making a broad range of communication possible.
- **Chemistry:** Good chemistry is critical to controlling and empowering an alliance. With trust as an underpinning, partners can remain confident that the alliance will not careen out of control due to unscrupulous behavior.
- **Creativity:** Work to develop and support creativity and flexibility. By maintaining a strong vision, and allowing a fairly high level of experimentation to exist, managers can help the relationship expand its horizons.
- **Commitment:** Success relies on persistence and commitment. Top-rank support from both sides of a relationship sets a clear direction and helps put strength and credibility behind reward systems.
- **Clarity:** When goals, milestones and responsibilities have been established and are regularly monitored, people will know what they need to do and where they are going.

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- **Consistency:** Consistency forms the basis for effective decision making and for reward and incentive processes, because it allows people to know what to expect and what is expected of them.

The structure of an alliance should provide a mix of autonomy, support and control. Effective control will come from using all nine of these mechanisms together as a whole system. Take away one or two of them, or substitute the more traditional--and limiting--auditing and reporting systems, and the alliance will suffer.

At the same time, however, remember this advice from Kenichi Ohmae of McKinsey and Company: "Few businesses succeed because of control. Most make it because of motivation, entrepreneurship, customer relations, creativity, persistence and attention to the 'softer' aspects of organization, such as values and skills."

3. Agree on performance objectives and operating measures.

Work with your sourcing partner(s) to finalize the performance objectives and operating measures that will be used to evaluate the relationship and determine the sharing of risks and rewards. Many of these objectives and measures will have been tentatively established in the Analytics and Selection phase (Chapter Three), and more clearly defined in the memorandum of understanding developed during the Co-Creation phase (Chapter Four).

At times, rolling targets are more appropriate than fixed targets. As one executive says of his company's arrangement: "Instead of writing key performance measures, we've defined a process for setting, measuring and reporting objectives as we go along." Because the ability to adapt to change is so important to the success of collaborative relationships, this kind of flexible approach to performance measures can be valuable.

Effective measurements will be critical to the success of the relationship. As discussed earlier in this guide, strategic sourcing measurement systems should look at more than the costs of the outsourced business process. Instead, they should look at whether the relationship is generating the overall business results that you want to achieve. That means that STROI measurements (innovation capacity, market impact, etc.) or some other balanced measures should be at the heart of the performance-reporting system.

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The judicious use of legal advice

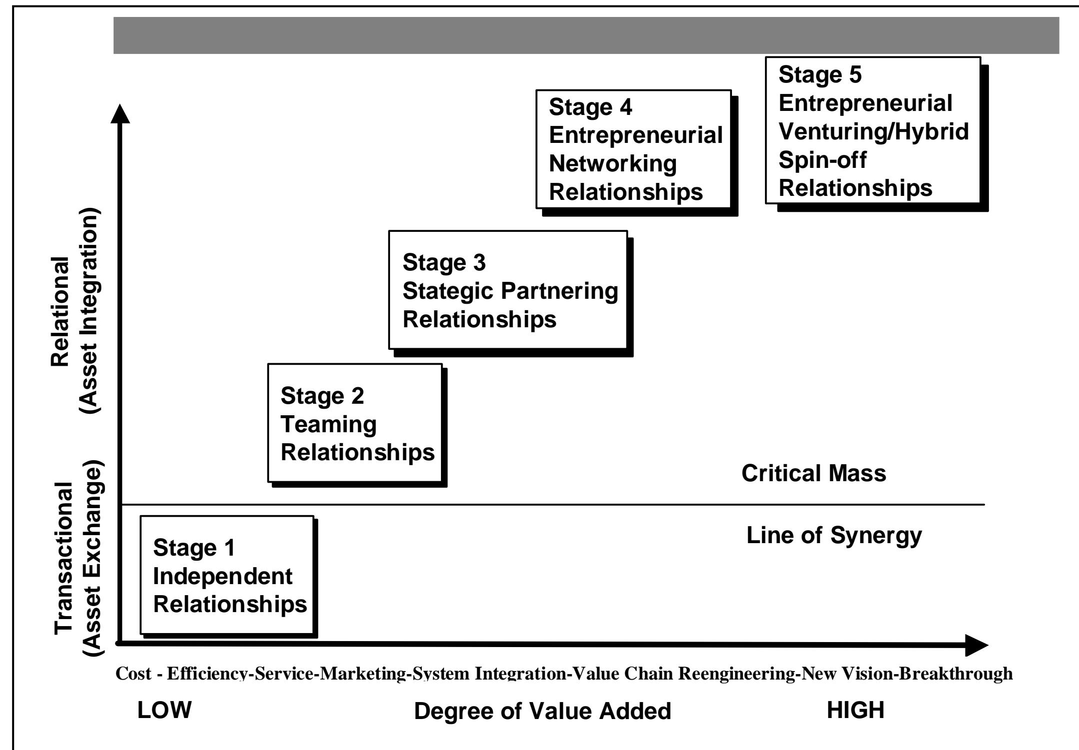
Some alliances never get beyond the initial discussions (or lose all semblance of a win-win approach) because legal advisers are brought into the process too early or are allowed to negotiate the business issues--a task that should be handled by senior and operational managers. In general, lawyers are trained in an adversarial system. They therefore tend to focus almost exclusively on "protecting" their client, and too often they impede the collaborative process that is vital to identifying a breakthrough value proposition. In addition, too strong a focus on legal issues can erode the trust and flexibility that leads to a successful relationship.

To avoid such problems, try to use legal advisers who are experienced in alliances and strategic sourcing arrangements. In addition, use your legal help in a supporting role, rather than in a leading role, in the early stages of legal, financial and ownership discussions. Your lawyers should be available to advise against potentially illegal acts, such as negotiations that may violate antitrust restrictions, and to contribute positively to discussions. As one manager says, "The lawyers have to know that they are legal counsel and not negotiating legal agreements. They are there to provide advice". Also, when lawyers are involved positively in early discussions, they are in a better position to craft legal agreements that protect their clients *and* capture the spirit of collaboration.

4. Agree on financial, legal and ownership matters.

Determine who will be responsible for specific investments, and establish the financial controls, legal structure and ownership split for the relationship.

The types of legal structures used in sourcing relationships vary widely, from simple contractual agreements to joint ventures, as shown on the Strategic Sourcing Spectrum discussed in Chapter 1. Customer/Vendor-type contractual agreements are generally more suitable to lower-level, transaction-based outsourcing arrangements.



Higher-level relationships with integrated operations and investments made by each party may warrant a separate partnership, limited liability entity or corporate joint venture. A recent trend is the use of a newly incorporated joint venture to house an entrepreneurial "split-off" operation. This approach allows for totally separate employee benefits packages, including stock and other equity plans, and a distinct corporate identity.

In general, it is not the legal structure itself, but the substance of the underlying operational and structural plans that will have the greatest effect on the success of the relationship, because these plans define *operational control*, *ownership of equity* and *distribution of rewards*. Generally, these factors can be dealt with in the terms of a contract, in a partnership agreement or in the provisions of a corporate stock issuance or joint-venture agreement.

Operational control is often given outright to the outsourcing provider in more traditional outsourcing arrangements, since that party is usually chosen for its operating competencies. In more strategic arrangements, such control will often be given to the joint governance board made up of members from both organizations.

Ownership of equity will only be an issue if a separate business entity is created; if so, the organizations should seek to balance equity ownership as close to 50-50 as possible. When substantial equity infusions and the significant integration of operations are required, a relatively even split will help ensure that each party makes similar front-end equity contributions and that the parties will have similar levels of continuing interest in the venture's success.

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Strategic sourcing relationship structures

- **Traditional outsourcing agreements** tend to*:*
  - Be short-term and project- and task-oriented.
  - Be contractual, with exacting terms.
  - Be transaction-based; satisfaction is based on very specific deliverables.
  - Be subject to swift termination if they do not serve the immediate needs of one of the parties.
  - Involve no sharing of risk.
  - Use communication that is task-oriented rather than relationship-oriented.
- **Strategic sourcing alliances** are characterized by:
  - Top-rank support.
  - Frequent contact between top and middle levels of the partner organizations.
  - A long-term, "evergreen" strategic orientation.
  - Tight operating linkages, such as cross-training, product-development coordination, long-term contracts and cross-licensing.
  - A mutual vested interest in each other's future.
  - Reciprocal relationships--the sharing of strengths, skills and information for mutual advantage.
  - Management styles that are based on collaboration, not hierarchical power.
- **Equity partnerships** take strategic sourcing alliances to the next level, and involve one company purchasing a minority stake (usually 5%-35%) in the partner company, often with options or preemptive rights for the purchase of more stock. Usually, such arrangements entail a larger outsourcing client investing in the outsourcing provider, in order to give the provider the cash it needs to support technology or services development.
- **Joint ventures** are:
  - Formal alliances that result in the creation of a new, separate business entity.
  - Staffed and managed by a separate management team.
- **Acquisition or spin-off joint ventures** are those in which one company purchases interest in an existing subsidiary or division of another company, which is then spun-off as a separate joint-venture corporation.

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Strategic sourcing relationship structures, *continued*

- **Shadow joint ventures:**
  - Function exactly like a joint venture, but do not have a formal separate organization.
  - Allow for a separate culture.
  - Involve clear integration of management-team functions.
  - Involve separate financial accounting for the venture's activities.
- **Quasi joint ventures:**
  - Are "shell" companies that exist only for tax and finance purposes.
  - Rely on employees who still work for the individual parent companies, rather than for a separate legal entity. This structure allows employees to remain in their parent companies' compensation systems and makes it easier to terminate the venture if it is not successful.

5. Evaluate all structural elements for balance and a win-win approach.

Review all aspects of the agreed-upon structure to ensure that risks, resources, responsibilities and rewards are balanced. Avoid arbitrary determinations of what constitutes a win-win situation - both parties should decide that in an open manner. Also, remember that the best apportionment agreements are short, basic and easy to understand.

Risks and rewards should be divided fairly and in a way that motivates both you and the sourcing partner. It is imperative to create incentives that allow both companies to *gain more through the relationship than they could gain independently.* This does not imply that all sourcing relationships must split rewards 50-50; instead, each organization should see its investment and abilities as essential to success.

The valuation of intangibles, services and technologies that are contributed to the relationship can be difficult. If there is a wide disparity in perceived value in such areas, try using a contingent valuation approach, which adjusts the contributed value/royalty/licensing fee over time based on actual marketplace results. In addition, consider the use of independent valuation experts to provide an objective foundation for agreement or compromise; too many deals have fallen apart because of subjective, rosy estimates of asset value.

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Asking the right questions

Before formalizing a legal agreement, it is essential to ensure that the relationship is truly a win-win agreement. The questions that need to be answered can include:

- ❑ Who invests **cash,** and how much?
- ❑ Who invests **time,** and how much?
- ❑ Who receives the **rights** to:
  - Market or distribute products?
  - Manufacture products?
  - Acquire or license technology?
  - Purchase future products or technology?
- ❑ Who receives **tax** benefits?
- ❑ Who is **responsible** for specific accomplishments?
- ❑ What happens if more **money** is needed?
- ❑ How are the **profits** and **losses** allocated?
- ❑ How is **confidential information** handled?
- ❑ What **products** are specifically included and excluded?
- ❑ What are the **patent** provisions?
- ❑ What are the guidelines for **terminating** or **revising** the agreement?

6. Draft the contract.

Prepare a draft of the legal agreement for the relationship, and conduct negotiating sessions as necessary. The memorandum of understanding produced in the Co-Creation phase and the joint operational plan created in the Operational Planning phase should form the basis of the legal agreement.

In addition to the standard legal and tax issues normally addressed in a contract, consider including agreements about:

- **Customer relationships.** (How will you deal with pre-existing customers, non-compete agreements and conflicts created by product or territory overlaps?)

- **Rights to new products, derivatives and intellectual property.**
- **Contacts with competitors.** (How will the "bleedthrough" of confidential information be controlled?)
- **Conduct guidelines.** (What ethical and trust-building standards of conduct are both partners expected to maintain?)

Allow room to grow

Traditional legal counsel will tell you that the most important clause in the contract is the "exit strategy," which spells out what will happen if the relationship collapses. This is an important issue, but the exit strategy should be encompassed within a larger "transformation strategy" that outlines how the partners will change the structure, direction, rewards formula, and roles and responsibilities when the conditions around the strategic sourcing relationship shift. And they will shift--the only questions are, "When?" and "In what direction?"

The length of time that the contract should cover varies, but the time frame for a strategic sourcing agreement is usually longer (perhaps 5 to 10 years) than it is for traditional outsourcing arrangements. Such long-term agreements give the relationship time to evolve, and the time needed to achieve more strategic benefits. As one executive says, "I think five years from a business planning perspective is very manageable: The shorter the duration, [the greater] the chances are the economics of the deal may not be as sound. Your supply partner will not be able to plan out as far in advance and have that commitment on volume and revenue to do a lot of the service piece things that they need to do."

The contract should also have adjustment clauses that require midcourse corrections. Such flexibility is an integral part of building a strong, enduring partnership.

If you are not able to reach an agreement about the shape of the contract, management needs to assess and address where the process has broken down. Have the parties been unsuccessful in building mutual trust? Is the value proposition simply not compelling enough? The use of an objective facilitator may be helpful in such situations.

Finally, continue to build on the positive momentum you have created so far. Bargaining over contract provisions will be easier and less divisive if a win-win attitude and a sense of trust are maintained throughout the final drafting of the contract.

7. Obtain final senior management approvals.

Review the draft contract with the joint governance board and other senior management, as necessary. A clear understanding of the final agreements is vital to gaining the future support of these constituencies.

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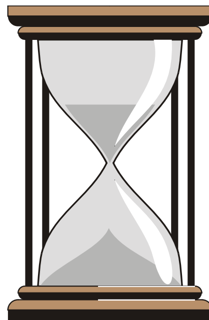
8. Sign the contract.

Convene a signing session to seal the agreement. Key team members and management personnel should initial a draft of the final contract to formally and symbolically show their agreement with its terms.

However, do not draw too much attention to the contract and the closing negotiations; focus instead on the relationship that has been created. Highlight the value proposition, emphasize the trust and teamwork that have developed, and build enthusiasm for the upcoming roll-out of the relationship. The Structuring phase will have been successful if all parties are more focused on the future prospects for success than they are on the concessions made by either side in finalizing the contracts.



When am I done?

At the end of the Structuring phase, you will have determined the approaches to leadership, organizational systems and risk-and-reward sharing that are right for the relationship - and then forged a contract that reflects and enables those approaches. At the same time, you will have developed a strong sense of teamwork and enthusiasm in your joint team, and you will be ready to execute the launch plan created in the Operational Planning phase.

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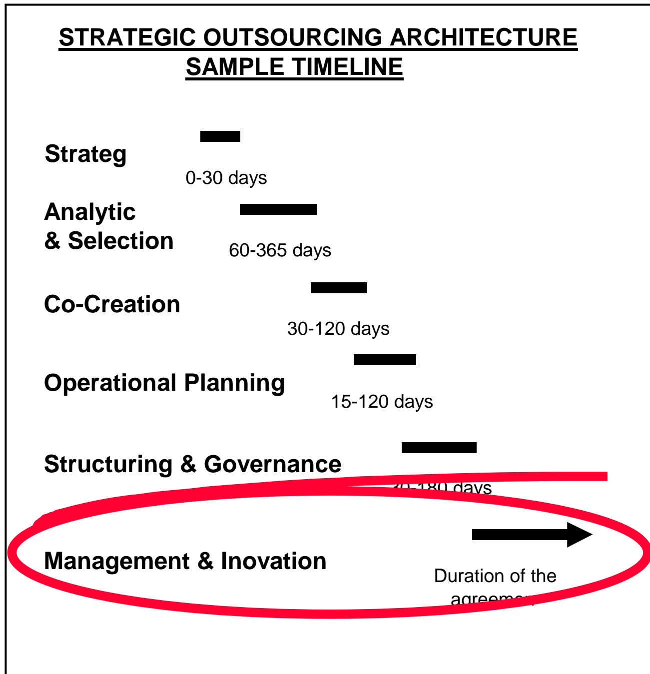
Chapter Seven Management & Innovation



In the Management & Innovation phase, the agreement established in the Structuring phase is implemented and managed over time. This phase involves two teams: the operational team and the joint governance board.

The joint governance board, which was formed in the Structuring phase, includes executives from your company and your provider(s). This board guides policy, reviews the relationship's performance regularly, and is generally responsible for keeping the relationship "healthy" and focused on continued improvement.

The operational team, which is was formed in the Operational Planning phase, is responsible for ensuring that the sourcing agreement is implemented and managed. This team also works with the joint governance board to ensure that issues are handled in a timely manner. Team members should have a clear understanding of the business process in question and of the nature and expected benefits of the relationship. At the same time, team members should have strong communication and problem-solving skills that will allow the partner organizations to work together to find new approaches and breakthroughs beyond those spelled out in the original agreement.

The action steps of the Management and Innovation phase are:

1. Hold initial implementation meeting.
2. Maintain continuity of personnel.
3. Monitor performance.
4. Exploit short-term opportunities.
5. Review service levels.
6. Resolve problems.
7. Maintain top-management support.
8. Maintain motivation of alliance managers.
9. Renew the alliance by focusing on Continuous Innovation.

Building teamwork

Several qualities and techniques can help build a cohesive team:

- **Responsibility:** Individuals should be given enough responsibility to feel a sense of control and personal satisfaction.
- **Creativity:** Team members should be allowed to offer new ideas and alternatives before tackling a project. Foster creativity by focusing on results, rather than dictating processes and procedures.
- **Focus:** Make the team's mission and responsibilities clear.
- **Communication:** Teams should be provided with accurate information and timely feedback.
- **The "big picture" view:** Keep the team focused on the results being produced for the customer, and the value being created by the team's work and the overall strategic sourcing relationship.
- **Intervention:** Managers should act quickly to stop anti-team behavior.

Management & Innovation
ACTION STEPS

1. Hold initial implementation meeting.

A meeting of the relationship's operational team and the outsourcing provider's implementation team should take place as soon as the sourcing agreement is approved in principle. (In order to ensure that the transition occurs in a timely manner and to implement the agreement as soon as possible, you may want to hold this meeting before the signing of the contract. This will give the team more time to consider human-resources and asset-transfer issues.)

The meeting should focus on making sure everyone understands the nature of the relationship and, in particular, their roles in executing the 90-to-120-day launch plan created in the Operational Planning phase. The meeting also gives the operational managers a chance to get to know each other and begin building a team.

The launch meeting agenda

In the launch meeting, review the following issues in order:

1. **Mission/Value proposition**. Start the meeting with a review of the big picture--the reason the alliance was formed in the first place. Be sure everyone is 100% committed to the alliance.

2. **Strategic Return on Investment for both partners**. Discuss what each company will get out of the relationship, so that everyone understands each partner's perspectives.

3. **Values**. Review the core values outlined in the memorandum of understanding.

4. **The plan and the goals**. Be sure everyone understands their roles and responsibilities, and what is expected of them. Refine any plans that are unclear or incomplete.

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5. Potential problems. Identify possible problems, and develop approaches to resolving such problems. Pay particular attention to making the people who are being transferred feel secure in the new working environment.

6. Breakthrough projects. Identify any elements of the plan that require extraordinary results or quantum leaps in performance.

2. Maintain continuity of personnel.

In a strategic sourcing relationship, all parties need time to build trust and understanding. Excessive turnover in the operational team can result in:

- Loss of direction.
- Lack of confidence in an organization's commitment to the relationship.
- Missed opportunities for learning.
- Loss of institutional knowledge.
- The collapse of the relationship.

In short, continuity of personnel is essential if a strategic relationship is to thrive. Try to avoid the typical 18-month management rotation cycle, and consider three-to-five-year stints for senior alliance managers and key staff. Also, provide for six-month overlaps for new people coming into key positions; this will give them time to become acclimated and to understand the nature and value of the relationship.

3. Monitor performance.

Monitor the service levels and performance indicators finalized in the Structuring phase, including the broader indicators of business results, such as customer satisfaction, market share, product-development cycles and so on.

In the first few months of the relationship, allow for a "discovery period" in which to compare actual performance and expected performance. Remain flexible enough to change measures and adjust incentives so that you are accurately tracking and motivating performance under real-world conditions.

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In general, measures evolve over time in a strategic sourcing relationship. In the early stages, they tend to be tightly defined, but as the relationship grows more strategic, and a sense of trust develops, broader measures and increased flexibility come into play.

Hold regular, formal performance-review meetings. Otherwise, problems will tend to "slip through the cracks," and changes in the business environment that are altering the dynamics of the relationships may go undetected. Regular meetings allow people to plan ahead in discussing issues, clarifying roles, presenting new ideas and so forth.

In addition to performance indicators, monitor the state of the relationship itself, using surveys, interviews and informal conversations. Keep tabs on your sourcing partner's needs and objectives, as well as your own, and make adjustments to the risk-and-reward formula to ensure that the arrangement continues to be attractive and profitable for both parties.

Early warning signs

There are several early warning signs that indicate potential problems in the strategic sourcing relationship. Watch for danger signs such as:

- **Too many tasks on the "back burner."** One or more of the parties doesn't give top priority to getting the job done.
- **Missed deadlines,** which usually signals unforeseen problems, poor planning or poor management. In particular, watch for a spiraling progression of missed deadlines.
- **Role confusion.** If a team does not seem to understand its assignments, clarify roles and expectations immediately.
- **"Winners and losers."** Be on guard against any feeling that one partner is gaining at the other's expense.
- **Cost overruns:** Early-stage cost overruns may indicate inaccuracies in risk analysis and planning.
- **Missed goals and milestones**, which are particularly troubling early in the relationship, because they tend to create problems that are amplified over the long term.

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Breakthrough project criteria

Breakthrough teams should focus on opportunities that:

- Are driven by an urgent, compelling goal.
- Have a quick, achievable first step.
- Can show a measurable, bottom-line result.
- Have a benchmark standard for comparison.
- Can be achieved using available resources.

4. Exploit short-term opportunities.

Short-term opportunities are small, measurable successes. In the short term, they provide tangible evidence of success; in the long run, many quick wins can add up to fairly significant benefits.

Create breakthrough project teams charged with identifying and exploiting opportunities for quick performance improvement. You don't need to invest a lot of money in such teams - the idea is to produce better results with the same resources. Consider appointing those who participated in the Co-Creation process as leaders of these breakthrough project teams, in order to tap into their understanding of the relationship and their already-established interest in its success.

Conditions for breakthroughs

Breakthroughs in performance are enabled by a variety of conditions, such as:

Triggering conditions.

- ❑ Breakdowns or conditions of stress
- ❑ Demands for extraordinary action

Operational conditions.

- ❑ Diversity of input/viewpoints
- ❑ Willingness to confront traditional paradigms
- ❑ Willingness to diagnose and to seek new patterns
- ❑ A belief that new levels of performance can be achieved quickly

Supportive conditions.

- ❑ High expectations
- ❑ Top-rank support
- ❑ Existence of a focused team

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Adapting to change

During the course of a strategic relationship, there will inevitably be changes in the strategic and operational environments and in the chemistry that exists between partners.

Potential changes in the *strategic environment:*
- Price changes
- Change in technology
- Competitors entering the market
- Market changes
- Production-cost increases or decreases

Potential changes in the *operational environment:*
- Internal financial problems
- Production and marketing costs
- Lack of productivity

Potential changes in *chemistry:*
- Change of key personnel
- Lack of commitment and support
- Conflicting organizational values

5. Review service levels.

The service levels used to gauge the performance of the outsourced process should be reviewed regularly to see if they are still realistic and whether they continue to support a true win-win relationship. If not, they should be adjusted to reflect real-world conditions.

At a minimum, reviews should take place quarterly. "The establishment of regular review cycles can help keep the relationship on track," notes an IT manager at a UK transportation company. "We're putting in new applications and changing our technology all the time, so the requirements and the service level agreements have to change, too. We have quarterly reviews where we can tinker, and an annual review where we can change services wholesale. In hindsight, we made the initial contract too inflexible, but we've slackened it off since."

Conditions in the business and technological environments change constantly. If the changes are significant enough, they can affect the assumptions and plans that underpin the relationship. Monitor change in the strategic and operational environments and in the chemistry between the two organizations. Be prepared to alter or even rethink the relationship in order to adjust to new conditions.

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Problem-solving "rules of thumb"

- **Deal with problems quickly.** Problems sometimes seem to "go away" on their own, but in reality they fester and grow.
- **Work through problems together.** Rushing to place blame on the other party will doom the relationship. Partners should engage in a full discussion of the issues, and an exploration of alternatives, and try to reach a consensus on actions to be taken.
- **Make a commitment to action.** Once a solution is found, take the initiative; set deadlines and milestones, and ensure that results are achieved.
- **Communicate.** No alliance has ever failed because of over-communication. Be sensitive to the difficulties and delays that sometimes occur when communicating across corporate boundaries, and make sure that the right people from both sides of the relationship are involved in problem-solving discussions.
- **Keep your partner whole.** Keep your partner's best interest in mind.

6. Resolve problems.

Aggressive schedules and extensive change make some friction inevitable, so make sure that processes are in place for resolving issues as quickly as possible.

When problems arise, use the principles of the three-dimensional fit (strategy, operations, chemistry) described in Chapter 3 to isolate the root causes. Determine whether the problem stems from *strategic* changes (such as a change in market conditions), whether it is chemistry-related (has one of the partners lost interest?), or whether it is operational (is there a problem in management, marketing or production?).

In resolving problems, remain flexible -- and avoid going to court. To address operational issues, bring teams together for problem-solving sessions. For chemistry-related or strategic issues, consider going to senior management and the use of "summit meetings" to get things back on track. "You need a way to escalate issues so they don't boil over and cause an 'I'm-going-to-get-my-lawyer' reaction," says one executive at a major aerospace company. "It's important to develop an ongoing relationship. Once you have to start looking at the small print, you've lost the spirit of it."

Don't rely solely on formal problem-solving mechanisms, however. Active communication - informal and formal - will help you identify problems and find solutions before problems fester and endanger the relationship. "You need to have open and honest communication and raise issues early, and not wait until the quarterly review meeting," says one computer-company executive.

Finally, try to see the opportunities that are often hidden in problems - that is, try to turn breakdowns into breakthroughs, and draw on the "creative tension" that is present when two groups work together. Understand the differences in viewpoints and culture that partner organizations bring to the table, and incorporate those diverse views into plans and operations. The interplay of different and even opposing ideas helps uncover new approaches and drives new levels of performance.

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Maintaining the win-win attitude

To sustain a strategic sourcing relationship, both parties must continue their commitment to a win-win approach. This requires a willingness to:

- ❑ Work through issues and not "point fingers."
- ❑ Invest management time and resources to ensure a smooth transition and smooth ongoing operations.
- ❑ Share in planning.
- ❑ Share confidential information.
- ❑ Conduct internal communications and training on business goals and relationship management.
- ❑ Bridge cultural differences between organizations.
- ❑ Continuously exchange knowledge and expertise.

Maintaining senior management involvement

To keep senior executives involved in the strategic sourcing relationship:

- Appoint senior managers to the joint governance board.
- Have the joint governance board regularly brief senior management.
- Involve your CEO during the implementation of the relationship.

7. Maintain top-management support.

Successful strategic sourcing requires both partners to devote management time - at the senior and operational levels - to regular meetings concerning the relationship. The support of senior management signals the organization's commitment to the relationship, and it helps maintain a focus on the "big picture" so that the relationship does not become hobbled by small disagreements and differences. The champion and alliance manager should ensure that there is a high level of awareness of the relationship at the top of the organization, and they should communicate regularly with senior management, providing updates on the relationship's progress. In addition, meetings between senior managers should occur monthly at the outset of the agreement, moving to quarterly as the agreement matures.

8. Maintain motivation of alliance managers.

Motivate managers to stay with the alliance and help it grow through the life of the agreement. Provide compensation packages with performance bonuses that are based on meeting the business goals of the relationship. In addition, provide managers with training opportunities and rotational assignments to build their breadth of skills and heighten their satisfaction with their role.

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The alliance manager

The alliance manager plays a key role in maintaining and growing the strategic sourcing relationship over time. The alliance manager should:

- ❑ Wield influence through personal persuasion.
- ❑ Be able to persuade others based on both personality and competence as an expert.
- ❑ Transform conflict into creative problem solving.
- ❑ Be able to relate to diverse perspectives.
- ❑ See the "big picture."
- ❑ Be recognized as knowledgeable and credible.
- ❑ Have access to top management of his or her organization.
- ❑ Be responsible for the overall success of relationship; success is not just financial measures.

9. Renew the alliance through Continuous Innovation.

A successful strategic relationship continues to evolve and grow over time. Many of the techniques and approaches described in this guide can be used on an ongoing basis to look for new breakthroughs and new approaches; it is not necessary, or recommended, to wait for the contract renewal period to explore new possibilities. Thus, managers should constantly encourage:

- *Flexibility*, to enable the organization to move quickly and adapt to changing conditions.
- *Creativity*, to find new solutions that outdistance the competition.
- "*Masterful*" *productivity*, which means making commitments to extraordinary results.

Innovations often come about because a team sees the world from a new frame of reference. Remember that strategic sourcing relationships have a "hidden asset" in this regard - their inherent diversity of viewpoints. Tapping into the views and perspectives of your partner can be a powerful way to find new approaches and drive new breakthroughs in the relationship's business performance.

Strategic Relationships that focus on Innovation are far more likely to drive costs down continually, while maintaining a win-win for both parties. Innovations can take the form of technology inventions, process improvements, or market extensions – each of which are valuable and vital to the long-term successful strategic outsourcing relationships.

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Conclusion

This guide is intended to provide a general sense of how a systematic alliance-building process can be used to forge strategic sourcing agreements. By following this alliance-building process -- and adapting it to your situation -- you can help your company be more effective in tapping into the skills, resources and capabilities of sourcing providers. In fact, you can help your company achieve a broad range of benefits, from reduced costs to increased market share and customer service to the ability to enter new markets. Perhaps most important, you can help your company develop new relationship -- and alliance-building skills that will make it a powerful competitor in the coming decades.

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Appendix A

Process-Specific Guidelines

Although the focus of this Practitioners Guide is to outline a set of procedures and concepts for engaging in a strategic sourcing relationship, many readers will also be interested in how to determine which business process(es) to outsource.

Most high-level outsourcing decisions regarding which business process(es) to outsource are made during the Strategy phase, followed by the establishment of the baseline performance of those business processes and the setting of key service level targets in the Analytics and Selection phase.

This appendix addresses many of the key process-specific considerations involved in outsourcing end-to-end IT management, application management, finance and administration services, and logistics management services. For each of these processes, topics covered include:

- State of the Market
- Critical Metrics to Measure and Manage
- Expected Challenges and Benefits
- Vendor Selection Criteria

The material in this appendix was provided by G2R. G2R is an applied market research and management consulting firm for the IT and Professional Services industry. The Warren Company wishes to thank G2R for its participation in this project.

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State of The Market: Information Technology Outsourcing

Information Technology Defined

Information can literally change the way a company or an entire industry does business, not only enabling organizations to survive, but to thrive in their respective markets. Among those activities which organizations undertake for themselves, there are very few in which information systems and management do not play a central role -- sales, marketing, cost control, quality management, productivity, partnerships and alliances, etc.

In the broadest terms, an Information System comprises people, processes, and technology which combine to help companies to identify, collect, store, analyze, and distribute the information required to drive all of the business functions which define an organization. These include both general functions (e.g. accounting) and industry or company-specific functions (e.g. computer circuit board manufacturing).

Therefore, Information Technology (IT), as a subset component of IS, is that part of an information system which includes the hardware (e.g. a mainframe computer), the software (an operating system, a database, your word processing program) and the supporting services designed to maximize the utility of a system to an organization's internal and external customers. Today, businesses are developing Information Technology-based business systems that are increasingly complex, sophisticated, and powerful, which, in turn, produces a correspondingly more complex management and financial burden on those organizations. Nevertheless, the integration of these systems into the "fabric" of business is essential.

For the purpose of this paper, it is important to know only the high-level model for such computer-based information systems -- i.e. how services components fit together -- as well as how the Information Technology of today is changing within companies and among marketplace constituents -- for example, how disintermediation in customer service is causing retail end users to now serve themselves on the Internet, instead of calling a customer service representative over the telephone. Logically, outdated or otherwise ineffective IT systems can cripple a company and directly impact key business performance areas such as cashflow, revenue generation, market share, employee retention, and customer satisfaction.

Among the key building blocks of today's organizational computing paradigm are:

- Data Center Operations: Centralized processing in a Data Center Operations computing environment occurs on a stand-alone, mid-range (e.g., HP 3000) and/or high-end (e.g., IBM 3090) systems that are physically located in one or more controlled environments. These systems typically optimize management of large databases and information, which are not well-suited for individual end user interaction.

- Network Operations: Networks bridge Data Center Operations and Client/Server Operations at the departmental and divisional levels. Traditionally, MIS Departments have managed corporate data networks, while either users themselves (e.g., a non-IT engineer with desktop

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expertise in a design department) or designated IT professionals (e.g., LAN administrators) have managed end-user computing. The "network" can also be intra-LAN or intra-WAN and include the transport-side (router-out) voice, video, and data communications.

- Client/Server Operations: This term refers to that part of the IT infrastructure which apportions applications processing tasks between multiple *servers* (centralized, multi-user units optimized for data management and information sharing) and *clients* (units with the full range of processing capabilities, optimized for user interaction - e.g., workstations or PCs). This is the emerging computing paradigm to which many organizations are migrating at an enterprise level as they attempt to enhance their employees' and customers' ability to share and use information. However, it would be naive to think that all computer-based processing and workload will take place on a client/server platform.

- Applications Management: This refers to system management and program applications maintenance. For example, just as a book is a collection of words and pages, applications are collections of computer-programming languages which comprise the various types of software required to yield users with a specific type of functionality in completing a work task. There are several types of computer applications, which include systems software (intermediates between hardware and software system components) and applications software (intermediates among multiple types of software or provides a specific utility such as a database, spreadsheet, word processing or business processing program). *Please note that Applications Management is covered under a separate chapter and will not be analyzed in this section.*

- Desktop Operations: The desktop environment includes systems components from the Network Interface Card inward, such as: the desktop computer's Central Processing Unit (CPU), monitor, keyboard, and mouse; and the end-user applications (commercial off-the-shelf software, or "COTS") residing on the desktop, such as word processing, graphics, and sales and financial management programs. As companies seek to enhance the individual computing power of their employees and customers, the ability to properly configure, test, deploy and maintain thousands of personal desktop (and laptop) computers will be a key challenge.

Information Technology Outsourcing Services

Many end-user groups lack the labor, management, and financial resources to effectively maintain or remedy often mal-attended to but critical systems. One answer to this dilemma is to hire an outside firm to *continually* maintain and repair the existing IT. This strategy is known as "*Information Technology Outsourcing*" (ITO). In some cases, ITO can involve the purchase of new components for the system which are better, more flexible, and more technologically advanced.

The logic and acceptance of outsourcing is manifest in the very strong demand for Information Technology Outsourcing services. G2R forecasts the market for ITO alone at $104.4B (1998) growing at an average annual growth rate of 23% to $248.3B (2002). G2R defines **Information Technology Outsourcing (ITO)** as ***the contractual vehicle though which end users externalize life-cycle services and support operations for their IT infrastructure.*** Outsourcing can be partial (i.e., modular or selective) or total, and can involve not only the operation but also the acquisition of customer assets and personnel. This service assures the performance management of the IT systems.

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Parallel to the above IT models, IT Outsourcing services divide into several categories:

- Data Center Operations Outsourcing is the most mature of the IT-Outsourcing market and provides a very standard (and easily benchmarked) set of services, including (1) Systems Audits and Benchmarks; (2) Operations Maintenance and Disaster Recovery; (3) Education and Training; (4) Help Desk; and (5) other services such as data entry, quality control and assessment, administration, etc.

- Network Operations Outsourcing can be packaged either as a stand-alone service or bundled as part of a Client/Server Operations or Data Center Operations Outsourcing contract. Includes: (1) Audit and Assessment; (2) Architecture and Planning; (3) Monitoring; (4) Management; (5) other services such as education and training and help desk (usually embedded in Network Operating Center services).

- Client/Server Operations Outsourcing combines ownership, management and support services into a bundle delivered through a single contract to manage that portion of the infrastructure from the Network Interface Card in the individual PC up to and including the servers. Includes: (1) Change/Configuration Management; (2) Help Desk Operations; (3) Operations Support; (4) Performance Management; (5) Disaster/Recovery Management.

- Applications Management Outsourcing links the customer's business and IT concerns through a vendor and business services group, since it is the IT application which supports actual business goals. This service addresses the life-cycle needs of the IT application, from the initial IT infrastructure development to the maintenance of a complete set of IT business applications. ***Please note that Applications Management is covered under a separate chapter and will not be analyzed in this section***.

- Desktop Operations Outsourcing is the market which recently experienced very rapid growth, as a new breed of outsourcer focusing on "PC Life-Cycle Support Services" or "Desktop Outsourcing" emerged. Providers of these services include heritage aggregator/deployment firms who have moved away from being PC product distributors to external desktop management experts.

Figure 1 below displays G2R's base-line model for IT Outsourcing Services bought and sold in the marketplace today:

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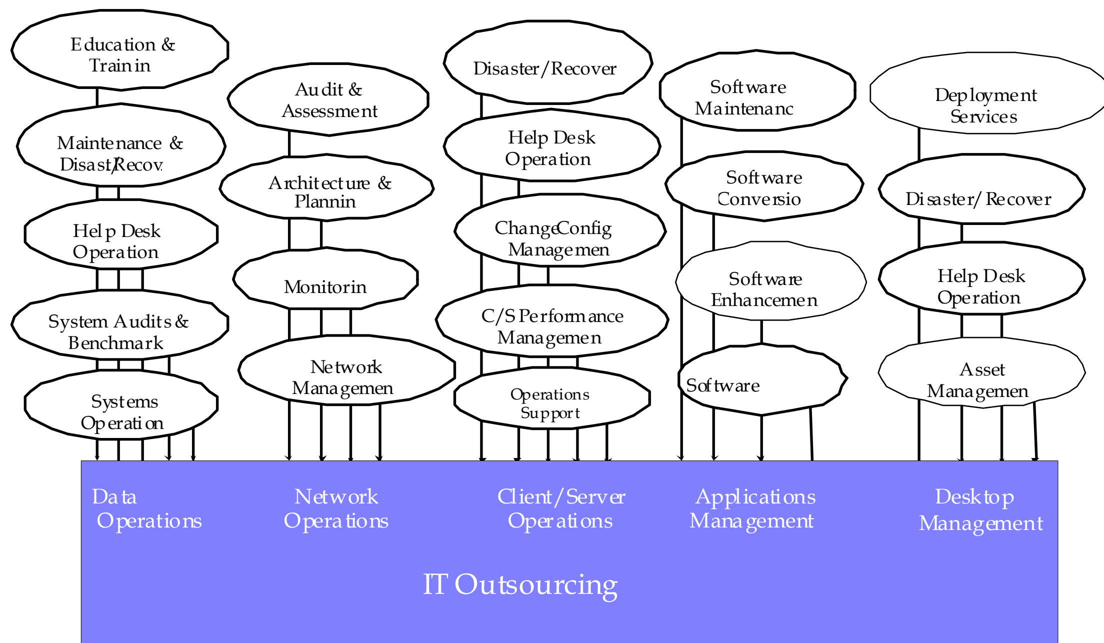
Fig-1 G2R's IT Outsourcing Market



Additionally, there are several market attributes, trends, and drivers which reflect the current state of today's IT Outsourcing market:

- Changing Motivations to Outsource IT Services: At the beginning of the 1990's, most organizations viewed IT outsourcing as a financial life-boat, an opportunity to off-load their balance sheet of IT -related expenses, equipment, and personnel. The drive was to save on cost rather than any desire to increase productivity or organizational differentiation/competitiveness. Today, cost is no longer always the key metric, as organizations seek to understand and manage increasingly complex environments and determine how their recent investments in IT can be put to good business use.

- Industry/Business Drivers to Outsource: Deregulation in the Banking and Finance and Utilities industries; the emergence of client/server computing; increased globalization; the growing importance of self-service customer care systems; the rise of the virtual corporation -- these are just some of the phenomena responsible for the changes within companies and between companies, industries and market constituents. Just as multitudes of companies underwent Business Process Reengineering (BPR) initiatives in the early 1990's, today those same companies must implement the fruits of their reengineering. This includes downsizing, cost control initiatives, redeploying assets to focus on "core competencies", and variabilizing service levels and cost for many corporate activities, among other activities. Outsourcing is often the strategy of choice to help meet these goals.

- Emergence of Both Total and Niche IT Outsourcing Suppliers: Today, end users may choose from both niche-focused outsourcers (e.g. desktop management, datacenter service, etc.) and larger, more comprehensive outsourcing vendors, who offer end-to-end outsourcing solutions. The growth of the IT-outsourcing industry, and its relative maturity, have spawned a host of long-term players with the requisite skills and experience to help customer manage their IT environments. For example, sample IT Outsourcing vendors in the U.S., by alpha, include ACS, Andersen Consulting, AT&T Solutions, CSC, EDS, IBM, MCI Systemhouse, and Perot Systems, among others. Specialized firms include companies such as I-Net (network management), Hewlett Packard (client/server management), and Vanstar (desktop management).

- Increased Propensity to Sole Source Engagements: Some companies today have chosen to work more closely with fewer partners; while this does not imply complete sole sourcing among end users, it does suggest that end-user organizations are shifting their focus in outsourcing from one of pure cost (the lowest bidder) to one of value, such that, in return for the trust and annuity streams end users commit to in selecting vendor partners, these vendors will improve upon both IT efficiency and business effectiveness of a function over the long term.

- Shortage of IT Skills: The number and type of IS staff required to support today's complex IT environments has placed strains on organization's HR departments and IT shops. For example, consider the demand for COBOL programmers in order to manage Year 2000 compliance challenges, or for Cisco-certified network engineers capable of effectively managing high-end distributed systems. Such IT personnel are in short supply and carry high price tags, particularly for employers who cannot leverage their expense across multiple accounts.

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A.II Critical Process Metrics To Measure and Manage for IT Services

The critical metrics to manage within an IT Outsourcing engagement are really a measurement of an organization's IT-related Key Performance Areas (KPA's). Therefore, Information Technology Outsourcing metrics should ideally mirror the business factors identified in the introduction of this paper. Many of these metrics will fall within the following KPA's across a variety of processes:

- Cost
- Functionality
- Quality
- Customer Satisfaction
- Management - IT/Business Integration

The way in which IT can affect these Key Performance Areas, or rather the appropriate IT-related contract performance metrics, are unique to IT Outsourcing.

Cost: Typical cost metrics within IT systems management include *price per MIP* (mainframe transactional unit), *price per user/desktop* (common in client/server environments), and even *price per device* or sub-device (cost per router interface in a network). Sources of cost control in IT Outsourcing engagements hail from several categories:

(1) removal of hardware/software assets from the customer's site and balance sheet;

(2) reduction in operating costs and, often, staff, which the vendor can more easily afford when they are being employed on multiple engagements; and

(3) improvement in the efficiency/cost ratio of IT processes.

Although there are no common standards for either capital or operational cost savings (these depend on the end user's baseline costs and efficiencies), typical savings curves track between 10-30% for outsourced IT operations. One point of note: those companies not outsourcing just to save cost (i.e. they are outsourcing for other reasons, such as productivity improvement), may already have cost-effective IT operations, but outsource so that they can use their existing assets in mission critical applications development, rather than less core activities, such as systems management.

Functionality: There are literally hundreds metrics related to IT functionality, which is really a measure of three systems/process areas:

(1) *Usability*: Sample usability metrics in IT systems include:

- proper system set-up and installation
- ease of systems use
- introduction/maintenance of common standards and applications

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- distribution of systems skills and procedures
- availability of technology and training

(2) *Reliability*: Sample reliability metrics include:
- throughput of voice/data/video flow
- systems uptime and fault tolerance
- response/repairs times for system or sub-system outages

(3) *Security*: Refers to the ability to run the system in the event of natural disasters or "acts of god". Also includes the protection and control of critical information contained an information systems.

Quality: There are numerous measures of quality within the IT function -- ***ISO*** compliance, ***CMM*** compliance (applications management), various technology certification (Cisco-Certified Network Managers), etc. Quality assurance is as much a function of *control* as of support; that is, the demand for IT services, when unchecked, can produce massive inefficiencies in and astronomically high costs for the IT process. Therefore, there are both supply and demand factors associated with effective quality assurance and *control* - i.e., proper demand management.

Customer Satisfaction:: There are several beneficiaries in any information system. An organization's IT organization must serve its individual end users, who, in turn are serving their customers. Or perhaps the ultimate end user, the customer, directly interacts with all or some portion of an organization's information systems (e.g. ATM's at banks, the Fed Ex shipper, touch-screen order entry systems at fast-food chains). How quickly and effectively a vendor can perform upon all of the other metrics directly contributes to end-user satisfaction (or dissatisfaction).

Leading-edge outsourcing vendors provide customer satisfaction benchmarks (often performed by a third party). These benchmarks cover all of the metrics which the vendor and end user have determined are important to the engagement, both subjective ("how happy are you with vendor?") and objective (downtime, time to move/add/change systems, accuracy of system configuration).

People/Process Integration Management: Outside of all technical metrics, there are a host of "management metrics" which are crucial to the successful implementation and maintenance of a service, outsourced or otherwise. For example:

(1) HR Management: How well motivated are the IT staff? What is IT employee morale? What kinds of career paths do these persons have?

(2) Risk Sharing/Management: What assurances can the IT shop provide that the best technology (cost and quality) is serving the correct role within the organization? How are critical IT issues being handled (e.g. Year 2000 applications compliance)?

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(3) *Supplier Management*: How well does the IT shop leverage suppliers of hardware/software products for cost, quality, and availability? How does the IT group (internal or external) effectively manage other 3rd party IT-support services vendors to fulfill the organization's IT support needs for maintenance and/or break-fix services?

The following **Figure 2** outlines the high level key metrics and sample measurements for how an IT Outsourcing vendor might be able to impact a customer's IT environment and business. The individual metrics and measurements required in any ITO contract will vary by company, IT service outsourced, industry, and nature of the ITO engagements (duration, risks, cost vs. value, etc.).

Fig-2 Expected Average Values Achieved

Vendors and End Users Expect Outsourcing to Achieve the Following Benefits

Metric	Benefit
Cost Savings	10%-20% savings
Availability	Increase 5%-10%
Response Times	Reduced
Worker Productivity	Increased 10%-15%
Internal Customer Satisfaction	Increased 10%-20%
MIS Staff Morale	Increased
MIS Staff Turnover	Initial increase, then decrease (stabilize)

Vendors expect to deliver these benefits after the first contract year, while end users expect to receive them upon contract initiation. Thus vendors must set expectations during the sales process about the benefits they will deliver and when they will deliver them.

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A.III Challenges and Benefits In Outsourcing IT Services

While there can be many benefits to outsourcing some or all of an Information Technology process, those benefits will not be realized unless buyers of outsourcing services understand and address the outsourcing's challenges, including:

- Understanding and Establishing Why You Are Outsourcing**:** To take advantage of outsourcing opportunities, executives must first understand their own motivations to outsource, as well as the outsourcing process. Many organizational leaders still view outsourcing solely as a cost-cutting tool; however, outsourcing is a new strategy for doing business, becoming more competitive, and growing. Companies that do not define their *business* goals will fail to build outsourcing relationships that result in the achievement of those goals.

- Lack of Proper Process Knowledge and Benchmarks: Often, companies fail to define the processes they are outsourcing. Without proper process definition, buyers inevitably purchase the wrong services at the wrong price -- i.e., companies must know what their needs are before determining what to buy. Companies that outsource without understanding what metrics to rely upon have no means by which to compare the quality of their existing processes with vendor offerings. Thus, they have no means by which to evaluate the value of outsourcing, evaluate different vendors' value propositions, or ensure vendor performance.

- Selecting A Compatible Vendor: Unless outsourcing decisions are approached in a rigorous and methodical manner, the wrong vendor may likely be selected. The costs of such mistakes include: process disruptions or failure, lost productivity, contractual penalties, and possibly legal costs. Also, as in any relationship, there are a host of soft skills for which an end user (and vendors) must test, including corporate and cultural issues, commitment to work goals, work styles and methods, prioritization, etc. End users should *evaluate vendors in a systematic manner* -- i.e., start with a set of requirements that allows your company to compare vendors, but also encourages the vendors to provide alternatives. Please see Section IV below for more on vendor selection criteria.

- Transition Management: A poorly executed outsourcing transition can lead to decreased productivity, low morale, employee flight, missed deadlines, poor service, and, ultimately, lower profits. End users and vendors must possess a game plan for all aspects of the deal to be managed -- human resources, structural/organizational entities, financing, legal back-ups, etc. Part of this transition is the inevitable need to *achieve organizational buy-in* at all levels - i.e. if a company determines that outsourcing is a good strategy, the end user and vendor executive teams must cascade this conviction downward and across the organization.

Challenges aside, there are also a variety of compelling reasons why companies outsource Information Technology. Potential benefits include:

- Increased Business Focus. Most companies depend upon a variety of mission critical systems to support key business functions and processes. However, their management's talents and energies are often better spent on strategic activities, such as developing new products, targeting acquisitions, or developing new clients, than on attempting to build and maintain their IT systems.

- Labor Shortages: Information technology personnel are in very short-supply, especially those persons familiar with leading-edge innovations. Only those companies that can fully utilize these personnel can afford them; typically only very large companies or companies which provide computer services to other companies can do so.

- Project Management Skills: Even if an organization could acquire the pieces necessary to manage or develop all of their IT systems, coordinating those ingredients to complete massive projects is beyond the abilities of most internal Information Systems groups.

- Cost Management: Additional fixed costs are a by-product of managing and developing IT internally. Outsourcing IT can reduce fixed costs and avoid new costs associated with keeping up with technological innovations. Generally, companies specializing in ITO can deliver the same or better service quality as an in-house group, but at reduced costs. These outside firms benefit from economies of scale and productivity advantages. Vendors also reveal hidden costs and enable users to variabilize, or "pay per drink" for service.

- Organizational Change: Successful mergers and acquisitions depend upon the integration of new companies. A key element of business integration is information technology systems integration. The need to quickly integrate acquired or merged companies exacerbates problems in internal IT maintenance, as companies often inherit disparate systems.

- New Opportunities: Realizing opportunities to extend existing markets or enter new markets, whether defined by product or geography, often depends upon the maintenance or replacement of existing IT systems.

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A.IV Vendor Selection Criteria for IT Outsourcing

G2R advises outsourcing buyers to build a balanced scorecard for conducting systematic and rational vendor analyses. Factors to build into the scorecard include:

(1) "*The Raw Ingredients*" or hard skills (e.g., technical skills and bandwidth);

(2) *Client Empathy*, or the ability to design a solution that delivers results (which depends on such things as business and industry knowledge);

(3) *Operational Tools*, such as the on-going project management skills necessary to create something from those ingredients; and

(4) *Management Capabilities,* such as the transition management methodologies necessary to implement and deliver an ongoing solution.

How each outsourcing buyer weighs each criteria will vary with their business goals; however, vendors' ability to contract for and deliver performance across the key metrics discussed in Section II will always be one of the most important vendor selection criteria.

Fig-3 Vendor Selection Criteria

Identtifed by End Users	Identtifed by Vendors
1 Vendor's Reputation (23%)	1 Technical Skills
2 Price (22%)	2 Global Reach (12%)
3 Technical Skills (20%)	3 ROI Story (10%)
4 Quality of Service (17%)	4 Vendor's Reputation (10%)
5 Vendor's Access to Resources (14%)	5 Integrated & Complete Services (6%)

CONNECT	Both vendors and end users named **Vendor's Reputation & Technical Skills** as key selection criteria.
DISCONNECT	**Price.** End users say that price weighed heavily in their decisions (22%), while vendors felt that as long as they could present a cogent argument supporting their pricing, users are flexible. G2R agrees.

Source: 79 End Users and 11 Major Vendors, Worldwide

The sample vendor scorecard included in the general introduction of this paper provides an over-arching list of possible vendor selection criteria for all processes. In addition, **Figure 3**, below, summarizes the vendor selection criteria which emerged as "critical" among end users recently surveyed for IT Outsourcing deals.

B.I State of the Market: Applications Development and Management Outsourcing

Applications Defined

There are several types of computer applications, which include *systems software* (intermediates between hardware and software system components) and *applications software* (intermediates among multiple types of software, or provides a specific utility, such as a database, spreadsheet, word processing or business processing program). More specifically, applications software consists of instructions that direct a computer system to perform specific information processing activities.

There are two main types of applications: 1) *General Purpose Applications*; and 2) *Process Support* Applications. *General Purpose Applications* are not linked to any specific business function, but support general work activities, such as quantitative analysis, data management, and word processing. *Process Support* Applications drive the operations of specific business processes such as:

- Accounts receivable and payable
- Cost control and reporting systems
- Customer service
- Inventory
- Order entry
- Sales analysis

Process Support Applications are generally more complex and require a greater degree of customization to meet the specific needs of a particular business than do *General Purpose Applications*. This customization depends upon the use of industry- and process- knowledge in effectively developing and maintaining applications. Outdated or otherwise ineffective applications can cripple a company and directly impact key business performance areas such as cashflow, revenue generation, market share, employee retention, and customer satisfaction. However, many companies lack the labor, management, and financial resources to effectively maintain or remedy these flawed, yet critical, applications. By applying their specialized understanding, applications development and maintenance experts can better anticipate and respond to the application users' needs and, ultimately, can increase the business effectiveness of applications.

Applications Management and Development Outsourcing Services

One remedy available to companies: hire an outside firm to *continually* maintain, repair, support, and administer existing applications. This solution is known as "*Applications Management Outsourcing*" *(AMO)*. By outsourcing *Applications Management (AM)*, a company can often more easily and cost-effectively integrate new technologies and process improvements into its existing systems.

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Another alternative: replace the existing application with one that is better, more flexible, and more technologically robust. Many companies lack the capabilities, experience, or resources to create new applications ("*Applications Development," or AD*). Fortunately, there are firms which possess the requisite skills, experience, and bandwidth for developing new applications. The strategy of hiring an outside expert to build and install a company's required business process applications (the applications "design and build" function) is known as "*Applications Development Outsourcing*" *(ADO).*

ADO and AMO contracts are increasingly linked in the minds of end users. For example, many AMO contracts may include small-scale applications development (mainly conversions and enhancements), as AD contracts are generally limited to large-scale development projects. In addition, particularly for applications that include client-server and relational database technologies, companies see synergistic benefits in hiring the same service provider to both develop and maintain these applications, which often drives further development work. Finally, it stands to reason that if AD is proprietary and external, there is no reason AM should not be as well.

According to research by the University of California at Irvine, applications development costs surged by 50% from 1991 to 1995; in addition, for every dollar spent on development, more than 50 cents was spent on maintenance. Vendors are well aware of the trends favorably affecting applications development and maintenance outsourcing. Many developers are offering applications management services as well. Systems integrators and development firms are accentuating their willingness to move beyond an application's coding and implementation into the traditionally under-supported tasks such as user support. Full-service ITO firms include applications maintenance as part of their "total solutions" approach.

Why Outsource?

There are many compelling factors driving companies' decision to outsource *Applications Management* and *Applications Development*, including:

- Business Focus. Most companies depend upon a variety of mission- critical applications, such as inventory management applications in a retail environment. However, their management's talents and energies may be better invested in strategic activities, such as developing new products, targeting acquisitions, or developing new clients, than in attempts manage these software applications.

- Cost Reductions: Generally, companies specializing in applications maintenance and development can deliver the same or better quality services at reduced costs, as compared with an in-house group. These outside firms benefit from economies of scale, highly trained and experienced staff, and other factors leading to cost and productivity advantages.

- A "Roadmap": While companies may realize their IS environments could be strengthened, many have difficulty determining which processes to focus on and where to apply improvements. External service providers can help their clients formulate a "roadmap" for process improvements,

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enabling companies to better institutionalize processes by identifying deficiencies, adopting standard practices, and sequencing the evolutionary steps necessary to meet specific goals.

- IT Expertise: Information technology personnel are in very short-supply, especially those persons familiar with the archaic computer languages (e.g., COBOL) from which, most existing or "legacy" applications are built or, conversely, the cutting-edge technologies (e.g., Java) used in creating new applications. Only those companies which can fully utilize these personnel can afford them, which typically consist of very large companies or IT services firms. Year 2000 software issues are excellent examples of projects that can dramatically increase or decrease in cost depending on the quality of existing application knowledge.

- Project Management Skills: Even if an organization can acquire the raw capabilities necessary to manage or develop applications, coordinating those ingredients to complete massive development or maintenance projects is beyond most internal Information Systems groups, who tend to address users' needs in a more reactive ("fire fighting"), rather than proactive (process-oriented), manner.

- Emergence of ERP Applications: Enterprise Resource Planning (ERP) applications contain huge advantages in scale and business process standardization as compared to traditional proprietary applications. ERP solutions represent the platform of choice for many companies. However, they also require a great deal of support, both in their installation/implementation and in their ongoing management, in order to maximize their capabilities. Who better to provide those services than the integrators most familiar with these packages?

- Emergence of Shared Services Environments: Many vendors are now offering shared services centers, which provide multiple companies access to best-in-class software and the accompanying talent pool to support it. Many middle market companies could not individually afford or support an ERP package, whose implementation costs are approximately 3.5 times its licensing cost. However, by leveraging a common supply chain, geography, or industry, these smaller companies can band together to make the outsourcing of ERP applications implementation a cost-effective solution.

Given the above drivers, business executives now view applications outsourcing as a strategic business decision rather than a defensive maneuver signaling weakness. The business world's adoption of outsourcing is manifest in its strong demand for *Information Technology Outsourcing (ITO)* services. G2R forecasts the market for Applications Management at $12.1B (1997), growing at an average annual growth rate of 18.1% to $27.8B (2002).

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B.II Critical Metrics To Measure and Manage in Applications Outsourcing

Adopting metrics tied to business performance ("*management through metrics*") is the best way to:

- define an organization's applications development and maintenance requirements;
- specify the scope and goals of the outsourced services;
- measure contract performance and quality; and
- ultimately optimize a company's AD and AM functions.

Laying this groundwork prior to the vendor's assuming responsibility for the AD and/or AM function(s) enables higher contract performance. In addition, the process of identifying metrics helps management reach a better understanding of its initial applications environment as a baseline for improving services and containing costs. Ultimately, the use of metrics results in both higher customer satisfaction ratings and increased success rates for vendors' BPO offerings.

The main challenge in outsourcing applications services consists of keeping projects "on time, on task, on budget." According to the Standish Group, 31% of AD projects are canceled after commencement, 52.7% are over budget by more than 189%, and only 42% have the agreed upon functionality. In order to improve upon service levels, G2R suggests breaking the engagement down into the following five Key Performance Areas (KPAs):

- Cost
- Quality
- Functionality
- People/Process Integration Management
- End-User Satisfaction

Cost: Whether paid up-front (fixed pricing) or over-time (time and materials pricing), contract cost is critical for assessing the value of applications work. It is important to remember that improving applications can reduce the overall cost of a *business function*, not just total IT spending. For example, within the procurement function, replacing separate inventory, production, and purchasing databases with an ERP application can create cost savings through a decrease in stock levels ("just-in-time" vs. "just-in-case" inventory), the consolidation of suppliers, and discounted early net payment terms.

In addition, outsourcing is as much about *cost containment* as about cost savings. According to research by Cowen and Co. and Datamation, information systems budgets grew approximately 7% in 1996, not enough to keep up with the 10% pace of growth in applications development and maintenance expenses. This squeeze on technology dollars results in a need to *manage user demand* (one vendor, for example, has helped one of its clients save over $1 million through billing end users for services consumed), as much as to save costs.

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In AM outsourcing, costs should decrease throughout the life of the contract, as the maintenance staff becomes increasingly fluent in a company's different applications and the underlying code. Therefore, one important cost metric is the reduction in the total number of full time equivalents involved in the support function. This can be measured *absolutely* (in terms of total employees), *proportionally* (in terms of the redeployment of resources into higher value-add activities), or both. Other AM cost metrics include:

- the # of full-time equivalents (FTE's)/cost per head
- cost of tools and methodologies vs. their output
- cost of Software licenses and platforms
- cost to maintain "lean" vs. "bloated" apps., as measured in software function points

In AD, cost is often a function of developer productivity, and successful AD providers will improve productivity and/or lower costs through the provision of more experienced
workers, better project management, re-usable tools, and more consistent staffing. A common metric to look at in AD costing is volume of code per "software function point,"
which constitutes a standardized, auditable means for determining and tracking an application's size (and related cost) relative to its functionality.

***Quality*:** While cost is an important metric, evaluating the business case for any function requires considering not only the inputs (service cost) but also the outputs *(value created*). For example, hiring an outside firm responsible for the documentation of enterprise applications could result in more timely and effective enhancements to those applications down the line, thereby creating long-term efficiencies, productivity improvements, and cost reductions. However, these services may initially "cost" more in the short term than not documenting those systems adequately.

Some "costs", therefore, should be seen as a worthwhile *investment* for a company to make. Year 2000 (Y2K) software issues are excellent examples of projects that can dramatically increase or decrease in cost depending on the quality of existing application documentation. According to International Data Corporation, an information technology research firm, U.S. companies alone will spend $115 billion to fix their organizations' Y2K problem. Because of the risk and enormity of this issue, most businesses will secure at least some outside assistance to solve this predicament.

Several frameworks exist through which companies can *appraise* and *improve* baseline service quality. One prominent framework is the ***Capability Maturity Model (CMM)***, developed by Software Engineering Institute (SEI). CMM aims to turn initial *ad hoc*, informal applications environments into optimized environments demonstrating continuous process improvement through a series of benchmarked stages (Levels I to V). The full transformation usually takes years to accomplish, and requires each new level of process maturity to be fully embraced throughout the organization.

Figure 4 shows how these improvement steps correspond to the levels in the CMM. Each step builds on the previous step, and its successful completion moves the organization up to the next level of process maturity. Note that the vast majority (75%) of companies' IT process environments are characterized as chaotic (Level I), with 15% at Level II (marginal) and only 8% at Level III (adequate).

Functionality: An application may embody all critical aspects of a business process, but if it is always "down" (i.e., not functional) or if modifications cause it to fail, then it is useless. Functionality metrics include:

- Uptime (the mean time between failures)
- Structural integrity
- Resilience to upgrades
- Scalability (the ability meet increasing numbers of users' needs)
- Openness (the ability to interact with other applications and IT infrastructure elements)
- Fault tolerance (the reduction in internally and externally perceived failures, and in the severity of failure types)
- Redundancy (the extent to which an application is backed up by supporting systems that can be brought on-line in the event of failure)
- Mean response time -- to respond, to repair, etc.

Fig - 4
The Capability Maturity Model (CMM)

Level	Characteristics	Goals	% Occurence
Level I (initial)	• Ad hoc • Little formalization	**Basic management control**	**75%**
Level II (repeatable)	• Processes defined • Prccesses repeatable	**Process definition**	**15%**
Level III (defined)	• Foundation achieved • Basis for ctd. progress	**Process management**	**8%**
Level IV (managed)	• Substantial improvements • Comprehensive framework	**Process control**	**1.5%**
Level V (optimized)	• Major qualitative & quantitative	**Continuous process improvement**	**.5%**

***People/Process Integration Management*:**
Process capability metrics ask "How well does the developed application embody and support the related business process?" If one uses procurement as an example, what are the improvements in cash flows, inventory levels, and the consolidation of suppliers? Do the application's customized reporting capabilities fulfill users' needs? Process capability should be tested by the application's users throughout the development cycle to ensure that the application meets end their functional requirements. Further, those users' satisfaction levels with the application's usability and performance are also a key indicator of process capability.

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Management metrics are also crucial to the successful implementation and delivery of a service. Who employs the applications development and management staff and is ultimately responsible for staff performance—the vendor or the client? How willing is the vendor to move from input-based pricing, where the client takes on the consequences of the vendor's potential failure to be "on time, on task, on budget" to "pay for performance" arrangements, where vendors are compensated based on the delivery of agreed-upon results, rather than costs?

A vendor with both business process and management experience will be able to leverage past experiences to create repeatable solutions for clients.

Customer Satisfaction*:** Ultimately, customer satisfaction is the end result of satisfying the client's metrics within the other KPA's identified. In addition to defining these metrics up front, service providers have begun to rely upon third-party performance reviews in order to evaluate contract performance. For example, ***Andersen Consulting has established the ***Client Quality Management Approach***, which requires interim third party audits every three, six, or twelve months (a "subjective" or "soft" customer satisfaction measurement, which asks open-ended questions such as, "Are we meeting your expectations?"), as well as yearly client surveys (an "objective" or "hard" measurement, which asks clients to rank performance in different areas on a scale of 1 to 5).

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B.III Challenges and Benefits in Applications Outsourcing

While there are many benefits to applications outsourcing, those benefits will not be realized unless buyers of outsourced services understand and address the outsourcing's challenges, including:

Lack of Business Case: In order to evaluate potential opportunities to outsource, executives must first understand the outsourcing process and its impact on their business goals. Many business people still view outsourcing as only a cost-cutting tool; however, outsourcing is a new strategy for becoming more agile, becoming more competitive, and growing. Therefore, management should ask itself "What does outsourcing applications management mean to this company? What kind of cost savings are we looking for?"

Unclear Requirements: Often companies fail to define the processes they are outsourcing. Without proper process definition, buyers inevitably purchase the wrong services at the wrong price. Companies must know what they need before determining what to buy. Some questions to consider include, "What does our baseline environment look like? What kinds of operational improvements are necessary for this company?"

Scope Changes: "Scope creep" is a common phenomenon, and results directly from a lack of process understanding and unclear project requirements.

Lack of Project Planning and Sequencing: Companies and vendors must jointly agree to project timelines, costs, and scope, as well as requirements for technology and process improvements. Otherwise, vendors' solutions may not meet clients' needs. In addition, vendors may begin building systems prior to finishing the design. A lack of proper project planning and sequencing will have a domino effect on the project's backlog.

Lack of Metrics: Companies that outsource without understanding what metrics to rely upon have no means by which to compare the quality of their existing processes with vendor offerings, on the one hand, or performance, on the other. For example, "How many defects per function point does this application have? What are the current defect removal costs per function point?"

Vendor Identification: Unless outsourcing decisions are approached in rigorous and methodical manner, the wrong vendor will likely be selected. The costs of such mistakes include: operations outages, lost productivity, contractual penalties, and possibly legal costs. The transition period from when a company first considers outsourcing to when a vendor's solution is operational must also be carefully managed. A poorly executed outsourcing transition can lead to decreased productivity, low morale, employee flight, missed deadlines, poor service, and, ultimately, lower profits. Please see Section IV for more on vendor selection criteria.

Risk Identification: Many companies fear relinquishing the control of a business function to a third party. In the evaluation process, companies must identify the risks involved, the likelihood of those risks occurring, their tolerance for risk, and potential mitigating factors. Common concerns

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include, "Do I want to give an external party access to my applications source code? Who should ultimately be responsible for the security of my source code? What is the risk if this application crashes?"

Overpromising by the Vendor: Because applications outsourcing is a relatively new field with little comparative data, vendors can easily oversell their solutions. Vendors can combat this tendency by developing a "show me" attitude, asking vendors to convince them of their capability by citing examples, demonstrated core competencies, and technologies. Many vendors also perform "due diligence" reviews of companies' baseline environments in order to avoid this pitfall.

The expected benefits of applications outsourcing are directly linked to the business drivers identified in Section I. The metrics identified in Section II help identify and measure these benefits, which include:

Process Improvement: Through the identification of metrics and the introduction of tight management controls, vendors can help clients improve the information systems function. Vendors should have experience in a number of applications environments, with different client types, in order analyze clients' baseline environment, improve upon their current performance, and implement a best-in-class solution. Greater efficiency also leads to lower costs—savings which will improve the bottom line.

Process Compliance: Through the implementation of demand management and quality control, vendors can help clients ensure that their applications management process is consistently implemented, continuously monitored, and periodically improved upon. Most companies have no mechanism for funneling support requests and evaluating their necessity; consequently spend much more effort than is truly necessary on support functions. Outsourcers can help their clients establish a standardized process through which support requests are channeled and, in turn, evaluated, based on the supporting business case.

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B.IV Vendor Selection Criteria for Applications Outsourcing

G2R advises outsourcing buyers to build a balanced scorecard for conducting systematic and rational vendor analyses. Factors to build into the scorecard include:

(1) "*The Raw Ingredients*" or hard skills (e.g., technical skills and bandwidth);

(2) *Client Empathy*, or the ability to design a solution that delivers results (which depends on such things as business and industry knowledge);

(3) *Operational Tools*, such as on-going project management skills, necessary to create something from those ingredients; and

(4) *Management Capabilities,* such as transition management methodologies, necessary to implement and delivery an ongoing solution.

How each outsourcing buyer weighs each criteria will vary with their business goals; however, vendors' ability to contract for and deliver performance across the key metrics discussed above will always be one of the most important criteria. The sample vendor scorecard included in the general introduction of this paper provides an over-arching list of possible vendor selection criteria for all processes.

In the AM services arena, two characteristics capture the essence of leading service providers: strong critical mass and an effective corporate culture.

Critical mass has several implications, including:

- A strong distribution network for their services
- An efficient operating structure
- Strength in the breadth and depth of managerial and technical staff to support large outsourcing efforts.

Through these strengths, service providers with critical mass are better equipped to develop and manage both individual projects and long-term client relationships.

A strong *corporate culture* relates to the ability to capture, share, and learn from organizational experiences and apply this learning to service delivery and internal processes. The corporate culture encompasses many facets of an organization, including:

- Proven methodologies
- Human resource and management processes
- Service delivery and financial strength.

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In summary, both critical mass and organizational culture reveal a company's ability to commit to and achieve a client's performance requirements. The ability to develop strong client partnerships and continuously improve services and operations is central to success.

In addition to the metrics identified here, please refer those outlined in the general introduction to this whitepaper, which are applicable across all processes.

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C.I State of the Market: Finance and Administration Services Outsourcing

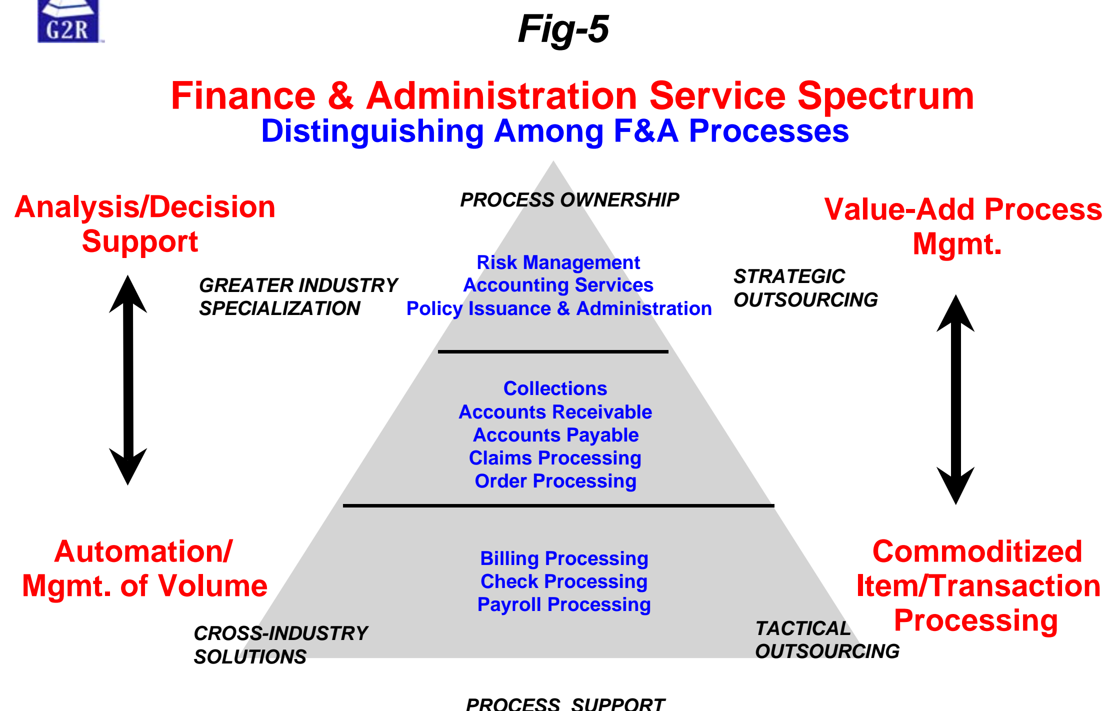
The Finance and Administration (F&A) Function Defined

Companies have been outsourcing high volume, transaction-intensive financial processes such as payroll and billing for so long now that many companies no longer view these arrangements as "outsourcing." Beyond these more mature F&A market segments, the market for other types of Finance and Administration Services outsourcing is rapidly expanding, both in terms of size and in the types of processes outsourced. **Figure 5**, below, depicts those services which this whitepaper includes in the arena of Finance and Administration. Furthermore, this paper will focus largely on Accounting Services as a subset of total F&A services outsourcing.

Among potential buyers, even mature companies are finding in-house financial services infrastructures strained and obsolete, and are now asking external vendors to supply continual technological and process improvements. Small-to-medium sized companies wishing to remain flexible or perhaps seeking to augment resources which they lack (or never had!) may not want to develop in-house process capabilities. These companies are also increasingly seeking F&A Outsourcing vendors with whom they can partner and who can keep up with the increasing needs of a high-growth organization.

Why Outsource?

Companies of all sizes, across multiple industries and geographies, have begun to redefine the operations of their organizations. The bipolar distinction between "core" and "non-core" processes has evolved to include a third category: "non-core but critical." Such a process distinguishes best-in-class performers from their peers, but nevertheless does not represent the key competitive differentiator for a company. Rather, once a single company in an industry has demonstrated its expertise



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in the operation of a "non-core but critical" process common to the industry, peer companies simply cannot afford to ignore the fact that they must develop commensurate expertise. For example, revenue accounting in upstream Oil and Gas companies is undergoing this phenomenon now.

Outsourcing F&A processes offers management more time to focus on decision making and planning by transitioning critical but non-core activities to external vendors. More and more, end users lack the time, capacity, or knowledge to develop F&A processes fully. With the advent of full-scale Electronic Commerce, internal groups often lack the expertise or bandwidth to introduce their organization to more advanced A/P and A/R tools and methodologies. This will become more critical as larger numbers of companies require their business partners to be EC-capable in their management of financial transactions. In fact, it may not make sense for companies to invest in F&A infrastructure that may rapidly become outdated.

The F&A function, long viewed as a back-office necessity, is ripe for re-engineering and outsourcing. The majority of companies across all industries do not (1) adequately understand and benchmark their total F&A costs (e.g. 1-2% of total revenues); (2) leverage technology to the fullest extent possible; or (3) combine like functions into centralized shared-services centers in order to maximize both cost and productivity efficiencies. These same companies have come to accept outsourcing as a viable means of correcting these deficiencies in business operations.

Motivations for Outsourcing F&A (Accounting) processes today include:

- Lack of staff, as a result of downsizing
- Increased focus on improving F&A processes supporting customer care
- Deregulation of financial markets
- Emergence of F&A outsourcing service providers
- Increasing IT component of F&A processes and development of sophisticated financial applications
- Digitization of money
- Consumer acceptance of electronic commerce

Finance and Administration Outsourcing Services

F&A processes should be integrated, but total functional solutions would be difficult to create, unwieldy to manage, and are not currently available. This situation is markedly different than that within other process outsourcing markets such as logistics management, where it is both possible and preferable that vendors attempt to provide total logistics solutions which include various component processes.

As a result, there is really no "F&A" outsourcing market in total. Rather the various processes which compose the market are unevenly developed. Some processes are established and commoditized -- e.g. Payroll Management services from recognized leaders such as ADP, Paychex, and Ceridian-- while others are just emerging as formal F&A BPO markets-- e.g. Accounting Services. For services such as A/P and A/R outsourcing, 80-90% companies who look at F&A BPO are not yet actively providing those services. Still, the market is evolving rapidly. For example a recent

study by Andersen Worldwide and *The Economist Intelligence Unit* reveals that while only 26% of several hundred companies surveyed currently outsource some F&A, 42% expect to do so over the next two to three years.

There are several industry trends and drivers which define the F&A Outsourcing marketplace today:

- Certain segments of Finance and Administration process outsourcing are commoditized and familiar - e.g. payroll.
- Market growth will be driven by demand for more sophisticated value-add Finance and Administration process management.
- Leading solutions will be both process- and industry- specific.
- Demand for such services is just emerging (for many deals there are no formal RFPs).
- The market is being led by vendors who are educating end users and engaging in consultative sales.
- Most vendors' BPO offerings are still relatively undeveloped.
- Currently, end users and vendors have little experience or historical data to draw upon, hence F&A BPO pursuit teams lack meaningful benchmarks.
- End users and vendors are relying upon lessons learned in IT Outsourcing to help bridge the experience gap.

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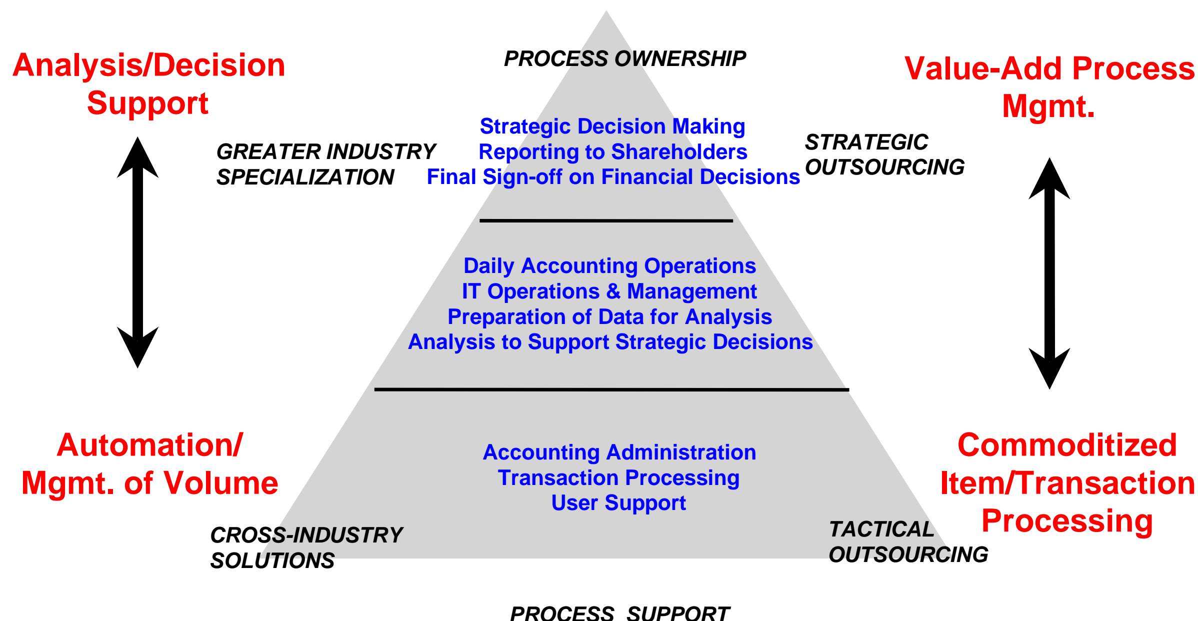
C.II Critical Process Metrics to Measure and Manage for F&A/Accounting Services

The market for accounting management outsourcing services involves the ongoing engineering, operation, administration, and management of one, several, or all of the processes included within Accounting Management. G2R divides the accounting management outsourcing services into the following areas:

- Strategic Accounting Services: These include processes such as strategic cost analysis, tax planning, and internal audit, etc.
- Management Accounting Services: These include budgeting, business performance reporting, and JV accounting.
- Financial Accounting Services: These services include processes such as statutory accounting, tax analysis/reporting, and cash accounting.
- Accounting Operations Services: These services include processes such as A/P, A/R, inventory accounting, and general ledger.

Figure 6, below, depicts the types and levels of Accounting Services currently outsourced in more detail. Generally, companies do not relinquish strategic accounting control, as they are ultimately liable to government authorities, shareholders, suppliers, and customers for the performance of their finance and accounting functions. In any case, before engaging in an outsourcing contract, companies must identify key performance areas, understand desired performance levels for each area, and devise a methodology to measure targeted performance against stated metrics. It is also important that organizations realize HOW these key metrics impact key performance areas for the business as a whole (e.g., how does report customization and the accuracy of data collection affect overall financial reporting and decision making?)



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As companies negotiate outsourcing contracts, using metrics tied to business performance is the best way to ensure rigor in the deal, or "management through metrics." Contracting parties should build performance metrics objectives into an outsourcing contract at its inception. If no such metrics exist, then the first several months of the relationship should be geared towards baselining (i.e., benchmarking) a "standard" level of performance.

As the general introduction outlines, there are a number of cross-functional Key Performance Areas (KPA's) across financial, operational, and management capabilities which apply to any process, F&A and Accounting Services included.

- Cost
- Functionality
- Quality
- Customer Satisfaction
- Business/Process Integration

Within each of these key performance areas, there are specific metrics which apply to F&A/Accounting function:

Cost: Relevant cost metrics relating to F&A and Accounting Services include:

- *Total Process Cost:* Assuming the same level of service is provided by either internal or external parties, the cost of operating accounting processes is a function of (1) worker productivity; (2) tools and process knowledge; and (3) the proper integration of these two. Various improvements in process design, technology, operator experience, etc. can reduce the overall process cost, but each industry may have a different methodology for determining the cost of F&A functions (e.g., Oil and Gas companies compare costs of F&A vs. the cost to extract a barrel of oil from the ground, which normalizes the calculation for the industry).

  In some cases, vendors have been able to save their clients as much as 50% on original process costs over time. Also, insofar as buyers are willing to participate in shared service arrangements, users will be able to enjoy a level of cost savings above and beyond what they could create for themselves internally or through a singular relationship with a vendor.

- *Cashflow:* A steady stream of cash is the life-blood of a business. Poor accounting operations can undermine fantastic product and sales campaigns if accounting operations interfere with cashflow. Companies with dependable, positive cashflow can recognize benefits including early payment discounts, fewer penalties, and increased shareholder confidence. While procurement and supplier management have the greatest overall impact on cashflow, the back office function of accounting helps to support or hinder A/P and A/R operations. Activities which should be monitored and affect cashflow performance include timeliness and accuracy of order inputs, timeliness and accuracy of invoicing, and timely/accurate collections and payments.

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Functionality: There are literally hundreds of operational performance metrics (one F&A outsourcing deal supported over 480 separate operations metrics), most of which relate to the timeliness, accuracy, utility and flexibility of various accounting transactions and reports. Among these transactional metrics which provide functionality in accounting are:

- invoice payment performance
- bank reconciliations
- account reconciliation
- return filing - income, excise, property tax
- technology change/enhancements in applications and systems
- accounting data collection
- system uptime and accessibility (e.g., through enterprise applications)
- production/utility of reports
- speed of execution/mean time to resolve problems
- ability to access external/internal accounting information

For all of these operations, users are most concerned with whether these activities are on time, on budget, accurate, and useful/adaptable.

Quality: Issues of cost, functionality, and quality are all inextricably linked. However, particularly among the accounting processes, there are special issues and factors which require that performance of services meet or beat the expectations of various customer groups.

- *Proper Stewardship:* Suppliers of material and credit, not to mention customers, may all "penalize" companies who conduct sloppy financial transactions. Customer satisfaction will decrease when accounting processes produce inaccurate information, documentation errors, documentation that is not timely, etc. Likewise, the government and its various agencies may levy actual financial penalties against companies that fail to maintain accuracy and professionalism in accounting procedures, reporting, and payment. In any case, the cascade effect from auditor to government body to shareholder and customer is a downward slope all companies would like to avoid.

- *Reduction of Type/Number of Audit Points:* Related to the above metrics, proper accounting procedures should effectively limit the number and severity of audit points registered by an independent third party. Audit points should be assessed during the life of an outsourcing engagement to assure there is a decrease in the number and severity of points assessed during an audit. The number of audit points will be a good indication as to how well an outsourcer is managing the books.

- *Providing The Appropriate Level of Service (Service Rigor):* No vendor would ever promise to deliver less than their "best"; however controlling service and service demand so that the corresponding costs and quality standards can be maintained is as important as the relative degree of

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quality delivered. That is, assuming a baseline level of required service, vendors enable user groups to properly limit demand to only those inquiries and requests which are really needed.

- *Security/Reduction of Fraud:* This includes maintaining proper protections against false claims, padded payments, falsely reconciled accounts, etc. The vendor should protect against both individual and institutional cases of fraud and security breach. Maintaining systems security (a likely place of intrusion) and appropriate background checks on accounting personnel ensures a higher level of protection.

Business/Process Integration: Effective accounting practices combine the management of internal HR, and IT processes, as well as external third parties. There are two business integration benefits an outsourcer can bring to the end user's accounting function:

(1) enable accounting personnel to be recognized and rewarded for their specific role within a professional back office organization (vs. an "auxiliary" service for a company which is actually in some other business - i.e. internal Oil and Gas accounting staff are part of the Oil and Gas industry whereas, in working for an F&A vendors, they are part of a professional services team whose focus is F&A Outsourcing services.)

(2) drive the traditional "cost-center" mentality and model of accounting into a more client-facing, service-oriented, *profit center* paradigm. In building back office solutions, vendors are creating professional service organizations which focus exclusively on accounting as a business and career for their staff.

Among the metrics and performance areas associated with the proper management and business/process integration are:

- employee morale and retention
- ability to co-manage a vision of future business/needs
- forecasting accuracy - for budgets, for payments, etc.
- matching performance and business value - e.g., what is the incremental ROI for more back office spending
- improved decision making and planning

All organizations desire a better and faster understanding of their financial state, which in turn enables development of quicker and more appropriate strategies for financial and corporate management (both short- and long-term).

Customer Satisfaction: At the end of the day, the success or failure of a service provider can be measured by constituent satisfaction. Within an end-user organization there are various customer levels including:

(1) the senior officers - CEO, CFO, CO, CIO;
(2) functional/divisional managers, often those who directly "own" the outsourced process (e.g. comptroller); and

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(3) the eventual end user of service, or ultimate beneficiary—i.e., the employee who relies on the timely deposit of his or her payroll, the supplier submitting/receiving an invoice, etc.

In order to effectively measure and evaluate constituent satisfaction over the long term, it is necessary for the vendor and end user to baseline service quality and satisfaction at the start, middle, and end of any engagement, using both qualitative and quantitative means to reflect user satisfaction. This process includes tools such as *end-user service perception surveys* (e.g. "on a scale of 1-5, how satisfied are you?") and *business scorecards* --matrices which reflect the aggregate satisfaction of all users.

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C.III Challenges and Benefits in Outsourcing Finance and Administration Services

As noted above, there are many more companies considering outsourcing their back office than actually doing so today. Therefore, the barriers and challenges to outsourcing are a function of both (1) end users' uncertainty over the novelty of A/P and A/R outsourcing within their industry and/or company; and (2) the inherent skepticism and caution with which many first-time customers approach outsourcing.

Among the challenges to outsourcing F&A processes, A/P and A/R included, are:

Existing End-User Culture/Fear of Loss of Control: Understandably, most CFO's and/or comptrollers are not used to deploying outside assistance to manage a major portion of their domain. Aside from any perceived threats on the part of an external third party, the level of security and comfort with outside resources is generally initially limited, as both vendor and user come to understand exactly how and where outsourcing fits into the user organization. Additionally, both parties must consider that the end user, at one level or another, may be unable/unwilling to accept and execute change. Finally, the risk of failed performance in any financial function can have serious repercussions for the user organization at large.

The Time to Develop Trust for A Critical Process: As part of any outsourcing engagement, vendors must demonstrate that they understand a user's industry, company, and processes in order to garner the requisite trust which should be deeply ingrained in a successful outsourcing partnership. References, individual client contact, and time all contribute to the development of such trust. For Accounting Services, users must believe that the vendor owns and/or can access all the right people/tools, at the right time, in order to better manage the function.

Issues Over Ownership/Management of IT and Staff: In order to properly manage back office processes, vendors may insist on owning some/all of the supporting staff and IT infrastructure. That is, to be responsible for supporting a business function without control of all of its inputs exposes the contract to unnecessary risk and potential setbacks. However, users may be unwilling or unable (because of pre-existing third-party suppliers) to simply relinquish all control of HR and IT to a prospective vendor. User and vendors should also ensure that there are no conflicts of interest (e.g., independence issues) in managing financial functions/processes.

Delivery Issues Associated With A Relatively Immature Business: Accounting Services contracts can be delayed or altogether thwarted if the vendor is unable to properly baseline the service and explain where/how third-party resources can impact the metrics associated with cost, quality, and business process integration. Since full-on Accounting Services are relatively new to the marketplace, there is a necessary learning curve for both parties and an understandable amount of caution on the part of users who want to be assured that the vendor's service is viable.

Overselling On The Part of the Vendor: Pursuant to the above point, vendors can over-promise on cost/quality metrics, either in promising them too early in the contract or by simply being unable to meet stated goals. Within the accounting function, for those deals underway today, users have experienced significant cost savings and service quality improvements. However, such benefits generally require some time to evolve. This raises parallel challenge of properly managing both parties' expectations.

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Creating An Identity for Outsourcing Unit: In many of the A/P and A/R deals today, the employees providing service, be they vendor employees or transferred end-user staff (or some of both), must be managed from the onset as to what their roles/responsibilities are and as well as what their importance is within the overall organization Generally transferred staff actually become more satisfied with their work post-outsourcing because they are then being deployed for their specific skill in an organization whose sole purpose is to constantly improve and manage a specific process or function. Creating this mindset and self-identity for outsourced staff is a difficult task initially.

Even with all of the barriers and potential challenges to outsourcing F&A processes, many organizations today have successfully moved through and managed such obstacles. More importantly, the benefits which F&A BPO contracts can provide logically flow from the above metrics and key performance areas already discussed. Among the benefits cited by end users of accounting services are:

- Opportunity to redirect attention from finance and administration services to strategic decision-making and core competencies
- Liberation of financial (overhead) and management resources
- Improved speed of execution (e.g., access to more timely financial reports)
- Process redesign/integration and elimination of redundancies
- Faster implementation of leading technologies (e.g. electronic commerce)
- Technology refresh and process re-engineering on an ongoing basis
- Improved HR - not just staff/overhead reductions

These are just some of the benefits associated with WHY companies are increasingly more willing to outsource back office and accounting functions. Such processes are undoubtedly critical to the success of a company, yet they are not core (i.e. outsourcing them does not create competition). This is precisely the right landing zone for an external process leader to help enhance the overall competitiveness of the organization in providing the above benefits through outsourcing.

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C.IV Vendor Selection Criteria for F and A Services Outsourcing

The long-term success of a vendor's F&A BPO business depends on a number of factors which end users may wish to consider. Successful vendors will have to:

(1) structure and solidify a repeatable solution;
(2) focus upon discernible F&A processes on an industry-by-industry basis; and
(3) harness talent to deploy in a centralized location (shared services center).

Among the key attributes which define leading F&A vendors are:

- long-term ability to successfully effect change and deliver improvements
- experience in managing process and people - A/P and A/R staff
- track record/references
- service "set-up" ability and breadth of services
- supplier management skills
- ability to define what the relationship looks like on an ongoing basis
- demo centers for process research and expertise
- appropriate geographic capabilities - "global coverage"
- comparable ethical/people standards
- right partnering approach - issues related to control and communication styles
- appropriate mix of staff
- achievement of "best-in-class" benchmark status - e.g. ISO, API, etc.
- IT expertise (especially in ERP applications - PeopleSoft, Baan, SAP, Oracle)
- A well-defined value proposition

Another effective method for discerning if/how a particular vendor can positively impact the cost and performance of a company's F&A processes is to simply identify and submit those questions which represent the entire spectrum of fears, concerns, desired benefits, and hopes on the part of the prospective outsourcing end user. Examples of questions end users should ask a potential vendor are, Can the vendor :

- *reduce the number of manual check requests? By how much?*
- *reduce check fraud?*
- *quickly transition our company toward electronic payments or respond to a supplier's request for electronic payments more quickly?*
- *improve the speed and amount of collections without damaging customer relationships?*

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- *provide faster accounting reporting without increased errors?*
- *make faster payments so that the prospective customer is eligible for early payment discounts?*
- *integrate and leverage customer data that we have already collected?*
- *increase process flexibility – comfortably manage seasonal increases or issue payments at irregular intervals without increasing costs?*
- *increase customer or supplier loyalty to the customer?*
- *decrease the time which it takes to acquire employees of "x" profile?*
- *decrease a customer's employee turnover?*

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D.I State of the Market: Logistics Management

"Logistics" Defined

The term "Logistics" refers to a broad range of processes, some more information technology-intensive than others. Logistics Management (or Supply Chain Management) involves *managing the flow of physical materials, information, and money across the supply-chain from procurement, to manufacturing, to distribution, to customer care.* For the purpose of this paper, we will use "Logistics" to refer to the range of services performed for one or some combination of the following reasons:

(1) to help companies acquire goods (raw materials, component parts, or finished products) and services for their own internal use – *indirect* Procurement – generally referred to as simply "Procurement" or "Maintenance, Repair and Operations" (MRO is primarily a manufacturing term);

(2) to help companies acquire goods (raw materials, component parts, or finished products) and services for the purpose of delivering those goods/services in some form to their own market and customers – *direct* Procurement; or

(3) to help companies store, package and distribute finished products. This functional definition reflects the idea that vendors of Logistics Services do not need to necessarily own the assets required to deliver Logistics Services.

For instance, Logistics Services include distribution services – one vendor may supply *their* employees and *their* trucks to help move a product. Another vendor may select, subcontract, and manage those services without owning any of the supporting assets or employing any of the involved personnel. Both are supplying Logistics Services.

There are four (4) major functions involved in logistics: (1) Procurement (Direct or Indirect); (2) Materials Management; and, (3) Warehousing; and (4) Distribution. Though not formally included in Logistics management, another closely related component of the supply chain is *customer care*. G2R believes that the competitive advantage will fall to those companies who can integrate, synchronize, and apply all relevant technological and operational knowledge to managing all of these processes and functions.

Logistics and Business Performance

For most companies, Logistics Management is not a core competency, yet it is critical to the day-to-day operations of the organization. However, a best-in-class supply chain can be crucial to maintaining a company's competitive advantage in any market. Accordingly, the pressure to reduce overall costs and improve efficiencies in the supply chain will emerge as one of the most significant market forces facing companies in the near

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future. According to The American Warehouse Society, even though 95% of chief executives at major corporations think Logistics should be incorporated into their business strategy as a formal practice, only about one-third actually do so.

Consequently, as organizations realize the importance of their Logistics function, they will seek means to improve it. For example, according to a recent study by KPMG Peat Marwick, 37% of Fortune 500 Companies use one or more third-party Logistics providers, primarily to manage warehousing and shipment consolidation. Other industry analysts anticipate that the market for integrated Logistics will grow by 300% over the next decade, from a current level of $6 billion per year to $25 billion annually, while still more optimistic estimates place the current market value at $100 billion already. It is obvious that companies will achieve this goal, in part, by outsourcing those processes that can be performed more optimally by third-party providers.

Today, Logistics is evolving from a low-value-add, labor-intensive, asset-based, and commoditized service of storing and moving supplies and products to a more complex, value-added, and business critical service, involving aptitudes in every step of the supply chain. Very few end users currently possesses the skill sets necessary to supply a complete "best-in-class" Logistics Management solution. Consequently, firms are attempting to acquire the missing competencies, be it through organic growth, acquisitions, or outsourcing. For example, large in-house logistics divisions, rich in assets and operational experience are partnering with consultancies which offer experience in developing business and IT solutions (e.g. the recent alliance among Andersen Consulting, IBM and Ryder).

Why Outsource*?*

Among end users, several trends are contributing to changing perceptions on the relative importance of Logistics Management in their business. For example, growing time-to-market considerations for product companies are paramount because makers of goods who are able to get to market first generally outlast their competitors. A May 1997 *Harvard Business Review* study revealed a direct correlation between a manufacturer's survival and speed of output. The study showed that, in a given period of time, successful companies (1) commercialize their products and processes two to three times faster than competitors of equal size and (2) bring those products to market in half the time. Additionally, this study found that "introducing a product six months after the market leader reduced cumulative profit by one-third whereas being first to market and 30% over budget trimmed profit by only 2.3%."

Factors such as these are leading companies to realize that Logistics Management can be a means of competitive differentiation. Often unable to comply much less excel in all categories of effective supply chain management, many companies are turning to outsourcing. Additional reasons include:

- ***Reduced Order-Cycle-Time and Time-to-Market:*** The transit time from factory to shelf is constantly decreasing and can strain a company's supply chain. Upon product introduction, time-to-market considerations are paramount as companies who are able to get to market first generally outpace their competition.

- ***Shrinking Product Life Cycles:*** Customers' demand elasticity for products is more volatile than ever, such that the corresponding speed and quality of service (delivery, deployment, operation of a product) are as important to the consumer as the product itself. Companies must respond to shorter product life cycles while synchronizing those products with customer needs.

- ***Increasing Emphasis on Customer Service:*** Customer service is becoming a chief differentiator in any industry. The supply chain is an integral component of customer service and meeting consumers' ever increasing demands for quality, convenience, and lower prices.

- ***Rising Costs of Maintaining Internal Logistics Process:*** Increases in fuel and carrier costs have left end users looking for organizations that can leverage shipping suppliers for the lowest costs.

- ***The Importance of Technology In The Supply Chain:*** The development and increasing sophistication of logistics' IT applications makes it difficult to keep up with technological innovation. Furthermore, users who do not specialize in such technologies cannot necessarily choose the best applications and configuration for their supply chain environments vs. their end business goals.

- ***Global Marketing, Global Sales, and Global Delivery:*** The flow of trade across international boundaries has increased 800% since 1970, due in part to international trade treaties such as GATT and NAFTA, the break-up of the former Eastern Block, and the increasing trade liberalization in Asia Pacific. Competition is now local, national, and international.

- ***Cooperation Among Supply Chain Participants:*** Although the current power imbalance between supply chain participants continues to increase – with retailers having more leverage over manufacturers – severe price and competitive pressures are beginning to force greater information sharing, coordination of efforts, and reward sharing along the supply chain. If more powerful retailers and manufacturers adopt this model, cooperation will become a competitive necessity.

Because of these trends, Logistics Management outsourcing offers reductions in costs and time-to-market, while improving operational efficiencies and customer satisfaction. Accordingly, businesses are increasingly outsourcing their logistics function as indicated by the growing demand for not only piece-meal outsourcing services, but also end-to-end supply chain management outsourcing.

Defining Logistics Management Outsourcing

G2R defines **Logistics Management Outsourcing** as ***the ongoing engineering, strategic management, and operational management of the flow of physical materials, information, and money across the supply chain from procurement, to manufacturing, to distribution, and to customer care***

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(i.e., total supply management). Logistics Management Outsourcing can include some or all of the process listed below or can be a separate, management-based service in which the vendor controls all the suppliers of services below, but is not directly responsible for the delivery of those services.

Indirect Procurement - Planning, selecting, purchasing, and receipt of ancillary products and materials (i.e., not raw materials or unfinished products) that are not direct inputs into the end product.

Direct Procurement - Planning, selecting, purchasing, and receipt of raw materials and components from which finished products can be made; from the initial resource site (e.g. raw material such as iron ore for the manufacture of steel) to the manufacture plant.

Materials Management - Managing, monitoring and moving materials that are within a company's product site.

Warehouse Management - Managing, monitoring and moving materials for follow-on distribution to another wholesale/retail user. Service components include warehouse planning and improvement (e.g., contingency plans, master plans); operations management (e.g., receiving, cross-docking, storing, picking, and shipping); equipment planning and improvement (e.g., dock, storage, and materials handling equipment); space planning; personnel training and improvement (staffing requirements team evaluation, and competency-based training). May include product finishing and packaging as value-add services.

Inventory Control - (as a subset of Warehouse Management) The management of goods-on-hand which often involves a software function enhanced by inventory-specific technologies such as bar-coding and Electronic Data Interchange (EDI). This allows companies to implement Just-In-Time (JIT) services by using the manufacturer as the warehouse, thus avoiding costly storage fees.

Distribution Management - Planning and management of distribution of finished or partially-finished products to wholesalers, retailers and consumers.

As end users seek to establish competitive differentiators, they will seek solutions (be they internal or external) that can leverage IT, not just to discrete segments of the logistics function, but to all segments of the supply chain.

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D.II Critical Metrics to Manage in Logistics Outsourcing

Importance of Metrics and Benchmarking

Before engaging in an outsourcing contract, companies must identify key performance metrics, understand desired performance levels for each metric, and devise a methodology to measure targeted performance against those metrics. It is also important that organizations realize HOW these key metrics impact key performance areas for the business as a whole (e.g., how does system accessibility and accuracy of data collection affect overall company decision making, productivity and profit?)

As companies negotiate outsourcing contracts, using metrics tied to business performance is the best way to ensure rigor in the arrangement - "management through metrics." Contracting parties should build performance metrics objectives into an outsourcing contract at the onset. If no such metrics exist, then the first several months of the relationship should be geared towards baselining a "standard" level of performance (i.e., benchmarking). It should be noted that for many metrics, no standard of evaluation exists, but the means to track such metrics can be developed in the context of a specific contractual negotiation or industry.

Logistics Management - Key Performance Areas

- Cost
- Functionality
- Quality
- Customer Satisfaction
- Management - IT/Business Integration

In examining any integrated logistics operation, whether it be internal or external, a handful of key service metrics quantify the efficiency and effectiveness of a company's supply chain operation. As noted in the general introduction to this paper, these metrics impact companies in one of three areas: *Financial*, *Operational*, and *Management* capabilities.

More specific to Logistics Management, one can define these metrics in a variety of ways:

- by *functional area*, i.e., understanding the impact logistics has on a functional area such as sales and marketing, finance and administration, and operations;
- by *constituency*, i.e., measuring logistics' impact on different "clients" e.g., shareholders, customers, and employees; and/or more simply,
- by *impact on the bottom line*, i.e. the ability of logistics management to save money and/or make money.

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When transposed over the entire supply chain management process (e.g., procurement, materials management, and distribution/warehousing), these metrics divide into three process performance groups, which help to quantify optimal performance for world-class integrated logistics management:

A. Capacity to Manage Market Forces
B. Impact on Customer Satisfaction
C. Ability to Add Economic Value (e.g., Reduce Expenses, Free Up Capital, etc.).

Please note that these metrics must be tailored to a specific business situation (i.e., metrics differ not only by industry, but also by culture, type of consumer, etc.). For example, inventory turns for a distributor of perishable goods are undoubtedly higher than for spare parts manufacturers. One caveat: all of these key performance areas and metrics are inter-linked, such that users and/or suppliers may categorize and define them somewhat differently. The overall purpose, however is to comprehensively identify and discuss *all* of the high-level issues within the outsourced LM process.

A. Capacity to Manage Market Forces

At its core, logistics involves satisfying end-user demand through the timely and cost-effective delivery of a product. This fact makes logistics dependent on various market forces which impact demand. As fluctuations occur in a given market, the ability to manage and/or react to these market forces is a key capability which allows a company to capitalize on new opportunities. As previously noted, most corporate executives would agree that product delivery time is at least as important as product quality.

Key metrics include:

- ***Supply Chain Response Time:*** The time needed to adapt to a shift in market demand, recognize the shift, incorporate into forecasts, and reflect in all processes (purchasing, manufacturing, etc.). Response time refers to that moment when the end user can use the transported item(s).
- ***Flexibility Gain:*** The amount of time the organization needs to adapt to a significant (+/-20%) change in volume.
- ***Published Lead Time:*** The time elapsed between order acceptance and product reception.

As indicated by the above metrics, if managed efficiently, logistics can empower a company to pursue new opportunities by meeting emerging demand almost instantaneously. On the other hand, if the supply chain cannot rapidly and effectively adapt to ever-changing market situations and customer demands, an organization will find itself only *reacting* to market forces, rather than pro-actively managing them.

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B. Impact on Customer Satisfaction

Customer Satisfaction has not traditionally been an area of strength for internal logistics providers, or even external logistics groups for that matter! Traditionally, the role of the supply chain has been to satisfy the first key performance area, "capacity to manage market forces." However, companies are realizing that the logistics function is but one of many processes which impact their company's brand image, customer satisfaction, and, ultimately, market share and revenue. Through customer service, product quality, product price, and promotion, logistics has an important role to play in the satisfaction of the end user. Customer service starts with day-to-day operations and the ability to carry out basic engagements in a timely fashion.

Metrics include:

- ***Delivery to Customer / Order Fulfillment:*** The ability of an organization to fulfill its own commitments at order acceptance and the actual cycle time from order receipt to product installation at customer site (customer placement) both impact customer satisfaction.
- ***Faultless Fulfillment:*** Number or percentage of deliveries performed to exact customer commitment.
- ***Customer Inquiry Response and Resolution Time:*** The measured time from first call to complete resolution. Direct Customer Service is one of the few instances where customers and logistics providers interact. It is a simple way to positively (or negatively) impact end-user opinion and should not to be overlooked.
- ***Overall Customer Satisfaction:*** Customers' perception of cycle time, advanced notice of price changes, fill rate, and status/inquiry responses. Customer satisfaction should be appraised from both the end-consumer, and dealers/intermediary points, using both quantitative (scorecards) and qualitative (surveys) measurements.
- ***Reduced Number of Returns/Reverse Logistics:*** Inferior quality, delays in product arrival, and damage during the logistics process result in increased returns (reverse logistics),
  which not only affects a company's standing in the eyes of the end user, but potentially a company's bottom line.

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C. Ability to Add Economic Value

Optimal performance of a company's supply chain leads to reduced expenses and freed up capital resources. An effective integrated logistics service synchronizes the sub-processes and allows for the smooth flow of goods, money, and information. Economic Value-Add (EVA) attributed to the supply chain results from its impact on cost, earnings per share, or stock price. For example, if a company adjusts its product mix to reduce the time on the shelf for goods sold and increase sales of faster-moving product, this will not only liberate tied up capital in inventory but increases revenues as well. Sample EVA metrics include:

- ***Cash-to-Cash Cycle Time:*** Incorporates not only the logistics aspect of the supply chain, but also the ability of a company to sell and invoice for its services and products by measuring how quickly the invoice can be collected after the product is purchased/sold.
- ***Capital Costs:*** Measures the cash tied up in capital assets - plants, warehouses, equipment, or other capital expenditures.
- ***Inventory Turns:*** That portion of inventory which is depleted/replenished over some fixed time period vs. the amount of total inventory for that same good.
- ***Consolidation of Inputs in Supply Chain:*** The ability to consolidate the inputs in the supply chain by reducing the number of interactions and iterations with outside vendors leads to increased accountability, increased economies of scale, and decreased expense on redundancies.
- ***Reduced Variable and Fixed Costs:*** Can be measured as logistics cost as percentage of (sales) revenue.
- ***Value Added Productivity:*** As measured by full-time employees or per payroll expense to the company's bottom line. How many persons are required in a particular LM function (e.g. certified procurement managers)?
- ***Increased Automation Throughout the Supply Chain:*** Increased automation not only allows for a decrease in headcount, but also facilitates the flow of information throughout the supply chain, maximizing management's visibility of the logistics process which can resulting in better decisions to lower expenditures and increased efficiencies.

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Figure 7 below places sample metrics for measuring value in Supply Chain in a matrix. Ideally companies would generate several such value models and benchmarks in order to determine how they compare to their peers in an industry and to a vendor's proposed offering, Such models also enable parties to define what value an LM partnership may bring to a user group.

Whether the process be performed internally or externally by an outsourcing vendor, it is important to have established audit capabilities to properly asses the processes' value-add to the organization's bottom line.

Fig -7 Process Evaluation Matrix: Procurement

SLA Measurement	Metric	Internal	External
# of Suppliers	as indicated by accts. payable	**10,000**	**8-10 for 50-80% of purchases**
# of Staff	# redeployed (e.g. CPMs); # reduced; # of IT staff	**25-30**	**N/A (senior mgt. stays)**
Product Returns	as % of total inventory; fill accuracy; correct labels	**Decreases**	
Fill Accuracy	properly labelled in correct amount; bar-coded	**Increases**	
Degree of Automation	measure paper reduction; C/S capabilities; database	**Low; Varied by location**	**High; Standards set and sustained**
Cash Flow	more for suppliers than for end user; faster A/P and A/R	**Increases**	
Data Entry	# of FTEs for data entry;	**Decreases**	

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D.III Challenges and Benefits in Outsourcing Logistics Management:

As end users consider outsourcing all or portions of their supply chain, they may encounter multiple barriers to a potential successful Logistics Management Outsourcing contract, both in the sales and delivery processes.

- ***Identifying the Process Owner/Buyer:*** No doubt companies can name and define their procurement function and specialists (e.g. the certified purchasing manager), their VP of Customer Service, or their head of accounts payable. However high-end LM solutions require the input, participation, and eventual blessing of all the supply chain players.

- ***Finding and Believing In A Single, Sole-Source Provider of All LM Services:*** There are literally hundreds of so-called LM "solutions" providers but very few companies can bring all of the requisite HR, IT, and asset-based elements together in a single service across all portions of the supply chain.

- ***Matching LM Solutions To Business Goals*: ** This includes the ability to identify, measure and perform upon LM-specific metrics (see *Section II*). Internal groups and outsourcing vendors must able to show HOW their LM services will affect financial, operational, and management metrics. This is difficult to do across various elements of the supply chain. Many users still employ traditional accounting methods to evaluate the efficacy of their Logistics function vs. more advance and business critical productivity metrics.

- ***Maintaining Appropriate Process Control*: ** Since logistics services really drive the value of a company's product delivery to customers, companies can never relinquish *strategic* control of their distribution function. Therefore, LM business partners must be able to articulate how the lines of responsibility will divide between the user and supplier.

- ***Non-Standard Systems and Technologies*: ** Integrating and managing supply chains means managing not only people and products but IT and processes as well. Along with the consolidation occurring in many industries is the corresponding need to merge suppliers and customers, and therefore supply chains. Non-standard IT platform and technology/process configurations can pose daunting problems for in-house groups, much less outsourcers (although this could also be a motivation to Outsource!).

- ***Shifting Supply Chains*: ** Where and how products are manufactured and distributed can constantly change. For example, today certain retail clothiers can tailor customer orders directly from the store to the manufacturing plant, which can then ship direct to the retail buyer. This type of disintermediation produces different supply chain needs than previously.

- ***Global Supplier Management*: ** Organizations which cannot self-manage their internal yet expanding global network of customers and suppliers will face the same challenges in working with an external provider - can the vendor place resources on the ground and/or remotely manage all aspects of the supply chain?

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By outsourcing logistics management, end users seek to acquire not only the tactical skills to improve the process, but also the management capabilities and experience of vendors who have repeated such solutions for numerous clients and can apply that knowledge to maximize improvements. Outsourcing can provide end users with an instant solution that would otherwise consume significant resources to develop internally. It not only allows for improvements in the labor and IT components for distribution of goods and services, but more importantly, in the strategic design and implementation of those services as well.

As exemplified by the metrics, outsourcing Logistics Management is not simply about externalizing a cost center, but rather about also improving and growing a company's business. As such, below are examples of benefits end users may anticipate when Outsourcing Logistics Management:

- Opportunity To Focus On Core Competencies
- Cost Savings - Capital, Operational, etc.
- Improved Service Levels
- Reduced/Shared Liability and Risk
- Access to Best-In-Class Industry, Process, and Technical Expertise
- Process Redesign, Integration and Elimination
- Faster Problem Resolution
- Improved User Satisfaction For Multiple Supply Chain Constituents
- Greater Flexibility and Innovation (vendors actively undertake improvement as they have vested interest in maximizing process efficiency)

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D.IV Vendor Selection Criteria for Logistics Management Outsourcing

While many vendors advertise "Logistics Management Outsourcing" or "Supply Chain Outsourcing" services, these service descriptions are often employed primarily for their marketing power. Unfortunately, many vendors which claim to offer Logistics Management (over 400 in the U.S. alone claim to offer Supply Chain Management) are merely selling traditional Logistics commodities (basic warehousing and freight-forwarding) under a new name. In addition, many software and IT service shops add to the market confusion by advertising their software and applications development services as Supply Chain or Logistics Management services. However, few companies even attempt to offer the comprehensive business solution which meets the evolving definition of Logistics Management discussed in this paper.

Such vendors must have:

(1) ***An Understandable Service Offering:*** Does the vendor understand the user's industry and company supply chain model and needs? Can the vendor quickly articulate the pieces of the supply chain which they are able and willing to support and explain how/why? Key performance areas and metrics are an intrinsic part of this understanding.

(2) ***Dedication To Quality and Continuous Improvement:*** What certifications and LM memberships does the vendor possess? Can the vendor reengineer an improve the LM function on an ongoing basis? How?

(3) ***Proven Track Record and Operations Experience:*** How many logisticians does the vendor employ? Does the vendor own or can it access the right mix of capital-assets, HR, and technology to provide for the user? Are there any reference accounts and/or has the vendor attempted this service for itself (if appropriate)?

(4) ***High Level of Industry and Process Expertise:*** It is incumbent upon vendors to demonstrate their knowledge of both industry (e.g. Retail) and process (e.g. indirect procurement) knowledge to the satisfaction of the customer.

(5) ***Willingness/Ability to Develop Compatible Cultures and Systems With End-Users:*** Both soft and hard skills are necessary to work well in a business partnership. The vendor must be able to manage the HR and corporate culture issues associated with (a) the inherent nature of the LM services provided and (b) the fact that there is now an EXTERNAL service provider, which undoubtedly raises internal political and business issues.

(6) ***Requisite IT Skills:*** According to suppliers surveyed, one of the fasting growing needs among vendors for successful Logistics Management solutions is Information Technology - applications, systems, and networks - which can support (a) distribution requirements planning (DRP), (b) Logistics Management-focused customer services, and (c) track and trace systems.

(7) ***Ability To Manage Third-Party Providers In the Supply Chain:*** Insofar as the supply chain is also a *supplier* chain, primary LM vendors must be able to identify and work with those companies whose products and services provide the best fit to a company and its customers.

(8) ***Access to A Supplier Network:*** As part of successful supplier management, leading LM vendors will offer companies access to a leverageable and scaleable network of product and service providers in order to exploit economies-of-scale savings. As companies move to fewer suppliers for more services, this attribute will become even more critical.

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