

OUTSOURCING: THE STRATEGIC RISKS

Introduction

Outsourcing is big business and is expanding at an almost exponential rate. The Economist Intelligence Unit for example notes that whilst some 34% of firms outsourced all or part of their IT in 1997 this percentage is expected to rise to nearly 60% in the next six years. It looks as if this forecast may be an understatement – India's business process outsourcing industry is growing at a rate of over 50% per annum.

Let there be no mistake, outsourcing can deliver benefits to an organisation that are beyond its internal capabilities. Some of the most frequently cited benefits include:

- § Increased focus upon the core business
- § Access to lower process costs
- § The restructuring of internal business areas that have resisted change
- § Higher value adding and more flexible services than internal sources can offer
- § Access to best in the world knowledge sources to enhance innovation
- § The achievement of better cross process co-ordination than traditional organisational structures can deliver.

However, recent surveys point to the fact that outsourcing may not be delivering. Research indicates that nearly 80% of managers who have outsourced an IT function have terminated the contract early. Another survey conducted by the American Management Association reveals that 75% of managers thought that outsourcing failed to live up to their expectations. End customers don't seem to have much confidence in the outsourcing process either with in one survey 81% feeling that the financial benefits of outsourcing won't be passed onto the customer. Others feel that outsourcing may be just another management fad or cure-all.

So the time is ripe to take a cold look at the potential downsides of outsourcing.

Specifically, there are four questions that I would like to address in this article:

1. Are there hidden downsides in outsourcing?
2. What can we learn from downsizing – the last management cure-all deployed extensively in the 1990s?
3. Should we enhance traditional methods of assessing outsourcing benefits and risks?
4. How well will outsourcing allow an organisation to deliver 21st century strategies?

Outsourcing and 21st Century Strategies

I would like to start by answering the last question first. Strategy is changing and an appreciation of this should be at the heart of the outsourcing decision.

Competing in the opening decades of the 21st century will be different to the 1990s in four ways.

Firstly, as Professor Michael Porter of Harvard Business School predicts, the cost reduction train is about to hit the buffers. Throughout the 1990s we have had a pre-occupation with cost reduction. Cost minimisation has been at the heart of many organisations' competitive strategies. But it's a train going nowhere. As all organisations gravitate to the same cost base, there's no unique source of competitive advantage left. Operating using efficient processes is a fact of life. It won't be an approach that will successfully differentiate one competitor from another.

One of the defining characteristics of 21st century strategy will be a shift from *costs and products* to *relationships* as the primary focal point of strategy. In the 1980s products were the primary focal point of an organisation's strategy.

Do we provide a commodity product? Do we offer a product with many add ons? Do we supply products to a broad or narrow customer segment? These were the questions that drove the shape of competitive strategy in the 1980s. In the 1990s we have had a pre-occupation with BPR, downsizing and cost reduction.

In the 21st century it's going to be different. A combination of freedom of information, open standards and the outsourcing of product development functions means just one thing. Product development lead times, the tradition bastion against new entrants, have been slashed. As Palm found out, a new rival Handspring could make use of outsourced product developers and open standards to produce a rival product in a matter of months, not years.

This example is becoming the norm and organisations are starting to turn to *relationships* particularly with end customers as new sources of enduring competitive advantage. This change in strategic focus will demand a new organisational competency set – more of this later.

Innovation is therefore back in. As I have observed, the cost reduction train is about to hit the buffers. To stay ahead managers must focus upon innovation in three core areas – products, processes and relationships.

Finally, we have uncertainty. We thought that life in the 1990s competitive arena was uncertain. Now, managers have to cope with both economic and global uncertainty making it impossible to predict the exact trading environment one year out, let alone three or five. In response, organisations are making more use of scenario planning – multiple views of a future environment and a response strategy for each. This technique was pioneered by Shell and enabled it to move rapidly when the oil crisis of the 1970s unfolded.

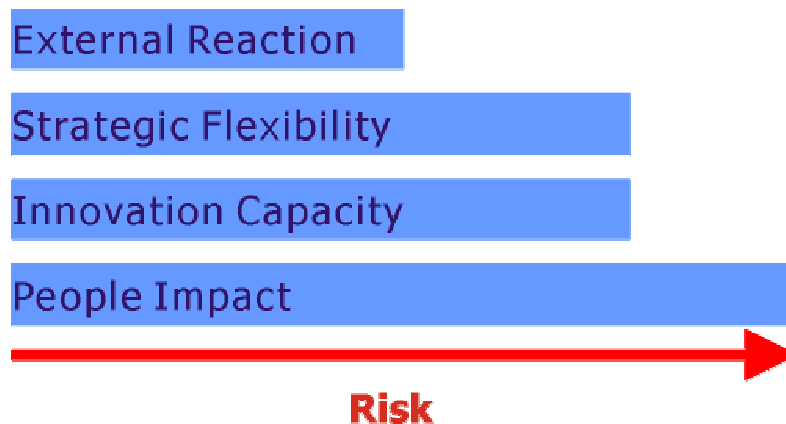
Each of these four characteristics of competitive life must be factored into the outsourcing evaluation process – an issue that I will return to at the end of this article.

Outsourcing: The Hidden Downsides

There are many reports of drawbacks in the outsourcing process, most focusing upon outright failure of outsourcing arrangements, selecting the wrong vendor, poor contract construction and the costs of exit. I would like to look here at the costs or risks in outsourcing that have potentially a far deeper and longer-lasting impact for the organisation. These are:

- § Negative Innovation Impact.
- § Strategic Inflexibility.
- § The HR Dimension
- § Negative Environmental Response.

Outsourcing Risk Families



Negative Innovation Impact.

Many supporters of outsourcing hold that outsourcing can greatly enhance the innovative capability of the organisation – and in the right setting it *can*. However, it's important to understand the *innovation trail* of your organisation and how outsourcing might affect it. When I talk about the *innovation trail* I mean the path that starts from idea generation and ends up with a successfully launched new product or service.

Many of the organisations that have increased their innovative capability through outsourcing have innovation trails that start in the R & D area – drug companies are a good example. Research develops ideas. In many organisations, particularly service industries, the innovation trail starts with the end customer – it's the end customers' comments and ideas that really kick-start and drive innovation.

Instead of outsourcing customer contact some organisations are starting to use "innomediaries" or partners to leverage up the collection, analysis and use of customer contact information. Elly Lilly's approach in this area – its *Innocenter* has become so successful that it is now a self-contained subsidiary offering mediated innovation services to a range of organisations. On a final note it's interesting to observe that one of the leaders in the outsourcing arena – Dell – has announced that it is to bring home its overseas customer facing call centre operations.

The important point is to understand where in your organisation the innovation trail starts. If you're in an industry where the innovation trail starts with the customer, beware outsourcing customer contact activities – you just might cut yourself off from future winning ideas.

Strategic Inflexibility

I have two messages here.

My first message is don't follow a trend in your industry. Take insurance. If all competitors outsourced their call centres to the same outsourcer the scope for differentiation is greatly reduced. Insurers will have effectively excised their capacity to be different and driven themselves into a position where they are suppliers of pure commodity products. Remember that organisations like Procter and Gamble are careful to insource both the development of processes and products to build competitive advantage not competitive parity. This issue of outsourcing the capability of an organisation to be different is seen by me and others as being one of the major downsides in the outsourcing process.

The second message is to remember that strategy – how organisations gain competitive advantage – will change. I predict that there will be greater focus on end customer relationships and less focus upon cost reduction than we have seen in past decades. Of course everyone is careful not to outsource "core" processes – processes that really make the organisation different. My point is however that tomorrow's core processes may be very different from those we use today.

This last message is compounded by the fact that the 21st century business environment is an incredibly uncertain environment. The capacity for an organisation to be *strategically flexible* should be an essential part of the outsourcing risk assessment process. The strategic risks associated with outsourcing *any* process or activity should be tested against not just today's competitive environment but *multiple* views of tomorrow's possible environment. Unfortunately, research tells us that the competitive environment is not yet at the forefront of managers' minds when the outsourcing decision is made. The most important criterion would still appear to be the scope for cost reduction.

The HR Dimension

This is the big risk factor.

Users of performance measurement concepts such as the Balanced Scorecard will realise that *people* are the true performance-driving dimension. People are the ultimate drivers of corporate excellence.

Assessing the HR risk is more than just ensuring that critical employees aren't outsourced. Just as strategy is changing so is the employment contract. By the *employment contract* I mean what employees expect and what motivates them. And this is a changing dimension as well. In addition to economic rewards (the pay cheque), to be motivated employees expect fair treatment, a degree of security, rewarding relationships with fellow workers and most importantly the support of the organisation in developing a skill and experience set that will help them survive in an uncertain environment. Research again shows us that if this contract is broken or threatened, neither promotions nor pay rises will repair the damage.

The effect of the outsourcing decision upon the motivation and retention of employees is a central risk factor. Remember, that employees *across the organisation* generally react to an outsourcing announcement by thinking that management under-estimate their skills and contribution. To successfully manage the HR dimension the organisation must:

- § Identify and retain employees with the skills and knowledge that provide the organisation with the flexibility to excel in an uncertain environment. This requires the delivery of a clear vision of how retained staff will contribute to the organisation's success in the long-term.
- § Retain a cadre of employees with a deep firm specific knowledge of the outsourced processes to (i) effectively manage the bridge between the organisation / outsourcer and (ii) if all fails, to manage the back-sourcing process.
- § Deliver an enhanced employment contract to outsourced employees. Remember that the treatment of outsourced employees is a powerful advert to core retained staff. It's important that retained staff see their former colleagues receiving better opportunities and support than they had received in the past.

Negative Environmental Response

This is the unknown issue.

Is outsourcing an “acceptable” management practice?

Well, the jury is out. Currently, the threat of a political backlash is high on the strategic agendas of overseas outsourcers. Judge your core customers’ reaction carefully.

Downsizing: What Can We Learn?

Arguably, downsizing was the panacea or cure all of the 1990s. Again, it’s had a mixed track record. Commonly reported post downsizing problems are:

- § Decreases in employee motivation and commitment to the organisation.
- § Decreased levels of work effort on the part of *surviving* employees.
- § Working atmospheres or “cultures” characterised by low levels of trust and high levels of insecurity.
- § The appearance of the “survivor sickness syndrome” whose symptoms include decreased creativity, increased fatigue and importantly extreme risk aversion.

Most worrying of all is the loss of the experience that really made the organisation different. Only now are some organisations learning that middle managers really did play a valuable role – being repositories of organisational memories – what went right and wrong in the past.

If we look back at the downsizing experience and learn a lesson it should be the management of the HR dimension. The HR dimension is the primary risk factor.

Outsourcing: Benefit and Risk Assessment

A total reversal in our approach to benefit and risk assessment is needed if we are to gain real long-term benefits from outsourcing. Remember, in the right context outsourcing *can* work and deliver substantial rewards.

The first issue that must change is our motivation to outsource. Recent research has shown us that the primary motivator behind outsourcing is to lower operational costs. Secondary motivators are to focus upon core activities and then thirdly to gain flexibility. In the 21st century we need a different motivational hierarchy to drive outsourcing:

- § Strategic flexibility
- § Competency enhancement
- § Innovation enhancement covering the broad spectrum of product, relationship and process innovation.
- § Continuous operational cost reduction.

This hierarchy of motivation matches more clearly the strategic demands of the opening decades of the 21st century.

If we are going to change the forces that encourage organisations to outsource we need to change our approach to risk assessment.

Firstly, I see risk assessment as tied very closely to the demands of tomorrow’s business scenarios. Development of strategy is an issue that is personal to an organisation. So should the risk assessment process. But we must redefine the risks posed to an organisation by the outsourcing process. Current risk headings are frequently seen as:

- § Risk of dependence upon a single supplier
- § Financial failure of the supplier
- § Failure of the supplier to reach agreed service levels or deliver benefits on time

- § Failure to deliver cost savings
- § Failure to manage suppliers
- § Outsourcing model benefit assumptions are unrealistic
- § Failure to negotiate an acceptable contract

Again, I would like to propose a different hierarchy of risk assessment:

- § People: Impact on future competency portfolio and culture.
- § Future strategic responsiveness.
- § Innovation impact.
- § Supplier dependency.
- § Supplier delivery continuity.
- § Environmental response risk

Concluding Guidelines

Outsourcing *does* work and can help an organisation excel in the next decade, but the decision needs to involve more than just costs. To conclude, here are some guidelines:

- § If you're worried about costs, challenge existing processes and buying arrangements. The consultants McKinsey have calculated that most organisations can deliver process cost savings by conducting a ground up review of processes - for example up to 30% gains in direct labour productivity, lower material costs and reductions in establishment costs.
- § Before you start to consider the outsourcing question, develop with your fellow executives multiple scenarios of the competitive environment that you might face over the next ten years.
- § Consider carefully how your organisation's sources of competitive advantage will change in the 21st century. What might be core today may well not be core tomorrow. What competencies must you nurture *in-house* to secure these competitive advantages?
- § Understand where your innovation trail starts.
- § The primary drivers of the outsourcing decision must be the enhancement of your organisation's strategic flexibility and the supporting competencies. Cost will very much be a secondary issue.

Finally

I hope that you have enjoyed this short read. You can find more on the website or e-mail me using the link below. I enjoy personally helping businesses - some of the work I undertake includes:

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| § Market research to identify the product performance and service needs of B2B customers | § Competency definition, development and assessment |
| § Facilitating board level strategic reviews, with a particular emphasis upon the definition of tomorrow's competitive environment | § Product portfolio assessment. Helping the business to define the optimal product portfolio – balancing future competitive conditions with the probability of achieving future planned performance |
| § Design and implementation of Balanced Scorecard performance tracking systems | § Communication programmes |
| § Research to help identify what potential capital providers will look for in your business plan | § Organisational audits – assessing the innovative capability of your organisation |

Best regards,

Robert Davies