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Outsourcing: A Strategic Advantage or a Sub-optimal alternative?

Till a few decades ago, most of the companies had vertically integrated organization structure with in-house functions like Manufacturing, Research and Development (R&D), Sales, Distribution, etc. However, now the leading companies focus on managing these key functions without committing significant capital for owning them. These companies have evolved themselves by developing abilities to control the core functions without owning them and selecting the right partners to whom these functions can be outsourced. In turn, these companies are able to achieve better cost control, outsourcing of risks and strengthening of their competitive position in the market. →

Challenges in outsourcing

Leading companies assess the need for outsourcing and resultant competitive advantages vis a vis the risks associated with it. There are instances wherein companies have reversed the decisions of outsourcing fully or partly as they could not reap the desired benefits or could not manage the outsourcing function. As per a survey conducted by Bain, more than 50% of outsourcing initiatives fall short of the targets set in terms of cost-saving and improvement of operational efficiency. Only 10% of the participants in this survey confirmed that the set targets were exceeded. This amply indicates that a "one-size- fits all" outsourcing approach is not the best solution. Instead, it has to be customized to the needs of the organization after considering all available options. Last but not the least, it is important to constantly keep a tab on the progress of the outsourcing initiative and to continue to develop outsourcing partners and the ability of the organization to measure the performance of the outsourcing partners. →

What helps in achieving the most from outsourcing?

Outsourcing arrangements work better and remain sustainable where the companies and their outsourcing partners go beyond transactional relationship. These relationships demonstrate Trust and Transparency, very good contract management, ability of the company to use the strengths of the partners without losing control over key decisions and independent assessment of outsourcing. →

Outsourcing: A Strategic Advantage or a Sub-optimal alternative?

Currently, companies strive to make their value chains more elastic and flexible. Consequently, outsourcing is evolving as a very important function for organizing and fine-tuning the value chain. The focus remains mostly on *how* to source every single activity in the value chain. It is not uncommon to see the evolution of “capability sourcing” in these companies.

- **Outsourcing of non-core functions –** For years, Nike has focused on Quality, R&D and marketing as the core function and outsourced the manufacturing activity on account of cost advantage. Nike continues to ensure the quality of the finished product as well as the customer experience at the point of sale. This not only meets customer expectations but also helps Nike in maintaining a competitive advantage. It has now evolved as a focused provider of marketing services to other companies by lending its brand to an array of products from eyewear to MP3 players.

- **Outsourcing of core functions** - Amidst rising costs and slow industry growth, Bharti Airtel Limited outsourced all core functions like Telecom Network Management, Information Technology, Billing and Customer Care. In case of the financial sector, JPMorgan Chase and Co. sent shock waves across the IT services industry in 2004 when it canceled its landmark $5 billion outsourcing contract with IBM and took the majority of the business in-house. JPMorgan, later on, started increasing offshoring IT operations to India among other centers.

- **Function-specific outsourcing -** Concentration of scale and skills within a single function has led to outsourcing success stories in logistics management (e.g. United Parcel Service), in contract manufacturing (e.g. Solectron) and in Human Resource Management (e.g. Hewitt Associates). The growth of function-specific companies has given numerous options to various organisations including governments and not for profit organisations.

Challenges In Outsourcing

There are diverse challenges in outsourcing that can lead to achieving sub-optimal results or gross failure of outsourcing. For example:

- **Lack of clarity about "what to outsource" -** Generally, companies opt for outsourcing based on Cost-Benefit Analysis (CBA) i.e. when the cost of operating the functions in-house is prohibitively higher as compared to outsourcing or when the quality offered by the outsourcing partners is significantly better at the same or cheaper cost than that of in-house resources. It must also be reviewed from the perspective of customer experience, where applicable. This also calls for building additional costs that the implementation partner will have to bear to maintain brand-specific perceived customer experience to ensure that they continue to remain associated with the company. Any ambiguity about what to outsource and the absence of criteria for this decision making may lead to suboptimal results from outsourcing.

- **A comprehensive strategy of outsourcing Vs. Piecemeal Decisions** – A large organization, spread over different geographies may have decentralized sourcing authorities although it is possible to manage it centrally for key functions of services. E.g. A large company in India with a presence in 26 states used different media agencies for television and print media. Consequently, it lost a significant cost saving that could be achieved by clubbing all the media spend centrally at the time of contracting to get a volume discount.

- **Inability to measure the performance of outsourcing partners –** Some organizations literally implement outsourcing by closing down the respective in-house function. This does not work in many cases. Outsourcing does not mean that company should do away with the skilled staff at the decision-making level**.** Imagine outsourcing Information Technology function without any senior-level resource in-house to measure the performance of the outsourcing partner.

- **Non- monitoring and no claw-back - In** the absence of in-house functional skills and knowledge to monitor outsourcing, the company may be at the mercy of the outsourcing partner to know significant deviations from the targets, if any. Alternatively, the company may have to engage an external firm to audit the contract compliance with the outsourcing partner. This may be worthwhile when there are provisions for recovery of penalties for non-compliance. **E.g.** Virgin Airlines had outsourced its IT support work to Navitaire. In September 2010, Virgin's Internet booking, reservation, check-in and boarding system, and other mission-critical applications abruptly crashed - for the second time in three months. Navitaire quickly traced the cause of the latest failure to a failed disk drive. Under its contract with Virgin Air, Navitaire was obligated to resolve mission-critical system failures within a "short period of time" without defining it in measurable units. It took nearly 24 hours, during which time the FAA grounded all Virgin flights, leaving more than 50,000 passengers stranded and frustrated. In hindsight, Navitaire's decision to attempt repairs on the bad unit, rather than switching its backup hardware, was not the wisest use of time and resources. This outage represented an example of the kind of technical and contractual due diligence required before entering into any outsourcing agreement. An initial assessment of this interruption shows an estimated pre-tax profit impact of $15-20 million for Virgin Airline.

- **Not considering the impact on customer perception -** It is a well-known fact that Nike outsources its shoemaking process to factories in southeast Asian countries. The quality of the end product continues to remain impeccable. However, a few years ago news-reports indicated that the factories manufacturing these shoes employed child labor. It was not liked by the Nike customers and adversely affected the brand image of Nike. Nike swung into action to take preventive and corrective measures to prevent further damage to the brand.

- **Continuity of Services - Procurement Teams prefer "an expected quality at low-cost service model" while engaging an outsourced service provider. However, it is prudent to opt for sustainable delivery of outsourced services. e.g. A Security Agency or a Logistics company may offer the lowest cost to win the assignment. However, these companies may not have sufficient backup of resources and vehicles respectively, to meet the expectations of the client companies. Typically, their liability may be restricted to the amount of the fees paid or payable to them. However, the liquidated damages may be significantly more than the amount recovered from outsourcing partners.**

- **Why not to have an in-house Shared Services Centre? – Large companies who had outsourced non-core operations have started re-thinking about the merits of**

outsourcing functions like Accounting, Human Resources, Strategic Procurement, Compliances, etc. catering to a large number of group companies. Currently, about 1400 companies in India have Shared Services Centres (SSCs) and they employ nearly 0.8 million people generating nearly 25 billion USD of revenues. India's talent pool and cost arbitrage have resulted in an impressive growth of this industry over the last two decades. Over time, many other countries have come up the curve to compete with India as an outsourcing destination, yet India continues to be the most attractive as per the 11th biannual edition of Global Service Centre Report 2019 by Deloitte, leaving countries like Philippines, Poland, Malaysia and Costa Rica behind. SSCs have to adapt quickly to the changing priorities of CXOs and constantly achieve cost-effectiveness.

What Helps In Achieving The Most From Outsourcing?

- **Trust and Transparency -** When 3 major automakers started losing market to their Japanese counterparts, they forged strategic outsourcing relationships for complex subassemblies such as seats, steering columns, and braking systems. The outsourcing partners had to meet stringent cost and quality parameters. However, to ensure that the relationship is sustainable in the long run, they agreed to open their respective books for sharing important information between them and sharing the savings generated from improved efficiency in the operations as well as incentivizing continuous improvement and removal of unnecessary costs. Chrysler implemented it and named it “value-managed relationship” wherein it consolidated component purchases with the few suppliers it believed could sustain competitive costs, high quality, and efficient delivery. The carmaker and its key suppliers set a common goal of achieving the lowest total systems cost. More importantly, it created managers who were capable of understanding the dynamics of the outsourcing relationship.

- **Contract Management -** A well-drafted and legally vetted contract for outsourcing which is fair to both the parties to the contract is a must in any outsourcing scenario. It is also important to spell out without any ambiguity the Key Performance Measures, a methodology of performance measurement, costs which are to be borne by both the parties, access to the facilities and records of the outsourcing partner for audit and penalty, if any.

- **Ability to use the strengths of the partners without losing control over key decisions -**7- Eleven Stores strengthened its relationship with Frito-Lay since snack foods are one of the most important product lines for convenience stores. It allowed Frito-Lay to distribute its products directly to the stores, 7-Eleven has been able to take advantage of the chip maker's vast warehousing and transport system. However, 7-Eleven doesn't allow Frito-Lay to make critical decisions about order quantities or shelf placement. Instead, the retailer mines its extensive data on local customer purchasing patterns to make those decisions on a store-by-store basis. Companies that wish to use the strengths of outsourcing partners but who are unable to keep control over key decisions do not achieve the desired results from the outsourcing.
- **Independent Assessment of Outsourcing -** Boards and management look for an independent assessment of outsourcing in terms of the targets set by the company, adequacy of count and ability of the outsourcing partners, alternatives to the existing outsourcing partners, contingency planning, etc. They also look for hidden losses or avoidable costs, deviations from the set targets, and an independent analysis of the same to address the root causes and prevent recurrence of the same. Auditors use various techniques like contract reviews, data analytics, mystery shopping, interviews of key personnel of outsourcing partners, in-house skills for measuring outsourcing performance and shortfall, if any.

- **Independent Assessment of Shared Services Centers (SSCs) – SSCs are in a way related outsourcing partners bound by contracts, SLAs and competitive costing. It is quite common for SSCs to further outsource the operations which can be carried out by other service providers at a lower cost without compromising the quality. The processes of the SSCs must be robust enough to not only ensure that they meet their commitment to the client companies but also to ensure that their outsourcing partners, too, match the standards and SLAs. Independent process reviews and performance measurement of SSCs as well as their outsourcing partners can ensure that not only the performance is measurable but also to identify avenues for further improvement in optimizing processes, resources and costs.**