The NEW Economics of Global Outsourcing

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Introduction

There is a profound and impassioned stigma associated with outsourcing. For companies it offers hope and promise for survival but for those displaced the topic is met with strong resentment. During years of prosperity outsourcing was utilized to increase operating return-on-investment (ROI) and fill resource gaps that could not be accommodated domestically. Now that conditions are different outsourcing is viewed as a means for survival. Yet outsourcing (offshoring, near-shoring, on-shoring, retrosourcing…) continues to carry the social stigma surrounding lost jobs, wholesale relocation of operations, and even a sense of disloyalty to our native country. There are also those that view outsourcing as risky business. Despite current unprecedented economic conditions outsourcing is still viewed as far too risky an option to consider.

For establishing proper context the topic of outsourcing will encompass offshoring, near-shoring, on-shoring, and all of the various types of services that can be serviced outside of an organizations (ITO, BPO, KPO…). Outsourcing has existed for a very long time but not always under the title as such. One could argue that even mercenaries represented an early form of outsourcing. Prior to semi-official recognition in the 1990, outsource related services were referred to in many ways; service centers, external providers, service suppliers and even contract support. Recently a LinkedIn™ discussion suggested that the term 'outsourcing' should be called something different. This probably resulted from the lingering negativity associated with the title. No matter what you call it, it's a service being provided to another with the express intent of making it economical, whether in money or in terms of delivery of value that can't be realized by one's self. The emergence of 'outsourcing' reached recognition as a result of high service demands surrounding the urgency in addressing the impact of the year 2000 (Y2K). What was a low cost side-benefit became a value added promotion for outsourcing. India was one of the first to present itself as a source of low cost services supported by a richly educated talent pool. From these early years emerged an industry, promoted by size, qualifications, and a portfolio of globally recognized companies. In the shadows hid stories of deceit, failures and cumbersome delivery of services. These situations placed at risk the potential savings that lured buyers to consider outside support.

Since that time we have seen an explosion of service providers covering virtually every country around the globe. Buyers too have looked to these sources as a way to save money, provide flexible staffing, and still provide the same level of service. While numerous risks continue to influence IT service support decisions, companies continue to recognize this form of service solution as highly attractive. Others may feel trapped by relationships that seem to provide little or no suitable way out, and as a result conclude that all is lost as it relates to economic realization. Regardless of these circumstances there is value provided by extending your business capacity through controlled commitment. Understanding the true economics of outsourcing will guide buyers (and suppliers) to a rewarding, risk overt experience.

<u>The Basics</u>

The simple economics of outsourcing is based on <u>rate</u> for service. While buying decision are sometimes guided by region, it is based on the <u>rate</u> that suppliers offer that will promote specific locale interest. Based on this premise, the economics and conditions for positive outsourcing will start to increase in complexity.

Some of the leading mistakes that erode the economic benefit of outsourcing include,

- Inaccurate work effort estimates,
- Poor supplier qualification,
- Overlooking onshore engagement management requirements,
- Lack of accommodations for change,
- Excessive prescriptive direction, and
- Overreliance on contractual provisions.

Each of these errors are discussed further in later sections of this document. Note that additional study (as noted by ☝) will provide added insight and mastery in the various topical area. For purposes of this article we will introduce the concept and illustrate solution examples.

<u>Effort Estimates (☝)</u>

All potential outsource efforts should have estimates established by the buyer. It is not uncommon to find companies who rely purely on bid proposal as the test for service legitimacy. The purpose of buyer based estimation is to qualify and quantify the service initiative, serve as a basis of supplier evaluation, and determine a general reasonableness of approach. Historically, companies have great difficulty producing reasonable estimates. Inaccuracy can be attributable to a wide variety of reasons,

- Single person estimations,
- Lack of defined, lean and consistently applied processes,
- Overly complex or simplified estimation model,
- Group based confusion and controversy,
- Poor empirical estimation information,
- Real-time vs. Ideal-time confusion, and
- Date and Resource influences.

While it could be argued that these are simply factors of business, each situation is solvable and produce positive flexible opportunities for overall improvements. Pre-proposal estimates are essential in measuring the level of understanding of the service needs by the supplier. The buyer can gauge the level of understanding in the transference of information, via the Request-for-Proposal (RFP) or Request-for-Information (RFI) to the suppliers. Unexpected variations brings attention and promotes resolution before commitment decisions are made that further erode outsource value gains. This also creates an channel for an open dialog that, when exploited, will generate lasting synergy.

Processes (☝)

Processes do not make system solutions, people do. But we also must recognize that the power contained in defined processes afford opportunities for skill development and delivery consistency. Suppliers with vague or non-existent processes give rise to questions about the durability and quality of the outsource service. As buyers, control must be maintained over being prescriptive vs. permissive.   It is more a question of 'what' service are needed and accommodated vs. 'how' it needs to be produced/ delivered. A key to depending on this approach is placing reliance on both sound process models that the supplier may have, and the supplier themselves. Common process related problems that reduce outsourcing value include,

- Narrow applicability of defined processes,
- Non-Lean,
- Inflexible,
- Use, misuse and misguided,
- Document vs. Delivery Intense, and
- Lack of process alternatives for varying reasons.

In each case these onshore (in buyer company) issues will cause costs that reduce benefits, increase costs and delivery risk.

Estimation Model (☝)

Everything requires balance, excesses lead to unstable and unreliable outcomes. Too much or too little formality in the estimation process increases the risk that results will be unrealistic. Estimation models that operate at a gross level tend to overlook significant areas of service need. Whereas comprehensive detail driven models create excessive unsubstantiated confidence while overlooking the overall initiative. Remember that an 'estimate' is an educated and informed prediction of an outcome that will be used to guide and control delivery. It is neither a 'prediction' of reality nor a 100% guarantee or certainty. To be discussed in a later section, 'delivery guidance (Are We Done Yet?)', estimations are used initially to measure cohesion between buyer and potential supplier, and later to guide delivery. There are several solutions that can be used to deliver more realistic and lasting effective estimates.

- (☝) Group estimations utilizing such techniques as wide-band Delphi, estimation poker, Putnam's Standard Component Method (PERT), story point assignment, and Critical Chain Buffering (CCB),
- Incremental work delivery dissection,
- Task level estimation for larger service delivery components, and
- Resource balancing and delivery scaling.

In short, if you have had a history of estimation issues realize that they will not resolve themselves without purposeful attention. Appropriate consideration must be given to establishing an appropriate and reliable model for proper engagement sizing. As in the case of processes value, an estimation model will establish a climate for consistency, promote skill based mastery and serve a vehicle for improving reliable estimation results.

Estimation Information (☝)

In continuation, the use of historical delivery information can serve to be a useful tool for further validation of estimates. While it was initial considered useful for helping to construct estimates many have also found it more beneficial in validating the authenticity of new estimates. This eliminates the repeating of previous estimation mistakes while adopting a more fact based approach to estimation. Problems begin to show in the areas of collection consistency and depth of detailed information. These problems give rise to doubt in new estimates which then lead to questions about historical information, ultimately raising concern over anything to do with estimates. In doing so, wild and misdirected guessing occurs that produces unrealistic expectations and creates a climate that no one will endorse.

Estimations have two purposes, the effort expectations and delivery anticipation. As buyers concern is about cost, this drives the effort required while at the same time there is a level of anticipation surrounding delivery. Delays or unexpected quality issues consume the gains that the outsourcing relationship promoted. Estimate information serve and should be viewed as a control mechanism in support of the engagement. Buyer need to recognize that the validity of the pre-project estimates, supported by historical estimate delivery will serve as a strong base for authenticating supplier legitimacy.

Real vs. Ideal Time (☝)

A misconception is that the units of measure for estimates are all the same. After all a work day is the same equivalent to a productive work day, right? Does your 8 hour work day equate to 8 hours of productive result? When an estimate of effort is provided there will be someone who will take this total and attempt to predict when delivery will occur (and may even shorten that if the number isn't to their liking or suggest adding more resource to deliver quicker). The fact is that time to produce a component or a system is not free from non-productive work related aspects. When this is overlooked one is adopting an 'Ideal' time attitude (e.g. 8 hour work day) vs. understanding that there are reduce productivity (referred to as 'Real' time). While further internal study might be required some have found this may be as much as 3 hours of unproductive time per day dedicated to such things as,

- Holidays,
- Productivity rate,
- Unexpected meetings,
- Error repair,
- Email,
- Phone Calls,
- Sick Time, and
- General disruptions.

There is also the potential for further distortion caused by unaccounted for overtime or work performed outside of the workplace. True accounting, at least for project/service control, is essential for forming an intelligent base for guiding estimation information. Otherwise, these conditions will distort delivery expectations and undermine historical estimate information.

Delivery Influences (☝)

From the onset stakeholders have a healthy curiosity concerning delivery. From top management to technicians, everyone is wondering when they can expect to see product/service delivery. Whether using traditional delivery methods, characterized as the 'big bang approach', or more iterative forms utilizing incremental delivery, everyone has a healthy (sometimes unhealthy) interesting when the end will occur. Without question there will be those who will challenge whatever estimates are presented. While responsible challenging is encouraged to optimize approaches, methods, needs and increase ROI, irresponsible challenges introduce risk that will destroy the positive economics of outsourcing engagements. Misguided actions are commonly involve,

- Excessive and thinly managed resources,
- Adding more time but holding delivery dates constant, and
- Not establishing a sense of delivery importance to each.

Healthy and open discussions encourage responsible behavior and reduce risky date driven behavior. Do not take this lightly. Buyers need to adopt a responsible behavior concerning delivery in order to encourage a proper buyer attitude. Suppliers operate in a highly competitive environment and will do everything possible to gain trust and business, sometimes at the mutual peril of themselves and of their customer. For this reason a proper responsibility must be exercised. There will be ample opportunities to discuss, debate and develop solution delivery that will fit the needs of buyers and service providers.

Outsourcing Gone Bad

Even with a profound understanding about the fundamental mechanics of outsourcing estimation pitfalls, there remains an element of risk. This is contributed by issues involving transitioning of operational culture from buyer to supplier. Factors involving the mode of operation, terminology, explicit and assumed expectations and general desires require formal transference to the supplier. The supplier then must make adjustments and adaptations in order to fulfill the delivery commitment while sustaining a stable operating environment within their company. The level of coordination and adaption is often underestimated. When failures occur it is blamed on culture and not on inattention to this important project administration point.

The first step to chipping away at these risks is to reflect on the level of project management involvement. Has proper care been given to,

- Correcting known deficiencies in artifacts, processes and operational involvement?,
- Established an orderly transitioning of duties from internal staff to external suppliers?,
- Developing sufficient checks-and-balances to retain continuity and control?,
- Adopting a 'buy right' vs. a 'buy large' attitude that insures viability and capability as cornerstones for select?,
- Clearly understanding governance responsibilities?, and
- Appropriately prepared for known contingencies (e.g. scope change)?

Contractual provisions help to arbitrary differences, and are essential, but do little to soften the effects of failed service delivery.

True Costs

As described earlier, outsourcing saves money based purely on a cost per unit (rate) of measure basis. To illustrate this point, if a company spends $50 per hour for a project manager and their benefits represent an additional 25% ($12.50/hr.) this would equate to $62.50 per hour for labor cost. This does not include office occupancy and related professional developmental requirements. This also assumes 100% utilization, which as previously discussed relative to 'Ideal Time', is impossible to attain and as a result further increases the delivery costs when serviced internally. For the purposes of this example let's assume that the overall net-net domestic cost is $65 per hour, on simple on a rate basis it's hard to overlook the positive economics of a service provider rate of $45 per hour in China or $57 in India. A buying company can take on a substantial amount of buying risk for even $12 per hour over the range of a several thousand hour project engagement. If you work for a company who is considering a return to in-house servicing (known as retrosourcing) bear in mind that these economies will require reverse justification despite compelling circumstances.

Appropriate attention given to ways of reducing buying and estimation risks will minimize cost misconceptions and promote responsible risk control. Illustrated below are points worth considering.

1. There are efficiency and familiarization costs associated with first time outsource service transitioning. The buying organization can expect to realize less ROI during the initial engagement of outsource services. The speed of transitioning and acclimation will determine the realization of expected target ROI goals. A maximum of 10% transitioning impact can be expected (historically).
2. The influence of culture will contribute added cost. It is less a question of culture but the measures needed to overcome cultural challenges (language, customs, distance, time zone…). To illustrate, it is not uncommon that what took a chat in the hall may now requires a small written testimony to communicate with the provider of service. The good news is that this level of formality produces health benefits (better precision) and fulfills requirements directed through laws and regulation. Expected impact of 2% (historically).
3. Don't expect a smooth sail on the initial engagement or year of service offering. There are going to be things that neither of you expected or anticipated so remain adaptive and flexible. Close attention and vigilant communications will minimize the impact in this area. With proper attention no impact can be expected, if loosely attended to it can rise to as high as 5% (historically).

In summary, if you are anticipating a gross saving of 30% the preceding will reduce savings to a net of 18% in the initial orientation period and return ROI to a healthy level in the order of 23-25%.

Although there are few public studies or metrics available one can expect a gross savings in the area of 20-40%, and when considering the initial transitioning costs of 10-20% (a nearly break even situation) at the onset of the relationship. However, don't be scared away . This remains short term, controllable and offers added flexible service delivery that would not have been possible using conventional domestic resources. Over the run of a service project gains of 15 to 20% are common (a figure much better than one could realize from traditional investment choices). Even small one time service engagements will have lower cost effects with yields in line with longer term engagements. This is caused in large part to an appropriate lower level of formalization that would be attributable to longer term and larger service projects.

Purely based of economics outsourcing in both the short and long term can produce substantial gains and a positive ROI for companies.

The Next Steps

Let's assume we have dealt with the leading risks involving engagement and estimation management. Our next hurdle is to determine what region to seek qualified suppliers from. Some consider this simply a matter of choosing a popular destination and start canvassing the thousands of potential suppliers. This approach, while quick, may totally miss the optimized economic objectives that have been set. In keeping with our theme of 'positive economics' a good place to start is where we can get the most for our money. Currency valuations, trends and current status help to influence what region might make the most sense to seek service providers. For example, if we look at how much we can get for our dollar ($), euro (€) or pound (£) this would help narrow the group of service providers. At present;

	USD ($)	Euro (€)	GBP (£)
India (INR)	49.18	63.7129	67.9751
China (CNY)	6.842	8.8638	9.4568
Russia (RUB)	32.696	42.3578	45.1914
Brazil (BRL)	2.3458	3.039	3.2423

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What does this chart tell you? Are there clear choices or does it raise further questions for added consideration? Does the stability of the currency influence your decision or are you willing to take some risks and hedge your aggressiveness with a dabbling of monetary future speculations. These represent a small fraction of the questions that are worth asking. Obviously our interest is to optimize the economies of the outsourcing engagement and while we could overlook such matters we might be facing the unfortunate decline in monetary value. This would jeopardize and potentially put at risk our ROI. Some additional factors for consideration include,

- Are suppliers requested to quote in native currency or in local buyer currency? Keep in mind that quotes in buyer currency may be padded for currency fluctuations. Given present economic conditions, deflated USD ($)s will be more expensive in the future whereas supplier currencies are poised for a reduction. Whoever controls the currency will control the risk.
- For longer term service delivery engagements buyers may wish to consider the economics of currency futures. While there are investment risks there are opportunities to develop gains that can be used for a variety of other purposes (e.g. funding estimation errors or new feature additions). The previous chart does not reflect whether the respective currencies are at the bottom or top of trading. However, in concept what is up will go down, and what is down will

go up. Obviously there is allot more to these topic (☝) and one should seek the advice and counsel of your corporate investment department when formulating your outsourcing strategy.

- Utilization of currency rate information can provide guidance on whether to utilize fixed price or time-and-materials outsource engagements. High volatility or economic uncertainties are suitable for fix price engagements. Low volatility with reasonable economic expectations offer sufficient value through a time and materials relationship. In both cases aggressive buyer (and supplier) project management will insure mutual engagement benefits.
- How do the costs match for specific service project roles? Even though a specific country may offer favorable currency exchange rates (and it's relatively stable) consideration must be given to cost per role.
- All roles need to be reviewed collectively. By way of example, if there are two roles that have a relatively higher rate, but the remaining 14 roles have a lower rate for a longer consumption period then this choice might be more economically beneficial. Usually in these circumstances additional questions about qualifications, tenure, turnover and language skills may be explored.

Are We Done Yet?

In terms of the topic of outsourcing economics, the answer is yes (almost). But in terms of realizing the value the fun is just beginning. Despite proper care and due diligence, estimation adjustments and risk reduction economic success will hinge on aggressive and coordinated project management. Utilizing the fundamentals of sound project management, such as the Project Management Body of Knowledge (PMBOK by the Project Management Institute (PMI www.PMI.org)) ,specialize outsourcing related project management topics, focus, and direction exists. This include unique attention to,

- Global coordination,
- Communication systems, vehicles and formalization,
- Pre-engagement synchronization,
- Advanced coordinated metrics, and
- Shared service delivery.

A targeted body of knowledge exists specifically for global outsourcing project management and can be obtained at www.Int-IOM.org (Outsourcing Management Body of Knowledge – OMBOK). Simply put, the economics visions formed as a part of service project definition can only become a reality through purposeful joint commitment by buyers and suppliers. Your governance responsibilities continue no matter whether you continue to provide direct services or utilize the resources of an independent supplier. Continued oversight, care and attention remain and will last for as long as services are provided to stakeholders in your company.

Conclusion

Can outsourcing yield a positive ROI?	*Yes*
Are the yields as high as we expected?	*Probably Not*
Should we expect some added costs?	*Expectedly so*
Will we need to realign our approaches?	*Definitely*
Should we expect that some changes will need to be made?	*Probably*

The good news is that there is an abundance of case studies, articles, and resources that can be put to work to overcome risk, guide in the realignment of processes and methods, and assist in the delivery of high yielding risk overt outsourcing. As a buyer, or as an experience veteran of outsourcing the opportunity to reinvent/rediscover the economics has come at a time when success may mean survival. Economics lead the score card of reasons behind choosing outsourcing as an operational alternative. However a close and critical examination of other service provider attribute will be necessary. Question of supplier viability, regional stability, intellectual property rights (IPR), delivery capability and organization synergy are but a few of the other factors that will influence your economic realization.

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