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SUSTAINABLE VALUE FROM OUTSOURCING: FINDING THE SWEET SPOT[1]

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IT and business process outsourcing clients seek a variety of benefits including cost reductions, variable capacity, and reduced management time spent on IT. But outsourcing succeeds only if the vendor, as well as the client, achieves expected benefits. Often client and vendor interests are not aligned. How can clients and vendors settle into a "sweet spot" where their interests coincide? New CISR research has examined 90 outsourcing deals in 84 firms to help firms recognize opportunities for long-term benefits from outsourcing relationships.

We found that the outsourcing "sweet spot" depends on the nature of the client-vendor relationship. We distinguish among three types of outsourcing relationships: (1) a ***transaction relationship*** in which an outsourcer executes a well defined, repeatable process for a client; (2) a ***co-sourcing alliance*** in which client and vendor share management responsibility for project success; and (3) a ***strategic partnership*** in which an outsourcer takes on responsibilities for a bundle of client operational services.

Figure 1 summarizes the benefits and risks of these three relationships. In this briefing we will describe for each type of relationship the kinds of services outsourced, the metrics that enable firms to assess the success of the outsourcing arrangements, and the risks to both client and vendor.

Transaction Relationships

Transaction relationships are appropriate for activities guided by clear business rules that are common across many organizations. These activities include commodity services—necessary but non-distinctive services—such as accounts payable processing; expense reporting; desktop provisioning; backup and disaster recovery; and mainframe processing, as well as more specialized, repeatable processes, like credit checks, online gift registry services or unique technology services.

Our study found statistically significant greater satisfaction with transaction relationships than either of the other types of relationships and 90% success rates for both clients and vendor. We attribute the satisfaction to a large overlap between what clients want from their vendors and what vendors are able to deliver (Figure 2). Clients had three key objectives in their transaction relationships: access to best practices, variable capacity, and the ability to re-direct management attention to core competencies. Vendors address those needs by developing best practices; solid scalable technical platforms; and other valuable assets that allow them to improve service and lower costs. For example, eFunds has built a large database of debit information that is the key to its credit checking process. This distinctive asset—which clients either cannot or would not replicate—helps to protect the vendor's margins.

Successful transaction relationships have low management overhead. Customization, protracted contract negotiations, or client interference with how the vendor performs the process will increase cost and undermine benefits for both parties. But a hands-off transaction relationship can deliver hassle-free, high-quality services to clients and reasonable margins to vendors

Co-sourcing Alliances

In a co-sourcing alliance, clients and vendors share management responsibilities, usually for application project initiatives. They draw on both the vendor's specialized technical skills and the client's deep business knowledge.

Client interest in co-sourcing arises from the desire to access lower cost but higher quality technology and project management expertise while maintaining control over the project. Vendors seek to develop industry and application knowledge as they deliver expertise at a cost that often mixes local and offshore labor rates. When the client and vendor both have strong capabilities, they create a mutually beneficial arrangement (Figure 2).

[1] The authors gratefully acknowledge *CIO Magazine* for help in collecting the data for this study.

The contribution of the outsourcer in a co-sourcing alliance is difficult to isolate from the contribution of the client's employees. One manufacturing firm, which deploys project teams with, on average, four vendor employees for every internal team member, has a set of metrics to assess team productivity on factors such as function points. But ultimately, the CIO notes, the measure of success for the outsourcing arrangement is the project outcome. He considers his alliance a success because alliance teams consistently deliver high functionality on time and on budget. The CIO does not know—or care—whether outcomes would be different if the vendor were not involved. He has an affordable variable staffing model that works.

Co-sourcing alliances present risks to both clients and vendors. For clients, generating value requires relying on vendor expertise, but too much reliance can result in insufficient internal knowledge to apply new technologies effectively. Vendor risk results from the need to teach project methodology to the client in order to ensure project success. Vendors run the risk of working themselves out of a job as they strengthen their clients' skills.

Strategic Partnerships

In a strategic partnership vendors provide an integrated set of operational services. For example, a single IT outsourcing deal might encompass mainframe operations, WAN and LAN management, telephony, and help desk services—some of which are commodity services. By integrating its service offerings, the vendor adds value beyond the value of the individual services.

In a strategic partnership, the client expects to be able to focus on core competencies after handing off major operational responsibilities to the vendor. Clients also usually expect to realize cost savings and have access to variable capacity. To meet these expectations, vendors rely on economies of scale and scope, shared resources and best practices. Despite the potential for mutual benefit, these deals are risky. Only 50% of strategic partnerships in our study were successful.

Metrics are part of the problem. While vendors expect to earn a margin on the integrated set of services, client assessments of their partners often rely on a set of service level agreements for the individual services. We believe the value of a strategic partnership is better assessed by its impact on the client's bottom line. For example, one CIO noted that when he needed to reduce his IT budget by $10 million, his vendor partner identified $3 million in outsourced services that could be cut with minimal pain to the client. Recognizing that this reduction would be painful to the vendor the client and vendor identified $1M in new outsourcing services that reduced the client's IT budget, and the client award the vendor a number of new projects, which restored and in fact increased the vendor's revenues.

Strategic partnerships work best when they are treated by both client and vendor as long-term inter-dependencies with shared risk. Clients need vendors to adapt their offerings and processes to changing business conditions; vendors need clients to adapt their expectations and behaviors to permit appropriate process innovations and service changes. Successful strategic partnerships often apply a first-choice provider principle, meaning that the strategic partner is favored when new activities are to be outsourced. This reduces search costs for the client and sales costs for the vendor.

Conclusion

These three types of outsourcing relationships are so different that learning gained in one type of relationship does not transfer to another. We believe a firm can become competent in all three types of relationships, but it is important to match the services outsourced with the appropriate type of relationship. Clients and vendors in strategic partnerships who refuse to adapt to the strategic needs of their partners will become embroiled in bitter contract battles. Firms that manage transaction relationships like strategic partnerships incur expensive and unnecessary overhead. And co-sourcing that is treated like anything but a team environment is sure to sub-optimize outcomes.

Firms need to understand the risks of each relationship. Risks increase as the boundaries between client and vendor responsibilities blur and the scope of responsibilities expands. However, even transaction relationships bear significant risks. We found that firms emphasizing transaction relationships had statistically significantly less mature enterprise architectures.2 Low architecture maturity may indicate that transaction relationships often reinforce application silos. In the short term, this could help a firm clean up isolated processes, but over time it inhibits the firm's ability to respond to changing market conditions.

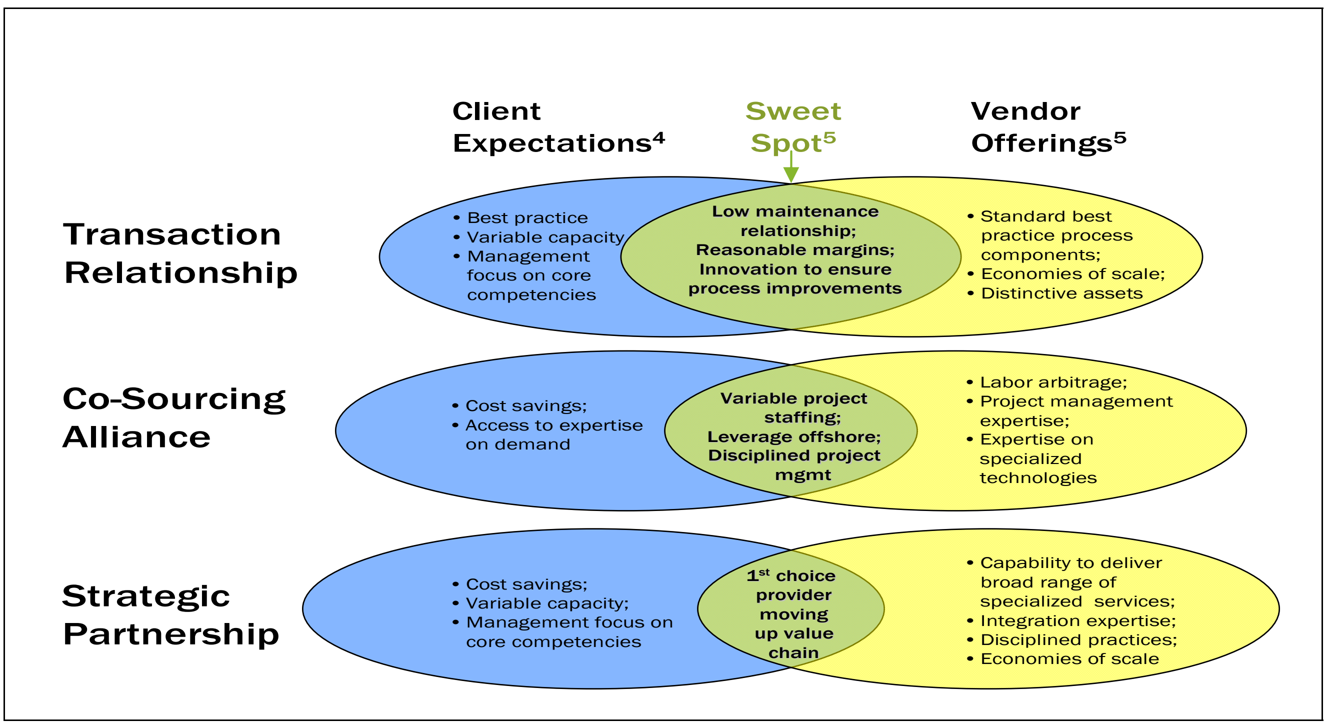
For firms to generate value from their outsourcing arrangements they must design governance and relationships that fit the services they are outsourcing. Most importantly, for each type of outsourcing, both client and vendor should target the sweet spot to maximize benefits to both parties.

[2] For a discussion of architecture maturity see *Maturity Matters: How Firms Generate Value from Enterprise Architecture*, MIT Sloan CISR Research Briefing Vol. IV, No. 2B, July 2004.

Figure 1: Summary of Benefits and Risks

	TYPE OF RELATIONSHIP		
	Transaction	**Co-sourcing**	**Strategic Partnership**
What is outsourced	Clearly defined, repeatable process	Shared responsibility for project management and implementation	Range of responsibilities for operational activities
Key metrics	Quality and/or cost per transaction	Project success	Bottom-line impact
Client risks	Desired service may not be available in the market	Difficult to assess vendor contribution	Integrated services hard to assess individually; Vendor may not adapt to changing business needs
Vendor risks	Competition may erode margins	Transferring project management expertise undermines value proposition	Client unwillingness to change limits impact; Poor relationship inhibits add-on sales
Client success / Vendor success[3]	90% / 90%	63% / 75%	50% / 50%
Increasing Risk			

Figure 2: Outsourcing Objectives



[3] Client perception based on 80 surveys. Questions asked: "Within the firm we view this outsourcing agreement as a success" and "The vendor is profiting from the outsourcing arrangement." Percentage is based on number of respondents who rated the statement as a "4" or "5" on a scale of 1 to 5.

[4] Based on surveys of 80 IT managers.

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In July of 2008, Jeanne W. Ross succeeded Peter Weill as the director of CISR. Peter Weill became chairman of CISR, with a focus on globalizing MIT CISR research and delivery. Drs. George Westerman, Stephanie L. Woerner, and Anne Quaadgras are full time CISR research scientists. MIT CISR is co-located with MIT Sloan's Center for Digital Business and Center for Collective Intelligence to facilitate collaboration between faculty and researchers.

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