

## Business Process and IT Outsourcing: Big Companies, Big Deals

Hugh H. Dyar \*\*\*\*

Senior Executive

Accenture

There is no doubt that the opportunity for Information Technology outsourcing and its closely related counterpart, Business Process outsourcing, is on the rise. What started over a decade ago as application development outsourcing to India has now grown by leaps and bounds from a call centers and legacy software application maintenance, to many other IT functions and business processes, and to delivery centers spanning Asia, Europe, and Latin America. A global industry has emerged based upon Indian companies and the worldwide expansion of US-based multinationals that contract for services in dozens of locations, in virtually all time zones. This brief synopsis will attempt to cover the motivations behind these trends, how large companies do it, why they do it, and the legacies they leave.

Outsourcing of IT and Business Processes can take many forms. Large corporations, in an effort to remain competitive, build shareholder value, and refocus finite resources on more strategic endeavors, will often run out of ways to improve internal efficiencies. This realization, that modest incremental year on year improvements will never produce meaningful cost savings, is often a painful point of arrival for executives who manage large cost centers inside of major corporations. Only the most imaginative, disruptive, and courageous individuals can marshal and maintain the internal inertia that is required to bring about massive change inside a large and bureaucratic organization that is too mired in its own legacies. In some cases, external forces highlight certain operational deficiencies. Independent rating agencies such as J.D. Power, the Gartner Group, Forrester Research, or Wall Street analysts who follow the stock and earnings announcements, will pronounce that certain players are far ahead of others in common corporate metrics, thus driving an internal focus to gain

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more customers, revenues, profits, and lower costs. Boards of Directors, responsible for

corporate governance, sometimes find shortcomings with senior leadership and appoint new executives who have demonstrated the ability to take cost out and drive productivity. For these and other reasons, the motivation drives certain internal behaviors that cannot be satisfied with the status quo.

What has driven the ease with which outsourcing can be accomplished? The emergence of the Indian economy beginning with 1991, their established credibility with projects such as Y2K at the end of the decade, the glut of worldwide optic fiber deployed during the dot com boom, and the availability of well educated and highly motivated labor have all contributed. Other geographic areas such as Eastern Europe and more recently, China have exerted further downward pressure on the price of worldwide skilled labor for such functions such as programming, customer facing help desk, accounting, claims processing, tax preparation, procurement, learning, and human resources, to name a few. Wherever there is a recently liberated, connected, and hungry workforce and a supportive government, the economic laws of supply and demand eventually prevail. In some cases, a single company may outsource large parts of a particular function and thereby establish a remote processing center under the ownership and management of one of the many established or emerging outsourcing providers. The establishment of such an anchor client gives service providers the ability to price even more aggressively to subsequent potential clients, thus building momentum, a reputation in the local economy for growth of available jobs, career paths for those working in the center, and a grateful regional government.

What kinds of functions lend themselves most readily to an investigation and possible contract for multiyear outsourcing contracts? Wherever there are large numbers of employees, concentrated in one or few specific locations, doing essentially the same thing, whose wages and length of service make them expensive as a group, these employees are prone to be targeted for

moving their functions to a more cost effective location. Widely dispersed, disparate functions are more difficult to pinpoint as areas for large gains in cost reduction or process efficiency. Highly repetitive processes, requiring little or no ongoing formal training can easily be benchmarked against industry standards and offshore centers using widely accepted sets of criteria. Seldom does the entire function move in its entirety, rather, the more strategic and policy setting functions remain close at hand near the corporate or divisional headquarters.

Does outsourcing of these functions always mean the relocation of jobs? In many cases, it does not. Companies may already have a combination of domestic and established offshore functions of their own, which they elect to turn over to service providers who manage them more efficiently, using best practices learned from multiple engagements with other companies. Clients will often demand that service providers price these services over the course of 3, 5, 7, or 10 year contracts, assuming aggressive productivity and economies of scale as their formerly captive processing centers grow into shared service centers for multiple clients of the service provider. In some cases, service providers will retain all or a fraction of the employees in place, to maintain subject matter expertise and the top performers. Moving work from one location in the US to another can be an acceptable solution, given certain factors such as a loss of a contract somewhere else in a service provider's domestic footprint. Labor pools in areas whose populations have lost jobs in shipbuilding, manufacturing, or steelmaking, for example, create an environment where unemployed workers flock to steady jobs with good health benefits. Many families rely on one wage earner with health benefits to cover the entire family. Even for low hourly wages in entry level positions, health benefits and flexible or off shift work schedules provide a welcome safety net in certain U.S. areas. Call Center operators naturally seek out locations in which there is a need for steady employment and a large available supply of motivated potential employees.

How, then, do companies launch the process of evaluating their outsourcing options? In the largest and most formal situations, these processes can take anywhere from six

months to over a year, involving industry experts from well known specialty consultancies or law firms, that promise to deliver a thorough, fair, and competitive procurement process through which the company can be assured that they are getting the best possible deal. These procurement engagements alone can easily cost several million dollars, but clients receive value for these services when, in some cases, they are outsourcing functions that are costing them \$100M per year to perform. Over the life of a 10 year contract, hundreds of millions of dollars worth of savings can be delivered. Selection of the procurement process consultant, and the outside law firm who will negotiate the contract on behalf of the client, is the very first step for those who are new to the concept of outsourcing and therefore feel the need to do it properly. Many companies choose to attempt this themselves, but are often ill equipped to deal with the sophisticated sales engines of major service providers, the complex pricing, and contractual constructs. Simply put, clients need to know they have a solid deal which satisfies their objectives, and will be harmonious over the long haul.

Once underway, the first step is the development of a Request for Proposal, using methodologies developed by the consultancies ,which can be voluminous. The response to such RFPs can be very structured, and take months for responders to prepare. Often these responses contain hundreds of pages of required material, with supporting marketing information touting the advantages of selecting their company. Each company seeks to position itself with a unique value proposition based on a wide range of characteristics. Then the company performs the internal process of down selecting from 10 or more responders to a manageable number of 2 or 3. Oral presentations, site visits to far flung locations, and multiple iterations of documentation will be used to narrow the field to these finalists. Eventually the client will elect to proceed with due diligence and contract negotiations with one or possibly two. Contract negotiations can easily take several months to complete. With all of the science involved, there is always an additional, qualitative, comfort factor which comes into play. They might feel as though their employees are going to be properly treated, if rebadged into service provider employment. Depending on the age and length of service of the affected population,

there may well be major implications for severance, retention of earned retirement benefits, and earned vacation, and the comparable benefits when transferring from the company to the service provider. They might simply feel more comfortable or confident with the people managing the centers.

What kinds of expectations are common? Companies will invariably demand cost savings of 20, 30, or 40 percent, with a seamless transition. Delivering on this kind of expectation, especially in the first year, can be a daunting proposition for even the most sophisticated outsourcers. Often it involves the assumption of tremendous business risk for which stringent contract contingencies are required, involving hefty termination penalties. There is little chance of transitioning work without an acceptable period of parallel operation, extensive training, and advance provisioning of office facilities. Expenses such as substantial severance payments, earned vacation, transitional insurance coverage, and other factors add up quickly, for those employees not being retained. Service providers must effectively finance their upfront investments over the first few years of the contract in order to avoid very large upfront payments. In the end, both companies become highly dependent on each other and a mutual, symbiotic relationship ensues. Over time, both companies will become operationally intertwined in a way that is much different from a typical client/vendor relationship.

Transactions whose scope extends across multiple countries or continents are common, especially for larger corporations who serve global customers. In these cases the labor laws of various countries must be dealt with, and the United States generally has the most liberal policies. In many countries in continental Western Europe, labor laws preclude moving work from one country to another without hefty deterrents such as multiyear payment of salaries. The difference in wages for similar functions can be dramatic between western and eastern Europe, for example. This presents tremendous opportunities for workers in progressive countries such as Belarus, Poland, Hungary, and the Czech Republic, to name a few. Legacy manufacturing facilities in Scotland and Ireland offer underutilized facilities and labor pools that are easily enabled to become cost effective centers for performing help desk, forms processing, accounting, and other processes. Many outsourcing providers can present a panoply of possible delivery

centers in Latin America, Europe, China, India, the Philippines, Canada, and Mexico, many of which specialize in a particular function and which have reached sufficient economies of scale that enable them to offer excellent levels of service far much lower costs. Whether the functions involve fluency in written and oral communication in certain languages is often a main determinant in the ultimate site selection. Oral communication in particular is heavily scrutinized for accent neutralization and adherence to local dialects. American English, for instance is very different than UK English, both in vocabulary and accents. For this reason, the Philippines has been an attractive alternative to India for US companies seeking American oral communication. Even with the extensive use of sophisticated, pre-defined online scripting, call centers go to great lengths to hire and retain customer support agents who can speak fluent English with no discernable accent.

The emergence of Greater China has added a significant pool of very well educated workers to the global supply. Since 2001, the sheer volume of available talent is causing immediate and significant pressure on countries like India, the Philippines, and others. Moreover, the Chinese labor force is not satisfied with low end, entry functions such as Help Desks. American companies like Microsoft, IBM, GE, HP, and others have opened research and development centers for perform high level research in advanced technologies such as search engines. The available talent from which to select only the most qualified applicants is enormous., and is stretching beyond the limits of Shanghai and Beijing to some of the 158 cities like Dalian with populations over 1 million. Consider how selective the most advanced software development companies can be in recruiting from the top university graduates in the United States. Those who rise to the top of the most demanding technical curricula compete for the available positions. There are far less than a million graduates per year in these disciplines in the United States. The tremendous growth of graduates in China alone is beginning to tip the balance. In general, if you are on in a million in the United States, there are 1300 people just like you in China today. China has not even begun to hit its stride.

What will become of the most desirable jobs in the United States in the information technology field? One can easily argue that the overwhelming numbers of job creation in the industry worldwide, has been driven by the creation of innovation based enterprises. Companies like Cisco, Google, Microsoft, Yahoo, have been created out of nothing to generate billions of dollars in shareholder value and thousands of jobs where there were not only no companies, but no industries before they created them. How hard should we argue to retain low end IT jobs in the US when it is so difficult to attract applicants to fill them? Recruiting and retaining \$10-12 per hour call center employees in U.S. cities is challenging and expensive for employers, especially if seeking to hire for the second or third shifts. Challenging because these entry level jobs are at the bottom of the IT food chain and do not pay significantly more than the minimum wage; expensive for employers because the churn rate exceeds 20-30% per year and demands constant recruiting and training expense. Advertising in local papers, online job boards, and paying incentives to existing employees for referrals are simply not enough.

Companies must proactively recruit on campus at the local Community Colleges, with dedicated recruiting staffs. Once hired, the fallout rate in the early months can be 10% or more. Employees working in call centers located in the suburbs of Atlanta, Tampa, Colorado Springs, and other US cities will sometimes be supporting a small family on wages in the \$12-13 per hour range. The more dedicated among them will commute long distances from less expensive housing far outside city limits, subject to the impacts of climbing gasoline prices and worsening commutes to retain these jobs, at least until they can find something closer to home or something with a \$1 per hour better wage. On the other hand, Indian companies have hundreds of eager, well qualified applicants for the same job, who are very motivated once hired. Each one of them occupies an office cubicle which is provisioned mainly by American products, in a building which may be cooled by Carrier air conditioning. Each of them becomes a consumer who spends money on American products available in India. Our greater concern should be the shifting of higher level IT jobs offshore. As long as innovative companies continue to be created and grow in the United States, new higher level jobs should be created and the lower level jobs will be sourced offshore.

In the manufacturing sector, jobs tend to be highly concentrated in manufacturing facilities. The jobs are tied to the factory. Their fate lies with the company's success or failure to remain competitive. Within the IT community, jobs are no longer tethered to a particular building, city, country, or continent. The era of centralized mainframes, operating in dedicated data processing centers, has long been replaced with a need for only a desktop computer and a network connection. Flexible and open-minded companies such as Jet Blue have embraced tele-commuting and at-home customer support agents. Unlike some manufacturing jobs, IT jobs do not tend to dominate communities, and have not existed long enough, in isolation, so they seldom become the anchor employer. IT workers do not tend to do the same, very repetitive, manual tasks, requiring minimal incremental training, as a machinists, for example, would. Because of this, layoffs in IT seldom garner the media attention that manufacturing job layoffs do, and in fact, skilled IT professionals can much more easily find employment due simply to the growth in the sector overall, and the need to relocate is less than other industries simply because they do not have to be anywhere specific to perform their jobs.

In information technology, one can argue that seldom does the situation arise where a large gap is left behind, with workers lacking relevant skills. Many Call Center operators in the U.S tend to cluster together, within commuting distance of one another, thereby establishing a local micro economy of technical support agents or customer support agents who can float from one employer to another, while each employer may support a number of end user clients in their call center. This tends to protect the skills worker from being unable to find employment should a service provider lose a particular client. In fact it tends to set up a competitive environment where the better agents and manager try to secure higher wages, more challenging assignments, or more flexible working hours.

In the U.S., the outsourcing of certain business processes and information technology will continue to thrive for years to come. Corporations will look to improve their

processes and take advantage of labor arbitration, especially in a world where others have blazed the trail, and service providers have established worldwide footprints of skilled workers.

References: Thomas L. Friedman, The World is Flat, Farrar, Strauss, and Giroux, April 2005.