MINEFIELD? OR GREENFIELD?

Challenges and Opportunities for Mid-Tier Sourcing Clients

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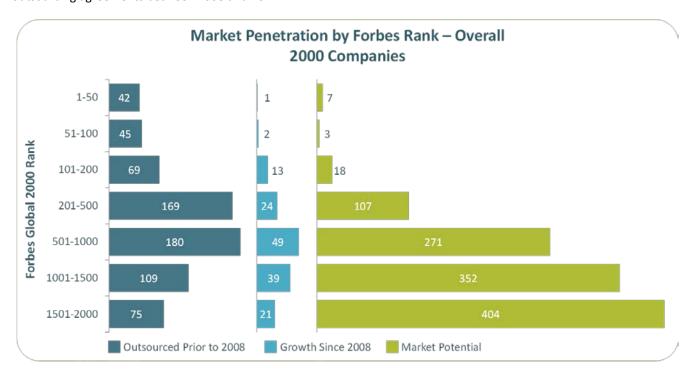
INTRODUCTION

ISG research shows that mid-size organizations are increasingly turning to outsourcing IT systems and business processes to reduce costs, increase organizational agility and focus on core competencies. In other words, they outsource for the same reasons that their larger, global business counterparts do.

As relative newcomers to the sourcing marketplace, mid-tier businesses can potentially benefit from the experiences of more mature sourcing organizations – by adopting established best practices, by leapfrogging to new technologies, and by avoiding mistakes of the past. That said, businesses with limited outsourcing experience often don't know what they don't know, and remain vulnerable to the pitfalls inherent in negotiating sourcing contracts and managing relationships.

This ISG white paper assesses recent trends in the mid-tier sourcing marketplace, and basic considerations faced by buyer organizations with differing levels of outsourcing experience. Risks and opportunities are discussed, and potential sourcing strategy options and key success factors are outlined.

NEW ENTRANTS

Momentum research from ISG shows that sourcing activity in the Forbes G2000 is relatively entrenched within the world's largest 500 organizations, with over two-thirds engaged in outsourcing prior to 2008 (see chart below). In the 501-2000 range of companies, overall penetration rates are lower, although 109 businesses in this category have entered into outsourcing agreements between 2008 and 2011.

Market Penetration by Forbes Rank – Overall 2000 Companies

Forbes Global 2000 Rank	Outsourced Prior to 2008	Growth Since 2008	Market Potential
1-50	42	1	7
51-100	45	2	3
101-200	69	13	18
201-500	169	24	107
501-1000	180	49	271
1001-1500	109	39	352
1501-2000	75	21	404

Further, Momentum research shows that a total of 408 service providers are winning deals among the Forbes 2000. The days when a few major providers owned the lion's share of the market are clearly over. While the growing number of providers reflects the increasing propensity to engage in specialized multi-provider relationships, it also points to a high degree of market complexity. Today's clients require fact-based analyses to understand and effectively navigate a broad range of provider capabilities and options.

INITIAL STEPS

Mid-tier organizations outsource for a variety of reasons, and may outsource different functions – ranging from payroll to IT to business processes to procurement and sales support. In addition cloud-based strategies are being deployed to support growth or to expand IT capability into other geographies.

In many cases, clients seek the basics – cost reduction, offloading of non-strategic functions, the ability to focus on core competencies and access to improved technology. At the same time, many mid-sized companies are aiming to leapfrog their less agile larger peers by taking a more strategic approach to capability sourcing. These companies may also lack the scale needed to meaningfully benefit from a traditional approach of outsourcing basic back office functions.

Regardless of the client organization's specific situation, the starting point is to focus on a basic strategy; specifically, what needs to be accomplished? Cutting costs? Acquiring capabilities? Adding capacity? While this sounds obvious, experience shows that many outsourcing initiatives fail at this early stage. To facilitate success, key stakeholders must be involved so that the sourcing strategy is effectively articulated, understood and communicated across both the client and provider organizations.

Once the basic objectives are defined, key considerations around implementation include the following:

Understand the existing environment: Before outsourcing, a baseline of current costs and service quality in the context of competitive market trends is essential. For one thing, it quantifies the potential "size of the prize" in terms of an improvement opportunity and allows the client to clearly define objectives. More specifically, the baseline allows a client to gauge whether a vendor's bid is reasonable, outrageously high or unrealistically low.

Expect the provider must make a profit: A successful relationship has to work for both parties. While clients can sometimes negotiate extremely low prices, and while providers will occasionally take on an unattractive deal in order to win a logo, ultimately it's a lose/lose proposition. The provider will cut corners on service delivery, find ways to charge for additional services, and assign their weakest team to the account.

Big isn't necessarily better. Mid-tier companies may not be best served by the largest, most well-known providers. Detailed and reliable market intelligence regarding the capabilities of tier two and niche providers is essential to assess business requirements against options, identify the appropriate candidates and ensure an effective match.

Don't underestimate internal management requirements: Outsourcing does not mean abdication of management responsibility. Despite years of experience with outsourcing, many businesses continue to underestimate the retained resources required to manage a service provider. Starting with transition, the client must dedicate sufficient resources to effectively manage its side of the relationship. Broadly speaking, ISG recommends that the retained resource budget for governance should be 3 percent to 5 percent of the total budget scope, and can be higher if strategic functions are involved.

Put the right team in place with the right tools: The client organization team tasked with managing the outsourcer may lack the necessary skills. Individuals thrust into a new role often yield to the temptation to revert to their comfort zones of "doing" rather than "supervising;" duplication of effort and inefficiency result. To avoid this pitfall, clients need to evaluate skills and requirements and potentially invest in training and proven governance tools and frameworks. Specific skills that ISG has identified as key attributes of a successful outsourcing manager include strategic leadership and the ability to wield organizational influence.

Focus on continuous improvement: Effective outsourcing is never a one-and-done proposition, but requires ongoing attention and governance to respond to constantly-changing business requirements. While the sourcing arrangements of mid-tier organizations may be less complex than their global counterparts, the stakes for business success are every bit as high.

Facilitate innovation and transformation: Increasingly, organizations seek to use outsourcing to transform their operational environments and move beyond incremental improvement to a fundamentally new and better way of doing things. To succeed in this approach, service providers need to bring innovation to the table. To foster innovation, meanwhile, clients must allow their providers the flexibility and leeway to leverage their expertise to deliver a solution. In terms of structuring the agreement, this means an increased focus on the "what" of the desired outcome, and a less prescriptive approach to defining the "how" of service delivery. (Click here for more on this topic.)

THE NEXT LEVEL

Businesses that have an established track record in the basics of outsourcing may aim to take the next step on the maturity scale and integrate multi-sourced models, governance mechanisms and process optimization into their environments. To achieve these increasingly ambitious agendas, mid-tier organizations need to address a range of considerations; including:

- Managing multiple contracts and relationships to prevent value leakage
- Getting multiple providers to collaborate on end-to-end processes
- Responding to changes in the business environment that impact outsourcing partnerships
- Assessing renewal or rebidding options

ENABLING GROWTH

The opportunity to support and enable growth through e-commerce, mobile technology and enhanced customer care is a key driver of IT outsourcing among many mid-sized organization. Rather than simply adding more servers and more people to the IT operation to support growth, an outsourcer can look beyond the constraints of the existing environment and develop a plan to put an operational environment in place that supports the client's future state vision.

Mid-size organizations, moreover, enjoy an advantage as they typically don't have the legacy burden that larger companies do, and can change systems and processes easier. They also tend to have fewer applications to integrate, so building the right infrastructure and systems profile can dramatically, and quickly, increase process automation and visibility into key business data.

Any IT initiative aimed at driving significant change requires project management and governance expertise – capabilities that outsourcers can bring to the table. Research shows that more than 50 percent of enterprise IT projects fail. In most cases, the failure is caused not by technology, but by ineffective practices around project selection, project management and project oversight. Organizations that lack maturity in these key areas tend to fail more often – and mid-tier organizations rarely have the time or resources to nurture project management and governance expertise within their internal staff.

To effectively develop and implement an IT-enabled growth strategy, a mid-size business (whether outsourced or internally managed) needs a strong, business-focused technology leader. This can be a CIO, but can also be a technology-savvy CFO, CMO, or any other senior leader within the company. Without a senior executive to lead, educate and drive accountability, strategic initiatives usually fail, because clear linkage between the technology vision and the expected business outcomes is lacking.

CLOUD BENEFITS

Cloud-based service delivery is perhaps the single most important emerging technology development for mid-tier companies. Software-as-a Service (SaaS) eliminates the need for a company to invest in servers and developers to support and extend their enterprise software, as these costs are carried by the SaaS vendors. As a result, the cost to run and support the software dramatically declines. This allows smaller companies to run world-class business software that traditionally has only been available to large enterprises.

Security is a key concern around cloud-based services. Contrary to popular opinion, however, the people that build and support the infrastructure – rather than the technology itself – represent the greatest potential security risk. As most failures and breaches result from human error, client organizations need to hire qualified individuals for security roles and ensure proper back-ups are in place to avoid single points of failure. Regular infrastructure audits by a third party are also essential, regardless of whether the infrastructure is in-house, hosted or outsourced.

BPO OPPORTUNITIES

Cloud-based Business Process as a Service (BPaaS) solutions for e-commerce, account and claims management and other functions can be an attractive option for mid-tier organizations that seek to adopt best-in-class practices but might lack the budget or resources for on-premise applications. The cloud can also be an effective way to hold down costs of system upgrades or software licensing renewals for existing applications.

Cloud-enabled business process outsourcing (BPO) combines managed services with cloud-based applications as a hybrid offering. This approach allows companies to leverage on-demand resources from providers, utilizing the flexibility of the cloud model to dynamically meet peak systems demand without investing in local IT resources, and to have the same provider manage the business services on that technology. This approach makes it possible to optimize both the business process and technology environments.

Service providers are today delivering cloud-based BPaaS solutions on a wide range of vertical-specific platforms, including banking, insurance, manufacturing and logistics.

PROCUREMENT

Improved procurement practices are increasingly accessible to mid-tier players. A number of service providers are targeting mid-tier companies for indirect procurement, delivering significant savings through improved transactional and sourcing capability on industry-leading platforms.

The stakes are significant. Depending upon the industry and the types of goods and services, the procurement function may comprise as much as 20 percent to 60 percent of a business' entire expense base. ISG has found that businesses that implement comprehensive procurement strategies and best practices can yield, on average, 4 percent improvement on external costs, with the most successful strategies exceeding these results.

PROVIDER SELECTION

Within the sourcing market in general, and specifically within BPO, service providers are increasingly focused on carving out specializations aligned with industries and/or particular client needs. This trend is impacting the mid-tier sector as well, as a growing number of mature service providers are entering the space. Increasing specialization provides clients with the opportunity to find a provider particularly qualified to understand and address their business requirements. It also puts the onus on the client to navigate a maze of options.

KEYS TO SUCCESS

Wherever a mid-tier organization is on its sourcing journey, essential success factors include:

- Knowledge of competitive market standards shows clients where existing services stand on the cost/quality spectrum, what opportunities for improvement exist and whether a proposed solution is economically viable
- Negotiating expertise is needed to define requirements, evaluate proposals and craft a successful agreement
- Knowledge of provider capabilities allows a client to identify and assess vendors best-suited to meet a particular set of requirements

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