Is Application Outsourcing Right for Your Business?

By Thomas F. Kelly

Thomas F. Kelly currently serves as CEO and chairman of BlueStar Solutions, a leading provider of enterprise application outsourcing services. With more than 26 years of executive management experience in the technology industry, Tom has established a reputation of leadership in a wide range of executive management roles at high growth companies. Prior to joining BlueStar Solutions, he served as chairman and CEO of Blaze Software. Under his leadership, Blaze dramatically increased its revenues, successfully completed its IPO and was acquired by Brokat International AG of Germany.

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Among the countless transformations Jack Welch led as CEO of General Electric was challenging GE's traditional disdain for so-called "NIH" (not invented here) products and processes. Recognizing that no organization—not even one as large and diversified as GE—has a monopoly on good ideas or valuable expertise, he pushed the company to become "the world's thirstiest pursuer of big ideas—from whatever their source."[1] *Welch realized that sometimes it makes good business sense to let someone else do the work, a point he hammered home during a speech to GE shareholders that included the following anecdote:*

> *"In Louisville recently, we needed a new transmission for a washing machine—a part we have traditionally designed ourselves… This time, rather than start a GE engineering team wrestling with the design of the transmission, we went instead to four qualified suppliers whose businesses are focused on components like this, and asked them to give us their best shot on a new design; and they did. The result is, we are getting a better transmission than we could have designed ourselves, and we're getting it faster and at a lower cost."*[2]

GE's corporate culture places a premium on innovation and invention. From the time of Thomas Edison, the company has built its reputation on forward-looking R&D efforts that constantly strive to create new products and services. Yet, when faced with a real and immediate challenge to the success of his businesses, Welch chose to delegate responsibility to someone else, using a process known as ***outsourcing****.*

[1] Jack Welch, General Electric letter to shareholders, February 12, 1993.
[2] Jack Welch, General Electric annual meeting, Fort Wayne, IN, April 28, 1993.

An Introduction to Outsourcing

Outsourcing occurs whenever an organization transfers ownership of one or more recurring business processes to another organization under a contractual agreement. Outsourcing is similar to other business relationships such as subcontracting, joint ventures, or consulting, but differs in that it focuses on *recurring* processes instead of one-time projects, and because the emphasis is on results rather than on the process itself. Instead of instructing the provider *how* to do the work, the buyer specifies *what* it wants to achieve and lets the provider determine how to achieve those ends. The provider becomes directly (and contractually) accountable for the success of the process being outsourced.

Outsourcing offers a number of important business benefits, including:

- **Increased productivity** via faster time-to-market and contractual agreements that mandate shorter cycle times, higher utilization, and increased output
- **Higher quality** because providers have access to the most up-to-date skills and technology and can leverage lessons learned across their entire customer base
- **Lower costs** through providers' economies of scale and buyers' ability to turn fixed costs into variable costs
- **Reduced risk** for buyers who can hold providers accountable for guaranteed performance levels
- **Greater satisfaction** among customers, partners, employees, and shareholders

While these quantitative gains are compelling, the real value of outsourcing comes from the qualitative benefits companies receive by being able to refocus on their *core competencies*. Core competencies are the unique capabilities, processes, and technologies that provide competitive advantage, create profitability, and sustain growth. In short, they are the fundamental *raisons d'être* for any business—the things that the business must own and execute on to meet customers' needs.

Just because an activity is important—even critical—to the business does not mean that it is a core competency. Consider Nike, for example. With so many top athletes choosing its products, Nike's core competencies must include the sophisticated manufacturing processes behind its athletic shoes, right? Think again:

> "Nike's core competencies revolve around its understanding of athletes' footwear needs (attained through research and development), the design competencies to meet those needs, the marketing skills to deliver the message (including endorsements and advertising skills), and the logistics systems to get the shoes delivered. But Nike doesn't make the shoes! The manufacturing and most of the remaining competencies and activities are outsourced. Nike does what it does best, and outsources the rest."[3]

[3] Greaver, Maurice F. (II). *Strategic Outsourcing: A Structured Approach to Outsourcing Decisions and Initiatives*. New York: AMA Publications. 1999.

Jack Welch's story about GE highlights the quantitative benefits of outsourcing, which include increased productivity and reduced costs. The Nike example illustrates the qualitative advantage of delegating non-core activities to specialized service providers so companies can focus on their core competencies. By now, you may be wondering whether—and how—you can achieve similar results for your company.

The Applications Outsourcing Opportunity

Belgian-based Solvay S.A. is a leading global chemical and pharmaceutical manufacturer with locations in 46 countries and more than 33,000 employees. The products Solvay manufactures—plastics, hydrogen peroxide, soda ash, and other chemicals—are very different from the large appliances made in GE's Louisville plant or Nike's athletic shoes. But when Solvay CIO Ben Gilbert wanted to improve performance and availability of the company's ERP application, he too understood that the most strategic course of action was to look outside his organization:

> "We had been installing [the application] for three or four years and needed to make the transition from a development mode into a maintenance mode… It was a business need to have the systems available. I liked [the outsourcing] business model… they focused only on [ERP]. Things were remarkably better from the very first second. We now have a much more predictable services IT organization and I've reduced my direct operating expenses… by 20 to 25 percent. I estimate that I saved the company $3 million in absolute dollars by outsourcing."[4]

Your organization may or may not have complex manufacturing processes like GE or Nike. But, like Solvay, you probably do have one or more enterprise applications that require a great deal of time and effort to install, manage, and support. While keeping these applications running may be critical to your day-to-day business operations, it is almost certainly not a core competency vital to defining and differentiating your company—yet applications management consumes large amounts of valuable IT and business resources that could be used more strategically elsewhere.

By eliminating the "busy work" of applications maintenance through outsourcing, you can refocus your efforts on leadership activities that grow the business, secure competitive advantage, and increase stakeholder value. At the same time, your organization will benefit from lower operating costs, enhanced technical capabilities, and improved performance and service.

To develop an effective applications outsourcing strategy, however, you must first understand the benefits—and the potential pitfalls. This document examines the historical evolution of outsourced services, probes the key business and technology drivers behind the applications outsourcing movement, and provides some important guidelines to help you maximize the ROI of your company's outsourcing initiatives.

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[4] International Data Corporation. *Financial Impact of ASPs,* September 2001.

A Brief History of Outsourcing

Although the term outsourcing was not introduced until the mid-1980s, the idea of hiring someone else to manage and perform specific, non-core business activities is not new. As noted outsourcing expert Maurice F. Greaver II points out, "Outsourcing is similar to subcontracting, joint venturing, and strategic partnering concepts, which date back hundreds of years."[5] For example, after Gutenberg's invention of the printing press in the 15th century, monks who had once written or engraved religious texts by hand began to outsource production of books to merchant printers. Other longstanding practices that helped set the stage for modern outsourcing include the seasonal hiring of migrant farm workers and subcontracting in industries such as construction that rely on a diverse set of skills.

As these examples suggest, early outsourcing efforts primarily focused on labor-intensive manual production tasks. Over time, however, companies began to rely on specialized providers to perform a whole range of business activities outside their core competencies. Figure 1 shows how the growth of outsourcing over the last century has been driven by the ever-expanding quest to improve productivity, reduce costs, and deliver greater value to customers and shareholders.

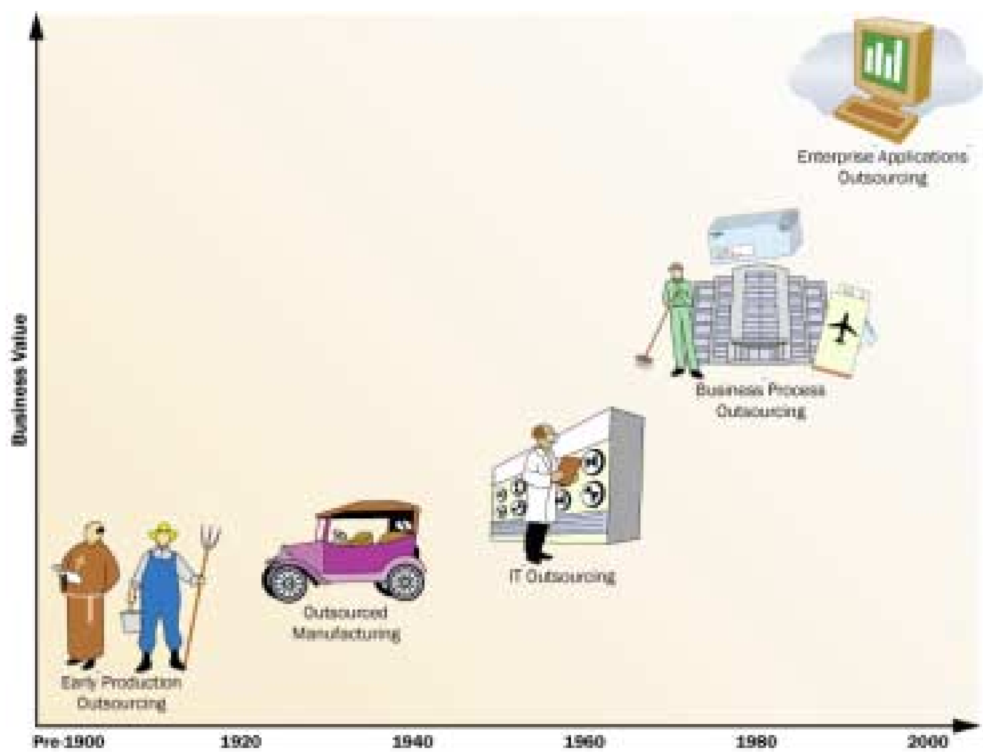

Figure 1. Historical development of outsourcing

[5] Greaver, 1999.

Outsourced Manufacturing

The early industrial economy was dominated by large, vertically integrated manufacturers that built their core competencies around controlling the production process from end-to-end. Two significant events changed all that. The first was the Great Depression, which forced industrial giants to look for new ways to cut costs and improve efficiency. Manufacturers began to embrace the idea of outsourcing complex production tasks, and by the end of the 1930s two-thirds of Ford's production came from outside sources. The second event was World War II, during which the US government relied on subcontractors to provide vital components for weapons and other military technology.

With the cost savings and productivity benefits of outsourced manufacturing firmly established in the post-war economy, many companies began turning over some or all of their production processes to business partners. Today, *contract manufacturing* is the norm in industries ranging from electronics to telecommunications to biotechnology, and the vertically integrated company is all but dead. Cisco Systems, for example, owns only 2 of the more than 30 manufacturing plants that make its networking products, allowing Cisco to focus on its core competencies of marketing and direct distribution.

Any concerns about losing control over proprietary production processes have been more than offset by the financial benefits of contract manufacturing. Companies can have a single part or a complete product line custom designed and built to their specifications without incurring the overhead costs of investing in specialized equipment or managing a full-service manufacturing complex. Some contract manufacturers even offer services such as assembly, packaging, and distribution to ship custom manufactured parts or products anywhere in the world. Thus, contract manufacturing helps companies deliver new products to market more quickly, provides a cost-effective way to stay up-to-date with the newest technology and latest procedures, and enables companies to concentrate on extending their brand identity and increase their global reach.

IT Outsourcing

The dawn of the computer era created a new set of business processes that, like manufacturing, demanded complicated and expensive technology and specialized expertise that was beyond the reach of many organizations. By the mid 1960's, companies like ADP began providing computer services such as accounting and payroll processing on a contract basis. The primary benefits for their customers were access to the latest equipment and skilled IS staff, without the tremendous up-front investment required to build those capabilities internally.

As computers became smaller, cheaper, and more widely available, demand for IT services sagged. Then, in 1989, a blockbuster decision by Eastman Kodak to outsource virtually its entire IT infrastructure—mainframes, PCs, and telecommunications systems—changed the rules of the game. While reducing costs and gaining access to the latest technology continued to be important factors in the decision to outsource, companies also began to recognize the broader benefits of refocusing the organization on its core competencies.

Business Process Outsourcing

Even the earliest IT outsourcing initiatives required service providers to assume some degree of process responsibility. By the 1990's, however, this equation was being turned upside down as companies began to actively seek process expertise—not just technical capabilities—from their outsourcing providers. The business process reengineering (BPR) and total quality management (TQM) movements emphasized the cultivation of best practices to support core business activities. Toward this end, companies aggressively sought to outsource business processes that did not directly contribute to shareholder value. According to a study by Pricewaterhouse Coopers, the business processes most frequently outsourced include benefits management (51 percent), payroll (49 percent), human resources (26 percent), and internal auditing (26 percent)[6].

Business process outsourcing (BPO) takes advantage of economies of scale by handing off non-revenue generating activities to third parties with the resources and expertise to perform them more efficiently—and for whom those activities are part of their core competency. BPO also creates strategic value by reexamining longstanding business processes and changing the way they are performed. It is common for service providers to reengineer existing processes to incorporate their acquired expertise, introduce best practices, or to leverage technology in new ways. Outsourcing can even improve the way a particular business process affects and interacts with other internal activities, utilizing service providers' knowledge of integrating their solutions into all kinds of business environments.

Enterprise Applications Outsourcing

As companies continue to seek new ways of using technology to run their business, *enterprise resource planning* (ERP) applications are replacing legacy systems and other "islands of automation" with a single, integrated platform that supports a wide range of business processes. The promise of these applications is compelling—but, as with earlier technologies, installation and management tasks can be a significant distraction and a drain on valuable resources.

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[6] *InformationWeek.* April 6, 1999

Enterprise applications outsourcing lets businesses rapidly harness the power of ERP applications without losing focus on their core competencies. Combining many of the advantages of IT outsourcing and BPO initiatives, applications outsourcing delivers the following benefits:

1. ***Better service.*** Applications outsourcing solutions are customized and tailored for each customer's specific needs and requirements. This ensures optimal business efficiency across all levels of the technology infrastructure—from hardware to application. When a problem does occur, certified and experienced engineers—as well as hardware, database, and network certified architects—have extensive experience in performing upgrades, changes, and fixes. This enables customers to rapidly resolve issues and leverage the functionality of new application releases. A dedicated 24x7 support staff provides customer service, answers technical questions, and troubleshoots any problems.

2. ***Faster performance (implementation).*** Outsourcing lets any company implement critical enterprise applications faster than its competitors. It saves time by eliminating the lengthy process of evaluating, purchasing, and installing the underlying hardware and networking infrastructure. A qualified outsourcing partner also brings to the table extensive expertise with the actual application itself, thus avoiding the false starts, delays, and other mistakes that can derail implementation. Faster deployment translates into improved responsiveness to changing business and technology conditions, and therefore into faster time to benefit. Applications outsourcing also ensures that performance gains are sustainable and scalable. Ongoing system monitoring and tuning ensure maximum availability and efficient operation.

3. ***A more cost-effective solution.*** Applications outsourcing obviously reduces up-front capital expenditures by eliminating the need to invest in dedicated servers or other hardware. But, in most cases, that's just the tip of the iceberg; outsourcing also lowers *all* of the ongoing operational expenses that contribute to total cost of ownership (TCO). For companies implementing applications in-house, TCO can be many times—or even several orders of magnitude—more costly than up-front expenses. An effective outsourcing strategy can reduce these ownership costs by as much as 30 to 40 percent.

Recognizing these advantages, leading companies around the world and in every kind of industry, have begun to embrace the applications outsourcing movement. Market researcher IDC states that "it is generally accepted that the software as service concept will become the accepted delivery model for application functionality,"[7] and forecasts a $13.1 billion global market by 2005.

[7] International Data Corporation. *Delivering Software as a Service.* June, 2001.

An Outsourcing Decision Framework

Outsourcing is an important business tool that has delivered real and meaningful benefits for countless companies of every size, in every industry. Yet decisions about the what, when, and how of outsourcing can be extremely difficult. While each company and each situation is obviously unique, the following guidelines can help you determine whether outsourcing is appropriate for your needs and, if so, develop an effective outsourcing strategy that minimizes your risks and maximizes your potential for success.

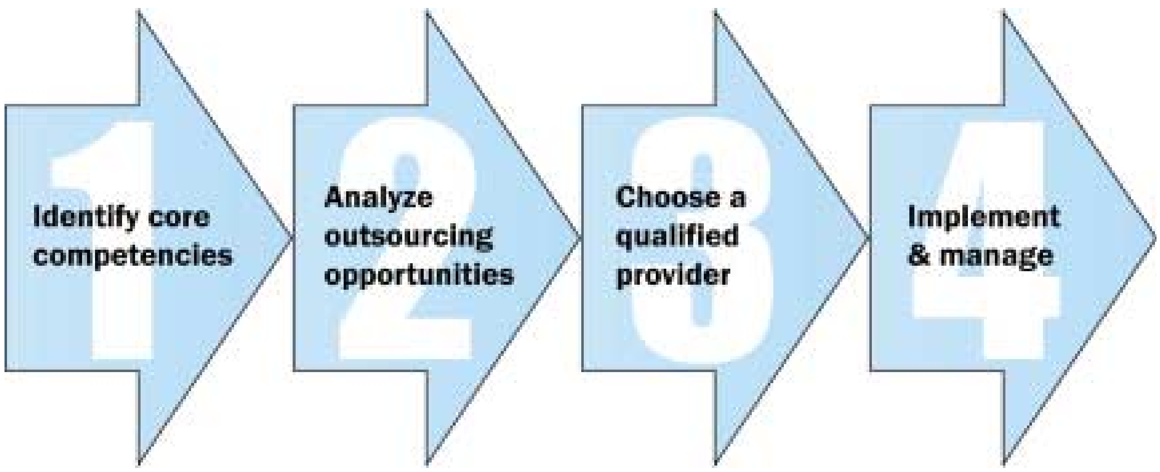

Figure 2. Outsourcing decision framework

1. Identify those business processes that define your core competencies

The first step in developing an effective outsourcing strategy is to determine which of your business processes are core competencies and which are not. The underlying principle of outsourcing is that any business activity, which isn't a core competency, is simply a distraction from those that are—and is therefore a candidate for outsourcing. If someone else can perform this non-core activity better, faster and cheaper than you can, why not let them?

Make a list of as many business activities within your company as you can. A systematic, company-wide analysis may deliver the best results, but even a quick "back of the envelope" inventory is useful. As you identify each activity, consider whether it is something that helps fundamentally define and differentiate your company within the marketplace. Ask yourself the following questions:

- Is this process something that **differentiates** your company or your products from competitors?
- Is this process critical to gaining new customers or improving existing **customer relationships**?
- Does this process **deliver direct value** to your customers and/or shareholders?

Even with these guidelines, separating core competencies from "merely critical" business processes isn't easy. As a final rule of thumb, consider this: If there is *any* doubt at all about whether something is a core competency, then it's probably not. When put to the test, most executives discover that they have pretty strong intuition about what is core to the success of their businesses. Still, you may be surprised by the results of this exercise. As the table below shows, public perceptions of a company's strength often do not correspond with its real core competency.

Company	Public perception	Core competency
Domino's Pizza	Pizza delivery	Cycle time and logistics management
Sony	Consumer and professional electronics	Miniaturization technology
Toys R Us	Toy retailer	Information and distribution systems
Wal Mart	Discount retailer	Channel management and logistics
Honda	Automotive manufacturer	Engine and drive train technology

2. Isolate and analyze your outsourcing opportunities

As stated above, any business process that isn't a core competency is a candidate for outsourcing. But outsourcing is obviously more appropriate for some processes than others, and there are many activities where the costs and effort would outweigh any potential benefits.

Remember that outsourcing is a long-term strategy, not a quick fix. As with any major business decision, it is crucial to understand the potential risks and rewards before taking action. Perform a thorough analysis and careful evaluation of your current capabilities, and clearly define what benefits you are seeking by outsourcing. Wherever possible, try to *quantify* these benefits and the costs of achieving them.

The most common metric used to quantify the financial impact of applications outsourcing is total cost of ownership (TCO). TCO analysis attempts to capture *all* of the costs associated with owning and managing applications—including infrastructure, personnel, and operating expenses—so you can make a fair comparison with the cost of outsourcing. The specific factors included in TCO obviously vary from application to application and from company to company, but a comprehensive analysis should take into account all of the following:

- Hardware purchase and maintenance costs
- Software purchase and maintenance costs
- Networking infrastructure costs
- Technology upgrade costs
- Security, backup, and disaster recovery costs
- Operations staff salary, benefits, and taxes
- Contractors and temporary staffing costs
- Training costs
- Space costs
- Power costs
- Networking charges
- Consumables costs

3. Choose a qualified outsourcing provider

It is critical that the outsourcing provider you select be capable of quickly and efficiently responding to your unique business needs. Carefully review each potential partner's technical and personnel resources and choose a company with leading-edge expertise, tools, and methodologies. Ask about the history and current status of providers' relationships with other clients—as well as with leading software and hardware vendors. Certification and accreditation programs can show you which providers have the most complete and up-to-date skill sets. You should also look for an outsourcing partner with well-defined best practices and a comprehensive quality assurance program. Ask to see documentation for these and other initiatives the provider has put in place to improve the consistency of service and to leverage expertise across customer projects.

Insist on guaranteed Service Level Agreements (SLAs) that include *exact* requirements for key metrics such as availability, performance, and customer support. This ensures that your outsourced processes will be implemented rapidly and effectively, and that they will be managed with maximum efficiency. Your provider should commit to regular status reports on performance and SLA compliance, so you can evaluate how well your needs are being served.

Finally, understand who is responsible for delivering on the service terms outlined in the SLA. Does the outsourcing provider take full responsibility, or is it shared with various subcontractors and/or technology vendors? If the latter is the case, it may introduce additional complexity into the relationship—and isn't reducing complexity one of the key reasons you decided to outsource in the first place?

4. Implement and manage

The word "partner" is used to describe all sorts of business relationships these days, but a real and comprehensive partnership with your outsourcing provider is essential to your success. Apply the same basic management principles that you would with any other arm of your business: maintain open channels of communication, establish clear goals and hold people accountable, and manage without micromanaging. Stay focused on the results your provider delivers—rather than getting bogged down in the details of how they deliver them.

As discussed above, a good SLA is important—but it is only the first step. Make sure that you have processes in place for regularly evaluating your provider's performance and for making any necessary changes. One of the strengths of outsourcing is that you can pay for and utilize the *exact* amount of functionality you need right now, but are able to make easy and rapid adjustments as your business evolves.

Remember Ben Gilbert, the CIO from Solvay who reduced costs and improved performance by outsourcing his enterprise applications? He understands that a big part of this success is the strong relationship between Solvay and its outsourcing provider. "At the end of the day," Gilbert says, "your business has to get done. I don't want to get in a semantic discussion about whether something is or isn't covered by the contract. I expect it to be fixed… Outsourcers are how you measure operational excellence, how you achieve it."

Applying What You've Learned

As the advantages of applications outsourcing become increasingly clear, it is gaining widespread acceptance across every industry and type of company. By understanding the historical trends, business drivers, and critical success factors behind the outsourcing movement, you can avoid many common pitfalls and develop an effective strategy that maximizes your opportunity and minimizes your risk. The potential benefits for your company include reduced costs, improved performance, and greater focus on the core competencies that make or break your business.

Organizational Obstacles to Outsourcing

The path from opportunity to action is rarely easy, and any decision to outsource is almost certain to create uncertainty, controversy, and even active resistance. Common obstacles and objections are:

- **Fear of losing control.** Many businesses—like many people—figure that "if I want it done right, I'd better do it myself." But the truth is that outsourcing actually *increases* your ability to manage and control vital business processes. In addition to providing access to valuable skills, expertise, and technology you may not have within your organization, outsourcing relationships are generally based on service level agreements (SLA) that specify key objectives and guarantee performance.
- As Outsourcing Center analyst Wendell Jones points out: "in the past companies outsourced to get rid of assets; today more and more companies outsource to gain capabilities."[1] Most companies have already applied this line of thinking to many areas of the business. For example, while it was once common for companies have their own in-house travel and payroll departments, now the vast majority of this work is outsourced to external providers who can do the work better, faster, and cheaper.
- **Financial uncertainty**. It's not uncommon for outsourcing decisions to be derailed by concerns over upfront costs and ongoing service fees. Upon closer examination, however, the many financial benefits of outsourcing become abundantly clear. Applications outsourcing, for example, not only eliminates the need to invest in dedicated servers or other hardware, but also lowers *all* of the ongoing operational expenses that contribute to total cost of ownership (TCO), which can be orders of magnitude more costly than up-front expenses.
- You must also consider the "ripple effect" of being able to execute more effectively on your core competencies. As Charles Gibbons, outsourcing expert with Pricewaterhouse Coopers, points out: "If I have a dollar to invest and can manage not to spend any portion of that investment dollar on my back office costs and put it instead in my real core business, that gives me a tenfold return."[1]
- **Concerns about security and privacy**. Outsourcing providers develop their expertise and derive their economies of scale by providing the same set of services to many different companies. This may create worries about whether valuable and sensitive information assets are being protected sufficiently. The reality, however, is that most outsourcing providers have much more aggressive security policies and far more sophisticated backup and recovery capabilities than do their customers. Outsourcing ensures affordable access to advanced technology capable of everything from detecting and blocking attempts at unauthorized access to rapidly recovering from system crashes, energy blackouts, or natural catastrophes.

  Concerns about job security. Almost every outsourcing initiative is sure to meet significant—and often emotional—opposition from people afraid of losing responsibility, losing influence, or losing their jobs. Systems administrators, IT managers, and even CIOs may perceive applications outsourcing as a criticism of their abilities or a threat to their existence.

  Resistance to change and fear of the unknown are natural human reactions, but the truth for most IT staffers is that offloading tedious applications management tasks frees them up to perform more important and interesting work. For CIOs in particular, applications outsourcing can be a transformational force that lets them refocus their careers. By taking ERP management off the CIO's plate, outsourcing makes room for more strategic initiatives that lead the business in new directions and deliver greater value to the enterprise.