Pillsbury | Global Sourcing

Realities of Outsourcing:

7th in a Series
of Webinar Presentations

Business Process Outsourcing (BPO) –
Why It is Different

March 15, 2007

Robert Zahler, Partner
2300 N Street, N.W.
Washington, DC 20037
tel: +1.202.663.8130
robert.zahler@pillsburylaw.com

Pillsbury Winthrop Shaw Pittman LLP

All Rights Reserved © 2007

Outsourcing model

- Outsourcing defined: The delegation to a third party of responsibility for performing a significant business function
- The basic commercial proposition: The outsource supplier will do:
  - What the customer currently does
  - At the same or a better level of performance
  - For the same or a lower price
- Information technology outsourcing (ITO)
  - The delegation to a third party of a significant portion of a company's IT operations ***typically*** involving the transfer of personnel, the sale or assignment of hardware, and the granting of access rights to software
- Business process outsourcing (BPO)
  - The delegation to a third party of a significant portion of a company's back office, technology-enabled operations ***potentially*** involving the transfer of personnel, the sale or assignment of hardware, and the granting of access rights to software
  - BPO often is an updated, re-incarnation of business process reengineering

IT Outsourcing	Business Process	Platform Delivery (née ASP)
Mainframe	Human Resources (HRO)	Billing
Servers and Distributed Computing	Finance and Accounting (FAO)	Customer Information and Customer Care
Desktop Support	Procurement	Claims Processing
Local Area Networks	Equipment Maintenance	Credit Card Processing
Wide Area Networks	Facilities Management	Hosted ERP System
Applications Development and Maintenance	Applications Development and Maintenance	Mortgage Servicing
Help Desk	Call Centers	Computer Reservation System (CRS)

Marketplace dynamics

- Companies continue to be under ongoing and relentless pressure to reduce costs and improve delivery of services within the company
  - The "low hanging fruit" no longer exists
  - Cost savings arise [only?] from:
    - Less facilities, labor, equipment, software or third-party services
    - Cheaper facilities, labor, equipment, software or third-party services
  - In the absence of cost savings, it often is difficult to develop a compelling business case for performance improvement
- The "less" drives companies to:
  - Eliminate the non value-added processes
  - Make more efficient the value-added processes
  - Increase the level of automation
  - Reduce demand for the service

  generally through transformation
- The "cheaper" drives companies to:
  - Use low cost providers who specialize in particular products or services
  - Go offshore
  - Retain expert procurement personnel with enhanced processes (and, maybe outsource procurement)

Key factors leading to BPO popularity

- Allure of achieving “significant” cost savings and not just “marginal” savings
- Perceived need to transform both basic and core business functions
  - PGS point of view: the need for ***service delivery optimization***
  - The blurring of distinctions between front-office, back-office and mid-office
  - Capability outsourcing (Bain article, February 2005 HBR)
- Current emphasis on standardization and centralization
- Gaining “control” of geographic-based cultural differences
- Capabilities of suppliers
  - Global suppliers
  - Niche suppliers (domain specific)

BPO examples

- Significant semantics issue
  - BPO is treated as something new, yet many of the services labeled as BPO have been around for years
    - For example, payroll processing, item processing, claims processing
    - What is new is the scale of the offering
  - Large domain-specific transactions are a form of BPO (point solutions)
  - Multi-disciplinary BPO hardly exists (and, maybe not at all)
    - Distinguish multi-point solutions from integrated services
- Major forms of transaction
  - Human resources
  - Finance and accounting
  - Procurement and supply chain
  - Call center
- Offshore BPO
- Until the “shared services” BPO transaction is completed, the marketplace is immature and not adequately established

BPO market characteristics

- The BPO market ***remains*** immature
- The product offerings are changing as suppliers gain experience
- Identifying the proper ***role*** for offshore supply is evolving
  - As a result, achieving the value from offshore supply is often difficult
- Nonetheless, the drivers for significant BPO activity are powerful
  - Most information technology outsourcing (ITO) suppliers have concluded that their market is commoditized
  - BPO suppliers have developed meaningful capabilities to offer business process functions on a broad basis
  - ***In theory***, margins are higher and capital requirements are lower for BPO business
  - Elongated sales cycles can be covered by "consulting" engagements
  - The market is being driven by supplier offerings
  - Supplier "value propositions" can be very seductive to potential customers

- Thesis: Business process outsourcing and information technology outsourcing cannot long survive together
- The issue: How is BPO delivered?
- The response:
  1. Using the customer's infrastructure
  2. Using the supplier's infrastructure
  3. A combination of the two
- The impact:
  » The IT "factors of production" are part of the BPO transaction
  » Separately sourcing IT may create hurdles for BPO
  » Customers need to have the flexibility to remove IT resources from their outsourcing arrangements

Don't be fooled BPO is more difficult than ITO

- There are some who say that, because BPO is aimed at a higher functional level (the end-service being delivered to the customer), it should be easier to identify, structure and complete a BPO transaction
  - In addition, the claim goes that BPO can carry itself on the experiences learned from IT outsourcing so a BPO transaction is not as risky as an early IT outsourcing deal
- This is all wrong
  - Because the industry is less mature, there continues to be a need to focus on the "right" statement of work, an "appropriate" set of service levels, and "meaningful" pricing constructs
  - From a supplier viewpoint, services among customers may be less fungible than in the IT area and variability in service delivery and pricing may be more difficult
  - From a customer viewpoint, understanding your own costs (and the supplier's price) is more difficult since you are focused on outputs (the service delivered) and may have substantially less insights about the inputs (people, hardware, software, etc.) that drive cost and price
- The IT outsourcing model does provide guidance, but brings to BPO the same baggage that historically has troubled IT outsourcing
  - Also, it does not sufficiently address the number of "one-off" activities inherent in people-based work

Is BPO different?

- Yes, in fundamental and important ways that have hardly ever been recognized
- Many (not all) BPO transactions are ***not*** based on the original outsourcing paradigm; distinction between doing
  - What the customer did, and
  - Delivering a specified service described in a statement of work
- The cost drivers for BPO relationships are fundamentally different than the cost drivers for ITO
  - Oftentimes, assets are not sold and significant numbers of people are not transferred
  - The importance of properly document transition and transformation activities
  - Addressing what happens if those activities do not occur as planned or on time
- The need to focus on the “knowledge capture” activity

- The classic ITO value proposition
  - ***Core competence:*** suppliers invest in training and process standardization that makes them more efficient providers of IT services than companies whose core competence is elsewhere
  - ***Economies of scale:*** suppliers have larger operations that allow them to spread the costs of IT services across numerous customers
  - ***Diversity of operations:*** less capacity (of all resources) is required to service customers with different peaks and valleys (avoiding the "step function")
  - ***Better purchasing:*** supplier experts focused on procuring hardware and software do a better job than their client counterparts
  - ***Less expensive labor:*** both from offshore operations and tightly controlled subcontractor contracts (providing greater staffing flexibility)
  - ***Control over hardware and (system) software:*** Buying a client's hardware, and assuming financial responsibility for a client's software, often provides significant cost savings some portion of which can be passed on to the client

What is different with BPO?

- BPO providers have developed significant core competencies, but have not been able to effectively deploy them in many transactions
  - Customers are not accepting changes to how matters were previously done
- Economies of scale are proving elusive in many BPO transactions
  - Much of the activity is, in fact, decentralized and not easily addressed from shared service centers
- But for call center activity, diversity of operations does not provide meaningful advantage in BPO transactions
  - Given the decentralized nature of many functions, sharing of staff or resources has proven illusive
- Purchasing expertise (other than in procurement outsourcing) provides only limited value in many BPO transactions
- Less expensive labor is a significant factor so long as clients let their suppliers use that labor
  - There is client resistance to moving “high touch” activities into foreign shared service centers

What is different with BPO?

- Oftentimes, the underlying deal paradigm is different than that used in ITO
  - While the functions a BPO supplier provides are those provided by the customer, the services offered may not be those previously provided by the customer
  - Self-service HR is the classic example
- In many cases, BPO suppliers do not buy assets, acquire software licenses or transfer personnel from their customers
  - BPO suppliers often do not “need” these resources
  - But, this makes knowledge capture and transition activities significantly more important (and difficult) in the BPO context than in the ITO world
  - Potentially limits the available cost savings
- Transformation typically is a key element of the BPO relationship
  - Customers are proving unwilling or unable to accept the level of transformation required
  - The IT projects underlying much of the transformation are often ill-defined
    - These transactions are like ***complex*** systems development and systems integration deals, not outsourcing contracts

What needs to be done?

- The parties should include in the contract a short summary schedule that concisely, but comprehensively, describes the proposed solution
  - For example, the extent of:
    - Onshore and offshore supply
    - Centralized versus decentralized operations
    - New technology or existing technology (the client's or the supplier's)
    - Transformation
  - And, the role the client will or will not play in assuring that the change implicit in these options is, in fact, accomplished
- Based on the specified solution, the contract should reflect the solution being delivered
  - If there are significant transformation projects planned, the contract should include separate, and to the extent possible, detailed schedules specifying:
    - Transition activities; a Gantt chart (even if detailed) does not suffice
    - Project activities with specific requirements and procedures for testing and acceptance
  - It may not be appropriate, and in fact may be counter-productive, to include the typical "overarching" scope provisions about what the client's displaced personnel previously did or what is included in the base case
- And, of course, the Pillsbury Global Souring point of view on how a scope of work should be documented
  - Separate the verbs (processes) from the nouns (elements on which the verbs act)
  - Use industry standard definitions to define the verbs and the nouns
  - Work visually to depict complex environments with multiple service delivery actors

Pillsbury | Global Sourcing

Pillsbury Winthrop Shaw Pittman LLP

All Rights Reserved © 2007