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From strategy to execution
An Outsourcing Advisory Services compendium

Executive summary

Welcome to Deloitte's Outsourcing Advisory Services quarterly compendium. This compendium reflects our belief in execution-based strategy and strategy-based execution. It is designed for the triad of clients that Deloitte Outsourcing Advisory serves: Corporate, Mergers and Acquisitions (M&A)/Private Equity (PE) and the Outsourcing Vendor Community.

This compendium offers insights for those ranging from CEOs to front-line managers. Articles have been selected based on recent developments in the world of outsourcing, insourcing and offshoring and offer insights on trends, approaches and specific challenges faced by clients as they embark on their respective journeys.

In this document we present a number of useful ideas on risk mitigation approaches, as well as advise on common mistakes our advisors see across multiple engagements. The case studies included also help to identify practical insights and ideas that can be applied to the strategic assessments, negotiations, transitions and vendor management.

The world of outsourcing and offshoring continues to evolve on several dimensions. Key insights from Deloitte's 2012 Global Outsourcing and Insourcing Survey and recent engagements include:

- The outsourcing market continues to confuse outsourcing with offshoring. Many respondents still see the two processes as inseparable — even though many times outsourced work never leaves the originating country and retained work is offshored to captive shared services centers.
- Vendor Management Organizations (VMOs), while highly competent at "day-to-day" activities, can still improve in delivery of innovation and at resolving conflicts that arise during the course of service delivery. In addition to people skills and technology, platforms in VMOs remain a concern.
- Survey respondents listed underestimating scope by the vendor as the largest contributor to deal dissatisfaction, and respondents use vendor communications and escalations most often to remedy deal dissatisfaction. In addition, though generally satisfied with their most recent transaction, many companies don't achieve the expected cost reductions.
- A significant number of respondents have terminated contracts with their vendors in the past, primarily due to concerns with the quality of services. Insourcing, though rare, does occur. We are beginning to see more clients contemplating insourcing functions due to vendor non-performance or changes in business strategy.
- Cloud computing can provide significant benefit for small and medium-sized companies, but organizations should develop a clear, long-term strategy and overcome several specific risks.

The five articles in this compendium build upon the above themes. Each of these articles can be read as a self-contained piece or can be reviewed in concert as they describe a number of activities and challenges in the end-to-end outsourcing journey.

1. The Strategy article focuses on **releasing value through the sale of captive centers**. It outlines the framework and approach leveraged for a sale, the valuation techniques, marketing, buyer selection process, deal negotiation tactics and disentanglement steps.

   The 2008 financial crisis led to a number of companies looking for a quick release of cash for their balance sheet. In addition, some clients had faced challenges maintaining competitive offshore centers against specialized external providers. The paper explores how **adopting a methodological approach rather than an opportunistic sale can lead to optimum deal value for both parties while reducing financial and operational risk**.

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2. The Negotiations article focuses on **driving value from the renegotiation process**. As organizations continue to face increasing pressure to realize significant cost savings, inevitably there is a drive to reduce spend on third parties and outsourcing partners.

   The paper explores a range of techniques for contract renegotiation, including how **benchmarking may not lead to an optimum result when focused on proving or disproving a number**. A more productive approach may require buyers and suppliers to collaborate to reduce the cost of delivery, improve business performance and address non-financial factors like efficiency, demand management and contract structure.

3. The Transition article focuses on **the critical period just after contract execution when services are transitioned to the new provider**. Our experience indicates many companies struggle to complete smooth transitions unless they adopt a well-thought through plan and approach, staffed with skilled resources.

   Effectively executed transitions lay the groundwork for the governance model and reporting frameworks which form the foundation of the relationship with the outsourcing provider. The paper outlines the **different phases in the transition lifecycle, how clients can prepare more appropriately for transition activities and how to "avoid the ditch"**.

4. The Vendor Management article focuses on **how the relationship with the service provider should be managed**. Too often companies have relied on the contract to manage the relationship, however as the nature and scope of outsourced services have evolved, via market demands, increased focus on cost reduction or innovative new approaches; the approach to manage external providers has also shifted.

   The paper outlines the five deadly sins of Vendor Management. Areas that can be frequently overlooked by clients as they commence operations with external outsourcers, including the relationship between Vendor Management, sourcing and procurement organizations, the optimal operating model, Service Integration issues across providers and the increasing focus from regulators on supplier risk management and third party compliance controls and monitoring.

5. The Spotlight article this quarter focuses on **a growing trend of companies who had previously outsourced functions now bringing them back in house**, commonly known as "insourcing".

   The paper examines the insourcing trend, its drivers and the opportunities and challenges associated with insourcing. Whether to improve customer service or capture additional savings, **the paper provides some key considerations for insourcing vs re-tendering**.

Whether you are looking to embark on an outsourcing journey, assessing your current operations, bringing operations back in house or renegotiating, we hope you find these articles of value. As the world's largest outsourcing advisor by revenue and FTEs and ranked #1[1] as the 2013 World's Best Outsourcing Advisory Services organization, we hope you find this and the continued installments of the compendium accretive to your business.

1 IAOP World's Best Outsourcing Advisors Ranking — Source: May 20, 2013, *FORTUNE®*

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Introduction

Over the past decade, many companies made investments in consolidating back-office processes and technology in offshore captive centers. While many of these companies initially realized significant cost savings, some have found it increasingly difficult to maintain their offshore captives' cost and service quality advantage over specialized external service providers. At the same time, the 2008 credit crisis and the recession that followed left many companies strapped for cash. These organizations faced — and continue to face — increasing pressure from shareholders to reduce costs and shore up their balance sheets.

The need to raise cash, coupled with the perception of diminishing returns from their offshore captives, have led a number of companies to sell their large-scale captives to business process outsourcing (BPO) or information technology outsourcing (ITO) firms. In such a transaction, sellers may pursue a variety of goals: to monetize assets; to reduce capital expenditures (CAPEX); to reduce sales, general, and administrative (SG&A) expenses; and, in some instances, to gain an optionality of economics where the sale includes a credit in exchange for long-term services. Buyers, on the other hand, may wish to expand their geographic footprint and/or capabilities and generate more revenue over the long run. For their part, BPO/ITO firms typically purchase captives in order to gain capabilities in a particular area, thereby improving their ability to capitalize on the global demand for services in that area.

Our experience suggests that the opportunistic nature of many captive sales often works against the seller's interests in two ways. First, an opportunistic approach can limit a seller's ability to appropriately position the captive in the marketplace. In this paper, we explore how a more methodical approach that structures the captive operation as an operating business — not as a pure asset — can help sellers pursue their goals more effectively. Second, an opportunistic sale may hamper the seller's efforts to divest the captive in such a way as to support its performance after its acquisition by the buyer. Yet a divested captive's future performance is a critical long-term value driver for sellers that expect to receive services from its former captive through a contract with the captive's buyer. This paper therefore also discusses several factors to consider

in the sale process that can help a seller prepare its captive to deliver the required level of service after it becomes part of the buyer organization — when Day 1 is the beginning, not the end, of a relationship.

The offshore captive model, which first gained popularity in the 1990s, has matured to the point where many organizations have sought to release value from their captive organizations by selling them to BPO and ITO providers (see Figure 1). With the nascent economic turnaround encouraging outsourcing service providers to prepare for growth, sellers today can have a window of opportunity to sell their captives to a receptive BPO/ITO marketplace.

Selling a captive service center, however, is often very different from a "typical" divestiture, where the organization being sold is a revenue-generating business unit. In most divestitures, the seller and buyer are free to go their separate ways after the transaction. In a captive sale, on the other hand, the seller and buyer more frequently maintain a strong, interdependent relationship after the sale is concluded, with the seller contracting to receive services from the buyer on a long-term basis. In fact, most sellers expect buyers to deliver these services through the seller's former captive. The captive's value to both the buyer and seller thus depends as much on its future performance as on its material assets.

This dynamic has significant implications for each phase of the transaction, from valuation, marketing, and buyer selection to deal negotiation and disentanglement. A company should understand and address these implications to help enhance deal value and reduce financial and operational risk.

Case in point: CoreLogic's divestiture

CoreLogic sold its Indian captive center to a service provider as part of an effort to refocus the company on its core operations. By divesting the captive and forming a long-term outsourcing agreement with the buyer, CoreLogic hoped to establish a service delivery model to support global expansion; increase the flexibility of its cost base; and enhance the efficiency and effectiveness of the business' IT platforms.

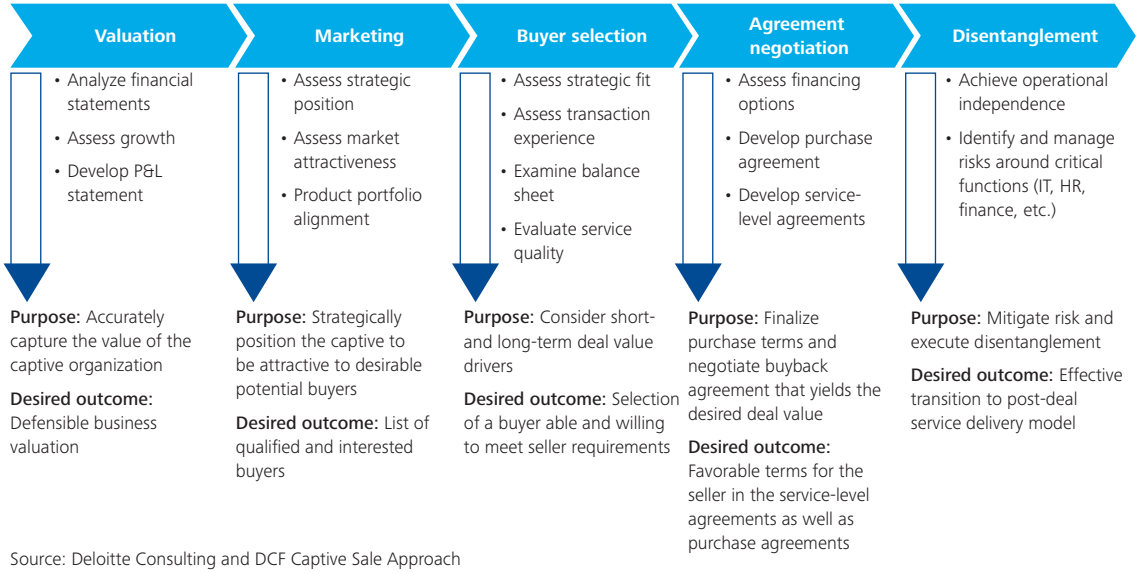
CoreLogic took several steps to increase the likelihood of achieving the desired results. It developed a master professional services agreement that specified what services the company wanted to buy back and provided for a flexible cost base. Well before the deal closed, it established a vendor management program office to manage the new service relationship on an ongoing basis. The company also addressed communications and change management throughout the deal process and the captive's subsequent transition to the buyer organization. Finally, the team negotiating the captive's purchase agreement collaborated with the team negotiating the service buyback agreement to understand how both agreements could be framed in a way that would yield a desirable overall outcome.

CoreLogic was able to find an appropriate strategic buyer for its captive and negotiate an outsourcing agreement that would allow it to obtain services from its former captive, but decrease the company's recurring fixed costs. Apart from helping to enable CoreLogic to focus on its core activities, the sale of the captive also gave the company a large cash injection. The company received an up-front cash payment for the captive as well as service credits to reinvest in its business.

A framework for a captive center sale

In our experience, companies selling captive centers can potentially increase deal value and help mitigate risk through a systematic approach to the five focus areas illustrated in Figure 1: Valuation, marketing buyer selection, agreement negotiation, and disentanglement.

Figure 1. Captive sale approach: Five focus areas



Source: Deloitte Consulting and DCF Captive Sale Approach

The pre-buyer selection stage of the sale process starts with a financial statement analysis of the captive center. Although formal financial statements may not be available for captives that historically did not generate revenue, the seller should develop an estimate based on the cost of running the captive, the CAPEX required to maintain service levels, and an assessment of the captive's intellectual property. This last item is particularly important to address early in the process: If the value of the captive's intellectual property is not identified until the due diligence phase, the seller will likely need to make adjustments to capture locked value. Unlike in a typical valuation exercise, the sale of a captive center should be treated as an annuity in which the buyer receives regular payments for services provided. In conjunction with the financial analysis, sellers should analyze the strategic position and market attractiveness of the captive center. In many cases, this marketing effort may require repositioning the captive's current service portfolio in order to make it more attractive to prospective buyers.

In the buyer selection stage, sellers should consider potential buyers' strategic fit with their business strategy (increasing geographic footprint, platform compatibility, etc.). Sellers also evaluate the potential buyer's ability to provide services back to the seller as well as its ability to meet service quality levels.

In the post-buyer selection stage, the seller and buyer negotiate agreements around financing options, service buyback agreements (including service-level agreements), and handover dates. The seller should keep in mind that, unlike in most divestitures, it will probably continue to maintain a "partnering" relationship with the buyer. This ongoing relationship typically requires that the negotiation focus equally on the sale of the captive center as well as the buyback agreements. After the agreements are finalized, the actual disentanglement of the captive's operations takes place. This typically involves converting the internal captive center into a third-party outsourced service provider that will deliver services to the seller once the transition is concluded.

Figure 2 provides an overview of major differences between a typical divestiture and a captive center carve-out for consideration. The following section offers a deeper dive into the implications of these differences.

Figure 2. Differences between a typical divestiture and a captive center sale

Focus areas	Typical divestiture approach	Recommended captive center approach
Valuation	Value using explicit multiplier approach against projected revenue and EBITDA (earnings before interest, taxes, depreciation, and amortization).	In the absence of revenue history, develop implied multiplier based on the captive's expected revenue-generating potential after internal services are converted to externally provided services.
Marketing	Develop materials (including business value proposition, growth and profitability projection, product portfolio, organization and administration, and financial statements) based on historical financial performance. These materials reflect the anticipated synergies that would be gained by the buyer, along with an assessment of the divested business' organizational and strategic fit with the buyer.	Develop materials that illustrate the captive center's capabilities as a platform for growth. Synergy opportunities may often be secondary to the captive's locked-in revenue base from the service buy-back agreement with the seller; the ability to cite the seller as a client of reference; and the captive center's ability to generate incremental revenue for the buyer by enabling it to serve additional clients.
Buyer selection	Identify either strategic or private equity buyers based on their ability to offer a competitive price.	Identify strategic buyers based on both their ability to effectively continue to deliver services to the seller, and their ability to offer a competitive purchase price.
Agreement negotiation	Primary focus on purchase agreement; secondary focus on transition service agreements (TSAs) and commercial agreements.	Equal focus on purchase agreement, including TSAs and commercial agreements, as well as additional focus on the service contract through which the seller agrees to buy back services from the captive center after it has been acquired by the buyer.
Disentanglement	Terminate the divested organization's dependencies on the parent company to achieve full operational independence on Day 1 and/or at the end of a limited transition service period.	Convert the captive's dependencies on the parent company to those appropriate for an external service provider-client relationship. The seller should retain the level of access needed to support long-term service delivery by its former captive.

Source: Deloitte Consulting and DCF Captive Sale Approach

Valuation

Value the captive center as a business and not as a pure asset.

Potentially significant incremental value can be generated from a captive sale if the seller values the captive, its activities, and associated intellectual property as a business and not simply as an asset. If viewed purely as an asset sale, a captive center is unlikely to obtain more than book value. When viewed as a platform for future revenue and profit generation, however, its value can multiply.

In order to develop an expected valuation, a seller will need:

1. A cash flow projection that estimates the revenue the captive could earn as an external service provider
2. Historical multiples as a basis for setting the valuation multiple

In contrast to most valuations, captive center valuations often take place in the absence of externally visible cash flows. One way to deal with the lack of historic revenue data is to think of the valuation as an annuity contract in which the buyer receives regular payments for services that the seller's former captive — as part of the buyer organization — delivers to the seller. In this approach, the anticipated revenue from the service buyback contract can be treated as cash inflow in order to arrive at a valuation. Although the final valuation will, of course, depend on the buyer and on prevailing market rates for the services in question, the seller should enter the market with a realistic range of potential valuations that it can use as a basis for decisions.

Cash flow projection

The first step in the valuation of a captive as a business should be to develop stand-alone financial statements that describe what the captive would look like as its own profit and loss center. Sellers may find this to be one of the hardest steps in the sale process, largely due to historically skewed practices regarding the internal pricing of services and corporate allocations or overheads.

The cost component of the projection should not only account for the captive center's internal costs, but also include an allocation for corporate and other services as well as for overhead that may have not been carried as part of the captive center financials. Allocations that should be reviewed include personnel, finance, systems, real estate, and contracts/licenses. As a side note, the seller should remember that these overheads now need to be redistributed back inside its own organization as part of the business case.

The revenue component of the captive's stand-alone financials will require an appraisal of the captive center's implied revenue and implied profit margin. These metrics are implied because companies that treat captive centers as cost centers rather than revenue centers typically do not maintain financials that reflect a captive's revenue and profit margin. In our experience, one of the most important ways for a buyer to substantiate the seller's revenue projection is to examine the buyer's own demand for the captive's services following the sale. If a seller signs service contracts as part of the sale and intended revenue to the buyer as part of the commercial agreement, the buyer may view the intended revenue from the seller as one of the sale's central valuation drivers.

Historical multiples

In a typical business divestiture, multiples are usually calculated and reviewed in terms of multiples of annual EBITDA or multiples of annual revenue. However, because captive centers are frequently not treated as revenue centers, information that can be used to develop valuation multiples is often limited and not well documented in public information sources and analyst reports. One effective alternative method of calculating a captive's valuation multiples can be to leverage the expected value, based on historical transaction data, of the seller's annual service buyback contract with the buyer. (This figure is often referred to as the "annual contract value.") The sale price valuation can then be assessed as a multiple of the annual contract value. Our recent experience suggests that this calculation method (multiple = sale price/annual contract value) yields, on average, a multiple of 0.8 to 2.0 for captive centers.

A number of additional factors may affect the valuation, including potential sources of revenue in addition to the buyback contract with the seller, prevailing market conditions, and existing market capacity for the captive's service delivery capabilities. Ultimately, of course, the final valuation will be determined by the buyer's motivation and the captive's perceived value to the buyer organization. The more fully a seller approaches the valuation process from the buyer's perspective, the more likely it will be to enter the divestiture marketplace with realistic expectations about the range of valuations that prospective buyers may propose.

Source of value	Value drivers
The seller's demand for future services	For buyers of captive centers, a seller's commitment to buy back services formerly provided by its captive represents a concrete source of value. Furthermore, buyers may appreciate the incremental sales potential represented by the seller's possible need for services outside its former captive's scope (e.g., services to additional business units, in additional functions, and/or additional service locations).
Market credentials	Some sellers can offer buyers a "pedigreed" client reference, especially if the seller is a top player in the buyer's target market. This source of value can be compounded if the seller is willing to allow its name to be used in the buyer's marketing materials as well as to serve as a reference upon request.
Platform for growth	A captive's services may draw upon knowledge, skills, technology, and/or processes that are not standard or prevalent in the market, making these assets potentially valuable to buyers that wish to gain these competencies to serve a larger client base. When marketing this source of value, sellers should carefully consider the range of potential buyers for its captive. While some buyers may view a captive's assets as standard or commonplace, other buyers may regard the captive's capabilities and knowledge areas as valuable additions to their overall service and/or industry portfolio.
Intellectual property	Ownership or joint ownership of patents, applications/delivery platforms, and/or tools can be a source of value to prospective buyers. That said, sellers may find it advisable to place confidentiality and usage constraints on intellectual property in order to retain an appropriate degree of control over this value.
Efficiency gains	Sellers should not be shy about pointing out opportunities for buyers to pursue unrealized efficiencies. For instance, sellers can highlight any efficiencies buyers may gain by combining support services, as well as the potential opportunity to increase the volume of service provided by the captive's existing headcount.

Marketing

Market the captive center as a business with a viable stand-alone value proposition.

In a captive sale, the core objective of the marketing process is to present the captive center in a way that can attract multiple potential buyers. Sellers in a typical divestiture usually market the operation being sold based on its ability to expand the buyer's geographic footprint and deliver efficiencies to the buyer. In a captive center sale, the marketing effort should focus more on the value of the captive's current revenue stream (if any) as well as its value as a potential platform for growth among particular customer or industry segments.

As in other sales, the marketing effort should aim to generate competitive bidding for the captive center. Hence, it is important to understand what factors might motivate a buyer to acquire a captive. It is essential to understand the range of potential buyers, the industries in which they operate, and their various methods of creating value in order to create a value proposition around the captive that can capture prospective buyers' interest. This can be difficult for some companies, as their own perceptions of the value their captive delivers can stand in the way of appreciating a buyer's likely perspective. For example, while a seller may place great value on its captive's specific skills related to the company's industry-specific legacy applications, buyers may be less interested in these skills than those that can be applied across many clients in a variety of industries. The captive's seller-specific skills, while they may help the buyer retain the seller as a client after the sale, may therefore not generate as much incremental value for the buyer as the seller may at first believe.

In a captive sale, the seller's marketing materials should address the following sources of value that the transaction can offer to buyers:

- **The seller's demand for future services:** The seller should describe the extent of its commitment to the buyer to buy back services currently executed by its captive. Such a commitment represents a concrete source of value to potential buyers.
- **Market credentials:** Buyers of captive centers often value the ability to use the seller's name as a reference in their efforts to drive new business development, especially if the buyer wishes to grow in the seller's industry.
- **Platform for future growth:** A captive's functional and industry/business-specific skill sets can be valuable to buyers. Rare skills, high-quality processes, and/or proprietary technologies represent value to buyers that can leverage these assets to gain additional revenue.
- **Intellectual property:** The value of intellectual property can be a complex issue in a captive center sale. While many buyers tend to place higher value on gaining explicit rights to a captive's intellectual property, some may also find value in gaining indirect access to intellectual property.
- **Efficiency gains:** This source of value can have two components. The first is the possibility that the buyer may be able to execute efficiency opportunities that the seller did not pursue, but that could provide a near-term reduction in run rate. The second is the potential for the buyer to realize operational synergies after the captive's absorption into the buyer organization. Especially with captive centers that are much smaller than the target buyer, such as an information technology (IT) captive being targeted to a large IT services vendor, the integration process may offer the opportunity for an appreciable increase in volume.

Buyer selection

A captive center sale is usually an agreement, not just to sell the captive organization, but also to enter into a long-term service delivery relationship with the buyer.
In parallel with valuation and marketing, a seller should identify potential buyers for its captive center. While sellers can choose to host an open auction, our experience suggests that a targeted approach may be preferable. Most sellers should be able to draw on their knowledge of their captive center to develop a sound perspective on which potential buyers are most likely to value the captive organization. One of the biggest drivers for these sales is the potential of locking in a revenue-generating long term contract. Hence, the seller of a captive center is selecting not only a potential buyer but also a collaborator that will act as a service provider in the future. Therefore, sellers should carefully define the characteristics they desire in potential buyers with a view to enhancing returns and mitigating the risk of transitioning the services performed by its captive center to an external provider.

Of the many factors that play into buyer selection, the four described below are especially important.

Strategic fit and growth trajectory

Sellers should look at potential buyers that specialize in offering services that the captive center currently provides to determine whether these companies might perceive the seller's captive as a good strategic fit for an acquisition. Sellers should review prospective buyers' strategic plans for factors related to geography, service scope, industry, client base, and top-line expansion goals.

Service providers currently under contract with the seller, and those that the seller has used in the past, may be obvious initial candidates. However, the seller should consider not stopping there. Additional, non-incumbent vendors should be brought into the mix to make the process more competitive.

Experience with past transactions

The buyer's track record in executing similar transactions can reveal whether past sellers have profited from their transactions and unlocked both short- and long-term value. Companies that have shown themselves capable of acquiring a captive in a way that creates value for both the seller and themselves are more likely to inspire confidence in the seller than prospective buyers with less experience in executing such transactions.

Strength of balance sheet (margins and cash flow)

A company's financial strength can be of high importance when selecting potential buyers. A steady stream of cash flows can indicate a strong business and demonstrate sound financial management. Comparing prospective buyers' margins with those of their competitors can help sellers understand each candidate's operational efficiency. A strong balance sheet may also give sellers greater confidence in an organization's ability to deliver services over the term of the contract.

Service quality

Apart from the proceeds of the transaction itself, the value a seller gains from a captive sale depends largely on the quality of the service it receives from its former captive after it becomes part of the buyer organization. Sellers should consider the extent to which prospective buyers maintain quality programs such as Capability Maturity Model Integration (CMMI) or Six Sigma, as well as the degree to which these programs have improved the buyer's performance over time. Benchmarking buyers against industry competitors can also help sellers gauge the quality of the service each buyer is likely to provide.

Of course, if a seller wishes to spin off its captive into a stand-alone entity (e.g., through a management buyout) or sell to a private equity firm rather than to a strategic buyer, the above techniques for estimating potential service quality will likely not apply. That said, spin-offs and private equity sales tend to be rare for major captive centers, as most sellers prefer to sell captives to a buyer with a strong history of providing the kinds of services the seller will need to purchase after the transaction.

Agreement negotiation

The transaction agreement should address short-term purchase value and long-term service value.
Once a buyer is selected, the next focus area is the negotiation of the final agreement. As in a typical divestiture, the seller and buyer will typically create a purchase agreement that includes a letter of intent, signed by the buyer and seller at the start of the due diligence

process, and a terms and conditions agreement, which is signed once the deal is closed. In addition, if the seller intends to retain the buyer as a service provider after the transaction, the seller and buyer should consider crafting a service buyback agreement that defines the scope, price, service levels, and terms under which the seller will continue to receive services from the captive center after its acquisition by the buyer.

It is important to consider negotiating the purchase agreement in conjunction with the terms of the service buyback agreement to help maintain consistency between the two. This approach can encourage both the seller and buyer to negotiate and understand the short- and long-term sources of the transaction's value as a unified package. Conducting the two negotiations in parallel can also help mitigate risk as well as unlock additional synergies.

Purchase agreement

The due diligence phase begins when the buyer and seller sign the letter of intent. During due diligence, the buyer will evaluate the captive organization to arrive at a valuation and identify risks that may be associated with the deal.

Upon completion of due diligence, the buyer and seller can develop the terms and conditions agreement. This agreement should specify the value and assets included in the deal, as well as any efficiencies the transaction is expected to generate. It should also describe any conditions of engagement agreed to by the parties, including any interim transition services the seller will provide to the buyer.

Sellers can use a number of tactics to pursue their financial goals in a captive sale. For instance, in addition to contract price and transaction price, elements such as service credits and inflation caps can impact the transaction's financial outcome as well as its balance sheet and tax treatment.

Service buyback agreement

The development of the service buyback agreement usually commences after the letter of intent to purchase the captive has been signed. Issues for the seller and buyer to negotiate include the scope of the services to be provided to the seller, the pricing structure, and the length of the service contract.

While the structure of a service buyback agreement can be similar to that of a standard outsourcing contract, a service buyback agreement may include references to the purchase agreement. Matters related to pricing, scope of services and service levels, and the terms of engagement are specific areas in which to maintain consistency between the two agreements.

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Five important areas to address in negotiating the service buyback agreement include:

- **Scope of services:** The resources and assets listed in the purchase agreement as part of the sale should align with the resources and assets that the buyer will need to deliver the services to the seller specified in the service buyback agreement. For example, a purchase agreement typically includes a list of software and hardware assets to be transferred to the buyer. A similar list should be included in the service buyback agreement based on the scope of work to be provided by the buyer to the seller after the transaction.
- **Minimum commitments:** The "minimum commitments" clause in a service buyback agreement specifies the contract term — that is, the minimum timeframe over which the seller commits to purchase services from the buyer. Buyers typically offer discounts to sellers based on the length of the contract term, with larger discounts offered for longer-term contracts. In some instances, a seller may choose to bring in another vendor to provide a portion of the services previously performed by the captive. This is usually done in order to keep pricing competitive and/or to establish redundancy for certain services, such as data center operations that are deemed business-critical.
- **Service-level agreements**: After the parties agree on the scope of work that the buyer will provide to the seller after the transaction, the seller should lay out specific criteria or service-level targets against which the buyer's services will be evaluated. These targets are usually based on industry benchmarking studies but should also take the buyer's prior performance into account. Among other things, service-level agreements may specify the metrics that will be used to measure service quality, the hours during which services will be provided, and the processes by which

unsatisfactory performance will be addressed. Service-level agreements can also drive service pricing if the services in question are considered critical to the seller and require dedicated support.

- **Pricing structure:** As the value of a multi-year service contract may be many times a captive's sale price, it is critical to negotiate the sale price and the pricing structure for the service buyback agreement in parallel. Factors that may drive service pricing include the scope of work, the performance targets and other expectations specified in the service-level agreements, and the minimum commitment. An additional factor is the financial baseline based on the current costs on the captive center as well as corporate allocations. Depending on the scope of services under consideration, benchmarking studies can be conducted to inform the pricing negotiations. The longer the contract to which the seller is willing to commit, the stronger the seller's position may be in negotiating discounts with the buyer. Additionally, the seller may need specific contract negotiation skills to develop a service buyback agreement in which the variable cost of engaging the buyer as a service provider is lower than the historic fixed cost of maintaining its captive.
- **Governance and relationship management:** A well-defined governance structure can increase the likelihood of acceptable service delivery and mitigate operational and business risk for both the buyer and the seller. When the buyer and seller develop mechanisms for governance and relationship management, they should take care to include elements that foster cultural alignment between the two organizations. For instance, the seller may specify that the buyer must continue to provide a similar level of training and support to the employees who will provide services to the seller so that service quality is maintained or improves. The governance structure should also specify the compensation as well as career progression structure to facilitate a smooth transition.

Disentanglement

The seller should approach disentanglement in a way that supports its former captive's long-term effectiveness.

Disentanglement — the operational separation of the captive's resources and assets from the seller and their handoff to the buyer — is frequently a complex process that can result in business risk and value loss if not executed in a disciplined manner. In a captive sale, furthermore, the disentanglement process may represent even more risk than in a typical divestiture, as an ineffective disentanglement can compromise the former captive's ability to continue to reliably deliver services to the seller. Sellers should strive for a disentanglement process that aims to move the captive's knowledge, people, and processes to the buyer organization intact.

In most divestitures, sellers appoint a cross-functional separation lead to manage the overall disentanglement process, with functional separation leads (e.g., for human resources [HR], finance, IT, etc.) to manage disentanglement in their respective areas. In a captive center carve-out, the separation lead will not only need to address the operational separation requirements common to most divestitures, but also manage the conversion of the divested captive from an internal unit to an external service provider. Primary areas of concern should include service delivery, HR, finance, and IT. Sellers should follow a planned and structured approach that considers the impact of disentanglement on each of these areas.

Service delivery

As a part of the sales process, the seller will likely be expected to articulate the scope of services that will be divested with the captive center and the portion that will be retained by the seller (e.g., due to intellectual property, business knowledge, or other concerns that limit the seller's ability to outsource particular services). In cooperation with the buyer, the seller should refer to this description of the services transitioned to the buyer to develop a detailed operational plan for its interactions with the captive center as an external service provider. Particular attention should be given to defining process hand-offs, establishing the division of responsibilities between the seller and the provider, and determining the buyer's operational responsibilities.

Case in point: A captive sale in the financial services industry

With only two months between sign and close, a major financial services institution was facing the challenge of setting up its divested Indian captive as an external vendor. A key complication was that, to continue to serve the company as an external vendor, the captive center needed to comply with all security and compliance requirements applicable to outside providers. To do this, the company needed to convert the access rights for the captive's 1,000 employees from unsecured access to firewalled access. As part of the process, more than 600 applications were tested and a 24/7 "testing command center" was created to troubleshoot and fix access issues. The company was able to complete the conversion in six weeks, allowing the deal's critical-path IT requirements to be concluded on time.

HR

In most divestitures, the seller's HR concerns, apart from any residual TSA obligations, essentially end on Day 1, when the resources formally become part of the buyer organization. However, in a captive sale, the seller — as a continued recipient of services from the divested captive after the transaction — has a vested long-term interest in the performance of its former captive's personnel. Sellers should therefore consider crafting an HR separation strategy that explicitly addresses the way risks to business value and continuity will be mitigated in the transition process. Identified risks include the loss of critical personnel as well as overall resource attrition. Especially in tight labor markets, such as some Indian cities where many captive centers reside, these risks should be carefully managed.

Finance

In addition to preparing for the financial close of the deal and managing the captive's separation from internal accounting, the seller will also need to convert the captive from an internal center to an external billing entity. This can introduce additional complexity into the financial disentanglement process. The separation lead and the financial lead should work closely together to establish a third-party billing structure that is effective at close.

IT

Most captive centers, as internal service providers, have open access to internal corporate systems. When converting a captive into an external provider, the separation lead and IT lead should work with the seller's internal security, risk, and data teams to design a post-sale access strategy. The scope of the captive's access will likely need to be reduced, and appropriate tracking mechanisms should be put in place to monitor compliance. Sellers should keep in mind that creating firewalls and taking other appropriate security measures frequently involve long lead times for equipment and circuit acquisition. In addition, sellers should be aware that any privacy restrictions on sharing information with external parties will apply to a captive from the moment it joins the buyer organization. To reduce the risk of privacy-related violations, a seller should review the databases accessible by its former captive from a business risk perspective.

Conclusion

Captive center sales can offer businesses a way to increase cash flow and to sharpen their focus on their core competencies. While captives often represent significant value, however, many companies sell them in an opportunistic fashion driven either by ad hoc queries from potential buyers or discussions with existing service providers. Such an opportunistic approach can limit the seller's gains from the transaction in two ways. First, the time and resource pressures characteristic of an ad hoc sale can reduce the seller's ability to position its captive as a stand-alone business unit rather than as a pure asset. Yet a captive that is evaluated as a stand-alone business unit may fetch a much higher sale value than it would if its assets were to be sold individually. Second, the same time and resource pressures may prevent the seller from devoting appropriate attention to matters that can improve the odds of maintaining an effective long-term service delivery relationship with the buyer.

A process that specifically addresses the distinctive qualities of a captive center sale can result in a deal that delivers a mutually desirable outcome. By positioning its captive as a revenue-generating business, a seller can seek to obtain an appropriate price for the divestiture. By laying the foundation for a long-term service relationship during the sale process, the seller can seek to maintain effective service delivery from its former captive while giving the buyer the opportunity to pursue future revenue opportunities from the seller as a client. We encourage companies that are considering selling a captive service center to keep these points in mind in their efforts to execute a transaction that can yield short- and long-term value.

2 Negotiations: Beyond the contract
Driving value from the renegotiation process

The recent economic downturn has underscored the difficulties involved in the area of managing third-party spend, making contract renegotiations even more centerstage. That puts the focus on the numbers, which can be relevant. However, it can also be problematic as it can underplay the importance of the renegotiation process as an opportunity to reassess operational efficiencies.

Since the 1960s, companies have increasingly moved away from vertical integration and instead veered toward greater specialization as they strive for competitive advantage. One indicator of this trend is the increasing size and breadth of the outsourcing industry. According to research analysts, IT and business process outsourcing are now a $400 billion to $800 billion dollar industry.[1] In fact, these numbers — while large — understate the true scope of outsourcing, as they do not include the outsourcing of industry-specific functions such as contract manufacturing, oil field services and clinical trials. Outsourcing relationships are clearly important, both financially and strategically.

This trend has had many benefits, but it also requires a core competency associated with building and maintaining an extended network of suppliers, distributors and other alliances. The recent economic downturn has underscored the difficulties involved in the area of managing third-party spend, making contract renegotiations even more centerstage. That puts the focus on the numbers, which can be relevant. However, it can also be problematic as it can underplay the importance of the renegotiation process as an opportunity to reassess operational efficiencies. For reasons we will describe, this process can be a valuable event.

The not so fine print

Unlike salary and related costs, which are typically directly under the control of the company's management, spend with third-party suppliers is generally governed by stringent contracts, which often dictate terms such as the price paid to the supplier over the entire life of the contract. Such protections prevent suppliers from using any leverage after the contract has been signed. Yet quite often this protection against a rise in prices is the same stipulation that greatly limits the buyer's ability to reduce its spend with third-party suppliers through promotions such as quantity discounts.

There are significant limitations to the approaches many companies use in negotiating and renegotiating third-party contracts. Getting beyond these typical approaches can result in significant savings to the buyer of services, while preserving, or even improving, the relationship with the suppliers.

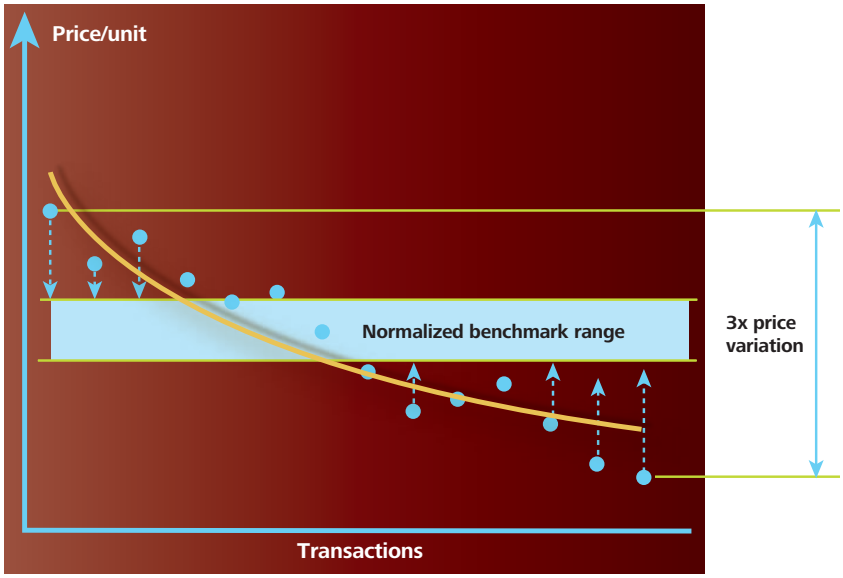
Typical approach #1: Benchmarking

When faced with financial difficulties, buyers of outsourced services frequently approach contract renegotiations aggressively. If they have the right to conduct a benchmark, they hire a benchmarking organization with the hope of discovering that the "market price" is substantially lower than their current contracted pricing.

Unfortunately, there can be issues with benchmarking. First, in many service areas, the price per unit varies tremendously, in our experience often by as much as 300 percent between the lowest and highest price in the market. This variance makes it technically difficult to conduct an assessment of pricing because the veracity of any purported benchmark will likely cause a nonproductive discussion.

Next, the process of benchmarking normalizes the actual pricing curve to adjust for various factors. This adjustment or normalization flattens the actual shape of the pricing curve in order to produce a set of comparable data points (Figure 1). While this may seem at first to be a coffeehouse conversation for statisticians, this reshaping of the pricing curve can remove what is potentially valuable information to the buyer and supplier. Specifically, the buyer often makes choices regarding level of service, method of service delivery (e.g., onshore/offshore) and level of customization that significantly drive up the cost of service delivery. The normalization process results in the removal of the effects of those choices on the range of pricing — effectively hiding from the buyer the cost of their decisions. The authors find that revelation of the true pricing curve often results in a very productive conversation in which the buyer and supplier can review the requirements and service levels and their impact on both cost and pricing. Together they can then make informed choices as to requirements going forward.

Figure 1: Sample benchmarking exercise



Finally, and perhaps most importantly, the benchmark focuses the dialogue with the supplier on proving or disproving the numbers rather than getting to the heart of the issue: What can the buyer and supplier do together in order to reduce the cost of delivery and price of service, while maintaining or improving business performance?

Typical approach #2: Strong-arm

In combination with or in place of benchmarking, the buyer often uses strong-arm tactics during contract renegotiations. In order to gain a small price reduction, the buyer may threaten to end the business relationship if the supplier does not meet his or her demands. This approach also has a number of challenges.

> While a natural focal point of any contract discussion tends to be "the number," it can be helpful to consider some of the other areas for negotiation. Of ten these will yield better results for all sides.

First, contracts often contain termination clauses that either prevent the early termination of the contract or generously compensate the supplier should early termination occur. In other words, the buyer lacks leverage, and suppliers are often disinclined to negotiate. (A health plan provider recently asked 10 suppliers for price reductions as a result of the economic crisis. Out of the 10, only one offered a substantial price reduction — greater than 5 percent. Not too surprisingly it was the supplier whose contract term ended within 12 months.)

In one respect this is understandable — what may be viewed by the buyer as a modest price reduction (e.g., 10 percent) can represent two-thirds of the supplier's profit margin on the account. As a result, this difference in perspective on even a seemingly modest price reduction between buyer and seller can often result in contentious and unproductive discussions.

Finally, an almost gladiatorial focus on price can inhibit the ability of the parties to address additional underlying contractual issues and opportunities that can have a worthwhile impact on both parties.

Taking it up a level: a relationship focus

During the renegotiation process it may be more beneficial and productive to consider a big picture view of a mature outsourcing relationship. A more holistic approach can be more effective while preserving and generating value from the relationship with one's suppliers. Following are some important characteristics of a broader approach:

Use the renegotiation as an opportunity to address many factors beyond price. For example, the buyer may want to increase the supplier's scope of services provided in

one area but decrease its responsibilities in another area. A common example of this in today's IT outsourcing market is to increase the amount of applications maintenance and support services provided by a supplier thus enabling the buyer's project managers and business analysts to be redeployed to more strategic development projects.

Solicit the supplier's ideas, and solicit them early. The supplier is often better positioned than the buyer to recommend opportunities for financial and operational improvement. There is a potential benefit to the early involvement of the supplier, as it can create positive momentum for the renegotiation and reduce the level of contention. A common concern in outsourcing is the potential lack of innovation from the supplier, however, any such fault is often mutual.

In one contract renegotiation we observed, the supplier developed a list of over 20 cost reduction ideas, many of which had not been identified by the buyer. One opportunity was to remove the duplication in the two quality assurance groups by using only the buyer's QA group, rather than the buyer's and supplier's, to measure service levels and audit quality. A second opportunity was to review the buyer's rather onerous security requirements, which resulted in unnecessary site startup costs in excess of $600,000 per site more than those of other supplier sites for companies in the same industry.

Pull all negotiation levers, not just rates. Many companies approach contract renegotiations purely from a financial standpoint: What is the rate paid? Can procurement negotiate a rate reduction of 10 percent? In the authors' experience, pure rate negotiations tend to result in minimal price reductions as suppliers' margins are directly impacted.

Areas for renegotiation

There are several additional areas that can be addressed during contract renegotiations that can positively impact both buyer and seller. Prominent among these are efficiency, demand management and contract structure.

Efficiency

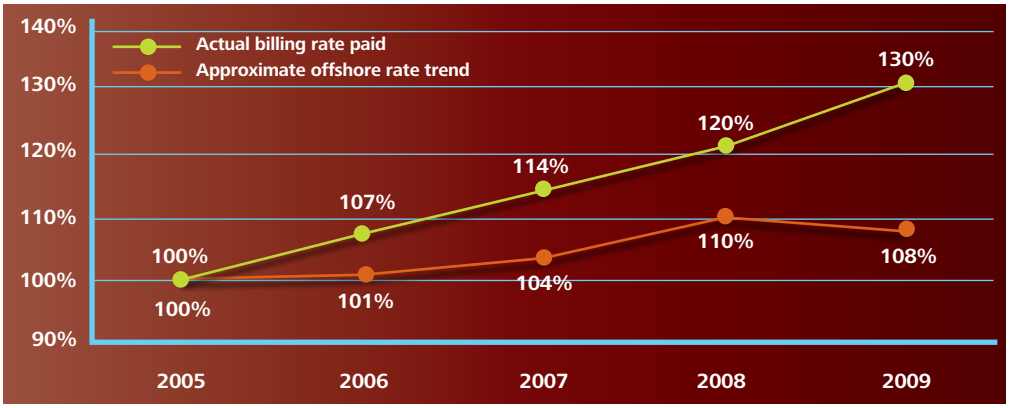
Efficiency is an obvious lever and opportunity for cost reduction. Reducing cost by leveraging the supplier's greater scale, experience and labor arbitrage is often the critical objective in an outsourcing transaction. However, there are two areas that the renegotiation team should analyze in order to determine the potential for improved efficiency.

The first area to explore is market-driven opportunities that have developed since the execution of the original contract. It is likely that the competitive procurement process revealed operating efficiencies available at that time. However, outsourcing markets evolve over time. Technologies improve. Price points come down. Suppliers increasingly find ways to drive down their costs through automation, better use of scale, self help and increased offshoring. As a result, there is often an opportunity to update and enhance the efficiencies associated with the current operating model, enabling a supplier to reduce the cost to serve and thus the price that supplier must charge.

The second area to analyze is the removal of certain contractual constraints placed upon the supplier. In a first generation contract, the buyer often imposes specific conditions upon the supplier such as requiring the use of certain assets, sites and personnel. This is not uncommon in the world of outsourcing, given the uncertainties associated with it. However, during contract renegotiation, the buyer may gain a better understanding of the supplier's capabilities and may be in a position to remove some of the restrictions stipulated in the original contract. Examples of such restrictions might include the use of the buyer's data center and associated software, the use of the buyer's customized software rather than the supplier's standard platform, and limitations on the use of offshore

> Contract structure can provide incentives to the supplier to achieve the desired balance of cost, service levels and innovation. It can also motivate and improperly reward the supplier for actions that improve the supplier 's margin without any cor responding benefit for the buyer.

Figure 2: Actual billing rate vs. Approximate offshore rate trend



Source: Deloitte Consulting LLP analysis; Infosys Annual and Quarterly Investor Reports

resources. Removal of these constraints can allow the supplier to standardize its delivery of services for the buyer. The supplier may also develop stronger economies of scale in its client delivery model.

Demand management

An important task during contract renegotiations is to determine if the buyer is exercising proper governance over its demand for services. After all, one effective cost management approach is not to incur the cost at all.

In the case of one company, the scope of outsourcing services provided by the supplier was too large. The IT supplier was responsible for both the provision of computing power and the performance of the application portfolio. The IT supplier stopped regularly fine-tuning the applications' performance, and MIPS (a measurement of data center capacity) nearly tripled over a five-year period while the underlying business volumes grew less than 50 percent. Perhaps this is not a surprising result given that the supplier was paid per installed MIPS. After re-tendering the data center services, another supplier was found that would guarantee a reduction in data center capacity by a third without a degradation of the service to the business. This provided the buyer the ability to reduce cost by a third before even considering rate reductions and other potential cost reduction levers.

This example is far from atypical. Effective governance of any supplier is a necessity, and this often requires a refocusing of resources: While the delegation of the review of the financials to the finance department is common, that group may not have the subject matter expertise to exercise sufficient control over the resources expended.

Contract structure

Contract structure can provide incentives to the supplier to achieve the desired balance of cost, service levels and innovation. It can also motivate and improperly reward the supplier for actions that improve the supplier's margin without any corresponding benefit for the buyer. There are many examples of these contract structures that bear unexpected consequences. In application development and maintenance contracts, it is common to pay for support by the hour and to pay for development in a fixed fee arrangement. While there are positives to such rate structures, the potential negatives must be understood and mitigated. For the provision of application support services, pay per hour does not encourage productivity, as greater productivity equates to less revenue. A solution is to monitor cost of support per application group and other forms of productivity. Similarly, for the provision of application development services, fixed fee pricing can be useful in a competitive bid situation.

Although the above examples are specific to one form of outsourcing, there are similar challenges in other forms of outsourcing (e.g., pay per hour in a call center versus pay per call or pay per transaction). More generally, a very common structural challenge is in the annual cost of living adjustment (COLA) clause. The authors have seen many situations in which the COLA clause has inflated the price of service to 30+ percent over the first-year contract pricing in spite of the fact that market rates were flat during this period. The reality is that market pricing continues to fall in real terms in most service areas due to innovation and the neverending competitive pressures. A long-term COLA charge not only prevents the buyer from benefitting from lower prices, but actually *raises* costs instead. (See Figure 2.)

Putting it into play

While a natural focal point of any contract discussion tends to be "the number," it can be helpful to consider some of the other areas for negotiation. Often these will yield better results for all sides.

One example with which we are familiar brings many of these factors into play and highlights several underlying issues.

A U.S.-based health plan provider spent approximately $70 million per year with one primary IT supplier. While generally pleased with the relationship and the service levels, this company — like many health plans — faced significant cost pressures in 2009 due to the continuing recession and turned to its primary supplier to find ways to reduce those costs. However, (perhaps because the contract had been renegotiated and signed recently in 2006), the supplier was unable to offer substantial savings.

In fact, the initial price reduction offered was under 2 percent.

This seemed very low to the health plan provider and was not a particularly satisfactory outcome for either party. Leadership recognized that the conversation would have to be broadened beyond pricing for the status quo and appointed a team to conduct four weeks of analysis and data gathering. The team identified several opportunities for renegotiation:

- **Move out of the health plan provider's dedicated data center into a fully leveraged supplier data center.** This decision highlights an important aspect of renegotiations: *They are often the trigger point for a reassessment of efficiencies and service levels.* In this case, the supplier data center was an enabler for offshoring and — through scaling — much-improved disaster recovery capabilities as well as more cost-effective upgrade opportunities. The dedicated data center was a customized solution and perhaps made economic sense when it was created. But time and technology changed the cost and service level equations. The supplier did not knock on the buyer's door to recommend these potential changes. Nor did the manager of the dedicated data center have an incentive to reassess whether the status quo was the preferred solution. However, a joint analysis of the opportunities for improved efficiency surfaced the option and enabled a proper decision. A simple price renegotiation in this case would have resulted in lower levels of cost saving and potentially reduced service levels with increased operational risk over time.
- **Change the infrastructure support model by moving from a dedicated resource pool into the supplier's global delivery model.** Related to the move to the supplier data center, *cost savings were realized through offshoring with no negative impact to service levels.*
- **Right skill the delivery team.** The original intent had been for the IT supplier to perform, among other things, the network architecture role, resulting in a resource profile that was more senior in some areas than called for based on the types of work done. However, the health plan provider assumed much of the architecture function in-house. Tasks had changed in the interim, a very common situation in IT in any industry. But the contract had been structured with high-priced people in the data center even as the buyer had kept its own architects in place, essentially doubling the cost basis for this IT function. The lesson here was a simple one: Look at actual work being done and the assumptions made in the existing contract.
- **Move from input-based pricing (hourly rate) to an output-based model (fixed price per device per month).** The initial pricing approach, paying at a blended hourly rate, has advantages and disadvantages in various environments. In the data center scenario, where task metrics were available, reliance on an hourly rate was not an effective motivator for improved productivity. During the renegotiation process, the team looked at service operations industry trends in terms of the number of calls handled, the number of PCs supported, the number of remote problems resolved on the first call and other measures. They determined that those metrics had improved industrywide. Rather than simply latching onto benchmarks and using those as a numerical cudgel, however, the team analyzed what had happened that had driven efficiency and which of those innovations or improvements had been implemented by the IT supplier. Renegotiation is an opportunity to assess what has happened in marketplace trends, to incorporate any such efficiencies into the resultant contract, and to determine that any

The increasing importance of outsourcing as a core component of corporate strategy suggests that the traditional hardball approach to negotiation may be precluding more useful conversations — ones that can lead to mutually beneficial improved efficiencies and service level sand, perhaps more optimistically, to improved business models.

marketplace technology gains are shared equitably. This was the basis for a collaborative conversation about how to apportion the gains. It is important to note that some efficiency gains require collaboration between buyer and supplier. For example, while a call center may be able to function more efficiently if a company uses a single sign-on process for its intranet applications, such a process may require technology changes driven by the company's CIO and perhaps organizational changes to overcome silo tendencies.

- **Improve the contract structure (e.g., by implementing a third rate card as opposed to the two rate card structure that was in place).** This was a fairly straightforward change. In effect, the supplier had staffed positions billed at a $90 hourly rate (U.S.-based or "onshore") with medium-term workers in the United States. A third rate card captured the savings the supplier realized in staffing these roles and passed the cost savings to the health plan provider. The issue was not legality. However, it does reinforce the risk of focusing contract renegotiations solely on price and placing the supplier in a defensive, perhaps subtly adversarial, position.

The above opportunities represented a potential cost reduction between 15 percent and 25 percent by service area. After renegotiation and careful evaluation of these options, the health plan provider realized overall savings of approximately 20 percent. The vendor likewise emerged with an arrangement that was far preferable to taking a 3 percent haircut.

In another example, a telecommunications provider was divesting from a larger cell phone company to be in compliance with a regulatory requirement. It needed to negotiate a new contract for customer service (call center, interactive voice response {IVR} and so on) and associated functions and was under significant time pressure. Initially, to expedite the separation of its operations, the company decided to obtain a relatively standard bid from a single provider. It did not look for opportunities to leverage its volume of business nor encourage efficiencies.

As advisers on this project, we encouraged the telecommunications company to postpone the final award so as to renegotiate better terms, using the potential for additional business and the threat of reopening bidding to the second-place finisher as levers. Specifically, the business risk of an abrupt termination of call center services was considerable, making the contract language around termination support more important than what was reflected in the standard bid. In addition, the standard bid assumed a certain operational model without encouraging a search for efficiencies.

The outcomes brought several improvements that meshed well with the telecom company's interests and controlled costs in a way that was fair to both vendor and buyer:

- Agreed to a "stair-step" IVR model that rewarded the vendor with small increases in IVR pricing for significant increases in IVR call capture. The negotiated model had the potential to save over $1 million annually on billings in the $15 - $18 million range.
- Agreed to continue post-termination support as long as 18 months, providing the telecom company with the ability to terminate if necessary.
- Obtained better COLA language by removing cost items that do not actually increase over time from the COLA calculation, thereby lowering cost in succeeding years of the contract.
- Strengthened contract language about at-risk service level penalties from 1 percent to more than 10 percent of monthly fees to put "bite" into the consequences of service level failures

In this case, an improved contract resulted from a closer look at the company's risk factors as well as a sharing of benefits derived from efficiencies.

Handshake versus head butt

Companies increasingly rely on third-party suppliers for services ranging from support for their IT infrastructure through manufacturing of their core product line. If anything, this trend seems poised to continue as the economy becomes still more global and technologies make the vertically integrated, brick-and-mortar company far less common.

While this outsourcing trend can have many benefits, it results in a need for strong vendor management and a focus on innovation for the relationship to evolve and succeed over time. By approaching mature outsourcing relationships with their longer-term strategic importance in mind, it is possible — and desirable — to get beyond immediate pricing considerations and more fully realize the "relationship" aspect of the arrangement.

There is a "procurement disconnect" common to outsourcing relationships. While the due diligence performed one or more years ago may have been proper, the analysis done at that point in time eventually becomes outdated. Technologies advance and offer new efficiencies. Strategic priorities and risks change, and with them the opportunities afforded by various suppliers. While contracts are of necessity fairly static, seemingly everything else changes as the ink dries.

The increasing importance of outsourcing as a core component of corporate strategy suggests that the traditional hardball approach to negotiation may be precluding more useful conversations — ones that can lead to mutually beneficial improved efficiencies and service levels and, perhaps more optimistically, to improved business models.

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Endnote

1. Various sources such as Gartner and AMR Research estimate the outsourcing market between $400 billion and $828 billion depending on inclusions, exclusions and methodology for estimation, among other factors.

3

Avoiding the "ditch"
Making an effective transition to outsourcing

Our research shows that information technology (IT) outsourcing is here to stay. During times of economic prosperity, outsourcing can enable a company to focus on core competencies, improve processes, and increase flexibility. During an economic downturn, outsourcing can help a company reduce costs, generate cash flow, and/or shed low-value operations.

Once a rare endeavor, outsourcing is now a common tool found in most CIOs' toolkits. Unfortunately, common is not synonymous with simple. Based on Deloitte's research and our experience as outsourcing advisors, we believe that realizing the true value of an outsourcing engagement depends greatly on the client's and the vendor's ability to plan and execute effective outsourcing transitions.

Understanding transitions

In the context of outsourcing, a transition can be defined as "the smooth transfer of services from a legacy organization to a vendor organization in accordance with contractual requirements." Typically, a transition starts on the service commencement date and continues until the vendor has reached the "steady state" of maturity defined by the contract.

When well executed, a transition establishes the long-term governance model, service levels, and reporting framework that form the foundation of the client's relationship with the outsourcing vendor. An effective transition can unlock the value of an outsourcing engagement, thereby laying the groundwork for a relationship that can last for many years to come. However, Deloitte's research has shown that approximately one-third of transitions fail in the first year and over two-thirds of executives reported problems during a transition.[1]

Why are transitions so challenging? One fundamental issue is that many companies, even if they have experience with previous outsourcing engagements, do not retain the skills and experience it takes to be ready for a complex outsourcing transition. And why should they? A transition is an event that should only happen once or twice in a company's IT evolution. The catch-22 is that staffing these skills simply does not make sense — yet the lack of the right skills can seriously hamper a company's ability to execute an effective transition when necessary. In fact, some companies, recognizing the need for specialized skills to manage the transition process, turn to outside service providers for assistance in this area.

Other reasons center on weaknesses in client-vendor communications, including lack of transparency, lack of reporting, and misaligned expectations. Expectations often diverge quickly, since the vendor's interest lies in adjusting its cost structure to hit internal profitability targets while the client's interest may be in adding premium services and driving innovation.

The bottom line is that a transition to outsourcing can affect nearly every key aspect of the business. Therefore, the transition needs to occur in a seamless, cost-effective, and transparent manner while maintaining business continuity and performance. Outsoucing can be a long-term endeavor, and it tends to proceed most smoothly when both the client and the vendor have previous experience with the transition process.

1 Deloitte Development LLC, "Calling a change in the outsourcing market: The realities for the world's largest organizations," 2005.

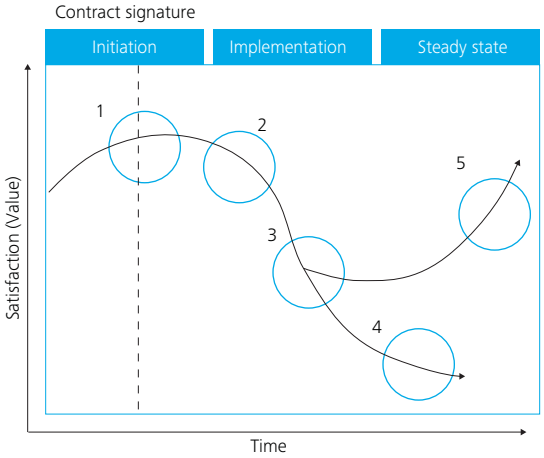
The transition lifecycle

Diverging interests
A client's and vendor's interests are most closely aligned at the time that the contract is signed. Thereafter, the client's interests are likely to diverge from the vendor's in three main areas:

a. **Cost:** The client has the savings of the entire life of the transaction "booked." Attitudes toward the vendor may shift towards, "What have you done for me lately?" Meanwhile, the vendor may be pursuing aggressive cost reductions while managing to a fair margin, which can act to the detriment of quality and client satisfaction.
b. **Operations:** The client's business is in constant flux. From the moment a contract is signed, products may be added, geographies may shrink or grow, and acquisitions and divestitures may take place. While these changes are happening, the vendor is trying to stabilize operations while meeting performance and cost targets. The vendor may find it difficult to accommodate continuous change, and the pricing mechanisms established in the contract may not satisfy one or both parties in their ability to adjust prices to the new workload.
c. **Services:** The client is looking for business results and the adoption of new leading technologies, whereas the vendor is interested in "good enough" solutions that improve its profit. Additionally, the vendor's "A" team is often reallocated to newer opportunities, which usually causes service quality to deteriorate over time.

The typical transition lifecycle involves three phases with as many as five inflection points in the process (Figure 1). Our experience suggests that these phases and inflection points usually proceed as follows:

Phase 1: Initiation and planning



Inflection point 1 — the "honeymoon:" The client has just negotiated the contract, expectations are high, and the relationship is solid. There is a general feeling of excitement, anticipation, and expectation. The tendency is to let the vendor take the lead in the transition, sit back, and enjoy the ride. However, the fast pace can mask deeper issues in methodology, approach, and delivery. Quick wins can give a false sense of confidence.

Phase 2: Implementation

Inflection point 2 — the "natural decline:" A transition to outsourcing represents a massive change, and change generally makes people apprehensive. The client organization may experience a decline in satisfaction as people come to understand the complexity of the change and the lasting effect it will have on the enterprise.

Meanwhile, the vendor is in a dynamic state. As the vendor teams ramp up, delivery pressures mount, and service delivery becomes a reality. In order to meet the go-live date, budgets, and contractual commitments for the transition, vendors tend to become internally focused on their own operations. This can give the client the impression that the vendor does not understand or care about the client's business, leading to a decline in the client's confidence. Divergences between the client's and the vendor's interests (see sidebar, "Diverging interests") can also contribute to the "natural decline" and may further erode the client's confidence in the vendor as well as the decision to outsource itself.

Inflection point 3 — the "tipping point:" At this point, the weight of the project and its complexity are fully apparent to the client organization. The relationship's governance mechanisms, the client's prior planning and sourcing strategy, and the vendor value proposition are all being tested. Multiple workstreams are now in motion and the dynamics are often difficult to balance and manage.

The challenges of this stage are frequently compounded by the vendor's continuing tendency to focus primarily on internal issues in order to meet the go-live date. The vendor, feeling the contractual pressure to execute, may concentrate first and foremost on getting its own resources in order. The client, especially if it is inexperienced in transitions, may not understand the resulting apparent lack of attention and guidance from the vendor.

Phase 3: Steady state

Potential inflection point 4 — the "ditch:" When poorly executed, the transition can spiral downward and erode the client's confidence in the vendor and its ability to deliver. The overall decision to outsource may be second guessed. Costs may increase rapidly for the vendor and the transition may grind to a halt as teams evaluate problems

and attempt to resolve them. The parties can begin "finger pointing" and the client may start voicing thoughts that things were "better before."

The "ditch" represents an off-track program. Milestones have been missed, costs are increasing for both parties, and recovery requires a massive shock to the program — sometimes with a new transition leadership team. The result: increased cost and investment for both parties; value leakage in terms of efficiency, process, and transformative improvement; and unsatisfactory client service.

Potential inflection point 5 — the "hand-over:" When the foundation is properly laid, a transition can avoid the "ditch" and begin to realize the value of the outsourcing agreement. When this happens, the vendor and client are both comfortable with what has been delivered and can begin strategizing about next steps. The program begins to execute as planned, and the relationship builds up positive momentum as value begins to be realized in terms of improved performance, price, and stability.

A well-planned transition can reduce the duration and inclination of the "natural decline" and help guide both parties through the "tipping point" to an effective "hand-over."

Avoiding the "ditch"

On the surface, avoiding the "ditch" appears to be simple. The widespread view is that following good project management methodologies while executing the transition and governance plans will likely contribute to an effective outcome/desired results. However, although effective transition management is indeed based on good project management principles, the reality is that outsourcing transitions are difficult to plan and execute even for an experienced vendor. In part, this is because vendors and clients lack common, repeatable processes for planning and executing an outsourcing transition. Additionally, a failure to establish roles and responsibilities at the client's retained organization can add to the complexity and confusion inherent in transitions. Further complexity can come if the client fails to clearly document and communicate its requirements and current processes to the vendor.

If a client has not previously outsourced, its leaders are likely to be unprepared for the complexity of the change that outsourcing forces on the enterprise. Thus, the transition will often have a larger impact on the enterprise than the client expects. For example, the overall effort required by the client team can be greater than planned: In a Deloitte survey, 63% of the organizations surveyed reported that managing outsourcing relationships took more effort than expected.[2]

Our research has uncovered several lessons learned that can help companies execute a transition more smoothly:

- **The readiness of an organization for the transition** to a service provider is crucial. (However, one survey found that 75% of service providers polled said that clients are not operationally well prepared for an outsourcing initiative.[3])
- **Joint initiation and planning activities** should lead to the creation of a detailed master transition plan. Both parties should develop the plan and develop clearly understood tasks, roles, and responsibilities across the entire span of the transition. Also, it is important that the vendor perform appropriate due diligence.
- **Managing the service provider relationship and monitoring performance is a full-time commitment**, not a matter of simply reviewing periodic reports. Clients need to invest in their vendor management functions and factor those costs into their plans. (The cost of a relationship management organization can range up to 7%, or more, of the annual contract cost.[4]) The relationship with the vendor should not be treated as a one-off procurement transaction; the vendor should be viewed as a business collaborator. Detailed vendor management processes that focus on making the relationship work can support long-term value and continuous improvement.
- **The underlying drivers of quality and cost must be understood** to enable a smooth hand-off to steady state operations.
- **Executive reporting during the transition is often needed** to allow both the client and vendor to understand performance and progress towards business objectives.

2 Deloitte Development LLC, "Calling a change in the outsourcing market: The realities for the world's largest organizations," 2005.

3 Deloitte Development LLC, "Why settle for less? Deloitte Consulting 2008 outsourcing report," 2007.

4 Ibid.

- **Staffing the right people for the job** requires the client to design their vendor management organization around define processes and with specific skill sets in mind. Too often clients allow familiarity with personnel, proximity, or politics cloud the selection process. As hard as this may be, the formal management team may not make the best retained organization.
- **The transition should have IT leadership involvement and sponsorship**, and leaders should understand and communicate the value of the relationship. IT leadership needs to act as an advocate and ambassador for the outsourcing relationship to the business.
- **Mature transition methodologies (process, tools, and templates) are needed** to make both parties aware of the risks involved in a complex transition.
- **Facilitation and tracking processes should be established** to identify and report transition issues early and enable their rapid resolution.
- **The client should have a strong and experienced transition leadership team in place**, either by hiring in-house resources or by contracting to an external service provider. The probability of a transition's success, in our view, is directly related to the client's experience in previously managing transitions.
- **The vendor and client should set up governance processes** that focus on the requirements of the transition. This includes procedures for achieving consistent reporting to both the client's and the vendor's internal management.
- **Appropriate investment in the retained organization** will facilitate integration of the business with the vendor, and it can help promote the attention to detail required for establishing a strong relationship.
- **Communications and relationship management** are two of the most common challenges that are escalated to senior management. Proper attention to these aspects of the transition can help the client and vendor work together more effectively and identify issues early.

It is important to remember that a client may outsource tasks and IT functions but not the accountability for delivering IT services. The retained IT organization must manage the vendor and actively work to integrate the vendor's activities with the dynamic needs of the business, starting with the retained organization's design, governance processes, and joint planning processes. Above all, the client should not make the mistake of assuming that the vendor is going to drive all parts of the transition.

Accountability for the success of a transition project — as well as the overall outsourcing initiative — should reside clearly with the client's executive sponsor. The client's transition team and the retained organization should be poised/equipped to manage the vendor through the transition period. Then the transition team should evolve into a vendor management organization, with standard processes to effectively manage the relationship in its steady state.

Recovering from the "ditch"

Unfortunately, some projects do fail, and recovery can be more art than science at times. When transitions become stuck in the "ditch," two things are apt to happen: first, denial by both parties that the project is actually in trouble, and second, denial of responsibility for the issues. If the vendor realizes the transition is indeed in trouble, for instance, it will generally want to avoid admitting culpability for the problem for fear of suffering a negative impact on the transition budget.

In most cases, when a transition hits the "ditch," it takes a key event (such as a service outage) to initiate escalations of project issues in a meaningful way. At this point, a determination needs to be made about what must be done to get the transition back on track. Defining the steps to take will depend on where in the project the transition hit the "ditch," the nature of the root cause of the breakdown, and the amount of additional effort (and cost) the remediation will require. Potential actions may include:

- Wholesale replacement of the transition team
- Escalation to a level that is empowered to affect change
- Resetting of expectations
- Re-planning of work with a focus on recovery, risk mitigation, and financial reconciliation

Inputs to the recovery plan need to be based on the original contractual commitments and take into account financial considerations as well as the risk to the business. A prioritized plan needs full buy-in from both the vendor and client. Both will need to dedicate and incent resources to complete the recovery according to the newly established timeline. New processes should be established to manage the program more closely and increase the focus on project management and communication. At times, a special governance process may be created to increase management visibility, garner management support, and effect a positive change in perception and momentum.

Toward an effective steady state

When the foundation for a transition has been properly laid, a transition program is more likely to remain healthy, and risks are more apt to be properly identified and controlled throughout the process. As a result, the program has a greater chance of being executed as planned and of gaining positive momentum as the expected value begins to accrue. Transitions are complex, difficult events that can place great stress on an organization. There is no magic formula that can guarantee a successful transition, but following the principles described above can significantly increase the likelihood of an effective outcome.

4 The Vendor Management Program Office (VMPO): Five Deadly Sins of Vendor Management

Are hurdles blocking you from getting the most out of your third party relationships?

Introduction

As outsourcing continues to go mainstream, organizations are not only considering opportunities to offshore processes but also to outsource them within the originating country. Traditional processes such as information technology, finance, and human resources continue to be the main focus, although others, such as legal, procurement, and sales/marketing, are becoming more common. Meanwhile, some companies are moving in the opposite direction of bringing off-shored processes back in-house[1]. Even this latter trend, however, does not diminish the requirement for a broad Vendor Management Program Office (VMPO). Whether vendors are being engaged on-shore, offshore or by a captive organization, companies increasingly need a strong and capable VMPO. This need is being driven largely by governance, risk and compliance obligations. In the wake of the global financial crisis, regulators are increasingly scrutinizing how companies track, measure, manage and report supplier risk and third-party compliance requirements. This scrutiny is driving companies to institute new vendor management functions or to increase the scope of their existing ones. Nonetheless, many organizations are not achieving the business objectives they intended when establishing or expanding their VMPOs. Their limited achievements can likely be attributed to some of the following misperceptions and challenges.

The five deadly sins of vendor management

1. **Sourcing and procurement vs. vendor management:** Companies generally have limited appreciation for the specialized skills of vendor-management professionals. As a result, they often call upon staff members from other functions, who are ultimately less effective in this role. Many organizations also underestimate the interdependencies between supply chain functions and the VMPO.
2. **Reliance on the service provider to "run the show":** Organizations often assume contracts are robust and service providers will automatically manage successful transitions as well as provide ongoing benefits associated with innovation, productivity and continuous improvements.

1 Deloitte's "From Bangalore to Boston: The trend of bringing IT back in-house" 2013

3. **Optimal vendor management operating model:** Many companies are shifting from centralized vendor management models to hybrid programs, which remain sub-optimal in many instances due to lack of common controls, policies and procedures.
4. **Importance of service integration:** Service integration (SI) continues to be a commonly misunderstood concept that is typically underleveraged and ineffectively deployed. Consequently, many organizations with multi-vendor operating models have yet to develop and reap the benefits of a SI function.
5. **Consistent risk management processes:** Third-party risk management processes are often adopted inconsistently. Additionally, executives frequently do not understand the type and degree of risks involved, which inadvertently exposes the organization to risks that could otherwise be effectively mitigated.

Sourcing and procurement vs. vendor management

The role of the vendor management professional is typically not well understood. This often creates the misperception that people with sourcing and/or procurement experience or relevant degrees are well suited for vendor management roles. Indeed, organizations have historically staffed vendor management positions with procurement professionals who have led or been involved in the contract negotiations with the outsourced service provider. This common staffing approach can be detrimental.

Although the vendor management function is interrelated with the sourcing and procurement functions, there are distinct differences (Exhibit 1). While sourcing and procurement functions focus on the transactional areas of selecting service providers and coordinating orders and payments, vendor management focuses on teaming with the service providers to improve overall performance

and drive efficiencies once contracts are executed. In other words, the sourcing and procurement functions are responsible for "creating the outsourcing program," and the vendor management function for "maximizing the benefits of the outsourcing program."

Exhibit 1: Interrelation between Strategic Sourcing, Procurement Operations and Vendor Management

Typically, organizations invest significant time and effort in "creating the outsourcing program," while they pay limited attention to deploying the appropriate resources for "making the outsourcing program work." While negotiating an optimized, robust contract is the first step in the journey, service provider relationships need to be effectively managed from inception, focusing on activities related to transition, transformation, governance and change management. Otherwise, significant business value can be eroded, or even worse, entire programs can be derailed.

Vendor management professionals who are well trained and have the requisite skill-sets understand the importance of these activities and can help organizations to focus on them with enough intensity to keep their outsourcing programs on track. A common question with most companies is: Where can these skilled professionals be found? Historically, identifying and selecting vendor management resources with the appropriate skill-sets has been a big challenge. This situation is now improving as the discipline of vendor management matures, with both industry and the provider community growing the pool of experienced resources.

Despite differences in skill-set requirements for vendor management professionals vis-à-vis sourcing and procurement resources, close interaction between these two functions is imperative. In order to "maximize the benefits of the outsourcing program," vendor management professionals often have to work hand-in-hand with their sourcing and procurement counterparts either to support the negotiations around new services and scope changes or to manage and resolve contractual issues. One way to integrate these functions is to have appropriate sourcing and procurement personnel participate in governance committees so they are aware of ad-hoc requests and have clear lines of communications.

In the end, vendor management remains a specialized function whose purpose is to bring maturity and process discipline to the many aspects of governing and managing the performance of service providers. Additionally, it brings a view of the service provider as a partner, thus enabling information-sharing and alignment of incentives, which in turn generates greater value for both parties. Effective vendor management can improve productivity, enhance performance, maximize the business case, mitigate risks, and reduce overall costs related to third-party providers. More and more companies are recognizing these benefits. Although vendor management functions have traditionally focused on strategic outsourcing programs due to their value, risk and criticality, companies are increasingly expanding them to encompass many types of third-party relationships.

Reliance on the service provider to "run the show"

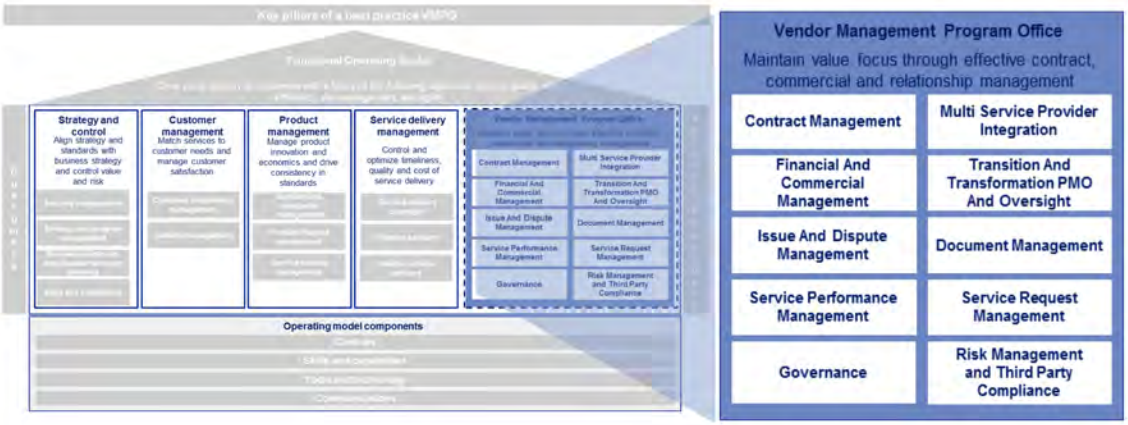
There is a general misperception that once the outsourcing contract is executed the service provider should "run the show" with limited oversight and/or management. This misperception usually arises during the transition phase — often considered the "honeymoon period" — as expectations are high and the relationships between the company and the service provider are at their best. Soon, however, declining satisfaction typically sets in, as the organization fully perceives the complexity and lasting consequences of the change. Additionally, the service provider is typically in a dynamic state during the transition as new teams ramp up, but as time passes, delivery pressures mount and execution becomes a reality. Most providers are ill-equipped to navigate these changes on their own: The "show" must go on, but they can't do it themselves.

Recent research supports this assertion. According to Deloitte's 2012 Global Outsourcing and Insourcing Survey, more than 50% of respondents reported business disruptions during the transition phase. This underscores the importance of having a vendor management function with clearly defined roles and responsibilities in place from the very beginning to effectively manage the transition.

Companies have also historically relied on service providers to produce ongoing, incremental benefits, such as innovation and greater productivity within the outsourced processes. Indeed, many outsourcing contracts include targets for continuous improvements, but as organizations become enmeshed in managing day-to-day operations they tend to lose sight of the longer-term benefits beyond immediate cost savings that the service provider is expected to deliver. A vendor management function with a broad mandate can help the organization to "keep its eye on the prize" over the long run, so it has a better chance of realizing the full range of anticipated benefits from its outsourcing arrangement. But what should the mandate of a broad vendor management function encompass? Based on Deloitte's field experience and knowledge of leading practices, it should span most of the following ten pillars (Exhibit 2).

Some subject matter specialists believe that spanning these ten pillars is still not enough. Some organizations that have been effective in implementing broad vendor management functions have gone beyond these supporting elements to: 1) gain a clear understanding of the service provider's capabilities via a thorough selection process; 2) negotiate a contract that meets both current and future business requirements and is aligned with enterprise strategy; 3) proactively manage the transition and transformation phases via stakeholder involvement and appropriate governance forums that include stakeholders with the authority to make decisions; and 4) develop a holistic view of service provider performance across quantitative and qualitative measures, including service level agreements (SLAs), executive performance indicators (EPIs)[2] and operating level agreements (OLAs)[3]; Collectively, these activities further support organizations in their efforts to manage outsourcing costs, reduce risks and improve overall service quality.

Exhibit 2: Vendor Management Pillars



2 EPIs are an increasing common metric used to measure a service provider's progress in innovation, productivity, continuous improvement, staff retention and overall quality of the service provider relationship.

3 OLAs are a common contractual vehicle used to facilitate collaboration and seamless issue resolution between companies and their service providers.

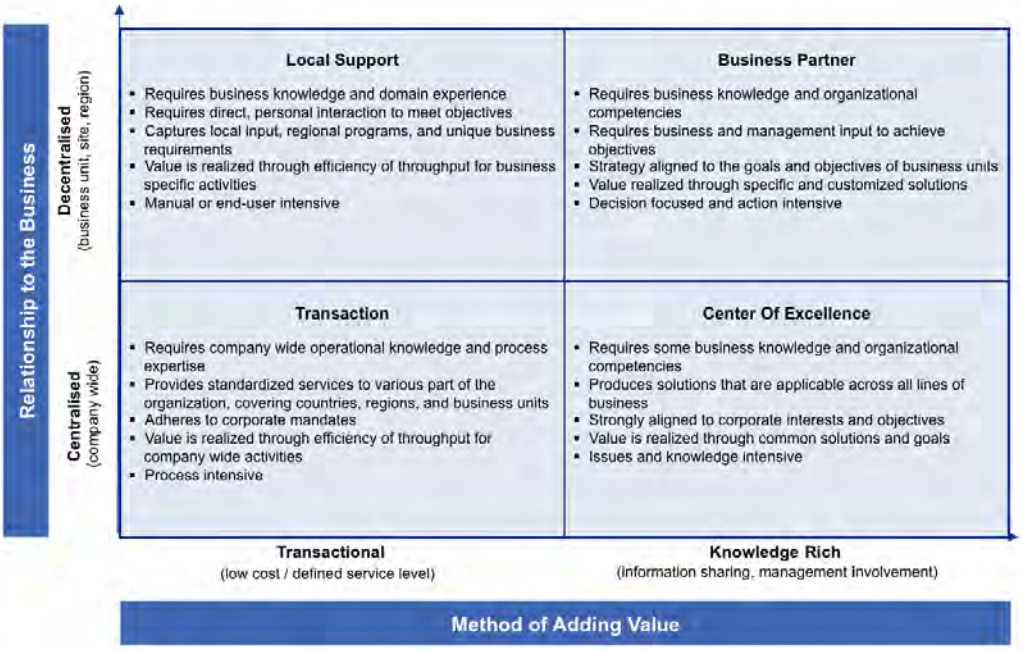
Optimal vendor management operating model

Centralized, decentralized or hybrid? Organizations are often perplexed about which vendor-management operating models to adopt and how often they should re-evaluate them. In Deloitte's 2011 Vendor Management survey, 62 percent of the respondents reported using a centralized vendor-management model whereas 29 percent reported using a decentralized one. In choosing between a centralized and a decentralized model, examining the ways in which the vendor management functions add value can be helpful in determining where to place them (Exhibit 3).

Nonetheless, determining an optimal vendor-management operating model has become more of an art than a science as the purview of the vendor management function has expanded from managing select vendors to managing a broad cadre of service providers across the enterprise. While an enterprise-wide approach to vendor management is often desirable, organizations frequently struggle to implement it because several barriers stand in the way of attaining the requisite visibility and collaboration across multiple business units and stakeholders. These barriers include:

- **Lack of standardized and centralized vendor management processes** — often leads to inconsistent vendor management activities and value erosion.
- **No formal single point of contact for enterprise vendors** — frequently limits enterprise-wide visibility into the overall performance of vendors who work across business units
- **Decentralized risk management practices** — potentially leads to inconsistent risk management processes and duplication of effort
- **No overarching governance authority** — usually makes it difficult to evaluate the performance of vendors, owners and overall programs
- **Lack of dedicated and trained vendor management resources at a centralized location** — typically leads to inconsistent implementation of vendor management processes, tools and templates
- **No central repository** — often creates challenges in storing and retrieving contracts and vendor-related information
- **Limited adoption of vendor management policies** — potentially increases exposure to risks since vendors may be engaged without executed contracts

Exhibit 3: Placement of Vendor Management Function



A hybrid operating model can be helpful in addressing many of these challenges (Exhibit 4). It first relies on a centralized vendor-management team to develop a standardized set of policies and processes, and then vendor relationship managers within the business units to promulgate them. Within a hybrid operating model, vendor management personnel in the business units additionally provide performance metrics and scorecards so that service-provider performance can be strategically evaluated at an enterprise level. An effective hybrid model also includes a centrally led governance structure to provide appropriate oversight across the relationship managers, thus ensuring compliance with policies, including risk management activities. Overall, the potential benefits of a hybrid model are many (Exhibit 5).

Exhibit 4: Hybrid Vendor Management Model

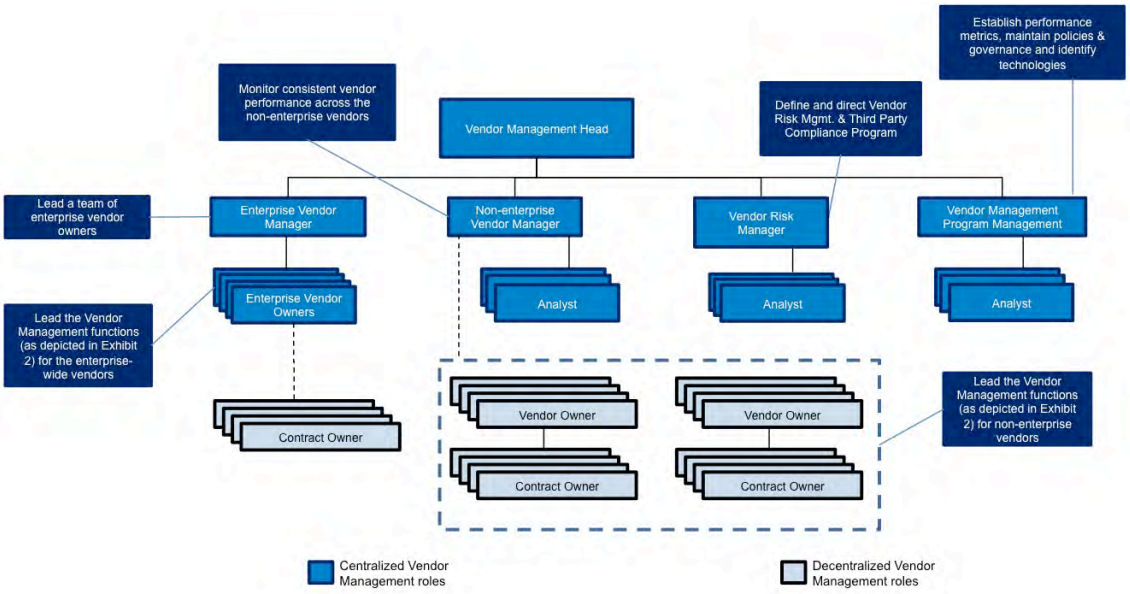
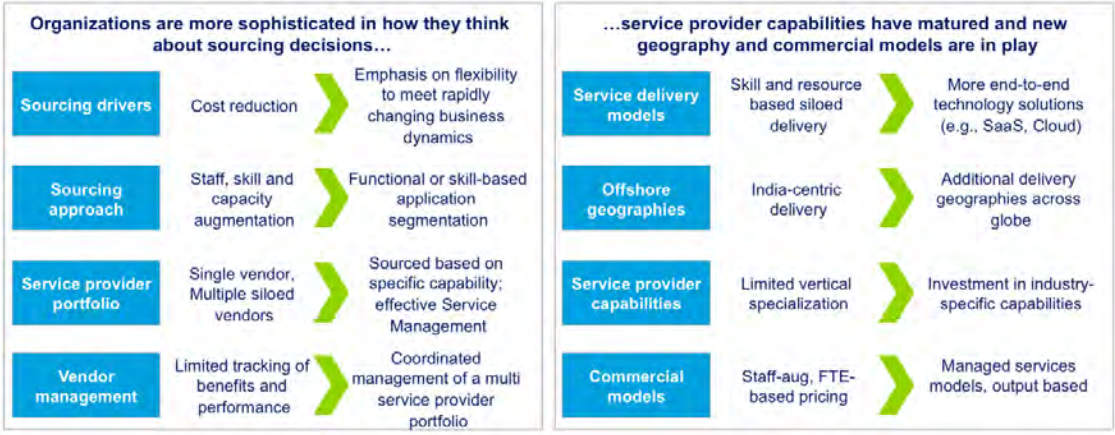


Exhibit 5: Characteristics and Benefits of a Hybrid Vendor Management Model

Characteristics	Potential Benefits
Focus on specific objectives of risk mitigation, organizational efficiency and cost-effectiveness	Reduced risk exposure from vendor relationships and improved cost-effectiveness
Dedicated vendor management executive who reports to the CIO, COO, or the head of shared services	Successful implementation and ongoing support of vendor management processes and policies
Centrally led vendor management organization responsible for developing and administering vendor management policies	Increased efficiencies throughout the organization from centrally developed, standardized and enforced vendor-management policies
Governance committees with mandates to own and enforce vendor management policies and procedures at executive, tactical and operational levels	Effective implementation and enforcement of vendor management policies and processes with increased visibility into performance
Establishing and monitoring a broad set of vendor management metrics that are linked to performance evaluation	Transparency and objectivity in performance tracking and ability to proactively identify risk areas
Formal and consistent end-to-end processes for the vendor management organization	Improved handoffs and interactions among vendor managers, business units and the supply chain
Defined accountabilities and responsibilities for stakeholders across each process and sub process	Clearly identifiable point of contact for each activity
Adoption of industry-leading tools and technology	Better-enabled vendor management processes and increased efficiency from automation

Exhibit 6: Drivers resulting in shift to multi-vendor operating models



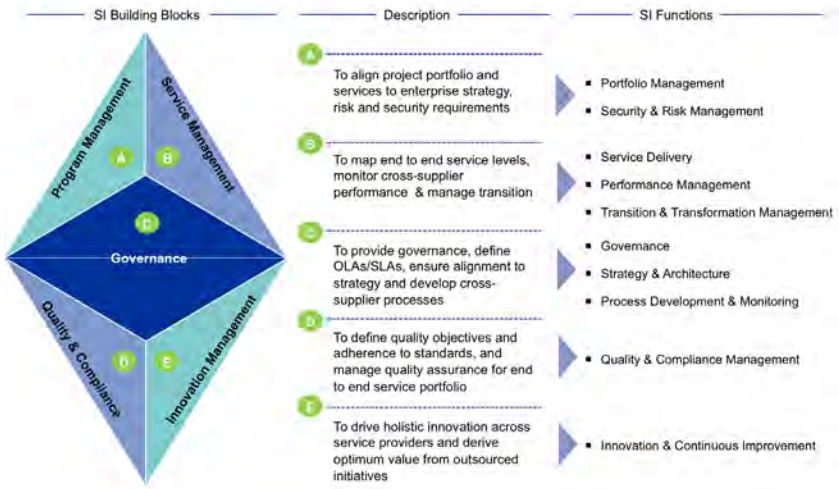
Importance of service integration

With greater experience in the outsourcing arena, companies are becoming more aware of the pros and cons of the single "mega-vendor" model. Thus, emerging leading practices include leveraging contract renewal opportunities and creating multi-vendor operating models that facilitate healthy competition among service providers (Exhibit 6). Multi-vendor operating models, however, can create a complex environment since they often comprise a mix of captive, offshore, onshore, and near-shore approaches.

In response to this complexity, a service integration (SI) function is now commonly required. This function primarily integrates services among providers and identifies and mitigates interdependencies among them. Exhibit 7 on the next page lists the main building blocks in establishing an SI function:

- **Program management** — involves managing the full program portfolio, including prioritizing and tracking individual projects through standardized processes. Status and exception reporting as well as risk and issue management are also important components.
- **Service management** — includes managing operations across the various domains and developing key processes such as incident and problem management, change and release management, escalation management, and configuration management.
- **Governance** — encompasses a governance framework, operating policies, and procedures for the SI organization, including establishing metrics and standards, monitoring operating and service-level agreements, and devising communication plans.
- **Quality and compliance management** — emphasizes defining an enterprise service-delivery charter and quality objectives as well as performing quality assurance (QA) for the portfolio of in-flight services and projects. It often includes recommending and managing processes for service improvement and service-provider management.
- **Innovation management** — leverages a vendor-agnostic organization to drive innovation across the service provider portfolio. This includes fostering a culture of continuous improvement based on refinement of operational processes and standards.

Exhibit 7: Service Integration Function



The SI function is typically considered to be a part of the retained organization. However, some organizations transitioning to a multi-vendor operating model lack the skills within the retained organization to effectively perform this role. As an alternative, the retained organization and an external service provider can team up to perform the SI function or a new external provider specializing in SI can be engaged on its own to provide these services.

Consistent risk management processes

Supplier risk management is increasingly becoming a critical component of enterprise risk management (ERM). As third-party providers expand their roles across the value chain, the potential for a supplier failure increases dramatically. While organizations have traditionally focused their supplier risk management efforts on contractual or financial risks, this narrow scope is no longer sufficient.

Since the global financial crisis, companies around the world are generally facing stricter requirements for reporting and managing service-provider risks and third-party compliance obligations. For regulated entities (e.g. financial services institutions, pharmaceutical manufacturers, etc.), robust supplier risk management capabilities are becoming even more critical, as regulatory complexity escalates along with the financial and reputational consequences of non-compliance.

This situation, coupled with the increasing sophistication of outsourcing deals, has caused many companies to invest in developing supplier risk management capabilities built upon robust risk management frameworks. These frameworks are critical for assisting organizations in understanding the risks posed by their service providers at an enterprise level and in providing near-real-time transparency into how certain risks could have financial repercussions and/or damage the company's reputation. Exhibit 8 provides further details on the service provider risk categories and their potential implications. However, these risks can be typically addressed via a robust supplier risk management framework.

Exhibit 8: Service Provider Risk Categories

Categories	Potential Risk
Contractual	Contract language misunderstood or missing critical components
Financial	Supplier unable to meet contract obligations due to financial difficulties
Service Delivery	Supplier unable to meet client service standards or SLAs (e.g. quality, availability, responsiveness)
Reputational	Supplier's security issues affect your company brand
Privacy	Supplier disclosure of confidential data
HR	Supplier not adherent to enterprise employment requirements
Business Continuity	Supplier unable to provide services in accordance with service level agreements
Geopolitical	Country-specific factors (e.g., government, climate, and politics) affect supplier's performance
Information Security	Supplier access to information outside of defined business requirements
Fourth Party Risks	Inadequate controls around supplier subcontract arrangements with fourth parties
Cyberspace Risk	Supplier exposure to threats from organized crime and nation-state sponsored cyber terrorism

In addition to these categories, a robust supplier risk management framework typically comprises four main elements, which are necessary in order to consistently track, measure, manage and report service-provider risk across the enterprise.

- **Filter.** Large organizations may have upward of 10,000 unique suppliers, and it is unrealistic to assess them all in the same way. A filter, based on documented and consistent criteria, can be applied to identify those service providers that require full, partial, or no assessments. By using a filter, only service providers that meet certain thresholds will be short-listed for in-depth risk assessments.
- **Assess.** The assessment process is typically based on well-defined and measurable criteria to ensure that suppliers are reviewed consistently and carefully. Assessments should also be performed on an on-going basis. The objective is to arrive at an aggregate risk rating for a given provider after all relevant risk areas have been evaluated.
- **Segment.** Service providers can be segmented according to the results of the risk assessment. Segments are typically based on the aggregate risk ratings and qualitative risk-related characteristics of the service providers. Providers are subsequently managed according to their segments. For example, Tier 1 suppliers may be subject to enhanced or more frequent reviews.
- **Monitor.** Effective monitoring is proactive and ongoing, including periodic re-assessments of individual suppliers and occasional re-balancing of the supplier portfolio. It also encompasses general risks not related to specific suppliers, such as geopolitical risks, which come into play when services are provided near-shore or off-shore, and concentration risks, where the volume of services provided by a single vendor or originating from a particular country is great.

Although companies are more aware of the need for supplier risk management, developing an appropriate risk management framework has been more onerous than many organizations expected. This is mainly because of difficulties in gaining alignment among internal stakeholders (e.g., compliance, risk, audit, etc.); a tendency to underestimate the amount of effort required; and challenges convincing business units of the need for relationship managers to undertake additional risk-management activities. In many instances, budget constraints and data-access barriers (i.e., the availability of contractual documentation or poor system interoperability) also complicate the task.

Despite these obstacles, organizations can no longer ignore the risks to which they are subjected via their supplier relationships. For an unlucky few, costly high-profile incidents have been the triggers for implementing their supplier risk management and third party compliance programs. No longer can real or perceived internal barriers be allowed to thwart the development of what has become a core component of enterprise risk management.

Conclusion

Any one of the "five deadly sins of vendor management" can greatly harm the health of a company's outsourcing program. Avoiding them is important but so is keeping the big picture in mind. Those who are most intent on maximizing the benefits of their third-party relationships maintain a long-term view of building the VMPO. This includes putting forth the necessary time and effort to establish relationships with key internal stakeholders and critical service providers, investing in leading IT solutions with suitable tools and scalable capabilities, and designing an agile vendor-management operating model that can readily adapt to changes in enterprise strategy. Like any fitness program, building a strong and capable VMPO requires flexibility, determination, and ultimately, endurance.

5 From Bangalore to Boston
The trend of bringing IT back in-house

Introduction

The last two decades have seen a phenomenal rise in the outsourcing of Information Technology (IT) to external service providers. The driver for this trend has largely been economic, since outsourcers often offer more competitive price points for the same services at comparable service levels. Beyond cost savings, companies also use outsourcing to drive their IT strategy — the choice of focusing on core, strategic competencies and relying on a network of external service providers to perform less strategic functions. In recent years we have witnessed a small but growing reversal of this trend where companies that have previously outsourced functions are bringing them back in-house. This trend is generally referred to as "insourcing".

A full 48% of respondents in Deloitte's 2012 Global Outsourcing and Insourcing Survey[1] (The Survey) reported that they have terminated an outsourcing agreement early for cause or convenience. More importantly, 34% of those who terminated a contract for cause or convenience chose to bring the work back in-house. While the large majority of clients chose to move to a different service provider, it is worth noting that insourcing has become a viable option, particularly in the event that an outsourcing transaction did not meet expectations. In this paper we examine the insourcing trend, its drivers and discuss the opportunities and challenges associated with insourcing.

Insourcing drivers

Improve customer service: Based on the results of The Survey, the single biggest driver for insourcing was the need to improve customer service and customer experience. This is particularly relevant when customer facing functions are outsourced and moved to offshore locations. Voice-based functions, such as call centers, come under direct scrutiny due to issues such as language, accent and contextual familiarity of the call center representatives. Such scrutiny can often lead to real or perceived concerns about the quality of service. These concerns are less severe for transaction-based processes and back office related IT processes/functions that don't directly touch

the end customer. In The Survey, 100% of respondents who brought work back in-house indicated that improving customer service was a driver in their decision.

Improve controls: 77% of The Survey respondents indicated that a key factor for insourcing was to improve control on the functions that were previously outsourced. It is not uncommon for organizations to feel uncomfortable with a perceived loss of control when functions are decoupled from traditional IT organizations or moved to an output or performance based model. Organizations can overreach in their effort to outsource and include functions in the outsourcing scope that should, perhaps, be left in-house. IT Architecture, for example, is at the heart of an organization's IT policy and contributes to the organization's IT Strategy and roadmap. Outsourcing such a function can result in a perceived loss of control over the technology direction.

Other examples could be functional requirement definition, code development for critical systems, policy and procedures management and User Acceptance Testing (UAT). Depending on the client industry, regulatory constraints could also result in a need to improve internal control over certain processes or functions. As indicated earlier, much of the outsourced work is done in offshore locations. In some cases, recent regulations have mandated that certain types of data and certain functions be performed within the country where the organization's customers are located. The Health Insurance Portability and Accountability Act (HIPAA) is one such example. Other companies find compliance with certain standards, such as Payment Card Industry (PCI) data security standards to retard their ability to maintain successful outsourcing relationships.

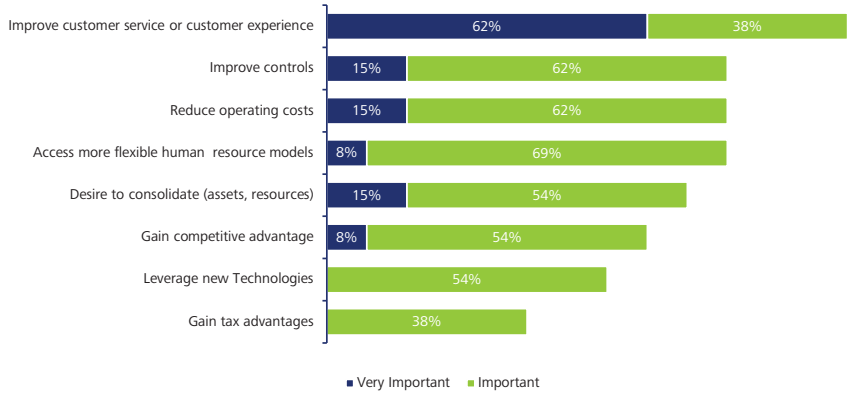
1 An executive summary of survey results is available at http://www.deloitte.com/view/en_US/us/Services/additional-services/Service-Delivery-Transformation/c78f7ebb3c356310VgnVCM2000001b56f00aRCRD.htm

Cost reduction: It may seem counter-intuitive that 77% of respondents mentioned cost reduction as a driver for insourcing. After all, cost reduction can often be the main driver to outsource work. However, in some cases organizations may not be able to realize projected economic gains from their outsourcing program. This could be due to several factors, including:

- The need for additional internal quality control due to poor quality from the outsourcer
- An increase in true price of service delivery through scope "creep" and excessive change orders

Thus, when combined with some of the other factors mentioned above, if economic gains are less than expected, an organization may choose to bring some or all of the previously outsourced work back in-house.

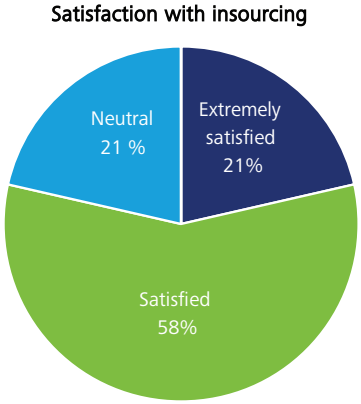
Figure 1: Drivers of insourcing in case of post contract termination — Deloitte's 2012 Global Outsourcing and Insourcing Survey



In addition to the three drivers discussed previously, other drivers can influence an insourcing decision. Notable among them is the desire to consolidate internal assets and resources, which can often reflect a shift in organizational philosophy from outsourcing to IT Shared Services (ITSS). Outsourcing decisions can be taken by individual business units or functions operating within silos or without a broader cross functional or enterprise perspective. In such cases, it may become apparent that from an integrated organizational view, it may be better to leverage certain assets or resources across various business units rather than outsourcing some functions or processes. IT testing is one example of where this can occur. A particular business unit may have outsourced its testing function as it did not have the scale economies to house such a function internally, but when combined with the testing requirements of other business units the organization may choose to build a Testing Center of Excellence (TCOE) to cater to such needs across all units.

In The Survey, 79% of respondents indicated that they were either satisfied or very satisfied with their insourcing program. In fact, none of The Survey respondents felt that the insourcing program was dissatisfactory.

Figure 2: Insourcing satisfaction post deal termination



There could be many reasons for the overwhelming satisfaction with insourcing. We surmise that given the organizational and financial costs of insourcing, an outsourcing deal may likely be in a state of serious disrepair to even contemplate insourcing. As such, The Survey respondents who insourced a deal after early termination for cause or convenience may have been pre-disposed to see the outcome of the insourcing as positive.

Challenges of moving to an insourced model

Although given the right situation the call to insource can be very compelling, there can also be several substantial challenges, including:

Sub-optimal knowledge transfer: In many outsourcing contracts, clients include a provision that allows them to hire the in-scope staff from the outsourcer particularly in the event that the outsourcing contract has been terminated for cause. Such a provision can greatly ease the reverse transition of the work back in-house. However, in the absence of such a provision, it may be difficult for the client organization to ramp up the required staff in order to be able to bring the work back in-house. It is this challenge that often precludes any insourcing movement, even if there are other compelling motives to do so.

The need to build internal capabilities: Particularly in cases where work has been outsourced for a significant period of time, the client organization no longer retains the capability to manage that work internally. Such capability includes service delivery management, tools & methodologies and technology. While knowledge transfer can be enabled through the transfer of in-scope staff, developing other capabilities, such as delivery management and technology can be a significant challenge.

Potential cost increase: It was discussed earlier that in some cases, projected economic gains from an outsourcing program may not be realized. However, in most cases outsourcing results in some level of cost efficiency. Thus, bringing work back in-house may result in a cost increase, at least in the initial years, as the client organization should make investments to make itself capable of managing the work.

Figure 3 outlines more information on whether a particular situation calls for insourcing or re-tendering. However, it is important to note that the first step of determining whether your outsourcing arrangement should be insourced or re-tendered is a thorough business case that takes into account the full set of costs associated with the change.

Figure 3: Considerations for Insourcing vs. Retendering

Considerations	Insource	Re-tender
Strategic nature of the outsourced work	• Outsourced work is a strategic differentiator for client • Vendor is causing a direct reputational risk to client	• Outsourced work is a commodity that is not providing a strategic advantage
Contract terms	• Have ability to solicit vendor employees • Low termination fees • Robust transition support clause • Ability to reduce the services gradually as work transitions • Favorable intellectual property (IP) clause	• High termination fees • Inability to reduce costs during transition • IP clause makes knowledge transfer difficult • Minimal contractual transition support
Supplier leverage	• Ability to influence vendor behavior during insourcing transition	• Transactional relationship; minimal leverage
Organizational readiness	• Resources exist or can be quickly procured to assume insourced functions	• Long resource procurement time and/or high specialty resources needed
Institutional knowledge	• Robust current state documentation, processes, procedures, job aids, and metrics	• Long resource procurement time and/or high specialty resources needed
Infrastructure	• Physical infrastructure for insourced functions exists or can be built quickly and cost effectively	• Supplier infrastructure footprint or cost structure hard to duplicate
Business case	• Given positions for other considerations, ROI in relation to re-tendering	• Given positions for other considerations, ROI in relation to insourcing

Selecting the right insourced organizational model

Once a decision has been made to insource an outsourced function, the right organizational model needs be to chosen to help ensure that the function can be successfully integrated back into the core business.

Figure 4 illustrates that the choice of the right model can depend largely on the driver behind the insourcing movement, as well as specific organizational characteristics and limitations.

Figure 4: Insourced organizational models

Insourcing Model	Description	Pros	Cons
Center of Excellence	• Each process is delivered by a "best in class" internal organization • Differ from Service Centers in that COEs tend to involve more knowledge-based work	• Retention of talent • Greater competitive advantage • Greater control over key processes	• Lower cost efficiency
Service Center	• Stand-alone (physically or organizationally) center that is developed, measured and governed to execute selected processes. • Service centers are generally used for transactional processes rather than knowledge-based processes	• Greater control over key processes • High cost efficiency • Better management of regulatory compliance	• Lower cost efficiency (although superior to COE)
Offshore Captive	• Captives are wholly owned Service Centers established in low-cost, offshore locations (typically outside of North America) with the intention of combining the performance, cost, labor pool benefits of offshore outsourcing while retaining operational control in-house	• Highest level of cost efficiency • High degree of scalability	• Data and IP protection issues • Limited control on regulatory compliance • Requires more coordination within the organization

Conclusion

Though insourcing is a small trend as compared to the global outsourcing juggernaut, given the maturity of the outsourcing industry we are seeing more and more clients wrestling with the question of whether an outsourcing deal that is not meeting expectations should be re-tendered or insourced.

Most clients still prefer to fix broken deals by either renegotiating with the incumbent provider or re-tendering the work. However, insourcing is also being considered a viable option when the business case and business drivers make sense.

6 Information Technology Outsourcing
Cracking the code

Information Technology (IT) has long been an enabler of complex outsourcing initiatives and the driver for many companies to execute large-scale outsourcing agreements. Over the years, IT outsourcing (ITO) has matured into a well understood construct which drives over 60% of the total sourcing market. The market, however, is now at an inflection point. Recent advances in technology (e.g., cloud computing, social computing, green IT, etc.), increased vendor specialization, and the need for contracted agility and flexibility have all irrevocably changed the IT services delivery model. It is no longer enough to simply rely on consolidation, economies of scale, and labor arbitrage. Sophisticated consumers of outsourced IT services are seeking service partners and arrangements that will allow them to adjust to and take advantage of future (anticipated and un-anticipated) changes in the IT landscape.

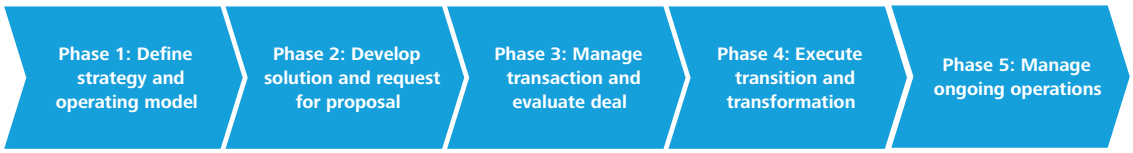
When designing new IT service delivery models, sourcing can no longer be an afterthought. IT buyers have to understand how services add value to their internal customers and align with the overall corporate strategy. This can be difficult when thinking of IT in its traditional context. When the business demands instant "à la carte" services, buyers should aggressively manage costs while meeting business needs. The challenges and tradeoffs require today's IT leaders to assess and anticipate business needs and to form relationships with external partners to deliver on present and future requirements. Determining the right mix of internal and external IT services is now a strategic decision, requiring alignment with internal customers and the external marketplace.

Overview of the market

The ITO provider marketplace is experienced and mature relative to other types of outsourced services providers. Over the last few years, there has been a migration away from "mega deals," instances where large organizations sole-sourced significant chunks of their IT service delivery environment to a single provider through long term deals. Rather, as clients have become more sophisticated, they have begun to segment their environments and to aggressively employ multi-provider sourcing strategies to regain leverage with incumbents and benefit from the capabilities of smaller, specialized vendors.

As companies have further increased competition within their portfolios of services, service providers have sought to redefine their value propositions to move up-stream on the IT services value chain. This has been met with limited success — where providers can generate real, specific intellectual property, customers have demonstrated a willingness to accept higher margin commercial arrangements. However, where the effort has simply resulted in "re-branding" of the same old services, clients have turned to alternative providers. The net effect is that the cost of sourced services, both in the infrastructure and in the applications spaces, has remained more or less constant for the last several years while performance (transition, transformation, and service delivery) has improved significantly.

Deloitte's outsourcing advisory methodology[1]



Our methodology

Deloitte's demonstrated methodology consists of five phases. First, it is essential that the organization define the most effective service delivery model by analyzing the current state against business goals and industry benchmarks. If an opportunity exists to modify the current sourcing mix, the next phase involves designing the right solution and engaging with potential vendors, often via a competitive sourcing process. Potential providers (incumbents or new entrants) are then evaluated on technical capability, compliance with client requirements, and value proposition. Once one or more providers are selected, a detailed transition program, including the formation of a vendor management organization, is stood up to drive implementation. On-going monitoring, through the vendor management organization, focuses on alignment to business goals, adherence to required service levels, risk management, continuous improvements, and tracking value for money.

Our services are designed to help our clients achieve measurable benefits

Deloitte is a recognized leader in supporting IT organizations develop their IT strategy and evaluate their current sourcing mix and look to improve against varied, and often conflicting, business imperatives. Deloitte has deep experience with IT outsourcing advisory, specialized industry knowledge, and functional experience in finance, procurement, change management, organization design, risk management, offshoring, functional re-sourcing, mergers & acquisitions, private equity, shared services, tax, and technology. Our detailed knowledge of clients in various industry sectors enables us to effectively customize analyses to specific situations and to accelerate the time to achieve benefits. Our ITO advisory professionals work cross-functionally with procurement, human resources, operations, technology, and functional leaders to implement and enhance organizational sourcing capabilities and help position our clients for future growth.

In a dynamic, competitive global market, Deloitte's ITO services can enable organizations to:

- Develop an integrated IT roadmap
- Develop a platform for global growth
- Access leading class services on a global scale
- Access flexible human resource models and scarce talent
- Create a variable cost base
- Implement process methodologies and standards (e.g., ITIL, Six Sigma and LEAN)
- Improve customer service or customer experience
- Leverage new technologies

Our numbers

	Yearly revenue ($MM)	Full time equivalents	Engagement history (since 2000)
ITO	103	252	500

Based on Deloitte internal figures

7 Business Process Outsourcing
Tapping the advancements

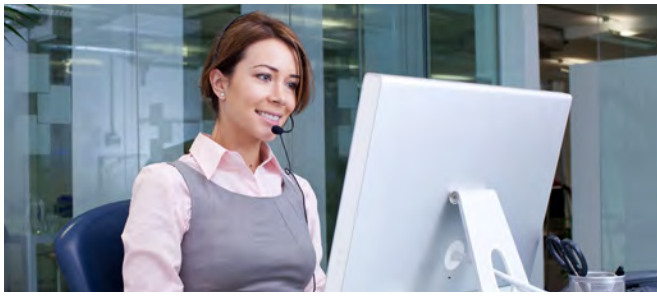
The Business Process Outsourcing (BPO) market continues to hold large potential for both large and middle market companies to gain a significant competitive advantage by optimizing their service delivery models. BPO models today include not only the sourcing strategy, but also a complementary review of the associated management model required to support business processes functions. Today's BPO landscape includes, but is not limited to, finance and accounting, legal, real estate, procurement, sales and marketing, as well as, vertical BPO process such as settlement and closing.

Globalization and offshoring continue to factor heavily in the expansion of BPO and the delivery location landscape continues to diversify. Labor arbitrage remains a significant driving factor followed closely by technology-led transformation.

Overview of the market

The BPO provider market is competitive and energetic. Many major providers continue to expand their global footprints in order to support near-shore and offshore service delivery needs. Providers struggle to protect margins while buyers continue to demand increasing savings and innovation.

India continues to be the hub for BPO, whilst second tier cities continue to gain traction. Since many companies have accelerated the momentum with which they move back office processes offshore and near-shore, the demand for providers to develop stronger presence in regions such as China, Central Europe and Latin America is increasing. In those offshore and near-shore locations, providers can service regional clients with multi-lingual staff and higher-touch processes.

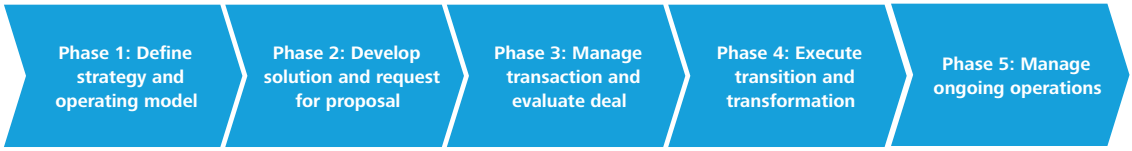


The BPO market is still heavily focused on transactional processes; however, buyers are becoming more experienced with providers that deliver increasingly customized and complex processes.

Fortunately, with a maturing provider landscape, transition performance has improved. That said, it is still not without risk. In outsourcing and offshoring, generally, most risk is due to the inherent disruption caused by a less-than-seamless transition (moving processes from a buyer to a provider). For buyers, throwing everything over the fence to providers (essentially 'mess for less') is not a real option.

Companies can benefit from a broad, executable business process service delivery strategy which leverages outsourcing as one lever to create a scalable, global platform for growth, whether to access leading class services or to take advantage of flexible human resources models on a global scale.

Deloitte's outsourcing advisory methodology[1]



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Our services are designed to help our clients achieve measurable benefits

Deloitte has deep experience with BPO specialized industry knowledge, and functional experience in finance, procurement, change management, organization design, risk management, offshoring, functional re-sourcing, mergers & acquisitions, private equity, shared services, tax, and technology. Our detailed knowledge of clients in various industry sectors enables us to customize analyses to specific situations and to accelerate the time to achieve benefits.

Deloitte's BPO services can enable organizations to:

- Gain competitive advantage
- Develop a platform for global growth
- Access leading class services on a global scale
- Access flexible human resource models and scarce talent
- Improve financials
- Monetize existing captive centers
- Consolidate assets and other resources
- Address tax implications
- Enhance performance
- Advance controls
- Leverage new technologies

Our numbers

	Yearly revenue ($MM)	Full time equivalents	Engagement history (since 2000)
BPO	58	141	250

Based on Deloitte internal figures

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